

Essay Q4: Inflation – Problem and Policies

The British economy's relentless progress, the growing confidence of British companies and skilled workers demanding higher pay imply the day the Bank of England will raise interest rates to stabilize prices is drawing near.

[Source: The Telegraph, 9th August 2014]

- (a) Explain the domestic and external factors that cause inflation. [10]
- (b) Discuss the view that the use of exchange rate policy is preferred over interest rate policy to ensure price stability. [15]

Suggested answers:

(a) Explain the domestic and external factors that cause inflation. [10]

Introduction:

- Define inflation: period of sustained and inordinate increase in the general price level.
- 2 main types of inflation: demand-pull and cost-push inflation.

Development 1: DD-pull inflation: Explaining domestic and external factors

Explain one external Factor

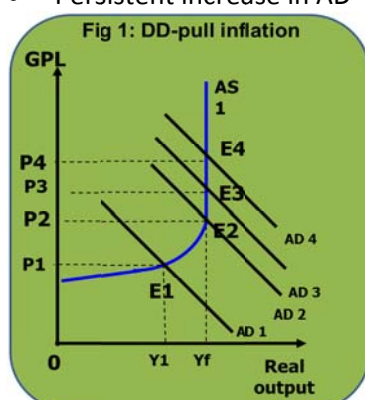
- E.g. Autonomous increase in Exports due to Global recovery → Global recovery will lead to an increase in national incomes of foreign countries and hence an increase in their purchasing power. This would lead to an increase in their DD for imports. . Thus, there will be an increase in the export revenue for UK.
→ increase in AD

Explain one Domestic Factor

- E.g. Autonomous increase in Consumption:
UK economy facing positive growth rates creates a positive economic outlook, which in turn boosts consumer confidence. This would lead to an increase in consumption spending given expectation of rising incomes.
→ Increase in AD

Explain link to demand pull inflation

- Persistent increase in AD → excess demand in the economy at every price level → sustained increase in GPL → Demand pull inflation.



EV: E.g. Extent of rise in GPL affected by the extent of rise in AD and the state of economy

Development 2: cost-push inflation: Explaining domestic and external factors

External causes

- E.g. Increase in imported inflation:

Higher prices of imported raw materials such as agricultural supplies, oil, metals, etc. from foreign countries (e.g. due to higher inflation rates in the foreign country) would lead to an increase in unit COP in the domestic economy.

→ upward and leftward shift in AS curve

Domestic causes

- E.g. Increase in wages due to tight labour market:

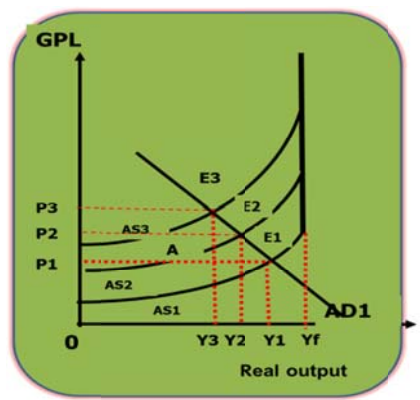
Tight labour market → workers demand higher pay (as stated in the signpost) → If this increase in wages outweighs the increase in productivity, this would lead to an increase in unit COP of domestic firms.

→ upward and leftward shift in AS curve

Explain link to cost push inflation:

Short-run AS curve to shift to the left from AS1 to AS2 (i.e. AS falls), GPL rises & real output falls. Persistent rises in wages which causes further ↑ in unit COP and further leftward shift in AS from AS2 to AS3. GPL further ↑ from P2 to P3 etc. The rises in GPL are sustained and cost-push inflation ensues.

Fig 2



Conclusion:

Give a reasoned judgement on whether domestic or international factors are more important causes of cost push and demand pull inflation.

Mark scheme:

Level	Knowledge, Application, Understanding and Analysis	Marks
L3	For an answer that uses appropriate analysis to discuss whether domestic or international factors are more important causes of cost push and demand pull inflation in the context of UK with reference to the links between the factors mentioned and inflation.	7-10
L2	<p>For an answer that gives a descriptive explanation whether domestic or international factors are more important causes of cost push and demand pull inflation.</p> <p>or one that only refers to domestic or one that only refers to international factors.</p> <p>For an answer that describes how internal and external factors cause cost push and demand pull inflation.</p> <p>OR</p> <p>For an answer that analyses ONLY how internal OR external factors cause cost push <u>and</u> demand pull inflation</p> <p>OR</p> <p>A theoretical answer with NO reference to the stem.</p>	4-6
L1	For an answer that shows knowledge of the domestic and international factors that might affect price stability – this could be in the form of a largely unexplained list .	1-3

(b) Discuss the view that the use of exchange rate policy is preferred over interest rate policy to ensure price stability. [15]

Introduction:

- **Meaning of price stability :**
- **Benefits of price stability and hence need for govt policies:**

Thesis: Exchange rate policy is preferred over interest rate policy to ensure price stability

(i) Exchange rate policy may be preferred over interest rate policy to ensure price stability if the economy is suffering from imported inflation.

Revaluation of the currency (e.g. SGD) curbs cost push inflation in the form of imported inflation. Stronger exchange rate leads to lower import prices in SGD and curbs cost push inflation in a number of ways. E.g. It lowers the price that SG residents have to pay for imported final goods and services, which lowers imported inflation directly. In addition, a stronger SGD leads to a fall in the price of imported raw materials, which puts downward pressure on the price level by lowering the costs of production.

(ii) Exchange rate policy can help to reduce demand pull inflation for an economy that relies heavily on external demand.

Explain how a revaluation of SGD helps to curb demand pull inflation when the Marshall-Lerner condition holds.

Evaluation: The Marshall Lerner Condition may not hold in the short term, i.e. $PED_x + PED_m < 1$, thus revaluation may not reduce demand pull inflation.

Anti-thesis: Interest rate policy is preferred over exchange rate policy to ensure price stability

(i) Interest rate policy can help to reduce demand pull inflation for an economy that relies heavily on domestic demand.

Higher interest rates lower consumption and investment spending, thereby lowering AD and reducing demand pull inflation.

Evaluation: Interest inelasticity of demand for investment limits the effectiveness of interest rate policy.

Synthesis and Conclusion:

Make a reasoned judgement on whether the use of exchange rate policy or interest rate policy is the preferred measure to maintain price stability.

Mark scheme:

L3	For an answer using <u>appropriate analysis</u> to discuss whether the use of <u>exchange rate policy</u> or <u>interest rate policy</u> is the preferred measure to maintain price stability.	9-11
L2	For an answer that gives a <u>descriptive explanation</u> to discuss whether exchange rate policy or interest rate policy is the preferred measure to maintain price stability. OR For an answer using <u>analysis</u> to explain how exchange rate policy OR interest rate policy is used to maintain price stability. OR A theoretical answer that gives an explanation of different policies to ensure price stability with NO reference to the stem.	6 - 8
L1	For an answer that shows some basic but largely unexplained knowledge of how exchange rate policy and/or interest rate policy is used to ensure price stability with NO reference to the stem. OR For an answer that gives a <u>descriptive explanation</u> of the use of one policy e.g. exchange rate policy OR interest rate policy to ensure price stability with NO reference to the stem.	1- 5
<u>Evaluation</u>		
E2	For a reasoned judgement supported by relevant economic analysis that either exchange rate policy or interest rate policy is better.	3-4
E1	For an unexplained judgement e.g. a largely unexplained statement that either exchange rate policy or interest rate policy is better.	1-2