How the uk government manage the economy economics essay

In this essay I will examine how the UK government manage the economy and what they use to manage it. I will explain the government's economic objectives and policies and how these policies effect business organisations. I will briefly explain the different types of unemployment and explain the effects of unemployment on businesses. I will also explain the different causes of inflation and its effect on business organisations and the economy and to conclude I will explain the effects of international trade on business organisations.

Managing the economy competently is important to the government for the reason that if it is done correctly they will stay in power. To stay in power a political party (Labour Party, Conservative Party and Liberal Democrats etc) must win a general election. For this to happen, people must vote for them. People vote for a party they want to win because they believe once in power they will govern a steady economy. People paying tax contributes to a steady economy and the government use that money to pay for public services such as NHS, transport, education, benefits for parents, disabled people and the unemployed.

All governments have common economic objectives, achieving these objectives will accomplish one main goal, maintain a steady economy. To do this unemployment must be low. High unemployment has costs which affect the economy. If there is high unemployment more people will be on benefits. This means fewer people are paying tax and not as much money is being put into public services. Having stable prices also contributes to a stable economy. If prices are constantly rising businesses have to accommodate for these changes. This will eventually lead to some of their employees being made redundant or dismissed. Then that leads to more unemployment and fewer people paying tax. That is why the government try to keep inflation as low as possible.

To understand how money flows in an economy we must look at a theory called circular flow which was first explained by a British economist that also explained that high unemployment is one cause to an unstable economy. His name is John Maynard Keynes. Keynes was born in Cambridge, England on the 5 June 1883. Keynes wrote a book which was published in 1936 called " The General Theory of Employment, Interest & Money.[1]In this book it explains a theory he formed in the 1930's describing how money flows from private sector businesses (e. g. Tesco, HSBC, and HMV etc) to households. This theory is known today as the Circular Flow. Circular Flow is when businesses employ people to manufacture or sell a product or service. Businesses then supply their employees' with wages. This creates demand for the product or service being sold by the business. Then the employees buy the service or product from the business thus creating a Circular Flow of Income. If this process continues to go round it will cause the economy to grow.

But this flow can have a negative effect. The flow concentrates on the confidence of people and if they believe that a time of hardship is on its way they will hold on to some money to get through that time. This lowers the demand for a product or service. Once this happens people will not buy as much products or services, lowering businesses income. Businesses then start cutting costs to save some money to get through their time of hardship, this negative effect is called a recession.

Although demand is good for businesses, too much demand will cause prices to rise. This rise is called inflation. Inflation occurs when demand for a product or service is high and businesses raise their prices to make more profit. Inflation also has effects on businesses, one of these effects are employee's demand higher wages. Employee's demand higher wages when the business is making profit and decide to put up their prices to make more profit. Another effect inflation has on businesses is less customers will spend their money purchasing goods and services because businesses put their prices up to make more profit and customers decide not to shop there anymore because the price is too high and maybe they will be able to get it cheaper elsewhere.

To control inflation the government use leakages to take money away from people who are spending their money on products and services. A leakage is money no longer recycled from businesses to households in the circular flow (money that leaks out of the economy). There are four main leakages from a household expenditure; they are tax payments, savings, interest rates and imports. Tax payments are money being paid to the government through wages (income tax), VAT (value added tax) and tax on petrol and cigarettes. The government could use tax payments to control inflation by increasing tax, which will reduce demand because people will not have as much money to spend. This will make businesses lower their prices. But tax payers do not like tax, therefore if the government increase tax people will not vote for that political party to stay in power. Savings is not controlled by the government but it is still categorized as a leakage. Savings is that part of an income which in not spent buying goods or services. If people are not spending their income, that money escapes the circular flow and is not reused by businesses. Interest rates are the price a person borrowing money has to pay back on top of what he or she borrowed (e. g. mortgages, credit cards and loans). Interest rates are normally expressed as a percentage rate. The Bank of England decides what that percentage is. They use interest rates to control inflation by increasing it, for example if somebody had a £250, 000 mortgage with an interest rate of 5% they would have to pay back £12, 500 on top of £250, 000. But if the Bank of England increases the interest rate to 6%, that person would have to pay back £15, 000 instead of £12, 500. That’s not only a 1% increase for that person but for everyone who has a mortgage in the UK. Imports are a leakage and Peter Maunder explains why it is a leakage in Economics Explained (Collins Educational, 2000). He says

“ Imports constitute as a leakage from our economy because in effect households are spending their money overseas”

He is telling us that people are spending money abroad instead of in this country. They are injecting money into other economies thus the money spent is not being reused in our economy. If people spend more money abroad businesses in this country will not sell as much products and services. This will then lead to businesses in this country lowering their prices and making their employees redundant or dismissing them. If this happens demand will decrease because less people are earning money. Therefore if more imports are performed inflation will go down and could even cause unemployment.

There are four types of unemployment, frictional, cyclical, seasonal and structural. Frictional unemployment is when people are transitioning from one job to another and are unemployed while looking for another job. Cyclical unemployment is when there are changes in the business conditions (i. e. recessions and depressions) and employee's need to be dismissed to sustain the business. Seasonal unemployment is when people are only employed for a particular season then they dismissed. This happens mainly in resorts because people are only needed during the warmer seasons. Alain Anderton explains what structural unemployment is in Economics Second Edition (Causeway Press Ltd, 1995). He says

" Structurally unemployed persons are usually those who simply cannot find any job they can do"

He is telling us that structural unemployment is when people cannot find a job because they cannot find a job which requires their particular set of skills. For example labour saving machines are doing some of the manufacturing in factories, so people are not needed to do some of the work. Some of these people do not know how to do anything else so their sets of skills are no longer needed. Unemployment is caused by the lack of demand in the economy; consequently businesses are not making enough money to pay their entire workforce because not enough people are buying their products. If unemployment is high businesses will be affected because not enough people will be purchasing their products or services and will cause the business to dismiss more employees or closedown.

The government can control unemployment by using injections. They use these when there is not enough demand and need to stimulate the economy to create demand. What President Roosevelt did during the Great Depression is a perfect example of stimulating the economy. Injections are payments to businesses that do not originate from households.[2]Injections consist of investments, tax, interest rates, Public Sector Borrowing Requirement (PSBR) and exports. Investment is the purchase of capital goods or new machinery by businesses. This helps boost demand because if businesses invest in these things they will need more employees to operate the machinery or sell the new goods purchased. The businesses then pay the employees which will create demand because the employees will need to purchase goods and services. Exports are similar to imports but instead of taking money out of the economy, it injects money into it. Exports are products or services being sold to businesses or persons in another country. If businesses carry out more exports they will be able to employ more people because more money will be flowing into the business. This will then create demand because more people will have jobs and they will need to purchase products and services. Therefore more exports will decrease unemployment and create more demand. PSBR is now known as the Public Sector Net Cash Requirement (PSNCR). PSNCR is the term used when the government borrow money to pay for activities in the public sector of the economy i. e. wages, maintenance on hospitals etc. This happens when the government expenditure exceeds the income of tax revenue. To finance this borrowing the government will sell government bonds or borrow from the public. [3]PSNCR is an injection because the government could use it to build more hospitals, police departments or local authorities (Enfield council, Barnet council etc) and pay employees to work there. Doing this will then create demand because the employees will buy products and services with their wages. In addition to this these employees will also be paying tax and that will contribute to tax revenue. Although tax and interests rates are a leakage if they are increased, they can also be an injection if they are reduced. Doing this will increase the amount of money people have, to spend on goods and services thus creating demand. If the government do this people are more likely to vote for them at the next general election because people do not like paying tax or interest.

To conclude we will examine the effects of international trade on businesses organisations. International trade is importing and exporting and too much of one or the other can affect the value of a currency thus affecting the price of a product in another country. If a business in the UK wants to buy a car in Germany (import) they cannot use pounds because the business in Germany cannot use pounds to pay their employees or buy more materials to manufacture more cars. The business in Germany use euro’s to do this. So the business in the UK has to change their pounds in to Euros before purchasing and how much Euros they get for a pound is determined by the exchange rate at that present time. Exchange rates are the rate at which one currency is worth in another currency. For example £1 will buy a person €1. 18. Hypothetically let’s say for a £1 a person can get €2 and a car in Germany costs €1000. The business in the UK will only have to pay £500 to purchase one car which will not affect the price of the car in Germany but the business in the UK can purchase two cars for £1000 because £1000 will get them €2000 thus being able to purchase two cars. But if £1 will buy a person €1 then the business in the UK will only be able to buy one car for £1000 because £1000 will become €1000 in Germany. However if a lot of imports are performed the value of the pound will decrease, making it more expensive to import from Germany the next time. The value of the pound will decrease because demand for the pound will decrease as business will be selling pounds to get other currencies to purchase products abroad. This is good if the government needed decrease inflation. On the other hand if a lot of exports are performed it will increase the value of the pound because there is demand to buy pounds to purchase products in the UK. If the value of the pound is too high it will be difficult to export goods because businesses in other countries will have to pay more to purchase goods but it will be good for the UK to import because they will be able to purchase more goods than if the value of the pound was low. If the value of the pound is low it will have the opposite effect which is good if the government needed to get the economy out of a recession. If the value of the pound is too low the Bank of England could raise the interest rates to attract foreign investors. The investors will want to buy pounds to put into a UK bank account and gain interest on the money deposited. For example in 1992 the value of the pound had decreased so much interest rates were increased from 10% to 15% in an effort to raise the value again[4]. Even though increasing interest rates is good the increase in value of the pound it is not good for the domestic economy because people with mortgages and credit cards will have to pay back the high interest which may not be affordable.

The government's primary objective is to manage the economy; this is because the economy is the foundation of a country. If it is not done correctly it could be a disaster for everyone in the UK. The government have the necessary tools to control the economy but how they use these tools will determine if they will be voted back into power and how the economy prospers. If the economy is managed well the political party in power will be voted back into power and that is their main objective.

In conclusion it is possible to say that the UK government can manage the economy with the tools they possess. For example if there is inflation the government will use leakages (tax payments, savings, interest rates and imports) to decrease demand and lower inflation. If there is a recession the government will use injections (investments, tax, interest rates, Public Sector Borrowing Requirement (PSBR) and exports) to increase demand and reduce unemployment. But on the other hand we can say that the UK government cannot manage the economy. This can be said because even though the tools can affect the economy, they are not powerful enough to stop the economy from going into a recession. This can be proven with today's current climate. The current financial crisis, the great depression and the recession in the 1970's are perfect examples of the government not being able to control the economy.