

5	<p>“Falling prices dragged on growth prospects in the advanced world, especially in the Eurozone. Deflation is dangerous in European countries—most of which are highly indebted—as they increase the real values of fiscal debt burdens, while encouraging firms and consumers to delay their spending.”</p> <p>Adapted from: The Telegraph, 2014</p>		
	a)	Explain why a government in the Eurozone should be concerned about deflation.	[10]
	b)	Discuss the effects of the deflation in the Eurozone on the standard of living in Singapore.	[15]

Part A

Introduction

- Define deflation – inordinate fall in general price level
- List macroeconomic goals
- Governments should be concerned about deflation because it can negatively affect its macroeconomic goals

Body

- 1. Deflation may lead to fall in consumption due to delayed consumption which can exacerbate recession and fall cyclical unemployment**
 - In a deflation, it is likely that the economy is also experiencing unemployment (i.e. AD cuts AS at the Keynesian range of the AS curve)
 - During periods of deflation, consumers delay their current spending because they expect prices to fall in future.
 - This fall in current consumption can lead to a fall in AD, ceteris paribus, which can lead to a multiplied fall in real NY and hence a recession.
 - A recession can lead firms reducing output and reducing derived demand for labour hence increase in cyclical unemployment
- 2. Deflation may worsen business sentiments and reduce I which can lead to fall in I therefore fall in actual and potential economic growth**
 - In periods of deflation, business sentiments may worsen as falling price levels may be due to fall on consumers' demand for goods and services
 - As prices fall, revenues of producers fall and this may be a signal to them to reduce output and investment
 - A fall in investment can lead to a fall in AD, ceteris paribus, and hence multiplied fall in real NY and possibly a recession.
 - A fall in investment may also affect replacement of capital and growth of productive capacity. Therefore, LRAS falls leading to a fall in potential economic growth
- 3. Deflation may cause capital outflow which may increase a BOP deficit/reduce BOP surplus**
 - Deflation leading to poor business sentiments, due to reasons explained above, may lead to capital outflow as firms move their operations to focus on foreign markets
 - The uncertainty and pessimism caused by the fall in real NY and GPL may also lead to short-term capital outflows
 - These can cause a deficit in the capital account which can increase a BOP deficit/reduce BOP surplus
- 4. Deflation may increase real value of fiscal debt hence need to implement austerity which leads to great recession and cyclical unemployment**
 - A persistent fall in GPL increases the real value of fiscal debt incurred from the past
 - The increase in real value of debt may necessitate austerity measures by the government to restore its credit worthiness and business confidence
 - Austerity measures – involving a fall in government spending and rise in taxes – may lead to a fall in C, I and G, and therefore AD, ceteris paribus. This would then lead to a multiplied fall in real NY and hence cyclical unemployment when firms cut output and reduce derived demand for labour

Level		Descriptors
L3	7-10	<ul style="list-style-type: none"> Provides at least three possible ways in which deflation may adversely affect economic goals of the government – all three points do not have to be free of errors to attain L3, however, that would be expected of a 10m answer. Effective use of economic framework (e.g. AD/AS framework). Makes relevant and essential assumptions (e.g. holding other factors of AD constant, level of spare capacity etc.)
L2	5-6	<ul style="list-style-type: none"> Provides at least two possible ways in which deflation may adversely affect economic goals of the government Superficial/incomplete explanation of the workings of policies in bringing about macroeconomic goals. Superficial/incomplete explanations of how deflation affects economic goals of the government Limited or erroneous use of economic framework (e.g. AD/AS framework). Limited use of assumptions (e.g. holding other factors of AD constant, level of spare capacity etc.)
L1	1-4	<ul style="list-style-type: none"> Conceptual errors Insufficient elaboration and link to economic frameworks

b)	Discuss the effects of the deflation in the Eurozone on the standard of living in Singapore.	[15]
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Introduction

- Define SOL and unpack material and non-material SOL
- Establish characteristics of Singapore's economy – small and open
- Deflation from Eurozone can affect Singapore through trade and capital flows
- Stand

Body

Effects of deflation in Eurozone on **material SOL** in Singapore

- Thesis: Negative impact on material SOL
 - Fall in net export revenues as deflation-induced recession in Europe might reduce DD for SG's exports → fall in AEG → fall in material SOL in SR
 - Evaluation: Singapore may still be able to maintain export performance by exporting to other economies like US and China → increase AEG and material SOL*
 - Fall in FDI inflows to SG due to worsening MEI in Europe → fall in AEG and PEG → fall in material SOL in SR and LR
- Antithesis: Positive impact on material SOL
 - Investors in Europe may choose to increase investment in Asia due to worsening consumer sentiments in Europe – capital inflow to Singapore and hence improvement in BOP, AEG and reduce cyclical unemployment → increase AEG and material SOL
 - Evaluation: Slowing growth in China and Asia may also worsen MEI in the region*
 - MAS can bring about a depreciation to improve export competitiveness /jobs credit schemes to alleviate cyclical unemployment caused by fall in FDI → increase AEG and PEG → improve material SOL in SR and LR
 - Evaluation: MAS avoids depreciations as they may exacerbate imported inflation*

Effects of deflation in Eurozone on **non-material SOL** of Singapore (assuming FDI to Singapore and export revenue for Singapore falls)

- Thesis: Positive impact on non-material SOL
 - Deflation in Eurozone → reduces price of European exports → increases exports to SG → increase competition in domestic market in Singapore → reduces market dominance and supernormal profits of firms → improves equity → improves non-material SOL
 - Fall in FDI → reduce income inequality between skilled labour in industries with CA (which tend to attract FDI) and unskilled labour sunset industries
 - All in FDI to knowledge-based industries with comparative advantage in Singapore may slowdown the moving of value-added chain, and hence the winding down of sunset low-skilled industries. Hence structural unemployment abates, which prevents worsening of income gap between structurally unemployed workers and high-skilled workers in industries that tended to attract FDI

- Fall in AEG due to fall in export volumes to Europe and fall in FDI from Europe may lead to fall in national o/p → fall in work hours and stress levels → improves non-material SOL
- Antithesis: Negative impact on non-material SOL
 - Fall in AEG due to fall in export volumes to Europe and fall in FDI from Europe may lead to fall in tax revenues for government and hence fall in ability to provide merit goods and social services → worsens non-material SOL
 - Fall in FDI to Singapore may reduce level of competition in markets and lead to market dominance → supernormal profits for local firms → worsen inequity
 - *Evaluation: Openness of Singapore economy to trade makes the market very competitive*

Synthesis

- Key factor that determines extent of impact of Eurozone deflation on Singapore depends on exposure of economy to that of that in Eurozone (i.e. scale and direction of trade and capital flows).
- As Asian economies increasingly decouple themselves from the US and Eurozone since the Global Financial Crisis, the impact of the Eurozone deflation may become increasingly less significant for Singapore. Therefore, impact of the Eurozone deflation on SOL in SG may be overshadowed by the impact of other Asian economies, such as China which has become the largest trading partner of Singapore.

Level		Descriptors
L3	9-11	<ul style="list-style-type: none"> Well-developed explanation of how deflation in Eurozone affects trade and capital flows between Eurozone and Singapore Well-developed links between the above effects and the standard of living in Singapore Addressed both material and non-material standard of living Sufficient balance of arguments – (e.g. positive vs. negative effects or long-run vs. positive effects)
L2	6-8	<ul style="list-style-type: none"> Incomplete explanation of how deflation in Eurozone affects trade and capital flows between Eurozone and Singapore Insufficient links between the above effects and the standard of living in Singapore Addressed both material or non-material standard of living Attempts to provide sufficient balance of arguments – (e.g. positive vs. negative effects or long-run vs. positive effects)
L1	1-5	<ul style="list-style-type: none"> Serious conceptual errors Answer is largely out of point For a descriptive answer that is poor in or lack economic analysis No attempt at providing balance
E1	1-2	<ul style="list-style-type: none"> Relevant stand taken but with inappropriate or inadequate justification.
E2	3-4	<ul style="list-style-type: none"> Relevant stand taken with appropriate and adequate justification.

Marking Rubrics			
	Material SOL	Non-Material SOL	
Positive/SR effect	Point 1	Point 2	Max L1 - 5
Negative/LR effect	Point 3	Point 4	Max L1 - 5
Max Low L3 – 10m	Max L2 – 8m	Max L2 – 8m	Max Low L3-10m

3 out of 4 boxes – Max L3-10m

4 out of 4 boxes – Eligible for full marks