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Economics and Regional Development

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The macroeconomic environment and how this is managed has a direct influence on our daily lives. The performance, structure, behaviour, and decision-making of an economy as a whole have long held the attention of both policymakers and academia. Casual familiarity with daily newspapers, websites or other media suggests that we have not yet developed a clear understanding of how best to secure stable and prosperous economies. Nevertheless over time terminology, theories and indicators have been developed in an effort to explain what is happening within any given macroeconomic environment. Additionally, policymakers have developed tools and strategies in an effort to ensure stability and economic growth at national, regional, and even local levels. Trade is a vital component of any macroeconomic policy, with governments displaying various different attitudes towards its management.

This chapter will explain some of the most important theories and concepts regarding the macroeconomic environment. It will also look at the different economic systems and the complex nature of trade, noting its impact on economies.

What is the macroeconomic environment?

When attempting to explain **macroeconomics** it is imperative to distinguish it from **microeconomics**, as they are two commonly confused concepts. **Microeconomics** is the study of decisions that individuals and businesses make regarding the allocation of resources and the prices of goods and services. It is concerned with the study of markets (e.g. food markets, financial markets) and specific segments and sectors of the economy. It focuses on supply and demand

in these individual markets and analyses forces that help determine prices in the economy. These forces include individual labour markets, looking at areas such as the demand for labour as well as how wages are determined. It is also concerned with both positive and negative externalities of production and consumption. For example, the pollution caused from cars and motorbikes, or the impact of research and development, which often leads to new technologies that other firms can benefit from.

Macroeconomics looks at the bigger picture (aggregate economy), focusing on the movement and trends of the 'economy as a whole', rather than on individual markets. These can be national, regional, and global economies. Macroeconomics examines economy-wide phenomena such as output and income, inflation and deflation, and unemployment, using aggregated indicators to measure and understand how the economy functions. It usually involves the development of models that analyse and explain the relationship between major economic factors including: national income, output, consumption, unemployment, inflation, savings, investment, international trade and international finance. Such models help governments and corporations formulate economic policies and strategies. The study of macroeconomics also covers the analysis of the role of these fiscal and monetary policies, along with issues surrounding economic growth, the determination of consumption and investment levels, and to do with foreign trade and its economic relationships with other countries.

■ **The circular flow of income**

The concept of the circular flow of income allows us to better understand the 'economy as a whole' along with the role that individuals and households, businesses and governments play in the flow of money, goods and services. Understanding the circular flow process is key to explaining how national income, output and expenditure are created over time. It can be shown in its most basic form as a simple economy consisting solely of businesses and individuals, to more complex iterations that include financial and factor markets as well as incorporating the rest of the world. Figure 8.1 provides a suitable overview of the interdependence of the 'flows', or activities, that occur in the economy, such as the production of goods and services (or the 'output' of the economy) and the income generated from that production.

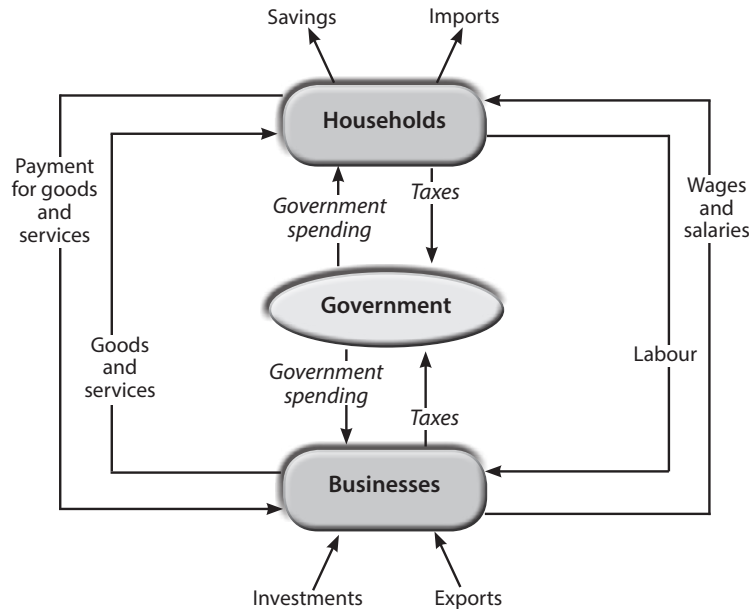


Figure 8.1: The circular flow of income model

- **Households:** Provide labour to businesses in return for wages and salaries. Make payments for goods and services provided by businesses in an attempt to satisfy their unlimited needs and wants. Receive support from the government in return for paying taxes. Make savings and make purchases from other economies.
- **Businesses:** Provide wages and salaries in return for labour. Provide goods and services in return for payment. Receive support from the government in return for paying taxes. Purchase capital goods from other firms, replacing worn out machinery or increasing their capacity to produce. Receive payment for exports made to other economies.
- **Governments:** Provide support to businesses and individuals by spending on public and merit goods like defence and policing, education, and health-care, and also on support for the poor and those unable to work. Levy taxes in order to fund their activities.
- **Injections** come from investment, government spending and export sales, and flow into the economy, increasing the demand for domestically produced goods and services. Conversely, **leakages** are when demand for domestically produced goods and services is reduced due to money being diverted or lost into savings, taxes or imports. So long as leakages are equal to injections the circular flow of income continues indefinitely. This is known as being in equilibrium.

Savings (S) + Taxes (T) + Imports (M) = Investment (I) + Government Spending (G) + Exports (X)

However, due to the dynamism of any given economy, it is often in varying states of disequilibrium. Economies suffer from inherent instability. If $(S + T + M) > (I + G + X)$, levels of income, output, expenditure and employment will fall causing a recession or contraction in overall economic activity. But if $(S + T + M) < (I + G + X)$, levels of income, output, expenditure and employment will rise causing a boom or expansion in economic activity.

In each case, changes to expenditure and output lead to equilibrium being regained. For example, if $(S + T + M) > (I + G + X)$, households will save less, pay less in taxation, and with a lower income spend less on imports. Alternatively, if $(S + T + M) < (I + G + X)$, households will have the opportunity to save more, the levels of tax they pay will rise and they will be able to spend more on imports. National income can increase and decrease as a result of the changes in the various flows.

When there is a new injection of spending, the resulting increase in final income is called the **multiplier effect**. The size of the **multiplier** depends upon households' marginal decisions to spend, called the marginal propensity to consume (MPC), or to save, called the marginal propensity to save (MPS).

Gross Domestic Product (GDP) measures the total value of economic activity in a country (including both domestic and foreign producers) over a 12-month period and is commonly used as an indicator of the economic health and standard of living. However, when making year-on-year comparisons it is important to take into account inflation. **Inflation** is the increase in the general level of prices for goods and services. Therefore, it is important to distinguish between **nominal GDP**, which measures GDP at current prices, and **real GDP**, which measures GDP taking into account inflation. This allows us to make comparisons with a base year, enabling us to see how much real GDP had changed from one year to another.

Gross National Income (GNI) is the total income from products and services produced by a national economy (including residents' foreign investments). It is another indicator used to measure national income. Some of the incomes earned in an economy from wages, interest, profit or rents will be repatriated abroad by foreign residents. Conversely, some of the incomes earned by domestic residents will come from abroad. GNI takes this 'net income from abroad' into account. GDP, however, is only concerned with incomes generated within the country, irrespective of ownership. Hence it can be said that GDP is based on location, while GNI is based on ownership. GNI is quite similar to **Gross National Product (GNP)**, which measures output from the citizens and companies of a particular nation, regardless of where they are located.