Conflicts between macroeconomic objectives

Unfortunately, it is virtually impossible for a government to score in all these goals at once. We shall begin with the three major conflicts and then look at two more that are linked to microeconomics.

Healthy growth and low inflation

If an economy grows too quickly, especially if it is due to excessive consumer spending as it tends to be in the UK, then demand will outstrip supply and prices will rise. Equally, the steps taken to keep inflation low, like relatively high interest rates, can often restrict growth via reduced consumer spending and investment. It is difficult to achieve both aims.

The 'trend' rate of growth is seen as the rate of growth an economy can grow without igniting inflation. Most economists believe that this is around 2½% to 3% at the moment. For the last six years the UK has managed to walk this tightrope without slipping into either higher inflation or recession. Perhaps the economic cycle has been eliminated, but most economists find this difficult to believe.

Healthy growth and a balance of payments equilibrium

When an economy is growing quickly, consumer spending tends to be high. As we have already noted, British consumers tend to buy goods from abroad in preference to home produced goods. Hence, import growth picks up relative to exports, assuming an average growth rate in the countries that buy British goods, leading to a worsening trade deficit.

In the old days, when the balance of payments was seen as possibly the most important macroeconomic objective, the government had three options if they wanted to eliminate the deficit.

First, the exchange rate could be devalued within the fixed exchange rate system. A fall in the exchange rate would make exports relatively cheaper and imports relatively more expensive, and so help cure the trade deficit. Unfortunately, the increased import prices also caused inflation to rise.

Secondly, import controls could be used. These were physical controls on the number of imports allowed into the country, or taxes (tariffs) on imports, causing prices to rise. Both types of control reduced the amount of imports bought in the UK. Of course, the 'import controls' option is difficult to use these days with the World Trade Organisation.

Finally, the government could deflate the economy by increasing taxes or reducing government spending. The subsequent reduction in consumer spending will reduce the number of imports bought, but reduced consumption leads to a lower standard of living and a lower rate of economic growth.

Low unemployment (or full employment) and low inflation

This is the classic conflict in economic theory. In fact, an economist called Phillips constructed a curve (the Phillips curve) using empirical data to show that this conflict existed (although this did not mean that the relationship would hold forever).

These two variables have, in theory, an inverse relationship. If a government tries to reduce unemployment through reflationary measures, such as lower interest rates or increased public spending, then the resulting reduction in unemployment will push wages higher (as employers try to attract workers from a diminishing pool of the unemployed). This will lead to higher prices.

On the other hand, when the government tries to control high inflation with higher interest rates and reduced spending, the resulting reduced consumer spending and lower investment will result in job losses. Norman Lamont, Conservative Chancellor of the early 90s, famously said '…unemployment is the price worth paying for lower inflation.'

Healthy growth and the environment

Of course, not everyone would consider the environment a 'minor' objective, but unfortunately governments have not quite woken up to the problem yet. Although there have been summits at which controls on various types of pollution were agreed, the US amongst others seem to find it difficult to keep their promises!

Quite simply, the faster the rate of growth, the higher the level of production, and so the level of pollution from factories, cars, etc. rises. Also, vital rain forests tend to disappear, not just because we consume the wood; new factories, towns and housing are built on the resulting land.

Healthy growth and equality

Equality was an objective of socialist governments and so is now obsolete in the world of 'new' Labour! Although it is true to say that forcing equality throughout a country can lead to inefficiencies (where are the incentives), those on the left wing feel that it is an admirable and important aim. Ronald Reagan (US President from 1981-89) used to talk about the 'trickle down' effect. As an economy grows the poor may well get a smaller slice of the cake, but the cake gets so large that the poor man still gets more cake. Of course this does overlook the fact that the rich man is getting a larger slice of a bigger cake!

The developed world has grown hugely since the Second World War, but even with the creation of welfare states it is the wealth creators that have benefited hugely whilst those at the bottom of the pile have seen their standard of living just plod along. The communist Soviet Union kept the more equality conscious socialist model going right into the 80s, but its inefficiencies meant that the rate of growth was much slower. Now even they have embraced capitalism, although the transition has not exactly been smooth! For lots more detail on transition economies, see the topic called 'Free market .v. command economies'.