Question 4

(a) Explain the possible effects of rising inflation. [10]

(b) Most agree that inflation can create uncertainties and undermine confidence in the economy. That is why most Central Banks are tasked with keeping a lid on inflation through interest rate and exchange rate. Discuss the extent to which Central Banks could keep a lid on inflation. [15]

Suggested answer outline:

Part (a)
Candidates should show a good understanding of the possible consequences of inflation. Good candidates will explore the implications on both micro and macro aims and will also explain how it will affect the internal and external sectors of the economy. Candidates should also explain giving the scope on how these effects of rising inflation can be both a positive or negative outcome.

<u>Internal - Micro Aims</u>

Redistribution of income (Equity)

- Fixed income earners will suffer a decrease in real income.
- Firms such as businesses will gain if the prices rise faster than cost of production, hence earning higher profits
- Borrowers will gain from having to return less in real value but lenders will lose out.

Efficiency

- Rising inflation may cause producers to misinterpret price signals and make wrong production and investment decisions such as producing more output thinking that there is an increase in AD and divert resources and FOP into the production of a good for which there is no additional demand, resulting in an inefficient allocation of resources

Standard of Living

- A rising inflation may result in higher prices to be paid by consumers in consumption. Assuming there is no increase in income, it will lower the purchasing power of consumers, resulting in a lower material SOL of the consumers.

<u>Internal -Macro Aims</u>

A reduction in Unemployment

- With rising inflation and an increase in general price level, producers will wish to produce more to make more profits. This increases the derived demand for FOP such as labour and increases employment, reducing unemployment.

Economic Growth

- With rising inflation, the value of money will fall. The opportunity cost of consumption will now be lower and savers will also decrease savings and increase consumption. With a lower level of savings placed in the banks, it will lower the amount of loans available funds for investment from the banks. This lack of supply of loanable funds will increase interest rates; hence increase cost of borrowing and will result in a fall in capital investment. This will lower AD and in the long run also lowers potential growth.

External- Balance of Payment

- Rising inflation will make domestically produced goods and services more expensive to the trading partners. In the short run, assume demand for exports and imports to be price inelastic, hence
  ↑Px, ↓ Qx →↑PxQx
  ↓Pm,↑Qm→↓PmQm

There will be an improvement in the current account. However capital account may fall in run as investors may lose confidence. Overall BOP will likely to improve in the short run.

- However, in the long run, assume demand for imports and exports to be price elastic, hence
  ↑Px, ↓↓ Qx →↓PxQx
  ↓Pm,↑↑Qm→↓PmQm

  There will be likely a fall in LR Capital account as investor may lose confidence. Overall, BOP is likely to worsen in the LR.

Part (b)
Candidates should show a good understanding of the benefits and limitations of monetary and exchange rate policy on controlling inflation. Good candidates will first explain how the interest rate and exchange rates work and their limitations. Other factors such as the root cause of the inflation, eg. Government taxation, or cost push inflation should be factored in to answer the question requirement on 'to what extent'

<u>Monetary policy on interest rate to help curb inflation</u>

- Contractionary Monetary policy-↑ interest rates-↑ COB – assume same level of expected returns – decrease profitability to investors - ↓I.

- Contractionary Monetary policy-↑ interest rates-↑ returns to savings – ↑opportunity cost of consumption – ↓C

- ↓C↓I -↓AD-↓ Demand-pull inflation.(internal)

- Contractionary Monetary policy-↑ interest rates-↑ short term capital inflows- ↑demand for domestic currency-↑ external value of currency appreciates if supply remains the same-↓Pm, export competitiveness falls- BOP↓- lowers demand-pull inflation.

Limitations

- It raises the debt burden of those who borrow to finance spending.
- Frequent changes may not be desirable for producers to make long term investment decisions-↓I- which may worsen inflation in the long run as productive capacity does not increase.
- Leads to an increase in short term capital flow(Hot Money) which may result in inflation still.
- IT cannot solve cost-push inflation/imported inflation

<u>Exchange rate to help curb inflation</u>

- Contractionary Monetary policy-Appreciation-↑Px,↓Pm, assume demand for imports and exports to be price elastic and Marshall Lerner's law of (PEDx+PEDm>1) hence
  ↑Px, ↓↓ Qx →↓PxQx
  ↓Pm,↑↑Qm→↓PmQm

  Overall, (X-M) ↓, -↓AD-↓ Demand-pull inflation (external)

- Contractionary Monetary policy-Appreciation- more costly for foreign investors to invest-↓FDI-↓AD-↓GPL-↓Demand pull inflation(external)
- Contractionary Monetary policy-Appreciation- ↓Pm- ↓imported inflation fromimported raw materials.

Limitations

- But only if the government have sufficient foreign exchange rate reserves to engage in manipulation exchange rate. Thus it is not a long-term solution to curb inflation.
- It also has implications on balance of payments for the reason tat cheaper imports and dearer exports will boost outflow leading to a balance of payments deficit.

- It is unable to solve demand pull inflation caused by C, I, G and also internal led cost-push inflation.

Evaluation and stand:

- The extent to which the Central Banks can keep a lid on inflation depends on the root cause of inflation:

  - If it is due to cost-push inflation (internal). Raising interest rates / exchange rates will not be effective. Supply management policies such as raising productivity or introducing wage freeze should be used to deal with the problem.

  - If the root cause of inflation is high government expenditure or lower taxes, fiscal policy will better reduce G and increase tax and is more effective in reducing demand-pull inflation.
- Exchange rates and interest rates may also result in a long term problem of ↓I. Hence supply side to boost productivity is better to meet increasing demand to curb inflation instead.

- If a country is facing exports slump, exchange rate policy will only worsen the actual growth and may result in cyclical unemployment instead.

- If a country's economic activity is dependent on trading partners' state of economy and there is no control over trading partner's policies, it is hard to curb inflation using these policies.

- If a country is part of Eurozone and has no control over monetary policy, these policies will not be applicable in curbing inflation.