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Economics Today

Articles

Regular Features

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To what Degree is there Competition in the UK Postal Market?

***Amy Chapman**, Head of Economics and Business Studies at Cheltenham College and a Principal Examiner, discusses the muted degree of competition that faces Royal Mail in postal services in the UK.*

The postal sector over recent years has declined relative to other communications sectors. It can be argued that this is due partly to greater dynamism and technological innovation elsewhere, such as in the telecoms sectors with the development of mobile phones and increasing electronic-substitution possibilities. However, despite this relative decline of mail as a form of personal communication, overall mail volumes have stayed constant due a rise in the use of mail as a form of advertising and marketing.

Exam Board	AS	Unit	A2	Unit
AQA	✓	1(3.1.3 & 3.1.4)	✓	3(3.3.3 & 3.3.5)
Edexcel			✓	3(3.3.7 & 3.3.11)
OCR			✓	F584
WEJC			✓	EC3(D)
CCEA			✓	3
Int. Bacc.	Higher Level 2.3			

The mail market today is vastly different to that of five years ago. Royal Mail – then the monopoly mail service provider – was losing more than one million pounds a day. Its future, and the future of the universal postal service, looked bleak.

Market liberalisation of postal services began in 2003 when one-third of Royal Mail's letters market was opened to competitors. Market liberalisation is the process of introducing competition into a market where monopoly power exists.

In January 2006 the whole of the UK postal market was liberalised and Royal Mail now shares the letters market with 21 competing companies, all licensed by Postcomm. However, Royal Mail is still by far the dominant operator with a virtual monopoly of delivery over 'the final mile'.

The present Labour government has shown a real commitment to market liberalisation through its competition policy. The Department for Trade and Industry said:

> Competition is a process, in which the long-run and short-run may look very different, and in which firms use a variety of weapons – not just price – with which to compete. Innovation, product design and variety are often important parts of the competitive game between firms.[1]

When discussing competitive markets economists apply the following characteristics:

- Economic efficiency – competition should ensure that firms attempt to minimise their costs and move towards productive efficiency. There will also be dynamic efficiency.
- Greater innovation – in order to keep consumers interested entrepreneurs need to keep improving and innovating the product.
- Low barriers to entry – there is little stopping firms entering and exiting the market if they feel there are abnormal profits to be made. Barriers to entry can be structural (economies of scale), strategic (predatory pricing) or statutory (patents and licenses).
- Lower prices – prices will be lower due to the large number of firms in a market competing to attract customers. Suppliers face elastic demand curves and any rise in price will lead to a fall in demand and in total revenue. There is a high cross-price elasticity of demand showing the ease of substitution of one product for another when the price changes.
- Lower total profits – prices restrained by keen competition so therefore profits are constrained.

As we look at the UK postal market in more depth we will refer back to these characteristics to assess the amount of competition.

Postcomm, the postal market regulator, has detailed why it felt introducing competition into the postal market was the best policy.

> The Commission believes that the growth of competition offers by far the best route to achieving our vision. While price and other regulatory controls over Royal Mail's behaviour can help to drive efficiency, competition should also stimulate innovation and customer focus by allowing customers to choose the optimal mix of types of service, service quality, and price. Wherever possible we believe competition is a better stimulus to customer benefits than regulation. One of the key benefits of competition is encouraging further cultural change in Royal Mail to ensure that it becomes more customer focused.[2]

The outcome of this approach favouring competition is that there are now 22 licensed mail providers including Royal Mail offering a variety of services:

- Citipost AMP Limited
- City Link Post (trading name of Target Express Parcels)
- CMS (trading name of Royale Research Limited)
- DHL Express Limited (formerly Securicor Omega Express)
- DHL Global Mail (UK) Limited
- Document Outsourcing Limited
- DX Network Services
- FedEx UK Limited (formerly ANC Limited)
- Intercity Communications
- LDS Cambridge Limited
- Lynx Mail (trading name of Red Star Parcels)
- The Mailing House Group (trading as Northern Mail)
- Peoplepost Limited
- Post 123
- Racer Consultancy Management Services Ltd
- Royal Mail
- Scotpost (trading name of Mr Wesley Pollock)
- Secure Mail Services (formerly Special Mail Services Limited)
- Secured Mail Limited
- TNT Post UK Limited
- UK Mail
- Zip Mail Ltd

It can certainly be said that there are a large number of firms in the market now, but it is doubtful whether we can really say that overall competition has been increased. There are so many different services that the firms provide such as business to business mail, bulk pre-sorted mail, business to consumer mail and UK and international courier

Royal Mail now shares the letters market with 21 competing companies.

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1. DTI, Report on competition in UK markets, July 2004.
2. http://www.psc.gov.uk/about-postcomm/annual-reports-and-plans/archived-reports-and-plans/Corporate_strategy_2005-2008.pdf

Royal Mail still dominates postal services delivering 99% volume of addressed letters.

services. Royal Mail still dominates postal services delivering 99% of volume in the addressed letter market (2007/08). But nonetheless new operators are delivering nearly 26 million items (2007/08).

Most of the competitors to Royal Mail have entered the market by using third party access to Royal Mail's delivery network, i.e. through 'access competition'. This is a process in which the operator collects, sorts and trunks its customers' mail to Royal Mail's mail centres, and Royal Mail then take responsibility for the final delivery of the items. It can therefore be said that this area of the market has been opened up and is now much more competitive. 'End-to-end competition' describes the situation in which a competitor provides the entire mailing process from collection to delivery. This type of competition is far less developed in the UK, representing just 0.2% of licensed mail volumes. The few operators that do offer end-to-end services tend to offer local services or high-value services.

Innovation

Innovation is a key expected benefit of market liberalisation in the postal market. There has been some technological innovation by Royal Mail through its transformation strategy. Royal Mail has introduced a number of measures to be innovative following the introduction of competition into the market. For example, recently Royal Mail has launched a new direct mail service that allows companies to send customised CDs called the Personalised Integrated Media (PIM) Service. This is a bulk mail service with a minimum quantity of 10,000 units. It can be argued that had the market not been opened up to competition Royal Mail would not have had the incentive to become innovative due to a lack of competitive pressure.

Stamp prices

Royal Mail announced at the end of 2008 that the price of First and Second class stamps for standard letters weighing up to 100g would rise by 3p, to 39p and 30p respectively, from 6 April 2009, in line with the price controls set by the regulator, Postcomm. The price increases will add less than 5p to the average UK household's weekly expenditure. Households currently spend around £26 on postage each year, considerably less than on other forms of communication, including telephone and broadband services. Royal Mail's stamp prices continue to remain among the lowest in Europe. However, even after these price rises stamped mail will still be loss-making for Royal Mail.

There are two reasons why Royal Mail can offer lower prices than its competitors. The first of these is its exemption from charging VAT for its postal services and secondly the economies of scale from which it benefits.

Previously as a statutory monopoly Royal Mail had little need to control its costs. Similarly, price sensitivity would not be a priority since customers would have no other option but to pay for a product or service they need. You can understand this if you consider a demand curve with low price elasticity, indeed almost perfectly inelastic.

Barriers to entry

Barriers to entry block potential firms from entering a market. The main barrier to entry in the postal market is the economies of scale which Royal Mail can benefit from. As Royal Mail have enjoyed many decades of being the sole provider of postal services in the UK they have built up and enjoyed economies of scale which new entrants into the postal market will struggle to achieve. Royal Mail continue to be protected by the statutory barrier to entry of being exempt from charging VAT. All other competitors in the postal market must charge VAT so are already at a disadvantage on the price front.

▶ *Economic efficiency*
Royal Mail is far less efficient than other European postal services which sort letters into 'walk order' by machine, but in the UK this is still done by hand. It is however early on in the process of opening up the market and it will take time for Royal Mail to introduce new technology.

If we consider the characteristics of competitive markets as discussed earlier then we can conclude that the postal market is becoming more competitive. If we simply take competition as the number of firms in the market then we can say yes there is more competition as we now have 22 firms. However it is a long way from being a genuine contestable market.

The Hooper Commission report released on 16 December 2008 set out a number of critical requirements for a sustainable future for Royal Mail. Lord Mandelson announced that Royal Mail will be part-privatised in order to protect its long term future. Lord Mandelson, who made his announcement in a statement in the House of Lords, said Hooper had concluded that "the status quo was untenable" and that, without reform, the universal postal service (delivery to all 28 million households and businesses in the UK six days a week) was under threat.

The Hooper report identified five threats to the Royal Mail's future:

- The revolution in communication technology – Royal Mail are delivering 5 million fewer letters a year compared with two years ago.
- Poor efficiency – Royal Mail has less automation and less efficiency than its European counterparts.
- The size of the Royal Mail's pension fund deficit.
- Poor labour relations.
- Poor relationship with its regulator (Postcomm).

TNT have announced an interest in exploring a strategic partnership with Royal Mail following the recommendations of the Hooper Commission report. Peter Bakker, CEO of TNT, said:

> Royal Mail and TNT have explored partnership opportunities in the past. The views of the Hooper Commission provide a clear framework for the UK postal sector going forward. Assuming the UK government implements these recommendations, I think that exploring a strategic partnership with Royal Mail makes a lot of sense for both our companies.[3]

So it would seem that the market liberalisation of the UK postal market is set to continue: watch this space!

Summary of key points

- The process of market liberalisation in the postal market started in 2003, with it fully open to competition in January 2006. There are now 22 firms, including Royal Mail, operating in the postal market.
- Royal Mail still dominates the postal market delivering 99% of volume in the addressed letter market.
- Most competition has occurred in the 'access market' which is when a firm collects and sorts mail before delivering it to Royal Mail who deliver it (taking it the 'final mile').
- End-to-end competition, a company collecting, sorting and delivering mail is still very low with only 0.2% being handled by firms other than Royal Mail.
- The Hooper report released in December 2008 details how the postal market must move forward in order for Royal Mail to continue to offer a sustainable service.

TAKING IT FURTHER

with Chief Examiner,
Robert Nutter

1. Using the Postcomm website (www.postcomm.gov.uk) find out who they are and what they do (follow the About PostComm link). Using the same website and the Royal Mail website, www.royalmailgroup.com, research the terms of the 2006-2010 price review.
2. On 1 October 2008 the consumer watchdog for postal consumers Postwatch merged with Energywatch and the National Consumer Council to form Consumer Focus. Investigate the functions of Consumer Focus.

   http://www.consumerdirect.gov.uk
3. Access the website of the French postal service La Poste and compare and contrast it with the Royal Mail in the UK.

   http://www.laposte.com
4. Research the role of the European Commission in opening up European postal markets to competition and the reasons why the EU should benefit from this policy.

   http://ec.europa.eu/internal_market/post/index_en.htm

Some suggested sources for further development:

http://group.tnt.com
http://www.royalmail.com
http://www.psc.gov.uk
http://www.berr.gov.uk/whatwedo/sectors/postalservices/Review/page45129.html

Questions for discussion

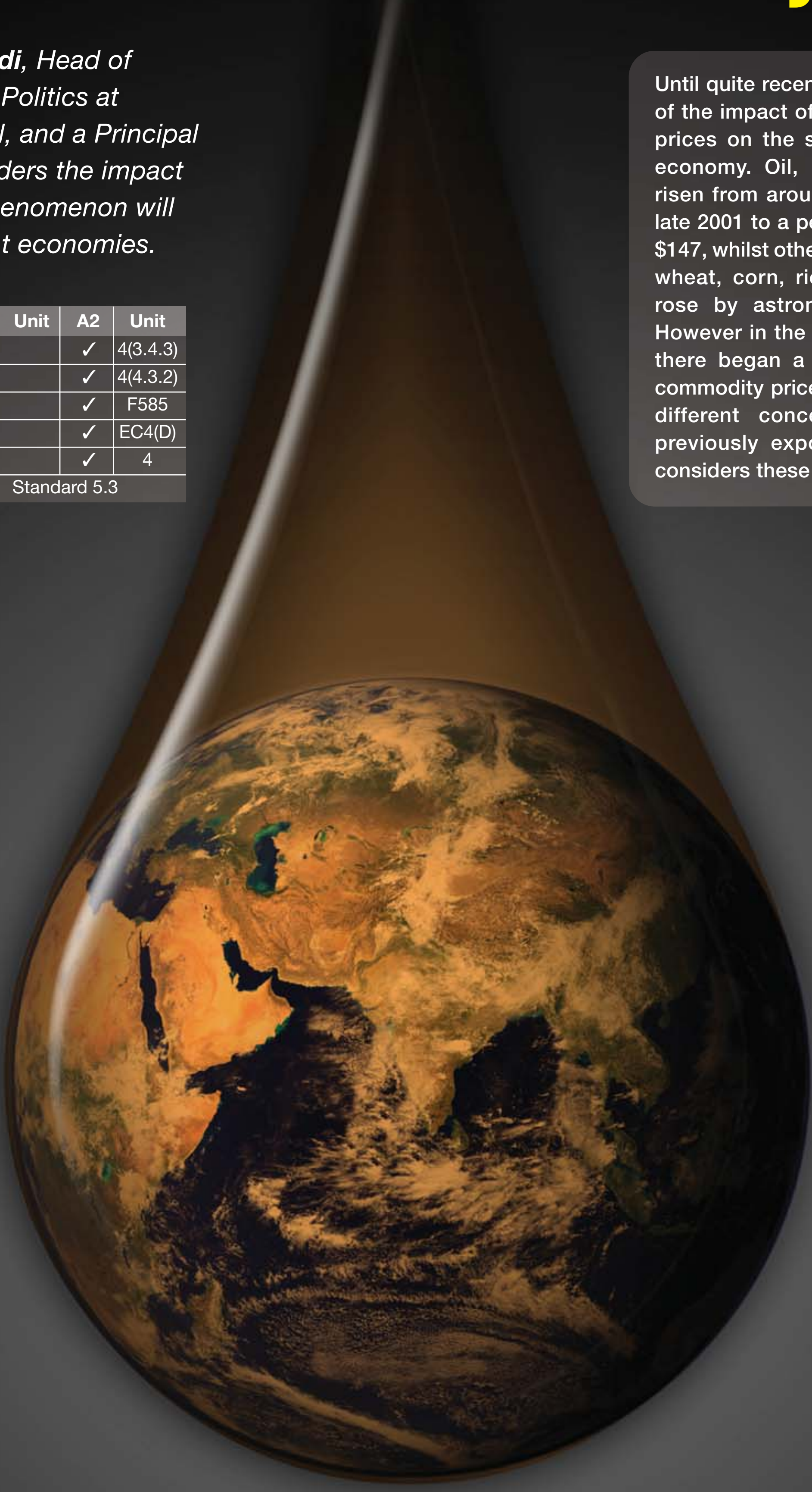
1. Explain the characteristics of a competitive market.
2. Explain what is meant by market liberalisation.
3. Do you agree that Royal Mail's monopoly power harms consumers and other postal service providers. Justify your answer.
4. Evaluate the case for and against Royal Mail being part privatised.

3. http://www.roadtransport.com/Articles/2008/12/17/132556/tnt-expresses-interest-in-working-with-royal-mail-html

What Impact will **Falling Commodity Prices** have on the **World Economy?**

***Marwan Mikdadi**, Head of Economics and Politics at St Paul's School, and a Principal Examiner, considers the impact that this new phenomenon will have on different economies.*

Exam Board	AS	Unit	A2	Unit
AQA			✓	4(3.4.3)
Edexcel			✓	4(4.3.2)
OCR			✓	F585
WEJC			✓	EC4(D)
CCEA			✓	4
Int. Bacc.	Standard 5.3			



Until quite recently all the talk was of the impact of rising commodity prices on the state of the world economy. Oil, in particular, had risen from around $25 a barrel in late 2001 to a peak in July 2008 of $147, whilst other commodities like wheat, corn, rice and metals all rose by astronomical amounts. However in the latter part of 2008 there began a significant fall in commodity prices prompting quite different concerns from those previously exposed. This article considers these new concerns.

The rise in the price of various commodities until the middle of 2008 was largely driven by rapid economic growth in India and China. The need in these economies for oil, in particular to provide the energy necessary to fuel their economies, ensured demand outstripped any growth in supply. Coupled with this was the increased desire to use bio fuels, which increased the price of corn and the inability of many traditional agricultural suppliers to increase their output quickly. This in turn contributed to inflation and pressure on central banks to raise interest rates as well as enormous financial pressures on those less developed economies which lack natural resources.

The changing picture by August 2008

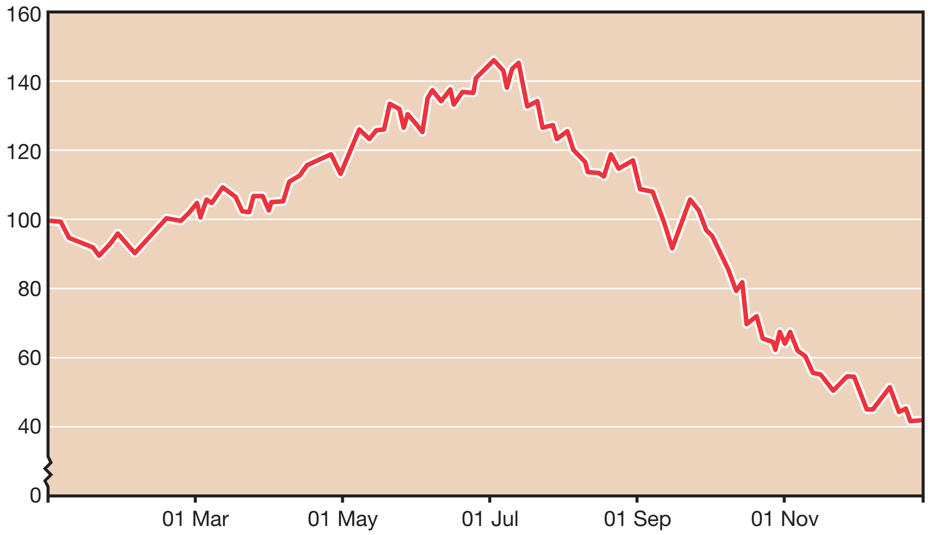
However in recent months commodity prices and oil in particular, have fallen by significant amounts. This dramatic change in prices is shown in Figure 3. Indeed oil has fallen from the peak in July 2008 to less than $40 a barrel in January 2009. The impact of this significant fall in prices has been felt throughout the world both in developed and developing countries.

The reasons for the fall in commodity prices are varied but the most significant factor has been the slowdown in demand in Europe and the USA as a result of the credit crunch and the general weakening of these economies which has had a knock-on effect on India and China which has seen their demand for oil fall. Between October 2007 and October 2008 US demand for oil fell by 4.07 per cent from 20.476m barrels per day (bpd) to 19.643m bpd. This fall in demand has come at a time when the supply of oil has increased as Iraqi oil supplies have started to normalise and countries like Angola and Brazil have started to play a greater role in the global oil market.

In addition speculators have started to sell off their stocks of commodities knowing that demand is going to decline as a result of the onset of recession. With that there is forecast to be a record wheat harvest and a decline in demand for corn as a bio-fuel as demand for petrol falls globally.

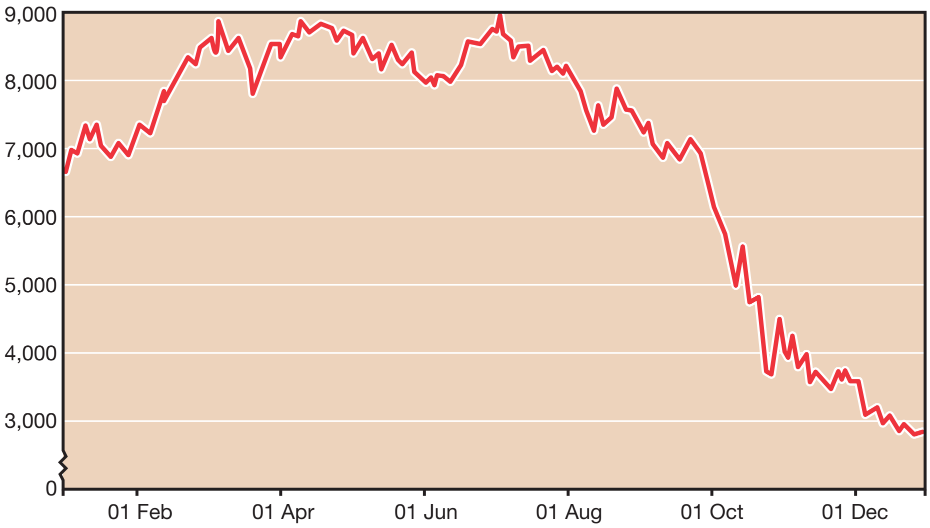
The impact of falling commodity prices can be felt in a number of different areas. Whilst overall it would appear, at first sight, to be positive, however there are both winners and losers as a result of these falling prices.

Figure 1: Brent crude oil, $/barrel



Source: BBC News online – 31 December 2008

Figure 2: Copper cash unofficial confirmed, $/m tonne



Source: BBC News online – 31 December 2008

The winners

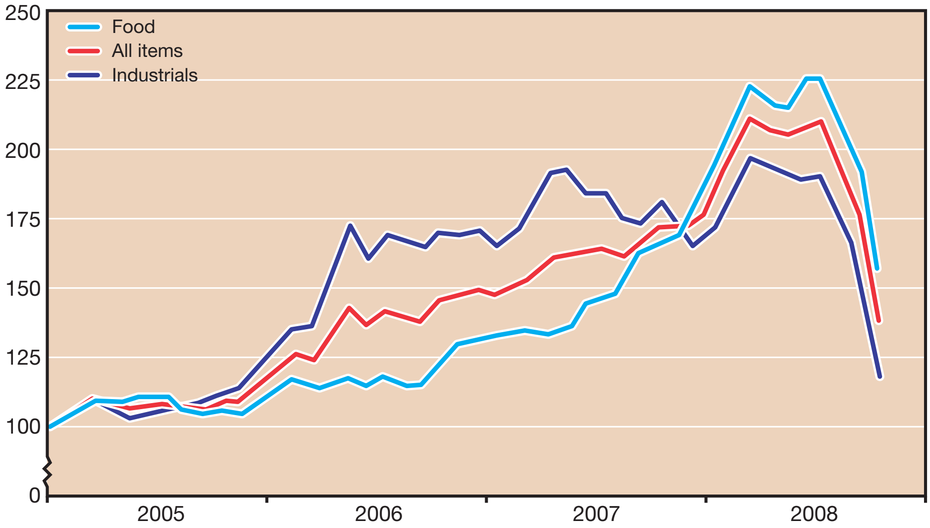
In those countries that are significant importers lower commodity prices have ensured that the amount spent on imports has declined and with it pressures on the current account of the balance of payments. Furthermore as the price of those imported commodities has fallen so have the inflationary pressures that come with soaring commodity prices, with the short run aggregate supply curve shifting to the right as shown in Figure 4. In the UK the Bank of England has forecast that CPI inflation will fall from the peak of 5.2 per cent in September 2008 to potentially less than 1 per cent. Much of this decline being as a result of cheaper imports of fuel. As the UK economy enters a recession the decline in inflationary pressures has given the Monetary Policy Committee of the Bank of England the scope to reduce interest rates dramatically to kick start the economic recovery, without fear of stoking inflationary pressures.

In a number of developing countries during recent months the fall in food prices has reduced a number of fiscal and economic pressures. Haiti and Egypt suffered food riots as the price of wheat and rice increased and the United Nations' World Food Programme had to commit greater amounts of their reserves to purchase the food stuffs necessary to sustain their worldwide projects. As a consequence of falling food prices a number of countries that faced particular strain and potential starvation can now afford to buy greater quantities of food to feed their population.

The losers

However it has not all been positive news. Whilst lower commodity prices

Figure 3: The Economist commodity-price index, January 2005 = 100, $ terms



Source: *The Economist*, 23 October 2008

mean it is cheaper to import goods at the same time as countries which are significant exporters of commodities, these commodities now face a decline in their export revenues. Indeed it may actually appear that these countries are likely to experience the greatest change in their circumstances as they have been getting themselves used to spending all the increased revenue they have been receiving from previous high commodity prices.

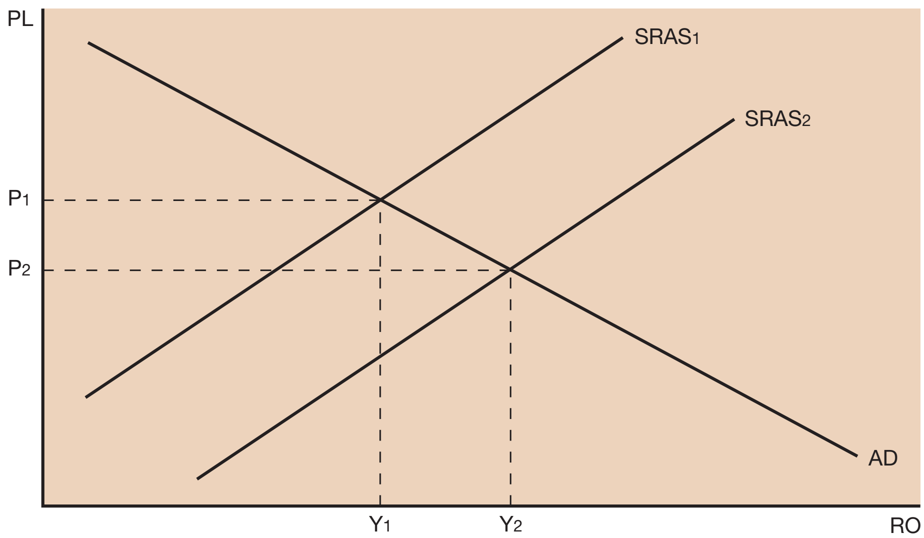
The fall in export revenues is likely to tip a number of countries into recession. Both Venezuela and Ecuador have been steadily increasing their spending on social services and the public sector using the proceeds of their oil boom. In recent months as oil prices have declined it has been harder to find the money to spend and Ecuador may end up running a budget deficit of as much as five per cent of GDP in 2009/10.

In Russia the currency, the Rouble, which was fixed against a basket made up of the Euro and US Dollar, has been allowed to devalue 9 times in the month of December alone. On 29 December 2008 the Rouble fell to an all time low of 41.6 to one Euro and 29.3 to 1 USD, the lowest since 2005. Largely due to the fall in the value of oil the Rouble has lost 20 per cent of its value against the Dollar. This has placed greater pressure on the Russian government to intervene to protect the Rouble, with the central bank spending more than £70 billion to date. In response to the increasing amount of reserves that the government has had to use Standard & Poor's rating agency has cut Russia's credit rating. The continued fall in the price of oil has placed greater challenges in the way of the Russian government which has based the budget on an income stream of $70 a barrel for its oil exports. In order to satisfy its growing budgetary requirements Russia will look to reduce its reserves further and borrow internationally.

Dubai has experienced a property boom in recent years fuelled by an ever-increasing level of income from oil states and investment by oil-rich fellow Gulf States. However the dramatic fall in oil prices is predicted to result in a significant decline in investment in Dubai

Quito, Ecuador. The country may end up with a budget deficit of up to 5% of GDP in 2009/10.

Figure 4: A shift in the short run aggregate supply curve



with property prices predicted to fall by 80 per cent in 2009. Dubai's government debt has spiralled to 148% of GDP and it has been forced to borrow funds from fellow Emirate Abu Dhabi. There is also a feeling that the continued falls in revenue in these economies may cause greater levels of political instability with greater levels of the indigenous population facing uncertain times on the unemployment rolls.

In other parts of the world like Indonesia and the Philippines where the impact of rising food prices was felt there has been a rush to expand production of rice and other foodstuffs such as corn and wheat. However, as a consequence of this increase in supply, this has further driven prices down. Due to the inelastic nature of the supply of these commodities farmers were not able to increase supply until late in 2008 when the harvest was ready and this was done by almost all farmers around the world simultaneously. As the bottom has fallen out of the market these farmers, many of whom have borrowed either from private institutions or government, will come under even greater financial pressure as they find it hard to meet their repayments. Metal prices have fallen by almost half since March causing Indonesia to cut tin production and forcing Canada to close some nickel mines.

Conclusion

It is still early days but the impact of falling commodity prices is being felt around the globe. In general UK residents are just starting to see the benefits in the form of lower fuel prices for their cars and over the coming months in their gas and electricity bills. In addition it may mean that the UK can get out of recession quicker than many forecast. The global impact is harder to predict but it seems likely that we should expect to see economic slowdown and political instability in those developing countries which have become accustomed to higher commodity prices and the wealth that brings with it.

Questions for discussion

1. What is the forecast for oil prices? What are organisations like OPEC doing about it?
2. Pick a country that is forecast to do less well as a result of falling commodity prices and see what has happened since this article was written at the end of 2008.
3. To what extent do commodity prices play a role in determining levels of economic output in developed countries?
4. What is the Bank of England forecast for inflation in the UK? What role are falling commodity prices playing in causing this change?

Summary of key points

- **During 2008 there was a change in the general movement of commodity prices from one of rapid increase to one of falling prices.**
- **This change in commodity prices has an impact on the macroeconomic state of activity in several respects. It affects the rate of inflation and also the size of expenditures on both imports and exports in developed and developing countries.**
- **As the world economy slides into recession some developing economies may face difficulties arising from the adverse impact of falling commodity prices.**

TAKING IT FURTHER

with Chief Examiner,
Robert Nutter

1. Visit the website of the London Metal Exchange (LME) and follow the links from the home page as follows: non-ferrous metals – tin – price graphs. Construct a graph for the price of tin from 1 January 2003 to 1 January 2009. Investigate the causes of the fluctuations in the price of tin over the period shown.

   www.lme.co.uk   www.itri.co.uk   http://cruonline.crugroup.com

2. Visit the BBC news website and investigate via news and video clips the reopening of the South Crofty tin mine in Cornwall. Use the BBC search engine with the key words 'South Crofty'.

   http://news.bbc.co.uk

3. Research the history and functions of the International Tin Council which was formed in 1956 as a buffer stock scheme. Investigate the reasons why it collapsed in 1990.

Credit Crunch and the UK Economy

DATA Question and Answer

***Quintin Brewer**, a Chief Examiner and teacher at North London Collegiate School, considers a data response question concerning the impact of the credit crunch on the UK economy.*

2008 was a momentous year for the world economy and for the UK economy in particular. It saw the credit crunch resulting in spectacular banking failures. The price of oil rose to more than $147 a barrel and then fall back to less than a third of that price. 2008 also saw the collapse of various businesses including Woolworth's and MFI. You should be familiar with the causes, consequences and policy responses to these events because you will almost certainly have the opportunity to discuss these in your examinations in the summer. Examiners are always impressed by those candidates whose responses reflect understanding of current economic issues together with an ability to apply relevant economic theory in discussing them.

The following charts show some of the changes in the UK economy over that last year.

Figure 1: Bank of England base rate

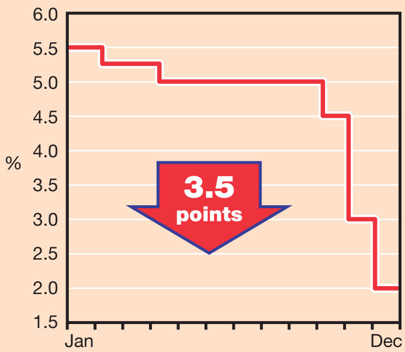


Figure 2: The pound sterling trade-weighted index

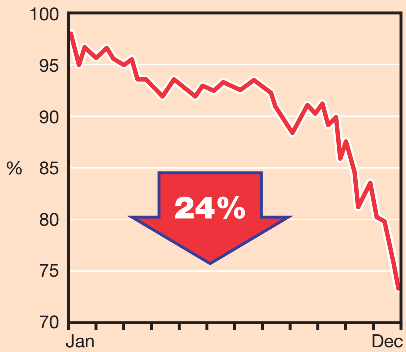


Figure 3: UK consumer spending

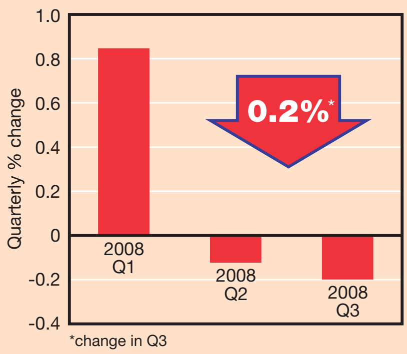


Figure 4: GDP growth

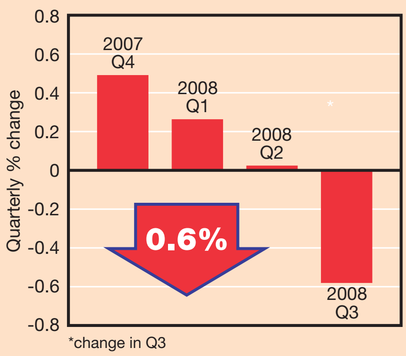


Figure 5: FTSE 100

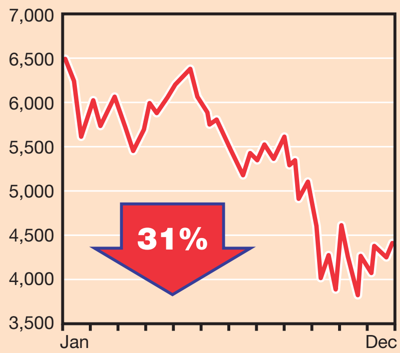
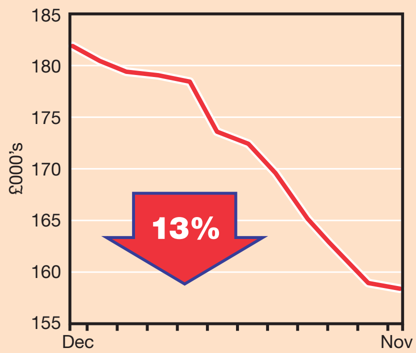


Figure 6: Average house price



Source: P. Hosking, 'How the financial system nearly crashed in 2008', *The Times*, 1 January 2009

The fall in the value of sterling

Nobody other than holiday-makers, second-home owners and retirees living overseas on a sterling pension seem much bothered about or have even noticed the collapse in the value of the pound over the past year. This is not just because there have been more immediate matters to worry about such as the near death of the banking system. It is also because this very substantial depreciation has been positively welcomed by policymakers who regard it as a reflationary tool just as important as lower interest rates. Not only does it make British goods more competitive, it also makes Britons less willing to travel abroad to spend their hard earned cash but may also attract more free-spending foreigners to our shores.

Unfortunately, in a world economy where there is no demand, these beneficial effects may be largely absent. Equally unfortunately, there are a number of negative effects that spring from a weak currency. More expensive raw materials are just one. More importantly, a weak currency is only a symptom of capital exodus to more attractive or safer homes overseas. This matters because there is less money available to support economic activity back home.

Government ministers criticise the banks for not lending enough, yet the reason credit is being squeezed is because it is no longer possible to borrow as freely as we used to. Many international investors regard the outlook for the UK economy as truly dire. Its key strengths, the housing market and financial services lie in ruins and now there isn't even the attraction of high interest rates to keep the money flowing in. Further, the public finances are in a mess, which might undermine confidence among foreign investors who hold a third of all government bonds (gilt-edged securities).

Supporters of British membership of the euro found it difficult to make their case while sterling was thriving. Now that the pound is depreciating they are finding a more receptive audience. Yet monetary sovereignty is all the more crucial when the economy is in trouble. The Bank of England has been able to cut interest rates below those in the euro area for the first time since 1999. That in turn has pushed sterling down, a stimulus all the more welcome since monetary policy is less effective than usual because banks are reluctant to lend. The weaker pound will not just soften the blow of recession but also create a subsequent recovery that will be necessarily less reliant on consumers.

Source: Adapted from 'Sinking Sterling – Fall from Grace', *The Economist*, 20 December 2008 (pages 51-2) and J. Warner, 'Peril's of Sterling's Devaluation', *The Independent*, 1 January 2009.

(a) With reference to Figures 1-6, briefly comment on how the state of the UK economy changed during 2008.

(b) Discuss the likely economic effects of the changes in house and share prices as shown in Figures 5 and 6.

(c) With reference to the information provided, outline the possible factors which have contributed to the fall in sterling's trade-weighted index, as shown in Figure 2.

(d) Why might the depreciation in the external value of the pound be regarded by policy makers "as a reflationary tool, just as important as lower interest rates"? (Extract, lines 8-9.)

(e) Assess the negative effects of a weak currency for the UK economy.

(f) In the light of the sharp depreciation in the value of the pound, evaluate the case for British membership of the euro.

Suggested approach to the questions

(a) With reference to Figures 1-6, briefly comment on how the state of the UK economy changed during 2008.

The key in answering a question like this is to describe the changes precisely. It is not good practice to describe the changes in minute detail but rather to outline the broad trends illustrated in each chart.

Initially, the rate of economic growth was positive but falling. However, by the third quarter it was negative perhaps indicating the onset of a recession. (A recession is defined as two successive quarters of negative economic growth.) Meanwhile, the rate of inflation was rising for most of the year reaching a peak of 5.2% before falling in the last few months. Unemployment showed a net increase of 277,000 on the claimant count measure. The fall in share prices might indicate a fall in the expected profitability in companies while the fall in house prices might reflect weakening consumer confidence and fears over job security. All this suggests a deterioration in the state of the UK economy and it is clear that the Bank of England recognised this by slashing interest rates by 3.5% to 2%.

(b) Discuss the likely economic effects of the changes in house and share prices as shown in Figures 5 and 6.

As with the previous question, it is important to make direct reference to the data. Further, the command word is 'discuss' which implies that evaluation is required. This is included in the second paragraph.

The data show a 31% fall in share prices and a 13% fall in house prices. Both of these are assets which form part of an individual's wealth. Given that both share prices and house prices are falling, there is likely to be a negative wealth effect i.e. people feel less wealthy and so will reduce their expenditure. This is reflected in the data on consumer expenditure which was falling in the second and third quarters of 2008. In a period of rising house prices people are able to spend more by borrowing against the increased value of their homes – mortgage equity withdrawal. However, when house prices are falling this becomes more difficult. Indeed, many people now face negative equity – a situation in which the mortgage is greater than the current value of the house.

House prices are falling which will have a negative wealth effect.

Consumer expenditure is the largest component of aggregate demand so a fall in it will have a very significant impact on the economy unless it is offset by significant rises in the other components of aggregate demand. Given the current economic climate, business confidence is low so investment is also falling. Exports are also sluggish, despite the fall in the value of the pound, because our major markets (e.g. the EU and the USA) are also suffering a severe economic downturn. The only component of aggregate demand which is rising is government expenditure but, even with a massively rising fiscal deficit, it is unlikely to outweigh the negative effects of the falls in the other components.

The above analysis could be supported with an aggregate supply and aggregate demand diagram showing a leftward shift in the AD curve causing a fall in real output and a fall in the price level.

(c) With reference to the information provided, outline the possible factors which have contributed to the fall in sterling's trade-weighted index, as shown in Figure 2.

There are several factors which may be identified from the information.

One factor which has caused a fall in the value of the pound is the dramatic cut in the rate of interest from 5.5% at the start of 2008 to just 2% in December 2008. This makes it less attractive for foreigners to place funds in UK banks, so reducing the demand for sterling on the foreign exchange market, resulting in a fall in its value.

Currencies are also vulnerable when there is a deterioration in the state of the economy. One aspect of this is the size of the fiscal deficit which is expected to be 8% of GDP in the year 2009-2010. This undermines the confidence of foreign investors who may be less willing to buy UK government bonds (gilt-edged securities).

A further concern is the importance of the financial services sector to the UK economy. London is a leading financial centre and financial services account for a significant proportion of the UK's GDP.

The data illustrates the weakness of the UK economy in terms of negative GDP, rising unemployment and falling consumers' expenditure. This also makes sterling appear unattractive. Indeed, the prospects for the UK economy are poor relative to those of other countries. For example, the IMF recently predicted that the UK recession would be the most severe of developed economies.

(d) Why might the depreciation in the external value of the pound be regarded by policy makers "as a reflationary tool, just as important as lower interest rates"? (Extract, lines 8-9.)

This question demands a basic understanding of how depreciation can stimulate aggregate demand. A brief reference should also be made to the significance of lower interest rates in reflating the economy.

Reflation refers to measures which stimulate aggregate demand. When the pound depreciates in value against other currencies it causes UK goods to become more competitive because the foreign currency price of UK exports will be lower and the domestic price of imported goods will be higher. In turn, this should increase demand for exports and reduce demand for imports. Obviously, much will depend on the price elasticities of demand for exports

and imports and there will only be a reflationary effect on the UK economy if the Marshall-Lerner condition is met i.e. that the sum of the price elasticities of demand for export and imports must be greater than 1. If this is the case, then aggregate demand will increase. In the same way, lower interest rates can help to increase aggregate demand by stimulating consumption and investment. For example, a reduction in interest rates makes it cheaper to borrow money for both consumers and firms so increasing incentives for consumers to spend and for firms to invest.

(e) Assess the negative effects of a weak currency for the UK economy.

The extract provides help in answering this question so rather than producing a textbook response, it is better to use the context provided as shown below. Evaluative comments are included at the end of each paragraph since there is a requirement to "assess".

The pound's weakness has made it much more expensive for British tourists travelling abroad because the purchasing power of the pound in terms of foreign currency has declined so much. Therefore, there is likely to be a rise in demand for holidays in the UK not just from its own citizens but also from foreigners (e.g. those from the eurozone) whose currency is worth about 20% more than at the start of 2007.

However, there is some evidence that British citizens are very reluctant to forgo their foreign holidays while foreigners suffering from the global economic downturn might be unwilling to travel to the UK so the impact of the weakness of sterling on this sector of the economy may be fairly small.

The price of imported raw materials will also increase, anything from cocoa to make chocolate to steel for car manufacture. This could cause inflationary pressures because there will be an increase in costs. However, the current economic climate means that it will be very difficult for manufacturers to raise prices. Given this situation, firms will aim to increase productivity in order to reduce unit costs of production which should have a long term benefit to the UK economy. Overall, in the current economic circumstances, inflationary pressures are likely to be very subdued. Indeed, some economists are concerned that deflation might become a problem.

There could also be an increase in the price of imported manufactured goods as the fall in the value of the pound is reflected in the higher costs of importing goods. However, this should give UK goods a competitive advantage.

(f) In the light of the sharp depreciation in the value of the pound, evaluate the case for British membership of the euro.

The last part of the extract provides some basis for an answer. It is important to consider both sides of the argument in order to answer this question adequately.

It can be argued that the 24% depreciation in the value of the pound is disadvantageous because it makes it difficult for firms to plan their budgets, for example, the cost of imports. In other words, membership of the euro would give greater stability. In addition, there are the usual arguments about the elimination of transaction costs which occur in changing currencies and the possible benefits of increased integration with the other members of the euro. In practice, the transactions costs are fairly insignificant. Further, the UK's non-membership of the euro does not appear to have had a detrimental impact on foreign direct investment: in the past decade the UK has been the largest recipient of FDI in Europe.

However, non-membership of the euro has allowed the UK to adopt an independent monetary policy – "the Bank of England has been able to cut interest rates to below those in the euro area for the first time since the single currency started in 1999". In turn, this has caused a significant fall in the value of sterling which should reduce the impact of recession on the UK economy and ensure that it will provide a stronger basis for recovery based on exports rather than increased consumer expenditure.

The key issues appear to be whether the possibility of greater stability by joining the euro outweighs the benefits of having an independent monetary policy and the fact that sterling can fluctuate freely against other currencies.

How is a weak currency affecting the UK economy?

Index Numbers

BACK to BASICS

***Rachel Cole**, teacher at Cheltenham Ladies' College and a Principal Examiner, offers an explanation of the mysteries of indices.*

"With the FTSE Aim 100 having plummeted 64% in 2008 to 1852 – far worse than the FTSE 100 31% tumble and the FTSE 250's 40% crash – investors are hoping for a better year this year,"[1] So might run almost any business newspaper, and although you can guess something dramatic has been happening, the use of index numbers can make it quite hard to follow. The aim of this Back to Basics is to help you feel more confident in handling numbers-with-no-units, the strangely simple-looking index numbers, which are perhaps even simpler than they appear to be.

Maths is what puts many people off economics. But the only maths you really have to understand fully at A level is percentage change, and to be able to apply this to various contexts, one of which is index numbers. Index numbers are used to collect data from various sources and give a special kind of average. They are a simplifying device for showing changes and comparisons in data by showing percentage changes relative to a chosen base year, which is normally given the value 100, but when more detailed changes are wanted such as the stock market sometimes 1000 is the base. A base is simply a comparison year, and there is some evaluation you might do about which date is chosen for a comparison, which we discuss at the end.

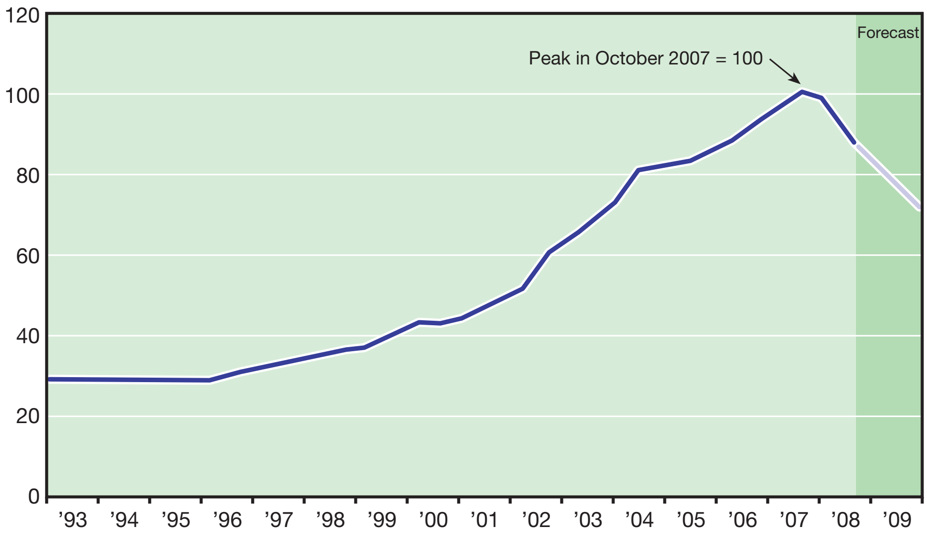
Figure 1 is a simple use of an index. The base year has been chosen as the peak in UK house prices, and it is

1. A. Monaghan, 'The New Year brings a key resolution', *The Daily Telegraph*, 5 January 2009.

therefore easy to see the falls since October 2007 in percentage terms. It is also useful in that you can see when prices in January 2009 fall to the level that they were in 2004. Rather than house prices in raw terms, it is easy to see what has happened on average over a defined period of time.

Before going on to look at some of the problems of index numbers, we look at some of their other applications, and then incorporate the concept of weights.

Figure 1: House prices in the UK



The index shown is an average of Halifax and Nationwide house price indices. House price projections are based on a range of forecasts from 'Forecasts for the UK economy: a comparison of independent forecasts', October 2008 (compiled by HM Treasury).

Source: www.bankofengland.co.uk/publications/fsr/2008/FSR08Oct2.ppt

The FTSE (pronounced 'Footsie)

The UK daily newspaper most respected by economists is probably *The Financial Times*. Although owned by Pearson, a very large publishing firm originating in the US, it has the age-old credentials for giving reliable reports on the share prices in the London Stock Exchange. So the FTSE is a collaboration between *The Financial Times* (FT) and the Stock Exchange (SE) to give the index of the leading shares.

There are several versions of the FTSE, however, and a useful way to distinguish between movements in the largest shares from the movement in companies more generally is to use the FTSE 100 and compare it to the FTSE 250, 350 or the Alternative Investment Market (AIM). The FTSE 100 charts the changes in share prices of the top 100 shares when ranked in order of size, or 'market capitalisation' as explained below. The FTSE 100 started at a base of 1000 in 1984 and before the credit crunch was coming close to 7000 in 2007. This means that in just over 20 years share prices were seven times their starting price, which isn't a bad rate of return if you compare that with what would happen if you had put money in a bank – at 5% it would be at around 3386.

Weighted indices

An index should be able to tell you how you have been affected by changes in the economy. Because of this, it is a useful tool for policy makers to decide how much your allowance should rise if you are on government income, for instance job seekers' allowance, maternity benefits or pensions. But just knowing how much prices have changed on their own is of little relevance. If you are a pensioner you are less likely to be worried about the rising cost of school fees but rather more worried about the changing price of heating fuel. If you are a parent claiming paternity or maternity benefits then the cost of nappies might be more significant than that of a can of Red Bull. Whilst on income support the price of rent might be more significant than that of bingo tax. The point of these examples is to illustrate that the cost of living index should be related to what people actually buy, and in the proportion that they buy these things.

The way in which an index is related to the amount actually bought or traded is by using weights, to form a *trade weighted index*. Clearly if the stock markets were not weighted then a spike in the price of a small firm could make things look a lot more optimistic than they actually are. The change in share price must be multiplied by the *market capitalisation* which shows how much the company is worth if you multiply price per share with the number of shares issued. Then as with all weights, you divide out the weights at the end so that the rather random total of the number of shares is removed, just their influence on prices remains.

CPI and RPI

Until December 2003 the main index for prices in the UK was the **Retail Price Index** (**RPI**), with a very useful modification, the RPIX, which removed the effect of the changes in mortgage interest repayments. This index is still used for setting pensions in the UK, and therefore cannot be scrubbed from the economics text books. However in the UK the government now pins its eyes on the **Consumer Price Index** (**CPI**) which does not include any housing costs at all (no council tax, for example) and is based using a geometric mean, which suffice it to say you don't need to know in great detail, but it makes the variations look smaller when individual items change.

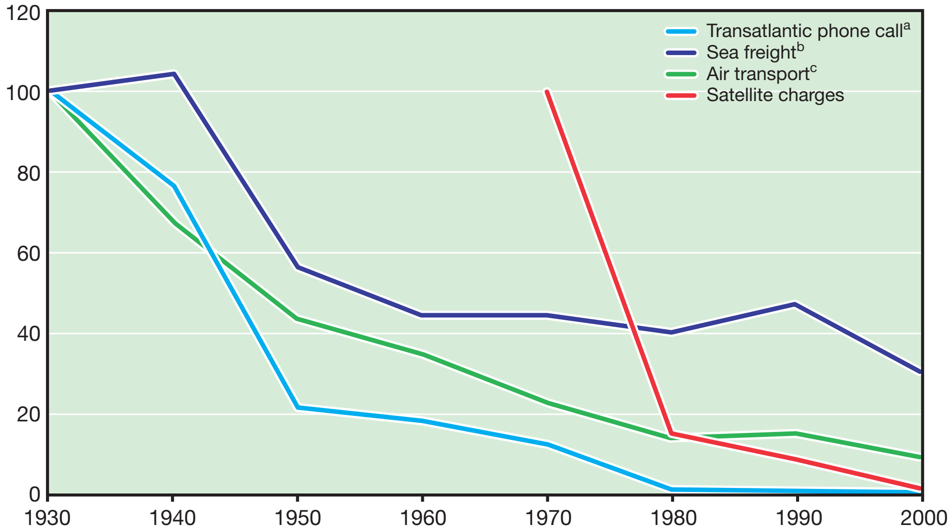
Some fundamental problems with indices

Comparing changes from year to year is not always as simple as it ought to be. If the base year that is given is 2004 for house prices, and the news tells us that house prices have fallen back to their 2004 level, then it's clear that they are back at 100. But how do I know the change in house prices this year if all I have is the index for 2005 at 80 and 2006 at 86. Is it just a 6% rise? Sadly not. Here you need to make use of that never-fail formula for percentage changes, *change over original times 100*. As you plug in the number for the original, in this case 80, you will find the result is a good deal larger, 7.5%. So prices have risen by 7.5% compared with 2005, but only 6% when compared with the peak. This is very useful for explaining just how much of the change over the period happened in one last year though it often hides the fact that prices might have risen or fallen quite considerably in the intervening period.

Another problem with index numbers is that sometimes more than one factor is changing. In Figure 2 there are two base years being used. Figure 2 illustrates one of the main causes of globalisation, one of the BBC's special reports in 2008 (see source).

Here the base year for three types of cost is 1930 and changes are shown

Figure 2: Falling transport and communication costs



a = Cost of three minute telephone call from New York to London; b = Average ocean freight and port charges per short ton of import and export cargo; c = Average air transport revenue per passenger mile. Data is measured relative to costs in 1990.

Source: www.bbc.co.uk http://news.bbc.co.uk/1/shared/spl/hi/guides/457000/457022/html/nn3page1.stm

relative to this year. Clearly the changes for satellite charges cannot be based on 1930 as the technology had not been developed then, so there is another base used in 1970. The use of index numbers is a powerful and simple tool to show some dramatic changes in the fall in transport and communication costs.

Some common mistakes when handling index numbers

The most common mistake, outlined above when discussing house prices, is the failure to take account of the original year in question, and most calculations that students use in exams simply forget the *change over original formula*, or just don't seem to know that the original is the first of the figures, chronologically. Hopefully by reading this far you are now going to be able to avoid that problem in future.

Another very common mistake is to add some units. For example, when describing the changes in house prices as a fall of 6 index points, you might be tempted to add 'thousand pounds' at the end. When asked to describe changes in index numbers, students strive to show some units, such as pounds or millions. Unfortunately, because the changes shown are percentage changes, you cannot simply switch back to the units. You would have to know the value for the original base year, and you are not often given that. So avoid the temptation to embellish your answer with some irrelevant symbols.

A very common use for index numbers is to show changes between sets of data, for example by country, removing the absolute values and just showing the relative changes. It's a common trick by examiners, trying to see whether you can understand that one set of data has been chosen as a base, given the value 100, and other countries' data is simply whether the gap is widening or narrowing. Figure 3 was used on a recent examination paper for macroeconomics, and the data originally came from the Office of National Statistics but then quoted in *The Economist*:[2]

The most surprising conclusions were drawn by the candidates. Almost 90% of respondents could not see that productivity in Britain could still be rising even though there was an index number of 100. The productivity of France is not actually falling, but is instead rising more slowly than that of Britain, and the productivity gap is closing. What was supposed to be a simple question fooled most people. It makes me wonder how many people would have read this article in *The Economist* and drawn the wrong conclusion themselves.

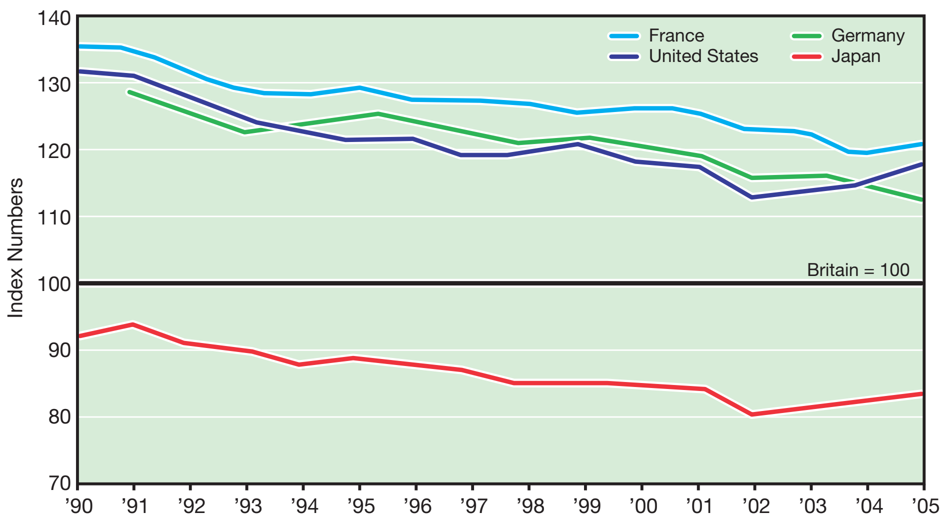
Exchange rate index

When trying to show what has happened to the buying power of a currency it is just as important to weight the exchange rates against those with whom the trade happens. It may well be that the pound has risen against the Argentinean *peso* but this is not going to make it much easier for importers in the UK. Much more significant is the *euro*, since we do around 57% of our trade with the 13 euro zone countries, and the US dollar, where we trade about 17%, against which currencies the pound has recently fallen dramatically. Because of this, UK importers will find it very difficult to make a profit. The change in relative currencies should be weighted in accordance with this proportion of foreign spending, giving a much more meaningful *exchange rate index* which you will come to see is quoted more often than you realised now you know what it means!

Scope for evaluation?

As with all Economics, there is scope for evaluation when considering index numbers. One area is the reasons for choice of the base. If you want to make percentage increases in crime look small then choose a base year which was particularly bad for crime. If you want to argue that your pocket money should go up in line with inflation then use the 2007-2008 figures and you'll get

Figure 3: Hourly productivity in five countries



Source: ONS

2. 'A lost opportunity', *The Economist*, 1 February 2007.

a real increase, but in nominal levels if you use just the 2009 figures. When politicians use statistics that look simple like index numbers then they can be used to mislead us much more convincingly.

Another issue is that the figures are over-simplified. We use the weighting system just to look at around 650 goods and services in the CPI, but this leaves out many items that many of us buy. The statisticians upgrade the basket of goods once a year, much more slowly than new innovations come to market.

Further, index numbers can break down whenever you need to change the pattern of the weights. Statisticians are not happy if you compare price changes over time when the pattern of spending changes. This can lead to dramatic imbalances in the data because you are no longer comparing like with like. As it happens, the Office of National of Statistics has recently updated its figures retrospectively going back decades.

But it is worth bearing in mind that none of these problems are new. Here's an extract from a very old book that I happened to be reading over the holidays:

> Index numbers are a widespread disease of modern life, a symptom of the modern disease of constantly keeping a close check on everything. So many of these index numbers are so ancient and out of date, so out of touch with reality, so completely devoid of any practical value when they have been computed, that their regular calculation must be regarded as a widespread uncontrollable impulse. Only lunatics and public servants with no choice go on doing silly things and liking it. Yet we become more and more the servants of our servants, and they persist in tying us down to this dismal system whereby we all have our difficulties compressed into the brevity of an index number.
>
> Source: Adapted from M.J. Moroney, *Facts from Figures*, Pelican Books, 1951.

Index numbers can actually cause more problems than they solve and you should be careful before handing them to politicians. But as economists just remember that they are meant to be there to help!

Questions for discussion

1. Why are index numbers based on 100?
2. What factors influence the decision to choose one base year over another? Can political motives influence the choice?
3. Weights show the proportion spent. Does it matter what the weights add up to?
4. Can data be over-simplified?
5. Look again at Figure 2 where the data is shown with 1930 and 1970 as the base years but with 1990 also as a point of comparison because the value of money changed over the 70 year period. Thus the data shows the fall in transport cost in real terms. What is significant about this data? How different would the cost data have looked if it had been shown in nominal terms?
6. Consider the reasons why index numbers are so unreliable. These might include the changes in technology, the effect of short-term price changes that might go unrecorded, the problem of being untypical where price changes are linked to an average. Why then do we base our very important decisions such as rises in pensions and benefits on these index numbers? Is it better to have more indices to give averages for smaller groups, such as the pensioner price index? What's wrong with taking this further – for example, a vegetarian price index to reflect the increased price of fresh vegetables relative to meat, or an index based on gender as after all girls have to spend so much more on their appearance, don't they?

Politicians can use statistics to mislead.

Key terms

Index – a device for showing changes in trends, usually relative to a base year or a comparator country.

Weights – a system for attaching the significance or importance of one item relative to another. For example a weight can show the proportion spent on certain goods and services in a chosen basket or selection of items.

Basket of goods – a selection of goods and services chosen to be a representative sample of what people spend their money on.

Market capitalisation – the value of a company when calculated as share price multiplied by number of shares.

FTSE 100 – the top 100 shares listed on the London Stock Exchange, when ranked by market capitalisation.

CPI – the Consumer Price Index, used as the main indicator of the average price level in the UK since December 2003. More details and a comparison with other price indices can be found at www.statistics.co.uk.

Base year – a year chosen for comparison. It is usually chosen for being a 'normal' year and therefore the percentage change since then will give a clear sense of change over time.

Exchange rate index – a composite index of exchange rates in a basket of currencies, linked to the amount traded.

Affordable Housing and Labour Mobility

__Peter Cramp__, Head of Economics at Nottingham High School, discusses some government policies affecting the housing market.

The term 'affordable housing' is housing that is cheaper than that which is generally available in the local housing market. There are several types of affordable housing and we can identify these as follows:

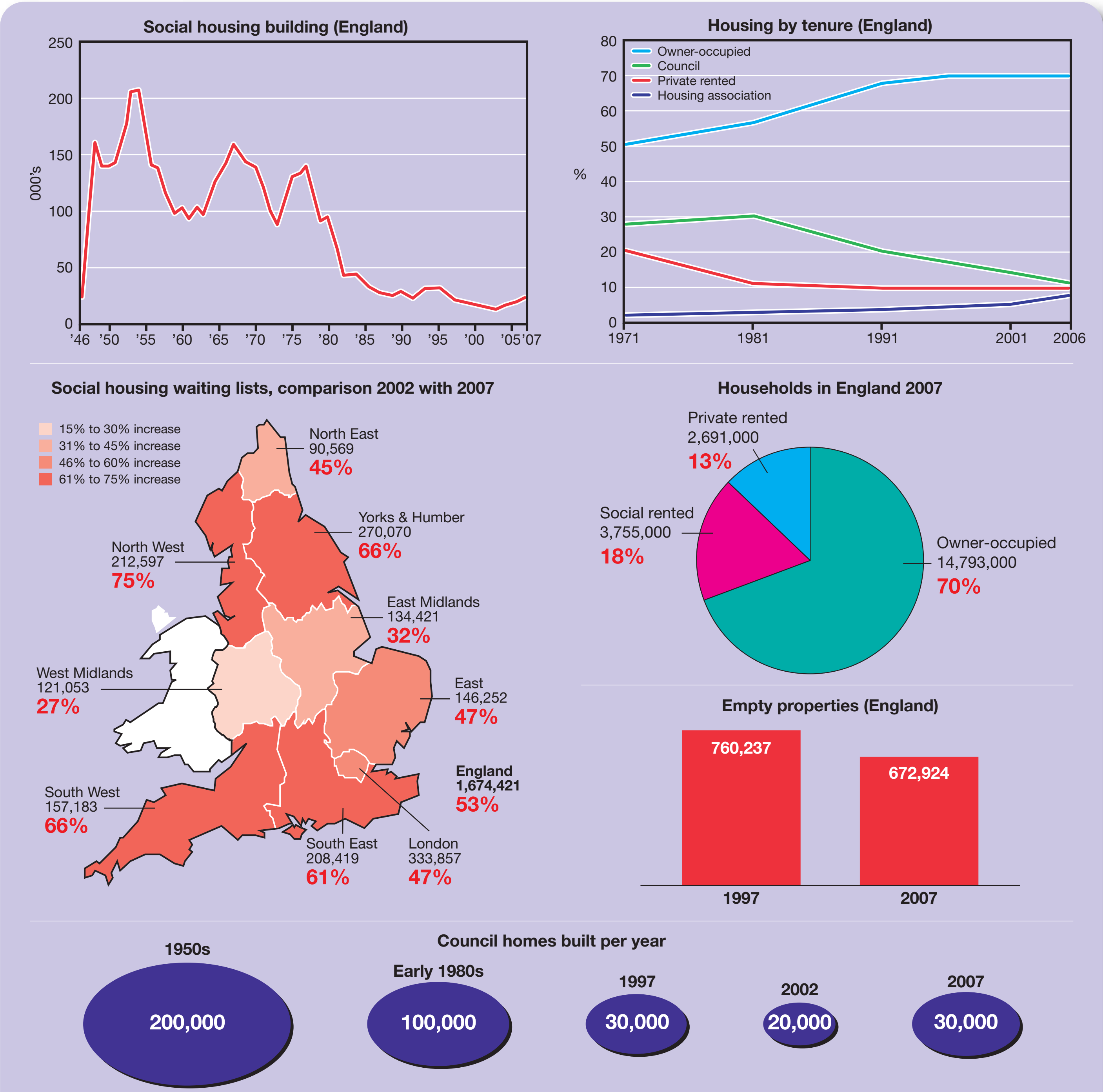
▶ *Social housing*

- Houses rented from local authorities ('council houses').
- Houses rented from housing associations (not-for-profit organisations which aim to make housing affordable for all. Many housing associations are registered charities).

▶ *Other affordable housing*

- Rented accommodation where the government subsidises the rent payment, so that the rent is set at an intermediate level, somewhere between that for private rented accommodation and social housing.
- Shared ownership schemes, where the occupier of the house buys part of the property, while the government, housing association or the construction company which built the property owns the rest. The occupier must usually pay some rent on the property because part of it is owned by someone else.
- A broad definition of affordable housing may also include schemes to make cheaper mortgage finance available to some selected occupations known as 'key workers' (for example, teachers) buying property in London.

Figure 1: Social housing data



Source: J. Sherman, 'Council ghettos may return as recession kills mixed estates', *The Times*, 12 December 2008.

The provision of affordable housing represents an intervention in the housing market. Such intervention occurs because of a perception that the market is failing to produce desirable outcomes. A situation where some people cannot afford housing of a decent quality might be judged unfair. Alternatively it can be seen as inefficient that high house prices prevent workers moving to areas with skill shortages. In other words, a lack of affordable housing can restrict labour mobility.

Social housing

The demand for social housing in the UK is set to soar. Many have already turned to social housing in recent years in the face of rapidly rising property prices. This is reflected in Figure 1 by the increased waiting lists between 2002 and 2007. Now, as the recession bites in 2009 and unemployment rises, the increase in demand for social housing will accelerate. Repossessions of homes will rise as people struggle to meet their mortgage commitments and this too will put pressure on social housing. Government forecasts suggest that the numbers on the waiting list for social housing will swell from 4 million to 5 million by 2010.

A fall in the supply of social housing also helps to explain the increased size of waiting lists. There are two key drivers of the reduction in supply. Firstly, national income grew continuously in the UK for more than 15 years prior to the current recession. Growing incomes meant that more people could buy their own homes in preference to social housing. Housing demand is generally thought to be income elastic and owner-occupation of property has boomed, as indicated

Police officers are included in the list of key workers.

in Figure 1. Indeed, many council houses have been sold to their tenants and so are now owner-occupied. Secondly, as Figure 1 also shows, fewer council houses have been built in recent years.

Current government plans include a target to build 70,000 new social homes every year, representing a significant increase in comparison to recent years. The Labour government recently announced a £2.5 billion emergency package for the social housing sector, bringing forward spending that had originally been intended for 2010-11. This is a response to the growing demand for social housing, but can also be seen as part of a wider injection of government spending designed to counter the recession. The government is especially keen to prevent high unemployment in the construction industry, as the workers possess skills that will be needed when the economy begins to recover. Government spending may also generate positive multiplier effects.

Because few people are buying houses at the moment, whole estates consisting entirely of council houses or subsidised rented accommodation may be built. This causes concern because evidence suggests that the employment prospects of those in social housing are brighter when they live in areas where social housing is integrated with owner-occupied properties. Further, statistics show a correlation between concentrations of social housing and problems such as high crime rates and anti-social behaviour. These factors generate costs for third parties in the community (negative externalities).

Figure 1 hints at another instance of market failure. There are well over half-a-million empty properties in the UK. This cannot be efficient when there are also homeless people. The market has not been able to match those in need of accommodation with the numerous empty properties.

Labour mobility

Affordable housing is vital to geographical labour mobility. Areas where property prices and rents are high may experience significant shortages of skilled workers.

As property prices boomed prior to the current recession, many workers were unable to take up attractive employment opportunities because they could not afford to live in the area where the job was located. This is likely to be a particular problem in public sector occupations. Many government employees such as teachers, nurses and policemen have their salaries set in accordance with a national pay structure. While there is some allowance for the higher cost of living in areas such as London, this is nowhere near enough to compensate for the higher property prices found there.

One policy response has been the Key Worker Living Programme, open only to specified workers in London and the South East of England. This offers help to make housing more affordable to key workers through shared ownership, intermediate rents or provision of 'equity loans' where the government, as the lender, shares in any increase in the value of the property once purchased.

The list of key workers includes:

- Clinical NHS staff (with the exception of doctors and dentists)
- Teachers and nursery nurses in schools and further education/sixth form colleges
- Police officers, Community Support officers and some civilian staff
- Prison officers and some other prison staff
- Probation Service staff
- Social workers, nursery nurses, educational psychologists, and therapists (e.g. occupational therapists)
- Local Authority Planners
- Firefighters and other uniformed staff below principal level in Fire and Rescue Services
- Connexions Personal Advisors employed by a local authority or a Connexions Partnership
- Ministry of Defence (certain personnel)
- Qualified Environmental Health Officers/Practitioners who work in a local authority, government agency, NHS or other public sector agencies
- Highway Agency Traffic Officer staff in safety critical roles within the Traffic Officer Service

It is likely that property prices in London and the South East will fall more rapidly during the recession than in other areas. This is partly because speculation has driven London prices to unrealistically high levels during the boom years and these gains in price will now be undone. Also, key sectors of the London and South East economy such as financial services are suffering particularly badly at present. However, skills shortages and a lack of labour mobility are likely to continue to affect the region. Affordable housing is one part of the solution. Other possibilities might include the use of local pay bargaining so that the wages of key workers rise in London relative to other parts of the country, making it more affordable for them to choose to live and work in London.

VIEW FROM the CITY

Quantitative Easing

***Professor Graeme Leach**, Chief Economist at the Institute of Directors, examines how the Bank of England could use 'quantitative easing' to increase liquidity into the banking system.*

What is quantitative easing (QE)?

QE does not mean that the Bank of England is considering 'printing money' in the same manner as the hyperinflations experienced during the French Revolution, Weimar Republic or present day Zimbabwe.

Instead, quantitative easing draws on the experiment undertaken by Japan over the 2001-06 period and to some extent the US Federal Reserve over recent months.

Short-term interest rates are falling towards zero. Clearly the Bank of England will then run out of bullets with regard to generating a monetary stimulus through base rate reductions. However, whilst this weapon will have been exhausted, the Bank of England will still retain other significant weapons at its disposal.

As interest rates move towards zero the MPC could announce that it intends to keep base rates at say a quarter-point for the next 24 months. This would help pull down other interest rates of a longer maturity. In addition it could help reduce deflationary expectations and increase consumer and corporate confidence.

If QE is introduced it could also be used to put downward pressure on sterling in order to help exporters hit by the global recession.

Additional measures

However, this stimulus may not be enough and so the Bank of England could then attempt to flatten the yield curve and push down yields at the far end of the curve – by purchasing long-term securities such as gilts. This would have two effects.

Firstly, higher demand should raise demand and gilt prices. Given the inverse relationship between bond prices and yields, bond yields (long-term interest rates) would then be pushed down.

Secondly, by purchasing gilts from the banks, the Bank of England would expand the money supply. Banks would be sitting on a lot more cash (excess reserves) and this would provide an incentive for them to increase lending.

In theory the QE process should be very effective. In practice it may be much less effective, for a number of reasons.

Firstly, bond markets are deep and very large purchases might be required to push down yields.

Secondly, even if the banks acquire much higher reserves there is still no guarantee they will increase lending. In the wake of the financial crash they may decide to operate with a much thicker cushion of reserves.

Finally, consumers and companies may be unwilling to borrow even at zero interest rates.

In a financial crisis induced recession QE is more likely to be effective if bank balance sheets have been re-built. Of course this also means that interest rate reductions should then be more effective as well, even in the absence of QE.

Do we need a 'Bad Bank'?

It may well be that a parallel approach is what will happen in the UK, with the creation of a Bad Bank (to take on toxic assets and remove them from bank balance sheets) and simultaneous attempts to employ QE in order to reduce rates at the far end of the yield curve. The Government's announcement of a £120 billion asset protection scheme is meant to help insure banks against borrower default and ring fence toxic debt. If this process fails, the creation of a so-called Bad Bank or even nationalisation may be implemented for the banks in greatest difficulty. The Government has also announced the creation of a new £50 billion facility which would enable the Bank of England to introduce quantitative easing.

Conclusion

QE may become a necessary but by no means sufficient condition for stabilising the downturn. But this policy should be pursued very carefully. If the printing press runs too hot the economy could swing from deflation to inflation. Moreover, there are serious problems on the 'other side' of quantitative easing when the Bank of England would need to 'mop-up' excess money and may face a conflict between taking money out of the system at the same time that the Government wants it to hold-off in order to let any recovery become more established.

Extraordinary times are leading to extraordinary economic measures.

Is it Time to Abandon the Common Agricultural Policy?

__Robert Nutter__, Head of Social Science, Watford Grammar School for Girls, and a Chief Examiner, discusses the pressures on the EU in continuing significant financial support for agriculture.

The European Union (EU) has provoked much controversy in the UK over the 35 years of British membership as issues such as the euro, the common fisheries policy and the EU budget have produced vibrant debate. However, it is the Common Agricultural Policy (CAP) that has probably been most contentious, partly because the UK cannot opt out of it and also because it has affected everyone, mainly through higher food prices. Over the years, particularly since the 1980s the CAP has gone from crisis to crisis provoking heated disagreements among EU leaders. The 21st century has brought new pressures on the CAP, soaring world food prices, climate change, and the controversy over using land to grow crops for bio fuels. To assess the future viability of the CAP it is important to examine its past and to try to understand the complexity of a system that angers so many, particularly countries in the developing world.

Exam Board	AS	Unit	A2	Unit
AQA	✓	1(3.1.5)	✓	4(3.4.3)
Edexcel			✓	4(4.3.2)
OCR			✓	F585
WEJC	✓	EC2(D)	✓	EC4(G)
CCEA			✓	4
Int. Bacc.	Standard 4.3			

The creation of the CAP

When the Treaty of Rome created the EU in 1957 it was Article 39, which outlined the objectives of the CAP, which eventually came into force in 1962. These were to (i) increase productivity in agriculture (ii) ensure a fair standard of living for farmers, (iii) stabilise agricultural markets, (iv) provide certainty of food supplies and (v) ensure that consumers pay reasonable prices for food. Two things need to be recognised in the framing of the CAP. Firstly, it is important to remember that with World War II only recent history the six founding members of the EU wanted Europe to be able to feed itself after the devastation of war. Secondly, farmers were a particularly powerful political lobby in France, one of the major founding EU members. Essentially these two factors were very significant when the rules of the CAP were devised; rules the UK had to accept when it joined in 1973.

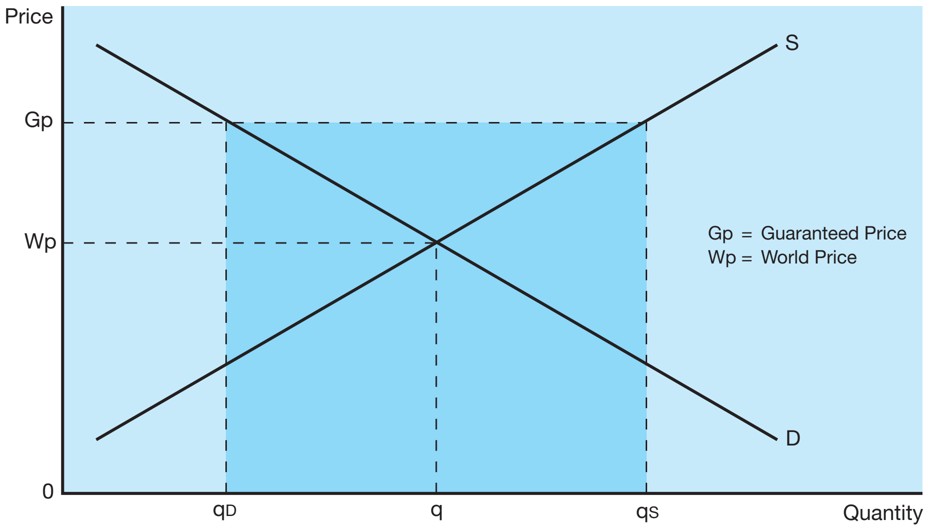
The price support mechanism

The problem for the EU when it devised the CAP was that many countries outside the EU could produce agricultural goods at far lower prices than the member states and this is a factor which is still significant today. North American countries such as the United States and Canada produced commodities such as wheat on such enormous farms that the **economies of scale** gave them significant cost advantages over EU producers. Similarly developing countries, with their lower labour costs, also had a price advantage with products such as sugar for example. In order to meet the objectives of the CAP the EU devised a complex price support system which was to prove very expensive. Its main features were:

- **a target price:** the price which EU farmers should get for their produce on the open market.
- **a guaranteed price:** the price at which the EU will buy surplus production from farmers. This price was usually set at about 10%-20% below the target price.

In addition import tariffs were imposed on food produce from non-EU countries when world prices fell below the EU target price, leading to **trade diversion**. Thus the CAP was setting a **price floor** (**a minimum price**) for agricultural commodities produced in the EU. Figure 1 shows the consequences of setting a guaranteed price above the world price leading to excess supply as farmers were incentivised financially to produce as much as possible. The shaded area demonstrates the expenditure by the EU to buy up the surplus in order to maintain the guaranteed price. A high guaranteed price meant that stocks of unwanted food produce quickly built up.

Figure 1

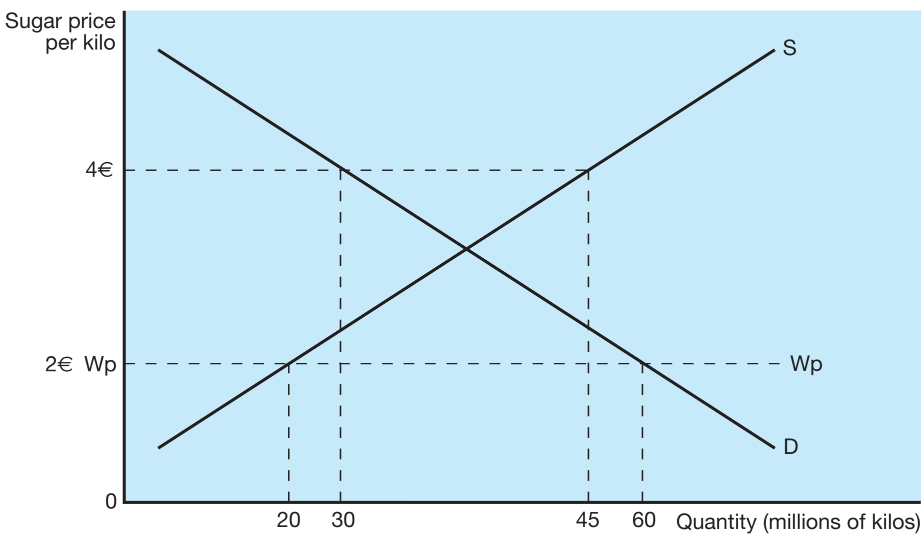


As the EU expanded during the 1970s and 1980s new members were obliged to adopt the CAP when they joined, and the massive overproduction was soon a cause of disquiet in the UK as stories of butter and grain mountains along with wine lakes were exposed by the popular press. By the late 1980s the CAP absorbed about two-thirds of the CAP budget which was funded by EU taxpayers. Britain in particular was a loser which, despite a rebate negotiated in 1984, was a major net contributor to the EU budget because the UK had a relatively small and efficient farming sector and was a relatively small recipient of CAP support. Not only were EU taxpayers paying the running costs of the CAP but EU consumers had to pay higher food prices than would have been the case if a free market in agriculture existed. Paying prices, which were significantly above world prices meant a loss of **consumer surplus** among EU citizens.

Anger at the CAP among non-EU countries was not confined to the lack of access to the EU market. As a result of EU production consistently exceeding consumption the excess supply was often resold on world markets at a loss or EU farmers were enticed to sell their surplus production on world markets with the aid of an **export subsidy** which was equal to the difference between the EU guaranteed price and the far lower world price. Figure 2 illustrates the effect of an export subsidy.

If the world price of sugar were €2 per kilo then in a free market the EU would import 20m kilos of sugar. If an export

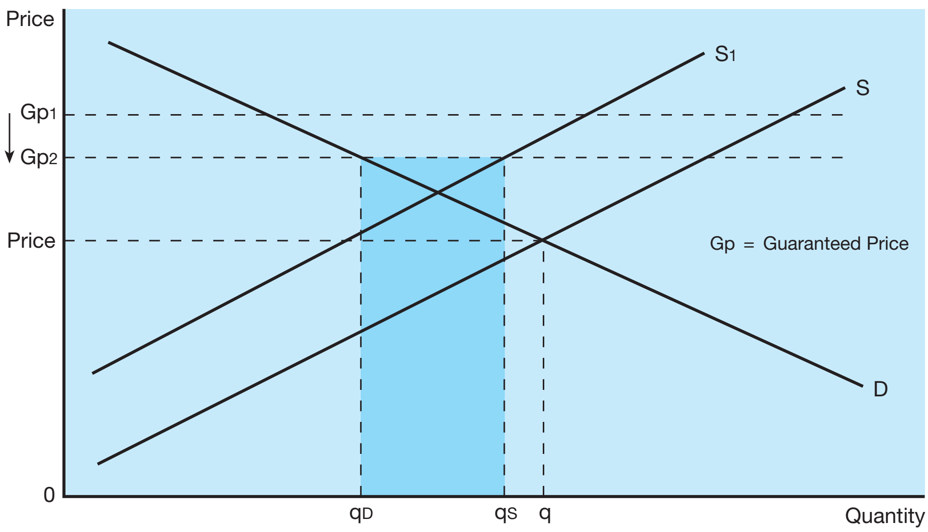
Figure 2



subsidy of €2 per kilo were introduced for EU sugar beet growers coupled with a tariff to prevent EU consumers from buying imported sugar then the EU would become an exporter of sugar rather than an importer. EU production would expand from 20 million kilos to 45 million kilos and EU sugar exports would be 15 million kilos.

The CAP also began to cause disquiet among environmentalists, as the intensive farming methods used to raise production, inevitable in view of the high guaranteed prices, were responsible for rural degradation. The use of chemical fertilisers, destruction of hedgerows and the use of heavy farm machinery damaged flora, fauna and wildlife habitats. By the end of the 1980s there were also accusations of corruption and fraud and the cost of running the CAP was in danger of destabilising the whole of the European economy.

Figure 3



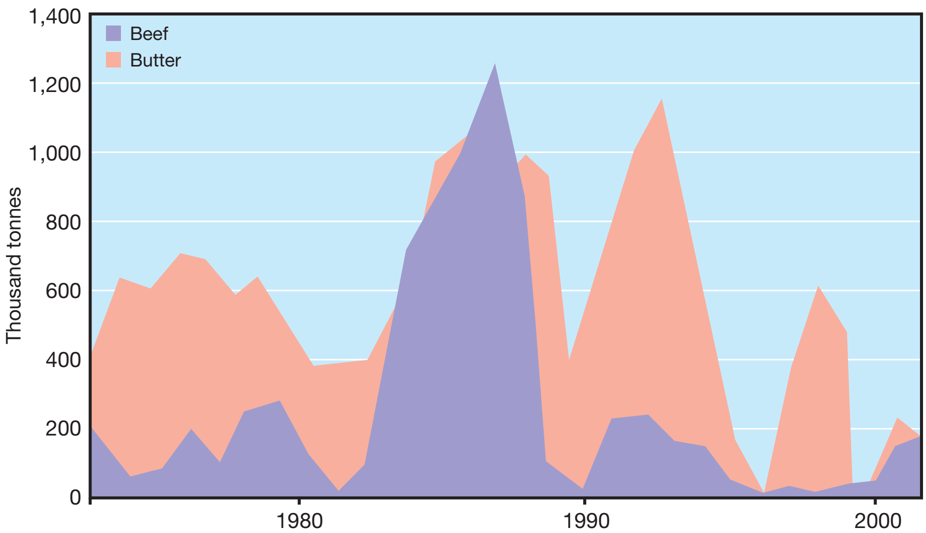
The reform process

Pressure for reform increasingly came from outside the EU and the Uruguay Round of world trade talks (organised by GATT which later became the WTO) led to the McSharry Reforms in 1992. These reforms were significant in that they began the process of moving the CAP away from price support to income support (the so-called decoupling of subsidy based on output). Guaranteed prices on cereals were reduced so they were closer to world prices, and in compensation for the cutbacks in price support farmers were given direct payments. In addition the system of set-aside was extended which paid farmers not to use some of their land for production. The result of these reforms resulted in a significant reduction in the food mountains, as shown in Figure 3. The combination of a lower guaranteed price and set-aside (which shifted the supply curve to the left to S1) meant that the cost to the EU of purchasing excess supply fell to the shaded area.

However, the CAP was still an extremely costly system to operate with EU consumers, EU taxpayers and non-EU food producers the losers. The EU's farmers were the only winners. In 1999 the Berlin Council reformed the CAP further under what was called Agenda 2000. Coming into force in 2003 the key reform was to introduce a 'single farm payment', which was unrelated to the scale or type of farm production. Thus farmers would increasingly make their production decisions for the market rather than merely farming for subsidies. Farmers only received the payment if they met standards of environmental protection and animal welfare. Unfortunately under the scheme the biggest single farm payments are given to the largest farms usually owned by rich landowners. Reductions in guaranteed prices continued and reform of the EU sugar regime, adopted in 2006, was an example of this process. The guaranteed price of EU sugar was cut by 36%, following protests from developing countries seeking to export sugar to the EU. The continued decoupling of subsidies to production meant the beef and butter mountains fell significantly as shown in Figure 4.

The 12 new EU members who joined in 2004 and 2007 brought new challenges for the embattled CAP. A number of the new members had large and relatively inefficient agricultural sectors and the massive cost of including these countries in the CAP scheme meant an agreement to freeze CAP spending until 2013. The UK's CAP rebate was negotiated down by 20% in 2005 for the period 2007-2013. The UK only agreed to this deal on condition that the money was matched by other countries' contributions and given to the new member states.

Figure 4: Beef and butter in storage



Source: European Commission

Recent developments

With the WTO Doha Development round of trade negotiations deadlocked over agricultural protection by the EU and the United States the CAP 'health check' in 2008 was an attempt to point the way forward for major reforms in 2013. The main proposals from the 'health check' published in May 2008 were five-fold:

- No change in CAP spending (42% of the EU budget) until 2013.
- A reduction in the single direct payment to the biggest landowners.
- An end to set-aside where growers leave 10% of their land fallow and also the abolition of milk quotas.

Many believe the CAP helps preserve rural communities and the countryside.

- More of the fixed CAP budget to be used for rural development programmes.
- Programmes to support traditional smaller farms and projects, which boost wildlife and preserve the environment.

The EU currently spends about €43bn (£34bn) annually on the CAP of which about 88% of it is spent on direct aid. The rest is market price support – purchases to protect farmers with guaranteed prices. In addition, about €7.7bn is spent on rural development.

The root and branch reform of the CAP, scheduled for 2013, has been brought into sharp focus by the rapid rise in food price during 2007-08. Those who support protection in agriculture say that the recent high food prices show a need for more subsidies to boost production. They tend to be the same people that say when prices are low subsidies are needed to boost farm incomes! With booming world demand and food shortages some have called for the abolition of the CAP. The **opportunity cost** of the CAP within the EU budget is significant when one considers the alternative uses of these funds such as boosting EU competitiveness and infrastructure projects to name but two. Abolition of the export subsidies given to EU farm producers and a cut in import tariffs on non-EU farm produce could boost living standards in the developing world. Before the Doha talks collapsed in July 2008 the potential gains from extensive reform of the CAP were significant because the removal of EU and US farm protection would have been reciprocated in the developing world by cuts in import tariffs on industrial goods from developed economies. A real chance to boost world growth had been lost.

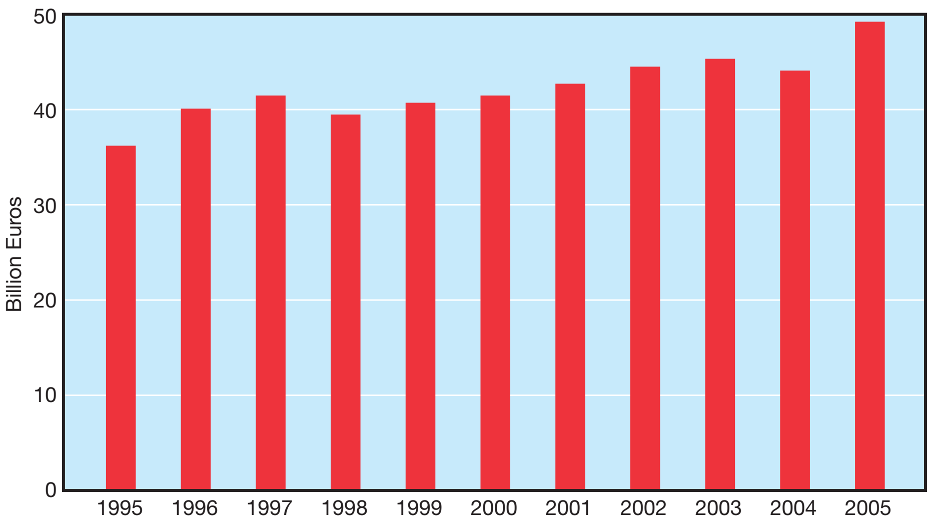
Is there a case for keeping agricultural support in the EU?

Many believe that the CAP helps to preserve rural communities and the countryside, which is particularly important now that preserving the environment is much higher up the political agenda. In addition many developed countries, such as the United States, provide financial support to farmers so the CAP is not unusual. Also farmers and their employees often work very long hours in arduous conditions for low and unpredictable incomes, thus financial support is needed. Many farms would be unprofitable and be abandoned if EU subsidies were withdrawn and the CAP dismantled. Even with the present system of support 2% of EU farmers leave agriculture each year. It is also important to remember that as agricultural markets are much more unstable than in the manufacturing sector (as illustrated in the cobweb diagram) agriculture needs intervention and protection to give some stability to farm incomes. The volatility of prices and incomes in farming, often due to the unpredictability of the climate, means that agriculture cannot be left to the free market.

Should the EU abandon the CAP?

In May 2007 Sweden stated that all EU farm subsidies should be abolished (except those related to environmental

Figure 5: CAP agricultural support and rural development, 1995-2005



Source: European Commission

protection), but whether they will be joined by other EU members remains to be seen. When reform is discussed in detail in 2013 there will certainly be a powerful case for abolishing the CAP or at the very least changing it beyond all recognition.

The CAP has come under increasing pressure in recent years as it is seen as a barrier to development among poorer countries. Denied full access to the EU market by import duties and hit badly in their domestic markets by cheap subsidised EU farm produce the developing world has used the Doha development talks to demonstrate the damage being done by developed countries' protectionist farm policies. The Organisation for Economic Co-operation and Development (OECD) has estimated that cutting agricultural tariffs and subsidies by 50% would add an extra $26bn to world income. The EU and the US are the principal guilty parties with tariffs and subsidies in agriculture but their economic power in the world is declining with the rise of the so-called BRIC economies (the initial letters denoting Brazil, Russia, India and China). The old developed world can no longer have its own way in trade negotiations as the collapsed Doha trade negotiations illustrate.

In addition future expansion of the EU is likely to be eastwards with new members likely to have large and inefficent agricultural sectors. The CAP in its present form may well be unable to cope financially with further enlargement. By 2013, when the CAP is supposed to be reformed, the enlargement process will have progressed further with Croatia and possibly other Balkan states as new EU members. Pressure for fundamental change will be considerable.

With the huge rise in world food prices and the need for land to grow crops for biofuels it could be argued that farming no longer needs the level of support provided by the CAP. In any case EU consumers, who are paying high food prices in the supermarket in an increasingly tough inflationary environment, would benefit from food accessed in world markets. Few Europeans benefit from the CAP and with only 5% of the EU's population working on farms contributing less than 3% to EU GDP the reforms scheduled for 2013 will need to be far reaching – the rest of the world will tolerate nothing less.

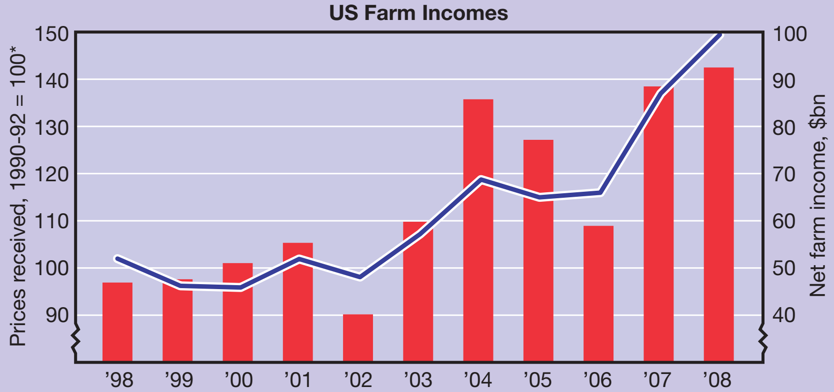
Summary of key points

- **The CAP came into force to preserve and protect agriculture in the EU. The system was based on price support giving farmers a guaranteed price for products such as cereals which was usually significantly above world prices.**
- **Cheap food products from outside the EU were subject to import tariffs and food prices in the EU were higher than in world markets. Large surpluses built up due to over production caused by the high guaranteed price. Some of the EU surpluses were sold in world markets with an export subsidy which often undercut world prices hitting developing economies who are dependent on agricultural exports.**
- **In the 1990s as the expense of running the CAP soared reforms were introduced to base the system more on income support rather than price support. Direct payments and set-aside reduced the cereal and beef mountains. The CAP budget has been frozen in real terms until 2013.**
- **The WTO Doha trade talks saw the developing countries put pressure on the EU and the USA to remove their significant financial support for agriculture otherwise they would not open their markets to industrial goods. No agreement was reached and the Doha talks foundered.**
- **Rising global food prices and the enlargement of the EU have put pressure for fundamental CAP reform at the top of the agenda when the EU reasseses the CAP in 2013.**

TAKING IT FURTHER

with Chief Examiner,
Robert Nutter

1. **US Farm Incomes**



Source: The Economist *All farm products

Investigate the key provisions of the 2008 US Farm Bill.

www.usda.gov www.whitehouse.gov http://en.wikipedia.org

2. Research the disputes investigated by the World Trade Organisation (WTO) which relate to US farm subsidies.

   www.wto.org

3. Investigate the Doha Declaration (2001) as it related to agriculture and the extent to which any progress was made in the subsequent negotiations.

   http://www.wto.org/english/tratop_e/dda_e/dohaexplained_e.htm

4. The European Union Commission announced in January 2009 that it was to increase support to EU milk producers. Investigate the reasons for this.

   www.eubusiness.com (search agriculture)

Multiple Choice
QUESTION & ANSWER

In this regular feature Chief Examiner ***Robert Nutter*** *of Watford Girls' Grammar School, looks at AS and A2 questions which in this volume will aim to reflect the order that schools and colleges cover topics from the specifications. There are three AS (1-3) and three A2 (4-6) questions per edition plus explained answers.* (See page 40 for answers.)

Questions

1. Which one of the following pairs of products has positive cross elasticity relationship?

A. Apple ipods and itunes.
B. iphones and Blackberries.
C. Windows Vista and desktop PCs.
D. HD television sets and Sky HD.

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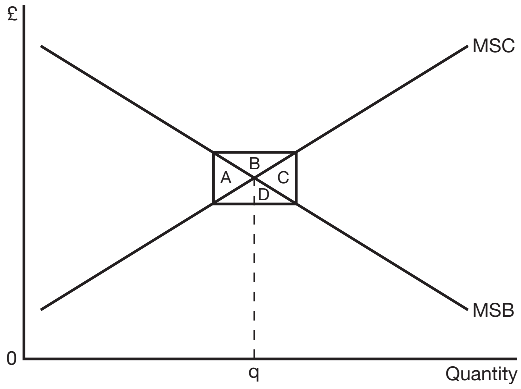
2. The diagram below shows the marginal social benefit (MSB) and the marginal social cost (MSC) for a product.



Which area represents the welfare loss from a positive consumption externality?

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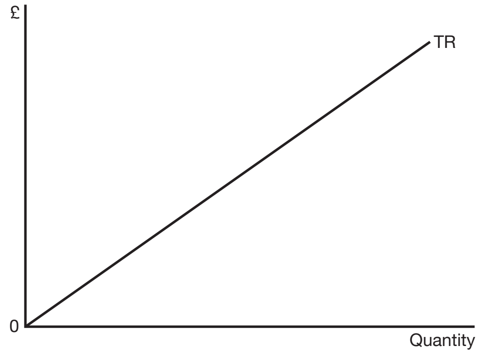
3. A depreciation of the pound sterling against all other major currencies is most likely to result in a

A. reduction in cost push inflationary pressures in the UK economy.
B. fall in costs for overseas firms embarking on FDI in the UK.
C. deterioration in the UK's balance of payments on current account.
D. reduction in the number of foreign tourists visiting the UK.

Where does the positive cross elasticity lie in Q1?

4.



The diagram above shows the total revenue for a firm. It can be deduced that the price elasticity of demand for the firm's product is

A. zero
B. -0.5
C. -1.0
D. -1.5
E. infinity

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5. If the government imposes a windfall tax on a privatised utility making abnormal profits the impact on the company will shift its

A. marginal cost curve upwards.
B. average cost curve downwards.
C. marginal and average cost curves downwards.
D. average cost curve upwards.
E. marginal cost curve downwards.

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6. Which one of the following will lead to an improvement in the UK's terms of trade (ceteris paribus)?

A. A significant rise in the world price of oil and gas.
B. A depreciation of the pound on the foreign exchanges.
C. A fall in the average price of UK exports.
D. A significant rise in inflation in the United States and the euro zone.
E. A depreciation in the United States dollar and the euro against the pound.

What will improve the UK's terms of trade in Q6?

What Impact have Supply Side Reforms had on the UK Economy?

***Ian Black**, St. Alban's School, examines the impact of some policies to improve the UK's economic performance.*

Exam Board	AS	Unit	A2	Unit
AQA	✓	2(3.2.4)	✓	4(3.4.2)
Edexcel	✓	2(2.3.8)		
OCR	✓	F582	✓	F585
WEJC	✓	EC2(D)		
CCEA	✓	2		
Int. Bacc.	Standard 3.4			

Imagine the following scenario: you are a successful professional working in the City of London, after graduating from university. At the end of your first year, you decide to look back at your pay slips to calculate the rate of income tax you are paying to the government. (In this hypothetical example, of course, you don't yet know!) You calculate that out of every £100 of taxable income earned, you have paid £33 to the government in income tax. In other words, your rate of income tax is 33%, almost one-third of your income.

Rather disturbed by this, you have a chat to your rich uncle about the situation, who is a successful entrepreneur. During the discussion, he reveals to you this amazing fact: for every extra £100 he earns, he has to pay **£83** to the tax authorities: in other words, a higher rate of tax of 83%! As if this wasn't bad enough, says your uncle, your great uncle made £1,000 in share dividends last year, of which he had to pay **£980** to the authorities. The higher rate of tax on unearned* income is 98%.

The scenario above is, of course, invented. However, the tax rates are not. Back in the 1970s, when Denis Healey was Chancellor of the Exchequer, the basic and higher rates of income tax were 33% and 83% respectively, while the higher rate of tax on unearned income was a whopping 98%. Think about what might have happened to the incentives to work and to create wealth with such high marginal tax rates as these!

*'Earned' income is essentially income from supplying labour, while 'unearned' income is from other sources, e.g. interest, rent, dividends.

As well as high income tax rates, there were many other features that prevented the UK economy from working efficiently in the 1970s. These included strong trade union power, inefficient state-controlled monopolies and high benefit levels. It was against this background that the **supply-side revolution** took hold. A number of economists were advocating the use of supply-side policies in order to boost economic growth and living standards. **Supply-side policies** are simply any policies designed to boost aggregate supply in the economy. The idea is to raise the economy's productive potential and to improve the efficiency of resource allocation. Policies to increase the incentive to work, the competitiveness of industry, the productivity of workers, investment and innovation are all classed as supply-side policies.

The effect of supply side policies is illustrated in Figure 1. The economy is initially in macroeconomic equilibrium at P_1Yf_1. The neoclassical $LRAS_1$ is vertical at the full employment level of output Yf_1. Successful supply side policies will increase the efficiency of the economy and raise the economy's productive potential. This will cause a rightward shift in the LRAS curve to $LRAS_2$. This causes a rise in the level of real output to Yf_2 and a fall in the general price level to P_2. Successful supply side policies should therefore allow the economy to achieve non-inflationary economic growth.

The Conservative governments of 1979-97 believed strongly in supply-side economics and they introduced a

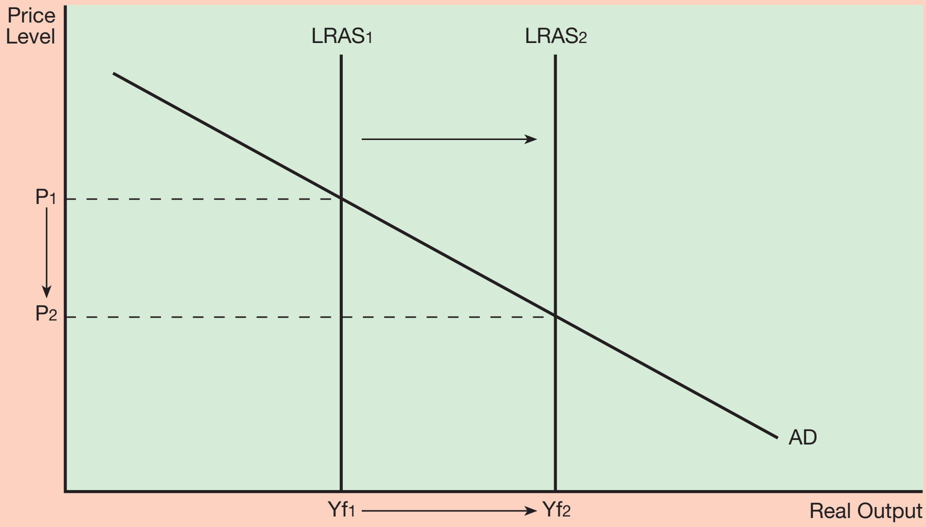
number of policies designed to reduce the role of the state and increase the efficiency of resource allocation in the UK economy. Since 1997 the Labour government has maintained that faith in a supply-side strategy, although its policies have involved more government intervention than that of the Conservatives. Conservative policies included a massive privatisation programme, deregulation of transport, financial, communications and other markets, legislation to reduce substantially the power of trade unions, as well as cutting what we have just seen were very high basic and higher rates of income tax. Labour policies have included massive investment in the public services, such as education, training and the health service, a substantial toughening of UK competition policy and tax incentives to boost research and development.

In this article, rather than going through every possible supply side policy, we are going to look at two sets of supply side policies in detail, in the way that you would have to in the AS examination. Hopefully, this approach will gain knowledge marks (K) for knowing and understanding the policy, application marks (Ap.) for applying the policy to the UK economy specifically, analysis marks (An.) for using economic theory to explain the impact of the policy, and evaluation (E) marks for using theoretical and empirical evidence to make a judgement on what the impact of the policy actually was. The first set of policies comprise fiscal measures and the second set relate to the labour market. We consider these in turn.

Tax and social security reform

By 1988 the basic rate of income tax, which had stood at 33%, had been cut to 25%, while the higher rate had been cut from 83% to 40%. The basic rate has since been cut incrementally by successive governments, standing today at 20%. The Labour government introduced a working families tax credit in 1999, before replacing it with the working tax credit and the child tax credit in 2003. The working tax credit provides a direct payment to low paid workers with or without children, while the child tax credit is available for low income families regardless of employment status.

Figure 1: Illustrating the macroeconomic impact of supply side policies



The rationale behind these measures is that they should lead to a rise in the *incentive to work*. The Conservative and Labour governments both believed that lower income taxes would boost the labour supply in the economy, raising the economy's productive potential, and leading to a shift in LRAS to the right. In fact, economic analysis suggests that there are two contrasting effects on incentives of lower income tax rates. Suppose you have a choice between work and leisure. If your income tax rate falls, you earn more disposable income per hour worked. Work has become 'cheaper', while leisure has become 'more expensive'. In the same way as you would substitute consumption towards a cheaper good, it is argued that the worker substitutes work for leisure. In the jargon, this is called the *substitution effect*. So the first effect says that when income tax rates go down, you work harder.

The second effect says that your higher disposable income may lead you to decide to work less. If you had a 'target' income in mind that you were happy with, a fall in tax rates would mean you wouldn't have to work as many hours to achieve that 'target' level of income. This is called the *income effect*. Unfortunately, economic theory alone cannot tell us which effect outweighs the other. All that theory can tell us is that income tax systems that are *progressive* tend to have higher substitution effects than those that are proportional. Since the UK income tax system is progressive, one would imagine that the substitution effects of the tax cuts outlined above would be strong.

However, the economist needs evidence before concluding that cuts in income taxes have boosted the incentive to work. One study twenty years ago by Minford and Ashton concluded that a cut in the higher rate of income tax to 40% in 1988 would increase hours worked by 8%. A more recent analysis by the Institute for Fiscal Studies suggests that, although incentives matter, the effect of changes in income taxes on incentives depends on the type of individual.[1] For example, male hours worked are almost entirely unresponsive to changes in incentives, while female hours are very responsive. Both male and female participation rates are also highly responsive to changes in tax incentives. So we can conclude that cuts in direct taxes boost the incentive to work, boost the labour supply, leading to an outward shift in LRAS.

A full evaluation of this policy should also consider its negative consequences. There is lots of evidence to suggest that the cuts in direct taxes, coupled with the squeeze in benefits that have taken place since the 1980s have led to a rise in inequality in the UK. Whether or not higher inequality was a price worth paying for faster economic growth depends on your value judgement about which macroeconomic objective you think is the most important!

The Labour government's tax credits should not only boost work incentives, but also narrow the gap between the working poor and the rest of the UK labour force. The new tax credits are certainly more generous than the old Family Credit system that existed before 1999. However, the 2009 Mirrlees review suggested that many low-paid workers still have high tax rates at the margin, while tax credits are complicated, time consuming to claim, hard to administer,

1. C. Meghir and D. Phillips, 'Labour supply and taxes', Institute for Fiscal Studies, part of *Reforming the Tax System for the 21st Century*, The Mirrlees Review, IFS, (2009).

The New Deal is a scheme to help people back into work.

and significantly prone to fraud and error. It is thought that many workers who are entitled to claim tax credits do not claim them!

The New Deal

The New Deal is also classed as a supply side policy. However, in contrast to the policy on tax cuts, the New Deal is a more 'interventionist' policy. The New Deal was introduced by the Labour government in 1998 to help unemployed people to move off benefits and find work. It was initially targeted at 18-24 year olds, but is now targeted at a number of different groups, such as 25+, 50+ and lone parents.

The New Deal aims to help young people find and keep a job, or become self employed. Each person is assigned a personal adviser who helps people build on the skills they have and learn new skills. Everyone between the age of 18 and pensionable age must go on the New Deal after a period of time in order to carry on getting benefit. This is 6 months for 18-24 year olds, 18 months for those 25 years or older. The personal adviser works with you to try and find you a job. Participants are given help with filling in application forms and producing an updated CV. Participants may go into full time education or training, the voluntary sector or join an Environmental Task Force if they can't find a job or become self employed.

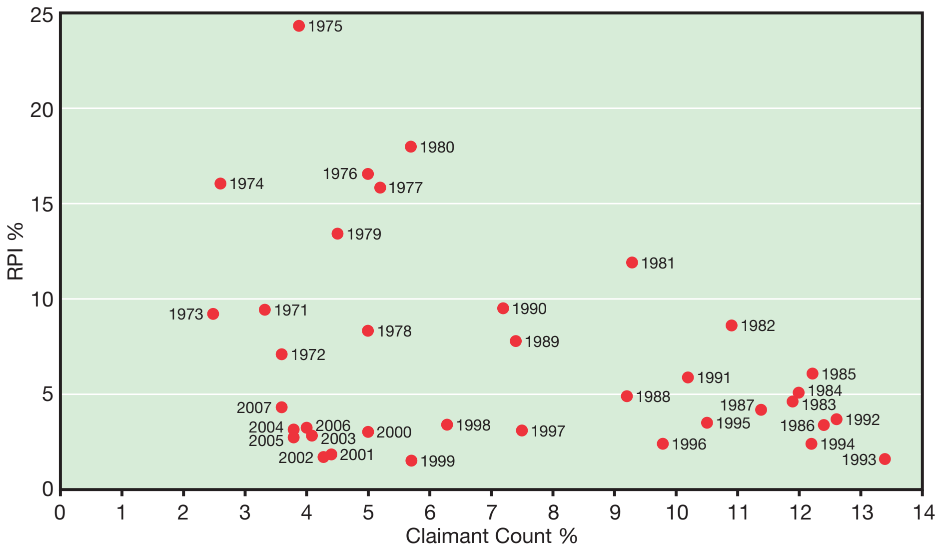
The New Deal aims to improve the skills of individuals and help them back into the job market. It should reduce *occupational immobility* in the labour market, reducing the amount of *frictional unemployment*, and making the labour market work more efficiently. Again, the ultimate goal is to boost the supply of labour in the UK, increasing the economy's productive potential, and shifting the LRAS curve to the right. The government believes that the advantage of the New Deal is that it is specific to the needs of the individual worker and provides skills appropriate to the local community. There is an incentive for job seekers to participate, since they may not be entitled to job seekers' allowance if they are uncooperative. By January 2008, the scheme had helped 1.8 million workers find work.

However, some groups of participants have been less successful than others. In particular, job entry rates for the Lone Parents, 18-24 and 25+ had been "declining or stable for some years", according to the Commons Public Accounts Committee in February 2008. Some of these workers may have found jobs anyway, and it is not clear exactly how long these workers held onto their jobs. Channel 4 News reported early in 2008 the London School of Economics' belief that the New Deal raised the chance of people finding a job by between 5% and 7%. Evidence from the National Audit Office also suggests that only around 10% of successful participants kept their job for more than 6 months. Channel 4 concluded that those who found jobs exclusively because of the New Deal numbered less than 180,000. This seems rather modest compared to a labour force of 30m, but worth the money invested, according to the LSE. On balance, therefore, it would appear that the effect of the New Deal has been modest but positive. It has raised the skills base of some UK workers and helped to make the labour market work more efficiently. However, it is perhaps not the triumphant success that Gordon Brown suggests!

Overall impact of supply side policies

There is a general consensus that supply side policies in the UK have led to a rise in the UK's trend rate of economic growth and a fall in the rate of inflation, as our simple AD/AS analysis would suggest. It is also likely that these policies have improved the trade-off between unemployment and inflation. Figure 2 indicates that between 1997 and 2007 the UK was able to sustain low unemployment with lower levels of inflation than was possible during the 1970s. The two policies mentioned in detail above, coupled with reduction in trade union power and increased spending on education and training have improved the inflation/unemployment trade-off.

Figure 2: The UK inflation/unemployment trade-off



Source: ONS

In addition, supply side policies have improved UK productivity and international competitiveness. In 2001 Crafts found that during the 1980s and 1990s, relative productivity decline compared with France and Germany had stopped, but not reversed, while the UK had begun to catch up with the US, until the late 1990s.[2] The main reason for the productivity gap was low capital per worker and a low rate of spending on R&D; rather than inefficient use of labour. Stronger competitive pressures, a fall in the number of working days lost to strikes and less over manning all helped to improve UK labour productivity performance, and all were a result of policies to reform the labour market.

Conclusion

This article has only considered two supply side policies in detail. In the examination, if you have to discuss the impact of supply side policies on one or more of the government's macroeconomic objectives, it may be tempting to try to cram in everything you know about a number of different supply side policies. The examiner will be looking to reward deep rather than shallow learners. In other words, choose a policy that you know something about, and write about it in detail, making sure you include evidence of Knowledge, Application, Analysis and Evaluation. The evaluation techniques I have used here include looking at both sides of an argument, weighing up evidence, drawing a conclusion and looking at any negative consequences of a policy.

Questions for discussion

1. Explain how supply side policies can help to achieve the UK goverment's macroeconomic objectives.
2. Which do you think is more important: the income effect or the substitution effect? Justify your answer.
3. Evaluate the extent to which the New Deal was responsible for the maintenance of low unemployment between 1998 and 2007.
4. Explain the reasons for the UK productivity gap.
5. Choose one supply side policy not considered in depth in this article. Evaluate the economic effects of your chosen policy.

2. Crafts (2001) 'Supply-Side Policy and British Relative Economic Decline', www.hm-treasury.gov.uk

Summary of key points

- **Supply side policies aim to boost economic efficiency and raise the productive potential of the economy.**
- **Both the Conservative Party and Labour have implemented supply side reforms. However, the Conservative policies were arguably more 'laissez faire', while Labour's can be been seen as more 'interventionist'.**
- **Since 1979, direct taxes have been cut, and policies introduced to 'make work pay'. They have improved work incentives, but increased income inequality.**
- **The Labour government's New Deal programme has been a qualified success since its launch in 1998.**
- **You should analyse and evaluate a small number of supply side policies in detail, rather than listing a large number of them in the examination.**

TAKING IT FURTHER

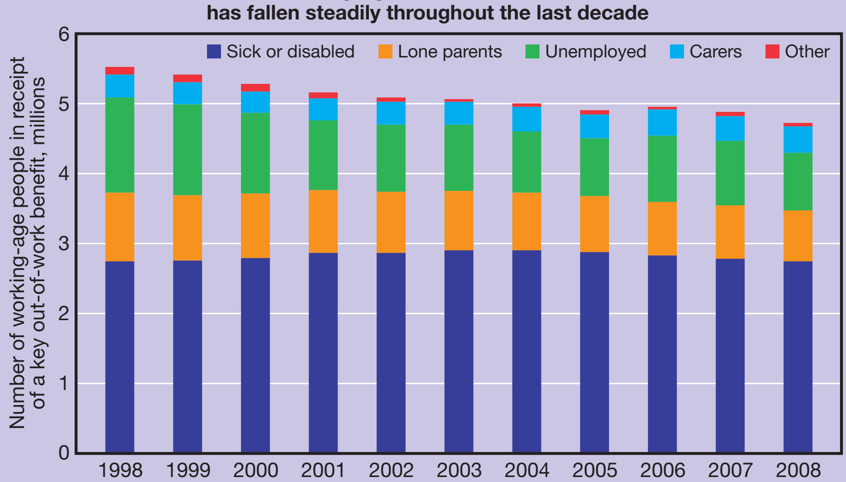
with Chief Examiner,
Robert Nutter

1. Investigate the role of the Learning and Skills Council and how it might contribute to improving the supply side of the UK economy.

   http://www.lsc.gov.uk/aboutus

2. 4.7 million people were in receipt of an out-of-work benefit in early 2009. Of these, 2.6 million (60%) were sick or disabled.

   The number of working-age claimants of out-of-work benefits has fallen steadily throughout the last decade

   Source: Work and Pensions Longitudinal Study, DWP; Great Britain; updated August 2008

   The government is committed to reforming the benefit system and to reducing the number of people on incapacity benefit by 1 million by 2015. Research the government's Green Paper 'No one written off – reforming welfare to reward responsibility'.

   http://www.dwp.gov.uk/welfarereform/noonewrittenoff

3. Investigate the aims of the Lisbon Agenda and the extent to which the aims set out in 2000 look likely to be achieved by 2010.

   www.civitas.org.uk   http://news.bbc.co.uk

4. Research the trends in the % employment rate in the UK over time. Use the Child Poverty Action Group website (http://www.cpag.org.uk) and use their search engine (80% employment rate).

What are the Benefits to Football of the Introduction of Foreign Player Quotas?

***Stephen Romer**, discusses the arguments about increasing the number of home-grown players in the Premier League.*

In December 2008, the 72 clubs in the Football League in England voted in favour of the introduction of quota restrictions on foreign players in teams match-day squads. This means that on any given Saturday afternoon, four of the sixteen players nominated by the manager for duty on the pitch and the substitutes bench would have to be home-grown.

The Football League's quota may strike one as rather a modest restriction given that it can be seen as a regulation promising only a limited constraint on the hordes of foreign players that have swamped professional soccer teams in England in recent years. But it is important to note that although the League's quota measure might not make for much change in the first few seasons in which it will apply, the supporters of the quota see it as a crucial first step.

Current Topics in ECONOMICS

Now that the reality of a quota has been established in principle, it is probable that the size of the home-grown quota will be raised from four players in seasons to come. And if the mandated number of home-grown players is gradually raised, we can safely assume that the average Football League club will find itself becoming more interested in making the investment needed to bring more local players through, coaching them from a young age until they are ready for first team duty.

The Football League in England covers only the second, third and fourth divisions (the Championship and Leagues One and Two). But we must not regard the League's quota in isolation: today, quota policy has developed into an increasingly important aspect of the Economics of Football in all sectors of the pro football market. Indeed, it is not an exaggeration to say that in 2009 the quota question has become the most preponderating topic of discussion as regards the business side of the national sport.

At world, European and national levels, there are forceful advocates of quotas – of policies of the kind introduced by the Football League. There is a campaign for reductions in the number of foreigners in domestic competitions because, it is argued, fewer foreigners would be beneficial for two principal reasons:

- A quota would improve the competitive balance between the teams in the major league and cup competitions because the richest clubs – such as the Big Four in the Premier League in England (the EPL) – would no longer be allowed to fill up their squads with expensive foreign superstars.
- Quotas would lead to an improvement in the World Cup and European Championship prospects of the England national team. In England, for example, the dominance of foreign players in EPL line-ups means that in recent years there has been a strictly limited number of top-flight players qualified to play for the national team. In turn, says this argument, the consequent poor performance of the England team is all but inevitable.

Most of the top officials in world football administration share the following belief: during the recent imported-foreign-player boom, football in England has neglected the development of talented local players. Sepp Blatter, the head of Fifa, holds this view, as does Michel Platini, the boss of Uefa and also Sir Trevor Brooking, the FA's Director of Football Development. The West Ham legend has expressed the view that the long-term outlook for a successful England team has been severely reduced by the increasing number of overseas players in the EPL. It means, he says, there is a lack of depth in the national team. One must not underestimate the difficulties this presents: Sir Trevor fears that if recent trends are allowed to continue, success will come to be regarded as just qualifying for international tournaments – rather than winning them.

In 2007, Sir Trevor pointed out that Italy had recently won the World Cup (in Germany in 2006) and that well over 70% of players in Serie A in 2005-6 were Italian nationals. In contrast, alarming trends in the EPL seemed to be pointing to the number of England-qualified players soon falling below a third.

Sir Trevor said that there would inevitably be a detrimental effect on the national team – inevitable when you consider the extent to which foreign players deprive local talent (potentially, tomorrow's internationals) of the chance to gain experience of first team football. What is needed is more investment in youth academies, Brooking's Institutes.

Sir Trevor is the very personification of the advantages to both club and country of youth development. Joining his local club at an early age, he became West Ham's outstanding player, playing more than 600 games – and 47 for England.

He played in an era when there were few overseas players in football in England, and most of the foreign stars were the great Scots of the era, the likes of Denis Law, Kenny Dalgleish and Charlie Cooke.

But to find an absence of foreigners in top flight football in England, you don't have to go nearly as far back as the great days of Brooking and Dalgleish or Law and Graham. As recently as August 1992, on the opening weekend of the then new EPL, 76% of the players in the starting line-ups were qualified to play for England (and only ten players came from outside the British Isles). But then came the deluge. The foreign invasion of the EPL meant that by February 2005, Arsenal became the first club to name a sixteen man match-day squad composed entirely of foreign players. And for EPL matches played on the opening weekend of the 2007-8 season, the proportion of England-qualified players in starting line-ups had fallen from 76% in 1992 to just 37%. A further 7% came from Scotland, Wales and Northern Ireland. The majority, 56%, were foreign.

Arsenal Whinger

What about Mr Blatter, the head of Fifa? His opinion is that football's world governing body would like to see the introduction of a hard-and-fast quota regulation under which every club's starting eleven would be allowed to include no more than five foreign players. This is known as the 6 + 5 rule. (There would be a two year transition period of 4 + 7.)

In England, the Premiership and its top clubs are opposed to the 6 + 5 proposal. It would kill the Premier League, complained Arsene Wenger, the Arsenal manager, when, in 2007, Mr Blatter announced plans to lobby the European Commission (EC) to give its permission for the five foreigner quota.

The EPL position was that domestic footballers are better in an environment where foreign stars dominate: if they are to make the grade in competition with the imports, local players have to be especially good. In support of this view, Arsene Wenger cites the schooling of an intelligent child: If you put a gifted child in a bad class, he will go down. But if you put him in a good class, he will get even better.

When it comes to 6 + 5, Arsene Wenger and the top officials of the EPL may have little to worry about in practice. The point to note is that for the 6 + 5 plan to eventuate, it would take the granting of an exemption from EU labour law (a so-called specificity of sport amendment) before footballer-quotas could be introduced in EU member states.

And the EC's disappointingly predictable Commissioner for Equal Opportunities, the previously obscure Señor Spidla, responded to Fifa's 6 + 5 proposal by saying that it was unacceptable because it is directly discriminatory and therefore incompatible with the EU law.

In essence, European labour law says that the freedom of movement of labour is basic to the EU. Workers (including footballers) must be allowed to supply their labour wherever they want throughout all 27 member countries. Hence, a quota which restricted movement would violate this basic policy.

Some observers have taken the view

that Fifa's boss, Sepp Blatter, known for a rent-a-quote approach to publicity, lacks the diplomatic skills of his Uefa counterpart, Michel Platini, the suave and sophisticated Frenchman. Fifa's quota campaign, they conclude, has less chance of acceptance and implementation than the more realistic proposals of Uefa.

Football fans have great memories of Michel Platini, probably one of the twenty greatest players in the history of the game. One may be mistaken, but it is easy to imagine Platini bringing a similar brand of flair to the politics of European football administration as that which was characteristic of his performances as an attacking midfielder with Juventus and France twenty-five years ago.

Platini, the Machiavellian maestro of the midfield, assumed the Presidency of Uefa in January 2007. At a remarkably early stage (giving a new meaning to the term quota quickie), he had, by mid-2008, implemented a quota arrangement for Uefa matches.

Careful to involve the EC in its plans, Uefa launched the idea of quotas of so-called home-grown players. Home-grown is a designation intended to allow quotas to exist without infringing EU law.

Uefa's home-grown rule was introduced for the 2008-9 season. It applies to clubs playing in the Champions League and the Uefa Cup: at the beginning of the season, all clubs participating in Uefa's competitions are obliged to nominate a 25 player squad. Of the 25, at least eight must be home-grown, that is players who have spent a minimum of three years between the ages of 15 and 21 in the youth development teams of their club. But the key point to note is that this is not a nationality-based restriction.

In the light of EU labour regulations, the Uefa quota policy is regarded as practical in a way that 6 + 5 is not. A club's eight home-grown squad members may or may not be from abroad; what they cannot be is foreign stars that a wealthy club has recently imported. Thus, the invention of the home-grown category is a clever way to get round the EU regulations, and is widely assumed to be unassailable legally. We have noted its adoption by the Football League. Other leagues may follow.

Are there other comparably ingenious EU law evading schemes? In cricket, the England and Wales Cricket Board (ECB) offers a bonus to counties which bring through a player who is selected for England. But all is not well on the cricketing front.

For many years, the ECB has limited the number of foreign players allowed in county teams. But the EU-related farce of the Kolpak player in recent times has given access to county squads of numerous overseas (usually South African) players. A cricketer secures his Kolpak status through the fiction that he seeks to qualify to play for England. In reality, he's probably pining for the Veldt.

Mancheater United

For Michel Platini, the European Cup Final of 2008 was a major disappointment in the sense that it was contested by two heavily-indebted foreign-owned EPL clubs. Indeed, for Uefa's President the Moscow final was an occasion that embodied just about everything that is wrong with football today: (a) the crowding-out of local talent by costly foreign imports of star players, and the deleterious knock-on effect on the national team and (b) the free market in the ownership of clubs, and the takeover of clubs by foreign speculators.

For its President, Uefa's own showpiece occasion was not a fixture to savour. It was not a fixture in which Chelsea played Manchester United: more accurately it should have been advertised as Russian Oligarch v Highly Geared US Takeover Speculators. We are, of course, referring to Roman Abramovich, the owner of Chelsea, and the Glazer Brothers, acquirers of Manchester United.

The combined debts of Chelsea and Manchester amount to about £1.5 billion, and it is the extent of the indebtedness of EPL clubs that particularly concerns Uefa. Michel Platini's position is that, almost invariably, debt is the foundation stone in the EPL, but high levels of debt are essentially unsustainable in the long run.

In the UK economy as a whole, we saw in 2008 that a boom based on debt may have lasted for a period of several years, but it tends to come to an end eventually. And when it does, there is the most almighty crash. Does the same fate await football?

Time will tell. But while the debt-based boom endures in the EPL, it represents for its critics an unacceptable imperfection in the European football market because vast debts make possible the payment of sky-high transfer fees and wages of the imported foreign superstars.

It was no wonder two EPL sides contested the European Cup Final: clubs in other countries can no longer compete very effectively if they are not prepared to get into debt on an EPL scale. For Michel Platini, clubs carrying excessive debt are, in a word, cheating.

But Platini's policies are controversial. For example, the eight home-grown player policy is too weak, say some observers. They argue that it will not have any impact because eight-out-of-twenty-five is such a relatively small requirement. It means that the top clubs can go through the motions of compliance, but then systematically leave the eight out of starting line-ups and named substitutes. Your home-grown contingent will be found sitting in the stands watching the match.

However, while there may be some merit in this view, there is growing evidence in football of a belief that what we are seeing in 2008-9 is the beginning of a period which will eventually lead to the implementation of limits on the number of foreign players in starting line-ups – perhaps not as severe a restriction as 6 + 5, but some version of it.

Look at Chelsea, for example. The League Champions of 2005 and 2006 have had many expensive foreign superstars in the team in recent years – Drogba and Deco, Carvalho and Cech, Makelele and Malouda. But in late 2008, apparently believing that effective foreigner-quotas will begin to be enforced sooner or later, Chelsea dramatically announced the sacking of 15 international scouts. The resources would be reallocated to the development of local players. The mounting consensus seems to be that if the EU exemption on 6 + 5 is not forthcoming, the regulation will eventually be enacted, having been adapted to something like 6 home-grown + 5.

The Wally with the Brolly

In recent tournaments, the performance of the England football team has varied between the mediocre (quarter final defeats in the World Cups of 2002 and 2006 and in the European Championship in 2004) and the outright disastrous. Following a catastrophic defeat by Croatia at Wembley in 2007, Steve McClaren's England team failed even to qualify for the first round of the European tournament in Austria and Switzerland.

In June 2008, Europe's top soccer

nations met on the playing fields of Vienna and Salzburg, Basel and Berne: Germany entertained, France disappointed, Italy went home early, and Holland did well. And England? At this summit conference of leading football nations, the England team was conspicuous only by its absence.

You might argue that this was a positive development for the simple reason that the good citizens of Austria – the gentle folk of Europe's picture postcard Alpine region – were spared the terrifying prospect of invasion by thousands of drunken English football hooligans.

But although non-qualification in 2008 meant that the external disbenefits of hooliganism – bad manners, yobbery, violence, and widespread anti-social behaviour – were avoided, it is not safe to assume that countries hosting football tournaments don't welcome England's participation.

On the contrary, the economic success of the event depends to some extent on the injection of expenditure from the visiting British football fans. For example, during the World Cup in 2006 it was estimated that, as long as their team survived in the competition, more than 100,000 England followers were living in Germany. Their spending on local goods and services amounted to an aggregate sum approaching €200 million.

And as it looks forward to hosting the World Cup in 2010, one can assume that the South African government is rooting for the England team in the qualifying tournament, praying that it will get through and bring with it a travelling economic stimulus package.

But why has the England team performed so poorly in recent years? The Premier League is very rich and successful, and is watched by TV audiences all over the world. Its top clubs have become dominant in European football, supplying three of the four Champion League semi-finalists in both 2006-7 and 2007-8.

However, when the England team is picked only about 40% of the Premier League's players can be selected – as we have noted, the majority are not eligible for selection because they are foreigners. New young England-qualified players are not coming through in sufficient numbers: in season 2007-8, Chelsea, Liverpool, Arsenal and Man U – the Big Four of the EPL – gave first team debuts to only three players (in total) coming out of their youth set-ups.

As we know, it is against this sort of background, that we have seen pressure for the introduction of quotas of England-qualified players. The belief is that this would help to bring about an improvement in the fortunes of the national team. Why? The team would be selected from a larger number of players with experience of club-level football at the top.

It's an interesting argument, and there may be something in it. EPL Chairman Sir Dave Richards certainly seems to think so. The official view of the EPL is that foreign imports do no harm to the national team and that quotas must be opposed. But Sir Dave has expressed the view that the EPL cost Steve McClaren his job because we've brought all these foreign players in. Going dramatically off-message at a press conference on football administration in the UAE in mid-2008, Sir Dave let the cat out of the bag when he said that the threat of the financial disaster of relegation from the Premier League means that clubs sign foreign players rather than concentrating on the nurturing of talent in their youth academies. The Chairman's remarkable outburst was in dramatic contrast to the EPL's party line which argues that the presence of top quality foreigners raises the standards of the pool of players from which Fabio Capello, the England manager, can select his team.

Vast debts make possible the payment of sky-high transfer fees and wages of the imported foreign superstars.

Is the EPL in a state of denial? Or is there some truth in what they say? One can argue that fewer foreign players would not be a sufficient condition for national team glory: it is not just in the era of foreign imports that the national team has disappointed its fans. You have to go back 43 years to Bobby Moore and Bobby Charlton at Wembley in 1966 to find any real success.

And there were precious few foreign footballers in England in 1974, 1978 and 1994, the years of failure to qualify for the World Cup.

Questions for discussion

1. What are the advantages and disadvantages of (a) Fifa's 6 + 5 proposal; and (b) the home-grown restrictions introduced by Uefa and by the Football League?
2. Argue the case for and against Michel Platini's opinion that rampant commercialism in football has damaged youth development.
3. In the EPL, the Big Four permanently dominate. Would quotas help to reintroduce an improved competitive balance between all clubs in the Premier League?
4. Evaluate the views (as noted above) of Sir Trevor Brooking and Sir Dave Richards.
5. "Arsene Wenger says that with quotas the EPL would no longer be the best league in the world. I would not be happy if somebody told me that I have to say to a player sorry, you have the ability to play but you were not born in the right place." Discuss.
6. "The introduction in 2009-10 of quota limitations on foreign players in the EPL would guarantee that England would succeed in the World Cup of 2014." Discuss.

Summary of key points

- **A limitation on the number of foreign players in football teams is advocated by influential personalities in football administration. Fifa has called for a quota of five foreign players in starting line-ups.**
- **Uefa has introduced the concept of a quota of home-grown players in squads for clubs participating in European competition. But the home-grown category is not nationality-based.**
- **Nationality-based quotas would not be acceptable under EU labour law.**
- **There is debate about the extent to which quotas in the EPL would facilitate an improvement in the performance of the England team.**

The Economic Downturn in the United Kingdom

***Andrew Reeve**, Head of Economics and Business Studies, King's School, Macclesfield, reviews the data on the state of the UK economy in 2008.*

"We are in the midst of the worst financial crisis since the 1930's".
This is the opening remark made by George Soros in his latest text.[1]

The current economic situation of economic slowdown and recession affecting a large proportion of developed nations has its beginning in August 2007 in the United States, when American Home Mortgage, a large home loan provider, filed for bankruptcy. This was closely followed by the French Bank, BNP Paribus, suspending three of its investment funds worth €2 billion. By the end of the month interest rates were being cut by the Federal Reserve and in September 2007 the crisis had spread to the United Kingdom when the Northern Rock announced it was in financial difficulty leading to a run on a bank not seen in the United Kingdom for 100 years.

Making Sense of Economic Data

1. George Soros, 'The Credit Crunch of 2008 and what it means, the new paradigm for financial markets', 2008, www.publicaffairsbooks.com

So how did this financial crisis first start? The search for this answer takes us back to 2000. During 2000 there was a dot com or internet bubble which developed. Hundreds of internet businesses became vastly overvalued and eventually the bubble burst. This depressed the markets and in reaction to this the Federal Reserve Bank reduced interest rates from 6.5% to 3.5%. In September 2001 there were terrorist attacks on the United States which caused a widespread loss of confidence and a depression in the market value. Once again, in response to this, the Federal Reserve cut interest rates, down to a low of 1% in 2003. Interest rates maintained this low level for a significant length of time, allowing individuals to access cheap credit for the first time. Banks increased their lending to sub-prime, high risk individuals in America, on the rational basis of if the individual defaulted on their loan then the increased value of their house would cover their mortgage during repossession. Indeed, this was a safe assumption as between 2000 and 2005 American real estate saw a 50% increase in its average value. However, as interest rates began to rise, the number of people defaulting on loans escalated and banks saw significant rises in bad debt exposure as property prices stalled and eventually reversed.

However, even though the financial crisis was growing the effects of this so-called ‘Credit Crunch’ did not appear to have any major effect on the ‘real’ economy during the first half of 2008. Analysts believed that GDP might slow down and at worst there might have been a stagnation in house prices for a few months. However, the challenges in the financial markets have spread and over the last few months the United Kingdom has entered economic slow-down and potential recession.

This article is written just ahead of the fourth quarter 2008 GDP figure for the UK in late January 2009. It is widely expected that by the time you are reading this piece these figures will have officially confirmed that the United Kingdom economy has entered a period of recession.*

Measuring economic growth

The measurement of the economy is carried out by using Gross Domestic Product or GDP. In the United Kingdom the official level of GDP is measured by the UK Statistics Authority (www.statistics.gov.uk) who produce monthly figures.

There are three methods of calculating GDP levels within an economy: the Income, Output and Expenditure methods. Although they are different methods, all three lead to the same figure for GDP within an economy. The method analysed the most at Advanced Level is the expenditure approach. This is calculated by adding up all of the expenditure by various economic agents in the economy, including spending by consumers, firms, government and by customers aboard. This can be shown in the following formula:

GDP = Spending by Consumers
+ Firms (Capital) + Government
+ (Spending on UK Exports
– spending by UK economic agents
on Imports from overseas)

This can be shortened to:

GDP (expenditure) = C + I + G + (X – M)

Generally, we value items by the amount we paid for them. If we add up all of the transactions in the economy, we gain a figure for GDP at Market Prices. However, this level of GDP also includes all of the taxation which the government levies on goods and services as well as any subsidies. If we correct for these items we obtain GDP at Basic Prices.

When calculating and measuring changes in GDP over time it is important to take account of changes in the rate of inflation. Failure to do so will result in a level of GDP which suggests that the economy is improving at a rate greater than it actually is. GDP levels which have not been adjusted for inflation are known as nominal values and those which have been amended are called Real Values. The Statistics Agency produces a

Table 1: Gross domestic product by category of expenditure: chained volume measures, £m, (reference year 2003)

	Domestic expenditure on goods and services at market prices											
	Final consumption expenditure			Gross capital formation								
	Households	Non-profit institutions	General government	Gross fixed capital formation	Change in inventories	Acquisitions *less* disposals of valuables	Total	Total exports	Gross final expenditure	*less* Total imports	Statistical discrepancy (expenditure)	Gross domestic product at market prices
	ABJR	HAYO	NMRY	NPQT	CAFU	NPJR	YBIM	IKBK	ABMG	IKMBL	GIXS	ABMI
2006	766,378	28,289	248,776	212,146	4,575	290	1,260,454	365,818	1,626,272	397,076	–	1,229,196
2007	789,163	29,269	253,200	227,188	6,849	535	1,306,204	349,290	1,655,493	389,724	628	1,266,397
Seasonally adjusted												
2006 Q1	189.581	6,945	61,989	50,715	1,593	101	310,924	96,005	406,929	102,518	–	304,412
Q2	192,015	7,037	61,854	52,139	-153	229	313,121	98,339	411,460	105,003	–	306,456
Q3	191,988	7,120	62,329	53,681	1,844	-28	316,934	85,722	402,656	94,804	–	307,853
Q4	192,794	7,187	62,604	55,611	1,291	-12	319,475	85,752	405,227	94,751	–	310,475
2007 Q1	194,532	7,243	62,927	56,457	1,449	73	322,682	86,055	408,737	95,628	122	313,232
Q2	196,339	7,260	63,193	56,209	623	329	323,953	86,847	410,800	95,360	151	315,591
Q3	198,538	7,314	63,468	56,764	2,744	44	328,872	88,508	417,380	99,549	173	318,004
Q4	199,754	7,452	63,612	57,758	2,033	89	330,697	87,880	418,576	99,187	182	319,570
2008 Q1	201,446	7,602	64,227	56,609	485	205	330,573	88,535	419,108	98,860	203	320,452
Q2	201,195	7,728	64,544	55,031	1,163	429	330,089	88,493	418,583	98,333	203	320,453
Q3	200,821	7,815	65,173	53,715	925	331	328,779	88,217	416,996	98,399	280	318,877
Percentage change, latest quarter on previous quarter												
												IHYQ
2008 Q3	-0.2	1.1	1.0	-2.4			-0.4	-0.3	-0.4	0.1		-0.5

Source: http://www.statistics.gov.uk/pdfdir/oie1108.pdf

*On 23 January 2009 the ONS stated that GDP fell by 1.5% in the 4th quarter of 2008. This represented the biggest quarter for quarter fall since 1980.

Household expenditure has been falling.

chained volume measure of GDP to ensure that its figures take into account changing prices.

Table 1 shows the chained volume measure of GDP in the third quarter of 2008. It can be seen that the total level of GDP was £318,877 million and represented a fall of 0.5% from the previous quarter (Q2). It is also noted that there was 0% growth in the level of GDP between the second and third quarters in 2008. At this point it is worth noting that to officially enter a recession, there must be negative economic growth over two successive quarters. Therefore, although we have not seen economic growth for two quarters, the United Kingdom was not technically in recession at the time of writing this article. However, as we see later most analysts believed that the economy was already in recession before the end of 2008 and would formally enter it when the figures are released in late January 2009.

If we consider the third quarter figure for GDP in 2008, we can see that the largest component is spending by households, who contribute £200,821 million out of £318,877, a percentage of 62.98%. The other components of GDP in the third quarter were spending by firms on Gross Fixed Capital Formation (Investment) of £53,715 million, Government spending of £65,173 million, spending on UK exports of £88,217 million and finally UK spending on overseas imports of £98,399 million.

According to the original release by National Statistics, between the second quarter and third quarter, the volume of output in production industries fell by 1.1%, within which manufacturing fell by 1.3%. The output of services fell by 0.4%. In real terms, household expenditure fell by 0.2% and gross fixed capital formation fell by 2.4%, as shown in Table 2.

On the 23rd December 2008, the ONS revised its third quarter figure for the UK's GDP, revising it down from a 0.5 fall to a 0.6 fall on the previous quarter (see Figure 1). In the revised figures household expenditure maintained its fall of 0.2%. However, expenditure on Gross Fixed Capital Formation was now estimated to have fallen by 2.8%.

The 2009 outlook?

As the official GDP figures continue to fall, there are many well-respected organisations who are predicting that 2009 and 2010 will see prolonged economic recession and slowdown. The National Institute of Economic and Social Research (NIESR) is an independent economic research institute with over sixty years experience of predicting economic models and outcomes. On 9 January 2009 the NIESR predicted that UK GDP for the final quarter of 2008 (Q4) had fallen by 1.5%, which, if correct, would mean that the nation had already technically entered a **recession**. In the same press release the NIESR also suggested that the Q3 figure of -0.6% ought to be lowered still further to around 1.1%. The NIESR said:

> Since 1955, when quarterly figures were first produced, there have been only five quarters in which output has fallen more sharply, with the lowest figure of -2.6% in 1958.[2]

It is worth noting that the NIESR claim to be accurate to within 0.2% of GDP with its predictions. If these figures are borne out then it would represent the worst economic performance for the UK economy for 28 years.

These predictions come on the back of official figures by the ONS that the UK manufacturing sector saw production fall by 7.4% over the year to November 2008, the largest drop since 1981.

It is not surprising therefore that the Bank of England has reduced interest rates several times over the past few months. In early January 2009 members of the Monetary Policy Committee (MPC)

Table 2: Percentage quarterly changes in the UK economy

		At current market prices		Chained volume measures		
		Gross domestic product	Compensation of employees	Gross domestic product	Household expenditure	Gross fixed capital formation
2007	Q1	1.4	1.2	0.9	0.9	1.5
	Q2	1.7	1.0	0.8	0.9	-0.4
	Q3	1.4	0.9	0.8	1.1	1.0
	Q4	0.9	0.5	0.5	0.5	1.8
2008	Q1	1.6	1.6	0.3	0.8	-2.0
	Q2	0.4	0.4	0.0	-0.1	-2.8
	Q3	0.1	0.8	-0.5	-0.2	-2.4

Source: *Ibid*

2. www.niesr.ac.uk

reduced UK interest rates by a further 0.5% to 1.5%, the lowest rate of interest in the bank's 315 year history. This most recent fall has seen interest rates fall by 3.5 percentage points since October 2008. Obviously, with the Consumer Price Index being significantly above the 2.0% target level, the bank must weigh up the advantages and disadvantages of any interest rate cut. However, it is widely expected that CPI will fall back rapidly over 2009 and might become negative, a situation known as deflation. Analysts believe that the Bank of England will reduce interest rates still further in 2009. According to George Buckley, chief UK economist at Deutsche Bank AG in London, "there's further negative news to come, we are going to see negative GDP numbers for most if not all of 2009. We expect the bank to cut rates to 0.5% by the end of the first quarter."[3]

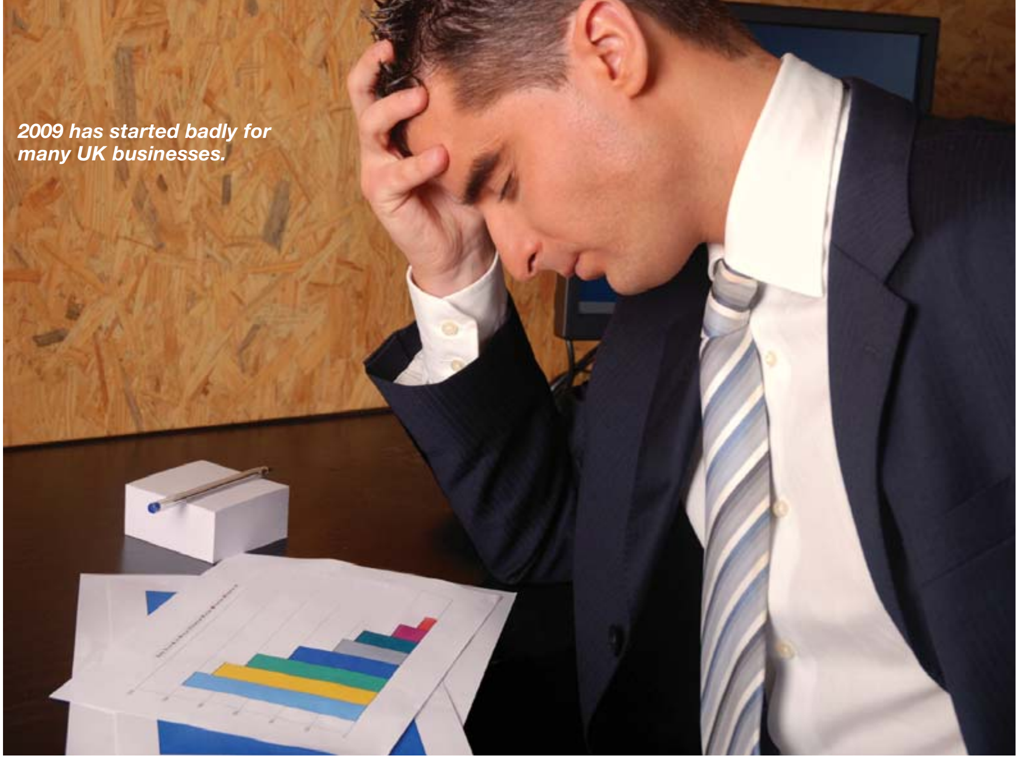
Roger Bootle of Capital Economics and adviser to Deloitte believes that GDP will fall by 2.5% during the whole of 2009 and then by a further 1% in 2010, the largest drop since 1947. In his monthly report to Deloitte in January, he stated that:

> To prevent a depression and persistent deflation, the Monetary Policy Committee will need to cut rates to zero. And once it has done that, it will have to resort to other measures designed to boost the quantity of money in the economy and lower longer-term rates of interest.[4]

Bootle predicts that unemployment could rise by 1.7 million people, resulting in one in every ten people being unemployed.

And the High Street?

2009 has started badly for many UK businesses. The number of profit warnings by UK-listed companies hit a seven year high in 2008, according to Ernst & Young. This accounting firm suggested that 60% of firms in the building and car industries have issued profit warnings and that 2009 will be no better. In a statement, Keith McGregor, a restructuring partner at E&Y claimed that "With credit markets frozen and confidence continuing to deteriorate, the next 12 months look set to be equally dramatic, if not more so". The number of new cars sold in the UK in 2008 fell by 11.3% from 2007 with sales in December falling by 21.2% compared to the same month one year earlier.[5] It is not surprising that Nissan announced on 8 January 2009 that it would have to lose 1,200 jobs from its Sunderland plant. The gloomy outlook persisted over Christmas with the administration of Woolworths, MFI, Zavvi, Wedgewood and Viyella to name a few. However, it is not all doom and gloom. Sainsbury's reported strong sales growth in the lead up to Christmas, with like for like sales, excluding petrol, rising by 4.5% in the 13 weeks up until 3 January 2009. Likewise, the budget retailer, Poundland also reported a rise in sales of 3.9% in the four week period up until 4 January 2009.[6]

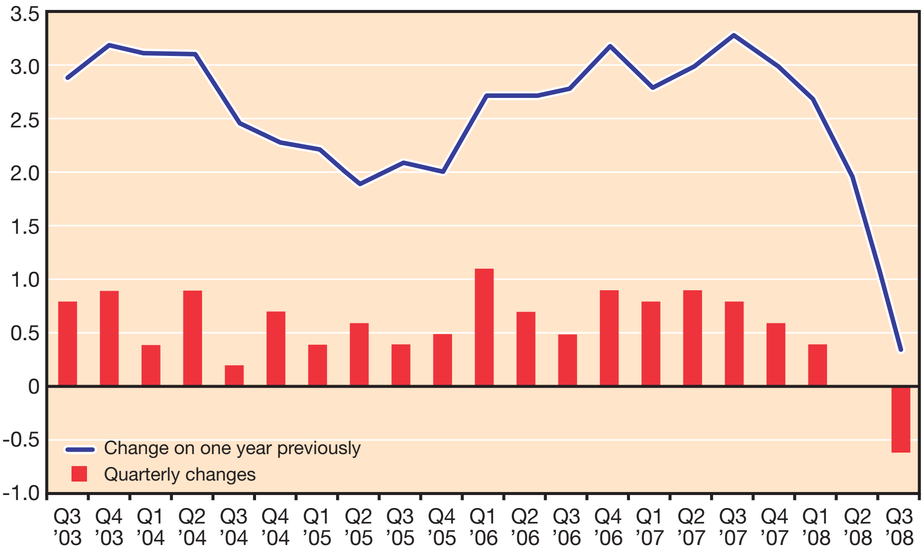


2009 has started badly for many UK businesses.

2009 – one to forget?

As we enter into 2009 it is looking likely that it will be one that is recorded in the economic textbooks of the future as being the first economic recession in most of our living memories. On 13 January 2009, *The Daily Telegraph* commented that "the recession is now of a scale that could leave Britain's economy permanently scarred".[7] There are bound to be losers, firms entering into administration and thousands of individuals losing their jobs. 2009 is going to be a painful experience for many in the nation. However, as with all economic slowdowns, rises in GDP levels will return and we will begin to see a improvement in economic growth once again.

Figure 1: Quarterly changes in the UK's GDP



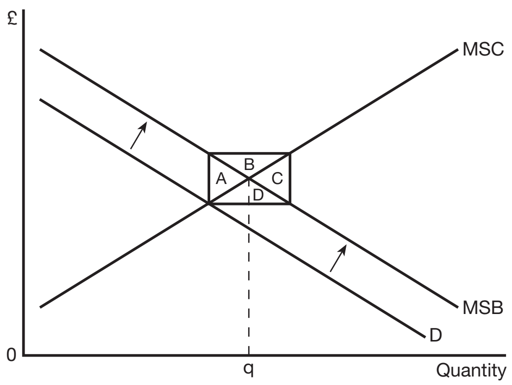
Source: www.bbc.co.uk, 9 January 2009

3. www.bloomberg.com, 'UK Economy Contracted the Most Since 1990 in the 3rd Quarter', by Svenja O'Donnell, 23 December 2008.
4. *Deloitte Economic Update – Monthly Report*. Thursday 8 January 2009. Roger Bootle.
5. www.bbc.co.uk, 9 January 2009.
6. www.bbc.co.uk, 12 January 2009.
7. 'Recession will leave UK economy scarred', E. Conway and A. Monaghan, *The Daily Telegraph*, 13 January 2009.

Answers

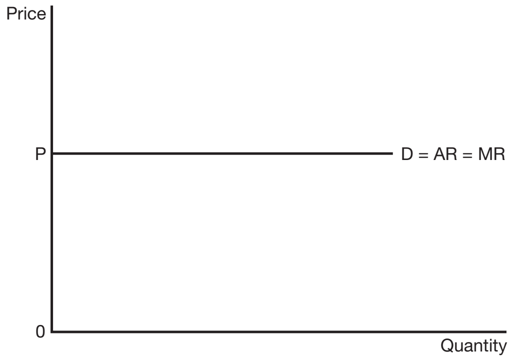
1. Cross elasticity of demand measures the relationship between the price changes of one product and their effect on the quantity demanded of another product. It is measured by the equation % change in quantity demand of product divided by the % change in price of Y. If the result of this calculation is positive (+) then the two goods are substitutes and if it is negative (-) then they are complements. If the price of Blackberries rises significantly it is likely to result in a rise in demand for rival iphones. This means that the cross elasticity relationship is positive and that they are substitutes. The other three pairs of goods are complements (joint demand) as they are bought together and thus have a negative cross elasticity relationship. The answer is thus B.

2. At levels of output below q (the socially efficient level of output because MSC = MSB) society values the product more than has to be foregone by society in resource costs as a result of producing that output. This is because at output levels below q MSB > MSC. For example there are significant positive consumption externalities from vaccinations against infectious diseases which, if they were provided by the free market would be over-priced and under-consumed from a welfare point of view. To correct market failure vaccinations should be subsidised to shift the demand to the right to coincide with MSB where MSB = MSC. The answer is thus A.

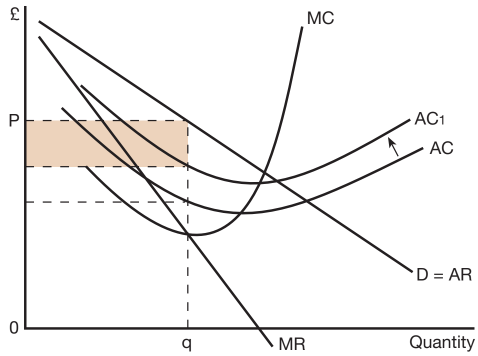


3. A depreciation of the pound will make UK exports cheaper and imports more expensive. This should in due course improve the UK trade balance. A depreciation of sterling will encourage more tourists to visit the UK because their currencies will have increased purchasing power. Higher import prices for raw materials and components has an effect which is inflationary as higher costs push up prices. However, overseas firms investing in UK land, buildings and other assets will find this attractive as their currencies have appreciated against the pound. The answer is thus B.

4. If total revenue is shown as an upward-sloping straight line then the marginal revenue will be both positive and constant meaning that price and average revenue are both constant. The price elasticity of demand for the firm's product must therefore be perfectly elastic (infinity) with demand/average revenue shown as horizontal as seen in the diagram below. At a certain price (p) consumers will buy any quantity, but at any price above p the quantity demanded is zero. The answer is thus E.



5. A windfall tax will increase the fixed costs for a firm for one year. Thus its average costs will increase although there will be no effect on marginal costs as these costs only relate to changes in output. As a result of the tax the average cost curve will shift upwards as shown in the diagram below. The profit-maximising output and price remain the same but the level of abnormal profit is substantially reduced. The answer is thus D.



6. The terms of trade measures the ratio of a country's export prices to its import prices in the form of an index:

$$\frac{\text{Index of export prices}}{\text{Index of import prices}} \times \frac{100}{1}$$

An improvement in the UK's terms of trade will mean that the UK's export prices are rising faster than its import prices. In practical terms this means that the sale of a unit of exports will now earn enough to buy more imports – hence an improvement in the terms of trade. If a country used barter for international trading it would mean that the export of a tractor would now exchange for 25 bales of straw rather than 20. If the US dollar and the euro fell against the pound this means that UK imports from the US and the euro zone will become cheaper while UK exports will be more expensive. The answer is thus E.

Revision Guide 2009

Steve Tidball, Ipswich School

Do any of these sound familiar? – I'm sure they do. We've all experienced these feelings – we've all been guilty of saying things like these at some point in our lives. For some, postponing crunch issues, making excuses, rationalising delays can become a chronic problem – a way of avoiding life; for others it only affects certain parts of their lives. The net effect though, is usually the same – wasted time, missed opportunities, poor performance, increased stress and often a deterioration in self-esteem. Be prepared to learn from your past and be resolved to change for the better in the future.

Experience is the toughest of teachers – it gives you the test first and the lesson afterwards.

Change of this sort, however, is quite tough to achieve. We all seem to be OK with the things we want to do or the things we have fun doing. However, when we see things as difficult, inconvenient or a bit scary we shift into 'procrastination mode' – unfortunately, we can be very creative and convincing in coming up with reasons to put things off. Preparing for examinations, of course, is one of those areas where 'manana' thoughts come into our minds all too easily.

Remember, for many, tomorrow is the busiest day of the week!

But however hard you try, and some people try very hard indeed, you just can't get away from examinations. No matter how much the education system is changed, written examinations still form a large part of the assessment process in this country at all age levels. Many myths surround examinations, so in this article, I want to show you how you can put yourself in a position to handle exams confidently and effectively.

We all encounter great opportunities – think what you could be doing in six months time… in two years time… in five years time if you can pass these wretched exams. Unfortunately our minds disguise these marvellous opportunities as impossible situations.

A journey of a thousand miles must begin with a single step.

The article is mainly intended for those sitting external exams on a standard two year A level course. The principles and techniques, however, can easily be adapted to modular examinations and internal end of year exams in any subject.

Stating the obvious

- Only you can revise for your own exams.
- Only you are responsible for your own learning and final performance.
- Ultimately, to the questions of what you will make of your life, you are the only answer; ultimately, to the problems of your life, you are the only solution.

Although articles like this can help, your A level grade will ultimately be determined by your own efforts alone. There is actually no big secret to exam success – if you adopt a sensible systematic approach to learning you'll do fine. Remember the saying used by many sports coaches…

FAILING TO PREPARE = PREPARING TO FAIL

- **Your own teacher remains the best source of advice** about the subject matter and revision in general. Not only does your teacher have expert subject knowledge but she or he knows the specific exam requirements and also knows your own personal strengths and weaknesses.

Initial self-assessment

It is worth spending a few moments to reflect on how you currently approach study and revision. You may, of course, already have acquired a good understanding of the subject, your study skills may be very advanced and you may be well into a carefully structured, progressive and systematic revision programme.

If that is so, great… keep going – much of what I have to say will probably appear very obvious to you. On the other hand you may not be in so fortunate a position; you may be feeling very apprehensive about the coming months; you may be feeling guilty and regretting a less than whole hearted attitude to work earlier in the course.

If you have not really got into gear yet, the good news is that you are not alone and it is still not too late. There are many other A and AS level students who have devoted less than 100% effort to their course. Assuming you have done some work during the course (you have done **some** work, haven't you?) and have a reasonable, if somewhat superficial, understanding of the main ideas, you can still enjoy outstanding success this summer.

The reality (here comes the bad news!!) is that success will not come without considerable sacrifice. Sorry, but at both A and AS level there is no substitute for hard work. If you postpone the inevitable much longer, it will be too late and you will either fail outright or fail to get the grade you need. Remember, if you are studying for AS exams but planning to carry on to A2 **it is the mark** not the grade that is important. Ask your teacher to explain this to you.

The only place where success comes before work is in the dictionary.

However, hard work on its own may be insufficient, the work you do has to be of the right sort as well.

Coping with Exams – some general comments

There are THREE fundamental features of effective study.

1. Clearly established priorities and good organisation

It is important to place all exams in context – these exams are important but they are not a matter of life and death. However, you have already spent a lot of time in classes and private study and the outcome of these exams has the potential to exert a powerful influence over the next few years of your life.

Are you really clear on your priorities, are you really prepared to make that extra bit of effort and sacrifice to achieve success? Do you really want to succeed? "Of course I do" you will say. Do you? I often ask my students to put themselves to '**the S-day 7 test**'. Picture this, it's seven o'clock in the morning on an S-day (Saturday or Sunday!!) – you are faced with the prospect of rolling over and having another two hours in bed or doing an extra two hours work – what do you choose to do? What about next week? The week after? Are you really so clear and focused on what you want to achieve that you are prepared to make the necessary sacrifices. What about if it's seven o'clock on a Saturday night – would you be prepared to do some work and go out an hour later… or occasionally stay in and do work all evening? It is in these situations that you discover your real priorities in life! Of course if going out to have fun really is top of your list then that's OK, just be prepared to accept the consequences.

If you really want to do something you'll find a way… if you really don't want to do something you'll find an excuse.

So you must sort out your priorities and then get yourself and your life organised. You should treat your studies as a job and adopt a professional, disciplined approach to revision. So get into a regular pattern of working, this will help you to stay in control of events. Remember to allocate an appropriate amount of time to each of your subjects. You also need to give yourself breaks – so think about setting a certain amount of time aside for leisure or sporting activity, it will help you relax. Provided you are working conscientiously, success in 'the S-day 7 test' doesn't mean you have to stay in every Saturday night!!

It might be worth creating a vision or ultimate goal – where do you see success in this exam leading – a good job, three (or more) great years at university. Keep this private vision firmly in your mind (some people actually put it on a poster on their bedroom wall) – it will help you through days when morale is low.

2. SUCCESS is an attitude of mind

You need to get yourself psychologically prepared for SUCCESS. Exams produce anxiety and stress. There may be a lot of pressure on you to pass, to get certain grades or whatever. A certain amount of stress can be beneficial, but too much anxiety does not help, nor does fear, depression or constant self doubt. You can't ignore these negative feelings but you can control them by preparing yourself effectively. So be positive in your self-talk, be positive in your actions and be positive in your dreams. Alter your attitude and you can alter your life.

Losers visualise the costs of failure… winners visualise the benefits of success.

Also, don't be misled into thinking that exams are a battle of wits with devious and malicious examiners who are trying to trip you up and are looking for any excuse to fail you. Quite the reverse is true – there are no trick questions. Of course, examiners set questions that test you… but questions that test you in a fair way. Every examiner is actually delighted to give well-prepared students high marks for their knowledge if it is relevant and effectively used.

So, assuming you have done some work throughout the course, (you have done some work haven't you?) your performance in the exams is determined by the quantity and quality of work you do particularly in the last 2-3 months. This should be reassuring – you were accepted onto the course because you had enough ability to pass; if you work correctly and conscientiously, you WILL do yourself justice in the exam. Of course, if you do not bother to do much work at all then you do not deserve to pass anyway.

The regret we feel for the things we did can be eased by time – but what happens to the regret we feel for the things we did not do?

3. Planned, active, regular learning and testing

Learning is more effective if it is undertaken over time with regular reviews and consolidation. So avoid last minute cramming – despite any 'success' you feel you may have enjoyed in the past using this approach, you will probably tire yourself out for the exam (or the next one!) and your anxiety level will increase and that will undermine recall in the exam room. Sure you will remember some material and of course if you have done no revision this last chance saloon technique may be all you've got. However, much will be forgotten and you will probably only be able to reproduce the material in a very list like manner which may not be what the question requires.

So make sure that you spread you revision sensibly over time – the sooner you start working the better. Concentration spans are limited, so limit yourself to intensive bursts of about 45 minutes. Remember, to build in adequate breaks both between and at the end of study sessions. This will help you physically, intellectually and emotionally.

You have to be active in your learning. Avoid just passive reading, rewriting or copying notes. Osmosis is actually one of the more ineffective revision techniques!!

Even if you are on the right track, you'll get run over if you just sit there!

During your revision programme, you must practise repeatedly the skills and activities that will be required in the exam. This means lots of self-testing and plenty of practise at recalling material and reorganising it in a coherent and relevant way.

Remember – Practice does not make perfect, it makes permanent.

So if you practise good techniques and important skills, these will be with you when you need them in the exam – you can be CERTAIN of that.

The 4Ps of Revising

I like to think of any revision programme as being made up of the 4Ps.

Planning, Preparing, Practising and Performing.

Planning

This is the stage where you get yourself and your material together to create the conditions and attitude of mind that allow you to focus clearly on the tasks in hand.

1. Learn the Rules of the Examination Game

In any sport or game, all the players have to acquire a reasonably good knowledge of the rules that will be applied. Very often those that have a detailed knowledge of the rules can place themselves at a big advantage. Exams are no different, you need to be very clear in your own mind about what it is that the examiners are looking for in answer scripts.

All external exam questions that you will face this May/June have gone through an extensive process of checking and revising to make sure that they are a fair examination of your knowledge and understanding and that they clearly fall within the scope of the written syllabus.

So get a copy of the syllabus from your teacher or directly from the exam board that is setting your examination. The syllabus shows the main concepts and terminology that you must be familiar with and the main skills and qualities that examiners are looking for in good answers. Ask your teacher to explain what these mean.

Make use of material that is published by your exam board. The materials available for both A and AS levels are generally of very high quality so use them. Ask your teacher for a copy of recent Chief Examiner's reports – these highlight the main strengths and weaknesses of answers to that year's exam. Use these in conjunction with the relevant past paper to help you in your preparation and practise sessions. Some exam Boards publish graded samples of past exam scripts with comments by the Chief Examiner. These are useful to make you aware of how to get the best marks for your own answers by incorporating the key characteristics of good answers and avoiding the common mistakes of poor ones.

2. Get your key resources organised

Set aside a fixed place for study. Make sure it is reasonably quiet, well lit and relatively free of distractions. You need good ventilation, a desk or table large enough to spread out your materials and a chair that is comfortable but not too comfortable – you want to study not sleep remember. Try to arrange the room or part of the room so that this place is clearly for study and nothing else – you may need your family's support and co-operation here!! After a while, if you are genuine in your intentions, your attitude and behaviour can be shaped by the little pre-study rituals and symbols to complement study and studying becomes the appropriate behaviour in that place. How about playing a favourite track that has an 'inspirational' effect on you before each session? Before my own revision classes at school, we play 'Nothing's Gonna Stop Us Now' by Jefferson Starship. Cheezy, corny, clichéd I know but it can send out an important psychological signal that many of my own students have said, on reflection, did positively alter their mental state.

Get your notes and essays ordered into topic areas. Class notes must be complete – you may have been absent on certain occasions so that there are gaps in your class notes – make sure these gaps are filled in thoroughly.

Get hold of a copy of the text book that you feel most comfortable with. If you are thinking of buying a revision guide, I would strongly advise you to consult your teacher before parting with any cash. She or he will be able to identify which book, if any, is most suitable for your individual circumstances and your particular syllabus.

Try to replicate exam conditions as much as possible. Although certain types of music can probably help to promote learning, at this stage, I'd advise you to work in a room that is free of distractions. Body posture is very important in maintaining your concentration and preventing drowsiness – so work at a table or desk with an upright chair with all your resources easily accessible. It often helps to go through a specific routine just before starting work since this can help to prepare you mentally for the work to be done. So get the MP3 player out, cue music and…

"Looking in your eyes, I see a paradise
This world that I've found is too good to be true…
…Nothing's gonna stop us now."

3. Set yourself short, medium and longer term goals

Setting clear, short term targets and longer term goals as part of a psychological contract with yourself is a very important aspect of the mental preparation for the task in hand. These goals should be clear, realistic yet demanding statements about what you are planning to learn. Try to write these down. You should then reward yourself when you have reached the target – go and do something you enjoy.

Winners have two things… definite goals and a burning desire to achieve those goals.

So… draw up a revision programme based on the syllabus requirements and stick to it. You really should cover the whole syllabus. Remember multiple choice questions and data response questions can be drawn from any part of the syllabus. Even where you have a choice of questions, the more of the syllabus you cover, the better your chances of being in a position to answer the relatively straightforward questions that do appear each year. If your revision is very narrow you may be forcing yourself to answer questions that are quite tricky or worded in a more difficult manner… you know that Sod's Law will prevail if you are very selective about the topics you choose to revise.

4. Constructing your Personal Revision Programme – some practical help

Most students are aware of at least some of the points raised above but still find it very difficult to turn this advice into a plan of action. Below is an example of one possible revision programme for each day of a 'typical' two week Easter holiday. It focuses on AS basics and A2 microeconomics (excluding factor markets) and is similar to the one that my own students are usually given. It should be adapted to your own needs **after** consultation with your teacher.

It IS challenging but it is NOT unattainable – it is structured, systematic and it includes complete time off. It does however require you to make considerable sacrifices over the Easter holiday. Of course, the extent to which you follow it depends on your own particular circumstances and how badly you want to succeed, remember the S-day 7 test. It does however give you a clearer idea of what has worked very well for Sixth Form students in the past.

In times like these, it is worth remembering that there have always been times like these!

Easter Revision Programme 2009

- **Get yourself into a positive frame of mind… YOU CAN DO IT.**
- Break the syllabus down into manageable chunks and take each chunk in turn. The first four days activities are shown in more detail – complete the remaining days in a similar manner using the detailed information provided by your teacher or the exam syllabus itself.
- If you are sitting A2 papers remember the need to review all of the course because of the so-called synoptic assessment that you will face.
- Before the holiday – get all your notes, textbooks, past papers etc. in order.

Section 1

Day	**Topic Area**
1	Basic ideas – scarcity, choice, opportunity cost PPF – shape/position Economic systems – types/operation/strengths/weaknesses – transition economies
2	Demand – theory of consumer behaviour – demand curve movements along/shifts in – elasticities of demand (PED, YED, XED)
3	Supply – theory of costs (short run and long run) – supply curve movements along/shift in – elasticity of supply
4	Supply & demand – equilibrium/disequilibrium – changes in equilibrium – causes/consequences – role of elasticities – 'government' intervention – tax/subsidy/price controls/buffer stocks etc
5	Essay testing and final review of Section 1

6 Break from study

Section 2

Day	**Topic Area**
7	Competitive and contestable markets
8	Monopolistic and oligopolistic markets
9	Review of all market structures
10	Essay testing and final review of Section 2

11 Break from study

Section 3

Day	**Topic Area**
12	Microeconomic policy – economic efficiency and market failure
13	Microeconomic policy – ownership (privatisation/nationalisation) and competition
14	Microeconomic policy – externalities/merit/demerit goods/public goods
15	Essay testing and final review of Section 3

- Draw up a further revision plan for factor markets, macroeconomics and international economics when you are in back in class.
- Plan a final run-through of the whole course in the 2-3 weeks immediately before the exam.
- Draw up a work programme for the period of the exams themselves.

Preparation

Throughout the programme, I would suggest that you allocate about two hours per day to each topic area and set some time aside for the final consolidation session. I would advise getting up early so that you get a good session before lunch.

To get into the *rhythm of the exam*, it's probably best to work for **40-45 minutes** at a time since this matches the time that is usually available for questions in the final exam. Take a short but complete break of **5-10 minutes** in between sessions.

For example, the session on supply and demand (Day 4) could go something like this:

8.00-8.45am	Session 1 – Equilibrium/disequilibrium/causes of changes in equilibrium including government intervention.
8.50-9.35	Session 2 – Elasticities and the effect of PED/PES on equilibrium changes.
9.45-10.30	Session 3 – Test yourself on terminology/diagrams/essay plans or perhaps some multi-choice questions if these are in your exam.
10.40-11.15	Final review – prepare final revision notes.
11.15 onwards	Do something completely different – play sport, have lunch, watch some TV.

You could also adopt this format for your other A and AS levels. This would probably mean doing one subject in the morning, one in the afternoon and one in the evening. Remember, it's very important to do something completely different before the afternoon or evening session – light physical activity is very beneficial in all sorts of ways; so go for a jog or walk until lunch or dinner time. This will be extremely hard at first but you will get into the swing of things… after all, you have to and many others have done it before.

Backbone beats wishbone every time and nothing is more certain than the failure of the person who gives up!!

Active Effective Preparation

Remember that to be effective revision must be ACTIVE. It is the quality of the work that you do as well as the quantity that is important. It really is no use sitting in front of a book and reading with a wishful hope that something will stick.

A useful and effective approach is to go through each block of material from your notes or textbooks in a systematic way:

(i) Survey or preview the material – skim through your notes and try to think why this particular section of the course is important; what aspect of the economy does it help you to understand. What do you already know about the topic? What additional understanding do you expect or need to get out of this section?

(ii) Having set your mind up for the material, you should then read through your notes thoroughly. You will need a pen and paper for jottings. Diagrams are essential here to help focus on the key concepts that you need to understand. Jot down key words and definitions. Link points together to see how ideas develop and relate to each other.

(iii) It is often more effective to read a passage two or three times relatively quickly than to read it once slowly. You can reinforce what you grasped the first time and you often find by moving on that the brain has a chance to work on the difficult part subconsciously. When you come back you will have seen the implications or extensions of the point and may be able to look at it from the other side and consider the idea in context.

(iv) Put your notes to one side and test yourself. Repeat the key diagrams and write out your understanding of how they are derived and what they show. Jot down any areas that you realise still need attention. Open the book again and survey your notes to check on the accuracy. Repeat the process until you are satisfied that you have really grasped the ideas – don't deceive yourself here.

(v) Prepare a summary of the key points and diagrams in a memorable way on revision cards, tapes or wall chart. Be thorough in your initial revision noting but more imaginative, selective and original when creating the final version. Use plenty of colour and distinctive images. Many students find A3 wall-charts useful – the more bizarre the better. You can surround yourself with key ideas and walk around the room mentally rehearsing and reviewing the ideas.

(vi) These memory aids will then be used for the final review sessions which will take place at the end of a topic block and should be repeated regularly right up to the final exam.

Practice

Examinations require you to recall information and to use it in new ways so a good chunk of your revision time must be spent:

(i) proving to yourself that, without notes, you can recall the main theories and supporting evidence;

(ii) re-organising, recombining and applying the material you have learned to answer specific and unseen questions.

Realistic Practice

Examiners unfortunately never set questions which ask you to "Write four sides on all that you know about inflation" – why do you think that is? If you begin to think like an examiner you will start to answer in a more focused way.

Irrelevant writing and a failure to adapt knowledge to the requirements of the specific question remain the biggest causes of exam under-performance. Last minute cramming and the rote-learning of model answers simply encourage your mind to absorb material in an inappropriate and usually irrelevant form… so don't practise doing what will not be in the exam. Use model answers as a way of reviewing material, don't try to memorise them; change the question title slightly – could you still cope.

I repeat, **practice doesn't make perfect it merely makes permanent**, so you must make sure that what you practise is both relevant and of a high quality. Remember that in the exam you are likely to face structured questions that are broken up into various sections; make sure that you practise writing answers which reflect the variety of questions you will face on the day.

Practise interpreting the common question commands – remember some of these commands will not be used at AS level this summer because they will test skills that are not being tested at that level – check with your teacher on this. With that in mind, what is the difference between the following questions:

- What is economic growth?
- What is the difference between trend and actual growth?
- What are the problems in measuring the rate of economic growth accurately?
- What are the costs of economic growth?
- What are the benefits of economic growth?
- What are the causes/consequences of economic growth?
- Explain the causes/consequences of economic growth.
- Discuss the causes/consequences of economic growth in the UK.
- Discuss the effect of higher interest rates on economic growth.
- Assess the policy options to increase the rate of economic growth.

Now make all of this very topical by flipping the questions to address the definition/measurement, causes and consequences of a **recession**.

Answer questions from past papers and refer to the comments in the Chief Examiner's Report – plan, write and rewrite timed answers to the sort of questions you are likely to get both in full and in part especially on critical areas of the course. Review your work and rewrite if necessary – set yourself high standards.

Life's funny – if you refuse to accept anything but the best from yourself… you very often get it!

Certainly if you are going to have essay questions in your exam, you need to familiarise yourself with certain economic statistics (what do you think are likely to be the most useful statistics for the exam?). Remember that trends are probably going to more useful than figures for one period of time. Get into the habit of reading the economics and business sections of at least one of the major Sunday papers. These will provide you with a good, topical range of micro and macro material which can be used also to practise data response techniques. Reading these articles gives you opportunities to recall and review what you have learned.

Remember every time you recall and review you are reinforcing your memory.

Final review – links and different perspectives

Turn your final review and testing sessions into opportunities to get a new view on the subject. Simulate the unpredictability of the exam by asking someone to choose your 'test-essay' from a selection of questions drawn from previous papers. This should help to discourage you from the 'rote-learning' approach – read through your answer or get a fellow Economics student to do so. How did you answer the question? Be honest with yourself.

Try to see how separate parts of the course can be linked together. You could use Post-it notes here – stick them on a wall and move them around to see how ideas can be linked to give the big picture. Force yourself to think how topical issues could form the base of new essay questions… then make sure you plan answers to those questions.

Go though the articles in past copies of *Economics Today* – pick out some exam related concept or diagrams. Take any article which mentions costs. Then think of the opportunities this provides to revise a wide range of microeconomic principles.

- **Definitions of the various types of cost** – private, external, social – fixed, variable – total, average, marginal
- **Calculation practise** – can you calculate each from a set of data?
- **Diagram practise** – can you draw diagrams to explain each of the above?
- **Outline the factors that influence each type of cost** – what influences MC in the short run? …ATC in the long run?
- **Explain the usefulness of an understanding of costs to a profit maximising company.**
- **Essay practise on externalities.**
  "Explain why a Government might be concerned about the existence of negative externalities."
  "Discuss the economic consequences of a policy to reduce negative externalities."
- **Play around with different mark allocations for this question** – how would different mark schemes affect the balance of your answer?

Now do the same with demand, profit, aggregate supply and so on. Think of the amount of varied revision that this offers. The scope for challenging and effective revision in this way is almost limitless – hard work I know but…

Help each other – revision groups

Working in isolation is pretty dispiriting even for the most determined student. Why not form a revision group so that you can learn from each other. In the past, students have found this sort of group work an excellent way of maintaining morale especially during the holidays when the first flush of rampant enthusiasm has turned a shade paler!! Even the 'best' benefit from having to explain ideas to their friends who may not have grasped ideas fully the first time around.

First of all, learn all you can on your own. Remember, the object of the study group is to share knowledge not ignorance. Identify tricky parts of the course and work through these together. Show each other your revision cards etc. and explain them – all of you will benefit.

Set yourself a few essay questions to discuss – this helps you to articulate and clarify your understanding and therefore reinforces learning. Each person could prepare a detailed essay plan for discussion – get each other to present their plan and subject each other to questions. Review each others test essays… you will be staggered at how much progress you can all make if you work together.

Sharing revision with others can actually be fun (well almost!!) and it helps you to keep a sense of proportion about the exam… you are not alone in your anxiety and working with others confirms how much progress you are actually making (and you WILL make progress).

Performance

This of course is what it is all leading towards. Your big chance to demonstrate what you know by answering the specific questions in a relevant and informed manner. Really, if you have worked consistently and conscientiously, the performance should not be an ordeal. You know your stuff, you've practised using your knowledge in a variety of ways, you can recognise and write answers to a range of specific commands and you know how to time and pace each essay so that you will avoid the crippling 'last question syndrome'. If you are mentally and physically prepared… you know that you can cope.

The day before the exam

Use the last day sensibly. On the day before each exam check again the time and place. Make sure you have all the necessary materials (pens, pencils, rubber, ruler, calculator with spare battery, lucky mascot). Have a brief run through the top priority items again. Be very wary about doing any new learning at this late stage – it might simply block out things you have already studied. Break off studying well before bedtime and relax so that you don't stay awake all night with an overactive mind.

The day itself

Everyone has their own set routine on the day of the exam. I would however advise you to take a tip from top athletes. Start to visualise yourself settling down to the exam a week or so before the exams start. **Rehearse a set routine that you will follow at the start of the exam** – set routines are calming.

Arrange to be woken up in good time so that you can get to the exam location early but not excessively so. Just before the exam I'd suggest that you keep yourself separate from others so as to avoid the energy-wasting, concentration-sapping nervousness of pre-exam silliness.

Focus your mind clearly on the task in hand. Run through a couple of key ideas, I always used to take a few of my revision cards with me. Although this was often more for comfort than anything else, it was an important relaxation technique that worked for me. When you get into the room go through the set routine you've been visualising.

The Essay Paper

In terms of marks, this is usually a very important paper. Although at AS level, full essays do not feature highly, the skills, knowledge and understanding required to answer essays questions of any length are directly and indirectly relevant for the other papers you will sit too. In particular, in data response questions there will often be a longer question with more marks available, in effect, this becomes a mini-essay question.

The main weakness on the essay paper can be divided into THREE categories. Think about how you can deal with each in turn.

1. **Poor exam technique**
   Revealed by – failure to answer fully the required number of questions.
   – failure to answer all parts of the question.
   – failure to allocate time and effort in line with the mark allocation (which is usually stated).
   – failure to identify the key skills that are being tested. These are usually revealed by the question command – analyse, describe, discuss, explain etc.).

2. **Poor subject knowledge**
   Revealed by – limited or inaccurate reference to economic theory.
   – poor or non-existent definitions.
   – poor or non-existent diagrams.
   – no context, examples or factual support.

3. **Poor writing technique**
   Revealed by – poor reference to key question commands.
   – incoherent structure with no clear beginning, middle or conclusion.
   – clumsy or ambiguous expression – bluffing/evasive answers are easily spotted.
   – points only listed often in a fragmented or random and thoughtless manner.
   – inaccurate or, at times, contradictory expression.
   – assertions rather than explanations (are you clear of the difference?).

Key points

- Following a pre-set routine before the exam helps keep you calm and in control… **there will be questions that you can do**.
- Read the question paper THOROUGHLY.
- Select your questions carefully.
- Make sure you take notice of questions that have subsections – usually mark allocations will have been indicated and these of course should be reflected in your time allocation.
- Don't write out the whole question but identify and underline key words (terms and commands). Plan your answers – what economic theory do you need? – what diagrams do you need?
- Your plan and answer will develop as you proceed and the ideas start to flow but remember to stick to your basic outline and try to be coherent and consistent.
- **Answer the specific question set** – really you **will** get more credit if you attempt to do this rather than simply write wildly however many pages you cover.
- Start the essay with precise, relevant definitions.
- USE RELEVANT ECONOMIC THEORY WHENEVER YOU CAN.
- Try to support your comments with a few relevant examples or statistics.
- Try to finish with a conclusion that adds something to the essay and is not simply a summary.
- Be very strict about the time allocation. Remember extra minutes extending the answer to one question are unlikely to gain you much extra credit; far better to get on and write fuller answers to the remaining questions.

The Data Response Paper

This is usually the most unpredictable part of the overall exam but remember that the ability both to collect and interpret data is a critical skill for economists. Data, of course, can be in numerical form (perhaps a set of statistics) or verbal form (perhaps an article from a newspaper) or a combination of both. Use the Data Response in past copies of *Economics Today* to help you.

The main weaknesses displayed in this paper can be divided into THREE categories. Once again you should see how you could deal with each in turn.

1. **Poor subject knowledge**
   Revealed by – a reluctance to use economic theory to substantiate observations or bolster explanations.
   – a superficial grasp of terminology and theory.
   – poor awareness of the role that diagrams can play in aiding explanation to data response questions.

2. **Poor awareness of basic 'statistical' techniques**
   Revealed by – a lack of confidence in dealing with numerical data.
   – an inability to detect patterns, trends and trends within trends.
   – confusion over – relative and absolute changes.
   – real and nominal values.
   – correlation and causation.
   – poor numerical understanding especially when calculating % changes/ratios.

3. **Poor exam technique**
   Revealed by – a failure to allocate time and effort in line with the available marks.
   – weak writing style.
   – excessive use of clichés, journalistic or conversational language.
   – a lack of confidence to relate theory to the evidence provided.

Key Points

- If the question contains numerical data make sure you look very closely at the source of the data, the units of measurement employed and the time span of the data.
- Try to identify general trends and trends within the trends.
- Do some calculations – percentage changes help you to get a feel for the data.
- Don't confuse variations in rates of change with variations in absolute levels (e.g. falling inflation is not the same as falling prices).
- Try to identify the key aspects of economic theory that the examiner is testing and use that theory. Although common sense helps, this is not a general knowledge paper – your answers must contain economic terms, concepts and diagrams.
- You must answer the specific question set and allocate your time sensibly in line with the mark allocation.
- Define economic terms precisely.
- Practise interpreting data regularly.
- Don't forget to practise using your calculator and make sure you take it to the exam.

The Multiple Choice Paper

The best way to improve your performance on this paper once again is through regular practise to past questions, coupled with a fairly detailed investigation of the theory underlying questions you get wrong – see the regular feature on multiple choice in *Economics Today*. Very high marks (90-100%) are obtained quite frequently on the multiple choice paper and you can boost your overall grade quite sharply if you are prepared to make the effort to get this style of questioning sorted.

Experience suggests the following factors contribute significantly to unnecessarily poor performance on this paper:

1. **Narrow and superficial revision with too much emphasis during revision/practice on memory rather than understanding**
   Revealed by – an excessive amount of guessing.
   – an inability to reason through questions on basic concepts that are presented in a novel way.

2. **Misreading the question and/or the various responses**
   Revealed by – a lack of concentration when reading questions and response options.
   – easy marks thrown away because of silly errors and mistakes on straightforward questions.

3. **Unwillingness to think in detail about questions that require detailed analysis**
   Revealed by – large numbers of incorrect answers to questions that test applications of theory or policy issues.
   – panic and wild guess responses to questions that involve numerical calculations or diagram interpretation.

Key Points

- Read each question carefully, look closely at the diagrams.
- Try to work out the answers before looking at the options offered.
- Use spare paper to rough out diagrams, calculations or your thoughts.
- Move on if you can't answer a question. Give yourself a maximum amount of time per question – do all those that you can and mark those that you can't and then come back – you should have time.
- Make sure you answer every question – most Boards do not penalise candidates for wrong answers so if there are a few that really beat you then eliminate the options that you know are wrong and make a sensible guess.
- Practise, practise, practise multiple choice questions – it really will pay off.
- Don't forget to practise using your calculator and make sure you take it to the exam.
- Make sure you follow the instructions about what to do if you make a mistake and want to change an answer.

Don't look back – no post mortems

After the exam do not get involved in post mortems. The exam is over and there is nothing you can do about it. Omissions or mistakes remembered in retrospect tend to be exaggerated anyway. Relax for a short while before preparing for the next exam.

My students tell me that there is at least one more P… the destination en masse of almost all of the students immediately after the final exam. Enjoy your celebrations in June… perhaps this will reveal one or two additional P's ;-)

More importantly enjoy your celebrations in August when the results are released.

YOU CAN DO IT

I am a great believer in luck… funnily, the harder I work the luckier, I seem to get.

With a sensible approach to preparation you too will make your own luck in the exam and…

…YOU WILL DO IT.

So… GOOD LUCK.
May you get the grade you deserve.

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ECONOMICS TODAY

et

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ECONOMICS TODAY

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ECONOMICS TODAY

THE ESSENTIAL MAGAZINE FOR 'A' LEVEL ECONOMICS

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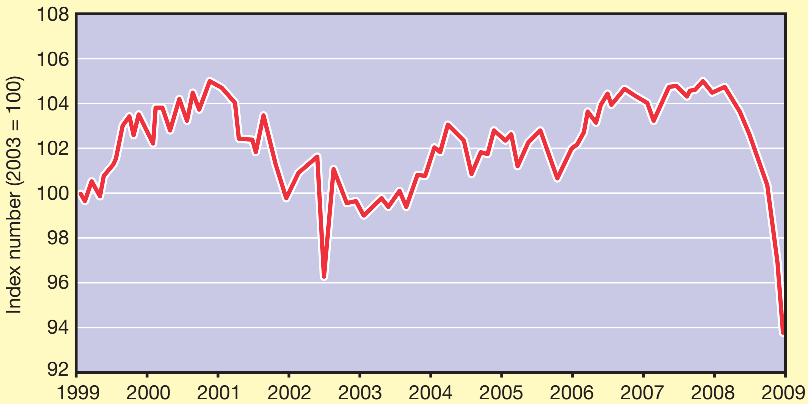
ECONOMICS TODAY

Continued slump in UK manufacturing

Index of manufacturing output



Source: ONS

According to the Office of National Statistics manufacturing output fell by 5.1 per cent in the fourth quarter of 2008 compared with the previous quarter. Of the thirteen sub-sectors of manufacturing which are measured, output decreased in twelve of them. The decline included 9.4 per cent in the basic metals and metal product industries, 7.7 per cent in the transport equipment industries and 5.8 per cent in the paper, printing and publishing industries. There has also been a decline in the service sector but, by contrast, this only fell by 0.4 per cent in the three months to November 2008.

When looked at on an annual basis UK manufacturing in December was down around 10 per cent on a year-on-year basis. This was similar to the situation in the US, whilst Germany declined 12 per cent and Japan fell 20 per cent.

According to the Chartered Institute of Purchasing and Supply (Cips) in February 2009, its Purchasing Managers Index showed that the rate of decline in manufacturing orders and output slowed slightly in January. According to Cips: "Purchasing managers in the manufacturing sector reported an anaemic opening to 2009 with record falls in employment as factory jobs were cut at an astonishing rate of 30,000 a month. In fact, the latest government figures show that manufacturing employment fell from 3,195,000 in the 3rd quarter of 2007 to 3,095,000 in the 3rd quarter of 2008 – a decline of 100,000. But, according to Cips, this decline is now gathering pace.

Manufacturers had gained from the fall in the sterling exchange rate making our exports cheaper, but this has been countered by the global collapse in demand. On top of this demand continued to contract at home. Nearly three-fifths of manufacturing firms reported a decline in orders during January according to research by Cips. The outlook continues to look grim for UK manufacturing for the foreseeable future.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For AS & A2 Students

Prize Competition

for AS & A2 Students

Things are starting to get worse … a leading manufacturer of pedigree dog food has just called in the retrievers.

We thought we would end this volume of *Economics Today* magazine with a bit of humour. Things are tough all over at the moment so we are asking you to come up with a humorous one-liner that will make us laugh back here in the office.

All you have to do is finish the sentence: "Things are starting to get worse…".

You can enclose more than one suggestion in your submission – but it must be clean and it must be funny.

Here are a couple more which we thought up to get you thinking.

Things are starting to get worse… a company making bras has just gone bust.

Things are starting to get worse… a company manufacturing drainpipes has just gone to the wall.

We will publish the best entries on our website whether you win or not.

All you have to do is send us your suggestions by 14th June 2009. The two best contributions will win £25 each in music tokens. The winners of the September competition were **Ranjana Rai** of London and **Ms E. Cockerton** of Stowmarket.

£25 in music tokens to be won!

Send your suggestions to: **Economics Today Ltd., Stocksfield Hall, Stocksfield, Northumberland NE43 7TN**, marking your envelope 'Prize Competition'.