Edexcel (B) Economics A-level

Theme 2: The Wider Economic Environment

2.6 Introduction to Macroeconomic Policy

2.6.2 Policy instruments

Notes

Fiscal policy

The budget position:

- The budget position refers to whether the government has a deficit, surplus, or if the budget is balanced.

- A government has a **budget surplus** when tax receipts exceed expenditure.

- The government has a **balanced budget** when expenditure is equal to revenue.

- A government has a **budget deficit** when expenditure exceeds tax receipts in a financial year.

- It is important to distinguish between the government **debt** and the government **deficit.** The debt is the accumulation of the government deficit over time. It is the amount the government owes. The deficit (or surplus) is the difference between expenditure and revenue at any one point.

- The **national debt** is the amount of money the government has borrowed at one time through issuing securities by the Treasury.

How discretionary fiscal policy could be used to improve macroeconomic performance:

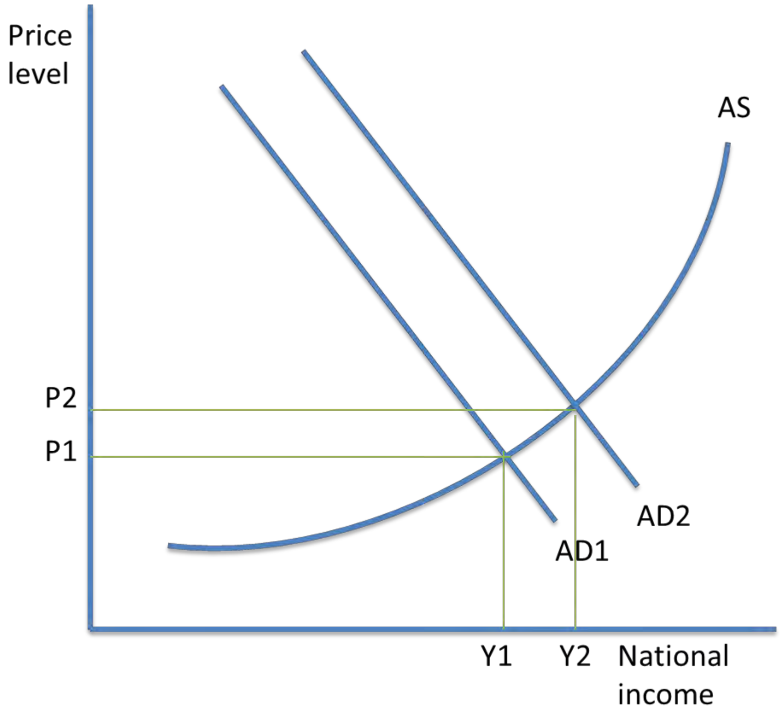
- Discretionary fiscal policy involves deliberate changes in government expenditure and taxes with the intention of influencing aggregate demand.

- 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.

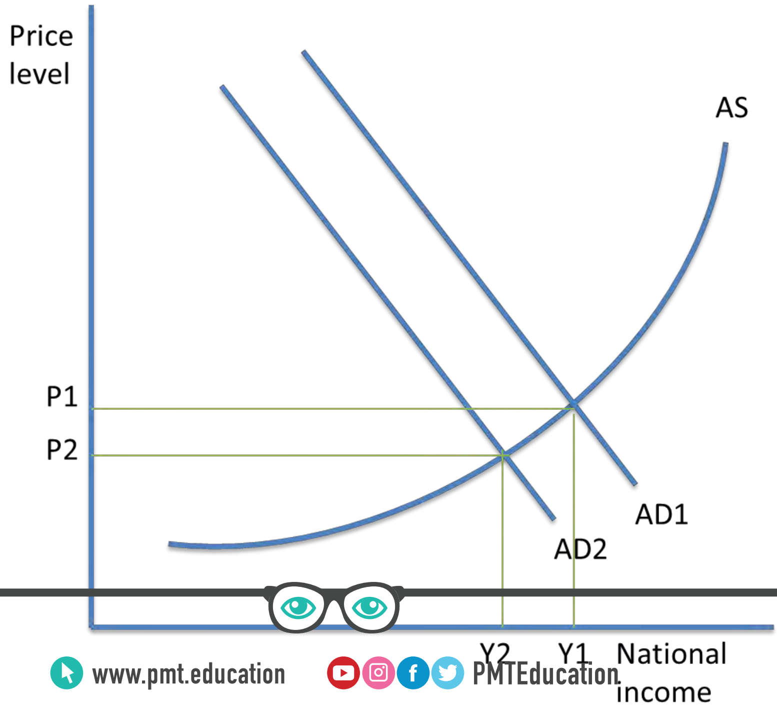
Expansionary fiscal policy

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.



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.

Monetary 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.

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 objective of monetary policy, to ensure there is price stability is described here:

  http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx

  The government inflation target is 2%, measured by CPI. It is symmetrical, so inflation should not fall 1% outside of this target.

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.

The Bank of England is considered to be a lender of last resort. If there is no other method to increase the supply of liquidity when it is low, the Bank of England will lend money to increase the supply.

- **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.

Supply Side Policies

Supply-side policies aim to improve the long run productive potential of the economy. This increases the quantity or quality of the factors of production. They aim to increase AS instead of AD.

Education and training

The government could subsidise training or spend more on education. This also lowers costs for firms, since they will have to train fewer workers. It makes the quality of labour better, which results in a more productive workforce. This increases the potential output of an economy.

By improving access to training and education, it becomes more convenient for people to improve their skills, which is likely to encourage them to do so. For example, universities might use access schemes to encourage more people to apply, or apprenticeships might become more widely available.

Reforming tax and benefits, or reducing marginal tax rates

By reducing income and corporation tax, governments could encourage spending and investment.

Tax reforms could encourage more people to work, and benefits could be more stringent. They can also encourage more entrepreneurship.

- **Improving labour market flexibility- including consideration of the housing market**

Reducing the National Minimum Wage (or abolishing it altogether) will allow free market forces to allocate wages and the labour market should clear.

Governments could try and improve the geographical mobility of labour by subsidising the relocation of workers and improving the availability of job vacancy information.

Working arrangements could be made more flexible.

- **Immigration**

Migration can fill skills gaps and reduce the unemployment rate. This could result in higher productivity among the labour force.

- **Privatisation and deregulation**

By deregulating or privatising the public sector, firms can compete in a competitive market, which should also help improve economic efficiency.

- **Trade union reform**

Reducing trade union power makes employing workers less restrictive and it increases the mobility of labour. This makes the labour market more efficient.

- **Infrastructure development- including consideration of transport market**

Governments could spend more on infrastructure, such as improving roads and schools. This could make transport more efficient, since it will take less time and cost less to move between places. It might also contribute to the geographical mobility of labour.

Research and development incentives

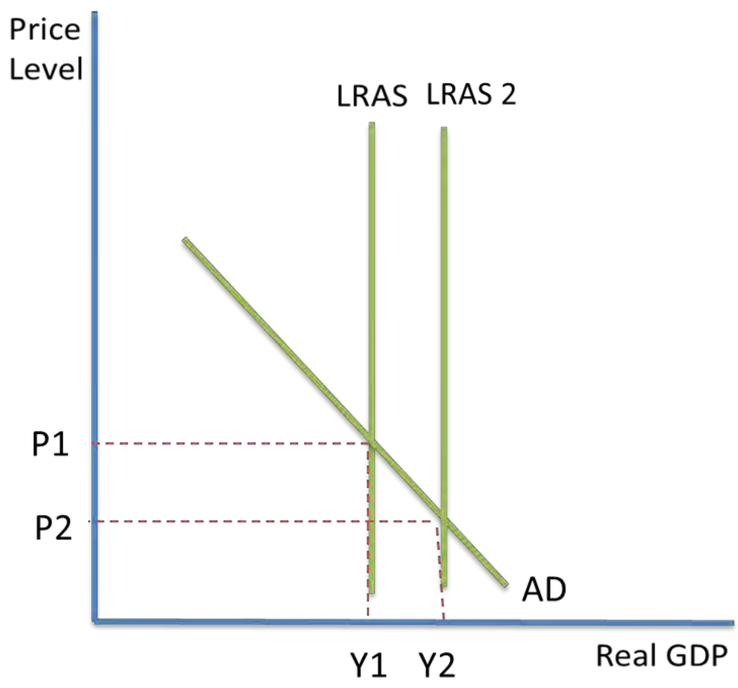
This can encourage more investment, which can benefit the economy in the long run by helping firms find more efficient methods of production and innovating.

Subsidies

These could be directed towards small businesses to encourage them to expand, or to lower training costs for firms.

AD/AS diagrams:

The diagram shows the effects of employing a supply-side policy. The LRAS curve shifts to the right, to show the increase in the productive potential of the economy. In other words, the maximum output of the economy at full employment has increased. This leads to a fall in the average price level, from P1 to P2, and an increase in national output, from Y1 to Y2.



Strengths and weaknesses of supply-side policies:

- Supply-side policies are the only policies which can deal with structural unemployment, because the labour market can be directly improved with education and training.
- Demand-side policies are better at dealing with cyclical unemployment, since they can reduce the size of a negative output gap and shift the AD curve to the right.
- There are significant time lags associated with supply-side policies.
- Some supply-side policies, such as reducing the rate of tax, could lead to a more unequal distribution of wealth.

Exchange rates policy

The exchange rate of a currency is the weight of one currency relative to another.

The determination of exchange rates

Floating:

The value of the exchange rate in a floating system is determined by the forces of supply and demand.

In a floating exchange rate system, the market equilibrium price is at P1. When demand increases from D1 to D2, the exchange rate appreciates to P2.

The demand for a currency is equal to exports plus capital inflows. The supply of a currency is equal to imports plus capital outflows.

Depreciation and appreciation

Depreciation: when the value of a currency falls relative to another currency, in a floating exchange rate system.

Appreciation: when the value of a currency increases. Each pound will buy more dollars, for example.

The causes of exchange rate changes

Inflation:

A lower inflation rate means exports are relatively more competitive. This increases demand for the currency. This causes the currency to appreciate.

Interest rates:

An increase in interest rates, relative to other countries, makes it more attractive to invest funds in the country because the rate of return on investment is higher. This increases demand for the currency, causing an appreciation. This is known as **hot money.**

Speculation:

If speculators think a currency will appreciate in the future, demand will increase in the present, since they believe a profit can be made by selling the currency in the future. This can cause an increase in the value of the currency.

Other currencies:

If markets are concerned about major economies, such as the EU, the currency might rise. This happened with the Swiss Franc in 2010 when markets were worried about the EU economy.

- **Government finances:**

A government with a high level of debt is at risk of defaulting, which could cause the currency to depreciate. This is since investors start to lose confidence in the economy, so they sell their holdings of bonds.

- **Balance of payments:**

When the value of imports exceeds exports, there is a current account deficit. Countries which struggle to finance this, such as through attracting capital inflows, have currencies which depreciate as a result.

- **International competitiveness:**

An increase in competitiveness increases demand for exports, which increases demand for the currency. This causes an appreciation of the currency.

- **Government intervention:**

Governments might try and influence their currency, such as by maintaining a fixed exchange rate. For example, China has previously kept the Yuan undervalued by buying US dollar assets to make their exports seem relatively cheaper.

- **Quantitative easing:**

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.

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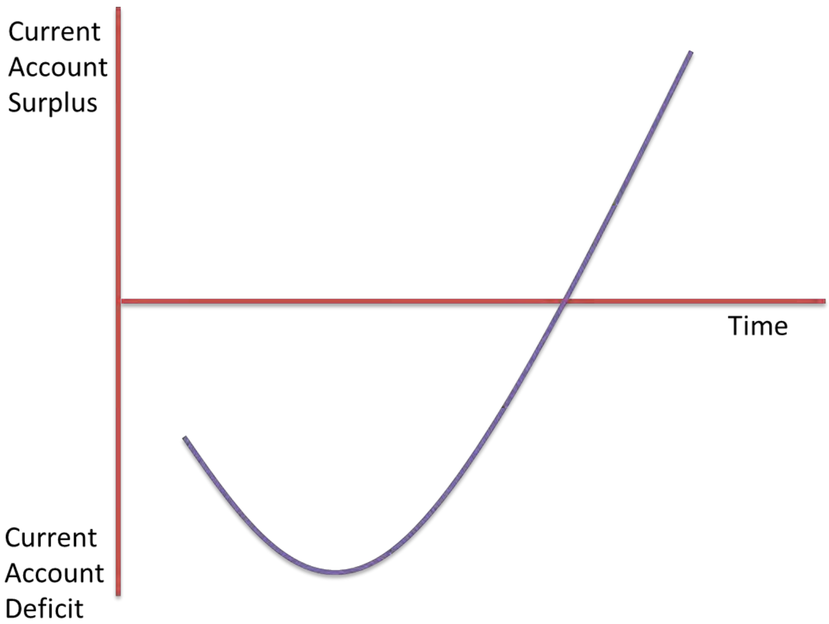
The possible impacts of changes in exchange rates

A reduction in the exchange rate causes exports to become cheaper, which increases exports. This assumes that demand for exports is price elastic. It also causes imports to become relatively expensive. This means the UK current account deficit would improve.

However, this is inflationary due to the increase in the price of imported raw materials. Production costs for firms increase, which causes cost-push inflation.

Marshall-Lerner condition and the J-curve effect

The Marshall-Lerner condition states that a devaluation in a currency only improves the balance of trade if the absolute sum of long run export and import demand elasticities is greater than or equal to 1.



The J-curve effect occurs when a currency is devalued. Since devaluing the currency causes imports to become more expensive, at first the total value of imports increases, which worsens the deficit. Eventually, the value of exports decreases, which leads to a reduction in the trade deficit.

When the currency is devalued, there may be a time lag in changing the volume of exports and imports. This could be due to trade contracts and the price inelasticity of demand for imports in the short run, whilst consumers search for alternatives. In the long run, consumers might start purchasing domestic products, for example, which helps improve the deficit.

The effect of exchange rates on AD

Exchange rate affects AD because they affect the price of exports and imports. If the exchange rate appreciates, AD is likely to fall since imports become cheaper and exports become more expensive. Households are likely to switch from buying domestically produced goods to imports. However, this depends on the inflation rate. A lower domestic inflation rate, compared to other countries, might mean that consumers still purchase domestic goods. It also depends on the price elasticity of demand for domestic goods and imports. The UK has a high marginal propensity to import, so households are still likely to import goods, even if the pound appreciates.

The effects of exchange rates on imports and exports can be remembered using the acronym SPICED:

Strong
Pound
Imports
Cheap
Exports
Dear

The effect of exchange rates on firms

A depreciation in the pound means that UK exports become more price competitive. Firms could then reduce the price of the good in the export market to increase sales, or they can keep the price the same to increase their profit margins.

However, if UK goods are relatively price inelastic, a depreciation in the pound will not increase sales in the export market significantly. Moreover, it depends on the rate of economic growth in the export market. The higher the level of consumer and firm confidence, and the more disposable income they have, the more likely they are to purchase UK exports.

If firms are net importers of raw materials, costs of production will increase because imports are relatively more expensive when the pound is weaker. This could make the firm less internationally competitive, and it could mean they make lower profits. However, if firms have fixed contracts for how long they import materials from another country, then changes in the exchange rate will not affect quantity purchased or the price paid. This reduces uncertainty of production costs for firms.

If the pound depreciates, firms might think that they can increase their profit margins by keeping the price the same, without having to increase efficiency or productivity to lower their average costs.