Economical assignment

Economics

Question 1

- (a) Explain clearly whether the data is primary or secondary (define these terms). The data used in developing the above graph is secondary since the data has been collected from a journal published by the office of national statistics. Primary data is data corrected personally by a researcher through such methods as interviews, questionnaires, andobservation. Secondary data is an already available data not collected for specific problems in question. Sources of secondary data include government press, official publication, magazine, s and journals.
- (b) Discuss the reliability or otherwise of the data. As the data has been collected from the office of national statistic it is highly reliable as such data is collected by highly trained and competent staff and using the correct methodology in collecting the data. Furthermore there is less likely that such data is incorrect therefore can be used for further analysis.
- (c) Identify the main trends shown by the data. From 1997 to 2000 there was a gradual increase in house price but as from 2000 to 2007 house price increased steeply due to the boom in housing market. In comparing the house price between 2000 and 2007 the price was more than double as there was an increase in price by 125%. However from the beginning of 2008 house price began to drop due to the bursting of the housing bubble and the financial crisis which started to be experienced in mid-2007 and into 2008. At the end of the 2nd quarter of 2008 house prices had decreased by 5%.

2. Define supply and demand. Draw a supply and demand diagram and explain it. Demand is described as the quantity of goods consumers are willing and able to buy. Supply refers to the quantity of goods that supplies are willing and able to supply to the market. The demand curve slopes downward since as the prices of goods decrease consumers will demand higher quantity of that product and vice versa. Supply curve slopes upward as prices increase supplies will supply less quantities of that product. The equilibrium point occurs at the point of intersection between demand curve and the supply curve. As shown in the following diagram.

3. Discuss four of the main factors that may explain the changes in house prices shown on your graph above. Include two diagrams showing the change in supply and demand for housing.

Factors contributing to increase in house price over the period:

- a. Interest rate. Where interest rates are higher mortgage lenders increases the cost of variable mortgages. In UK interest rate is a very important factor since many people have variable mortgages. As from the year 2000 there was more capital accumulation all over the globe and with increased liberalization more funds found their way into the UK economy. An increase inmoneysupply circulating in the economy causes the interest rates to increase which increases the cost of mortgages and ultimately to house prices. The deliberate effort of the bank of England to cut interest rate as from 2008 led to lower cost of servicing mortgages which partly contributed to lower house prices in 2008.

- b. Demographic factors. There has been an increase in demand for housing as a result of increase in level of immigrant particularly from Eastern Europe such as Romania and Poland. In addition the number of households has increased due to demographic changes such as an increase in the number of people living alone as a result of an increase in thedivorcerate. Through the law of demand, where demand is high and supply is low then prices are high.
- c. Increase in real income. Due to an increase in real income more people could afford to buy new houses and thus increase in income increases demand and ultimately increases price of houses.
- d. Increase in the cost of land – due to scarcity of land, the cost of land have increased over the period and due to the direct relationship between the cost of land and house price, increase in cost of land has caused house price to increase over time.
- e. increase in wages – labor as one of the major inputs in housing construction is a major determinant of price and an increase in wages also increases house prices.

Explain what is meant by vertical merger, horizontal merger and conglomerate merger. Vertical merger – a vertical merger involves combination of two firms producing different goods or services but for a specific finished product for instance a merger between a tire company and a car manufacturer. Horizontal merger – it involves a merger between two or more firms producing the same goods or services and in the same production level and industry. nConglomerate merger involve combination of firms involved in unrelated business for instance where a mining firm acquires a supermarket chain.

Discuss the investigation into the take over of Safeway supermarket chain. In 2003 Morrison, a supermarket chain based in North England proposed to takeover Safeway supermarket chain. Following this announcement other potential buyers including other main supermarket chain namely Tesco, Asda, and Sainsbury also entered the race. This triggered the competition commission to investigate the issue. Following the five-month investigation, the commission declared that among the top four supermarket chains only Morrison should be allowed to proceed with the takeover of Safeway.

1. Which of the categories in (a) did the merger fit into? The merger between Morrison and Safeway was a horizontal merger since it involved a combination of two firms in the same stage of production and in the same industry.
2. What are advantages and/or disadvantages of this type of merger? One of the advantages of this type of merger is that it reduces the intensity of competition within the industry and this leads to saving some of the expenses that would have otherwise been spent in fighting competitors. The other advantages of this merger include economies of scale, increased market power, differential management efficiency, and accelerated growth. The disadvantage of this type of merger is that it can reduce creativity and innovation due to lower competitive pressure. Where the resulting entity acquires a greater market share it can create a kind of monopoly in the market therefore reducing healthy competition which is beneficial to consumers. Finally, since it is

a combination of firms in the same industry and the same stage of production there is less diversification of market risk compared with such merger as a conglomerate.

3. Why did the competition commission recommend that Morrison's bid be allowed to proceed and others not? In comparing the market shares among the four competitors Tesco was leading with 26% followed by Asda 17%, then Sainsbury 16% and Morrison with allowed 6%. Therefore the competition commission was of the view that if any of the other three was allowed to take over Safeway they would have a greater market share, therefore, having a competitive advantage thereby reducing healthy competition in the industry. With the takeover of Safeway Morrison would be able to occupy the fourth position just behind Sainsbury.
4. Discuss the conditions that were attached to this bid Morrison would be allowed to take over Safeway on condition that it sell 53 of the 479 strong chain of supermarkets and Sainsbury, Tesco, and Asda were given permission to bid for these stores.

Does the retail sector now have a satisfactory level of competition or is further action needed by the competition authorities? With the big four firms controlling about 75% of the market share it increases the level of competition within the industry and since there is no much significant difference in market share among the four firms then no single firm can be said to dominate the industry. Following the takeover, the industry will now have a 4 firm concentration ratio of 75% which implies that the market structure is an oligopoly. Therefore putting into consideration the large number of small firms in the industry the competition authority should take steps to ensure that they are able to compete. An oligopoly market is characterized by strong mom-price competition, increased branding and brandloyalty, stable prices, high barriers to entry high degree of interdependence between rival firms, potential of collusion, and possible price leader. There has been a lot of complaint by those in supply chain concerning pressure to deliver higher quality product at lower price the small firm are also complaining of unfair competition as big firms are moving into groceries as well as non-fooditems. These lead to reduced local shopping facilities as well as the death of other facilities in small villages and towns. Therefore the office of fair trading and competition commission should continue to monitor the activities of businesses to ensure that public interest is protected and competition is maintained (Prest, 2008).

Question 2

Explain the four main macro-economicgoalsthat you would expect the UK government to pursue and the policy instrument at their disposal.

The four macroeconomic goals that the UK should pursue include

- a. price stability
- b. economic growth
- c. higher employment levels
- d. exchange stability

Price stability – where prices are unstable i. e. where inflation occur the economy will be adversely affected. Inflation increases uncertainty about cost and return therefore decreasing the incentive to invest and distort economic decision. In the long run fewer goods and services will be produced which leads to slow growth in employment and output. In its bid to maintain price stability the government should not attempt to achieve zero inflation but should aim to maintain a certain low level of inflation. As indicated in the Philip curve an increase in inflation causes employment to increase up to a certain limit. Therefore a low level of inflation is desirable in reducing employment in the economy.

Economic growth – economic growth is attained in the economy when real output increases rapidly than its population. As a consequence the per capita increases and the standard of living also improve. However, measures put into place to accelerate economic growth often result to some increase in inflation. Higher employment levels – higher employment is closely related to economic growth as the government cannot achieve higher employment without attaining economic growth.

Exchange stability – where domestic currency depreciates against foreign currency exporter benefit while importers benefit. On the other hand where the domestic currency is stronger compared to foreign currency import become cheap while exports are expensive. This leads to decrease in export and increase in export causing an unfavorable balance of payment. The aim of the government should be to maintain exchange stability in order to achieve a stable balance of payment. The government can use both fiscal and monetary policy in achieving these goals. Monetary policy means those measure adopted by the central bank to increase or decrease the supply of money in circulation.

The main monetary policy instrument include

- a. Bank rate – in order to reduce the amount of money in circulation bank rate is raised and in view of this, the commercial bank also raises their rate of interest. Due to rise in interest rate borrowing is discouraged and the supply of money is decreased. This measure is adopted when there is experiencing inflation. In a time of recession, bank rate is usually decreased for instance during the current period where most economies around the globe are experiencing a decline in growth including the UK the best measure to adopt is to decrease the bank rate.
- b. Open market operation – in reducing the supply of money the central bank can sell securities such as bond and treasury bills to the public. To increase the supply of money then the government buys back these securities.
- c. Reserve requirement – during inflation, reserve requirement is raised by the central bank and due to that money at disposal of commercial banks decreases. It helps to control the supply of money in circulation.
- d. Rationing of credit – all commercial banks can get loans from the central bank up to a certain limit. The central bank can lower or raise this limit to control the amount of money in circulation.
- e. Margin requirement – the difference between the value of security and loan advanced against that security is known as the margin requirement. To reduce money supply margin requirement is raised.

The government can also use fiscal policy in achieving a desirable effect in the economy. Fiscal policy is that policy which uses publicfinanceas a balancing factor in the development of the economy.

The main instrument of fiscal policy include

- a. Public expenditure – during inflation, the government reduces it expenditure. As a result, the money supply in circulation decreases and price falls. During recession like the one currently experienced the government should increase its spending in order to stimulate economic growth.
- b. Taxation – as there is a decline in economic growth the government should lower taxes. Where taxes are lowered disposable income increases and as a result aggregate demand increases.

This forces supplies to increase output in order to satisfy the growing demand. In turn, supplies will require more input in terms of capital, material, and labor, therefore, increasing employment rate and economic growth.

Question 2(b).

Describe and comment on the performance of the UK economy inrespectof the above goals. Collect the appropriate statistics and present them clearly using graphs or tables. In maintaining price stability the UK government has adopted inflation targeting regime as their main monetary policy. The government has managed to maintain price stability by keeping inflation at low levels. The data below indicate the changes in inflation rate from 2000-2009 as measured by the consumer price index (CPI). As indicated from the graph and the table there has been a gradual increase in inflation over the period but from the beginning of 2008 inflation started to decrease. The increase in inflation had been caused by the boom in the housing market and the increase in global fuel price which has put on pressure on producers of a consumer products to increase the price. The current financial crisis combined with a decrease in global fuel price has caused inflation to decrease as from the beginning of the year 2008. The auk government was able to maintain a low level of unemployment till 2008. As a result of the financial crisis, many companies have been downsizing their operation while others are opting for business closure. This has led to many lay off particularly from mid-2008 and into 2009. The decline in economic growth has also played a major role in increasing unemployment since it is operating below potential output thereby creating potential output. In addition, an increasing number of immigrants from Eastern Europe are partly to blame for increasing unemployment in UK.

Economic growth can be measured using the gross domestic product (GDP). The GDP equation can be expressed as

$Y = C + I + G + (X-M)$

WhereY = real national income

C = household consumption

I = private investment

G = government spending

X = export

M = import

The UK GDP growth from the year 2001 to 2007 is illustrated in the following graph

As from 2001 to 2006 there was a high increase in economic growth particularly in the stock and housing market which recorded double growth. The growth in the economy was largely attributed to the boom in the housing market. Increase in house price made it possible for the household to re-mortgage their debt and this further increased household consumption. However, from mid-2007 the economic growth started to decline due to the busting of the housing bubble. The situation was made worse from the collapse of the northern rock bank that led depositor to scramble in withdrawing their deposit at the same time share prices dropped by 32% and this marked the start of the credit crunch. In 2008 the economy started to experience the spillover effect from the US mortgage and housing market. Many companies experienced a liquidity problems and had to rely on the government for a bailout. In the 2nd quarter, 0f 2008 UK recorded a negative GDP growth. GDP contracted by 1. 9% in 1st quarter of 2009. during the same period industrial output fall by 5. 3%, construction by 2. 4%, household expenditure by 1. 2% and capital accumulation by3. 8%. However, government spending increased by 0. 3% to reach 3. 5% while the trade deficit decreased from £7. 6 billion to £7. 3 billion. Export reduced by 6. 1% and imports were also down 5. 9% (Prest, 2008).

Question 2(c).

Select one of the macro-economic indicators identified above and discuss government policies that could be used to keep it under control. One of the macroeconomic indicators is GDP and there are several policies which the government can employ to restore the economy back to economic growth. Currently, as indicated by GDP the economy is experiencing a decline in growth. The government can employ both fiscal and monetary policies to restore the economy back to growth. Using the Keynesian standard analysis a reduction in tax will increase the disposable income in the hand of the household. This will lead to an increase in consumption spending expanding aggregate demand. Producers will be forced to increase output in order to cater to increased demand and they will, in turn, require more input in terms of material, labor, and capital. This decreases the rate of unemployment and increases economic growth. Assuming an economy operating below full employment level which means that there are idle resources then the effect of tax cut can be illustrated with the use of the following graph.

Before the implementation of the policy, the equilibrium point was E0 which is below the full employment potential (If). After the government implements a tax cut which is an expansionary fiscal policy the aggregate demand increase from AD0 to AD1 and a new equilibrium (E1) is attained at full employment level thereby eliminating idle resources. Therefore this decreases the rate of unemployment and boosts economic growth. The government can also use public expenditure to attain the same result as an increase in government spending also increases aggregate demand. On the other hand, the government can employ expansionary monetary policy to stimulate spending. However, the problem with the use of expansionary fiscal and monetary policy is that they cause inflation in the economy. In a case where the economy is responsive to increases in aggregate demand i. e. the economy is not at full employment level and is responsive to policy changes, at the point of widespread unemployment increases in aggregate demand as a result of the tax cut would not only create additions to output but would cause inflation as well at the rate of trade-off. A trade-off would exist between changes in the level of output and employment and changes in the level of prices.

An expansionary fiscal policy that increases AD leads to an increase in the level of output from Q1 to Q2 and prices from P1 to P2 i. e. the level of employment at Q2 is higher than at Q1. Associated with a high employment level is a higher price level or some level of inflation. The other adverse effect of a tax cut is that it causes a budget deficit which usually leads to a crowding-out effect. When a government faces a budget deficit it has to borrow by selling bonds to the general public. In order to coax the public into buying government bonds rather than those issued by the private sector the treasury issue bonds at a lower price which would concurrently increase the interest rate on those bonds. By creating an interest rates above the equilibrium rate the government crowd out private investment resulting in no effect on national income.

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