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Mind the Gap!

Economics
STUDY GUIDE

GRADE 12

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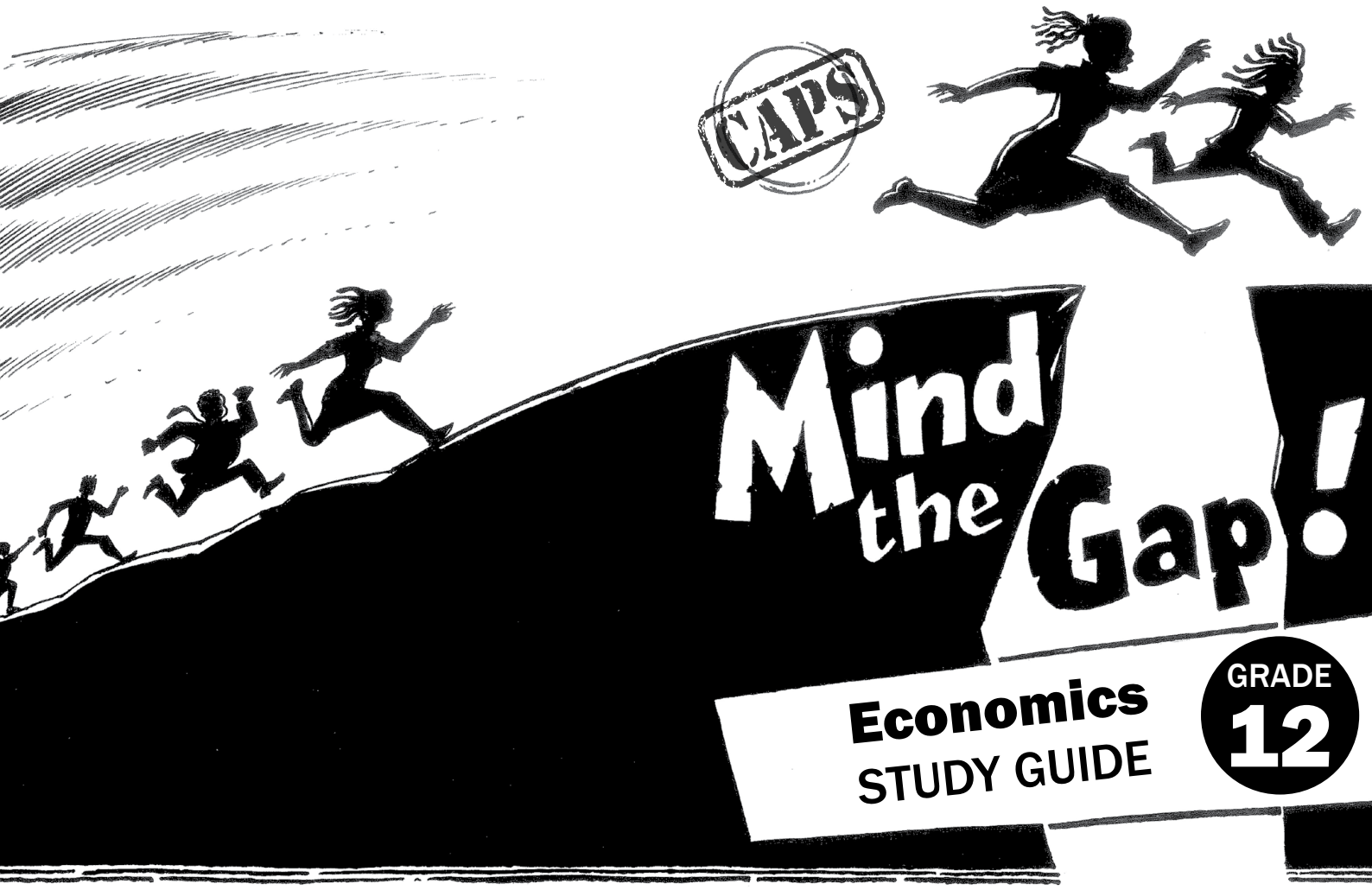

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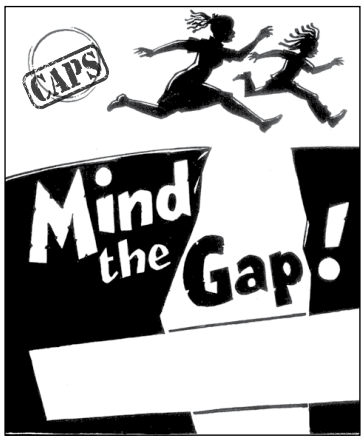

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Curriculum and Assessment Policy Statement (CAPS) Mind the Gap Grade 12 Study Guide Economics
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Ministerial foreword

Matsie Angelina Motshekga, MP
Minister of Basic Education

The Department of Basic Education has pleasure in releasing the second edition of Mind the Gap study guides for Grade 12 learners. These study guides continue the innovative and committed attempt by the Department of Basic Education to improve the academic performance of Grade 12 candidates in the National Senior Certificate (NSC) examination.

The study guides have been written by subject expert teams comprised of teachers, examiners, moderators, subject advisors and subject co-ordinators. Research started in 2012 shows that the Mind the Gap series has, without doubt, had a positive impact in improving grades. It is my fervent wish that the Mind the Gap study guides take us all closer towards ensuring that no learner is left behind, especially as we move forward in our celebration of 20 years of democracy.

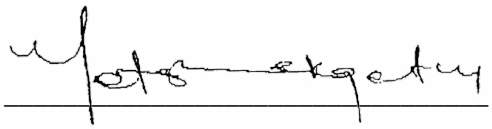
The second edition of Mind the Gap is aligned to the 2014 Curriculum and Assessment Policy Statement (CAPS). This means that the writers have considered the National Policy pertaining to the programme, promotion requirements and protocol for assessment of the National Curriculum Statement for Grade 12 in 2014.

The Mind the Gap CAPS study guides take their brief in part from the 2013 National Diagnostic report on learner performance and draws on the 2014 Grade 12 Examination Guidelines. Each of the Mind the Gap study guides provides explanations of key terminology, simple explanations and examples of the types of questions that learners can expect to be asked in an exam. Marking memoranda are included to assist learners in building their understanding. Learners are also referred to specific questions in past national exam papers and examination memos that are available on the Department's website – www.education.gov.za.

The CAPS edition include Accounting, Economics, Geography, Life Sciences, Mathematics, Mathematical Literacy and Physical Sciences. The series is produced in both English and Afrikaans. There are also nine English First Additional Language study guides. They include EFAL Paper 1 (Language); EFAL Paper 3 (Writing); and a study guide for each of the Grade 12 prescribed literature set works.

The study guides have been designed to assist those learners who have been underperforming due to a lack of exposure to the content requirements of the curriculum and aims to mind-the-gap between failing and passing, by bridging the gap in learners' understanding of commonly tested concepts so candidates can pass.

All that is now required is for our Grade 12 learners to put in the hours preparing for the examinations. Learners make us proud – study hard. We wish each and every one of you good luck for your Grade 12 examinations.



Matsie Angelina Motshekga, MP
Minister of Basic Education
May 2014

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Dear Grade 12 learner

This *Mind the Gap* study guide helps you to prepare for the end-of-year CAPS Economics Grade 12 exam.

The study guide does NOT cover the entire CAPS curriculum, but it does focus on core content of each knowledge area and **points out where you can earn easy marks**.

You must work your way through this study guide to improve your understanding, identify your areas of weakness and correct your own mistakes. To ensure a good pass, you should also cover the remaining parts of the curriculum using other textbooks and your class notes. We are confident that this *Mind the Gap* study guide can help you to prepare well so that you pass the end-of-year exams.

The importance of your success cannot be over-emphasised. You form part of the future generation, and we all hope for a better future, a future where all our young South Africans can enjoy a high standard of living.

Education is the passport to the future, for tomorrow belongs to those who prepare for it today.

Overview of the exam for CAPS Economics Grade 12

The Economics exam consists of TWO × 1½ hour papers of 150 marks each. The paper consists of SIX questions divided into three sections. Question ONE is COMPULSORY. There are FIVE other questions from which THREE must be answered. The detailed requirements for each section are shown below:

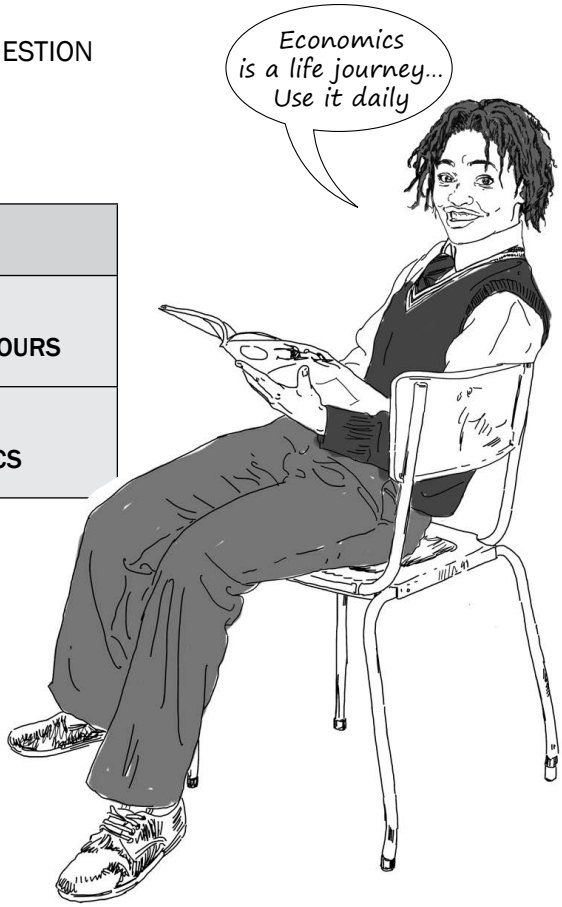
FORMAT OF THE GRADE 12 ECONOMICS QUESTION PAPERS

1. CLASSIFICATION OF TOPICS FOR GRADE 12 ECONOMICS QUESTION PAPERS

   MIDYEAR EXAMINATION PAPERS

   The two question papers are structured as follows:

ECONOMICS GRADE 12	
PAPER 1 **150 MARKS – 1½ HOURS**	**PAPER 2** **150 MARKS – 1½ HOURS**
MAIN TOPIC: MACROECONOMICS	**MAIN TOPIC: MICROECONOMICS**
TOPICS: • Circular flow • Business cycles • Public sector • Foreign exchange markets • Protectionism and Free Trade	TOPICS: • Perfect markets • Imperfect markets • Market failures



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TRIAL AND FINAL EXAMINATION PAPERS

ECONOMICS GRADE 12		
PAPER 1 **150 MARKS – 1½ HOURS**		**PAPER 2** **150 MARKS – 1½ HOURS**
MAIN TOPIC: **MACROECONOMICS**		**MAIN TOPIC:** **MICROECONOMICS**
TOPICS: • Circular flow • Business cycles • Public sector • Foreign exchange markets • Protectionism and Free Trade		TOPICS: • Perfect markets • Imperfect markets • Market failures
MAIN TOPIC: **ECONOMIC PURSUITS**		**MAIN TOPIC:** **ECONOMIC ISSUES**
• Growth and Development • Industrial development policies • Economic and social performance indicators		• Inflation • Tourism • Environmental sustainability

hint

- Each paper carries 150 MARKS
- The duration of each paper is **1½ HOURS**
- Each paper comprises of SIX QUESTIONS divided into three sections.
- From the six questions only FOUR must be answered as follows:
  - SECTION A: Question 1 is COMPULSORY
  - SECTION B: Consists out of THREE questions: Questions 2–4 from which the candidate must choose only TWO
  - SECTION C: Consists out of TWO questions: Questions 5–6 from which the candidate must choose only ONE
- The above papers must not be written on the same day.
- The detailed requirements for each section are indicated on the following pages:

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1. DETAIL OF GRADE 12 ECONOMICS QUESTION PAPERS

SECTION A (COMPULSORY) TOTAL: 30

QUESTION 1 (TO BE ANSWERED IN THE ANSWER BOOK – NO LOOSE ANSWER SHEETS ARE ALLOWED)

1.1 Multiple-choice items (lower order)
FOUR per main topic = 8 items (2 marks per item) (8 × 2) (16)

1.2 Matching column A and B (lower order)
FOUR items per main topic = 8 items (1 mark per item) (8 × 1) (8)

1.3 Identify the concept (middle/lower order)
THREE items per main topic **(6 × 1) (6)**

SECTION B (Answer TWO QUESTIONS FROM THIS SECTION) TOTAL: 80

QUESTIONS 2 – 4 (THREE QUESTIONS)

ONE question per MAIN TOPIC and ONE combination question (not necessarily equally distributed) of the 2 MAIN TOPICS

2.1 Short items
- **2.1.1** Lower order (2 × 1) (2)
- **2.1.2** Middle order (1 × 2) (2) (4)

2.2 Data response (middle order): Study the following graph/cartoon/table/text, etc. and answer the questions that follow: (10)

2.3 Data response (middle order): Study the following graph/cartoon/table/ text, etc. and answer the questions that follow: (10)

2.4 ONE short question (middle order): (2 × 4) OR (4 × 2) (8)

2.5 ONE short question (higher order): (2 × 4) OR (4 × 2) (8)

[40]

SECTION C (ANSWER ONE QUESTION FROM THIS SECTION) TOTAL: 40

QUESTIONS 5-6 (TWO ESSAY QUESTIONS) – ONE question per MAIN TOPIC

STRUCTURE OF ESSAY	MARK ALLOCATION
Introduction	Max. 2
Body: • **Main part:** Discuss in detail/Indepth discussion/Examine/Critically discuss/Analyse/Compare/Evaluate/Distinguish/Differentiate/Explain/Assess • **Additional part:** Give own opinion/Critically discuss/Evaluate/Critically evaluate/Draw a graph and explain/Use the graph given and explain/Complete the graph/Calculate/Deduce/Compare/Explain/Distinguish/Interpret	Max. 26 Max. 10
Conclusion	Max. 2
TOTAL	**40**

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Essays play a very big role in your success in Economics, because you must choose ONE essay to answer in each question paper, counting 40 marks out of the grand total of 150 marks. Each essay counts 40 marks. This study guide includes essay topics that have been asked in past question papers. Make sure that you study each of these topics in detail in your preparation for your preparatory and final papers.

Never leave a question unanswered if you are asked to offer your own opinion. Remember: each section includes questions that are easy and almost-easy, so make sure you get these marks too.

Good luck for your NSC exams, your doorway to a better future. Dream big, set your goals and go for it!

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How to use this study guide

- The study guide includes a table of **key concepts with definitions** which need to b**e learnt off by heart. You can gain easy marks for the recall of definitions in the single mark questions.**

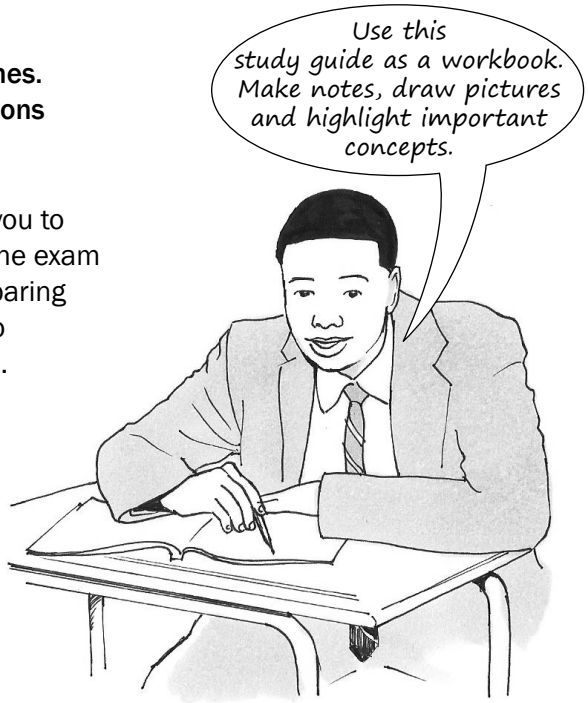
NB	Pay special attention	hint	Hints to help you remember a concept or guide you in solving problems	e.g.	Worked examples
	Step-by-step instructions	exams	Refers you to exam questions		Activities with questions for you to answer

- **A checklist from the exam guidelines for Economics has been provided on page xvi for you to keep track of your progress. Once you have mastered the core concepts and have confidence in your answers to the questions provided, tick the last column of the checklist.**

- **The activities are based on exam-type questions. Cover the answers and do the activity on your own. Then check your answers. Reward yourself for the things you get right. If you get any incorrect answers, make sure you understand where you went wrong before moving on to the next section.**

- **Each topic is briefly covered according to the exam guidelines. Valuable guidelines are provided to help you answer questions on graphs.**

- **Exemplar Exam papers** are included in the study guide for you to do. Check your answers by looking back at your notes and the exam memoranda. An example of a paper goes a long way in preparing you for what to expect and helps reduce exam anxiety. Go to **www.education.gov.za** to download more past exam papers.



True individual freedom cannot exist without economic security and independence.

Franklin D Roosevelt

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Top 10 study tips

1. Have all your materials ready before you begin studying – pencils, pens, highlighters, paper, etc.

2. Be positive. Make sure your brain holds onto the information you are learning by reminding yourself how important it is to remember the work and get the marks.

3. Take a walk outside. A change of scenery will stimulate your learning. You'll be surprised at how much more you take in outside in the fresh air.

4. Break-up your learning sections into manageable parts. Trying to learn too much at one time will only result in a tired, unfocused and anxious brain.

5. Keep your study sessions short but effective and reward yourself with short, constructive breaks.

6. Teach your concepts to anyone who will listen. It might feel strange at first, but it is definitely worth reading your revision notes aloud.

7. Your brain learns well with colours and pictures. Try to use them whenever you can.

8. Be confident with the learning areas you know well and focus your brain energy on the sections that you find more difficult to take in.

9. Repetition is the key to retaining information you have to learn. Keep going, don't give up.

10. Sleeping at least 8 hours every night, eating properly and drinking plenty of water are all important things you need to do for your brain. Studying for exams is like tough exercise, so you must be prepared physically.

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Study skills to boost your learning

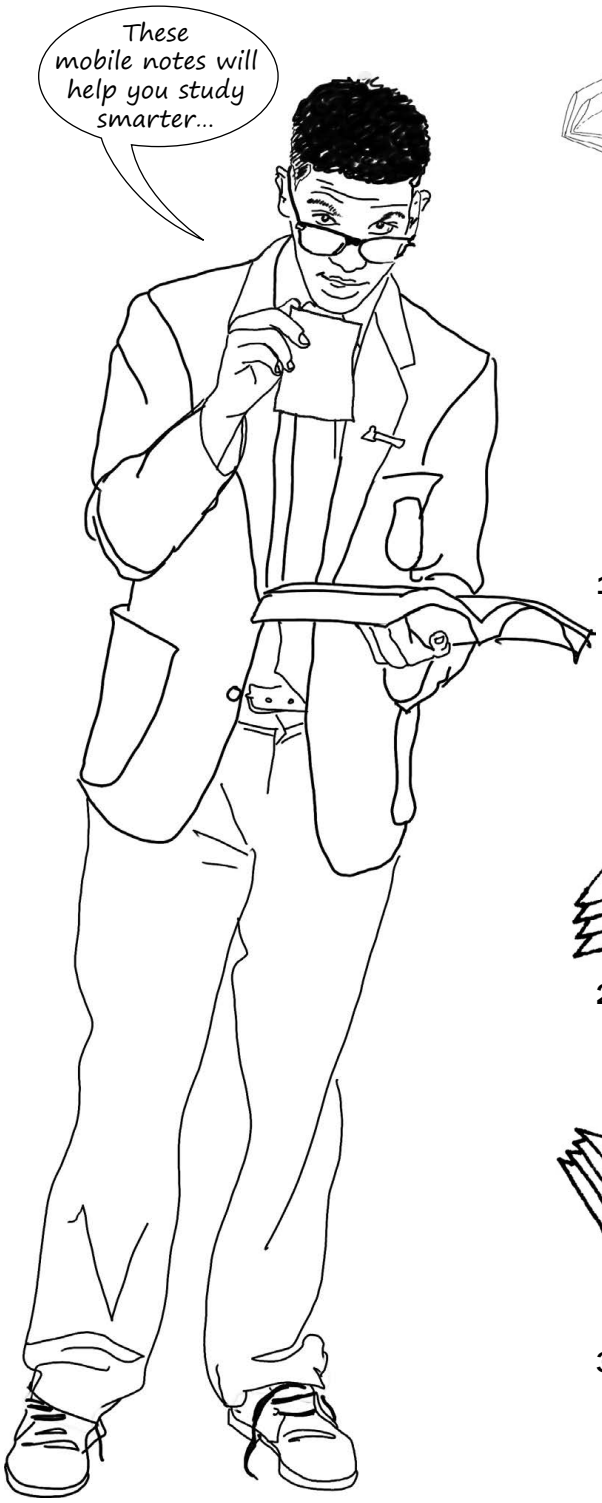
This guide makes use of three study techniques you can use to help you learn the material:

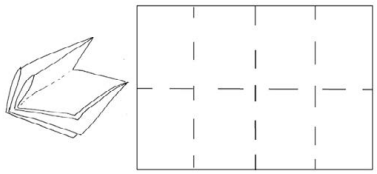
1. Mobile notes
2. Mnemonics
3. Mind maps

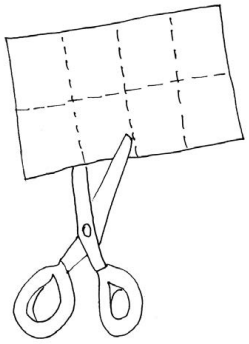
Mobile notes

Mobile notes are excellent tools for learning all the key concepts in the study guide. Mobile notes are easy to make and you can take them with you wherever you go:

1. Fold a blank piece of paper in half. Fold it in half again. Fold it again.
2. Open the paper. It will now be divided into 8 parts.
3. Cut or tear neatly along the folded lines.
4. On one side, write the basic concept.
5. On the other side, write the meaning or the explanation of the basic concept.
6. Use different colours and add pictures to help you remember.
7. Take these mobile notes with you wherever you go and look at them whenever you can.
8. As you learn, place the cards in three different piles:
   - I know well
   - Getting there
   - I need more practice
9. The more you learn them, the better you will remember them.

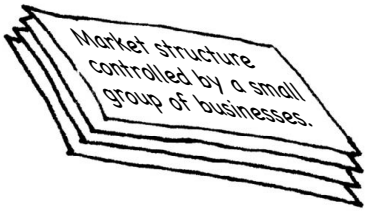






1. Fold an A4 paper into 8 squares. Cut or tear neatly along the folded lines.

2. Write the basic concept on one side of a bit of paper.



3. Write the definition of the basic concept on the back of the piece of paper.

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Mnemonics

A **mnemonic** code is a useful technique for learning information that is difficult to remember.

Here is a made-up word to help you remember the 6 reasons for market failure – EMILII – each letter of the word stands for a reason:

E – Externalities

M – Missing markets

I – Imperfect competition

L – Lack of information

I – Immobility of factors of production

I – Imperfect distribution of income & wealth

Here is a sentence to help you remember the 5 demand reasons for international trade – each word in the sentence begins with the same letter as one of the reasons:

People	**I**n	**W**itbank	**P**refer	**C**offee
Population	**I**ncome	**W**ealth	**P**references	**C**onsumption

Mnemonics code information and make it easier to remember.

The more creative you are and the more you link your 'codes' to familiar things, the more helpful your mnemonics will be.

This guide provides several ideas for using mnemonics. Be sure to make up your own.

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Mind maps

There are several mind maps included in this study guide, which summarise some of the sections.

Have a look at the following pictures of a brain cell (neuron) and a mind map:

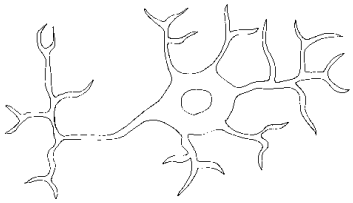


Figure 1: Brain cell or neuron

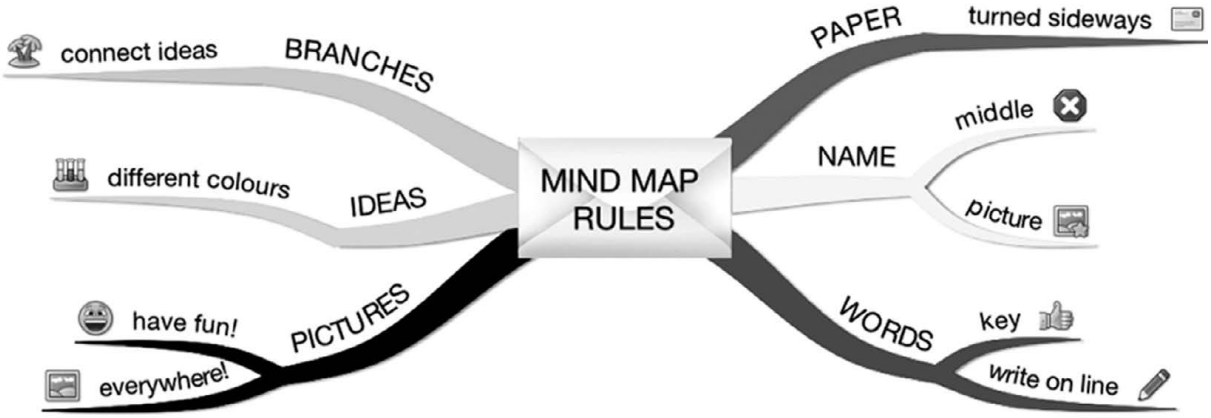


Figure 2: Mind map rules

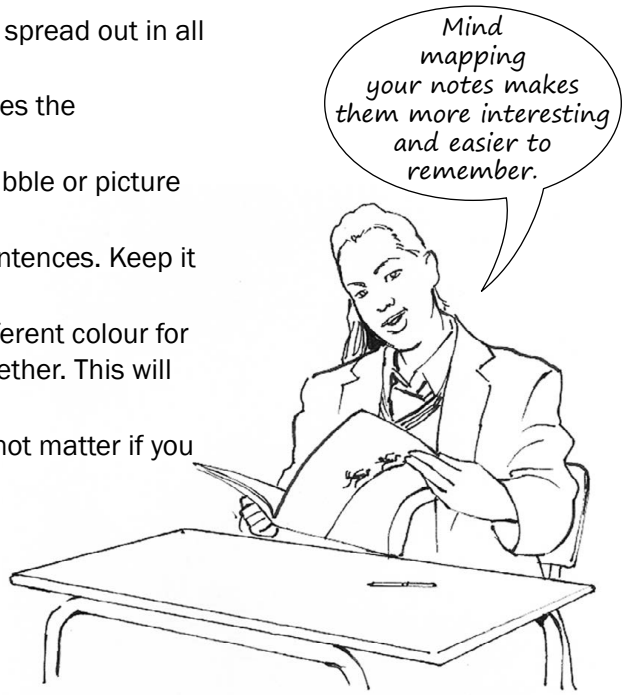
Mind maps work because they show information that we have to learn in the same way that our brains 'see' information.

As you study the mind maps in the guide, add pictures to each of the branches to help you remember the content.

You can make your own mind maps as you finish each section.

How to make your own mind maps

1. Turn your paper sideways so your brain has space to spread out in all directions.
2. Decide on a name for your mind map that summarises the information you are going to put on it.
3. Write the name in the middle and draw a circle or bubble or picture around it.
4. Only write key words on your branches, not whole sentences. Keep it short and simple.
5. Each branch should show a different idea. Use a different colour for each idea. Connect the information that belongs together. This will help build your understanding of the learning areas.
6. Have fun adding pictures wherever you can. It does not matter if you can't draw well.



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On the day of the exam …

1. Make sure you have all the necessary stationery for your exam, i.e. pens, pencils, eraser, **calculator (with new batteries)**, as well as your ID document and exam admission letter.

2. Arrive on time, at least one hour before the start of the exam.

3. Go to the toilet before entering the exam room. You don't want to waste valuable time going to the toilet during the exam.

4. Use the 10 minutes reading time to read the instructions carefully. This helps to 'open' the information in your brain. Start with the question you think is the easiest to get the flow going.

5. Break the questions down to make sure you understand what is being asked. If you don't answer the question properly you won't get any marks for it. Look for the key words in the question to know how to answer it. A list of these words is on page xvii of this study guide.

6. Try all questions. Each question has some easy marks in it so make sure that you do all the questions in the exam.

7. Never panic, even if the question seems difficult at first. It will be linked with something you have covered. Find the connection.

8. Manage your time properly. Don't waste time on questions you are unsure of. Move on and come back if time allows.

9. Check weighting – how many marks have been allocated for your answer? Take note of the ticks in this study guide as examples of marks allocated. Do not give more or less information than is required.

10. Write big and bold and clearly. You will get more marks if the marker can read your answer clearly.

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Question words to help you answer questions

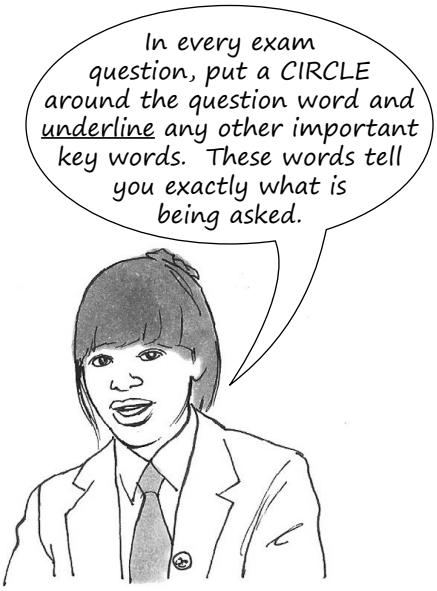
It is important to look for the question words (the words that tell you what to do) to correctly understand what the examiner is asking. Use the words in the following table as a guide when answering questions.

Question word	What is required of you
Account for	Explain the cause of; explain why; give reasons for
Analyse	Separate; examine and interpret critically; positives and negatives; pros and cons
Argue	Put forward reasons in support of or against a statement
Assess	Estimating the nature, quality or value of something
Calculate	Use maths to work out an answer
Classify	Place things with similar characteristics in the same group; arrange according to type or sort
Comment	Give your opinion, based on facts
Compare	To list both similarities and differences
Contrast	Stress the differences between things, events or problems
Critically	Analyse something, expressing agreement or disagreement with it
Define	Give a short and clear meaning
Demonstrate	Show or make clear; illustrate or explain; prove by reasoning and evidence (note that you can give examples)
Describe	List the main characteristics of something; give an account of (note that a diagram or map may be part of a description)
Discuss	Give the reasons for your statement; present both sides and reach a conclusion
Evaluate	Express an opinion, using evidence, of how good/bad, negative/positive, successful/ unsuccessful something is
Examine	Look at something carefully and in detail
Explain	Make clear, interpret, and spell out the material you present. Give reasons for differences of opinion or of results
Give	To state facts without discussions or explanations (note that you may be asked to 'Give a reason')
Identify	Single out one particular piece of information
Illustrate	Explain or make something clear by using examples, charts, pictures and drawings
Interpret	To give an explanation of; to give the meaning of
List	Writing a list of the facts in their simplest form
State	Write down information without discussion
Suggest	Give possible reasons or ideas
Summarise	Reduce a lot of information to its main points

e.g. Examples of question words

Refer to Table 1.2.2 (income method) and answer the following questions:

1. Which organisation is responsible for the recording and publishing of GDP figures in South Africa? (2)
2. Explain the concept 'subsidies on products'. (3)
3. Give TWO examples of taxes on products. (4)
4. Calculate the consumption of fixed capital in 2009 as a percentage of GDP at market price. Show all calculations. (4)



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Learner's Checklist

Use this checklist to monitor your progress when preparing for the exam. **The ticks (✓) tell you which aspects of the curriculum are covered in the study guide. The stars (*) tell you to go to textbooks and class notes.**

Topic	Aspects of the curriculum	Covered in Study guide	I do not understand	I understand
Main Topic: Macroeconomics				
Topic 1 Open economy circular flow model	Concepts	✓		
	Four sector diagram	✓		
	Participants	✓		
	National account aggregates and conversions	✓		
	Multiplier	✓		
Topic 2 Business cycles and forecasting	Concepts	✓		
	Composition and features of business cycles:	✓		
	Causes of business cycles	✓		
	Types of business cycles	✓		
	Government policy	✓		
	The new economic paradigm (smoothing of cycles)	✓		
	Features underpinning forecasting with regard to business cycles	✓		
Topic 3 Public Sector	The composition and necessity of the public sector	✓		
	Problems of public sector provisioning	✓		
	Objectives of the public sector and its budget	✓		
	Fiscal policy (including the Laffer curve)	✓		
	Reasons for public sector failure	✓		
Topic 4 Foreign exchange market	The main reasons for international trade	✓		
	The balance of payments	✓		
	The establishment of foreign exchange rates	✓		
	Foreign exchange markets	✓		
	Corrections of BOP surplus and deficit (disequilibria)	✓		

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Topic	Aspects of the curriculum	Covered in Study guide	I do not understand	I understand
Main Topic: Macroeconomics				
Topic 5 Protection and free trade (Globalisation)	Export promotion	✓		
	Import substitution	✓		
	Protectionism (the arguments)	✓		
	Free trade (the arguments)	✓		
	A desirable mix	✓		
	Evaluation of South Africa's trade policies	✓		
Main Topic: Microeconomics				
Topic 6 Dynamics of Perfect Markets	Perfect competition	✓		
	Individual business and industry	✓		
	Market structure	✓		
	Output, Profits, Losses and Supply	✓		
	Competition policy	✓		
Topic 7 Dynamics of imperfect markets	Monopoly	✓		
	Oligopoly	✓		
	Monopolistic competition	✓		
Topic 8 Dynamics of markets: Market failures	The causes of market failures	✓		
	Consequences of market failures	✓		
Main Topic: Economic Pursuits				
Topic 9 Economic Growth & Development	Background/A comparison between	✓		
	The demand-side approach	✓		
	The supply-side approach	✓		
	Evaluation of the approaches used in South Africa	✓		
	The North/South divide	✓		

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Topic	Aspects of the curriculum	Covered in Study guide	I do not understand	I understand
Main Topic: Economic Pursuits				
Topic 10 Economic growth and development: industrial development policies	Industrial development in South Africa	✓		
	Regional development	✓		
	South Africa's endeavours	✓		
	Incentives to encourage industrial development	✓		
	Appropriateness of South Africa's industrial policies	✓		
	Appropriateness of South Africa's regional development policies	✓		
	Small business development	✓		
	The appropriateness of Black Economic Empowerment in the SA economy	✓		
	Best practice for regional development	✓		
Topic 11 Economic and social performance indicators	The performance of an economy	✓		
	Economic indicators	✓		
	Social indicators	✓		
	International comparisons	✓		
Main Topic: Contemporary Economic Issues				
Topic 12 Economic issues of the day: Inflation	Definition	✓		
	Measuring inflation	✓		
	Types and characteristics of inflation	✓		
	Causes of inflation	✓		
	Consequences of inflation, on	✓		
	The inflation problem in South Africa	✓		
	Measures to combat inflation	✓		

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Topic	Aspects of the curriculum	Covered in Study guide	I do not understand	I understand
Main Topic: Contemporary Economic Issues				
Topic 13 Economic issues of the day: Tourism	Definition	✓		
	Purposes/types of tourism	✓		
	Measuring tourism	✓		
	Reasons for its growth	✓		
	The effects of tourism on	✓		
	The benefits of tourism on	✓		
	South Africa's profile (indigenous knowledge systems)	✓		
	Policy suggestions – Department of Tourism	✓		
Topic 14 Economic issues of the day: Environmental sustainability	The state of the environment	✓		
	Measures to ensure sustainability	✓		
	Major international agreements	✓		

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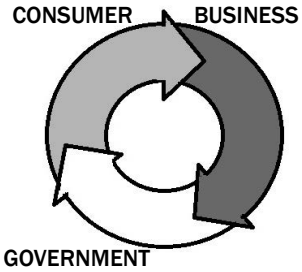
Chapter 1

The circular flow model, national account aggregates and the multiplier

The **circular flow model, national account aggregates** and the **multiplier** are three key terms in Economics.



According to the **circular flow model**, the three key sectors of the economy (**consumer, business** and **government**) all work together to ensure that society's needs are provided for through the creation of goods and services.

The **national account aggregates** are an important means of **analysing the performance of a country**. The most important of these aggregates is the **Gross Domestic Product** (GDP).

The marginal propensity to consume is what shows the amount of each rand that people will use for consumption within a country at a particular time.

The **multiplier** is derived from the marginal propensity to consume. It is a ratio which shows that the increase in income in a country will be greater than the initial increase in spending.

Formula: $M = \frac{1}{(1 - mpc)}$

The formula can also be written as $K = \frac{1}{(1 - mpc)}$ or $\alpha = \frac{1}{(1 - mpc)}$

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Overview

TOPIC	CONTENT	CONTENT DETAILS FOR TEACHING, LEARNING AND ASSESSMENT PURPOSES
1. **Circular flow**	**Present the circular flow as a macroeconomic model** • **The open economy circular flow model** – **Concepts** – **The complete four sector diagram** – **Participants** – Households – Business sector – Government – Foreign sector – **Real and money flows** – **Injections (J = I + G + X)** – **Leakages (L = S + T + M)** – **Equations e.g. Y = C + I + G + (X – M)** – **Markets** – **Factor market** – **Market for goods and services/ products** – **Financial Market – Money and Capital** – **Foreign market/foreign exchange** – **Flows through different markets (production, income and spending)**	• Definitions and explanations • Identification of participants, flows, injections and leakages from a diagram • In-depth discussion of the inter-relationships between participants • Draw and interpret a circular flow diagram • Discussion of an economy in equilibrium • Justify the equality: L = J and illustrate its component elements • Explain the relationship between markets within the FOUR SECTOR model • Link the operation of financial and foreign exchange markets to the other participants of the circular flow
	Deduce and analyse the national account aggregates and conversions • **National account aggregates and conversions** Measuring National Account Aggregates: – Production GDP(P) – GDP – Income GDP(I) – GDI – Expenditure GDP(E) – GDE National Account Conversions: – System of National Accounts (SNA) – (Nominal and Real prices, Basic prices, Factor cost, Market prices, Net Figures, Domestic and National figures and disposable national income)	• Definitions and explanations • Identify from table • Briefly discuss the THREE methods • Explain the concepts used in national accounts • Analyse, interpret and derive aggregates • Analyse the national account conversions **HOT QUESTION: How is expenditure related to income and production?**

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	Derive and apply the multiplier • **The multiplier** – Definition of multiplier effect – Explanation of the multiplier process – Aided with a circular flow and examples (using a graph and illustration) – Application of basic formulae	• Define the concept **HOT QUESTION: Explain the multiplier process by using the graph and the following formula: ΔY/ΔE** **HOT QUESTION: What is the effect of the marginal propensity to consume (mpc) and marginal propensity to save (mps) on the multiplier (1/1-mpc or 1/mps)?** • Link the multiplier to the circular flow model **HOT QUESTION: Why is the value of the multiplier in reality a small figure?**

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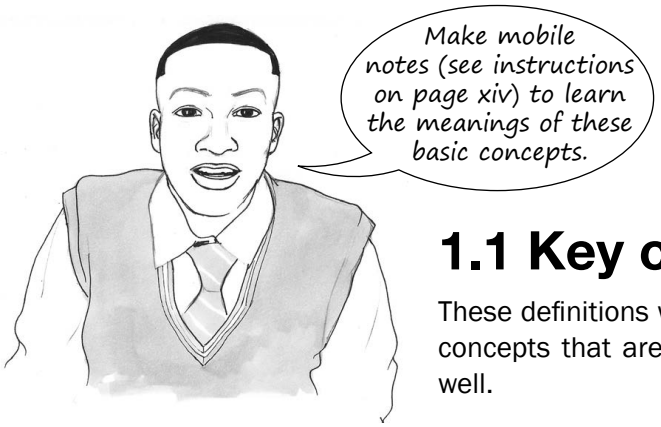

1.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well.

Term	Definition
Base year	A year with very small price changes or price fluctuations. The current base year used by the Reserve Bank is 2005
Basic prices (bp)	Used when GDP is calculated according to the production method and represents the production costs of firms
Capital market	Market for long-term financial instruments, for example, bonds, shares
Circular flow model	Continuous flow of spending, production and income between different sectors
Closed economy	An economy that has no foreign sector as a participator
Consumption (C)	Consumption spending by the population
Domestic figures (GDP)	Value of all final goods and services produced within the borders of a country for a specific period
Economic equilibrium	The economy is in equilibrium if leakages are equal to injections: **L = J or S + T + M = I + G + X**
Expenditure method	When the national accountants add together the spending of the four major sectors of the economy: **C + G + I + (X – M)**
Exports (X)	Goods and services produced locally and then sold for consumption outside the borders of the country
Factor market	Market where factors of production are traded, e.g. labour market
Factor cost/Factor prices	These terms can be used interchangeably and refer to the cost of or price paid for the factors of production (land, labour, capital and entrepreneurship) used by firms. [Note that the term factor income may also be used]
Financial market	The market where both short- and long-term financial assets are traded
Financial sector	Those financial institutions that are not directly involved in the production of goods and services, e.g. banks, insurance companies, pension funds and the JSE
Foreign exchange market	The market in which one currency can be traded for another, e.g. rands for dollars
Goods market	Market where goods and services are traded, e.g. cars, milk (also known as Product market)
Government (G)	The expenditure of the government sector
Imports (M)	Goods and services produced in other countries and purchased by local firms or households. Imports can also be represented by "Z"

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Term	Definition
Income method	Gross Domestic Income is derived by adding all income earned by the owners of the factors of production – GDP(I)
Injections (J)	The introduction of additional money into the economy by investment (I), government (G), and payments for exports (X)
Investments (I)	Spending by firms on capital goods
Leakages (L)	Money withdrawn from the circular flow, e.g through savings (S), taxes (T) and import expenditure (M)
Marginal propensity to consume (mpc)	The **marginal propensity to consume** (mpc) indicates that, as **disposable income increases**, an increase in personal consumer spending (consumption) occurs. For example, a marginal propensity to consume of 0.65 indicates that for every extra rand earned, the household will spend 65 cents and save 35 cents
Market price (mp)	Prices actually paid by consumers for goods and services plus all taxes less subsidies. Calculated according to the expenditure method
Money flow	The flow of income and expenditure between the participants in the circular flow
Money market	The short-term and very short-term market for savings and loans
Multiplier	A small initial increase in spending produces a proportionately larger increase in aggregate national income
National figures (GNP)	Value of all final goods and services produced by the permanent citizens of the country for a specific period
Net figures	Net indicates that some amount has been taken away, e.g. net exports reflects the value of exports less imports
Open economy	An economy that trades with the foreign sector
Production method	The adding of final values of all goods and services calculated as gross value added – GDP(P)
Real flow	The flow of goods and services between the participants in the circular flow
Savings (S)	Income that is not consumed
Subsidies on production	Refers to subsidies that are not linked to specific goods or services, e.g. subsidy made on employment
Subsidies on products	Financial incentives to help struggling industries produce, as well as direct subsidies payable per unit exported to encourage exports (e.g. government subsidy on bread)
Taxes (T)	Compulsory payments made by private individuals or business enterprises to the government sector with no direct benefit
Taxes on production	Refer to taxes on production not linked to a specific good or service (e.g. tax on land and buildings)
Taxes on products	Taxes that are payable per unit of some good or service (e.g. VAT, import duties)

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1.2 The open economy circular flow model

Description

- 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.

1.2.1 Four sector diagram

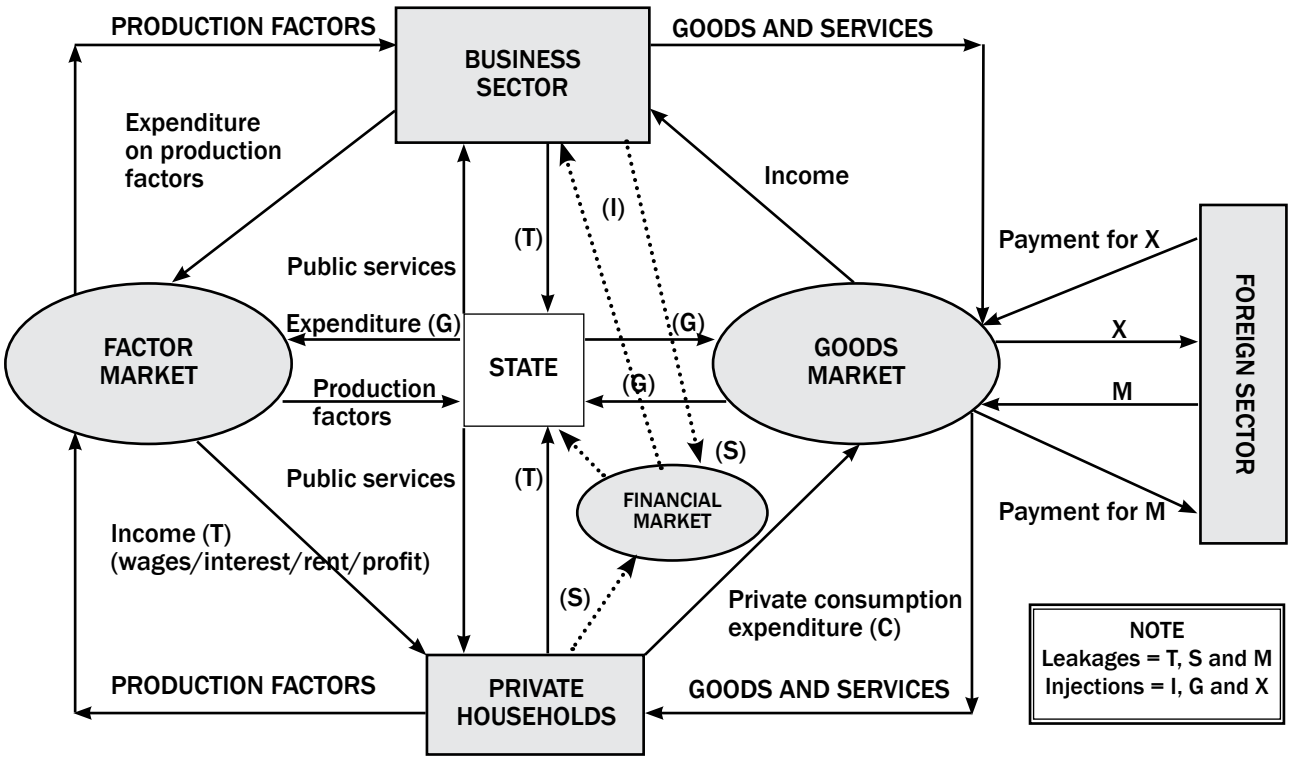

Figure 1.1 An open economy circular flow model

1.2.2 Participants
Household sector

- Households are the major consumers of economic goods and services – they use their income to buy from firms.
- Households are the primary economic participants because they are the owners of the four factors of production.
- Households sell factors of production in the factor market to firms.
- Households receive a remuneration from the firms in the form of wages, rent, interest and profit.

You must be able to draw a detailed diagram of a circular flow model. Figure 1.1 is a typical example of an open economy circular flow model.

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Firms/business sector

- Firms purchase the factors of production from the household in the factor market.
- Firms use the factors of production to produce goods and services.
- Businesses sell goods and services to households, government and the foreign sector.
- Businesses receive an income from the other three participants (households, government and the foreign sector).

Households = consumers
Firms = suppliers

The state/public sector

- This refers to local, regional and national government.
- The state provides the households and businesses with public goods and services.
- The state receives taxes from households, e.g. income tax.
- The state receives taxes from the business sector, e.g. company tax.
- The state spends money in the economy. (G)

Foreign sector

- There is a flow of goods or imports that flow from the foreign sector and are paid for by the individual households, businesses and the public sector.
- These imports can be seen as expenditure by individual households, businesses and public sector. (A monetary outflow.)
- There is also a flow of goods and services to the foreign sector from businesses (exports).
- These exports will result in an income for individual households, businesses and public sector. (A monetary inflow.)

Interaction between participants

- Households provide production factors to producers (firms).
- Households receive an income (Y) in return – rent, wages, interest and profits.
- Households purchase goods and services from firms.
- Firms receive income from sales revenue.
- Households and firms purchase goods and services from the foreign sector as imports (M).
- The foreign businesses receive money from firms and households.
- Firms sell goods and services to the foreign sectors, and this is called exports (X).
- Households and firms pay taxes to the government. (T)
- The government provides public goods and services to households and firms.
- The unexhausted (unspent) part of the household and firms' income earned is saved in the financial sector of the economy. (S)
- The money invested by firms and households is known as savings (S).
- The funds received by the financial sector are used by firms/ businesses to purchase infrastructure for the production of goods and services.
- This flow of money from the financial sector for use by firms is known as investment (I).

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1.2.3 Real and money flow

- **Real flow:** Factors of production flow from the owners (households) to producers via the factor markets. Goods and services flow from the producers via the goods markets to households and other users of goods and services. Factors of production and goods and services flow from foreign countries to South Africa (imports). Factors of production and goods and services flow from South Africa to foreign countries (exports).
- **Money flow:** Factor remuneration represents the expenditure of producers and the income of households (wages, rent, interest and profit). On the other hand, consumption expenditure represents the expenditure of households and the income of producers.

1.2.4 Leakages and injections

Leakages refer to the outflow of money from the economy.

The following are leakages or withdrawals from the circular flow:

- Savings (S)
- Taxation (T)
- Payment for Imports (M)

In other words:

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

Injections refer to an inflow of money into the economy. The following are injections (additions to) the circular flow:

- Investment (I)
- Government expenditure (G)
- Payments for exports (X)

In other words:

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

1.2.5 Equations

Equilibrium

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

$$L = J$$

$$S + T + M = G + I + X$$

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Disequilibrium

The economy is in disequilibrium when:

- Leakages are more than Injections.
- Injections are more than Leakages.

Restoring the equilibrium causes changes to national income

National Income increases 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 an increase in the production of goods and services.

National Income decreases when Injections are less than Leakages

$$J < L$$

$$I + G + X < S + T + M$$

- The amount by which leakages exceed the injections contributes to a decreased demand.

  $$J < L$$

  Demand for goods and services drop.
- Less goods and services are produced.
- Less income in an economy.

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	R40 million
Investment Spending	R180 million
Consumption Spending	R 110 million
Exports	R 25 million
Government Spending	R110 million

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The Formula to calculate the Aggregate Income in the economy:
Y = C + I + G + (X – M)

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

Graphical Presentation

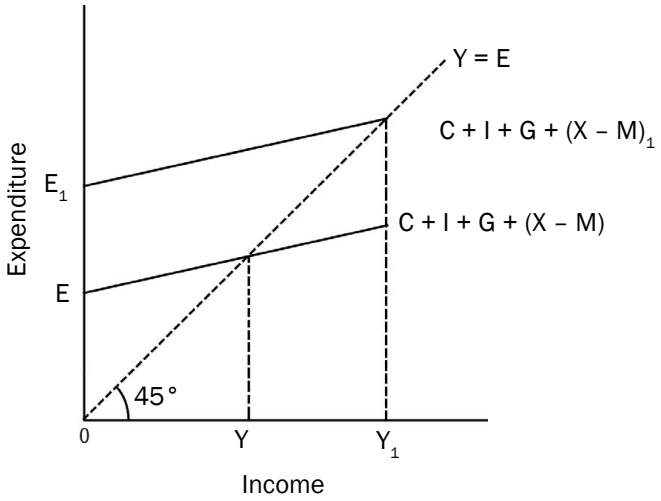

Figure 1.2: Expenditure and income

- 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 represented by a 45° line.
- It halves the 90° angle into two equal portions of 45°.

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

- The curve slopes upwards and to the right.
- At an income of Y the AE intersects the vertical axis at E.
- Assume planned AE increases to E_1.
- This means more money is injected into the economy.
- This causes an increase in Y to Y_1.

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1.2.6 Markets

MARKETS

Goods/Product markets
- These are markets for consumer goods and services.
- Buying and selling of goods that are produced in markets.
- E.g. Durable consumer goods.
- Semi-durable consumer goods.
- Non-Durable consumer goods.
- Services

Factor markets
- Factors of production are traded on these markets.
- Natural resources, Labour, Capital, and Entrepreneurship are traded in this market.

Money markets
- Short term loans and very short term funds are saved and borrowed by consumers and business enterprises.
- Banks, Insurance companies are examples.
- Bank debentures, treasury bills, government bonds are traded.

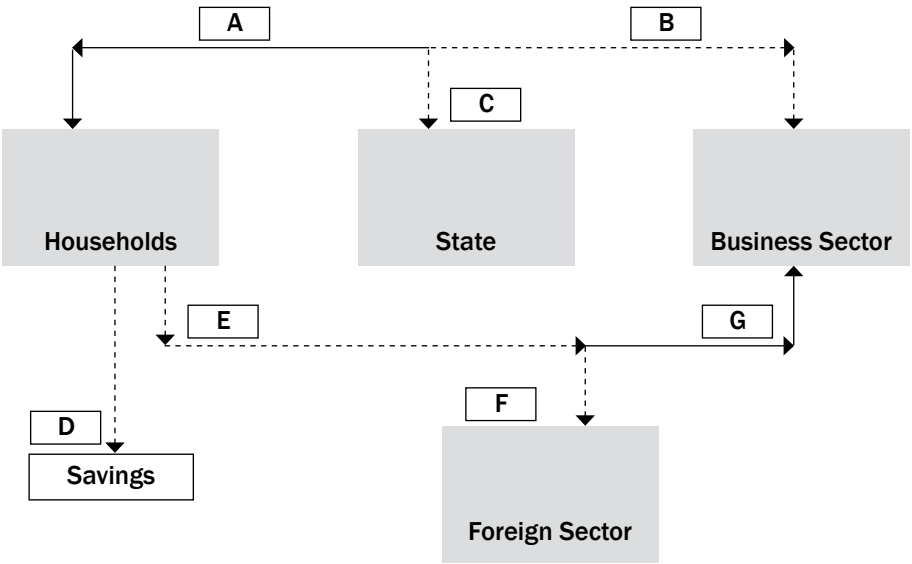
Capital markets
- Long term funds are borrowed and saved by consumers and business enterprises.
- E.g. Mortgage bond.
- The Johannesburg Stock exchange is a key institution in the capital market.
- Shares are traded.

FINANCIAL MARKETS

Foreign Exchange markets
- Businesses buy foreign currency to pay for imported goods and services.
- In S.A these transactions occur in banks.
- The most important foreign exchange markets are in London, New York and Tokyo.
- The S.A Rand is traded freely in these markets.
- E.g. It is when a person buys travelers cheques to travel abroad.

Activity 1

Study the diagram below and answer the questions that follow:



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1.1 Use the information below and calculate the values A – G: (7)

Total production	R25 000	Income Taxation	R 5 000
Savings	R4 000	Imports	R 3 700

1.2 Explain the impact of an increase in income taxes on the level of production. (3)

1.3 Calculate the total leakages (L) in the above diagram. (4)

1.4 Give the identity (equation) used to represent GDP in an open economy. (2)

1.5 If a country has a marginal propensity to consume of 0.1, calculate the value of the multiplier. (4)

[20]

Answers to activity 1

1.1 A – R20 000✓
B – R25 000✓
C – R5 000✓
D – R4 000✓
E – R16 000✓
F – R3 700✓
G – R12 300✓ (7)

1.2 Leads to a decline in production✓✓✓ (3)

1.3 S + T + M✓
R4 000 + R5 000 + R3 700✓
R12 700✓✓ (4)

1.4 C + G + I + (X – M)✓✓ (2)

1.5 M = 1/(1 – mpc)✓
= 1/(1 – 0,1)✓
= 1/0.9✓
= 1.1✓ (4)

[20]

1.3 National account aggregates

1.3.1 Deriving national account aggregates

The national account aggregates are methods that are used to determine the value of economic activity. The **production method**, **income method** and **expenditure method** are three different ways the economic activity is measured. They are all used at different times and for different purposes. Be sure you learn how to use these methods.

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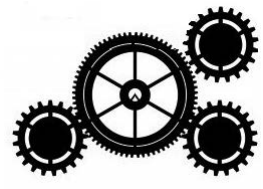
PRODUCTION METHOD	INCOME METHOD	EXPENDITURE METHOD
		
GDP	**GDP**	**GDP**
Adds final values of all goods and services produced	Adds all income earned by owners of factors of production	Adds spending of four main economy sectors – consumption, government, investments and exports (minus imports)

The production (output value added) method

The production method is a method whereby we determine the **Gross Domestic Product at basic prices by adding the final values of all goods and services** produced in the primary, secondary and tertiary sectors.

In the national accounts Gross Domestic Product at basic prices is usually referred to as Gross Value Added (GVA) at basic prices.

Table 1.3.1 shows the GDP in the different sectors of the economy for 2005–2012 in (R millions).

Value added (GVA)	2005	2007	2009	2011	2012
1. Primary sector	143 394	210 803	260 176	321 229	335 409
2. Secondary sector	330 669	403 129	478 627	508 953	542 821
3. Tertiary sector	927 004	1 178 144	1 439 517	1 791 197	1 956 857
4. Gross value added at basic prices	1 401 067	1 792 076	2 178 320	2 621 379	2 835 087
4.1 Plus – taxes on products	175 667	230 000	237 117	311 033	338 792
4.2 Less – subsidies on products	5 652	5 891	9 036	14 873	18 684
5. Gross domestic product at market prices	1 571 082	2 016 185	2 406 401	2 917 539	3 155 195

Table 1.3.1: GDP by economic sector for 2005–2012 *Source: SARB Quarterly bulletin (September 2013)*

NB

If we merely add up the market values of all outputs, we obtain a total greatly in excess of the value of the economy's actual output. Such a calculation would lead to double counting or multiple counting. So, to solve the problem we use 'value added'.

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Activity 2

Study the following data and answer the question that follows:

Compensation of employees R1 086 907; Final consumption expenditure by households R1 472 824; Net operating surplus R728 426; Final consumption expenditure by government R504 169; Taxes on products R245 198; Subsidies on products R3 113; Taxes on production R38 173; Subsidies on production R 5 092; Gross capital formation R467 878; Exports of goods and services R657 113; Imports of goods and services R667 740; Consumption of fixed capital R332 824; Primary sector R278 518; Secondary sector R466 749; Tertiary sector R1 435 971.

1. Determine the gross domestic product at market prices according to the production method. **[10]**

Answer to activity 2

1.

Primary sector		R 278 518✓
Secondary sector		R 466 749✓
Tertiary sector		R1 435 971✓
Gross value added at basic prices	✓	2 181 238✓✓
Plus taxes on products		R 245 198 ✓
Less subsidies on products		R 3 113 ✓
Gross domestic product @ market price		R2 423 323✓✓

[10]

The income method

The income method is a method whereby we determine the gross domestic product – **GDP at factor prices (factor cost) by adding all the income earned by the owners of the factors of production (gross domestic income).**

In the national accounts this is referred to as Gross Value Added at factor cost.

Table 1.3.2 Indicates the gross domestic income for the South African economy for 2005–2011 in (R millions).

National income or Gross Value added at factor cost (rbn)	2005	2007	2009	2011	2012
1. Compensation of employees	699 018	882 379	1 081 640	1 330 315	1 447 429
2. Net operating surplus	485 761	629 116	736 427	874 877	942 903
3. Consumption of fixed capital	187 790	252 595	332 333	375 982	404 947
4. Gross value added @ factor cost	**1 372 569**	**1 764 090**	**2 150 400**	**2 581 174**	**2 795 279**
5. Other taxes on production	32 927	35 374	40 898	51 525	54 166
6. LESS other subsidies on production	4 421	7 388	12 978	11 320	14 358
7. Gross value added @ basic prices	**1 401 067**	**1 792 076**	**2 178 320**	**2 621 379**	**2 835 087**
8. Taxes on products	175 667	230 000	237 117	311 033	338 792
9. LESS subsidies on products	5 652	5 891	9 036	14 873	18 684
10. Gross domestic product @ market prices (GDI)	**1 571 082**	**2 016 185**	**2 406 401**	**2 917 539**	**31 155 195**

Table 1.3.2: South African GDP (I) for 2005–2012 *Source: SARB Quarterly Bulletin (September 2013)*

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Activity 3

Refer to Table 1.3.2 (income method) and answer the following questions:

1. Which financial institution is responsible for the recording and publishing of GDP figures in South Africa? (2)
2. Explain the concept 'subsidies on products'. (3)
3. Give TWO examples of taxes on products. (4)
4. Calculate the consumption of fixed capital in 2009 as a percentage of GDP at market price. Show all calculations. (4)
5. What is the difference between 2007 and 2011 concerning the GVA @ factor cost? (2)

Answers to activity 3

1. SARB ✓✓
2. Direct payments by government✓ to the producer✓ to decrease price of a product, e.g. government subsidy on bread.✓
3. VAT✓✓ Import duties✓✓
4. 332 584/2 398 152 × 100% ✓✓ = 13.9%✓✓
5. 2 631 227 – 1 764 090 = 1 258 658✓✓

The expenditure method

The expenditure method is a method whereby we determine the gross domestic product – **GDP – at market prices by adding the spending of the four main sectors of the economy** – households (C), government (G), businesses (I) and foreign sector (X – M).

Differentiate between GDE and Expenditure on GDP: GDE = C + I + G

Expenditure on GDP = C + I + G + (X – M)

Table 1.3.3 shows total spending on GDP at market prices for 2005–2012 (in R millions).

NB

Table 1.3.3 shows that South Africa imported more goods and services than it exported in 2005. This caused a leakage from the circular flow to the value of about –R7 390 billion in 2005.

Gross domestic expenditure and GDP at market prices (Rbn)	2005	2007	2009	2011	2012
1. Final consumption expenditure by households	990 773	1 264 726	1 460 764	1 743 989	1 907 247
2. Final consumption expenditure by government	305 733	380 004	507 330	635 019	707 031
3. Gross capital formation	282 130	428 231	470 298	568 875	612 551
4. Residual items	–164	–1 618	–10 857	–12 329	24 585
5. Gross domestic expenditure	**1 578 472**	**2 071 343**	**2 427 517**	**2 935 554**	**3 251 414**
6. Exports of goods and services	430 169	634 626	657 192	854 343	891 562
7. Imports of goods and services	437 559	689 784	678 308	872 358	987 781
8. Expenditure on gross Domestic product @ market prices	**1 571 082**	**2 016 185**	**2 406 401**	**2 917 539**	**3 155 195**

Source: SARB quarterly bulletin (September 2013)

Table 1.3.3: Total spending on GDP at market prices for 2005-2012

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1.3.2 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 have 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.

Factor Cost

- Factor cost is used with the income method of measuring economic activity.
- GDP at factor cost – other taxes on production – other subsidies on production = GDP at basic prices.

Basic Prices

- Used with the production method.
- Includes taxes on production and excludes subsidies on production.
- 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.

Market prices

- Used with the expenditure method.
- Conversion of values from:
  - **Basic prices to market prices:**
    GDP at 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.
- Taxes on products are payable per unit, e.g. VAT.
- Subsidies on products include direct subsidies paid per unit.

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

GDP: Domestic production includes foreigners operating in South Africa.

GNP: Only includes the production/income of South Africans.

Conversion of Domestic to National figures

Domestic figures (GDP) relate to the income and production happening within the borders of the country.

National figures (GNP) relate to the income or production by the citizens of the country.

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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**

Nominal figures vs Real figures

Nominal figures

- It is also known as market or money value.
- It is also known as national product at current prices.
- Nominal value of 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 expressed in prices which applied in a certain base year.

Activity 4

Two key national accounts conversions

A. How to convert domestic totals to national totals:

	2005	2007	2009	2011
GDP @ MARKET PRICES	**1 571 082**	**2 016 185**	**2 398 155**	**2 964 261**
PLUS: Primary income from the rest of the world	29 550	48 448	34 075	38 118
MINUS: Primary income to the rest of the world	60 975	117 266	87 593	104 689
GNP @ MARKET PRICES	**1 539 657**	**1 947 367**	**2 344 637**	**2 897 690**

Source: SARB Quarterly Bulletin (December 2011)

Table 1.3.4: How to convert domestic totals to national totals

NB

PLEASE NOTE! Table 1.3.4 shows you how to apply the conversion of domestic figures to national figures and vice versa. **You must learn these conversions.**

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Study Table 1.3.5 below and answer the questions that follow.

NATIONAL ACCOUNT AGGREGATES	R MILLIONS
Final consumption expenditure by households	1 473 490
Final consumption expenditure by government	505 040
Gross capital formation	467 878
Residual item	–18 092
Gross Domestic Expenditure (GDE)	**2 428 316**
Export of goods and services	657 113
Import of goods and services	677 740
Expenditure on GDP at market prices	**A**

Source: Quarterly Bulletin, SARB (June 2010)

Table 1.3.5: National account aggregates

1. Explain the concept gross capital formation. (2)
2. Calculate the value of A. Show all calculations. (4)
3. Differentiate between GVA at basic prices and Expenditure on GDP at market price. (3)

[9]

Answers to activity 4

1. Expenditure on assets used repeatedly in the process of production ✓/Increase in the stock of capital ✓ (2)
2. GDE = 2 428 316 ✓
   + Exports = 657 113 ✓
   – Imports = 677 740 ✓
   R2 407 689m ✓ (4)
3. GVA at basic prices is calculated using the production method and is usually less than Expenditure on GDP at market prices.✓✓
   To convert GVA at basic prices to Expenditure on GDP at market prices; subtract subsidies on products; add indirect taxes on products.✓ (3)

[9]

B. How to convert GDP at factor cost to GDP at basic prices or market prices:

GDP @ factor cost to GDP at basic prices, or GDP at market prices:

GDP at **basic price** = GDP @ factor cost
+ tax on production
– subsidies on production

GDP at **market price** = GDP at basic price
+ tax on products
– subsidies on products

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1.4 The Multiplier

- The multiplier effect is the process whereby an initial change in **spending changes** the level of output and income by more than the initial change in spending.
- The formulae to calculate the value of the multiplier (M) is:

$$M = \frac{1}{1 - mpc} \quad \text{OR} \quad \frac{1}{mps}$$

The multiplier in a two sector model

The multiplier is 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 = R40 000 = 40% 0.4
  E = R60 000 = 60% 0.6
- **Marginal Propensity to consume = 0.6 (mpc)**
- **Marginal propensity to save = 0.4 (mps)**

The total of the mpc + mps is always = 1 (one)

FORMULA to calculate the Multiplier:

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

$$\alpha = \frac{1}{1 - mpc} = \frac{1}{1 - 0.6} = \frac{1}{0.4}$$

= 2½ (Multiplier)

The multiplier in a four sector circular flow model

- The following leakages are found
  - mps = marginal propensity to save
  - mrt = marginal rate of taxation
  - mpm = marginal propensity to import

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The multiplier in a graph

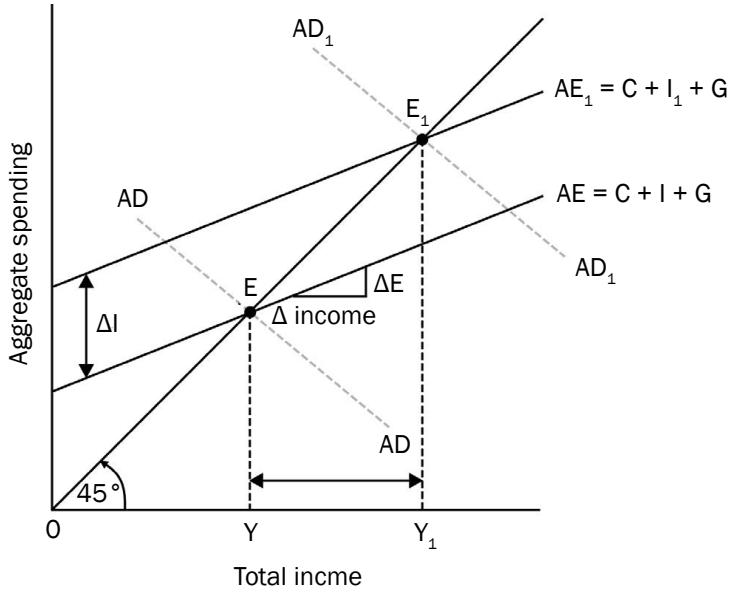

Figure 1.4.1: An increase in aggregate expenditure

Use the following formula to calculate the multiplier

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

- I = R40 000 m and it increases 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 increases to R125 000 m
- **ΔY = R25 000 m**

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

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

- In the above sketch:
  - E = Original equilibrium.
  - Y = Original income.
  - Change in investment spending is added.
  - The AE curve (Aggregate expenditure) shifts upwards to AE_1.
  - Total spending at each level of income (Y) increases to Y_1.
  - Planned spending determines aggregate expenditure. Aggregate Demand increases to AD_1.
  - The new equilibrium position is at E_1.
  - The multiplier effect shows that the increase in Y (ΔY) is greater than the change in I (ΔI).

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- National Income changes when:
  - Total spending ≠ to Production
  - Total Demand ≠ to Total supply
  - Planned leakages ≠ to planned Injections

Explain the multiplier effect

- The multiplier relates to how much national income changes as a result of an injection or withdrawal.
- Assume an increase in injections into the economy (investment, government spending or exports), which would lead to a proportionate increase in national income.
- The extra spending would have a 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.
- Initially 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.
- But 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.

Application

Keynesian approach

1. Keynes argues that if the government wants the economy to grow, they can increase (G). Increase (G) and finance it with loans.
2. They can decrease taxation, put more money in the pockets of the consumer.
3. The consumer spends this extra money, aggregate demand will increase, production will increase and employment will increase.
4. Government can decrease company taxes and this can lead to greater investment by businesses (I).

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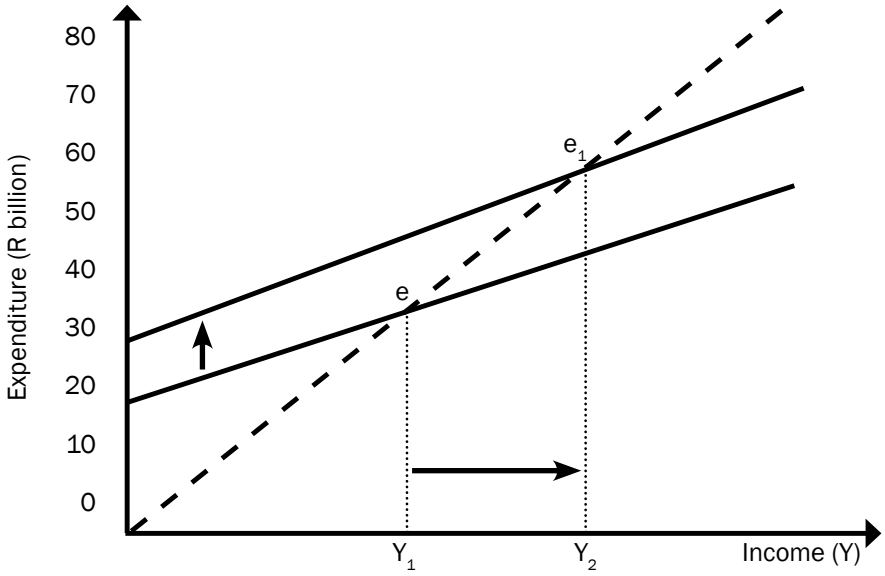
Activity 5

Study the graph below of the Keynesian model in a two-sector economy where the consumption function is given by $C = c_0 + c(Y)$ and answer the questions that follow.



1. Define the term multiplier. (3)
2. With reference to the graph, name the TWO sectors involved in deriving the macro-economic multiplier. (4)
3. Indicate what is represented by the dotted line. (2)
4. What is the value of autonomous consumption for the original consumption function? (2)
5. Suppose the marginal propensity to save (MPS) = 0.4. Use the multiplier formula to calculate the eventual change in aggregate income, if there was an injection of R10 billion into the economy. Show ALL the calculations. (6)
6. Describe the relationship between the mpc and the multiplier. (3)

[20]

hint Determine the size of the multiplier first.

Answers to activity 5

1. The multiplier shows how an increase in spending (injection) produces a more than proportional increase in national income ✓✓✓ (3)
2. Household ✓✓ Business ✓✓ (4)
3. Indicates all points where income = expenditure / 45° line / Keynesian equilibrium ✓✓ (2)
4. 20 bn ✓✓ (2)
5. $M = \frac{1}{mps}$ ✓ $= \frac{1}{0.4}$ ✓ $= 2.5$ ✓
   2.5 x 10 bn P = 25 bn. ✓✓✓ (6)
6. The larger the marginal propensity to consume (mpc) the bigger the multiplier and vice versa ✓✓✓ (3)

[20]

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Chapter 2

Business cycles and forecasting

Business cycles refer to fluctuations in economic activity or production over several months or years. They seem to indicate a long-term trend, typically involving shifts over time between periods of rapid economic growth (expansion or boom), and periods of stagnation or decline (contraction or recession).

Forecasting relates to the economic indicators used to forecast the trends in the business cycle.

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Overview

TOPIC	CONTENT	CONTENT DETAILS FOR TEACHING, LEARNING AND ASSESSMENT PURPOSES
2. **Business cycles**	**Analyse and explain business cycles, show how they are used in forecasting** • **The composition and features of business cycles** – Definition – The nature of business cycles – Demonstration/diagram – The real (actual) business cycle • **Explanations** – **Exogenous explanation** – **Endogenous explanation** – **Types of business cycles** • **Government policy** – **Monetary policy (expansionary and contractionary policies)** – **Fiscal policy (expansionary and contractionary policies)** – **Combination of monetary and fiscal policy** • **The new economic paradigm (smoothing of cycles)** – **Definition** – **Demand side policy** – Inflation and Unemployment – **Supply side policy** – Reduction in costs – Improvement in the efficiency of inputs – Improvement in the efficiency of markets • **Features underpinning forecasting with regard to business cycles** – **Indicators** – Leading – Coincidence – Lagging – Composite – **Length of a cycle** – **Amplitude** – **The trend line** – **Extrapolation** – **Moving averages**	• An in-depth discussion is required • Define the concept • Explain the nature of business cycles • Draw/illustrate a typical business cycle • Use a diagram and discuss the different phases in a business cycle • Only a broad outline of the real business cycle is required • Discuss the Exogenous explanation • Discuss the Endogenous explanation • Only a broad outline of the types of business cycles is required **HOT QUESTION: Compare and contrast endogenous and exogenous explanations of business cycles** Explain the monetary and fiscal policies used by government to smooth out business cycles **HOT QUESTION: Explain how fiscal and monetary policy might be used to stimulate economic activity during a recession** • Define 'The new economic paradigm' • Explain the meaning of 'The smoothing of cycles' • Discuss demand and supply side policies with the aid of graphs **HOT QUESTION: Explain how supply side and demand side policies would be used to stimulate economic activity in the smoothing of cycles** • Explain the relevant concepts • Discuss in detail the features underpinning forecasting • Make use of a diagram and discuss the cycle length, amplitude and the trend line as features underpinning forecasting **HOT QUESTION: Make use of a given real business cycle diagram and explain why it serves as a forecasting model**

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2.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide.

Term	Definition
Business cycle	Successive periods of growth and decline in economic activities
Depression	Economic activity is at its lowest. Deepening of the recession
Economic indicator	Used to measure trends in the economy, e.g. GDP
Peak	Point where the economic expansion is at its highest
Phillips-curve	Illustrates the relationship between unemployment and inflation
Recession	A negative economic growth for at least two successive quarters
Trough	Point where the economic contraction is at its lowest

2.2 The composition and features of business cycles

2.2.1 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;
  - Four phases, namely recovery, prosperity, recession and depression.

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2.2.2 Demonstration/diagram of a business cycle

Figure 2.1 below shows economic activity over an extended period of time as the economy moves between periods of expansion and periods of contraction.

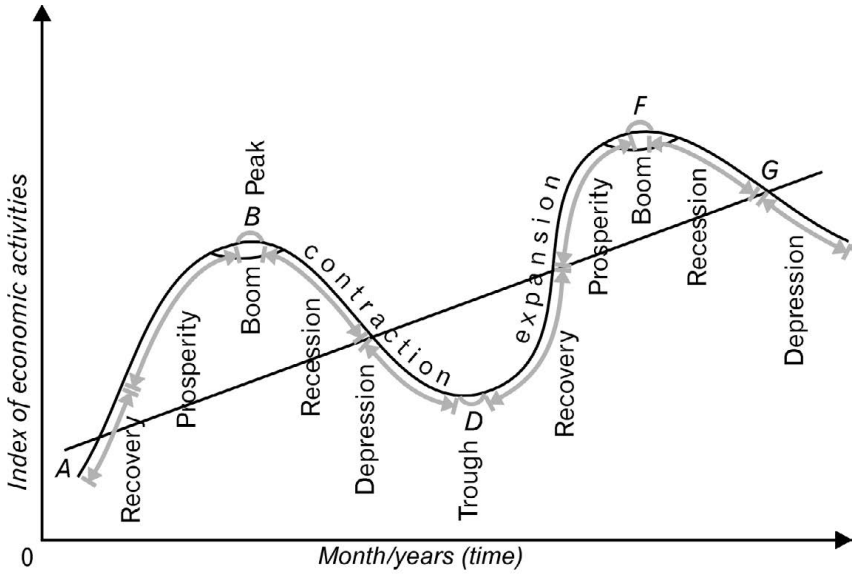

Figure 2.1 Business cycles (trend line)

As shown in Figure 2.1, economic activity clearly shows periods of contraction (**recession/depression**) and periods of expansion (**recover/prosperity**) in the economy.

- Economic activity 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 an **upswing**.
- A period of general decline in economic activity is called a **downswing**.
- The business cycle oscillates between the upper (**peak**) and lower (**trough**) turning points along a trend line.
- 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**.
- The **trend line** is the long-term average position or pattern.

2.2.3 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.

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- 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.

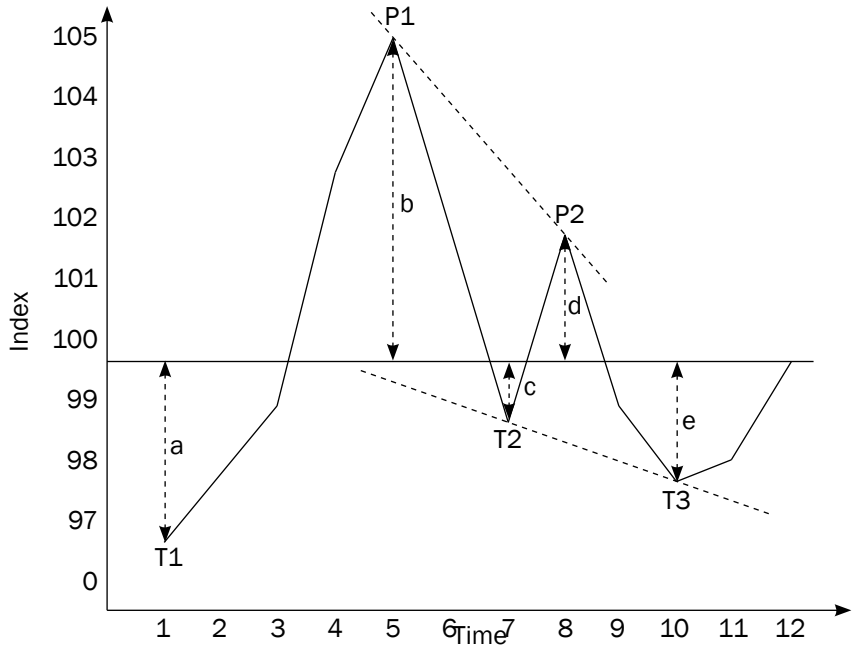

Figure 2.2 The real business cycle

- The percentage point difference of successive peaks and troughs can be calculated e.g. a + b (3 + 5 = 8) compared to b + c (5 + 1.5 = 6.5).

2.3 Explanations

There are numerous theories as to the causes of business cycles. Among these are the **monetarist approach** and the **Keynesian approach**. The government uses monetary instruments such as interest rates to mediate these business cycles.

2.3.1 The exogenous explanation

Exogenous variables are those independent factors that can influence business cycles and originate outside the economy. Some economists believe that business cycles are caused by exogenous factors such as those described below:

- The monetarists believe markets are inherently stable and disequilibrium is caused by incorrect use of policies, e.g monetary policy.
- Weather conditions and market shocks cause upswings and downswings.
- Governments should not intervene in the market.
- Sunspot theory based on the belief that increased solar radiation causes changes in weather conditions.
- Technological changes.

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Figure 2.3 is based on the view that economics are generally stable. This is illustrated by the thick trend line representing the normal progress of a growing economy. Movements away from the trend are caused by exogenous factors, for example, inappropriate monetary policy.

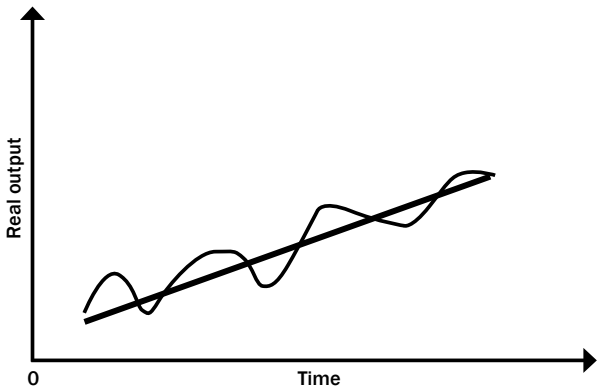

Figure 2.3 Monetarist approach

2.3.2 The endogenous explanation

Endogenous variables are dependent variables. This follows the belief that economic growth is primarily the result of endogenous and not external forces.

- This is often called the Keynesian view.
- The Keynesian approach holds the view that markets are inherently unstable and therefore government intervention may be required.
- The price mechanism fails to co-ordinate demand and supply in markets and this gives rise to upswings and downswings.
- Prices are not flexible enough (e.g. wages).
- A business cycle is an inherent feature of a market economy.
- Indirect links or mismatches between demand and supply are normal features of the economy.

Figure 2.4 helps to illustrate the Keynesian view of the business cycle. The thick cycle line indicates the endogenous nature of the business cycle, while the thinner trend line shows that the economy is inherently unstable. The argument is that business cycles are a natural part of market economies and can have a major impact on the overall performance of an economy.

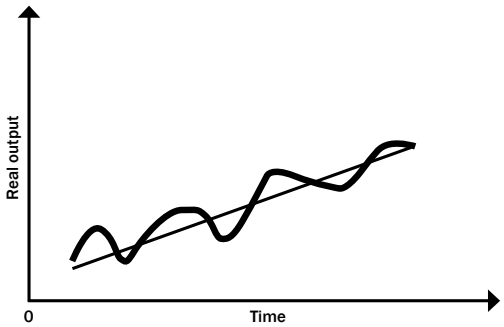

Figure 2.4 Keynesian approach

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2.3.3 Types

The business cycle is one kind of cycle found in market economies. Other less obvious kinds occur less regularly:

- **Kitchen cycles:** last between 3 to 5 years caused by adapting inventory levels in businesses.
- **Jugler cycles:** last from 7 to 11 years and are caused by changes in net investments by government and businesses.
- **Kuznets cycles:** last between 15 to 20 years, caused by changes in activity in the building and construction industry.
- **Kondratieff cycles:** last longer than 50 years, caused by technological innovations, wars and discoveries of new deposits of resources e.g. gold.

2.4 Government policy

Government can use monetary and/or fiscal instruments to help stabilise business cycles, also called "fine tuning" the economy.

2.4.1 Policy instruments

MONETARY POLICY – can be defined as policies used by monetary authorities (SARB and MPC) to change the quantity of money in circulation as well as the interest rates, with the aim to stabilise prices, reach full employment and achieve high economic growth.

The size of the M3-money stock is an important determinant of the quantity of money. The following TWO theories explain changes in the quantity of money and its impact on the economy:

- The **quantity theory of money** shows how an increase in the stock of money can lead to an increase in the inflation rate and a decrease in the buying power of money.
  Quantity theory-equation:

  $$MV = PT$$

  Where: M = Total stock of money
  V = Velocity of money
  P = Prices of goods and services
  T = Quantity goods and services
  When the stock of money (M) increases, prices (P) will rise and because production (T) cannot be increased immediately it will lead to INFLATION, assuming velocity (v) remains constant.
- The second theory links the change in deposits and the cash reserve requirement. If the amount of new deposits increase, the money multiplier kicks in:

  $$Tm = \Delta D \times 1/rd$$

  Where: Tm = Total stock of money at the end of the process
  ΔD = The initial inflow of new money to the banks/new deposits
  Rd = Minimum cash reserve percentage kept by banks.

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It can be seen that a relatively small deposit of R1 000 with a relatively small cash reserve requirement of 5% (0,05) may lead to a relatively large increase in the total stock of money.

Tm = 1 000 × 1/0,05 = 1 000 × 20 = R20 000

- Keeping the TWO theories in mind, the central bank can use the following instruments separately or jointly from its arsenal of monetary and related policy instruments in a selective or discretionary manner:

1. **Open market transactions**

   The SARB can directly increase/decrease the supply of money by buying/selling government securities in the open market.

2. **Interest rates**

   If banks experience a shortage of funds in the money market, they are accommodated by the SARB, when they are allowed to borrow money through the Repo system (Repurchase tender system) at a rate known as the repo rate. By increasing this rate, money becomes more expensive for commercial banks, who pass on the increase to their clients by increasing interest rates on loans. Loans become more expensive to the consumer and so the demand for money will decrease.

3. **Cash reserve requirements**

   The SARB is permitted by the Banks Act to occasionally change the minimum cash balances the banks are required to maintain in order to manipulate the money creation activities of the banks. See the money multiplier equation. Change the 5% to 10% and see what the effect would be on the creation of credit/money in the economy.

FISCAL POLICY – Fiscal policy = Is the process of using taxation and public expenditure to even out the swings of the business cycle. Governments, through their fiscal policy have a powerful weapon for stabilising/ironing out/smoothing of cycles, to stop peaks from ending in high inflation and troughs in too high levels of unemployment.

> While the monetary policy focuses on managing the total money supply, the fiscal policy tries to stimulate or curb the economy, by increasing or decreasing total consumption expenditure.
>
> Fiscal policy is dependent on the multiplier effect where a relatively small change in spending will cause a large change in income (GDP).

The original equilibrium situation:
Accepts that all economic activities are stable and all markets in equilibrium.
Assumes the beginning of the following undesired conditions/problems:

1. **Total demand is low and unemployment is high.**

   The State can increase total demand by increasing expenditure, the multiplier will kick in. The state has THREE options:

   - **Raising government spending** (G) with borrowed money (Budget Deficit). Aggregate expenditure increases and so does demand. The economy is stimulated and employment is likely to increase.
   - **Decreasing taxes.** Consumers and producers have a larger part of their incomes available to spend on goods and services. Aggregate expenditure increases. The economy is stimulated

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and employment is likely to increase.

- **Raising government spending and simultaneously decreasing taxes.** This will have a double effect. Government spending increases and consumers and producers also have more to spend. Demand increases substantially. Employment increases.

2. **Aggregate demand is too high and leads to demand pull-inflation.**
   The state can decrease spending, decrease aggregate demand, the multiplier will kick in negatively and total spending will decrease.
   To achieve this, the government has THREE options:
   - **Cut down on government spending** (G). The unspent money is preserved. Aggregate expenditure is less and demand drops. Inflation is likely to decrease.
   - **Increasing taxes (T).** Workers pay more tax and this results in consumers having less income to spend and demand dropping. Inflation is likely to decrease.
   - **Reducing government spending (G) and simultaneously increasing taxes (T).** This will have a double effect. Government spending decreases and consumers and producers also have less to spend. Demand drops substantially. Inflation decreases.

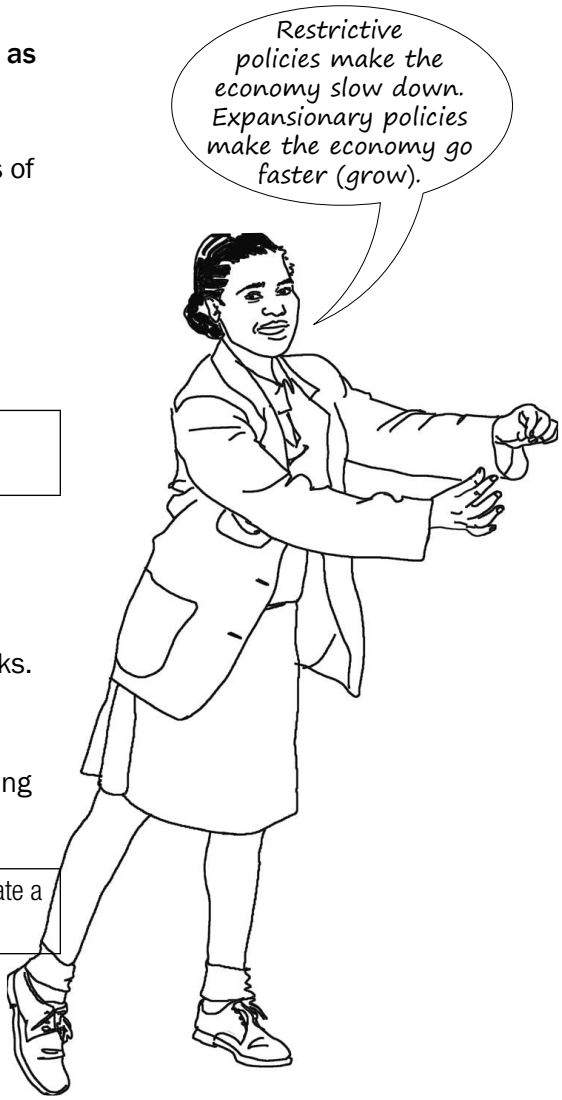
A COMBINATION OF MONETARY AND FISCAL POLICY:
The strongest effects are obtained when a government uses these policies in combination with one another to manipulate aggregate demand.

1. **Where demand is too high, restrictive policies can be combined as follows:**
   Monetary policy:
   SARB can increase interest rates, increase reserve requirements of banks.
   plus
   Fiscal policy:
   Reduce government spending and increase taxes – budget for a surplus.

Doing these things simultaneously triggers negative money multiplier and a negative income multiplier, which doubles the effect of the measures.

2. **If aggregate demand is too low, expansionary policies can be combined as follows:**
   Monetary policy:
   SARB lowers interest rates and cash reserve requirement of banks.
   plus
   Fiscal policy:
   Government decreases taxes and increases spending by budgeting for a deficit.

A combination of the above policies will lead to a positive money multiplier and activate a positive income multiplier, which will double the effect of measures.



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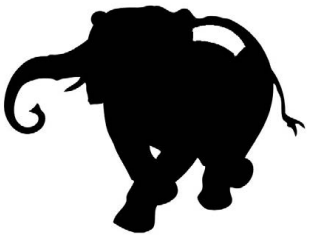
• **I**nterest rates	**I**
• **C**ash reserve requirements	**C**atch
• **O**pen market transactions	**O**ne
• **M**oral persuasion	**M**ore
• **E**xchange rate policy	**E**lephant



2.5 The new economic paradigm

The "new economic paradigm" discourages policy makers from using monetary and fiscal policies to fine-tune the economy, but rather encourages achieving stability through sound long-term policy decisions relating to demand and supply in an economy.

2.5.1 Demand-side policies

Demand-side policies focus on aggregate demand in the economy. When households, firms and government spend more, demand in the economy increases. This makes the economy grow but can lead to inflation.

- Inflation:
  - Aggregate demand increases more quickly than aggregate supply and this causes prices to increase.
  - If the supply does not react to the increase in demand, prices will increase.
  - This will lead to inflation (a sustained and considerable increase in the general price level).
- Unemployment:
  - Demand-side policies are effective in stimulating economic growth.
  - Economic growth can lead to an increase in the demand for labour. As a result more people will be employed and unemployment will decrease.
  - As unemployment decreases inflation is likely to increase. This relationship between unemployment and inflation is illustrated using the Phillips curve.

2.5.2 Supply-side policies

Supply-side policies include:

- **Reduction of costs of production**
  - Infrastructural services
  - Administrative costs
  - Cash incentives
- **Improving the efficiency of inputs**
  - Tax rates
  - Capital consumption
  - Human resources development
  - Free advisory services
- **Improving the efficiency of markets**
  - Deregulation
  - Competition
  - Levelling the playing field

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2.6 Features underpinning forecasting with regard to business cycles

There are many economic indicators that can be used to forecast business cycles. Some of these are:

2.6.1 Leading indicators

- Leading indicators give consumers, businesses and the state a glimpse of the direction in which the economy might be heading.
- When these indicators rise, the level of economic activities will also rise a few months later.
- Examples of leading indicators are job advertising space; inventory; and sales.

2.6.2 Co-incident indicators

- Co-incident indicators move at the same time as the economy.
- They indicate the actual state of the economy.
- Examples of these indicators are value of retail sales and real GDP.

2.6.3 Lagging indicators

- Lagging indicators won't change direction until after the business cycle has changed its direction.
- Examples of these indicators are hours worked in construction and total of commercial vehicles sold.

2.6.4 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.

2.6.5 Trend

- The trend is the general direction of the economy.
- The trend line that rises gradually will be positively sloped in the long run. This rising line indicates a growing economy.

2.6.6 Length

- Length is measured from peak to peak or from trough to trough.
- Longer cycles show strength and shorter cycles show weakness with regard to economic activities.

2.6.7 Amplitude

- Amplitude refers to the vertical (height) difference between a trough and the next peak of a cycle.
- The larger the amplitude, the more extreme the changes that occur.

2.6.8 Extrapolation

- Extrapolation means to estimate something unknown from facts that are known. For example, extrapolations from known facts are used to predict future share prices.

2.6.9 Moving averages

- Moving avarages are used to analyse the changes in a series of data over a certain period of time.

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Leading indicators show us where we're heading
Lagging indicators won't change direction
Co-incident indicators, moving together

What's the **trend**? Show me the way
What's the **length**? Weak or strong today

Pump up the **amplitude** to see the difference
I need to **extrapolate** to make my predictions

Activity 1

Study Figure 2.5 below and answer the questions that follow:

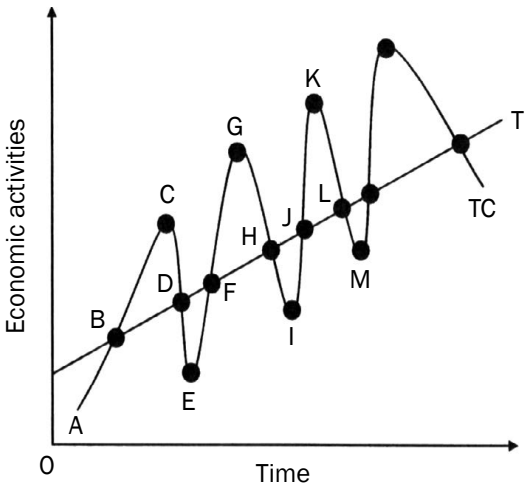

Figure 2.5 Business cycles

1. Define the term business cycle. (3)
2. Indicate which indicator is represented by T. (2)
3. What is measured by the horizontal axis? (2)
4. At which point did the economy reach a peak and a trough? (4)
5. Identify the four phases into which the business cycle is divided in the above illustration. (8)
6. How is the length measured in the above business cycle? (2)
7. Explain lagging and coincident indicators used in the forecasting of business cycles. (2 × 4) (8)

[29]

Answers to activity 1

1. Successive periods of growth and decline in economic activities✓✓✓ (3)
2. Trend line✓✓ (2)
3. Time✓✓ (2)
4. Peak – C✓✓
   Trough – E✓✓ (4)

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Answers to activity 1 (continued)

5. BC – Prosperity✓✓
   CD – Recession✓✓
   DE – Depression✓✓
   EF – Recovery✓✓ (8)
6. From C to G ✓✓ or E to I ✓✓ (2)
7. **Lagging indicators**
   These do not change direction until after the business cycle has changed its direction. ✓✓
   E.g. hours worked in construction; total number of commercial vehicles sold.✓✓
   Co-incident indicators
   These move at the same time as the economy ✓✓
   They indicate the actual state of the economy.✓✓
   E.g. value of retail sales; real GDP (8)

[29]

Activity 2

Study the cartoon below and answer the questions that follow:

Source: Mail & Guardian, 2010

1. What is the message behind the cartoon? (2)
2. Why do you think that unemployment will not lead to an economic lift off? (2)
3. To which forecasting indicator does unemployment refer? (2)
4. How would you describe the recovery phase of a typical business cycle? (2)

[8]

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Answers to activity 2

1. Illustrate the business cycle struggling to recover due to the burden of unemployment✓✓ (2)
2. Due to a high percentage of unemployed people in South Africa✓✓ (2)
3. Co-incident✓✓ (2)
4. Economic activities start to increase✓✓ **OR**
   Exports will start to increase, resulting in an increase in production✓✓ (2)

[8]

Activity 3

Discuss the monetarist approach as a cause of business cycles. **[8]**

Answers to activity 3

- Exogenous approach ✓✓
- Believe markets are inherently stable.✓✓
- Departures from the equilibrium state are caused by factors outside of the market system.✓
- Market forces (supply and demand) kick in and bring the economy back to its natural state or equilibrium route.✓✓
- These interferences are not part of the normal forces operating in the market. ✓✓
- Governments should not interfere in the markets. ✓✓
- Major cause of economic fluctuations are inappropriate government policies ✓ undesirable increases and decreases in money supply ✓

(maximum 4 marks for examples) **[8]**

Activity 4

Discuss the trend line in the forecasting of business cycles. **[8]**

Answers to activity 4

- The trend line represents the average position of a cycle. ✓✓
- It indicates the general direction in which the economy is moving. ✓✓
- An upward trend suggests that the economy is growing. ✓✓
- The trend line usually has a positive slope, because production capacity increases over time. ✓✓
- Diagram showing trend line (see Figure 2.1 on page 26 for an example) .✓✓
- Accept any other relevant facts ✓✓ (any 4 × 2)

[8]

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Chapter 3

The role of the public sector

The **public sector,** also known as the **state** or **government**, is responsible for providing certain goods and services to citizens. It also determines the policy regarding these goods and services at national, regional and local levels. The public sector is also involved in the delivery of social security, public facilities and policing.

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Overview

TOPIC	CONTENT	CONTENT DETAILS FOR TEACHING, LEARNING AND ASSESSMENT PURPOSES
3. Public sector	**Evaluate the role of the public sector in the economy with special reference to its socio-economic responsibility in the South African context**	
	• **The composition and necessity of the public sector** – **Composition** – **Necessity** – To supply public goods – To conserve resources – To manage the economy	• Briefly describe the composition of the public sector **HOT QUESTION: Illustrate the composition of the public sector by means of a diagram** • Briefly discuss the necessity for the public sector
	• **Problems of public sector provisioning** – **Accountability** – **Efficiency** – **Assessing needs** – **Pricing policy** – **Parastatals** – **Privatisation/Nationalisation**	**HOT QUESTION: Assess the effectiveness of the public sector in supplying public goods** • Discuss in detail the problems of public sector provisioning (clearly show why each of these factors contributes to poor public sector provisioning)
	• **Objectives of the public sector and its budgets** – **Objectives** – Economic growth – Full employment – Exchange rate stability – Price stability – Economic equity – **Budgets** – Medium Term Expenditure Framework (MTEF and MTBPS) – The national (main), provincial and municipal budgets	• Discuss in detail the main objectives of the public sector in the economy • Supply a broad outline of the various budgets • Evaluate each budget within a South African context • Analyse budget data
	• **Fiscal policy (including the Laffer curve)** – **Features of Fiscal Policy** – Goal bound – Demand based – Cyclical – **Composition of Fiscal Policy** – Government expenditure – Taxation – Borrowing (State's debt)	**HOT QUESTION: Identify and explain how social rights are embedded in the budgets of the South African government** • Briefly discuss the features of fiscal Policy • Propose five major purposes of Fiscal Policy • Briefly discuss the composition of the Fiscal Policy

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	– **Effects of Fiscal Policy**
	  – Income distribution
	  – Consumption
	  – Price level
	  – Incentives/Disincentives :
	  – The Laffer Curve
	  – Discretion
		• Discuss in detail the effects of Fiscal Policy
		• Analyse/evaluate the effects within a South-African context
		• Draw and interpret the Laffer-Curve

	• **Reasons for Public Sector failure**
	  – **Characteristics/features**
	  – Ineffective
	  – Inefficiency
		• Briefly discuss the characteristics/ features of Public Sector failure

	– **Reasons for Public Sector failure**
	  – **Management failure**
	  – Apathy
	  – Lack of motivation
	  – Bureaucracy
	  – Politicians
	  – Structural weaknesses
	  – Special interest groups
		• Discuss the reasons for public sector failure in detail
		• Write a proposal as to how the South African Government can avoid Public Sector failure

	– **Effects of Public Sector failure**
	  – Allocation of resources
	  – Economic instability
	  – Distribution of income
	  – Social instability
		• Give a broad outline of the effects of Public Sector failure

	Infuse where appropriate: national macro-economic policy and service delivery with regard to socio-economic rights, education, health, and the environment, and social security, convention of the rights of the child, taxation, and compensation for human rights abuses.	

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3.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide.

Term	Definition
The budget	A document that details expected revenue and projected expenditure
Bureaucrat	An official in a government department
Central national government	Concerned with national issues, e.g. safety and security
Collective goods	Goods provided for society as a whole. E.g. parks and public utilities. Provision of these goods gives rise to the free rider problem
Community goods	E.g. police stations. Everyone can use these whether they are prepared to pay for them or not
Demerit goods	Harmful goods, e.g. cigarettes
Deregulation	Removal of unnecessary restrictions by law
Direct taxes	Taxes that are not shifted to the end user, e.g. PAYE
Indirect taxes	Taxes levied on the sale of goods and services
Local government	Deals with local issues within a town or municipal area
Merit goods	Goods and services whose provision has benefits for the user (private) and for society, e.g. education
Monetary Policy Committee (of the Reserve Bank) (MPC)	Decides on the country's monetary policy
Medium Term Budget Policy Statement (MTBPS)	Government's statement setting out its three-year budget
Medium Term Expenditure Framework (MTEF)	Estimates income and expenditure for a three-year period
Nationalisation	Transfer of functions and ownership of entities from the private sector to the public sector
Public goods and services	Provided by the state for use by all the members of a society, e.g. public libraries
Regional government	Deals with economic and other issues specific to a region/province
Regulation	Putting laws in place to regulate activities
State Owned Enterprises (SOE)	A business owned wholly or partly by the state and run by a public authority, e.g Eskom and SAA
Value Added Tax (VAT)	An indirect tax on goods and services consumed in the economy

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3.2 Composition and neccessity

3.2.1 Composition

- **National/central government**
  Concerned with national issues e.g. health, defence, education safety and security.
  Also includes non-profit organisations, e.g. SABS and CSIR.
- **Provincial/regional government**
  Concerned with the administration of the nine provinces and economic issues specific to the region.
- **Local government**
  Concerned with local issues within a town for municipal area.
  E.g. electricity delivery, libraries, traffic control and refuse removal.
- **Public corporations**
  State-owned enterprises (SOEs) that provide public goods and services, such as Eskom, Transnet and SABS.

3.2.2 Necessity of the public sector

- **To provide public goods**
  Goods and services provided by the state for use by all the members of society. Three groups can be distinguished:
  - *Community goods*
    Goods of which there is a complete supply or none, e.g. defence, police.
  - *Collective goods*
    Differ from community goods as fees, charges or tolls can be levied to exclude free-riders, e.g. beaches, drainage, parks.
  - *Merit goods*
    Goods provided by the state, because it is believed that they would be under-supplied if their provision was left entirely to market forces.
    E.g. education, health care, research.
- **To conserve resources**
  - Government has to intervene to protect the environment if the environment is exposed to insensitive and even carless use it may be damaged.
  - E.g. the oceans for fishing, the air we breathe; natural scenery.
- **To intervene in the economy**
  - Ensures a social and legislative environment.
  - Apply suitable and credible economic and development policies.
  - Promote policies that ensure equal opportunity for all members of society.
  - Limit anti-competitive behaviour.

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Accountability	**A**lways
Efficiency	**E**at
Assessing of needs	**A**pples
Pricing policy	**P**ears
Parastatals	**P**eaches
Privatisation	**P**ineapples

3.3 Problems of public sector provisioning

Learn these six problems of **public sector provisioning**:

3.3.1 Accountability

- **Government** is required to make and implement policies. Accountability is underpinned by ministerial responsibilities, parliamentary questioning, treasury control and the Auditor-general.
- **Public servants** are required to give an explanation of their decisions and actions.
- **The public** holds government accountable for the effective delivery of services and the implementation of policies.

3.3.2 Efficiency

- **Efficient provisioning:** Public servants provide the public with goods and services promptly and in the desired quantity and quality.
- **Inefficient provisioning**: Public servants fail to deliver services to the public because of bureaucracy, incompetence and corruption.

3.3.3 Assessing of needs

- **Government provides** goods and services according to the needs of people. Assessing these needs is difficult.
- **Market forces** determine the price of goods and services in the private sector.
- **State enterprises** are not subjected to the forces of demand and supply.

3.3.4 Pricing policy

- **Free of charge:** Certain services are provided free of charge from taxes, e.g. public health services. (Tax revenue is used to cover the costs.)
- **Price value:** It is difficult for government to establish the correct pricing.
- **Paid services:** People pay for some services, e.g. TV licences.
- **Subsidised products:** The public pay less for goods because government subsidises (pays towards) the cost, e.g. the price of bread is subsidised by government.

3.3.5 Parastatals

- **State Owned Enterprises** (SOEs) can be created as a result of nationalisation.
- **Service provisioning:** SOEs support service delivery, e.g. Eskom, SABC and Transnet. Can lead to monopolies, high prices and inefficiency.
- **Infrastructure provisioning:** SOEs provide essential infrastructure, especially when there are insufficient funds in the private sector, e.g. the road network.
- **Limited liability:** SOEs have limited liability in South Africa because they are financially supported by government.

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3.3.6 Privatisation/Nationalisation

- **Privatisation** refers to the **transfer of functions and ownership** from the public to the private sector.
- The aim of privatisation is to reduce the relative size of the public sector.
- Advantages of privatisation:
  - Privatisation stimulates growth and improves the overall efficiency and performance of the economy.
  - Privatisation provides additional funds to the government.
  - Privatisation attracts foreign investment.
- Nationalisation is the opposite of privatisation.
  - It is the process whereby the state takes control and ownership of privately-owned assets and private enterprises.
  - Some argue that the state-owned enterprises e.g. ESKOM should be privatised.

3.4 Objectives of the public sector and its budgets

3.4.1 Objectives

Economic growth

- Refers 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 benefits its citizens because it often leads to a higher standard of living.

Full employment

- It is when all the people who want to work, who are looking for work must be able to get work.
- A high level of employment is 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.

Exchange rate stability

- Effective Fiscal and Monetary policy can be used to keep the exchange rate relatively stable.
- Depreciation and appreciation of the currency creates uncertainties for producers and traders and should be limited.
- The SARB changed the Exchange rate from a Managed floating to a Free floating exchange rate.

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Price stability

- Stable prices lead to better results in terms of job creation and economic growth.
- The SARB inflation target is 3% – 6% and have been successful in keeping inflation within this target.
- Interest Rates, based on the Repo Rate are the main instruments used to achieve price stability.
- A stable budget deficit also has a stabilizing effect on the inflation rate.

Economic equity

- 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 are basic education; primary health and to finance basic economic services. E.g. Cash Grant to the poor, e.g. child grants and cash grants to vulnerable people, e.g. disability grants.
- Progressive taxation means that the higher income earners pay higher/more tax.

3.4.2 Budgets

Definition

- It is a document with expected income and projected expenditure.
- The budget is the most important item on the economic calendar.
- The main budget is read in Parliament during February by the Minister of Finance.
- It is authorised in Parliament and signed by the President, and it becomes law.
- The financial year of the government runs from 1 April to 31 March the following year.
- The main source of income for the State is Revenue Tax.

Different types of budgets

- Medium Term Expenditure Framework (MTEF)
- The Minister of Finance delivers it in the last week of October.
- The Medium Term Budget Policy Statement (MTBPS) – the Minister of Finance informs Parliament of any changes that have occurred since February.
- The Medium Term Expenditure framework (MTEF) requires that the state sets budgets over a **three-year period**, consisting of rolling expenditure and revenue projections.
- This is set against the backdrop of economic and fiscal goals and prospects for the economy.

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The Main (national) Budget

- Is the statement of government's planned expenditure and anticipated income for the fiscal year.
- Minister of Finance finalises the budget.
- There are three considerations when setting up the budget:
  - Financial – Cabinet decides whether taxes have to be increased or decreased.
  - Economic – Cabinet must know the needs or requirements in the economy.
  - Political – Political parties use the budget to implement their policy.

The Provincial Budget

- They are the main beneficiaries from tax income collected by the government.
- Money paid to Provinces is based on **equitable share** and **conditional grants**.
- Each province set up its own budget and presents it to the provincial legislator.
- Financial year of provinces runs from 1 April – 31 March the following year.
- Equitable share formula is used to distribute revenue to the provinces:
  - Education (51%) – based on size of the school age population and the number of learners enrolled for the last 3 years.
  - Health (19%) – based on the portion of population who do not have access to basic medical services.
  - Basic Share (15%) based on each 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 output component (1%) – determined by the Province's contribution to GDP of the country.
- Provinces may levy taxes, duties, grants, fines and surcharges.
- Conditional grants: these are given to the provinces to promote national priority spending and to assist them in complying with national norms and standards.

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3.5 Fiscal policy

Fiscal policy can be defined as the action taken by government in respect of taxation, government spending and borrowing in order to influence economic activity.

3.5.1 Features

- **Goal bound**
  - Central government determines economic and social goals during the budgetary process.
  - The budget is used to realise these economic and social goals.
- **Demand biased**
  - Fiscal policy is the main demand-side policy.
  - The government improves infrastructure to support fiscal policy.
- **Cyclical**
  - Business cycles have an effect on fiscal policy decisions.
  - During an upswing profits increase, and as a result government income increases.

3.5.2 Composition

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

Expenditure

Government spending is classified in 2 main ways:

- **Functional classification:** Social; Protection; Economic; Interest; General.
- **Economic classification:** Current payments; Transfers and subsidies; Payment for capital assets.

Government spends money to provide public and merit goods and services free of charge or at a subsidised price.

- To pay interest on government debt.
- To redistribute income.
- To influence aggregate demand and supply.

Taxation

Government imposes 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 discourage imports
- To redistribute income
- To influence the level of aggregate demand and aggregate supply

Borrowing (State debt)

- The main budget must always balance. If there is a deficit, loans are made to balance it.
- If there is a surplus, the money is used to pay off state debt.
- Loans add to loan debt, also known as public debt.

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3.5.3 Effects

- **Income distribution**
  - Progressive tax system: Fiscal policy aims to achieve a more even distribution of income.
  - Regressive tax system: Fiscal policy causes an uneven distribution of income.
  - Proportional tax system: Fiscal policy uses this when it does not wish to disturb the existing distribution of income.
- **Consumption**
  - Direct and indirect taxes influence people's disposable income and spending patterns.
  - An increase in taxes will cause spending to decrease especially when savings are low.
- **Price level**
  - Direct tax reduces inflationary pressure.
  - A rise in indirect taxes will raise the general price level.
- **Disincentives/incentives**
  - High and progressive income tax rates discourage people from entering the labour market, from accepting promotions, and from working longer hours.

Laffer Curve

Figure 3.1 shows the relationship between tax rates and income tax in what is called the Laffer Curve.

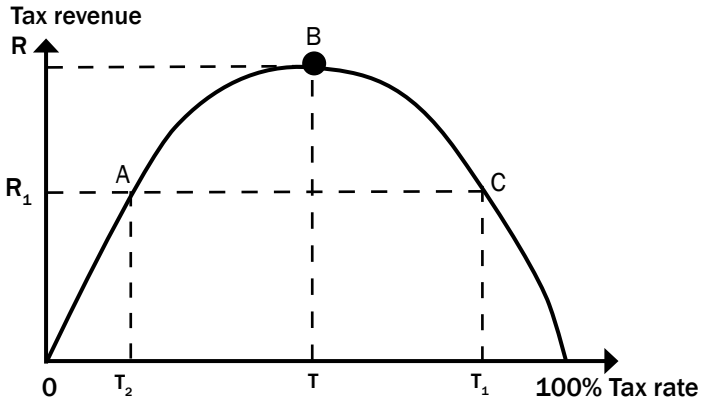

Figure 3.1 The Laffer Curve

The Laffer Curve shows the relationship between (income) tax rates and tax revenue.

- At point 0, average tax rate is 0 and tax revenue is 0.
- As the tax rate increases, the tax revenue will also increase up to a certain point. The curve will slope upward then peak at T.
- Maximum tax revenue is at point R (the peak) and the best tax rate is at point T.
- The state earns maximum revenue at point B.
- If the tax rate increases from T to T_1 then the tax revenue will decrease from R to R_1.
- People work less as a result of the higher tax rate.
- If taxation decreases to T_2, the government may receive less revenue, but people may have more money to save and spend.

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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

3.6.1 Characteristics/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.

3.6.2 Reasons

Public sector failure occurs when the public sector fails to provide goods and services to the people. There are many reasons for public sector failure. Some of these are:

Management failure

Ignorance, e.g. lack of leadership, experience and training, might result in the improvement of the welfare of someone at the expense of someone else.

Apathy

Government officials show little or no interest in delivering an efficient service to the public. There is no accountability. Corruption and poor service delivery are some of the symptoms of apathy.

Lack of motivation

Workers rarely receive incentives for successful service delivery, but are only monitored on inputs and correctly following procedures and processes. This might lead to limited services, high cost and low quality.

Bureaucracy

Bureaucrats tend to obey rules and regulations without judgement. They tend to be more interested in obeying the rules than the efficient delivery of goods and services to the people.

Structural weaknesses

Objectives are not met. Some objectives may work against each other, e.g. government redistributes income and wealth too aggressively.

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Special interest groups

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

3.6.3 Effects

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 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.

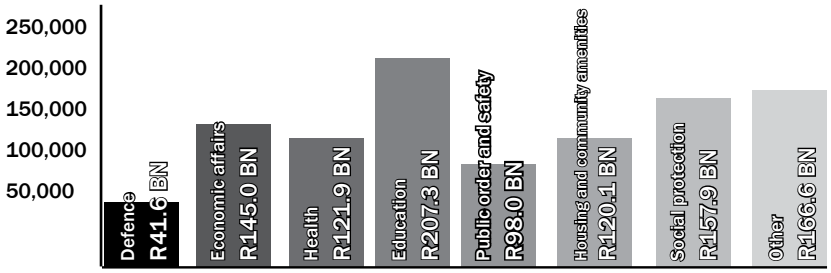
Social instability

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

Activity 1

Figure 3.2 below is a news article on the *National Budget 2012.* Study the information and answer the questions that follow.

HOW MUCH IS GOING TO BE SPENT?



IMPROVING THE QUALITY OF LIFE FOR ALL SOUTH AFRICANS

Over the long term, government aims to grow the economy so that all South Africans who wish to work can work. But given our history, it will take some time before we can reach this goal. and we urgently need to assist millions of South Africans who do not have access to an income, or who are otherwise vulnerable.

Poverty alleviation is at the heart of government's agenda. The social assistance programme is South Africa's most direct means of combating poverty. In 2012/13, R104.9 billion is allocated to social assistance, rising to R122.0 billion in 2014/15. The number of grant recipients will rise from about 15.6 million in 2011/12 to 16.1 million in 2012/13 and is set to rise to 16.8 million in 2014/15.

The Isibindi project will benefit 858 000 children and adolescents, with a focus on rural communities, orphans and child-headed households. About 10 000 youth workers will be employed in this programme.

The Department of Social Development receives an additional R1.4 billion over the next three years, mainly to increase access to early child development from 50 000 to 580 000 and to roll out an in-house and community-based childcare and protection programme (Isibindi).

Figure 3.2: A news article on the National Budget 2012

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1. To which economic concept does "***Improving the quality of life***..." refer to? (2)
2. From the extract, name **TWO** macroeconomic aims (objectives) reflected in the 2011/12 Budget. (2 × 2) (4)
3. Which **THREE** departments received the largest allocation according to the graph? (3 × 2) (6)
4. Give **TWO** reasons why government spent more on education in 2012 than last year. (4)
5. Name **TWO** priorities that are included in the money allocated for social protection. (2 × 2) (4)

[20]

Answers to activity 1

1. Economic development✓✓
2. Job creation✓✓ and economic growth✓✓
3. Education✓✓ Social protection✓✓ Administration✓✓
4. Infrastructure development✓✓ and increase in educators' salaries✓✓
5. Poverty relief✓✓ and skills development for orphans✓✓

[20]

Activity 2

Classify each of the following activities according to CENTRAL/NATIONAL; PROVINCIAL; LOCAL GOVERNMENT and PUBLIC CORPORATIONS.

1. Traffic control (1)
2. Denel (1)
3. SABS (1)
4. Inflation target (1)
5. Telkom (1)
6. RDP housing (1)
7. Education (1)

[7]

Answers to activity 2

1. Traffic control – Local✓
2. Denel – Public corporation✓
3. SABS – Public corporation✓
4. Inflation target – Central/National✓
5. Telkom – Public✓
6. RDP housing – Provincial✓
7. Education – Central/National✓✓

[7]

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Chapter 4

The foreign exchange market and the balance of payments accounts

The **foreign exchange market** (currency market) is an exchange market which determines the relative values of different currencies, and enables the conversion of currency to facilitate international trade.

The **balance of payments** (**BoP**) accounts record all financial transactions between a country and the rest of the world over a period of a year. They include export and import transactions, financial transfers and financial capital transactions.

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Overview

TOPIC	CONTENT	CONTENT DETAILS FOR TEACHING, LEARNING AND ASSESSMENT PURPOSES
4. Economic growth and develop-ment: Foreign exchange market (Globali-sation)	**Examine the foreign exchange market and the establishment of exchange rates and show how the balance of payments account is affected**	
	• **The main reasons for international trade** – **Demand reasons** – Size of population – Income levels – Change in the wealth of the population – Preferences and taste – The difference in consumption patterns – **Supply reasons** – Natural resources – Climatic conditions – Labour resources – Technological resources – Specialisation – Capital	• Give a brief discussion on the main reasons for international trade • Distinguish between the demand and supply reasons
	– **The effects of international trade** – Specialisation – Mass production – Efficiency – Globalisation	• Briefly discuss the effects of international trade • Give your opinion on the effects of international trade
	• **The balance of payments** – **Description/definition** – **The value of the BoP** – **Composition of the BoP** – The current account – The capital transfer account – The financial account – The reserve account	• Define the BoP • Explain the purpose/value of the BoP • Analyse and interpret the BoP • Give a brief overview of the subaccounts of the BoP **HOT QUESTION: 'It is often said that a BoP shows if a country is living within its means'. Evaluate this statement with regard to each section in the BoP**
	• **Foreign exchange markets** – **Description/definition** – **Supply and demand/Price formation** – **Appreciation and depreciation** – **Revaluation and devaluation** – **Interventions in the market**	• Define/Explain/Compare the relevant concepts • Draw/interpret graphs • Briefly discuss the demand and supply factors • Briefly discuss market intervention **HOT QUESTION: Draw a fully labelled graph that illustrates equilibrium in the foreign exchange market and predict the effects that changes in the underlying forces of supply and demand will have on the value of a currency**

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	• **The establishment of foreign exchange rates** – **Exchange rate systems** – Free floating exchange rate system – Managed floating exchange rate system – Fixed exchange rate system – **Terms of trade** – **Free trade and protection** – **South Africa's foreign trade** • **Corrections of BOP surplus and deficit (disequilibria)** – **Description/definition** – **Interest rates** – **Import controls** – **Borrowing and lending** – **Change in demand** – **Export promotion** – **Import substitution** – **Change in exchange rates**	• Define and explain the relevant concepts • Briefly discuss each exchange rate system • Briefly explain the concept terms of trade • Broadly outline the concepts free trade and protectionism • Broadly outline, analyse and interpret data on the composition of SA trade and trading partners • Evaluate South Africa's exchange rate system • **Assess South Africa's foreign trade in relation to its terms of trade, free trade and protection** • Explain the concepts: corrections and deficit/ disequilibria • Briefly discuss the different measures **HOT QUESTION: 'South Africa's BoP shows an overall deficit of R10 billion rand over three successive quarters this year.' Assume the biggest problem appears to be the current account. How would you advice the Governor of the Reserve Bank to reduce the deficit on the BoP?**

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4.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well.

Term	Definition
Absolute advantage	Where one country can produce goods or services cheaper than another
Balance of payments	A systematic record of all transactions between one country and other countries, e.g. between South Africa and all other countries in the world
Comparative advantage	A situation where one country has a relative advantage in the production of goods or services
Direct investment	Includes transactions relating to investment, e.g. investments in businesses
Exchange rate	The rate at which one currency is exchanged for another. It is also considered the value of one country's currency in terms of another country's currency
Free trade	When consumers and producers are free to buy goods and services anywhere in the world without any restrictions
International Monetary Fund (IMF)	An international organisation that lends money to countries with ongoing balance of payment problems
International trade	The exchange of goods or services across international borders
Net balance	Money that enters the country is offset against money that leaves the country
Portfolio investment	Buying and selling equities and debt securities, e.g. shares and bonds
Special Drawing Rights (SDR)	A financing instrument distributed among member countries of the IMF
Terms of trade	Compares a country's export prices with its import prices by means of indexes. The formula used to determine the terms of trade is: $\frac{\text{Index of export prices}}{\text{Index of import prices}} \times 100$ The terms of trade will improve when export prices increase of import prices decrease
Trade balance	The value of exports minus imports
Transfer payment	Money received without any productive service rendered, e.g. gifts

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4.2 The reasons for international trade

There are many reasons for **international trade.** Countries may have a surplus of some goods and a shortage of other goods, and they will trade in order to correct these imbalances. For example, South Africa has more minerals than it can use, but less oil than it needs. Certain goods are only produced in specific countries (e.g. French champagne) and the citizens of other countries may desire access to those goods. Droughts can severely damage the production of staple crops in a country resulting in the need to import crops to feed the population.

NB

Learn these five **demand** reasons for international trade.

Use the following word mnemonic to help you remember the 5 demand reasons:

P = Population → **P**eople
I = Income → **I**n
W = Wealth → **W**itbank
P = Preferences → **P**refer
C = Consumption → **C**offee

4.2.1 Demand reasons

- **The size of the population impacts demand.** If there is an increase in population growth, it causes an increase in demand, as more people's needs must be satisfied. Local suppliers may not be able to satisfy this demand.
- **The population's income levels effect demand.** Changes in income cause a change in the demand for goods and services. An increase in the per capita income of people results in more disposable income that can be spent on local goods and services, some of which may then have to be imported.
- **An increase in the wealth** of the population leads to greater demand for goods. People have access to loans and can spend more on luxury goods, many of which are produced in other countries.
- **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.
- **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.

4.2.2 Supply reasons

- **Natural resources** are not evenly distributed across all countries of the world. They vary from country to country and can only be exploited in places where these resources exist.
- **Climatic conditions** make it possible for some countries to produce certain goods at a lower price than other countries, e.g. Brazil is the biggest producer of coffee.
- **Labour resources** differ in quality, quantity and cost between countries. Some countries have highly skilled, well-paid workers with high productivity levels, e.g. Switzerland.
- **Technological resources** are available in some countries that enable them to produce certain goods and services at a low unit cost, e.g. Japan.
- **Specialisation** in the production of certain goods and services allows some countries to produce them at a lower cost than others, e.g. Japan produces electronic goods and sells these at a lower price.

NB

Learn these six **supply** reasons for international trade.

Use this word mnemonic to help you remember the 6 supply reasons:

R = Resources → **R**ich
C = Climate → **C**ountries
L = Labour → **L**ike
T = Technology → **T**o
S = Specialisation → **S**end
C = Capital → **C**hocolate

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- **Capital** allows developed countries to enjoy an advantage over under-developed countries. Due to a lack of capital, some countries cannot produce all the goods they require themselves.

4.2.3 The effects of international trade

- **Specialisation** increases the standard of living, especially when the area of specialisation is in great demand due to a shortage of supply, e.g. Angola has oil so it can specialise in oil products. Mozambique has no oil resources and cannot specialise in these resources.
- **Mass production** becomes possible if the domestic demand is added to foreign demand, e.g. manufacturing of cell phones.
- **Efficiency** increases when there is competition. Lower prices means that the same income can buy more goods and services.
- **Globalisation** is driven by international trade, e.g. trade in IT products and vehicles (cars and trucks).

NB

Learn these four **effects** of international trade.

Use this word mnemonic to help you remember the 4 effects of international trade:

S = Specialisation → **S**elling
P = Production → **P**roducts
E = Efficiency → **E**quals
G = Globalisation → **G**rowth

4.3 The balance of payments accounts

4.3.1 Definition

A systematic record of all transactions between one country and other countries, e.g. between South Africa and all other countries in the world.

4.3.2 The value of the balance of payments

Each country keeps a record of all its international transactions with the rest of the world. A country is said to have a BoP surplus when inflows are greater than outflows. An example of a BoP surplus on the current account would be when exports are greater than imports. A BoP deficit occurs when outflows are greater than inflows (imports are greater than exports).

NB

Learn these four **balance of payments** accounts.

4.3.3 Composition

The current account

The current account is the account in the BoP that records international transactions relating to production, income and expenditure.

In calculating the balance on the current account, 5 groups of items are taken into account. They are merchandise (goods), gold, services, income and current transfers.

The capital transfer account

The balance shown reflects the net amount of the capital transfer, either negative or positive. The balance is a net amount and includes firstly transactions and grants relating to the ownership of fixed assets, for example a grant by a foreign NGO for a housing project in South Africa, secondly, debt forgiveness, thirdly, the value of households and personal effects, and financial claims and liabilities of migrants.

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The financial account

The financial account shows records of investments by South Africans in other countries and by foreigners in South Africa.

These investments will include:

- **Direct investments:**
  Foreign direct investment (FDI) refers to investment in real estate (fixed property) and obtaining a meaningful share (10%+) or control of such business.
  E.g. USA Walmart's takeover of the local chain Massmart was a foreign direct investment of US$2.2 billion.
- **Portfolio investments:**
  Refers to the buying of financial assets such as shares in companies on the stock exchange of another country. These investments are highly liquid and their flows can be reversed at any time. Portfolio investment money is also known as 'hot money'.
- **Other investments:**
  Other investments are a residual category. Transactions that cannot be classified as direct investments, portfolio investments or reserve assets and liabilities are classified as other investments.
  Refers to other financial transactions not covered by FDI. Short term investment that flows in and out of a country, trade credits and short term loans.

The reserve account

The reserve account records changes to the amount of gold and foreign exchange reserves (Dollars, Pounds, Euros) held by the country. These changes are a reflection of the international transactions recorded in all the other accounts on the BoP.

South Africa's total gold and foreign exchange reserves are a stock item and are not shown in the reserve account. Only the changes to the gold and foreign reserves are shown.

Table 4.1 shows the latest available balance of payments from the Quarterly Bulletin from the South African Reserve Bank. You should be able to make certain assumptions from the data given, for example:

- Determine whether there was a surplus or deficit in one of the accounts.
- Identify possible reasons for funds flowing out of or into the country.

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South African Reserve bank: Balance of payment, annual figures in R millions									
	2004	2005	2006	2007	2008	2009	2010	2011	2012
Current account									
Merchandise exports, free on board[2] ..... (5000J)	281 827	331 338	412 220	497 618	655 759	503 656	565 860	671 220	696 180
Net gold exports[3] ..... (5001J)	28 698	27 023	35 470	39 898	48 534	52 776	59 499	75 298	71 050
Service receipts ..... (5002J)	63 425	71 808	82 643	97 110	105 351	100 760	102 362	107 825	124 332
Income receipts ..... (5680J)	20 973	29 550	41 207	48 448	48 254	34 075	34 099	38 118	48 501
Less: Merchandise imports, free on board[2] ..... (5003J)	311 759	360 362	476 966	573 850	739 852	554 161	598 151	730 128	842 775
Less: Payments for services ..... (5004J)	66 420	77 197	96 623	115 934	138 885	124 147	134 843	142 230	145 006
Less: Income payments ..... (5681J)	48 823	60 975	75 982	117 266	122 129	87 593	87 022	104 689	118 508
Current transfers (net receipts+) ..... (5006J)	–10 869	–15 680	–15 768	–16 575	–18 906	–22 428	–16 762	–14 199	–31 369
Balance on current account ..... (5007J)	–42 948	–54 495	–93 799	–140 551	–161 874	–97 062	–74 958	–98 785	–197 595
Capital transfer account (net receipts +) ..... (5682J)	338	193	205	197	208	216	225	241	239
Financial account[4]									
Direct investment									
Liabilities[5] ..... (5640J)	5 155	42 270	–3 567	40 120	74 403	45 465	8 993	30 808	37 540
Assets[6] ..... (5656J)	–8 721	–5 916	–41 058	–20 896	25 888	–9 757	554	1 865	–35 867
Net direct investment ..... (5683J)	–3 566	36 354	–44 625	19 224	100 291	35 708	9 547	32 673	1 673
Portfolio investment									
Liabilities ..... (5644J)	46 262	36 188	144 501	97 485	–71 540	107 234	107 876	45 878	94 655
Assets ..... (5660J)	–5 946	–6 123	–15 044	–24 026	–63 325	–13 470	–33 374	–62 223	–40 002
Net portfolio investment ..... (5684J)	40 316	30 065	129 457	73 459	–134 865	93 764	74 502	–16 345	54 653
Other investment									
Liabilities ..... (5650J)	10 944	32 735	60 750	58 711	47 730	–39 956	65 736	43 005	65 736
Assets ..... (5666J)	–3 555	–22 895	–38 823	2 119	82 983	23 703	–22 138	–13 444	40 368
Net other investment ..... (5685J)	7 389	9 840	21 927	60 830	130 713	–16 253	–14 239	29 561	106 104
Balance on financial account ..... (5688J)	44 139	76 259	106 759	153 513	96 139	113 219	69 810	45 889	162 430
Unrecorded transactions[7] ..... (5686J)	35 999	12 306	16 627	34 657	91 593	664	36 229	85 359	43 881
Change in net gold and other foreign reserves owing to balance-of-payments transactions ..... (5020J)	37 528	34 263	29 792	47 816	26 066	17 037	31 306	32 704	8 955
Change in liabilities related to reserves[8] ..... (5021J)	2 949	2 577	–5 453	–7 631	–7 761	–2 724	–2 683	7	16
SDR allocations and valuation adjustments ..... (5022J)	–10 617	11 003	23 350	5 642	74 214	–38 647	–30 712	74 441	24 141
Net monetisation(+)/demonetisation(–) of gold ..... (5283J)	84	–226	163	169	158	45	13	42	11
Change in gross gold and other foreign reserves . (5023J)	29 944	47 617	47 852	45 996	92 677	–24 289	–2 076	107 194	33 123
Memo item: Change in capital transfer and financial accounts including unrecorded transactions ..... (5687J)	80 476	88 758	123 591	188 367	187 940	114 099	106 264	131 489	206 550

Table 4.1 Balance of payments *Quarterly Bulletin September 2013*

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4.4 Foreign exchange markets

A foreign exchange rate is the price of one country's currency in terms of another. It is expressed (quoted) as the domestic price of one unit of a foreign currency, for example, $1=R10.00.

In South Africa, the forex market is known as the interbank foreign exchange market. It does not have a physical location or corporate form, such as the Johannesburg Stock Exchange (JSE). It is a worldwide practice, transactions are done electronically by computers, in writing by e-mail, fax or letter or by phone.

4.4.1 Definition: Foreign exchange markets

A foreign exchange market is a market engaged in the buying and selling of foreign exchange. The leading markets are in London, New York and Tokyo.

4.4.2 Supply and demand

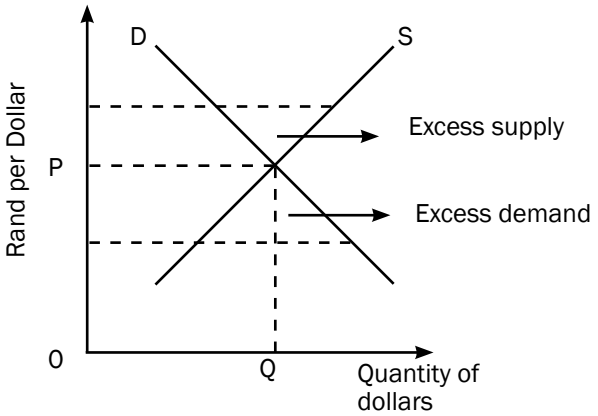

Figure 4.1: The interaction of demand and supply in establishing the rate of exchange

A demand for dollars exists when, for example, South African importers wish to exchange rands for dollars to pay for goods/services to be imported from the United States of America. On the other hand, the holders of dollars seek to exchange dollars for rands when, for example, the American importer wants to pay for goods/services to be imported from South Africa.There might be an excess supply or excess demand for dollars when the price rises above or falls below the market price of QP (see Figure 4.1).

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FACTORS THAT WILL INFLUENCE DEMAND AND SUPPLY	
Demand factors for foreign exchange	**Supply factors of foreign exchange**
• Importing goods • Payment for services from foreign countries • Buying shares in another country • Tourists spending money overseas • Repayment of debt borrowed from foreign countries	• Exporting goods • Providing services to foreign countries • Receiving dividends on shares invested in foreign countries • Inflow of foreign capital • Expenditure of money by foreign tourists • Raising new loans in foreign countries

Table 4.2 Factors that will influence demand and supply of foreign exchange

4.4.3 Appreciation and depreciation

Appreciation of a country's currency is an increase in the price of the currency in terms of another currency due to market forces. For example when the dollar goes from $1 = R9 to $1 = R10, then the dollar has appreciated.

Depreciation of a currency is a decrease in the price of the currency in terms of another country's currency due to market forces. For example if the dollar goes from $1 = R9 to $1 = R8, then the dollar has depreciated against the rand.

4.4.4 Revaluation and devaluation

Revaluation of a currency refers to the deliberate increase in the value of the currency in terms of another currency. (As a result of central bank intervention.) This occurs under a fixed exchange system.

Devaluation of a currency refers to the deliberate decrease in the value of the currency in terms of another currency. (As a result of central bank intervention).

4.4.5 Intervention in the market

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.

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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 Establishment of foreign exchange rates

4.5.1 Exchange rate systems

Every country manages the value of its currency by determining the exchange rate system that will apply to its currency. There are numerous exchange rate systems. Among these are:

Free floating exchange rates

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

Managed exchange rates

These are exchange rates which are allowed to respond to market forces within certain limits.

Fixed exchange rates

Currencies are devaluated and revaluated. The gold standard backed the value of the currency to a certain amount of gold. South Africa stepped off the gold standard in 1932.

4.5.2 Terms of trade

- The terms of trade compare a country's export prices with its import prices by means of indexes. The formula is:

Index of export prices/Index of import prices × 100

Item	2008	2009	2010	2011	2012	2013
Index	105,3	113,7	122,0	124,7	123	121.4
% Change	0,0	8,0	7,3	2,2	–1,7	–1,6

Table 4.3 South Africa's terms of trade (excluding gold) *(SARB QB)*

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- South Africa's terms of trade index increased at high rates in 2009 and 2010. If the numerical value indexes increase, it is said that the terms of trade have improved. If the numerical value decreases, it is said that the terms of trade have deteriorated.
- **An improvement in the terms of trade may be the result of the following:**
  - An increase in export prices
  - A decrease in import prices
- **A deterioration in the terms of trade may be the result of the following:**
  - A decrease in export prices
  - An increase in import prices

4.5.3 Free trade and protection

- **Free trade** – Happens when producers and consumers are free to buy goods and services anywhere in the world without interference from a government.
- **Protection** – Limits the extent of trade between countries. For example limiting imports.

4.5.4 South Africa's foreign trade

- South Africa has a relatively open economy. Foreign trade is approximately 30% of the GDP, which means that the economy at large is sensitive to changes in the terms of trade.
- The composition of our exports and imports in Table 4.4 shows that mining and manufacturing will be more sensitive in terms of trade than, for instance agriculture.

Trade	Agriculture	Manufacturing	Mining
Exports	4,02%	50,29%	45,69%
Imports	1,54%	82,53%	15,92%

Table 4.4 Composition of South Africa's' foreign trade (2010) (SAIRR SAS)

- Table 4.5 shows that South Africa's trade is almost equally divided between countries of the East and West or countries from the North and South.

	Africa	Europe	NAFTA	Asia	Other
Imports %	7,9	33,9	8,5	44,2	6,5
Exports %	14,7	27,4	9,7	45,3	2,9
Total R billion	130,8	352,7	104,6	448,4	113,7

Table 4.5 South Africa's trade with the world (2010) (SAIRR SAS)

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4.6. Corrections of the balance of payments

Balance of payments disequilibria exist when the outflow of foreign currency continuously exceeds or is less than the inflow of foreign currency. You will remember that a deficit on the balance of payments implies that the outflow of foreign currency exceeds the inflow of foreign currency while a surplus exists when the outflow is less than the inflow.

A way to correct balance of payments disequilibrium lies in earning more foreign exchange through more exports and reducing imports.

The following are methods that can be used to correct the deficit or surpluses on the balance of payments.

4.6.1 Lending and Borrowing

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 International Monetary Fund (IMF).

Borrowing is nevertheless not a long-term solution for fundamental balance of payments disequilibrium.

4.6.2 Change in exchange rate

Currency depreciation or devaluation makes imports more expensive for domestic consumers and exports cheaper for foreign buyers. For example, when the rand depreciates, South African goods (exports) become cheaper for foreign buyers. Imports become more expensive for South Africans.

4.6.3 Change in demand

The following four instruments are used in various countries to restore the equilibrium:

Long-term policies – 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, for example, government incentives to produce goods domestically rather than to import them. The South African government favours export promotion.

Interest rates – Domestic demand can be changed by changing interest rates. If interest rates are increased spending, including on imports, decreases. Foreign traders will try to take advantage by increasing their investment in the country with the higher interest rate. The opposite happens when interest rates are decreased.

Import control – They include import tariffs, other duties and quotas. The WTO is trying to phase them out for the sake of trade liberalisation.

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Exchange control – There are domestic regulations that allow central banks to ration foreign exchange. Earners of foreign exchange are compelled by law to hand it over to the central bank. Those who require foreign exchange have to apply to the central bank.

Activity 1

Study Figure 4.2 concerning international trade and answer the questions that follow.

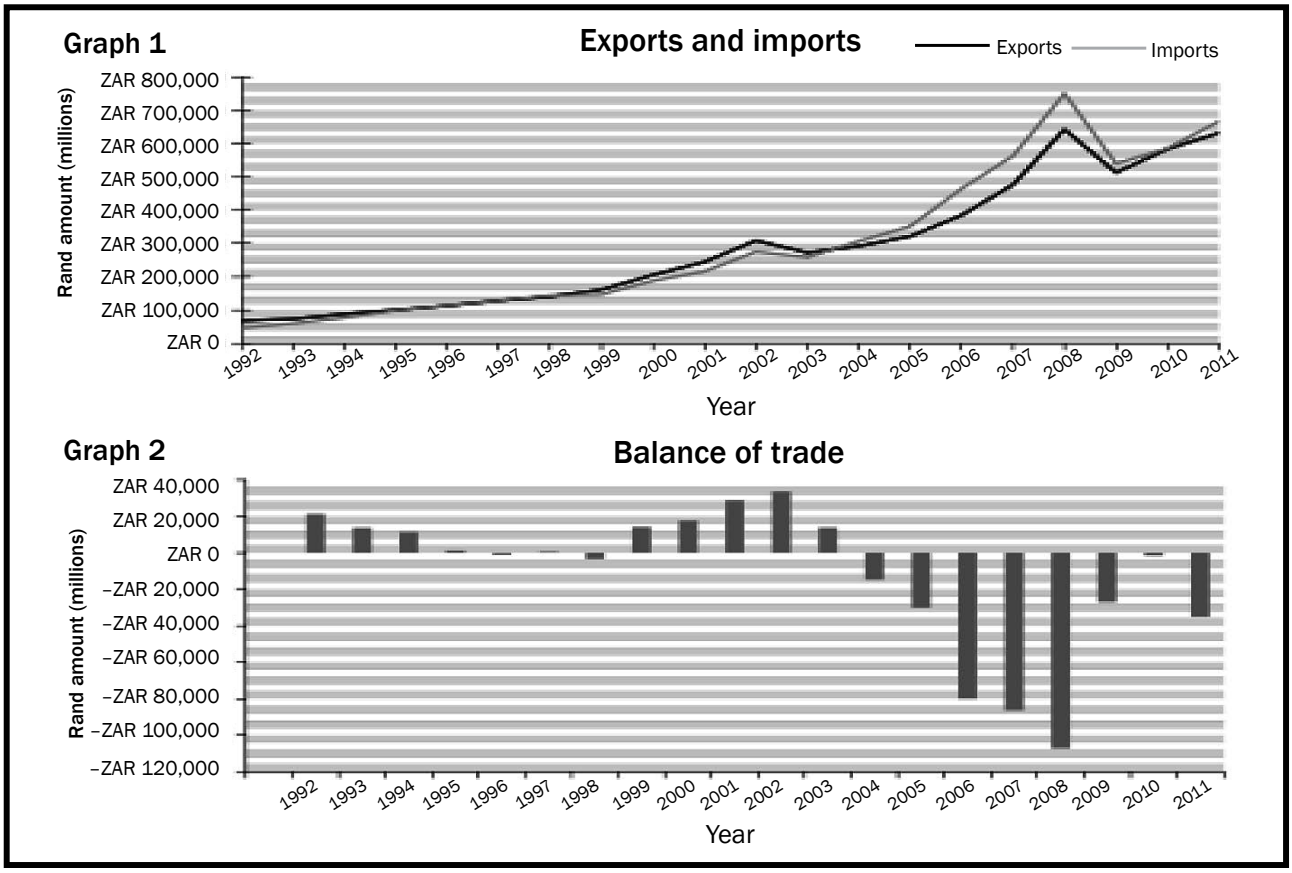

Figure 4.2 International trade

1. What does graph 1 depict? Supply a reason for your answer. (2)
2. Define the term balance of trade. (3)
3. Does the balance of trade in 2008 indicate a positive or a negative balance? (2)
4. Estimate the balance of trade for 2008. (4)
5. What effect did the closing of textile factories in South Africa have on the balance of trade? (3)
6. Which economic trend in 2009 contributed to the decline in imports and exports? (2)

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Answers to activity 1

1. It depicts the difference between the imports and exports.✓✓ (2)
2. It is the value of exports minus the value of imports.✓✓✓ (3)
3. Negative balance✓✓ (2)
4. Approximately 600 000 – 700 000✓✓ = –100 000✓✓ (2)
5. A negative effect✓ because there was an increase in imports✓✓ (3)
6. Global recession✓✓ (2)

[16]

Activity 2

Study Table 4.2 which shows the balance of payments extract and answer the questions that follow:

BALANCE OF PAYMENT – ANNUAL FIGURES – R millions	2009	2011
Balance of current account	–97 062	–98 785
Capital transfer account (net receipts)	216	241
Financial Account:		
Direct investment (net)	35 708	**B**
Portfolio investment (net)	93 764	–16 345
Other investment (net)	–16 253	29 561
Balance on financial account	**A**	45 889
Unrecorded transactions	664	85 359
Change in gross gold and other foreign reserves	–24 289	107 194

Source: Quarterly Bulletin, SARB. March 2012.

Table 4.2 Balance of payments for 2009–2011

1. Define the concept balance of payments. (2)
2. Calculate the missing figures in A and B. (4)
3. What does 'net figures' indicate in the financial account? (2)
4. Give TWO examples of income receipts earned by South African residents. (4)
5. Briefly explain how balance of payments disequilibria can be corrected. (6)

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Answers to activity 2

1. This is a systematic record of all transactions between one country, e.g. South Africa and all other countries in the world.✓✓ (2)
2. A = R113 219 million✓✓ B = R32 673 million✓✓ (4)
3. Money that enters the country is offset against money that leaves the country. ✓✓ (2)
4. Income earned by South Africans working in other countries, e.g. a South African teaching in Dubai.✓✓ ✓✓
   When South Africans receive dividends on the shares they hold in foreign companies.✓✓ (4)
5.
   - Borrowing money from the IMF✓✓
   - Policies of export promotion and import substitution✓✓
   - Increase in aggregate supply will reduce prices. Exports are promoted through cheaper prices.✓✓
   - Higher interest rates help to decrease spending on imports.✓✓ (any 3 × 2) (6)

[18]

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Chapter 5

Protectionism and free trade

Protectionism refers to government policies and regulations (such as restrictive quotas and tariffs on imported goods), which are designed to benefit local producers of goods and services in their competition with imported goods, thus helping them to survive.

Free trade occurs where government creates very few barriers to international trade. This allows the free flow of goods and services into the country from any other country that can produce these goods cheaper, better, or in the required volumes.

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Overview

TOPIC	CONTENT	CONTENT DETAILS FOR TEACHING, LEARNING AND ASSESSMENT PURPOSES
5. Economic systems: Protection and free trade (Globalisation)	**Discuss protectionism and free trade and evaluate the South African international trade policies and major protocols in terms of the following:**	
	• **Export promotion** – **Definition** – **Reasons** – **Methods** – **Advantages** – **Disadvantages**	• Define/explain the concept • Discuss export promotion in detail
	• **Import substitution** – **Definition** – **Reasons** – **Methods** – **Advantages** – **Disadvantages**	• Define/explain the concept • Discuss import substitution in detail **HOT QUESTION: Evaluate the effectiveness of the application of the policies of export promotion and import substitution**
	• **Protectionism (the arguments)** – **Definition** – **Arguments in favour of protectionism** – Industrial development – Infant industries – Stable wage levels and high standard of living – Increased employment – Self-sufficiency and strategic industries – Prevention of dumping – Stable exchange rates and BoP – Protection of natural resources	• Define/explain the concept • Discuss arguments in favour of protectionism in detail • Broadly outline the concept free trade and protectionism
	• **Free Trade (the arguments)** – **Arguments in favour of free trade** – Specialisation – Economy of scale – Choices/increased welfare – Innovations/best practice – Improved international relations	• Define/explain the concept • Discuss free trade in detail **HOT QUESTION: Argue a case in favour of protectionism and against free trade, OR in favour of free trade and against protectionism**
	• **A desirable mix** – **Import substitution and export promotion** – **Protection of free trade** – **Globalisation** – **Economic integration**	• Explain in your own words the meaning of a desirable mix • Briefly outline economic integration as part of trade protocols **HOT QUESTION: How does globalisation impact on the desirable mix of South Africa?**

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	• **Evaluate South Africa's trade policies** – **Import substitution and export promotion** – **Protection and free trade** – Southern African Custom Union (SACU) – Multilateral Monetary Area (MMA) – Southern African Development Community (SADC) – African Union (AU) – European Union (EU) – Mercusor – AGOA – The partnership between South Africa and China – Brazil, Russia, India, China and South Africa (BRICS) – **Trade Liberalisation** – World Trade Organisation (WTO)	• Explain the meaning of the concept protocol • Briefly evaluate the South African policies in terms of protectionism and free trade • Briefly evaluate South Africa's trade protocols in terms of their benefits • Explain the concept • Broadly outline the role of the World Trade Organisation in trade liberalisation

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5.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide.

Term	Definition
BRICS	An association of emerging economies consisting of Brazil, Russia, India, China and South Africa set up to promote co-operation, policy coordination and political dialogue in international, economic and financial matters
disinvestment	Withdrawal of capital investment from a company or country
embargo	An official state ban on trade or other activities with a particular country
export promotion	Incentives to encourage the production of goods that can be exported. It is part of South Africa's international trade policy
Free trade	When producers and consumers are free to buy goods and services from anywhere in the world without the interference of government
import substitution	Goods that were previously imported are replaced with locally produced goods. It is part of South Africa's international trade policy
Mercosur	An organisation to promote free trade amongst Argentina, Brazil, Paraguay and Uruguay
New Partnership for African development (NePad)	Provides for regional cooperation and integration among African states
Protection	A trade policy whereby the state discourages the importing of certain goods and services in order to protect local industries against unequal competition from abroad
Southern African Development Community (SADC)	An economic and monetary union comprising Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, SA, Swaziland, Tanzania, Zambia and Zimbabwe, which allows imports from member states to qualify for duty-free access to other member states
Sanctions	A penalty applied by one or more countries on another country
trade liberalisation	The abolition of government intervention in trade flows on both the import and the export side
World trade Organisation (WTO)	The international organisation that was created to monitor and liberalise international trade
Protocol	The established code of procedure or behaviour in any group or organisation. The official procedure governing affairs of state, e.g. cultural activities and international affairs

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5.2 Export promotion

5.2.1 Definition

Export promotion involves providing incentives to encourage local businesses to produce goods for export.

5.2.2 Reasons for export promotion

Some of the reasons for export promotion are:

- The country achieves significant export-led economic growth.
- Export promotion enlarges the production capacity of the country.
- Export markets are much bigger than local markets.
- More workers will be employed.
- Prices will be reduced.

5.2.3 Methods of export promotion

Methods used to support export promotion include:

- **Incentives:** The government supplies information on export markets, research on new markets, concessions on transport charges, export credit, etc. in order to stimulate exports.
- **Subsidies:** These include direct and indirect subsidies:
  - Direct subsidies: Cash payments to exporters.
  - Indirect subsidies: Refunds on import tariffs and general tax rebates.
- **Trade neutrality:** Subsidies equal in size to import duties, are paid. Neutrality can be achieved through trade liberalisation.

5.2.4 Advantages of export promotion

The advantages of export promotion include:

- There are no limitations to size and scale of market.
- Production is based on cost and efficiency.
- There is increased domestic production.
- Exchange rates would be realistic.

5.2.5 Disadvantages of export promotion

The disadvantages of export promotion include:

- The real cost of production is reduced by subsidies and incentives.
- Incentives and subsidies reduce prices and force competitors out of the market. This leads to a lack of competition.
- Export promotion results in increased tariffs and quotas by powerful overseas competitors.
- Export promotion results in the protection of labour-intensive industries by developed countries.

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5.3 Import Substitution

5.3.1 Definition

Import substitution is part of South Africa's international trade policy. It occurs when locally produced goods replace goods that had previously been imported. This has a positive impact on the balance of trade.

5.3.2 Reasons for import substitution

Reasons for import substitution include the following:

- **Diversification:** when goods that were previously imported are produced locally domestic manufacturing expands and an economy becomes less reliant on foreign countries.
- **Industrialisation is promoted**: the development of new industries to produce previously imported goods can increase tax revenues and create jobs.
- **Balance of payment problems:** if the deficit on the BoP is too high, a decrease in imports can help to rectify this.
- **Trade:** developing countries' reliance on natural resources as a basis for growth and development limits their ability to grow. If these resources are used to produce goods and services which can be used domestically or exported, economic growth might be increased.

5.3.3 Methods of import substitution

The government imposes certain measures to restrict the amount of imports into the country and to support local industries. Restrictive measures used to reserve the domestic market for local manufacturers are:

- **Tariffs:** Customs duties or import duties are taxes on imported goods. They can be ad valorem (based on the value) or specific to certain goods. Prices of imported goods increase for domestic consumers, and they tend to shift demand from imports to domestic products (goods).
- **Quotas:** Limits are put on the supply of goods and services. Supply is reduced and prices rise. Foreign enterprises benefit if demand for their products remains high.
- **Subsidies:** They enable relatively high cost domestic enterprises to undercut more efficient foreign enterprises in the domestic market.
- **Exchange control:** Government reduces imports by limiting the amount of foreign exchange made available to those who wish to import.
- **Physical control:** A complete ban or embargo is imposed on the import of certain goods from a particular country.
- **Diverting trade:** Monetary deposits, time-consuming customs procedures and high-quality standards are imposed to make the importing of goods more difficult.

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5.3.4 Advantages of import substitution

Some of the advantages of import substitution are:

- **Increased employment:** More local workers are employed. This stimulates the economy and GDP increases.
- **More choice:** Available foreign exchange can be used for other imports, thus increasing choices.
- **Diversification:** By producing more goods locally, the range of available goods increases, and the country becomes less vulnerable to foreign actions and conditions.

5.3.5 Disadvantages of import substitution

Some of the disadvantages of import substitution for the local economy are:

- **Capital and entrepreneurial talent:** This is drawn away from comparative advantage.
- **Technology borrowed from abroad:** This may be unsuitable for local production.
- **Competitiveness of certain sectors decreases:** Where comparative advantages exist.
- **Import substitution leads to demand for protection:** This demand comes from industries that provide inputs to local industries.

5.4 Protection

Many economists argue for protection, especially for developing countries. Many other economists insist that free trade is the best way to regulate markets. Governments often choose a mix of selected protectionist and free trade policies that suit the particular conditions of their country.

5.4.1 Definition of protection

A trade policy whereby the state discourages the importing of certain goods and services in order to protect local industries against unequal competition from abroad

5.4.2 Arguments in favour of protection

- **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.
- **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.
- **Stable wage levels and higher standards 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.
- **The protection of job opportunities:** If local industries cannot find profitable markets because of cheaper imports, production may decrease and this will lead to more unemployment.
- **Economic self-sufficiency and strategic key industries:** In times of conflict, cut-off or friction between countries occurs. Protection

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should be granted, especially to key industries to ensure the availability of these key products.

- **Dangers 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.
- **Stabilise exchange rates and balance of payments:** 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.
- **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.

5.5 Free trade

5.5.1 Definition of free trade

When producers and consumers are free to buy goods and services from anywhere in the world without the interference of government.

5.5.2 Arguments in favour of free trade

- **Specialisation:** The theory of comparative advantage shows that world output can be increased if countries specialise in what they are relatively best at producing. If each nation does what it does best, everyone will enjoy lower prices and higher levels of output.
- **Economies of scale:** Free trade allows economies of scale to be maximised and thus unit cost are reduced. Economies of scale are a source of comparative advantage.
- **Choice:** Free trade allows consumers the choice of what to buy from the whole world, and not just what is produced domestically. Consumers' welfare is thus increased because some consumers at least will prefer to buy foreign goods rather than domestic goods.
- **Innovations:** Free trade increases competition and this encourages innovation in goods and processes.
- **Improves global efficiency:** Under free trade, resources are allocated more efficiently as markets expand, because each country specialises in its most effective production.
- Free trade leads to **greater world production** of traded goods, leading to an increase in economic welfare.
- Free trade leads to **mutual gains** from international trade to all countries.

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5.6 A desirable mix of protection and free trade

5.6.1 Import substitution and export promotion

The strategies of Import substitution and export promotion should not be regarded as unavoidable opposites. Many countries started out by protecting their domestic industries and then applied export-orientated policies only after a considerable length of time. Import substitution almost inevitably leads to export promotion.

5.6.2 Protection and free trade

Regionalisation, in the form of trade blocks, makes use of free trade and protection. Member countries pursue free trade with one another but apply trade restrictions outside their block. (Free trade area, e.g. NAFTA and Custom unions, e.g. Mercusor)

5.6.3 Globalisation

Restrictive practices, whether they relate to imports or to exports have the same effect – they reduce the potential volume of world production that would be possible if there was complete free trade and only those goods for which countries had comparative advantage were produced. To pursue this objective of free trade, an independent facilitator was required. The WTO is such a facilitator.

5.6.4 Economic integration

Some of these trade protocols that focus on economic integration are:

- **Free trade areas** (**FTAs**) – Member countries agree to the removal of all tariffs. Each member country is still permitted to maintain its own level of trade protection against non-member countries.
- **Customs unions** – Member countries agree to the removal of all tariffs. However, in a custom union, member countries all set and maintain the same external restrictions on non-member countries.
- **Common markets** – Are a form of economic integration that satisfies all the requirements of a customs union but also allows for the free movement of factors of production between member countries.
- **Economic unions** – Meet all the requirements of a common market, but go further which results in member countries establishing a single authority responsible for joint economic policy making, a single monetary system, one central bank, a unified fiscal system and a common foreign economic policy.

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5.7 Evaluation of South Africa's trade policies

5.7.1 Export promotion and import substitution

South Africa's export promotion policy unfolds as follows:

Export promotion

- **1970's** – measures such as cash grants, tax concessions on export turnover and profits and rail freight concessions were introduced in order to reduce costs for manufacturers of goods with export potential.
- **1980's** – some quotas were removed and replaced with tariffs. Export subsidies were introduced. A list of importers that needed approval replaced a list of imports that did not need approval.
- **1985** – When the US banks refused to roll over import guarantees, South Africa declared a debt standstill and unilaterally restructured the payment of its foreign loans. The rand depreciated substantially and surcharge of 10% on imports was introduced. This led to the effective protection rate increase from 30% to 70%.
- **1990's** – the General Export Incentive Scheme (GEIS) was introduced for the purpose of encouraging the production of value-added exports. For the first time the official policy stance was one of export-orientated industrialisation.

South Africa's Import substitution policy unfolds as follows:

Import substitution

- **Tariff protection** – in 1910 the Cullinan Commission was appointed to investigate the feasibility of establishing a domestic manufacturing industry in South Africa. Tariffs were introduced by the Customs Tariff Act of 1914 and provided protection for local manufacturing industries. In 1925 a new act was implemented and the 'South Africa first campaign' was introduced. South Africa thereby introduced an official inward-looking policy.
- **The Second World War** – Iscor (now Arcelor Mittal) was established as a strategic industry in 1928, in time to take advantage of the opportunities brought about by the Second World War. The SWW stimulated manufacturing and industrial development in general. This was because SA was isolated from many imports and had to produce many products itself.
- **Export ready** – After the SWW it was accepted that import substitution was the best policy to enhance economic growth. Sasol was established in 1955 to produce oil from coal. From the mid-1960's, import substitution reached a mature phase when manufacturing increasingly focused on intermediate and capital production. Domestic demand was the main stimulus. However large markets were essential for these goods and necessitated exports. South Africa was ready for an export promotion policy. SA manufacturing sector's contribution to GDP increased from 5,8 in 1912 to 31,1% in 1981. Import substitution had indeed been successful.

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5.7.2 Protection and free trade

The Customs Union Agreement of 1910 was the origin of the Southern African Customs Union (SACU). This is one of the world's oldest customs unions. The members of the SACU are: South Africa, Lesotho, Namibia, Botswana and Swaziland. The Common Monetary Area (CMA) – made up of South Africa, Lesotho and Swaziland – was replaced with the Multilateral Monetary Area (MMA) in 1992 and was joined by Namibia. Various protocols have been signed with the **African Union (AU)** and Southern African Countries, including the **Southern Africa Development Community (SADC)** and the **Africa Free Trade Zone (AFTZ)**. Since 1994 South Africa also made significant progress towards strengthening bilateral ties with its main trading partners and free trade areas (FTAs). They include the EU, Asian Free Trade Area (AFTA), Asian countries – in various combinations and BRICS.

5.7.3 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.

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6 Chapter

The dynamics of perfect markets

A **perfect market** is characterised by perfect competition. The conditions that result in perfect competition include:

- Equal access to the technology required for production
- No barriers to entry or exit from the marketplace
- Accurate and available market information
- No participant with the power to set the market price
- According to equilibrium theory, a perfect market will reach an equilibrium where the quantity supplied equals the quantity demanded at the market price

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Overview

MAIN TOPIC: MICROECONOMICS		
TOPIC	**CONTENT**	**CONTENT DETAILS FOR TEACHING, LEARNING AND ASSESSMENT PURPOSES**
6. Dynamics of markets: Perfect markets	**Examine the dynamics of perfect markets with the aid of cost and revenue curves** hint 1. Review cost and revenue tables and curves done in Grade 11. 2. Differentiate between the short and long run. • **Perfect competition** – **Description** – **Characteristics/conditions** • **Individual business and industry** – **The demand curve for:** – Individual business – The industry – **Profit maximization** – **Derivation of supply curve from cost curves** • **Market structure** – **Definition** – **Characteristics** – Number of businesses – Nature of product – Entrance – Control over prices – Information – Examples – Demand curve – Economic profit – Collusion – Allocative efficiency – Technical efficiency • **Output, Profits, Losses and Supply** – **Individual business** – Short run (economic profit, economic loss, normal profit) – Long run (normal profit) – Shut-down/closing down – **The industry** – Short-run (economic profit, economic loss, normal profit) – Long run (normal profit)	**HOT QUESTION: Examine in detail how cost and revenue curves can be used to illustrate and explain the dynamics (working) of markets** • Explain the concept • Examine the characteristics of a perfect market in detail • Compare the individual businesses to the industry in detail • The examination of individual business and industry should be accompanied by an analysis of tables and graphs **HOT QUESTION: Explain why the individual maize, wheat or milk farmer does not have an influence on the price of their products in the market** • Define the concept • Compare and contrast the FOUR broad types of market structures hint As the various market structures are discussed in detail, all characteristics will feature. • Examine in detail the THREE equilibrium positions with the aid of graphs • Explain shut-down/closing down point with the aid of a graph hint When teaching the various equilibrium positions a link must be made between individual businesses and the industry.

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	• **Competition policies** – **Description** – **Goals with the competition policy** – **Anti-monopoly policy** – **Competition Policy, Act 89 of 1998** – Competition Commission – Competition Tribunal – Competition Appeal Court	**HOT QUESTION: Draw three fully labelled graphs showing the possible equilibrium positions of a business operating under perfect market conditions** • Define/explain the policy • Briefly discuss/analyse the goals of the SA competition policy • Briefly analyse the SA Anti-monopoly policy • Briefly discuss the Competition policy Act and its implications highlighting the roles of the key institutions • Give your opinion about the successes/ failures of the Competition policy Act **HOT QUESTION: In your opinion is the competition policy in South Africa destroying or saving businesses?**

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6.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well.

Term	Definition
Economic loss	When total costs are greater than total revenue. When average revenue is lower than average cost the firm makes an economic loss
Economic profit	Profit that is made in addition to normal profit. When average revenue is greater than average cost the firm makes an economic profit
Explicit cost	Actual expenditure of business, e.g. wages and interest
Implicit cost	Value of inputs owned by entrepreneur and used in the production process (forfeited rental, interest + salary)
Long run	The period of production where all factors can change. The time is long enough for variable and fixed factors to change
Market	An institution or mechanism that brings together buyers and sellers of goods or services
Market structure	How a market is organised
Monopolistic competition	A market structure in which businesses have many competitors, but each one sells a slightly different product (e.g. CD's and books)
Monopoly	Exclusive control of a commodity or service in a particular market
Normal profit	The minimum earnings required to prevent an entrepreneur from leaving the industry. When average revenue equals average cost the firm makes a normal profit
Oligopoly	A market structure controlled by a small group of businesses
Perfect competition	A market structure with large numbers of producers and buyers
Price taker	Has no influence on price. Takes price that is determined by the market
Short run	The period of production where only the variable factors of production can change while at least one factor is fixed
Shut-down point	Business will close where MC = AVC
The Competition Appeal Court	An institution whose main functions is to review orders made by the Competition Tribunal and amend or confirm these orders
The Competition Commission	An institute that investigates restrictive business practices, abuse of dominant positions and mergers in order to achieve equity in the South African economy
The Competition Tribunal	An institution whose main function is to approve large mergers, adjudicate in the case of misconduct and issue orders on matters presented to it by the Competition Commission

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NB

It is important to review production, cost and revenue concepts covered in Grade 11. This is vitally important for the understanding of cost and revenue curves for the different market structures which you will study in this section.

6.2 Review of production, costs and revenue

Production takes place in the short run and the long run

- **Short run**
  The short run is the period of production where only the variable factors of production can change. The time period is too short to permit the number of firms in the industry to change.
- **Long run**
  The long run is the period of production where all factors can change. The time is long enough for variable and fixed factors to change. It allows enough time for new firms to enter the industry and/or existing firms to exit.

Total Product/Output	Total product is the maximum output that the firm can produce with the given number of fixed and variable inputs at its disposal	
Marginal Product/Output	Marginal product is the additional unit of output which is produced as one more unit of the variable input (labour) is combined with the fixed input	$MP = \frac{\Delta TP}{\Delta Q}$
Average Product/Output	Average product of a variable input shows the contribution that each labourer makes towards production	$AP = \frac{P}{Q}$
Fixed Costs (indirect costs/overhead costs)	Costs that remain the same even if the output changes. Examples are rent, depreciation, insurance	
Variable Costs (direct costs/prime costs)	Costs that change according to changes in output. E.g. wages the cost of raw materials, electricity etc.	
Total cost	The cost/remuneration for all the factors of production used in the production process	$TC = FC + VC$
Marginal costs	Marginal cost is the amount by which total cost increases when one extra product is produced	$MC = \frac{\Delta TC}{\Delta Q}$
Average cost	Average cost is the cost per unit of production	$AC = AFC + AVC$ or $\frac{TC}{Q}$
Average fixed cost	To calculate average fixed costs, we divide fixed costs by the amount of goods produced	$AFC = \frac{FC}{Q}$
Average varible cost	To calculate average variable costs, we divide variable costs by the amount of goods produced	$AVC = \frac{VC}{Q}$
Total Revenue	Total revenue is the total income received from the sale of goods or services	$TR = P \times Q$
Marginal revenue	Marginal revenue refers to the extra amount of income gained by selling one more unit of production	$MR = \frac{\Delta TR}{\Delta Q}$
Average revenue	Average revenue refers to the amount a firm earns for every unit sold	$AR = \frac{TR}{Q}$

Table 6.1: Review of production, costs and revenue

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Summary of costs

Cost schedule for Kael's Pie shop							
Q	TFC	TVC	TOTAL COSTS	AFC = $\frac{TFC}{Q}$	AVC = $\frac{TVC}{Q}$	(ATC = AFC + AVC) or $\frac{TC}{Q}$	MC = $\frac{\Delta TC}{\Delta Q}$
0	120	0	120	–	–	–	
10	120	100	220	12	10	22	10
20	120	160	280	6	8	14	6
30	120	210	330	4	7	11	5
40	120	280	400	3	7	10	7
50	120	400	520	2,4	8	10,4	12
60	120	600	720	2	10	12	20
70	120	910	1 030	1,7	13	14,7	31

Table 6.2: Summary of costs

The following sketches should resemble the shape for the above cost curves.

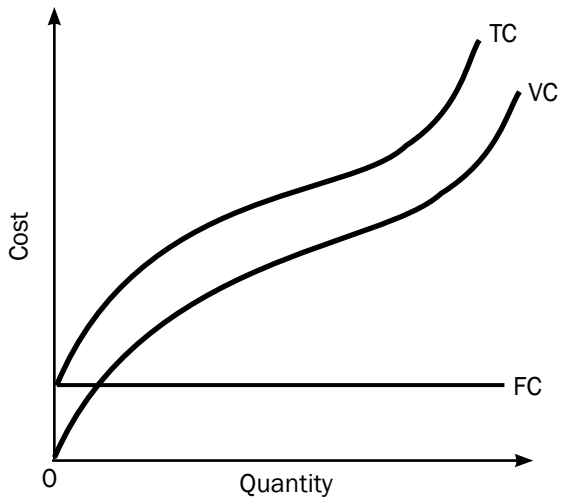

Figure 6.1 a): Total and variable cost

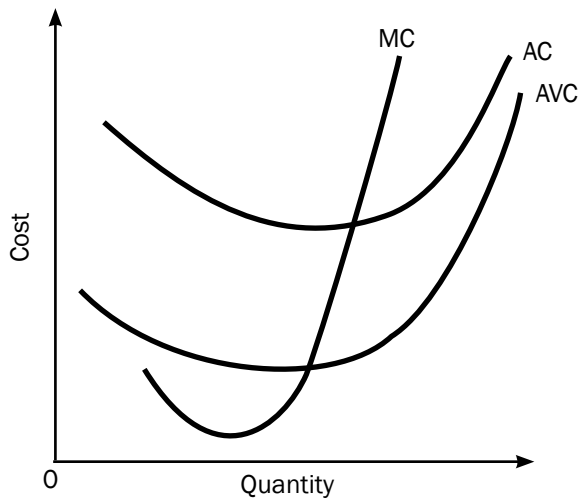

Figure 6.1 b): Marginal and average variable cost

Important observations

- The difference between the total cost and variable cost is the fixed cost
- TVC curve starts from 0 and TC starts from the fixed cost curve on the Y- axis.
- The gap between the AC curve and the AVC curve gets smaller as output increases.
- The MC Curve will always cut the AC and AVC curves at their minimum points.

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6.3 Perfect competition

Perfect competition occurs in a market structure with a large number of participants who have access to all required information about the market place and are all price-takers. Prices are determined by demand and supply. Examples of market structures demonstrating most conditions of a perfect competition include the stock exchange, the foreign exchange market, the central grain exchange, and agricultural produce markets.

A perfect market is a market where no single buyer or seller has a noticeable influence on the price of a good. This gives a true reflection of the scarcity value of goods and services.

6.3.1 Characteristics/conditions of a perfect market

Products must be homogenous (i.e. identical)

- Products must be identical. There should be no differences in style, design and quality.
- In this way products compete solely on the basis of price and can be purchased anywhere.

There should be a large number of buyers and sellers

- It should not be possible for one buyer or seller to influence the price.
- When there are many sellers the share of each seller in the market is so small that the seller cannot influence the price.
- Sellers are price takers, they accept the prevailing market price. If they increase prices above the market price, they will lose customers.

No preferential treatment/discrimination

- Collusion occurs when buyers and sellers make an agreement to limit competition. In a perfect market no collusion takes place.
- Buyers and sellers base their actions solely on price, homogenous products fetch the same price and therefore no preference is shown for buying from or selling to any particular person.

Free competition

- Buyers must be free to buy whatever they want from any firm and in any quantity.
- Sellers must be free to sell what, how much and where they wish.
- There should be no State interference and no price control.
- Buyers should not form groups to obtain lower prices, nor should sellers combine to enforce higher prices.

Efficient transport and communication

- Efficient transport ensures that products are made available everywhere.
- In this way changes in demand and supply in one part of the market will influence the price in the entire market.
- Efficient communication keeps buyers and sellers informed about market conditions.

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All participants must have perfect knowledge of market conditions

- All buyers and sellers must be fully aware of what is happening in any part of the market.
- Technology has increased competition as information is easily obtained via the internet.

Free access to and from markets

- Producers may enter and leave a market with little interference.
- Entering and leaving a perfect market is easy as less capital is required and there are fewer legal restrictions.

The factors of production are completely mobile

- They can move freely between markets.

In reality there are few perfect markets, however there are some sectors such as mining (e.g. gold) and agriculture (e.g. maize) where many of the conditions are met. These sectors illustrate the way in which the market mechanism works.

6.4 The individual business and the industry

6.4.1 Determining the market price

To determine the market price for a firm under perfect competition you need to draw two graphs next to each other. On the left is the graph for the industry and on the right is the graph for the firm (individual producer).

- Figure 6.2 a) (the industry) shows the interaction of demand and supply (market forces).
- The market forces are in equilibrium at the point of intersection of the demand and supply curves, at "e".
- At equilibrium the quantity demanded is equal to the quantity supplied. This determines the market price.
- Now look at Figure 6.2 b) (firm or individual producer). One producer will not be able to influence the market price and has to accept the market price (P_1), he is a price taker.
- Because this is the only price the producer can charge, the demand curve for the producer is a straight line drawn at price P_1.
- This horizontal line at the market price (P_1) is the demand curve (DD), the average revenue (AR) curve and the marginal revenue (MR) curve.

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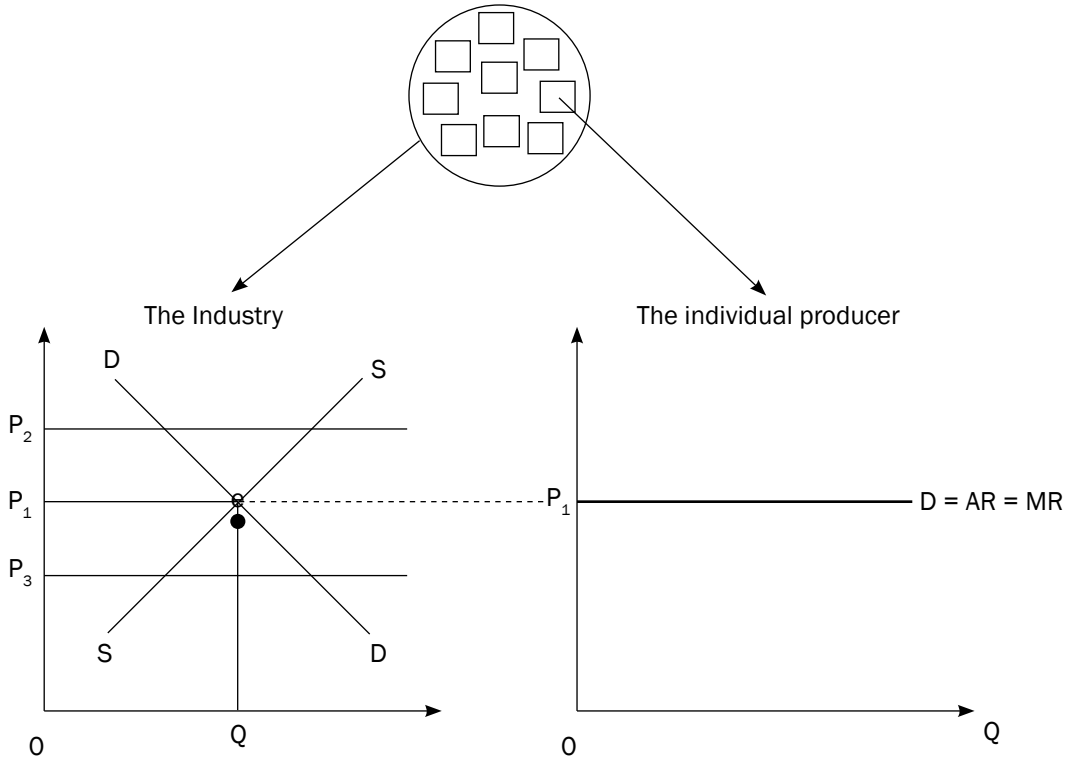

Figure 6.2 a): Industry

Figure 6.2 b): Individual producer

6.4.2 Demand curve for an individual producer

The individual producer is a price taker and sells goods at the market price. At this price, demand remains constant. A higher price such as P_2 cannot be charged as customers will be lost to other producers.

A lower price such as P_3 cannot be charged as a small profit or a loss will be made.

Quantity	Price (P)	Total Revenue	Marginal Revenue $MR = \frac{\Delta TR}{\Delta Q}$	Average Revenue $AR = \frac{TR}{Q}$
0	5	0	5	5
1	5	5	5	5
2	5	10	5	5
3	5	15	5	5
4	5	20	5	5
5	5	25	5	5
6	5	30	5	5

*Table 6.3: depicting the **DEMAND, MARGINAL REVENUE** and **AVERAGE REVENUE** for an individual producer in a perfect market.*

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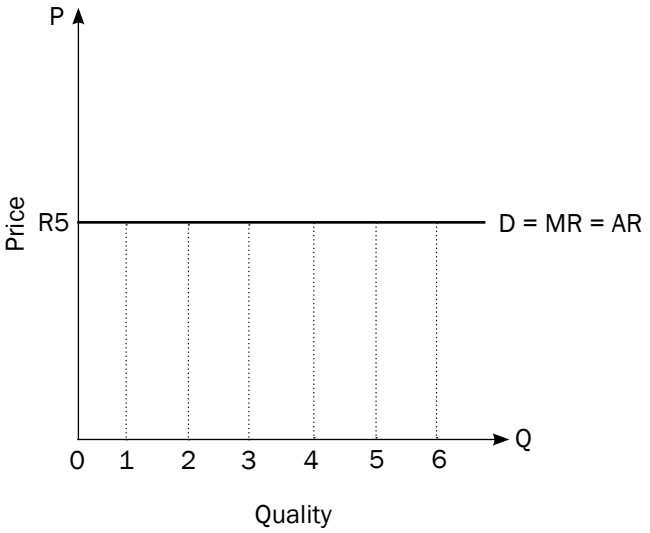

Figure 6.3: The demad curve for the individual producer

6.4.3 Profit maximisation

Occurs in 2 ways:

1.

Quantity	Price	Marginal Revenue	Marginal Cost	Contribution to profits
1	5	5	2	3
2	5	5	3	2
3	5	5	4	1
4	**5**	**5**	**5**	**0**
5	5	5	6	-1
6	5	5	7	-2

Table 6.4: Depicting profit maximisation

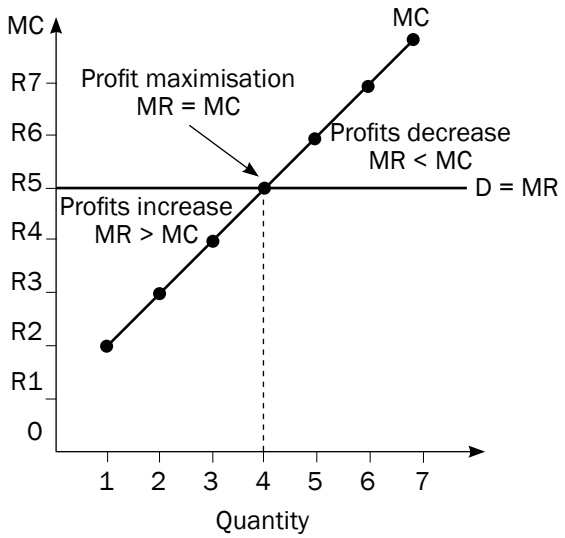

Figure 6.4: The marginal cost curve for the individual producer

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- At all pionts where MR is above MC, the firm is adding to profit. From unit 1-3, the firm is increasing its profit.
- At all points where MC is above MR, the firm is decreasing profit. From unit 5-7, the firm's profit will decrease.
- The firm maximises profit where MR = MC. The firm maximises its profits at unit 4.

2.

Quantity	Price	Total Revenue	Total Cost	Profit (Difference between revenue and cost)
0	5	0	1	–1
1	5	5	3	2
2	5	10	6	4
3	**5**	**15**	**10**	**5**
4	**5**	**20**	**15**	**5**
5	5	25	21	4
6	5	30	28	2

Table 6.5: Depicting Profit Maximisation

- If TC > TR the business makes a loss. If TR > TC it makes a profit.
- Maximum profit is achieved at units 3 and 4.
- Once the maximum profit is achieved, profits start to decrease with the next unit of output.
- Therefore the firm will not produce more than 4 units.

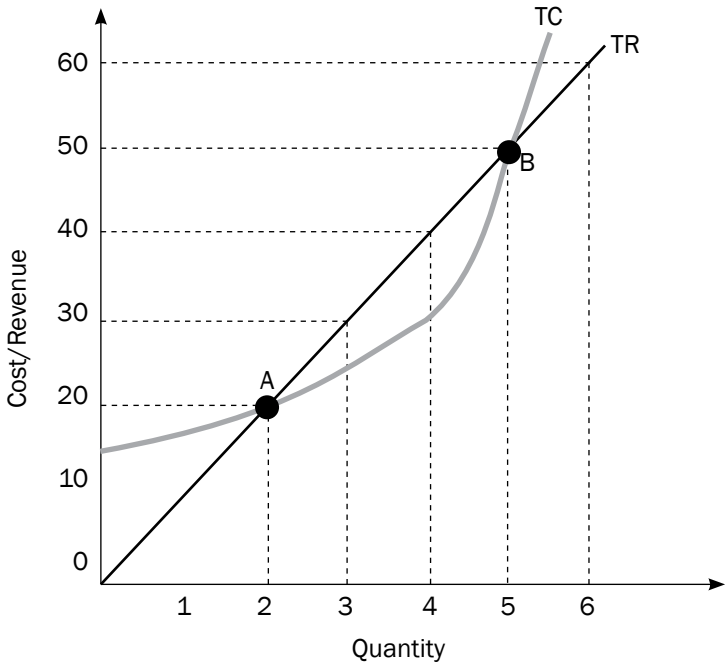

Figure 6.5: Profit maximisation

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Interpretation of graph:

- At all points where TR is above TC, the firm is making a profit.
- At all points where TC is above TR, the firm is making a loss.
- The gap between TR and TC represents profit.
- Profit is maximised when the gap between TR and TC is the greatest. This is occurs at between 3 and 4 units.

6.5 Market structures

There are FOUR different **market structures**:

- Perfect competition
- Monopolistic competition
- Oligopoly
- Monopoly

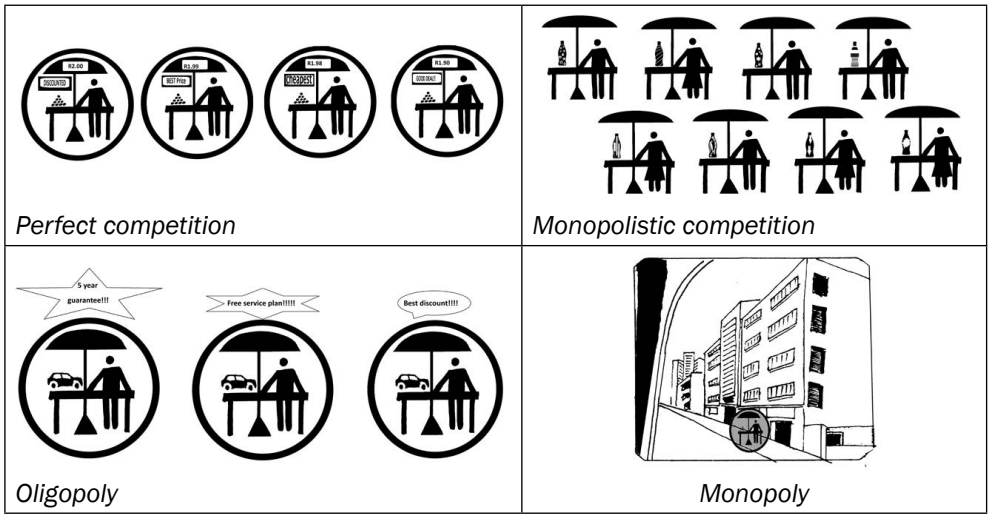
Table 6.6 shows the 5 broad characteristics which distinguish the four market structures:

As you study each market structure in detail, you will be able to identify more distinguishing characteristics.

Characteristic	Perfect competition	Monopolistic competition	Oligopoly	Monopoly
Number of businesses	Enough that a single business cannot influence the market price	A very large number	So few that each business must take the actions of the others into account	One business
Nature of product	Homogenous (same kind)	Differentiated, e.g. cool drinks	Homogenous or differentiated	Unique product without any close substitutes
Market entry	Completely free	Free	From free to restricted	Blocked
Control over price	None	Few	Considerable, but less than with a monopoly	Considerable
Information	Complete	Incomplete	Incomplete	Complete
Examples	International commodity markets, e.g. gold and oil	Fast-food outlets	Petrol and oil markets	Eskom

Table 6.6: The characteristics of different market structures

The illustration below shows the four different market structures:



Perfect competition *Monopolistic competition* *Oligopoly* *Monopoly*

Figure 6.6: The four different market structures

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6.6 Output, profit, losses and supply

6.6.1 The individual business

Short term equilibrium position

NB

When Average Revenue is above Average cost the firm makes an ECONOMIC PROFIT.

1. Economic profits

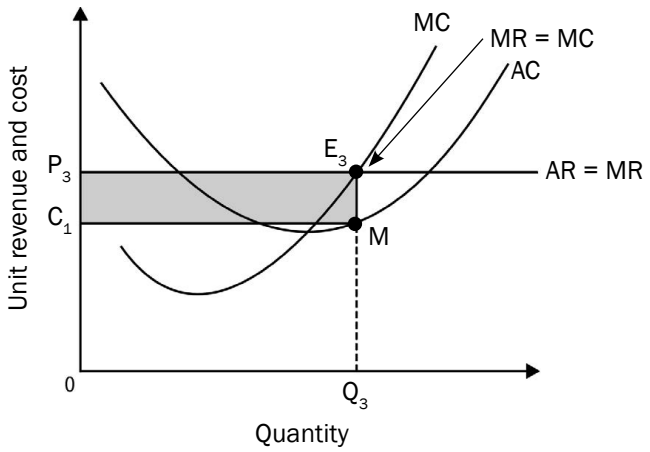

Figure 6.7: Economic profits

- Given a market price of P_3, profit is maximised where $MR = MC = P_3$.
- This occurs at a quantity of Q_3.
- At Q_3 the firm's average revenue (AR) per unit of production is P_3,
- The average cost per unit is C_1 which is lower than the price of P_3.
- The firm is making an economic profit per unit of production of $P_3 - C_1$.

Another explanation

- Total revenue equals $P_3 \times Q_3$, therefore total revenue is represented by the area $OP_3E_3Q_3$.
- Total cost equals $C_1 \times Q_3$, this is represented by the area OC_1MQ_3.
- The difference between these two areas is the economic profit which is represented by the light grey shaded area $C_1P_3E_3M$.

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2. Economic Losses

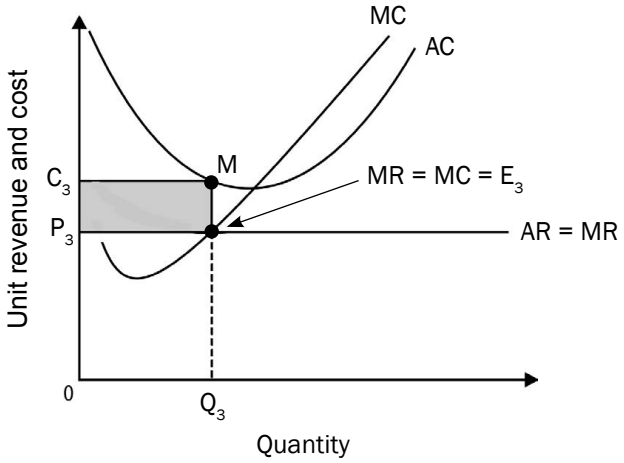

Figure 6.8: Economic losses

- Given a market price of P_3, profit is maximised where MR = MC at point E_3.
- This occurs at a quantity of Q_3.
- At Q_3 the firm's average revenue (AR) per unit of production is P_3,
- The average cost per unit is C_3 which is higher than the price of P_3.
- The firm is making an economic loss per unit of production which is equal to the difference between C_3 and P_3.

Another explanation.

- Total revenue equals $P_3 \times Q_3$, therefore total revenue is represented by the area $OP_3E_3Q_3$.
- Total cost equals $C_3 \times Q_3$, this is represented by the area OC_3MQ_3.
- The difference between these two areas is the economic loss which is represented by the light grey shaded area $C_3P_3E_3M$.
- Whether the firm should continue production would depend on the level of AR (that is P_3) relative to the firm's average variable cost.

NB

When Average Revenue is below Average Cost the firm makes an ECONOMIC LOSS.

3. Normal profits

- A firm makes normal profits when total revenue (TR) equals total costs or when average revenue (AR) equals average cost (AC).
- Normal profit is the maximum return the owner of a firm expects to receive to keep on operating in the industry.

NB

When Average Revenue equals Average Cost the firm makes a NORMAL PROFIT.

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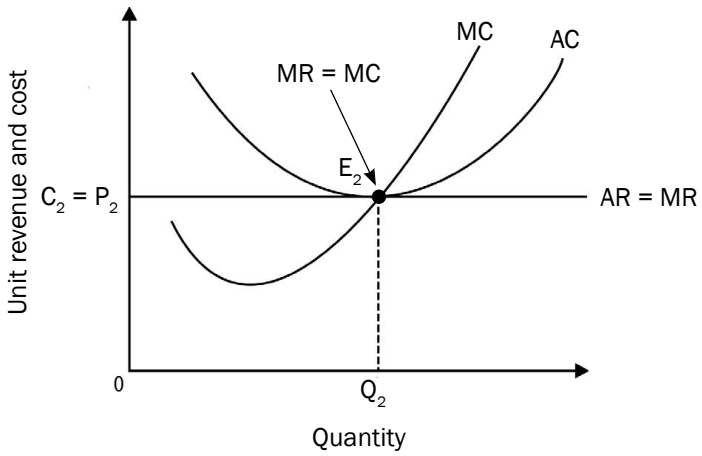

Figure 6.9: Normal profits

- Given a market price of P_2, profit is maximised where MR = MC = P_2.
- This occurs at a quantity of Q_2.
- At Q_2 the firm's average revenue (AR) per unit of production is P_2, which is also equal to the average cost per unit C_2 (AC).
- Since AR = AC, the firm earns a normal profit since all its costs are fully covered.
- Point E_2 is usually called the break-even point.

Another explanation

- Total revenue equals P_2 x Q_2, therefore total revenue is represented by the area $OP_2E_2Q_2$.
- Total cost equals $C_2 \times Q_2$, this is represented by the area $OP_2E_2Q_2$.
- Since Total revenue equals Total Cost the producer makes a normal profit.

NB

The individual business can make an economic profit, economic loss or normal profit in the Short Run. They are referred to as short run equilibrium positions.

In the long run the individual business will always make normal profit.

6.6.2 The industry

The long term equilibrium for the industry and the individual firm

The impact of entry and exit on the equilibrium of the firm and industry

- Profits are a signal for the entry of new businesses.
- Losses are a signal for businesses to leave the market.
- The long-term equilibrium in the perfect market will be influenced by the entry or exit of individual businesses.

a) Entry into the apple market

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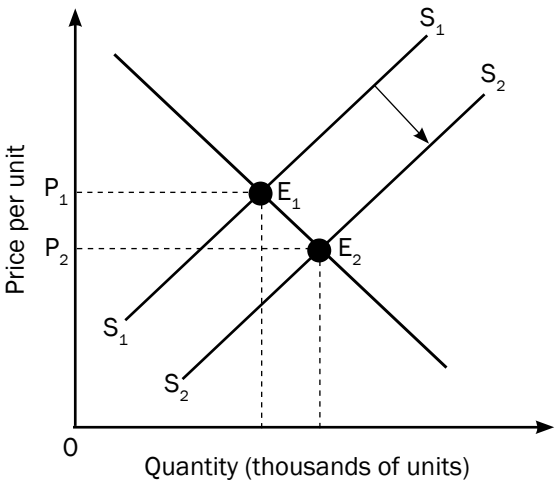

Figure 6.10 a): The industry

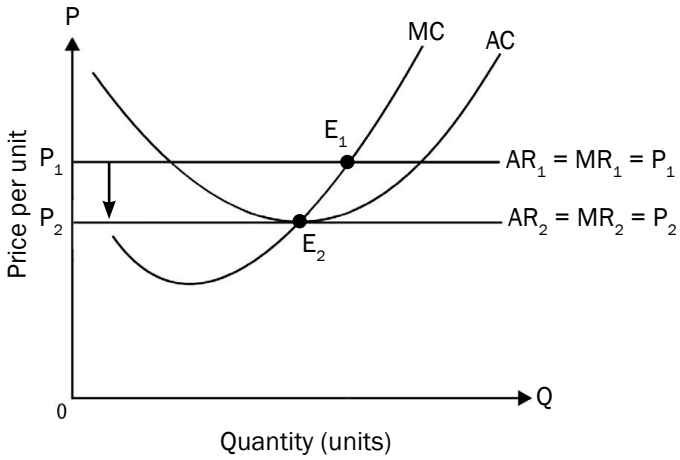

Figure 6.10 b): The firm

- If individual farmers are earning an economic profit at P_1.
- New farmers will enter the market, more apples will be supplied.
- The market supply curve will shift to the right from S_1 to S_2.
- The Equilibrium price will drop from P_1 to P_2.
- Individual farmers will then earn normal profits. There will be no further reason for new farmers to enter the market. The industry is in equilibrium.

b) Exit from the apple market

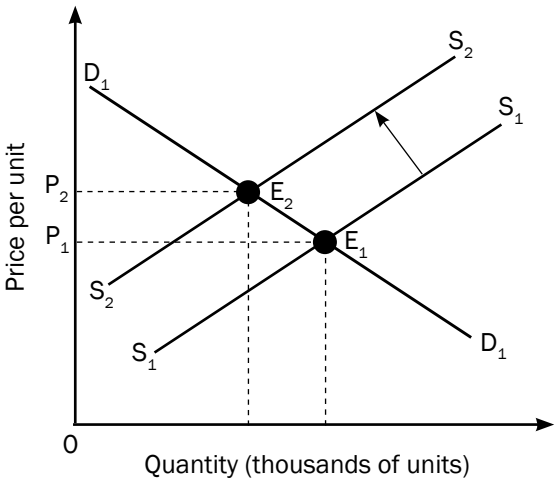

Figure 6.11 a): The industry

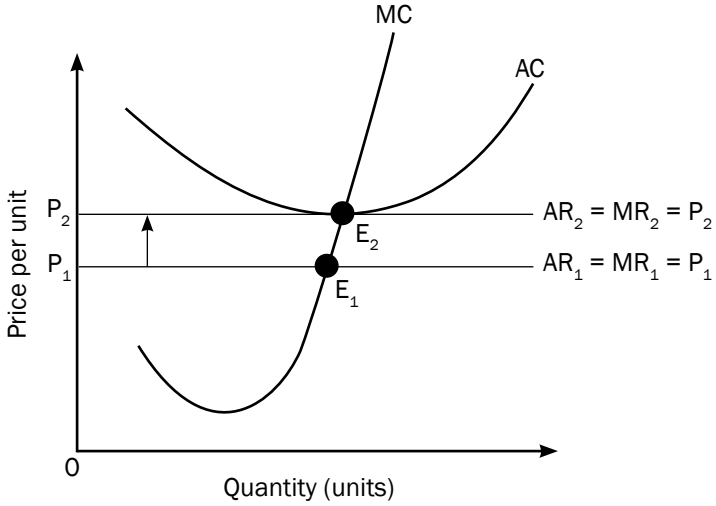

Figure 6.11 b): The firm

- If individual farmers are making economic losses, some farmers may leave the industry.
- When a few farmers leave the market, fewer apples will be supplied. The market supply curve will shift to the left from S_1S_1 to S_2S_2.
- The equilibrium price will increase from P_1 to P_2. Individual farmers will then earn normal profits. There will be no reason for individual farmers to leave the market.
- Therefore in a perfect market the long term equilibrium is achieved when individual firms earn a normal profit.

c) Longterm equilibrium – normal profit

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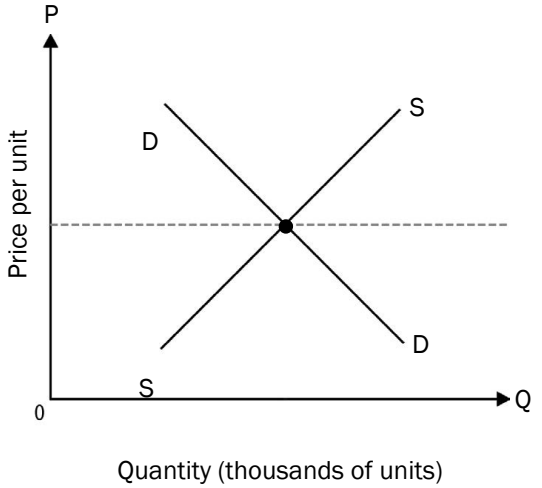

Figure 6.12 a): The industry

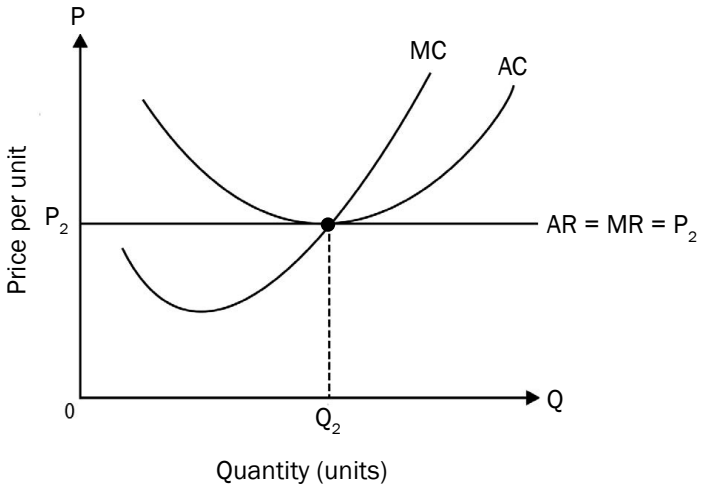

Figure 6.12 b): The firm

6.6.3 The supply curve of an individual firm

The short-run supply curve of an individual producer is that part of the marginal cost curve that is above the minimum average variable cost. This starts from shut-down point upwards. Below the shut-down point, the firm will not sell any goods. A firm will sell goods if the price is above the shut-down price level. This is shown in Figure 6.13 below:

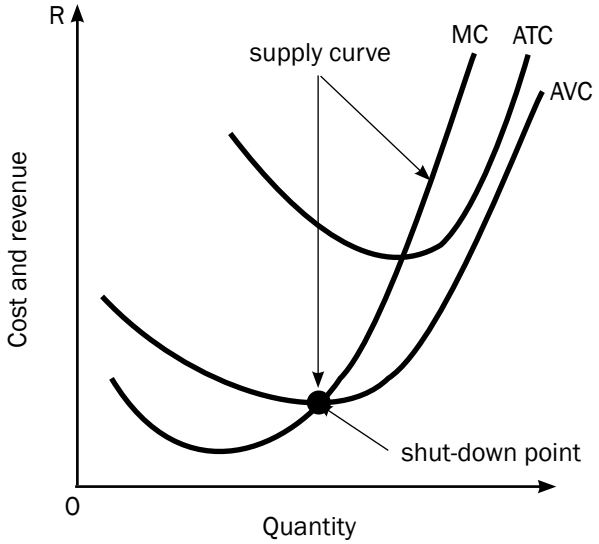

Figure 6.13: The supply curve of an individual firm

6.6.4 Shut-down/closing down point

Shut-down point

A firm will shut down if it cannot meet its average or total variable costs.

Hence we conclude that:

ACTUAL SHUT-DOWN should only take place when:

- TR < TVC
- AR < AVC

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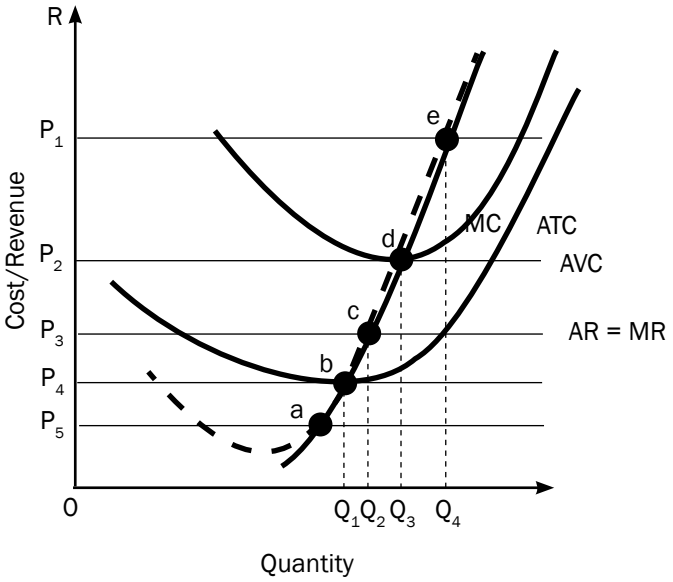

Figure 6.14: The shut-down/closing down point

- **Point a:** a firm will not produce here because AR < AVC
- **Point b:** it is the lowest price that the firm will charge (shut-down point). It represents the beginning of the supply curve.
- **Point c:** the firm is making an economic loss. Because AR < AC. The loss is minimised because the firm produces where MR = MC.
- **Point d:** the firm is making normal profit (breaking even) because AR = AC.
- **Point e:** the firm is making economic (supernormal) profits because AR > AC.

6.7 How to draw graphs to show various equilibrium positions

First draw your TWO axes: **Price (P)** on the vertical axis and **Quantity (Q)** on the horizontal axis. Remember, they meet at the **origin (0)**. Note that the labelling of the axes is not the same for all graphs.

In showing the various equilibrium positions the following sequence should be followed.

1. Draw the demand curve followed by the Marginal revenue curve, (in a perfect market D = MR = AR).
2. Then draw the AC curve.
3. Then draw the MC curve which must cut the AC curve at its minimum point.
4. Identify profit maximising point. MC = MR
5. Determine quantity (drop a line from the profit maximizing point to the x-axis).
6. Determine price (extend line upwards from the profit maximizing point to the demand curve) and then extend the line horizontal to the y-axis.
7. Compare AR/price to AC to determine profit or loss.

Everything is important – do not leave out anything! Each step counts for marks. Label all axes, curves and graphs.

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6.8 Competition policies

6.8.1 Description

Competition refers to the existence of free entry into and exit from markets. This ensures that markets are not dominated by certain businesses.

6.8.2 Goals of competition policy

- To prevent monopolies and other powerful businesses from abusing their power.
- To regulate the formation of mergers and acquisitions who wish to exercise market power.
- To stop firms from using restrictive practices like fixing prices, dividing markets etc.

6.8.3 The Competition Act in South Africa

The government introduced the Competition Act 89 of 1998 to promote competition in South Africa in order to achieve the following objectives:

- promote the efficiency of the economy (its primary aim)
- provide consumers with competitive prices and a variety of products
- promote employment
- encourage South Africa to participate in world markets and accept foreign competition in South Africa
- enable SMMEs to participate in the economy
- to allow the previously disadvantaged to increase their ownership of businesses

6.8.4 Institutions

The Competition Commission

It investigates restrictive business practices, abuse of dominant positions and mergers in order to achieve equity and efficiency in the South African economy.

The Competition Tribunal

It has jurisdiction throughout the Republic. It is a tribunal of record and independent from the other competition institutions.

The Tribunal's main functions are to: grant exemptions, authorise or prohibit large mergers, adjudicate if any misconduct takes place, issue an order for costs on matters presented to it by the Competition Commission.

The Competition Appeal Court

Its status is similar to the High court. It has jurisdiction throughout the Republic and is a court of record.

Its main functions are to review orders made by the Competition Tribunal and amend or confirm these orders.

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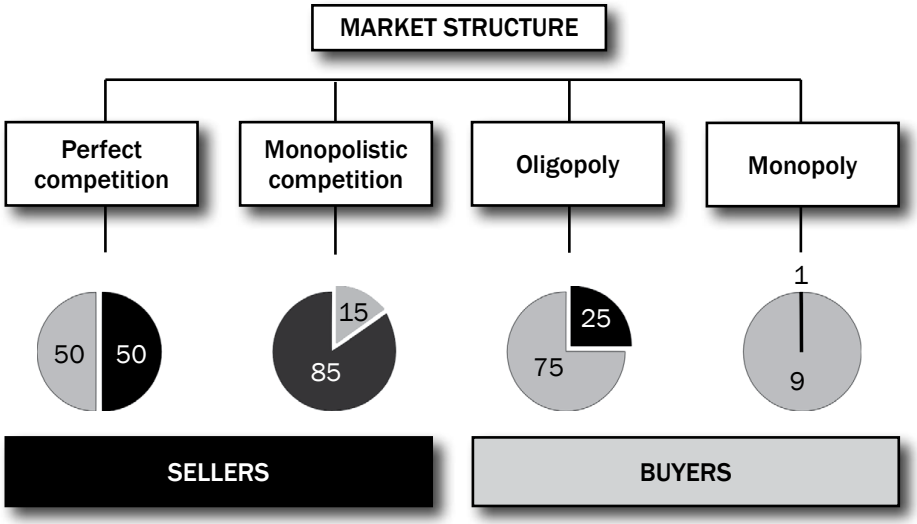
Activity 1

Study the diagram below and answer the questions that follow.



1. Define the concept market structure. (2)
2. How many sellers will one find in a monopoly market? (2)
3. In what market are all participants price-takers? Motivate your answer. (4)
4. Explain the shape of the individual demand curve under perfect competition. (4)
5. Under which market structure will you place the following businesses?
   - KFC
   - Eskom
   - Vodacom (6)
6. Explain in your own words the message behind the pie-charts shown above. (4)

[22]

Answers to activity 1

1. Market structure refers to how a market is organised✓✓ (2)
2. One ✓✓ (2)
3. Perfect markets ✓✓ there are too many producers and consumers for one producer to influence the price ✓✓ (4)
4. Horizontal to the quantity axis/perfectly elastic ✓✓✓✓ (4)
5. KFC: monopolistic competition ✓✓ Eskom: monopoly ✓✓ Vodacom: oligopoly ✓✓ (6)
6. Under perfect competition there are many sellers and buyers.✓Under monopolistic competition there are many sellers and a few buyers.✓ In the oligopoly there are many buyers but few sellers. ✓ In a monopoly there is only one seller but many buyers.✓ (4)

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Chapter 7

Dynamics of imperfect markets

There are a number of different types of **imperfect markets**, e.g. monopolies, oligopolies and monopolistic competition. An **imperfect market** is characterised by **imperfect competition**. Some participants have earlier or exclusive access to information that benefits them in the marketplace at the expense of their competitors. Certain participants will be able to access the market more easily than other participants, i.e. the supply of and demand for products will not be equal, and the matching of buyers to sellers will not be immediate.

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Overview

TOPIC	CONTENT	SCOPE AND DEPTH OF EXAMINABLE CONTENT
7. Dynamics of markets: Imperfect markets	**Examine the dynamics of imperfect markets with the aid of cost and revenue curves** • **The dynamics of imperfect markets with the aid of cost and revenue curves** – **Income/revenue** – Revenue schedule – Average and Marginal revenue curves – **Costs** – Cost schedule – Average and Marginal cost curves • **Monopolies** – **Description/Definition** – **Characteristics** – **Income** – Average and Marginal revenue curves – Profit and loss in the short run – Long term equilibrium – Comparison between a monopoly and a perfect competitor (curves, higher prices, lower production, economic profit) • **Oligopolies** – **Description/Definition** – **Characteristics** – **Non-price competition** – **Collusion** – Cartels – Price leadership – **Prices and levels of production** – **Kinked demand curve** • **Monopolistic competition** – **Description/Definition** – **General characteristics** – **Non-price competition** – **Collusion** – **Prices and levels of production** – **A comparison with perfect competition**	• Briefly discuss the cost and revenue tables and graphs • Draw and interpret graphs • Define/explain the concept monopoly • Examine the characteristics in detail • Distinguish between natural and artificial monopolies • Emphasise and highlight good practical examples of businesses in this market • Explain the downward slope of the demand curve of the monopolist with the aid of a table/graph • Briefly discuss with the aid of graphs short and long run positions **HOT QUESTION: Compare a monopoly with a perfect competitor in terms of price, output and profit** • Define/explain the concept • Examine the characteristics in detail • Emphasise and highlight good practical examples of businesses in this market • Briefly discuss non-price competition • Briefly discuss collusion • Distinguish between price leadership and cartels as forms of collusion • Broadly outline prices and production levels • Broadly outline the rationale of the Kinked demand curve • Use the graph and briefly explain the kink in the kinked demand curve **HOT QUESTION: 'Collusion is a punishable offence in South Africa'. Analyse this phenomenon** • Define/explain the concept • Examine the characteristics in detail • Emphasise and highlight good practical examples of businesses in this market • Compare a monopoly to monopolistic competition • Briefly compare monopolistic competition with oligopolistic competition • Briefly discuss product differentiation in this market • Briefly discuss non-price competition in this market **HOT QUESTION: Compare monopolistic competition with perfect competition**

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7.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well.

Term	Definition
Artificial monopoly	The barriers to entry are not economic in nature, but are caused by other factors. For example, a patent – this is the legal right of a holder to exclusively manufacture a product
Cartel	A group of producers whose goal is to form a collective monopoly in order to fix prices and limit supply and competition
Collusion	An arrangement between businesses with the aim of limiting competition between them by fixing prices
Imperfect market	When the market price is not a pure reflection of the scarcity (lack) of that product
Legal monopoly	Monopoly based on laws preventing other companies from competing
Monopolistic competition	A market structure with many buyers and sellers where entry is relatively easy but the product is differentiated, e.g. toothpaste
Monopoly	A market structure where only one seller (producer) operates. Entry is blocked and the product has no close substitutes
Natural monopoly	High development costs prevent others from entering the market. A single business can serve the whole market at a lower price due to economies of scale, being large e.g. water and electricity
Non-homogenous	Manufacture different variations of their products in order to make it difficult for other companies to copy that specific product
Oligopoly	A market structure where only a few sellers operate. Entry is difficult and products can be differentiated or standardised
Price leadership	A situation where one firm fixes a price and the others accept it as the market price

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7.2 Monopolies

A monopoly exists when there is one seller of a good or service for which there is no close substitute.

7.2.1 Characterictics of monopolies

- There is only **one seller** of the product
- **There are barriers to entry.** These are caused by patents and other forms of intellectual property rights, control over resources, government regulations and decreasing costs.
- The monopolist is regarded as a **price maker** since it is able to influence the market price through changing the quantity it supplies to the market.
- The are **no close substitutes**. The product cannot be easily replaced. Consumers have no choice in price and quality of the product.
- There is **no competition**. One business in the market will control the supply of goods and services.
- **Products are differentiated and unique.** Monopolies manufacture a variety of products which are difficult for other companies to copy.
- **Large amounts of starting capital** are required. Large industries like Eskom and SASOL require millions of starting capital.
- **Monopolies have legal considerations.** New inventions are protected by patent rights. Services, like the Post Office are protected by law and other businesses are prohibited from entering the market.
- It is also possible for the monopolist to make an **economic profit** in the long run. This is because it faces no competition from new entrants as a result of the barriers to entry.

Monopolies can be classified as two main groups due to barriers that exist

Natural monopolies: High development costs prevent others from entering the market and therefore the government supplies the product. E.g. Electricity in South Africa is provided by the government enterprise, Eskom. It costs billions of rands to build and maintain power stations and therefore there are no other suppliers.

Artificial monopolies: Here the barriers to entry are not economic in nature. An example of a barrier is a patent. A patent is a legal and exclusive right to manufacture a product, e.g. Denel Land Systems manufacturing Casspirs.

7.2.2 The demand curve of the monopolist

- Under perfect competition the individual producer faces a horizontal demand curve where D = MR = AR, since it is a price taker.
- By contrast, the monopolist faces a **normal market demand curve** which slopes **downwards from left to right**. Here **D = AR**.
- It is also the market (or industry's) demand curve, since the monopolist is responsible for the entire output of the industry.

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7.2.3 The marginal revenue curve of a monopolist

- Since a monopolist faces a downward sloping demand curve, its **marginal revenue curve and its demand curve are not the same** curve as is the case with an individual producer under perfect competition.
- Under perfect competition, the individual producer is a price taker and can sell any quantity at the market price and therefore faces a horizontal demand curve, which is also its marginal revenue curve.
- The demand curve for a monopolist, which is downward sloping, implies that, if it wishes to increase its sales by an additional unit, it must decrease the price of the product.
- The lower price applies to all its customers. Its marginal revenue – that is the amount by which total revenue increases if it sells an additional unit – will therefore be less than the price.
- The marginal revenue curve and the demand curve are therefore not the same curve. The Marginal revenue curve will be lower than the demand curve.

Activity 1

Use the table below of a typical monopolist and plot the revenue curves on the same set of axes. Notice the position of the Marginal revenue curve in relation to the Demand curve.

Price	Quantity	Total revenue	Average revenue	Marginal revenue
–	0	0	0	0
100	1	100	100	100
90	2	180	90	80
80	3	240	80	60
70	4	280	70	40
60	5	300	60	20
50	6	300	50	0
40	7	280	40	–20
30	8	240	30	–40

Answer to activity 1

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7.3 Output profit and loss

7.3.1 Revenue

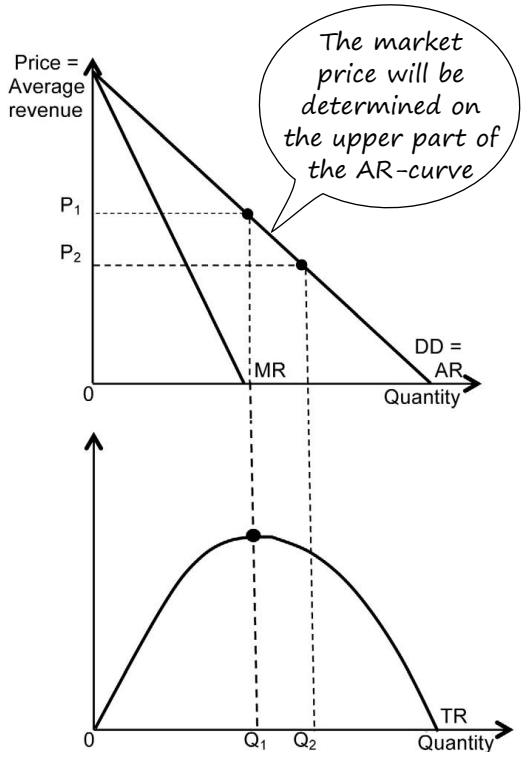

Figure 7.1 Revenue curves of the individual producer

- **The demand curve** for a monopolist is the market demand curve and slopes downwards from left to right (DD/AR). See the top graph in **Figure 7.1**.
- Any point on the curve is an indication of the **quantity** of the product to be sold and the **price** at which trade takes place.
- Any price-quantity combination on the demand curve is also its average revenue (AR) curve.
- The average revenue from each product is calculated by dividing the total revenue by the quantity = the price. See the bottom graph in **Figure 7.1** (left).
- The **marginal revenue** (MR) curve runs below the **demand curve** (AR) – it always intersects the horizontal axis at a point halfway between the origin and the point of intersection of the demand curve (AR).
- The monopolist will try to **fix the price above the centre of the demand curve**, because only then will his total revenue increase. See **Figure 7.1**. Note how at Q_1 total revenue is at its highest. Q_1 intersects the demand curve of the top graph above the centre of the curve.

7.3.2 Economic profit in the short term

Step 1: Draw your two axes

First, draw your TWO axes: Price (vertical) and Quantity (horizontal) – remember, they meet at the origin (0). Everything counts for marks – do not leave out anything. Now go to step 2.

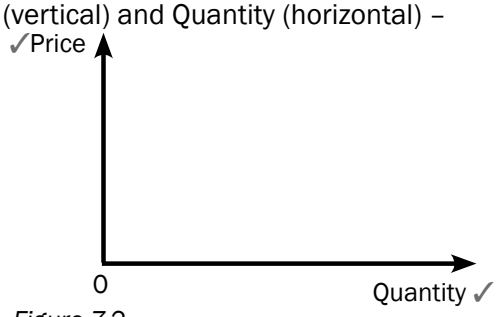

Figure 7.2

Step 2:

The two revenue curves start on the price axis and move down to meet the **quantity axis**. Draw these axes now. Then go to step 3.

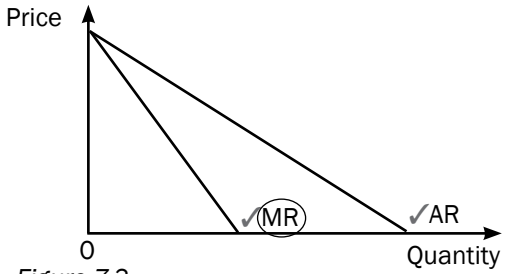

Figure 7.3

hint It is easy to draw a graph – **YOU MUST JUST KNOW HOW.** Practise makes perfect.

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Step 3:

This MC curve intersects the AC curve **at the minimum point of the AC** curve.

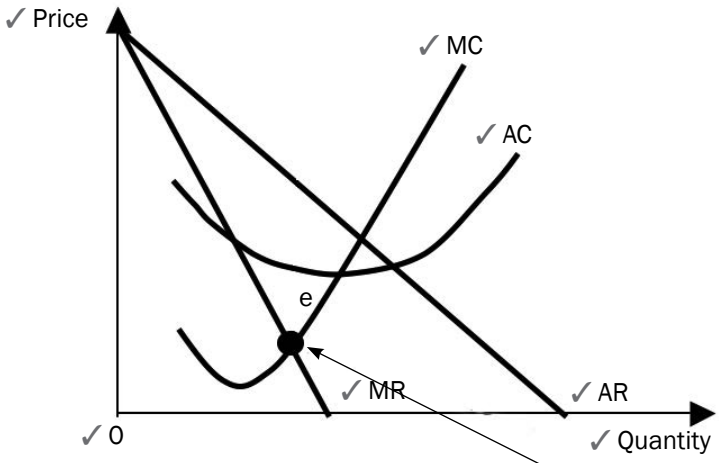


Figure 7.4

Step 4:

The most important point on the graph is where **MC = MR** (look for the dot ●). At this point: equilibrium/ maximum profit/profit maximisation is reached (all the same point).

Step 5:

This **dot** is extended upwards and downwards. Your **cost** occurs where it meets the AC curve, and your market price occurs where it meets the AR curve (demand curve). Remember, a monopoly company will determine the price.

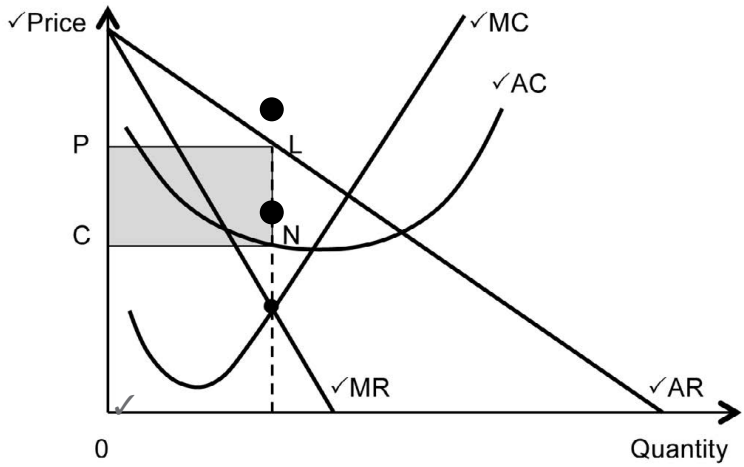
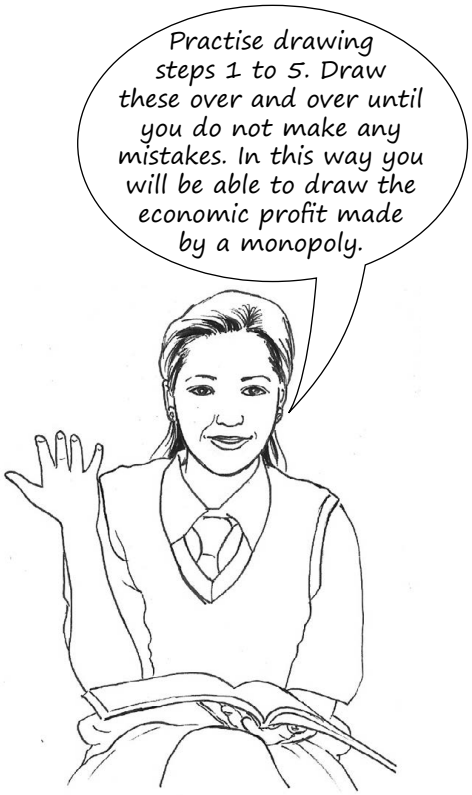


Figure 7.5



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The graph below shows the economic profit made by a monopoly:

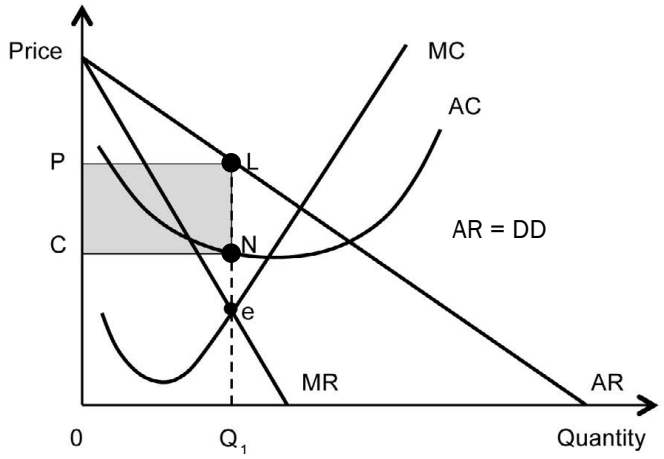

Figure 7.6: The economic profit made by a monopoly

- The cost structure of the monopoly is the same as that of competitive businesses.
- Determine the point where MC = MR, the point where the production cost of the last unit is equal to the revenue it earns (point e) – profit-maximising production quantity of Q_1 on the horizontal axis.
- To determine the price at which Q_1 is sold, move vertically upwards from e to L on the demand curve. The market price is therefore determined at P.
- Total revenue is greater than the short-term total costs. The monopolist makes a profit (due to demand and cost of production).

7.3.3 Economic loss in the short term

When you draw the economic loss for the monopolist, the graph stays the same, EXCEPT the AC curve moves to the right - up, and totally misses the AR (demand) curve (see Figure 7.7).

> **Remember:** To draw the economic loss, you find the market price (OP) where the dotted line meets AR. Then extend the line further to meet the AC curve – THAT indicates your cost (OC).

The **total income** = Price (OP) × Quantity (OQ) = the area OPNQ
The **total cost** = Cost (OC) × Quantity (OQ) = the area OCLQ.
Economic loss = income – cost

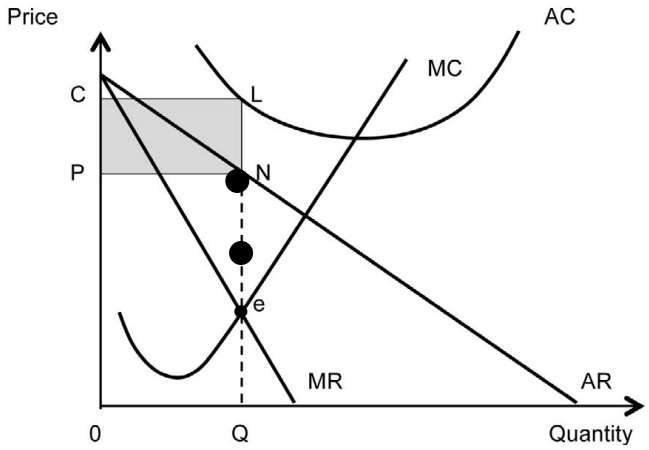

Figure 7.7: The economic loss of the monopoly

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Learn the following THREE bullets as a description for the economic loss of a monopoly:

- The monopoly suffers short-term losses when the AC curve lies above the demand curve (DD).
- Equilibrium is reached where MR = MC (a loss-minimising situation).
- The monopoly will produce a quantity Q and sell at price P. The total costs are the area OCLQ; the total revenue is the area OPNQ. The loss will be that part that is shaded (the area PCLN).

7.3.4 Comparison of a monopoly and a perfect market

Monopoly	Perfect market
1. Downward sloping DD curve MR curve lies below the DD curve	Horizontal DD curve MR curve same as DD curve
2. Price setter (maker)	Price-taker
3. Individual business is the industry	Individual businesses add up to make the industry
4. Consumer buys less if the selling price is high (and vice versa)	Business can't choose its price and if it sells at a different price it loses out
5. Monopolist produces a lower output at higher prices and in so doing produces at sub-efficient quantities. It does not produce at the minimum point of the LAC curve	Larger output and lower prices. Economically efficient quantities produced. Produces on the lowest point on the AC curve
6. Producer and consumer surpluses are smaller	Surpluses bigger
7. Products differentiated – unique – no close substitutes	Product are homogenous
8. Long-term: can make economic profit	Only normal profit in the long-term

7.4 Oligopolies

An oligopoly exists when a small number of large companies are able to influence the supply of a product or service to a market. By controlling the supply of the product or service on the market, oligopolies aim to keep its prices and profits high. Oil companies are one of the best examples of an oligopoly. A special type of this market form is a duopoly – an industry with only two producers.

7.4.1 Characteristics of oligopolies

- There is **limited competition**. Only a few suppliers manufacture the same product.
- Products may be **homogenous or differentiated**.

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- This market is characterised by **mutual dependence**. The decision of one company will influence and will be influenced by the decisions of the other companies.
- Oligopolies can **frequently change their prices** in order to increase their market share. However this can result in a price war.
- Extensive use is made **non-price measures** to increase market share e.g. advertising, efficient service or product differentiation.
- Producers have **considerable control over the price** of their products although not as much as in a monopoly.
- If oligopolies operate as a cartel, firms have an **absolute cost advantage** over the rest of the competitors in the industry. **Abnormal high profits** may be a result of joint decisions in an oligopoly.
- **Entry** is not easy in an oligopolistic market. This is due to brand loyalty and it also requires a large capital outlay.

7.4.2 Kinked demand curve for the oligopolist

- One theory devised by an American economist, Paul Sweezy, can be used to determine the oligopolist's demand curve.
- An oligopolist faces a kinked demand curve. This demand curve consists of two sections.
- The top section, the section that relates to high prices is a very elastic slope (i.e. demand is very sensitive to a price change.)
- The bottom section, the section that relates to lower prices is very inelastic (i.e. demand is not sensitive to a price change).
- To understand the demand curve of an oligopolist, view the graph below.

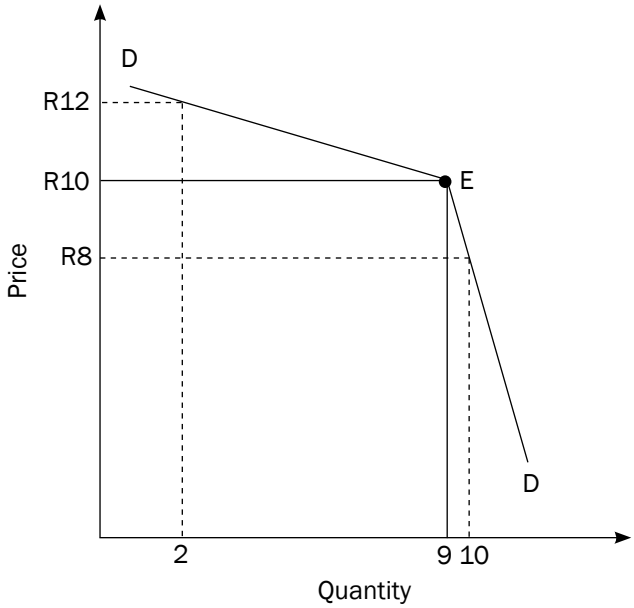

Figure 7.8: The kinked demand curve of the oligopolist

- Suppose the oligopolist is selling at the original/present price of R10 and 9 units of output are sold. Total revenue is R10 × 9 = R90
- If the firm tries to increase profit by increasing the price by R2 to R12, quantity demanded would fall to 2 units and total revenue would decrease to R24 (R12 × 2).
- If the firm tries to increase profit by reducing the price by R2 to R8

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and increasing its total sales, total revenue would be R80.
- The oligopolist is therefore faced with a difficult decision because in both instances it will not benefit.
- Increasing the price of goods or reducing the price to increase sales will not lead to greater revenue earned.

7.4.3 Non-price competition

- Oligopoly firms are reluctant to change prices because a price war will drive prices down and profits will be eliminated.
- They make use of non-price measures to attract customers and increase their market share.
- An important aspect of non-price competition is **to build brand loyalty, product recognition and product differentiation**.
- This is done by means of advertising and marketing. As a result, oligopoly firms tend to spend a substantial amount of money on this.

Other forms of non-price competition include:
- extended shopping and business hours
- doing business over the internet
- after-sales services
- offering additional services
- loyalty rewards for customers
- door-to-door deliveries

Examples of firms that use kinds of non-price strategies are those in petrol retailing such as Shell, BP and Caltex and in the banking sector such as ABSA, FNB etc.

7.4.4 Collusion

Collusion takes place when rival firms cooperate by raising prices and by restricting production in order to maximise their profits. When there is a formal agreement between firms to collude it is called a **cartel**. A cartel is a group of producers whose goal is to form a collective monopoly in order to fix prices and limit supply and competition.

In general, cartels are economically unstable because there is a great incentive for members not to stick to the agreement, to cheat by cutting prices illegally and to sell more than the quotas set by the cartel. Although there is an incentive to collude there is also an incentive to compete. This has caused many cartels to be unsuccessful in the long term. Some well known cartels are the Organisation of Petroleum Exporting Countries(OPEC) and De Beers diamonds in South Africa.

Overt/Formal collusion e.g. cartels are generally forbidden by law in most countries. However, they continue to exist nationally and internationally.

Sometimes in an oligopoly market, a dominant firm will increase the price of a product in the hope that its rivals will see this as a signal to do the same. This is referred to as **price leadership** and is an example of a **tacit collusion**.

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7.5 Monopolistic competition

7.5.1 Characteristics of monopolistic competition

- The **products are differentiated**. Products are similar but not identical. The are similar in that they satisfy the same need of the consumer. There may be differences in packaging but the product is the same. e.g. sugar and salt.
- Differentiated products create opportunities for **non-price competition** e.g. advertising.
- Monopolistic competition displays a **hybrid structure**. It is a combination of competition and a monopoly.
- There **are many sellers**.This indicates the element of competition.
- **Entry** into the market is **easy**.
- Businesses have **little control over the price** of the product. Each business sells at its own price since a single price cannot be determined for the differentiated product because a range of prices could apply.
- **Information** for buyers and sellers is **incomplete**.
- **Collusion is not possible** under monopolistic competition.
- Restaurants, plumbers, lawyers, insurance brokers, hairdressers, funeral parlours and estate agents are all examples of monopolistic competitors.

7.5.2 Non-price competition

- Differentiated products create opportunities for **non-price competition** i.e. competition is not based on prices but rather on factors relating to the product's uniqueness.
- Advertising campaigns and further product differentiation are powerful forms of non-price competition.
- The greater the product differentiation the less price elastic the demand for the product will be.
- Large sums of money are spent on research, development and advertising to build a loyal consumer group.
- Therefore **brands** play a significant role in determining customer loyalty where a consumer may choose one producer over another. Large chain stores e.g. Checkers, Spar etc. have their own brands for some products. Most of these products are exactly the same as known brands.

7.5.3 Prices and production levels in the short-term and long-term

- The demand curve for a monopolistic competitor is similar that of a monopolist.
- Short term equilibrium (economic profit and economic loss) corresponds with a monopoly, but the demand curve is more price elastic (flatter) due to good substitutes.

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- Long-term equilibrium is characterised by normal profit, due to the ease of entry and exit into the market (similar to a perfect market). The economic profit made in the short-term attracts more businesses to enter the market.

7.5.4 Comparison of monopolistic competition with perfect competition

- Both firms make normal profit in the long run. Therefore there is no difference in the long-run between the perfect market and the monopolistic market as far as profit is concerned.
- The equilibrium price is higher than in a perfect market. The consumer therefore pays less in the perfect market and more in the monopolistic market.
- The monopolistic competitor does not produce at the minimum of the LAC whereas the perfect competitor does. He is less efficient.
- The perfect competitor produces more at a lower price while the monopolistic competitor produces less at a higher price.

7.6 Summary of market structures

	Firm	Perfect Competition	Monopolistic Competition	Oligopoly	Monopoly
A	Number of firms	Many	Large numbers	Very few	One
B	Entry into market	Completely free/ unrestricted	Free/Unrestricted	Free but not easy Varies from free to restricted	Restricted or completely blocked
C	Nature of product	Homogenous/ Identical	Diffferentiated	Homogenous/ Differentiated	Unique (with no substitute)
D	Demand Curve	Horizontal – firm price taker	Downward sloping but relatively elastic	Downward sloping Kinked (relatively inelastic and elastic)	Downward sloping (INELASTIC) Equals the market demand curve
E	Market information (Knowledge of market conditions)	Perfect knowledge i.e. Complete	Incomplete	Incomplete	Perfect knowledge i.e. Complete
F	Control over market price	No control Price taker	Limited/some control	Substantial control but not price setters	Complete control Price setter/ makers
G	Profit/Loss	Short-run = economic profit/ loss Long-run = Normal profit	Short-run = economic profit/ loss Long-run = Normal profit	Economic profit in the long-run	Economic profit in short-run and long-run

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H	Decision-making	Decision has no influence on others	Influenced by other competitors	Influenced by other competitors	Independent
I	Examples	Fresh produce	Restaurants	Petrol, Oil	Water & electricity supply (Eskom)
J	Collusion	Not possible	Not possible	Possible	Not relevant
K	Technical effifiency	Yes	Close	Possible	Possible
L	Allocative efficiency	Yes	Close	No	No

Activity 2

Complete the following table by filling in the missing information:

Characteristics	Perfect market	Monopolistic competition	Oligopoly	Monopoly
	So many competitors that a single business cannot influence the market price		So few competitors that each business takes the actions of the others into account	
Market entry	Completely free	Free		
			Downward sloping	
Long-term economic profit			Positive	
Seller market power				
Control over price		Some control		Considerably more than oligopoly
Examples		Fast-food outlets		Eskom

[20]

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Answer to activity 2

Characteristics	Perfect market	Monopolistic competition	Oligopoly	Monopoly
Number of businesses✓	So many competitors that a single business cannot influence the market price	**A very large number✓**	So few competitors that each business takes the actions of the others into account	**One business✓**
Market entry	Completely free	Free	**Free to restricted✓**	**Blocked✓**
Demand curve✓	**Slopes from left to right✓**	**Downward sloping✓**	Downward sloping	**Downward sloping = market demand✓**
Long term economic profit	**Normal profit✓**	**Normal profit✓**	Positive	**Positive✓**
Seller market power	**None, price-taker✓**	**Some✓**	**A whole lot✓**	**Many (price-maker)✓**
Control over price	**None✓**	Few	**Considerable✓**	Considerably more than oligopoly
Examples	**Gold and oil✓**	Fast-food outlets	**Petrol and oil✓**	Eskom

[20]

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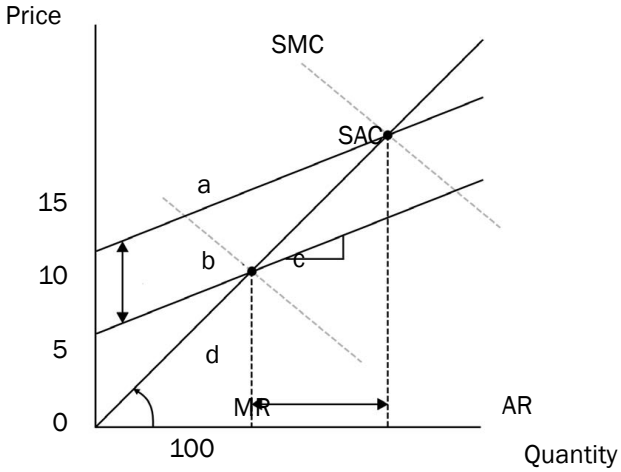
Activity 3

Study the following graph and answer the questions that follow:



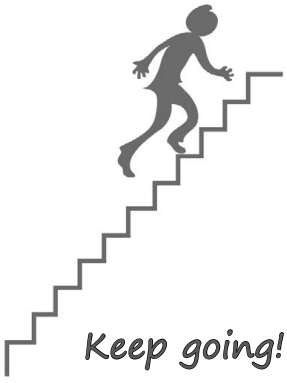
1. Define the term imperfect market. (2)
2. Motivate why the above graph indicates short-term equilibrium. (4)
3. Which point on the graph indicates profit maximisation? (2)
4. Calculate the economic profit. (6)

[14]

Answers to activity 3

1. An imperfect market occurs where the market price is not a pure reflection of the scarcity of that product.✓✓ (2)
2. The firm is producing where SMC = MR and is therefore in equilibrium in the short term. ✓✓✓✓ (4)
   The slope of the curves indicates a short run. ✓✓
3. d where MR = MC ✓✓ (2)
4. Income = Price (15) × Quantity (100) ✓
   = R1 500 ✓
   Cost = Cost (10) × Quantity (100) ✓
   = R1 000 ✓
   Economic profit = Income (R1 500) – Cost (R1 000)
   = R500 ✓✓ (6)

[14]



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Chapter 8

The reasons for and consequences of market failures

Markets can fail for many reasons. The reasons for, and consequences of, **market failure** are explained in this Topic.

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Overview

TOPIC	CONTENT	SCOPE AND DEPTH OF EXAMINABLE CONTENT
8. **Dynamics of markets: Market failures**	**Explain the reasons for and consequences of market failures, reflecting on the cost-benefit analysis** • **The causes of market failures** – **Externalities** – Private cost – Private benefits – Social cost – Social benefits – **Missing markets** – Community goods – Collective goods – Public goods – Merit and demerit goods – **Imperfect competition** – **Lack of information** – Consumers – Workers – Entrepreneurs – **Immobility of factors of production** – Labour – Physical Capital – Technological change – **Imperfect distribution of income and wealth**	• Discuss the causes of market failures in detail **HOT QUESTION: Draw a fully labelled graph to demonstrate the basic elements of the concept externalities** **HOT QUESTION: Why do governments produce goods and services themselves?** hint: It is important to explain how these causes relate to market failure.
	• **Consequences of market failures** – **Inefficiencies (Refer to Pareto efficiency)** – Productive inefficiency – Allocative inefficiency – **Externalities** – Negative externalities – Positive externalities – **State Intervention** – **Rules and regulations** – Direct control – Imperfect markets – Minimum wages – Maximum prices – Minimum prices	• Discuss the consequences of market failure in detail • Illustrate productive and allocative inefficiency with the aid of a production possibility curve (refer to Pareto efficiency) **HOT QUESTION: Draw two graphs to demonstrate negative and positive elements in the concept "externalities"** • Illustrate with the aid of graphs

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	– **Taxes and Subsidies**
	  – The price mechanism
	  – Subsidies on goods and services
	  – Redistribution of wealth
	– **Government involvement in production**
	
	• **Cost-benefit analysis**
	– **Description/Definition**
	– **Reasons for a CBA**
	– **Applications/examples in South Africa**
		• Define/explain the concept
		• Briefly discuss the rationale/reasons
		• Emphasise and highlight good practical examples
		• Apply by graphical or numerical illustration
		
		HOT QUESTION: Present a case for the use of CBA in practice

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8.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well.

TERM	DEFINITION
Allocative Inefficiency	When resources are not allocated in the right proportions and the product mix does not match consumers' tastes. It is possible to reallocate resources to make one person better off while not making someone else worse off
Allocative/Pareto Efficiency	Occurs when resources cannot be readjusted to make one consumer better off without making another consumer worse off. There is zero opportunity cost
Black market	An illegal market in which illegal goods are bought and sold or illegal prices are charged
Cost-Benefit Analysis	An analysis done by government which weighs the costs and benefits of a project to determine whether it should be carried out
Demerit Goods	Goods that are seen to be socially harmful e.g. cigarettes, gambling
Externalities	Costs or benefits to third parties which are not included in the market price of a good
Market Failure	When the forces of demand and supply fail to allocate resources efficiently
Maximum Price/ Price Ceiling	A price set below the equilibrium price/market price to make goods affordable
Merit Goods	Goods that are so beneficial to society that every individual should consume them irrespective of their income e.g health care, education
Minimum Price/ Price Floor	A price set above the equilibrium price/market price to allow producers to make a fair profit
Minimum Wage	A wage rate set by the government, below which no employer can pay their workers. It is set above the equilibrium wage rate
Negative Externalities	A cost to a third party which is not included in a market price of a good. It is a difference between social cost and private cost. E.g. the harmful effect of a product e.g. pollution
Non-Excludable Goods	Goods whereby individuals can benefit even if they do not pay for it e.g. the television or the police force
Non-Rival Goods	Goods when consumed by one person will not reduce the consumption by another individual e.g. street lights
Positive Externalities	The benefit gained by a third party which is not included in the market price
Private Benefit	The gain a consumer gets from the use of a goods or the gain a producer gets from the sale of a product. E.g. The joy gained by a consumer from driving a car
Private Cost	The actual cost paid by a consumer when a good is purchased. E.g. R150 000 for a car
Producer Subsidies	A cash allowance given to a producer to lower the cost of production and allow more goods to be supplied at a lower price
Productive/ Technical Inefficiency	When resources are not used appropriately to produce the maximum number of goods at the lowest cost and best quality
Public Works Programme	A government initiative aimed at reducing poverty by creating temporary jobs in areas of infrastructure and other areas
SABS – South African Bureau Of Standards	An institute that monitors the quality of goods in South Africa
Social Benefit	The benefit gained by society from the use of a good or service. E.g. taxpayers pay for the maintenance of roads, society will benefit from fewer accidents. It is calculated by adding the private benefit and external benefit
Social Cost	The cost of a good or service which is paid by society. It is calculated by adding the private cost and external cost. E.g. the air pollution caused by cars, will affect people's health bills

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8.2 The reasons for market failures

There are many reasons for **market failure**. These include:

8.2.1 Externalities

Externalities are costs not included in the pricing of goods/services, and consequently there is a difference between the **private costs/benefits** and the **social costs/benefits** of production.

- **Private costs:** the cost of producing the good or service which translates into the prices that consumers pay. Also called internal costs.
- **Private benefits:** Internal benefits that accrue to those who produce goods and buy these goods, e.g. producing a bicycle (for producer) and using the bicycle (consumer).
- **Social costs:** these are total costs incurred by society as a whole. For example the social cost of electricity includes the cost of capital, labour, inputs and the cost of the externalities such as dirty water and air. Social cost = private costs plus external costs.
- **Social benefits:** this includes the total benefit experienced by society as a whole. For example, municipalities provide clean water to society which results in fewer illnesses. Social benefits = private benefits plus external benefits.

Negative externalities are things like pollution, tobacco smoking and alcohol abuse. The costs of negative externalities are paid by society rather than by the producers. For example, Styvesant produces cigarettes, many illnesses are related to smoking. The treatment for these illnesses is paid for by society.

Positive externalities are the positive effects of products to third parties which are not paid for.

Negative externalities are often over-produced while positive externalities are under-produced. This leads to market failure.

8.2.2 Missing markets

Markets are incomplete because they cannot meet the demand for certain goods.

Public goods (community and collective goods) are in high demand but are not supplied by the market because of the low profit gained from them and the high cost of capital needed to supply them. Since private producers cannot withhold these goods for non-payment, they are reluctant to provide these goods. The government thus provides these goods and services.

Public goods

This includes community and collective goods and has two features:

- **Non-rivalry:** Consumption by one person does not reduce consumption by another individual, e.g. a lighthouse.
- **Non-excludability:** Consumption can't be confined to those who pay for it (free riders can use them), e.g. radio and television.

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In addition

- **Social benefits outstrip private benefits:** e.g. health care and education.
- **Non-rejectability:** Individuals are not able to abstain from consumption, e.g. street lighting.
- **Continuous consumption.** E.g. traffic lights.

Community goods

These are goods such as, defence, police services, prison services, street lighting, flood control, storm water drainage and lighthouses.

Collective goods

These are goods such as parks, beach facilities, streets. Markets are incomplete and cannot meet the demand for all goods. Government provides public goods, which consist of:

Merit and demerit goods

- **Merit goods:** These are highly desirable for general welfare, but not highly rated by the market, e.g. health care, education and safety. If people had to pay the market price for them, very little would be consumed. The market fails because the market produces less than the desired quantity.
- **Demerit goods:** These are over-consumed goods, e.g. cigarettes, alcohol and drugs. Thus more of the good is produced than is socially desirable. The government bans or reduces consumption of these products through taxation, and provides information to the population on their harmful effects.

8.2.3 Imperfect competition

- Competition in market economies is limited by the power of certain producers to **prevent** new businesses from entering the market. This is imperfect competition.
- Barriers to entry are created because of advertising, a lack of capital and the controlling of resources.
- The imperfect market doesn't allow for price negotiations.
- Advertising is used to promote producer sovereignty (dominance), which encourages consumers to buy existing products and allows producers to delay new products from entering the market until it is in their own interest (e.g. businesses have had the technology to produce long-life light bulbs for many years but have chosen not to launch them in the market).

8.2.4 Lack of information

Consumers, workers and entrepreneurs do not have the necessary information to make rational decisions. This results in resources not being allocated efficiently.

- **Consumers:** To maximise their benefits, consumers need detailed information about goods and services. Although technology offers this to the consumer, they obviously do have perfect information.
- **Workers:** Are often unaware of job opportunities.
- **Entrepreneurs:** Lack of information on costs, availability and

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productivity of factors of production impacts their effectiveness.

8.2.5 Immobility of factors of production

- Labour takes time to move from one area to another.
- The supply of skilled labour cannot be increased because of the time it takes to be trained or educated.
- Physical capital, like factory buildings or infrastructure such as telephone lines cannot be reallocated easily.
- Structural changes like a change from producing plastic packets to paper packets or shifting from labour-intensive production to computer based production requires a change in labourers' skills, employment and work patterns. This takes time to change.

8.2.6 Imperfect distribution of income and wealth

- **Income distribution:** The market system is neutral on issues of income distribution.
- **Discrimination:** Distorts earnings for women and minority groups, disabled persons and people subject to illness and incapacity.
- The market produces goods and services only for those who can afford it.
- This leads to some people having too many goods while others have too few goods.
- The difference in income occurs because there is a difference in market power, unequal educational opportunities, discrimination and inheritance.

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8.3 Consequences/effects of market failures

Learn these four consequences of market failure.

8.3.1 Inefficiencies

Two kinds of inefficiencies are possible:

1. Productive inefficiency/Technical inefficiency
   When resources are not used appropriately to produce the maximum number of goods at the lowest cost and best quality.
2. Allocative inefficiency
   Allocative inefficiency means that the types/quantities of goods or services produced are not what is best for consumers.

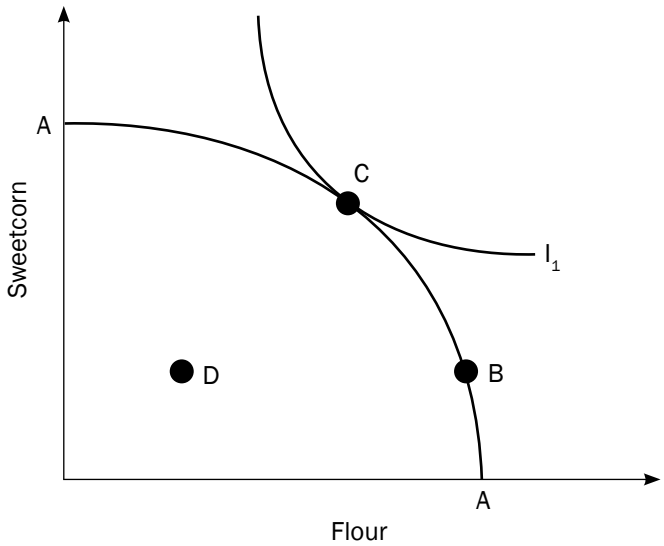

Figure 8.1: Inefficiencies can be described using a production possibility curve

- The Production possibility curve (AA), above, shows a combination of goods that can be produced using all the available resources.
- Any point on the curve shows a combination of goods where resources will be used efficiently.
- Therefore any point on the curve indicates Productive/Technical efficiency.
- The indifference curve (I1) shows a combination of two goods which gives the consumer the same level of satisfaction. However, if production takes place at point B on the curve, but the demand for goods is actually represented by point C, Allocative inefficiency will occur where the tastes of consumers are not met.
- Any point to the left of the curve such as D, indicates that some resources are unused. If this occurs some customers may be deprived of goods. This depicts Allocative and Productive inefficiency.

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8.3.2 Externalities (spill-over effects)

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. This is depicted in Figure 8.2 below.

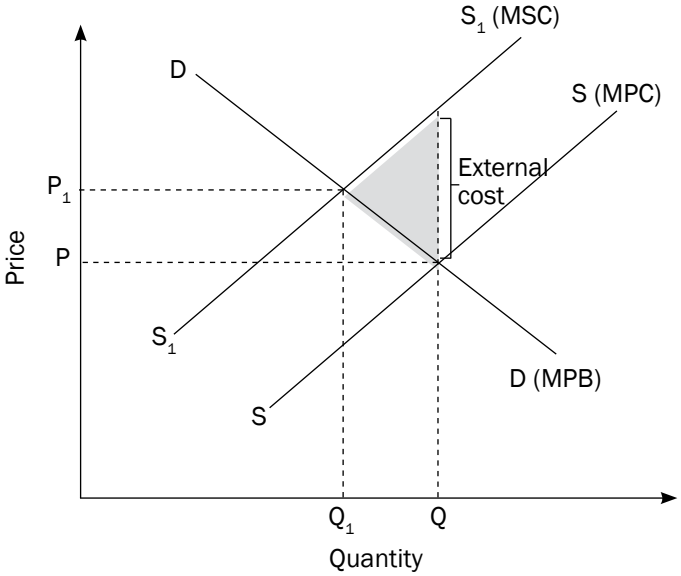

Figure 8.2 Negative externalities

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. This is depicted in the Figure 8.3 below.

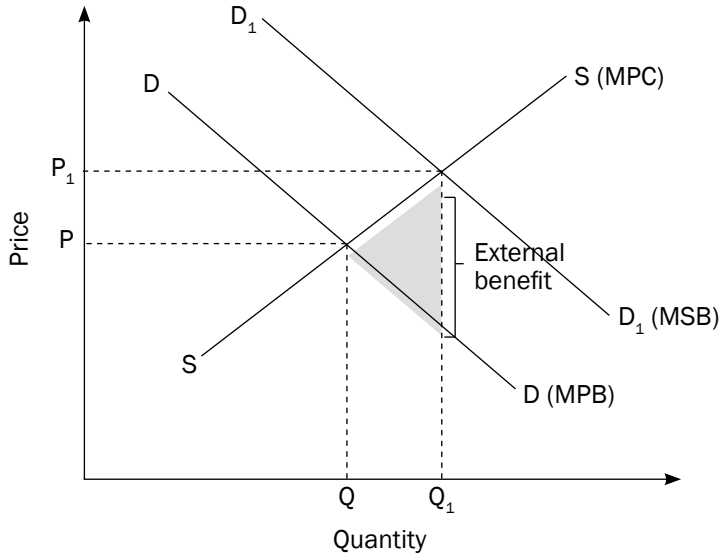

Figure 8.3 Positive externalities

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_1 will be produced at price P_1.
- More education would be demanded, this will lead to social efficiency.
- 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.

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8.3.3 Government intervention

Rules and regulations

a) Direct controls

The government can pass laws or use existing legislative framework to control businesses that generate negative externalities.

b) Imperfect markets

Firms in an imperfect market supply a limited quantity of goods and services at a very high price.

The government uses its laws on competition to prevent exorbitant prices charged by firms, to ensure entry to the market is free, prevent harmful collusion and encourage foreign competition which helps keep prices of goods low.

c) Establishing minimum wages

- When the government enforces a minimum wage, it means workers have to be paid a certain wage amount and not anything less than this.
- The Figure 8.4 below shows that if the wage rate is set at W, the corresponding demand and supply of labour will be Q.
- If a minimum wage of W_1 is set, the demand for labour will decrease from Q to Q_1. Some people may become unemployed due to the introduction of a minimum wage.
- However, the quantity of labour supplied will increase from Q to Q_2.
- More people will offer their labour because of the higher wage.

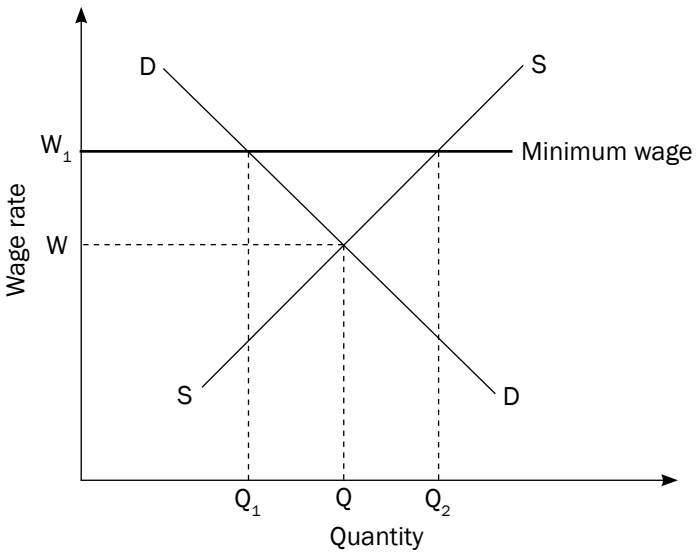

Figure 8.4 Establishing minimum wages

d) Setting maximum prices/price ceilings

- The government sets a **maximum price ceiling below the market price** to make goods more affordable.
- Maximum prices allow the **poor greater access to certain goods and services**.

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- A maximum price is set on goods such as basic foods, housing and transport.
- In South Africa the price of petrol, diesel fuel and paraffin are controlled at their maximum prices.

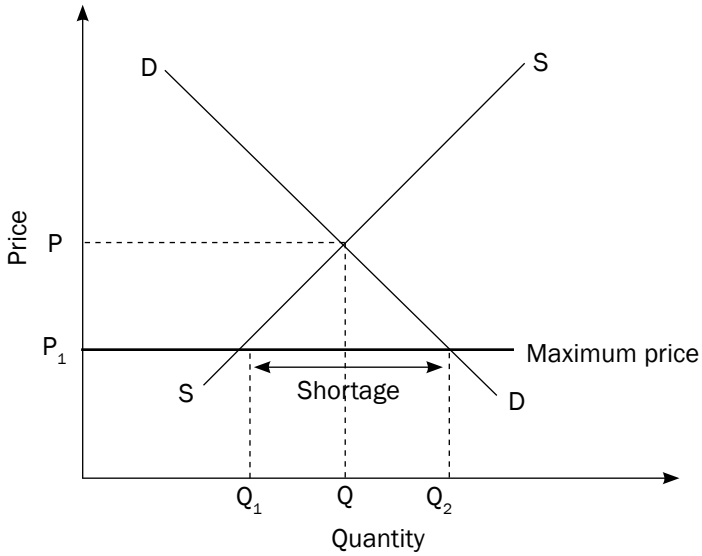

Figure 8.5 Setting maximum prices

- Initially the market equilibrium price is P and equilibrium quantity is Q.
- The government intervenes and passes a law that milk cannot be sold for more than P_1.
- The effect of this maximum price is that quantity supplied decreases to Q_1 and quantity demanded increases to Q_2.
- There is a shortage of milk equal to the difference between Q_1 and Q_2.
- A shortage creates a problem of how to allocate milk to consumers.
- Black markets often develop where people can obtain milk. A black market is an illegal market in which either illegal goods are bought and sold or illegal prices are charged.
- Maximum prices may cause a shortage of goods but they do improve the welfare of some consumers since goods can be purchased at lower prices.

e) Setting minimum prices/price floors

- The government sets a **minimum price at some point above the market price**.
- This is done to **enable producers to make a comfortable profit** and thus encourages them to **supply important essential goods**.

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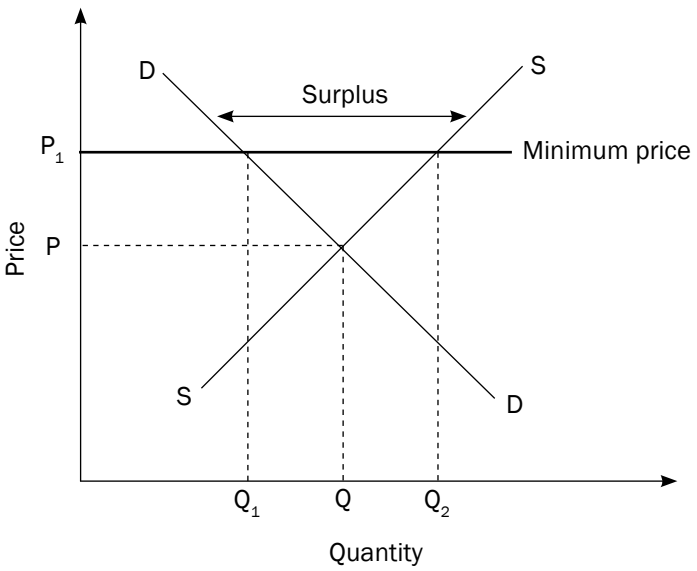

Figure 8.6 Setting minimum prices

- Consider the market for wheat.
- The market equilibrium price is P and the equilibrium quantity is Q.
- If the government sets a minimum price at P_1, farmers will be earn greater profits and supply more wheat. Quantity supplied will therefore increase to Q_2.
- However, quantity demanded will decrease to Q_1.
- There would be a surplus of wheat equal to the difference between Q_2 and Q_1.
- A surplus means the government will have to buy the extra wheat and dump it locally or abroad.
- Although minimum prices may cause a surplus they do encourage the supply of important food stuffs.

f) Taxes and subsidies

Levying of taxes

Governments intervene in the market by levying taxes to recover the external cost. These taxes will increase the price and will result in a decrease in production. This could help to reduce a negative externality such as pollution.

Providing Producer Subsidies

- The government provides subsidies to producers in order to encourage them to increase the production of goods. Supply increases.
- Producer subsidies are often given to suppliers of agricultural products such as milk, wheat and maize.
- Subsidies lower the cost of producing goods and thus the market price of these goods is lowered.

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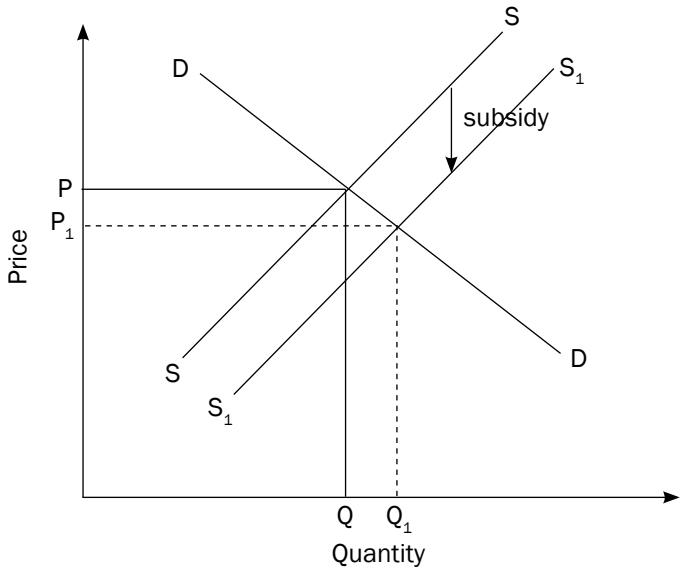

Figure 8.7 Taxes and subsidies

For example, if we look at Figure 8.7:

- The market price of rice is P and the corresponding quantity is Q.
- If the government subsidises the production of rice, the market price will decrease to P_1 with corresponding quantity Q_1.
- The lower price, P_1, allows the poor to purchase more rice.

g) Redistribution of wealth

- Traditional methods e.g. the levying of various taxes and the provision of free services, services in kind and cash benefits to the poor.
- Implementing Redress methods e.g. the use of law to enforce redistribution. It includes BEE, affirmative action, empowerment, land restitution, land redistribution and property subsidies (for RDP houses).

The government can use other ways to improve income distribution and overcome market failure:

- Transfers income directly to the poor e.g. child support grants, unemployment benefits etc.
- Provides goods free of charge e.g. community goods, education etc.
- Implements employment creation programmes e.g. public works programme.
- Subsidising merit goods e.g. subsidising arts and cultural events.
- Imposes taxes and laws on demerit goods to discourage consumption.
- Uses fiscal and monetary policy to achieve macroeconomic stability.
- Makes sure that consumers are informed about products through legislation. The South African Bureau of Standards (SABS) checks consumer goods in South Africa.
- Tries to prevent misleading advertising. (Advertising Standards Authority)

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8.4 Cost-benefit analysis (CBA)

8.4.1 Description

In both private and public sectors project evaluations are done in terms of cost and benefits. In the **private sector** feasibility studies are done which also provides for legal aspects relating to externalities. Expected private costs and benefits are taken into account.

In the **public sector** a Cost Benefit Analysis is done which takes into account expected social costs and social benefits of providing such goods and services.

Learn these three points about cost benefit analysis.

8.4.2 Reasons for cost benefit analysis

- Market signals e.g. price help to allocate resources through demand and supply.
- Goods supplied by the government such as roads, bridges etc. are provided free.
- With the absence of market signals, decisions on the desirability of a project may be subjective.
- Objective criteria may be required to ensure economic efficiency in resource allocation.
- CBA brings greater objectivity to decision making.
- This is done by identifying all the relevant benefits and costs of a project so that an informed decision can be made.

8.4.3 Applying the CBA (an example)

CBA is usually applied to projects where it is expected there will be a significant difference in private and social costs and benefits.

Imagine the Gautrain project, a rail service that connects Hatfield in Tshwane with Johannesburg and the OR Tambo International Airport.

Private costs would include:	Private benefits would include:
• The cost of land. • The cost of building materials and equipment. • Transport costs. • Labour costs. • Overhead costs etc.	• Train fares. • Subsidies from government. • Money from allowing companies to advertise.
External costs would include:	**External benefits would include:**
• Pollution. • Destruction of plants, animals and insects. • Resettlement for people whose homes were expropriated. • Increased traffic in certain areas and blockages of certain driving routes.	• Employment and income. • Opportunities for new businesses. • Time saved because of the high speed of the train. • Fewer accidents and less traffic. • Less strain on medical facilities.

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Once all benefits and costs were determined it was eventually decided that the idea of the Gautrain would benefit society more than harm it. Planning for the Gautrain started in 2000 but building only started in 2006.

Activity 1

Study Figure 8.8 and answer the questions that follow.

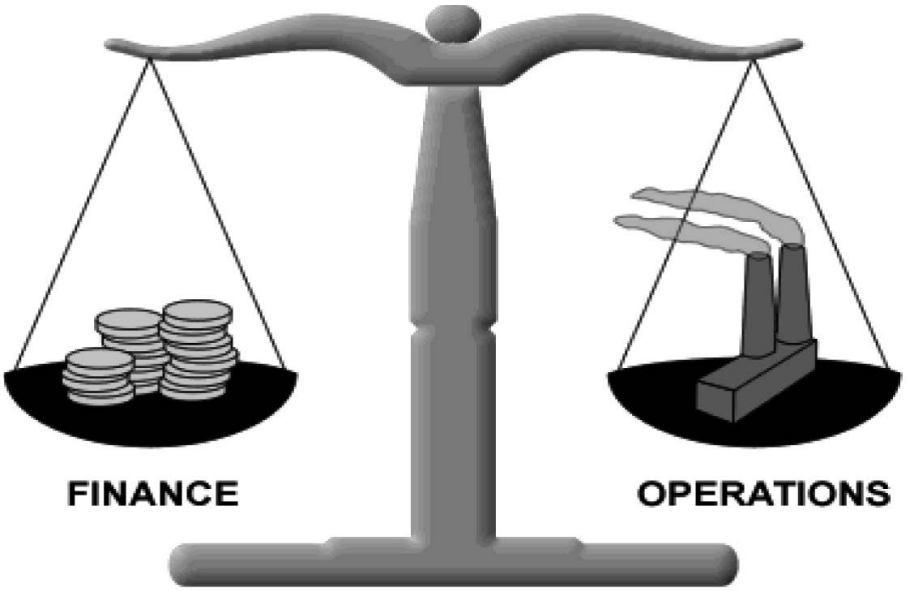

Figure 8.8

1. What economic technique for enumerating and evaluating is depicted in the illustration? (2)
2. Give TWO recent examples of potential 'operations' in South Africa that will fit into the illustration. (2)
3. List ONE social benefit of each of the above projects. (4)

[8]

Answers to activity 1

1. Cost benefit analysis ✓✓ (2)
2. Gautrain ✓ Coega ✓ (2)
   Any other relevant fact.
3. Gautrain: Better infrastructure ✓✓More effective transport✓✓
   Coega: Job creation✓✓/increased standard of living ✓✓ Any other relevant fact. (any 2 × 2) (4)

[8]

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Activity 2

Distinguish between merit and demerit goods. [8]

Answer to activity 2

- Taxation, subsidies and legislation are used to control merit and demerit goods. ✓✓
- **Merit goods**: higher consumption of goods is regarded as good for society ✓✓ government makes use of subsidies ✓✓ (distribute condoms). ✓✓
- **Demerit goods**: government imposes taxes to discourage consumption ✓✓ (cigarettes). ✓✓

[8]

Activity 3

Discuss the features of collective goods. [8]

Answer to activity 3

- **Non-rivalry:** ✓✓ Consumption by one person does not reduce consumption by another individual ✓✓ e.g. a lighthouse ✓✓
- **Non-excludability:** ✓✓ Consumption can't be confined to those who pay for it (free riders can use it) ✓✓ e.g. radio and television ✓✓

[8]

Activity 4

Discuss the distribution of wealth and income as a consequence of market failure. [8]

Answer to activity 4

- Through the national budget and taxation✓✓
- Change the distribution of income by: ✓✓ Subsidies, transferring payments to poor households, providing goods and services free of charge, implementing job creation programmes✓✓
- Regulatory measures: ✓✓ Land reform, labour legislation, preferential access to government procurement contracts, black economic empowerment policies ✓✓

[8]

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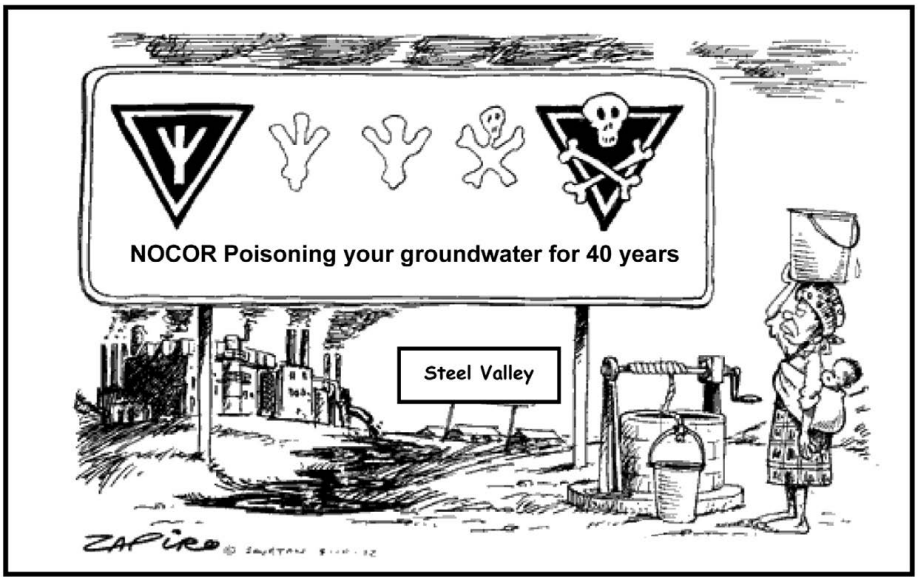
Activity 5

Study the following illustration and answer the questions that follow:



1. Identify the negative externality depicted in the illustration. (2)
2. List TWO measures that can be applied by government to reduce this externality. (2)
3. What is the liability of the factory in this regard? (2)
4. What effect will this have on consumer prices? (2)

[8]

Answers to activity 5

1. Pollution ✓✓
2. Legal actions ✓and taxes ✓ (any 1)
3. To reduce the pollution ✓✓
4. Consumer prices will increase ✓✓

[8]

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Chapter 9

Economic growth and economic development

Overview

TOPIC	CONTENT	SCOPE AND DEPTH OF EXAMINABLE CONTENT
9. Economic growth & Development	**Compare South African growth and development policies in terms of international benchmarks, also highlight the North/South divide** • **Background** – Economic growth – Economic development • **The demand-side Approach** – **Growth and Development** – Monetary policy – Fiscal policy – **South Africa's Approach** – **Monetary policy** Interest rate changes Open market transactions Moral suasion – **Fiscal Policy** Progressive personal income tax Wealth tax Cash benefits Natura benefits Other redistribution Land restitution and redistribution Subsidies on property • **The supply-side Approach** – **Creation of growth** – Aggregate supply and demand – **South Africa's approach** – Efficiency and effectiveness of markets – Business efficiency – The cost of doing business	• Distinguish between growth and development • Distinguish between government policies, strategies and initiatives • Discuss the demand-side approach in detail • Focus on discretionary changes in monetary and fiscal policies with the aim of changing the level of aggregate demand and therefore output (Real GDP) • Analyse SA's approach in terms of its monetary policy • Focus on: the SARB which is responsible for the implementation of the policy. Its primary goal is to protect the value of our currency • Analyse South Africa's approach in terms of fiscal policy • Focus on: the budgetary process, the purpose of fiscal policy to stimulate macroeconomic growth and employment and to ensure a desirable redistribution of income • Discuss the supply-side approach in detail **HOT QUESTION: Critically analyse the use of demand and supply-side policies in South Africa**

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	• **Evaluate the approaches of the growth and development policies used in South Africa** – **Growth and Development Policies** – Reconstruction and Development policy (RDP) – Growth Employment and Redistribution Programme (GEAR) – National Skills Development Strategy (NSDS) – Accelerated and Shared Growth Initiative for South Africa (ASGISA) – Joint Initiative on Priority Skills Acquisition (JIPSA) – Expanded Public Works Programme (EPWP) – The New Growth Path (NGP) – National Development Plan (NDP) – Small Business Development Promotion Programme – Black Economic Empowerment Programmes	• Discuss South Africa's growth and development policies in detail • Appraise South Africa's growth and development policies • Evaluate (benchmark) elements of South Africa's growth and development policies from given data **HOT QUESTION: Analyse South Africa's Growth and Development Plan (GDP) in terms of growth and development objectives**
	• **The North/South divide** – **Unequal standards of living** – Per capita income – Life expectancy – Education – **Challenges of Globalisation** – Poverty – Growth – Trade – **Environment** – Countries in the North – Countries in the South	• Compare the standard of living between North/South countries • Explain the positive/negative impact of globalisation on developing countries • Explain the negative environmental effects as a result of the economic activities in both North and South

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9.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well.

Term	Definition
Accelerated and Shared Growth initiative for South africa (ASGISA)	An initiative to promote development strategies, e.g. infrastructure and skills development
Broad Based Black economic empowerment (BBBEE)	Has the goal of the sustainable (able to continue) distribution of wealth across as broad a spectrum of South African society as possible, especially the most vulnerable such as women, mainly through ownership and management of business enterprises
Black economic empowerment (BEE)	An earlier policy similar to BBBEE, with the aims of distributing wealth to and developing skills in black citizens in post-apartheid South Africa
Development Bank of Southern Africa (DBSA)	Promotes development in the Southern African region by financing important development projects
demand-side approach	The focus is on attempts to increase aggregate demand in an economy. Fiscal and monetary policy can be used
economic development	The process by which the standard of living improves
economic development policy	A policy that involves the interaction of economic, social and human development
economic growth	An increase in the productive capacity of an economy over time. It is a change in the real GDP
economic growth policy	A policy that helps to increase the annual total production or income in the economy
Growth, employment and redistribution (Gear)	A strategy to promote economic growth, increase employment and redistribute income
Globalisation	The worldwide interaction of economies with trade as an important element
Integrated Manufacturing Strategy (IMS)	A strategy to strengthen institutional capacity to deliver services that will facilitate development
Joint initiative on Priority Skills acquisition (JIPSA)	An initiative to aid the development of urgently needed skills to facilitate job creation
Life expectancy	Expresses in number of years how long a child born today is expected to live
National Growth Path (NGP)	Initiatives to stimulate economic growth
North-South divide	Refers to the developed countries in the Northern hemisphere and the developing countries in the Southern hemisphere

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Public and Private Sector Partnerships (PPP)	These are contracts between a public sector institution/municipality and a private business, in which the design, financing, building and operation of public sector projects is managed by the private business
Reconstruction and Development Programme (RDP)	A development policy to improve service delivery to the poor and create an environment for human development
South African Reserve Bank (SARB)	Central bank of South Africa with the main goal to maintain price stability, thereby promoting balanced and sustainable growth
Small, Medium and Micro Enterprises (SMMEs)	A small business that has a small share of the market place; operates independent of larger enterprises; employs few people; and is managed directly by owners
Supply-side approach	Policies aimed at increasing the aggregate supply

9.2 Economic growth and economic development

The difference between economic growth and economic development

Economic growth	Economic development
• Increase in a country's real gross domestic product • It is measured by the increase in the production of goods and services over time	• Increase in a country's real gross domestic product per capita over time • A process that concentrates on peoples' standards of living, self-respect and freedom of choice • Growth should lead to development

9.3 Demand-side approach

9.3.1 Growth and Development

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 stabilise prices by managing inflation.

Fiscal policy is driven 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 is dependent on all components of aggregate demand, that is, C, I, X and G.

hint When you prepare for the exam, memorise CONCEPTS FIRST!

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9.3.2 South African approach

The South African approach uses both monetary and fiscal measures to influence aggregate demand in the economy.

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 stabilised 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 lend and cannot extend as much credit as before. To encourage credit creation the SARB buys securities. Money flows into the banking system.
- **Moral suasion**
  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 limited amount to give out as credit.

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 than 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 estates of the deceased. These taxes are used to finance development expenditures which benefit 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 (natura benefits)**
  These include the provision of healthcare, education, school meals, protection etc. When user fees are charged, poor or low income earners pay less or nothing. Limited quantities of free electricity and water are provided.

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- **Other redistribution**
  Public works programmes, 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 focuses on land for residential (town) and production (farm) for previously disadvantaged groups. The money for these programmes 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 scheme provides funding to all people earning less than R3 500 per month.

9.4 The supply-side approach

9.4.1 Creation of growth

A supply-side approach includes anything that can influence the aggregate supply of goods and services, with the focus on microeconomic components, e.g. competition and potential output.

Government intervention aims to facilitate the smooth operation of markets in order to stimulate growth and development.

9.4.2 South African approach

The South African approach aims at improving the **effectiveness** and **efficiency** of markets. This requires:

- Markets to operate more equitably and inclusively: More blacks must be accommodated in the mainstream economy if it is to work efficiently.
- Business **efficiency**: Taxes must be collected efficiently, capital formation must increase, human resources must be supported to improve, and free advisory services must be made available so that business efficiency improves.
- **The cost of doing business** must be lowered: transport, communication and energy costs must decrease.

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9.5 Evaluation of the South African approaches used in South Africa

9.5.1 Growth and development policies

Growth	Development
Macroeconomic policies	**Development 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.	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 on economic growth, while at other points, policy emphasis has shifted to economic development (see Figure 1 below).

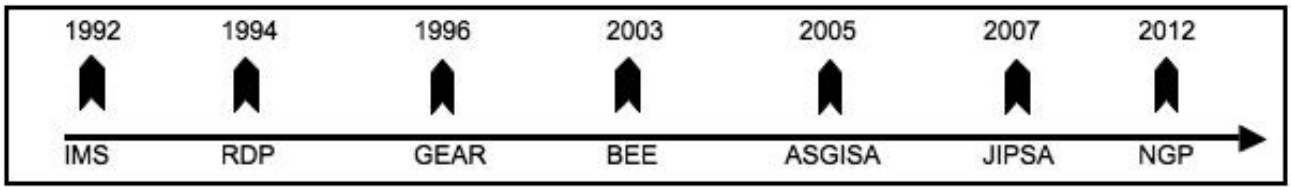

Figure 9.1 Growth and development policies

The main growth and development policies are:

1. Reconstruction and Development Programme (RDP)

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.

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.

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- 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.

2. Growth, Employment and Redistribution (GEAR)

The main strategy was to strengthen economic development, redistribute income and create socio-economic opportunities for the poor.

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.

3. Accelerated and Shared Growth Initiative for South Africa (ASGISA)

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.

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.

4. Joint Initiative on Priority Skills Acquisitions (JIPSA)

It is the skills development arm of ASGISA. Focus is on skills development, especially through the SETAS.

5. 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.

6. 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.

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Focus is to:

- Create 5 million jobs by 2020, reducing unemployment from 25% to 15%.

7. National Development Plan (NDP)

It sets out to expand economic opportunities through investment in infrastructure, more innovation, private investment and entrepreneurship.

8. 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.

9. 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.

9.6 The North/South divide

The table below shows different ways to distinguish between developed countries (in the North) and developing countries (in the South).

	North (developed)	South (developing)
Standard of living: • Real GDP per capita • Life expectancy • Education: Literacy level	• High • 75 years • High	• Low • 48 years • Low
Globalisation inequalities: • Poverty level • Economic growth • Production and trade	• Low • High • Manufacturing goods • Receive subsidies	• High • Low • Raw material • Agriculture/mining without subsidies
Environment: • Mass production and consumption damages the ozone layer, caused by pollution and toxic waste	• Mainly responsible for damaging the ozone layer	• Affects developing countries more negatively
Sustainable development: • The pattern of development that permits future generations to live as well as the current generation	• Practices used in production are more in favour of sustainable development	• Production practices do not promote sustainable development

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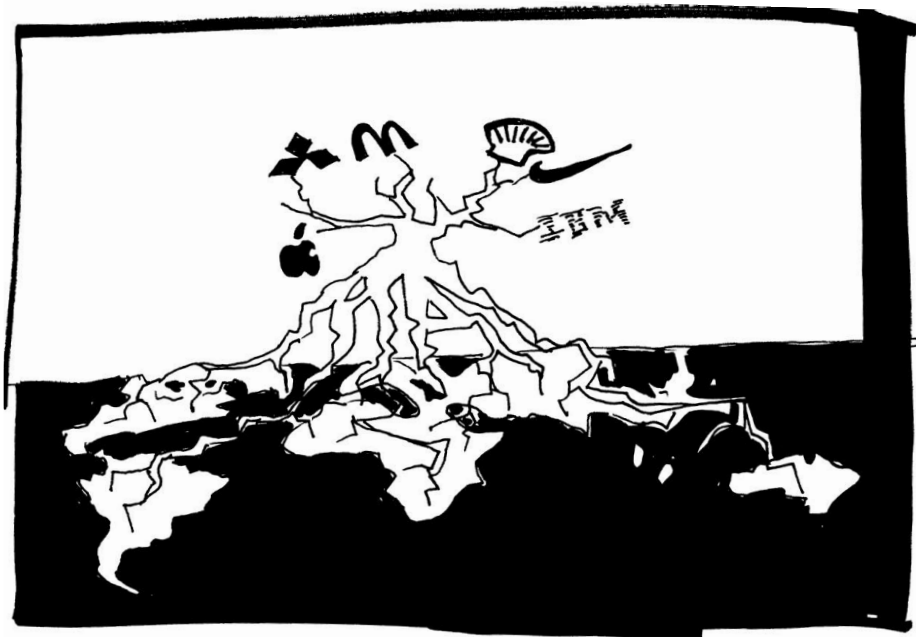
Activity 1

Study the cartoon below and answer the questions that follow:



1. What is the message behind the cartoon? (2)
2. List any TWO countries involved in this phenomenon. (2)
3. List any TWO products displayed in the cartoon. (4)

[8]

Answers to activity 1

1. Globalisation ✓✓ (2)
2. USA ✓and Japan ✓ (2)
3. Motor vehicles ✓✓and fuel✓✓ (4)

[8]

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Activity 2

Study the cartoon below and answer the questions that follow:

1. What is the message behind the cartoon? (2)
2. What is the main objective of Broad-Based Black Economic Empowerment? (2)

[4]

Answers to activity 2

1. The people are dissatisfied about the way the government is handling Black Economic Empowerment (corruption and nepotism). ✓✓ (2)
2. To advantage the previously disadvantaged section of the population.✓✓ (2)

[4]

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Activity 3

Distinguish between economic growth and economic development.

[8]

Answer to activity 3

Economic growth	Economic development
• A process by which the productive capacity of the economy increases over time. ✓✓ • Leads to rising levels of national output and income. ✓✓ • Is an increase in real gross domestic product (GDP).✓✓	• A process that concentrates on people's standard of living, self-respect and freedom of choice. ✓✓ • Growth should lead to development. ✓✓ • The ultimate aim of economic policy is an improved standard of living of the population per capita by means of economic growth and development. ✓✓

(any 2 × 2) × 2 [8]

Activity 4

Explain unequal standards of living as a characteristic of the North/South divide.

[6]

Answer to activity 4

- The real per capita income in developing countries is low compared to developed countries, ✓ e.g. 87% of the world's total income is produced by 15% of the world's population ✓
- Life expectancy in developing countries is as low ✓ as 47 years compared to a life expectancy of over 80 years in a country like Sweden ✓
- Low levels of education ✓ the adult literacy rate determines the effectiveness of education ✓

[6]

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Chapter 10

South Africa's industrial policies and their suitability in terms of international best practice

Overview

TOPIC	CONTENT	SCOPE AND DEPTH OF EXAMINABLE CONTENT
10. Economic growth and development: Industrial development policies	**Justify South Africa's industrial development policies and their suitability in terms of international best practice** • **Industrial development in South Africa** – **Industrial Development Policies** – National Industrial Policy Framework (NIPF) – Industrial Policy Action Plans (IPAP) – **Industrial development Strategies** – National Research and Development Strategy (NRDS) – Integrated Manufacturing Strategy (IMS) – **Focus of these Policies and Actions** – Targeted industries, sectors and regions – Sectors with potential – Special Economic Zones – Southern Africa	• Define/explain the concept • Briefly discuss the reasons for industrial development • Justify South Africa's Industrial Development Policies • Briefly explain South Africa's Industrial Development Strategies

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	• **Regional Development** – **Aims** – **Regional development in South Africa** – **International best practice for regional development**	• Define/explain the concept • Briefly discuss regional development
	• **South Africa's endeavours** – **Spatial Development Initiatives (SDIs)** – **Industrial Development Zones (IDZs)** – **Special Economic Zones (SEZs)** – **Corridors** – **Strategic Integrated Projects (SIPs)** – **Infrastructure Plan**	• Briefly discuss Spatial Development Initiatives (SDIs) in South Africa • Briefly discuss Industrial Development Zones (IDZs) in South Africa • Briefly discuss Special Economic Zones (SEZs) in South Africa • Briefly discuss corridors in South Africa
	• **Incentives to encourage industrial development** – **Small Businesses Support Program** – **SEDA Technology Program (STP)** – **Skills Support Program (SSP)** – **Critical Infrastructure Facilities (CIP)** – **Custom Free Incentives** – **Foreign Investment Incentives** – **Strategic Investment Program** – **Services to Business Processes**	• Critically discuss the incentives used by the SA government to improve industrial development
	• **Appropriateness of South Africa's industrial policies** – **Success factors** – **External Limitations** – **Internal Limitations** • **Appropriateness of South Africa's regional development policies** • **Small business development** • **The appropriateness of Black Economic Empowerment in the SA economy** – **Best practice for regional development – Benchmarks criteria:** – Free Market orientation – Competitiveness – Sustainability – Good governance – Provisioning of resources – Investment of social capital – Integration – Partnerships	• Briefly discuss the appropriateness of SA endeavours • Evaluate the appropriateness of the South African industrial development strategies in terms of international benchmark criteria

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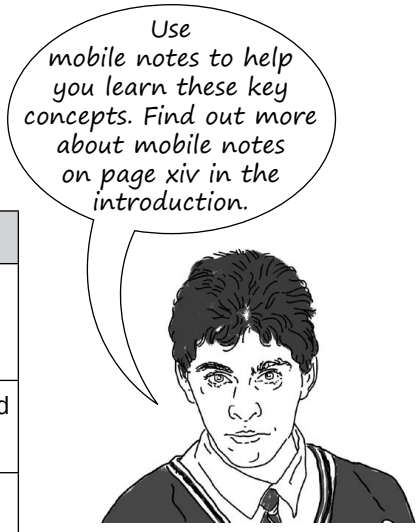
10.1 Key Concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well.



Term	Definition
Black Business Supplier Development Programme (BBSdP)	An incentive for black businesses consisting of an 80% cash grant to help increase the number of cash suppliers
Critical Infrastructure Programme (CIP)	Offers cash grants for projects that require new, expanded or improved infrastructure
Department of Trade and Industry (DTI)	Provides a competitive, socially responsible environment for investment, trade and enterprise development. It helps broaden participation in the economy to strengthen economic development; and it promotes structural transformation of the economy
Foreign Investment Grant (FIG)	Offers cash grants for foreign investors who invest in new manufacturing businesses in South Africa
General agreement on tariffs and trade (GATT)	A multilateral agreement regulating international trade. Its purpose is to reduce tariffs and other trade barriers
Industrial Development Corporation (IDC)	Set up by government to promote economic growth and industrial development in South Africa and Africa. It promotes entrepreneurship by building competitive industries and enterprises based on sound business principles
Industrial Development Zone (IDZ)	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
Integrated Manufacturing Strategy (IMS)	A strategy to strengthen institutional capacity to deliver services that will facilitate development
industrial development	Refers to policies that are aimed at the encouragement of industrial investment and greater industrial efficiency
Regional industrial development	Refers to policies that are aimed at increasing the economic livelihood of specific areas or geographical regions
Southern African Development Community (SADC)	An inter-governmental organisation whose goal is to further socio-economic cooperation and integration, as well as political and security cooperation among 15 Southern African states
Spatial Development Initiatives (SDI)	Initiated to attract infrastructure and business investments to neglected and underdeveloped areas, e.g. Maputo Corridor
Small and Medium Enterprise Development Programme (SMedP)	A progamme that offers grants paid to local and foreign manufacturers starting new businesses
Skills Support Programme (SSP)	A cash incentive granted for skills development

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10.2 Industrial development policies in South Africa

10.2.1 Industrial development policies

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.

National Industrial Policy Framework (NIPF)

- Is the industrialisation policy of the Department of Trade and Industry.
- Aims:
  1. To make the economy more diverse so that exports can increase.
  2. To make industrialisation more intensive in the long run.
  3. To promote the development of labour-intensive industries.
  4. Greater participation by disadvantaged groups and development of marginalised areas.
  5. Increase potential for large scale production.

Industrial Policy Action Plans (IPAP)

- As part of the NIPF, the DTI developed a revised three-year rolling action plan each year with a ten year outlook.

First Industrial Policy Action Plan (IPAP-1), 2007	Second Industrial Policy Action Plan (IPAP-2), 2011	Third Industrial Policy Action Plan (IPAP-3), 2012
Establish a new support programme for the clothing and textile industry	Increase the availability of financing for industrial development	Launch manufacturing Competitiveness Enhancement Programmes
Provide a programme to assist the motor industry	Improve the procurement policy under BBBEE policy	Develop special economic zones including IDZs
Strengthening the Competitions Act Increase energy savings	Strengthening the trade policy	Provide government support for regional economic development
Make business management more efficient and increase job creation	Reduce anti-competitive practices	Encourage integration of South Africa into Southern African region

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10.2.2 Industrial development strategies

- National Research and Development Strategy (NRDS)
- Integrated Manufacturing Strategy
  - The IMS focus on improving competitiveness in manufacturing by looking at a range of factors, such as input prices, improving infrastructure, technology and innovation, skills and effective regulation.

Focus of these policies and actions

- Targeted industries, sectors and regions
- Sectors with potential
- Special Economic Zone (SEZ)
- Southern Africa

10.3 Regional development

10.3.1 Aims

- Reduce unequal development of economic activities within the country
- To stimulate development in poorer areas
- To implement and coordinate the implementation of national and regional industrial policies
- To prevent new imbalances from emerging

10.3.2 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.

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10.3.3 International best practice for regional development

These are the best international practices for regional industrial development policies:

Best practice	Description
Good governance	Regional development strategies should be managed effectively and free of corruption. Democratic decision-making, transparency, financial management and control.
Integration	An integrated approach, ensuring that the benefits of one region spill over to other industries and areas.
Partnerships	Partnerships should be built between central government, local authorities, civil society, special interest groups, NGOs and the private sector.
Provision of resources	Sufficient resources should be provided in resource-poor areas, e.g. infrastructure, human resources.
Competitiveness	Industries or business established as a result of regional policies should be competitive and not need ongoing financial aid from government.
Development of people, for people, by people	Regional development concerns people, and aims to serve the people of the region. Training, education, improving productivity and providing essential goods and services to raise the standards of living in regions. People should be involved.
Development from below	Concentrate on issues at grass roots level where most urgent human needs exist. It starts by dealing with poverty.
Total development as a multi-dimensional process	Treat development from a global perspective covering all human life, including the interaction of special forces in a community, e.g. education, health, nutrition.

10.4 South Africa's endeavours

10.4.1 Spatial Development Initiatives (SDIs)

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 main objective is to stimulate economic growth and employment in those regions.

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These are the main SDIs and their economic focus:

SDI	Economic area
KwaZulu-Natal SDI	Industrial
Wild Coast SDI	Agri-tourism
Fish River SDI	Industrial
West Coast Investment Initiative	Industrials and agri-processing
Coast to coast Corridor	Transport and Tourism
Platinum SDI	Mining and agri-tourism
Phalaborwa SDI	Industrial and agri-tourism
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.

10.4.2 Industrial Development Zones (IDZ)

A purpose built industrial estate linked to an airport or seaport with export as the main objective (it will be incorporated into the SEZ in future).

These are the current IDZs in SA:

- Coega – Steel and auto components
- OR Tambo International Airport – high tech industries
- East London – vehicles
- Richards Bay – metals
- Saldanha Bay – steel

10.4.3 Special Economic Zones (SEZ)

Geographically demarcated area where specific economic activities have been identified to be developed. These areas may enjoy incentives such as tax relief and support systems to promote industrial development.

It creates a basis for a broader range of industrial parks and provides economic infrastructure to enable the effective clustering of value-adding and employment-enhancing manufacturers.

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10.4.4 Corridors

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).

10.4.5 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.

10.4.6 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.

10.5 Incentives to encourage industrial development

10.5.1 Small Business Support Program

- This programme is designed for small businesses with assets of R100 million or less.
- This incentive consists of a tax free cash grant for investment in industries.
- Grants were available to new and expanding businesses.
- Grants are given for three years after which the company is expected to become self-sustaining.

10.5.2 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.

10.5.3 Skills Development Programme (SSP)

- This a cash incentive to encourage greater investment in skills training and to introduce new, advanced skills to the SA labour force.
- A maximum of 50% of a company's trading costs are covered.

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10.5.4 Critical Infrastructure Programme (CIP)

- It is a cost sharing grant for projects designed to improve infrastructure in SA.
- It covers a qualifying development cost between 10% and 30% towards the total development cost.
- It becomes available on completion of the project.
- It extends to both the public sector (e.g. municipalities) and private sector (companies).
- It is deemed "critical" if the investment had not taken place or would not work optimally without the infrastructure.

10.5.5 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.

10.5.6 Foreign investment incentives

- It is a cash incentive to assist foreign investors who want to invest in new manufacturing businesses in SA.
- It covers the cost of relocating new machinery and equipment from abroad.
- It becomes available to any registered company who would like to operate in the manufacturing sector.
- It also covers up to 15% of the costs of new machinery and equipment to a certain value.
- Strategic Investment Programme.

10.5.7 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.

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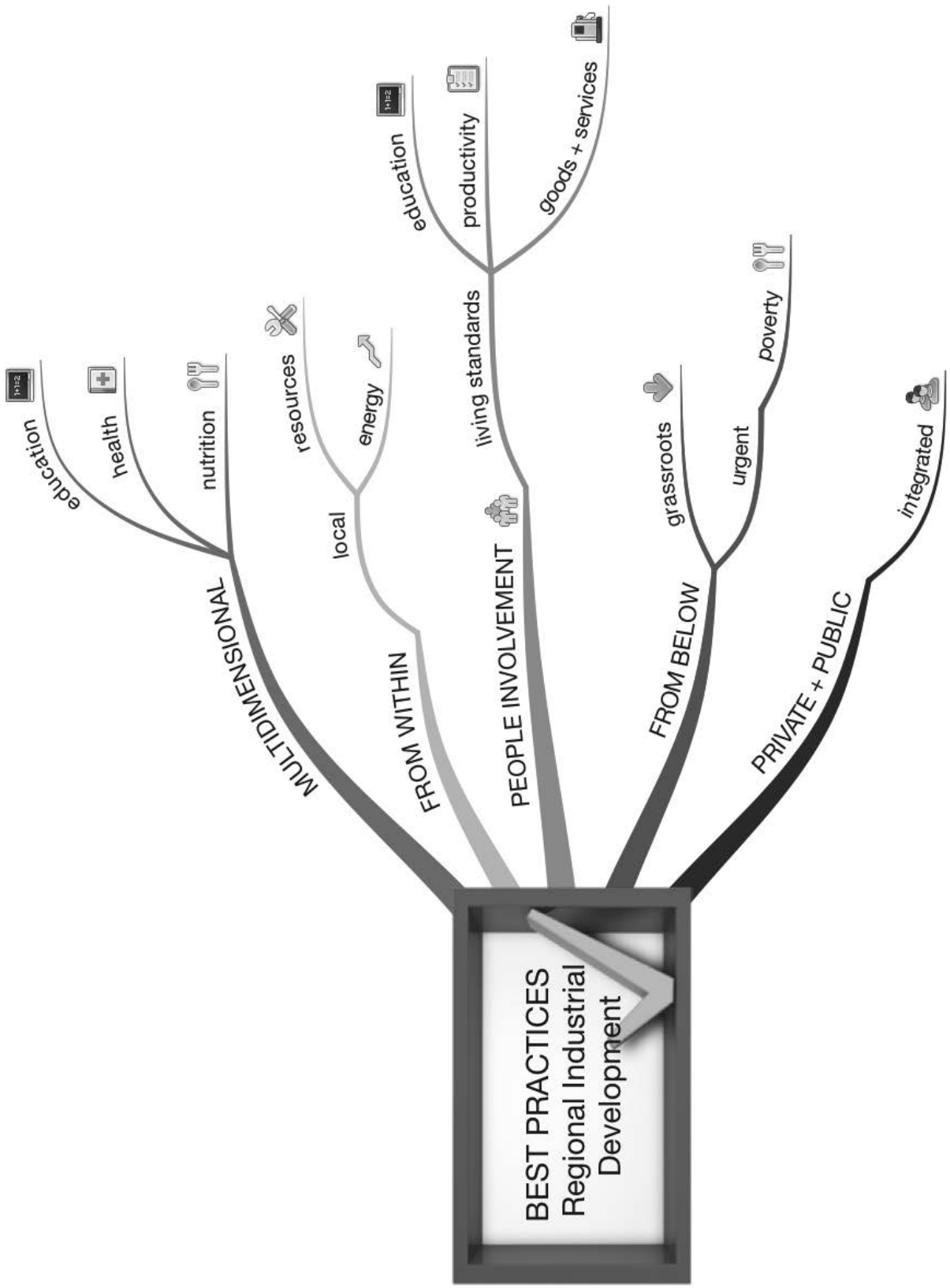

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10.6 Appropriateness of South Africa's industrial policies

10.6.1 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.

10.6.2 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.

10.6.3 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.

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10.7 Appropriateness of South Africa's regional development policies

The **regional policy** is underpinned by most important international best practice principles: job creation, human development and macro- and microeconomic development. It focuses on:

- **Workers-to-the-work:** The priority is on employment creation. Workers have to move to where employment is.
- **Work-to-workers:** This is internationally regarded as the policy most likely to affect long-term problems of structural unemployment (unemployment resulting from a mismatch between demand in the labour market, and the skills and locations of workers).

10.8 Small business development policies

- 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.

10.9 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.
- Benchmark criteria.

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Activity 1

Study the logos in **Figure 10.1** and answer the questions that follow:

Figure 10.1: Logos

1. What government bodies do the acronyms in the logos stand for? (2)
2. Define the concept industrial development. (2)
3. Describe in your own words the important role of these institutions. (2)

[6]

Answers to activity 1

1. DTI – Department of Trade and Industry✓
   IDC – Industrial Development Corporation✓ (2)
2. Refers to policies that are aimed at the encouragement of industrial investment and greater industrial efficiency. ✓✓ (2)
3. They promote industrial development in underdeveloped regions.✓✓ (2)

[6]

Activity 2

Discuss any TWO international best practices in terms of regional development. **[8]**

Answers to activity 2

1. **Total development as a multidimensional process** ✓✓ This is from a global development perspective. It includes all dimensions of human living, including the interaction of social forces in a community, e.g. education, health, nutrition.✓✓
2. **Development from within** ✓✓This is endogenous or independent development. In the past development programmes were forced upon regions. Now regions strive for independence with development assistance from outside included in their strategies. Local physical resources, human resources and energy are utilised.✓✓ **[8]**

Activity 3

Explain the rationale of industrial development highlighting the past and present approaches. **[8]**

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Answers to activity 3

1. **Past: Manufacturing development** ✓✓ is a method to advance economic development. It is financed by foreign loans, aid and generous financial and other incentives received by businesses. ✓✓
2. **Present: Emphasis has shifted to industrial development** ✓✓ – services and agricultural activities – focus on role for SMMEs – policies continue to exist – aim to export, employ and raise standard of living. ✓✓ **[8]**

Activity 4

Study **Figure 10.2** and answer the questions that follow:

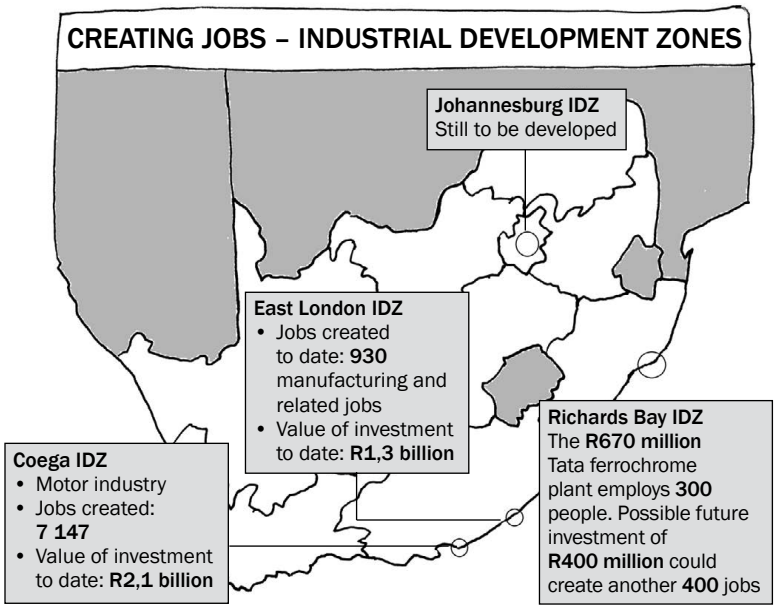

Figure 10.2: Creating jobs. Industrial development zones

1. Define the concept IDZ. (2)
2. List any TWO IDZ 's from the map. (2)
3. Mention the industry involved in TWO of the above mentioned IDZ's. (2)
4. Discuss an incentive applied to businesses within the IDZ. (4)

[10]

Answers to activity 4

1. Industrial Development Zones are purpose-built industrial estates that are physically enclosed and linked to an international port or airport.✓✓ (2)
2. Johannesburg,✓ Richards Bay, ✓East London✓ and Coega ✓ (any 2) (2)
3. Coega = motor industry✓ and Richards Bay = metal industry✓ (2)
4. No duties are paid on imported goods.✓✓
   Designed to encourage domestic and foreign businesses to open in an IDZ and produce goods and services for export. ✓✓ (4)

[10]

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Chapter 11

South Africa's economic and social indicators

Economic and social indicators are useful tools to determine a country's well-being. There are many economic and social indicators, including production, employment, education and demographic indicators.

Overview

TOPIC	CONTENT	SCOPE AND DEPTH OF EXAMINABLE CONTENT
11. **Economics: basic concepts and quantitive elements: Economic and social performance indicators**	**Analyse South Africa's economic and social performance indicators and their uses** • **The Performance of an Economy** – Performance – Comparisons – Specifications – Purposes • **Economic Indicators:** – **Inflation Rate** – Production prices (PPI) – Consumer prices (CPI) – **Foreign Trade** – Terms of trade – The exchange rate – **Employment** – Economically Active Population (EAP) – Employment rate – Unemployment rate – **Productivity** – Labour productivity – Remuneration per worker – **Interest Rates** – Repo Rate	• Define/explain the relevant concepts • Broadly outline the performance of an economy **HOT QUESTION: Propose five considerations when assessing the performance of an economy** • Analyse the economic indicators in detail

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	– **Money Supply**
	  – M1
	  – M2
	  – M3
	
	• **Social Indicators:**
	  – **Demographics**
	  – Population growth
	  – Life expectancy
	  – **Nutrition and Health**
	  – **Nutrition**
	  – Malnutrition
	  – Obesity
	  – **Health**
	  – Infant mortality
	  – Under 5 mortality
	  – Spending on health
	  – Access to clean water
	  – Access to sanitation
	  – **Education**
	  – Percentage public sector spending
	  – Percentage enrolment in Secondary Schools
	  – **Services**
	  – Electricity
	  – Refuse/Garbage removal
	  – Water supply
	  – Sanitation
	  – **Housing and Urbanisation**
	  – **Housing**
	  – Number of houses completed
	  – **Urbanisation**
	  – Natural growth in population
	  – Migration
	  – Founding of new towns
	
	• **International Comparisons**
	  – **Globalisation**
	  – **International standardisation**
	  – **Aid and support**
	  – **Comparison and forecasting**
		• Analyse the social indicators in detail
		
		HOT QUESTION: Identify five social indicators that are used for international benchmarking and give an analysis of their importance

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11.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well.

Term	Definition
Consumer Price Index (CPI)	Measures changes over time in the prices of an average market 'basket' of consumer goods and services purchased by households
Economically active Population (EAP)	All persons of either sex between the ages of 15 and 65 who supply labour for productive activities
International Monetary Fund (IMF)	An organisation working to promote employment, exchange rate stability, and international trade and economic cooperation by making financial resources available to member countries to meet their balance of payments needs
System of National accounts (SNa)	Techniques which include double-entry accounting, for measuring the economic activity of a nation
United Nations Children's Fund (UNICEF)	An international body working for the development of children's rights, and their survival and protection
World Bank	The international bank established to promote economic recovery and development

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11.2 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 behaviour 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.

11.3 Economic indicators

11.3.1 Price change indicators

Price increases occur either because of scarcities of a product or changes in consumer preferences. Price increases over long periods of time are known as inflation.

There are two key price change indicators:

- **Producer Price index (PPI):** This is the indicator used to measure an increase or decrease over time in the prices of goods produced locally when they leave the factory floor; and an increase or decrease in the price of imported goods.
- **Consumer Price index (CPI):** Weights are obtained from the expenditure of households and show changes in the purchasing power of the rand. This is the official index used in inflation targeting.

11.3.2 Foreign trade indicators

International trade is important in a globalised world. Exports stimulate employment and imports widen the choice of consumers.

- **Terms of trade:** The ratio of export and import prices. If the ratio deteriorates (gets worse), a greater volume of exports must be produced that may cause a spill-over effect into the balance of payments.
- **Exchange rate:** The value of one country's currency in relation to another country's currency.

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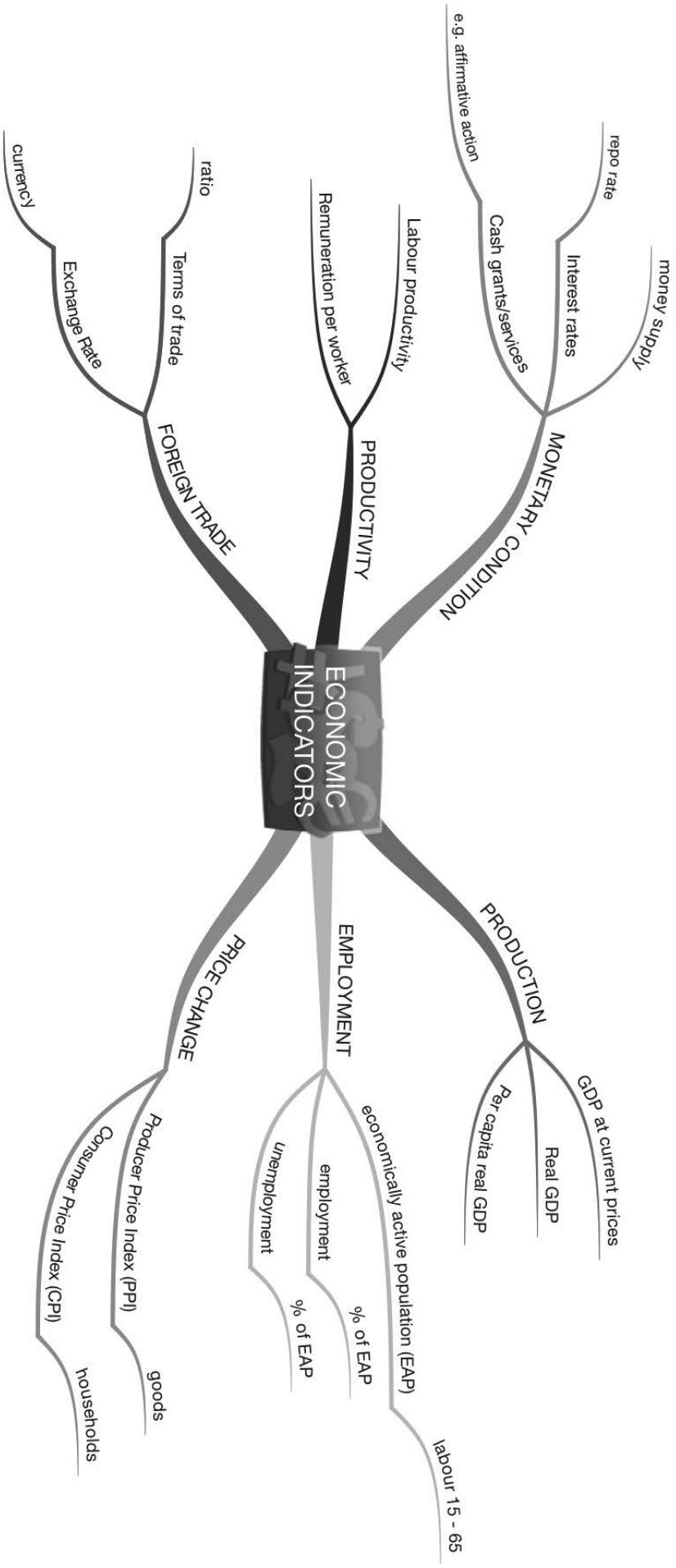

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11.3.3 Employment indicators

- **The economically active population (EAP):** The labour force between15 – 65 years of age.
- **Employment:** The number of employed persons as a percentage of the economically active population (EAP), e.g. 73.5% in South Africa.
- **Unemployment:** The unemployed (who are actively looking for work) as a percentage of the economically active population.

11.3.4 Productivity indicators

Labour productivity is watched very closely, particularly in relation to real wage increases.

- **Labour productivity:** This 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.

11.3.5 Interest rates

Interest is the charge made for borrowing money.

- Repo rate is one of the most important interest rate indicators. It is the rate at which the SARB lends money to banks.

11.3.6 Money supply

The supply of money is controlled by the SARB. The money is classified in three categories.

- **M1:** notes and coins in circulation and demand deposits of the domestic private sector at banks.
- **M2:** M1 plus other short term and medium term deposits of the domestic private sector at banks.
- **M3:** M2 plus long term deposits of the domestic private sector at banks.

11.4 Social indicators

Social indicators are concerned with people. They monitor identifiable and definable issues related to human well-being over a period of time.

11.4.1 Demographics

The size of the population is important for infrastructure and social programmes.

- **Population growth:** The population numbered 46.8 million in 2005. Growth is slowing down. Measuring population growth is important for delivering social services and for identifying the size of the tax base (the total number of people paying taxes).
- **Life expectancy:** South Africa's life expectancy rate is down from 62,8 years to 47 years.

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11.4.2 Nutrition and Health

The standard of living of the population is related to the quality of nutrition and health:

Nutrition

- **Child malnutrition:** Malnutrition is expressed in two ways – weight for age (under weight) and height for age (dwarfism). The proportion of underweight children is the most important indicator of malnutrition.
- **Overweight children:** there is an association between obesity of children and other diseases.

Health

- **Infant mortality:** The number of children that will die before one year of age is one way of measuring the health of a population.
- **Under-five mortality:** the number of children that will die before the age of 5 years.
- **Health expenditure:** the amount of health expenditure as a percentage of GDP.
- **Access to safe drinking water:** the percentage of a population that has reasonable access to safe drinking water.
- **Access to sanitation facilities:** the percentage of a population with at least adequate sanitation facilities that can prevent human, animal and insect contact.

11.4.3 Education

The standard of living is related to the level of education. Education is a key social indicator:

- **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.

11.4.4 Services

A number of services that are vital to enhance people's lifestyle and level of economic and social development:

- Electricity
- Refuse removal
- Water supply
- Sanitation

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11.4.5 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

11.5 International comparisons

International comparisons are the key means of measuring a country's economic and social development.

NB

Learn these four points that are used by international organisations to measure a country's level of economic and social development.

11.5.1 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.

11.5.2 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.

11.5.3 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.

11.5.4 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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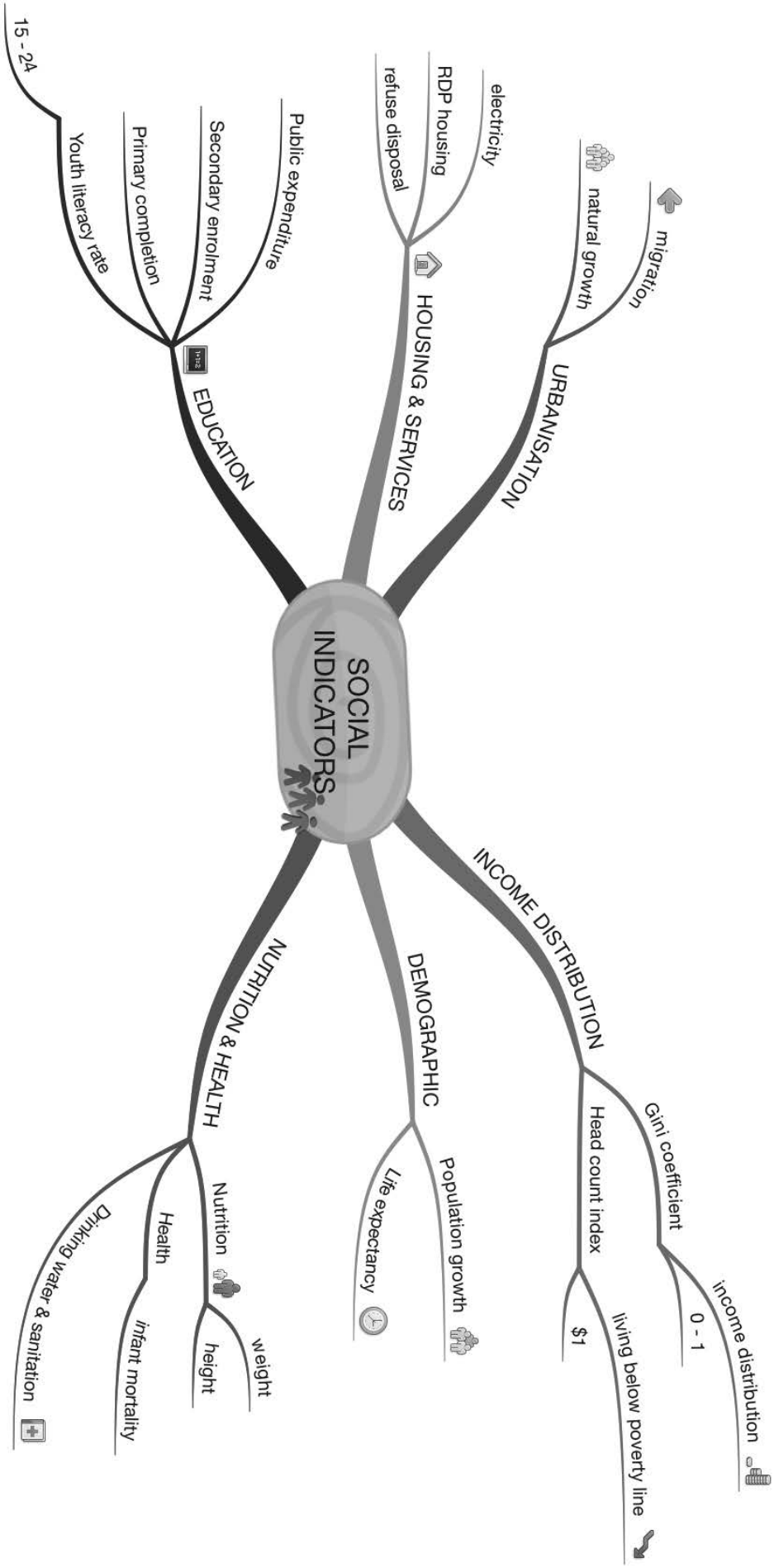

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Activity 1

Choose the correct word between brackets:

1. The key rate of interest in SA is the (repo/exchange) rate. (2)
2. The growth performance of a country is measured in terms of the (per capita real GDP/increase in the real GDP). (2)
3. The economically active population is the labour force between 15 and (55/65) years of age. (2)
4. The index used to determine the prices of inputs is called the (consumer/producer) price index. (2)
5. Social indicators are concerned with people, such as education and (corruption/health). (2)

[10]

Answers to activity 1

1. Repo rate ✓✓ (2)
2. Increase in the real GDP✓✓ (2)
3. 65✓✓ (2)
4. Producer✓✓ (2)
5. Health✓✓ (2)

[10]

Activity 2

Give **ONE** answer for each of the following:

1. An international bank established to promote economic recovery and development (2)
2. Used to establish the performance of the economy in terms of basic economic objectives of growth, price stability, exchange rate stability and full employment (2)
3. It is depicted in the Lorenz curve and shows the distribution of income (2)
4. The price of one country's currency in terms of another country's currency (2)
5. Ratio of export and import prices (2)

[10]

Answers to activity 2

1. World Bank✓✓ (2)
2. Economic indicator✓✓ (2)
3. Gini coefficient ✓✓ (2)
4. Exchange rate✓✓ (2)
5. Terms of trade✓✓ (2)

[10]

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Activity 3

Distinguish in tabular form between the Consumer Price Index and the Producer Price Index. (2 × 4) **[8]**

Answers to activity 3

PPI	CPI
Producer Price Index: an index that assesses the impact of changes ✓ in the relative prices of production inputs ✓ • Relates to the cost of production ✓ • Basket consists of goods only✓✓ • Capital and intermediate goods are included✓✓ • Prices exclude VAT ✓✓ • Interest rates are excluded ✓✓ • Prices of imported goods are shown explicitly ✓✓	Consumer Price Index: an index that measures the price ✓ of a fixed basket of consumer goods and services ✓ • Relates to the cost of living ✓ • Basket consists of consumer goods and services ✓✓ • Capital and intermediate goods are excluded ✓✓ • Prices include VAT ✓✓ • Interest rates are taken into account ✓✓ • Prices of imported goods are not shown ✓✓

[8]

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12 Chapter

Inflation

Inflation occurs when there is a sustained and significant increase in the general price level over a period of time. At the same time, there is a decline in the buying power of money, i.e. the general price level increases more than the general increase in wages or salaries.

Overview

TOPIC	CONTENT	SCOPE AND DEPTH OF EXAMINABLE CONTENT
12 Economic Issues of the day: Inflation	**Analyse and investigate inflation and the policies used to combat it** **Inflation** • **Definition** • **Measuring Inflation** – Indexes (CPI/PPI) – Weighting (Basket of goods and services) – Inflation Rate (Calculations)	• Define/explain the concept • Examine ways to measure inflation
	• **Types and Characteristics of Inflation** – **Consumer Inflation** – Headline Inflation – Core Inflation – Administered Prices Inflation – **Producer Inflation** – **All inclusive Inflation** – **Hyperinflation** – **Stagflation** – **Comparison of inflation rates**	• Define/explain the different types of inflation • Distinguish between the different types of inflation
	• **Causes and consequences of inflation** – **Demand-pull inflation** – Monetarists explanation – Causes of demand inflation – Increase in household consumption – Decline in saving – Tax reduction – Access to credit – Investors expenditure – Government expenditure – Export services	• Briefly discuss demand-pull inflation • Analyse the causes of demand-pull inflation

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	– **Cost-push Inflation**
	  – Causes of cost-push inflation
	  – Wages
	  – Key inputs
	  – Exchange rate depreciation
	  – Profit margins
	  – Productivity
	  – Natural disasters
		• Briefly discuss cost-push inflation
		• Analyse the causes of cost-push inflation

	– **Consequences of Inflation, on**
	  – Debtors/Creditors
	  – Wage and salary earners
	  – Investors and savers
	  – Taxpayers
	  – Industrial peace
	– **Expectancy and Inflation**
		• Examine in detail the consequences of inflation

	• **The inflation problem in South Africa**	• Broadly outline the inflation problem in South Africa

	• **Measures to Combat Inflation**
	– **Demand-pull inflation**
	  – Monetary policy
	  – Fiscal policy
	– **Cost-Push Inflation**
	  – Productivity
	  – Competition
		• Examine the measures to combat inflation in detail
		• Use the following information to calculate the CPI for September 20…
		
		HOT QUESTION: What effects does inflation have on the current account of the South African BoP?

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12.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well.

Term	Definition
Administered prices	Prices set or controlled by government
Core inflation	Excludes items from the CPI basket that are highly volatile or prices affected by government policy
Cost-push inflation	Occurs when there is an increase in the general price level caused by an increase in the cost of production
Consumer Price Index (CPI)	An index that measures the price of a fixed basket of consumer goods and services • Relates to the cost of living • The basket consists of consumer goods and services • Capital and intermediate goods are excluded • Prices include VAT • Interest rates are taken into account • Prices of imported goods are not shown
Demand-pull inflation	Occurs when the aggregate demand for goods and services exceeds the aggregate supply of goods and services
Headline inflation	Unadjusted CPI figures
Hyperinflation	An inflation rate above 50%. People lose confidence in the value of money and start bartering goods and services
Inflation	A sustained and significant increase in the general price level over a period of time; and a simultaneous (at the same time) decline in the buying power of money
Inflation targeting	Forms part of monetary policy and is managed by the Reserve Bank to keep inflation within the range as set by the Minister of Finance (between 3% and 6%)
Monetary Policy Committee (MPC)	Consists of the Governor of the Reserve Bank, 3 deputy governors and another 3 members. Their main purpose is to determine an interest rate that will be consistent with meeting the inflation target
Producer Price Index (PPI)	Assesses the impact of changes in the relative weighting of production inputs: • Pertains to the cost of production • The basket consists of goods only • Capital and intermediate goods are included • Prices exclude VAT • Interest rates are excluded • Prices of imported goods are shown explicitly
Stagflation	Low growth, high unemployment and high inflation rates occur simultaneously

12.2 Measuring inflation (define, explain, examine)

Price indexes are used to measure the changes in the general price level. The following are important concepts related to measuring inflation:

1. **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.

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2. **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.
3. **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.
4. **Inflation targeting:** Forms part of monetary policy set by government and is managed by the Reserve Bank to keep inflation within the range as set by the Minister of Finance (between 3% and 6%). The aim of inflation targeting is to keep the inflation rate at low and more stable levels.

12.3 Types and characteristics of inflation

There are two main types of inflation – demand-pull inflation and cost-push inflation. Their characteristics are explained below:

12.3.1 Consumer inflation

- **Headline inflation:** it is measured by the CPI and is calculated for urban areas only. It represents the cost of a shopping basket of goods and services of a typical SA household. Stats SA identifies 1 500 different consumer goods/services, assigns a weight to each, decides on a base year, on formula and on the collection of prices. The unadjusted CPI rate is known as headline inflation.
- **Core inflation:** it is published by Stats SA and excludes items from the CPI basket with highly volatile prices and those affected by government intervention and policy, e.g. fresh and frozen meat and fish, vegetables, interest rates on mortgage bonds, VAT and assessment rates.
- **Administered prices:** the prices are set by government or controlled by government through appointed authorities. Price changes must remain within the inflation target prescribed by the Minister of Finance.

12.3.2 Producer inflation

PPI is used to measure the prices of domestically produced goods. It also shows domestic output. When the rand depreciates it will first be reflected in the PPI.

Differences between CPI and PPI:

CPI:

- Pertains to cost of living
- Basket consists of consumer goods and services
- Capital and intermediate goods are excluded
- Prices include VAT
- Interest rates are taken into account
- Prices of imported goods are not shown

PPI:

- Pertains to cost of production.
- Basket consists of goods only.
- Capital and intermediate goods are included.
- Prices exclude VAT.
- Interest rates are excluded.
- Prices of imported goods are shown explicitly.

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12.3.3 All-inclusive inflation

- Economists check what happened to prices of all final goods and services produced in a particular year.
- Use the calculated implicit GDP deflator.
- GDP figures at current and constant prices are used as published in the national accounts.
- GDP at constant prices measures economic growth and measures inflation.
- Measures the inflation rate for economy as a whole.
- Implicit GDP deflator is the ratio of GDP at current prices to GDP at constant prices.
- To determine inflation: $\frac{\text{GDP deflator for next year}}{\text{GDP deflator for previous year}} \times 100$.

12.3.4 Hyperinflation

- Very high rate of inflation (more than 50%).
- Price levels rise so rapidly that people lose confidence in the value of money.
- Becomes difficult for the economy to operate.
- People resort to goods as medium of exchange – barter.

12.3.5 Stagflation

A low growth rate, high unemployment and high inflation rate.

12.3.6 Comparison of inflation rates

- Annual inflation rates of CPI, PPI and GDP deflation are provided.
- For policy purposes and forecasting all these indexes as well as other implicit deflators are considered.
- For the consumer the CPI is by far the most important indicator because it relates to their cost of living and the interest rate policy of the Reserve Bank.

12.4 The causes of inflation

12.4.1 Demand-pull inflation

Demand-pull inflation occurs when aggregate demand in an economy outpaces (is faster than) aggregate supply, even though gross domestic product rises and unemployment falls. Effectively, too much money is spent chasing too few goods. Generally, an increase in the supply of demanded goods will reverse the inflationary trend. Some of the characteristics of demand-pull inflation are:

- 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).
- **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

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- **Tax reduction:** If personal income tax is reduced more money is available for private consumption expenditure.
- **Access to credit:** Ggreater availability of consumer credit (credit cards) and cheaper credit – credit multiplier kicks in and more credit is created.
- Figure 12.1 illustrates an increase in aggregate demand from AD_1 to AD_2 and a single aggregate supply AS_1. As the aggregate demand increases, the price level and production output will also increase until full employment is reached. The initial increase in demand will have a positive influence on production, employment and income, but when full capacity is reached further increases in demand will lead to price increases.

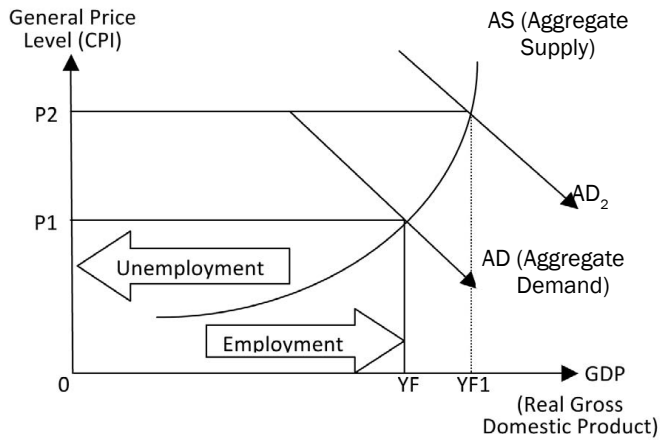

Figure 12.1: The inflationary process

Causes of demand-pull inflation

There are many causes of demand-pull inflation. Some of these are:

- **Increase in household consumption:** due to easily available credit, a reduction in taxes and less savings.
- **Investors expenditure:** may lead to higher profit expectations of businesses. They will invest more, this might lead to an increase in the demand for goods and services.
- **Government expenditure:** an increase in government spending leads to an increase in prices. More money comes into circulation due to an increase in spending on infrastructure, consumption spending and social spending.
- **Export earnings:** the growth in foreign countries might create an increased demand for locally produced goods without an increase in production.
- **The Monetarist explanation:** According to the monetarists sustained high rates of growth in the money supply cause high inflation, while low rates of growth cause low inflation. They base their view on the quantity theory of money (MV = PT). They make three basic assumptions: the velocity of circulation of money is stable; the quantity of money is exogenously determined by monetary authorities and real output is determined by the quantity and quality of various factors of production.

12.4.2 Cost-push inflation

Cost-push inflation is caused by an increase in the cost of goods or services that are very important to the economy, and for which no alternatives exist. Examples can be spikes in the oil price due to war, huge price rises in essential food products due to drought, or excessive increases in the cost of labour due to control of industries by trade unions. Some of the characteristics of cost-push inflation are:

- **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**.

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- **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.

Causes of cost-push inflation

- **Wages:** an increase in wages constitutes 50% of GVA at basic prices and is one of the major causes of cost-push inflation.
- **Key inputs:** When the prices of key input goods that are imported, increase, domestic cost of production increases especially in the manufacturing sector.
- **Exchange rate depreciation:** The depreciation in the rand will lead to more expensive imports.
- **Profit margins:** When businesses increase their profit margins, their cost of production and prices consumers must pay, will also increase.
- **Productivity:** Less productive factors of production will lead to increased cost per unit.
- **Natural disasters:** Prices will increase due to weather changes such as droughts, floods and global warming.

Expectancy and inflation

The inflationary process is triggered by demand pull and cost push inflation. The role of inflationary expectations:

- during inflation consumers expect prices to rice and start to buy more goods
- labour unions wish to protect their members' income against erosion of purchasing power caused by inflation
- expectation that wages will rise encourages some businesses to increase prices in advance.

12.5 The consequences of inflation

SUMMARY: Fiscal policy makes use of **tax increases** and **spending cuts** to combat inflation.

- **Debtors/Creditors:** debtors benefit because they receive money with a high purchasing power and repay their debt with money with low purchasing power. Creditors on the other hand suffer.
- **Wage and salary earners:** people with a fixed income will be able to purchase less as prices are rising.
- **Investors and savers:** Assets with a fixed nominal value have a fixed return and lower purchasing power as prices increase. Real value of savings decreases.
- **Tax payers:** In South Africa income is taxed on a progressive system. We experience a bracket creep, resulting from inflation and progressive income tax and the government benefits.
- **Disruption of industrial peace:** Wage bargaining is accompanied by strikes and mass action.

12.6 Measures to combat inflation

Policy makers can use various policy measures to fight inflation when it gets too high. Three types of policy measures are highlighted.

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12.6.1 Fiscal measures

Fiscal measures are measures taken by the Minister of Finance regarding taxation and expenditure. Examples of measures that can be taken include:

- An increase in **direct taxation** (personal income tax) which will help to decrease demand.
- An increase in **indirect taxation** (VAT) causes spending to decrease because goods become more expensive.
- A **loan levy**. Reduces the disposable income of consumers.
- **The state cuts back on expenditure** by cancelling government projects like roads, hospitals and schools.
- **The country's finance budget deficit is non-inflationary** (the government uses loans from the non-banking sector to limit inflation).
- **The state imposes surcharges** on imported goods. This increases the price of these imported goods, resulting in many people being unable to afford to buy these goods.

SUMMARY: Monetary policy involves **reducing money supply** to combat inflation.

12.6.2 Monetary measures

The South African Reserve Bank (SARB) and the government apply certain monetary measures to curb inflation:

- The SARB **adjusts the quantity of money to the needs of the economy**, (e.g. through open-market policy, thus maintaining a fine balance) between the supply of goods and services and money supply.
- The SARB **curbs inflation** caused by excess demand by reducing the money supply.
- The **bank rate** of the central bank (SARB) affects the interest rates in the economy (repo rate). The bank rate can be raised to encourage savings.
- Excessive credit can be reduced by **restricting the granting of credit** by banks.
- The SARB can apply **moral pressure** (moral suasion) on financial institutions to be more careful when granting credit.

12.6.3 Other measures

Additional measures that can be taken to combat inflation include:

- **Increase productivity:** This is a long-term measure generated through improved education and training which allows more people to be employed and ensures they are more productive.
- **Price control:** By fixing the price of certain essential goods, the government assures they remain affordable.
- **Wage policy**: The government takes a decision to break the inflationary spiral of increased wages and prices by keeping the increase in wages below or at the level of inflation.
- **Stricter conditions for consumer credit**: The government makes it harder for consumers to get credit in order to restrict their spending.
- **Encourage personal savings**: The government implements measures to encourage savings, e.g. by cutting taxes on savings. The imbalance between demand and supply is corrected by increased savings, as people save more and spend less.
- **Import controls** are relaxed.
- **Floating exchange rate:** Prices are automatically adjusted to international conditions.
- **Indexation**: A policy of linking prices of items such as wages, pensions and mortgage bond interest rates to price indices to eliminate the effects of inflation.

Use the following word acronyms to help you remember these additional measures to combat inflation:

W – Wage
I – Import
P – Productivity
E – Exchange rate

S – Savings
C – Credit
I – Indexation
P – Price

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Activity 1

Study Figure 12.2 below and answer the questions that follow:

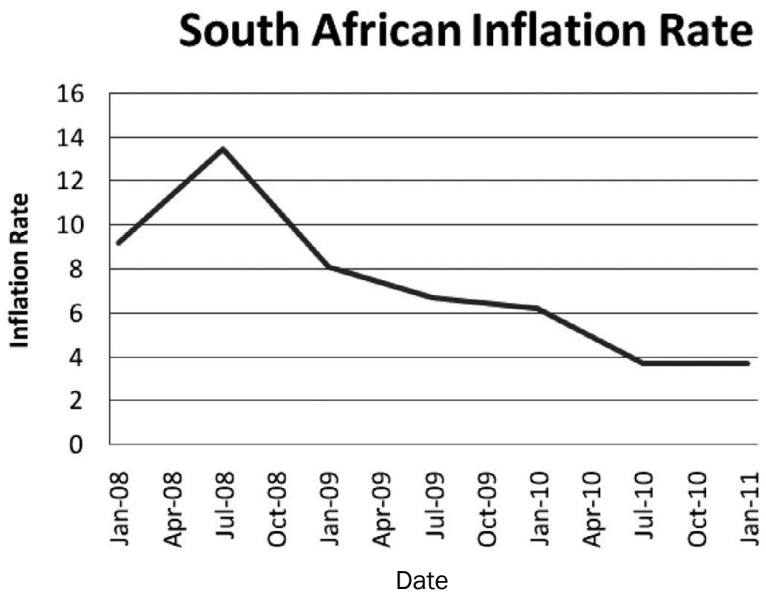

Figure 12.2 South Africa's inflation rate

1. Define the concept inflation. (2)
2. When did the inflation rate peak? (2)
3. Do we adhere to the inflation target set by government from July 2010–Jan 2011? Supply figures. (4)
4. Explain what you would do to lower the inflation rate in our country? (4)
5. Which institutions in South Africa make inflation figures available? (2)
6. What, according to you, caused the double figures in April–July 2008? (4)
7. Why are these figures in the graph not a reflection of hyperinflation? (4)

[22]

Answers to activity 1

1. A sustained and significant increase in the general price level over a period of time. ✓✓ (2)
2. July 2008 ✓✓ (2)
3. Yes ✓✓ Inflation target between 3 – 6 % ✓✓ (4)
4. Apply monetary (repo rate) ✓✓ and fiscal policies (tax increases) ✓✓ (4)
5. SARB and Stats SA ✓✓ (2)
6. Excessive consumer spending. ✓✓ Due to the capital expenditure by the state for the Soccer World Cup ✓✓ (4)
7. Hyperinflation starts at 50% ✓✓✓✓ (4)

[22]

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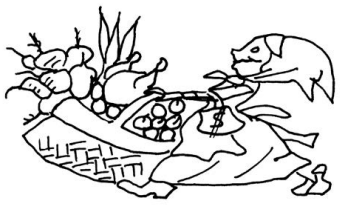
Activity 2

Study the cartoon below and answer the questions that follow:

	
Before inflation - she goes to the market carrying her money in her **HANDBAG**	And brings her groceries home in a **BASKET**
After inflation - she carries her **MONEY** in a basket, and.....	Brings her groceries home in her **HANDBAG**

1. What is the message behind the cartoon? (2)
2. What is happening to the purchasing power of the money? (2)
3. In which country is this woman a consumer? Motivate your answer. (4)

[8]

Answers to activity 2

1. Due to inflation, the consumer can buy less for the same amount ✓✓ (2)
2. Declining ✓✓ (2)
3. USA ✓✓ She is carrying US Dollars ($) in her basket ✓✓ (4)

[8]

Activity 3

Name any THREE fiscal measures to control inflation. (3 × 2) **[6]**

Answers to activity 3

Increase direct taxation (personal income tax) if inflation is due to excess demand✓✓

- Increase indirect taxation (VAT) ✓✓
- A loan levy is introduced ✓✓
- The state cuts back on expenditure ✓✓
- The finance budget deficit is non-inflationary ✓✓
- Impose surcharges on imported goods ✓✓ (any 3) (3 × 2)

[6]

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13 Chapter

Tourism

Tourism is travel for the purpose of leisure, recreation or business. Local tourists travel to different places in their own country. **Inbound tourists** come to South Africa from other countries. South African tourists who travel overseas are known as **outbound tourists**. South Africa is a popular tourist destination because of its beauty, wildlife, good weather and its interesting political history.

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Overview

TOPIC	CONTENT	CONTENT DETAILS FOR TEACHING, LEARNING AND ASSESSMENT PURPOSES
13. **Tourism and Economic Redress: Environmental sustainability**	**Debate the economic importance of tourism to South Africa and suggest policies to promote it, also refer to the importance of indigenous knowledge systems (IKS)** **Tourism:** • Definition • Types of tourism • Measuring tourism	• Define/explain the relevant concepts • Broadly outline the types of tourism • Broadly outline the measuring of tourism
	• **Reasons for its Growth** – International – Domestically	• Examine the reasons for growth in the tourism industry in detail
	• **The Effects of Tourism on:** – GDP – Employment – Poverty – Externalities – Environment – Investment	• Examine the effects of tourism in detail
	• **The Benefits of Tourism for:** – Households – Businesses – State – Infrastructure Development	• Examine the benefits of tourism on: Households, Businesses, Government and Infrastructure development
	• **South Africa's profile (indigenous knowledge systems)** – South Africa's Profile – Aim with visits – Local Destinations – Local Tourists – Indigenous Knowledge	• Broadly outline the tourism profile of South Africa
	• **Policy Suggestions – Department of Tourism** – Marketing, infrastructure, education and training and environmental management	• Broadly outline the Department of Tourism's policy suggestions • Briefly analyse the relationship between tourism and indigenous knowledge within the South African context

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13.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well. Use mobile notes to help you remember them.

Term	Definition
Domestic tourist	South African citizens travelling within the borders of South Africa
Department of Tourism	Ensures and accelerates (speeds up) the delivery of tourism benefits
Foreign tourist	Visits a foreign country as a destination
Inbound tourist	Tourists from other countries (foreign tourists) who stay for more than one day
Outbound tourist	South African citizens travelling abroad. They have the same effect as imports on the balance of payments
Tourism	Activities of people travelling to and staying in places outside their usual environment for no more than one year for leisure, business and other purposes. It does not relate to any work done for money in the place visited
Transit tourist	Tourists travelling through South Africa using air, road, rail and sea transport to get to another destination

13.2 Definition of tourism

Tourists travel to foreign countries for holidays, business, conferences and to discover more about other countries. **Tourism** allows people to experience the world. Tourism can be defined as activities of people travelling to places outside their usual environment for less than one year for business, leisure or other purposes without any remuneration.

An activity is seen as tourism if it fits in with the following criteria:

- There is a purpose for the visit or activity.
- There is no remuneration (money) earned in the place visited.
- A minimum length of stay is one night.
- A maximum length of stay is one year.
- There is a travelling distance of more than 160 km from the tourist's home environment.

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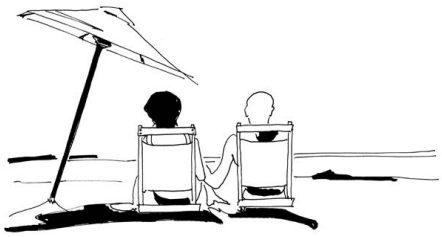
13.3 The purposes (types) of tourism

- **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.



Leisure and recreation

Cultural tourism

Ecotourism

Business and professional

13.4 Measuring tourism

Tourism consists of different activities that should comply with the following:

- There should be a purpose for the visit e.g. camping, business or studies.
- No remuneration should be earned at the tourist destination.
- A minimum length of stay should be one night.
- The maximum length of stay should not exceed one year.
- The travelling distance should exceed 160 km from a person's residence.

13.5 Reasons for growth

The rapid growth in the tourism industry has resulted in a steady change in the standard of living as well as people's lifestyles. Tourism is much more evident in the developed than developing countries, although tourism is increasing faster in the developing countries. Local tourism is booming since South Africa is becoming more attractive as tourist destination.

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Reasons for the growth of the tourism industry are:

- Increased disposable income.
- Less working hours so more time to travel.
- An awareness of leisure and recreation.
- Improved transport, communication and accommodation facilities.
- Increased advertising and promotion.
- Enjoying the benefits of holidays and travel.
- Easily obtainable foreign exchange.
- **International:** tourism is much more evident in the developed than developing world, but tourism is growing faster in developing countries, e.g. 4.6% growth from 2010 to 2011.
- **Locally:**
  - **Foreign arrivals:** foreign tourists who visit the country as their destination.
  - Those who are stopping over, are called transit tourists or same-day travellers.
  - **Foreign tourists:** come for the experience – visit friends, game farms, enjoy the different cultures, heritage spots or sports activities and events.
  - **Domestic tourism:** South Africans are free to travel locally (domestic tourists) or abroad (outbound tourists). Outbound tourists have the same effect on the Balance of Payments as imports.

Use the acronym PIGEEE to help you remember the 6 effects of tourism:

P – Poverty

I – Infrastructure

G – GDP

E – Employment

E – Environment

E – Externalities

13.6 The effects of tourism

Tourism has a significant effect on the economy and the country as a whole. The following **6 areas** are greatly affected by tourism:

13.6.1 Employment

- Tourism employs 7% of South Africa's workforce (approximately 1,12 million people).
- Tourism is the largest provider of jobs because it:
  - Is labour intensive.
  - Employs many different kinds of skills, e.g. tourist guides, hotel staff.
  - Provides immediate employment.
  - Provides entrepreneurial opportunities.
- Tourism is the largest earner of foreign exchange because:
  - Foreign tourists pay for services in foreign exchange.
  - Foreign tourists usually spend more than local tourists.

13.6.2 Gross domestic product (GDP)

- Tourism has the biggest impact on the services industry.
- Indirect contribution: Tourism is a service-based industry. It is responsible for 65% of the GDP in developed economies and 40% of the GDP in developing countries.
- Direct contribution: Tourism contributes 7,9 % of GDP in South Africa (compared to 12% worldwide).

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13.6.3 Poverty

Poverty is most evident in rural areas due to a lack of job opportunities. Tourism can alleviate (ease) poverty in the following ways:

- Tourism is a fast and effective mechanism for distributing resources to rural areas to develop them as tourist sites.
- Many prime tourist attractions are located in rural areas.
- Tourist developments in rural areas increase the number of available jobs in areas where there aren't many jobs.
- Tourism promotes a balanced and sustainable form of development. People are able to earn a living in their home areas, resulting in a reduction in urbanisation and a more balanced population distribution.

13.6.4 Externalities

Externalities are costs and benefits that result from a specific activity. Tourism results in both:

Positive externalities:

- Tourism attracts large amounts of revenue.
- Tourism leads to an improvement in infrastructure development.
- Tourism can stimulate employment indirectly.
- Tourism can help conserve cultural and natural assets and alleviate poverty, but needs to be carefully planned.

Negative externalities:

- Tourism can cause environmental damage if not managed correctly.
- Tourism can result in a lot of waste and damage to sensitive tourist sites.
- The infrastructure at tourist sites can come under pressure to cater for increased tourist numbers.
- Tourism can lead to increased prices for locals.

13.6.5 The environment

Tourism can create environmental stress. It can result in:

- Permanent restructuring of the landscape, e.g. construction work on highways.
- Additional waste products, e.g. biological (sewage) and non-biological (litter) waste.
- Direct environmental stress, e.g. the loss of wildlife species due to safari hunting.
- Effects on population dynamics, e.g. migration and changes in population density in response to the needs of tourist sites.

13.6.6 Investment

Tourist destinations require adequate physical (hotel rooms), economic (ATMs) and basic (water and electricity) services infrastructure. This includes:

- Transport infrastructure, e.g. improved roads are needed to access tourist sites.
- Communication infrastructure, e.g. hotels need telephone lines to take bookings at tourist sites.
- Energy infrastructure, e.g. tourists need electricity at tourist sites.
- Basic services, e.g. clean water and refuse removal.

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Use this mnemonic to help you remember the 4 benefits of tourism:

H – Households – HOT

B – Businesses – BEACHES

I – Infrastructure – IN

G – Government – GEORGE

13.7 The benefits of tourism

South Africa benefits from tourism through the growth in the gross domestic product (GDP), employment and infrastructure development. An additional benefit is that spending by foreign tourists results in an increase in foreign exchange earnings, which has a similar impact on the GDP to an increase in exports.

13.7.1 Households

Tourism benefits a household's prosperity (wealth) in three ways:

- **More people earn salaries and wages** because of additional job opportunities.
- **Infrastructure** built for tourists is available both for tourists and local people's use.
- **Skills**: A variety of skills is required in the tourism industry.

13.7.2 Businesses

Tourism has many benefits for the business sector:

- The economic and basic services infrastructure required for tourism is provided by the public sector.
- Tourism needs superstructure, which consists of businesses that provide accommodation, transport, built attractions, retailing and recreation services.
- Superstructure is normally supplied by the private sector, and the building and running of the superstructure make profits.
- Public and private sector partnerships (PPPs) are used to develop tourist destinations.
- Other work opportunities become available for the previously disadvantaged. These include:
  - Employment opportunities in entertainment, laundry and transportation.
  - Business opportunities in car rental, arts, craft and curio sales.

13.7.3 Government

The main benefit to government is in the levying (charging) of taxes. This has two purposes:

- **To recover external costs**: To compensate the host community for providing infrastructure.
- **To raise revenue**: Tourists are seen as part of the overall tax base (e.g. airport departure taxes and hotel tourism levies increase the amount of taxes collected).

13.7.4 Infrastructure development

South Africa benefits from tourism because all infrastructure built to support tourism becomes an asset to the country.

As a result:

- Residents and visitors enjoy adequate and well-maintained physical and basic services infrastructure.
- The Department of Transport prioritises economic infrastructure. Spatial Development Initiatives and economic corridors focus on tourism, and public and private sector partnerships (PPPs) are used for the development of infrastructure.

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- Tourists require social infrastructure – ambulances, medical clinics, police protection services and information services – that becomes a national asset.

13.8 A South African tourism profile

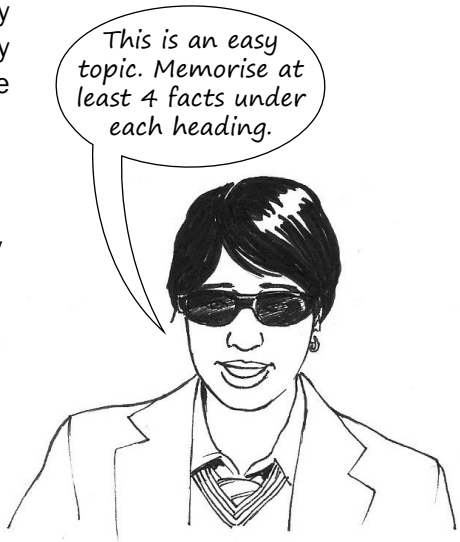
1. Aim with visits: most foreign tourists visit South Africa for vacation (94.3%) and business (2%). The major attractions are the coast, wildlife and scenery.
2. Local destinations: Destinations link all aspects of tourism – demand, supply, transport, accommodation and marketing. The success of tourism is determined by the variety of destinations as well as the geographical distribution of tourist destinations.
3. Local tourists: There has been a steady growth in the number of South Africans travelling domestically.
4. Indigenous knowledge
   - Tourists want to understand the indigenous (local) culture, history and environment.
   - Tourists seek authentic (genuine) and unique destinations. They want to see how local people live and work.
   - The Khoi San are among the world's oldest people, and their way of life is of interest to many foreign tourists.

World heritage sites:
- Mapungubwe (Limpopo)
- Vredefort Dome (Free State and North West)
- Sterkfontein caves
- Robben Island
- Richtersveld Cultural and Botanical Landscape

Environmental World Heritage Sites:
- iSimangiliso Wetland Park (ecosystems)
- Cape Fynbos Region
- uKhahlamba Drakensberg Park

13.9 Tourism policy 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**. Some tourism policy initiatives include the following:



13.9.1 Marketing

SA Tourism was created to promote tourism internationally and nationally
- **Nationally**: SA Tourism persuades South African citizens to travel in their own country.
- **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

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- South Africa's political miracle
- The climate
- Safety
- The friendliness of South Africa's people
- The cleanliness and tranquility (peace) of our tourist destinations

13.9.2 Directing tourists' 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.
- **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.

13.9.3 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.

13.9.4 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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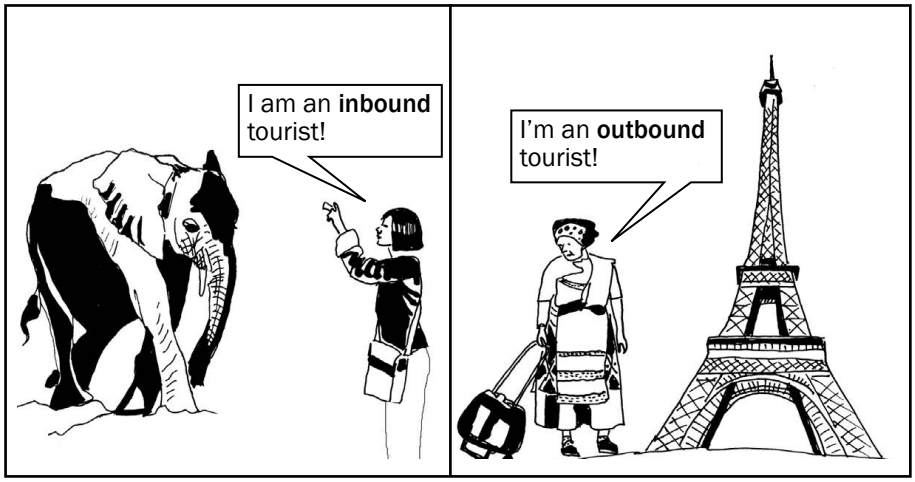
Activity 1

Study the diagram below and answer the questions that follow:



1. Define the concept tourism. (4)
2. Explain the difference between an inbound and an outbound tourist. (4)
3. List any THREE World Heritage Sites in South Africa. (3)
4. Discuss the effect of tourism on infrastructure. (4 × 2) (8)

[19]

Answers to activity 1

1. Activities of people travelling to and staying in places ✓ outside of their usual environment for no more than one consecutive year ✓ for leisure, business and other purposes. ✓ It does not relate to any work done for money in the place visited. ✓ (4)

2.

Inbound tourist	Tourists from other countries ✓ who stay for more than one day ✓ are inbound tourists (foreign tourists).
Outbound tourist	South African citizens travelling abroad ✓ have the same effect as imports on the balance of payments. ✓

(4)

3. Mapungubwe in Limpopo ✓ Vredefort Dome (meteorite) in North West ✓ Sterkfontein caves (Mrs Ples and Cradle of Humankind) ✓ Robben Island ✓ (any 3) (3)
4. Tourism requires economic infrastructure (roads), social infrastructure (ambulances) and basic services (clean water). ✓ This infrastructure needs to be maintained for local citizens, domestic and foreign tourists. ✓

   Basic considerations for infrastructure development are:
   - More infrastructure (e.g. water) ✓✓
   - Upgrading (e.g. upgrade dirt roads to tarred roads) ✓✓
   - New technology (e.g. transport) ✓✓ (8)

[19]

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Activity 2

Choose the correct answer from the following alternatives:

Tourism is _____ intensive.

A. Labour
B. Capital
C. Risk

[2]

Answer to activity 2

A. Labour ✓✓

[2]

Activity 3

Choose the correct answer from the following alternatives:

Tourism benefits the household through_____ .

A. Lower incomes
B. Lower productivity
C. More infrastructure

[2]

Answer to activity 3

C. More infrastructure ✓✓

[2]

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Chapter 14

Environmental sustainability

Environmental sustainability relates to the ability of the environment to survive its use for economic activity. The environment is not an unlimited resource and it is important that we sustain the environment so that it can be used by future generations.

Overview

TOPIC	CONTENT	CONTENT DETAILS FOR TEACHING, LEARNING AND ASSESSMENT PURPOSES
14. **Basic economic problem: Environmental sustainability**	**Analyse environmental sustainability and investigate recent international agreements in this regard, for example, the Rio de Janeiro and Johannesburg summits** • **The State of the Environment** – **Pollution** – Definition – Types – **Erosion, deforestation and climate change** – **Conservation** – **Preservation** • **Measures to Ensure Sustainability** – **Using the market** – The market does not take care of social costs and benefits – The market fails because of specific reasons – The mechanism of market and social costs and benefits	• Define/explain the relevant concepts • Briefly discuss the state of environment • Examine the measures to ensure sustainability in detail **HOT QUESTION: How effective are the South African government's interventions with regard to environmental sustainability? Motivate your response!**

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	– **Government Interventions**
	  – Give property rights
	  – Pay for environmental use
	  – Levying of environmental tax
	  – Pay for environmental subsidies
	  – Issuing of marketable permits
	– **Public sector control**
	  – Command and control
	  – Voluntary agreements
	  – Education
	– **International**
	  – Sustaining biodiversity
	  – Chemical waste
	  – Hazardous waste
	  – Climate change policy – adaptation and mitigation
	  – Loss in indigenous knowledge
	
	• **Major International Agreements**
	  – **Rio de Janeiro summit (UNCED)**
	  – **Johannesburg summit (WSSD)**
	  – **Rio + 20 summit**
	  – **Kyoto-protocol**
	  – **Millennium Development Goals**
	  – **United Nations Framework Convention on Climate Change (COP 17)**
		• Distinguish between the concepts, protocol and agreement
		• Briefly discuss the major protocols in terms of the following:
		  – Name of the agreement
		  – Environmental issue to be addressed by the agreement/protocol
		  – Envisaged outcome of the agreement/protocol

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14.1 Key concepts

These definitions will help you understand the meaning of key Economics concepts that are used in this study guide. Understand these concepts well. Use mobile notes to help you study them.

Terms	Definitions
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

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14.2 The state of the environment

The state of the environment is very important for environmental sustainability. If the environment is damaged, it will become more difficult to sustain life on earth. The environment can be damaged by excessive (too much) mining; by farming without allowing the soil to recover; by excess fishing without allowing the fishing stocks to build up again; and by not controlling the release of pollution.

14.2.1 Pollution

Pollution relates to the introduction of contaminants (poisons) that damage the natural environment. Pollution can come from chemical substances released by factories, as well as from household and business waste and rubbish. Pollution policy is difficult to apply in practice. The following are 3 ways of dealing with pollution:

- **Technology and control**: New technology is cleaner and has less impact on the environment. The government controls pollution by limiting the use of older technologies that pollute the environment.
- **Marginal decisions**: These are decisions made by government on what acceptable levels of pollution are. If the government is too tolerant, or makes its decisions in the interest of expanding business rather than sustaining the environment, then pollution levels can rise to the point where they damage the environment.
- **Self-interest**: For example, keeping a beach litter-free. People use dustbins on the beach because they want to use a beach that is clean.

14.2.2 Conservation

Conservation relates to the preservation (looking after) of natural resources to ensure they are not completely used up and disappear from the environment. Conservation is necessary due to pollution and the over-utilisation (using too much) of resources:

The conservation of stocks (resources):

- Conservation is needed when stocks are utilised (used) more than they can reproduce to replace what has been used.
- This leads to a search for substitutes.
- Conservation policies help to conserve renewable stocks (e.g. trees) and non-renewable stocks (e.g. fossil fuels).

Maintaining renewable stocks:

- A **market economy** has an interest in conservation as it helps maintain renewable stocks, e.g. timber and fishing. Conservation is achieved through the force of demand and supply which helps to sustain these kinds of industries.
- **Direct controls**: The government maintains the stock levels of environmental resources through the issuing of permits and quotas. For example, the government sets quotas for fishing to stop catches being so large that they exceed (are bigger than) the growth of the fish population. It also sets quotas for cutting down trees to ensure deforestation does not exceed the rate of renewal.

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14.2.3 Preservation

Preservation is linked to conservation. It is about preserving existing assets to ensure they do not get used in a way that is destructive to the environment.

- **Private property**: A game reserve may be sold to a businessman to be used for farming. But the government can intervene and stop the sale because they recognise the importance to the environment of preserving game reserves.
- **Preservation requires compromise** (give and take): Farmers may develop their river mouth as a holiday resort. If this is not controlled, and too many other farmers do the same, the entire ecosystem will be damaged, and animal and plant life will be negatively affected.
- **Government policy**: Government intervenes to preserve environmental assets by:
  - Buying, confiscating, expropriating (taking ownership) or nationalising resources, e.g. indigenous forests.
  - Subsidising key resources, e.g. privately owned ecosystems.

14.2.4 Externalities

Externalities imply costs and benefits that were not planned for.

- The extra costs and benefits of externalities are not factors when the state of the environment is assessed.
- Goods that have negative externalities such as air and water pollution are generally oversupplied in the market.
- When businesses are expected to bear the cost of equipment to reduce pollution, it could have a positive externality on others. Businesses tend to spend little on pollution abatement equipment due to its limited marginal private benefit. The major role of government, regarding the environment, is to correct inefficiencies arising from externalities.

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14.3 Measures to ensure sustainability

It is important for governments to take steps to ensure **sustainability**. Sometimes, businesses are driven by self-interest, and they see nothing wrong with using all available resources if they can make a profit from them. There are 5 controlling mechanisms to ensure sustainability:

14.3.1 The market

Use this mnemonic to help you remember the 5 controlling mechanisms

M – Market – Make

I – Intervention – It

C – Control – Count

M – Measures – More

A – Agreements – Always

The market is driven by self-interest. The market considers the environment as an asset to be used for its own benefit. Sustainability is achieved in the free market only to the extent that **resource prices** rise as they become scarce (less available), and through the development of **environment-friendly technology**.

There is a **social interest** in using the environment, not only to the direct producer/consumer, but also to people in general, now and in the future. This means we all have an interest in preserving the environment.

Reasons why the market fails to ensure sustainability:

- The market sees the environment as a common resource.
- **Externalities** such as air pollution caused by factories cannot be stopped without restrictive policies.
- **Lack of knowledge**: Businesses cause damage without realising it, e.g. companies making aerosol cans (such as spray-on deodorants) and did not know the damaging effect they had on the ozone layer.
- **Carelessness**: People continue with harmful practices and leave future generations to worry about the consequences.

Optimum market decisions

- Market mechanisms have failed when market forces fail to produce the desired result of environmental sustainability.
- All costs and benefits are not captured in the market price. The future cost of the resource disappearing is not often considered.

14.3.2 Public sector intervention

Public sector intervention aims to achieve social efficiency. This occurs through:

Granting property rights:

- **The conservationist effect**: People care for things that belong to them.
- To prevent fauna and flora species from becoming extinct, people are granted property rights if they agree to preserve the flora and fauna.
- Property rights can be expanded to common goods such as clean air.
- The **Kyoto Protocol** is an international agreement whereby developed countries pay developing countries for their right to pollute.

Charging for the use of the environment:

- **Price the environment**: The government levies fees for waste produced and dumped in the environment.
- In South Africa, local authorities levy charges on rubbish collection and sewage disposal.

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- The best results are achieved when charges are proportional (related to) to waste produced.

Environmental taxes:
- Environmental taxes are taxes imposed on the output of goods that generate external environmental costs (pollution). These are called **green taxes**.
- **Carbon dioxide emissions** from wineries and vehicle tyres are taxed. The tax rate is equal to the marginal external cost.

Environmental subsidies:
- Subsidies are granted to businesses to reduce environmental damage, e.g. the government subsidises new technology that saves energy, such as energy-saving light bulbs or solar geysers.

Marketable permits:
- The government gives each business a licence to pollute to a certain degree.
- Businesses sell their licences to other businesses.
- In South Africa, marketable permits are granted by the **Department of Minerals and Energy.**

14.3.3 Public sector control

When government environmental policies don't produce positive results, the government takes direct control through **Command and Control** (**CAC**) systems:

Command and Control (CAC):
- The government enforces **policy** by setting maximum levels of the emission of pollution.
- Most developed countries have **regulations** that control air and water pollution.

There are **3 approaches** in CAC systems:
- **Quantity standards**: These focus on the amount of pollution emitted.
- **Quality standards**: These focus on the environmental impact of the pollution emitted.
- **Social impact standards**: These focus on the effect on people of the pollution emitted.

Voluntary agreements:
- The government concludes **agreements** with businesses on a voluntary basis to cut pollution.

Education:
- Education is used to try to change **people's attitudes** towards the environment.
- Innovative approaches have been tried in the developing world to educate people, e.g. setting up community wildlife reserves.

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14.3.4 International measures

Environmental problems are global problems. For example, pollution from motor vehicles and the greenhouse effect have an impact on the entire world. Polluted air and water moves from one country to another, and if the ocean is polluted in America, it can affect beaches in Australia. **International measures** have been implemented to deal with the following 5 environmental problems:

Biodiversity loss:

- If species become **extinct** (die out completely), this cannot be reversed.
- Modern techniques such as **gene transplants** can limit the loss of species.
- **The Convention on International Trade in Endangered Species (CITES)** sets many policies to deal with species loss.

Chemical waste:

- Chemical waste is toxic (it has a negative effect on living beings and can cause infertility or death).
- Chemical waste needs to be carefully managed to ensure it does not seep into the ground water.
- The **Stockholm Protocol** is a United Nations agreement to limit chemical waste.

Hazardous waste:

- Hazardous waste is highly toxic. It has a slow decomposition rate (it stays poisonous for a very long time).
- The most hazardous (dangerous) waste is radioactive waste from nuclear power.
- The **Basel Convention** is an international agreement to manage nuclear waste. South Africa is a signatory to the agreement.

Climate change:

- Global warming primarily causes climate change.
- Climate change can be reversed through widespread international co-operation, e.g. sharing weather information and weather patterns; agreeing to limit pollution; and banning chemical products such as greenhouse gases that damage the ozone layer.
- The **Kyoto Protocol** of 1997 is an international agreement to limit the production of greenhouse gases, because voluntary reductions of carbon dioxide levels did not succeed.

Loss of indigenous knowledge:

- Indigenous people have a lot of knowledge about the natural environment, which they use to make a living.
- Indigenous people traditionally used organic methods and natural processes.
- As indigenous people lose their habitats or are urbanised, this knowledge is disappearing and is being lost to the world forever.
- **Local capacity-building** is very important for the environmental sustainability of indigenous people, i.e. finding a way for them to earn a living in their traditional environment.

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14.3.5 Major international agreements

Since the 1990's the United Nations has convened various meetings with all countries worldwide on issues affecting them. They should take responsibility for the management of these issues.

- **Rio de Janeiro summit (UNCED):** This summit took place in 1992 with the objective of sustainable development. Envisaged outcomes included: environmental protection as an integral part of development, cooperation to conserve, protect and restore the health of the ecosystem, prevent environmental degradation where the polluter should bear the cost of pollution and assess the environmental impact.
- **Johannesburg summit (WSSD):** Hosted in 2002 in Johannesburg on Sustainable Development. Envisaged outcome of the programme includes: poverty eradication, changing unsustainable patterns of consumption, globalisation, health and the environment.
- **Rio +20 summit:** Also known as die United Nations Conference on Sustainable Development took place in Brazil. The main issue was sustainable growth and poverty eradication without damaging the environment. It was agreed that a green economy would be one of the tools for sustainable development. Sustainable development goals covering economic, social and environmental aspects will replace the MDG from 2013.
- **Kyoto-protocol:** This conference held in 1997 in Kyoto, established legally binding obligations whereby industrialised countries agreed to reduce their emission of six greenhouse gases.
- **Millennium Development Goals:** Communities depend on healthy ecosystems to survive and prosper. Some of the MDGs are: eradication of extreme poverty and hunger, achieve universal primary education, gender equality, reducing child mortality rates, improve maternal health, combat HIV/Aids and other diseases and create a global partnership for development.
- **United Nations Framework Convention on Climate Change (COP 17):** The 17th Conference of the Parties was held in Durban where the following decisions were taken:
  - Commitment to the Kyoto Protocol and reducing pollution by greenhouse gases.
  - A Green Climate Fund to help developing countries to establish cleaner sources of energy and to adapt to climate change.
  - An Adaptation committee of 16 members to report to COP 18 on the improvement of the ability of the poorest and most vulnerable countries to adapt to climate change, better protection and help against losses and damage related to climate change.

The Kyoto conference was held in Japan in 1997 and focused specifically on climate change. It resulted in the Kyoto Protocol which attempted to get the developed countries to commit to reducing their emission of greenhouse gases.

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Activity 1

Study the following sign and answer the questions that follow:

1. What environmental hazard is depicted in the above logo? (1)
2. Explain in your own words how the above can threaten the environment. (3)
3. Name an international protocol which addresses this hazard. (2)

[6]

Answers to activity 1

1. Chemical waste ✓ (1)
2. Pollution of water resources which can be very harmful to humans ✓ plants and animals ✓ (3)
3. The Stockholm Protocol ✓✓ (2)

[6]

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Appendix: Exemplar exam papers

The 2014 Economics exams have a new format in line with CAPS. The Department of Basic Education has offered an example of Economics Paper 1 and Paper 2 with marking memoranda.

Use this exam paper and marking memorandum to help you prepare for your exams:

1. Answer the questions in the exam. **Time yourself** so you complete it within 1½ hours (which is the time you will have in the real exam).
2. Treat each one as a 'real' exam by making sure you have all the materials you need (pens, pencils, eraser, protractor and calculator).
3. This exercise is meant to test your knowledge – so **don't cheat yourself** by looking up the answers provided in the marking memoranda before you've finished each exam.
4. Use the memoranda to **check whether or not your answers are correct**. Note where you have got answers wrong – these are the sections of the curriculum that you need to do more work on. Go back to your textbooks and to the relevant sections of this study guide, and **spend time learning** the sections for which you got the lowest marks.
5. And remember: success depends on **practise, practise, practise, and then more practice!** Repeat this exercise as often as you can so that you fly in your year-end exams!

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basic education

Department:
Basic Education
REPUBLIC OF SOUTH AFRICA

NATIONAL SENIOR CERTIFICATE

GRADE 12

ECONOMICS P1

EXEMPLAR 2014

MARKS: 150

TIME: 1½ hours

This question paper consists of 12 pages.

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INSTRUCTIONS AND INFORMATION

1. Answer FOUR questions as follows in the ANSWER BOOK:

   SECTION A: COMPULSORY
   SECTION B: Answer TWO of the three questions.
   SECTION C: Answer ONE of the two questions.

2. Answer only the required number of questions. Answers in excess of the required number will NOT be marked.
3. Number the answers correctly according to the numbering system used in this question paper.
4. Write the question number above each answer.
5. Read the questions carefully.
6. Start EACH question on a NEW page.
7. Leave 2–3 lines between subsections of questions.
8. Answer the questions in full sentences and ensure that the format, content and context of your responses comply with the cognitive requirements of the questions.
9. Use only black or blue ink.
10. You may use a non-programmable pocket calculator.
11. Write neatly and legibly.

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SECTION A (COMPULSORY)

QUESTION 1 **30 MARKS – 15 MINUTES**

1.1 Various options are provided as possible answers to the following questions. Choose the answer and write only the letter (A–C) next to the question number (1.1.1–1.1.8) in the ANSWER BOOK.

1.1.1 The money market is a market for … term savings and loans.

A short-
B short- and long-
C long-

1.1.2 Consumption of fixed capital is used to calculate the gross value added at …

A basic prices.
B market prices.
C factor cost.

1.1.3 During an economic recession …

A unemployment will increase.
B production increases.
C spending increases.

1.1.4 The new economic paradigm is embedded in … side policies.

A demand-
B supply-
C demand-and-supply-

1.1.5 According to the UN classification, South Africa's HDI ranking is categorised as a … level.

A low
B middle
C high

1.1.6 Economic growth is measured in terms of …

A real GDP.
B real GDP per capita.
C nominal GDP.

1.1.7 The ratio of export prices and import prices is known as the …

A terms of trade.
B exchange rate.
C balance of payments.

1.1.8 An example of an economic indicator is …

A labour productivity.
B life expectancy.
C housing. (8 x 2) (16)

1.2 Choose a description from COLUMN B that matches an item in COLUMN A. Write only the letter (A–J) next to the question number (1.2.1–1.2.8) in the ANSWER BOOK.

COLUMN A	COLUMN B
1.2.1 Capital Transfer Account	A the weakening of a currency as result of market forces
1.2.2 Depreciation	B policies aimed at increasing the economic livelihood of a specific area
1.2.3 Free floating	C the interest rate which banks charge on loans to preferential clients
1.2.4 Tariffs	D world-wide interfacing with trade as the major element
1.2.5 Regional development	E the removal of unnecessary laws that inhibit the free operation of markets
1.2.6 Prime rate	F subaccount in the balance of payments
1.2.7 Globalisation	G a protection measure against unfair foreign competition
1.2.8 Deregulation	H exchange rate system
	I the interest rate at which the Reserve Bank charges commercial banks
	J subaccount in the current account

(8 x 1) (8)

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1.3 Give ONE term for each of the following descriptions. Write only the term next to the question number (1.3.1–1.3.6) in the ANSWER BOOK.

1.3.1 A small initial change in spending produces a proportionately larger increase in national income

1.3.2 The sale of state-owned enterprises to the private sector

1.3.3 Goods used as inputs to produce other goods and services

1.3.4 An increase in the capacity of the population to produce more goods and services

1.3.5 It consists of people between the ages of 15 and 60/65 who are willing to work for an income

1.3.6 Return of land to their original owners after confiscation by the government (6 x 1) (6)

TOTAL SECTION A: 30

SECTION B

Answer TWO of the three questions in this section in the ANSWER BOOK.

QUESTION 2: MACROECONOMICS 40 MARKS – 20 MINUTES

2.1 Answer the following questions.

2.1.1 Give TWO examples of injections into the economy. (2 x 1) (2)

2.1.2 What effect will an increase in the value of the rand against the US dollar have on imports from the USA? (1 x 2) (2)

2.2 Study the table below and answer the questions that follow.

EXTRACT FROM NATIONAL ACCOUNTS OF SOUTH AFRICA AT CURRENT PRICES	
R million	**2012**
Gross domestic product (GDP) at market prices	3 155 195
Primary income from the rest of the world	48 501
Primary income to the rest of the world	**A**
Gross national product (GNP) at market prices	3 085 188

[Source: *SARB Quarterly Bulletin*, March 2013]

2.2.1 Define the concept *gross domestic product*. (2)

2.2.2 Calculate the value of **A** in the table. (2)

2.2.3 Give an example of a primary income from the rest of the world. (2)

2.2.4 Explain the difference between *current prices* and *constant prices*. (4)

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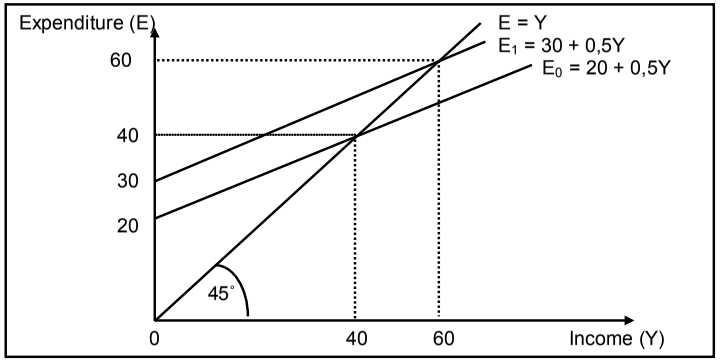
2.3 Study the graph below that depicts a simplified two-sector economy (where E = C + I) and answer the questions that follow.



2.3.1 Identify ONE participant in the economy above. (2)

2.3.2 What does the line E = Y represent? (2)

2.3.3 Calculate the multiplier using the following formula:

$$k = \frac{1}{(1 - mpg)}$$

The marginal propensity to consume (mpc) = 0,8.
(Show ALL calculations.) (4)

2.3.4 What is the relationship between the *marginal propensity to consume (mpc)* and the *multiplier*? (2)

2.4 Explain the new economic paradigm. (4 x 2) (8)

2.5 Argue ONE case in favour of free trade and ONE case against protectionism. (2 x 4) (8)

[40]

QUESTION 3: ECONOMIC PURSUITS **40 MARKS: 20 MINUTES**

3.1 Answer the following questions.

3.1.1 State TWO fiscal policy measures that can be implemented to redistribute wealth in South Africa. (2 x 1) (2)

3.1.2 What effect will import restrictions have on the local textile industry in South Africa? (1 x 2) (2)

3.2 Study the extract below and answer the questions that follow.

INDUSTRIAL POLICY ACTION PLAN

The Industrial Policy Action Plan (IPAP) is located in the vision of the National Development Plan and forms one of the fundamental cornerstones of the New Growth Path Framework. IPAP is predicated to bring about significant structural change to the South African economy. The existing growth path is led by the consumption-driven sectors, which are growing twice as fast as the manufacturing sectors. The economy is import intensive, especially with respect to value-added products. Stronger domestic growth in the manufacturing sector is imperative. High structural unemployment is a constant, oscillating between 22,5% and 25% if the strict definition is used.

[Adapted from www.bdlive.co.za]

3.2.1 Identify the main objective of the IPAP. (2)

3.2.2 How will the above objective be achieved? (4)

3.2.3 Explain how unemployment will be addressed by the New Growth Path Framework. (4)

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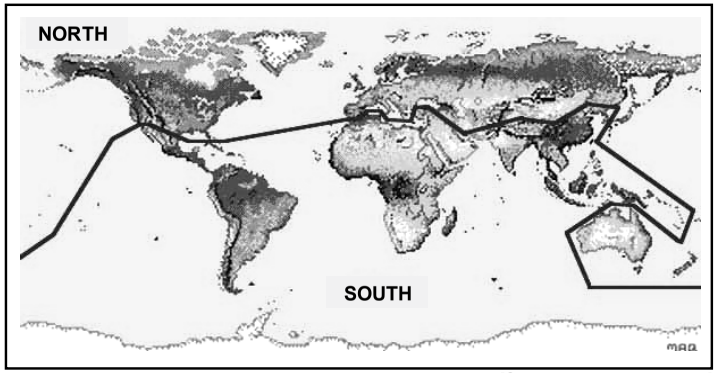
3.3 Study the map below and answer the questions that follow.



[Source: www.cartoons.com]

3.3.1 What is indicated by the solid line in the map above? (2)

3.3.2 Name TWO countries that make up the G8 grouping of countries in the North. (2)

3.3.3 Briefly comment on the trade relations between the countries in the North and South. (6)

3.4 Briefly explain the integrated manufacturing strategy in South Africa. (4 x 2) (8)

3.5 How can the repo rate be used to stimulate aggregate demand? (4 x 2) (8)
[40]

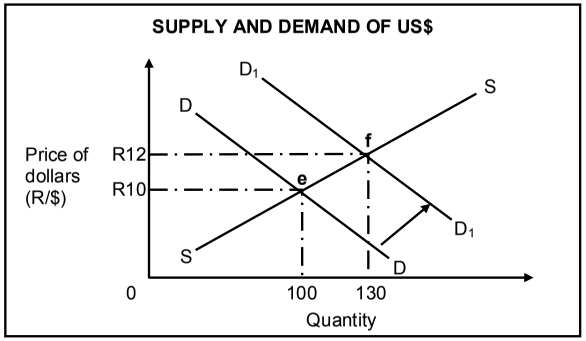
QUESTION 4: MACROECONOMICS AND ECONOMIC PURSUITS
40 MARKS – 20 MINUTES

4.1 Answer the following questions.

4.1.1 Name TWO problems of public sector provisioning. (2 x 1) (2)

4.1.2 What effect will low labour productivity have on inflation? (1 x 2) (2)

4.2 Study the graph below and answer the questions that follow.



4.2.1 At what point on the graph does the equilibrium for foreign exchange originally occur? (2)

4.2.2 What happens to the value of the rand when DD shifts to D_1D_1? Motivate your answer. (4)

4.2.3 How can the Central Bank of South Africa intervene in the market to influence the exchange rate? (4)

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4.3 Study the extract below and answer the questions that follow.

SPECIAL ECONOMIC ZONES TO EMPLOY REGIONAL STRENGTHS

The announcement that 10 potential special economic zones have been identified in conjunction with the provinces could be a game-changer for South African manufacturers. Such zones are intended to bring mainstream economic activity to poor and isolated parts of South Africa by leveraging the commercial potential of the particular regions.

This will include industry clustering, or targeted development. Upington, in the Northern Cape, is a natural home for solar energy research and development. Saldanha Bay will service the growing oil and gas industry on Africa's west coast, while expanding iron ore exports.

The Department of Trade and Industry is devising a draft of regulations that will see the country's industrial development zones (IDZs) in Richards Bay, East London and Coega, near Port Elizabeth, taken into a new special economic zones framework. This envisages zones including free ports, free trade zones, and sector development zones.

A special corporate tax rate of 15% is proposed, well below the 28% currently applied. There was, however, a concern that the incentive would cause dislocation and would have 'distorting effects' on the economy.

[Source: www.bdlive.co.za]

4.3.1 Define the concept *IDZ*. (2)

4.3.2 Identify TWO new proposed economic regions. (2)

4.3.3 What is the main difference between an *IDZ* and an *SEZ*? (2)

4.3.4 What, in your opinion, would be the 'distorting effects' on the economy? (4)

4.4 Explain *leading* and *lagging business cycle indicators*. (2 x 4) (8)

4.5 Explain the TWO social indicators used for children under the age of five. (2 x 4) (8)
[40]

TOTAL SECTION B: 80

SECTION C

Answer only ONE of the two questions in this section in the ANSWER BOOK.

STRUCTURE OF THE ESSAY:	MARK ALLOCATION:
Introduction	Max. 2
Body: **Main part:** Discuss in detail/In-depth discussion/Examine/ Critically discuss/Analyse/Compare/Evaluate/Distinguish/ Explain/Assess/Debate	Max. 26
Additional part: Give own opinion/Critically discuss/Evaluate/ Critically evaluate/Draw a graph and explain/Use the graph given and explain/Complete the given graph/Calculate/Deduce/ Compare/Explain/Distinguish/Interpret/Briefly debate	Max. 10
Conclusion	Max. 2
TOTAL	**40**

QUESTION 5: MACROECONOMICS 40 MARKS –35 MINUTES

International trade is the backbone of our modern commercial world as producers in various nations try to profit from an expanded market, rather than be limited to selling within their own borders.

- Discuss export promotion as part of South Africa's international trade policy. (26 marks)
- In your opinion, how successful is South Africa with the implementing of the above policy? Motivate your answer. (10 marks) **[40]**

QUESTION 6: ECONOMIC PURSUITS 40 MARKS – 35 MINUTES

Supply-side policies focus on the ability of markets to supply enough goods and services to meet aggregate demand.

- Discuss this statement by focusing on effectiveness and efficiency of markets in the South African context. (26 marks)
- In your opinion, how successful is the South African government in providing for the basic needs of the poor? (10 marks) **[40]**

TOTAL SECTION C: 40
GRAND TOTAL: 150

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GRADE 12

ECONOMICS P1

EXEMPLAR 2014

MEMORANDUM

MARKS: 150

This memorandum consists of 13 pages.

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SECTION A (COMPULSORY)

QUESTION 1

1.1 **MULTIPLE-CHOICE QUESTIONS**

1.1.1 A short ✓✓
1.1.2 C factor cost ✓✓
1.1.3 A unemployment will increase ✓✓
1.1.4 C demand and supply ✓✓
1.1.5 B middle ✓✓
1.1.6 A real GDP✓✓
1.1.7 C terms of trade✓✓
1.1.8 A labour productivity✓✓ (8 x 2) (16)

1.2 **MATCHING ITEMS**

1.2.1 F subaccount in the balance of payment ✓
1.2.2 A the weakening of a currency as result of market forces ✓
1.2.3 H exchange rate system ✓
1.2.4 G a protection measure against unfair international competition ✓
1.2.5 B policies aimed at increasing the economic livelihood of a specific area ✓
1.2.6 C the interest rate which banks charge on loans to preferential clients✓
1.2.7 D world-wide interfacing with trade as the major element ✓
1.2.8 E the removal of unnecessary laws that inhibit the free operation of markets ✓ (8 x 1) (8)

1.3 **IDENTIFY THE CONCEPT**

1.3.1 Multiplier effect ✓
1.3.2 Privatisation ✓
1.3.3 Capital goods ✓
1.3.4 Economic development ✓
1.3.5 Economically Active Population ✓
1.3.6 Land restitution ✓ (6 x 1) (6)

TOTAL SECTION A: 30

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SECTION B

Answer TWO of the three questions in this section in the ANSWER BOOK.

QUESTION 2

2.1 2.1.1
- Government spending ✓
- Investments ✓
- Exports ✓ Any (2 x 1) (2)

2.1.2 Imports will increase ✓✓ (1 x 2) (2)

2.2 2.2.1 The final value of goods and services produced within the borders of a country in one year. ✓✓ (2)

2.2.2 R87 593 million ✓✓ (2)

2.2.3 RSA citizen working and earning money in the UK. ✓✓ (2)

2.2.4 Current prices – (Nominal) Does not take into account changes in the general price level ✓✓

Constant prices – (Real) Where the change in the general price levels were taken into account ✓✓ (4)

2.3 2.3.1 Households/Consumers ✓
Business sector/Firms/Producers ✓ (2)

2.3.2 It shows all the possible levels of expenditure and output ✓ at which the economy is in equilibrium ✓ (2)

2.3.3 $k = \frac{1}{(1 - 0,8)}$ ✓✓

$= \frac{1}{0,2}$

$= 5$ ✓✓ (4)

2.3.4 The bigger the mpc, the bigger the multiplier (and vice versa) ✓✓ (2)

2.4
- Theories by the Monetarists (Friedman) and Keynesians (Keynes) extreme and only true under specific circumstances ✓✓
- Under real circumstances, government pursues economic growth irrespective of inherently stable or unstable market. ✓✓
- Therefore governments aren't extreme, but transparent and follow pragmatic policies ✓✓
- The root of the new economic paradigm is embedded in the **prevention** of unstable conditions that will lead to contractions ✓✓
- According to the new economic paradigm it is possible for output to rise over extended periods of time without being hampered by supply constraints and inflationary pressures
- Embedded in demand-side and supply-side policies ✓✓ (Any 4 x 2) (8)

2.5
- **Argument in favour of free trade:** ✓✓
  - **The free trade argument is persuasive**. ✓✓If each nation does what it does best, everyone will enjoy lower prices and higher levels of output. ✓✓
  - **Free trade leads to greater world production** ✓✓of traded goods, leading to an increase in economic welfare. ✓✓
  - **Free trade allows countries to specialise** ✓✓in economic activities in which they have a comparative advantage (economies of scale). ✓✓
  - **Free trade leads to mutual gains** ✓✓from international trade to all countries. ✓✓
  - **When there is free trade, more efficient distribution of resources** ✓✓ is possible because each country specialises in its most effective production. ✓✓
  - **Free trade offers consumers greater choice**. ✓✓It allows consumers the choice of what to buy globally and not just from what is available locally. ✓✓ **Any 1 argument (2 x 2)** (4)
- **Argument against protectionism:** ✓✓
  - Once the protection measures are introduced it became problematic to remove those measures.
  - The local business never getting strong enough to confront the global arena on their own.

Any 1 argument (2 x 2) (4)
[40]

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QUESTION 3

3.1 3.1.1
- Progressive personal income tax✓
- Wealth taxes✓
- Cash benefits - grants✓
- Benefits in kind – food parcels/user fee charge/school meals/✓
- Land reform programmes – land restitution and land redistribution✓
- Property subsidies✓
- Youth wage subsidies ✓ (Any 2 x 1) (2)

3.1.2
- Increased sales of locally produced clothing ✓✓
- Expansion of local industries ✓✓
- Increased employment ✓✓

(Accept any relevant answer) (Any 1 x 2) (2)

3.2 3.2.1
- IPAP is predicated on the need to bring about significant structural change to the South Africa economy. ✓✓ (2)

3.2.2
- Stronger domestic growth in the manufacturing sector. ✓✓
- High employment levels ✓✓ (4)

3.2.3
- Creation of employment. ✓✓
- NGP envisage the creation of 5 million new jobs by 2020. ✓✓ (4)

3.3 3.3.1 North/South divide or developed/developing countries✓✓ (2)

3.3.2 USA, Canada, UK, France, Germany, Japan, Italy, Russia (2 x 1) (2)

3.3.3 **Developing countries:** mainly export raw to developed countries and import manufactured products from developed countries. ✓✓ **Developed countries:** continue to subsidise production of their agricultural goods, making it difficult for developing countries to compete, ✓✓ while insisting that developing countries eliminate their tariffs on manufactured goods. ✓✓ Most developing countries have very little foreign trade. ✓✓ (6)

3.4
- 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 involve cross cutting issues such as technology, human resource development, access to finance and infrastructure✓✓
- It also concentrate on key input sectors like transport, telecommunications and energy✓✓
- The IMS prioritise certain growth sectors like tourism, agriculture, information technology and cultural industries✓✓ (4 x 2) (8)

3.5
- The SARB is using interest rates to manipulate the market✓✓
- The repo rate is the key interest rate. This is the rate at which the SARB lends money to banks for short periods of time✓✓
- The SARB will lower the interest rate if it wants to stimulate the demand for credit. ✓✓
- Many people will be encouraged to buy more at lower interest rates. ✓✓
- This will lead to a higher demand for goods and services✓✓ (4 x 2) (8)

[40]

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QUESTION 4

4.1 4.1.1 Accountability/Efficiency/Assessing needs/Pricing policy/ Parastatals/Privatisation✓✓ (Any 1 x 2) (2)

4.1.2 Low productivity – low production – negative effect on the aggregate supply of goods and services – same/or growing aggregate demand = rapid increase in general price level ✓✓ (demand inflation) (1 x 2) (2)

4.2 4.2.1 Point, e ✓✓ (2)

4.2.2 The value of the rand depreciates ✓✓ As a result of the increase in the demand for dollars, the value of the rand decreases from R10 for one dollar to R12 for one dollar✓✓ (4)

4.2.3 In case of devaluation of the rand, the Central Bank will sell foreign exchange. ✓✓
In case of revaluation of the rand, the Central Bank will buy foreign exchange. ✓✓ (4)

4.3 4.3.1 An IDZ is a purpose-built industrial estate which is closed off and situated in a specific area. ✓ (2)

4.3.2 Upington, in the Northern Cape, is a natural home for solar energy research and development. ✓✓
Saldanha Bay will service the growing oil and gas industry on Africa's west coast, while expanding iron ore exports. ✓✓ (2)

4.3.3 SEZ's currently get a special incentive, which is not applicable to the IDZ. A blanket corporate tax rate of 15%, well below the 28% currently applied. ✓✓

IDZ is located in a smaller area linked directly to a port, whereby an SEZ covers a wider area. The plan is to incorporate the IDZ into an SEZ. ✓✓ (2)

4.3.4 Distorting effects – the current IDZ does not benefit from the special tax incentive scheme. ✓✓
The concern is that companies within the IDZ will close their operations and move over to the SEZ's to enjoy this incentive. ✓✓
This could mean dislocations and movement to other areas. ✓✓
Valuable investments will be lost in the area withdrawn. This will cause distortions in the production and output for that region. ✓✓ (4)

4.4 **Leading:**
- Give consumers, businesses and the state a glimpse of the direction in which the economy might be heading.✓✓
- When these indicators rise, the level of economic activities will also rise a few months later. ✓✓
- Examples of leading indicators are job advertising space; inventory; and sales. ✓✓ (Any 2 x 2) (4)

Lagging:
- Lagging indicators won't change direction until after the business cycle has changed its direction. ✓✓
- Examples of these indicators are hours worked in construction and total of commercial vehicles sold. ✓✓ (Any 2 x 2) (4)

4.5 **Infant mortality rates** ✓✓– the number of children younger than one year old who die in a year per 1 000 births during that year. In 2010 in SA it was 34 per thousand✓✓ (Any 2 x 2) (4)

Under five mortality rates✓✓ – the number of children under five years old who die per 1 000 live births during that year. In SA it was 50 per thousand. ✓✓ (Any 2 x 2) (4)

[40]

TOTAL SECTION B: 80

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SECTION C

Answer only ONE of the two questions in this section in the ANSWER BOOK

STRUCTURE OF ESSAY:	MARK ALLOCATION:
Introduction	Max. 2
Body: **Main part:** Discuss in detail/In-depth discussion/Examine/ Critically discuss/Analyse/Compare/Evaluate/Distinguish/ Explain/Assess/Debate	Max. 26
Additional part: Give own opinion/Critically discuss/Evaluate/ Critically evaluate/Draw a graph and explain/Use the graph given and explain/Complete the given graph/Calculate/Deduce/ Compare/Explain/Distinguish/Interpret/Briefly debate	Max. 10
Conclusion	Max. 2
TOTAL	**40**

QUESTION 5: MACROECONOMICS **40 MARKS – 30MINUTES**

International trade is the backbone of our modern commercial world as producers in various nations try to profit from an expanded market, rather than be limited to selling within their own borders.

- Discuss export promotion as part of South Africa's international trade policy. (26 marks)
- In your opinion, how successful is South Africa with the implementing of the above policy? Motivate your answer. (10 marks) **[40]**

Introduction

Incentives or mechanisms to encourage domestic manufacturers to increase the exports of goods and services to foreign countries ✓✓ **(Max. 2)**
(Any other relevant definition of export promotion)

Body

MAIN PART

Reasons for export promotion✓

- The country achieves significant export-led economic growth. ✓✓
- Export promotion enlarges the production capacity of the country. ✓✓
- Export markets are much bigger than local markets. ✓✓
- More workers will be employed. ✓✓
- Prices will be reduced. ✓✓

Methods of export promotion✓

- Incentives: The government supplies information on export markets, research on new markets, concessions on transport charges, export credit, etc. in order to stimulate exports. ✓✓
- Subsidies: These include direct and indirect subsidies: ✓✓
  - Direct subsidies: Cash payments to exporters.✓✓
  - Indirect subsidies: Refunds on import tariffs and general tax rebates.✓✓
- Trade neutrality: Subsidies equal in size to import duties are paid. ✓✓
  Neutrality can be achieved through trade liberalisation. ✓✓

Advantages of export promotion✓

- There are no limitations to size of scale since the market is very large.✓✓
- Production is based on cost and efficiency.✓✓
- There is increased domestic production.✓✓
- Exchange rates would be realistic.✓✓

Disadvantages of export promotion✓

- The real cost of production is reduced by subsidies and incentives.✓✓
- The lack of competition because of incentives and subsidies forces competitors out of the market.✓✓
- Export promotion results in increased tariffs and quotas by powerful overseas competitors.✓✓
- Export promotion results in the protection of labour-intensive industries by developed countries.✓✓ **(Max 26)**

NOTE: A maximum of 8 x 1 marks will be allocated for headings.

ADDITIONAL PART

The candidate can offer a positive or a negative argument.

Positive/Negative ✓✓ **(1 x 2)**
Arguments ✓✓ ✓✓ **(2 x 2)**
Substantial evidence ✓✓ ✓✓ **(2 x 2)**
(Accept any other relevant answer) **(Max. 10)**

Conclusion

.
Any relevant conclusion. **(Max. 2)**

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QUESTION 6: ECONOMIC PURSUITS **40 MARKS – 30 MINUTES**

Supply-side policies focus on the ability of markets to supply enough goods and services to meet aggregate demand.

- Discuss this statement by focusing on effectiveness and efficiency of markets in the South African context. (26 marks)
- In your opinion, how successful is the South African government in providing in the basic needs of the poor? (10 marks) **[40]**

Introduction

The stimulation of supply means to increase the output, in terms of goods and services. ✓✓
(Any other relevant definition) **(Max. 2)**

Body

MAIN PART:

There are various factors that promote the efficiency and effectiveness of resources:

- **Education and training✓**
  - The Sectorial Education and Training Authorities (SETA's) have been created to promote and facilitate work-related training for the different sectors of the economy. ✓✓
  - The increase in the number of skilled workers will improve the productivity levels of workers. This will lead to an increase in output. ✓✓

- **Fiscal policy✓**
  - High tax rates discourage individuals, leading them to work less and businesses to invest less. ✓✓
  - In South Africa the tax rates for individuals and businesses have been systematically reduced. Tax incentives give industries an area to operate at lower costs. These additional funds can be used to increase production. ✓✓
  - Individuals get tax rebates. ✓✓
  - This will increase the disposable income levels of individuals. This will stimulate the demand for consumer goods and services. ✓✓

- **Competition✓**
  - The promotion of competition services as an incentive for new businesses to enter the market. ✓✓
  - The Competition Act is aimed at limiting the number of monopolies formed and reducing or eliminating the powers of monopolies. ✓✓
  - In addition, the many barriers of international trade have been lifted over the years. ✓✓

- **Deregulations✓**
  - The deregulation of regulated industries provide for greater competition in the market. ✓✓
  - Many unnecessary laws and other barriers to competition in SA have been removed, although there are still some regulations, especially the informal sector that has to be revised. ✓✓

- **Labour legislation✓**
  - In South Africa, the Labour Relations Act, the Employment Equity Act and the Basic Conditions of Employment Act provide a fair and equitable working environment. ✓✓
  - Such a workplace atmosphere will motivate workers to not only improve the quality of their work but also strive towards self-development. ✓✓

- **Small, medium and micro enterprises✓**
  - In South Africa, the government encourages the establishment of SMMEs through various financing and support structures. ✓✓
  - Institutions such as Khula, the National Empowerment Fund, the Industrial Development Corporations and Business Partners are in partnership with national government. ✓✓
  - There are also free advisory centres available to provide information on topics such as managing and running SMMEs✓✓

- **Broad-Based Black Economic Empowerment Act (BBBEE) ✓**
  - BBBEE is the economic empowerment of all black people, especially women, workers, youth, the disabled and people living in rural areas. ✓✓
  - It is aimed at addressing historical imbalances of the past, through increasing the number of black people that can own, control and control the country's economy and decreasing income inequalities. ✓✓

- **Research and Development✓**
  - An R&D strategy has been implemented by the government to improve national competitiveness. ✓✓
  - The R&D Strategy has three pillars: innovation; science, engineering and technology (SET), human resources and transformation; creating an effective government system. ✓✓
  - Examples are the CSIR and Mintek✓✓

- **Privatisation✓**
  - Many publicly owned businesses have been privatised or partly privatised. ✓✓
  - Privatisation is essential in promoting competition in the market place. ✓✓
  - It is also proven that private companies are more effective and efficient than state-owned businesses. ✓✓
  - Examples are Telkom, Iscor, ✓✓

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- **Infrastructure ✓**
  - A well-developed infrastructure is the backbone of a growing economy. South Africa has one of the better-developed infrastructure is Southern Africa. ✓✓
  - Transport: The South African transport network consists of highways, railways and ports. ✓✓
  - Energy: Currently Eskom generates 95% of electricity in South Africa. It is one of the world's ten largest electricity suppliers in the world. It also exports to other countries. ✓✓
  - Telecommunications: this is one of the fastest growing sectors in the SA economy. It offers fixed-line, wireless and satellite communication and has the most developed network on the African continent. ✓✓

- **Cost of doing business✓**
  - It refers to cost of doing business, such as transport, communication and energy costs✓✓.
  - Other costs involve water, sanitation, vehicle and registration and labour markets. ✓✓ **(Max 26)**

NOTE: A maximum of 8 x 1 marks will be allocated for headings.

ADDITIONAL PART:

In your opinion, is the South African government successful in meeting the basic needs of the poor? Motivate your response.

Yes/No✓✓

Almost 26% is regarded as absolutely poor in terms of international benchmark poverty line ($1,25 per day)

(1) Social security grants: old age pensions, child support grants, disability grants✓✓
(2) Benefits in kind: free quota water (6 000 litres per household) and electricity (20 kWh) per household, school-feeding schemes✓✓
(3) Housing: RDP houses✓✓
(4) Sanitation: Access to clean water, energy, sewerage system✓✓
(5) Primary healthcare: poor receive free hospitalisation and medicine. From certain income levels fees are staggered. Immunisation for all children is free. ✓✓
(6) Education: no-fee schools✓✓
(Candidates must mention some of these basic needs and how it affects the poor) **(Max.10)**

Conclusion

Any relevant conclusion ✓✓ **(Max. 2)**

TOTAL SECTION C: 40
GRAND TOTAL 150

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GRADE 12

ECONOMICS P2

EXEMPLAR 2014

MARKS: 150

TIME: 1½ hours

This question paper consists of 12 pages.

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INSTRUCTIONS AND INFORMATION

1. Answer FOUR questions as follows in the ANSWER BOOK:

   SECTION A: COMPULSORY
   SECTION B: Answer TWO of the three questions.
   SECTION C: Answer ONE of the two questions.

2. Answer only the required number of questions. Answers in excess of the required number will NOT be marked.

3. Number the answers correctly according to the numbering system used in this question paper.

4. Write the question number above each answer.

5. Read the questions carefully.

6. Start EACH question on a NEW page.

7. Leave 2–3 lines between subsections of questions.

8. Answer the questions in full sentences and ensure that the format, content and context of your responses comply with the cognitive requirements of the questions.

9. Use only black or blue ink.

10. You may use a non-programmable pocket calculator.

11. Write neatly and legibly.

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SECTION A (COMPULSORY)

QUESTION 1 **30 MARKS – 15 MINUTES**

1.1 Various options are provided as possible answers to the following questions. Choose the answer and write only the letter (A–C) next to the question number (1.1.1–1.1.8) in the ANSWER BOOK, for example 1.1.9 C.

1.1.1 As a rule, a firm should consider shutting down its business at the point where its …

A MC = AVC.
B MR = AC.
C MC = MR.

1.1.2 A market which has major government influence and control can be described as being ...

A unregulated.
B deregulated.
C regulated.

1.1.3 The value of inputs owned by the entrepreneur and used in the production process is known as ... costs.

A variable
B explicit
C implicit

1.1.4 A patent which gives one the exclusive right to manufacture a product is characteristic of a/an … monopoly.

A artificial
B natural
C local

1.1.5 The aggregate demand for goods and services that exceeds the aggregate supply thereof is known as …

A cost-push inflation.
B demand-pull inflation.
C deflation.

1.1.6 Tourism is … intensive.

A labour
B capital
C risk

1.1.7 When tourists are given the opportunity to experience South Africa's natural beauty it is known as … tourism.

A cultural
B eco-
C international

1.1.8 The government can play a very important role in environmental sustainability through its … policy.

A monetary
B fiscal
C urbanisation (8 x 2) (16)

1.2 Choose a description from COLUMN B that matches an item in COLUMN A. Write only the letter (A–J) next to the question number (1.2.1–1.2.8) in the ANSWER BOOK.

COLUMN A	COLUMN B
1.2.1 Core inflation	A price increases combined with high unemployment
1.2.2 Stagflation	B items that have highly volatile prices are excluded from the CPI basket
1.2.3 Climate change	C when it is impossible to increase the welfare of one without decreasing the welfare of another
1.2.4 Pollution	D often under-produced by the market, for example education
1.2.5 Duopoly	E two industries that dominate a particular market
1.2.6 Pareto efficiency	F excessive price increases
1.2.7 Merit goods	G average revenue = average costs
1.2.8 Normal profit	H occurs due to global warming
	I the flow of residual emissions exceeds the natural environment's capacity to absorb them
	J cigarettes and alcohol

(8 x 1) (8)

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1.3 Give ONE term for each of the following descriptions. Write only the term next to the question number (1.3.1–1.3.6) in the ANSWER BOOK.

1.3.1 A market structure dominated by a small number of large firms

1.3.2 Prices that are set below equilibrium price in the market and which allow the poor greater access to goods and services

1.3.3 The additional cost incurred when production is increased by one more unit

1.3.4 Seeks creative continuity of the environment, while ensuring that environmental change considers the quality of life of both present and future generations

1.3.5 The cost of a basket of consumer goods and services of an average South African household

1.3.6 A general increase in prices caused by increases in factor input costs (6 x 1) (6)

TOTAL SECTION A: 30

SECTION B

Answer any TWO of the three questions in this section in the ANSWER BOOK.

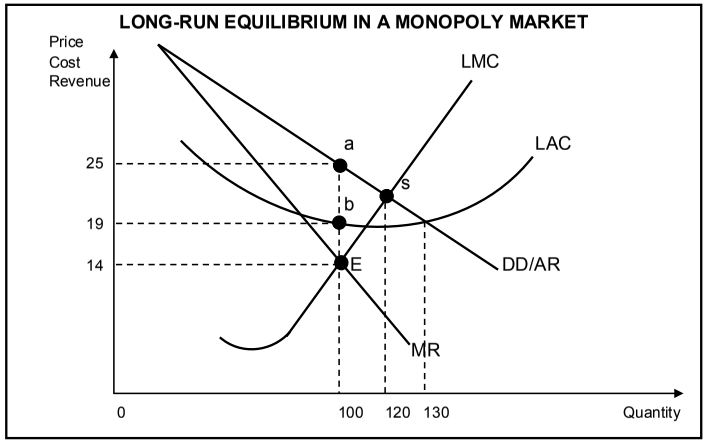
QUESTION 2: MICROECONOMICS 40 MARKS – 20 MINUTES

2.1 Answer the following questions.

2.1.1 Name TWO redress methods used by the government to improve income distribution. (2 x 1) (2)

2.1.2 Explain how price leadership can result in consumers paying higher prices in an oligopoly market. (1 x 2) (2)

2.2 Study the graph below and answer the questions that follow.



2.2.1 Define the concept *long run* as used in economics. (2)

2.2.2 Identify the optimum production level. (2)

2.2.3 Explain why the marginal revenue (MR) curve will always lie below the demand curve (DD) in this type of market. (2)

2.2.4 Calculate the profit or loss of this monopolist. Show ALL calculations. (4)

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2.3 Study the article below and answer the questions that follow

COMMISSION CRACKS GLASS CARTEL

Six firms active in the manufacturing and distribution of glass products for the building and construction industry have been found to be involved in a cartel by a Competition Commission investigation.

In its latest ruling on anti-competitive practices in the building and construction industry, the commission alleged that National Glass, Northern Hardware & Glass, Furman and Glass, McCoy's Glass, AF-FSL Glass and Glass South Africa were involved in price fixing, market allocation and the fixing of trading conditions through various arrangements and agreements.

The investigation into cartel activity in the glass industry was initiated in February 2010 based on information received in June 2009. AF-FSL Glass was granted conditional leniency from prosecution.

[Adapted from *Business Report*, 9 April 2013]

2.3.1 Define the term *cartel*. (2)

2.3.2 Which market structure is depicted in the above article? (1)

2.3.3 What prompted the Competition Commission to investigate anti-competitive behaviour in the glass industry? (2)

2.3.4 Explain how the glass cartel's behaviour can affect the economy negatively. (4)

2.3.5 Name the institution that the glass companies can approach if they are not happy with the fine imposed on them. (1)

2.4 Explain the reasons why cost-benefit analysis is used in practice. (8)

2.5 How can non-price strategies assist firms to increase their market share? (8)
[40]

QUESTION 3: CONTEMPORARY ECONOMIC ISSUES 40 MARKS – 20 MINUTES

3.1 Answer the following questions.

3.1.1 Give TWO examples of places or events that form part of cultural tourism. (2 x 1) (2)

3.1.2 How will a sound political climate lead to an increase in tourist figures? (1 x 2) (2)

3.2 Study the cartoon below and answer the questions that follow.

[Source: *Internet Globalisation*, 22 February 2013]

3.2.1 What is the meaning of the *greenhouse effect*? (2)

3.2.2 Why is it necessary to prevent global warming at all times? (2)

3.2.3 Name ONE international convention/protocol against global warming. (2)

3.2.4 Explain how the market fails to protect the environment. (4)

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3.3 Study the table below and answer the questions that follow.

EXPECTED GDP: R51,1 billion		
Tourist group	**Volume of local tourism market (number of trips)**	**Value of local market (%)**
Visits to family and friends	32	37,2
Holiday makers	8,1	44,5
Religion	5,3	4
Business	3,8	12,8
Medical reasons	0,8	14

[Fictitious figures]

3.3.1 Which tourist group contributed most (%) to the local economy? (2)

3.3.2 Determine the percentage contribution to the gross domestic product by people visiting friends and family. (2)

3.3.3 Why do you think that tourist figures increased locally after 1994? (2 x 2) (4)

3.3.4 How can tourism eradicate poverty in South Africa? (2 x 1) (2)

3.4 Discuss taxation as a fiscal measure to combat inflation. (4 x 2) (8)

3.5 Discuss why the loss of indigenous knowledge requires international measures. (4 x 2) (8)
[40]

QUESTION 4: MICROECONOMICS & CONTEMPORARY ECONOMIC ISSUES
40 MARKS – 20 MINUTES

4.1 Answer the following questions.

4.1.1 Name TWO characteristics of monopolistic competition. (2 x 1) (2)

4.1.2 What is the value of the production price index (PPI) as an inflation indicator? (1 x 2) (2)

4.2 Study the extract below and answer the questions that follow.

TIME RIPE FOR SMART TRANSPORT

Motorists will have to reconsider their transport options in the light of current petrol price hikes. According to Findalift.co.za many motorists drive to work causing millions of empty seats daily. Registering with Findalift will bring you into contact with people traveling the same route on a daily basis. Sharing the total cost of travelling 25 km daily will save you more than R6 500 every year – four people per vehicle will bring this saving up to R10 000. The Universities of Cape Town and Stellenbosch have already registered their students and employees to lower their travel costs.

[Adapted from *Beeld*, March 2013]

4.2.1 Define the concept *inflation*. (2)

4.2.2 Explain the influence Findalift might have on consumer consumption expenditure. (4)

4.2.3 What impact will reduced petrol costs have on savings and investment in general? (4)

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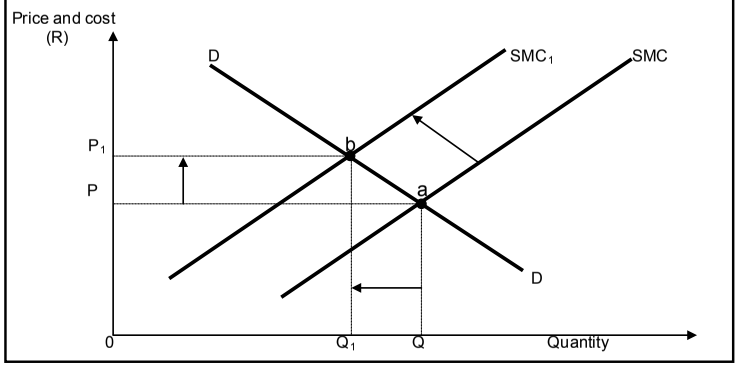
4.3 Study the graph below and answer the questions that follow.

NEGATIVE EXTERNALITIES – A CAUSE OF MARKET FAILURE



4.3.1 Define the concept *market failure*. (2)

4.3.2 Give ONE example of a negative externality. (1)

4.3.3 Which curve indicates the social cost to society? (1)

4.3.4 Explain how negative externalities can lead to market failure by using the data given in the above graph. (6)

4.4 Explain inefficiency in the economy as a consequence of market failure. (4 x 2) (8)

4.5 What are the effects of taxes and subsidies on the South African economy? (4 x 2) (8)
[40]

TOTAL SECTION B: 80

SECTION C

Answer any ONE of the two questions in this section in the ANSWER BOOK.

Your answer will be assessed as follows:

STRUCTURE OF THE ESSAY:	MARK ALLOCATION:
Introduction	Max. 2
Body: **Main part:** Discuss in detail/In-depth discussion/Examine/ Critically discuss/Analyse/Compare/Evaluate/Distinguish/ Explain/Assess/Debate	Max. 26
Additional part: Give own opinion/Critically discuss/Evaluate/ Critically evaluate/Draw a graph and explain/Use the graph given and explain/Complete the given graph/Calculate/Deduce/ Compare/Explain/Distinguish/Interpret/Briefly debate	Max. 10
Conclusion	Max. 2
TOTAL	**40**

QUESTION 5: MACROECONOMICS 40 MARKS – 35 MINUTES

Markets are broadly categorised into perfect and imperfect markets. However, in reality very few examples of perfect markets exist.

- Examine the conditions of a perfect market in detail. (26 marks)
- Draw a clearly labelled graph to show economic profit for an individual producer in the market. (10 marks) **[40]**

QUESTION 6: CONTEMPORARY ECONOMIC ISSUES 40 MARKS – 35 MINUTES

Tourism is one of the fastest growing industries worldwide.

- Critically discuss the effects of tourism. (28 marks)
- Evaluate how tourism benefits the households in your community by using appropriate examples. (10 marks) **[40]**

TOTAL SECTION C: 40
GRAND TOTAL: 150

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NATIONAL SENIOR CERTIFICATE

GRADE 12

ECONOMICS P2

EXEMPLAR 2014

MEMORANDUM

MARKS: 150

This memorandum consists of 14 pages.

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SECTION A (COMPULSORY)

QUESTION 1

1.1 **MULTIPLE-CHOICE QUESTIONS**

1.1.1 A (MC = AVC) ✓✓
1.1.2 C (regulated) ✓✓
1.1.3 C (implicit) ✓✓
1.1.4 A (artificial) ✓✓
1.1.5 B (demand-pull inflation) ✓✓
1.1.6 A (labour) ✓✓
1.1.7 B (eco) ✓✓
1.1.8 B (fiscal) ✓✓ (8 x 2) (16)

1.2 **MATCHING ITEMS**

1.2.1 B (items that have highly volatile prices are excluded from the CPI basket) ✓
1.2.2 A (price increases combined with high unemployment) ✓
1.2.3 H (occurs due to global warming) ✓
1.2.4 I (the flow of residual emissions exceeds the natural environment's capacity to absorb them) ✓
1.2.5 E (two industries that dominate a particular market) ✓
1.2.6 C (when it is impossible to increase the welfare of one without decreasing the welfare of another) ✓
1.2.7 D (often under-produced by the market e.g. education) ✓
1.2.8 G (average revenue = average costs) ✓ (8 x 1) (8)

1.3 **IDENTIFY THE CONCEPT**

1.3.1 Oligopoly ✓
1.3.2 Maximum prices ✓
1.3.3 Marginal cost ✓
1.3.4 Conservation ✓
1.3.5 Consumer Price Index ✓
1.3.6 Cost push inflation ✓ (6 x 1) (6)

TOTAL SECTION A: 30

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SECTION B

Answer TWO of the three questions from this section in the ANSWER BOOK.

QUESTION 2: MACROECONOMICS

2.1 2.1.1
- BEE✓
- affirmative action✓
- land restitution✓
- land redistribution ✓
- property subsidies (for RDP houses) ✓ (2 x 1) (2)

2.1.2 A dominant firm may increase the price of a product✓ His rivals will see this as a signal to do the same and increase prices. ✓ (1 x 2) (2)

2.2 2.2.1 The long run is the period of production where all factors can change. The time is long enough for variable and fixed factors to change✓✓ (2)

2.2.2 100✓ (2)

2.2.3 The negative sloping demand curve means that more goods are sold at low prices✓, hence additional revenue will decrease as more goods are sold. ✓ (2)

2.2.4 Unit profit: 25 – 19= 6✓✓
Total profit: 6 x 100 = R600✓✓
OR
TR – TC ✓
(25 x 100) ✓ – (19 x 100) ✓ = R600✓ (4)

2.3 2.3.1 A cartel is a group of producers working together to form a monopoly by fixing prices. ✓✓ (2)

2.3.2 Oligopoly✓ (1)

2.3.3 They received information when AF-FSL Glass had applied for leniency for their part in collusive behaviour. ✓✓ (2)

2.3.4
- Consumers will pay higher prices. ✓✓
- Competition will be eliminated which could result in poor quality goods. ✓✓
- Supply will be reduced which will affect employment

Any(2 x 2) (4)

2.3.5 Competition Appeal Court✓ (1)

2.4
- Market signals, e.g. price helps to allocate resources through demand and supply. ✓✓
- Goods supplied by the government such as roads, bridges etc. are provided free. ✓✓
- With the absence of market signals, decisions on the desirability of a project may be subjective. ✓✓
- Objective criteria may be required to ensure economic efficiency in resource allocation. ✓✓
- CBA brings greater objectivity to decision making. ✓✓
- This is done by identifying all the relevant benefits and costs of a project where an informed decision can be made✓✓ (Any 4 x 2) (8)

2.5
- An important aspect of non-price competition is to build brand loyalty, ✓ product recognition✓ and product differentiation. ✓
- This is done by means of advertising and marketing. As a result, firms tend to spend a substantial amount of money on this. ✓✓
- Other forms of non-price competition include:
  - extended shopping and business hours✓✓
  - doing business over the internet✓✓
  - after-sales services✓✓
  - loyalty rewards for customers✓✓
  - In-store competitions✓✓
  - door-to-door deliveries✓✓ (Any 4 x 2) (8)

[40]

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QUESTION 3: CONTEMPORARY ECONOMIC ISSUES

3.1 3.1.1
- Museums ✓
- Art galleries ✓
- Archaeological sites ✓
- Festivals ✓
- Sports events ✓

Any other relevant fact (2)

3.1.2
- Where government intervenes to preserve environmental assets more tourists will visit a country ✓✓
- Better control and management of e.g. indigenous forests will maximize a country's income over the long run ✓✓

Any other relevant fact (2)

3.2 3.2.1 Pollutants contribute to a layer or blanket in the atmosphere that traps heat ✓✓ (2)

3.2.2 There is a steady increase in the average temperature of the earth's near-surface air and oceans that influences all economic sectors like agriculture and transport negatively ✓✓ (2)

3.2.3
- Kyoto protocol ✓✓
- Montreal protocol ✓✓

Any other acceptable answer (1 x 2) (2)

3.2.4
- The environment is a common resource ✓✓many parts of the environment are not privately owned e.g. the sea
- Externalities ✓✓ when people pollute the environment costs are borne by others
- Lack of knowledge ✓✓ people cause damage without realizing it
- Carelessness ✓✓ people continue with harmful practices and leave future generations to worry about the consequences (4)

3.3 3.3.1 Holiday makers with a 44,5 % share ✓✓ (2)

3.3.2 $\frac{51,1 \times 37,2}{100}$ ✓✓ = 19% ✓✓ /19% ✓✓ (2)

3.3.3
- Safety ✓✓
- Increased media coverage ✓✓
- Interest in politics ✓✓
- Interest in sport ✓✓
- Improved infrastructure ✓✓ (2 x 2) (4)

3.3.4
- Job creation – jobs can be provided immediately ✓✓
- Entrepreneurial opportunities ✓✓
- Tourism allows rural people to share in the benefits of tourism development ✓✓

Any other relevant fact (2)

3.4
- Direct taxation increased ✓✓ less money available for consumption expenditure by consumers ✓✓
- Indirect taxation increased ✓✓ as part of a restrictive fiscal policy government can reduce its spending or increase taxation e.g. sins tax (2 x 4) (8)

3.5
- Today's tourists seek authenticity and uniqueness at destinations ✓✓
- They want to understand the indigenous culture, history and environment and how local people live and work ✓✓
- Of importance is the World Heritage Sites, e.g. Mapungubwe, Vredefort Dome, Sterkfontein Caves and Robben Island ✓✓
- Environmental World Heritage Sites represent the extreme of our indigenous environmental uniqueness, e.g. iSimangaliso Wetland Park (4 x 2) (8)

[40]

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QUESTION 4

4.1 4.1.1

- The product is differentiated. ✓
- Use of non-price competition. e.g. advertising. ✓
- Displays a hybrid structure. It is a combination of competition and a monopoly. ✓
- There are many sellers✓
- entry and exit is easy Entry into the market is easy. ✓
- Businesses have little control over the price of the product. ✓
- Information for buyers and sellers is incomplete. ✓
- Collusion is not possible under monopolistic competition. ✓

(Any 2 x1) (2)

4.1.2 Pertains to cost of production ✓✓
Basket consists of goods only ✓✓
Capital and intermediate goods are included ✓✓
Prices exclude VAT ✓✓
Interest rates are excluded ✓✓
Prices of imported goods are shown explicitly ✓✓ (Any 1 x 2) (2)

4.2 4.2.1 Inflation is a sustained and significant increase in the general price level over a period of time and a simultaneous decrease in the value or buying power of money. ✓✓ (2)

4.2.2 Major savings on transport cost will increase consumer consumption expenditure ✓✓
The consumer can redirect his consumption expenditure on other goods and services ✓✓ (4)

4.2.3 Reduced petrol cost could increase savings and investment in general if most of the consumer's needs are met. ✓✓ **OR**
Reduced petrol cost will not necessarily influence savings and investment if the consumer spends the extra money on goods and services. ✓✓ (4)

4.3 4.3.1 Market failure occurs when the market is not operating efficiently e.g. a firm may produce fewer goods than it is capable of. ✓✓ (2)

4.3.2

- Pollution✓
- Traffic congestion✓

Any other relevant answer✓ (1)

4.3.3 MSC_1 ✓ (1)

4.3.4 Negative externalities are costs to third parties which are not included in the market price. ✓✓Therefore production is at Q✓, If the external costs were included then production would be at Q1 which is less than Q✓ and is socially desirable✓. Thus goods which generate negative externalities are over-produced. ✓✓ (6)

4.4 **a) Productive inefficiency/Technical inefficiency**✓✓
When resources are not used appropriately to produce the maximum number of goods at the lowest cost✓ and best quality✓.

b) Allocative inefficiency✓✓
When resources are not allocated in the right proportions and the product mix does not match consumers' tastes✓.i.e. the quantity and type of goods produced do not cater for consumers' needs. ✓

An allocation of resources is inefficient if it is possible to reallocate resources to make one person better off while not making someone else worse off. ✓✓ (8)

4.5 ENVIRONMENTAL TAXES:

- Rather than taxing environmental use, tax could be imposed on the output of a good wherever external environmental costs are generated ✓✓
- These are known as green taxes, charged on items such as tyres – will increase the price ✓✓

SUBSIDIES:

- Provide subsidies for activities that reduce environmental damage ✓✓
- Cost to reduce or prevent the harmful effects is recovered from the proceeds of taxation ✓✓
- E.g. development of new techniques or equipment to save energy or to reduce smoke ✓✓ (Any 2 x 4) (8)

[40]

TOTAL SECTION B: 80

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SECTION C

Answer ONE question from this section in the ANSWER BOOK.

STRUCTURE OF ESSAY:	MARK ALLOCATION:
Introduction	Max. 2
Body: • Main part: Discuss/Distinguish/Differentiate/Explain/Analyse /Evaluate/Assess • Additional part: Use/Draw/Sketch a graph/diagram …/ Deduce …/Outline/Briefly explain/Expand on .../Your own opinion	Max. 26 Max. 10
Conclusion	Max. 2
TOTAL	**40**

QUESTION 5: MACROECONOMICS **40 MARKS – 25 MINUTES**

Markets are broadly categorised into perfect and imperfect markets. However, in reality very few examples of perfect markets exist.

- Examine the conditions of a perfect market in detail. (26 marks)
- Draw a clearly labelled graph to show economic profit for an individual producer in the market. (10 marks) **[40]**

Introduction

It is a market structure with a large number of participants who are price-takers. ✓✓The price is determined by the market demand and supply, This market is most efficient in the allocation of resources ✓✓ **Max (2)**

BODY:

Characteristics:

a) **Products must be homogenous (i.e. identical).** ✓
- Products must be identical. There should be no differences in style, design and quality. ✓✓
- In this way products compete solely on the basis of price and can be purchased anywhere. ✓✓
- If products differ, sellers can persuade buyers to buy their more expensive products by grading them. ✓✓ E.g. The markets for maize and coal consist of homogenous products which are graded. Grade 1 fetches a higher price than other grades.

b) **There should be a large number of buyers and sellers.** ✓
- It should not be possible for one buyer or seller to influence the price.
- When there are many sellers the share of each seller to the market is so small that the seller cannot influence the price. ✓✓
- Sellers are price-takers, they accept the prevailing market price. If they increase prices above the market price, they will lose customers. ✓✓.

c) **No preferential treatment/discrimination**✓
- Collusion occurs when buyers and sellers make an agreement to limit competition. In a perfect market no collusion takes place. ✓✓
- Buyers and sellers base their actions solely on price, homogenous product fetch the same price and therefore no preference is shown for buying from or selling to any particular person. ✓✓

d) **Free competition/Unregulated market:** ✓
- Buyers must be free to buy whatever they want from any firm and in any quantity. ✓✓
- Sellers must be free to sell what, how much and where they wish. ✓✓
- They should be no state interference and no price control. ✓✓
- Buyers should not form groups to obtain lower prices nor should sellers combine to enforce higher prices.✓✓

e) **Efficient transport and communication**✓
- Efficient transport ensures that products are made available everywhere. ✓✓
- In this way changes in demand and supply in one part of the market will influence the price in the entire market. ✓✓
- Efficient communication keeps buyers and sellers informed about market conditions. ✓✓

f) **All participants must have perfect knowledge of market conditions.** ✓
- All buyers and sellers must be fully aware of what is happening in any part of the market. ✓✓
- Technology has increased competition as information is easily obtained via the Internet. ✓✓

g) **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. 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. ✓✓

h) **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. ✓✓

i) **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. ✓✓

Max. 26

NOTE: A maximum of 8 x 1 marks will be allocated for headings

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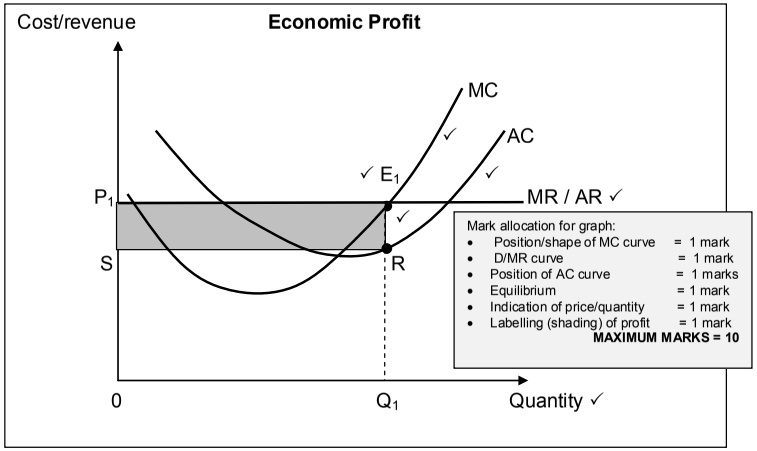
BODY: ADDITIONAL PART



(Max. 10)

Conclusion

The characteristics above indicate that the market has to meet strict requirements before it can be described as perfectly competitive ✓✓
Although there very few examples, the conditions of a perfect market does serve a frame of reference when studying other markets. ✓✓

(Any other relevant conclusion) **(Max. 2)**

QUESTION 6: CONTEMPORARY ECONOMIC ISSUES 40 MARKS – 25 MINUTES

Tourism is one of the fastest growing industries worldwide.

- Critically discuss the effects of tourism. (28 marks)
- Evaluate how tourism benefits the households in your community by using appropriate examples. (10 marks) **[40]**

Introduction

In general we say that tourism involves people moving from their usual place of residence to a destination where they make use of the facilities and take part in activities ✓✓
Any other relevant definition. **(Max. 2)**

BODY: MAIN PART

1.1 GDP ✓
- Biggest impact on services industry than on agriculture or manufacturing ✓✓
- Indirect contribution: service-based industry – responsible for 65% of GDP in developed economies and 40% of GDP in developing countries ✓✓
- Direct contribution: contribution of 6,8% of GDP compared to 11.6% worldwide. ✓✓

1.2 Employment ✓
- Employs 7% of SA workforce (1,12 million) ✓✓
- largest provider of jobs and earner of foreign exchange, due to:
  - ❖ Tourism is labour intensive ✓✓
  - ❖ Tourism employs many skills ✓✓
  - ❖ Tourism can provide immediate employment ✓✓
  - ❖ Tourism provides entrepreneurial opportunities ✓✓

1.3 Poverty ✓
- Tourism is fast + effective distribution mechanism in development of rural areas ✓✓
- Prime tourism attractions located in rural areas ✓✓
- Promote balanced + sustainable form of development ✓✓
- Provides alternative to urbanisation, permitting people to continue - a rural family existence, enfranchising both women and youth ✓✓
- Offers diversity of income sources to poor people:
  - ❖ Allowing them a stake
  - ❖ Empowering them
  - ❖ Creating partnerships ✓✓

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1.4 Externalities

Has positive and negative impacts:

- ❖ Attracts large amounts of revenue, but can cause undue environmental damage (uses resources and produces waste) ✓✓
- ❖ Rapid growth aimed at short-term benefits has more negative than positive effects: degeneration of traditions + cultural values, environmental damage to sites and natural settings – pollution and waste ✓✓
- ❖ Global tourism will grow due to increased population, improved living ✓✓ standards, increased free time and expansion of transportation systems
- ❖ Pressure on tourist sites will increase ✓✓
- ❖ Potential: attract revenue to country, alleviate poverty, conserve cultural and natural assets – needs conscious planning ✓✓
- ❖ Needs to achieve ethical and sustainable tourism must respect tradition and customs of area, plough back earnings into local community – area must be protected as attractive tourist resort. ✓✓

1.5 Environment

Industrial development has impact on physical environment in which it takes place.✓✓
Creates environmental stress – categories:

- Permanent environmental restructuring (construction work on highways, airports) ✓✓
- Waste product generation (biological + non-biological waste) ✓✓
- Direct environmental stress (destruction of coral reefs) ✓✓
- Effects on population dynamics (migration and urban density, declining rural population) ✓✓

1.6 Infrastructure

- Adequate physical, economic + basic services infrastructure essential for tourist destinations:
  - ❖ Transport infrastructure (roads, railway lines, airports, car parks) ✓✓
  - ❖ Communication infrastructure (telephone lines, electronic signal stations) ✓✓
  - ❖ Energy infrastructure (electricity and liquid fuels) ✓✓
  - ❖ Basic services infrastructure (clean water, reuse removal, sewerage systems). ✓✓
- Lack of economic + basic services infrastructure prevents growth of tourism ✓✓
- This infrastructure is seen as public investment ✓✓
- Seasonality – major problem for infrastructural development ✓✓ (Max 26)

ADDITIONAL PART

Tourism benefits households' prosperity in THREE ways:

- Income – salaries and wages – due to involvement with tourism ✓✓ example from the candidate's environment ✓✓
- Infrastructure – available for tourists and local people's use ✓✓ example from candidate's environment ✓✓
- Skills – variety required – education + training required – school subject ✓✓ example from the candidate's environment ✓✓ **(Max. 10)**

Accept any other relevant answer.

Conclusion

In reality tourism is a much wider concept and can be quite demanding but very interesting when it is related to a specific community ✓✓
Any other relevant conclusion **(Max. 2)**

TOTAL SECTION C: 40
GRAND TOTAL 150

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