

# **Edexcel Economics (A) A-level**

## **Theme 2: The UK Economy - Performance and Policies**

### **2.6 Macroeconomic Objectives and Policies**

#### **Summary Notes**

## 2.6.1 Possible macroeconomic objectives

The government has four main macroeconomic objectives. These aim to provide **macro stability**.

### **Economic growth:**

In the UK, the long run trend of economic growth is about 2.5%. Governments aim to have sustainable economic growth for the long run.

In emerging markets and developing economies, governments might aim to increase economic development before economic growth, which will improve living standards, increase life expectancy and improve literacy rates.

### **Low unemployment:**

Governments aim to have as near to full employment as possible. They account for frictional unemployment by aiming for an unemployment rate of around 3%. The labour force should also be employed in productive work.

### **Low and stable rate of inflation:**

In the UK, the government inflation target is 2%, measured with CPI. This aims to provide price stability for firms and consumers, and will help them make decisions for the long run. If the inflation rate falls 1% outside this target, the Governor of the Bank of England has to write a letter to the Chancellor of the Exchequer to explain why this happened and what the Bank intends to do about it

### **Balance of payments equilibrium on current account:**

Governments aim for the current account to be satisfactory, so there is not a large deficit. This is usually near to equilibrium.

A balance of payments equilibrium on the current account means the country can sustainably finance the current account, which is important for long term growth.

Additionally, the government might have the following macroeconomic objectives.

 **Balanced government budget:**

This ensures the government keeps control of state borrowing, so the national debt does not escalate. This allows governments to borrow cheaply in the future should they need to, and makes repayment easier.

 **Protection of the environment:**

This aims to provide long run environmental stability. It ensures resources used are not exploited, such as oil and natural gas, and that they are used sustainably, so future generations can access them too. Moreover, it means there is not excessive pollution.

 **Greater income equality:**

Income and wealth should be distributed equitably, so the gap between the rich and poor is not extreme. It is generally associated with a fairer society.

## 2.6.2 Demand-side policies

Demand-side policies are policies designed to increase consumer demand, so that total production in the economy increases.

### The distinction between monetary and fiscal policy:

Monetary policy is used by the government to control the money flow of the economy. This is done with interest rates and quantitative easing. This is conducted by the Bank of England, which is independent from the government.

Fiscal policy uses government spending and revenues from taxation to influence AD. This is conducted by the government.

### Monetary policy instruments:

- **Interest rates**

In the UK, the Monetary Policy Committee (MPC) alters interest rates to control the supply of money. They are independent from the government, and the nine members meet each month to discuss what the rate of interest should be. Interest rates are used to help meet the government target of price stability, since it alters the cost of borrowing and reward for saving.

The bank controls the **base rate**, which ultimately controls the interest rates across the economy. A reduction in the base rate will lead to a rise in AD. This happens through a number of transmission mechanisms:

- Consumption and investment increase due to lower costs of borrowing
- Higher consumption, due to lower borrowing, will mean that asset prices increase. This will lead to a positive wealth effect.
- Saving becomes less attractive, as a lower rate of return is offered, so consumption and investment both increase. Mortgage interest repayments are lower and so therefore consumers have more income left to spend, which also increases consumption.
- Lower interest rates reduce the incentive for investors to hold their money in British banks, so demand for the pound will fall. The pound will be weaker, so exports will be cheaper and imports more expensive. Net trade will therefore increase.

- **Asset purchases to increase the money supply: Quantitative Easing (QE)**

This is used by banks to help to stimulate the economy when standard monetary policy is no longer effective. This has inflationary effects since it increases the money supply, and it can reduce the value of the currency.

QE is usually used where inflation is low and it is not possible to lower interest rates further.

QE is a method to pump money directly into the economy. It has been used by the European Central Bank to help stimulate the economy. Since the interest rates are already very low, it is not possible to lower them much more. The bank bought assets in the form of government bonds using the money they have created. This is then used to buy bonds from investors, which increases the amount of cash flowing in the financial system. This encourages more lending to firms and individuals, since it makes the cost of borrowing lower. The theory is that this encourages more investment, more spending, and hopefully higher growth. A possible effect of this is that there could be higher inflation.

If inflation gets high, the Bank of England can reduce the supply of money in the economy by selling their assets. This reduces the amount of spending in the economy.

### **Limitations of monetary policy:**

- Banks might not pass the base rate onto consumers, which means that even if the central bank changes the interest rate, it might not have the intended effect.
- Even if the cost of borrowing is low, consumers might be unable to borrow because banks are unwilling to lend. After the 2008 financial crisis, banks became more risk averse.
- Interest rates will be more effective at stimulating spending and investment when consumer and firm confidence is high. If consumers think the economy is still risky, they are less likely to spend, even if interest rates are low.

## Fiscal policy instruments:

- **Government spending and taxation**

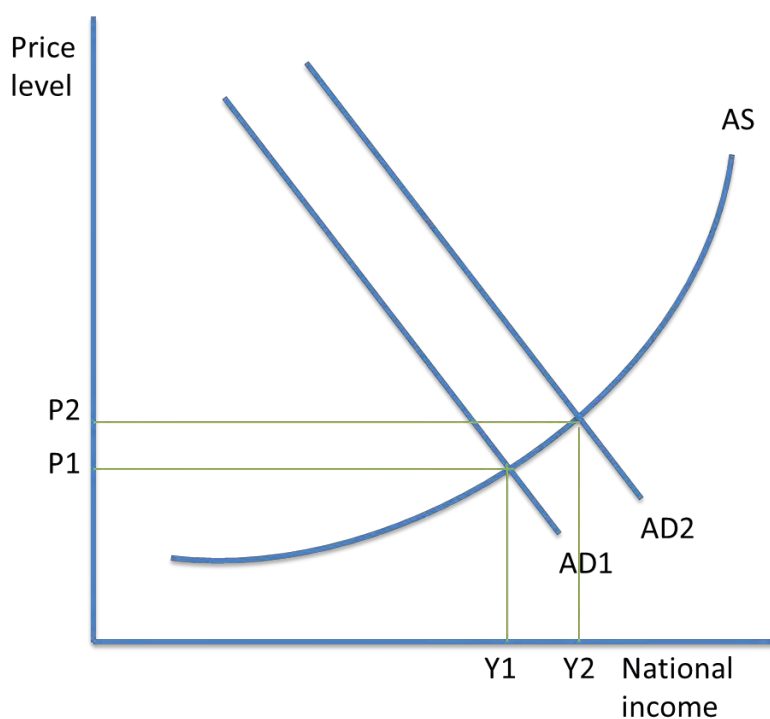
Governments can change the amount of spending and taxation to stimulate the economy. The government could influence the size of the circular flow by changing the government budget, and spending and taxes can be targeted in areas which need stimulating.

Fiscal policy aims to stimulate economic growth and stabilise the economy.

In the UK, the government spends most of their budget on pensions and welfare benefits, followed by health and education. Income tax is the biggest source of tax revenue in the UK.

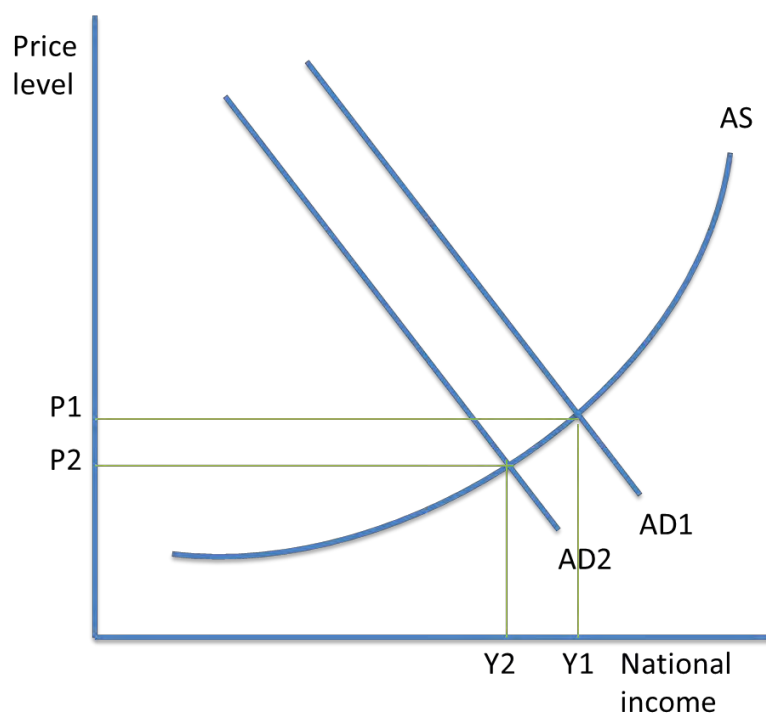
### Expansionary fiscal policy

This aims to increase AD. Governments increase spending or reduce taxes to do this. It leads to a worsening of the government budget deficit, and it may mean governments have to borrow more to finance this.



### Deflationary fiscal policy

This aims to decrease AD. Governments cut spending or raise taxes, which reduces consumer spending. It leads to an improvement of the government budget deficit.



### The government budget (fiscal) surplus and deficit:

A government has a **budget deficit** when expenditure exceeds tax receipts in a financial year.

A government has a **budget surplus** when tax receipts exceed expenditure.

### Direct and indirect taxes:

**Direct taxes** are imposed on income and are paid directly to the government from the tax payer. Examples include income tax, corporation tax, NICs and inheritance tax. Consumers and firms are responsible for paying the whole tax to the government.


**Indirect taxes** are imposed on expenditure on goods and services, and they increase production costs for producers. This increases market price and demand contracts.


### **Limitations of fiscal policy:**

- Governments might have imperfect information about the economy. It could lead to inefficient spending.
- There is a significant time lag involved with employing fiscal policy. It could take months or years to have an effect.
- If the government borrows from the private sector, there are fewer funds available for the private sector, which could lead to crowding out.
- The bigger the size of the multiplier, the bigger the effect on AD and the more effective the policy.
- If interest rates are high, fiscal policy might not be effective for increasing demand.
- If the government spends too much, there could be difficulties paying back the debt, which could make it difficult to borrow in the future.

### **Demand-side policies in the Great Depression and the Global Financial Crisis of 2008:**

#### **The Great Depression**

 The Great Depression initiated in 1929, and by 1933 real GDP had fallen by 30% and the unemployment rate increased to 25%. In the 75 years prior to this, economic declines lasted about 2 years; The Great Depression lasted over a decade.

 Keynes shifted macroeconomic thought from a focus on AS to AD. Keynesian economists emphasize the use of demand-side policies to close gaps between actual and potential output.

#### **Causes:**

- It was set off by the Wall Street Crash of 1929
- This led to a huge loss in consumer and business confidence, decreasing consumption and investment
- The 1920s had been a period of unsustainable boom and the banking system was unstable; the government allowed the banks to crash
- The USA had introduced protectionism whilst the UK was committed to the gold standard, where its currency was fixed to gold and was overvalued.



### Responses in the UK:

- The government thought balancing the budget was essential so they cut public sector wages and unemployment benefits and raised income tax
- Interest rates were high to help maintain the pound, which came under attack from speculators
- Eventually, they left the gold standard and cut interest rates.



### Responses in the USA:

- Roosevelt's New Deal used public sector investment, work schemes for the unemployed and fiscal stimulus to increase AD and bring about a recovery
- Some argue that not enough spending was undertaken for it to be effective; it was the war which eventually ended the Depression
- They also tried to increase the money supply, but it is unclear how effective this was.



### The Global Financial Crisis



The Global Financial Crisis is sometimes called The Great Recession, and it refers to the decline in world GDP in 2008-2009



#### Causes:

Before the crash, asset prices were high and rising, and there was a boom in economic demand. There were risky bank loans and mortgages, especially in the US where government securities were backed by subprime mortgages. This means the borrowers had poor credit histories, and after house prices crashed in the US in 2006, several homeowners defaulted on their mortgages in 2007. Banks had lost huge funds, and required assistance from the government in the form of bailouts.



#### Policy responses in the UK and USA:

- Both governments were forced to nationalise banks and building societies. They guaranteed savers their money in order to prevent the chaos of a collapsed system.
- They used expansionary monetary policies, including record low interest rates and quantitative easing.
- The UK cut VAT from 17.5% to 15% and saw a huge increase in government borrowing.
- The USA used more expansionary fiscal policy, and this is perhaps why it recovered faster. In 2010, the UK prioritised reducing National Debt but the USA did not make this decision until 2013.

#### Synoptic point:

Any government policy decision will also have microeconomic impacts, for example firms may see higher post tax profits and have more to invest which could increase efficiency.

## 2.6.3 Supply-side policies

Supply-side policies aim to improve the long run productive potential of the economy.

### **The distinction between market-based and interventionist policies:**

Market-based policies limit the intervention of the government and allow the free market to eliminate imbalances. The forces of supply and demand are used.

Interventionist policies rely on the government intervening in the market.

### **Market-based policies:**

- **To increase incentives**
  - Reducing income and corporation tax to encourage spending and investment.
  - Reducing benefits to increase the opportunity cost of being out of work
- **To promote competition**
  - By deregulating or privatising the public sector, firms can compete in a competitive market, which should also help improve economic efficiency.
- **To reform the labour market**
  - Reducing the NMW (or abolishing it altogether) will allow free market forces to allocate wages and the labour market should clear.
  - Reducing trade union power makes employing workers less restrictive and it increases the mobility of labour. This makes the labour market more efficient.

### **Interventionist policies:**

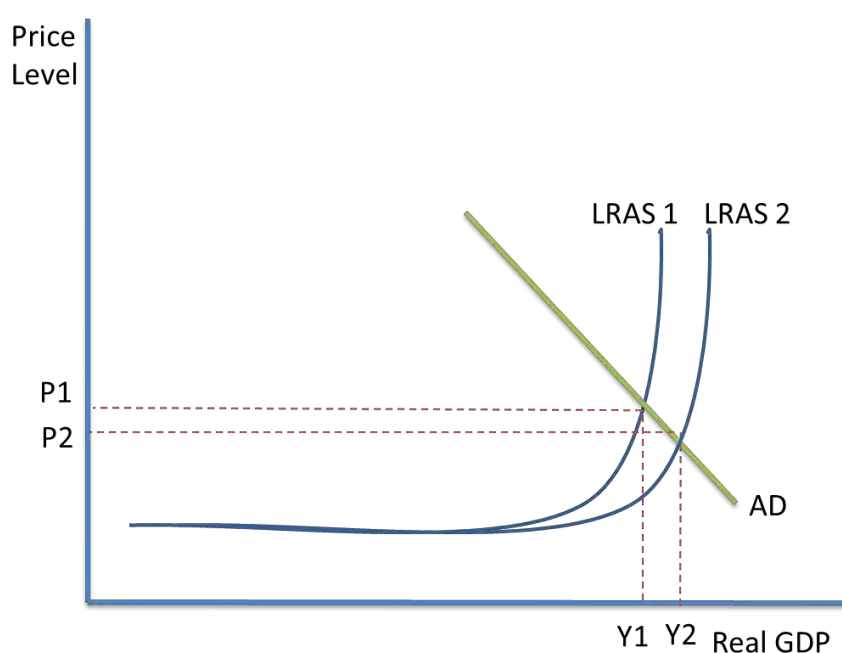
- **To promote competition**
  - A stricter government competition policy could help reduce the monopoly power of some firms and ensure smaller firms can compete, too.
- **To reform the labour market**
  - Governments could try and improve the geographical mobility of labour by subsidising the relocation of workers and improving the availability of job vacancy information.
- **To improve skills and quality of the labour force**

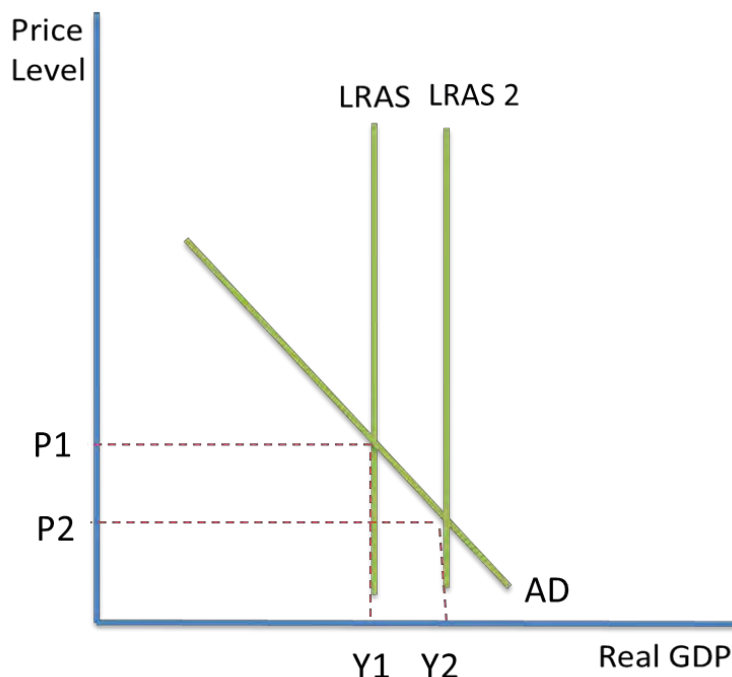
- The government could subsidise training. This also lowers costs for firms, since they will have to train fewer workers.
  - They may spend more on education, such as university, so workers will be more skilled and efficient.
  - Spending more on healthcare helps improve the quality of the labour force, and contributes towards higher productivity.
  - This may help to reduce occupational immobility.
- **To improve infrastructure**
- Governments could spend more on infrastructure, such as improving roads and schools.

### AD/AS diagrams:

Both diagrams show the effects of employing a supply-side policy. The LRAS curve shifts to the right, to show the increase in the productive potential of the economy. In other words, the maximum output of the economy at full employment has increased. This leads to a fall in the average price level, from  $P_1$  to  $P_2$ , and an increase in national output, from  $Y_1$  to  $Y_2$ .

The first diagram is the Keynesian LRAS curve, and the second is the Classical LRAS curve.





**Strengths and weaknesses of supply-side policies:**

- Supply-side policies are the only policies which can deal with structural unemployment, because the labour market can be directly improved with education and training.
- Demand-side policies are better at dealing with cyclical unemployment, since they can reduce the size of a negative output gap and shift the AD curve to the right.
- There are significant time lags associated with supply-side policies and not all policies will be successful.
- Market-based supply-side policies, such as reducing the rate of tax, could lead to a more unequal distribution of wealth.
- There may be negative impacts on the government budget due to higher government expenditure or lower taxes.
- Policies may impact AD before they impact AS and so they could have inflationary effects.
- If there is a lot of spare capacity in the economy, then supply side policies will have no impact. On the Keynesian curve, if the economy is producing on the elastic part of the curve, there will be no change in output following the policy.

**Synoptic point:**

Some of these policies are aimed at solving microeconomic issues, for example under-performing monopolies, in order to improve a macroeconomic concept. If the economy is not successful at a microeconomic level, it will be unable to meet macroeconomic objectives.

## 2.6.4 Conflicts and trade-offs between objectives and policies

### Potential conflicts and trade-offs between the macroeconomic objectives:

#### Economic growth vs inflation:

A growing economy is likely to experience inflationary pressures on the average price level. This is especially true when there is a positive output gap and AD increases faster than AS.

#### Economic growth vs the current account:

During periods of economic growth, consumers have high levels of spending. In the UK, consumers have a high marginal propensity to import, so there is likely to be more spending on imports. This leads to a worsening of the current account deficit. However, export-led growth, such as that of China and Germany, means a country can run a current account surplus and have high levels of economic growth.

#### Economic growth vs the government budget deficit:

Reducing a budget deficit requires less expenditure and more tax revenue. This would lead to a fall in AD, however, and as a result there will be less economic growth.

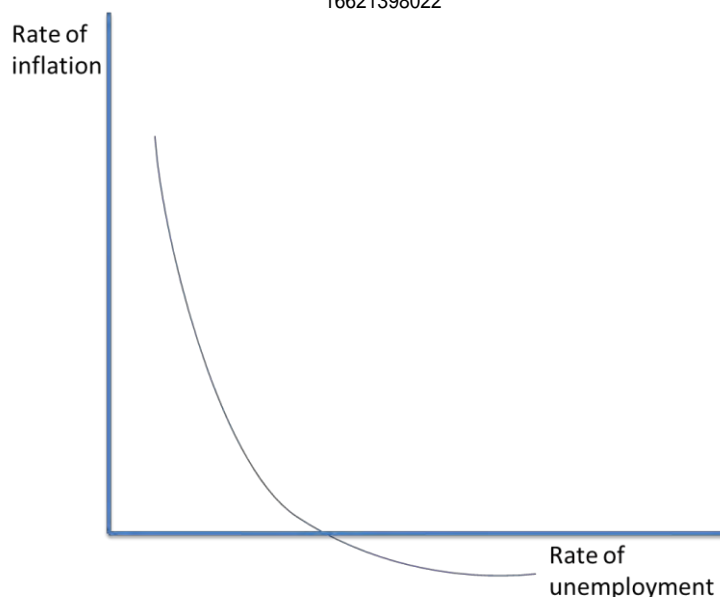
#### Economic growth vs the environment:

High rates of economic growth are likely to result in high levels of negative externalities, such as pollution and the usage of non-renewable resources. This is because of more manufacturing, which is associated with higher levels of carbon dioxide emissions.

#### Unemployment vs inflation:

In the short run, there is a trade-off between the level of unemployment and the inflation rate. This is illustrated with a **Phillips curve**.

As economic growth increases, unemployment falls due to more jobs being created. However, this causes wages to increase, which can lead to more consumer spending and an increase in the average price level.



The extent of this trade off can be limited if supply side policies are used to reduce structural unemployment, which will not increase average wages.

### **Potential policy conflicts and trade-offs:**

This occurs when one macroeconomic policy has a larger impact than another, which conflicts with the other policy or reduces its effectiveness. Every policy is likely to have unintended consequences; these are some examples:

#### **Environment vs competitiveness:**

If 'green taxes' are implemented, such as carbon taxes, or if there are minimum prices on pollution permits, the competitiveness of domestic firms could be compromised. This is because they are limited in their production.

#### **Fiscal vs monetary policy:**

Expansionary fiscal policies involve more government borrowing, which could cause interest rates and the inflation rate to rise.

#### **Interest rate vs inequality:**

The low interest rate could affect the distribution of income. Savers only receive a small return on their savings.

### **Synoptic point:**

Some microeconomic policies could have adverse macroeconomic impacts and vice versa, for example indirect taxes to fix market failure could reduce competitiveness and decrease SRAS.