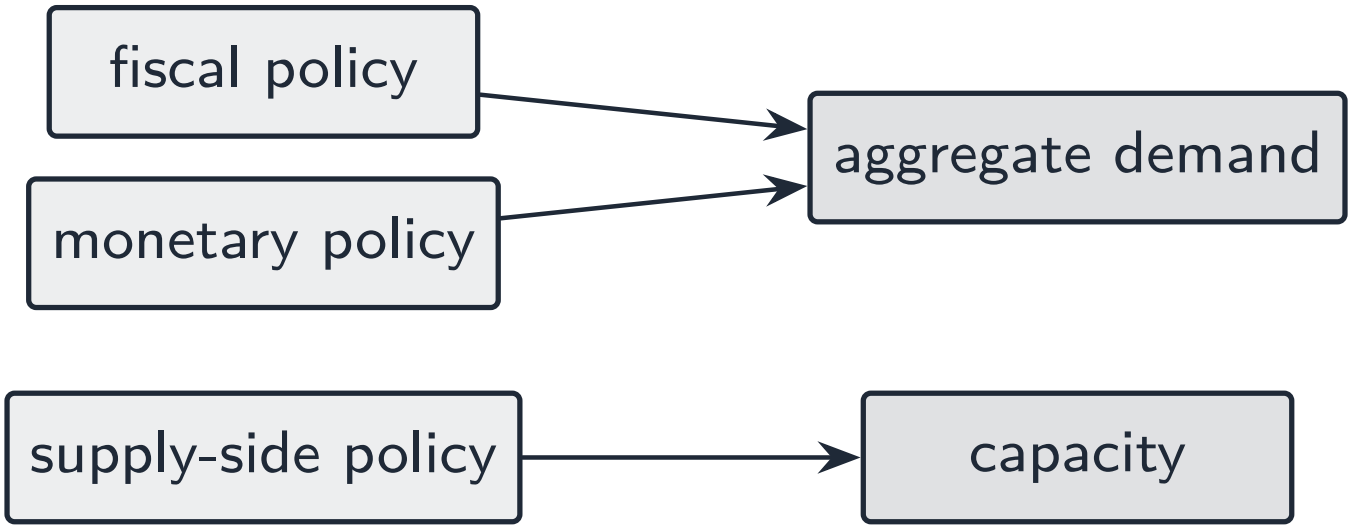
Exercise walk-through

# 5.7
# Demand management: fiscal policy

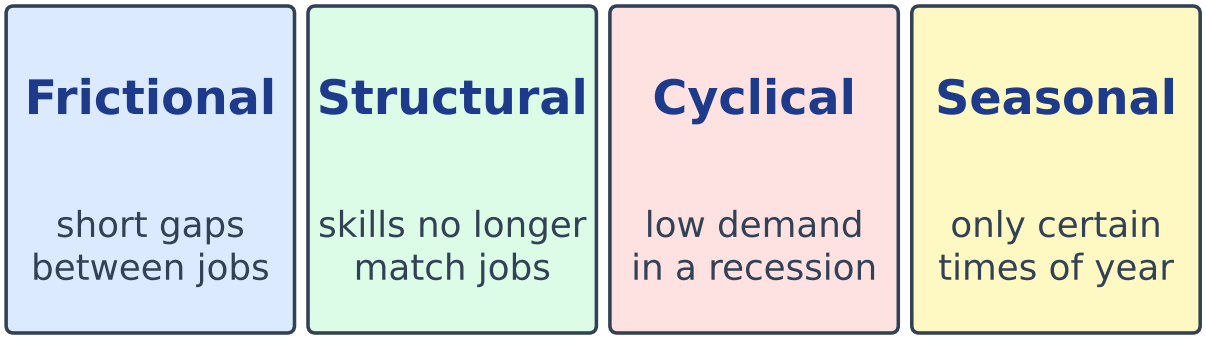
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# Figure: Macroeconomic activity, objectives and policy




- Fiscal and **monetary policy** act on demand; supply-side on capacity
- Match each part of the diagram to the text.

# Figure: Macroeconomic objectives




Exam: name the type + cause — match policy to cause; results depend on vacancies and spare capacity

- The four types of unemployment: frictional (between jobs), structural (skills no longer match), cyclical (low demand in a **recession**) and seasonal
- Match each part of the diagram to the text.

# Key terms (2)

- **Multiplier**: the ratio of the final change in national **income** to the initial change in spending.
- **Natural rate of unemployment**: the rate of unemployment when the labour market is in equilibrium, made up of frictional, structural and seasonal unemployment.
- **Monetary policy**: the **central bank**'s use of interest rates and the **money supply** to influence aggregate demand.
- **Supply-side policy**: policy that aims to increase the economy's productive capacity (LRAS).

# Exercises 2.1·2.2

**2.1** Distinguish between current and capital government spending, with an example of each. [2]







**2.2** Explain how unemployment benefits act as an automatic stabilizer. [2]



# Exercises 2.1·2.2

**2.1** Distinguish between current and capital government spending, with an example of each. [2]







**2.1**

current: day-to-day spending on running services, e.g. teachers' wages, medicines; capital: spending on long-lasting assets, e.g. roads, hospitals, schools

**2.2** Explain how unemployment benefits act as an automatic stabilizer. [2]




**2.2**

in a recession more people lose jobs and receive benefits, so government spending rises automatically; this supports household income and spending, so AD falls less

# Exercise 2.3

**2.3** Using an AD/AS diagram, explain how a cut in income tax could close a recessionary gap. [4]




[[drawlines:4]]

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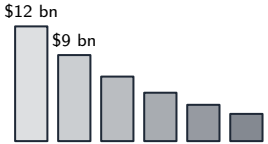

[[drawlines:4]]

**2.3**

lower income tax raises disposable income; consumption rises, so AD shifts right; real GDP rises towards potential output and unemployment falls; correctly labelled diagram with $AD_1 \rightarrow AD_2$, $Y_1 \rightarrow Y_p$

# Exercises 2.4·2.5

**2.4** The MPC is 0.75. The government increases spending on roads by \$12 billion. Calculate the final change in real GDP. [3]

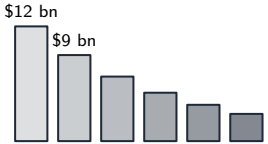



**2.5** Explain why a \$12 billion tax cut would raise real GDP by less than a \$12 billion rise in government spending, when MPC = 0.75. [3]



# Exercises 2.4·2.5

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**2.4**

$k = 1 \div (1 - 0.75) = 4$; change in GDP $= 4 \times 12 =$ \$**48** bn

**2.5** Explain why a \$12 billion tax cut would raise real GDP by less than a \$12 billion rise in government spending, when MPC = 0.75. [3]




**2.5**

$G$ enters AD in full in the first round; with a tax cut, households save part: only $0.75 \times 12 =$ \$9 bn is spent in the first round; so the total effect is $4 \times 9 =$ \$36 bn, less than \$48 bn

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# Exercise 3.1 (a)

**3.1** A government plans to spend $50 billion on railways during a recession.

(a) Identify **two** groups that would gain. [2]

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(a) Identify **two** groups that would gain. [2]

(a) any two: construction firms and their workers; steel and other suppliers; passengers and businesses using the railway later; the unemployed who find jobs

# Exercise 3.1 (b)

**3.1** A government plans to spend $50 billion on railways during a recession.

(b) Evaluate the use of this spending to end the recession. [6]



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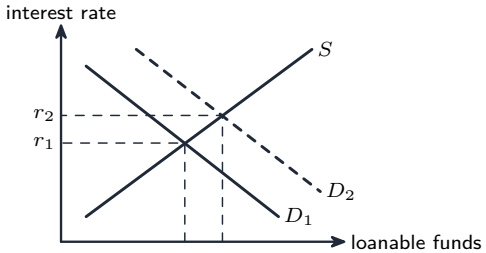


(b) $G$ adds directly to AD, with a multiplier effect on income and jobs; it also raises long-run capacity (LRAS) by improving transport; but large projects take time to plan and start, so the effect may come after recovery; borrowing raises debt and may crowd out private investment if interest rates rise; judgement: effective if projects are ready and the recession is deep with idle resources

# Exercise 3.2

**3.2** Some economists argue that government borrowing to finance higher spending "crowds out" private investment.

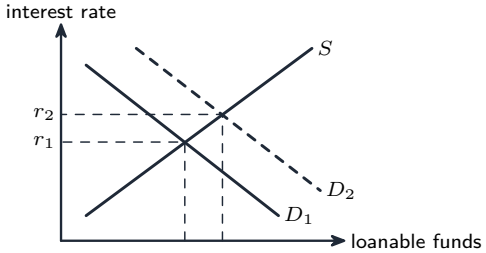
Explain crowding out, and evaluate whether it is likely in a deep recession. [8]



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**3.2** Some economists argue that government borrowing to finance higher spending "crowds out" private investment.

Explain crowding out, and evaluate whether it is likely in a deep recession. [8]




**3.2**

award up to [8]: to finance a deficit, the government borrows; higher demand for loanable funds raises interest rates; higher rates reduce private investment and consumption on credit; so the net rise in AD is smaller than the rise in $G$; in a deep recession, private demand for loans is weak and savings are high; so government borrowing may not raise interest rates much: little crowding out; central banks may also keep rates low; judgement: crowding out matters more near full employment than in a deep recession

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