4(a) Explain the possible economic trade-offs faced by a small and open economy. [10]

Question interpretation

- What are some possible economic trade-offs?
- How does the size and openness of the economy dictate the kind of trade-offs an economy faces?

Introduction

- Macroeconomic trade-offs refer to two desirable but necessarily incompatible aspects of the economy
- A small economy generally has a small domestic population and thus limited domestic demand, while a globalised economy is one which is highly reliant on trade and international factor flows.
- This essay aims to explore some of these trade-offs that are characteristic of a small and open economy.

Internal versus external stability

- A small and open economy is likely to manage its exchange rates to better regulate the impact of trade on the economy as it is likely to be both export and import dependent
- If the central bank undervalues exchange rate by selling its own currency in the forex market, this leads to an overall BOP surplus, which raises money supply, thus potentially causing demand-pull inflation.
- If the central bank overvalues the exchange rate by buying back its own currency in the forex market, this leads to an overall BOP deficit, which causes money supply to contract, thus potentially curbing aggregate demand, output and employment.
- Hence, maintaining external stability could result in greater internal instability.

- Alternatively, efforts to maintain internal stability could result in external instability.
- If a small and open economy tries to fight inflation by raising interest rates, in the absence of capital controls, hot money inflows leads to an appreciation of the exchange rate.
- This could erode export competitiveness, harm the country's exports, worsen the country's BOT and potentially lead to demand-deficient unemployment.
- On the flipside, if the country lowers interest rates to fight demand-deficient unemployment, hot money outflows leads to a depreciation of the exchange rate, hence bringing about imported inflation.

Long run growth versus macroeconomic stability

- A small and open economy is likely to rely on trade and foreign capital to drive its economic growth.
- Given its small domestic population and thus limited source of internal demand, a small open economy has to look outwards in order to sustain actual growth, both in the short and long term.
- However, as external sources of growth like exports or foreign capital can potentially be very volatile, higher economic growth often comes at the expense of greater macroeconomic stability
- Conversely, if a small open economy were to hedge itself against external macroeconomic risks by shifting towards a consumption driven growth model or an import-substitution industrialisation model, its long run growth would likely be lower.

Long run growth versus equity

- Reducing income inequality can be achieved by raising corporate taxes and making the personal income taxes more progressive
- However, raising corporate taxes discourages inflows of FDI and foreign portfolio investments, thus adversely affecting both the quantity and quality of investments.
- Making personal income taxes more progressive often involve raising tax rates on high income earners, which will not only deter the inflow high skilled labour but also drive local high skilled labour overseas
- Such reductions in the quality and quantity of capital and labour will adversely affect long-run growth.
- Conversely, attempts to raise long run growth by attracting FDI and foreign portfolio investments as well as foreign high skilled labour with lower and less progressive direct taxes will worsen income distribution.
- As a small open economy tends to be more dependent on foreign capital and labour, the trade-off between growth and equity is likely to be greater

Inflation and unemployment

- Achieving full employment requires the AD curve to rise up along the upward sloping portion of the AS curve, thus resulting in higher prices
- A larger rightward shift of the AD curve results in lower unemployment but also higher prices, hence there is a trade-off between inflation and unemployment (illustrate with a diagram).
- Compared to larger economies, smaller ones are likely to face more serious land and labour constraints, so factor prices will likely be bided up more quickly, thus causing the trade-off to be more severe.

Suggested Mark Scheme		
L1	Identify the macroeconomic trade-offs of the Singapore economy.	1
L2	Explain the macroeconomic trade-offs but in very general terms, without consideration of a small and open economy.	2 – 5
L3	Analyse the various trade-offs in the context of a small and open economy.	6 – 10

4(b) Discuss the effectiveness of the policies currently adopted by the Singapore government to manage these trade-offs. [15]

Question interpretation

- What are policies currently adopted by Singapore to deal with the possible economic trade-offs?
- How do these policies work to avoid or reduce these trade-offs?
- How effective have these policies been in avoiding or reducing these trade-offs?

Introduction

- The existence of economic trade-offs means that governments need to either choose policies which enable such trade-offs to be avoided or if not employ additional policies to mitigate the unintended consequences
- This essay thus aims to first analyse such policies that the Singapore government has employed before evaluating their effectiveness in achieving their intended outcomes

Internal versus external stability

- While attempting to achieve external stability by managing the exchange rate, MAS has to allow domestic interest rates to follow world interest rates because Singapore needs free international capital mobility to function as an international financial centre.
- With major economies like the US, the EU and Japan all having near zero interest rates, this has caused Singapore's interest rates to also be very low, thus resulting in a property market bubble and also higher inflation because of escalating COE prices
- The Singapore government has managed the resulting internal instability with property cooling measures e.g. raising of the Buyer's Stamp Duty and implementing the Total Debt Servicing Ratio (TDSR).
- By taxing property purchases and placing tighter limits on households' ability to borrow, this has quelled the demand for mortgages and car loans, thus slowing the growth of housing and car prices.
- These policies have arguably been effective as housing prices have since fallen by about 10% from the height of the property market boom in 2013 and COE prices have also been declining since the TDSR was implemented.

Economic growth and macroeconomic instability

- While a high dependence on trade and FDI has enabled Singapore to grow strongly, this has caused Singapore to be very susceptible to external demand and supply shocks.
- The Singapore government reduces the extent of such trade-offs by diversifying the country's export and import markets though the establishment of a plethora of bilateral and multilateral FTAs
- Singapore also uses supply side policies to counter external demand shocks, which not only boosts output and employment in the short run but also promotes potential growth in the long run
- One such policy is the Wage Credit Scheme which is essentially a wage subsidy that lowers production costs, thus shifting the AS curve downwards thereby boosting output and employment during a recession
- Wage subsidies also help to improve the cash flow of firms thus minimising bankruptcy, thereby helping to preserve productive capacity so that economy recovers faster when the global markets eventually pick up

- Such supply side policies have arguably been very effective as evident by Singapore's stellar 14.5% growth in 2010, which occurred right after the 2009 recession that was caused by the global financial crisis

Long run growth versus equity

- To promote long run growth, Singapore has always relied on inflows of FDI and foreign skilled labour
- To attract such investments and labour, Singapore has one of the lowest corporate and personal income tax rates in the developed world
- However, Singapore Gini's coefficient has also increased substantially over the years, thus illustrating the trade-off between long run growth and equity

- To counter rising income inequality, the Singapore government has increased transfer payments to the low-income group in the form of larger tax rebates and direct transfers like Workfare which works like a wage subsidy that is targeted at low-wage workers.
- Unlike unemployment benefits which reduce the incentive to work, such targeted wage subsidies create the incentive for employment, hence greater equity can be achieved without jeopardising long run growth

- These policies have <u>arguably</u> been effective as Singapore's Gini coefficient (before transfers and taxes) has declined from 0.482 in 2007 to 0.464 in 2014.
- Singapore's Gini Coefficient after transfers and taxes is also significantly lower at 0.412 in 2014, which <u>arguably</u> shows that substantial redistribution of income has occurred

Conclusion

- The Singapore government has used a variety of policies to either avoid or reduce the mentioned trade-offs and the evidence so far shows that they have been <u>largely</u> effective in achieving their intended objectives
- Nevertheless, as a small open economy in an increasingly complex globalised environment, new trade-offs are bound to arise
- Hence the Singapore government <u>must</u> continue to look ahead so that it can foresee and implement appropriate policies to deal with such unintended consequences.

Suggested Mark Scheme		
L1	Identifies the relevant macroeconomic policies used by the Singapore government.	1 – 2
L2	Explain the various macroeconomic policies without considering how they help manage the trade-offs.	3 – 6
L3	Analyse the various policies in context of the macroeconomic trade-offs.	7 – 11
E	Evaluate the effectiveness of the macroeconomic policies.	+4