2.6.2 Demand-side policies

a) Distinction between monetary and fiscal policy
b) Monetary policy instruments:
- *interest rates*
- *asset purchases to increase the money supply (quantitative easing)*

c) Fiscal policy instruments:
- *government spending and taxation*

d) Distinction between government budget (fiscal) deficit and surplus
e) Distinction between, and examples of, direct and indirect taxation
f) Use of AD/AS diagrams to illustrate demand-side policies
g) The role of the Bank of England:
- *the role and operation of the Bank of England's Monetary Policy Committee*

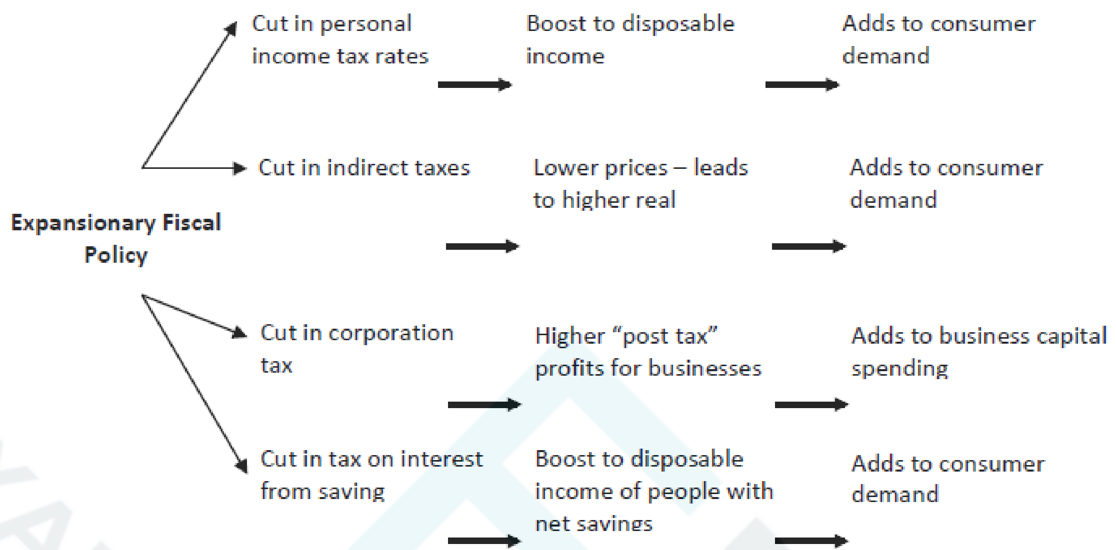
h) Awareness of demand-side policies in the Great Depression and the Global Financial Crisis of 2008
- *different interpretations*
- *policy responses in the US and UK*

i) Strengths and weaknesses of demand-side policies

- Demand-side policies: any deliberate action taken by governments or monetary authorities to shift the aggregate demand curve
- Monetary policy: involves the use of interest rates and quantitative easing to control the demand and supply of money and credit
- Fiscal policy: the manipulation of government spending and taxation in order to change aggregate demand
- Changes in fiscal policy affect AD and AS
- Monetary policy instruments
    - Interest rates: If aggregate demand needs to decrease (left shift), the interest rate is raised so C, I and (X-M) decrease. If aggregate demand needs to increase (right shift), interest rate is cut so C, I and (X-M) increase. There are multiplier effects, increasing the impact of change.
    - Asset purchases to increase money supply (quantitative easing): After 2008, interest rates weren't enough to stimulate AD so monetary authorities purchased long-term assets in the money or capital markets. As demand for these assets increased the price rises, so bond dividend yield falls; the amount of dividend relative to the price of the bond falls. This is the same impact as cutting interest rates, but has a direct effect on money markets. It means the bonds are more useable in the market because more people want to buy them the holders of the bonds now they can be sold. It can restart money markets and is therefore used in a credit crisis
- The short-term base interest rate is set by the monetary policy committee (MPC) of the Bank of England, which meets every month to look at factors that will tend to make prices rise and fall over the coming 18 months or more. The committee votes to determine the rate
- Interest rates: they show the cost of borrowing and the reward for saving
- Factors affecting the cost of borrowing:
    - Mortgages
    - Loans
    - Credit card repayments

- High interest rates reduce the inflationary gap
- In response to the 2008 financial crisis the MPC spent £375 billion (2009-2012) with further spending in 2016 after the 'Brexit vote. The Federal reserve in the US spent $3.7 trillion (2008-2015).
- From the data about spending after the financial crisis we can see the USA policy response to the global financial crisis has been far greater than the UK, and as many argue that is why the US economy recovered more quickly than the UK
- Fiscal policy instruments:
    - A budget is used to lay out fiscal spending. There can be a budget/ fiscal deficit or a fiscal surplus
    - A rise in direct taxes could mean reduced incentives to work hard, whilst if indirect taxes are raised, the cost of living increases, particularly for lower incomes because the tax will be a higher proportional of overall income
- Aims of fiscal policy:
    - Financing government spending
    - Changing final income and wealth
    - Providing a welfare state safety-net
    - Managing the economic cycle
    - Improving long run competitiveness
    - Tackling market failure
- A fiscal deficit is where G is greater than T. This has an expansionary effect on AD with multiplier effects which is shown by a right shift in the AD curve.
- A fiscal surplus is where G is less than T which has a contractionary effect on AD, with multiplier effects which is shown by a left shift in the AD curve
- Types of taxes: direct taxes (on incomes) such as income tax and corporation tax, and indirect taxes (on spending) such as VAT
- Bond yield: The rate of interest paid on government debt
- Cyclical fiscal deficit: the size of the deficit is influenced by the state of the economy
- Structural fiscal deficit: the deficit not related to the health of the economy which doesn't disappear when the economy improves
- Strengths of demand-side policies (according to Keynesian economics):
    - Demand-side policies are the only way to get a country out of demand-deficient unemployment and stagnation, at least in the short run
    - If the multiplier is large, they can have a significant impact on growth
    - If there is spare capacity, the economy can grow quickly
    - If used to control demand-pull inflation, they can act quickly and solve the problem
- Weaknesses of demand-side policies (according to Keynesian and classical economics)
    - Expansionary demand-side policies only cause inflation in the long run
    - The multiplier might be so low that they have little effect
    - If there is no spare capacity, then supply-side policies are needed instead in order to achieve economic growth
    - The government can end up running a huge deficit, which adds to national debt, and can be unsustainable (Greece from 2009)

- Monetarists believe fiscal policy only has temporary effects on AD and monetary policy is more effective in controlling inflation and maintaining macroeconomic stability



- Discretionary fiscal policy: deliberate changes in direct and indirect taxation and government spending
- Automatic stabilisers: changes in tax revenues and government spending that come about as an economy moves through the business cycle
- Fiscal policy in a boom:
    - Discretionary fiscal policy: contractionary/ tight/ deflationary fiscal policy (high taxes, low spending)
    - Automatic stabilisers: spending falls as there are lower welfare payments and taxes revenues are higher
- Fiscal policy in a recession:
    - Discretionary fiscal policy: expansionary/ loose/ reflationary fiscal policy (low taxes, high spending)
    - Automatic stabilisers: spending increases as there are more welfare payments and tax revenue falls