Economics Part 4

The Labour Market & The Role of Money & Financial Markets

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- The demand for labour is said to be ‘derived’. This means that the demand for labour is dependent on the demand for the products and services for which the labour is required.
- The Labour market is where workers sell their labour and employers buy their labour. The market is made up of household’s supply of labour and firms demand for labour.

How are wages determined?

- In a free market economy wages are determined by the interaction of demand and supply. However, in reality the government and trade unions will exert influence on the actual wage level.
- The labour market offers a meeting place for workers and employers to determine pay and the number of workers who will be employed. A shortage of workers leads to higher pay; this in turn sends a signal to the labour market that more workers are needed.

How are workers paid?

- Some workers are paid a salary where their annual pay is divided into 12 equal parts and paid monthly. Other workers are paid an hourly rate and this is known as their wage. Economists often use the term ’wage’ to cover both salary and wages.

Types of Labour market

- Some labour markets only exist in certain locations because of the nature of the work and it's reliance on proximity to certain areas.

- However, some labour markets can exist everywhere and are only reliant on the skills of the workers entering the market.

When does a labour market not operate perfectly?

- Labour markets may not operate perfectly when:
  1. Workers entering the market do not have the skills required.
  2. In the case of a location-based market, skilled workers may be unwilling to relocate.
  3. Personal factors – for example specific individual factors which may cause workers to leave the market.
  4. Information failure, this is a form of market failure where economic agents lack full information i.e. Some people will be unaware of all of the job opportunities that exist.

How can we use demand and supply to determine wages?

- Previously, we have used demand and supply diagrams to show how price and quantity is determined in the market place. We can use a similar process in the labour market.

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- **Profitability of firms** – the more profit a firm is making the more likely they are to increase employment.

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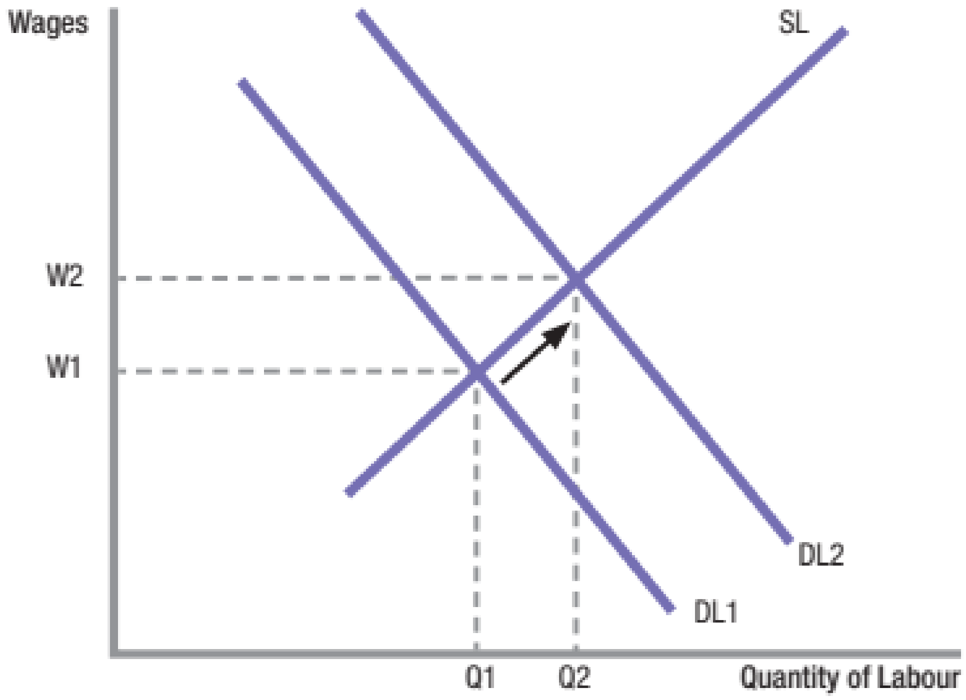
- **Education and training** – the more educated and trained people are the more likely they are to offer their services.

Demand/Supply diagrams for labour

- For example, what happens to the supply and demand for labour if the economy sees growth?

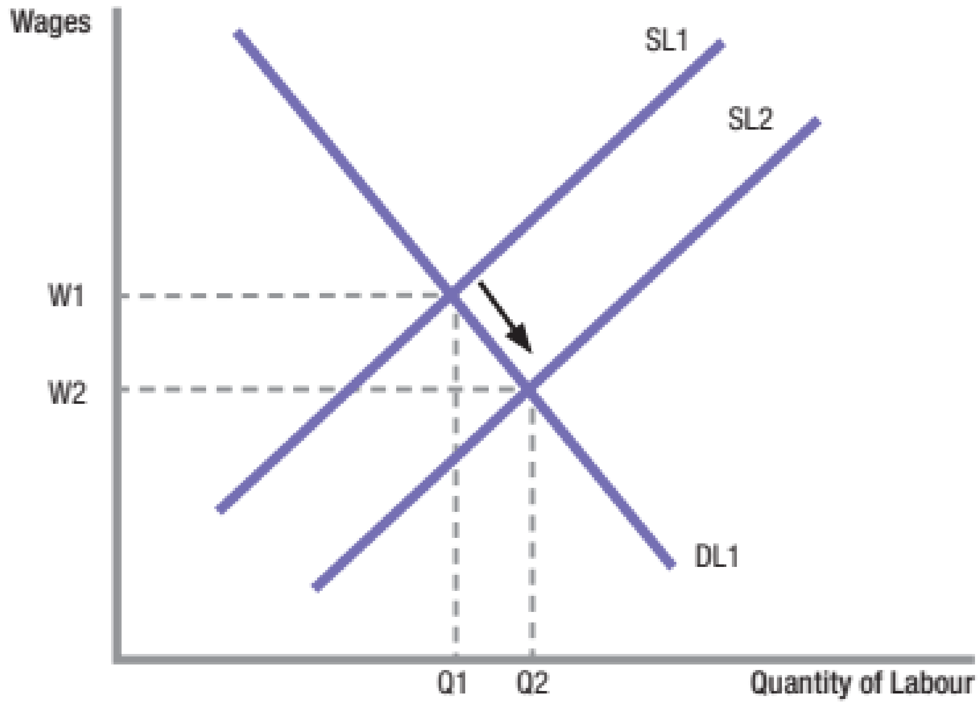
- Note: the different labels for the axes and curves compared to demand and supply diagrams we used before. Here, the improvement in the economy has resulted in an increase in demand for labour. This causes a rightward shift in the Labour demand curve.



Demand/Supply diagrams for labour

- What if there is a decrease in the cost of nursery or creche facilities?

- Here, as childcare facilities have become cheaper, more people are willing to supply their labour.



How much can wages fluctuate?

- At this stage, it is worth recapping your knowledge of Price Elasticities of Demand and Supply. Both of these will have an impact on the size of any change.
- It is the interaction of the two that is important. For example, when demand is low and elastic and the supply is high and inelastic, the wage will be low e.g. cleaners.
- There are cases where supply may be perfectly inelastic, for example a footballer with very rare talents, such as Premier League footballer will receive very high wages.

Independent Task – 5 minutes

Draw a demand and supply of labour diagram to show what might happen to the wages of a Premier League Footballer after they have got their first call up for their international team.

Gross & Net Pay

- Gross pay is the wage that you receive before any deductions are made. Net Pay is the amount of money that you have to spend or save after all deductions such as income tax have been made. This is often referred to as take-home pay

Independent Task – 5 minutes

Complete the tables below to show gross pay	
Monthly wage	£
Basic wage	22,500
Commission	1500
Gross Pay:	
Income tax	4,000
National insurance	1900
Pension contribution	1200
Net pay:	

The Role of Money as a Medium of Exchange

- Before the existence of money, people traded goods through a barter system. For example, a carpenter who wanted to buy some bricks, needed to find a brickmaker who may be in need of carpentry services and swap products/services. Of course, this assumes that both parties want to make the trade – if the carpenter can't find a bricklayer who needs their skills, they may not be able to make a trade.
- So, money allows that exchange. As long as all parties have confidence in the currency being used they will swap the money for products or services in the knowledge that they can use the money elsewhere.

Other functions of Money

- **Store of value:** this can refer to any asset whose “value” can be used now or used in the future i.e. its value can be retrieved at a later date. Money performs this function, because it allows purchasing power to be transferred from the present to the future. This means that people can save now to fund spending at a later date.

- **Unit of account:** this refers to anything that allows the value of something to be expressed in an understandable way, and in a way, that allows the value of items to be compared.

Criteria of Money

- It must be durable and not fall apart easily
- It must be portable and easy to carry
- It must be divisible – i.e. be able to break down into smaller denominations (e.g. 1p, 5p, 20p)
- Complex enough to prevent people making counterfeit versions
- Accepted by everyone
- Limited in quantity (so that it maintains some value)

Independent Task

Consider the following items and imagine that they were used as a form of money. Give one advantage and one disadvantage of each item if it were used as money.		
Item	**Advantage**	**Disadvantage**
Pebbles		
Grains of rice		
Coconuts		
Diamonds		

The role of the Financial Sector

- The financial sector in any country exists to manage the process of transferring money in an economy. In modern economies, the financial sector in any one country (or internationally) is vital to ensure that economic transactions take place. The financial sector has the following functions:

Functions of the Financial Sector

- **Facilitating the exchange of products and services** - this is achieved by storing money and transferring money when required. Many people have ‘cards’ that allow transfer of money through electronic machines or allow people to withdraw cash from cashpoints

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- **Monitoring borrowers** – the financial sector monitors the performance of businesses and individuals to minimise the loss of money

Key Financial Terms

Savings	'Deposits' made into a bank or building society to be stored in an account. Money held in savings accounts will often earn 'interest' (see later) which encourages the saver to store money in the account.
Loan	A set amount of money lent to an individual or group. This money may be used to purchase something (e.g. a car) or pay off debt. The financial institution giving the loan will earn money by charging 'interest' at a set rate (quoted as a percentage).
Mortgage	A long-term loan used by individuals to purchase homes. Because a home is usually the most expensive item an individual will purchase, the loan has to be a large amount. Repayment of a mortgage is usually over many years (e.g. 25 years). Again, the financial institution will earn money from charging interest on the mortgage – this interest may be 'fixed' (does not change) or 'variable' (changes over time at rates set by the lender).
Overdraft	A smaller, often short-term loan. In effect, the financial institution allows account holders to withdraw more money from their account then they have placed in that account. The financial institution may change interest on the overdraft or may lend the money for free with prior agreement.

Main Institutions in the Financial Sector

- **Banks** – banks can exist in several forms. You will find different banks on many High Streets in the UK but they can also be accessed using other methods (such as telephone banking or internet banking). Banks allow people to store their money securely and then access this money through taking out cash or transferring money electronically (or by using cheques). Banks will offer their customers ‘overdrafts’ (the facility of short term borrowing directly from an account), short and long-term loans and other services such as financial advice. Banks earn most of their own finances through the interest on loans they have given out.

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- **Building Societies** – in the UK, building societies have become less popular than banks as the number of services that they offer is more limited. Building societies are owned by their 'members' (the people who save) and operate more to the benefit of their members than banks (who tend to be more profit focused). The primary services offered by building societies are saving accounts and long-term loans (especially mortgages).

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- **Insurance Companies** – insurance companies enable people to reduce risk. Individuals or organisations will 'take out' insurance against something bad happening (e.g. accidentally breaking a mobile phone, a house being burgled, a holiday being cancelled). The cost of the insurance is much smaller than the item being insured but the financial institutions make profits from the fact that most people do not have to claim.

Interest Rates

- ‘Interest rates’ can have several meanings:
  - A percentage charge on a loan as a reward for granting the loan by the financial institution and the cost of taking out the loan for the loanee. For example, if a bank loans an individual £1,000 at a 5% interest, then the individual will need to pay the £1,000 back plus an additional (5% of £1,000) £50.
  - A percentage reward (often paid annually) to an individual holding money in a savings account. For example, if I save £2,000 in a savings account with a 2% interest rate, at the end of the year the financial institution will reward me with (2% of £2,000) £40 in interest. My savings account will now show £2,040.

The impact of changing interest rates

- If Interest rates rise:
  - People will be encouraged to save more as the reward for saving has increased. For example, if interest on my £2,000 savings increases from 2% to 3%, the reward changes from £40 to £60 (per year).
  - People are less likely to take out loans. This is because the cost of borrowing has increased.
  - Monies paid into other investments will decrease. For example, monies can be earned from investing in shares (a proportion of the ownership of businesses). Individuals are more likely to put money into savings accounts as they are safer and earn more money than the share investment.

The impact of changing interest rates

- If Interest rates fall:
  - People will be encouraged to save less as the reward for saving has decreased.
  - People are more likely to take out loans. This is because the cost of borrowing has decreased.
  - Monies paid into other investments will increase.

More Key Terminology

Base rate	The ‘Base’ rate in the UK is set by the Bank of England. This is the percentage rate charged to banks for borrowing from the BoE. This base rate then impacts on the interest rates set by the High Street banks.
AER	Annual Equivalent Rate – the amount of interest a savings account will earn in a single year.
Gross annual	This is the annual income from a savings account that is earned before tax is deducted.
Compound interest	This is where a savings accounts starts to earn by receiving interest payments from the interest already earned from the account.
Access	Different banks will allow different levels of access to savings. Some accounts allow holders to instantly withdraw any amount. Other accounts may only allow the holder to withdraw after they have given notice that they wish to do so (e.g. 30 days notice).

Independent Task

Calculate the amount of interest earned in the following cases:

- David saves £2,000 with a bank that offers a 2% interest rate per year.
- Madge saves £5,000 with a bank that offers a 4% interest rate per year.
- Clyde saves £7,500 with a bank that offers a 3.5% interest rate per year.

Independent Task

Calculate how much would be paid back to a bank in the following cases:

- Brian takes out a loan of £2,500 charged at an interest rate of 2%. He has to pay the loan back at the end of a one-year period. How much will Brian pay back?
- Susan takes out a loan of £4,500 charged at an interest rate of 3%. She has to pay the loan back at the end of a one-year period. How much will Susan pay back?