Script G – Paper 4

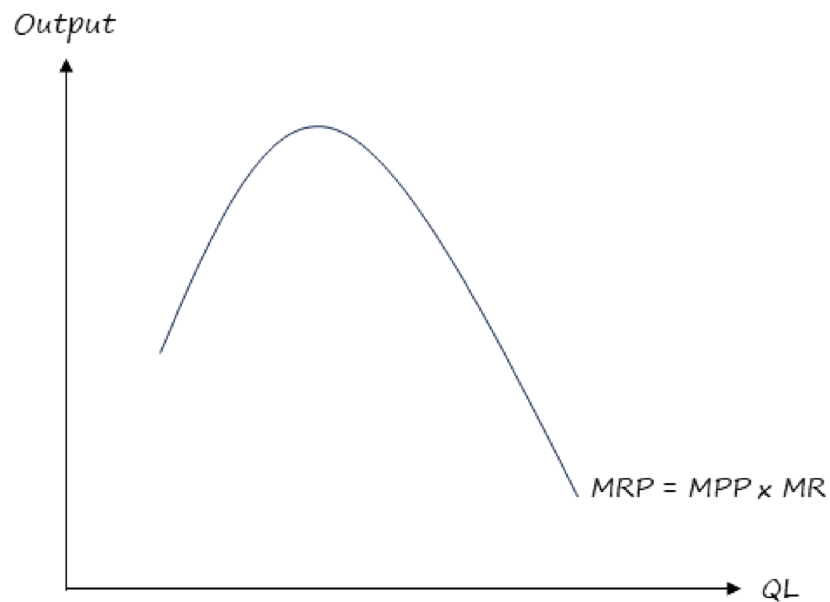
1a Loyalty cards make markets imperfectly competitive as they attract customers by giving promotions and price reductions to those with a card. The card also helps the supermarket build barriers between retailers to gain a marketing advantage.

1b Price elasticity is the ability to respond to a price. Profit maximisation is when a firm is making the minimum level of normal profit and is said to be producing at break-even output. Most firms prefer to make abnormal profits where total revenue is greater than total cost, compared to normal profits, as a reward for taking risks. Due to loyalty, consumers will not change their buyers easily, which leads to a low-price elasticity of demand.

1c Loyalty cards did not have information about consumers purchasing habits or what they wanted. This will make it hard for producers to target the products that are highly demanded by consumers. Moreover, a loyalty card can't ensure that consumers will be loyal or keep purchasing from the firm, as consumers have a low-consumption attachment to the firm.

1d The idea of rationality is used in the indifference curve theory of consumer behaviour. An indifference curve shows all the combinations of two products between which the consumer is indifferent. However, this approach has been criticized as there are limitations such as it assumes that satisfaction can be easily measured and the idea that consumers behave in a rational way. As well as the idea that consumers have limited income, but it is possible that income may significantly rise over a period. The idea is that consumers aim to maximize their total utility and that consumer tastes and preferences remain constant, but this is contradictory.

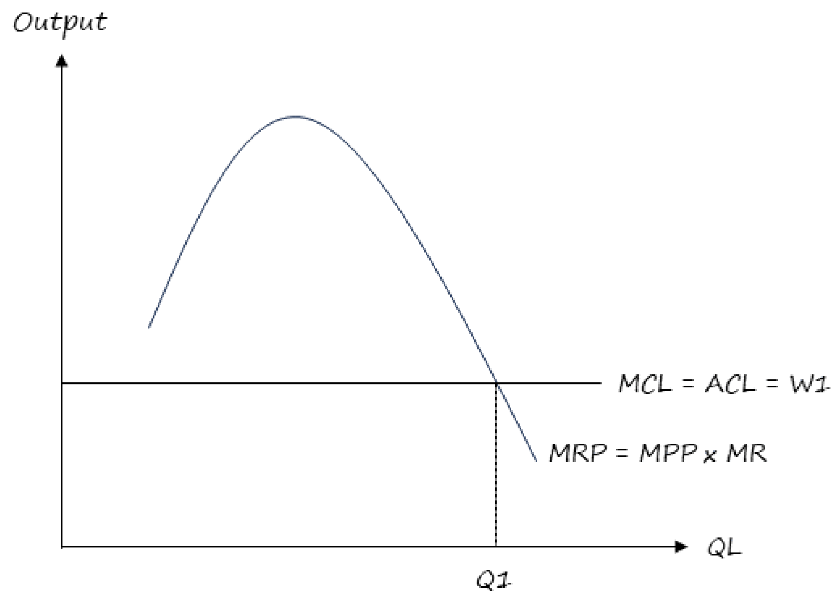
3 The demand for labour is derived from Marginal Revenue Product (MRP) theory. The MRP of a unit of labour is the additional revenue generated from hiring that unit of labour. MRP = MPP*MR. Marginal Physical Product (MPP) is the extra output that an extra worker produces.



Due to the law of diminishing returns, in the short run, there is usually a diminishing marginal product when increasing the number of workers. On the other hand, Marginal Revenue (MR) is the revenue gained by firms from selling the last unit of output. As MPP is downward sloping and MR is either horizontal or downward sloping, it follows that the MRP curve is downward sloping.

The market labour supply curve is obtained by horizontally summing all individual supply curves. Since workers in the same labour market are paid the same wage, the market supply curve for labour is the same as the average cost of labour curve. It is upward-sloping.

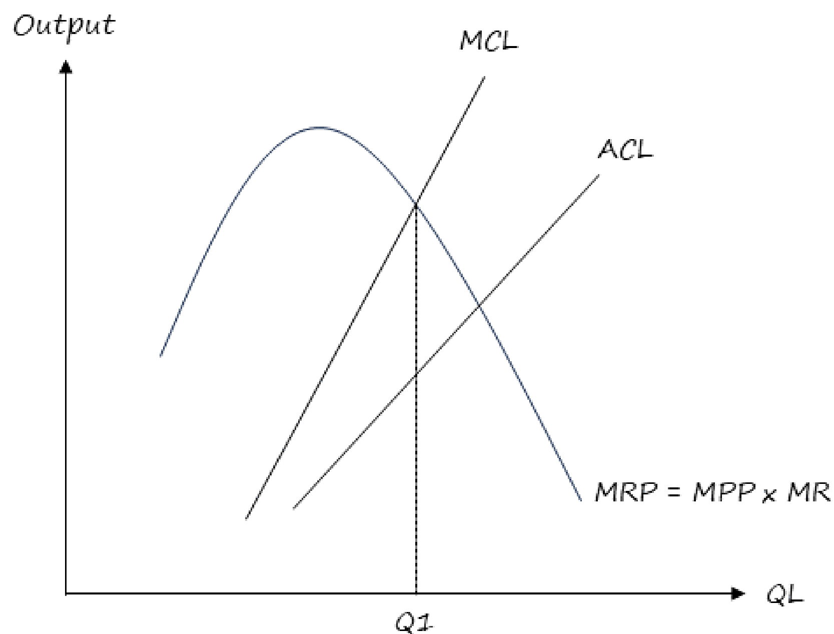
In a perfect labour market, there are very large numbers of firms employing labour; there are very large numbers of homogeneous workers who are perfectly mobile within the industry; there is perfect knowledge for both workers and employers. Under these circumstances, firms are wage-takers. The wage rate will be determined by the demand and supply of labour.



According to the diagram, the equilibrium wage rate is W1. As the wage rate is fixed, the marginal cost of the firm remains constant. Thus, MCL=ACL=W1. In profit maximisation, if MCL>MRP, then the last unit of labour hired would have a loss, so they would employ less. If MRP>MCL, then the employer would employ more to maximise profit. As a result, the employer would employ at point Q1, where MRP=MCL.

The wage rate is determined by labour demand and supply. Thus, the wage differences between jobs could be explained by the demand and supply of labour. For example, managers may have higher productivity and contribute high MRP for the firm. They are not easily replaced by machines so they may have an inelastic demand. The supply of those jobs may tend to be relatively inelastic due to the long education and training period. This makes them receive high pay. On the other hand, workers who collect rubbish have low MRP and are easily replaced by machines. Thus, the demand is relatively elastic. The supply of jobs is also relatively elastic: there are large amounts of people who could collect rubbish as it does not require any complex training. This would lead to a lower wage rate.

In an imperfect market such as monopsony, there is only one single buyer of labour and the labours are non-homogeneous. Thus, a firm is a wage-setter, wage determination requires analysis of the firm's equilibrium. In monopsony, the marginal cost of employing one more worker will be higher than the average cost because to employ one extra worker the firm has to increase the wages of all workers.



In a bilateral monopoly, there is a monopoly supplier, a trade union and a monopsonist buyer of labour. Trade unions could engage in collective bargaining with employers. If the trade union sets a wage that is less than the value of the workers to the firm, the firm still makes a supernormal profit. Since the firm can afford to absorb the increase in wages, the trade union can raise wages and employment simultaneously.

Finally, discrimination and exploitation also exist in the real world. For instance, a sexist monopsonist might pay women less because they believe that a woman will do a worse job than a man purely because they are a woman, other things equal. On the other hand, it may be the case that employers simply do not follow through on their promise to pay the required wage or alter wages once the worker has already started working. This usually happens in constructing industry, where the company is a monopsonist.

To conclude, the wage rate is determined by MRP and supply. Market forces could explain the difference in wages. Those who have higher MRP and inelastic supply would receive a higher wage rate. However, there are other factors to explain wage inequality. Workers in less competitive markets will earn lower wage due to exploitation; trade union could bargain for higher wage if there is a bilateral monopoly; government could also set minimum wage to help low-paid workers. Thus, the market forces could partly explain this wage difference, but there are also institutional factors need to be taken into consideration.

4 Current account has four components: trade in goods, trade in services, primary income and secondary income. Trade in goods covers the exports and imports of goods such as cars, TVs and clothing. On the other hand, trade-in services cover the trade-in services, such as shipping, tourism, banking and insurance. Primary income includes income in the form of profits, interest and dividends earned on direct investment abroad and foreign earnings on investment in the country. Secondary income covers payments made and receipts received for which there is no corresponding exchange of an actual good or service. They include government transfers such as foreign aid, as well as private transfers.

A current account deficit means money coming into the current account is less than money going out from the current account. Whether a current account deficit is a serious problem for an economy depends on several factors. For a growing domestic economy, it is possible to experience a current account deficit. When firms are increasing their output, they may buy more raw materials and capital goods from abroad. This cause of a current account deficit is not likely to be considered to be a problem because a growing economy is likely to attract foreign direct investment, which will lead to credit items in the financial.

In addition, as the country's firms use the imported raw materials and capital goods to produce more products, they are likely to sell more products both abroad and at home. Export revenue may rise to match the higher import expenditure. However, if the deficit indicates that domestic firms are not internationally competitive, this will last a long time and will be considered as a structural problem. The relatively high inflation rate, and low labour and capital productivity will be a cause of concern. If a country is borrowing from abroad to finance consumption, this is damaging in the long run. If the economy experiences depreciation, foreign debts will increase. Investors may be quicker to fear an economic downturn and remove their capital. This will accelerate the depreciation so that the country may not have enough reserves to maintain the value of the currency.

Exchange Rate refers to the value of one currency in relation to the value of another, it is the price of one currency expressed in terms of another. A fixed exchange rate is a type of exchange rate system where the external value of a currency is determined by the government of the country, the government decides to fix the exchange rate at a particular level, rather than leaving the rate to be decided by the market forces. If an exchange rate is lowered in a fixed exchange rate system, it is called a devaluation. If the rate is increased, it is called a revaluation. The government can intervene in the foreign exchange market whenever needed by acting as a buyer and seller of currency.

When the exchange rate appreciates, the cost of buying imported goods will be lower. Consumers will consequently spend more on imports and less on exports, which become more expensive as the value of currency increases. The higher spending on imports than exports will then lead to a current account shortfall. A lack of export competitiveness can also cause CAD. When a country's exports cannot compete with imports in terms of price, branding and innovation, the demand for exports will fall and remain low.

In the short run, trading patterns are unlikely to change significantly. If there is no significant changing the quantities traded, the rise in the price of exports and fall in the price of imports will improve the trade balance, which is represented by (X-M) therefore causing an increase in AD. This is likely to result in a rise in the price level and an increase in real GDP. A fall in unemployment is also expected as firms hire more workers to increase domestic output. In the long run, economic agents are able to respond to the appreciation. International consumers find different sources for their exports, and domestic consumers substitute imports for local goods. This will worsen the trade balance, causing a fall in AD, and therefore a fall in the price level. A fall in AD will also decrease real GDP based on the following reasons. First, exporters will reduce their production as a result of the fall in international demand for their products. Second, even if exports do not change, firms may have to cut down production as consumers substitute relatively cheaper imports for domestic goods. If real GDP falls, unemployment is expected to rise as a consequence, since fewer workers are needed to produce the lower level of output. However, appreciation of the currency leads to inflation. This is because AD decreases while firms pay less for imported raw materials so that costs of production will fall as well. Exporters will also be forced to improve the competitiveness of their goods and services to maintain strong export sales and revenues.

The situation can be analysed mathematically using the Marshal-Lerner condition, which states that an appreciation will improve the trade balance if the sum of PED for imports and exports needs to be greater than 1. I, therefore, argue that the effect of the appreciation is not likely to benefit the US economy overall, as real GDP is likely to fall in the long run, with unemployment rising. There is some benefit in terms of imports becoming relatively cheaper and the domestic price level falling, thus making consumer goods more affordable. However, since this comes at the cost of higher unemployment, economic agents in the US economy may perceive this as being negative overall.

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