IB ECONOMICS – INTERNAL ASSESSMENT

FRONT COVER

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Candidate name	Student A
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Teacher	
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Bank voted 8-1 to maintain rates

The Bank of England voted eight to one to keep interest rates on hold at 5%, minutes of its last meeting show.

Inflation has risen in recent months, driven by high oil and food prices, making policymakers reluctant to cut rates despite the cooling economy.

March's 0.8% monthly rise in consumer prices was the steepest for nearly seven years.

"Given the sharp rise in inflation in April it is not surprising that eight of the nine-strong Monetary Policy Committee (MPC) voted in favour of interest rates on hold two weeks ago," said George Buckley, head economist at Deutsche Bank.

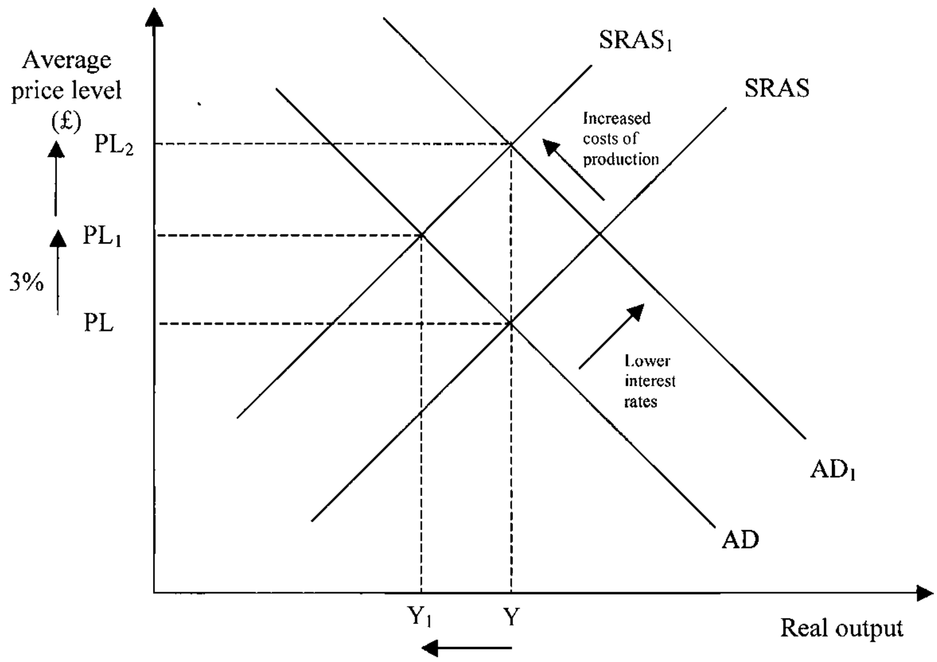
Recent figures showing weakness in both the manufacturing and service sector have increased pressure on the MPC to cut rates to 4.75%.

"Most believe that a significant slowdown is required to get inflation back to target and were concerned that another cut this month would give the impression that the committee was targeting growth, not inflation."

Two of the macroeconomic goals for all governments are: low and stable inflation, and high and stable growth. Inflation is a persistent increase in the general price level of the economy and growth is an increase in real output. These two goals often oppose each other in terms of monetary policy, and now the Bank of England must choose whether to raise interest rates to get inflation back on target to 2% or lower interest rates to deal with weakening aggregate demand, meaning rate cuts. Aggregate demand is the total spending on goods and services in an economy at every given price level.

The current inflation in the UK is mostly due to high oil and food prices and is therefore an example of cost-push inflation. Oil is important to nearly all areas of the economy, and therefore an increase in price will lead to an increase in costs of production, shifting the short-run aggregate supply curve inwards (SRAS → $SRAS_1$). Aggregate supply is the total amount of goods of services that all industries in an economy will produce at every given price level.

Effect of an increase in oil price and lower interest rates



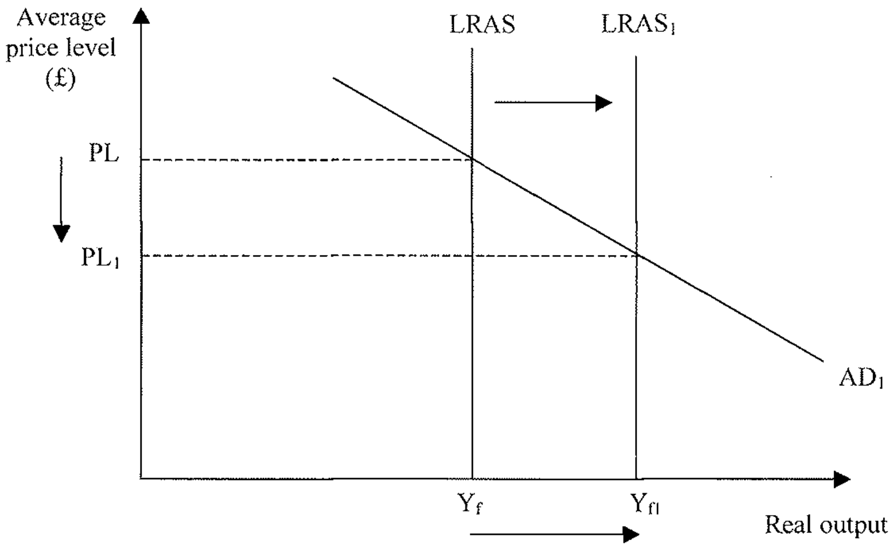
This leads to an increase in the general price level (PL → PL_1) and a decrease in real output (Y → Y_1). This inflation with negative growth is called stagflation and is particularly dangerous for the economy. Consumers with incomes that are not linked to inflation, or those with inflation-linked incomes when inflation is higher than expected, will experience a loss of purchasing power and, hence, a decrease in living standards because they can buy less goods and services for their money. It is important that the MPC “give the impression that [they are] targeting … inflation”, so that workers and labour unions do not start demanding higher wages, which will increase costs of production further and initiate a wage-price spiral. For richer sections of society, this decrease in living standards may be less significant but they are also more likely to have large savings, which will lose value. Fortunately, the UK is currently not experiencing higher inflation than its trading partners, so British goods’ competitiveness on foreign markets should not be significantly affected.

Dixon implies that “rate hikes” could be used to combat this inflation. However, the costs of production are not largely affected by interest rates and therefore it is unlikely that raising them will counter-act this primarily cost-push inflation. Interest rates do, on the other hand, affect aggregate demand, which Blanchflower fears is weakening. Lowering interest rates would increase the incentive for firms to invest and add to the capital stock of the economy because loans are cheaper. Similarly, it increases consumption on durable goods, because consumers are more likely to take a loan to buy for example, a new car, if interest rates are lower. Investment and consumption are both components of aggregate demand so aggregate demand would increase (AD → AD_1)

boosting output again ($Y_1 \rightarrow Y$). However, this would lead to a higher general price level in the economy ($PL_1 \rightarrow PL_2$), worsening inflation.

The best solution would be for the government to use supply side policies. These lead to growth ($Y_f \rightarrow Y_{f1}$) and a decrease in the general price level ($PL \rightarrow PL_1$), combating inflation.

Effect of supply-side policies



The government can shift the long run aggregate supply curve outwards by improving the quality and quantity of the factors of production. In the 80's and 90's there was much privatisation, a reduction in power of labour unions and lower income taxes but there are further measures that could be taken. Encouraging small business start-ups with grants and lower corporation tax would improve the factor of production entrepreneurship. The government can also directly provide education and training, which will improve the quality of labour and reduce structural employment thus increasing the quantity of labour as well. Structural unemployment refers to those actively seeking employment but cannot find jobs due to a mismatch between their skills and location and the jobs available. As with all government spending, there is an opportunity cost, as other alternatives are foregone and the government is likely to run a deficit. Moreover, supply side policies are only effective in the long run.