Government macroeconomic intervention (A Level)

Macroeconomic policy objectives in more depth, the links and conflicts between macroeconomic problems, and the effectiveness of fiscal, monetary and supply-side policy options in meeting all the objectives.

10.1 Government macroeconomic policy objectives

Governments pursue **growth**, **low unemployment**, **price stability**, **balance of payments equilibrium**, **income redistribution** and **sustainability**. **Targets** are set for the objectives (for example **a 2% inflation target**) and judged over **short and long runs**.

Costs and benefits of each objective:

Objective	Benefits	Possible costs of pursuing it
Growth	higher incomes, jobs	**environmental damage**, **inflation**
Low unemployment	output, income, social benefits	**wage-push inflation** if below the natural rate
Price stability	**certainty** for investment, **competitiveness**	**higher interest rates**, **slower growth**
External balance	**confidence**, stability	**contractionary** policy
Redistribution	**equity**	**reduced incentives**

Policy instruments: fiscal, **monetary**, **supply-side**, **exchange rate** and **direct controls**.

10.2 Links between macroeconomic problems and their interrelatedness

Macroeconomic problems are **linked**:

- **Growth and inflation: fast growth** with **spare capacity exhausted** raises **inflation**.
- **Growth and unemployment: growth** lowers **cyclical** unemployment (**Okun's law**).
- **Growth and the current account: growth raises imports** (high **income elasticity of demand for imports**), so the **deficit widens**.
- **Inflation and the current account: higher inflation** makes **exports uncompetitive**.
- **Unemployment and inflation:** the **Phillips curve** trade-off.

Note Academy

- **Growth and inequality / environment:** growth may **increase inequality** and **environmental harm**.
- **Government budget: recession** lowers **tax revenue** and raises **benefit spending**, widening the **budget deficit**; **national debt** rises.

> **Trade-offs and conflicts between objectives mean that governments rarely hit them all: a policy that helps one objective often harms another, so priorities are value judgements.**

Government debt

The **budget deficit** adds to the **national debt**; **debt interest** is a **burden** and may **crowd out** other spending; **sustainability** depends on the **debt-to-GDP ratio** and the **growth rate** relative to the interest rate. **Cyclical** (automatic) and **structural** (underlying) deficits differ.

The **internal value of money** is its **purchasing power at home** (inversely related to the price level); the **external value** is the **exchange rate**. **Higher inflation lowers the internal value** and, unless the exchange rate falls, **raises the price of exports**, **worsening the balance of payments**. The **balance of payments** also depends on **growth**: faster growth **sucks in imports**. The **expectations-augmented Phillips curve** shows that the **short-run** curve **shifts up** when **inflation expectations rise**, so the **long-run curve is vertical** at the natural rate.

10.3 Effectiveness of policy options to meet all macroeconomic objectives

Fiscal policy

Expansionary fiscal policy raises **AD**: effective for **demand-deficient** problems; **size** depends on the **multiplier**; **crowding out**; **lags**; **debt** concerns. **Contractionary** policy (**austerity**) reduces **deficits** and **inflation** but can **slow growth** and **raise unemployment**. **Fiscal rules** and **independent fiscal bodies** may limit deficits.

Structural use of fiscal policy: **spending on infrastructure and education** supports **supply-side** growth; **taxes** shape **incentives**.

Monetary policy

Interest rate policy by an **independent central bank** targeting **inflation**; **quick** to change but **long lags** to take effect; **transmission** works via **spending, asset prices, exchange rates**. **Limits** when rates are **near zero** (the **zero lower bound**), where **QE** and **forward guidance** are used. **Exchange rate** effects help **external** balance but hit **importers** or **exporters**.

Note Academy

Supply-side policy

Raises potential output, easing the **trade-off** between **growth and inflation**; works **slowly**; may **widen inequality** or need **large spending**. **Market-based** (deregulation, tax cuts, labour reform) and **interventionist** (education, infrastructure, R&D).

Choosing and combining policies

Problem	Appropriate policies	Evaluation
Recession, demand-deficient unemployment	**expansionary** fiscal and monetary	**inflation**, **debt**, lags
Demand-pull inflation	**contractionary** fiscal and monetary	**growth and jobs** fall
Cost-push inflation	**supply-side**, **exchange rate**, wage restraint	demand policy is **ineffective**
Structural unemployment	**training**, **mobility** policies	slow, costly
Current account deficit	**expenditure-switching and -reducing**	**elasticities**, **retaliation**

TRY IT

The economy has **cost-push inflation** and rising unemployment. Why is **monetary tightening** a poor fit?

It lowers **AD** and may reduce **inflation** but **deepens the recession** and **unemployment**; the cause is **supply-side**, so **supply-side** policies or **wage restraint** may be more suitable.

Factors influencing success

Time lags, **accuracy of forecasts**, **size of multiplier**, **expectations and confidence**, **international conditions** (world growth, capital flows), **political constraints**, the **state of the economy** and the **scale of spare capacity**. Policy effects are **uncertain** and depend on the **causes** of the problem.

Fiscal policy may use the **Laffer curve**: at very high tax rates, **revenue falls** because of **reduced incentives and avoidance**, so **cutting rates** may increase revenue; but the **peak is hard to find**. **Problems and conflicts** arise from the outcomes of policies: **reducing unemployment** may **raise inflation**, **cutting inflation** may **cut growth**, **boosting growth** may **harm the environment and the current account**, and **deficit reduction** may **slow the economy**. **Government failure** in macroeconomic policy includes **poor forecasts, time lags, political short-termism**, **policy mistakes**, **crowding out** and **unintended effects** on expectations.

Note Academy