Economics Revision: Conflicts between Macro Objectives

This revision note looks at possible conflicts between macroeconomic objectives and some of the policy prescriptions for over-coming them. When conflicts arise, choices have to be made about which objectives are given greatest priority. This is a different issue – for example which ought to be the main objective of macroeconomic policy. These choices will vary from one country to another since the needs of different nations will differ according to their stage of economic development.

Here are some possible macro policy conflicts:

1. **Inflation and unemployment:**
   a. During a period of strong GDP growth, falling unemployment might create demand-pull and cost-push inflation leading to a fall in the real purchasing power of money.
   b. This trade-off is often explained using the Phillips Curve (for A2 students only)
   c. Policies designed to control demand-pull or cost-push inflation for example by reducing AD may lead to a contraction of output and a rise in unemployment
   d. Deflation (negative inflation) may also lead to a rise in unemployment (see later)

2. **Economic growth and environmental sustainability:**
   a. Rapid GDP growth and development puts extra pressure on scarce environmental resources threatening the sustainability of living standards for future generations

3. **Economic growth and inflation**
   a. An overheating economy may suffer accelerating inflation because of rising demand and an increase in prices of raw materials, energy & unit wage costs
   b. China and India are two countries where this combination of strong growth and rising inflation has been seen in recent years. In 2010
i. China grew by 9.8% but her inflation rate was 4.9% and rising. India grew by 8.6% but her inflation rate was 8.3%

ii. Brazil and Russia (the other two BRIC countries) have also seen a rise in inflation partly because of their strong growth – In 2010 inflation in Brazil was 6% and in Russia it was 9.5%

c. Persistently higher rates of inflation can then have negative effects on international trade performance, business profits and jobs and ultimately economic growth

d. Attempts to control inflation by higher interest rates, may cause the exchange rate to appreciate and this can have a damaging effect on demand in export industries

4. **Economic growth and the balance of payments:**
   a. Strong GDP growth fuelled by high levels of consumer demand might lead to a worsening of the trade balance – likely when marginal propensity to import is high
   b. An improvement in the balance of payments – for example brought about by a strong surge in export sales will boost growth (exports are an injection of AD into the circular flow) but might cause demand-pull inflation depending on the stage of the economic cycle and the size of the output gap.

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**Inflation and Unemployment**

![Diagram](image-url)

The possible conflict between unemployment and inflation can be moderated if:

1. The economy achieves higher labour productivity – this raises efficiency, reduces unit costs and also leads to higher real wages which boosts consumer demand
2. Innovation allows businesses to produce new products at cheaper cost per unit
3. Expectations of inflation remain stable – a credible inflation target can help here – so that we do not see an acceleration in wage demands and pay settlements
4. The economy is sufficiently flexible to weather external demand and supply-side shocks such as unexpectedly volatility in the prices of raw materials and components.
Resolving the possible conflict between growth and inflation

An improvement in the supply-side capacity of the economy (shown above by an outward shift of long run aggregate supply) can help to resolve the growth – inflation trade off. We see in the diagram how the LRAS has moved outwards and this allows aggregate demand (C+I+G+X-M) to operate at a higher level without threatening a persistent increase in the general price level (inflation). Make sure you revise supply-side policies to understand more about how this can happen.

Stagflation

Stagflation is a period of economic stagnation accompanied by rising inflation. In other words, both of these key macro objectives are worsening. It can happen when an economy goes into a downturn or a recession but when other external forces are bringing out higher inflation. The obvious example of this is when recession is afflicting a country but the prices of imported products are surging causing prices to rise and real incomes and profits to fall. The rise in the cost of imports can be shown by an inward shift in the short run aggregate supply curve leading to a contraction in real national output and an increase in prices.

One of the dangers of stagflation is that the fall in real incomes causes consumer and investment spending to fall and thus the rate of economic growth suffers too (a deterioration in a third objective of policy). Wage demand may also pick up as people experience rising prices. The central bank needs to consider appropriate policy responses to this. Too severe a tightening of monetary policy for example will help to curb inflation but risk causing a deep recession. The combination of deflation and a sustained drop in economic output is termed an economic depression.
Deflation is a sustained fall in the prices of goods and services, and thus the opposite of inflation. Increased attention has focused on the economic impact of persistent price deflation in several countries in recent years – notably in Japan (inflation -0.3% in 2010) and also in some Euro Area
countries such as Ireland Greece where prices have been falling, national output has dropped sharply and unemployment has been rising.

It is normally associated with falling level of AD leading to a negative output gap where actual GDP < potential GDP. But deflation can be caused by an increase in a nation’s productive potential, which leads to an excess of aggregate supply over demand.

Intuitively a period of falling prices seems good news for consumers and ought to prompt a rise in the volume of goods and services sold and a boost to economic growth? So why might deflation be in conflict with other macroeconomic objectives such as economic growth and reducing unemployment?

**Possible damaging consequences of persistent price deflation**

1. **Holding back on spending:** Consumers may postpone demand if they expect prices to fall further in the future.
2. **Debts increase:** The real value of debt rises when the general price level is falling and a higher real debt mountain can be a drag on consumer confidence and people’s willingness to spend. This is especially the case with mortgage debts and other big loans.
3. **The real cost of borrowing increases:** Real interest rates will rise if nominal rates of interest do not fall in line with prices. If inflation is negative, the real cost of borrowing increases and this can have a negative effect on investment spending by businesses
4. **Lower profit margins:** Lower prices hit revenues and profits for businesses - this can lead to higher unemployment as firms seek to reduce their costs by shedding labour.
5. **Confidence and saving:** Falling asset prices including a drop in property values hits wealth and confidence – leading to declines in AD and the threat of a deeper recession.

**Resolving the threat of price deflation**

- **Monetary Policy**
  - Interest rates: Deep cuts in interest rates can be made to stimulate the demand for money and thereby boost consumption
  - Quantitative Easing – printing money in the hope that, by injecting it into the economy, people and companies will be more likely to spend.
- **Fiscal policy**
  - Keynesian economists believe that fiscal policy is a more effective instrument of policy when an economy is stuck in a deflationary recession.
  - The key Keynesian insight is that a market system does not have powerful self-adjustments back to full-employment after there has been a negative economic shock. Keynes talked of persistent under-employment equilibrium – an economy operating in semi-permanent recession leading a persistent gap between actual demand and the potential level of GDP.
  - Keynes argued that this justified an exogenous injection of aggregate demand as a stimulus to get an economy on the path back to full(er) employment and to prevent deflation

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