The Economic Environment

Learning objectives

- *To become familiar with concepts and tools used by economists for comparing national economies*
- *To identify the differences between divergent economic systems, including their market openness, social perspectives and the role of the state in economic life*
- *To assess the prospects and opportunities of the world's developing and transitional economies*
- *To gain an overview of regional integration in the global economy*
- *To highlight the challenges faced by the least developed economies*

National economies diverge in their activities, size and organizations.

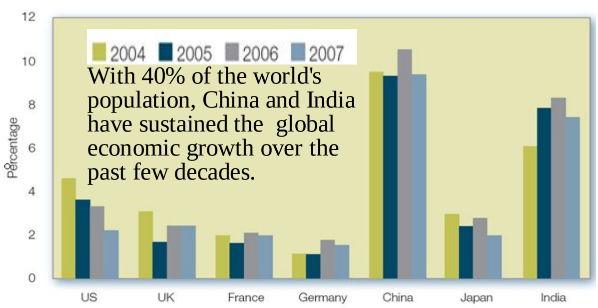
The rich countries of the developed world, mainly in America and Western Europe, enjoy the highest levels of GDP (Gross Domestic Product or the total sum of goods and services produced in an economy) per capita. The following expenditure-identity is one way to measure the GDP:

GDP = Public consumption (C) + Government expenditure (G) + Investment (I) + Trade/ Payments balance (= Export - Import)

The earliest to industrialize, these high-income economies are now mainly service based and rely on high-tech sectors. Joined by Japan in the 1970s, they developed states share concerns about competitiveness in the global economy.

All face the public spending pressures of ageing populations, and rising costs of healthcare. Attracting and retaining FDI becomes difficult in these high-cost environments, and manufacturing jobs have tended to migrate to lower cost developing economies.

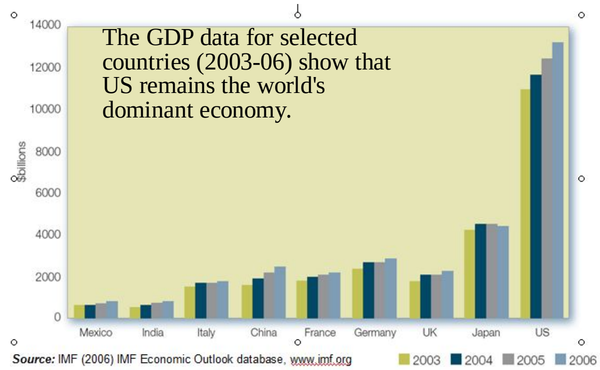
On the positive side, large markets and good infrastructure in the developed countries provide location advantages for international business strategists.



Inflation, measured using the consumer price index (CPI)

Inflation, measured using the **consumer price index (CPI)** for each country, follows economic growth. Improving **labour productivity** can raise economic growth, **unemployment** is linked to weak economic growth. Country differences in employment policies and costs of labour stimulate (or discourage) business activity.

Income inequality is measured by **Gini coefficient** as the proportion of income earned by each quintile (20%) of population. It reflects the accumulation of wealth in a few hands that causes social unrest.



Economy and Economic Growth

Economic development is the processes of change in economic activities and organizations, on which the country's wealth and prosperity depend.

Economic development usually progresses through these three stages

1. primary (agriculture, mining and fishing),
2. secondary (manufacturing and industrial production) and
3. tertiary (services)

However, wealth in resource-rich countries is mainly generated by exploiting their resources (often through FDI).

- Suppose we write the output of an economy GDP, denoted by Y, as the following function of capital (K) and labor (L):

$$Y = K^{\alpha} [(1-u) L]^{(1-\alpha)} \qquad (1)$$

Here, u denotes the unemployment rate. Dividing both the sides by L, we then obtain

$$y = Y/L = (K/L)^{\alpha} (1-u)^{(1-\alpha)} \qquad (2)$$

as the expression for y = Y/L or the GDP per capita.

Note how (1) shows that GDP (Y) varies inversely with the unemployment rate (u). Though overtly simplistic, this explains Okun's Law, that each 1% rise in unemployment rate produces a 2½-3% drop in the GDP. The factor (K/L) in (2) is the productivity of labor, and has contributed most to economic growth in US and other developed economies over these past few decades.

- Divergent models of economy have emerged as more countries have become industrialized. Alongside the liberal economic model of the UK and US, there has evolved the social market model prevalent in European countries, which takes a more state-oriented approach to social welfare. Although there is no specifically Asian model of capitalism, Asian countries tend to share a view of the state as guiding economic development, although not acting in a strong welfare role. China is now the world's largest developing economy, and also a transition economy, progressing from state planning to market institutions. Its high growth rate owes much to FDI and the burgeoning domestic private sector. Despite strong growth, China still has much to do to raise levels of prosperity for all the population.