**03 Economic Growth**



1. Economic Growth

**A. Economic Growth**

**Starter**: True or false?

1. The UKs inflation target is 2% of RPI (+ or – 1%)
2. Short-run economic growth is caused by a rise in AD and/or SRAS
3. Short-run economic growth causes a rightward shift in the PPF
4. Net exports equals… X (revenue gained from eXports) minus M (revenue spent on iMports)
5. ‘Full employment’ means that everyone has a job
6. A negative output gap means that there must be some FoP that are unemployed
7. Cost-push inflation is caused by a rise in AD
8. Structural unemployment is caused by occupational and structural immobility of labour

**Causes of Economic Growth**

**Activity 1**: Complete the diagrams below to show short-run and long-run economic growth

a) Short-run economic growth is shown by an increase in AD and/or SRAS

1. Increase in AD and extension in SRAS ii) Increase in SRAS and extension in AD

b) Long-run economic growth is shown by an increase in LRAS and PPF

1. Increase in the PPF ii) increase in the LRAS and extension in AD

**Ext**: How would the examples above affect the Govt’s 4 macro objectives? Annotate the diagrams above.

**Activity 2:** Complete the mind map to explain the causes of economic growth i.e. factors causing a rightward shift in AD, SRAS and LRAS:

**a) Demand-Side**

e.g. increased consumer confidence

e.g. lower corporation tax

AD = C + I + G + (X – M)

e.g. spending on healthcare

e.g. rising incomes abroad

**b) Supply-side**

Shifts in LRAS and SRAS

**Increased quantity Reduced costs for firms  
 or quality of factors  
 of production**

|  |  |
| --- | --- |
| **Land** | e.g. fall in oil prices |
| **Labour** | e.g. net inward migration |
| **Capital** |  |
| **Enterprise** |  |

**Ext:** What type of growth is more desirable? Demand-side growth or supply-side growth? Relate your answer to the government’s 4 macroeconomic objectives.

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**Activity 3:** Explain the benefits and drawbacks of economic growth to an economy

**Benefits Drawbacks**

**Ext:** For each of the stages of 4 stages of the economic cycle (boom, slowdown, recovery, recession), describe what is happening to the 4 macro objectives (inflation, growth, U and BoP)



|  |  |
| --- | --- |
| **Boom**  **Inflation**: Generally, above target (2% CPI) and rising | **Slowdown**  **U:** Generally fairly low level of U, but beginning to rise |
| **Recession**  **BoP:** Low level of iMports due lack of disposal income. High eXports due to low inflation/deflation | **Recovery**  **Economic Growth:** Turning positive, on the rise |

**Activity 4**: Using a monetarist/classical ADAS diagram, fill in the missing words in the text below

**Point A:**

The economy is in long run equilibrium as here are no inflationary pressures. Assuming AD increases (perhaps G is increased), AD shifts from AD1 to AD2……..

**Point B:**

The economy is no longer in \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

There is a \_\_\_\_\_\_\_\_\_\_\_\_\_ output gap and the economy is booming. Y has increased and \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ inflation has occurred. At this point, \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ will be very low.

**Point C:**

Wage rates increase, causing \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ inflation.

SRAS therefore shifts SRAS1 to SRAS2 and there is \_\_\_\_\_\_\_ output gap. At point C, the economy is back in \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

**Words to use**: *no, equilibrium, positive, negative, cost-push, demand-pull, spare capacity*

**Monetarists Say...**

**Keynesians Say...**

**“It’s about spending and investment!”**

Accelerator principle: Investment is determined by

consumption. If consumption grows, investment grows

(because confidence is high).

Multiplier Principle: Increases in AD in both are Multiplied through the economy, fuelling further growth.

At some point, a ceiling in growth is reached, (perhaps full

employment is reached). Demand falls, investment falls, and a

downward spiral starts.

At some point, a ceiling in the downturn is reached. Perhaps

consumers borrow or use savings to sustain a level of lifestyle.

Perhaps G is increased to kick start the recovery.

So, demand increases and the whole cycle starts

Again.

**“It’s about the money supply!”**

If the money supply grows faster than

output grows, then consumption increases,

because people feel better off.

The extra consumption causes inflation.

Consumers later reduce consumption again

when they realise they are not really better

off (because of the inflation).

Exports also fall (so AD falls) because domestic

firms are now less competitive internationally

(due to the inflation).

NB. Monetarist argue that increases in government spending to encourage growth in the economy will lead to increases in the money supply greater than output in the economy

**Extension Material: Principles of Keynesianism and Monetarism**

**Keynesianism**

In a recession / liquidity trap, government intervention can stimulate aggregate demand and real output through government borrowing and higher government spending. Therefore Keynesians advocate [expansionary fiscal policy](http://www.economicshelp.org/blog/617/economics/impact-of-expansionary-fiscal-policy/) in a recession.

Keynesians reject the theory of [crowding out](http://econ.economicshelp.org/2007/02/keyness-paradox-of-thrift.html) presented by Monetarists. Keynesians say that if there is a sharp rise in private sector borrowing, government spending can offset this decline in spending.

[Paradox of thrift](http://econ.economicshelp.org/2007/02/keyness-paradox-of-thrift.html). A key element in Keynesian theory is the idea of a ‘glut’ in savings. Keynes argued in a recession, people responded to the threat of unemployment by increasing saving and reducing their spending. This was a rational choice, but it contributes to an even bigger decline in AD and GDP.

Keynesians usually believe there is a degree of wage rigidity. In a recession, Keynes said wages may be ‘sticky downward’ as unions resist nominal wage cuts, this can lead to real wage unemployment. Also, in a recession, when an economy has spare capacity, increasing Aggregate demand will have an impact on real output and only minimal effect on the price level.

Keynesians believe there is often a multiplier effect. This means an initial injection into the circular flow can lead to a bigger final increase in real GDP.

Generally, Keynesians are more likely to stress the importance of reducing unemployment rather than inflation.

Keynesians reject real business cycle theories (an idea that the government can have no influence over the economic cycle)

**Monetarism**

Monetarists are critical of fiscal policy to stimulate growth in real GDP – the less Govt. intervention, the better.

Monetarists / classical economists believe wages are more flexible and likely to adjust downwards to prevent real wage unemployment

Monetarists stress the importance of controlling the money supply to keep inflation low.

Monetarists more likely to place emphasis on reducing inflation than keeping unemployment low.

**Ext 1: Classical equilibrium exercise**

**Negative Output Gap Positive Output Gap**

**Negative Output Gaps**

When aggregate demand is too low (shown by point B on the diagram), the economy is said to be operating with a negative output gap. At this point Aggregate Demand is not high enough to ensure that the factors of production including labour are fully employed. However for classical economists (Monetarists) this situation will correct itself, as unemployed labour will agree to work for lower wages rather than be unemployed. This will reduce firm’s costs and the Short Run Aggregate Supply curve will shift to the right. Due to less unemployment and lower prices, there will be an extension down the aggregate demand curve. The economy will settle at a new equilibrium at point C.

**Activity 1:** Use the diagram above to explain what a positive output gap is. Complete this exercise in the space provided below, using the hints provided to help your explanation.

**Hint:** If you can answer each of these key questions then you should be able to explain how a positive output gap occurs and why this disequilibrium in the macro economy is resolved.

**Key Questions**

1. What has caused the AD curve to shift to the right? At what output level did we assume the economy started?
2. Explain what will happen to the demand for goods and services following the increase in Aggregate demand.
3. How will firm’s get more workers?
4. What is the impact on firm’s costs?
5. What is the long run impact of the initial factor increase in AD? (what has been the impact on output in the economy and price levels)

**Key words in your explanation:** Full employment, firm’s costs, wages levels, long run, output

**Notes Page**



**Activity** : For each of the scenarios illustrate the affect on economic growth(the correct type). Explain your answers using a logical chain. Try to use a range of diagrams

**Explanation**

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**Diagram 1**: Economic downturn in a major trading partner

**Diagram**

**Diagram 2**: Steep rise in oil and gas prices

**Diagram**

**Explanation**

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**Explanation**

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**Diagram 3**: Unexpected tax increases

**Diagram**

**Explanation**

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**Diagram 4**: Political turmoil including strikes by unions

**Diagram**

**Explanation**

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**Diagram 5**:Natural disaster causing a sharp fall in production

**Diagram**

**Explanation**

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**Diagram 6**: Financial crisis causing a lack of bank lending

**Diagram**

**Diagram 7**: Bigger than expected rise in unemployment

**Diagram**

**Explanation**

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**Explanation**

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**Diagram 8**: Unexpected breakthroughs in production technology

**Diagram**

# Tick list of tasks you must complete to finish this module:

|  |  |  |  |
| --- | --- | --- | --- |
| **Do you understand Economic Growth fully?** |  | | ✓ |
| **Short run economic growth, can you:** | | | |
| Define economic growth | |  |  |
| Define short run economic growth | |  |  |
| Identify the causes of short run economic growth and illustrate using a diagram | |  |  |
| Explain the benefits of short run economic growth on macro objectives | |  |  |
| Explain drawbacks of short run economic growth on macro objectives | |  |  |
| **Long run economic growth:** | |  |  |
| Can you define long run economic growth | |  |  |
| Identify the causes of long run economic growth and illustrate using a diagram | |  |  |
| Explain the benefits of long run economic growth on macro objectives | |  |  |
| Explain drawbacks of long run economic growth on macro objectives | |  |  |
| Explain why macro objectives don’t conflict with LR economic growth | |  |  |
| **Overall Economic Growth** | |  |  |
| Explain impact on macro objectives during different phases of economic cycle | |  |  |
| Summarise the monetarist view of economic growth | |  |  |
| Summarise the Keynesian view of economic growth | |  |  |
| Explain using a diagram a negative output gap and appropriate economic policy | |  |  |
| Explain using a diagram a positive output gap and appropriate economic policy | |  |  |
| **Demand and Supply side shocks:** | |  |  |
| Can you identify the four main demand side shocks | |  |  |
| Can you identify the four main supply side shocks | |  |  |
| Explain policies that may be used in the face of demand and supply side shocks | |  |  |
| **Help can be found in the following places … ?:** | |  |  |
| Answered the “mastered this topic questions” on Godalming Online | |  |  |
| Watched recommended videos from Godalming online | |  |  |
| Attended a support session in rm 206 (Mon, Wed and Fri 1300) | |  |  |

**Boost exam performance:**

|  |  |  |
| --- | --- | --- |
| Complete the multiple choice questions on Godalming online |  |  |
| Complete 4 & 9 marker questions on Godalming online |  |  |
| Read year 2 economics textbook section on Economic Growth |  |  |