

Q4.

Household final consumption expenditure in 2013 as a proportion of the country's GDP was 38% for Singapore and 69% for USA.

Source: <http://data.worldbank.org/indicator>, accessed 25 July 2014

Discuss whether raising consumption is the best approach for sustaining economic growth.

[25]

Answer requirements:

- Examine the strengths and limitations of consumption-led growth strategy.
- Offer other policies, such as export-led and supply-side policies, for overcoming the limitations of consumption-led growth.

Introduction

- Unpack conceptual terms in the question
 - Definition of consumption expenditure: expenditure on goods and services by households, inclusive of import content in the expenditure.
 - Components in consumption: autonomous consumption (rise in consumption due to non-income factors) and induced components (rise in consumption due to rising national income).
 - Sustained economic growth: the ability of a country to continue growing domestic production (real GDP); this ability requires country to continue having potential growth, which is expansion in productive capacity through having more resources or improvement in the productivity of resources. **Essential** to point out that to sustain economic growth a country has to grow both aggregate demand (AD) and productive capacity (LRAS).
- Growing through raising consumption refers to growth strategy that is domestic-led, possibly through continuous expansionary fiscal and monetary policies which encourage household spending. This approach can work for countries with large domestic population but there are limits in terms of sustaining the growth in the long term if there is lack of potential growth or economic problems such as rising household debt due to over-consumption and over-borrowing.
- Increasing emphasis on consumption as an approach to sustaining economic growth is indicated by the larger proportion of consumption to GDP.

Body

Thesis: Raising consumption can contribute to sustaining economic growth

Argument 1: An autonomous increase in consumption leads to economic growth

- Raising autonomous consumption, for example through low interest rate policy, could lead to an increase in national output and hence economic growth. An increase in autonomous consumption would increase aggregate expenditure causing magnified increase in national output through the **multiplier process**.
- Explain briefly the multiplier effect using Y-AE diagram. An increase in autonomous consumption will cause an initial increase in income by the same extent. This initial injection increases the income of the manufacturers of the consumption goods. This increase in income will induce further consumption while part of this increase in income is withdrawn from the circular flow in the form of saving, tax and imports. This induced consumption

will further increase the national output and hence income of another group of producers, which will once again induce consumption. Process continues to generate actual economic growth.

Argument 2: A rise in consumption could raise the marginal propensity to consumption (MPC) in the country, hence raising the effectiveness of domestic management policies for greater growth stability

- The size of multiplier depends on size of MPC.
- In order to raise consumption level in the country, government may need to implement policies that will raise the purchasing power of households so that households could consume. Government could raise the minimum wage, reduce tax and raise social security to encourage householders to consume more and save less. Such measures would raise the MPC while reducing the MPS and MPT. A larger MPC would mean that household would spend a larger proportion of the **increase** in income for consumption.
- Conversely, a smaller MPT and MPS would mean that household would save and be taxed a smaller proportion of the **increase** in income. This smaller MPS and MPT would mean that at each time the leakage out of the circular flow of income will be smaller.
- The larger multiplier will make the domestic policies more effective as a counter cyclical approach to reducing volatility in economic growth.
- Unlike countries such as Singapore and Ireland which depend on external demand to drive economic growth, the dependence on external demand would mean that government of these countries have to depend on supply-side policies to increase competitiveness of the export and attempt to reduce fluctuation of external demand, ensuring sustain EG.
- The effects of supply side policies may vary and may not effectively allow countries to achieve its aims. However, with the emphasis on consumption, the large MPC and APC would mean that government could use its demand management policies to effectively manage AD to achieve the aim of sustained EG.

Argument 3: Explain how raising consumption could reduce vulnerability of the economy to external shocks

- Raising consumption on domestic consumption could reduce vulnerability of the economy to external shocks such as the Global Recession in 2008-09. In Singapore, one of the approaches the government had taken then was to adopt the Jobs Credit Scheme in order to keep consumption demand stable and domestic economy going.
- Thus should there be an external shock, the impact on domestic growth would be reduced as the domestic consumption is able to support EG - the extent of fall in national income could be minimal due to the high APC in the country.

Anti-Thesis: However, consumption-led growth strategy is not be the best approach as not all countries have the ability to adopt this to sustain EG and for all countries, rising consumption cannot sustain EG because potential growth through investment and other supply-side improvements are needed as well.

Argument 1: Consumption-led growth is not appropriate for countries with small population

- To a certain extent, consumption-led growth is only appropriate for countries with large population. Countries like Singapore with small domestic market and open economy may find such approach unsuitable due to the small multiplier. The small multiplier would mean that an increase in consumption will not lead to substantial EG.
- Singapore has a smaller APC of 38% compared to countries like USA with an APC of 69%. This smaller APC indicates that Singapore has a small MPC compare to other countries.
- While Singapore could implement policies to increase the MPC, it is unlikely that Singapore could raise the MPC by a large extent due to import reliance and high savings (high MPM and MPS).

Argument 2: Effect of rising consumption on EG is limited by rising imports

Even if consumption-led growth is attractive to large economies, the extent of benefit on EG is limited by rising imports. Import expansion will also worsen the current account and balance of payments.

Argument 3: If consumption-led growth model is not accompanied by an increase in productive capacity, such approach could lead to demand-pull inflation.

- When there is little spare capacity, raising consumption will lead to demand-pull inflation → erosion of households' purchasing power of household & weakening of economic environment and sentiments for EG.

Transition to suggestion of other economic policies

Raising consumption is not the best approach for sustaining economic growth. Certain conditions have to be met in order for such approach to be adopted. The conditions or criteria include the size of the multiplier and the availability of spare capacity. As mentioned earlier, such approach may not be suitable for a small and open economy like Singapore. But countries like China, USA and India maybe at a better position to adopt such strategy, but even then this is only for the short term because Inflation would likely arise as a result of using consumption to sustain EG. Supply-side policies are needed to grow productive capacity and tapping on growth of external demand to sustain EG.

Supply-side Policies - Explain how supply-side policies lead economic growth

- Training and skill upgrading would increase labour productivity → increasing productive capacity & greater stability of unit labour cost.
- More productive and skilled workforce could attract more investors into the country leading to an increase in AD. An increase in AD coupled with increase in AS would sustain EG.
- Infrastructural growth and high R&D strategies are other ways adopted in Singapore to expand both AD and AS in the long term.

Synthesis

- There are various approaches towards achieving sustained EG in a country. While consumption-led EG is one such approach, it is not the best approach even for large economies because it is primarily demand-sided in effects on economy. While high

consumption has supported growth in years prior to the global recession, this has contributed to the debt problem which triggered the recession.

- Rather than focusing on only one approach to sustain EG, it is necessary to adopt a combination of approaches which improve both productive capacity and the expansion of external demand.
- Countries with large domestic market like China and USA are in a better position to adopt consumption-led growth than small countries like Singapore. China has been moving its emphasis to from an export-led to consumption-led growth because of its excessive reliance on external demand since it opened up the economy. This allows the country to reduce its vulnerability to external shocks while not completely cutting off the other possible growth avenue.
- Unlike China, it is very challenging for Singapore to shift her focus to its own domestic consumption due to the nature and characteristic of its country. Thus Singapore's growth strategy will have to remain export-led.

Level Descriptors for Essay Question 4		Marks
L3	<ul style="list-style-type: none"> • Accurate, well-developed and balanced analysis which considers these: <ul style="list-style-type: none"> ○ Rising consumption and magnified expansion in equilibrium national income ○ The possible expansion in size of multiplier and effect on the effectiveness of domestic management policies as counter-cyclical approach (growth stabilisation) ○ Limitations of consumption-led growth strategy: size of domestic market, demand-pull inflation, size of imports • Recognising the nuances that underpin the effectiveness of consumption-led growth, such as <ul style="list-style-type: none"> ○ Nature/ size of economy ○ Importance of potential growth for growth sustainability (supply-side improvements) 	15– 21
L2	<ul style="list-style-type: none"> • Balanced but primarily undeveloped arguments • Developed analysis but one-sided 	10 – 14
L1	<ul style="list-style-type: none"> • Answer is not addressing issue of sustaining economic growth • Major conceptual errors 	1 – 9
E2	<p>Well-reasoned and supported judgement, using valid factors/criteria to assess whether</p> <ul style="list-style-type: none"> • Raising consumption can sustain growth • Consumption-led growth is best for sustaining growth 	3 – 4
E1	<ul style="list-style-type: none"> • Lack of clarity in focus of evaluation • Making some judgement, but mainly not supported 	1 – 2