4. Describe & understand the different stages of the economic cycle.

Economic Cycle

Economic cycle: fluctuations in the level of economic activity measured by GDP.
Trend growth rate: the average rate of economic growth measured over a period of time, normally over the course of the economic cycle.

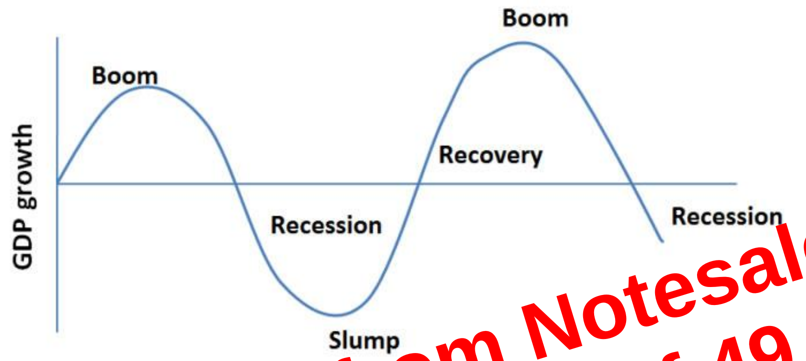
4 Stages of economic cycle:

1. Recession:
   - When the rate of economic growth becomes negative and real GDP actually falls.

2. Recovery:
   - When economic growth becomes positive after a recession.

3. Boom:
   - When the rate of economic growth exceeds the rate of growth of potential GDP so that the output gap is narrowed.

4. Slowdown:
   - When the rate of economic growth begins to fall and approach 0.



Problem of Fluctuations:
-Periods of unemployment lead to the deskilling of the workforce (hysteresis):
- A loss of **human capital**.

Human capital: the knowledge and skills of the labour force.

Importance of Stocks:

Recovery:
-Low confidence of firms due to uncertainty of whether demand will continue to rise.
-More reluctant to increase output by investing, so instead they will sell their stocks.
-The rise in output will be less than the rise in demand (output growth will be slow).

Boom:
-As the demand continues to rise firms' confidence increases and stock is limited.
-This means they will increase their stock levels again by increasing their output.
-The growth of output will exceed the growth of demand (output growth will be fast).

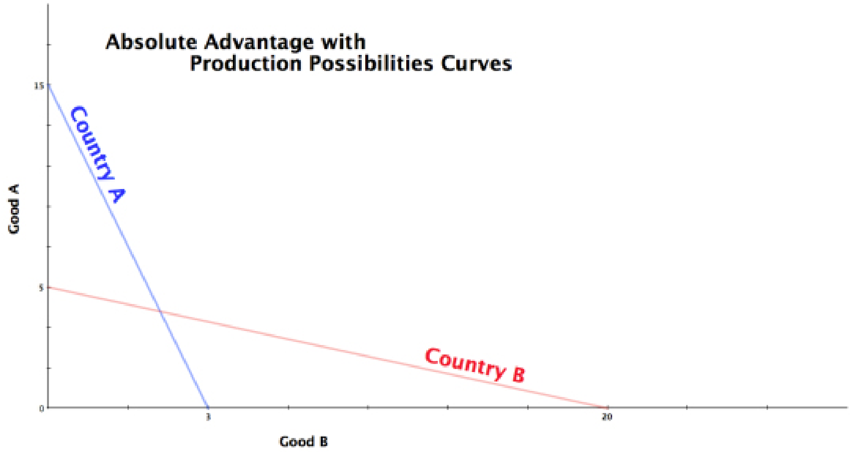
Slowdown:
-Once stock levels are high, output growth will slow down to growth in demand.
-This will bring about the end of the growth phase of the economic cycle.
-The cycle will start again once firms cannot satisfy demand from their stocks.

Extract 4: Trends in world trade and the pattern of global trade

1. Distinguish between absolute and comparative advantage:

ABSOLUTE ADVANTAGE

Absolute advantage: where one country is able to produce more of a good or service with the same amount of resources, such that the unit cost of production is lower.



-As seen above Country A's absolute advantage complements Country B's (there is **reciprocal absolute advantage**).

Reciprocal absolute advantage: where, in a theoretical world of two countries and two products, each country has an absolute advantage in one of the two products.

What if a country does not have an absolute advantage in the production of any good or service? Surely, there is no basis for trade?

COMPARATIVE ADVANTAGE

Comparative advantage: where one country produces a good or service at a lower relative opportunity cost than others.

Relative opportunity cost: the cost of production of one good or service.

If you have an absolute and comparative advantage, you would mostly produce the comparative advantage product and some of the other.

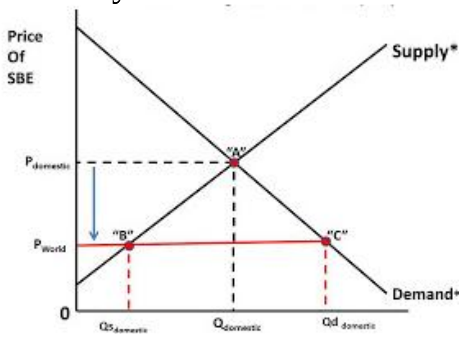
If you have not got an absolute but a comparative advantage, you would only produce the product you have a comparative advantage in.

Sources of comparative advantage:

1. **Factor endowments**:

Factor endowments: the mix of land, labour and capital that a country possesses.

2. Analyse the effects of international trade.



EFFECTS OF INTERNATIONAL TRADE

Advantages:

1. Specialisation:

-More efficient use of global scarce resources.

- Increased productivity.

-Increased economies of scale.

2. Increased economies of scale:

-Without trade, the production of goods and services would be limited to the domestic market.

3. **Knowledge and technology transfer**:

Knowledge and technology transfer: the process by which knowledge and technology developed in one country is transferred to another.

-This allows countries to benefit from existing technology innovations:

- Increases productive capacity.

4. Direct benefits of increased exports:

-Short-run exogenous growth (exports are a component of AD).

-Rebalances the UK economy.

-Macroeconomic objective of favourable balance of payments.

5. Higher consumer surplus:

-Increased competition will put downward pressure on domestic firms' prices and increase the product range (allocative efficiency).

Disadvantages:

1) **Infant industries** may suffer:

Infant industries: industries in an economy that are relatively new and lack the economies of scale that would allow them to compete in international markets against more established competitors in other countries.

2) Direct disadvantages from increase imports:

-Higher imports lead to leakages from the circular flow of income.

-Higher imports increase the size of the trade deficit (bad for rebalancing).

3) Unequal distribution of income:

-MEDCs benefit more from trade than LEDC.

4) Dangers of over-specialisation:

-To reliant on other countries.

5) Higher unemployment:

-Domestic firms may produce less as they lose market share to foreign firms:

- This may result in a lower derived demand for labour.

3. Define, measure and analyse the significance of the terms of trade, and changes in the terms of trade over time

TERMS OF TRADE

Terms of trade: an index that shows the price of a country's exports relative to the price of its imports (also known as real exchange rate).

$$\text{Terms of Trade} = \frac{\text{Index of average export prices}}{\text{Index of average import prices}} \times 100$$

-It tells you the volume of exports needed in order to purchase a given volume of imports.
-It gives some indication of the extent to which an economy will benefit from international trade.
-An increase in export prices means fewer exports will be needed to pay for imports.

- A rise in terms of trade is an improvement in terms of trade.

-An increase in import prices means more exports will be needed to pay for imports.

- A fall in terms of trade is called a deterioration in terms of trade.

-For economies dependent on a narrow range of imports, changes in the terms of trade can be highly significant.
Since 2000, there have been dramatic decreases in the price of **primary commodities**.
Primary commodities: goods produced in the primary sector of the economy, such as oil, copper and tin.

Prebisch-Singer Hypothesis
Prebisch-Singer Hypothesis: the argument that countries exporting primary commodities will face declining terms of trade in the long-run, which will trap them in a low level of development as more and more exports will need to be sold to 'pay for' the same volume of imports of secondary sector or capital goods.
Problems of moving from primary to secondary:
1. Training costs.
2. Need more infrastructure.
3. Risk for unemployment.
4. Import costs of primary goods.
5. Costs of importing capital goods to produce secondary goods.
6. Occupational immobility.

Evaluation of an improvement in terms of trade
-Whilst higher exports prices encourage higher output and may lead to greater economies of scale, much depends on PED and PES:

- If PED is elastic the higher prices cause a more than proportional fall in the quantity demanded so total export revenue falls.
- If PES is inelastic, firms can't produce more to take advantage of higher prices.

-Falling import prices and rising export prices can be a sign of reduced international competitiveness.
-Changes in terms of trade reveal nothing about volume of exports and imports:

- These determine the effects on the current account of the balance of payments and AD.

5. Evaluate comparative advantage as explanation of trade patterns

COMPARATIVE ADVANTAGE AND THE PATTERN OF GLOBAL TRADE

-Comparative advantage explains inter-industry trade.

e.g. A capital abundant economy gains by exporting capital intensive products and importing labour intensive products.

-Comparative advantage does not explain intra-industry trade:

- Rich countries tend to trade with other rich countries, which should not be the case, they should be trading with poor nations, given differences in factor endowments.

-The opportunities for specialisation and trade based on comparative advantage increases within the trading bloc but is only restricted to member countries.

-Comparative advantage does not take account the market structure of many industries e.g. the automotive industry that has differentiated products that appeal to different segments in the market.

8. Evaluate different economic policies to correct imbalances on the balance of payments (current account)

POLICIES TO CORRECT IMBALANCES ON THE BALANCE OF PAYMENTS

Expenditure-switching policies:

Expenditure-switching policies: policies that increase the price of imports to reduce the demand of imports and/or reduce the price of exports in order to raise the demand of exports to correct a current account deficit.

1. Fall in the exchange rate:

-A lower exchange rate will cause export prices to fall and import prices to rise:

- This should reduce the demand for imports and increase the demand for exports.

2. Tariffs on imports:

-A tax on imports should raise the price of imports and therefore reduce the demand for imports.

3. Subsidising exports:

-A subsidy on exports should lower the price of exports and therefore reduce the demand for exports.

Issues:

-An increase in the price of imports will add to domestic inflation by raising both retail prices and the cost of production.

-The policies take time to affect spending patterns.

-Policy not directed at the cause of imbalance in the balance of payments:

- Raising productivity, increasing investment and reducing unit labour costs would be more appropriate (they tackle the problem).

Depends on:

-PED of imports:

- If imports are price inelastic (domestic products are low substitutes) a rise in price of imports will cause a proportionally smaller decrease in the volume of imports demanded, having little effect on the balance of payments.

-PED of exports:

- If exports are price inelastic (domestic products are low substitutes) a decrease in price of imports will cause a proportionally smaller increase in the volume of exports demanded, having little effect on the balance of payments.

Expenditure- reducing policies:

Expenditure-switching policies: policies that reduce the overall national income in order to reduce the demand for imports and correct a current account deficit.

1. Raising the level of taxation:

-Raising taxation reduces disposable income, which can't be spent on imports:

- This should reduce the demand for imports.

2. Raising interest rates:

-This will make borrowing more expensive and therefore disincentivise consumers to borrow and spend that money on imports:

- This should reduce the demand for imports.

Issues:

-Have a large effect on AD and therefore on growth:

- Requires a sustained period of recession in order to bring it under control.

-Policy not directed at the cause of imbalance in the balance of payments:

- Raising productivity, increasing investment and reducing unit labour costs would be more appropriate (they tackle the problem).

Questions relating to Extract 3:

1. Define the following:

Real GDP: the volume of national output of goods and services adjusted for changes in inflation.
Regionalisation of trade: increased intra-regional trade.
Intra-regional trade: the exchange of products between nations in the same geographical area e.g. the UK and France. Hence, trade occurs between one member of a trading bloc and another member.
Inter-regional trade: the exchange of products between nations in different geographical areas e.g. UK and USA.It is the trade between one country or trading bloc and another e.g. trade between the EU and NAFTA (North America Free Trade Area) or ASEAN (Association of South East Asian Nations).
Intra-industry trade: the exchange of products within the same industry.
Inter-industry trade: the exchange of products between different industries.
Tariff: a tax on imports.
Quota: a limit on imports.
Non-tariff barrier: anything that restricts trade other than a tariff or quota
e.g. product safety or pollution control laws.

2. Explain why the EU has the following (common) policies:

a) Common Fisheries Policy (CFP):
To control exploitation of fish stocks which would have been depleted without international action.

b) The Common Agriculture Policy (CAP):
To protect European agriculture against outside competition and, at the same time, ensure food supplies to European consumers.

c) Environment Policy:
As pollution knows no boundaries there is a common interest on reducing pollution.

d) Competition Policy:
To prevent distortion of the market, either by dominant firms, or by collusion between suppliers.

3. Analyse the economic consequences of free movement of labour.

Advantages:

-Can deal with labour shortages:

- Immigrants can fill vacancies.

-More flexible labour markets:

- There may be shortages in certain professions in an economy, which can be filled by workers overseas.

-Fill undesirable jobs:

- Immigrants may be willing to fill jobs that people in developed countries don't want to do due to the wage premium from working in that country.

Disadvantages:

-Developing countries may lose best skilled labour:

- This could harm economic development in developing countries.

-Immigration may mask the shortage of skilled labour.

4. Analyse reasons for greater tax harmonisation within the EU.

Or else it could distort the market e.g. corporation tax concessions could be used to attract capital in the country.

Introduction

1. Analyse the meaning of development and its relationship to economic growth

Poverty: when income is below the level that would allow someone to enjoy some agreed minimum standard of living.
Extreme poverty: the World Bank defines this as living on less than US$1 per day.
Medium poverty: the World Bank defines it as living on less than US$2 per day.

MEANING OF DEVELOPMENT

Economic development: the process of improving people's economic well-being and quality of life.

-Increase availability and distribution of basic life-sustaining goods:
- Food, shelter and health.

-Increase in standards of living:
- Higher incomes, better jobs and better education.
- Enabling people and societies to feel a greater sense of worth and self-respect.

-Expansion of economic and social choices available:
- Frees people from misery, ignorance and dependence on others.

COMPARING GROWTH WITH DEVELOPMENT

-Growth raises a nation's income:
- Making it easier to provide better healthcare, better education and more jobs.
- Therefore growth provides the conditions for development to take place.

-Not enough:
- Economic growth may raise income but the additional income may be unequally distributed (large number of people see no increase in their individual income).
- Economic growth might deplete natural resources affecting future generations to achieve the same level of income (unsustainable development).
- Economic growth through capital-intensive methods may reduce job availability (unemployment and poverty remains high).
- Economic growth may result in high pollution (damaging health and levels of living).

Difference:

-Much easier to compare income levels than economic and human development.
-Development encompasses much more than just income:
- Income levels (GDP per capita) tell use the total use of a nation's resources, but they don't tell us what the resources were used for, who gets the income generated production and how people's lives and environments are affected by production and consumption.