Case Study Question 2

Extract 1

India's inflation problem eases

Lower inflation should allow the Reserve Bank of India to cut rates within months – so long as the eurozone crisis doesn't bring capital flight risks to the fore

There's no doubt about the Reserve Bank of India's (RBI) desire to cut interest rates to support the slowing economy: RBI deputy governor Subir Gokarn said as much two weeks ago.

WPI (Wholesale Price Index) inflation in last month was 6.55% year-on-year, down significantly from 9.5% in November and at its lowest for more than two years.

The speed of the turnaround has not been quite as great as that implies, since base effects and food prices accounted for most of the fall. As Capital Economics puts it:

"Two factors explain why the annual inflation rate has fallen so steeply. Firstly, large price rises in December and January the previous year have dropped out of the annual comparison. Secondly, food prices have been declining as a result of a good harvest: vegetable prices alone have fallen by more than 30% in the past two months, and overall food price inflation is now near zero."

Still, with underlying trends looking favourable – over the last three months, prices of non-food manufactured goods increased at an annualised rate of less than 5%, says Capital Economics – a first rate cut looks possible within the next three months.

That should be good news for an economy that is showing the combined effects of the RBI's 13 rate hikes this cycle, a slowing global economy, a eurozone crisis-induced nervousness in global markets about providing financing to emerging market companies and poor sentiment over corruption scandals and the slow pace of reforms. GDP growth in the July-September quarter was 6.9% year-on-year and the fourth quarter figure due out soon may well be significantly lower. So hints that cuts are on the way aren't coming a moment too soon.

That said, inflation is not the central bank's only headache: the country's large current account deficit and resulting dependence on foreign investment inflows is also a persistent worry. So while the RBI's bias is clearly towards cutting rates as soon as possible – by far the most likely outcome – it's still conceivable that another twist in the eurozone crisis might yet hold it back

www.emergingmarkets.org – 14 February 2012

Extract 2

Japan's Central Bank Marks a Goal for Higher Inflation

TOKYO — Hoping to win its long-futile battle against falling prices, Japan's central bank on Tuesday said it would try to kindle inflation, setting a goal of 1 percent, by pumping tens of billions more dollars into the economy.
The Bank of Japan on Tuesday said it would expand a program of buying government bonds as a way to inject additional money into the economy. And it set a goal of continuing the effort until inflation had reached 1 percent.

The government said Monday that the Japanese economy shrank at a 2.3 percent annual rate in the October-to-December quarter, reversing robust gains in the previous three months, as weak overseas demand and a strong yen hurt manufacturing.

Prices in Japan have not risen at an annual pace above 1 percent since 1997, when deflation set in. As widely expected, the bank left its benchmark interest rate unchanged at a range of zero to 0.1 percent.

"We welcome the Bank of Japan's policy measures, which constitute aggressive steps to beat deflation," the finance minister, Jun Azumi, told reporters after the decision. "We hope the bank's bold monetary easing will boost the economy."

Tokyo stocks rose modestly, yields on Japanese bonds fell and the yen weakened against the dollar on the news. ***A weaker yen is good news for Japan's economy*** because it strengthens the competitiveness of its exports. The yen's recent strength has battered the country's exporters like Panasonic, which predicts record losses for the year.

The bank's message was also clouded because it maintained expectations for a moderate recovery, causing confusion among some analysts over why bank officials had chosen to act now. The yen has recently come off record highs and economists expect better numbers this quarter as reconstruction demand takes off in earnest.

Comments from Masaaki Shirakawa, governor of the Bank of Japan, appeared to further play down the actions' significance. He told reporters after the decision that the bank merely wished to better communicate its anti-deflationary stance to markets.

Mr. Shirakawa has long argued that monetary policy alone cannot bring an end to deflation in Japan, a situation that he says is caused by a lack of demand. Economists say the bank is running out of options, since interest rates are already effectively at zero and because it has little leeway to expand its asset-buying program.

No amount of money can energize a recovery, Mr. Shirakawa has said, without measures to restructure and expand the real economy. But the Japanese government, saddled with a debt twice the size of its economy, has struggled to spend enough to sustain strong economic growth, and economic reforms have fallen short.

Adapted from www.nytimes.com – 14 February 2012

Extract 3

Singapore exchange rate policy losing anti-inflationary mojo?

Emilyn Yap (Business Times, 9 Mar 2012) (Adapted)

A debate on the effectiveness of Singapore's exchange rate policy in controlling inflation has surfaced as the country restructures its economy to boost productivity.

The restructuring – a large part of which involves capping the expansion of the foreign workforce – is likely to lead to higher inflation from rising wages. At least one economist believes this limits the centra bank's ability to keep price increases in check through a strong Singapore dollar, since this works mainly by making imports cheaper.

'If inflation is being driven by domestic supply-side pressures, in particular those owing to tight foreign labour supplies or policies, then the ability of the exchange rate policy to curb inflation will be muted or less effective than in the past,' said DBS economist Irvin Seah in a report yesterday.

But there are market watchers who think that ***a strong currency still helps*** by containing domestic price pressures indirectly. And with oil prices creeping up, the spectre of imported inflation remains.

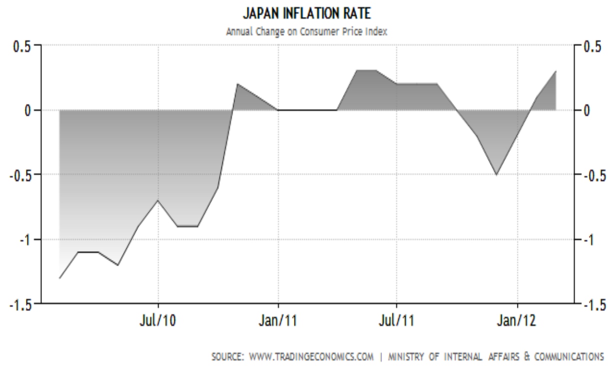
Credit Suisse economist Wy Kun Lung noted that the economic restructuring has, to some extent, made Singapore's exchange rate policy more challenging to manage, but the 'mechanism still works'.

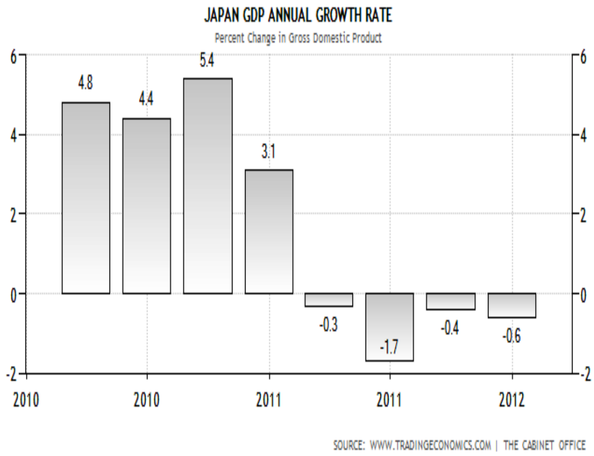
The DBS report threw the spotlight on how the measures could affect exchange rate management. Mr Seah support a 'slightly softer' monetary policy stance as it could facilitate restructuring. There wold be more pain for the export sector if the policy is tightened further, he said.

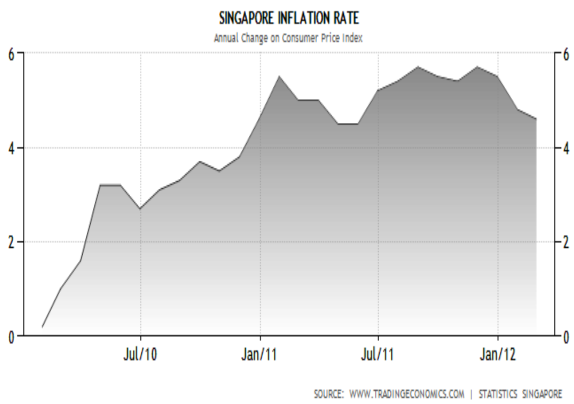
And if the growth momentum turns out to be slower than expected, an even more gradual pace of appreciation would support the economy, he added.

In any case, a robust Singapore dollar wold be less effective in capping inflation that is driven by tight labour supplies at home, not high import prices, said Mr Seah.

But Citigroup economist Kit Wei Zheng pointed out that Singapore's exchange rate policy works through another indirect channel, by restriciting external demand. This effectively reduces demand for labour and other factors of production here so that, in the long run, 'the exchange rate will help to temper some of the wage pressures.'







Questions (Macro CS H1 & H2)

<table>
<tr><th>#</th><th>Question</th><th>Marks</th><th>Level</th></tr>
<tr><td>a)</td><td>Describe the trends in the inflation rates for Singapore, India and Japan, from January 2010 to Januay 2012.</td><td>3m</td><td>L1</td></tr>
<tr><td></td><td colspan="3">

1. *Singapore: Inflation rates are generally rising*
2. *India: Inflation rates are generally falling*
3. *Japan: A change from from deflation to slight inflation OR –ve to +ve*

(1m for each trend)

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<tr><td>b)i)</td><td>Using economic theory explain why economic growth is often accompanied by inflation.</td><td>3m</td><td>L1</td></tr>
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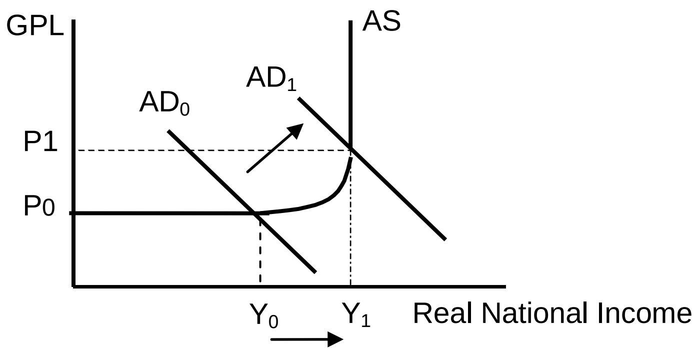
1. *Use of AS/AD diagram exhibiting increase in aggregate demand resulting in increase in actual growth plus inflation is expected; (2m)*



2. *Explaining that as AD continues to rise the eventual supply bottleneck would cause upward pressures on the GPL. (1m)*

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<tr><td>b ii)</td><td>Explain how it is possible for inflation rates in Singapore to continue to rise in the face of falling growth rates.</td><td>4m</td><td>L2</td></tr>
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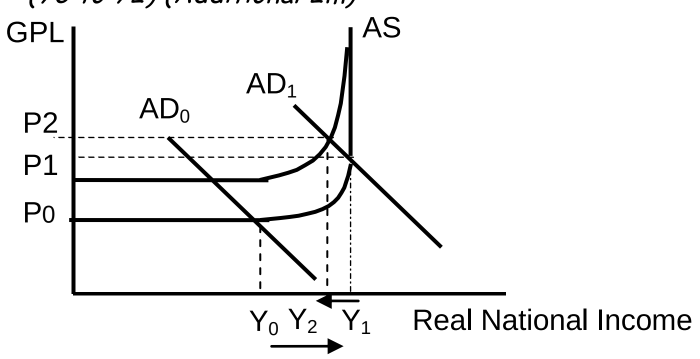
Scenario described – must be contextual referring to the Singapore economy

1. ***Cost-push pressures** (eg. tight labour market in Singapore) resulting in fall of SRAS will result in cost-push inflation (2m), Providing **evidence** for cost push factor (additional 1m)*
2. ***Increase in AD** for Singapore adds even more inflationary pressures (P1 to P2). With AD led growth and a simultaneous rise in CoP, growth is dampened (Y1 to Y2), although there may be overall growth (Y0 to Y2) (Additional 2m)*



A good answer would include shifts in both AD and AS. (4m) - showing a shift in both AS & AD with examples referring to the Singapore economy and includes an AS shift greater than the shift in AD shift.

*Answers that relied exclusively on the cost-push approach with evidence **or** increase in AD near full employment level exhibiting falling growth rates (max 3m)*

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<tr><td>c</td><td>Explain one possible reason for the weakening Yen.</td><td>2m</td><td></td></tr>
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Possible reasons accepted

- *Weakening demand for Japanese exports*
- *Deliberate e-rate policy of the Bank of Japan*

To earn full credit answers must explain how these reasons affect Dd & Ss of Yen in the forex market.

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d	'A weaker yen is good news for Japan's economy', whereas 'a strong Singapore dollar helps' the Singapore economy. Assess the continued validity of these claims.	8m	L3 & E
	Reconciliation revolves around 2 considerations; 1. Different objectives and 2. Different natures of demand and supply of exports and imports. ***Thesis "valid"*** *1. Japan desires to reflate their economy; Dd for Japanese exports are very price elastic and Japan economy is export driven and needs a weak Yen to encourage exports. whereas S'pore needs to contain inflationary pressures. (quote evidence)* *2. S'pore still imports large amounts of resources and needs a strong currency to keep prices low. This helps fight cost push inflation.* *3. Extract also suggests that by restricting ext. DD wage pressures are tempted.* ***Anti-thesis (not valid)*** *Assessment:* *1. A weak Yen may continue to help the recovery in Japan, but may not be sufficient. There are many other factors contributing to Japan's sluggish economy. E.g weak foreign demand for exports (due to weak global outlook) poor domestic business sentiment.* *2. A strong S$ may not be able to help keep inflation low, as domestic sources of inflation are becoming stronger. Higher and higher value added means erosion of export competitiveness is more and more of a problem.* *Concl'n: Should address LR considerations (qn: 'continued validity')* *Japan cannot weaken perpetually due to lowered SOL and possible infl'n in LR* *Singapore's situation will depend on future recessions.*	L1 (1-3m) One-sided answer. L2 (4-5m) Two-sided answer w/o much use of case materials. L3 (6-8m) Two sided answer with relevant references to case materials	
e)	Discuss the extent to which interest rate policy is effective in managing the economies of India and Japan.	10m	L3
	Explain how the transmission mechanism works ***<u>INDIA</u>*** *<u>Effective:</u>* • *Low danger of capital flight due to current Euro crisis* • *Signs of low inflation (lower price rises for Dec & Jan, food prices projected to fall)* *<u>Not Effective:</u>* • *nervousness in global mkts* • *'poor sentiment over corruption scandals'* • *May worsen CA deficit* *<u>Overall :</u> interest rate policy in India can be quite effective.* ***<u>JAPAN</u>*** *<u>Effective:</u>* • *Low danger of capital flight due to current Euro crisis* • *Low inflation environment provides room for expansionary i/r policy to work.* *<u>Not Effective</u>* • *Liquidity trap* • *Dd deficiency 'lack of demand' Extract 5* *Overall: interest rate policy in Japan not effective* ***Conclusion*** *Given current global climate, domestic expansionary interest rate policy runs little risk of capital flight (hot money outflow).* *However, ver differences in the domestic conditions renders i/r policy in India more effective than in Japan.* *May suggest other policies*	L1 (1-3m) One-sided poor/inadequate analysis or a theoretical answer only describing MP mechanics L2 (4-5m) Two-sided Explains both effectiveness and ineffectiveness in both c'tries. L3 (6-8m) Well explained and supported with reference to the extracts. E (1-2m) Makes a valid judgement	