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Topic 10

Macroeconomic Factors


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Session Objectives

- Define macro-economic policy
- Explain the main determinants of the level of business activity in the economy and how variations in the level of business activity affect individuals, households and businesses




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Session Objectives

- Explain the impact of economic issues on the individual, the household and the business:
 - i) Inflation
 - ii) Unemployment
 - iii) Stagnation
 - iv) International payments disequilibrium




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Session Objectives

- Describe the main types of economic policy that may be implemented by government and supra-national bodies to maximise economic welfare
- Recognise the impact of fiscal and monetary policy measures on the individual, the household and businesses



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Macroeconomics

- It is the study of how society allocates scarce resources which have alternative uses, between competing ends.
- It focuses on:
 - Overall demand for goods and services
 - Output of goods and services
 - Supply of factors of production
 - Total incomes earned by providers of factors of production

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Difference between Macro- and Micro-economics

- **Microeconomics** –study of economic behaviour of individual consumers, firms and industries
- **Macroeconomics** – Considers aggregate behaviour and the sum of individual economic decisions

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Macroeconomic Policy Objectives

- Economic Growth
- Inflation
- Unemployment
- Balance of Payments

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Factors Influencing Level of Business Activity

- Confidence
- Aggregate demand
- Capital
- Use of Resources
- Government Policy
- Exchange Rate Movements

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Confidence

- Greater Consumer confidence lead to higher business confidence and higher investment in new factories
- Confidence is adversely affected by political instability, disasters, unemployment, inflation

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Aggregate Demand

- It is the total demand for the country's output
- It is calculated as:

$$AD = \text{Consumer spending} + \text{Investment by firms} + \text{Government spending} + \text{Demand from exports} - \text{imports}$$
- Higher demand results in firms increasing output
- Higher demand can result in inflationary pressure

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Capital

- Firms need finance to invest in new projects
- Greater availability of finance results in higher investments
- Lower interest rates will make capital cheaper

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Use of Resources

- New Technology and more efficient working practices can improve productivity and lower costs
- Advances in level of education

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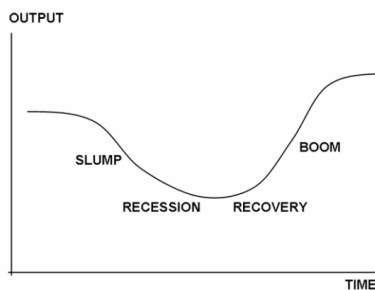
Government Policy

- Governments can increase or decrease the level of aggregate demand through fiscal policy
- Investment in the infrastructure of the economy can attract investment

Exchange Rate Movements

- Strengthening currency will make a country's exports more expensive
- Imports will get cheaper

Trade Cycles



Trade Cycles

- **Recession** starts when demand begins to fall.
- Reduction in demand feeds into household incomes and the economy moves into a **slump**
- Slowly economic activity begins to pickup and the economy moves to **recovery**.
- The economy will expand pushing upwards into **boom**.

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Stagnation and Economic Growth

- Growth implies:
 - More goods demanded and produced
 - People earn more and can afford more goods
 - More people should have jobs

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Problems with Growth

- Growth may not keep up with population growth
- Growth rates should exceed inflation rates for benefits to arise
- Growth may be in illegal goods like drugs
- Gap between haves and have nots may grow
- Measurement of growth is difficult given the existence of black market
- Rapid growth means rising incomes and leads to imports thus worsening BOP condition

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Inflation

- Government wants stable prices and low inflation because:
 - Inflation causes uncertainty and stifles investment
 - Not all incomes rise in line with inflation
 - Inflation may cause civil unrest

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Unemployment

- Unemployment is a problem because:
 - Unemployment benefits
 - Rise in crime
 - Waste of human resources

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Balance of Payment

- It is a statement of the balance of a country's trade and financial transactions with the rest of the world over a specific period - usually a year.
 - A long-term trade deficit needs to be financed.
 - A long-term trade can lead to inflationary surpluses leading to loss in international confidence

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Economic Policy Options

- Fiscal Policy options
- Monetary policy options
- Demand and supply side policies

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Fiscal Policy options

- Fiscal policy refers to government's taxation and spending plans. It includes:
 - A balanced budget: In the medium to long term, government should aim to achieve a balanced budget
 - Government income = Government Expenditure

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Fiscal Policy options

Balanced Budget

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Balance of Payment

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Relationship between government income and spending

Flow of funds into and out of country

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Running a Budget Deficit

- Govt income < Govt expenditure = Budget deficit
- Budget deficit is financed through borrowing
- It is referred to as the Public Sector Net Cash Requirement
- It is often used to close a deflationary gap

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Running a Budget Deficit

- Deflationary gap is said to exist when the current equilibrium level of national income is too low to provide employment opportunities for all those seeking work
- The government follows an expansionary policy to boost demand and reduce unemployment

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Running a Balanced Surplus

- Govt income > Govt expenditure = Budget surplus
- This may lead to inflation
- Inflationary gap exists
- Government follows a contractionary policy to reduce aggregate demand

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Monetary Policy Options

- Monetary policy refers to management of money supply in the economy.
- It can involve:
 - Changing interest rates
 - Setting reserve requirements for banks
 - Trading in foreign exchange markets

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Expansionary / Contractionary Monetary Policy

- Expansionary increases the money supply and contractionary decreases it
- Expansionary combats unemployment in a recession and contractionary raises interest rates to combat inflation

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Money Supply

- Money supply is the total amount of money in the economy.
- Measures of money supply include:
 - M0 = Notes and coins in circulation and balances at the country's Central Bank
 - M4= Notes and coins and all private sector sterling bank / building society deposits

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Reserve Requirements

- Banks operate a fractional reserve system.
- Only a part of their deposit is kept in cash.
- The proportion of deposits retained in cash is known as the **reserve asset ratio or liquidity ratio**.

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Open Market Operations

- By buying and selling its own bonds the government is able to exert some control over the money supply
- By buying back its bonds, it will release more cash
- By selling it will reduce the money in circulation

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Interest Rates

- High interest rates suppress demand for money due to increased cost of borrowing. Over a period of time the money supply will react to this reduced demand for money by contracting.
- In UK interest rates are set by Central bank

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Demand and Supply Side Policies

- Classical view (Do nothing)
- Keynesian View (Demand Side)
- Monetarist view (Supply Side)

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Achieving Policy Objectives: Growth

- Cut interest rates
- Running a budget deficit
- Supply side policies (Increase the availability of skilled labour through training schemes etc)
- Others:
 - Protectionist measures to reduce imports
 - Creating a stable economy
 - Tax incentives to boost growth

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Achieving Policy Objectives: Unemployment

- Cyclical unemployment
 - Unemployment is due to small demand to create employment
 - Monetarist can reduce this unemployment by supply-side measures
- Frictional Unemployment
 - People who move from job to job are short term unemployed
 - Can be reduced by a provision of better information through job centres and supply policies

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Achieving Policy Objectives: Unemployment

- Structure and Technological Unemployment
 - Caused due to structural change in economy leading to change in skills required
 - Supply side policies will be more effective
 - Government funded retraining schemes
 - Business start up advice and soft loans
 - Help with worker relocation costs
 - Improved information on employment opportunities

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Achieving Policy Objectives: Unemployment

- Seasonal Unemployment
 - Creates highly seasonal demand for workers
- Real Wage Unemployment
 - Occur in industries that are highly unionised
 - By keeping wages artificially high by the threat of strike action and closed shops, the number of people employed in the industry is reduced

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Achieving Policy Objectives: Inflation

- Demand-pull inflation
 - If demand for goods and services in the economy is growing faster than the ability of the economy to supply these goods and services, prices will increase
 - Demand side policies would focus on reducing aggregate demand through tax rises, cuts in government spending and higher interest rates

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Achieving Policy Objectives: Inflation

- Cost-push inflation
 - If the underlying cost of factors of production increases, this is likely to be reflected in an increase in output prices as firms seek to maintain their profit margin

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Achieving Policy Objectives: Inflation

- Imported inflation
 - A weakening of the national currency will increase the cost of imports and lead to domestic inflation
 - This can be reduced by policies to strengthen the national currency

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Achieving Policy Objectives: Inflation

- Monetary inflation
 - Inflation can result from over expansion of money supply as it increases the purchasing power
 - If the expansion is faster than the supply of goods it will lead to inflation

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Achieving Policy Objectives: Balance of Payments

- Balance of Payment Deficits
 - **Expenditure reducing strategies:** Shrink the domestic economy and thus reduce demand for imports
 - **Expenditure switching strategies:**
 - Import controls
 - Boost exports
 - Lower exchange rates or devaluation in case of fixed exchange rates

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