

Overview of the Specification

This section of the web guide seeks to offer additional guidance to the unit 3 specification. It is assumed that teachers already have the “Teacher’s guide” which contains a gloss on many of the terms in the original specification. These further remarks are in response to the performance of candidates in the June 2001 examination.

Definitions

Candidates need working definitions of the key macroeconomic concepts. The specification begins with a standard list of the RPI, Unemployment, the Balance of Payments and Gross Domestic Product.

A knowledge of how the RPI is calculated is required. This should include price surveys, the Household Expenditure Survey, the principle of weighting and the idea of a base year. Candidates do not need to be able to construct indices themselves although they should be able to interpret published index numbers e.g. in calculating percentage rates of inflation. They should understand the difference between the RPI and the RPIX, and know why the latter rather than the former is targeted by the Bank of England. They should be able to make criticisms of the RPI as a measure of the cost of living. Standard criticisms include errors in the survey, that the index only represents an average household, and that it tends to overestimate changes in the cost of living both because the survey lags behind changes in expenditure patterns caused by higher prices of particular goods and because the definitions of categories of goods lags behind technological change.

Two measures of unemployment are included in the specification, the ILO (or Labour Force Survey) measure and the Claimant Count. Candidates should know some details of how these are calculated and be able to identify specific strengths and weaknesses of the definitions.

The main emphasis of the specification as far as the Balance of Payments is concerned is with the current account. The main subdivisions of this account should be known: trade in goods, trade in services, investment income and transfers. A brief sketch of the capital account is all that is required, but this should include some reference to hot money flows which in turn should be related to changes in the exchange rate following, say, changes in UK interest rates. Candidates should understand that UK Balance of Payments figures are not altogether reliable given the need to estimate many of the trade figures.

It is important that the concept of GDP is accurately grasped, in both nominal and real terms. It is expected that candidates will understand the difference between “GDP in current prices” and “GDP in constant prices” and know how to get from the former to the latter. Although it may be helpful to introduce it in the AS, the term GNP and

other definitions from national income accounting do *not* appear in the unit 3 specification.

The AD and AS Framework

A detailed description of this framework appears separately in this web guide. To summarise, candidates are expected to use a short-run AD/AS diagram with the price level on the vertical axis and real output horizontally. Consideration of the long run can be limited to shifts in the short-run curves. It is clear from marking scripts that many pupils are easily confused by combinations of short and long run (e.g. vertical) AS curves on the same diagram – and such combinations will *not* be required although they can clearly add value for the evaluation component of questions if properly presented.

Although the “circular flow” is not mentioned in the specification, it is probably useful to start with this concept before introducing the AD/AS model. This allows a proper discussion of the significance of withdrawals and injections – terms which *do* appear in the specification - and should also enable a descriptive approach to teaching the multiplier. It is certainly not expected that candidates will know formulas for the multiplier for unit 3; rather, they should be able to explain that increases in AD may have knock-on consequences – and that these will gradually dampen out due to leakages. They should be able to tell a similar story for multiplied contractions.

It is important that candidates are confident about the effects of exogenous shocks on this framework. A useful approach is simply to list out $C+I+G+X-M$ and check whether any of these elements of AD are likely to have been affected by the shock in question. Very often more than one will have been. If none have, then an AS shift has probably taken place. There are many shocks where *both* AD and AS will shift e.g. a rise in spending on the health service will raise AD through G but may also, in the longer term, raise the productivity of a healthier workforce.

A number of potential exogenous shocks are mentioned in the specification. These include: changes in wealth, interest rates, levels of government expenditure and taxation, the exchange rate, oil prices and the effect of financial crises within the global economy. Changes in labour costs, e.g. through changes in productivity, should also be considered. Candidates need to be confident about handling the analysis of all of these through the AD/AS framework. Some background information about the structure of the UK economy, e.g. that the UK is a net exporter of oil, is very useful in this context.

Macroeconomic Policy Objectives

The specification lists the following as macroeconomic policy objectives: full employment, price stability, economic growth, balance of payments equilibrium income redistribution and concern for the environment. The main emphasis of this section of unit 3 is the “causes, costs and effects” of failing to achieve any of these

objectives together with a recognition of the difficulties of achieving them all simultaneously.

Candidates should therefore be in a position to write out some suggested causes of unemployment, inflation, growth or lack of growth, and uneven income distribution. These should certainly, wherever possible, be related back to the AD/AS framework. They should also know why each of these may be seen as economic problems.

The discussion of economic growth should be conducted in a broader framework than just the UK. There should be an understanding of the limitations of GDP as an indicator of standards of living both over time and between countries. Explanations of the differences in growth rates between countries in different economic circumstances need to be considered. Here a “factors” approach is probably best, linking with unit 5B.

In this and other discussions the concept of the “output gap” is probably very helpful, illustrated as the difference between the full employment level of output and the equilibrium level of output on an AD/AS diagram. This term does not appear in the specification but it adds clarity to a discussion of issues such as the Monetary Policy Committee’s interest rate decision making.

A key part of this section of the syllabus concerns the potential *conflicts* between policy objectives. A simple Phillips curve can be used to illustrate the potential trade-off between inflation and unemployment, and there is no requirement to take this analysis into the territory of expectations augmented Phillips curves or discussions of the natural rate. The discussion should be generalised to include a consideration of potential trade-offs between all the macroeconomic objectives considered above. It may be useful to construct trade-off diagrams, e.g. between economic growth and current account equilibrium relating this to the basic AD/AS framework.

Relative Merits of Demand Side and Supply Side Policies

It was noticeable in the summer 2001 examinations that candidates from some centres seemed unaware of supply side policies. The term “productivity” appears in the specification but few were able to define it. When asked for supply side policies many listed fiscal or monetary policies instead. Candidates should be able to critically evaluate the use of measures to improve productivity, incentives to work, competition and innovation.

Under the heading of demand side policies, candidates should be fully informed about current arrangements for monetary and fiscal policy. They should be aware of the rationale behind the monetary policy committee, and consider alternative sources of information when assessing interest rate decisions. On the fiscal side, candidates should understand the concept of fiscal deficit (PSBR) and be aware of factors affecting its size.

Some recognition of the appropriateness of different policy mixes according to the state of the macro-economy is also required.

Conclusion

The unit contains a relatively narrow but well specified theoretical base. Candidates who have mastered the elementary AD/AS apparatus and who are prepared to critically evaluate the assumptions behind their analysis can expect to do very well on this paper. However, a necessary condition for success is some attention to the *details* of the basic definitions and concepts. This is addressed in the definitions list.