Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.4 Macroeconomic Policies and Impact on Firms and Individuals

4.4.2 Demand-side policies

Notes

Demand-side policies are policies designed to increase consumer demand, so that total production in the economy increases.

Distinction between monetary and fiscal policy

Monetary policy is used by the government to control the money flow of the economy. This is done with interest rates and quantitative easing. This is conducted by the Bank of England, which is independent from the government.

Fiscal policy uses government spending and revenues from taxation to influence AD. This is conducted by the government.

Monetary policy instruments:

- **Interest rates**

  In the UK, the Monetary Policy Committee (MPC) alters interest rates to control the supply of money. They are independent from the government, and the nine members meet each month to discuss what the rate of interest should be. Interest rates are used to help meet the government target of price stability, since it alters the cost of borrowing and reward for saving.

  The bank controls the **base rate,** which ultimately controls the interest rates across the economy.

  When interest rates are high, the reward for saving is high and the cost of borrowing is higher. This encourages consumers to save more and spend less, and is used during periods of high inflation.

  When interest rates are low, the reward for saving is low and the cost of borrowing is low. This means consumers and firms can access credit cheaply, which encourages spending and investment in the economy. This is usually used during periods of low inflation. However, during the financial crisis, the UK interest rate fell to a historic low of 0.5%, and has been at this rate since March 2009. Despite high inflation, the interest rate was set at a low rate to stimulate AD and boost economic growth.

- **Asset purchases to increase the money supply: Quantitative Easing (QE)**

  This is used by banks to help to stimulate the economy when standard monetary policy is no longer effective. This has inflationary effects since it increases the money supply, and it can reduce the value of the currency.

  QE is usually used where inflation is low and it is not possible to lower interest rates further.

  QE is a method to pump money directly into the economy. It has been used by the European Central Bank to help stimulate the economy. Since the interest rates are already very low, it is not possible to lower them much more. The bank bought assets in the form of government bonds using the money they have created. This is then used to buy bonds from investors, which increases the amount of cash flowing in the financial system. This encourages more lending to firms and individuals, since it makes the cost of borrowing lower. The theory is that this encourages more investment, more spending, and hopefully higher growth. A possible effect of this is that there could be higher inflation.

  If inflation gets high, the Bank of England can reduce the supply of money in the economy by selling their assets. This reduces the amount of spending in the economy.

Limitations of monetary policy:

- Banks might not pass the base rate onto consumers, which means that even if the central bank changes the interest rate, it might not have the intended effect.
- Even if the cost of borrowing is low, consumers might be unable to borrow because banks are unwilling to lend. After the 2008 financial crisis, banks became more risk averse.
- Interest rates will be more effective at stimulating spending and investment when consumer and firm confidence is high. If consumers think the economy is still risky, they are less likely to spend, even if interest rates are low.

Fiscal policy instruments:

- **Government spending and taxation**

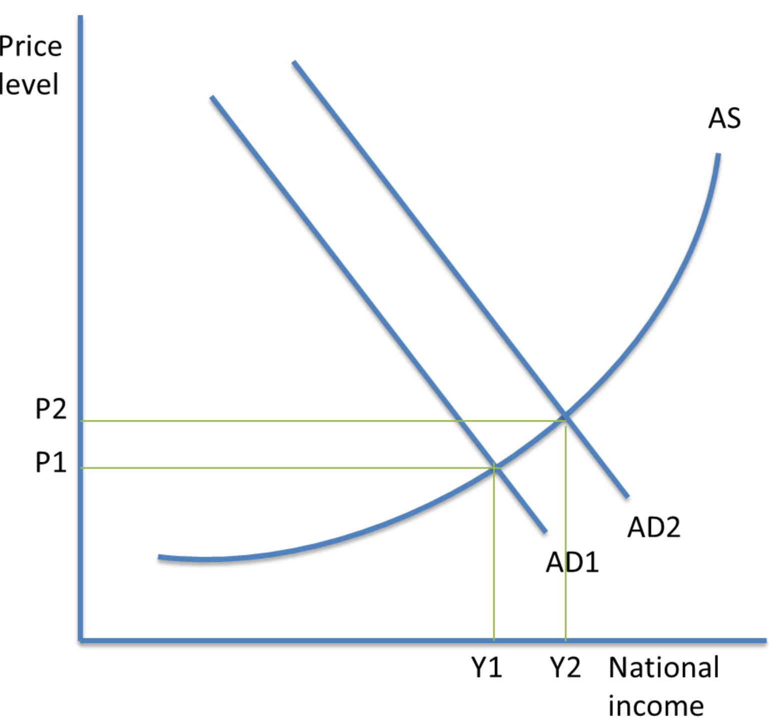
  Governments can change the amount of spending and taxation to stimulate the economy. The government could influence the size of the circular flow by changing the government budget, and spending and taxes can be targeted in areas which need stimulating.

  Fiscal policy aims to stimulate economic growth and stabilise the economy.

  In the UK, the government spends most of their budget on pensions and welfare benefits, followed by health and education. Income tax is the biggest source of tax revenue in the UK.

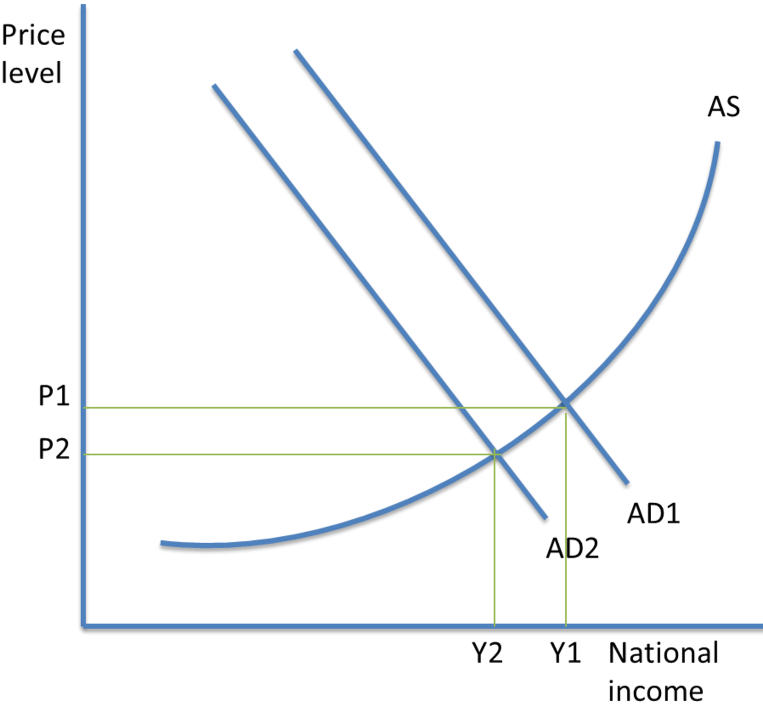
Expansionary fiscal policy

This aims to increase AD. Governments increase spending or reduce taxes to do this. It leads to a worsening of the government budget deficit, and it may mean governments have to borrow more to finance this.



Deflationary fiscal policy

This aims to decrease AD. Governments cut spending or raise taxes, which reduces consumer spending. It leads to an improvement of the government budget deficit.



Direct and indirect taxes:

Direct taxes are imposed on income and are paid directly to the government from the tax payer. Examples include income tax, corporation tax, NICs and inheritance tax. Consumers and firms are responsible for paying the whole tax to the government.

Indirect taxes are imposed on expenditure on goods and services, and they increase production costs for producers. This increases market price and demand contracts.

There are two types of indirect taxes:

- **Ad valorem** taxes are percentages, such as VAT, which adds 20% of the unit price. This is the main indirect tax in the UK.

- **Specific taxes** are a set tax per unit, such as the 58p per litre fuel duty on unleaded petrol.

Limitations of fiscal policy:

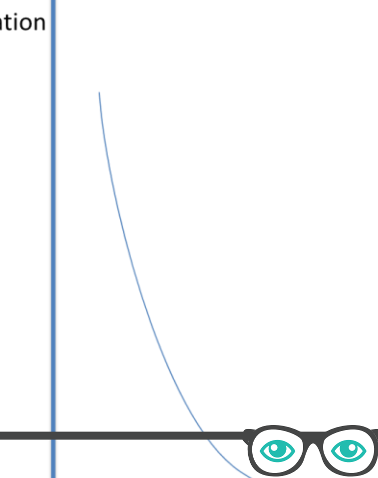
- Governments might have imperfect information about the economy. It could lead to inefficient spending.
- There is a significant time lag involved with employing fiscal policy. It could take months or years to have an effect.
- If the government borrows from the private sector, there are fewer funds available for the private sector, which could lead to crowding out.
- The bigger the size of the multiplier, the bigger the effect on AD and the more effective the policy.
- If interest rates are high, fiscal policy might not be effective for increasing demand.
- If the government spends too much, there could be difficulties paying back the debt, which could make it difficult to borrow in the future.

Potential policy conflicts and trade-offs facing policy-makers when applying policies

Unemployment vs inflation:

In the short run, there is a trade-off between the level of unemployment and the inflation rate. This is illustrated with a **Phillips curve.**

As economic growth increases, unemployment falls due to more jobs being created. However, this causes wages to increase, which can lead to more consumer spending and an increase in the average price level.



The extent of this trade off can be limited if supply side policies are used to reduce structural unemployment, which will not increase average wages.

Economic growth vs inflation:

A growing economy is likely to experience inflationary pressures on the average price level. This is especially true when there is a positive output gap and AD increases faster than AS.

A **negative output gap** occurs when the actual level of output is less than the potential level of output. This puts downward pressure on inflation. It usually means there is the unemployment of resources in an economy, so labour and capital are not used to their full productive potential. This means there is a lot of spare capacity in the economy.

A **positive output gap** occurs when the actual level of output is greater than the potential level of output. It could be due to resources being used beyond the normal capacity, such as if labour works overtime. If productivity is growing, the output gap becomes positive. It puts upwards pressure on inflation. Countries, such as China and India, which have high rates of inflation due to fast and increasing demand, are associated with positive output gaps.

Economic growth vs the current account:

During periods of economic growth, consumers have high levels of spending. In the UK, consumers have a high marginal propensity to import, so there is likely to be more spending on imports. This leads to a worsening of the current account deficit. However, export-led growth, such as that of China and Germany, means a country can run a current account surplus and have high levels of economic growth.

Economic growth vs the government budget deficit:

Reducing a budget deficit requires less expenditure and more tax revenue. This would lead to a fall in AD, however, and as a result there will be less economic growth.

Economic growth vs the environment:

High rates of economic growth are likely to result in high levels of negative externalities, such as pollution and the usage of non-renewable resources. This is because of more manufacturing, which is associated with higher levels of carbon dioxide emissions.

The issues governments face in managing the macro-economy

The government might face some issues when managing the macro-economy.

- **Potential policy conflicts and trade-offs:**

  This occurs when one macroeconomic policy has a larger impact than another, which conflicts with the other policy or reduces its effectiveness.

- **Environment vs competitiveness:** If 'green taxes' are implemented, such as carbon taxes, or if there are minimum prices on pollution permits, the competitiveness of domestic firms could be compromised. This is because they are limited in their production.

- **Progressive taxes vs inflation:** Taxes to reduce inequality could lead to higher rates of inflation. For example, a higher VAT rate increases the price of goods for firms and consumers.

- **Fiscal vs monetary policy:** Expansionary fiscal policies involve more government borrowing, which could cause interest rates and the inflation rate to rise.

- **Interest rate vs inequality:** The low interest rate could affect the distribution of income. Savers only receive a small return on their savings.

Other problems the government might face include:

- When reducing the size of the government deficit, the government might need to reduce their spending and increase the tax rate. However, these are politically unpopular.
- Some policies might take a long time to show an effect. This is particularly true of supply-side policies. For example, the effects of education cannot be seen until the education has been given and acted upon. This could take several years. Changes in taxes have an effect more quickly.
- Some events are beyond the control of the government, and this could limit how well policies work. For example, the financial crisis and global interest rates can affect the domestic economy, and this influences and limits the effectiveness of government policy.

The likely effects of individual policy instruments on specific problems; possible unintended consequences

When governments employ a policy, there could be unintended consequences. This is when the actions of producers and consumers have unexpected consequences.

With government policies, consumers react in unexpected ways. A policy could be undermined, which could make government policies expensive to implement, since it is harder to achieve their original goals.

For example, the government could increase in the minimum wage with the intention of raising living standards. However, this could make it unaffordable for employers to employ so many workers, so it could lead to workers being sacked.