**Essay Question 23**

**Are the supply-side policies an effective solution to the most significant macroeconomic problem that is currently being experienced in your country? Discuss.**

Introduction

Singapore is a small and open economy with limited natural resources. It depends on external market to fuel its growth through exports and foreign direct investment (FDI). It is natural that Singapore will experience certain economic problems that will restrict the growth of the economy. Inflation is one of the most significant macroeconomic problems as small changes in the external market can adversely affect Singapore’s general price level and real national output. To tackle the inflationary problem, the government can introduce various supply side policies that will either decrease cost of production or increase resource capacity, solving inflation to a great extent.

Main Body

Inflation is a sustained increase in the general price level of goods and services. The value of domestic currency is reduced and thus more cash has to be spent on the purchase of a fixed basket of goods and services. Inflation can be divided into demand-pull and cost-push inflation. Demand-pull inflation is caused by an excessive rise in the Aggregate Demand even when resources are already at full employment or at rising cost condition, leading to an upward pressure on the price level with little to no increase in real national output. Inflation can also be classified as cost-push inflation, whereby factors such as firms charging indiscriminately higher prices or strong trade unions demanding for higher wages to meet rising cost of living result in profits-push and wage-push inflation. Yet, these are less common as Singapore has regulatory measures to prevent the proliferation of trade unions. Singapore is more susceptible to import-induced inflation, whereby the Middle East crisis results in a decreased supply of oil, leading to a rise in price and thus a rise in cost of production as Singapore imports huge amounts of oil as a raw material for multi-purpose uses, and then, the rise in cost of production results in cost-push inflation.

Inflation is extremely significant as it brings with it a whole host of detriments and disadvantages to society. Firstly, externally, a rise in general price levels will raise the cost of exports, decreasing export competitiveness. Assuming the price elasticity of demand is higher than 1, quantity of exports demanded will decrease by more than proportionate. The value of exports will decrease, leading to a lower net value of X-M as imports will increase as citizens will favor cheaper foreign goods over the more costly local ones. This may lead to a decrease in AD which will decrease real national output and hence employment rate will decrease as firms will produce less to compensate for the fall in AD.

Furthermore, internally, a rise in general price level will decrease the purchasing power of the lower income group especially, causing them to enjoy less of goods and services and decreasing their standard of living. Moreover, inflation will contribute to an increase in the income disparity of the rich and poor as the rich have more fixed assets such as houses and bonds and the value of these assets will scale upwards with inflation rate, hence the rich will lose no value whatsoever. Ultimately, the cost of living will increase as it costs more to purchase a fixed basket of goods and services to maintain the same standard of living.

Supply-side management policies aim to solve the problem of inflation by attempting to decrease to cost of production and increase resource capacity in the long run. One way the government can achieve this is to conduct various programs to retrain workers and increase their productivity. Through the training of new skills, workers will be able to produce more goods within a given period of time, decreasing their average cost price per good. Furthermore, the government can conduct infrastructural projects which contribute to an increase in the mobility of resources so as to decrease the cost of production. This will, decrease average cost of production and then curb cost-push inflation.

Y₁

Y₀

AD

AS₀

AS₁

Real National Y

P₀

P₁

GPL

As seen from the diagram, the decrease in cost of production results in a downward shift of the AS curve from AS₀ to AS₁, resulting in a fall in price from P₀ to P₁.

Finally, the government can provide heavy subsidies for firms to conduct research and development and increase the technological prowess of the economy. This will result, in the long run, in an expansion of resource capacity as new machines will be able to make production more efficient with much higher output. More machines will also produce more, and there are more resources to be utilized before it reaches full employment.

Y₀

Y₁

Real National Y

AS₀

AS₁

AD₀

P₁

P₀

GPL

As seen from the diagram, this leads to an increase in potential growth and results in an outward shift of the AS curve from AS₀ to AS₁, decreasing the price from P₀ to P₁, as illustrated above.

Generally, supply-side policies are effective because it solves the root of the problem as there are too few resources to be employed and they are of low productivity and with this expansion of resource capacity, the increase in output will lower cost conditions.

Supply-side policies also create a more permanent impact on the economy with sustainable economic growth that prevents future onset of inflation. Furthermore, workers’ skills are raised which will raise their wage rate and restore some form of purchasing power to them, solving the unequal distribution of income, by raising productivity to raise the wage of the lower income group. Finally, the effects on supply-side management policies are multi-dimensional as it can promote the attainment.

However, there are also limitations to supply-side policies. Firstly, there is time lag of identifying the inflations condition and coming up with the appropriate policy to solve it. Secondly, there is extreme uncertainty that research and development will lead to a technological breakthrough. Given the high cost of financing, this may result in a failed investment and the government may have to borrow and incur public debt to finance their increased expenditure, perhaps even increasing tax rates which worsen inflation. Furthermore, workers may be unreceptive to the training or they may not get the chance to utilize their few skills, resulting in an effective management. Moreover, the effectiveness also depends on the efficiency of the public administrative system in disseminating the information that there are subsidies for firms to invest and the duration before the policies to take effect. Also, there are inherent limitations which supply-side policies cannot solve. Supply-side policies cannot solve import-induced inflation because it cannot manipulate the exchange rate of Singapore, and it cannot really affect the aggregate demand affected by external demand. It can only affect AD indirectly, as opposed to monetary and fiscal policies which directly affect Aggregate Demand.

Conclusion

In conclusion, supply-side policy may not be the best policy to solve inflation as a policy package has to be introduced so that one policy will solve the limitations of another and a combination of a reduction in AD and increase in AS will definitely keep inflation low and mild – a healthy level for the economy.