



Edexcel A - AS Level Economics

Theme 2 – The UK economy – performance and policies

2.5 Economic Growth
Revision Notes

Contents

Hey there! 🤝

We're **Tutor Packs**, and our mission is simple: making learning easy, stress-free, and actually enjoyable. ✨📚

We've got FREE revision notes and worked examples for loads of subjects, perfect for smashing those exams. 💪🤪

Want to see what we're all about and show support please visit our social media pages: <https://www.tutorpacks.com/links>

- [2.5.1 Causes of growth](#)
- [2.5.2 Output gaps](#)
- [2.5.3 Trade \(business\) cycle](#)
- [2.5.4 The impact of economic growth](#)

2.5.1 Causes of growth

Factors which could cause economic growth


Economic growth is the **increase in the production of goods and services** in an economy over time. It is usually measured by the **rise in real Gross Domestic Product (GDP)**, which adjusts for inflation.

For an economy to grow, it needs to **increase the quantity or quality** of at least one of the **four factors of production**:

- 1 Land 
- 2 Labour 
- 3 Capital 
- 4 Enterprise 

Alternatively, **using these resources more efficiently** can also lead to economic growth. When these factors improve, the **Long-Run Aggregate Supply (LRAS) increases**, boosting the economy's ability to produce more goods and services. Let's break this down with examples.

1 Land – More Natural Resources = More Growth

 **Land** refers to **natural resources** like oil, gas, minerals, and farmland. If a country **discovers new resources**, its economy can grow because **there's more to sell and use**.

◆ Example:

Norway experienced rapid economic growth after **discovering oil in the North Sea**, which boosted exports and government revenue.

◆ Why it matters:

- Developing countries **benefit the most** from new resource discoveries.
- In richer nations, economic growth depends more on **technology and innovation** than raw materials.



2.5.1 Causes of growth

Factors which could cause economic growth

2 Labour – More Workers & Better Skills Help Growth

◆ The size of the workforce:

- More **immigration**, higher **birth rates**, or an increase in **retirement age** can **increase the number of workers** in an economy.
- More workers = **more production** = **higher GDP**.

◆ Example:

Countries like **Germany** encourage skilled immigration to **fill job vacancies and boost growth**.

◆ The quality of the workforce:

- A well-educated and skilled workforce **produces more goods and services efficiently**.
- Governments can improve this by **investing in education and training**.

◆ Example:

South Korea's focus on **STEM (Science, Technology, Engineering, and Math) education** helped it become a **global technology hub** (think **Samsung, Hyundai, and LG**).

2.5.1 Causes of growth

Factors which could cause economic growth

3 Capital – Investment in Technology & Infrastructure 🏠

◆ What is capital?

Capital refers to **man-made goods** used to produce other goods and services (like **factories, machines, and technology**).

◆ How does capital increase growth?

- **More investment** in machinery and technology **boosts production**.
- **Better infrastructure** (roads, railways, internet) makes **businesses more efficient**.

◆ Example:

China's **investment in high-speed rail** helped connect cities, boosting trade and economic activity.

◆ Why it's important:

- Some investments **fail** to increase GDP (e.g., building **ghost cities** with no demand).
- Smart investment in **technology and innovation** leads to sustainable growth.



2.5.1 Causes of growth

Factors which could cause economic growth

4 Enterprise – Encouraging Entrepreneurs & Business Innovation 💡

Entrepreneurs **take risks and create businesses**, driving economic growth by **introducing new products, services, and jobs**.

◆ How governments encourage enterprise:

- ✓ Lower taxes on businesses
- ✓ Grants and loans for start-ups
- ✓ Reducing excessive regulations

◆ Example:

The **Silicon Valley tech boom** happened because the **US government supported innovation** with **grants, tax incentives, and strong property rights**.

◆ Why it's important:

- If taxes are **too high**, businesses **lose motivation** to expand.
- If **welfare benefits are too generous**, fewer people may **choose to work**, slowing growth.

2.5.1 Causes of growth

Factors which could cause economic growth

Other Key Factors That Drive Economic Growth

5 Technological Progress – The Game Changer!

New technology helps produce goods **faster, cheaper, and better**. It also creates **entirely new industries** (e.g., AI, renewable energy).

◆ Example:

The invention of the **smartphone** led to **app-based businesses like Uber, TikTok, and mobile banking**, creating millions of jobs!

◆ Why it matters:

Without **constant innovation**, economies **stagnate** and fall behind competitors.

2.5.1 Causes of growth

Factors which could cause economic growth

6 Efficiency – Doing More with Less

Efficiency means using **fewer resources to produce the same (or more) output**.

◆ How governments improve efficiency:

✓ Encouraging competition → Forces businesses to **lower prices and improve quality**.

✓ Protecting property rights → People are more likely to **start businesses** if they know their ideas are safe.

✓ Investing in infrastructure → Efficient roads, energy, and internet **reduce business costs**.

◆ Example:

Japan is highly efficient because of **automation, strict quality control, and advanced robotics**, making its economy strong despite a **small workforce**.

Final Thoughts – What Makes an Economy Grow?

✓ More resources? Great! But only if **they're used wisely**.

✓ More workers? Yes! But **they need the right skills**.

✓ More investment? Absolutely! But it must be in **productive industries**.

✓ More technology? Always! But **governments must support innovation**.

💡 **Bottom Line:** Economic growth isn't about **just having more**; it's about **using what you have efficiently**. The best economies **combine investment, innovation, and smart policies** to stay ahead! 🔥

2.5.1 Causes of growth

Actual vs Potential Growth

When we talk about **economic growth**, we're really talking about two different things: **actual growth** and **potential growth**.

◆ Actual Growth – What's Happening Right Now?

📌 **Definition:** Actual growth is when a country **produces more goods and services** than before, leading to a **higher Gross Domestic Product (GDP)**. It's the **real, measurable increase** in output.

Example: If a country's GDP grows from **£2 trillion to £2.2 trillion**, that's actual growth! This happens when businesses **produce more, hire more workers, and use resources more efficiently**.

What causes actual growth?

More **consumer spending** 🛒, More **investment by businesses** 🏢, Government spending on **infrastructure, healthcare, education** 💰, Higher **exports** 📦

◆ Potential Growth – What the Economy *Could* Produce

📌 **Definition:** Potential growth refers to an **increase in the economy's capacity to produce goods and services** over time. It doesn't mean we are producing more right now, it means we **could produce more in the future**.

Example: Imagine a country discovers **new oil reserves** or invents a **revolutionary AI technology**. These things don't instantly increase GDP, but they **increase the country's ability to grow** in the future.

What causes potential growth?

- **New technology** (e.g., AI, robotics, green energy) 🤖, **More workers** (higher birth rates, immigration, later retirement) 👥, **Better education & skills training** 🎓, **Investment in infrastructure** (faster internet, better transport) 🚗
- **Potential growth is shown by a shift in the Long-Run Aggregate Supply (LRAS) curve or the Production Possibility Frontier (PPF).**

2.5.1 Causes of growth

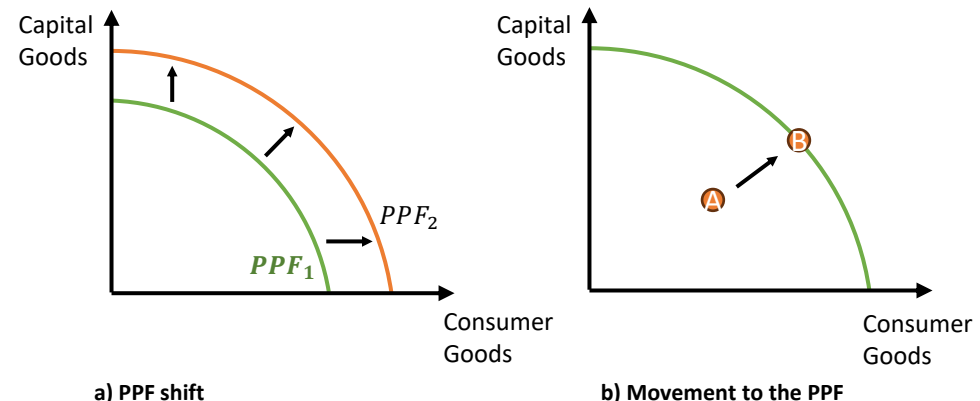
Actual vs Potential Growth

◆ The PPF and Economic Growth – A Simple Explanation

The **Production Possibility Frontier (PPF)** shows the **maximum amount of goods and services** an economy can produce with its current resources.

- If the **PPF shifts outward**, the economy **can now produce more** → **Potential growth**. Shown below in **figure (a)**.
- If the economy **moves from inside the PPF to the PPF itself**, it means resources are being **used more efficiently** → **This is economic recovery, not growth**. Shown below in **figure (b)**.

✅ **Example:** If a country has **high unemployment**, it's **not using all its resources**. When unemployment falls and people start working again, the economy moves **closer to its PPF**, this is recovery. But **if the economy invents new technology or trains a highly skilled workforce**, the PPF **shifts outward**, this is potential growth.




a) PPF shift

b) Movement to the PPF

2.5.1 Causes of growth

International trade for (export-led) economic growth

 International trade plays a **huge role** in economic growth, especially when a country **exports more than it imports**. This is known as **export-led growth**, where a country's economy grows because **more people from around the world are buying its goods and services**.

Export-Led Growth – How Does It Work?

Many economists believe that a rise in **Aggregate Demand (AD)** (the total demand for goods and services in an economy) can **fuel economic growth** when exports increase. This is called **export-led growth** because higher exports mean:

- ✓ **More money flows into the country** from foreign buyers.
- ✓ **Businesses expand** to meet the demand.
- ✓ **More jobs are created** as firms hire workers to produce more goods.
- ✓ **The economy grows.** 

Examples of Export-Led Growth

- **South Korea** – Became a major global economy by **exporting electronics (Samsung, LG) and cars (Hyundai, Kia)**.
- **Germany** – Known for **exporting high-quality machinery, cars (BMW, Volkswagen), and chemicals**.
- **Vietnam** – Rapid economic growth thanks to **exports of textiles, electronics, and agriculture**.

These countries **focused on producing goods the world wanted** and became **export powerhouses**.






2.5.1 Causes of growth

International trade for (export-led) economic growth

How Exports Lead to Long-Term Economic Growth

At first, a rise in exports **only increases Aggregate Demand (AD)** because more people are buying the country's products. But if **high exports continue**, businesses:

- ✓ **Invest in better technology** to stay competitive 
- ✓ **Expand production** to meet global demand 
- ✓ **Hire more workers**, reducing unemployment 

This **increases Long-Run Aggregate Supply (LRAS)**, meaning the economy can **produce more in the long run**, leading to **sustainable economic growth**.

Competing in International Markets = More Efficiency

When businesses **sell internationally**, they **compete with companies from all over the world**, not just local firms. This **forces them to become more efficient**, producing **better quality goods at lower costs** to stay competitive.

◆ Example:

- **Tesla & Toyota** constantly **innovate and improve** their electric and hybrid cars to compete in global markets.
- **British companies** wanting to succeed abroad **must also improve efficiency, cut costs, and boost productivity**.

2.5.2 Output gaps

Actual growth rate vs long-term growth

What is Actual Growth?

Actual growth refers to the **increase in a country's production of goods and services in the short term**, measured by changes in **Gross Domestic Product (GDP)**. It happens when businesses produce **more stuff**, consumers spend **more money**, and the economy is **booming**.

◆ **Example:** If the UK's GDP **grows by 3% in a year**, that's actual growth! It shows that businesses have been producing more, people have been spending more, and the economy has expanded.

💡 **However, actual growth can go up and down due to recessions, booms, and external shocks like financial crises or pandemics.**

What is Long-Term Growth?

Long-term growth is the **steady increase in an economy's productive capacity over time**. Instead of looking at short-term fluctuations, it focuses on how much an economy **can** produce if all its resources (workers, land, machines, technology) are fully used.

◆ **Example:** Over the last 50 years, China's economy has grown significantly because of **investment in infrastructure, education, and technology**. This is **long-term growth** because it has **increased the country's ability to produce more** year after year.

💡 **Long-term growth is shown by an outward shift in the Long-Run Aggregate Supply (LRAS) curve or the Production Possibility Frontier (PPF).**

2.5.2 Output gaps

Positive and negative output gaps

What is an Output Gap?

An **output gap** is the **difference between what an economy is actually producing (real GDP) and what it could produce at full capacity (potential GDP)**.

There are **two types of output gaps**:

✔ **Positive Output Gap** – When **real GDP is greater than potential GDP**.

A **positive output gap** happens when the economy is **producing more than its sustainable capacity**; businesses are working overtime, unemployment is extremely low, and demand is so high that it's **pushing prices up** (inflation).

◆ **Example:**

- In **2008, before the financial crisis**, many economies were booming, **businesses couldn't keep up with demand**, and inflation was rising fast.

✔ **Negative Output Gap** – When **real GDP is below potential GDP**.

A **negative output gap** happens when the economy is **not using all its resources efficiently**, there's **spare capacity**, meaning businesses **could** produce more, but **demand is too low**.

◆ **Example:**

- During the **COVID-19 pandemic**, many countries had a **negative output gap**, businesses were closed, workers were unemployed, and the economy was running below full capacity.

2.5.2 Output gaps

Positive and negative output gaps

🤔 Why Are Output Gaps Hard to Measure?

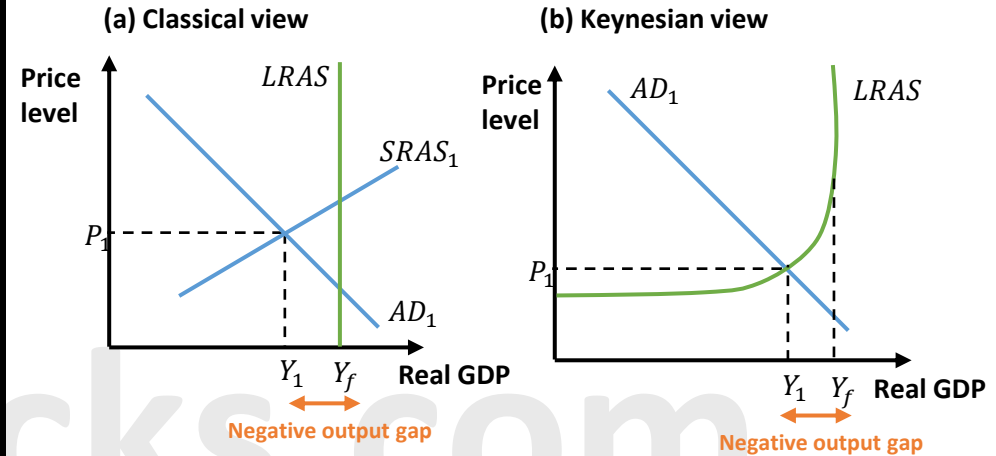
It's difficult to know exactly how much an economy *could* produce because:

- Technology changes (new innovations can increase capacity). 🤖
- Immigration and workforce size fluctuate. 👤
- Productivity improvements (better education, new skills). 🎓

2.5.2 Output gaps

Positive and negative output gaps

Negative output gap



📌 What's the Situation?

The economy's **potential output** (how much it *could* produce at full capacity) is at Y_f . However, right now, the economy is **not performing at full potential** and is in a **short-run equilibrium** at P_1, Y_1 , meaning it's producing less than it could.

This creates a **negative output gap** ($Y_1 - Y_f$), which means there is **spare capacity**, factories, workers, and resources are available but **not being fully used**.

😬 Why is This Happening?

A **negative output gap** usually happens when **Aggregate Demand (AD)** falls, this means:

- ✓ People are **spending less** (maybe due to higher interest rates, uncertainty, or lower wages).
- ✓ Businesses **cut production** because demand for goods and services is down.
- ✓ **Unemployment rises** as companies hire fewer workers.



2.5.2 Output gaps

Positive and negative output gaps

Negative output gap

Different Economic Views on What Happens Next

The Classical View:

Economists who follow **Classical Economics** believe that the economy **will naturally fix itself** in the long run. Prices and wages will **adjust downward**, making goods cheaper and encouraging **more spending and investment**. Eventually, the economy **returns to full employment (Y_f) at a lower price level**.

Example:

If wages fall, businesses **hire more workers**, increasing production and closing the output gap.

The Keynesian View:

Economist **John Maynard Keynes** had a different take, he argued that **the economy could stay stuck in a negative output gap for a long time** if people **don't start spending again**. If businesses don't see demand rising, they won't invest, and unemployment could **stay high** for years.

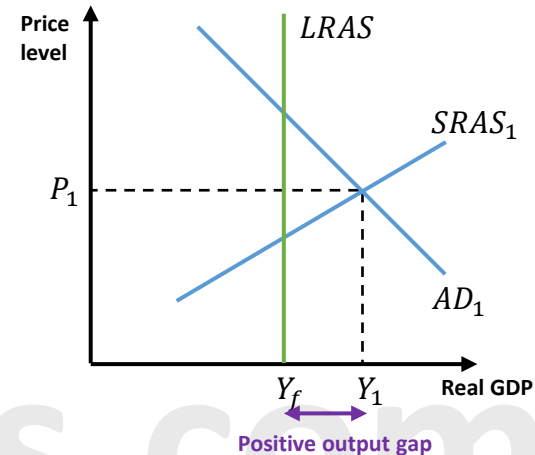
Example:

During the **Great Depression (1930s)**, unemployment stayed **high for a decade** because **demand didn't recover quickly**, proving that economies don't always fix themselves fast.

2.5.2 Output gaps

Positive and negative output gaps

Positive output gap



What's the Situation?

- The **potential output** of this economy is at Y_f . However, in the **short run**, the economy is operating above its full capacity at P_1Y_1 , meaning it's producing **more than usual**.
- This creates a **positive output gap ($Y_f - Y_1$)**, where demand is so high that businesses are **pushing beyond normal capacity** to keep up.
- This could happen when, **workers put in overtime** to meet rising demand or **factories run 24/7** to keep up with production.
- While high production sounds great, it **comes at a cost**. **Workers burn out** from constant overtime, **machines wear down** due to overuse or **inflation rises** as demand outstrips supply, pushing up prices.
- Classical view is that the economy naturally corrects itself over time, output returns to normal (Y_f) but at a higher price level.

2.5.3 Trade (business) cycle

Understanding the trade cycle

The **business cycle** (or **trade cycle**) refers to the **regular ups and downs in economic activity over time**. It shows how **real GDP (the value of goods and services produced) changes**, creating periods of **booms and recessions**.

💡 **Think of it like a rollercoaster**, sometimes the economy is growing fast (**boom**), sometimes it slows down (**downturn**), and sometimes it crashes (**recession**) before recovering again.

📊 How Does GDP Fluctuate?

The economy doesn't grow at a **constant rate**, instead, it moves **above and below the long-term trend of growth**.

💎 Example:

- The **US economy boomed in the 1990s** due to rapid technology growth (internet, computers).
- In **2008, the Global Financial Crisis** caused a sharp **recession**, where businesses shut down and unemployment soared.
- **By 2010, economies started recovering**, and by 2021, some even **overheated** due to high post-pandemic demand.

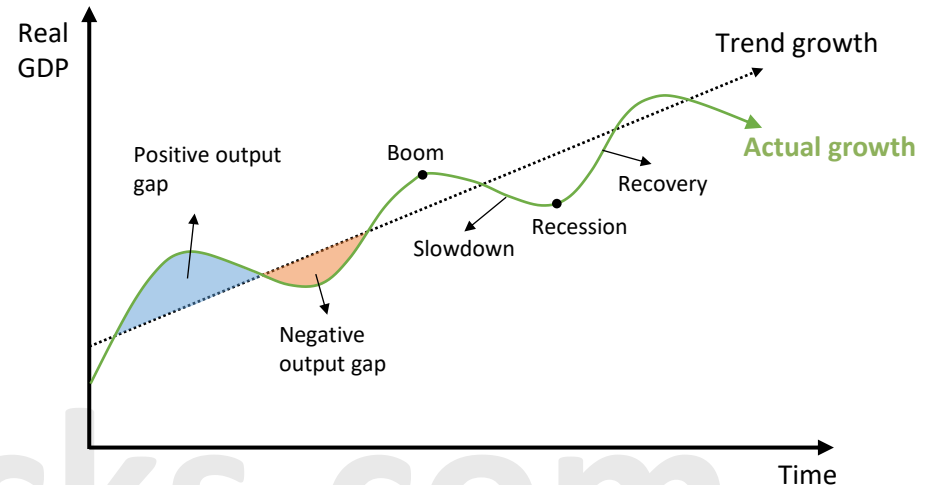
The output gap

✅ **A positive output gap** occurs when **real GDP grows faster than the long-term trend**, meaning the economy is **overheating** with high demand and pressure on resources.

✅ **A negative output gap** occurs when **real GDP grows slower than the long-term trend** or contracts, indicating **unused capacity, lower demand, and higher unemployment**.

2.5.3 Trade (business) cycle

Understanding the trade cycle



📌 The Four Stages of the Business Cycle

1. **Boom (Peak)** 🚀 – The economy is **growing fast**, businesses are thriving, and unemployment is **low**. However, inflation may start rising as demand outstrips supply.
2. **Slowdown (Downturn)** ⚠️ – Growth begins to **slow**, businesses make **fewer profits**, and unemployment starts to **rise**.
3. **Recession (Contraction)** 📉 – Economic activity **shrinks**, businesses may **close**, unemployment is **high**, and GDP **declines** for at least **two consecutive quarters**.
4. **Recovery** 🔄 – The economy **picks up again**, businesses start **hiring**, consumer confidence **improves**, and GDP **starts growing**.

2.5.3 Trade (business) cycle





Characteristics of a boom and recession

Boom (Economic Expansion)

◆ What is a boom?

A boom happens when the economy **grows rapidly**, and businesses **struggle to keep up with demand**.

Key Signs of a Boom:

-  **High economic growth** – Businesses expand, and GDP **rises quickly**.
-  **Unemployment falls** – More jobs are created, and there are **many job vacancies**.
-  **Output gaps close** – The economy uses **most of its resources efficiently**, sometimes even exceeding capacity (**positive output gap**).
-  **High consumer and business confidence** – People **spend more**, and firms take **risks** on new projects.
-  **Inflation rises** – Demand is high, so prices start increasing (**demand-pull inflation**).
-  **Better government budget** – Tax revenues increase, and governments **spend less on welfare**, reducing the **budget deficit**.

◆ Example:

During the **1990s tech boom**, companies like **Microsoft, Apple, and Amazon** saw massive growth, stock markets soared, and economies thrived.



2.5.3 Trade (business) cycle

Characteristics of a boom and recession

Recession (Economic Downturn)

◆ What is a recession?

A recession happens when **economic activity slows down for at least two consecutive quarters (six months)**, meaning GDP is **falling**.

Key Signs of a Recession:

-  **Negative economic growth** – Businesses produce **less**, and GDP **shrinks**.
-  **Unemployment rises** – Companies lay off workers to cut costs.
-  **Negative output gap increases** – Factories and offices have **spare capacity** because demand is low.
-  **Low consumer and business confidence** – People **spend less**, and firms avoid risky investments.
-  **Low inflation** – With less demand, **prices rise slowly or may even fall (deflation)**.
-  **Higher government spending** – The government may **increase spending on benefits and support programs**, often leading to a **budget deficit** (spending more than it earns in taxes).

◆ Example:

The **2008 Financial Crisis** led to a **global recession**; millions lost their jobs, businesses collapsed, and governments had to **bail out banks** to stop the economy from crashing further.

2.5.4 The impact of economic growth

Economic growth happens when a country **produces more goods and services over time**, leading to **higher incomes, more jobs, and improved living standards**. Governments aim for growth because it **benefits consumers, businesses, and the government**, but it also comes with challenges.

How does economic growth affect consumers?

- ✓ **Higher Incomes, More Spending Power** – As wages increase, people can **afford better homes, cars, and holidays**. More disposable income means **higher demand for goods and services**.
 - ✓ **More Choice, Better Quality** – As businesses grow, they develop **new products and services**, leading to **greater variety and better quality**. Think about how the **food industry now offers more organic and plant-based options** due to higher consumer demand.
 - ✓ **Lower Unemployment** – With businesses expanding, **more jobs** become available, reducing unemployment and increasing financial security.
- ⚠ Potential Downsides:**
- ✗ **Rising Inequality** – The rich often **benefit more** than the poor.
 - ✗ **Inflation Risk** – If demand rises too quickly, **inflation** can make everyday essentials **more expensive** (e.g., food, transport, and rent).

2.5.4 The impact of economic growth

How does economic growth impact firms?

- ✓ **More Investment & Expansion** – Businesses make **higher profits**, allowing them to **open new locations, hire more workers, and invest in innovation**.
 - ✓ **New Markets & Opportunities** – Economic growth allows companies to **expand globally**.
 - ✓ **Better Wages & Benefits** – As companies compete for workers, they **offer better salaries and perks**, improving employee well-being.
- ⚠ Potential Downsides:**
- ✗ **Labour Shortages** – When unemployment is low, businesses **struggle to find skilled workers**, leading to **higher wages and production costs**.
 - ✗ **Smaller Businesses May Struggle** – Large corporations can **dominate the market**, making it harder for small businesses to survive. **Independent bookstores, for example, struggled against online giants like Amazon**.

How does economic growth impact the Government?

- ✓ **Higher Tax Revenues** – As businesses and workers earn more, the government **collects more taxes**, which can be invested in **education, healthcare, and infrastructure**.
 - ✓ **Lower Government Debt** – When the economy is booming, the government **needs to spend less on welfare programs** (like unemployment benefits) and can focus on **reducing national debt**.
 - ✓ **Stronger Global Influence** – A wealthier country can **invest in diplomacy, military, and trade agreements**, strengthening its global position.
- ⚠ Potential Downsides:**
- ✗ **Public Expectations Increase** – As people earn more, they **expect better public services**, putting pressure on governments to **continuously improve infrastructure and welfare**.
 - ✗ **Risk of Overborrowing** – Governments may **overinvest in projects**, leading to unsustainable spending.



2.5.4 The impact of economic growth

How does economic growth affect living standards?

- ✓ **Less Poverty, More Opportunities** – With **higher employment and rising wages**, fewer people depend on government aid, improving overall living standards.
- ✓ **Better Healthcare & Education** – Governments can **invest in hospitals, schools, and social services**, leading to **longer life expectancy and better education systems**.
- ✓ **Technological Advancements** – Growth leads to **better infrastructure, cleaner energy, and innovation in medicine and technology**. Think about how **high-speed internet became widely accessible due to economic expansion**.
- ⚠ **Potential Downsides:**
 - ✗ **Environmental Impact** – More production and consumption can lead to **pollution, deforestation, and climate change**. **The Amazon rainforest is being destroyed partly due to economic expansion in agriculture and logging**.
 - ✗ **Widening Inequality** – The rich may **benefit more than the poor**, leading to a larger wealth gap.



2.5.4 The impact of economic growth

How does economic growth affect living standards?

Continue to the next page...

Please see the '2.5 Economic Growth Worked Examples' pack for exam style questions.

For more FREE revision notes, tutorials, worked examples and help visit www.tutorpacks.com

