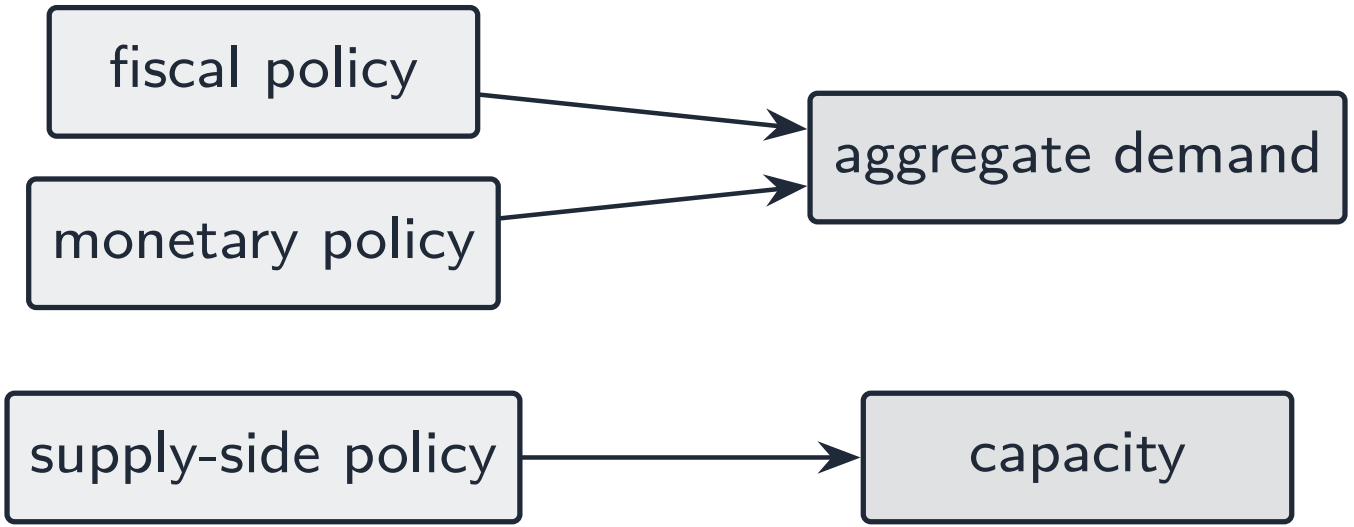
Exercise walk-through

4.7
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.

Supply-side policies

- **Supply-side policies** aim to raise the economy's productive capacity, shifting LRAS to the right.
- **Worked example.** LRAS shifts from 85 to 105 along AD $P = 90 - Y/2$.
- The price level falls from $90 - 85/2 = 47.5$ to $90 - 105/2 = 37.5$ while real GDP rises by 20.
- Unlike demand-side policy, this gives growth without **inflation**.

Key terms (2)

- **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]]

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]]

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 $AD_1 \rightarrow AD_2$, $Y_1 \rightarrow Y_p$

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]



Exercise 3.1 (b)

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



(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