

7

Macroeconomic policies Core

On completion of this core section you should know:

- how governments can take steps to correct persistent deficits and surpluses in their balance of payments
- why their reaction is dependent upon the exchange rate regime under which they are operating
- the likely side effects on the domestic economy of the policies they might choose.

Introduction

The exchange rates of all major international currencies fluctuate on a daily basis. As seen in Chapter 6, some exchange rates are freely floating. However, many currencies are managed in the sense that they are linked to either the US dollar or the euro, the principal reserve currencies in global markets.



Euro currency

The Hong Kong dollar is an example of a currency that has a managed exchange rate traditionally pegged to the US dollar like other Asian currencies. It can fluctuate but only within a very narrow range of HK\$7.75–7.85 to the US dollar. This has been a good system for Hong Kong. It has brought exchange rate stability which has been so important to its economy which is heavily dependent on international trade and related services. Fluctuations against other currencies have been more extreme. From October 2008 to October 2009, for example, the UK pound exchanged at between HK\$ 10.52 and 12.64, a

variation of around 20%. The downside of stability against the US dollar has been that the Hong Kong authorities have, on occasions, had to use large reserves of currency to keep within the narrow pegged rate for its own dollar. In turn, this has caused instability and uncertainty in the domestic economy.

The move to a single currency, the euro, by 12 EU member states from 2002 has been designed to give these countries exchange rate stability. There is just one exchange rate for trade outside the eurozone whilst internal trade takes place using the common currency. Supporters of the euro believe that it has led to increased investment in the eurozone from the US, China and elsewhere in Asia and provided a stable currency regime for increased internal trade. By 2010, four more countries had joined the euro, with others expected to follow. The UK, Denmark and Sweden remain outside the eurozone but remain as member states of the EU.

Where exchange rates are managed and there is pressure to keep a currency within its permitted range, it is necessary for governments to buy and sell reserve currencies such as the US dollar or the euro. If there is persistent upward pressure, there is the added problem that currency reserves are not limitless. So, a country may not be in a position to use reserves indefinitely in this way. When this occurs, it is indicative that there is some fundamental underlying weakness – it is consistently spending more on imports of goods and services than it is generating from export revenue. To restore balance, import and export prices have to be adjusted.

Correction of the balance of payments

There are two broad policy approaches that can be used to correct an imbalance in the balance of payments where an economy has such underlying weakness. These are **expenditure switching** and **expenditure dampening** policies.

Expenditure switching policies

An expenditure switching policy is any action taken by a government which is designed to persuade purchasers of goods and services both at home and abroad to purchase more of that country's goods and services and less of the goods and services produced by others. Effectively this would include any policies designed to persuade domestic purchasers to purchase home-produced goods and services rather than imports. It would also include any policies designed to persuade foreign purchasers to buy more exports from the domestic economy. These policies are not designed to reduce the total amount of spending in a country but to redirect or 'switch' spending to a country's products rather than those produced in another country. The impact should be a fall in import expenditure and a rise in export earnings. The former will lead to a fall in the supply of a country's currency on the foreign exchange market and the latter will lead to a rise in the demand for the country's currency on the market. Both will lead to upward pressure on the exchange rate.

Expenditure switching policies include the following measures:

- tariffs
- quotas
- exchange controls
- export subsidies.

These were described in Chapter 4. Along with embargoes and voluntary export restraints, all have the disadvantage that they interfere with market forces and prevent the consumer from benefiting from the effects of specialisation and trade.

Expenditure switching policies may be ineffective if the demand for imports is price inelastic or if domestically produced goods are poor quality substitutes. In addition, a government's ability to resort to expenditure switching policies is limited by its membership of the World Trade Organization

(WTO). As a result, it may be forced to resort to expenditure dampening policies.

Expenditure dampening policies

An expenditure dampening or reducing policy is any action taken by a government that is designed to reduce the total level of spending in an economy. This will have two effects. First, a reduction in spending will mean that there will be fewer purchases of imported goods and services. Secondly, domestic producers will find that their domestic market is 'dampened'. As a result, they may try to make up for the decrease in domestic sales with increases in sales abroad. The overall impact therefore should be a fall in imports and a rise in exports. Expenditure dampening policies include the following:

- **Deflationary fiscal policy** This means raising taxes and reducing government expenditure. Raising taxes will reduce disposable incomes meaning that less will be available to spend on imports. In addition, the reduced government spending will lead to a downward multiplier effect which will depress incomes further. The extent of the reduction in import spending will depend upon the **marginal propensity to import**. This measures the change in import spending as disposable incomes change. A high marginal propensity to import will mean that a fall in disposable incomes will have a great impact upon import spending, and taxes may not have to be raised by much to reduce import spending by the required amount. Alternatively, if the marginal propensity to import is low, it will require a large increase in taxes to bring about the necessary reduction in import spending.
- **Deflationary monetary policy** This means raising interest rates and reducing the money supply. In addition to attracting inflows of foreign capital that will increase the demand for the currency on the foreign exchange market, increases in the rate of interest will reduce the money supply and deflate the economy. This is because the higher interest rate will reduce the demand for loans for consumption and investment and lead to a fall in aggregate monetary demand.

A major disadvantage of a managed exchange rate system is that it creates a deflationary situation when there is downward pressure on the exchange rate as a result of a balance of payments deficit. The deflationary outcome will have the intended effect of reducing spending on imports, but it will also have the additional unintended effect of reducing spending on home-produced products. This means that unemployment will rise in the domestic economy.

The maintenance of a managed rate in times of balance of payments deficits requires exchange market intervention on a daily basis together with expenditure switching and expenditure dampening policies with their resulting negative side effects. If the problem persists, then it is clear that the deflationary pressure will cause the economy to operate at less than full capacity, with all the waste in terms of lost output that this implies. Under these circumstances there may be a case for a **devaluation** of the currency. This means that the government announces that it will now adjust or peg the exchange rate at a new lower value. This has the same effect as a depreciation of the currency. It alters the relative price of imports and exports to restore competitiveness. If the economy continues to suffer from inflation, devaluation will become increasingly frequent and the benefits of a managed exchange rate will be lost.

The long-term answer to the difficulties associated with a persistent balance of payments deficit is to improve the quantity and quality of goods and services produced in the economy. As a result governments have increasingly adopted supply-side policies to improve the underlying competitiveness of the economy so that persistent deficits do not arise (see Supplement section of this chapter). Only in this way can economies enjoy full employment and the full benefits of international trade.

A persistent balance of payments surplus can also create difficulties for an economy but under these circumstances the pressure on the government will not be so acute. This is because the government will be selling quantities of its own currency to prevent a rise in the rate. The effect is that the country's reserves of foreign exchange will be rising. Nevertheless, if an economy suffers from a persistent surplus it may choose to undertake a **revaluation** of the currency to restore long-term equilibrium to the accounts.

Finally, it is worth raising the whole question as to whether an imbalance on the balance of payments caused by a current account deficit or surplus is really a bad thing. Economists are somewhat divided on this issue. Look at the current global position. The US has had a string of deficits for many years. In 2009 this was estimated at \$540 billion. To fund this, at a time of recession, the US government has done what it has always done, namely borrow money from itself. In stark contrast, China had an estimated surplus of \$364 billion. China has also been feeling the wind of global recession and has continued to resist pressure to revalue its seriously undervalued exchange rate. In neither case have these countries really done what economic theory says they should have done.

Conflicts between policy objectives on inflation, the balance of payments and the exchange rate

Managing the economy is a far from an easy task. There are many reasons for this, one of which is the inherent conflict that exists when governments are confronted with policy objectives which cannot be simultaneously achieved. This inevitably means that priorities have to be made or, more likely, there has to be compromise.

Most developing (and indeed some developed) economies have persistent deficits on their balance of payments. These deficits are likely to be on trade in goods and services, other parts of the current account or the capital account. Expenditure switching and expenditure dampening policies, often used together, are the usual policy methods used to try to rectify the situation. This is particularly the case when the deficit is on the balance on goods, the balance on services or both.

Switching expenditure away from imports may reduce trading deficits and can be achieved by a fall in the exchange rate. This makes imported goods more expensive relative to those produced in the domestic economy. This is fine, but it could create a rise in the rate of inflation since domestic producers are increasing their share of the home market and are also in a better competitive position to sell what they make on the international market. In turn, after a time lag, it is likely to mean that the government



Study the information below and then answer the questions that follow.

America's economic weakness?

	Current account balance (\$bn)	As % of GDP
2001	-384	3.8
2002	-461	4.7
2003	-523	5.1
2004	-624	5.8
2005	-728	6.1
2006	-788	5.9

Table 7.1 US current account balance, 2001–2006

On the surface, the United States has the strongest economy in the world. Investors have been happy to pour their money into the US's booming markets. As a result, the current account deficit has ballooned. In 2006 it stood at an estimated 5.9% of GDP.

The worry is that foreign investors will be concerned that the US is using their capital to finance low savings and a consumer spending boom rather than boost investment. As a result, they will start to shift their money elsewhere – the dollar should therefore fall, boost US exports and slow import growth. A weaker dollar in turn will aggravate fears of inflation and a slowdown in economic growth.

- 1 As well as currency depreciation, what other policies could the US use to reduce the current account deficit? What consequences might occur?
- 2 Discuss whether the US government should be concerned about the large negative current account balances that are occurring?

has to introduce further policies to suppress domestic demand. This is not entirely a bad thing since it will be consistent with the objective of reducing balance of payments deficits.

This is fine in theory. It is most likely to be effective in the case of economies that have a strong manufacturing sector since this sector can respond to the challenge of increased demand. Where an economy is dependent upon agricultural goods and raw materials, as with most developing economies, the effect is less clear since export demand is likely to be price inelastic. It is also likely to be effective, with a time lag, in the case of economies that have

substantial earnings from international tourism. A fall in the exchange rate say of the East Caribbean dollar will make holidays in Jamaica more attractive to US tourists in the same way as the price of a bottle of Jamaican rum will be cheaper in the US domestic market.

For some economies, where their currency is directly linked to the US dollar, there is often very little they can do to directly affect their exchange rate. As a result, they may experience balance of payments problems as a result of a weak US dollar on the global currency market.

SPECIMEN EXAM QUESTIONS

The following questions have been set in a recent CIE examination paper.

- 1 a** Explain what is meant by a current account deficit. [8]
b Discuss the effectiveness and desirability of imposing tariffs to correct a current account deficit. [12]

[20 marks]

(May/June 2008)

SUMMARY

In this core section it has been shown that:

- Governments may find it necessary to use various policies to correct a balance of payments deficit or surplus.
- The use of these policies is necessary where a country has a managed exchange rate.
- Such policies can have short-term detrimental effects upon the domestic economy.
- From a longer-term standpoint, supply-side policies can enhance a country's competitiveness.

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7

Macroeconomic policies Supplement

On completion of this supplement section you should know:

- what policies are applied globally to assist the economic development of developing economies
- the objectives of macroeconomic policy
- what is meant by fiscal, monetary, exchange rate and supply-side policies
- how policies can be used to control inflation, stimulate employment and economic growth and correct balance of payments disequilibrium
- how economists assess the effectiveness of these policies
- the possible conflicts between policy objectives.

Policies towards developing economies

Before looking at macroeconomic policies in detail from the perspective of the domestic economy, it is important to establish the wider context within which developing economies have to manage their macroeconomic affairs. This introductory section builds upon the content of Chapter 4 and looks at the activities of the World Trade Organization, the International Monetary Fund and the World Bank and how these impact on developing economies.

World Trade Organization

The World Trade Organization (WTO), with headquarters in Geneva, Switzerland, currently has 153 members. Vietnam was the latest country to be admitted from 2007. Significantly after 15 years of tense negotiations, the People's Republic of China became a member in 2001.

The WTO's mission is a simple one. In its own words, it 'helps trade flow smoothly, freely, fairly and predictably'. In practice, this should produce a trading system with the following characteristics:

- **Non-discrimination** Two key principles are involved here. The first is known as the most-favoured-nation treatment. Under WTO agreements, countries cannot grant a special favour (for example a lower rate of duty or



World Trade Organization head quarters in Geneva, Switzerland

duty free access) to one WTO member over another. In other words, all countries should be treated on an equal basis. The second principle is called national treatment. This involves treating foreigners and locals equally. Under this agreement, imported and locally produced goods should be treated equally after goods have reached the domestic market. This does not prohibit a country imposing tariffs on imported goods though it does mean that the goods then compete on the same basis thereafter. The principle also applies to services so that foreign firms, for example, trying to set up in business elsewhere should be treated in exactly the same way as domestic firms wishing to expand their operations.

- **Free trade** The most obvious way in which this can be done is by lowering trade barriers, tariff and non-tariff barriers. This will enable goods and services to flow more openly and fairly between members, providing the benefits of the gains from trade that were described in Chapter 4.
 - **Predictability** The purpose of this objective is to 'bind' WTO members once they have agreed to open their markets. The rationale behind this is to provide a stable business environment whereby firms will feel secure that trade barriers will not be raised at some future date. This should create a business environment where investment is encouraged, jobs are created and consumers can enjoy the benefits of lower prices and more choice. It has particular relevance for businesses moving into emerging and developing economies where there is likely to be concerns over future political stability and economic prospects.
 - **Promoting fair competition** The WTO system allows tariffs and in some circumstances, other forms of protection. Having said this, once a restriction has been imposed by a member, WTO agreements mean that thereafter there should be free and fair competition in the market. This must not be distorted by further constraints on foreign-produced goods and foreign-owned services.
 - **Special provision for developing countries** From the outset, the WTO has sought to assist the development of developing countries. This has not been easy given the stances taken by the USA and EU, for example, with respect to trade in certain agricultural products. Nevertheless, the WTO has sought to give such countries time and flexibility to implement various agreements. The agreements provide special assistance and trade concessions for developing countries.
- by governments. The so-called Uruguay Round agreements are the basis of the current WTO system. The Uruguay Round covered three main areas:
- **Tariff cuts** Developed country members of WTO agreed a 40% cut in their tariffs on industrial products to be phased in over a 5-year period from 1995. This agreement reduced the average tariff from 6.3% to 3.8%. They also agreed that fewer imported products should be charged at higher duty rates. This was of particular benefit to developing countries which saw the proportion of their exports faced with tariffs of 15% and above in industrialised countries fall from 9% to 5% of total products.
 - **More binding tariffs** This is the term used to denote a commitment by a member to not increase tariffs above the listed rate. Developed countries increased the number of 'bound' product lines to 99%; developing countries increased their pledges to 73%. The purpose behind these agreements is to provide rather more security for traders and other investors.
 - **Agriculture** Substantial progress was made to remove almost all import restrictions of a non-tariff form on agriculture products in world trade. Most of these physical restrictions were converted to tariffs, a process known as *tariffication*. At the same time, tariffs applying to products from developing countries have been progressively reduced and commitments have been received from developed countries to reduce domestic support and export subsidies for agricultural products. The Uruguay Round represents the first time that such agreement has been reached in principle.

The agreements

Agreements by the WTO cover goods, services and intellectual property. They are often called the WTO's trade rules since the WTO is a rules-based system of agreements that have been negotiated

Doha Round

This round of negotiations started in November 2001 at the Fourth Ministerial Conference in Doha, Qatar. Negotiations have been extremely contentious and agreement on many issues has not been reached.

Central to the Doha Round has been the determination of members to put the needs of developing countries at the heart of the WTO's work programme. In particular, there has been some

commitment to assist the least developed countries through seeking to provide them with an increasing share of world trade as a means of assisting their economic development.

Some limited agreement has been forthcoming. Countries have agreed to phase out all export subsidies by the end of 2013 and to terminate any cotton subsidies. Other concessions to developing countries are known as the 'Everything But Arms' initiative – this is an agreement to introduce tariff-free access for goods from least developed countries for 97% of all products that are traded.

International Monetary Fund

The International Monetary Fund (IMF) was set up in 1945 at the Bretton Woods Conference to help promote the health of the world economy following the catastrophic damage caused by World War II. With headquarters in Washington DC, it currently has 184 members. Notable non-members are Cuba and North Korea.

Over the past 60 years of its operation, the IMF's purposes have remained unchanged, although its activities have evolved and developed in line with the emerging global economy. These purposes and responsibilities are:

- to promote international monetary co-operation
- to facilitate the expansion and balanced growth of international trade
- to provide exchange rate stability
- to assist in setting up a multilateral system of payments
- to make resources available to members experiencing balance of payments difficulties, provided adequate safeguards are provided.

These activities have been central to the development of global trade since a stable system of international payments and exchange rates is necessary for trade to take place between two countries. In carrying out its responsibilities, the IMF has three main functions that are known as surveillance, technical assistance and lending. The first two are in line with its mission of promoting global growth and economic stability by encouraging countries to adopt sound economic policies. The third function is used where member

countries experience difficulties in financing their balance of payments.

Many IMF members have experienced severe balance of payments problems over the past 60 years. In the 21st century, it is mainly developing economies that face fundamental disequilibria on their current accounts. In such circumstances, the IMF lends money to such countries to ease their immediate positions – it is though a necessary condition for such help that recipients work closely with the IMF to avoid similar, probably more serious problems in the future.

World Bank

Like the IMF, the World Bank arose out of the Bretton Woods agreements. Unlike the IMF though, the World Bank's function is to provide financial support for internal investment projects such as building new roads, improving port infrastructure, constructing new health facilities and so on.

It is best described as the World Bank Group through the activities of its five constituent agencies. These are:

- International Bank for Reconstruction and Development (IBRD)
- International Finance Corporation (IFC)
- International Development Association (IDA)
- Multilateral Investment Guarantee Agency (MIGA)
- International Centre for Settlement of Investment Disputes (ICSID).

The IBRD and IDA provide low or no interest loans and grants to countries that do not have favourable access to international credit markets. Therefore, the focus of activities is very much on developing economies, including the emerging economies of central and eastern Europe and South East Asia. Grants are only provided to the world's poorest countries. Loans cover areas such as:

- health and education in order to enhance human development in a country – for improving sanitation and combating Aids
- agriculture and rural development – for irrigation programmes and water supply projects

- environmental protection – for reducing pollution and for ensuring that there is compliance with pollution regulations
- infrastructure – roads, railways, electricity
- governance – for anti-corruption reasons.

Like the IMF, loans tend to be linked to conditions that involve wider-reaching changes being made to the economic policies of the recipient countries.

The World Bank has its critics. It has been accused of being a US/Western European dominated agency for supporting their economic and political interests. Through its strong support for free market reforms, its policies have been criticised as being harmful to the interests of some countries, particularly where the ‘shock therapy’ of reform has been introduced too quickly. Notwithstanding these and other criticisms, the World Bank has had a considerable impact in assisting the world’s poorest economies.

Trade and development

As we saw in Chapter 4, in terms of economic theory it is clear that participation in international trade brings benefits to participant countries in respect of economic welfare. In the early 19th century David Ricardo developed the Principle of Comparative Advantage to argue that where differences in opportunity cost ratios exist, specialisation and free trade will result in participant economies enjoying living standards beyond those achievable if they pursued a policy of self-sufficiency. Developing this idea further it can be argued that if developing countries pursue policies to encourage the growth of trade, not only will living standards rise in the present time period, but also the economy will experience an increase in the pace of its economic development. This view suggests that international trade can act as an engine for growth.

This approach offers a very positive view of the participation of developing countries in international trade. The full benefits can be summarised as follows:

- International trade improves supply conditions in developing economies since:
 - economies of scale become possible because the market is much wider

- the increased competition encourages domestic entrepreneurs to innovate and look for new techniques of production
- trade leads to the transfer of skills and technology from developed to developing economies
- because international trade raises incomes, it provides the means for increased savings and investment.

- As a result, it is claimed that international trade increases the supply of capital in developing economies.
- All of the above will lead to reduced costs and more efficient production and provide a stimulus for growth.
- In addition to the impact upon the supply side of the economy, participation in international trade will impact upon demand conditions. This is because the expansion of production to cater for the export market will draw formerly unused resources into production. The result will be an expansion of spending power in the home market that will create demand for domestic output.

Although the beneficial effects of international trade upon the growth rates of developing economies have a strong theoretical basis, many economists have a far more pessimistic view. This is based upon the pattern of world trade that emerged as economies specialised. Developed economies specialised in manufactured products, while the developing countries specialised in primary products. This meant that the developing countries were at a distinct disadvantage in trading relations since the prices of primary products have declined relative to the prices of manufactured products over time. This is for two reasons:

- First, the income elasticity of demand for primary products is low so that as world incomes have risen, there has been little extra demand for primary products and demand has shifted to manufactured goods.
- Secondly, producers of manufactured goods in developed economies have an element of monopoly power which they have used to maintain high prices.

In addition, the effects of trade have been quite limited in their impact upon the internal economies of developing countries for the following reasons:

- Usually the production of primary products took place on plantations and mines that were foreign owned so that profits were remitted abroad. Profits were seldom re-invested in the host country.
- The techniques of production adopted in the plantations and mines were often inappropriate in terms of the resource endowments of the developing country. As discussed earlier, developing economies have abundant labour but usually capital-intensive methods were used. This typically had to be imported from abroad, as did the skilled labour, and had negative effects upon the balance of payments position of developing economies.

Unsurprisingly, given these features of trading relationships between developing and developed economies many have questioned the value of policies designed to generate export-led growth in developing economies. Trading patterns are seen as essentially exploitative. As a result, many developing economies turned to import substitution policies. They tried to prevent imports of manufactured goods from developed countries in order to develop their own manufacturing industries. The overall trend is that developing countries are now generally less dependent upon exports of primary products than they once were. The total number of developing countries in which the export of primary products makes up 80% or more of total exports is now falling. Those countries that remain overly dependent upon primary products, with all the attendant problems that this dependency brings, tend to be concentrated in Africa. Emerging countries in other regions tend to have more balanced exports, with increasing emphasis on manufactured consumer goods.

The case of China is in many respects exceptional in its scale and impact. The consistently high rates of growth recorded over many years have come largely from export-led growth derived from the sale of manufactured goods to more developed high cost economies such as the USA, Canada, Australia and the EU. Chinese exports have also figured

prominently in the imports of poorer countries in the Caribbean and parts of Africa. It is a model of growth that is also being followed by other Asian economies such as Malaysia, Thailand and Indonesia.

Development thinking is now inclined to accept that there is no single policy which is appropriate for all countries at all times. There is a recognition that sweeping policies are often incomplete and development issues are often quite complex. Policies that were appropriate and successful in generating development in some countries at some times are not necessarily appropriate in all countries at all times. In any given country, progress depends on a wide range of factors, the relative importance of which shifts over time. Sustainable development has many objectives of which raising per capita incomes is only one among many. Although governments matter in the development process, there is no simple set of rules which tell governments what to do and which apply in which circumstances.

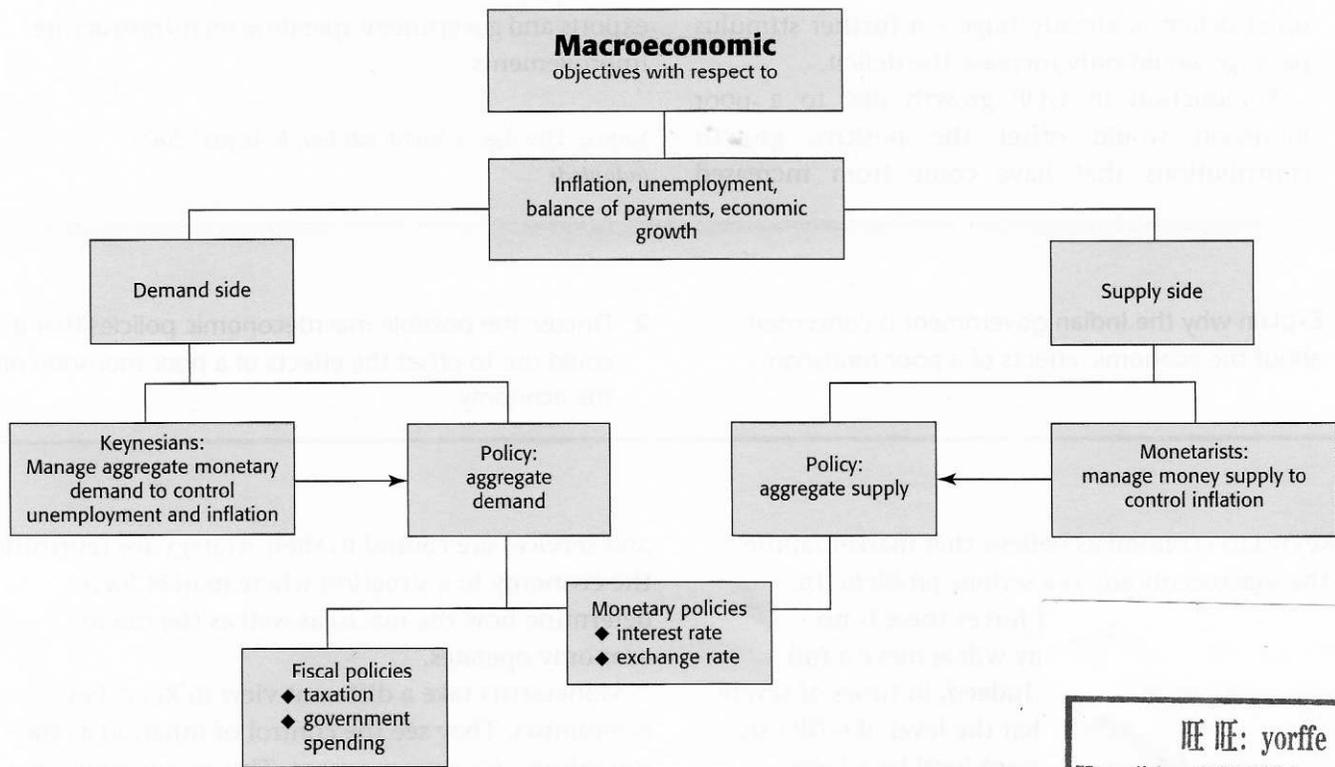
Objectives of macroeconomic policy

Governments share the same main objectives of macroeconomic policy regardless of whether they are developed, emerging or developing economies. However, at any particular time, they may have different priorities. In seeking to achieve these macroeconomic objectives, governments can use a range of policies, although each of these policies has its limitations. There can also be conflicts between policy objectives.

The main government macroeconomic policy objectives are:

- full employment
- low and stable inflation
- equilibrium in the balance of payments position
- sustainable economic growth
- avoidance of exchange rate fluctuations.

Few economists would argue with these objectives. There is though considerable debate as to which macroeconomic policies should be used to achieve these objectives. As introduced in Chapter 5, various schools of economic thought persist as to what is the best way to deal with, for example unemployment, rising inflation, a current account deficit, sluggish economic growth and so on. Figure 7.1 summarises the two main approaches.



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Figure 7.1 Macroeconomic issues and policies

SELF-ASSESSMENT TASK 7.2

Read the feature below and answer the questions that follow.

Poor monsoon to hit growth

India's growth rate will take a hit of 0.5% to 1% if the current shortfall in the monsoon continues. This was the view of Mr Jyotivardhan Jaipuria, head of research at DSP Merrill Lynch. Indian GDP growth for 2009 was expected to be around 7% but if the shortfall in the monsoon continues, the output of the agricultural sector is likely to fall by at least 2%. This would inevitably mean higher food prices.

Agriculture is very important in the Indian economy and is responsible for generating an estimated 18% of GDP. If there is a decrease in output many farmers would be in trouble, prompting calls for the government to offer a stimulus package. The problem for the economy is that the



Parched farmland in India

fiscal deficit is already huge – a further stimulus package would only increase the deficit.

A reduction in GDP growth due to a poor monsoon would offset the positive growth contributions that have come from increased

exports and government spending on infrastructure improvements.

Source: The Age, London edition, 8 August 2009 (adapted)

- 1 Explain why the Indian government is concerned about the economic effects of a poor monsoon.
- 2 Discuss the possible macroeconomic policies that it could use to offset the effects of a poor monsoon on the economy.

Keynsian economists believe that market failure in the macroeconomy is a serious problem. In particular, if left to market forces there is no guarantee that the economy will achieve a full employment level of GDP. Indeed, in times of severe recession, they maintain that the level of GDP can fall below the full employment level by a large amount and for long periods of time.

Keynsians maintain that government intervention is needed to improve the workings of the market. So, if there is high unemployment, they argue that the government should engage in deficit financing to raise the level of spending in the economy. The role of government is to assess the appropriate amount of spending to inject into the economy and to act accordingly. For most Keynsians the avoidance of high unemployment is seen as a key priority.

Keynsian principles for managing the macroeconomy were very much to the fore in many economies, the UK especially, up to around the mid-1970s. Today, many Keynsian principles persist as the world's economies struggle out of the worst recession since the 1930s. The use of fiscal policies involving an increase in aggregate demand through tax cuts and increased government spending will be discussed below and in Self-assessment task 7.5 on how the US is trying to address its unemployment problems (see page 285).

The new classical economists take the view that markets usually work efficiently. In their view, government intervention is not required apart from ensuring that laws, regulations and institutions are in place to allow market forces to operate in an appropriate way. Deregulation and reducing government involvement in the provision of goods

and services are central to their strategy for returning the economy to a situation where market forces determine how the macro as well as the micro economy operates.

Monetarists take a different view to Keynsian economists. They see the control of inflation as the top priority for a government. This group argue that the prime macroeconomic function of government is to control the money supply. By controlling the money supply, inflation can be controlled. They also maintain that the attempts to reduce unemployment by increasing government spending will have the negative long-term effect of raising inflation. They believe that economies are in the main stable, unless disturbed by erratic changes in the growth of the money supply.

The Great Debate in Economics has been one of Keynsian versus Monetarist views on how the economy should be managed. Although Keynsian views are much more to the fore than a generation ago, empirical experience has shown that the most successful economies have applied macroeconomic policies that encompass both types of approach.

Introduction to fiscal and monetary policies

Figure 7.2 shows a broad representation of the means by which governments are able to manage their economies. Traditionally, fiscal policy and monetary policy have been used in virtually all types of economy to manage aggregate demand in order to achieve the government's macroeconomic objectives. This is still the case, although particularly in developed economies and increasingly in developing

Problem	Short-term policy		Difficulties
	Monetary	Fiscal	
↓ Unemployment	↓ rate of interest ↑ MS	↓ indirect taxes ↑ government spending	Higher inflation in short-term. Could increase national debt.
	→ Shift to right of AD		
↓ Rate of inflation	↑ rate of interest ↓ MS	↑ direct taxes ↓ government spending	Increased unemployment and lower output. Unpopular with voters.
	→ Shift to left of AD		
Current account deficit on balance of payments	↑ rate of interest (depreciate exchange rate)	↑ taxation	Effectiveness depends on price elasticity of demand for imports and exports.
	→ Shift to left of AD		

Key: ↓ - decrease, ↑ - increase, → - leading to

Figure 7.2 Monetary and fiscal policy options

economies, **supply-side policies** have been used to meet longer-term objectives such as sustained economic growth.

Fiscal policy is the way in which governments manage aggregate demand by making changes to taxation and their own expenditure. This is the traditional Keynesian approach and like monetary policy, has been widely practised in all types of economy. Like monetary policy, fiscal policy is used to ‘fine tune’ the economy from a short-term perspective.

Monetary policy refers to any measures that are used by the government to bring about changes in the supply of money or interest rates. (Some economists would also include policies that change the exchange rate.) Increasingly though, experience has shown that the control of interest rates rather than the money supply is the most effective way of regulating aggregate demand. This is now the main policy that is used by central banks and governments for the short-term management of the economy in most types of economy.

Monetary policy and fiscal policy do not operate in isolation – they work together in affecting aggregate demand at any one time, although one may well have rather more importance than the other. (This is a very valid reason for considering both topics in this section.)

The effects of monetary and fiscal policies on aggregate demand are shown in Figure 7.2. This figure also indicates the reasons why these policies are applied and some of the difficulties that might arise. As shown, using monetary and fiscal policies are by no means straightforward and the outcomes are by no means guaranteed as will be explained later.

Fiscal policy

Managing the economy is a complex task. The annual budget, which is the most important statement of fiscal policy, is eagerly awaited and attracts much media attention as the overall outcome is a very clear indicator of the state of the economy. In this statement, the Finance Minister outlines the government’s spending and taxation plans for the year ahead. The direction taken in the budget should give a clear indication of the government’s macroeconomic priorities.

In principle, there are three types of budget:

- **Budget deficit** In this situation, projected government spending exceeds projected revenue from the many forms of taxation. This is where the government sees the need to reflate the economy by increasing aggregate demand. Normally this is in response to a situation where

there is a need to expand the economy in order to create more jobs and income.

- **Budget surplus** In contrast, this describes a budget where government revenue from taxation exceeds the projected expenditure by the government on social protection, health care, education, transport and so on. Here the government has identified a need to deflate the economy by cutting back aggregate demand. This is normally in response to a situation where the rate of inflation in the economy is higher than the government feels to be appropriate. It could also be in response to a deteriorating deficit on the balance of trade.
- **Balanced budget** As its name suggests, this is a neutral situation where projected revenue and government spending are equal. Within the budget though there is likely to be some re-allocation of taxation and expenditure.

As seen in the different types of budget, a government can deliberately alter tax rates and levels of government spending to influence economic activity. This is referred to as discretionary fiscal policy and can be used to influence aggregate demand. If a government wants to raise aggregate demand it will increase its spending or cut tax rates. Keynesians favour raising government spending because they believe this will have a bigger multiplier effect (see Chapter 5). This is because the rise in government spending, especially if it is on welfare payments, is most likely to benefit the poor who have a high marginal propensity to consume (mpc). In contrast, a cut in tax rates may benefit mostly the rich who tend to have a low mpc.

A government can also allow automatic stabilisers to influence economic activity. These are forms of government spending and taxation which change, without any deliberate government action, to offset fluctuations in GDP. For example, during a recession government spending on unemployment benefits automatically rises because there are more unemployed people. Tax revenue from income tax and indirect taxes will in contrast fall automatically as incomes and expenditure decline. Figure 7.3 shows how tax revenue and government expenditure automatically change as GDP changes.

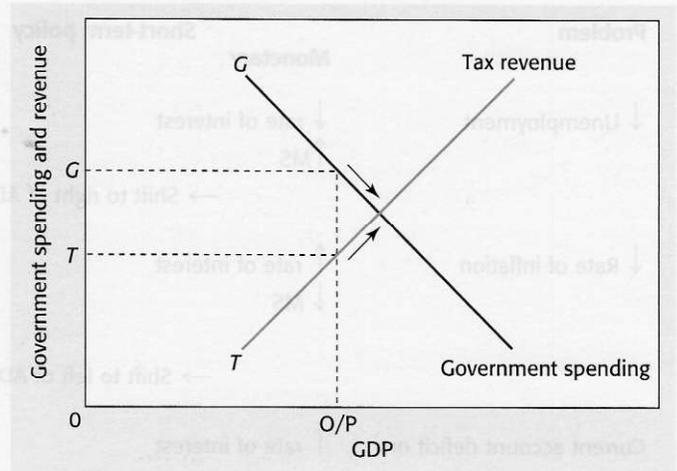


Figure 7.3 *The automatic stabilisation process*

Fiscal policy may also be employed to affect aggregate supply by changing incentives facing firms and individuals. In recent years, governments throughout the world have increasingly been using fiscal policy in this way to improve the competitiveness of their economies.

For fiscal policy to be effective it is important that the government can accurately estimate the impact that changes in government spending and taxation will have on the economy. To do this they have to have a good idea of the value of the multiplier and an awareness of the possible side-effects of policy measures. If a government underestimates the value of the multiplier, it may inject too much extra spending and thereby generate inflation and balance of payments problems. Fiscal policy instruments may also have undesirable side effects. For example, a government may raise more tax in order to reduce aggregate demand. However, this may also have disincentive effects and so reduce aggregate supply (see Chapter 5). This is true of progressive taxation such as with income tax where rates increase as the level of earnings increases. Indirect taxes such as sales taxes and excise duties are regressive since they have to be paid at the same rate irrespective of income.

Some instruments of fiscal policy also suffer from significant time lags. Whilst changes in indirect taxes are relatively easy to effect, alterations in direct taxes and government spending take longer to implement and to work their way through the economy.

It can be difficult to raise taxation and lower government spending because of the political unpopularity of such measures and because of, in the case of government spending, the long-term nature of some forms of government spending.

For example, once a decision has been announced that the pay of government employees will be increased it would be difficult to reverse it and will commit the government to higher spending for some time.

SELF-ASSESSMENT TASK 7.3

Read the feature below and answer the questions that follow.

Barbados PM delivers long-awaited budget

After postponing his budget statement on two occasions, Prime Minister Owen Arthur has delivered news that will bring some relief to low and middle income earners.

The Prime Minister has also proposed a major initiative to reduce energy costs in a plan that could save BD\$65 million to \$90 million.

The main features of the Economic and Financial Statement are:

- an increase in the National Insurance Scheme contributory pensions
- personal allowance for low income earners to increase from BD\$20 000 to BD\$22 500.
- marginal tax rate to fall from 37.5% to 35%.

With respect to energy saving measures:

- import duty on energy-saving systems to be waived; 5% tax on fluorescent light bulbs and fittings to be introduced

- taxi owners and operators of vehicles used for tourism must purchase diesel powered vehicles with an engine capacity of 1600cc or more in order to be exempt from import duty
- a flat rate excise tax of 20% to be levied on energy-efficient vehicles, including those using alternative energy sources
- financial incentives for farmers growing fuel cane and significantly
- an increase in the import tax on goods from outside the Caribbean region from 3% to 6%. Food and special health care products to be taxed at former rate.

Source: Caribbean Net News, 19 January 2006 (adapted)

1 Explain why these measures appear to be constituent parts of an overall deficit budget.

2 What objectives appear to underpin this budget?

Monetary policy

Monetary policies are usually implemented by the Central Bank of the country or area. In recent years, in a number of countries, changes in interest rates have been the main policy used to control inflation and, more recently, to influence economic activity.

An increase in the rate of interest, for example, will tend to reduce aggregate demand. This is because saving will be encouraged, borrowing discouraged and the spending power of households, who are borrowers, will be reduced. This downward pressure on spending is likely to reduce inflationary pressure

but it may have an adverse effect on the balance of payments. This is because a higher rate of interest will attract hot money flows into the country which will raise the value of the currency and cause export prices to rise and import prices to fall.

It has been found difficult to control the money supply. In the past, governments have sought to limit the growth of a range of money supply measures, without great success.

The use of interest rates is not without problems. As with some fiscal policy instruments, there is a time lag between changing interest rates and the change taking effect. Some economists have estimated that it can take as long as 18 months for interest rate changes to fully work their way through the economy.

Interest rates are a powerful instrument but they are also a blunt and uncertain one. When the rate of interest is changed all households and firms are likely to be affected. Some are more likely to cope with such a change. For example, a rise in the rate of interest may hit the poor more than the rich as they are more likely to be net borrowers. Firms and households may also not respond in the way the government expects. If the economy is entering a recession, lowering interest rates may not persuade households and firms to spend more if they are worried about their job prospects and future markets.

With increasing mobility of financial capital, it can be difficult for a country to operate an interest rate that is significantly different from its competitors. If, for example, the country reduces its interest rates to a level noticeably lower than that in its competitor countries, hot money may flow out of the country.

Exchange rate policy

Exchange rate policy covers government decisions on whether to influence the value of its currency, whether to operate a fixed, managed or floating exchange rate and whether to link its exchange rate to that of other countries (see Chapter 6 Core).

A government can influence the value of its currency by changing its interest rate and/or buying

and selling its own currency. Raising the value of the currency will increase its purchasing power and put downward pressure on inflation. However, it may also harm its balance of payments position and reduce economic activity. In contrast, reducing the value of the currency may increase employment and growth, help the balance of payments position but increase inflationary pressure.

Operating a floating exchange rate allows market forces to determine the value of its currency but may create some uncertainty. A fixed exchange rate removes uncertainty but to maintain it, a government may have to introduce policies which harm its other macroeconomic objectives. For example, if there is downward pressure on the exchange rate, the government may raise taxes to discourage spending and thereby reduce expenditure on imports. Such a measure may lower economic growth and increase unemployment.

In deciding on its exchange rate policy a government may face a number of restrictions. In the case of the eurozone, members have agreed to a common currency and a single exchange rate. In other cases they may have adopted another country's currency. This is true of some Latin American and African countries that have adopted the US dollar for all external transactions.

If a country is operating an independent exchange rate policy and decides to have a fixed exchange rate, it can be difficult to decide on the rate. It should be at the long run equilibrium level but this is hard to assess. If the government, for example, over-estimates the value it may run out of resources in seeking to maintain it or may have to raise interest rates to an unacceptable level. If it operates a floating exchange rate, speculation may result in significant fluctuations in its value. Changing an exchange rate to achieve a macroeconomic objective may not always work because its effects can be offset by other factors. For example, lowering the exchange rate to improve the balance of payments position will not work if demand for exports and imports is interest inelastic or if the quality of the country's products falls.



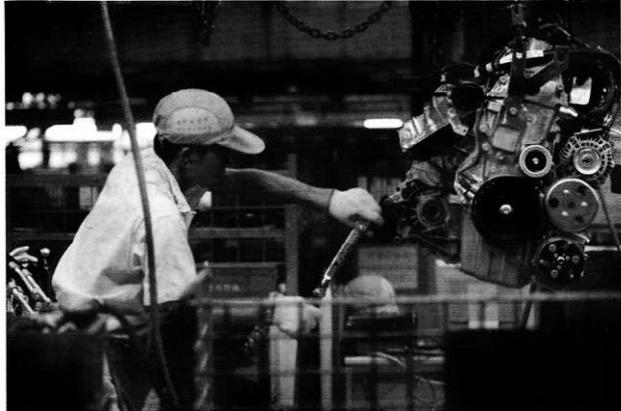
Read the feature below and then answer the questions that follow.

Land of the rising yen

For much of the 20th century Japan's growth has been driven by exports; consumption has remained stable at about 55% of GDP since 1980. It can be argued that there has been a fixation with a weak yen which keeps export prices cheap and import prices uncompetitive. Stacking up positive current account balances has been the norm.

This fixation, it is believed, has come at a high price – much needed capital, and with it, purchasing power goes abroad. So much so in fact that Japan is ready to scrap some of its long-held economic traditions.

The reason can be illustrated by looking at the case of automobiles. When these are manufactured in Japan and sold on the domestic market, this gives a boost to Japanese car dealers, insurance brokers and motor vehicle repairers. But when the vehicles are shipped abroad, they do not make the same meaningful contribution to the Japanese economy. This is because income earned by exporting is offset by the capital that Japanese manufacturers invest in the US. Replacing external demand with domestic demand would cause the yen to appreciate.



Honda car assembly production line in Guangzhan, China

Keeping the yen weak is costly to the Japanese economy. Japan has been hit hard by the global financial crisis. Some economists are of the view that this time, exports will not save Japan. The yen cannot be undervalued forever because it is costing the domestic economy dear.

Source: International Herald Tribune, 8–9 August 2009 (adapted)

- 1 Explain how exchange rate policy has been used to:
 - a increase demand for exports
 - b suppress demand for imports.
- 2 Discuss the arguments for and against the use of exchange rate policy in this situation.

Supply-side policies

These are policies designed to increase aggregate supply by improving the workings of product and factor markets in an economy. Typical supply-side policies are increasing incentives to work, education and training, trade union reform, privatisation and deregulation.

More people may be encouraged to enter the labour force by cutting income tax and welfare benefits. This will increase a person's incentive from work and reduce the return from not working.

Improving education and training will raise workers' productivity and increase their flexibility and mobility. Trade union reform may also increase workers' flexibility and mobility and cut down on the number of days lost through strikes.

Many countries in recent years have adopted privatisation programmes in the belief that firms operate more efficiently under private ownership (see Chapter 3 Supplement). Some have also deregulated a number of their industries by removing barriers to entry.

Supply-side policies have become very popular in recent years and there is evidence that reforms have increased the responsiveness of labour markets and reduced unemployment. However, the effectiveness of some labour market reforms and some of the other measures is more uncertain. For example, cutting income tax may encourage some people to work fewer hours if they are currently content with their earnings; lowering welfare benefits will not succeed in reducing unemployment if there are no jobs available. Privatisation may also not result in an increase in efficiency if the privatised industries act as a monopoly and do not take into account external costs and benefits.

Supply-side policies tend to be long-term and uncertain in their measurable outcome as they require structural changes to be made to increase aggregate supply in the economy. They therefore have little relevance from the point of view of short-term economic management.

Monetary policy, fiscal policy and unemployment

If an economy has high unemployment, or if there is a substantial risk of unemployment increasing, the obvious monetary policy response is to cut interest rates. The response to this action is that:

- firms may increase investment as the cost of borrowing has fallen
- consumers may save less and spend more as the return from holding money in commercial banks has been reduced
- consumers may also decide to borrow more money for financing large purchases such as a new house or car
- the exchange rate may depreciate leading to a rise in exports.

Reflationary fiscal policy can also be used to reduce unemployment. Various possibilities include:

- a reduction in indirect or direct taxation to increase people's purchasing power and disposable income
- a cut in the profits tax on firms in order to stimulate new investment
- an increase in government spending, in particular current spending.

Taken together these responses are designed to increase the level of aggregate demand. The extent of any of these changes will depend on the size of the multiplier and many other factors such the extent of the changes, the response from consumers and firms and the general level of confidence in the economy. Figure 7.4 shows the effect of the increase in aggregate demand which shifts from AD to AD_1 and real GDP increases from Y to Y_1 . Provided the economy is operating on the horizontal part of its long run AS curve, the price level will remain at P . The difficulty, as Figure 7.4 indicates, is that the increase in aggregate demand might fuel inflation – if this happens, the shift in AD_1 will cross the $LRAS$ curve at some point on its vertical section, indicating that the full employment level of real GDP has been reached at that time.

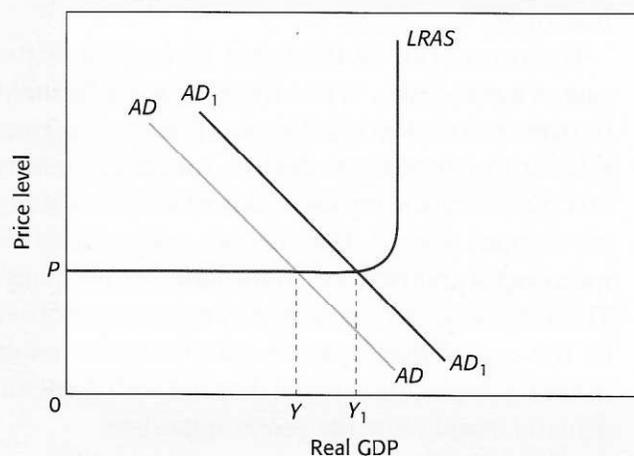


Figure 7.4 An increase in aggregate demand

Monetary policy, fiscal policy and inflation

In theory, monetary policy and fiscal policy can be used to control a problem of inflation through lowering aggregate demand. In practice, monetary policy is now more widely applied for this purpose, in particular through a rise in the rate of interest. This should reduce inflationary pressures as:

- borrowing will become more expensive. Firms may cut back on their investment plans and individuals may defer large-scale purchases as their real cost has increased.

Read the feature below and then answer the questions that follow.

Job losses in US hit 2.6 million for 2008

US employers shed 2.6 million jobs in 2008, the worst year since 1945. Further substantial losses are predicted for the rapidly deteriorating economy. The unemployment rate jumped to 7.2%, with more than 11 million Americans unemployed at the start of 2009. In 2008, manufacturing lost 800 000 jobs and construction shed 630 000 jobs. The remaining jobs were largely lost in the services sector.



Unemployed US workers protest

A leading economist, Nariman Behraves at IHS Global Insight commented that 'the US economy is in a free fall...unless something is done and done quickly to turn the economy around, we're looking at an awful situation later in 2009'.

This bad news put further pressure on President Obama and Congress to act quickly on a stimulus package that mixed tax cuts and public spending. Critics have argued that even with such a package, unemployment will rise.

The problem faced by the US economy is a lack of demand and poor business confidence. Measures are needed to strengthen consumer demand and to encourage banks to make more credit available in order to revive consumer spending.

Source: International Herald Tribune, 10–11 January, 2009 (adapted)

1 Explain what types of macroeconomic policy are being suggested to enhance the economic prospects of the US economy in 2009.

2 Discuss how the US government might assess the effectiveness of these policies in reducing unemployment.

- savings will be increased. At the same time, those people with bank loans will have to pay more for the money they have borrowed, reducing disposable income.
- firms begin to shed labour, putting pressure on wage demands to be reduced.
- 'hot money' will flow into the economy; the increased demand for a domestic currency will cause the exchange rate to rise which in turn will raise the price of exports. This loss of price competitiveness is likely to lead to a reduction in earnings from visible exports.

Deflationary fiscal policies may also be used to reduce aggregate demand. Such policies involve:

- raising direct taxation in order to cut back on the disposable income of consumers or increasing indirect taxes on products such as alcohol, tobacco, petrol and purchase taxes so as to reduce spending power
- cutting back on various forms of government spending – this is a direct means of reducing aggregate demand.

Figure 7.5 shows how reducing aggregate demand can achieve the objective of reducing inflation. As aggregate demand falls from AD to AD_1 , as a consequence of one or more of the means described above, the price level falls from P to P_1 . The level

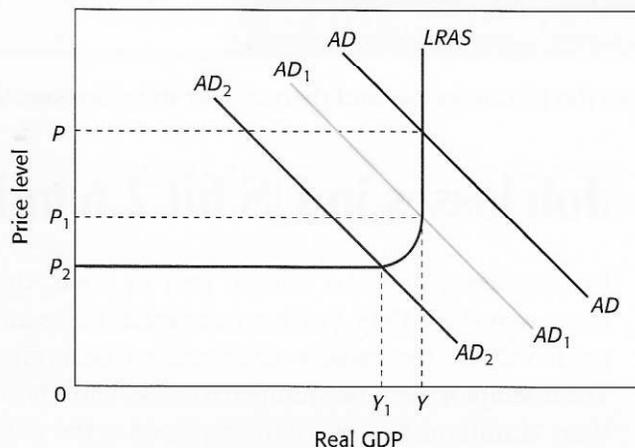


Figure 7.5 A reduction in aggregate demand

of real GDP remains unchanged at Y . The reality of reducing aggregate demand is that the final effect

SELF-ASSESSMENT TASK 7.6

Read the feature below and then answer the questions that follow.

Beijing moves to curb consumer price increases

Beijing has issued price control measures for certain consumer products. These measures include a freeze on prices it controls.

The measures strongly indicate that the Chinese government is giving top priority to combating inflation, which is currently running at an annual rate of 6.5%, an 11-year high brought about by soaring food prices.

The prices that will be frozen at least until the end of 2007 include transport, water, electricity, fuel and land. Some economists believed that these new price controls would ease pressure on the central bank to raise interest rates.

Other prices though will continue to rise due to the demand for goods exceeding supply. Shortages

of pork and cooking oil especially have led to price increases. Fresh food prices are also rising.



Supermarket in Beijing

1 Discuss the advantages and disadvantages of price controls as a means of combating inflationary pressures in an economy.

2 How else might the Chinese government control inflation?

of any measure is uncertain. So, it could be that aggregate demand is reduced too much resulting in real GDP falling below Y . This is shown when aggregate demand falls from AD to AD_2 , the cost being more unemployment. The skill in managing the economy in this situation is to control aggregate demand so that it is at the full employment level.

Monetary policy, fiscal policy and the balance of payments

Fiscal policy measures can be effective where an economy is experiencing a deficit on the current account of its balance of payments. (The most likely reason for the deficit is that imports of visible goods exceed the exports of such goods.) Two main ways are possible:

- Expenditure dampening measures that aim to reduce total expenditure by consumers and firms on imported goods (see Core section of this chapter). A rise in income tax, for example, will reduce disposable income, leaving less income for consumers to spend on imported as well as home-produced goods. A cut in government spending, particularly where this involves imported goods, could also be used.
- Measures that result in domestic consumers substituting home-produced goods for imported goods. An obvious way to achieve this is by imposing a tariff or increasing the tariff levied on imported goods. Such a measure works more effectively where quality home-produced substitutes are readily available. A second measure could be to provide subsidies for home producers – this would reduce the price of domestically produced goods relative to similar imported products.

Monetary policy is unlikely to be used in this context. It may even worsen a current account deficit since a rise in interest rates could lead to an increase in the value of a currency, making imported goods even cheaper.

Overall the potential for using fiscal policy to correct a balance of payments problem is short term. For most economies, supply-side weaknesses underpin adverse balance of payments situations. The

only long-term policy therefore is for a deliberate and concerted effort to use supply-side policies to improve competitiveness.

The potency of monetary policy and fiscal policy

There is little argument that monetary and fiscal policies are powerful tools that are available for the effective management of the economy. If proof were needed, it comes in the extent to which they have been used and remain in use in all types of economy, developed or developing, where there is some form of market function in operation. Over time, they have had different levels of importance and influence.

In the UK, for example, successive governments have taken the view that monetary policy is the best means of controlling aggregate demand, avoiding the 'boom–bust' cycle experienced when fiscal policy was the dominant means of economic management. In Caribbean economies, fiscal policies arguably have a greater role to play in managing the economy, mainly because of the nature of these economies due to their stage of economic development (see Self-assessment task 7.3, page 281).

For any country though, the short-term management of the economy invariably involves the use of both fiscal and monetary policies in order to regulate aggregate demand. The role of government is therefore one of deciding which policies will best allow it to meet its stated objectives, and to take such decisions within the much broader context of its underlying political ideology. Managing the economy therefore cannot be entirely set apart from political reality. It is though necessary to appreciate that as policy tools, their effectiveness is limited. Some limitations are summarised in Table 7.2.

A more general problem facing any government is that of a lack of up-to-date, accurate information on the present state of the economy and forecasts of future prospects. This is particularly acute in many developing economies where the quality of statistical information available to the government is not what it is in most developed economies. Although the quality has much improved in recent years through

Monetary policy

- A rise in interest rates is likely to cause new unemployment.
- A rise in interest rates will benefit savers at the expense of borrowers. The converse applies when interest rates fall.
- Changes in interest rates will only be effective if businesses and consumers match the government's confidence in future economic prospects.
- 'Hot money' flows are likely to be influenced by interest rates.

Fiscal policy

- It can take a long time to implement major changes to the tax structure in an economy.
- There are long time lags in making changes to most types of government spending.
- Increases in some forms of direct taxation can have a disincentive effect on working and on the investment plans of firms.
- Some fiscal measures have side effects. For example, an increase in sales taxes to reduce inflation will increase the cost of living.

Table 7.2 *Limitations of monetary policy and fiscal policy*

the efforts of the World Bank and regional trade blocs such as CARICOM, it remains an obstacle to more effective economic management. A further obstacle that affects all economies is that of uncertainty brought about by external shocks to the global economy. Events such as the Asian financial crisis of the mid-1990s, the aftermath of 9/11, conflicts in the Middle East and the collapse of US financial institutions have had profound effects on all economies. Events like these could not possibly have been forecast.

Conflicts between policy objectives

If we look back at Figure 7.2 (page 279), we can see that the final column indicates that economies are likely to experience problems when applying fiscal and monetary policies. This final section will explain some of these conflicts.

The most common conflict that has faced most developed economies is that between inflation and unemployment. (Their relationship was shown earlier in Figures 6.20 and 6.21 on page 264.)

The problem is that when governments use policies to increase aggregate demand, and hence the level of employment, this invariably leads in time to an increase in the rate of inflation. This

has been particularly true with attempts to push unemployment below the natural rate. In turn, there is likely to be an increase in the growth rate. The reverse of this relationship also holds true. How this conflict is addressed largely boils down to which of the three objectives has priority. For the last 20 years or so, the control of inflation has been the more pressing objective – governments have been prepared to tolerate a modest rise in the unemployment rate if this has meant an inflation rate of less than 4% or 5%. It has also meant that growth has had to be sacrificed in order to keep inflation under control.

The above conflicts can also affect the exchange rate. Again, for a developed economy, there may be a conflict when the central bank (or Monetary Policy Committee in the case of the UK) sets the interest rate. If there is inflationary pressure, then the accepted reaction is to raise the interest rate. Such a move will not only increase unemployment; there will also be a knock-on effect on the balance of payments position and the exchange rate. A rise in the interest rate is likely to lead to an appreciation in the exchange rate. This makes imported goods cheaper, more difficult to sell exports and so worsen the current account position. On the other hand, 'hot' FDI may well be attracted by the higher interest rates.

In this supplement section it has been shown that:

- Policies of trade and aid to assist developing economies are carried out by individual governments and various international organisations.
- Governments manage their macroeconomies using fiscal, monetary, exchange rate and supply-side policies.
- These policies aim to achieve particular objectives with respect to inflation, employment, the balance of payments, the exchange rate and economic growth.
- Conflicts inevitably arise since it is most unlikely that all objectives can be achieved simultaneously.

