CONTENTS

GLOBALISATION

Not all countries benefit from trade, particularly those with poor international competitiveness. If a country is not benefiting from participating in free international trade, it is more likely to want to introduce some form of import control or protectionist measure. There is an enormous debate at the moment about the costs and benefits of globalisation, although there is vehement disagreement about what globalisation actually means.

THE WORLD TRADE ORGANIZATION (WTO)

The World Trade Organisation helps to promote free trade by persuading countries to abolish import tariffs and other barriers to open markets. The WTO was established in 1995 and was preceded by another international organisation known as the General Agreement on Tariffs and Trade (GATT). Membership of the WTO has expanded to 144 countries with 30 more nations waiting to join. It has evolved into a complex web of agreements covering everything from farm goods and textiles to banking and intellectual property.

The WTO is the only international agency overseeing the rules of international trade. It helps to settle trade disputes between governments. Advocates of free trade say the gains in economic welfare are substantial. Critics of the WTO say the poor have just got poorer as a result of free trade. They say that the rich countries have maintained protectionist policies, and that poorer countries do not have the type of manufacturing infrastructure and economies of scale to enjoy the benefits of free trade.

Supporters point to the World Bank's view that developing countries will grow twice as fast as industrialized countries in the first decade of the new millennium. Increasingly, the global economy is being concentrated into enormous trading blocs (e.g., EU and NAFTA) where free trade is encouraged within each bloc, but a range of import controls are established for goods and services entering a trade bloc.

INTERNATIONAL EXCHANGE

Britain needs to export goods and services to finance imports of those products we cannot produce in this country. Exports represent an injection of demand into the circular flow of income. There is an improvement in economic welfare if countries specialize in the products in which they have an comparative advantage and then trade with other nations.

Trade allows firms to exploit scale economies by operating in larger markets - the European Union has over 450 million consumers with a massive purchasing power. Economies of scale lead to lower average costs of production that might be passed onto consumers.

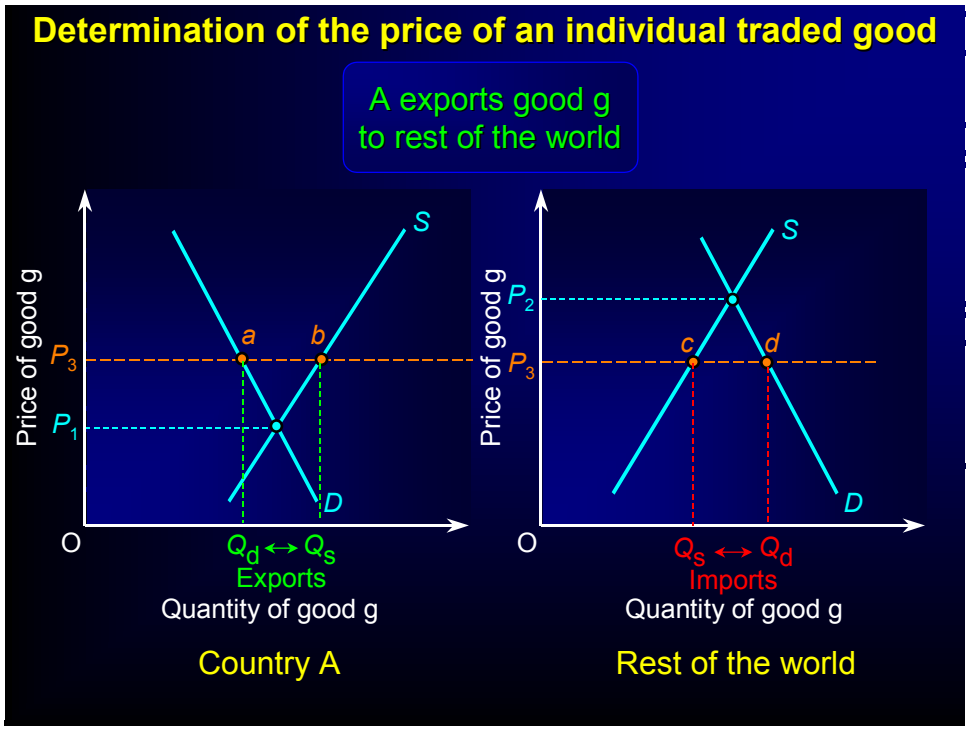
International competition stimulates higher efficiency - particularly for domestic monopolies. For example, Chorus faces very stiff competition from overseas steel producers.

Free trade provides greater choice for consumers and competition helps keep prices down

Imports can help to satisfy excess demand from consumers - acting as a safety valve for the economy. A trade deficit during an economic boom helps to reduce demand-pull inflation.

Trade in ideas stimulates product and process innovations that generates better products.

It is possible to demonstrate the gains from trade using supply and demand analysis:



The diagram shows Japan can produce camcorders at lower costs - its supply curve is lower than the UK. This means that Japan has a comparative advantage in producing camcorders.

In the absence of international trade between the two countries, British consumers would have to buy at a higher equilibrium price than Japanese consumers. Since Japan is more efficient, it makes sense for Japan to specialise in production of camcorders and export their surplus output to the UK at a lower free trade price. At the intermediate price shown in the diagram, (the free trade price) Japan sells exports to the UK for a higher price but this is still lower than the UK equilibrium price. Japan receives revenue from the sale of these exports.

UK consumers can now buy more camcorders at a lower price and have more choice in the market

We are ignoring transportation costs between the two countries and we are assuming that the resources that were previously allocated to producing camcorders in the UK can be reallocated to other industries (i.e. resources are assumed to be occupationally mobile).

THE COMMON AGRICULTURAL POLICY

Do not learn, just be aware of!

WHY INTERVENE IN THE AGRICULTURE MARKETS?

In the past most of the population were employed by agriculture. Labour has been very slow to leave agriculture which has resulted for most of the sector incomes which are below those of other occupations. This was deemed to be inequitable, so the government used *social policies* to try and raise them.

An economic reason for intervention is that prices are inherently unstable in a free market. Price elasticities of demand for food products are low because they are a need. This means that a very small change in quantity will lead to a large change in price. Supply is perfectly inelastic in the shortrun as farmers are unable to increase supply of foodstuffs until the following year. Unstable prices fail to signal to producers what consumers really want, therefore stabilising prices will lead it improve economic efficiency. This can also have a detrimental effect on the disposable incomes of farmers and consumers.

There is also a strategic argument for intervention, as a secure food supply is essential to any nation.

THE OBJECTIVES OF CAP

The following aims were highlighted in the Treaty of Rome:

- Increase productivity.
- Raise farm incomes.
- Stabilise markets.
- Assure the availability of supplies.
- Ensure reasonable prices for the consumer.

The formal title for the executive body of CAP is the European Agriculture Guarantee and Guidance Fund (EAGGF).

GUARANTEE SYSTEM

Whilst different agricultural goods are treated in different ways, the basis of the system is in the setting of a *target price* for each product. Different target prices are set for each area of the EU. This is not set with reference to world prices, but is based upon the price which is needed to cover costs, including a profit. The EU then sets an intervention or guaranteed price for the product in that area - this is usually about 7-10% below the target price.

If the price is in danger of falling below the guaranteed price then the commission will intervene to keep the price above that level. This is done for

all areas in the union. The guaranteed price acts as a floor below which the price cannot fall.

If this system of guaranteed prices is to work then EU farmers must be protected from low priced imports from overseas. This is done by the use of tariffs. This will not need to cover exactly the difference between the world price and the target price as the importer incurs transport costs. The tariff must therefore be large enough to raise the import price at the border to the target price minus transport costs - this is known as the *threshold price*. This calculation takes place in the highest cost area of the EU, this means that the import tariff will more than protect the producers in areas with lower target prices.

Finally should the EC producer wish to export an agricultural product, then an export subsidy will be paid to bring the receipts up to the intervention price.

THE EFFECTS OF THE CAP

The downgrading of the guidance section has meant the continuance of many small high cost farmers with correspondingly high target prices. High target prices have in turn encouraged excess supply in a number of products. This has required substantial purchases by EAGGF to keep the prices at the target level. These purchases create a number of problems of storage, which can only be reduced by selling at prices well below the intervention price. This puts a further strain on the budget. Many agricultural countries therefore suffer the effects of the world price for their good being depressed in addition to the lack of access to the European market. A study by the Australian Bureau of Agricultural Economics in 1985 suggested that CAP surpluses reduce the price of wheat, meat and sugar by between 9% and 17%.

Nearly 30 years of the policy has seen the EU transformed in markets such as wheat, where it used to be a net importer to a situation now where it is the second largest exporter after the USA. This situation came about from the mid 1970s and has led to an increasingly costly policy as the USA has tried to recover sales lost to EU farmers. Their export enhancement programme has had the aim of winning back sales to selected markets by offering extra subsidies. The effect of this subsidy war has been to lower the world price in many different agricultural goods. This problem has been amplified by the fact that production has been rising at a faster rate than consumption. Many farmers are also paid large sums of money to not grow anything, obviously this demonstrates there is a large amount of excess capacity (see following page).

PROBLEMS OF REFORM

Although we have seen a series of measures taken to try and reform the CAP, involving both price and output measures they have had relatively little impact. This has meant that within the union there have been many budget crisis's.

As we have seen it is not only the EU which has a costly system of protecting domestic agriculture. An OECD report estimated that the cost of this

protectionism ran at $53 billion for the EU, $33 billion for Japan and $32 billion for the USA.

During the Uruguay round of GATT talks there was a willingness to discuss a withdrawal of agricultural subsidies and to negotiate reductions of tariffs on foodstuffs.

GATT hoped the following points would be implemented, however to date, they have yet to be achieved:

- To allow market signals to influence agricultural production through a progressive and concerted reduction of agricultural support.
- The immediate need to prevent yet greater market imbalances by reducing the guaranteed prices and other production incentives.
- Any production restrictions or other interventions in markets should be implemented in ways that allow markets to work better.
- Low income farmers would be best helped through direct income support rather than by price guarantees or output related assistance.

Eventually under pressure after the Uruguay round of the GATT talks the MacSharry reforms were agreed to lower the level of support provided by the EU.

ECONOMIC ARGUMENTS FOR IMPOSING IMPORT CONTROLS

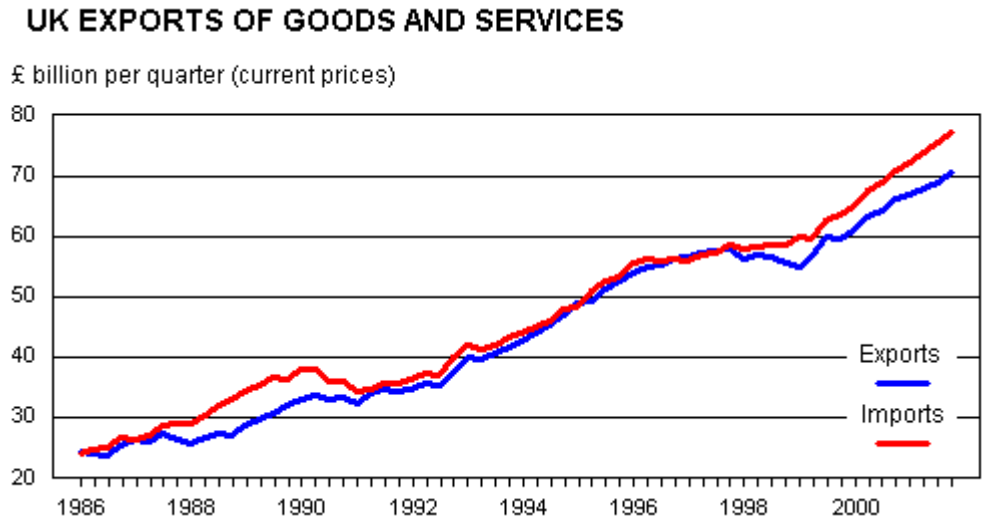
INFANT INDUSTRY ARGUMENT
Certain industries possess a potential comparative advantage but have not yet exploited the potential economies of scale.

Short term protection from established foreign competition allows the infant industry to develop its comparative advantage. At this point the protection could be relaxed, leaving the industry to trade freely on the international market. The danger of this form of protection is that the industry, free of the disciplines of foreign competition, will never achieve full efficiency.

PROTECTION AGAINST " DUMPING"
Dumping' refers to the sale of a good below its cost of production. In the short term, consumers benefit from the low prices of the foreign goods, but in the longer term, persistent undercutting of domestic prices will force the domestic industry out of business and allow the foreign firm to establish itself as a monopoly. Once this is achieved the foreign owned monopoly is free to increase its prices and exploit the consumer. Therefore protection, via tariffs on 'dumped' goods can be justified to prevent the long term exploitation of the consumer.

IMPROVING THE BALANCE OF PAYMENTS IN GOODS AND SERVICES
Trade barriers might be viewed as one vehicle to control the growth of demand for imports and therefore improve the overall balance of trade in

goods and services. The main problem with this is that import controls do not address fundamental issues of a lack of international competitiveness - and that trade barriers simply as a device for controlling a trade deficit do not wash with the World Trade Organisation.



EXTERNALITIES AND IMPORT CONTROLS

Protectionism can also be used to take account of *externalities and* dealing with *de-merit goods.* Goods such as alcohol, tobacco and narcotic drugs have adverse social effects and are termed de-merit goods. Protectionism can safeguarding society from the importation of these goods, by imposing high tariff barriers or by banning the importation of the good altogether.

NON ECONOMIC REASONS

Other arguments have been forward for protection, which although they may be valid are not purely economic. Countries may wish not to over-specialise in the goods in which they possess a comparative advantage. One of the potential dangers of over-specialisation is that unemployment may rise quickly if an industry moves into structural decline as new international competition emerges at lower costs

The Government may also wish to protect against high levels of imports to protect domestic employment

Protection may also be used to prevent trade with certain countries on political grounds. The UK government currently has trade sanctions with numerous countries, including Iraq, Nigeria and in certain commodities with the former Soviet bloc countries.

PROBLEMS WITH IMPORT PROTECTION

Loss of economic welfare

Welfare is reduced through higher prices and restricted consumer choice. Firms that are protected from competition have little incentive to reduce production costs. These disadvantages must be considered carefully by governments.

There is the danger that one country imposing import controls will lead to retaliatory action by another leading to a decrease in the volume of world trade

PROTECTIONISM - BARRIERS TO INTERNATIONAL TRADE

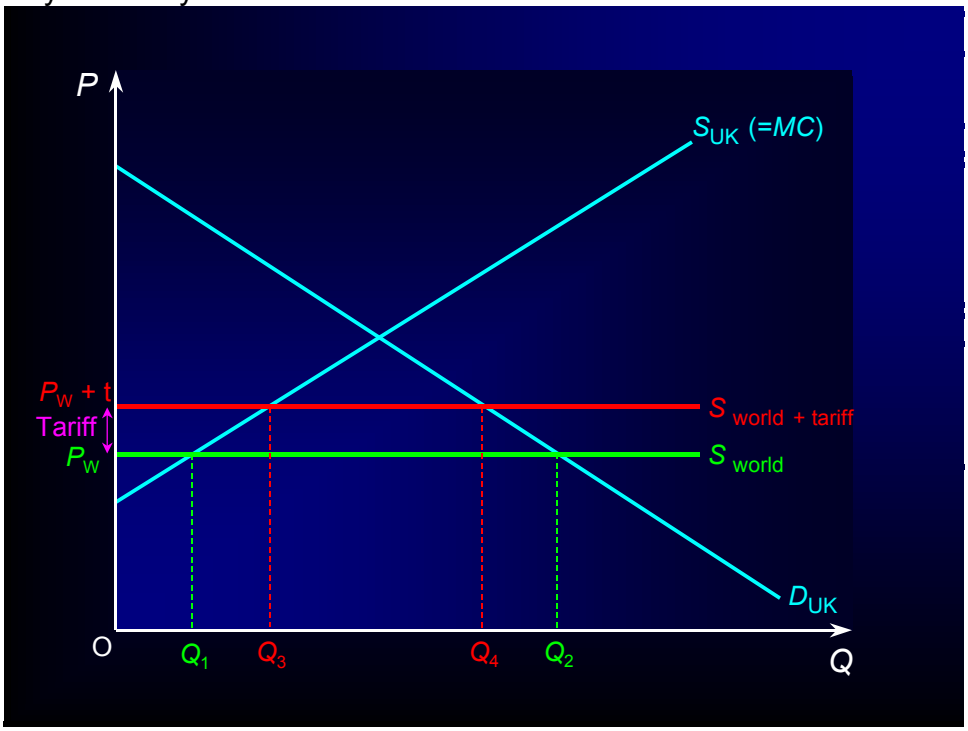
Import controls are barriers to the free movement of goods and service that seek to distort the pattern of trade between countries. In recent years, there has been a long running dispute between the European Union and the USA over bananas, beef, cashmere and steel.

A variety of import controls can be introduced:

TARIFFS

A tariff is a tax on imports and is used to restrict imports and raise revenue for the government. We assume in the diagram below that producers from other countries can supply the good at a constant price of P_W - their supply curve is perfectly elastic.

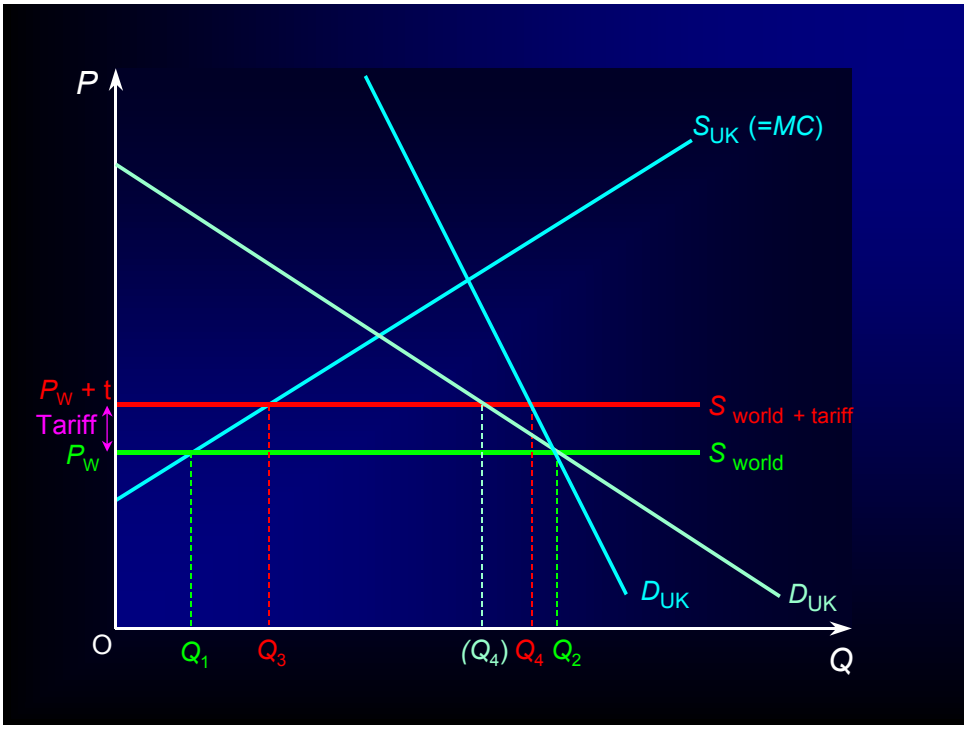
The domestic demand and domestic supply curves are shown. If the market price is P_W output Q_1 is produced by domestic firms and Q_2 will be the demand from home consumers. Because $Q_2 > Q_1$ imports will come into the economy to satisfy the excess demand.



A tariff is placed on the value of imports. This raises the price of imports to P_{W+T} and as a result, domestic demand contracts to Q_4 and domestic supply expands to Q_3. Home producers can supply more at the new higher price. The

tariff gives domestic firms a competitive boost. The volume of imports has reduced.

The effect of the tariff depends on the price elasticity of demand and the price elasticity of supply. A tariff will have a greater effect the more elastic the demand and supply. If the demand is inelastic then the imposition of a tariff will have little effect on the level of imports.

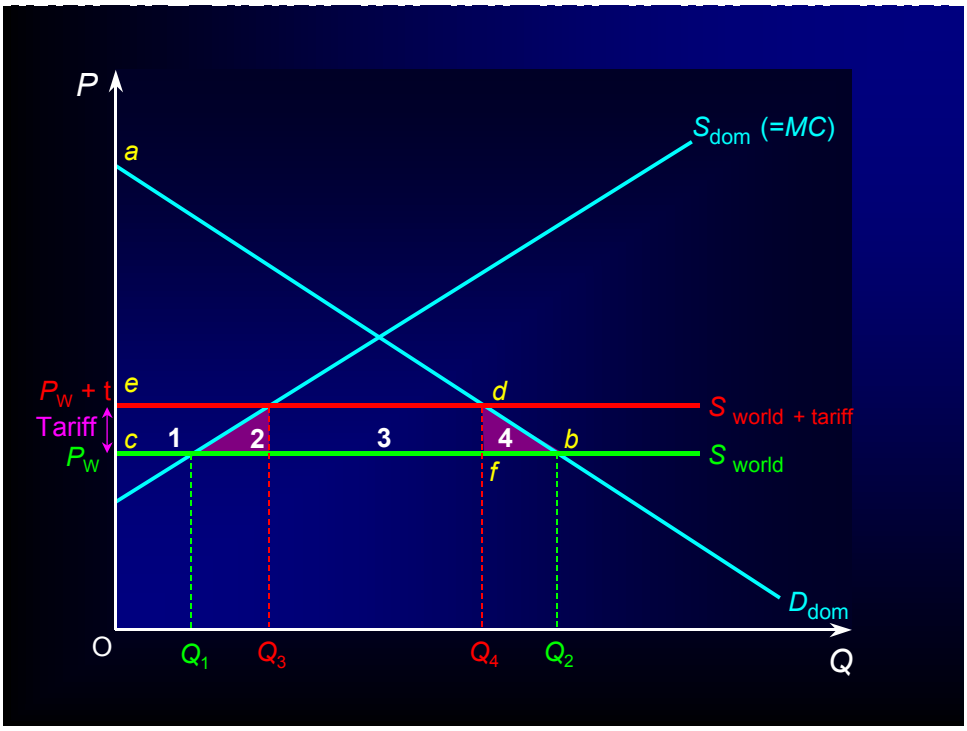


The introduction of tariffs by one country can lead to retaliation responses from other countries. This retaliation can lead to damaging trade-wars.

The imposition of a tariff will impose a cost on society. After the tariff is imposed the consumers have to pay a higher price and hence consumer surplus will fall from ABC to ADE. The cost to consumers is therefore EDBC (areas 1+2+3+4). Part of the cost is redistributed as benefit to other parts of society.

Firms receive a higher price and their producer will increase by area 1. The government receives extra revenue from tariff receipts - area 3 – i.e., $Q_4 – Q_3 \times$ Tariff.

However part of this cost is not recovered. Areas 2 and 4 are a net cost to society. Area 2 represents the extra costs of producing at home rather than importing. Area 4 represents the loss in consumer surplus as a result of the decrease in quantity from Q_2 to Q_4. The government should weigh up the costs and benefits before implementing any tariffs.



IMPORT QUOTAS
An import quota directly reduces the quantity of a product that is imported and indirectly reduces the amount of money that the export producers receive. The main beneficiaries of quotas are the domestic producers who face less competition.

EMBARGOES
This is where the government completely bans certain imports, e.g., drugs; or exports to certain countries, e.g., to enemies during a war.

ADMINISTRATIVE BARRIERS
Regulations may be designed in such a way to exclude imports. For example in Germany lagers had to pass certain purity tests and in Japan importers must complete so much paperwork and satisfy so many safety tests that many are put off.

PROCUREMENT POLICIES
This is where governments favour domestic producers when purchasing equipment, e.g., defence equipment.

VOLUNTARY EXPORT RESTRAINT
A voluntary export restraint is similar to an import quota. With a VER, the exporting country voluntarily restricts the number of goods that it ships to its trading partner. Foreign exporters must purchase licences from its government and then exports its allotted amount. The price they receive for their goods, minus the cost of the export licence, is their profits

EXPORT SUBSIDY

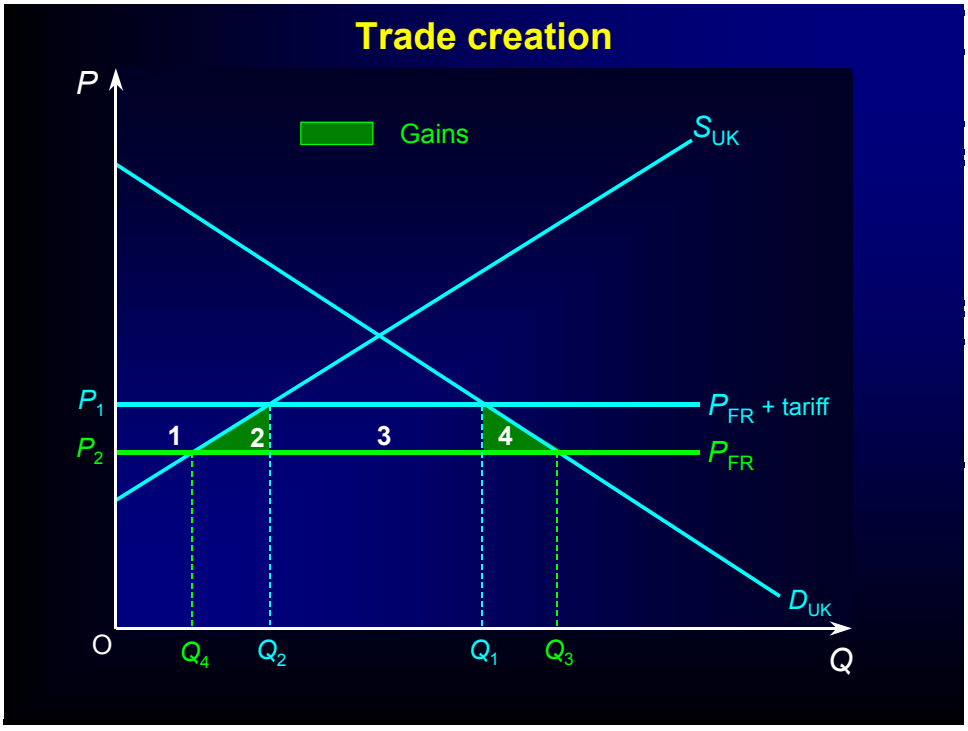
An export subsidy is a payment to a domestic producer who exports a good abroad. If receiving an export subsidy, a firm can remain competitive abroad by exporting up to the foreign price (because the subsidy will cover some of the difference) yet receive the higher price domestically. The effects of a subsidy are the opposite of those of a tariff. In the spring of 2001, a trade dispute arose between Canada and Brazil about trade-distorting export subsidies by the Canadian Government to its firms when trying to sell aircraft to the United States.

TRADE CREATION AND TRADE DIVERSION

These concepts are used to distinguish between the effects of free trade area or customs union formation that may be beneficial from those that are detrimental.

TRADE CREATION

This occurs when consumption shifts from a high cost producer to a low cost producer. If we assume that France is the most efficient producer of wine. After joining the EC it is now possible to import wine from France without paying the tariff. This will lead to an efficiency gain to UK consumers.



The diagram above shows that before joining the EC the UK had to pay the French price plus the tariff, P_1. At P_1 the UK produced Q_2, consumed Q_1, and therefore imported $Q_1 - Q_2$. With the removal of the tariff the price falls to P_2. Consumption increases to Q_3 and domestic production falls to Q_4. Imports have therefore increased to Q_3 - Q_4. Trade has been created.

The gain in welfare from the removal of the tariff can also be demonstrated in the diagram above. There has been an increase in consumer surplus of areas 1 + 2 + 3 + 4. On the other hand there has been a reduction in the producer surplus of UK wine producers of area 1 and a loss in government tariff revenues of area 3. This means there will always be a net gain of 2 + 4 when trade creation occurs as a result of a country joining a trading bloc.

TRADE DIVERSION

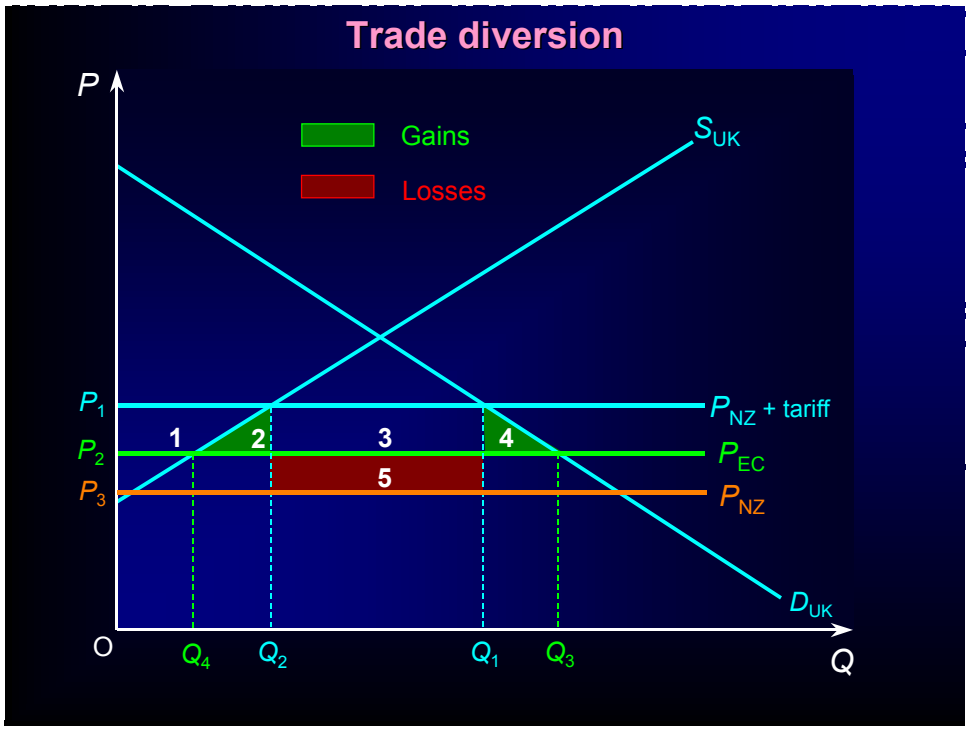
This occurs when consumption shifts from a lower cost producer outside the trading bloc a higher cost one within it.

Assume the most efficient producer of lamb in the world is New Zealand – a country outside of the EC. Assume that before membership the UK an identical tariff on lamb from any country, it would therefore import lamb from New Zealand rather than the EC.

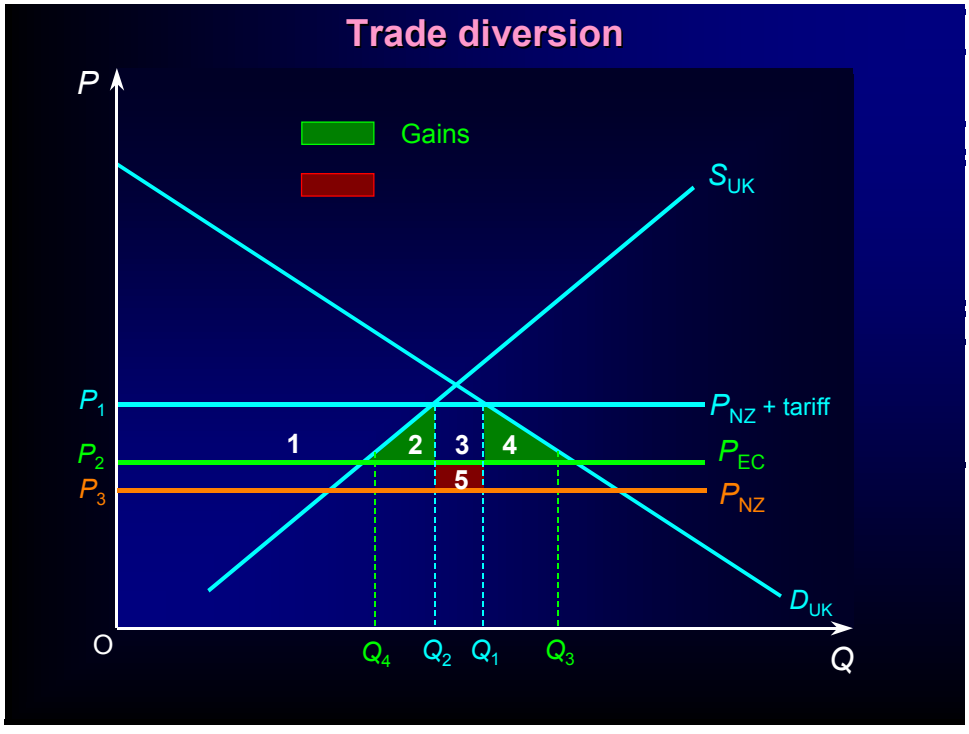
After joining the EC the removal of the tariff made the EC lamb cheaper as the tariff remains on the New Zealand lamb. Consumption is therefore switched to the higher cost EC lamb. This will lead to a reduction in worldwide efficiency. As far as the UK is concerned there will be gains and losses in welfare.

In the diagram overleaf, before joining the EC the UK was importing lamb from New Zealand at price P_1 (the New Zealand price the tariff). At this price the UK consumed Q_1, produced Q_2 domestically and therefore imported the remainder $Q_1 – Q_2$. On joining the EC it is now possible to consume the EC tariff free price of P_2 (this is above the New Zealand tariff free price of P_3). It is possible to state the gains and losses in welfare:

- There has been an increase in consumer surplus of areas 1 + 2 + 3 + 4.
- There has been a reduction in the producer surplus of UK lamb producers of area 1.
- There will be a loss of government tariff revenue of 3 + 5.



The will be a net loss in UK welfare if 2 + 4 < 5. It is possible that trade diversion will lead to an increase in UK welfare if 2 + 4 > 5, this is shown below.



These theories of trade creation and trade diversion hold for any good, e.g., agricultural goods (CAP).

A trading bloc is more likely to lead to trade diversion rather than trade creation if:

- When the bloc's external tariff is very high. Under these circumstances the abolition of the tariff within the union is likely to lead to a large reduction in the price of the goods imported from any other country within the bloc.
- When there is a relatively small cost difference between goods purchased with and outside the bloc. Here the abolition of even relatively low tariffs will lead to internally goods becoming cheaper than externally produced ones.

Preferential trade arrangements are often supported because they represent a movement in the direction of free trade. If free trade is economically the most efficient policy, it would seem to follow that any movement towards free trade should be beneficial in terms of economic efficiency. It turns out that this conclusion is wrong. Even if free trade is most efficient, it is not true that a step in that direction necessarily raises economic efficiency. Whether a preferential trade arrangement raises a country's welfare and raises economic efficiency depends on the extent to which the arrangement causes trade diversion versus trade creation.

AGGREGATE WELFARE EFFECTS OF A FREE TRADE AREA

The analysis above considers the welfare effects upon participants in one particular market in one country that is entering into a free trade area. However, when a free trade area is formed, presumably many markets and multiple countries are affected, not just one. Thus to analyse the aggregate effects of a FTA (Free Trade Agreement), one would need to sum up the effects across markets and across countries.

The simple way to do that is to imagine that a country entering a FTA may have some import markets in which trade creation would occur and other markets in which trade diversion would occur. The markets with trade creation would definitely generate national welfare gains while the markets with trade diversion *may* generate national welfare losses. It is common for economists to make the following statement, "If the positive effects from trade creation are larger than the negative effects from trade diversion, then the FTA will improve national welfare." A more succinct statement, though also somewhat less accurate, is that "if a FTA causes more trade creation than trade diversion then the FTA is welfare improving."

However, the converse statement is also possible, i.e., "if a FTA causes more trade diversion than trade creation then the FTA may be *welfare reducing* for a country." This case is actually quite interesting since it suggests that a movement to free trade by a group of countries may actually reduce the national welfare of the countries involved. This means that a movement in the direction of a more efficient free trade policy may not raise economic efficiency. Although this result may seem counterintuitive, it can easily be reconciled in terms of the theory of the second-best (not required knowledge for the A2 examination).

FREE TRADE AREAS AND THE THEORY OF THE SECOND-BEST

One might ask, if free trade is economically the most efficient policy, how can it be that a movement to free trade by a group of countries can reduce economic efficiency? The answer is quite simple once we put the story of FTA formation into the context of the theory of the second-best. Second-best theory suggests that when there are distortions or imperfections in a market, then the addition of another distortion (like a trade policy) could actually raise welfare, or economic efficiency. In the case of a FTA, the policy change is the removal of trade barriers rather than the addition of a new trade policy. However, the second-best theory works much the same in reverse.

Before a country enters a FTA it has policy imposed distortions already in place in the form of tariff barriers applied on imports of goods. This means that the initial equilibrium can be characterized as a second-best equilibrium. When the FTA is formed some of these distortions are removed, i.e., the tariffs applied to one's FTA partners. However, other distortions remain, i.e., tariffs applied against the non-member countries. If the partial tariff removal substantially raises the negative effects caused by the remaining tariff barriers with the non-FTA countries, then the efficiency improvements caused by free trade within the FTA could be outweighed by the negative welfare effects caused by the remaining barriers outside the FTA and national welfare could fall.

This is in essence what happens in the case of trade diversion. Trade diversion occurs when a FTA shifts imports from a more efficient supplier to a less efficient supplier which by itself causes a reduction in national welfare. Although the economy also benefits through the elimination of the domestic distortions, if these benefits are smaller than the supplier efficiency loss, then national welfare falls. In general, the only way to assure that trade liberalization will lead to efficiency improvements is if a country removes its trade barriers against all countries.

TRADING BLOCS

The world is increasingly dividing into trade blocs. The world's two most powerful economies, the United States, and the European Union, have each sought to forge links to neighbouring countries and deny access to rivals. Other major trading countries, like the fast growing exporters on the Pacific Rim and the big agricultural exporting nations, have also sought to create looser trade groupings to foster their interests.

The formation of free trade zones and trade blocs is one of the major issues facing the world trading system - whether it will lead to increased protectionism, or whether the trade blocs will promote trade liberalisation. A number of the main trade blocs are described below.

THE EUROPEAN UNION

Trade Flow:

- exports $813bn
- imports $801bn

The EU has become the most powerful trading bloc in the world with a GDP now exceeding that of the United States. The creation of the euro as a single currency for 12 EU members has led to ever closer economic links. The EU has found it difficult to shed its protectionist past based on the idea of self-sufficiency in agriculture which limits agricultural exports from the other countries.

Members:

- Austria
- Belgium
- Denmark
- Finland
- France
- Germany
- Greece
- Ireland
- Italy
- Luxembourg
- Netherlands
- Portugal
- Spain
- Sweden
- UK

NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA)

Trade Flow:

- exports $1,017bn
- imports $1,277bn

The United States has linked with Canada and Mexico to form a free trade zone, the North American Free Trade Agreement, and now hopes to extend that to the rest of Latin America to create a Free Trade Area of the Americas. The US is already negotiating with Chile to join NAFTA, but that has caused controversy with some other South American countries. The NAFTA agreement covers environmental and labour issues as well as trade and

investment, but US unions and environmental groups argue that the safeguards are too weak.
Members:

- Canada
- Mexico
- United States

THE CAIRNS GROUP

Trade Flow:

- exports $577bn
- imports $549bn

The Cairns group of agricultural exporting nations was formed in 1986 to lobby at the last round of world trade talks in order to free up trade in agricultural products. It is named after the town in Australia where the first meeting took place. Highly efficient agricultural producers, including those in both developed and developing countries, want to ensure that their products are not excluded from markets in Europe and Asia. Canada, Brazil and Argentina are other leading members.

Members:

- Argentina
- Australia
- Brazil
- Canada
- Chile
- Columbia
- Fiji
- Indonesia
- Malaysia
- New Zealand
- Paraguay
- Philippines
- South Africa
- Thailand
- Uruguay

ASIA-PACIFIC ECONOMIC COOPERATION FORUM

Trade Flow:

- exports $2,592bn
- imports $2,581bn

The Asia-Pacific Economic Cooperation forum is a loose grouping of the countries bordering the Pacific Ocean who have pledged to facilitate free trade. Its 21 members range from China and Russia to the United States, Japan and Australia, and account for 45% of world trade. Progress on free trade initiatives was seriously dented by the Asian crisis, which hurt the economies of the fast-growing newly industrialised countries like South Korea and Indonesia.

Members:

- Australia
- Brunei
- Canada
- Chile
- China
- Hong Kong
- Indonesia
- Japan
- South Korea
- Malaysia
- Mexico
- New Zealand
- Papua New Guinea
- Peru
- Philippines
- Russia
- Singapore
- Taiwan
- Thailand
- United States
- Vietnam

EUROPEAN FREE TRADE ASSOCIATION (EFTA)

It was established by the Stockholm Convention in 1960. It is a loose **free trade area** set up solely for industrial goods by the UK, Austria, Denmark, Norway, Portugal, Sweden and Switzerland.

It was set up in response to the EEC, which had closer political and economic ties. EFTA member countries feared that they would be excluded from the EEC's market.

As nations joined the EEC they had to leave the EFTA, presently leaving only Iceland, Norway, Sweden and Liechtenstein. As the EU expands it's likely that the number of EFTA members will continue to fall.

EUROPEAN ECONOMIC AREA (EEA)

Created by the signing of a treaty in Oporto in May 1992. It is a **free trade area** comprising of 18 nations, 380 million people and is responsible for about 40% of world trade.

The member states are those of the EU plus Iceland, Liechtenstein and Norway.

The purpose of the treaty is to allow the free movement of goods, persons, services and capital throughout the EEA.

If a country wishes to join the EU, it must first become a member of the EEA. Member states of the EFTA have the choice of joining the EEA.

Areas of EU policy that lie outside of the EEA are relations with other countries (trading and development), fiscal policy, economic and monetary union (EMU) and the common agricultural policy (CAP).

SOURCES OF POSSIBLE CONFLICT BETWEEN TRADING BLOCS

These disputes are constantly changing, information can be found at:
www.revisionguru.co.uk/economics/rows.htm

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BALANCE OF PAYMENTS

The balance of payments is a record of all the financial dealings of the UK with the rest of the world. It can be split into two components:

- The current account
- The capital account

Our trading performance with other countries has a big effect on prospects for the British economy. Over recent years we have tended to import more goods and services than we have exported. This is shown in the chart below which tracks the quarterly value of exports and imports since the mid 1980s.

THE CURRENT ACCOUNT

The current account is split into two sections itself:

- Visible trade
- Invisible trade

TRADE IN GOODS (VISIBLE TRADE)

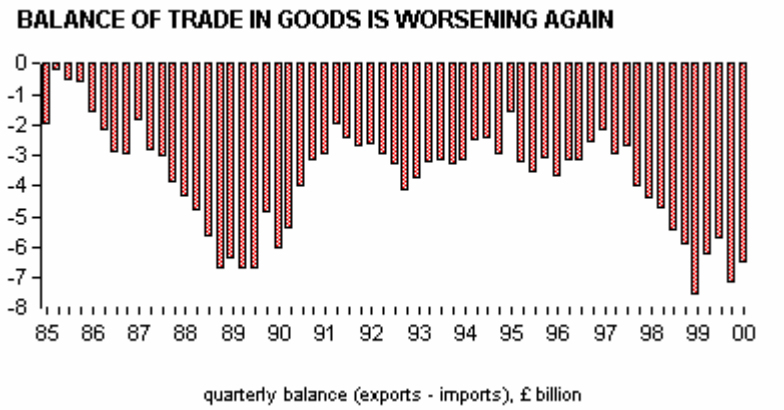
Trade in goods includes:

- Manufactured goods
- Semi-finished
- Components
- Energy products
- Raw materials
- Consumer and capital goods

The table overleaf shows the annual deficit in UK trade in goods with other countries since 1995

£ million	1995	1996	1997	1998
Food, beverages and tobacco	-4143	-5497	-5120	-6027
Basic materials	-3507	-3757	-3527	-3110
Oil	4331	4823	4549	3059
Other fuels	-542	-516	-371	-423
Semi-manufactures	-1763	-1482	-915	-1776
Finished manufactures	-6311	-6846	-6709	-12568
Unspecified goods	211	189	183	80
Total trade balance	**-11724**	**-13086**	**-11910**	**-20765**

The economy has run a **trade deficit** since 1983 with the gap widening considerably because of the excessive economic growth in the mid-late 1980s. The deficit shrunk in the early 1990s recession and during 3-4 years of exchange rate weakness between 1993-96. However the trade gap has widened again in 1998-99. This is due to the slowdown in export volumes caused by recession in other leading economies and the lagged effects of a sustained appreciation in the exchange rate over the last three years.

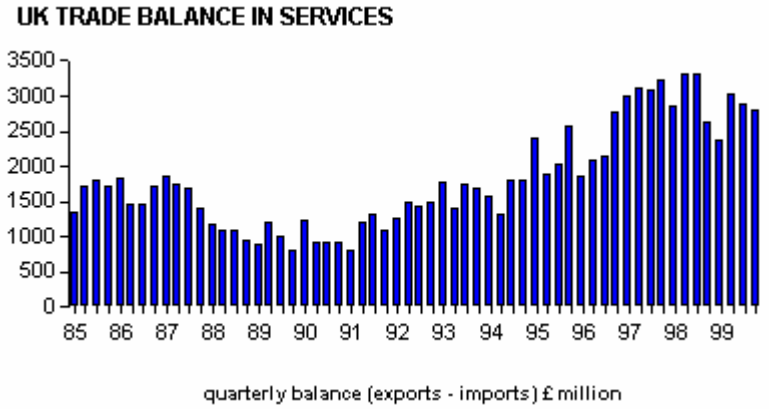


TRADE IN SERVICES (INVISABLE TRADE)

Trade in services includes:

- Financial services, e.g., banking and insurance
- Transport services, e.g., shipping and air travel
- Tourism
- Transfers resulting from the loan of factors of production abroad, e.g., interest received on a loan of capital to an American firm and a civil engineer working in Brazil on a construction project

The long-term growth and development of service sector industries is reflected in an improving trade balance for Britain with the rest of the world. This is shown in the chart below. The UK has now over-taken France and Germany to become the second biggest service exporter in the global economy.

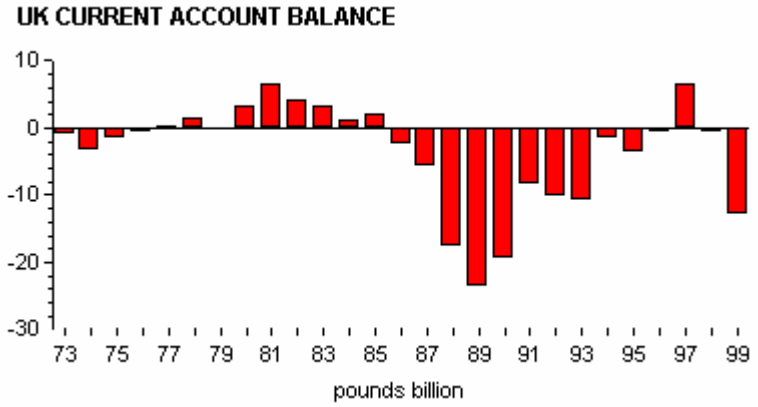


Is this where our comparative advantage now lies? The surplus in net exports of services has been on an up-ward path since the downturn of the early 1990s as the chart makes clear. In 1997 the surplus reached nearly £12 billion and in 1998 this grew to over £13 billion.

Not every service industry makes a net surplus in trade. The UK's main money earner is in business and financial services. Travel and tourism has been in deficit in recent years.

THE CURRENT ACCOUNT FOR THE UK

After recording small surpluses in the early 1980s, the UK balance of payments deteriorated badly in the late 1980s following the consumption driven economic boom. Recent years has seen a clear improvement in the figures although 1999 is forecast to see a return to deficit.



Often the root cause of a current account deficit is cyclical. During a boom the demand for imported goods and services rises strongly and if exports cannot keep pace the trade figures move into the red. The economic recession of the early 1990s caused the current account deficit to shrink. Then a boom in exports in 1994-96 lead to small quarterly surpluses in the bop accounts.

The UK has enjoyed current account surpluses in five of the last seven quarters. This is despite a worsening of the balance of trade in goods. The main reason for the improvement in the figures is the growing surplus in trade in services and very strong net investment income from overseas assets.

If the deficit is symptomatic of a lack of competitiveness in those sectors of the economy exposed to international trade, then specific policy measures may be required to help correct the deficit. In the UK's case, some economists believe that there is a structural problem in trade in goods - with the economy failing to export enough products to pay for the imports that we require.

If a country has open capital markets where money can flow into and out of an economy with ease, it should not be a problem to attract the capital inflows needed to finance a balance of payments deficit on the current account. However, in the long-term if imports are increasingly taking over from domestic producers, this threatens economic growth, employment and living standards in the deficit country.

THE CAPITAL ACCOUNT

To aid simplicity it can be split into two:

- Short term money flows
- Long term money flows

SHORT TERM MONEY FLOWS

Sometimes we describe this money as hot money or speculative money. Money is moved from country to country in the hope of making a profit, whether it is from higher interest rates in one country or because changes in the exchange rate are expected.

LONG TERM MONEY FLOWS

These are mainly associated with long term savings and investment. Foreign companies may choose to invest in the UK by building a new factory or widening its share portfolio by investing in the London Stock Exchange.

THE BALANCE OF PAYMENTS MUST BALANCE

If the UK is experiencing a current account deficit, then we have to find the money from somewhere to pay for it. We could borrow money from abroad to pay for it, run down our savings from abroad or sell some of the gold and foreign currency reserves.

CAN A COUNTRY SAFELY IGNORE A PERSISTENT CURRENT ACCOUNT DEFICIT?

The answer depends in part on what is causing the net outflow of money from the economy.

- A current account deficit has to be financed. This is normally done by attracting inflows of capital from other economies. The UK has found few problems in achieving this in recent years.
- If the deficit is due to excessive consumer demand – a recession or slowdown should help to reduce the problem. Consumers cannot go on spending in excess of their income for ever. Eventually they have to control their spending and start saving again to improve their own finances.

REMEDIES FOR BALANCE OF PAYMENTS DISEQUILIBRIUM

There are a number of policy options available to reduce a balance of payments deficit.

EXCHANGE RATE ADJUSTMENT

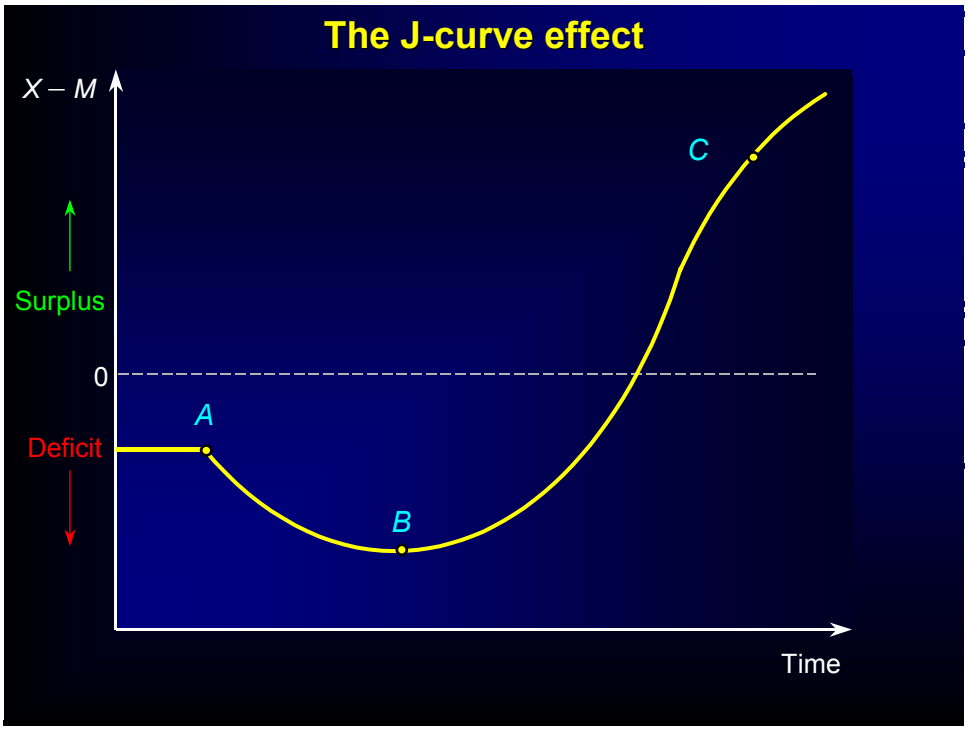
Devaluation results in **expenditure switching**. Foreigners buy more of our exports and less of their own and other countries' production, whilst domestic producers buy fewer imports and more domestically produced goods.

The extent to which exchange rates affect exports and imports will depend upon the elasticity of demand for the products and the nature of the contracts that have been agreed.

After a depreciation of the pound demand for exports will grow faster if the demand for UK goods overseas is elastic.

After a depreciation it may not be possible to switch away from imports as they maybe part of a long term contract, essential for production or cannot be made in the UK and have an inelastic demand. Then we end up spending more when the exchange rate falls in value causing the balance of payments to worsen in the short run a process known as the J curve effect.

Assuming that the economy begins at position A with a substantial current account deficit and there is then a fall in the value of the exchange rate. Initially the volume of imports will remain steady partly because contracts for imported goods will have been signed.



However, the depreciation raises the sterling price of imports causing total spending on imports to rise. Export demand will also be inelastic in response to the exchange rate change in the short term, therefore the earnings from exports may be insufficient to compensate for higher spending on imports. The current account deficit may worsen for some months. This is shown by the movement from A to B on the diagram.

Providing that the elasticities of demand for imports and exports are greater than one, in the longer term then the trade balance will improve over time. This is known as the Marshall-Lerner condition. In the diagram, as demand for exports picks up and domestic consumers switch their spending away from

imported goods and services, the overall balance of payments starts to improve. This is shown by the movement A to C on the diagram.

DEMAND MANAGEMENT

This is an **expenditure reducing** policy as aggregate demand falls causing fewer imports to be demanded. This is very effective in the UK as we have a very high marginal propensity to import. This can be carried out using either monetary or fiscal policies.

MONETARY POLICY

Higher interest rates reduce aggregate demand in four ways;

- Discouraging borrowing by both households and companies
- Increasing the rate of saving (the opportunity cost of spending has increased)
- The rise in mortgage interest payments will reduce homeowners' real 'effective' disposable income and their ability to spend. Increased mortgage costs will also reduce market demand in the housing market
- Business investment may also fall, as the cost of borrowing funds will increase. Some planned investment projects will now become unprofitable and, as a result, aggregate demand will fall.

These policies will reduce the demand for imports by households and firms in the UK.

FISCAL POLICY

- Higher direct taxes (causing a fall in disposable income)
- Lower Government spending
- A reduction in the amount the government sector borrows each year (PSNCR)

These fiscal policies increase the rate of leakages from the circular flow and reduce injections into the circular flow of income and will reduce demand for imports.

SUPPLY SIDE POLICIES

These should lead to increased exports and reduced imports as the quality of UK goods improve whilst they decrease in cost. Examples of supply side policies are:

- changes in size & quality of the labour force available for production
- changes in size & quality of capital stock through investment
- technological progress and the impact of innovation
- changes in factor productivity of both labour and capital
- changes in unit wage costs (wage costs per unit of output)
- changes in producer taxes and subsidies
- changes in inflation expectations - a rise in inflation expectations is likely to boost wage levels and cause AS to shift inwards

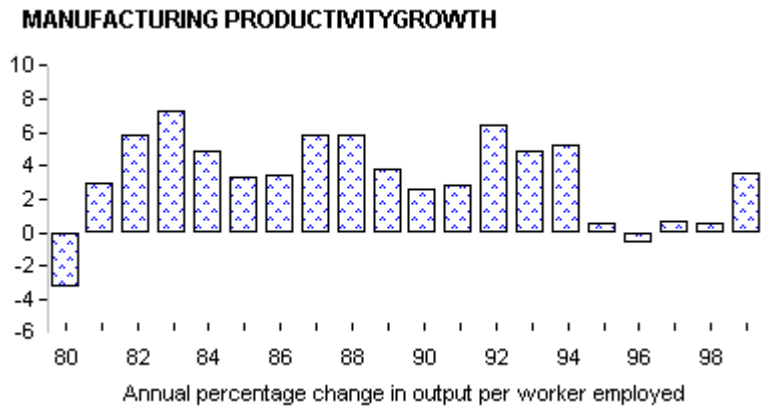
MEASURING INTERNATIONAL COMPETITIVENESS

"We have some of the greatest companies, some world class sectors, some global champions in whom we do and should take pride. But let us face facts. We have not enough of them and over the last 50 years, productivity growth in Britain has been just over two and a half per cent a year, compared to between three and a half per cent and four per cent among our main European competitors"
Gordon Brown, Speech to the British Chamber of Commerce, April 2000

Competitiveness is the ability of a nation to compete successfully internationally and sustain improvements in real output and wealth. There is no unique measure of competitiveness. We can use tangible measures such as unit labour costs, comparisons of GDP per worker, long-run average growth of real GDP and the IMD's Global Competitiveness Report.

The chart above shows relative unit labour costs for the UK against our major trading competitors. A rise in the index signifies a worsening of Britain's competitive position. Clearly in the last few years we have see a sharp rise in relative unit labour costs.

The main explanation for this is the sustained appreciation in the value of the exchange rate against other currencies. This has caused problems for exporters and domestic businesses who face severe competition from imported goods and services. Another reason is the relatively slow growth of manufacturing productivity - raising questions about why certain British industrial sectors lag behind in productivity against their major competitors.



The chart below shows the growth in real GDP for the UK. There is a rise in the long run trend, however it is susceptible to short run changes that are accounted for by cyclical factors.
A better method of international comparison is to use GDP per worker data as

produced by the Office of National Statistics. In the table below UK figures are indexed at 100.

	France	Germany	Japan	USA	G7	G7-UK
1992	128.6	108.3	103.9	137.1	120.8	122.8
1993	125.6	107.4	104.1	138.4	121.3	123.2
1994	124.6	111.1	103.4	138.5	122.0	124.0
1995	127.8	115.2	108.1	139.4	124.9	127.1
1996	120.8	110.0	106.6	136.6	121.9	124.0
1997	117.2	110.2	104.5	137.5	121.4	123.3
1998	115.2	107.2	100.5	137.3	120.0	121.8
1999	114.9	107.3	100.8	139.0	120.9	122.9
2000	114.4	106.6	100.9	141.6	121.9	124.0

Further information can be obtained by comparing the GDP per work per hour, again the UK is indexed at 100.

	France	Germany	Japan	USA	G7	G7-UK
1992	135.1	118.6	91.4	131.8	117.6	119.2
1993	131.8	118.6	94.1	131.4	118.1	119.8
1994	132.0	124.2	94.6	131.7	119.5	121.2
1995	137.7	131.0	99.8	131.8	122.6	124.6
1996	130.6	126.6	98.0	129.1	119.7	121.4
1997	126.9	127.1	97.3	129.2	119.1	120.8
1998	124.4	122.9	94.5	127.4	117.3	118.9
1999	123.8	122.8	94.2	127.7	117.4	119.0
2000		123.0		128.9		

WHAT DETERMINES THE VALUE OF AN EXCHANGE RATE?

The global market for foreign exchange currencies is massive. Hundreds of billions of £s and $s are traded in the dealing rooms each day. The market is open 24 hours a day for people, companies and governments needing foreign exchange to finance their transactions. Money now moves round the international financial system at tremendous speed (aided by the spread of computer technology and the gradual abolition of exchange controls between countries). Speculative activity in the market is a major determinant of a currency's value.

Short and long-term movements in the exchange rate, like any price, are caused by changes in market demand and supply conditions

THE DEMAND FOR STERLING (£S)

Sterling is demanded for several reasons:

- To purchase UK exports – foreigners need sterling in order to buy our exports (although this is usually done through a third party such as the original importer). As exchange rates rise so does the price of UK exports and therefore there should be a fall in exports meaning a fall in the demand for sterling.
- Foreign investment in the UK – Nissan may want to build a new factory in the UK they need to spend pounds to do this. Foreign investors may wish to put money in UK banks, perhaps attracted by high rates of interest.
- Speculation – Traders on the foreign exchange markets buy and sell sterling for profit. A high exchange rate usually means demand for sterling is low as traders realise that the next movement is likely to be a fall in the exchange value. This is the most important cause of short term exchange rate changes.

As the exchange rate rises the demand for sterling falls and vice versa.

THE SUPPLY OF STERLING (£S)

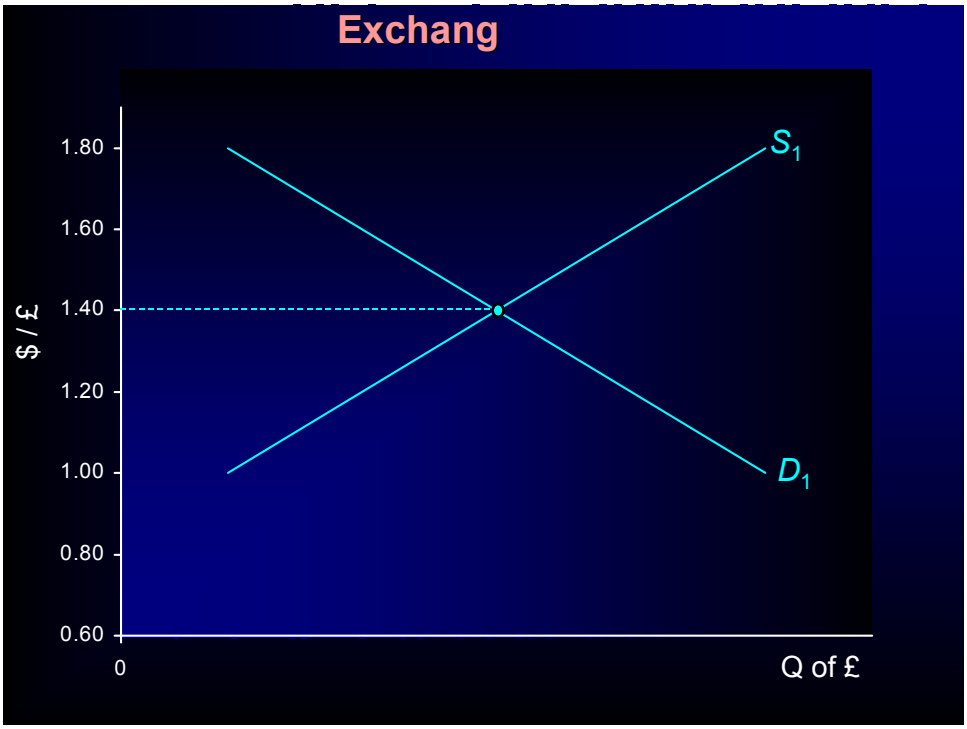
Sterling is supplied for similar reasons:

- To purchase foreign imports – UK importers need to supply sterling in order to buy foreign currency so that they can buy their imported goods. As the exchange rate rises, the price of imports falls, there should be an associated increase in imports, which leads to an increase in the supply of sterling to pay for them.
- UK investment abroad
- Speculation.

As the exchange rate rises the supply of sterling will also rise and vice versa.

EQUILIBRIUM

The equilibrium exchange rate is shown below:



The equilibrium is set where D = S at £1:$1.40.

FUNDAMENTAL FACTORS THAT DRIVE A CURRENCY

INTEREST RATES

Interest rates have a large effect in a world where financial capital can move freely between countries. When a country's interest rates are high relative to elsewhere this attracts inflows of money into a country seeking to take advantage of the high interest rates. This "interest differential" boosts the demand for the currency and can cause its value to rise.

ECONOMIC GROWTH

Countries experiencing a **deep recession** often find that their exchange rate is weakening. Traders in the currency markets may take the slow growth to be a sign of general economic weakness and "mark down" the value of the currency as a result.

On the other hand, economies with strong "export-led" growth may see their currency's rise in value. Japan is a good example of this in recent years. The Euro was weak during the first six months of its existence in part because the financial markets were worried about the slow growth of the European economy and the persistently high level of unemployment.

INFLATION

In the long run, those countries with higher than average inflation see their exchange rate fall. When inflation is high, a country becomes less competitive in international markets causing a fall in exports (a demand for a currency) and a rise in imports (a supply of currency overseas). A fall in the exchange rate may be needed to restore a country's competitiveness in overseas markets.

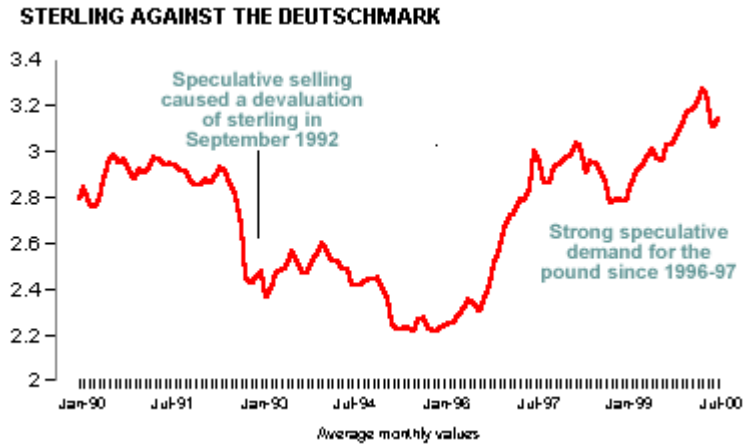
THE BALANCE OF PAYMENTS

Selling exports represents a demand for the domestic currency from foreign importers. When US consumers but British Whisky they supply dollars and this is eventually translated into a demand for pounds.

Similarly when UK consumers buy imports, they supply their own currency and this is eventually translated into a demand for foreign currencies. If a country is running a substantial trade surplus there is a large demand for the currency and its value should appreciate. By contrast a massive trade deficit usually causes the currency to lose value.

MARKET SPECULATORS

Special factors (such as political events, changing commodity prices etc.) can have an effect on a currency. In addition the power of market speculators has grown. When speculators decide that a currency is going to fall in value, they sell that currency and buy ones they anticipate will rise in value.



It is difficult for government's to offset the power of speculators because their reserves of foreign currencies are very small compared to daily turnover in the market. We saw in 1997 and 1998 speculative attacks on currencies in Asia and seven years ago, the pound was forced out of the European exchange rate mechanism because of speculative selling of the pound.

GLOBAL FOREIGN EXCHANGE MARKETS

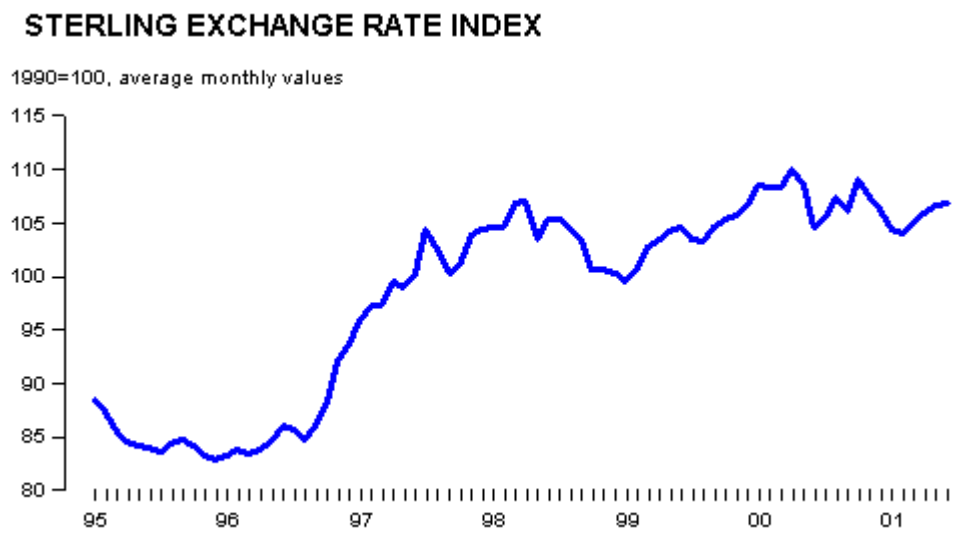
The exchange rate measures the external value of sterling in terms of how much of another currency it can buy. For example - how many dollars you can buy with £1000. The daily value is determined in the foreign exchange markets (FOREX) where billions of $s of currencies are traded every hour.

Currencies are traded around the world in a truly **global market**. The scale of currency transactions is enormous. In London alone over $450 billion worth of currency is bought and sold each day with London easily the largest FOREX market in the world.

MEASURING THE UK EXCHANGE RATE

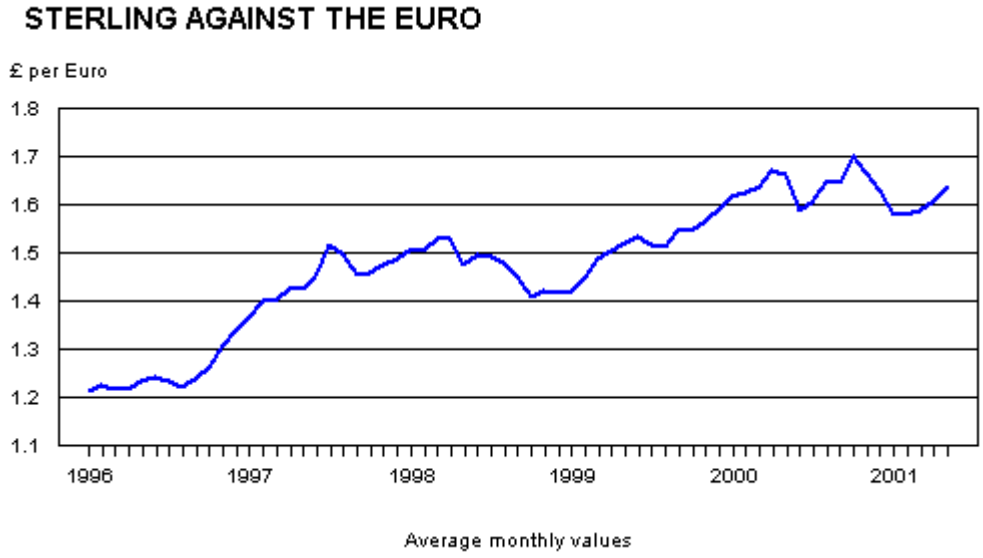
Exchange rate index (EER)

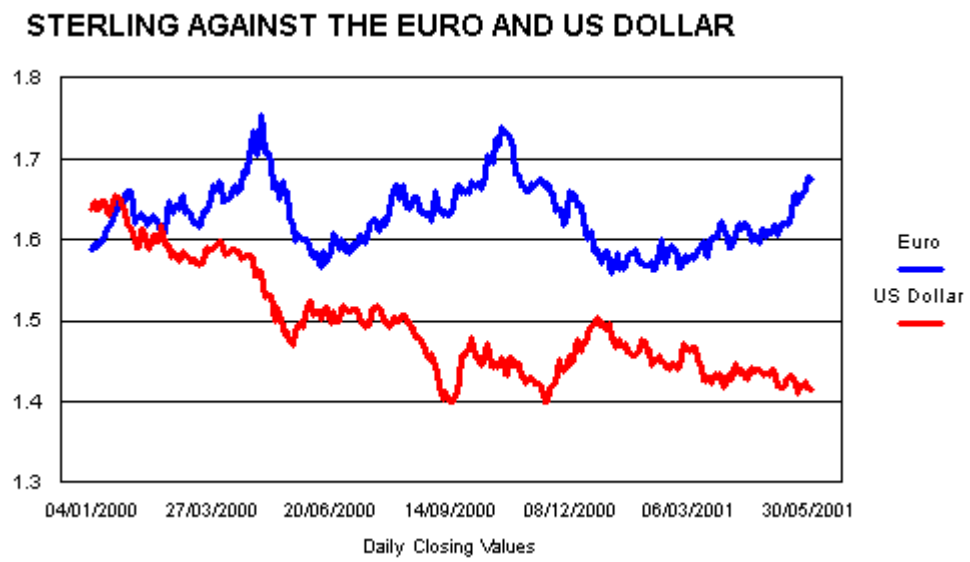
The EER is a weighted index of sterling's value against a basket of international currencies Weights used are determined by the proportion of trade between the UK and each country



Bi-Lateral Exchange Rate

This is simply the value of sterling against another country. No weighting is made concerning the importance of trade. Two examples would be sterling against the Euro (i.e. the 12 member nations of the Euro Zone) or sterling against the US dollar



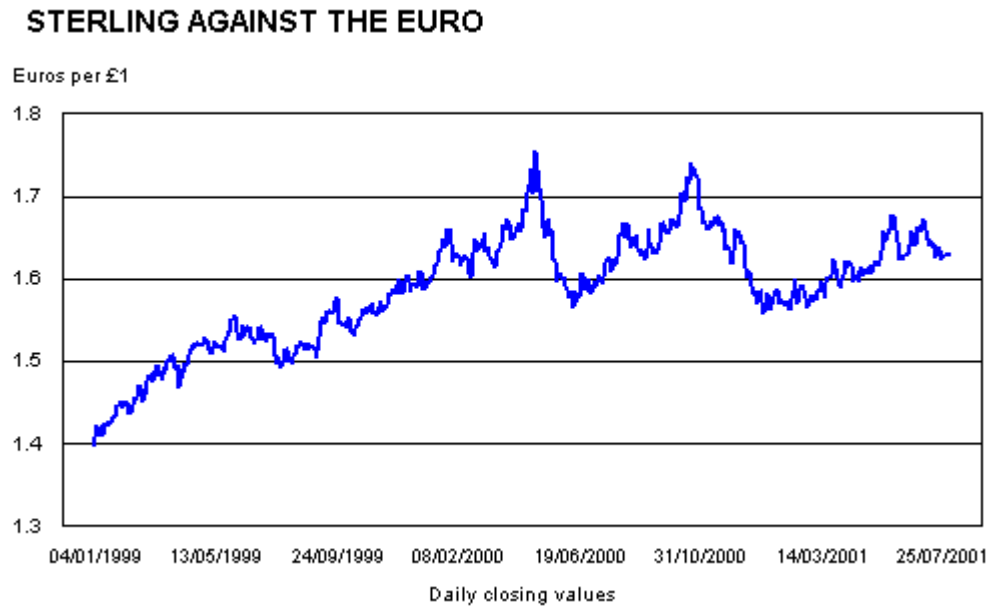


ECONOMIC EFFECTS OF EXCHANGE RATE CHANGES

Changes in the exchange rate can have a powerful effect on the economy - but these effects take time to show through. There are time lags between a rise or a fall in the exchange rate, and changes in variables such as inflation, GDP and exports & imports. Much depends on

- The scale/size of any change in the exchange rate
- Whether the change in the currency is short term or long term
- How businesses and consumers respond to exchange rate fluctuations

WINNERS AND LOSERS FROM EXCHANGE RATE FLUCTUATIONS



In recent years the sterling exchange rate has risen appreciably against a range of other leading currencies - not least the Euro since its inception in January 1999. Who are the main gainers and losers from a rising exchange rate?

An appreciation of the exchange rate has economic consequences both in the short and long term. As the economy adjusts to a higher exchange rate, some of the main beneficiaries and losers start to emerge.

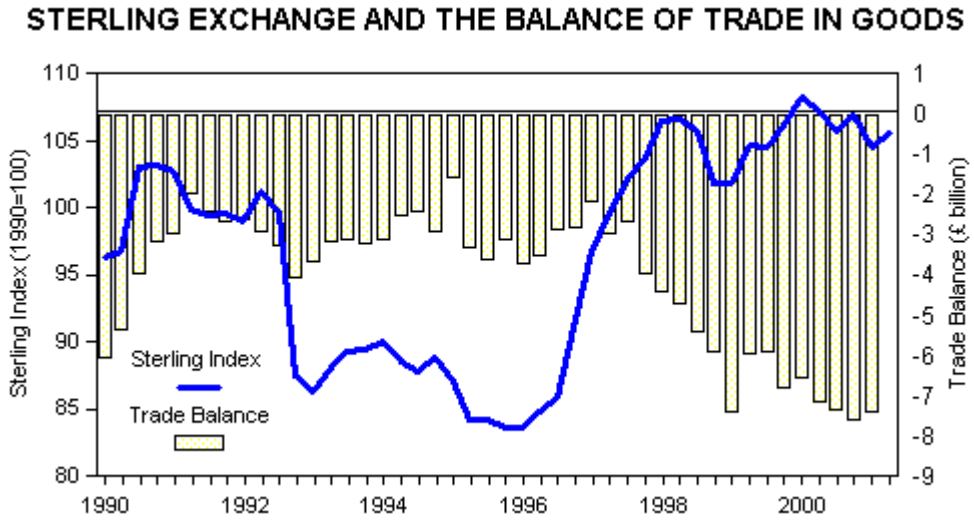
ADVANTAGES OF A STRONG POUND

A high pounds leads to lower import prices - this boosts the real living standards of consumers at least in the short run - for example an increase in the real purchasing power of UK residents when travelling overseas

When sterling is strong, it is cheaper to import raw materials, components and capital inputs - good news for businesses that rely on imported components or who are wishing to increase their investment of new technology from overseas countries.

A strong exchange rate helps to control inflation - domestic producers face stiff international competition from cheaper imports and will look to cut their costs accordingly. Cheaper prices of imported foodstuffs etc. will also have a negative effect on the rate of consumer price inflation.

DISADVANTAGES OF A STRONG POUND



Cheaper imports leads to rising import penetration and larger trade deficit e.g. the £28bn trade deficit in goods in 2000

Exporters lose price competitiveness and market share - this damages profits and employment in some sectors - notably manufacturing industry in the last three years

If exports fall, this has a negative impact on economic growth. Some regions are affected more than others. The strength of sterling in the last five years is one of the factors highlighted when economists analyse the north-south economic divide in the UK

Many business organisations have identified the strength of the exchange rate as a major economic problem over recent times.

Economists argued in the summer of 2001 that the pound should be lower by at least 10% in order to prevent manufacturing industry falling into an economic slump.
However it should be noted that business can adapt to a high exchange rate. There are ways in which industries can adjust to the competitive pressures that a strong pound imposes. Some of the options include:

- Cutting export prices (lower profit margins) to maintain competitiveness and market share
- Out-sourcing components and raw materials from overseas
- Seeking productivity / efficiency gains to keep unit labour costs under control
- Investing resources in new product lines where both domestic and overseas demand is more price inelastic and less sensitive to exchange rate fluctuations. This involves producing products with a higher income elasticity of demand, where non-price factors are more important in securing orders.
- Moving production overseas

THE EFFECTS OF AN EXCHANGE RATE DEPRECIATION
A **depreciation of the pound** sees the pound fall against other currencies. The economic effects of a lower pound take time to happen - economists say that there are **time lags** between a change in the exchange rate and changes in, for example, inflation and the balance of payments.

The last major depreciation in the value of sterling came in the early-mid 1990s following sterling's departure from the exchange rate mechanism. The pound was devalued by nearly 15% against a range of currencies in September 1992 and continued to drift lower in value for the next three years.

Below are some of the main economic effects of a lower value for the pound

Inflation
A fall in the exchange rate makes imported goods and services more expensive in the UK. Producers may then pass on higher costs of imported components and raw materials onto consumers. This causes extra "cost-push" inflation. Wages may rise in response to this triggering off the possibility of a wage-price spiral.

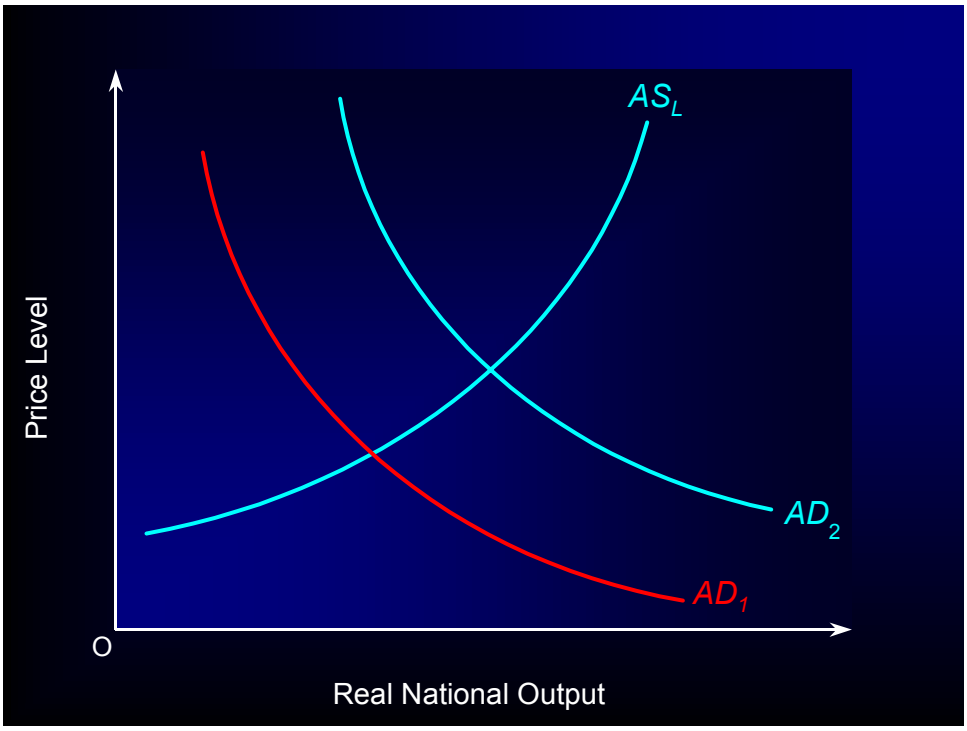
The extent to which a depreciation of the pound causes inflation depends in part on how dependent producers are for their imported components and also their willingness to "price to the market" and pass on costs to consumers.
In a recession demand for many goods is elastic and a lower pound may have little effect on retail price inflation.

Exports And The Balance Of Payments
Exporters should benefit from a lower pound (even allowing for the inevitable time lags). A depreciation makes UK goods cheaper priced in a foreign currency. Demand for exports will grow faster if the demand for UK goods overseas is elastic.

Imports
The demand for imports should fall as imports become more expensive. However, some imports are essential for production or cannot be made in the UK and have an inelastic demand - we end up spending more on these when the exchange rate falls in value. This can cause the balance of payments to worsen in the short run (a process known as the J curve effect, see unit 3).

Wage Demands
Partly due to higher inflation and falling real incomes, wages may rise. This depends on what stage of the economic cycle the economy is in. When unemployment is high, workers may have little confidence that their wage demands will be met.

Economic Growth (GDP)
Higher exports (an injection into the circular flow) and falling imports leads to rising GDP levels.



FIXED AND FLOATING EXCHANGE RATES

In a fixed exchange rate system, the government (or the central bank acting on the government's behalf) intervenes in the currency market so that the exchange rate stays close to an exchange rate target. When Britain joined the European Exchange Rate Mechanism in October 1990, we fixed sterling

against other European currencies. The pound, for example, was permitted to vary against the German Mark by only 6% either side of a central target of DM2.95. Britain left the ERM in September 1992 when the pound came under sustained selling pressure, and the authorities could no longer justify very high interest rates to maintain the pound's value when the domestic economy was already suffering from a deep recession.

Since autumn 1992, Britain has adopted a floating exchange rate system. The Bank of England does not actively intervene in the currency markets to achieve a desired exchange rate level.

In contrast, the twelve members of the Single Currency agreed to fully fix their currencies against each other in January 1999. In January 2002, twelve exchange rates became one when the Euro entered common circulation throughout the Euro Zone.

EXCHANGE RATE SYSTEMS FOR THE UK SINCE 1944
1944-72: Fixed Exchange Rates
Occasional devaluations against dollar (1948 and 1967)
1972-87: Managed Floating
1987-88: Shadowing the DM (Under Chancellor Nigel Lawson)
1988-90: Managed Floating (prelude to ERM entry)
1990-92: Semi-Fixed Exchange Rates
1992-01: Floating Exchange Rate
Bank of England has not intervened in the currency markets for the last nine years meaning that Sterling has been market determined.

TYPES OF EXCHANGE RATE SYSTEM

FREE FLOATING

With floating exchange rates, changes in market demand and market supply of a currency cause a change in its value. Trade flows and capital flows are the main factors affecting the exchange rate. In the long run it is the macro economic performance of the economy (including trends in competitiveness) that drives the value of the currency (see later notes).

No pre-determined official target for the exchange rate is set by the Government. The government and/or monetary authorities can set interest rates for domestic economic purposes rather than to achieve a given exchange rate target. It is rare for pure free floating exchange rates to exist - most governments at one time or another seek to "manage" the value of their currency through changes in interest rates and other controls

UK sterling has floated on the foreign exchange markets since the UK suspended membership of the ERM in September 1992

MANAGED FLOATING EXCHANGE RATES
Value of the pound determined by market demand and supply of the currency with no pre-determined target for the exchange rate is set by the Government. Governments normally engage in managed floating if not part of a fixed exchange rate system. Policy pursued from 1973-90 and since the ERM suspension from 1993-1998

SEMI-FIXED EXCHANGE RATES
Exchange rate is given a specific target. Currency can move between permitted bands of fluctuation. Exchange rate is dominant target of economic policy-making (interest rates are set to meet the target). Bank of England may have to intervene to maintain the value of the currency within the set targets. Re-valuations possible but seen as last resort. October 1990 - September 1992 during period of ERM membership

FULLY-FIXED EXCHANGE RATES
Commitment to a single fixed exchange rate. No permitted fluctuations from the central rate. Achieves exchange rate stability but perhaps at the expense of domestic economic stability. Bretton-Woods System 1944-1972 where currencies were tied to the US dollar. Gold Standard in the inter-war years - currencies linked with gold. Countries joining EMU in 1999 . fixed their exchange rates until the Euro was introduced in January 2002.

ADVANTAGES OF FLOATING EXCHANGE RATES

Fluctuations in the exchange rate can provide an **automatic adjustment** for countries with a large balance of payments deficit. If an economy has a large deficit, there is a net outflow of currency from the country. This puts downward pressure on the exchange rate and if a depreciation occurs, the relative price of exports in overseas markets falls (making exports more competitive) whilst the relative price of imports in the home markets goes up (making imports appear more expensive).

This should help reduce the overall deficit in the balance of trade provided that the price elasticity of demand for exports and the price elasticity of demand for imports is sufficiently high.

A second key advantage of floating exchange rates is that it gives the government / monetary authorities **flexibility in determining interest rates.** This is because interest rates do not have to be set to keep the value of the exchange rate within pre-determined bands.

For example when the UK came out of the Exchange Rate Mechanism in September 1992, this allowed a sharp cut in interest rates which helped to drag the economy out of a prolonged recession.

ADVANTAGES OF FIXED EXCHANGE RATES

Fixed rates provide greater **certainty** for exporters and importers and under normally circumstances there is less **speculative activity** - although this depends on whether the dealers in the foreign exchange markets regard a given fixed exchange rate as appropriate and credible. Sterling came under intensive **speculative attack** in the autumn of 1992 because the markets perceived it to be overvalued and ripe for a devaluation.

Fixed exchange rates can exert a strong discipline on domestic firms and employees to keep their costs under control in order to remain competitive in international markets. This helps the government maintain low inflation - which in the long run should bring interest rates down and stimulate increased trade and investment.

COUNTRIES WITH DIFFERENT EXCHANGE RATE REGIMES

Countries with fixed exchange rates often impose tight controls on capital flows to and from their economy. This helps the government or the central bank to limit inflows and outflows of currency that might destabilise the fixed exchange rate target,

The Chinese Renminbi is essentially fixed at 8.28 renminbi to the US dollar. Currency transactions involving trade in goods and services are allowed full currency convertibility. But capital account transactions are tightly controlled by the State Administration of Foreign Exchange.

The Hungarians have a semi-fixed exchange rate against the Euro with the Forint allowed to move 2.5% above and below a central rate against the Euro. The Hungarian central bank must give permission for overseas portfolio investments on a case by case basis.

The Russian rouble is in a managed floating system but there is a 1% tax on purchases of hard currency. In contrast, the Argentinean peso was pegged to the US dollar at parity ($1 = 1 peso) and international trade transactions (involving current and capital flows) were not subject to stringent government or central bank control (recent devaluation means parity no longer occurs).

ECONOMIC AND MONETARY UNION

EMU CONVERGENCE CRITERIA

- price stability : a sustainable inflation rate which does not exceed by more than 1.5% the lowest 3 rates in the EU
- long term interest rates within 2% of the best 3 performing i.e. lowest
- a government deficit of no more than 3% of GDP
- total government debt of no more than 60% of GDP

ADVANTAGES OF EMU

- **Increased Credibility**
  With a single currency, there is far greater anti-inflation credibility. This is because all of the EMU nations are linked with Germany's Central Bank's very successful anti-inflation policy, therefore expectations of inflation will be lower which leads to lower actual inflation. It will also increase a currency's stability on the markets, therefore, there is no interest rate premium on the currency which may lead to interest rates being reduced.

- **Reduction in Costs**
  a) Transaction Costs and Information Costs - estimates have put these costs at 1.6% of EU income each year.
  b) Reduced Uncertainty - from multi (flexible) currencies. Companies may insure against this happening, but this is still an expense.
  c) Increased Investment - with increased certainty both internal and international direct and portfolio investment should increase, hopefully increasing economic and productive efficiency and promoting economic growth.
- **The Optimum Currency Area Theory**
  If all of the factors of production are mobile, economic polices are similar and there are no barriers to trade then it makes sense to have a common currency.
- **Increased Trading**
  As firms will have a greater certainty about future costs and revenues they will be more willing to partake in international trade. This will lead to increased competition which results in lower prices. Costs for firms may lower as well as they take advantage of economies of scale and strive to lower costs in the face of increased competition.

- **Independence of Monetary and Fiscal policy**
  No one Government will have control which will lead to more long-term economic planning. This argument holds for an independent European Bank as they will not alter the rate of interest for political gain e.g., lowering unemployment at the expense of inflation, decreasing interest rates just before an election to increase the feel good factor. Government Policy will hopefully follow the business cycle rather than the election cycle. European policies should have:
  a) better long-term planning
  b) more efficient use of taxes (as cannot simply raise taxes, as people will move elsewhere).

- **Lower Capital Flows**
  It is often argued that due to the existence off many separate currencies, short term speculation leads to de-stabilisation of them, with the ECU this is less likely.

- **Effects on Wages**

Wages should converge and become more competitive, as workers will realise that they are competing at only with other British firms, but also with European Firms.

- **Inflows at Capital to Europe**
  The ECU will be a major world currency and it is estimated that there will be a one-off purchase of ECUs by non-Europeans that will result in a revenue of up to $35bn.
- **Protection of the City of London**
  The City of London ranks with N.Y. and Tokyo as the major world financial centres. It is doubtful if the City would maintain its pre-eminence outside a single currency area, formed by the rest of Europe.

- **Balance 0f Payments**
  With a single European currency it will be easier to finance a deficit as interest rates will be lower as no interest rate premium. (Overall borrowing will be easier as large sums of money available).

DISADVANTAGES OF EMU

-

ABILITY TO SET INTEREST RATES

Since the UK withdrew from the ERM we have followed a strict anti-inflationary policy. This stance against inflation was compounded when the Bank of England was given independence over interest rate policy. By joining EMU the UK will be losing control over one of its main economic instruments. No longer will the UK be able to react to inflation by raising interest rates, it will have to wait until inflationary pressures across Europe become too strong. If the trade cycles of different countries across Europe do not converge, some nations will suffer as central policies may amplify any problems they already have.

- **No Devaluations**
  This will mean that domestic countries will have reduced powers to control their economies. European regional policies will have to compensate.
- **Central Bank**The administration of the European Central bank is controversial. Will it simply be a means of the Bundesbank continuing to control monetary policy? It. will have to be accountable and democratically controlled.
-

REGIONAL CHANGES

There may be massive problems (unemployment, balance of payments deficits, etc.) caused by a free market. Fiscal policy is under European control in the medium term, and it is unlikely that large Government expenditure and a large PSBR would be allowed in the long run. Therefore, regional aid from Europe would be required, but this would dramatically increase the size of the budget, or other areas would have to be cut.

- **Taxes**
  If too high, a nation will experience a brain-drain, therefore countries may be unwilling to tax which can lead to a decline in the provision of services.

- **Infrastructure**
  This is a problem of the EMU not due to EMU itself, but the domestic problems of Britain (and its geographical position). If Britain is to compete, its rail, road and communication network must be improved.

- ### LEVEL OF CURRENCY ON ENTRY TO EMU
  Arguments took place on the level of a country's currency as it has implications on its exports and imports.

INWARD FOREIGN INVESTMENT

The UK has maintained its position as one of the main destinations for worldwide inward investment, in spite of the relative strength of sterling and non-participation in the euro-zone. Many companies in the US and Japan continue to see the UK as the natural jumping-off point for the rest of Europe and Continental companies have continued to invest in UK subsidiaries and to look out for opportunities to acquire UK manufacturing and service operations.

The UK and its regions spend substantial amounts of money promoting itself to potential foreign investors.

PUBLIC EXPENDITURE AND TAXATION.

To be added at a later date.

THE WORKING OF FISCAL, MONETARY AND SUPPLY SIDE POLICIES.

To be added at a later date.

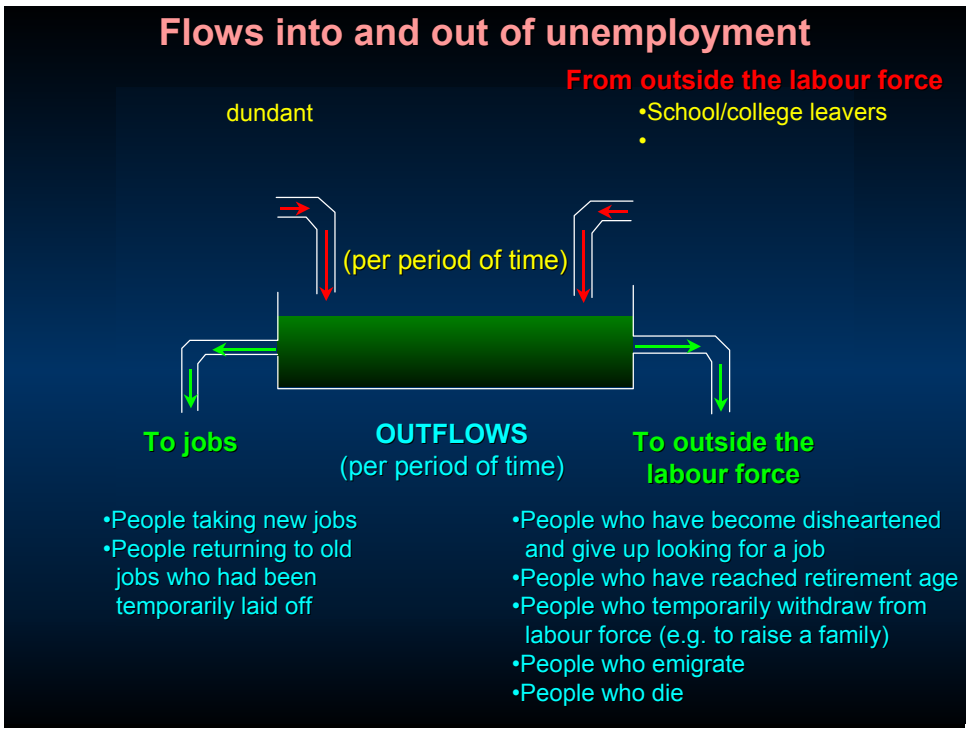
UNEMPLOYMENT

MEASURING UNEMPLOYMENT

THE CLAIMANT COUNT

The **unemployed** are those registered as able, available and willing to work at the going wage rate in any suitable job who cannot find employment.

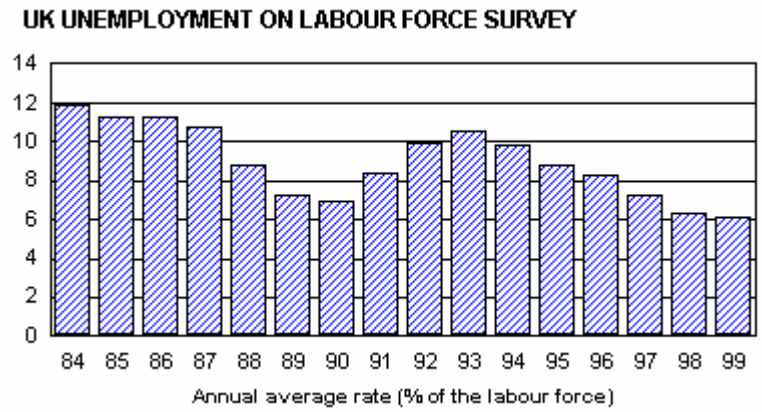
Unemployment is a **flow concept** - i.e. there are inflows and outflows from the total. Unemployment falls when more people leave the unemployment register (when they find work) than sign on each month.



The annual average rate of unemployment for the UK since 1971 using the claimant count figures are shown in the chart below.

THE LABOUR FORCE SURVEY

In April 1998, the Government introduced a new monthly **Labour Force Survey** using a different measure of unemployment. The new measure is based on the International Labour Organisation (ILO) definition of unemployment. It covers those who have looked for work in the past four weeks and are able to start work in the next two weeks.



The previous monthly count only included those who were unemployed and claiming benefit. This excluded a number of people who are classed as unemployed under the ILO definition.

The most significant group who are now included in the monthly unemployment statistics are women seeking work whose partners are on means tested benefit.

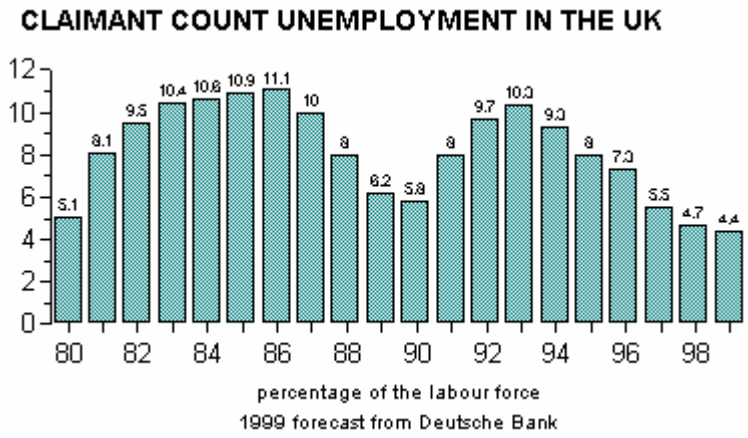
SEASONAL ADJUSTMENT

This is an adjustment made to economic data that allows for changes due solely to the period of time at which the data was collected, instead of examining the underlying forces in which we may in fact be interested.

For example, at Christmas, the unemployment figures may be artificially reduced due to the number of people taking temporary employment in the retail sector. The seasonally adjusted unemployment figures will exclude this rise in temporary employment from their calculations.

ECONOMIC COSTS OF UNEMPLOYMENT

Most economists agree that high levels of unemployment are costly not only to the individuals and families directly affected, but also to local and regional economies and the economy as a whole. We can make a distinction between the **economic costs** arising from people out of work and the **social costs** that often result.



LOST OUTPUT OF GOODS AND SERVICES

Unemployment causes a **waste of scarce economic resources** and reduces the long run **growth potential** of the economy. An economy with high unemployment is producing within its production possibility frontier. The hours that the unemployed do not work can never be recovered.

But if unemployment can be reduced, total national output can rise leading to an improvement in economic welfare.

FISCAL COSTS TO THE GOVERNMENT

High unemployment has an impact on government expenditure, taxation and the level for government borrowing each year

- An increase in unemployment results in higher benefit payments and lower tax revenues. When individuals are unemployed, not only do they receive benefits but also pay no income tax.
- As they are spending less they contribute less to the government in indirect taxes.
- This rise in government spending along with the fall in tax revenues may result in a higher government borrowing requirement (known as a public sector net cash requirement)

DEADWEIGHT LOSS OF INVESTMENT IN HUMAN CAPITAL

Unemployment wastes some of the **scarce resources** used in training workers. Furthermore, workers who are unemployed for long periods become **de-skilled** as their skills become increasingly dated in a rapidly changing job market. This reduces their chances of gaining employment in the future, which in turn increases the economic burden on government and society.

SOCIAL COSTS OF UNEMPLOYMENT

Rising unemployment is linked to **social and economic deprivation** - there is some relationship between rising unemployment and rising crime and

worsening social dislocation (increased divorce, worsening health and lower life expectancy).

Areas of high unemployment will also see a decline in **real income** and **spending** together with a rising scale of **income inequality**. As younger workers are more geographically mobile than older employees, there is a risk that areas with above average unemployment will suffer from an ageing potential workforce - making them less attractive as investment locations for new businesses.

The duration of unemployment affects the economic and social costs. It is clear therefore that unemployment carries substantial **economic** and **social costs**. These costs are greatest when long-term structural unemployment is high. Indeed many government focus their labour market policies on improving the employment prospects of the long-term unemployed.

THE MAIN CAUSES OF UNEMPLOYMENT

In a modern economy unemployment has a variety of causes. Some of them relate to the general level of economic activity, others are the result of a failure of the labour market in an economy to work optimally.

Among the main types of unemployment we can consider:

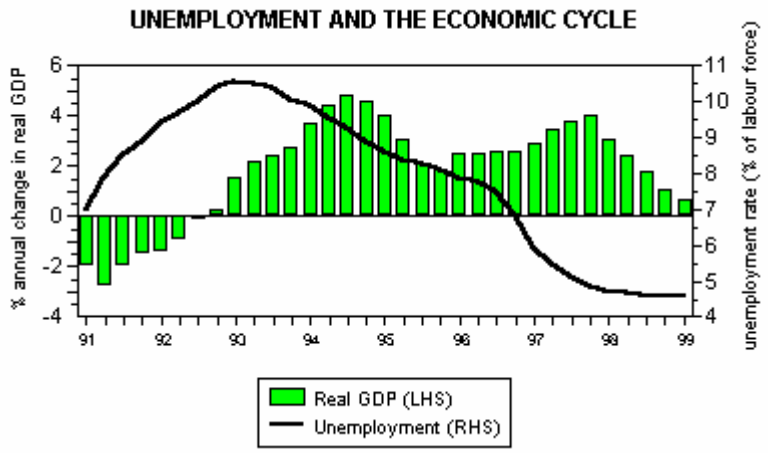
- Real wage unemployment
- Demand deficient unemployment
- Frictional unemployment
- Structural unemployment
- Hidden unemployment

REAL WAGE UNEMPLOYMENT

Real wage unemployment is a form of **dis-equilibrium unemployment** that occurs when **real wages** for jobs are forced above the market clearing level.

Traditionally, **trade unions** and **wages councils** are seen as the institutions causing this type of unemployment although the importance of trade unions in the UK labour market has diminished significantly over recent years and this has not stopped unemployment reaching nearly three million twice in the last twenty years.

DEMAND DEFICIENT UNEMPLOYMENT



Demand Deficient Unemployment is associated with an economic recession or a sharp economic slowdown. It occurs due to a fall in the level of national output in the economy causing firms to lay-off workers to reduce costs and protect profits.

Remember that labour as a factor input is a derived demand and a fall in the demand for output will cause an inward shift in the demand for labour at each wage level. This is a process known as labour-shedding.

Although demand deficient unemployment is usually associated with economic recessions it can also exist in the long run when the economy is constantly run below capacity. As the economy recovers from a downturn, we expect to see the problem of cyclical unemployment decline.

FRICTIONAL UNEMPLOYMENT

This type of unemployment reflects job turnover in the labour market. Even when there are plenty of vacancies available, it takes time to search and find new employment and workers will remain frictionally unemployed.

STRUCTURAL UNEMPLOYMENT

Structural unemployment exists even when there are unfilled job vacancies due to a mismatch between the skills of the registered unemployed and those required by employers. People made redundant in one sector of the economy cannot immediately take up jobs in other parts as they do not have the relevant skills.

For example, it would be hard for a redundant ship yard worker to instantly take a job in a high-tech electronics business. Likewise workers laid-off in steel manufacturing may have problems in finding re-employment in financial services. This type of unemployment is linked to occupational immobility of labour.

Structural unemployment often occurs more heavily in certain regions because of the long-run decline of traditional industries. For example the loss of manufacturing jobs in the north-east of England, the closure of coal mines

in Scotland and Wales and the long-run decline of ship-building in the United Kingdom.

Employment in these sectors contracts due to changes in the pattern of demand or methods of production. The scale of the problem depends on the regional concentration of the industry, the speed of changes in demand and the immobility of labour both occupational and geographical. Simply raising the level of aggregate demand in the economy will do little to alleviate the problem of structural unemployment.

HIDDEN UNEMPLOYMENT

Whatever the published figures for unemployment, there are bound to be people who are interested in taking paid work but who, for one reason or another, are not classified as unemployed.

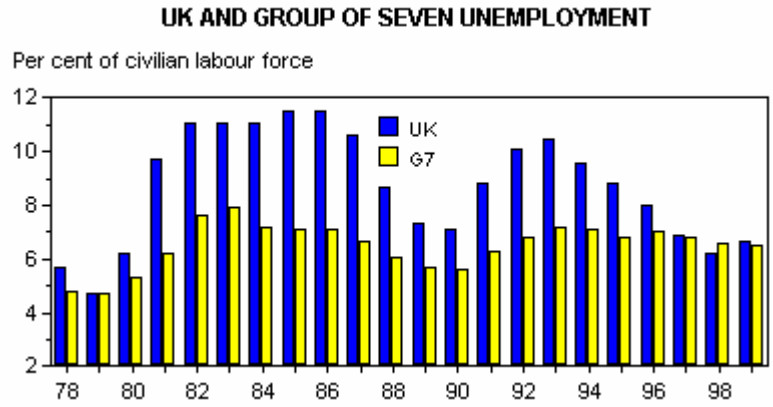
An example of this is discouraged workers - people who have effectively given up active search for jobs perhaps because they have been out of work for a long time and have lost both the motivation to apply for jobs and also the skills required.

The poverty trap can also act to increase hidden unemployment. Jobless workers may not apply for jobs because of financial disincentives created by the interaction of the income tax and state benefits system.

POLICIES TO REDUCE UNEMPLOYMENT

A range of government policies are available for Governments wanting to reduce the scale of unemployment in the economy. These policies need to focus on the underlying causes of unemployment for them to be successful.

- Real Wage
- Keynesian
- Structural
- Frictional



REAL WAGE UNEMPLOYMENT

Prescriptions for reducing real wage unemployment normally focus around the strategy of making each labour market more flexible so that pay conditions become more adaptable to changing demand and supply conditions.

Real wages should rise when demand, output and employment and rising, but they may need to fall if an industry experiences recession which puts jobs at threat. The UK economy has developed a flexible labour market model similar to that of the United States during the last fifteen years.

Trade Union reforms were a centre-piece of the Conservative Government's strategy to improve the performance of the labour market. The Labour Party under Tony Blair has not reversed these reforms since coming to office, although some new legislation has been introduced to give workers the right to achieve union recognition. A National Minimum Wage has also been introduced.

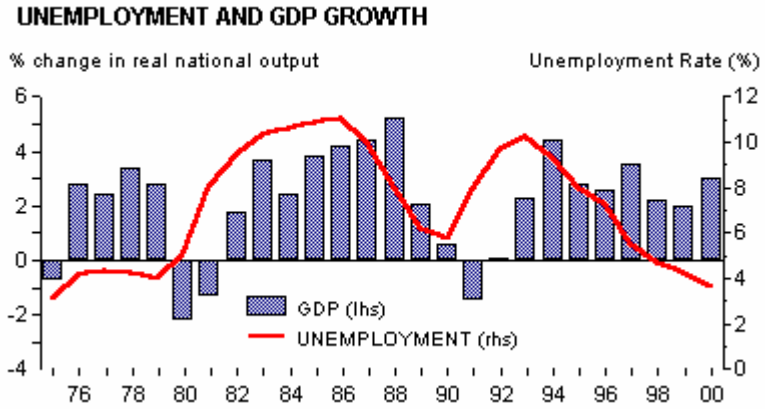
KEYNESIAN UNEMPLOYMENT

Policies to reduce Keynesian demand-deficient unemployment need to raise the level of aggregate demand for goods and services in the economy. A number of options are available.

Increased Government Expenditure

The Government can raise the level of its own spending. This "fiscal pump-priming" directly increases aggregate demand and can have a multiplier effect on equilibrium national income. The government could raise current expenditure (for example raising pay levels in education and the health service) or expand spending on capital projects which add to the stock of capital (for example spending on new roads, new hospitals or other major infrastructural projects)

Sustained economic growth provides a platform for more jobs to be created in



the economy.

Lower Taxation

A reduction in direct taxation increases consumers' disposable income and should boost household spending. The effect may be greater if taxes are cut

for people on lower than average incomes. These tax-payers are likely to spend a greater percentage of their disposable income.

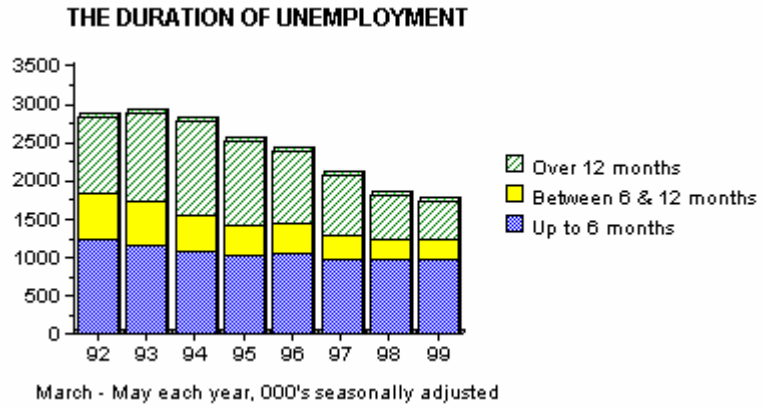
Lower interest rates
A relaxation of monetary policy through lower interest rates encourages the demand for credit, reduces saving and increases consumers' real 'effective' disposable incomes; all of which will boost consumption and demand. It may also encourage firms to invest, as the marginal cost of investment will fall.

Remember that interest rates are not set by the government. The Bank of England now sets interest rates each month at the meetings of the Monetary Policy Committee.

Depreciation of the exchange rate
A lower value for the pound should lead to a rise in the orders of exports from UK firms and to a reduction of import penetration by making exports cheaper and imports more expensive.

Remember the importance of time lags!
Government policies to stimulate increased aggregate demand for domestic output take time to have their effect. There are variable time lags between the government reflating the economy using fiscal and or monetary policy and the final effect on output and employment in specific industries.

STRUCTURAL UNEMPLOYMENT

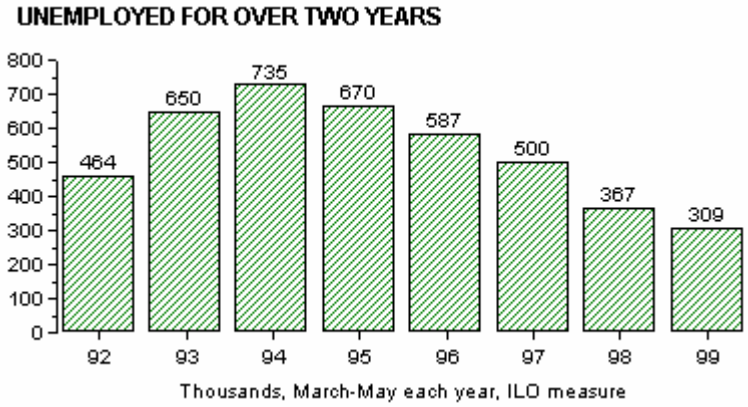


There are a number of different approaches that can be adopted to help alleviate structural unemployment. These are sometimes known as active labour market policies. The first involves direct government action to match jobs to the unemployed.

Regional policy incentives
Gives grants and subsidies to firms to locate in areas of high unemployment. However, this does not solve the problem of occupational immobility. Often

regional policy requires extra retraining schemes to give workers the relevant skills to allow them to take up new jobs.

Investment in worker training
Spending on training schemes to re-skill the unemployed through investment in vocational education or guaranteed work experience for unemployed "outsiders" in the labour market.



Improving geographical mobility of labour
The government could provide grants or low cost housing to encourage workers to move to other regions where there are jobs. The problem with this policy is that people are inherently immobile as they are often bound by family and social ties.

Market solution - no need for government to get involved!
One approach is to simply leave the problem of structural unemployment to the market. Some economists argue that intervention slows the natural reallocation of resources to high growth areas and only makes the problem worse. In areas of above average unemployment it may make some sense to allow wage levels to fall to attract new capital into an area.

FRICTIONAL UNEMPLOYMENT

Lower real values of unemployment benefit and improved job information
The implementation of the Job Seeker's Allowance in 1996 ensures that workers are actively seeking work as the payment of benefit is dependent on them proving this at fortnightly interviews.

However, if the government reduced the real value of unemployment benefits, or limited the duration of a claim, search times between jobs could be reduced even further as workers would have to quickly take on new positions before their financial situations deteriorated.

Better information on job vacancies in the labour market can help to reduce job search.

CUTS IN DIRECT TAXES

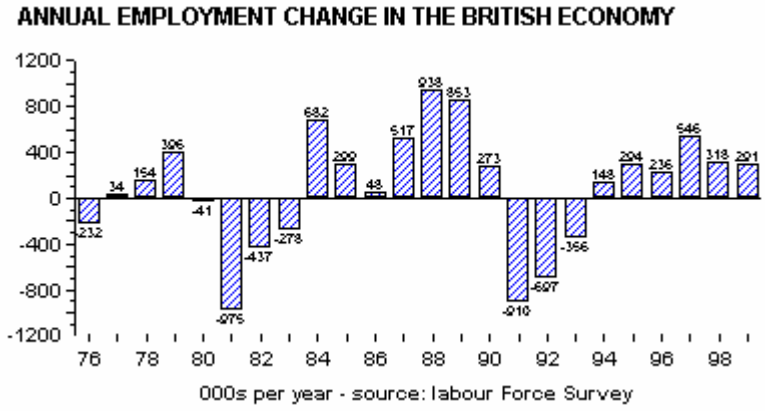
The government could reduce direct taxes for the low paid to increase the post tax wage and, therefore, encourage them to find work more quickly. The Labour Government is introducing a 10% starting rate of tax to encourage more low income groups back into work.

Most analysts believe that tax cuts on their own are insufficient to reduce frictional unemployment. Complementary reforms to the benefits system to reduce the problem of the poverty trap may also be needed.

THE CHANGING LEVEL AND PATTERN OF EMPLOYMENT

Changes in the level of employment

The cyclical nature of the British economy is shown in the chart below. It shows the annual changes in total employment using data from the Labour Force Survey.



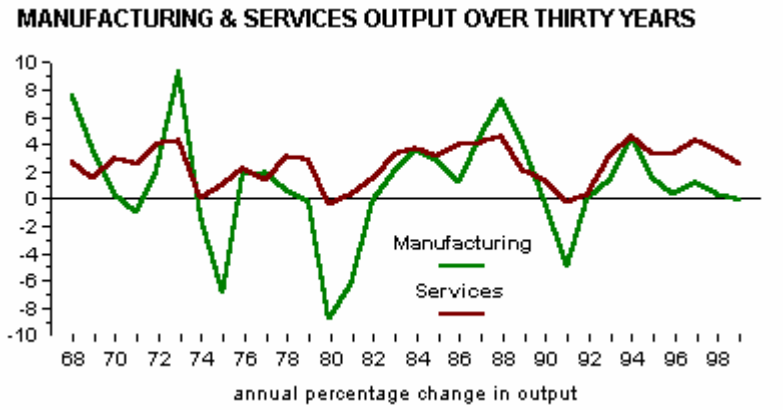
In the last two recessions we have seen severe cut-backs in employment levels throughout the economy. This had led to high unemployment and posed major problems for economic policy-makers. However in recent years the performance of the economy in creating and sustaining a higher level of employment has improved. Total employment has increased in each of the last six years. Despite fears of recession last year, the total number of people in paid work increased by 291,000.

What have been the main structural changes in the UK labour market in recent years?

The labour market is continuously evolving and this has implications for everybody involved in the world of work. Because the nature of the economy changes, we always expect to see **structural change** in the pattern of employment in the economy.

Some of the main long term structural changes in the labour market are as follows:

- **Shift from manufacturing to services.** There has been a long decline in manufacturing employment in the economy and an increase in service sector employment. This is part of the process of **de-industrialization**. Total manufacturing employment now accounts for less than one-fifth of the employed labour force. The underlying reason behind this is the faster growth of output in the service sector. This trend is shown in the chart below

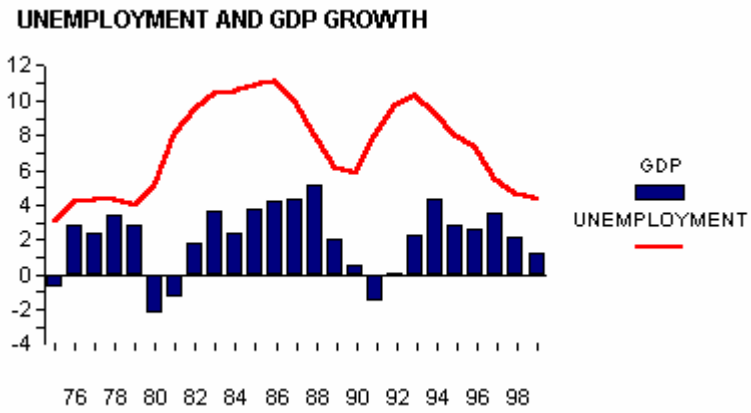


- **Rising female employment -** noticeably in service industries
- **Rise of flexible employment patterns** including greater part-time employment and a switch towards short-term contracts
- **Expansion of self-employment -** now over 3,00,000 people registered as self-employed.
- **Long term rise in part-time employment**
- **Higher** long-term unemployment
- **Long term decline in trade union membership and union density**
- **Growing scale of economic inactivity** - particularly for males over the age of 50, lone parents and people with disabilities

The UK labour market is a very different animal than twenty years ago. We have seen the development of a **flexible labour market** in which employment patterns change quite quickly - with important economic and social implications.

FULL EMPLOYMENT

Can the UK economy move towards **full-employment**? This question is now being raised as total unemployment continues to decline and evidence grows that the economy has managed to avoid a recession in the current economic cycle.

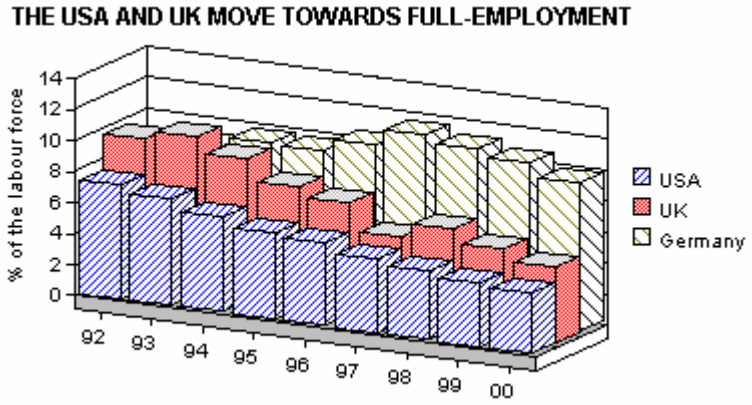


WHAT IS FULL-EMPLOYMENT?

There is no unique definition of full-employment. Most economists are in agreement that unemployment cannot fall to zero since there will always be some frictional unemployment caused by people moving into the labour market (searching for work) and others switching between jobs and experiencing short periods of time out of work.

Full-employment might also be defined as a situation where the labour market has reached a state of equilibrium - i.e. when those in the active labour force who are willing and able to work at going wage rates are able to find work. At this point the remaining unemployment would essentially be frictional.

Several countries have made significant progress towards reaching full-employment in recent years. The chart below shows the standardised unemployment rates for the United States, UK and Germany since 1992. Germany clearly still has an unemployment problem - but in the States and the UK - the current unemployment rates are at their lowest rates for over twenty years.

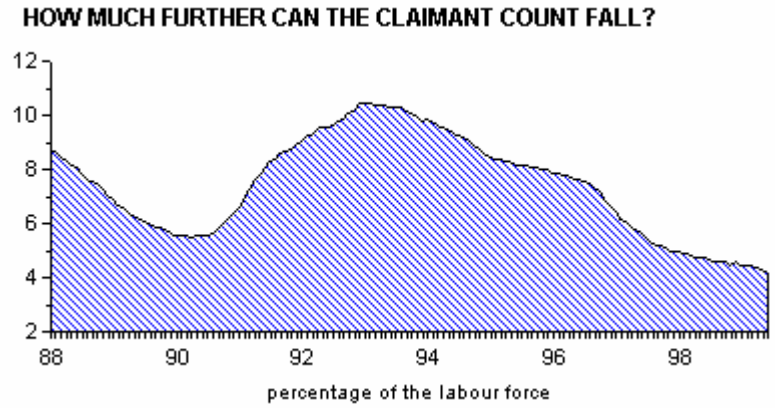


Another interpretation of full-employment is when the total of people out of work matches the number of unfilled job vacancies. The problem with this is that estimates of the scale of job vacancies vary considerably. Some economists believe that the true number of jobs available is three times the official published figure.

HOW CLOSE IS THE UK TO REACHING FULL-EMPLOYMENT?

According to the claimant count measure, there are 1.2 million people claiming the Job Seekers' Allowance (4.0% of the labour force). The alternative Labour Force Survey puts unemployment somewhat higher at 1.7m (5.9%). In some towns however we have already reached effective full-employment

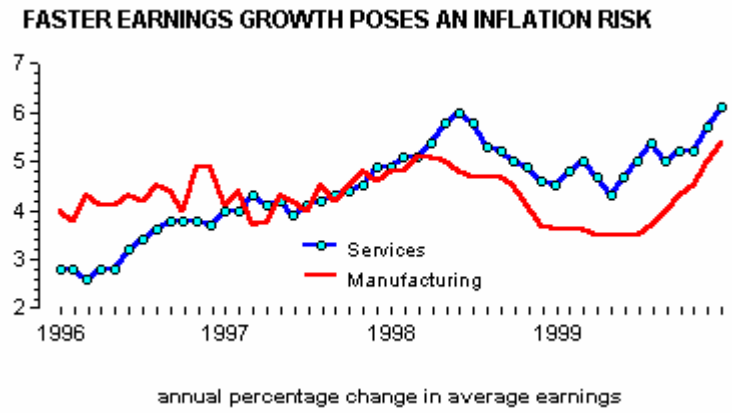
Assuming that full-employment is achieved when 2% of the labour force are out of work (i.e. when the employment rate has reached 98%) - the UK economy will have to create another 800,000 to 1,000,000 new jobs for full-employment to be achieved. Many of those unemployed at the moment are out of work for structural reasons and despite a series of active labour market policies designed to bring them back into work, they remain a major long-term problem for the economy.



THE RISK OF WAGE INFLATION

Another obstacle to reaching full-employment is the risk that inflation will pick up as more people find work and total spending in the economy causes businesses to raise prices.

When unemployment is falling, there is pressure on firms to bid up wages both to attract and retain staff. Labour shortages that cause an acceleration in wage inflation might persuade the Bank of England to increase interest rates. This would slow down the economy and the rate of new job creation might suffer as a result.



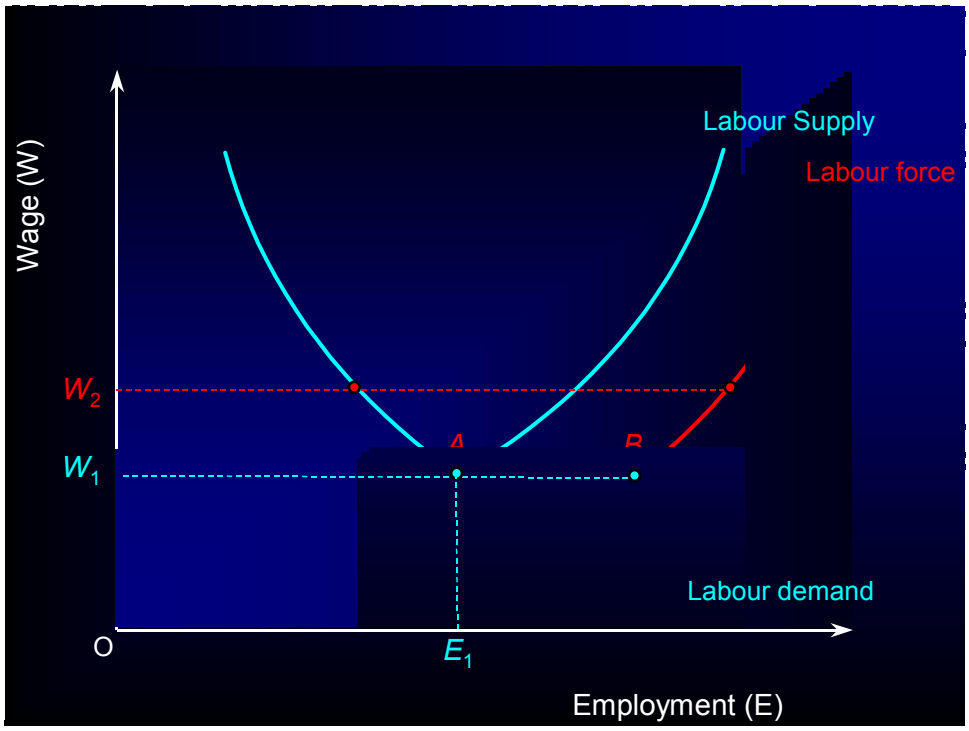
Although the economy has enjoyed a sustained fall in unemployment over the last six years, bringing unemployment down much further may prove difficult.

THE NATURAL RATE OF UNEMPLOYMENT

The natural rate of unemployment is the rate of unemployment where the labour market is in a position of equilibrium. This means that the labour supply = labour demand at a given real wage rate. All those people willing and able to take paid employment at the going wage rate do so.

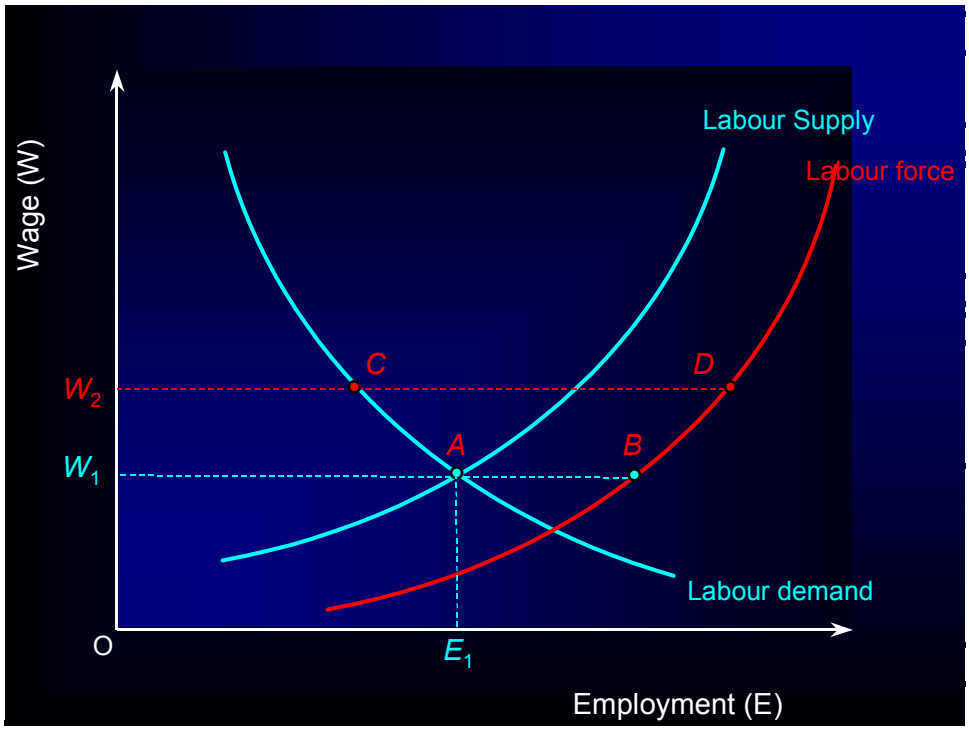
The diagram below shows the labour supply (those willing and able to take work at a going wage rate) and the labour force - the number of active participants in the labour market. The labour force expands as the real wage rises because there is a greater incentive to search for paid work and sacrifice leisure.

Employment on the x-axis measures the total labour hours supplied by workers in the economy in a given time period. As the real wage increases, the total number of hours supplied by the labour force will expand.

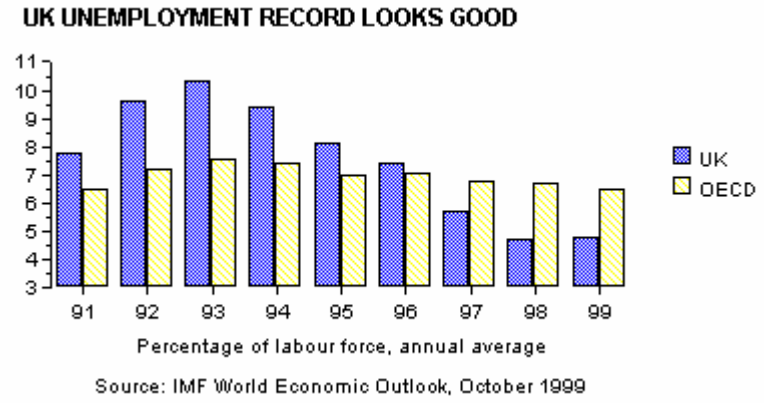


The natural rate of unemployment is not zero - at the equilibrium wage W_1 in the diagram above, there is unemployment measured by AB. This is made up of frictional plus structural unemployment.

At a wage rate W_2 (above the equilibrium "market-clearing wage") employment contracts along the labour demand curve and total unemployment rises (see the diagram below)



Dis-equilibrium unemployment rises to the level shown by the distance CD. This is because labour demand has fallen and the labour force has expanded. There is an excess supply of labour - some people who are willing and able to find employment cannot get paid work.



Unemployment in the UK economy has fallen someway below the average for the leading 23 nations that comprise the Organisation of Economic Cooperation and Development (OECD). This is shown in the chart above. Some economists claim this is evidence that the natural rate of unemployment has fallen, allowing the economy to operate at a higher level of economic activity without experiencing an acceleration in inflation.

THE CHANGING NATURE OF THE WAGE BARGAINING PROCESS

- **Strength of Trade Unions** - Unions have become much less powerful in the UK over the last twenty years. This has tilted the balance of power towards employers and helped to keep "inflation-busting" pay claims in check
- **Centralisation / decentralisation of pay bargaining** There has been a switch towards local and regional pay settlements that can take more account of local differences in labour demand and supply
- **Scale of involuntary structural unemployment in the economy** - measures to reduce structural unemployment should help to reduce the NAIRU if effective. This is because they increase the available labour supply in the economy

Competitiveness of product markets - impact on producers and labour

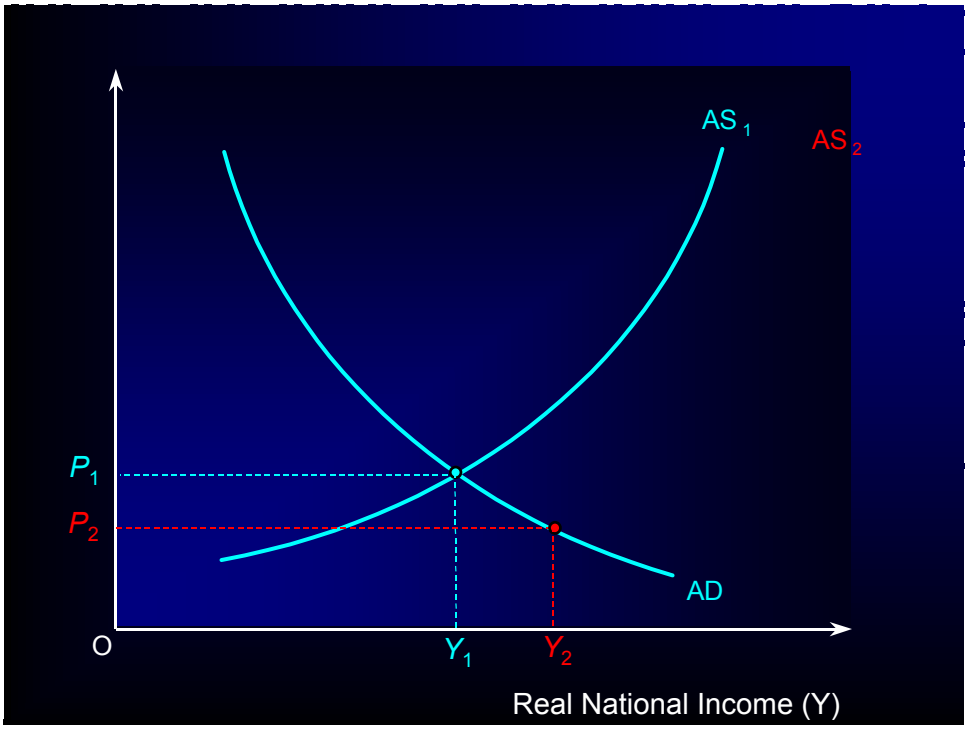
- When **product markets are more competitive** there is intensive pressure on firms to control costs. Wage increases might only be justified by improvements in productivity

"External-shock" effects on wage bargaining

The economy can be affected by **external economic shocks** that effect expected inflation.

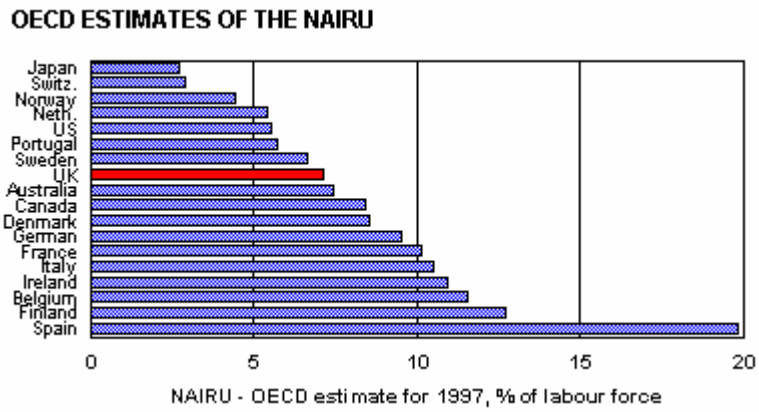
- The global economic crisis in 1998 has brought down expectations of inflation

- The fall in international commodity prices has had a similar effect - causing a sharp fall in inflation in many countries across the world. Lower input costs cause an outward shift in short run aggregate supply in the economy and should help to increase the real volume of national output



Most economists believe that the natural rate of unemployment has fallen in the UK over the last decade. This means that the economy can sustain a lower rate of unemployment without triggering off a renewed burst of wage inflation. The evidence supports this positive view often improving trade-off between unemployment and wage/price inflation. By the summer of 2000, unemployment in the UK had fallen to just 3.8% of the labour force (using the claimant count measure) whilst retail price inflation had remained comfortably within the government's target (2.5%0 and wage inflation was under control.

Economists at the OECD have estimated the NAIRU for the leading industrialised countries. Their estimates for 1997 are shown in the chart below. The UK comes out favourably in this international comparison. Our estimated NAIRU is substantially below that of Germany and France - although some way above that for the United States and Japan. The Netherlands (another country to have introduced widespread labour market reforms over the last fifteen years) is also estimated to have a lower NAIRU than the UK.



JOB VACANCIES IN THE LABOUR MARKET

Why are so many jobs left unfilled in the economy?
Official unemployment has been falling for over six years yet the total stock of unfilled vacancies has remained at a very high level for some time. See the chart below.

One reason is that the new jobs created in the economy are not taken by the registered unemployed. Instead they are taken by new and re-entrants into the labour market (including females joining the active labour force and recently qualified graduates).

Long-term structural unemployment remains a problem and many of those out of work do not have the specific skills, qualifications and relevant work experience to fill the available jobs. They suffer from occupational mobility of labour and require specific help to get them back into employment.

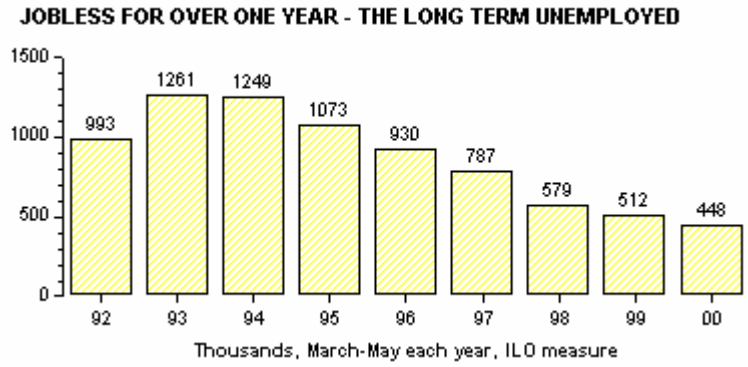
Labour introduced the New Deal in the spring of 1998 but it will be some time before New Deal and other employment training programmes to have any significant impact.

Another cause is the **disincentive effects** of the welfare system. Many vacancies offer relatively poorly paid jobs with little job security.

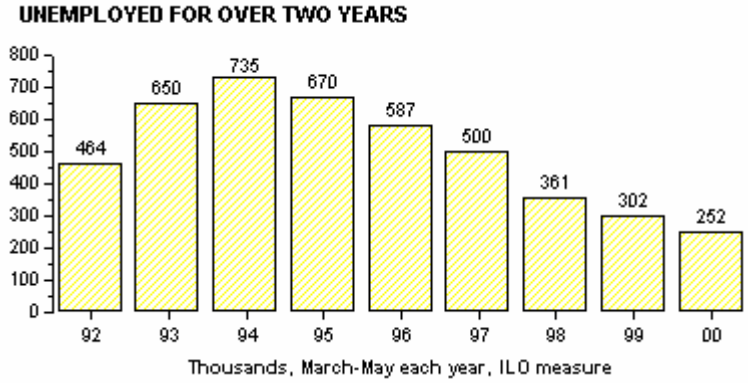
For low-income households looking for new work, the **"poverty trap"** created by the interaction of the tax and benefit system is a real hurdle to them accepting paid employment. As a result many lowly paid jobs remain open.

LONG TERM UNEMPLOYMENT

Long term unemployment occurs when workers fail to find new paid employment after six months of unemployment. Many workers remain out of work for very long periods and the economic and social costs are much higher than for those experiencing transitory periods of unemployment. Most of the long term unemployed are out of work for **structural reasons**.



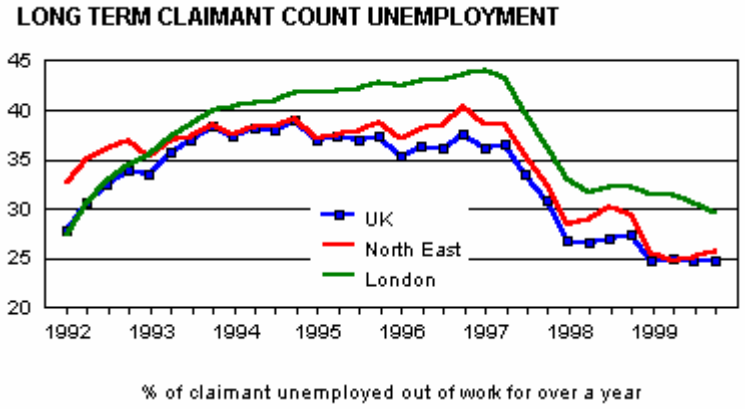
The chart above shows the rate of long term unemployment in the UK using the labour force survey measure. Gradually, the scale of long term unemployment has fallen during the latter half of the 1990s. Employment prospects have improved and the Government's special employment measures have helped to take many thousands of people off the unemployment figures. However even after eight years of sustained economic growth, between March-May in 2000, an average of over 440,000 people were counted as having being out of work for over a year. As the chart below indicates, in the summer of 2000 there were still a quarter of a million people counted as unemployed for over two years.



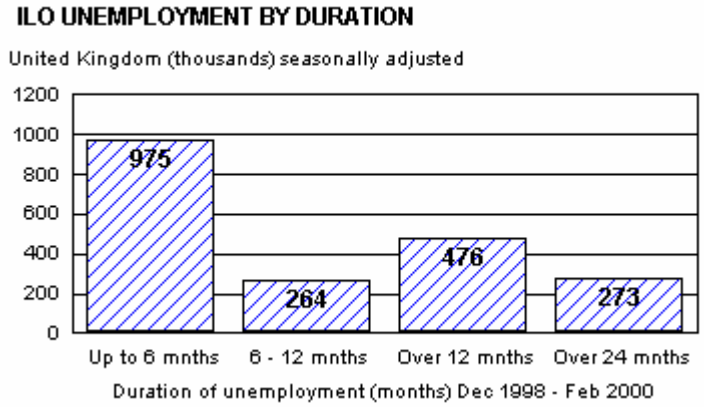
THE COSTS OF LONG TERM UNEMPLOYMENT

Long-term unemployment is an economic disaster. It damages individuals because they lose their self-respect and employers lose interest in them.

Those who have been unemployed for a short time have a good chance of leaving unemployment, while those who have been unemployed for a long time have a much lower chance.



Employers often do not consider the long-term unemployed to be interesting candidates for vacancies because they perceive them to have lower productivity than other workers. It is therefore possible to have a large number of vacancies coexisting with high unemployment if many of the jobless have been out of work for a long time.



Policies to reduce long term unemployment normally focus on improving the employability of these "outsiders" in the labour market. If successful, structural unemployment can be reduced and the natural rate of unemployment can decline.

NEW DEAL - NEW HOPE?

Labour's New Deal programme for young unemployed people was introduced across the UK in April 1998. In June 1998 the Government launched a separate New Deal for Long-Term Unemployed People aged over 25+.

Over two years later we are starting to see some of the effects of these active labour market policies on the UK economy.

People enter New Deal by moving into a Gateway where they are given an interview and support in choosing a suitable option.

The main options are:
- a subsidised job with an employer
- remaining in full-time education and training
- work within the accredited voluntary sector and
- work experience with an environmental task force.

The fifth option of staying on benefits has been taken away!

The programme is designed to provide pathways back into work for the long term unemployed – many of whom have become outsiders in the labour market despite the continuing strength of the British economy. Higher levels of employment and economic activity add to total national output and should help to improve the overall performance of the labour market in sustaining long run economic growth.

IS NEW DEAL DELIVERING?

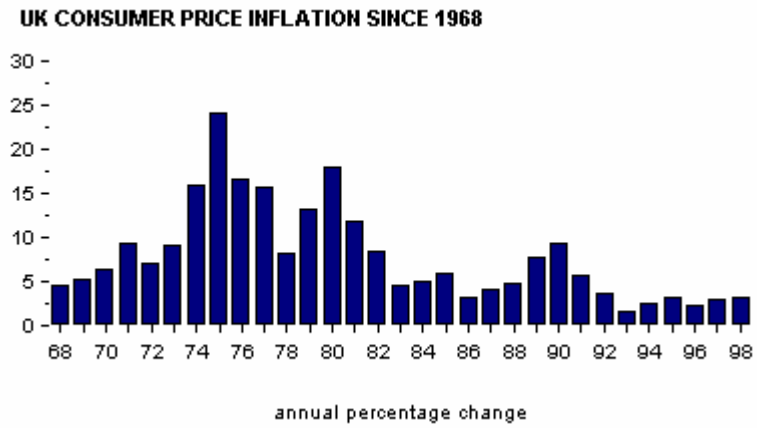
The latest data on New Deal participants published shows that up to the end of July 2000, over 518,000 people have now passed through the New Deal scheme, 402,000 have left leaving 116,000 currently on the programme. 237,040 young people had entered employment. Of which 180,600 were in sustained jobs, and 56,440 in jobs lasting less than 13 weeks.

There are wide differences in the success rate in getting New Deal participants into work across the regions. Just over one third of participants among 18-24 year olds have moved into employment but in some cities (including Birmingham) the percentage is only 25%.

The New Deal programme for workers aged 25+ has been running for a shorter time period. Nonetheless less than 15% of participants have moved into employment. In some areas (Glasgow for example) only one person in ten has passed through the programme into either a subsidised job or non-subsidised employment. Note that these tables show people who have moved into “sustained” jobs involving employment for three months or more.

INFLATION

Inflation measures the annual rate of change of the general price level in the economy. Inflation is a sustained increase in the average price level.



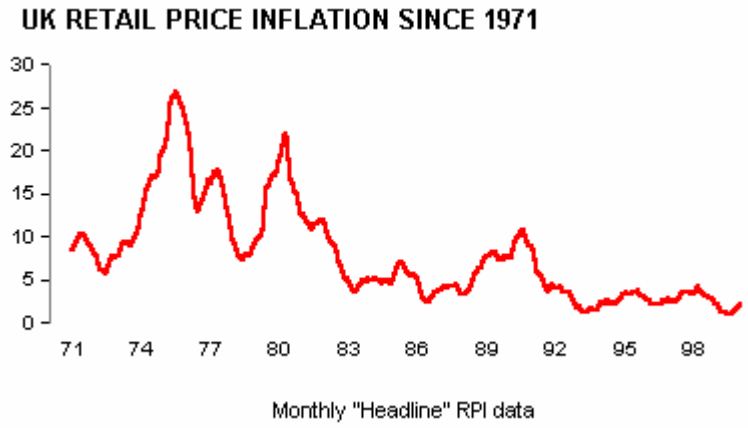
INFLATION AND THE PRICE LEVEL

When prices rise, the value of money falls. There is an inverse relationship between the price level and the internal purchasing power of money. When there is inflation money buys less in real terms. People can protect themselves against the effects of inflation by investing in financial assets that give a rate of return at least equal to the rate of inflation.

Hyper-inflation is extremely rare, although some countries experience it. In fact even when the rate of inflation is rising, the prices of some goods will be falling. Deflation is also fairly unusual although some countries such as Japan and China have experienced price deflation in their economies in recent years. In the United Kingdom, the main measure of inflation is done through the **Retail Price Index**.

THE RETAIL PRICE INDEX (RPI)

The Retail Price Index (RPI) measures the average change in prices of a representative sample of over 600 goods and services. Each month, over 120,000 separate price samples are taken to compile the inflation statistics.



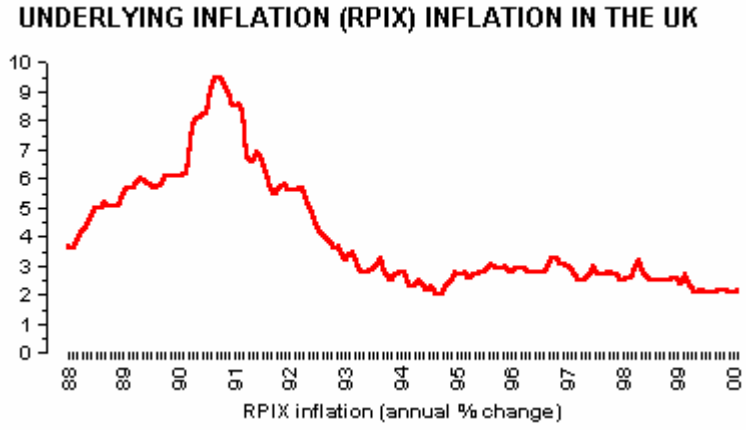
The index is weighted according to the proportion of income spent by the average household on categories of goods such as food and housing. These are periodically changed to reflect changing consumer spending patterns in the economy. For example the weighting attached to food has fallen as

average living standards have grown. The weighting attached to leisure services and transport has increased because these categories of spending have a relatively high income elasticity of demand.

RPI WEIGHTS (%)
Food 13.6
Catering 4.9
Alcohol 8.0
Tobacco 3.4
Housing 18.6
Fuel & Light 4.1
Household Goods 7.2
Household Services 5.2
Clothes 5.6
Personal Goods 4.0
Motoring 12.8
Fares 2.0
Leisure Goods & Services 10.6

UNDERLYING INFLATION (RPIX)

The underlying rate of inflation, known as RPIX, was originally set a target of between 1-4%. However, the Labour Government's target is for an average of rate of growth of 2.5% over the duration of this parliament which ends in 2002. Inflation is allowed to move between 1% either side of the 2.5% benchmark. The Bank of England has been given the responsibility for meeting the inflation target. The chart below tracks RPIX also known as underlying inflation for the UK since 1988.



The calculation of the RPIX is similar to the RPI, but *excludes* mortgage interest payments. This is because when interest rates are increased to control aggregate demand and inflation, the immediate effect is to increase mortgage interest payments and, therefore, housing costs.

As housing costs are a significant component of the RPI (see the table above), inflation is artificially increased. Thus the very policy adopted to tackle inflation actually creates a greater problem in the short run, and explains why the Government discounts this component of the RPI.

RPIY INFLATION

RPIY, or the core rate of inflation, *excludes* indirect taxes and the council tax on the inflation rate. By stripping out the effect of these taxes, the Government can establish the core change of prices within the economy. Cynics would argue that it is just another way of reducing the headline rate.

A new measure of inflation has recently been introduced by countries within the European Union. This is called the harmonised index of consumer prices (HICP) and is meant to provide a standardised measure of inflation for each member nation of the European Union.

OTHER MEASURES OF INFLATION

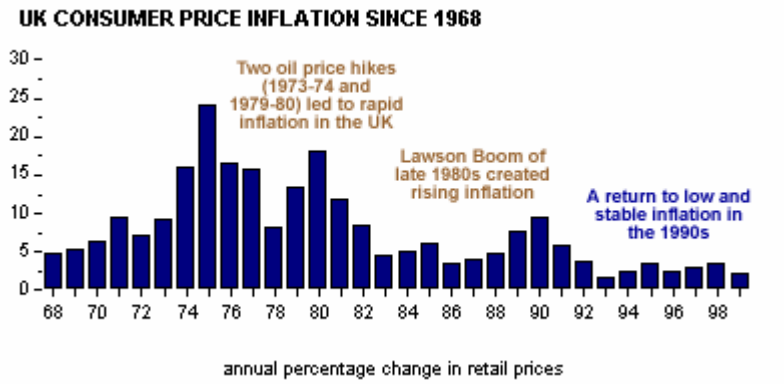
Input cost inflation measures prices paid by firms for raw materials, components and fuel. However, it does not include labour costs. Over recent years the prices of essential inputs have stayed fairly low. Indeed the rate of input price inflation has been negative for a long period (see chart below). This has helped keep cost-push inflationary pressure under control. These are measured separately by **Unit Labour Costs** (ULCs) which are calculated by dividing total labour costs by output - to give the labour cost per unit of output. A common misconception is that a rise in wages or average earnings immediately places upward pressure on producer prices. This is not necessarily true, since rising earnings may be offset by an equivalent increase in productivity with ULCs remaining unchanged

.

The prices at which finished goods leave the factory is measured by the Producer Price Index (PPI). The PPI is also a good leading indicator of the RPI.

THE MAIN CAUSES OF INFLATION

The British economy has experienced inflation throughout the last thirty years - but the rate at which prices have been rising has not been stable. The chart below tracks the annual rate of inflation for the British economy in each year since 1968.



In an open economy (i.e. a country that engages in international trade), price inflation can be caused by a number of factors. Economists divide them into two main groups, demand-pull and cost-push inflation.

DEMAND PULL INFLATION

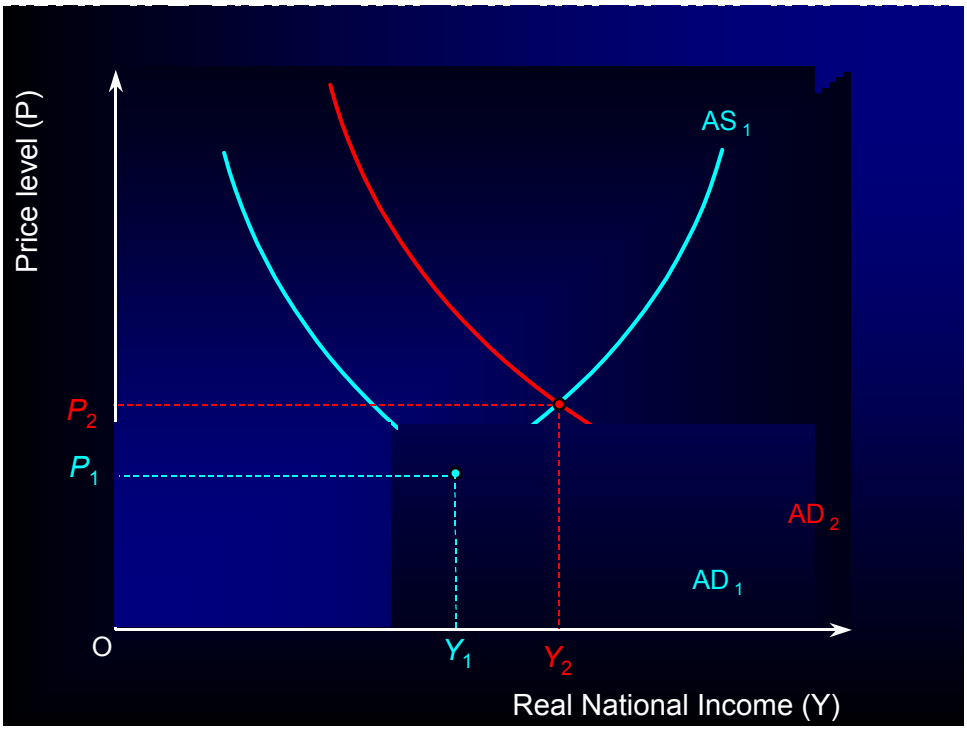
Demand Pull inflation occurs when total demand for goods and services exceeds total supply. This type of inflation happens when there has been excessive growth in aggregate demand and there is an inflationary gap.

Demand-pull inflation is often monetary in origin - because the authorities allow the money supply to grow faster than the ability of the economy to supply goods and services. The phrase that is often used is that there is "too much money chasing too few goods"

An example of this was during the late 1980s with the so-called "Lawson Boom". There was a sharp rise in the demand for credit and an explosion in house prices. The amount of money in circulation grew at alarming rates and caused excess demand in the economy. By the autumn of 1990, retail price inflation had climbed to 10.9%. A recession was needed to bring it back down again.

A similar though smaller inflationary gap appeared in the UK economy in 1997/98 after five years of sustained economic growth. This led the newly independent Bank of England to raise interest rates from 6% to 7.5% between May 1997 and June 1998. Fortunately the British economy responded well to the "monetary medicine" and experienced a slowdown through late 1998 and 1999. Demand-pull inflationary pressures subsided leaving retail price inflation comfortably within the Government's chosen target range.

Demand pull inflation can be illustrated graphically using aggregate demand and aggregate supply analysis.



Aggregate supply (AS) shows the total supply of goods and services that firms are able to produce at each and every price level. At low levels of output when there is plenty of spare productive capacity, firms can easily expand output to meet increases in demand, resulting in a relatively elastic AS curve.

As the economy approaches full employment (or full capacity), labour and raw material shortages mean that it becomes more difficult for firms to expand production to meet rising demand. As a result, the AS curve becomes more inelastic. When aggregate demand (AD) increases from AD_1 to AD_2 the economy is still operating at relatively low levels of capacity. Output can expand relatively easily so firms will only implement small increases in prices from P_1 to P_2.

When aggregate demand increases from AD_2 to AD_3 the economy is moving towards the full employment of factors of production. Many firms choose to increase price to widen profit margins. Shortages of factor inputs mean that the firms' costs of production start to rise.

Furthermore, it is likely that, as employment in the economy grows, demand for goods and services will become more inelastic. This will allow firms to pass on large price increases (P_2 to P_3) without any significant fall in demand.

Main causes of increased aggregate demand:

- Rapid growth of household consumption
- Increases in government spending
- Injections of demand from higher exports

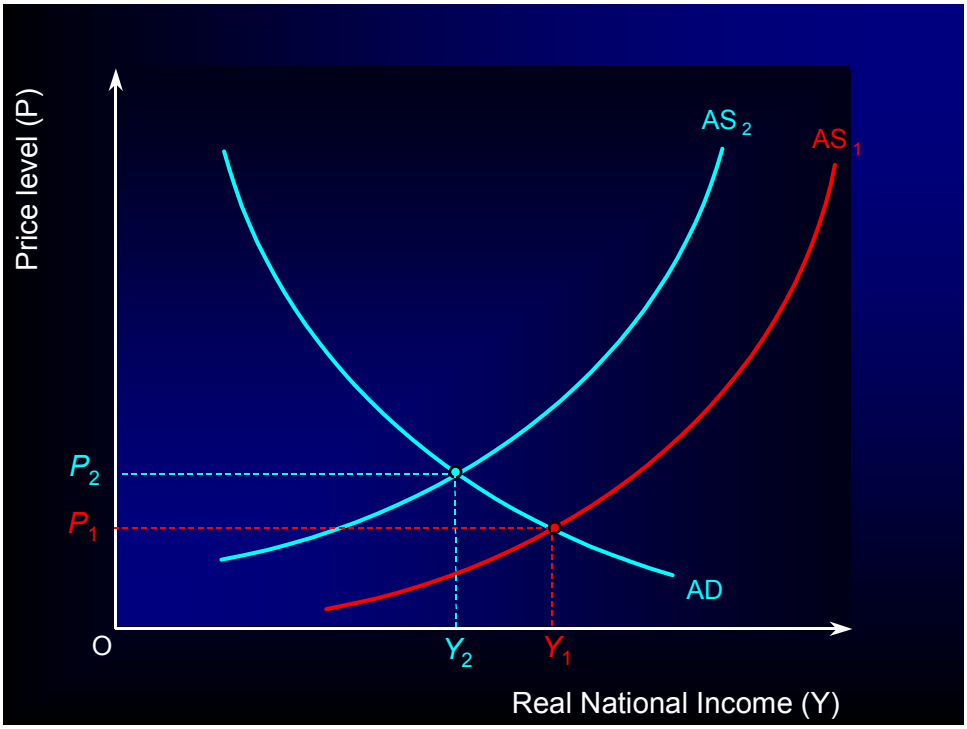
COST PUSH INFLATION

This occurs when firms increase prices to maintain or protect profit margins after experiencing a rise in their costs of production.

The main causes are:

- Growth in Unit Labour Costs
- Rising input costs
- Increases in indirect taxes
- Higher import prices (Imported inflation)

An increase in input costs will mean that firms can produce less at each and every price level and, as a result, the AS curve will shift to the left from AS_1 to AS_2.



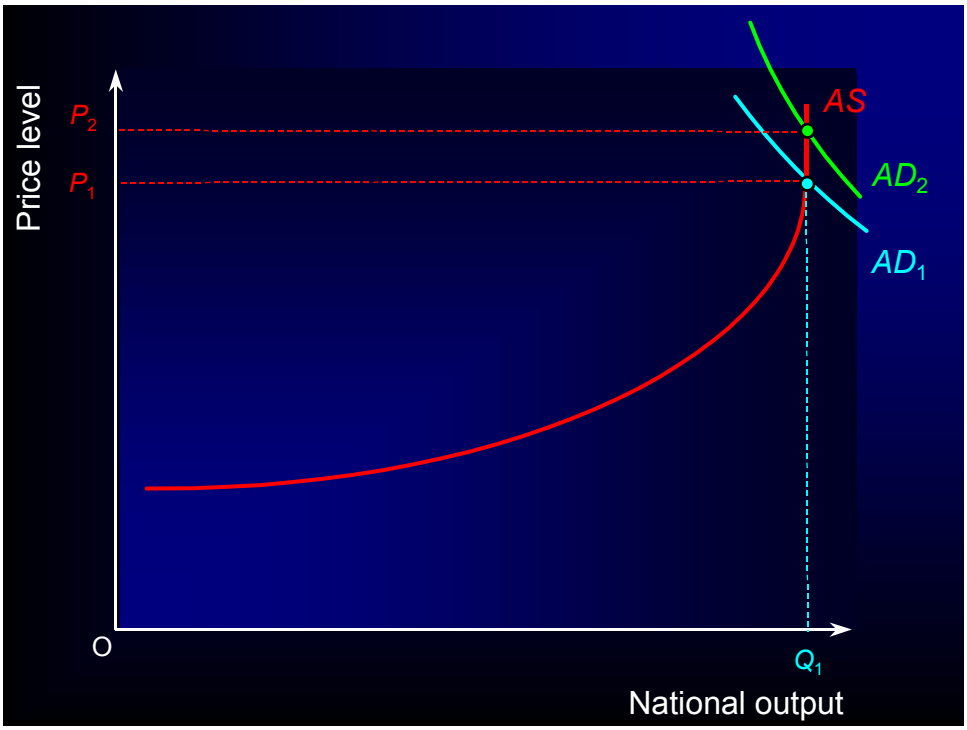
At the new equilibrium level of national output, the economy is producing a lower level of output (Y_1) at a higher price level (P_1). Higher cost push inflation therefore causes a contraction in real output as well a higher average price level.

Will an increase in a firm's costs always feed through into inflation?
No, because a business can absorb an increase in costs by reducing its profit margin. An example of this occurred after the devaluation of Sterling in September 1992. The fall in the value of the pound caused a rise in the cost of imported fuel and raw materials. Although input costs rose in 1993, this increase did not fully feed through into the prices of goods and services leaving the factory gate, as measured by Producer Prices.

Many firms were forced to reduce profit margins and absorb the increase in costs or face a loss in market share. This was due to the high level of spare capacity in the economy. Effectively, firms were facing elastic demand curves and any increases in price would have resulted in a fall in demand and total revenue.

INFLATIONARY GAPS

When aggregate demand exceeds an economy's productive potential there is an inflationary gap. We tend to see rising inflation and a worsening trade situation at these times



CONTROLLING AN INFLATIONARY GAP

The government may use monetary and or fiscal policy to help reduce the size of the inflationary gap. An improvement in the supply-side performance of the economy would also achieve this.

- **Monetary Policy:** Higher interest rates to curb consumer demand
- **Fiscal Policy:** A rise in the burden of taxation to reduce real disposable incomes
- **Supply-side Policy:** Measures to increase productivity and efficiency. This leads to a rise in aggregate supply and reduces the amount of excess demand in the long run.

Inflationary gaps can arise when the economy has grown for a long time on the back of a high level of aggregate demand. Total spending may rise faster than the economy's ability to supply goods and services. As a result, actual GDP may exceed potential GDP leading to a positive output gap in the economy.

COSTS AND EFFECTS OF INFLATION

There is widespread agreement that high and volatile inflation can be damaging both to individual businesses and consumers and also to the economy as a whole.

However, economists disagree about the relative seriousness of inflation. The revision notes below cover some of the main economic and social costs associated with persistent inflation in goods and services.

Effect on UK competitiveness - if the UK has higher inflation than the rest of the world it will lose price competitiveness in international markets. This assumes a given exchange rate. If the exchange rate depreciates, this may help to restore some of the lost competitiveness. Consider the chart above which shows the annual average increase in consumer prices for the UK, the United States and Euroland during the last four decades. Inflation in Britain has been relatively higher than in other major competitor countries - although the chart also indicates a movement towards inflation convergence during the 1990s

This rise in relative inflation leads to a fall in the world share of UK exports and a rise in import penetration. Ultimately, this will lead to a fall in the rate of economic growth and the level of employment.

The problems of a wage-price spiral – price rises can lead to higher wage demands as workers try to maintain their real standard of living. Higher wages over and above any gains in labour productivity causes an increase in unit labour costs. To maintain their profit margins they increase prices. The process could start all over again and inflation may get out of control.

Higher inflation causes an upward spike in inflationary expectations that are then incorporated into wage bargaining. It can take some time for these expectations to be controlled. Higher inflation expectations can cause an outward shift in the Philips Curve.
Inflation can also cause a reduction in the real value of savings - especially if real interest rates are negative.

This means the rate of interest does not fully compensate for the increase in the general price level. In contrast, borrowers see the real value of their debt diminish. Inflation, therefore, favours borrowers at the expense of savers.

Consumers and businesses on fixed incomes will lose out. Many pensioners are on fixed pensions so inflation reduces the real value of their income year on year. The state pension is normally uprated each year in line with average inflation so that the real value of the pension is not reduced.

However it is unlikely that pensioners have the same spending patterns as those used to create the weights from which the RPI figure is calculated. For example in November 1999, the state pension was up-rated by just 1.1% - the headline rate of inflation for that month.

Inflation usually leads to higher nominal interest rates that should have a deflationary effect on GDP.

Inflation can also cause a disruption of business planning – uncertainty about the future makes planning difficult and this may have an adverse effect on the level of planned capital investment.

Budgeting becomes a problem as firms become unsure about what will happen to their costs. If inflation is high and volatile, firms may demand a

higher nominal rate of return on planned investment projects before they will go ahead with the capital spending. These hurdle rates may cause projects to be cancelled or postponed until economic conditions improve. A low rate of new capital investment clearly damages long-run economic growth and productivity.

Cost-push inflation usually leads to a slower growth of company profits which can then feed through into business investment decisions.

Inflation distorts the operation of the price mechanism and can result in an inefficient allocation of resources. When inflation is volatile, consumers and firms are unlikely to have sufficient information on relative price levels to make informed choices about which products to supply and purchase.

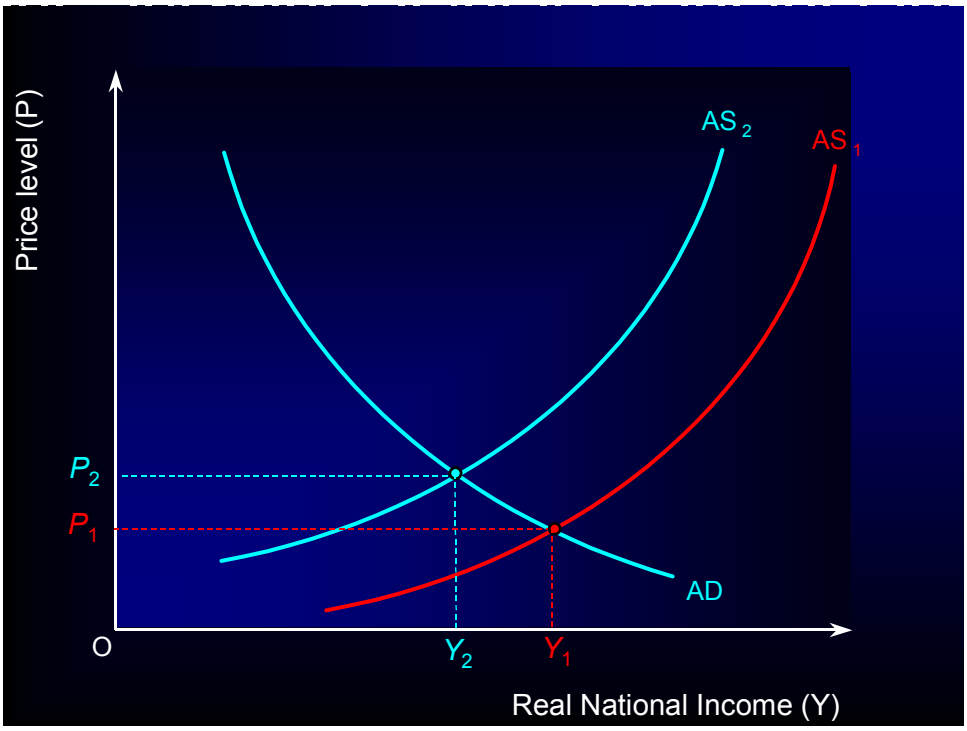
Shoe leather costs - when prices are unstable there will be an increase in search times to discover more about prices. Inflation increases the opportunity cost of holding money, so people make more visits to their banks and building societies (wearing out their shoe leather!).

Menu costs - extra costs to firms of changing price information. This can be important for companies who rely on bulky catalogues to send price information to customers. (Note there are also significant menu costs associated with any future transition to the European Single Currency)

Anticipated and unanticipated inflation
In general the costs of inflation to consumers are smaller when inflation is anticipated. They can take steps to protect the real value of their income and savings. The economic problems from high and variable inflation are more serious for the whole economy in the long run - particularly for those countries that are heavily dependent on international trade for their prosperity.

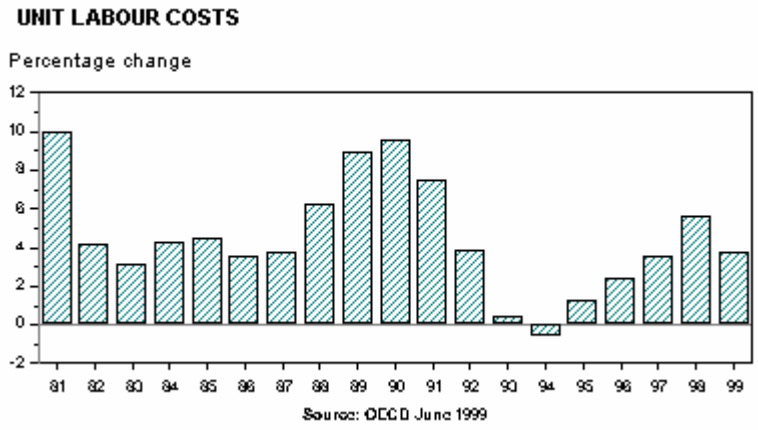
UNIT LABOUR COSTS AND INFLATION

Changes in unit labour costs (ulc's) are important in determining the underlying rate of inflation for the economy in the medium term. When the economy experiences an increase in unit labour costs - the effect is to reduce aggregate supply at each price level. The diagram below shows how an inward shift of AS for a given level of aggregate demand causes an increase in the general level of prices - this is known as cost-push inflation



Unit labour costs measure the labour cost per unit of output produced. ULCs will rise when total labour costs rise faster than output. For example if wages rise by 5% and labour productivity (output per worker) grows by 2%, unit labour costs will rise by 3%. A rise in labour productivity helps to control unit labour costs. This is because a producer is achieving a higher output from each unit of labour employed for a given wage cost.

The annual change in UK unit labour costs since 1981 is shown in the chart below



Unit labour costs tend to rise fastest when (a) there is an acceleration in wage demands / basic pay settlements and (b) there is a slowdown in the growth of productivity. Unit labour costs have grown less quickly in the 1990s compared with the 1980s. In part this is because wage demands have been much lower on average during the current decade. This has been an important factor in

explaining the continued low rates of inflation in the British economy over the last ten years.

MONETARY INFLATION

The Monetarist explanation of inflation operates through the Fisher equation.
M.V = P.T
M = Money Supply V = Velocity of Circulation
P = Price level T = Transactions or Output

As Monetarists assume that V and T are fixed, there is a direct relationship between the growth of the money supply and inflation. The mechanisms by which excess money might be translated into inflation are examined below.

Individuals can also spend their excess money balances directly on goods and services. This has a direct impact on inflation by raising aggregate demand. The more inelastic is aggregate supply in the economy, the greater the impact on inflation.

The increase in demand for goods and services may cause a rise in imports. Although this leakage from the domestic economy reduces the money supply, it also increases the supply of pounds on the foreign exchange market thus applying downward pressure on the exchange rate. This may cause imported inflation.

If excess money balances are spent on goods and services, the increase in the demand for labour will cause a rise in money wages and unit labour costs. This may cause cost-push inflation.

ECONOMIC POLICES TO CONTROL INFLATION

Policies to control inflation need to focus on the underlying causes of inflation in the economy. For example if the main cause is excess demand for goods and services, then government policy should look to reduce the level of aggregate demand. If cost-push inflation is the root cause, production costs need to be controlled for the problem to be reduced.

MONETARY POLICY - INTEREST RATES

Since May 1997, the Bank of England has had operational independence in the setting of official interest rates in the United Kingdom. They set interest rates with the aim of keeping inflation under control over the next two years.

Monetary policy can control the growth of demand through an increase in interest rates and a contraction in the real money supply. For example, in the late 1980s, interest rates went up to 15% because of the excessive growth in the economy and contributed to the recession of the early 1990s. This is shown in the chart above

Higher interest rates reduce aggregate demand in three ways;

- Discouraging borrowing by both households and companies

- Increasing the rate of saving (the opportunity cost of spending has increased)
- The rise in mortgage interest payments will reduce homeowners' real 'effective' disposable income and their ability to spend. Increased mortgage costs will also reduce market demand in the housing market

Business investment may also fall, as the cost of borrowing funds will increase. Some planned investment projects will now become unprofitable and, as a result, aggregate demand will fall.

Higher interest rates could also be used to limit monetary inflation. A rise in real interest rates should reduce the demand for lending and therefore reduce the growth of broad money.

FISCAL POLICY

- Higher direct taxes (causing a fall in disposable income)
- Lower Government spending
- A reduction in the amount the government sector borrows each year (PSNCR)

These fiscal policies increase the rate of leakages from the circular flow and reduce injections into the circular flow of income and will reduce demand pull inflation at the cost of slower growth and unemployment.

AN APPRECIATION OF THE EXCHANGE RATE

An appreciation in the pound sterling makes British exports more expensive and should reduce the volume of exports and aggregate demand. It also provides UK firms with an incentive to keep costs down to remain competitive in the world market. A stronger pound reduces import prices. And this makes firms' raw materials and components cheaper; therefore helping them control costs.

A rise in the value of the exchange rate might be achieved by an increase in interest rates or through the purchase of sterling via Central Bank intervention in the foreign exchange markets.

DIRECT WAGE CONTROLS - INCOMES POLICIES

Incomes policies (or direct wage controls) set limits on the rate of growth of wages and have the potential to reduce cost inflation. The Government has not used such a policy since the late 1970s, but it does still try to influence wage growth by restricting pay rises in the public sector and by setting cash limits for the pay of public sector employees.

In the private sector the government may try moral suasion to persuade firms and employees to exercise moderation in wage negotiations. This is rarely sufficient on its own. Wage inflation normally falls when the economy is heading into recession and unemployment starts to rise. This causes greater job insecurity and some workers may trade off lower pay claims for some degree of employment protection.

LONG-TERM POLICIES TO CONTROL INFLATION

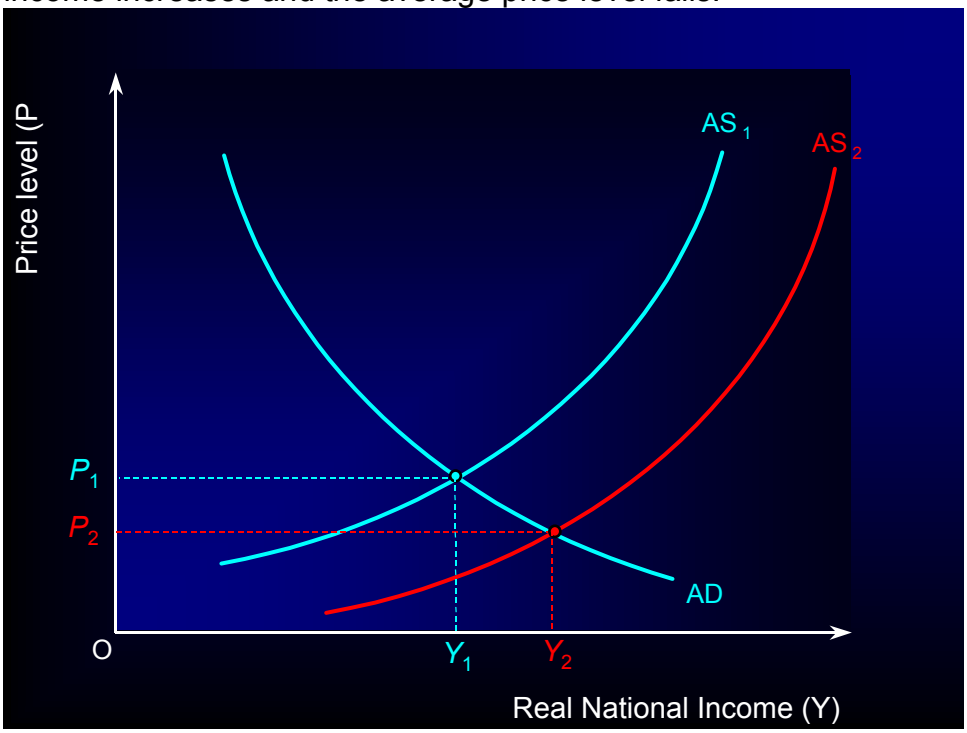
LABOUR MARKET REFORMS

The weakening of trade union power, the growth of part-time and temporary working along with the expansion of flexible working hours are all moves that have increased **flexibility** in the labour market. If this does allow firms to control their labour costs it may reduce cost push inflationary pressure.

Certainly in recent years the UK economy has not seen the acceleration in wage inflation normally associated with several years of sustained economic growth and falling inflation. One reason is that rising job insecurity inside a flexible labour market has tilted the balance of power away from employees towards employers.

SUPPLY SIDE REFORMS

If a greater output can be produced at a lower cost per unit, then the economy can achieve sustained economic growth without inflation. An increase in **aggregate supply** is often a key long term objective of Government economic policy. In the diagram below we see the benefits of an outward shift in the short run aggregate supply curve. The equilibrium level of real national income increases and the average price level falls.



Supply side reforms seek to increase the productive capacity of the economy in the long run and raise the trend rate of growth of labour and capital productivity. A number of supply-side policies have been introduced into the British economy in recent years. Productivity gains help to control unit labour costs (an important cause of cost-push inflation) and put less pressure on producers to raise their prices.

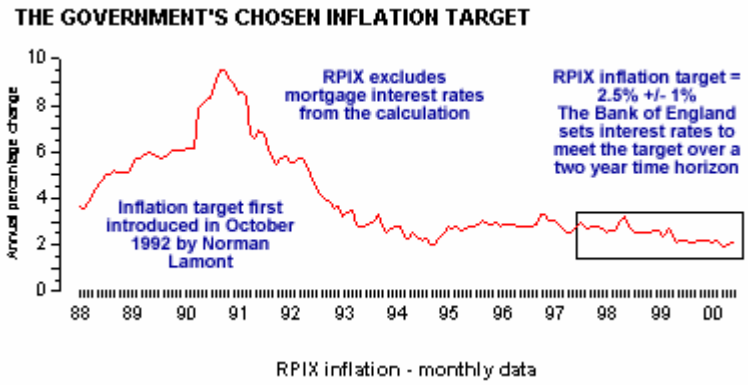
The key to controlling inflation in the long run is for the authorities to keep control of aggregate demand (through fiscal and monetary policy) and at the

same time seek to achieve improvements to the supply side of the economy. The credibility of inflation control policies can often be enhanced by the introduction of inflation targets.

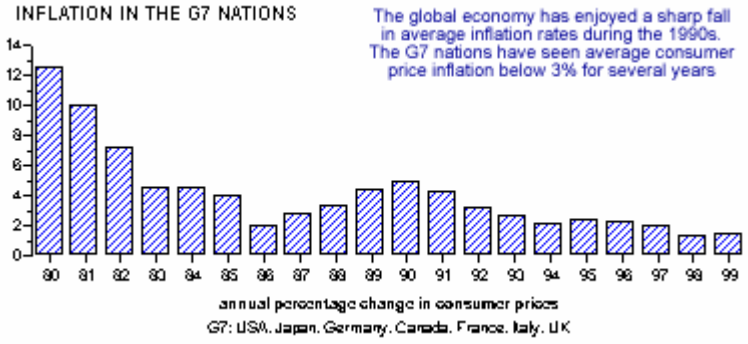
INFLATION TARGETS IN THE UK AND OTHER ECONOMIES

Many countries operate inflation targets. The number of countries with explicit inflation targets increased almost sevenfold between 1990 and 1998 from 8 to 54. Since October 1992, the British Government has pursued an explicit inflation target for the economy. When Labour came to power in May 1997, they set the target for RPIX inflation at 2.5% (+ or - 1%) for the next five years.

The **Bank of England Monetary Policy Committee** sets interest rates with a view to meeting the inflation target over the next two years. If RPIX inflation



moves 1% either side of the 2.5% target, the Governor of the Bank has to write an open letter to the Chancellor explaining the reasons for the inflation undershoot / overshoot and the steps the MPC are taking to bring inflation within the target zone again. Over the last seven years, RPIX inflation in the UK has stayed within 1% of the target measure. The 1990s has seen a return to the low, stable inflation last seen in the 1960s.



ADVANTAGES OF AN INFLATION TARGET

An effective inflation target can have several economic benefits:

- It can reduce inflationary expectations if people believe a low inflation target will be met. This will then reflect in the wage demands of people in work. If employees expect low inflation they may be prepared to accept a slower growth of pay. This reduces the risk of cost-push inflation in the economy. A fall in inflation expectations can cause an inward shift of the Phillips Curve.

- A target gives monetary policy a clear anchor and improves the accountability and transparency of economic policy-making. The quarterly Bank of England Inflation Report is a highly detailed assessment of economic trends and the Bank's best guess about future movements in inflation. All A-Level Economists and Degree students should make a habit of reading it!
- Sustained low inflation improves prospects for higher levels of capital investment in both manufacturing an service industries. This is because businesses will not demand such high nominal rates of return on potential investment projects if they believe that inflation will remain low and stable.
- A Bank of England report in August 1999 argued that inflation targets have been successful in reducing inflation expectations and improving people's understanding of the inflation process

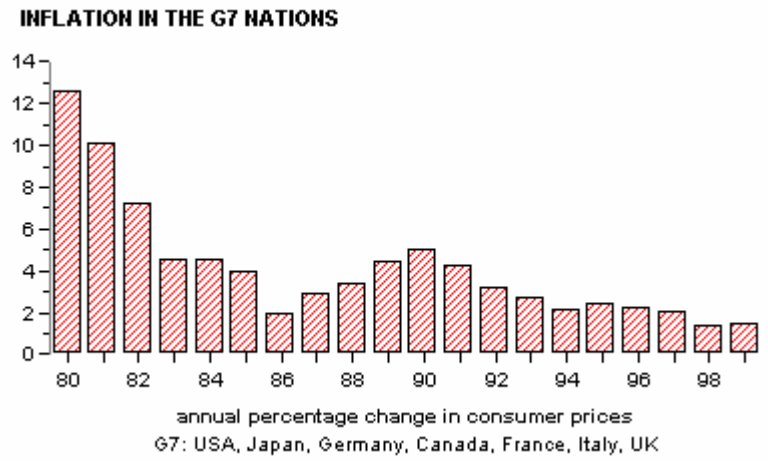
POTENTIAL DISADVANTAGES OF AN INFLATION TARGET

- The main drawback is that a narrow inflation target is risky for an open economy such as the UK. Am open economy relies heavily on exports and imports and imposes few restrictions on free trade between countries.
- Fluctuations in the exchange rate and changes in inflation rates in other countries or in the prices of imported goods and services can push the domestic inflation rate higher and lead to increases in interest rates. Higher interest rates have the effect of damaging economic growth and employment.
- There is a danger that strict adherence to a tough inflation target may lead to the economy operating well below its long-run productive potential. This can create much higher unemployment - which in itself generates economic and social costs.

Nonetheless, most countries have decided that some target for inflation should be maintained. How they achieve the target is a matter of continuous economic debate!

WHAT IS DEFLATION?

Deflation refers to a decrease in the general price level of the economy. A fall in prices in particular markets, such as housing, share prices or the market for electronic goods or textiles is not the same as economy-wide deflation.



Most economists believe that disinflation or falling inflation is beneficial for the economy. A stable price level can lead to better decisions and a more efficient use of scarce resources. Lower inflation also helps to stabilize inflationary expectations. A decline in prices after an improvement in productivity is allows companies to cut costs and prices, thereby raising living standards.

The type of deflation that analysts fear is the kind that is broadly-based throughout the economy, long-lasting, and symptomatic of a weak economy stuck in recession. When prices are falling , consumers may decide to postpone purchases in the expectation of buying the item at a cheaper price later on. This causes a fall in demand and can create further price declines.

Deflation also causes real interest rates to rise, curbing demand. As well, falling asset prices (including housing and equities) reduce personal sector wealth and inflate the real value of debt, resulting in higher business failures and personal bankruptcies. It is clear therefore that deflation in the economy brings risks as well as opportunities. This is something that a government and the monetary authorities (i.e. the Central Bank) might be concerned to avoid.

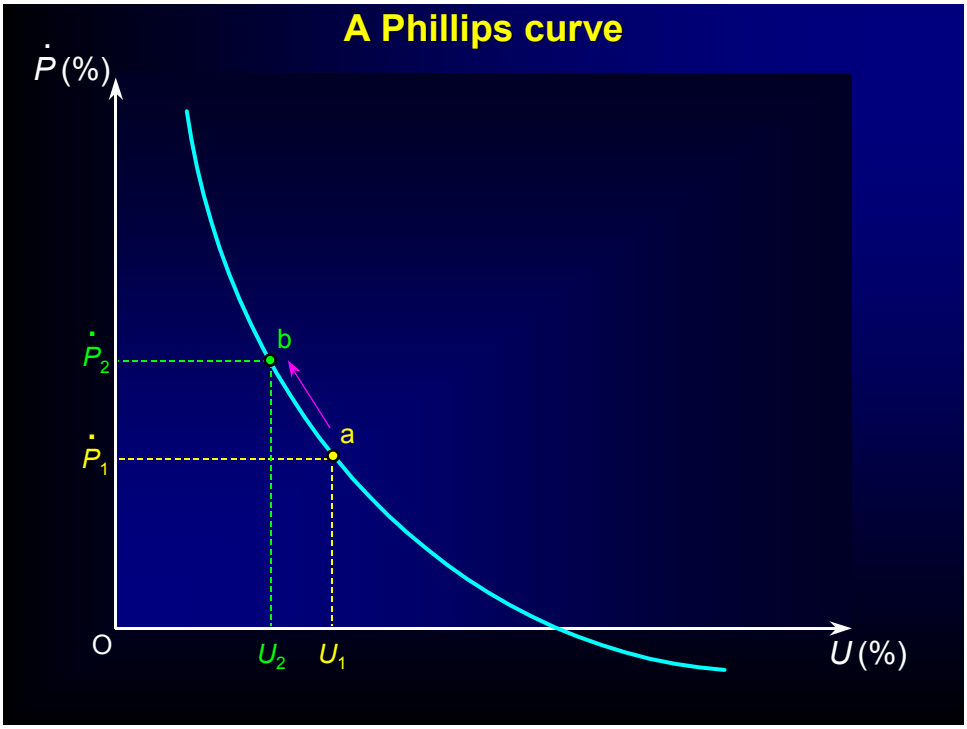
DEFLATION AND ECONOMIC POLICY

Deflation can normally be controlled by an expansionary monetary policy with the Central Bank or the Government allowing the money supply to expand. This causes interest rates to fall and stimulates consumer spending and investment demand. Occasionally though, when prices are falling, lenders may call in loans or refuse to lend out to potential borrowers. This is known as a credit crunch.

Cutting interest rates may not be sufficient during a credit crunch. In this case, expansionary fiscal policy (lower direct and indirect taxes and higher government spending) is often prescribed to cure deflation. One reason deflation is difficult to cure is that nominal interest rates cannot fall below zero, while prices of goods and services can fall for a long time. In this event, monetary policy is unable to prevent higher real interest rates and the economy spirals downwards towards a slump caused by falling prices, contracting output, falling investment, plant closures and increasing levels of job losses in those industries affected.

THE PHILLIPS CURVE AND THE NAIRU

THE PHILLIPS CURVE



The **Phillips Curve** demonstrates the trade off between unemployment and inflation. It is based upon unemployment and wages data between 1862 and 1957.

ADAPTIVE EXPECTATIONS THEORY OF THE PHILLIPS CURVE

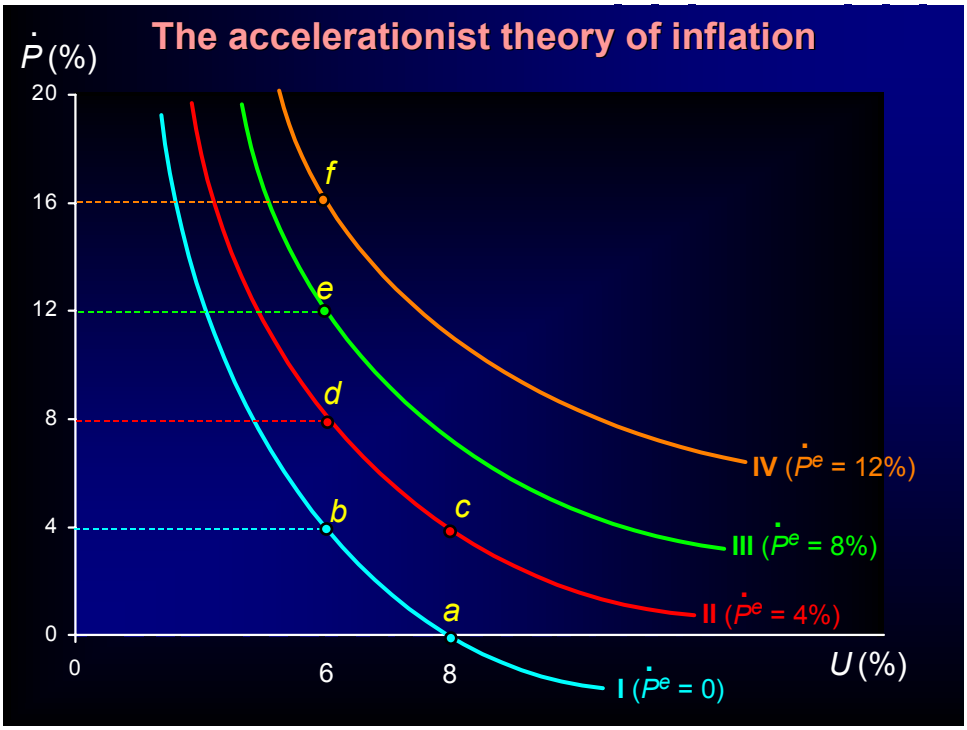
Each short-run Phillips Curve (SRPC) is drawn on the assumption of a given **expected rate of inflation.** If there is a change in inflation expectations in the economy we see a shift in the Phillips Curve.

This theory is based upon **adaptive expectations** – people base their expectations of inflation on past levels of inflation.

If we look at an imaginary economy over a number of years it will help us understand the relationship between different SRPCs.

Year 1 - there is no inflation of any sort and it leads to unemployment of 8% at point a on the diagram.

Year 2 – the government expands AD in order to reduce unemployment. Unemployment falls to 6%, moving along SRPC I to point b where inflation is now 4% as people are basing their expectations of inflation on year 1.



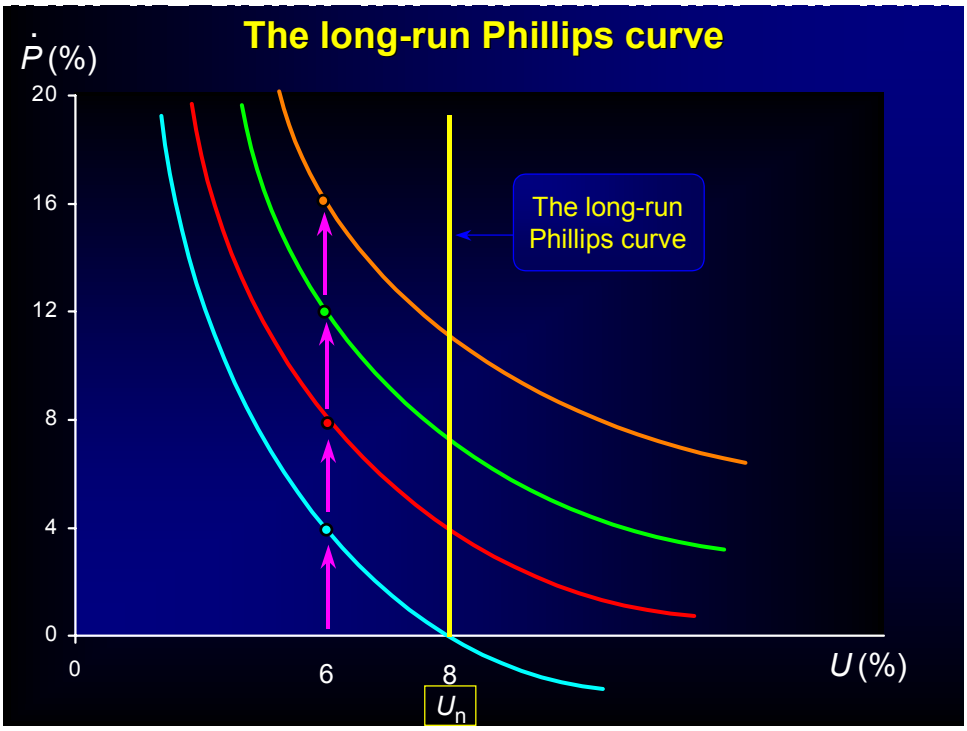
Year 3 – People now revise their expectations to the level of year 2, 4%. The SRPC shift upwards by 4% to II. If money AD continues to rise at the rate, the whole of the increase will be absorbed into higher prices. Real AD will fall back to its original level and the economy will move to c where unemployment is 8% again, but it's now associated with 4% inflation.

Year 4 – the government isn't happy that unemployment has risen to 8%, therefore it expands AD and the unemployment level falls to 6% again, moving to d on the SRPC II. Inflation has now risen to 8%.

Year 5 – Expected inflation is now 8% and the SRPC shifts to III. If the government wishes to keep unemployment at 6% it must increase AD again moving the economy to e at 12% inflation.

This adaptive expectations theory of the Phillips curve is sometimes known as the accelerationist theory as the government must accelerate the price level each year if it wishes to keep the level of unemployment below the equilibrium.

In our example unemployment of 8% will be the natural rate of unemployment or the non-accelerating inflation rate of unemployment (NAIRU). This means the government can only reduce unemployment below the NAIRU in the short run. In the longrun we are able to construct a long run Phillips curve, which is drawn vertical at the NAIRU.



THE NAIRU

The Non Accelerating Inflation Rate of Unemployment is the level of unemployment at which inflationary pressures in the economy are stable. According to supply-side economists, unemployment cannot be held permanently below its natural level.

Some argue if actual unemployment falls below the NAIRU/natural rate (i.e. equilibrium unemployment) - there is upward pressure on wage inflation that then feeds into general price inflation.

Clearly changes in unemployment do have an effect on the risk of inflation. Consider this comment from the Bank of England.

"Developments in the labour market are a key determinant of domestically generated inflation." (UK Monetary Policy Committee minutes)

As unemployment falls towards the NAIRU, skill shortages exert upward pressure on wages and producer prices, until any further falls in unemployment lead to future higher inflation.

WHAT DETERMINES THE NAIRU?

The NAIRU can and does vary between countries and changes over time for any one particular economy.

The rate of unemployment at which inflation starts to accelerate is determined by the efficiency of the labour market and the relative strength of employers and employees in the wage bargaining process

The changing nature of the wage bargaining process

- **Strength of Trade Unions** - Unions have become much less powerful in the UK over the last twenty years. This has tilted the balance of power towards employers and helped to keep "inflation-busting" pay claims in check
- **Centralisation / decentralisation of pay bargaining** There has been a switch towards local and regional pay settlements that can take more account of local differences in labour demand and supply
- **Scale of involuntary structural unemployment in the economy** - measures to reduce structural unemployment should help to reduce the NAIRU if effective. This is because they increase the available labour supply in the economy, e.g., Labour's New Deal

Competitiveness of product markets - impact on producers and labour

- When **product markets are more competitive** there is intensive pressure on firms to control costs. Wage increases might only be justified by improvements in productivity

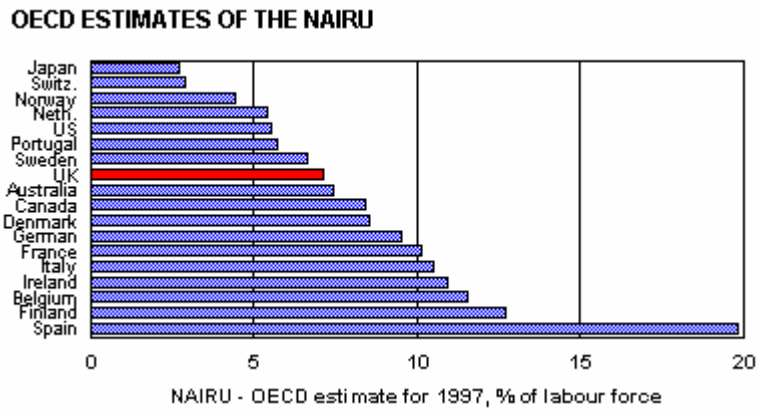
"External-shock" effects on wage bargaining

The economy can be affected by **external economic shocks** that effect expected inflation.

- The global economic crisis in the Far East in 1998 has brought down expectations of inflation
- The fall in international commodity prices has had a similar effect - causing a sharp fall in inflation in many countries across the world. Lower input costs cause an outward shift in short run aggregate supply in the economy and should help to increase the real volume of national output
- The events on September 11th caused people to feel that the global economy would move towards recession as aggregate demand falls; this would lead to a reduction in inflation.

Most economists believe that the natural rate of unemployment has fallen in the UK over the last decade. This means that the economy can sustain a lower rate of unemployment without triggering off a renewed burst of wage inflation. The evidence supports this positive view often improving trade-off between unemployment and wage/price inflation. By the summer of 2000, unemployment in the UK had fallen to just 3.8% of the labour force (using the claimant count measure) whilst retail price inflation had remained comfortably within the government's target (2.5%) and wage inflation was under control.

Economists at the OECD have estimated the NAIRU for the leading industrialised countries. Their estimates for 1997 are shown in the chart below. The UK comes out favourably in this international comparison. Our estimated NAIRU is substantially below that of Germany and France - although some way above that for the United States and Japan. The Netherlands (another country to have introduced widespread labour market reforms over the last fifteen years) is also estimated to have a lower NAIRU than the UK.

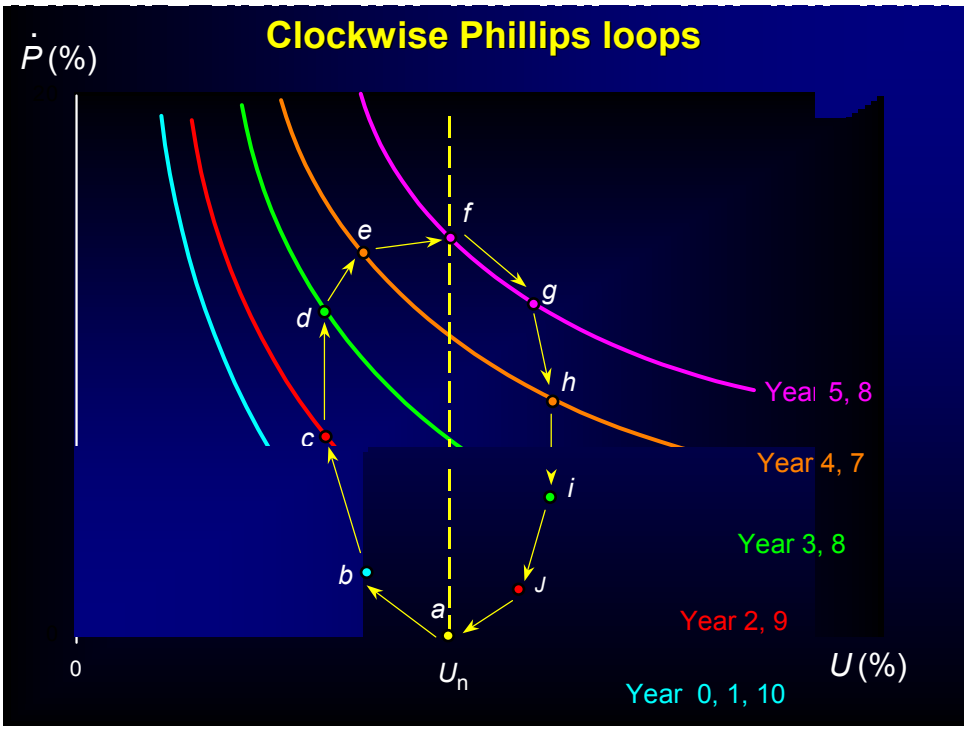


CLOCKWISE PHILLIPS CURVE LOOPS

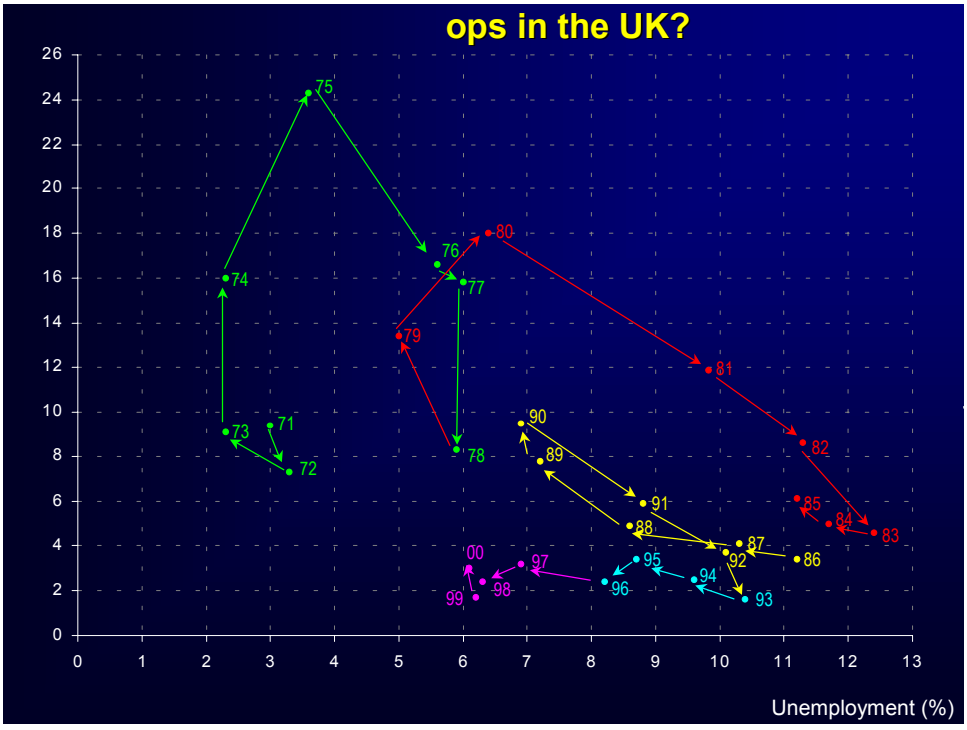
Over recent years the Phillips curve relationship has broken down, as the UK was able to enjoy low inflation and unemployment during the 1960s. The clockwise Phillips curve loop was developed to explain the boom/bust years. If we consider a 10 year period where we start at 0% inflation at the NAIRU. The government then pursues an expansion policy in order to reduce the level of unemployment and the economy moves through points b, c and d.

The government now starts to worry about the level of inflation and allows unemployment to rise and the economy moves to e. There is still some demand pull inflation as expected price level is below the actual price level and the economy moves to f.

The government now wishes to reduce the level of inflation so it allows unemployment to rise above the natural rate as AD is reduced. The economy returns to a via g, h, i and j. We are able to see stagflation (inflation and unemployment rising) from points d to f.



From 1971 we can see that there have in fact been a number of Phillips loops that have occurred. The shifting loops imply that the natural rate of unemployment changed from 1970-2000.



Monetary policy is used to control inflation NOT unemployment. In order to reduce unemployment in the longrun it is necessary to undertake supply side policies.

INDEX