Western Cape Government

Education

Directorate: Curriculum: FET

ECONOMICS GRADE 12 CORE NOTES

WESTERN CAPE EDUCATION DEPARTMENT

ECONOMICS GRADE 12 CORE NOTES

BASED ON THE NATIONAL EXAMINATION GUIDELINES

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Adapted by: Economics Subject Advisors 2018

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MAIN TOPIC: MACRO ECONOMICS – PAPER 1

TOPIC 1: CIRCULAR FLOW MODEL

SUBTOPICS:

1.1 The open eocnomy circular flow model.
- **Equation**
- **Markets**

1.2 National account aggregates
- **NationaL account conversions**

1.3 The multiplier

1.1 The open economy circular-flow model

CONCEPTS related to the circular flow:

Mind-the-Gap **Enjoy Economics**	

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Description / Definition

- The circular-flow model of the economy is a simplification showing how the economy works and the relationship between income, production and spending in the economy as a whole.
- The circular-flow model of an open economy shows the workings of an economy that is open to foreign trade.
- It is different to a closed economy because it includes the foreign sector.

Diagram

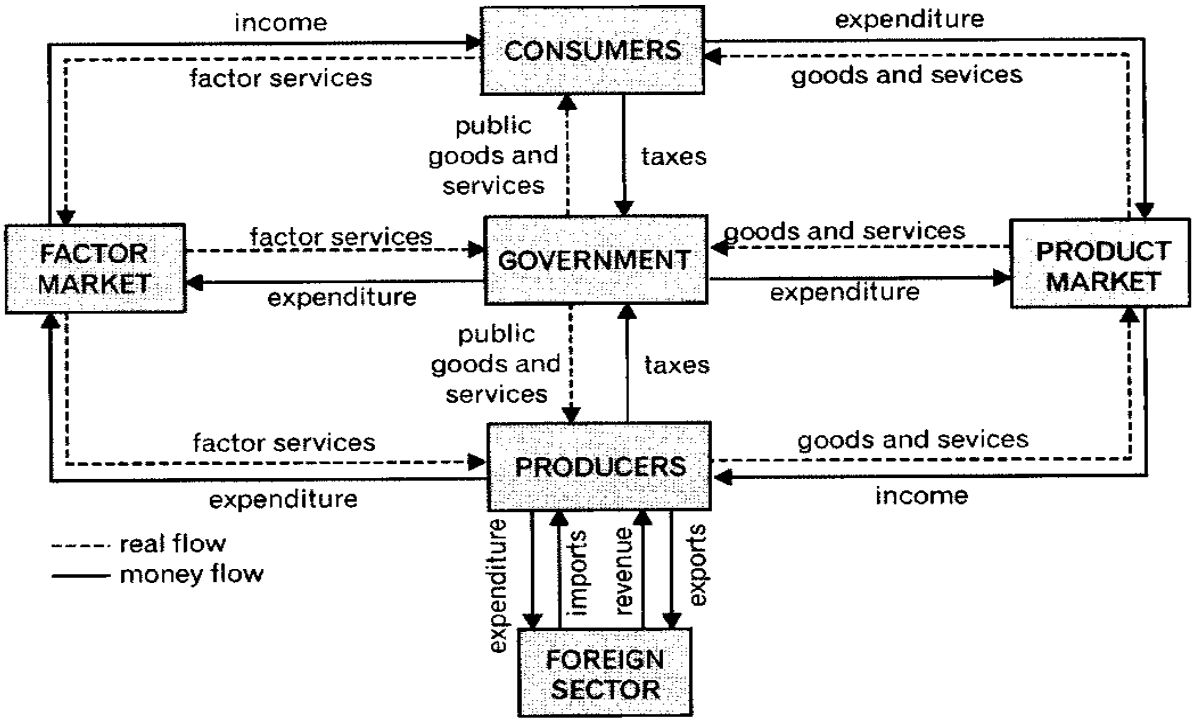

Figure 1.1: The circular flow model

(Enjoy Economics)

Participants:
Households

- There is a flow of money and goods and services between the household sector and business sector.
- Households are the owners of the services of factors of production and they place their factors of production on the market so that it can be bought.
- Households earn income in the form of wages by selling their factors of production to business.

Business Sector

- Business uses factors of production to produce goods and services on which the household sector spends their income
- Businesses place goods and services on the product market which is bought by households to satisfy their needs
- Business receives an income.
- **State / Government**

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- There is a flow of money and goods and services between the household sector and State.
- Household sector provides the state with labour and receive income.
- The state provides the household with public goods and services
- (e.g.) parks, hospitals
- Households pay taxes to the state.
- This is income for the state.

- There is a flow of money and goods and services between the business sector and State.
- The business sector provides the state with goods and services for which the state pays.
- The state provides the business sector with public goods and services
- E.g. Roads, Electricity, harbours, etc.
- Business pay taxes to the state.

Foreign Sector

- There is a flow of goods (imports) to the business from the foreign sector
- Businesses that import these goods, pays for it.
- This will be regarded as expenditure for the business

- There is also a flow of goods (exports) from the business in the country to the foreign sector.
- Businesses export their goods and services to other countries and earn money for it.
- This will be income for the business.

The relationship of the financial sector in the circular flow

- The financial sector consists of banks, insurance companies and pension funds.
- They act as a link between households and firms who have surplus money and others in the economy who require funds.
- The money which households and firms provide to the financial sector is known as savings.
- Businesses can Borrow money from the financial institutions and use it to purchase capital goods.
- This spending on capital equipment by firms is regarded as investment.

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Real flow and Money flow

- Transactions takes place on markets.
- The exchange process has two components, namely

1 **Real flow**: Goods and services and Factors of production.
2 **Money flow**: The earning of money (income) and payments that is made.

Real flow

- Consumers render production factors to producers and government via the factor market.
- Goods and services are supplied by producers via the product market to government and consumers.
- Government provides public goods and services to consumers and producers.
- Producers receive goods and services (imports) form and deliver goods and services (exports) to the foreign sector.

Money Flow

- Consumers earn an income for their production factors via factors market from businesses.
- Business sector earn an income for goods and services via the product market from consumers and government.
- Government earn an income consumers and businesses
- Businesses earn an income for exports from the foreign sector and make payments to the foreign sector for imports.

EQUATIONS

Leakages

- A leakage represents the withdrawal of money from the economic cycle (local economy)
- It does not give rise to a further round of income.
- Domestic purchases on goods and services decrease.
- In an open economy, the leakages are taxes (T), the expenditure on imports (M) and savings (S).

In other words:

L	**=**	**S**	**+**	**T**	**+**	**M**
Leakages	=	Savings	+	Taxes	+	Import expenditure

Injections

- Injections represents the injection of money into the economic cycle (local economy)
- It refers to the flow of any spending which is not derived from income (Y)
- Additional money enters the economy and it increases income
- Domestic purchases on goods and services increase

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- In an open economy, injections are government spending (G), the revenue earned from exports (X) and investment spending (I).

In other words:

J	**=**	**I**	**+**	**G**	**+**	**X**
Injections Income	=	Investments	+	Government expenditure	+	Export

Equilibrium

- The economy is in equilibrium when leakages are equal to Injections.
- In other words

L = J

S + T + M = G + I + X

Disequilibrium

- The economy is in disequilibrium when:

1 Leakages are more than Injections (L > J).
2 Injections are more than Leakages (J > L).

Restoring the equilibrium causes changes to national income.

1. **National Income increase when Injections are more than Leakages.**

J > L

G + I + X > S + T + M

- The amounts of injections which exceed leakages contribute to additional demand.
- This additional demand must be satisfied.
- This causes in increase in the production of goods and services.

2. **National Income decrease when Injections are less than Leakages.**

J < L

I + G + X < S + T + M

- The amount with which leakages exceeds the injections contribute to a decreased demand.
- Demand for goods and services drop.
- Less goods and services are produced.

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- Less income for participants.

DIAGRAM: participants, financial sector and flows

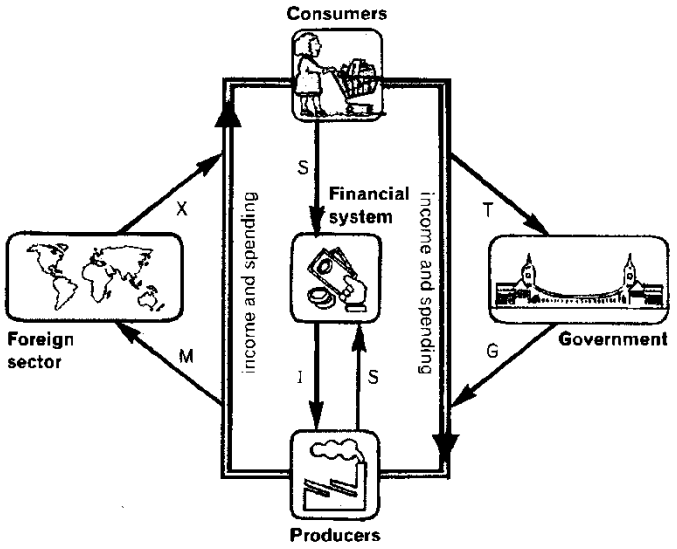

Figure 1.3: The circular flow of income and spending

(Enjoy Economics)

Mathematical and Graph Presentation

- **Income (Y) is equal to Expenditure (E)**

In other words: • Y = E **Y = C + G + I + (X-M) = E = C + G + I + (X-M)**

Mathematical Calculation

Imports (M)	R40 million
Investment Spending (I)	R180 million
Consumption Spending (C)	R 110 million
Exports (X)	R 25 million
Government Spending (G)	R110 million

Calculation of the aggregate Income in the economy.

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

Y = R110 million + R180 million + R110 million + (R25 million – R40 million)

Y = R385 million

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Graphical Presentation

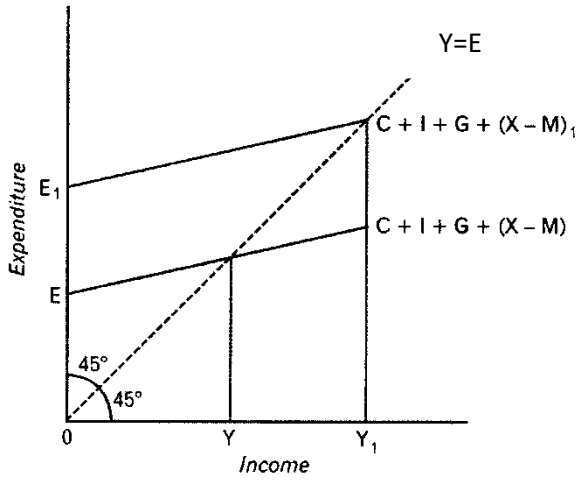

Figure 1.4: Expenditure and income

(Enjoy Economics)

- Expenditure is (E) and it is shown on the vertical axis.
- Income is (Y) and it is shown on the horizontal axis.
- E = Y and it is separated by scale line.
- It halves the 90^0 angle into two equal portions of 45^0

- Aggregate Expenditure (AE) = C + I + G + (X-M)
- This curve shows the amount which consumers, producers, government and foreign sector plans to spend at every level of income.
- It also equals aggregate demand.

- The curve slope upwards and to the right.
- At an income of Y, the AE intersects the vertical axis at E.
- If planned AE increase to E_1
- This means more money is injected into the economy than what are leak out.
- This cause an increase of Y to Y_1.

MARKETS

INTRODUCTION
The circular flow model is a simplified representation of the interaction between the participants of the economy.
Markets coordinate economic activities and determine prices for goods and services

MAIN PART
Goods/Product/Output markets
These are markets for consumer goods and services
In economics a distinction is made between goods and services:
Goods are defined as any tangible items such as food, clothing and cars that satisfy some human wants or need
Buying and selling of goods that are produced in markets
e.g. - Capital goods market for trading of buildings and machinery

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- Consumer goods market for trading of durable consumer goods, semi-durable consumer goods and non-durable consumer goods
- Services are defined as non-tangible actions and includes wholesale and retail, transport and financial markets

Factors/Resources/Input markets
Households sell factors of production on the markets: rent for natural resources, wages for labour, interest for capital and profit for entrepreneurship
The factor market includes the labour, property and financial markets

Financial markets:
They are not directly involved in production of goods and services, but act as a link between households, the business sector and other participants with surplus funds
E.g. banks, insurance companies and pension funds

Money markets
In the money market, short term loans and very short term funds are saved and borrowed by consumers and business enterprises
Products sold in this market are bank debentures, treasury bills and government bonds
The SARB is the key institution in the money market

Capital markets
In the capital market long term funds are borrowed and saved by consumers and business enterprises The Johannesburg Security Exchange is a key institution in the capital market
Products sold in this market are mortgage bonds and shares

Foreign exchange markets
On the foreign exchange market businesses buy/sell foreign currencies to pay for imported goods and services
These transactions occur in banks and consists of an electronic money transfer from one account to another
The most important foreign exchange markets are in London/New York/Tokyo
The S.A Rand is traded freely in these markets
e.g. when a person buys travellers cheques to travel abroad

Flows
Flows of private and public goods and services are real flows and they are accompanied by counter flows of expenditures and taxes on the product market
Factor services are real flows and they are accompanied by counter flows of income on the factor market
Imports and exports are real flows and they are accompanied by counter flows of expenditure and revenue on the foreign exchange market

National Accounts

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The aim of National accounts

- It is to provide a systematic and comprehensive record of national economic activities.

- National income figures are NOT 100% accurate.
- There are many shortcomings or problems when we calculate or determine national income figures.
- Irrespective of all these problems and shortcomings, it still remains important economic statistics.

- South Africa uses the System of National accounts (SNA) - as suggested by the United Nations (UN)

COMPOSITION OF NATIONAL ACCOUNT

- GDP is total value of final goods and services, produced within the boundaries/borders of a country for a specified period.
- GNP is total value of final goods and services produced by the permanent residents of a country for a specific period.

- Another name for GDP is: Gross Value Added

THREE METHODS THAT IS USED TO CALCULATE GDP

- Production method - GDP (P)
- Expenditure method - GDP (E)
- Income method - GDP (I)

1. THE PRODUCTION METHOD (VALUE ADDED APPROACH / METHOD)

- When using this method, the GDP is determined by calculating the sum of the value added at each stage of the production process.
- This method yields GDP at basic prices.
- It is the quantity multiplied with the market or production price.
- To avoid double counting, only added values are taken.
- The value of intermediate goods and services are not included in the calculation.

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Production method	R Billions
Primary Sector	129
Secondary Sector	316
Tertiary sector	908
Gross value added at basic prices	**1 353**
Plus: Taxes on production	174
Less: Subsidies on products	4
Gross domestic product at market prices	**1 523**

2. EXPENDITURE METHOD (APPROACH)

- When using this method, the GDP measure the total value of expenditure (spending) on final goods and services, at market prices, within the geographical borders of the country in a specific period of time.
- The spending of the four spenders in the economy is added together.
- That is spending by households, business enterprises and stat, on consumer goods, services and capital goods.

Expenditure method	R Billions
Final consumer spending on goods and services	968
Final consumer spending by the general government	307
Gross capital formation	278
Residual items	**8**
Gross domestic expenditure	1 545
Exports of goods and services	413
Less: Imports of goods and services	**435**
Expenditure on GDP at market prices	**1 523**

3. INCOME METHOD (APPROACH)

- When using this method, GDP measure the total remuneration earned by the owners of factors of production within the geographical borders of a the country for their services of their factors in the production process over a period of time (year).
- It is based on factor cost.

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Income method	R Billions
Compensation of employees	680
Net operating surplus	454
Consumption of fixed capital	190
Gross value added at factor cost	**1 324**
Other taxes on production	34
Less other subsidies production	5
Gross value added at basic prices	**1 353**
Taxes on products	174
Less subsidies on products	4
Gross domestic product at market prices	**1 523**

- Net operating surplus include the total value of goods and services less the costs.

Costs consist of:

1. Intermediate goods and services
2. The cost of compensation of workers
3. The cost of capital consumption.

NATIONAL ACCOUNT CONVERSIONS

- All countries use national account figures
- **South Africa uses the SYSTEM OF NATIONAL ACCOUNTS (SNA) prescribed by the United Nations.**
- GDP, GDE, and GDI has a great deal to do with the prices we use such as nominal and real prices, prices before or after taxes.
- Indirect taxes and subsidies are the most important determinants of the end values of the circular flow aggregates.

Basic Prices

- Indirect prices and subsidies are related to production process and not individual products.
- With the production method, taxes on production is subtracted as a cost and subsidies on production are added as an income.
- Taxes on production are payroll taxes (SITE and PAYE), recurring taxes on land & buildings, Business licenses.
- Subsidies on production include employment subsidies and subsidies paid to prevent pollution.

Factor Cost

- GDP at basic prices – other taxes on production + other subsidies on production = GDP at factor cost (factor income).

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Market prices

- Conversion of values form:

- **Basic prices to market prices:**
  GDP ate basic prices + Taxes on products – subsidies on products = GDP at market prices.

- **Factor cost to market prices:**
  GDP at factor cost + other taxes on production – subsidies on production = GDP at basic prices + taxes on products – subsidies on products = GDP at market prices.

Net figures

Net operating surplus = surplus after taxes
Net income = income after taxes
Net fixed capital formation = After consumption of fixed capital (depreciation)
Net exports = exports – imports

Conversion of Domestic to National figures

Domestic figures relate to the income and production happening within the borders of the country.
National figures relate to the income or production by the citizens of the country.

E.g.

	R Billions
GDP at market prices	**1 523**
Plus: Factor income earned abroad by South Africans	29
Less: Factor income earned in South Africa by foreigners	60
GNI at market prices	**1 492**

<u>Nominal figures vs Real figures</u>

Nominal figures

⇒ It is also known as nominal or money value.
⇒ It is also known as national product at current price.
⇒ Production is calculated by multiplying the volume of the final goods and services by their prices.
⇒ Inflation has not yet been taken into consideration.

Real figures

⇒ It is also known as national product at constant prices.
⇒ The rate of inflation as expressed by the consumer price index (CPI) has been taken into account.
⇒ Real values of production are the nominal values of national product adjusted for price increase.
⇒ Real national product is the national product express in prices which applied in a certain base year.

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The Multiplier

Definition
The multiplier shows how an increase in spending (injection) produces a more than proportional increase in national income.

- The multiplier must always be more than 1.
- The multiplier works in opposite directions.

THE MULTIPLIER IN A TWO SECTOR MODEL

1 The multiplier derived from the marginal propensity to consume (mpc)

- The size of the multiplier depends on the proportion of any increase in income that is spent.
- The larger the mpc the bigger the multiplier and the smaller the mpc the smaller the multiplier.
- It is the money that stays in the economy.

E.g.

Y = R100 000		
S = R 40 000 =	40%	0,4
C = R 60 000 =	60%	0,6

- **marginal propensity to consume (mpc) = 0,6**
- **marginal propensity to save (mps) = 0,4**

Please note:
- mpc + mps is always = 1
- mps = 1 – mpc
- mpc = 1 - mps

FORMULAE to calculate the multiplier:

Formula 1:

$$\alpha = \frac{1}{1 - mpc}$$

$$\alpha = \frac{1}{1 - mpc} = \frac{1}{1 - 0,6} = \frac{1}{0,4} = 2,5$$

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Formula 2:

$$\alpha = \frac{1}{mps}$$

$$\alpha = \frac{1}{0,4} = 2,5$$

Formula 3:

$$K = \frac{\Delta Y}{\Delta E}$$

- I = R40 000 m and it increase to R50 000 m
- Δ I = R10 000 m: in other word investment in infrastructure and development and building of houses

- Y = R100 000 m increase to R125 000 m
- ΔY = R25 000 m

$$K = \frac{\Delta Y}{\Delta I}$$

$$\frac{R25\ 000}{R10\ 000} = 2.5 = 2½$$

THE MULTIPLIER IN A GRAPH
(Add steps in drawing the graph)

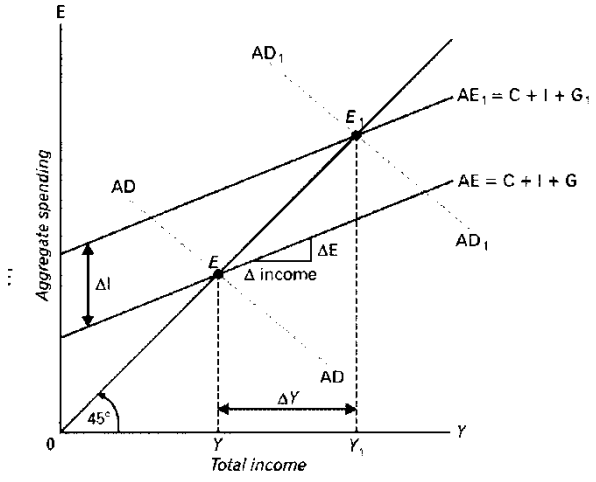

Figure 1.7: An increase in aggregate expenditure

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- **In the above sketch:** **PLEASE CHECK THIS SECTION!**

- E = Original equilibrium.
- Y = Original income.
- AE = Aggregate Demand is illustrated by C + I + G
- Δ I = Δ G
- Investment spending (I) is added.
- Total spending at each level of income (Y) increase with the amount of Investment.
- Government Investment increase
- The AE curve shifts to AE_1
- The multiplier causes that Y increase to Y_1
- The AE curve (Aggregate demand) shift upwards to AE_1
- Planned spending determines aggregate demand.

Explain the Multiplier effect

- The multiplier relates to how much national income changes as a result of an injection or withdrawal such as an investment.
- Initially there is an increase in injections into the economy (investment, government spending or export), which would lead to a proportionate increase in national income.
- The extra spending would have knock-on effect and create even more spending
- The size of the multiplier will depend on the level of leakages.
- (E.g.) assume firms increase investment spending by R1000. This is done by ordering capital goods from domestic firms to the value of R1000.
- Total spending has increased by R1000. Total production has increased by R1000, which also leads to an increase in R1000 in income. The increase in spending = the increase in production which = an increase in income.
- When households earn income (R1000) leakages can occur, through income tax, savings and spending on imports.
- If this amounts to R300, then spending on domestic goods will increase by R700. At this stage the multiplier starts to kick in.

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TOPIC 2: BUSINESS CYCLES

Subtopics:
2.1 Composition and features of business cycles
2.2 Explanations / Causes
2.3 Government policy
2.4 The new economic paradigm (smoothing of cycles)
2.5 Features underpinning forecasting

2.1 Composition and features of business cycles

Concepts

Definition: Business Cycles

- It refers to the phenomenon of successive periods of increasing and decreasing economic activity.

OR

- A business cycle is defined as the recurrent but not periodic pattern of expansion and contraction in the level of economic activity that occurs within a country.

Nature of business cycles
Changes in economic activity are recurring but never exactly the same or of the same magnitude.
Different circumstances and expectations cause consumers and producers to respond differently to initiating forces.
The duration and amplitude of every business cycle will be different.
Business cycles are recognised by the following:
— Two periods namely contraction and expansion;
— Two turning points namely trough and peak;

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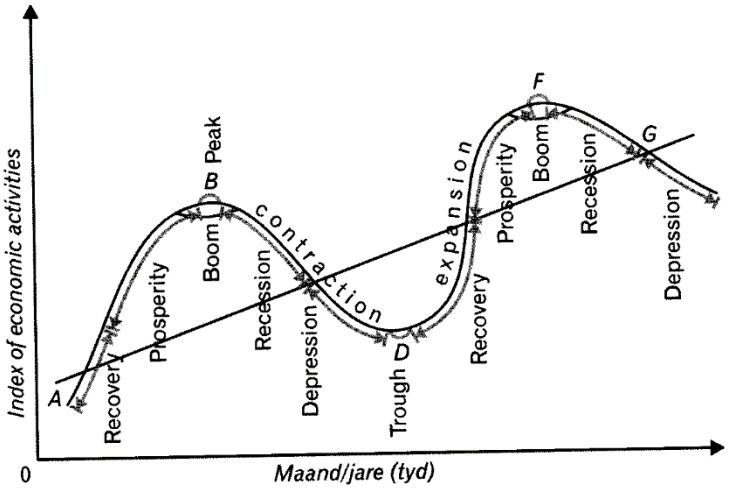
— Four phases, namely recovery, prosperity, recession and depression.

Typical business cycle



- Economic activity clearly shows periods of contractions **(Recession / Depression)** and periods of expansions (**Recovery / Prosperity**) in the economy.
- It is shown by the upward and downward movements of the curve.
- A period where there is a general increase in economic activity is known as **UPSWING.**
- A period of general decline in the economic activity is called a **DOWNSWING.**
- The business cycle oscillates between the upper **(Peak)** and lower **(Trough)** turning points.
- The length of the business cycle is measured from **Peak to Peak** or from **Trough to Trough**.
- The entire period from the **Peak to the Trough** is known as the Downswing.
- The entire period from the **Trough to the Peak** is known as the Upswing.
- The period immediately before and through the upper turning point of the cycle is called the **BOOM.**
- The period immediately before and through the lower turning point is known as the **SLUMP**.

PHASES OF BUSINESS CYCLES

Recovery phase

- There is a greater demand for goods and services
- This lead to an increase in Production
- More jobs are created
- Business confidence rises and there is increased spending by firms
- There is increased economic activity and the country enters into a period of prosperity

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Expansion phase

- There is a great degree of optimism in the economy
- Entrepreneurs borrow more money to buy machines and equipment (Investment)
- Employment levels rise, and this give rise to a rise in salaries and wages and spending increases
- A peak is reached
- There is a larger amount of money in circulation and this leads to an inflationary situation in the economy and lead to a recession.

Recession phase

- A recession phase is when there is negative economic growth rate for two consecutive quarters.
- It is introduced by a decrease in profits of businesses that is the result of inflation and over production
- There is a decrease in production that lead to a drop in employment
- Unemployment increase and this give rise to a feeling of pessimism
- There is a decrease in economic activity, and the economy slows down

Depression phase

- During a depression money is in short supply, leading to a further decline in spending
- There is a negative impact on investment spending
- Economic activity is at its lowest, and a trough is reached
- Cost of production decreases
- This encourages foreign trade and leads to a recovery.

REAL (ACTUAL) BUSINESS CYCLE

An actual business cycle is obtained when the effects of irregular events, seasons and long-term growth trend are removed from the time series data.
Figure 2.2 shows the real GDP of South Africa over a 12-year period displayed in a jagged diagram.
The length or duration of the cycle is measured from trough to trough or peak to peak.
The distance of the peaks and troughs from the trend line is known as the amplitude and shows the severity of cyclical fluctuations.

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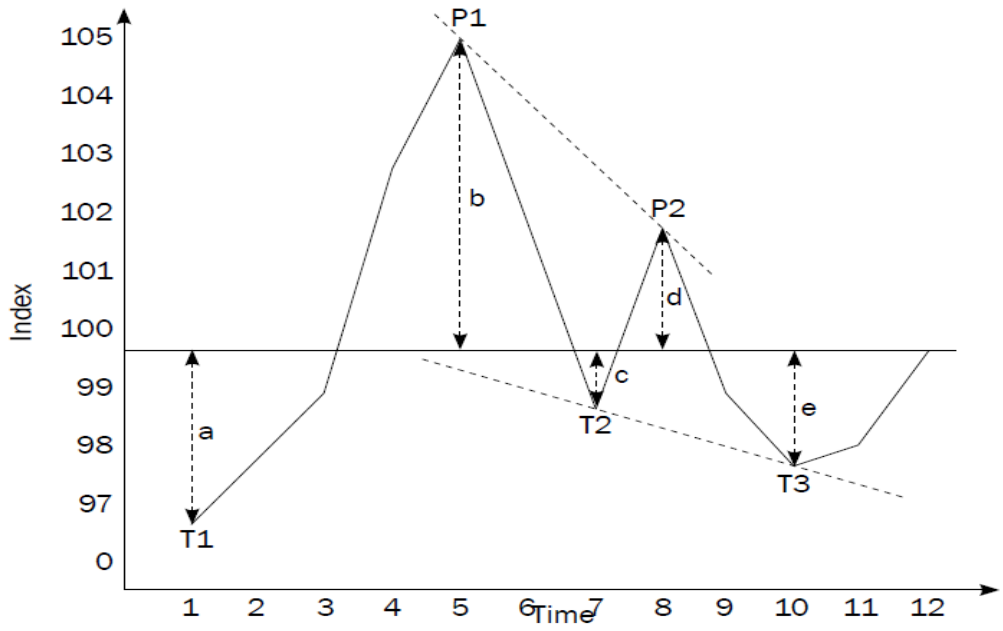

Figure 2.2 The real business cycle

2.2 EXPLANATIONS / CAUSES

EXOGENOUS EXPLANATION (MONETARIST EXPLANATION / REASONS)

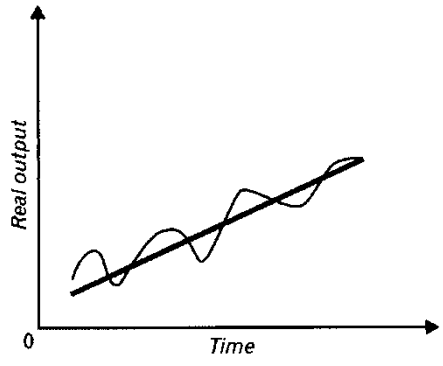

Figure 2.3: The monetarist view of business cycle behaviour

- It is also called the sunspot theory / exogenous approach
- Believe markets are inherently stable.
- Departures from the equilibrium state are caused by exogenous factors (factors outside of the market system).
- When disequilibrium exist in the economy, Market forces (supply and demand) kick in and bring the economy back to its natural state or equilibrium route.
- Government interferences are not part of the normal forces operating in the market.
- Governments should not interfere in the markets.

- The straight bold line indicates the natural growth of the economy.

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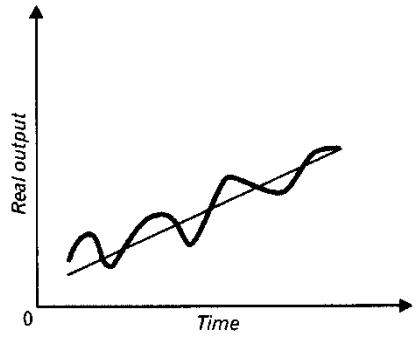
Causes of economic fluctuations

1. are inappropriate government policies
2. undesirable increases and decreases in money supply
3. weather conditions
4. shocks (September 11) severe increases in the price of fuel and wars
5. structural changes

ENDOGENOUS EXPLANATION (KEYNESIAN EXPLANATION)



gure 2.4: The Keynesian explanation of usiness cycles

- Also known as the Keynesian Approach or Interventionists
- Hold the view that markets are inherently unstable
- Level of economic activity constantly tend to be continually above or below its potential
- Price mechanism fails to co-ordinate demand and supply in markets
- Prices are not flexible enough e.g. wages
- Business cycle is an inherent feature of market economy
- The potential growth path is indicated by the thin black line.
- The cyclical bold line around the thin black line indicates the real path of the economy.
- Governments must intervene in the economy processes to smoothen the peaks and the troughs as far as possible.

TYPES OF BUSINESS CYCLES

TYPES OF BUSINESS CYCLE	DESCRIPTION
Business Cycles	**In South Africa ±60 months.** There are clear expansions and contraction periods. During these periods the major sectors of the economy move up and down more or less together. There duration is not fixed.
	They last between 3 to 5 years.

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Kitchin Cycles	This happen because businesses adapt their inventory levels.
Jugler Cycles	**They last 7 to 11 years** Are caused by changes in net investments by business and the government.
Kuznets Cycles	**They last 15 to 20 years.** They are caused by changes in the building and construction industries. They are also called building cycles.
Kontratieff Cycles	**They last 50 years and longer.** They are caused by technological innovation, wars, and discoveries of new deposits, e.g. gold.

2.3 GOVERNMENT POLICY

- Government must intervene in the economy with policies to smooth out peaks and troughs.
- Higher peaks lead to Inflation.
- Lower troughs lead to Unemployment.

- The new economic paradigm, results in the state using monetary policy and fiscal policy to smooth out the business cycle

FISCAL POLICY

- It has been successfully used to stimulate a depressed economy

Stimulate Private sector demand / Private sector demand can becomes too low (at E)

- An increase in unemployment is the indicator.
- The government has **THREE choices** that can lead to an increase in Total Spending and therefore an increase in Demand.

1. **Decrease Taxation (T)**

- Households and producers have more disposable income in their pockets which they can spent on goods and services.
- There is an increases consumption spending which lead to an increase in demand.
- The economy is stimulated and it leads to Employment.

2. **Increase Government Spending (G)**

- Achieved with borrowed money
- Reason: as a result of the deficit on the budget

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- Total spending increase
- Demand increase
- The economy is stimulated and employment increase.

3. Increased government spending and simultaneously decreasing taxes.

- This will have a double strength effect.
- Government spending increase.
- Consumers and producers have more money in their pockets to spend on goods and services.
- Demand increase.
- Employment increase.

<u>Reduce private sector demand / Private sector demand can become too high at (E)</u>

- Inflation is the indicator.
- The government has **THREE choices** that can lead to an decrease in Total Spending and therefore an decrease in Demand.

1.1 Reduced Government spending (G)

- Unspent money is preserved (Frozen)
- Total spending decrease.
- Demand decrease.
- Inflation will decrease.

1.2 Increased Taxation

- Tax income is preserved (frozen).
- Consumers and producers have less money in their pockets to spend on goods and services.
- Demand decrease.
- Inflation decrease.

1.3 Reduced Government spending and simultaneously increasing taxation

- This will have a double strong effect.
- Government spending decrease.
- Consumers and producers have less money to spend on goods and services.
- Demand decrease.
- Inflation decrease.

<u>MONETARY POLICY</u>

- Monetary policy uses **Interest rates and Money supply** too expands or contract aggregate demand.
- Large increases in money supply lead to inflation
- Monetary policy can be utilised more effectively to dampen an overheated economy with severe inflationary pressures.

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Monetary policy instruments:

1. Interest Rates
2. Cash reserve requirements
3. Open market transactions
4. Moral Persuasion
5. Exchange rates

1. **Interest Rates**

Overheated economy / Boom – Increase interest rates
Decrease Money supply

- This will make credit more expensive and reduce and discourage consumer credit.
- Demand will decrease.

Recession / Slump - Decrease Interest Rates
Increase Money supply

- This will make credit cheaper and it will increase and promote consumer credit.
- Consumer Demand will increase.
- Stimulate the economy

2. **Cash reserve requirements**

- Banks are required by law to keep cash reserves at the SARB.
- SARB can increase or decrease these cash requirements.

Overheated economy / Boom

- An increase in the cash reserve requirements - Decrease the supply of capital to commercial banks, so that banks have less money to lend to consumers.
- Demand will decrease.

Recession / Slump

- A decrease in the cash reserve requirements – Increase in the supply of capital to commercial banks, so that banks have more money to lend to consumers.
- Demand will increase.

3. **Open market transactions**

- The SARB can directly increase or decrease the amount of money in the economy.

Overheated Economy / Boom

- If they want to reduce the supply of money in the economy, they can sell government bonds / securities on the open market.

Recession / Slump

- If they want to increase the supply of money in the economy, they buy government bonds / securities on the open market.

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4. **Moral persuasion**

- The SARB can enter into discussion with banks, to
- Morally persuade them to limit credit and increase the cooperation to fight inflation

5. **Exchange rate policy**

➢ Central banks (SARB) can use the following ways to stabilize exchange rates.

i. Free floating
ii. Control (Managed) floating

Free floating

1. Demand and supply determine the price of foreign currency.

2. **Controlled (Managed) floating**
3. The central bank interferes in the foreign exchange markets by buying and selling the currency in order to stabilize it.

THE NEW ECONOMIC PARADIGM (SMOOTHING OF CYCLES)

➢ In real life circumstances, governments must strive towards economic growth.
➢ They must do it irrespective if markets are inherent stable or inherent unstable.

➢ Governments learned to be pragmatic.
➢ They apply policies that are not extreme but it must be transparent.

➢ Economists are convinced that it is possible for production output to rise at a high rate for an extended period of time, without being tripped by supply constraints and without the pressure of inflation.
➢ This paradigm lies in demand-side and supply-side policies.

(A) DEMAND SIDE POLICY

➢ Monetary policy and Fiscal policy focus on Aggregate Demand.
➢ Demand side policy is relying on Aggregate Demand only.
➢ Demand side policy does not render ideal results on its own.
➢ Growth is often cut short because of all sorts of bottle necks that develop in the economy.
➢ Bottle necks such as, inflation, balance of payment s deficits, and shortages of skilled labour, etc.

➢ It is clear that Aggregate Supply also needed to be managed.
➢ It the cost of increasing production is flexible; a greater real production output can be supplied at any given price level.

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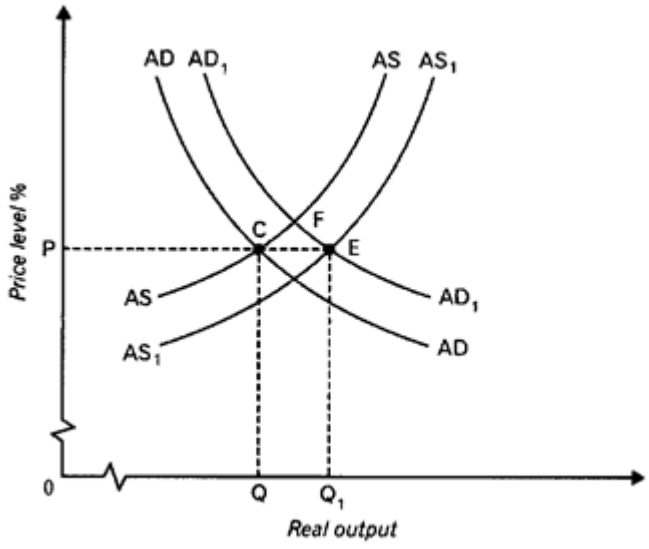
1 Inflation



- **Aggregate Demand (AD)** is the total spending on goods and services in the economy.
  AD = C+I+G+(X-M).

- **Aggregate Supply (AS)** is the total quantity of goods and services supplied at every price level.
- It is the total value of goods and services produced in the economy in a given period.

- At Point C, Aggregate Demand (AD) and Aggregate Supply (AS) are in equilibrium.
- When Aggregate Demand (AD) increases in the economy, it shifts the Aggregate Demand (AD) to the right AD_1.
- If the Aggregate Supply curve responds promptly and increase, the Aggregate Supply (AS) shifts to the right to AS_1.

- **At Point E t**he new equilibrium is formed – The new AD_1 and AS_1 intersect at Point E.
- At this point a larger production output becomes available (Q – Q1), without any price increases.
- This occurs over the long-term – because aggregate Supply adjust easier over long-term.

- Supply does not adjust easy over the short term.
- **Over the short-term:**
- When Aggregate Demand (AD) increase, it shifts to the right (AD_1) and when Aggregate Supply (AS) remains unchanged, the AD_1 intersect the AS at point F.
- At Point F a new equilibrium is formed.

- At **Point F** real production increase but the price also increases.
- Inflation increase.
- To solve this problem, a situation must be created where supply is more flexible.

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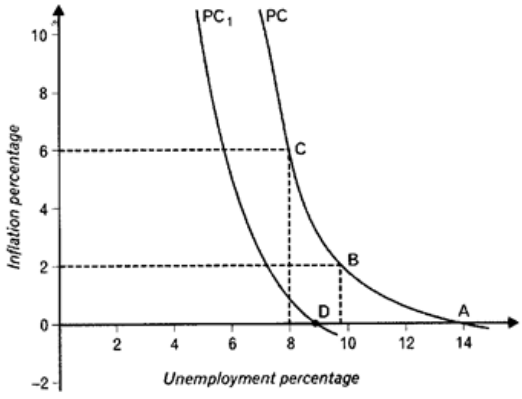
2 Unemployment

- Unemployment is illustrated by the **Philips Curve (PK-curve)**
- **The Philips curve illustrates the relationship between Unemployment and Inflation.**
- As unemployment decrease, Inflation Increased and vice versa.



- PK-curves indicate the original situation.
- At Point A the PK-curve intersects the x-axis.
- This indicates the Natural unemployment rate, 14%.

- **Point A** indicates the natural employment level.
- At this point unemployment is 14% with no inflation pressures (0% inflation)

- A movement left from Point A to Point B will cause a decrease in unemployment (increase in employment) and an increase in inflation.

- **At Point B**
- If economic growth occurs and it causes a decrease in unemployment to 10%, it means the more people will get a job.
- Wages increase (people have more money) and this will lead to an increase in inflation up to 2%.

- **At Point C**
- If unemployment decreases to 8% - this will lead to an increase in inflation to 6%.
- This increase in inflation is caused by an increase in wages of people because they have more purchasing power.

- If unemployment decrease, then inflation will increase
- The government decides the amount of unemployment they will accept for less inflation.

- **Supply side measures can be used to shift the PK curve to PK_1.**

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- Supply side measures are:

  1 Improved education
  2 Effective training
  3 Fewer restrictions on migration of skilled labour.

  - If the PK curve shifts to the left (PK_1), the natural level of unemployment will decrease from 14% to 9%.
  - It means that unemployment is lower at 9% and the inflation rate is 0%.

(B) SUPPLY SIDE POLICY

1 Reduction of cost

- **Infrastructure services**: Are supplied by the government. It contributes substantially to the cost of businesses.

- **Administrative cost**: Inspections, reports on the implementation of laws, Regulations, all contribute to increased costs and expenditure of businesses.

- **Cash incentives:** Subsidies can be given to businesses when they want to establish their business in neglected areas where unemployment is high.

2 Improving the efficiency of inputs.

- **Tax rates:** High personal income tax is disincentives to work. Higher company taxes are disincentives to investment.

- **Capital consumption**: Replacing of capital goods create opportunities to keep up with technology and to compete with their competitors.

- **Human Resources**: The quality of labour of people increased the efficiency of businesses. The quality human resources are created by improving health care, education, Training schemes, etc.

- **Free advisory services**: These are services that promote exports. E.g. Research, agricultural services, Statistical information, etc.

3 Improving the efficiency in markets

- **Deregulation**: It is the removal of laws and regulations and all other forms of government control to make the markets freer.

- **Competition**: It creates the establishment of new businesses. It also attracts foreign investment.

- **Leveling of the playing fields**: Private sector businesses cannot compete with the public sector.
  Public enterprises have legislative protection and they are supported by the government.
  Privatisation are important.

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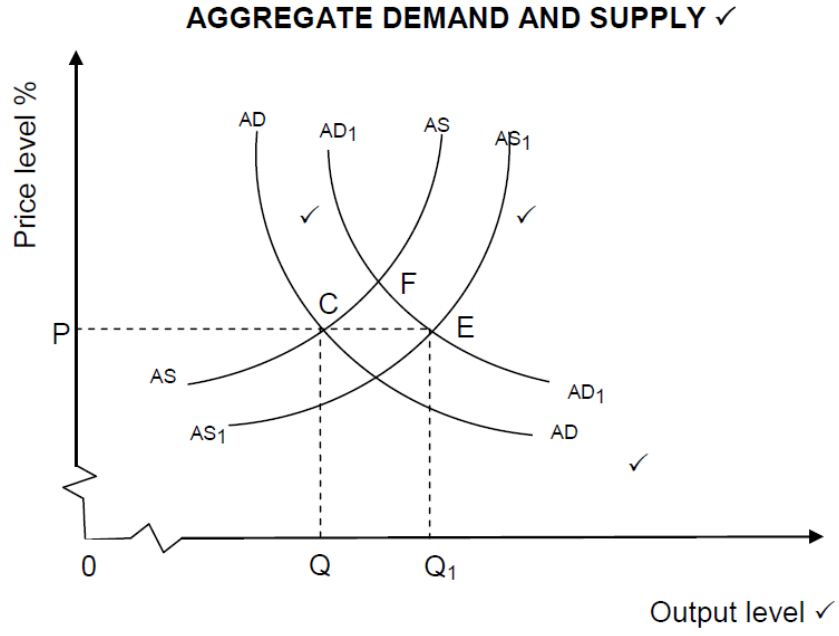
Effect of demand-side and supply-side policies using a graph (aggregate demand and aggregate supply)



2.5 FEATURES UNDERPINNING FORECASTING BUSINESS CYCLES

Definition of Forecasting
Forecasting is the process of making predictions about changing conditions and future events that may significantly affects the economy.

1. **INDICATORS**

Leading economic indicators

- These are indicators that change before the economy changes
- They give consumers, business leaders and policy makers a glimpse of where the economy might be heading
- When these indicators rise, the level of economic activities will also rise in a few months' time.
- E.g. job advertising space/inventory/sales ratio

Lagging economic indicators

- They do not change direction until after the business cycle has changed its direction.
- They serve to confirm the behaviour of co-incident indicators.
- E.g. the value of wholesalers' sales of machinery if the business cycle reaches a peak and begins to decline then we are able to predict the value of new machinery sold

Co-incidental economic indicators

- They simply move at the same time as the economy moves
- It indicates the actual state of the economy.

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- E.g. value of retail sales.
- If the business cycle reaches a peak and then begins to decline, then the value of retail sales will reach a peak and then begin to decline at same time

Composite indicators

- It is a grouping of various indicators of the same type into a single value.
- The single figure forms the norm for a country's economic performance.

2. LENGTH of a cycle

- It is measured from peak to peak or from trough to trough.
- It is the number of years it takes for the economy to get from one peak to the next.
- It is useful to know the length of the cycle because the length tends to remain relatively constant over time.
- If a business cycle has the length of 10 years it can be predicted that 10 years will pass between successive peaks or troughs in the economy.
- Longer cycles show strength and shorter cycles show weakness
- Cycles can overshoot

3. AMPLITUDE

- The amplitude refers to the vertical difference between a trough and the next peak of a cycle.
- The larger the amplitude the more extreme changes may occur
- e.g. during an upswing unemployment may decrease from 20% to 10 %
- (i.e. 50 % decrease)
- A large amplitude during an upswing indicates strong underlying forces – which result in longer cycles

4. TREND LINE

- It represents the average position of a cycle.
- Indicates the general direction in which the economy is moving.
- An upward trend suggests that the economy is growing.
- Trend line usually has a positive slope, because production capacity increases over time.

5. EXTRAPOLATION

- It is when forecasters use past data e.g. trends and by assuming that this trend will continue, and then they make predictions about the future
- E.g. if it becomes clear that the business cycle has passed through a trough and has entered into a boom phase, forecasters might predict that the economy will grow in the months that follow
- It's also used to make economic predictions in other settings e.g. prediction of future share prices

6. MOVING AVERAGE

- It is a statistical analytical tool that is used to analyse the changes that occur in a series of data over a certain period of time
- E.g. the moving average could be calculated for the past three months in order to smooth out any minor fluctuations

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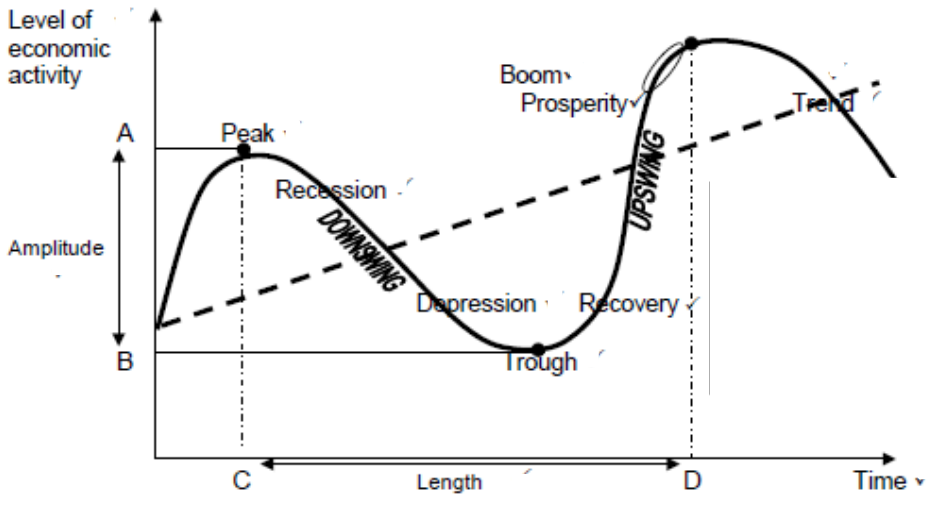
- They are calculated to iron out small fluctuations and reveal long-term trends in the business cycle
- **Calculating of moving averages**

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
5	6	7	5	8	9	11	12	14	10
$= \frac{(5+6+7+5+8)}{5} = 6.2$									
	$= \frac{(6+7+5+8+9)}{5} = 7.0$								
		$= \frac{(7+5+8+9+11)}{5} = 8.0$							
			$= \frac{(5+8+9+11+12)}{5} = 9.0$						
				$= \frac{(8+9+11+12+14)}{5} = 10.8$					
					$= \frac{(9+11+12+14+10)}{5} = 11.2$				

DIAGRAM



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TOPIC 3: PUBLIC SECTOR

SUBTOPICS:

1.1 The composition and necessity of the public sector

1.2 Problems of public sector provision

1.3 Objectives of the public sector

1.4 Budgets

1.5 Fiscal policy (Including Laffer curve)

1.6 Public sector failure

CONCEPTS related to the public sector:

Mind-the-Gap **Enjoy Economics**	

3.1 Composition

Levels of Government

General Government Consist of:

Central Government
Provincial Government
Local Government

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Central Level

Manage and govern the country
Head is the President
Make strategic decisions

Provincial Level

Manage and administer the Province
Nine Provinces
Head is the Premier

Local Level

Responsible for service delivery in the community
Head is Mayor

Public Corporations (State owned enterprises) Parastatals

Eskom
Transnet
Denel

<u>Necessity of the Public Sector</u>

To supply public goods

Goods are mostly in the form of services
Government use policies such as taxation and government spending to supply it

Public goods and services consist of:

Community Goods E.g.: Defence, Police, Street lightning

It is characterised by Non **Excludability**
Everyone can use it irrespective if they are prepared to pay a price for it or not

It is characterised by **Non rivalry**
The use by one does not exclude the use by another person.

Collective goods e.g. Parks, Beaches
Free Riders or people who do not want to pay can be excluded by levying fees.
Can be excluded

Merit goods e.g. Health, Education
Merit goods benefit people more than private goods
If the public sector does not provide it, then there will be a undersupply.
It generates little income that is why the private sector is not keen in providing it.

Non-Merit goods e.g. Cigarettes
It is harmful to society
Government impose taxes and regulations to discourage consumption

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To conserve resources

The environment consists of resources that no one owns but everyone can use it free of charge.
E.g. Oceans for fishing, Air that we breathe, the natural scenery

Governments must intervene to protect the environment
Governments must intervene in the economy by making Laws and setting up legal structures to protect the economy.

E.g. Against:
Poaching of Lobster and Abalone sources
Extensive fishing
Air pollution
Poaching and killing of the rhinos

To manage the economy

The government manage the collective interest of its people
The government create the social and legislative environment in which businesses and individuals peruse their own interests.
Governments apply suitable and credible economic and other policies in order to achieve Internationally Respected objectives.

The government must be able to achieve its objectives, namely:

- To ensure Job creation
- Price stability
- Economic Growth
- Stability of the Exchange Rate
- Economic Equity (Justice)

3.2 <u>Problems of Public Sector Provisioning</u>

1. **Accountability**

- Accountability means that it is expected of a person to explain his/her decisions, actions and expenditure.
- People wants to sure about the amount and quality of goods and services they receive in return for the taxes they pay.
- State enterprises are not directly accountable to the tax payers
- People want to be sure that the government officials do not abuse their position and power through corruption, nepotism and incompetence
- State officials does not always act on behalf of the public - Many times they act in own interest - benefit themselves
- State officials do not have to set profit or loss statements

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DIFFERENT FORMS OF RESPONSIBILITY

Ministerial Responsibility

- Minister of Departments are the spokespersons for their departments
- Each department has a Director-General: Responsible for departments

Parliamentary Questioning

- Members of the National Assembly may pose questions to Ministers
- Ministers are compelled to respond to these questions
- Portfolio committees monitor individual government departments and make
- recommendation to Parliament
- Members of the public are invited to participate in public hearings

Treasury control

- National treasury is responsible for the expenditure control of the public sector
- Minister of Finance is the chairperson of the Treasury committee

Auditor - General

- Is the watchdog over the expenditure of public finance
- Report annually on each department
- Report to parliament
- They point out unauthorized and fraudulent spending

2. Efficiency

- Accountability does not guarantee efficiency
- Inefficiency means that goods and services are not produced in the desired quantity and quality.
- Public goods and services are efficiently produced when the Pareto efficiency is achieved
- Pareto efficiency: It is impossible to make someone better off without making the other worse off.
- Objectives such as Housing, Health, Job creation etc. are not always possible because of limited resources and serious structural weaknesses in the economy

The following contribute to inefficiency

Bureaucracy

Too much rules and procedures (Red Tape)
Officials focus on rules and the quality and quantity of services are neglected
They are sometimes insensitive to the needs of the people
Policies take a long time to be implemented

Incompetence

Lack of skills or ability to do a task successfully
As a result of improper qualifications, lack of training and lack of experience

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Corruption

Government officials sometimes use their position for personal gain
Taking bribes, commit fraud and resort to Nepotism
Trade Unions and businesses influence government to distribute resources so that they benefit at the country's expense.

3. **Assessing of Needs**

- In the private sector, supply and demand determine the prices of goods and services
- These forces of demand and supply also communicate the needs of consumers
- State Enterprises are not run by the forces of demand and supply
- Government provide goods and services according the needs of people
- It is difficult for government enterprises to determine the needs, that is why public goods and services are sometimes over or under supplied

4. **Pricing policy**

- The state does not operate within the market system of
- demand and supply
- When price is determined, the following must be taken into account:
  Economic considerations, Political considerations, Social Considerations,
  Public opinion

- Prices can be over value or under valued

Free services:

- Certain services rendered by the government are free of charge to certain groups while other groups have to carry the burden.
- E.g. Primary Health services

User tariffs

- People pay for the use of these services, e.g. Television licence

Subsidies

- The government partially covers the cost of the service or product
- e.g. The public pay less for bread
- **Direct subsidies**: A portion of the cost is covered
- **Indirect subsidies**: Accumulated losses are written off e.g. SAA

5. **Semi State Enterprises (SSE) (Parastatals)**

- (Government Controlled Enterprises) GCE are created as a result of Nationalisation because of the necessity for service delivery
- E.g. ESCOM, SABC, ISCOR, TELKOM, Transnet

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Reasons for existence

- To reduce the dependence on other countries
- To provide essential services of national importance
- To provide essential infrastructure
- Private sector does not have sufficient funds to set up these industries
- Many SGE obtained exclusive rights and later become Monopolies
- Some of these SGC encountered large losses and it placed a huge financial burden on the government
- Some of these SGE function's very inefficient and it put pressure on the economy

6. Privatisation

Description

- Refer to the transfer of functions, activities and ownership from the public sector to the private sector.

Aims of Privatisation

- To reduce the relative size of the public sector
- To stimulate the growth of the Private Sector
- To improve the overall efficiency and performance of the economy
- To broaden the economic base of the economy so that tax levels ca be reduced

Arguments in favour

- Provides additional funds to the government
- Broaden the tax base which lead to an increase in government income
- Improve the efficiency of the economy
- Attract foreign investment
- Lessen pressure on government budget
- Promote Black economic empowerment
- Reduce personal income tax and government debt

Argument Against

- Public monopolies are replaced by Private Monopolies
- People lose their jobs - Contribute to unemployment
- Ownership of assets are transferred - no capital investment

Advantages

- Improve the efficiency of businesses
- Broaden tax base
- Attract foreign investment
- Lessen the pressure on the government budget
- Provides additional funds to finance projects

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Nationalisation

- Is the opposite of Privatisation
- It refers to the transfer of functions, activities and ownership from the private sector to the public sector.

Regulation

- It refers to the deliberate actions to put laws, regulations and prescriptions in place to regulate economic activities.

Deregulation

- It refers to the deliberate action by government to remove all unnecessary restrictions placed on economic activities by law, regulations and prescriptions.

3.3 Macro economic objectives of the government = GEAR (Growth, Employment and Redistribution Policy)

1. **Economic Growth**

- Refer to an increase in the production of goods and services
- Measured in terms of Real GDP
- For economic growth to occur, the Economic growth rate must be higher than population growth.
- Growth and development in a country benefit its citizens because it often leads to a higher standard of living.

2. **Full Employment**

- It is when all the people who wants to work, who are looking for a work must be able to get a work.
- High levels of employment are the most important economic objective of the government
- The unemployment rate increased over the past few years
- Informal sector activities must be promoted because it is an area where employment increases.
- GEAR as a strategy was implemented to create a positive climate that was conducive to employment creation by the private sector.

3. **Exchange Rate Stability**

- The economy must be managed effectively and effective Fiscal and Monetary policy must be used to keep the exchange rate relatively stable.
- Depreciation and Appreciation of the currency create uncertainties for producers and traders and should be limited
- These uncertainties must be limited
- The SARB changed the Exchange rate from a Managed floating to a Free floating exchange rate

4. **Price Stability**

- Stable price causes better results in terms of job creation and economic growth

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- The SARB inflation target is 3% - 6% and they are successful in keeping inflation within this target
- Interest Rates, based on the Repo Rate are the main instruments used in the stabilisation policy
- The stable budget deficit also has a stabilizing effect on the inflation rate.

5. Economic Justice

- Redistribution of income and wealth is essential.
- South Africa uses a Progressive Income Tax system - Taxation on profits, Taxation on Wealth, capital Gains Tax and taxation on spending are used to finance free services.

Free Social Services

- Basic education
- Primary health Care
- To finance Basic economic services:
  E.g. Cash Grants to the poor, e.g. Child Grant and
  E.g. Cash grants to vulnerable people, e.g. Disability Grants
- Progressive taxation means that higher income earners pay higher taxation

3.4 <u>Budget</u>

1. <u>Budget / Main Budget</u>

Defn: It is a document with expected income and projected expenditures

- Budget is the most important item on the economic calendar
- Main Budget is read in Parliament during February
- By the Minister of finance: Read it in Parliament
- Authorised in Parliament: Sign by President: Becomes Law
- Financial year of the Government: 1 April tot 31 March the following year
- Main source of income for the State is Income Tax
- The Budget reflect the Functional division

2. Importance of the Budget

- Long term planning: Departments need to know before the time of their future involvement
- Dominant role of the Government: Certain sectors need to know in advance so that they can adapt their capacity
- Minister of Finance finalises the budget
- Does it help the Cabinet and the Financial and Fiscal Commission (FFC)?

There are THREE considerations when setting up the budget

Financial Considerations:

- Cabinet decides whether taxes have to be increased or decreased

Economic Considerations:

- Cabinet must know the needs or requirements in the economy. Taxes and spending must meet these requirements

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Political Considerations:

- Political parties use the budget to implement their policy
- Uses the budget to reach their Macro Economic Policy

3. **Different Types of Budgets**

Medium Term Budget Policy Statements (MTBPS)

- The Minister of Finance deliver it the last week of October
- The Minister of Finance inform Parliament of any changes that occurred since February in the economy

Medium Term Expenditure framework (MTEF)

- More detailed
- It consists of a 3-year rolling expenditure and revenue projections for the national and provincial governments, presented against the backdrop of economic and fiscal goals and prospects for the economy.

Conditional grants

- To promote spending on National Priorities
- Compensate provinces for providing services beyond provincial boundaries
- For compliance to National Norms and standards

Specific Grants for

- General Academic hospitals
- Land care
- School feeding
- HIV-Aids
- FET- School support

Municipal budget

- Municipalities are entitled to impose taxes on property
- They may impose a use charge for, electricity, water, and waste removal

Equitable share from the Government

Basic services: Water
Sanitation
Electricity

Development needs: Street and street lightning
Previously deprived areas must be serviced

Institutional needs: Cost for administration and management

Fiscal capacity: Capacity to generate or raise money

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Conditional share

Infrastructure: Roads
Water
Electricity connections

Capacity building and restructuring: Financial management
Systems implementation

The Provincial Budget

- Are the main beneficiaries from tax income collected by the government?
- Money paid to Provinces by Government are based on:
  - Equitable share: Based on the demographic profile
  - Conditional grants: Mainly for spending on infrastructure

- Each province setup its own budget: Present it to the Provincial Legislator
- Financial year of Provinces: 1 April tot 31 March the following year
- Reflect the Functional classification

Equitable Share divide income into:

- Education 51%: Based on the size of the school age population and the amount enrolled for the last 3 years
- Health 19%: Is based on the portion of population who does not have access to basic medical services
- Basic Share (15%): Province's share of total population of the country
- Institutional component (5%): Divided equally amongst provinces
- Poverty Component (3%): Based on the number of people who are poor in the province
- Economic component (1%): Determine by the Province's contribution to GDP of the country

Provinces may levy the following

- Taxes
- Duties and Grants
- Fines
- Surcharges

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Discretion

The deficit rule: Shortages on the budget should not be more than 3% of GDP.
The Borrowing rule:
Borrowing must only be used for capital expenditure
Current expenditure should be financed by current income
The debt rule: Public debt and guarantees should not exceed 60% of nominal GDP
Analyse current main budget relating to:

- **Taxes**
- **Sources of income**
- **Expenditure allocation**
- **Personal income tax tables (tax calculations)**

Identify how social rights are embedded in the budgets of the South African government.

3.5 FISCAL POLICY
Fiscal policy is implemented through the Budget

1. **Description**

It any attempt by the State to influence the economy with changes in government expenditure and taxes to achieve economic and social goals.

2. **Features**

It is goal bound

- Central government determine the economic and social goals
- It takes place through the budgetary process
- The budget is used to realise these goals
- Provincial and local governments execute the approved budget

It is demand biased

- Fiscal policy is the main demand -side policy that is used
- Elements of fiscal are also used to realise supply-side objectives
- e.g.: The government improve infrastructure
  Taxation is used as an incentive
  Human resource development is subsidised

It is cyclical

- Businesses has a direct effect on fiscal policy
  During an upswing:
  - Profits increase
  - Aggregate demand and expenditure increase
  - Income tax and profits increase
  - Taxation on goods and services increase
  - Government income increase
  - Government has more money to spend

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3. **Main variables**

- Instruments of fiscal policy is taxation and government spending
- When Income and expenditure is equal = a balanced budget
- When Income is more than expenditure then you will get a budget surplus
- When expenditure is more than income you will get a deficit

Government Spending

- Government spending are classified in 2 formats:
  Functional: Social Services, Defense, Economic services, Interest
  Economic: Current Payments, Transfers and Subsidies, Payment for capital assets
- Government spend money to provide public and merit goods and services
- free of charge or at a subsidies price
- Pay interest on government debt
- To redistribute income
- To influence aggregate demand and supply

Taxation

Government impose tax for the following reasons

- To raise income to cover expenditure
- To discourage the use of demerit goods
- To convert external cost into private cost: To prevent pollution
- To discourage imports
- To redistribute income
- To influence the level of aggregate demand and Aggregate supply

State Debt:
Main Budget must always balance:
If there is a deficit, loans are made to balance the budget
If there is a surplus, then the money is used to pay of state debt

- Loans add to loan debt: also known as public debt

Effects of Fiscal policy

- During a upswing fiscal policy contracts
- During a downswing fiscal policy expands

Income Redistribution

Progressive taxation

- Ensure a more even distribution of income
- Higher income groups pay more taxation s lower income groups

Regressive taxation

- Cause an uneven distribution of income
- Lower income groups pay more taxes as higher income groups

Proportional taxation

- Income distribution is unchanged
- Everybody pays the same tax rate

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- Spending on social goods, security goods and welfare payments supplement income of poor more than the rich

Consumption

- Direct and Indirect taxation influence peoples spending patterns
- Direct taxation decreases disposable income
- The real effect on consumption will depend on the marginal propensity to consume and the level of savings
- Very little savings cause that direct taxes will decrease consumption
- The income multiplier kicks in when government spending increases due to higher levels of employment, higher income and consumption spending

4. **Price Level**

- Direct taxation reduces inflationary pressures because aggregate demand decreases
- Result in Cost Push because workers demand higher wages
- An increase in indirect taxation cause an increase in the general price level
- Inflationary and deflationary spending depends on the availability of production factors

5. **Incentives/Disincentives**

Taxation

- Direct taxation (income and company tax) reduce incentives to work, save, invest and take risks.
- High and progressive income tax rates discourage people to enter the labour market, to accept promotions and to work long hours

LAFFER CURVE

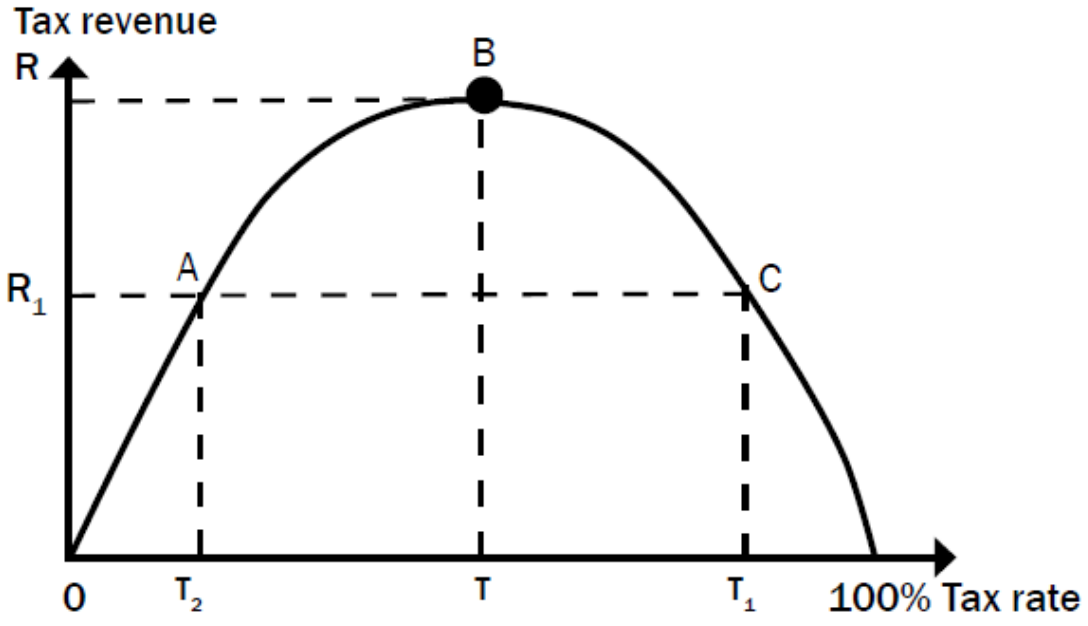

Figure 3.1 The Laffer Curve

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- Show the relationship between tax rates and tax income collected by the government
- The average Tax rate is 0 and the Income is 0
- If the tax rate increase above 0 then the tax revenue of the State will also increase to a certain point
- The curve has an upward slope: The curve slopes upward then peak at (t)
- At the peak tax revenue is R and Tax rate is t: At this point the State earn maximum revenue from taxation
- If the Tax rate increase from t to t1: Production decrease and Tax revenue decrease from R to R1

- Reasons:
  - Less people want to work as a result of high taxation
  - Some people will evade and others will avoid the payment of taxation
  - If taxation is 100% then nobody will want to work, because ALL income goes to the State
  - If Taxation decrease to t2:
    - Lead to less tax evasion
    - Lead to less tax avoidances
    - Encourage people to work harder / Save more / Invest more
  - Economist use this to justify a reduction in the level of taxation
  - The turning point of the Laffer curve is the same for all countries
  - There is evidence that the turning point for all countries are below t.

6. **Discretion**
   The Minister of Finance use his discretion on fiscal decisions e.g. how much to reduce income tax. Rules are:
   - deficit rule: not to exceed 3% of GDP
   - borrowing rule: only for capital expenditure
   - debt rule: not to exceed 60% of nominal GDP.

3.6 PUBLIC SECTOR FAILURE

Description

- It is when the public sector fails to manage an economy and the resources under its control optimally

Key features

Ineffectiveness

Public sector is failing when the following are prevalent:
— Missing targets, example regarding inflation, growth and employment.
— Incompetence in using monetary and fiscal policy and harmonising them.

Inefficiencies

Wasting resources, such as taxpayers' money.
These may occur in relation to protection and social, economic and administrative services for which money is voted in the budget.

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Reasons for Public Sector Failures

Management Failures

- Politicians tend to promote policies and continue to spend money on projects as long as they can get votes in return
- These policies might involve the inefficient allocation of resources

- Many Public sector entities lack capacity because of a lack of skills
- This means that funds are often not spent and must be returned to the treasury

Apathy

- Successful public production relies on long-term accountability
- If not addressed properly, then it could lead to inefficiency / corruption / violence and poor service delivery

Lack of Motivation

- Frontline workers rarely receive incentives for successful service delivery
- There are little or no stipulations for quality and quantity, effective and productive service delivery and this lead to limited service delivery, low quality and high costs.

Bureaucracy

- Individuals and enterprises influence government to act in their interest
- e.g. Profitable contracts, favourable regulations, ignorance, personal and hidden agendas.
- These are questionable motives and promote the welfare of certain groups at the expense of the others.

Politicians

- Those who aim is to be re-elected and who pursue vote-maximising strategies to secure or retain their political offices.
- Such politicians have a short-term horizon which is limited to the date of the next election

Serious structural weaknesses in the economy / Privatisation

- This can result in social goals not been attained

Special interest groups

- Attempts by interest groups such as farmers or organised labour to influence government to their own advantage.

Effects of Public sector failure

Allocation of resources

- When the government fails an optimal allocation of resources is not achieved and consequently resources are wasted.

Economic instability

- Government failure can lead to macroeconomic instability. Government is

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unable to use fiscal policy effectively.

Distribution of income

- If government fails to use the tax system effectively then there will be an unfair distribution of income in the economy.

Social instability

- When the public sector fails to deliver the required social services to the poor, the economy can be destabilised.

TOPIC 4: FOREIGN EXCHANGE MARKETS

SUBTOPICS:

4.1 The main reasons for international trade
4.2 The Balance of Payments
4.3 Corrections of Balance of Payments surplus and deficit
4.4 Foreign exchange markets
4.5 The establishment of foreign exchange rates

4.1 The main reasons for international trade

Definition of international trade
International trade is exchange of goods or services across international borders.

Demand reasons

- Countries trade with other countries because they have a demand for goods which they cannot produce themselves.
- Sometimes countries have no goods at all.
- E.g. Namibia imports oil.
- Sometimes countries have the product but they do not produce enough themselves. They must import it.
- E.g. South Africa produces oil, but they produce too little, therefore they must import it.
- S.A. only produces 30% of the oil that is needed in the country, the rest they import from Saudi- Arabia.

1 **Size of the population**. If there is an increase in population growth, it causes an increase in demand, more needs must be satisfied. If the country does not have enough goods and services, then it must be imported from other countries.

2 **Income levels**. Changes in income cause a change in the demand for goods and services.

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An increase in the per capita income of people – More disposable income that can be spend on goods and services.
This greater demand must be satisfied – if there is not enough goods and services in the country – then it must be imported from other countries.

3 **Change in the wealth of the population**: An increase in wealth lead to greater demand for goods.
People have excess to loans – they can purchase bigger and more luxurious goods.
If countries cannot supply these luxury and technological advanced products – then it must be imported.
These factors are favourable for developed countries but not for developing countries.
Develop countries gain more from international trade than Developing countries.

4. **Preferences and tastes** can play a part in the determining of prices, e.g. customers in Australia have a preference for a specific product which they do not produce and need to import, and it will have a higher value than in other countries.

5. **The difference in consumption patterns** is determined by the level of economic development in the country, e.g. a poorly developed country will have a high demand for basic goods and services but a lower demand for luxury goods.

<u>Supply reasons</u>

1. Natural resources

- They are not evenly distributed across all countries of the world
- They vary from country to country and can only be exploited in places where there are such resources
- Each country has its own unique mix of natural resources that makes it possible for them to produce certain goods and services more efficiently and at a relatively lower price
- (E.g.) South Africa's gold and diamond resources has given us an advantage in producing gold and diamonds

2. Climatic conditions

- Differences in climatic conditions between countries make it possible for some countries to produce certain goods at a lower price than other countries
- Many crops can only be cultivated in certain climatic conditions and areas and in certain kinds of soil
- Topography
- E.g. Brazil is the biggest producer of coffee in the world

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3. Labour resources

- The quality, quantity and cost of labour also differ between countries
- Some countries have highly skilled labour with high productivity rates
- This enables them to produce goods and services at a lower price than they are produced in other countries
- Certain individuals have greater ability and aptitude for certain tasks
- It is a worldwide phenomenon that some countries have developed a skill and aptitude for the production of a certain commodity
- E.g. The Swiss (watch making)

4. Technological resources

- Some countries have access to technological resources that enable them to produce certain goods and services at a low unit cost
- Improved production processes, the availability of equipment and machinery, and other technological factors all influence the supply of goods and services and thereby contribute to cost differences between countries
- (e.g.) Japan

5. Specialisation

- Some countries specialize in the production of certain goods and services
- By specializing in the production of certain goods and services, a country is able to take advantage of economies of scale and therefore produce the goods at a comparatively cheaper unit cost
- (e.g.) Japan has specialized in the production of certain electronic goods and the sell them at a much lower price than they can be produced in other countries
- This often results in mass production because of division of labour automation and mechanization
- Cost differences occur because goods and services can be produced at lower costs in one country than another because of the theory of comparative advantage

6. Capital

- Cannot be obtained as easily in some countries as in others
- Developed countries usually enjoy an advantage over undeveloped countries
- Due to a lack of capital some countries cannot produce all the goods they require themselves, or they may not have the favourable conditions of other countries
- In many countries there is a lack of Physical infrastructure and this hamper local production of goods and services

<u>The EFFECTS of international trade</u>

1 Specialisation

- Specialisation increase the standard of living of people.
- Specialisation and trade causes countries to have more goods which they can sell at the same costs.
- Certain countries would not have had certain goods without International trade.
- E.g. Mozambique have no oil and Greenland have no citrus fruit.

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- Without international trade countries would only have goods that they produced in the country.
- Only the rich would have been in a position to excess or get to certain goods.

2 Mass production

- If domestic demand is added to foreign demand, it makes large scale production (mass production) possible.
- The production of manufactured goods requires that it should take place on large scale in order to make it affordable and to make it profitable.
- E.g. The manufacturing of computers, cell phones, motorcars, etc.
- Small countries can only compete with larger countries if they can export successfully.
- South African businesses export to African countries.

3 Efficiency

- Unlimited international trade increase competition.
- Competition increase efficiency because eliminate and reduce unnecessary cost and waste.
- Increase efficiency leads to lower cost and thus lower prices.
- Lower prices mean that the same income can buy more goods and services.
- It causes an increase in standard of living.

4 Globalisation

- International trade is at the heart (core) of globalization.
- Other elements of international trade are Information technology, Transport, Communication, Multi National Enterprises (MNE), Capital liberalization and standardization.
- As countries become involve in international trade, it spills over to other elements of globalization.
- India and China experience it.
- As these elements expand and improve it stimulate international trade.
- Domestic economic growth follows and it lead to an increase in the standard of living.

4.2 BALANCE OF PAYMENTS

Description

- This is a comprehensive and systematic record of all transactions between one country e.g., South Africa and all other countries of the world for a specific period of time, for example one year.

General Aspects

- Credit entries is indicated as positive (+)
- Payments by foreigners to SA for goods and services
- South Africa receives money - Money flows into the country.

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- Debit entries is indicated as a (-)
- SA pay foreigners for goods and services
- SA pay for imports – money flow out of the country

Shortage on the Balance of Payment

- Money leaving the country (outflow) is more than money entering the country (inflow).
- This is unfavourable (bad) for any country

Surplus on the Balance of Payment

- Money entering the country (inflow) is more than money leaving the country (outflow)
- This is favourable (good) for any country.

Determine the value of the BoP
CURRENT ACCOUNT DETAIL

TRADING BALANCE

Merchandise exports	754
Net gold exports	71
Merchandise imported	(857)
TRADING BALANCE	**A -32**

NET SERVICES, INCOME AND CURRENT TRANSFER ACCOUNT

Net services payments	**-9** (1)
Transport	-40
Passenger fares	-15
Other	-25
Travel	49
Other services	-18
Manufacturing services	0
Repairs and maintenance	0
Financial and insurance services	3
Intellectual property usage	-15
ITC	-3
Personal, cultural and recreational services	1
Other services	-4
Net income payments	**-88** (2)
Net current transfer payments	**-31** (3)
NET SERVICES, INCOME AND CURRENT TRANSFER BALANCE	**B -128** (1) + (2) + (3)
BALANCE ON CURRENT ACCOUNT	**A + B -160**

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Composition of the current BoP

BALANCE OF PAYMENTS COMPOSITION

1. CURRENT ACCOUNT

DEF: International daily transactions in terms of production, income and expenditure.

Composition:
1. Goods exported (+) and imported (-)
2. Net gold exports (+ / -)
3. Services receipts (+) and payments (-)
4. Income receipts (+) and payments (-)
5. Current transfer payments (+ /-)

2. CAPITAL TRANSFER ACCOUNT

DEF: International transactions in terms of ownership of fixed assets.

Composition:
1. Allowance for a non-government organisation that develops property e.g. housing project.
2. The transfer of houses
3. Debt forgiveness (**Writing-off of a portion of one or more loans to a financially troubled firm by its lender(s). The objective is to help that firm in its debt restructuring so that it remains viable and is able to pay off the remaining part of the loan(s).)

3. FINANCIAL ACCOUNT

DEF: International investment transactions by South Africans in other countries and by foreigners in South Africa.

Composition
1. Direct investments
'An investment in fixed property or the acquisition of a significant (10 % or more) share in a business.

2. Portfolio investments
The purchase of financial assets e.g. shares on a shares market of another country. Another name = hot money because it can be quickly converted into cash.

3. Financial derivatives
An investment made in a specific asset with a fixed future value that is paid out on a specific date.

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4. Other investments
Transactions that do not fall under 1, 2, 3 or 5, are classified as other investments.
Example: Short term loans.

5. Reserve assets
Financial capital held by the monetary authorities such as a central bank or the IMF to finance the trading disequilibrium.

4. UNRECORDED TRANSACTIONS

Provide for any omissions.

5. BALANCING AMOUNT

NB: EXCLUDES RESERVE ASSETS AND INCLUDES UNRECORDED TRANSACTIONS

Balance on current account
+ Capital transfer account
+ Balance on financial account **(NOT RESERVE ASSETS)**
+ Unrecorded transactions

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BALANCE OF PAYMENT FORMAT

	2015
Current account	
Merchandise exports	671 220
Net gold exports	75 298
Service receipts	107 825
Income receipts	38 118
Less: Merchandise imports	730 128
Less: Payments for services	142 230
Less: Income payments	104 689
Current transfer (net receipts +)	-14 199
Balance on current account	-98 785
Capital transfer account (net receipts +)	241
Financial account	
Net direct investment [Inflow (+) / Outflow (-)]	46 778
Net incurrence of liabilities	42 168
Net acquisition of financial assets	4 610
Net portfolio investment [Inflow (+)/Outflow (-)] (2)	2 502
Net incurrence of liabilities	46 976
Equity securities	43 245
Debt securities	3 731
Net acquisition of financial assets	-44 474
Equity securities	-46 325
Debt securities	1 851
Net financial derivatives [Inflow (+)/Outflow (-)] (3)	9 547
Net incurrence of liabilities	8 993
Net acquisition of financial assets	554
Net other investments [Inflow (+)/Outflow (-)] (4)	28 085
Net incurrence of liabilities	31 696
Net acquisition of financial assets	-3 611
Reserve assets (Increase (-)/ Decrease (+)) (5)	2 120
Balance on financial account (1) +(2) +(3) +(4) +(5)	89 032
Memo item: Balance on financial account excluding reserve assets (1) +(2) +(3) +(4)	86 912
Unrecorded transactions (6)	53 883
Memo item: Balance on financial account excluding reserve assets including unrecorded transactions (1) +(2) +(3) +(4) +(6)	140 795

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Measures to correct the BoP

Interest rates

- Domestic demand can be changed by charging interest rates.
- If interest rates are increased, spending (including on imports) decreases
- Simultaneously, foreign savers try to take advantage by increasing their investment in the country with the higher interest rate
- The opposite happens when interest rates are decreased
- This is the most widely used instrument
- It works well over the short term.

Import controls

- They include import tariffs, other duties and quotas.
- The WTO is trying to lower tariffs and other trade barriers for the sake of trade liberalization
- SA complied with the policies of the WTO and reduce its import controls.

Borrowing and lending

- Countries with surpluses often lend money to countries with deficits
- Countries with deficits often borrow
- This is why some developing countries have so much foreign debt
- In the event of a fundamental disequilibrium, member countries may borrow from the IMF
- Borrowing is nevertheless not a long-term solution for afundamental balance of payments disequilibrium

Change in demand

- Changes in demand is either domestic or foreign
- An increase in domestic demand cause imports to increase and this has a negative effect on the balance of the balance of payments.
- A decrease has the opposite effect

Export promotion

- Export promotion (such as government incentives), is applied to encourage the production of goods that can be exported, for example European countries pay subsidies to farmers.

Import substitution

- Government pay incentives to produce goods domestically rather than to import them.
- The South African government favours export promotion.

Change in exchange rates

- The three systems of controlling exchange rates have different effects:
- Free-floating exchange rates. They work automatically. If imports increase, the demand for foreign exchange increase. The currency depreciates as a result of the working of market forces. Depreciation makes imports more

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expensive in the depreciating country and exports cheaper in the foreign country. Imports decrease and exports increase, and the currency appreciates.
- Managed floating exchange rate. Central banks use their reserves to effect depreciations and appreciations. Over the long term, currencies have to find their equilibrium levels.
- Fixed exchange rate. Currencies are devalued and revalued.

The following ways/ methods can be considered to make corrections on the Balance of payments:

1. Borrowing money from the IMF
2. Apply policies of export promotion an import substitution
3. Increase in aggregate supply will reduce prices. Exports are promoted through cheaper prices.
4. Higher interest rates help to decrease spending on imports.
   Increase in import tariffs and controls, although SA complies with policies of the WTO to reduce its import controls. (Trade liberalisation)
5. Exchange control that allows central banks to ration foreign exchange.
6. Currency depreciation/devaluation makes imports expensive (reduction) exports cheaper for foreign countries. (increase exports)
7. Increase in tax which reduces disposable income which decreases demand in imports.
8. Reduction of reserves by SARB to correct deficits if we adopted a Managed floating
   exchange rate.

4.4 Foreign exchange markets

Concepts:

Definition: Exchange rate

- **It is the price of one country's currency, i.e. the RSA-Rand express in terms of another country's currency, i.e. the USA-Dollar**
- i.e. A South African business importing goods from America must buy Dollars to pay for the imported goods.
- R1 = $0,1428

- The opposite is also true
- An American business that wants to buy goods from South Africa must obtain Rand to pay for such imports.
- $1 = R7,000

Appreciation
- Appreciation of a currency is an increase in the price of the currency in terms of another currency as determine by supply and demand.

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Depreciation

- Depreciation is a fall in the price of the currency in terms of another country's currency as determine by demand and supply.

Dollar Appreciates and Rand Depreciates.

E.g.

$1 = R7
$1 = R 8

Dollar Appreciates - Dollar become more expensive in terms of the Rand.
Rand depreciates - Rand become cheaper in terms of the Dollar.

Imports **from USA** become more expensive in SA. **Imports tend to decrease**.
SA exports **to the USA** become cheaper. **Exports tend to increase**.

Rand Depreciates – will have a positive impact on the balance of current account.

Dollar depreciates and Rand appreciates

E.g.

$1 = R7
$1 = R6

Dollar depreciates - Dollar become cheaper in terms of the Rand.
Rand appreciates - Rand become more expensive in terms of the Dollar.

Imports **from the USA** become cheaper in SA. **Imports tend to increase**.
SA exports **to the USA** become more expensive. **Exports tend to decrease**.

This will have a negative impact on the balance of the current account.

Devaluation

- When foreign reserves become low, they **devalue their currency. (Lower the value of their currency)**
- It is a deliberate action taken by the central bank to lower a fixed exchange rate.

Revaluation

- When foreign reserves become too high they **re-valuate the currency. (Increase the value of their currency).**
- It is a deliberate action taken by the central bank to increase a fixed exchange rate.

Foreign exchange control

- Various forms of control imposed by a government on the purchase or sale of foreign currencies by private residents.

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Supply and demand of foreign exchange

Factors affecting demand

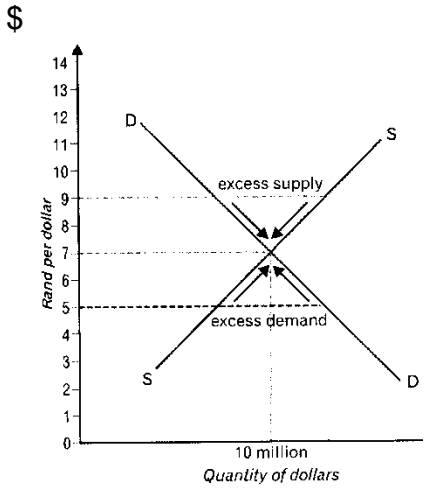
- The import of goods from foreign countries.
- Services rendered by foreign countries, e.g. shipping-, insurance- and banking services to South Africa
- Expenditure of South African tourists traveling to foreign countries.
- South African's pay interest, dividends and profits to foreign lenders or investors.
- The repayment of loans to foreign countries.
- Investments made by South African citizens in the foreign countries.
- Speculation in foreign currency (South African citizens that buy foreign currency)

Factors affecting supply

- The exporting of South African goods to the foreign countries.
- South Africa renders services such as shipping, insurance and banking to the foreign countries.
- Spending by foreigners in South Africa.
- South African citizens receive interest, dividend and profits from foreign lenders or investors.
- The repayment of loans by foreigners to South Africans.
- Investments made by foreigners in South Africa.
- Speculation by foreigners - buy the South African Rand.

Exchange rate equilibrium

- The value of a currency in terms of other currencies under floating exchange rates is subject to continuous fluctuations.
- The value of the currency is determined purely by the forces of the market i.e. demand for the Rand and supply of the Rand.
- The rate of exchange can change if there is a change in the demand or supply of foreign exchange
- The central bank has little control over it



- Vertical axis shows the Rand per Dollar exchange rate.
- Horizontal axis shows the quantity of Dollars trades at the equilibrium rate.

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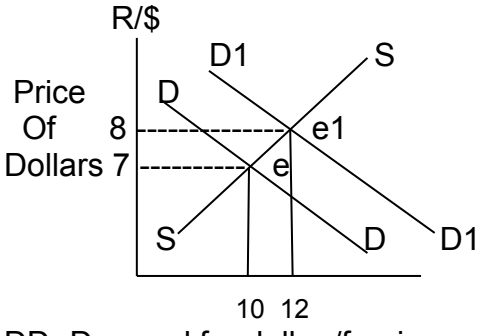
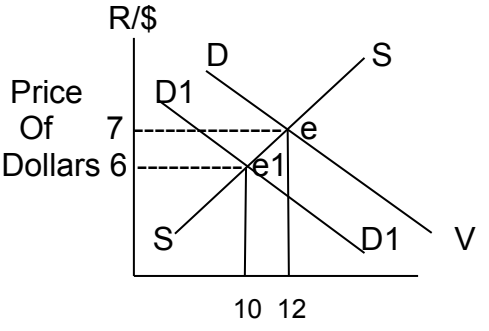
- $1 = R7,00
- DD = Demand curve for Dollars.
- It is the South Africans who has the Rand and want to buy Dollars.
- E.g. To pay for imports or to make investments in the USA.
- SS = Supply of Dollars.
- It is Americans who has the Dollar and want to the Rand.
- E.g. To pay for pay exports from South Africa.
- The Equilibrium exchange rate is DD = SS
- $1 = R7,00 = This is the equilibrium exchange rate.

Changes to equilibrium

- At $1 = R5,00
- There is an Excess demand of Dollars.
- There is pressure on the price to increase and move to $1 = R7,00.
- When the price rises, the quantity supplied rise along the supply curve.
- More suppliers enter the market.
- The demand falls along the demand curve.
- At $1= R9,00
- There is an excess supply of Dollars.
- Suppliers cannot sell their Dollars.
- They are prepared to accept less Rand for their Dollars.
- There is a fall in the supply of the Dollars along the supply curve.
- The fall in the price, increase the demand along the demand curve.
- It continues until it reached $1 = R7,00.

Demand for the Dollar (Foreign Exchange)	
Imports Increased	**Imports Decreased**
 DD- Demand for dollar /foreign currency. e = equilibrium exchange rate $1 = R7,00 Amount of Dollars purchased = 10 mil - Imports Increased. - Buy more machines from overseas.	 DD – Demand for Dollar/ foreign exchange. E=equilibrium exchange rate -$1 = R7.00 Amount of Dollars purchased = 12 mil. - Imports decreased

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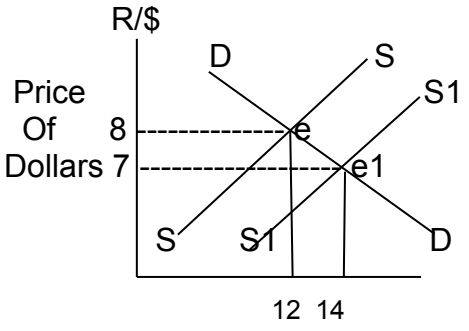
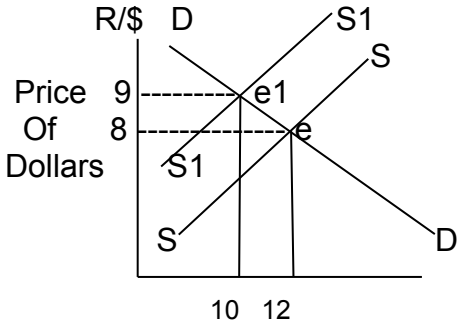
- South African citizens make more investmenst overseas, etc. More money flow out of the country. Demand for Dollars / foreign exchange increase. Demand curve shifts to the right – DD to D1D1 New equilibrium exchange rate is form- e1= $1 = R8.00 The amount of Dollars / foreign exchange purchased increased from 10mil to 12 mil. The value of the Rand Weakened- in other words the value of the Rand Depreciated against the Dollar. The value of the Dollar strenghened – The value of the Dollar Appreciated against the Dollar.	DD shifts to the left – DD to D1D1 New equilibrium exchange rate is formed e1 = $1 = R6.00 The amount of Dollars purchased decrease from 12 mil to 10 mil. The value of the Rand Strengthened – The Rand appreciated against the Dollar. The value of the Dollar weakened – The Dollar Depreciated against the Rand.

Supply of the Dollar (Supply of Foreign Currency)	
Exports Increased	**Exports Decreased**
 SS- Supply of the Dollar (froereign Currency) e=equilibrium exchange rate = $1 = R8.00 Equilibruim quantity = 12 mil. - Exports from SA increased - South Africa receive more loans from overseas - More American tourist visit SA. More money flow into the country.	 SS – Supply of the Dollar (foreign currency) e = equilibrium exchange rate $1 = R8.00 Equilibrium quantity – 12 mil - Exports decreased Supply- shifts to the left SS to S1S1 New equilibium exchange rate e1 = $1 = R9.00

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Supply curve shift to the right – SS shift to S1S1. New equilibrium exchange rate - e1 = $1 = R7.00. equilibrium qauntity increased from 12 mil to 14 mil. The value of the Rand strengthened – The value of the Rand Appreciated against the Dollar. The value of the Dollar weakened – The value of the Dollar Depreciated against the Rand.	Equilibrium quantity reduced from 2 mil to 10mil. The value of the Rand weakened – The value of the Rand Depreciated against the Dollar. The value of the Dollar Strengthened – The value ofthe Dollar Appreciated against the Rand.

<u>Interventions in the market</u>

A symbiotic (mutually dependent) relationship exists between the exchange rate of a country and its balance of payments. This relationship invites continuous attention from the central bank. Central banks often intervene when the currency is either overvalued or undervalued.

Overvalued: When a country's currency is valued too high, for example, the South African rand is R7 rather than R8 for a US dollar. This can lead to continuous deficits on the current account of the balance of payments.

Undervalued: When a country's currency is not valued high enough, for example, the South African rand is R9 rather than R8 to a US dollar. Such undervaluation can be demonstrated by continuous surpluses on the current account of the balance of payments.

Two methods of intervention are traditionally used:
Direct intervention: The Central bank buys foreign exchange when the currency is overvalued, and sells foreign exchange when the currency is undervalued.

Indirect intervention: The most important instrument used by the central bank for indirect intervention is interest rate changes. When a currency is overvalued an increase in interest rates invites an inflow of investments. A surplus is created on the financial account that balances out the deficit on the current account. When the currency is undervalued interest rates can be decreased to cause an outflow of foreign currency and drain excess liquidity from the economy and release inflation pressure. The surplus on the current account will then decrease.

4.5 The establishment of exchange rate systems

Free floating exchange rate system

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- The value of the currency is determined purely by the forces of the market, i.e. demand for rand and supply of rand.

Managed floating exchange rate system

- Very few countries have free floating or fixed exchange rates
- Countries prefer not to leave the determination of exchange rates entirely to market forces (supply and demand) because of the danger of speculation
- These are exchange rates which are allowed to respond to market forces within certain limits.
- These limits are determined by the central bank
- When these limits are reached the central bank interfere in the foreign currency market
- The central bank buy or sell the foreign exchange (currency)
- South Africa has an independent floating system
- The Rand has its own exchange rate independent from other currencies

Fixed exchange rate system

- The value of the currency is fixed or pegged.
- The gold standard backed the value of the currency to a certain amount of gold.
- It was until 1971.
- After 1971 the value of the currency is determined against the Dollar.
- Countries tried to pegged their currency at a certain level for as long as possible.
- It tends to avoid uncertainties with regard to exchange rates.
- It prevents them from running out of foreign currency
- **Terms of trade**

Description

- The terms of trade compare a country's export prices with its imports prices by means of indexes.

TERMS OF TRADE

Year	Index of export prices	Index of import prices	Terms of trade
2005	100	100	100
2010	105	101	**103.9 / 104**

The formula

$$\frac{\text{Index of Export prices}}{\text{Index of Import prices}} \times 100$$

- When the numeric value increase = Terms of trade strengthen
- When the numeric value of decrease = Terms of trade Weakened

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$$\frac{\text{Export prices}}{\text{Import prices}} \times 100$$

$$\frac{105}{101} \times 100 = 103{,}9 \text{ or } 104$$

- NB: A base year is used as a reference point.
- The base year is always 100.
- The year used as base year is always the last census year.

Effect on the economy

An improvement of terms of trade may be result of the following:
- An increase in the terms of trade indicates an improvement in the welfare
- Fewer exports needed to be produced to buy the same amount of imports.
- An increase in export prices
- A decrease in import prices

A deterioration of terms of trade may be a result of the following:
- A decrease indicates that a country is poorer
- Greater volumes of exports needed to be produced to afford the same value of imports
- A decrease in export prices
- An increase in import prices

TOPIC 4: NO ESSAYS WERE IDENTIFIED FOR THE NEXT THREE-YEAR CYCLE

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TOPIC 5: PROTECTIONISM AND FREE TRADE

Subtopics

5.1 Export Promotion

5.2 Import substitution

5.3 Protectionism

5.4 Free trade

5.5 A desirable mix

5.5 An evaluation

Concepts

5.1 EXPORT PROMOTION

DEFINITION

- Export promotion refers to measures taken by governments to increase the production of goods and services that can be exported.
- The government provides incentives to encourage production
- It is an outward policy.

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METHODS OF EXPORT PROMOTION

Exports are promoted through:

Incentives

- Export incentives include information on export markets, research with regard to new markets, concessions on transport charges, export credit and export credit guarantees and publicity commending successful exporters.
- This will encourage manufacturers to export an increased volume of their production.
- Trade missions help to market SA products abroad and supply SA companies with information about potential markets

Subsidies

- **Direct Subsidies:**
- It is described as direct because it involves government expenditure.
- Include cash payments to exporters, refunds on import tariffs and employment subsidies.
- It reduces the cost of Production.
- It increases the competitiveness of exporting company.

Indirect subsidies

- It is regarded as indirect because it results in the government receiving less revenue.
- E.g. General tax rebates, tax concessions on profits earned from exports or on capital invested to produce export goods, refunding of certain taxes e.g. custom duties on imported goods used in the manufacturing process.
- Allows companies to lower their prices and enables them to compete in international markets

The challenge for governments is to design incentives and subsidies in such a way those prices of export goods cannot be viewed as Dumping prices.

1) **Trade neutrality**

- Can be achieved if incentives in favour of export production are introduced up to point that neutralises the impact of protectionist measures in place
- E.g. Subsidies is equal to import tariffs.

2) **Export Processing zones (EPZs)**

- It is free-trade enclave within a protected area. It is a fenced and controlled industrial park that falls outside the domestic customs area, and it is usually located near a harbour or airport.

REASONS FOR EXPORT PROMOTION

- Export promotion measures lower cost of production which make it easier to compete on the international market.
- Achieve significant export-led economic growth.
- Export enlarges production capacity of country because more and larger manufacturing industries are established.

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- The first step to export-led economic growth is to implement policies that encourage the establishment of industries to produce goods and services for export markets.

ADVANTAGES OF EXPORT PROMOTION

- No limitations on size and scale since world market are very large.
- Based on Cost and efficiency of production and organised along lines of comparative advantage
- Increased domestic production will expand exports to permit more imports and
  may result in backward linkage effects that stimulate domestic production in related industries.
- Exchange rates are realistic and there is no need for exchange control and quantitative restrictions.
- Value can be added to natural resources of the country.
- Creates employment opportunities.
- Increase in exports has positive effect on balance of payments.
- Increase in production leads to lower domestic prices, which benefit local consumers.

DISADVANTAGES OF EXPORT PROMOTION

Real cost of production

- Subsidies and incentives reduce the total cost of production which must be met from sales.
- Real cost is thus concealed by subsidies.
- Products cannot compete in open market.

Lack of competition

- Businesses charge prices that are so low that they force competitors out of the market.

Increased tariffs and quotas

- Can be against the spirit of the provisions of the WTO
- Overseas competitors can retaliate with tariffs and quotas on goods sold domestically below their real cost of production (export subsidies and dumping)

Protection of labour-intensive industries

- Developed countries maintain high levels of effective protection for their industries that produce labour-intensive goods in which developing countries already have or can achieve comparative advantage.

Withdrawal of incentives often leads to closure of effected companies □□

Incentives often lead to inefficiencies in the production process, since companies don't have to do their best to compete.

Can be seen as dumping.

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5.2 IMPORT SUBSTITUTION

Definition

- It is a process whereby goods that were previously imported, are now replaced by local manufacturing.
- It is an inward policy

Methods to encourage import substitution

Tariffs

- Also known as Customs duties or import duties
- These taxes are levied on imported goods in order to deliberately increase the price of imported goods.

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Two types of Tariffs:

1. **Ad Valorem taxes**: This is a percentage that is levied on the value of the imported goods.
2. **Specific tariffs**: It is an amount per unit, mass or quantity that is levied on imported goods.

Quotas

- It is levied on imports.
- It places a limit on the supply of a good or service.
- E.g. 10 ton per grain per year or 50 ton mutton per year.
- The supply of goods is reduced and this will increase the price of goods.

Subsidies

- It is financial help given to exporters to help them export their goods.
- E.g. on transport costs or employment
- Subsidies reduce the cost of production – It cause businesses to sell their goods at lower prices.

Exchange controls

- The South African government limits the amount of currency that can leave the country.
- It dampens exports.
- All foreign currency entering the country must be submitted to the SARB.
- All payments to foreign companies or institutions must be reported to the SARB.

Physical controls

- A complete ban can be placed on imports of certain products or imports from specific countries.
- It is called an embargo

Diverting trade

1. Import Deposits: The government may require of importers from abroad to deposit a sum of money before they can import goods.
2. Time-consuming customs procedures are used.
3. High Quality Standards can be prescribed which foreign exporters may find difficult to comply with.

<u>Reasons</u>

1. **Diversification**

- Countries use import substitution to diversify. This strengthens the Industrial base of the economy.
- Make countries less dependent on others.
- New industries are established and Infant industries are protected.

2. **Trade**

- Local manufacturing accelerates economic growth (e.g. clothes, household goods etc. are locally produced)

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- Imports are replaced with local production, which increase employment.

Advantages of Import Substitution

- Increased employment. Increased GDP.
- Bigger variety of products are produced as a result of diversification. There exist a broader industrial base. Country become less vunerable as a result of Boycotts ad sanctions.
- Decrease in imports. It has a positive effect on the Balance of Payments.
- Industrial development is encouraged.
- It is easy to implement through the imposition of tariffs and quotas.

Disadvantages of Import Substitution

- Imports do not decrease necessarily, because technologies and intermediate products are imported from abroad.
- Capital and entrepreneurial talent are dawn away from the areas of competitive advantage to areas with higher profits due to protection.
- Artificial profits are created as a result of the protection of industries.
- Competitiveness is reduced in sectors where there is a comparative advantage.
- Local production may be inadequate because they are protected from international competition.

5.3 PROTECTIONISM

DEFINITION

- Protection is the application of a trade policy whereby the state discourages importing of certain goods and services with a view to protecting home industries against unequal competition from abroad.

ARGUMENTS IN FAVOUR OF PROTECTION

1. **Industrial development**
   Some developing countries are well suited to establishing certain kinds of industries. Free trade makes it difficult for these countries to compete with countries with well-established industries.

2. **Infant industries**
   Newly established industries find it difficult to survive because of high average costs of production which are higher than those of well-established foreign competitors.

3. **Stable wage levels and high standard of living**
   A country with high wages has a view that the standard of living will be undermined if cheaper goods are imported from countries with low wages.

4. **Increased employment**
   If local industries cannot find profitable markets because of cheaper imports, production may decrease and this will lead to more unemployment.

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5. **Self-sufficienty and strategic industries**
   In times of conflict, cut-off or friction between countries occurs. Protection should be granted, especially to key industries to ensure the availability of these key products.

6. **Prevention of dumping**
   Some countries sell their surplus goods in a foreign country at lower prices than it cost them to produce the goods. Local producers cannot compete, and their factories may close.

7. **Stable exchange rates and BoP**
   Traders buy in the cheapest markets and sell in the most expensive ones. Countries export primary products and import manufactured goods, causing disrupted balance of payments and exchange rates.

8. **Protection of natural resources**
   Free trade can easily exhaust natural resources, therefore protection is needed to protect local industries and indigenous knowledge systems so that they can survive. The South African government has taken steps to protect *Rooibos* tea as natural resource and safeguard indigenous knowledge that allows the *hoodia* plant to be used for medicinal purposes.

<u>Raising revenue for the government:</u>

- In developing countries the tax base is more often limited because of low incomes
  of individuals and businesses.
- Low incomes do not provide much in form of income taxes.
- Customs duties on imports forms a significant source of revenue for the state.

<u>Protecting the whole industrial base</u>

FOUR considerations relevant for protecting industrial base of country:

2.1 Maintaining domestic employment, to reduce unemployment and provide more job opportunities.

- Countries with high levels of unemployment is pressurized to stimulate employment creation.
- Protectionist policies are used to stimulate industrialisation.
- Domestic employment is encouraged through imposing import restrictions.
- **Domestic employment creation at the expense of other countries is known as "Begger my neighbour" policies.**

2.2 Protecting workers

- Countries with low wages represent unfair competition and threaten the standard of living of more highly paid workers.
- Protection is necessary to prevent local wage levels from falling.
- Helps protect local businesses from closing down or becoming unprofitable.

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2.3 Diversifying the industrial base

- Protectionism helps countries not to over-specialise.
- Import restrictions may be imposed on a range of products in order to ensure that number of domestic industries develop.

2.4 Developing strategic industries

- Certain industries of strategic importance, eg agriculture and energy.
- Developing countries need to develop these industries to become selfsufficient.

3. <u>Protecting particular industries</u>

3.1 Dumping

- Foreign enterprises may engage in dumping because government subsidies permit them to sell goods at very low prices or below cost or because they are seeking to raise profits through price discrimination.
- The initial reason for exporting products at a low price may be to dispose of accumulated stocks of goods.
- In the short term, consumers in the importing country will benefit.
- However, their long-term objective may be to drive out domestic producers and gain strong market position.
- In this case consumers are likely to lose out as a result of the reduction in choice and the higher prices that the exporters will be able to charge.
- Protectionism prevents foreign industries from dumping their surpluses and out-of-season goods at low prices, which may be harmful to home industries.

3.2 Infant industries / Industrial development

- Newly established industries suffer to survive due to higher average costs.
- Competition in the early days makes growth possible, they can take advantage of economies of scale, lower average costs and become competitive, protection can now be removed.

3.3 Declining industries

- Structural changes in demand and supply may influence the industry negatively.
- These businesses must leave business gradually – It is possible if protection is granted. This will give factors of production time to gradually move to other industries.
- They lost their comparative advantage. This may lead to large scale unemployment.

4. Protecting domestic standards

- Trade restrictions like food safety, human rights and environmental standards.
- Stabilising exchange rate and balance of payments.
- Protecting natural resources from being exploited.
- Economic self-sufficiency.
- Greater economic stability

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- Natural resources not depleted.

5.4 FREE TRADE

1. Definition

- Free trade occurs when there are no barriers to trade, such as taxes on imported goods or bans on imports.

2. THE ARGUMENTS IN FAVOUR OF FREE TRADE.

Specialization

- The theory of comparative advantage shows that world output can be increased if countries specialize in what they are best at producing.
- This leads to lower prices and higher levels of output.
- Developing countries can take advantage of foreign expertise.
- There are mutual gains from international trade to all countries.
- Most efficient distribution of resources because each country specializes in most effective production.
- Free trade argument is persuasive – if each nation produces what it does best and permits trade.
- Over the long run, all will enjoy lower prices and higher levels of output, income and consumption.
- Productivity is boosted.
- Trade restrictions tend to invite retaliation.
- Protectionism leads to cost on society, inefficiency and loss in welfare.

Economies of scale

- Trade allow economies of scale to be maximized and thus unit costs are reduced
- It promotes competition and improves resource allocation
- Allows each country to optimally use of the endowment of its factors of production.
- Promotes increased efficiencies, product improvement and technological advancement.
- Enterprises are always competing to find new production methods that cut costs and will improve the quality and reliability of goods.

Choice / increased welfare

- Consumer welfare is thus increased because some consumers will prefer to buy foreign goods than domestic goods
- This leads to greater world production of traded goods.
- Increase in economic welfare.
- Increases total output.

Innovation / best practice

- Free trade implies competition, which provides a powerful incentive to innovate.

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- It generates foreign exchange.
- Businesses compete to find better production methods which enables producers to cut costs and improve the quality and the reliability of goods.
- Accelerates overall economic growth which raises profits and promotes greater savings and investment.
- Open economy will prefrom much better in an era of globally integrated production and technological reform than a closed economy.

Improved international relations

- Better foreign relations are usually an unintended result of free trade
- Developing nations are often subject to international threats of, for instance, tariffs, quotas, quality standards and credit restrictions.
- developing strategic free trade relations with more powerful countries can help ensure a developing nation has additional protection from international threats.

5.5 A DESIRABLE MIXTURE

IMPORT SUBSTITUTION AND EXPORT PROMOTION

- Import substitution and export promotion should not be seen as two opposites.
- E.g. SA applies import substitution, with time industries become strong and start focusing on exports. (Import substitution lead to export promotion).

PROTECTION AND FREE TRADE

- **Regionalization** is the formation of trade blocks and makes use of free trade and protection.
- Member countries pursue free trade with one another, but apply trade restrictions to non- member countries.

There are TWO types:

Free trade areas (FTA)

- Countries within the free trade zone remove all trade restrictions between them but they can apply trade restrictions against Non-member countries.
- Example of trade areas:
- North American Free Trade Area (NAFTA)
- Association of South East Asian Nations (ASEAN)

Custom Union

- There are no trade restrictions between member countries.

Member countries apply the same import restrictions on Non-member countries.

Globalisation

- Globalisation is a world- wide exposure and interaction of economies with trade as a key element.

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- The World Trade Organisation (WTO) facilitates free trade.

Trade liberalisation

- South Africa's economic policy bias towards exports as a major stimulant of economic growth was further entrenched after 1994.
- An agreement was reached with GATT (WTO) in terms of what trade had to be liberalised as from January 1995.
- South Africa's offer to the WTO consisted of a five-year tariff reduction period. More than 100 tariff categories were reduced to six categories.
- South Africa's average tariff declined from 11,7% in 1994 to 5% in 2011.

World Trade Organisation (WTO)

- The General Agreement on Tariffs and Trade (GATT) was signed in 1974.
- In 1995 the GATT was replaced by the WTO.
- The function of GATT and WTO is to liberate trade.

The four most important roles of the WTO

1 Administration and implementation of multilateral trade agreements.
2 Acting as a forum for multilateral trade agreements.
3 Seek to resolve trade disputes.
4 To supervise the review of national trade policies.

Economic integration

- An economic arrangement between different regions marked by the reduction or elimination of trade barriers and the coordination of monetary and fiscal policies.
- The aim of economic integration is to reduce cost for both consumers and producers, as well as to increase trade between the countries taking part in the agreement, and thereby increasing welfare.
- Examples are Preferential Trade Agreements (PTA such as provided for by the WTO, AGOA is an example)
- Free trade Areas (FTA), customs unions, common markets and economic and monetary unions.

5.6 Evaluate the successes and failures of the following South Africa's Protocols

- SA was part of the Customs union since 1910
- Various protocols are now replaced by SADC protocol
- Progress has been made towards strengthening bilateral ties with main trading partners
- It has taken the form of free trade area (FTA) protocols.

South African Customs Union (SACU)

- South African Custom Union members currently negotiate jointly on Free Trade Areas (FTA) with the rest of the world like European Free Trade Association.

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Multilateral Monetary Area (MMA)

- From 1910, a form of monetary union existed between South Africa, Botswana, Lesotho and Swaziland.
- In 1974 Botswana withdrew and introduced its own currency, the pula.
- An official monetary agreement – the Rand Monetary Area agreement – was signed between Lesotho, South Africa and Swaziland.
- In 1986 the name was changed to the Common Monetary Area (CMA)
- The CMA has since been replaced by the present Multilateral Monetary Area (MMA) when Namibia formally joined the monetary union.

South African Development Community (SADC)

- South african Development Community (SADC) presently has the status of Free Trade Area
- 97 % of imports from SADC qualifies for duty-free access to SA
- Trade should be fully liberalized by 2010.

African Union (AU)

- The aim of the African Union is developing the continent into an economic and monetary union
- This strategy was adopted by Nepad (New Partnership For Africa's Development) as a strategy
- The first phase is to develop a 5 regional Free Trade Areas (FTA)
- SADC is one of the FTAs.

European Union (EU)

- The European -SA Free Trade Area (FTA) entails the freeing of tariffs
- 95 % of EU imports from SA by 2010 and 86 % on imports from EU to SA must be free of tariffs over 12 year period
- Trade, Development and Cooperation Agreement was implemented in 2000 and established free trade between SA and EU.

Mercusor

- Mercusor – SA : SA signed a Framework Agreement with Mercusor in 2000,
- The Aim is to expand trade and create free trade area between parties (Latin America)
- The Free Trade Area will eventually include all SACU members.

AGOA

- The USA implemented the African Growth and Opportunity Act (AGOA) in 2001, whereby it granted duty-free exports to the USA of some goods (including apparel) from some African countries.
- The Act is to be reviewed in 2015.

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Japan-South Afria's Partnership Forum

- Bilateral trade between Japan and South Africa had been expanding since the establishment of full diplomatic relations in 1992.
- Companies such as the Toyota Motor Corp had entered South Africa in 1962 and investment by Japanese companies continued during this period.
- South Africa exports mainly primary products (base metals, agricultural products, etc) to Japan whilst importing technology-intensive goods from Japan.
- An interesting and significant change in the nature of exports to Japan can be discerned with South Africa becoming the second largest exporter of motor vehicles to Japan in 2003.
- There has been over Yen 100-billion in Japanese investments to South Africa since 1994. Japanese investments into South Africa are mostly in the automotive, metals and chemicals sectors.
- The first "Japan-South Africa Business Forum" between business organisations was launched in Tokyo on 3 October 2001, during the State Visit by President Mbeki and has become an important mechanism which facilitates business relations between South Africa and Japan.

BRICS (Brazil, Russia, India, China and South Africa)

- SA joined as a full member of the BRICS bloc countries in 2011.
- With this, it joined four of the seven biggest economies of the world.
- BRICS comprises the countries that in all livelihood will be the pivot on which the global economy will centre over coming decades.
- As a BRICS member, SA enjoys trade and investment benefits well as influence on world forums.

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MAIN TOPIC: MICRO ECONOMICS

TOPIC 6: PERFECT MARKETS

6.1 Perfect competition

6.2 Individual business and industry

6.3 Market structure

6.4 Output, profits, losses and supply
- **Individual business**
- **The industry**

6.5 Competition policies

Examine the dynamics of perfect markets with the aid of cost and income curves.

NOTE:
1. Review cost and revenue tables and curves done in Grade 11.
2. Distinguish between the short and long run.
Concepts:

Concept	Description
The Competition Appeals Court	Should any dispute over the recommendations arise, it will be referred to the Competition Appeals Court.
The Competition Commission	An institution that investigates restrictive business practices, abuse of dominant positions and mergers to acquire shares in the South African economy.
The Competition Tribunal	An institution with the main function to approve major mergers, to appeal against misconduct cases, and to issue orders on submissions submitted by the Competition Commission.
Economic loss	Total cost is more than total income. When average income exceeds average cost, the business makes an economic loss.
Economic profit	Profit that is additionally made to normal profit. When average income is higher than average cost, the business makes economic profit.
Explicit cost	Actual expenditure of an enterprise, e.g. wages and interest.

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Implicit cost	Value of inputs owned by the entrepreneur and used in the production process (rent, interest and salaries given)
Short term	The production period during which only the variable factors can change while at least one factor remains fixed in this period.
Long term	The production period during which all factors can change. The period is long enough for all factors to change.
Market	An institution or mechanism that brings together buyers and sellers of goods and services
Market structure	How a market is organised.
Monopoly	Exclusive management of a good or service in a certain market
Monopolistic competition	A structure where businesses have many competitors but each sells a slightly different product (e.g. CDs and books)
Normal profit	The minimum earnings required to prevent an entrepreneur from leaving the industry. When average revenue equals average cost, the business makes normal profit.
Oligopoly	A market structure controlled by a small group of companies
Price take	Has no influence on the price. Accept the price determined by the market.
Shutdown point	The business will close when MC = AVC
Perfect competition	A market structure with a large number of buyers and sellers

<u>What is a market?</u>

- Can be defined as buyers and sellers who influence the price of a good or service.

OR

- It is an institution or mechanism that brings together the buyers and sellers of a good or a service.

OR

- It exists as a result of the interaction between buyers (demand) and sellers (supply). It is also called the market mechanism.

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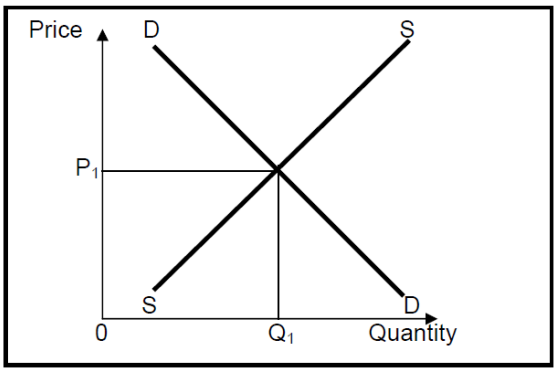

What is market conduct?

- Market conduct involves the things done by firms in their capacity as suppliers and buyers and relates to their objectives, competition methods to achieve their objectives and inter firm conduct.

What are the objectives of the business?

- To make profits
- To increase turnover
- To grow the business

The market structure

The major organisational features of a market, (e.g. number of sellers/buyers the degree of product differentiation/the availability of information) are called the structure of the market.

There are FOUR market structures / types of markets

1. Perfect Competition
2. Imperfect competition:
   - Monopolistic competition
   - Oligopolies
   - Monopolies

DIFFERENT TYPES OF COSTS

MC = Marginal Cost
It is the amount by which the total cost increase when one extra unit of a product is produced. **∆Total Cost (TC) ÷ ∆ Output (Q) = MC**
MR = Marginal Revenue
Marginal revenue refers to the extra amount of income earned when an additional (extra) unit of a product is sold. **∆TR ÷∆ Q = MR**

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AC = Average Cost
Fixed Cost + Variable Cost = Total Cost Total Cost ÷ Total output = AC. Also called unit cost.
AR = Average Revenue
Average revenue refers to the amount the enterprise earns for every unit sold. **TR ÷ Q = AR** Because TR = P x Q, it follows that AR = PQ ÷ Q therefore, AR = Price
AVC = Average Variable Cost
Variable cost divided by number of units produced. Variable costs ÷ total output = AVC.
P = Price
A value that will purchase a definite quantity, weight, or other measure of a good or service.
Q = Quantity
The extent, size, or sum of countable or measurable discrete events, objects, or phenomenon, expressed as a numerical value.

ECONOMIC COST

Economic cost of production = Opportunity cost = Explicit Cost + Implicit cost

Explicit cost

Explicit cost is the actual expenditure of a business on the purchase or hire of the inputs required for the production process.

Explicit costs include:

- Wages of labourers / Interest on borrowed capital / Rent on leasing land and buildings
- Expenditure on raw material / Water / Electricity / Property taxes /Motor car expenses

Implicit costs

Implicit costs = is the value of inputs that are owned by the entrepreneur and used in the production process.

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Implicit costs include:
- Forfeited rent that could have been earned if the owner used his own building.
- Forfeited interest that could have been earned if the owner had invested his/her money.
- Forfeited salary that could have been earned if the owner had worked elsewhere and earned a salary.

6.1 PERFECT COMPETITION (PERFECT MARKETS)

Describe the term: Perfect competition
- It is a market structure with a large number of participants who are all price takers, there are no entry or exit barriers in the long run, all information is available to both the buyers and sellers and a homogeneous product is sold.

OR
- A market in which the conditions for perfect competition are satisfied.

OR
- Perfect competition occurs when none of the individual market participants can influence the price of the product

Examples of markets in perfect competition
- Stock exchange
- Foreign currency market
- Central grain exchange market
- Market for agricultural produce

Markets are impersonal
- Businesses strive towards maximum profit and only take its own cost structure into account, when determining the production levels.
- All are price takers.

CHARACTERISTICS OF PERFECT COMPETITION

Many buyers and sellers:
- The number of buyers and sellers in the market is so large that individual market participants are insignificant in relation to the market as a whole.
- The number of buyers and sellers in the market is so large that the individual buyer or seller cannot influence the market price (price takers).

Homogenous product:
- All the products sold in the specific market are homogenous, that is, they are exactly the same regarding quality, appearance, etc.
- It makes no difference to a buyer where or from whom he/she buys the product.

Freedom of entry / exit:
- There is complete freedom of entry and exit, that is to say the market is fully accessible.
- Buyers and sellers are completely free to enter or to leave the market.

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- Entry should not be subject to any restrictions in the form of legal, financial, technological or other barriers that curtail the freedom of movement of buyers and sellers.

Mobility of factors of production:
- All factors of production are completely mobile, in other words labour, capital and all other factors of production can move freely from one market to another.

Perfect information:
- Both buyers and sellers have full knowledge of all the prevailing market conditions.
- For example if one business ventured to raise its price above the market price, buyers would immediately become aware of it and would switch their purchases to businesses who still charge the lower price.

No collusion:
- Collusion between sellers does not occur.
- In a perfectly competitive market, each buyer and seller acts independently from one another.
- Collusive practices are illegal in South Africa, according to the Competition Act 1998.

Unregulated market:
- There is no government intervention that could affect buyers or sellers.
- Decisions are left to individual sellers or producers and buyers.

No preferential treatment (no discrimination):
- Nobody is advantaged above the others.

Efficient transport and communication:
- Makes access to and from markets possible.

6.2 THE INDIVIDUAL BUSINESS AND THE INDUSTRY

- Individual businesses form a small part of the market, therefore, they do not influence market price. Individual business is a price taker.
- Market price is determined by the interaction of demand and supply.
- DD (demand curve) slopes downwards from top left to bottom right and SS (supply curve) slopes upwards from bottom left to top right.
- The point where demand and supply intersect, is called the equilibrium.
- Individual business can offer any quantity on the market at the market price.
- Business will not charge a higher price, because buyers will buy elsewhere and they will not charge a lower price, because they can sell all their goods at the current market price.

DEMAND CURVE FOR INDIVIDUAL BUSINESS

Sketch A **Sketch B**

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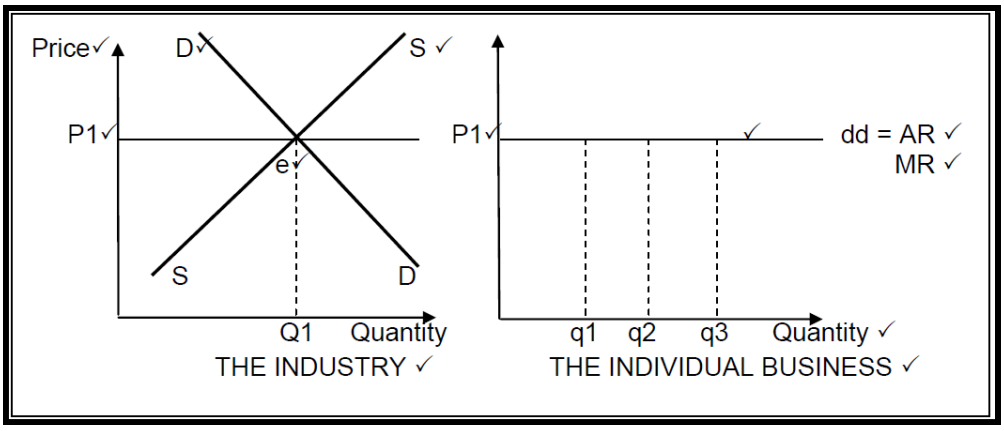

Sketch B

- Demand curve for individual business is a horizontal line at market price.
- For each unit sold, business receives the same price – the market price, Therefore P1 = AR = MR equals individual demand curve.
- The average revenue the business receives is therefore equal to the market price and the horizontal demand curve represents the average revenue curve (AR).
- The revenue from any additional unit the business sells, that is the marginal revenue, is equal to market price P1, and the horizontal demand curve therefore also represents the marginal revenue curve (MR).

REVENUE TABLE

Perfect market

Total Product / Output	Price	Fixed Cost	variable Cost	Total Cost	Average Fixed Cost	Average Variable cost	Average Total Cost	Average Revenue	Marginal Cost	Total Revenue	Marginal Revenue	Profit
0	0	40	0	40								-40
1	35	40	28	68	40	28	68	35	28	35	35	-33
2	35	40	48	88	20	24	44	35	20	70	35	-18
3	35	40	64	104	13.33	21.33	34.66	35	16	105	35	1
4	35	40	78	118	10	19.5	29.5	35	14	140	35	22
5	35	40	90	130	8	18	26	35	12	175	35	45
6	35	40	107	147	6.67	17.83	24.5	35	17	210	35	63
7	35	40	129	169	5.71	18.42	24.13	35	22	245	35	76
8	**35**	**40**	**159**	**199**	**5**	**19.88**	**24.88**	**35**	**30**	**280**	**35**	**81**
9	35	40	199	239	4.44	22.11	26.55	35	40	315	35	76
10	35	40	253	293	4	25.3	29.3	35	54	350	35	57
11	35	40	440	480	3.64	40	43.63	35	187	385	35	-95

<u>Profit maximisation</u>

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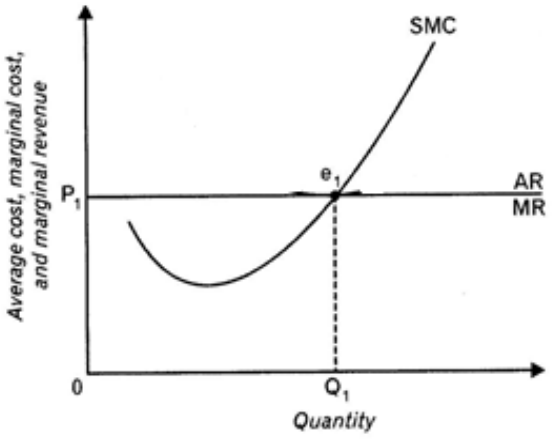
Total Cost (TC) and Total Revenue (TR)

- Between 0 and 3 units the firm makes a loss (TC is greater than TR).
- At 3 units the firms economic profit is zero.
- Between 3 units and 8 units the firm makes economic profit.
- At 8 units the firm makes zero profit.
- Beyond 8 units the firm is making a loss (TC is greater than TR)

<u>Marginal cost (MC) and Marginal Revenue (MR)</u>



When
MR > MC (marginal revenue greater than marginal cost) = output should increase
MR = MC (marginal revenue equals marginal cost) = profit is maximized
MR < MC (marginal revenue lower than marginal cost) = output should be reduced

<u>Supply of the business</u>

- Under perfect competition profits are maximized where SMC = MR and it is used to derive business's supply curve
- The different market prices are taken to determine how much a business would produce at each price.

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- The production determines the supply curve.
- Average variable cost (AVC) consists of the per unit value of e.g. labour cost, material cost, fuel and electricity cost, etc.

Sketch A **Sketch B**

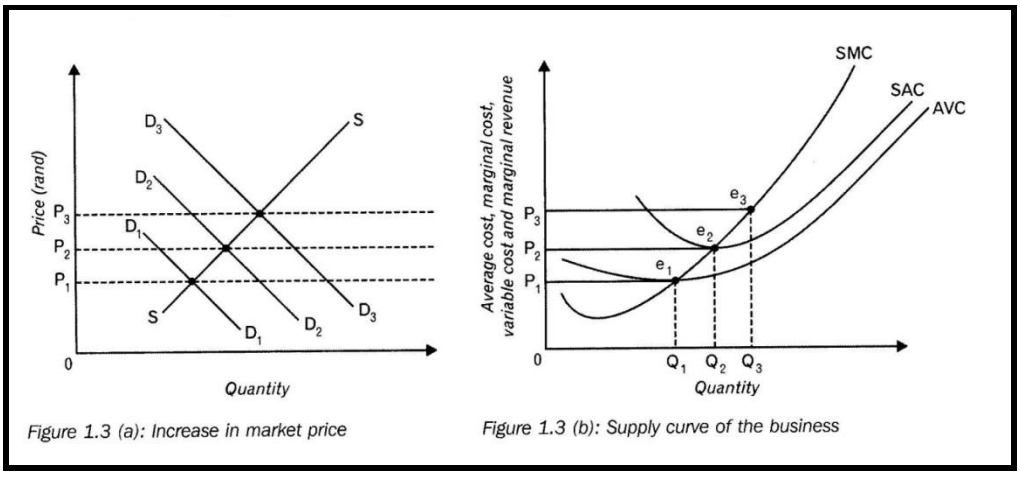

Figure 1.3 (a): Increase in market price

Figure 1.3 (b): Supply curve of the business

(Enjoy Economics, p. 94)

Sketch A

- The market price rises due to an increase in demand.
- The increase in the market demand is shown as a rightward shift of the market demand curve.

Sketch B

- The horizontal demand curve for the business' product shifts upward: Demand = AR = MR.
- The horizontal demand curve intersects the SMC at point e_1, e_2 and e_3 (to the right of the previous point)
- Each point shows the profit maximisation point where SMC = MR.
- Points e_1, e_2 and e_3 plot business's supply at different market prices – supply begins at e_1.
- The firm's supply starts at e_1, where the AR = AVC.
- The amount supplied by the business increase as price increase.

Below point e_1

- To the left of point e_1: business cannot even cover its variable cost.
- The business should close its doors.
- Also known as shutdown point.

Important:

- To determine the market supply, the supply curves of all the businesses are added horizontally.
- In the short term the supply curve is also called the market supply curve.

Equilibrium positions:

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- In a perfect market the individual business faces a perfectly horizontal demand curve.
- The market price is determined by the industry (demand and supply curves).
- This means that individual businesses are price takers i.e. they are not able to influence prices.
- An individual business can increase or decrease output in order to maximize profit.
- Profit is maximized where SMC = MR.
- This is the point at which profit is maximized; (loss minimized) which is known as the equilibrium point.

THE INDUSTRY

The industry's short term supply curve

- The short term supply curve is also called the market supply curve.
- The market supply curve of the industry is derived by horizontally adding up the quantity supplied (at a particular price) of individual businesses.
- The market is used as a synonym for the industry.

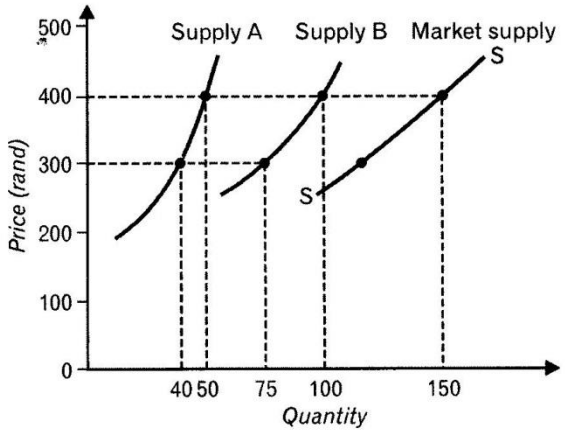

Figure 1.5: Horizontal summation

(Enjoy Economics, p. 98)

- At R400 business A supplies 50 products and business B supplies 100 products.
- The market supply is 150 units of the product at a price of R400.
- The location and shape of the supply curve are determined by technology and the price of factors of production.

The industry's short term equilibrium

- The industry is in equilibrium at a price that clears the market.
- That is at a price where the quantity demanded is equal to the quantity supplied.
- Short term equilibrium of the industry will not apply in the long term.
- Businesses that make economic profit in the short term will have to expand their businesses in the long term.
- As a result of economic profit, more businesses will be attracted to the industry.

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- Businesses that make losses and who are unable to adjust their business will have to close in the long term.

6.3 MARKET STRUCTURES

	Perfect Competition	Imperfect Competition		
Characteristics/ Criteria	**Perfect Competition**	**Monopoly**	**Oligopoly**	**Monopolistic Competition**
Number of Firms / Businesses	So many that no single business can influence the market price	ONE Seller and many buyers	Small number of businesses / sellers.	Large number of businesses / sellers.
Nature of product	Products sold on the market are homogeneous, e.g. maize	Products / services are unique with no close substitutes	Products are homogenous or differentiated.	Products are differentiated.
Entrance	Entry is completely free	Entry is completely restricted or blocked	Entry into the market varies from free to restricted.	Free entry and exit into the market.
Market Information	Both buyers and sellers have full knowledge of all the prevailing market conditions	Buyers and sellers have full knowledge of all the prevailing market conditions (Complete)	Incomplete information between buyers and sellers.	Information for buyers and sellers is incomplete.
Collusion	Impossible. Sellers act independently from each other.	Irrelevant, only one firm	Collusion is possible.	There are many sellers / producers and this makes collusion impossible.
Control over price	Price taker - no control cover price The market determines the price for the individual firm	Is regarded as a price maker Have some control over price Prices not determined by market forces of supply and demand but by the business itself Considerable control over the price of the	Have control over prices. They are price makers.	Businesses have little control over prices of products.

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		product, but limited by market demand and the goal of profit maximization.		
Output demand curve for firms' / businesses product.	The demand curve for the perfect competitor is horizontal - (Perfectly elastic)	Demand curve slopes downward and it equals the market demand curve	Demand curve is downward sloping.	Demand curve is downward sloping.
Economic profit	The perfect competitor can realise economic profits in the short term Abnormal profits will attract new entrants into the market for both structures Both perfect market and monopoly can only realise normal profits in the long term The price for the product for both market structures equals the average cost The perfect competitor does produce the ideal production quantity and has no surplus capacity	The monopolist also realise economic profits in the short term The monopolist will charge a higher price than the perfect competitor The monopolist will not produce at the lowest point of the LAC, like the perfect competitor, the output will be less than the perfect competitor Both perfect and monopoly can only realise normal profits in the long term The monopolist's production will be less than the ideal production quantity where LAC is the minimum and has surplus capacity	Can make economic profit in the long term.	Make normal profit

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Allocative Efficiency	Efficient	Inefficient	Inefficient	Inefficient
Productive Efficiency	Efficient	Inefficient from a society point of view	Inefficient from a society point of view	Inefficient from a society point of view
Decision-making	Decision has no influence on others	Independent	Influenced by other competitors	Influenced by other competitors
Examples	International commodity markets e.g. gold, oil, etc. Financial Markets (JSE).	Eskom DSTV Stainless Steel (Columbus steel)	Petrol and oil, Cellular phones, Motorcars	Fast food outlets, Clothing stores, Household furniture, etc.

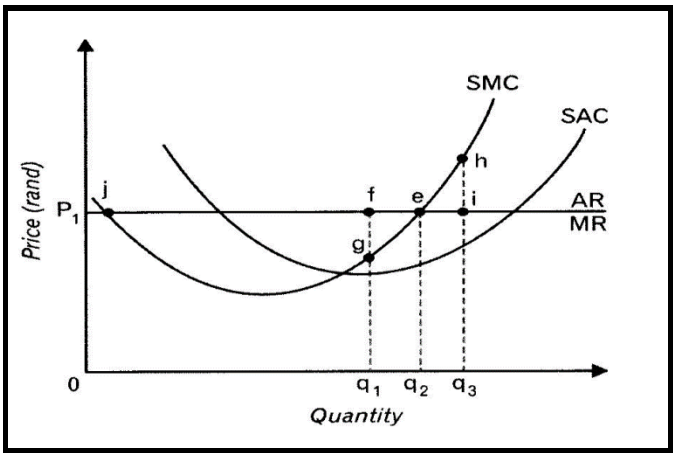
Allocative efficiency: (Also called Pareto efficiency)
- It is where goods and services are allocated in the most efficient manner.
- Allocative efficiency is obtained when a distribution strategy exists where one party's situation cannot be improved without making another party worse off.

Productive efficiency (Technical efficiency):
- The production of goods and services in the least costly way and without wasting scarce resources.

6.4 Output (Production), Profit, Loss and Supply

6.4.1 Individual business

- Under perfect competition the demand curve for the individual business is a horizontal line at the market price.
- To obtain maximum profits for the business, only the given market price and its own cost structure are taken into account when determining its production output.



(Enjoy Economics, p. 93)

At point e
- Horizontal demand curve represents MR and AR.

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- Maximum profit at point e. This is the point where SMC = MR.
- It is known as the equilibrium point.
- Point e = profit maximization = equilibrium

At point g

- Profits are not maximized.
- Businesses render revenue that is greater than the marginal cost.
- MR lies above SMC.
- Business Expand its production up to a point where SMC = MR on the ascending part of the SMC.

At point h

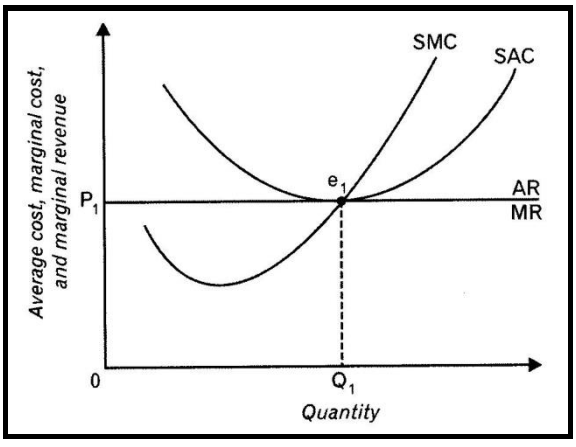
- The business makes a loss on each product when producing here and it reduces it profits.
- At point h, SMC > MR (SMC more than MR)
- The output unit produced at point q_3 costs more to produce than the price that will be received for it.
- It does not benefit the business to produce here, because it makes a loss on that particular unit.

At point j

- Maximum losses are made here.
- The business will not produce here.
- It is on the descending part of the SMC.

Profit for the Business

Normal Profit



- The business makes normal profit which is the minimum earnings required to prevent the entrepreneur from closing the business and using his factors of production elsewhere.
- Equilibrium is at point e_1. The business will produce at this point where SMC = MR.
- At point e_1, Q_1 goods are produced at a price of P_1.
- Point e_1 is the Profit Maximisation point of the business.

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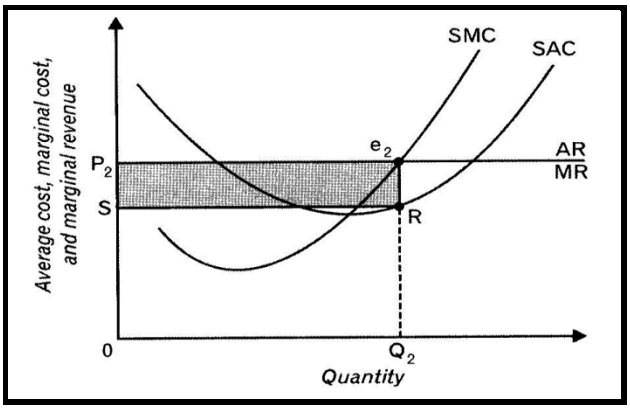
At point e:

- Average cost is equal to price.
- The SAC curve is tangent to the demand curve which means that P/AR = SAC (TR = TC).
- The firm makes only normal profits.

Economic Profit

- This is a profit which is made in addition to normal profits.
- This is the difference between Total Revenue and Total Cost.



- Business maximizes profit at point e_2.
- Equilibrium is at point e_2. At this point SMC = MR.
- The business produces at market price P_2 and the quantity produced is Q_2.
- The averages cost for Q_2 units is point R on the SAC curve.
- Price (or AR) is greater than SAC. (TR > TC)

E.g.

- Total Revenue = OP_2 x OQ_2
- Total Cost = OS x OQ_2

- Total revenue is more than Total cost.
- The business makes a profit.
- The economic profit area is represented by P_2e_2RS

Loss for the business

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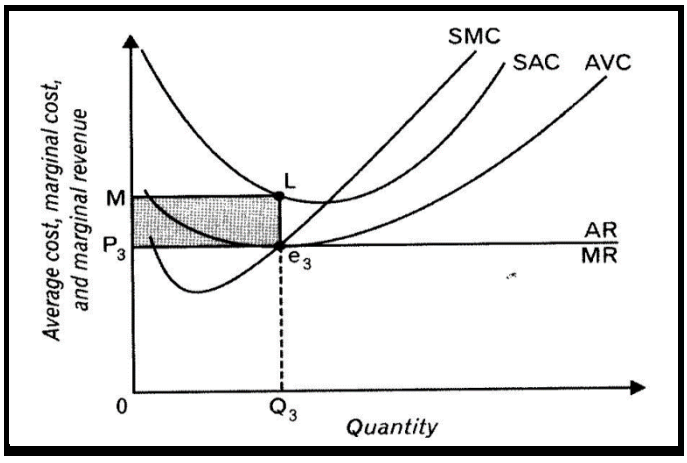

- The minimum point of the SAC curve is higher than the market price P_3.
- The business (firm) is in equilibrium is at point e_3. The firm will produce where SMC = MR.
- At point e_3, Q_3 goods are produced at a price of P_3.
- At equilibrium (point e3) Price/AR is less than Average Cost.
- The AC lies above the demand curve which means that P/AR < AC (TR < TC)
- The business makes an economic loss.

E.g.

- Total cost is represented by OM x OQ_3 = $OMLQ_3$
- Total Revenue is represented by OP_3 x OQ_3 = $OP_3e_3Q_3$
- Total Revenue is less than Total Cost
- The business makes a loss.
- The loss is indicated by P_3MLe_3

SHUTDOWN POINT

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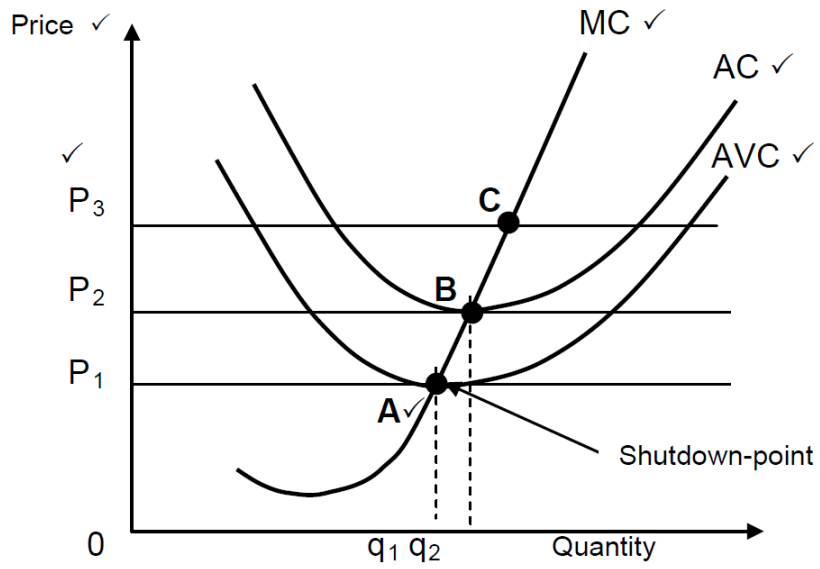
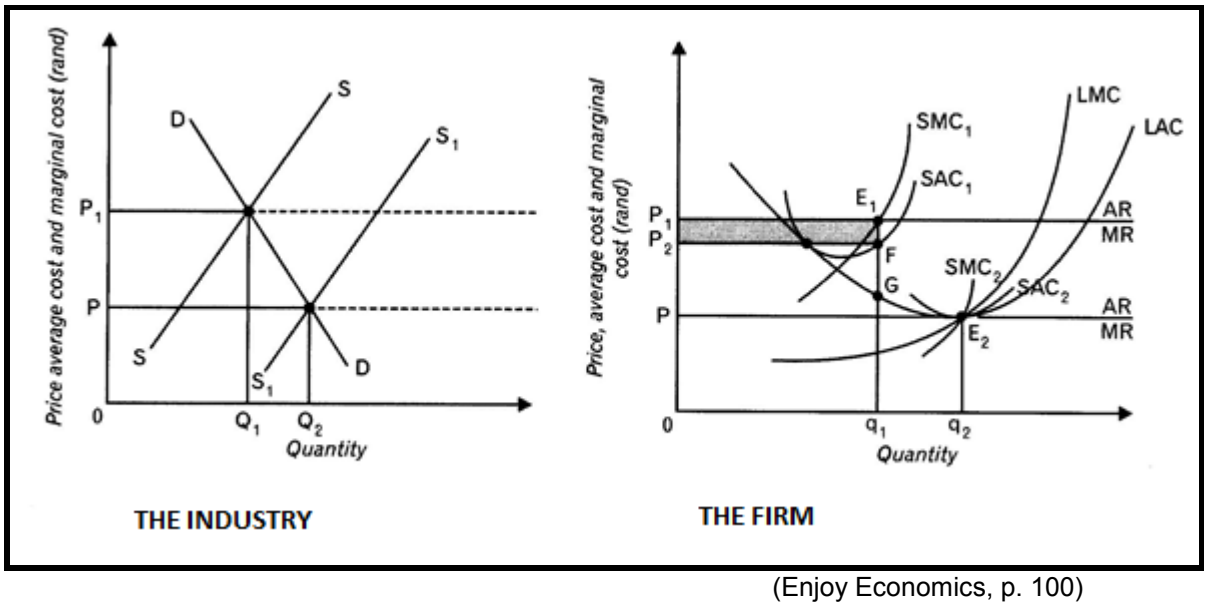


- The rising part of the businesses' MC curve above the minimum of its average variable cost curve represents the supply curve of the business.
- The supply curve starts at point A (shutdown-point) and slopes upward from there due to the marginal cost that increases as output increases.
- At a market price of P_1 the business is only able to pay its variable costs.
- If the market price drops below P_1 the business will be forced to close down and this point (A) is known as shutdown-point.

6.4.2 <u>The industry's long-term equilibrium</u>

Compare the individual firm and industry under conditions of perfect competition.



(Enjoy Economics, p. 100)

- The industry is in equilibrium at the price that clears the market.

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- It is the price at which the quantity demanded is exactly equal to the quantity supplied.

1. <u>In the long run, two things can change</u>:

(a) New businesses can enter or leave the market.

(b) Businesses can adjust their production capacity.
All factors of production become variable and existing firms earning economic profit in the short run may decide to expand their plant size to realize economies of scale.

2. <u>Economic profit</u>

- Suppose the business's short-term plant is represented by SAC_1.
- If the market price is P_1 the business is making an economic profit of $P_1E_1FP_2$ with the short-term plant-size represented by SAC_1.
- At a price of P_1 the business will maximise profit in the short-term at point E_1 where the profit maximisation (MR=MC) applies, and the quantity q_1 will be produced.

3. <u>Bigger plant, lower unit cost</u>

- If the producer does a cost estimate, he/she will realize that he/she will be able to produce at a lower unit cost in the long-run.
- This is illustrated by the downward sloping portion of the LAC curve.
- The prospect of increased profit would therefore encourage the producer to build a bigger plant.
- The business would however not be interested in producing output levels greater than those presented by the minimum point E_2 of the LAC because such output levels are only possible at higher cost levels – internal scale disadvantages cause the LAC to rise to the right of point E_2.

4. <u>New entrants, increased supply</u>

- The economic profit that businesses make is likely to attract new businesses to the industry.
- The quantity offered on the market increases as a result of expansion by existing businesses and the entry of new businesses. The market supply curve will shift to the right from S to S_1 and the price will drop until it eventually reaches P.
- At the price P, which is at the same level as the minimum point of the LAC curve, total revenue ($0P \times 0q_2$) is equal to total cost ($0q_2 \times q_2E_2$).
- At $0q_2$ the business is making normal profit, because it is exactly covering its total cost.
- Over time all the businesses in the industry will make normal profit and will be in long run equilibrium.

5. <u>Initial losses</u>

- Individual firms can be in equilibrium in the short run where it makes an economic profit or an economic loss.
- These positions, however, are not sustainable in the long run under conditions of perfect competition.

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- If the market price is below the minimum point of the long-term average cost curve, the adjustment process simply works the other way around.
- Eventually the LAC curve will also form a tangent with the demand curve and the businesses that have remained in the industry will be making normal profit.

6. Price in the long term

- The above analysis leads to the conclusion that under perfect competition the price of a product in the long term will settle at a level that corresponds to the lowest point of the LAC curve.
- A point such as E_2 represents the equilibrium point of the business in the long run.
- The business is making normal profit and there will be no incentive to leave or enter the industry.
- When a market price has been established under perfect competition at a level where each business is in equilibrium at the minimum point of its LAC curve and only making normal profit, the industry will also be in long-term equilibrium.

7. Equilibrium

- Once long-term equilibrium has been achieved, and provided that there are no changes in the technology or the factors of production, there will be no further entry or exit of businesses.

COMPETITION POLICY

Definition

Competition policy wants to promote competition and prevent the abuse and exploitation of economic power and instead exploit the advantages of healthy competition to benefit the society as a whole.

- Markets can only operate efficiently if there is healthy competition.
- The first step in promoting competition is to open up a country's economy to imports.
- South Africa was one of the founder members of the World Trade Organisation (WTO) in 1994.
- The WTO promotes global free trade through the reduction of import tariffs and the abolition of import control.

The aims of the competition policy in South Africa

- Prevent the abuse of economic power, e.g. by a monopolist.
- Regulate the growth of market power by means of takeovers and mergers.
- Prevent restrictive practices, especially by oligopolist, such as fixing of selling prices, collusion in respect of tenders or price discrimination.
- Contribute to the developmental objectives of the state.
- To improve efficiency of markets through legislation.

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- Improve equity in markets e.g. Employment Equity Act.
- Protect the consumer against unfair prices and inferior products e.g. Competition Act.
- Prevent price fixing.
- Promote competition.

THE ANC's POLICY ON MONOPOLY FORMULATION

- In 1994 the African National Congress, which propagated a strict anti-monopoly policy, came to power in South Africa.

This meant a further boost for competition policy in the country:

- A great deal of emphasis was placed on the fact that there should be no restrictions on entry (to any industry), because this would be to the detriment of previously disadvantaged groups.
- These groups should obtain access to resources and economic power in order to promote economic transformation in the country.
- A further objective was to curb the economic power of the big conglomerates in the South African economy in order to arrive at a more equitable distribution of income and wealth.
- The fact that South Africa was able to regain access to the world economy also served to make South African businesses more competitive.
- Another factor was that new trade agreements with other countries made it mandatory for South African competition law to comply with certain requirements.

PROVISIONS OF THE COMPETITION ACT 89 OF 1998

- The result of the above developments was the adoption of a new law, the Competition Act 89 of 1998.
- This act makes provision for a:
    - Competition Commission
    - Competition Tribunal
    - Competition Appeals Court

1. Competition Commission

- The Competition Commission tries to give all South Africans equal opportunities to participate fairly in economic activities in order to make the economy more efficient.
- One of the provisions of the act is that the Competition Commission must be advised of any mergers and takeovers.
- Mergers cannot take place without the consent of the Commission.
- When the Commission evaluates mergers, any matters relating to competition and efficiency, and the public interest, must be taken into account.

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2. Competition Tribunal

- The Commission's recommendations are submitted to the Competition Tribunal.
- The Commission Tribunal can accept or reject the recommendation made by the competition commission.

3. Competition Appeal Court

- If there are any disputes over the recommendations, they are referred to the Competition Appeal Court.

TOPIC 7: IMPERFECT MARKETS

Subtopics:

7.1 The dynamics of imperfect markets with the aid of cost and revenue curves
7.2 Monopolies
7.3 Oligopolies
7.4 Monopolistic competition
7.5 Summary of market structures

CONCEPTS

Concepts	Description
Cartel	A group of producers whose goal is to form a collective monopoly in order to fix prices and supply, and limit competition.
Artificial monopoly	The barriers to entry is not economic in nature but is due to other factors. For example, a patent - it is the legal right of a patent holder to exclusively produce the product.
Monopoly	A market structure where only one seller (producer) do business. Access is blocked and the product does not have similar substitutes.
Monopolistic competition	A market structure with many buyers and sellers and which entry is fairly easy, but the product is differentiated, e.g. toothpaste.
Natural monopoly	High development costs prevent others market entry. A single enterprise can offer the whole market at a lower price because of the size of the scale, e.g. water and electricity.
Non-homogenous	Produce different versions of their products in order to make it difficult for other companies to view the specific product.

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Oligopoly	A market structure where only a few sellers do business. Access is difficult and products can be differentiated or standardized.
Imperfect market	When the market price does not purely reflect the scarcity of the product.
Price leadership	A situation where an enterprise determines the price and the others accept it as the market price.
Collusion	An agreement between enterprises for the purpose to restrict competition between them by fixing prices.
Legitimate monopoly	Monopoly that by law prevents other businesses from competing.

7.1 The dynamics of imperfect markets with the aid of cost and revenue curves

<u>Marginal, average and total revenue schedule</u>

Units	Market price	Total revenue	Average revenue	Marginal revenue
1	9	9	9	9
2	8	16	8	7
3	7	21	7	5
4	6	24	6	3
5	5	25	5	1
6	4	24	4	-1

<u>Marginal revenue and Average revenue curves</u>

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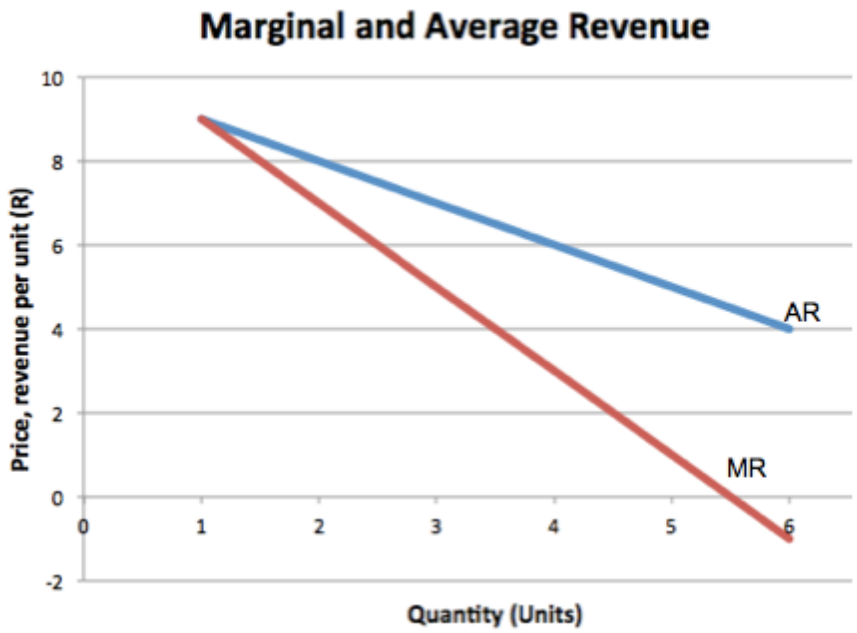

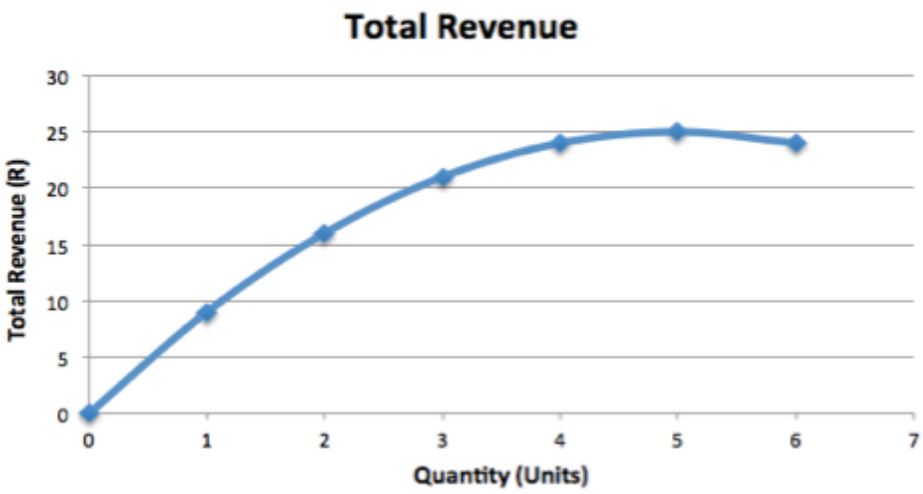

Total revenue (TR) is equal to Price x Quantity

TR = P x Q (Quantity sold)

Average revenue (AR) is equal to the total revenue of product divided by quantity.

AR = TR divided by number of units sold.

Marginal revenue (MR) is the change in total revenue when one extra unit of output is sold.

MR is the addition to TR from the sale of one extra unit.

The marginal revenue is always lower than the price of the product except for the first unit sold.

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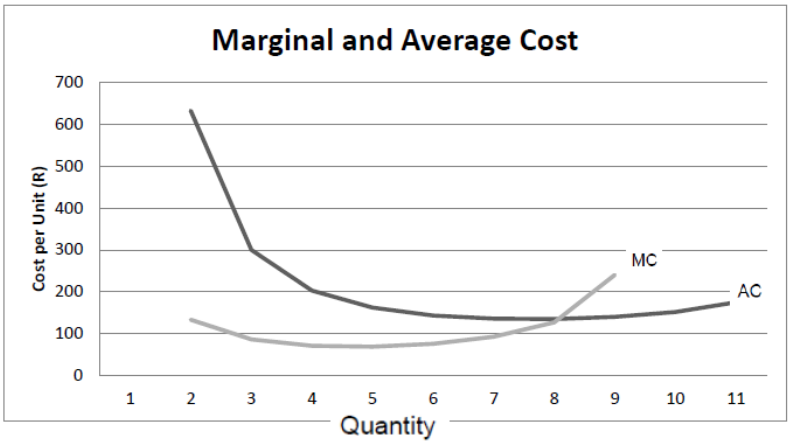
Marginal, average and total cost schedule

Quantity (units)	Increase in output (marginal product)	Total Cost (Rand)	Average Cost (Total cost ÷ units) (Rand)	Increase in total cost (Rand)	Marginal Cost (addition to total cost) = ΔTC ÷ ΔQ (Rand)
0		9000			
18	18	11400	633.33	2400	133.33
46	28	13800	300.00	2400	85.71
80	34	16200	202.50	2400	70.59
115	35	18600	161.74	2400	68.57
147	32	21000	142.86	2400	75.00
173	26	23400	135.26	2400	92.31
192	19	25800	134.38	2400	126.32
202	10	28200	139.60	2400	240.00
202	0	30600	151.49	2400	
189	-13	33000	174.60	2400	

Marginal and average cost curves



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- MC decreases, reaches a minimum and then increases.
- AC decreases, reaches a minimum and then increases.
- MC curve intersects the AC curve at the minimum of the AC curve.
- Before the MC curve intersects the AC curve, it lies below the AC curve but after the MC intersects the AC curve at its minimum, it lies above the AC curve.

Types of imperfect markets

- Monopolies
- Oligopolies
- Monopolistic Competition

7.2 MONOPOLY

Definition of monopoly

It is a market structure in which there is only ONE seller of a good or service that has no close substitutes, entry into that market is completely blocked.

Examples:

- The exclusive ownership of raw materials
  - Example: De Beers Consolidated Mines (diamonds)

- A patent, which is the legal right whereby a patent holder obtains the exclusive right to manufacture a product
  - Example: Kreepy-Krauly

- Licensing is another way in which artificial monopoly comes to existence
  - Example: SABC/Cell C/Vodacom/MTN

- Legal restrictions, where there are laws protecting them.
  - Example: The Post Office in South Africa

- Technical superiority, a business whose technological expertise vastly exceeds that of any potential competitor
  - Example: Microsoft

- Deliberately created entry barriers.
  - Example: To start costly lawsuits against new rivals.

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Characteristics of a monopoly

- **Number of producers**
  - The monopolist has full control over the supply of a product, because it is the only seller.
  - The monopoly also represents the total industry.
  - E.g. De Beers (diamond sales), Eskom

- **Nature of the product**
  - The product is unique and has no close substitutes.
  - E.g. electricity and rail transport.

- **Economic profit**
  - The monopoly makes a short-term loss or profit.
  - The monopoly makes a long-term economic profit.

- **Technical superiority**
  - A monopoly has technical advantage over potential competitors and their access to resources and technical superiority make it difficult for others to compete.

- **Access to scarce resources**
  - A single firm owns and controls a specific scarce resources and excludes other companies from entering the market.

- **Demand curve**
  - Monopolists are also confronted with a demand curve for their product but because they are the only supplier of the product they can decide at what point on the demand curve they wish to be.
  - The monopolist is the only supplier of the product in the market - the demand curve that confronts the monopolist is that of the market as a whole.
  - The market demand curve which slopes downwards from top left to bottom right / graph.

- **Production levels**
  - Once the monopolist has decided on a price, the quantity sold is determined by market demand.
  - By reducing the price, monopolists can sell more units of the product and vice versa.
  - Monopolists influence the product-price combination of the product they sell without any reaction from other market participants.
  - Other participants cannot act because a basic requirement for the existence of a monopoly is that entry to the market is blocked.

- **Market forces**
  - Although the monopolist is the only supplier of a product, the product is still influenced by market forces in the economy.
  - Consumers have limited budgets and a monopoly can therefore not demand excessive prices for the product.

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- The monopolist's product has to compete for consumer's favour with all the other products available in the economy.
- E.g. Transnet competes road, air etc. means of transport.

- **Control over the price**
  - A monopolist has considerable control over the market price – but demand limits it.
  - The monopolist is a price maker.
  - A monopoly does not have control over demand, so demand will influence the final market price.
  - A monopoly can only decide at which point on the demand curve it wants to produce.

- **Substitutes**
  - There are few products that have no close substitutes whatsoever.
  - For many years even though there was no competition for telephone services in South Africa, consumers could still use alternative forms of communication such as letters and telegrams.

- **Favourable circumstances**
  - Sometimes an entrepreneur may enjoy favourable circumstances in a certain geographic area.
  - E.g. there may be only one supplier of milk in a particular town, a hardware store or hotel.
  - There may even be laws that protect them, e.g. Post Offices in South Africa.
  - Pure monopolies are a common rarity in South Africa.
  - Not only are substitutes available, but there is often nothing to prevent other entrepreneurs from entering the market hence what may be called a quasi-monopoly.

- **Market information**
  - It refers to information available to market participants about market conditions.
  - All buyers and the single seller have full knowledge of all the current market conditions.

- **Exploitation of consumers**
  - The monopolist may exploit the consumer because it is the only supplier of a product.
  - The government continuously guard against existing and new monopolies. E.g. the Competition Act, Act 89 of 1998.

- **Market entry**
  - Refer to how easy or difficult it is for businesses to enter or exit the market.
  - Entry is totally blocked.
  - The barriers prevent other producers from entering the market to supply the same type of product.
  - A number of barriers to entry as a result of monopolies are:
    - Economies of scale

    - Restricted size of the market

    - Exclusive ownership of resources

    - Patents

    - Licensing

    - Sole rights

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- **Economies of scale**
  - These give advantages to large existing companies.
  - Occur when the cost per unit decreases when the output increases.
  - Large businesses production costs per unit are lower than those of small businesses, e.g. Eskom

- **The geographical area**
  - This can cause a natural barrier as well, e.g. only one holiday resort can fit on the seafront as an exclusive beach.

- **Size of the market**
  - Sometimes a business enjoys favourable circumstances in a certain small market.
  - E.g. there may be only one hardware store in a particular small town.

Distinguish between natural and artificial monopolies

Natural monopolies

- High development costs are frequently a reason - the provision of electricity is often used as an example.
- They are owned and regulated by the government.
- It is a huge and expensive process – it can cost billions of rands.
- A single business in the industry can supply the market demand.
- They can do it at a price that is lower as if there were two or more businesses.
- E.g. Eskom as a single business in the country that supplies electricity operates as a natural monopoly and is frequently owned and regulated by the government.

Artificial monopolies

- The barriers to entry are not economic in nature but artificial like patent rights which are legal and exclusive rights of a patent holder to manufacture a product.
- Patents are also frequently encountered in the pharmaceutical industry.
- Licensing is another way in which artificial monopoly is applied, e.g. TV and radio licenses.
  licenses protect operators against entry of other competitors.

Demand curve of the monopolist

The demand curve that faces the monopolist is that of the market as a whole – that is, the market demand curve which slopes downwards from top left to bottom right, because the monopolist is the only supplier of the product in the market.

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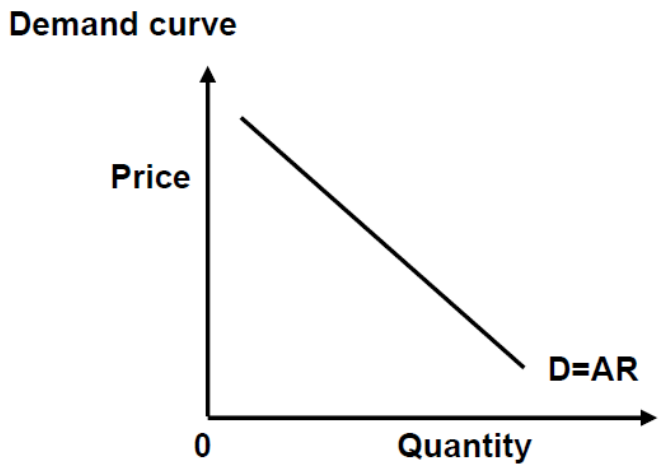

Average and marginal revenue

- The monopoly is confronted with a normal demand curve.
- It slopes from top left to bottom right.

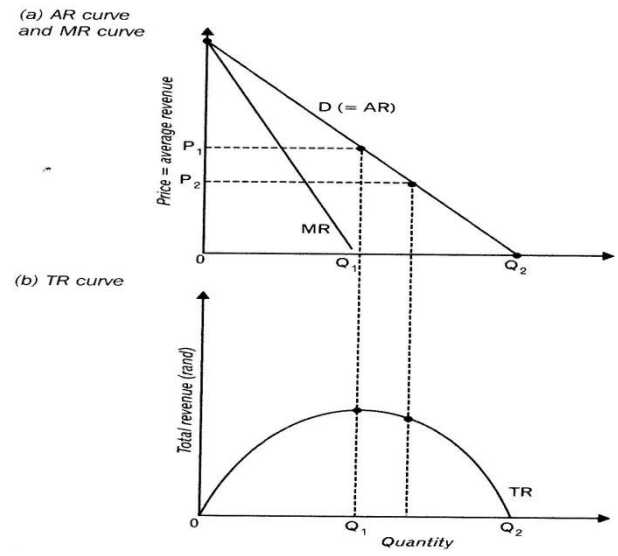

Figure 3.1: Average, marginal and total revenue

(Enjoy Economics, p. 141)

- Any point on the demand curve of the monopoly is an indication of the quantity of the product sold and at which price.
- At $0P_1$ the monopolist can sell $0Q_1$.
- The monopolist can sell each individual product at $0P_1$.
- It means that $0P_1$ = average price or average revenue that the monopolist earns for each unit.
- This applies for every price-quantity combination on the demand curve.
- The demand curve is also the average revenue (AR) curve.

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Price (P)	Quantity sold (Q)	Total revenue (P × Q)	Average revenue (TR ÷ Q)	Marginal revenue (MR)
11	0	0	–	–
10	1	10	10	10
9	2	18	9	8
8	3	24	8	6
7	4	28	7	4
6	5	30	6	2
5	6	30	5	0
4	7	28	4	–2
3	8	24	3	–4
2	9	18	2	–6
1	10	10	1	–8

Table 3.1: Calculating average revenue and marginal revenue

(Enjoy Economics, p.152)

- The first two columns represent the demand curve.
- 0P = the different prices.
- 0Q = the quantity demanded at each price.

- **Total Revenue** = Price x Quantity
- **Average Revenue** = Total Cost divided by Quantity
- **Marginal Revenue** = it is the change in Total Revenue when one additional unit has been sold.

The implications of the downward-sloping demand curve

1

- The marginal revenue curve (MR) runs below the demand curve.
- The marginal revenue curve (MR) intersects the horizontal axis at a point that is exactly halfway between the origin and the point of intersection of the demand (AR) curve.

2

- The monopolist will have a pricing policy.
- The monopolist is the only supplier on the market and has a downward-sloping demand curve.
- It is where each unit sold is associated with a unique price.
- When the price decreases, more units are sold.
- The monopolist can influence the price-quantity combination to a great extent.

3

- The monopolist will not fix his/her price lower than the centre point of the demand curve.
- **Reason**: The monopolist's total revenue will decrease when the price is in the bottom half of the demand curve.
- A point will be reached where the marginal revenue will become negative.

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- When the price is lower than $0P_1$, the monopolist sells more units.
- But they will end up on a lower point on the total revenue curve.

<u>The AR and MR are two different curves because:</u>

- In a perfectly competitive market the AR = MR = P.
- A monopoly is confronted with a normal market demand curve, which slopes downwards from top left to bottom right: D = AR.
- Any point on the monopolist's demand curve (D) is an indication of the quantity of the product that can be sold and the price at which it will trade.
- The MR curve runs below the demand curve with the exception of the first unit.
- TR increases at a diminishing rate up to a point and then starts to decrease.
- MR is always lower than AR.
- The percentage increase in quantity demanded is greater than the percentage decrease in price at all points (in the top half of the demand curve), therefore the MR will always be lower than AR.

<u>Profit and loss in the short term</u>

<u>Profit</u>

- A monopolist also tries to maximize profit in the short term and long term.

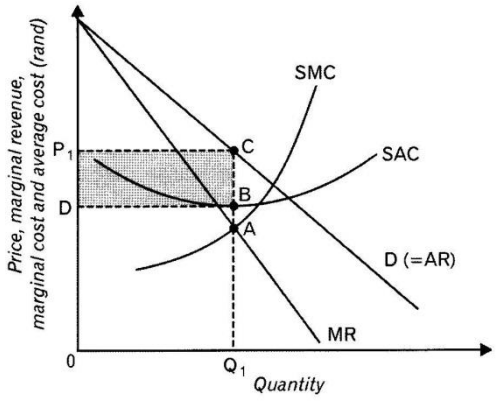

Figure 3.2: Short-term equilibrium for the monopolist

(Enjoy Economics, p.143)

- The graph illustrates short term equilibrium.
- The demand curve slopes from top left to bottom right.
- Demand curve = Average Revenue curve (AR).

Cost curves:

1 The short term marginal cost curve (SMC)
2 The short term average cost curve (SAC)

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Short term equilibrium is determined as follows:

1. It is where short term marginal cost is equal to marginal revenue: SMC = MR
   - The business increases production to a point where production cost of the last unit is equal to the revenue it earns.
   - At point A: SMC = MR: It is the profit maximisation point and the quantity is $0Q_1$.

2. The price at which $0Q_1$ must be sold has to be determined:
   - Draw a vertical line upwards from point A up to point C until it reaches the demand curve.
   - The price at point C is $0P_1$.
   - The price is $0P_1$ and the quantity is $0Q_1$.

Calculate the short term profit

Total Revenue

- Price x Quantity = Total Revenue
- $0P_1$ x $0Q_1$ = $0P_1CQ_1$

Total Cost

- Average Cost x Quantity = Total Cost
- 0D X $0Q_1$ = $0DBQ_1$

Total profit

- Total Revenue – Total Cost = Total Profit
- $0P_1CQ_1$ - $0DBQ_1$ = DP_1CB

Loss

Calculate short-term loss

- Monopolies can also make losses.
- Profitability depends on the demand for the product and the cost of production.

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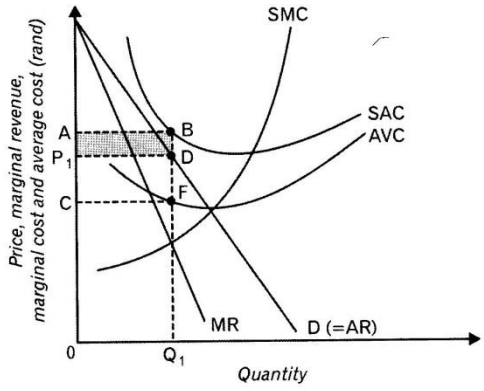

Figure 3.3: Short-term loss for the monopolist

(Enjoy Economics, p. 144)

- The SAC lies above the demand (AR) curve.
- Equilibrium is where MR = SMC.
- It is a loss-minimizing situation.

- Monopoly is in equilibrium:
- Produce at $0Q_1$ (at $0Q_1$, MR=MC), sell at a price of $0P_1$.
- Price $0P_1$ is lower than the SAC and is indicated by BD.

Total Cost

- $0Q_1$ x Q_1B
- Total output cost at Q_1 = $0Q_1BA$

Total Revenue

- $0Q_1$ x Q_1D = $0Q_1DP_1$

The monopolist's loss is:

- $ABDP_1$

<u>LONG TERM EQUILIBRIUM</u>

- When the monopolist makes losses in the short term, they will expand their plant size so that they can make profits.
- If they do not get it right, they will have to close their business.
- When the monopolist makes profit in the short term, they will try to expand their plant size to make more profits.

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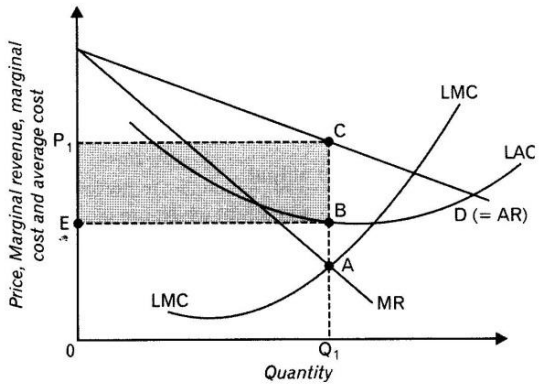

Figure 3.4: The monopoly in long-term equilibrium

(Enjoy Economics, p.145)

- The long term marginal cost (LMC) and the long term average cost curve (LAC) appear in the graph.
- Long term profit is maximised where MR = LMC.
- The MR = LMC at point A.
- Profit maximising output is $0Q_1$ at a price of $0P_1$.

<u>Comparison of monopoly with perfect competition</u>

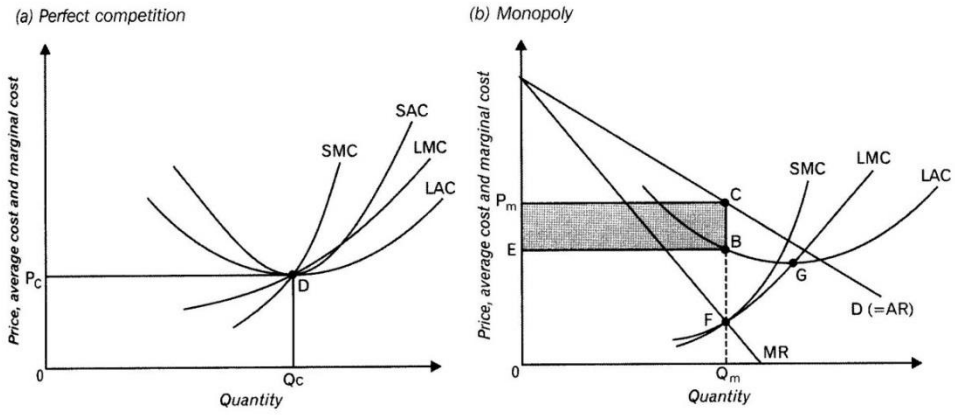

Figure 3.5: Long-term equilibrium: monopoly versus perfect competitor

(Enjoy Economics, bl. 145)

1. **Assumptions**
   - We accept that all details of all businesses in perfect competition are added together.
   - Their cost curves do not change.
   - The collective cost curves are shown above (figure (a)).
   - Cost curves (structure) of all the businesses in the industry are the same as that of the monopoly (figure (b)).
   - Businesses retain the characteristics of perfect competition and do not act like a monopoly.

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2. Higher prices, lower production

- The two graphs above are fully comparable.
- When businesses are in long term equilibrium under perfect competition, then they will produce at quantity Q_c and sell it at a price P_c.
- When businesses are in long term equilibrium under monopolies, they will produce at quantity Q_m and sell it at a price of P_m.
- Monopolies produce less ($Q_m < Q_c$) and sell at a higher price ($P_m > P_c$).
- Under perfect competition production takes place at the minimum point on the LAC curve.
- With monopolies it is not the case.

3. Economic profit

- Perfect competition only earns normal profit on the short term as well as long term.
- A perfectly competitive firm makes normal profit at point D.
- A monopoly makes economic profit in the short term as well as the long term.
- Monopoly makes economic profit of P_mCBE in the long term.

Summary

In the long term, a monopoly:

- produces less than perfect competition (P_c).
- charges a higher price for its products than P_c.
- does not produce at the lowest possible cost.
- makes economic profit.

7.3 Oligopoly

<u>Definition of oligopolies</u>

- It is a market structure in which a few sellers dominate the market.
- Each seller does not influence the others, but has to consider them.
- E.g. identical goods, such as steel, cement, sugar.
- E.g. highly differentiated goods: motor cars, newspapers, airlines.
- When there are only two businesses in an oligopoly, then it is called a duopoly.

<u>When does this market form exist?</u>

- It exists when a small group of large firms dominate the market for a particular product.

<u>Characteristics of a typical oligopoly.</u>

Type of product

- The product is homogeneous (pure oligopoly) or differentiated (differentiated oligopoly)

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Entry

- New producers have free entry, but this is not easy since there are only a few businesses in market.

Control over prices

- Producers generally have considerable control over the price of products.

Mutual dependence

- Only a few businesses sell the product.
- Businesses are influenced by other firms' actions.
- Businesses are mutually dependent on each other, that is why competitors react to price changes.

Non price competition

- Oligopolists do not compete with each other on price because price wars will not benefit any of them.
- Prices are determined by mutual, tacit agreement.

Forms of non-price competition

- Doing business over the internet
- After-sales service
- Loyalty rewards for customers
- Door-to-door deliveries
- Building brand loyalty and product recognition
- Offering additional services (free travel insurance by banks)
- They compete with each other on product differentiation and efficient service.
- Convenience shopping, e.g. extended shopping and business hours
- Firms make use of advertisements to increase awareness and to attract customers towards their products. E.g. Pick 'n Pay use extensive advertising to increase their market share.

A. Collusion

- No oligopoly can be sure of the behaviour and policy of their competitors.
- Businesses function in an uncertain environment.
- To reduce these uncertainties, businesses often collude.
- They agree on the prices of their products.
- They also decide on the quantities to be produced.

It causes:

- higher prices.
- less uncertainties.
- makes it difficult for other businesses that want to enter the market.

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TWO types of collusion

1. Cartels
2. Price leadership

1. Cartels /Overt collusion

- It is when oligopolies collude openly and formally.
- Definition: It is an organization of oligopolistic businesses that comes into existence in an industry with the specific aim of forming a collective monopoly.
- Cartels control the production of goods and this influences the prices of products.
- E.g. OPEC (oil)

2. Price leadership / Tacit collusion

- Formal collusion (a cartel) is usually prohibited.
- Collusion agreements often fail.
- It leads to tacit collusion.
- Price signals are frequently the key element to tacit collusion.
- One business increases its price in the hope that its rivals will increase their prices – such a firm is known as a price leader.
- When the other businesses follow with the increase, they are known as price followers.
- Price leaders are usually the strongest and most dominant business whose production cost is the lowest.
- E.g. steel industry, transport industry.

Prices and production levels

- The prices and production levels of an oligopoly depend on the model of the market structure studied.

The kinked demand curve

- The kinked demand curve shows the reason why we experience price rigidity in an oligopolistic market.

Rationale

- The kinked demand curve does not explain how price and output are determined under oligopolies.
- It illustrates the importance of interdependence and uncertainty in oligopolistic markets.
- If a firm raises or reduces the price of its products the outcome will be determined by the reaction of its competitors.
- The oligopolistic firm assumes that its competitors will not react to a price increase by also raising the price of their products.

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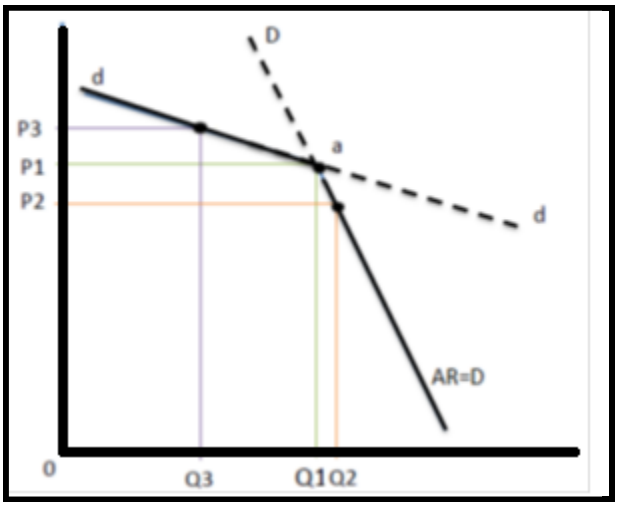
Graph



Assumption: the price of the product is P_1 and the quantity supplied is Q_1 indicated at point a.

<u>The firm has three options:</u>

1. **The firm can increase the price.**
   - If the firm increases the price above its present price at P_1 (from P_1 to P_3), it is more likely that other firms will not increase their prices.
   - The firm will end up losing customers (market share) to other firms because consumers will buy where the price is lower.
   - An increase in price (from P_1 to P_3) will cause a greater decrease in quantity demanded (Q_1 to Q_3) because consumers will switch to cheaper products of other firms.
   - The firm will face a relatively elastic demand curve above the point "a" and this is indicated by the demand curve "da".

2. **The firm can lower the price.**

- If the firm lowers the price below P_1 (from P_1 to P_2), it will start a price war because other firms will lower their prices as well.
- It is more likely that the competitors will set their prices even lower than the firm.
- There will not be a great increase in quantity demanded even with a relatively large high price cut.
- That is why a decrease in price (P_1 to P_2) will cause a smaller increase demand (Q_1 to Q_2).
- The firm will face relative inelastic demand curve below the point "a" and this is indicated by the demand curve "aD".

3. **The firm can keep the price the same.**

- The firm should, therefore, not change the price and should continue to sell at price P_1.

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Therefore:

- The best strategy is to stick to the existing price level.
- In order to avoid a price war firms will compete on other factors rather than price.
- This is known as non-price competition.

Note:

- The kinked demand curve "daD" consist of two demand curves "DD" and "dd"
- Both demand curves are kinked at point "a".
- D = AR

Comparison with perfect competition

	Oligopoly	Perfect competition
Profit	• Can make economic profit in the long term	• Make only normal profit in the long term
Cost	• Unlikely that they will produce at the lowest point on the long LAC curve. • Consumers do not get products at the lowest possible prices.	• Produce at the lowest possible point on the LAC curve. • Therefore, the consumer receives the product at lowest possible price.
Price	• Price of the products is higher than marginal cost (P > MC). • Consumers attach a greater value to the additional units than the resources required to produce it. • Businesses produce less and sell their products at a higher price.	• The price of the product will be equal to marginal cost (P = MC). • Businesses produce more products and sell any quantity at the market price.

7.4 MONOPOLISTIC COMPETITON

Definition

Monopolistic competition is a market structure which combines certain features of monopoly and perfect competition.

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Monopolistic competition is a combination of certain characteristics of a monopoly and perfect competition.

Examples

Sport Store	Household cleaning agents	Clothing stores	Food	Fast-food suppliers	Clothing label
Billabong	Omo	Edgars	Tastic	KFC	Mr Price Red
Total Sport	Sunlight	Jet	Ace	Chicken Licken	Levi's
Roxy	Handy Andy	Pep Stores	Koo	Steers	Aca Joe
Edgars	Jik	Sales House	Iwisa	Wimpy	Dickies
Hang Ten	Surf	Woolworths	Huletts	Nando's	Hip hop

The nature of the product – is differentiated (heterogeneous products)

Products are not identical

- Products are similar but not identical.
- They satisfy the same consumer needs.
- E.g. shoes, men's clothing, women's clothing, etc.

Differences may be imaginary

- The name of the product differs but ingredients are exactly the same, e.g. medicines.
- Sometimes only the service of the seller differs from the others.

Difference in packaging

- E.g. sugar and salt
- Only the packaging makes the difference.

<u>General characteristics of monopolistic competition</u>

1. **There are no barriers to entry or exit (no barriers exist).**

2. **The business has little control over the prices of products.**

3. **Information for buyers and sellers is incomplete.**

4. **Large number of diverse firms**
   - Because of product differentiation we cannot derive a demand and supply curve the same as we did under perfect competition.
   - An equilibrium price for a single product cannot be determined, because a range of prices will apply.
   - A graphic analysis does not focus on the industry but on the typical or representative business.
   - The term 'industry' refers to all the sellers of a differentiated product in a specific product group.

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5. **Hybrid structure**
    - Monopolistic competition is a combination of perfect competition and a monopoly.

6. **Often it is local**
    - Occurs generally in the retail or service sector.
    - On a national level we have e.g. wine, clothing, furniture, etc.
    - Locally (especially in urban areas) there are numerous examples of monopolistic competition.
    - E.g. filling stations, pharmacies, grocery stores, etc.
    - All these businesses have a certain amount of monopolistic power, as a result of the uniqueness of the product or favourable location, slightly lower prices, better service.
    - Monopolistic power is not very strong because of the availability of substitutes.

Non-price competition

- It is competition on the basis of product differentiation, efficient service and by using advertisements, rather than on the basis of prices.
- Product differentiation creates the opportunity to increase the demand for the product and to make the demand less price elastic.
- It is done by means of product variations and marketing campaigns.
- Differentiation may even be imaginary – it depends on the perception of the consumer, e.g. medicine
- Different trade names but products consist of the same ingredients, e.g. beauty products - try to articulate the feeling of beauty.
- Huge sums of money are spent on research, development and advertisements to build a loyal consumer group.
- Brand names play an important role.
- Producers try to maintain their own consumer group, e.g. Pick ‘n Pay – “No Name” products.
- Products are exactly the same as the known brand.
- The goods even originate from the same factory.

Collusion

- There are many producers and this makes collusion impossible.
- No agreements on things such as prices and production quantities.

Prices and production levels: short term and long term

- Demand curve slopes from top left to bottom right.
- Entry into the industry is unrestricted.
- Economic profit in the short term eventually attracts new businesses with competitive products.
- In the long term, this will eliminate economic profit.
- Short term equilibrium of the monopolistic competitor corresponds with that of the monopolist.
- In other words, the equilibrium quantity he/she is going to produce in the short term and at which price it will be sold will yield an economic profit for the firm.

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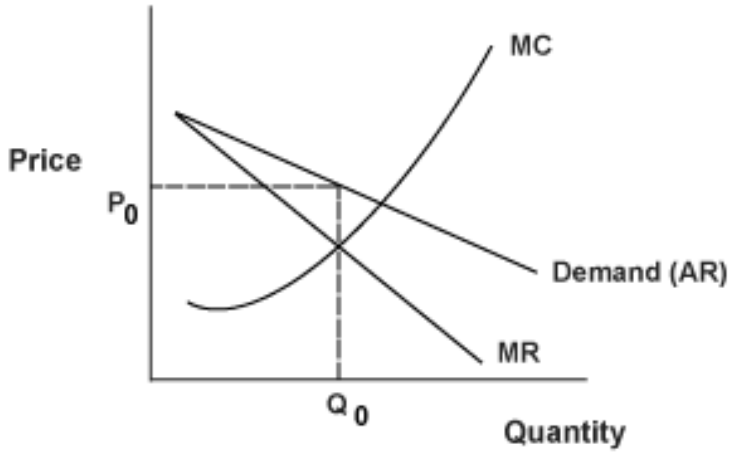
- The demand curve of monopolistic competition is more elastic than the monopolist's demand curve.
- Reason: There are a number of substitutes - this is not the case with monopolies.

Graph



- Firms under monopolistic competition have a downward sloping demand curve.
- The demand curve is also the AR curve.
- The demand curve is more elastic than the demand curve of a monopolist, because there are more close substitutes for the product.
- Profits are maximized where MC = MR.
- Equilibrium quantity is at Q_0 and equilibrium price is at P_0.

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TOPIC 8: MARKET FAILURES

Subtopics

8.1 The causes of market failures

8.2 Consequences of market failures

8.3 Cost-benefit analysis

Concepts

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Description of market failures

- Market failures occur when the market is not efficient.
- Sometimes free markets fail to produce maximum of goods and services from a given set of resources.
- The market also fails to produce the optimal mix of goods and services desired by consumers.

8.1 The causes of market failures

a) Externalities
b) Missing markets
c) Imperfect Competition
d) Lack of Information
e) Immobility of production factors
f) Imperfect distribution of income and wealth

a) Externalities

- Known as spill-over effects.
- Sometimes in ideal market conditions some people gain or suffer due to the existence of externalities.
- Externalities are costs and benefits to third parties which are not included in the market price of goods and services.

Four important concepts:

i) Private (internal) costs
Costs consumers incur when buying goods, e.g. price of bicycle of R1500.

ii) Private (internal) benefits
Benefits of those who buy and produce goods like profit for the producer.

iii) Social costs
Cost to producers and society at large – includes additional costs like disposing waste products, decreasing appeal of an area.

iv) Social benefits
Positive externalities like clean water leading to few illnesses, healthier workforce, higher productivity.

- Private costs (internal costs) and benefits are determined the market mechanism – they have a price attached to them.
- Externalities do not go through the market mechanism and thus do not have a price attached to them.
- Externalities converts private costs and benefits to social costs and benefits.
- Externalities are the difference between social costs and benefits and private costs and benefits.

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b) Missing markets

- Markets are often incomplete in the sense that they cannot meet the demand for certain goods.
- The public sector provides these goods known as public goods.
- Public goods are divided into community goods (water drainage and light houses) and collective goods (parks, pavements).
- Public goods are not provided by price mechanism because the producer cannot withhold goods for non-payment.
- The state finances public goods through taxation and provide it themselves.
- In South Africa, most goods and services that are private goods, have rivalry in consumption and excludability.

Public goods

- Non-rivalry
  Consumption by one person does not reduce the consumption by another individual, e.g. lighthouse, streetlights.

- Non-excludability
  Consumption of public goods cannot be confined to only those who pay for it (results in free riders, e.g. radio and television licenses).

- Social benefits outstrip private benefits
  Social benefits are relatively larger than private benefits e.g. health care and education.

- Infinite consumption
  Once provided, marginal cost of supplying one more individual is zero (traffic lights)

- Non-rejectability
  Individuals may not be able to abstain from consuming them even if they want to, e.g. streetlights.

Merit goods

- Merit goods are highly desirable for the general welfare but not highly rated by the market.
- If people had to pay market prices for them, relatively too little would be consumed – the market will fail.
- E.g. health care, education, safety, etc.
- Merit goods are a special form of private goods, because few people would pay for education if they had to meet the full cost and this would result in market failure.
- In a pure market system, consumers' spending on merit goods is determined by private benefits.
- Merit goods have positive externalities – the social benefits derived from there

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consumption exceed their private benefits.

- A common method to overcome the eminent market failure is for the state to provide them.

Different options of the state in provisioning of merit goods:

- **Provide them in part** - focus on primary health care and education in general;
- **Statutory requirements** - youth compelled to stay in school until age of 15;
- **Outsourcing**: contract private sector to provide some merit goods (some education and training and health care services).

Demerit goods:

- Demerit goods are regarded as socially harmful for consumption.
- E.g. cigarettes, addictive drugs, tobacco, alcohol and gambling.
- While the market is willing to supply demerit goods, it tends to oversupply demerit goods.
- Some consumers may be unaware of the true cost of consuming them, i.e. increased health costs, social decay, their negative externalities.
- Demerit goods are regarded as bad for us and we should use less of these goods.
- Government can ban their consumption or reduce it through taxation and provide information about their harmful effects.

c) Imperfect competition

- Competition is often impaired by power in market economies – the power lies with the producers.
- Most businesses operate under conditions of imperfect competition: they restrict output, they raise prices where price exceeds marginal cost, they prevent new businesses from entering the market and prevent full adjustment to changes in demand.
- Modern market does not allow for price negotiations.
- Advertising is used to promote producer sovereignty. It encourages consumers to buy the products. Businesses delay products from entering the market until it is in the businesses' financial interest.
- E.g. businesses had technology to produce long-life light bulbs, for cars to be driven by fuels other than fossil fuels, cure for the common cold.

d) Lack of information

- Businesses, consumers and workers lack of information to make rational decisions.
- Consumers need detailed information to maximize their utility. Technology increases information, but it is not always perfect.

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- Workers may be unaware of job opportunities. They may be unaware of advantages and disadvantages, including health risks of current jobs.
- Entrepreneurs lack of information about costs, availability and productivity of some factors of production. They may be operating on the basis of incorrect information about reliability and life span of machines in use.

e) <u>Immobility of factors of production</u>

- Most markets do not adjust rapidly to changes in supply and demand. It is due to lack of information and the fact that resources are not mobile.
- Labour takes time to move occupationally and geographically and it adjusts slowly and inadequately.
- Unskilled workers not able, willing or have time to gain necessary skills.
- Physical capital infrastructure like telephone lines – can move from one location to another at irregular intervals.
- Structural changes occur slowly. Demand increases or decreases.
- Technology changes, e.g. people can be replaced by robots. It takes time for labour-intensive textile production to be switched to computer assisted production methods.

f) <u>Imperfect distribution of income and wealth</u>

- The market system is neutral to the issue of income distribution.
- Discrimination distorts earnings of women, minority groups and the disabled.
- Illnesses and incapacity distort earnings.
- Price discrimination - A situation in which identical goods and services are sold at different prices to different consumers.
- Leads to a situation where some consumers pay lower prices.
- E.g. when airlines sell tickets on the same flight at different prices to different customers.

8.2 The consequences (effects) of market failures

a) Inefficiencies
b) Externalities / Spill-over effects / Ripple effects
c) Government intervention (State intervention)
d) Taxes and Subsidies
e) Government involvement in production

a) <u>Inefficiencies</u>

- Sometimes consumers pay prices that are too high.
- Sometimes goods are available, but not in the quantities preferred by the consumers.

Productive inefficiencies

- Businesses do not produce at the lowest possible cost.

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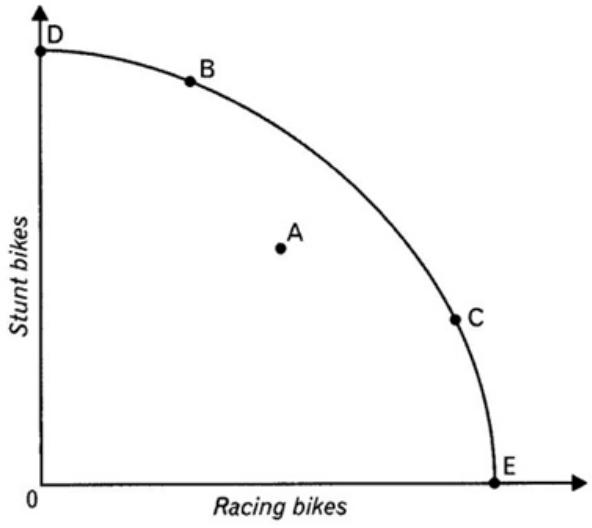
- There is room to lower cost – without producing less or poor quality goods.

Allocation inefficiencies

- Product mix does not reflect the consumer's tastes.
- Resources are not allocated in the right proportions.
- The amount preferred by the consumers is not available.



Production Possibiblity Curve of a bicycle

(Enjoy Economics, p. 117)

- Allocative efficiency can be improved if the producer changes the mix of bicycles to reflect the market demand for the two kinds of bicycles.
- At point B produce more stunt bicycles than racing bicycles.
- Move along the production possibility frontier from point B to point C.
- At point C produce more racing bicycles than stunt bicycles.
- Productive inefficiency is eliminated.
- Point A represents inefficient production, production can increase and move to any point on the production possibility curve.

b) <u>Externalities (Spillover Effects) (Ripple Effects)</u>

- An externality is an effect of consumption or production that is not taken into account by the consumer or producer and which affects the utility or cost of other consumers or producers.

Negative externalities

Negative externalities bear a private cost, the cost of producing the actual product and a social cost, a cost suffered by society.

If the social cost of a good were added to the private cost of a good, the final price would be pushed up and fewer goods would be supplied.

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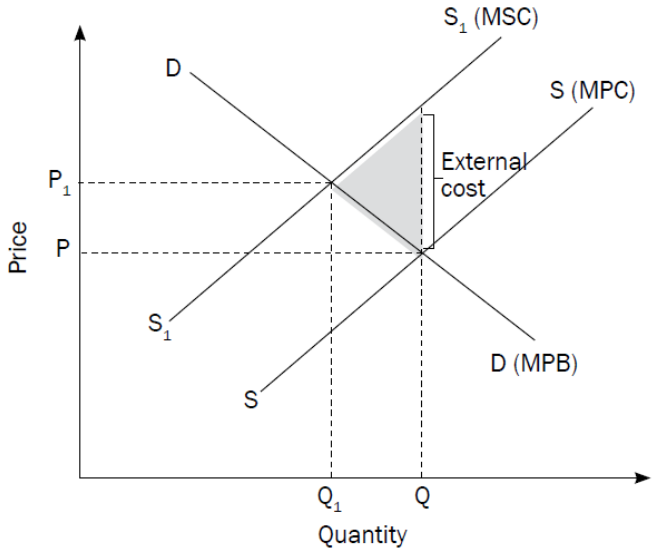
Example: negative externality – cigarettes. See graph below:



(Mind the Gap, p. 123)

From the graph it can be seen:

- The demand for the cigarettes is represented by DD.
- The supply of the product, which is also the marginal private cost (MPC) of the industry, is represented by SS.
- As a result of the pollution, the marginal social cost (MSC) is greater than MPC.
- If the market is left to its own devices, a quantity Q will be produced at price P.
- This is a socially inefficient solution.
- Social efficiency requires that MSC be equal to the price of the product.
- This occurs at price P_1 and quantity Q_1.
- Fewer goods should be produced at a higher price.
- The shaded angle represents the negative externality (welfare loss) to society.

The government has used three methods to reduce negative externalities:

- The government has carried out campaigns in order to change/persuade people from causing negative externalities.
- Levying taxes on goods that cause negative externalities. E.g. taxes are levied on cigarettes and alcohol.
- Passing laws and regulations to prevent activities that cause negative externalities. E.g. tobacco companies are not allowed to advertise. There are laws that regulate the amount of air pollution and waste.

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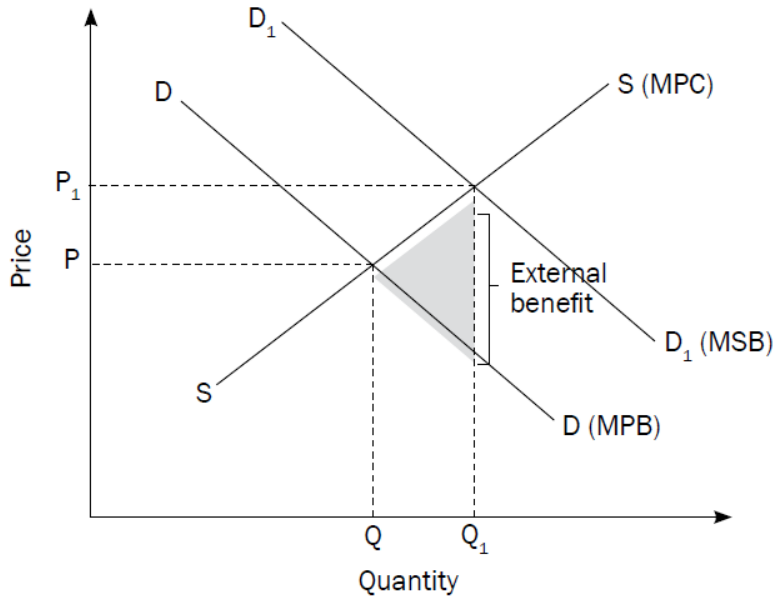
Positive externalities

If people acknowledged the social benefit of a good, they would demand more of that good. The price of such a good would therefore increase.

Example: positive externality – education. See graph below:



(Mind the Gap, p. 124)

From the graph it can be seen:

- The supply of education, which is also the marginal social cost, is represented by SS.
- The demand for school education, which is also the marginal private benefit (MPB) of the industry, is represented by DD. The cost of school fees is P and the quantity demanded and supplied is Q.
- If the cost of school fees is P, most learners will not be able to afford it.
- The demand curve D_1D_1 also represents the marginal social benefit. (MSB), that is, the level of education that should be demanded.
- As a result of the benefits of education, MSB is greater than MPB. • If the market is left to its own devices, a quantity Q will be produced at price P.
- There would be social inefficiency in the market since not enough education is being demanded.
- However, if social benefits are acknowledged, a quantity Q will be produced at price P.
- More education would be demanded; this will lead to social efficiency.

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- The shaded angle represents the positive externality (the welfare gain) to society.

The government encourages positive externalities by:

- Advertising on the radio or television.
- Providing education, health care and other services at a low cost or free.
- Providing consumer subsidies.
- Consumer subsidies lower the cost of a good and encourage its usage.

c) <u>Government intervention (Government involvement / State Intervention)</u>

<u>Rules and regulations</u>

Direct control measures

- Government can use laws, regulations and the legislative framework to control and constrain the behaviour of businesses and industries that generate negative externalities.
- In S.A. potential dangerous gasses, air pollution, environmental pollution, are controlled by laws and regulations.
- E.g. cigarette advertisements are illegal in S.A.

Non-competitive markets

- There are TWO types of non-competitive markets / monopolies:
  - **<u>Artificial monopolies</u>**
    - They operate where perfect markets are technically feasible but they are prevented by entry restrictions.
    - The laws are imposed by the government.
    - E.g. Telkom, Eskom
    - E.g. radio stations = must get a license
    - E.g. patent rights on products = Kreepy Krauly
  - **<u>Natural monopolies</u>**
    - Natural monopolies arise in industries where economies of scale (or cost savings to be gained) are so large that a single business can supply the entire market (without increases in average costs).
    - Only one business in the country will be profitable.
    - One of the most important advantages of mass production will be lower costs per unit.
    - Large capital outlays in network companies such as water and electricity.

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Government uses the following FOUR instruments for correcting or limiting allocative distortions resulting for non–competitive markets.

- **Competition from abroad**
  - Sometimes only competition from abroad has the capacity to restrain harmful local monopolies.
  - E.g. SAA competes locally with British Airways.
  - In some cases, the removal or reduction of tariffs has rendered local markets more competitive.
  - E.g. textile industry

- **Competition promotion**
  - In S.A. the Competition Tribunal, Competition Commission, and the Competition Appeal Court were established by the government.
  - They must ensure that competition does not become eroded but enhanced.

- **Control bodies**
  - In S.A. there are supervisory control boards that keep an eye over certain industries.
  - E.g. electricity provisioning, communication, broadcasting, etc.
  - Enterprises (even a single monopoly) need permission from these controlling bodies to increase their fees.
  - These control bodies often limit these price increases and tariff increases in terms of the inflation rate.

- **Statutory requirements**
  - In exceptional cases, laws are used to temper abusive price increases.
  - Oligopolies are known for their collusive and other anti-market principles.

Minimum wages

- Politicians often feel that a minimum wage is necessary to enforce redistribution.
- It is because unskilled workers are disadvantaged in the negotiation of employment conditions.
- They cannot be sure that real wages will increase.
- This means their wage remains relatively low and this contributes to unequal distribution of income.
- Especially farm workers and domestic workers.
- In S.A. there are laws that enforce a minimum wage are paid to workers and that Unemployment fund contributions are paid.
- Annually the government announces an increase with regard to these wages.

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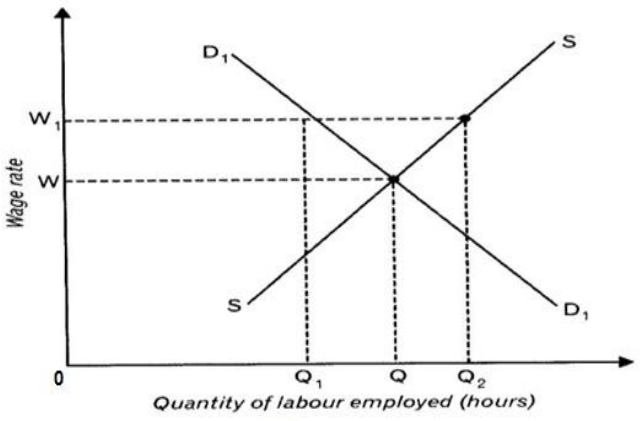

Minimum wages improve the distribution of income

- When the government does not intervene in the market:
  - Wage level is 0W and the quantity employed 0Q.

- A minimum wage is set above 0W at $0W_1$.
  - Workers can earn more but not less than $0W_1$.
  - The quantity of labour demanded will decrease from 0Q to $0Q_1$.
  - The quantity of labour supplied will increase from 0Q to $0Q_2$.
  - Less labour is employed.

- The enforcement of a minimum wage causes the following:
  - The quantity demanded of labour decreases.
  - The amount of labour employed decreases.
  - Wages will increase.
  - Income distribution between workers is improved.

Maximum prices (Price ceilings)

- The government can intervene in the market and set a maximum price.
- On goods such as: paraffin, basic foodstuffs, public transport.
- It is done to benefit the poor.
- In S.A. there is a maximum price on paraffin.
- The price is regularly adjusted.
- When the price is too high the government can set a price that is below the market price.
- The seller can charge less than the maximum price, but not more.

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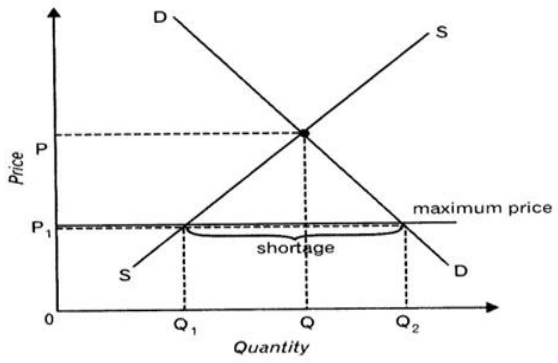

The effect of a fixed maximum price for paraffin

- 0P = market price for paraffin.
- 0Q = the quantity (in litres) of paraffin bought.
- Government announce a maximum price = $0P_1$.
- The quantity supplied decreases from 0Q to $0Q_1$.
- The quantity demanded increases from 0Q to $0Q_2$.
- This causes a shortage on the market for paraffin.
- It creates significant problems on the market.
- A black market for paraffin will develop.
- Maximum price increases the welfare of the people who buy the product.
- Some people will not be able to buy it, as a result of the shortage on the market or the higher prices on the black market.

<u>Minimum prices (Price floors)</u>

- It is important for all countries that their agricultural sector produces enough food to feed the population.
- Some foodstuff is more important than others because it is a staple food.
- Poor people will suffer if there is no staple food available and it could lead to famine.
- Governments intervene in the market to ensure that enough quantities of food are produced.
- Sometimes they introduce a minimum price on staple food.
- They want to make it worthwhile for farmers to produce enough food.
- In S.A. maize and wheat are staple food.
- Before 1994 farmers were guaranteed a minimum price on these foodstuffs.
- Setting of minimum prices has side-effects.

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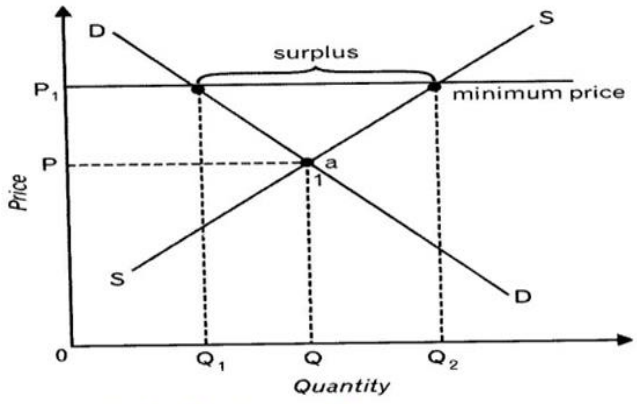

The effect of a minimum price for wheat

- When government is not involved in the market:
  - 0P = equilibrium price.
  - 0Q = equilibrium quantity.
  - Point a = market price.
- Government intervenes, and a minimum price is established above the market price at $0P_1$.
  - Price increases from 0P to $0P_1$.
  - The quantity demanded decreases from 0Q to $0Q_1$.
  - The quantity supplied increases from 0Q to $0Q_2$.

- A surplus (excess supply) exists on the market.
- Quantity supplied is more than the quantity demanded.
- Farmers have a surplus = a problem which they will have to solve.
- They can dump it on other markets. (Dumping = selling of goods on foreign markets at a price that is less than the country of origin.)
- The WTO prohibits this.
- The only manner to get rid of this surplus is to destroy it or feed it to animals.

Taxes and subsidies

Indirect taxes

The price mechanism”

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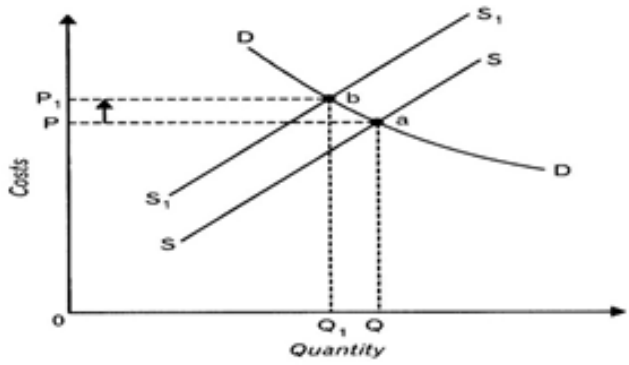

- The appropriate way for governments to intervene in markets is by levying a tax to recover external costs.
- Taxation causes that prices of products increase form (0P to $0P_1$) and that causes production to decrease from (0Q to $0Q_1$).
- In S.A such taxes are levied on cigarettes and alcohol.
- These taxes are called excise duties.

<u>Subsidies on goods and services</u>

- Subsidies take the form of financial grants by the government to support the production of goods and services.
- Subsidies can be:
  - Direct = cash grants or interest free loans.
  - Indirect = depreciation write-offs, rent rebates, meeting of expenses on behalf of the producers and persons.
- It can be used for production, income, employment and exports.
- A subsidy paid directly to producers (with profit motive), have the effect that the cost of production of goods and services are lower.
- Merit goods provided by the private sector are examples of such a good.
- Private school's education where parents pay for the education of their children, the government usually pay a subsidy to promote such education.

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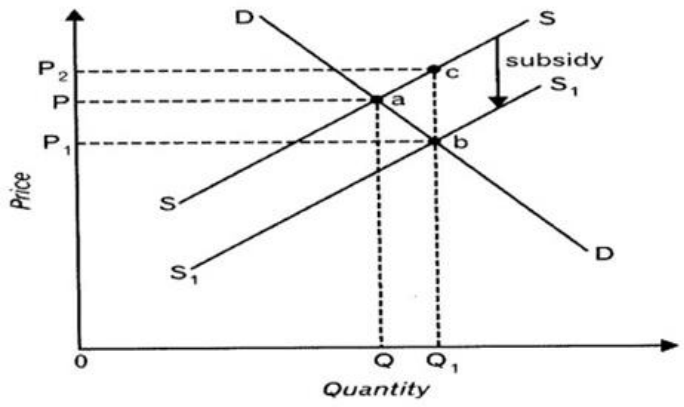

The effect of a subsidy

- 0Q = quantity produced.
- 0P = price of the product.
- DD = demand for the product.
- SS = supply of the product.

- The government decides to pay the producers a certain amount of money = give them a subsidy.
- SS shifts to S_1S_1 as a result of the subsidy.
- Leads to a decrease in the market price.
- Price changes from 0P to $0P_1$.
- Quantity produced increases from 0Q to $0Q_1$.
- A new equilibrium is established at point b.

- The subsidy amount paid by the government is higher than the original price = 0P.
- Farmers will not produce more if they don't earn more.
- The government must compensate for the cost of the higher production.

- $0Q_1$ intersects the original supply curve (SS).
- That is at point c = at a price of $0P_2$.

- The subsidy amount is = P_2cbP_1.
- Consumers benefit from this subsidy because they pay price $0P_1$.
- Producers benefit from the subsidy = they produce at $0Q_1$.
- Producers receive the subsidy price $0P_2$.

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Redistribution of wealth (Improved income distribution)

The South African government uses the following methods to improve income and wealth distribution.

- Taxation to provide free goods and services
- Subsidising goods and services
- Transferring income to the poor
- Job creation programmes / Expanded Public Works Programme
- Labour legislation: Basic Conditions of Employment Act, Employment Equity Act
- Preferential access to the disadvantaged to government contracts
- BEE policies
- Affirmative action
- Land redistribution
- Land restitution
- Property subsidies
- RDP
- Minimum wages
- Maximum prices
- Minimum prices
- Free education and training

Government involvement in production

Incomplete markets / Public goods

- Market failures, due to incomplete markets are particularly important sources of allocation distortions.
- Government intervenes in the markets to supply community goods and services and collective goods and services.
- People pay taxes to the government in order for the government to supply these goods and services.
- People pay income taxes, indirect taxes, wealth taxes.
- Community goods are provided free of charge.
- E.g. police, defense, street lights, etc.
- Some collective goods are provided at a user fee, e.g. refuse removal
- Some collective goods are subsidized.

Macroeconomic stability

- Markets can function freely if markets do not achieve the economic objectives such as growth, employment, price stability and exchange rate stability.
- This may be perceived as a market failure.
- The government can see it as important and intervene in the market.

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- They can focus on the demand-side or the supply-side of the market.
  - Demand-side of the market
    - The Keynesian school of thought believes that the government has an important stabilizing function.
    - They believe that macro-economic stability is best achieved by intervening with macro-economic policies.
    - The most important macro-economic policies are monetary and fiscal policies.

  - Supply-side of the market
    - Sometimes the macroeconomic objectives are not met because of market rigidities.
    - Two causes of rigidities are a lack of information and immobility of factors of production.

8.3 COST BENEFIT ANALYSIS

What is cost benefit analysis? (CBA)

- It is a technique for enumerating and evaluating the total social cost and total social benefits associated with an economic project.

Private sector

• A comparison needs to be made between expected private cost and benefits over the estimated time span of the new project.	• A feasibility study needs to be done. • Provision must be made for legal aspects.

Public sector

• A comparison needs to be made between expected social cost and benefits over the estimated time of the new project.	• A cost benefit analysis must be made.

When should a cost benefit analysis be done?

- It is usually applied to those projects where it is expected there will be a significant difference between private and social cost and benefits.

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Private cost **Social cost**

Difference between the two

- The social benefits must always exceed social cost.
- CBA is generally used by governments.

Rationale of cost benefit analysis (CBA)

- CBA helps to make better decisions on how scarce resources are allocated to satisfy wants.
- Involves making decisions based on comparing economic benefits with economic costs of a project.
- The feasibility of the project is determined by subtracting costs from benefits.
- If the difference is positive (benefits > costs) then the project will be undertaken.
- Besides efficient use of resources, CBA also ensures the right combination of goods is produced.
- It also provides us with deciding alternate solutions to specific problems.
- Thus a project that maximizes benefits compared to costs should be chosen.
- There is a need to consider the time value of money because the project will only occur in the future.
- Therefore, future benefits and costs are discounted to present values.
- In the market economy, resources are allocated through interaction of demand and supply in the market.
- Decisions by people, businesses and governments are important for society – involves allocation of scarce resources.
- The right combination of goods and services must be produced to satisfy needs and wants.
- Brings objectivity to decision-making – identify relevant benefits and costs of project and quantify them in money terms to make informed decisions.

Seven stages of a CBA

1. Identification and quantification of all private costs.
2. Identification and quantification of all external cost.
3. Calculation of social cost – these are the private cost and external costs added together.
4. Identification and quantification of all private benefits.
5. Identification and quantification of all external benefits.
6. Calculation of social benefits – these are the private and external benefits added together.
7. Comparison of social costs with social benefits.

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Application:

- Usually applied to those projects where it is expected there will be a significant difference between private and social costs and benefits.
- Example: a new highway through a densely populated area will have high social costs, while a large dam in a dry urban area will have high social benefits.
- The project will usually go ahead if the social benefits exceed the social costs.

Uses:

- CBA is used for instance where the government wants to produce output for which consumers will not pay (e.g. public road).
- When public and private sectors try to make sure that society is making the best use of its rare resources.

Note the following:

CBR = Cost Benefit Ratio
When the Cost Benefit Ratio (CBR) is below 1, the project reduces the welfare of the community or society at large.
When the Cost Benefit Ratio (CBR) is above 1, the project will benefit the community or society at large.

An example of cost benefit analysis

Costs and benefits in the supply of clean water to a community:

ALTERNATIVES	ECONOMIC COSTS	ECONOMIC BENEFITS
A	1 000 000	500 000
B	1 500 000	2 000 000
C	1 200 000	2 000 000
D	800 000	100 000

Calculate the cost-benefit ratio of A and B by using the following formula:

$$\text{Cost Benefit Ratio (CBR)} = \frac{\text{Present value of economic benefits}}{\text{Present value of economic costs}}$$

Which alternative should the community adopt?

$$\text{CBR (A)} = \frac{\text{Present value of economic benefits}}{\text{Present value of economic costs}}$$

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$$= \frac{500\ 000}{1\ 000\ 000}$$

$$= 0.5$$

$$\text{CBR (B)} = \frac{2\ 000\ 000}{1\ 500\ 000}$$

$$= 1.33$$

Answer = Alternative B

<u>Comparison between a cost-benefit analysis done by government and the private sector.</u>

- In the private sector a comparison needs to be made between the expected private cost and benefits over the estimated time span of a new project.
- In the public sector a comparison needs to be made between the expected social cost and benefits over the estimated time span of a new project.

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MAIN TOPIC: ECONOMIC PURSUITS – PAPER 1

TOPIC 9: ECONOMIC GROWTH AND DEVELOPMENT

SUBTOPICS:

9.1 The demand-side approach

9.2 The supply-side approach

9.3 Approaches to growth and development policies used in SA

9.4 The North/South divide

Concepts:

SOUTH AFRICA'S GROWTH AND DEVELOPMENT POLICIES

Introduction

- **Economic growth** is the increase in the capactiy of the economy to produce more goods and services.
- **Economic development** is the the ability of the population to produce more goods and services which improve the standard of living of the people.
- **Economic growth does not always lead to economic development.**

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THE DIFFERENCE BETWEEN ECONOMIC GROWTH AND ECONOMIC DEVELOPMENT

Economic Growth	Economic Development
It is an increase in the production capacity of the economy to produce more goods and services over a period of time. It is measured in terms of an increase in **Real GDP**. It requires policies that empower the economy.	It is the process by which the standard of living of the people improves. It is measured in terms of **Per Capita Real GDP (GDP per capita).** It requires policies that empower people
Goals: • To increase production of goods and services.	**Relates to:** • Improve the quality of living of inhabitants and make sure that their basic needs are met. • Create a climate where the people's dignity and self-respect are promoted. • Increase the freedom of choice of people by providing them with opportunities. • E.g. Education, Health, Housing

Economic growth relates to Economic development in the following ways:

When an economy is growing the following may result:
• More jobs will be created
• More people will receive income
• The standard of living will improve
• You need economic growth for economic development to take place. Economic growth does not guarantee economic development

The relationship between economic growth and economic development.

- Economic growth should ensure more job opportunities and higher income to more households thus leading to improvement to the standards of living of the people

FACTORS NECESSARY FOR ECONOMIC GROWTH

- Improved Technology
- Increased in productivity
- Increase in factors of production, e.g. Capital
- Effective government policy and efficient administration
- Investment

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9.1 DEMAND SIDE APPROACH IN PROMOTING GROWTH AND DEVELOPMENT IN SOUTH AFRICA. (Discuss in detail)

The **demand-side approach** emphasizes the fact that for a country to have growth there is a need to increase aggregate demand by making discretionary changes to the monetary and fiscal policies of the country.

- A demand side approach includes discretionary changes in monetary and fiscal policies with the aim of changing the level of aggregate demand
- **Monetary policy** is driven by the South African Reserve Bank (SARB)
- It aims to stabilize prices by managing inflation
- **Fiscal policy** is drive by the Department of Finance
- It aims to facilitate government, political and economic objectives
- A demand side approach to economic growth and development does not only depend on fiscal and monetary policy
- It depends on all components of aggregate demand, that is C, I, X and G.

1. MONETARY POLICY

The South African Reserve Bank (SARB) as the central bank in South Africa formulates the monetary policy.
They use the following instruments:

- **Interest rate changes**
  - It is used to influence credit creation by making credit more expensive or cheaper.
  - The exchange rate is stabilized by encouraging inflow or outflows

- **Open market transactions**
  - To restrict credit the SARB sells securities
  - When banks buy these securities money flows from banks to the SARB
  - The banks have less money to borrow out and cannot extend as much credit as before.
  - To encourage credit creation the SARB buys securities
  - Money flows into the banking system

- **Moral persuasion**
  - The SARB consults with banks to act in a responsible manner based on the prevailing economic conditions.

- **Cash reserve requirements**
  - Banks are required to hold a certain minimum cash reserve in the central bank
  - Banks have a limit amount to give out as credit

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2. FISCAL POLICY

South Africa's fiscal policy is put into practice through the budgetary process. The main purpose of fiscal policy is to stimulate macroeconomic growth and employment, and ensure redistribution of wealth.
The following instruments are used:

- **Progressive personal income tax**
  - Higher income earners are taxed at higher tax rates
  - These taxes are used to finance social development
  - The poor benefit more that those with higher incomes

- **Wealth taxes**
  - Properties are levied (taxed) according to their market values
  - Transfer duties are paid when properties are bought
  - Securities (shares and bonds) are taxed when traded
  - Capital gains tax is levied on gains on the sale of capital goods (e.g. properties, shares)
  - Estate duties are paid on the estate of the deceased
  - These taxes are used to finance development expenditures which benefits the poor more often

- **Cash benefits**
  - Old age pensions, disability grants, child support and unemployment insurance are cash grants
  - These are also known as social security payments

- **Benefits in kind (in natura benefits)**
  - These include the provision of healthcare, education, school meals, protection
  - When user fees are charge, poor or low income earners pay less or nothing
  - Limited quantities of free electricity and water are provided

- **Other redistribution**
  - Public works programme, e.g. the strategic Integrated Projects (SIP), provides employment subsidies and other cash and financial benefits such as training, financing and export incentives.

- **Land restitution and land redistribution**
  - Land restitution is the return of land to those that have lost it due to discriminatory laws in the past.
  - Land redistribution focusses on land for residential (town) and production (farm) for previously disadvantage groups.
  - The money for these programme is provided in the main budget

- **Subsidies on properties**
  - It helps people to acquire ownership of fixed residential properties
  - E.g. government's housing subsidy schemes provide funding to all people earning less than R3500 per month.

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9.2 SUPPLY-SIDE APPROACH IN PROMOTING GROWTH AND DEVELOPMENT IN SOUTH AFRICA. (Discuss in detail)

Description

- Anything that can influence the supply of goods or resources is a supply-side measure
- Supply-side policies focus on supply and its microeconomic components, such as competition and potential output.

The supply-side explanations

- The supply-side explanations are based on the monetarist approach
- It maintains that government intervention in the economy is only necessary if it improves the smooth operations of markets
- Supply in the economy is fairly fixed particularly in the short term
- For the economy to produce more, more workers are needed/more machines need to be built and installed/more electricity needs to be produced/and better roads need to be provided.

The South African approach

- The South African government uses the supply-side approach complementing or in addition to a demand-side approach
- Its objective is growth and development, higher levels of employment and equity distribution (equity) that are embedded in the budget.
- The Medium Term Expenditure Framework (MTEF) was created to give certainty to the trend and emphasize the real magnitude of the expenditure
- The aim is to shift the supply curve to the right – important focus of growth and development is government's industrial development policy and maintenance, upgrading and creation of new infrastructure
- Supply-side policies are also designed to create an environment where businesses and markets can function optimally

1. **The effectiveness and efficiency of markets**

- If businesses accomplish their aims, (profitability and growth), the business is effective
- In South Africa, government imposes aims on markets by laws, which they are forced to follow and they become effective when they meet these aims together with their own aims which are in fact merged with their own

Effectiveness

- Government demands that markets function in a manner that ensures that more black people are absorbed into the mainstream economy because they were previously deliberately disadvantaged
- Two Acts were promulgated to enforce preference for black workers and the businesses of black people

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- The Employment Equity Act

- The Act prohibits discrimination and requires that the workforce reflects the racial and gender profile of the population at large enterprises have to file an employment equity plan with the Department of Labour, and inspectors from the department visit business sites to ensure compliance

- **Broad-Based Black Economic Empowerment Act**
  - The Act provides the legal basis for the transformation of the South African economy. It requires redress so that the number of black people who won, manage and control businesses in the country can increase significantly and income inequalities can be decreased substantially

Efficiency

- Pareto efficiency means that given the constraints of the effectiveness parameters, it is not possible to change the allocation of resources in such a way that someone is made better off without making someone else worse off.
- It includes productive and allocative efficiency

Competition

- Competition in the markets was increased in three ways:
  - by establishing new businesses (small businesses)
  - Recruiting Foreign Direct Investment (FDI)
  - The reduction or removal of import restrictions that hampered competition from abroad
- In addition, the competition regulator network was created to enforce competitive practices among domestic businesses
- The Competition Act (1998) is aimed at anti-competition practices eliminating the abuse of dominant positions and strengthening merger controls
- The Act provides for the operation of the Competition Commission, a Competition Tribunal and a Competition Appeal Court and
- In spite of all these, the Global Competition Index shows that South Africa's competitiveness is slipping by

Deregulation

- Private sector causes imbalances that inhibit the free operation of markets have been revised and some were even abolished in the mid-1990s
- Government maintains it is committed to improving the ease of doing business in the country
- Exchange control measures were occasionally relaxed

2. Business efficiency

- Some measures serve as incentives to increase efficiency while others assist in establishing and improving efficiency and the end result is greater profitability

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Taxes

- The corporate income tax rate is 28%
- Small business pays a lower rate as long as their income is less than the SARS income tax threshold
- Individual income tax starts at 18% and increases slightly as determined by SARS on tax review yearly
- The effect of tax bracket creeping on personal income tax has been attended to in almost every budget with adjustments to income tax brackets
- The increase for the individuals was 33%
- VAT changed in 2018 to 15%
- The level of taxation in South Africa are reasonable compared to developed countries
- As a developing country, lower tax rates would be helpful to promote economic growth

Capital formation

- Depreciation of capital goods used by businesses is designed to encourage investment e.g. new machinery may be depreciated over four years at 40% in the first year/and computers and electronic equipment over three years
- The government through the DTI and the IDC also promote capital and loans to SMMEs and bigger business
- This serve as an incentive to promote business efficiency

Human resources

- Education receives proportionally a bigger slice of the budget expenditure
- Sector Education and Training Authorities (SETAs) have to facilitate post-school, work-related training
- The labour relations Act that came into operation in 1998, promotes economic development, social justice, and peaceful labour relations in the promotion of efficiency

Free advisory services

- The development of export markets/managing and running SMMEs/agricultural production/ weather forecasts/and prevention and curing of animal diseases

3. **Cost of doing business**

- In South Africa government controls most physical infrastructure components
- The availability and cost of infrastructure services play an important role in the financial viability and profitability of businesses

Transport costs

- Transport options in air, road, rail and sea are available
- The government controls air and sea transport in South Africa.
- The government has committed to improving the efficiency and reliability of its rail transport services and to make it more affordable

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Communication costs

- Communication options are in cable, signal and mail
- The government controls cable (land or fixed lines) and mail communication services
- The cable communication services in South Africa is one of the most expensive in the world but reasonably efficient
- High costs make IT services for businesses and individuals expensive and inhibits global competitiveness

Energy costs

- Electricity and liquid fuels are the main sources of energy in South Africa
- Eskom is the only electricity supplier (monopoly)
- The government regulates the prices for petrol and paraffin
- The prices for imported crude oil are linked to international market prices, which are high
- High liquid energy prices undermine the efficiency of the economy

Factors of production

Growth

- It has to do with the expantion of the production capacity of the economy**.**

- **<u>Supply factors include:.</u>**

Natural resources

- These are things provided by nature.
- E.g. Water, Land, Minerals, etc.
- The supply of natural resources is limited and must be used sparingly.

Labour

- It consists of the physical and mental effort by people with the aim to earn an income.
- Labour is influenced by training, skills, education, health, etc.

Capitaal

- Capital is man-made resources used in the production of other goods and services.
- Capital is needed for the production of goods and services.
- The more capital we have, the more goods and services can be produced.
- For efficient production to occur, both human / social and physical capital are needed.
- Money Capital: Rand and cents to buy machines and tools.
- Real capital: machines, buildings, etc.
- Social Capital: Knowledge

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Technology

- This is new scientific knowledge in the form of new inventions and innovations.
- Sometimes it is referred to as the fifth factor of production.
- Sustained economic growth requires technological progress and innovation.
- Technological advances mean new kinds of capital goods and new production processes.
- Technological advances can lead to economic growth.

Entrepreneurskap

- Essential for development
- They combine capital, labour and natural resources to produce goods and services to satisfy the needs of the people.
- Entrepreneurs must be supported by good and ongoing education and training.

9.3 APPROACHES TO GROWTH AND DEVELOPMENT POLICIES USED IN SOUTH AFRICA

Growth	Development
Macroeconomic policies These include measures to achieve the following macroeconomic objectives: 1. Higher economic growth 2. High levels of employment 3. Price stability 4. Exchange rate stability 5. Economic equity Increased economic growth leads to more tax revenue which can be used to provide more social goods and services with the aim of achieving economic development. All the above measures should be evaluated in terms of international benchmarks.	**Development policies** These include measures aimed at achieving industrial, agricultural and human development: **1. Microeconomic initiatives** • Facilitating increased competition, opening up resource markets, enabling land-use and environmental policy. **2. Social care** • Social welfare and security and poverty alleviation • Policies to redress past inequalities, including Employment Equity and BEE/BBBEE • Affirmative action • Land redistribution and restitution **3. Macroeconomic characteristics and desired outcomes:** • Standard of living low – increase the per capita income. • Unemployment high – create more employment, e.g. public sector work programme. • Productivity low – improve the level of knowledge, skills and motivation, e.g. JIPSA.

At certain periods, the South African government has focused its initiatives

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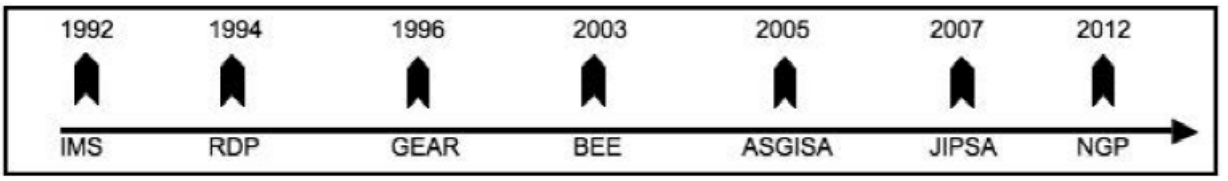
on economic growth, while at other points, policy emphasis has shifted to economic development (see figure below).



SOUTH AFRICA USES THE FOLLOWING GROWTH AND DEVELOPMENT POLICIES

The main growth and development policies are:

1. **Reconstruction and Development Programme (RDP)**

- Adopted as a development strategy in 1994 by the ANC government.

- **The main strategy** was to alleviate poverty and address the inequalities and shortfalls in social services by focusing on job creation, welfare, housing, transport, land reform, healthcare, education, training, water and sanitation.

Focus on:

- Improved service delivery to the poor.
- Creation of an enabling environment that is suitable for human development
- In 1996 it become part of the budgetary process.
- It serves as a road map for economic development in S.A.

Evaluation thus far:

- Meeting basic needs: Government creates an increased demand for goods and services.
- The expanded public works programmes were mostly labour intensive.
- This helped alleviate unemployment and poverty slightly.
- Some social achievements: building houses, providing clean water, electrification, land reform, and healthcare.
- Real GDP growth erratic since 1994, unemployment in formal sector increased.
- Key objectives of poverty reduction and improved service delivery hardly successful.

Role of the RDP in the improvement in the lives of people

The RDP:

- met the basic needs of people.
- increased infrastructure development.
- laid the foundation for sustained economic growth and job creation.
- developed human resources.
- ensured the safety and security of South Africa's citizens and the state.
- transformed the government to reflect development and people-centred nature of the democratic state

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2. **Growth, Employment and Redistribution (GEAR)**

- Introduced in June 1996 as South Africa's Macro economic policy

- **The main strategy** was to strengthen economic development, redistribute income and create socio-economic opportunities for the poor.

Objectives are:

- Promote Economic growth
- Job creation
- Redistribution of income
- Exchange rate stability
- Price stability (Inflation)

GEAR coincides with the international Macro Economic best practices.

Core programmes:

- Renewed focus on budget reform.
- Faster fiscal deficit reduction
- Exchange rate policy
- Consisted monetary policy
- Reduction in tariffs
- Tax incentives
- Intro flexibility into the labour market
- Expansion of trade

Evaluation thus far:

- Mixed outcomes.
- Brought greater financial discipline and macroeconomic stability.
- Real reduction in fiscal deficit (less than 3% in terms of international benchmarks).
- Inflation has dropped mostly to within inflation targets.
- Foreign exchange reserves increased in most regards.
- Failure to create sustainable job opportunities.
- Failure to redistribute wealth more evenly.

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3. **National Skills Development Strategy (NSDS)**

Description
The NSDS is the overarching strategic guide for skills development and provides direction to sector skills planning and implementation in the SETAs.

What is it
The National Skills Development Strategy (NSDS) is intended to radically transform education and training in South Africa by improving both the quality and quantity of training to support increased competitiveness of industry and improved quality of life for all South Africans.

Purpose
The National Skills Development Strategy (NSDS) is the tool used by the Department of Labour to drive the process of developing the skills of the South African labour force. Six conceptual pillars: Inclusion, Relevance, Sustainability, Creativity, Quality and Quantity inform its key aims and objectives.

4. **Accelerated and Shared Growth Initiative for South Africa (ASGISA)**

- In 2006 the government introduced Accelerated and shared Growth, Initiative for South Africa (Asgisa). It does NOT REPLACE GEAR

- **Its objective** is to co-ordinate government initiative to create economic development:

The key elements are:
- Halve unemployment and poverty by 2014.
- Accelerate economic growth to an average of 6% between 2010 and 2014.

Want to achieve it by:
- To improve and developed infrastructure.
- Industrial development
- Skills development
- Stimulation of the second economies (Informal sector)
- Improve state administration

Evaluation thus far:
- Growth in infrastructure investment, especially in the public sector.
- Employment growth has lagged behind economic growth – reason real wage increases are higher than productivity.
- The second economic strategy helped slightly to reduce unemployment through the Expanded public Works Programme.
- Poor economic growth and high unemployment for the youth.

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5. **Joint Initiative on Priority Skills Acquisitions (JIPSA)**

- It is the skills development arm of ASGISA. Focus is on skills development, especially through the SETAS.

6. **Expanded Public Works Programme (EPWP)**

- It is a nationwide government intervention to create employment using labour-intensive methods, and to give people skills they can use to find jobs when their work in the EPWP is done.
- **The Main aim:** Create employment using labour intensive methods / Give people skills that they can use to find jobs

The main objective:

- Provide people with better jobs,
- decent work for all
- and sustainable livelihood
- education
- health
- rural development
- food securities
- and land reforms
- and fight against crime
- and corruption.
- Give people skills
- that they can use to find better jobs.

Evaluation thus far: How successful?

- Although the number of unemployed people decreased, the economic growth is still decreasing/low.
- EPWP contributes toward supporting employment generation although it is of temporal nature.
- Training is provided to unskilled, unemployed people and should lead to a positive growth rate and development.
- The government uses more labour-intensive construction and maintenance methods in public infrastructure projects.
- Government was also successful in targeting women, the youth and people with disabilities e.g. through temporal employment.
- Helps to reduce the negative effects of unemployment, which include erosion of self-esteem, drug and alcohol abuse as well as loss of knowledge and skills.
- Those participated have a higher prosperity to participate in savings clubs, to use their personal resources to enhance social services and community assets and to use media as a source of information.

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7. **The New Growth Path (NGP)**

- Its aim is to enhance growth, create employment and create greater equity.
- The strategy is to identify key sectors as "job drivers" and promote and support industries and sectors that can drive job creation.

Focus is to:

- Create 5 million jobs by 2020, reducing unemployment from 25% to 15%.

8. **National Development Plan (NDP)**

- It sets out to expand economic opportunities through investment in infrastructure, more innovation, private investment and entrepreneurship.

The main aim:

- Eliminate poverty and reduce inequality by 2030
- Reduce unemployment 14% by 2020 and 6% in 2030
- Grow an inclusive economy
- **Financed by:** NDP is funded by government tax.

The role of the state in the implementation of the NDP.

- The government role is to set up the framework for the private sector to function

Evaluate thus far: How successful?

The implementation of NDP will be successful due to the following reasons:

- A good progress has been made since 2014 in the construction of renewable energy sources e.g. solar farms and wind farms
- Standard of living might improve that will reduce poverty levels e.g. housing, social grants

AND / OR

The implementation of NDP will not be successful due to the following reasons:

- Since 2014 there has been no improvement in the unemployment rate and this scenario might continue to exist e.g. unemployment might increase even further
- The gap between rich and poor might increase further
- The following targets set out in the NDP will be difficult to reach: an economic growth rate of 5% (currently 0,8%) job creation of 5 million per annum

Positive elements of the NDP

- Infrastructure expansion with investment in five key physical and social infrastructure areas (namely in the energy, transport communication water and housing)
- The agricultural value chain by addressing the high costs of fertilizers a do the inputs and the promotion of processing and export marketing
- Mining value-chain by increasing mineral extraction improving infrastructure, skills development and supporting the beneficiation on the final manufacture of consumer and capital goods

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- Green economy by expanding construction and production of technologies for solar energy, wind energy and bio fuels
- Manufacturing sector through innovation strong skills development, reduced input costs and increased research and development investment
- Tourism and certain high-level services

Aims of the NDP
Create jobs

- Expand infrastructure
- Use resources properly
- Inclusive planning
- Quality education
- Quality healthcare
- Build capable state
- Fight corruption
- Unite the nation
- Improve integration
- Reduce pollution
- Improve equality
- Improve safety

9. Small Business Development Promotion Programme (SBDPP)

- It was designed to deliver support and services to small, medium and micro enterprises.
- Department of Trade and Industry (DTI), Industrial Development Corporation (IDC) and the National Small Business Act offer these services.
- Laws are revised to help change power imbalances.

10. Black Economic Empowerment Programmes (BEE)

- The Black Empowerment Act and Employment Equity Act were designed to assist in the transformation and redress of previously disadvantaged groups.
- Measures are implemented to ensure redress and affirmative action in the workplace and business environment.

9.4 THE NORTH AND SOUTH DIVIDE

	Developed Countries (North)	**Developing Countries (South)**
Standard of Living	**Real GDP Per capita income** • **It is high,** approximately 87% of the world's total income is produced by 15% of the total population • People live in the economically developed regions of the world	**Real GDP Per capita income** • It is low • 85% of the world population lives on only one fifth of the world's income.

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	Life expectancy • in developed countries life expectancy is high = 75 years	**Life expectancy** • In developing countries life expectancy is low due to problems such as malnutrition, disease and ill health. • Life expectancy is 48 years.
	Literacy levels • Literacy levels are high. • Most people are literate	**Literacy levels** • Literacy levels are low. • This relates to the low standard of living. • Only 46% adult literacy rate.
Globalisation	**Globalization inequalities** • Globalization inequalities = low **Poverty Level** • Poverty level is low **Economic growth** • Manufactured goods **Production and Trade** • Rich countries subsidise the production of agricultural products. • This makes it difficult for developing countries to compete	**Globalization inequalities** • Globalization inequalities = high **Poverty level** • Poverty level is high **Economic growth** • Raw materials **Production and Trade** • Agriculture/mining are not subsided • There is an insistence that developing countries should remove tariffs on manufactured goods.
Environment Mass production and consumption damages the ozone layer, caused by pollution and toxic waste	**Mass production and Consumption** • Mainly responsible for damaging the ozone layer	**Mass production and Consumption** • Affects developing countries more negatively
Sustainable development The pattern of development that permits future generations to live as well as the current generation	**Sustainable development** • Practices used in production are more in favour of sustainable development	**Sustainable development** • Production practices do not promote sustainable development

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TOPIC: 10 REGIONAL DEVELOPMENT POLICIES IN SOUTH AFRICA

SUBTOPICS:

10.1 Industrial development in South Africa

10.2 Regional development

10.3 South Africa's endeavours

10.4 Incentives to encourage industrial development

10.5 Appropriateness of South Africa's industrial policies

10.6 Appropirateness of SA's regional development policies in terms of benchmark criteria

10.7 Small business development

10.8 The appropriateness of BEE in SA economy.

Concepts:

10.1 Industrial development in South Africa
Concept Industrial development related to planning and building new industries in certain areas, as well as to expand existing industries in certain area. **OR** Industrial development refers to planning for and building new industries in certain areas, as well as expanding existing industries in certain areas. **Aim of industrial development** An important aim of industrial development is to increase economic growth.

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Reasons for industrial development
• Exploit the world economy to trade and acquire knowledge.
• Maintain macroeconomic stability.
• Achieve high rates of savings and investment.
• Establish large scale manufacturing, agricultural, mining and services production.
• Diversification of the economy.
• Develop domestic manufacturing capacity to increase exports.
• Create jobs.
• Develop and maintain appropriate incentives to attract investors.
• Contribute to the industrial development of the African continent.

Importance / Necessity of industrial development in South Africa

- **Generate income** - Industries will accommodate thousands of workers who will receive an income
- **Boost economic growth** – Industrial development will ensure an increase in the production of goods and services
- **Increase job creation** – Labour intensive industries will offer many new job opportunities
- **Increase the export of value-added products** – Industries can add value to the many natural resources available in our country

Examples of key sectors to promote Industrial development

- The **clothing, textiles and automotive sectors** have been identified as key strategic sectors for which the Department of Trade and Industry will continue improving incentives schemes to boost manufacturing capacity and support job creation.

Institution that promotes industrial development

- Department of Trade and Industry

What is the role of the Dept. of Trade and industry?
They provide incentive schemes in order to **boost manufacturing capacity** and to **support job creation**.

SA industrial development policies
What is an industrial development policy? • It is government policies that relate to manufacturing policies **What is Industrial policy?** It is laws and regulation to enhance manufacturing operations
There are two industrial development policies: 1. National Industrial Policy Framework (NIPF) **2.** Industrial Policy Action Plans (IPAP)

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1. National Industrial Policy Framework (NIPF)

Defn:
The NIPF is a policy setting out the government's broad strategic approach to industrialization / industrial development.

The Aims/objectives of the National Industrial Policy framework (NIPF)

- To make the economy more diverse so that exports can increase.
- To make industrialisation more intensive in the long run.
- To promote the development of labour-intensive industries.
- Greater participation by disadvantaged groups and development of marginalised areas.
- Increase potential for large scale production.

2. Industrial Policy Action Plans (IPAP)

Defn:

- The industrial development policy that aims at promoting long-term industrialisation

How is it financed?

- IPAP is funded by private investment

The main objective of the IPAP

- IPAP is predicated on the need to bring about significant structural change to the South Africa economy

What does the NBAP entail?

- NBAP is about increasing private investments; businesses and labor are consulted intensively.
- NBAP remains the DHN flagship, which supports local procurement. It further supports local industries and job creation.

How will the objectives of the IPAP be achieved?

- Stronger domestic growth in the manufacturing sector.
- High employment levels

The reason why the IPAP was designed
IPAP was designed to increase industrialisation in the **manufacturing sector**.

How can IPAP "beef" up competition policies?

- IPAP can strengthen the role of the competition authorities in relation to private sector behaviour.
- Interventions across institutions must be geared to monitor conduct of dominant private firms.
- IPAP must ensure that firms' strategies do not exploit market power.
- New firms that enter the market must be supported.

Evaluate IPAP's success in attaining job creation.
Unemployment figures in South Africa are still very high.
Small business development – specific government programmes were successful.

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The promotion of entrepreneurship (amongst women and youth) has been reasonably successful.
Improved access to finance and capital, information and advice has been reasonably successful.

Targeted industries
- Advanced manufacturing
- Tourism
- Software industries (for computers)
- Airspace and defense
- Etc.

Industrial Development Strategies
There are two:
1. **Integrated Manufacturing Strategy (IMS)** 2. **National Research and Development Strategy (NRDS)**
1. **Integrated Manufacturing Strategy (IMS)**

Description
A strategy to strengthen institutional capacity to deliver services that will facilitate development

The Integrated Manufacturing Strategy focuses on
- The main focus was on developing the global competitiveness of the SA manufacturing enterprises
- (Implemented by the DTI)
- It is a strategy that applies to all processes that transforms natural products into manufactured products
- It involves cross cutting issues such as technology, human resource development, access to finance and infrastructure
- It also concentrates on key input sectors like transport, telecommunications and energy
- The IMS prioritise certain growth sectors like tourism, agriculture, information technology and cultural industries

Growth sectors which are identified:
The IMS priorities certain growth sectors such as:
- Exports
- Tourism
- Agriculture
- Information Technology and Communication
- Cultural

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National Research and Development Strategy (NRDS)

10.2 Regional development

Concept

- Regional industrial development refers to policies which are aimed at increasing the economic livelihood of specific areas or regions.

OR

- The purpose of this policy is to increase the economic livelihood of specific areas or regions.

OR

- Regional development initiatives in South Africa are to attract infrastructure and business investments to neglected and underdeveloped areas.

Reasons for regional development

- Attempts to reduce the centralization of industries
- To increase economic livelihoods of certain areas

Aims

- Refers to policies that are aimed at increasing the economic livelihood of specific areas or geographical regions
- To limit the effects of economic centralisation, reduce the unequal development of economic activities
- To promote the advantage of more regional development by using labour, other natural recourses and infrastructure in neglected areas
- Stimulate development in poor rural areas to prevent new imbalances from emerging
- To implement and coordinate the implementation of national and regional industrial policies

An example of the regional development initiative

- A regional development initiative focusing on the socio-economic development of southern Africa is known as the Southern African Development Community (SADC).

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Regional development in South Africa
• An estimated 80% of the country's GDP is produced in four industrialised areas, namely: - Johannesburg-Pretoria-Tshwane - Durban-Pinetown - Cape Town metropole - Port Elizabeth-Coega-Uitenhage **Reasons for the uneven geographical economic development** - Unequal spending on regional development - Uneven distribution of economic resources, such as natural resources and skilled workforce • The regional development policy aims to promote a more even spread of industries so that capital and labour can be directed towards under-developed areas. • Regional development is currently based on the Spatial Development Initiatives (SDIs), Special Economic Zones (including IDZs and corridors) • The Integrated Manufacturing Strategy (IMS) was implemented by the DTI to assist industries to grow by identifying certain cross cutting issues and competitive input sectors. The cross cutting issues are technology, human resource development, access to finance and infrastructure. The competitive input sectors are transport, telecommunications and energy. • Strategic Integrated Projects (SIPs) are being implemented to uplift economic and social infrastructure projects across the country. There are currently 17 identified SIPs.

10.3 Discuss in detail South Africa's initiatives (endeavours) in regional development
1. Spatial Development Initiatives (SDIs) in South Africa 2. Industrial Development Zones (IDZ) in South Africa 3. Special Economic Zones (SEZ) in South Africa 4. Corridors 5. Strategic Integrated Projects (SIPs) 6. Infrastructure plan
Spatial Development Initiatives (SDIs) in South Africa
Description Regional development initiative in South Africa to attract infrastructure and business investments to neglected and under developed areas **OF** • SDI is a policy to promote sustainable industrial development in areas where poverty and unemployment are at their highest. **What is the main aim of SDIs?** • Stimulate growth • Create employment

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What is Spatial Development Initiatives?

- SDI is a policy to promote sustainable industrial development in areas where poverty and unemployment are at their highest
- It can be defined as a link between important economic hubs and regions in a country
- The intention was to grow the SDI's mostly through private sector investment
- The state was to enhance inward investment through the granting of incentives
- The Public Private Partnerships, promotes the economic potential of underdeveloped areas
- In a PPP a private business may provide the capital to build the factory and to buy raw materials and employ labour, while the government provides the capital for the infrastructure e.g. roads and water
- There are 2 types of PPPs which are compensated differently: unitary payments and user-fees
- The SDI involves an interdepartmental investment strategy that the DTI and the Department of Transport (DOT) lead

Objectives of Spatial Development Initiatives

- Develop physical infrastructure such as roads and harbours
- Stimulate economic activities in the underdeveloped areas
- Create employment and stimulate economic growth in the underdeveloped areas
- Develop inherent economic potential in the under developed areas
- Attract private sector and foreign direct (FDI) investment
- Establish Public Private Partnerships (PPP)

Evaluate Spatial Development Initiatives in South Africa

- SDI refers to national government programme aimed at unlocking inherent and underutilised economic development potential of certain spatial locations in South Africa
- Stimulate investment by private sector businesses.
- Create employment and growth in selected areas
- Develop infrastructure projects in the selected areas.
- Provide high level support for development in the selected areas
- Spread economic activity to poorly developed areas with potential for development
- Establish private-public partnership

These are the main SDIs and their economic focus:

ROI	Economical area
KwaZulu-Natal SDI	Industrial
Wild Coast SDI	Agri-tourism
Fish River SDI	Industrial
West Coast Investment SDI	Initiative Industrials and agri-processing
Coast to coast Corridor	Transport and Tourism
Platinum SDI	Mining and agri-tourism
Phalaborwa SDI	Industrial and agri-tourism

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Gauteng Special Economic Zone	Information technology. telecommunications
Maputo Development Corridor	Industrial and agri-processing
Lubombo SDI	Agri-tourism
Richards Bay Initiative	Mining, industrial and agri-processing

Financial incentives for SDIs:

- Duty-free incentives – duty-free import of raw materials or intermediate goods.
- Small and Medium Enterprise Development Programme (support operations).
- Skills support programme – tax-free grants for skills development.
- Critical infrastructure programme – cash grant to build or expand physical infrastructure.
- Foreign investment grants – cash grant to foreign companies that want to invest in new manufacturing businesses.

Corridors in South Africa

Description

- A corridor is a track of land that forms a passageway allowing access from one area to another and is developed as part of regional development (also forms part of an SDI).

OR

- Spatial areas that link one area to another and offers advantages to mining, manufacturing and other businesses

OR

- Spatial areas that offer particular advantages to mining and other businesses along a particular trade route

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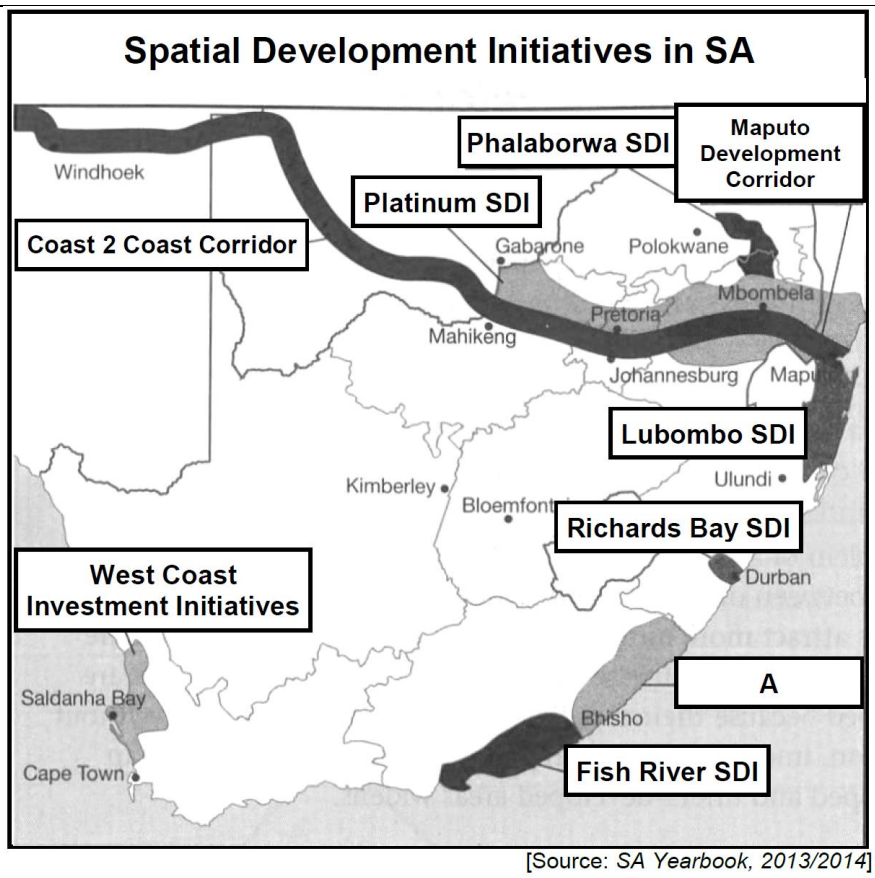

[Source: *SA Yearbook, 2013/2014*]

Corridors

- These are spatial areas that offer specific advantages to mining, manufacturing and other businesses
- The advantages also include the presence of existing infrastructure and the specialisation of products or services
- These corridors are development areas within South Africa and are the development priorities of all development agencies
- The DTI provides help in support of the development corridors
- E.g. Maputo corridor that starts in Gauteng and extends through Mpumalanga to the Maputo port

Industrial Development Zones (IDZs) in South Africa

- Industrial Development Zones (NOSs) in South Africa will later join Special Economic Zones

Description

These are purpose-built industrial estates that are physically enclosed and linked to an international port or airport e.g. Coega. Businesses are encouraged to open in IDZs by being offered improved tax rates or incentives

Industrial development zone (IDZ)

- This is a purpose built industrial estate, physically enclosed and linked to an international port or airport with duty free incentives

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- It is designed to encourage international competitiveness in the SA manufacturing sector -This strategy was aimed at making exports internationally competitive
  They focus on creating jobs and promoting exports
- The idea is that goods produced in these zones should be exported to foreign countries
- As services are provided from outside, the economy in the areas should be stimulated
- Businesses develop around the IDZs (banking, personnel, insurance, auditing, IT, communication, accommodation, catering, shopping, transport)
- An IDZ offers a world-class infrastructure, enjoys a zero rate of VAT on supplies from South African sources and reduced taxation on some products
- Each IDZ offers direct links to an international port or airport, world-class infrastructure, a zero rate VAT on supplies from South African sources, government incentive schemes, reduced taxation for some products, access to latest information
- IDZ's fall outside domestic customs zones and therefore able to import items free of customs and trade restrictions, add value, and then exports their goods

Examples

- Coega – steel and auto components
- OR Tambo International Airport – high tech industries
- East London – vehicles
- Richards Bay – metals.
- Mafikeng IDZ – agro-processing, oil seeds and bio fuels
- Saldanha Bay – proposed, feasibility study completed 2012 - Steel

Special Economic Zones (SEZ's) in South Africa

Description

- Geographically demarcated area where specific economic activities have been identified to be developed.

OR

- Geographical areas that have a wider industrial development objective and which can be located anywhere to promote cluster development are called Special Economic Zones (SEZs).

Special Economic Zones

- It creates a basis for a broader range of industrial parks and provide economic infrastructure to promote employment
- It was introduced because of the limitations of the IDZs and need not be linked to a port of airport
- IDZs are only created for export industries while the SEZs cater for exports and domestic consumption
- Geographically demarcated area where specific economic activities have been identified to be developed
- These areas may enjoy incentives such as tax relief e.g. 15% incentive to attract new industries
- Main aim is to expand the manufacturing sector
- Create employment
- Produce for the export market
- Create additional industrial hubs so that the national industry base will be diversified

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- Investment is based on public-private partnerships with the state providing the infrastructure and private enterprises setting up businesses

The aims of SEZ's:

- Promote rapid development by acting as a magnet for investment in key growth areas
- Enable the development of new industrial regions through the establishment of new industrial hubs in under-developed regions and the strengthening of existing one
- SEZ's are used for the purposes such as export promotion, enterprise development, urban renewal, rural development and domestic or regional production □□

How can special economic zones (SEZs) contribute to regional development?

- The government will use the new programme specifically to promote the creation of a regionally diversified industrial economy
- Establishing new industrial hubs in underdeveloped regions of the country
- This programme is crucial for government's strategic objectives of industrialization, regional development and job creation
- It will improve South Africa's attractiveness as a destination for FDI as well as domestic investment
- It gives a greater opportunity for regional development because it is not linked to a port or airport
- SEZ's accommodates the foreign market for goods and services as well as the domestic market
- Because of a special tax incentive, more industries are established

Strategic Integrated Projects (SIPs)

- Integration of economic and social infrastructure projects in the country.
- There are currently 17 designated projects identified.
- The Strategic Integrated Projects main objective is to identify and implement projects to achieve the provisioning of infrastructure.

Infrastructure plan

- The focus is on assessing infrastructure gaps and needs in terms of population growth.
- The main focus is on water, electricity, roads, sanitation and communication.

10.4 Incentives to encourage industrial development (The incentives used by the South African government to improve industrial development)

Small Business Support Program / Small and Medium Enterprise Development Programme (SMEDP)

- This is a government initiative to assist the SMME's in the economy to begin operating or to expand.
- Grants are given to SMME's with total assets under R100 million.

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- A variety of industries are eligible for these grants, ranging from manufacturing and tourism to agriculture.
- Grants are given for a maximum of three years.

Seda Technology Program (STP)

- STP was created as part of government's national strategy of consolidating and rationalising small enterprise support interventions across the different government departments and government agencies, within the overall objective of improving the delivery of small business support services to entrepreneurs and small enterprises.

Skills Support Programme (SSP)

- The main objective of the Skills Support Programme is to encourage greater investment in training.
- This incentive is provided as a tax-free cash grant for skills development.
- It is aimed at providing investment in training and skills development to gain new expertise.
- A maximum of 50% of a company's training costs are covered.
- The grant is provided for three years

Critical Infrastructure Programme (CIP)

- It is a cash grant provided to build or expand physical infrastructure.
- This infrastructure typically includes roads, railways, electricity and water supply.
- Grants of up to 30% of the cost of infrastructure can be obtained.
- The goal of these types of grants is to get companies to invest in various locations that are usually not very attractive (e.g. rural areas) so as to stimulate the area's economy.
- It becomes available on completion of the project and it extends to both the public sector (e.g. municipalities) and private sector (companies).

Custom free incentives

- These incentives are aimed at export orientated manufacturing businesses that operate in the IDZs and SEZs.
- Duty-free imports on intermediate products that will be used in the IDZ to produce other final goods.

Foreign investment grant (FIG)

- This takes the form of cash grants that is allocated to foreign companies that wish to invest in new manufacturing businesses.
- The grant covers 15% to maximum of R3 million to the costs of moving equipment and machinery into South Africa.
- The goal of this incentive is to increase foreign investment and technologies in the country.

Strategic Investment Program (SIP)

- Cash incentives for businesses in information technology

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Services to business processes

- The BPS aims to attract investment and create employment in South Africa through off-shore activities.
- A base incentive as a tax exempt grant is paid over three years for each offshore job created and maintained.
- **A graduated bonus incentive is paid as follows**:
  - 20% bonus for more than 4 000 but less than 8 000 offshore
  - jobs paid once off in a year in which the bonus is reached;
  - 30% bonus for more than 8 000 offshore jobs paid once off in the year in which the bonus level is reached

Why would the government offer these financial incentives?

- Establish new businesses.
- Involve domestic and foreign businesses in the government 's SDIs.
- Promote industrial development
- Promote employment creation programmes
- Established sustainable businesses that will be able to compete locally and internationally.

10.5 Appropriateness of South Africa's industrial policies

Success factors

- GEAR did not do enough to promote development and an increase in economic growth did not occur.
- Asgisa policy was not successful in the main aim of reducing unemployment and increasing skills.
- The New Growth Path has not seen any decrease in the number of people who are unemployed.
- The National Industrial Policy Framework is an appropriate policy within best practice, but is hindered by an unemployment problem.
- SDIs the growth rate is lower than expected despite the huge amount spent on improvement on infrastructure in the SDIs. The main aim of creating employment has not been achieved.
- IDZs – growth has been very slow. The incentives offered were not attractive enough. Investors have not been attracted to Gauteng and Saldanha Bay as expected. Coega and Richards Bay have been more successful.
- Regional development is still uneven, concentrated mainly in the four metropolitan areas.
- Workers still have to move where employment is.
- Small business development – specific government programmes were successful. The promotion of entrepreneurship (amongst women and youth) have been reasonably successful. Improved access to finance and capital, information and advice have been reasonably successful.

External limitations

- Global recession had a severe negative effect on the manufacturing industry.
- An unstable exchange rate resulted in slow economic growth and development in the industrial sectors.

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Internal limitations

- Huge increase in electricity and logistic costs – these price hikes affected smaller businesses and many more were forced into bankruptcy.
- Skill shortages – slow progress in addressing this need.
- Infrastructure –backlogs in expenditure at all government levels.
- Restructural scale – government sectoral programme to restructure the industrial economy was not of a significant scale for the structural scale envisaged.
- Neglect of larger firms – much emphasis has been placed on smaller firms and larger firms were neglected.
- Uncompetitive behaviour of firms – competition policy needs to be strengthened to counter high levels of industry concentration and anti-competitive behaviour.
- Poor industrial financing – insufficient financing to meet South Africa's investment and industrialisation challenges.

10.6 Appropriateness of South Africa's regional development policies in terms of benchmark criteria. (Discuss in detail)

Free Market Orientation

- Government intervention must be minimized in the market so that the force of supply and demand and the profit motive ensures the effective allocation of resources**.**

Competition

- Companies are more focused, innovative and effective if strong competition is present.
- This improves the overall quality of the manufactured products.
- As with technological advancement, high quality products can more easily be exported and compete on an international level.

Sustainability

- The region must support its own development and the natural and human resources of the region must be used to ensure employment and sustainable development**.**

Good governance

- Regional development must be managed effectively and free of corruption.
- The principles of accountability and transparency must be applied to ensure financial control.
- Projects must be programmed, monitored and evaluated correctly.

Provision of resources

- Sufficient resources should be provided in resource-poor areas, e.g. infrastructure

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Investment in Human capital / social capital

- The development of human capital through skills development is of critical importance, as skilled employees are more productive than unskilled ones.
- By investing in human capital, a country is assured of having long-term economic growth.
- Governments must improve the quality of education and health care in a region

Integration

- An integrated approach, ensuring that the benefits of one region spill over to other industries and areas.

Partnerships

- Regional development is the responsibility of different stakeholders.
- Partnerships between the central government, local government, civil society, special interest groups, NGOs and the private sector must be formed.

10.7 Small business development
The Department of Trade and Industry has various programmes in place to support SMMEs. • The creation of employment for structurally unemployed people. • Focus is on incentives for small businesses. • Providing easier access to capital, information, business advice. • Promotion of entrepreneurial development among women and the youth.

10.8 The appropriateness of black economic empowerment in the South African economy
• This strategy is in line with the empowerment of indigenous people in the development in developing countries. • It is in line with the UN and World Bank development initiative of indigenous people in a country.

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TOPIC 11: ECONOMIC AND SOCIAL INDICATORS

SUBTOPICS

11.1 Assessing the performance of the economy

11.2 Economic indicators

11.3 Social indicators

11.4 International comparisons

Concepts:

11.1 ASSESSING THE PERFORMANCE OF AN ECONOMY

The performance of an economy
When we assess the economy, there are a few things that should be considered:

Performance

- Economic indicators are used to establish the state of the economy. An economic indicator is a statistic (data) that shows the behavior of one or other variable.

Comparisons

- Changing statistics (data) inform us of changes in the economy. By comparing these changes, we can determine whether there is a growth or slowdown in the economy.

Specifications

- To be meaningful, indicators have to be compiled in terms of their rules of compilation.

Purposes

- Indicators are compiled for specific purposes. Example, the CPI is calculated to show increases in consumer prices and reflect the cost of living.

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11.2 ECONOMIC INDICATORS (Discuss in detail)

Defn
Economic indicators are statistics that show general trends in the economy and are used to analyse the economic performance and predict the future performance of the economy

OR

Economic indicators are statistical data that shows the behaviour of one or other economic variable, usually overtime

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1. PRODUCTION INDICATORS

GDP is total value of final goods and services, produced within the boundaries/borders of a country for a specified period.
It measures the total production of an economy

Nominal GDP

- Nominal GDP is gross domestic product (GDP) measured at current market prices.
- Nominal GDP values are not adjusted for inflation.
- Nominal GDP values will often appear higher than real GDP
- Nominal GDP cannot be used because its magnitude is partly caused by price increases and not by an increase in the physical numbers.

Real GDP / Real Gross Domestic Product

- Real GDP measures growth performance of economy.
- Real GDP are adjusted with price increases - the effect of inflation is removed from the data. (GDP-Deflator)
- An increase in the **Real GDP** will cause economic growth, which is defined as the annual rate of increase in total production
- Real GDP are used in forecasting - Real GDP is used to describe business cycles
- If real GDP decrease (or the real value of production decrease), it can be an indication of an recession.
- A Recession is a negative growth for two consecutive quarters.
- The decrease in real GDP will cause:
  - An increase in the unemployment rate (layoffs)
  - An increase number of bankruptcies (due to debt)
  - Poor profit margins etc
- Formula that is used is:

$$\frac{GDPt - GDPo}{GDPo} \times \frac{100}{1}$$

Per capita GDP

- Per capita GDP is a measure of the total output of a country that takes gross domestic product (GDP) and divides it by the number of people in the country.
- The per capita GDP is especially useful when comparing one country to another, because it shows the relative performance of the countries.
- A rise in per capita GDP signals growth in the economy and tends to reflect an increase in productivity.

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2. THE INFLATION RATE INDICATORS

- Inflation can be described as an increase in the general level of prices in an economy that is sustained over a period of time
- SARB aims to keep the inflation rate stable between 3 and 6%

The following instruments are used to measure inflation:

Consumer Price Index (CPI) / Headline inflation

- This is the weighted average of the prices of a general basket of goods and services likely to be bought by consumers
- The weights are obtained from expenditure of different income categories of households
- Decides on a base year for calculating the CPI which is similar for all SNA items
- Decides on a formula for calculating the CPI
- Decides on the collection of prices – in SA it is obtained by means of surveys
- It shows changes in the general purchases of a currency (e.g. rand)
- It is also used for inflation targeting
- Pertains to cost of living
- Capital and intermediate goods are excluded
- Prices include VAT
- Interest rates are taken into account
- Prices of imported goods are not shown explicitly

Producer Price Index (PPI)

- PPI measured prices of locally produced goods when they leave the factory gate and imported goods when they enter the country
- It consists of a basket of local, exported and imported goods
- It includes capital and intermediate goods, but not services
- Prices exclude VAT
- Interest rates are excluded
- It measures the cost of production and not the cost of living
- It also serves as an indicator to predict consumer inflation (CPI)

3. FOREIGN TRADE INDICATORS

- In our increasingly globalized world, international trade is most important
- Exports serve to stimulate employment and imports serve to widen the choice of consumers

The terms of trade

- This is the ratio of exports and import prices
- Although the terms of trade express prices only, changes in them have quantity (volume) effects
- Changes in terms of trade serve as indicator of changes that may spill over into the balance of payments
- If this happens the currency may depreciate or appreciate

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The exchange rate

- An exchange rate is the price of one country's currency in terms of another country's currency
- Most currencies have a number of exchange rates, similar to the rand
- If the rand appreciates against the US dollar it may depreciate against the euro
- Changes in an exchange rate affect the prices for imports and prices of exports e.g. a depreciation of the rand against the dollar will result in US goods and services becoming more expensive domestically and earnings from exports to the US increasing, although the volume will remain the same and the opposite will happen when the rand appreciates

4. EMPLOYMENT INDICATORS

- In addition to economic growth, the employment of people of working age (15-64 years) is a major economic objective.
- We need to know more than this; we need to know who the people are that need to be employed.
- The numbers are determined, not only by age, but also by people's willingness to work.

The economically active population (EAP)

- The EAP is also known as the labour force.
- It consists of people between the age of 15 and 64 who are willing to work for income in cash or in kind.
- It includes workers in the formal sector, informal sector, self-employed persons, unemployed persons.
- The 2011 estimate of the South African population was 50.5 million people and the EAP numbered 17.5 million. (34.6% of the population).

Employment rate

- The number of employed persons expressed as a percentage of the EAP gives the employment rate
- The employment rate can also be converted into an index
- The SA employment rate was 74.9% in 2011

- This is low, compared to rates in developed and even some developing countries such as Argentina and Pakistan
- In SA the growth in the economy is not accompanied by the similar growth in employment numbers

Employment indicators are used for:

- To calculate trends in employment in different sectors or industries. This indicates structural changes in the economy.
- To calculate productivity.
- To show the success of the economy in utilising its full potential.

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Unemployment rate

- Statistics SA (SSA) obtains its labour data each year from Quarterly Labour Surveys (QLFS)
- It uses the standard definition of the International labour Office (ILO) to calculate unemployment.
- The strict definition of unemployment is used to calculate the unemployment rate.

- The unemployment are those people within the Economically Active Population (EAP) who:
    - Did not work during the seven days prior to the interview
    - Want to work and are available to start work within a week of the interview
    - Have taken active steps to look for work or to start some form of self-employment in four weeks prior to the interview.

- In SA the official unemployment rate was 25.2% in 2012.
- In developed countries, change in the unemployment rate trigger responses:
    - from governments to fine-tune the economy.
    - Increases require more funds for unemployment insurance (UIF) drawings.
    - In developing countries, unemployment is the most important cause of poverty.

5. PRODUCTIVITY INDICATORS

It is possible to calculate THREE kinds of productivity, namely labour, capital and multi-factor productivity

Labour productivity

- is watched most closely, particularly in relation to real wage increases
- E.g. In South Africa productivity increased less than labour remuneration
- The economy as a result battled to stay out of a recession
- Labour productivity is measured by dividing the real GDP by the number of workers employed

Remuneration per worker

- If productivity increases are lower than the real wage increases, inflationary pressures will occur
- The relationship between productivity and wages is crucial for employers and workers and they are therefore important indicators
- For the employers to survive in vigorous markets
- For the employees to survive on their salaries

6. INTEREST RATE INDICATORS

Interest rates

- Interest is the charge made for borrowing money.

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Repo rate

- Repo rate is one of the most important interest rate indicators. It is the rate at which the SARB lends money to banks.

7. **MONEY SUPPLY INDICATORS**

The supply of money is controlled by the SARB. The money is classified in three categories.

- **M1 money supply**: notes and coins in circulation and demand deposits of the domestic private sector at banks.
- M2 **money supply**: M1 plus other short term and medium term deposits of the domestic private sector at banks.
- M3 **money supply**: M2 plus long term deposits of the domestic private sector at banks.

11.3 SOCIAL INDICATORS (DISCUSS IN DETAIL)

Defn.

Social indicators are concerned with people. They monitor identifiable and definable issues related to human well-being over a period of time.

Of

Social indicators are a measure used by economists and governments to evaluate the performance of the economy with regard to the social well-being of the inhabitants.

1. **DEMOGRAPHIC INDICATORS**

- This deals with the characteristics of the population, e.g. population /size/race/ age/sex/ income/geographic distribution/ language/education/occupation/ religion/birth rate/ fertility rate/life expectancy at birth/infant mortality rate/death rate.
- Definable issues related to human well-being over a period of time
- This information can be used by government to plan for e.g. infrastructure development and implementation of social programmes
- it is also important to business as it indicates the size and characteristics of business' target markets

The population growth:

- In 2013 the South African population was estimated at 52.98 million and IN 2017 the population stood at 55,91 million.
- South Africa has a relatively high population growth compared to other developed countries
- The population growth rate is an important indicator to the government in terms of the number of social services that are needed

Life expectancy:

- This expresses the number of years a new-born infant will live if the prevailing patterns of mortality remained the same throughout his or her life in South Africa
- Life expectancy went down from 62,8 years in 1991 to 49.7 years in 2015

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- It is important for the government to know the average life expectancy of the population since working human beings require a range of social services and also the tax base of the country
- Assurance companies in particular are interested in the life expectancy unexpected reductions in life expectancy reduce the number of years' policy holders can pay their premiums and can have detrimental effect on the services of such businesses

2. NUTRITION AND HEALTH INDICATORS

These are two related social indicators.

Nutrition:

- This is an important indicator for the well-being of infants and young children
- Two important conditions of nutrition in child malnutrition and overweight which are both particularly important for children under the age of five years of age:

Child malnutrition

- Malnutrition is expressed in two ways, namely weight for age (underweight) and height for weight (stunted or dwarfism)
- The proportion of children who are underweight is the most important indicator of malnutrition
- It is important to monitor malnutrition and weight because being overweight increases the risk of death and inhibits cognitive development in children

Overweight children

- The prevalence of overweight children is growing concern in South Africa
- There is an association between obesity in children and the high prevalence of diabetes, respiratory diseases, high blood pressure, and psychological and orthopedic disorders
- Being overweight can lead to numerous adverse health conditions which affect people's ability to work and take care of themselves obesity is a killer
- Governments often legislate that health supplements such as vitamin A be added to basic food stuffs such as bread while the health department also encourage breast feeding
- Malnutrition and obesity in children are indicators taken into account when deciding on feeding schemes and their extent

HEALTH:

- A number of indicators are used both nationally and internationally to monitor the health of a population

Infant mortality

- The number of children who die before the age of 1 is a way to measure the health of the population
- Child mortality is significantly higher in poor households

Under five mortality

- The number of children that will die before the age of 5 years

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Health expenditure

- This is measured in terms of the amount of public and private expenditure on healthcare as a percentage of GDP
- Healthcare has extremely positive externalities

Access to safe and drinking water

- This is measure in terms of the percentage of the population that a reasonable access to safe and drinking water (treated or uncontaminated) –

Access to sanitation facilities

- This is measured in terms of the percentage of a population with at least adequate sanitation facilities that can effectively prevent human/animal/and insect contact
- A healthy population saves on medical and other costs, produces income and contributes to a stronger economy

3. EDUCATION

- The standard of living is related to the level of education
- Education is a key social indicator:
  - **Percentage public-sector spending**: Public expenditure: the percentage of the national budget that is directed towards education
  - **Secondary enrolment:** this shows the percentage of an age group attending high school
  - **Primary completion:** the percentage of an age group that has completed primary education is an indicator of the efficiency of the education system
  - **Youth literacy rate**: the percentage of the 15-24 age group that are literate

4. SERVICES

- Services are vital to enhance people's lifestyles and level of economic and social development
- In South Africa, in terms of the Constitution's requirements of human dignity and social justice the following are identified:

Electricity

- The national Electricity Regulator reports that 83,1% of households has access to electricity in 2010 compared to 50% in 1995

Refuse removal

- Some 61% of households in South Africa had access to refuse removal by the local authorities once a week

Water supply

- Some 89% of households had access to clean water in 2010 this is the average of urban and rural access to improved water schemes
- Improved water resources refer to an adequate amount of water from sources. e.g. households' connections/taps inside the yard/ public taps /boreholes/protected springs/and rainwater collection

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Sanitation

- Just over 71% of households in South Africa had access to functioning basic sanitation in 2010
- e.g. flush toilets/pit toilets with ventilation pipes/and chemical toilets

5. **HOUSING AND URBANISATION**

- The standard of living of the population is related to the quality of their housing and services:

Housing

- Housing: Many South African citizens are poor and cannot afford property. The government supplies housing subsidies and the private sector provides housing loans.

Urbanisation

- The level of urbanisation is one of the indicators of a country's social development.
  It is measured by:
- Natural growth of the urban population
- Migration
- Establishment of new towns

11.4 INTERNATIONAL COMPARISONS

International comparisons are the key means of measuring a country's economic and social development.

Globalisation

- International trade: Payments are affected by the exchange rate.
- Internationalisation: Branch offices in foreign countries monitor indicators to publish financial reports in a single currency and pay dividends in different currencies.

International standardisation

- Economic and social indicators are useful. International organisations, like the World Bank and the IMF, are very specific in determining, utilising and applying these indicators.
- Benefits from organisations cannot be measured if indicators are not available, e.g. bridging finance from the IMF, World Bank and the UN.

Aid and support

- Foreign countries, governments, international institutions and NGOs are globally involved in providing financial aid.
- • A country needs indicators, including domestic income, production and expenditure, poverty, education and health data, to receive aid and to measure the impact of this aid.
- Human rights (children's rights), environment (pollution) and governance (corruption) indicators might also be requested by aid organisations.

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Comparison and forecasting

- Capital markets are liberated through globalisation.
- Capital moves where it receives the best returns.
- Publications for global players give indicator values for the 3 previous and 3 future years to spot underlying trends.

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MAIN TOPIC: CONTEMPORARY ECONOMIC ISSUES (PAPER 2)

TOPIC 12: INFLATION

SUBTOPICS:

12.1 Inflation

12.2 Types and characteristics of inflation

12.3 Causes of inflation

12.4 Consequences of inflation

12.5 The inflation problem in South Africa

12.6 Measures to combat inflation

12.7 Inflation targets

12.1 Description

Definition: Inflation is a sustained and a significant increase in the general price level over a period of time.

- People's real disposable income tends to decrease**.**
- There is a inverse relationship between the purchasing power of money and inflation, e.g if the inflation rate increase then the purchasing power of money will decrease.

Concepts

The instution which play an key role in controlling inflation.	South African Reserve Bank
The committe that gathers on a regular basis to monitor inflation and to implement policy to control inflation.	Monetary Policy Committee
What does the abbreviation MPC stand for?	Monetary Policy Committee
What rates are used to influence consumer spending?	Interest Rates
The Inflation Target of South Africa.	3–6%
Which policy is used by the government to control the money supply in South Africa?	Monetary Policy

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An institute that is responsible for calculating and publishing of separate inflation data for certain metropolitan areas.	StatsSA
If the rand depreciates, prices and the rate of inflation will **increase.**	

Measuring of Inflation (MTG 172)

I. **Indexes**: A price index is compiled by using the prices of a representative range of goods and services which are recorded on a regular basis.
II. **Weighting:** The difference in the importance of items in an index is solved through a weighted index which reflects the relative importance of each item.
III. **Inflation rate:** The inflation rate is determined by using changes in the CPI and/or PPI index. The figures for each month are compared to the corresponding month in the previous year.

12.2 TYPES OF INFLATION

Consumer Inflation	Producer inflation	All inclusive inflation	Hyper inflation	Stagflation
Head line Inflation (CPI) Core inflation Administered Price Inflation				

A. Consumer inflation

Headline inflation (CPI)

- Measured by the Consumer Price Index (CPI).
- Represents the cost of the 'shopping basket' of goods and services of a typical South African household.
- The unadjusted CPI inflation rate is also known as headline inflation.
- Interest rates are the main monetary instrument used by the SARB to fight inflation.
- The main indicator of inflation in its pursuit of the inflation target set by the Reserve Bank.

CPIX inflation

- it calculates the inflation rate excluding the effect of mortgage bond (housing loan) interest rates.

Core inflation

- Excludes items from the CPI basket that have highly volatile prices and items with prices that are affected by government intervention and policy.

Administered prices inflation

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- These are prices of goods and services that are set by government or controlled by government appointed authorities.

B. Producers inflation

- Measured by the production price index (PPI) and measures the cost of production.

C. All-inclusive inflation

- The implicit GDP deflator is simply the ratio of the GDP at current prices to the GDP at constant prices for a specific year.

D. Hyperinflation

- Most extreme form of inflation / runaway inflation / inflation out of control.
- Inflation rate increase with 50% or more per month.
- National currency is almost worth nothing and people lose their confidence in the monetary unit.
- Leads to exchange of goods for goods (barter) – widespread phenomenon.
- E.g. Zimbabwe.
- People lose confidence/faith in the economy.
- It can occur in times of war.

E. Stagflation

- Low economic growth rate exists due to strong monetary and fiscal policies to curb high inflation rates
- It is a condition of stagnation of economic growth (low growth and unemployment) and high rates of inflation.
- Occurs in economies that lost the ability to create new jobs.

F. Deflation

- When prices of goods and services decrease continuously over a long period of time.

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Differences between Consumer Price Index (CPI) and Producer Price Index (PPI) (MTG 173)

CPI	PPI
Pertains to cost of living	Pertains to cost of production.
Basket consists of consumer goods and services	Basket consists of goods only.
Capital and intermediate goods are excluded	Capital and intermediate goods are included.
Prices include VAT	Prices exclude VAT.
Interest rates are taken into account	Interest rates are excluded.
Prices of imported goods are not shown	Prices of imported goods are shown explicitly.

12.3 CAUSES OF INFLATION

Monetarist Explanation	Demand Pull Inflation (Demand Inflation)	Cost Push Inflation (Cost inflation)

1. Monetarist Explanation of Inflation

Increase in the money supply

- A higher increase in the supply of money in circulation in the market than in supply of goods and services.
- There is more money available to buy the same goods.
- If the supply of goods does not increase (increase in productivity) sellers will want more money for their goods because buyers are willing to pay more.

2. Demand-pull / demand inflation

2.1 **Definition:** Demand-pull inflation occurs when aggregate demand for goods and services exceeds the aggregate supply of goods and services.

Demand-pull inflation can be described as a case of "too much money chasing too few goods"

2.2 **Characteristics** (MTG 174-175)

- Aggregate demand rises more than aggregate supply, causing an increase in the general price level.
- **Groups that are responsible:** Consumers, businesses and government.
- **Foreigners' contribution:** They further increase the demand for our goods and services through an increase in exports.
- **Relative increase in aggregate demand's components:** C (consumption spending), I (investment spending), G (government spending), M (cost of imports).

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- **Decline savings:** if savings habits are changed and consumers start spending their current and accumulated savings, growth in aggregate demand can outstrip growth in aggregate supply
- **Tax reduction:** If personal income tax is reduced more money is available for private consumption expenditure.
- **Access to credit:** Greater availability of consumer credit (credit cards) and cheaper credit – credit multiplier kicks in and more credit is created.

2.3 Causes of demand-pull inflation (Refer to memo – November 2016)

Increased consumption by households (C)

The disposable income of households can increase at a faster rate than aggregate supply for the following reasons

- It is caused by easier access to credit or lower interest rates, which make credit cheaper. With credit being cheaper, households will borrow more.
- Lack of savings - Consumers may spend their entire income and fail to save. This results in a lack of liquidity for banks to finance essential capital investment.
- Reduction in taxes- If the government decides to decrease personal income tax, consumers will use the extra income to buy more goods and services.

Investment spending (I)

- A reduction in interest rates will encourage firms to expanding their operations
- Businesses invest more and this may lead to an increase in the demand for goods and services that are part of the investment, e.g. new buildings, cement, bricks and labour
- If aggregate demand increases at a faster rate than aggregate supply, price increases will follow

Government spending (G)

- An increase in government spending without an increase in productivity will lead to inflation
- If increases in government spending are financed by borrowing from financial institutions, large sums of money are placed into circulation – aggravating the demands in the economy's real capacity
- Government uses three channels for increased spending:
    - Infrastructure - government may embark in capital projects, such as roads, housing and water; the sizes of these projects outstrip the economy's capacity which will increase prices.
    - Consumption expenditure- most governments will at times increase expenditures on education and health
    - Social spending- Governments sometimes feel they have to do something substantive about unemployment and poverty, e.g. public work programmes. Such expenditures invariably lead to inflation because they add to aggregate demand without adding anything to aggregate supply

Export earnings (X)

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- Increases in earnings from exports can come from various sources:
  - Foreign growth - growth of the economies of trading partner countries may create a demand for a variety of locally produced goods. The sales of exports bring money into the country, demand increases without corresponding increases in supply, resulting in an increase in prices.
  - Commodities demand - the world's demand for commodities expands and contracts like business cycles do. During an expansionary period, foreign demand increases and this leads to greater volumes of exports. The income earned from these exports adds to aggregate demand and prices increase.

3. **Cost-push inflation**

3.1 **Definition:**

Cost push inflation is triggered by an increase in the cost of production, which push up the general price level of goods and services.

3.2 **Characteristics: (MTG 174-175)**

- **An increase in labour costs:** Aggressive trade union negotiations push the price of labour up above the increase in productivity.
- **Producers increase profits:** Prices rise more than the rise in production costs.
- The state imposes a **higher VAT rate**.
- **Expensive imported products** (intermediate goods) cause an increase in the prices of locally finished goods.
- **Lower productivity but the same remuneration:** The cost of production increases.
- **Natural disasters**: Floods or droughts increase the cost of production.
- Increased total costs on the supply side.

3.3 **Causes of cost-push inflation** (Refer to memo June 2017)

Wages

- Wage increases that are higher than productivity cause a cost increase for producers.
- Single most important cost item in any economy
- Contributes to almost 50% of value added to basic prices

Key inputs

- When the price of imported key inputs increases, the domestic costs of production increase
- Producers recover these costs by increasing the prices of their products

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Profit margins

- When businesses push up their profit margins, they increase the cost of production and the price that the consumers have to pay
- This is because manufacturers recover the higher prices they have to pay by increasing their prices

Productivity

- If various factors of production become less productive while still receiving the same remuneration, the cost of producing each unit of output increases

Exchange rate depreciation

- If the rand depreciates against the major currencies, imports from such countries will be more expensive
- Producers have to pay more money for the same quantity of products than before; as such, they often shift the increase to the consumers

Natural disasters

- Disasters, such as floods and droughts, affect the cost of production negatively
- Food prices are one of the most volatile price items as a result of the effect of weather changes

Theft by employees/Shoplifting

- Many businesses make provision for losses caused by theft by employees and shoplifting, which increases the prices of goods
- Cost of installing security measures increases the input costs

12.4 CONSEQUENCES OF INFLATION

Debtors/Creditors

- Debtors are favoured at the cost of creditors
- The original debt was incurred when money had a higher real value, but is repaid in money with a lower real value.

Wage and salary earners

- People with a fixed income will be able to purchase less as prices are rising.

Investors and savers

- People who invest in negotiable instruments and securities, shares, etc., often benefit from inflation.
- This is because the value of their paper investment may increase more rapidly than the rate of inflation.
- People who lend money will be affected by high inflation rates
- If interest rate received is lower the inflation rate, then the real value of money will decrease.

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Tax payers

- More personal income tax payable to state due to higher salaries caused by inflation.

Industrial peace

- Wage bargaining is often accompanied by strikes and mass actions
- These actions can spill over into violence.

12.5 THE INFLATION PROBLEM IN SOUTH AFRICA

Expectancy and inflation (Enjoy p291)

- The demand-pull and cost-push factors can all act as **triggers** to set an inflation process in motion.
- *Role of inflation expectations are as follows:*
    - During periods of inflation, consumers expect prices to rise.
        - They buy goods before their prices increase and thereby add to aggregate demand.
        - People thus spend their money because they expect prices to rise.
        - Similarly, businesses try to persuade their customers to rather buy now before the price rise.
        - If they do, they push up aggregate demand and stimulate demand inflation.
    - Labour unions wish to protect their members against the erosion of purchasing power caused by inflation.
        - They bargain for wage increases that will neutralize the effect of future inflation
        - However increased labour cost increases production costs, which are passed on to consumers by means of higher prices
    - The expectations that wages will rise encourages some businesses to increase prices in advance.
        - They use the expectations window to increase their profit margins, which increase the prices of their goods and cause cost push inflation.
- Thus, the higher the expected rate of inflation, the higher the level of wage and price increases will be, and hence the resulting actual rate of inflation will be.
- *Inflationary expectations are thus self-fulfilling*.

Inflation problem in South Africa (enjoy p293 – 296)

- In 2000, the SARB set an inflation target of between 3% and 6% as part of its monetary policy.
- The inflation rate in South Africa is currently higher than the inflation rate of its trading partners.
- It makes South African goods more expensive than other countries, thus South Africa is less competitive.
- The high prices have a negative effect on exports.
- The weakening value of the Rand against its trading partners' currencies also contributes to the high cost of imports.
- Income and wealth is very unevenly distributed in South Africa.

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- Trade unions therefore demand wage increases higher than inflation to eliminate the inequality.
- If the money supply increases in a country without a corresponding increase in production, inflation will also increase.
- Some key prices are set by the government (Administered price inflation – API), for example Eskom's electricity price.
- A significant increase hereof leads to an increase in inflation.
- South Africa's citizens lend and spend excessively their money.
- They do not have a savings culture. Inflation therefore also increases as a result of this culture of spending.

SHORT TERM EXPECTATIONS

DEMAND PROBLEMS

- **Production capacity:** If local manufacturers have little capacity to increase output and formal employment increases, inflationary pressure develops.
- **Borrowing (Loans):** Household debt increased as % of disposable income.
- **Sales of durable goods:** Domestic, new car sales increased but prices remained in the inflation target range.
- **Money supply and credit:** M3 increased above target of 10%; also bank loans to the private sector increased.

COST PROBLEMS -

- **World inflation:** If the world inflation rate is higher than South Africa's, it put pressure on domestic prices.
- **Labour costs:** Wage increases above productivity put pressure on business' viability and on inflation rate.
- **Key inputs:** A key imported input / cost factor is crude oil.
- **Administered prices:** Are continuously above the inflation target and individuals and businesses suffer.
- **Market prices:** The prices of goods, such as food, clothing and medical services are continuously under the scrutiny of the MPC.
- **Exchange rates:** The level of the exchange rate is always highly uncertain and its volatility effect is felt in the depreciation of the rand.

a) LONG-TERM EXPECTATIONS

INFRASTRUCTURE -

Government established the Presidential Infrastructure Coordinating Commission (PICC), which identified 645 infrastructure projects across the country to be completed over the next 20 years. In the meantime, inflationary pressures are being caused by inadequate capacity of e.g. electricity and transport. In addition, the cost of financing of the projects always escalates and these escalations find their way into inflation.

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ENERGY PROBLEMS

- **Liquid fuels –** Imported crude oil are a direct cost item for businesses and consumers.
- **Fuel stocks -** An increase in consumption implies direct imports and the unavailability of fuel results in inflation.
- **Electricity -** Eskom have inadequate capacity to deliver uninterrupted supplies to growing SA economy.

LABOUR

- The private and public sectors are experiencing severe shortages of skilled workers because of work permits

EXCHANGE RATE DEPRECIATION

- South Africa attracts large "hot money" capital.
- Risk is a sudden increased deficit balance of current account, financed by portfolio investment from abroad

SOCIAL SPENDING

- Government is under continuous pressure to increase social spending, particularly on cash grants.
- 30% of the population benefit from this expenditure.
- Further increase in taxes will fuel inflation.

12.6 MEASURES TO COMBAT INFLATION

Demand-pull inflation

1. **Monetary Measures (The role of the SARB)**

- SARB apply certain monetary measures to curb inflation.
- A fine balance must be maintained between goods and services and the monetary sector of the economy.
- It is the responsibility of the monetary authorities to adjust the quantity of money to the needs of the economy, eg through open-market policy.
- Inflation caused by excess demand can be curbed if the monetary authorities reduce the money supply.
- The SARB can raise the repo rate (bank rate) and this will encourage savings.
- The granting of credit through banks can also be reduced by the SARB.
- The SARB can apply moral pressure on financial institutions to be more careful when granting credit.
- Relaxing exchange controls is also often mentioned as a measure to combat inflation.

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2. <u>Fiscal policy</u>

- Fiscal policy:entails a reduction in government spending and/or increased taxation.
- The minister of finance uses policies of taxation and expenditure to control inflation.
- This reduces the demand for goods but also has a negative effect on employment and production.

Fiscal measures that can be used to combat inflation

- increasing indirect taxes which will increase the price of specific products and therefore reduce aggregate demand, e.g. VAT
- increasing direct taxes to reduce disposable income and demand, e.g. personal income tax
- reducing corporate tax to encourage production of goods and services to increase supply, i.e. tax rebates to improve productivity
- implementing or increasing a surcharge on imported goods to curb the buying of imported goods
- increasing excise duties (sin tax) will help to reduce the demand for demerit goods
- Reducing government spending, eg cancel government projects.
- Loan levy can be introduced.

<u>Cost-push inflation (Enjoy 297)</u>

- Productivity
  - Increases in factor productivity are the most viable option.
  - Wage increases need to be accompanied by productivity increases.
  - Improvements in technology can play an important role.

- Competition
  - The best method for keeping a check on profit margins is to ensure competition- domestically and from abroad.

12. 7 INFLATION TARGETS (Success of inflation targeting -Refer to Q3.5 Nov 2017)

Inflation targetinghas been effective by:

- Curbing demand-pull inflation through limiting consumption expenditure
- Managing consumers' expectations about future trends in inflation
- Ensuring the central bank adjust interest rates if inflation is outside the target range of 3-6%
- Stimulating economic activity due to the relative small changes in input prices.
- Allowing businesses to make investment decisions knowing that priceswill be stable.
- Providing an explicit measure that serve to improve discipline and accountability of the SARB

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Inlation targeting has not been effective in:

- Controlling cost-push inflation since it was designed to control the aggregate demand
- Controlling many factors, because the increase in costs of production is influenced by factors that fall outside the control of the monetary policy, eg increase in oil price

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TOPIC 13: TOURISM

SUBTOPICS

13.1 Tourism

13.2 Reasons for its growth

13.3 The effect of tourism

13.4 The benefits of tourism

13.5 South Africa's tourism profile

13. 6 Policy suggestions

13.1 TOURISM

Definition:

Tourism describes the activities of people traveling to and staying in places outside their usual environment for no more than one consecutive year for leisure, business and other purposes. No compensation is paid from the destination.

Concepts:

Ecotourism	It is a combination of tourism and the environment.
Asgi-SA / GEAR	The macroeconomic strategy of the government that is closely linked to tourism is.
Department of Environmental Affairs and Tourism (DEAT)	Drive and direct the tourism policy at national level.
Community tourism	When tourists are given the opportunity to experience the life in South African townships.
International tourist / Inbound tourists	When tourists / foreigners are given the opportunity to experience the life in of South African.
Inbound tourists	Foreigners visiting South Africa.
A **uni-visa**	It is a visa that is acceptable in all SADC-countries. It is a common visa.
SA Tourism	It is a public enterprise with private stakeholder representation on its council.
The **tourism multiplier**	It implies that the benefit from a tourist is greater than the money spent.
Destination country	The country that tourists visit.
Tourist in transit	It is tourists who travel through South Africa for example. From Africa to the East, they experience something of the country.

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Tourist generating country	Country where tourists come from.
World Travel and Tourism Council – (WTTC)	It is the organisation which promotes tourism.
NDT : National Department of Tourism	Driven and directed the tourism policy at national level.

Tourism is **labour intensive.**

Organisation which promote Tourism

World Travel and Tourism Council – (WTTC)

Purpose: Supervising the industry
Standardize activities
Do research on tourism

Types of Tourism

- **Leisure and recreation:** Tourists come to South Africa on holiday, to play sport, to visit friends, and to see the tourist attractions
- **Cultural tourism:** Tourists come to visit museums and art galleries, e.g. Robben Island and the Apartheid Museum.
- **Ecotourism:** Tourists visit undisturbed natural areas, e.g. the Richtersveld Cultural and Botanical Landscape, the Cape Floral Region Protected Areas and the Kruger National Park.
- **Business and professional:** Tourists visit for business meetings and conferences.
- **Other**: For studies, or medical reasons.

Measuring tourism

- There should be a purpose for the visit and activity
- No remuneration should be earned
- The minimum length of stay is one night
- The maximum length of stay is one year
- The travelling distance should be more than 160 km
- Foreign exchange generator
- Every time money is spent locally, it helps to ensure the balance of payments equilibrium

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Supply of Tourism

Enterprises that are dependent on tourism

- Hotels, guesthouses, recreational facilities
- Retailers selling travelling accessories
- Hotel schools, tourism educational programmes
- Tour guides, travel agents, information centers
- Car hire businesses, taxis, buses, trains

13.2 THE REASONS FOR GROWTH in the tourism industry (International & Domestically)

- Increase in disposable income
- Reduction in working hours
- More awareness of leisure and recreation
- Improved transport, communication and accommodation facilities
- Increases in advertising and promotion
- Awareness of the benefits of holidays and travel
- Ease of obtaining foreign exchange and making payments
- Cheaper flights
- Favourable exchange rates
- Peaceful political transformation
- Dramatic increase in the MICE (Meetings, Incentives, Conferences and Exhibitions)
- Global travel trends
- Improvement in the tourism infrastructure
- Improved coordination with neighbouring countries
- Well-established National Parks
- Companies who are leaders in best-practice

13.3 THE EFFECTS OF TOURISM

- Tourism represents a unique industry in an economy because its effects extend far beyond the tourism industry itself.
- Tourism is an industry that provides a substantial economic stimulus to other industries.
- We must see tourism as a means for a better life for all.
- Tourism is the world's largest industry and every year it 'pumps' millions of dollars into some of the poorest countries.

13.3.1 Gross Domestic Product (GDP) / Economic Growth

- Tourism is basically a service-based industry partly responsible for the service sectors growth in South Africa.
- It impacts is more on the service industry than on agriculture or manufacturing.

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- Direct contribution - WTTC estimated 6,8% in South Africa and 11,6% worldwide - direct spending on tourists goods and services - money income received from a tourist.
- It's indirect impact is about 9.0% in real terms – more than the contribution of gold mining.
- It's contribution differs from country to country – Mauritius gets about 1/3 of its national income from this sector.
- It is estimated that tourism could contribute 12% to the GDP by 2014.
- Fourth-largest industry in South Africa and supports about 700 hotels, 2 800 guesthouses and bed-and-breakfast establishments, and 10 000 restaurants .

13.3.2 Employment

- Tourism is labour intensive - more jobs are created with every unit of capital invested in tourism than elsewhere.
- Tourism employs many skills. Numerous skills are needed. The potential of job training is enormous.
- Tourism can provide immediate employment - if organized and focused, many jobs can be created in short period of time.
- Tourism provides entrepreneurial opportunities. Significant part of tourist expenditure goes towards informal sector activities.
- Employs an estimated 7% of the South African workforce (2010 employ more than 1,2 million people) and is potentially regarded as the largest provider of jobs and earner of foreign exchange.
- Largest generator of jobs - provide one in every nine jobs.
- Every eight tourists to visit results in the creation of one permanent job.
- Creates direct jobs - tourist accommodation establishments, entertainment, restaurants etc.
- Creates indirect jobs - other sectors of the economy as a result of tourism.

13.3.3 Poverty

- Tourism makes a substantial contribution to economic growth and job creation. It is not sufficient to ensure poverty eradication but it affects the lives of the poor in many ways. It is a fast and effective distribution mechanism in development of rural areas.
- Sensible policy guidelines can counteract the potentially negative effects of tourism.
- Prime tourism attractions are located in rural areas.
- It promotes balanced and sustainable development.
- It provides alternatives to urbanization, permitting people to continue – enfranchising both women and youth.
- Offers diversity of income sources to poor people: allowing them a stake, empowering them, creating partnerships.
- Poverty relief through sustainable work opportunities for the poorest communities over the long-term (e.g.) walkways, rock art, ablution facilities.

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13.3.4 Externalities

- Benefits that arise from economic activities that are not reflected in the actual prices of the transactions. It is referred to as economic side-effects of certain transactions.
- Tourism strategies will maximize external benefits and minimize external costs of various externalities
- Such benefits are normally measured in terms of an impact or cost-benefit analysis.
- Attracts large amounts of revenue, but cause undue environmental damage and pollution.
- Rapid growth aimed at short-term benefits.
- Global tourism will grow due to increased population and increased living standards.
- Potential: attract revenue to country, alleviate poverty, conserve cultural and natural assets – needs conscious planning.
- Needs to achieve ethical and sustainable tourism. We must respect tradition and customs of area, plough back earnings into local community – area must be protected as attractive tourist resort.

13.3.5 Environmental effects

- People have become more aware of the negative environmental consequences and implications for consumption and waste.
- Tourism's relationship with environment is complex. It involves many activities that have adverse environmental effects.
- It led to the emphasis on ecotourism development. It involves guidelines for managing social, economic and environmental impact of tourism.
- The objective is to achieve an equitable spread of benefits across the entire population.
- Local communities engaged in tourism to achieve local empowerment.
- Ecotourism development embraces principles of ecological preservation.
- Permanent environmental restructuring e.g. highways, airports.

13.3.6 Investment

- SA has a modern, world-class infrastructure, sophisticated transport system, low-cost and widely available energy and advanced telecommunication system
- Quality infrastructure will increase the volume of tourism. It needs good travel facilities, well-maintained road network and excellent tourist accommodation, such as hotels and lodges
- Most centres have good transport lines, superior road and highway infrastructure
- Proper infrastructure planning needed to accommodate growth in tourism
- Development of infrastructure is seen as public investment

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13.4 THE BENEFITS OF TOURISM

- South Africa benefits directly from tourism because of the growth it causes in GDP, government, infrastructure development and exposure to foreigners.
- A major spin-off benefit is foreign exchange earnings.

13.4.1 Households

- Income is earned through employment.
- Infrastructure is created for use by both tourists and local people e.g. roads, hotels, etc.
- Skills require education and training – offered as school subjects: Tourism and Hospitality Studies.
- Creation of job opportunities and learnerships for a number of skills required. by the tourism industry are offered e.g. tour guides, travel agents and chefs.

13.4.2 Businesses

- Economic and basic services infrastructure is usually provided by the public sector.
- A superstructure consists of businesses that provide accommodation, transport, and retailing and recreation services.
- E.g. accommodation, transport, built attractions, retailing and recreation services.
- Informal opportunities like car rental, arts and craft also exist.
- Tourism also stimulates certain socio-economic objectives such as entrepreneurship development, Black Economic Empowerment and SMME development.
- They are normally private sector activities and make up the profit-generating element of a tourist destination.
- A combination of public and private sector finance is used to develop destinations (Public-private-partnerships).
- The public sector also provides a range of financial incentives for private sector tourism investment (grants, subsidies, loans, taxes).
- There are also many informal and less traditional opportunities for tourism benefits and these serve as stepping stones for previously neglected groups in the tourism business.
- (E.g.) car rentals, craft curios sales.

13.4.3 State

- The main avenue for governments to benefit from tourism is through the levying of taxes.
- These taxes have a dual purpose:
  - To recover external costs - This cost is recovered from the tourist through adding the taxes to the supply price / normal expenditure taxes (e.g. VAT, excise duties, customs duties). This amount serves to compensate the host community for providing the infrastructure, public amenities (showers, toilets) to the tourists.
  - To raise revenue. Tourists are seen as part of the overall tax base. (E.g.) through airport departures, air ticket taxes and taxes on hotel rooms.)

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13.4.4 Infrastructure development

- Adequate and well-maintained physical and basic services infrastructure are essential for tourist destination areas.
- Economic infrastructure has been prioritised by Department of Tourism. (SDI, corridors and PPPs) with tourism as focus.
- (E.g.) accesses to beaches, lakes and rivers)
- Social infrastructure has also been improved.
- (E.g.) ambulance services, medicines, and information services.

13. 5 SOUTH AFRICA'S PROFILE

- **Aims of visit**: most foreign tourists visit South Africa for vacation (94.3%) and business (2%). The major attractions are the coast, wildlife and scenery.

- **Local destinations:** Destinations link all aspects of tourism – demand, supply, transport, accommodation and marketing. The success of tourism is determined by the variety of destinations as well as the geographical distribution of tourist destinations.

- **Local tourists:** There has been a steady growth in the number of South Africans travelling domestically

Indigenous knowledge

Definition

- Indigenous knowledge systems refer to the culture, history and environment that is unique to the local people.

OR

- Tourists are fascinated by local community practices, food preparation and rituals. This complex set of knowledge and skills is known as indigenous knowledge systems.

- Most of the indigenous tourist attractions are situated in rural areas.
- An example of South African indigenous uniqueness is represented by Robben Island.
- Robben Island is also a World Heritage Site.

The indigenous forms of art in South Africa.

- Rock painting
- Beading
- Tiling
- Weapons
- Traditional clothing
- Pottery

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Explain how indigenous knowledge systems (IKS) will promote tourism in South Africa.

- Tourists want to have an understanding of indigenous cultures, history, environment and how people live.
- Indigenous knowledge systems (IKS) are crucial to the development of a common consciousness and pride among the people of Africa.
- An awareness of the life, customs and beliefs, religion, ceremonies and rituals of the people.
- The arts, music, dance, writing, songs that people create.
- Values- the qualities we consider to be important, such as honesty and respect for other people.
- Ways in which we behave, as groups or individuals.
- What we wear, what we eat, where and how we live, the language we speak, the things that make us happy.
- Objects that are associated with ceremonies and rituals.

The importance of indigenous knowledge systems in strengthening South Africa's tourism profile.

- Tourists seek authenticity and uniqueness at destinations.
- They want to understand indigenous culture, history and environment.
- How local people live and work.
- World Heritage Sites e.g. Mapungubwe – ruins of Early Stone Age in Limpopo, Vredefort Dome – 2-billion-year meteorite impact site in Free State, Sterkfontein Caves – Cradle of Mankind, Robben Island – where Nelson Mandela was incarcerated.
- Environmental World Heritage Sites represent extreme of indigenous environmental uniqueness, e.g. Greater St Lucia Wetland Park, Cape Fynbos Region, uKhahlamba Drakensberg Park.
- Cultural tourism - museums, galleries and theatres
- Cultural villages - traditional dances and rituals in rural areas, excursions into urban and township areas. Local tourists want to learn more about the people
- Cultural industries - music, craft, books and publishing, film.
- Arts festivals - National Art Festival in Grahamstown, Klein Karoo Arts Festival, Aardklop in Potchefstroom, offers visitors the opportunity to combine their pursuits of culture with sightseeing, wine tasting, history etc.

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Ecotourism

Definition:
Ecotourism is a combination of tourism and the environment.

Examples of ecotourism in South Africa.

- Visiting natural areas that are undisturbed
- Drakensberg mountains
- Kruger National Park
- visiting attractions of scenery
- flora and fauna
- vegetation
- forests
- wildlife
- enjoying the climate, sunshine, the sea, a river or lake

13.6 POLICIES SUGGESTIONS

- The Department of Tourism leads and directs tourism policy.
- The starting point for policy on tourism is the White Paper on Tourism.
- Tourism policy is also supported and directed by the Tourism Forum, which is an advisory body to the Minister of Tourism.

Marketing:
SA Tourism was created to promote tourism internationally and nationally:

- Nationally: SA Tourism persuades South African citizens to travel in their own country. E.g. The Sho't left campaign.
- Internationally: Marketing initiatives try to ensure South Africa is selected as a tourist destination. Foreigners visit our country for the following reasons:
  - Value for money
  - The world in one country
  - South Africa's political miracle
  - The climate
  - Safety
  - The friendliness of South Africa's people
  - The cleanliness and tranquility (peace) of our tourist destinations

Spatial distribution
Three approaches are followed to distribute tourists effectively to the many tourist sites:

- **Create representative bodies**: Tourist-based industries are linked to form representative bodies. Tourists can then easily access knowledge about all tourist destinations.

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- **Improve marketing:** Tourists receive accurate product descriptions and information about competitive prices. Less well-known destinations are aggressively marketed.
- **Improve supporting services:** The standards of transport, accommodation and other amenities (facilities and services) are world class.

Taxation
Growth in tourism results in increased tourist taxes. Guidelines for levying taxes are:

- **Equity:** Taxes must be fair, e.g. taxes on air tickets.
- **Efficiency:** Nature and game reserves charge entry taxes to regulate tourist flows.
- **Simplicity:** A flat tax rate is used to ensure taxes are easy to pay and administer.

Infrastructure
Tourism requires economic infrastructure (roads), social infrastructure (ambulances) and basic services (clean water):

- Infrastructure is maintained for the benefit of domestic and foreign tourists, as well as local citizens.
- The basic considerations are:
  - More infrastructure is required, e.g. water supplies.
  - Existing infrastructure must be upgraded, e.g. upgrade dirt roads to tarred roads.
  - Use new technology to extend the infrastructure, e.g. build the Gautrain.

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TOPIC 14: ENVIRONMENTAL SUSTAINABILITY

SUBTOPICS

14.1 The state of the environment

14.2 Measures to ensure sustainability

14.3 International measures

Concepts:

Command and Control (CAC)	The direct regulation of an industry or activity through laws that state what is allowed and what is illegal
Conservation	Seeks creative continuity of the environment, while ensuring that environmental change considers the quality of life for both present and future generations
Environmental sustainability	The ability of the environment to survive its use for economic activity. It refers to meeting the needs of the present generation without compromising the needs of future generations
Pollution	Emissions which flow into the natural environment from human activity, and which are beyond the capacity of the environment to absorb
Preservation	To keep resources that are non-renewable intact, e.g. ecological systems, heritage sites
The United Nations Conference on Environment and Development (UNCED)	UNCED was held in 1992 and is known as the Earth Summit. The goal of UNCED was to create strategies to stop and reverse the effects of environmental degradation (damage), and to support international efforts to promote sustainable development in all countries

14.1 THE STATE OF THE ENVIRONMENT

Define environmental sustainability
Sustainability of the environment refers to the ability of the environment to survive its use for economic activities.

Sustainable development
Sustained development means meeting the needs of the present generation without compromising the needs of future generations.

The term 'sustainability' relevant to the environment.
When pollution levels and environmental degradation are too high and the free market system has failed to bring about an optimal utilization of the environment, then can government intervenes or takes control.

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RENEWABLE AND NON-RENEWABLE RESOURCES

Renewable sources	Non-renewable sources
• Resources that can be generated, replaced or replenished. • Limiting factor of the availability is the rate at which they can be produced. • E.g. timber, forest products, agricultural products.	• Once these materials are extracted they are gone forever. • Once used they cannot be replaced. • E.g. mineral resources, fossil fuels, such as oil, petrol, copper, gold and coal.

Renewable energy sources

- bio-mass / bio-diesel / bio-gas / bio-fuel
- hydro
- wind turbines
- waves / tidal energy
- solar power
- fire wood

The effect of natural disasters renewable resources

- Natural disasters limit their availability due to the rate at which they can be produced.

THE STATE OF THE ENVIRONMENT

1. Pollution

Definition

- Pollution occurs when people introduce waste matter into the environment, both directly and indirectly, which have a negative impact on human, animal and plant life.

OR

- Pollution occurs when the flow of residual emissions resulting from human activity exceeds the natural environment's capacity to absorb them.

Forms of pollution

- Air pollution
- Water pollution
- Land pollution
- Residual waste (household waste, obsolete consumer durables and litter)
- Production pollution (affects land, sea and atmosphere like acid rain, smoke, gases, toxic chemicals, pesticide contaminants, liquid chemical effluents, noise pollution, scenic degradation and oil spillages)

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Examples of industrial pollution

- Smoke
- Smog
- Contaminated water
- Acid rain
- Poisonous gasses
- Poisonous chemicals
- Noise
- Environmental damage
- Air pollution

Industrial pollution regarded as a more serious type of pollution

- Large scale production leads to continuous, increased pollution or high rate of pollution.
- It affects the health of people (life expectancy), animal and plants species.

Forms of pollution in terms of environmental sustainability

When people introduce waste matter into the environment, both directly and indirectly.

i. Air pollution

- It is the accumulation in the atmosphere of substances in sufficient quantities that damage human health.
- (e.g.) power and heat generation, ozone layer depletion.
- Climate changes
- Fund and stock pollutants

ii. Land pollution

- It is the degeneration of the earth's land surface through misuse of soil.
- e.g. poor agricultural practices, mineral exploitation.
- It will have a negative effect on food production and eco-tourism.
- Pollution has a detrimental effect on the ecosystem.
- One of the greatest causes of pollution is the high rate of energy used by modern, growing populations.

iii. Water pollution

- It is the introduction into fresh or ocean waters of chemical, physical or biological materials that degrade the quality of the water and affects the organisms that live there.
- e.g. industrial effluents', mining wastages

iv. Noise pollution

- Excessive amounts of noise pollution will lead to detrimental effects on all participants in the economy.

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Impact of pollution on the South African fishing industry

Biological pollution
- Animal or plant species can change or suffer from ill health, due to sewage in rivers / sea.

Chemical pollution
- The effects from oil leakages on beaches or waste from a factory.

Land pollution
- Includes visible waste and litter as well as pollution of the soil itself.

Water pollution
- Relating to sea and fresh water pollution.

How the impact of pollution can be reduced
- Studies, research and discussions have shown that some types of pollution have less effect than other types for future generations.
- Air pollution vs noise pollution - replacing filters in factories to reduce noise pollution.
- Pollution can affect people - can be reduced by various awareness programmes.
- (e.g.) Aerosol sprays can be replaced with ozone friendly gases.
- Stock pollutants are those waste products that accumulated over a period of time.
- Some waste products from production can be recycled or regenerated.
- The presence of plastic materials has an effect on the environment - recycling can reduce the impact.
- Emissions into the atmosphere - Factories can be replaced where there is low density of population.

Green taxes

Definition:
- Green taxes are taxes on output or consumption which are charged for the adverse effects on the environment / taxes levied on consumers and producers for waste and pollution
- Also known as environmental taxes.
- E.g. levied on tyres, gas emission tax, plastic bags.
- South Africa coordinates the Valdivia group of Decertification
- Aim: to ensure scientific and technological cooperation.

2. Erosion
- Erosion occurs when soil is removed at a greater rate than it is formed.
- E.g. through the action of wind and water.
- Soil is a non-renewable resource and once destroyed, it is gone forever.
- Poor agricultural methods which cause soil to move.

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3. **Deforestation**

- The permanent destruction of indigenous forests and woodlands.
- E.g. soil is not covered any longer and is easily washed away.
- The increased demand for food is a big cause of deforestation.

4. **Climate change**

- Climate change is the change in normal weather patterns.
- E.g. an increase or decrease in rainfall or average temperatures.

5. **Conservation**

Definition: Seeks creative continuity of the environment, while ensuring that environmental change considers the quality of life for both present and future generations.

- Human activities affect the environment, not only because they cause pollution but also because they tend to over-utilise it.
- Conservation is used for botanical parks, game parks, museums and any place of historical interest.
- Charging for the use of the environment - the government levies a fee on consumers and producers for the waste (solid, liquid, gas) they produce and dump in the environment. The best results are obtained if these charges are proportional to the waste produced.
- Education - plays a major role in improving people's capacity to manage the environment . Pressure groups such as the Green Party and Friends of the Earth have forced industries to encourage managers to integrate environmental responsibility into all their business decision making.

6. **Preservation**

Definition: To keep resources that are non-renewable intact, e.g. ecological systems, heritage sites.

- Means to keep something intact.
- Some resources are not only non-renewable but if lost, irreplaceable.
- (e.g.) ecological systems, heritage sites.
- Government can intervene in order to preserve environmental assets through subsidies, control measures, or to buy or expropriate certain assets.
- Voluntary agreements, rather than imposing laws and regulations, the government can seek to enter into voluntary agreements with businesses for them to cut pollution.

14.2 <u>MEASURES TO ENSURE SUSTAINABILITY</u>

14.2.1 Markets can be used to ensure sustainability since:

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i. The market does not take care of social grants and benefits

- Driven by self-interest – implies that environment is for individuals to use for own benefit – weigh marginal cost to benefits
- Sustainability achieved in free market to extent of price of resources that rise as they become scarce and to extent of environment-friendly technology
- Social interest (cost and benefit) in using environment – not only to direct producer/ consumer, but also to people in general (now and in future)

ii. The market fails because of specific reasons

Four important reasons are often given for market failure:

- **Environment is a common resource**
  - Many parts of the environment are not privately owned and have the characteristics of non-excludability.
  - Environmental resources are scarce and there is rivalry in their use.
  - At a zero price these resources will be overused.

- **Externalities**
  - A polluted environment where costs are often borne by others.
  - The greater these external costs, the lower the socially efficient level of output will be.
  - Air pollution by businesses cannot be stopped because there is no one to enforce property rights over the environment.

- **Lack of knowledge**
  - People cause environmental damage without realizing it.
  - These effects build up over a period of time causing excessive damage to the environment. (E.g. aerosol cans that destroys the ozone layer)

- **Carelessness**
  - Consumers and businesses are frequently prepared to continue with various harmful practices.
  - These environmental consequences are often left to future generations to worry about.

iii. The mechanisms of the market and social costs and benefits

- Market mechanism has failed when market forces failed to produce desired result of environmental sustainability.
- All costs and benefits are not captured in the market price – quantities produced and consumed inappropriate.

- Market-related solutions refer to a set of measures designed to accommodate the price mechanism and improve the effect.
- Can be based on incentives taxed or paid by polluters, according to the extent of the damage they caused.

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14.2.2 Public sector involvement / Public sector intervention

Granting property rights

- The conservationist effect: It ensures that people care for the things that belong to them.
- To prevent fauna + flora species to become extinct allow people property rights It has little cost to tax payers.
- Can be expanded to common goods e.g. clean air where polluters pay victims to reduce pollution.
- (e.g.) Kyoto Protocol where developed countries agreed to provide financial assistance to developing countries because they cause less pollution.
- The developed countries therefore pay for the right to pollute.

Pay for environmental use

- The pricing of the environment is one method used by government to impose environmental charges.
- E.g. in S.A. local authorities levy charges on rubbish collection and sewage disposal.
- Government levies a fee on consumers and producers for the waste (solid, liquid, gas) they dump in the environment.
- Best results are obtained when these charges are proportional to the waste they produce.

Levy environmental tax

- A tax could be imposed on the output or consumption of a good, wherever external environmental costs are generated.
- These are known as green taxes, (e.g.) tyres
- The rate of tax should be equal to the marginal external cost.

Pay environmental subsidies

- These subsidies reduce activities that cause environmental damage.
- These costs are recovered from taxation.
- Subsidies could be for the development of new technology or equipment.
- Encourage production of environmental friendly subsidies.
- Encourage recycling of waste such as bottles or cardboards.

Issue marketable permits

- Governments may wish to charge for the pollution (externality) and it could raise a levy or a tax to pay for it.
- A license (credits) or permit is offered and businesses are allowed to sell their licenses to other businesses who wish to expand.
- Licenses or permits or credits are traded in a permit market.

Command and control (CAC)

- Set maximum permitted levels of emission or resource use inspectors monitor activities and impose fines
- Developed countries have environmental regulations e.g. air and water pollution, noise, waste management, recycling

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3 approaches to devising CAC systems:

- Quantity standards focus on amounts of pollution caused
- Quality standards focus on environmental impact
- Social impact standards focus on the effect on the people

Voluntary agreements

- Between government and businesses on voluntary basis to cut pollution – formal contract and legally binding or informal commitments
- Businesses prefer these agreements – can negotiate – build into planning

Education

- Manage the environment through education people's attitude change towards environmental consequences of their actions.
- Innovative approaches in developing world to educate people to manage environment is: community wildlife reserves transformed into areas managed for conservation, households more conscious of waste-recycling, co-operatives established to produce organic foods, groups like Green Party + Friends of the Earth encourage environmental responsibility

14. 3 INTERNATIONAL MEASURES

Biodiversity loss

- Biodiversity is the variety of species of plants and animals in a particular area.
- It is concerned with the genetic variety among individuals within the same species and the number of species within a community of organisms.
- The diversity of species in the world decreases rapidly due to the extinction which is an irreversible process.
- Modern techniques such as gene transplant can help to limit the loss of species.
- The United Nations' Convention on International Trade in Endangered Species (CITES) prohibits trade in endangered plant and animal species.
- Monitoring and regulation of trade in endangered species is carried out using permits and quotas.
- In South Africa, a permit is needed for one to import plants and animals.

Chemical waste

- Chemical waste is toxic and their effect on an organism can be death or infertility
- Chemical waste needs to be carefully managed to ensure that it does not leak into the ground water.
- The *Stockholm Protocol* bans the 12 of the deadliest manufactured chemicals.
- The *Rotterdam Convention* protects countries that lack adequate infrastructure to monitor the import and export of dangerous chemicals.

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Hazardous waste

- Hazardous waste is more than a chemical waste and it includes toxic metal waste such as lead.
- Hazardous waste has a slow decomposition rate (it stays poisonous for a long term)
- Hazardous waste can endanger all life forms and entire ecosystem.
- The Basel Convention on the control of Trans boundary Movement of Hazardous waste allows trade between countries that have signed the convention.
- Hazardous waste is dumped illegally because it is convenient and cheap

Climate change

- Climate change is the change in the composition of the atmosphere that is related to human activity.
- A build-up of certain gases such as carbon dioxide in the atmosphere causes the heat to be captured into the atmosphere, which leads to global warming.
- Effects of climate change include change in temperature and weather patterns.
- The United Nations' Framework Convention on Climate Change (UNFCCCC) sets objectives to reduce greenhouse gases.
- Kyoto Protocol was signed as an agreement in which greenhouse gases emission level for developed countries were agreed upon.
- The objectives of the agreement were not achieved.

5. Loss of Indigenous Knowledge

- Indigenous people have knowledge about the natural environment, which they often use to make a living.
- Indigenous people use organic methods and natural processes in dealing with the environment.
- Local capacity building is important as it can help indigenous people to learn more of the environment beyond their traditional lifestyles and experiences.
- UNESCO's management of social transformation programme (MOST) is a global effort to document local/indigenous knowledge before it is lost forever.

INTERNATIONAL PROTOCOLS AND AGREEMENTS

INTERNATIONAL AGREEMENTS

- 1992: UNCED – United Nations Conference about Environment and Development
- 1992: Montreal Protocol on Substances that Deplete the Ozone Layer
- 1992: Convention on Biological Diversity
- 1992: Framework Convention on Climate Change
- 1992: Convention to Combat Desertification
- 1996: Habitat II Conference in Istanbul
- 1997: Kyoto Protocol on Climate Change in Bonn in Germany
- 2002: Johannesburg World Summit on Sustainable Development

International events / Meetings

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Stockholm Conference

- Recognized that rapid changes in science and technology, have given human beings the power to transform their environment.
- Both natural and man-made environment are essential to mankind's wellbeing and to the enjoyment of basic human rights.

Earth Summit / Rio de Janeiro

- Also called the UNCED (United Nations Conference on Environment and Development), held in June 1992.
- The Earth Summit establish new and equitable global partnership through creation of new levels of co-operation among states, key sectors of societies and people.
- Agreement that humans are at the centre of sustainable development and entitled to healthy and productive life in harmony with nature.
- Agenda 21 as action plan originated from the Earth Summit.
- Agenda 21 outlined detail key issues to ensure sustainable development and aimed at the sustainable development and the protection of the environment
- Agenda 21 focus on:
    - social and economic issues (poverty, consumption patterns, protect and promote health)
    - conservation and management of resources (atmosphere, deforestation, oceans, freshwater resources, wastes.
- Rio Plus 5 noted that globalization made some countries poorer (low level of growth) – what place, share and benefits are there for a global system.
- Main value of the summit is that it made countries across the globe aware of the dangers unsustainable development pose to individual countries and the whole world.

Johannesburg World Summit on Sustainable Development

- Largest conference in the country since Rio de Janeiro – 10 years previously.
- Focus attention on difficult challenges (improving people's lives, conserving natural resources, ever-increasing demand for food, water, shelter, sanitation).
- African environmental issues were also highlighted, namely to improve access to clean water and to help fight the HIV/Aids pandemic.
- Divide between rich and poor posed major threat to global prosperity and stability.

Kyoto Protocol

- Signed in 1997 and the end of the first commitment period is the end of 2012.
- The agreement deal with the problem of global warming.
- It is a guide or action plan that set targets for developed countries to reduce greenhouse gas emissions by 7% before 2010.
- The protocol started 16 February 2005 and the first commitment term ends the end of December 2012.
- Signed by 141 nations, including all European and other developed countries USA and Australia.

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- To achieve this, countries put controls on the emissions of greenhouse gases by their largest polluters, which are large companies.

COP 17 / CMP 7

- COP = Conference of the parties / 17 = It is the 17th Conference
- CMP 7 = It is the 7th meeting for the Parties to the Kyoto Protocol.
- COP 17 / CMP 7 = Held in Durban from 28th November – Desember 2011.
- COP = Serve as meeting for the Parties to the Kyoto Protocol and they meet annually.

COP 17 / CMP7 = Important because:

- The first commitment of the Parties to the Kyoto Protocol comes to an end December 2011.
- A new commitment must be negotiated.

Outcome of COP17/CMP7

- 2nd commitment Period for Kyoto Protocol are signed.
- Start 1st January – Desember 2017 or Desember 2020.
- Emissions to be reduced between 25% - 40% on the base year of 1990.

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