

ACJC Preliminary Examination 2017 Paper 2 Question 5

- a) Explain why Singapore government aims for low rates of inflation. [10]
b) Discuss whether failure to achieve low rates of inflation in Singapore is more likely to be caused by domestic or international factors. [15]
-

Question 5(a)

Introduction

- Explain the term “low rate of inflation”.
- State the benefits achieving “low rate of inflation”.

Body Paragraph 1

Singapore government aims for low rate of inflation to reduce redistributive effects on households and lenders. This will protect certain groups that will be worse off during high inflation as inflation has a regressive effect on lower and fixed-income families.

- Low inflation ensures that workers with weak or without trade unions could maintain their purchasing power. These workers may face difficulty pressing for higher wage to compensate for the price rises compare to workers in unions with strong bargaining power. Thus when there is low inflation, the purchasing power of this group of workers could be maintained at their given wages.
- Furthermore low inflation prevents lenders from losing out to borrowers. Inflation could reduce the real value of the debt such that when the debts are repaid, the real value of the debt will be less than that prevailing when the loans were made. Therefore low inflation is essential so that the real value of the debt is higher than that prevailing when the loans were made.

Hence, low inflation helps to reduce redistributive effects on households and lenders.

Body Paragraph 2

Singapore government aims for low inflation rate as it ensures high SOL in the country.

- Low inflation protects consumers, savers and lower income families.
- Low rates of inflation ensure the purchasing power of the consumers, especially consumers with fixed wages and fixed interest deposits.
- The low inflation ensures that all income recipients in this group will have high real income → high purchasing power → high consumption of goods and services → high SOL.
- This is because the nominal income they receive remains the same, but the cost of goods and services has risen slowly, ensuring their purchasing power.

Thus low inflation helps to ensure that all income recipients maintain their high standard of living.

Body Paragraph 3

Low rates of inflation are desirable as it encourages economic growth and reduce unemployment.

- A low rate of inflation indicates an increase in AD and hence reduce unemployment and increase NY → suggests that Singapore economy is experiencing economic growth
- This creates confidence in the economy and encourages firms to increase investment and attract FDI.
- Low inflation in Singapore also indicates that prices of input and wages of workers remain low, making Singapore an attractive place for investment.

- The low inflation rates is especially important for Singapore as it ensures that Singapore's exports remain competitive in the global market, given that Singapore is heavily dependent on export for economic growth.
- Low rates of inflation indicate that Singapore's export remains competitive in the global market → increase X
- Low inflation indicates that general price level in Singapore increases at a slow rate. This suggests that prices of goods and services produced in Singapore remains price competitive when exported to other countries → increase in X
- Increase in X and I → increase in AD → increase in NY and reduce cyclical unemployment. Thus Singapore government aims for low inflation as it ensures economic growth and reduce unemployment.

Body Paragraph 4

Singapore government aims for low rate of inflation as it ensures that Singapore has a healthy BOP.

- Low inflation → ensure export competitiveness → increase export revenue → increase inflow into the BOT → improves BOP
- At the same time, low inflation attracts investment into the country → increase inflow into the capital and financial account → improves the BOP

Thus low rates of inflation help to ensure healthy BOP in Singapore.

Conclusion

Singapore government aims for low rate of inflation because it has desirable impact on the households and the country. A low rate of inflation could reduce redistributive effectiveness of inflation, ensure high SOL and helps to ensure high EG, low unemployment and healthy BOP in Singapore.

Knowledge, Understanding, Application & Analysis		
<i>Level</i>	<i>Descriptors</i>	<i>Marks</i>
L3	<ul style="list-style-type: none"> • Develop analysis of the benefits of low inflation. • Answers are well-organized and coherent, contextualize to the context of Singapore. 	8 – 10
L2	<ul style="list-style-type: none"> • Undeveloped explanation of the benefits of low inflation. • Answers are supported by some economic analysis • Theoretical answer not supported by examples 	5 – 7
L1	<ul style="list-style-type: none"> • Points are largely irrelevant • Descriptive answer lacking economic analysis or contains many conceptual inaccuracies. 	1 – 4

Question 5(b)

Introduction

- Explain the various types of inflation
- Identify the possible domestic and international factors

Body Paragraph 1(international factor – increase in export revenue)

Failure to achieve low rates of inflation is likely due to international factors rather than domestic factors given the **nature of Singapore economy**. Being an economy with small domestic

economy and reliance on export for economic growth, Singapore is likely to face DD-pull inflation due to rising export.

- Singapore has a small domestic market and depends heavily on export for economic growth.
- Her export is 300% of its GDP while other components, domestic consumption, government expenditure and investments each constitute less than 50% of its GDP.
- Thus given the nature of Singapore's economy, Singapore is likely to face DD-pull inflation due to rising X.
- Prior to 2008 Global Financial crisis, Singapore's major trading partners USA, China and EU were experiencing strong economic growth → higher income per capita and higher disposable income → higher purchasing power → likely to see an increase in DD for goods and services produced by Singapore.
- Economic growth and growth in affluence in countries like China and Indonesia sees an increase in tourist arrivals in Singapore → increase Singapore's X. The number of Chinese tourists visiting Singapore triple from 2010 to 2017.
- Increase in X → increase in AD against a rigid AS → increase in GPL and hence DD-pull inflation → failure to achieve low rates of inflation
- A rise in consumption and investment is not likely to have significant impact on AD as the components constitute a smaller proportion (less than 50%) of the GDP.

Hence failure to achieve low rates of inflation in Singapore is likely due to international factors rather than domestic factors.

Transition

Besides being a small and open economy that depends on trade for economic growth, Singapore also relies on import for survival. Singapore is a small country with limited resources and thus has to rely on import of basic necessities such as water and food for survival. Not only that, Singapore also imports raw material and semi-finish goods so that Singapore could value-add to the products and re-export to other countries. The nature of Singapore economy means that Singapore would also be vulnerable to imported inflation.

Body Paragraph 2 (international factor – increase in prices of imports)

Given the **nature of Singapore economy**, failure to achieve low rates of inflation is likely due to international factors rather than domestic factors.

- Singapore has limited resources and imports most basic necessities. An increase in prices of goods imported into Singapore → imported inflation
- In addition to basic necessities, Singapore also imports raw materials and factors input such as crude oil. Oil refinery is a major sector in Singapore and Singapore imports crude oil and refines it for re-export.
- Increase in oil prices or higher prices of import such as raw material → increase the price of import → increase COP as oil is an input for production → SRAS shifts up → inflation.
- Hence failure to achieve low rates of inflation in Singapore is likely due to international factors.

Transition

International factors such as increase in export revenue and rise in import prices played a large role in pushing up the general price level in Singapore. Given Singapore dependence on X and M, international factors seems to be a stronger contributing factor to high inflation. This also explains why Singapore uses exchange rate policy to manage her economy rather than interest rate policy. However, in the recent years, Singapore government finds that exchange rate policy has difficulty managing inflation in the country. This suggests that causes

of inflation in the country may have changed. Rather than international factors, domestic factors seem to play a more dominant role in contributing to inflation in Singapore.

Body Paragraph 3 (domestic factor – higher wages)

In the recent years, domestic factors rather than international factors have been causing high inflation in Singapore.

- In a bid to increase productivity and reduce reliance on cheap foreign workers, SG government restrict the intake of foreign workers → shortage of workers in Singapore amidst strong economic growth → wages of workers increase → higher COP for producers
- However, the increase in wages is not match by an increase in productivity → average COP will increase → SRAS shifts up.
- In addition to the rising wages, producers also see an increase in rental fees. Limited land space but increase in demand for land space → shortage → increase in rental fees → higher COP for producers → SRAS shifts up
- When SRAS shifts up → increase in GPL and hence cost push inflation.

Hence failure to achieve low rates of inflation in Singapore could also be due to domestic factors.

Transition

Singapore's limited land space and labour pool make it challenging for Singapore government to achieve low rates of inflation. And these same domestic factors increase the likelihood for Singapore to experience DD-pull inflation. While it was argued earlier on that surge in export revenue, an international factor, could lead to DD-pull inflation in Singapore, the rigid AS also contributed to the inflation too.

Body Paragraph 4 (domestic factor – rigid AS)

Domestic factors also play an important role in causing high inflation in Singapore.

- Increase in export revenue could increase AD. However, if there is sufficient spare capacity, a surge in export revenue might not lead to DD-pull inflation in Singapore. Thus AS plays an important role in contributing to the failure to achieve low inflation.
- Aging population → labour force may grow at a slower rate. This is further exacerbated by the restriction on intake of foreign workers. Thus quantity of resources increase at a lower rate → productive capacity may expand at a slower rate → slower increase in LRAS.
- While Singapore government has attempted to increase productivity through the use of SS-side policies such as SkillsFuture, the result has yet to be seen. Productivity growth was low in 2017. This would mean minimal growth in production of output per unit time → productive capacity may expand at a slower rate → slower increase in LRAS.
- Thus if there is a surge in AD, the rigid AS could lead to high inflation in Singapore.

Hence failure to achieve low rates of inflation in Singapore could also be due to domestic factors.

Conclusion

- International factors – harder for Singapore to manage and control. Singapore is a price taker in the global market. Any attempt by Singapore to influence the SS and DD of goods such as crude oil and rice will have no impact on price. Singapore has to take the price set in the global market. While Singapore could use exchange rate policy to manage the impact of global prices, such policy will have limited and short term impact. There is an extent to how much and how long Singapore could strengthen her Sing dollar before causing harm to her economy.

- Domestic factors – Singapore has more control over. Rising rental fees was managed rather effectively by a series of policies to cool the property market. While attempts to increase productive do not seems to work as evident by the weak growth in productively, it may be too quick to conclude that the policies are not effectiveness. Given the nature of Singapore workforce, highly educated and skilled, it is likely that Singapore workers could adapt and increase productivity in the workplace.
- Furthermore, improvement in domestic factors such as higher labour productivity would increase LRAS which could create the spare capacity to meet the surge in X and hence AD, reducing the likelihood of DD-pull inflation.
- The higher labour productivity could also dampen the increase in COP due to higher import prices, reducing the likelihood of cost-push inflation.

Level	Descriptors	Marks
L3	<ul style="list-style-type: none"> • Developed and balanced analysis of the domestic and international factors causing the failure to achieve low inflation rates. • Comparison between domestic and international factors using criteria. • Answer is applied to Singapore context. 	8 – 10
L2	<ul style="list-style-type: none"> • Developed but one-sided answer: failure to achieve low rate of inflation is more likely to be caused by domestic factors OR failure to achieve low rate of inflation is more likely to be caused by international factors. • Undeveloped but balanced answer supported by some economic analysis. • Weak attempt at comparing between domestic and international factors. 	5 – 7
L1	<ul style="list-style-type: none"> • Points are largely irrelevant • Descriptive answer lacking economic analysis or contains many conceptual inaccuracies. 	1 – 4

Evaluation		
E3	<ul style="list-style-type: none"> • Reasoned judgment support by well-reasoned arguments as to which factors is more likely to lead to failure to achieve low rate of inflation. • Uses criteria to compare and address the question (e.g. nature of the economy, time period). 	4 – 5
E2	<ul style="list-style-type: none"> • Reasoned judgment based on some analysis. • An attempt to use criteria to compare and address the question. 	2 – 3
E1	<ul style="list-style-type: none"> • Unexplained judgment of relative importance of domestic and international factors. 	1