2.12 Conflicts and Trade-Offs Between Macroeconomic Objectives

Total Marks

AQA 7136 · Calculators not allowed · about 60 minutes · Write-in edition

Name: _____ Date: ____ / ____ / _____

Answer all questions. Time suggested: 60 minutes.

1 Explain briefly why a short-run policy that stimulates demand to reduce cyclical unemployment might be less effective if the economy is close to its potential output, referring to the shape of the SRAS curve.

(Total for Question 1 is 2 marks)

2 Explain the growth-versus-inflation conflict that can arise when an economy operates above potential output due to demand-side stimulus.

(Total for Question 2 is 3 marks)

3 Explain the growth-versus-current-account conflict that arises from 'import-sucked-in' effects when domestic growth strengthens.

(Total for Question 3 is 3 marks)

4 State two policy options a government could use to mitigate the environmental costs of rapid GDP growth while still supporting some growth, and briefly explain how each helps reduce the conflict.

(Total for Question 4 is 2 marks)

5 State one potential conflict between achieving a balanced current account and pursuing an export-led growth strategy, and explain the reason in one sentence.

(Total for Question 5 is 3 marks)

6 Explain the monetarist critique that the long-run Phillips curve is vertical at the natural rate of unemployment (NAIRU), in the context of expectations of inflation.

(Total for Question 6 is 3 marks)

7 Explain why attempts to reduce unemployment below the natural rate using expansionary monetary policy can, according to monetarists, lead to accelerating inflation rather than a permanently lower unemployment rate.

(Total for Question 7 is 3 marks)

8 Explain how a strong recovery in domestic demand that raises GDP might reduce net exports and therefore worsen the current account, explicitly referring to income elasticity or marginal propensity to import in your explanation.

(Total for Question 8 is 4 marks)

9 Evaluate the view that it is possible for a government to achieve all of its macroeconomic objectives simultaneously, considering objectives such as low inflation, low unemployment, strong economic growth, a balanced current account and environmental sustainability. In your answer include analysis of trade-offs, the role of expectations, supply-side policies, and any relevant time horizons. Use diagrams where helpful and reach a supported judgement.

(Total for Question 9 is 15 marks)

Mark scheme · 2.12 Conflicts and Trade-Offs Between Macroeconomic Objectives

Question 1

identifies that SRAS becomes steeper as output approaches potential, so supply is less responsive — **M1**

explains that increased AD in this region mainly raises prices rather than output, so unemployment falls little while inflation rises — **A1**

Answer: Near potential output SRAS is steep, so demand stimulus mostly increases the price level with little extra output; unemployment therefore falls only a little while inflation rises.

Question 2

identifies that growth above potential uses spare capacity and increases demand relative to supply — **M1**

explains mechanism: as output approaches capacity firms face rising costs and bid up prices, causing demand-pull inflation — **A1**

links to conflict: policy aimed at higher growth therefore risks higher inflation when near full capacity — **A1**

Answer: When growth pushes output above potential, spare capacity is used up, production costs rise and firms raise prices, so policies that raise short-run growth can generate demand-pull inflation.

Question 3

identifies that stronger growth raises domestic income and spending, including on imports — **M1**

explains mechanism: higher imports reduce net exports, worsening the current account while growth increases GDP — **A1**

links to conflict: a policy boosting growth can therefore worsen the trade balance via import leakage — **A1**

Answer: Higher domestic growth increases incomes and spending on imported goods, reducing net exports and potentially deteriorating the current account, so growth can conflict with external balance.

Question 4

valid policy option one named, e.g. carbon pricing or an emissions tax — **B1**

brief explanation of how it helps, e.g. raises cost of polluting activities so firms and consumers switch to cleaner production/consumption, reducing emissions while allowing growth in low-carbon sectors — **B1**

Answer: Example: implement carbon pricing (emissions tax) which makes polluting activity more expensive and encourages cleaner production; subsidise green investment which shifts growth toward low-carbon industries and reduces environmental damage.

Question 5

states a conflict, e.g. export-led growth can lead to overreliance on external demand and vulnerability to foreign shocks — **M1**

explains consequence: a boom in exports may improve the trade balance but can cause exchange rate appreciation, making other tradable sectors less competitive, or create terms of trade volatility — **A1**

links to balanced current account: rapid export growth can mask deficits in other components (income account, services) or produce cyclical swings that make a balance harder to sustain — **A1**

Answer: Export-led growth can cause exchange rate appreciation and dependence on external demand, which may create volatility and undermine a stable, balanced current account.

Question 6

states that in the long run inflation expectations adjust so there is no trade-off between inflation and unemployment — **M1**

explains that workers and firms incorporate expected inflation into wage and price setting, returning unemployment to the natural rate — **A1**

concludes that the long-run Phillips curve is vertical, so attempts to keep unemployment below NAIRU cause accelerating inflation — **A1**

Answer: As inflation expectations adapt, wages and prices adjust so unemployment returns to the natural rate; therefore the long-run Phillips curve is vertical and there is no permanent inflation-unemployment trade-off.

Question 7

identifies that expansionary policy raises AD, temporarily reducing unemployment below the natural rate — **M1**

explains that over time workers and firms expect higher inflation and negotiate higher wages/prices, eroding the real wage effect that reduced unemployment — **A1**

concludes that unemployment returns to the natural rate while inflation continues to rise, producing accelerating inflation if policy persists — **A1**

Answer: Expansionary policy raises AD and temporarily cuts unemployment, but as inflation expectations adjust wages and prices rise, removing the temporary employment gain; unemployment returns to the natural rate while inflation accelerates if policy continues.

Question 8

identifies that higher domestic income increases demand for imports or that imports have a positive income elasticity **M1**

explains mechanism using MPm or income elasticity: a higher marginal propensity to import means each extra pound of domestic income produces a relatively large increase in import spending **A1**

relates to net exports: rising imports reduce (X-M), so net exports fall as domestic demand recovers **M1**

links to current account: the trade balance and current account can deteriorate even while GDP rises because import leakage offsets some of the rise in output **A1**

Answer: If imports are income elastic or the marginal propensity to import is high, a recovery raises import spending strongly as incomes grow; this raises M and reduces (X-M), so the current account can worsen even as GDP rises.

Question 9

Level 1 Basic statements about possible conflicts or complements between macro objectives are offered with limited development. Answers may show little use of theory, no diagrams, and conclusions are undeveloped or missing. **1-5**

Level 2 Clear explanation of at least two trade-offs or interactions, for example between growth and inflation, growth and the current account, or growth and the environment. May include reference to the short-run Phillips curve, expectations and the difference between short-run and long-run policy effects. Some evaluation is present and partial judgement offered. **6-10**

Level 3 Comprehensive analysis of multiple trade-offs, including the monetarist critique of a permanent inflation-unemployment trade-off, role of expectations, and how supply-side policies can shift possibilities. Draws on diagrams where appropriate, considers time horizons and distributional issues, weights arguments, and reaches a well-supported and balanced judgement on whether all objectives can be achieved together. **11-15**

Indicative content:

- Recognise the existence of genuine trade-offs: e.g. short-run Phillips curve trade-off between inflation and unemployment; demand-led growth can worsen the current account via import leakage; growth can increase pollution unless green measures accompany it.
- Monetarist critique: in the long run the Phillips curve is vertical, so attempting to keep unemployment permanently below NAIRU leads to accelerating inflation; expectations matter for the persistence of trade-offs.
- Time horizons: some objectives may be jointly achievable in the short run if spare capacity exists, but conflicts re-emerge as the economy approaches potential; supply-side policies can change the trade-off by shifting LRAS and the LRPC.
- Role of supply-side policies: investment in infrastructure, education and technology can expand productive capacity, reduce structural unemployment and allow higher growth without inflation, though with long implementation lags and potential financing costs.
- Policy mix and sequencing: monetary and fiscal policy can stabilise demand in the short run while supply-side reforms aim to improve long-run outcomes; active macroprudential or industrial policies can mitigate exchange rate or current account effects.
- Constraints and practical limits: political economy, financing requirements, international shocks, and distributional consequences can prevent simultaneous attainment; environmental objectives may require growth to be restructured rather than maximised.
- Evaluation: consider magnitude and speed of policies, trade-off intensity, whether a government accepts some relaxation of one objective to meet others, and conclude with a balanced judgement on feasibility, likely partial attainment, or need for prioritisation.