

Exercise walk-through

4.2

Macroeconomic policies (2.3.6.3-4)

Pearson Edexcel · International A-Level · Economics

1. Topic 4 at a glance

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WEC12 macro second half: spec section 2.3.6 in full - the six macroeconomic objectives, the four conflicts between them, supply-side policies and demand-side policies with the central bank's roles.

Must-know: the Phillips curve trades inflation against unemployment in the short run, points (4, 8), (6, 5), (8, 3), (10, 2); supply-side policy shifts LRAS right; fiscal uses G and T ; monetary uses interest rates, QE, lending criteria and reserve ratios; the central bank targets inflation, banks the government and the banks, and is lender of last resort.

4. Supply-side policies

Supply-side policies

Supply-side policy raises productivity, competition and incentives - LRAS shifts right. Free market: deregulation of product and labour markets; privatisation; tax reduction; welfare payment reform; cutting firms' bureaucracy costs. Interventionist: education, training and skills; investment tax incentives or subsidies; infrastructure; start-up finance; regional policy.

On the model, LRAS from 85 to 105 along AD $P = 90 - Y/2$ cuts the price level from 47.5 to 37.5 while output RISES - growth and disinflation together. Strengths: market policies are cheap and fast to announce; interventionist policies fix real capacity constraints. Weaknesses: uncertain incentives, worsened equality; slow, costly, government failure.

5. Demand-side policies and the central bank

Demand-side policies and the central bank

Fiscal policy: government spending and taxation. Monetary policy: interest rates, asset purchases (QE - the SAM Q10 mechanism: bond purchases improve loan availability, lifting C and I and the price level), lending criteria, reserve requirements. Reflationary raises AD; deflationary cuts it. Against a vertical LRAS a reflation only raises the price level - the model shows 47.5 to 57.5 with no output gain.

The central bank: implements monetary policy; pursues the inflation target (credibility shifts the Phillips curve favourably); banker to the government; banker to the banks - lender of last resort. SAM context: India's base rate cut 6.5 to 6.25 to support demand. Strengths: monetary policy is quick and insulated; fiscal is direct. Weaknesses: lags, crowding out, deficits.

Exercises 2.1·2.3

2.1 Distinguish fiscal policy from monetary policy. [2]

2.2 Classify each as reflationary or deflationary: (a) a rise in income tax; (b) an open-market asset purchase by the central bank. [2]

2.3 Name any three free-market supply-side instruments. [2]

Exercises 2.1·2.3

2.1 Distinguish fiscal policy from monetary policy. [2]

2.1 Fiscal policy uses government spending and taxation (set by the government); monetary policy uses interest rates, asset purchases, lending criteria and reserve requirements (implemented by the central bank).

2.2 Classify each as reflationary or deflationary: (a) a rise in income tax; (b) an open-market asset purchase by the central bank. [2]

2.2 (a) Deflationary – higher withdrawals cut AD. (b) Reflationary – QE injects money and lowers yields, stimulating borrowing and spending.

2.3 Name any three free-market supply-side instruments. [2]

2.3 Any three of: deregulation of product and labour markets; privatisation; reduction in taxation; changing welfare payment levels; cutting bureaucracy costs for firms.

Exercises 2.4·2.6

2.4 Name any three interventionist supply-side instruments. [2]

2.5 (*SAM WEC12/01 Q10, adapted.*) Define quantitative easing in one sentence. [2]

2.6 State the central bank's four roles. [2]

Exercises 2.4·2.6

2.4 Name any three interventionist supply-side instruments. [2]

2.4 Any three of: education, training and skills investment; investment tax incentives or subsidies; infrastructure investment; finance for start-ups; regional policy.

2.5 (*SAM WEC12/01 Q10, adapted.*) Define quantitative easing in one sentence. [2]

2.5 The central bank's purchase of government or corporate bonds, increasing the money supply and the availability of loans.

2.6 State the central bank's four roles. [2]

2.6 Implementing monetary policy; pursuing the inflation target; banker to the government; banker to the banks – lender of last resort.

Exercises 3.1·3.2

3.1 (*Original.*) With AD: $P = 90 - Y/2$ and LRAS vertical at $Y = 85$, a reflationary fiscal expansion shifts AD up by 10. Explain the likely effect on output and the price level, and why the outcome differs with spare capacity. [4]

3.2 (*Original.*) A supply-side programme shifts LRAS from 85 to 105. Using the model, find both equilibria and evaluate one strength and one weakness of interventionist supply-side policy. [4]

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3.1 With LRAS vertical at 85, output cannot rise: the price level alone rises from $90 - 85/2 = 47.5$ to $100 - 85/2 = 57.5$ – pure inflation. With spare capacity (Keynesian range), the same shift raises real output with little price rise until capacity binds. The conclusion: demand-side policy's effect depends on the economy's position relative to capacity.

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3.2 E1: AD $P = 90 - Y/2$ at $Y = 85$ gives $P = 47.5$. E2: LRAS at 105 gives $P = 90 - 105/2 = 37.5$ – output up 20, price level down 10: growth AND disinflation together. Strength of interventionist policy: infrastructure or skills fix real capacity constraints, permanently raising LRAS. Weakness: slow, costly, and information gaps mean projects can misfire (government failure).

Exercise 3.3

3.3 (*Original.*) Explain how a cut in the base rate from 6.5% to 6.25% (SAM Extract B, India) is expected to affect aggregate demand. [4]

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3.3 A lower base rate cuts the cost of borrowing: consumer credit and mortgages cheaper → consumption rises; investment projects clear the hurdle rate → I rises. Both shift AD right, raising output and (towards capacity) prices. Caveats: transmission depends on banks passing the cut on (lending criteria), business confidence, and the 25-point cut's small size.

Local review guidance: the two price levels computed before the conclusion; instrument names exactly from the specification lists; (R1 3.2) the strength/weakness pair weighs time horizon and information gaps. This is authored classroom guidance.