WEC12 · Unit 2

Macroeconomics

Exam Revision Notes

Macro Objectives · Conflicts · Economic Growth · Demand-Side · Supply-Side · 20-Marker Plans

Edexcel International A-Level

1. Macroeconomic Objectives

KEY IDEA

Governments juggle four goals simultaneously — but the economy rarely allows all four to be achieved at once. The tension between them is what makes macro policy difficult.

The Four Core Objectives

Economic Growth — a sustained rise in real GDP. Target: ~2–3% per year in developed economies. Measured by the real GDP growth rate.

Low Unemployment — keeping unemployment low (full employment ≈ 4–5%, accounting for frictional/structural). Measured by ILO and claimant count methods.

Low and Stable Inflation — most central banks target ~2% CPI. Too high erodes real incomes; too low risks deflation. The UK MPC targets 2% CPI.

Balance of Payments Equilibrium — the current account should be broadly balanced over time. A persistent deficit signals the economy is consuming more than it earns abroad.

EXAM MATTERS

Always define any objective you use in a 20-marker — examiners award marks for accurate definitions. For evaluation, argue that governments often prioritise growth or inflation above the others.

2. Conflicts Between Macro Objectives

Phillips Curve Trade-off: Inflation vs Unemployment

KEY IDEA

When unemployment falls, workers gain bargaining power and wages rise — feeding through to higher prices. You cannot easily have low inflation and low unemployment simultaneously.

The short-run Phillips Curve (SRPC) shows an inverse relationship: cutting unemployment via AD stimulus causes inflationary pressure. Governments targeting growth push AD right, reducing unemployment but raising inflation.

↑ AD stimulus (e.g. cut interest rates) → ↑ Real GDP / ↓ Unemployment → ↑ Wage demands → **↑ Cost-push & demand-pull inflation**

REAL EXAMPLE

The UK in the late 1980s under Nigel Lawson saw a major AD boom that reduced unemployment below 6% — but inflation surged above 10% by 1990, forcing sharp interest rate rises and triggering a recession. This is a textbook Phillips Curve conflict.

MISCONCEPTION

Students often say 'high growth always causes high inflation.' This ignores supply-side improvements — if LRAS shifts right at the same rate as AD, growth can occur without inflation. Instead say: high growth causes inflationary pressure when the economy is near full capacity.

Growth vs Balance of Payments

KEY IDEA

Fast growth sucks in imports — when incomes rise, consumers and firms spend more on foreign goods, worsening the current account. Growth and a healthy trade balance often pull in opposite directions.

↑ Economic growth → ↑ Consumer incomes → ↑ Demand for imports (high MPI) → **Current account deficit widens**

EXAM MATTERS

For a high-marks evaluation, argue this conflict depends on the marginal propensity to import (MPI). Countries with strong domestic production sectors (e.g. Germany) can grow without worsening BoP. This is a Level 4 evaluation point.

All Key Conflicts — Quick Reference

Growth ↔ Inflation Expanding AD near full capacity causes demand-pull inflation. The closer to potential output, the more severe.	**Low Unemployment ↔ Low Inflation** Phillips Curve trade-off. Tight labour markets → wage-push inflation → CPI rises above target.
Growth ↔ Current Account Growth raises import demand (high MPI), worsening the current account balance.	**Inflation ↔ Current Account** High domestic inflation makes exports less price-competitive, worsening the trade balance.

CHAPTER TAKEAWAY

- The core trade-off is inflation vs unemployment — the SRPC shows that AD stimulus reduces unemployment but raises prices.
- Growth worsens the current account via rising import demand, especially if MPI is high.
- Conflicts are most acute when the economy is near full capacity — the output gap is key for evaluation.
- Supply-side policies can reduce conflicts by shifting LRAS right, enabling growth without inflationary pressure.

3. Economic Growth

Actual vs Potential Growth

KEY IDEA

Actual growth closes the output gap — the economy moves towards its productive frontier. Potential growth shifts that frontier outward by increasing the productive capacity of the economy itself.

Actual growth occurs when the economy uses more of its existing capacity — AD shifts right when a negative output gap exists. Shown as rightward movement inside the PPF.

Potential growth occurs when productive capacity increases — LRAS shifts right, PPF shifts outward. Caused by improvements in the quantity or quality of factors of production.

Investment in capital / technology → ↑ Productive capacity (LRAS shifts right) → Economy can grow without inflation → **Sustainable long-run growth**

Benefits and Costs of Growth

Benefits: Higher real incomes → improved living standards, more tax revenue for public services, lower cyclical unemployment, more R&D investment.

Costs: Can cause inflation if near full capacity, environmental damage (negative externalities), widening inequality if gains are unevenly distributed, depletion of natural resources.

MISCONCEPTION

Students say 'economic growth always improves living standards.' This ignores inequality and externalities — GDP per capita can rise while median incomes stagnate. Instead say: growth improves living standards if benefits are widely distributed and environmental costs are managed.

REAL EXAMPLE

China achieved ~10% GDP growth per year 1990–2010, lifting hundreds of millions out of poverty. However, it brought severe air pollution and rising income inequality (Gini coefficient rising from 0.30 to 0.49). Growth's benefits and costs must both be evaluated.

EXAM MATTERS

If asked about the desirability of growth, weigh short-run vs long-run. Growth driven by AD stimulus is short-run and inflationary; growth via LRAS shifts is sustainable and non-inflationary. The examiner rewards this distinction at Level 4.

CHAPTER TAKEAWAY

- Actual growth = closing the output gap; potential growth = shifting LRAS rightward — both are distinct mechanisms.
- Growth driven purely by AD is inflationary near full capacity; LRAS-driven growth is non-inflationary.
- Always evaluate growth against inflation, inequality, and environmental costs — never accept it as universally beneficial.

4. Demand-Side Policies

Fiscal Policy

KEY IDEA

The government controls the economy's temperature by adjusting its spending and tax levels — more spending or lower taxes puts heat in (expansionary); less spending or higher taxes cools it down (contractionary).

Expansionary fiscal policy involves increasing government spending (G) or cutting taxes (T), raising AD. The size of the effect depends on the fiscal multiplier.

The multiplier effect amplifies fiscal stimulus. An injection of £1bn of G can raise GDP by more if the MPC is high. Multiplier = 1 ÷ (1 − MPC).

↑ Government spending (G) → ↑ AD (C + I + G + X−M) → Multiplier effect raises incomes → **↑ Real GDP, ↓ Unemployment**

MISCONCEPTION

Students often say 'cutting taxes always boosts growth.' This ignores crowding out — if the government borrows to fund a deficit, it may crowd out private investment by raising interest rates. Instead say: fiscal stimulus is most effective when there is significant spare capacity and interest rates are already low.

EXAM MATTERS

Evaluate fiscal policy with: (1) size of multiplier depends on MPC; (2) crowding out — borrowing raises interest rates; (3) time lags — fiscal policy requires parliamentary approval. These three points each earn an evaluation mark.

Monetary Policy

KEY IDEA

Central banks don't control how much people spend directly — they control the price of borrowing. Cut interest rates, and borrowing becomes cheap, spending rises, and AD increases.

The Bank of England's MPC sets the base rate. Lower rates → cheaper mortgages and loans → more consumer spending (C) and business investment (I) → AD rises.

Quantitative Easing (QE) is used when interest rates hit the zero lower bound. The central bank buys government bonds from banks, increasing bank reserves and the money supply, pushing down long-term interest rates.

↓ Bank Rate → ↓ Cost of borrowing → ↑ Consumer spending & investment → **↑ AD → ↑ Real GDP**

REAL EXAMPLE

After the 2008 financial crisis, the Bank of England cut rates to 0.5% and launched a £375bn QE programme. Unemployment peaked at 8.4% but was prevented from rising further. However, QE inflated asset prices, benefiting wealthier households more than lower-income workers.

EXAM MATTERS

Evaluate monetary policy with: (1) time lags of 18–24 months for full effect; (2) the zero lower bound — rates cannot go much below zero; (3) effectiveness depends on confidence — in a recession, cheap credit may not stimulate if firms don't want to invest.

CHAPTER TAKEAWAY

- Fiscal policy shifts AD via G and T; effectiveness depends on the multiplier, crowding out, and time lags.
- Monetary policy shifts AD via interest rates; key evaluations are time lags, the zero lower bound, and confidence.
- Both policies only affect the demand side — they cannot shift LRAS or permanently boost potential output.

5. Supply-Side Policies

What Supply-Side Policies Do

KEY IDEA

Supply-side policies are the only tool that can shift LRAS right — increasing productive potential so the economy can grow without generating inflationary pressure.

Unlike demand-side policies, supply-side policies improve the quantity or quality of factors of production. This shifts LRAS rightward, raising potential output.

Two types: Market-based (lower taxes, deregulation, privatisation) and Interventionist (education, training, infrastructure investment).

Market-Based Supply-Side Policies

Lower income tax / reduce benefits: Increases the incentive to work — raises labour supply and reduces the natural rate of unemployment (NRU). The 'supply-side revolution' of Thatcher/Reagan in the 1980s.

Privatisation & deregulation: Transfers firms from public to private ownership / reduces entry barriers. Intended to increase competition, efficiency, and innovation.

Trade union reform: Limits wage bargaining power → reduces wage costs → lowers SRAS costs and improves competitiveness.

Lower income tax rates → ↑ Incentive to work → ↑ Labour supply / ↓ NRU → **LRAS shifts right → ↑ Potential output**

MISCONCEPTION

Students say 'privatisation always improves efficiency.' This ignores natural monopolies — utilities like water and rail have high fixed costs that make competition impractical. Instead say: privatisation works best in competitive markets; in natural monopolies it may just transfer monopoly power from public to private hands.

Interventionist Supply-Side Policies

Education & training: Improves human capital — a more skilled workforce is more productive, raising potential output and reducing structural unemployment.

Infrastructure investment: Roads, broadband, transport networks reduce firms' costs and raise productivity. Justification for government spending with long-run supply-side benefits.

R&D subsidies: Fund technological innovation → productivity improvements → LRAS shifts right without cost-push inflation.

↑ Education spending → ↑ Human capital (skills, productivity) → LRAS shifts right → **↑ Potential GDP, non-inflationary growth**

REAL EXAMPLE

South Korea invested heavily in education from the 1960s–1990s, raising tertiary enrolment from near-zero to over 70%. This is widely credited as a driver of the 'Miracle on the Han River' — GDP per capita rising from ~$100 to over $30,000 in two generations.

EXAM MATTERS

The biggest weakness of supply-side policies is time lags — education takes a generation to feed through. Also: market-based policies may increase inequality (Gini rises), while interventionist policies risk government failure. These are Level 4 evaluative points.

CHAPTER TAKEAWAY

- Only supply-side policies shift LRAS — they raise potential output without the inflationary pressure of AD expansion.
- Market-based: lower taxes, deregulation, privatisation → increase incentives and competition.
- Interventionist: education, training, infrastructure → improve human and physical capital.
- Key weakness for both types: very long time lags before effects materialise — ineffective as a short-run stabilisation tool.

6. Twenty-Marker Essay Plans

The 20-marker requires: definition → analysis (developed chains) → balanced evaluation → judgement. Aim for 4–5 paragraphs. Each analysis paragraph needs a full chain. Each evaluation must give a specific reason beyond 'however, it depends.'

Essay 1: Supply-Side Policies as Most Effective

"Evaluate the view that supply-side policies are the most effective way to achieve macroeconomic objectives."

INTRODUCTION — Define & Signpost

Define supply-side policies (policies to increase productive capacity / shift LRAS right). State the four macro objectives. Signpost: supply-side is highly effective for long-run, non-inflationary growth, but has significant weaknesses relative to demand-side tools in the short run.

ANALYSIS POINT 1 — Growth Without Inflation (Strongest Point)

Chain: Supply-side policies shift LRAS right → potential output rises → the economy can grow without demand-pull inflation → growth and price stability achieved simultaneously, resolving the core Phillips Curve conflict. Diagram language: 'LRAS shifts from $LRAS_1$ to $LRAS_2$, enabling a new equilibrium with higher real output and stable price level.'

ANALYSIS POINT 2 — Reducing Structural Unemployment

Chain: Education/training raises human capital → workers acquire skills matching labour market demand → structural unemployment falls → employment objective met without AD stimulus → avoids wage-push inflation that AD-driven approaches would cause.

EVALUATION 1 — TIME LAGS (COUNTER THE SSP CASE)

Chain: Education takes 12–18 years to raise human capital → infrastructure projects take years to tender and build → supply-side policies offer no short-run stabilisation → in a recession, governments need demand-side responses immediately. Conclusion: SSPs are complementary to, not a replacement for, demand-side tools in the short run.

EVALUATION 2 — INEQUALITY TRADE-OFF

Chain: Market-based SSPs (tax cuts, welfare reduction) increase incentive to work but reduce redistribution → income inequality rises (Gini coefficient increases) → worsens living standards for lower quintiles → undermines the equity objective. This undermines the claim that SSPs are 'most effective' overall.

EVALUATION 3 — DEPENDS ON THE OBJECTIVE

If the objective is controlling inflation in the short run → monetary policy (raising interest rates) is faster and more targeted than SSPs. If the objective is closing a deflationary output gap → fiscal stimulus is more direct. SSPs are most effective for long-run growth/unemployment, not short-run stabilisation.

JUDGEMENT — Final Paragraph

Overall, supply-side policies are the most sustainable route to achieving macro objectives — particularly growth and low unemployment without inflation — but they cannot work in isolation. Their effectiveness is severely limited in the short run by time lags. The most effective policy mix combines SSPs for long-run potential growth with demand-side tools for short-run stabilisation. The relative weight depends on the current stage of the economic cycle.

Essay 2: Conflicts Between Macro Objectives

"Assess the view that conflicts between macroeconomic objectives make it impossible for governments to achieve them all simultaneously."

INTRODUCTION

Define macro objectives (growth, low inflation, low unemployment, BoP equilibrium). Define 'conflict' — pursuing one objective makes another harder. Signpost: conflicts are real and unavoidable in the short run, but can be reduced in the long run via supply-side policy.

ANALYSIS 1 — Phillips Curve Trade-off (FOR the view)

Chain: Government cuts interest rates to reduce unemployment → AD rises → economy moves along SRPC → wage-push and demand-pull inflation rise → inflation exceeds target → Bank of England must raise rates → unemployment rises again. This shows the short-run trade-off makes simultaneous achievement very difficult.

ANALYSIS 2 — Growth vs Current Account (FOR the view)

Chain: Fiscal stimulus raises household incomes → marginal propensity to import (MPI) means spending rises on foreign goods → import spending rises faster than exports → current account deficit widens → growth objective conflicts directly with BoP equilibrium.

EVALUATION 1 — LRAS SHIFTS CAN DISSOLVE THE CONFLICT (AGAINST THE VIEW)

Chain: Supply-side policies shift LRAS right → potential output rises → the economy can grow with lower unemployment AND stable inflation → the short-run Phillips Curve shifts inward → the NRU falls. This suggests conflicts are not inevitable in the long run with the right policies.

EVALUATION 2 — CONFLICTS VARY BY ECONOMIC CONDITIONS

Chain: When there is a large negative output gap (e.g. 2009 recession), spare capacity allows the government to stimulate growth AND reduce unemployment without significant inflation (AS is relatively flat). Conflicts are sharpest near full capacity. The word 'impossible' is too absolute.

EVALUATION 3 — GLOBALISATION AND BOP

Chain: Export-led economies (e.g. Germany) can achieve growth without worsening the current account if domestic production is competitive and MPI is low. The BoP conflict is not universal — it depends on the industrial structure of the economy and exchange rate competitiveness.

JUDGEMENT

Conflicts between macro objectives are real and significant in the short run — particularly the inflation/unemployment trade-off and growth/BoP conflict. However, the claim that it is 'impossible' to achieve them simultaneously is too strong. With supply-side policies expanding productive capacity, and demand-side tools calibrated to the position in the cycle, objectives can be broadly achieved. The feasibility depends on the economy's position relative to potential output, its industrial structure, and the time horizon considered.

Essay 3: Demand-Side Policies for Economic Growth

"Evaluate the effectiveness of demand-side policies in achieving economic growth."

ANALYSIS 1 — Fiscal Multiplier (FOR)

Chain: ↑ G → AD shifts right → multiplier amplifies effect → real GDP rises by more than initial injection → unemployment falls. Most effective when MPC is high and there is significant spare capacity (negative output gap).

ANALYSIS 2 — Monetary Policy Transmission (FOR)

Chain: ↓ Interest rates → ↑ C and I → AD rises → real GDP → growth achieved. QE extends this when rates hit the zero lower bound by expanding the money supply and reducing long-term borrowing costs.

EVALUATION 1 — ONLY CREATES ACTUAL, NOT POTENTIAL GROWTH

Demand-side policies cannot shift LRAS → they only close the output gap → once at full capacity, further AD stimulus is purely inflationary → demand-side tools cannot deliver long-run sustainable growth alone. Supply-side policies must complement them.

EVALUATION 2 — CROWDING OUT & CONFIDENCE

Fiscal expansion via borrowing → higher interest rates → crowds out private investment (I↓) → net effect on AD is smaller than intended. Monetary policy equally limited if business confidence is low — 'pushing on a string.'

EVALUATION 3 — TIME LAGS AND POLICY CONFLICTS

Fiscal policy: 12–18 month implementation lag via parliament. Monetary policy: 18–24 month transmission lag. By the time the policy works, the economic cycle may have moved on, creating pro-cyclical effects that destabilise rather than stabilise the economy.

JUDGEMENT

Demand-side policies are effective at stimulating actual growth in the short run, particularly during recessions with large output gaps. However, they are insufficient for long-run sustainable growth because they cannot shift LRAS. The most effective approach combines demand-side stimulus in the short run with supply-side reform to expand potential output over time. The effectiveness also depends critically on the size of the output gap, the level of consumer/business confidence, and whether interest rates have already hit the zero lower bound.