

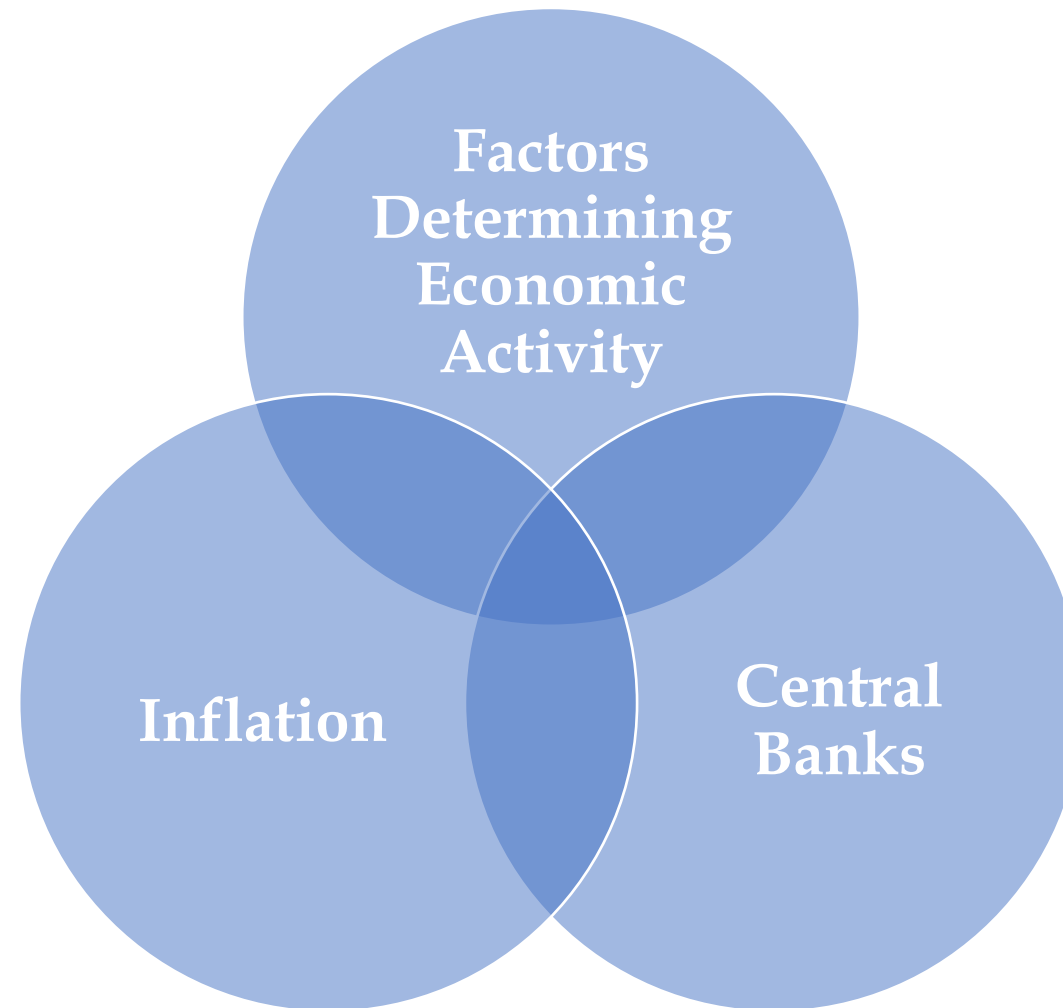


Chapter 2 – The Economic Environment

4 Questions



The Economic Environment



Factors Determining Economic Activity - Types of Economy

State-controlled economies

- State determines what is produced and how distributed
- Also, known as planned economies - production and allocation of resources is planned in advance rather than left to market forces
- Excessive layers of bureaucracy
- Lack of individual choice

Market economies

- Supply and demand is allowed to determine how resources are allocated
- Businesses produce goods and services to meet the demand from consumers - market-clearing price
- Market also for labour and money- i.e. the price is the wage level and interest rate
- Competition is everything!



Factors Determining Economic Activity - Types of Economy

Mixed Economies

- Combines a market economy with elements of state control
- The government will provide a welfare system to support the unemployed, the infirm and the elderly
- Also provide key services such as defence, education, public transport, health and police services.
- **How does the government pay for things?**

Open Economies

- Few barriers to trade or controls over foreign exchange
- Governments have policies to promote free trade
- Disagreements can result in imposition of sanctions
- **Protectionism** - When a country prevents other countries from trading freely with it in order to preserve its domestic market
- The World Trade Organization (WTO) - arbitrate when disputes arise.



The Economic Cycle and Economic Policy

Governments responsibilities include:

- Managing the economy through taxation, economic and monetary policy.
- Ensuring a fair society by providing welfare and benefits.
- Businesses are given a fair amount of freedom to respond to any problems or chances that may come up.

Governments use stabilization policies to lessen the effects of swings in the economy by using fiscal and monetary policy.

- Monetary policy entails adjusting interest rates and the money supply
- Fiscal policy involves adjusting government spending and taxation.

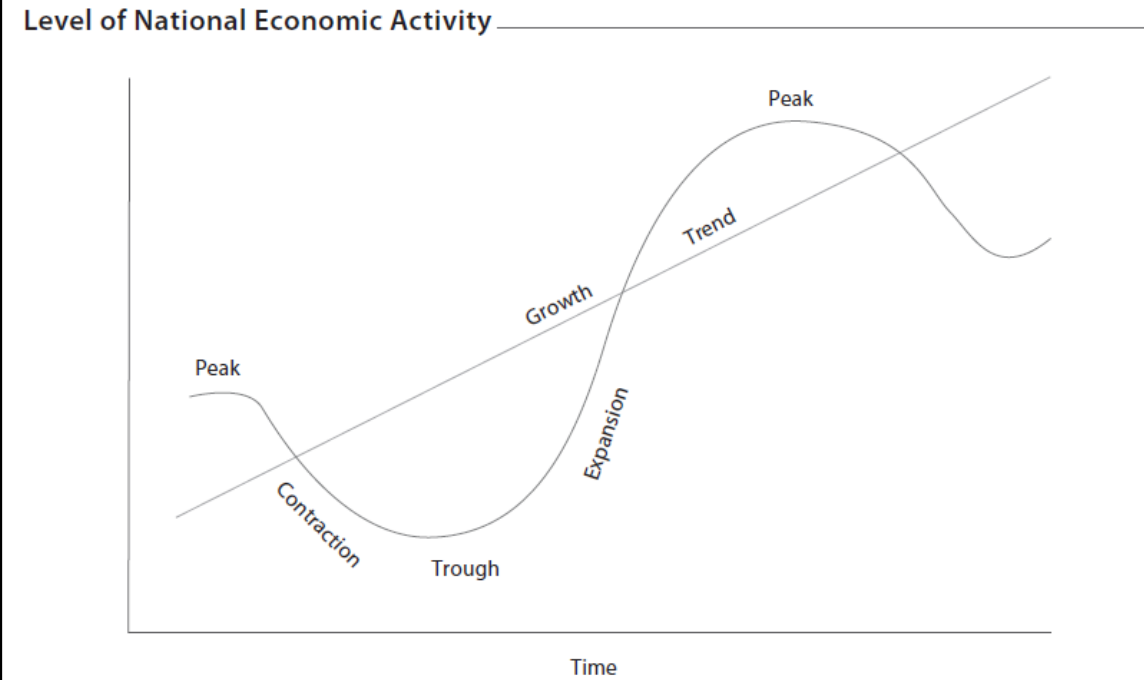


Macroeconomic Objectives

Full Employment	As far as possible, all factors of production, i.e., land, labor capital and enterprise should be fully utilized.
Economic Growth	Measured by increases in gross domestic product (GDP).
Low Inflation	Achieving price stability. Typically, a rate of inflation of 2% is set as a target.
Balance of Payments equilibrium	Deficits in external trade, with imports exceeding exports, might be damaging for the prospect of economic growth.



Stages of the Economic Cycle



Stage	Explanation
Peak	GDP is at its highest point. Any growth in output stops. The point at which GDP is expected to decline, e.g., contraction of the economy is expected
Contraction	GDP declines as economic activity slows. When there are two consecutive quarters of declining GDP or 'negative growth', economists refer to this as a 'recession'
Trough	GDP is now at its lowest point. The contraction phase is over
Expansion	economic activity picks up & GDP begins growing. Early expansion is usually characterised by a moderate increase in GDP, whereas with late expansion, the rate of increase is higher



The Budget

- It is a statement of public income and expenditure over a period of one year.
- A balanced budget is where income equals expenditure
- A deficit budget where expenditure exceeds income or
- A surplus budget where income exceeds expenditure.

Taxation

- Direct tax is levied on income, or indirect tax is charged on goods and services.
- Through tax system, the government influences the level of spending
- By reducing tax, demand increases - it would mean that firms and households would have more disposable income.
- The government could reduce demand by raising taxes or reducing its expenditure



Planning

- Fiscal policy influences the level of aggregate demand in, businesses need to take this into account when planning output levels, future employment levels, and deciding on investments. Planning will be much easier if government policy is stable.

Cost

- Taxation, especially an employer's national insurance contributions, will affect total labour costs, hence the ultimate cost for products and services. In addition, if indirect taxes such as VAT rise, the cost would either have to be absorbed by the firm or passed on to the customer



Monetary Policy

Regulation of the economy through control of the monetary system by operating on such variables as the money supply, the level of interest rates and the conditions for the availability of credit. Monetary policy is generally concerned with the volume of money in circulation and the price of money or the interest rate.

The Money Supply

- The stock of money in the economy is believed to influence the volume of expenditure in the economy.
- This, in turn, influences the level of output and prices. Under monetary policy, the government can
- target the stock of money as an economic tool.
- Governments may decide to impose a 'credit squeeze' and restrict credit lending to control the level of spending and reduce **inflation**.
- Alternatively, governments may impose reserve requirements on banks, eg, a minimum cash reserve ratio



Interest Rates – The Price of Money/Cost of Borrowing

Direct relationship between the interest rate and the level of spending in the economy. An increase in interest rates is thought to discourage spending in the economy and thereby reduce the level of aggregate spending. Other possible outcomes include:

- Consumers would be encouraged to save.
- Mortgage payments would rise.
- The higher cost of credit would deter borrowing and, hence, spending.
- The level of corporate investments would decline

The following effects of a high rate of interest also need to be considered:

- Higher interest means greater interest income for savers.
- Demands for higher wages to make higher mortgage payments.
- Higher interest rates attract capital inflows. This would lead to an appreciation in the exchange rate
- Low demand could result in high unemployment; low tax income. Unemployment benefits may increase.
- Low investment means poor prospects for future economic growth



The role of government - manage the economy through taxation, economic and monetary policy

Stabilisation Policies:

Policies to reduce the impact of fluctuations in economic activity.

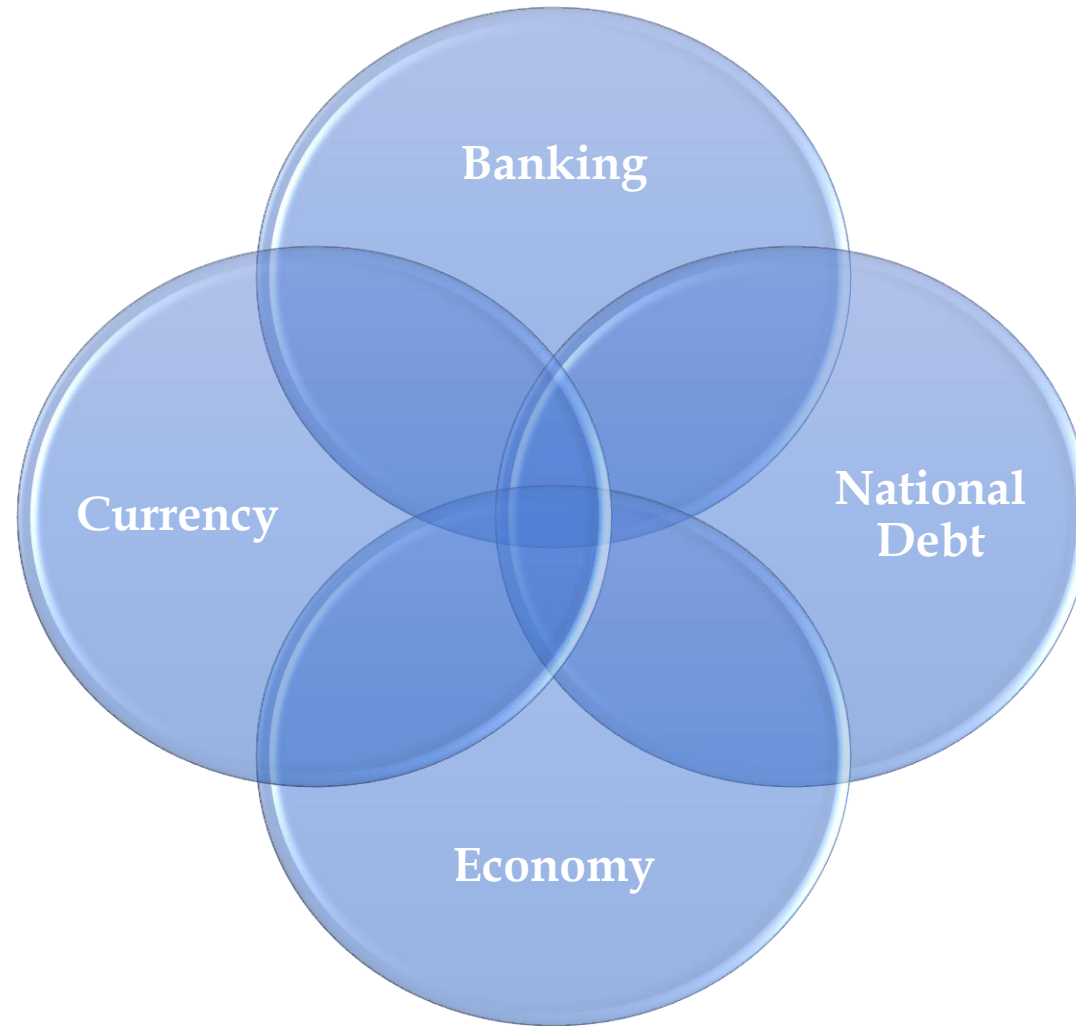
Fiscal Policy involves making adjustments using government spending and taxation.

Monetary Policy involves making adjustments to interest rates and the money supply.

Governments implement their monetary policies through their central bank



Role of Central Banks



Central Banks

Federal Reserve

- Statutory duty of promoting price stability and sustainable economic growth
- FOMC meets every six weeks to set rates
- Lender of last resort

European Central Bank

- Responsible for setting monetary policy for the entire Euro zone with the sole objective of maintaining internal price stability
- Its objective of keeping inflation, as defined by the Harmonised Index of Consumer Prices (HICP), “close to but below 2% in the medium term” is achieved by influencing factors such as the external value of the euro and growth in the money supply

Bank of England

- Manages inflationary targets by interest rate setting through the Monetary Policy Committee
- Responsible for all other traditional central bank activities with the exception of managing the national debt and providing a depositors protection scheme for bank deposits

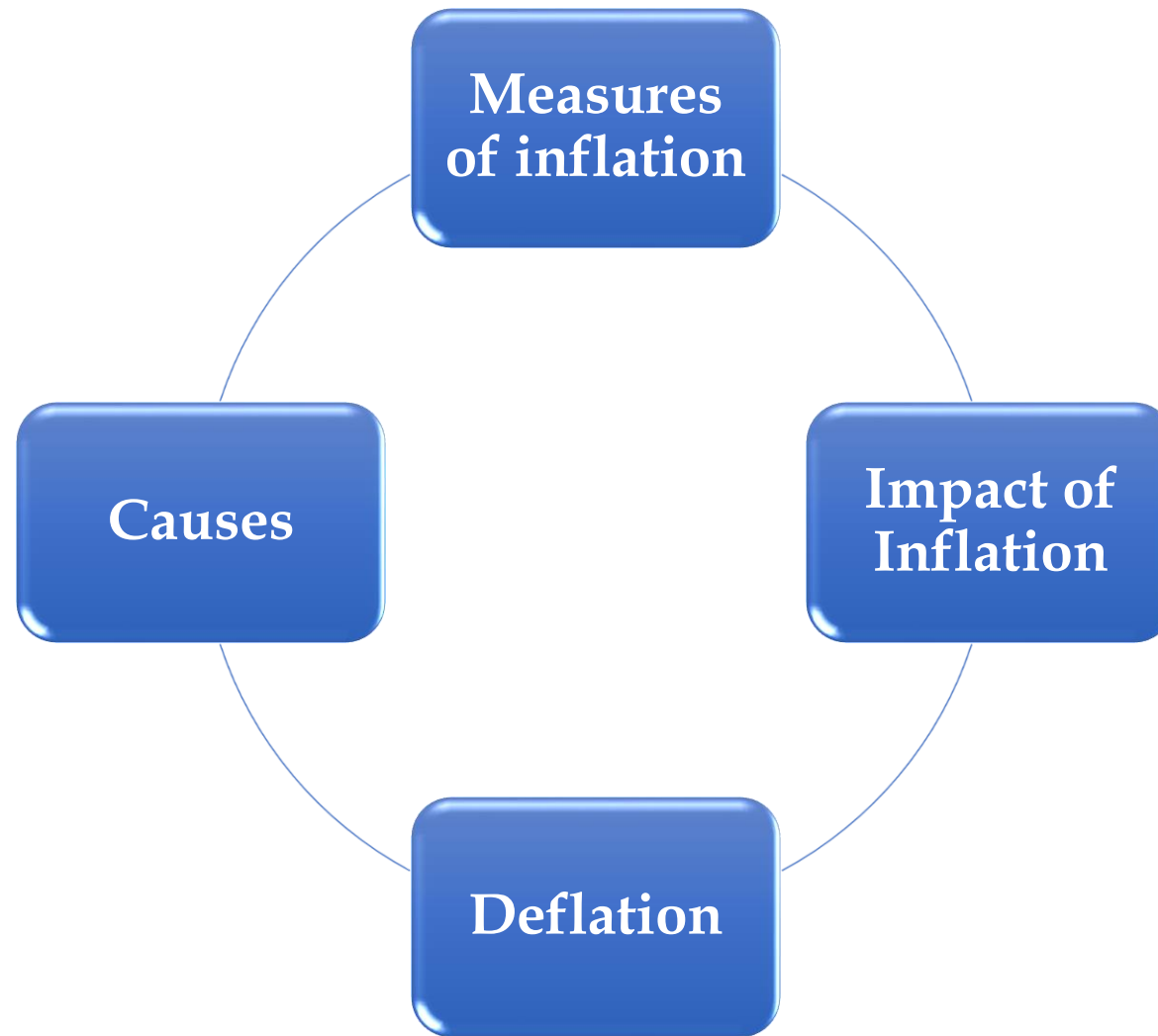


Bank for International Settlements (BIS)

- Acts as a bank for central banks - Central banks are guided in their activities by the Bank
- Established in 1930
- 60 member central banks representing countries – accounting for 95% of world gross domestic product

Mission: Serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas.





Inflation

Persistent increase in the general level of prices.

Causes –

- Excess demand in the economy
- Scarcity of resources and key workers
- Rapidly increasing government spending

Most western governments seek to control inflation at a level of about 2–3% pa

What problems does it cause? What are the benefits?

Central banks use interest rates to control inflation. What happens if rates fall or rise?

Changes in base rate can take up to two years to have their full impact on inflation

Deflation: General fall in price levels. Typically results from negative demand shocks

Consumer Price Index (CPI) – most common method for measuring inflation.



GDP

- Measure of a country's output
 - Consumer spending
 - Plus Government spending
 - Plus Investment
 - Plus Exports
 - Less Imports
- = GDP

Balance of Payments

- A summary of all the transactions between a country and the rest of the world

Level of Unemployment

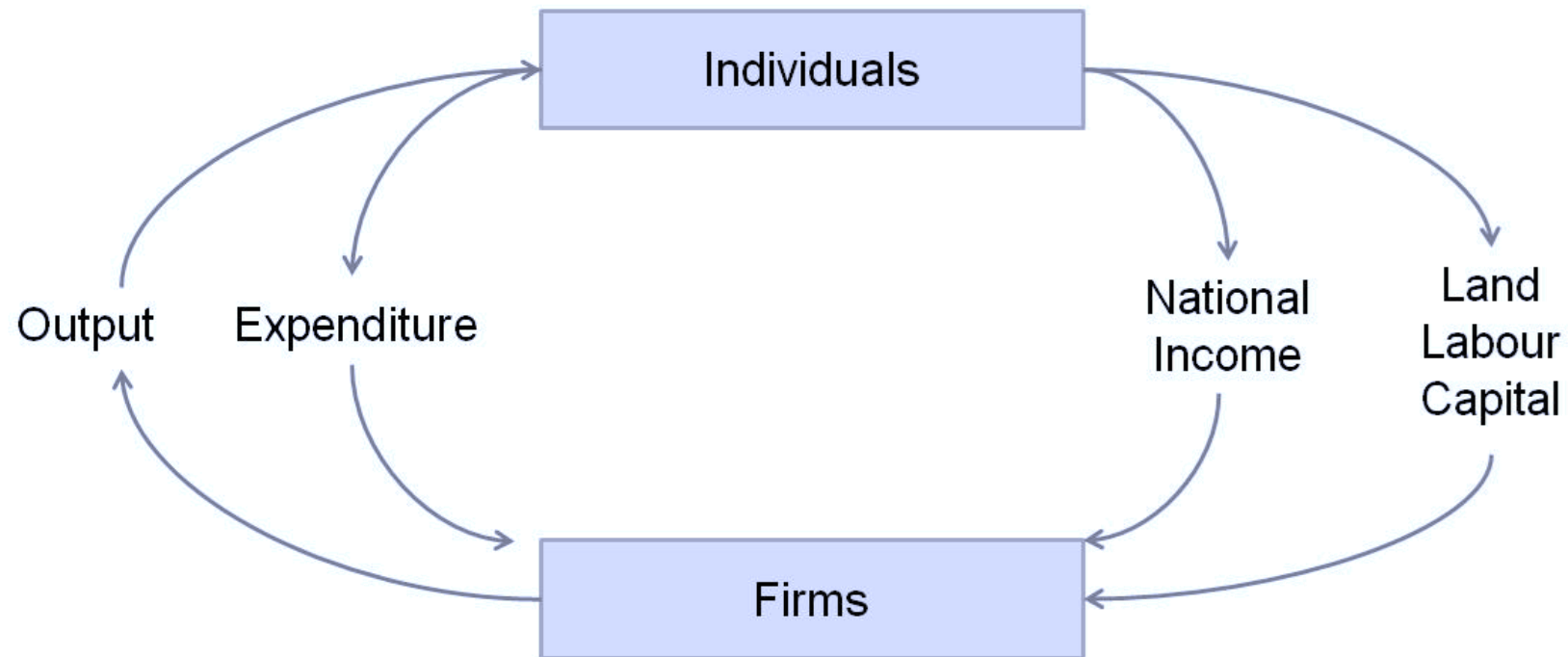
- Extent to which those seeking employment cannot find work is an important indicator of the health of the economy

What effect does High Unemployment have on an Economy?



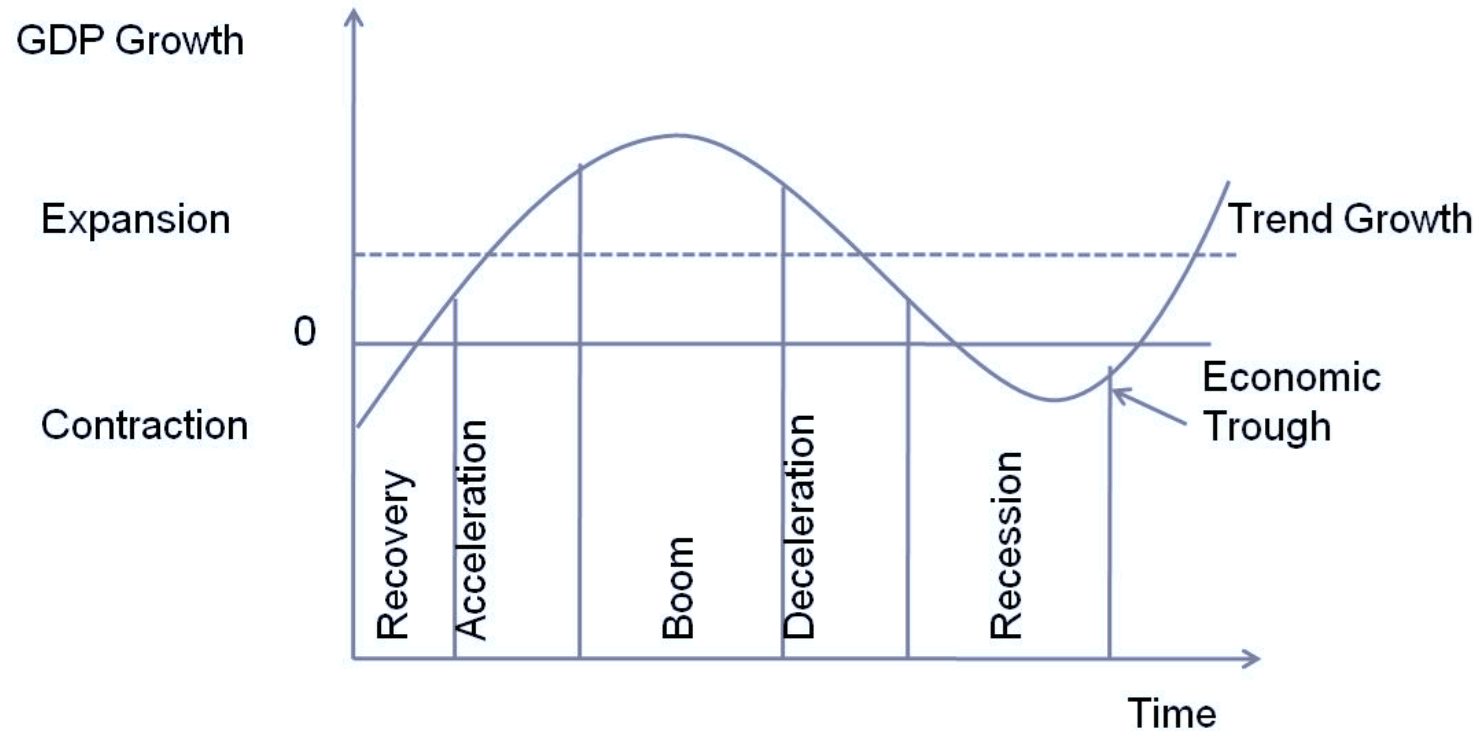
Simplified Model of the Economy

Simple Model of Circular Flow of Income



Economic Cycle

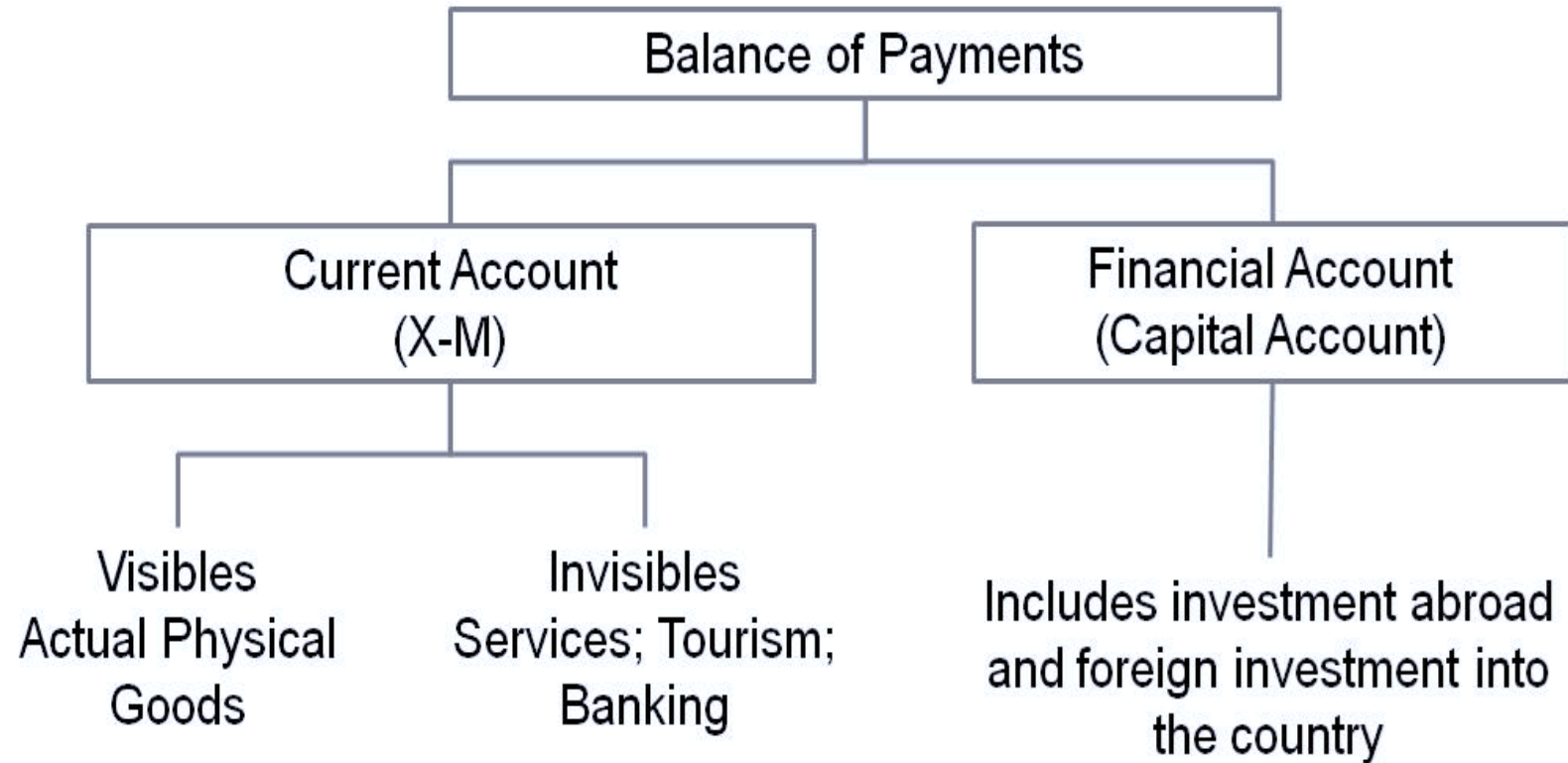
Actual growth fluctuates and deviates from trend growth in the short term gives rise to the **economic cycle**, or **business cycle**.



Recession: When its economic growth rate turns negative for at least two consecutive calendar quarters



Balance of Payments



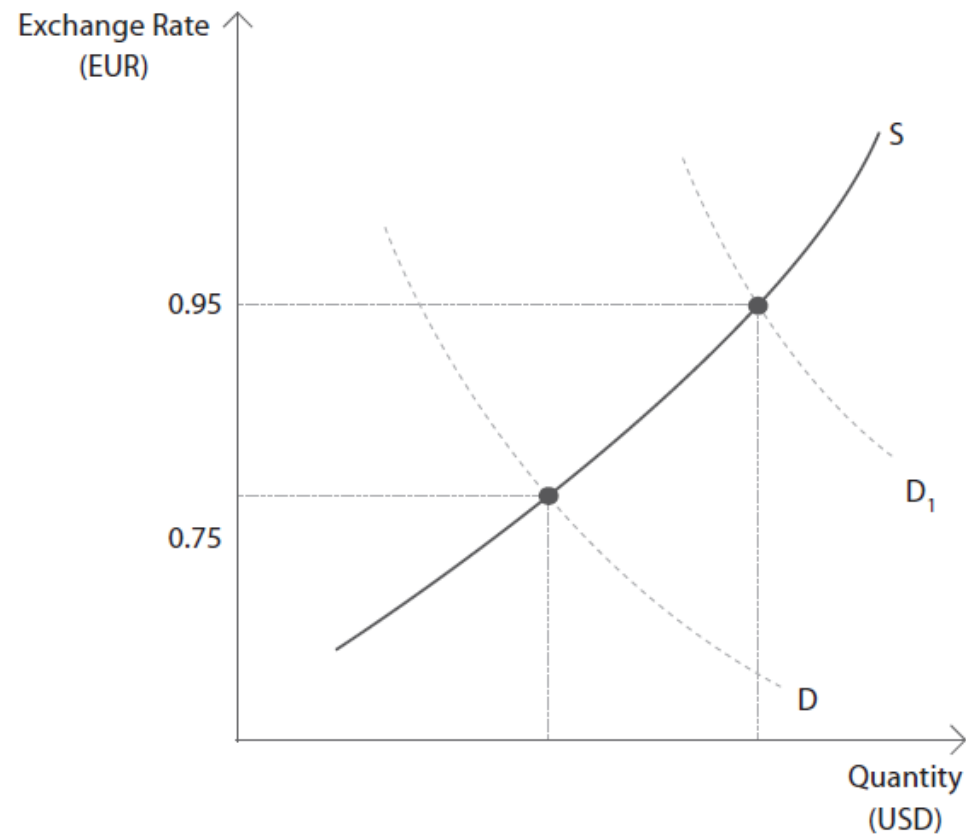
To Balance: $CuA = CaA +/-$ balancing item (used to rectify the many errors in compiling the balance of payments) $+/-$ any change in central bank foreign currency reserves



Exchange Rates

An exchange rate can be described as the price of one currency in terms of another and is quoted for pairs of currencies. If the exchange rate changes, such that currency A can buy more of currency B, this shows an appreciation of currency A and a depreciation of currency B.

For example, in the diagram below, we can see the exchange moves such that USD 1 (formerly, equivalent to EUR 0.75) is now equivalent to EUR 0.95. This appreciation of the USD against the EUR has been caused by an increase in demand for the USD



Fixed rate system – the exchange rate is pegged to a particular currency, e.g., the US dollar or a basket of currencies. To ensure that the rate stays 'fixed', the central bank will intervene in the currency market to offset the natural forces of demand and supply by spending its foreign currency reserves or buying foreign currency.

Floating rate system – the exchange rate is determined by the natural forces of demand and supply. There is no intervention in the market by the central bank. This is, sometimes, referred to as a 'free' floating rate system.



Exchange Rates

Target zone – similar to the fixed rate system, however, the exchange rate is managed within a band (with upper and lower limits). This means that the rate can fluctuate, therefore, the central bank will only intervene if the upper or lower limits for the rate are breached.

Crawling peg – similar to target zone, but with upper and lower limit bands gradually widening. This system is generally used as a strategy for moving away from a fixed rate system.

Managed float – this is also known as a ‘dirty’ float. With this system, the exchange rate is largely a floating rate, but with occasional intervention from the central bank to alter the direction of the rate or the speed with which the rate changes.

