Managing the Economy

1. Outline how fiscal policy can be used to raise the level of aggregate demand.

2. Using aggregate demand and/or supply analysis outline the effect of each of the following on the level of real GDP and the price level in the UK: (1) a fall in GDP in the rest of Europe, (2) a rise in UK consumer confidence.

3. Using Aggregate demand and supply analysis, assess monetary policy's and fiscal policy's role in correcting an economy experiencing rapid inflation

Fiscal policy involves the government using taxation and expenditure to manipulate aggregate demand and influence the overall level of economic activity.
Aggregate demand is the total nominal demand or expenditure on products by consumers, governments, foreigners, and producers within an economy over a specified period of time.
Before Keynes, governments had budgets but they did not use fiscal policy. After Keynes's ideas were adopted, governments felt empowered to act against the fluctuations in economic activity by stabilizing the economy at full employment. This meant budgeting for a deficit when the economy was turning down to lower prices, incomes and unemployment, and budgeting for a surplus when the economy was expanding too rapidly and inflation was threatening.
Fiscal policies include; lower direct taxes (causing a rise in disposable income), higher Government spending, and an increase in the amount the government sector borrows each year (PSNCR). These fiscal policies reduce the rate of leakages from the circular flow and increase injections into the circular flow of income generating economic growth and employment at the cost of demand pull inflation.
An increase in government spending or a fall in taxes which increases budget deficit or reduces the budget surplus is known as expansionary fiscal policy. Fiscal policy is said to loosen as a result. On the other hand, a higher budget surplus or lower deficit will lead to a tightening in the fiscal stance.
A rise in government spending will not just increase aggregate demand by the value of its increase in itself. There will be a multiple increase in aggregate demand. This multiplier effect will be larger the smaller the leakages from the circular flow. Today, where leakages from savings, taxes and imports tend to be of a high proportion of national income, multiplier values are inclined to be small. However, Keynesian economists argue that they can still have a significant effect on output in the economy if the economy is below full employment.
In the future the UK economy maybe subject to a lot more fiscal policy, this is because if we join the Euro, our monetary policy committee (MPC) will have no control of the interest rate as it will be set in Brussels by the ECB (European central bank) . As a result it will be necessary to allow fiscal policy to control government objectives such distribution of wealth, inflation and unemployment.
Keynesians consider fiscal policy as their most important tool of economic management especially when it is used with an accommodating monetary policy. In contrast, monetarists consider monetary policy as all important and fiscal policy must be used to accommodate monetary targets.