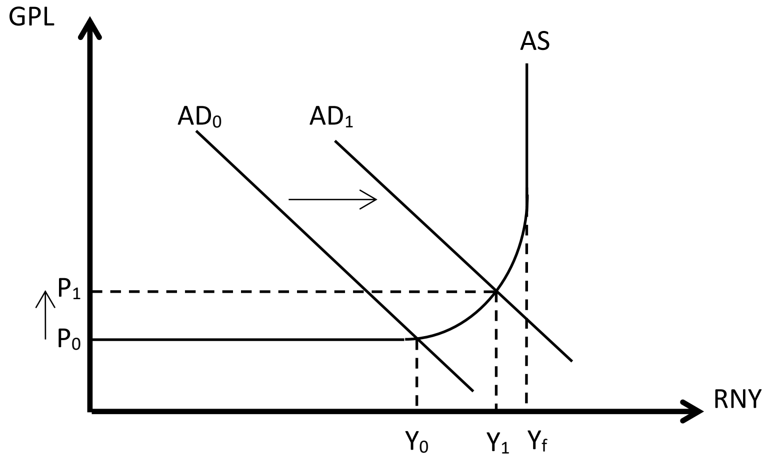
N2016 H1 CSQ 1- suggested answers

(a)	**Using the data from Fig. 1, summarise how the cost of living in the UK had changed over the period 2008-2014.**		**[3]**
	The cost of living has been rising constantly over the period due to inflation rate being positive throughout. [1m] The cost of living increased by the greatest extent towards the end of 2008 before the rate of increase in cost of living fell to its' lowest point in October 2009. [1m] Subsequently the rate of increase in cost of living increased gradually till the end of 2011 and it has been falling since then. [1m]		
(b)	**Using Fig. 1, explain how the data might be used to estimate changes in the average standard of living in the UK over this period.**		**[3]**
	In 2008, the growth in real wage is about 2% [4%-2%]. Meaning in 2008, the increase in wage is rising faster than inflation rate and this lead to a rising real wage. Therefore, there is a rise in purchasing power. In 2014, the growth in real wage is -0.3% [1.4%-1.7%]. Meaning to say the increase in wage is rising slower than the increase in inflation rate and this lead to fall in real wage. People now has lower purchasing power. Thus, there is a change from a higher purchasing power to a lower purchasing power from 2008 to 2014. Thus, there is a fall in ability to purchase goods and services for consumption and there is a fall in material standard of living.		
(c)	**With reference to Extract 1:**		
	(i)	**Suggest how the overall inflation rate over the period 2008—2013 is possible, given the rise in food and energy prices over the same period.**	**[2]**
		The overall inflation rose by 20% although food prices rose by 30% and energy prices rose by 60%, faster than overall inflation rate. This is possible as the overall inflation rate is measured by the Consumer price index (CPI) which tracks the changes in prices of a weighted basket of goods and services consumed in the UK. For overall inflation to be lower than the increase in food and energy prices, this suggests that food and energy do not form significant components of a consumers' total expenditures of goods and services.	
	(ii)	**Comment on the suggestion that higher income earners suffered most over the period.**	**[4]**
		[Perspective 1]There is some validity in the suggestion that higher income earners suffered most over the period as they are on average worse off by 9% while middle income households real income declined by 6% and low income earners were worse off by 2.4%. This is because "earnings had increased more slowly than prices" suggesting that real disposable income of the higher income earners has been falling. Compared to lower income earners, the welfare benefits provided by the government has "kept pace with inflation". This suggests that the purchasing power of the lower income earners have not fallen significantly as they continue to receive benefits that are adjusted to the inflation rates. **[Perspective 2]** On the other hand, higher income earners may not have suffered the most as despite the rise in expenditures on food and energy, these expenditures take up a small percentage of total spending. Hence, the net impact on their purchasing power is minimal. Also, if high income earners are also asset	

		owners, the increase in prices would lead to higher levels of wealth and hence, they may not have suffered most. **[Alternative perspective 1]** For the high income earners, expenditures on food and energy take up a smaller percentage of their income and hence, demand for these goods will be price inelastic. Thus, with a rise in prices, there will be a less than proportionate fall in quantity demanded and hence, an increase in total expenditure. Thus, higher income earners would have suffered most in terms of the increase in total expenditure whereas for low income earners, the increase in price would lead to a more than proportionate fall in quantity demanded and a fall in total expenditure. **[Alternative perspective 2]** Low income earners may also have to switch to inferior goods. Hence, this may lead to a fall in material standard of living. Overall, it is difficult to ascertain whether higher income earners suffered most over the period as different consumers have different consumption patterns and their consumption of energy and food may have changed over the period. Thus, the changes in prices may not have had a significant impact on higher income earners.	
(d)		**With reference to Extract 2 and 3, explain two reasons why government tend to 'fear' a period of price deflation.**	[4]
		One reason why government fear deflation as mentioned in Extract 2, people might postpone their consumption and wait for lower prices as they form expectation of future price to fall. This will cause a decrease in C, fall in AD and it will lead to a fall in national income. One other reason for why government fear deflation as mentioned in Extract 3 is people might reduce consumption so as to service their debts and the fall in consumption might be a long-term issue that can possibly cause another great depression as it has happened in the 1930s as massive unemployment might occur as a result of the fall in national output. Labour is a form of derived demand, the lesser output a country produced, lesser labour will employed. Thus, this might lead to an increase in demand deficient unemployment.	

(e)	**With reference to Extracts 3 and 4, and using AS/AD analysis, explain why interest rates in the eurozone were cut in September 2014 but no such cut was expected in Singapore.**	**[6]**
	The eurozone is expected to fall into a deflationary trap with falling Aggregate Demand (AD) as consumers consume less to service rising debts. The European Central Bank (ECB) has cut interest rates in September 2014 to raise AD and maintain price stability in the eurozone. When interest rates are cut, this leads to a fall in cost of credit and a lower opportunity cost for consumption. This would lead to an increase in consumption expenditure (C) by consumers as they are more willing and able to take up loans to purchase big ticket items. This tackles the issue of falling levels of spending as mentioned in Extract 3. Furthermore, lower costs of credit would make previously unprofitable investment projects profitable. Firms would also be incentivised to increase their level of investment expenditure (I). An increase in C and I would lead to an increase in AD (AD = C+I+G+X-M) as shown in fig. 1 below.  As AD rises, this leads to an increase in the derived demand for labour and higher competition for remaining spare resources in the economy. Firms will have to pay a higher wage rate to attract labour, resulting in higher unit costs of production incurred and some of these costs will be passed on to the economy in terms of higher general price levels (as prices increase from P_0 to P_1). Furthermore, this leads to a fall in demand deficient unemployment and an increase in real national income from Y_0 to Y_1. Thus, lower interest rates raises the level of inflation in the eurozone and prevents the zone from falling into a deflationary trap by increasing the level of AD. [2] On the other hand, there is no need for the Singapore government to expand the economy as the lower inflation rates are "largely the result of one-off supply-side factors in transport and housing". Lower transport costs will lead to a fall in unit cost of production and an increase in SRAS. This leads to a fall in prices but also an increase in real national income. Thus, the reason for lower prices is different between Singapore and the Eurozone and there is no fear of Singapore facing falling AD and hence, falling national income. Furthermore, other sectors in the economy, such as the services sector continue to experience high inflation rates. Therefore, cuts in interest rate or expansionary monetary policy will not be expected in Singapore. [2m] Furthermore, due to the nature of the Singapore economy that is open and small, the economy is open to inflow and outflow of capital which makes it impossible for the economy to control interest rates. Hence, the Singapore government is more likely to continue using exchange rates to manage the Economy. [2m]	

(f)	**Explain and evaluate one supply-side policy that the Singapore government might choose in order to achieve a reduction in the core rate of inflation.**	**[8]**

Based on Extract 4, Singapore is currently facing wage push inflation. The tight labour market has led to a fall in labour supply and this has caused an increase in wage. The increase in wage will then affect firms as their cost of production has gone up thus leading to wage push inflation.

One supply side policy that the Singapore government can adopt is the long run supply side policy of developing human capital. Singapore government can invest in education and training for Singaporeans. By providing education and chances to upgrade labour skills, the knowledge possessed by workers will go up and at the same time, their skills will go improve after attending specific training. This will help to increase the total labour productivity and leading to an increase in productive capacity. This will then lead to a shift in the Long Run Aggregate Supply curve (LRAS) to the right. As shown in the diagram below, a shift of the LRAS curve will then help to lower core inflation as the general price level fall from Po to P1.

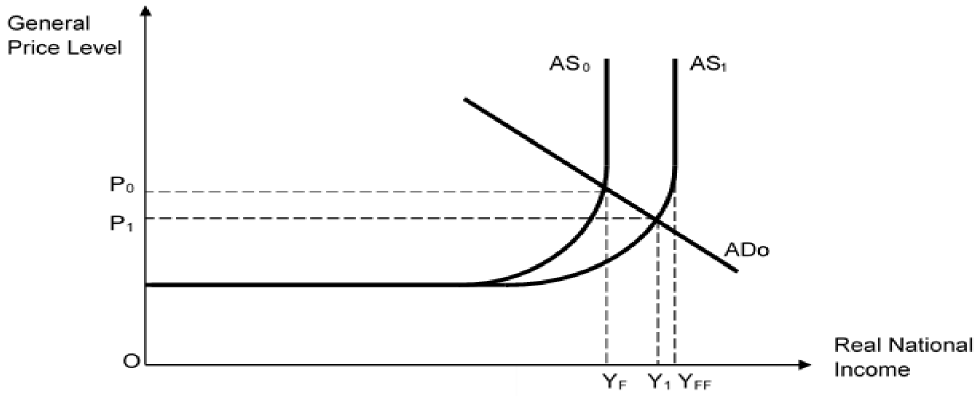


Figure 1: Increase in LRAS and Its Effects on GPL

I would then evaluate this long run supply side policy by looking at the effectiveness and limitations of this policy. Firstly, one strength of this policy is that it will have the extra knock on effect on the Short Run Aggregate Supply (SRAS) curve as well. When workers become more productive after attending their training curve, this will also help firms to lower cost per unit of production. This is possible as workers will be getting similar pay package as before and yet the output he or she can produce goes up. This helps to lower cost per unit of production. This helps firms to lower their SRAS curve and this helps to lower core inflation further. This policy is effective as it targets the root cause of the problem, which is the rise in SRAS due to tight labour market in Singapore.

By developing our human capital, Singapore will also become more attractive to foreign direct investment (FDI). With more FDIs coming into Singapore, there could be more transfers of skills and knowledge to our country. Thus, with this, it will increase our labour productivity further and shifting LRAS out to a large extent than before and it brings about bigger spare capacity. This will help us to lower core inflation further in the long run.

One limitation is that there is a time lag to produce results because it takes time to train workers. There is a lack of incentives for firms to go for training. Firms may not want to spend workers for training as there will be loss of output during training. Workers face difficulties in learning new skills especially the elderly. Thus, the increase in labour productivity might be minimal and will not help much in reducing core inflation.

One other limitation could be by investing in policy of developing human capital, it will forgo their expenditure on other area of concerns to Singaporeans. They might incur the opportunity cost in terms of forgoing expenditures on national defence or healthcare.
In conclusion, the use of this long-term supply side policy is a timely and relevant one. With the tight labour market, the retraining provided by government also helps to reduce occupational immobility problem as it will lead to increase in supply of workers in sunrise industry. Therefore, Singapore government should adopt this policy to ease the tight labour market.

Levels	Descriptors	Marks
L1	For an answer that provide general and superficial description of a supply side policy without any attempt at giving any strength or limitation.	1-2
L2	For an answer that provide balanced explanation of a relevant supply side policy with one strength and or one limitation.	3-4
L3	For an answer that provide thorough and balanced explanation of a relevant supply side policy with strengths and limitations (at least 2 strengths with one limitation or one strength with two limitations)	5-6
E1	Stand made with no justification	1
E2	Stand made with justification based on context and given situation	2