CIE Economics A-level

Topic 5: Government Macro Intervention

b) Inter-connectedness of problems

Notes

Links between macroeconomic problems and their interrelatedness

Relationship between internal and external value of money

The internal value of money is the value of money when buying goods and services. This is the real value of money and it is measured by the purchasing power of money.

The external value of money is what the currency is worth, as measured in foreign currency. This is the exchange rate.

Relationship between balance of payments and inflation

The increase in AD might cause demand-pull inflation, which could make UK goods more expensive than elsewhere. This might increase imports, if they are cheaper than domestic goods, which could worsen the current account deficit. However, this means the UK has a capital account surplus.

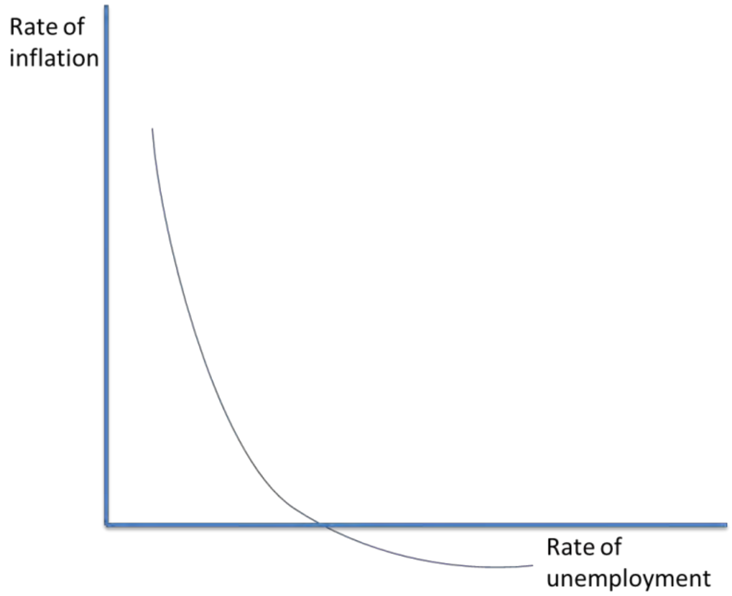
If imported raw materials are expensive, there could be cost-push inflation in the UK, since firms face higher production costs.

When the pound appreciates, imports become relatively cheaper and exports become more expensive.

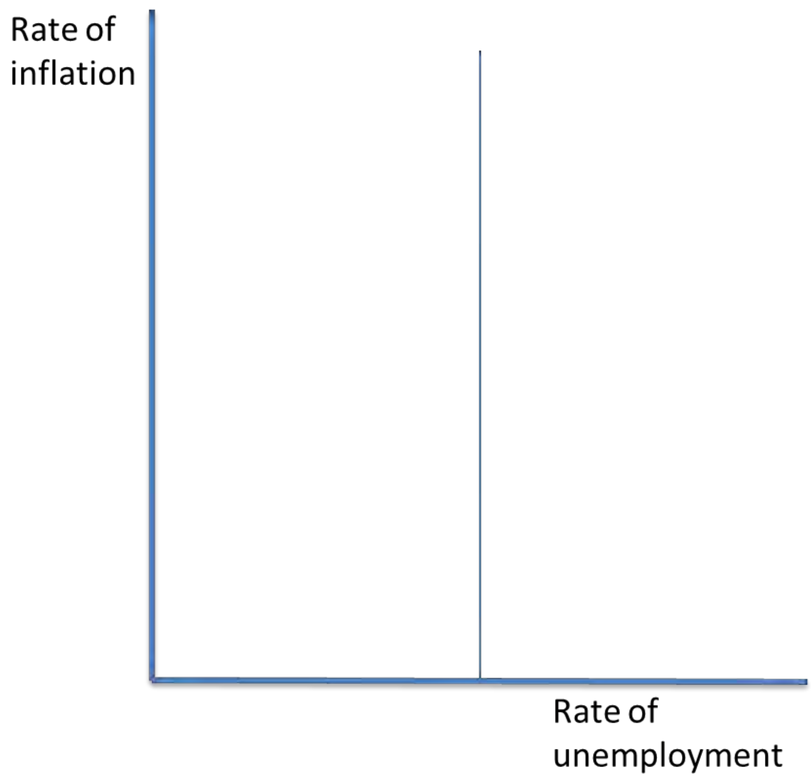
If the UK becomes more productive, the UK will be more internationally competitive. This causes exports to increase relative to imports.

Trade-off between inflation and unemployment; Phillips curve

The short-run Phillips curve represents the trade-off between unemployment and inflation. In the short run, the Phillips curve is roughly L-shaped, which shows how as unemployment increases, inflation decreases. The Phillips curve below is for the short run.



The long run Phillips curve is L-shaped. It is also known as the vertical long-run Phillips curve (shown below). It is at the natural rate of unemployment, and there is no trade-off between unemployment and inflation. The two variables are unrelated.



The implications of the short-run Phillips curve and the long-run, L-shaped Phillips curve for economic policy

If the government tries to lower unemployment in the short run, there could be inflationary pressure on the price level. In the short run, the economy suffers from demand-deficient unemployment. This might encourage the use of demand-side policies to tackle unemployment.

In the long run, changes in the unemployment rate do not affect the inflation rate. Therefore, policies can be more flexible. Since there is no demand-deficient unemployment in the long run, supply-side policies are more likely to be used.