Syllabus Item:

Webnote 263

SYLLABUS REFERENCE 3.7: Demand side policies[1]

- **Key role for Government**
- **Keynesian approach to Demand side management**

Demand side policies

AD = C+I+G+(X-M)

(A)

Demand side policies to shift AD outwards: **AD1 to AD2**

1. INCREASE **G** - Fiscal
2. DECREASE **T** -Fiscal
3. INCREASE Ms – open market operations (quantitative easing)
4. Decrease **R** –Monetary
5. Foreign income increases or exchange rate decreases
6. Expectations: inflation, income +profits

(B)

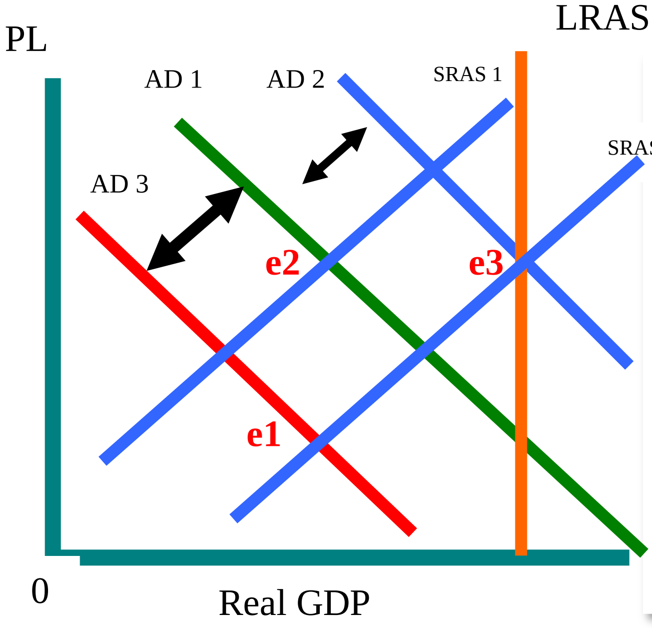
What is the economic problem ?

- The key problems are inflation / unemployment (= policy conflict. See web 409)
- While some agreement exists on both sides, for example the government must use fiscal + monetary policies to manage the economy, the difference is how the government uses policies i.e. to stimulate Aggregate Demand or Aggregate Supply.
- Monetarists favour the use of market led strategies
- Keynesians favour government led strategies. If the economy is at e3 Keynesian policy runs into trouble
- The best solution is probably a combination of policies that both sides put forward

(C) What can we conclude about Monetarists and Keynesian policy?

1. At some juncture the AS is vertical. See **diagram**. Therefore if the AD curve shifts in this vertical region the outcome will be higher inflation with no increase in employment / wealth / economic growth / output
2. A mixture of policies must be used to stimulate the economy or to manage the economy
   - Fiscal – taxes, spending, transfer payments
   - Monetary – interest rates/money supply
   - Legislative- minimum wage, anti-trust
   - Direct intervention e.g. setting wage rise restrictions or use of national pay agreements.
   - Foreign trade policy – higher or lower value for the currency
3. Where LRAS is vertical the only alternative is to shift the LRAS outwards i.e. increase the ability of the nation to produce more = shift the PPF
   - Requires more quantity and quality of capital and labour
   - More efficient resource allocation

AS/ AD Model



(D)

e1, e2 or e3?

Note: A key issue in managing an economy is the current state or equilibrium of that economy. Is the economy operating at e1, e2 or e3? This will influence which policies are best suited to use.

(E)

Shifts in AD

1. fiscal policy
2. monetary policy
3. exchange rates

- [1] See Webnote 330 on Fiscal policy.
- Reading: Peter Smith, "Growth and the government", Question and Answer 19(3), February 2002 .Reading: Peter Smith, "Fiscal policy and the macroeconomy", Question and Answer, 18(4), April 2001