

Macroeconomic Aims and Issues Cheat Sheet

Definitions

Economic Growth = Refers to actual growth and potential growth

Actual Growth = Increase in real GDP of a country over time measured by annual % change in real GDP

Potential Growth = Increase in the production capacity of the economy for a given period of time

Inflation = A sustained increase in the general price level over time

Unemployment = The situation where people who are available for work and are actively seeking work cannot find jobs

Full Employment = The level of employment that results from the efficient use of the labour force after allowance is made for the natural rate of unemployment

Balance of Payments = The record of the receipts and payments arising from a country's international transactions with the rest of the world over a period of time

Economic Growth

Benefits

1. **Actual Growth \Rightarrow \uparrow current mSOL
2. **Potential Growth \Rightarrow \downarrow Inflation (Demand-pull inflation)
3. **Potential Growth \Rightarrow \uparrow future mSOL
4. ** \downarrow Income Inequality due to \uparrow tax revenue for redistribution of income \Rightarrow \uparrow mSOL + nmSOL
5. ** \downarrow Unemployment (esp cyclical unemployment)
6. **Actual Growth \Rightarrow \uparrow nmSOL as society has greater ability to spend on healthcare, education and caring for the environment
7. Actual Growth \Rightarrow Potential Growth

Costs

1. \uparrow Income Inequality as rich tend to get richer \Rightarrow \downarrow nmSOL
2. Achieving economic growth may lead to \uparrow environmental costs (negative externalities)
3. Depletion of scarce resources \Rightarrow \downarrow productive capacity

Inflation

How to explain demand-pull inflation

1. Assume that the economy is initially operating in intermediate range of the AD curve
2. $\uparrow C, I, G, (X-M) \Rightarrow$ m.t.p. \uparrow in AD represented by rightward shift in AD curve
3. $\uparrow AD \Rightarrow$ shortages in the economy as current spending (Y_{AD}) $>$ current production (Y_0) at initial GPL

4. Firms draw on existing inventories to meet \uparrow sales
5. \downarrow Existing inventories \Rightarrow Firms employ more workers and resources to \uparrow output
6. As economy approaches full employment, \uparrow output \Rightarrow \uparrow scarcity of resources \Rightarrow \uparrow competition for increasingly scarce resources \Rightarrow Firms bid up factor prices \Rightarrow Higher prices required as an incentive for firms to increase production to ensure that production remains profitable
7. GPL rises until disequilibrium is eliminated at equilibrium price, P_1 , and equilibrium real NY, Y_1
8. \uparrow real NY \Rightarrow \uparrow consumer and business confidence \Rightarrow $\uparrow C$ and $I \Rightarrow$ Further $\uparrow AD$ from AD_1 to $AD_2 \Rightarrow$ Further $\uparrow GPL$ from P_1 to P_2

How to explain cost-push inflation

1. \uparrow in cost of production due to [reason] \Rightarrow upward shift of the AS curve from AS_0 to AS_1 as shown in Fig. 1
2. Shortages at prevailing price level
3. Firms raise prices in order to maintain their profits
4. $\uparrow GPL \Rightarrow \downarrow$ spending on goods and services $\Rightarrow \downarrow$ real NY
5. GPL rises until shortage is eliminated at eqm price P_1 and eqm national income Y_1
6. If prices are expected to increase further, workers will ask for higher wages \Rightarrow Further $\uparrow COP \Rightarrow AS$ curve shifts from AS_1 to $AS_2 \Rightarrow$ Further $\uparrow GPL$ from P_1 to P_2

Types of cost-push inflation:

- Wage push
- Profit push
- Imported inflation
- Tax push
- \uparrow Factor prices

How to explain wage-price inflationary spiral

1. Demand-pull inflation/Cost-push inflation $\Rightarrow \uparrow GPL$
2. Trade unions see \uparrow in prices and argue for \uparrow wages for workers
3. $\uparrow COP \Rightarrow$ Cost-push inflation $\Rightarrow \uparrow GPL$
4. Cycle repeats itself
5. When inflation is poorly managed it will result in an inflationary spiral

Benefits

1. \uparrow Certainty in prices $\Rightarrow \uparrow C, \uparrow I$ (due to \uparrow certainty) \Rightarrow Promotes Economic Growth $\Rightarrow \downarrow$ Unemployment
2. \uparrow Savings $\Rightarrow \uparrow SS_{LF} \Rightarrow \downarrow i/r \Rightarrow \uparrow I$
3. Assuming domestic inflation lower than in other countries, $\uparrow(X-M) \Rightarrow \uparrow$ BOT position \Rightarrow Improvement in current account \Rightarrow Improvement in BOP + EG + \downarrow Unemployment
4. Maintain purchasing power of income \Rightarrow Maintain current mSOL
5. Economic agents can take actions to protect themselves from inflation \Rightarrow Maintain future SOL
6. Protect real value of savings (esp in Singapore with high savings rate due to CPF)
7. $\downarrow DD$ for imports + $\uparrow DD$ for exports $\Rightarrow \downarrow SS$ of local currency + $\uparrow DD$ of local currency \Rightarrow Appreciation of local currency

Costs

1. Achieving low inflation through contractionary monetary policy may lead to \downarrow economic growth

Costs of High and Unstable Inflation (apart from opp of benefits of low stable inflation)

1. Erosion of purchasing power of money $\Rightarrow \downarrow$ mSOL
2. Hoarding of consumer goods \Rightarrow Greater \uparrow in inflation
3. Shoe leather and menu costs \rightarrow Diverts funds from productive to unproductive investments
4. Misallocation of resources as prices lose signalling function
5. Arbitrary redistribution of income $\Rightarrow \uparrow$ Income inequality
 - o From those on fixed incomes to those with assets e.g. property
 - o Savers lose out, borrowers benefit
 - o Pensioners likely to be badly hit

Costs of Deflation

1. $\downarrow C$ as consumers opt to postpone demand + $\downarrow I$ as firms expect lower profits in future
2. \uparrow Real cost of borrowing $\Rightarrow \downarrow I$ and $\downarrow C$
3. \uparrow Real burden of debts $\Rightarrow \downarrow$ consumer confidence
4. $\downarrow C, I \Rightarrow \downarrow AD \Rightarrow \downarrow AG + \downarrow PG$

Unemployment

Frictional Unemployment

Definition: Unemployment that arises as workers search for suitable jobs and firms for suitable workers

Solutions:

- Provision of better job information by govt job centres, private employment agencies and national newspapers
- Reduction in level of unemployment benefits to make unemployed more desperate to get a job and be prepared to accept a lower wage

Structural Unemployment

Causes:

- Occupational immobility of labour
- Geographical immobility of labour

Changes in demand

1. ↓ DD for a country's goods and services
2. ↓ Production ⇒ ↓ Labour since labour is a derived demand
3. ↑ Unemployment in the declining industry
4. Structural unemployment exists as new job vacancies require skills that they do not have

Changes in supply

1. ↓ SS due to high COP/exhaustion of raw materials
2. Firms forced to close down due to exhaustion of raw materials/unprofitability
3. ↑ Unemployment
4. Structural unemployment exists as new job vacancies require skills that they do not have

Solutions:

- Supply-side:
 - Encourage workers to be more willing to undergo retraining/accept a reduced wage
 - Provide subsidies for retraining programmes
- Demand-side
 - Provide grants to firms to create jobs in areas with severe structural unemployment

Cyclical Unemployment

Increase in cyclical unemployment

1. Fall in AD represented by leftward shift of AD curve
2. Firms unable to sell their current level of output and stocks of unsold goods get built up
3. Firms start to cut back on production
4. ↓DD for labour since it is a derived demand
5. ↑ Unemployment assuming real wages are downward sticky

Fall in cyclical unemployment

1. Increase in AD leads to depletion of stocks in economy
2. Firms step up production to increase stocks and in the process employ more factors of production including labour
3. Fall in demand-deficient unemployment

Solutions:

- AD-management policies

Costs

1. ↑ underutilisation of resources ⇒ Output loss ⇒ ↓G&S produced ⇒ ↓ mSOL
 - ↓ profits for firms
 - ↓ additional wages that could have been earned from higher output for workers
2. ↓ Productive capacity in the LR due to hysteresis
3. Negative impact on government budget due to ↓T and ↑G on unemployment and welfare benefits
4. ↑ Social problems

Benefits of low unemployment (apart from opp of costs of high unemployment)

1. Associated with higher real economic growth due to rises in AD and AS
2. Some frictional unemployment allows individuals to better match their skills and preferences with the requirements of the jobs + employers to select more suitable applicants ⇒ ↑ productivity ⇒ ↑ output + profits for the firm in the LR
3. Some structural unemployment is often inevitable as CA changes over time due to changing international conditions

BOP

Costs of persistent BOP deficit

- Depletion of foreign reserves in order to maintain exchange rate ⇒ {Needs to be financed ⇒ ↑ public debt ⇒ ↓ future mSOL} + ↓ Ability to ward off potential

speculative attacks

- Likely to lead to outflow of hot money as investors are worried about ability of country to maintain value of the currency
- Current account deficit due to $\downarrow(X-M) \Rightarrow \downarrow AD \Rightarrow \downarrow AG$
 - However, could be due to import of capital goods which would $\uparrow AS$ in LR
 - Could help to moderate demand pull inflation
- Financial account deficit due to $\downarrow FDI \Rightarrow \downarrow \text{funds for } I \Rightarrow \downarrow AG + \downarrow PG$

Costs of persistent BOP surplus

- Current account surplus due to $\uparrow(X-M) \Rightarrow \{\uparrow AD \Rightarrow \uparrow \text{Inflation}\} + \{\text{If due to } \uparrow X, \text{ could mean } \downarrow \text{G\&S available for domestic consumption assuming real NY remains constant} \Rightarrow \downarrow mSOL\}$
 - Could help to lead to AG
- Large BOP surplus in one country \Rightarrow Large BOP deficit in other countries \Rightarrow Other countries may adopt protectionist measures
- Dutch disease: $\uparrow X$ in one sector \Rightarrow Appreciation of currency $\Rightarrow \downarrow X$ in other sectors
 - However, allows accumulation of foreign reserves if country chooses to depreciate exchange rate

Solutions:

- Protectionism
 - Tariffs
 - Export subsidies
- Supply-side policies
- Depreciation of exchange rate
- Contractionary FP/MP to $\downarrow M$ and \downarrow inflation

Benefits of stable exchange rate

- Greater certainty in predicting profits $\Rightarrow \uparrow FDI \Rightarrow \uparrow \text{funds for } I \Rightarrow \uparrow AD \Rightarrow \uparrow AG + \uparrow PG$

Costs of unstable exchange rate

- \uparrow likelihood of speculative attacks on the currency \Rightarrow May cause currency to depreciate/appreciate excessively

Income Inequality

Benefits of \downarrow Income Inequality

- Promotes social cohesion
 - ↑ sense of fairness
 - ↑ social mobility + avoids middle income squeeze
 - Poor have their basic needs satisfied
 - ↓ number of strikes and riots
- ↑SOL
 - Poor have higher MPC than rich ⇒ For the same ↑ income, poor would consume more goods than rich ⇒ Overall ↑mSOL in the country
 - ↓ crime rates ⇒ ↑nmSOL
- Economic growth
 - ↑ political and economic stability + ↓ crime rates ⇒ ↑I due to more conducive business environment
 - Avoid middle income squeeze ⇒ ↑ morale ⇒ ↑ productivity + ↓ brain drain ⇒ ↑ productive capacity ⇒ ↑AS

Benefits of Income Inequality

- Allocative function of moving resources into activities where returns are superior
- Incentive to work hard, innovate and be enterprising ⇒ ↑ productivity