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H2 Economics – Essay Model
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Topic: Macroeconomic Policies & Goals
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Describe and explain the macroeconomic policies that can be implemented to move an economy from a point within the Production Possibility Curve (PPC) to being on it. [13]

The Production Possibility Curve is a theoretical conception of the maximum output that can be produced by the country at any one point of time given the factors of production available. The presence of an economy at a point that is within the PPC rather than being on it indicates that the resources in the economy are under-utilized and therefore the economy is not producing at the maximum capacity of production (the case when the economy is exactly on the PPC). The movement of the economy from this state of underemployment to a full employment of resources therefore represents actual growth of the economy.

[Diagram of PPC with a point labeled within the curve moving to a point on the PPC]

[Diagram of AD-AS, with a AD_1 and AD_2, AD_2 being the demand closer to full employment level of the AS]

Actual growth would mean increase in aggregate demand to utilize the excess capacity present in the economy and attain the maximum production possibility. The figure above demonstrates part of the process of attaining actual growth where the aggregate demand increases to match the productive capacity of the economy denoted by the aggregate supply curve. Therefore, any macroeconomic policy that helps to attain actual growth and raise employment level in the economy would be able to move the economy from a point within the PPC to being on it.

The most straight-forward policy would be the use of expansionary fiscal policy. The aggregate demand of the economy is made up by consumption, investment, government expenditure, and net-exports; by raising government expenditure in the economy, the aggregate demand would thus rise and push the level of employment in the economy higher, attaining actual growth. The increase of government expenditure would produce actual growth more effectively when they are directed at areas where resources are evidently under-utilized. This would allow the economy to move towards being a point on the PPC.

Nevertheless, there are potential barriers to the effectiveness of fiscal policy as a means to achieve actual growth. If the government is facing severe deficits, and therefore have insufficient funds to conduct the expansionary fiscal policy, they will end up having to borrow in order to implement the policy. This borrowing, if from domestic sources such as the local banking sector, could result in crowding out effect, where public spending increase in the expense of private investment. This would mean that the eventual aggregate demand could stay at the same sector or increase only insignificantly, thus actual growth may not be substantial.

Another problem with fiscal policy would be the ineffectiveness resulting from a small multiplier. For economies that relies largely on the external sector and thus have a high marginal propensity for withdrawal resulting from import leakages or because of high savings rate, the multiplier of the economy would be tiny, implying that any expenditure increases by the government may not result in more than proportionate change in the increase of aggregate demand.

Monetary policies can also be used to stimulate aggregate demand and create actual growth that will move the economy towards being on the PPC instead of being just within it. Loose monetary policy resulting from either low interest rates or a low value currency would help to raise aggregate demand by encouraging consumption and investments while boosting export revenues. Low interest rates discourage having too much savings since the returns are low and would encourage borrowing

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since the cost of debt would be lower and this added liquidity would push up investments. Likewise, an undervalued currency would keep exports competitive and raise net export revenues thus increasing the components of aggregate demand. This would translate into the actual growth that utilizes spare capacity within the economy and help to push the economy towards a point on the PPC. Of course, monetary policies have their drawbacks including the fact that interest rates cannot go below zero and that exchange rate monetary policy requires the accumulation of foreign reserves or large surpluses.

Eventually, no matter how effective the fiscal or monetary policies are, the economy can only move closer to the PPC at best but never actually be on it. Reaching the point on the PPC implies the maximum utilization of the capacity of the economy, which is impossible in reality. The presence of bottlenecks creating pressures for price rises means that inflation will set in before the economy reaches the full employment level. Besides, the labour force may prefer a certain level of leisure, which is not necessarily the maximum productive capacity of the economy, thus making it impossible for the policies to push the economy on to the PPC. At any single moment, it is impossible to gain perfect productive efficiency in the economy.

Having said that, it is imperative for the government to implement supply-side policies to ensure the long term actual growth of the economy. Since it is impossible for the economy to be on the PPC at any one point of time, it can only grow beyond the current PPC by having the PPC shift out first. This is known as potential growth and can be achieve through the expansion of aggregate supply through discovery of additional factors of production, invention of new technologies or improving know-how of the workers to raise labour productivity. In conclusion, fiscal and monetary policies can be implemented to help generate actual growth that will shift the economy from a point within the PPC towards a point on the PPC but never exactly on the PPC. To be able to shift the economy further, the PPC will first have to shift out and this entails potential growth that can be achieved only through the use of supply-side policies.

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