Government and the economy

Edexcel IGCSE Economics 4EC1 sections 2.1.1-2.1.3 full package

Topic 6 at a glance

> Six objectives, three policy families, and the trade-offs between them.

- 4EC1 spec sections 2.1.1 to 2.1.3.
- Paper 2 rewards the CPI arithmetic and trade-offs.

The six objectives

Objective	Means
economic growth	**real GDP** rising
low, stable inflation	the price level rising slowly
low unemployment	few people seeking work
current-account balance	exports close to imports
environment	less pollution
redistribution	less inequality and poverty

The economic cycle

> Output swings above and below its trend.

- GDP misses non-market work, distribution, pollution.
- A boom raises inflation and cuts unemployment.

Worked: the consumer price index

1. **Weights** 50, 30 and 20 out of 100
2. **Price relatives** 110, 100 and 120
3. **CPI** $0.5 \times 110 + 0.3 \times 100 + 0.2 \times 120 = 55 + 30 + 24 = 109$

Decision

CPI 109 against a base of 100: inflation is 9%.

Cost-push inflation, drawn

Dearer inputs shift SRAS left: prices up, output down.

- Demand-pull: AD right, output and prices rise.
- Cost-push: prices rise while output falls.

What inflation costs

Rising prices erode pay, exports and confidence.

- Shoe-leather costs: time spent managing cash.
- Higher interest rates fight it, at a cost.

Five types of unemployment

Type	Cause
cyclical	too little demand in a downturn
structural	an industry declines; skills no longer fit
seasonal	work that stops with the season
frictional	between jobs
voluntary	choosing not to take the work offered

The other three objectives

Objective	**Tools and causes**
current account	deficits from dear goods and an overvalued currency
environment	taxes, subsidies, regulation, fines, permits, parks
redistribution	progressive taxes, benefits, education and health

Three policy families, and controls

Policy	Tools	Works by
fiscal	taxes and spending	changing demand
monetary	interest rates, QE	the cost of borrowing
supply-side	training, deregulation	raising capacity
controls	regulation, fines, permits	rules, directly

How a rate rise cools inflation

> Dearer borrowing cuts spending, so prices rise more slowly.

- Set by the central bank.
- Full effect takes one to two years.

Reflation, drawn

> AD up by 15: output 70 to 85, prices 55 to 62.5.

- Expansionary fiscal or **monetary policy**.
- The risk: demand-pull inflation.

Supply-side policy

> Raise capacity: more output at lower prices.

- Also: privatisation, regional policy.
- Slow to work, but lowers prices.

The four trade-offs

Pair	Why they clash
unemployment vs inflation	deflating demand costs jobs
growth vs inflation	fast growth overheats
growth vs environment	more output, more pollution
inflation vs current account	dearer exports sell less

Data response: Country K's price index

1. **Food** $30 \times 115 = 3450$
2. **Energy and other** $20 \times 130 = 2600$; $50 \times 104 = 5200$
3. **Index** $(3450 + 2600 + 5200) \div 100 = 112.5$

Decision

CPI 112.5: prices up 12.5% since the base year.

Data response: are rate rises best?

For	Against
cut demand and expectations	cannot lower gas prices
quick to change	cost growth and jobs
inflation fell to 2%	one to two years to work

Check yourself

Question	**Answer**
CPI 109: inflation?	9%
Cost-push: SRAS moves?	left: prices up, output down
A rate rise shifts AD?	left
Supply-side policy shifts?	SRAS right
Growth trades off against?	inflation, environment