CHAPTER 6 : Macroeconomic Goals

THE ABOUT

CHAPTER ANALYSIS

MASTERY

- Understand the importance of each macro aim
- The cost and trade offs of pursuing each goal
- Need to understand when to prioritize the various goals
- Policies to achieve the macroeconomic goals, especially evaluation

EXAM

- Commonly tested
- Question would usually ask which macroeconomic goal should government prioritize
- Important to evaluate and understand that there is no such thing as best macroeconomic goal

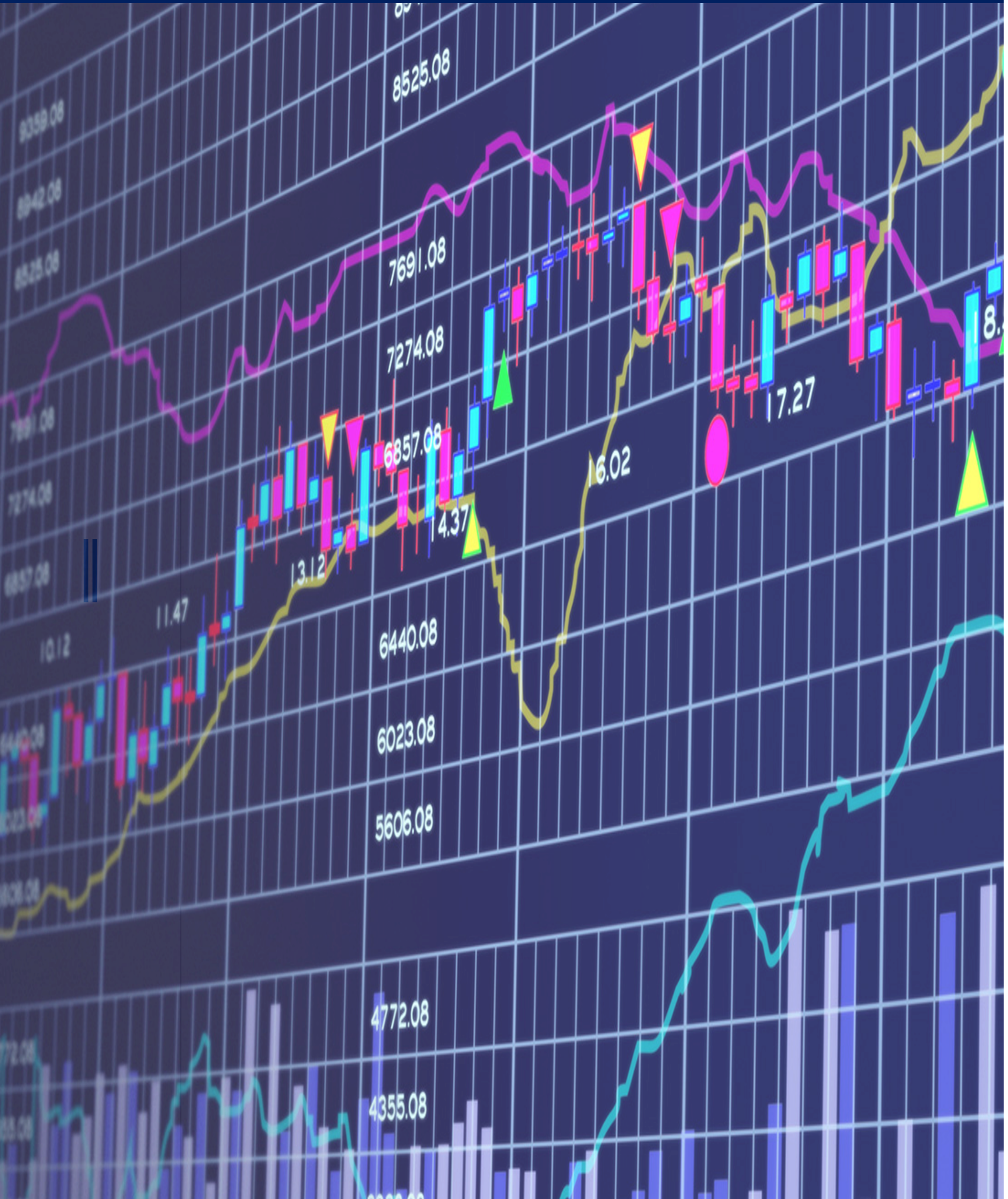
WEIGHTAGE

- Heavy overall weightage as it is a foundation to your macroeconomic concepts

KEY CONCEPT

Economic Growth
Low Unemployment
Low Inflation
BOP

Economic Growth



Economic Growth

Actual growth refers to the percentage annual increase in national output.
Potential growth refers to the speed at which the economy could grow should no resources be left idle.

FACTORS AFFECTING RATE OF ECONOMIC GROWTH

Productivity refers to the quantity of goods/services that a worker can produce for each hour of work

- Natural resources
  - Increase in natural inputs
  - Increase in quantity of labour
  - Increase in population size of participation
- Human capital
  - Knowledge/skills acquired
  - Education, training, retraining
- Physical capital
  - Increase in stock of capital goods
  - Economic growth is fastest when the share of output devoted to capital formation is large
- Technological knowledge
  - Innovation, new production methods

CAUSES OF SLOW/ NEGATIVE ECONOMIC GROWTH

1. AD – if AD does not expand at the rate of supply increase, unemployment may exist, and growth may be slowed
2. Low rate of Investments – may be due to low savings.
3. Capital accumulation – a lack of increase in capital would mean that growth has an upper limit. Technological change would then be necessary for economic growth
4. Lack of natural resources
5. Lack of human capital – education, training and retraining plays a part in preparing the workforce for growth.
6. Sociocultural factors – religious/social norms may impact the economy
7. Political factors – stability is essential for growth
8. Policy mistakes/external shocks

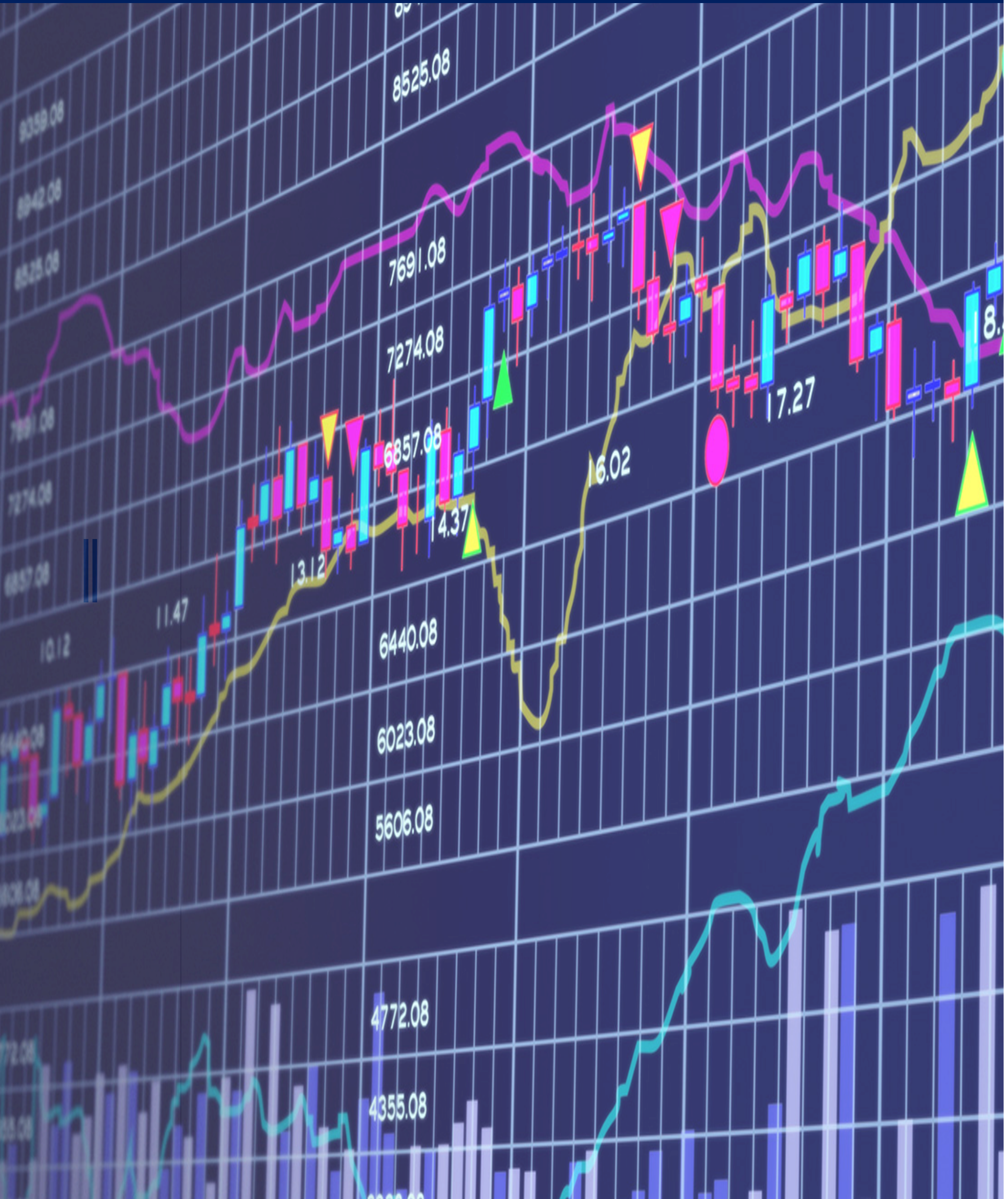
Consequences of slowed EG

Unemployment/ lost output	Less consumption/ savings	Lower investment/ LR growth
Less workers would be hired, capital accumulation falls.	Lower income mean falling expenditure as well as savings. Borrowing may also be greater	Recession may lead to falls in investment via the accelerator effect. Long term economic growth is compromised

Cost-Benefit analysis of EG

Benefits	Costs
<u>Increased levels of consumption Higher standards of living</u> An increase in real GDP per capita indicates increased consumption levels *However higher consumption may not necessarily lead to higher utility, as new wants are created when old ones are met*	**<u>Present opportunity costs of growth</u>** To achieve even faster growth, firms must finance more investments etc. These finances come from savings, or retaining profits or taxes, and raising these means, in some way or other, a cut in consumption. In the SR high growth thus leads to less consumption and more.
<u>Avoiding other macroeconomic problems</u> Without a growth in productive potential, a demand for higher income may lead to higher inflation, BOP disequilibrium etc. Growth helps to meet these demands and avoid such crises.	**<u>Growth might generate extra demand</u>** "The more people have, the more they want" – higher consumption many not necessary lead to higher utility
<u>Equity</u> • If incomes rise, governments find it easier to redistribute income to the poor without the rich losing out. • Increased tax revenue collected from the rich through progressive tax system can be redistributed to the poor *However, if growth is mainly enjoyed by the rich and government fails to help the poor, the poor may not be able to share the wealth and hence worsening of income inequality*	**<u>Environmental costs</u>** Society may be more concerned for the environment, but also more likely to destroy it. Higher levels of consumption translate to higher levels of pollution and waste.
<u>Externalities to environment</u> As people grow richer, they may become less occupied with private consumption, and more concerned to live in cleaner environments. Likewise, the regulation of pollution tends to be stricter in DCs than in LDCs. *However, higher consumption level can still result in pollution, waste and depletion of natural resources*	**<u>Non-renewable resources</u>** Such resources are rapidly depleted, rather than used more efficiently.
<u>Increase in government tax revenue</u> Extra revenue can be channeled into government expenditure which further boosts EG and the welfare of people (education, infrastructure).	<u>Effects on income distribution</u> While some people may gain from higher SOLs, other may lose. If the means to growth are greater incentive (such as cuts in progressivity of Y tax), then the rich get richer and the poor get poorer – no trickle-down is felt. Growth may also involve changes in production, which also means changes in the skills required. People may find their skills no longer relevant as a result of growth. Unemployment may rise.

Economic Growth



Policies

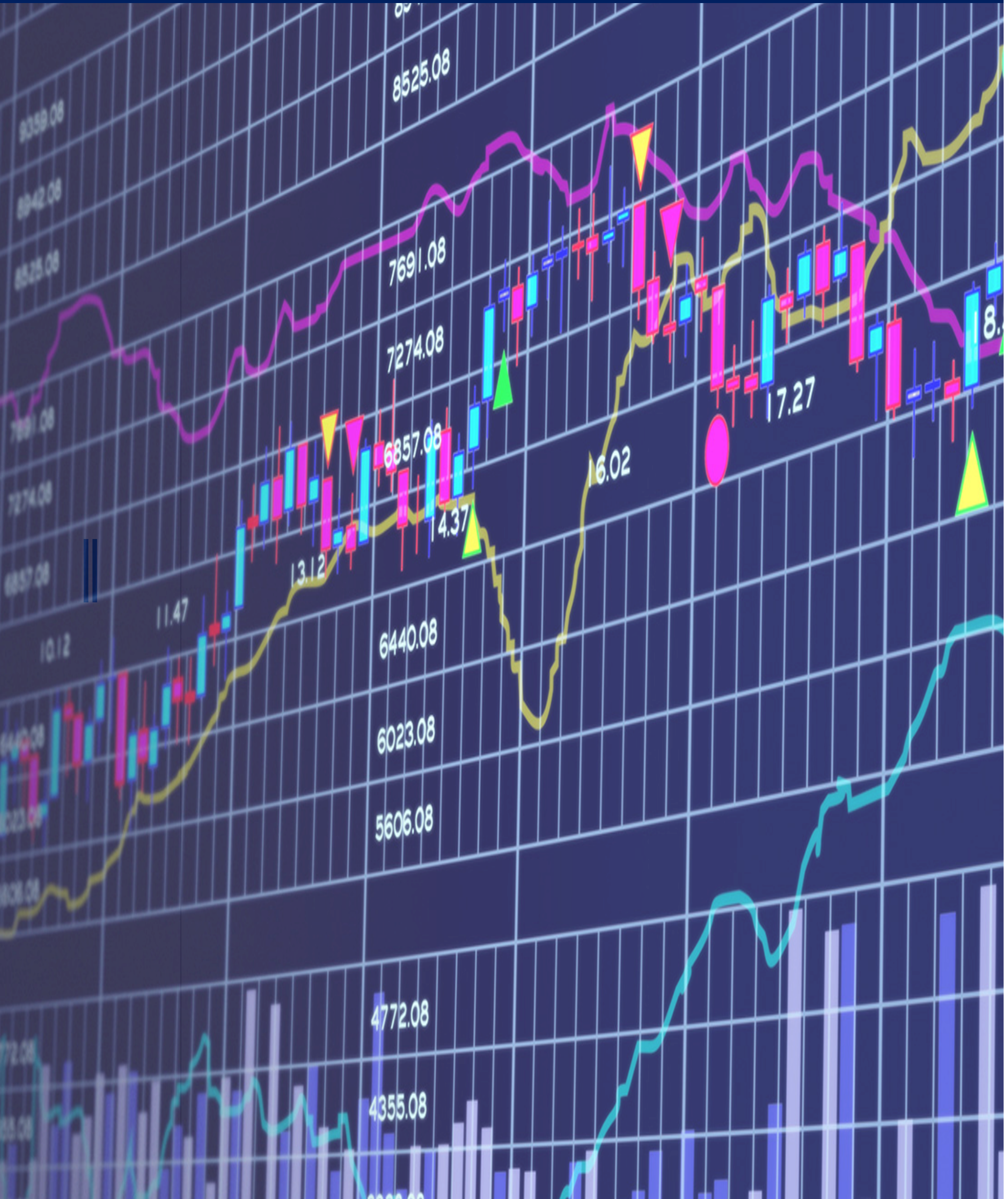
Actual Growth: Expansionary fiscal and monetary policies (anything that increases AD)
Potential growth: Supply side policies (anything that increases AS)

Evaluation

Economic growth is the most important goal in SG, it is the driver of achieving other goals as well.

- Cyclical and structural unemployment is reduced through actual and potential growth respectively.
- While achieving economic growth, our exchange rate centered monetary policy and supply-side policies also help to achieve low inflation.
- The exchange rate centered monetary policy also helps us achieve a healthy BOP in the process. However, if there are other more urgent economic problems (e.g. high inflation) at hand, should temporarily focus on them instead of economic growth.

Unemployment



Types and causes of Unemployment

Frictional	Structural
Arises when people are in between jobs – exists even when the economy is at full employment. • Imperfect labour market operations e.g. Imperfect information • Immobility of workers	Arises due to • Changes in the structure of the economy • Mismatch between skill/location of the labour force and those required for new jobs ➢ Changes in pattern of demand/supply
Classical (real-wage)	**Demand deficient(Cyclical)**
Monopoly power causing wages to be above market clearing level ➢ Role of unions	• Involuntary unemployment • 1. Due to lack of AD for goods • 2. Associated with transitions of the economy through • the business cycle

Costs

- **Lost of production**
  - ➢ Economy producing inside PPC. Hence loss in potential NY and SOL
- **Waste of resources**
  - ➢ Deskilling of workers overtime. They may lose their skills and knowledge, reducing their productivity even if they join back the workforce later on. Hence reducing country's potential output.
- **Financial cost to government**
  - ➢ Loss of tax revenue
  - ➢ Increased spending on welfare payments and benefits
- **Welfare of unemployed**
  - ➢ Low self-esteem
  - ➢ Financial instability
  - ➢ Affecting mental health
- **Social Instability**
  - ➢ Increased crime and violence

Policies to tackle unemployment

<table>
<tr><th>Frictional</th><th>Structural</th></tr>
<tr><td>Job fairs
Better job information services to solve the problem of imperfect information in job market</td><td>Supply side policy
Government can provide education to nurture workforce with the relevant skills needed
Provide training grants and subsidies for the retraining of unemployed workers.</td></tr>
<tr><th colspan="2">Demand deficient(Cyclical)</th></tr>
<tr><td colspan="2">Fiscal policy: paired with supply-side policies to ensure long term growth
Monetary policy: Not effective in Singapore as domestic consumption takes up small % of our GDP
Exchange Rate: devalue currency to make X more price competitive→increasing employment in export sector
However, if imports are price inelastic, import expenditure will rise and hence worsening BOP</td></tr>
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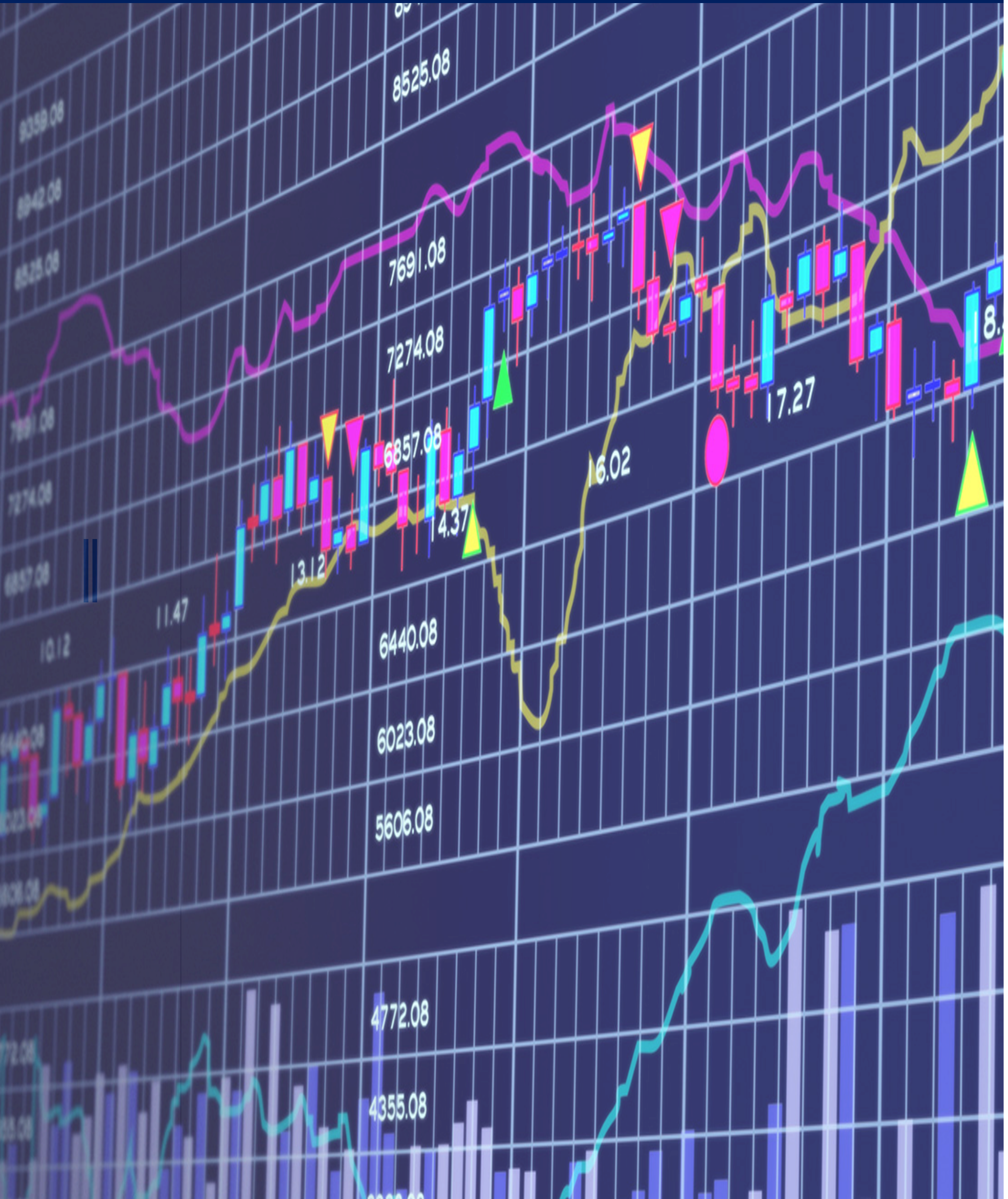
Evaluation of Goal

- Reducing cyclical through expansionary fiscal policy will lead to demand-pull inflation
- However, solving low unemployment issue is more important than achieving price stability.
- If consumers have a stable income from being employed, they will be less affected by the higher prices of goods and services
- Hence we can achieve low unemployment through achieving economic growth and potential growth

Inflation



INFLATION

Inflation refers to a situation in the economy where there Is a general and sustained increased in prices, and is measured in terms of indices such as the CPI.

Types

Hyperinflation (up to a million or a trillion percent).
Reflation refers to a period of mild inflation. Disinflation refers to the process of elimination or reducing inflation
deflation refers to a situation in which there are falling prices.
Slumpflation refers to a period during which there is both inflation and unemployment.
Stagflation refers to a period during which there is inflation with no or negligible growth in GDP/GNP

CAUSES OF INFLAT IO N

Demand-pull inflation (shifting AD) may be caused by

- Increased AD (anything that changes C,I,G,X-M)

When unmatched by an increase in AS, especially if economy is already producing at full employment

  - Reduction in exchange rates
  - Reduction in taxes
  - Reduction in i/r
  - Rising consumer confidence
  - Faster economic growth externally

- Changes in money supply
  - Money supply growing faster that output
  - When banks hand out loans too freely or the governments print too much money such that people now have more money to increase their consumption
  - Hence increasing AD

Cost-push inflation (shifting AS) may be caused by

- Higher costs
  - Wage-push inflation: if trade unions push up wages without corresponding increase in labour productivity
  - Profits-push inflation - firms passing on costs to consumers by raising prices
  - Supply-side inflation - rise in prices of imported raw materials
  - Higher import/export prices
  - Increase in the level of indirect taxes: Indirect taxes increase COP of firms, some tax burden passed on to consumers
  - Structural inflation due to structural rigidities (like labour immobility)

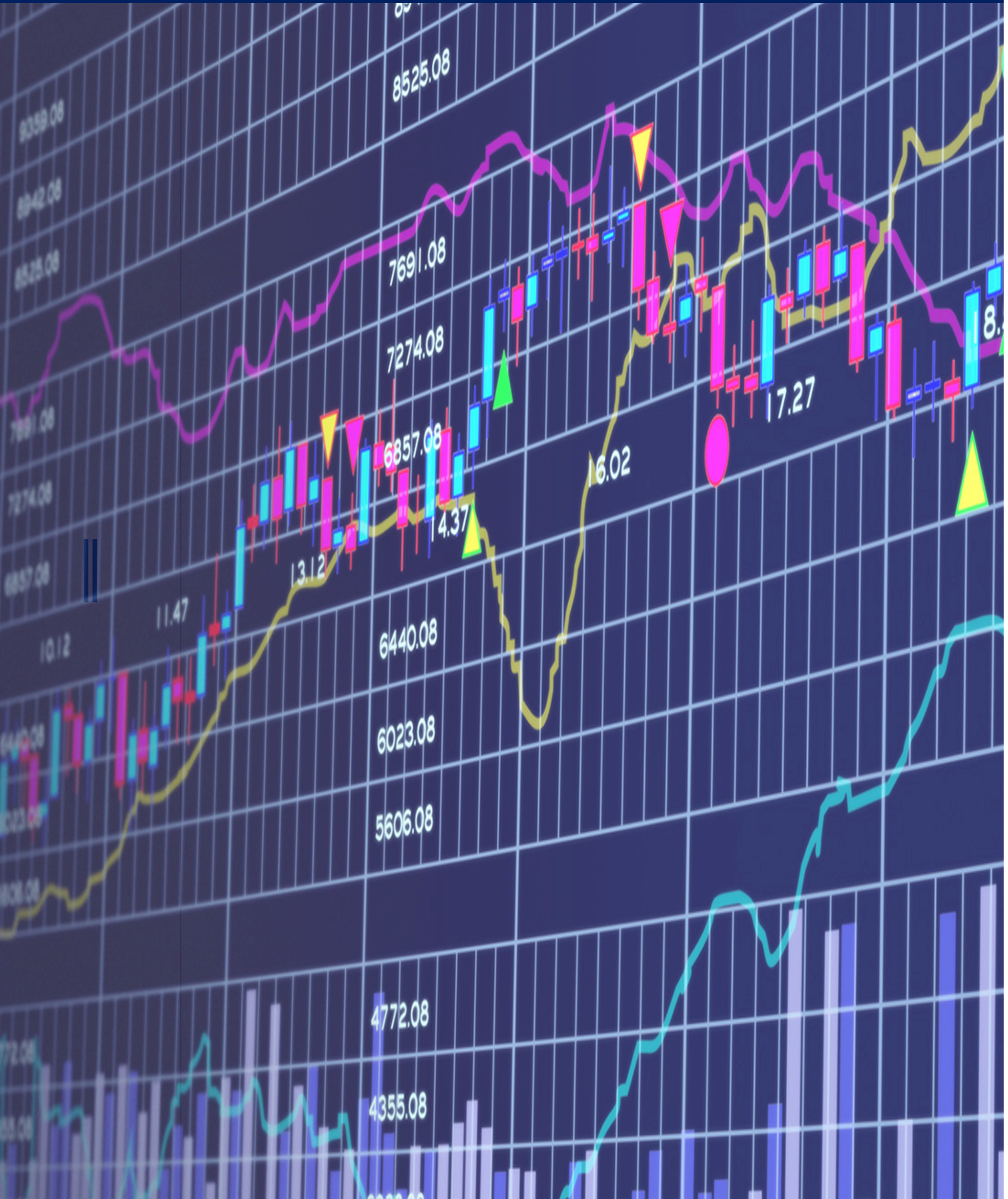
Costs of Inflation

Effects of income redistribution	Effects on production and investment
• Fixed income earners lose out – Yreal falls • Demand-pull inflation generally widen profit margins • Cost-push inflation may squeeze profit margins. • In general, consumers lose out if inflation causes Yreal to fall • Savers lose out-value of money eroded • Debtors gain, creditors lose out. In general, inflation tends encourage borrowing and discourage lending.	• Mainly depends on the extent of inflation ➢ Favourable to economic growth – profits rise, costs lag behind ➢ Sends the wrong signals to produces if inflation is unexpected ➢ Creates uncertainty ➢ Increases speculation
Effects of income redistribution	**Other effects**
• Depends on the extent of inflation with respect to other countries. Consider the situation in which the domestic market experiences greater inflation that foreign markets ➢ Exports become less competitive in foreign markets, foreign imports become more competitive in domestic markets	• Wage spiral (higher prices→demand for higher wages→higher wages→ higher prices etc.) • Stimulus: depends on the level of employment at which the economy is at ➢ Consider the different effects of cost-push and demand-pull inflation

<u>Policies to correct inflation</u>

- Demand-pull inflation: Contractionary fiscal and monetary policy, Supply-side policy
- Cost-push inflation: Supply Side policy
- Imported inflation: Exchange rate policy

Balance of Payment



BOP

A BOP is in **equilibrium** if annual trade is in overall balance and the exchange rate remains stable

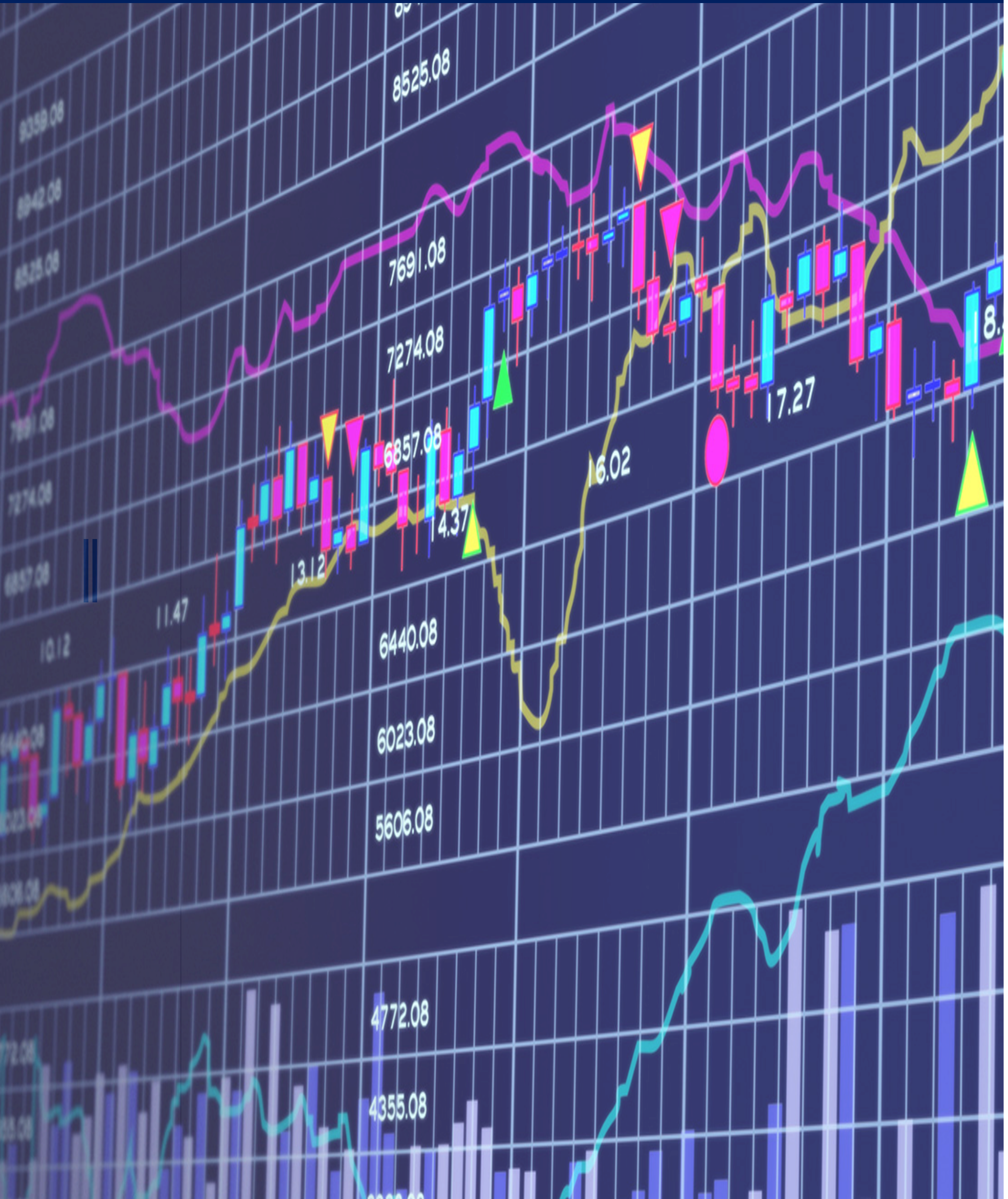
Causes of disequilibrium

- High MPM – caused by a preference for foreign products leading to trade deficits. In Singapore's case may be due to lack of natural resources
- Changes in pattern of demand
- Changes in pattern of production – production may shift overseas
- Changes in terms of trade – if DD_M is price inelastic, a fall in imported goods may mean that BOP improves
- Exchange rates – appreciations of domestic currency means that imports are cheaper
- Inflation
- Cyclical and monetary changes – and increase in GDP due to higher AD means that imports become cheaper.
- Institutional changes
- Sociopolitical factors

Consequences of persistent BOP disequilibrium

Persistent Deficit	Persistent Surplus
Foreign reserves/exchange rates – foreign reserves decline, borrowing may be necessary to finance deficit, currency may depreciate and consequently, external purchasing power declines. External debts incurred, the servicing of which leads to further outflows of currency	Other countries' deficit – another country's deficit may become a problem for the country with a surplus in the future
Reduction investments – a persistent deficit implies problems in a country. This leads to a loss of confidence and thus investments	Short term capital flows my result in speculation, causing an appreciation in a country's currency. Exports become less price competitive
Employment – if deficit is due to higher cost of production, a persistent deficit may imply further job loss is a present threat	Inflation – if the surplus is due to an increase in AD, inflationary pressures may occur if the economy if close to full employment level

Balance of Payment



Policies to correct BOP Deficit

1. Expenditure reducing policies-contractionary fiscal and monetary policies
   - Reduce incomes to reduce demand for imports
     - Producers will turn to overseas markets → X ↑
   - Raise interest rates to draw in hot money
   - Reduces inflation but at the expense of Economic Growth
     - X become more price competitive

2. Expenditure switching policies-lowering exchange rate
   - Devaluation of domestic currency: Exports get cheaper while imports get more expensive and assuming marshall-lerner condition holds, this will improve trade balance

[Evaluation]
- May be ineffective if X and M demand is price inelastic
- Trading partners may retaliate by devaluing their currencies
- Spare resources must be available to meet the increase in demand for exports
- This may result in imported inflation
- J-curve effect: it gets worse before it gets better
  - Current account may actually worsen in short run after devaluation
  - X will fall
  - M will increase
  - It takes time for consumers to adjust to price changes
  - SG context: X competitiveness will worsen because we are highly import reliant and hence out X consist of high import content. Therefore, BOP will worsen

3. Supply-side policies
   - This is the most effective policy but it takes time to work. Hence usually goes hand in hand with other policies to complement it
   - To increase output and quality of X and hence increasing price competitiveness