

- 4 (a) Explain the possible causes of rising inflation in some countries. [10]
- (b) Discuss whether low inflation should always be the main macroeconomic objective of the Singapore government. [15]

### Suggested Answers for Question 4(a)

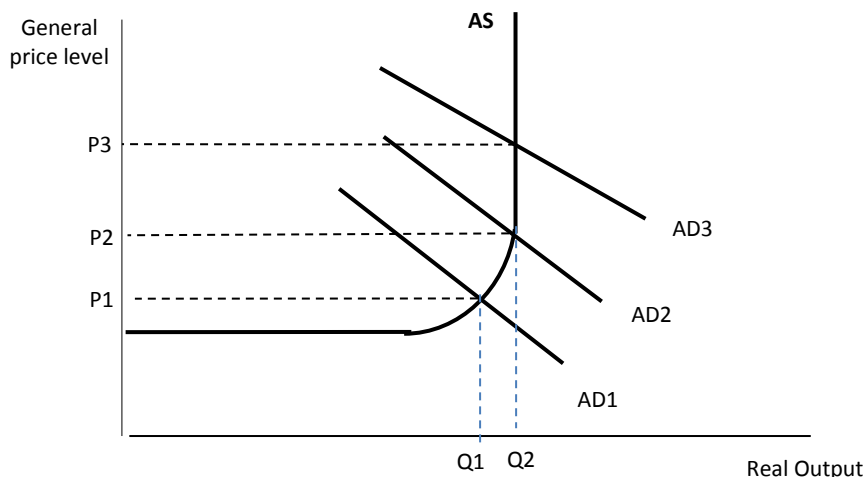
#### **4 (a) Explain the possible causes of rising inflation in some countries. [10]**

**Introduction:** Define inflation as sustained increase in the general price level of goods and services in the country. Rising inflation means fast rate of increase in the country's general price level. Rising inflation leads to rising cost of living and falling purchasing power.

**Development:** Explain the different types of inflation, i.e. demand-pull inflation, cost-push inflation and imported inflation and the causes of each type of inflation.

##### **(1) Demand-pull inflation**

Demand-pull inflation is likely when AD is expanding at a time when there is already full employment of resources, i.e. when an economy is becoming stretched and is said to be danger of over-heating. This is when the country's short run aggregate supply is inelastic  $\rightarrow$  AD increases beyond the economy's usual capacity to supply  $\rightarrow$  resulting in higher prices (draw diagram to illustrate this)



##### Causes of demand-pull inflation

###### Rising exports

- In an export-oriented economy like Singapore, demand pull inflation is very likely to be due to strong external demand.
- This could be due to rising global growth or high global expectations and consumer confidence in the global market. High global growth  $\rightarrow$  higher income and hence stronger purchasing power. Also boost business confidence  $\rightarrow$  boost export revenue and foreign investments into the country  $\rightarrow$  drive up AD and hence GPL
- The high export could also be due to depreciation of the country's currency causing a fall in its export prices in foreign currencies. Cheaper currency also means lower business cost in the country to the foreigners  $\rightarrow$  attracts FDIs  $\rightarrow$  increases AD and hence inflation.

###### Rising domestic demand

- Inflation in countries with large domestic market e.g. USA and China, is more likely due to increase in its domestic demand. With household consumption taking up a larger share of their countries' GDP than Singapore, household consumption has a greater effect on the country's AD and thus (as compared to Singapore).
- Positive growth  $\rightarrow$   $\uparrow$  business and consumer confidence in the economy  $\rightarrow$   $\uparrow$  C and I and hence AD  $\rightarrow$   $\uparrow$  general price level.

Other likely reasons for rising inflation in large economies:

- Rising money supply, lower interest rate and easy access to cheap loans
- Government low income taxes

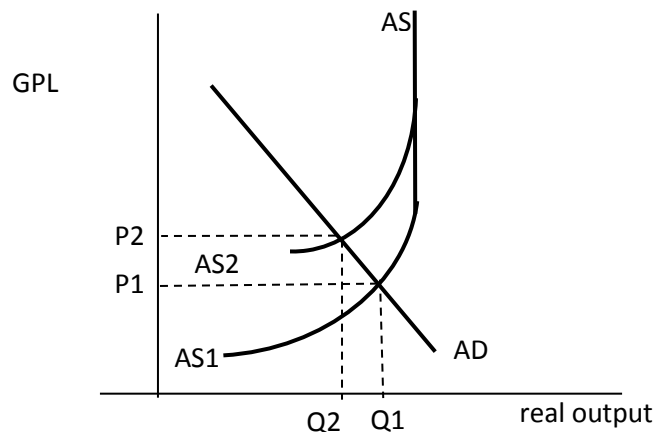
Government budget deficit (implies expansionary fiscal policy)

i.e. the government's increasing its spending and imposing tax cuts and subsidies, perhaps to stimulate the economy during economic slowdown or to achieve higher economic growth

- In some countries, inflation is caused by excessive government spending, especially when such spending is financed by increasing money supply. This is often true in cases of countries facing hyper-inflation. Increased government spending will add to the country's aggregate demand and further strains the country's already stretched resources.
- Government expansionary policies to increase growth will lead inflation in the face of structural rigidities in the country. When direct taxes are reduced consumers have more disposable income causing demand to rise. Lower corporate taxes will attract more investments.

## **(2) Cost-push inflation**

Cost-push inflation can be illustrated by an inward shift of the short run aggregate supply curve. A fall in aggregate supply causes a contraction of real national output together with a rise in the general level of prices. (Diagram to illustrate this)



### Causes of cost-push inflation

#### Government subsidies and taxes

In countries which enjoy high government subsidies on necessities, cost-push inflation can be caused by government reducing subsidies. E.g. Indonesia and Malaysia's inflation rose due to government decision to reduce subsidies on oil.

- An increase in fuel duties or a rise in the standard rate of Value Added Tax or an extension to the range of products to which VAT is applied, will lead to higher costs in the country. Depending on the price elasticity of demand and supply for their products, producers can opt to pass on the burden of the tax to consumers. For example, if the government were to choose to levy a new tax on aviation fuel, this would contribute to cost-push inflation. The 2% point increase in GST is said to be one of the factors that led to the high inflation in Singapore in 2007.
- In some countries, government subsidies of ethanol production led to inflation in due to rising food prices in 2008 as agri-businesses grew corn for energy production, taking it out of the food supply.

#### Rising labour costs

- In countries with strong trade unions, wages might increase when people expect higher inflation. Trade unions may use their bargaining power to bid for and achieve increasing wages in order to protect their members' real incomes → wage increases are greater than improvements in productivity → this could be a cause of cost-push inflation
- Singapore's rising labour costs are mainly due to government policies – higher levy on foreign workers and higher employers' contribution to workers' CPF accounts

#### Exhaustion of natural resources

As resources run out, their price will inevitably gradually rise. This will increase firms' costs and may push up prices until they find an alternative source of raw materials. In many countries, the problems of soil erosion when forests have been cleared makes the land quickly becomes useless for agriculture.

### (3) Imported inflation

For countries with an open economy like Singapore, inflation is most likely due to external reasons, for example a sudden rise in the cost of crude oil or other imported commodities, foodstuffs and beverages.

- The high inflation in Singapore in 2008 was mainly due to rising oil and food prices, which are mainly imported. The oil and food prices caused global inflation → imported inflation in Singapore as most of the imported goods prices rises due to the rising inflation in the countries they were produced.
- Depreciation of currency → rising import prices in domestic currency → in an open economy heavily dependent on imports, leads to an increase in the prices of imported products such as essential raw materials, components and finished products → rising inflation

### Conclusion

The causes of inflation in a country may come from both the demand and the supply-side of an economy and may even arise from internal and external events. The main causes of inflation in different countries may differ from one another depending on factors such as the openness of the economy, the size of its domestic market, the level of dependence on external market and domestic market and even the objectives of the government.

Level	Descriptors for Q4(a)	Marks
L3	<u>High L3</u> <i>An insightful answer that is aware that causes of inflation in different countries may differ from one another depending on several factors, mainly nature of the economy</i>	9-10
	<u>Low L3</u> <i>Clear explanation of causes of inflation,, addressing both demand-pull and cost-push inflation.</i>	7-8
L2	<i>Explanation of causes of inflation using economic framework but not developed and lack clarity and accuracy</i> <i>Developed answer that considers only the causes of demand-pull inflation <u>or</u> cost-push inflation in different countries</i>	5-6
L1	<u>High L1</u> <i>Attempt to use economic framework, shows some awareness of causes of inflation. Some conceptual errors.</i>	3-4
	<u>Low L1</u> <i>Smattering of points or irrelevant answers. No economic framework.</i>	1-2

### Suggested Answers for Question 4(b)

#### 4 (b) Discuss whether low inflation should always be the main macroeconomic objective of the Singapore government. [10]

##### Introduction:

One of the objectives of the government in making its policy decisions is to achieve a low inflation rate of 1-3%. There are many benefits of low inflation. Low inflation helps to boost growth and the creation of job. Low inflation relative to other countries improves the country's competitiveness in the global market, not only in the export market but also in attracting foreign investments.

**Thesis:** The government aims to achieve low inflation because of the benefits it brings to the economy.

##### Increased economic growth and employment

- Low inflation implies price stability → stronger business confidence as the risk of doing business is reduced, fostering a business-friendly environment for the country.
- Low inflation rate of 1-3% (i.e. small increases in GPL) is a signal of growing demand with not much strain on the country's resources → incentive for firms to continue or increase production → greater possibility of higher investments.

- Higher levels of investment → increase in AD and hence national income → actual growth. High investment also allows for the creation of jobs, thus working towards the achievement of low unemployment. In the long run, higher investments could lead to higher productive capacity (AS) → non-inflationary sustained economic growth.

#### Improvement in BOP

- Relatively lower inflation rate than other countries → improvement in Singapore's export competitiveness → higher export revenue → improvement in trade balance
- Low inflation rates also help to keep Singapore attractive as an investment destination to foreigners, promoting FDI inflows and hence improving the capital and financial accounts
- Price stability in which there is lower inflation leads to lower costs & reduces uncertainty in the country as future projections of costs and revenues are more accurate with price stability. This can help to improve a country's attractiveness as an FDI location. So more investors will move their funds into Singapore from other countries.
- As a small and open economy, these are especially important to Singapore due to its high reliance on FDI as well as external demand (which accounts for 2/3 of total demand) as the main drivers of our economic growth.

Therefore, the government's objective in achieving low inflation rate helps it to attain the goals of healthy BOP, sustainable economic growth and low unemployment. There is thus a need for the government to make low inflation its main macroeconomic objective, especially during periods of high inflation e.g. in 2008 and 2011. Measures such as freezing spending on government projects and allowing for gradual appreciation of the Singapore currency were taken to achieve price stability. Putting priority on low inflation is also justifiable when the economy shows signs of overheating i.e. when AD and national output are rising amidst structural rigidities in the country.

#### **Anti-thesis: Low inflation should not always be the main macroeconomic objective of the Singapore government.**

- Government's objective to maintain low inflation rate may be at the expense of its other macroeconomic objectives. The inverse relationship between unemployment and inflation implies that demand-pull inflation may occur if production were to increase to meet rising AD.
  - AS the economy reaches full employment, further production to meet the rising AD will cause greater strain on the country's available resources → rising demand-pull inflation.
  - Therefore, to maintain or achieve low inflation whenever there is rising AD, need to reduce government spending and/or raise taxes → contracts AD → lowers production → lowers employment and output, increasing unemployment and slows down economic growth.
  - Employing appreciation of Singapore currency to control inflation → prices of exports increase in foreign currency → this erodes Singapore's export competitiveness → net exports fall.
  - Erosion of export competitiveness would also spell a worsening BOP position for Singapore. Currency appreciation makes investment into Singapore more expensive in foreign currency → may adversely affect FDIs and hence the creation of new jobs.
  - Appreciation of currency also makes Singapore's services sectors e.g. tourist, medical services more expensive in foreign currencies → slows down economic growth of the country. Demand for factors of production may fall → firms may retrench workers or even shut down → rise in the unemployment rate.
  - Hence there is a need for the government to be mindful of the policies it takes to minimise the trade-offs between low inflation and the other macroeconomic objectives.
- Low inflation should not be the main government objective during recession or period of high unemployment.
  - During recession when the economy is experiencing falling output and high/rising unemployment, the government should strive to improve the economic performance of the country by imposing expansionary measures to stimulate AD and hence production and growth (while at the same time adopt measures to create jobs to address the country's unemployment problem)
  - E.g. the global recession caused by the US sub-prime crisis in 2008, led to a huge fall in Singapore's external trade and hence economic recession and high unemployment. The government's concern during this period is to stimulate growth to get the economy out of the recession by imposing expansionary policies to increase AD to increase production and increase employment level.

- On the other hand, maintaining low inflation as the main objective will mean maintain low AD which will not help in solve the current economic condition.

**Synthesis /Conclusion: Possible judgements and supporting reasons**

- Given that there are various economic goals in Singapore, the one most important is to achieve sustained economic growth in order to raise the standard of living. Given the small size of domestic consumption and our high ratio of trade to GDP (an indicator of openness of an economy), rising inflation can have a great negative impact on economic growth. However, there is a need for the government to be mindful of the possible negative impact of pursuing low inflation on growth, unemployment and even BOP.
- Also, whether low inflation should be the main macroeconomic objective depends largely on the current economic conditions of the country. In times of high inflation caused either by rising cost of resources or rising external or domestic demand, the government's priority should be on keep inflation rate low. When faced with low or stagnant growth, or even high structural unemployment, price stability should take a lower priority and not be the government's main macroeconomic objective.
- Low inflation should be a major macroeconomic aim as it helps to achieve the other macroeconomic objectives. *(The arguments were given in the closure to the thesis argument)*

Level	Descriptors for Q4(b)	Marks
L3	<p><u>High L3</u> A developed and balanced discussion on whether low inflation should be a main objective weighing against the trade-offs that may result, with clear considerations of the characteristics of the economy as well as the existing economic conditions prevailing in the economy. Effective application to Singapore context, considering the severity of the policy objective trade-offs to the prevailing economic condition of the country.</p> <p><u>Low L3</u> A developed and balanced discussion on whether low inflation should be a main objective weighing against the trade-offs that may result, with clear considerations of the characteristics of the economy <u>or</u> existing economic conditions prevailing in the economy. Also, explanation of low inflation as a pre-requisite to achieve the other macroeconomic objectives.</p>	9-11
L2	For an analysis of why low inflation should be the main government macroeconomic objective and considers the trade-offs between low inflation and other objectives of the government but lacking in clarity with no clear considerations of the characteristics of the economy as well as the existing economic conditions prevailing in the economy.	6-8
L1	<p><u>High L1</u> Answer shows some awareness of why the government should be concerned with high inflation. Attempt to use economic framework; some conceptual errors.</p> <p><u>Low L1</u> Smattering of points without use of economic framework or irrelevant answer.</p>	1-5
E2	<p>Evaluation with explanation and elaboration e.g.</p> <ul style="list-style-type: none"> <li>○ Evaluation based on economic analysis (clearly explained)</li> <li>○ Using examples as illustration on government main macroeconomic objective depends on the current economic condition and seriousness of the problem.</li> </ul>	3-4
E1	<p>Unsupported evaluation e.g.</p> <ul style="list-style-type: none"> <li>○ evaluation not clearly explained or elaborated, lacking in examples</li> <li>○ examples used are inappropriate/not effectively used to substantiate judgement</li> <li>○ not supported by economic analysis</li> </ul>	1-2