A level Economics

The UK Economy-
Performance and Policies

Edexcel

Course companion 7

2018-19

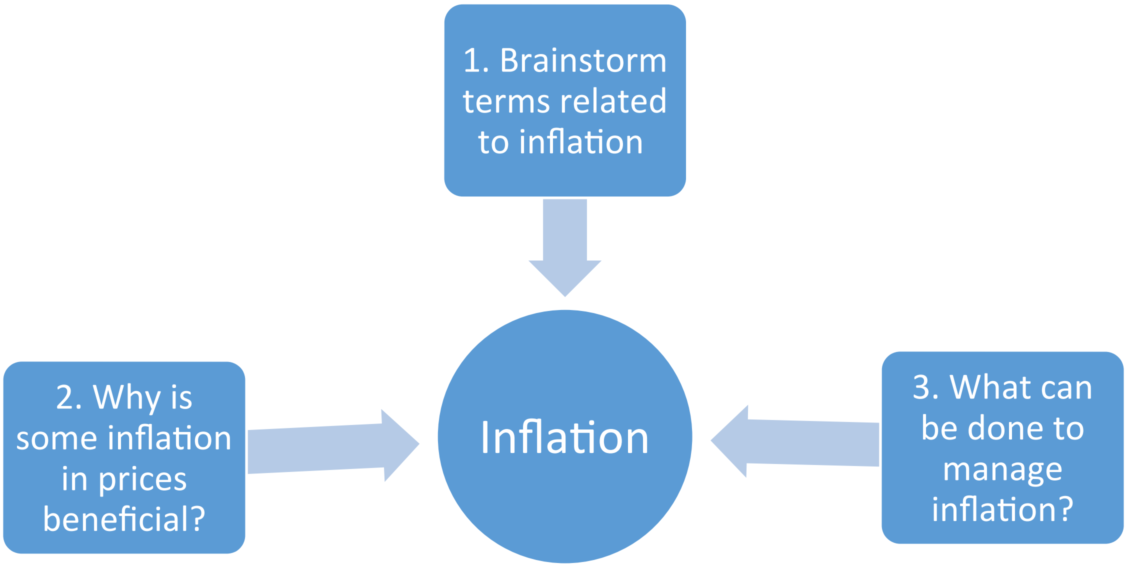
Demand-side policies

Conflicts and trade-offs between objectives and policies

NAME: **TEACHER:**

Contents

Introduction activity 1



Introduction activity 2

Write down factors that affect the rate of interest charged on borrowing for the following:

1. Payday loans. Rate of interest is High / Medium/ low	2. Credit cards. Rate of interest is High / Medium/ low
3. Mortgages. Rate of interest is High / Medium/ low	4. Personal loans. Rate of interest is High / Medium/ low

Demand-side policies: Monetary Policy

Specification 2.6.2   Anderton Chapter 38

Definitions

Monetary policy	The use of changes in the base rate of interest and the money supply to influence the rate of growth of aggregate demand and the rate of price inflation
Interest rate	The price of money i.e. the reward for saving or the cost of borrowing
Bank rate	The interest rate set by the Monetary Policy Committee of the Bank of England- the rate the Bank pays on commercial bank reserves
Quantitative easing	The process by which liquidity in the economy is increased when the Bank of England purchases assets from banks

The role of the Bank of England

The Bank of England, the UK central bank, has had responsibility for the operation of monetary policy in the UK since 1997.

Brown gives Bank independence to set interest rates (Guardian 7 May 1997)

The Chancellor, Gordon Brown, set the seal on a frenetic first 100 hours of activity by the Blair government when he stunned the City and Westminster yesterday by handing control of interest rates to an independent Bank of England.

He announced at his first Treasury news conference that he would increase interest rates by 0.25 per cent today but that would be the last time he would have day-to-day control over borrowing costs...and his shake-up of monetary policy were designed to defeat inflation and lay the foundations for long-term stability and growth.

From next month, the Government's attempt to take the politics out of interest-rate decisions would mean the Bank would have 'operational control' of monetary policy.

The Bank of England was established in 1694 to help the government to borrow money. Its main functions are:

- Issue of currency
- Management of government debt
- Operation of monetary policy
- Regulation of financial system
- Ensuring financial stability

One of the Bank of England's two core purposes is monetary stability. Monetary stability means stable prices and confidence in the currency. Stable prices are defined by the Government's inflation target, which the Bank seeks to meet through the decisions taken by the Monetary Policy Committee (MPC).

Source: Bank of England

The Monetary Policy Committee (MPC)

- The **Monetary Policy Committee** (MPC) meets at the Bank of England. It is chaired by the Governor of the Bank. There are 9 members in total, 5 from the Bank and 4 independent experts.
- The MPC meets monthly to decide on the Bank Rate and the amount of QE
- The MPC is responsible for meeting the government's inflation target
- The MPC publishes the minutes of its meetings (8 times a year) and if the inflation target of 2% is missed the Governor must send an open letter to the Chancellor

Current members of the MPC https://www.bankofengland.co.uk/about/people/monetary-policy-committee

Each member of the MPC has expertise in the field of economics and monetary policy. Members do not represent individual groups or areas. They are independent. Each member of the Committee has a vote to set interest rates at the level they believe is consistent with meeting the inflation target. The MPC's decision is made on the basis of one-person, one vote. It is not based on a consensus of opinion. It reflects the votes of each individual member of the Committee.

Source: Bank of England

The Bank's remit and the inflation target

- ✓ The inflation target is 2% CPI inflation. The target is announced each year in the Budget
- ✓ Although the Bank has independence, in extreme circumstances the Government could instruct the Bank for a limited period
- ✓ The target is NOT the lowest possible rate of inflation. Inflation below target is considered just as undesirable as above the target.
- ✓ If the target is missed by 1% point or more, either side of target, then the Governor has to write an open letter to the Chancellor explaining why the target has been missed and what can be done to get back to target.
- ✓ It is recognised that it is very unlikely that inflation will be 2% all the time. There are many factors that change all the time making it unlikely the target will be hit exactly. The idea is that the MPC aims to get inflation back to target within a reasonable time.

Questions:

a. Why is it desirable to have a Central Bank which is independent of government?

b. What aspects of monetary policy as described above are likely to make households and businesses feel confident in the operation of policy?

c. Why is inflation below target just as undesirable as above target?

How monetary policy works

When the MPC changes the official interest rate, called the **Bank Rate**, it is aiming to influence the level of aggregate demand in the economy.

The Bank Rate is the rate that the Bank pays on the reserves held by commercial (high street) banks at the Bank. When this changes it is a signal for all other borrowing and lending rates in the economy to change. When the Bank Rate rises, all other interest rates (for saving, lending and borrowing) should rise and when the Bank Rate is cut, all other rates should fall.

Higher interest rates should reduce spending in the economy so reducing aggregate demand and lower interest rates should increase spending in the economy so increasing aggregate demand.

Up

Contractionary monetary policy

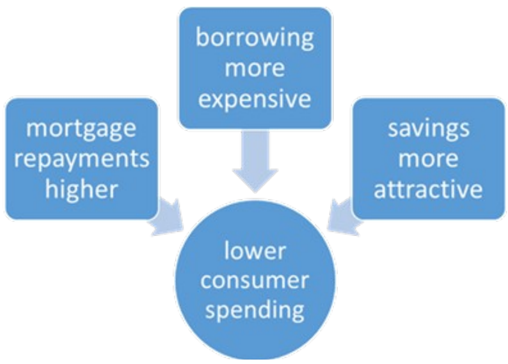
If inflation is moving above target, then the Bank Rate will be increased. This will have the following effects:

- All other interest rates in the economy will rise
- Saving will become more attractive compared to spending
- Borrowing will become more expensive so the demand for consumer durables will fall
- Mortgage interest will increase leading to a fall in the demand for houses and a fall in house prices
- Lower house prices might cause a negative wealth effect
- The demand for business borrowing and investment will fall
- The external value (exchange rate) of the £ will rise
- The level of exports will fall

As C, I and X are all likely to fall then AD will fall. Illustrate this below and show the effect on inflation.

Evaluation:

What does the impact on consumer spending depend on?



What does the impact on investment depend on?

More costly borrowing → Fewer projects worthwhile at higher cost → Less investment

Interest rates and exchange rates

A higher UK relative interest rate (compared to other countries) will attract hot money flows into the UK to take advantage of higher interest on bank deposits. This means depositors will need to buy £s in the foreign exchange market. The causes a rise in the demand for £s and a rise in the exchange rate.

A fall in the UK rate of interest would cause hot money outflows and a fall in the exchange rate.

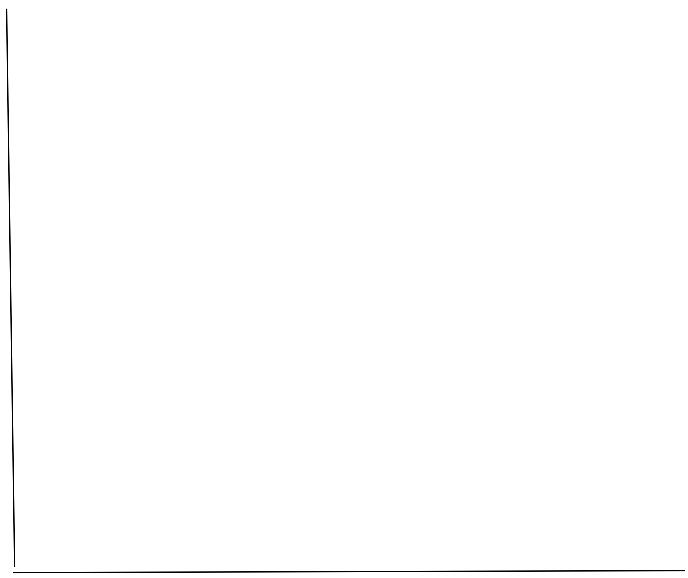
What does the impact on the exchange rate depend on?

More attractive to save in sterling in UK banks → Higher demand for £ sterling → Rise in value of sterling → Exports more expensive → Fall in demand for exports → Exports fall

Expansionary monetary policy

Expansionary monetary policy to stimulate aggregate demand if inflation is expected to move below target, would usually involve a cut in the bank rate. Explain how this would lead to a rise in AD:

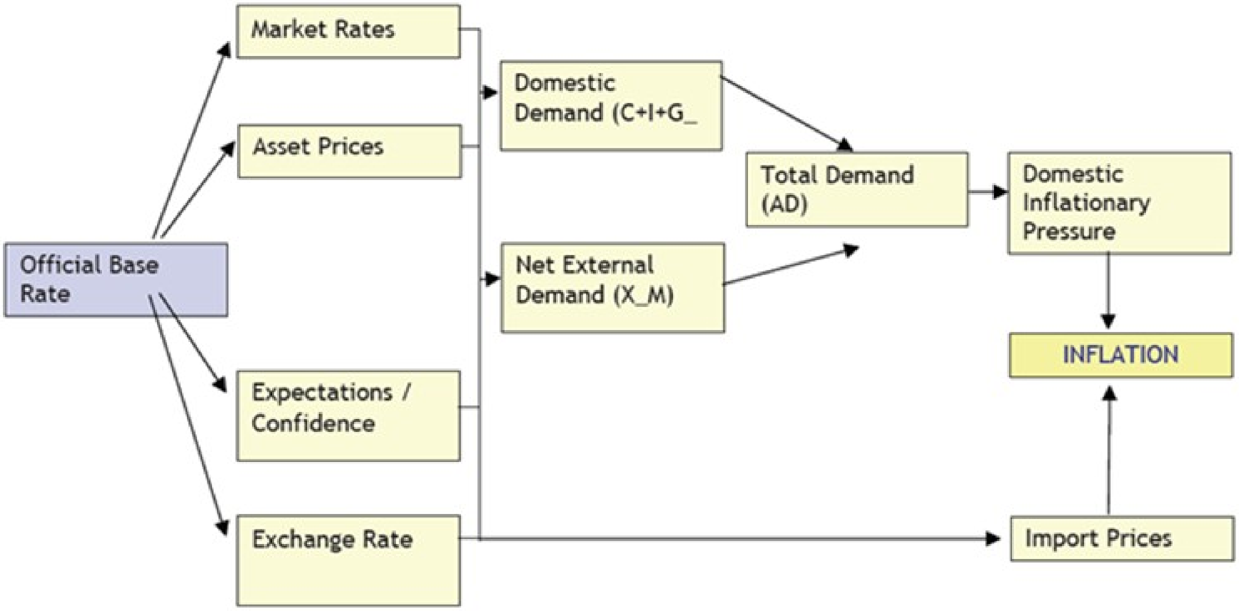
- All other interest rates in the economy will ________
- Saving will become _______ attractive compared to spending
- Borrowing will become __________ so the demand for consumer durables will _______
- Mortgage interest will _________ leading to a ________ in the demand for houses and a _______ in house prices
- _________ house prices might cause a __________ wealth effect
- The demand for business borrowing and investment will ______
- The external value (exchange rate) of the £ will ______
- The level of exports will ______



Show the impact on AD, the price level and national income of expansionary monetary policy

The interest rate transmission mechanism.

The transmission mechanism shown below summarises the effects of changes in the Bank Rate on the economy and the rate of inflation.



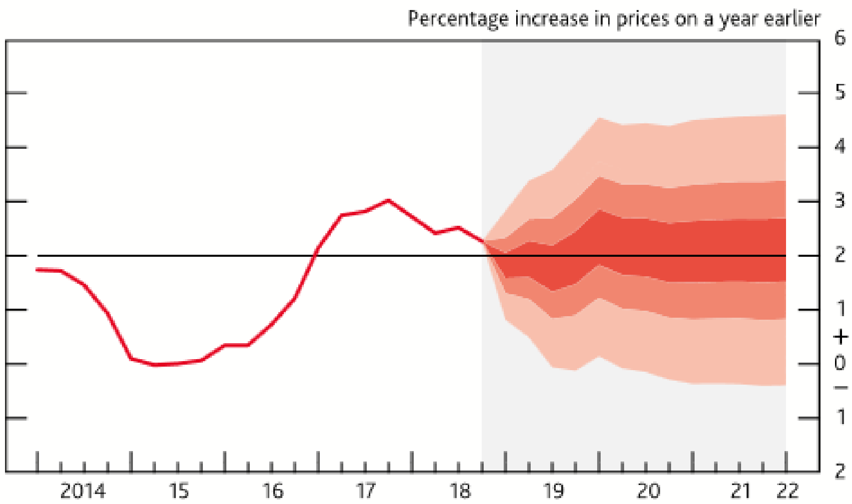
Time lags of interest rate changes

The Bank estimates that it takes between 18 months and 2 years for a change in the Bank Rate to have its full effect on the economy. Some things may change quickly e.g. other market rates and the exchange rate, but it takes longer for the effects to be seen in the housing market, investment and export demand.

This means the MPC must forecast future inflation and take action early, or be 'ahead of the game'.

Bank of England predictions of future inflation

These predictions are published in the quarterly Inflation Report, with a 'fan chart' illustrating the possible future rates of inflation. This is the fan chart for CPI inflation as published in the February 2019 Inflation Report.



What does this suggest is the current forecast for inflation from 2019-2022?

Evaluation: **How effective are interest rate changes?**

Explain how each of the following would limit the effectiveness of monetary policy using interest rate changes

1. Mortgage interest rates (and other rates) do not always follow base rate changes

2. Many home-owners are on fixed rate mortgages

3. People in rented accommodation are less affected

4. Credit-card lenders may not change rates immediately

5. If businesses are operating with spare capacity, a fall in rates will not necessarily lead to higher planned capital investment.

6. Many sources of funding for capital spending (e.g. loans and debentures) are at fixed rates of interest.

7. Lower interest rates cause a fall in disposable income for millions of savers.

8. Record low interest rates for several years after 2009 failed to stimulate UK consumer spending due to low levels of confidence, high unemployment and falling real incomes

9. The time lag of 18 months-2 years

Monetary Policy since 2009

Unconventional monetary policy- Quantitative Easing

In March 2009, the Monetary Policy Committee announced that it would **reduce Bank Rate to 0.5%**.

This cut in interest rates was followed in most other major economies. However, it was feared that this would not be enough to prevent deflation.

In order to give a further 'monetary stimulus' to the economy, it decided (with agreement from the Chancellor of the Exchequer) to undertake a programme of 'quantitative easing' in the form of buying financial assets in exchange for cash which could then be used for spending in the economy. This was 'unconventional' monetary policy and had been tried before in Japan but with little success.

With permission from the Treasury, between March and November 2009 the MPC authorised the purchase of £200 billion worth of assets, mostly UK Government "gilts" (government bonds). This was later followed by further purchases up to the value of £375bn.

The purpose of the purchases was to inject money directly into the economy in order to boost demand. Despite this being a different type of monetary policy, the objective remained the same - to meet the inflation target of 2 per cent CPI inflation. Without that extra spending in the economy, the MPC thought that inflation would undershoot the target.

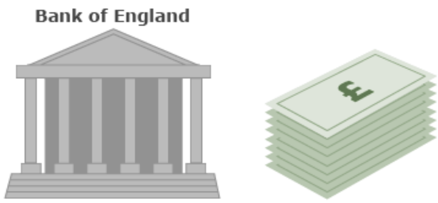
This policy of asset purchases does not involve printing more banknotes. The Bank of England electronically creates new money and uses it to purchase gilts (bonds) from private investors such as pension funds and insurance companies. These investors typically do not want to hold on to this money, because it yields a low return. So they tend to use it to purchase other assets, such as corporate bonds and shares. That lowers longer-term borrowing costs and encourages the issuance of new equities and bonds to stimulate spending and keep inflation on track to meet the government's target.

Source: *Adapted from the Bank of England.*

Gilts, or gilt-edged securities are bonds that are issued by the British government, and they are generally considered low-risk investments. The name originates from the original certificates, issued by the British government, which had gold edges.

Watch the Bank of England video,- QE- how it works

1. QE was first introduced in the UK in 2009. Why was it introduced at this time and what was its aim?



2. Who did the Bank of England buy assets from and what sort of assets were they?

3. As the Bank bought these assets what happened to asset prices?

4. What did institutions do with the money they gained from the sale of these assets?

5. As asset prices rose so the yields on these assets fell, i.e. long term interest rates. How was this expected to affect the cost of borrowing?

6. Why was there a resulting 'wealth' effect?

7. The Bank also bought some corporate bonds. What was the effect of this?

8. As institutions deposited some of their extra cash in bank accounts, what could the commercial banks have done more of?

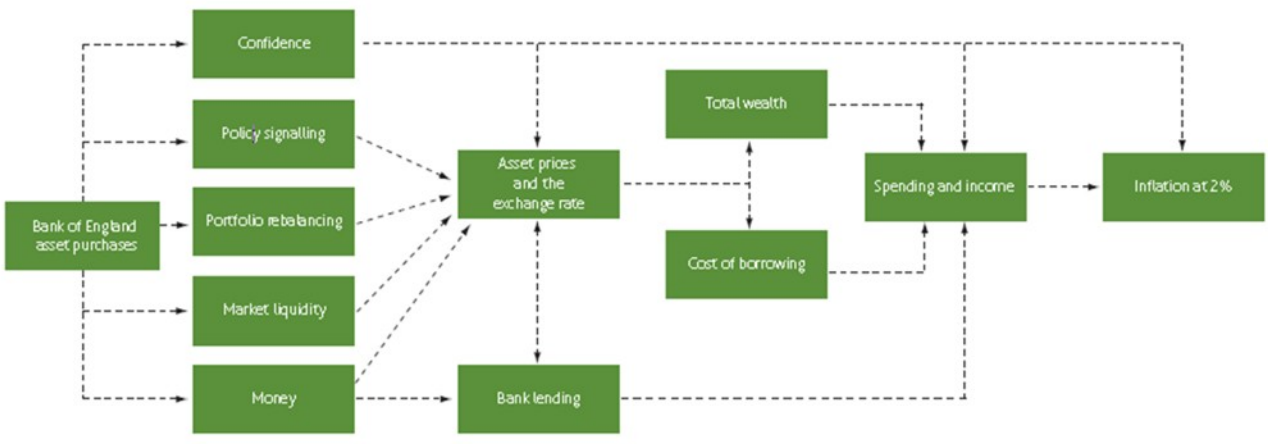
9. Why was the effect of this limited?

10. If QE had not been introduced, what might have happened to the rate of inflation?

11. When are decisions about QE considered by the MPC?

This transmission mechanism flow chart shows how the process of QE is expected to affect the rate of inflation in the economy.

Figure 1 QE transmission channels



Evaluation of QE:

http://www.bbc.co.uk/news/business-15198789 Why was it no 'miracle cure'?

1. It is estimated QE has contributed to higher growth and inflation. (The Bank estimated that the first £200bn of QE had the effect of boosting GDP by 1.5-2% and CPI inflation by 0.75-1.5%)
2. It has made it much easier (and cheaper) for governments to borrow
3. It is very hard to measure its precise effects as it is not known what would have happended otherwise
4. QE was supplemented by other schemes to encourage lending such as Funding for Lending scheme and Government support for mortgage lending to first time buyers in the housing market, 'Help to Buy'.
5. QE has been damaging to savers and pensioners. It has hampered their spending power because it led to a fall in long term interest rates.
6. Some claim QE has increased inequality. It has boosted stock markets as funds have moved out of bonds into shares, increasing the wealth gap in the UK and the USA.

Questions.

1.

Which one of the following is an instrument of monetary policy?

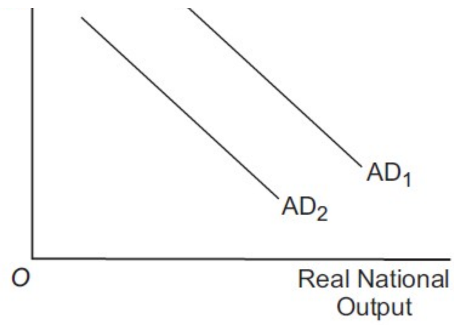
A Taxation

B The exchange rate

C The inflation rate

D Government spending

2.



Which one of the following combinations, **A**, **B**, **C** or **D**, is most likely to have caused the shift from AD_1 to AD_2?

	Rate of interest	Exchange rate
A	Fall	Fall
B	Fall	Rise
C	Rise	Rise
D	Rise	Fall

3.

4. 'Unemployment has begun to rise in the UK. What should policy makers do? Already the Bank of England has cut interest rates. Also, the government has begun to spend more without covering all of the increase by a rise in taxes.'

5. The Bank of England raises interest rates to reduce aggregate demand. Which one of the following combinations, **A**, **B**, **C** or **D**, is most likely to reduce the effectiveness of such a policy?

	Real incomes	**Unemployment**	**Indirect taxation**
A	Falling	Rising	Rising
B	Rising	Falling	Falling
C	Falling	Falling	Falling
D	Rising	Rising	Rising

Which one of the following is a correct statement about monetary policy in the UK?

A Monetary policy is used mainly to affect the supply side of the economy.

B Whenever the government uses contractionary fiscal policy, the Bank of England will use expansionary monetary policy to offset the effects.

C Higher interest rates may reduce inflationary pressure but they may also reduce employment.

D Monetary policy may involve the expansion of the money supply to reduce aggregate demand.

Peter Smith p.202-207

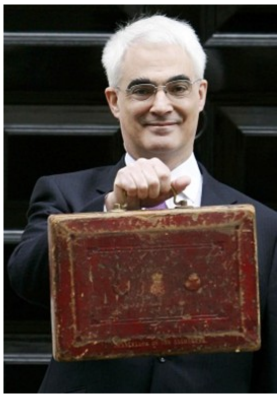
Sloman p.640-644

Demand-side policies- Government spending and fiscal policy

Specification 2.6.2 Anderton Chapter 38

Definitions

Fiscal policy	the manipulation of government spending and taxation to change aggregate demand and achieve macroeconomic objectives
The Budget	the annual statement of planned spending and tax revenue
Budget (fiscal) deficit	When government spending exceeds tax revenue
Budget (fiscal) surplus	When tax revenue exceeds government spending
Direct tax	Direct taxation is levied on income, wealth and profit, e.g. Income tax, National insurance contributions, Capital gains tax, Corporation tax
Indirect tax	Indirect taxes are levied on spending by consumers on goods and services, e.g. VAT, or specific taxes on fuel and alcohol, car tax



Possible exam questions:

- Distinguish between fiscal policy and monetary policy.
- Discuss the fiscal policies the UK Government could pursue to reduce the rate of unemployment.
- Discuss the likely effectiveness of 'expansionary... fiscal policies' as a means of closing the output gap.

Some Budget facts

It was not until the early 18th century that a version of the annual Budget emerged. The origins of the word Budget lie in the term "bougette" - a wallet in which documents or money could be kept. While at first referring only to the Chancellor's annual speech on the country's finances, the word quickly became used for any financial statement or plan.
Daily Telegraph

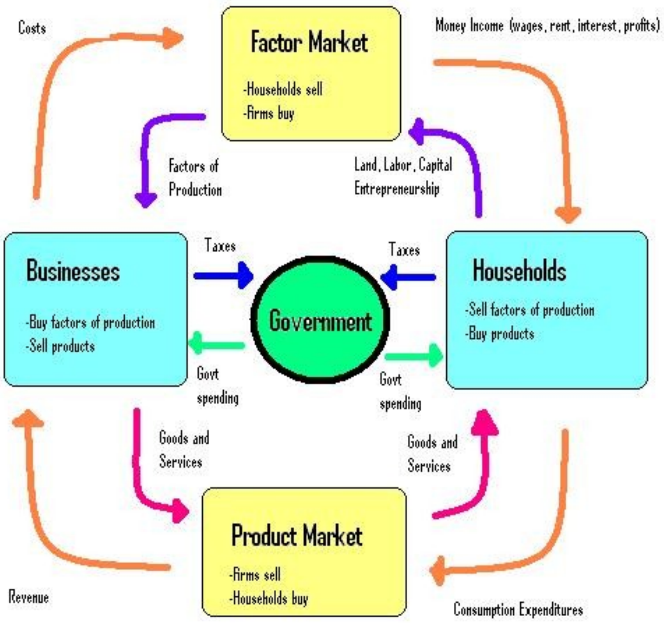
How do changes in government spending and tax affect the economy (using the circular flow of income model)?

Government spending represents an ______________ ______ the circular flow of income

Taxation represents a ______________ ______ the circular flow of income

A budget deficit will cause a net ____________ ______ the circular flow of income

A budget surplus will cause a net ____________ ______ the circular flow of income

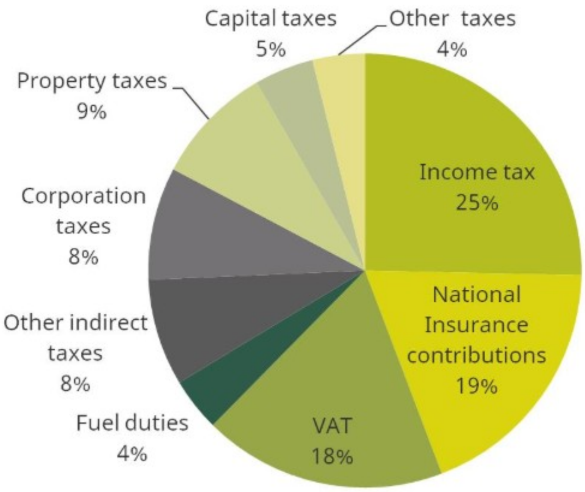


Type of Taxation

Taxes are classified as direct or indirect. The main UK taxes are:

Direct taxation	Indirect taxation
• Levied on income, wealth and profit Examples:	• Levied on expenditure Examples:

Composition of UK tax receipts 2017-18 www.ifs.org.uk/publications/9178



Identify the top 3 revenue raisers (individual taxes) for the UK
1
2
3

Note: 'Other indirect taxes' includes alcohol duties, tobacco duties, betting and gaming duties, air passenger duty, insurance premium tax, landfill tax, climate change levy, vehicle excise duties and soft drinks industry levy. 'Corporation taxes' includes corporation tax, petroleum revenue tax, oil royalties, bank surcharge, bank levy and diverted profits tax. 'Property taxes' includes council tax and business rates. 'Capital taxes' includes stamp duties, capital gains tax and inheritance tax. 'Other taxes' is a residual measure, including devolved taxes and environmental levies, which are generally part of government schemes that translate higher revenues directly into higher spending.
Source: Authors' calculations using Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017, http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/.

Income tax payments are highly concentrated

In 2016–17 (the most recent year for which data are available), the top 10% of income tax payers (those with incomes over about £54,000) paid 59% of income tax, while the bottom half of income tax payers accounted for less than 10% of income tax receipts.
Source: HMRC table 2.4, https://www.gov.uk/government/statistics/shares-of-total-income-before-and-after-tax-and-income-tax-for-percentile-groups.
This extreme concentration of income tax payments among a small number of people is partly a reflection of the progressivity [2] of the income tax system and partly a reflection of the fact that private income is very unequally distributed.

Government spending

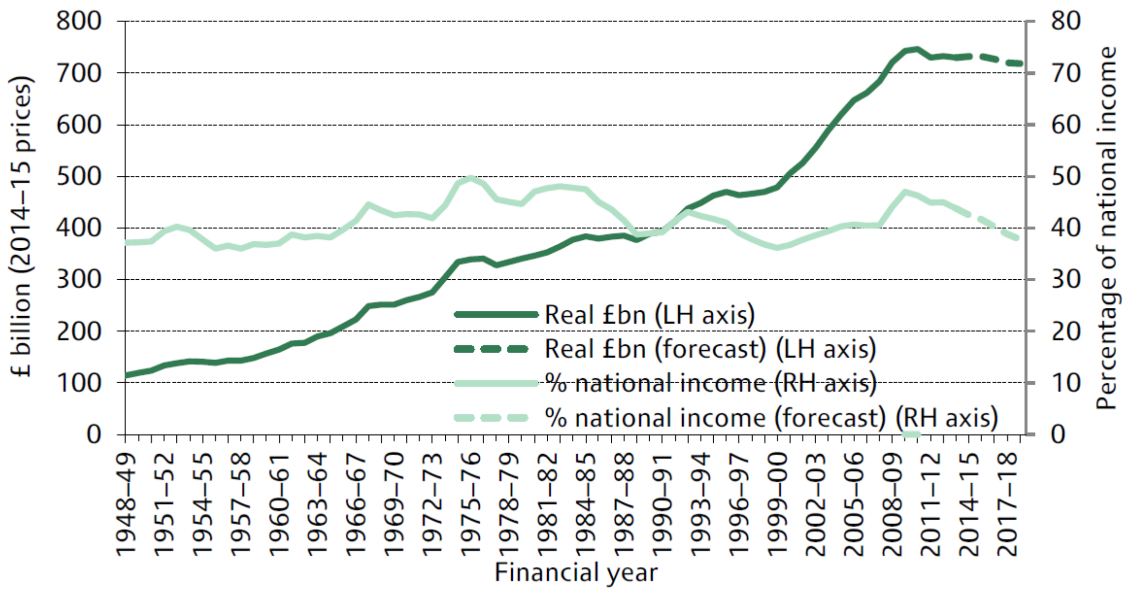
Government (or public) spending each year takes up over 40% of GDP.

Three types of spending:

Transfer payments: i.e. welfare payments made to benefit recipients such as state pension and the Jobseeker's Allowance.
Current government spending: i.e. spending on state-provided goods and services such as education and health.
Capital spending: i.e. infrastructure spending such as spending on new roads, hospitals, motorways and prisons

= total managed expenditure *source IFS.org.uk*

Figure 2.1. TME in real terms and as a percentage of national income, 1948–49 to 2018–19



How has government spending changed over this period?

a. In real terms

b. As a % of GDP

Budget deficits and surpluses
In years when government spending is greater than tax revenue, the government needs to borrow to make up the shortfall. This is called a **budget deficit**.

In years when government spending is less than tax revenue, the government has a **budget surplus.**

Chart 2: Public sector current receipts 2018-19

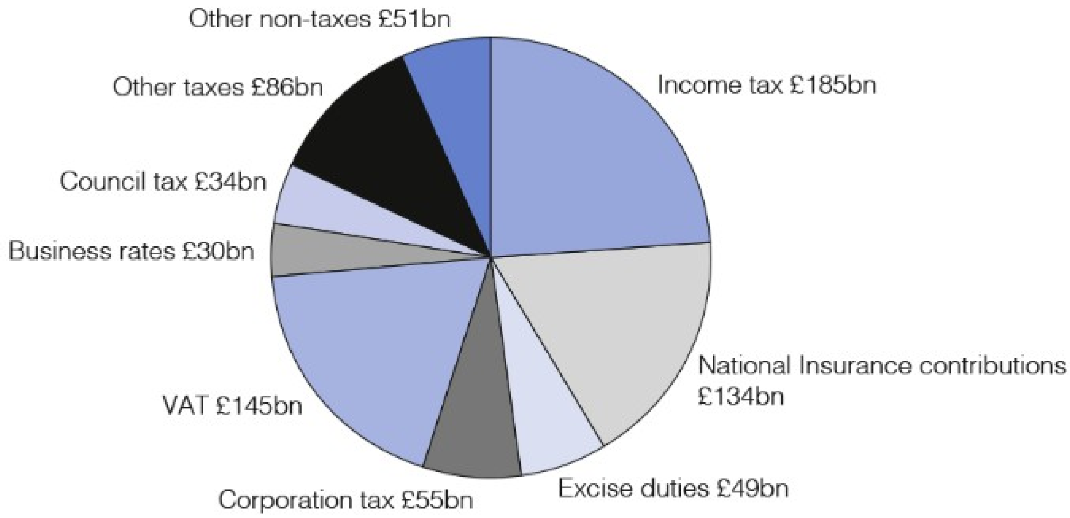
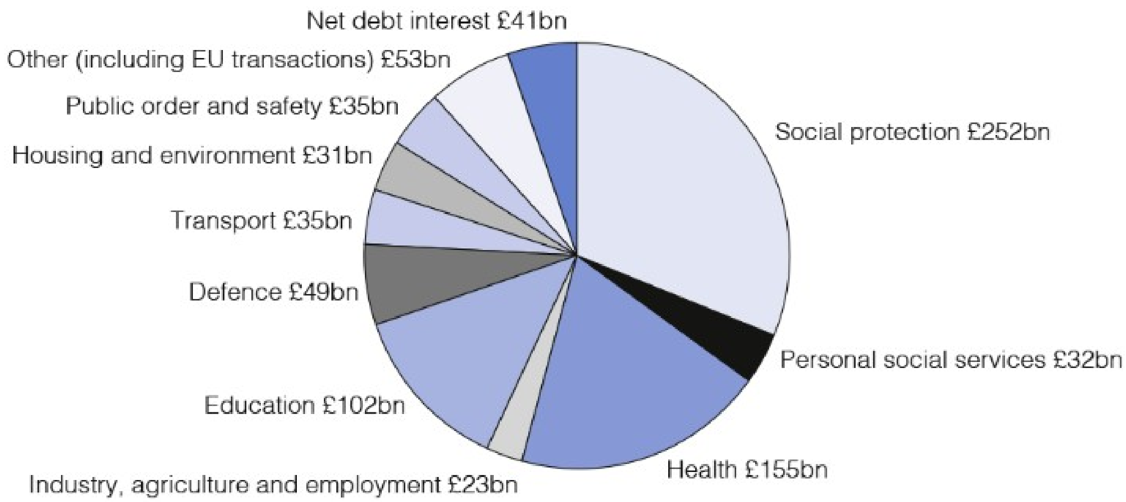


Chart 1: Public sector spending 2018-19



Using the above data:

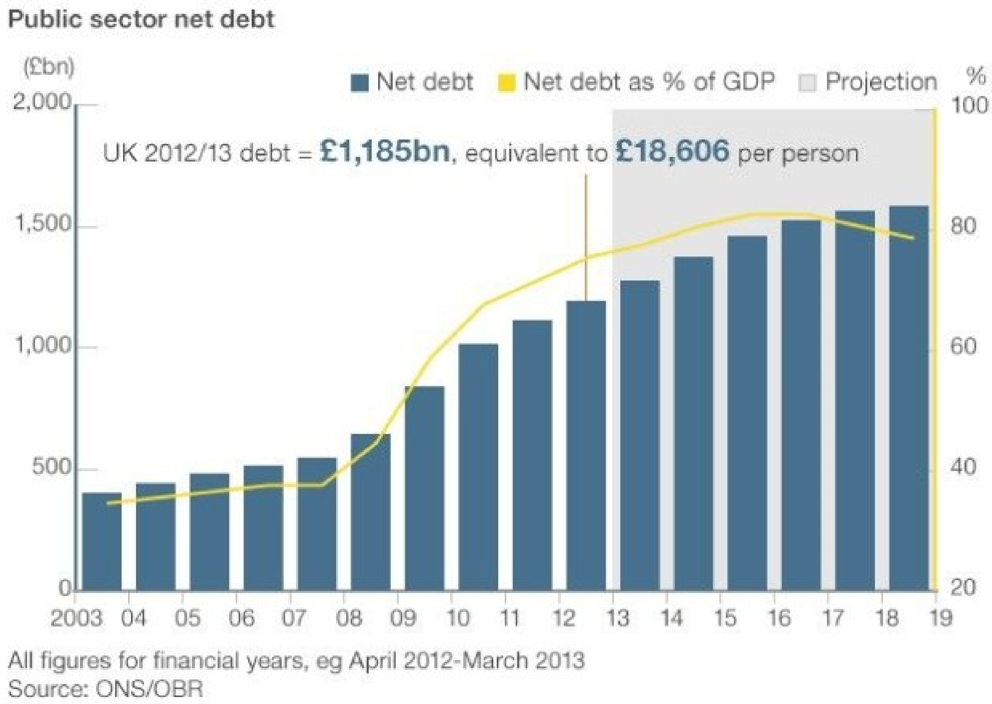
a. Calculate the total government revenue ____________________

b. Calculate the total government spending ____________________

c. The government has a Surplus / Deficit of ____________________

d. The 3 biggest spending areas are:

National debt-this is the total outstanding debt. In years when there is a budget deficit the national debt grows. The graph below shows how the national debt has risen since 2003. Describe the change in money terms and as a % of GDP:



Government spending, tax and aggregate demand
AD = C + I + G + (X-M)

- Government spending is a component of AD.
- A rise in government spending will lead to a rise in AD and national income.
- A fall in taxes will cause a rise in **disposable income** and therefore a rise in **consumer spending**.
- There will be a multiplier effect on national income as long as the economy is not at full capacity
- Expansionary fiscal policy will also cause a fall in unemployment if new jobs are created in the public sector or if the rise in spending means more demand for private sector goods and the creation of new jobs in the private sector.

- Contractionary fiscal policy, i.e. a fall in G or a rise in T or a cut in the budget deficit, will cause AD to fall. This will cause a fall in national income and have a negative multiplier effect. It will also cause job losses.

Questions

1. Use the diagrams below to show the effect on the economy (real output and the price level) of expansionary and contractionary fiscal policy

Expansionary

Contractionary

2. In the short run, a fall in a budget deficit is most likely to increase

A imports.

B unemployment.

C interest rates.

D inflation.

3. A government wishing to reduce the level of unemployment through the use of fiscal policy would be most likely to

A lower interest rates.

B decrease the size of the budget surplus.

C increase interest rates.

D encourage a depreciation of the exchange rate.

4.

Which one of the following is an example of fiscal policy?

A decision by the government to

A decrease the exchange rate

B raise the minimum wage

C increase its budget surplus

D reduce the rate of interest

5.

Which one of the following fiscal policy measures would be most likely to reduce aggregate demand?

A Reducing state retirement pensions and leaving taxation unchanged

B Reducing indirect taxes and increasing direct taxes on higher income levels to maintain the same revenue

C Increasing welfare payments and leaving taxation unchanged

D Increasing government spending and reducing taxation by equal amounts

6.

In which one of the following situations is a government most likely to pursue an expansionary fiscal policy in order to increase aggregate demand?

When

A there is a positive output gap

B the long-run trend rate of economic growth is too low

C there is a high level of structural unemployment

D cyclical unemployment is increasing

7.

In the short term, contractionary fiscal policy is most likely to cause

A a deterioration in the current account on the balance of payments.

B a rise in unemployment.

C a fall in export volumes.

D an increase in the rate of inflation.

Evaluation of fiscal policy

1. How will the effectiveness of fiscal policy depend on the size of the multiplier?

2. How will the effectiveness of fiscal policy depend on the amount of spare capacity in the economy? (use a diagram)

3. How will the impact of fiscal policy changes depend on private sector investment and consumption?

4. What are the costs to the government of using expansionary fiscal policy to reduce unemployment?

Peter Smith p.199-202

Sloman p.626-637

The Great Depression and the 2008 Global Financial Crisis- the application of demand-side policies

Specification 2.6.2

Background to the Great Depression- USA

The 1920s was a period of rising prosperity and confidence. By 1928, the stock market was booming as people borrowed to buy shares, driving up share prices.

Meanwhile, the US central bank, The Federal Reserve, raised interest rates.

Many were aware that the stock market rise was not sustainable. Investment was falling.

The supply of industrial goods outweighed demand and firms ran down their stocks

Meanwhile, tariffs had risen during the 1920s- US tariffs quadrupled and uncertainty prevailed in trading.

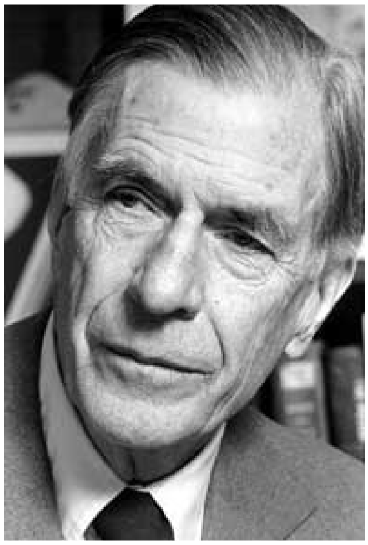
The 'Wall Street' crash of autumn 1929, when US share prices fell by a third of their value, caused many to lose their livelihoods, their savings, their homes, their farms, so consumer spending and consumer confidence plummeted. Even those unaffected by share price falls lost confidence. Whereas previously people had financed much of their consumer spending by borrowing, for example to buy cars, they were no longer able or willing to do this.

The economist Joseph Schumpeter said: *"people felt that the ground beneath their feet was giving way"*

In 1930 spending on consumer durables fell by 20%.

How would this have affected AD, real output and employment (using the Keynesian model)?

In his book 'The Great Crash 1929', Galbraith claimed that **reckless bank lending** before the crash and **inappropriate government policies** to deal with it were largely responsible for the severity of the recession.



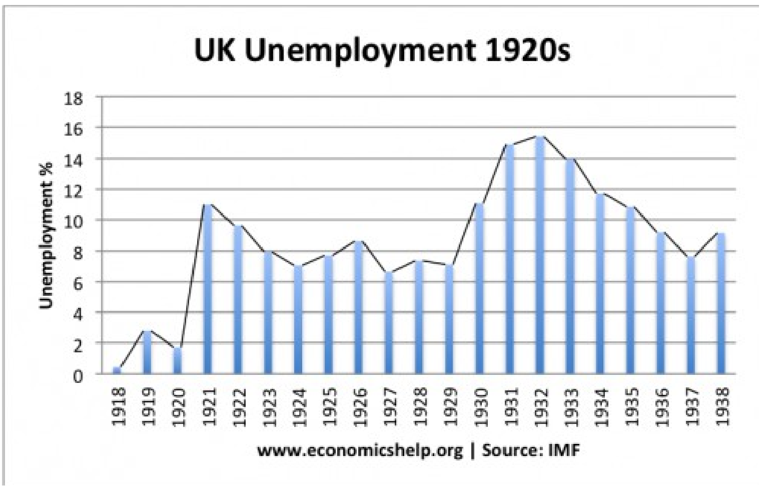
What is the difference between a recession and a depression?

A recession is a slowdown in economic activity over the course of a normal bu~~siness cycle. A depression is a sustained, long-te~~rm downturn in economic activity in one or more economies.

The UK economy in the 1930s

During the 1920s, the UK was struggling to pay for the effects of WW1.UK trade was falling and businesses struggled to be competitive. Following the Wall Street crash exports halved plunging industrial areas into poverty. Unemployment rose.

Bundesarchiv, Bild 102-10246



Throughout the 1930s, areas of Britain struggled with high unemployment and poverty although London suffered less.

Policy responses to the Great Depression

	USA and UK
Fiscal	**Classical response:** Both governments aimed for a balanced budget, which meant spending cuts as tax revenues fell. In the UK in 1931, there was an **emergency budget**, which cut public sector wages and unemployment pay by 10% and raised income tax from 22.5% to 25%. **Keynesian Response- The New Deal (USA):** This was a huge public spending stimulus. There was increased government spending on infrastructure, construction, conservation, housing, reforestation and many other public goods, initiated by Roosevelt in 1933. There were a number of programmes such as the Works Progress Administration (WPA), which created millions of jobs. Even writers and artists were employed.

	There is much debate as to whether this caused the recovery of the US economy or the second world war, which followed.
Monetary	Many claim that interest rates were too high at the start of the Depression. In 1930 the Federal Reserve cut the interest rate from 6% to 4% but then increased it again to maintain the value of the \$. In the UK the gold standard was abandoned in 1931 allowing the £ to fall by 25% and improve competitiveness. Interest rates were cut from 6% to 2%. Roosevelt rescued the banks and passed the Emergency Banking Act in 1933. Banks were closed during a 'bank holiday' and measures were put in place to prevent further bank collapses, with support from The Federal Reserve for banks in trouble.

Exercises:

1. Draw AD/AS diagram to show effect of UK budget cuts in 1931 and explain why Keynes criticised this policy.

2. Using a diagram to support your answer, explain why the New Deal appeared to be a Keynesian policy response designed to stimulate economic growth.

3. Using a diagram to support your answer, explain why the classical view was opposed to such a stimulus.

4. Compare the impact on GDP of the Great Depression in the UK and the USA, with reference to charts 1 and 2

5. Comment on changes in nominal and real interest rates in the UK in the 1920s and 1030s from chart 3

Chart 1

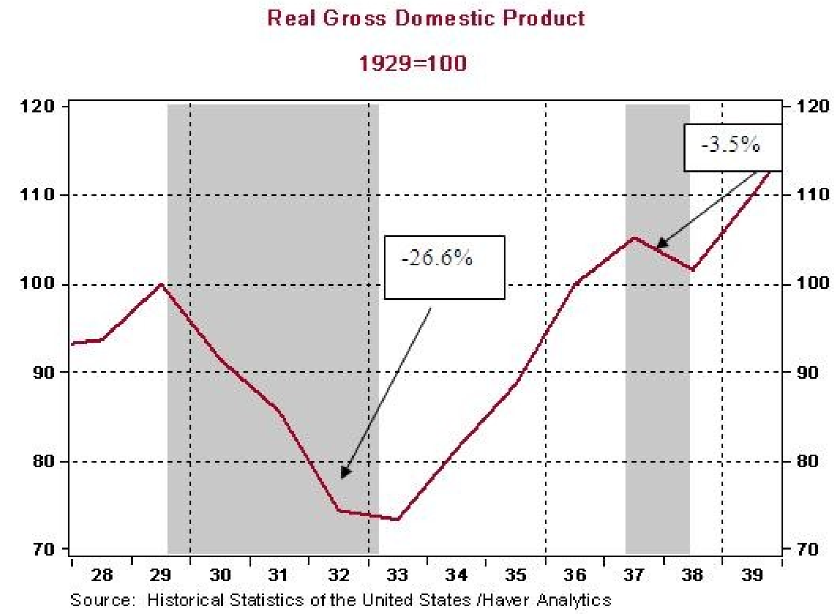
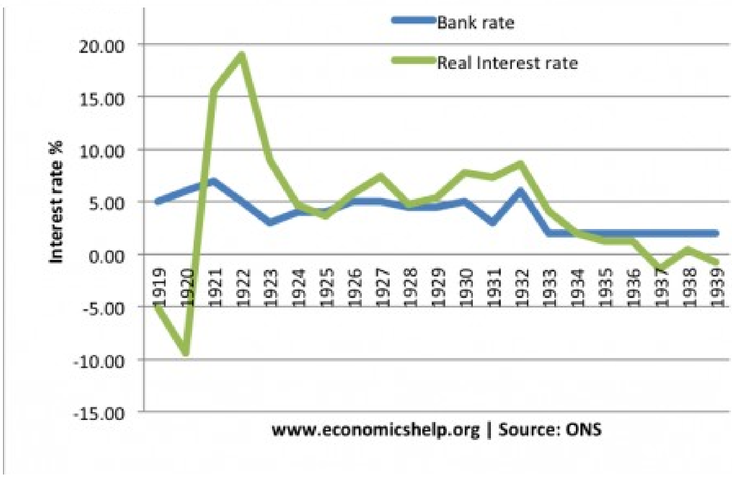


Chart 2

Chart 3



Peter Smith p.107

See video clips:

1. Stock market crash and bank failures

http://www.history.com/topics/great-depression/videos/1929-stock-market-crash

note the various causes of the Great Depression

2. http://study.com/academy/lesson/the-great-depression-the-wall-street-crash-of-1929-and-other-causes.html

   Note the

- *Role of stock market speculation*
- *Role of consumer credit*

Demand-side policies in the Global Financial Crisis

Specification 2.6.2

Watch the video clip

http://www.teachertube.com/video/the-great-depression-and-the-great-recession-188243

Note: how do they compare statistically; how did governments react; the different views within US about appropriate role of government intervention; the severity for households- better or worse in 2008?

Expansionary fiscal policy measures were used by many governments experiencing slowdown or recession during and after the financial crisis in 2008-2009. In the UK there were tax cuts and increases in government spending. In the US there was a significant rise in government spending.

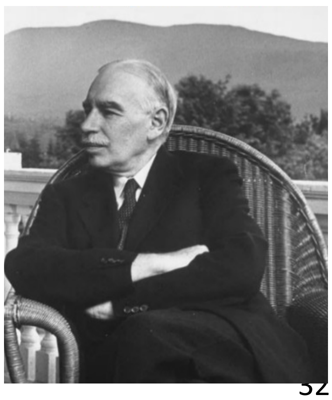
Expansionary monetary policy was also applied. Interest rates were cut in the US and UK until they were close to zero. In addition QE was introduced.

	UK	**USA**
Fiscal	2008 a number of measures including: temporary 2.5% cut in VAT, cut for basic rate income tax payers, £3bn of public investment brought forward. 2009 'car scrappage' scheme with £1000 subsidy towards purchase of new cars. 2010 a reversal of policy to reduce the budget deficit through public spending cuts.	Economic Stimulus Act (2008) with \$152 billion public spending. American Recovery and Reinvestment Act (2009), \$787 billion of public spending planned.
Monetary	MPC cut the Bank Rate from 5.75% in 2007 to 0.5% by March 2009. March 2009 **QE** began with £200bn authorised, increased to £375bn by July 2012.	Federal Reserve cut the interest rate from 5.25% in 2007 to 0-0.25% by the end of 2008. Three rounds of **quantitative easing** to boost the money supply: QE1 2008-9 QE2 2010 QE3 2012 Fed holds about £3trillion more assets as a result of this.

Keynes helped us through the crisis … (Guardian 7.2.16)

The initial response to the crisis followed Keynes's ideas pretty much to the letter, with an assumption that action should be taken to prevent what was clearly going to be a painful recession turning into a full-blown depression. Central banks were the first to act. They sought to make money cheaper and more plentiful through deep cuts in interest rates and quantitative easing. Keynes was primarily a monetary economist who believed that governments should only turn to fiscal policy - raising public spending and cutting taxes - when all other options had been exhausted. Fiscal policy was deployed in 2008-09, but only as a supplement to monetary policy.

Up to a point, the strategy worked. There was no second Great Depression and within six to nine months output had steadied across most of the global economy. Fiscal policy was relaxed by Alistair Darling during the depths of the crisis, but the Treasury was already returning to a more orthodox approach to the management of the public finances even before Labour left office in 2010. George Osborne then adopted the sort of approach that would have been



followed in the early 1930s: using low interest rates and QE to boost growth while at the same time cutting spending and raising taxes in order to rein in the budget deficit.

1. What was the intended effect of the temporary cut in VAT?

2. What was the intended effect of the car scrappage scheme?

3. What were the possible drawbacks of these policies?

Much ado about multipliers (Economist 24.5.2009)

IT IS the biggest peacetime fiscal expansion in history. Across the globe countries have countered the recession by cutting taxes and by boosting government spending. The G20 group of economies, whose leaders meet this week in Pittsburgh, have introduced stimulus packages worth an average of 2% of GDP this year and 1.6% of GDP in 2010. Co-ordinated action on this scale might suggest a consensus about the effects of fiscal stimulus. But economists are in fact deeply divided about how well, or indeed whether, such stimulus works.

The debate hinges on the scale of the “fiscal multiplier”. This measure, first formalised in 1931 by Richard Kahn, a student of John Maynard Keynes, captures how effectively tax cuts or increases in government spending stimulate output. A multiplier of one means that a $1 billion increase in government spending will increase a country's GDP by $1 billion.

The size of the multiplier is bound to vary according to economic conditions. For an economy operating at full capacity, the fiscal multiplier should be zero. Since there are no spare resources, any increase in government demand would just replace spending elsewhere. But in a recession, when workers and factories lie idle, a fiscal boost can increase overall demand. And if the initial stimulus triggers a cascade of expenditure among consumers and businesses, the multiplier can be well above one.

The multiplier is also likely to vary according to the type of fiscal action. Government spending on building a bridge may have a bigger multiplier than a tax cut if consumers save a portion of their tax windfall. A tax cut targeted at poorer people may have a bigger impact on spending than one for the affluent, since poorer folk tend to spend a higher share of their income.

Crucially, the overall size of the fiscal multiplier also depends on how people react to higher government borrowing. If the government's actions bolster confidence and revive animal spirits, the multiplier could rise as demand goes up and private investment is “crowded in”. But if interest rates climb in response to government borrowing then some private investment that would otherwise have occurred could get “crowded out”. And if consumers expect higher future taxes in order to finance new government borrowing, they could spend less today. All that would reduce the fiscal multiplier, potentially to below zero.

Different assumptions about the impact of higher government borrowing on interest rates and private spending explain wild variations in the estimates of multipliers from today's stimulus spending. Economists in the Obama administration, who assume that the federal funds rate stays constant for a four-year period, expect a multiplier of 1.6 for government purchases and 1.0 for tax cuts from America's fiscal stimulus. An alternative assessment … America's stimulus will boost GDP by only one-sixth as much as the Obama team expects.

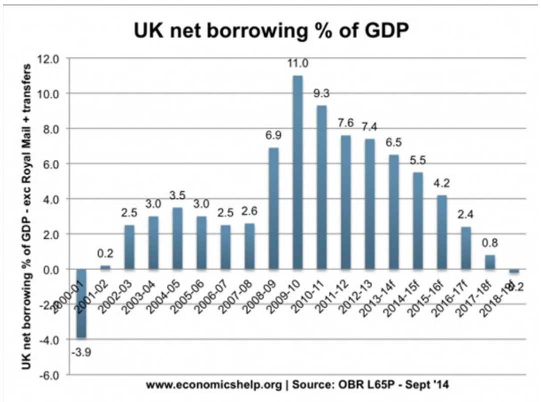
1. Why is the size of the multiplier so important to the success of fiscal policy?

2. Why might the multiplier have a larger value in a recession?

Watch the video clip 'Fear the boom and bust' and summarise differences between the Hayek (classical) and Keynesian view: https://www.youtube.com/watch?v=d0nERTFo-Sk

Questions

1. With reference to the chart, explain why UK fiscal policy changed in 2010.



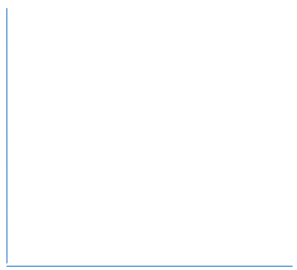
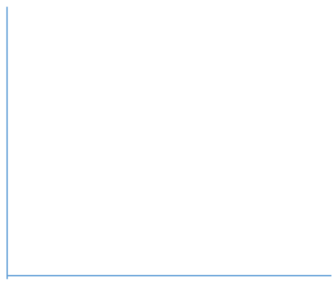
2. Using the classical AD/AS model, explain why attempts to stimulate aggregate demand would be ineffective

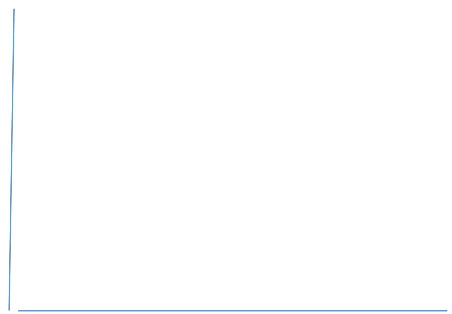
Conflicts and trade-offs between objectives and policies *specification 2.6.4* Anderton Chapter 40

Revision of the macro economic objectives
ICE BUGS

- Economic growth (G)
- Low unemployment (U)
- Low and stable inflation (S)
- Equilibrium on current account (of balance of payments) (C)
- Balanced government budget (B)
- Protection of the environment (E)
- Greater income equality (I)

It is likely to be difficult for an economy to achieve all objectives, especially in the short run.
https://www.slideshare.net/tutor2u/as-macro-revision-macro-objectives-and-conflicts
Potential conflicts:

	Analysis	**Evaluation**
Low unemployment and low inflation	The Phillips curve suggests low unemployment will lead to higher wages as shortages emerge in the labour market. Therefore, high levels of AD will lead to rising wage and price inflation. This assumes the Keynesian AS curve.  	Why might low or falling unemployment not lead to **high** inflation?
Economic growth and	• Growth means rising incomes	However…

the current account	• Rising Incomes means more imports • Rising imports means a rise in the current account deficit	
Economic growth and the environment	Growth may lead to resource depletion because Growth may lead to environmental degradation because	However…
Economic growth and inflation	Growth will be caused by or accompanied by a rise in AD Rising AD is likely to cause a rise in the price level 	However…
Economic growth and greater income equality	Growth is likely to involve the wages of some rising faster than the wages of others	However…

Balanced government budget and low unemployment	In a recession AD will be low Maintaining a balanced budget is likely to mean unemployment will remain high	However…
Greater income equality and economic growth	Greater income equality may require high rates of income tax This might have disincentive effects and reduce business activity	However…

Policy conflicts

Revision of policies:

		Instruments
Demand side	Monetary	Bank rate (interest rates) Quantitative easing (money supply)
Demand side	Fiscal	Government spending Taxation Budget surpluses and deficits
Supply side	A range of policies: To increase incentives To promote competition To reform the labour market To improve the skills and quality of the labour force To improve infrastructure	1.Reducing income tax rates 2.Reducing corporation tax rates 3.Deregulation and privatisation 4.Encouraging free trade 5.Reducing/abolishing national minimum wage 6.Reducing trade union power 7.Reforms to benefit system to make work more attractive 8.Increased government spending on education and training 9.Increased government spending on health care 10.Increased government spending on infrastructure 11.Stricter government competition policy 12.Policies to reduce geographical immobility of labour

Policy	**Intended effect**	**Other effects**
Increased government spending on education	To improve supply-side of the economy through improvements in human capital and productivity leading to growth	In the short run…
Increased Bank Rate	To reduce demand-pull inflation	Higher costs of investment leading to

Exercises

1.

A government attempts to reduce the rate of inflation by reducing aggregate demand (AD). All other things being equal, in the short run, which one of the following combinations, **A**, **B**, **C** or **D**, is most likely to result from the reduction in AD?

	Level of unemployment	**Economic growth**	**Balance of payments on current account**
A	Increases	Decreases	Worsens
B	Decreases	Increases	Improves
C	Decreases	Increases	Worsens
D	Increases	Decreases	Improves

2.

Choosing between faster economic growth and a satisfactory balance of payments best illustrates

A a choice between different macroeconomic policy instruments.

B that the short-run aggregate supply curve is vertical.

C a possible conflict between competing policy objectives.

D a government sacrificing future consumption in favour of current consumption.

3. The table below shows both the unemployment rate and inflation rate for an economy between 2010 and 2012.

	Unemployment rate (%)	**Inflation rate (%)**
2010	5.3	4.0
2011	4.9	4.5
2012	4.6	4.2

Which one of the following can be deduced from the data?

A Employment rose between 2010 and 2012.

4.

B Prices fell between 2011 and 2012.

C There was an inverse relationship between inflation and unemployment throughout the period.

D The value of money fell throughout the period.

5. An expansionary monetary policy designed to increase aggregate demand is less likely to achieve this objective if, at the same time, the government

A increases spending on defence.

B cuts the basic rate of income tax.

C increases unemployment benefits.

D reduces the budget deficit.

6. The government introduces a policy which initially increases the budget deficit but, in the long run, increases the trend rate of economic growth.

This policy is most likely to have been

A placing a tax on imports.

B increasing subsidies for research and development.

C bringing about a fall in the exchange rate.

D increasing the age of retirement.

7. A conflict between macroeconomic policy objectives sometimes exists because

A demand-pull inflation requires action that increases aggregate demand.

B costs can be reduced only if prices fall.

C an increase in aggregate demand might reduce unemployment but result in a deterioration in the balance of payments on current account.

D supply-side policies cannot be used alongside demand-management policies.

8. Explain why an expansionary fiscal policy could conflict with monetary policy

Explain why a contractionary fiscal policy could conflict with supply-side policy

Explain how fiscal and monetary policy can **work together** to manage AD