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UPDATED TO 2022 SYLLABUS

# CAIE AS LEVEL
# ECONOMICS (9708)

SUMMARIZED NOTES ON THE THEORY SYLLABUS

# 1. Basic Economic Ideas and Resource Allocation

## 1.1. Scarcity, Choice & Opportunity Cost

- **The fundamental economic problem:** of scarcity arises due to unlimited human wants of consumption exceeding finite economic resources for production.
- **Consumption:** is process by which consumers satisfy their wants.
- **Production:** is process of creating goods and services in an economy
- **Economic goods** – these are goods which require resources to be produced and obtained and therefore have an opportunity cost. Allocative mechanism will be used to allocate such goods. Ex. cars.
- **Free goods** – these are goods which do not require any resources to be produced and obtained and therefore are abundant and have no opportunity cost. Ex. sunlight.
- **Ceteris paribus** is a Latin word meaning 'all other things being equal'
- Needs are necessary, wants are not.
  - Thus, choices have to be made at all levels
- Consumers – maximum satisfaction.
- Producers – maximum profit.
- Governments – maximum benefits.
- **Choice:** is the need to make decision about the possible alternative uses of scarce resources due to scarcity. It gives rise to the concept of opportunity cost and the 3 basic economic problems.
- **Opportunity cost:** is the cost of choosing something in terms of the benefit derived from the best alternative forgone.
- **Economic resources/factors of production:** are inputs available for production of goods and services.

## 1.2. Positive and Normative Statements

| Statement | Basis | Type |
|---|---|---|
| **Positive** | Facts | Objective |
| **Normative** | Value judgments | Subjective |

**Value judgments:** reflect particular beliefs, while facts: are evident to all.

## 1.3. Factors of Production

| Factor | Definition | Reward |
|---|---|---|
| **Land** | Natural resources | Rent |
| **Labour** | Physical and mental human effort | Wage |
| **Capital** | Man-made resources | Interest |
| **Enterprise** | Production organization, risk-bearing | Profit |

## 1.4. Resource Allocation in Different Economic Systems & Issues of Transition

- Different economic systems answer the 3 basic economic questions differently.
  - Note, that mixed economics try to gain advantages and avoid disadvantages of both market and planned economies.

| Question | Market economy | Planned economy |
|---|---|---|
| **What to produce** | Price mechanism | Cost-benefit analysis |
| **How to produce** | Least cost combination | Directives to SOEs |
| **For whom to produce** | Purchasing power | Vulnerable groups |

**Comparison between market & planned economies:**

| Feature | Market economy | Planned economy |
|---|---|---|
| **Ownership** | Private | State |
| **Decision** | Consumers | Governments |
| **Mechanism** | Price mechanism | Directives to SOEs |
| **Key sector** | Private | Public |
| **Public goods** | Absent | Present |
| **Profit motive** | Present | Absent |
| **Other names** | Free enterprise, private enterprise, *laissez faire* | Central, collectivist, state-owned. |
| **Examples** | USA | North Korea |

- Note that in reality, all economic systems are mixed.
- SOE: State-owned enterprise.

| Market economy | |
|---|---|
| **Advantages** | **Disadvantages** |
| Efficiency | Information failure |
| | Public goods not provided |
| Consumer sovereignty | Merit goods under-consumed |
| | Demerit goods over-consumed |
| Quick response | Negative externalities |
| | Unemployment of resources |
| Profit incentive | Factor immobility |
| | Market power abuse |

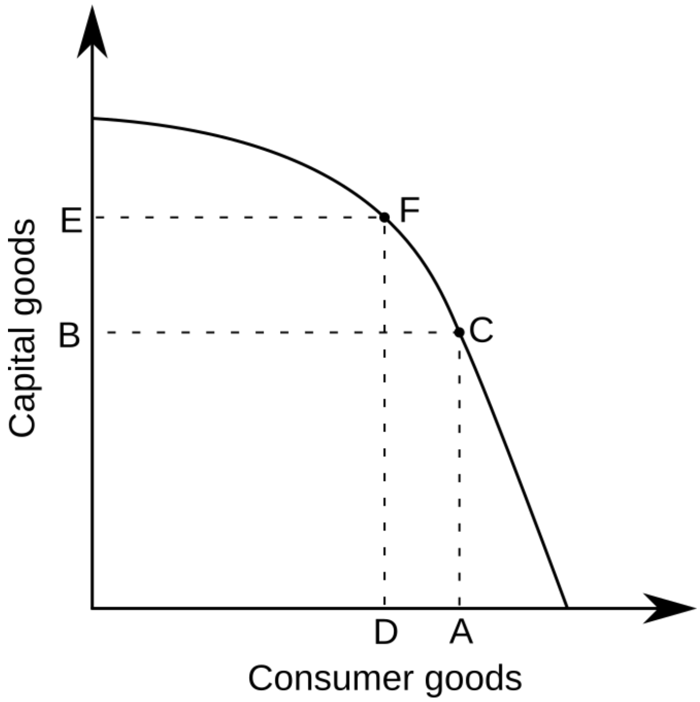
| Market economy | |
|---|---|
| Maximizes producer and consumer surplus | Advertising distortion |
| | Too much consumer goods |
| Government freedom | Poor lack purchasing power |
| | Inflation |

| Planned economy | |
|---|---|
| **Advantages** | **Disadvantages** |
| Provision of public goods | No incentives |
| Merit goods encouraged | Low production |
| Demerit goods discouraged | Low competition, low efficiency |
| Full cost-benefit analysis | Bureaucracy |
| Full employment | Unresponsive |
| Wasteful duplication avoided | Too much of capital goods |
| Vulnerable groups protected | Lack of consumer sovereignty |

- **Transitional economy:** is one which is in process of changing from a planned economy to a mixed economy where market forces have greater importance.
- **Issues of transition:**
  - Inflation.
  - Industrial unrest.
  - Fall in output.
  - Unemployment.
  - Balance of payments' deficit.
  - Reduction in welfare services.

## 1.5. Production Possibility Curves

**Production possibility curve:** is one which joins together the different combinations of products that can be produced in an economy, over a period of time, given existing resources and technology.




- It is also known as production transformation frontier, boundary or a production transformation curve. It demonstrates the ideas of choice, trade-offs and opportunity cost.
- Point inside curve indicates unemployment and point on curve shows full employment. This is productive efficiency.
- Point shifting occurs owing to allocative efficiency.
- Production point shifting from C to F requires a reallocation of resources to capital goods and factor mobility determines the speed of this. This would act as an investment, shifting the PPC to the right. This indicates economic growth.
- **Factor mobility:** is extent of reallocation of resources or ease of moving factors of production.
- **Investment:** is expenditure of capital goods, both fixed and working.
- **Economic growth:** is an expansion in the productive capacity in an economy.
  (Lowering of long-run average cost, i.e., LRAC ensures this.)
- **Other causes of PPC shifting right:**
  - New resources.
  - Increased labour supply.
  - Improvements in human capital.
  - Improved resource management.
  - Privatisation.
- **Straight** PP line indicates constant opportunity cost which is next to impossible.
- **Curved** PP line indicates increasing opportunity cost which occurs when the extra production of one good involves ever-increasing sacrifices of another as less suitable economic measures have to be diverted into the production of the former, increasing marginal cost and decreasing productivity.

## 1.6. Money

- **Money:** is anything which is universally acceptable as a means of payment for goods and services. Most money, except coins is 'legal tender' for settlement of debt.
- **Functions:**
  - Medium of exchange.
  - Measure of value.
  - Standard for deferred payment.
  - Store of value.
- **Characteristics:**

| Acceptability. | Scarcity. |
|---|---|
| Divisibility. | Stability of supply and value. |
| Portability. | Recognizable. |
| Durability. | Uniformity. |

- **Advantages over barter:**
  - Avoids double coincidence of wants.
  - Permits evaluation.
  - Enables giving change.
  - Eases saving.
- **Barter:** is the direct exchange of one product for another. It was used before money.

*Cash + Bank deposits = Money*

- **Cash:** includes the notes and coins in an economy. It is the most liquid form of asset.
- **Bank deposits:** are money held in accounts with a financial institution, e.g. bank, building, society, etc.
- **Liquidity:** refers to the extent and ease of converting a non-cash asset into cash.
- **Near money:** or 'quasi-money' are non-cash assets that can be quickly and easily converted into cash.
- **Cheques:** are written instruction to a financial institution to pay an amount of money from an account. So, they are means of payment through bank deposits, not money.

## 1.7. Classification of Goods & Services

| Good | Opportunity cost & scarcity | Rivalry | Excludability | Free-rider | Rejectability |
|---|---|---|---|---|---|
| Free | ✗ | ✗ | ✗ | ✓ | ✗ |
| Economic/ Private | ✓ | ✓ | ✓ | ✗ | ✓ |
| Public | ✓ | ✗ | ✗ | ✓ | ✗ |

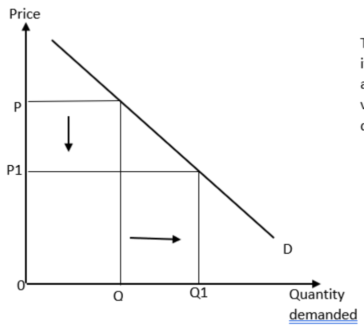
# 2. The Price System & the Micro Economy

## 2.1. Price mechanism

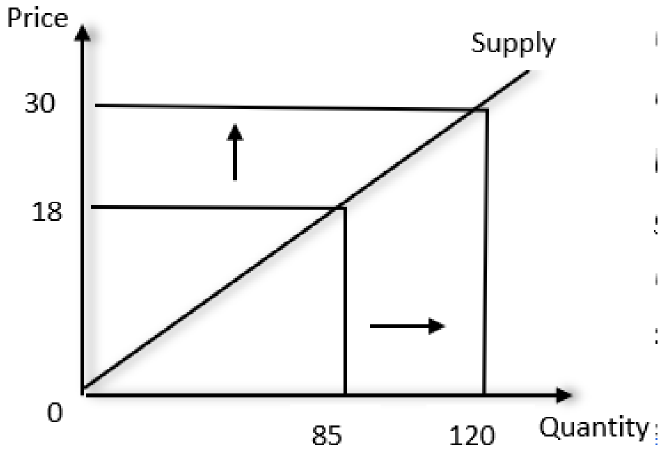
- It is the means through which scarce resources (factors of production) are allocated in a market economy.
- Signaling – prices act as a signal to both producers and consumers. Ex. if there is excess demand for a product due to a fall in quantity, this indicates to the producer that they must supply more of the product in the market. In turn, if consumers withhold their demand, it signals to the producers that they must lower price and in turn produce less.
- Rationing – if a producer wants to retain exclusivity for their product, they may limit the supply of the product in the market, thereby driving its price up and in turn restricting its demand.
- Transmission of preferences – this means that if consumers do not buy a particular product because they don't like it, or it is not priced to their liking, then this message is transmitted back to the producer.

## 2.2. Demand and supply

- **Demand/supply:** is the quantity of a product that **consumers/producers** are willing and able to **buy/sell** at various prices per period time, ceteris paribus.
- **Note** that demand & supply are also referred as market forces or the invisible hand.
- **Laws of demand: Rise in price, fall in demand and vice versa**
- **Laws of supply:** ***Rise in price, rise in supply and vice versa***
- **Schedules:** lists these relations while **curves:** graphically represent them.
- **Notional demand/supply:** isn't backed up by ability to **pay/sell** but effective **demand/supply** is.
- **Individual:** refers to a certain producer/consumer in the **market:** which is an arrangement for buyers and sellers to trade.
- Products in joint demand/supply: are produced/consumed together.
- Products in alternative demand/supply: are those whose consumption/production reduces need/availability of the other.
- Multi-purpose products have composite demand.
- Products which help in producing other product have a demand **derived** from the product produced.
- **Note:** As **income** rises, demand of **normal** goods rises, **inferior** good falls.




This is a demand curve. It is downwards sloping as it depicts the inverse relation between demand and price. When price rises, demand falls and vice versa. In the figure, as price fell from P-P1, quantity demanded rose from Q-Q1.




- Contractions/Extensions of demand/supply: are movement along curves due to changes in price, while:
- Shifts of demand/supply: are movements of the whole curve due to changes in conditions.
- Their effects on equilibrium price, quantity and revenue will depend on degree of shifting and price elasticity of other curve.

| Demand conditions | Supply conditions |
|---|---|
| Disposable income<br>Price of related products | Costs of production<br>Price of related products. |
| Taste and fashion | Climate & technology |
| Population structure | Government regulations |
| Price speculation | Availability of resources |
| Income distribution | Taxes and subsidies |
| Taxes and subsidies | Competitor actions |

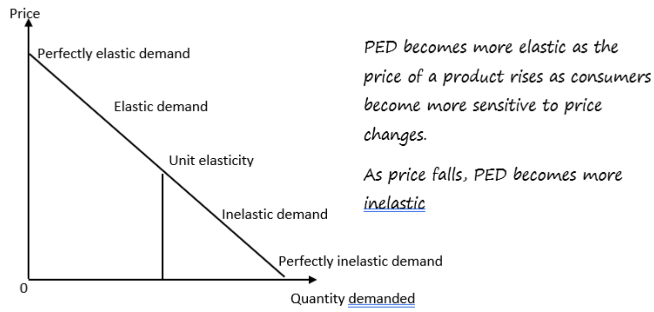
png)**

## 2.3. Price Elasticity, Income Elasticity & Cross-Elasticities of Demand, and Price Elasticity of Supply

- **Elasticity:** is responsiveness of quantity **demanded/supplied** to a change in **price, income or prices of related products.**
- **Note:** It is a numerical measure of the inverse of the gradient, so lower elasticity gives steeper curve.
- **Limitations of elasticities:**
  - Irrelevant and unreliable data
  - Unrealistic assumptions
  - Omission of Total Cost
  - Omission of Production Capacity

| | | | | |
|---|---|---|---|---|
| **Elastic** | >1 | Perfectly elastic | ∞ | Horizontal line |
| **Inelastic** | <1 | Perfectly inelastic | 0 | Vertical line |
| **Unitary** | =1; | Such PED gives rectangular hyperbola, i.e. change in demand/supply doesn't affect revenue. | | |

| | | |
|---|---|---|
| PED = % change in QD / % change in P | **(−)ve; used to inspect** revenue and tax effects. | |
| PES = % change in QS / % change in P | (+)ve; indicates **allocative efficiency** and need to expand. | |
| YED = % change in QD / % change in income | (+)ve – **normal good** | (−)ve – **inferior good** |
| XED = % change in QD / % change in P (another) | (+)ve – **substitutes** | (−)ve – **complements** |

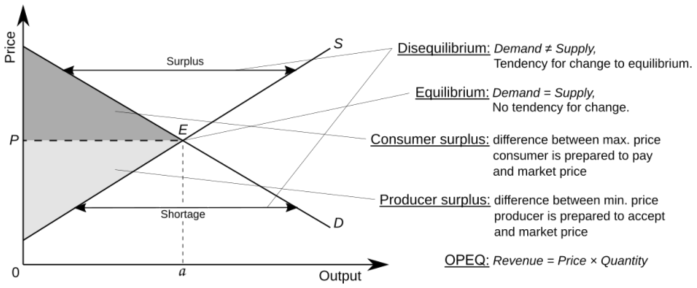



| PED conditions | PES conditions |
|---|---|
| **Time period** | Time period |
| **No. Of substitutes** | Availability of resources |
| **Degree of necessity** | Spare capacity/stocks |
| **Durability** | No. of firms in market |
| **Proportion of income** | Allocative efficiency of factors |

## 2.4. Interaction of Demand & Supply, Market Equilibrium & Disequilibrium, and Consumer & Producer Surplus

**Prices:**

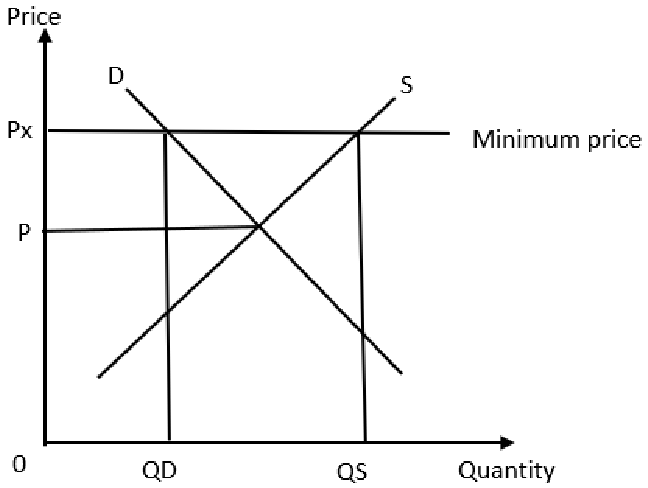
- Signal surpluses/shortages.
- Ration resources to uses.
- Transmit preferences by encouraging producers to produce according to consumer demand.

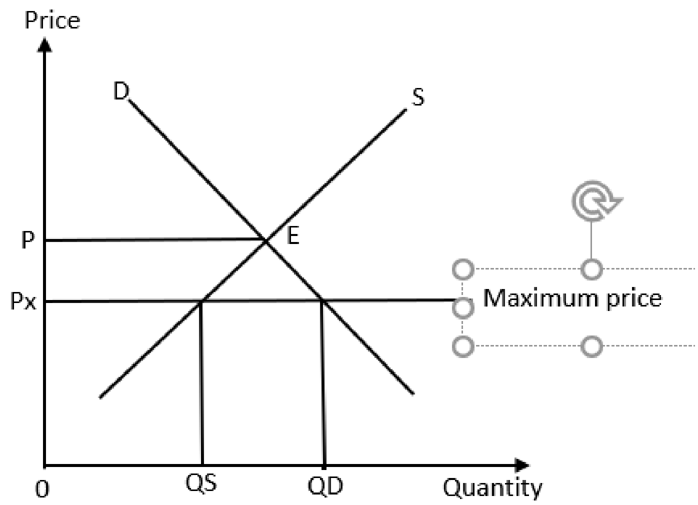



# 3. Government Microeconomic Intervention

## 3.1. Maximum and Minimum Prices

| MAXIMUM PRICES | MINIMUM PRICES |
|---|---|
| Max. price control: is where a price ceiling is established below equilibrium price, creating a shortage. | Min. price control: is where a price floor is established above equilibrium price, creating a surplus. |
| Cheap essentials | Demerit goods |
| Rent control | Proper wages |
| Restriction of fares | Import reduction |
| More affordable to the poor | PED dependent |
| Queueing | Unemployment |
| Corruption | Smuggling |
| Black market | Inefficiencies |




## 3.2. Taxes, Subsidies and Transfer Payment

| Fiscal measure | Levied on/ Given to | Shift | Burden/Benefit |
|---|---|---|---|
| Direct tax | Income | D ← | Consumer |
| Indirect tax | Expenditure | S ← | Elastic demand – producer & converse |
| Subsidy | Consumer | D → | Consumer |
| Subsidy | Producer | S → | Inelastic demand – consumer & converse |

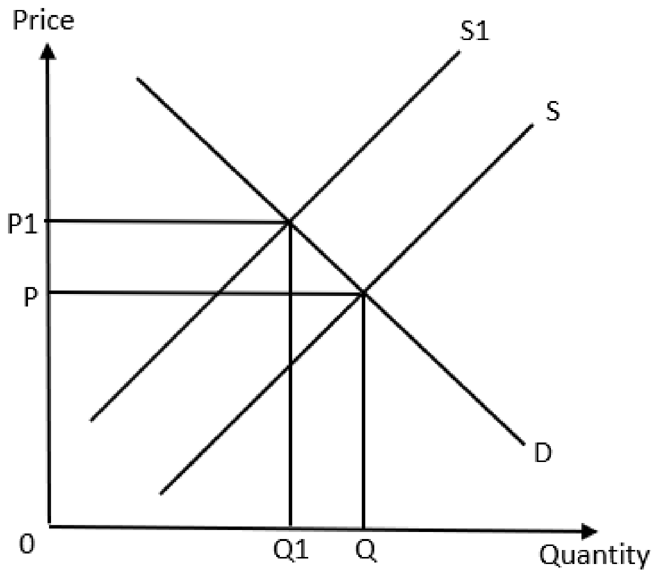
Note: Specific measures cause parallel shift, *ad valorem* ones non-parallel.

| Direct tax | |
|---|---|
| Advantages | Disadvantages |
| Economic stability | May discourage: |
| Progressive | Saving |
| Certain & convenient | Effort |

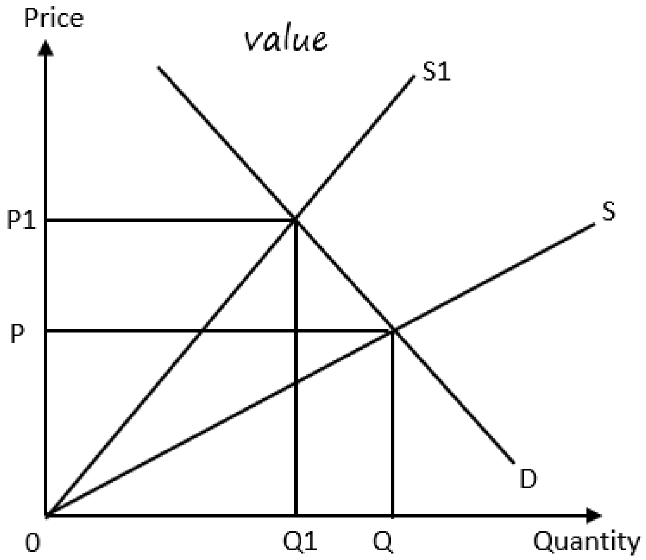
| Indirect tax | |
|---|---|
| Redistribute income | Risk-taking |
| Economic stability | Regressive |
| May not discourage effort | Inflationary |
| Difficult to evade | Reduce consumer surplus |
| Can be adjusted quickly | Move demand abroad |
| Discourage imports | Distort choice |
| Discourage demerit goods | Effect depends of PED |

| Aims of taxes | Canons of taxes |
|---|---|
| Demerit goods | Cost |
| Income distribution | Efficiency |
| Release resources | Equity |
| Discourage imports | Transparency |
| Demand/supply management | Convenience |

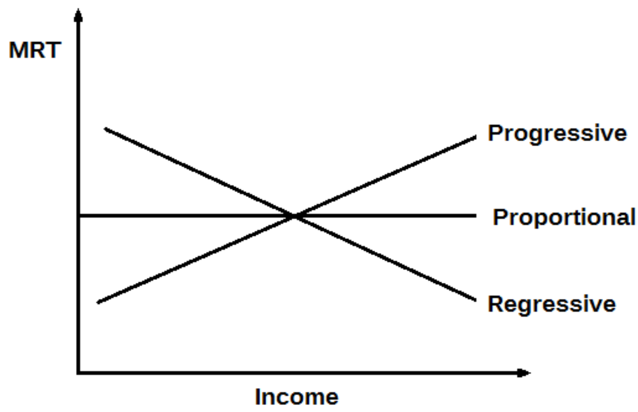
- **Impact of tax:** refers to unit on which a tax is levied.
- **Incidence of tax:** refers to burden of taxation.
- **Specific tax:** is paid in fixed amount.




- ***Ad valorem* tax:** on consumption, is paid as **percentage** of value of product.




- **Average rate of tax:** is the average percentage of total income that is paid in taxes.
- **Marginal rate:** is the **proportion of additional income** that is taken in income tax.
- **Marginal rate of taxation:** is the **addition to tax** paid out of change in income.




- **Transfer payment:** is a **govt. provided benefit to poor units, without protective effort**; so funds shift from **taxpayers to recipients.**
- **Means-tested benefit:** is paid to units whose income is below a level.
- **Universal benefit:** is paid to units without **income reference.**
- **Poverty-trap:** is a situation in which an individual has **work-disincentive**, as additional income will be taken away as **taxes & lost benefits**.
- **Negative income-tax:** is a system which brings together payment of tax and receipt of benefits thus, making markets more flexible by removing poverty-traps.

## 3.3. Direct Provision of Goods & Services

- **Certain goods and services that ought to benefit the public are under-provided, or under-consumed in the economy.**
- **Direct provision of goods and services in the form of merit and public goods are a solution to this issue.**

## 3.4. Nationalisation & Privatisation

- **Nationalisation:** is a process whereby private sector firms become part of the public sector of economy, with state involved in **direct provision of goods and services.**
- **The converse is: Privatization:** which is achieved by **sale of assets, deregulation, outsourcing & franchising.**

| Nationalisation | |
|---|---|
| Advantages | Disadvantages |
| Economies of scale | Inefficient |
| Reduce income inequality | Non-competitive |
| Private monopoly prevented | Political-mileage |
| Avoids wasteful duplication | SOE monopoly |
| CBA involved | Limited scope for increase in long term investment |

| Privatisation | |
|---|---|

| Privatisation | |
|---|---|
| **Advantages** | **Disadvantages** |
| Economic efficiency | Private monopoly |
| Government revenue | One off income generated |
| Growth by investment | Regulations needed |
| Lower price | Unemployment |
| Enterprise encouraged | Wasteful duplication |

- **Government failure:** occurs when government intervention reduces economic performance rather than increasing, thus failing to correct market failure, due to:
  - Imperfect information
  - Policy conflicts
  - Political mileage
  - Corruption

# 4. The Macro Economy

## 4.1. Aggregate Demand & Aggregate Supply Analysis

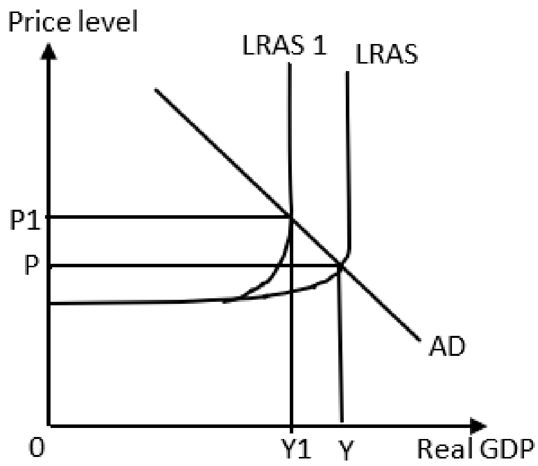
- **Macroeconomy:** is the economy as a whole.
- **Aggregate demand $(\mathbf{AD})$:** is the total spending on an economy's goods and services, at a given price level in a given time period.
  - Total spending in an economy in a certain time period
  - In consists of Consumption, Investment, Government spending and Net Exports (C+I+G+(X-M))
  - Consumption – spending by households and other consumers. Depends on income levels, interest rates, tax rates, etc. A major part of AD.
  - Investment – expenditure made by firms in terms of capital equipment. Depends mostly on profits and interest rate, corporation tax rates, etc
  - Government spending – total spending by the government on both consumer and capital goods. Depends on tax revenue collected.
  - Net exports – exports minus imports. Depends on inflation rates domestically and abroad, exchange rates, etc
- Aggregate supply (AS) is the total output produced in an economy within a given time period.
  - Shifts in the LRAS curve
    - AS, in the long run may increase due to:
      - Increase in quantity of resources:
        - Net immigration
        - Increase in retirement age
        - More women entering the labour force
        - Net investment
        - Discovery of new resources
        - Land reclamation
      - Increase in quality of resources:
        - Improved education and training
        - Advances in technology

## 4.2. Inflation

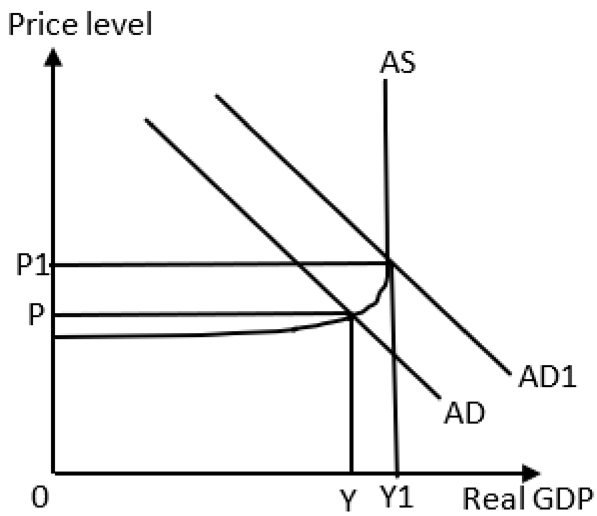
- **Inflation:** is a sustained increase in general price levels in an economy over a given time period, causing a fall in purchasing power of a currency.
- **Creeping inflation:** has a low rate.
- **Hyper-inflation:** has an exceptionally high rate of inflation, which may result in people losing confidence in currency.
- **Inflation rate can be measured by $(CPI)$ or $(RPI)$:**
  - Selecting a **stable base year** for comparison.
  - Carrying out **surveys** to find spending patterns.
  - Attaching **weights** to products to indicate relative importance.
  - Finding out **price changes**.
  - Multiplying **weights by price changes**.
- **Deflation:** is a sustained decrease in general price levels in an economy over a given time period, causing a rise in purchasing power of a currency.
- **Disinflation:** is a fall in the inflation rate.

| Causes | Inflation | Deflation |
|---|---|---|
| Good | AD $\uparrow$ | $AS \uparrow$ |
| Bad | $AS \downarrow$ | $AD \downarrow$ |

- **Money values:** are of prices operating at the time.
- **Real values:** are adjusted for inflation.
- Real values = nominal values * price index of base year (100)/price index of current year
- **Menu costs:** are incurred by firms for having to change prices.
- **Shoe-leather costs:** are incurred by firms moving money for high-interest.
- **Fiscal drag:** is pushing of income into **higher tax brackets** by inflation.
- **Inflationary noise:** is confusion over relative prices.
- **Causes of inflation:**
- **Cost-push inflation:** is caused by increases in costs of production decreasing aggregate supply, e.g.
  - Wages rising by more than productivity.
  - Raw material costs rising (**especially imported ones**).
  - Increase in indirect/corporate taxes.
  - Rise in profit margins.




- **Demand-pull inflation:** is caused by increase in aggregate demand unmatched by equivalent rise in aggregate supply, e.g.
  - Consumer boom.
  - Money supply growing faster than output (**monetarist**)
  - Growing budget deficit.
  - Increase in net exports.




| Consequences of disequilibrium | |
|---|---|
| **Domestic** | **External** |
| Change in money supply | Change in exchange rate both appreciation & depreciation naturally and artificial devaluation & evaluation. |
| Confidence & FDI levels change, leading to changes in $AD$, employment, growth etc | Government pressured to change protectionist measures. |
| Changes in standard of living owing to different access of imports. | |
| Change in government policies | |

| Disadvantages | Advantages |
|---|---|
| • Reduction in net exports. | Stimulate output |
| Unplanned redistribution of income | Reduce burden of debt |
| Fiscal-drag | Prevent some unemployment |
| Inflationary noise | **Factors effecting extent of consequences** |
| Investment discouragement | Cause of inflation |
| Unemployment | Rate of inflation |
| Cost-wage spiral | Stability |
| Menu costs | Expectancy |
| Shoe leather costs | Comparability |

## 4.3. Balance of Payments

- Balance of payments: is a record of a country's economic transactions with the rest of the world over a year. It consists of:

| Current account: | Financial account: |
|---|---|
| • Visible trade in goods<br>• Invisible trade in services<br>• Income, e.g. profits, interest<br>• Current transfers (no exchange involved) | • Direct investment<br>• Portfolio investment<br>• Reserve assets<br>• Other investment |
| **Capital account:** | **Balancing item:** |
| • Capital transfers<br>• Nonfinancial assets | • Net errors and omissions |
| **Note:** | Money into country, credit (+) items, e.g. export. |
| | Money out of country, debit (−) items, e.g. import. |

* Financial account: * Hot money flows * Lack of business confidence * Balancing item: * Imperfect information * Smuggling, black market

## 4.4. Exchange Rates

- Factors determining exchange rate:
  - Balance of payments disequilibrium – Deficit causes reduction.
  - Inflation rate – High rate reduces confidence, hence demand.
  - Foreign direct investment – Inflows increase rate.
  - Speculation – Acts in a way to aggravate problem.
- Purchasing power parity: is a way of comparing international living standards by using an exchange rate based on amount of each currency needed to purchase some basket of products.

- Nominal exchange rate: is price of one currency in terms of another.
- Trade-weighted exchange rate: is price of one currency against a basket of weighted currency.
- Real effective exchange rate: is a currency's value in terms of its real purchasing power.

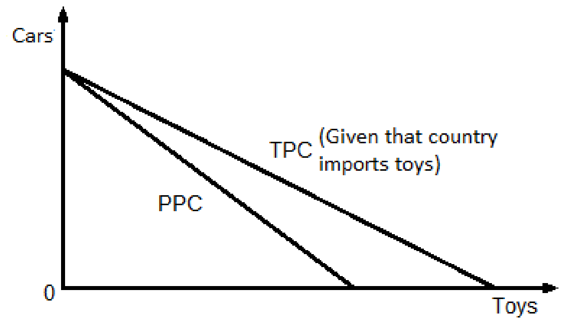
$$\therefore Real\ effective\ exchange\ rate = \frac{Nominal\ exchange\ rate \times Domestic\ price\ rise}{\text{Foreign exchange rate}}$$

| Effect of changing exchange rates – Domestic | |
|---|---|
| **Aspect** | **Effect** |
| **Inflation** | Depreciation will make imports more expensive. **(Imported cost push inflation)** |
| **Unemployment** | Appreciation will make exports more expensive reducing AD. |
| **Economic growth** | Depreciation will reduce terms of trade, leading to economic growth if Marshall-Lerner condition holds. |

(+) |

## 4.5. Principles of Absolute and Comparative Advantage

- **Absolute advantage:** is the ability to produce more of a product than another country using same amount of resources.
- **Comparative advantage:** is ability to produce **at lower opportunity cost.**
- **Trading possibilities curve:** is the consumption possibilities of rations post specialization and trade at any term of trade.



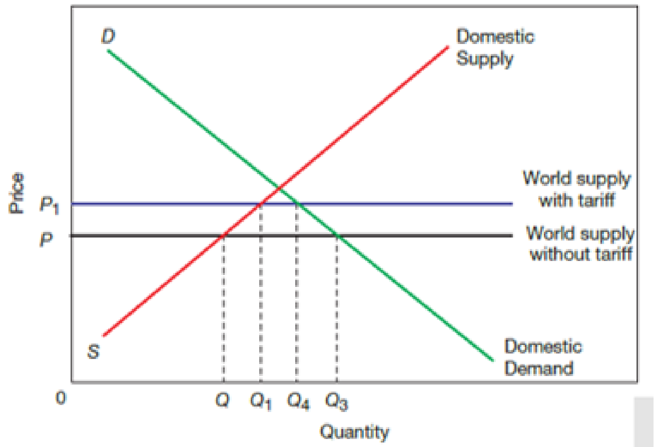

## 4.6. Protectionism

- **Protectionism:** is an action designed to help domestic products from foreign competition by reducing international trade.

**Measures include:**

| **Tariffs (tax)** | **Embargoes (bans)** |
|---|---|
| Quotas (limits) | Voluntary export restraint (agreed limit) |
| Foreign currency exchange control | Red tape (administrative delays) |
| Export subsidies | Dirty float exchange rate |

| **Free trade** | **Protectionism** |
|---|---|
| Foreign products within reach | Avoids over specialization |
| Greater variety | Improve terms of trade |
| Importing raw materials | Strategic industries |
| Better quality | Declining/sunset industries |
| More sales | Infant/sunrise industries |
| Economies of scale | Prevent dumping |
| Larger market | Reduce current account deficit |
| Greater competition | Raise revenue |
| Lower price | Protect employment |
| Spread of ideas & technology | Retaliation |



# 5. Macroeconomic Policies

## 5.1. Macroeconomic aims

- Full employment
- Low and stable inflation
- Balance of payments equilibrium
- Sustained and steady economic growth
- Stable exchange rate
- Sustainable economic development

## 5.2. Types of policies

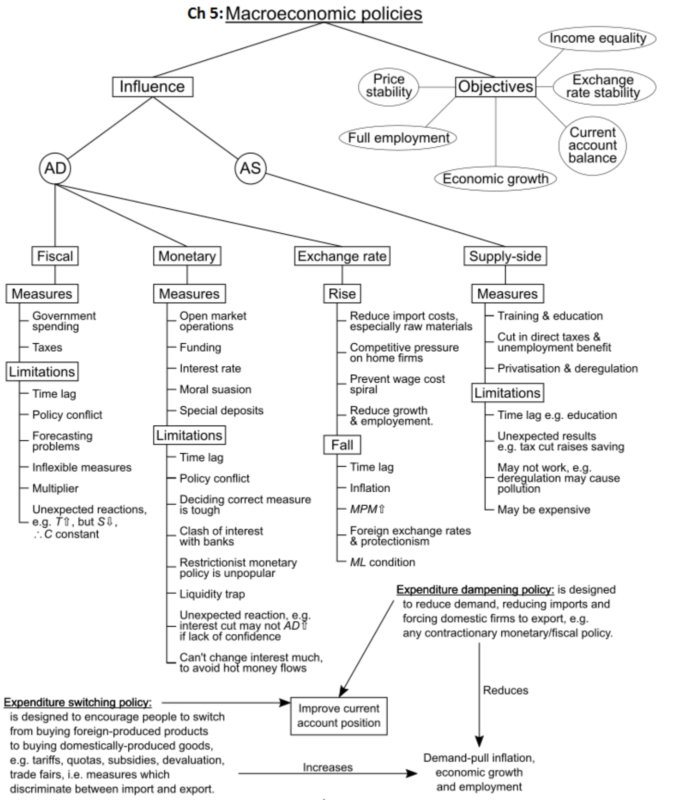
- Fiscal policy
  - It involves the use of taxation and government spending to influence AD
  - Expansionary/reflationary fiscal policy – lower taxes, higher government spending
  - Deflationary/contractionary fiscal policy – higher taxes, lower government spending
  - A budget is a government's estimates for its revenue and spending
    - Budget deficit – expenditure exceeds revenue
    - Budget surplus – revenue exceeds expenditure
    - Balanced budget – revenue equals expenditure
  - Only a short-term measure, households and firms will go back to older spending patterns once implementation of these policies is stopped.
  - Raising taxes can create disincentive to work, lowering labour force and productive capacity, increasing unemployment, lower GDP lowering economic growth
  - Tariffs may not be possible in a trade bloc. May even provoke retaliation. Domestic firms may become dependent
  - Workers press for higher wages, wage-price spiral, cost push inflation
  - Skilled workers may emigrate
  - May increase AD, demand-pull inflation
  - Firms may become dependent, complacent

- Monetary policy
  - It involves the use of interest rates, money supply and exchange rates to influence AD
  - Expansionary monetary policy – lower interest rate, increase money supply, currency depreciation
  - Contractionary monetary policy – increase interest rate, lower money supply, currency appreciation
  - Money supply can be controlled through the changes in the cash reserve ratio (CRR)
  - Difficult to control money supply
  - Interest rates have a time lag of 12-18 months
  - Interest rates are uncertain
  - Higher interest rate can have negative effect on unemployment, economic growth
  - Lower interest rates will lower hot money flows into the country
  - Higher interest rate will discourage FDI
  - Higher ROI will not guarantee fall in consumer spending as commercial banks may not pass on the higher interest rate
  - Fixed exchange rate, interest rate rises will cause currency appreciation leading the government to sell its currency to go back to the fixed level

- Supply-side policy
  - They are designed to increase AS
  - Increased spending on education and training
  - Deregulation & Privatisation
  - Direct tax cuts
  - Subsidies
  - Spending on infrastructure
  - Trade union/labour market reforms
  - Reduction in welfare payments
  - Only effective in the long run, have a time lag
  - Uncertain outcomes
  - Privatisation & deregulation – may develop monopolies
  - Subsidies – may not be passed to consumers
  - Education & training – only works if quality improved
  - Spending on training will reduce costs only if productivity rises greater than wage rates
  - Corporate tax – depends on confidence levels

- Expenditure switching policies
  - Measures designed to encourage consumer to switch to domestic products rather than foreign produced ones
  - Ex. protectionism measures like tariffs

- Expenditure reducing/dampening policies
  - Measures designed to lower domestic demand
  - Ex. higher income tax, interest rate




**Budget:** is an annual statement in which government outlines plans for its spending and tax revenue.

**Cyclical deficit:** is caused by economic activity change while structural one by imbalance between spending and tax revenue.

**Inflation target:** is the rate a central bank is set to achieve to keep prices stable. (around 5%)

**Tradeoff:** is when, in order to obtain an economic aim, it is necessary to accept an adverse effect on another. This is related to opportunity cost and *PPC*.

**Stagflation:** is high levels of both unemployment & inflation.

# CAIE AS LEVEL
## Economics (9708)