

# **CHAPTER 13: The National Economic Environment**

## **Key Revision Points**

### **Macro-economic analysis**

This chapter is concerned with 'macro-economic' analysis. Although the workings of the economy at a national level are the focus of this chapter, it must be remembered that even national economies form part of a larger international economic environment.

The national economy is a complex system whose functioning is influenced by a range of planned and unplanned forces.

### **The structure of the economy**

Most analyses of national economies divide the productive sectors into three categories:

- The primary sector
- The secondary sector
- The services sector

A further division in the economy occurs between the productive sector and the consumption sector.

- **Measures of economic structure**

The relative importance of the three productive sectors is usually recorded by reference to three key statistics:

- The share of gross domestic product (GDP), which each sector accounts for
- The proportion of the labour force employed in the sector
- The contribution of the sector to a nation's balance of payments.

A key trend in Britain, like most developed economies, has been the gradual decline in importance of the primary and manufacturing sectors, and the growth in the services sector.

- **Towards a service economy?**

The services sector has become a dominant force in developed economies, accounting for about three-quarters of all employment in the USA, UK, Canada and Australia.

A large part of the growth in the service sector during the 1980s and 1990s reflected the buoyancy of the primary and secondary sectors during that period.

- **International comparisons**

There appears to be a high level of correlation between the level of economic development in an economy (as expressed by its GDP per capita) and the strength of its services sector.

The more highly developed economies were associated with high percentages of workers employed in the services sector.

- **Consumer, producer and government sectors**

Consumer goods and services are provided for individuals who use up those goods and services for their own enjoyment or benefit.

Producer goods and services are those that are provided to other businesses in order that those businesses can produce something else of economic benefit.

There has been continuing debate about the role of government in the national economy, which has led to shifts in the proportion of GDP accounted for by the public sector.

By the mid 1990s, the proportion of UK government expenditure as a proportion of total GDP appeared to have stabilised in the range 38-42 per cent.

### **The circular flow of income**

Households, firms and government are highly interdependent and the level of wealth created in an economy is influenced by the interaction between these elements. To understand the workings of a national economy, it is useful to begin by developing a simple model of a closed economy comprising just two sectors - firms and households - which circulate money between each other.

In this simple model, the income of households is exactly equal to the expenditure of firms and vice versa. It follows that any change in income from employment is directly related to changes in expenditure by consumers.

Instability in this static model can come about for two principal reasons: additional money can be injected into the circular flow, while money currently circulating can be withdrawn.

- **The multiplier effect**

The multiplier effect can be compared to the effects of throwing a stone into a pond of water. The impact of the stone with the water will cause an initial wave to be formed, but beyond this will be waves of ever-decreasing strength. The strength of these ripples will lessen with increasing distance from the site of original impact and with the passage of time.

- **The accelerator effect**

Changes in the demand for consumer goods can lead, through an accelerator effect, to a more pronounced change in the demand for capital goods. This phenomenon is known as the accelerator effect. A small increase in consumer demand can lead to a sudden large increase in demand for plant and machinery with which to satisfy that demand.

- **Inflation**

Multiplier effects are associated with injections to the circular flow of income, causing more money to chase a fixed volume of goods and services available for consumption. This leads to the classic case of demand-pull inflation.

An alternative cause of inflation is referred as cost-push inflation. On the supply side, increases in production costs may push up the price at which companies are prepared to supply their goods.

- **Complex models of the economy**

Developing a model of the economy is very different from developing a model in the natural sciences. In the latter case, it is often possible to develop closed models where all factors that can affect a system of interrelated elements are identifiable and can be measured.

In the case of economic models, the system of interrelated components is open rather than closed. This means that not only is it difficult to measure components, it can be difficult to identify what elements to include as being of significance to a national economy.

### **The business cycle**

National economies are seldom in a stable state. This leads to the concept of the business cycle, which describes the fluctuating level of activity in an economy.

- **Measuring economic activity**

Gross Domestic Product (GDP) is just one indicator of the business cycle. In fact, there are many indicators of economic activity that may move at slightly different times to each other.

- Gross domestic product
- Unemployment rates
- Output levels
- Average earnings
- Disposable income
- Consumer spending
- Savings ratio
- Confidence levels
- Inflation rate
- Interest rates
- Overseas trade figures
- Exchange rates
- Government borrowing

- **Tracking the business cycle**

Businesses interested in predicting the cyclical pattern in the immediate and medium term future. If the economy is at the bottom of an economic recession, that is the ideal time for firms to begin investing in new productive capacity. In this case, accurate timing of new investment can have two important benefits:

- Firms will be able to cope with demand as soon as the economy picks up.
- At the bottom of the business cycle, resource inputs tend to be relatively cheap.

It is extremely difficult to identify a turning point at the time when it is happening.

## Macro-economic policy

Most Western governments have accepted that the social consequences of free market solutions to economic management are unacceptable and they therefore intervene to manage the economy to a greater or lesser extent.

- **Policy objectives**

This section begins by reviewing the objectives governments seek to achieve in their management of the national economy.

- **Maintaining employment:**

Three different types of unemployment require different solutions:

- ❖ Structural unemployment occurs where jobs are lost by firms whose goods or services are no longer in demand.
- ❖ Cyclical unemployment is associated with the business cycle.
- ❖ Technological unemployment occurs where jobs are replaced by machines.

- **Stable prices:** Rapidly rising or falling prices can be economically, socially and politically damaging to governments.

- **Economic growth:** A growing economy allows for steadily rising standards of living, when measured by conventional economic indicators.

- **Distribution of wealth:** Governments overtly and covertly have objectives relating to the distribution of economic wealth between different groups in society.

- **Improving productivity:** Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. Increasing the productivity of the economy has become a key objective of successive UK governments.

- **Stable exchange rate:** A stable value of sterling in terms of other major currencies is useful to businesses that are thereby able to accurately predict the future cost of raw materials bought overseas and the sterling value they will receive for goods and services sold overseas.

- **Government borrowing:** Government borrowing tends to rise during periods of economic recession and fall during periods of boom.

- **Government management of the economy**

Of the three principal economic objectives (maintaining employment, controlling inflation and economic growth), satisfying objectives for any two invariably causes problems with the third.

Two commonly used approaches to economic management can be classified under the headings of:

- Fiscal policy, which concentrates on stimulating the economy through changes in government income and expenditure
- Monetary policy, which influences the circular flow of income by changes in the supply of money and interest rates.

- **Limitations of government intervention in the national economy**

The fundamental concept of government intervention has been challenged in an emerging body of theoretical and empirical research which is commonly referred to as rational expectations theory. Proponents of the theory claim that it is too simplistic to regard government economic intervention in terms of simple stimulus–response models.

The theory of rational expectations holds that business people have become astute at interpreting economic signals and, because of this; government's ability to manage the national economy is significantly reduced.

- **The central bank**

A nation's central bank plays an important role in the management of the national economy. In the United Kingdom, the Bank of England acts as a lender of last resort and has responsibility for regulating the volume of currency in circulation within the economy. Through its market operations, it intervenes to influence the exchange rate for sterling. The Bank of England also has a supervisory role in respect of privately owned banks within the United Kingdom.