**RWS7+8: INTRODUCTION TO GOVERNMENT POLICY**

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| **Fiscal Policy** | “use of Government spending and taxation to influence the level of aggregate demand” |
| **Monetary Policy** | “the use of interest rates (and other monetary instruments – money supply and exchange rates) to influence the level of aggregate demand in the economy” |
| **Supply-Side Policy** | “policies undertaken by the government designed to increase the productive potential of the economy and long run aggregate supply.” |

Policy makers will attempt to use macroeconomic policy in order to meet their various macro-economic objectives by shifting aggregate demand and supply. This is summarised below:



**Bank of England Governor**



**Sajid Javid**

**Chancellor of Exchequer 2019+**

**Andrew Bailey 2020+**

**Mark Carney until March 2020**

The Chancellor sets the Budget *every year* to help improve the economy

The Bank of England has the power to set interest rates *each month* to **target inflation**

The Monetary Policy Committee (MPC) makes a decision every month about the level of the ‘base rate’

**The Budget**  
(via G and taxation (affecting C and I)

**Interest Rates**

via C, I and (X – M)

**Shifts LRAS**  
e.g. cuts in income tax boost incentive to work

**Shifts AD**  
e.g. cuts in income tax boosts consumption

**Shifts AD**

**SUPPLY-SIDE POLICIES**

**FISCAL POLICY**

**MONETARY POLICY**

**DEMAND-SIDE POLICIES**

TASK: Explain the difference between monetary and fiscal policy

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**Context: Case Study of the Financial Crisis 2008**

Research the financial crisis of 2008 and fill in the boxes below. Please be warned that there is a level of knowledge needed here which is beyond you in terms of looking at how the banking industry and money markets are constructed so do not panic! I just want you to get a sense of the causes of the financial crisis and why it happened. I have attached some initial resources to get you going below and I would also urge you to watch the film ‘The Big Short’ which can be found on Netflix and I think is free on Amazon Prime. I also believe it is on our e-stream and you might be able to find a copy on YouTube.

**Economics HELP Website**

“The Great Recession 2008-13”: <https://www.economicshelp.org/blog/7501/economics/the-great-recession/>

“Credit crunch explained”: <https://www.economicshelp.org/blog/706/economics/essays-on-the-credit-crunch/>

**YouTube Videos (some of these use long words which you might not understand….do not worry at this stage!)**

The 2008 Financial Crisis: Crash Course Economics #12: <https://www.youtube.com/watch?v=GPOv72Awo68>

The Causes and Effects of the Financial Crisis 2008 (11 Minutes): <https://www.youtube.com/watch?v=N9YLta5Tr2A>

**Film**

‘The Big Short’ (2015): Christian Bale etc. – Look it up on Netflix, Amazon, our e-stream….watch this. It is a good film!!

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| Causes of the financial crisis of 2008 (HINT: Credit crunch? Sub-prime mortgages, financial derivatives (CDO’s and CDS’s!) |
| Effects of the financial crisis of 2008 (HINT: Global impacts? UK impacts? ‘The Great Recession’?) |
| Government responses to the financial crisis of 2008 (HINT: Interest rate response? Bailing out the Banks? New legislation? Quantitative Easing?) |
| To what extent have the Government responses been effective? Try to put down a few arguments on each side? |

**RWS7: MONETARY POLICY FACT SHEET**

**TASK:** Read this sheet, ready for an assessment in class and to be able to answer the end of pack questions

In recent years monetary policy has used tools other than interest rates to manage UK aggregate demand, such as “quantitative easing” which is where the Bank of England effectively increases the money supply by ‘printing more money’. Interest rates are used less today because interest rates have been reduced to very low numbers – it is currently at 0.25%. Just like Fiscal Policy, Monetary Policy is a demand-side policy as the policymakers are trying to influence aggregate demand.

**Expansionary and Contractionary Monetary Policy**

**(1)** Expansionary Monetary Policy (also known as inflationary or looser monetary policy)

This involves cutting interest rates in order to boost aggregate demand.

* **Boost consumption** as there is less incentive for consumers to save due to a lower reward for saving. There is also, more incentive to borrow as credit is cheaper and more incentive to consume if home-owners gain higher disposable income as they are on variable rate mortgages (so they have to pay back less on their loan every month which leaves more money for consumption).
* **Boost investment** as there is less incentive for businesses to save money in the bank due to low returns on saving and there is more incentive to borrow to finance investment as the cost of borrowing is lower.
* **Boost net exports** as lower interest rates means less foreign investors will put money into UK banks thus reducing the demand for the pound and reducing the exchange rate. A lower exchange rate will make imports more expensive and exports cheaper. This should boost UK net exports assuming demand is elastic a drop in price of exports will boost export revenues and a rise in price of imports will reduce import revenues.

**(2)** Contractionary Monetary Policy (also known as deflationary or tighter monetary policy)

This involves raising interest rates in order to reduce aggregate demand. The opposite of above!

**The Role of the Bank of England**

* **Bank of England and the UK’s Financial System:** The Bank of England is in charge of the banking system in the UK. Commercial, or High Street banks are ones like HSBC, NatWest, Lloyds etc, who we come into contact with on a day to day basis. At the end of every day some of these commercial banks will be short of money, and so may need to borrow. The Bank of England has the role of ‘Lender of Last Resort’, and will lend to these commercial banks if they are short of funds. When we refer to ‘the interest rate’ we are talking about the Base Rate (also called the Discount Rate), which is the rate of interest the Bank of England charges commercial High Street Banks when it lends them money. In reality there are lots of different interest rates, for instance mortgage rates, interest rates for different credit cards, interest rates for car loans, and the interest rate you earn if you save money. When the Bank of England changes the Base Rate, this causes all the commercial banks and other financial institutions to change their interest rates in the same direction. So, if the Bank of England announces it is raising the Base Rate by 1%, the High street banks will all put up their interest rates too. The Bank of England is also responsible for controlling the money supply and has the sole monopoly on printing money. This was granted to it by the Government in 1694.
* **The Inflation Target and Bank Independence:** In 1997 the Bank of England was granted independence and given the task of achieving an inflation target using interest rates. The inflation target is a Government-set goal set by the Chancellor, currently allowing inflation of 2% (plus or minus 1%) using the CPI measure. If inflation deviates significantly from the target, the Governor of the Bank of England must write an open letter to the Chancellor explaining the reasons why inflation has moved away from the target and the policy action being taken to deal with it. Low inflation benefits the UK economy as it promotes price stability and therefore helping boost investment, growth and employment. It also helps control the cost of living, especially important for those on low incomes. It will also maintain the UK’s international competitiveness as UK goods should be more competitive.
* **The Monetary Policy Committee (or MPC):** Every month the Monetary Policy Committee of the Bank of England meets to decide on the appropriate monetary policy in order to meet the inflation target. They consider all the data about the UK economy and assess the possible level of inflation in two years time (the medium term). They will then vote on what to do with monetary policy that month. It is important that they look at inflation in two years time as 18-24 months is the perceived time lag when using interest rates for the full effects to occur. For example, if inflation is likely to be below target in two years they will cut interest rates (or use quantitative easing) in order to boost AD and get inflation back into the target range.

**Quantitative Easing and ‘The Liquidity Trap’**

* **Liquidity Trap:** Keynes famously said that monetary policy was ineffective in stimulating aggregate demand if it got too low. A scenario of negative interest rates is very unlikely (so it costs you money to put your money in the bank and the bank ends up paying you to take out a loan!). Therefore interest rates cannot go below 0 and so as they are reduced to this, their use as a demand side policy becomes less effective as despite low interest rates, people decide to hang onto their money and thus there is very little ‘liquidity’ of credit in the system. There is in effect a credit crunch.
* **Quantitative Easing**: In recent years, the Bank of England has therefore used ‘quantitative easing to boost AD. This involves the Central Bank increasing the money supply and using these electronically created funds to buy government bonds or other securities from savers. This then injects a greater money supply into the economy in the hope of getting banks to lend again.

**RWS7: FISCAL POLICY FACT SHEET**

**TASK:** Read this sheet, ready for an assessment in class and to be able to answer the end of pack questions

Remember, fiscal Policy is the use of Government spending and taxation to influence the level of aggregate demand. Although changes in fiscal policy may influence aggregate supply this will be covered when we look at supply-side policies (or as an evaluation point).

**Expansionary and Contractionary Fiscal Policy**

**(1)** Expansionary Fiscal Policy (also known as inflationary or looser fiscal policy): Expansionary fiscal policy aims to increase aggregate demand. These policies will increase the budget deficit or reduce the budget surplus. Therefore it involves:

* Increasing Government spending: which boosts AD directly
* Cutting income tax: which increases disposable income, consumption and AD
* Cutting corporation tax: which increases profits, investment and AD

**(2)** Contractionary Fiscal Policy (also known as deflationary or tighter fiscal policy): Contractionary fiscal policy aims to decrease aggregate demand. These policies will decrease the budget deficit or increase the budget surplus. Therefore it involves:

* Decreasing Government spending: which reduces AD directly
* Raising income tax: which decreases disposable income, consumption and AD
* Raising corporation tax: which decreases profits, investment and AD

**Fiscal Policy: the ‘Multiplier Effect’ and Automatic Stabilisers**

* **Positive Multiplier Effect:** If the Government increases the budget deficit (e.g. via Government spending increases), then it will be injecting more money into the economy. This injection of money into the economy will have a multiplier effect associated with it. This means that AD may increase by more than the initial injection from Government spending. For example: Government subsidises a firm - More Government spending 🡪 more firms & employment 🡪 more income for employees 🡪 more consumption 🡪 more profits 🡪 more investment 🡪 expansion & more jobs 🡪 …etc.
* **Negative Multiplier Effect:** If the Government decides to reduce the budget deficit (as they currently trying to do) then this will reduce AD due to there being less money injected into the economy than last year. However, there will be further knock-on effects again due to the multiplier effect but this time negatively. For example, if there is less Government spending then there is likely to be fewer public sector jobs. This means these workers will have less income, which will lower their spending. Therefore local businesses will have less profit and may go out of business in the long-term. This would then lead to fewer jobs and further effects on income, consumption and profits.
* **Automatic Stabilisers:** Automatic stabilisers refer to how fiscal instruments (tax and government spending) will influence the rate of growth and help counter swings in the economic cycle. For example in a period of high growth, automatic stabilisers will help to reduce the growth rate to prevent too much inflation. With higher growth, the government will receive more tax revenues – people earn more and so pay more income tax (note the tax rate doesn’t change, the amount received just becomes higher). With higher growth, there will also be a fall in unemployment so the government will spend less on unemployment benefits. This will create less of a budget deficit or more of a surplus and slow down AD. Alternatively, in a recession, economic growth becomes negative. However, automatic stabilisers will help to limit the fall in growth. With lower incomes people pay less tax, and government spending on unemployment benefits will increase. This increase in benefit spending and lower tax helps to limit the fall in aggregate demand by increasing the budget deficit.

**Debt of the Government**

* **The National Debt:** The UK national debt is the total amount of money the British government owes to the private sector and other purchasers of UK gilts. In September 2016 Public sector net debt is £1,627.2 billion, or 83.3% of GDP
* **The ‘Deficit’:** This is the amount the Government has to borrow each year to make up for a shortfall in taxation. Every year that the Government is in deficit, the higher the ‘national debt’.
* **How do Government’s borrow money?** Governments issue treasury bills or ‘gilts’ or Government ‘bonds’ to consumers (savers), firms and ‘foreigners’. The idea is that the Government will issue you a £1000 gilt. A saver buys up the gilt and gives the Government £1000 (who can then spend it). In return, the Government will provide a ‘yield’ or rate of interest on that gilt or bond which the saver will receive each year. At the end of the terms of the gilt/bond, the Government pay back the initial amount. The level of interest the Government has to pay will depend on how secure the Government is (both in terms of power, the state of the economy and also how large the overall ‘national debt’ is.

**Era of Austerity**

After the 2007 Financial Crash, the UK economy descended into a recession from 2008 Q2 for 1 year. This led to large increases in unemployment and a fall in living standards for many in the UK. To prevent the problems caused by the banks, the Government’s national debt ballooned from 38% of GDP to 76% of GDP as they ‘bailed out the banks’. In 2010, a Coalition Government spearheaded by the Conservative Party, started a policy of ‘Austerity’. Austerity involves policies to reduce government spending and or higher taxes in order to try and reduce government budget deficits. Arguably it meant that our borrowing costs in the future would be lower as the Government were However critics pointed to one of the slowest recovery’s have seen lasting until 2013 as AD was not allowed to increase very much.

**RWS7: FISCAL AND MONETARY POLICY DATA**

**FISCAL: Government Spending (spending by the government on various areas – usually through government departments)**

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| **Welfare Payments** |  |

TASK: Calculate the percentage of welfare payments which state pensions make up. Then calculate the percentage that unemployment benefit makes up. Does this surprise you?

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**FISCAL: Government Taxation (income revenue for the government through a series of different taxes)**

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|  | * **NICs = National Insurance Contributions** * **North Sea = revenues from oil extraction by private companies** * **VAT = Value Added Tax – a sales tax on certain items (20%)** * **Sin Tax = Tax on alcohol and tobacco**   **TASK: What do you think is significant about this pie chart to the left?** |

**MONETARY: Bank of England Base Rates (The Core Interest Rate set by the Bank of England)**

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|  | **TASK: Explain why you think the Bank of England base rate looks like this? In other words explain why in 2008, the interest rate was slashed from 5% to 0.5%? What do you think the Bank of England’s rationale was for doing this?** |

**TASK: Complete the following scenario’s using AD/AS Diagrams after reading the two fact sheets above**

**(HINT: You are using the toolkit from the previous worksheet on macroeconomic equilibrium to help. Please just have a go as well.)**

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| **DIAGRAM**  (Make sure you have labelled the diagrams correctly) | **ROUGH NOTES OF EXPLANATION**  (Can be bullet points and symbols) |
| **1.** Draw a macroeconomic equilibrium with a negative output gap and explain how Keynes would reduce this gap. In other words, explain how the Government might use fiscal policy to return to long run equilibrium. |  |
| **2.** Draw an economy with a positive output gap. Show how the Bank of England might intervene to reduce demand-pull inflationary pressures using Monetary Policy. |  |
| **3.** Draw an economy in macroeconomic equilibrium with a negative output gap. Show how the use of demand side policies (either Fiscal or Monetary – you choose) might actually lead to a wage spiral effect. What has happened as a result of this policy ultimately? |  |

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| **DIAGRAM**  (Make sure you have labelled the diagrams correctly) | **ROUGH NOTES OF EXPLANATION**  (Can be bullet points and symbols) | |
| **4.** Using a diagram, explain how ‘automatic stabilisers’ might work in correcting an economy suffering from a recession. (HINT: You need to have read the FactSheets above and it refers to fiscal policy being the stabilising effect) |  | |
| **5.** Since 2010, the UK Government has had a fiscal policy of ‘Austerity’. Given that we suffered a recession before 2010, explain what effect ‘Austerity’ might have had on the economy from 2010 to 2013? |  | |
| **6.** The MPC are worried about inflationary forecasts for 2018which suggests there will be greater ‘cost-push’ inflation due to the weaker pound. HINT: Read FactSheet above if unsure about ‘MPC’ definition.  (i) Draw what ‘cost-push’ inflation would look like (if we assume we are at long run equilibrium) on an AD/AS diagram.  (ii) How could the MPC now respond to reduce these inflationary pressures? Draw this on the diagram to demonstrate a fall in the price level.  (iii) What problem might there be now for the UK economy with this response by the MPC? | |  |