Inflation, unemployment and policy judgement

Edexcel IAL Economics WEC12 section 2.3.6 full package

Topic 4 at a glance

> Six objectives clash, and each policy family pays a price.

- WEC12 spec section 2.3.6.
- Judgement questions weigh trade-offs.

Six objectives, six measures

Objective	**Measured by**
economic growth	real GDP growth
low, stable inflation	CPI inflation
low unemployment	the ILO rate
current-account balance	the current-account balance
balanced budget	the budget balance
income equality	an inequality measure

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The Phillips curve trade-off

> Cutting inflation from 8% to 3% costs unemployment rising from 4% to 8%.

- A short-run **trade-off**.
- Credible targets ease it over time.

Three more conflicts

Conflict	Mechanism
growth vs environment	more output, more emissions
inflation vs current account	imports rise; exports less competitive
growth vs equality	skilled sectors pull ahead

A supply-side policy, drawn

More capacity: output rises while the **price level** falls.

- Aim: **productivity**, competition, incentives.
- LRAS shifts right.

Free-market supply-side policies

Instrument	How it helps supply
deregulation	lower costs, easier entry
privatisation	profit discipline
tax cuts	incentives to work and invest
welfare reform	incentives to accept work
less bureaucracy	lower costs for firms

Interventionist supply-side policies

Instrument	How it helps supply
education and training	more productive labour
investment incentives	tax breaks, subsidies
infrastructure	lower costs for firms
start-up finance	new firms, more competition
regional policy	activity in lagging regions

Which supply-side family?

Free market

+ cheap, quick
− incentives uncertain
− may worsen equality

Interventionist

+ fixes real constraints
− slow and costly
− **government failure**

Reflationary or deflationary

Family	Reflationary	Deflationary
fiscal	G up, taxes down	G down, taxes up
monetary	rates down, QE	rates up

Worked: reflation with a multiplier

1. **Injection** government spending $+10$
2. **Multiplier** $k = 2$
3. **Income** $2 \times 10 = +20$

Decision

$+20$ in output with **spare capacity**; mostly prices at capacity.

Quantitative easing

> Buying bonds makes loans easier, lifting spending and prices.

- Japan used it to fight **deflation**.
- Used when rates are near zero.

The central bank's four roles

> It sets rates, targets inflation, and banks for the state and the banks.

- India's **base rate**: 6.5% to 6.25% (2016).
- Credibility anchors expectations.

Monetary or fiscal?

Monetary

+ quick, technical
+ insulated from politics
− indirect, long lags

Fiscal

+ targets demand directly
+ can redistribute
− slow, crowds out, deficits

Data response: the ECB raises rates

1. **July 2022** deposit rate -0.5%
2. **September 2023** deposit rate 4.0%
3. **Change** $4.0 - (-0.5) = 4.5$ **percentage points**

Decision

A rise of 4.5 points: percentage points, not per cent.

Data response: cheaper energy, drawn

Falling costs cut inflation without the usual rise in unemployment.

- Gas prices fell sharply in 2023.
- Firms hoarded scarce skilled workers.

Data response: were rates the main reason?

Rates mattered

large, fast rise

anchored expectations

stopped second-round effects

Energy mattered more

cost-push cause faded

lags too long by 2023

unemployment stayed low

Check yourself

Question	**Answer**
Phillips curve: 8% to 3% inflation?	unemployment 4% to 8%
LRAS 85 to 105: **price level**?	47.5 to 37.5
Spending +10, k = 2?	income +20
−0.5% to 4.0%?	4.5 **percentage points**
Lender of last resort?	the central bank