5 Global inflation has been revised upwards due to rising food and energy prices.

(a) Explain the conflicts between the government macroeconomic goals. [10]

(b) Discuss the other factors that can influence government choice of policies to tackle the rising prices. [15]

Suggested answer for part (a)

Introduction:

- Government aims to achieve the following 4 macroeconomic goals: High and sustainable economic growth, low inflation (price stability), low unemployment and healthy balance of payments.
- Possible conflicts may arise in achieving the 4 macroeconomic aims.

Body:

1. Low inflation vs actual growth/low unemployment

Conflict arises when the economy aims to achieve low inflation and actual growth/unemployment. For example, as Vietnam experience growth from 6.2% to 7.0% growth and fall in unemployment from 2.33% to 2.21% from 2016 to 2018, her inflation rate increases from 2.6% to 3.5% for the same period. This is because as AD increase close to full employment from AD1 to AD 2 to AD3 as seen in Fig 1, this will lead the real national income increases from Y1 to Y2 to Y3, hence achieving actual growth in the short run. In addition, the increase in AD will also result in an increase production level as firms will need to step up production to meet the higher demand. This result in a higher need for factor of production and increase in the hiring of factor of production like labour, thus reducing the cyclical unemployment.

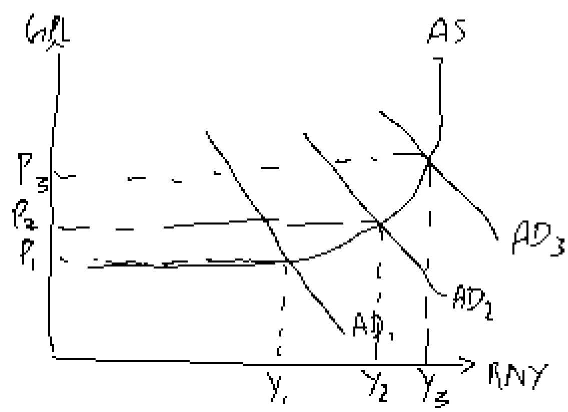

Fig 1: Impact of rising AD on GPL & RNY

However, the trade off to economic growth and low unemployment is that general price level increases as AD increases close to full employment level, causing demand pull inflation. As AD increases, the economy moves closer to the full employment, thus resulting in higher competition for the depleting available resources. This pushes the price of resources up and results in firms experiencing a rising cost of production. The firms will then transfer the rising cost of production to the consumer therefore prices charged for their commodities will rise. GPL will therefore increase as real output increases. Hence, this explains for the conflict in achieving low inflation and actual growth/low unemployment.

2. Low inflation vs healthy balance of trade

When export revenue is increasing due to the increase in export demand and/or import expenditure is decreasing due to fall in import demand, this will result in an increase in net export and improving the balance of trade. However, the increase in net export will lead to the increase in AD. As AD increases as seen in figure 1, the economy moves closer to the full employment, thus resulting in higher competition for the depleting available resources. This pushes the price of resources up and results in firms experiencing a rising cost of production. The firms will then transfer the rising cost of production to the consumer therefore prices charged for their commodities will rise and GPL increase.

3. Economic growth vs low structural unemployment

Economic growth involves changes in production both in terms of the goods produced, and techniques used and the skills required. Hence the more rapid the rate of growth, the more rapid the rate of change in production techniques. People may then find their skills are no longer relevant or their jobs may be replaced by machines. Workers may thus find themselves unemployed as their skills do not match the available jobs. For instance, when the economy experience economic growth, firms are more likely to invest in machines such as self check out/in machines in retails stores or hotels, as well as technology like cashless payment technology to streamline their production process and increase productivity, these new machines and technology increases the productive capacity and LRAS of the economy, achieving economic growth. Yet at the same time, workers may not have the relevant skills to operate these new machines and technology, resulting in them being unemployed. Thus there is a mismatch of skills and opportunities as economic growth brings about a change in the structure of the economy, causing the conflict in achieving economic growth and low unemployment.

Conclusion:

In aiming to achieve the 4 macroeconomic objectives, government is likely to face the possible conflicts: low inflation vs actual growth/low unemployment, economic growth vs low structural unemployment, economic growth vs healthy BOP and low inflation vs healthy BOP. Hence, there is a need for government to implement the relevant macroeconomic policies to help achieve the macroeconomic objectives.

	Knowledge, Application/Understanding and Analysis	
L 3	Answer shows a thorough and complete analysis of at least 2 possible conflicts between the various macroeconomic goals of EG, inflation, unemployment and balance of trade, with appropriate use of examples.	8-10
L 2	Answer shows an under-developed analysis of possible conflicts between the various macroeconomic goals of EG, inflation, unemployment and balance of trade, with some or no use of examples. Max L2 – 5m if only 1 conflict is given	5-7
L 1	Full of conceptual errors and mere listing of possible conflicts between the various macroeconomic goals.	1-4

<u>Suggested answer for part (b)</u>

<u>Introduction</u>

To tackle rising price, government can consider using contractionary demand management policies such as contractionary fiscal policy or increasing interest rate or appreciation of exchange rate as well as possible use of supply side policies such as subsidizing of factor of production or encourage adoption of technology etc. However, as mentioned in part a, there are possible rise in conflict between the macro goals so the government will need to take into consideration whether the possible rise of conflict when choosing the appropriate policy to use. Apart from taking into consideration the possible rise of conflict in macro goals, the government will also take into consideration of other factors such as the root cause of the rising prices, openness of the economy and the time lag etc.

Factor 1: Root cause of the rising inflation
As mentioned in the preamble, the recent inflation that most economies are experiencing is mainly due to the rising food and energy price. The rise in the food and energy price is due to the supply disruption caused by the border and movement restriction during the COVID-19 period as well as the rise in political conflict such as Russia – Ukraine war, which resulted in both fall in global food and oil supply. This resulted in the rising cost of production of all processed food items as well as transportation cost, so resulting in a rise in cost push inflation. As such, the government should choose to adopt short run supply-side policies such as subsidy for fuel or energy so as to help reduce the cost of production for the firms and increase the SRAS, thus reducing the general price level.

Whereas the use of demand management policy such as contractionary fiscal may have limited effectiveness in reducing the inflationary pressure caused by rising food and oil prices. As the government adopt contractionary fiscal policy like increase income tax, which cause household disposable income and purchasing power to reduce. This will then reduce the consumption level and AD, thus reducing the general price level. But the reduction of consumption may be limited as the food and energy are essential for survival, so the reduction in consumption for food and energy may not reduce significantly. Hence resulting in a limited reduction in AD and GPL, so limiting the effectiveness to tackle the inflationary pressure as the policy does not tackle the root cause of cost-push inflation.

Factor 2: Openness of the economy
If the economy is experiencing rising inflation mainly due to the rising AD, then the government may need to the degree of openness of the economy. As economies (such as Singapore and Hong Kong) which have a small domestic market often depend more on exports to boost their aggregate demand and the rise of the demand-pull inflation. Domestic consumption is small in relation to total aggregate demand. Due to the small relative size of domestic consumption and domestic investment and but a larger dependency of export, so the use of the contractionary fiscal policy of increase income tax and corporate tax or the use of monetary policy of increase in interest rate will have limited impact on aggregate demand. As the increase in interest rate will increase the cost of borrowing, which reduces consumption and investment. This will reduce the AD and GPL but the fall in AD is limited as the component of C and I contributing to the AD is relatively small. This will limit the increase in of AD and render the interest rate policy and fiscal policy to less effective than the exchange rate policy which will influence the larger component of AD mainly the net export. Whereas for an economy like China and US where they have a large domestic market, the fiscal and monetary policies will be more effective in reducing demand-pull inflation.

At the same time, if the small economies lack natural resources to produce, there will be a high dependence on imports both for production and consumption. So the adoption of the appreciation exchange rate policy will also be able to help reduce the rising imported price. As the exchange rate appreciation will lead to a fall in price of imported factor of production reduce the imported cost of production. Hence reducing the inflationary pressure due to rising imported price.

Factor 3: Time lags of various policy instruments

Fiscal tools such as changes in level of government expenditure, tax rates, changes in types of taxes have to be approved through parliamentary process. As a result these tools suffer from longer time lags compared to monetary policy instruments such as interest rates which will take less time for changes to take place. As such, there is a need to consider the speed at which a problem needs to be addressed. In some cases, a short term policy may be implemented in order to reduce the impact due to the urgency of the problem before long term policies are undertaken in order to resolve the underlying cause of the problem.

Possible conclusion/ evaluation:

- Government policy decisions are based on a multitude of factors thus conflict is not the sole factor. However, the rising global food and energy prices may have increased the attention of governments to the importance of the root cause of the inflation.
- Choice of policy may even be influenced by political interests such as political objectives of ruling parties.

	Knowledge, Application/Understanding and Analysis	
L3	Answer provides a thorough and complete explanation on how at least 2 considerations that the government has will affect the choice of policy in tackling rising prices/inflation, with appropriate use of example	8 - 10
L2	Answer provides an under-developed explanation on how the considerations that the government has will affect the choice of policy in tackling rising prices/inflation, with some or no use of example	5 - 7
L1	Answer that only explain and evaluate how the macro policies can reduce inflation, no clear link to factor of consideration. Full of conceptual errors and mere listing of the considerations that the government has will affect the choice of policy in tackling rising prices/inflation.	1 – 4
E3	Good attempt to provide well-reasoned evaluation/opinions, supported with clear explanation/evidence on the overall extent.	4 – 5
E2	Some attempt to provide synthesis/conclusion but lack clear substantiation/elaboration.	2 – 3
E1	Listing of opinion/conclusion, without any substantiation.	1