

LESSON 3.3 : INFLATION IN THE ECONOMY

It is the rise in the average prices of goods.

INFLATION

Example: \$5 note will buy you less now than what you get previously.

As the price of goods increases, there is a fall in the value or the purchasing power of money.



4 MAJOR TYPES OF INFLATION



•Suppressed inflation

Situation where demand exceeds supply but the effect on the price level is minimized by the use of such devices as price controls/ rationing.



•Hyper inflation (galloping inflation)

•An accelerated price increase (sudden increase)



•Creeping inflation

•Increasing of prices at a slower rate but continually overtime.



•Imported inflation

Increasing in price of foreign raw materials and semi processed goods which adds to costs in domestic production and imported goods.

Deflation vs Stagflation :

Deflation is the opposite of inflation. It refers to situation, where there is decline in general price levels. It occurs when the inflation rate falls below 0% (or it is negative inflation rate). It increases the real value of money and allows one to buy more goods with the same amount of money over time. It has caused the side effects of increasing unemployment in an economy, since the process often leads to a lower level of demand in the economy.

Stagflation refers to economic condition where economic growth is very slow or stagnant and prices are rising. The side effects of stagflation are increase in unemployment- accompanied by a rise in prices. Stagflation occurs when the economy isn't growing but prices are going up.

Comparison of Inflation Rates

PERIOD	2005 (BASE)	2008 (BASE)
2009	3.7	3.2
2010	5.5	3.7
2011	8.7	7.3

Source: Bureau of Statistics

Current Price Index

- Measures the average level of goods and services consumed by average household.
- The CPI measures the change in cost of purchasing a fixed basket of good and services which represents the average expenditure patterns

$$\text{CPI} = \frac{\sum \text{Base Year Quantity} \times \text{Current Year Price}}{\sum \text{Base Year Quantity} \times \text{Base Year Price}} \times 100$$

Example:

Assume that there are only 3 goods in the typical consumers' basket- bread, juice, peanuts. The quantities bought are the prices prevailing in the base period/ current period are shown in the table.

Goods	Quantity Bought (Base Year)	Price Per Unit (Base Year)	Price Per Unit (Current Year)
Bread	10 loaves	30 cents	40 cents
Juice	1 bottle	40 cents	50 cents
Peanuts	2 kg	80 cents	1.00

Calculate the CPI for the current year.

Solution

$$\begin{aligned}
 \text{CPI} &= \frac{\sum \text{Base Year Quantity} \times \text{Current Year Price}}{\sum \text{Base Year Quantity} \times \text{Base Year Price}} \times \frac{100}{1} \\
 &= \frac{(10 \times .40) + (1 \times .50) + (2 \times 1)}{(10 \times .30) + (1 \times .40) + (2 \times .80)} \times \frac{100}{1} \\
 &= \frac{6.5}{5} \times \frac{100}{1} \\
 &= \underline{\underline{130}}
 \end{aligned}$$

RATE OF INFLATION CALCULATION

The annual percentage in CPI will give the annual rate of inflation. Measuring inflation from a base year is simply a matter of subtracting the latest years of CPI from the base years.

Formula 1 : (From the base year)

$$\text{Rate of inflation (\%)} = \frac{\text{CPI (Current Year)} - \text{CPI (Base Year)}}{\text{CPI (Base Year)}} \times \frac{100}{1}$$

Formula 2 : (from the CPI figures without base year)

$$\text{Rate of Inflation (\%)} = \frac{\text{CPI}^2 - \text{CPI}^1}{\text{CPI}^1} \times \frac{100}{1}$$

ACTIVITY 3.3.1

The table below shows the price and quantity of four goods.

Item	Base Year		Current Year Price(2013)
	Quantity (2012)	Price(2012)	
Sugar	20,000kg	0.60 cents per kg	0.70 cents per kg
Flour	30,000 kg	0.80 cents per kg	1.00
Soap	50,000 bars	1.50 per bar	1.80 per bar
Oil	20,000 litres	1.80 per litre	2.40 per litre

A. What is the Current Price Index for the current year 2013?

B. Calculate the rate of inflation for the year 2013?

ACTIVITY 3.3.2

Items	Base Year (\$)	Current Year (\$)	
2 packets milk	2.50	3	
4 kg potatoes	2.50	2.75	
1 kg onion	0.75	1	
1 kg sugar	0.67	0.75	

1. Calculate CPI for Year 2.
2. Calculate the rate of Inflation for year 2.
3. Give reasons for calculating inflation rate.

CAUSES OF INFLATION

1. Increase in Money Supply

A group of economists called the “Monetarists” believe that if there is more money in the economy, the producers will increase their prices of goods to make more profits.

2. Increase in Costs of Production (Cost-Push Inflation)

This kind of inflation arises when there is an increase in the ‘cost of production’. Example : when the cost of raw materials increases, the producer will increase their prices so as to make more profits.

3. Increase in Market Demand for Goods and Services (Demand – Pull Inflation)

Arises when consumers demand more of certain goods but the supply is not enough. Therefore, producers will increase their prices to make a lot of profits.

4. Imported Inflation

This arises when the price of imported goods increases and there is a devaluation of the nation’s currency.

EFFECTS OF INFLATION

Those Who Lose:

1. **Income Distribution:** Those with fixed income such as salary earners and pensioners suffer a loss in purchasing power and decline in their living standards.

2. **Trade:** A country with high rate of inflation and a huge domestic cost structure is at a disadvantage which affects international competitiveness.

3. **Savings**– Is discouraged.

4. **Wages** – Tends to increase but less rapidly than prices.

5. **Creditors / Lenders** – Lose during inflationary period.

6. **Production** - Cost push inflation squeezes profit margin which leads to cash flow problems and either shows business expansion or forces firms out of the market.

Those Who Gain :

1. **Wages** -Tend to increase more rapidly than prices.

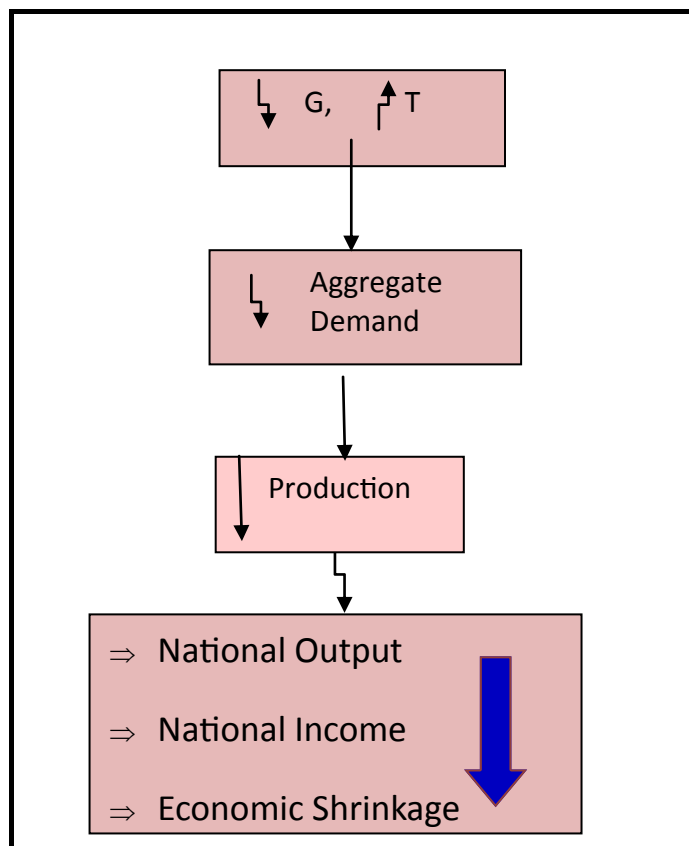
2. **Debtors** - As they pay less than what they borrowed.

3. **Production** – Moderate demand pull inflation encourages business expansion because of higher potential profits.

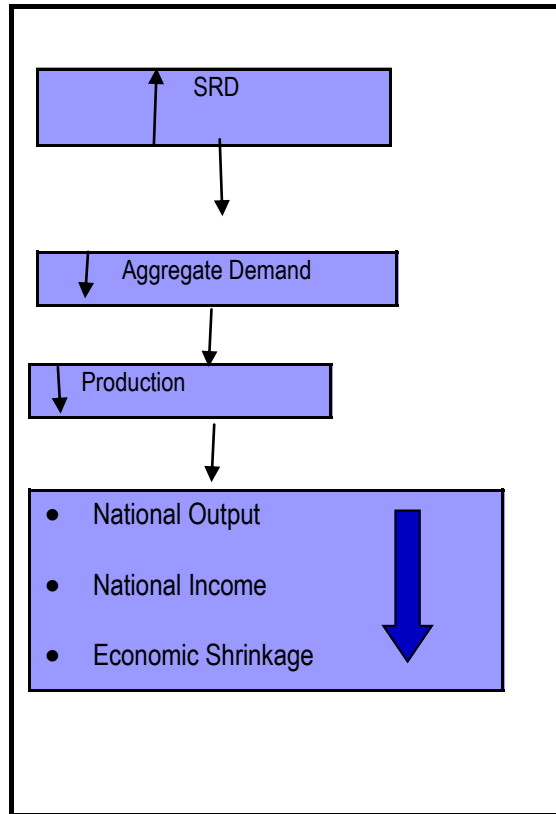
4. Sellers of properties e.g. land owners gain.

Policies to Curb Inflation

1. Contractionary Fiscal Policy



2. Tight Monetary Policy (Contractionary Monetary Policy)



However, inflation is controlled , unemployment still increases.

ACTIVITY 3.3.3

A. Multiple Choice Questions

- Cost push inflation is caused by increase in
 - factor prices.
 - exchange rates.
 - aggregate supply.
 - aggregate demand.
- The Current Price Index
 - measure changes in the cost of living in all consumers.
 - measure the average price change of all goods and services produced.
 - does not take into account changes in the pattern of consumer's expenditure.
 - weighs each item according to its relatively importance in the consumer expenditure budget.
- Which of the following is a type of inflation?
 - Demand pull.
 - Galloping.
 - Cost push.
 - Increase in money supply.

4. Which of the following groups of people will lose out during inflation?

- A. Debtors.
- B. Creditors.
- C. Borrowers.
- D. Sellers of properties.

5. Which policy could be used to curb inflation?

- A. Expansionary fiscal policy.
- B. Loose monetary policy.
- C. Expansionary monetary policy.
- D. Tight monetary policy.

B. Fill In The Blanks : Inflation is the _____ i _____ in the average price of goods and services and the _____ ii _____ in value of the purchasing power.

C. Short Answer Questions/Calculations:

Study the table given below and calculate the CPI for 2012 and 2013. 2012 is the base year and the base index is 100.

The cost of the CPI basket at base –year prices:2012			
CPI basket			Cost of CPI per basket
Item	Quantity	Prices per Unit	
Dalo	10 bundles	\$15	\$150
Cassava	5 heaps	\$3	\$15
Kumala	3 heaps	\$3	\$9
Hair cut	5	\$3	\$15
Cost of CPI basket at base –year prices			

The cost of the CPI basket at base –year prices:2013			
CPI basket			Cost of CPI basket
Item	Quantity	Prices	
Dalo	10 bundles	\$20	\$200
Cassava	5 heaps	\$5	\$25
Kumala	3 heaps	\$5	\$15
Hair cut	5	\$5	\$25
Cost of CPI basket at current –year prices			

(Show all working for full marks)

1. Calculate CPI for year

i) 2012

ii) 2013

2. If the CPI for Fiji in 2009 is 135 and in 2010 145. Calculate the inflation rate for Fiji for the period ending 2010.

ACTIVITY 3.3.4

Essay

Discuss about **Inflation** with reference to:

- **three** types of inflation; (3m)
- three **causes** of inflation; (3m)
- **two** negative effects and **one** positive effects of inflation. (3m)

ACTIVITY 3.3.5

Consumer Price Index Activity

Study the extracted Consumer Price Index (CPI) table for Fiji to a 2008 base year and answer the questions that follow.

CONSUMER PRICE INDEX: CENTRAL DIVISION

(BASE: AVERAGE 12 MONTHS 2008 = 100.0)

(Extracted)

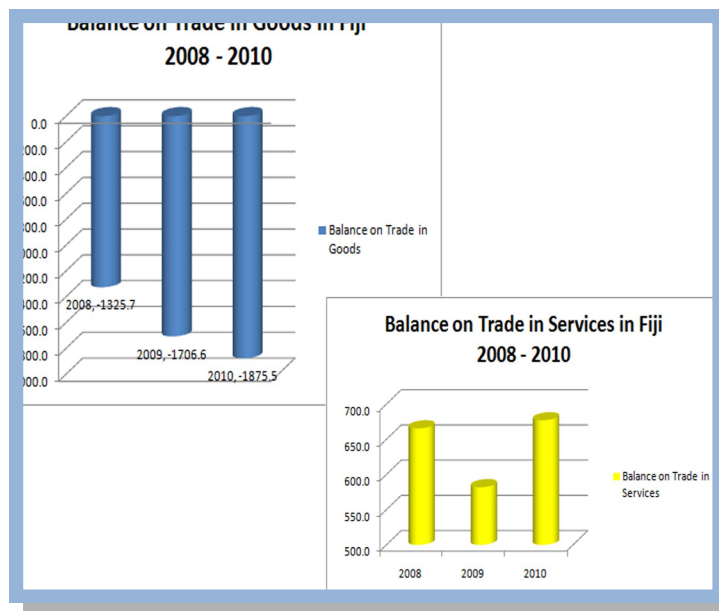
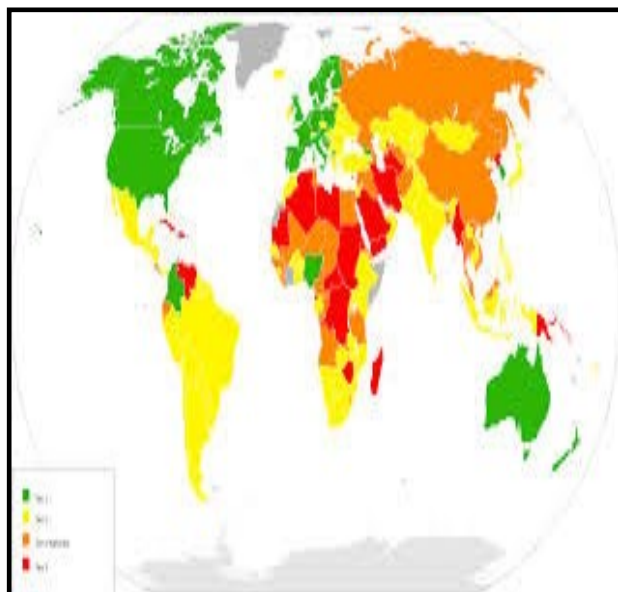
SECTION		ALL ITEMS	FOOD AND – ALCOHOLIC BEVERAGE	ALCOHOLIC BEVERAGE, TOBACCO AND NARCOTICS	CLOTHING AND FOOT-WEAR	HOUSING, WATER, ELEC., GAS AND OTHER FUELS	FURNISHINGS, HHLD EQUIP. & ROUTINE HHLD MAINT.	HEALTH
2009	JAN	101.2	104.4	103.7	100.3	103.1	101.5	96.5
	JUNE	102.8	106.3	102.5	101.1	99.3	105.8	107.5
	DEC	105.2	105.1	106.0	104.2	100.2	106.1	111.7
2010	MAR	107.2	108.4	109.1	104.4	102.6	108.3	113.6
	JUN	106.8	109.9	106.5	105.1	98.7	108.2	112.8
	SEPT	108.2	112.1	110.0	110.3	98.9	111.4	112.8
	DEC	110.7	111.7	108.1	108.2	118.9	111.3	112.8
2011	MAR	114.1	119.2	113.4	112.	119.8	112.1	127.9
	JUN	115.5	123.2	112.5	109.3	120.5	113.5	134.8
	SEPT	112.8	120.6	112.4	109.3	120.7	113.5	124.2
	DEC	116.0	119.6	116.5	110.8	120.4	113.7	124.2

Source: Fiji Bureau of Statistics 2013.

- A) Apart from the title, give another way of identifying the base period.
- B) Name the group which has moved the most since December 2007.
Suggest a reason for this.
- C) Name the group which has been most volatile, that is, had the greatest fluctuations.
- D) Using the All items figure, calculate the rate of inflation for the years
 - (i) June 2009 – June 2010
 - (ii) December 2009 – December 2010
 (Round off the answer to one decimal place)
- E) In which of the periods above would the purchasing power of money be most affected?

STRAND 4

INTERNATIONAL ECONOMICS



Strand Outcome

**Investigate Fiji's International Trade Pattern to Gauge
its Status in the Global Economy**

Learning Outcomes

- Upon completion of the different lessons in this strand, students should be able to:
- calculate the balance of trade, balance of current account, balance of capital account and balance of payment and foreign reserves.
- explain the effects of the current account deficit and surplus on the economy.
- define and calculate balance of trade.
- differentiate free trade versus protectionism.
- discuss the nature and argument for and against free trade and protectionism.

FIJI AND INTERNATIONAL TRADE

International trade - refers to all economic transactions which takes place between a country and the rest of the world.

Domestic Trade relate to trade within the country .It is very difficult to become self sufficient in all commodities because the world is heading towards specialization which causes Economies of scale.

- Therefore as a country becomes specialized, it tends to produce that particular commodity & uses resources to produce this commodity.

This leads to interdependence, hence countries have to trade with each other.

Fijis Export and Imports

The major export goods of Fiji are:

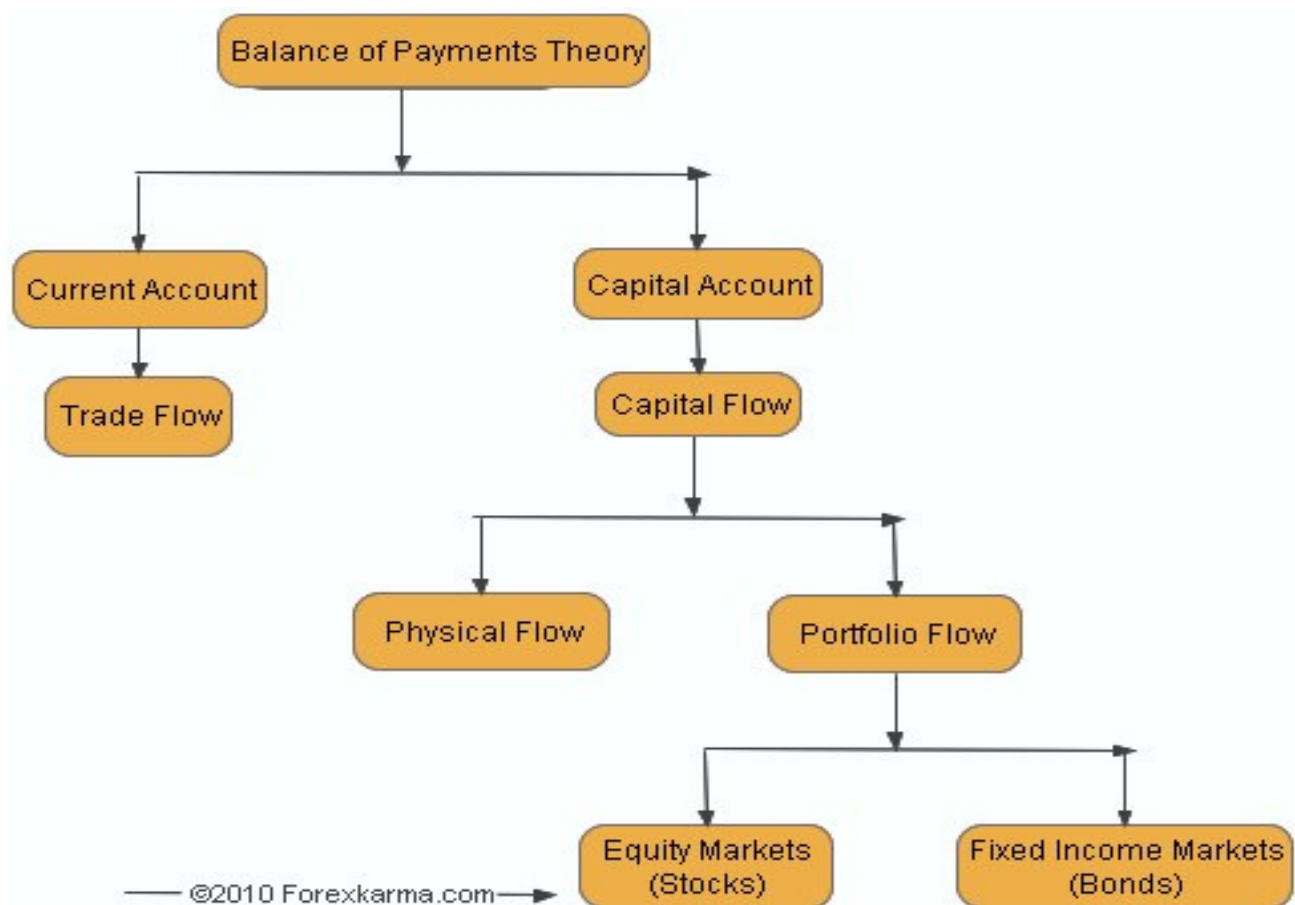
- Sugar, copra, timber, gold, ginger, garment, fish, cocoa and *yaqona*.

The major imports are:

- Rice, meat, government, onion, potatoes, fruit, dairy products, machinery, medicines, steel, sports equipment etc.

LESSON 4.1 : BALANCE OF PAYMENT (BOP)

LESSON 4.1.1 **COMPONENTS OF BALANCE OF PAYMENT**



Source: Forexkarma

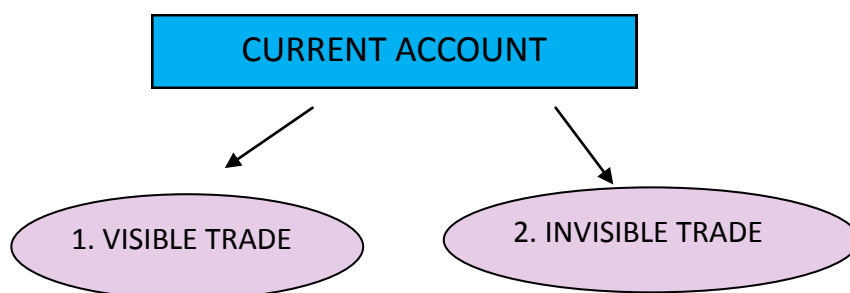
The **Balance of Payment** is the record of transaction between a country and the rest of the world.

- A country draws up its annual account with other country to compare its Receipts and Payments arising out of trade of goods and services.
- A BOP deficit means that total receipts is less than total payments.
- The BOP provides useful data for economic analysis of a country's weaknesses and strengths as a partner in international trade.

LESSON 4.1.2 CURRENT ACCOUNT

Current Account

- It records the value of exports and imports of goods and services (visible and invisible items).
- It is regarded as the most important section of the BOP because it measures the nation's earnings and spending abroad.



Balance of Trade (BOT)

- ⇒ **Visible Trade** – it represents the export and import of goods only, which can be seen and touched (physical items e.g. cars, furniture etc).
- ⇒ **Balance of Trade /Balance of Visible /Balance of Merchandise:** is the difference between value of visible exports and values of visible imports.

$$\text{BOT} = \text{Visible Export} - \text{Visible Import}$$

The balance on merchandise trade can have **three possible outcomes**:

1. **BOT = Zero** i.e. exports would be exactly matched by money leaving our country to pay for imports.
2. **BOT shows a positive result** indicating merchandise exports exceeds merchandise imports. Thus there is a surplus on the merchandise trade.
3. **BOT shows a negative** or a minus result indicating that imports are more than exports. This is known as a deficit on merchandise trade.

Example : Use the table given below to answer this question.

A country has:

	\$(m)
Visible export	100
Visible import	200

Required:

1. Calculate the balance of trade.
2. Interpret the balance of trade.
3. State two possible suggestions that the government could undertake to improve the balance of trade.

Solution

1. BOT = Visible Export – Visible Import
 $= \$100\text{m} - \200m
 $= \underline{-\$100\text{m}}$
2. BOT shows a deficit on merchandise trade.
3. Diversification , import substitution or import replacement, trade protections

Invisible Trade/Services

Items include costs of freight & insurance on merchandise, port charges, international passenger fare, accommodation and expenditure by foreign travelers as well as domestic travelers overseas.

Invisible Exports (Service Credits)

Are those invisible items that earn foreign exchange such as tourists in Fiji, factor income earned from abroad (profits or interest earned abroad, interest earned from abroad and dividend earned from abroad.)

Invisible Imports (Service Debits)

Invisible imports are those that use foreign exchange to purchase invisible items such as purchase of insurance policy from a foreign company, dividend paid abroad, overseas trips etc.

Net Services is the different between service credits and service debits. It is also known as balance on invisibles.

$$\text{Balance on Goods and Services} = \text{BOT} + \text{Net Services}$$

Income

⇒ covers earnings on investment made by domestic residents in other countries and investment made by foreigners in domestic country. It also includes dividends received by domestic citizens from overseas sources as well as payments to foreign residents by domestic country.

$$\text{Net Income} = \text{Income Credits} - \text{Income Debits}$$

UNREQUITED TRANSFERS

• This may be described as unearned, one way money flows between Fiji and the rest of the world.

⇒ **2 types of unrequited transfers** –:

1. Unrequited transfers credits -It include funds brought to Fiji by immigrants (remittances), gifts and donations received from foreigners, social security payments made to Fiji residents by foreign government

2. Unrequited transfers debits -It include payments made to LDCs as part of international aid and relief fund ,funds taken aboard by emigrants and cash gifts and donations paid aboard.

Factors influencing Current Account (CA)

1. The demand for Fiji's goods and services in overseas market.

↑exports →↑BOT→↑CA and vice versa.

2. Our demand for imports : ↑imports →↓net exports→↓ CA and vice versa.

3. The degree of protection both in the domestic country as well as overseas

4. Our international competitiveness : refers to the price and the non price advantages that a domestic country has over the foreign markets

.i.e. ↓ in price of goods in domestic market relative to those produced overseas→↑ in international competitiveness and vice versa.

ACTIVITY 4.1.2.1

Use the following hypothetical balance of payment data to answer the question that follow.

	\$m
Merchandise exports	20 000
Merchandise imports	19 000
Services debits	3 000
Services credit	1 000
Income and transfers debit	-6 000
Income and transfers credit	2 000

- Calculate the Balance of Trade.
- Calculate the Balance of Invisibles.
- Calculate the Balance of Goods and Services.
- Calculate the Net income and transfers.
- Calculate the Balance on Current Account.

LESSON 4.1.3 CAPITAL ACCOUNT

- Records all international borrowing, lending and investment transactions of the domestic country's private
- When borrowing from other nations we create a liability – a debt which we have to pay thus borrowing of funds by domestic residents from overseas is called **capital inflow**.e.g borrowing, foreign direct investment to domestic country.
- When we lend to overseas, we gain a new assets- a claim over foreign resources and lending funds to overseas is called **capital outflow e.g.** lending, portfolio investment abroad (purchase of share, debentures and other securities)

Capital Account also include total official and total non official capital transactions

Official transaction – are those involving Government Authorities and Reserve Bank.

Non- official capital transactions – comprises all overseas borrowing and lending by the private sector as well as public sector.

1. The Balance on Capital Account = Capital Inflow – Capital Outflow

2. The Balance of Capital Account is sum of Official and Non-Official capital transactions.

The Balancing Item

In theory a surplus on capital account is always = to the deficit on current account. The required equality between the sum of the credit and debits entries in the Balance of Payment is brought about by the inclusion of a balancing item. It ensures that the Balance of Payment always balances.



Factors influencing Capital Account.

1. The relative attractiveness of Fiji to the foreign investors i.e. the interest rate we offer, inflation rate, economic policies, and political climate.
2. International borrowing and lending.

Example:

BALANCE OF PAYMENT ACCOUNT		
Current Account	\$m	\$m
Merchandise (visible trade)		
Exports	51.8	
Less Imports	-49.2	
BOT		2.6
Services (Invisible Trade)		
Services Credit	13.2	
Less Services Debit.	-16.5	
NET SERVICES		-3.3
BALANCE ON GOOS AND SERVICES		+ -0.7
Income:		
Income Credit	5.0	
Less Income Credit	-22.3	
NET INCOME		+ -17.3
Unrequited Transfers		
Unrequited Transfers Credits	4.7	
Unrequited Transfers Less Debits	-2.2	
NET UNREQUITED TRANSFERS		+ -2.5
Balance of Current Account (Deficit)		- 15.5
Capital Account		
Official capital transactions		
General government	-1.8	
Plus Reserve Bank	+(1.5)	
TOTAL OFFICIALS		(3.3)
Non official capital transactions		+18.8
Balance on capital account (surplus)		\$15.5m

Activity 4..1.3.1

Use the following hypothetical balance of payment data and answer the question that follow

	\$m
Merchandise exports	24
Merchandise imports	25
Services debits	3
Services credit	-2
Net income and transfers	-4
Official capital transactions	3
Source: <i>Introducing Economics Book 1 (1988)</i>	

Calculate

- i. the Balance of Trade
- ii. the Balance on Goods and Services
- iii. Balance on Current Account
- iv. the Balance on Capital Account
- v. the Non-official Capital Transaction

Activity 4.1.3.2

Merchandise exports	39 000
Merchandise imports	40 000
Service credits	7 300
Service debits	9 000
Income and unrequited transfers	
Credits	6 600
Debits	11 700
Official capital transactions	
General government	+5 000
Reserve bank	+1 000

Calculate:

- the Balance of Trade.
- the Balance on Goods and Services.
- Balance on Current Account.
- the Balance on Capital Account.
- the Non Official Capital Transaction.

Source: *Introducing Economics Book 2* (1993)

Activity 4.1.3.3

- What is included in the reserve bank item in the capital account?
- Explain the term private foreign investment and what forms can it take?
- "Today's surplus of capital account is tomorrow's deficit of current account". Explain.
- Explain the term foreign debt? Why is Fiji's foreign debt considered to be such a problem?
- Differentiate between current account and capital account transactions.

Activity 4.1.3.4

Use the information given below for Economy Z to answer the questions that follow

	\$m
Capital inflow	65
Imports of services	50
Capital outflow	35
Exports of goods	200
Exports of services	105
Import of goods	350

Calculate the following

- Balance of Trade
- Balance on invisibles
- Balance on Current Account
- Balance on Capital Account
- Balance of Payment Account

Activity 4.1.3.5

Classify the following into visible trade, invisible trade, and capital inflow and capital outflow.

Cars from Japan	Sugar to Australia
Overseas trip	Dividend paid abroad
Foreign investment	Tourist in Fiji
Interest received from abroad	Borrowing
Lending	Insurance policies bought by Fiji residents abroad
Remittances for abroad	International aid to Fiji

Activity 4.1.3.6

Use the information given below and answer the question that follows.

Fiji's balance of payment for the month of January, 2010

	(\$m)	Calculate the following:
Capital inflow	2 500	* The Balance on Merchandise Trade
Capital outflow	1 200	* The Balance on Goods and Services
Services debit	1 556	* The Balance on Current Account
Services credit	1 386	* The Balance on Capital Account
Merchandise exports	4 375	
Merchandise imports	4 023	
Income (credits)	377	
Income (debits)	1 736	

Activity 4.1.3.7

Essay

The Balance of Payment records transactions between Fiji and the rest of the world.

Discuss the statement with reference to:

- three main components of current account; (3m)
- three component of capital account; (3m)
- three ways of solving balance of payment deficit. (3m)

Activity 4.1.3.8

Explain the following terms:

Balance of payment	Current account
Capital account	Merchandise
Balance on merchandise trade	Net services
Balance on goods and services	Unrequited transfers
Net transfers	Balance on current account
Official capital transactions	Non official capital transactions
Capital inflow	Direct investment
Portfolio investment	Balance on capital account



LESSON 4.2 : FREE TRADE VS PROTECTIONISM

FREE TRADE

Free Trade is a situation in which there are no artificial barriers imposed by government upon movement of commodities across national boundaries.

Advantages of Free Trade

The main benefits of free trade are:

- efficiency of resource allocation.
- higher living standards.
- greater competition.

1. Efficiency of Resource allocation

- Free Trade allows each country to specialize in production of those commodities in which it has the greatest comparative advantage. This means that countries produce commodities with least opportunity cost.
- Free Trade therefore involves most efficient allocation of resources in each country.
- This leads to higher productivity and increase in total world output of goods and services. As more goods and services become available to satisfy consumer demand, those countries engaged in free trade experience rising living standards, increased real income and higher rates of economic growth.

2. Higher Living Standards

- Free Trade promotes higher living standards by encouraging both imports and exports.
- On the import side, free trade gives each nation unrestricted access to goods and services produced by other nations.
- By increasing the quality and variety of goods and services available to the domestic consumers, producer's free trade improves both present and future living standards.

Increased exports on the other hand can improve domestic living standard by:

3. Increasing Domestic Employment

- When other nations buy locally produced goods there is greater demand for domestic resources. This increases in demand, provides either new employment opportunities to idle resources or the incentives to improve productivity.
- Giving domestic producers accesses to larger market. This encourages large scale production which in turn results in economies of scale and increased profit.

Greater Competition

- Free trade gives overseas producers unrestricted access to local markets. This represents greater competition of domestic producers and has the added advantage of the development and expansion of local monopolies.
- Consumers also gain from the lower prices of goods and services. The increased competition arising from free trade has several other important implications.

Despite the benefits of free trade government of all nations protect their domestic industries. Protection occurs when the artificial advantage is given to domestic firms facing competition from foreign producers.

PROTECTION

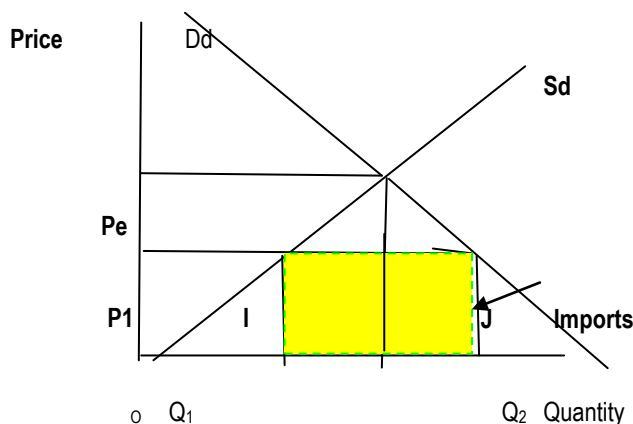
⇒ occurs when an artificial advantage is given to domestic firms facing competition from foreign producers.

Forms Of Protection

a. Tariff

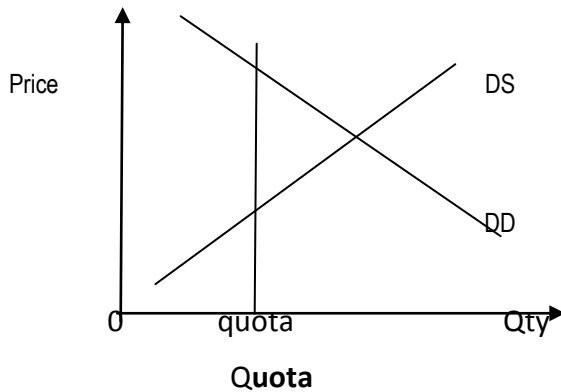
⇒ is tax on imported goods. Tariff raising the prices of imports results in locally produced goods become more competitive in the domestic market and domestic producers increase their share of the market at the expense of foreign producers.

Figure 1.1



STRAND 4
INTERNATIONAL ECONOMICS

- The above figure shows the situation in the domestic market before a tariff is imposed. Demand and Supply for a particular good in the domestic market are indicated by D_d and S_d respectively. With no trade the price of this good settles at P_e and equilibrium quantity at Q_e .
- If we assume that the world price is OP_1 , then free trade causes the domestic market price to fall to this level.
- At OP_1 local producers are willing to supply OQ_1 units of goods but consumers demand OQ_2 units of goods. The **difference** of Q_1 and Q_2 is made by **imports**.
- Total Expenditure by consumers on this good OP_1JQ_2 .
- The amount received by domestic producers is OP_1LQ_1 , while Q_1LJQ_2 goes to the foreign producers.



c. Embargo

- ⇒ An embargo is total ban on imports or exports of a commodity. In some cases it gives a local producer a monopoly in the domestic market. In Fiji, embargos are placed on goods that are considered to be socially undesirable e.g. narcotics.
- ⇒ It is used to protect the future of domestic industries i.e. by safeguarding certain stocks of commodities. E.g. Australia totally banned export of iron ore and merino sheep in order to safeguard the stock level.

d. Subsidies

- ⇒ Cash payments made by the government to local firm in order to encourage domestic production are called subsidies. A Subsidy offsets the domestic firm's high production and is the difference between the price consumers pay and the cost incurred by the producers. The lower selling price allows local producers to compete more favorably with foreign competition. Subsidies are generally preferred to tariffs for a number of reasons. These include:
 1. Subsidies are part of government expenditure and as such are reviewed annually in the government budget. Tariffs **do not** face the same review and tend to become permanent.
 2. Consumers receive the same quantity at the same price when a subsidy is used. Tariff raises the price of the goods and lowers consumers demand.
 3. A tariff is a **regressive tax**. Subsidy is paid out by government which is mainly collected through progressive income tax.

E. Local Content Rule

- ⇒ Local content rule require that certain goods be constructed with a specified minimum % of locally produced components.

f. Quarantine Regulations

- ⇒ The purpose of this barrier is to prevent the international spread of diseases. However the cost and delays of this restriction temporarily gives local producers an artificial advantage over imports.

g. Voluntary Restraint

- ⇒ Involves agreement between national governments and foreign suppliers. Governments may enter onto such agreement in order to avoid the imposition of tariffs and quota.

Tax Concessions and Export Incentives

Tax concession is simply a special tax deduction granted to domestic producers to encourage them to be more competitive with foreign firms.

REASONS FOR PROTECTION

Many arguments have been advanced in favor of protection. Not all arguments are placed on valid reasoning but we will consider some of the popular reasons given in favor of protection.

- 1. Infant Industry Argument-** To protect infant industries from foreign competition.
- 2. Promoting Domestic Employment-**protection such as tariff gives consumers an incentive to substitute locally produced goods for imported goods. ↑in demand for locally produced goods increases local employment opportunities.
- 3. Prevention of Dumping-**this occurs when foreign producers sell goods on domestic market at prices which are below their own production costs.
- 4. Cheap Foreign Labor Argument-**local producers require protection because they cannot compete with cheap foreign labour
- 5. Diversification-**the argument is that a diversified economy is one which is more flexible and more capable of adjusting the changes demanded by a competitive international environment.
- 6. Military Self-Sufficiency – The Defense Argument**

EFFECTS OF PROTECTION

1. Misallocation of Resources

All forms of protection involve transfer of resources from efficient industries to inefficient ones. Industries that are productive and competitive levels are effectively disadvantaged to give assistance to less productive and uncompetitive industries. This misallocation of resources means that scarce resources are wasted and hence output in the economy is less than it could be. That means lower living standards and lower rates of economic growth.

2. Inflationary Effects

Protection especially in the form of tariffs raises the price of imports and allows domestic producers to maintain the high price of their goods and services.

The higher prices are left by both producers and consumers in other industries unless demand for imported goods is highly inelastic, consumers react to the increased prices by lowering consumption levels

3. Redistribution of Income

The reallocation of resources brought about by protection, necessarily means a redistribution of income in the economy. Protection increases the profitability of inefficient industries. Moreover the higher prices paid by consumers as a result of protection means a redistribution of income away from consumers and towards producers in protected industries.

4. Reduced Incentive to Innovate

Protection shields domestic industries from competition. Without competition the pressure on domestic industries to respond to changing demand patterns and to introduce new methods of production and technological advances is weakened.

5. Decreased Welfare

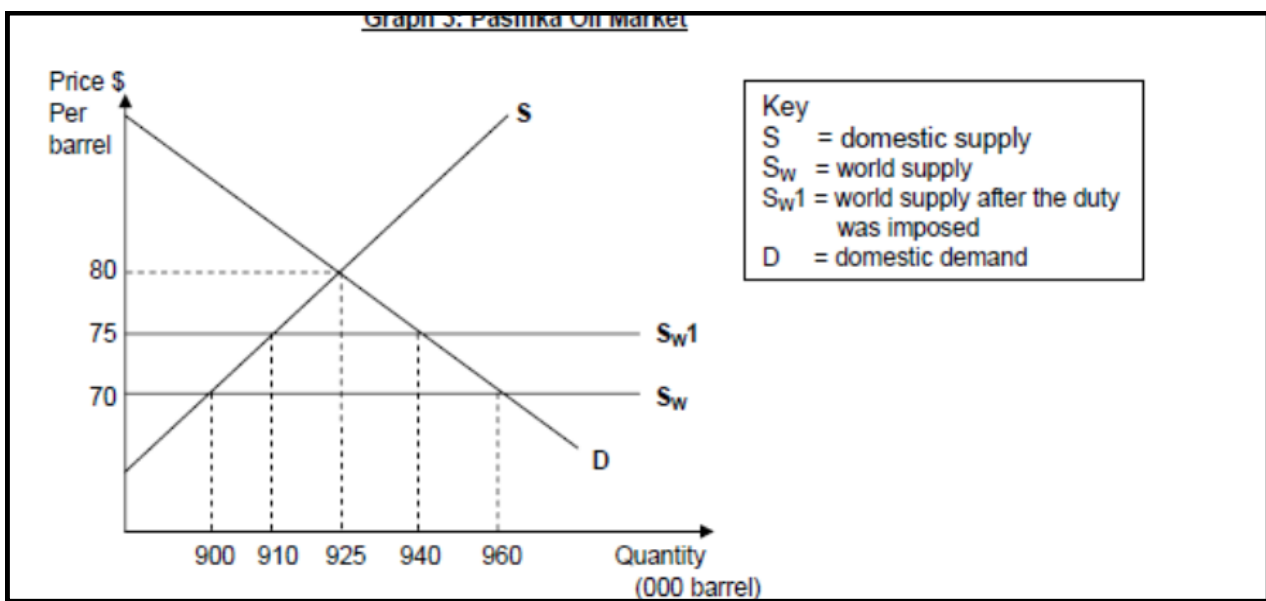
Protection result in higher cost, lower productivity, inefficient use of scarce resources, less consumer choice, lower consumer demand, decrease in demand for exports, redistribution of income and reduced international competitiveness. In the long run, therefore protection leads to a fall in living standards and lower rate of economic growth.

The overall effect is a decrease in the general level of welfare in the economy.

6. Retaliation Effect

Protection of import competing industries can adversely affect export industries by lowering demand from trading partners.

Activity 4.2.1



i) Identify the equilibrium quantity and price of oil in Pacifica. Initially assume that Pacifica is a close economy with no free trade.

ii) Form the graph assuming that Pacifica trades with other countries, calculate the following :

- Total consumer expenditure before imposing import duty.
- The quantity of oil imported after imposing import duty.
- The total government revenue rose from oil import duty.

iii) Explain why the world supply curve (S_W) is drawn as a horizontal line.

Activity 4.2.3

Essay :

PROTECTION ENCOURAGES US TO BUY 'FIJIAN MADE AND KEEP OUR MONEY IN THE COUNTRY.'*Discuss the above statement with reference to*

- ⇒ the definition of free trade and two benefits of free international trade (3marks)
- ⇒ the definition of protectionism and two forms of protectionism (3marks)
- ⇒ three arguments against protection if LDCs are ever to compete with advanced countries on world market. (3marks)

Activity 4.2.4

(a) The following are some of the methods of protectionism.

- | | | | |
|-----------|---------|-----------------------|----------|
| • Subsidy | • Quota | • Import substitution | • Tariff |
|-----------|---------|-----------------------|----------|

Explain any THREE methods of protectionism from the above list.

- (i) *Subsidy is a cash payment made by the government to local firms in order to encourage domestic production. It offsets the domestic firm's high production costs and is the difference between the price consumers pay and the costs incurred by the producers.*
- (ii) *Quota is the physical limit or restriction on the actual output supplied.*
- (iii) *Import substitution is deliberate government policies designed to replace commodities which are currently being imported with domestic sources of production and supply.*
- (iv) *Tariff is a tax on imported goods. It has the immediate effect of raising the price of imports.* (3 marks)

(b) Apart from dumping, state TWO reasons for protectionism.

- *Infant industry argument.*
- *Promoting domestic employment.*
- *The cheap foreign labour argument.*
- *Diversification.*
- *Military self-sufficiency – the defence argument.* (2 marks)

Activity 4.2.5

Explain the following terms:

Free trade	Protection
Tariff	Quota
Embargo	Subsidy local content rule
Infant industry	Dumping

STRAND 5

DEVELOPMENT ECONOMICS

Strand Outcome

Investigate the different potentials and issues affecting the Fiji Economy.



Learning Outcomes

Upon completion of the different lessons in this strand, students should be able to:

- define Economic Growth
- identify and describe the sources of Economic Growth.
- identify and explain indicators of Economic Growth.
- discuss the different government actions aimed at economic growth.
- identify, explain and discuss about other development issues which include poverty, pollution, crime, unemployment, and pollution.

LESSON 5.1: WHAT IS ECONOMIC GROWTH?

ECONOMIC GROWTH

⇒ It is simply the increasing ability of a nation to satisfy the material wants of its people over a period of time. It refers to increase in productive capacity of a nation.

Sources of Economic Growth:

A nation can expand its productive capacity through:

1. Increase in the Quantity of Its Resources

The quantity of land can be increased through the discovery, development and use of new natural resources. Likewise, the bringing of once unproductive land into use, such as, draining of swamps, clearing of scrubs for grazing purposes and the development of irrigation.

2. Improvements in the Quality of Its Resources

The quality of the labor force, have traditionally been considered as one of the most important sources of economic growth. However, a large, well trained workforce means increased opportunities for specialization and a greater potential output for goods and services.

A well-educated, high skilled workforce is conducive to high levels of productivity and real output. It is also more competent, more adaptable to change, and has a greater capacity for innovations.

3. Technological Progress

- An economy must undertake **capital accumulation** in order to increase its productive capacity. Thus, requiring **net investment** which can result in greater potential output of goods and services and an even greater rate of economic growth.
- Therefore, the application of new technology generally involves the use of new, improved capital productivity and contributing to higher rates of economic growth.

Indicators of Economic Growth:

1. Real GDP Per Capita

Allowance for population changes can improve the usefulness of Real GDP as a good indicator of the rate of economic growth. As such, it will become more *reliable* measures of Economic growth. Furthermore, it will allow comparison of growth rates between different countries.

2. Real GDP Per Capita

Measures the value of real goods and services available on average to each member of the population. Alternatively known as *real income per capita*.

$$\text{Real GDP per Capita} = \frac{\text{Total Real GDP}}{\text{Total Population}}$$

3. Real Per Capita Consumption Expenditure

Attempts to measure the standard of living in terms of the quantity of consumer goods and services purchased per household. Thus, rising consumption per capita indicates increasing levels of want satisfaction among the consumers.

4. Real Productivity Growth

Indicates the rate of increase in the volume of goods and services per person in the labour force, thus, rising in productivity levels indicates that society is potentially capable of satisfying more of its material wants over time.

5. Real GDP Per Capita Adjusted For The Terms Of Trade

This improves the accuracy of Real GDP per capita as an indicator of improvement in the standard of living by measuring the goods and services which are available to consumers through international trade. Such adjustment is considered due to the exclusion of imports from GDP.

6. Measure Of Economic Welfare And Physical Quality Of Life Index

Measure of Economic Welfare focuses on the consumption of goods and services, inclusive of the estimated value of household activities, leisure with associated cost of pollution and environmental damage.

Physical Quality of Life Index measures a nation's standard of living in terms of its ability to meet the basic needs of its people.

The Benefits of Economic Growth

ADVANTAGES

1. Improve Standard Of Living

Results in higher material well-being, where there is greater volume and variety of consumer goods and services, improvement in the quality of goods, better standard of health and nutrition with improved housing conditions.

2. Increased Employment Opportunities

Economic growth provides improved employment opportunities for an expanding workforce, where structural changes accompany development of new markets; expansion of existing ones, giving rise to new avenues of employment in some sectors and growing employment opportunities in others.

3. Improved Economic And Social Mobility

Economic Mobility of Resources refers to the ease with which resources move between avenues of employment, resulting in a more flexible economy promoting structural change conducive to rapid economic growth.

Social Mobility brings forth rising income, improve access to higher education and a wider range of occupational choice allowing individuals to move easily between social groups.

4. Increased Social Welfare

With economic growth is a greater provision for the elderly, sick and unemployed. Thus, rising incomes and expenditures accompanying growth provide increased tax revenue for the government, therefore, increasing transfer payments, which reduce income inequalities.

5. Increase Participation In International Trade

- ⇒ Economic growth allows each country to participate more fully on world trade to enjoy the advantages of specialization. These advantages are found in greater volume and variety of commodities available for consumption, greater access to raw materials and more efficient use of resources and transfer of new technologies.

6. Increase Assistance to Less Developed Countries

- ⇒ Rising real incomes and increasing participation in trade, make it possible for developed nations to contribute towards the growth and well-being of less developed nations.

The Costs of Economic Growth

DISADVANTAGES

1. Harmful Externalities And Social Cost

- ⇒ **Externalities** refer to those costs and benefits associated with production and consumption of certain commodities which the price mechanism fails to account. Such cost can include carbon monoxide from cars, chemical waste dump into rivers and sea. These harmful externalities are called **Social Cost**.
- ⇒ **Social costs** are regarded as the worst consequence of economic growth, which falls under two categories, namely those associated with pollution and environmental damage and those with deteriorating quality of life.

2. Structural Unemployment

- It arises because the skills of the unemployed no longer match those required by the employer. Also, is regarded as a serious issue since it involves an important opportunity cost to society, in terms of commodities that the unemployed could have produced.
- It tends to be long term in nature, as the acquisition of new skills takes time and pose particular problems for older workers. However, in a rapidly growing economy, such structural unemployment is inevitable.

3. Lower Current Living Standards

- ⇒ Capital accumulation involves an opportunity cost of the consumer goods foregone, therefore, effectively sacrificing current living standards. This sacrifice is regarded by many as the **prime cost of economic growth**.

4. Inflation

- ⇒ High levels of economic growth are likely to accompany inflation. Which is a threat for it lowers real incomes, increase income inequality and leads to misallocation of resources.
- ⇒ As the economy approaches full employment, competition between firms for increasingly scarce labor, forces up wages which leads to increase production cost which are borne by consumers, such is known as **cost inflation**.
- ⇒ However, inflation can occur because the rate of growth in output is insufficient to meet demand for additional commodities by the people, resulting in **demand inflation**.

5. Balance of Payments Deficit

- ⇒ An economy's international competitiveness tends to decline when local rate of inflation exceeded that of trading partners, causing rise to more imports, falling exports and large current account deficit.
- ⇒ Furthermore, increasing demand for imports tends to put pressure on exchange rate, which can also lead to a rise in foreign debt.

6. Concentration of Economic Power

- Economic growth has been accompanied by expansion of large scale production and monopolies. The growth of monopolies has meant concentration of ownership and control by fewer firms. This has resulted in reduce competition, higher prices and delay technological progress.
- Therefore, monopolies acting on the interest of shareholders rather than those of the government tend to have a significant impact on the economy as a whole.

7. Depletion of Resources

- ⇒ Rapid economic growth has resulted in excessive use of resources to meet the increasing demand of goods and services for consumers. As such is accompanied by misusing natural resources where there is a small portion left only to cater for future demands.

ACTIVITY 5.1.1**MULTIPLE CHOICE QUESTIONS****1. *A serious problem associated with economic growth is***

- A. Increase pollution and increase unemployment
- B. Equal income distribution
- C. Poor international relation
- D. Increase private investment

2. *Which of the following is not a source of Economic Growth?*

- A. Increase quantity of its resources
- B. Real GDP per capita
- C. Improvement in the quality of its resources
- D. Technological progress

ACTIVITY 5.1.2**SHORT ANSWER QUESTIONS**

1. What is meant by Economic Growth?
2. Differentiate between **Measure of Economic Welfare** and **Physical Quality of Life Index**.

ACTIVITY 5.1.3**ESSAY WRITING QUESTION**

Discuss ***Economic Growth*** with reference to:

- **three** sources of Economic Growth [3m]
- ♦ **three** indicators of Economic Growth [3m]
- ♦ **two** benefits and **two** costs of Economic Growth [3m]

ACTIVITY 5.1.4**ESSAY WRITING QUESTION**

'The Fiji Economy is moving towards its goal of increasing economic growth'.

With reference to the above statement, explain the following:

- **definition** and **two** importance of Economic Growth [3m]
- **three** factors affecting Economic Growth in Fiji [3m]
- **three** costs of Economic Growth [3m]

ACTIVITY 5.1.5

Use the case study given below and answer the questions that follow.

Why is growth wide held activity? The answer is self evident. The growth of total output relative to population means a higher standard of living. An expanding real output means greater material abundance, and implies a more satisfactory answer to the economizing problems. A growing economy, by definition, enjoys an increment in its annual real output, which it can use to satisfy existing needs more effectively or to undertake new projects. However there are costs to **Economic growth**.

- I) Define the term Economic Growth
- ii) State two indicators of economic growth in an economy
- iii) Why is economic growth desirable
- iv) define the term sustainable growth
- v) Economic growth should be judged as much for what it destroys as for what it creates. Explain.

LESSON 5.2: OTHER DEVELOPMENT ISSUES

UNEMPLOYMENT

This is an issue that has been affecting Fiji for a long period of time.

⇒ Unemployment exists when there are people willing and able to work but they are unable to find suitable jobs.

Causes of Unemployment

The following are the major causes of unemployment:

- i) reduced spending by business firms.
- ii) high wage rates.
- iii) overpopulation.
- iv) lack of skills and education.
- v) decrease in demand for goods and services.

Effects of Unemployment

Unemployment has economics effects as well as social effects.

Economic Effects

- i) Loss of skills or a decrease in human capital.
- ii) Decrease in production levels
- iii) Reduction in income which will in turn affect demand therefore inversely affecting economic growth.
- iv) Leads to reduction in savings which can result in lower investment therefore reduction in GDP.
- v) Decrease in investment levels.
- vi) Decrease in tax revenue collected by the government
- vii) Increase in welfare spending on unemployment

Social Effects

- i) Hurts the worker and his/her family.
- ii) Loss of self-respect or self-esteem.
- iii) Disrupts families and households.
- iv) Leads to low morale, frustration and boredom.
- v) Lead to an increase in other social problems e.g. crime, illiteracy, poverty, malnutrition etc.
- vi) Can also lead to physical health issues

Types of Unemployment

- ⇒ **Involuntary Unemployment** occurs when people are willing to work at the given wage rate but cannot find a job. Involuntary unemployment can be explained by the following economic concepts:
- ⇒ **Structural unemployment** : generally caused by the decreased in the final demand for goods and
 - i) services perhaps the good has become unpopular or due to technological change e.g. automation in the factory.

- ii) Frictional unemployment : short term unemployment caused by movement in between jobs i.e. a few weeks of unemployment before starting a new job.
- iii) Seasonal unemployment : is unemployment caused by the regular season nature of the work e.g. cane cutting workers after the cane cutting season.
- iv) Cyclical unemployment : caused by the general downturn in economic activity which can be due to the fall in aggregate demand.

Government Actions to Curb Unemployment in Fiji

- i) Encourage more foreign investors as this will create more jobs and employment opportunities in Fiji.
- ii) Education reform – Free education system; BEST program to promote employment skills training; Vocational Programs to allow students to be self-employed; Bus Fare assistance scheme allows students to attend schools in order to acquire the necessary skills for Tertiary as well as the job market.
- iii) Bridging the gap in terms of development by focusing on rural areas as well. This will prevent the rural-urban drift.

Note :

- ⇒ Unemployment can lead to self-employment
- ⇒ Unemployment can also lead to migration

POLLUTION

⇒ refers to the presence of any harmful substance in the atmosphere.

There are four major types of pollution :

- i) Land pollution
- ii) Water pollution
- iii) Air pollution
- iv) Noise pollution

ACTIVITY 5.2.1

Research Work

Conduct a Research on other development issues faced by the Fiji economy. In the Research include the following:

- i) Causes of each development issue
- ii) Effects of each development issues (both positive and negative effects)
- iii) 3 Government actions aimed at curbing each development issue.
- iv) Effectiveness of the above actions in curbing each issue.

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