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Economics Revision Focus: 2004

A2 Economics

Economic Policy Objectives and Trade-Offs

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Revision Focus: Economic Policy Objectives and Trade-Offs

AS Syllabus Requirements:

Candidates should know that the control of inflation, minimizing unemployment, achieving a steady rate of economic growth and a satisfactory balance of payments position are the main objectives of the government's macroeconomic policy. They should understand the factors which are likely to affect the government's ability to achieve these objectives and that, at least in the short run, conflicts may arise when attempting to achieve these objectives.

A2 Syllabus Requirements:

Candidates should be able to use **macroeconomic models** to analyse the causes of possible conflicts between policy objectives in the short run and the long run. They should be able to discuss approaches to reconciling these conflicts and the supply-side view that the major macroeconomic objectives are compatible in the long run. They should appreciate the ways in which developments in the global economy and the United Kingdom's membership of the European Union affect economic policy and performance.

Policy objectives and instruments

Objectives are the **aims** of government policy whereas **instruments** are the means by which these aims might be achieved and **targets** are often thought to be intermediate aims – linked closely to the final objective.

Only a limited number of policies can be used to achieve the government's objectives. There is a huge amount of economic research conducted in trying to determine the effectiveness of different policy instruments in meeting key objectives. Indeed the debates about which policies are most suitable lie at the heart of differences between economic schools of thought.

Limitations of macroeconomic policy-making

Macro-economic policy-making is rarely an exact science! The levers (or instruments) of macro-economic policy do not work with a high level of accuracy and inevitably the job of setting objectives and choosing appropriate and instruments is open to error and misjudgement. In part, this is because data on the economy is inaccurate or unavailable at the right time. Macroeconomic policy-making is as prone to **government failure** as is microeconomic intervention in the price mechanism.

Uncertain time lags

Changes to government policy (e.g. changes in direct taxation, a cut in interest rates or a rise in investment tax allowances) operate with uncertain time lags. They take time to work their way through the circular flow of income and spending and through to final objectives such as GDP growth and inflation.

Make sure you are confident in using **aggregate demand and supply analysis** to show the possible effects of government policy. And remember

The main policy instruments available to meet the objectives are

- Monetary policy (including changes to the exchange rate)

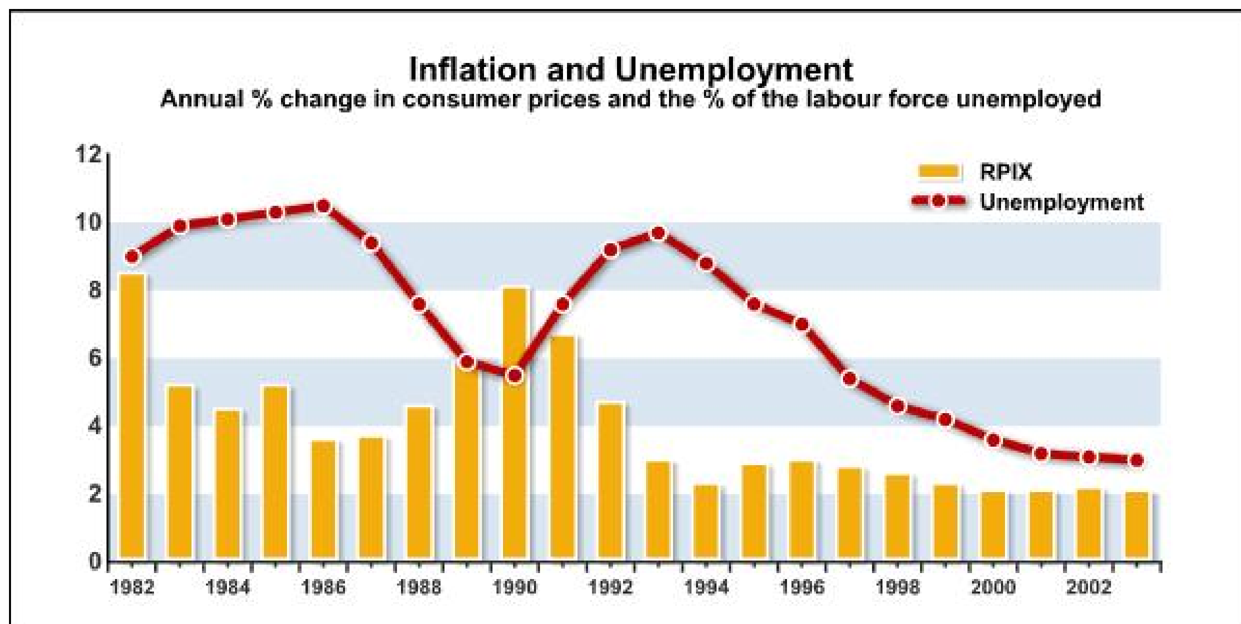
- Fiscal policy
- Supply-side policies
- Direct controls / regulation

Macro Economic Policy Trade-Offs

There are potential trade-offs between objectives imply that choices may have to be made in the short and medium run.

- Should greater priority be given to keeping inflation under control?
- Or can the British economy now operate at a higher level of GDP growth and lower unemployment without worrying too much about the inflationary consequences?
- Should the government be concerned about a large and rising trade deficit with other countries? Or can the trade deficit be ignored because it is the result of a high level of short term growth and strong consumer spending?

What we find is that the nature of macro economic trade-offs can change over time, partly as the structure of the economy changes. For example, it is widely acknowledged that the relationship between unemployment and inflation in the UK (and some other countries) has altered over the last fifteen years. As a consequence, the British economy has enjoyed a very long period of falling unemployment without any significant acceleration in inflation. This is shown in the data chart below.



Why has the "trade-off" between unemployment and inflation that still forms a core part of most economics textbooks, now altered for the good?

Some economists point to the effect of supply side improvements in the British economy such as higher capital investment; increases in productivity, lower labour costs and the benefits of rapid innovation. All of these factors have helped to increase the supply-side potential of the economy which has contributed to a period of **non-inflationary growth**.

But it would be wrong to automatically assume that inflation is now dead! There are plenty of possible causes of a return to higher inflation. For example, the UK is not immune to fluctuations in global

commodity prices, or the effects of a sharp fall in the exchange rate. And too much domestic demand for goods and services, perhaps driven by the continued boom in house prices and consumer borrowing, might also bring about a return of **demand-pull inflationary pressure.**

The Current Objectives of UK Economic Policy

The Labour Government has several current objectives:

- **Stable low inflation** - the Government's inflation target is **2.0%** for the **consumer price index**. The MPC sets interest rates at a level it thinks will meet the inflation target over a two year forecasting horizon. The Bank of England has been independent since May 1997 but inflation targets pre-date the decision to hand over control of monetary policy to the BoE. Inflation targets were first introduced into the UK in October 1992 and have played an important role in keeping inflation expectations under control.
- **Sustainable growth** – as measured by the rate of growth of real gross domestic product – sustainable both in terms of maintaining low inflation and also in terms of the environmental impact of growth (for example the impact of growth on pollution, waste and our scarce resources)
- **Higher levels of capital investment and labour productivity** – to improve international competitiveness and boost the UK's trade performance in goods and services. The pressures of globalisation and the increasing competition within the European Single Market make this one of the most important long-term objectives of the government
- **High employment** - the government wants to achieve full-employment – a situation where all those able and available to find work have the opportunity to work. But unemployment can never fall to zero since there will always be a degree of **frictional** and **structural unemployment** in the labour market
- **Rising living standards and a fall in relative poverty** – for example the objective of cutting child poverty and reducing pensioner poverty over the next few years
- **Sound government finances** - including tight control over government borrowing and the national debt so that the Chancellor meets his own fiscal rules over the course of the economic cycle.

The general point is that the government emphasizes **macroeconomic stability** as one of its main policy aims – it believes that stability is a **pre-condition** for improvements in investment, productivity, profits and employment. Of course the vagaries of the global economy make this a difficult objective to pursue. Good luck as well as sound judgement is required given the **domestic and external shocks** that can affect the British economy at any time.

Economic forecasts always have an error margin and with some of the indicators (for example the government budget deficit, the final out-turn can be many billions away from initial forecasts)

Wider points worth bearing in mind

- There is no official target for economic growth or for unemployment
- Unofficially the government seeks to improve the UK's **trend rate of growth** – the rate at which the productive capacity of the economy is estimated to grow each year.
- The UK operates with a **floating exchange rate** – i.e. the currency finds its own level in the foreign exchange markets and the government (through the Bank of England) does not intervene in the currency markets to achieve a desired level for sterling. This has been the case since the pound fell out of the European exchange rate mechanism in September 1992. Having a floating

exchange rate means that interest rates can be used to control aggregate demand and inflation rather than being used to influence the exchange rate towards a target level.

- The UK is outside of the **Euro Zone** and seems certain to remain outside of the single currency for the foreseeable future. The 12 countries inside the Euro Zone have their interest rates set by the ECB but the UK has decided to maintain an opt-out from the Euro. The Treasury insist that entry will only be considered if a series of five economic tests are met that cover the issue of UK economic convergence with other Euro Zone countries
- The UK is also outside of the **European Fiscal Stability Pact** which limits how large a government budget deficit can be – but Gordon Brown has his own fiscal rules to control government borrowing over the economic cycle
- We are heavily dependent with trade inside the European Single Market. In 2003, nearly 60% of our trade was with fellow members of the European Union, so clearly macroeconomic developments in the EU have a heavy bearing on our own cycle performance. About 15% of our trade is with the United States and a much smaller (although growing) percentage of trade is now taking place with the fast-growing Chinese economy.
- The last recession in the UK finished in the autumn of 1992. This is the longest sustained period of economic growth for over 40 years (the economy is over 30% bigger in terms of real national output than it was at the trough of the last recession)
- The main drivers of aggregate demand at the moment are consumer spending and government spending. Investment and exports are both relatively weak. Consumer spending has surged in the last eight years. And, measured as a percentage of national income (GDP) the UK now has the highest level of consumption in its history. Some economists are concerned that the British economy is now too dependent on the consumer and that macroeconomic policy should seek the **rebalance** demand away from consumption towards capital investment ands exports
- The UK is running a **large trade deficit** in goods and services. In 2002 there was a £45 billion deficit in goods partially offset by a £15 billion surplus in services. In 2003 the trade gap in goods widened to £46 billion but the surplus on services dipped to only £11 billion. Fortunately a fairly strong net inflow of interest, profits and dividends from UK investment overseas helps to balance our current account to a degree – but the UK still ran a current account deficit of nearly £20 billion in 2003, a touch below 2% of GDP

What has happened to the British economy in the last few years?

The table below provides a five year summary of ten of the main macroeconomic indicators for the British economy. It is always good to back up your answers in an exam with some evidence. It would be a good idea to include some of this evidence if you get the chance on the main macroeconomic data response and essay papers!

	Household Consumption	Real Disposable Income	Real GDP	Unemployment	RPIX Inflation	Trade Balance (Goods)
	% change	% of income	% change	% of labour force	% change	£ billion
1999	4.6	3.3	2.8	4.1	2.3	-29.1
2000	4.4	6.2	3.8	3.6	2.1	-33.0
2001	3.1	4.7	2.1	3.2	2.1	-40.6
2002	3.4	1.6	1.7	3.1	2.2	-46.6
2003	2.3	2.5	2.1	3.1	2.8	-46.8
2004	2.6	3.2	2.9	2.9	2.3	-53.7
Average 1992-2004	**3.0**	**2.9**	**2.6**	**5.5**	**2.7**	**-26.7**
Maximum	4.6	6.2	4.4	9.7	4.7	-11.1
Minimum	0.5	0.3	0.2	2.9	2.1	-53.7
Standard Deviation	1.1	1.5	1.0	2.6	0.7	15.8

	Government Budget Balance	Short Term Interest Rate	Sterling Exchange Rate Index	Unemployment	Output Gap
	£ billion	%	1990=100	000s	%
1999	10.0	5.4	103.7	1236.2	0.0
2000	15.0	6.1	107.5	1077.8	0.6
2001	8.1	5.0	105.8	966.4	-0.1
2002	-15.3	4.0	106.0	944.8	-0.8
2003	-34.3	3.7	100.2	931.4	-1.1
2004	-38.6	4.3	102.4	888.8	-0.6
Average 1992-2004	**-21.6**	**5.9**	**98.2**	**1651.3**	**-0.4**
Maximum	15.0	9.6	107.5	2861.4	0.9
Minimum	-50.9	3.7	84.8	888.8	-2.9
Standard Deviation	23.2	1.6	8.1	753.0	1.2