

Government macroeconomic intervention (A Level)

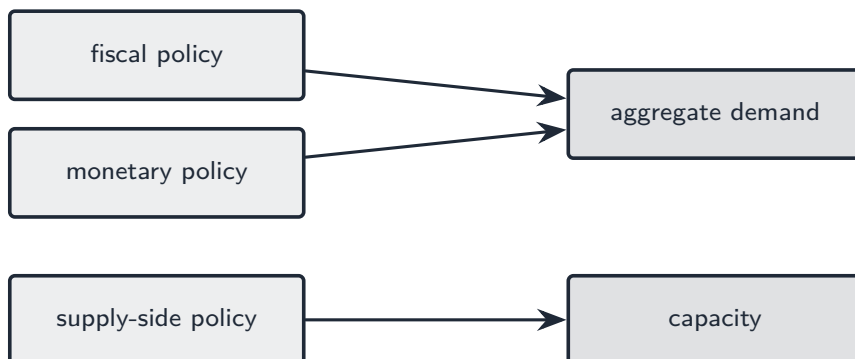
A-Level Economics

This topic pulls the macroeconomics together: the goals a government has, how they clash, and how well its tools work.

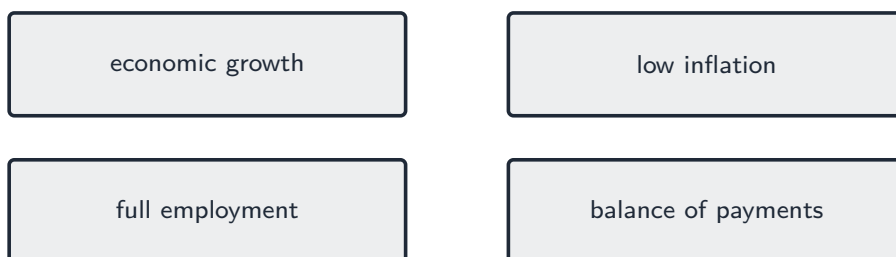
Objectives and the tools to reach them

Governments aim at several **macroeconomic objectives**

at once:



Fiscal and monetary policy act on demand; supply-side on capacity



The four macroeconomic objectives

Objective		How it is measured
economic growth		the % change in real GDP
price stability	(low inflation)	the % change in the consumer price index
full employment		the unemployment rate
balance of payments	stability	the current account balance

To reach these goals, the government uses three sets of tools:

- **fiscal policy** – changing government spending and taxes.
- **monetary policy** – changing the **interest rate** and the money supply.
- **supply-side policy** – raising the economy's capacity and productivity.

Fiscal and monetary policy can change **aggregate demand**, with effects depending on timing, confidence and spare capacity. Supply-side measures aim to improve capacity and productivity, but their speed and effectiveness vary. Public investment can have both demand effects now and capacity effects later.



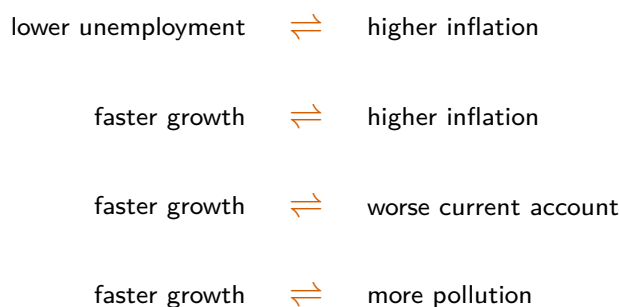
Central banks, such as the European Central Bank, are a main tool of macroeconomic policy.

Links and trade-offs between objectives

The objectives are **interrelated** – reaching one can move another. Often there is a **trade-off**, a **conflict** where gaining on one goal costs you on another.

- **unemployment versus inflation.** Raising demand to cut unemployment tends to push prices up. The **Phillips curve** shows this short-run trade-off. (In the long run it may disappear.)
- **growth versus inflation.** Fast demand-led growth can overheat the economy and cause inflation.
- **growth versus the balance of payments.** As incomes rise, people buy more imports, so the current account can worsen.
- **growth versus the environment.** More output often means more pollution and use of resources.
- **growth versus equality.** Growth does not always reach everyone, so the income gap can widen.

these goals pull against each other



The objectives pull against each other, so a government must trade one off against another – there is rarely a way to win on all of them at once

Because the goals are linked, a government must often accept “second best” on one aim to protect another. A clever policy mix tries to ease the trade-offs – for example, productive supply-side measures may raise capacity and ease inflation pressure. Demand expansion with ample spare capacity can also increase output without strong inflation pressure; neither result is guaranteed.

The effectiveness of policy

Each tool has strengths and weaknesses.



Financial markets react quickly to policy, which affects how well a policy works.

■ Fiscal policy

Government purchases can directly add to demand and target particular groups or regions. Their effect depends on subsequent spending, private-sector responses and available resources.

Worked fiscal comparison. An illustrative economy has unused capacity and weak private spending. Government proposes an extra £10 billion of purchases, financed by borrowing. Use a multiplier $k = 2.5$; hold taxes, exports and other spending changes constant. In Case A, private investment is unchanged. In Case B, higher interest rates reduce private investment by £4 billion. Let ΔA be the net autonomous spending change. All spending and income changes in these equations are in £ billions.

$$\Delta A_A = \Delta G + \Delta I = 10 + 0 = 10.$$

$$\Delta Y_A = k\Delta A_A = 2.5 \times 10 = 25.$$

$$\Delta A_B = \Delta G + \Delta I = 10 + (-4) = 6.$$

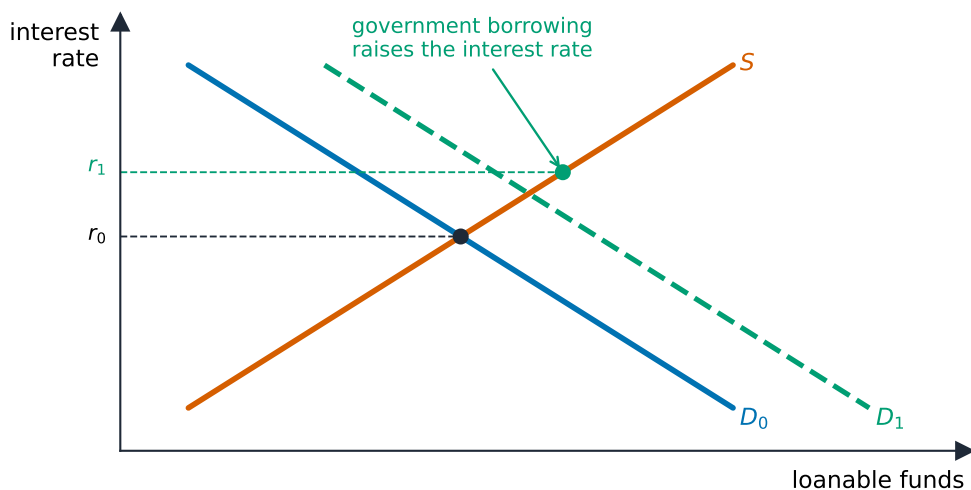
$$\Delta Y_B = k\Delta A_B = 2.5 \times 6 = 15.$$

In this model, **crowding out** reduces the income gain by £10 billion; income still rises. Partial crowding out does not mean each pound of government spending replaces a pound of private spending. The multiplier and private investment response are stated assumptions, not forecasts for every economy.

One mechanism is government borrowing increasing demand for loanable funds, raising interest rates and discouraging private investment, other things equal. Its size depends on the supply of finance, central-bank action, confidence and firms' responsiveness to rates. With idle resources or supportive monetary conditions, the interest-rate effect may be small. Productive public infrastructure may instead encourage some private investment. Near capacity, public projects may compete for workers and materials even without a large interest-rate rise; identify that resource constraint separately.

Timing and financing. Time lags arise in diagnosis, approval, implementation and spending responses. A construction programme approved during a slump may arrive after recovery, when capacity constraints create more inflationary pressure and less extra real output. Tax cuts need not all be spent. Automatic changes in taxes and benefits can begin without a new budget decision.

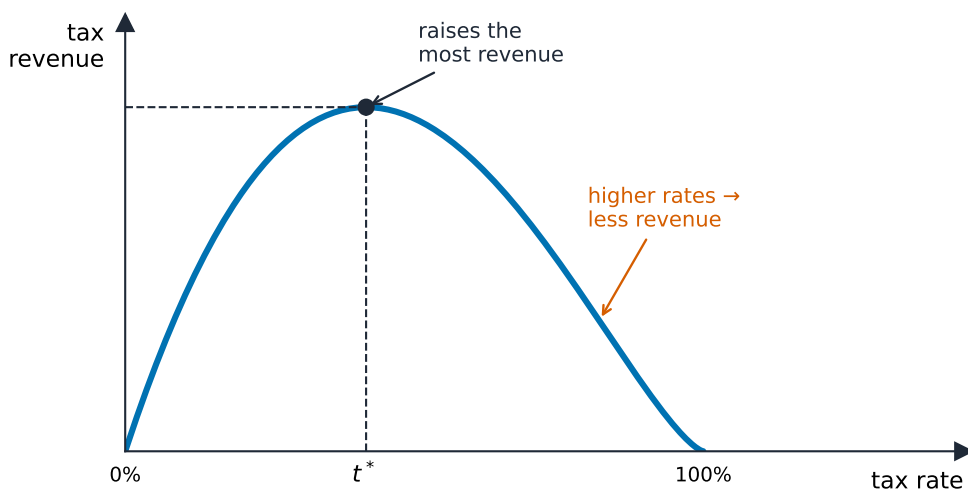
A deficit is a flow over a period; the **national debt** is an outstanding stock. Additional borrowing tends to add to debt, holding other flows constant. Not every spending increase is borrowed, and public investment can improve future capacity.



govt borrow $\Rightarrow r \uparrow \Rightarrow$ private $\downarrow$

In this loanable-funds diagram, extra borrowing raises interest rates and may reduce private investment, holding the supply of finance and monetary conditions constant.

The **Laffer curve** is a useful warning. It shows that as the tax rate rises, **tax revenue** first rises but then **falls**: very high rates discourage work and encourage tax avoidance, so revenue drops. There is a tax rate that raises the most revenue, and going above it is self-defeating.



peak revenue at t^* · beyond t^* : rate $\uparrow$ revenue $\downarrow$

Tax revenue is zero at both a 0% and a 100% tax rate; it peaks at the rate t^* , and pushing rates above t^* actually lowers revenue.

■ Monetary policy

It is flexible – the interest rate can be changed at any time. But it also works with a long time lag, and in a deep slump even very low rates may fail to make worried firms and households borrow.

■ Supply-side policy

Productive measures can raise capacity and ease inflation pressure. They are not free of trade-offs: education and training take time and funding, some measures can widen inequality, and infrastructure can impose environmental costs. Outcomes depend on implementation and on which constraints actually limit production.

■ Putting it together

No single policy can hit every target. The objectives conflict, the effects come with delays, and the future is uncertain. So governments usually combine **demand-side policies** (fiscal and monetary) for the short term with supply-side policy for the long term, and accept that some goals must be traded against others.

Worked policy judgement. A government cuts interest rates to reduce cyclical unemployment. If households and firms respond by borrowing and spending more, aggregate demand may rise. With spare capacity, firms can expand output and employment; near capacity, more of the response may be inflation. Weak confidence or already-low rates can reduce the response. Imports may rise with income, but the current account depends on exports and other influences too. State the transmission mechanism and conditions before judging the objective at risk. Capacity improve-

ments may ease a conflict, but no policy label guarantees growth with lower inflation and no other cost.

Exam tips

- Show the **trade-offs between objectives** (for example growth versus inflation, unemployment versus inflation).
- Evaluate **policy effectiveness** using time lags, expectations and the state of the economy.
- Match the tool (fiscal, monetary, supply-side, exchange rate) to the target, and judge the conflicts.

Vocabulary card meanings

macroeconomic objectives: The main aims for the whole economy, such as jobs and stable prices. tax revenue: Money a government collects through taxation.