Edexcel Economics AS-level

Unit 2: Macroeconomic Performance and Policy

Topic 7: Macroeconomic Objectives and Policies

7.3 Macroeconomic policy instruments

Notes

Demand-side policies

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

The 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**

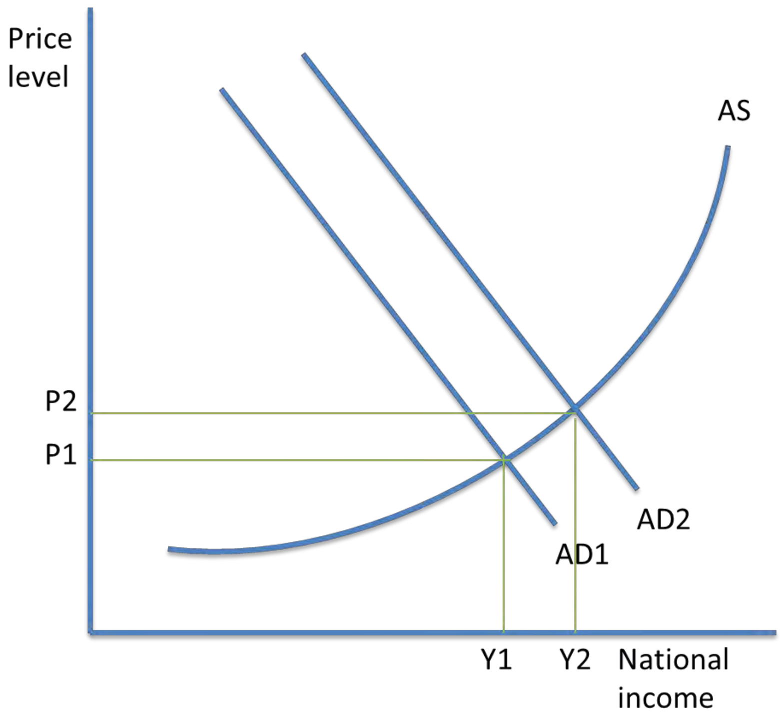
Governments can change the amount of spending and taxation to stimulate the economy. The government could influence the size of the circular flow by changing the government budget, and spending and taxes can be targeted in areas which need stimulating.

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.

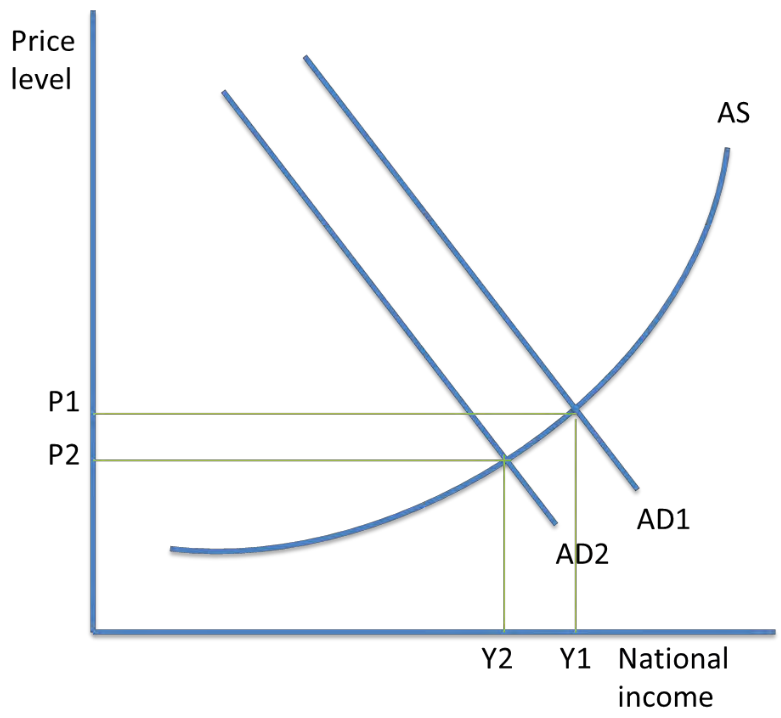
Expansionary fiscal policy

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.

- **Distinction between market-based and interventionist methods**

Supply-side policies aim to improve the long run productive potential of the economy. The economy can experience **supply-side improvements** in the private sector, without government intervention. For example, there could be improvements in productivity, innovation and investment. The aims of supply-side policies include:

- **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.

- Market-based supply-side policies, such as reducing the rate of tax, could lead to a more unequal distribution of wealth.

- **The distinction between market-based and interventionist policies:**

  Market-based policies limit the intervention of the government and allow the free market to eliminate imbalances. The forces of supply and demand are used.

  Interventionist policies rely on the government intervening in the market.

- **Free market supply-side policies**

  - **To increase incentives**
    - Reducing income and corporation tax to encourage spending and investment. This could increase the long run productive potential of the economy, especially if labour and capital becomes more productive. This improves the underlying trend of economic growth.
  - **To promote competition**
    - By deregulating or privatising the public sector, firms can compete in a competitive market, which should also help improve economic efficiency.
  - **To reform the labour market**
    - Reducing the NMW (or abolishing it altogether) will allow free market forces to allocate wages and the labour market should clears. Reducing trade union power makes employing workers less restrictive and it increases the mobility of labour. This makes the labour market more efficient.

- **Interventionist supply-side policies:**

  - **To promote competition**
    - A stricter government competition policy could help reduce the monopoly power of some firms and ensure smaller firms can compete, too.
  - **To reform the labour market**
    - Governments could try and improve the geographical mobility of labour by subsidising the relocation of workers and improving the availability of job vacancy information.
  - **To improve skills and quality of the labour force**
    - The government could subsidise training or spend more on education. This also lowers costs for firms, since they will have to train fewer workers.
    - Spending more on healthcare helps improve the quality of the labour force, and contributes towards higher productivity.
  - **To improve infrastructure**
    - Governments could spend more on infrastructure, such as improving roads and schools.