

AQA Economics A-level **Macroeconomics**

Topic 3: Economic Performance

3.4 Possible conflicts between macroeconomic policy objectives

Notes



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.

A **negative output gap** occurs when the actual level of output is less than the potential level of output. This puts downward pressure on inflation. It usually means there is the unemployment of resources in an economy, so labour and capital are not used to their full productive potential. This means there is a lot of spare capacity in the economy.

A **positive output gap** occurs when the actual level of output is greater than the potential level of output. It could be due to resources being used beyond the normal capacity, such as if labour works overtime. If productivity is growing, the output gap becomes positive. It puts upwards pressure on inflation. Countries, such as China and India, which have high rates of inflation due to fast and increasing demand, are associated with positive output gaps.

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:

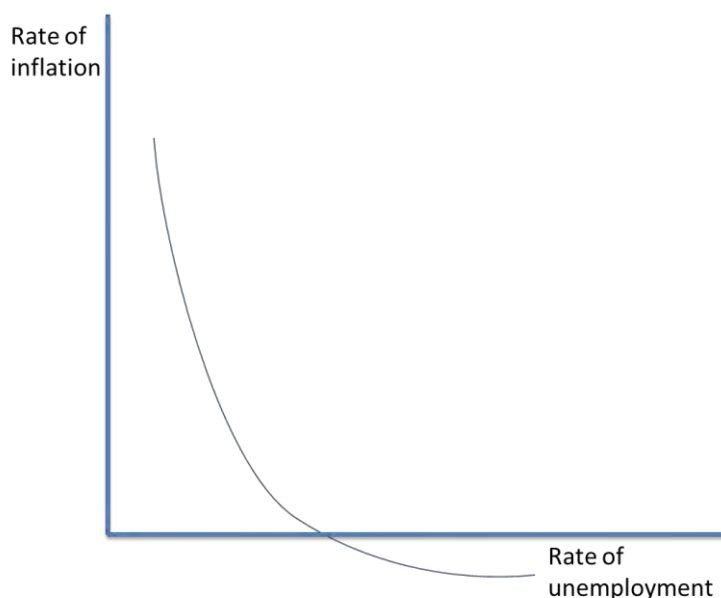
High rates of economic growth are likely to result in high levels of negative externalities, such as pollution and the usage of non-renewable resources. This is because of more manufacturing, which is associated with higher levels of carbon dioxide emissions.

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.

The Phillips curve

The short-run Phillips curve represents the trade-off between unemployment and inflation. In the short run, the Phillips curve is roughly L-shaped, which shows how as unemployment increases, inflation decreases. The above Phillips curve is for the short run.

The long run Phillips curve is L-shaped. It is also known as the vertical long-run Phillips curve (shown below). It is at the natural rate of unemployment, and there is no trade-off between unemployment and inflation. The two variables are unrelated.



Rate of
inflation



 **The implications of the short-run Phillips curve and the long-run, L-shaped Phillips curve for economic policy**

If the government tries to lower unemployment in the short run, there could be inflationary pressure on the price level. In the short run, the economy suffers from demand-deficient unemployment. This might encourage the use of demand-side policies to tackle unemployment.

In the long run, changes in the unemployment rate do not affect the inflation rate. Therefore, policies can be more flexible. Since there is no demand-deficient unemployment in the long run, supply-side policies are more likely to be used.

