Question for discussion

**1a. Explain how an increase in rental cost leads to inflation. (8)**

**2a. Inclusive growth is economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society.**

**Source: http://www.oecd.org, accessed on 10 July 2016**

1. **Explain why a government might aim to achieve inclusive growth. [10]**
2. **(b) Evaluate the measures adopted by the Singapore government to achieve inclusive growth. [15]**

**Essay Question 3**

Singapore's economy expanded a faster-than-expected 1.8 per cent in the last quarter of 2016. Moving ahead, growth remains uncertain. Internally, Singapore has adopted a policy of restricting foreign labour and restructuring towards productivity-driven growth. Externally, higher US interest rate may lead to higher interest rates in Singapore. Source: Adapted from Channel NewsAsia, 3 January 2017

(a) Explain the possible conflicts in government macroeconomic objectives caused by a policy of restricting foreign labour and restructuring towards productivity-driven growth. [10]

(b) Assess the impact of higher US interest rate on Singapore’s macroeconomic performance. [15]

**Essay Question 1**

**Explain how an increase in rental cost leads to inflation. (8)**

Inflation refers to the condition where there is an increase in price level. An increase in rental cost would lead to an increase in cost of production as the rental of the factory or office space is the factors of production, leading to cost-push inflation. Cost-push inflation occurs which leads to the rise in cost of production and creates an excess demand condition when the aggregate supply is greater than the aggregate demand at a particular price level.

When the rental cost of the firm is higher, there is an increase in cost of production which means that it is more expensive to produce the goods and the supply of the goods will be reduced as there is lower level of production. Consequently, the aggregate supply reduces, creating an excess demand condition that induces the price level (GPL) to rise.

When this cost-push inflation occurs, the increase in price contributes to a price-wage spiral as the rise in cost of production due to increase in rental cost leads to rise in price level. Trade union demands higher wage increment as there is rise in cost of living due to inflation and this further increases the wage rate and further contributes to rise in cost of production which leads to increase in price level of goods and services. Consequently, a price-wage spiral is formed.

ASF

GPL

Real GDPGDPGDP

P₁

P₀

Y₁

Y0=YF

AD₀

AS1

AS0

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.

In sum, it can be observed that inflation can occur as a result of the increase in rental cost as it is part of the cost of production, The extent of increase in price depends on the significant proportion of rental as part of cost of production.

**2(a) Explain what could restrict the effectiveness of fiscal policy as a tool to stimulate stagnating economies. [10]**

Fiscal policy is the policy that manipulates government spending and tax rates to achieve various macroeconomics goals. A stagnating economy can be seen from slow growth. To stimulate stagnating economies, expansionary fiscal policy through the use of increased government spending and tax cuts is the policy that most governments would adopt. Yet, there are factors which could limit the effectiveness of the expansionary fiscal policy and we shall examine these factors in this essay.

Fiscal policy is used as a tool to stimulate a stagnating economy as it has the ability to raise actual growth. The most direct method of increasing actual growth is through the increase in aggregate demand (AD) . The increase in government spending in an expansionary fiscal policy will increase AD through the multiplier effect which results in actual growth as seen from the increase in real GDP. The multiplier effect takes place when there is an increase in autonomous spending (in this case government spending) which will create additional rounds of spending in other AD determinants such as consumption, investment and exports until the initial injection is consumed. Similarly, the reduction in taxes, will increase firms’ after-tax profits, making firms more willing and able to invest while consumers will see an increase in purchasing power which will increase their willingness and ability to consume. Hence, both the increase in investment and consumption will result in an increase in AD and real GDP through the multiplier effect.

Furthermore, fiscal policy can also increase the potential growth of the economy. This is done through the infrastructure developments funded by government spending and through increased investments into R&D by firms. Infrastructure developments will increase the efficiency of the flow of the factors of production, while R&D will increase the productive efficiency. Both of which will increase the production capacity and lower the cost of production which is observed from the increase in aggregate supply. This will increase production capacity and address a stagnating economy that is due to the economy reaching full employment.

Yet, there are many factors which inhibit the effectiveness of an expansionary fiscal policy which is crucial for governments to consider.

The first factor would be the size of the multiplier. A small multiplier would limit the increase in AD, as the subsequent injection and rounds of spending from the multiplier process depends on the size of the multiplier to determine the size of the injection and the number of rounds. This will limit the increase in AD which limits the increase in the actual growth. This is prevalent in countries with a high marginal propensity to save such as Singapore as the size of multiplier is inversely related to the extent of the marginal propensity to save. Hence, the small size of multiplier in Singapore would make fiscal policy a poor policy to drive AD growth due to its limited effectiveness.

Second, high public debt or a lack of government budget will limit the extent of fiscal policy that the government can take. Expansionary fiscal policy sees the increase in government spending which increases government expenditure while the reduction in taxes will result in a fall in government revenue. The net result would be an increase in budget deficit in which countries without adequate reserves or budget surplus would incur opportunity cost. Such opportunity costs could be seen from the reduction of government services such as subsidies on education or healthcare. Hence, governments might choose not to implement the best possible fiscal policy but rather a more limited version suited to their financial situations, which would correspondingly limit the effectiveness of the policy.

Third, high government corruption could also limit the effectiveness of the policy as such policies require careful planning and constant implementation. Fiscal policy consists of an increase in government spending and tax cuts, which potentially could be exploited in a corrupted government. Government contracts to companies with dubious links to politicians or tax cuts to companies who politicians have a stake in are some of the potential forms of corruption that could threaten the effectiveness of the policy. Instead of the funds going to investments and improvements in the flow of production, it is instead funneled to support the system of crony capitalism, greatly limiting the fiscal policies ability to increase both actual and potential growth.

Furthermore, the crowding out effect is a serious threat to the effectiveness of the fiscal policy in dealing with a stagnating economy as it may undermine investments as a driver of growth. Crowding out effect takes place since the increase in government spending could reduce the capital available for private investments, which means that the increase in government spending is met with an equal or greater fall in investments. This would not only limit the increase in AD, but also limit the effectiveness in tax cuts as the increased propensity to invest is not followed by the increased availability of funds to invest. Hence, the impacts of fiscal policy could be limited by the crowding out effect.

Also, the phenomenon of fiscal drag would limit the growth of AD through the dampening of consumption due to consumers seeing an increase in taxes because of the fiscal policy. The effects of increase in government spending and the following increase in actual growth could result in consumers seeing an increase in income to the point where they would be placed in a new tax bracket. This could dampen consumption as consumers experience an increase in taxation without the increase in tax rate. As a result, this will lower the consumers purchasing power and reduce their propensity to consume, limiting the increase in AD and real GDP.

The most important factor that limits the effectiveness of fiscal policy would be the factors that prevent the adoption and implementation of the fiscal policy. Even though the policies of crowding out and fiscal drag exist, the overall effects of the shift in AD and AS will result in some potential and actual growth. However, the lack of funds or the presence of corruption will completely negate the implementation of such fiscal policy.

In conclusion, fiscal policy can be a particularly useful tool to address a stagnating economy. However, careful planning is needed as governments should consider the potential factors that would limit the effectiveness of the policy such as the size of multiplier, their budgetary requirements, crowding out effect and fiscal drag. These factors can be mitigated and avoided with proper planning and policies.

**Essay Question 3**

**Inclusive growth is economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society.**

**Source: http://www.oecd.org, accessed on 10 July 2016**

**(a) Explain why a government might aim to achieve inclusive growth. [10]**

Introduction

definition and meaning of inclusive growth – refers to a condition where the benefits of economic growth is well distributed and extended to all segments of the citizens in the country

manifestation of inclusive growth – sustainable growth and well-distributed growth to different segments of population / maximization of economic benefits

measures – policies and directives that can be used to achieve sustainable EG and eradicate disparity of income

**benefits of growth to be distributed to more segments of the citizens**

* **sustainable economic growth (consistent rise in real GDP)**
* **equal distribution of the gain from economic growth**

**why must have inclusive growth**

* **raise SOL for more people**
* **reduce the negative effects of unequal distribution of income**
* **induce a more permanent and large base of consumption – pivot to growth**
* **more saving to generate more funding for investment**

**why inclusive growth is beneficial to the economy?**

* **A larger consumer base – wealthier and in larger volume – create more economic activities in terms of higher consumption**
* **Higher value of national income – (higher economic growth) - higher tax revenue – higher consumption (GST)**
* **A measurement of the state of governance – higher standard of living**

**How do measure the degree of inclusive**

* **Degree of equal distribution of income and wealth – Gini co-efficient**
* **Full employment condition**
* **Higher economic growth – increase in GDP**
* **Price stability – stable price – sustain real purchasing power**
* **Exchange rate stability – BOP stability or surplus – lower price of imports – stabilize price level**

**Essay Question 1**

**Inclusive growth is economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society.**

**Source: http://www.oecd.org, accessed on 10 July 2016**

**(b) Evaluate the measures adopted by the Singapore government to achieve inclusive growth. [15]**

Analysis of the question:

definition and meaning of inclusive growth – manifestation of inclusive growth – sustainable growth and well-distributed growth to different segments of population

measures – policies and directives that can be used to achieve sustainable EG and eradicate disparity of income

Introduction

To achieve inclusive growth, the Singapore government emphasize on improving the productive capacity of individuals and creating conducive environment for employment and on income redistribution as a means of increasing incomes for excluded groups.

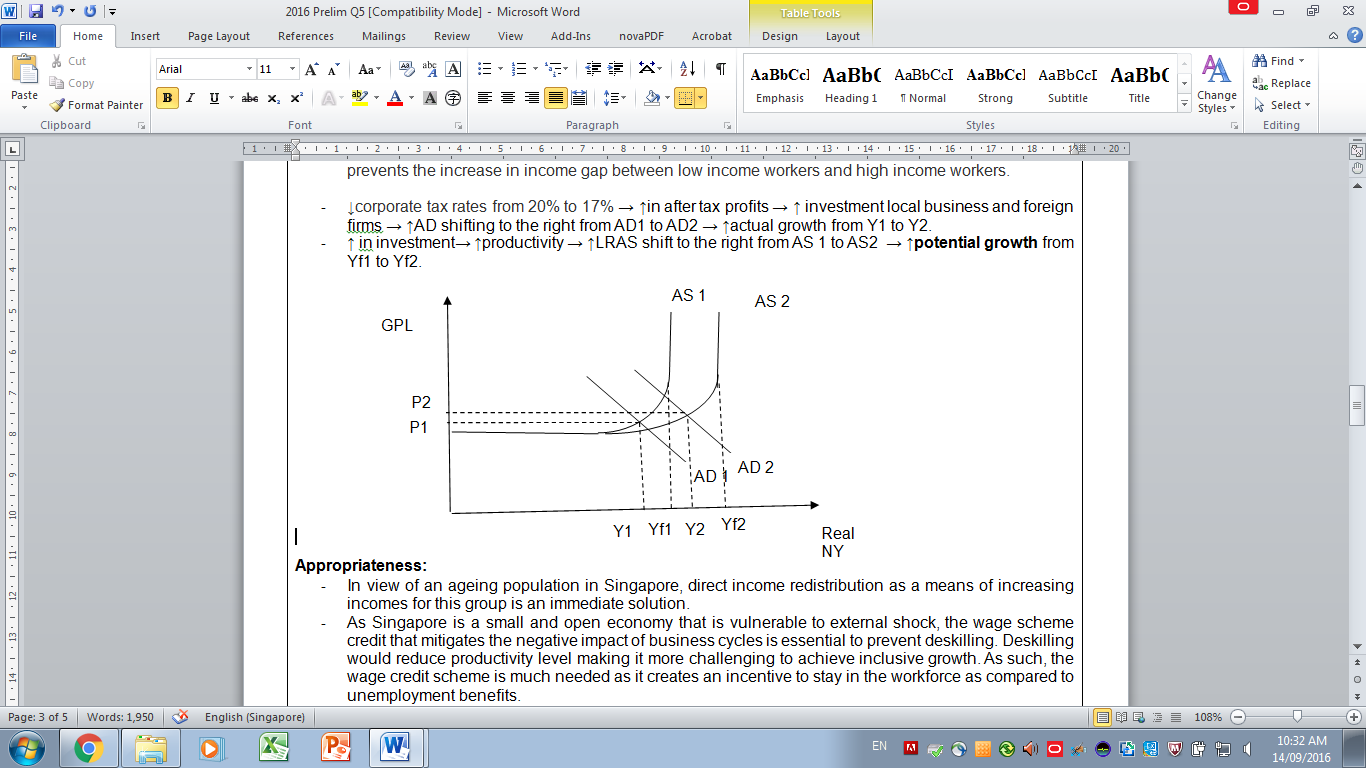
Main Body

Measures to achieve inclusive growth include:

* Fiscal Policy
* SS-side policies
* Progressive Tax system with capacity to induce rise in disposable income

**Fiscal Policy to achieve economic growth and reduce income gap**

* ↑ in G → ↑ in AD assuming economy operating below full employment level, via muitiplier → ↑actual growth, reduces demand deficient unemployment.
* For example, $8 billion Pioneer Generation Package. It helps citizens aged 65 and above in 2014 meet their healthcare costs for life, with further subsidies on healthcare services and medicines → ↑ affordability of healthcare services for senior citizens, reduce the effects of income inequality.
* Wage Credit Scheme launched in 2013, which has seen more than $2.2 billion handed out to help local businesses subsidise wage increases for low-income workers. This helps to maintain employment and prevents the increase in income gap between low income workers and high-income workers.



* ↓corporate tax rates from 20% to 17% → ↑in after tax profits → ↑ investment local business and foreign firms → ↑AD shifting to the right from AD1 to AD2 → ↑actual growth from Y1 to Y2.
* ↑ in investment→ ↑productivity → ↑LRAS shift to the right from AS 1 to AS2 → ↑potential growth from Yf1 to Yf2.

**Appropriateness:**

* In view of an ageing population in Singapore, direct income redistribution as a means of increasing incomes for this group is an immediate solution.
* As Singapore is a small and open economy that is vulnerable to external shock, the wage scheme credit that mitigates the negative impact of business cycles is essential to prevent deskilling. Deskilling would reduce productivity level making it more challenging to achieve inclusive growth. As such, the wage credit scheme is much needed as it creates an incentive to stay in the workforce as compared to unemployment benefits. – prevent unemployment and reduce income inequality
* Corporate tax rate is one of the most important factor in attracting FDI in Singapore. FDI makes up a large proportion of GDP in Singapore given the nature of the economy. The move to reduce corporate tax rate is effective in attract foreign firms to invest in Singapore.

**Limitations:**

* Size of multiplier is small. As MPM is large (import reliant) in Singapore, MPS is large due to high CPF savings. Large leakages in the circular flow of income will result in a small increase in real national income.
* Strained government budget. In the long run, the Singapore government might have to adopt “growth at all cost” instead of inclusive growth to generate tax revenue in order to sustain her fiscal position.
* Singapore’s corporate tax rates are competitive, therefore, further cuts would need to be compensated by an increase in GST which is regressive by nature. This will limit the scope for inclusive growth.

**Lower income group will be taxed more than higher income group (GST is regressive) – govt tries to switch to GST to raise tax base – more will be taxed**

**SS-side policies to enhance productivity for sustainable growth**

* Improvement in Infrastructure in Jurong Island, Biopolis → ↑external EOS→ ↑productivity
* The Productivity and Innovation Credit Scheme (PIC) scheme was introduced by the government to encourage productivity and innovation in Singapore. It creates the incentive to invest in areas to improve their productivity. Businesses enjoy 400% tax deductions/allowances if they qualify.
* The increase in investment → ↑ productivity → ↑AD and AS → ↑sustainable growth.

**Appropriateness:**

* PIC support local businesses which might not enjoy internal EOS due to the small domestic market and therefore, cannot compete with foreign firms in the global market.

**Limitations:**

* Expensive to fund and costly to monitor the appropriate use of the PIC.
* Higher global economic uncertainty, leaving little impetus for firms to invest in productivity-enhancing capital despite these SS side policies.

**SS-side policies to reduce income gap**

* Education subsidy making it affordable to low income family → ↑ labour productivity → ↑demand for labour → ↑wages → reduce income gap
* The Continuing Education and Training Masterplan, aims to ensure a competitive and career resilient workforce. It enables working adults, regardless of their starting qualifications, to continue to build and deepen their skills and competencies, throughout their careers.
* This reduces occupational immobility and helps workers to stay relevant in view of changing demands in the job markets.
* Allows workers in all sectors to remain relevant and generate stable incomes.
* Increases productivity growth which is essential for inclusive growth.

**Appropriateness**

* Singapore being a small economy, lack resources which results in a tight labour market. Hence, it is critical to increase productivity to match with the increase in wages.
* The openness of the Singapore economy allows free mobility of capital. This leads to increase in the pace and frequency of structural changes in the economy.
* Therefore, policies focusing on reducing occupational immobility is instrumental to achieve inclusive growth in Singapore as direct income distribution is not sustainable.

**Limitations:**

* Time lag between reforms and outcomes. For example, there is a time lag between the time when investments in education are made and the time when returns from improved labor skills are collected.

**Progressive Tax System**

Singapore’s personal income tax rates for resident taxpayers are progressive. This means higher income earners pay a proportionately higher tax, with the current highest personal income tax rate at 20%. Tax revenue generated are redistributed as subsidies to make healthcare, education and housing affordable to all. One limitation for a more progressive tax system is that it creates a disincentive to work and deter foreign talent, this might lower the quality of labour, reducing potential growth.

Other possible policies:

* Exchange rate policy
* Wage policy

Conclusion

Upon evaluation, government policies focusing on income redistribution to achieve inclusive growth is necessary in the short run but may not be sustainable, especially for a small and open economy like Singapore. As such, SS side policies that focus on productivity growth and productive employment will remain to be the most important approach to achieve inclusive growth in Singapore as it mitigates the negative impact of structural changes and her vulnerability to external shocks.

**Lesson 8 – Essays – Inflation, Unemployment, Aims of Government, Policies – CSQ Q1**

**Oil prices and deflationary impacts on various countries**

**Figure 2: Crude oil prices and UK inflation, 2007–2015**

**-0.1**

Source: OPEC, Office for National Statistics

**Extract 6: Falling oil prices: Who are the winners and losers?**

Global oil prices have fallen sharply over the past seven months, leading to significant revenue shortfalls in many energy exporting nations, while consumers in many importing countries are likely to have to pay less to heat their homes or drive their cars.

From 2010 until mid-2014, world oil prices had been fairly stable, at around $110 a barrel. But since June prices have more than halved. The reasons for this change are twofold - weak demand in many countries due to insipid economic growth, coupled with surging US production.

Russia is one of the world's largest oil producers, and its dramatic interest rate hike to 17% in support of its troubled rouble underscores how heavily its economy depends on energy revenues, with oil and gas accounting for 70% of export incomes. Russia loses about $2bn in revenues for every dollar fall in the oil price, and the World Bank has warned that Russia's economy would shrink by at least 0.7% in 2015 if oil prices do not recover.

For most of Europe and Asia, lower oil prices may be a blessing. With Europe's flagging economies characterised by low inflation and weak growth, any benefits of lower energy prices would be welcomed by beleaguered governments. A 10% fall in oil prices should lead to a 0.1% increase in economic output, say some.

China, which is set to become the largest net importer of oil, should gain from falling prices. However, lower oil prices won't fully offset the far wider effects of a slowing economy. India imports 75% of its oil, and analysts say falling oil prices will ease its current account deficit. At the same time, the cost of India's fuel subsidies could fall by $2.5bn this year - but only if oil prices stay low.

Source: *BBC*, 19 January 2015

**Extract 7: UK slips into deflation**

The UK has officially slipped into deflation for the first time in more than half a century, but economists and policy makers are not concerned, saying that a brief period of gently falling prices is more likely to help growth than harm it.

Prices, as measured by the consumer prices index (CPI), fell by 0.1% because of the slide in global oil prices, which has reduced the cost of imports. It is not just the price of oil that is falling; so are the prices of most commodities. Now that prices of consumer essentials like food and energy are stagnant or falling, many households are finally getting a boost in living standards as purchasing power of incomes rise. Many, including pensioners, should benefit. Moreover, deflation will help the country to fully restore export competitiveness. Bank of England Governor Mark Carney has consistently said that any period of negative inflation is likely to be temporary, and will not morph into the pernicious deflation seen in countries such as Japan.

However, while the data should not be mistaken for “damaging deflation”, Chancellor George Osborne cautioned, “We have to remain vigilant to deflationary risks even when our system is well equipped to deal with them should they arise.” Deflationary expectations create a vicious cycle of falling prices and wages which shrinks an economy as households put off consumption in anticipation of lower prices. This leads to bankruptcies, firms selling off unprofitable branches, higher unemployment and output decline. Meanwhile, the Trades Union Congress general secretary, Frances O’Grady, commented, “The first period of negative inflation in over half a century could signal that there’s something very wrong with the recovery.” David Kern, Chief Economist at the British Chambers of Commerce, said: “(The) recent trade and manufacturing figures have been disappointing, and ongoing global uncertainties, especially in the emerging markets, reinforce our view that the recovery is fragile, and no risks should be taken.”

Source: Various, 2015

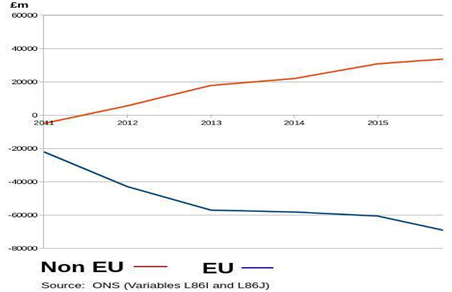
**Extract 8: Eurozone threat to the UK**

Deflationary forces have been kicking up turbulence in Europe. The European Central Bank wants to weaken the euro so Europe will be more competitive with other countries. Currently, the euro has hit an 11-year low against the U.S. dollar. The Eurozone price falls are very bad news for Britain due to the UK’s massive 6% current account deficit. All other things being equal, a weakening euro will widen that deficit further. Or to put it another way, the European Central Bank's putative cure for Eurozone deflation is to export it to the UK. At the same time, the UK has huge aggregate indebtedness (household, business and government debt as a share of GDP or national income). If serious deflation took hold in the UK, she would experience a hideous combination of economic stagnation and growing doubts about her ability to service her huge debts. Hence the President of the European Central Bank’s supposed cure for the Eurozone's economic woes could be toxic for the UK.

Source: Adapted from *BBC News*, 8 January 2015

**Figure 3: The UK’s balance of trade with EU and non-EU countries**

**Goods and services, % of GDP**



**EU**

**Non-EU**

Source: Office of National Statistics

**Table 2: UK Economic Statistics, 2012 – 2015**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | 2012 | 2013 | 2014 | 2015 |
| GDP growth (%) | 1.313 | 1.911 | 3.07 | 2.194 |
| Unemployment (%) | 8.0 | 7.6 | 6.2 | 5.4 |
| Government budget (% of GDP) | -4.97 | -4.91 | -4.01 | -3.15 |
| Current Account (% of GDP) | -3.67 | -4.39 | -4.66 | -4.28 |

Source: OECD; Office of National Statistics

**Questions:**

|  |  |  |  |
| --- | --- | --- | --- |
| **(a)** | **(i)** | State the relationship between crude oil prices and the UK inflation rate in Figure 2. | [1] |
|  | **(ii)** | With the help of a diagram, explain why the supply factor rather than the demand factor is more likely to cause the fall in crude oil prices. | [3] |
| **(b)** | Explain why a fall in crude oil prices would impact the economic growth of countries differently. | | [4] |
| **(c)** | Explain the impact of Russia’s “interest rate hike to 17%” on the rouble. | | [2] |
| **(d)** | Explain why pensioners benefit from a period of deflation. | | [2] |
| **(e)** | Discuss the extent to which small firms with high levels of competition are more likely to shut-down than big firms with less competition with the onset of deflationary pressures. | | [8] |
| **(f)** | Discuss whether the UK government should be worried about the impact of domestic and Eurozone deflation on its economy. | | [10] |

[Total: 30]

**Suggested Answers**

**(a)(i) State the relationship between crude oil prices and the UK inflation rate in Figure 2. [1]**

There is a positive relationship between crude oil prices and the UK inflation rate.

**(a)(ii) With the help of a diagram, explain why the supply factor rather than the demand factor is more likely to cause a fall in crude oil prices. [3]**

The demand for oil is derived from the demand for goods and services, as oil is a key factor input in the production of many goods. Insipid economic growth has resulted in a small increase in demand for oil, which would raise oil prices.

However, supply of oil has increased to a large and significant extent due to surging US production. The increase in global oil producers thus placed downwards pressure on price, which outweighed any increase in prices from a rise in demand.

[Illustrate with a diagram and description]

Hence, supply is likely to have had a more significant impact on the fall in oil prices.

**(b) Explain why a fall in crude oil prices would impact the economic growth of countries differently. [4] ( countries which exports / countries which imports)**

A fall in crude oil prices would impact the economic growth of countries differently, depending on whether they were exporters or imports of oil.

For exporters of oil like Russia, a fall in the price of oil would result in a less-than-proportionate increase in quantity demanded, as PED of oil < 1 due to a lack of substitutes. Thus, exporters of oil would experience a fall in export revenue (X), which reduces AD and causes a fall in NI, ceteris paribus. The fall in crude oil would thus have a negative impact on economic growth.

For importers of oil like China and many European countries, however, a fall in the price of oil is likely to encourage growth. Oil is a key factor of production, so lower oil prices result in a fall in costs of production across the economy and increase SRAS. This would cause a rise in NI, ceteris paribus.

(efficiency of oil usage)

**(c) Explain the impact of Russia’s “interest rate hike to 17%” on the rouble. [2]**

A sharp rise in Russia’s interest rate would attract capital inflows and reduce capital outflows as investors seek higher rates of return for their short-term investments.

This would increase demand and decrease supply of the rouble on the forex market, placing upward pressure on the rouble, causing rouble to appreciate.

Qn – Why raise interest rate? increase price of oil in foreign value – increase revenue fr exports

**(d) Explain why pensioners benefit from a period of deflation. [2]**

A fall in the general price level during a period of deflation implies that there is a rise in purchasing power / internal value of money. Pensioners tend to rely on a fixed amount of savings or fixed incomes. With deflation, they are now able to consume a greater quantity of goods and services with the same amount of money.

**(e) Discuss the extent to which small firms with high levels of competition are more likely to shut-down than big firms with less competition with the onset of deflationary pressures. [8]**

Introduction

Shut down condition for firms: AR<AVC in the short-run and AR<AC in the long-run which is probable since Extract 7 mentions on the higher likelihood of bankruptcies.

Main Body

**1. Analyse the factors will lead to firms shutting-down**

Revenue Analysis:

1.1) Reasons why revenue is likely to fall

Deflationary expectations may cause “households (to) put off consumption in anticipation of lower prices”. Firms would then experience a fall in demand and thus revenue.

1.2) Reasons why revenue is likely to rise

However, since deflation is likely to increase export competitiveness of its goods and services and assuming demand is price elastic, the quantity demanded for exports will increase more than proportionate and this will increase the revenue for firms which produce exports.

Cost Analysis

Firms will experience a reduction in cost of production due to the lower oil, commodity and energy prices (Extract 7) – fall in variable cost

Impact on profits and shutting-down

* Firms will be faced with losses if the deflation is severe and households indeed procrastinate their purchase till TR<TVC. They may shut-down temporarily in the short-run.
* Only when the situation is permanent till TR<TC, the firms may shut-down permanently and exit the market.

**2. Explain why small firms with high levels of competition are more likely to shut-down than big firms with less competition**

The above applies generally to all firms but small firms with high levels of competition, which is monopolistic competitive firms might be more likely to shut-down than big firms with less competition, oligopoly, given that they only earn normal profits in the long-run. So even a small fall in demand can mean making losses. They also do not have excessive past profits for them to cover the losses to keep them in business.

For larger firms in the oligopolistic market, they have more means/money to do excessive product promotion to woo their consumers to buying their goods. And instead of shutting-down their entire business, they can explore options such as “selling off unprofitable branches” (divestment). This will help the firms to survive.

It will be relatively harder for monopolistic firms to survive the impact of deflationary pressures. AR < AVC

**Evaluate the extent:**

But, whether the monopolistic firms will shut-down depends on the type of good that they sell. If these are necessities and perishables, then it is unlikely for the consumers to “put off consumption in anticipation of lower prices”, hence demand for these goods are unlikely to fall.

However, if these firms were to sell goods which are not necessities, then it is likely that demand will fall by a greater extent and there will more likely to shut-down than bigger firms, given they only earn normal profits in the long-run and have little means to revive the demand.

**(f) Discuss whether the UK government should be worried about the impact of domestic and Eurozone deflation on its economy. [10]**

**domestic deflation – worry about local consumer and investor confidence which will affect local demand like C and I**

**Eurozone deflation – worry about the foreign consumer and investor confidence which will affect export demand and FDI**

The impact of both domestic and Eurozone deflation on the UK economy may be assessed by considering the impact on UK macroeconomic goals.

**1. Analyze the impact of domestic deflation on the UK economy**

1.1) Why the UK govt **should be** worried

If deflation persists for an extended period of time, the UK may be caught in a deflationary spiral (‘vicious cycle of falling prices and wages’ in Extract 7). Consumers put off consumption due to expectations of lower prices in the future, causing a fall in C and thus AD.

Fall in investment too due to fall in investor confidence due to bankruptcies and the “selling off unprofitable branches”.

This lowers real output, i.e. negative growth. It also increases unemployment and causes a further fall in GPL, worsening deflation.

Furthermore, the UK government is already running a budget deficit (Table 2) and has ‘huge aggregate indebtedness’ (Extract 8). Deflation may cause the real value of any government debt to increase as the internal value of money rises, making it more difficult for the government to repay its debt.

1.2) Why the UK govt **should not** be worried

However, given that deflation is primarily due to fall in oil prices (Extract 7), this would reduce costs of production within the economy, causing SRAS to shift right.

While GPL falls, there is in fact a rise in production and output, i.e. positive growth, and hence increased employment of labour.

Deflation may also improve price competitiveness of exports (Extract 7), which may improve BOP.

1.3) Evaluation

Whether the UK should be concerned about deflation depends critically on the root cause of deflation. If deflation stems from a fall in costs of production within the economy, as it appears to be given the drastic decrease in crude oil prices, then deflation is largely benign and may even be welcomed as it improves living standards of many households (Extract 7). Moreover, Extract 7 states that “any period of negative inflation is likely to be temporary”, so perhaps it is unlikely that deflation would last long enough for people to develop deflationary expectations which may cause damaging deflation.

**2. Analyze the impact of regional (EU) deflation on the UK economy**

2.1) Why the UK govt **should be** worried

Deflation in the EU may have spillover effects on the UK economy. It may reduce export demand for UK goods as EU consumers hold back spending, resulting in a fall in X and thus AD. This lowers real output, increasing unemployment, and resulting in a fall in the UK’s GPL.

It also worsens the UK’s current account deficit, as EU goods become cheaper over time, resulting in a more than proportionate increase in quantity demanded for imports and raising the UK’s import expenditure (assuming PEDm>1). This effect is reinforced by Figure 3 which shows a sharp worsening of UK’s balance of trade deficit with the EU from 2015.

The current account deficit could also be exacerbated by the EU’s decision to weaken the Euro, as an EU policy response to Eurozone deflation.

Increase in the size of external debt

2.2) Why the UK govt **should not** be worried

Impact of government policies: EU is seeking to reduce deflation via currency depreciation (Extract 8). This would stimulate economic growth and raise employment in the Eurozone.

If successful in ‘jump-starting the economy’, this may reduce the possible negative spillover effects on the UK economy.

2.3) Evaluation

It is likely that the negative impact of regional deflation effects will be felt on the UK in the short run while the positive effects may be experienced in the longer term. However, if the Chief Economist at the British Chambers of Commerce recommends that ‘no risks should be taken’ (Extract 7) in light of the global uncertainties and UK’s fragile recovery, then the UK government should take proactive steps to implement expansionary demand-management policies to counter the short term negative impact of regional deflation.