Anderton Ch26

26 National economic performance

IB SL/HL 2.3

OCR A2 and AS2 Economic policy objectives and indicators of macroeconomic performance

AQA 4.2.1.1, AS 3.2.1.1

WJEC/EDUQAS A and AS Government policy objectives

CCEA AS2 The scope of macroeconomics; Macroeconomic policy objectives of government

Key points

1. The macroeconomic performance of an economy can be judged on its rate of economic growth, rate of unemployment, rate of inflation and its current account balance on the balance of payments.
2. The macroeconomic objectives of government include high economic growth, low unemployment, low and stable inflation and a balance of payments equilibrium on current account.
3. Macroeconomic objectives also include limiting fiscal deficits and might include objectives about income inequality and the environment.

Starter activity

Find out the current rate of economic growth, the rate of unemployment, the inflation rate and the level of the current account deficit on the balance of payments. Why might a high rate of economic growth benefit you and the household in which you live? Why might a high rate of inflation impose costs on you and your household? Why might a high rate of unemployment affect you in the future?

Microeconomics and macroeconomics

Microeconomics is the study of individual markets within an economy. For instance, microeconomics is concerned with individual markets for goods or the market for labour. Housing, transport, sport and leisure are all mainly microeconomic topics because they concern the study of individual markets.

In contrast, **macroeconomics** is concerned with the study of the economy as a whole. For instance, macroeconomics considers the total value produced of goods and services in an economy. The price level of the whole economy is studied. Total levels of employment and unemployment are examined. Housing becomes a macroeconomic issue when, for instance, rises in house prices significantly affect the average level of all prices in the economy.

National economic performance

One of the reasons why macroeconomics is useful is because it tells us something about the performance of an economy. In particular, it allows economists to compare the economy today with the past. Is the economy doing better or worse than it was, say, 10 years ago? It also allows economists to compare different economies. Is the Japanese economy doing better than the US economy? How does the UK compare with the average in Europe?

An economy is a system which attempts to resolve the basic economic problem of scarce resources in a world of infinite wants. An economic system is a mechanism for deciding what is to be produced, how production is to take place and who is to receive the benefit of that production. When judging the performance of an economy, one of the criteria is to consider how much is being produced. The more that is produced, the better is usually considered the economic performance. Another criterion is whether resources are being fully utilised. If there are high levels of unemployment, for instance, the economy cannot be producing at its potential level of output. Unemployment also brings poverty to those out of work and therefore affects the living standards of individuals. The rate at which prices rise is important too. High rates of price rises disrupt the workings of an economy. A national economy must also live within its means. So over a long period of time, the value of what it buys from other economies must roughly equal what it sells. In this, it is no different from a household which cannot forever overspend and accumulate debts.

Economic growth

One of the key measures of national economic performance is the rate of change of output. This is known as **economic growth**. If an economy grows by 2.5 per cent per annum, output will double roughly every 30 years. If it grows by seven per cent per annum, output will approximately double every 10 years. At growth rates of 10 per cent per annum, output will double every seven years.

There is a standard definition of output based on a United Nations measure which is used by countries around the world to calculate their output. Using a standard definition allows output to be compared between countries and over time. This measure of output is called **gross domestic product** or GDP. So growth of three per cent in GDP (adjusted for inflation) in one year means that the output of the economy has increased by three per cent over a 12-month period.

Economic growth is generally considered to be desirable because individuals prefer to consume more rather than fewer goods and services. This is based on the assumption that wants are infinite. Higher economic growth is therefore better than lower economic growth. Periods when the economy fails to grow at all, or output shrinks as in a recession or depression, are periods when the economy is performing poorly. The depression years of the 1930s in Europe and the Americas, for instance, were years when poverty increased and unemployment brought misery to millions of households. In contrast, a boom is a period when the economy is doing particularly well with economic growth above its long run average.

Unemployment

Unemployment is a major problem in society because it represents a waste of scarce resources. Output could be higher if the unemployed were in work. It also leads to poverty for those who are out of work. So high unemployment is an indicator of poor national economic performance. Conversely, low unemployment is an indicator of good national economic performance.

Economic growth and unemployment tend to be linked. Fast-growing economies tend to have low unemployment. This is because more workers are needed to produce more goods and services. Low levels of economic growth tend to be associated with rising levels of unemployment. Over time, technological change allows an economy to produce more with fewer workers. If there is little or no economic growth, workers are made redundant through technological progress but fail to find new jobs in expanding industries. If growth is negative and the economy goes into recession, firms will lay off workers and unemployment will rise.

Fast economic growth, then, will tend to lead to net job creation. More jobs will be created than are lost through the changing structure of the economy. So another way of judging the performance of an economy is to consider its rate of job creation.

Inflation

Inflation is the increase in average prices in an economy. Low inflation is generally considered to be better than high inflation. This is because inflation has a number of adverse effects. For instance, rising prices mean that the value of what savings can buy falls. If a person had £50 in savings and the price of a T-shirt went up from £10 to £25, then they would be worse off because their savings could only now buy two compared to five before. Another problem with inflation is that it disrupts knowledge of prices in a market. If there is very high inflation, with prices changing by the month, consumers often don't know what is a reasonable price for an item when they come to buy it.

Today, inflation of a few per cent is considered to be acceptable. When inflation starts to climb through the five per cent barrier, economists begin to worry that inflation is too high. Inflation was a major problem for many countries including the UK in the 1970s and 1980s. In the UK, inflation reached 24.1 per cent in 1975, for instance. Today, some countries in the industrialised world are faced with the opposite problem: **deflation**, or falling prices. Japan, for example, has had bouts of deflation for the past 20 years. Deflation makes it more difficult for a country to grow its GDP. Hence deflation and recessions are linked.

The current balance

A household must pay its way in the world. If it spends more than it earns and takes on debt, then at some point in the future it must repay that debt. Failure to repay debt can lead to seizure of assets by bailiffs and the household being barred from future borrowing. The same is true of a national economy. A nation's spending on foreign goods and services is called the value of its imports. It earns money to pay for those imports by selling goods and services, known as exports, to foreigners. If the value of its imports is greater than the value of its exports then this must be financed, either through borrowing or by running down savings held abroad. The economic performance of a country is sound if, over a period of time, its exports are either greater than or approximately equal to its imports. However, if its imports are significantly greater than exports, then it could face difficulties.

Where exports of goods and services are greater than imports, there is said to be a current account surplus. Where imports exceed exports, there is a current account deficit. Deficits become a problem when foreign banks and other lenders refuse to lend any more money. A 'credit crunch' like this occurred, for instance, in Mexico in 1982 and Thailand in 1998. Countries have to respond to restore confidence. This is likely to involve cutting domestic spending, which leads to less demand for imports. Cutting domestic spending, though, also leads to reduced economic growth and rising unemployment. So the current account position of a country is an important indicator of performance.

Government objectives

Governments attempt to manipulate the economy so as to improve its economic performance. Different economies perform in different ways. So what is possible for the UK economy might be very different from what is possible for the Chinese economy, the Afghan economy or the Serbian economy. However, typically governments have macroeconomic objectives relating to four variables: economic growth, unemployment, inflation and the current account on the balance of payments. They will also have objectives in relation to government budgets, the environment and income inequality.

Economic growth

All other things being equal, governments attempt to maximise the growth rate of their economies. For low and middle income countries like China, Uganda or Brazil, it may be possible to reach annual growth rates of up to ten per cent or even more. For high income countries such as the UK, the USA or Germany, an annual growth rate of 2.5 per cent might be possible. High rates of growth in low and middle income countries can be achieved, for example by moving large numbers of workers from low-productivity agriculture to higher-productivity manufacturing. Using modern technology can also significantly increase output per worker.

High income countries, however, have already been through an industrialisation process and are at the forefront of technological developments. Moreover, a number of high income countries, including Japan and Italy, face a rapidly ageing population, where the number of workers in the economy is falling. Achieving even a 2.5 per cent growth rate is now seen as challenging in these circumstances.

Unemployment and employment

Governments would like to see unemployment as low as possible without there being inflationary pressure in the economy. It is impossible to have zero unemployment in a market economy because there is always frictional and seasonal unemployment. The UK government has no official target for UK unemployment. Unemployment rates in the 1950s and 1960s, an era of full employment, were around 1.5 per cent. Over the past 20 years, the best unemployment figure was a 4.8 per cent rate achieved in 2004. Under present circumstances, a five per cent rate would be seen as a considerable policy achievement.

Recent governments have also been keen to expand employment. Higher employment should increase tax revenues and reduce welfare benefits to the unemployed and those on low incomes. Getting people out of unemployment and off benefits has been a major policy objective in recent years.

Inflation and deflation

Central banks and governments in the industrialised world have tended to set inflation targets of around two per cent. This is low but positive inflation. Higher inflation is seen as undesirable, particularly because of the fear that inflation will then increase even further. On the other hand, governments want to avoid deflation. Deflation is seen as being linked to recession and low or negative economic growth.

The balance of payments on current account

Governments aim for the balance of payments on current account to be broadly in balance over time. Economies where the current account is persistently in surplus are seen to be 'strong' economies whilst those running persistent deficits are seen to be 'struggling' or 'weak' economies. However, the reality is far more complex than these initial judgements. Countries can run persistent surpluses, for example, and have low economic growth rates. Other countries can run persistent deficits and grow very fast over time without significant economic problems.

Very large current account deficits, measured as a percentage of GDP can, however, be very dangerous. If borrowers in these countries reach a point where they can no longer repay their loans, as Argentina did in 2001 or Greece in 2009, then there will be an economic crisis and a sudden large fall in GDP.

Government budgets

Since the financial crisis of 2008, the importance of fiscal (i.e. government) budget deficits as a major economic objective has grown. If a country is growing at around 2.5 per cent per year and there is two per cent inflation and low interest rates, then a fiscal deficit of around three per cent per year will probably maintain a stable level of national debt (the sum total of all outstanding government borrowing) as a percentage of GDP.

Following the financial crisis of 2008, a number of countries including the UK, the USA, Greece and Spain saw their fiscal deficits grow to over 10 per cent of GDP. These levels are unsustainable in the long term because it means that governments have to borrow far more money than they expect to repay with interest in the future. In the short term, however, large fiscal deficits which increase the national debt from, say, 40 per cent of GDP to 100 per cent of GDP, are sustainable so long as the fiscal deficit is reduced to manageable levels over time.

Economists disagree about the path to long-term equilibrium. Some argue that fiscal deficits should be cut as quickly as possible even if this means negative economic growth and significant increases in unemployment. Others argue that cutting fiscal deficits at a slower pace is better because it allows the economy to grow faster, leading to a quicker rebound in tax revenues and fall in welfare payments to the unemployed.

The environment

There is no simple measure of the impact of economic activity on the environment. Governments therefore have a wide variety of objectives in relation to the environment. These might range from global warming to pollution on beaches to air quality in cities. There is a range of opinion about whether economic growth is good or bad for the environment.

Environmentalists tend to be anti-growth, arguing that any increased economic activity will damage the planet. Pro-growth economists tend to argue that increases in output and improvements in technology allow economies to clean up their environments and reduce pollution.

Income distribution

Economists and politicians disagree about income distribution policies. Very broadly, right-wing economists and politicians tend to argue that inequality is positive because it increases incentives to work and to take economic risks. This increases economic growth rates, raising incomes for all in society. They therefore are against policies which reduce inequalities, particularly increases in taxes on higher earners and businesses.

Left-wing economists and politicians tend to argue that, on principles of fairness, everyone in society should have access to a certain standard of living and that free markets lead to high levels of inequality. Therefore, governments need to intervene to reduce inequality. They can intervene in markets, for example, by setting minimum wages or maximum prices for essential goods. They can also provide goods such as health care and education free to every citizen and fund this through raising taxes, particularly on high earners. They can also transfer income directly through taxes and benefits. Left-wing economists would tend to argue that high levels of inequality are not correlated economic growth. Individuals will work and take risks even if marginal rates of tax are high.

There are many variations on these views. So whilst economists and politicians would on the whole agree, for example, that fiscal deficits need to be contained over time or that low unemployment is desirable, there is no consensus about objectives for income inequality.

Thinking like an economist

A tale of four economies

The USA, Germany, Japan and the UK are four of the largest economies in the world. Their governments are all committed to securing a high rate of economic growth for their economies.

Figures 1 and 2 show how well they have achieved that over the period 2001 to 2014. Looking at the data, it is clear that none of the four economies was able to avoid the impact of the 2008 financial crisis. In 2009, for example, the US economy contracted by 2.8 per cent whilst the German economy contracted by 5.6 per cent.

Figure 3 shows the percentage change in GDP at purchasing power parities over the whole period 2001-2008. This shows that over these eight years, the performance of the UK and US economies were significantly better than those of Japan or Germany. Japan faced particular problems. An ageing population, a high savings rate and prices at times falling rather than rising (deflation) served to dampen the growth of domestic demand.

Growth in exports, the main driver of the Japanese economy in the 1960s, 1970s and 1980s, was disappointing as Japanese companies lost competitive advantage to lower cost countries such as China and South Korea. Germany, in the early 2000s, was still suffering from the costs of the reunification of East and West Germany in 1990.

However, Figure 3 shows the disastrous cost of the 2008 financial crisis. In five years, 2009-2013, the four economies barely achieved what might have been one year's growth in the period 2001-2007. It also shows the poor relative performance of the UK economy compared to the US economy. In the USA, the government adopted a much looser fiscal policy than the UK in order to increase demand and reduce unemployment. The UK, from 2010, saw significant government spending cuts and rises in taxes designed to reduce the government budget deficit. However, it had the effect of reducing demand in the UK economy and lowering economic growth. The UK government chose to prioritise cutting its budget deficit over its aim to achieve the long-term growth rate for the economy.

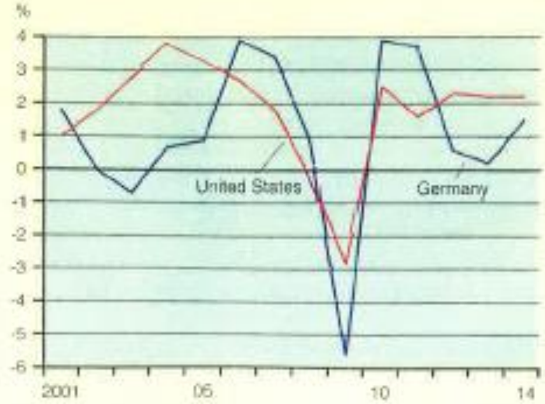
Figure 1

Annual % growth rate in GDP, Japan and the UK

Source: adapted from www.oecd.org.

Figure 2

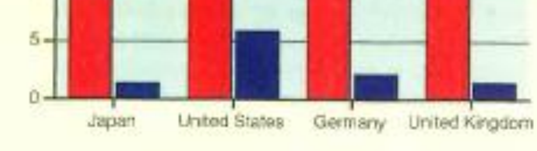
Annual % growth rate in GDP, Germany and the USA



Source: adapted from www.oecd.org.

Figure 3

Percentage growth in real GDP (at PPPs) over the periods 2001-2008 and 2009-2013



Source: adapted from www.oecd.org.

JAPAN

GERMANY

UK

USA

Data Response Question

Missed objectives

In March 2007, Gordon Brown, the Chancellor of the Exchequer, said: 'In this, my 11th Budget, my report to the country is of rising employment and rising investment; continued low inflation and low interest and mortgage rates; and this is a Budget to expand prosperity and fairness for Britain's families - and it is built on the foundation of the longest period of economic stability and sustained growth in our country's history. I can report the British economy is today growing faster than all the other G7 economies - growth stronger this year than the euro area, stronger than Japan and stronger even than America. Our forecast and the consensus of independent forecasts agree that looking ahead to 2008 and 2009 inflation will also be on target. Mr Deputy Speaker, six months ago when we published the Stern report on climate change, we set a framework for environmental action combining a call to personal and social responsibility, with European and international co-operation. Since then we have secured support for a strengthened European carbon trade scheme on the road to a global scheme.'

Source: excerpts from The Budget Speech, March 2007.

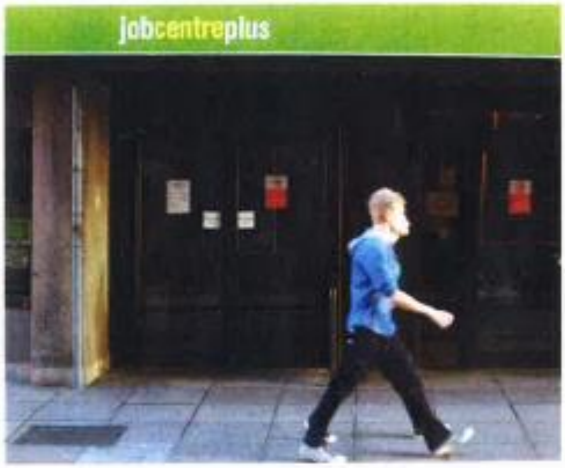
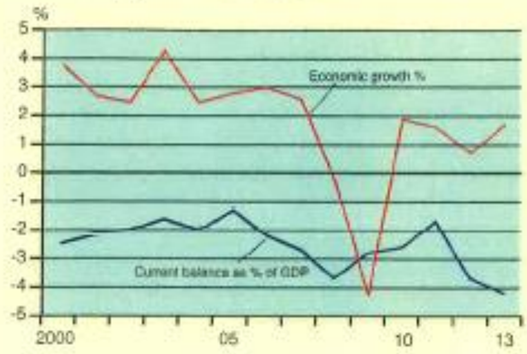


Figure 4

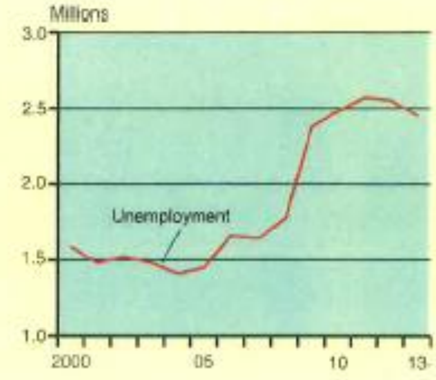
Economic growth, %; the current balance on the balance of payments as % of GDP



Source: adapted from www.ons.gov.uk.

Figure 5

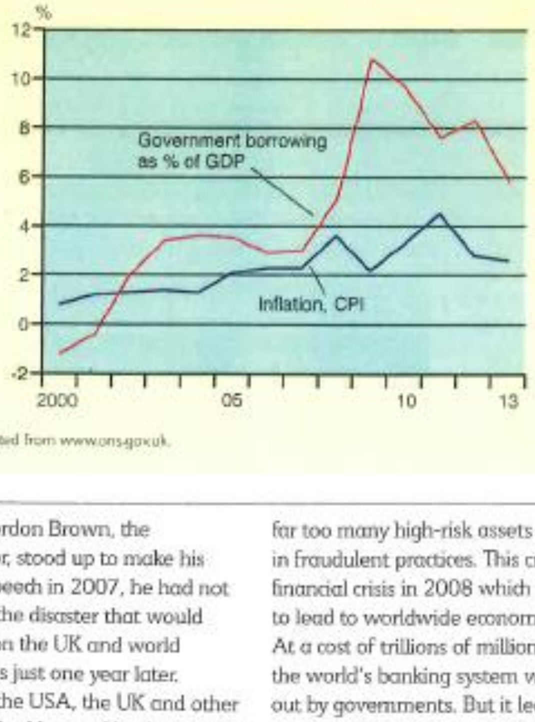
Unemployment, millions



Source: adapted from www.ons.gov.uk.

Figure 6

Inflation (CPI), %; government borrowing as % of GDP



Source: adapted from www.ons.gov.uk.

When Gordon Brown, the Chancellor, stood up to make his Budget speech in 2007, he had not foreseen the disaster that would descend on the UK and world economies just one year later. Banks in the USA, the UK and other countries had lent recklessly, created far too many high-risk assets and engaged in fraudulent practices. This created a financial crisis in 2008 which threatened to lead to worldwide economic collapse. At a cost of trillions of millions of pounds, the world's banking system was bailed out by governments. But it led to years of recession and high unemployment.

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1. Using Figures 4 and 5, identify two significant points of comparison over the period shown between changes in the rate of economic growth and the level of unemployment.
2. Explain why 'low inflation' and 'strong growth' might be objectives of the UK government.
3. Evaluate how well the UK government met its probable economic objectives over the period 2008-2013 compared to 2000-2007.

Evaluation

First, outline briefly the probable economic objectives of government over the whole period 2000 to 2013. Take each objective and comment on how well this was achieved in the two periods 2000-2007 and 2008-2013. In your conclusion, make an overall judgement as to whether 2008-13 was a more successful period than 2000-2007. Identify areas where you might not have enough evidence to come to a conclusion (which might include any environmental objectives).