

2017 Y6 H2 Prelim II Essay Q5 (Section B)

Economists often distinguish small and open economies, such as Singapore, from large and less open ones.

(a) Explain how size and openness could account for why economies pursue policy mix to different extent. [10]

(b) Discuss how far the size and openness of Singapore have influenced her choice of policies to achieve price stability. [15]

Suggested Mark Scheme

(a)	Knowledge, Application/ Understanding and Analysis	
L3	Developed explanation of how size & openness influence the effectiveness of DD-mgmt policies and thus account for why economies rely on policy mix to different extent <i>'Developed'</i> : (i) Use multiplier process as a tool of analysis to illustrate how size & openness affects k (ii) Highlight how differing values of k determine the effectiveness of DD-mgmt policies and thus the need for other policies	8-10
L2	Undeveloped explanation of how size & openness influence the effectiveness of DD-mgmt policies and thus account for why economies rely on policy mix to different extent <i>'Undeveloped'</i> : (i) Missing assumptions/ incomplete or superficial explanation for multiplier process (ii) Fail to link back to the question by contrasting between economies with different k and what this implies about the extent of policy mix pursued	5-7
L1	Smattering of valid points <i>*Answers without explanation of multiplier process will only be in Level 1</i>	1-4

(b)	Knowledge, Application/ Understanding and Analysis	
L3	Developed discussion of at least 2 factors (including size & openness) that have influenced Sg's choice of policies to achieve price stability <i>'Developed'</i> : Explicit link between (i) Small & open economy to the use of $X\Delta$ rate policy + inability to use conventional MP (Thesis) (ii) Causes of inflation to appropriate policies e.g. SSP/ Macro prudential policies (Anti-thesis)	8-10
L2	Undeveloped discussion OR developed explanation for one side (either thesis or anti-thesis) <i>'Undeveloped'</i> – Superficial link between factors and policies to achieve price stability	5-7
L1	Smattering of valid points	1-4

E3	Arrives at an analytical, well-reasoned judgement about the relative importance of various factors (including size & openness) in influencing policy choice to achieve price stability	4-5
E2	Makes some attempt at a judgement about how important the size & openness of Sg is in influencing policy choice to achieve price stability	2-3
E1	Unsupported statement about the importance of size & openness in influencing policy choice	1

Suggested answer points: (a)

Intro

- State the implication of being 'small, open economies'. Specifically, for a country like Spore:
 - Small domestic mkt
 - Lacking in natural resources such as land
 - Implication: Need to be open to trade, capital and labour flows
- In contrast, state the implication of being 'large & less open economies'. Specifically, for a country like US:
 - Larger domestic mkt
 - Likely to be endowed with more natural resources
 - Implication: Less reliant on trade and capital flows
- **Overview:** One key determinant for the difference in extent to which a policy mix is pursued is the size & openness of the economy, which in turn depends on the nature of the economy

Development

- More evident during situations where the government undertakes DD-management policy to achieve certain macro aims e.g.: During a recession (Alternative: Students can also look at achieving other macro aims)
- Students are to give a detailed explanation of the multiplier process to illustrate the role played by size and openness
 - Assumptions
(Idle resources need to be available; values of marginal propensity to consume, withdraw etc.)
 - Explain at least 3 rounds
(Suppose government expenditure G increases by \$100m, what happens subsequently)
 - Highlight how different values of the multiplier can give rise to different increase in national income
(if $k=2.5$ vs $k=5$, how would this affect the final increase in national income)

(i) For small, open economies

- Small value of multiplier due to large marginal propensity to import
→ A rise in AD leads to small increase in NY
- Likely to rely less on DD-management policies (e.g., FP/ MP) to achieve the desired Δ in NY; may need to make use of other policies such as exchange rate policy and supply side policies

(ii) In contrast, for large & less open economies

- Larger value of multiplier due to smaller marginal propensity to import
→ A rise in AD leads to a bigger increase in NY
- Likely to rely more on DD-management policies to achieve the desired Δ in NY; no/ less need to make use of other policies such as exchange rate policy and supply side policies

Conclusion

- Between small, open economies vs large and less open economies, the former is more likely to use a policy mix to a larger extent due to their smaller value of multiplier

Suggested answer points: (b)

Introduction

- Attainment of 'price stability' → Ensuring low & stable inflation
- **Overview:** Size & openness of Singapore do influence her choice of policies to achieve price stability to a large extent, although other factors also play a part depending on the situation

Development

Thesis: Yes, size & openness of Singapore do influence her choice of policies to achieve price stability. How so? Why?

- Sg: Small, open, import reliant → Implication:
 - Open to trade flows
 - Open to capital flows
 - Global financial centre
 - Rely heavily on exports and FDI as growth engines

① More strategic to use exchange rate policy as the 'key' policy to achieve price stability

- Explain how keeping Singdollar on a gradually appreciating stance helps to achieve price stability
 - (i) More expensive exports help to deter exports and hence prevents AD from rising excessively
 - (ii) Cheaper imports keep out imported inflation
 - Environment of price stability attracts FDI
- ∴ Price stability is pre-requisite before X and FDI can serve as growth engines

② Cannot use contractionary monetary policy

- Explain why it is ineffective to \uparrow i/r to achieve price stability i.e.
 - (i) Any Δ i/r will be negated by hot money flows
 - (ii) Δ i/r have minimal impact on I

Anti-thesis: No, other factors influence Singapore's choice of policies to achieve price stability. Such as?

① Causes of inflation/ px instability

- If \uparrow GPL stems from domestic sources, then 'size & openness' is less important in determining the policy to use. Instead, the choice of policy depends on the root cause of inflation
- E.g.: Hikes in foreign worker levy → \uparrow COP → \uparrow GPL
- In this case, the government may need policies that address this problem i.e.
→ mitigate cost push inflation
- Over the long term: use supply side policies to:
→ moderate DD-pull inflation (show diag)
- Alternatively, if high property prices or car prices are the source of inflation, then other policies will need to be used

② Other considerations

- Government may consider the opportunity cost of a policy or concerns about long term growth
- For e.g., if undertaking a certain policy leads to high opportunity cost, then the government will unlikely choose that policy to achieve price stability

Conclusion

- Size and openness is just one factor that determines policy choice; depending on circumstances, other policies may be chosen instead