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CIE IGCSE ECONOMICS 0455

SUMMARIZED NOTES ON THE SYLLABUS

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1. The Basic Economic Problem

1.1 Economic Problem

- There are too few productive resources to make all the goods and services that consumers need and want.
- Unlimited wants and limited resources
- Scarcity of resources is the basic economic problem

Types of goods

- **Economic goods:**A good or service that has a degree of scarcity and therefore an opportunity cost.
- **Free goods:** A good or service that is not scarce and is available in abundance. For example, the air we breathe.

1.2 Factors of Production

- Consumers are people or firms who need and want goods and services
- Resources or factors of production are used to make goods and services

LLCE

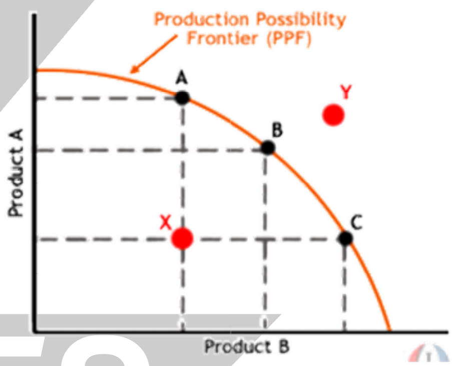
- **L**and: natural resources used in production (e.g. land)
- **L**abour: human effort used in production of goods/services (e.g. workers)
- **C**apital: the man-made resources that are used to produce goods/services (e.g. tractor)
- **E**nterprise: the skills and willingness to take the risks required to organize productive activities
- Entrepreneurs organize and combine resources in firms to produce goods and services
- Durable consumer goods last long while (e.g. furniture) non-durable consumer goods (e.g. food) do not
- Capital goods and semi-finished goods or components are used up in production

1.3 Opportunity Cost

- Opportunity cost is the cost of choosing between alternative uses of resources
- Choosing one use will always mean giving up the opportunity to use resources in another way, & the loss of goods & services they might have produced instead
- Problem of resource allocation is choosing how best to use limited resources to satisfy as many needs and wants as possible and maximize economic welfare
- Economics aims to find most efficient resource allocation
- **Example 1:**A person invests $10,000 in a stock
  - Could have earned interest by leaving $10,000 dollars in bank account instead
  - Opportunity cost of decision to invest in stock is the value of the potential interest
- **Example 2:** A city decides to build a hospital on vacant land it owns
  - Could have built school or sports centre
  - Opportunity cost is the value of the benefits forgone of the next best thing which could have been done

1.4 Production Possibility Curves& Choice

- Opportunity cost can be shown using a production possibility curve (PPFC)
- It shows the maximum combinations of goods and services that can be produced by an economy in eachperiod of time with its limited resources
- A PPC shows all the combinations of possibilities, involving two goods or options
- Each combination is a **choice**
- An economy can use all its scarce resources to produce this combination
- A point within the curve signifies like **X**, represents inefficiency
- A point outside the curve like **Y**, represents combinations that cannot be produced due to the lack of resources



2. Allocation of Resources

2.1 Microeconomics and Macroeconomics

Microeconomics

- It is the study of particular markets, and segments of the economy. It looks at issues such as consumer behaviour, individual labour markets, and the theory of firms.
- It involves supply and demand in individual markets,Individual consumer behaviour, and individual labour markets

Macroeconomics

- Study of the whole economy. It looks at ‘aggregate’ variables, such as aggregate demand, national output and inflation.
- Involves decisions made by the government regarding, for example, policies

2.2 The role of markets in allocating resources

The Market System

- A market economy is an economic system in which economic decisions and the pricing of goods and services are guided by the interactions of supply and demand- the market mechanism

Key Resources Allocation Decisions

The basic economic problem of scarcity creates three key questions

- What to produce?
- How to produce?
- For whom to produce?

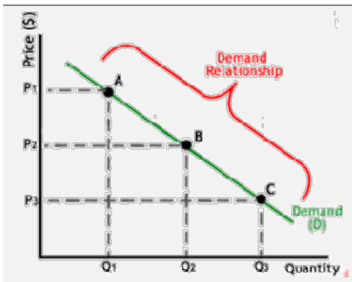
Introduction to the Price mechanism

- It aids the resource allocation decision making process. The decision is made at the equilibrium point where supply and demand meet

2.3 Demand

- Demand refers to how much of a product or service is desired by buyers

DEMAND CURVE



Higher price of good = less people demand that good

$$Price \propto \frac{1}{Demand}$$

FACTORS THAT AFFECT DEMAND

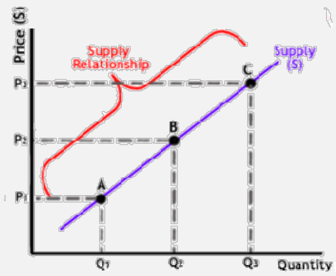
- Price
- Consumer tastes/preferences
- Consumer Income
- Prices of substitute/ complementary goods
- Interest rates (price of borrowing money)
- Consumer population (population increase = demand increase)

- **The individual demand** is the demand of one individual or firm
- **The market demand**represents the aggregate of all individual demands

2.4 Supply

- Supply represents how much the market can offer

SUPPLY CURVE



Higher price of good = higher quantity supplied

$$Price \propto Supply$$

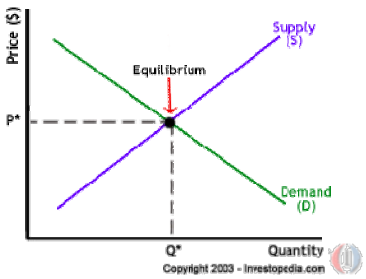
FACTORS THAT AFFECT SUPPLY

- Cost of factors of production
- Prices of other goods/services
- Global Factors
- Technology Advance
- Business Optimism/ Expectations

- **The individual supply** is the supply of an individual producer
- **The market supply** is the aggregate of the supply of all firms in the market

2.5 Price Determination

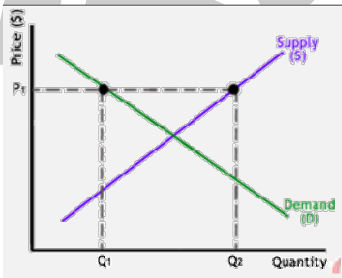
Market Equilibrium



- When supply & demand are equal the economy is said to be at equilibrium
- At this point, the allocation of goods is at its most efficient because amount of goods being supplied is the same as amount of goods being demanded & everyone is satisfied

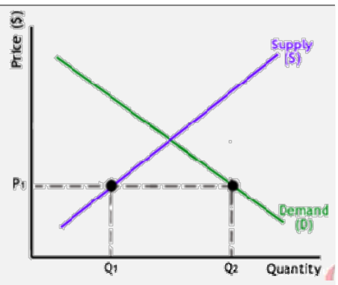
Market Disequilibrium

Excess Supply



If the price is set too high, excess supply will be created within the economy and there will be allocative inefficiency

Excess Demand



When price is set below the equilibrium price. Creates demand that exceeds production due to the low price.

2.6 Price Changes

Causes of Price Changes

- A change is supply
- A change in demand

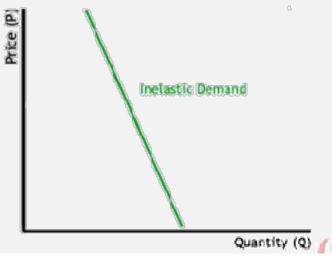
Consequences of Price Changes

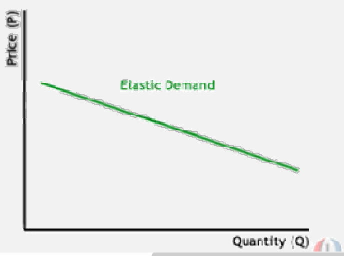
- An inward shift of the supply curve will increase prices and vice versa
- An inward shift of the demand curve will decrease prices and vice versa

2.7 Price Elasticity of Demand

- **Definition:** The responsiveness of demand to a change in price

INELASTIC DEMAND	ELASTIC DEMAND
• **PEDlower than 1**	• **PEDgreater than 1**
• The necessity of the product is high – it is either essential or habitual	• The necessity of the product is relatively low
• A change in price has little effect on the change in demand	• Demand would respond quickly and more drastically





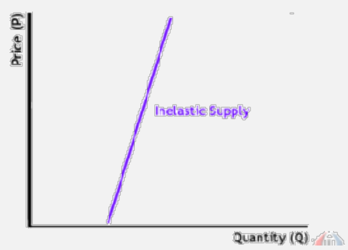
$$PED = \frac{\%\ change\ in\ quantity\ demanded}{\%\ change\ in\ price}$$

- When demand is price inelastic:
  - An increase in price would raise revenue
- When demand is price elastic:
  - A decrease in price would raise revenue
- Factors that affect PED:
  - The number of substitutes
  - The period of time
  - The proportion of income spent on the commodity
  - The necessity of the product

2.8 Price Elasticity of Supply

- **Definition:** The responsiveness of quantity supplied to a change in price

INELASTIC SUPPLY	ELASTIC SUPPLY
• **It has a PES less than 1**	• **It has a PES more than 1**
• A large price change will have little effect on the amount supplied	• A large price change will have a large effect on the amount supplied



$$PES = \frac{\%\ change\ in\ quantity\ supplied}{\%\ change\ in\ price}$$

- Factors that affect PES:
  - Time
  - Availability of resources
  - Supply available to meet demand
  - Spare production capacity available
  - Factor substitution available

2.9 Market Economic System

- Has a private sector only
- They produce a wide variety of goods and services if it is profitable to do so but only for those consumers that are willing and able to pay for them
- Market failures can cause scarce resources to be allocated to uses that are wasteful, inefficient or even harmful to people and the environment

ADVANTAGES	DISADVANTAGES
• Wide variety of goods/services	• Serious market failure
• Profit motive encourages development of new and more efficient products & processes	• Only profitable goods provided
• Quick response to change in consumers tastes and demand	• Firms will only supply products to consumers with the ability to pay
No taxes on incomes and wealth or goods and services	• Resources will only be provided if it is profitable to do so
	Harmful goods may be available to buy readily

2.10 Market Failure

- Market failure occurs when the market mechanism fails to allocate scarce resources efficiently, so social costs are greater than social benefits

Causes and Consequences of Markets Failure

- Only goods and services that are profitable to make will be produced
- Services such as street lighting won't be provided as you are unable to separate it
- Resources only employed if profitable – people may be left unemployed without an income
- Harmful goods may be produced and sold freely
- Producers may ignore environmental impacts
- Monopolies dominate supply of products and charge high prices

2.11Mixed Economic System

- Has a private sector & a public sector
- A government can try to correct market failures in a mixed economic system
- It can allocate scarce resources to provide goods and services that people need
- Can introduce laws and regulations to control harmful activities

Government Intervention

- Produce merit goods such as education for the needy
- It can provide public goods such as street lighting
- Public sector can employ people and welfare benefits can be given to the needy
- Laws to make goods illegal or high taxes to reduce consumption
- Laws and regulations would protect natural environment
- Monopolies can be broken up or regulated to keep prices low

3. Microeconomic Decision Makers

3.1 Money and Banking

Functions of money

- **Medium of exchange:** accepted as means of payment
- **Unit of account:**for placing a value on goods/services
- **Store of value:**can save money since it keeps its value
- **Standard for deferred payment:** borrowers are able to borrow money and pay back later

Characteristics of money

- **Acceptability:** Anything can be used as money as long as it's generally accepted
- **Durability:** Good money must be hard-wearing
- **Portability:** Should be easy to carry around
- **Divisibility:** Must be able to divide it into smaller values
- **Scarcity:** Should be limited in supply to create value

Commercial Banks

- Accepting deposits of money and savings
- Helping customers make and receive payments
- Making personal and commercial loans
- Buying and selling shares for customers
- Providing insurance
- Operating pension funds
- Providing financial and tax planning advice
- Exchanging foreign currencies

Central Banks

- **Printing notes & minting coins** that are legal tender
- **Destroying torn notes & worn-out coins**
- **Setting interest rates**
- **Lender of last resort**: if a bank needs cash in a hurry, they can borrow from central bank
- **Supervising monetary policy:** heads of the central bank hold meetings with officials from other banks to determine interest rate and quantity of money in economy
- **Banker for commercial banks & the government:**
  - Government accounts & spending are carried out with central bank
  - Helps government to borrow money
  - Total amount government owes is national debt
- **Manage international financial system**: governments of different nations lending each other money

3.2 Households

Influences on Spending, Saving and Borrowing

- **Disposable income:** amount of income left to spend or save after direct taxes have been deducted
- **Spending:** enables a person to buy goods/services to satisfy their needs/wants
- **Saving:** involves delaying consumption
  - As interest rates rise, people may save more
- **Borrowing:** allows a person to increase their spending; enabling them to buy goods they cannot afford now
- People with low disposable incomes may spend less in total than people with high incomes
- But will tend to spend all or most of their income meeting their basic needs

INCREASE IN…	SPENDING	SAVING	BORROWING
Real income	↑	↑	↑
Direct tax	↓	↓	↕
Wealth	↑	↓	↑

Interest rates	↓	↑	↓
Availability of saving scheme	↓	↑	↓
Availability of credit	↑	↓	↑
Consumer confidence	↑	↓	↑

3.3 Workers

- **Entry:** young employee will receive low earnings due to lack of work skills and experience; can become an apprentice or join a management training scheme to become more skilled
- **Skilled workers:** the more skilled a worker is, the more opportunities he has for increasing his earnings; bonuses will be given and higher rate of overtime paid
- **End-of-career employees:** if workers keep updating skills, they will continue to have opportunities to increase wages however when they stop this, their demand would fall & income would diminish, finally reaching a stop when retired

Why firms change demand for labour

- Changes in consumer demand for products
- Changes in the productivity of labour
- Changes in price and productivity of capital
- Changes in non-wage employment costs

Why labour supply might change

- Changes in net advantages of an occupation
- Changes in provision and quality of education and training
- Demographic changes

Factors that Cause Occupational Wage Differentials

- Different abilities and qualifications
- 'Dirty jobs' and unsociable hours
- Job satisfaction
- Lack of information about jobs and wages
- Labour immobility
- Fringe benefits

Factors that cause wage differentials in the same job

- Regional differences in supply and demand of labour
- Length of service
- Local pay agreements
- Non-monetary agreements
- Discrimination

Specialization

- **Division of labour:** workers concentrate on a few tasks then exchange their product for other goods/services
- **Specialization:**production process broken up into a series of different tasks

ADVANTAGES FOR INDIVIDUAL	DISADVANTAGES FOR INDIVIDUAL
• Employees can make best use of their particular talents/skills and can increase them by repeating tasks • Employees can produce more output and reduce business costs • More productive employees can earn higher wages	• Doing same job or repetitive tasks is boring and stressful • Individuals must rely on others to produce goods and services they want but cannot produce themselves • Many repetitive tasks can now be done by machines, leading to unemployment of low-skilled workers

3.4 Trade Unions

- An organization of workers formed to promote & protect the interest of its members concerning wages, benefits & working conditions

Functions

- Negotiating wages & benefits with employers
- Defending employee rights and jobs
- Improving working conditions
- Improving pay and other benefits, including holiday entitlement, sick pay and pensions
- Encouraging firms to increase worker participation in business decision-making
- Developing skills of union members, by providing training and education courses
- Supporting members taking industrial action

Types of Trade Unions

- **General Unions:** represent workers across many different occupations
- **Industrial Unions:** represent workers of the same industry
- **Craft Unions:** represent workers with the same skill across different industries
- **Non-manual unions/Professional unions:** represent workers in non-industrial and professional occupations

Collective Bargaining

- Process of negotiating wages and other working conditions between trade unions and employers
- A trade union will be in a strong bargaining position to negotiate higher wages and better conditions if:

- It represents most or all of the workers in a firm
- Union members provide goods/services that consumers need which have few alternatives

Industrial Action

- Industrial action is taken when collective bargaining fails to result in an agreement
- Taking industrial action can help a union force employers to agree to their demands
- **Industrial actions:**
  - **Overtime ban:**workers refuse to work more than their normal hours
  - **Work to rule:**workers deliberately slow down production by complying with every rule & regulation
  - **Go slow:**workers deliberately work slowly
  - **Strike:**workersprotest outside their workplace to stop deliveries/non-unionized workers from entering

Impact of Trade Unions

POSSIBLE ADVANTAGES	POSSIBLE DISADVANTAGES
• Could help to bring about minimum working standards • Could help keep pay higher • Could help maintain Employment/enhanced job security • Could lead to improvement in health and safety	• Might cause lack of flexibility in working practices • Could be major problem as fashions change very quickly • Could lead to some firms going out of business • Workers made redundant • Workers will need to pay union membership fees

3.5 Firms

Size of Firms

- **Number of employees:** less than 50 are classed as small
- **Amount of capital employed:** large firms invest a lot in fixed assets such as machinery & equipment
- **Market share:** relative size of firms compared by percentage share of total market supply/revenue
- **Organization:** large firms may be divided into many departments &be spread over many locations

Small Firms

ADVANTAGES	DISADVANTAGES
• Size of market is small • Consumers like tailored goods/services • Governments provide help	• Markets cannot raise enough capital to expand their business

Economies and Diseconomies of Scale

Economy of Scale	Diseconomy of Scale
Cost savings due to increased scale of production • **Financial:** larger firms often have access to cheaper sources of finance • **Marketing:** larger firms employ specialists to buy best quality materials in bulk at discounted prices& spread advertising costs • **Technical:** larger firms invest in specialized production equipment, highly skilled workers; develop new products • **Risk-bearing:** ability to spread risk over many investors & reduce market risks by selling range of products in different locations	*Rising costs because a firm has become too large* • **Management:** larger firms must manage so many different departments in different locations, making communication/ decision-making difficult • **Labour:** demotivated workers lead to decrease in productivity due to boring, repetitive tasks • **Agglomeration:**company takes over or merges with too many other firms producing different products, making it hard for business owners and managers to co-ordinate all activities

Integration

- Growth often involves integration with other firms
- **Takeover:** a company acquires ownership & control of another company by purchasing its shares
- **Merger:** two or more firms agree to form an entirely new company & issue new shares

Types of Integration

- **Horizontal integration:** occurs between firms at the same stage of production producing similar products
- **Vertical integration:** occurs between firms at different stages of production
  - **Forward:**taking over firm at later stage of production
  - **Backward:** integration is the opposite
- **Lateral integration or conglomerate merger:** occurs with firms at same stage of production but different products

3.6 Firms and production

Demand for "Factors of Production"

- **Demand for goods & services by consumers:** higher demand = more labour/capital firms will need
- **Price of labour & capital:** higher cost = less labour & capital demanded
  - Firms may also decide to substitute labour for more capital and vice versa

- **Productivity of labour & capital:** more output/revenue labour & capital help to produce, more profit they will generate over & above cost of employing them
- **Capital-intensive Production:** requires heavy capital investment to buy assets relative to sales or profits that assets can generate
- **Labour-intensive Production:** main cost is labour; cost is high compared to sales or value added by additional manpower

- **Labour-intensive** production method primarily involves labour, whereas, **capital-intensive** methods primarily involve machinery

Productivity & Production

- **Productivity:** the ratio of output to input
- **Labour Productivity:**

$$Output\ per\ Labour = \frac{Total\ Output}{Number\ of\ Labour}$$

- **Capital Productivity:**

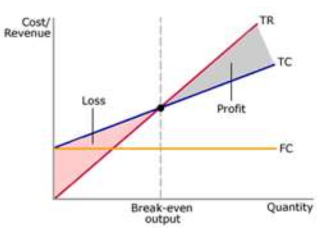
$$Value\ per\ Capital = \frac{Total\ Output\ Value}{Value\ of\ Capital}$$

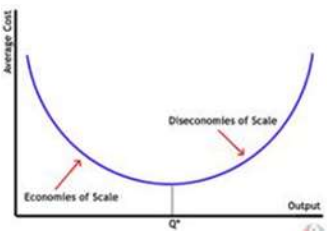
- Productivity refers to the efficiency of a business whereas production refers to output only

3.7 Firms' Costs, Revenue and Objectives

- **Fixed costs:** don't vary with level of output e.g. interest on loans
- **Variable cost:** vary directly with level of output e.g. electricity
- **Breakeven:** where total revenue = total cost
- **Total revenue:** the total receipts a seller can obtain from selling goods or services to buyers
- **Average revenue:** the revenue generated per unit of output sold

$$\mathbf{Average\ Fixed\ Cost} = Fixed\ Costs/Output$$
$$\mathbf{Average\ Variable\ Cost} = Variable\ Costs/Output$$
$$\mathbf{Total\ Variable\ Cost} = Variable\ Costs \times Output$$
$$\mathbf{Total\ Cost} = Total\ Variable\ Cost + Total\ Fixed\ Cost$$
$$\mathbf{Average\ cost} = (Total\ Cost)/Output$$
$$\mathbf{Total\ Revenue} = Price\ Per\ Unit \times Quantity\ Sold$$
$$\mathbf{Profit\ or\ Loss} = Total\ Revenue - Total\ Cost$$





Objectives of firms

- Survival
- Social welfare
- Profit maximisation
- growth

3.8 Market Structure

Competitive Markets

- Businesses will charge same price, a minimum price they can charge without going out of business
- Price will be equivalent to the lowest average cost of producing goods
- Average cost of production would be same as average revenue for selling
- No firm would risk charging more than market price
- A business would be a **price taker**; the market price

Monopoly Markets

- Firms with monopolistic powers control at least 25% of the market share
- Able to influence price; **price makers**
- Can restrict competition with artificial barriers to entry & other pricing strategies
- One firm controls entire market supply
- May use predatory pricing to force competing firms out
- Other firms deterred from competing due to lack of capital

Advantages of Monopolies

- Avoids duplication &wastage of resources
- Economics of scale; benefits can be passed to consumers
- High profits can be used for research &development
- Monopolies may use price discrimination which benefits the economically weaker sections of the society
- Monopolies can afford to invest in latest technology & machinery to be efficient & avoid competition

Disadvantages of Monopolies

- May supply less & charge higher prices
- May offer less consumer choice and lower quality products than if they had to compete with other firms
- May have higher production costs because they are poorly managed
- Restrict competition using barriers to entry

Barriers to entry

NATURAL	ARTIFICIAL
• Cost savings from large scale production • Lots of capital equipment that other firms can't afford • Large customer base built up over years • Developed advanced products or processes that are protected by patents	• Predatory pricing strategies to force smaller firms out • Preventing suppliers from selling materials & components to other firms by threatening to switch to rival suppliers • Forcing retailers to stock & sell only their product

4. Government & The Macroeconomy

4.1 Role of Government

AS A PRODUCER	AS AN EMPLOYER
• Produce essential goods & services e.g. health care & education • Supply merit goods • Supply public goods e.g. road repairs/lights • Control natural monopolies; they may take over companies providing necessities e.g. electricity or water	• People work directly for the government as civil servants, e.g. tax collectors • Employees in public sector: ○ Secure employment ○ State pension • Money earned by government employees is mainly spent in national economy

4.2 The Macroeconomic Aims of The Govt.

Objectives

- ○ Achieve low and stable rate of inflation in general levels of price
- ○ Achieve high and stable level of employment; low unemployment
- ○ Encourage economic growth in national output and income
- ○ Encourage trade & secure favourable balance of international transactions

- Additional objectives:
  - ○ Reduce poverty & inequalities in income & wealth
  - ○ Reduce pollution &waste; sustainable growth

Conflicting Aims

- Spending more money to stimulate growth can lead to rising prices because of increased demand
- If spending is reduced to stop inflation, this will lead to a fall in growth
- If government tries to create full employment, labour becomes increasingly scarce
- Employers must compete more strongly to attract labour
- They raise wages, which leads to wage inflation
- If the government tries to redistribute income, richer workers may feel that they are unfairly penalized for working hard & may decide to migrate
- This may slow down economic growth

4.3 Fiscal Policy

- **Budget:** It is an estimate made by the govt., of income and expenditure for a future period

Reasons for Government Spending

- To supply goods and services that are not supplied by the private sector, such as defence; merit goods such as education
- To achieve improvements in the supply-side of the macro-economy, like providing subsidies

Reasons to Tax

- To finance public expenditure; building schools and infrastructure
- To discourage certain activities; e.g. taxes on cigarette
- To discourage import of goods; tariffs are import taxes and can be levied as a % of value of imports or a set tax on each item
- To redistribute income from the rich to the poor
- To achieve other macro-economic objectives

TYPES OF TAXATION	DESCRIPTION	EXAMPLES
Progressive Tax	Tax rate rises with income; higher income = higher tax	Income tax
Regressive Tax	Tax rate falls with income; higher income = lower tax	VAT
Proportional Tax	Everyone pays same effective tax rate	Corporate income tax
Direct Tax	Levied on individuals	Capital gains tax
Indirect Tax	Added to price of commodities	Tariffs

Principles of Tax

- Equitable
- Economic
- Transparent
- Convenient

Fiscal Policy

- It is the use of taxation and government spending to influence aggregate demand

POLICY	ABOUT
Expansionary	Reducing taxes and increasing govt.

Fiscal Policy	spending to boost demand, so employment and output rises. May be used to **reduce recession**.
Contractionary Fiscal Policy	Increasing taxes and increasing govt. spending to reduce demand, so employment and output rises. May be used to **reduce price inflation**.

Effects of fiscal policy on govt. macroeconomic aims

- Expansionary fiscal policy can reduce unemployment
- Expansionary fiscal policy can increase economic growth
- Contractionary fiscal policy can reduce high inflation

4.4 Monetary Policy

- It is the use of interest rates, direct control of the money supply and the exchange rate to influence aggregate demand

POLICY	ABOUT
Contractionary Monetary Policy	May be used to **reduce price inflation** by increasing interest rates charged by the central bank. This means commercial banks will also raise interest to encourage more savings.
Expansionary Monetary Policy	May be used **during a recession**&to increase employment by cutting interest rates

Effects of monetarypolicy on govt. macroeconomic aims

- Expansionary monetary policy can reduce unemployment
- Expansionary monetary policy can increase economic growth
- Contractionary monetary policy can reduce high inflation

4.5 Supply-Side Policies

- Supply-side policies aim to increase economic growth by raising productive potential of economy
- An increase in the total supply of goods & services will require more labour &other resources to be employed
- It will reduce market prices & provide more goods & services to export

INSTRUMENT	EFFECT ON MACROECONOMIC AIMS
Tax Incentives	Reducing taxes on profits and small firms can encourage enterprise. It can also encourage investments in new equipment.
Subsidies/Grants	To reduce production costs and help firms fund research and development of new technologies.
Education and Training	Teaching new/existing workers new skills to make them more productive.
Labour Market Regulations	Include minimum wage laws to encourage more people into work, and legislation to restrict the power of trade unions.
Competition Policy	Regulations that outlaw unfair trading practices by monopolies and other large, powerful firms.
Free Trade Agreements	Removing barriers to international trade allow countries to trade their goods and services more freely and cheaply
Deregulation	Removing old, unnecessary and costly rules and regulations on business activities

4.6 Economic Growth

- Economic growth is when there is an increase in real output over time, i.e. increased GDP & national income
- Important as it increases the standard of living

Measurement of Economic Growth

- **Gross Domestic Product (GDP)** is the main measure of total value of all the goods and services produced in a given period of time
- An increase in prices will increase **nominal GDP** but this is measured in current dollars thus includes inflations

$$Real\ GDP = \frac{Nominal}{CPI} \times 100$$

$$Real\ GDP\ Per\ Capita = \frac{Real\ GDP}{Number\ of\ Population}$$

Recession

- It is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP growth, real personal income, employment, industrial production, & wholesale-retail sales
- A recession would cause the economy to produce at a point that is within the PPC

Causes of Economic Growth

- Discovery of more natural resources
- Investment in new capital and infrastructure
- Technical progress
- Increasing the amount and quality of human resources
- Reallocating resources

Consequences of Economic Growth

- An increase in output can improve living standards of people

- Higher output and incomes increase government tax revenue. This can increase govt. spending without increasing tax rates
- However, it can increase pollution, lead to depletion of non-renewable resources and damage the natural environment

Policies to Promote Economic Growth

- Expansionary fiscal policy
- Expansionary monetary policy
- Supply-side policies

4.7 Employment and Unemployment

INDICATOR	RECENT TRENDS
Labour force	• Risen as world population has grown
Participation Rate: labour force as a proportion of total population of working age	• Risen in many countries especially among females as it is now socially acceptable • Poverty and rising living costs in developing countries has forced many women to work
Employment by Industry: Number of people employed in different industrial sectors	• Employment in services has been growing while employment in agriculture and other primary sector industries has fallen
Employment Status: Number of full-timers, part-timers or with temporary contracts	• Most employees work full-time • Part-time employees have grown rapidly, especially among female employees
Unemployment: Number of people registered as being without work	• Tends to rise during economic recessions • Almost half the unemployed are young unskilled workers
Unemployment Rate: Unemployment as a proportion of labour force	• Relatively stable in the recent years but did increase in 2008 during a global financial crisis

Types of Unemployment

- **Cyclical Unemployment:** occurs during recession due to falling consumer demand & incomes
  - Firms reduce output & lay off workers
- **Structural Unemployment:** caused by changes in industrial structure of an economy
  - Entire industries close due to a permanent fall in demand for their goods/services
- **Frictional Unemployment:** refers to short-lived unemployment; e.g. moving to different job
- **Seasonal Unemployment:** occurs because consumer demand for goods/services changes with seasons; e.g. no job for ski instructor when/where there is no ice

Measurement of Unemployment

- Taking claimant count
- Labour force survey
- $\boldsymbol{Unemployment\ Rate} =$
  $Number\ of\ Unemployed\ Persons\ /\ Labor\ Force$

Consequences of Unemployment

PERSONAL	ECONOMICAL
• Loss of income and reduced ability to buy goods & services • Unemployed people de-skill if long out of work • Unemployed people may become depressed & ill • Strain on family relationships & health services	• Unemployment is a waste of human resources • Fewer goods & services produced • Total output & income in economy is lower • Government tax revenues also lower • People in work may have to pay more taxes • Government spending on welfare may rise

Policies to Reduce Unemployment

- Expansionary monetary policy
- Expansionary fiscal policy
- Increase in quality and quantity of education and training

4.8 Inflation and deflation

- **Inflation:** general & sustained increase in the level of prices of goods/services in an economy over a period of time
- **Deflation:**decrease in general price level of goods and services and occurs when the inflation rate falls below 0%

Measurement

- **Base year:** first year with which the prices of subsequent years are compared
- **Inflation rate:** percentage change in annual CPI

$$CPI\ in\ Year\ x = \frac{Weighted\ Average\ Price\ in\ Year\ x}{Weighted\ Avereage\ Price\ in\ Base\ Year} \times 100$$

Causes of Inflation

- **Demand-pull Inflation:** caused by total demand rising faster than total output, causing market prices to rise
- **Cost-push Inflation:** cost of production increases, so firms try to pass cost to consumers through higher prices

Causes of Deflation
- Fall in the money supply
- Decline in confidence
- Lower production costs
- Technological advances
- Increase in unemployment
- Increase in the real value of debt

Policies to Control Inflation & Deflation
- Contractionary fiscal and monetary policy for inflation
- Expansionary fiscal and monetary policy for deflation
- Supply-side policy can increase aggregate supply and thus control both inflation and deflation

5. Economic Development

5.1 Living Standards

Real Gross Domestic Product (GDP) Per Capita
- **GDP** is the main measure of total value of all the goods and services produced in a given period of time
- An increase in prices will increase **nominal GDP** but this is measured in current dollars thus includes inflations

$$Real\ GDP = \frac{Nominal}{CPI} \times 100$$

$$Real\ GDP\ Per\ Capita = \frac{Real\ GDP}{Number\ of\ Population}$$

- If economy has an extremely rich person & everyone else is poor, it brings up the Real GDP per capita

Human Development Index (HDI)
- Used by the United Nations to make comparisons of human & economic development in different countries
- Combines three different measures for each country
  - Standard of living, measured by average incomes
  - Being educated, measured by adult literacy rate
  - Living a long healthy life, measured by life expectancy
- Single index with a value between 0 and 1
- Greater than 0.8 = high human development. Less than 0.5 = low human development

Reasons For Low/Varying Economic Development
- Over-dependence on agriculture
- Domination on international trade by developed nations
- Lack of capital
- Insufficient investment in education, skills & healthcare
- Low levels of investment in infrastructure
- Lack of efficient production and distribution systems
- High population growth
- Other factors like a corrupt govt. or war

5.2 Poverty

ABSOLUTE POVERTY	RELATIVE POVERTY
• Number of people living below a certain income threshold or number of households unable to afford certain basic goods & services • Occurs when people do not have access to basic food, clothing and shelter	• Measures extent to which a household's financial resources falls below an average income level. • Occurs when people are poor relative to other people in the country; unable to participate fully in normal activities of society they live in

Causes of Poverty
- Unemployment
- Low wages
- Illness
- Age

Alleviating Poverty
- Governments will use policies to help alleviate poverty in their country, or in another country:

POLICY	WHY IS IT NEEDED?	WHAT ARE THE PROBLEMS?
Food aid	Poor farming methods produce insufficient food	Free food supplies can force farmers out of business
Financial aid	LEDCs lack capital to invest in an industrial base, modern machinery and infrastructure	Loans have to be repaid sometimes with interest
Tech aid	LEDCs lack access to modern machinery, equipment and knowledge of modern production methods	Most people lack skill to use modern technology; instead of using machinery, more jobs are needed to employ people
Debt relief	Relieving LEDCs of debt will allow them to use money for economic development instead	May encourage LEDCs to borrow more money or money may be misused by corrupt governments
Removing overseas trade barriers	LEDCs may have natural supplies, can be exported for money	MEDCs will force down their price
Economic	Governments in	Advice not enough;

Advice	LEDCs lack economic knowledge	LEDCs need more capital & stability

5.3 Population

Factors that affect population growth

- Birth rate
- Death rate
- Net migration
- Immigration & emigration

Reasons for different population growth rates

Varying Birth Rates

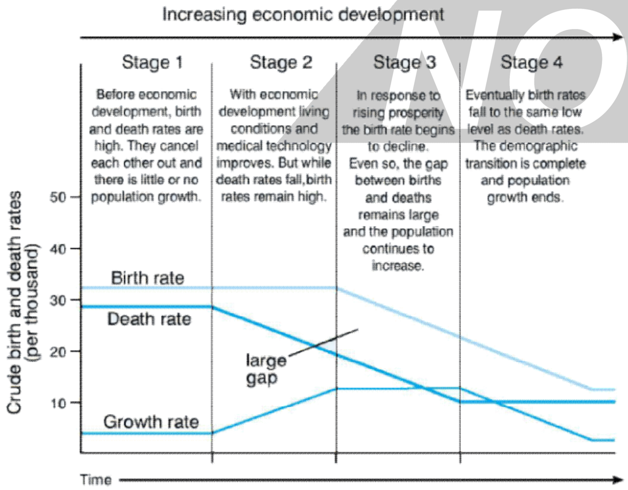
- LEDCs have:
  - Large families to help produce food & work for money
  - High infant mortality rate
  - Low supply of contraceptives/forbidden to use them
- In MEDCs, people marry later in life so birth rates fall

Varying Death Rates

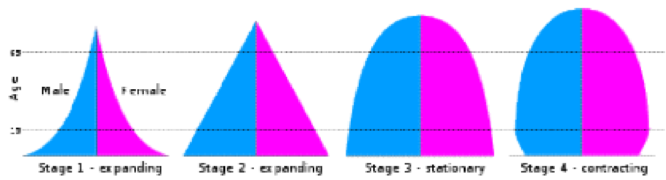
- MEDCs have:
  - Better food, housing, hygiene &high life expectancy
  - Fatty foods, smoking and lack of exercise has increased rates of diabetes, cancer & heart disease
  - Improved medicine & healthcare; preventsmany diseases & increased life expectancy
- LEDCS have:
  - Widespread diseases which lower life expectancy
  - Natural disasters, famines, wars

Population Structure

- **The Demographic Transition Model:**



- This shows that population growth occurs in stages
- **Population Pyramid:** a type of graph that shows the age and sex structure of the country



- Stage 1: high birth rate; high death rates; short life expectancy; less dependency (since there are few old people and children must work anyway)
- Stage 2: high birth rate; fall in death rate; slightly longer life expectancy; more dependency due to more elderly
- Stage 3: declining birth rate; declining g death rate; longer life expectancy; more dependency
- Stage 4: low birth rate; low death rate; highest dependency ratio; longest life expectancy

6. INTERNATIONAL TRADE & GLOBALISATION

6.1 International Specialisation

Specialization at a National Level

- Countries specialize in production of those goods and services in which they have an absolute advantage or comparative advantage over other regions or countries
- A country has an **absolute advantage** if it can produce a given amount of a good or service with far less resources and therefore at an absolute cost advantage over any country
- A country has a **comparative advantage** in the production of a good or service if it can produce it at a lower opportunity cost relative to other countries

Advantages of Specialisation

- Greater efficiency
- Consumer benefits from lower prices, greater variety and quality of goods & services
- Opportunities for competitive sectors
- Gains from trade

Disadvantages of Specialisation

- Threats to uncompetitive sectors
- Risk of over-specialization
- Dependency on other countries

6.2 Globalisation, Free Trade and Protection

- **Globalisation:** The process by which businesses or other organizations develop international influence or start operating on an international scale.

Multinationals

- Operates in more than one country
- Some of the largest companies in the world
- Governments often compete to attract multinationals

- Can provide jobs, incomes, business knowledge, skills and technologies which can help other firms
- Pay taxes on their profits to boost government revenue

- Headquarters are based in one country

Advantages	Disadvantages
• Can reach many more consumers globally & sell far more than other types of businesses • Can minimize transport costs by locating plants in different countries to be near raw materials or big markets • Minimize wage costs by locating in countries with low wages • Can enjoy low average production costs	• Can switch profits to other countries to avoid paying taxes on profits • Can force smaller local firms out of business • May exploit workers in low wage economies • May use their power to get generous subsidies & tax advantages from the government

Benefits of Free Trade

FOR CONSUMERS	TO PRODUCERS	TO GOVERNMENTS
• Cheaper products • Better products • Workers more productive • International Trade • Increased competition from international companies • Lower Prices – Better Qualities	• Larger markets • Economies of scale • More produced, lower average per unit cost • International trade increases number of products you make	• Exports increase jobs, GDP, incomes • But imports take them away

Trade Protection

- **Tariffs:** tax on imports to raise its price and make them more expensive than local goods to stop people buying them
- **Subsidies:** grant given to an industry by government so industry will lower its prices encouraging consumers to stop buying foreign imports by making home-produced goods cheaper
- **Quota:** limit on number of imports allowed into country per year, reducing quantity of imports without changing their prices
- **Embargo:** complete ban on imports of certain goods. An embargo may be used to stop imports of drugs
- **Excessive quality standards and bureaucracy**

Protection

ARGUMENTS FOR	POSSIBLE CONSEQUENCES
• Protection of a young industry • To prevent unemployment • To prevent dumping • Because other countries use barriers to trade • To prevent over-specialization	• Other countries will retaliate with trade barriers • It protects inefficient domestic firms • The loss of domestic jobs from overseas competitions will only be temporary • Trade barriers have increased the gap between rich and poor countries

6.3 Foreign Exchange Rates

- **Exchange rate** is the price of a country's currency in terms of another country's currency
- Most countries have a floating exchange rate, which means no set value for their currency compared with any other currency
- Currency is a commodity thus the value of a currency is totally dependent on demand and supply of that currency in the foreign exchange market.
- An appreciation in the value of currency means its exchange rate against other countries has risen
- A depreciation in the value of currency means its exchange rate against other countries has fallen

Exchange Rate Fluctuations

- Demand for a currency comes from foreign money flowing into the country. If demand rises, the currency's value will rise in relation to the other currency
- Supply of the currency comes from domestic money flowing out of the country. If supply rises, the currency's value will fall

A currency might depreciate because:	A currency might appreciate because:
• There is a balance of payments deficit • Demand for other currencies rises as domestic consumers buy more imports • Interest rates fall relative to other countries • People move their	• There is a balance of payments surplus • Demand for the currency rises as overseas consumers buy more exports • Interest rates rise relative to other countries • This attracts savings

savings to bank accounts overseas • Inflation rises relative to other countries. This makes exports more expensive and demand for them, and the currency needed to buy them, falls • People speculate that the currency will fall in value and they sell their holdings of the currency	from overseas residents • Inflation is lower than in other countries so exports will be cheaper and overseas demand for them, and the currency required to pay for them, will rise • People speculate that the currency will rise in value and they buy more of the currency

Consequences of Exchange Rate Fluctuations

- An appreciation of the currency will make exports more expensive and imports will be cheaper, vice versa
- If PED<1 for exports, an exchange rate appreciation will improve a current account deficit
- If PED<1 for imports, an exchange rate depreciation will worsen a current account deficit

Types of Exchange Rate

- **Floating exchange rate:** it is determined by the forces of market supply and demand
- **Managed floating exchange rate:** it is influenced by state intervention
- **Fixed exchange rate:** it is set by the government and maintained by the central bank buying and selling the currency and changing interest rates

Floating Exchange Rate

ADVANTAGES	DISADVANTAGES
Automatic stabiliser	Uncertainty
Frees internal policy	Lack of investment
Management	Speculation
Flexibility	Lack of investment
Can avoid inflation	
Lower reserves	

Fixed Exchange Rate

ADVANTAGES	DISADVANTAGES
Elimination of uncertainty and risks	Foreign exchange reserves needed
Speculation deterred	Internal objectives sacrificed
Prevents currency depreciation	Restricts international competition
Attracts foreign direct investment	

6. 4 Current Account Balance of Payments

Structure

- **Visible trade account:** the difference between the export revenue and import spending on physical goods, e.g. cars, washing machines
- **Invisible trade account:** measures the difference between export revenue from and import spending on services, e.g. banking, insurance and tourism
- **Income flows:** e.g. interest, profit and dividends flowing in and out of the country
- **Current transfers:** e.g. grants for overseas aid.

Balance of Payments Deficit	Balance of Payments Surplus
• Money flowing out greater than in. • Current + Capital + Financial is negative.	• Money flowing in greater than out. • Current + Capital + Financial is positive.

Trade Deficit

- Means people are buying more imports and may be spending less on products made by domestic firms
- Deficit may be a symptom of a declining industrial base
- Foreign exchange for the national currency is likely to fall
- Increases prices of imports and cause imported inflation

Trade Surplus

- Means people are buying less imports and may be spending more on products made by domestic firms
- Surplus may the result of economic growth
- Foreign exchange for the national currency is likely to rise
- Increases prices of exports

Policies to achieve balance of payments stability

- Supply-side policy will increase domestic production and exports which can correct a current account deficit
- Expansionary fiscal policy, by reducing taxes and increasing government expenditure can increase total demand for imports to fix current account surplus, vice versa
- Contractionary monetary policy can correct a current account deficit, vice versa

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