6.1 Government and the economy

Name: _____ Class: _____ Date: _____ **Total: 22 marks**

KEY WORDS inflation • fiscal policy

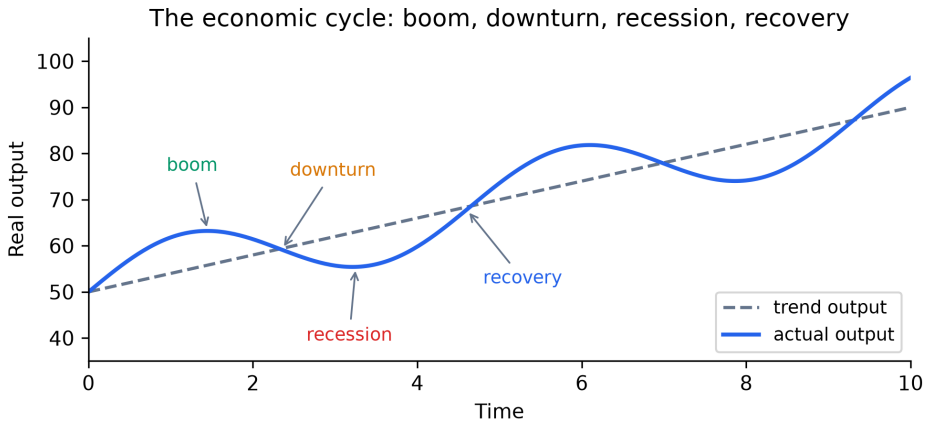
Government and the economy

Objective

Apply the six objectives with their measures, the CPI calculation, the inflation types, the policy families on the AD/AS model, and the trade-offs between objectives (spec 2.1.1–2.1.3).

1 Key knowledge and worked examples

Objectives and policies. Growth is rising real GDP; the cycle runs boom → downturn → recession → recovery. CPI from a weighted basket: 50/30/20 with relatives 110/100/120 → CPI 109 → 9% inflation. Demand-pull: AD right; cost-push: SRAS left. AD $P = 90 - Y/2$ vs SRAS $P = 20 + Y/2$ at $(70, 55)$; a reflation to AD +15 gives $(85, 62.5)$. Fiscal: G and T; monetary: interest rates; supply-side: seven measures. Trade-offs: unemployment ↔ inflation; growth ↔ inflation; growth ↔ environment; inflation ↔ current account.



Original cycle; the stage effects are worked in the questions.

2 Practice

2.1 Define economic growth and name one limitation of GDP as its measure. [2]

2.2 A CPI basket has weights 50, 30 and 20 with price relatives 110, 100 and 120. Calculate the CPI and the inflation rate. [3]

2.3 Distinguish demand-pull from cost-push inflation by their diagrams. [2]

2.4 Name any four of the five types of unemployment. [2]

2.5 Name the four trade-offs between macroeconomic objectives. [2]

3 Exam-style questions

3.1 *(Original.)* On AD $P = 90 - Y/2$ and SRAS $P = 20 + Y/2$, equilibrium is $(70, 55)$. A reflationary policy shifts AD up by 15 at every output. Find the new equilibrium and state the effect on output and the price level. [4]

3.2 *(Original.)* The central bank raises interest rates. Explain the mechanism by which this is expected to reduce inflation, and name one trade-off the policy accepts. [4]

3.3 *(Original.)* A country's growth is 5% but air pollution is rising. Explain the trade-off and suggest one policy that eases it. [3]

Solutions

2.1 An increase in real GDP over a period (1). Limitation: GDP misses non-market activity (or ignores distribution; excludes environmental damage) (1).

2.2 CPI $= 0.5 \times 110 + 0.3 \times 100 + 0.2 \times 120 = 55 + 30 + 24 = 109$; inflation $= 9\%$.

2.3 Demand-pull: the AD curve shifts RIGHT – prices and output both rise. Cost-push: the SRAS curve shifts LEFT – prices rise but output falls.

2.4 Any four of: cyclical; structural; seasonal; voluntary; frictional.

2.5 Unemployment and inflation; economic growth and inflation; economic growth and environmental protection; inflation and the current account.

3.1 New AD: $P = 105 - Y/2$. Setting $105 - Y/2 = 20 + Y/2$ gives $85 = Y$; price level $= 105 - 42.5 = 62.5$. Output rises from 70 to 85 and the price level from 55 to 62.5 – reflation buys output at the cost of inflation.

3.2 Higher interest rates raise the cost of borrowing and the reward to saving: consumption and investment fall, so AD shifts left and demand-pull inflation eases. Trade-off accepted: lower AD raises unemployment and slows growth (the unemployment–inflation trade-off).

3.3 The trade-off: growth raises output and incomes but its energy and transport demand increases air pollution – an external cost the market price omits. Policy (any one, explained): a pollution tax internalises the cost; regulation caps emissions; permits fix the total – each lets growth continue while cutting the pollution per unit.

Local review guidance: the CPI shows each weighted product before the sum; the AD/AS solution sets the equations before reading either variable; (R1) trade-off answers NAME both objectives and the direction of the conflict. This is authored classroom guidance.