Downturn – This is that phase, where economic activity falls beyond the trend rate of growth, where unemployment begins to rise and additionally, inflation also begins to fall.

Recession – This is where the output in the economy is negative for two successive quarters, i.e. two quarters.

There are a range of reasons for **fluctuations** in the economic cycle, which includes:

- **A speculative bubble** is where economic growth can lead to a rise in asset prices, which prompt people to invest in these assets, knowing that the value of these assets will rise. Once the value has gone well beyond its true value, people will start to sell these assets to ensure a maximisation of profit. This leads to a fall in consumer and business confidence.
- **Inventory changes** is quite simply, the supply side version of the speculative bubble. For example, businesses will overstock their goods despite demand not actually meeting expectations and thus, due to their hopes, businesses will actually suffer a loss.
- **Political cycles** come of particular importance in the months leading up to a general election. In an attempt to gain support from the electorate, parties will attempt to engineer an economic boom by increasing AD through expansionary fiscal policies.
- **Shocks** are unexpected changes in either AD or AS. These can be endogenous or exogenous (explained below) such as crops being damaged or ruined due to a storm in a foreign country.

<u>Uses of National Income Data:</u> There are 3 main ways in which the size of an economy is measured, and they are:

I. **GDP – Gross Domestic Product**
II. **GNP – Gross National Product**
III. **NI – National Income**

All of the above serve very similar purposes and it doesn't really matter which is used, however, GDP is the most commonly used measure.

If to GDP, we add interests, profits & dividends which flow into the country & take away those flowing out, we get the GNP.

And minus the depreciation of a nation's stock of capital equipment, you get NI.

However, with GDP there are a number of difficulties when using it as a measure of living standards, such as:

- GDP **does not really measure output completely** in the sense that it can only measure the value of goods and services that have been recorded as traded in markets. This means that the whole non-monetised sector of the economy is ignored and not calculated as a part of GDP, such as unpaid labour of parents who choose to look after their kids, or elderly parents etc. It also does not account for the 'black market economy' which makes up 10-15% of the UK economy.
- GDP also **does not take into account quality improvements** such as technological advancements and thus underestimates the welfare gains. Prices of goods/services such as computers will have fallen, however, their capabilities will have increased greatly.

IV. Money can also be used as a **standard of deferred payment** which allows people to purchase items on credit and pay for them at a later date/time.

Money comes in two different types, **Narrow Money & Broad Money.**

Narrow money is basically notes and coins which are printed by the central bank and are available to normal daily financial transactions.

Broad Money (M4) is money which is held in the banking system, including sight and time deposits, which is used for saving and for spending, based on the needs/wishes of the consumer in relation to how & what they want to spend.

There are a number of instruments used by governments to influence the monetary positions of the economy, and they include:

I. By controlling the supply of money, governments used **monetary base control** to reserve asset ratios on banks meaning that they are obliged to hold a certain proportion of their assets in reserve at all times in an attempt to also control inflation.

II. **Open-Market Operations** are when the Bank of England can issue government bonds which when purchased by non-financial sectors, passes money to the central bank. This in turn reduces money supply because any money which is stored with the Bank of England is not usually counted as part of the money supply.

III. There can also be a control on the **demand for money** by the Bank of England either lowering or raising interest rates which will either increase or decrease the demands for either saving or spending. So money supply can increase or decrease. So if for instance, the BoE decides to raise their **repo rates**, high street banks are forced to also increase their interest rates charged to their customers and thus bank loans increase too and thus consumption and investment reduces, reducing inflation.

When setting interests rates, the Monetary Policy committee take into consideration a number of factors, which include:

I. They will look at **financial markets** including share prices, which indicates investor confidence in the economy.

II. They also take into consideration the entire **international economy** whilst comparing the value and strength of the pound to other currencies like the Euro and the Dollar – link this to the exchange rate policy below.

III. The levels of consumer spending and credit figures in terms of the **Money and credit** levels in the economy which will cover both broad and narrow money in the economy.

IV. **Demand and output** will also be considered in terms of consumption and planed investment into the economy which will help predict the size of the output gap in terms of growth of real GDP.

V. Figures for employment and unemployment are presented as the **Labour Market** can be a key indicator of demand-pull and cost-push inflationary pressure.

VI. **Costs and prices** in an economy are indicators of whether firms are passing inflation along the 'pipeline' to the high street through VAT etc.

However, there are periods when it is necessary for the BoE to adopt a loose monetary policy to actually stimulate aggregate demand to create an upwards pressure on inflation at a time when strengthening economic links between countries. MCN's as a whole have been able to influence globalisation, because of the following specific actions:

I. **Technology and Process Transfer** – MNCs generally operate to higher managerial and technical standards than the local developing economy. Local employees can learn these processes and techniques, and the local economy can benefit from this new expertise thereby which was the whole thought process behind the Chinese Open Door Policy.
II. **Employment Opportunities filled by Foreign Workers** – when MNCs set up production plants in developing economies, depending on the industry, local workers may lack the core skills to fill the available jobs, and so workers are sourced in from other countries. A classic example is oil-drilling in the Middle East, for which the majority of local workers are unsuitably qualified, and expat workers are brought in from India and the Philippines simply because the native Arabs can't (and won't!) do the dirty work. Their willingness to adhere to the employment, training, environmental protection and health & safety considerations have helped in the advancements of previously unskilled labour markets, like in China, but then again, some firms don't really focus on this much, as their sole intention is to cut costs as much as they can & in China, in SEZ's (Special Economic Zones), they're able to do this quite easily due to the limited restrictions, special tax rates, subsidies and dispensations from labour laws, such as minimum wage legislations.
III. **Capital flows (for a variety of reasons**) – setting up a production plant in a foreign, developing economy will inevitably require capital transfers to and from the economy in question. For example, workers may be paid from a foreign account, or company finances and accounts may be located abroad (e.g. to avoid paying tax or for other reasons) and when the plant is physically built, capital will need to be transferred to pay for the work of the foreign employees.

There are a number of factors which have influenced the speed at which globalisation has been able to spread, such as:

I. There has been a mass **technological change** in relation to communication, which has enabled easy, secure and quite cheap transfer of information for MNC's between sites across the globe. Additionally, for consumers, the Internet provides a platform for us to compare prices of goods for sale across the globe, allowing us to choose the best option according to our wishes.
II. **Transportation** has improved significantly. Firms pack their products on site & can send out huge quantities of goods through containers, which don't have to be packed by inefficient dock labour, which has subsequently reduced the costs of sea transport, the mode which is commonly used for the transportation of goods. Plane travel has also become much easier and more common, allowing for air deliveries for goods which are required urgently.
III. The **collapse of communist states** such as the USSR have opened the markets available in Eastern Europe to the global business for international competition, especially as these markets have lower costs of production and thus attract inward investments from multinational companies.
IV. Thanks to organisations such as the **WTO or the GATT** agreement as well as the whole being of the EU, trade between countries is much cheaper, as there are less tariffs which have to be dealt with/overcome.

of Productions overseas, such as a UK firm having a branch in Singapore. Current transfers consist mainly of government transfers to and from overseas organisations including the EU, UN, and NATO etc. The current balance thus, quite simple, is the difference between the value of total exports and the value of total imports. The fact that the UK's net income flows are usually positive, suggests that we tend to own more profitable assets across the globe compared to the assets held by foreign multinationals in the UK.

II. **Financial (Capital) Account of the Balance of** Payments is the part of the Balance of Payments that records the vast majority of flows of financial capital into and out of the UK, both in the sense of long term and short term flows. It consists of three main components, which are:
   a. The net levels of Foreign Direct Investment which is effectively the net acquisition of productive assets by UK firms overseas (outward direct investment), and by foreign firms in the UK (inward direct investment)
   b. The net portfolio level of investment which simply involves the purchase of financial assets such shares
   c. Other capital flows, mainly short term capital movements for speculative purposes such as hot money.

III. **Insignificant Capital Account of the Balance of Payments** is the part of the Balance of Payments that shows either how the current account deficit is financed how the current account surplus is used but is largely irrelevant and unimportant. It records international flows of financial capital, these entries will generally make investment income at some point in the future, and for example, if a loan is given to an overseas economy, it'll generate interest, which is entered under the investment income flows section of the current account. Examples of entries on the capital account include inter-government loans, private-sector loans as well as certain types of foreign aid.

A **Surplus** in the balance of payments, is where the value of exports exceeds the value of imports in the country. And on the other hand, a **deficit** is where the value of imports, exceeds the value of imports.

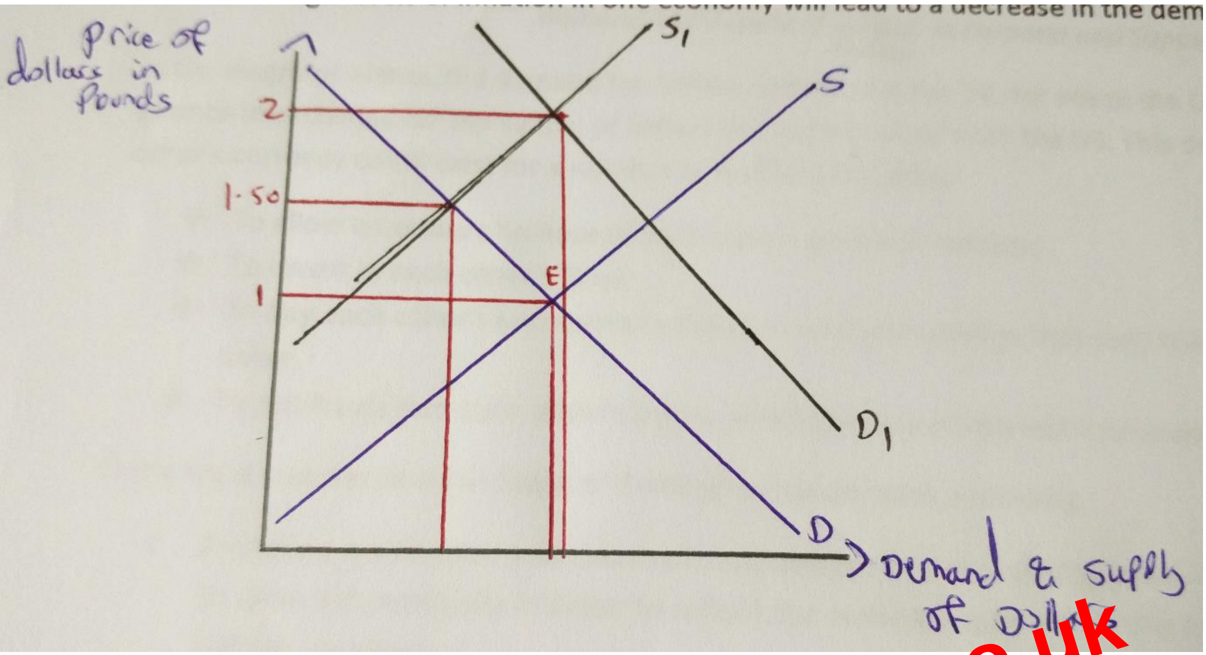
Short-term capital flows make up the largest component of capital income flows, which is usually defined as a period of one year, arising predominantly from companies, banks and wealthy individuals who are seeking quick profits, by the moving of capital around the globe, where they anticipate possible chances to achieve large sums of 'hot money', as well as the movement of capital into countries with a higher level of interest, so that investors can get a large share of interest on their wealth.

Long-term capital flows can be simply split up into **direct investment and portfolio investment,** which means that the investment is made up for a period much longer than a year. Direct investment is the acquisition of productive assets such as factories and offices, whilst portfolio investment are the acquisitions of financial assets such as shares and financial derivatives.

The benefits of a rapid growth in the levels of international capital flows due to globalisation, include:

I. The promotion for world trade has grown significantly and has been made even easier by organisations such as the EU or the WTO.

- A fall in the interest rates of one currency coincided with a rise in another currency, speculation will lead to a depreciation of one currency and thus the demand for it may decrease significantly
- High levels of inflation in one economy will lead to a decrease in the demand for its currency



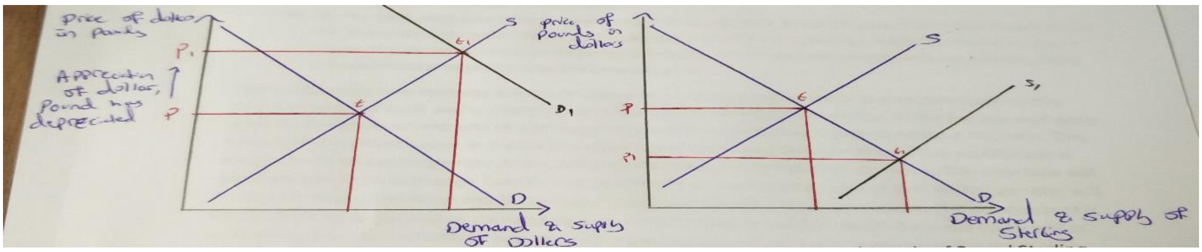
The effect of inflation on exchange rates

There are additionally a number of factors which affect the supply of a currency, including:

- Demand for its imports
- Outflows of Foreign Direct Investment
- Outflows of Portfolio Investment
- The levels of speculative selling of the currency
- Officially selling of the currency by the Central Banks
- A deficit of imports over exports will increase the supply of a currency and thus lead to a depreciation of its value, through trade deficits. Since British importers will need to supply pounds in order to pay for the import of goods, there is a downward pressure on exchange rates.

There are two main types of exchange rate systems, and they are:

Floating exchange rates is determined solely by the market demand for and supply of a currency, with no government intervention needed..



Demand and Supply of Labour vs Demand and Supply of Pound Sterling

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A customs union also ensures that those within the union are able to benefit from both static and dynamic gains which come about due to their abilities to enjoy **economies of scale**. With a market of over 500 million people living in the union, economies of scale can easily be exploited through the intra-community trade. Furthermore, in a customs union, there is a greater level of **competition** due to the larger size of the market which will only further increase dynamic efficiencies because firms stand to lose their market share if they do not remain efficient which thus allows them to further invest money into research & development, innovation, new products, new processes, new techniques and consequent reduced costs of production and thus prices. There is of course the danger that oligopolistic markets could arise with the increased demand on competition, however, the EU Competition Commissioner has ensured that there will be no infringement on ensuring a high level of competition.

Since, there has been talks about the **expansion of the EU** (from which we in the UK are permanently free from thanks to David Cameron's reforms in relation to an ever closer union) with more and more central and eastern European countries joining the union. From the point of view of the UK, we see the new entrants as beneficial because:

I. New entrants will most certainly lead to an expansion of the European market and thus this will lead to more and more potential customers to sell to thanks to the free market by increasing the collective population of the EU by 100 million
II. Central and Eastern European countries have the tendency to be countries with low rates of tax
III. They can be taken advantage of and be used as a powerful counterweight alongside the power of countries such as Germany & France

However, by the expansion of the 10 Eastern European countries joining the EU, there have also been a range of consequences, such as:

I. With 100 million increased in population, these 10 countries have only added 5% to the GDP of the EU – this is very small
II. Led to a fear of a huge influx of cheap labour and consequent withdrawals from the economy due to these workers sending their money back home
III. Huge influx of migration from the East to the West of Europe due to the freedom of movement causing tension in countries to whom migrants are migrating to

One of the final stages of the development of the EU would be the introduction and advancement of a **Monetary Union** which would encompass common policies for economic growth, monetary and fiscal policies and to do so, there was the creation of the single currency, the Euro which went ahead on the 1st January 1999 and was regulated by the ECB described above.

There are a range of benefits of the single currency, some of which are:

I. By having all transactions in one currency, there is a **reduction in transaction costs** in relation to changing one currency to another because there is no element of foreign exchange involved which can boost EU countries GDP by 0.4% according to the European Commission.
II. By joining a single currency, there is a removal of **exchange rate uncertainty** because all transactions between countries are done with the same money, which is worth the same