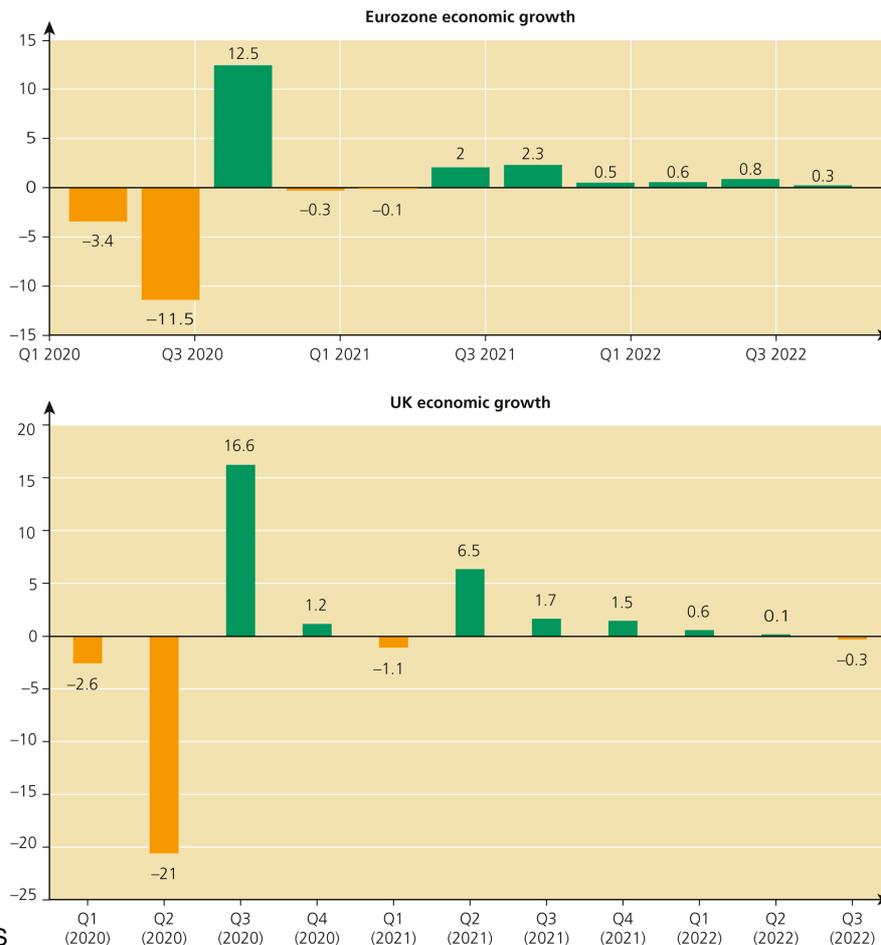


Chapter 11: Economic performance

Application of economics in the real world

Application of economics in the real world 11.1: Recession: 'now you see it, now you don't'

- 1 In the UK a recession is defined as two or more quarters of falling real output or GDP. Three features of a recession are negative economic growth, growing unemployment and falling business and consumer confidence.
- 2 In the USA, the National Bureau of Economic Research (NBER) defines a recession as 'a period of falling economic activity spread across the economy, lasting more than a few months'. The NBER is a private non-profit organisation that announces when recessions start and stop. It is the national source for measuring the stages of the business cycle.
- 3 As these notes were written at the time of publication, it is impossible for us to provide an answer to this question. However, the UK economy shrank by 0.3% in the 3 months to November 2022. It then grew by 0.1% in November, which was largely attributed to the football World Cup which boosted spending. It is likely that the UK economy will be in a recession, possibly a shallow one, by the time the book is published.
- 4 Figure AERW11.1 compares economic growth rates in the UK and the eurozone since January 2020.



Source: ONS

Figure AERW11.1 UK and eurozone growth shown by quarterly percentage changes in real GDP

Application of economics in the real world 11.2: Under-employment and zero-hours employment contracts

- 1 Under-employment is a situation where people are working fewer hours than they wish. Women are often employed in part-time jobs. If their personal circumstances change and they wish to be employed full time, there may not be the opportunities for them to make this change.
- 2 According to www.money.co.uk the advantages of zero-hours contracts are:
 - **Flexibility:** *if you are asked to work a shift that isn't worth your while, you can turn it down. This can quickly turn into a disadvantage, though, if you consistently refuse to work and your contract is put at risk.*
 - **Freedom to find extra work:** *if you aren't getting regular hours, you can look elsewhere. Exclusivity clauses in zero-hours contracts that restrict you from working somewhere else are now banned. To help you find extra work you can use GOV.UK.*
 - **More jobs to apply for:** *zero-hours contracts are often all a business can offer based on its own budgetary restrictions. This means you have a wider variety of job roles to apply for, and possibly a better chance of getting valuable experience.*
 - **Improve your CV:** *it's important to remember that any experience is positive, especially on your CV. When you apply for future jobs, employers will favour you if you have a continuous history of work experience compared to someone who hasn't worked for a prolonged period of time.*
 - **A chance of permanent work:** *some companies reward hard-working zero-hours contract workers with permanent or fixed contracts. This means that working hard during your contract could help you land a steady income.*

However, the disadvantages of zero-hours contracts include:

- **No fixed income:** *with no set hours, how much you earn will vary each week. While you might have lots of work one week, you might find yourself with much less the next. In this situation, it's possible to find financial help through benefits.*
- **Missing out on benefits:** *working a zero-hours contract means you'll miss out on benefits that full-time or permanent employees get as standard, like a pension and redundancy rights. This can leave you feeling undervalued, especially if you are working to the same level as those with extra company benefits.*
- **Constantly on call:** *not knowing when you'll work can make you feel restricted, especially if you have more than one job, or other responsibilities. While you can't get set hours with a zero-hours contract, you could explain your possible working hours to your employer, to try to avoid being offered shifts you cannot take.*
- **Damaging to your social life:** *if you don't want to miss out on work from your employer, you may find yourself waiting at home and turning down your normal social activities.*
- **Struggle with bills:** *zero-hours contracts don't offer a stable cash flow. This means if you are short of work, you may struggle to keep up with your household bills. Try to set aside some funds on the weeks when you have lots of work to cover the weeks when shifts are harder to come by.*

Assessing the pros and cons of zero-hours contracts requires knowledge of the firms offering these contracts, the personal circumstances of the people accepting the contracts, and whether or not full-time contracts are available. Again, according to www.money.co.uk, if you can focus on learning new skills, even if the job is temporary, you will continue to look employable and push yourself closer to a permanent job role.

- 3 According to Larry Elliot, the economics editor of the *Guardian*, the UK is locked in a low-wage, low-skill economy, in which few workers are now members of trade unions. In 2018, Elliot argued that workers are cowed and feel unable to ask for higher wages for fear that their employer will get shot of them. There has been a dramatic shift in the balance of power since the high point of union influence four decades ago. In the 1970s, 70% of workers were covered by collective bargaining agreements. The fall to 26% today is the largest of any OECD country.
- 4 The TUC agrees that zero-hours contracts should be made illegal. In December 2017, the TUC found that:
 - More than half (51%) of zero-hours workers have had shifts cancelled at less than 24 hours' notice.
 - Nearly three-quarters (73%) have been offered work at less than 24 hours' notice.
 - Only 25% say they prefer being on zero-hours contracts.
 - Only 1 in 8 (12%) say they get sick pay.
 - Only 1 in 14 (7%) would get redundancy pay.
 - Two-fifths (43%) say they do not get holiday pay.
 - Half (47%) say they do not get written terms and conditions.
 - Just 1 in 20 (5%) say they have the right to a permanent contract after working the same hours consistently.

However, an anonymous student employed on a zero-hours contract used his personal experience in part to justify them. He wrote:

I used to work as a waiter while at college. I found my zero-hours contract to be very beneficial as I could fit my college work around my job. Although only part time, I was treated equally alongside the full time staff.

From my experience, a zero-hours contract works well for students. Once I had finished college, I needed something more permanent with a consistent pay check with financial security that a zero-hours contract wouldn't have given me.

For me it can depend on what stage of life you are at, so I am both for and against zero-hours contracts with the sole responsibility being upon the employee to determine what type of work they want.

Application of economics in the real world 11.3: Beveridge and full employment

- 1 The UK Labour Force Survey unemployment rate for September to November 2022 was 3.7%. It had fluctuated around 3.5%–3.8% for most of 2022.
- 2 According to the free-market definition, full employment is the level of employment occurring at the market-clearing real-wage rate, where the number of workers whom employers wish to hire equals the number of workers wanting to work. By contrast, Lord Beveridge defined full employment as occurring when unemployment falls to 3% of the labour force. Conservative governments have generally favoured the free-market definition, whereas Labour governments have been more inclined to Beveridge's definition, though this is generally regarded as a historical anachronism that is less relevant to modern-day Britain than it was 80 years ago. For further discussion, access the article 'Whatever happened to full employment?' at <https://www.bbc.co.uk/news/magazine-15276765>.
- 3 At the time of writing in early 2023, there is some evidence of deficient aggregate demand in the UK. The number of job vacancies has fallen for a few months, indicating that there is a lower demand for workers. Interest rate increases over 2022 will mean consumer spending

moderates, which may mean less need for workers. Deficient aggregate demand is, of course, the cause of cyclical unemployment, defined as unemployment occurring in the downswing of the economic cycle caused by falling aggregate demand. In recent years, consumer spending boosted by loose monetary policy and very low interest rates has been the main driver of aggregate demand in the economy. But with a Brexit-induced fall in both consumer and business confidence, combined with deteriorating confidence in countries such as Germany, the UK may be on the cusp of a new recession, which of course would be associated with a growth in cyclical unemployment.

- 4 Seasonal unemployment is prevalent in those industries which are engaged in seasonal production activities such as agriculture, where the demand for workers is higher during harvesting than in other months of the year. Similarly, in the case of the hotel industry, the demand for catering staff as well as housekeeping staff is higher during the peak season as compared to the demand in the off-season.

Seasonal unemployment is obviously significant for the workers, businesses and towns affected, such as coastal holiday resorts. However, because seasonal activities make up only a small part of the UK economy, seasonal unemployment is generally insignificant for the economy as a whole.

Application of economics in the real world 11.4: Are lower prices a good thing? Not really

- 1 Deflation is defined as a persistent and sustained fall in the average price level. It is the opposite of inflation. The question of who benefits from deflation depends on whether it is a 'good' or a 'bad' deflation. In a 'good' deflation, caused by an increase in aggregate supply, consumers benefit from falling prices and firms may benefit from increased business confidence. But in a 'bad' deflation, caused by a collapse in aggregate demand, recession or even depression occurs, which harms many people in the economy. Prices may be lower, but people's income falls and many people lose their jobs. People who keep their jobs and their incomes and successful speculators benefit, but others suffer.
- 2 A deflationary spiral is a downward price reaction to an economic crisis, leading to lower production, lower wages, decreased demand and still lower prices. It is illustrated in Figure AERW11.2.

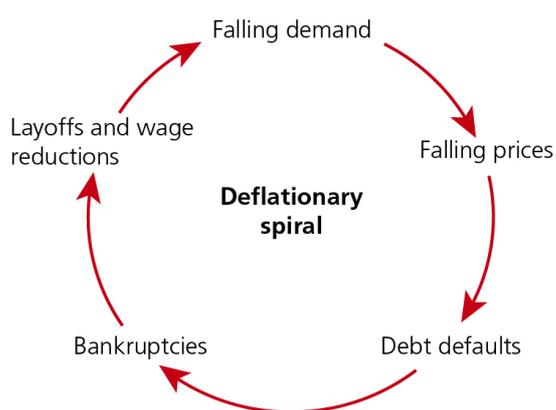


Figure AERW11.2 A deflationary spiral

- 3 People suffer from negative equity when what they owe is greater in value than what they own. In the boom of the early 2000s, house prices rose far faster than people's incomes. Young people felt that they had to get on the 'housing ladder', which added to the demand for property and fuelled further increases in house prices. Desperate to buy, young people took out large mortgages which were far higher than their incomes, believing that once they owned a

property its value would continue to rise. Instead, what happened was a collapse in house prices. This created the negative equity trap. Young people who had recently bought houses found that what they owed (their mortgage) was higher than the now lower market value of the house they owned. Some managed to sit tight and wait for house prices to rise again. Others, who lost their jobs in the recession, had their house repossessed by banks or building societies, with some ending up homeless.

- 4 A scrappage programme is a government spending programme to promote the replacement of old vehicles with modern vehicles. Scrappage programmes generally have the dual aim of stimulating the automobile industry and aggregate demand, and removing inefficient, more polluting vehicles, nicknamed ‘clunkers’, from the road.

End-of-chapter questions

- 1 When governments intervene to reduce unemployment, the appropriate policy obviously depends on identifying the underlying cause of unemployment correctly. For example, if unemployment is incorrectly diagnosed in terms of demand deficiency, when the ‘true’ cause is structural, a policy of fiscal or monetary expansion to stimulate aggregate demand will be ineffective and inappropriate. Indeed, reflation of demand in such circumstances would probably create excess demand, which would raise the price level in a demand-pull inflation, with no lasting beneficial effects upon employment.
- 2 Free-market economists generally take the view that controlling inflation is necessary to create the conditions in which market forces can then deliver sustained economic growth and full employment. But how low should the rate of inflation go? More interventionist economists argue that trying to reduce the rate of inflation to 0% is a bit like killing the goose that lays the golden egg: that is, it will destroy the economy. Perhaps the policy of the last few years, trying to hit an inflation rate target of 2%, has been about right.

- 3 According to the economist Tejvan Pettinger, writing in 2017:

During the long boom of the late 1990s and 2000s, unemployment fell to a low of 5%. This was near full-employment. In 2008, the deep recession caused a sharp rise in unemployment due to people being laid off in the recession.

Yet, despite the extent of the fall in GDP, unemployment peaked at 8.5% and since 2011 has fallen. This fall in unemployment has surprised some economists because the economy has remained weak, with economic growth stagnant. In a less severe recession, unemployment rose by more. The lower unemployment in this recession is due to several factors:

- *Falling real wages. Nominal wages grew only 0.7% to July 2014 (lower than CPI inflation).*
- *Greater labour market flexibility encouraging firms to keep on workers, through flexible working practices such as zero hour contracts.*
- *A fall in labour productivity, meaning that firms have been willing to keep on workers, despite falling output.*
- *Benefit changes making it harder to get job seekers allowance and encouraging more people to seek jobs.*
- *A rise in disguised unemployment/under-employment — shorter working hours.*

Pettinger seems to be saying that falling unemployment, which continued in 2018 and 2019, is due to a mix of demand-side and supply-side factors and a breakdown or shifting of the Phillips curve relationship.

- 4 Inflation is a persistent tendency for the price level to rise. Deflation is the opposite: namely, a persistent tendency for the price level to fall. Disinflation is a slowing down in the rate of inflation. Reflation is a word which describes how an increase in aggregate demand, usually brought about by fiscal or monetary policy, leads to a growth in real output rather than an increase in prices.

5

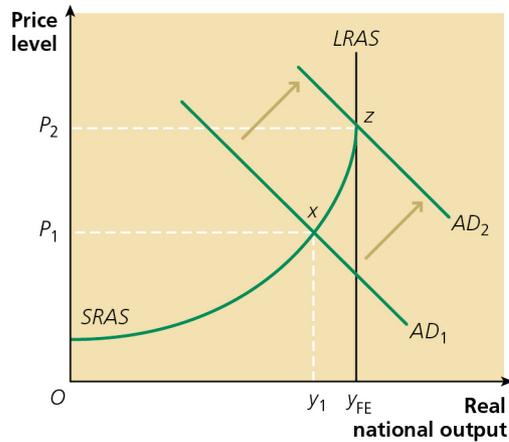


Figure A11.1 Unemployment and inflation in the short and long run

In Figure A11.1, we have assumed that macroeconomic equilibrium is initially at point x . The AD curve is in the position AD_1 ; real output is at the level y_1 and the price level is P_1 . Point x depicts a situation in which the economy is initially fairly close to full employment or the normal capacity level of employment.

Following an increase in aggregate demand to AD_2 , macroeconomic equilibrium is at point z , with the economy also on its long-run aggregate supply ($LRAS$) curve. This means the economy is producing at full capacity, which in turn means that any further rightward shift of aggregate demand would result solely in demand-pull inflation, with no increase in real output. Thus in the short run an increase in aggregate demand can increase both employment and the price level, but once full employment is reached any further increase in aggregate demand only increases the price level in the long run.

- 6 Free-market economists generally agree with this view, believing that it, in order to control inflation, it is necessary to create the conditions in which free-market forces can deliver sustained economic growth and full employment. Keynesian economists approach the issue from a different starting point, arguing that when the rate of inflation is initially relatively low, full employment and economic growth are the main policy objectives.

Test yourself answers

TEST YOURSELF 11.1

Short-run economic growth results from the use of spare capacity in the economy; long-run economic growth results from investment in new capacity or from an increase in the size of other factors of production, such as labour, which shifts the economy's production possibility frontier outward.

TEST YOURSELF 11.2

According to Austrian School economists, Schumpeter and Hayek, in *The Economist* magazine: 'recessions are a natural feature of an economy'. Joseph Schumpeter argued that recessions are not an evil that should be avoided, but a necessary adjustment to change. Only by allowing the

‘winds of creative destruction’ to blow freely could capital be released from dying firms to new sectors of the economy, thereby boosting future productivity.

Hayek counselled against massive monetary easing to prevent a recession. If unprofitable investments were made during a boom, then it was better to shut those firms down and clear the way for new, more productive investment. For the Austrian economists, the policy choice is not between recession or no recession, but between one now or an even nastier one later. A recession is necessary to work off an imbalance between too much investment and too little saving.

In contrast, Keynes ridiculed the idea that in the long run the Great Depression might turn out to have been a good thing. The USA’s output fell by 30% as the American authorities sat on their hands and did almost nothing to correct the downturn. In the modern-day UK, Rishi Sunak’s government seems on the whole to agree with Keynes, though it is also wary about extended state bail-outs of the economy, which might allow the survival of so-called zombie firms that it believes should not be rescued.

TEST YOURSELF 11.3

Sustained economic growth is growth which can be maintained over a long period of time. Sustainable economic growth is growth that takes into account the needs of future generations.

TEST YOURSELF 11.4

The real change in GDP was 2.5% (8% minus 5.5%). However, the population was also growing by 2.5%, so the approximate change in real GDP per capita over the year was approximately zero.

TEST YOURSELF 11.5

An economic cycle can also be called a business cycle. An old-fashioned name for an economic cycle is a trade cycle.

TEST YOURSELF 11.6

Frictional unemployment is transitional unemployment due to people moving between jobs. Structural unemployment occurs when there is a long-run decline in demand in an industry, leading to a reduction in employment, often because of international competition. Structural unemployment exists where there is a mismatch between people’s skills and the requirements of the new job opportunities.

TEST YOURSELF 11.7

Overall unemployment, structural unemployment and frictional unemployment were all greatest in the euro area. Indeed, they were more than double the rates of the USA and Japan, though only marginally so with regard to structural unemployment in the USA. The data show percentages of the total labour force in the three areas in just one year, so we need more information about changes taking place over a number of years and whether or not the three areas were in the same phase of their economic cycles.

TEST YOURSELF 11.8

Demand-deficient (or Keynesian) unemployment.

TEST YOURSELF 11.9

Classical unemployment.

TEST YOURSELF 11.10

Possible points to use in comparison:

- Employment rate rose from 2011 each year to 2019.
- Index of production also rose from 2011 each year to 2019.
- Both items fell from 2019 to 2021.
- Peak year for index of production was 2019, as it was for employment rate.

TEST YOURSELF 11.11

Deflation is a decrease in general price levels throughout an economy. Disinflation, on the other hand, shows the slowing down in the rate of inflation over time. The inflation rate is declining over time, but it remains positive.

TEST YOURSELF 11.12

Refer to Figures 11.19 and 11.20 and their accompanying explanations on pages 398 and 399 of the textbook.

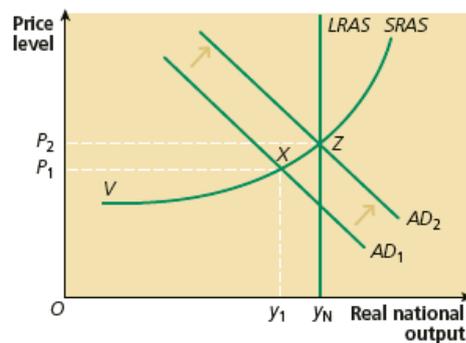


Figure 11.19 Demand-pull inflation illustrated by an AD/AS diagram

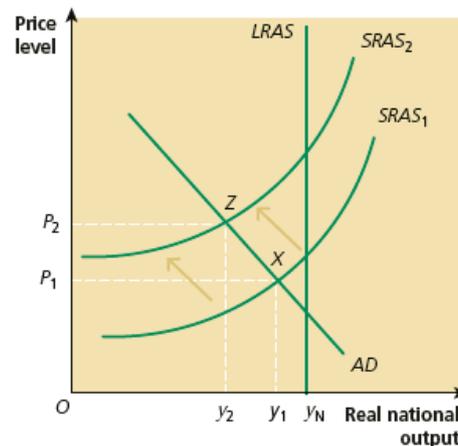


Figure 11.20 Cost-push inflation illustrated on an AD/AS diagram

As their names indicate, demand-pull inflation is caused by a rightward shift in the *AD* curve, whilst cost-push inflation results from a leftward or upward shift in the *SRAS* curve.

TEST YOURSELF 11.13

Monetarism is a school of thought that argues that inflation is caused by an excess rate of growth in the money supply or stock of money in the economy, and that governments should use monetary policy to control this rate of growth. A monetarist is simply an economist who believes in this central tenet of monetarism. Most monetarists are free-market economists who distrust government intervention in the economy, except to control the rate of growth of the money supply.

TEST YOURSELF 11.14

The velocity of circulation of money (*V*) is the speed at which a unit of money circulates around the economy. Monetarist economists argue that *V* is stable and that if the money supply increases, excess demand pulls up the price level in a demand-pull inflation. Keynesian economists reject this view and argue that *V* simply slows down and there is little or no effect on the rate of inflation.

TEST YOURSELF 11.15

A slow and stable rate of inflation is generally good for the economy. According to *The Economist* magazine, ‘many economists argue that a small amount of it may not be a bad thing and could even be beneficial. One of the first was James Tobin of Yale University, who suggested in 1972 that a bit of inflation helps “grease the wheels” of the economy. In today’s world of low inflation, the validity of his argument is increasingly important for policy-makers. If it is correct, then the pursuit of extremely low levels of inflation may be misguided — not only because of the short-term rise in unemployment that can result from cutting inflation, but also because zero inflation might cause permanently and unnecessarily higher levels of unemployment.’

When inflation is relatively low, with little variation from year to year, it is quite easy to anticipate next year’s inflation rate. It can be argued that creeping inflation, which is associated with growing markets, healthy profits and a general climate of business optimism, ‘greases the wheels’ of the economy. Thus, a low rate of inflation may be a necessary side-effect or cost of expansionary policies to reduce unemployment. On the other hand, inflation may ‘throw sand in the wheels’ of the economy, making it less efficient and competitive. Which of the two effects is greater determines whether the costs or disadvantages of inflation exceed its benefits or advantages.

TEST YOURSELF 11.16

Commodities include foodstuffs and industrial raw materials. When the prices of imported food commodities such as wheat fall, this feeds into falling bread and confectionery prices, and the consumer prices index in turn falls. Likewise, if the price of an imported industrial raw material such as steel falls, this can cause the prices of cars manufactured in the UK to fall, which lowers the UK consumer prices index.

TEST YOURSELF 11.17

The answers to both of the questions are ‘no’. It is conventional, when constructing price indices for several goods or commodities, to use the same base year for each good or commodity, and to represent the base year price as 100 in each case. This is why each series starts at 100 in January 2019. The graph then shows energy prices falling by a greater percentage than the prices of metals, raw materials and food (agriculture). However, we are given no information about the actual prices of any of the commodities in any of the years in the series.

TEST YOURSELF 11.18

A policy conflict is a situation where one economic objective is achieved at the cost of another objective, such as setting an objective of reducing unemployment, which could lead to rising prices.

TEST YOURSELF 11.19

A positive output gap occurs when actual output is more than normal capacity output. A negative output gap occurs when actual output is less than what an economy could produce at normal capacity. A negative gap means that there is spare capacity, or slack, in the economy due to weak demand.

TEST YOURSELF 11.20

In the original Phillips curve diagram, the variable on the vertical axis was the rate of wage inflation (the rate of change of the wage level), and the variable on the horizontal axis was the unemployment rate. In later Phillips curve diagrams, the variable on the vertical axis changed to the rate of price inflation (the rate of change of average prices).

TEST YOURSELF 11.21

To answer this question you should read an article published by the American Federal Reserve Bank in Richmond, USA, titled 'The evolution and policy implications of Phillips curve analysis'. The article can be accessed at

https://www.richmondfed.org/publications/research/economic_review/1985/er710201.