Government and the economy

Edexcel IGCSE Economics 4EC1 sections 2.1.1-2.1.3 full package

Government and the economy

- explain the six macroeconomic objectives and how each is measured;
- calculate a **consumer price index** and an inflation rate;
- explain the causes and effects of inflation and unemployment;

Government and the economy (2)

- explain fiscal, monetary and **supply-side policies** and government controls;
- use an AD/AS diagram to show the effect of policies;
- explain the conflicts between the objectives.

The macroeconomic objectives

- **boom** : output grows fast; unemployment is low; inflation tends to rise;
- **downturn** : growth slows;
- **recession** : output falls (two quarters in a row of falling GDP); unemployment rises; inflation falls;

The macroeconomic objectives (2)

- **recovery** : output starts to grow again.
- **demand-pull inflation** : total spending rises faster than the economy can produce, so firms raise prices;
- **cost-push inflation** : firms' costs rise (energy, wages, imported materials) and they pass them on in higher prices. The UK's inflation in 2022 was mainly cost-push: gas and food prices jumped after Russia invaded Ukraine.

The macroeconomic objectives (3)

- **prices and wages**: if prices rise faster than wages, workers' **real income** falls;
- **exports**: the country's goods become dearer abroad, so exports may fall;
- **unemployment**: firms that lose sales cut jobs;

The macroeconomic objectives (4)

- **menu costs** : firms must keep changing price lists, menus and websites;
- **shoe-leather costs** : people spend time and effort moving money to protect its value;
- **uncertainty**: firms cannot plan, so confidence and investment fall.

The macroeconomic objectives (5)

- **cyclical** : caused by a fall in demand in a **recession**;
- **structural** : an industry declines and its workers' skills are no longer wanted, such as coal miners when mines close;
- **seasonal** : jobs exist only at certain times of year, such as ski instructors or fruit pickers;

The macroeconomic objectives (6)

- **frictional** : people between jobs, while they search for a new one;
- **voluntary** : people choose not to take the jobs available, for example because benefits are close to the wages offered.

Government policies

- To boost demand in a **recession**, the government spends more or cuts taxes. In 2024 China issued 1 trillion yuan of extra-long government bonds to pay for major projects.
- To cool a **boom**, it spends less or raises taxes.
- education and training, to make workers more productive;

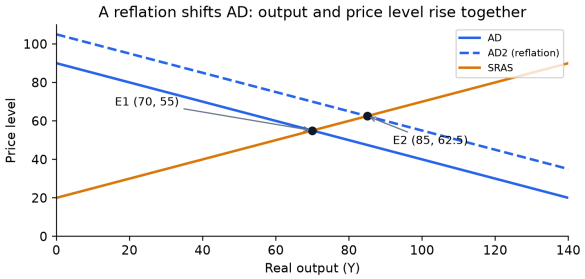
Government policies (2)

- privatisation and **deregulation** , to bring competition and efficiency;
- regional policies, to bring jobs to poorer areas;
- spending on infrastructure, such as railways, ports and broadband;

Government policies (3)

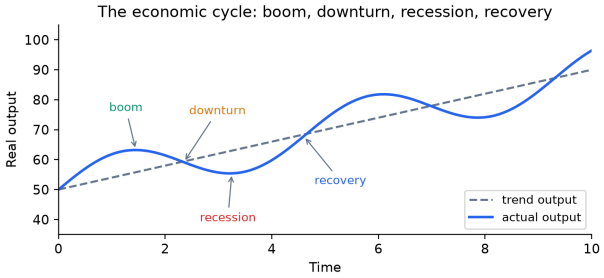
- lower taxes on business profits, to encourage investment;
- lower income taxes, to encourage people to work.

Figure: Government policies



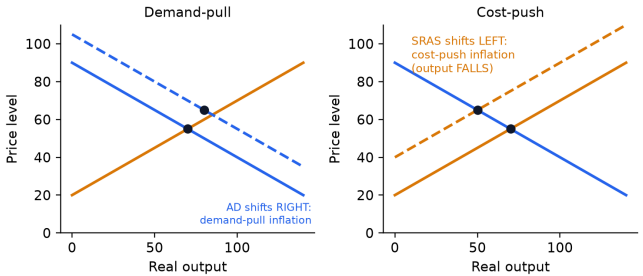
- A policy that raises demand moves equilibrium from (70, 55) to (85, 62.5): more output, higher prices.
- Match each part of the diagram to the text.

Figure: Government policies ·



- The **economic cycle**: **boom**, **downturn**, recession and recovery around the trend.
- Match each part of the diagram to the text.

Figure: Government policies . .



- Demand-pull: AD shifts right, raising output and prices. Cost-push: AS shifts left, raising prices and cutting output.
- Match each part of the diagram to the text.

Relationships between objectives and policies

- The objectives can conflict, so a policy that helps one may harm another:
- The UK in 2022–2023 shows the first conflict.
- Higher interest rates brought inflation down from 11.1% to 4.0% by the end of 2023, but growth almost stopped and unemployment began to rise.
- China in 2023 faced the other side: with prices flat, it could cut interest rates to support jobs without much risk of inflation.

Data-response practice

- (a) Define *inflation*. [2]
- (b) Using the table, calculate Country K's **consumer price index**, and state its inflation rate since the base year. [3]
- (c) Using the extract, identify the main type of inflation in the UK in 2022, and give a reason. [2]

Data-response practice (2)

- (d) Explain how a rise in interest rates can reduce inflation. [4]
- (e) Using the extract, explain **one** trade-off between macroeconomic objectives. [3]
- (f) Evaluate whether raising interest rates is the best policy to reduce inflation caused by higher energy prices. [9]

Common errors

- Defining inflation as "high prices". It is a sustained **rise** in the general price level.
- Adding up price indices without the weights. Multiply each index by its **weight** first.
- Confusing **fiscal policy** (government spending and taxes) with **monetary policy** (interest rates, set by the central bank).

Common errors (2)

- Saying a **supply-side policy** works quickly. Education, training and infrastructure take years.
- Calling any fall in output a **recession**. A recession is falling **real GDP** for two quarters in a row.
- Naming a policy without its trade-off: every policy helps one objective and may harm another.

Key terms

- **Economic growth**: an increase in **real GDP**.
- **Inflation / deflation**: a sustained rise / fall in the general price level.
- **Consumer price index**: a weighted average of the prices of a basket of goods and services.

Key terms (2)

- **Structural unemployment**: unemployment caused by the decline of an industry.
- **Current account deficit**: imports of goods and services greater than exports.
- **Fiscal policy**: changes in government spending and taxation.

Key terms (3)

- **Monetary policy**: changes in interest rates (and the money supply) by the **central bank**.
- **Supply-side policy**: a policy that raises the economy's productive potential.

Check yourself

- 1.
- Give two limitations of GDP as a measure of living standards. 2.
- A basket has two groups: clothes (**weight** 40, index 105) and food (weight 60, index 115).
- Calculate the CPI and the inflation rate. 3.