# St Andrew's Junior College

# Economics Department

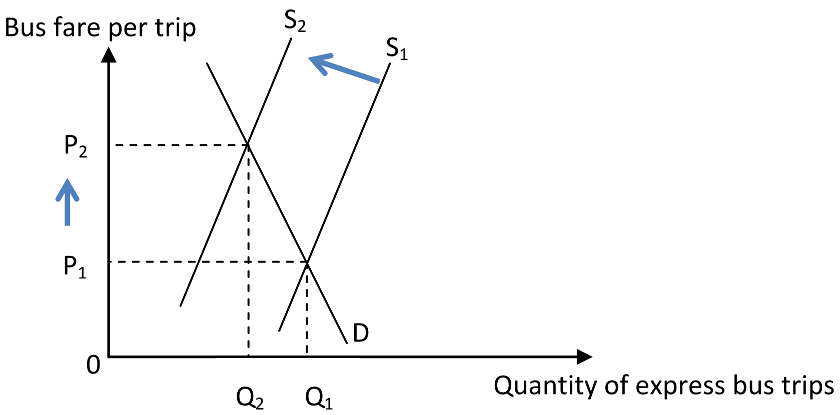
## JC 2 Prelims (2015)

## Examiner's Report

## H1 Economics

## (Syllabus 8819)

**Question 1: Changes in the Markets for Vehicles**

<table>
<tr><td>(a)</td><td></td><td>Compare the trend of the price of crude oil and diesel between 2008 and 2013.<br><br>Similarity [1m]<br>- Prices of both fuel generally increased throughout the period.<br>- Prices of both fuel moved in tandem throughout the period.<br><br>Difference [1m]<br>- Diesel prices were consistently higher than those of crude oil throughout the period.<br>- Prices of Diesel decreased more than than crude oil in 2008.</td><td>[2]</td></tr>
<tr><td>(b)</td><td>(i)</td><td>With the aid of diagram, explain how the changes in price of diesel will affect the market for express bus services.<br><br>Price of diesel increased. Diesel is a factor of production for express bus services, cost of production of Express Bus Services would increase, which will cause the Supply of Express Bus Services to fall [1m]<br>→ Market Pe ↑ and Qe ↓ [1m]<br><br>Optional: TR ↑ (assuming PED < 1)<br><br>Correct Diagram [1m]<br><br><br></td><td>[3]</td></tr>
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|---|---|---|---|
| | (ii) | **Explain how the completion of the High Speed Rail will affect the demand curve for Express Bus Services between Singapore and Malaysia.**<br><br>*Relationship between the two services – substitute*<br><br>- Completion of HSR<br>→ consumers who previously demand for Express Bus Services may switch to HSR [1m]<br><br>→ Demand for EBS would fall, demand curve shift left[1m]<br><br>*Increase in the availability of closed substitutes.*<br>- DD for EBS trips that end in KL becomes more price elastic, larger in PED value [1m] | **[3]** |
| **(c)** | **(i)** | **Explain the rationale behind the new regulation mentioned in Extract 2.**<br>Market failure due to negative externalities in consumption **<u>OR</u>** production<br><br>Identify Qp, state condition (MPB = MPC) [1m]<br>Identify and explain MEC (3rd parties must be clearly identified) [1m]<br>Establish MSC to be MPC + MEC [1m]<br>Identify Qs, state condition (MSB = MSC)<br>Identify DWL from the overconsumption or production of vehicles in text form or in diagram [1m]<br><br>Regulation aims to reduce the MEC which will reduce MSC or increase MPC depending on the way they explained.[1m]<br>Reduction in MSC (shifting MSC down) would increase in the Socially Optimum Level of Output.<br><br>With a higher QSOL, <u>resource allocation are improved as net welfare loss are reduced, DWL reduced.</u> [1m]<br>Or<br>the vehicle using cleaner engine and fuel will be more expensive causing MPC to increase and Qp to decrease. <u>This would reduce the over consumption and reduce the deadweight loss</u><br>***Note: Diagram is not required but strongly encouraged.***<br>***No marks given for diagrams.*** | **[6]** |
| | **(ii)** | **With reference to extracts 2 and 3, discuss whether the new regulation or the banning of diesel vehicles is the key to achieving efficient allocation of resources in the Express Bus Services market.**<br><br>*Question analysis:*<br>- *To identify and explain the pros and cons of each policy in achieving efficient allocation of resources.*<br>- *To provide a judgement on which is the 'key' to achieve AE – which one would better help attain AE.*<br><br>New regulation on emission<br>✓ Strong deterrent of $5000.<br>✓ If correctly measured, DWL could be successfully eliminated – achieve AE.<br>× New emission standards may not sufficiently eliminate DWL if they | **[8]** |

are wrongly measured/computed.
- × Adds administrative/monitoring costs to vehicle owners (private) and firms (delivery vehicles, EBS company, etc)

Total Ban
- ✓ Cheap, quick and easy to implement
- ✓ Improvement in air quality almost immediately after implementation
- × Unlikely to be allocatively efficient outcome – continued existence of DWL

Possible evaluation:
- Given strong law-enforcement and law-abiding culture/practice in Singapore, either method should be able to deliver its intended outcome. With increasing precision in the estimation of MEC, new regulation ought to be key in achieving AE compared to total ban, the latter of which tends to produce DWL even if one assumes it to be a smaller one than without intervention.

| Level and Marks | Knowledge, Understanding, Application, Analysis |
|---|---|
| Level 3<br>5-6m | Two sided **comparison** of Strength and Limitation of Ban and Regulation.<br>Max 6 for two sided answers without a judgment. |
| Level 2<br>3-4m | Two sided **explanation** of Strength and Limitation of Ban and Regulation. |
| Level 1<br>1-2m | One sided, Max 3<br>Unfocused answer or simply listed a large number of points<br>Smattering of points.<br>No use of economic theories. |
| E<br>1-2m | Judgment based on sound evaluation in the context of the case. |
| | |

**(d)** **Discuss how the High Speed Rail as a 'game changer' may affect the Singapore's economy.** **[8]**

*Question analysis:*
- *Singapore's economy – 4 KEIs.*
  *Focus on macro impact rather than micro impact.*
- *Need to use AD/AS framework.*
- *Positive and Negative impact on Singapore economy.*

Game changer:
- certain industries may face a shake-up (e.g. bus services and airlines serving Singapore and Malaysia)
- certain industries may flourish (complementary services such as hotels, taxi firms providing transfers from train stations, F&B due to increased tourists and business travellers, etc)

**<u>AD/AS framework:</u>**
**Aggregate Demand**
- C = no significant change or may face a fall due to increased imports as more Singapore residents begin to travel to Malaysia to satisfy their consumption needs (meals, shopping, etc) which used to be done in Singapore
- I = ↑ **I** in booming sectors (e.g. shopping malls near terminal stations, hotels, etc)
- G = ↑ ancillary amenities/facilities around the HSR train stations (expansion of bus/MRT terminals)
- X-M = More in-bound and out-bound travellers (tourists,

businessmen) between Singapore and Malaysia – impact on X-M indeterminate.

**If Aggregate Demand increased**

Positive impact
- Improvement of BOP* (If AD increased due to improvement BOT)
- Economic growth (Actual)
- Decrease in Unemployment

Negative impact
- Inflation
- Worsening of BOP* (After AD increased)
  *2 choose 1 depending on how the student structure the answer

**If Aggregate Demand decreased**

Positive impact
- Reduction of GPL or reduce Inflationary pressure

Negative impact
- Recession
- Increase in Unemployment
- Worsening of BOP (If AD decreased due to worsening BOT)

**Aggregate Supply**
- SRAS = Cost of imports of major inputs such as raw materials as well as foodstuff expected to fall. SRAS rises.
- LRAS = expansion of productive capacity (similar to expansion of airport terminal) to handle more travelers. LRAS rises.
- Likely effect - ↑ NY via k process, ↑ Employment, BOP balance indeterminate

**If Aggregate Supply increased**

Positive impact
- Economic growth (Actual and Potential)
- Decrease in Unemployment
- Reduction of GPL or reduce Inflationary pressure

**<u>Other Possible Points:</u>**

- Bundled Singapore-Malaysia tour packages to attract tourists from other countries due to relatively more hassle-free travel (no more arriving at airport 2 hours early and multiple transfers between airport and hotels)

- Long term plans to extend HSR to Thailand and beyond, bringing in more trade and investment opportunities.

- Outflow of investments from Singapore to Malaysia, both residential and commercial, to take advantage of lower land and labour costs.

Note: Not to include economic activities related to construction of the HSR.

| Level and Marks | Knowledge, Understanding, Application, Analysis |
|---|---|
| Level 3<br>5-6m | Two sided discussion of the positive and negative impact on the Singapore economy.<br>Good use of AD/AS<br>At least 3 of the 4 KEIs Max at 6<br><br>Max 6 for two sided answers without a judgment. |
| Level 2<br>3-4m | Two sided explanation of the positive and negative impact on the Singapore economy.<br>Average use of AD/AS |

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| | | At least 2 of the 4 KEIs.<br>Max at 4m for a very well one sided explanation of either the positive or negative impact on the Singapore economy. | |
| | Level 1<br>1-2m | One sided explanation of either the positive or negative impact on the Singapore economy.<br>Focus on 1 of the 4 KEIs.<br>Unfocused answer or simply listed a large number of points<br>Smattering of points.<br>No use of economic theories. | |
| | E<br>1-2m | Judgment based on sound evaluation in the context of the case. | |

**Question 2: Tale of Two Economies**

| | | | |
|---|---|---|---|
| **(a)** | **(i)** | **With reference to Table 1 and 2,**<br>**Compare the trend in the government budget balance as a percentage of GDP of Indonesia and Japan between 2009 and 2013.** | **[2]** |
| | | **<u>Similarity:</u>** Both countries were experiencing a deficit in the government budget balance as a percentage of GDP between 2009 and 2013. **[1]**<br><br>**<u>Difference:</u>** Japan's government budget balance as a percentage of GDP was worsening (deficit becoming bigger) from 2009 to 2013 except for 2010, while Indonesia's government budget balance as a percentage of GDP was improving (deficit becoming smaller). **[1]** | |
| | **ii)** | **Explain how GDP growth rate could have affected the government budget balance in Indonesia.** | **[3]** |
| | | **<u>From Table 1 and 2,</u>**<br>From 2009 to 2013, as in the case for Japan and Indonesia, when there was positive economic growth, the government budget deficit would become smaller while when there was negative economic growth, the government budget deficit would become larger. **[1]**<br><br>When there is positive/negative economic growth, household incomes and firms profits are higher/lower and thus there would be higher/lower tax revenue collected from income tax and corporate tax as well as indirect taxes (GST). **[1]**<br><br>Government expenditure on welfare payments would have also decreased/increased with positive/negative economic growth. **[1]** | |
| **b)** | **i)** | **Explain how the increase in FDI may affect Indonesia's current account balance and capital and financial account balance.** | **[2]** |
| | | Foreign direct investment (FDI) is a direct investment into production or business in a country by an individual or company from another country, either by buying a company or by expanding operations of an existing business into the target country.<br><br>In the short run, an increase in FDI would improve the capital and financial account balance as it is considered a credit item and a capital inflow into Indonesia. **[1]**<br><br>In the long run, when profits made by the foreign firms (FDI) are sent back to their parent company abroad, it will be recorded as a debit item into the current account of Indonesia due to income outflows. **[1]** | |

| | | | |
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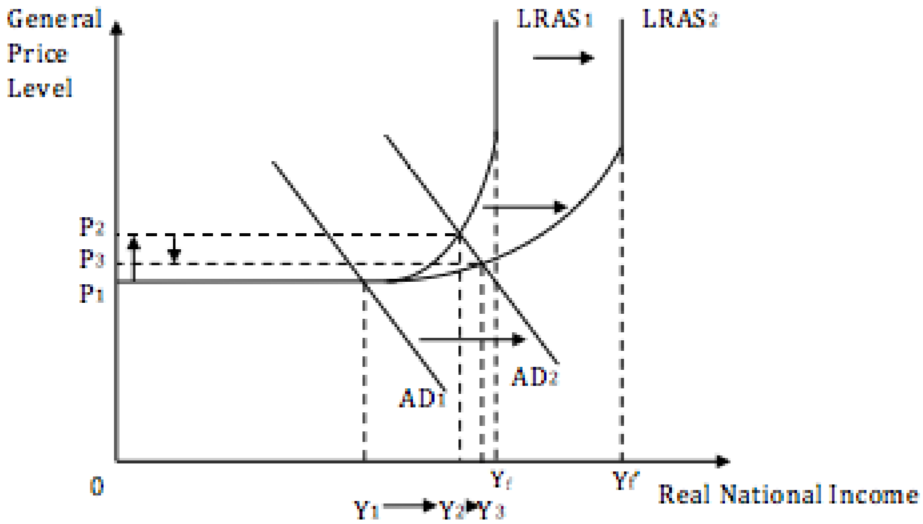
| | ii) | **Explain the rationale for Indonesia's aim "to increase foreign direct investment by 23 percent this year".** | [4] |
| | | Indonesia aim to increase foreign direct investment as it helps it in achieving its macroeconomic objectives of sustained economic growth (both actual and potential economic growth) as well as lowering unemployment and improving the balance of payment (BOP).<br><br><br>In the short run, an increase in foreign direct investment would increase investment (I). The increase in I would bring about an increase in AD. **[1]** When AD increases from $AD_1$ to $AD_2$, at the original equilibrium price of $OP_1$, there would be an excess demand for goods and services and this causes a rundown in inventories stocks. In response, producers would have to increase production of goods and services. To meet the increase in production of goods and services, producers would have to increase their demand for both labour and capital goods to increase output. As such, this would bring about an increase in national income from $Y_1$ to $Y_2$. **[1]**<br><br>Foreign direct investment would improve the capital and financial account. Assuming ceteris paribus, this would improve the BOP account. **[1]**<br><br>In the long run, due to the increase in foreign direct investment, the quantity of factors of production would have increased and this brings about an increase in the productive capacity of the economy leading to an increase in LRAS. This is represented by the rightward shift of $LRAS_1$ to $LRAS_2$ in the diagram above. This would bring about an increase in national income from $Y_2$ to $Y_3$. **[1]** | |
| c) | | **Discuss the extent to which the data provided supports the theoretical relationship between Indonesia's exchange rate and its current account balance between 2009 and 2013.** | [5] |
| | | When a currency weakens/strengthens in value relative to another country's currency, this should improve/worsen the current account balance assuming Marshall Lerner Condition holds.<br><br>Looking at Indonesia, the rupiah appreciated in value from 2009 to 2010 and this caused the worsening of the current account balance as it fell from a surplus of US$10.6 billion to US$5.1 billion in value. This thus shows that it supports the theoretical relationship.<br><br>However, from the period of 2011 to 2013, the theoretical relationship between exchange rate and current account balance does not seem to hold. | |

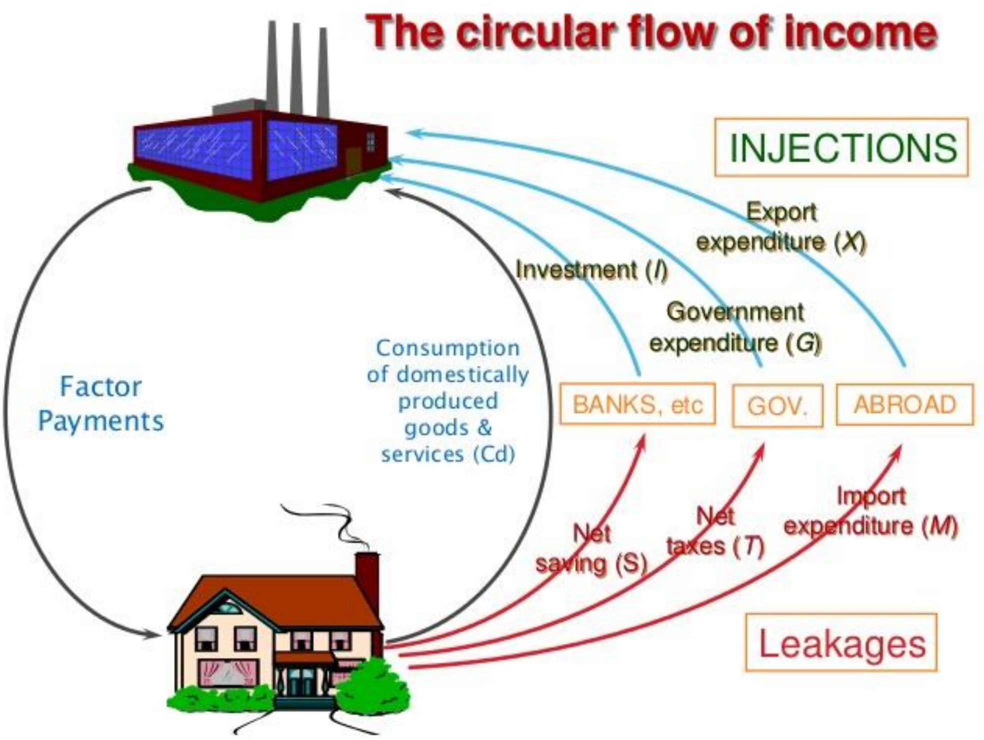
From 2011 to 2013, the Indonesia rupiah depreciated in value. If the theoretical relationship holds, we should be expecting an improvement in the current account balance. However, we saw a worsening of the current account balance as the surplus became smaller in 2011 before worsening to a deficit in 2012 and it became larger in 2013. This could be explained due to many reasons, namely,

I. Marshall-Lerner Condition does not hold. (for the relationship to be true, PEDx + PEDm >1 has to apply) However, there could be contractual obligations and consumers' taste and preferences, which cause Marshall-Lerner Condition to not hold.

II. Exchange rate given is only relative to USD. Indonesia's rupiah could have appreciated against other countries' currencies, which would then explain the worsening current account balance we see.

| Level (Marks) | Level Descriptor |
|---|---|
| L2 (3-5) | Well-developed explanation that examines both the sides in explaining if the data provided showed a relationship between the exchange rate and current account balance of Indonesia. |
| L1 (1-2) | One-sided and undeveloped explanation that has limited economic analysis in explaining if the data provided showed a relationship between the exchange rate and current account balance of Indonesia. |

**d)** **Using the concept of circular flow of income, explain how the fiscal expansion mentioned in Extract 2 as part of Abenomics will affect the equilibrium level of national income.** **[6]**



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| | | Assuming a 4-sector economy initially at equilibrium,<br><br>Injections = Withdrawals<br>(J) = (W)<br>$I + G + X = S + T + M$ **[1]**<br>According to Extract 2, the fiscal expansion was direct government spending on capital spending on infrastructure. This would increase G.<br>According to Extract 2, corporate taxes were also reduced and this would cause a fall in T.<br>G would increase to $G_1$ ($G < G_1$)<br>T would decrease to $T_1$ ($T > T_1$) **[1]**<br><br>This would cause disequilibrium in our circular flow of income, as injections are now more than withdrawals.<br>$J > W$<br>$I + G_1 + X > S + T_1 + M$ **[1]**<br><br>Increase in G is spent on goods and services: **[1]**<br>– Increase in demand for g/s<br>– Firms have to raise output to meet the additional demand<br>– By Output Approach → increase in output by firms will increase in national income<br>Getting back to equilibrium: **[1]**<br>– Increase in national income → increase in induced savings, taxes and imports → $S_1$, $T_2$ and $M_1$<br>– $S_1$, $T_2$ and $M_1$ is larger than the S, $T_1$ and M at the original equilibrium<br>– Therefore, withdrawals (S + T + M) would increase until a new equilibrium level of national income is reached where withdrawals are equal to injections.<br>$I + G_1 + X = S_1 + T_2 + M_1$<br>Injections = Withdrawals<br>$J = W$<br><br>**<u>Result: an increase in the equilibrium level of national income.</u>** **[1]** | |
| **e)** | **i)** | **Discuss the view that the approach of "Abenomics" undertaken by the Japanese government requires adjustment in response to the underlying problems faced by Japan.** | **[8]** |
| | | "Abenomics" as explained in Extract 2, "refers to an aggressive set of monetary and fiscal policies, combined with structural reforms, geared toward pulling Japan out of its decades-long deflationary slump."<br><br>**<u>Side 1: "Abenomics" may require adjustment in response to the underlying problems faced by Japan.</u>**<br>**<u>Monetary policy</u>**<br>Japan undertook "quantitative easing" and increased money supply, resulting in a fall in interest rates. This also has the added effect of causing the Japanese yen to weaken. (Extract 2)<br>While the aim of this policy is to increase domestic consumption (C) and investment (I), Japan's domestic demand is weak given the fact that is has been facing deflationary pressures in the past. The fall in interest rates could also run into a situation known as | |

the liquidity trap, whereby any further increase in money supply by the Bank of Japan (BoJ) would not cause any fall in the interest rates. This would then render the effectiveness of this policy to be limited.
The weakening of the Japanese yen could help spur Japan into a recovery, as it would make its exports relatively cheaper in terms of foreign currency. When this happens, assuming Marshall-Lerner condition holds, this would increase net exports revenue (X-M). Assuming ceteris paribus, this increase in (X-M) would increase AD and real national income by the multiplier effect. Nonetheless, as mentioned in Extract 3, this was not to be the case as "growth in Japanese exports has failed to keep pace with the rising cost of imports". The weakening of the Japanese yen would cause price of imports to be relatively more expensive in Japanese yen and could lead to imported inflation. This, according to Extract 3, " is an unsustainable source for growth in the long-run." Thus Japan would need to adjust in response to the challenges faced for monetary policy.

**Fiscal policy**
Japan undertook an expansionary fiscal policy and spent a large amount on capital spending to improve its infrastructure. Tax cuts were also introduced to encourage both consumption (C) as well as investment (I).
According to Extract 3, it seems that the focus of fiscal policy seems to be more on government spending. "*To stimulate productive investment, Japan must revamp the second arrow of Abenomics and focus on tax incentives rather than government spending."* (Extract 3) This would prove to be problematic for an economy like Japan as based on Table 2 as well as Extract 3, we know that Japan is facing a public debt amount of more than twice its GDP. Further increasing the public debt amount would have dire consequences to the Japanese economy as it may erode confidence in the Japanese economy and raise questions of the government's ability to repay the debt. While the intent of the government spending is to encourage households and businesses to increase C and I, it may not be sustainable for the government to spend in the long term to boost its AD. Thus, Japan would need to adjust in response to the challenges faced for fiscal policy.

**Structural reforms**
Japan embarked on "*structural reforms—including slashing business regulations, liberalizing the labor market, cutting corporate taxes, and increasing workfo*rce diversity—aims to revive Japan's long-term competitiveness. "(Extract 2)

While these reforms help in making Japan more attractive to businesses, with the slashing of business regulations which is more business-friendly, as well as the reduction in corporate taxes which contribute to higher post-tax profits for businesses, it has to address the issues that are plaguing them, namely, aging and shrinking population as well as improving the rigidity in the labour market in Japan.

To tackle the aging and shrinking population, Japan may wish to relook its policy on allowing foreign labour in to help plug the gap caused by the aging and shrinking population. The aging and shrinking population could cause labour cost and wages to increase and this would add on to businesses' cost of production. This may lead to firms looking elsewhere where cost of production is much lower. Allowing foreign labour in would help to reduce the pressure of the rising wages.

In addition to the above problem, there is also mention of rigidity in the labour market which leads to a 'dual' labour market. To improve this condition, the government may wish to embark on retraining and upgrading programmes to help the development of skills in the workforce. It could focus on retraining and upgrading for those who are stucked in "temporary" jobs so that with the completion of the training programme, they could go out and look for a job which would ensure that his/her skills are put to good use and contributing to the Japanese economy.

Thus Japan would need to adjust in response to the challenges faced for structural reforms.

**Side 2: "Abenomics" may not requires adjustment in response to the underlying problems faced by Japan.**
Based on Table 2, Japan seems to be on the rebound as they returned to positive economic growth in 2012 and 2013. In addition, Japan is also starting to move from a state of deflation to inflation again. Unemployment rate also fell during the period of 2009 to 2013. All these are positive signals and could imply that the Japanese economy is seeing an increase in economic activity. Typically, these policies undertaken would require time for the effects to slip in and thus it may be too premature for us to make the conclusion as to whether there is a need for adjustment in response to the problems faced by Japan.

**Evaluation and synthesis**
It is important to note that Japan will not grow as fast as China as it is already a developed country and the success of Abenomics should not be judged mechanically on it achieving its various targets. We should assess the policies and effects broadly to decide whether there is a need for adjustment of its policies. Nonetheless, the authorities in charge should review and monitor the performances of its policies so that any adjustment if necessary could be made in a timely fashion to help Japan and its economy to achieve its macroeconomic objectives and recover from their predicament.

| Level | Knowledge, Application, Understanding and Analysis |
|---|---|
| **L3**<br><br>(7-8) | Clear 2-sided answers<br>Answers show clear understanding of the working and the ineffectiveness of the Abenomics program outlined in the extracts<br>Able to analyse the changes suggested to increase the effectiveness of the policies<br>Appropriate data to support the view that Abenomics programme need/ need not be adjusted. |
| **L2**<br><br>(3-4) | Undeveloped answer<br>Able to explain at least 2 policies but lack the analysis to explain whether there is a need to adjust the Abenomics program |
| **L1**<br><br>(1-2) | Able to identify the policies used in Abenomics<br>Unable to link to the problems pertaining to Japan<br>1-sided answer |

| | |
|---|---|
| **E2**<br>(2) | Evaluative comments with justification. |
| **E1**<br>(1) | Evaluative comments without explanation. |

**2015 Prelim J2H1 Essay Question (3)**

**(a) Explain how globalisation could reduce the economic problem of scarcity. [10]**
**(b) Discuss the impact of globalisation on the economic agents of a country. [15]**

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**(a) Explain how globalisation could reduce the economic problem of scarcity. [10]**

**Suggested Answer:**
**Introduction**
Define Globalisation: Increasing integration of the international economy and is characterised by greater global interdependence through expansion in the volume and variety of cross-border transactions in goods & services, capital, foreign direct investments, exchanges in labour & technology.

Explain economic problem of scarcity: Unlimited wants and limited resources → resulting in scarcity → thus required to make choices between competing uses → incur opportunity cost, which is the next best alternative forgone.

**Development**
- With globalisation → increases access to goods and services internationally not available in domestic country → increases in quantity, quality and varieties → this increases consumers' utilities → reduces the economic problem of scarcity, i.e. unlimited wants but limited resources to produce where the domestic country might not have the resources to do so, such as lack of knowledge, technology etc. Hence with globalisation, the country can now consume beyond the production possibility curve (PPC).
- Globalisation increases competition → country would need to specialise in the production of goods that it has comparative advantage in order to stay competitive internationally → increasing world output → allow countries to consume beyond PPC → reduces the problem of scarcity.
- At the same time, specialisation allows the countries to be more productive and efficient → leading to better allocation of resources → increasing quality and quantity of resources → increases productive capacity → able to shift PPC to the right or LRAS to the right → reducing the problem of scarcity.
- Globalisation increases cross-border transfer of resources, in terms of labour, capital and technology. E.g. Labour → increase quantity of labour in the countries, with highly skilled labour, it will also increase in quality, enhance productivity. Likewise, capital and technology transfer → increase capital inflow and efficiency → thus lead to increase quality and quantity of resources → helping the country boost its productive capacity → shift PPC or LRAS to the right → hence reduce the resource constraints face by a country → reduce problem of scarcity.
- With more goods and services produce, increase in labour, capital inflow and technology transfer → increase both AD and AS → increase real NY via the multiplier process → speed up economic growth → leading to more and greater utilisation of resources.

**Conclusion**
Globalisation allows the economy to better utilise their resources due to comparative advantage. It also allows them to increase world output, thus reduces the 'limited resources' constraint. At the same time, with more goods and services available for consumption, it can also satisfy more wants, thus able to tackle the problem of 'unlimited wants'.

| Level (Marks) | Knowledge, Application, Understanding and Analysis |
|---|---|
| **L3 (7 – 10)** | For an answer that are well-developed with real-life examples to illustrate how globalisation is able to reduce the problem of scarcity. Candidates must explain at least 3 aspects of globalisation, i.e. goods and services, labour, capital and technology linking clearing how it can reduce the problem of scarcity of BOTH unlimited wants and limited resources. |
| **L2 (5 – 6)** | For an answer that covered only 2 aspects of globalisation with no clear link to the problem of scarcity. Or answer that only focus on unlimited wants or limited resources. Little or no examples given to support the analysis.<br>Max 5m: only 1 aspect of globalisation but well-explained with clear link to the problem of scarcity. |
| **L1 (1 – 4)** | Smattering of points. No link of globalisation to reduce the problem of scarcity. Superficial analysis with limited economic concepts and framework.<br>High L1: only 1 aspect of globalisation well-explained with clear link to only unlimited wants or limited resources |

**(b) Discuss the impact of globalisation on the economic agents of a country. [15]**

**<u>Suggested Answer</u>:**
**<u>Introduction</u>:**
As explained in (a), globalisation lead to freer flow of goods and services, labour, capital and technology. Even though it is able to reduce the problem of scarcity, benefitting the economic agents of a country, namely consumers, producers and government; it can also bring about negative impact to them.

**<u>Development</u>:**
**<u>Thesis: Globalisation leads to positive impact on the economic agents of a country</u>**
**<u>Consumers</u>:**
With more goods and services available → more variety, quantity and quality → this increases consumer welfare. With expansion of output, producers can increase its scale of production, reaping internal economies of scale, reducing average cost → if producers pass on the cost savings to the consumers → consumers will be able to enjoy lower prices → increases consumer surplus.
E.g. Singapore being a small economy with limited resources, globalisation would allow the consumers to obtain goods at a lower price from their trading partners who might be more efficient in their production using their existing vast resources available in their countries. Also Singaporeans would also get to enjoy greater varieties of goods and services → leading to an improvement in the material standard of living (SOL).

**<u>Producers</u>:**
Due to globalisation, firms can sell their goods to foreign markets → thus able to gain from larger export market → with greater demand → firms can increase total revenue. As explained above, firms can expand internally due to increase output level → thus lower their average cost → total cost fall. With higher revenue and lower cost → profits increase
For example, there is a limit on how much a firm such as Breadtalk could expand in the domestic market. Hence it ventured into China to tap on the huge markets available. This enables the firm to increase their revenue due to greater demand in overseas market. With greater output, Breadtalk would also be able to reduce their average cost. Also it allows them to tap on cheaper labour and production costs in China, reducing their total cost further → leading to increase profit.

**<u>Government</u>:**
Globalisation leads to increase in investment via the inflow of capital. It also increases export revenue → increase AD → leading to actual growth. It also allows the country to increase in

its productive capacity → increase LRAS. With technology and investment → cost of production would also fall → SRAS increase. All the above will lead to increase in real national income via the multiplier effect → allowing the country to attain economic growth and reduction of unemployment as firms would need to hire more labours. This reduces government expenditure, such as unemployment benefits.

With more people employed → more income tax revenue will be collected from the taxpayers. Also increase consumption lead to increase sales tax → both increase government revenue. Government would have more available fund to invest in infrastructure, further enhance the standard of living of the citizens.

**Anti-Thesis: Globalisation leads to negative impact on the economic agents of a country**

Due to freer mobility of capital → there would also be outflow of capital to other country. Firms would also want to look for cheaper alternatives to reduce their cost of production, setting up firms in other countries, especially country with cheaper labour cost. A reduction in production means less labour required in the domestic industry. This would lead to increase unemployment in the domestic country. If the workers do not possess the required skills in other sectors → this will increase structural unemployment. Consumers would also have lesser purchasing power → leading to a fall in consumption → worsen SOL.

Government would also need to increase its expenditure to assist these workers, either through unemployment benefits or to equip the workers with the relevant skills through training → all these increase government expenditure.

More production would also deplete the available resources in the country. It could also result in environment degradation. Government might need to intervene to control the pace of such environment degradation and depletion of its scarce resources, leading to increase expenditure.

Also the above would worsen the economic problem of scarcity. If firms need to increase production to cater to increase demand due to globalisation, there would be an increase in total cost of production as firms would need to compete with the limited resources in their countries. This would adversely affect a firm's profit as total cost increase.

A country will also face stiffer competition and even unfair competition. E.g. Dumping; where a country sells their goods below its marginal cost → leading to a fall in total revenue of domestic producers. Both of the above would reduce profits → in extreme case, it could result in firms shutting down. E.g. US faced intense competition from China in the textile industry, leading to massive retrenchment → resulted in high unemployment → affected producers, workers and government.

With cheaper price and greater variety from the foreign markets → increase import expenditure and reduce export revenue → result in a fall in AD → firms would need to reduce output, affecting the producers. Likewise a reduction of output means less labour required → increase unemployment. Both affected consumers and producers negatively.

Also with increase import expenditure and reduction of export revenue → worsen balance of trade account, thus its current account position, ceteris paribus → also lead to lesser demand for domestic currency → leading to a depreciation of domestic currency → imports goods would become relatively more expensive in domestic currency → increase price of both imported goods for final consumption and raw materials for production → reduce purchasing power of consumers and increase cost of production for producers respectively → affected both negatively.

**Evaluation:**

Globalisation brings about both benefit and cost to the different economic agents of a country. Increasing integration means a country could not avoid the increasing competition as well. Hence a country could develop their area of comparative advantage so that the country can better utilise its resources to increase welfare gains to the society at large. Also the influx of capital and technology allowed a country to increase its capacity to produce, and with increasing labour flows, e.g. foreign talents, which would bring about their expertise; would lead to increase AD and AS both in the short and long run respectively. This allows an economy to achieve sustained economic growth, i.e. non-inflationary economic growth, which would thus increase the overall SOL of a country. Coupled with a more prudent government intervention to implement multi-pronged policies to reduce the negative impact of globalisation, it would have more positive impact on the economic agents of a country.

| **Level (Marks)** | **Knowledge, Application, Understanding and Analysis** |
|---|---|
| **L3 (9 – 11)** | For an answer with clear analysis and well supported with relevant examples on the positive **AND** negative impact of globalisation on the different economic agents of a country. |
| **L2 (6 – 8)** | For an answer with in-depth analysis on the positive **AND** negative impact on only 2 economic agents.<br>Max 6m: only positive **OR** negative impact but well-explained on the different economic agents of a country. |
| **L1 (1 – 5)** | High L1: only positive **OR** negative impact explained on the different economic agents of a country but lack in depth and scope.<br>Low L1: Smattering of points. Superficial analysis with limited economic concepts and framework. |
| **Allow up to 4 additional marks for Evaluation** | |
| **E2 (3 – 4)** | For an evaluative assessment based on economic analysis. Able to substantiate judgement on the relative impact on the different economic agents of a country. |
| **E1 (1 – 2)** | For an unexplained assessment or not supported by analysis. |

## 2015 Prelim J2H1 Essay Question (4)

**Be it to raise or lower inflation, governments around the world have used interest rates as a policy means to tackle this problem.**

**a) Explain why governments may want to achieve a low and stable inflation rate. [10]**

**b) Discuss whether the control of interest rates is the best way to tackle inflation. [15]**

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**Suggested Answer**

For this question, candidates were expected to explain the benefits of having a low and stable inflation rate to an economy. Candidates should link their answer to other economic objectives – both micro and macro.

Intro:
- Definition of inflation

Body:
- Low and stable inflation leads to higher growth and lower unemployment
  - Low and stable inflation creates certainty in terms of costs and revenue.
  - Firms are more confident and thus increase investment

- If economy's inflation rate is lower than another economy, exports will be relatively cheaper and thus export demand increases, increasing export revenue
- Imports will be seen as relatively more expensive and thus households switch away from consuming imports to consume domestically produced goods
- Increases net exports
- Increase in I and (X-M) leads to increase in AD and NY via the multiplier effect, thus actual growth
- Inc AD leads to firms employing more resources and thus lowers unemployment rate
- This leads to an increased standard of living as households earns higher incomes and thus can enjoy more goods and services

- Low and stable inflation leads to more favourable BOP
  - Increase in net exports will improve balance of trade and thus current account
  - Increased firm's confidence will lead to higher inflow of FDI, leading to improvement in the capital and financial account
  - Overall leads to an improvement in BOP

- Low and stable inflation encourages savings
  - Inflation erodes value of savings
  - Higher rates of inflation erodes the value of savings faster and thus households are less inclined to save
  - Reduces availability of loanable funds and thus increases interest rates
  - Low and stable inflation encourages savings as the interest earned can help reduce the erosion of the value of savings and also because households will not be withdrawing their money in large amounts to consume goods and services in anticipation of future price increases. This thus leads to the availability of loanable funds for borrowing to invest or consume

- Low and stable inflation leads to greater efficiency
  - High inflation results in more menu costs and shoe leather costs as firms would have to update their price lists in accordance with higher prices and this would incur some form of costs to reprint their price lists. Households, on the other hand, incur more shoe leather costs as they make more trips to the banks to withdraw money to consume goods and services.
  - These costs will be reduced if inflation is low and stable, allowing for less resources utilized and thus greater efficiency.

Conclusion:
- Low and stable inflation can help in the attainment of other macroeconomic objectives and governments would have to implement policies to attain this goal

| **Level (Marks)** | **Knowledge, Application, Understanding and Analysis** |
|---|---|
| **L3 (7 – 10)** | Answer provides clear explanation of the benefits of having low and stable inflation rate, drawing clear links to macroeconomic and microeconomic goals. |
| **L2 (5 – 6)** | Answer provides undeveloped explanation of the benefits of having low and stable inflation. Such answers would lack adequate links between statements. |
| **L1 (1 – 4)** | Answer provides some knowledge of the effects of high inflation and relate to why governments want to achieve low and stable inflation. |

**b) Discuss whether the control of interest rates is the best way to tackle inflation.** **[15]**

**<u>Suggested Answer</u>**

Candidates are expected to look at various policies that a government can implement to tackle inflation and come to a conclusion if monetary policy is the best policy to tackle inflation. Students can approach this question either by lowering inflation or increasing inflation to the desired rate.

Introduction:

- As explained in part (a) governments have reasons why they want to pursue low and stable inflation
- In order to achieve this, governments can employ a range of policies
- Will be evaluating various policies to assess if control of interest rates is the best way

Body:

- **Side 1: Control of interest rates to tackle inflation**
  ***Assumption: economy is operating near full-employment and encountering dd-pull inflation (i.e. increase in AD)***
  - Governments can choose to increase interest rates to decrease the rate of inflation
  - When interest rates increase, cost of borrowing increases and thus leads to lower levels of C and I as there will be reduced borrowing to consume and invest
  - This leads to a fall in AD which would mitigate the initial increase in AD and thus brings about a slower increase in GPL, assuming c.p
  - This is effective for economies that are experiencing high demand-pull inflation as the policy will cut down domestic demand
  - An example would be China in 2011 where it raised its interest rates due to the excessive demand for property resulted in high rates of inflation. This helped to curb some demand for property and other goods and services as a whole, thus curbing demand-pull inflation

- **Side 2:**

  **Limitations of Interest Rate Policy**
  - However, the fall in AD could also bring about a fall in growth as real NY would fall via the multiplier effect, if the economy was operating within the intermediate range of AS.
  - Furthermore, increase in interest rates could result in greater hot money inflow, leading to appreciation of the currency that could worsen its trade balance which would then adversely affect its balance of payments, which is a conflict of objective.
  - In addition, the inflow of hot money would increase domestic money supply and this increase in money supply would lead to a fall in interest rates which mitigates the initial increase in interest rates.
  - Control of interest rates may only be effective to reduce demand-pull inflation. If inflation is due to supply side factors, interest rate policy may be ineffective.

  **Other policies to tackle inflation**
  - Due to the limitations of monetary policy, governments can consider using other policies to tackle inflation such as exchange rate policy and supply-side policies

a) Exchange rate policy

***Assumption: economy is operating near full-employment and encountering dd-pull inflation (i.e. increase in AD)***

- In order to reduce inflation, the government could adopt a modest and gradual appreciation of its currency and that would make exports relatively more expensive in foreign currency while imports become relatively cheaper in domestic currency. This would lead to a fall in net exports, assuming Marshall-Lerner condition holds and thus bring about a slower increase in AD. This would bring about a slower increase in GPL assuming c.p.
- This policy would be effective for countries that suffer from imported inflation as it makes imports cheaper. This would make imported final goods (e.g. rice) cheaper as well as imported intermediate goods (e.g. electrical components) cheaper, making domestically produced goods cheaper. For an economy that is heavily dependent on imported raw materials, this would represent a fall in cost of production and would lead to a rightward shift of SRAS.
- An example of an economy that utilizes a modest appreciation of its currency is Singapore, due to the large import content of its exports and also because it imports most of the goods it consumes.
- However, the policy would take some time to be effective as the Marshall-Lerner condition does not hold in the SR
- Furthermore, with more expensive exports leading to fall in export revenue, this could lead to rise in unemployment within trade-related industries (e.g. tourism)

b) Supply-side policy

- Another policy the government can consider is the use of supply-side policies to tackle cost-push inflation
- Supply-side policies include training of workers to increase their productivity or foreign labour policies which would affect the size of the labour force within the economy. Examples would be Skills Programme and Upgrading for Resilience (SPUR) and Skills Redevelopment Fund which help to encourage firms to send their workers for training so that they become more productive and thus help to lower the unit costs of output produced.
- With the increase in productivity, labour resources are able to produce more goods and services per unit time and thus lowers the average cost of the goods, bringing about an increase in the SRAS and thus addresses cost-push inflation
- Having a looser foreign worker policy allows for more foreign workers to enter the country and thus there is an increase in the supply of labour. This would lead to a fall in wages and thus leads to lower COP. Thus increasing SRAS and bringing the inflation rate down.
- However, training requires time for the effects to be seen and this policy may be met with resistance from firms in sending their workers for training as well as workers' mindsets which make them unwilling to attend the training or benefit from it

**Synthesis/Conclusion:**

- The government has many policy tools at its disposal but each has its own merits and costs.
- Each policy tool is also more suited to tackle specific sources of inflation and thus there is no best policy to tackle inflation. As an economy can suffer from high inflation due to several sources, a government should consider implementing a mix of policies. Furthermore, it could implement complementary policies to address the trade-offs that are brought about by the policy to tackle inflation. For example, the government can implement supply-side policies alongside the exchange rate policy

so that the COP will be further reduced and thus allow for exports to be cheaper, stemming the fall in demand for exports due to the appreciation of the currency.

- The nature of the economy also affects the policy to be undertaken to tackle inflation. For example, Singapore is an interest rate taker and thus cannot control its interest rates to tackle inflation. Instead it utilises the exchange rate policy to tackle inflation as a large portion of the final goods consumed and intermediate goods are imported.
- Governments may also intervene to increase the inflation rate as an inflation rate that is too low is indicative of weak demand and thus the government would employ expansionary policies to stimulate the economy.

| **Level (Marks)** | **Knowledge, Application, Understanding and Analysis** |
|---|---|
| **L3 (9 – 11)** | Answer provides clear analysis of at least 3 policies that a government can employ to tackle inflation with examples.<br>Answer must encompass policies to address BOTH demand-pull and cost push inflation.<br>Max 9m with well-developed answer on 3 policies without real-life example. |
| **L2 (6 – 8)** | Answer provides an undeveloped analysis of at least 2 policies to tackle inflation. One of the policies MUST be interest rate policy as in the question requirement.<br>Explanation of policies without looking at its limitations will be given max 6m.<br>Well-developed answer on one policy with limitations and real-life example would be awarded max 6m. |
| **L1 (1 – 5)** | Answer shows some knowledge of the policies to tackle inflation but lacks of scope and depth. |
| **Allow up to 4 additional marks for Evaluation** | |
| **E2 (3 – 4)** | Judgement based on analysis. |
| **E1 (1 – 2)** | Mainly unexplained judgement. |