Inflation, unemployment and policy judgement

Edexcel IAL Economics WEC12 section 2.3.6 full package

Inflation, unemployment and policy judgement

- name the six macroeconomic objectives and how each is measured;
- explain the four main conflicts between them, including the **Phillips curve**;
- compare free-market and interventionist **supply-side policies**;

Inflation, unemployment and policy judgement (2)

- explain fiscal and **monetary policy** and the roles of a central bank;
- evaluate policies by their timing, side effects and risks of **government failure**.

Macroeconomic objectives

- **economic growth**: rising real GDP, measured by its growth rate;
- **low and stable inflation**, measured by the CPI. Many central banks have an **inflation target** : the Bank of England's is 2% CPI inflation, and China sets an annual CPI target, which was "around 3%" in 2024;
- **low unemployment**, measured by the ILO unemployment rate;

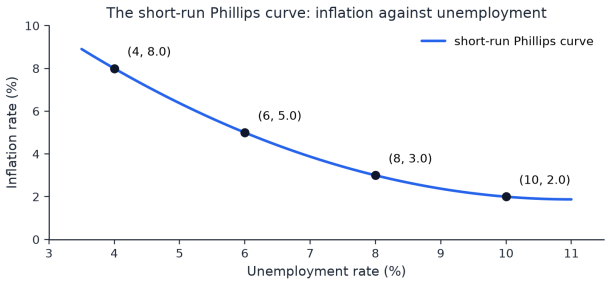
Macroeconomic objectives (2)

- **balance of payments equilibrium** on the current account, so that a country does not build up foreign debts it cannot repay;
- **a balanced government budget** over the economic cycle, so that public debt stays affordable;
- **greater equality** of income, measured by the Gini coefficient or income shares.

Conflicts between objectives

- The curve passes through (unemployment 4%, inflation 8%), (6%, 5%), (8%, 3%) and (10%, 2%).
- To cut inflation from 8% to 3%, the economy moves from 4% to 8% unemployment.
- The cost of five points less inflation is four points more unemployment in the short run.

Figure: Conflicts between objectives



- Moving along the short-run **Phillips curve**: lower inflation costs higher unemployment
- Read the axes and units first.

Supply-side policies

- **deregulation** : removing rules that block entry or raise costs, such as the opening of airline routes to new low-cost carriers in Europe in the 1990s;
- **privatisation** : selling state firms, so they face the discipline of profit. The UK sold British Telecom in 1984 and British Gas in 1986;
- lower taxes on income and profits, to reward work and investment;

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Supply-side policies (2)

- welfare reform: Germany's Hartz reforms of 2003–2005 cut long-term unemployment benefits and tightened job-search rules;
- cutting **bureaucracy** and red tape for firms.
- investment in education, training and skills, such as Singapore's SkillsFuture credits for adult training (2015);

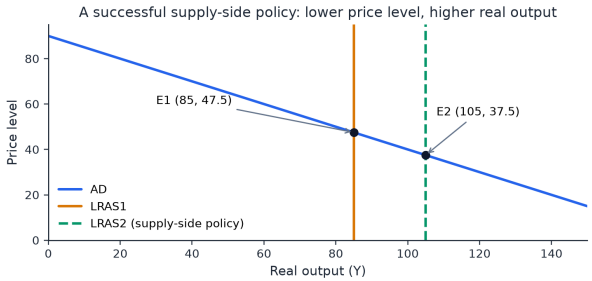
Supply-side policies (3)

- tax incentives and subsidies for investment;
- **infrastructure** : China's high-speed rail network grew from nothing in 2008 to about 45,000 km by 2023, cutting travel times for workers and firms;
- finance for business start-ups;

Supply-side policies (4)

- **regional policy** : China's Western Development strategy, from 2000, sent investment to poorer western provinces.
- Aggregate demand is $P = 90 - Y/2$. LRAS shifts from $Y = 85$ to $Y = 105$.
- Before: $P = 90 - 42.5 = 47.5$. After: $P = 90 - 52.5 = 37.5$.
- Real output rises by 20 while the **price level** falls by 10: growth without inflation.

Figure: Supply-side policies



- LRAS shifts right from 85 to 105: output rises and the **price level** falls from 47.5 to 37.5
- Match each part of the diagram to the text.

Demand-side policies and the central bank

- **Fiscal policy** uses government spending and taxation.
- **Monetary policy** uses interest rates, **quantitative easing** , lending rules and **reserve requirements** .
- The multiplier is 2, and the government raises spending by 10.

Demand-side policies and the central bank (2)

- With spare capacity, AD shifts right and real income rises by up to $2 \times 10 = 20$.
- Close to full capacity (a vertical LRAS), the same rise mainly raises the **price level** .
- So the right policy depends on the size of the output gap.

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.

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]

Sources for this lesson

- Federal Reserve Bank historical data (federal funds rate, 1979–1983); US Bureau of Labor Statistics (unemployment, December 1982).
- A. W. Phillips, "The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861–1957", *Economica* 25 (1958).
- Bank of England, Bank Rate history and Asset Purchase Facility reports.

Sources for this lesson (2)

- European Central Bank and Eurostat, inflation and policy-rate data (2022–2023).
- Pearson Edexcel International AS Economics specification (WEC12), Issue 2, section 2.3.6, and the WEC12 Sample Assessment Materials.

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.

Common errors (2)

- Confusing a **budget deficit** (one year's borrowing) with the national debt (the total owed).
- Ending a policy answer with no judgement. Say which policy works best, in what conditions and over what time.
- Describing QE as "printing banknotes". The central bank creates reserves to buy **bonds**.

Key terms

- **Macroeconomic objectives**: growth, low and stable inflation, low unemployment, current-account balance, balanced budget, greater equality.
- **Phillips curve**: the short-run **trade-off** between inflation and unemployment.
- **Supply-side policy**: a policy to raise productive capacity, shifting LRAS right.

Key terms (2)

- **Fiscal policy**: changes in government spending and taxation.
- **Monetary policy**: changes in interest rates, the money supply and credit.
- **Quantitative easing**: central-bank purchases of **bonds** with newly created money.
- **Lender of last resort**: the central bank's role of lending to banks in a crisis.

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Check yourself

- 1.
- Using the **Phillips curve** points in this unit, what is the cost of cutting inflation from 5% to 2%? 2.
- Why did unemployment rise in the USA in 1981–1982? 3.
- Classify each as free-market or interventionist **supply-side policy**: privatising a railway; building a new port; cutting the top rate of income tax; subsidising apprenticeships. 4.