OCR – A Level Economics

Component 2 – Macroeconomics

7. Economic policy objectives

Revision Notes

Contents

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7.1 Economic growth

The difference between short-run and long-run growth

Economic growth means the increase in the amount of goods and services a country produces over time. Basically, it's when an economy is making more stuff and (hopefully) improving living standards.

Now, this growth can happen in **two ways**: in the **short-run** or in the **long-run**.

Short-Run Economic Growth (Quick Boost)

Short-run growth happens when we make better use of the resources we already have like using spare workers, machines, or factories more efficiently. Think of it like tidying your room and suddenly having more space.

Two main causes:

- **Demand-side growth** – This happens when people spend more money. If more people start buying trainers, concert tickets, or takeaway pizza, businesses need to produce more to meet demand which leads to growth. This is usually driven by changes in aggregate demand.
- **Supply-side growth (short-run)** – Sometimes, short-term changes (like cheaper oil prices or a temporary tax cut for businesses) can make it easier to produce stuff, which also boosts growth. This is usually driven by short-run aggregate supply.

7.1 Economic growth

The difference between short-run and long-run growth

Long-Run Economic Growth (Slow and Steady Wins the Race)

Long-run growth is all about **increasing the economy's capacity to produce more over time,** not just using what we already have better, but actually **growing** the total.

This usually happens through improvements in the **factors of production** (the stuff we use to make goods and services). Here's how:

- **More education and training (human capital)** – Smarter workers = more productivity.
- **More machines and tools (capital accumulation)** – More gear = more output.
- **Technology improves** – Think of factories using robots or AI.
- **Investment in infrastructure** – Like building better roads or faster internet.
- **Policy changes** – New government policies might boost innovation or encourage business investment.

Example: If a country builds a high-speed rail network or improves education across the board, it's making long-run growth more likely.

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7.1 Economic growth

Gross Domestic Product (GDP)

What is Economic Growth and GDP

Let's think of GDP as your country's scoreboard. It tells us how much *stuff* (goods and services) a country is producing over a year. The more the country produces, the higher the score. It's a keyway to measure **economic growth**, which is just a fancy way of saying how much the country's output is growing over time.

- ***Definition: Economic growth - A long-term rise in an economy's productive capacity, leading to higher production of goods and services, typically measured by growth in real GDP.***

What is GDP?

GDP is the **value of all the goods and services** made in a country in one year. Imagine everything sold in shops, all the services like healthcare and teaching, and even the exports sent abroad – its all counted. It's also a way to compare how different countries are doing.

- **Total GDP**: This is the overall value of all the goods and services produced.
- **GDP per capita**: This is the value divided by the number of people in the country. Think of it as how much stuff each person gets, on average. If this grows, it means people are likely better off.

7.1 Economic growth

There are **two ways to measure GDP**:

1. **The Income Approach**:
   This adds up all the income earned from making the goods and services:
   - **Wages**: From workers' salaries.
   - **Rent**: From land or property.
   - **Interest**: From capital like loans or savings.
   - **Profits**: From businesses.
2. **The Expenditure Approach**:
   This adds up all the money spent in the economy:
   - **Consumption**: What households spend on things like groceries, clothes, Netflix subscriptions, etc.
   - **Government Spending**: Money spent on things like schools, roads, and hospitals.
   - **Investment**: What businesses spend on machinery, buildings, or tools.
   - **Net Exports**: Exports (stuff sold abroad) minus imports (stuff bought from abroad).

Both approaches should give the same number because one person's **spending** is another person's **income**. It's all connected.

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7.1 Economic growth

Gross Domestic Product (GDP)

Real GDP vs Nominal GDP

- **Nominal GDP**: Includes inflation, so prices might look bigger just because things are more expensive, not because there's more stuff.
- **Real GDP**: Strips away inflation to show the true growth in goods and services. It's like comparing apples to apples, not apples to super-expensive golden apples.

Value vs Volume of GDP

- **Value of GDP**: The actual monetary worth of all the goods and services produced.
- **Volume of GDP**: The total number of goods and services produced, stripped of price changes like inflation. It's the real stuff, not just the inflated cost.

So, if prices go up, the value of GDP may rise, but the volume might stay the same if the same amount of goods is produced.

7.1 Economic growth

Example: Cakes and Cookies Over Two Years

Year	Price per Cake (£)	Cakes sold	Prices per Cookies (£)	Cookies sold	Nominal GDP (£)	Real GDP (£)
2022	10	100	2	200	1,400	1,400
2023	12	120	2.5	220	2,010	1,780

1. **Nominal GDP**: Multiply the price of each product by the quantity sold and sum them up.
   - **For 2022:** (£10 × 100 cakes) + (£2 × 200 cookies) = £1,400.
   - **For 2023:** (£12 × 120 cakes) + (£2.50 × 220 cookies) = £2,010.
2. **Real GDP**: Use the first year's prices to calculate GDP for both years.
   - For 2023, adjust prices to 2022 levels: (£10 × 120 cakes) + (£2 × 220 cookies) = £1,780.

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Other national income measures

Let's talk about GDP (Gross Domestic Product). It's great for showing how much a country makes *within its borders*, but it doesn't tell the full story. Why? Because it ignores money made by citizens *outside* the country. Imagine your friend works abroad, sends money back home, but that cash doesn't show up in GDP.

That's where **Gross national income (GNI)** comes in. It's like GDP but cooler because it **includes income from citizens working abroad**. So, if someone from the UK is earning in Australia and sending money home, GNI counts that too.

Now, **GNP (Gross National Product)** takes things one step further. It's like saying, "Alright, let's include money sent **to** the UK by its citizens abroad and take away money sent **out** of the UK by non-residents." Clearer picture, right?

Finally, **GNP per capita** is even better because it divides GNP by the population. It's a more **realistic measure of wealth** – because it considers how much each person, on average, actually benefits from the country's income.

In summary

Think of it like pizza slices:

- **Nominal GDP** is the total pizza size.
- **Real GDP** is the same pizza without the "inflation toppings" you didn't ask for.
- **GDP per capita**? That's how many slices each person gets.
- **GNI/GNP per capita**? That's making sure you're counting the slices people earned, whether they baked the pizza at home or worked in a neighbour's pizzeria! 🍕

7.1 Economic growth

Comparing growth between countries

National income stats are like a global report card. They show us how countries are doing when it comes to **wealth**, **standard of living**, and whether governments are making good decisions. Here's how they help:

- You can compare countries across different eras or events. *Example:* Compare the rapid tech growth in South Korea over the last decade to the industrial boom in the UK during the 1800s.
- **Real GDP** - It's way better than nominal GDP because it removes inflation. *Example:* Imagine one country's economy is growing, but only because the price of bananas tripled. Real GDP looks past that banana inflation and tells the real story. 💪💰
- **Real GDP per person (GDP/capita) -** It's like dividing the country's wealth among its people to see how much each individual benefits. *Example:* A small country with 1 million people and a high GDP might be better off than a larger one with 100 million people and the same GDP.
- **Real GNI per person (GNI/capita)** - It checks how much money citizens are earning, even if they're working abroad. *Example:* If a lot of workers from India earn money in the Gulf and send it home, GNI shows how much income the country's citizens actually get.
- **Real GNP per person (GNP/capita)** zooms in on money earned **within the country**. *Example:* In Switzerland, you'd see the wealth generated from chocolate factories and banks staying in the country's economy. 🥤🏢

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Purchasing Power Parities (PPP)

Imagine PPP as your travel guide for money, it helps you compare what your currency can buy in different countries. It's like finding out how much of your currency is needed to buy the same good in different places, whether it's **GDP, GNI, or GNP** we're talking about.

- ***Definition: PPP – The exchange rate between two currencies that reflects the cost of living in different countries by comparing the price of a standard basket of goods.***

How Does PPP Work?

PPP shows how much money you'd need in one country to buy the same things as in another.

Example:

- A pair of trainers' costs **£50 in the UK**, but the same pair might cost **$150 in Australia**.
- PPP here would be **1:3**, meaning it costs 3 times as much in Australia in currency terms.

7.1 Economic growth

Purchasing Power Parities (PPP)

Why is PPP Useful?

It's the best tool to compare the **standard of living** between countries where prices for goods and services can be wildly different.

- A basket of groceries that costs **£110 in Thailand** might cost **£330 in the UK**. Here, PPP = 1:3.
    - This tells us the UK is more expensive.
    - BUT, if British works earn more than 3 times what people in Thailand earn, their standard of living might still be better.
    - On the flip side, if incomes in Thailand stretch further, it could mean they're living it up on less.

Breaking It Down:

- **High PPP** (like 1:3): Goods cost much more in one country compared to another.
- **Low PPP** (like 1:1): Things cost about the same, no matter where you are.

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Problems with comparing GDP between countries

Imagine if the economy grows by 8% in India, 4% in Nigeria, and 1% in France. At first glance, it might seem straightforward, but there's more to the story. These figures can hide significant differences because of several factors:

1. **Subsistence, Barter, and the Informal Economy**
   In many rural areas, people may grow their own food or trade goods and services without money. This activity isn't recorded in GDP. Similarly, informal work, like unregistered street vendors, flies under the radar. For example:
   - 10% of GDP in Germany may come from informal work.
   - 40% in Mexico.
   - Over 50% in Kenya.

This means GDP misses a big chunk of economic activity in some countries.

2. Currency Values

How do we compare the real value of money? Should we use the official exchange rate or consider how far a currency stretches in each country? For example, $10 might buy a simple meal in Canada but a week's worth of food in Cambodia. Using measures like purchasing power parity (PPP) can provide a fairer comparison.

3. Income Distribution

GDP per capita might look good, but is the wealth shared evenly? For instance, a tech billionaire in the USA skews the average, even if millions struggle to afford healthcare. A high GDP doesn't always reflect the reality for most citizens.

7.1 Economic growth

Problems with comparing GDP between countries

4. Size of the Public Sector

Some economies rely heavily on government spending, like Norway's public-funded healthcare and education. Meanwhile, in places like the Philippines, the public sector is much smaller, and most spending comes from individuals. Whether this spending improves welfare is not always clear.

5. Consumer vs. Capital Spending

If a country pours money into building high-speed rail networks (capital spending), it might boost future growth but won't immediately improve people's day-to-day lives. On the other hand, if the focus is on consumer spending (like buying cars or gadgets) GDP might grow, but long-term benefits could be limited.

6. Quality Issues

Spending on infrastructure like roads might be high, but are the roads actually usable? For instance, a country may build ten new hospitals, but if they lack staff or equipment, the quality of healthcare doesn't improve. Numbers alone don't tell the whole story.

National happiness

Let's talk about happiness, on a national scale. In the UK, the **Office for National Statistics (ONS)** measures how people feel about their lives, going beyond numbers like GDP.

While GDP is all about numbers, **national happiness** looks at the bigger picture, like **health, relationship status, employment status, the quality of housing, access to green spaces**, and how people feel about their daily commute.

Here's a twist: **GDP stats often paint a more positive picture**, but happiness surveys dive into how people *actually feel*. This makes happiness data more **normative** (focusing on what *should* be, not just what *is*).

There's also a famous idea called the **Easterlin Paradox** that explains how happiness links to income:

- More money *does* make people happier *but only up to a point*.
- Beyond that, extra cash doesn't always bring extra joy.
- In short, happiness isn't just about earning more, it's about living better.

7.1 Economic growth

National happiness

Continue to the next page…

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7.1 Economic growth

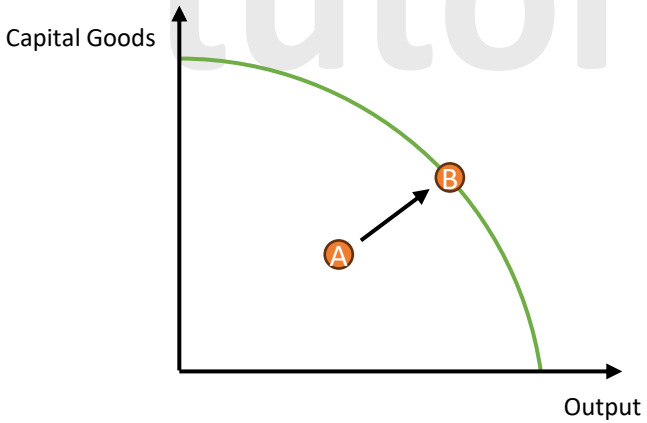
The difference between short-run and long-run growth – Diagrams

🍕 **Short-Run Economic Growth = Using What You've Got… Better**

This type of growth happens when we take resources we weren't using before (like unemployed workers or idle machines) and put them to work.

👉 Imagine you own a pizza shop, and you finally start using that second oven that's been gathering dust. You're not buying new equipment or expanding your shop, you're just **making better use of what you already have**.

🔍 **In economic terms**: This is like moving from **inside** the Production Possibility Curve (PPC), let's say from Point A to Point B. You're getting closer to your full potential.



7.1 Economic growth

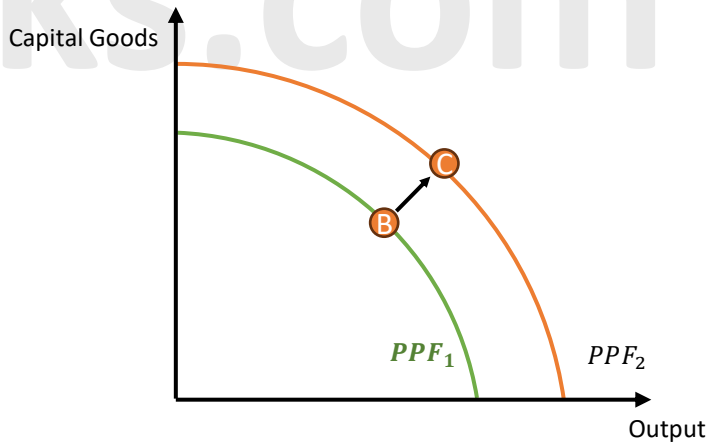
The difference between short-run and long-run growth – Diagrams

🏗️ **Long-Run Economic Growth = Growing Your Potential**

This is all about increasing your economy's capacity to produce more in the future.

👉 Back to the pizza shop; long-run growth would mean **building a bigger kitchen, hiring more staff, or inventing a new robot that makes pizzas faster.** You're not just working harder; you're expanding what you can do long-term.

🔍 **In economic terms**: This shows up as a **shift outward** of the PPC like going from Point B to Point C. It means the economy can now produce more goods and services overall.



The difference between short-run and long-run growth – Diagrams

As before, **Short-run growth** (also called **actual growth**) happens when an economy produces more using its current resources.

There are two main reasons this can happen:

1. 🔼 Increase in Aggregate Demand (AD)

Aggregate Demand is the total demand for goods and services in the economy at a given price level and time. When people, businesses, or the government spend more, AD increases.

Example: If the government lowers income tax, people have more money to spend. This extra spending boosts demand across shops, services, and industries, pushing economic growth in the short term.

2. 🛠️ Increase in Short-Run Aggregate Supply (SRAS)

Short-Run Aggregate Supply is the total amount of goods and services that firms are willing and able to produce in the short run, assuming some costs (like wages) are fixed.

Example: If energy prices fall suddenly, production becomes cheaper for businesses, so they make more stuff. That increase in supply helps grow the economy without changing long-term capacity.

🧠 Why AD is the Usual Suspect

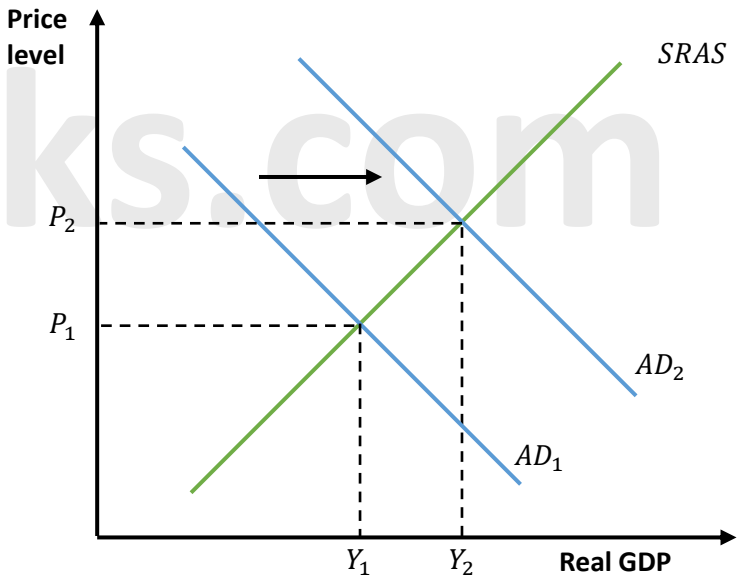
Although both AD and SRAS can drive short-run growth, it's usually **aggregate demand** that gets the credit and the headlines. Changes in consumer confidence, interest rates, government spending, or exports tend to affect demand more quickly and directly.

7.1 Economic growth

The difference between short-run and long-run growth – Diagrams

In the diagram, we see:

- A shift from **AD1 to AD2** = demand increases
- This moves the economy from **Y1 to Y2** = more output (aka growth)
- But it also leads to a higher **price level** (P1 to P2), so some inflation may come with that growth



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The difference between short-run and long-run growth – Diagrams

Long-run growth is all about expanding the economy's **productive capacity** basically, it's the economy levelling up so it can produce more stuff in the future, not just today.

This type of growth happens on the **supply side**, which means it's about improvements in how much we can produce, not just how much people want to buy. It's usually shown as a **rightward shift** in the **Long-Run Aggregate Supply (LRAS)** curve.

In simple terms: short-run growth = using existing resources better, long-run growth = getting better resources or more of them.

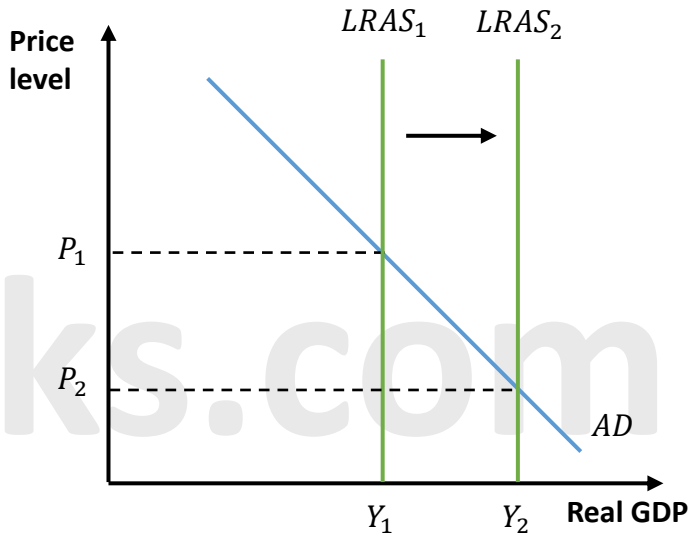
📈 **Graph Time**

In the diagram:

- **LRAS1 → LRAS2** shows the economy's capacity has increased
- More goods and services can be produced (GDP goes from Y1 to Y2)
- This growth isn't just a short-term burst, it's sustainable and long-lasting

7.1 Economic growth

The difference between short-run and long-run growth – Diagrams



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7.1 Economic 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.

7.1 Economic 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**).

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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.

7.1 Economic 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.

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7.1 Economic 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.

7.1 Economic 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! 🔥

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7.1 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).

7.1 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.

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7.1 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.

7.1 Economic growth

How does economic growth affect the environment?

Economic growth (when a country produces more goods and services) can be great for jobs and income, but it doesn't always come without a cost. One of the biggest downsides? **Environmental damage.**

A **negative externality** is a cost that affects people who aren't directly involved in an activity. Example: A factory makes more shoes (good for the economy) but also pumps out more smoke (not so great for nearby lungs).

When economies grow too fast, these side effects can pile up:

🗑️ **Too Much Waste**

Producing more stuff = more **waste**. And if countries don't have proper systems in place to deal with that (like recycling or clean energy), it can lead to serious pollution problems. 👉 Example: Factories dumping waste into rivers, or cities buried in plastic packaging.

🌲 **Overusing Nature's Resources**

More growth often means we're using more **natural resources,** things like forests, water, oil, and minerals. If we take too much, too quickly (called **overexploitation**), we can damage the environment in ways that are hard to reverse like chopping down forests faster than they can regrow or emptying rivers to water crops. 👉 Think: logging rainforests to meet rising furniture demand or draining aquifers for fast fashion cotton production.

🧬 **Long-Term Effects on Ecosystems and Health**

The damage from pollution, overuse of land, and poor waste management doesn't just disappear, it can harm entire **ecosystems** (interconnected plants, animals, and environments) and impact **public health** (especially air and water quality).

👉 Air pollution in cities like Delhi or Beijing is a classic case; the economy booms, but hospitals see more cases of asthma and lung disease.

7.1 Economic growth

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.

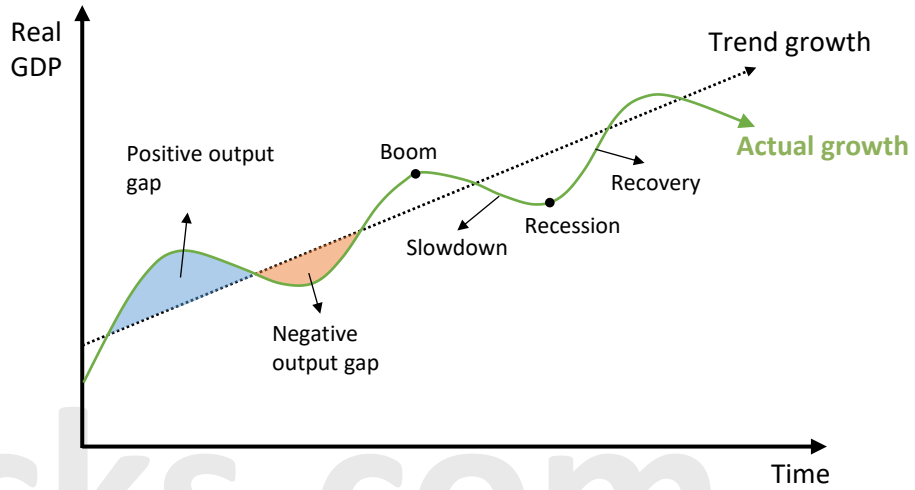
The output gap

✅ **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**.

7.1 Economic growth

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**.

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7.1 Economic growth

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.

7.1 Economic growth

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.

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7.1 Economic growth

The causes of changes in the various phases of the economic cycle

The ups and downs in economic growth might seem random, but there are actually several reasons why economies go through these **cycles**. Let's break them down:

🔁 **Multiplier–Accelerator Model**

Imagine this like a domino effect:

- A small increase in **investment** (like building new factories or buying machines) boosts **income**.
- That boost in income increases **spending**, which leads to more **investment**, and the cycle continues. This is the **multiplier** at work.
- At the same time, the **accelerator effect** says that when demand grows, firms invest even more to meet that demand.

Put the two together? A small change gets amplified into big economic swings, kind of like a snowball rolling downhill.

💥 **Asset Price Bubbles**

Ever seen housing prices skyrocket and then suddenly crash? That's a **bubble**.

- An **asset price bubble** happens when people keep buying things like houses or stocks just because prices are rising, not because the thing is actually worth more.
- They hope to sell it for profit later. But eventually, reality hits, the bubble "bursts", prices crash, and panic selling spreads.
- This leads to less spending (called the **wealth effect**) and can trigger a recession.

7.1 Economic growth

The causes of changes in the various phases of the economic cycle

🐒 **Animal Spirits (yes, really)**

A term coined by economist **John Maynard Keynes**:

- It means the emotions, instincts, and confidence of businesses and consumers.
- If everyone feels positive, they spend and invest more; boom!
- If everyone feels gloomy, even if interest rates are low, they might not spend; bust!
- So economic phases can be driven just by **how confident people feel**.

🐑 **Herding Behaviour**

This one's straight from behavioural economics:

- When people see others investing in property or stocks, they jump in too, not wanting to miss out (FOMO).
- Just like sheep following a herd, people may make decisions without thinking it through.
- This kind of behaviour fuels **bubbles** and crashes, especially when everyone tries to sell at once.

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7.1 Economic growth

The causes of changes in the various phases of the economic cycle

Excessive Growth in Credit

Credit = borrowing money to spend now and pay later.

- In good times, people borrow more to buy homes, cars, go on holidays.
- But if things take a turn, they still have to pay that debt back.
- That means **less money left to spend**, which can suddenly reduce demand and worsen a downturn.

Economic Shocks

These are unexpected events that shake things up and they can hit hard.

- Examples include oil price spikes, financial crises, pandemics (like COVID-19), or wars.
- They cause sudden shifts in **supply** or **demand**, leading the economy from one phase of the cycle to another.

7.1 Economic growth

The causes of changes in the various phases of the economic cycle

The Inventory Cycle

This is all about how businesses manage their **stock** (goods waiting to be sold):

- During slow times (like recessions), companies sell from their shelves instead of making new stuff. So, production drops more than sales.
- During good times (like a boom), they build up inventory for future sales which can cause a sudden rise in production.

These ups and downs in inventory levels can exaggerate the economic cycle.

7.2 Development

Economic Growth vs Development

The Primary sector

This is all about **extracting raw materials** directly from nature. Think farming, mining, fishing, or cutting down trees.

- **Example:** Wheat farming in Kansas or oil drilling in Saudi Arabia.
- A country with a big primary sector usually depends heavily on agriculture or natural resources.

The Secondary sector

This is where **raw materials are turned into products**. It's basically manufacturing and industry.

- **Example:** Turning cotton into T-shirts in Bangladesh, or steel into cars in Germany.
- Countries like **China and India** have huge secondary sectors, which means they rely heavily on manufacturing for their economies.

The Tertiary sector

This sector provides **services instead of goods**. Services can be anything from restaurants to banking to education.

- **Example:** Starbucks serving coffee or Apple running its App Store.
- Richer (developed) countries usually have large tertiary sectors because people spend more on services when their basic needs are met.

7.2 Development

Economic Growth vs Development

Economic Development

Economic development is more than just making money; it's about **improving people's lives**. It includes:

- Better living standards (higher incomes, access to healthcare).
- Longer life expectancy.
- More freedom and less oppression.

Development also asks: *is this growth sustainable? Will future generations be okay?*

Sustainability

Sustainability means using resources (like water, forests, oil) **wisely and efficiently**, so they don't run out for future generations.

- **Example:** Using renewable energy instead of burning coal, or recycling.

Sustainable vs Unsustainable Growth

- **Sustainable growth** = when today's economic growth can continue into the future without destroying the planet or running out of resources.
  - Example: Norway invests oil money into a sovereign wealth fund so future generations benefit.
- **Unsustainable growth** = growth today that causes problems tomorrow.
  - Example: If a country burns too much coal for fast growth, it pollutes the air and reduces health, making growth weaker later.
  - Another issue: if credit (borrowing) grows too fast, people spend more now but face a debt crisis later.

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The relationship between economic growth and sustainable development

The **Lewis Model** is an old but bold idea from economist W. Arthur Lewis. He said that most developing countries have what's called a **dual economy** which means two very different types of industries:

1. A **traditional agricultural sector** (think farms and villages) where people earn low wages, productivity is poor (not much gets produced), and savings are low.

2. A **modern industrial sector** (think factories and cities) where productivity and wages are higher, and there's more investment and urban development.

Lewis believed that **moving workers from farms to factories** would help boost **productivity** (how much people produce) and **income** (how much they earn). Why? Because factories and businesses tend to produce more value than small-scale farming.

So, the goal? Shift the economy from farming to industry, a process known as **structural transformation**.

Profits in Manufacturing

In factories, **entrepreneurs** (business owners) charge prices that are above what they pay workers.

- This creates **profits**, which (in theory) are reinvested into machinery, tools, and new technology (called **fixed capital**).

- Example: A textile factory reinvests profits into sewing machines to produce clothes faster.

Growth of Labour Demand

As factories become more productive (thanks to reinvestment), the **demand for labour increases**. Farmers who were underemployed can now get jobs in industry.

- Over time, this shift grows the **manufacturing sector** and transforms the economy from "traditional" (farming-based) to **industrialised** (factory-based).

7.2 Development

The relationship between economic growth and sustainable development

From Farms to Industry = Economic Growth

This process is seen as a key path for developing countries to grow richer.

- Example: **China** followed this path: millions of rural workers moved to cities to work in factories, boosting GDP and lifting millions out of poverty.

But Here's the Catch…

Reality doesn't always match theory:

- **Farming still needs people.** During harvest season, a lot of labour is still essential.

- Profits might not always be reinvested. Owners could spend money on luxury goods instead of machines.

- Investment in **capital (machines)** can replace labour. If machines do the work, fewer workers are needed → unemployment could rise.

- Moving from farm to factory isn't always easy. Skills, education, and even location can be barriers. A farmer in a remote village may not have the training (or transport) to work in a city factory.

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7.2 Development

Economic Growth vs Economic Development

- **Economic growth** means an increase in how much a country produces often measured by **real GDP** (Gross Domestic Product adjusted for inflation).
- **Economic development** means a country is getting better at meeting people's needs like longer life spans, access to clean water, better education, and higher incomes. It's not just about more money, but about **better lives**.

How Do We Measure It?

There are two main types of indicators:

Single Indicators – One Piece of the Puzzle

These focus on just **one aspect** of development, giving a limited snapshot.

For example:

- **Literacy rate** – What % of adults can read and write
- **Access to electricity** – How many people have reliable access to power
- **Average calorie intake per person** – Helps show whether people are getting enough food

Composite Indicators – A Bigger Picture

These combine **several indicators** into one score to give a more complete and balanced view of how developed a country is.

The most well-known is the **Human Development Index (HDI)**, which includes health, education, and income.

7.2 Development

Human Development Index (HDI)

The Human Development Index (HDI)

The HDI was created by the **United Nations (UN)** to give a more balanced picture of how developed a country is, not just by how rich it is, but by how healthy, educated, and fairly wealthy its people are.

It's based on 3 key areas:

1. Health

Measured by **life expectancy at birth** (how long people are expected to live).

Example: In 2021, life expectancy in **Japan** was around **84.8 years**, one of the highest in the world.
In **Sierra Leone**, it was around **60.6 years**.

2. Education

Measured using two things:

- The **average (mean)** years of schooling adults (age 25+) have completed
- The **expected years** a child entering school today is likely to complete

Example: A child in Germany might be expected to finish 14 years of schooling on average.

3. Income

Measured by **GNI (Gross National Income) per person**, adjusted for **purchasing power parity (PPP)**.
This tells us how much money people make on average, and what that money can actually buy in their country.

Example: In **Qatar**, GNI per capita is high — over **$55,000**.
In **Nepal**, it's much lower — closer to **$4,000**.

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Human Development Index (HDI)

⚖️ **How Is HDI Scored?**

Each of the three categories (health, education, and income) gets **equal importance**.

Countries receive a score between **0 and 1**:

- **Closer to 1** = higher development
- **Closer to 0** = lower development

HDI Score	Development Level	Example Country
Below 0.550	Low	**Chad** – 0.394
0.550–0.699	Medium	**India** – 0.633
0.700–0.799	High	**Brazil** – 0.754
0.800 and above	Very High	**Switzerland** – 0.962

7.2 Development

Pros and cons of using HDI

The **Human Development Index (HDI)** is a tool used to compare how developed different countries are. It uses three big indicators: health, education, and income.

Let's break down the pros and cons of using HDI to compare development:

✅ **Advantages of HDI**

- **It's a composite indicator** – That means it combines several factors (not just income!), which gives a fuller picture than using one stat on its own.

✏️ Example: Instead of just knowing how rich a country is, HDI tells us how healthy and educated its people are too.

- **It's used worldwide**, which means it's great for making **fair comparisons** between countries.

✏️ Example: You can compare Canada, Kenya, and Cambodia using the same scale.

- **It helps governments set goals.** If a country scores low on education, for example, it shows the government where to focus its efforts.
- **It helps people understand their quality of life**, not just how much money is floating around in the economy.
- It's **fairly simple to calculate**. Governments already collect most of the data needed, like life expectancy or school enrolment.

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Pros and cons of using HDI

❌ Limitations of HDI

- **It doesn't show inequality.** HDI uses average income (GNI per capita), so if a country has a few billionaires and lots of people in poverty, it won't show that gap.

✏️ Example: Two countries might have the same HDI, but one could have much worse income inequality.

- **It ignores poverty levels.** HDI doesn't tell us how many people are living in absolute poverty (struggling to afford basic needs) or in relative poverty (worse off than most others in their country).
- **Health scores don't show quality of life.** Just living longer doesn't always mean living better. Someone could live to 80 but in poor conditions or with bad healthcare access.
- **The data can be out of date.** Because it takes time to collect and report HDI data, it may not reflect **recent changes** like a new education policy or a health crisis.

✏️ Example: A country's 2023 HDI score might still be based on 2020 data.

- **Education stats don't measure learning.** Years in school say nothing about how good that education was. Someone might go to school for 10 years and still not be fully literate if the schooling was poor.

Other indicators of development

🔶 Other Composite Indicators

Composite indicators combine several indicators into one score, offering a more balanced view.

💡 IHDI – Inequality-Adjusted Human Development Index

The **IHDI** is like the regular HDI, but with a twist, it also looks at **inequality**. It adjusts a country's score based on how **fairly** health, education, and income are shared across the population.

- It uses something called the **Atkinson Index**, which reduces the HDI score if inequality is high.
- If **everyone is equal**, HDI and IHDI will be the same.
- But if there's a **big gap** between the rich and poor, IHDI will be **lower**.

✏️ **Example:**

- **Chile** has an HDI of **0.855**, but its IHDI drops to **0.731** once inequality is factored in, showing a **14.5% loss**.

7.2 Development

Other indicators of development

🌐 The Multidimensional Poverty Index (MPI)

The **MPI** measures the % of people who are **multidimensionally poor,** not just poor in income, but in **multiple aspects of life**.

It looks at **3 key dimensions** and **10 indicators**:

1. **Health** – child deaths, malnutrition
2. **Education** – years of school and whether kids are enrolled
3. **Living standards** – electricity, clean water, toilets, cooking fuel, flooring, and basic assets (like a fridge or bicycle)

✏️ Example: In **Burkina Faso**, over **55%** of people are classed as multidimensionally poor meaning they lack essentials in at least 3 or more areas.

✅ Great for spotting regions within countries where poverty is worst — even if the country's overall income looks okay.

🚫 But it can't be calculated for every country because **some data is missing**, and it **doesn't cover environmental issues**.

7.2 Development

Other indicators of development

🌍 The Genuine Progress Indicator (GPI)

The **GPI** is all about **sustainable development** — making sure today's progress doesn't harm tomorrow's future.

It's based on **26 indicators** across three big areas:

1. 💰 Economic –

Looks at how much people spend, unemployment rates, and income inequality.

2. 🌱 Environmental –

Tracks things like pollution, CO_2 emissions, destruction of forests, and the use of non-renewable resources.

3. 👥 Social –

Measures things like crime, time spent parenting, housework, and even the value of volunteering.

✏️ Example: A country may have high GDP growth but also high CO_2 emissions, deforestation, and rising crime. GPI would reflect that negatively.

🛑 Some critics say it's **anti-growth** because it often shows rich countries slowing down due to their environmental impact. Others say that proves growth isn't always sustainable.

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Characteristics of less developed economies (LDCs)

Less developed economies (sometimes called **developing countries**) are nations that haven't yet reached the high-income, high-standard-of-living stage of developed countries. While they vary in culture, size, and geography, they often share common traits:

1. Low GDP per capita

- **GDP per capita** = total value of goods/services produced ÷ population.
- In LDCs, this number is usually low, meaning people on average earn far less than in developed countries like the UK or Japan.
- Example: GDP per capita in Malawi is around a few hundred dollars per year, compared to over $40,000 in Germany.

2. Dependence on primary products

- Many rely heavily on exporting raw materials (like cocoa, coffee, or oil).
- Problem? Prices of these goods can swing wildly. If coffee prices crash, so do national incomes.

3. Fast population growth & young population

- Populations often grow quickly, and the **median age** (the age where half the population is younger and half older) is very low.
- Example: In Niger, the median age is about 15. This can be a challenge (more schools, jobs needed) but also an opportunity (a young workforce in future).

7.2 Development

Characteristics of less developed economies (LDCs)

4. Rural-based populations & agriculture-heavy jobs

- Many people live in the countryside and work in farming rather than industry or services.
- Example: In Ethiopia, agriculture employs around 65% of the workforce.

5. Large informal economy

- The **informal economy** = unregulated, untaxed jobs like street vendors, small-scale traders, or cash-in-hand work.
- While it provides livelihoods, it reduces government tax revenue and often lacks worker protections.

6. Weak infrastructure

- Roads, electricity, clean water, and internet access are often limited.
- Example: Frequent power cuts in Nigeria make it harder for businesses to grow.

7. Poorly developed financial markets

- Banks and stock markets are often underdeveloped. This makes it harder for people and businesses to borrow money and invest.
- Imagine trying to start a business but no one will give you a loan; that's a big barrier to growth.

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7.2 Development

Factors that affect growth and development

For an economy to **develop**, it's not enough to just grow quickly; that growth has to be **sustainable** (able to continue into the future). Economists often explain this using the **PPC (Production Possibility Curve)**, which shows the maximum output an economy can produce with its resources. Development happens when the PPC shifts outward *and* when the benefits of growth actually improve people's lives.

Here are two of the biggest factors:

1 Investment 💰

- **Definition**: Investment means spending on things that will boost future production, like roads, schools, hospitals, or technology.
- This helps in the **short run** (creating jobs during construction, for example) and the **long run** (making businesses more efficient and improving living standards).
- Example: Building new transport links (like railways in India or new highways in Kenya) reduces costs for businesses and makes it easier for people to access jobs and markets.
- This kind of investment is usually *more useful for development* than, say, military spending, which doesn't directly raise productivity or improve living standards.

7.2 Development

Factors that affect growth and development

2 Education and Training 🎓

- **Definition**: Education increases a country's **human capital;** the skills, knowledge, and abilities of its people.
- Training makes workers more **employable** (e.g. teaching digital skills so people can work in IT) and boosts **productivity** (workers produce more in the same time).
- Example: In South Korea, massive investments in education after the 1960s transformed the economy from being mostly agricultural to a global tech leader.
- This not only helps short-run growth (more skilled workers → more jobs filled) but also long-run growth (an economy with a smarter, more flexible workforce can adapt and innovate).

7.2 Development

Barriers to growth and development

Even if a country invests in **education** and **infrastructure**, it may still struggle to develop. Why? Because there are plenty of **barriers** (obstacles) that hold economies back.

1 Corruption

- **Definition**: Corruption is the abuse of power for personal gain (like bribery).
- It makes a country unattractive for **FDI (Foreign Direct Investment)** because businesses can't rely on fair treatment.
- Example: If a company has to bribe officials just to get electricity connected, they may simply choose to invest elsewhere.

2 Poor Infrastructure

- **Definition**: Infrastructure means the basic systems needed for an economy to function like roads, electricity, internet, and ports.
- Without good infrastructure, businesses can't operate efficiently. Imagine trying to run an online company without reliable internet.
- Example: Some African countries face frequent power outages, which discourage investment from multinational corporations (MNCs).

3 Weak Human Capital

- **Definition**: Human capital = the skills, education, and health of the workforce.
- If people don't have proper education or training, they can't fill the jobs businesses need.
- Example: Tech companies might avoid countries without enough skilled software engineers.

7.2 Development

Barriers to growth and development

4 Lack of Property Rights

- **Definition**: Property rights mean legal protection for ownership of land, assets, and ideas.
- Without strong property rights, investors fear their businesses or profits could be taken away.
- Example: In countries where land can be seized without fair compensation, farmers or businesses hesitate to invest.

5 Institutional Weakness

- **Definition**: Institutions are the "rules of the game"; stable governments, courts, healthcare, and education systems.
- Without them, development is nearly impossible.
- Example: War-torn countries often struggle to grow because there's no political stability to attract investors.

6 Undeveloped Financial System

- **Definition**: A financial system includes banks, stock markets, and credit institutions.
- If it's weak, businesses can't get loans to start or expand.
- Example: A farmer who wants to buy modern equipment may struggle if banks don't offer credit in rural areas.

7 Primary Product Dependency

- **Definition**: Relying heavily on one product (like oil, cocoa, or coffee) for exports.
- Problem? Commodity prices swing a lot; if prices drop, the whole economy suffers.
- Example: Venezuela relied heavily on oil. When oil prices collapsed, so did government revenues.

8 Volatile Commodity Earnings

- Exports like oil, copper, or coffee can fluctuate wildly in price. This makes it very hard for governments to plan budgets or provide stable public services.

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Policies to promote economic growth and development - Market-orientated strategies

Market-oriented strategies are policies that let private individuals and businesses take the lead in growing the economy. The idea is to create the right conditions where people can trade, invest, produce, and compete, all with the goal of making profits and boosting growth.

Here are some key strategies:

🌎 **1. Trade Liberalisation**

This means opening up your country to international trade by removing things like tariffs (taxes on imports) or quotas (limits on how much you can import). It encourages countries to specialise in what they're good at (comparative advantage), and trade for the rest.

📌 *Example:* When Vietnam opened up to international trade, it became one of the world's top coffee exporters, lifting millions out of poverty.

💸 **2. Foreign Direct Investment (FDI)**

FDI happens when a business from one country invests in a business in another. This could mean building a factory, buying a company, or forming a partnership.

FDI can create jobs, bring in new technology and skills and boost wages and incomes

📌 *Example:* Toyota's investment in car manufacturing in South Africa has helped boost jobs and industrial capacity.

BUT – there can be downsides:

- Profits are often sent back to the foreign company's home country (repatriation).
- Local businesses may struggle to compete.
- Jobs offered are often low-paid.

7.2 Development

Policies to promote economic growth and development - Market-orientated strategies

🚫 **3. Removing Government Subsidies**

Subsidies are government payments that make things like food or fuel cheaper. While they sound helpful, they can cause problems:

- They're expensive for governments.
- They often help everyone, not just those who need it.
- They can create inefficiencies if companies rely on them for too long.

Removing them encourages businesses to compete fairly and become more efficient. It can lead to better productivity and reduce government spending.

📌 *Example:* In 2015, India reduced its fuel subsidies to lower its budget deficit and encourage cleaner energy use.

💱 **4. Floating Exchange Rate Systems**

This is when a country lets its currency value be decided by the market (supply and demand), rather than setting a fixed rate. This means:

- No need for government to use gold or foreign reserves to manage the exchange rate.
- It adjusts automatically to economic changes.

A strong currency can make imports cheaper, lowering production costs and raising income.

But it's not perfect:

- Exchange rates can be volatile (unstable).
- This can make it hard for exporters/importers to plan.

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Policies to promote economic growth and development - Market-orientated strategies

💰 5. Microfinance

Microfinance gives small loans to people (especially women) who can't get traditional bank loans. It helps them start small businesses, invest in farming or trade and break the cycle of poverty

📌 *Example:* In Kenya, mobile banking like M-Pesa has helped farmers access small loans and improve their livelihoods.

⚠️ However, in places like **South Africa**, some people borrow to spend on daily needs rather than invest. This can lead to more debt and little real development.

🔄 6. Privatisation

Privatisation is when the government sells off state-owned businesses to private companies. The idea is that private companies are more efficient and profit-driven.

Privatisation can:

- Improve services
- Increase competition
- Raise money for governments

📌 *Example:* In the UK, the privatisation of British Airways made the airline more profitable and improved customer service.

7.2 Development

Policies to promote economic growth and development - Market-orientated strategies

⚠️ Watch out:

- If a private company becomes a monopoly, competition disappears.
- There's a risk of corruption, for example, selling public companies to friends or for cheap prices.
- Jobs and services may suffer if the company only focuses on profits.

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Policies to promote economic growth and development - Interventionist strategies

Sometimes, the free market doesn't work perfectly, and governments have to step in. These strategies are called **interventionist strategies** where the goal is to boost economic growth, reduce inequality, and help citizens live better lives.

🎓 **1. Development of Human Capital**

Human capital refers to the skills, knowledge, and health people have, which help them to be more productive.

Governments can invest in human capital through:

- Better schools, colleges, and universities.
- Job training programmes.
- Vocational skills, like apprenticeships for plumbers or digital bootcamps for coders.

More skilled workers = more innovation, better quality products, and faster economic growth.
For example, **Vietnam** has invested a lot in education and technical training to become a tech and manufacturing hub.

It also helps countries move away from relying on just raw materials (like crops or minerals) and grow industries like manufacturing or services instead.

7.2 Development

Policies to promote economic growth and development - Interventionist strategies

🛡️ **2. Protectionism**

This is when a country puts up barriers (like tariffs or quotas) to protect its local businesses from foreign competition.

- It helps **young industries** (called "infant industries") survive and grow.
- Can create jobs locally in the short term.
- Protects wage levels and jobs. If not, cheap imports might force local businesses to close or slash wages.

But, if protection lasts too long, companies might become **lazy** (less efficient), prices go up, and other countries might retaliate by putting tariffs on your exports.

Example: In 2025, the U.S. put tariffs on steel imports to protect its local steel producers.

💱 **3. Managed Exchange Rates**

Instead of letting the value of a country's currency float freely, governments sometimes **control the exchange rate**. They might fix the currency or buy/sell it to influence its value.

Why do this?

- A cheaper currency = cheaper exports, which boosts sales abroad.
- If a currency gets too strong, exports become more expensive, which can hurt businesses.
- A more stable currency = businesses find it easier to plan and trade.

But managing exchange rates can be tricky and lead to **black markets** or even **corruption** if not done transparently.

Policies to promote economic growth and development - Interventionist strategies

4. Infrastructure Development

Infrastructure = all the basic physical systems needed for a country to work properly (e.g., roads, electricity, internet, schools, hospitals).

Good infrastructure:

- Attracts foreign investors.
- Makes it easier for people and goods to move around.
- Increases productivity.

Example: Ethiopia's investments in railways and power plants are helping it grow faster.

But infrastructure projects can be expensive and vulnerable to corruption. Some experts suggest using **intermediate technology** (like local materials and tools) instead of big flashy projects.

5. Joint Ventures with Global Companies

In some countries, foreign companies aren't allowed to fully own local businesses. So, they team up with local firms (called **joint ventures)** to get around this.

Joint ventures share profits and risks and can bring in new skills, tech, and jobs.

This way foreign companies can still invest (even if full ownership is banned), local workers get jobs and training and more of the profits stay in the country.

Example: Starbucks teamed up with India's Tata Group to open stores in India, a win-win.

7.2 Development

Policies to promote economic growth and development - Interventionist strategies

6. Buffer Stocks

A buffer stock scheme is when the government tries to keep the prices of essential goods stable by stepping in to buy or sell those goods at the right time. It's like having an emergency supply cupboard for the economy.

How It Works:

- The government sets a **minimum price** and a **maximum price** for a product (usually a **commodity** like rice, coffee, or cocoa).
- If there's too much supply (and prices fall), the government **buys the extra stock** to stop prices crashing.
- If there's a shortage (and prices rise too high), the government **sells from its stockpile** to bring prices down.
- This helps keep prices within a "safe zone", not too high, not too low.

The idea is that the scheme should be **self-financing** meaning the money the government makes from selling stock when prices are high is used to buy more stock when prices fall.

Why Use It?

- It **stabilises prices**, which is super helpful for farmers and producers who rely on predictable income.
- It prevents sharp drops in price, which could push small producers into **poverty**.
- It protects consumers from soaring prices, which helps make food and essential items **more affordable**.

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Policies to promote economic growth and development - Interventionist strategies

6. Buffer Stocks

- It also encourages investment because producers can plan for the long term.
- It's a useful tool for countries that rely heavily on selling raw materials (this is called **primary product dependency**).

The Challenges:

- Prices must go up and down to work. If they only fall or only rise, the system breaks.
- It can be **expensive to run. Y**ou need money to buy stock, storage space to keep it, and systems to manage it all.
- If lots of countries benefit from price stability but don't take part in the scheme, they're called **free riders** and this can make some governments less willing to join.
- If the government sets the **minimum price too high**, farmers might overproduce, knowing the government will buy everything. This leads to **waste and inefficiency**.

7.2 Development

Policies to promote economic growth and development - Interventionist strategies

Continue to the next page…

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The role of aid and trade

For poorer countries (often called **less developed economies**), finding money to build roads, schools, hospitals, and businesses is tough. Two big ways they can get support are through **trade** and **aid**. But which is better? Economists are divided.

Trade

Definition: Trade means countries exchanging goods and services with each other.

- If countries specialise in industries where they have a **comparative advantage** (i.e. they're relatively more efficient at producing something compared to others), everyone can benefit.
- Example: Ethiopia specialises in coffee, while Germany focuses on cars. If they trade, both countries win.

But here's the catch:

- Developed countries sometimes protect their own industries (e.g. through tariffs or subsidies).
- Example: The EU has been criticised for subsidising its farmers, making it harder for African farmers to compete with their cheaper products.

Aid

Definition: Aid is money, goods, or services given by rich (developed) countries to poor (developing) countries, usually to help with growth or emergencies.

Types of Aid:

- **Money**: Can be unconditional (a free gift) or conditional (must be used in a certain way).
    - Example: A "soft loan"; a loan with very low interest.
- **Goods and services**: Often for emergencies, like food during famine, medicine during a pandemic, or tents during a natural disaster.

7.2 Development

The role of aid and trade

Benefits of Aid:

- Can build roads, schools, or hospitals.
- Can support social programmes like education and health.

Problems with Aid

- Money can be stolen by corrupt governments and never reach the people who need it.
- Countries may spend aid poorly like building "white elephant" projects (flashy airports or roads that nobody uses).
- Sometimes, aid doesn't match local needs. For example, sending wheat to a rice-eating country might not help much.
- Aid might come with strings attached, e.g. "You can have this money, but you must buy our country's products with it."

Conclusion

The truth? Both aid *and* trade can help but they work best when:

- Aid is given with few conditions, so governments can use it for what's really needed.
- Trade focuses on goods that are in demand (and less price-sensitive), so developing countries can actually compete globally.

Debt relief (cancelling or restructuring debt repayments) can also help poor countries breathe easier. But critics warn it may let corrupt governments off the hook, allowing them to stay in power without fixing deeper problems.

In short: aid is useful, trade is powerful, and the best results usually come from a mix of both.

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The role of debt relief

💰 **6. Debt Relief**

Debt relief means cancelling or reducing the money a country owes often because it just can't afford to pay it back without harming its economy and people.

Why is this important?

- Many developing countries owe huge sums of money and pay **high interest** on those loans. That means a big chunk of their budgets goes to debt repayments instead of vital things like schools, hospitals, and clean water.
    - 📌 *For example, in the early 2000s, debt repayments took up around 30% of government spending in countries like Mozambique.*
- Cancelling some of this debt means **governments can finally invest** in public services and infrastructure that improve people's lives.

Benefits:

- **More money for development** – Without the weight of debt, countries can spend more on building roads, paying teachers, and providing clean water.
- **Improves stability** – Less financial stress can make governments stronger and more effective.

7.2 Development

The role of debt relief

But there's a catch: Moral Hazard

Moral hazard happens when someone behaves recklessly because they know they'll be bailed out. In this case, if countries believe their debt will just be written off, they might:

- Keep borrowing irresponsibly
- Avoid making tough reforms (like fixing corruption or improving tax collection)
- Depend on aid and not take responsibility for their finances

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7.3 Employment

Unemployment: This is the **number of people** who *want* a job, are **able to work**, but currently **don't have one**.

- **Level of unemployment**: The **total number** of unemployed people.
- **Rate of unemployment**: This shows the **percentage** of the workforce that's unemployed.

Employment: This is the **proportion of people** in work compared to the **total workforce**.

The Workforce: Everyone of **working age** who is either **working** or **ready and able to work** (so it includes both the employed and unemployed).

Measures of unemployment

In the UK, **unemployment** is measured in two main ways:

1) The Claimant Count

What is it? A count of people claiming **Jobseeker's Allowance (JSA)** or **Universal Credit** because they're unemployed.

How does it work?

- Only includes those **eligible** for benefits.
- Claimants must meet **strict requirements**, like attending meetings with a **work coach**.

7.3 Employment

Measures of unemployment

2) The International Labour Organisation (ILO) and the UK Labour Force Survey

The **International Labour Organisation (ILO)**, used by the **Office of National Statistics (ONS)**, defines people over the age of 16 as either **employed**, **unemployed**, or **inactive**. Let's break it down:

a) Employed

- You're **working at least 1 hour a week** for pay or profit.
- Includes people on **holiday**, in **training schemes**, or doing **unpaid family work** (15+ hours).

b) Unemployed

- You're not working but are:
  - **Actively looking for work** in the past 4 weeks.
  - Available to **start work within 2 weeks**.

c) Inactive

- You're not working and **not looking for work**.
- Includes students, carers, retirees, those with health issues, or people **discouraged from applying**.

Labour Force Survey (LFS)

- A **sample survey** of households to classify people as employed, unemployed, or inactive.
- It's used in every EU country and gives an **estimate** of unemployment since it relies on a representative **sample**.

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The distinction between unemployment and under-employment

Unemployment refers to people who are not working but are actively looking for a job and are ready to work. **Underemployment**, on the other hand, means people have jobs but aren't working to their full potential. Let's break it down:

Underemployment:

What does it mean?
You're underemployed if:

- You **want more hours** than you're currently working (e.g., doing part-time work when you want a full-time role).
- You're **overqualified** for your job (e.g., a trained accountant working as a cashier).

Why Does Underemployment Happen?

- During **economic downturns (recession)** when jobs are scarce. People may settle for part-time jobs or roles outside their usual skill set just to make ends meet.
- When industries change or technology evolves, and workers' **skills become outdated**. Without retraining or gaining **new skills**, it's tough to find a job that matches their qualifications.

Impact on the Economy:

While underemployment isn't as bad as full unemployment, it still hurts. With less money to spend, the underemployed reduce their consumption, which leads to lower **aggregate demand** (the total demand in the economy) and slower economic growth.

7.3 Employment

Voluntary and involuntary unemployment

Let's talk about two very different reasons why someone might be out of work...

😔 **Involuntary Unemployment**

This happens when people want a job, are ready to work at the going wage, but **there just aren't any jobs available**.

- These folks are actively looking for work, but the economy isn't offering any.
- It's common during **recessions**, **economic slowdowns**, or when industries shrink or change like coal miners losing jobs due to a shift toward renewable energy.
- Think: "I'm trying my best, but no one's hiring!"

😌 **Voluntary Unemployment**

Here, people are unemployed because they've **chosen** not to take the jobs on offer.

- They're saying "no thanks" to current job opportunities, maybe because the pay is too low, or they're holding out for something better.
- Some might be taking a **gap year**, travelling, or switching careers.
- Think: "I could work, but I'd rather wait for a better gig (or go backpacking in Thailand)."

🔁 **In short**:

- **Involuntary = No job even though you want one**
- **Voluntary = You're out of work by choice**

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7.3 Employment

Types of unemployment

1. Seasonal Unemployment

- Some jobs are tied to seasons-like tourism or farming. For example, a strawberry picker is busy during the summer harvest but out of work the rest of the year.

2. Frictional Unemployment

This happens when people are **between jobs**-maybe they've left a job to find a better one or are fresh graduates entering the workforce. It's a **short-term problem.**

3. Structural Unemployment

This is more serious and long-term. It happens when industries decline, or new technology makes some jobs obsolete.
Key types include:

- **Technological Unemployment:** Robots and machines replace workers (e.g., self-checkout tills).
  Workers often need retraining to get back into the game.
- **Regional Unemployment:** Certain areas are hit harder, like when a factory closes in a small town.
- **Sectoral Unemployment:** Entire sectors (e.g., coal mining) lose jobs as demand falls.

4. Cyclical Unemployment

- This happens when the **economy slows down**. For example, during a recession, a furniture company may close shops because fewer people can afford new sofas. With falling demand, jobs are cut, leading to unemployment. It's also called **demand-deficient unemployment** because less spending = fewer jobs.

7.3 Employment

Understanding unemployment: Demand-side and supply-side causes

Not all unemployment is created equal. Some happens because people just aren't buying stuff (demand-side), while other times, it's more about the economy not working efficiently (supply-side).

📉 **Demand-Side Factors**

This is all about **aggregate demand** (the total spending in an economy).

- If demand for goods and services drops (like during a recession), businesses sell less and may lay off workers.
- This leads to **cyclical unemployment**, which follows the ups and downs of the economy.
- **Example**: During the 2008 financial crisis, people spent less, so companies downsized not because workers lacked skills, but because there wasn't enough demand.

Think of it as:
🛍️ Fewer shoppers → 🏭 Less production → 👷 Fewer jobs

🛠️ **Supply-Side Factors**

This is about how well the economy can produce goods and services over time also called **long-term aggregate supply**.

These factors cause:

- **Frictional unemployment**: When people are between jobs or just entering the workforce. *Example: A uni grad taking time to find their first job.*
- **Structural unemployment**: When workers' skills no longer match what employers need. *Example: A factory worker being replaced by automation and needing retraining.*

These are linked to deeper issues in the economy, like outdated skills, lack of training, or regional job mismatches.

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Understanding unemployment: Demand-side and supply-side causes

🎯 **So, what's the solution?**

Governments typically tackle unemployment with a **mix of demand-side and supply-side policies**:

- Boosting spending when demand is low.
- Improving education, training, and infrastructure to raise supply-side potential.

7.3 Employment

Diagrammatic analysis of labour market equilibrium

In the labour market, there's a sweet spot where things just balance out. This is called **labour market equilibrium**. It's the point where the number of people that **firms want to hire** (called the **demand for labour**) is exactly the same as the number of people who **want to work** (known as the **supply of labour**).

Here's how it works:

- The **demand for labour (D)** comes from businesses looking for workers. Think of a cafe hiring baristas or a game company looking for developers.
- The **supply of labour (S)** comes from people who are willing to work those jobs.

This perfect balance means no one is left unemployed *because* there are too many workers, and no jobs are left unfilled *because* there aren't enough workers.

What About Wages?

In a competitive labour market, firms are what we call **price takers**. That means they can't just decide to pay workers whatever they want. They have to go with the going wage, or they risk:

- **Paying too little**, and no one wants to work for them.
- **Offering too much**, and they get flooded with job applications.

At the **equilibrium wage rate**, everything's just right. Let's say, for example, in the software developer market:

- The **equilibrium wage** is **£W**
- The **number of developers employed** is **Q**

At this point, everyone wins. There's:

- **No excess supply** which means no group of developers is standing around with no jobs.
- **No excess demand** so companies aren't scrambling to fill positions either.

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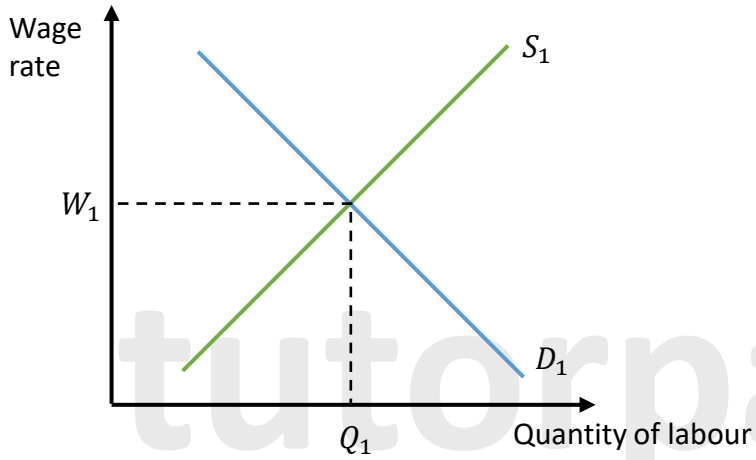
Diagrammatic analysis of labour market equilibrium

The diagram:



The graph you see shows two curves:

- The S_1 **line (supply of labour)** slopes upward. The higher the wage, the more people want to work.
- The D_1 **line (demand for labour)** slopes downward. As wages go up, companies want to hire fewer people because it costs more.
- They meet in the middle at point W_1Q_1. That's your **equilibrium**.

7.3 Employment

Real wage unemployment

Real wage unemployment happens when wages are set **too high** (higher than what the job market can handle) and it creates a mismatch between the number of people looking for jobs and the number of jobs available.

🧠 **A quick definition:**

- **Real wage**: The wage a worker earns adjusted for inflation, basically, what your pay can actually buy.
- **Unemployment**: When people who want to work at current wages can't find a job.

👷 **How does this happen?**

Let's say the government introduces a **high minimum wage**. That sounds good for workers, right? But if the wage is **above the level that balances supply and demand** in the job market, employers may not be able to afford as many workers.

- At a **lower wage (W_1)**, the number of people wanting to work (labour supply) equals the number of jobs available (labour demand) → equilibrium.
- But at a **higher wage (W_2)**, more people want jobs, but fewer jobs are available → causing **unemployment**.

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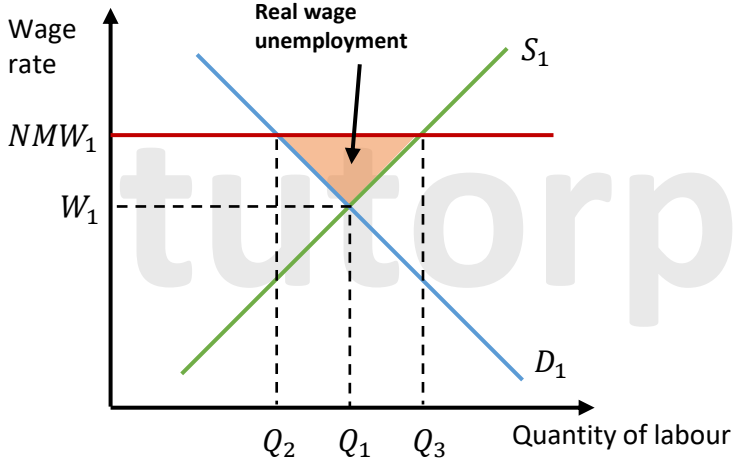
Real wage unemployment

📊 In the diagram:

- At wage W_1 → demand = supply at Q_1.
- At wage NMW_1 → supply = Q_3, demand = Q_2.
- The difference ($Q_3 – Q_2$) = **real wage unemployment**.



🧪 **Real-World Example:**

Imagine a small business like a local café. If the minimum wage goes up a lot, they might only afford to hire two baristas instead of four. That means two people who want the job at the new higher wage won't be hired, even if they're ready and willing to work.

7.3 Employment

The natural rate of unemployment

Even when the economy is doing well and the job market seems "in balance", there will always be **some** unemployment. This is totally normal and is known as the **natural rate of unemployment**.

This unemployment usually includes:

- People who **choose** not to work right now (e.g. job-hopping or taking a break)
- People who can't find a job that suits their **skills or location**

Let's look at the two main causes:

🔁 **Frictional (Voluntary) Factors**

Frictional unemployment happens when people are **between jobs** or just entering the job market (like recent graduates). It's often short-term.

One big influence here is something called the **replacement ratio**, which is:

Replacement Ratio = (Benefits received out of work) ÷ (Income in work)

If this ratio is high (close to 1 or even higher), it means people earn almost the same from benefits as they would from working, which might discourage them from taking up jobs.

✅ Things that can reduce frictional unemployment:

- Cutting back on generous unemployment benefits
- Raising the **minimum wage**
- Offering **tax credits** to low-income workers
- Lowering income taxes so work feels more rewarding

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The natural rate of unemployment

🏭 **Structural Factors**

Structural unemployment is a bit trickier. It happens when there's a **mismatch** between a worker's skills/location and the available jobs.

For example:

- A coal miner may struggle to find work in a city full of tech companies
- Someone in a rural area might not want to move cities even though jobs are available there

👷 Solutions? Better **training** and **education** to help people shift into growing industries.

🌍 **The Natural Rate of Unemployment and Aggregate Supply**

The terms **"full employment"** and **"natural rate of unemployment"** are often used to mean the same thing.

Here's the key idea:
At the natural rate, the economy is working efficiently, and unemployment is as low as it can go **without causing inflation**.

This level usually lines up with the **long-run aggregate supply** (LRAS) (the point where the economy is producing all it sustainably can).

🧠 What this means in real life:

7.3 Employment

The natural rate of unemployment

- Trying to lower unemployment **too much** with demand-side policies (like boosting government spending or cutting interest rates) may just push up **inflation**
- To go further, governments need to use **supply-side policies** like improving education, retraining workers, or encouraging business investment

The effects of unemployment

Unemployment, especially when it lasts a long time, can be incredibly harmful, not just for individuals, but for businesses, the government, and the economy as a whole.

Impact on Individuals

- **Loss of income**: No job means no paycheck, which can make life really tough.
- **Mental and physical health issues**: Stress from unemployment can lead to anxiety, depression, and even physical health problems.
- **Family strain**: Relationships can suffer due to financial pressure, leading to marital problems.
- **Low self-esteem**: People may feel a sense of failure or lose confidence in their abilities.

Impact on Businesses (Firms)

- **Loss of sales**: If people don't have jobs, they spend less, which means lower revenue for businesses.
- **Less production**: Without enough workers, firms can't produce as much, slowing the economy.
- **Skills drain**: Over time, workers lose their skills, making it harder for businesses to find qualified staff.

7.3 Employment

The effects of unemployment

Impact on the Government

- **Higher costs**: The government spends more on unemployment benefits and retraining schemes.
- **Lower tax revenue**: With fewer people earning wages, there's less income tax coming in.
- **Budget pressure**: The government has to juggle spending while dealing with a weaker economy.

Impact on Society/Economy

- **Homelessness**: Without income, more people lose their homes, putting pressure on social services.
- **Increased crime**: Financial struggles can lead to higher crime rates and vandalism.
- **Antisocial behaviour**: Communities can feel the strain as unemployment rises.

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7.3 Employment

The effects of full employment

Full employment is when almost everyone who wants a job can get one, and all the resources in the economy (like land, labour, and capital) are being used to their maximum potential.

Note: It doesn't mean *literally 0% unemployment;* there will always be some people between jobs (frictional unemployment) or switching careers.

The Main Effects

- **Maximum output**
  - When everyone is working, the economy produces as much as it possibly can. Think of it like a football team where every player is on the pitch and giving 100%.
- **Rising prices (inflation risk)**
  - If demand in the economy is high (because more people have wages to spend), it can push up prices → this is called **demand-pull inflation**.
  - Example: If almost everyone has a job and wants to buy new cars, car prices might rise because demand is greater than supply.
- **Wage inflation**
  - With fewer unemployed workers, firms may need to offer higher wages to attract staff. That raises costs of production for businesses, which can also push prices up.
  - Example: In the tech industry, firms sometimes offer big salaries and perks to secure scarce software developers.

7.3 Employment

The effects of full employment

- **Confidence boost**
  - Both consumers and firms feel more confident when resources are fully used.
  - Example: Businesses are more likely to invest in new factories or products if they see a strong, fully-employed economy. This supports long-term, sustainable growth.
- **Better government finances**
  - More people working = more people paying taxes.
  - At the same time, the government spends less on welfare benefits like unemployment support.
  - Result: A healthier government budget, which can be spent on schools, hospitals, or infrastructure instead.
- **Social benefits**
  - Crime rates might fall if more people have jobs and steady incomes.
  - Standards of living usually improve because households have more **disposable income** (the money left after paying taxes and essentials).
  - Inequality and poverty may decline as more people are lifted into stable work.

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7.4 Inflation

Inflation, deflation, disinflation and hyperinflation

Inflation

This is when prices **keep going up** across the economy, it's not just one or two things getting more expensive. Imagine a "basket of goods" filled with things you buy every month, like bread, milk, and shampoo. The average price of this basket is tracked using something fancy called the **Consumer Price Index (CPI)**.

For example, last year, a bread cost £1.04, and now it's £1.40. That's inflation in action. In the UK, the government tries to keep inflation steady at around **2% per year**, because a little inflation means the economy is growing.

Deflation

This is the opposite: prices **fall** across the economy. Sounds good, right? Not always. If prices drop too much, people might stop spending because they expect things to get even cheaper, which can harm businesses and jobs. Deflation happens when the **percentage change in prices goes below zero**.

Disinflation

Don't confuse this with deflation! Disinflation means prices are **still rising**, just **not as fast as before**.

For example:

- Year 1: Gym memberships go up by 10%.
- Year 2: They increase by 6%.
- Year 3: The rise slows to 3%.

Prices are still climbing, but the pace is relaxing, like a jog slowing down to a brisk walk.

7.4 Inflation

Inflation, deflation, disinflation and hyperinflation

Hyperinflation

Hyperinflation is when prices rise **extremely quickly** and keep accelerating, to the point where money loses its value and the economy spins out of control.

In normal inflation, prices rise a little each year (say 2–3%), which is healthy for an economy. But in **hyperinflation**, prices can rise by **hundreds or even thousands of percent per year** sometimes even per month or day.

Venezuela (2010s): Prices skyrocketed so fast that many shops started refusing the local currency, preferring dollars or even barter trade.

Understanding inflation is like solving a fun little puzzle using percentages, here's how it works:

Example 1:

If inflation is 20%, what will £300 worth of goods in Year 1 cost in Year 2?

Here's the process:

1. Add the 20% inflation to the original price.
2. So, 120% of £300 = **£360**.

By Year 2, those £300 goods will cost **£360**. 🛒

Example 2:

If inflation is 25%, what will £800 worth of goods in Year 2 have cost in Year 1?

Let's work backwards this time:

1. £800 is 125% of the original price (because 100% + 25% inflation = 125%).
2. To find 1%, divide £800 by 125.
3. Then multiply by 100 to find 100%:
4. Therefore, £800 ÷ 125 = £6.40. Multiply by 100 = **£640**.

So, in Year 1, those goods would have cost **£640**.

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7.4 Inflation

How index numbers are calculated and interpreted

An **index number** is like a scoreboard for the economy. It helps economists track changes in **prices**, **quantities**, or **economic activity** over time.

- It's a way of showing how something (like the price of milk or the cost of living) has changed compared to a certain starting point (called a **base year**).
- Index numbers also help make comparisons between countries easier; kind of like using the same units when comparing height.

🛠️ **How to Create an Index (Step-by-Step)**

Step 1: Choose What You're Measuring

Pick the item(s) or economic indicators you want to measure.

- Example: Let's say we want to track the price of coffee, bread, and petrol.

Step 2: Pick a Base Period

Choose a year (or time period) as your starting point. This will always have an index value of **100**.

- Example: You pick the year 2020 as your base year.

Step 3: Gather the Data

Collect price or quantity data over time for both the base year and future years.

- E.g. Coffee was £2 in 2020 and £2.20 in 2023.

Step 4: Apply Weights (If Needed)

Some items matter more than others, so we give them **weights**. A loaf of bread might be more important in your weekly budget than cinema tickets.

- This is common in **composite indices** like the **Consumer Price Index (CPI)**.

7.4 Inflation

How index numbers are calculated and interpreted

Step 5: Calculate the Index

For each item:

- Use the formula:
  Index = (Current Value ÷ Base Year Value) × 100
- If using weights, multiply the index by the weight and then find a weighted average.

Step 6: Make Sense of the Results

Once you have the index values:

- If the index = **120**, prices have gone **up 20%** since the base year.
- If the index = **90**, prices have gone **down 10%**.

Worked example

The average price of a cinema ticket was **£10** in 2020. By 2023, the average ticket price had risen to **£12.50**. Using 2020 as the **base year**, calculate the **index number** for cinema ticket prices in 2023 and explain what this indicates about price changes over the period.

🎯 **Step 1: Use the Formula**

$$Index = \left(\frac{Value\ in\ the\ current\ year}{Value\ in\ base\ year}\right) \times 100$$

$$\therefore Index\ for\ 2023 = \left(\frac{12.50}{10}\right) \times 100 = 125$$

✅ **Index = 125**

A value of **125** means that the price of cinema tickets **increased by 25%** between 2020 and 2023.

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7.4 Inflation

How index numbers are calculated and interpreted

Inflation is when prices go up over time. Basically, your money buys you *less* stuff than before. A chocolate bar that cost £1 last year might cost £1.10 this year; that's inflation.

📊 CPI: The Inflation Calculator

CPI stands for **Consumer Price Index**, which is just a fancy way of measuring how prices change over time for the things people typically buy like milk, clothes, train tickets, and even haircuts.

🛒 How CPI is Calculated – Step by Step

Step 1: Pick the stuff

Around 700 goods and services are chosen to represent what people buy; a typical "shopping basket." It's updated every year. E.g., if no one is buying CDs anymore, they get swapped for streaming services.

Step 2: Gather prices

Each month, price data is collected from around 150 places across the country to see what these items cost.

Step 3. Weighting

Some things are more important than others. We spend more on rent than we do on bubblegum, so rent has a higher **weight**. Each item's price is multiplied by its weight to show its real impact.

🧮 CPI Formula

To work out the CPI for a year:

$$CPI = \left(\frac{Cost\ of\ basket\ in\ current\ year}{Cost\ of\ basket\ in\ base\ year}\right) \times 100$$

So, if the basket cost £100 in 2020 (base year) and £110 in 2023, the CPI would be:

7.4 Inflation

How index numbers are calculated and interpreted

$$\therefore CPI = \left(\frac{110}{100}\right) \times 100 = 110$$

This means price increased by **10%** since 2020.

📈 Inflation Rate Formula

Want to know *how fast* prices are rising? Here's the formula:

$$Inflation\ rate = \left(\frac{New\ CPI - Old\ CPI}{Old\ CPI}\right) \times 100$$

For example:

- CPI in 2022: 105
- CPI in 2023: 115

$$Inflation\ rate = \left(\frac{115 - 105}{105}\right) \times 100 = 9.5\%$$

So, prices rose by 9.5% in a year.

✅ Why It Matters

Policymakers (like the Bank of England) watch inflation closely. If prices rise too quickly, it might mean:

- Wages can't keep up
- Interest rates might be raised to cool things down
- Your weekly shop starts looking scarier.

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7.4 Inflation

How index numbers are calculated and interpreted

Worked example

Using the information below, calculate the inflation rate for 2023 if the cost of the basket in the base year (2021) was £350. Show all steps clearly.

Household Item	Price 2022	Price 2023	Basket Weight	Cost in 2022 (Price × Weight)	Cost in 2023 (Price × Weight)
Rent	800	900	40%	320.00	360.00
Groceries	250	280	25%	62.50	70.00
Public Transport	100	120	15%	15.00	18.00
Internet & Mobile Data	60	65	10%	6.00	6.50
Entertainment (Netflix)	50	55	10%	5.00	5.50
Total basket cost				**£408.50**	**£460.00**

7.4 Inflation

How index numbers are calculated and interpreted

Step 1: Calculate CPI for 2022

Use the formula:

$$CPI = \left(\frac{Cost\ of\ basket\ in\ current\ year}{Cost\ of\ basket\ in\ base\ year}\right) \times 100$$

$$\therefore CPI for\ 2022 = \left(\frac{408.50}{350}\right) \times 100 = 116.71$$

Step 2: Calculate CPI for 2023

$$\therefore CPI for\ 2023 = \left(\frac{460}{350}\right) \times 100 = 131.43$$

Step 3: Work Out the Inflation Rate

$$Inflation\ rate = \left(\frac{New\ CPI - Old\ CPI}{Old\ CPI}\right) \times 100$$

$$Inflation\ rate = \left(\frac{131.43 - 116.71}{116.71}\right) \times 100 = 12.59\%$$

Final Answer:

Inflation rate = 12.59%
That means the general price level rose by around 12.6% between 2022 and 2023.

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7.4 Inflation

Limitations of CPI

The **Consumer Price Index (CPI)** is a useful tool, but it has its limitations when it comes to measuring the rate of inflation. Here's why:

- **Not Fully Representative**
  CPI uses an average "basket" of goods, which doesn't reflect everyone's spending habits. For example, someone who spends more on technology versus groceries won't see their personal inflation rate reflected accurately.
- **Excludes Housing Costs**
  Big expenses like house prices are left out, so CPI often underestimates inflation. If rent or property prices skyrocket, it won't show in the data.
- **Regional Differences Ignored**
  CPI averages inflation nationwide, missing variations like higher living costs in cities like London compared to rural areas.
- **Doesn't Account for Quality Changes**
  Product improvements aren't captured. A laptop in 2023 is far superior to one from 2000, but CPI treats them as the same if the prices match.
- **Survey Limitations**
  CPI relies on small sample surveys, which can be inaccurate. People might underreport or overreport their spending, leading to unreliable results.

7.4 Inflation

The Retail Price Index (RPI)

The **Retail Prices Index (RPI)** is a way to measure inflation, that is, how much the prices of everyday goods and services go up over time.
It works **very similarly to the CPI (Consumer Prices Index)**, but with a few key differences.

VS What Makes RPI Different from CPI?

While CPI leaves some items out, **RPI includes extra costs** that many households deal with, like:

- **Mortgage interest payments** – the extra money you pay when you borrow for a house
- **Estate agents' fees** – the cost of using a real estate agent to buy or sell property
- **Council tax** – a local tax paid by households to fund public services
- **House depreciation** – the fall in value of your house over time

Basically, RPI includes more of the "big life" expenses that CPI ignores.

🔺 Why Is RPI Usually Higher Than CPI?

Because it includes extra costs (especially ones that are affected by **interest rates)** RPI tends to give a **higher estimate of inflation**.

For example:

- When interest rates go up, mortgage payments also rise. Since RPI includes mortgages, it reflects this increase, while CPI doesn't.

🎯 So, Which One Is More Accurate?

Many argue that **RPI gives a better idea of the real cost of living**, especially for homeowners.
It's like comparing two shopping baskets, one has your rent, Netflix, and groceries (CPI), and the other also adds your house bills, mortgage, and council tax (RPI).

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7.4 Inflation

The causes of inflation

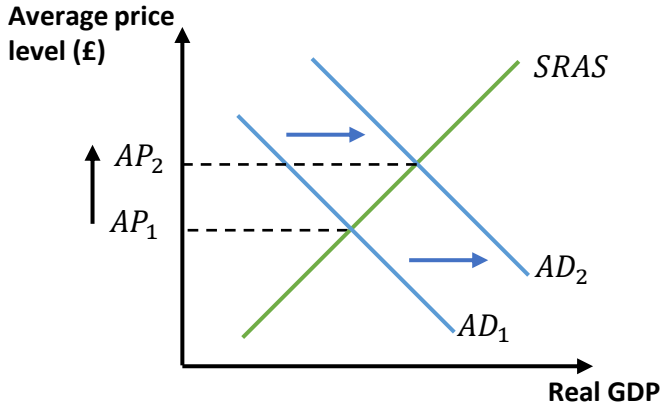
Demand-Pull Inflation

This type of inflation happens when there's too much demand in the economy – like everyone trying to grab the last PlayStation in stock.

- **Aggregate Demand (AD):** This is the total spending in an economy, made up of:
    - **C: Consumers spending** on goods/services.
    - **I:** Businesses **Investing** in things like factories or tech.
    - **G: Government spending** on roads, schools, etc.
    - **(X-M):** Exports minus imports (basically what we sell abroad versus what we buy from other countries).

When AD increases (like during a shopping spree), it pushes up prices.

- **Short-Run Aggregate Supply (SRAS):** This is how much the economy can supply at current price levels. If supply can't keep up with demand, prices increase, as shown in the diagram where **AD shifts right from AD1 to AD2**.



7.4 Inflation

The causes of inflation

Demand-Pull Inflation

Diagram Analysis:

- If any of the 4 factors of AD increases, the curve shifts **right** ($AD_1 \rightarrow AD_2$), showing higher demand.
- At the original price (**AP_1**), there's suddenly too much demand in the economy.
- Therefore, prices rise, causing less spending (**contraction of AD**) and more production (**extension of SRAS**).
- Prices move up from **AP_1 to AP_2**, resulting in **demand-pull inflation**.

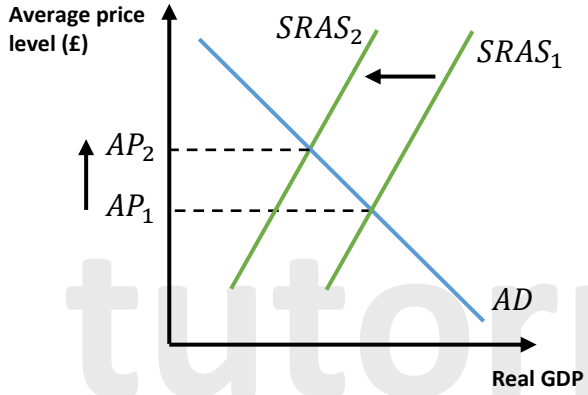
Example: Imagine a concert with only 100 tickets and 1,000 fans show up. People start offering more and more money for the tickets – that's like AD increasing and causing prices (aka ticket costs) to rise.

7.4 Inflation

The causes of inflation

Cost-push Inflation

Definition: Cost-push inflation happens when **the cost of making stuff goes up,** like higher wages, expensive raw materials, or rising fuel costs. Businesses pass these costs on to customers by **raising prices**.



What the Diagram Shows:

1. When production costs rise (e.g., oil becomes pricier), the **supply decreases**, shifting the supply curve **left** ($SRAS_1 \rightarrow SRAS_2$).
2. At the original price level (**AP_1**), there isn't enough supply to meet demand, leading to shortages.
3. Prices go up (**$AP_1 \rightarrow AP_2$**) as goods become harder (and costlier) to produce.
4. As prices increase, people buy less (**contraction of AD**), and businesses can't supply enough.
5. This is called **cost-push inflation,** it's when higher costs push prices up for everyone.

7.4 Inflation

The causes of inflation

Cost-push Inflation

Example: Chocolate bars need cocoa, and if cocoa prices skyrocket due to bad weather. Chocolate companies now spend more to produce each bar, so they **charge you extra**. Suddenly, your favourite £1 treat is now £1.50.

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The quantity theory of money

Ever wondered what causes inflation? One classic explanation comes from something called the **Quantity Theory of Money**. It all starts with a famous formula by economist **Irving Fisher**, called the **equation of exchange**:

M × V = P × Q

Where:

- **M** = Money supply (how much money is in the economy)
- **V** = **Velocity of circulation** – how often each unit of money is used to buy goods/services over a year
- **P** = Average **price level** (think of this like the average cost of things, measured by something like the CPI)
- **Q** = Real output – the amount of stuff we produce (also called real national income or real GDP)

This equation shows that the amount of money multiplied by how often it's spent equals the total value of goods and services sold in the economy.

🧠 **What Do Monetarists Say?**

Monetarist economists (like Milton Friedman) built on this theory and took it further:

- They believed **V** (velocity) stays more or less **constant** over time.
- They also said **Q** (real output) tends to grow steadily – not too fast, not too slow.

So, if **V and Q are steady**, then any change in **M (money supply)** must affect **P (prices)**.

🧨 Translation? Printing lots of money = higher prices = **inflation**.

This led to the idea that inflation happens not because people are spending too much or because of rising costs, but simply because **too much money is chasing too few goods**.

7.4 Inflation

The effects of inflation

💬 **So, Why Did It Matter?**

This idea became huge in the 1980s, especially under governments that tried to fight inflation by controlling the **money supply**. They thought: "If we can limit how much money is in the system, we can control inflation."

One of the biggest supporters of this theory was **Milton Friedman**, who even won a **Nobel Prize**. He believed inflation is always a **monetary phenomenon,** basically, if you want to stop prices from rising, stop printing money like there's no tomorrow.

🤔 **What Happened to This Idea?**

By the late 1980s, things changed:

- Governments found it **really difficult to control the money supply**.
- Plus, **velocity (V)** didn't stay as constant as people thought, it changed depending on interest rates, confidence, and other factors.

So, while the theory still has its place in economics, it's no longer the go-to method for tackling inflation.

📝 **In a Nutshell:**

- Too much money in the economy → prices go up.
- Control the money supply = control inflation (in theory).
- But in real life? It's messier than the maths.

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7.4 Inflation

Expectations and changes in the price level

People don't just react to prices; they try to **predict them**. That's what we call **inflation expectations** (what consumers and businesses *think* will happen to prices in the future). And surprisingly, these expectations can actually **influence real inflation.**

🔄 **How Expectations Affect Prices:**

- **If people expect prices to fall**, they might **hold off on buying** things, hoping to grab a bargain later.
    - 📉 Example: "TVs will be cheaper next month? I'll wait."
    - That delay in spending reduces demand and this can actually help prices fall.
- **If people expect prices to rise**, they might **rush to buy now** before things get more expensive.
    - 🔥 Example: "Petrol is going up tomorrow? Fill the tank today."
    - That extra demand drives prices up, making the price rise a self-fulfilling prophecy.

This is where **inflation psychology** comes in where it's all about how our expectations and emotions impact spending and pricing behaviour.

7.4 Inflation

Expectations and changes in the price level

🧠 **Types of Inflation Psychology**

🕰️ **Adaptive Expectations**

People look at the past to predict the future. If inflation was high recently, they assume it'll stay that way.

Example: Prices have been going up a lot lately, so I'd better ask for a big pay raise just in case.

🔮 **Rational Expectations**

People use **all available info** (not just past trends) to make informed guesses. They're more forward-thinking and logical.

Example: Inflation was high last month, but the government just raised interest rates. I think prices might stabilise.

🎯 **Why It Matters**

Expectations aren't just guesses, they **shape reality**. If people expect inflation to go up, they act in ways that push it up. That's why central banks and governments care so much about keeping expectations under control to avoid panic buying, unnecessary wage demands, and runaway inflation.

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The effects of inflation

For Firms:

- **Uncertainty**: Inflation makes it hard for businesses to plan because they can't predict future costs and revenues.
- **Menu Costs**: Constant price changes mean businesses have to update their price lists, menus, or catalogues frequently. It's not just annoying, it's expensive.

For Consumers:

- **Less Spending Power**: As prices rise, your money buys you less. The weekly shop feels like it costs a fortune!
- **Fixed Income Hit**: Retirees relying on pensions or others on fixed incomes feel the pinch most as their income doesn't stretch as far.
- **Savings Lose Value**: Got cash in the bank? It's worth less in real terms if inflation is higher than interest rates.

For the Government:

- **Harder Exports**: Inflation makes a country's goods more expensive abroad, reducing international competitiveness.
- **Difficult Choices**: Tackling inflation often means tough trade-offs, like potentially increasing unemployment or slowing economic growth.

For Workers:

- **Demand for Higher Wages**: To keep up with rising prices, workers push for better pay. Fair enough, right?
- **Productivity Dip**: If wages don't keep up with inflation, motivation falls and so does productivity.

7.4 Inflation

Deflation

Deflation is when the general price level of goods and services in an economy falls meaning prices go down instead of up. This is measured using the **Consumer Price Index (CPI)**.
🔷 **Note:** Deflation only officially happens when the rate of price change is below 0% (i.e. negative inflation).

What Causes Deflation?

Deflation can come from two main places:

- **Demand-side factors** — when people are buying less
- **Supply-side factors** — when businesses can produce more at lower prices

1 Demand-Side Deflation (aka "Bad Deflation")

What is Demand-Side Deflation?

This happens when **aggregate demand** (total demand for goods and services in an economy) **falls**.

Aggregate Demand (AD) =
C (Consumption) + **I** (Investment) + **G** (Government Spending) + **(X - M)** (Net Exports)

So, if people start spending less, businesses invest less, governments cut spending, or exports drop. In short, demand decreases, leading to falling prices.

Real Life Example:

Think back to the 2008 financial crisis, people lost jobs, cut spending, and businesses stopped investing. The demand for goods and services dropped sharply, and prices started to fall. That's demand-side deflation in action.

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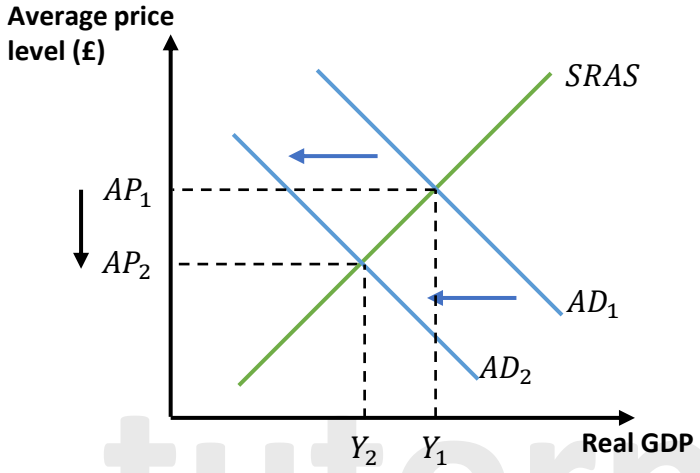
7.4 Inflation

Deflation



📉 **Diagram: Demand-Side Deflation**

The diagram shows what happens when aggregate demand falls:

- We start at **equilibrium** point **AP_1Y_1** — prices and output are stable.
- But then... Something (any factor mentioned previously) causes demand to drop.
  - The AD curve shifts left: **AD_1 → AD_2**
- As a result:
  - Average price level drops from **AP_1 → AP_2**
  - Output (real GDP) falls from **Y_1 → Y_2**
- This new equilibrium is now at **AP_2Y_2**

🎯 This shows that lower demand leads to falling prices **and** lower output — **bad news** for the economy.

7.4 Inflation

Deflation

The consequences of demand-side deflation

When people and businesses spend less, prices start falling, not just for one or two things, but across the whole economy. That's **demand-side deflation**, and while falling prices *sound* good, the effects can be seriously damaging.

👨‍👩‍👧 **Consumers hit pause on spending**

With businesses struggling and people losing jobs, households worry about the future and choose to **save instead of spend**.

Less spending = lower demand = even less output = the economy keeps shrinking.

Many delay buying goods and services because they believe prices will drop more, creating a cycle of falling demand.

🧠 Imagine knowing that that £100 jacket might be £80 soon; why buy now?

🏭 **Firms pull back**

Businesses see falling prices and sales, so they stop investing in new projects or hiring, worsening the economic slowdown.

🧠 Why build a new store if no one's buying what you already have?

❌ **Bankruptcy on the rise**

- Lower profits from falling prices = businesses can't survive.
- Smaller firms, in particular, might have to shut down for good.

🧠 Less revenue + same costs = some businesses going out of business.

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7.4 Inflation

Deflation

🏛 **Government tools lose their edge**

- **Less Effective Policies:** Tools like tax cuts (fiscal policy) or interest rate drops (monetary policy) don't work well because people still expect prices to fall. They keep waiting for even better deals instead of spending now.
- **Higher Unemployment:** As output (production) drops, fewer workers are needed. So, job losses rise.

🧠 Think of shoppers holding off on buying a new phone because they think it'll be cheaper next month.

🌍 **Exports Get a Boost**

- There's a silver lining. If UK prices fall, products become **cheaper for buyers abroad**.
- For example, British-made trainers might become hot sellers in Europe thanks to lower prices, helping boost exports.

7.4 Inflation

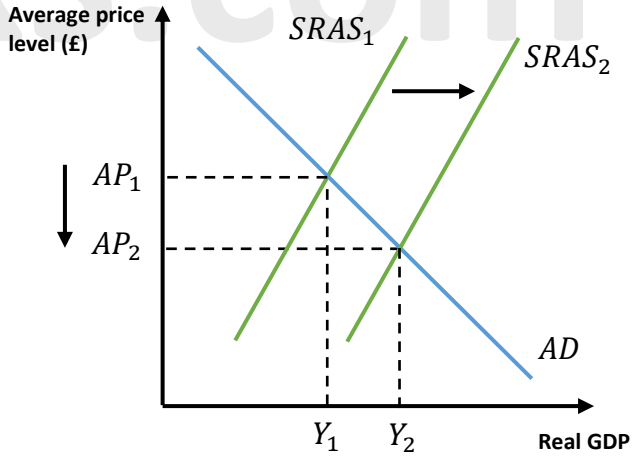
Deflation

2️⃣ **Supply-side Deflation (aka "Good Deflation")**

Supply-side deflation happens when the economy becomes better at producing goods and services, basically, when we can make **more stuff**, more efficiently. This can be due to improvements in the **quantity or quality** of what we use to produce things like better machines, more skilled workers, cheaper raw materials, or faster technology.

In simple terms:

If we can produce more goods using the same resources (or even fewer) then prices tend to **fall**, because supply has increased. But unlike demand-side deflation (which is bad), this is usually a **positive sign**. Why? Because it often means more output (real GDP increases), lower prices, and possibly more jobs.



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7.4 Inflation

Deflation

Diagram: Supply-Side Deflation Explained

The graph shows what happens when **Short-Run Aggregate Supply (SRAS)** increases (moves to the right).

- **SRAS1 → SRAS2**: This shift happens when production becomes more efficient.
- **Average Price Level (AP) falls** to **AP2**: With more goods available, prices drop.
- **Output (Y) increases** to **Y2**: We're making more stuff.
- **New equilibrium** is at **AP2 Y2**.

Result? More output, lower prices, and a boost to the economy = **Good deflation**

7.4 Inflation

Deflation

Consequences of Supply-side Deflation

Supply-side deflation is like getting a bigger pizza for the same price, great news for everyone. It happens when the economy becomes more efficient at producing goods and services, leading to **lower prices** and **higher output**. Let's break down the effects in everyday terms:

Exports Get a Glow-Up

When domestic prices fall, our products become **cheaper and more attractive** to international buyers. This boosts **exports** and improves a country's **global competitiveness**.

Example: A UK-made car becomes cheaper compared to a German rival, suddenly, more people abroad want the British car.

Debt Becomes Heavier

Even in a good deflation situation, debt doesn't get a free pass. When prices fall, the value of money increases, which means debts become **harder to repay** in real terms. This can be a downside, especially for people and governments with big loans.

Real-life effect: A student loan taken out years ago might feel tougher to pay off if wages don't rise but prices fall.

Consumers Feel Good

With prices falling and jobs becoming more available, households start to **feel optimistic**. They spend more, which keeps the economy buzzing and **real GDP** climbing.

Example: If the price of groceries drops and you get a raise, you're likely to splurge on that weekend trip or upgrade your phone and there is a demand boost.

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7.4 Inflation

Deflation

Firms Gain Confidence

When businesses can make more while spending less (like using automation or cheaper materials), they feel **confident**. That means they're more likely to invest in new projects, hire people, and expand. All of this helps grow the economy and this is reflected in rising **real GDP** (total value of goods and services produced, adjusted for inflation).

Example: A clothing company switches to energy-efficient machines and cuts costs, so it opens a second factory. There is more production and more jobs.

Unemployment Falls

As firms grow, they need more helping hands. So, they hire. With rising output, more workers are needed, and **unemployment drops**.

Example: A bakery installs faster ovens, needs more staff to handle growing orders, suddenly, the local job market gets a boost.

7.4 Inflation

Deflation

Continue to the next page…

Commodity prices and inflation

Let's talk about **commodities** (basic raw materials like oil, wheat, and metals that are used to make other goods). Their prices go up and down a lot (we call this being **volatile**), and people often trade them to try and make a profit. Think of it like trying to guess whether gold or oil will be worth more tomorrow and placing your bets accordingly.

Now, one commodity that really affects the **inflation rate** is **oil**. Why? Because oil is everywhere; it's used to fuel vehicles, power factories, and even make products like plastic. So, when oil prices rise, it becomes more expensive to make and move stuff around. This pushes up prices across the board, which means **inflation.**

⛽ **Who Controls Oil Prices?**

Sometimes, oil-producing countries (like those in **OPEC**) get together and decide to **cut supply,** basically producing less oil on purpose. If demand stays the same or goes up (and it usually does, since people and businesses still need oil), the price shoots up. This is because **demand for oil is price inelastic** (people need it no matter the cost).

A real-life example? In the 1970s, oil prices skyrocketed after supply was restricted. The result? The UK saw inflation go wild, so bad at one point it hit **25% in 1975.** That's huge. Just imagine your weekly shop costing a quarter more every year.

7.4 Inflation

How other countries can affect inflation in the UK

The UK is what's called an **open economy,** this means we do a lot of trading with other countries. So, when things change in other parts of the world, they can have a knock-on effect on prices (inflation) right here in the UK.

🚀 **1. Other Countries Boom → More Demand for UK Goods**

If a country like India or the U.S. sees strong economic growth, people and businesses there might want to buy more British products; think of luxury cars, tech services, or tea from Yorkshire. This can increase UK exports and may lead to **demand-pull inflation**, which is when prices rise because people are demanding more goods than the economy can produce.

📉 **2. Recessions Abroad → Less Demand for Our Stuff**

Now imagine the opposite: if a major trading partner like Germany goes into a recession (a period of shrinking economic activity), they'll likely buy fewer UK goods. That reduces demand for our exports, helping ease inflation here, especially demand-pull inflation.

🛢️ **3. Overseas Growth Pushes Up Prices of Raw Materials**

As countries grow, they buy more stuff like steel, oil, and timber. If global demand for these materials spikes, it can push up their prices. Since the UK often **imports** these resources, we end up paying more to produce things. That leads to **cost-push inflation** (when prices rise because the cost of making things goes up).

Example: If China ramps up building projects and buys loads of copper, global prices for copper rise. UK builders pay more, and those extra costs are passed on to consumers.

How other countries can affect inflation in the UK

4. Currency Exchange Rates Can Mess With Prices

When the **exchange rate** (the value of the British pound compared to other currencies) falls, it makes imported goods more expensive. So, if the pound drops against the euro or the dollar, buying foreign food, fuel, or electronics becomes pricier, again causing **cost-push inflation**.

Think of it like going abroad: if the pound is weak, your holiday spending money doesn't go far and it's the same for UK businesses buying foreign goods.

7.4 Inflation

How other countries can affect inflation in the UK

Continue to the next page…

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7.5 Balance of payments

Components of the balance of payments

Think of a country's **balance of payments** like its international bank statement; it keeps track of all the money flowing in and out as it trades, invests, and transfers money with the rest of the world.

📜 **The Two Big Parts of the Balance of Payments:**

1️⃣ **The Current Account**

This is the day-to-day stuff. It's all about trading goods, services, income, and transfers.
It includes:

- **Trade in goods** (e.g. cars, bananas, electronics)
- **Trade in services** (e.g. tourism, banking, Netflix subscriptions)
- **Primary income** (e.g. wages earned abroad or interest from overseas investments)
- **Secondary income** (e.g. foreign aid, remittances (when someone sends money back home))

2️⃣ **The Capital and Financial Accounts**

💼 **Capital Account:**

This part is kind of the sidekick; it tracks smaller things like:

- People bringing money into or out of the country (e.g. immigrants sending money home)
- Government transfers like **debt forgiveness** (when richer countries write off loans for poorer ones)

7.5 Balance of payments

Components of the balance of payments

💰 **Financial Account:**

Now this one's a big deal. It covers the movement of money related to investments and includes:

- **Foreign Direct Investment (FDI)**: Long-term investment in foreign businesses. For example, if Apple buys a 20% stake in an Indian software company; that's FDI.
- **Portfolio Investment**: Buying foreign shares or bonds but owning less than 10% (not enough to have control).
- **Financial Derivatives:** Fancy investment tools used to make a profit from future price changes, like options or futures.
- **Reserve Assets:** Gold, foreign currencies or special reserves held by the country's central bank to manage the economy.
- **Other Investments**: Things like loans to foreign governments, currency exchanges, or bank deposits overseas.

⚖️ **How It All Balances**

In theory, the total money flowing **in** (credits) and **out** (debits) should match up. If not, the statisticians use something called a **balancing item** to fill in the gaps, basically a plug for errors or unrecorded transactions.

🔍 **Quick Example - Japan (2022):**
Japan exported more goods than it imported, so it had a **trade surplus in goods** (think cars, electronics, and machinery).

However, it imported a lot of energy and raw materials, and it also had **net income outflows** (e.g. profits being sent back overseas by foreign companies operating in Japan).

Overall, Japan's **current account showed a surplus**, meaning more money flowed into the country than out. This helped strengthen its economy and keep the yen relatively stable.

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7.5 Balance of payments

Deficit and a surplus on the current account

The **Balance of Payments (BoP)** is like a country's financial scoreboard. It records all money flowing *in and out* through trade, investment, and financial activity.
In theory, the BoP should **balance to zero,** but in reality, it rarely does (so economists add a "net errors and omissions" line to tidy things up).

✅ **Current Account Surplus**

- A **current account** tracks trade in goods/services, investment income, and transfers (like aid or remittances).
- If exports **> imports**, the country earns more than it spends. This is a **surplus**.
- But then, the **financial account** (which records flows of money for assets like property, stocks, and bonds) must show a **deficit**.
- Example: If Germany sells loads of cars abroad (surplus), the extra euros they earn might be used to buy U.S. stocks or African infrastructure bonds (financial account deficit).

❌ **Current Account Deficit**

- If imports **> exports**, the country spends more than it earns. This is a **deficit**.
- To pay for this, money must flow *into* the financial account, usually through selling assets, borrowing, or attracting foreign investment.
- Example: If the UK imports loads of electronics from Asia (deficit), it might balance things by selling London property or government bonds to overseas investors (financial account surplus).

7.5 Balance of payments

Deficit and a surplus on the current account

🌎 **The See-Saw Effect**

- Think of the **current account** and **financial account** like a seesaw: when one goes up, the other goes down.
- Surplus on one side = deficit on the other, and vice versa.

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7.5 Balance of payments

Factors that influences a country's current account balance

In an ideal world, a country's **current account** (which tracks the value of its exports minus imports, plus income and transfers) should be balanced by its **capital and financial account** (which tracks investment flows like buying stocks, businesses, or bonds). If one is in deficit, the other must be in surplus. It's like a giant international seesaw of money. But why would a current account go into deficit or a surplus?

🔥 **1. Inflation**

Inflation = the rate at which the general price of goods and services rises over time.

- **High inflation**: exports become expensive → foreigners buy less → imports seem cheaper to locals → trade deficit 📉
- **Low inflation (or deflation)**: exports are cheaper → foreigners buy more → imports become pricey for locals → trade surplus 📈

Example:
If UK inflation is 10% but Germany's is 2%, UK cars (like Jaguars) will seem more expensive abroad, reducing exports.

⚡ **2. Productivity**

Productivity = how much output (goods/services) a worker can produce in a given time.

- If productivity rises, workers produce more per hour → goods become cheaper and better quality → exports increase 🌟
- Governments can boost productivity using **supply-side policies** (e.g., tax breaks for training, better education, or investment in technology).

Example:
South Korea invested heavily in education and tech training → now it exports high-tech goods (like Samsung phones) worldwide.

7.5 Balance of payments

Factors that influences a country's current account balance

💱 **3. Exchange Rates**

Exchange rate = the value of one currency compared to another (e.g., £1 = $1.25).

- **Stronger exchange rate (currency appreciates)**:
  - Exports become more expensive → fewer sales abroad
  - Imports become cheaper → locals buy more foreign goods
    ✅ Good for holidaymakers abroad, bad for exporters
- **Weaker exchange rate (currency depreciates)**:
  - Exports become cheaper → more foreign demand
  - Imports become more expensive → locals buy fewer foreign goods
    ✅ Good for exporters, bad if your country relies on imported food/energy

Example:
After Brexit, the pound (£) fell sharply → UK exports became cheaper abroad → tourism and some exports rose, but imports (like oil) became much more expensive.

✨ **In short:**

- **Productivity** = more output, more exports
- **Inflation** = high is bad for exports, low helps exports
- **Exchange rates** = strong hurts exports, weak helps exports

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The consequences of investment flows between countries

When money moves across borders in the form of **investment**, it affects not only businesses but also a country's **currency** and **exchange rate**.

💰 What is the Financial Account?

The **financial account** is part of a country's balance of payments. It records the inflows (money coming in) and outflows (money going out) of **financial assets**.
This includes:

- **Foreign Direct Investment (FDI):** when a company sets up a factory, buys land, or takes control of a business in another country (e.g., Toyota building a car plant in the UK 🚗).
- **Portfolio Investment:** when investors buy financial assets like shares, bonds, or property abroad.

📈 How Investments Affect the Exchange Rate

- **Inflow of investment (money coming in):**
  Foreigners need the local currency to invest. This **increases demand** for that currency, which can lead to an **appreciation** (currency gets stronger).

Example: If US investors buy lots of UK government bonds, they need pounds (£), pushing up the value of the pound.

- **Outflow of investment (money leaving):**
  Locals sell their currency to buy assets abroad. This **increases the supply** of the local currency in foreign markets, which can cause **depreciation** (currency gets weaker 📉).

Example: If UK pension funds heavily invest in US tech stocks, they sell pounds and buy dollars, which weakens the pound.

7.5 Balance of payments

The consequences of investment flows between countries

🔄 Exchange Rates and Investment Attractiveness

- **Stronger exchange rate:**
  Investing becomes **more expensive** for foreigners because they need more of their home currency to buy local assets. This can **reduce the appeal** of investing.

Example: If the pound is very strong, US investors find UK property pricey, so they might invest elsewhere.

- **Weaker exchange rate:**
  Investing becomes **cheaper** for foreigners because their money stretches further. This can **increase the attractiveness** of investing.

Example: After the pound fell post-Brexit, UK property and companies suddenly looked like a "bargain" for overseas buyers.

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Policies to correct a balance of payments deficit or surplus

A **current account deficit** happens when a country spends more on imports (goods/services bought from abroad) than it earns from exports (goods/services sold abroad). Governments don't like this imbalance because it can weaken the economy, so they use two main types of policies to fix it:

- **Expenditure reducing policies** – making people spend less (especially on imports).
- **Expenditure switching policies** – nudging people to buy more local goods instead of imports (like tariffs or devaluation).

1) Expenditure Reducing Policies 💸

These policies aim to cut back **consumer spending power** (how much people can buy). The idea is simple: if people spend less overall, they'll also spend less on imports.

Examples of tools the government can use:

- **Higher taxes** – People keep less of their income, so they spend less on goods (including foreign ones).
- **Higher interest rates** – Loans and mortgages become more expensive, so people save more and spend less.
- **Lower government spending** – Less money pumped into the economy means less overall demand.

Example: If UK households spend less on holidays in Spain because interest rates rise, imports (like airline tickets, hotels, etc.) fall.

Issues with This Policy

Sounds good on paper, but there are downsides:

- 💔 **Slower economic growth** – Cutting spending reduces demand in the economy, which may lead to higher unemployment.
- 🔄 **Unintended consequences** – Higher interest rates may cause the UK pound to rise in value (appreciation). This makes UK exports more expensive abroad, reducing export sales; the exact opposite of what we want.
- 😡 **Unpopular with voters** – Nobody likes higher taxes or more expensive loans, as it lowers living standards.

7.5 Balance of payments

Policies to correct a balance of payments deficit or surplus

2) Expenditure switching policies 🔁

These are government policies designed to **fix a current account deficit** (when imports > exports) by encouraging people to buy fewer imports and more domestically produced goods. They also aim to boost exports by making them cheaper for foreign buyers.

a) Devaluation

Devaluation = when a country deliberately lowers the value of its currency in relation to others.

👉 Example: If £1 used to equal $2 but now £1 = $1.50, the pound has been devalued.

Effects on the current account:

- Exports become **cheaper** for foreign buyers (their money now buys more of our currency), so exports should increase.
- Imports become **more expensive** for domestic consumers (we need more pounds to buy the same amount of foreign currency), so imports should fall.

Problem: The actual effect depends on how sensitive people are to price changes; this is called **price elasticity of demand (PED).**

📊 **Marshall–Lerner Condition**

This rule tells us whether devaluation will actually improve the current account.

- If **PED for exports + PED for imports > 1**, devaluation works ✅
- If **PED for exports + PED for imports ≤ 1**, then devaluation won't make much difference ❌

In other words, if people don't really change their buying habits when prices change (inelastic demand), devaluation won't fix the deficit.

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Policies to correct a balance of payments deficit or surplus

📉 **The J-Curve Effect**

Imagine the current account balance line shaped like the letter **J**.

- **Short term:** Things get worse before they get better. Why?
  - Exports are cheaper, but foreign buyers don't react instantly (contracts, habits, lack of info).
  - Imports cost more, but domestic consumers may keep buying them anyway (inelastic demand).
- **Long term:** As time passes, buyers adjust. Exports rise because they're cheaper, and imports fall as people look for alternatives. The current account improves, climbing up the "J" curve.

Example: When the UK devalued the pound after Brexit, imports like petrol became more expensive right away, but exports like cars and financial services became more attractive over time.

b) 🛡️ Protectionist Policies

Protectionism = when a government puts up barriers (like tariffs, quotas, or bans) to limit imports and protect its own industries.

How it works:
By restricting imports, governments hope people will buy more **domestically produced goods** instead. This reduces the current account deficit (when imports > exports).

Problems with protectionism:

- Other countries may **retaliate** by putting barriers on our exports. For example, if the UK slaps tariffs on Chinese steel, China might retaliate by taxing British cars, reducing our export sales.
- Protectionism assumes people can easily switch to domestic alternatives. But what if we don't make that good at home? (E.g., coffee in the UK, we don't grow much of it, so tariffs just make it pricier with no local substitute).

7.5 Balance of payments

Policies to correct a balance of payments deficit or surplus

3) Supply-Side Policies ⚙️

Supply-side policies = long-term strategies to make the economy more productive and competitive.

These include things like:

- Better education and training (so workers are more skilled 🚀)
- Investing in infrastructure like transport and broadband (so businesses can operate more efficiently).
- Keeping inflation under control, so our exports stay affordable abroad.

Why this helps:
If UK firms become more efficient and innovative, they can produce high-quality goods at lower costs. That means:

- Our exports become more competitive ✅
- Imports may fall because homegrown products are just as good (or better).

Example: If the UK invests in renewable energy technology, we could export green tech abroad, boosting exports and improving our current account balance in the long run.

Exam pointers ✍️

- Always state the main channel
  reduce spending or switch spending
- Mention time lags and side effects on growth, jobs, inflation, and the exchange rate
- For devaluation, write the Marshall Lerner condition and the J curve
- For protection, mention retaliation and consumer prices
- For supply side, stress long term gains in productivity and quality

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7.5 Balance of payments

Significance of global trade imbalances

Global trade is a bit like a see-saw. The total value of exports across the world has to equal the total value of imports. One country's **trade surplus** (exporting more than it imports) has to be balanced by another country's **trade deficit** (importing more than it exports).

But big or long-lasting imbalances can cause problems for both sides.

❗ **What Happens If a Country Keeps Running a Trade Deficit?**

A **trade deficit** means a country is spending more on goods and services from abroad than it's earning from exports. To plug the gap, it usually has to:

- Borrow from other countries or international lenders
- Sell off national assets like companies, land, or infrastructure
- Rely on foreign investors to buy government bonds

💥 **Example:** Sri Lanka faced a serious economic crisis in 2022 after running trade deficits for years. It borrowed heavily and sold assets to stay afloat. But when foreign reserves dried up and it couldn't pay for basic imports like fuel or medicine, the country experienced protests, blackouts, and inflation.

Over time, too much reliance on outside money can mean losing control especially if lenders get nervous and want their money back fast.

📉 **Is a Current Account Deficit Always Bad?**

Not necessarily. Just look at the US and the UK. They've been running current account deficits for years without major issues. Why? Because global investors have confidence in their economies and are happy to lend money or invest there.

A current account deficit isn't always a red flag as long as it's balanced by a **capital and financial account surplus**. That means foreign money is flowing in through things like buying property, government bonds, or investing in local businesses.

7.5 Balance of payments

Significance of global trade imbalances

👉 Example: If the UK is importing a lot but also getting loads of foreign investment in its housing market or tech firms, the books still balance.

But... the 2008 Global Financial Crisis was a wake-up call. Suddenly, the flow of money around the world slowed, and investors pulled out fast. That made deficits harder to fund.

❗ **What If a Country Always Runs a Surplus?**

A **trade surplus** might sound like a good thing, you're earning more than you spend, right? But it's not always great.

Here's what can go wrong when a country over-focuses on exports:

- Its economy becomes geared toward satisfying **foreign buyers**, not local needs
- Domestic demand (what local people want) gets ignored
- If the country stops its currency from rising (to keep exports cheap), it distorts **foreign exchange markets**

💡 **Example:** Germany often runs a large trade surplus. It exports cars, machinery, and more. But critics (like the IMF) argue that Germany should invest more at home (in public services and infrastructure) to raise living standards for its own citizens. Otherwise, Germans are saving too much and spending too little domestically.

🧠 Another case: Singapore attracts foreign wealth due to its constant surpluses, but that's also led to high housing prices and income inequality as much of that capital flows into real estate rather than benefiting the average person.

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7.5 Balance of payments

Implications of current account imbalances

When countries try to "fix" their current account (e.g., reduce a deficit), their actions often affect other economies too.

⚡ **How One Country's Fix Can Hurt Others**

- If a big economy (like the USA or China) adopts policies to cut imports and improve its current account, other countries feel the shock.
- Why? Because less importing by one country means **less demand for exports** from others. This can cause job losses, lower incomes, and reduced growth abroad.

Example: If the USA introduces **protectionist policies** (like tariffs on EU goods), EU exporters sell fewer products in the US. Factories in Germany or France might produce less, leading to layoffs and weaker growth in Europe.

🌀 **The "Beggar-Thy-Neighbour" Problem**

These kinds of policies are often called **"beggar-thy-neighbour"** policies.
📖 Definition: This is when one country tries to help itself by making things worse for others.

The danger? Other countries usually retaliate with their own policies (like tariffs or quotas), and soon everyone is worse off — global trade shrinks, jobs are lost, and economies slow down.

Think of it like a trade "food fight"; once one country throws the first plate, others throw theirs back, and in the end, the whole room is a mess.

7.5 Balance of payments

Implications of current account imbalances

🎯 **Exam Tip**

The importance of a current account balance depends on the country:

- **Advanced economies** (like the UK or USA) usually cope better with deficits since they can borrow easily.
- **Developing countries** (like Ghana or Bangladesh) often can't borrow as cheaply, so they need to pay closer attention to deficits. Otherwise, they risk debt crises.

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7.6 Trends in macroeconomic indicators

Macroeconomic indicators are like the "vital signs" of an economy; they help us see whether it's healthy, slowing down, or in trouble. Let's break down the main ones with some examples.

🚀 Economic Growth

Definition: Economic growth is the increase in the value of goods and services produced in a country over time, usually measured by GDP (Gross Domestic Product).

- Over the last 20 years, the UK economy has generally grown.
- But there was a big hiccup in **2008 during the global financial crisis**, when output (GDP) fell sharply after 16 years of steady growth.
- Think of it like someone running at a steady pace for ages, then suddenly tripping over a stone; that stone was the financial crisis.

💸 Inflation

Definition: Inflation is the rate at which the general level of prices for goods and services rises, meaning money buys you less than before.

- The **Bank of England's target** is 2% inflation (measured using CPI – Consumer Price Index).
- Prices spiked after the financial crisis: in 2008 and 2011, inflation hit **5.2%**, which is way above target.
- Fun fact: in **April 2015**, the UK briefly had **deflation** (prices fell by 0.1%); the first time since the 1960s.

👷 Employment

Definition: Employment rate is the percentage of working-age people (16–64 years) who have a job.

- From 1995 to 2014, employment generally improved, peaking at **73.2%** in late 2014.
- However, during the 2008–09 financial crisis, employment fell to **70.1%;** showing how recessions reduce job opportunities.
- In short: when the economy slows, fewer jobs are available; when it grows, more people are employed.

7.6 Trends in macroeconomic indicators

Implications of current account imbalances

🌍 Balance of Payments

Definition: This measures trade flows of goods, services, and money between the UK and the rest of the world.

- The UK is a **net importer**, meaning it buys more from abroad than it sells.
- For the past 20 years, the UK has usually run a **trade deficit** (more imports than exports).
- But the UK does well in services (like finance in London), running a **trade surplus in services**, while goods (like cars, electronics, clothes) tend to show a **trade deficit**.

🌍 UK vs. Other Economies

- In **2014**, the UK's economy grew by **2.6%**, faster than big names like the US (2.4%), Germany, France, and Japan.
- In terms of **nominal GDP (2012)**, the UK ranked **8th largest in the world**. Within the G7, it was 4th in GDP per person.
- Emerging markets (China, India, Brazil) are growing much faster and are expected to dominate future global growth.
- By **2050**, it's estimated that **Mexico and Indonesia** could overtake the UK in GDP size.

Example: The UK in 2012 had GDP of about **$2.47 trillion**, while China was already much larger at **$8.23 trillion**. By 2050, China could hit **$52.6 trillion**, becoming the world's giant.

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Absolute vs relative poverty

📏 **Absolute Poverty (a.k.a. "just trying to survive")**

What is it?
Absolute poverty means you don't have enough money to meet the **basic needs of life;** we're talking about food, clean water, shelter, clothing, healthcare, and education.

Global benchmark:
The **World Bank** says that anyone living on **less than $1.90 per day** is living in absolute poverty. That's about the price of a coffee in many places.

Where is it most common?
Absolute poverty is mostly found in **less developed countries**. As countries grow and improve economically, absolute poverty tends to decrease. In richer countries, governments often step in to provide basic services to help those in need.

💷 **Relative Poverty**

Relative poverty means your income is **much lower than the average** in your country, making it hard to fully participate in everyday life even if you have a roof over your head and food on the table.

- In the UK, you're in relative poverty if your **household income is less than 60% of the median income** after housing costs.
- As of **2023**, the **median UK household income** (after housing costs) was around **£565 per week**, so **60% of that is about £339 per week**, or **£1,356 per month**.
- So, if a household earns **less than £1,356 per month**, they're officially classed as living in relative poverty.

📊 According to the **Joseph Rowntree Foundation**, in 2023:

- About **14.4 million people** in the UK were living in relative poverty.
- That's more than **1 in 5 people**, including nearly **4.2 million children**.

🧊 **Example:** A family in Manchester earning £1,200 a month may struggle to afford heating, school uniforms, or internet access. They're not starving, but they're cut off from what most others see as "normal" life.

Causes of changes in absolute and relative poverty

💡 **What Even Causes Poverty?**

Poverty doesn't happen out of nowhere. Here are some common reasons:

- **Unemployment** – no job = no income.
- **Lack of skills** – without the right training or education, it's hard to find good-paying work.
- **Health problems** – being sick or disabled can limit your ability to work.
- **Income dependency** – some people rely on government support or family help because they can't earn enough.

📉 **Why Does Absolute Poverty Fall as Countries Get Richer?**

🚀 **Economic Growth = More Money for Everyone**

When a country's economy grows, it creates jobs and raises incomes. This helps people move out of **absolute poverty**.

- For example, when a new factory opens, people in the area get jobs, earn more, and can afford basics like food and healthcare.

🏛️ **Government to the Rescue**

Smart **tax and welfare policies** help those most in need like kids, the elderly, or people who can't work.

- In wealthy countries, governments often make sure **no one lives without essentials** by giving cash support or free services.

✅ Example: In countries like Vietnam, economic growth and government investment in education and rural development have dramatically reduced absolute poverty over the last 20 years.

7.7 Income distribution and welfare

Causes of changes in absolute and relative poverty

🏠 Why Relative Poverty Changes

📈 Wage Gaps Are Growing

- People in top jobs (like CEOs or bankers) are getting huge pay rises.
- But many public sector workers (like nurses or teachers) have seen barely any increases — some even earn **less in real terms** (when you factor in inflation).
- Today, the richest earn about **170 times more than the average worker**. That used to be only 60 times more.

🌐 Good Jobs Have Vanished

- **De-industrialisation** means factories closed, especially in towns that depended on them.
- Now there are more **service jobs** (like retail or hospitality), which often **pay less** and are less secure.

❌ Less Government Support = Trouble

- If a government cuts benefits like unemployment payments or child support, it can **make poor families poorer**. Less money coming in means they struggle to keep up with the average living standards around them.

7.7 Income distribution and welfare

Causes of changes in absolute and relative poverty

What's Happening in the UK?

📊 Overall Poverty Rates

- **Relative Poverty**: In 2023/24, about **21%** of the UK population lived in relative poverty after housing costs, equating to **14.2 million people** .
- **Absolute Poverty**: Approximately **18%** were in absolute poverty after housing costs, totalling **12.3 million individuals** .

👶 Child Poverty: A Growing Concern

- **Current Figures**: As of April 2024, **4.5 million children** (31% of all UK children) were living in relative poverty after housing costs .
- **Impact of Policies**: The two-child limit on Universal Credit has been linked to increasing child poverty rates, with calls for its removal to alleviate hardship .

🏘️ Housing and Poverty

- **Private Renters**: In 2023/24, **49% of children** in private rented accommodations were in relative poverty after housing costs .
- **Social Renters**: Similarly, **50% of children** in social housing faced relative poverty after housing costs .

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7.7 Income distribution and welfare

Wealth vs income inequality

Not all inequality is the same.

🏠 **Wealth Inequality**

- This is about the **stuff people own**, also called **assets** like houses, savings, cars, investments, and businesses.
- Some families own a lot (multiple homes, stocks, art collections), while others may own very little or nothing at all.

💡 Wealth is like a **pile of valuable things** someone has collected over time.
🏡 Example: One person may inherit a house and stocks, while another has no savings and rents their home. That's wealth inequality.

📈 **Income Inequality**

- This is about how **money coming in** (like wages, rent, interest, or profits) is shared across different households.
- Some people earn a lot, while others earn very little and that's **income inequality**.

🧠 Think of income like a **stream of money** that flows into your life every week or month.
💼 Example: A doctor earning £100,000 a year and a cleaner earning £18,000, a big gap, right? That's income inequality.

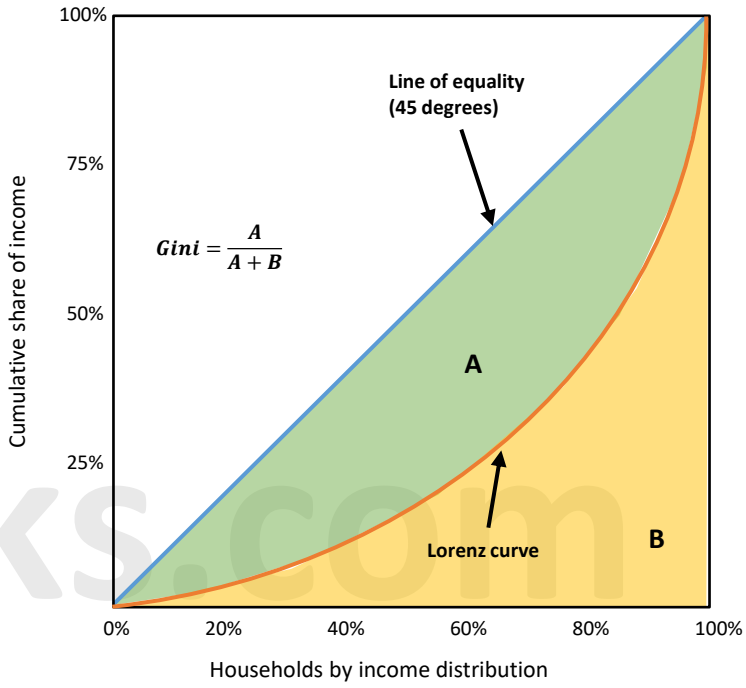
🔑 **In short**:

- **Wealth** = everything valuable you own.
- **Income** = money you earn regularly.

And while both types of inequality matter, **wealth inequality is usually much bigger** and harder to fix especially when it's passed down through generations.

7.7 Income distribution and welfare

Measurements of income inequality



Lorenz Curve

The **Lorenz Curve** is like a visual cheat sheet for understanding **how evenly (or unevenly) income is shared** between households in a country.

🔍 **What Does It Show?**

- It compares **households** (from poorest to richest) on the x-axis to **how much of the total income they earn** on the y-axis.
- The **Line of Equality** (the diagonal 45° line) shows what the world would look like if everyone earned exactly the same amount; that's **perfect equality**.
- The **Lorenz Curve** shows how things actually are. The more it bends away from that perfect line, the **more unequal** the income distribution is.

Measurements of income inequality

Lorenz Curve

📉 **Diagram Breakdown:**

This Lorenz Curve comparison gives us a clear picture of income inequality:

- The **bottom 20%** of households only receive **about 5% of the income**.
- The **top 10%** receive **about 60%** of the total income.
- The Lorenz Curve bends sharply = **more inequality**.

🧠 **Is Perfect Equality the Goal?**

Not necessarily.

- If everyone got the same income no matter what, there'd be **no incentive to work harder or take risks**, which could slow down innovation and productivity.
- A more **balanced level of income inequality**, though, helps **reduce poverty and keep society fairer and more stable**.

Canada vs Brazil: A Real-World Lorenz Curve Example

🍁 **In Canada:**

- The **bottom 20%** (poorest households) earn about **8% of total income**.
- The **top 10%** earn around **30% of total income**.
- The Lorenz Curve is **slightly curved** – inequality exists but is moderate.

In Brazil:

- The **bottom 20%** only earn about **3% of total income**.
- The **top 10%** earn a huge **55% of total income**.
- The Lorenz Curve is **very curved** – showing **high inequality**.

7.7 Income distribution and welfare

Measurements of income inequality

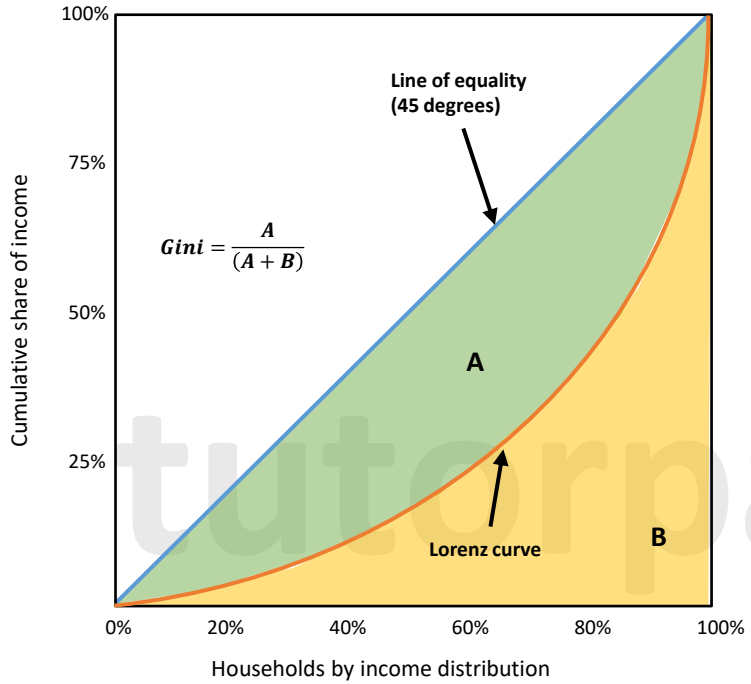
Lorenz Curve

✅ **Why It Matters:**

- More equal income distribution helps **reduce social tension**, **improve wellbeing**, and **build a fairer society**.
- Policymakers use these graphs to understand what's going on and decide whether taxes, benefits, or wage policies need adjusting.

7.7 Income distribution and welfare

Measurements of income inequality



The Gini coefficient

The **Gini Coefficient** is a number that tells us how unequal a country's income distribution is. It's based on the **Lorenz Curve**, and it helps us understand who's getting what slice of the money pie.

7.7 Income distribution and welfare

Measurements of income inequality

The Gini coefficient

What Is It, Exactly?

We use the **Lorenz Curve** to calculate the Gini Coefficient by looking at two areas on the graph:

- **Area A** is the space **between** the perfect equality line (the 45° line) and the Lorenz Curve.
- **Area B** is the space **underneath** the Lorenz Curve.

The formula is:

$$Gini\ Coefficient = \frac{A}{(A+B)}$$

What Do the Numbers Mean?

- A **Gini of 0** means everyone earns the same. That's **perfect equality**.
- A **Gini of 1** means one person has all the income and everyone else has none. That's **complete inequality**.

Think of it like this:

- A country with a Gini of **0.25** is pretty fair.
- A country with a Gini of **0.60** has a big income gap between rich and poor.

Measurements of income inequality

The Gini coefficient

🌎 **Real-World Examples (Updated!)**

- **Norway** has a Gini around **0.27** – most people have similar incomes, and inequality is low.
- **South Africa** has one of the highest Gini scores at around **0.63** – a few are very rich, and many are very poor.

🤔 **Why Does This Matter?**

Knowing a country's Gini score helps us:

- Spot income inequality trends over time.
- Compare fairness between countries.
- Shape policy – governments can decide whether they need to raise taxes on the rich, increase benefits for the poor, or improve access to jobs and education.

7.7 Income distribution and welfare

Measurements of income inequality

Continue to the next page…

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7.7 Income distribution and welfare

Causes of income and wealth inequality

Let's see why some people (or even whole countries) end up with more money, property, or resources than others.

🔍 **Within Countries (Why people in the same country earn or own different amounts)**

🏠 **Wealth Levels: What You Already Own**

If you already have **wealth** (like savings, property, or shares), it's easier to make more.

- Wealthy people can invest in things like property or stocks and when those go up in value, they get richer.
- Inheritance plays a big role. If your parents owned a house in a now-trendy area, you're probably better off today.

✏️ Example: Someone buys a flat in Manchester for £150k. Ten years later, it's worth £300k. That's wealth growth.

💼 **Wages: What You Earn from Work**

Some people get paid more than others, here's why:

- They may have better qualifications, more experience, or highly demanded skills.
- They might work longer hours or in harder jobs.
- Those not working (like retirees or people on benefits) usually have lower income.

💡 More income = more saving = more chances to build wealth.
But if you're on a low income, most of your money might go on essentials like food and rent with little left to save.

✏️ Example: A software engineer may earn £60k a year and invest in property. A supermarket cashier might earn £20k and just cover the bills.

7.7 Income distribution and welfare

Causes of income and wealth inequality

👴 **Age: Where You Are in Life**

- People in their 40s and 50s usually earn more as they're experienced and at their career peak.
- Younger people tend to earn less as they're just starting out.
- Older people might have more assets (like homes or pensions) but could also be using them to fund retirement.

✏️ Example: A 25-year-old teacher may earn £28k, while a 50-year-old headteacher might earn £65k and own a house worth £400k.

💰 **Benefit System**

- Countries that offer **financial help** (like unemployment benefits, housing support, or child payments) help **lift up the poorest households**.
- This makes income distribution **more equal**.

✏️ Example: In France, generous unemployment support helps people avoid falling into poverty between jobs.

🛡️ **Employment Laws**

- When **workers are protected by law**, they're less likely to be underpaid or fired unfairly.
- **Maternity benefits**, for example, ensure new mothers don't lose income while caring for a newborn.

✏️ Example: In Norway, parents can take paid leave after having a baby, reducing financial stress and helping family income stay stable.

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7.7 Income distribution and welfare

Causes of income and wealth inequality

🌍 **Between Countries (Why some countries are richer than others)**

Some countries have been **held back by big challenges**, like:

- **Wars**, **droughts**, **earthquakes**, or **famine**
- Historical colonisation, inequality, or exclusion from global trade deals

In contrast, richer countries often:

- Have stable governments and growing economies
- Trade with and support each other
- Invest more in infrastructure, healthcare, and education

✏️ Example: A worker in Germany might have access to high-paying jobs, good healthcare, and free university. A worker in a conflict-affected area may not have those opportunities.

📚 **Education, Training & Skills**

- People with **better skills and education** usually earn more.
- A country with a weak education system often sees **bigger income gaps**, because people aren't equipped for high-paying jobs.

✏️ Example: A graphic designer with digital skills may earn more than someone who left school early and works in retail.

7.7 Income distribution and welfare

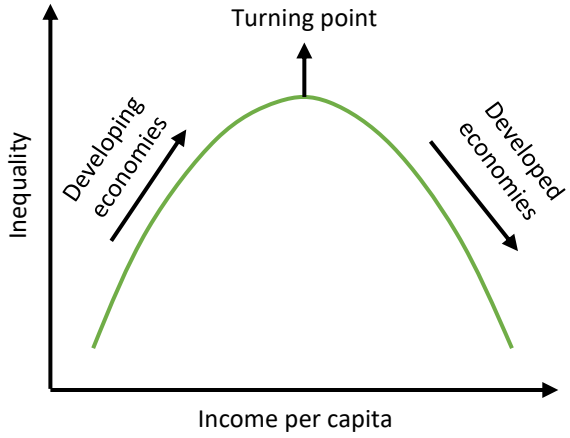
Impact of economic change and development on inequality

📈 **The Kuznets Hypothesis – Inequality Rises, Then Falls**

Economist Simon Kuznets had a theory:

- As a country **develops**, it shifts from farming (agriculture) to factories and offices (industry).
- At first, **inequality grows**. Why? Because people working in cities and factories earn way more than those still farming in rural areas.
- But over time, as the government collects more taxes and spends more on public services (like education, healthcare, and benefits), **wealth gets shared more fairly**, and inequality **starts to shrink**.

🎯 Think of it like a rollercoaster: inequality goes up during early development, then comes down again once the country is richer and more balanced.



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Impact of economic change and development on inequality

💥 **But Piketty Says: Not So Fast…**

Economist Thomas Piketty had a different view:

- He said that as a country develops, the **rich keep getting richer** especially from investments like stocks, property, and businesses (what economists call "capital").
- If the money earned from owning things (like rent, dividends, and profits) grows faster than wages, then **inequality actually increases over time**.
- So, unless governments step in to tax wealth or redistribute income, the **wealth gap just keeps widening**.

💸 Example: If someone owns 10 houses and rents them all out, they earn more and more over time, even without working. Meanwhile, someone with just a job might see their wage rise slowly, if at all.

7.7 Income distribution and welfare

Significance of capitalism for inequality

What Is Capitalism?

Capitalism is an economic system where businesses, land, and resources are mostly owned by individuals (not the government), and people make money through markets based on supply and demand. It's the core idea behind **free market economies** like the US or UK.

⚖️ **Inequality Is Built In**

In capitalism, **inequality is pretty much guaranteed**. Here's why:

- People with **higher skills** (like doctors, engineers, or coders) earn more.
- People with **low or no skills** (like those just entering the workforce) usually earn less or may struggle to get a job.
- Those with **higher incomes** can afford to buy **assets** (like houses, stocks, or businesses).
    - These assets generate more income.
    - So, the rich can keep getting richer.

Meanwhile, people with lower incomes:

- Have a harder time buying assets.
- Stay stuck in a cycle where their wealth doesn't grow much, if at all.

💡 Example: Someone earning £80,000 can invest in property and shares. Someone earning £18,000 might be just trying to cover rent and bills.

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7.7 Income distribution and welfare

Significance of capitalism for inequality

🚀 **Incentives: Why Capitalism Values Inequality (To a Point)**

Some economists argue that **perfect equality isn't possible (or even good)** in a capitalist system.

- The chance to **earn more** gives people a reason to work hard, take risks, and be creative.
- If everyone got the same pay no matter what, people might not bother working harder or starting businesses.

💡 Bottom line: **A bit of inequality helps the system run.**

⚖️ **But Too Much Inequality? That's a Problem**

A **little inequality** keeps things moving but **too much** can lead to trouble:

- People at the bottom may feel stuck and lose motivation.
- It can create **unfair advantages.**
- It can even **slow down the economy** if people can't afford to spend or invest.

🩹 **The Long-Term Problem**

Over time, **wealth and resources (called "factors of production" like land, labour, and capital)** often end up in the hands of a small group of people. This can lead to:

- **Extreme inequality**
- Many people feeling left behind
- Social tension or unrest

7.7 Income distribution and welfare

Significance of capitalism for inequality

🛑 **Why We Need Rules (aka Checks and Balances)**

Some argue capitalism works best when it's **managed carefully**. Without rules:

- The gap between rich and poor grows too wide.
- It can become unfair, and even inefficient.

That's why we need **government intervention** (like taxes, benefits, free education, or minimum wage laws) to help level the playing field.

7.8 The Phillips Curve

Short-run Phillips curve

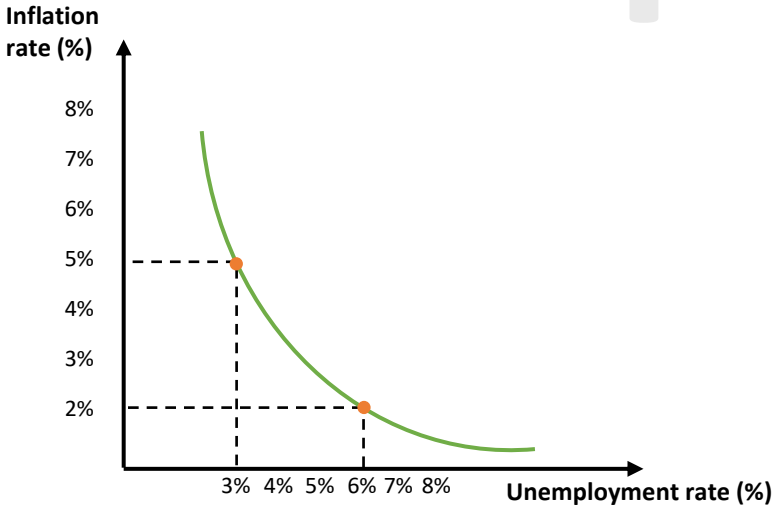
Ever wondered why **low unemployment** sometimes leads to **higher inflation**? Economist **A.W. Phillips** discovered this trade-off, now known as the **Phillips Curve**. He found that when **unemployment falls**, businesses must **compete for workers**, pushing up **wages**. These **higher wages** increase business costs, which are then **passed on to consumers as higher prices** (inflation).

🔄 **The Short-Run Phillips Curve: How It Works**

✓ **High Unemployment = Low Inflation** – When **lots of people are looking for work**, businesses can **offer lower wages**, keeping **costs and prices low**.

✓ **Low Unemployment = High Inflation** – When **jobs are plentiful**, workers **demand higher wages**, pushing up **business costs and prices**.

📊 **Graphically**, this is shown as a **downward-sloping curve**: as **unemployment falls, inflation rises**.



7.8 The Phillips Curve

Short-run Phillips curve

🚨 **The Breakdown: What Happened in the 1970s?**

The Phillips Curve worked **well for a while**, but then **stagflation** hit in the 1970s; **both high unemployment AND high inflation** happened at the same time! This was caused by:
✓ **Oil price shocks** – The **OPEC oil crisis** sent energy prices soaring, increasing costs for businesses.
✓ **Supply-side problems** – Factories struggled, leading to **economic stagnation**.

💡 **Example:** In the **UK and US during the 1970s**, inflation hit **double digits** while **unemployment remained high**, proving that **the Phillips Curve isn't always reliable**.

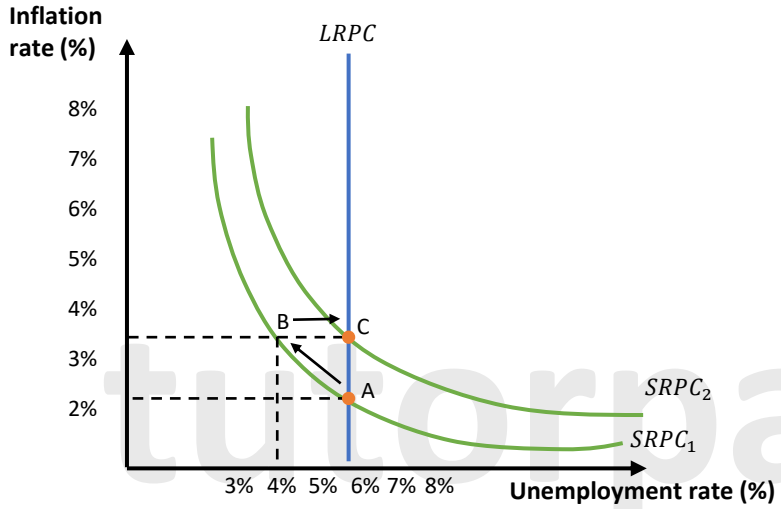
🎯 **The Big Question: Can We Have Both Low Inflation AND Low Unemployment?**

Some economists argue that **improving productivity and supply-side policies** (like education & innovation) can **shift the Phillips Curve**, allowing for **both stable inflation and low unemployment**. But others say **trade-offs are inevitable**

7.8 The Phillips Curve

Long-run Phillips curve

Economist **Milton Friedman** came up with an explanation for why the trade-off between inflation and unemployment doesn't hold in the long run.



🧠 In the Short Run…

People suffer from **money illusion;** they see more money in their paycheck and think they're better off, even if prices have gone up. So, when the government boosts **aggregate demand (AD)** to reduce unemployment, businesses hire more workers. Unemployment drops, and inflation rises. That's the short-run win.

This happens along the **Short-Run Phillips Curve (SRPC)**. For example, we move from **Point A to Point B** on the diagram:

- Inflation goes up (say, from 0% to 3.5%)
- Unemployment goes down (say, from 5.5% to 4%)

Seems great, right?

7.8 The Phillips Curve

Long-run Phillips curve

😬 But Then Reality Kicks In…

After a while, workers catch on. They realise that while their wages have gone up, so have prices and their **real wages** (what their money can actually buy) haven't improved. This is where **adaptive expectations** come in.

Adaptive expectations mean people adjust their future expectations based on what they've experienced. So now that they expect 3.5% inflation, they'll ask for higher wages to keep up.

Businesses, now facing rising wage bills, cut back on hiring. Unemployment rises again and this time we move from **Point B to Point C**.

We're now back to the same level of unemployment as we started with but stuck with higher inflation.

🧭 The Long-Run Picture

This brings us to the **Long-Run Phillips Curve (LRPC)**, which is:

- **Vertical** because in the long run, there's no trade-off between inflation and unemployment.
- Fixed at the **Natural Rate of Unemployment (NRU)** — the level of unemployment that exists even when the economy is stable, due to people switching jobs, mismatched skills, etc.

Trying to push unemployment below the NRU will only lead to rising inflation over time. It's like pressing down on a spring; it bounces back up, but now things are a bit messier.

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7.8 The Phillips Curve

Long-run Phillips curve

📌 **The Lesson for Governments**

There are **two kinds of Phillips Curves**:

- **Short-Run Phillips Curve (SRPC)** – In the short term, you can lower unemployment by tolerating a bit more inflation.
- **Long-Run Phillips Curve (LRPC)** – In the long run, workers adapt, and inflation expectations rise, so unemployment returns to the NRU.

💬 Want to reduce unemployment for good? Focus on **supply-side policies** like education, skills training, and making it easier to hire, not just pumping up demand.

🔁 **Real-World Example**

Imagine the government gives everyone a stimulus check to boost spending. Shops are busy, businesses hire more. Unemployment falls. But a few months later, prices rise. Workers realise their money isn't stretching as far and demand pay raises. Businesses pull back hiring. Back to square one, now with added inflation.

7.8 The Phillips Curve

Implications of the Philips curve for economic policy

🚦 **Impacts on Short-Run Policy**

Governments don't have a magic wand; they often have to make **trade-offs** when pursuing their goals. Solving one problem might make another worse.

- If the government wants **faster economic growth**, it might get **lower unemployment**.
- But that growth can **overheat** the economy, pushing prices up and causing **inflation**.

💡 Example:
Imagine the economy is like a car engine. If you press the accelerator (economic growth) too hard, the engine heats up (inflation).

⚖️ **Classic Trade-Offs in Economics:**

Growth vs Inflation: Faster growth = more jobs, but also higher prices. E.g., if unemployment drops, businesses compete for workers, so wages go up, and so do prices.

Growth vs Inequality: Wealth often increases faster for the rich. Example: Tech company owners gain millions, while average worker wages barely rise.

Low Unemployment vs Low Inflation: When most people are working, businesses struggle to find workers. They offer higher wages, which can raise prices across the board (wage inflation).

Growth vs Environment: More factories = more pollution. Example: Higher car production = more CO_2 emissions.

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7.8 The Phillips Curve

Implications of the Philips curve for economic policy

🧭 **Long-Run Policy Decisions (Looking Ahead)**

The **Long-Run Phillips Curve (LRPC)** says: "In the long run, there's **no trade-off** between inflation and unemployment."

Why? Because the economy naturally settles at its **potential output;** the maximum it can produce without causing inflation.

So, here's what smart policymakers should do:

❌ **Don't Rely on Demand-Side Policies**

- These are things like tax cuts or increasing government spending.
- They may reduce unemployment *temporarily*, but inflation can creep up and undo the benefits.

✅ **Focus on Supply-Side Policies**

These aim to make the economy more productive in the long term.

- Invest in **education and training** (so workers can do more skilled jobs)
- Reform the **labour market** (e.g., easier hiring and firing)
- Improve **technology and infrastructure**

7.8 The Phillips Curve

NAIRU

NAIRU stands for **Non-Accelerating Inflation Rate of Unemployment** which is basically the "sweet spot" of unemployment where **inflation stays steady**.

It's the lowest unemployment rate an economy can have **without causing inflation to speed up**.

🧠 **Think of it like this:**

- If unemployment is **too low**, businesses might compete for workers by offering higher wages. That pushes up prices = **inflation rises**.
- If unemployment is **too high**, there's less pressure to raise wages. Demand drops = **inflation falls**.

📈 **What Happens at Different Unemployment Levels?**

- ✅ **Unemployment = NAIRU** → Inflation stays the same
- 🔼 **Unemployment < NAIRU** → Inflation goes up (think: labour shortage, higher wages)
- 🔽 **Unemployment > NAIRU** → Inflation falls (think: surplus of workers, wages stay flat)

🧩 **What affects NAIRU?**

NAIRU isn't set in stone. It changes based on:

- **Structural unemployment** (e.g., mismatch between skills and job openings)
- **Frictional unemployment** (people between jobs)
- **Government policies** (like better training programs, benefits reform, or job creation schemes)

💡 **Example:** If a country improves its job-matching services (like better job centres or online platforms), NAIRU might drop because people can find work more easily.

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7.8 The Phillips Curve

NAIRU

In short:

NAIRU helps us understand the balance between unemployment and inflation. Staying close to it means we can enjoy low unemployment **without sending prices through the roof**.

7.8 The Phillips Curve

NAIRU

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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).**

Causes of growth

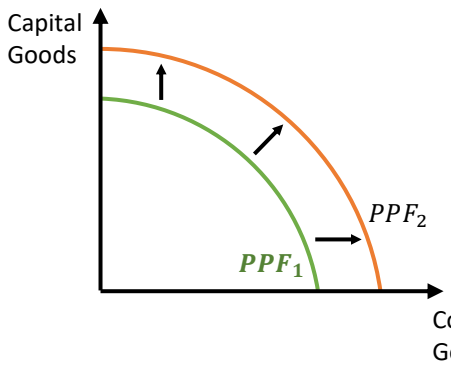
Actual vs Potential Growth

🔷 **The PPF and Economic Growth – A Simple Explanation**

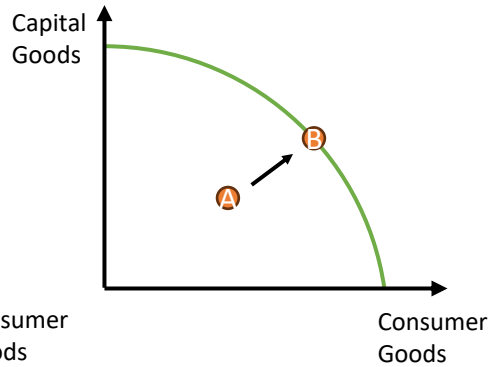
The **Production Possibility Frontier (PPF)** shows the **maximum amount of goods and services an economy can produce** with its current resources.

- 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

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