CIE Economics A-level

Topic 5: Government Macro Intervention

a) Government macro policy aims

Notes

Inflation

In the UK, the government inflation target is 2%, measured with CPI. This aims to provide price stability for firms and consumers, and will help them make decisions for the long run. If the inflation rate falls 1% outside this target, the Governor of the Bank of England has to write a letter to the Chancellor of the Exchequer to explain why this happened and what the Bank intends to do about it.

This is a good summary by the Bank of England about the government's inflation target:

http://www.bankofengland.co.uk/monetarypolicy/Pages/framework/framework.aspx

Balance of payments

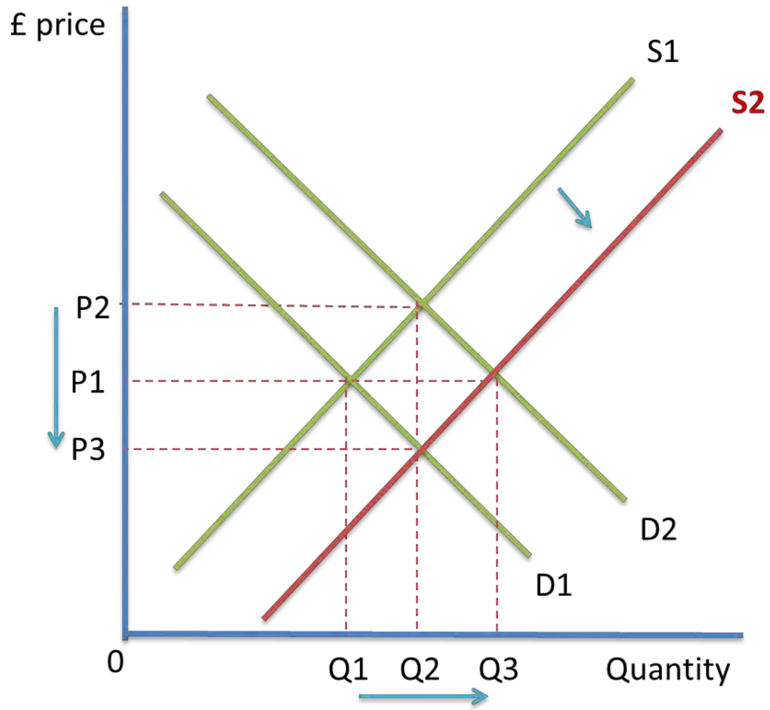
Governments aim for the current account to be satisfactory, so there is not a large deficit. This is usually near to equilibrium.

A balance of payments equilibrium on the current account means the country can sustainably finance the current account, which is important for long term growth.

Exchange rates

The exchange rate of a currency is the weight of one currency relative to another.

Governments might try and influence their currency, such as by maintaining a fixed exchange rate. For example, China has previously kept the Yuan undervalued by buying US dollar assets to make their exports seem relatively cheaper.



In a fixed exchange rate system, the supply of the currency can be manipulated by the central bank, which can buy or sell the currency to change the price to where they want. In the diagram, the supply has been increased (S1 to S2) by selling the currency so more is on the market (Q1 to Q3). The currency depreciates as a result (P2 → P3), which makes exports more competitive.

Unemployment

Governments aim to have as near to full employment as possible. They account for frictional unemployment by aiming for an unemployment rate of around 3%. The labour force should also be employed in productive work.

Growth and development

In the UK, the long run trend of economic growth is about 2.5%. Governments aim to have sustainable economic growth for the long run.

In emerging markets and developing economies, governments might aim to increase economic development before economic growth, which will improve living standards, increase life expectancy and improve literacy rates.