## Question 2 – Marking Guide (CSQ 2021 – inflation - Q1

2(a), **With reference to Figure 2:,**

2(a)(i), **Compare the gross fixed capital formation over the period 2013- 2016 between India and Singapore.**

It should be observed from Figure 2 that both countries recorded an overall increase in the level of gross fixed capital formation over the period 2013-2016, given by the positive growth rate (albeit a negative growth rate for Singapore in 2016) **(1)**.

The next statement may be to compare the rate of increase in GFCF for both countries. GFCF in India expanded at an increasing rate while GFCF in Singapore grew at a decreasing rate (1)

2(a)(ii), **Explain a possible reason for the trend of India’s gross fixed capital formation growth over the period 2013-2016.**

Following consecutive years of a decline in GFCF growth, India experienced a revival in investment spending over the period 2013- 2016 characterised by higher rates of year-on-year increase. There are many different possible reasons to account for such a trend. Any reason with valid economic reasoning should be accepted. One possible reason may have to do with a fall in interest rates, though the ‘relatively tight monetary stance’ in Extract 8 might not support such a view. Other possible reasons include government policies toward state-led investment spending, improved market prospects or business environment that lifted the profits expectations of firms, or favourable domestic or external factors that have encouraged private sector investment. For e.g. an increase in external demand (trade gains) may contribute to a pick-up in manufacturing activity reliant on capital- intensive production in India, the effect of which is to spur firms to spend more on capital goods to support the output expansion.

2(b), **Explain the meaning of real GDP per capita.**

2(c), **How far does the data in Table 2 allow one to conclude whether the average Indian or the average Singaporean is likely to experience a larger improvement in living standards over the period 2013-2016?**

, Definition of standard of living in terms of the material and non-material aspects of well-being.,

, A sustained increase in real per capita GDP over the years, given by the robust growth rates, means that Indian residents on average enjoyed a higher level of real income which made it possible to purchase a larger quantity of goods and services, thus allowing for improvements in their livelihoods. Compounded over time, that growth rates remained consistently above 5% indicates that there was a significant improvement in living standards. In comparison, the rate of real GDP per capita growth for Singapore was much lower over the same period.,

Despite the elevated rates of inflation, real wage growth (nominal wage growth adjusted for the effects of inflation) for India exceeded that of Singapore, considering the impressive nominal wage growth for the former. Since real wage is a direct measure of purchasing power, on this note, the average Indian seems to have experienced a larger improvement in living standards over the period.,

, As a measure of the true value of output or income, national income statistics (real GDP per capita) have limitations to do with:

* non-marketed or non-transacted output that may be significant in less developed countries as well as output sold in underground markets may not be included
* improvements in the quality of goods and services are not taken into account

value of negative externalities, such as pollution and other undesirable by-products of production or consumption is not accounted for,

, In addition, income statistics or wages may be inadequate as measures of standards of living. The inadequacies include:

* use of real GDP per capita and real wage growth as an indicator of average output/income or average wage growth per person

relevance of other economic information such as income distribution, levels of education & health, life expectancy, leisure time, as well as quality of life factors such as the crime rate, a sense of security and peace arising from relations with other countries, well-functioning institutions (free of corruption), stress levels from working conditions, the degree of political freedom etc. to account for SOL adequately.,

2(d), **Using AD/AS analysis, explain how a collapse in commodity prices (Extract 8) and a relatively tight monetary stance (Extract 8) have kept inflation low in India.**

A collapse in commodity prices means that prices of agricultural commodities and non-agricultural commodities such as metals (copper, iron ore), crude oil etc. have taken a tumble. Given that India imports a significant quantity of these items and since these raw materials are widely used as factor inputs across different sectors and industries, the decline in commodity prices will lower firms’ production costs and cause AS to increase, keeping inflation low. However, there are also other factors that can keep inflation rate low.

The effect of a collapse in commodity prices may also be to cause a fall in the prices of agricultural commodity exports from India. Given that demand is likely to be price-inelastic, a fall in price will result in a less than proportionate increase in quantity ceteris paribus, giving rise to a fall in export revenue. This will have the effect of lowering (X-M) and hence reducing AD, holding everything else unchanged. This prevents demand pull inflation.

A relatively tight monetary stance has to do with the Reserve Bank of India (RBI) opting to raise interest rates or to keep interest rates at elevated levels, likely due to heightened inflationary expectations. This

will have the effect of dampening private consumption and investment, spending. Given that domestic demand is likely to be buoyed by robust growth in industrial and manufacturing activity, including higher household spending spurred by wage growth, the resultant effect may be a smaller magnitude of increase in AD, in which case, the increase in GPL via the multiplier effect will be reduced.

Analysis:

2 (e), **Extract 11 suggests that slowing growth in Singapore is due to a ‘confluence of short-term cyclical headwinds, as well as longer- term structural issues’. Discuss the relative importance of cyclical and structural factors in causing growth to slow down.**

*Question Analysis:*

*The severity of the recession triggered by the 2008 financial crisis and the sluggishness of the subsequent recovery (including the slowdown in growth of economies relatively unaffected by the events) have raised questions about the relative weight of structural and cyclical factors that may impact the growth and employment in an economy. A small and open economy like Singapore is spared from neither.* ***Cyclical factors have to do with the upturns and downturns of the economic cycle of expansion and contraction. While cyclical factors tend to be relatively short-lived and may be easily offset by an appropriate fiscal or monetary stance*** *(e.g. fiscal and monetary stimulus during periods of recession), structural factors are more deep-seated and long-lived and are not easily overcome by such policies****. The latter is commonly associated with the ‘supply-side’ of the economy, which determines a country’s productive capacity (recall PPC and the vertical segment of the AS curve). These factors include infrastructure, quality institutions, workforce, level of education and training, labour and goods market efficiency, financial market development, extent of technological readiness, market size etc.*** *Given Singapore’s dependence on external demand for its exports, cyclical factors to do with an economic downturn in the economies of her major trading partners may cause export demand growth to slow and weigh on Singapore’s economic growth. However, if Singapore’s market size (including foreign markets) is affected by a fall in trade volume due to China’s rebalancing of its economy (transition towards domestic consumption away from investment as a source of growth will cause the overall level of imports to fall) or if Singapore embraced a growth model characterised by shift towards innovation and techno*, *are structural in nature.* ***The relative weight of the factors will then depend on the magnitude and duration of the cyclical and structural shocks, as well as, the ability of the government to provide an effective policy response to mitigate the effects (e.g. drag on growth and job creation).***

Slowing growth to do with a lower rate of increase in real national income.

Cyclical headwinds have to do with the ‘absence of a meaningful rebound in consumer confidence globally’ that may explain the lack of a significant pick-up in consumer and investment spending as well as the slump in oil prices, among other possible factors. Firms and households in the economies of Singapore’s major trading partners may hold back spending in the face of economic uncertainties and this translates to slower export growth for Singapore. Depressed prices of oil, largely a result of a slowdown in global growth, would also have caused a contraction of revenues for firms in oil and gas-related sectors in Singapore. This would make it difficult to sustain production and firms will be forced to cut back output and lay off workers. The net effect may be a smaller magnitude of increase in aggregate spending for Singapore, depending on how other components of AD may have changed.

Structural factors include government policies (e.g. foreign worker levy hikes, incentives to promote innovation and enterprise) to undertake economic restructuring to shift to a growth model underpinned by

innovation and technological utilization, as well as issues to do with weak productivity growth, loss of competitiveness, rising inequality among businesses in adopting new technologies or exploiting technological developments, shrinking labour force etc. These may either add to short-term cost, result in the closure of less competitive firms or contribute to rising structural unemployment that will either cause AS to decrease or limit the expansion of productive capacity, including possible impacts on AD, the effect of which is to dampen growth.

Analysis – which development accounts more for the development of slow growth.

(f), **India has progressed towards a free-market economy that saw the government introduce policies that included a reduction of taxes and subsidies, removal of price controls and opening up domestic markets for foreign investment. The International Monetary Fund says India also needs active government intervention to increase infrastructure spending.**

**Assess the case for a greater reliance on the free market, rather than government intervention, to achieve economic growth and low unemployment.**

*Question Analysis:*

*Most of the countries in the world today are mixed economies, an economic system that is strongly based on free markets with varying degree of government intervention. A free-market economy relies on the price mechanism to coordinate the independent decision-making of countless consumers and producers and under competitive conditions, prices work as signals and incentives to determine resource allocation in achieving maximum social surplus. The pursuit of self-interest by economic agents gives rise to risk-taking, enterprise, innovation and investment, which leads to higher levels of output and possibly higher standards of living. It thus follows that, in progressing towards a free-market economy, governments will implement policies that encourage competition and remove impediments such as taxes & subsidies or price controls or wage legislation in both product and resource (labour) markets so as to allow competitive market forces to work freely to achieve greater efficiency in production (through innovation and exploiting technological gains), lower prices and improved quality, and a better allocation of resources, as well as,* *increased levels of output, or economic growth. A more competitive labour market will also improve the motivation for workers to work and incentives for firms to hire.*

*Opening up domestic markets for foreign investment works on the same notion in that doing so will raise efficiency, facilitate the transfer of technology, skills and expertise that will allow for an expansion of a country’s productive capacity. However free-market outcomes are not always positive. Issues to do with market failures, regional inequalities, income disparities among households and businesses abound. Government intervention, including the provision of infrastructure, investment in human capital, the provision of quality institutions (e.g. a well-developed banking sector, enforcement of property rights, legal recourse, transparency in information), the provision of a stable macroeconomic economy and the provision of a social safety net or income redistribution, may then be necessary to correct market deficiencies (such that the problems do not become serious enough to pose threats to an economy) and to create the conditions in which markets can function effectively. Of course, government intervention can often be dogged with poor planning, excessive bureaucracy, and corruption. Assessing the case of a greater reliance on the role of free markets or government intervention may be to consider the stages of economic growth and development a country is in, prevailing economic conditions and particular needs or unique circumstances of a country.*

Introduction

Explanation of the role of government intervention to do with infrastructure provision, investment in human capital, macroeconomic stabilisation, provision of a social safety net etc. Education and health have significant external benefits, thus calling for government intervention (such as direct provision) that increases the consumption of both.

Education and health are one of the major areas behind increases in productivity that contribute to economic growth. Where the private sector may not be able to provide for, governments may need to invest in human capital to address emerging skill gaps and to equip workers with relevant industry skills that are in demand. Infrastructure as a type of physical capital, includes water supplies, sanitation and sewerage, power, communication, transportation, roads, irrigation, and many others. All of these play a very important role in promoting economic growth, apart from a direct contribution to improved standards of living. Therefore, there is a strong role for governments in order to ensure the provision of the appropriate kinds of infrastructure, with the appropriate access by the population.

 Macroeconomic stabilisation is also critical to the creation of a conducive and stable environment for consumption and investment spending. This may take the form of appropriate fiscal or monetary stances as well as exchange rate intervention. The Singapore government adopts an exchange-rate- centred monetary policy that allows for a gradual and modest appreciation of the domestic currency, which effectively allows the government to mitigate the onset of inflation pressures via AD and AS channels. This has helped to keep inflation rates relatively low and achieving price stability is fundamental to Singapore’s reliance on exports and foreign investment as sources of growth. To counter the effects of rising income disparities and the resulting impact on growth, governments also have to intervene with the provision of a social safety net as well as the implementation of progressive tax structure.