CIE Economics AS-level

Topic 5: Government Macro Intervention

a) Types of policy: fiscal policy, monetary policy and supply-side policy

Notes

Fiscal policy

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

- **Government spending and taxation**

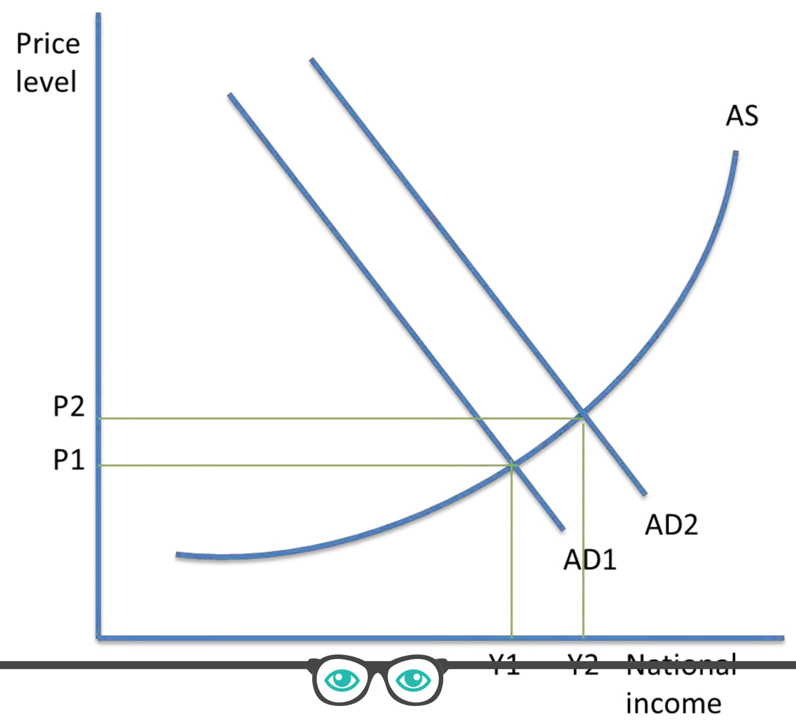
  Governments can change the amount of spending and taxation to stimulate the economy. The government could influence the size of the circular flow by changing the government budget, and spending and taxes can be targeted in areas which need stimulating.

  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.

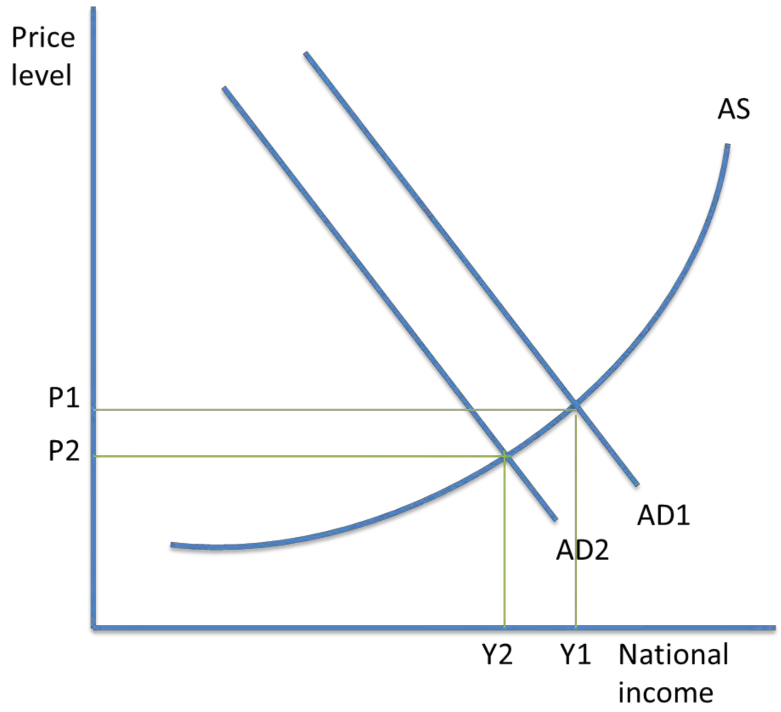
Expansionary fiscal policy

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.



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.

- **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.

Supply-side policy

Supply-side policies aim to improve the long run productive potential of the economy.

To increase incentives

Governments could reduce income and corporation tax to encourage spending and investment.

To promote competition

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

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

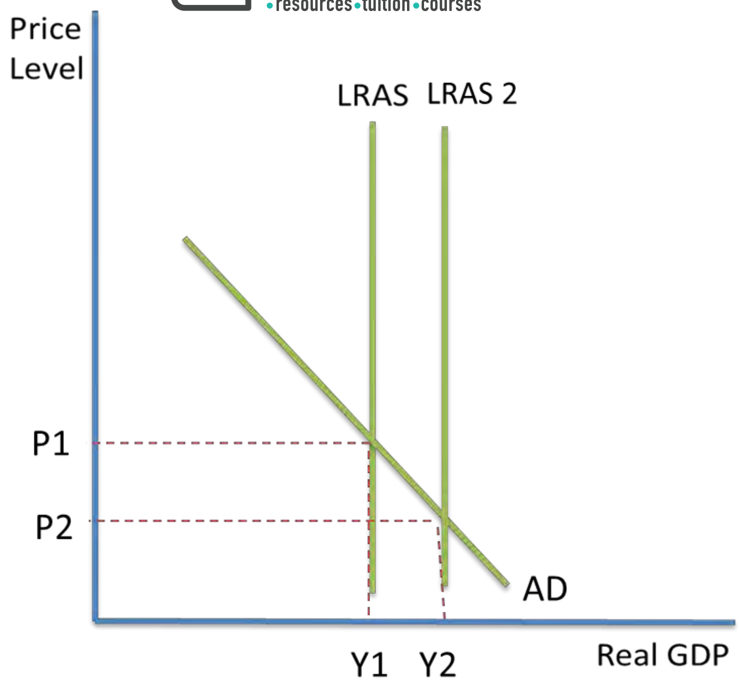
To improve skills and quality of the labour force

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.

The effect of employing a supply-side policy is shown on the diagram. 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.


Price Level
LRAS
LRAS 2
P1
P2
AD
Y1
Y2
Real GDP