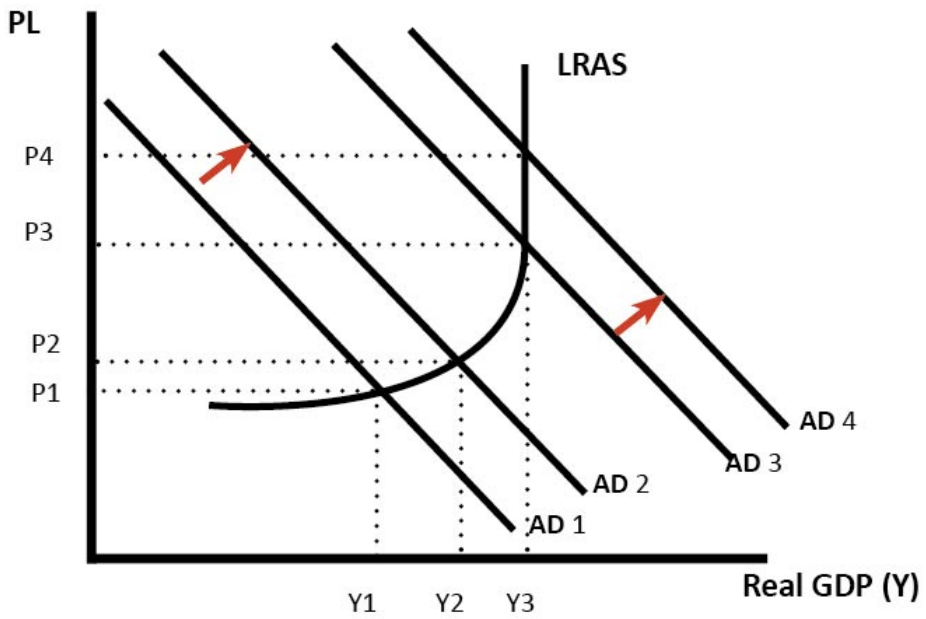
Discuss the view that achieving full employment will inevitably cause trade-offs with other macroeconomic objectives. (25)

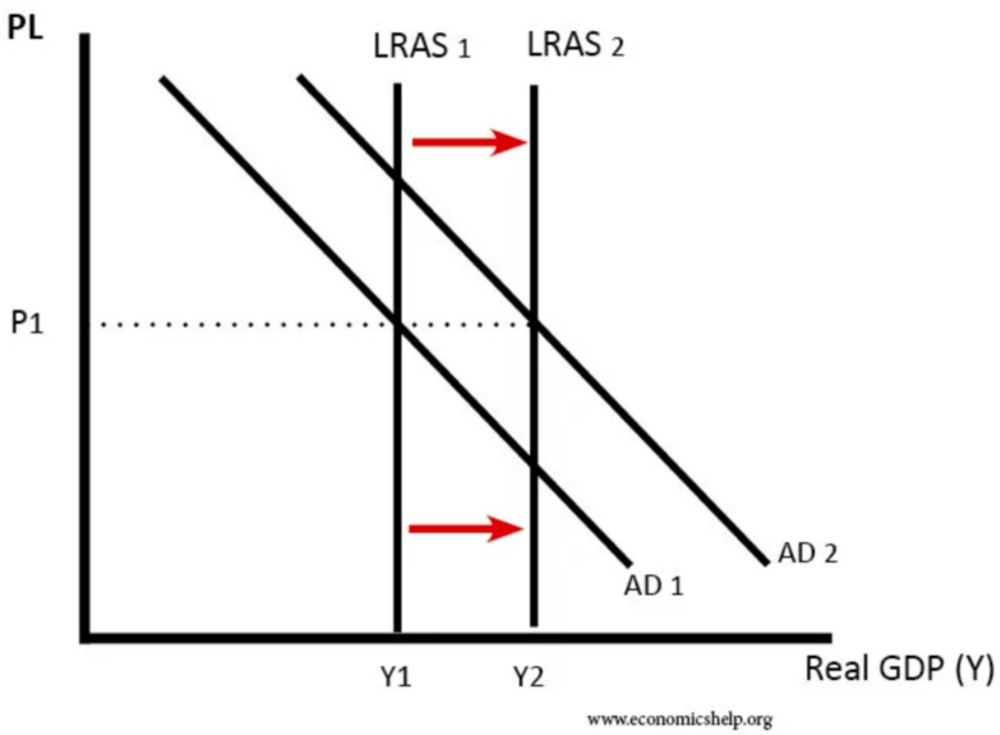
Full employment is a situation where everyone who wants employment is able to work; in practice there will only be a small amount of frictional unemployment of say 3%. Full employment also means that the economy is operating close to the production possibility frontier – there is no spare capacity in the economy, e.g. firms working close to full capacity.

If full employment is achieved by increasing aggregate demand, then it is likely that the economy will experience inflation. As the economy reaches full employment, firms face a shortage of workers and so have to increase wages to attract workers to take jobs; this wage inflation leads to higher costs and higher spending – two factors that lead to inflation.



Initially, the increase in AD doesn't cause much rise in prices. But, at Y3 (where the economy is near full employment, a rise in AD, causing a rapid rise in prices from P3 to P4. Therefore, achieving full employment through increasing AD can conflict with inflation.

However, this model of economic growth implies that AD is increasing faster than LRAS. However, in theory, it is possible to have both an increase in aggregate demand and long-run aggregate supply. If productive capacity meets the growth in aggregate demand, then the economy can achieve full employment without inflation. This simple AD and AS diagram shows economic growth without inflation.



A key factor is the rate of economic growth compared to the sustainable rate of growth. If there is a burst in economic growth, then there may be a rapid fall in unemployment. However, if demand is growing at 5% a year, but LRAS is increasing at 2.5%, then this will cause inflationary pressures. But, if economic growth is close to the sustainable rate, then the economy can get close to full employment without inflationary pressures.

However, If there is cost-push inflationary pressures (e.g. rising price of oil) or low productivity growth, then it is harder to achieve full employment without inflation. However, if productivity growth is high and cost-push inflation low, then it will be more likely to occur.

As the economy reaches full employment, there is also likely to be a trade-off with the current account on the balance of payments. With economic growth there is likely to be a rise in consumer spending and, there is likely to be a rise in import spending. With domestic inflation, consumers will prefer to buy cheaper goods from abroad, leading to a rise in imports and deterioration in the current account on the balance of payments.

However, it depends on the nature of economic growth. If the economy reaches full employment through the expansion of the export sector and investment-led growth, then it is possible to achieve full employment without a deterioration in the current account. For example, export-led economies such as Germany and China have frequently achieved high rates of economic growth with a current account surplus. The UK is more prone to a current account deficit because in the UK there is a high marginal propensity to import. When incomes rise, there is a bigger percentage rise in demand for foreign goods.

If the economy grows, and gets close to the full employment level – reducing the negative output gap, then we would expect unemployment to fall. Higher output leads to more demand for workers. Therefore, unemployment should fall and we should get an unemployment rate of close to 3%. However, if there is structural unemployment, then no matter what the rate of economic growth – there will be unemployment persisting. For example, if unskilled workers are made redundant, they may be unable to take jobs, because they lack the relevant qualifications. In this case, to achieve full employment will need supply-side policies to solve the structural unemployment and enable a fall in the natural rate of unemployment.

In conclusion, it is possible to achieve full employment without trade-offs of other macro-economic objectives, however, it requires a certain type of economic growth. The growth needs to be sustainable and not inflationary – in particular, the economy needs improvement in productivity, flexible labour markets and an ability to increase output without causing shortages. If we get this productivity led growth, then unemployment can fall, government borrowing can fall and the economy will reduce the negative output gap without inflation and a current account deficit. But, if there are structural inflationary pressures, then achieving full employment can cause trade-offs – such as inflation.