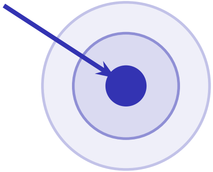
Government Macroeconomic Intervention

A-Level Economics ▪ Topic 5

A-Level Economics



What we will cover

1. Policy objectives
2. Fiscal policy & the budget
3. Types of tax
4. Monetary policy
5. The transmission mechanism
6. Supply-side policy

the state steers the economy

1 Objectives

Macroeconomic objectives

price stability 物价稳定	full employment 充分就业	economic growth 经济增长	balance of payments 国际收支	redistri-bution 收入再分配

Aims can conflict: fast growth can pull up inflation and worsen the balance of payments; cutting unemployment can raise inflation.

The five macroeconomic objectives

economic growth 经济增长	a rising real output, sustained over time
low inflation 通货膨胀	stable prices – usually a target around 2%, not zero
full employment 充分就业	everyone who wants work at the going wage can find it
balance of payments	a sustainable current-account position
redistribution of income 收入再分配	narrowing the gap between rich and poor
and increasingly	environmental sustainability, added alongside the traditional four

These conflict: growth can raise inflation and worsen the current account, and redistribution can weaken the incentive to work. Naming the conflict is the evaluation.

2 Fiscal policy

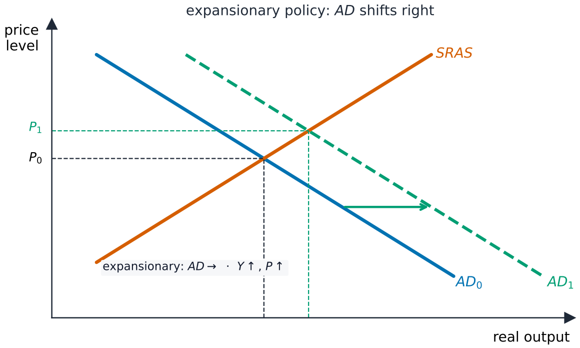
Fiscal policy and the budget

Fiscal policy 财政政策 uses government spending & taxation.

- **budget deficit** 预算赤字 – spend $>$ tax (borrow)
- **expansionary** 扩张性 – raises AD (fights recession)
- **contractionary** 紧缩性 – lowers AD (fights inflation)

Risk: **crowding out** 挤出效应 of private investment.

Fiscal policy and the budget, in detail



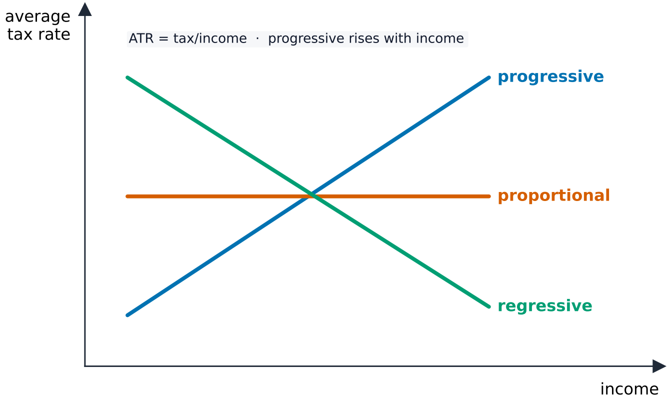
> Expansionary fiscal or monetary policy shifts AD right, raising output and the price level; contractionary policy does the reverse.

Types of tax

By what is taxed: **direct** 直接税 (income, profit) vs **indirect** 间接税 (spending). By how the rate moves with income:

- **progressive** 累进税 – rate rises
- **proportional** 比例税 – rate flat
- **regressive** 累退税 – rate falls

Types of tax, in detail



By what is taxed: **direct** 直接税 (income, profit) vs **indirect** 间接税 (spending).

Three tax structures, and the words around a budget

Progressive	The average rate *rises* with income – income tax with rising bands.
Proportional	A **proportional tax** 比例税 takes the same percentage from every income – a flat tax.
Regressive	A **regressive tax** 累退税 takes a larger share from a low income. Most **indirect tax** 间接税 is regressive, since the poor spend more of what they have.
Budget words	A **budget surplus** 预算盈余 is revenue above spending; the **national debt** 国债 is the stock of past deficits, not this year's flow.

> Progressive and regressive describe the *average rate as income rises* – not whether the tax is large.

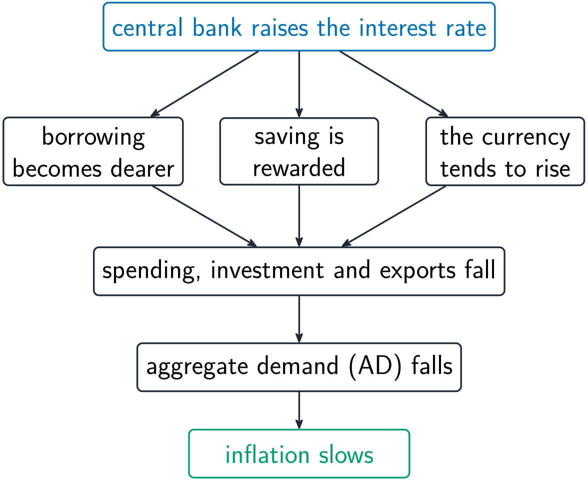
3 Monetary policy

Monetary policy

Monetary policy 货币政策 is run by the **central bank** 中央银行; its main tool is the **interest rate** 利率.

> Flexible (the rate can change anytime), but works with a lag of a year or more – and in a slump, low rates may not revive borrowing.

The transmission mechanism



A higher interest rate works through three channels:

- borrowing dearer → less spending & investment
- saving rewarded → less spending
- currency rises → exports fall

All lower AD, slowing inflation.

How a policy reaches the economy

Demand-side policies	**Demand-side policies** 需求管理政策 – fiscal and monetary – shift AD. Fast, and they cannot raise capacity.
The money supply	Monetary policy works through the interest rate and the **money supply** 货币供给: borrowing, saving, asset prices, and confidence.
The exchange rate	A lower interest rate weakens the **exchange rate** 汇率, which raises net exports – the channel students most often forget.
Supply-side	Supply-side policy raises **productivity** 生产率 and capacity instead. Slow, and it is the only route to non-inflationary growth.

> Every transmission channel has a lag. Naming the lag is usually worth an evaluation mark.

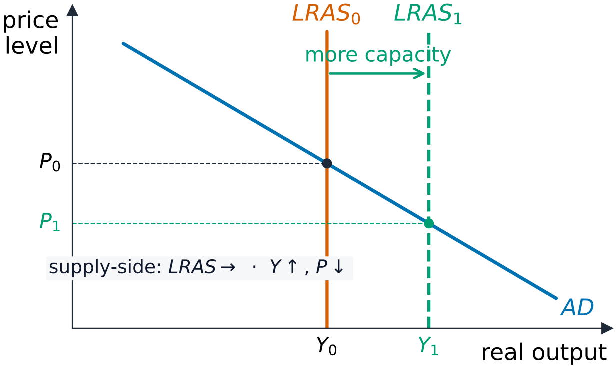
4 Supply-side policy

Supply-side policy

Supply-side policy 供给侧政策 raises **productive capacity** 生产能力, shifting LRAS right.

> Powerful – it can raise growth and cut inflation with no trade-off – but slow and costly.

Supply-side policy, in detail



> Supply-side policy raises capacity, shifting LRAS right: real output rises and the price level falls – growth with lower inflation.

Worked example – which policy in a deep recession?

A deep recession, a large output gap, and interest rates . Which policy?

- monetary policy is nearly exhausted – rates cannot fall much further
- supply-side policy works on capacity, and acts far too slowly
- so expansionary fiscal policy: raise spending, cut tax
- with spare capacity the multiplier is large and crowding out minimal

Match the tool to the diagnosis. The same recession with rates at 5% would be a monetary-policy answer.

Two kinds of supply-side policy

market-based	let markets work more freely
deregulation 放松管制	removing rules that block competition
lower direct tax 直接税	strengthening the incentive to work and invest
interventionist	the state supplies what markets under-provide
infrastructure 基础设施	spending on roads, ports and broadband
education and R&D	training, and support for research and new technology

> Supply-side policy is the only tool that can raise growth and lower inflation at once – but it is slow, costly, and its effects arrive years after the government that paid for it.

Two supply-side approaches

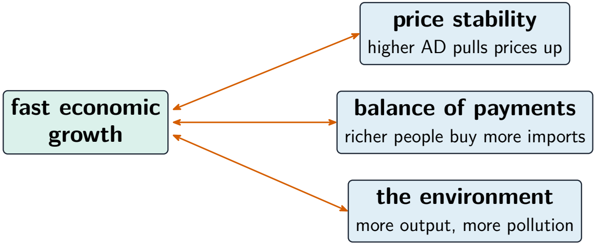
market-based 市场化

cut tax & benefits,
privatisation 私有化,
deregulation 放松管制

interventionist 干预型

training 培训,
infrastructure 基础设施,
research support

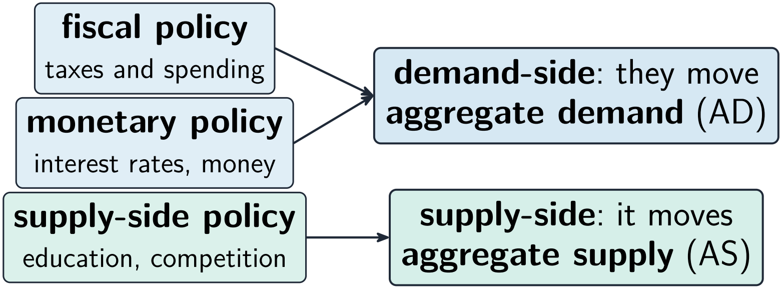
Conflicts between objectives



the same tension links **full employment** and **price stability**:
cutting unemployment by raising demand can cause more inflation

> Chasing fast growth can pull against price stability, the balance of payments and the environment

Conflicts between objectives, continued



Fiscal and monetary policy work on aggregate demand; supply-side policy works on aggregate supply

Exam tips

- Match a **policy to an objective**: fiscal and monetary policy act on demand; supply-side policy raises long-run capacity.
- Explain how a change in **interest rates** works through AD, and fiscal policy through G and T.
- Evaluate policy with **time lags, side effects and conflicts** between objectives.
- **Supply-side** measures (education, tax incentives) are long-run and slow to work.

5 Recap

Worked example – fiscal or monetary?

An economy is in recession with a large output gap. Compare using fiscal and monetary policy.

- Fiscal: cut tax or raise spending ⇒ AD rises, and the multiplier amplifies it.
- But it is slow to legislate and worsens the budget deficit.
- Monetary: cut rates ⇒ cheaper borrowing, less saving, weaker currency ⇒ AD rises.
- But confidence is low and rates may be near zero ⇒ a liquidity trap.

> Judge any policy on time lag, size of effect and side effects. Monetary is quicker to change; fiscal is more certain to work when confidence is broken.

Topic 5 – key takeaways

1 Objectives

stability, jobs, growth, trade, fairness – they conflict

2 Fiscal

spending & tax move AD; risk of crowding out

3 Monetary

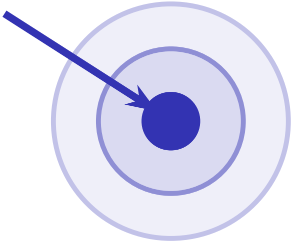
the interest rate works via transmission

4 Supply-side

lifts LRAS – growth with low inflation

Check yourself

1. A budget deficit means spending is how vs tax?
2. A progressive tax rate does what as income rises?
3. Who sets monetary policy?
4. Which policy shifts LRAS to the right?



Answers **1.** greater than tax **2.** rises **3.** the central bank **4.** supply-side policy