# 2.1.1 - Growth

**Economies of scale**

- Economies of scale occur when there is a fall in average total cost as the scale of production increases
- Internal economies of scale occur due to an increase in the scale of production of a firm
- External economies of scale occur due to an increase in the scale of production within the industry in which the firm operates

**Managerial economies of scale**

- Employing specialist labour e.g. accountants, lawyers, technical etc.
- Division of labour allows staff to focus on particular areas
- As the employee is allowed to concentrate on a specific job they are likely to be:
  - better qualified
  - more experienced
  - more efficient
- The manager of a small firm will often do the accounts, marketing and look after human resource management issues i.e. a 'Jack of all trades'
- In larger firms we might see a highly qualified accountant working in finance or a personnel department dealing with recruitment and selection

**Financial economies of scale**

- Better credit ratings as large firms are seen to be less likely to fail and can borrow money at lower interest rates

**External economies of scale**

- These occur within the industry.
- A fall in average total cost due to factors outside of the control of the firm
- They will impact on firms within the same industry or geographical region
- They will create positive externalities
- Examples include:
  - Improved transport infrastructure
  - A pool of skilled workers
  - More advanced communication systems
- These will benefit all firms within an industry or region

**Internal economies of scale**

- These occur when a firm becomes larger.
- Average costs of production fall as output increases.
- Way to remember internal economies of scale:

  **Really** – risk bearing economies
  **Fun** – financial economies
  **Mums** – managerial economies
  **Try** – technical economies
  **Making** – marketing economies
  **Pies** – purchasing economies

**Purchasing economies of scale**

- Discounts for bulk-buying
- As the firm is buying in bulk, they are able to secure lower prices per unit

**Marketing economies of scale**

- Larger firms can divide their marketing budgets across larger outputs, so the average cost of advertising per unit is less than that of a smaller firm.

**Risk-bearing economies of scale**

- When a firm becomes larger, they can expand their production range.
- Therefore, they can spread the cost of uncertainty.
- If one part is not successful, they have other parts to fall back on.

**Technical economies of scale**

- The use of specialist, often expensive, capital e.g. machines
- Large firms are able to spend more on bigger and more efficient machinery
- They are able to spread fixed costs over greater output
- They are likely to obtain lower costs per unit through this method
- This increases competitiveness
- Large firms can also spend more money on *scientific* Research and *technical* Development (R&D)

**Increased market share**

- There are a number of benefits in increasing market share including:
- Lack of competition can help them to:
  - Develop and maintain customer loyalty
  - Restrict output and charge higher prices
- Economies of scale such as:
  - Bulk buying, reducing unit costs
  - Advertising, helping to develop brand image
- Use its financial resources to maintain its position:
  - Predator pricing, selling at a loss to price new firms out of the market
  - Research and Development, to produce new products

# 2.1.1 - Growth

Economies of scale lead to falling costs and falling prices
↓
Products become more affordable
↓
We all have more purchasing power
↓
A mass market develops as more people are able to afford the product
↓
Standards of living rise.

**Market power over consumers and suppliers**

- By growing in size a firm is able to increase market power leading to higher prices and supernormal profits
- A monopoly exists where there is only one firm in the market. However, the Government refer to any company that has at least 25% market share as having monopoly powers
- Larger firms can exploit consumers by charging high prices due to less competition
- Therefore, they are likely to be regulated in order to protect the consumer
- Larger firms have a greater degree of buying power
- They can force suppliers to lower prices by threatening to cancel contracts
- Suppliers are less likely to argue with larger customers so are more likely to agree to lower prices or risk losing significant trade
- A larger firm is more likely to have an inelastic price elasticity of demand allowing it to set higher prices
- There are fewer substitutes when a firm begins to increase market share, so consumers have less choice in where they buy from
- The greater the degree of competition the less likely is a firm to have monopoly power

**Benefits of a strong brand**

- Brand loyalty exists when customers keep returning to buy a recognised brand
- Branding is a promotional method that involves the creation of an identity for a business that distinguishes it and its products from competitors
- Added value
- Ability to charge premium prices
- Reduced price elasticity of demand

**Brand recognition**

- Branding is a promotional method that involves the creation of an identity for the business that distinguishes that firm and its products from other firms
- Brand recognition can add value to a product allowing firms to charge higher prices
- Ultimately leads to brand loyalty whereby customers will continue to buy products from that firm
- Organisations spend enormous amounts of time and money branding their company and products

**Types of branding**

- Brand recognition comes in many forms including colour, logo, strap line and shape
- Branding is traditional in businesses associated with giving a unique recognisable characteristic to a product or corporate image e.g. Toblerone's unique shape or Heinz's shade of green
- This is corporate branding – it attaches a perception and promise to the goods and services associated with that brand e.g. quality, customer service, corporate culture
- Other types of brand include:
    - Personal – when a person brands themselves e.g. a sports personality or pop star
    - Geographical brand – when a region, city, county or country creates a brand that epitomises the people and the lifestyle of that country, often used in tourism

**Building brand recognition**

Sponsorship

- Associating a brand name with an event to raise its profile in the public eye, a business pays to sponsor an event in return for visual coverage of the brand e.g. around a stadium, on literature on sport kits etc.

The use of social media

- Use of targeted newsfeeds e.g. Facebook newsfeeds based on searches on other webpages
- Viral marketing e.g. Evian rollerblading babies

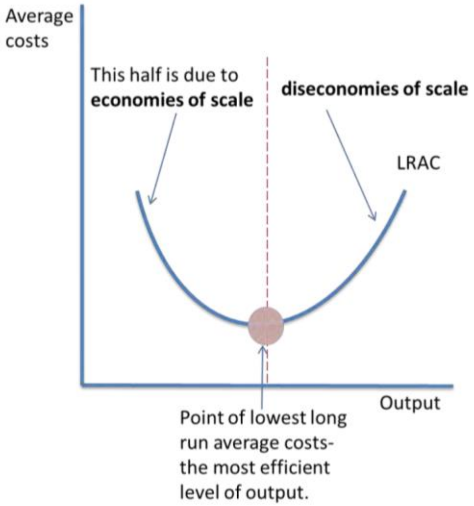
# 2.1.1 - Growth

**Increased profitability**

- By growing in size a firm can increase profitability:
  - Reduced costs due to economies of scale mean that profit margins are likely to increase as the firm is able to use its size to be more efficient
  - Larger size implies greater sales revenue. This is likely to lead to higher profits
  - However, it might not lead to higher profitability as many large firms work on lower profit margins
  - Although sales and profits are higher this does not mean that profitability will increase

**Long run average cost curve**

- Economies and diseconomies of scale operate at the same time.
- At first unit costs fall due to economies of scale. At this point economies outweigh diseconomies.
- The optimum output occurs when unit costs are at a minimum (productive efficiency).
- After this unit costs rise and diseconomies outweigh economies.
- Therefore, we can see a relationship between economies of scale, diseconomies of scale and the long-run average cost curve.




**Diseconomies of scale**

- Diseconomies of scale occur when there is an increase in average total cost as the scale of production increases
- Diseconomies of scale take a variety of forms, including:

<u>Internal communication</u>

- Larger firms find it more difficult to communicate efficiently within the organisation
- There will be an increased cost for communication methods within the firm
- The manager of a small firm will be able to communicate effectively with all members of the workforce

<u>Coordination</u>

- Larger firms find it more difficult to manage the increased number of personnel and customers
- It might become increasingly difficult to delegate to and motivate workers

<u>Control</u>

- It becomes harder to monitor how productive the workforce is, as the firm becomes larger.

**Potential skills shortages**

- Large firms might struggle to find enough skilled workers
- Labour immobility can occur as a result of:
  - Geographical immobility – where workers in an economy find it difficult to move from one region to another
- This may occur due to:
  - The cost of moving e.g. housing costs in London
  - Imperfect information e.g. not being aware of jobs
  - Not wanting to move away from family and friends
- Occupational immobility - workers are not equipped for different types of work e.g. a coal miner cannot easily transfer to become an accountant

# 2.1.1 - Growth

**The role of corporate culture**

- The corporate culture is the set of important assumptions that are shared by people working in a particular business and influence the ways in which decisions are taken there
- As a firm grows it is likely that the corporate culture will change
- This might lead to resistance to change and a period of adjustment
- The organisational structure will change and a more formal hierarchy is likely to exist
- This may impact on decision making in terms of:
    - Speed
    - Level of involvement

| A STRONG CULTURE | A WEAK CULTURE |
|---|---|
| • Employees believe in the corporate culture and strongly support it.<br>• Staff tend to be more loyal.<br>• Staff turnover is reduced.<br>• Mutual respect between management and employees grows, fostering creativity.<br>• Motivation tends to be higher, leading to greater flexibility.<br>• Productivity is likely to be higher.<br>• Good communications exist.<br>• A strong culture may encourage superior performance. | • Employees do not support the corporate culture<br>• Productivity and motivation are likely to be low<br>• There is a danger of developing an<br>• ‘Us and Them’ mentality<br>• Capable staff may move on, leaving disaffected and/or incompetent staff behind<br>• Staff need to be forced to comply with company policy and rules.<br>• End result tends to be poor performance. |

# 2.1.2 – Methods of growth

## How firms grow

- Businesses can both grow and contract.
- Directors may have an objective of growth which can be achieved by:
    - Internal growth (organic) e.g. opening new branches or new product development
    - External growth e.g. mergers and takeovers
- An objective of cost minimisation however may require the business to contract, this can be achieved by:
    - Internal contraction e.g. delayering or closing down unprofitable elements of the firm
    - External contraction e.g. selling off elements of the business
- Firms grow for a number of reasons:
    - To meet objectives such as gaining market share or increasing shareholder value
    - Respond to external forces such as technological advancements, political and legal change or changes in consumer demand
    - Respond to internal forces e.g. employee pressure, owners' power
    - Gain competitive advantage e.g. economies of scale, market development

## Organic growth

- Internal or organic growth occurs when a business expands in size by opening new stores, branches, functions, or plants
- This may be achieved within the UK or on a multinational scale
- Can be time consuming but is a relatively low risk strategy
- Control is easier to maintain
- For example, Apple has grown through creating new products such as iPads and iPhones.

## Inorganic growth

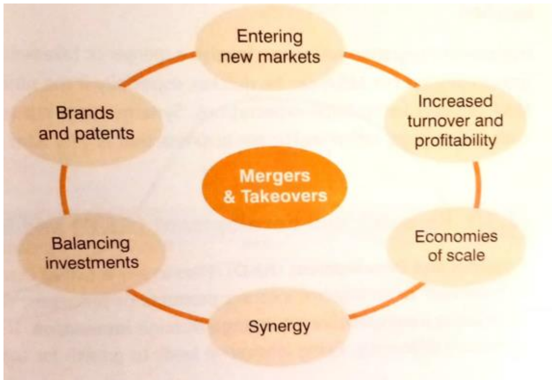
- Integration
    - The bringing together of two or more firms
- Merger
    - When two or more firms agree to become integrated to form one firm under joint ownership
    - An agreement
    - A + B = AB
- Takeover
    - When one firm gains control over another and becomes the owner, can be achieved by buying 51% of the shares
    - Can be hostile
    - A + B = A

## Pros and cons of organic growth

| ADVANTAGES | DISADVANTAGES |
|---|---|
| More control over how the business expands and less conflicts between shareholder objectives | No new ideas from outside the firm to stimulate innovation |
| There is less money paid in upfront costs | Risk of overextending capacity of management team or workers |
| Growth is more sustainable as the company is using retained profits rather than borrowing which avoids debt | Growth achieved is dependent on the strength of the market, which limits how much and how fast they can grow. |
| Less risky than inorganic growth and allows the business to build on its existing strengths | Growth is slow, and may not fulfil shareholder objectives of fast growth of revenues and profits |

## Pros and cons of inorganic growth

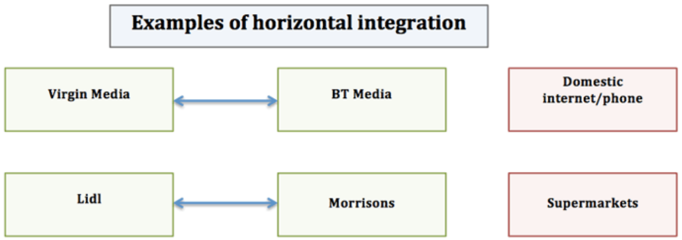
| ADVANTAGES | DISADVANTAGES |
|---|---|
| Fast once the negotiations or purchase has been agreed | Debt burden created if takeover includes buying out shares |
| Removes a competitor from the market and enhances market share | Risks of culture clash and dilution of management focus |
| Possible synergy from combining ideas | Efficiency saving can add to owners' profits but can cost employees' jobs |
| Often potential for rationalisation (lowered costs), leading to economies of scale | Customers could lose beloved brands |



# 2.1.2 – Methods of growth

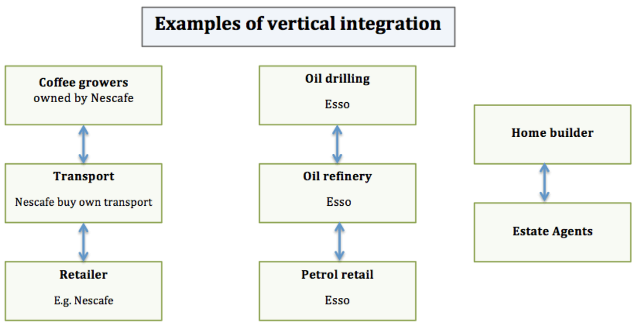
## Horizontal integration

- Horizontal integration occurs when two firms at the same stage within a process integrate
    - e.g. 2 car manufacturers




## Vertical integration

- Vertical integration occurs when two firms at different stages within a process integrate
- Forward vertical integration occurs when the firm integrates with another firm closer to the consumer. This involves taking over a distributor.
    - For example, a coffee producer might buy the café where the coffee is sold.
- Backward vertical integration occurs when a firm integrates with a firm closer to the producer. This involves gaining control of suppliers.
    - For example, a coffee producer might buy a coffee farm.



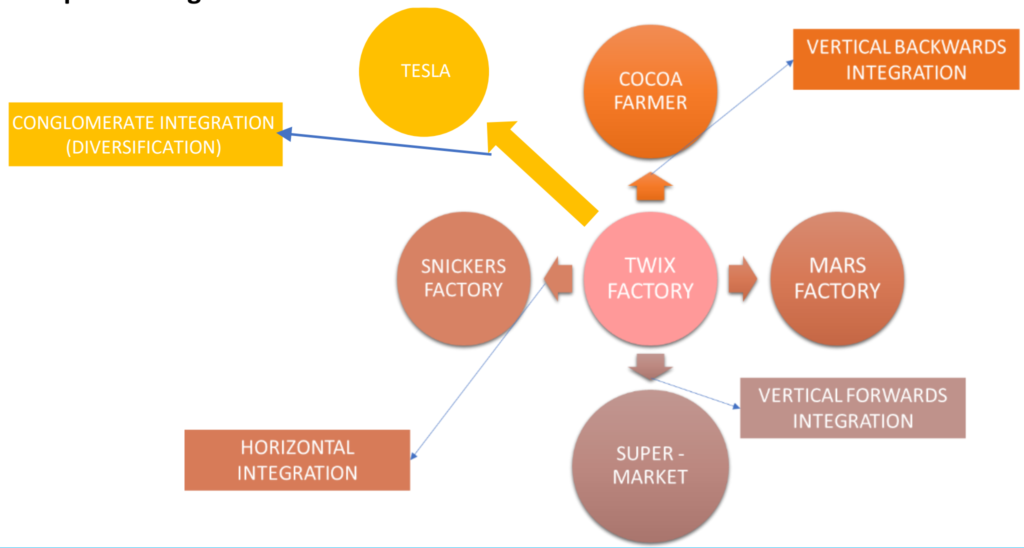

## Conglomerate integration (diversification)

- Conglomerate integration (also known as diversification) occurs when two unrelated firms integrate
    - e.g. A car manufacturer merges with a bookstore

## Pros and cons of integration

| | ADVANTAGES | DISADVANTAGES |
|---|---|---|
| VERTICAL | Firms can gain economies of scale, reducing avg. costs resulting in lower prices<br>Firms can increase control of the market; backwards integration means they control supply prices for themselves and can raise them for other firms, giving them a cost advantage over competitors<br>More certainty over production, esp. with quality, quantity and price | They may also suffer from diseconomies of scale which creates higher avg. costs.<br>Vertical integration could possibly create barriers to entry which could discourage/limit the number of new firms entering the market. This could lead to a less efficient market as firms has little incentive to reduce avg. costs when they have a high market share. |
| HORIZONTAL | Firms can grow quickly which gives them a competitive advantage against rivals.<br>They can increase output quickly so can achieve economies of scale.<br>The firm will have similar expertise as in the same market so merged firm will have advantages | The quick growth may lead to monopoly power, creating potential of higher inefficiency.<br>There may be disagreements between the objectives of the two merged firms. |
| CONGLOMERATE | Can help both firms become stronger in the market than if they were individual.<br>Economies of scale (risk-bearing esp.)<br>Can reach a wider customer base + reduction in market competition. | There is a risk of the product range being spread too thinly and there not being sufficient focus on each product. This could cause a drop in quality and increase production costs. |

## Example of integration



# 2.1.3 – Research & development (R&D) and innovation

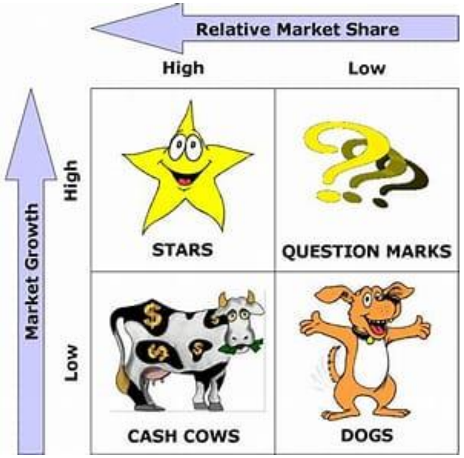
**What is R&D?**

- R&D is investment in research with the intention of improving goods and services, introducing new ones, or improving methods of production.
- This is vital to companies maintaining a competitive advantage through innovation.

**Purpose and risks of innovation and competitive advantage**

Purpose:

- Firms cannot afford to stand still in competitive markets – today's innovations are tomorrow's stars and cash cows
- This is what stars and cash cows are:




- A firm that comes up with the right innovation can guarantee future income if it is protected by a patent
- Although expensive, the alternative of losing future markets might be worse

Risks involved:

- Firms can make substantial losses if innovation fails
- Other companies are likely to react with their own innovations
- Legal implications often arise with other firms questioning whether the product/process is really an innovation

**Innovation and competitive advantage**

- Innovation is the development of an idea into a new product or process. Businesses invest tome and money in order to make a profit. Product innovation occurs through adapting a product that already exists
- An innovation is likely to have a patent as the business looks to recoup the cost of research and development by stopping other firms from copying their product. Often, a small business will sell out to a larger one.
- Competitive advantage – a business' ability to differentiate themselves over competitors
- Comparative advantage – ability of a business to product a cheaper good compared with other businesses

**Pros and cons of innovation and competitive advantage**

| ADVANTAGES | DISADVANTAGES |
|---|---|
| • Creates a USP for the product – strengthens brand<br>• Less competition due to patent – higher market share<br>• More efficient and cost effecting production process<br>• Likely to be a premium product with high prices | • Can be very costly in the R&D stage and therefore a drain on resources<br>• For all innovations there is an opportunity cost<br>• Few innovations see the light of day, so the firm is effectively financing waste<br>• Creative destruction (Joseph Schumpeter) means that creation of new products makes older ones obsolete e.g. each new iPhone makes the previous one more undesirable. |

**Product and process innovation**

- Product innovation – changing a product that already exists or developing an invention into a brand new product
- Process innovation – changing a process of production that already exists or putting iunto practise a brand new production process
- An innovation is likely to have a patent as the firm looks to recoup the cost of research and development by stopping other firms from copying their product or process

# 2.1.3 – Research & development (R&D) and innovation

**Incentive to increase market power**

- Investment in R&D is expensive
- High fixed costs:
  - Lead to a requirement to produce a significant output in some indisustries in order to recoup start-up and R&D costs
  - Require increased scale of production
  - Thus creating barriers to entry and a tendency towards less competition in the market
  - This increases the market power of the firm
- Through R&D a firm can differentiate it product leading to success in either a mass or niche market
- Differentiation means being able to offer a product or service that stands out from the competition:
  - Product – has to appear better than the competition, USP, patents
  - Promotion – create desire, exclusivity, brand loyalty
  - Operational objectives will focus on R&D and innovation
- This will lead to increased market power

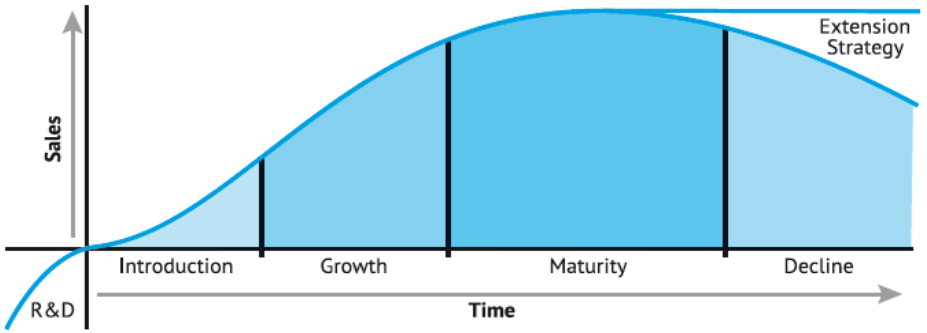
**Role of state funding**

- The state will often provide funding for firms that are innovative
- The government will fund innovation in a number of areas including science, technology and engineering
- This will help high-tech industries to grow, creating highly differentiated UK industries in the future

| BENEFITS | DRAWBACKS |
|---|---|
| • Costs can fall so rise in real wages, increase in employment levels and exports<br>• Helps to increase GDP | • Opportunity cost to government of spending<br>• Potential high taxes to fund extra spending<br>• Firms could be inefficient if they rely on subsidies, since they have less incentive to lower costs<br>• Causes government failure if inefficient industries are subsidised |

**The product life cycle**

**Product Life Cycle:** The stages that a product will go through in its lifetime.




1. Development – negative cash flow due to market research and R&D. No sales revenue before launch
2. Introduction – production and promotion costs can be high
3. Growth – sales revenue increases but as more units are sold production costs also increase. However, there will be economies of scale
4. Maturity – sales stabalise and the product acts as a cash flow
5. Decline – at some point the product will start to lose sales
6. Extension strategies – aim to lengthen the useful life of a product before it goes into decline.

<u>More on extension strategies:</u>

- Firms could use marketing techniques in order to improve sales. For example, firms might spend more on advertising in order to make the product more widely known and more appealing.
- Other marketing techniques include changing the packaging and branding, changing the price or adding value to a good.
- The brand of Microsoft is an example of a brand which makes products that are continuously improved, so it maintains a strong brand loyalty.

# 2.1.3 – Research & development (R&D) and innovation

**The product life cycle diagram in more detail**

Cash flow should be maximised as sales begin to peak. Average costs begin falling as economies of scale are reached.

Promotion may ease as brand becomes established with occasional bursts to maintain sales or differentiate from rival products

Some limited promotion to alert retailers and consumers prior to launch

Sales will fall but cash flow may remain positive as average costs are also low

R&D and testing, (before product launch)

Customer base gained and profit may begin coming in

High levels of investment an no sales means that cash flow is all negative

Sales fall as competitors/new alternatives appear. Low sales means product is often withdrawn


Little promotion, price is likely to fall to maintain some sales until the product reaches the end of its life

Product at peak. Economies of scale at highest level. Promotion less important.

Product launch , heavy promotion with only some initial sales

Promotion changes emphasis to building brand loyalty, prices may rise for premium or fall to match competition

Still negative cash flow as low initial sales do not outweigh high costs of initial launch and promotion

Heavy promotion to create awareness, may offer competitive costs or premium prices for new product

Sales pick up, promotional costs still high but cash flow becomes positive

## 2.1.3 – Research & development (R&D) and innovation

**Example of a product life cycle**

1. Introduction phase – Self-driving cars. Self-driving cars are still at the testing stage, but firms hope to be able to sell to early adopters relatively soon.
2. Growth – Electric cars. For example, the Tesla Model S is in its growth phase. Electric cars still need to convince people that they will work and be practical. As there are more electric charging points and more people adopt them, it becomes easier to sell to those who are more sceptical of new technology like electric cars.
3. Maturity – Ford Focus. The Ford Focus is a well-established car. It has a good brand reputation and has reached its peak level of market penetration. It would be difficult to gain a significantly greater market share. The product life cycle of the Ford Focus has been extended by constant upgrades and redesigns to keep the car on top of the market.
4. Decline – Diesel cars. Since governments have expressed concern at the level of pollution from diesel cars. Some cities have threatened to ban diesel cars within a few years. Sales have fallen considerably and the market for diesel cars may be in terminal decline.

# 2.1.4 – How the digital economy affects markets and firms

**The digital economy**

- The digital economy is the use of any form of digital technology
- Examples include:
  - Search engine optimisation (SEO)
  - Social media
  - Viral marketing
  - Digital display boards
  - SMS messages
  - Targeted feeds
  - Online advertising
- E-commerce is when buyers and sellers meet to trade in a virtual market place (e.g. on the internet)
- E-business is any process using a digital network

**The Digital economy**

| Pros | Cons |
|---|---|
| • **Greater information and choice**<br>• **Saves time**<br>• **Reduced costs for business**<br>• **Greater personalisation**<br>• **Lower barriers to entry**<br>• **Greater flexibility in work, enabling people to work from home.**<br>• **Benefits for developing world** | • **Monopoly power of tech giants**<br>• **Less community**<br>• **Addictive nature of technology**<br>• **Privacy issues**<br>• **Bypassing of labour laws.**<br>• **Disruption to traditional economy and jobs.**<br>• **Potential environmental costs.** |

**The supply side – micromarketing**

- Micromarketing is a market strategy focusing advertising on a small group of consumers within a niche market
- These are specifically targeted so that the marketing is more cost effective
- The consumer receives a more personalised level of marketing that shows a greater understanding of their needs.
- This is likely to lead to greater success and allows the firm to add value to their product, suggesting a higher price can be charged

**Market information in the digital economy**

Price comparison websites:

- Easier for customers to compare prices thereby forcing businesses to be more competitive due to the ease with which customers can access comparative information
- Popular sites include Go Compare, Trivago and Sky Scanner

Viral marketing:

- Use of social media to encourage the spread of promotional activities and increase brand awareness
- Uses blogs and online forums

Social media:

- The use of virtual communities to communicate with actual and potential customers

**The supply side – online retailing and online distribution**

- The process of buying and selling goods and services over the internet (also known as e-commerce or e-tail)
- Offers great convenience to the consumer – can shop 24/7, and breaks down geographical barriers
- Offers opportunities to businesses – lower overhead costs and access to a wider market
- May be used as part of a multi-channel distribution strategy
  - A multi-channel distribution strategy is where a business uses several methods to sell their products to customers (e.g. own website, retail store, comparison website)
- The distribution of media contents digitally as opposed to physically
  - News, music, films etc. can all be accessed via the internet without a need to have a physical copy
- One benefit of a business having a larger warehouse is that huge amounts of stock is in one place, means it is cheap to store it, which leads to lower costs
  - The process of online buying has changed distribution centres as businesses need more distribution centres because of the higher demand for products from all around the country.

# 2.1.4 – How the digital economy affects markets and firms

**Recruiting and training staff with digital skills**

- Human Resource Management (HRM) involves using the workforce of the company in the most productive way
- One element of HRM is the identification of employee positions and the process of attracting the right calibre of worker to fill these positions (recruitment)
- Firms are facing a skills shortage as they cannot find enough workers with high level digital skills
- As firms become more digitalised traditional jobs are being made redundant
- Whilst universities are bridging the gap, a larger number of firms are training up their workforce in order to meet requirements
- Rapid digital change means that ongoing training is required

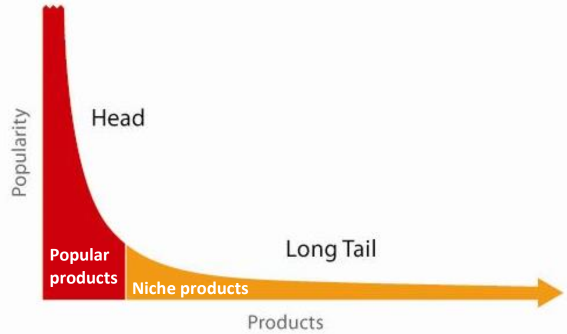
**Firm creation and destruction in a new business environment**

- The digital age has led to firm creation as new businesses such as Amazon and Netflix have embraced the technology and adapted to the new needs of the market
- There have been firm destruction as other businesses have been slow to adapt and have not recognised the requirements of the market

| IMPACT ON FIRMS | IMPACT ON MARKETS |
|---|---|
| Flexible working hours and workers can also work from home which creates a greater supply of labour who are more motivated | More intense competition as there are lower barriers to entry so more firms will enter the market |
| Likelihood of communication mistakes is increased | Competition encourages innovation, as firms are under pressure to differentiate products from rivals |
| Quicker business (placing orders/deliveries) | |
| Less conflict between workers | Innovation is encouraged, as firms are under pressure to differentiate products from rivals |
| Easier communication with suppliers and employees | Cheaper prices due to the saturation of the market and availability of substitutes |
| Time efficiency savings | Less oligopolistic behaviour as there are many firms with small amount of market share |
| Global markets opened up for smaller firms | |
| Economies of scale more likely | Shorter product life cycles (creative destruction) |
| Reduced fixed costs as no need for physical premises | Many businesses fail within six months of starting up – difficult to survive in competitive market |

**The demand-side**

- The long tail is a phrase created by Chris Anderson who suggested that products with low demand can still create an effective market given a large enough distribution channel
- Due to digital technology firms can supply a range of products that they would not have been able to do in traditional bricks and mortar businesses
- Physical retail stores only stock goods with high demand
- Digital stores can stock thousands of niche products making them cost effective and satisfying the wide-ranging demand of different consumers
- Digital technology has allowed firms to target wider geographical markets
- As they do not require a physical presence firms can target a global market
- To do this they might need to understand the geographical markets that they are entering
- Therefore, market research is required, and this might require a significant budget dependent on the scope of the marketing




**Impact on costs, prices, profit, and loss**

- The digital marketing economy has opened up a global market to firms giving 24/7 exposure and convenience
- Firms have been able to reduce costs due to no need to have a physical presence in the market
- This has enabled them to charge lower prices
- Despite this, mass markets have allowed firms to flourish and become profitable
- Even firms that do not succeed can restrict their losses as start up and running costs are less expensive

# 2.1.5 – How small firms compete

## Product differentiation and unique selling points (USPs)

Unique selling point (USPs)/differentiation

- Creating a feature or characteristic within a brand that makes it stand out
  - Logo or brand name e.g. Superdry
  - Different ingredient e.g. SuperJam is sweetened by natural grape juice not sugar
  - Product feature e.g. Ford's heated front windows

Advertising

- Creating awareness of and desire for a brand by communicating a clear brand massage
  - Use of humour e.g. compare the meerkat
  - Lifestyle/aspiration e.g. Its not just food, its M&S food
  - Persuasive language e.g. BA the World's favourite airline

- Product differentiation is important to small businesses in order to provide a competitive advantage (A situation in which products are sold in the same market but are made slightly different to others in order)
- Firms will try to establish brand loyalty and repeat customer by making the consumer aware of the product and persuading them to use it through informative and persuasive advertising (Pareto's Law: 80 percent of results will come from just 20 percent of the action)
- They will invest in new product development on a smaller scale than large businesses but will try to make their products stand out in highly competitive markets
- These are often niche markets as the economies of scale that lead to the creation of highly concentrated markets are not available to smaller firms
- This allows small firms to compete against much larger competitors

## Identifying and Responding to Customer Needs

- A customer need is a requirement of a potential buyer that can be solved through the purchase of a product.

| Needs | Wants |
|---|---|
| Water | A New Car |
| Food | A TV |
| Train ticket | Healthier Lifestyle |

- It is important that start-up businesses identify customer needs so that they have the flexibility to meet these needs of customers.
- It is not just about what the business wants to sell; it's whether the customer has a need for the product, and therefore buy.

How to satisfy customer needs?

- Understanding what is happening in the market:
  - Trends
  - Looking at past data to forecast the future
  - Changes in fashion
  - People's tastes change, often because of the influence of marketing
- What does the customer want?
  - Has the business got the right product?
  - … at the right price?

## Customer service

- Customer service is one of the most important areas of a business. Customer service begins pre-sale, during sale and after sale (if needed).
- Customer satisfaction can be measured by whether the product has met or surpassed customer expectations.
- A happy customer is a good source of advertising, especially in a local market, where recommendations can create trade.
- It is easier and cheaper to sell to existing or repeat customers.

# 2.1.5 – How small firms compete

**Maintaining customer service**

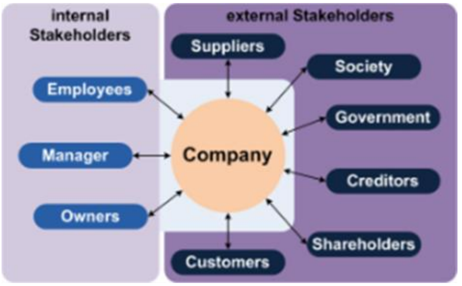
- For a small business it is essential to have good customer service in order to:
    - Distinguish the product from the competition
    - Obtain repeat custom
    - Gain a good reputation
- It is important to provide good customer service in a number of areas:
    - Accuracy and reliability
    - Product information
    - After-sales service
- Accuracy and Reliability:
    - Customers want a product that will meet their requirements each and every time
    - Consistent quality will earn customer loyalty and repeat custom
    - Customers expect predictability when buying a product – does the good or service meet expectations?
- Product information
    - To obtain the full benefit of a product the customer needs to know how it works
    - Expert knowledge of how a product works will allow the firm to inform customer needs when making a sale
    - Good customer service  based on product information can make the difference between making and losing a sale
- After sales service
    - Many products require an ongoing service including responding to any complaints
    - A good website, online helpdesk and a reliable repair/support team can provide this
    - This will increase the likelihood of repeat custom for new products aimed at a loyal customer base
    - Recommendation will also be key for small firms to increase their customer base

**Targeting niche markets**

- Niche marketing is when a firm targets a small subsection or previously unexploited gap in a larger market and specifically creates products to cater to them.
- Niche marketing may give a business first mover advantage and allow them to charge a premium price
- Identifying small, currently unsatisfied, gaps in the market
- The target market is well defined with distinct characteristics
- Promotional activities will be targeted at just a small subsection of the whole market
- Can often charge higher prices

**Stakeholders**

- Shareholder legally owns a share/stake in a business. They might have voting rights on how the business is run.
- Stakeholders are anyone with an interest in the actions of a business




Stakeholders can be categorised as:

- internal or external
- primary or secondary

- Primary stakeholders have a direct relationship with the business
- Whereas secondary stakeholders although affected by the actions of a business are not directly related to the business.

**Primary**

- Shareholders
- Customers
- Suppliers
- Employee
- Creditors

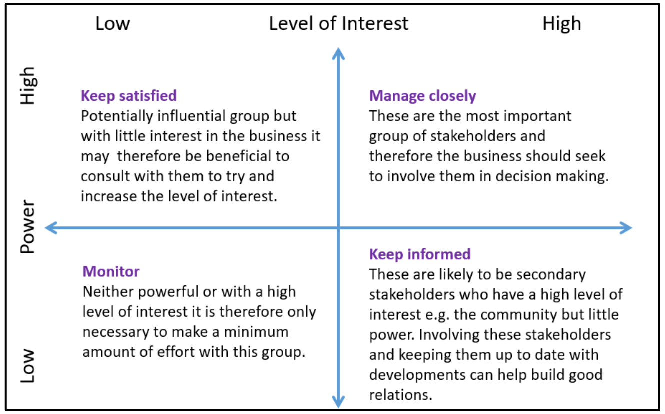
**Secondary**

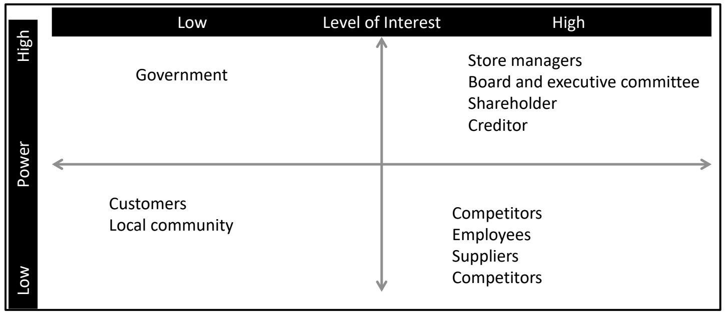
- Community
- Competitors
- Media
- Society
- Government
- Banks

# 2.1.5 – How small firms compete

**Competitive advantage and stakeholders**

- Stakeholder needs should be considered when making decisions
- This can help to establish good relationships which will provide a competitive advantage as stakeholders will want the firm to succeed
- Businesses use stakeholder mapping to help inform decision making
  - Stakeholder mapping maps the relative power of each stakeholder group against the degree of interest
  - This helps inform managers on how important each stakeholder group is and therefore how involved they should be in the decision-making process



# 2.2.1 - Price elasticity of demand (PED)

**Link between price and demand**

- When prices go up, demand is less. That statement makes logical sense and all businesses know this, so they try to avoid putting prices up
- If the business costs rise they try and absorb the costs so that the customers do not have to pay more, because this will affect the demand for their product.
- For example, if McDonald's put up the price of a big mac to £10 customer demand will decrease, sales revenue for that product will decrease and profits will decrease
- There is another argument that customers may switch to an available substitute, and it may be McDonald's Chicken Nuggets or the customer may switch to Burger King

**PED formula**

$$\%\ change\ in\ price = \frac{New\ price - old\ price}{Old\ price} \times 100$$

$$\%\ change\ in\ quantity\ demanded = \frac{New\ quantity - old\ quantity}{Old\ quantity} \times 100$$

$$PED = \frac{\%\ change\ in\ quantity\ demanded}{\%\ change\ in\ price} \quad OR \quad \text{PED=} \frac{\%\Delta QD}{\%\Delta P}$$

Have a look at this example:

- When the **price** of a type of toy car **increased** from **50p** to **70p** the **demand** for them **fell** from **15** cars to **10** cars.
- The **percentage change** in **quantity demanded** would be: $\frac{\text{change in demand}}{\text{original demand}} \times 100 = \frac{-5}{15} \times 100 = -33.33\%$
- The **percentage change** in **price** would be: $\frac{\text{change in price}}{\text{original price}} \times 100 = \frac{20}{50} \times 100 = 40\%$
- So **PED** = $\frac{-33.33\%}{40\%} = -0.83$

A common exam mistake is to write PED as a percentage — it's not.

**PED definition**

- Elasticity is a measure of how responsive demand is to a change in price or income
- PED stands for price elasticity of demand
- It measures the responsiveness of demand to a change in price
- It can be either elastic or inelastic
- The values can be calculated so that you can work out if a product or service has an elastic or inelastic demand
- PED values are always a minus

**The significance of price elasticity of demand to firms**

- Pricing decisions → a business needs to know what will happen to demand if they change the prices of products (due to changes in costs or competitors prices)
- Branding decisions → if a business uses branding for a product, it will become more inelastic which means prices can be raised without losing too many sales.
- Mass markets → Goods in these markets are more likely to have substitutes or be standardised so prices changes will have a larger effect on demand.
- Niche markets → these tend to rely on having a less competitive price as niche market products tend to be more specialised with fewer substitutes.

**How to interpret PED values**

- Elastic demand – value of PED will be more than 1 – e.g. -1.75
- Inelastic demand – value of PED will be between 0 and 1 – e.g. -0.1
- (ignore the minus sign when deciding if elastic of inelastic)
- If an elastic PED value is equal to 1, it is called unitary elastic – e.g. if price goes up 10%, demand will decrease by 10% (demand and price are inversely proportional)

# 2.2.1 - Price elasticity of demand (PED)

**Elastic demand**

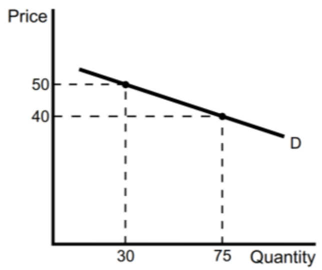
- Products and services that have elastic demand are responsive to a change in price
- This means if the business puts prices up then demand will decrease
- If prices decrease, then demand will increase. It stands to reason that if you make a product cheaper that more customers will want to buy it.
- If prices rise too high, customers may buy a substitute product as there are many alternatives
- If prices fall too low, the business may not produce enough supply to meet demand
- An example of elastic demand is burgers and fast food. This is because there are lots of different substitutes available.

**Inelastic demand**

- Inelastic demand is for goods that means if the price is changed the demands stays the same
- With elastic demand there are very few substitutes
- Generally addictive or essential products have inelastic demand because customers will always buy them not matter the price.
- Inelastic demand can change depending on the situation. For example, on a motorway, if you need petrol you have to go to a service station where the prices are higher, meaning elasticity will be lower. Whereas if you have half a tank and you are not desperate, then there are substitute petrol stations, meaning elasticity will be higher.

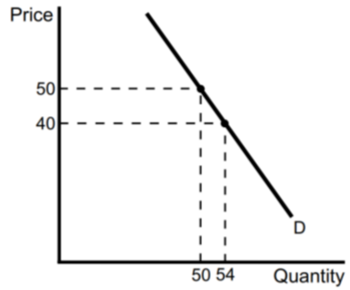
**Relatively elastic graph**

- A price elastic good is very responsive to a change in price. In other words, the change in price leads to an even bigger change in demand. The numerical value for PED is >1.



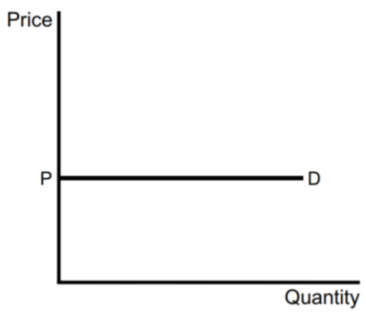

**Relatively inelastic graph**

- A price inelastic good has a demand that is relatively unresponsive to a change in price. PED is <1.



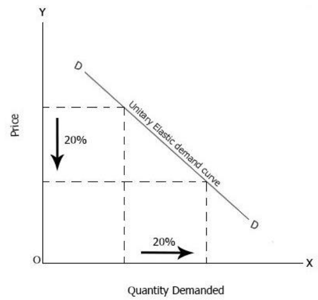

**Perfectly elastic graph**

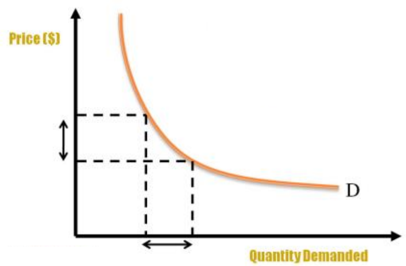
- A perfectly elastic good has a demand which falls to zero when price changes. PED = infinity.




**Unitary elastic graph**

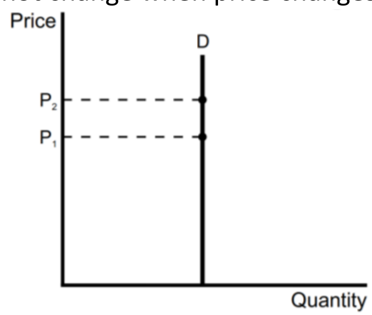
- A unitary elastic good has a change in demand which is equal to the change in price. For example, if price goes down 20%, demand will increase by 20%. PED = 1.




**Perfectly inelastic graph**

- A perfectly inelastic good has a demand which does not change when price changes. PED = 0.



# 2.2.1 - Price elasticity of demand (PED)

### Factors affecting elasticity

- Necessity – prices will not affect demand for products that are needed such as petrol or electricity (inelastic). Luxury goods such as holidays will see are elastic so if prices of flights increase then sales will fall dramatically.
- Habit/dependency – products such as cigarettes are habit-forming so people are willing to pay any price for them due to addiction and demand is mostly consistent even at higher prices.
- Substitutes – If the good has several substitutes, such as Android phones instead of iPhones, then the demand is more price elastic. The elasticity can also change within markets. For example, the market for bread is less elastic than the market for white bread. This is because there are fewer substitutes for bread in general, but there are several substitutes for white bread. Hence, white bread is more price elastic. The closer and more available the substitutes are, the more price elastic the demand. Elasticity also changes in the long and short run. In the long run, consumers have time to respond and find a substitute, so demand becomes more price elastic. In the short run, consumers do not have this time, so demand is more inelastic.
- Brand loyalty – the more brand loyalty a product has, the more inelastic it is as consumers are attached to the brand
- Durability of good – long-lasting products such as washing machines have more elastic demand as when prices rise consumers prefer to repair old ones etc. rather than buy new
- Proportion of income spent – if a good takes up a small amount of income such as a magazine, a rise in price will be relatively price inelastic as consumers do not mind paying a small amount more. On the other hand, purchases such as cars take up a significant portion of income so will be more price elastic.
- Peak/off-peak demand – during peak times, such as at 9am and 5pm, demand for train tickets is inelastic as more people need to travel at these times so tickets are more expensive as demand will not change much.

### PED and total revenue

- Total revenue is a measure of how much can be made from selling products / services (before costs have been taken off)
- A business will have an objective of maximising profits, to do this it will need to increase total revenue
- Total revenue can be increased by increasing price
- This is why business managers will need to know PED – they need to know how sensitive their customers are to a change in price
- Total revenue is equal to average price multiplied by quantity sold:

Total Revenue = Price x Quantity

If a good has **elastic** demand, then:

- A **reduction** in **price** will **increase** the firm's **total revenue.**
- An **increase** in **price** will **reduce** the firm's **total revenue.**

For example, a good has an **elastic** PED of -2.5. When the good's price is £5, 20 units are sold, giving a total revenue of **£100**. When **price falls** to £4, **demand rises** to 30 units and **total revenue increases** to **£120**.

However, if a good has **inelastic** demand, then:

- A **reduction** in **price** will **reduce** the firm's **total revenue.**
- An **increase** in **price** will **increase** the firm's **total revenue.**

For example, a good has an **inelastic** PED of -0.5. When the good's price is £5, 20 units are sold, giving a total revenue of **£100**. When **price falls** to £4, **demand rises** to 22 units and **total revenue falls** to **£88**.

### Summary

| Type of product | % change in demand | Response to price changes | Effect on total revenue: Price rises | Effect on total revenue: Price falls |
|---|---|---|---|---|
| **Elastic** | More than % change in price | Highly responsive | TR falls | TR rises |
| **Inelastic** | Less than % change in price | Slightly responsive | TR rises | TR falls |

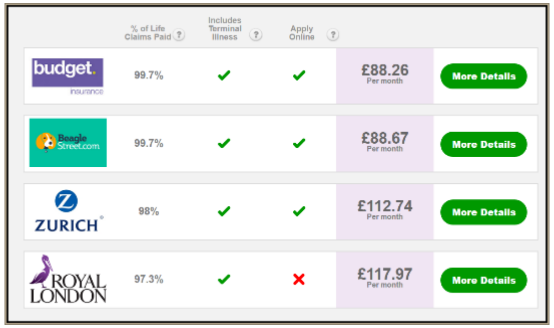
### Problems with elasticity

- Consumer reaction to changes in price takes time to monitor and changes frequently
- Other factors can affect demand, not just price e.g. taste, competitors, state of the economy etc.
- Difficult to measure and predict accurately (only a rough approximation of sales revenue).

# 2.2.1 - Price elasticity of demand (PED)

**Competitive pricing**

- Some products or services are priced very similar to close competitors
- This is used by a business which sells products that have very close substitutes
- This means that customers will have to judge a product or service on "non-price" methods such as; quality of service, speed, extras etc.



| | % of Life Claims Paid | Includes Terminal Illness | Apply Online | | |
|---|---|---|---|---|---|
| budget. insurance | 99.7% | ✓ | ✓ | £88.26 Per month | More Details |
| Beagle Street.com | 99.7% | ✓ | ✓ | £88.67 Per month | More Details |
| ZURICH | 98% | ✓ | ✓ | £112.74 Per month | More Details |
| ROYAL LONDON | 97.3% | ✓ | ✗ | £117.97 Per month | More Details |

**Skimming pricing**

- Products that are unique or first to market can have a high price can be charged at introduction or launch
- This is so that the business can maximise revenue and profits before substitutes appear on the market
- High demand when the product is first launched at it will have a Unique Selling Point (USP)
- The business will need to set high prices to recoup research and development (R&D) costs

# 2.2.2 – Competing on price

## Competing on price

- Price is the amount of money that a consumer has to pay to receive the good or service.
- A pricing strategy is the way in which a business decides upon the price of its products or service.
- Firms use different pricing strategies to price their products, taking into account a number of factors such as market research, competitors' prices and the state of the economy.

## Psychological pricing

- Phycological pricing occurs when a firm sets a price for the product in order to entice the customer into making a purchase by making it sound cheaper than it actually is
- A common example is when a firm charges £9.99 instead of £10

## Penetration pricing

- Price penetration involves setting a low initial price for a new product in order to get a foothold in the market and gain market share
- May be a suitable pricing strategy for a product in a mass market
- A firm will release a new product at a low price with the aim of enticing people to buy
- The aim is to gain an early customer base
- Once the product has been launched and built up a customer base, the firm may raise the price
- Likely to be used with a price elastic product

## Predatory pricing

- Predatory pricing is when prices are set low for a short period of time to force the competitors out of the market
- Prices are then put back to where they were previously or even higher
- This strategy is used by dominant businesses, who can afford to make a loss in the short run, to force new entrants out of the market

## Competitive pricing

- Prices are based on the prices charged by competitors, maybe the same or slightly lower, firms will try to compete on the other aspects of the marketing mix.

## Price makers (also known as price leaders) and price takers

- **Price taker –** this occurs when a firm or consumer has no option but to accept the price set by the market.
- The opposite concept is a price maker – when a firm has monopoly power is able to choose which price to set because consumers have no alternative. To gain more market power, a firm can try and differentiate its product.

| | Price maker | Price taker |
|---|---|---|
| **Characteristics** | • Firms with pricing power<br>• Greater market share<br>• Has monopoly power – less competition<br>• Able to choose prices as consumers have no alternative | • Prices set by the market<br>• Consumers can go elsewhere if prices go up, and firms have no incentive to decrease price<br>• Usually seen in a more perfectly competitive market |
| **Examples** | • Apple<br>• Amazon | • Tesco<br>• Asda |

## Price skimming (Premium pricing)

- Price skimming involves setting a high initial price for a new product in order to recoup costs
- When a firm releases a new product, it often charges a high price targeting a segment of the market known as 'early adopters'
  - Early adopters are customers who must have the product as soon as it is launched and are prepared to pay high prices to get it
- Firms often base their initial promotion campaign around this idea, trying to create a 'must have' mentality amongst their target market
- Once this market has been 'skimmed off' the company will lower the price

## Cost plus

- Cost plus is when a percentage mark up is added to the cost of producing a good or service to calculate the selling price

$$\begin{matrix} selling\ price \\ (cost\ plus) \end{matrix} = \begin{matrix} variable\ cost \\ per\ unit \end{matrix} + \begin{matrix} proportion\ of\ total \\ cost\ per\ unit \end{matrix} \times \%\ mark\ up$$

- The percentage mark up is how much the business wants to achieve as profit
- The price is decided by adding a fixed percentage profit to the cost, e.g. a business wanting to make a 20% profit with an average cost of £10 per unit would set the price at £12.

# 2.2.2 – Competing on price

| STRATEGIES | FEATURES | ADVANTAGES | DISADVANTAGES | WHERE USED |
|---|---|---|---|---|
| **COMPETITIVE** | Pricing is based off what competitors charge to keep appeal | There is a guarantee of some market share and sales if market price is accepted | They may not be able to cover their costs if focused on competitive pricing | Used in a market with homogeneous (similar) products, or one with many substitutes |
| **COST PLUS** | This is the cost of raw materials with a calculated mark-up on each product | Reduces uncertainty if the product is sold as seller knows that costs will be covered | As price is not competitive it could lead to a fall in quantity sold, revenue and market share | Can be used when the seller wants to know the gross profit margin in advance |
| **SKIMMING (PREMIUM)** | This is a short-term technique used when competition is low. High prices are set initially | Can gain quick profits when beginning with a new product | Can lead to lack of customers as they are deterred by the high prices | Used in new markets, or with new products that have differentiated features |
| **PENETRATION** | Low prices are used initially, which are raised after customer loyalty is gained | They can gain market share quickly, and can enter the market more easily | They may make a large loss through these low prices | Used by new firms when entering the market to gain market share |
| **PREDATORY** | Low prices are set, taking losses to drive other firms out of business | Able to reduce competition in the market and therefore maintain their market power | Could possibly make a large loss from their predatory prices | Used in oligopolistic markets, by large firms to prevent new firms from entering |
| **PSYCHOLOGICAL** | Uses emotional responses to prices as a good priced at 99p may seem cheaper to a customer than £1 | Could increase sales revenue which leads to a gain in market share | May not have the intended effect - pointless | Can be used on cheaper/smaller products (chocolate) to encourage impulse purchases |

**Factors that determine the best pricing strategy**

Number of USPs / amount of differentiation

- A new product entering the market that is highly differentiated might use a strategy of price skimming. The more differentiated the product, the higher the price the business can charge.
- A product that has little in the way of USP's or differentiation may rely on competitive pricing.

Level of competition in the business environment

- If the market is dominated by a few large firms, businesses will follow a strategy of competitive pricing.
- Businesses may choose a strategy of predatory pricing in order to reduce the level of competition in the market.

Stage in product life cycle

- The stage in the product life cycle strongly influences the prices, as a new product entering the market will use either penetration pricing (in competitive market) or use price-skimming (with no competition).
- On the other hand, in growth/maturity phases competitive pricing is likely to be used to sustain market share.

Strength of brand

- The strength of a brand affects customer loyalty as large and well-known brands can charge higher prices (Price skimming) as people are willing to pay for the name-brand product.
- An example would be the high cost of Nike sportswear which is similar in quality to other smaller brands but is quite expensive. For such brands, PED is inelastic.

Price elasticity of demand

- If customers are sensitive to changes in price i.e. the product is price elastic then a business might use competitive pricing.
- If customers are less sensitive to a change in price i.e. the product is price inelastic them a business might use price skimming.

Costs and the need to make profit

- The overall costs will be important as if profit is essential, firms will make the decision to use strategies such as cost plus to ensure that costs are covered.
- If profit is not an immediate necessity, they will use penetration pricing to gain profit long-term by sacrificing their initial profit margins.
- This may depend on when fixed costs or loans must be paid in.

# 2.2.2 – Competing on price

**Changes in pricing to reflect social trends**

Online sales

- Online sales have led to the frequent use of dynamic pricing.
- Dynamic pricing is a pricing strategy in which businesses set flexible prices for products or services based on current market demands.
- Prices change frequently and quickly in response to changes in demand.
- At times of peak demand prices will go up and vice versa
- Often used by businesses with set capacity e.g. an airline so as the plane reaches full capacity prices will start to rise
- Dynamic pricing is made possible by technology that tracks demand and levels of interest.

Price comparison websites

- Easier for customers to compare prices thereby forcing businesses to be more competitive due to the ease with which customers can access comparative information.
- Popular sites include Go Compare, Trivago and Sky Scanner.

# 2.2.3 – Non-price competition

**Non-price competition**

- Non-price competition occurs when a firm distinguishes or differentiates its product from that of its competitors
- This can take many forms including promotion, quality, customer service and branding
- It is common in oligopoly as competing on price is likely to lead to lower profits for the oligopolist
- This will reduce the likelihood of price wars
- The additional costs of non-price competition are likely to be less than the cost of engaging in a price war

**The Degree of Product Differentiation**

- Product differentiation provides a competitive advantage to a firm and shifts the demand curve to the right as more people are attracted to buying the product.
- Product differentiation includes:
  - Quality features that competitors' products do not have
  - Functional and design features that competitors' products do not have
  - Imperfect information where consumers are more aware of one firm's products over those of the competition
  - Advertising creating perceived differences in the mind of the consumer
  - Location, where the product can only be bought geographically through one supplier

**Advertising and other promotional methods**

- Advertising is an example of a sunk cost and deters new entrants
- Firms will spend heavily trying to establish brand loyalty and repeat custom
- This may take the form of loyalty schemes where incentives e.g. loyalty cards are offered to buy from the firm
- Marketing policy is how the firm differentiates itself from the competition
- By investing in new product development, the firm can increase demand and maintain brand loyalty

**Media advertising**

- Media Advertising is communication used to inform potential customers about products and persuade them to buy the products.
- Advertising takes a variety of forms:
  - Television and radio
  - Newspapers and magazines
  - Posters and bill boards
- As they grow businesses can afford to pay for more expensive advertising that will reach a wider market
- This will lead to an increase in the potential customer base and higher sales revenue

**Sales promotion**

- Sales promotions are short-term method designed to attract customers into purchasing a product.
- Sales promotion can take a variety of forms, including:
  - Competitions
  - Special offers
    - e.g. Buy one get one free (BOGOF) or 10% extra free
  - Free samples
- As they grow businesses target a wider audience through national sales promotions
- Sales promotions will create interest in the product and attract new customers, helping the business to grow

**Direct marketing**

- Direct marketing is any marketing activity that is aimed directly at the customer.
- Direct marketing can take a variety of forms, including:
  - Direct mail – sometimes referred to as junk mail
  - Electronic mail – may be seen as spam
  - Door to door selling
- A business can target and engage customers directly. Specific market segments can be targeted leading to a higher success rate in turning potential customers into sales
- New technologies have made it easier and cheaper for businesses to communicate with target markets

# 2.2.3 – Non-price competition

**The nature of the product**

- The type of product that a business sells will affect its use of the promotional mix
- Business To Consumers (B2C) – where firms sell to the general public the type of media used to promote the product will reflect this.  Television, radio and newspapers might be used by an expanding business targeting the whole country
- Business To Business (B2B) – where firms sell between each other we are more like to see direct marketing with businesses targeting other businesses with specialist information giving greater insight and detail of the product being sold.  There will be greater use of informative, rather than persuasive, advertising.

**Distribution methods**

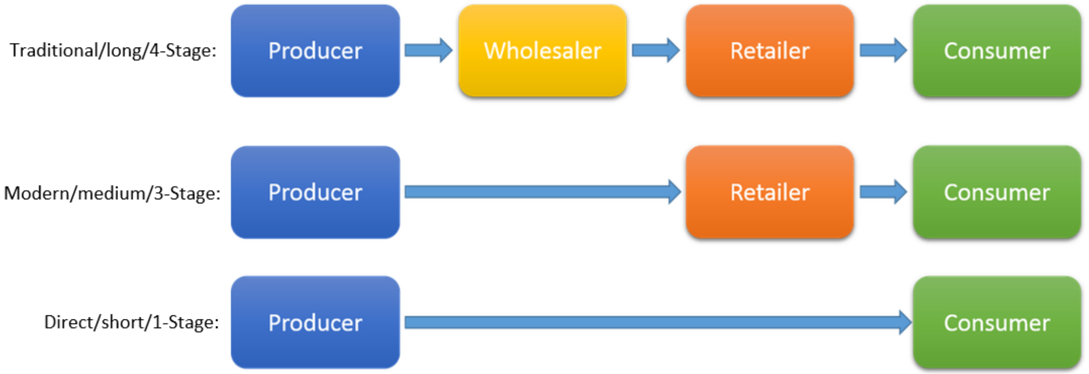
- Distribution is the process of getting the firm's product to the market
- Distribution channels are the routes to market that a product takes from producers to the final customer
- There are a number of distribution channels available to firms:
  - Short distribution channels are where the producer sells either directly to the customer or through a retailer
  - Long distribution channels are where there are more than one intermediary (middle person) between the producer and the customer

**The nature of the market**

- The type of market that a business operates in will affect its use of the promotional mix
  - Local v National
    - As a firm grows, moving from local to national markets, the type of promotion will differ.  Advertising is more effective in meeting national markets than direct marketing
  - Physical v Electronic
    - Through growing use of technology businesses are finding it easier to directly target individual consumers through electronic mail

**Types of distribution channels**

- Producers can use direct selling whereby they sell directly to the final consumer
- Often, producers use retailers who sell products on to the general public
- Wholesalers buy large quantities of supplies from producers and sell them on in smaller quantities. For example, a corner shop might go to a wholesaler to buy their products
- Increasingly, firms are using e-commerce benefiting from the power of the internet to sell on their products
- Multi-channel distribution is when a firm chooses to use a combination of methods



# 2.2.3 – Non-price competition

**Distribution decisions**

- Distribution decisions will be affected by a number of factors including:
  - Type of Product
    - The characteristics of the product need to be taken into account. For example, Coca Cola do not ship their product to the UK from the USA. Instead, they ship over the syrup and the actual product is then made in the UK using British water
  - Market
    - It is important that the customers being targeted can access the product. High streets are accessible by public transport so that all customers can shop, not just those with cars
- Is the businesses targeting a local, national or global market?
  - Quantity and frequency
  - Geographical location
    - How far is the target market from the firm? The firm will have to take into account the nearness of the market. Regional markets are far more accessible than international markets
  - Cost
    - This is very important for a firm. An expensive distribution method will reduce the contribution being made to a firm's profit. Therefore, the firm must ensure that the method is cost effective
  - Degree of control
    - Businesses may want to protect their brand by limiting the spread of the product and keeping tight control of where it is available and at what price

**Devising appropriate marketing approaches**

- Non-price competition means that firms must devise appropriate marketing strategies to be successful. These include:
  - Product differentiation in terms of higher quality product and customer service
  - A high degree of spending on advertising to inform and persuade customers to buy the product
  - A high level of spending on sponsorship to create awareness of the brand and build a relationship with stakeholders
  - Sales promotions to attract customers e.g. buy one get one free (BOGOF)
  - Loyalty schemes to attract repeat custom e.g. loyalty cards

# 2.2.4 - Income elasticity of demand (YED)

**Types of goods**

- An inferior good is products or services where demand decreases when consumer income increases – e.g. pot noodles
- A normal good (necessity good) is products or services for which demand increases when income increases – an every day good e.g. coco pops
- A luxury good is products or services for which demand increases more than proportionally as income rises – e.g. a Ferrari

**Income Elasticity of Demand**

- Income Elasticity of Demand is also known as YED for short
- It is a calculation used, by business, to estimate how demand will change given changes in income
- As consumer incomes change (up or down) so do demands
- So, a business can measure how much demand for a product or service will be affected by a change in consumers income

**Normal (necessity) goods in more detail**

- Normal goods are those for which consumer demand increases when income increases
- A good is normal when consumers demand more as their incomes increase
- YED value would be >0 (a positive value)
- For example, the YED value for Kellogg's cornflakes might be 0.4

**Inferior goods in more detail**

- Inferior goods are products where demand decreases as income increases
- YED value for an inferior good will be <0 ( a negative value)
- For example, charity shop clothes might have a YED of -1.5
- Leo is earning more money now he has been promoted, so he wants to buy fewer inferior goods.  This means that he can now afford Champagne and doesn't have to drink Tesco Value larger

**Luxury goods in more detail**

- A luxury good is when an increase in income causes a larger increase in demand (it's all about proportion)
- YED value for luxury goods will be >1 positive
- For example you buy a game with extra online downloadable content levels because you have had a 10% increase in income but your demand increases 25%. This gives a YED value of 2.5

**YED formula**

- Income elasticity of demand is the responsiveness of a change in demand to a change in income. The formula for this is:

$$\frac{\%\text{ change in quantity demanded}}{\%\text{ change in income}}$$

$$\frac{\%\Delta QD}{\%\Delta Y}$$

$$\%\ change\ in\ price = \frac{New\ price - old\ price}{Old\ price} \times 100$$

$$\%\ change\ in\ income = \frac{New\ income - old\ income}{Old\ income} \times 100$$

# 2.2.4 - Income elasticity of demand (YED)

**Interpretation of numerical values**

- YED measures the responsiveness of demand to a change in income

| Inferior | Normal | Luxury |
|---|---|---|
| YED value is <0 (negative) | YED value is between 0 and 1 (positive) | YED value is >1 (positive) |
| An increase in income means a decrease in demand | An increase in income means a small increase in demand | An increase in income means a higher increase in demand |
|  |  |  |

**Expectations of changes income**

- Incomes will fall if employees lose their job and end up claiming jobseeker's allowance
- Incomes will rise if an employee is promoted within a business, this may come with a pay rise
- Incomes may fall in times of recession – businesses may need to cut costs (staff wages)
- Incomes may rise in times of economic growth – businesses may want to keep key staff with a pay rise

**Factors influencing YED**

<u>Luxury goods</u>

- An increase in income will mean an increase in the demand for luxury goods
- In other words, Scott has had a pay rise and now he is considering purchasing a luxury watch

<u>Normal goods</u>

- An increase in income will lead to an increase in demand
- In other words, Kathryn is earning more because the minimum wage has increased this year, so she will buy more of the products that she needs

<u>Inferior goods</u>

- An increase in income will lead to a fall in demand for inferior goods
- In other words, Chazz earns more money, he no longer wants to buy ASDA Smart price food and is treating himself to a tin on Heinz branded beans

**The significance of income elasticity of demand to businesses**

- YED is used by business to help them decide what products and services they should offer in order to increase sales

<u>Poundland example</u>

- Poundland specialises in inferior goods
- Poundland specialises in negative YED products
- Poundland will thrive and have more sales when incomes are falling in a recession
- When incomes start to rise customers will demand better less inferior goods and the revenue and demand for Poundland products will decrease.

<u>ASDA example</u>

- When incomes start to rise, in a period of economic growth, ASDA may need to diversify into premium products and extra special ranges

# 2.3.1 – Productivity

**Productivity**

- Productivity measures the output created, in relation to units of input within a given time period.
- Productivity can be measured in three possible ways:
  - Output per unit of input per time period
  - Output in relation to labour input
  - Output in relation to capital/machine input
- High productivity means more output with the same amount of input over the same period of time, this reduces average costs.
- On the other hand, lower productivity means less output with the same input and period of time which in turn increases costs. This requires a larger input/period of time to reach the same output.

**Factors influencing productivity**

- Factors influencing productivity of machinery will include:
  - Age of machinery and maintenance
  - Training of operatives
  - Quality of inputs e.g. a high quality printer can jam if cheap paper is used
  - Hours used vs down time
  - Efficiency of programming
  - Unforeseen events e.g. power cuts

**Difficulties increasing labour productivity**

- May impact negatively on quality and customer satisfaction
  - Damage to long term reputation
  - Increase waste affecting unit cost
- Employees may feel exploited
  - Working harder for the same pay, may work with unions to negotiate higher wages
  - Business benefiting but not the employees
  - Increased workload leading to stress, demotivation and lower staff morale.

**Productivity and competitiveness**

- Rising productivity almost always leads to a fall in unit costs and may lead to increased output levels.
  - To customers: Customers may experience lower prices, this may lead to increased demand and possibly returning customers.
  - To businesses: Using fewer resources, lower unit costs, increased output, allows opportunity for reinvestment into the business for further projects/developing further. Gives opportunity to develop a competitive advantage.

**Productivity and wages**

- Productivity is linked to labour productivity which is a measure of output per worker.

***Labour productivity is calculated using this formula:***

$$\frac{\textbf{Output per period (units)}}{\textbf{Number of employees at work}}$$

***The answer from the formula is usually expressed in terms of output per employee***

***e.g. 1,000 units per employee per month***

- Labour productivity will be influenced by multiple factors including:
  - Training and skills of the workforce
  - Motivation
  - Complexity of the product
- Increasing labour productivity lowers labour cost per unit (assuming employee costs stay the same – However in most cases, this is not the same, employees expect to paid for their skills and expertise.
- Therefore, there is an inverse relationship between productivity and wages
- However workers may be motivated to increase productivity through financial incentives
- Piece rate is when workers are paid per unit produced, in which case the relationship would not be inverse but there is positive correlation i.e. as productivity goes up wages go up.

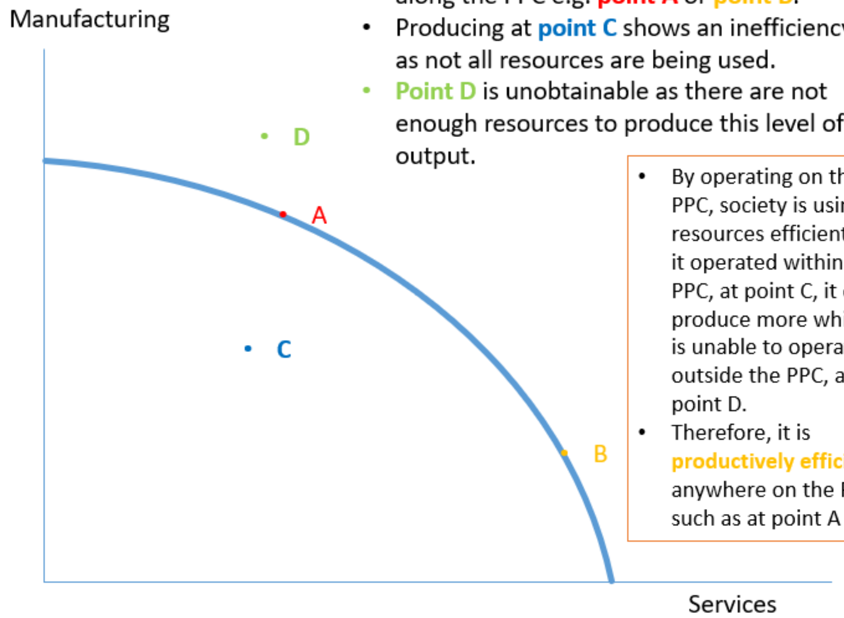
# 2.3.1 – Productivity

## Productivity and economic growth

- Productivity and economic growth: as businesses become more productive, the supply of consumer goods increases, costs and prices may fall, standards of living rise and real incomes increase.
- Productivity is an important element in economic growth. But it does involve structural change — some employees will be made redundant and will have to look for new jobs where demand is growing.


*Figure 1: Gaining from new technologies*

## Productivity and economic growth – shift in the PPF curve

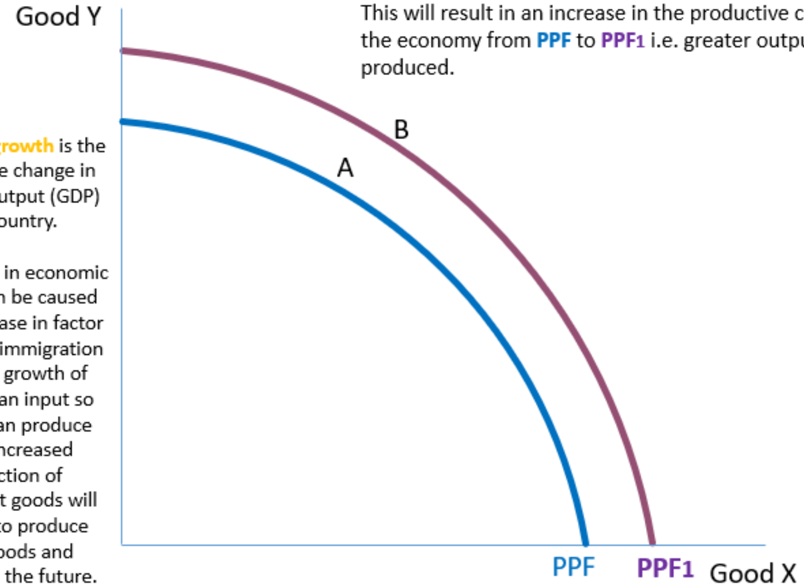



- **Productive efficiency** occurs anywhere along the PPC e.g. **point A** or **point B**.
- Producing at **point C** shows an inefficiency as not all resources are being used.
- **Point D** is unobtainable as there are not enough resources to produce this level of output.

- By operating on the PPC, society is using its resources efficiently. If it operated within the PPC, at point C, it could produce more whilst it is unable to operate outside the PPC, at point D.
- Therefore, it is **productively efficient** anywhere on the PPC, such as at point A or B.

**Economic growth** is the percentage change in the total output (GDP) of a country.

An increase in economic growth can be caused by an increase in factor inputs e.g. immigration will see a growth of labour as an input so that we can produce more; increased production of investment goods will allow us to produce more goods and services in the future.




Economic growth caused by an increase in factors of production available in an economy can cause the **PPF** to shift outwards to the right.
This will result in an increase in the productive capacity of the economy from **PPF** to **PPF1** i.e. greater output can be produced.

## Labour and Capital intensive production

- The mix of resources can be:
  - Capital intensive which uses a relatively high proportion of capital such as machinery in the production of a good or service
    - This tends to occur in the secondary sector of the economy i.e. manufacturing
  - Labour intensive which uses a relatively high proportion of labour i.e. workers in the production of a good or service
    - This tends to occur in the tertiary sector of the economy i.e. services

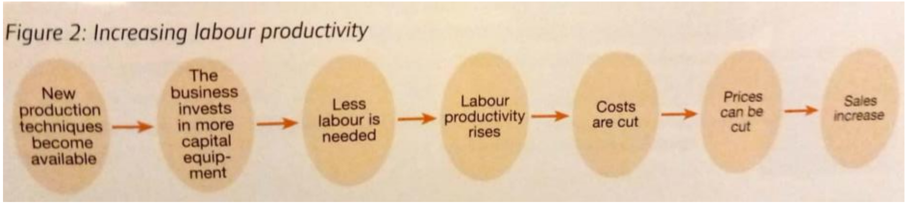



*Figure 2: Increasing labour productivity*

# 2.3.1 – Productivity

**Capital intensive pros and cons**

| ADVANTAGES | DISADVANTAGES |
|---|---|
| • Increased productivity<br>• Improved quality and speed<br>• Reduced labour costs<br>• Greater opportunities for economies of scale (the benefits to a business of producing on a large scale that lead to a fall in unit costs) | • High investment outlay<br>• Lack of human initiative<br>• Greater resistance to change by workforce e.g. retraining to use new equipment |

**Labour intensive pros and cons**

| ADVANTAGES | DISADVANTAGES |
|---|---|
| • Often cheaper, especially when produced in low wage locations<br>• Workforce can easily adapt to change, especially if multi-skilled<br>• Continuous improvement through workforce can benefit the firm e.g. new ideas<br>• Government funding often available to protect jobs in the economy | • Industrial relations can be a problem e.g. strikes<br>• Lack of skilled workers in some industries<br>• HRM costs can be very high e.g. recruitment, selection and training |

# 2.3.2 – Capacity utilisation

### Capacity utilisation

- Capacity utilisation measures the potential efficiency of the economy and how it is being used.
- Capacity utilisation can be defined as the extent to which a firm is using its available resources, equipment, and personnel to produce goods or services, in relation to its maximum production capacity.
- It can either be under or over utilised:
    - If the business has under-utilised capacity this means that some capital equipment is idle (the business is not using assets to its full capacity)
    - Over-utilised capacity means that the business is trying to produce more than its capital equipment can handle.

**Capacity Utilisation Formula**

*Capacity utilisation (expressed as a percentage) is calculated using this formula:*

$$\frac{\text{Actual level of output}}{\text{Maximum possible output}} \times 100$$

### Full capacity

- Full capacity (or maximum capacity) is the maximum amount of output achievable if all resources are fully utilised.
- In the long run, capacity can be increased by acquiring more resources e.g. bigger premises, more machinery, introducing a 3rd shift.
- In the long run, capacity can be reduced by downsizing resources e.g. laying off workers, smaller premises, less machinery.
- A business will aim to match capacity to demand.

### Spare capacity

- Spare capacity occurs when some resources are not being used and therefore there is a loss of potential output.
    - i.e. when actual production is less than full capacity.

### Implications of over-utilisation of capacity

- Over-utilised capacity means that the business is trying to produce more than its capital equipment can handle.
- There are many implications of this:
    - Average costs will be higher than necessary; bottlenecks, breakdowns, and overcrowding will reduce efficiency.
    - The business is not as competitive as it could be.

### Benefits of maintaining a high level of capacity utilisation

- Maintaining a high level of capacity utilisation can provide several benefits to a firm:
    - Increased revenue
    - Reduced unit costs
    - Improved profitability.
    - It can also help a firm to respond more quickly to changes in demand and to take advantage of new business opportunities.

### Implications of under-utilisation of capacity

- If the business has under-utilised capacity this means that some capital equipment is idle (the business is not using assets to its full capacity)
- There are many implications of this:
    - The business is producing less than it actually could; its average costs could rise because the fixed costs are shared across a lower level of output.
    - The business is not as competitive as it could be.
    - The productivity of either labour or capital could be increased.

# 2.3.2 – Capacity utilisation

**Factors causing a change in capacity utilisation**

- Several factors can cause a decrease in a firm's capacity utilisation
  - Declining demand for its products or services
  - Inefficient production processes
  - Equipment breakdowns
  - Labour shortages.
  - Old/broken/under-equipped technology
  - Changes in government regulations
- Several factors can cause an increase in a firm's capacity utilisation
  - Increased demand for its products or services
  - More efficient production processes
  - Investment in better equipment
  - Employ more skilled and efficient workers
  - Investment in new/better technology
  - Changes in government regulations

**Ways of improving capacity utilisation**

| WAYS TO REDUCE UNDER-UTILISATION | WAYS TO REDUCE OVER-UTILISATION |
|---|---|
| • Increase demand<br>• Downsize e.g. sell off assets or rationalise the workforce<br>• Lease off spare capacity | • Reduce demand<br>• Outsource parts of the business' operations<br>• Increase capacity by investing in more resources |

- The actions taken will depend upon:
  - Business objectives
  - Whether the issue is seen as short term or long term
  - Ease with which options could be implemented e.g. who could the business outsource to and how might this affect other targets such as dependability

# 2.3.3 – Efficiency and competitiveness using lean production

**The meaning of quality**

- Quality means the ability of a product or service to meet customers' expectations
- Different customers will however have a different perception of quality
- Customers' interpretation of quality may be influenced by a number of factors including:
    - Price
    - Brand
    - Customer's personal expectations and experiences
    - Nature of product or service
- Quality can be expressed or measured in a number of ways, these include:
    - Aesthetics i.e. physical appearance
    - Features i.e. physical attributes
    - Core aspects i.e. basic abilities/ functionality
    - Actual aspects i.e. added extras / functionality
    - Augmented aspects i.e. support feature e.g. warranty
    - Performance i.e. reliability, durability
    - Intangible aspects i.e. non physical attributes e.g. brand name, reputation
- Quality is also important when providing a service, the measures we apply may however be different, these include:
    - Friendliness of staff
    - Speed of service
    - Efficiency of service
    - Staff knowledge
    - Cleanliness of facilities
    - Appearance of environment

**Methods of improving quality**

- Training and motivating employees
- Understanding customers' expectations
- Using technology
- Working closely with suppliers
- Quality systems:
    - Quality control
    - Quality assurance
    - Quality circles
    - Total quality management (TQM)

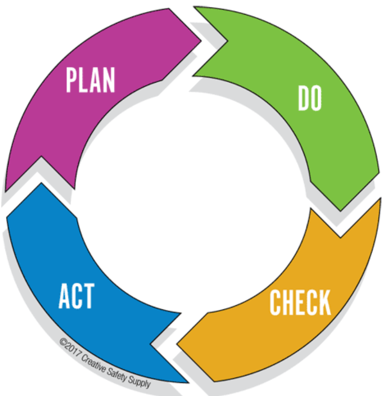
**Total quality management (TQM)**

- Employees are all involved in quality control and take responsibility for the quality of their and their team's work.
- This not only helps reduce costly wastage but also reinforces employee motivation.
- TQM aims to create responsibility, in both the individual and collective stages of production, for quality.
- Every team involved in production is considered to have responsibility for quality.
- Each subsequent stage of production is considered to be a customer, who has to be satisfied by the preceding stage.
- It is the final customer who determines the quality of the product, and the customer has to be satisfied.

| Advantages | Disadvantages |
|---|---|
| • Improved products and services<br>• Reduced costs<br>• Increased customer satisfaction<br>• Repeat purchases and brand loyalty<br>• Improved profitability<br>• Competitive advantage<br>• Motivated workforce | • Implementation costs<br>• Takes time to set up<br>• Retraining of employees<br>• Increased pressure on management<br>• May be difficult to involve staff<br>• Doesn't suit all businesses |

**Quality circles**

- Quality circles are informal groups of workers who volunteer to meet on a regular basis to discuss issues relating to the workplace
- Emphasis is placed on how to improve quality
- The workers who are involved in the production of the good or service are best placed to understand any quality issues and suggest ways on improving quality
- Recommendations are fed back to management
- Increased employee participation leads to higher motivation



# 2.3.3 – Efficiency and competitiveness using lean production

**Quality control**

- The checking of a good or service before it is delivered to a customer i.e. at the end of the process
- Normally relies on an inspection process
  - Head chef inspects a meal on a plate before it leaves the kitchen
  - Quality inspector tests a product at the end of the production line
  - Supervisor records and listens into a phone conversation at a call centre

| Advantages | Disadvantages |
|---|---|
| • Quality can be monitored<br>• Stops faulty products reaching the customer<br>• Common problems can be identified<br>• Inspector takes responsibility<br>• Often a robust system | • Takes responsibility away from operatives<br>• Requires specialist / additional personnel<br>• Problems only identified at end of process<br>• Waste levels may be high |

**Quality assurance**

- The checking of a product or service at each stage of its production e.g. as it travels along a production line
- Relies upon self-checking
  - A sauce chef tastes the sauce before passing to chef in charge of a dish
  - Each operative checks their stage of the process or component before passing it along
- Businesses will often strive for quality assurance through the adoption of a system
  - They will set down a clear process to be followed
  - The most frequently adopted system is Total Quality Management (TQM)
  - Many businesses will seek to achieve accreditation for their quality assurance standards e.g. ISO9000

| Advantages | Disadvantages |
|---|---|
| • Spots any faults early saving resources being wasted at the next stage of the production process<br>• Motivates workers who are responsible for ensuring quality standards are met<br>• Aims to achieve an objective of zero defects<br>• Ensures clear systems are in place<br>• Enhances the reputation of the business as less chance of faulty goods reaching the end customer | • Requires staff training and high levels of staff commitment<br>• Can slow down the production process and labour productivity leading to higher unit costs<br>• May demotivate workers who feel under pressure<br>• Opportunity cost of managers time when initially implementing the systems and procedures |

**Lean production**

- Efficiency means organising production so that waste is minimised and costs are the lowest possible.
- Lean production techniques are working practices derived from Japan that focus on cutting waste whilst maintaining or improving quality.
- Reducing waste is key to increasing efficiencies through lean production.
- Lean production techniques include:
  - Just-In-Time (JIT) management of stock – a technique used to minimise stock holdings at each stage of the production process, helping to minimise costs.
  - Kaizen (continuous improvement) – a technique that concentrates on small, but frequent, improvements in every aspect of the production process.

| Advantages of lean production | Disadvantages of lean production |
|---|---|
| • Reduces waste and related costs<br>• Reduced costs of storage and handling<br>• Improves quality<br>• Fewer reject costs<br>• More customer satisfaction<br>• Greater flexibility<br>• Shorter lead times<br>• More motivated staff, less staff turnover<br>• No waste caused by unsold output | • Doesn’t suit all production processes<br>• Failure by one small supplier may halt entire production process<br>• Some employees may not want more responsibility<br>• Managers may not be flexible enough<br>• May not be able to meet unexpected orders |

# 2.3.3 – Efficiency and competitiveness using lean production

## Kaizen

- Kaizen (continuous improvement) – a technique that concentrates on small, but frequent, improvements in every aspect of the production process.
- Small improvements can contribute towards leaner production, and they are unlikely to need major capital investment.
- These small changes are likely to have a larger impact on reducing waste and increasing productivity.
    - For example, a 5-minute saving per day per worker by reorganising a desk might save several hundred hours over the course of a year, which results in significant increases in productivity.
- Kaizen also encourages employees to take responsibility and ownership of their work and its quality.
- This could enforce a strong team working culture and help motivate employees.
- Employees are encouraged to suggest ways to improve the work.
- Since the employees are equal, there are unlikely to be significant conflicts between these ideas.

## Competitive advantage from lean production

- Some of the advantages of lean production include:
    - Reduced costs, so the firm can reduce prices for consumers. It could increase sales for the firm. This can also allow the firm to spend more money on investment, innovation or marketing.
    - Quality improves, so consumers are more satisfied. It could also make demand more inelastic if consumers become more loyal to the brand.
    - Staff might feel more motivated, since they are more involved in the production process.

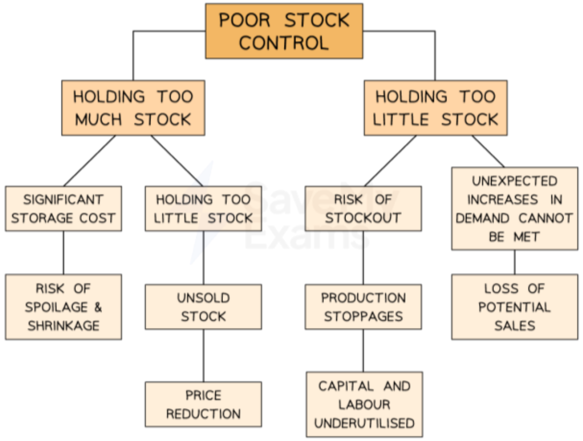
## Just in time (JIT) management of stock

- Just-In-Time (JIT) management of stock – a technique used to minimise stock holdings at each stage of the production process, helping to minimise costs.
- In other words, JIT ensures inputs to the production process only come as and when they are required, based upon consumer demand.
- This reduces the costs of holding stock and it builds a strong relationship between the firm and its suppliers.
- JIT can become complicated and require efficient handling of stock in order to be effective.
- If complex computer systems are used to calculate quantities of stock, a great deal of precision needs to be taken in order to avoid significant mistakes being made.

| Advantages | Disadvantages |
|---|---|
| • The firm will be holding less stock, which costs the firm less to store, as well as reducing the cost of rent and insurance<br>• Reduced costs in terms of buffer stocks and handling<br>• Less need for storage space – this can be converted to production<br>• Greater flexibility in responding to changes in demand<br>• Less working capital required | • The firm begins to rely heavily on suppliers. If the supplier cannot deliver the stock on time, it could delay the production process<br>• Won't benefit from reduced unit costs for bulk purchases<br>• If there is a break in supply, production will be lost<br>• High initial set up costs<br>• Complex systems have to be put in place and understood |

## Stock control

- Efficient stock control can reduce waste
    - Less obsolete or damaged stock
    - Lower costs of holding stocks
- Leading to a competitive advantage
    - Cost savings can be passed on in the form of lower prices
    - Better able to meet the needs of customers



# 2.3.3 – Efficiency and competitiveness using lean production

**Benefits and difficulties of improving quality**

| BENEFITS | DIFFICULTIES |
|---|---|
| • Achieve operational objectives<br>• Gain a competitive advantage<br>• Reduce unit costs<br>• Enhanced reputation<br>• Motivated workforce striving to achieve common goals | • Reluctance of employees to adapt to change or take on additional responsibility<br>• Requires finance to invest in training and test and implement new systems<br>• Reliant on good relationships with resource providers including suppliers<br>• Once achieved must be monitored and reviewed regularly to ensure standards are being maintained |

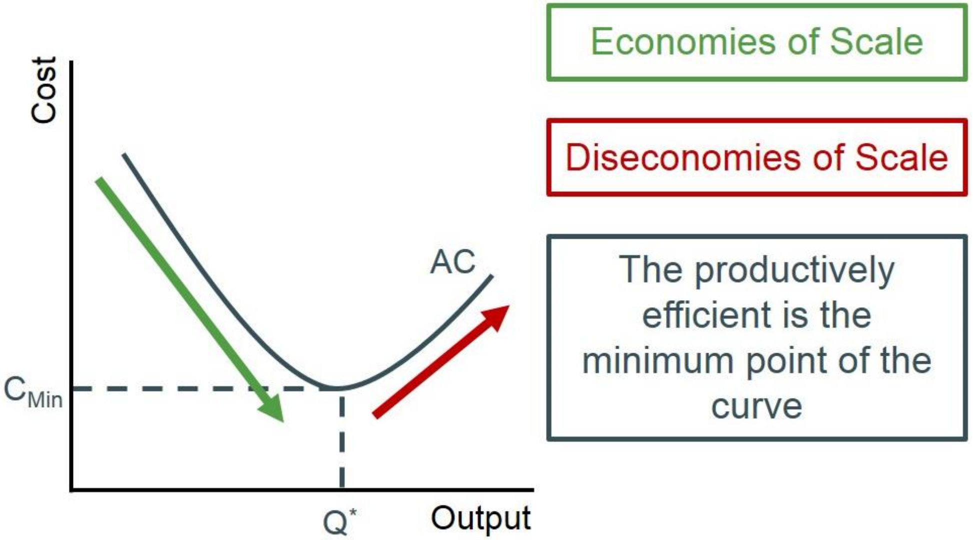
# 2.3.4 – Impact on costs and sales revenue

**Impact on average costs**

- Average cost is defined as cost per unit output.
- Productive efficiency occurs when an economy uses the minimum inputs to produce the maximum output at the lowest possible cost.

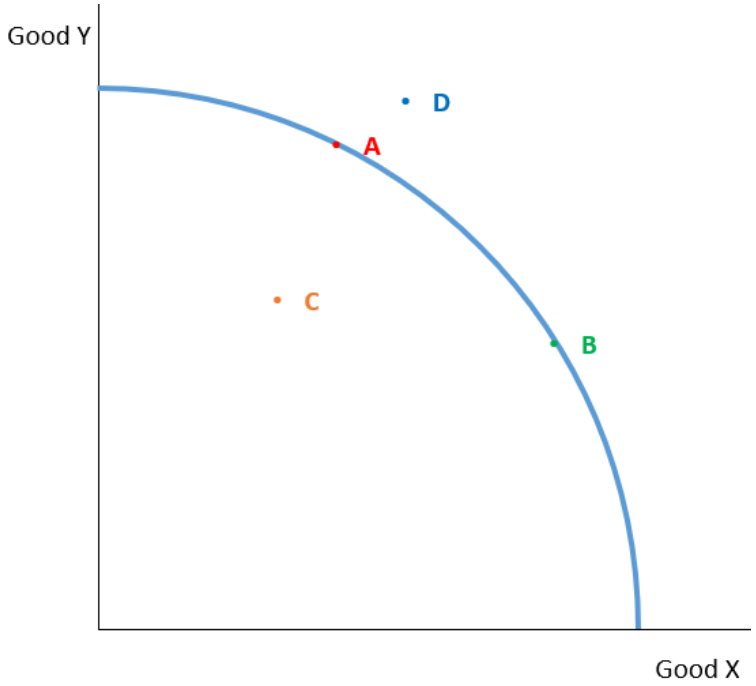
$$\text{Average Cost Formula} = \frac{\text{Total Cost of Production}}{\text{Number of Units Produced}}$$

- Increasing productivity results in a fall in average costs for the firm.
  - Consequently, the firm might earn higher profits and they are therefore able to invest more.
  - This might lead to further improvements in efficiency, so average costs become even less.
- Falling average costs could also be passed onto consumers in the form of lower prices.
  - This could make the firm more competitive in the market, so they can earn higher revenues and increase their market share.
- This can be shown using an average total cost diagram:
  - As output increases costs per unit fall. This occurs because fixed costs (e.g. rent) are spread over the higher output.
  - Productive efficiency occurs at output Q where average total costs are at their minimum.




**Production possibility frontier**

- Production-possible frontier (PPF) is a curve that illustrates the possible quantities that can be produced of two products if both depend on the same finite resources for their manufacturer.




- Any point on the PPF is said to be **productively efficient** e.g. point A or point B. On the curve we are producing at maximum production i.e. we cannot produce any more.
- At point C we can produce more goods (under production/productive inefficiency).
- Point D is unobtainable given our current factor inputs.

- The PPC also shows the trade-off between two variables, here good X and good Y.
- There is an opportunity cost as producing more of good X means producing less of good Y.

## 2.3.4 – Impact on costs and sales revenue

**Minimising waste of resources**

- Economies of scale occur as unit costs fall as the scale of production increases.
- The decisions of individuals, producers and government can, under certain circumstances, improve resource allocation
- Through economies of scale, we can see that productive efficiency is created when:
  - Purchasing economies lead to a reduction in costs
  - Specialisation can lead to a more efficient use of inputs
  - Better management can lead to increased output with the same factor inputs
- Diseconomies of scale occur as unit costs rise as the scale of production increases.
- Bureaucracy occurs when large organisations, particularly government, have overly complex administrative procedures. This increases costs.
- The decisions of individuals, producers and government can lead to a misallocation of resources
- Through diseconomies of scale, we can see that productive inefficiency is created where resources are misallocated:
  - Lack of communication between employees
  - Lack of coordination by management
  - Bureaucracy, particularly in large organisations

**Competitive advantage of short product development lead times**

- Time Based Management is the effective management of resources to ensure that unproductive time is eliminated from the production process
- This will involve the use of a variety of operations management systems including Just in Time and CAD/CAM
- Flexibility is crucial so that firms can alter the production process to meet changes in demand. If successful, then firms will have:
  - Reduced lead times and faster response to changes in the market meaning short product development lead times
  - Less wastage through increased efficiency
  - Faster development time for new products
- This will create a competitive advantage meaning that the firm has first mover advantage and can get the product to market quicker than the competition

# 2.4.1 – Globalisation

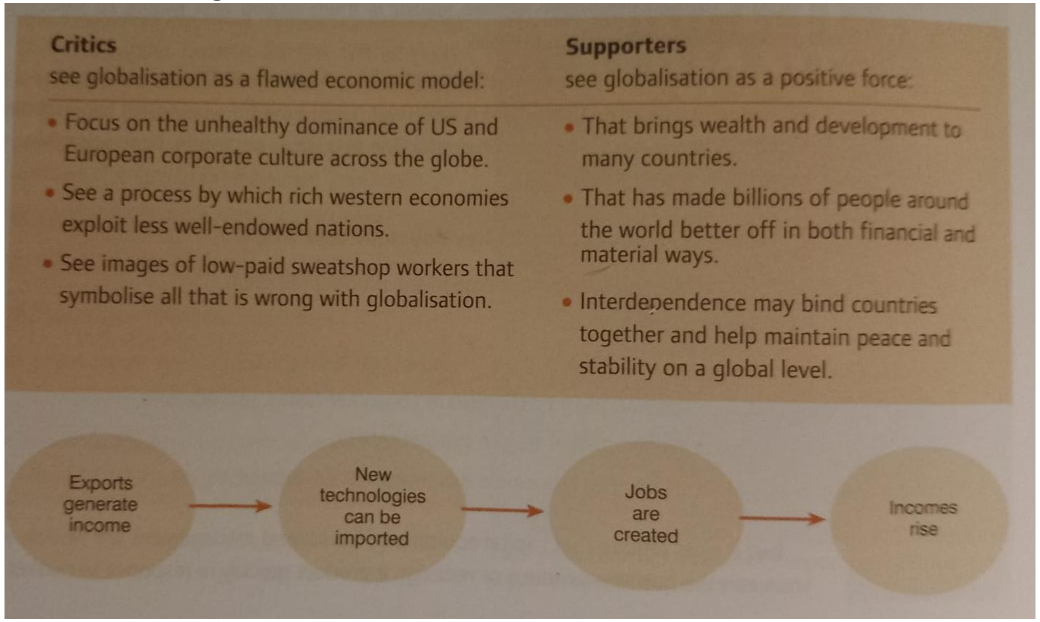
## Globalisation

- Globalisation is the process of greater integration and inter-connection between countries.
- Globalisation usually includes the following features and characteristics:
  - Free movement of goods and services
  - Free movement of labour
  - Free movement of capital
  - Increased cultural exchange

## Characteristics of globalisation

- Increased investment
  - The greater freedom of movement of capital enables firms to invest outside their country of origin. This may lower their own costs of production and improve economic prospects and job opportunities in the invested country.
    - Foreign direct investment (FDI) occurs when businesses or governments invest in other countries.
- World trade rising as a proportion of world GDP
  - The increased freedom of movement of goods and services increases export opportunities and therefore has a significant effect on economic welfare. This has led to a greater dependence on trade as a proportion of GDP.
  - Countries benefit from increased specialisation where they have a comparative advantage which lowers their production costs and improves efficiency.
- Increased migration
  - Globalisation allows the best talent to move quickly and easily across borders, creating a ‘brain drain.’
  - Less skilled workers can undercut wages in developed economies as the workforce of poorer countries seek to better their standards of living.
  - Although not always visible, increased globalisation has arguably damaged traditional cultures. The proliferation of multinational companies creates a uniformity of many economies and arguably less cultural diversity.
  - At the same time, traditional cultures have struggled to accommodate new ones, leading to social tension.

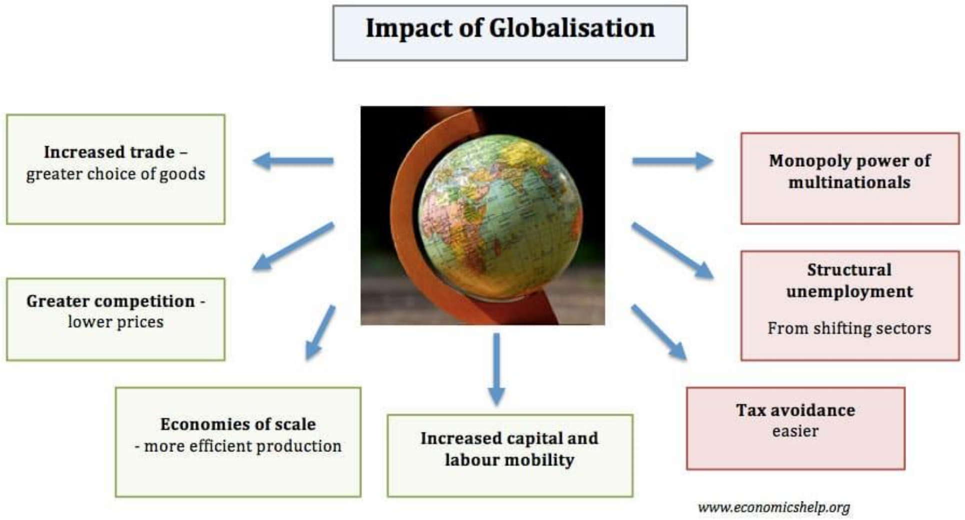
## Pros and cons of globalisation



| Critics see globalisation as a flawed economic model: | Supporters see globalisation as a positive force: |
|---|---|
| • Focus on the unhealthy dominance of US and European corporate culture across the globe.<br>• See a process by which rich western economies exploit less well-endowed nations.<br>• See images of low-paid sweatshop workers that symbolise all that is wrong with globalisation. | • That brings wealth and development to many countries.<br>• That has made billions of people around the world better off in both financial and material ways.<br>• Interdependence may bind countries together and help maintain peace and stability on a global level. |

Exports generate income → New technologies can be imported → Jobs are created → Incomes rise

## Impact of globalisation



# 2.4.1 – Globalisation

**Factors contributing to globalisation in the last 50 years**

- The International Monetary Fund (IMF) co-ordinates the international monetary system. It tries to maintain stability and provide adequate finance for world trade to continue without interruption.
- The World Bank (proper name International Bank for Reconstruction and Development) lends to developing countries in order to fund projects which will help them to raise incomes and make their economies more efficient.
- The WTO, World Trade Organisation, started out as GATT, the General Agreement on Tariffs and Trade. It supervises world trading arrangements and trade negotiations and helps to resolve disputes between governments.
- The factors are:
  - Trade liberalisation
  - Capital market liberalisation
  - Political change resulting in the opening up of China and the former soviet union
  - Reduced cost of transport and communications
  - Increased significance of global (transnational) companies

| FACTOR | EXPLANATION | HOW IT LEADS TO GLOBALISATION/BENEFITS | DRAWBACKS |
|---|---|---|---|
| **TRADE LIBERALISATION** | – Reducing barriers to trade (tariffs/ quotas) so economies are closer to free trade | – More choice of products which are also cheaper<br>– Easier to trade and make trade agreements<br>– Promoted by WTO | – Domestic economy and businesses are not protected – some businesses may not fail |
| **CAPITAL MARKET LIBERALISATION** | – Easier transfer of large sums of money from one economy to another (no longer seen as lost money to domestic market). Removal of capital controls | – Leads to potentially profitable investment projects<br>– Creates jobs in the recipient economy<br>– Helps expand productive capacity<br>– FDI across international borders has increased | – Fear of relocation no steady business (claws in foreign companies)<br>– Loss of money from the domestic economy |
| **POLITICAL CHANGE** | – China (strongly communist) is now open to trade. This is similar to the former USSR | – Cheaper goods produced by Chinese people and their businesses<br>– Chinese government has benefitted from western technology increased production, exports and GDP | – Domestic businesses will suffer as they have greater competition from the cheap Chinese imports |
| **REDUCED COST OF TRANSPORT/ COMMUNICATIONS** | – Due to containerisation and cheap air travel transport has become cheaper. | – Easier to load and cheaper to distribute due to standard sized containers<br>– More cargo can be distributed at once (Distribution economies of scale)<br>– Lower prices can be passed onto customers, making firms more competitive | – Loss of jobs as there is less need for workers due to increased use of machinery<br>– Causes structural unemployment<br>– Mainly benefits MNCs |
| **GROWING SIGNIFICANCE OF GLOBAL COMPANIES** | – Businesses who operate in more than one country. | – Creates jobs in less developed countries<br>– Economies of scale<br>– Lower costs of production | – Loss of individual cultures – Mcdonaldization |

# 2.4.2 – Developed, emerging, and developing economies

**Types of economies**

- A developed economy is typically characteristic of a developed country with a relatively high level of economic growth and security.
  - Countries with relatively high levels of economic growth and security are considered to have developed economies.
  - Common criteria for evaluation include income per capita or per capita gross domestic product.
  - If per capita gross domestic product is high but a country has poor infrastructure and income inequality, it would not be considered a developed economy.
- An emerging market economy is the economy of a developing nation that is becoming more engaged with global markets as it grows.
  - An emerging market economy is an economy that's transitioning into a developed economy.
  - Emerging market economies typically feature a unified currency, stock market, and banking system; they're in the process of industrializing.
  - Emerging market economies can offer greater returns to investors due to their rapid growth.
- A developing economy defines a country with a low human development index, less growth, poor per capita income, and more inclined toward agriculture-based operations rather than industrialization and business. In other words, a developing economy is often referred to as an underdeveloped country or a less developed economy.
  - Developing economies have a low per capita income, poor living standards, and less monetary growth. As a result, they often rely on their agricultural sector or a national resource alone.
  - Overpopulation, poverty line, poor infrastructure, poor quality of living, adverse health conditions, the struggle with management, social unrest, etc., are common problems seen in such economies.

**Growth rate of the UK and BRIC (Brazil, Russia, India and China) economies since 2000**

| | EXAMPLES | FEATURES |
|---|---|---|
| DEVELOPED (MATURE) ECONOMIES | – UK<br>– USA<br>– Germany<br>– Australia | – High income levels – Advanced technologies<br>– Developed capital markets – Robust financial institutions<br>– Good welfare provision – HDI of over 0.8<br>– More income from service sector than industrial sector |
| DEVELOPING ECONOMIES | – Angola<br>– Afghanistan<br>– Cambodia<br>– Mali | – Reliance in agricultural activity – Low incomes<br>– Lower standard of living – Low levels of healthcare<br>– Early stages of industrialism – Labour-intensive production<br>– Undeveloped welfare systems – Low HDI in comparison to others |
| EMERGING ECONOMIES | – Brazil<br>– Russia<br>– India<br>– China<br>– South<br>– Africa | – High growth – Increases in manufacturing output<br>– Rapidly expanding trade – Rapidly rising standards of living<br>– Areas of poverty/deprivation – High disposable income<br>– Extensive migration from countryside to urban areas |

- These emerging economies are the fastest growing economies and are characterised by their movement away from agriculture and recent industrialisation. The main countries are known as the BRICs, standing for Brazil, Russia, India, and China (sometimes South Africa is also included). All of these are members of G20 and have potential for innovation, especially in renewable energy.
- The distinguishing feature of the BRICs is their transformation of global trade relationships. Between 2000 and 2010, they were responsible for 1/3-1/2 of global economic growth. They suffered less than the rest of the world in the 2008-9 recession than the developed economies, but the growth rates have slowed after 2011.
- **Brazil** → Relies on selling commodities such as iron ore, soya, coffee and sugar. Falling demand and volatile commodity prices has slowed its growth rate.
- **Russia**→ Experiencing problems such as sanctions from the West and a depreciation of the rouble.
- **India** → Had a rapid growth spurt which then slowed (it is expected to improve in future). Income per capita is still very low.
- **China** → Growth rates as high as 10%. It was led by exports but relies on the rest of the world to buy it. Eurozone recession reduced demand for their exports

# 2.4.2 – Developed, emerging, and developing economies

**GDP per capita**

- This is the most commonly used method to measure a country's living standards.
- As GDP per capita rises, it is also assumed that living standards in that economy also rise.

$$Y = C + I + G + (X - M)$$

Y = National Income (GDP)
C = Consumer Spending
I = Investment
G = Government Spending
X = Exports
M = Imports

$$\text{GDP Per Capita Formula} = \frac{\text{GDP of the Country}}{\text{Population of that Country}}$$

Limitations

- GDP does not give any indication of the distribution of income. Therefore, two countries with similar GDPs per capita may have different distributions which lead to different living standards in the country.
- GDP may need to be recalculated in terms of purchasing power, so that it can account for international price differences. The purchasing power is determined by the cost of living in each country, and the inflation rate.
- There are also large hidden economies, such as the black market, which are not accounted for in GDP. This can make GDP comparisons misleading and difficult to compare.
- GDP gives no indication of welfare. Other measures, such as the happiness index, might be used to compare living standards instead or in conjunction with GDP.

**Literacy**

- Literacy is the ability to read and write.
    - A wider definition might include the skills required to access knowledge.
- Literacy is seen to be a key indicator of growth.
- Investment in human capital raises the average level of literacy in the economy.
- This can be contrasted with a high level of literacy within an economy.

**Indicators of growth**

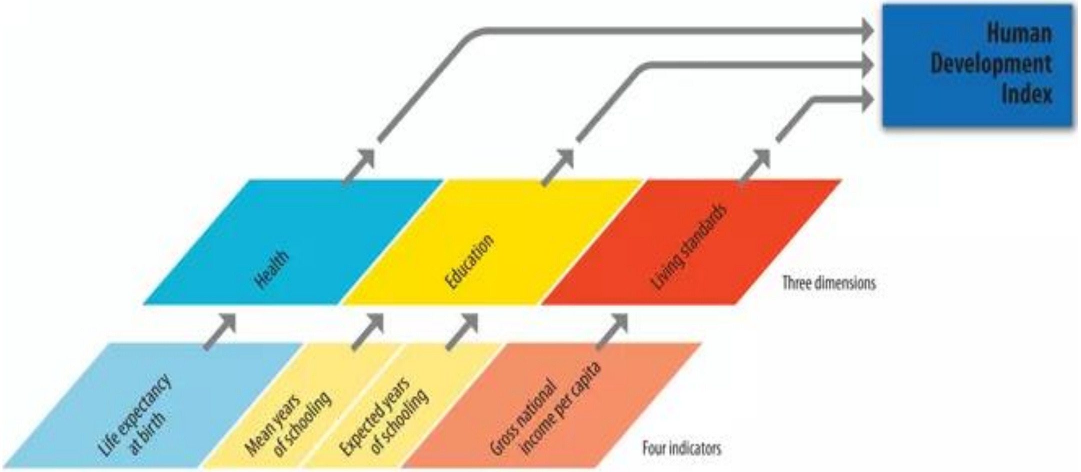
- GDP per capita
- Literacy
- Health
- Human Development Index (HDI)

**Health**

- Health is the absence of illness and injury.
    - A wider definition might include physical, mental, and social well-being.
- Health is seen to be a key indicator of growth.
- A healthy labour force is likely to be more productive and lack of health will be less of a burden on resources.
- A lack of health disproportionately affects poor people as they rely on their physical body to earn.

**Human development index (HDI)**

- The Human Development index (HDI) ranks countries in relation to several aspects of development. It has three strands:
- Income as measured by GDP per capita at PPP, giving an idea of the population's living standards.
- Life expectancy, an indicator of the population's health.
- Years spent in school, which indicates the population's level of education



## 2.4.2 – Developed, emerging, and developing economies

**Characteristics of developed, emerging, and developing economies**

| DEVELOPED | EMERGING | DEVELOPING |
|---|---|---|
| – Developed economies have high levels of economic growth and have stable economies.<br>– Long life expectancies<br>– High income per capita<br>– High levels of education<br>– Slow population growth per year<br>– Low mortality rates<br>– Low birth rates<br>– Urban and city populations are large<br>– A dominant industrial sector and weaker agricultural sector | – The BRIC economies are emerging markets, which is comprised of Brazil, Russia, India and China.<br>– They are characterised by their fast growth and their recent industrialisation. They are moving away from agriculture.<br>– They have significant influence in global affairs and all four nations are part of the G20.<br>– They rely heavily on industry: manufactured and engineered goods make up a lot of their exports<br>– There is a lot of potential for innovation, particularly in renewable energy (Brazil 3rd, Russia 5th, India 6th and China 1st in the world)<br>– They are all seeing a considerable increase in demand for a higher standard of living. This is driven by the growing middle classes in India and China who are demanding more goods and services, such as mobile phones. | – Low life expectancies<br>– Low or middle incomes<br>– High mortality rates<br>– High dependency ratio<br>– Low GDP<br>– Fast population growth<br>– Low levels of education, which results in low levels of productivity<br>– Poor standard of living<br>– Poor nutrition, lack of access to clean, safe drinking water and a lack of sanitation<br>– Poor or absent health care provision<br>– Low savings rate |

**Mean and median income**

- The average income can be measure either through mean or median of incomes.
- The *mean income* of the country is the total income of an economy (GDP) divided by the number of people of working age in the country (the population).
- The *median income* is the ‘middle value’ of all the incomes sorted into ascending order. Quartiles can also be used; this divides the population into four groups to compare the richest quartile (25%) with the poorest quartile. You can also use deciles and quintiles.
- Changes will affect the mean and median differently e.g. growing inequality of income can cause the mean income to rise but the median income to decrease. Many economists argue that the median income is better as it will not be skewed by a small number of high-income earners.

# 2.4.3 – International trade

**Specialisation and international trade**

- Specialisation means that people (or an economy) make the most of their skills by concentrating on those goods and services where they have an advantage. As appr people produce more, output per head rises.
    - This works when people or economies can trade, exporting part of their output in exchange for imports.
- Most economies will specialise to some extent by producing and exporting the things they are best at.
    - They may have competitive advantage over other countries in certain sectors.
    - Their advantages may include natural resources, abundant land, cheap labour, scarce skills, technical know-how, a favourable climate, beautiful scenery, a deep-water port, a university active in scientific research or accessible sources of finance.
    - By specialising, output can be increased. Some of this can then be traded for goods and services the country does not produce at all, or only in small quantities.

| Advantages of specialisation | Disadvantages of specialisation |
|---|---|
| • Specialisation leads to increased output and efficiency. | • Can lead to over-reliance on one area of the economy. |
| • Economies of scale are gained as output increases. | • Competitive advantage can move elsewhere. |
| • Goods and services can be produced more cheaply. | • Emerging economies often rely heavily on one commodity product (all your eggs in one basket). |
| • Competitive advantage is enhanced. | • Fluctuating commodity prices can be a problem. |
| • Export earnings increase. | • Reliance on imports for other goods and services. |
| • Competition amongst producers helps to lower price and drive innovation which benefits domestic and foreign consumers. | • If demand for exports falls, structural unemployment may be severe. |

**Trading blocs**

- Trade bloc – a group of countries that agrees to reduce/eliminate trade barriers between members.

Free trade area

- This is where countries agree to trade goods with other members without protectionist barriers. For example, the North American Free Trade Agreement (NAFTA) is a free trade area, as is the European Free Trade Association (EFTA).
- They allow members to exploit their comparative advantages, which increases efficiency.

Customs union

- Countries in a customs union have established a common trade policy with the rest of the world. For example, they might use a common external tariff. They also have free trade between members. The European Union is an example of a Customs Union.

Common market

- This establishes free trade in goods and services, a common external tariff and allows free movement of capital and labour across borders. When the EU was established, it was a Common Market. EU citizens can work in any country in the EU.

Monetary unions

- This is sometimes called a currency union. Members of a monetary union share the same currency. This is more economically integrated than a customs union and free trade area. The Eurozone is an example of this.
- A common central monetary policy is established when a monetary union is formed. The single European currency, the Euro, was implemented in 1999 to form the Eurozone.
- Monetary unions use the same interest rate. The Euro, for example, floats against the US Dollar and the Pound Sterling. Member nations are required to control their government finances, so budget deficits cannot exceed 3% of GDP. This is one of the four convergence criteria countries have to meet in order to join the Euro. The other three are:
    - Gross National Debt has to be below 6% of GDP
    - Inflation has to be below 1.5% of the three lowest inflation countries
    - The average government bond yield has to be below 2% of the yield of the countries with the lowest interest rates. This ensures there can be exchange rate stability.

# 2.4.3 – International trade

**Pros and cons of trading blocs**

| PROS | CONS |
|---|---|
| – Increased competition.<br>– Expansion into larger markets.<br>– Economies of scale.<br>– Lower prices for consumers and greater consumer choice.<br>– Increased investment: internal by firms from a member country or external by outsider firms, which escape the tariff imposed by the trading bloc on imports from outside.<br>– Better use of factors of production, especially if a trading bloc develops into a common market.<br>– Improved production efficiency and greater economic growth.<br>– Political advantages: Reduced likelihood of hostilities between countries becoming increasingly interdependent and political cooperation resulting from economic integration. | – Many economists think that trading blocs are inferior to the WTO's multilateral approach of reducing trade barriers towards all countries. Trading blocs involve an increasing amount of discrimination, which violates the WTO's non-discrimination principle.<br>– May create obstacles for global free trade. Some economists believe that conflicts between trading blocs might arise, difficulting the process of global integration. Trade barriers on non-members may result in limiting trade on a global scale, which would worsen the allocation of resources, lower global output and a weakened role for the WTO.<br>– Unequal distribution of gains from trading blocs, as not all members obtain the same benefit. |

**Trade and growth**

- Trade can lead to economic growth if countries specialise in the goods and services that they can produce most efficiently (or least badly) compared to other countries (see page 10 on specialisation).
- By specialising, economic growth is enhanced; output and income increase.
- By trading their surpluses and exchanging them for products the economy produces less efficiently (imports), consumer choice and welfare can be increased.
- By specialising, global output will increase (i.e. there will be economic growth).
- The link between trade and growth overall is well established. Exporting more raises GDP.
- Higher incomes mean people can afford more imports, which creates new markets for other producers.

**Imports and exports: visibles and invisibles**

- Exports are goods and services sold to foreign countries, and are positive in the balance of payments. This is because they are an inflow of money.
- Imports are goods and services bought from foreign countries, and they are negative on the balance of payments. They are an outflow of money.
- Visibles are physical goods, such as the products of manufacturing. These are most commonly produced by the primary and secondary sectors. Countries such as Germany and Japan are reliant on exports of visibles, such as manufactured goods like cars.
- Invisibles are intangible, such as services. For example, financial services, tourism and shipping services are all intangible. These are most commonly produced by the tertiary sector. Invisibles are important for countries such as the UK and Saudi Arabia, which are dependent on exports of financial services.
- The balance of trade is the difference in value between our visible exports and visible imports.
    - A positive balance of trade is known as a trade surplus (i.e. we are exporting more than we are importing).
    - A negative balance of trade is known as a trade deficit (i.e. we are importing more than we are exporting).

# 2.4.3 – International trade

**Impact of cheap imports on standards of living**

- If economies are functioning efficiently, the structural change that results from the increased trade creates new opportunities for businesses and employees. It is another form of creative destruction.

| PROS OF CHEAP IMPORTS | CONS OF CHEAP IMPORTS |
|---|---|
| – Importing allows countries to achieve higher standards of living by obtaining goods and services from the most efficient source, creating consumer choices.<br>– Cheaper imports raise standards of living because the consumer has more disposable income left to spend on other things; in real terms they are now better off.<br>– Producers may be able to source cheaper raw materials and components from abroad, enabling them to cut costs and be more competitive. This in turn, creates employment, income and wealth.<br>– Many economists believe that the flow of cheap imports from China from the late 90s onwards did much to keep the rate of inflation low. | – Cheap imports can harm domestic industry as consumers substitute cheaper foreign goods for more expensive home products.<br>– Some domestic businesses that cannot compete with imports will exit the market. Unemployment rises but in time, as standards of living rise, more jobs are created. Government support may be needed to help people to adjust. |

# 2.4.4 – Exchange rates

## Exchange rates

- The exchange rate is the weight of one currency relative to another.
- Depreciation: When the value of a currency falls relative to another currency in a floating exchange rate system.
- Appreciation: When the value of a currency increases. Each pound will buy more dollars, for example.
- Devaluation: This is when the value of a currency is officially lowered in a fixed exchange rate system.
- Revaluation: This is when the currency's value is adjusted relative to a baseline, such as the price of gold, another currency or wage rates.

## Fixed exchange rate graph

- A fixed exchange rate has a value determined by the government compared to other currencies.
- In a fixed exchange rate system, the supply of the currency can be manipulated by the central bank, which can buy or sell the currency to change the price to where they want.
- In the diagram, the supply has been increased (S1 to S2) by selling the currency so more is on the market (Q1 to Q3).
- The currency depreciates as a result (P2 to P3), which makes exports more competitive.

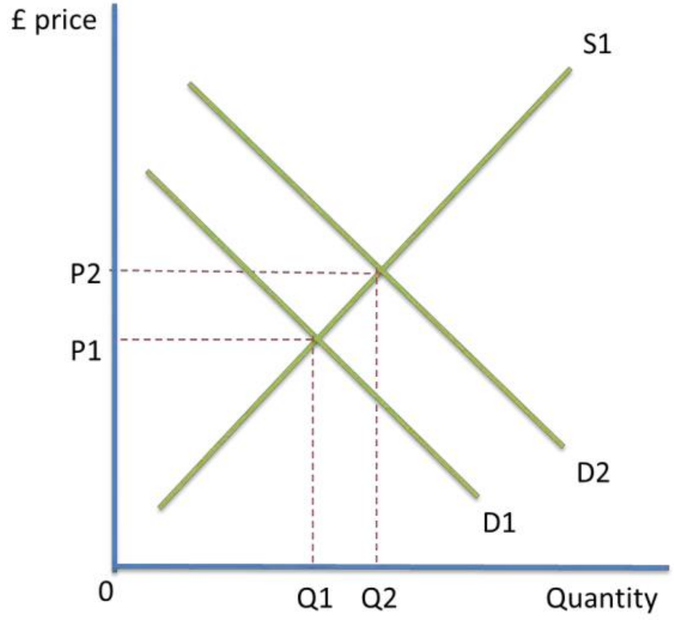

## Changes in exchange rates

**There are Two main types of Exchange Rate Systems**

1) A **fixed** exchange rate is where the **government** or its **central bank** (see p.196) sets the exchange rate. This often involves **maintaining** the exchange rate at a **target rate** (see below).
2) A **floating** exchange rate is free to **move** with changing supply of, and demand for, a currency.
3) A **hybrid** exchange rate system is a mixture of fixed and floating. There are a number of different hybrid systems, e.g.:
   - **Managed floating** — the exchange rate is mainly left to **market forces** (i.e. to float freely), but the government will occasionally **intervene** to influence the exchange rate. For example, to **reduce** the impact of an economic shock on the value of its currency.
   - **Semi-fixed** — the exchange rate is only allowed to **fluctuate** within a **set band** of exchange rates.
   - **Pegged** — the **value** of the currency is 'pegged' to **another** currency or **group** of currencies. This peg can be **moved** periodically, or as the government sees fit.

## Floating exchange rate graph

- The value of the exchange rate in a floating system is determined by the forces of supply and demand.
- In a floating exchange rate system, the market equilibrium price is at P1. When demand increases from D1 to D2, the exchange rate appreciates to P2.



# 2.4.4 – Exchange rates

## Pros and cons of exchange rates

| | Advantages | Disadvantages |
|---|---|---|
| Floating | Under **fixed** exchange rate systems, central banks require **foreign currency reserves** so that they can intervene to maintain their exchange rate target — a **floating** exchange rate will **reduce** the need for currency reserves. | Floating exchange rates can **fluctuate** widely, which makes business planning **difficult**. |
| Floating | A floating exchange rate can help to **reduce** a BOP current account **deficit** — a BOP deficit will lead to a **fall** in the value of the currency, so if demand for exports and imports is moderately **price elastic**, exports will **increase** and imports will **decrease**, reducing the BOP deficit. | Speculation can **artificially strengthen** an exchange rate — this would cause a country to **lose competitiveness**, as domestic goods will become **over-priced**. |
| Floating | A floating exchange rate means that a government **doesn't** need to use monetary policy, e.g. interest rates, to help to maintain the exchange rate — it can use it for **other objectives**. | **Falls** in exchange rates can lead to inflationary pressures — for example, if demand for imports tends to be **price inelastic**. |
| Fixed | **Speculation** may be **reduced** — unless dealers feel that the exchange rate is no longer **sustainable**. | If speculators feel a fixed exchange rate **isn't sustainable**, they might take advantage of this by **selling** the currency. |
| Fixed | **Competitive pressures** are placed on firms — they need to keep costs **down**, **invest** and **increase productivity** to remain competitive. | The country effectively **loses control** of interest rates, as they need to be used to keep the **exchange rate** at the desired level. |
| Fixed | Fixed exchange rates create **certainty**, which is likely to **encourage** investment (including FDI). | Fixed exchange rates are **difficult** to maintain. |

The various hybrid systems have a **mixture** of advantages and disadvantages of both floating and fixed systems. For example, a **pegged** system creates **more certainty** than a freely floating system, so this might lead to **more investment**. However, the country will also lose **some** control of interest rates, as they'll need to be used to **influence** the exchange rate.

## Factors influencing exchange rates

- Interest rates – higher interest rates encourage hot money flows and demand for currency. This causes an appreciation.
- Economic growth – higher economic growth will tend to cause an appreciation in the currency, this is because markets expect higher interest rates – when growth is rapid.
- Inflation – higher inflation makes exports less competitive and reduces demand for currency. This causes a depreciation.
- Confidence in the economy/currency.
- Current account deficit/surplus. A large current account deficit is more likely to cause a depreciation in the value of the currency because money is leaving the economy to buy imports.
- Speculation – i.e. currency speculators betting that the value of the £ will fall against the dollar
- FDI (Foreign Direct Investment)

## Impact of changing exchange rates on firms

- A depreciation in the pound means that UK exports become more price competitive.
    - Firms could then reduce the price of the good in the export market to increase sales, or they can keep the price the same to increase their profit margins.
- However, if UK goods are relatively price inelastic, a depreciation in the pound will not increase sales in the export market significantly.
    - Moreover, it depends on the rate of economic growth in the export market. The higher the level of consumer and firm confidence, and the more disposable income they have, the more likely they are to purchase UK exports.
- If firms are net importers of raw materials, costs of production will increase because imports are relatively more expensive when the pound is weaker.
    - This could make the firm less internationally competitive, and it could mean they make lower profits.
    - However, if firms have fixed contracts for how long they import materials from another country, then changes in the exchange rate will not affect quantity purchased or the price paid.
    - This reduces uncertainty of production costs for firms.
- If the pound depreciates, firms might think that they can increase their profit margins by keeping the price the same, without having to increase efficiency or productivity to lower their average costs.

# 2.4.4 – Exchange rates

**Interpretation of exchange rate data**

- Most exchange rates float but a few are pegged. For example, the Danish kroner is pegged to the euro. The purpose is to enhance economic stability. Fixed exchange rates were abandoned in the 1970s.
- Marked changes in exchange rates (e.g. the £ in 2008) can usually be traced to their causes. It is safe to assume that a fall in the exchange rate implies a gain in competitiveness and vice versa.
- Exchange rates change all the time because foreign exchange dealers are watching the news for every little event that might cause a small change in the market.
- Central banks often 'manage' the exchange rate in an attempt to iron out day-to-day fluctuations.

**Interpretation of effective exchange rates**

- An effective exchange rate is based on an exchange rate index that shows the relative strength of a currency compared to a basket of other currencies.
- The currency is valued as a weighted average of the currencies of its major trading partners, so that it is an accurate measure of competitiveness.
- This is a useful indicator of the relative strength of a currency, taking into account all of the trading partners' currencies.
- If the index rises, it means that the purchasing power of that currency has risen relative to its trading partners. This will reduce the price of imports but will increase the price of exports.

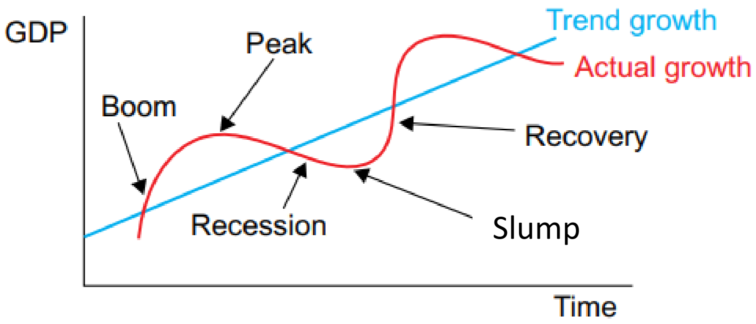
# 2.5.1 – The economic cycle

**Understanding the economic cycle**

- The economic cycle describes the fluctuations in the levels and rates of growth of GDP over a period of time.
    - It is sometimes referred to as the trade of the business cycle.

## *The **Economic Cycle** has **Different Phases***

1) The actual growth of an economy **fluctuates** over time. These **fluctuations** are known as the **economic cycle**.
2) A **boom** is when the economy is **growing quickly**. Aggregate demand will be **rising**, leading to a **fall** in **unemployment** and a **rise** in **inflation**.
3) A **recession** is when there's **negative economic growth** for at least **two consecutive quarters**. Aggregate demand will be **falling**, causing **unemployment** to **rise** and a **fall** in **price levels**.
4) During a **recovery** the economy begins to **grow again**, going from **negative economic growth** to **positive economic growth**. Aggregate demand will be **rising**, so **unemployment** will be **falling** and **inflation** will be **rising**.
5) **Long run** growth is shown by an **increase** in the **trend rate** of growth. The trend rate of growth is the **average rate** of economic growth over a period of both economic **booms** and **slumps**.




<u>Output gaps</u>

- A negative output gap occurs when the actual level of output is less than the potential level of output.
- A positive output gap occurs when the actual level of output is greater than the potential level of output.

**Characteristics of the phases in the economic cycle**

| | **CHARACTERISTICS** |
|---|---|
| **BOOM** | – Unemployment decreases<br>– Output increases as demand rises with more disposable income<br>– Income levels rise as there is more competition for skilled employees<br>– High interest rates to combat inflation<br>– High capacity – near full<br>– Demand-pull inflation<br>– Government budgets improve, due to higher tax revenues and less spending on welfare payments |
| **RECESSION** | – Consumer confidence will fall leading to less spending in the economy<br>– Businesses will cut investment<br>– Unemployment rises<br>– Low interest rates to encourage consumer spending |
| **SLUMP** | – Leads to falling sales and profits and encourages gloomy expectations<br>– Lots of spare capacity and negative output<br>– Unemployment rises as firms need less workers<br>– Real wages may fall as there is less competition for work<br>– Less disposable income causing demand in the economy to fall<br>– Firms lose confidence and are reluctant to invest, slowing the economy<br>– Government budgets worsen due to more spending on welfare payments and lower tax revenues |
| **RECOVERY** | – Increase in consumers' confidence of the market<br>– Increase in productivity to the increased aggregate demand in the economy<br>– Unemployment begins to fall as companies increase output<br>– Low interest rates charged by banks in the early years of the recovery phase act as an incentive to producers to borrow money – investment rises |

## 2.5.1 – The economic cycle

**Implications for firms of fluctuations in economic activity**

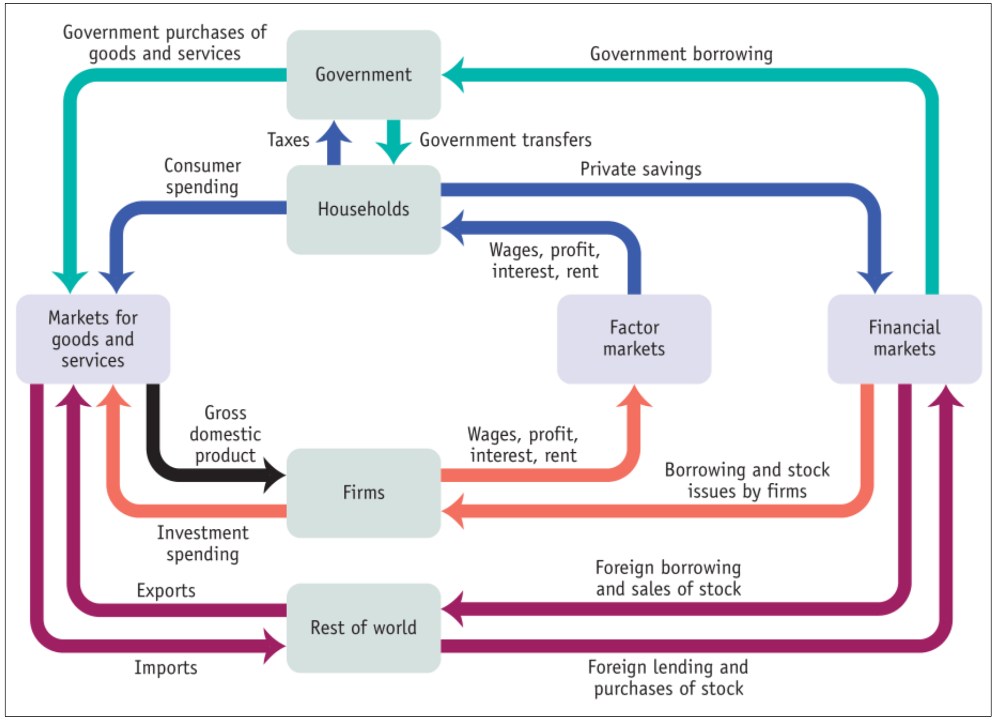
- Each stage of the economic cycle will have different implications for a business, and they may have to take action as a result.
- They will have to consider how a fall or rise in the average income level will affect their sales, which is dependent on the income elasticity of demand of their products.
- In response to this, businesses will have to plan the quantity they want to sell and the price they want to sell their products at.

| PHASE | IMPLICATION FOR FIRMS |
|---|---|
| **BOOM** | – Output will increase as will investment<br>– Unemployment is low but so is recruitment as wages must increase<br>– Consumers have more to spend – feel more confident about future<br>– New businesses will start up<br>– Existing businesses will expand<br>– Sales of income elastic goods e.g. perfume/cars will increase significantly<br>– Prices and cost rise as resources become scarce<br>– Demand-pull inflation occurs causing problems<br>– Some businesses take too many risks – overconfidence leads to downturn |
| **RECESSION** | – Sale of income elastic goods (such as jewellery and cars) will fall<br>– Sales of other goods will fall<br>– Unemployment begins to rise as firms make employees redundant to recover lost profit<br>– Consumers feel less confident; they may reduce spending<br>– Investment slows as expectations of growth diminish<br>– Output slows and may fall<br>– Costs and prices may rise more slowly; inflation may ease |
| **SLUMP** | – Sales of income elastic goods will fall significantly<br>– Unemployment is high, so consumers will have less disposable income<br>– Investment and output of normal goods falls<br>– Businesses cut back on output and some will fail<br>– Consumers replace normal goods with inferior goods, so output and sales of these products will rise<br>– Supply exceeds demand, so prices fall |
| **RECOVERY** | – Sales of income elastic goods begin to recover<br>– Sales of other goods begin to rise (milk and bread)<br>– Consumers feel the worst is over and unemployment begins to fall both causing people to spend more<br>– Investment begins to increase as confidence returns (e.g. savings accounts)<br>– Output begins to rise<br>– Early signs of inflation as economic growth returns |

# 2.5.2 – Circular flow of income, expenditure and output

**The circular flow of income**

- The circular flow of income models the basic working of the economy.
- Resources, income, expenditure, and output are shown as flows of money that continuously circulate around the economy.
- In the circular flow of income: $\boldsymbol{income = output = expeniture.}$




- Households supply factors of production to businesses. In return they receive income.
- Businesses supply goods and services to households, which pay for them, providing sales revenue.
- Households do not spend all the income they receive; they save some of it. Savings are a leakage from the circular flow, usually put in the bank.
- Other leakages are taxes, paid to the government and spending on imports, which goes abroad.
- Banks provide finance which businesses use to pay for investment, which is an injection into the circular flow.
- Government spending is also an injection, as are exports: money comes from abroad to pay for them.

**The impact of injections into and withdrawals from the circular flow of income**

- An injection into the circular flow of income is money which enters the economy. This is in the form of government spending, investment and exports.
- A withdrawal (also known as a leakage) from the circular flow of income is money which leaves the economy. This can be from taxes, saving and imports.
- The amount of savings in an economy is equal to the amount of investment. In the UK, there is a traditionally low savings rate, especially during periods of high economic growth, and this means that the rate of investment is also low. In Japan there is a high savings rate and with this comes a high level of investment.
- If there are net injections into the economy, there will be an expansion of national output.
- If there are net withdrawals from the economy, there will be a contraction of production, so output decreases.

**Marginal propensity**

- Marginal propensity to consume (MPC) measures how much more individuals will spend for every additional dollar of income. MPC is calculated as the ratio of marginal consumption to marginal income.
- Marginal propensity to save (MPS) is an economic measure of how savings change, given a change in income. It is calculated by simply dividing the change in savings by the change in income. A larger MPS indicates that small changes in income lead to large changes in savings, and vice-versa.

$$\text{Marginal propensity to consume (MPC)} = \frac{\text{Change in consumption}}{\text{Change in income}} = \frac{\Delta C}{\Delta Y}$$

$$\text{Marginal propensity to save (MPS)} = \frac{\text{Change in saving}}{\text{Change in income}} = \frac{\Delta S}{\Delta Y}$$

**The multiplier effect**

- The fiscal multiplier effect occurs when an initial injection into the economy causes a bigger final increase in national income.
  - For example, if the government increased spending by £1 billion but this caused real GDP to increase by a total of £1.7 billion, then the multiplier would have a value of 1.7.
- $multiplier = \dfrac{change\ in\ national\ income}{initial\ change\ in\ agregate\ demand}$
  - The higher the multiplier, the better.

# 2.5.2 – Circular flow of income, expenditure and output

**Factors influencing aggregate demand**

- Aggregate demand is the total demand in the economy.
- It measures spending on goods and services by consumers, firms, the government and overseas consumers and firms.

$$AD = C + I + G + (X - M)$$

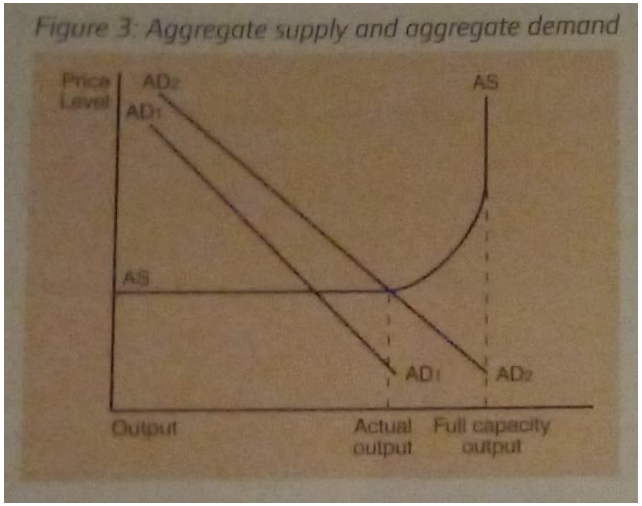
C = Consumption
I = Private Investment
G = Government Spending
X = Exports
M = Imports

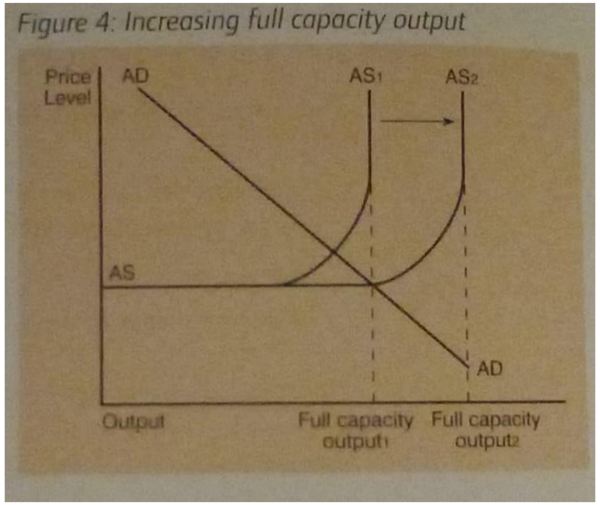
- Consumption is influenced by interest rates and consumer confidence, the lower the former the more spending as there is also more disposable income. The higher the confidence levels, the more investment and spending consumers will do.
- Investment is affected by: rate of economic growth, business expectations/confidence, demand for exports (market demand), interest rates, access to credit and regulations
- Government spending is influenced by economic growth and fiscal policy, the former affecting how much the government spends on welfare payments and how much they gain in tax revenue. Fiscal policy is based on government expenditure and depending on whether it is expansionary or contractionary it will affect the government deficit etc.
- Exports – Imports is affected by: real income (more domestic/imports consumed), exchange rates, state of the world economy (downturn in Eu will cause UK export market to fall), degree of protectionism and non-price factors. These factors may include competitiveness of goods and services through productivity or innovation as well as trade deals and trading blocs they are part of.

**Factors influencing aggregate supply**

- Aggregate supply is the total supply in the economy which measures all that firms are able to supply at a given price level.
- It can be affected by changes in the cost of inputs and resources e.g. if imported components become more expensive, firms will either choose to produce less or increase prices to cover their higher costs. They would perform well with a stronger currency as they will have lower costs (if using imported materials).
- Governmental regulation such as environmental laws or green taxes affect aggregate supply as firms may have increased costs and reduce production as a result.
- A net outward migration of workers would cause a 'brain drain' on the domestic economy, as skilled workers move elsewhere reducing supply of labour etc.
- An increase in productivity will cause an increase in production levels → more goods.

**The AD-AS curve**



# 2.5.2 – Circular flow of income, expenditure and output

**What effects aggregate consumption?**

- Disposable income
  - An increase in disposable income will lead to more spending. There will be increased marginal propensity to consume. Therefore, there will be an increase in consumption (65% of AD). There will be a shift to the right in AD>
- Availability of cheap credit
  - Cheaper interest rates on businesses/personal loans leads to more businesses taking on infrastructure projects. This will see an increase in investment and will cause a shift to the right in AD.
  - Cheaper interest rates on personal loans/credit means people are more likely to spend using credit cards/other forms of credit. There will be an increased consumption of goods and there will be a shift to the right in AD.
- Outlook for the future
  - If predictions show that the economy will do well in the future, people are more likely to spend less now. They are more likely to save their money and wait for the economy to do well before spending.
  - If predictions show that the economy will be worse in the future, people are more likely to spend now. They will be less likely to spend in the future.
- The weather
  - In the summer people are more likely to go out because it is hotter and less rain. Therefore, people are more likely to spend. Therefore, aggregate demand increases in the summer and there is a shift to the right in AD.
  - In the winter, people are less likely to go out as it is colder and more chance of rain. Some businesses may have to close earlier as it gets darker earlier. Therefore, people are less likely to spend in winter and hence aggregate demand decreases. There will be a shift to the left in the AD curve.
- Availability of new products
  - If there are more available products, people are more likely to spend as they have a choice of products to chose from. People also tend to want new products as soon as they come out. Therefore, aggregate consumption will increase that there will be a shift to the right in AD.
- Interest rates
  - If interest rates increase, people will have less disposable income as they will be encouraged to save and spend less. Therefore, there will be a decrease in aggregate demand. And the AD curve will shift to the left.
- Inflation rates
  - An increase in interest rates means there will be higher prices for goods and services. Therefore, people will spend less as the demand for the higher priced goods and services will decrease. Therefore, aggregate consumption will decrease, and the AD curve will shift to the left.

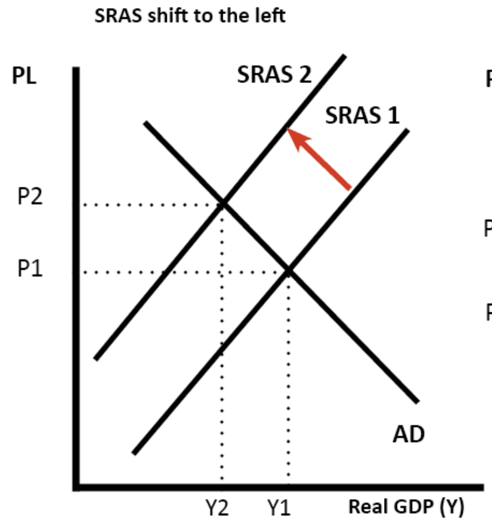
**Short run and long run**

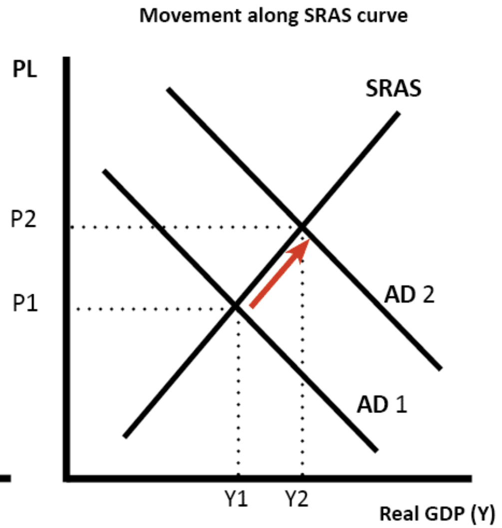
- Short run – where one factor of production is fixed (e.g. capital). This is a time period of less then 4-6 months.
- Long run – where all factors of production of a firm a variable (e.g. a firm can build a bigger factory). A time period of greater than 4-6 months.

# 2.5.2 – Circular flow of income, expenditure and output

**Short Run Aggregate Supply (SRAS)**

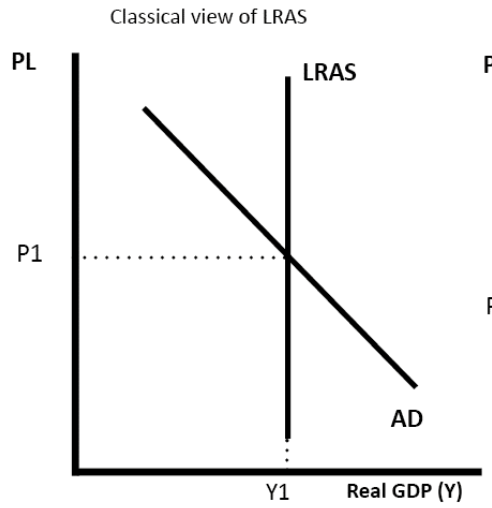
- Essentially the SRAS assumes that the level of capital is fixed. (i.e. in the short run you can't build a factory)
- However, in the short run you can increase the utilisation of existing factors of production (e.g. workers doing overtime.
- In the short run, an increase in the price of goods encourages firms to take on more workers, pay slightly higher wages and produce more.
- Thus, the SRAS suggests an increase in prices leads to a temporary increase in output as firms employ more workers.
- The short run aggregate supply is affected by costs of production. If there is an increase in raw material prices (e.g. higher oil prices), the SRAS will shift to the left. If there is an increase in wages, the SRAS will also shift to the left.
- A shift in SRAS could be due to higher oil prices.
- A movement along SRAS could be due to higher aggregate demand, which leads to increase in real GDP and price level.

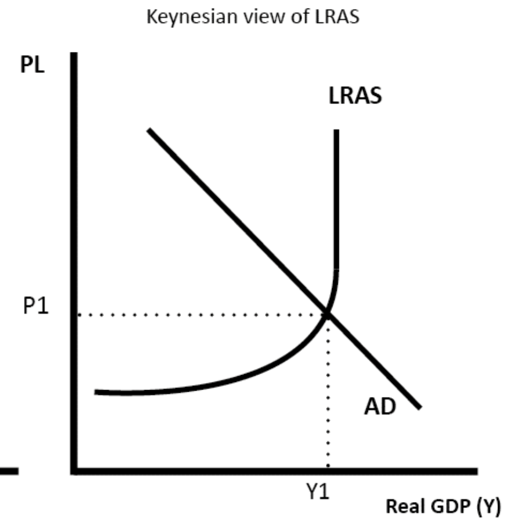



**Long Run Aggregate Supply (LRAS)**

- The long run aggregate supply curve (LRAS) is determined by all factors of production – size of the workforce, size of capital stock, levels of education and labour productivity.
- If there was an increase in investment or growth in the size of the labour force, this would shift the LRAS curve to the right.
- The classical view of long run aggregate supply (LRAS) states that aggregate supply is not determined by the price level or AD, but is determined by factors of production, – land, labour, capital and labour productivity.
- A further complication is that there are different views of the LRAS.
  - The Classical view is an inelastic LRAS.
  - The Keynesian view suggests it is elastic at a point up to inelastic.
- In a sense, the Keynesian view is a combination of the short run aggregate supply and long run.
- The Keynesian LRAS shows that there is a point in the economy of spare capacity where firms can use more.
- There also comes a point where full capacity is reached.
  - Y1 can also be written as Yfe, meaning full employment of resource (i.e. resources are being used to their maximum).



# 2.5.3 – Inflation

### Inflation, deflation, and disinflation

- Inflation is the sustained rise in the general price level over time. This means that the cost-of-living increases and the purchasing power of money decreases.
- Deflation is the opposite, where the average price level in the economy falls. There is a negative inflation rate.
- Disinflation is the falling rate of inflation. This is when the average price level is still rising, but to a slower extent. This means goods and services are relatively cheaper now than a year ago, and the purchasing power of money has increased.
- It is important to note that deflationary government policies aim to reduce AD, and do not necessarily result in deflation.

### Real and nominal values

- Real values are adjusted for inflation. For example, real GDP is the value of GDP adjusted for inflation. For example, if the economy grew by 4% since last year, but inflation was 2%, real economic growth was 2%.
- Nominal values are not adjusted for inflation. Nominal GDP is the value of GDP without being adjusted for inflation. In the above example, nominal economic growth is 4%. This is misleading, because it can make GDP appear higher than it really is.
- Real and nominal values are applied to data using constant and current prices. Constant prices consider inflation, whilst current prices do not.

### Impact of inflation on firms

- Loss of international competitiveness on a global scale if inflation is high and firms will be less price competitive. Also, less competitive in comparison to imported products.
- Unpredictable inflation will affect business confidence and create uncertainty which will reduce investment.
- Low interest rates mean borrowing and investing is more attractive than saving profits. With high inflation, interest rates are likely to be higher, so the cost of investing will be higher, and firms are less likely to invest.
- Workers might demand higher wages, which could increase the costs of production for firms. This could cause inflation to increase further, since firms have to put up prices to make up for the higher costs of labour.

### Pros and cons of inflation and deflation

**Inflation**

| Advantages | Disadvantages |
|---|---|
| • Moderate inflation enables economic growth<br>• Moderate inflation allows adjustment of real wages<br>• Moderate inflation allows adjustment of prices.<br>• Inflation is better than deflation – which can cause recession. | • Creates uncertainty and lower investment<br>• High inflation often leads to lower growth and less stability<br>• Reduces international competitiveness<br>• To reduce inflation can lead to recession<br>• Fall in value of savings<br>• If wages don't keep up – lower real wages. |

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## Pros of Deflation

- **Better prices.** Lower prices are good for consumers with money to spend. Timing is everything, but at the bottom of a deflationary cycle, the prices of most things are very attractive.
- **Stock opportunities.** During deflation, equity prices tend to fall. Stock prices of overvalued companies can become much more reasonable.
- **Benefits for creditors.** People and institutions that lend money during deflation are paid back with money that's worth more than the money they loaned out.

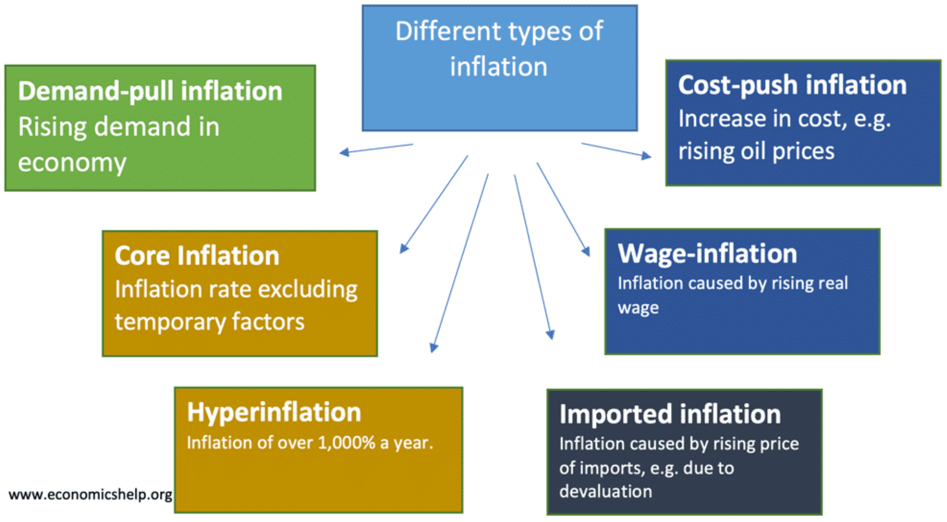
## Cons of Deflation

- **Smaller profit margins.** Lower revenues are bad for large corporations and small businesses.
- **Slow economic growth.** Businesses won't expand when income and earnings are dropping.
- **Higher unemployment.** Lower profit and slower growth can lead to layoffs in many industries.
- **Lack of control.** Deflation is difficult to manage. Because of its self-perpetuating nature, deflation is particularly dangerous to developed economies.

# 2.5.3 – Inflation

**Impact of inflation on individuals**

- Workers
    - Real incomes fall with inflation, so workers will have less disposable income which will reduce consumer spending, decreasing AD.
    - If firms face higher costs, there could be more redundancies when firms try and cut their costs.
- Consumers
    - Those on low and fixed incomes are hit hardest by inflation, due to its regressive effect, because the cost of necessities such as food and water becomes expensive.
    - The purchasing power of money falls, which affects those with high incomes the least, those on benefits/pensions suffer most.
- Savers and borrowers
    - Savings are worth less meaning that these people are less wealthy as their money has less purchasing power.
    - The value of repayment will be lower for borrowers, because the amount owed does not increase with inflation, so the real value of debt decreases.




**Measuring inflation**

- The two principle measures are:
    - The Consumer Prices Index (CPI)
    - The Retail Prices Index (RPI)
- Note that the preferred measure is the CPI, and this is the measure that forms the Bank of England target.

<u>The basket of goods and services</u>

- The office of National statistics (ONS) compiles the CPI and RPI
- Both measures are based upon a basket of goods and services which is designed to represent typical purchases of consumers throughout the UK.
- There are around 700 items in the basket of goods and services.
- Different items are weighted according to their relative importance in terms of how much their price changes impacts upon consumers.
    - For example, petrol is given a high weighting given that it forms a large part of an individual's disposable income and there are few direct substitutes.

<u>Limitations of measurement</u>

- Whilst the Office of National Statistics goes to great lengths to ensure the accuracy of its data, in reality each household and individual will experience a different rate of inflation.
    - Few people will fit the definition of 'average' as defined by the basket of goods ad services
- The governments targeted measure of inflation is the CPI, which excludes mortgage payments and their associated interest.
    - For many households, the monthly mortgage payment represents their biggest item of expenditure, but it is excluded from the CPI calculations.
- The CPI doesn't recognise improvements in the quality of goods and services over time.
    - For example, the prices of many electronic items (e.g. TVs, computers) have fallen in real terms, whilst quality has improved markedly.

# 2.5.3 – Inflation

**Causes of inflation – demand pull**

- Demand-pull
  - Demand-pull inflation is caused by excessive demand in the economy for goods and services.
    - There is too much money chasing too few goods and services.
  - The best way to think about this is using the AD formula.
  - Remember, consumption is the largest component of AD, although any stimulant to AD will create some demand-pull inflationary pressure if supply remains unchanged.

- Causes of demand-pull inflation:
  - Reduced taxation
    - Increases disposable income
  - Lower interest rates
    - Makes borrowing more attractive and saving less rewarding
  - A general rise in consumer spending
    - Perhaps from higher incomes and consumer confidence
  - Improved availability of credit
    - Banks/Building Societies widen the availability of credit or make it more affordable
  - A weak exchange rate
    - Will boost export growth
  - Fast growth in other countries
    - May increase demand for UK exports
  - General rise in confidence / expectations of future growth
    - May feed through to higher consumer spending and investment?
  - Certainty
    - Links to confidence and assists consumers and firms in their spending and investment decisions

**Causes of inflation – cost push**

- Cost-push
  - This occurs when firms respond to rising costs of production by increasing prices
  - Firms will typically do this to protect profit margins
  - That said, firms may be able to absorb some increases in their costs of production, but they will not be able to do this indefinitely, and so pass costs onto the consumer in the form of higher prices

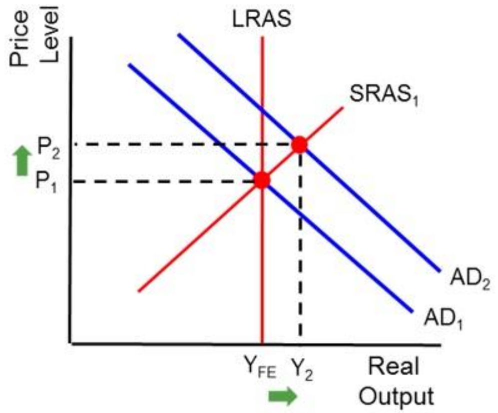
- Causes of cost push inflation:
  - Wage Increases
    - For many firms, wages is their largest single cost of production
    - It is likely that if prices are rising, workers will demand higher wages in order to maintain their "real" incomes
    - If these higher wage costs are reflected in higher prices, then workers will continue to demand higher wages, leading to a wage price spital
  - Higher raw material costs
    - As primary raw materials become more scarce and in even greater demand, raw materials and associated components may rise in price
  - Higher taxes
    - The government may impose higher taxes on firms; for example, corporation tax, national Insurance, or taxes on waste disposal
  - Higher import prices
    - A weaker exchange rate of rising prices abroad mean that imported components feed through to higher costs of production
  - Natural disasters
    - May temporarily or permanently reduce the supply of raw materials or disrupt the supply chain, adding to a firms costs

## 2.5.3 – Inflation

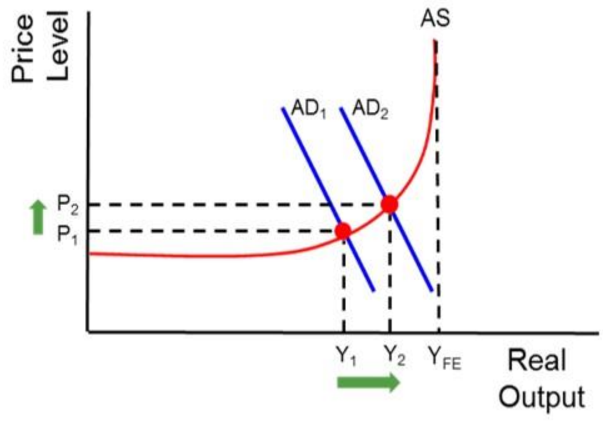
**Inflation diagrams**

### Demand-Pull Inflation

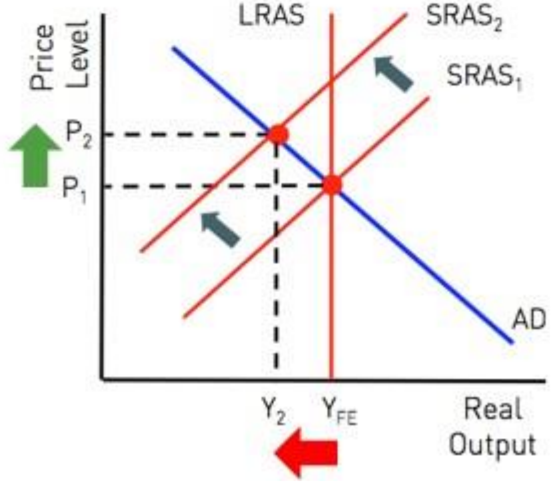
#### Classical




#### Keynesian




### Cost-push



# 2.5.4 – Employment and unemployment

**Employment**

- Employment – all people between 16 and 64 in work
- Underemployment – those in paid work that does not fully utilise their qualifications or forced into part-time employment.
- Unemployment – the number of people able and willing to work, but unable to find a paying job. They are actively seeking work and can begin a job within two weeks.

**Measures of unemployment**

- It is usually difficult to accurately measure unemployment.
  - Some of those in employment might claim unemployment related benefits, whilst some might not reveal they are unemployed in a survey.
- The two main measures of unemployment in the UK are:
- The claimant count
- The International Labour Organisation (ILO) measure

**The claimant count**

- This counts the number of people claiming unemployment related benefits, such as Job Seeker's Allowance (JSA). They have to prove they are actively looking for work.

Evaluating the Claimant Count

- Not every unemployed person is eligible for, or bothers claiming JSA.
- Those with partners on high incomes will not be eligible for the benefit, even if they are unemployed.
- Although there may be instances of people claiming the benefit whilst they are employed, the method generally underestimated the level of unemployment.

**The International Labour Organisation (ILO) measure**

- The LFS is taken on by the ILO. It directly asks people if they meet the following criteria:
  - Been out of work for 4 weeks
  - Able and willing to start working within 2 weeks
  - Workers should be available for 1 hour per week. Part time unemployment is included.
- Since the part time unemployed are less likely to claim unemployment benefit, this method gives a higher unemployment figure than the Claimant Count.

**Causes of unemployment**

- **Structural unemployment** → This is when there is a long-term decline in the demand for goods and services in an industry through structural change i.e. no longer need for the mining industry. People have the wrong skills for the employment on offer or labour is replaced by capital decreasing job opportunities.
- **Frictional unemployment** → This is the least problematic type of unemployment as it refers to when a person is between jobs. It is present in any economy as it is necessary but usually temporary.
- **Occupational immobility** → This is when the unemployed have a lack of transferable skills to move from one career to another. This is especially troubling when structural change in the economy makes industries redundant. This is caused by insufficient education, skills and training and can also be known as a skills mismatch.
- **Geographical immobility** → This is when employees (labour) cannot move to areas where jobs are available possibly due to family ties or housing costs. There is also variation in availability of housing and regional differences in housing costs.
- **Technological unemployment** → This when workers jobs are replaced by machines due to technological advances. This links to structural unemployment, as fewer employees are needed in more and more industries due to this.
- **Demand deficiency (cyclical) unemployment** → This is caused by a downturn in the economic cycle. During these times overall demand will fall due to economic decline. Firms will either make workers redundant or pay lower wages which further reduces spending as well as output. This can be caused by increased productivity as each worker has a higher output meaning less workers are needed to produce the same quantity of goods.

## 2.5.4 – Employment and unemployment

**The impact of unemployment**

| WHO IS IMPACTED | WHY THEY ARE IMPACTED |
|---|---|
| CONSUMERS | – If consumers are unemployed, they have less disposable income and their standard of living may fall as a result.<br>– There are also psychological consequences of losing a job, which could affect the mental health of workers. |
| FIRMS | – With a higher rate of unemployment, firms have a larger supply of labour to employ from. This causes wages to fall, which would help firms reduce their costs.<br>– However, with higher rates of unemployment, since consumers have less disposable income, consumer spending falls so firms may lose profits. Producers which sell inferior goods might see a rise in sales.<br>– It might cost firms to retrain workers, especially if they have been out of work for a long time. |
| WORKERS | – With unemployment, there is a waste of workers' resources. They could also lose their existing skills if they are not fully utilised. |
| SOCIETY | – There is an opportunity cost to society, since workers could have produced goods and services if they were employed.<br>– There could be negative externalities in the form of crime and vandalism, if the unemployment rate increases. |

# 2.6.1 – Possible macroeconomic objectives

## The main macroeconomic objectives

- Macroeconomic policy aims to control the level of activity in the economy so that the standard of living improves, and stability is maintained.
    - The economy is made up of countless individual and group decisions and predicting its behaviour is, at best, an inexact science.
    - Nevertheless, all governments attempt to control the economy in order to achieve desirable objectives or prevent undesirable outcomes.
    - They use a range of macroeconomic policies to achieve their objectives.
- The current account is the sum of the balance of trade (goods and services exported less than the value of all imports), net income from abroad and net current assets.

### *There are **Four Main Objectives** of **Government Macroeconomic Policy***

Governments have **four main macroeconomic objectives** they're trying to achieve:

**1 Strong economic growth**

1) Governments want economic growth to be **high** (but not **too** high).
2) In general, economic growth will **improve** the **standard of living** in a country.

**2 Keeping inflation low**

1) In the UK, the government aims for **inflation** of **2%**.
2) The **Monetary Policy Committee of the Bank of England** uses **monetary policy** (see pages 179-181) to try to achieve this target rate.

**3 Reducing unemployment**

1) Governments aim to **reduce unemployment** and move towards **full employment**.
2) If **more** people are employed then the economy will be **more productive**. **Aggregate demand** will also **increase** as more people will have a **greater income**.

**4 Equilibrium in the balance of payments**

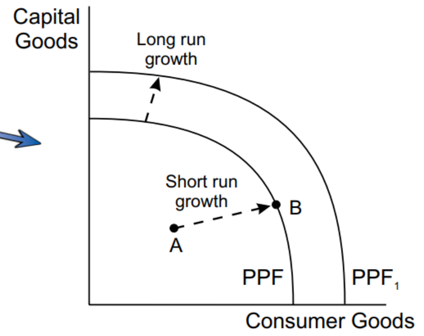
1) Governments want **equilibrium** in the balance of payments, i.e. they want **earnings** from **exports** and other **inward flows** of money to **balance** the **spending** on **imports** and other **outward** flows of money.
2) This is **more desirable** than a **long-term deficit** or **surplus** in the balance of payments — which can cause problems.

## PPF curve can show growth

### *A **Production Possibility Frontier (PPF)** can show **Economic Growth***

1) **Short run** and **long run** economic growth can be shown with a **PPF**.
2) Short run growth is shown by a **movement** from, say, point A to point B, while the PPF itself remains **fixed**.
3) Long run growth **occurs** if there's an **increase** in the **capacity** of the economy — this would make the PPF shift **outwards** to $PPF_1$.

See p.8-9 for more about PPFs.




## Other macroeconomic objectives

Balanced government budget

- This ensures the government keeps control of state borrowing, so the national debt does not escalate. This allows governments to borrow cheaply in the future should they need to and makes repayment easier.

Protection of the environment

- This aims to provide long run environmental stability. It ensures resources used are not exploited, such as oil and natural gas, and that they are used sustainably, so future generations can access them too. Moreover, it means there is not excessive pollution.

Greater income equality

- Income and wealth should be distributed equitably, so the gap between the rich and poor is not extreme. It is generally associated with a fairer society.

## Types of economic growth

### *There are **Different Types** of **Economic Growth***

1) **Economic growth** is an **increase** in the **productive potential** of an economy.
2) In the **short run**, economic growth is measured by the **percentage change** in real national output (real GDP — see p.128). This is known as **actual** (real) growth (this just means that the **effect** of **inflation** has been **removed** from the growth figure).
3) Increases in actual growth are usually due to an **increase** in **aggregate demand**, but they can also be caused by **increases** in **aggregate supply**. Actual growth doesn't always increase — it tends to **fluctuate up** and **down**.
4) **Long run** growth (also known as **potential** growth) is caused by an **increase** in the **capacity**, or **productive potential**, of the economy. This usually happens due to a **rise** in the **quality** or **quantity** of **inputs** (the **factors of production**) — for example, more **advanced** machinery or a more **highly skilled** labour force.
5) Long run growth is shown by an **increase** in the **trend rate** of growth. The **trend rate** of growth is the **average rate** of economic growth over a period of both economic **booms** and **slumps**. It **rises smoothly** rather than fluctuating like actual economic growth, so the **actual rate** of growth often doesn't **match** the **trend rate**.
6) **Increases** in long run growth are caused by an increase in **aggregate supply**.

# 2.6.2 – Policy instruments

**Policy instruments**

- The government tries to achieve its four main macroeconomic objectives using the following policies:
  - Demand-side policies – including fiscal policy and monetary policy
  - Supply-side policies
  - Exchange-rate policy
- In theory, it is possible to achieve the government's primary objectives by using relevant policies that move the economy in the required direction.

| Increase in National Income | Decrease in National Income |
|---|---|
| • Output expands. | • Output decreases. |
| • GDP grows faster. | • GDP growth slows. |
| • Unemployment falls. | • Inflation is reduced. |

- If the economy is growing too quickly and inflationary pressure is building up during a boom, contractionary policies will be used to reduce the level of economic activity and national income. This will also slow down the demand for imports.
- If there is a recession, or if the economy is not growing quickly enough and/or unemployment is too high, expansionary policies will be used to stimulate the level of economic activity, raise national income and, in turn, stimulate growth and reduce unemployment.
- Fiscal and monetary policies are designed to affect aggregate demand and the level of economic activity, stabilising the economy.

| Contractionary policy | Expansionary policy |
|---|---|
| • Higher interest rates. | • Lower interest rates. |
| • Tax increases. | • Tax cuts. |
| • Cuts in government expenditure. | • Increased government expenditure. |

**Fiscal policy**

- Fiscal policy involves changes in the levels of taxation and/or government expenditure in order to influence the level of activity in the economy.
- The government gains income from taxation and then spends it on providing services.
- The levels of either of these can be altered to reduce or increase the amount of economic activity.
- The level of spending does not have to match the level of taxation; the government can borrow and go into deficit. This will allow the government to stimulate growth in the economy with extra spending. Thes makes sense in a recession.
- A public sector deficit occurs when government spending exceeds the government's income, and it must borrow to fund the difference.

**How fiscal policy works to affect aggregate demand**

| Expansionary fiscal policy | Contractionary fiscal policy |
|---|---|
| Taxation is reduced and/or government expenditure increased. | Taxation is increased and/or government expenditure reduced. |
| ↓ | ↓ |
| As less tax is paid so disposable income rises. | As more tax is paid so disposable income falls. |
| ↓ | ↓ |
| If government expenditure (G) is increased, employment will rise and additional income is created. | If government expenditure (G) is reduced, employment will fall and incomes fall. |
| ↓ | ↓ |
| There is a rise in consumption (C). | There is a fall in consumption (C). |
| ↓ | ↓ |
| More goods and services are consumed meaning that businesses respond by increasing output. | Fewer goods and services are consumed meaning that businesses respond by decreasing output. |
| ↓ | ↓ |
| To do this, businesses are likely to take on more workers and so unemployment falls. | To do this, businesses are likely to reduce the workforce and so unemployment rises. |
| ↓ | ↓ |
| AD has increased and the economy has grown. | AD has decreased and there is less activity in the economy. |

- Expansion involves reducing leakages and increasing injections. Expansion in the economy encourages businesses to invest — they can expect growing demand.
- The opposite occurs if contractionary policies are used: injections will be reduced, leakages will rise, investment will be depressed, unemployment will rise and aggregate demand will fall.

# 2.6.2 – Policy instruments

**Limitations of fiscal policy**

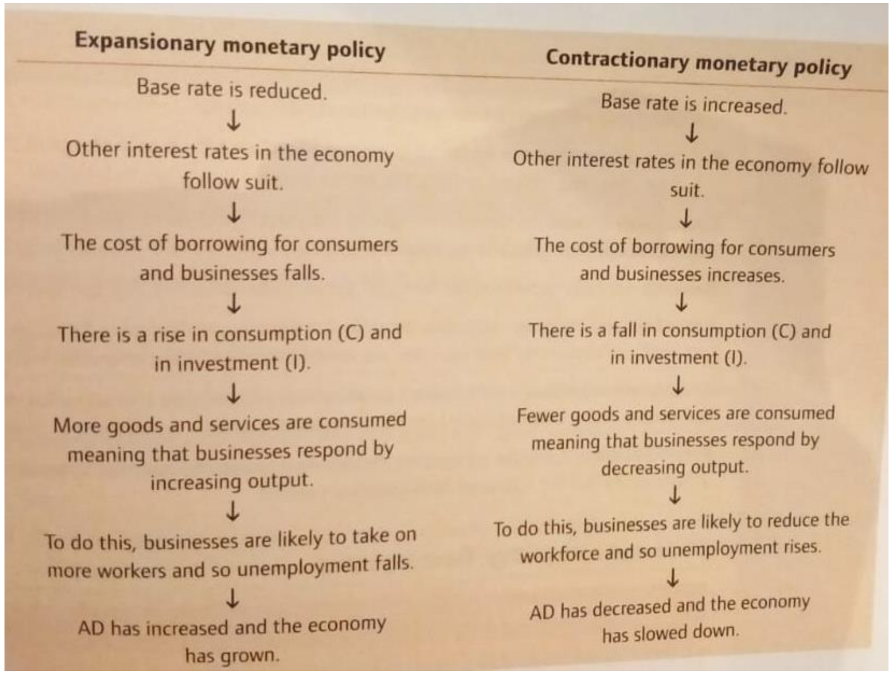
- Limits Government spending (with expansionary policy).
- If interest rates are high, fiscal policy may not be effective for increasing demand.
- If the Government spends too much there could be an increased deficit making it difficult to borrow in future.
- If the government has imperfect information about the economy, it could lead to inefficient spending.

**Monetary policy**

- Monetary policy uses interest rates to vary the costs of borrowing and influence the level of aggregate demand. Changes in the Bank of England's base rate will affect interest rates across the economy.
- Monetary policy usually relies on the use of interest rates to control the economy.
- In 1997 the incoming Labour government made the Bank of England independent of government control. The idea was to avoid making policy changes for political reasons.
- The Bank was also given the responsibility for ensuring monetary stability. This means stable prices — low inflation ~ and confidence in the currency. The government's inflation target is 2%.
- The Bank tries to achieve stability through decisions taken by the Monetary Policy Committee (MPC) which meets once a month to decide on the level of base rate. This is the rate charged by the Bank of England when banks need to borrow to cover their day-to-day needs.
- The base rate influences all the interest rates set by commercial banks, building societies and other institutions for their own savers and borrowers.
- It may also affect the price of financial assets, such as bonds and shares, and the exchange rete.
- Reducing or increasing interest rates affects spending in the economy.

**How monetary policy works to affect aggregate demand**

- Interest rates are the price of money. If interest rates increase:
  - Consumers have to pay more to take out loans and use credit cards, so they reduce consumption.
  - Those with mortgages find their monthly repayments increasing and also reduce consumption.
  - Businesses have to pay more to obtain finance and so reduce the level of investment.
  - Consumption and Investment (C + I) are two key components of AD.
  - The reverse happens if interest rates decrease.



| Expansionary monetary policy | Contractionary monetary policy |
| --- | --- |
| Base rate is reduced. | Base rate is increased. |
| ↓ | ↓ |
| Other interest rates in the economy follow suit. | Other interest rates in the economy follow suit. |
| ↓ | ↓ |
| The cost of borrowing for consumers and businesses falls. | The cost of borrowing for consumers and businesses increases. |
| ↓ | ↓ |
| There is a rise in consumption (C) and in investment (I). | There is a fall in consumption (C) and in investment (I). |
| ↓ | ↓ |
| More goods and services are consumed meaning that businesses respond by increasing output. | Fewer goods and services are consumed meaning that businesses respond by decreasing output. |
| ↓ | ↓ |
| To do this, businesses are likely to take on more workers and so unemployment falls. | To do this, businesses are likely to reduce the workforce and so unemployment rises. |
| ↓ | ↓ |
| AD has increased and the economy has grown. | AD has decreased and the economy has slowed down. |

**Limitations of monetary policy**

- There are time lags with the changing of the base rate to affect the interest rates as banks adopt the change.
- Banks may not pass the base rate onto consumers therefore it may not have the intended effect.
- Even if the cost of borrowing is low, banks may not be willing to lend as they are risk averse.
- Interest rates are less effective if firm and consumer confidence is low as if the economy seems risky they are less likely to spend despite low interest rates.

# 2.6.2 – Policy instruments

**Supply-side policies**

- Supply-side policies include all measures designed to increase the productive capacity of the economy by influencing aggregate supply. Some are based on long experience backed by economic arguments, others on political viewpoints.
- Supply-side policies are both more numerous and narrower in scope than fiscal and monetary policies. As the name suggests, they affect aggregate supply rather than aggregate demand.
- They include measures designed to help the economy produce more and use existing resources more efficiently. They can increase productivity.
- They include improvements to education and training, incentives to encourage investment, developing a flexible labour force, reducing structural unemployment, making markets more competitive and encouraging infrastructure development and R&D activity.
- Supply-side policies can be useful in helping to reduce inflationary pressures. If AS is growing, then AD can be expanded without causing the excess demand that leads to inflation.
- Examples of supply-side policies include:
    - Taxes — cuts in taxes are thought to increase the incentive to work, though there is little hard evidence of this. Tax credits provide an incentive to work.
    - Benefits — cuts in benefits make living off benefits less attractive and can decrease unemployment.
    - Education and training — improves the skills and flexibility of the labour force, can reduce the occupational immobility of labour and help maintain the competitiveness of the economy.
    - Grants and subsidies - can support development of desirable outcomes, for example, by encouraging sustainable and environmentally friendly production or energy generation or raising R&D spending.
    - Privatisation is a supply-side policy, resting on the assumption that competition will lead to greater efficiency; in fact the outcomes have been very varied.

**Strengths and weaknesses of supply-side policies**

| STRENGTHS | LIMITATIONS |
|---|---|
| – They are the only policies which can deal with structural unemployment as the labour market can be directly improved with education and training. | – Significant time lags for people to enter the labour market.<br>– Some policies, such as reducing the rate of tax, could lead to a more unequal distribution of wealth.<br>– Demand-side policies are more effective dealing with cyclical unemployment since they can reduce a negative output gap. |

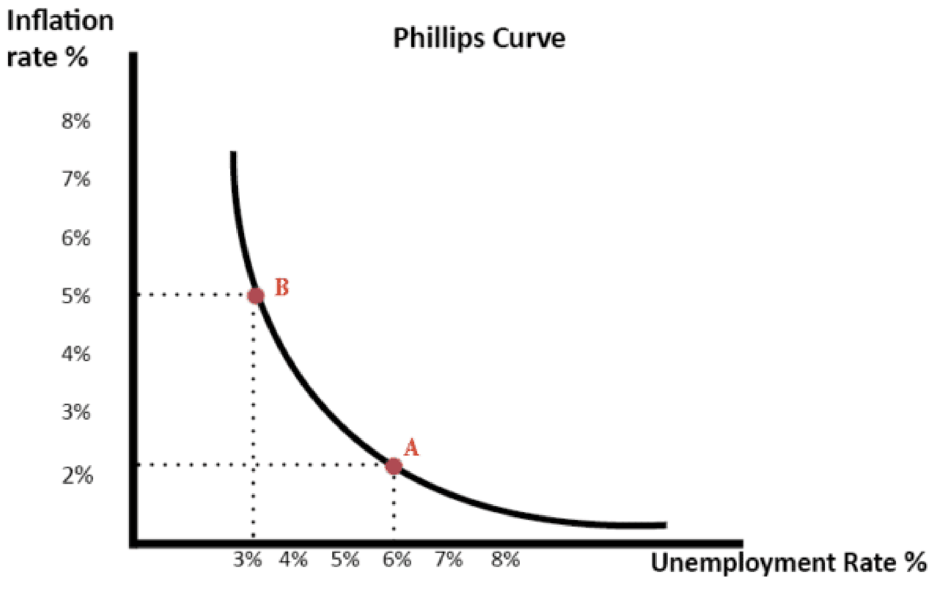
**Exchange rate policy**

- The exchange rate affects the economy because changes can alter the prices of exports and imports. Most economies have floating exchange rates which can up to a point be manipulated by monetary policy.
- With a floating exchange rate, the price (exchange rate) of the currency is determined by market forces i.e. demand and supply. It behaves just like any good or service. The demand for and supply of the currency are created by trade and capital flows.
- Higher interest rates tend to make the pound appreciate because investment in sterling assets becomes more attractive compared to other currencies.
    - This increases the demand for pounds.
    - Lower interest rates have the opposite effect.
- The Bank of England does not specifically target the exchange rate, but the Monetary Policy Committee (MPC) will take exchange rates into account.
    - Although a relatively high base rate will lead to appreciation, reducing the price of imports and helping reduce inflationary pressure, UK exports will become less competitive.

# 2.6.3 – Potential policy conflicts and trade-offs

**Inflation and unemployment**

- In the short run, there is a trade-off between the level of unemployment and the inflation rate. This is illustrated with a Phillips curve.
- As economic growth increases, unemployment falls due to more jobs being created.
- However, this causes wages to increase, which can lead to more consumer spending and an increase in the average price level.




- To reduce unemployment, some kind of expansionary policy is needed to stimulate aggregate demand.
  - The danger is that this growth can become unsustainable, leading to higher interest rates of inflation.

**Economic growth and the environment**

- High rates of economic growth are likely to result in high levels of negative externalities, such as pollution and the usage of non-renewable resources.
- This is because of more manufacturing, which is associated with higher levels of carbon dioxide emissions.

**Economic growth and inflation**

- A growing economy is likely to experience inflationary pressures on the average price level.
  - This is especially true when there is a positive output gap and AD increases faster than AS.
- A negative output gap occurs when the actual level of output is less than the potential level of output.
  - This puts downward pressure on inflation.
  - It usually means there is the unemployment of resources in an economy, so labour and capital are not used to their full productive potential.
  - This means there is a lot of spare capacity in the economy.
- A positive output gap occurs when the actual level of output is greater than the potential level of output.
  - It could be due to resources being used beyond the normal capacity, such as if labour works overtime.
  - If productivity is growing, the output gap becomes positive.
  - It puts upwards pressure on inflation.
  - Countries, such as China and India, which have high rates of inflation due to fast and increasing demand, are associated with positive output gaps.

**Economic growth and the government budget deficit**

- Reducing a budget deficit requires less expenditure and more tax revenue.
- This would lead to a fall in AD, however, and as a result there will be less economic growth.

**Economic growth and the current account**

- During periods of economic growth, consumers have high levels of spending.
- In the UK, consumers have a high marginal propensity to import, so there is likely to be more spending on imports.
- This leads to a worsening of the current account deficit.
- However, export-led growth, such as that of China and Germany, means a country can run a current account surplus and have high levels of economic growth.

# 2.6.3 – Potential policy conflicts and trade-offs

**The issues the government face in managing the macro-economy**

Potential policy conflicts and trade-offs

- This occurs when one macroeconomic policy has a larger impact than another, which conflicts with the other policy or reduces its effectiveness. Examples include:
    - Environment vs competitiveness
        - If 'green taxes' are implemented, such as carbon taxes, or if there are minimum prices on pollution permits, the competitiveness of domestic firms could be compromised. This is because they are limited in their production.
    - Progressive taxes vs inflation
        - Taxes to reduce inequality could lead to higher rates of inflation. For example, a higher VAT rate increases the price of goods for firms and consumers.
    - Fiscal vs monetary policy
        - Expansionary fiscal policies involve more government borrowing, which could cause interest rates and the inflation rate to rise.
    - Interest rate vs inequality
        - The low interest rate could affect the distribution of income. Savers only receive a small return on their savings.

Other issues

- When reducing the size of the government deficit, the government might need to reduce their spending and increase the tax rate. However, these are politically unpopular.
- Some policies might take a long time to show an effect. This is particularly true of supply-side policies. For example, the effects of education cannot be seen until the education has been given and acted upon. This could take several years. Changes in taxes have an effect more quickly.
- Some events are beyond the control of the government, and this could limit how well policies work. For example, the financial crisis and global interest rates can affect the domestic economy, and this influences and limits the effectiveness of government policy.

**How different macroeconomic perspectives influence policy decisions – free market economy**

- Also known as laissez-faire economies, where governments leave markets to their own devices, so the market forces of supply and demand allocate scarce resources.
- Economic decisions are taken by private individuals and firms, and private individuals own everything. There is no government intervention.
- In reality, governments usually intervene by implementing laws and public services, such as property rights and national defence.
- Adam Smith and Friedrich Hayek were famous free market economists.
    - Adam Smith's famous theory of the invisible hand of the market can be applied to free market economies and the price mechanism, which describes how prices are determined by the 'spending votes' of consumers and businesses.
    - Smith recognised some of the issues with monopoly power that could arise from a free market, however. Hayek argued that government intervention makes the market worse.
        - For example, shortly after the 1930s crash, he argued that the Fed caused the crash by keeping interest rates low, and encouraging investments which were not economically worthwhile: 'malinvestments'.
- In a free market economy:
    - What to produce: determined by what the consumer prefers
    - How to produce it: producers seek profits
    - For whom to produce it: whoever has the greatest purchasing power in the economy, and is therefore able to buy the good

| ADVANTAGES | DISADVANTAGES |
|---|---|
| – Firms are likely to be efficient because they have to provide goods and services demanded by consumers. They are also likely to lower their average costs and make better use of scarce resources. Therefore, overall output of the economy increases.<br>– The bureaucracy from government intervention is avoided.<br>– Some economists might argue the freedom gained from having a free economy leads to more personal freedom. | – The free market ignores inequality, and tends to benefit those who hold most of the wealth. There are no social security payments for those on low incomes.<br>– There could be monopolies, which could exploit the market by charging higher prices.<br>– There could be the overconsumption of demerit goods, which have large negative externalities, such as tobacco.<br>– Public goods are not provided in a free market, such as national defence. Merit goods, such as education, are underprovided. |

# 2.6.3 – Potential policy conflicts and trade-offs

**How different macroeconomic perspectives influence policy decisions – command economy**

- This is where the government allocates all of the scarce resources in an economy to where they think there is a greater need.
  - It is also referred to as central planning.
- Karl Marx saw the free market as unstable. He saw profits created in the free market as coming from the exploitation of labour, and by not paying workers to cover the value of their work. He argued for the "common ownership of the means of production".
- In a command economy:
  - What to produce: determined by what the government prefers
  - How to produce it: governments and their employees
  - For whom to produce it: who the government prefers

| ADVANTAGES | DISADVANTAGES |
|---|---|
| – It might be easier to coordinate resources in times of crises, such as wars.<br>– The government can compensate for market failure, by reallocating resources. They might ensure everyone can access basic necessities.<br>– Inequality in society could be reduced, and society might maximise welfare rather than profit.<br>– The abuse of monopoly power could be prevented. | – Governments fail, as do markets, and they may not be fully informed for what to produce.<br>– They may not necessarily meet consumer preferences.<br>– It limits democracy and personal freedom. |

**How different macroeconomic perspectives influence policy decisions – mixed economy**

- This has features of both command and free economies and is the most common economic system today.
  - There are different balances between command and free economies in reality, though.
  - The UK is generally considered quite central, whilst the US is slightly more free (although the government spends around 35% of GDP) and Cuba is more centrally planned.
- The market is controlled by both the government and the forces of supply and demand.
- Governments often provide public goods such as streetlights, roads and the police, and merit goods, such as healthcare and education.
- In a mixed economy:
  - What to produce: determined by both consumer and government preferences
  - How to produce it: determined by producers making profits and the government
  - For whom to produce it: both who the government prefers and the purchasing power of private individuals.

## Advantages and Disadvantages of Mixed Economies

<u>Advantages</u>

- "For Whom" question answered directly
- Those who are not fortunate or productive enough to earn competitive salary still share in benefits of society
- People can use their electoral power to influence many of the WHAT, HOW, FOR WHOM, questions that the government controls

<u>Disadvantages</u>

- Less Efficient than Market economies
- Government Guarantees of work can cause over-hiring of workers, increasing production costs
- Taxes are higher because more public services are provided

## 2.6.3 – Potential policy conflicts and trade-offs

**The likely effects of individual policy instruments on specific problems; possible unintended consequences**

- When governments employ a policy, there could be unintended consequences.
    - This is when the actions of producers and consumers have unexpected consequences.
- With government policies, consumers react in unexpected ways.
    - A policy could be undermined, which could make government policies expensive to implement, since it is harder to achieve their original goals.
        - For example, the government could increase in the minimum wage with the intention of raising living standards.
        - However, this could make it unaffordable for employers to employ so many workers, so it could lead to workers being sacked.