Bentley Wood
High School for Girls

Economics
GCSE to A level

Bridging Work
Year 11 into 12 for 2020/21

Name: _____

Tutor Group: _____

Teacher: _____

A Level Economics Bridging Work

Tasks to be completed for A Level Economics Bridging work:

Task 1-**Read the resource on Note-taking (Appendix 1)** to understand the different methods of Taking notes and Making notes.

Do not complete Tasks 2, 3 and 4, without completing Task 1 first!

Task 2-Using one of the Note-taking methods from the **resources provided in Appendix 1, make notes** on **Macroeconomic objectives** using the **website link** from the **Task 2 sheet** and the chapter from the textbook-**Appendix 2.**

Task 3-Using one of the note-taking methods from the **resources provided in Appendix 1**, **make notes** on **Demand** using the **website link** from the **Task 3 sheet** and the chapter from the textbook-**Appendix 3.**

Task 4-Research task

Research on the following economists:

- **John Maynard Keynes**
- **Friedrich Hayek**

All tasks are to be completed by **18th September 2020**

Name: **A Level Economics 2020 Bridging Work**

Task 2

https://www.tutor2u.net/economics/reference/macroeconomic-objectives-and-macro-stability

1. Using the link above, watch the video on Macroeconomic Objectives

2. Read the written section on Macroeconomic Objectives

3. Read the chapter from the textbook on Macroeconomic Objectives **(Appendix 2).**

4. Using **one** of the Note-taking methods from **Appendix 1**, **make notes** on the main **Macroeconomics Objectives** described, using the **website link above** and the **chapter from the textbook-Appendix 2.**

Additional tasks:

5. Watch the video on the "State of the British Economy"

6. Research and write down the latest UK economic statistics on:

   a) Inflation
   b) Unemployment
   c) Economic growth
   d) The balance of payments

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Task 3

https://www.tutor2u.net/economics/reference/theory-of-demand

1. Using the link above, **watch the video** and the **read the notes** on demand.

2. Read the chapter from the textbook on Demand **(Appendix 3).**

3. Using **one** of the Note-taking methods from **Appendix 1**, **make notes** on **Demand,** using the **website link above** and the **chapter from the textbook- Appendix 3.**

   Include the following information in your Demand notes:

   - What is demand?
   - Types of demand; composite demand, derived demand and joint demand
   - What causes movement along the demand curve?
   - What causes shifts in a demand curve?

Name: **A Level Economics 2020 Bridging Work**

Task 4- RESEARCH ON FAMOUS ECONOMISTS/ECONOMIC INFLUENCERS

NAME OF THE PERSON BEING RESEARCHED

John Maynard Keynes

Name: **A Level Economics 2020 Bridging Work**

Watch the following: https://www.youtube.com/watch?v=CkHooEp3vRE (Masters of Money – John Maynard Keynes) and write a summary on the documentary. (Minimum 1 and half page on A4, font size of 12)

Areas you must cover:

- Background?
- Educational experiences?
- Major events that influenced their thinking?
- Policies suggested to deal with these events?
- Famous publications?
- Current impact on economics?

Name: **A Level Economics 2020 Bridging Work**

Friedrich Hayek

Name: **A Level Economics 2020 Bridging Work**

Watch the following: https://www.youtube.com/watch?v=ElYqTj402PE (Masters of Money – Friedrich Hayek) and write a summary on the documentary. (Minimum 1 and half page on A4, font size of 12)

Areas you must cover:

- Background?
- Educational experiences?
- Major events that influenced their thinking?
- Policies suggested to deal with these events?
- Famous publications?
- Current impact on economics?

Name: **A Level Economics 2020 Bridging Work**

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YouTube:

- Econplusdal: https://www.youtube.com/user/EconplusDal
- Tutor2u: https://www.youtube.com/channel/UCe83jLdZ3PuqVwAHe6B3U2A
- TedTalks: https://www.youtube.com/user/TEDtalksDirector

Appendix 1

Bridging Work Resource Sheet for Business, Economics, Government and Politics and Law

An Introduction to the Skill of Note-taking: Taking Notes and Making Notes

During your A-level studies, and indeed your degree, you will be expected to make sense of the many hours of teaching/lecturing you receive, and any further reading/research that you have completed. The best and most efficient way of coping with so much information is to **take notes** at the time, from which further (and better) **notes can be made** when they are needed (such as for **revision**).

There are many methods of taking notes and you must choose the style that best suits you. In the lesson/lecture there are many styles of note-taking available to students and these will largely be determined by the format of the presentations you receive. Many A-level teachers provide handout material to assist your note-taking **('guided notes method')**: such resources encourage active learning by providing a framework of headings for you to understand the main elements of the topic, whilst requiring you to fill in some of the details and examples as they are being explained.

In the absence of supporting materials, you need to develop a style that will best enable you to filter the most important points, explanations and examples from the session, whether that be in a **linear written form** (using shorthand, where necessary: see the following guide developed by the University of Portsmouth (http://tinyurl.com/psu4cyt) or through a **non-linear method**, perhaps including visual cues, such as mapping ideas as they develop. Whatever

you choose, the method needs to capture the essential points of the lesson/lecture and filter out the digressions, anecdotes and asides that are not directly relevant to learning the topic.

Cornell method of note-taking

This refers to a method popularised by Professor Walter Pauk at this American Ivy League university in the 1950s, which may be used for lessons/lectures but strikes me as especially useful for making sense of further reading and research, and building on earlier notes, to achieve a greater degree of understanding and synthesis of a topic. It involves dividing the page into two columns, with the one on the right much larger than the one on the left. The left is used for key words/terms/ headings; the right is used for explanations and examples, in shorthand written form. The last few lines of the page are meant to be left blank for questions or for a short summary of the session – but I would reserve this for the end of your topic notes rather than for every page.

Notes should be frequently reviewed, added to and re-made in the important transformation process that has to take place during the revision process.

Note-taking: the top five

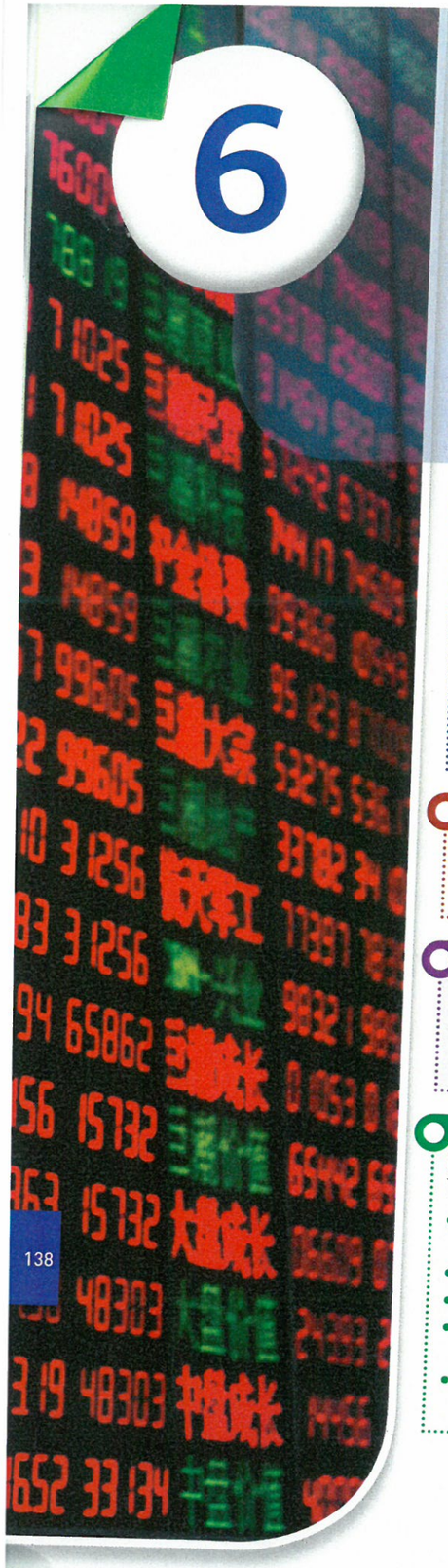
- Remain active in lessons/lectures by taking detailed notes
- Adopt a style that best suits you – linear notes or non-linear mapping?
- Use shorthand where possible to increase the efficiency of your note-taking – and ensure that you capture everything you need
- Review, add to and re-make your notes
- Transform your notes for revision

Introductory Tasks common to all subjects

1. Find the **note-taking resources** on the P Drive (Student Drive), titled P:\Bridging work for Business, Economics, Law and Gov Pol

and work through the activities to get a feel for note-taking methods.

2. Visit the University of Bradford's note-taking page to find resources and specific guidance on the Cornell method: http://www.bradford.ac.uk/academic-skills/writing/study/effective-learning/note/
3. Now **complete the Bridging Work for your chosen A-level subject(s).**



6 The measurement of macroeconomic performance

This is the first of the four remaining chapters in the book covering **macroeconomics**. The subject area of the first five chapters, microeconomics, describes, explains and analyses the 'little bits' of the economy, for example individual markets, firms and industries. By contrast, macroeconomics looks at the economy as a whole or in aggregate. Consider the question 'what determines the price of bread?' This is a microeconomic question, focusing on supply and demand in a single market *within* the economy. By contrast, 'what determines the average price level of *all* goods and services?' is a macroeconomic question. Similarly, 'what determines the annual rate of change of the overall price level, i.e. the rate of inflation?' is a macroeconomic rather than a microeconomic question. This and similar questions relating to the levels and rates of change of economic variables such as output, consumption, investment and exports and imports, lie at the heart of macroeconomics.

KEY TERM

macroeconomics involves the study of the whole economy at the aggregate level.

STUDY TIP

Make sure you understand the difference between macroeconomics and microeconomics, and also appreciate how many macroeconomic theories have microeconomic foundations.

LEARNING OBJECTIVES

This chapter will:

- outline and briefly explain the four main objectives of macroeconomic policy
- explain how the ranking of the policy objectives has changed over time
- discuss policy trade-offs and conflicts
- survey some of the data used to measure the performance of an economy
- explain how index numbers are used to show changes in key economic variables

6.1 The objectives of government economic policy

The four main objectives of a government's macroeconomic policy

KEY TERM

policy objective a target or goal that policy-makers aim to 'hit'.

A **policy objective** is a target or goal that a government wishes to achieve or 'hit'. Since the Second World War, governments in mixed economies such as the UK have generally had the same broad range of objectives. These are to:

- achieve economic growth and improve living standards and levels of economic welfare
- create and maintain full employment or low unemployment
- limit or control inflation, or to achieve some measure of price stability
- attain a satisfactory balance of payments, usually defined as the avoidance of an external deficit which might create an exchange rate crisis

We shall now take a brief introductory look at each of the four policy objectives in turn, before examining them in greater detail in the final two chapters of the book.

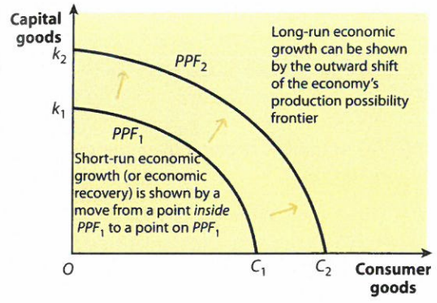


Figure 6.1 Short-run and long-run economic growth

KEY TERMS

short-run economic growth growth of real output resulting from using idle resources, including labour, thereby taking up the slack in the economy.

long-run economic growth an increase in the economy's potential level of real output, and an outward shift of the economy's production possibility frontier.

gross domestic product (GDP) the sum of all goods and services, or level of output, produced in the economy over a period of time, e.g. one year.

real GDP A measure of all the goods and services produced in an economy, adjusted for price changes or inflation. The adjustment transforms changes in **nominal GDP**, which is measured in money terms, into a measure that reflects changes in the total output of the economy.

nominal GDP GDP measured at the current market prices, without removing the effects of inflation.

Economic growth

You first came across economic growth in Chapter 1 when learning about production possibility curves. As a recap, Figure 6.1, which is much the same as Figure 1.4 in Chapter 1, will remind you of the distinction between short-run and long-run economic growth. **Short-run growth**, which occurs when there are unemployed resources (including labour) or 'slack' in the economy, is when there is a movement from a point *inside* the economy's production possibility frontier to a point *on* the frontier. Short-run growth is also called economic recovery. **Long-run growth**, by contrast, results from an outward movement of the production possibility frontier, from PPF_1 to PPF_2 in Figure 6.1.

Figure 6.2 shows what happened to UK growth between the first quarter of 2003 and the end of the first quarter of 2014. Note that the graph shows 'quarter-on-quarter' percentage growth rates of real **gross domestic product (GDP)** and not annual growth rates. The black bars show positive economic growth or increasing **real GDP**. By contrast, the red bars show negative economic growth or decreasing real GDP. In Figure 6.1, short-run negative economic growth could be depicted by a movement from a point on frontier PPF_1 to a point inside the frontier, or from an initial point inside the frontier to another point closer to the origin in the diagram. An inward movement of the production possibility frontier, for example from PPF_2 to PPF_1, would show long-run negative growth. A variety

STUDY TIP

Make sure you appreciate that economic growth is always measured in *real* rather than in *nominal* terms. You must understand the difference between real GDP and nominal GDP.

of events could be responsible for this. These include pollution degrading agricultural land within the economy and the destruction of buildings and other infrastructure in time of war.

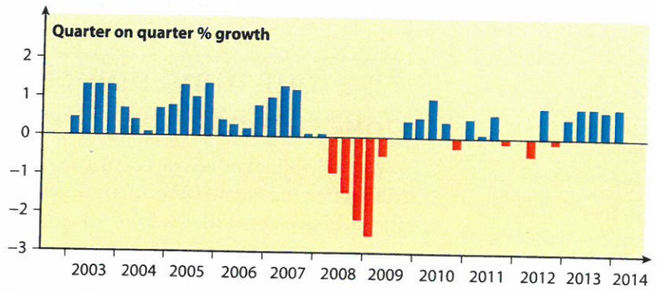


Figure 6.2 Quarter-on-quarter economic growth in the UK, Quarter 1 2003 to Quarter 1 2014
Source: ONS

QUANTITATIVE SKILLS 6.1

Worked example: calculating mean and median values

Calculate the mean and median values of nominal gross value added (GVA) in the UK regions over the period shown below.

Gross value added (GVA) is a term used in the UK's national accounts to measure the contribution to the economy of each individual producer, industry or sector in the United Kingdom. It is used in the estimation of GDP. Table 6.1 shows the percentage changes that occurred in *nominal* GVA for the 11 planning regions into which the UK is divided during recovery from recession in the years from 2009 to 2012. On first sight the percentage changes in the table may seem high. However, the table shows nominal rather than real changes in GVA. Both inflation and economic growth were occurring between 2009 and 2012 and these factors explain the percentage changes.

Table 6.1 Percentage changes in regional GVA in UK regions, 2009–12

London	11.1%
South East	10.5%
East of England	7.2%
East Midlands	8.5%
South West	5.3%
North West	4.8%
North East	7.7%
Scotland	3.6%
Wales	8.2%
Yorkshire & Humber	4.5%
Northern Ireland	3.4%

Source: Regions and Countries of the UK Recovering from the Economic Downturn, ONS (July 2014)

With a set of data such as this, the mean and the median are two measures of average values. The mean is the value obtained by dividing the sum of the percentage changes by the number of regions. Thus:

(11.1% + 10.5% + 7.2% +8.5% + 5.3% + 4.8% + 7.7% +3.6% + 8.2% + 4.5% + 3.4%) = 74.8%

74.8% ÷ 11 = 6.8%.

So 6.8 is the mean value.

By contrast, the median value is the 'middle number' in the sorted list of numbers. The sorted list, ranging from highest to lowest, is:

11.1% 10.5% 8.5% 8.2% 7.7% 7.2% 5.3% 4.8% 4.5% 3.6% 3.4%

As the sorted list contains 11 numbers (one for each of the UK's 11 planning regions), the middle number is the sixth number in the list, with five above and five below its value. Here 7.2% (East of England) is the median value.

CASE STUDY 6.1

Real and nominal GDP

It is important to avoid confusing real and nominal gross domestic product or GDP. (Nominal GDP is also called money GDP.) The difference between the two is that nominal GDP is real GDP multiplied by the average current price level for the year in question.

According to ONS data published in February 2014, while *nominal* GDP rose by 3.4% in the UK in 2013, *real* GDP rose by only 1.8%, the difference between the two reflecting the impact of the rate of inflation in 2013. It is the change in real GDP which measures the economy's rate of growth — the change in nominal GDP overstates the growth rate.

The approximate change in the real GDP can be calculated by subtracting the rate of inflation from the rate of change of nominal GDP.

The photograph shows some cheeses on display in a delicatessen in Oxfordshire at the end of 2014. The cheeses contributed in a small way to the UK's real national output in 2014 — a contribution made even smaller because all the cheeses on display were imported.

Two of the cheeses on display in the Oxfordshire delicatessen were priced at £1.80 and £1.99 per 100 grams. Estimates for the level of UK nominal national output in 2014 were based on information about the prices charged for all goods produced in the UK, including cheeses sold by market stalls, delis and supermarkets. However, with imports, only the contribution to output added in the UK is included in the real and nominal values of UK GDP.

Follow-up questions

1 Why do domestically produced cheeses such as British cheddar contribute more to UK national output than imported cheeses such as French brie?
2 Find out what has happened to real GDP in the UK in the years since 2014.

CASE STUDY 6.2

The Great Depression in the 1930s

These days, a **recession** is defined in the UK (though not in the USA) as a fall in real GDP which lasts for at least 6 months. However, a depression (or slump) is a vaguer term, best thought of as a very deep and long recession. (According to an old joke, a downturn is when your neighbour loses his job, a recession is when you lose your own job, and a depression is when economists lose their jobs!)

The 1920s was a period of growing national prosperity in the USA. Nevertheless, the Great Depression, when it arrived in 1929–30, was steeper and more protracted in the USA than in other industrial countries. The US unemployment rate rose higher and remained higher longer than in any other Western country. US real GDP fell by 9.4% in 1930 and the US unemployment rate climbed from 3.2% to 8.7%. In 1931, real GDP fell by another 8.5% and unemployment rose to 15.9%. But 1932 and 1933 were the worst years of the Great Depression. By 1932, real GDP had fallen in the USA by 31% since 1929 and over 13 million Americans had lost their jobs. The US economy began the first stage of a long recovery in 1934: real GDP rose by 7.7% and unemployment fell to 21.7%.

A soup kitchen in Chicago during the Great Depression

Follow-up questions

1 Find out how a recession is defined in the USA. See the article 'Economists who make the recession call' by Stephen Foley, 8 January 2008, **www.independent.co.uk**.
2 Research the details of the recession the UK experienced in 2008/09. When did recovery from recession start, and what is the state of the economy at the time you are reading this book?

KEY TERMS
recession a fall in real GDP for 6 months or more.

KEY TERM
full employment according to Beveridge's definition, full employment means 3% or less of the labour force unemployed. According to the free-market definition, it is the level of employment occurring at the market-clearing real-wage rate, where the number of workers whom employers wish to hire equals the number of workers wanting to work.

SYNOPTIC LINK
Economic growth is explained in further detail in section 8.1 in Chapter 8.

Full employment and unemployment

There are different definitions of **full employment**, two of which we briefly explain in this chapter. First is the so-called Beveridge definition. In 1944, a famous White Paper on employment policy, written by William Beveridge (an economist at the London School of Economics, who later became Lord Beveridge), effectively committed modern governments to achieving full employment. In the White Paper, Beveridge defined full employment as occurring when unemployment falls to 3% of the labour force.

Partly because they regard Beveridge's 3% definition as too arbitrary and lacking any theoretical underpinning, free-market economists favour a second definition of full employment. For them, full employment occurs in the economy's aggregate labour market at the market-clearing real-wage rate, where the number of workers willing to work equals the number of workers whom employers wish to hire. In Figure 6.3, this is shown where the aggregate supply curve of labour intersects the aggregate demand curve for labour. The full employment wage rate is w_{FE} and the full employment level of employment is E_{FE}.

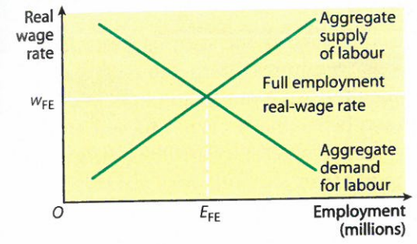


Figure 6.3 Full employment in the economy

Figure 6.3 could be interpreted as showing that when full employment occurs, there is absolutely no unemployment. However, as Figure 8.13 in Chapter 8 illustrates, in the real economy in which we live, this is not the case. Beveridge's definition of full employment accepts this fact. There will always be *some* unemployment, simply because the economy is constantly changing, with some jobs disappearing while new jobs are created. Chapter 8 describes and explains some of the main types of unemployment that economists recognise.

KEY TERMS
claimant count the method of measuring unemployment according to those people who are claiming unemployment-related benefits (Jobseeker's Allowance).
Labour Force Survey a quarterly sample survey of households in the UK. Its purpose is to provide information on the UK labour market. The survey seeks information on respondents' personal circumstances and their labour market status during a period of 1–4 weeks.

STUDY TIP
Make sure you appreciate the difference between the LFS and the claimant count measures of unemployment.

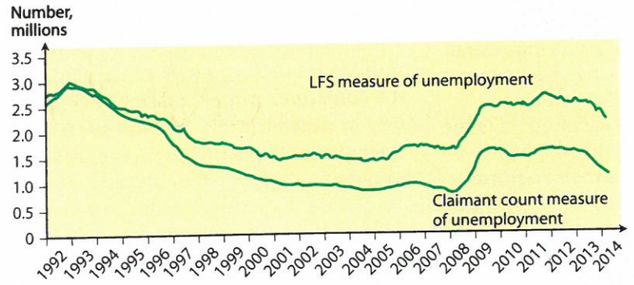


Figure 6.4 Changes in LFS unemployment and claimant count unemployment in the UK, 1992 to end of Quarter 1 2014

Two methods are used to measure unemployment in the UK. These are the **claimant count** measure and the **Labour Force Survey** (LFS) measure, which the UK government currently favours. The changes in UK unemployment, over a period starting in 1992 and ending at the beginning of the second quarter of 2014, using both measures of unemployment are shown in Figure 6.4.

SYNOPTIC LINK
Employment and unemployment are explained in further detail in section 8.2 in Chapter 8.

KEY TERMS

inflation a persistent or continuing rise in the average price level.

deflation a persistent or continuing fall in the average price level.

disinflation when the rate of inflation is falling, but still positive.

price index an index number showing the extent to which a price, or a 'basket' of prices, has changed over a month, quarter or year, in comparison with the price(s) in a base year.

consumer prices index (CPI) the official measure used to calculate the rate of consumer price inflation in the UK. The CPI calculates the average price increase of a basket of 700 different consumer goods and services.

retail prices index (RPI) the RPI is an older measure used to calculate the rate of consumer price inflation in the UK. Currently, the UK government uses the CPI for the **indexation** of state pensions and welfare benefits and for setting a monetary policy target, and the RPI for uprating each year the cost of TV and motor vehicle licences, together sometimes with taxes on goods such as alcoholic drinks.

indexation the automatic adjustment of items such as pensions and welfare benefits to changes in the price level, through the use of a price index.

Price stability

Inflation is a general rise in average prices (a rise in the price level) across the economy. This must not be confused with a change in the price of a particular good or service within the economy. Goods' prices rise and fall all the time in a market economy, reflecting consumer choices and preferences, and changing costs. If the price of one item — say, a particular model of car — increases because demand for it is high, this is not inflation. Inflation occurs when most prices are rising by some degree across the whole economy. A change in the price of one good may of course lead to a change in the measured rate of inflation, particularly if spending on the item makes up a significant fraction of total consumer spending.

Achieving absolutely stable prices is not necessarily the same as controlling the rate of inflation. Absolute price stability requires a zero annual rate of inflation, with the average price level neither rising nor falling from year to year. Although a zero rate of inflation has occasionally been achieved, it is extremely rare. Much more usually, in the UK at least, controlling inflation means achieving a low inflation rate rather than absolute price stability. For most of the last two decades, successive UK governments have aimed to achieve a 2% inflation rate. Usually, however, the inflation rate has been either a little above or a little below the 2% official target. On occasion, notably in the economic downturn in 2009, there were fears that the inflation rate would become negative. Negative inflation, which involves a falling average price level, is called **deflation**. Make sure you do not confuse deflation with **disinflation**, which occurs when the rate of inflation is falling but is still positive.

The changes that have taken place in the UK inflation rate between the start of 2000 and the end of the second quarter of 2014 are shown in Figure 6.5. The diagram introduces you to the fact that in the UK two different **price indices** are used to measure the rate of consumer price inflation. These are the **consumer prices index (CPI)** and the **retail prices index (RPI)**. The way in which the CPI and RPI are used to measure the rate of consumer price inflation are explained in section 6.3 of this chapter. (Note: *indices* is the plural of *index*.)

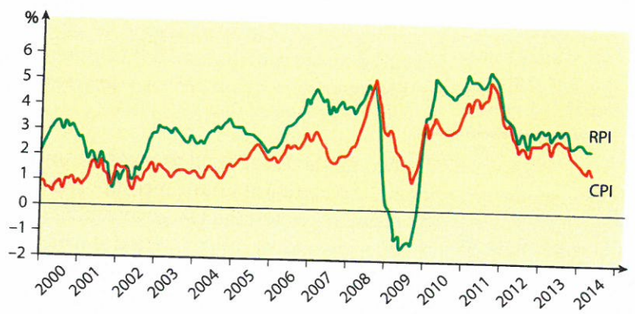


Figure 6.5 Changes in the RPI and the CPI inflation rates in the UK, 2000 to 2014
Source: ONS

QUANTITATIVE SKILLS 6.2

Worked example: calculating real values from nominal values

In Ruritania between 2014 and 2015, the rate of price inflation was 6% and the rate of increase of nominal GDP was 4%. What was the rate of increase of real GDP?

To answer this question, we use the equation:

rate of increase of real GDP = rate of increase of nominal GDP − rate of price inflation

Plugging the numbers given in the question into the equation, the rate of increase of real GDP = 4% − 6%, which equals −2%.

SYNOPTIC LINK
Inflation is explained in further detail in section 8.3 in Chapter 8.

STUDY TIP
You don't need to possess detailed technical knowledge of the construction of the CPI and the RPI, but you should appreciate the underlying features of the two price indices (see section 6.3).

KEY TERMS

balance of payments a record of all the currency flows into and out of a country in a particular time period.

current account of the balance of payments measures all the currency flows into and out of a country in a particular time period in payment for exports and imports, together with income and transfer flows.

exports domestically produced goods or services sold to residents of other countries.

imports goods or services produced in other countries and sold to residents of this country.

balance of trade the difference between the money value of a country's imports and its exports. Balance of trade is the largest component of a country's balance of payments on current account.

balance of trade deficit the money value of a country's imports exceeds the money value of its exports.

balance of trade surplus the money value of a country's exports exceeds the money value of its imports

TEST YOURSELF 6.1
Table 6.2 shows both the unemployment rate and inflation rate for an economy between 2013 and 2015.

Table 6.2

	Unemployment rate (%)	Inflation rate (%)
2013	5.4	3.3
2014	4.8	4.0
2015	4.0	4.5

What can you conclude from the data?

A satisfactory balance of payments

The **balance of payments** measures all the currency flows into and out of an economy in a particular time period, usually a month, quarter or year. An important part of the balance of payments is called the current account.

The **current account of the balance of payments** contains two main sections: the money value of **exports**, and the money value of **imports** (of both goods and services). Changes in these over a period extending from 1992 to 2012 are shown in Figure 6.6. Taken together, the money value of exports and imports make up the **balance of trade**. If the money value of imports exceeds the money value of exports, there is a **balance of trade deficit**; if the money value of imports is less than the money value of exports, there is a **balance of trade surplus**.

There are some other sections of the current account of the balance of payments, namely income flows and current transfers. These will be explained in Chapter 8.

The word 'satisfactory' can be interpreted in different ways. People sometimes assume that a satisfactory balance of payments only occurs when the government achieves the biggest possible current account surplus (i.e. the value of exports exceeding the value of imports by the greatest amount). However, a country can only enjoy a trading surplus if at least one other country suffers a trading deficit. It is mathematically impossible for all countries to have a current account surplus

STUDY TIP

You need to possess basic knowledge of the four sections of the current account of the balance of payments (exports, imports, income flows or primary income and transfers or secondary income).

SYNOPTIC LINK

The current account of the balance of payments is explained in further detail in section 8.4 in Chapter 8.

at the same time. Therefore, most economists take the view that a 'satisfactory' balance of payments is a situation in which the current account is in equilibrium, or when there is a small surplus or a small but sustainable deficit.

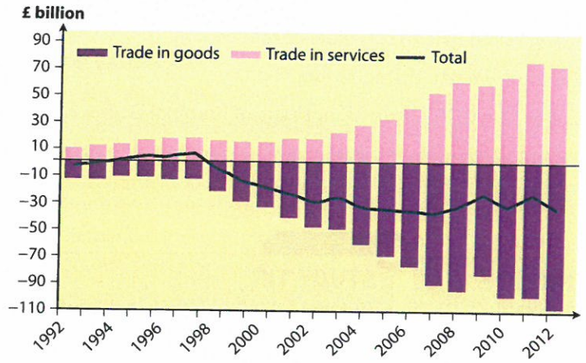


Figure 6.6 Changes in the UK's balances of trade in goods and services, 1992–2012

EXTENSION MATERIAL

The current account and capital flows

There are two main parts to the balance of payments: the current account and capital flows. The current account, which includes exports and imports, is so called because it measures *income* generated in the current time period flowing into and out of the economy. The second main section, capital flows, occur when residents of one country acquire *capital* assets located in other countries. Capital flows are of two types: direct capital flows and portfolio capital flows.

The Topshop store in New York, part of the Arcadia Group

Direct capital flows and their links with the current account of the balance of payments are illustrated as follows. A few years ago, Sir Philip Greene's Arcadia Group (a British company) invested in Topman shops in the USA. The payments made when purchasing the US stores were a capital outflow. However, once Arcadia's investment was complete and the company's American shops were up and running, they began to generate profits which flowed back to Arcadia in the UK. The profits repatriated to Arcadia in the UK were an inward investment income flow (a current account item), generated by the outward capital flow that had taken place in previous years.

By contrast, the payments made several years ago by Toyota when building car plants in Derbyshire were a capital inflow from Japan to the UK. Toyota's investment is an example of inward investment or foreign direct investment (FDI) into the UK. In this case, subsequent to Toyota's investment, profits made by the company's UK factories flowed out of the UK to the Japanese owners of the company. To sum up, outward capital flows generate inward income flows, while inward capital flows usually lead eventually to outward income flows.

Portfolio overseas investment involves the purchase of financial assets (that is, pieces of paper laying claim to the ownership of real assets) rather than physical or directly productive assets. Typically, portfolio investment occurs when fund managers employed by financial institutions, such as insurance companies and pension funds, purchase shares issued by overseas companies or securities issued by foreign governments. The globalisation of world security markets or capital markets and the abolition of exchange controls between virtually all developed countries have made it easy for fund managers and other UK residents to purchase shares or bonds that are listed on overseas capital markets.

KEY TERMS

balanced budget when government spending equals government revenue, which is mostly tax revenue.

budget deficit when government spending is greater than government revenue.

STUDY TIP

Make sure you are aware that governments have policy objectives other than achieving economic growth, low unemployment, a low inflation rate and a satisfactory balance of payments.

Other macroeconomic objectives

Governments may also have other objectives of macroeconomic policy, such as **balancing the budget** and achieving a more equitable or fairer distribution of income. Since the 2008/09 recession, the objective of balancing or at least reducing the government's **budget deficit** has become a very important macroeconomic objective. This will be explained in section 9.2 on fiscal policy in the final chapter of this book.

The opposite has been true in recent years in relation to achieving a more equitable distribution of income. During the recession and its aftermath, income inequalities have widened, which most people regard as inequitable.

SYNOPTIC LINK

Section 1.1 of Chapter 1 introduced you to the difference between positive and normative statements in economics. Section 5.7 of Chapter 5 explained how unequal and inequitable distributions of income illustrate the difference between positive and normative statements. At this stage, it will be useful to reread the two chapter sections.

KEY TERMS

policy conflict occurs when two policy objectives cannot both be achieved at the same time: the better the performance in achieving one objective, the worse the performance in achieving the other.

trade-off between policy objectives although it may be impossible to achieve two desirable objectives at the same time, e.g. zero inflation and full employment, policy-makers may be able to choose an acceptable combination lying between the extremes, e.g. 2% inflation and 4% unemployment.

A first look at policy conflicts

Economists often argue that it is difficult, if not impossible, for a government to 'hit' all its desired macroeconomic objectives at the same time. Believing they can't achieve the impossible, policy-makers often settle for the lesser goal of 'trading off' between policy objectives. A **trade-off** exists when two or more desirable objectives are mutually exclusive. Because the government thinks it cannot achieve, for example, full employment and zero inflation, it aims for less than full employment combined with an acceptably low and sustainable rate of inflation.

Over the years UK macroeconomic policy has been influenced and constrained by four significant conflicts between policy objectives. The main **policy conflicts** and their associated policy trade-offs are:

- between internal policy objectives of full employment and growth and the external objective of achieving a satisfactory balance of payments (or possibly supporting a particular exchange rate)

  full employment and economic growth ⟷ policy conflict and trade-off ⟷ satisfactory balance of payments or exchange rate

- between achieving full employment and controlling inflation

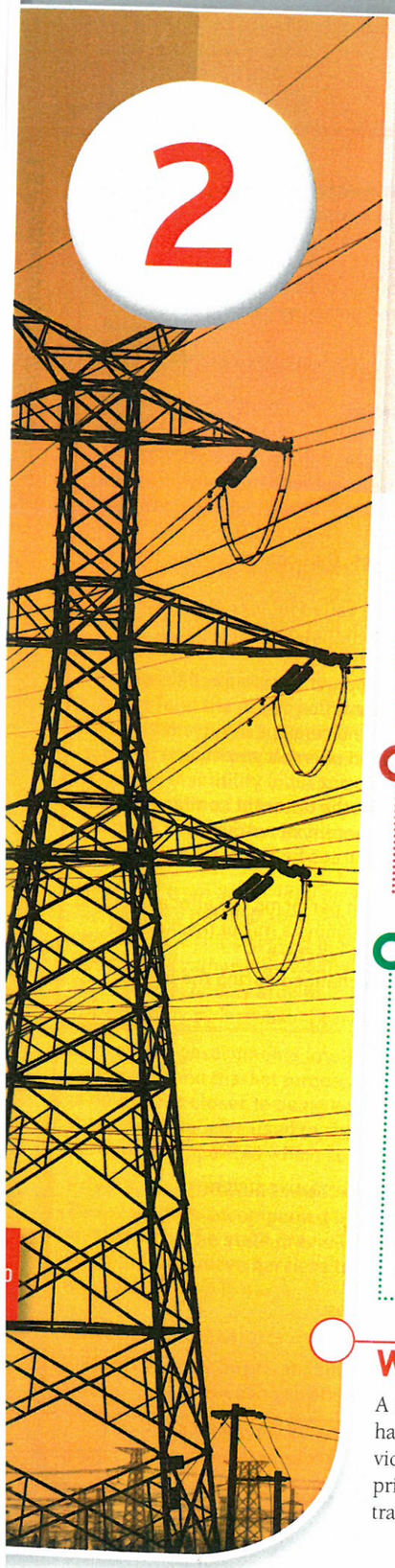
  full employment and economic growth ⟷ policy conflict and trade-off ⟷ control of inflation

- between increasing the rate of economic growth and achieving a more equal distribution of income and wealth

  economic growth ⟷ policy conflict and trade-off ⟷ greater income equality

- between higher living standards now and higher living standards in the future

  current living standards ⟷ policy conflict and trade-off ⟷ future living standards



2 Price determination in a competitive market

Chapter 1 introduced you to one of the fundamental economic problems: how to allocate scarce resources between competing uses in conditions in which there are limited resources and unlimited wants. In a market economy, resource allocation is undertaken by the price mechanism operating in the system of markets that make up the economy. This is true also in the 'market sector' of a 'mixed economy'. However, in a mixed economy there is also a 'non-market sector' in which goods and services such as roads and police are produced and delivered to final users 'outside the market'. The UK is often said to be a 'mixed economy' though in recent decades the nature of the 'mix' has been shifting towards a pure market economy and away from non-market provision.

This chapter focuses on markets and the price mechanism, and looks only at **competitive markets**. Many of the markets in the UK economy are uncompetitive markets, but these are investigated in Chapter 4.

KEY TERM

competitive market a market in which the large number of buyers and sellers possess good market information and can easily enter or leave the market.

LEARNING OBJECTIVES

This chapter will:

- explain the nature of demand and supply in a competitive market
- differentiate between a movement along a demand or a supply curve and a shift of a demand or a supply curve
- introduce the concept of elasticity and explain the different elasticities you need to know
- bring demand and supply curves together in a supply and demand diagram
- distinguish between market equilibrium and disequilibrium in a supply and demand diagram
- investigate different ways in which markets are interrelated
- examine a number of real-world markets

What is a market?

A market is a voluntary meeting of buyers and sellers. Both buyer and seller have to be willing partners to the exchange. If, for example, a buyer uses violence or the threat of violence to 'persuade' a seller to supply goods at a price unfavourable to the seller, this is a forced transaction and not a market transaction.

Markets do not have to exist in a particular geographical location. Whenever a good or service is voluntarily bought and sold, a market transaction takes place. Over history, market transactions shifted away from open-air street markets to take place in shops. Shops have higher overhead costs, but they offer a permanent site of exchange and a continuing relationship between sellers and buyers. In recent years, the growth of the internet has allowed 24/7 e-commerce. As a result many markets, especially those in commodities, raw materials and financial services, have become truly global.

Competitive markets

KEY TERMS

equilibrium price the price at which planned demand for a good or service exactly equals planned supply.

supply the quantity of a good or service that firms are willing and able to sell at given prices in a given period of time.

demand the quantity of a good or service that consumers are willing and able to buy at given prices in a given period of time. For economists, demand is always effective demand.

A market is highly competitive when there are a large number of buyers and sellers all passively accepting the ruling market price that is set, not by individual decisions, but by the interaction of all those taking part in the market. The ruling market price (or **equilibrium price**) is set by **supply** and **demand** in the market as a whole. Highly competitive markets lack entry and exit barriers. This means that new buyers and sellers can easily enter the market without incurring costs. In the same way buyers and sellers can leave the market if they wish to. Competitive markets also exhibit a high degree of transparency — buyers and sellers can quickly find out what everyone else in the market is doing.

2.1 The determinants of demand for goods and services

Households and firms operate simultaneously in two sets of markets. The first of these contains the goods markets in which households demand and buy consumer goods and services produced and supplied by firms. But for household demand in the goods market to be an **effective demand** — that is, demand backed up by an ability to pay — households must first sell their labour, or possibly the services of any capital or land they own, in the markets for factors of production. These were briefly mentioned in Chapter 1. Households' roles are therefore reversed in goods markets and factor markets. In this chapter, we ignore factor markets and focus solely on the determinants of demand for consumer goods and services.

KEY TERM

effective demand the desire for a good or service backed by an ability to pay.

Market demand and individual demand

KEY TERM

market demand the quantity of a good or service that all the consumers in a market are willing and able to buy at different market prices.

Normally when economists refer to demand, they mean **market demand**. This is the quantity of a good or service that all the consumers in the market wish to, and are able to, buy at different prices. By contrast, individual demand is the quantity that a particular individual, such as yourself, would like to buy. The relationship between market and individual demand is simple. Market demand is just the sum of the demand of all the consumers in the market.

The 'law' of demand

The 'law' of demand states that as a good's price falls, more is demanded. There is thus an inverse relationship between price and quantity demanded. Note that the word 'law' is in inverted commas. This is because a law in economics is not as strong or watertight as a law in a natural science subject such as physics. Whereas a law in physics will always hold, a social science

law always has 'ifs' and 'buts' attached. More of a good is *usually* demanded as its price falls, but there are exceptions, which are explained on page 24.

The market demand curve

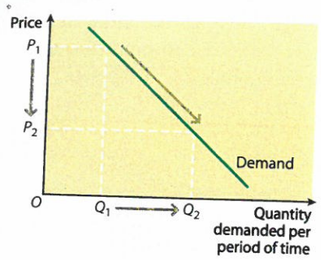


Figure 2.1 A market demand curve

The market demand curve in Figure 2.1 illustrates the 'law' of demand. If the price starts off high, for example at P_1, household demand is Q_1. But if the price falls to P_2, demand increases to Q_2.

Demand for a good varies according to the time period being considered. For example, weekly demand is different from daily, monthly and annual demand. For this reason, the horizontal axis in Figure 2.1 is labelled 'Quantity demanded per period of time'. It is normal practice to use the label 'Quantity' on the horizontal axis of a demand curve diagram, as we do in the rest of this book, but this is an abbreviation. It always refers to a period of time.

SYNOPTIC LINK

Microeconomic demand curves look very similar to aggregate demand curves, which are explained in Chapter 7. It is vital that you don't confuse the two. Likewise, don't confuse demand with consumption, which is a component of aggregate demand, also explained in Chapter 7.

ACTIVITY

Construct a questionnaire containing the following question: 'How many litre bottles of cola would you buy each week if the price was £2, £1.50, £1.00, 50 pence, 25 pence?' Ask a sample of your friends to answer the question and analyse their answers. What are the problems with estimating demand curves in this way?

Movement along a demand curve and shifts of a demand curve

STUDY TIP

You must understand the difference between a movement along a demand or supply curve and a shift of the curve.

Students often confuse a movement *along* a demand curve and a *shift* of a demand curve. A *movement along a demand curve* takes place only when the good's price changes. Provided the demand curve slopes downwards, a *fall* in price results in *more* of the good being demanded. This is sometimes called an extension of demand. Likewise, a contraction of demand occurs when a *rise* in price leads to *less* being demanded.

KEY TERM

condition of demand a determinant of demand, other than the good's own price, that fixes the position of the demand curve.

When we draw a market demand curve to show how much of the good or service households plan to demand at various possible prices, we assume that all the other variables that may also influence demand are held unchanged or constant. This is the ceteris paribus assumption, which means 'other things being equal'. Among the variables whose values are held constant or unchanged when we draw a demand curve are disposable income and tastes or fashion. Collectively, the variables (other than the good's own price) whose values determine planned demand are often called the **conditions of demand**. A change in a condition of demand shifts the demand curve to a new position.

The conditions of demand

The main conditions of demand are:

- the prices of **substitute goods** or goods in competing demand (see section 2.6)
- the prices of goods in joint demand or **complementary goods** (see section 2.6)
- personal income (or more strictly personal disposable income, after tax and receipt of benefits)
- tastes and preferences
- population size, which influences total market size

KEY TERMS

increase in demand a rightward shift of the demand curve.

decrease in demand a leftward shift of the demand curve

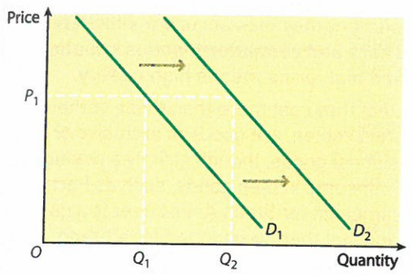


Figure 2.2 The effect of a rightward shift of demand

If any of the conditions of demand change, the position of the demand curve changes, shifting either rightward or leftward. Figure 2.2 illustrates a rightward shift of the demand curve, which is also called an **increase in demand**, and means more of the good is demanded at any given price. For example, at a price of P_1, the quantity demanded increases from Q_1 to Q_2. Conversely, a leftward shift of demand (known as a **decrease in demand**) causes the quantity demanded to fall at any given price.

Events that might cause a rightward shift of a demand curve include:

- an increase in the price of a substitute good or good in competing demand (see the section on the interrelationship between markets)
- a fall in the price of a complementary good or good in joint demand
- an increase in personal disposable income (but see the following section on normal goods and inferior goods)
- a successful advertising campaign making people think more favourably about the good
- an increase in population size

Normal goods and inferior goods

KEY TERMS

normal good a good for which demand increases as income rises and demand decreases as income falls.

inferior good a good for which demand decreases as income rises and demand increases as income falls.

When disposable income increases, a demand curve shifts rightward, but only if the good is a **normal good**, for which demand increases as income increases. However, some goods are **inferior goods**, for which demand decreases as income increases, and an increase in income shifts the demand curve leftward.

To take an example, private car transport and bus travel are not just substitutes for each other. As people's incomes rise, demand for cars generally increases, while, at the same time, demand for bus travel usually falls. If people respond in this way to changes in income then private transport is a normal good, but certain forms of public transport are inferior goods. For an individual, whether a good is normal or inferior depends on personal income, tastes and, possibly, age. For young children, junk food such as sweets is usually a normal good. When parents increase small children's pocket money, they generally buy more sweets. But as children get older, tastes change, and sweets may very well become an inferior good.

By contrast, a change in a condition of demand shifts the demand curve to a new position. As already explained, a rightward shift of demand is often called an increase of demand while a decrease of demand occurs when the demand curve shifts leftward.