- If confidence is lost in the government's ability to repay the debt, interest rates may rise to encourage investors to buy bonds in order to finance the debt
- Can lead to higher taxes and more cuts

Discretionary fiscal policy:

This involves deliberate changes in government expenditure and taxes with the intention of influencing aggregate demand

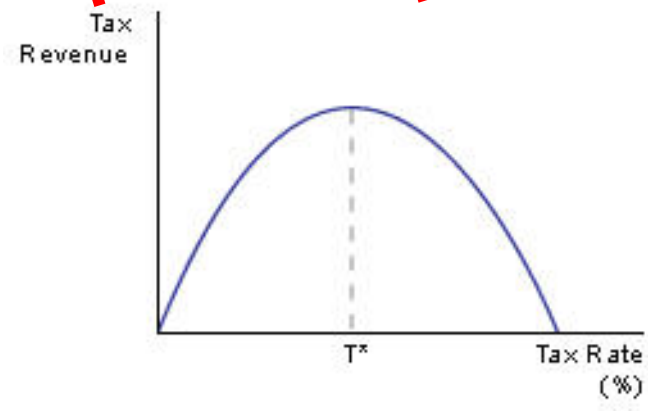
Expansionary Fiscal Policy:
This aims to increase aggregate demand. Government will increase spending or reduce taxes. It will lead to a worsening of the deficit

Contractionary Fiscal Policy:
This aims to decrease aggregate demand in order to reduce inflation - often in the form of tax raises and spending cuts

Limitations of Fiscal Policy:

- Governments may have imperfect information about the economy - leads to inefficient pending
- There is a time lag - it can take months or years to take effect
- The government borrowing from the private sector can lead to fewer funds available for the private sector and so crowding out
- The bigger the size of the multiplier, the bigger the effect on AD and the more effective the policy
- If interest rates are high, fiscal policy may not be effective for increasing aggregate demand
- If the government spends too much it can make it difficult to pay back the debt - making it difficult to finance future spending

The Laffer Curve
This shows how much tax revenue the government receives at each level of tax



The Laffer Curve shows that after a certain point, tax is too high and so it acts as a disincentive to pay taxes and so the government gets less revenue

Automatic stabilisers:
These are policies that offset fluctuations in the economy. They are triggered without government intervention.
e.g. during a recession, they limit the extent of negative economic growth

Inflation

Inflation:
The sustained rise in the general price level over time (the cost of living increases, and the purchasing power of money decreases)
In the UK, the government target for inflation is 2%

Deflation:
When the average price level in the economy falls, e.g. a change from 2% to -1%

Disinflation:
When the average price level is still rising but at a slower rate, e.g. a change from 4% to 2%

Hyperinflation:
When the rate of inflation is high and accelerating in an out of control manner

We measure inflation using 2 different measurements:

Consumer Prices Index - CPI

- This involves using a basket of goods that is weighted according to how much income is spent on each item
- Each year the basket is updated to allow for changes in spending patterns

Advantages of the CPI:

- It is widely understood by firms and households
- It helps to form future expectations about future price changes
- Can be used for international comparison

Limitations of the CPI:

- The basket of goods is only representative of the average household, so therefore it does not represent, for example those who own cars (14% of incomes spent on this)
- Different demographics have different spending patterns
- Housing costs account for 16% but this can vary greatly between family
- The CPI is very slow to respond to new goods and services
- It is very hard to make historical comparisons due to major advances in technology

Retail Price Index - RPI:

- RPI is the same as CPI, however it also includes housing costs such as mortgage payments
- It is better for comparisons over time as it has been used for longer
- CPI is more accurate when comparing between European countries

Limitations of the RPI:

- It excludes households in the top 4% of income
- The information given by households can be inaccurate
- The basket only changes once a year, so it may miss some short-term changes

Causes of Inflation:
Demand-pull Inflation:
This occurs when aggregate demand grows faster than long run aggregate supply

Implications:

- ΔM = ΔP
- ΔM - ΔY = ΔP
- If demand increases but supply does not, you will get rising prices due to excess demand, and thus inflation
- Increases in the money supply go to the economic agents, thus meaning they have more to spend - INFLATION IS DEMAND-PULL

Policy Implications:

- The policy - track and control the growth of the money supply relative to output
- Used in the 80's but didn't work - how to define and measure MS?, banks got around regulation etc.
- Now, B of E do study/track changes in MS as an indicator of future spending

Criticisms:

- It hasn't fitted UK experience since mid 80's
- Is the direction of casualty correct? - higher prices could require more money to service them?
- Assumes economy at near/full employment - ignores spare capacity (think about Keynesian inflation diagram)
- Is velocity stable?
- Assumes MS can be controlled and is set by central bank. In reality, there are many different measures and types of money
- The economy must have these characteristics:
    - An exogenous money supply
    - Full or near full employment
    - High capacity utilization
    - Relatively closed to trade
    - Stable velocity of circulation

However, there has never been a hyperinflation without the MS being significantly increased - suggests that QE could lead to hyperinflation

Opinions on Recessions:

Hysteresis:

- When an economy is disabled by a recession there is a big risk of a permanent loss of national output
- Loss of productive capacity due to low capital investment and many business closures
- High rates of structural unemployment may cause a shrinking labour force perhaps through outwards migration
- RECESSIONS CAN PERMANENTLY DAMAGE CAPACITY

Creative Destruction:

- Recessions can cast a dark shadow but capitalist market economies usually bounce back eventually
- Recessions prompt the emergence of new business models and an increase in start-ups
- New technologies can act as a catalyst for renewed economic growth and investment
- CHANGES IN CIRCUMSTANCES LEAD TO NEW WAYS OF DOING THINGS