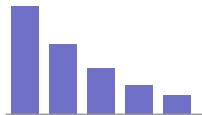


The Macroeconomy

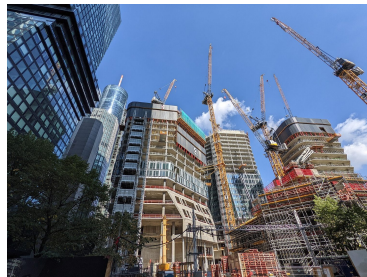
A-Level Economics ■ Topic 9

A-Level Economics



What we will cover

- 1 The multiplier
- 2 Growth & the output gap
- 3 Unemployment
- 4 The Phillips curve
- 5 Money & banking
- 6 The money market



investment drives growth



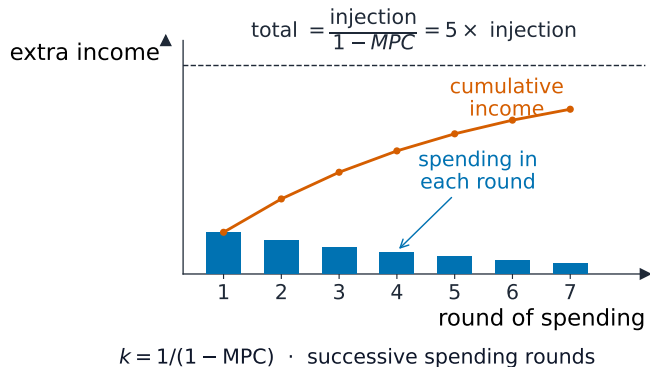
The multiplier

An injection of spending raises income, which raises further spending:

$$k = \frac{1}{\text{MPW}} = \frac{1}{1 - \text{MPC}}$$

A larger **MPC** (or smaller withdrawals) means a larger multiplier.

The multiplier, in detail



An injection is spent round after round (each smaller by the MPC), so total income rises by a mu

Why an injection is worth more than itself

the multiplier

an injection raises income by **more** than the first amount

the mechanism

a firm builds a factory; the builders earn income and **spend part of it**; those receipts become someone else's income, and so on

MPC

the marginal propensity to consume – the fraction of extra income that is **spent** on domestic goods

the leakages

MPS saving, **MPT** tax, **MPM** imports

the size

$$k = \frac{1}{1 - \text{MPC}} = \frac{1}{\text{MPS} + \text{MPT} + \text{MPM}}$$
 – a bigger MPC, or smaller leakages, gives a bigger multiplier

An open economy with high taxes has a **small** multiplier, because most of each round leaks abroad or to the exchequer before it can be re-spent.

The accelerator and what drives spending

consumption & saving
disposable income

, wealth,
interest, confidence

investment

interest, expected profit,
technology, confidence

The **accelerator** : investment depends on the **rate of change** of output – it jumps when demand rises fast.

The accelerator, and how unemployment is counted

the accelerator

investment depends on the **rate of change** of output, not its level

the consequence

when demand rises *quickly*, firms need a lot of new capital at once – so investment is far more volatile than output

and when growth merely slows

investment can **fall** even while output is still rising

claimant count

people claiming unemployment benefits – cheap to collect, and it misses everyone ineligible

labour force survey

a wider survey of people seeking work – the internationally comparable measure, and usually the higher one

The two measures disagree by design. Quoting which one a figure comes from is the difference between a described number and an analysed one.



Growth, the output gap and sustainability

The **output gap** is actual minus potential output.

- **positive** gap → inflation
- **negative** gap → spare capacity, unemployment

Sustainable growth weighs output today against tomorrow.

Two kinds of growth, and the floor under unemployment

Actual growth

Actual growth : a rise in real output – using more of the capacity already there. It closes an output gap.

Potential growth

Potential growth : a rise in what the economy *could* produce, from more or better resources. It shifts LRAS right.

Economic growth

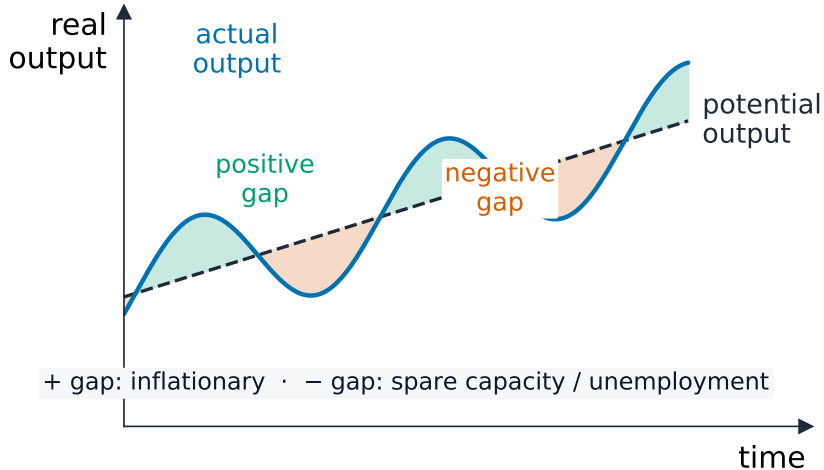
Economic growth in the headlines means the actual kind, measured as the change in real GDP.

The natural rate

The **natural rate of unemployment** is what remains at full employment: the **frictional**, **structural** and **seasonal unemployment** that no demand policy removes.

Only **cyclical unemployment** sits above the natural rate – which is why stimulus below it buys inflation rather than jobs.

Growth, the output gap and sustainability, in detail



The **output gap** is actual minus potential output.

Unemployment

frictional – between jobs (short)

structural – skills no longer match

cyclical – low demand in a recession

seasonal – only at certain times

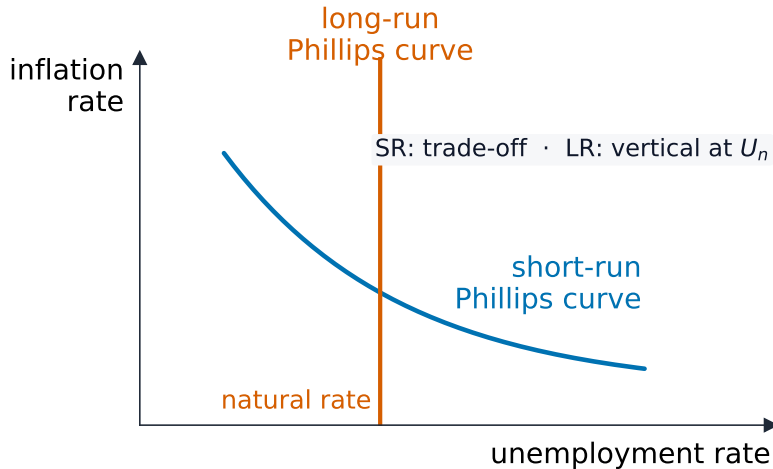
The **natural rate** (frictional + structural) cannot be removed just by raising demand.

The Phillips curve

The **Phillips curve** links unemployment & inflation.

- short run – a **trade-off**: less unemployment, more inflation
- long run – **vertical** at the natural rate; no lasting trade-off

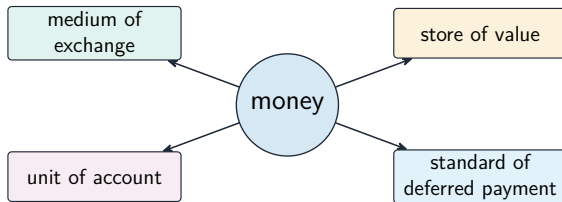
The Phillips curve, in detail



The **Phillips curve** links unemployment & inflation.



The functions of money



Money does four jobs:

- **medium of exchange** – avoids barter
- **store of value** – save it
- **unit of account** – measure prices
- **deferred payment** – borrow & repay

Banks



- the **central bank** runs policy & is **lender of last resort**
- **commercial banks** take deposits & lend – **creating money**

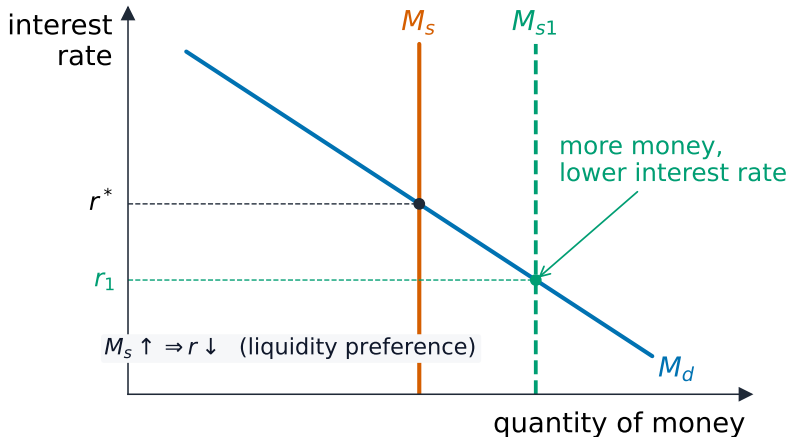
Moral hazard : banks may take big risks expecting a bailout.

The money market

People hold money for its **liquidity** (**liquidity preference**).

The **interest rate** is set where money demand meets the **money supply** ; a larger supply lowers it.

The money market, in detail



People hold money for its **liquidity** (liquidity preference).

What money is for, and why people hold it

the four functions

medium of exchange, **store of value**, unit of account, standard of deferred payment

good money is

durable, easy to carry, easy to divide, hard to fake, and **limited in supply**

liquidity

money can be spent **at once**, which other assets cannot – that is why people hold it despite the lost interest

demand for money

also called liquidity preference: transactions, precautionary and speculative motives

the interest rate

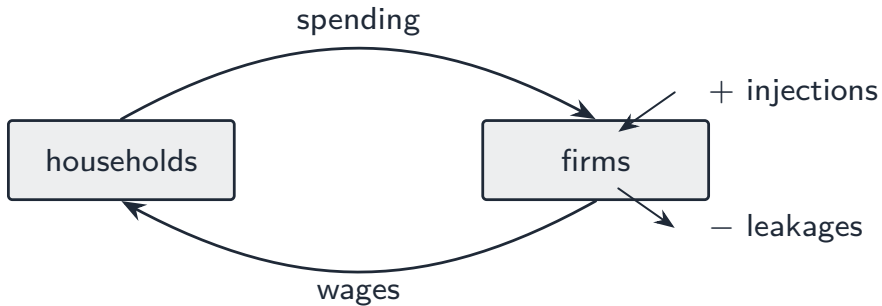
the **price** of holding money – higher rates make holding cash more costly, so the quantity demanded falls

moral hazard

banks take bigger risks when they expect to be rescued – the reason bank regulation exists

Money is defined by **what it does**, not what it is made of. That is why a token with no intrinsic value works perfectly well as money.

The circular flow and the multiplier



Income circulates between households and firms, with injections and leakages

The circular flow, and what leaks from it

The flow

The **circular flow of income** runs firms → households (wages) → firms (spending), round and round.

Injections

Investment, government spending and exports add to it.

Withdrawals

Saving, tax and imports leak out. The **marginal propensity to save** and the **marginal propensity to import** say how much of each extra pound leaks.

So the multiplier

The bigger those leakages, the smaller the multiplier – since less of each round is passed on.

Equilibrium is not where the flow stops; it is where injections equal withdrawals.

Employment and unemployment

frictional – between jobs

cyclical – low demand in a slump

structural – skills no longer fit

seasonal – only at certain times

Four types of unemployment: frictional, structural, cyclical and seasonal

Sustainability



The wind these turbines use is never used up, and they burn no fuel. Switching output from coal and oil to renewables like this lets an economy keep growing without spending the resources – or filling the air with the pollution – that would rob future generations

Exam tips

- Calculate the **multiplier** $= 1 \div (1 - MPC) = 1 \div MPS$ and apply it to an injection.
- Distinguish **actual from potential** growth and link sustainability to long-run capacity.
- Explain the **functions of money** and the role of banks and the central bank.
- Explain the **Phillips curve** trade-off (unemployment vs inflation) and why it may not hold in the long run.



Worked example – the multiplier

MPC = 0.8. Find the multiplier, then the effect of a £10bn rise in investment.

- $k = \frac{1}{1 - \text{MPC}} = \frac{1}{1 - 0.8} = \frac{1}{0.2} = 5$
- $\Delta Y = k \times \Delta \text{injection} = 5 \times 10 = \text{£}50\text{bn}$
- The extra spending becomes someone's income, 80% of which is spent again, and so on.
- With **spare capacity** that is real output; **near full employment** it is mostly inflation.

$$k = \frac{1}{1 - \text{MPC}} = \frac{1}{\text{MPW}}.$$

A **bigger** MPC $\Rightarrow$ bigger multiplier. Leakages (saving, tax, imports) **shrink** it.

Topic 9 – key takeaways

1

Multiplier

$1/(1 - MPC)$; an injection multiplies

2

Output gap

positive $\rightarrow$ inflation; negative $\rightarrow$ slack

3

Phillips curve

short-run trade-off; long-run vertical

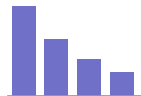
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Money

four functions; banks create money

Check yourself

- 1 If $MPC = 0.8$, what is the multiplier?
- 2 A positive output gap tends to cause what?
- 3 The long-run Phillips curve is what shape?
- 4 Name one function of money.



Answers 1. 5 2. inflation 3. vertical (at the natural rate) 4. medium of exchange
/ store of value / unit of account