

Question 5

Unemployment rate hits record high in some countries due to internal and external problems.

(a) Explain what causes the rate of unemployment to rise in an economy. [10]

(b) Discuss the alternative policies that a government could adopt to reduce the high rate of unemployment. [15]

Suggested answer outline:

(a) Explain what causes the rate of unemployment to rise in an economy. [10]

Unemployment: Refers to people who are registered as able, available and willing to work at the going wage rate in a suitable job but who cannot find paid unemployment despite an active search for work.

Cause of a rise in rate of unemployment:

(1) Cyclical unemployment → Demand- deficient unemployment

(2) Structural unemployment → Supply side unemployment

(Frictional unemployment is likely not a significant cause as this is a natural phenomenon and is generally not regarded as a serious problem. In addition, the preamble and question highlighted that there is a record high unemployment rate and rise in rate of unemployment which means that there are other more significant sources of unemployment)

(1) Cyclical unemployment: occurs when the economy is at the recessionary phase of the trade cycle. It is caused by a decrease in aggregate demand (from either internal or external problems).

Internal → Recession → C & I fall → AD fall → real output fall → demand for FOP fall → demand deficient unemployment

External → Global downturn → X fall → AD fall → real output fall → demand for FOP fall → demand deficient unemployment

Example: In Singapore, cyclical unemployment is observable when we experience a recession, especially from a global downturn. Since external demand is the largest factor that contributes to the determination of Singapore's AD. When X falls, demand for labour would fall too bringing about cyclical unemployment

(2) Structural unemployment: occurs when the economy undergoes structural changes due to changing consumer demand and technology. These changes result in certain industries and skills becoming obsolete and at the same time such changes create demand for other industries and skills.

External → Labour intensive sectors face more competition from rising economies such as China → lose CA → workers who are retrenched from these sunset industries do not have the relevant skills to find jobs in rising industries → structural unemployment

Example: Singapore focuses more on developing the knowledge-based sectors (such as pharmaceutical/life sciences). However, workers who currently have skills in labour-intensive production do not have the skills to be involved. Therefore, they become structurally unemployed as they are unable to gain jobs in these sunrise sectors.

5 (b) Discuss the alternative policies that a government could adopt to reduce the high rate of unemployment. [15]

Stand: Policies depends on the root cause of the unemployment

(1) Cyclical unemployment (Demand Deficient): Demand management policies

(2) Structural unemployment (Supply-side): Supply side policies

(1) Cyclical unemployment: Demand management policies

Internal or External Problems

Internal: Monetary Policy centered on i/r / Fiscal Policy

External: MP centered on E/R

Expansionary MP centered on i/r :

Fall in i/r → fall in cost of borrowing → rise in consumption of big-ticket items → higher C → AD rises

Fall in i/r → fall in return to savings → lower opportunity cost to consume → higher C → AD rises

Fall in i/r → fall in cost of borrowing → given the same expected returns to investment → more investment projects are profitable → investment rises → AD rises

Limitations:

- Liquidity trap
- Consumer and business confidence

Expansionary MP centered on E/R :

Weaken domestic currency → reduce the prices of exports in foreign currencies → if $PED_x > 1$, export revenue increases.

Weakening of domestic currency → prices of imports rise → if $PED_m > 1$, import expenditure falls.

Rise in net exports → AD rise

Limitations:

- Imports dependent reduces ability to substantially weaken currency

Expansionary FP:

Reduce income tax rates → consumers' disposable income rise → increase in C since the level of consumption expenditure is directly related to the level of disposable income → AD rises

Reduce corporate tax rate → increases firms' after-tax profits → increase in I → AD rises

Limitations:

- crowding out effect
- availability of funds

How demand management policies address cyclical unemployment:

An initial change in AD can have a greater final impact on equilibrium national income. Via the multiplier mechanism cause a multiple increase in output necessitating more workers to be employed, hence reducing cyclical unemployment.

(2) Structural unemployment: Supply side policies

Increase government spending (G) on training and/or reduce taxes (T) on firms which provide more training programmes for their workers.

training → improve employability and quality of our workforce → increasing capacity to produce (shown by AS shifting right → → increase in AD → workers can now be employed as the skills-vacancy mismatch is resolved → reduce severity of structural unemployment.

government establish training facilities/institutions for skills upgrading or acquire new skills

Training grants and subsidies (e.g. Skills Development Funds in Singapore) can also be provided to encourage skills retraining and upgrading. In Singapore, the government encourages retrenched and older workers to receive training in hospitality and healthcare sectors (such as house-keeping, patient services) so that they can be re-employed in these industries.

Encourages the use of new technology to boost the productivity of low-skilled, retrenched workers. E.g. re-design of cleaners' job to incorporate the use of new/high technology so that cleaners need to use more sophisticated machines in helping them to accomplish the work in lesser time with fewer workers.

Limitations:

- take a relatively long period of time
- SR: Workfare benefits
- may lead to budget deficit

Evaluation:

Which alternative policy to adopt depends on:

- root cause of unemployment (Demand deficient from which component of AD or structural unemployment)
- Size of government debt [USA]
- time lag (FP vs MP if cause of Unemployment is fall in C and I)
- short term measure for structural unemployment (Jobs credit scheme)