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| **Government Macroeconomic Policy** |
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| *In this chapter we consider the ways in which government economic policies can be used to achieve aims such as low inflation, stable growth and high levels of employment.*  **Is there a need for macroeconomic policy?**  A central issue in macroeconomics is whether or not markets, left alone, automatically bring about long run economic equilibrium.  If the free operation of market forces eventually resulted in a full employment level of national income with stable prices and economic growth, there would be no need for government intervention in the macro economy - no need for fiscal monetary exchange rate and supply side policies. The reality is that all governments intervene through their macroeconomic policies in a bid to achieve certain policy objectives and improve the overall performance of the economy.  **Main Objectives of Government Economic Policy**   * Sustained economic growth * Stable prices (low inflation) * A high level of employment * A rise in average living standards * Sustainable position on the balance of payments * Sound government finances   **Demand Management**  Demand management occurs when the government attempts to influence the level and growth of AD hence the levels of national income, employment, rate of inflation, growth and the balance of payments position   * **Reflationary policies** seek to increase AD and raise the level of planned expenditure at or near the level of potential GDP * **Deflationary policies** decrease AD in the event of aggregate demand running ahead of AS and posing inflationary risks or leading to an unsustainable deficit on the balance of payments   We will focus on fiscal and monetary policies as the main instruments of demand management  **The Main Problems of Managing the Macroeconomy**  The government’s task of managing the economy is made difficult by several factors some of which are discussed below:   * **Inaccurate economic data**: All of the main macroeconomic indicators are subject to a margin of error. They rely on statistical data collected from tax returns and surveys and data is often revised many months after its first release * **Conflicting policy objectives**:  A policy of stimulating aggregate demand may reduce unemployment in the short term but initiate a period of higher inflation and exacerbate the current account of the balance of payments. Choices have to be made between objectives i.e. there exist trade-offs between them * **Selecting the right policy instrument:** Each macroeconomic objective requires a separate policy instrument: The usual ‘rule of thumb’ is that one main policy instrument should be assigned to one policy objective. So, for example, interest rates might be assigned as the main instrument for keeping control of inflation, whilst fiscal policy instruments such as changes to the tax system might be allocated to achieving some supply-side objectives such as increasing the labour supply, boosting incentives, raising investment and increasing productivity. There are quite deep-rooted disagreements between some economists (who belong to different ‘schools of thought’) as to which policies are most effective to meet a certain objective * **Uncertain time lags when running a policy:** Changes in economic policies are subject to uncertain time lags e.g. a change in interest rates is estimated to take some 18-24 months to work its way fully through the whole economy to filter through to a change in prices. The length of the time lags can change over the years as the reactions of consumers and businesses to policy measures alters * **External shocks:** Unexpected external shocks to economy such as the events surrounding Sept 11th 2001 or unexpected volatility in exchange rates and commodity prices can upset economic forecasts and take the economy some distance from the expected path. The Government might under-estimate or exaggerate the potential impact of an economic shock to either the demand or supply-side of the economy and therefore apply too little or too much of a policy response.   Changes in direct and indirect taxes have an impact on people’s disposable incomes – this feeds through to the wider economy and affects demand, growth and employment  *Changes in direct and indirect taxes have an impact on people’s disposable incomes – this feeds through to the wider economy and affects demand, growth and employment*  **The main policies of economic management**   * **Fiscal Policy**   + Fiscal policy involves the use of government spending, taxation and borrowing to influence both the pattern of economic activity and also the level and growth of aggregate demand, output and employment. * **Monetary Policy**   + Monetary policy involves the use of interest rates to control the level and rate of growth of aggregate demand in the economy.   The **Bank of England** is charged with the task of 'maintaining the integrity and value of the currency'. The Bank pursues this objective through the use of monetary policy.  Above all, this involves maintaining price stability, as defined by the inflation target set by the Government, as a precondition for achieving a wider goal of sustainable economic growth and high employment. Since 1997, the BoE has had **operational independence** in the setting of interest rates. The Bank aims to meet the **Government's inflation target** - currently 2.0 per cent for the **consumer price index**- by setting short-term interest rates. Interest rate decisions are taken by the **Monetary Policy Committee** (MPC) at their monthly meetings.  Monetary policy also involves the effects of changes in the exchange rate – the external value of one currency against another – on the wider economy  **Supply-side Policies**  Supply-side economic policies are mainly **micro-economic policies** designed to improve the supply-side potential of an economy, make markets and industries operate more efficiently and thereby contribute to a faster rate of growth of real national output. Most governments now accept that an improved supply-side performance is the key to achieving sustained economic growth without a rise in inflation. But supply-side reform on its own is not enough to achieve this growth. There must also be a high enough level of aggregate demand so that the productive capacity of an economy is actually brought into play.  There are two broad approaches to the supply-side. Firstly policies focused on **product markets** where goods and services are produced and sold to consumers and secondly supply-side policies applied to the **labour market** – a factor market where labour is bought and sold.  **The effects of Monetary and Fiscal Policy on the economy**  There are some differences in the economic effects of monetary and fiscal policy, on the composition of output, the effectiveness of the two kinds of policy in meeting the government’s macroeconomic objectives, and also the time lags involved for fiscal and monetary policy changes to take effect. We will consider each of these in turn:  **Effects of Policy on the Composition of National Output**  Monetary policy is often seen as something of a **blunt policy instrument** – affecting all sectors of the economy although in different ways and with a variable impact.  In contrast, fiscal policy can be targeted to affect certain groups (e.g. increases in means-tested benefits for low income households, reductions in the rate of corporation tax for small-medium sized enterprises, investment allowances for businesses in certain regions)  Consider as an example the effects of using either monetary or fiscal policy to achieve a given increase in national income because actual GDP lies below potential GDP (i.e. there is a negative output gap)  **(i) Monetary policy expansion**  Lower interest rates will lead to an increase in consumer and business capital spending both of which increases national income. Since investment spending results in a larger capital stock, then incomes in the future will also be higher through the impact on LRAS.  **(ii) Fiscal policy expansion**  An expansion in fiscal policy (i.e. an increase in government spending) adds directly to AD but if financed by higher government borrowing, this may result in higher interest rates and lower investment. The net result (by adjusting the increase in G) is the same increase in current income. However, since investment spending is lower, the capital stock is lower than it would have been, so that future incomes are lower.  **Time Lags of Monetary and Fiscal Policies**  Monetary and fiscal policies differ in the speed with which each takes effect  Monetary policy in the UK is flexible (interest rates can be changed each month) and emergency rate changes can be made in between meetings of the MPC, whereas changes in taxation take longer to organize and implement. Because capital investment requires planning for the future, it may take some time before decreases in interest rates are translated into increased investment spending. Typically it takes six months – twelve months or more before the effects of changes in UK monetary policy are felt.  The impact of increased government spending is felt as soon as the spending takes place and cuts in direct and indirect taxation feed through into the economy pretty quickly. However, considerable time may pass between the decision to adopt a government spending programme and its implementation. In recent years, the government has undershot on its planned spending, partly because of problems in attracting sufficient extra staff into key public services such as transport, education and health. |