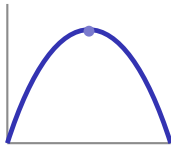


Government Macroeconomic Intervention

A-Level Economics ■ Topic 10

A-Level Economics



What we will cover

- 1 Objectives & tools
- 2 Trade-offs between objectives
- 3 Fiscal policy & crowding out
- 4 The Laffer curve
- 5 Monetary & supply-side
- 6 Putting it together



a central bank steers policy



Objectives and tools

objectives

growth

price stability

full employment

balance of payments

tools

fiscal

monetary

supply-side

Fiscal & monetary work on **AD** (quick); supply-side on capacity (slow but lasting).



Trade-offs between objectives

Objectives **conflict**, so a gain on one costs another:

- unemployment $\updownarrow$ inflation (**Phillips curve**)
- growth $\updownarrow$ inflation
- growth $\updownarrow$ balance of payments
- growth $\updownarrow$ the environment

these goals pull against each other

lower unemployment $\Rightarrow$ higher inflation

faster growth $\Rightarrow$ higher inflation

The objectives are interrelated

trade-off

a **conflict** in which gaining on one objective costs you on another

growth against inflation

demand-led growth pushes prices up as spare capacity runs out

growth against the current account

rising incomes suck in imports

growth against equality

growth does not always reach everyone, so the income gap can widen

unemployment against inflation

the short-run Phillips curve relationship

the consequence

a government must often accept “**second best**” on one aim to protect another

A clever **policy mix** eases a trade-off rather than pretending it is not there. Naming which aim was sacrificed is the evaluation mark.

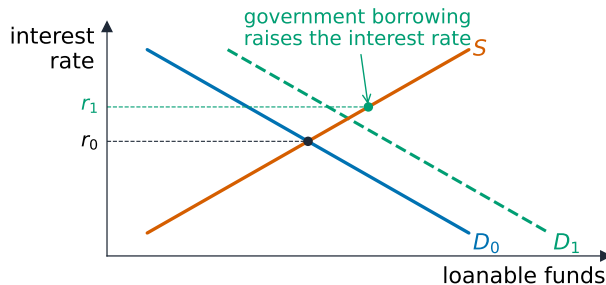


Fiscal policy and crowding out

Fiscal policy acts directly on demand, but:

- **time lags** ; adds to the **national debt**
- **crowding out** – borrowing raises interest rates, cutting private investment

Fiscal policy and crowding out, in detail



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

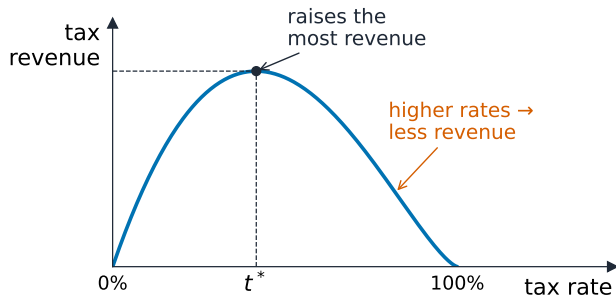
Heavy government borrowing shifts the demand for loanable funds right, raising the interest rate ($r_0 \rightarrow r_1$) and crowding out private investment.

The Laffer curve

The **Laffer curve** : as the tax rate rises, **tax revenue** first rises, then falls.

Very high rates discourage work & invite avoidance – above t^* , raising the rate *lowers* revenue.

The Laffer curve, in detail



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

The **Laffer curve** : as the tax rate rises, **tax revenue** first rises, then falls.

Monetary and supply-side policy

monetary

flexible (change anytime),
but a long lag – low rates
may not revive borrowing

supply-side

raises growth **and**
cuts inflation –
but slow & costly

Putting it together



No single policy hits every target
– goals conflict and effects come with delays.

Governments combine **demand-side** policy for the short term with supply-side for the long term, and accept trade-offs.

Which tool acts on what

Demand-side policies

Demand-side policies – fiscal and monetary – shift **aggregate demand**. They work in months, and they cannot raise capacity.

Supply-side policy

Acts on capacity: skills, infrastructure, competition, incentives. It works in years, and it is the only non-inflationary route to growth.

The headline target

Economic growth is measured as the percentage change in real GDP – so it is an *actual* growth figure, whatever caused it.

The combination

Governments usually pair demand-side policy for the short term with supply-side for the long, and accept that some goals must be traded off.

Match the tool to the diagnosis: an output gap needs demand, a capacity ceiling needs supply. Using the wrong one buys inflation.

Objectives and the tools to reach them

economic growth

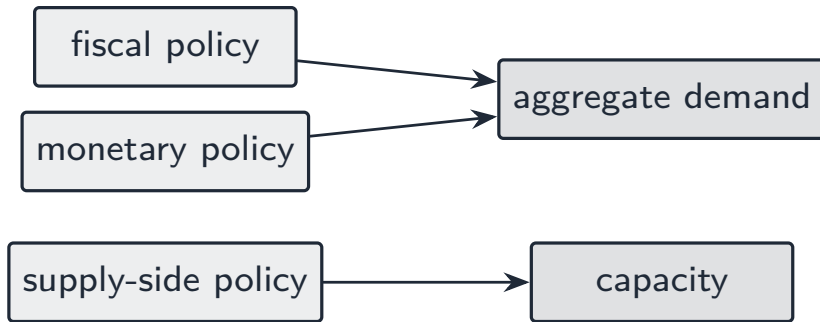
low inflation

full employment

balance of payments

The four macroeconomic objectives

Objectives and the tools to reach them, continued



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

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.



Worked example – a policy trade-off

A government uses expansionary policy to cut unemployment. What is the trade-off?

- Higher AD $\Rightarrow$ firms hire more $\Rightarrow$ unemployment falls.
- But nearer full capacity, scarce labour bids wages up and firms pass costs on $\Rightarrow$ inflation rises.
- That is the short-run **Phillips curve** trade-off.
- Higher incomes also pull in imports $\Rightarrow$ the current account worsens too.

Macro objectives **conflict**: growth and employment pull against inflation and the current account. **Supply-side** policy is the only route that can improve both at once.

Topic 10 – key takeaways

1

Trade-offs

objectives conflict – gain one, lose another

2

Crowding out

government borrowing raises interest rates

3

Laffer curve

above t^* a higher rate cuts revenue

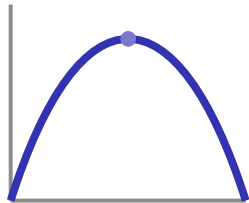
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Policy mix

demand-side short term, supply-side long term

Check yourself

- 1 Which curve shows the unemployment–inflation trade-off?
- 2 Crowding out raises what, cutting investment?
- 3 Above t^* , a higher tax rate does what to revenue?
- 4 Which policy raises growth and cuts inflation?



Answers 1. the Phillips curve 2. the interest rate 3. lowers it 4. supply-side policy