Inflation, unemployment and policy judgement

Pearson Edexcel · International A-Level · Economics

Pearson Edexcel International AS Economics (WEC12), specification Issue 2, June 2018. This topic covers spec section 2.3.6 in full: the six macroeconomic objectives, the four conflicts between them, supply-side policies (free market and interventionist) and demand-side policies (fiscal and monetary, with the central bank's roles). Worked examples are original or adapted from the WEC12/01 Sample Assessment Materials and labelled SAM.

Must-know for this topic:

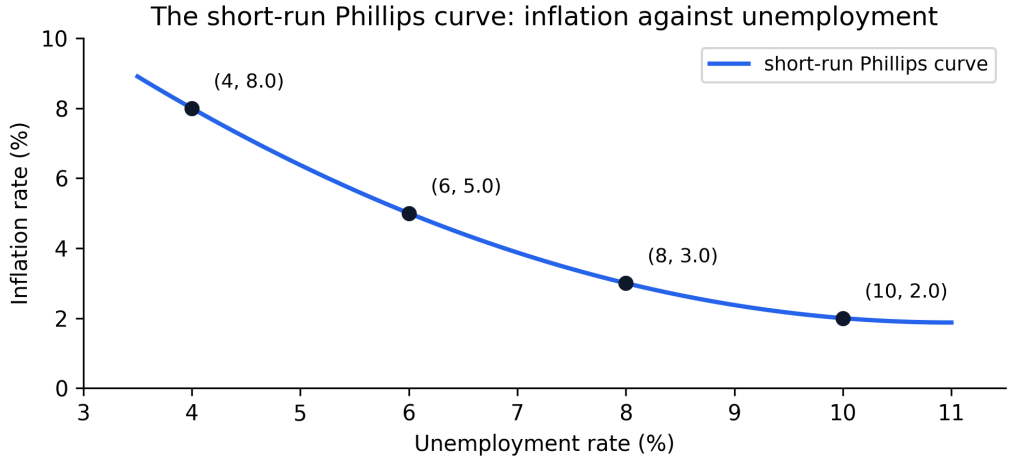
Family	Content
objectives	growth; low stable inflation; low unemployment; current-account equilibrium; balanced budget; income equality
conflicts	inflation ↔ unemployment (Phillips curve); growth ↔ environment; inflation ↔ current account; growth ↔ equality
supply-side	free market (deregulation, privatisation, tax cuts, welfare reform, bureaucracy cuts) vs interventionist (education, investment incentives, infrastructure, start-up finance, regional policy)
demand-side	fiscal (G, T) and monetary (interest rates, QE, lending criteria, reserve ratios); reflationary vs deflationary

Macroeconomic objectives

Governments pursue six objectives (2.3.6.1): economic GROWTH (rising real GDP); a LOW AND STABLE rate of inflation (an **inflation target** anchors expectations); LOW unemployment (waste of resources, PPF inside); BALANCE OF PAYMENTS equilibrium on the current account (sustainability of external borrowing); a BALANCED government budget (debt sustainability over the cycle); and GREATER income equality (equity and cohesion). Each objective has a measure from topic 3 – real GDP growth, CPI inflation, the ILO unemployment rate, the current-account balance, the budget balance, and an inequality measure – and each carries a trade-off against at least one other objective.

Conflicts between objectives

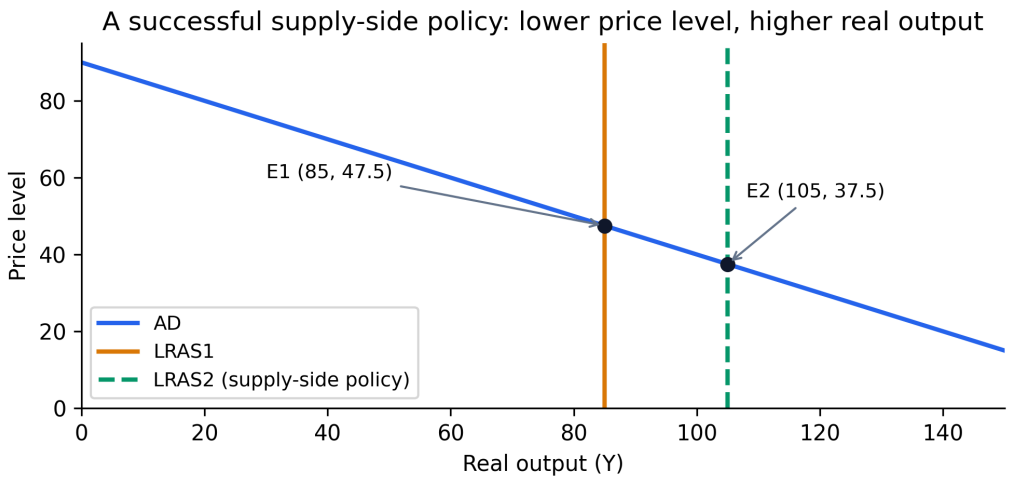
INFLATION versus UNEMPLOYMENT: the short-run **Phillips curve** shows the trade-off – points (4, 8), (6, 5), (8, 3), (10, 2) trace inflation against unemployment, so cutting inflation from 8% to 3% costs unemployment rising from 4% to 8% in the short run (2.3.6.2a). GROWTH versus the ENVIRONMENT: faster output raises emissions and resource use – the SAM's India extract shows Delhi closing schools for severe smog while growth ran above 7% (2.3.6.2b). INFLATION versus the CURRENT ACCOUNT: reflation raises incomes, sucking in imports and raising prices, which worsens competitiveness – both move the current account towards deficit (2.3.6.2c). GROWTH versus EQUALITY: growth driven by skilled sectors can widen income gaps even as average incomes rise (2.3.6.2d). Judgement questions want the conflict NAMED, the mechanism EXPLAINED, and the trade-off WEIGHED – that is where the evaluation marks live.



Original illustrative curve; the four labelled points are the worked trade-off pairs.

Supply-side policies

Supply-side policy raises productivity, competition and incentives – they shift LRAS right (2.3.6.3a). FREE MARKET policies (2.3.6.3b): **deregulation** of product and labour markets (lower costs, easier entry); **privatisation** (profit discipline); reduction in taxation (work and investment incentives); changing welfare payment levels (incentives to accept work); cutting bureaucracy costs for firms. INTERVENTIONIST policies (2.3.6.3c): investment in education, training and skills (productivity of labour); incentives to encourage investment (tax incentives or subsidies); infrastructure investment (reducing firms' costs); finance for business start-ups; regional policy (spreading activity to lagging regions). Strengths: market policies are cheap and quick to announce and can raise incentives; interventionist policies fix real capacity constraints. Weaknesses: market policies may worsen equality and their incentives are uncertain; interventionist policies are slow, costly, and subject to government failure (information gaps, cost overruns) (2.3.6.3d).

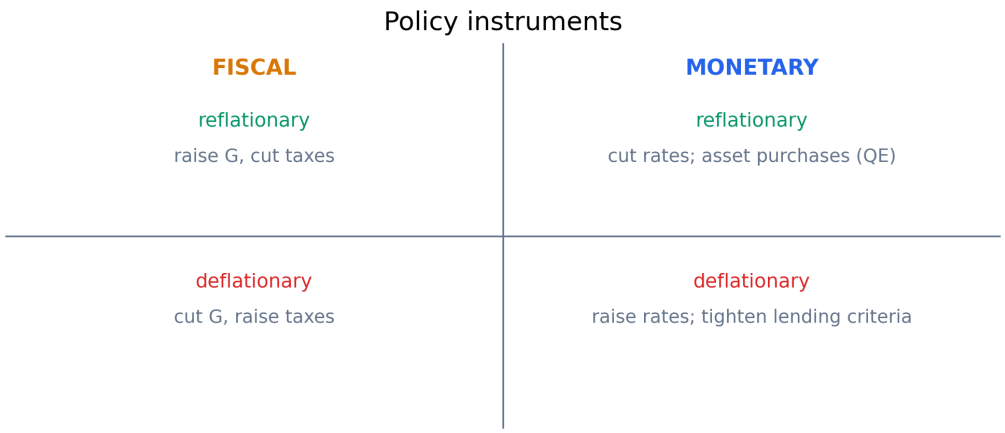


Original model: LRAS shifts from 85 to 105 along AD $P = 90 - Y/2$, cutting the price level from 47.5 to 37.5 while output rises.

Demand-side policies and the central bank

Demand-side policy manages AD (2.3.6.4a): **Fiscal policy** uses government spending and taxation; **Monetary policy** uses interest rates, asset purchases (quantitative easing), lending criteria and reserve asset (liquidity) requirements. REFLATIONARY policy raises AD (higher G, lower T, lower interest rates, QE); DEFLATIONARY policy cuts AD (the reverse). In the AD/LRAS model a reflation with multiplier 2 – spending up 10 raises income 20 – raises output only while spare capacity exists; against a vertical LRAS it mainly raises the price level. *(SAM WEC12/01 Q10, adapted)* **Quantitative easing** is the central bank's purchase of government or corporate bonds: it improves the availability of loans, stimulating consumption and investment, boosting AD and the price level – Japan used it to fight deflation. *(SAM Q12(a), adapted)* The **base rate** is the cost of borrowing set by the central bank; India's cut from 6.5% to 6.25% (November 2016) eased borrowing costs to support demand.

The CENTRAL BANK (2.3.6.4d): implements monetary policy (setting the base rate, conducting QE); pursues an inflation target (credibility anchors expectations – the key to the Phillips trade-off easing over time); acts as banker to the government (managing its accounts and debt); and as banker to the banks – **lender of last resort** stopping solvent banks failing in a panic. Strengths of demand-side policy: monetary policy is quick, technical and insulated from politics; fiscal policy directly targets demand and distribution. Weaknesses: monetary policy works only through indirect channels with long and variable lags; fiscal policy is slow to legislate, crowds out private spending, and enlarges the budget deficit (2.3.6.4e).



Original schematic; the four quadrants organise the specification's instrument lists.

Checklist

- The six objectives with their measures (2.3.6.1).
- The four conflicts: Phillips curve points (4, 8) to (10, 2); growth vs environment (India smog); inflation vs current account; growth vs equality (2.3.6.2).
- Supply-side: the five free-market and five interventionist instruments; strengths and weaknesses of each family (2.3.6.3).
- Demand-side: fiscal vs monetary; reflationary vs deflationary; the four monetary instruments; QE defined with its mechanism (SAM Q10); the base rate (SAM Q12a, India 6.5 → 6.25).
- The central bank's four roles incl. lender of last resort; strengths and weaknesses of demand-side policy (2.3.6.4).

Boundary notes: essay answers follow the WEC rubric – Knowledge, Application, Analysis and Evaluation are marked separately (20-mark essays: 12 KAA + 8 evaluation, with level caps for missing diagrams or context). Supply-side versus demand-side evaluation should reference the time horizon: demand-side works in the short run, supply-side in the long run. Worked examples are original or SAM-adapted as labelled, with arithmetic re-derived.