**JC Economics Essays 2020 – Inflation and Unemployment**

**Essay Question 1**

Domestic factors are likely to play a bigger role in driving inflation higher and this has led some analysts to question the effectiveness of the Monetary Authority of Singapore’s (MAS) use of exchange rate policy to manage inflation.

 Adapted from the Business Times, 22/03/2012

(a) Explain how inflation can be caused by domestic factors. [10]

(b) Discuss whether monetary policy is the most effective policy to manage inflation in Singapore. [15]

**Essay Question 2**

The price of oil jumped and hit a new high of US$135 a barrel on 26 May 2008 and it is likely that global food and oil prices would remain high in 2008. In addition, the jobless rate in the USA was at a 26-year high on 5 Dec 2008.

 Sources: AsiaOneNews, 26 May 2008 and The Straits Times, 5 Dec 2008

Explain the causes of stagflation in the USA. [8]

**Essay Question 3**

'The people in United States are weathering the economic storms of stagflation, fueled by rising oil and food prices, and intensifying housing and credit problems.'

Adapted from Worries grow for worse stagflation', Associated Press,

26 Feb 2008

Explain the economic problems faced by the United States. [10]

**Essay Question 1**

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 **Adapted from the Business Times, 22/03/2012**

**(a) Explain how inflation can be caused by domestic factors. [10]**

Introduction

* Definition of inflation
* Meaning of domestic factors that will contribute to inflationary condition
* Implies that these factors have their influence from the domestic aspect but will also contribute to excessive increase in aggregate or reduction in aggregate supply, creating and excess demand condition that will lead to inflation

Main Body

**1. Explain how the domestic factors will lead to demand-pull inflation**

-Explain how demand-pull inflation occurs (Economic causation/diagram/description of diagram)

### **Demand-Pull Inflation**

* + - This occurred as a result of the rise in aggregate demand, leading to **an excess demand condition** and a rise in price level, only when the economy is **experiencing rising cost condition or full employment condition.**

Y2=Y3=YF

Real GDP

GPL

AS0

AD3

AD2

AD1

AD0

Y1

Y0

P2

P3

P1=P0

* + - As seen from the diagram, the rise in AD from AD₀ to AD₃ will lead to inflation (rise in price level) when the economy is experiencing rising cost condition from Y₁ to Y₂ or it is at full employment at Y₂=YF
		- Rise in AD is mainly contributed by excessive ↑ in Xd/FDI or rise in local consumption and government expenditure

-Identify the domestic factors that will lead to demand-pull inflation

→Raise income

→Decrease interest rate

→Population growth

**2. Explain how the domestic factors will lead to cost-push inflation**

-Explain how cost-push inflation occurs (Economic Causation/diagram/description of diagram)

**Cost-Push Inflation**

* + - Caused by a rise in cost of production, which can be due to an increase in unit labour cost or an increase in cost of raw materials. The increase in cost of production will lead to a reduction aggregate supply, contributing to a shortage or excess demand condition leading to increase in price level.
		- There are two ways which cost-push inflation can develop, namely the wage-price spiral and price-wage spiral
		- **Wage-price spiral** happens when powerful union demands for higher wages but is not matched by a corresponding higher increase in productivity. It leads to higher prices and inflationary pressures. Higher prices then lead the unions to again demand higher wages, and the spiral continues.
		- **Price-wage spiral** happens when big business corporations increase price to increase their profit margin. Cost of living rises and unions may ask for higher wages to make up for loss of living standards. Cost of production and prices eventually will rise.

AS₀

GPL

Real GDP

P₁

P₀

Y₁

Y0=YF

AD₀

AS₀

AS1

As seen from the diagram, the rise in cost of production will lead to a fall in aggregate supply from AS0 to AS1 which will create an excess demand condition at P0 which will prompt the rise in price from P0 to P1. This diagram is used to explain how cost-push inflation can be affected by structural rigidities, asset-based inflation, imported inflation and tax-based inflation

The rise in cost of production due to rise in wages or cost of resources (all other reasons that affect COP will lead to rise in COP like imported inflation) will cause a leftward shift of the AS from AS₀ to AS₁, which means that there is an excess demand condition at P₀ and thus inducing rise in price level from P₀ to P₁. While the real GDP falls from Y₀ to Y₁ (no change in potential capacity – YF remains the same)

Identify the domestic factors that will lead to cost-push inflation

→Rise in wages/core items in cost of living index

→limited resources

→infrastructural rigidities

Conclusion

**Essay Question 1**

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 **Adapted from the Business Times, 22/03/2012**

**(b) Discuss whether monetary policy is the most effective policy to manage inflation in Singapore. [15]**

Introduction

 To control inflation with monetary policy, a contractionary monetary policy is adopted involving the reduction of money supply and the raising of interest rate to reduce aggregate demand so to clear the excess demand condition so to dampen inflation.

Main Body

* + 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 profitable. At the same time, the reduction in government expenditure will help to prevent the excessive demand for the resource when the government cuts down the building of infrastructures. Such an approach is more effective than contractionary monetary policy as it is more direct and impactful.

**5) 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) but the use of price and wage control can help to prevent a wage and price spiral.

**6) 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 but the effective planning will help to expand the resource capacity to ease the condition of rising cost condition which will prevent inflationary condition.

**7)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 as in the case of Singapore we are import dependent due to our lack of resources and small size of economy. Although it is often criticized that it will raise the price of export of Singapore, undermining our export competitiveness.

Conclusion

**Essay Question 2**

**The price of oil jumped and hit a new high of US$135 a barrel on 26 May 2008 and it is likely that global food and oil prices would remain high in 2008. In addition, the jobless rate in the USA was at a 26-year high on 5 Dec 2008.**

 **Sources: AsiaOneNews, 26 May 2008 and The Straits Times, 5 Dec 2008**

**Explain the causes of stagflation in the USA. [8]**

Introduction
Definition of Stagflation - An inflationary condition contributed by rising cost of production, which contributes to stagnation or reduction in economic activities. Based on the pre-amble, it can be observed that USA is experiencing stagflation due to rising oil and food prices while there is reduction in economic activities seen in term of rising unemployment

Main Body

1. **Explain how the rise in price of oil and rise in global food prices will lead to cost-push inflation**

 Rise in price of oil will lead to rise in cost of production which will reduce the aggregate supply, creating an excess demand condition that will contribute to rise in price of goods and services. The rise in price of goods and services will raise the cost of living, prompting trade unions to raise their wage to curb the rising cost of production. This will bring about price-wage spiral. The inflationary condition will lead to reduction in output as well.

1. **Explain how the high jobless rate will lead to stagnation or reduction in economic activities**

High jobless rate would imply high level of unemployment, which will reduce the disposable income of the consumers. As such, this will lead to a fall in consumption. The decrease in consumer market will mean lower level of aggregate demand, which will reduce the injection of investment as there is a weaker market demand in the economy. Consequently, a fall in aggregate demand in the economy due to the pessimistic market condition will lead to stagnation or reduction in economic activities.

1. **Draw diagram and explain how stagflation will occur (AS-AD diagram)**
2. **Evaluation**

Conclusion