

Cambridge AS & A Level · Economics 9708 · Notes

Government macroeconomic policy objectives

AS

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What you need to know

By the end of this topic you should be able to:

1. **Name the three macroeconomic objectives** a government sets itself: **price stability** (low, steady inflation), **low unemployment** and **economic growth** (a sustained rise in real GDP), and say why a government wants each one.
2. **Explain how government policy is used to work towards each objective**: which way fiscal policy, monetary policy (including the exchange rate) and supply-side policy should be set for a given problem, and how each one works through aggregate demand (AD) or aggregate supply (AS) to change the price level, real output and employment.

The syllabus says that **conflicts and trade-offs between objectives are not required**. You still need to know which way each policy pushes each objective, because multiple-choice questions ask which policy suits which problem, or which action works against a stated target.

Understand it

Macroeconomic and microeconomic policy

Microeconomic policy deals with one market, one industry or one group: a tax on cigarettes, a subsidy for bus travel, a rule on pollution from steel works, a buffer stock for coffee. **Macroeconomic** policy deals with the economy **as a whole**: the general price level, total employment, total output. It works through economy-wide institutions (the central bank, the government's budget, the tax system) and economy-wide behaviour (total spending, total saving).

A quick test: if the policy is about one product, one industry or one sector, it is micro; if it is about the whole economy's prices, jobs or output, it is macro. "Reduce unemployment in the service sector" is micro (one sector); "maintain general price stability" is macro.

The three objectives

1. Price stability. Inflation is a sustained rise in the general price level. Price stability means a **low and stable** rate of inflation, often a published target such as 2% a year, not zero. Steady, predictable inflation lets households and firms plan, keeps the country's exports competitive, and protects people on fixed incomes and savers. Zero is not the aim: a small positive rate leaves room before prices start falling (deflation), which brings its own problems.

2. Low unemployment. Unemployment is people who are willing and able to work, and actively looking, but have no job. The aim is **low**, not zero: some people are always between jobs. Low unemployment means more output (the economy uses more of its labour), higher incomes, more tax revenue, less spending on benefits and fewer social problems.

3. Economic growth. Growth is a rise in real GDP over time; the aim is **sustained** growth that does not run ahead of the economy's capacity. Governments want it because it:

- raises **living standards**: more real output per head means more goods and services for each person;
- gives **consumers more choice**: a bigger economy produces a wider range of goods and services;
- creates **jobs**, so it helps the unemployment objective;
- raises **business confidence**: firms that expect sales to keep rising invest more;
- raises **tax revenue** at the same tax rates, paying for schools, hospitals and roads.

Growth is **not** wanted for its side effects: faster growth can add to inflationary pressure, which is a cost of growth, never a reason for aiming at it.

Other aims. Governments also care about a fairer distribution of income, the balance of payments and the environment. At AS Level the syllabus lists the three objectives above; making incomes more equal is dealt with through taxes, benefits and other intervention covered in "Addressing income and wealth inequality", and is not one of the three.

Choosing objectives is a normative decision

Which objective matters most, and what counts as "low" or "stable", are **value judgements**. One government may put jobs first, another low inflation. So deciding between macroeconomic objectives is a **normative** decision, even though measuring how well they are met (the inflation rate, the unemployment rate, the growth rate) is positive economics.

Two other things to remember:

- **More output does not guarantee more jobs.** Output can rise because each worker produces more (higher productivity) or because firms use more machines, with no extra workers.
- **Growth does not guarantee a more even spread of income.** The gains often go mainly to some groups, so inequality can widen.

The policies a government can use

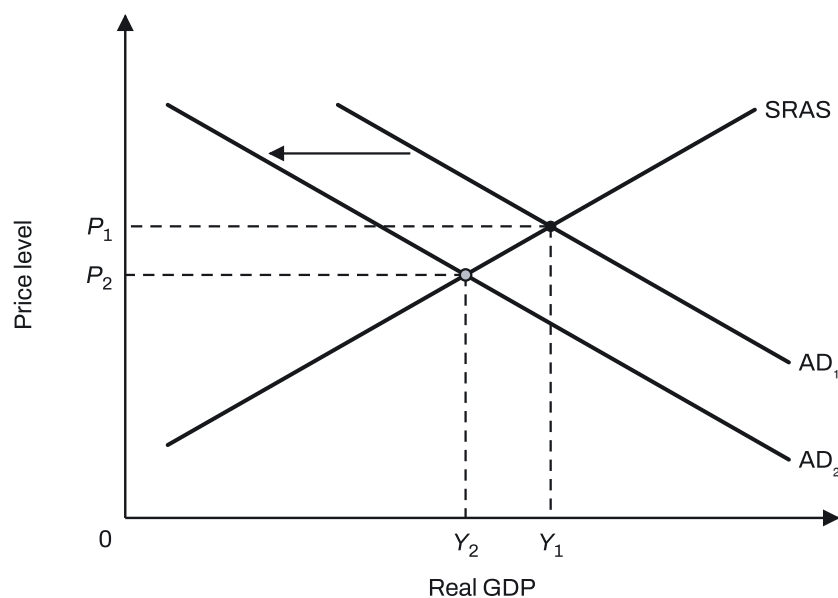
Each policy works on **aggregate demand** (total spending, $AD = C + I + G + (X - M)$) or on **aggregate supply** (the economy's ability to produce).

Policy	Tools	Works mainly on
Fiscal policy (the government)	government spending (G), tax rates, so the size of the budget deficit or surplus	AD
Monetary policy (usually the central bank)	interest rates, the money supply and credit, the exchange rate	AD
Supply-side policy	education and training, infrastructure, tax incentives to work and invest, removing restrictions, privatisation	AS (productive capacity)

Expansionary (or loose) demand-side policy raises AD: more government spending, lower taxes (a **bigger** budget deficit), lower interest rates, more money and credit, a **lower** (depreciating) exchange rate.

Contractionary (or tight) policy does the opposite: less government spending, higher taxes (a **smaller** deficit), higher interest rates, less credit, a **higher** (appreciating) exchange rate.

Demand-side policy to control inflation or cut unemployment

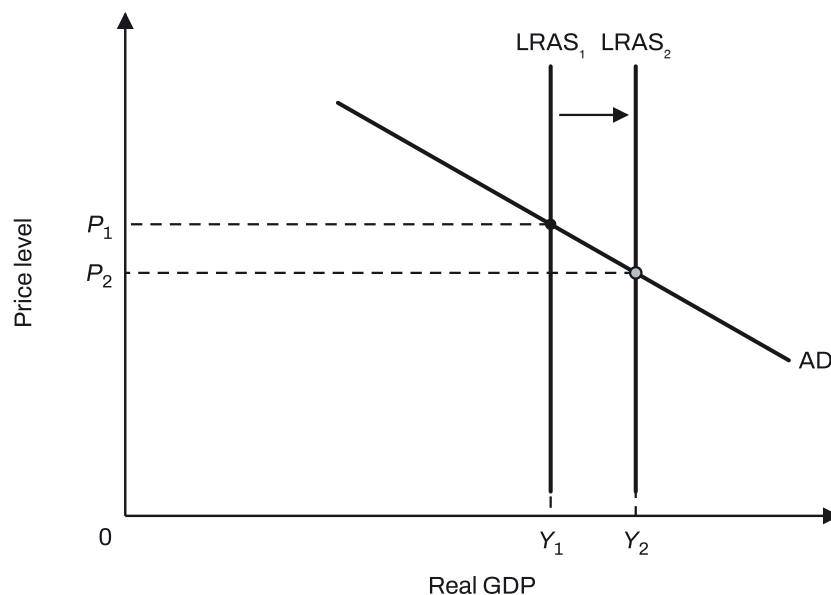


To reach price stability when inflation comes from too much spending (demand-pull inflation), the government uses contractionary policy. For example, the central bank raises interest rates: borrowing costs more and saving earns more, so households spend less on consumption and firms invest less. AD shifts left from AD_1 to AD_2 , and the price level falls from 120 to 100 (in practice, inflation slows). A cut in government spending or a rise in income tax works the same way, through G or through disposable income and C .

To reduce unemployment and raise growth when there is spare capacity, it does the opposite. Lower interest rates, tax cuts or more government spending shift AD right, from AD_2 to AD_1 . Firms sell more, so they produce more (real GDP rises from 400 to 500) and hire more workers, so unemployment falls.

The exchange rate. A **higher** exchange rate makes imports cheaper in the home currency and exports dearer abroad. Imported raw materials cost less, which eases **cost-push** inflation, and net exports fall, which eases **demand-pull** inflation. So an appreciation helps price stability. A **lower** exchange rate does the reverse: it raises AD (exports up, imports down), which helps jobs and growth, but it makes imports dearer and so works **against** low inflation.

Supply-side policy



Supply-side policies raise the **quantity or quality** of the factors of production: training makes workers more productive, better roads and ports cut firms' costs, lower taxes on profits encourage investment. Productive capacity rises, so the long-run aggregate supply curve shifts right, from $LRAS_1$ to $LRAS_2$. Real GDP rises from 500 to 600 and the price level falls from 120 to 100. Supply-side policy can therefore help **all three objectives at once**: sustained growth, fewer people unemployed because they lack skills, and less pressure on prices. The catch is time: training and infrastructure take years to pay off, and they cost the government money now.

Matching policy to the problem

Problem	Policy that helps
High demand-pull inflation	Raise interest rates; cut G or raise taxes (smaller budget deficit); let the exchange rate rise
Cost-push inflation from dearer imports	A higher exchange rate (cheaper imports); supply-side policy to cut costs

Problem	Policy that helps
High unemployment, slow growth, low investment	Cut interest rates; cut taxes or raise G (bigger deficit); a lower exchange rate; supply-side policy for the long run
Low long-run growth	Supply-side policy (training, infrastructure, incentives to invest)

Read the table both ways: a government that **raises** interest rates and **cuts** its deficit is fighting inflation, so it is most likely facing high inflation while unemployment is low (otherwise it would be making unemployment worse). A government that **cuts** taxes and **lowers** interest rates is fighting unemployment and weak investment.

Judging how well the objectives are met

The government checks each objective with a statistic: the **inflation rate** (the % change in a price index), the **unemployment rate** (the unemployed as a % of the labour force) and the **growth rate** (the % change in real GDP).

Data questions often give two GDP indices. **Money (nominal) GDP** changes with output **and** prices; **real GDP** changes with output only. So:

- the **growth rate** comes from real GDP alone;
- the **price level** is money GDP divided by real GDP (the GDP deflator): $\text{price index} = \frac{\text{money GDP index}}{\text{real GDP index}} \times 100$.

For example, if the money GDP index goes from 100 to 110 and the real GDP index from 100 to 105, real growth is 5% and the price index is $\frac{110}{105} \times 100 = 104.76$, so inflation was about 4.8%. Whenever money GDP grows faster than real GDP, prices are rising: inflation is **positive**.

Key facts and formulas

There is no formula list in the 9708 exam, so every formula here is "Learn it".

Formula	Status
The three objectives: price stability (low, stable inflation), low unemployment, economic growth	Learn it
$AD = C + I + G + (X - M)$	Learn it
Price index (GDP deflator) = $\frac{\text{money GDP}}{\text{real GDP}} \times 100$	Learn it
Inflation rate = $\frac{\text{price index this year} - \text{price index last year}}{\text{price index last year}} \times 100$	Learn it

Formula	Status
Growth rate = $\frac{\text{real GDP this year} - \text{real GDP last year}}{\text{real GDP last year}} \times 100$	Learn it
Unemployment rate = $\frac{\text{number unemployed}}{\text{labour force}} \times 100$	Learn it
Contractionary policy (higher interest rates, smaller deficit, higher exchange rate) shifts AD left: lower inflation, but less output and fewer jobs	Learn it
Expansionary policy (lower interest rates, bigger deficit, lower exchange rate) shifts AD right: more output and jobs, but higher prices	Learn it
Supply-side policy shifts LRAS right: more output, fewer unemployed and less inflationary pressure, but slowly	Learn it

How to do it

We tagged 12 questions for this topic (11 Paper 1 multiple choice and one Paper 2 essay, 2022–2025). Each has one type, so the counts add up to 12. For the Paper 2 question only part (b) is about this topic; part (a) belongs to monetary policy.

Question type	Questions
Multiple choice: which policy for which objective or problem	5
Multiple choice: what the objectives and macroeconomic policy are	5
Multiple choice: judge performance against the objectives from data	1
12-mark essay: assess how governments use intervention to meet their objectives	1

1. Multiple choice: which policy for which objective or problem (5 questions)

- Name the problem:** too much spending (demand-pull inflation), rising costs (cost-push inflation), too little spending (unemployment, slow growth, low investment), or several at once.
- Decide the direction** each problem needs: inflation needs contractionary policy; unemployment and weak investment need expansionary policy.
- Translate each tool** into that direction using the table in "Understand it": higher interest rates, a smaller budget deficit and a higher exchange rate are contractionary; the opposites are expansionary.
- Pick the option where every column points the same way.** One wrong column rules an option out.

Variations you will meet:

- "Which combination of policies helps achieve price stability?"** with columns for the budget deficit, the exchange rate and the interest rate: the answer is deficit **decreases**, exchange rate **appreciates**, interest rate **increases**. If inflation comes partly from dearer imported raw materials, the appreciation is doubly

right, because it makes those imports cheaper.

- **"When might this combination be used?"** (for example a smaller deficit plus higher interest rates): contractionary policy fits **high inflation with low unemployment**. With high unemployment it would make jobs scarcer still.
- **"Which objective is most likely to be achieved by raising income tax?"** Higher income tax cuts disposable income and consumption, so AD falls: **price stability**. It does not help growth or employment, and it is not about the exchange rate.
- **"Which problems would make a government cut taxes and lower interest rates?"** Both are expansionary, so the problems must both call for more spending: **high unemployment and low investment**. Any option containing demand-pull inflation is wrong, and so is a current account deficit, which more spending (on imports) would worsen.
- **"Which action conflicts with the target?"** Look for a tool pointing the wrong way. A **lower exchange rate** raises import prices and export demand, so it works **against lower inflation**. Lower interest rates do help consumer spending; smaller trade quotas do cut imports; a lower indirect tax does help the poor, who spend more of their income.

2. Multiple choice: what the objectives and macroeconomic policy are (5 questions)

1. **Recall the three objectives:** price stability, low unemployment, economic growth. An option outside these (such as **income equality**) is "not a macroeconomic objective".
2. **Macro or micro?** A policy is macroeconomic when it is about the whole economy and works through economy-wide institutions and behaviour. Anything about one market, one industry, one sector, a merit good, pollution from one industry, monopoly control or buffer stocks is microeconomic.
3. **Why the objective is wanted:** test each option as a benefit. Growth is wanted for living standards, business confidence, consumer choice, jobs and tax revenue; "to increase inflationary pressures" is never a reason.
4. **Statements about objectives:** true ones are about choices being **normative**. Common false ones: growth "ensures" a more even distribution of income; more output "ensures" more jobs; stable inflation "means zero" inflation.

3. Multiple choice: judge performance against the objectives from data (1 question)

1. **Growth** comes from the **real** GDP figures: work out each year's % change (or just see whether it is getting bigger or smaller).
2. **Inflation** comes from comparing money and real GDP. If money GDP grows faster than real GDP, prices are rising, so inflation is **positive**. For the size, divide: $\text{price index} = \frac{\text{money}}{\text{real}} \times 100$, then find each year's % change.
3. Describe each as the options do: **positive, negative, rising, declining**, or **cannot tell**. With both indices given you can always tell both.

For example, real GDP 100, 105, 106 and money GDP 100, 107, 115: growth is 5% then about 1%, so it is positive but **declining**; the price index is 100, 101.9, 108.5, so inflation is **positive** throughout.

4. 12-mark essay: assess how governments use intervention to meet their objectives (1 question)

The (b) part of a Paper 2 essay, marked by levels: 8 marks for knowledge and analysis, 4 for evaluation.

1. **Define the objectives:** price stability, low unemployment, economic growth, each in a sentence with what "low" or "stable" means.
2. **Explain the tools:** fiscal policy and the government budget, monetary policy, supply-side policy, and say whether each works on AD or AS.
3. **Link each tool to an objective with a developed chain:** for example, higher interest rates → dearer borrowing → less consumption and investment → AD shifts left → inflation falls (diagram 1). Do at least one chain for each objective, and one for supply-side policy (diagram 2). Name the diagram's axes **price level** and **real GDP**.
4. **Evaluate:** how far each intervention works. Monetary policy depends on how sensitive spending is to interest rates and on confidence; fiscal policy takes time to agree and to have its effect, and has to be paid for; supply-side policy is slow and costly; demand-side policy suits demand-pull inflation better than cost-push inflation. Then reach a conclusion that answers "how" and "how far".

A one-sided answer, describing the policies without saying when they fail, is capped at Level 2 and gets no evaluation marks. Three developed chains with a diagram, plus evaluation of each, reaches the top levels.

Worked examples

Example 1

An economy has an unemployment rate of 9%, an inflation rate of 1% and very little new investment by firms.

Which combination of policies is most likely to help its government achieve its macroeconomic objectives?

	government spending	rate of interest	exchange rate
A	decreases	decreases	depreciates
B	increases	decreases	depreciates
C	increases	increases	appreciates
D	decreases	increases	appreciates

[1]

The problems (high unemployment, weak investment) all call for more spending, and with inflation at only 1% there is little risk in that. Expansionary policy is more government spending, a lower interest rate (cheaper borrowing for investment) and a depreciation (more exports, fewer imports). The answer is **B**. (1)

A has one column pointing the wrong way (less government spending); C and D raise interest rates and the exchange rate, which would cut AD further.

Example 2

The table shows indices of real GDP and money GDP for a country over three years.

	year 1	year 2	year 3
real GDP	100	104	103
money GDP	100	106	110

Which row describes the country's record on its objectives of price stability and economic growth between year 2 and year 3?

	rate of inflation	rate of economic growth
A	falling	positive
B	rising	negative
C	negative	negative
D	cannot tell	positive

[1]

Growth: real GDP falls from 104 to 103, a change of $\frac{103-104}{104} \times 100 = -0.96\%$, so growth is **negative**.

Inflation: the price index is $\frac{106}{104} \times 100 = 101.92$ in year 2 and $\frac{110}{103} \times 100 = 106.80$ in year 3. Inflation was 1.92% in year 2 and $\frac{106.80-101.92}{101.92} \times 100 = 4.78\%$ in year 3, so it is **rising**. The answer is **B**. (1)

Example 3

Explain how a government could use macroeconomic policy to achieve price stability when inflation is caused by excess demand, and consider whether it is likely to succeed. [8]

Diagram: the first diagram in "Understand it", AD shifting left from AD_1 to AD_2 along SRAS.

Price stability means a low and stable rate of inflation, such as a target of 2% a year (**1, AO1**). Demand-pull inflation happens when aggregate demand, $C + I + G + (X - M)$, grows faster than the economy can produce (**1, AO1**). The government can use contractionary policy: the central bank raises interest rates, and the government cuts its spending or raises taxes to reduce its budget deficit (**1, AO1**).

Higher interest rates make loans and mortgages dearer and saving more rewarding, so households spend less and firms delay investment; C and I fall (**1, AO2**). A rise in income tax cuts disposable income, so consumption falls further, and lower government spending reduces G directly (**1, AO2**). AD shifts left from AD_1 to AD_2 , so firms cannot raise prices as easily and the price level is 100 instead of 120: inflation slows (**1, AO2**).

Success is not certain: if households and firms are confident, or have borrowed at fixed rates, higher interest rates change their spending little, and policy takes many months to work (**1, AO3**). It is likely to succeed when inflation really is demand-pull and the rise in rates is large enough, but it costs output and jobs (real GDP falls from 500 to 400), and it would do little if prices were being pushed up by costs instead (**1, AO3**).

(Knowledge 3, analysis 3, evaluation 2: **8/8.**)

Example 4

Assess whether supply-side policies are more effective than demand-side policies in helping a government achieve its macroeconomic objectives. **[12]**

Model answer (outline of each paragraph):

1. **The objectives and the policies.** A government aims for price stability (low, steady inflation), low unemployment and sustained economic growth. Demand-side policies (fiscal and monetary) change aggregate demand; supply-side policies change the economy's productive capacity. (*Accurate knowledge.*)
2. **Demand-side policy at work.** In a recession with high unemployment, lower interest rates and tax cuts raise consumption and investment, AD shifts right, firms produce more and hire workers, so unemployment falls and real GDP grows. When inflation is demand-pull, the same tools in reverse cut AD and slow inflation (diagram 1). (*Developed chains for each objective.*)
3. **Supply-side policy at work.** Training raises workers' productivity and helps the structurally unemployed find jobs; better infrastructure cuts firms' costs. LRAS shifts right, so real GDP rises while the price level falls (diagram 2): growth, jobs and price stability together. (*Developed chain, with the diagram labelled price level and real GDP.*)
4. **The limits of each.** Demand-side policy works quickly but moves output and prices in the same direction: expanding AD near full capacity mostly raises prices, and it cannot cure cost-push inflation or a shortage of skills. Its effect depends on confidence and on how sensitive spending is to interest rates. Supply-side policy is slow (a training scheme or a new port takes years), costly to the government now, and does nothing about a sudden fall in spending. (*Both sides explained: Level 3, 7–8 of the 8.*)
5. **Evaluation.** Which is more effective depends on **the problem**: a sudden recession or demand-pull inflation needs demand-side policy, because supply-side policy is too slow; low long-run growth and structural unemployment need supply-side policy, because extra spending would only raise prices. It also depends on **the time scale** and on how much **spare capacity** the economy has. (*Evaluation weighing the conditions.*)
6. **Conclusion.** Supply-side policies are more effective for sustained growth with stable prices, because only they raise capacity, but demand-side policies are needed to deal with short-term swings in spending; a government gets closest to all three objectives by using both. (*Justified conclusion: full evaluation marks.*)

Common mistakes

- **Describing instead of analysing.** In the essay on how governments use intervention, most answers listed policies and objectives without explaining how each tool changes AD or AS and so the objective; examiners rewarded only Level 1. Every point needs a chain: tool → spending or capacity → output, jobs or prices.
- **No evaluation.** Few candidates explained when a policy might **not** work (spending insensitive to interest rates, time lags, cost-push inflation). Without that, the evaluation marks are lost.

- **Thinking more output means more jobs.** In one Paper 1 question the most popular wrong answer said rising output "ensures" more workers are employed. Output can rise through higher productivity or more machines instead.
- **Treating price stability as zero inflation.** Stable inflation means a steady, low rate, not 0%.
- **Forgetting that choosing objectives is normative.** Which objective to put first is a value judgement; only about a third of candidates saw this.
- **Missing that inflation is positive in GDP data.** Over half of candidates said they could not tell the inflation rate from a table of money and real GDP, even though money GDP grew faster than real GDP every year. Divide money by real to get the price level.
- **Mixing up the direction of the exchange rate.** An appreciation (higher exchange rate) fights inflation; a depreciation helps jobs and growth but raises import prices.
- **Mixing up micro and macro.** Policies about one market or sector (pollution in one industry, merit goods, unemployment in one sector) are microeconomic, however important.

How to get the marks

- **Multiple choice:** write "inflation → tighten; unemployment → loosen" in the margin, translate each column into tighter or looser, and reject any option with a column pointing the wrong way.
- **Define first:** name the three objectives precisely ("low and stable inflation", "sustained increase in real GDP"). Definitions earn the knowledge (AO1) marks.
- **"Explain how":** for each tool give the full chain to the objective, naming the component of AD it changes ($C, I, G, X - M$) or the factor of production it improves. Analysis (AO2) marks are for the links, not the list.
- **Diagrams:** label the axes **price level** and **real GDP**, the curves **AD**, **SRAS** or **LRAS**, and show the old and new equilibria. A correct, labelled diagram strengthens the analysis; one with "price" and "quantity" axes is wrong.
- **"Assess", "consider", "to what extent":** both sides (how the policy works, and when it doesn't), then a judgement that says what it **depends on** (the cause of the problem, the time scale, spare capacity, confidence) and a final sentence that answers the question. A one-sided 12-mark answer is capped at Level 2 with no evaluation marks.
- **8-mark (a) parts** are point-marked: up to 3 knowledge, 3 analysis, 2 evaluation (one kept for a justified conclusion). **12-mark (b) parts** are level-marked: 8 for knowledge and analysis, 4 for evaluation.

Quick check

1. Which of these is a macroeconomic policy objective, and which is not: (a) price stability; (b) lower prices for bread; (c) sustained economic growth; (d) a more equal distribution of income?
2. A country's money GDP index rose from 100 to 108 and its real GDP index from 100 to 103. What was its rate of economic growth, and its rate of inflation (1 d.p.)?
3. A central bank cuts interest rates. Which objectives is this meant to help, and which objective could it put at risk?

4. A country's labour force is 40 million. The number unemployed falls from 2.4 million to 1.8 million. Find the unemployment rate before and after.
5. Explain why a government aiming for price stability does not aim for an inflation rate of zero. **[2]**

Answers

1. (a) and (c) are macroeconomic objectives. (b) is about one product, so it is microeconomic. (d) is something governments pursue through taxes and benefits, but it is not one of the three macroeconomic objectives in the syllabus.
2. Growth: real GDP rose from 100 to 103, so **3%**. Inflation: the price index is $\frac{108}{103} \times 100 = 104.85$, so inflation was **4.9%** (close to the shortcut $8 - 3 = 5\%$).
3. It is meant to help **low unemployment** and **economic growth**: cheaper borrowing raises consumption and investment, so AD, output and jobs rise. It could put **price stability** at risk, because higher AD can pull up prices.
4. Before: $\frac{2.4}{40} \times 100 = 6\%$. After: $\frac{1.8}{40} \times 100 = 4.5\%$.
5. Price stability means a low and **stable** rate that people can predict and plan around, such as 2% a year (1). Aiming at zero risks prices falling (deflation), which can make households delay spending and so raise unemployment (1).

Past questions to try

- 9708/11/O/N/25 Q22: which aim is not a macroeconomic objective.
- 9708/13/M/J/24 Q21: the objective a rise in income tax helps.
- 9708/12/M/J/24 Q23: the problems that call for tax cuts and lower interest rates.
- 9708/13/O/N/22 Q30: the government action that works against its target.