RELATIONSHIPS BETWEEN OBJECTIVES & POLICIES

Unemployment & Inflation

Governments often favour the use of contractionary monetary policy to reduce inflation because the government can quickly raise interest rates to reduce aggregate demand. Negative effects of this:

- Higher interest rates will discourage consumers and businesses from borrowing. As a result, there will be a fall in consumption and investment. This will reduce aggregate demand and lower economic growth. Unemployment is likely to rise.
- Higher interest rates will result in higher mortgage payments for many households. This will reduce the spending power and lead to a fall in aggregate demand. Firms will react by reducing capacity and laying off staff.
- Firms will incur higher interest charges. This will raise their costs and reduce their profits. They may invest less, which will reduce aggregate demand.
- Higher interest rates will also discourage firms from borrowing to invest in new technology and expansion. This will hamper their long-term development. They may also lose their competitive edge in foreign markets.
- If higher interest rates result in higher exchange rates it may be harder for firms to sell abroad. Exporters are likely to react by laying off staff.

The use of contractionary fiscal policy to reduce inflation has negative effects too:

- Higher taxes and lower government spending could result in unemployment. For example, if consumption falls as a result of higher taxes, businesses will see a fall in demand for their products. They may react by cutting production and laying off workers. Lower government spending means that some services are likely to be cut. As a result, civil servants, teachers and nurses may be laid off.
- People may suffer as a result of poorer government services after the cuts in expenditure, for example, waiting times for NHS treatments may arise, university places may fall and repairs to the infrastructure may be reduced.

Possible trade-off

A trade-off exists between inflation and unemployment. This is because reducing inflation mean that aggregate demand is falling. As a result, firms will decrease output since the prices of goods are decreasing. This means that firms will lay off workers, hence unemployment rates will increase.

- However, the use of supply side measures to reduce inflation may avoid rising unemployment because they're designed to increase the supply of output rather than decrease aggregate demand. Unfortunately, supply side measures are often very slow to have an impact on the economy. Consequently, governments are more likely to use them together with other measures to reduce inflation, rather than a sole measure.

Economic Growth & Inflation

- Expansionary fiscal policy can be used to promote economic growth. If taxes on households are lowered, people will have more disposable income. If they spend this extra money, aggregate demand will rise and businesses will be encouraged to produce more. If businesses raise output levels, the economy will grow. Similarly, if the government spends more, by employing more teachers, social workers and health workers, extra demand in the economy will be created. Again, firms should respond to this by producing more and national income will grow.

- The government could also use expansionary monetary policy. If interest rates are lower, people will usually borrow and spend more. If the cost of investment funds is lower, this will encourage businesses to develop new products, expand their existing activities and set up new ventures. Extra investment will help to drive economy growth. The government might also use quantitative easing to stimulate economic growth. This will help to increase the money supply and therefore aggregate demand.

Possible trade-off

A trade-off exists between rapid economic growth and inflation. This is because one of the dangers of policies designed to increase economic growth is that they may be too expansionary. Consequently, the economy might become overheated which means that firms will not be able to meet the rising aggregate demand and respond by raising prices instead of producing more. This will cause demand-pull inflation in the economy.

<u>Economic Growth & Environmental Protection</u>

As businesses produce more output there are likely to be more emissions from power generators, chemical processors and other manufacturers. Also, the extra wealth and income that comes along with economic growth means that increasing numbers of people buy cars and other vehicles. This results in more emissions and increasing congestion on road networks around the world. Pollution resulting from rapid business expansion is especially dangerous to health. Also, as more land is taken for business development, less is available for wildlife. The Earth's rainforests, swamps, plains, lakes and other habitats continue to disappear as they are cleared to make way for agriculture, housing, roads, pipelines and other industrial uses.

Possible trade-off

- In developing countries, it's unlikely that the majority of people would want to prevent economic growth that delivers poverty, longer life expectancy, lower infant mortality and improved living standards. If the environment is damaged along the way, many people in these countries might argue that this is a price worth paying. However, in some of these developing countries, governments are beginning to recognise that environmental damage can be costly and that measures are needed to protect the environment even if it means limiting business development.
- In developed countries, where environmental issues are perhaps more pressing, many governments have used a range of measures, such as legislation, regulations, fines and pollution permits to protect the environment. However, many of these do restrict business development and governments have to ensure that measures don't discourage the entrepreneurial spirit too much.

<u>Inflation & The Current Account on the Balance of Payments</u>

- If prices are rising, the price of exports will also be rising. This will reduce demand for exports creating pressure on the current account balance. It is also possible that consumers might switch from expensive domestic goods to relatively cheap imports. This would make the current account balance even worse. Consequently, high inflation rates have a damaging effect on a country's current account balance.
- If a government uses monetary policy to reduce inflation, the balance of payments situation could actually become worse. This is because monetary policy that uses higher interest rates to reduce inflation might strengthen the exchange rate. When interest rates are high, the demand for a domestic currency might rise and drive up the exchange rate. If this happens exports become dearer and imports cheaper. This would create further pressure on the current account balance.

Possible Trade-off

A government trying to reduce inflation by raising interest rates may have to accept that the current account will worsen for a period of time. Although, the impact of price changes on the demand for exports and imports will depend on the elasticity of demand for imports and exports. However, if the government uses fiscal policy alone to reduce inflation, a worsening of the current account might be avoided. For example, if the government cuts spending and/or raises taxes, there will be a fall in demand in the economy with no real direct effort on the exchange rate. Therefore, the prices of exports and imports will be fairly stable and the current account relatively unaffected. The use of supply side policies to reduce inflation will also avoid a negative impact on the current account. Supply side policies are not likely to affect the exchange rate and are also 'business friendly'. As a result, businesses might be able to produce more output at lower prices. This would help to boost exports and therefore benefit the current account.