Exercise walk-through

4.1
Inflation, unemployment and policy judgement

Pearson Edexcel · International A-Level · Economics

Demand-side policies and the central bank (3)

- it carries out **monetary policy**, setting the **base rate** and running QE;
- it pursues the **inflation target**; if people trust it, they expect low inflation, so wage demands stay moderate and the Phillips trade-off eases;
- it is banker to the government, managing its accounts and debt;
- it is banker to the banks and **lender of last resort** . In September 2007 savers queued outside Northern Rock, the first run on a British bank since 1866, until the Bank of England lent it emergency money.

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Data-response practice (Section B style)

- (a) Calculate the change in the ECB's deposit rate between July 2022 and September 2023, in **percentage points**. [2]
- (b) With the help of an AD/AS diagram, explain how a rise in interest rates can reduce inflation. [6]
- (c) Examine **two** reasons why unemployment in the euro area did not rise much while inflation fell. [8]
- (d) Evaluate whether higher interest rates were the main reason for the fall in euro-area inflation. [12]

Common errors

- Saying **supply-side policies** work quickly. Most take years; demand-side policies act in the short run.
- Treating the **Phillips curve** as fixed. Supply shocks and inflation expectations shift it.
- Writing "the government sets interest rates" in most advanced economies. An independent central bank does.

Exercises 2.1·2.2

2.1 List the six macroeconomic objectives. [2]



- growth
- low unemployment
- stable prices
- trade balance

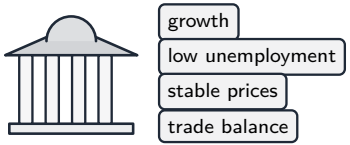
2.2 On the Phillips curve with points (4, 8), (6, 5), (8, 3) and (10, 2), what happens to unemployment if inflation is cut from 8% to 3%? [2]



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Exercises 2.1·2.2

2.1 List the six macroeconomic objectives. [2]



2.1 Economic growth; low and stable inflation; low unemployment; balance of payments equilibrium on the current account; balanced government budget; greater income equality.

2.2 On the Phillips curve with points (4, 8), (6, 5), (8, 3) and (10, 2), what happens to unemployment if inflation is cut from 8% to 3%? [2]



2.2 Unemployment rises from 4% to 8% – moving along the curve from (4, 8) to (8, 3).

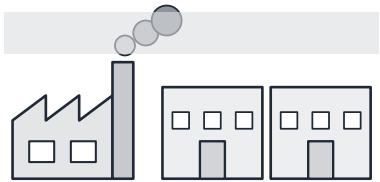
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Exercises 2.3·2.4

2.3 Why does reflationary policy tend to worsen BOTH inflation and the current account? [2]



2.4 Name the conflict between growth and the environment, with one mechanism. [2]



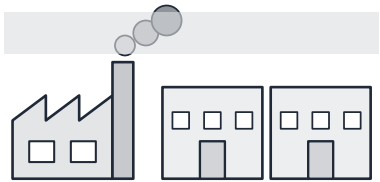
Exercises 2.3·2.4

2.3 Why does reflationary policy tend to worsen BOTH inflation and the current account? [2]



2.3 Reflation raises AD: prices rise (demand-pull inflation) AND incomes rise, sucking in imports – the current account moves towards deficit on both counts.

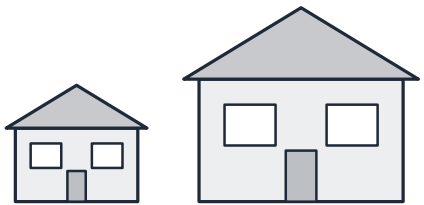
2.4 Name the conflict between growth and the environment, with one mechanism. [2]



2.4 Growth versus the environment: rising output raises energy use and emissions (negative externalities of production) – growth's price omits the external cost.

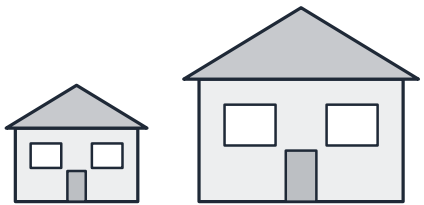
Exercise 2.5

2.5 Give one reason growth might widen income equality gaps. [2]



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2.5 If growth concentrates in skill-intensive sectors, the premium on those skills rises while others' wages stagnate – the income distribution widens even as average income grows.

Exercise 3.1

3.1 *(Original.)* Using a Phillips curve diagram, explain the short-run trade-off between inflation and unemployment, and one reason it may be easier to cut inflation than the curve suggests. [4]



Exercise 3.1

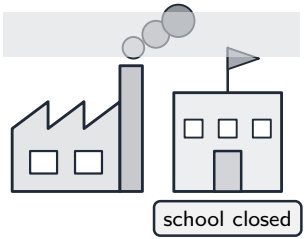
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3.1 Diagram: downward Phillips curve with the four points; disinflation from 8 to 3 moves the economy from (4, 8) to (8, 3) – unemployment rises to 8%. Why easier than it looks: if the inflation TARGET is credible, expectations fall, shifting the whole curve INWARDS so inflation falls without the full unemployment cost; also supply-side improvements can shift the curve favourably.

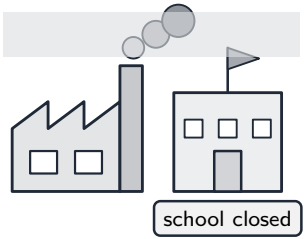
Exercise 3.2

3.2 *(Original, SAM context.)* India grew rapidly while Delhi suffered smog severe enough to close schools. Analyse the conflict between growth and environmental protection. [4]



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3.2 Growth raises output, incomes and tax revenue (the benefit) but its energy and transport demand produces emissions – Delhi's smog closed schools (an external cost the market price omits). The conflict is real but not absolute: growth also funds clean technology and environmental regulation; the judgement weighs current harm against the capacity growth creates to repair it.

Local review guidance: the Phillips answer moves along the drawn curve with both coordinates; (R1) "one reason it may be easier" needs the expectations/credibility mechanism; context marks come from using the India data. This is authored classroom guidance.