

Revision Note

AS Economics

Basic Transmission Mechanisms

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Basic transmission mechanisms:

1. Economic growth leads to lower unemployment

Growth → rising income per capita → greater spending into the economy → AD for goods and services increase → more manpower needed → lower unemployment

2. Economic growth leads to higher inflation

Growth → increase in wages/ bonuses → greater spending into the economy → increase in AD → price level increases → demand-pull inflation

3. Economic growth leads to the worsening of current account deficit

Growth → increase in wages/ bonuses → UK people have high marginal propensity to import → rise in imports and assume exports unchanged → worsening of the current account deficit

4. Economic growth leads to income inequality

Growth → wages for low/ middle class earners will usually increase but at a slower rate → probably worse off after adjustment for inflation, student loan repayments, income tax and NICs (National Insurance Contributions) → rich people may be subjected to higher income tax BUT there are other non-income gains that are taxed at much lower rate e.g. capital gain and share dividends → widening income inequality

5. Growth leads to deterioration of environment

Growth → increase in wages → greater AD for goods and services → more lands cleared to give way for residential homes, business parks and factories/ more cars on the road → deforestation and rise in global warming

6. Lower unemployment leads higher growth

Low unemployment → AD for goods and services will increase → higher real output → growth

7. Lower unemployment leads to higher inflation

Low joblessness → greater spending into the economy → AD shifts rightward → price level increases → demand-pull inflation

8. Lower unemployment leads to worsening of current account deficit

Low joblessness → unemployed people now have income to spend → UK people have high marginal propensity to import → rise in imports and assuming exports unchanged → current account deficit widens

9. Lower unemployment leads to deteriorating environment

Fewer jobless people → greater spending into the economy → more lands to be cleared to construct houses, leisure areas and factories/ more cars and busses on the roads → deforestation and emission of CO₂

10. Lower unemployment reduces income inequality

Fewer unemployed people → jobless people now have income and assume that their income is more than their previous benefits and UK government implements progressive taxation → narrowing the gap between the rich and poor

11. Lower unemployment leads to higher inflation

Fewer jobless people → total expenditure into the economy increases → AD shifts rightward → increase in price level → higher demand-pull inflation

12. High inflation leads to lower growth

Supposed that the inflation creeps beyond the targeted level of CPI 2% +/- 1% → Bank of England may consider an increase in base rate → if this happens, cost of borrowing will increase → lower consumption and investment → fall in AD → lower growth

13. High inflation leads to increase in unemployment

Increase in inflation → falling real income → limiting the spending ability of households → AD for goods and services will fall → fewer workers needed

14. High inflation leads to the worsening of current account deficit

Increase in production costs → less competitive pricing → export prices increase and assuming import prices unchanged → fall in demand for British manufactured goods → widening current account deficit

15. High inflation leads to widening income inequality

Rise in price level → wages growth rate is usually lower than the rate of inflation → falling real income → consumers/ households are priced-out → every pound purchases lesser goods and services

16. High inflation leads to less deterioration of environment

Increase in price level → falling real income → limiting the ability of households to spend elsewhere → fall in AD for goods and services → factories operate shorter hours and economic activities come to a slowdown → less severe congestion, deforestation and flights → improve the conditions of the environment

Remember, you don't have to study textbooks. It is incredibly sufficient if you're able to understand transmission mechanisms alone. LOGIC is the word. Please don't rot memorise