

**Q.31**

Topic:	Inflation situation in the US and its monetary policy
Relevant economic topics:	Demand and supply, aggregate demand and aggregate supply, inflation, monetary policy, exchange rate
Types of material:	Line graph, news excerpt, opinions
Question design: (total marks: 24 marks)	Elementary-level questions (13 marks); Advanced-level questions (11 marks)

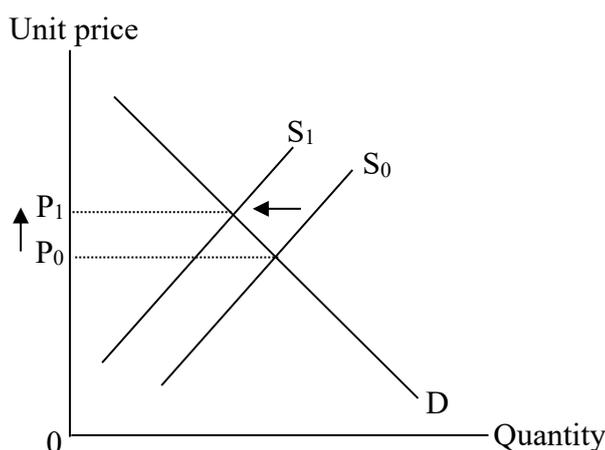
- (a) (i) The median one-year ahead expected inflation rate in the second half of 2020 was lower than the year-on-year percentage change of the consumer price index in the second half of 2021. (1 mark)  
 There was unexpected inflation in the second half of 2021. (1 mark)
- (ii) The employee would lose, (1 mark)  
 because the unexpected inflation would lower the purchasing power (real value) of the fixed wage. (1 mark)

(b) Verbal elaboration:

- A shortage of workers caused the supply of imported goods to decrease. (1 mark)
- The price of imported goods increased. (1 mark)

Indicate in the diagram:

- leftward shift of the supply curve (1 mark)
- price increases (1 mark)



- (c) The supply chain issues caused the short run aggregate supply of the US to decrease. (1 mark)

A contractionary monetary policy, e.g. raising the interest rate, would reduce consumption/investment, causing the aggregate demand to decrease. (1 mark)

If the decrease in the short run aggregate supply has a greater effect on the price level than the decrease in the aggregate demand, the price level will increase. (1 mark)

- (d) Marks award for effective communication (EC: max 2 marks)

Marks	Performance
2	<ul style="list-style-type: none"> <li>● <i>Arguments supported with the source/data and appropriate economic theories</i></li> <li>● <i>Relevant materials presented</i></li> <li>● <i>Well-organised and coherent answers presented without repetition of ideas</i></li> <li>● <i>Ideas clearly and fluently expressed with an appropriate use of language/words/terms/symbols</i></li> </ul>
1	<ul style="list-style-type: none"> <li>● <i>Arguments presented with some support of the source/data and economic theories</i></li> <li>● <i>Some irrelevant materials presented</i></li> <li>● <i>Answers presented in a less organised way with some repetition of ideas</i></li> <li>● <i>A clear message conveyed with some inappropriate use of language/words/terms/symbols</i></li> </ul>
0	<ul style="list-style-type: none"> <li>● <i>Arguments presented with no support of the source/data and economic theories</i></li> <li>● <i>Materials unrelated to the gist of the question presented</i></li> <li>● <i>Inconsistent arguments presented</i></li> <li>● <i>Limited ideas expressed with an inappropriate use of words/terms/symbols</i></li> </ul>

The maximum marks for content is 9 marks. Answers may include the following:

Employment level

- In the short run, raising the interest rate will reduce consumption/investment, causing the aggregate demand to decrease. The employment level will decrease. As there are more job openings than unemployed workers, the employment level may still be higher than the full-employment level even if it decreases.
- In the long run, raising the interest rate will not affect the productive capacity

of the US, the employment level will remain at the full-employment output level.

Tax revenue

- In the short run, raising the interest rate will reduce consumption/investment, causing the aggregate demand to decrease. Aggregate output will decrease. A decrease in average household income will lead to a decrease in income tax revenue.
- An increase in the US's interest rate will cause an appreciation of the US dollar against other currencies. The export price of the US (in terms of foreign currencies) will increase, causing a decrease in the competitiveness of US exports to other countries. Export-related industries will suffer and their profits will decrease, causing a decrease in profits tax revenue.

Trade balance

- Other things being constant, an increase in the US's interest rate will cause the US dollar to appreciate against other currencies. Assume the export price of the US (in terms of the US dollars) does not change. The export price of the US (in terms of foreign currencies) will increase, and the export volume will decrease. The export value of the US (in terms of the US dollars) will decrease.
- The import price of the US (in terms of the US dollars) will decrease, and the import volume will increase. The import value of the US (in terms of the US dollars) may increase, decrease or remain unchanged, depending on US's price elasticity of demand for the imported goods.
- The change in the US's trade balance depends on the relative extent of the changes in the export value and the import value. If the import value increases or remains unchanged, or the decrease in the export value is greater than the decrease in the import value, the US's trade balance will worsen. If the decrease in the export value is smaller than the decrease in the import value, the US's trade balance will improve.

(e) Measure:

- The government can adopt a fiscal policy, e.g. raising the income tax rate, to reduce the aggregate demand and thus lower the price level.
- The government can import more labour to relieve the shortage of labour, increasing the short run aggregate supply and thus lowering the price level.
- Any reasonable answer

(Mark the FIRST POINT only, 2 marks)