

- 4 Governments in economies worldwide solve unemployment problems through the use of loose monetary policy and investment in human capital.
- (a) Explain why reducing unemployment is a key macroeconomic objective in many countries. [10]
- (b) Discuss the view that Singapore would be better off reducing unemployment through the use of exchange rate policy. [15]

**Suggested Answer Model:**

**INTRODUCTION**

State the 4 macroeconomic objectives

The four macroeconomic objectives of the government are high and sustained economic growth, low and stable inflation, low unemployment, and healthy balance of payments.

Explain meaning of unemployment

There are two main types of unemployment: cyclical unemployment and equilibrium unemployment (structural unemployment & search unemployment)

Elaborate

Interpret the question

Low unemployment is a key objective of many governments because of the many benefits of low employment, and the pursue of low unemployment allows the countries to achieve other objectives.

**DEVELOPMENT 1**

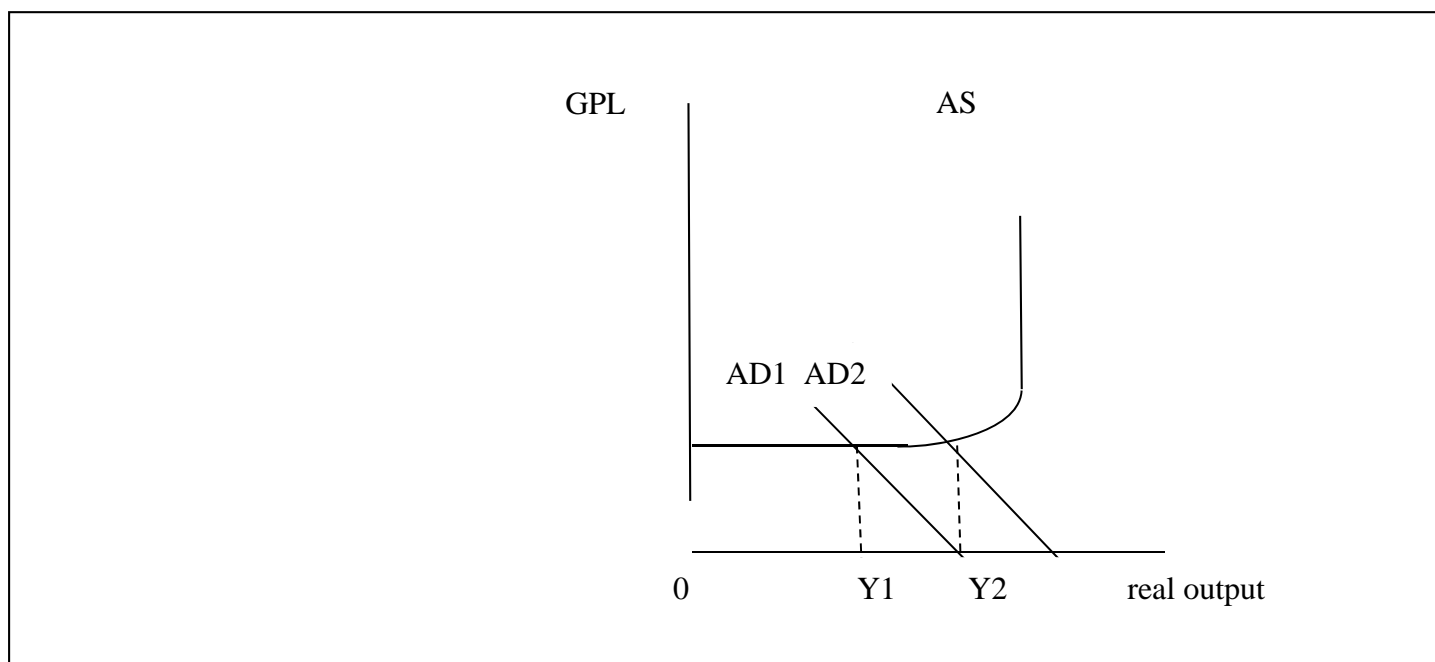
**Benefit of low unemployment**

Increase in Material Well Being

**Both demand and supply side caused growth can lead to lower unemployment and hence improvement in SOL**

**(1) Increase in AD** → increase the rate of economic growth when the economy is not operating at capacity → rightward shift in the AD curve from AD1 to AD2 in Figure 1. As total demand for goods and services in the economy increases, this stimulates producers to increase production and hence real output of the economy increases → raises the demand for labour → increases income of households, raise purchasing power and increases their ability to access goods and services and hence their material SOL.

Assuming income growth is faster than the growth in population, the real income per capita increases & increases the material well-being of the citizens.



Individuals :

→ Higher income & standard of living

EV: However, they have less leisure

Firms:

→ Lower unemployment leads to higher income & high demand for firms' goods and services

→ Higher workers' morale which in turn may raise labour productivity

EV:

→ More difficult to recruit staff and people applying for jobs may possess lower skills. The existence of lower unemployment may make workers less fearful of losing their jobs. As a result, they are less willing to adopt good working practices

Economy::

→ Most significant gain - higher output (operating nearer the PPC) → Rise in GDP growth

→ Higher standard of living

→ Less govt resources required to restructure the economy to solve unemployment problem

→ Higher revenue from direct and indirect taxes

EV:

→ If unemployment falls below the equilibrium level of unemployment (NAIRU/NRU) → 'overheating' of the economy and inflationary pressure.

→ Explain why rising inflation may be undesirable.

**Development 2**

The pursue of low unemployment allows the countries to realise other macroeconomics objectives such as economic growth and less strain on government budget. Increasing employment is often accompanied by higher economic growth and higher real GDP, increase in productive activities.

**CONCLUSION**

**Conclusion: Address the keywords 'many countries' & 'key' and Link to part b)**

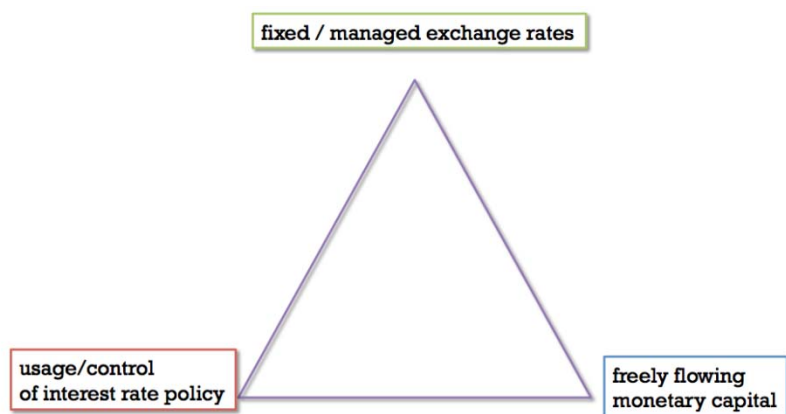
Low employment is often a key objective of many countries. However, there are times when unemployment may not be the main macroeconomic objective of the economy, for instance, severity of other problems. When a country faced hyperinflation, functions of money will be severely impaired. People will no longer be willing to accept money as a form of payment and store of value. The great uncertainty will result in capital flight and reduce the volume of savings, investment and economic growth. In such situation, government should address the problem of inflation and restore confidence in the economy before achieving macroeconomic aims.

(b) Discuss the view that a small and open economy such as Singapore would be better off solving unemployment problems through the use of **exchange rate policy**. [15]

### Introduction

- The policy choices that economies can employ to solve their unemployment problems will depend on
  - The nature and state of their economy restricting their usage of certain economic policies
  - The type of unemployment that they are experiencing

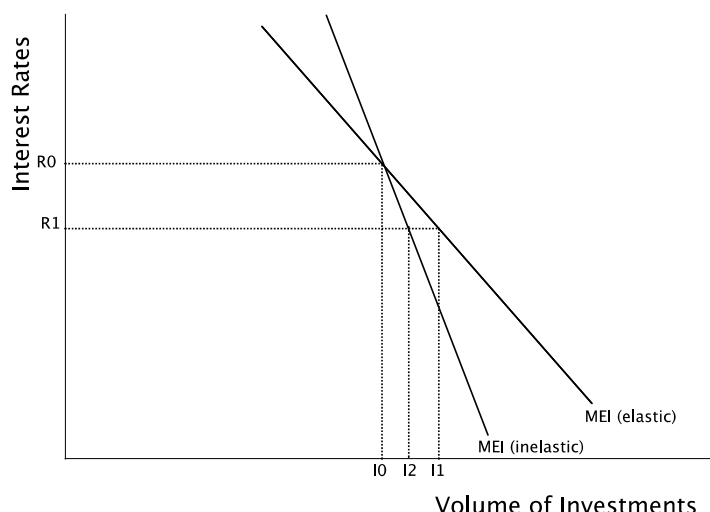
### Development 1 – Problems trying to use expansionary i/r policy to solve DD-deficient unemployment in SG



- Open economy trilemma restricts policy choice
  - Open economies like Singapore are heavily engaged in trade. SG's trade volume (X+M) is about ~400% of GDP. Due to the large amounts of trading done daily, SG requires freely flowing capital flows in and out of the economy
  - If Singapore were to decrease i/r → financial investors will face a fall in monetary returns → due to freely flowing capital, they will withdraw their investments to seek for better returns in other countries → hot money outflow → sell SGD to buy foreign currency → pressure on SGD to depreciate
  - In SG → as we are a small and open economy without natural resources → heavily dependent on imports of raw materials and intermediate products as inputs into production, as well as imports of final goods and services → as a result of the need for high amounts of imports, SG is extremely vulnerable to imported inflation
  - If SGD depreciates → price of imports become more expensive → worsens imported inflation → increases firms' costs of production and competitiveness, and at the same time decreases consumers' purchasing power and therefore decreasing consumers' material SOL
  - Open economies also tend to want to manage their exchange rates so as to control

the price of their exports (and therefore, their export competitiveness), and as such any changes in interest rates causing pressures on the exchange rates to appreciate or depreciate would mean that the government needs to further utilize their foreign reserves to manage the exchange rates, on top of what they are already doing → this is a wastage of time and resources for the government

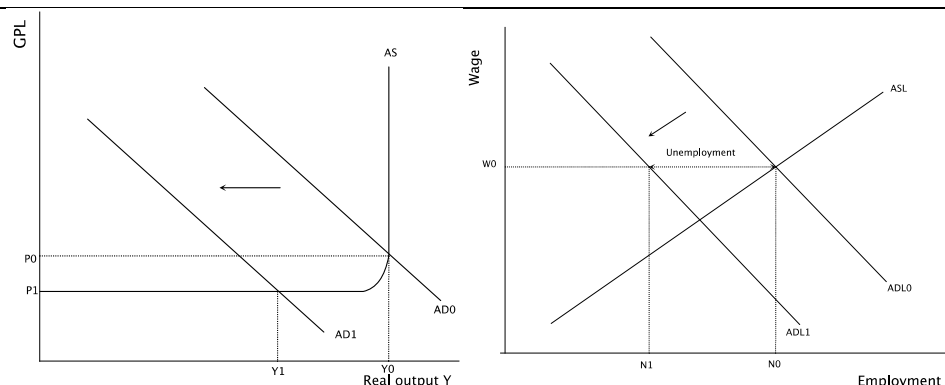
- Therefore, open economies like SG are unlikely to utilize interest rates as a policy tool



- Interest rates policy tends to primarily affect domestic producers and consumers, and work most effectively in economies that have a large domestic demand
  - Small economies like Singapore tend to have a small domestic demand, and are likely to be very open to foreign direct capital investments
  - Since most of the foreign capital investors are likely to have their own source of funding and will not be borrowing from the local banks, it is likely that they are very unresponsive to changes in interest rates
  - The MEI function is thus likely to be very interest inelastic, so for a given fall in interest rates from  $R_0$  to  $R_1$ , volume of investment is likely to increase less than proportionately to  $I_2$ , instead of to  $I_1$  when the MEI is relatively more interest elastic
  - Therefore, small economies like SG with a small domestic market tend to not utilize interest rates policy

#### Development 2 – Utilization of exchange rates policy would be better for open economies like SG

- Since open economies are highly dependent on trade, exchange rates policy, which affects prices of exports and imports, are more likely to have a direct impact on export revenue and import expenditure
- Furthermore, open economies are likely to be affected by external events and economic shocks. This increase in volatility would mean any factor affecting demand for their exports (such as a recession in their trading partners' economies, or fall in export competitiveness) will likely decrease export revenue (X) by a significant amount, causing AD to fall



- The fall in AD will cause surpluses of output in the economy, and exporting firms will start to face an unplanned increase in inventories → they thus decrease their demand for labour → since wages are sticky downwards (at W<sub>0</sub>) due to contractual obligations → dd-deficient unN of N<sub>0</sub>N<sub>1</sub> results
- Utilization of a depreciation of the currency will lead to a fall in the price of exports in foreign currency, increasing the demand for exports in domestic currency, and therefore causing X to rise → this directly solves the root cause of the problem, and exports can be more competitive, thus helping to resolve the fall in export competitiveness (albeit temporarily)
- For small and open economies that do not have a lack of natural resources → the increase in the price of imports due to a depreciation may not impact the standard of living of the households, and thus the depreciation of the exchange rates may not come with negative effects (like it does on SG)

### Development 3 – Which policy is best will still have to depend on the type of unemployment

- The situations described in Developments 1 and 2 related to demand-deficient unemployment, thus the discussion circled around demand-management policies
- If faced with structural unemployment, it is better to use supply-side policies
- Open, trading economies such as Singapore are likely to be very vulnerable to structural changes due to changing demand patterns worldwide
- As the economy changes its structure to develop new comparative advantages in trade, workers' skills may become obsolete. In this case, supply-side policies like retraining and skills upgrading may thus be necessary (as discussed in part (a)) rather than the demand-management policies such as exchange rates and interest rates
- In Singapore, the labour market is at full employment and much of the unemployment is equilibrium unemployment – structural and frictional unemployment
- Frictional unemployment in SG (in the form of search unemployment) is mostly caused by the open door policy to foreign labour that is adopted by many open economies → the influx of foreign labour into the economy → wages are lower → more people are voluntarily unemployed as they would prefer to search for a higher paying job → larger search unemployment
- Open economies that are reliant on foreign workers may thus need to explore policies that instead reduce the reliance on foreign workers to solve frictional unN, than to use demand-management policies
- Therefore, the utilization of policies to solve equilibrium unemployment will likely have to be

supply-side policies than demand-side policies

### Synthesis and conclusion

- The decision to utilize policies should ultimately depend on whether the country is restricted with policy usage, and if the policies solve the problem
- All things being equal, small and open economies will find it useful to utilize exchange rates policy, especially if trying to solve demand-deficient unemployment and if the expansionary exchange rates policy does not impact its households' standard of living (through higher import prices) severely
- But if the unemployment type is equilibrium unemployment, such as structural unemployment or frictional unemployment → better to solve the problems through supply-side policies

Knowledge, Application, Understanding and Analysis		
L 3	<i>For an answer <u>using analysis</u> to <u>support the conclusions</u> about the use of exchange rate policy as opposed to other policies to correct unemployment in small, open economies</i>	9-11
L 2	<i>For an answer that gives a <u>descriptive explanation</u> of exchange rate policy and other policies to correct unemployment</i>	6-8
L 1	<i>For an answer that shows some basic but largely <u>unexplained knowledge</u> of exchange rate policy, policies to correct unemployment <u>and/or</u> small, open economies</i>	1-5
Allow up to 4 additional marks for Evaluation		
E 2	<i>For an evaluative discussion supported by relevant economic analysis that either exchange rate policy or any other policy is justified</i>	3 – 4
E 1	<i>For an unexplained evaluative e.g. a largely unexplained statement that exchange rate policy is justified</i>	1 – 2