**Aims of Government and Policies**

**Question 1-Priority of Aims & Monetary Policy**

**“A low rate of inflation should be the economic priority of the government and it is achieved by keeping interest rates high in the economy.”**

- (explain and evaluate the effectiveness of the monetary policy in controlling inflation)

**Introduction**

Define inflation

State that it is one of the main objectives of the government and there are other aims to consider. However, there are certain conditions when price stability is more important than other aims while there are other times when other aims are more important than price stability.

**Main body**

1. **Explain why low rate of inflation is important to government**

# Internal aspect (write briefly)

* Low inflation helps to prevent inequality of distribution of income
* It also prevents rise in cost of living and cost of production.
* It also maintains purchasing power and ability to save.
* It will induce investment, production and employment.

## External aspect(write briefly)

* It helps to maintain international competitiveness due to cost competitiveness
* It helps to prevent the occurrence of balance of trade deficit.
* It helps to prevent fluctuation of exchange rate (depreciation).

1. **Explain why maintaining price stability is most important.**

* It maintains the cost of production so that rising cost condition will not occur and impede economic growth. (achieve sustainable growth)
* It also prevents the failure of businesses as rising cost of production will make it difficult for them to operate and compete with international MNCs
* It will maintain exchange rate of stability, encouraging flow of investment and trading activities and thus ensure balance of payment deficit. (inflation will keep COP low – prevent rise in Px – sustain production)

1. **Explain why other aims are more important than price stability**

* Economic growth will lead to the rise in national income, enabling the individuals to have a higher purchasing power to overcome the effects of rising prices
* Full employment is more important as underemployment will mean the loss of income for some citizens, may become a liability for the country as unemployment benefit is needed. With a source of income, individuals can still overcome the effects of rising prices.
* External stability is more important as it will ensure that there is stable exchange rate to prevent imported inflation, leading to rising cost of living and cost of production.

Part B)

One of the way to curb inflation is to increase interest rate and this will be a form of contractionary monetary policy.

* + 1. Explain how contractionary monetary policy is used to curb inflationary condition

(reduce MS – raise interest rate – increase cost of borrowing – decrease C & I – decrease AD – reverce multiplying effect – decrease price)

* + 1. Explain the limitations of the contractionary monetary policy
* The inability of the central bank to control money supply – liberalization of the banking sector undermining the use of monetary tools
* The presence of inelastic MEI and interest inelastic consumption
* The small value of k

Due to the inadequacy of the contractionary monetary policy, other policies may be used to curb inflation

* + 1. Explain how Fiscal Policy is used to curb inflation

Decrease G – decrease AD via K – decrease nominal NY and P

Increase taxes – decrease disposable income – decrease consumption – decrease AD

Increase corporate tax – decrease profitability – discourage investment – decrease AD

- both via K – decrease in nominal NY and price level

* + 1. Examine the effectiveness of the Fiscal Policy
* Contractionary fiscal policy is effective in controlling inflation as it can dampen consumption by lowering the purchasing power effectively and discourage excessive investment by raising tax to make it less profictable.
* The rigidity of fiscal policy – cannot be curbed for certain necessary form of expenditure.
* It may not be politically favourable
* The small value of the k
  + 1. Explain the use of price and wage control

To set price ceiling and prevent the wage cost and cost of living from rising to lead a cost-push inflation

Effectiveness

It depends on whether the inflationary condition is due to cost-push factors and the ability to government to impose control (ability to work with the trade union)

* + 1. Explain how the government can use SS-side management to increase AS

The government can introduce policies to increase production capacity by increasing productivity (Increase AS (lower COP), better utilization of resources and inducement for greater investment. (expansion of resource capacity – rightward shift of AS)

Manpower Policy

Infrastructural development

Research and Development

Effectiveness

Depends on the effectiveness of the public administrative system and the availability of resources and financing to implement the programmes

* + 1. Explain how the exchange rate policy is used to curb imported inflation

Appreciation of the exchange rate will allow the government to decrease the price of imports (Appn – reduce the PM in local value) but this policy depends whether there is extensive capital inflow.

Very effective for countries which depend on foreign sources of supply of resources.

**Conclusion**

The use of the interest rate can only provide a limited inflation can be curbed.

**Question 4 – Aims of government / Policies – Fiscal Policy**

**‘China will increase government borrowing and public spending this year where much of which are spent on infrastructure projects, education and health care.’**

**Assess the macroeconomic aims and other objectives that might be achieved by the Chinese government as it undertakes the above expenditure. [25]**

**Introduction**

The underlying public spending made by government is part of the fiscal expansionary policy. As a result of the policy, there will be extensive increase in economic activities which will help the Chinese government to achieve the aims. These aims can be divided into macro-economic and micro-economic aims and they are namely, full employment, economic growth, price stability, and equal distribute of income.

**Main body**

**1) State and explain the aims of the government in terms of their importance. (7)**

a) Economic growth/ SOL

b) Full Employment

c) Price stability

d) External equilibrium

e) Equal Distribution of income and wealth

**2) Explain how the above projects will be raise able to AD and raise national income and employment.**

Public spending on infrastructural development, education and healthcare will increase government expenditure which will increase the value of aggregate demand and via the multiplier effect, raise national income and production and employment. ( Increase in real GDP will lead to higher SOL as real per capita income will increase

(Increase in infrastructure will raise production – provision of more employment by government)

In the multiplier process, the initial increase in the aggregate expenditure expands the circular flow of income, increasing the income of the factor earners to further expand the circular flow of income with new transaction. As long as transactions are made, the circular flow of income will continue to expand until the withdrawal effects is equal to the initial injections which will cease the expansion of the circular flow of income. Consequently, the national income will increase by several folds, depending on the value of the multiplier which is determined by the sum of the MPW (Marginal Propensity to withdraw – MPS + MPT +MPM)

**3) Explain how the above projects affect price stability.**

The above expansionary effect will raise AD and price level. If the economy is experiencing deflationary condition, the increase in aggregate demand will not contribute to inflationary condition since there is spare capacity to increase production. However, if the economy is near full employment, excessive increase in AD will contribute to rising cost and inflationary condition.

Nonetheless, price stability can still be attained if the expansionary government spending can contribute to increase in potential growth. Infrastructural development will bring about more transport network to solve the problem of structural rigidities to prevent immobility of resources. Furthermore, government expenditure on education will raise the productivity of the workers and thus increase production capacity.

Thus, such government expenditure will create supply impact, inducing an increase in supply to undermine inflationary condition to ensure price stability.

**4) Explain how the above projects will promote external equilibrium.**

The above projects will induce greater export demand and inflow of Foreign Direct Investment which will lead to inflow of funds to prevent BOP deficit and depreciation of exchange rate which will have adverse consequences on the Chinese economy

As the government expenditure on infrastructural development, healthcare and education will raise the productivity of the workers to raise their export capacity, meeting the surging demand from the global market. This will lead to greater export revenue, promoting balance of trade surplus. (SS-side impact)

Lower cost of production due to higher productivity and greater infrastructural development will attract inflow of FDI which will improve the balance of payment, and thus raising the exchange rate of Yuan. This will promote china’s stability in the financial market.

**5) Explain how the above projects will promote greater equality in distribution of income and wealth.**

More government expenditure on public projects in terms of education and healthcare will raise the welfare of the people and for the poor if the focus of the expenditure is for the lower income group. Besides this, infrastructural development on public transport will make it more convenient and comfortable for the public and thus, raise the standard of living for the people.

**6) Evaluate the extent of the success – state the possible hindrances the government may face in the introduction of such a policy.**

a) The problem of time lag.

Time lag occurs during the recognition, implementation and regulation stage of the fiscal policy will undermine the effectiveness and efficiency of the policy. Consequently, there may be unforeseen problems undermining the results.

b) Crowding out effect (crowding out of fund for private investment and high cost of borrowing)

As the government finances the project by public borrowing, it is likely that it will deprive the private sector the necessary fund for private investment since the public borrowing will reduce money supply in the money market, cutting down credit creation and raising interstate. Faced with a shortage of funds for private investment and a higher interest rate, the level of domestic investment will decrease, undermining economic growth and employment.

Contractionary effect which will undermine the expansionary fiscal policy

c) The value of the multiplier and accelerator

If the value of the multiplier and accelerator is small, the impact on the change in national income will be small and thus, the desired level of effect of the policy is not attained. (High MPS – saving attitude)The value of the accelerator may be small if the economy increase in the income is temporary and limited to a certain group, therefore the increase in induced consumption will be less effective. Consequently, there will be lesser corresponding increase in induced investment to promote economic growth and employment.

d) The cost of financing

As the Chinese government is raising public debts to finance the public expenditure, the cost of financing is another consideration to take note. In the public dept is raised internally, the cost of financing will be passed on to the next generation as it will increase the tax payment for the future generation. If the public debt is raised externally, the cost of financing will decrease the earning of the nations as it is used for debt payment.

e) Rising cost condition/ complexity problem

It is likely that the expanding fiscal policy will lead to rising cost condition where the spare capacity of production is utilized with greater demand for the resources. Consequently, price stability may be undermined as the Chinese government seeks for greater economic growth and employment.

Conclusion

The implementation of a fiscal expansionary policy by the Chinese government as seem in the form of expenditure on education, healthcare and infrastructural development will help Chinese government to achieve the aim of government. However, it is important for the government to take note of the limitations and the possible conflicts it may generate.

**Question 5 - Aims of Government – Supply-side Management Policies**

**Are supply-side policies an effective solution to the most significant macroeconomic problem that is currently being experienced in your country? (17)**

**Introduction**

Singapore is small country with limited resources and is heavily relying on the external market for export demand and foreign direct investment for growth. Due to this peculiar market situation, the country will experience certain economic problems that will undermine the economy from achieving. It is observed that the government of Singapore has often introduced the supply-side policies to solve the macroeconomic economic problems and thus lead the perception that it is best policy to be adopted to solve the macroeconomic problems.

**Main Body**

1. **State the main macro-economic problems that Singapore is experiencing**

**(Why unemployment is the most significant problem?)**

**a) Explain the types of unemployment in Singapore**

**b) Explain why unemployment is a serious problem for the economy**

* Structural unemployment
* Technological advancement – less demand for workers and skill incompatibility
* Sectoral changes – change in the comparative advantage – rising sectors will demand for more workers while the declining industries will decrease in demand for workers
* Demand deficient Unemployment - occur as a result of the fall in export demand and foreign direct investment – what causes the fall in XD and FDI and how it decrease employment
* Unequal distribution of income and wealth
* Certain sectors of the population will gain more than the rest of the population as they are more skilled and possess assets
* It will also occur of structural unemployment
* Undesirable side-effects of economic growth
* Jobless growth – the growth of the industries do not provide a high percentage increase in the level of employment as the growth of the firms are capital intensive based, requiring highly skilful and qualified workers
* Lower income group of the population cannot gain the benefit of the growth

1. **Explain how the supply policies can be used to solve the macroeconomic problems**

* Meaning of the supply-side management policies

(adjustment of the economic structure by expanding resource capacity or by raising the efficiency of production)

* Explain the various ways the supply-side management policies can be used to solve the listed macroeconomic problems faced by the government

Manpower development/infrastructural development/ institutional development) (technological development/ capital development)

1. **Evaluate the effectiveness of the supply-side management policies**

* Strengths of the supply-side management policies

(solve the roots of the problems or deals with fundamental economic problems/ create a more permanent impact on the economy/can create dimensional impact on the economy – raise the skills of the workers which will also raise their Wage rate and thus solve unequal distribution of income)

* Limitations of the supply-side management policies

(time lag/ effectiveness depends on the efficiency of the public administrative system/involves high cost of financing/ faced constraints of the economy)

Weaknesses of the supply-side management policies that can be compensated by other policies

(cannot solve imported inflation/cannot determine the external demand directly)

**Conclusion**