Edexcel (A) Economics A-level

Theme 2: The UK Economy, Performance and Policies

2.6 Macroeconomic Objectives and Policies

2.6.2 Demand-side policies

Notes

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**

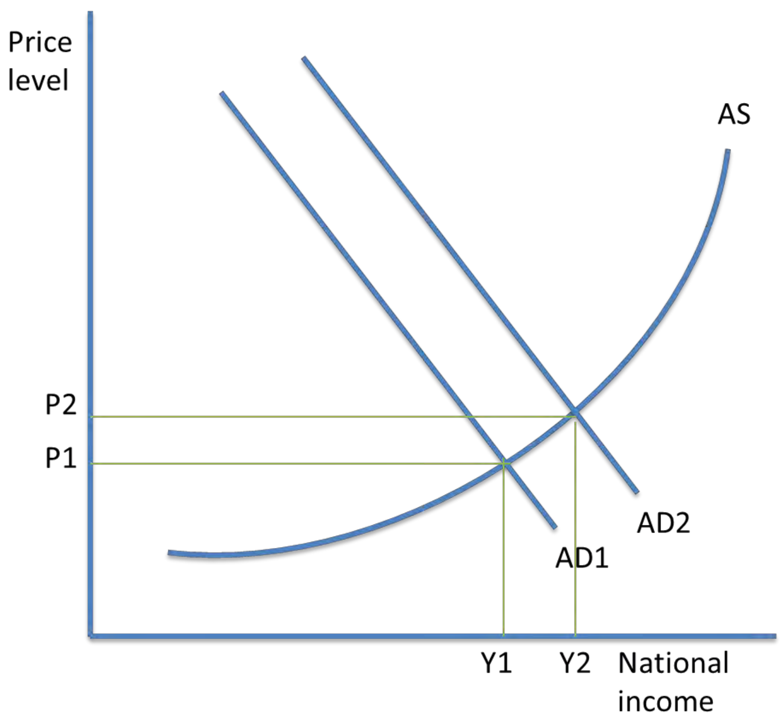
  Governments can change the amount of spending and taxation to stimulate the economy. The government could influence the size of the circular flow by changing the government budget, and spending and taxes can be targeted in areas which need stimulating.

  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.

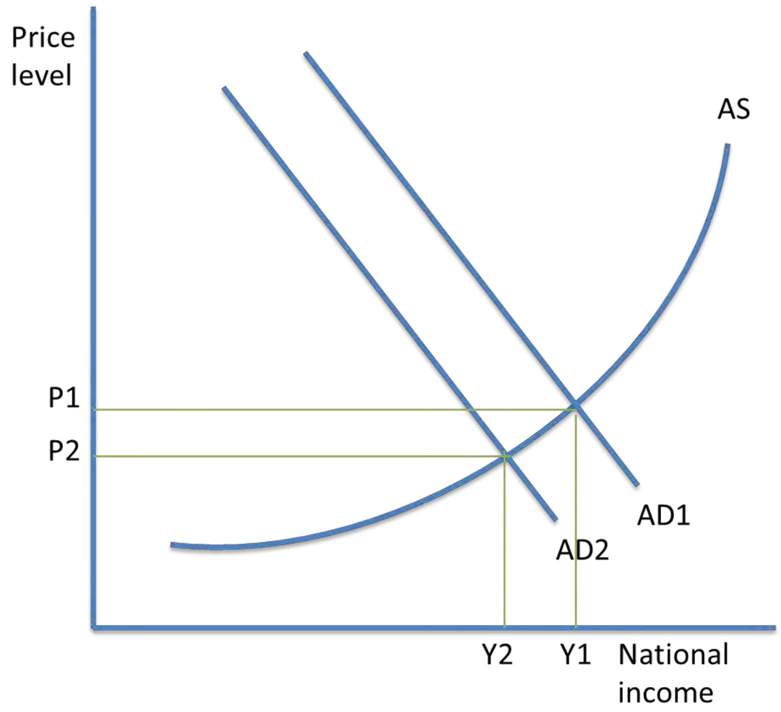
Expansionary fiscal policy

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.



The government budget (fiscal) surplus and deficit:

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

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

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.

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.

Demand-side policies in the Great Depression and the Global Financial Crisis of 2008:

The Great Depression

The Great Depression initiated in 1929, and by 1933 real GDP had fallen by 30% and the unemployment rate increased to 25%. In the 75 years prior to this, economic declines lasted about 2 years; the Great Depression lasted for over a decade.

- Keynes shifted macroeconomic thought from a focus on AS to AD. Keynesian economists emphasise the use of demand-side policies, fiscal and monetary, to close gaps between actual and potential output.
- AD fell during The Great Depression, and with this, investment fell. Although only 5% of America's population owed stocks, the stock market crash led to consumption falling across the population. Consumer and firm confidence plummeted.
- The Federal Reserve, the central bank of the US, implemented contractionary monetary policy during the first few years of The Great Depression. The money supply fell between 1929 and 1933, since 1/3 of US banks failed.
- The onset of WWII made the US government use expansionary fiscal policy, since they were spending on the war, and this helped The Great Depression come to an end.
- Roosevelt's New Deal in the US meant the US government increased its expenditure on public infrastructure and employment. It is debated whether it was this fiscal stimulus or the spending on the war which helped end The Great Depression.
- The UK government aimed to balance their budget by cutting public sector wages and raising income tax from 22.5% to 25%. This actually worsened the situation, since it was deflationary and the purchasing power of consumers fell.
- The Federal Reserve cut interest rates from 6% to 4%, and later raised them to maintain the dollar's value. This was because large quantities of dollars were converted into gold, which weakened the dollar.
- The US government tried increasing the money supply during 1930, although is it questionable how effective this was.
- In 1931, the UK government abandoned the gold standard, which caused the pound to depreciate by 25% and made the UK more competitive. The government also reduced interest rates, which further helped the economy improve.

The Global Financial Crisis

- The Global Financial Crisis is sometimes called The Great Recession, and it refers to the decline in world GDP in 2008-2009.

- Before the crash, asset prices were high and rising, and there was a boom in economic demand. There were risky bank loans and mortgages, especially in the US where government securities were backed by subprime mortgages. This means the borrowers had poor credit histories, and after house prices crashed in the US in 2006, several homeowners defaulted on their mortgages in 2007. Banks had lost huge funds, and required assistance from the government in the form of bailouts.
- The UK government used expansionary fiscal policy shortly after the financial crisis. VAT was cut from 17.5% to 15% in an attempt to increase consumer spending. The government received less tax revenue due to the recession, which led to an increase in government borrowing.
- UK interest rates were at 5% when the crisis had just started in 2008. When the US bank Lehman Brothers became bankrupt, the Bank of England cut the interest rates. The global recession started spreading and interest rates were cut further. By 2009, banks were unwilling to lend, unemployment soared, and firms and consumers had little confidence left.
- Eventually, interest rates were cut to the historic low of 0.5%. Since the economy was still in recession, the bank employed a programme of QE. Initially, £75bn was injected into the economy, but now £375bn has been injected.
- Since the bank is concerned about the sustainability of the UK's economic recovery, interest rates are being held low and QE is not being reduced. This is particularly because of the low inflation rates the UK has had.