presentation 10
Using the RM

Demand-side policies

In case of a fall in output in region 1, the state can use demand-side policies to stimulate the economy. Here is the example of a fiscal stimulus:

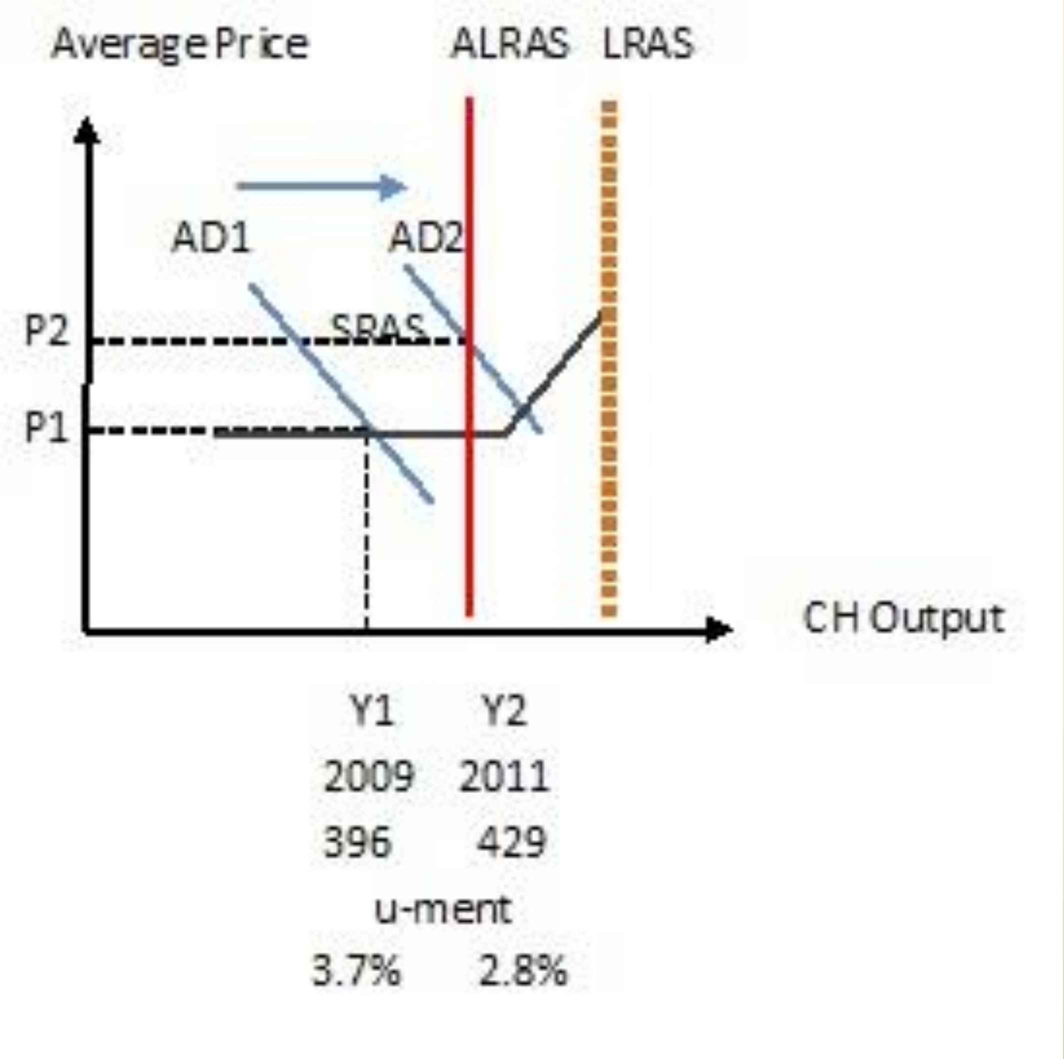
1. economy at (P1, Y1)
2. tax cuts or additional expenditure G↑: AD shifts rightwards at (P2, Y2)
3. price level rises from P1 to P2: goods/services are more expensive
4. as a result C ↓
5. AD shifts leftwards to (P1, Y1)
6. production is reduced; this could be resisted but firms will seek to lower prices instead
7. price level will be reduced from P2 to P1

As output

increases,

u-ment

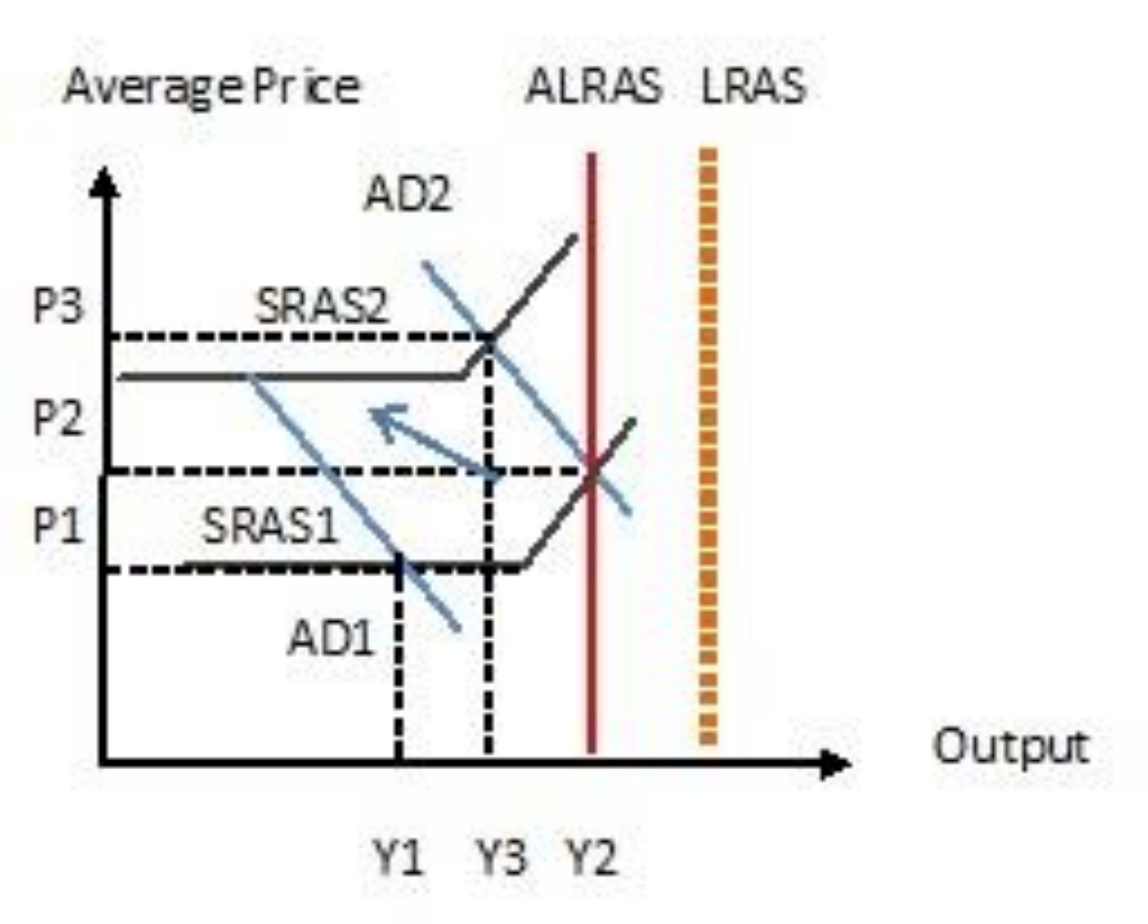
decreases



But the problem of demand-policies is that they can be inflationary. Here is the likely scenario:

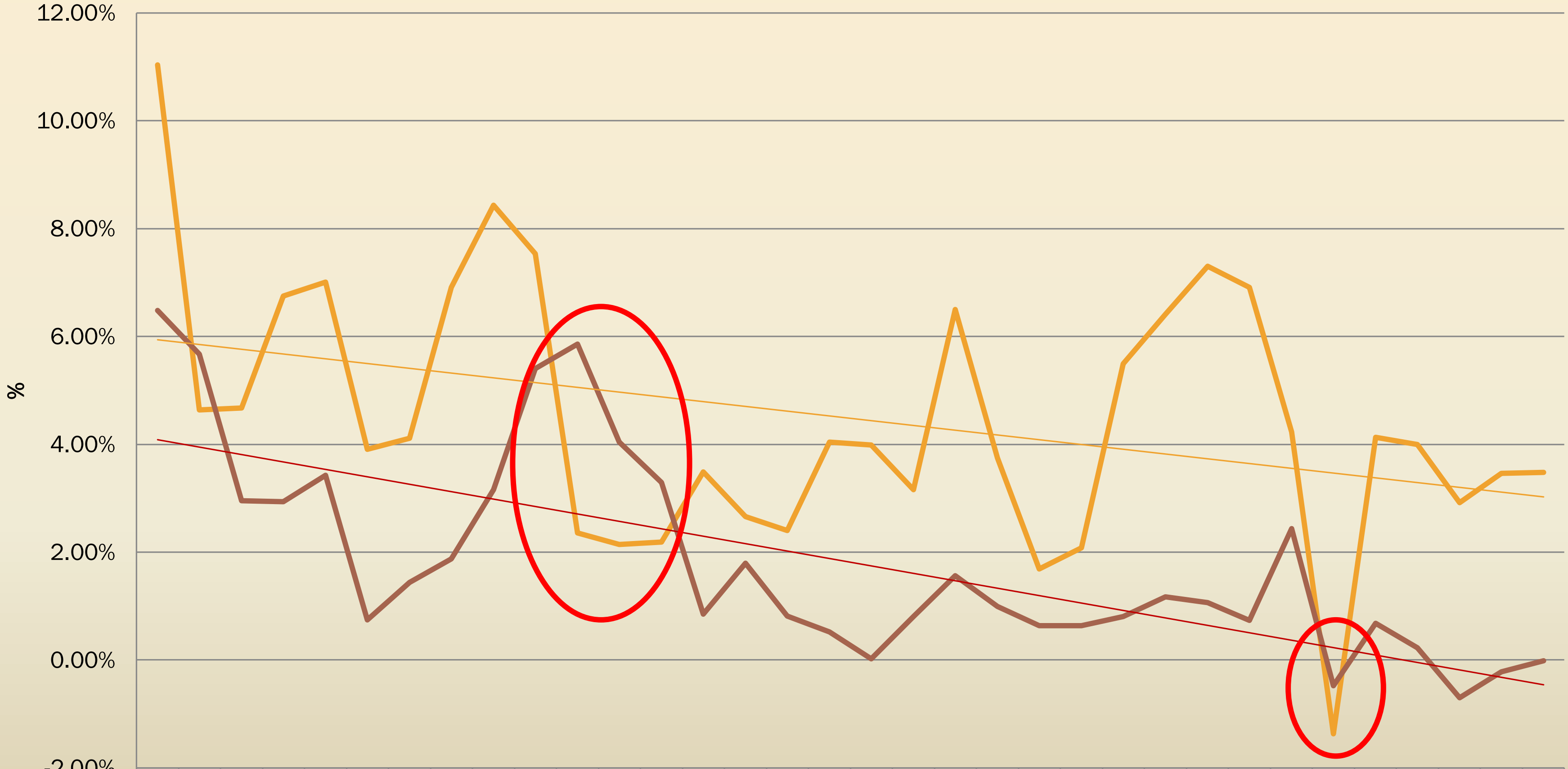
1. economy at (P1, Y1)
2. additional expenditure e.g. G↑: AD1 shifts rightwards to AD2
3. price level rises from P1 to P2: goods/services are more expensive
4. as a result C ↓
5. production is reduced but firms want to keep to the same prices = leftward shift in SRAS1 to SRAS2
6. price level will be increased from P2 to P3

A decrease in production spurs inflation = stagflation e.g. CH



Y	GDP	i-rate
2007	385	0.7
2008	401	2.4
2009	396	-0.4

CH GDP% VS IRATE%



	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
GDP%	11	4.	4.	6.	7.	3.	4.	6.	8.	7.	2.	2.	2.	3.	2.	2.	4.	3.	3.	6.	3.	1.	2.	5.	6.	7.	6.	4.	-1	4.	4.	2.	3.	3.
IRATE	6.	5.	2.	2.	3.	0.	1.	1.	3.	5.	5.	4.	3.	0.	1.	0.	0.	0.	0.	1.	0.	0.	0.	0.	1.	1.	0.	2.	-0	0.	0.	-0	-0	-0

But why is inflation such an issue?

Since inflation is an average increase in prices, it means that

- The cost of living increases relative to wages
- The value of money falls i.e. the money one holds is worth less relative to the value of the goods/services

Supply-side policies

Since demand-side policies are inflationary what should the state do?

It can use supply-side policies which means

- improving industries
- educating workers (positive externality)
- RnD
- cuts in corporate taxes

Inflation has been

reduced but not u-ment;

why?