Demand-side policies

Demand-side policies are used to influence aggregate demand (**AD**) in the economy. The two main types are fiscal policy and monetary policy .

What is Monetary Policy ?

Monetary policy is set by the **Bank of England** (The monetary policy committee) . It includes manipulating :

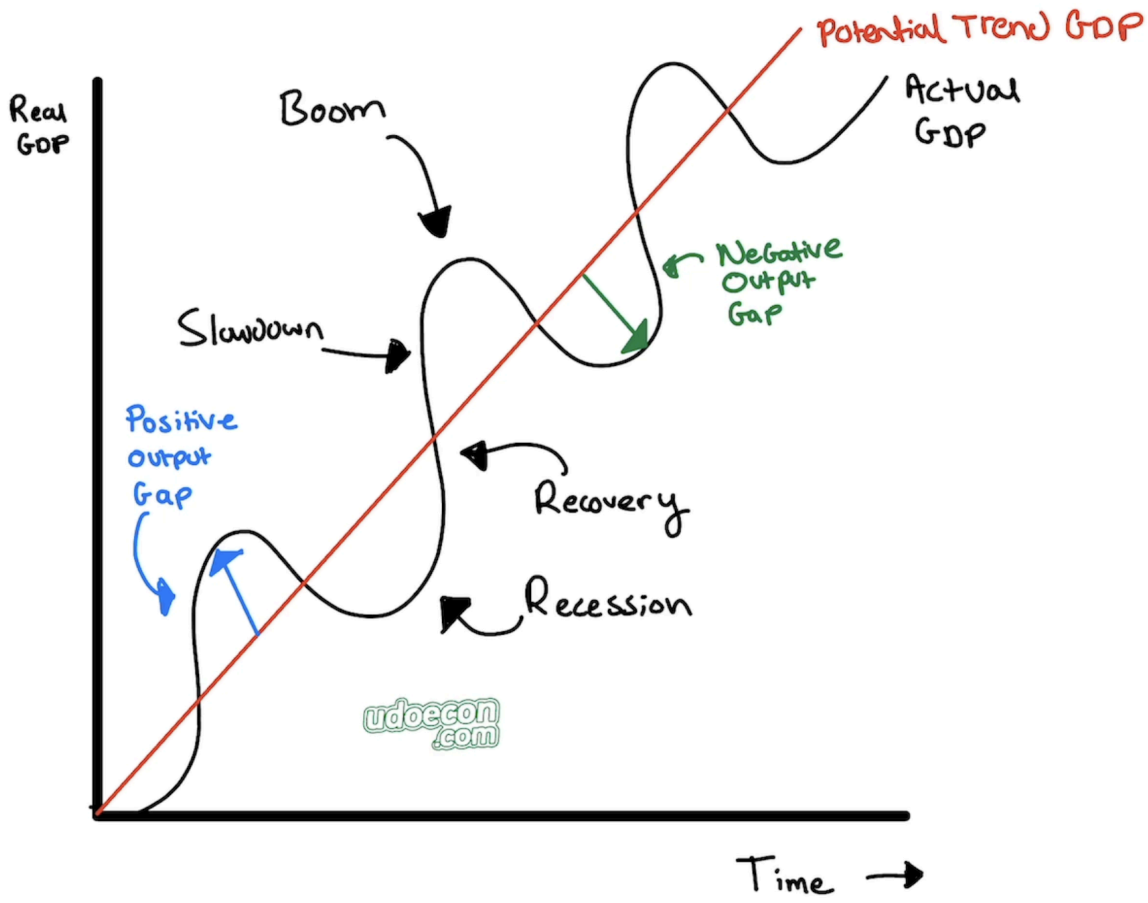
- Interest Rates
- Money Supply (Quantitative Easing)

What are the 2 types of demand side policy ?

There are 2 distinctions for each demand side policy e.g monetary policy can either be **expansionary** or **contractionary** .

Expansionary policies are used to **expand** the economy (shift out AD thus **increase** real gdp) . This is used to get the economy out of the **downturn** of the economic cycle e.g during a **recession** .

For example initially in covid lockdown hit , consumption significantly fell thus the UK was suffering from a large **recession** . The BOE responded to this by **cutting** interest rates to 0.1% (the lowest interest rates have ever been) and pursued **£895bn** worth of QE . On the other hand the UK govt pursued expansionary fiscal policy by lowering tax rates



Contractionary polices main aim is **not** to contract the economy (classic student misconception) , the main aim of contractionary policies is to reduce inflation rates and usually this leads to also decreasing economic growth (as AD shifting in primarily reduces inflation but also leads to negative economic growth) .

Contractionary policies are usually pursued during a boom when the level of demand pull inflation is getting out of hand .

For example in 2021 corporation tax increased from 19% to 25% (fiscal policy example) Also for example rates increased from 0.1% to 5.25% to tackle inflation that hit a 40 year high of 11.1% in 2022 (monetary policy example)

Interest rates and the transmission mechanism

Interest rates are the cost of borrowing and the reward for saving. When the MPC changes Bank Rate, high street banks usually adjust market interest rates across the economy.

If interest rates rise

This would be an example of contractionary monetary policy

Higher interest rates raise the reward for saving as more return on savings (Increasing MPS)

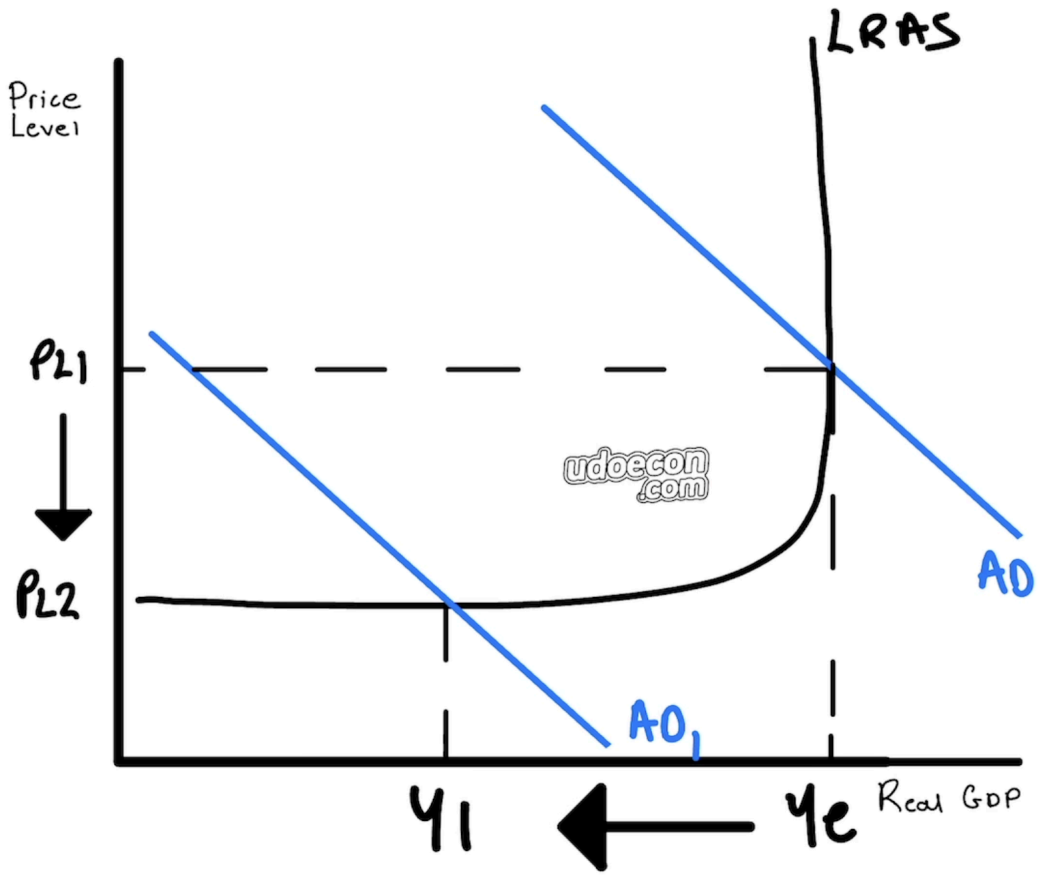
Increase the cost of borrowing(decreasing MPC), so AD tends to fall.

Consumption (C) is likely to fall because saving becomes more attractive and borrowing becomes more expensive. Households borrow less and spend less, so AD shifts left.

Investment (I) is also likely to fall because firms face higher borrowing costs. This reduces planned investment spending, which further shifts AD left.

Asset prices, especially housing, may fall due to higher mortgage costs reducing demand for houses . This can be exacerbated as with less demand for houses will lead to a fall in the equilibrium price of houses , which can create a negative wealth effect, lowering confidence and reducing consumption further.

The exchange rate may appreciate because higher interest rates can attract short-term financial inflows (hot money). A stronger currency makes exports more expensive and imports cheaper, so net exports (X−M) fall and AD falls further.



If interest rates fall

This would be an example of expansionary monetary policy.

Lower interest rates reduce the reward for saving as less return on savings (decreasing MPS)

Also reduces the cost of borrowing (increasing MPC), so AD tends to rise.

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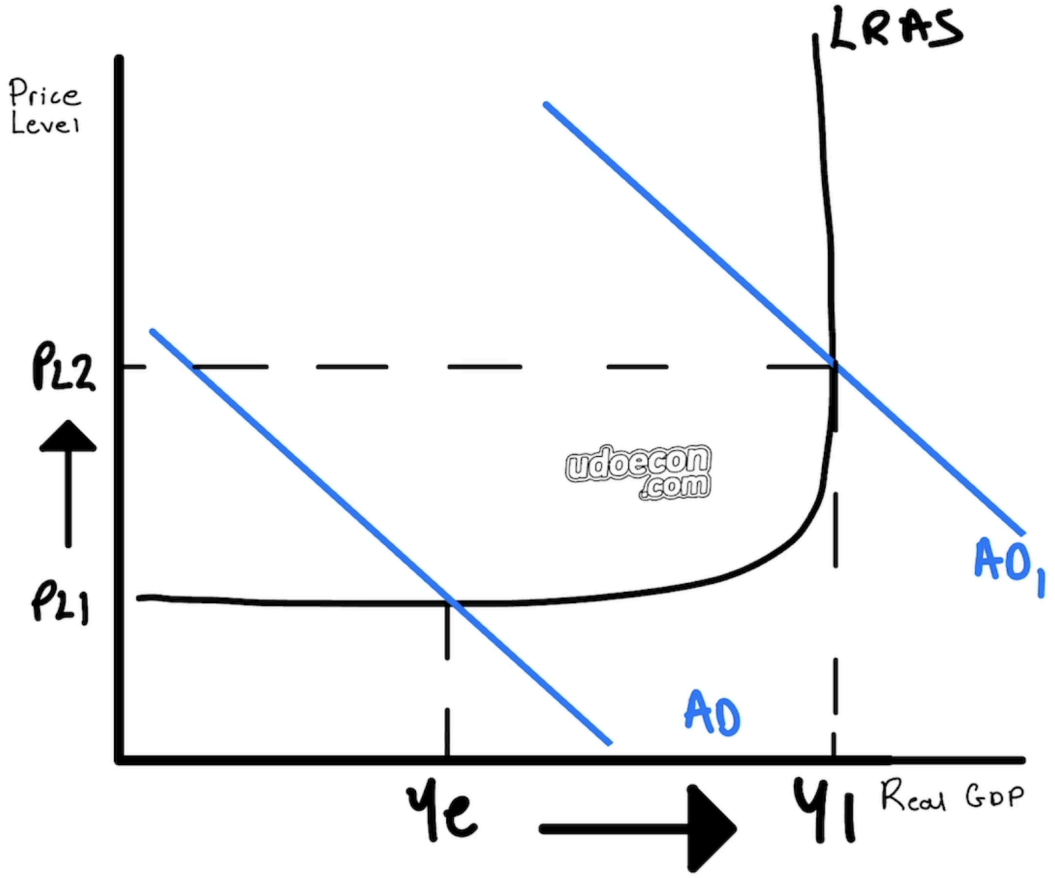
Consumption (C) is likely to rise because saving becomes less attractive and borrowing becomes cheaper. Households borrow more and spend more, so AD shifts right.

Investment (I) is also likely to rise because firms face lower borrowing costs. This increases planned investment spending, which further shifts AD right.

Asset prices, especially housing, may rise because lower mortgage rates increase demand for houses. Higher house prices can create a positive wealth effect, raising confidence and increasing consumption further.

The exchange rate may depreciate because lower interest rates make UK assets less attractive to short-term investors (hot money), reducing capital inflows (or causing outflows). A weaker currency makes exports cheaper and imports more expensive, so net exports (X−M) rise and AD increases further.



Quantitative easing (QE)

QE is when the central bank creates digital money and uses it to buy government bonds (gilts) from financial institutions. A government bond is effectively a loan to the government.

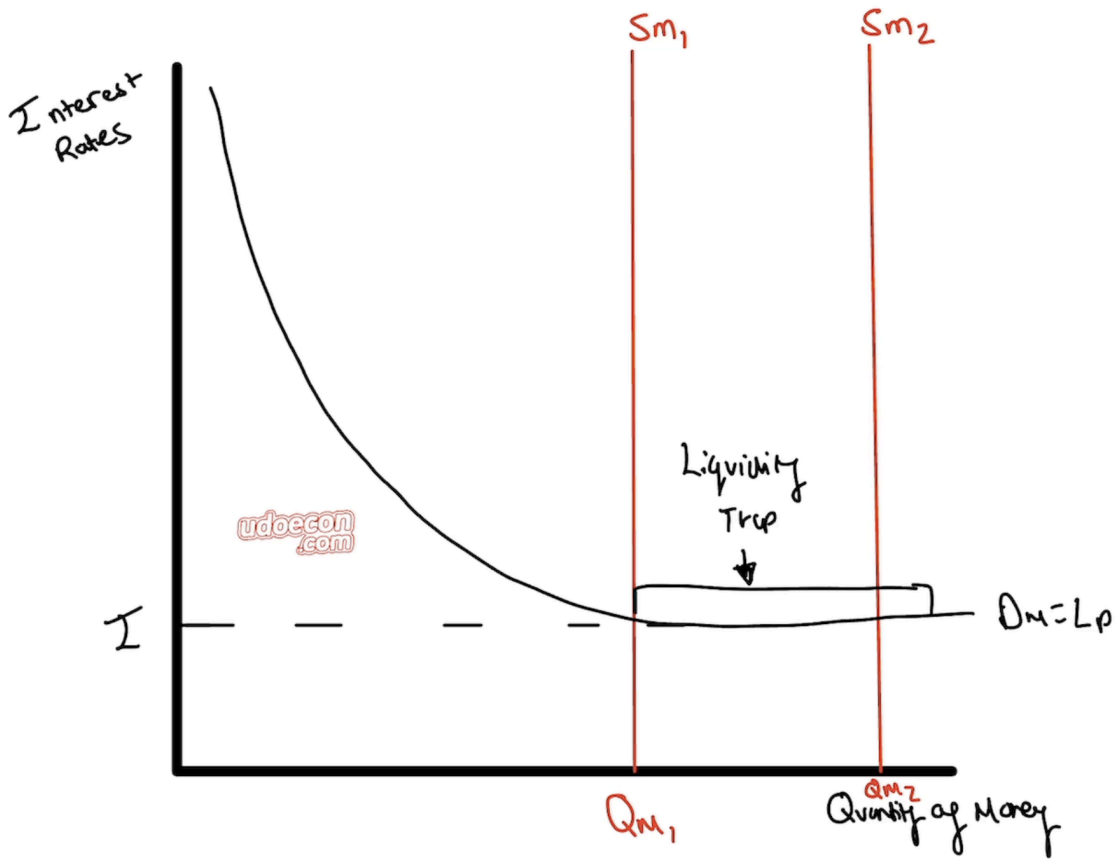
How QE increases AD

QE can increase AD through the following chain:

- Central bank creates digital money
- Buys government bonds from financial institutions .
- This increases demand for bonds, so **bond prices rise** and because the coupon **(fixed interest payment)** is fixed, **bond yields fall**.
- The institutions that sold the bonds now hold more cash, so liquidity increases and banks are more willing and able to lend
- Cheaper and easier credit increases household borrowing and spending and encourages firms to invest more, so **consumption (C) and investment (I) rise**, **AD shifts right**
- Also, lower bond yields mean the return on safe government bonds is low, which can push investors to move money into riskier assets such as shares and property. This raises asset prices, creating a positive wealth effect, increasing consumption and shifting AD to the right.

Liquidity trap

A liquidity trap happens when interest rates are close to 0%, so cutting them further has little impact on borrowing /spending (thus not stimulating AD) .Consumers prefer holding cash (remain liquid) due to uncertain economic climate (e.g low IR are usually pursued during a recession phase)



What is Fiscal policy

Fiscal policy is set by the **UK government** . It includes manipulating :

- Government spending
- Taxation

How can fiscal policy influence AD

Expansionary fiscal policy

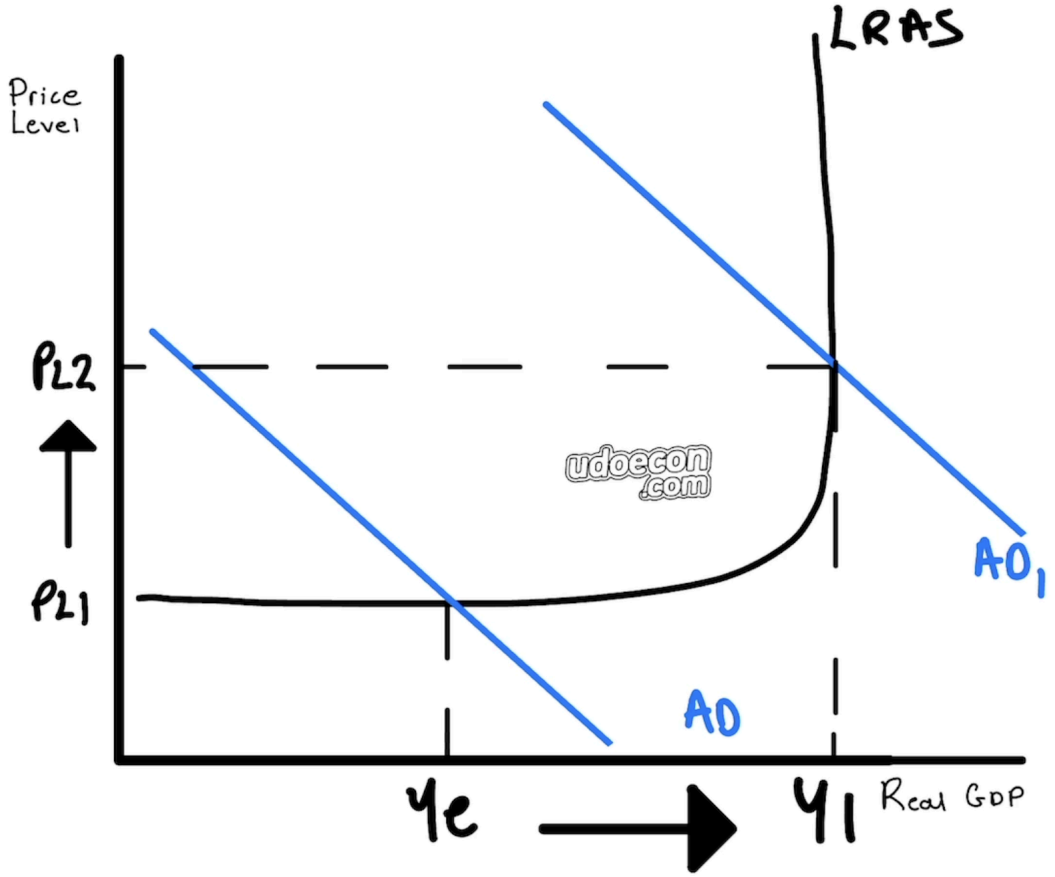
When pursuing expansionary fiscal policy the govt will lower tax rates **and/or** increase govt spending .

By **lowering taxes** (e.g., cutting income tax), households keep more of their income as **disposable income**, so they can **increase consumption (C)**. Because consumption is usually the **largest component of AD**, higher C helps **shift AD to the right**, raising **real GDP/economic growth**. The impact can be amplified by the **multiplier**: higher spending boosts firm revenues, so firms know demand is stronger, which can lead to **more hiring and investment**, raising incomes further and creating another round of spending.

By **increasing government spending** (e.g., £40bn spent on major infrastructure investment such as **HS2**), the government directly increases **G**, which **immediately raises AD** because G is part of the AD equation. This can also trigger a strong **multiplier effect**, as contractors and employees earn more, they spend more, and businesses respond by expanding output and employment. As a result, overall demand rises again, supporting **growth** and reducing unemployment.

Thus overall both lowering taxes and increasing govt spending both contribute to stimulating AD proving expansionary fiscal policy is an effective tool how help the UK govt respond to

the downturns of the economic cycle e.g recessions .



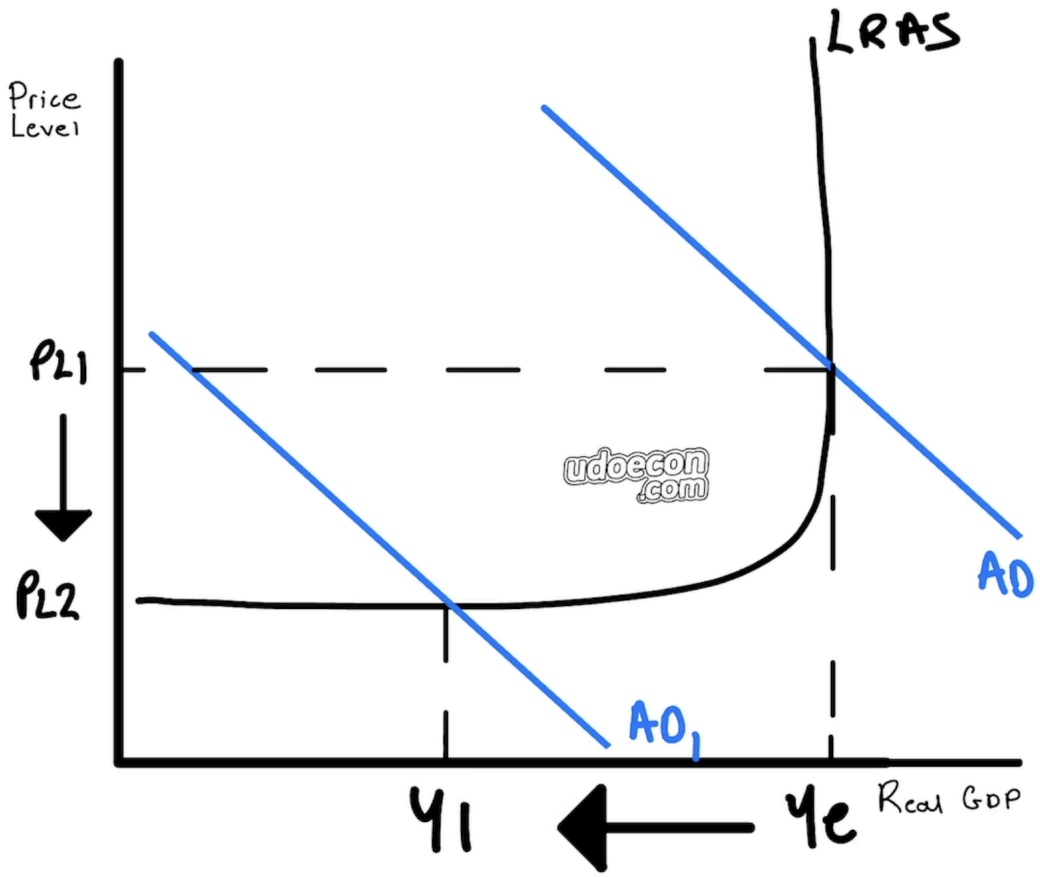
Contractionary fiscal policy

When pursuing contractionary fiscal policy, the government will **raise tax rates and/or reduce government spending** to **slow down aggregate demand (AD)**. This is mainly used when the economy is **overheating (boom phase of economic cycle)** and inflationary pressures are rising.

By **raising taxes** (e.g., higher income tax or VAT), households are left with **less disposable income**, so they **cut back on consumption (C)**. Since consumption is a large part of AD, weaker spending causes **AD to shift left**, reducing demand-pull inflationary pressure. This fall can be reinforced through the **reverse/downwards multiplier** as lower spending reduces firms' revenues, so firms may scale back output, hiring, and investment, causing incomes to fall and spending to weaken further.

By **reducing government spending** (e.g., delaying infrastructure projects or cutting departmental budgets), the government directly lowers **G**, which **immediately reduces AD** because G is a component of the AD equation. With fewer public-sector contracts and less spending in the economy, firms supplying the government face lower demand, which can lead to **lower output and employment**. Again, the reverse multiplier can spread this effect as incomes fall and consumer spending slows.

Overall, **higher taxes and lower government spending** both act to **reduce AD**, making contractionary fiscal policy a useful tool for managing **inflation and overheating**, though it can also **weaken growth and raise unemployment** if used too aggressively.



Strengths & weaknesses of demand-side policy

Monetary policy

Strengths

- **Independent Bank of England** → less political interference and more focus on long-run stability.
- Mainly used to **control inflation** and keep prices stable.
- Lower rates can weaken the pound → **exports more competitive**, raising AD.

Weaknesses

- **Time lags** (often 12–24 months) so it can overshoot/undershoot.
- **Trade-offs**: boosting growth can push up inflation (*demand pull inflation link*) .
- Can be weak in deep recessions/negative output gaps if confidence is low (**liquidity trap risk**) so people don't borrow/spend.
- Very low rates have a **floor (effective lower bound)**.
- Prolonged cheap credit can fuel **asset price bubbles** (housing/shares).

Fiscal policy (government spending + taxation)

Strengths

- Can be **targeted** (e.g., spending on specific regions/industries).
- Often **faster impact** on AD than monetary policy, especially via direct government spending.
- Taxes/spending can **redistribute income** and influence behaviour (e.g., indirect taxes to reduce externalities).
- Some spending (infrastructure/education) can raise **LRAS** as well as AD (better productivity/capacity).

Weaknesses

- More **political** → may change with governments; risk of short-termism.
- Big projects can face **delays/cost overruns**, so long-run benefits aren't guaranteed.
- Higher spending or tax cuts can create **budget deficits and rising debt** → future tax rises or spending cuts (austerity).
- **Conflicting objectives**: stimulating growth may increase inflation; cutting spending may reduce inflation but raise unemployment (*phillips curve link*) .

Awareness of demand-side policies in the Great Depression and the Global Financial Crisis of 2008

Both the Great Depression and the 2008 financial crisis saw a collapse in private spending (C and I) **(GDP fell 6.4% 2008)**, so governments used fiscal policy to boost AD and jobs: higher G **(£20bn 2008 stimulus package)** directly raises AD (plus multiplier), and lower Tax **(VAT cut 17.5% to 15%)** increases disposable income to support consumption.

In 2008, interest rates were cut quickly but hit the lower bound , raising the risk of a liquidity trap (rate cuts stop working), so the government resorted to QE **(£200bn initial QE program)** .

Main difference: the Great Depression had tighter constraints e.g. gold standard (this meant the UK currency was fixed to the value of gold thus the UK couldn't manipulate interest rates as would lead to value of gold decreasing - this consequently lead to the UK gold exit in 1931), while 2008 had faster, more coordinated action with monetary policy but had a different problem with interest rates which was they were already as low as they could go (IR have an effective lower bound) .

Distinction between government budget (fiscal) deficit and surplus

Each year, the government's fiscal position can be a **balanced budget**, **budget deficit**, or **budget surplus**.

Balanced budget: Government revenue = Government expenditure

→ no net borrowing needed for that year.

Budget deficit: Revenue < Expenditure

→ the government must **borrow** to fund the gap (**public sector borrowing**).

→ this borrowing is added to the **public debt / national debt** (the total stock of accumulated past borrowing).

→ The UK has been in a continuous budget deficit for **25 years**,

Budget surplus: Revenue > Expenditure
→ the government can **pay down existing debt** (or build reserves), reducing future borrowing needs.
→ Germany achieved eight consecutive annual budget surpluses between **2012 and 2019**, peaking at a record **€62.4 billion** (1.9% of GDP) in 2018.

Distinction between, and examples of, direct and indirect taxation

Direct taxes

Direct taxes are paid **directly to the government** by the person or firm.

- Examples: **Income tax**, **National Insurance contributions (NICs)**, **Corporation tax**, **Capital Gains Tax**, **Inheritance Tax**.

Indirect taxes

Indirect taxes are charged on **spending on goods and services**. Firms collect them through prices and then **pass the revenue to the government**.

- Examples: **VAT** (20%), **excise duties** (e.g. **fuel duty**, alcohol, tobacco), and taxes on **demerit goods**.

Specific tax : a **fixed amount per unit** (e.g. **£x per litre of fuel**, £x per pack of cigarettes).
Ad valorem tax: a **percentage of the price** (e.g. **VAT at 20%**).