**HCI Prelim 2019 Question 5**

Singapore’s inflation rate turned positive in 2017 after two years of negative inflation. But with the pace of price increases set to remain modest, economists are divided over the question of how soon the central bank will move to appreciate Singapore currency.

*Source: The Business Times, 24 Jan 2018*

1. Explain the internal and external factors that are likely to have contributed to the reported change in inflation rate in Singapore. [10]
2. Discuss whether you will support a move by the central bank to appreciate Singapore currency aimed at reducing inflation even though it might result in unintended consequences for the economy. [15]
3. **Introduction: Define inflation, state types (DD pull, Cost push or statutory factors)**

**2017 – Inflation rate was positive ie increase in rate of change in GPL**

**Internal factors:**

Increase in price of **property and cars** (if weightage is high for the price index of these items, it may affect the Inflation rate as measured by % change in CPI). The over-heating of the private property market could be caused by speculative demand while the control of car population using COE is statutory in nature.

**Restrictive Immigration law** on foreign labour could increase wage cost, giving rise to cost push inflation

**External Factors:**

**Cost push:** increase in price of imports such as oil & food as in 2008. Oil price can increase depending on the SS policy of OPEC countries. If the oil cartel agree to restrict output to raise price, cost of crude oil will rise. Food price can increase due to SS shock which is affected by the vagaries of nature eg drought, flood & extreme weather caused by climate change.

**DD-pull:** Higher demand for Singapore exports resulting in greater competition for scarce resources => exerting an upward pressure on GPL as economy has little spare capacity or is near to full employment level.

**COMBINED EFFECT (Draw Diagram)**

**Positive Inflation rate in 2017 :**

**AD increase & AS fall or AD ↑ > AS↑**

(global sentiments are still optimistic as US-China trade-war had not intensified, leading to vibrant export sectors). Higher productivity resulting in lower COP can dampen the increase in price => **modest** increase in rate of increase in GPL as in preamble.

**AD ↑ > AS ↓ (**higher business cost due to increased energy and labour cost can add on to inflationary pressure).

As economic recovery is not in full swing, the **pace** of price increase is **modest**.

**Conclusion**

The internal source of inflation in 2017 are statutory in nature in conjunction with government’s attempt to restrict car population and inflow of foreign labour. The external sources of inflation in 2017 can be recovery of export demand or supply shock in the form of fall in SS of essential items such as oil or food.

Part b)

Singapore’s inflation rate turned positive in 2017 after two years of negative inflation. But with the pace of price increases set to remain modest, economists are divided over the question of how soon the central bank will move to appreciate Singapore currency.

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1. Discuss whether you will support a move by the central bank to appreciate Singapore currency aimed at reducing inflation even though it might result in unintended consequences for the economy. [15]

**Introduction:**

**Key Issues & Approach** – shows **CONTEXT** in which decision of appreciation is to be made

* In 2017, inflation rate is positive and GPL expected to continue to rise modestly.

**Body:**

Explain how appreciation can have positive or negative impact

**Appreciation or GRAMA policy helps tackle :**

**Imported cost push inflation** => If the cause of the price increase is due to **higher cost of imports,** appreciation can mitigate cost push inflation.

Elaboration: Imported input would be cheaper in domestic currency after appreciation.

**DD pull inflation** => If economy is already at full capacity. Appreciation can **cool down** the over-heated economy and reduce the upward pressure on price.

**Evaluation**: DD pull is unlikely given the context that inflation has just turned positive from negative in 2017.

**However, there is unintended consequences:**

Appreciation would result in Px ↑ in terms of foreign currencies in foreign markets. If PEDx>1, TR↓ as Qty falls by a greater proportion=> adversely **affect BOT** => **fall in NI**

Appreciation of S$ can affect the export-oriented sectors adversely if exports become less price competitive. This can lead to **retrenchment and unemployment**. **=> fall in SOL**

**Evaluation**:

* However, Singapore can make its exports less price elastic by **SS side policies** ie improving the quality of its products via innovation etc which garners brand loyalty and reduce its substitutability.
* As current exchange rate policy is likely to be zero appreciation, it can be deduced that the global economy is experiencing slow growth & hence the threat of high import cost is low => mitigation of imported cost-push inflation is not applicable.

**Other possible adverse effects:**

**If appreciation is to a great extent and at rapid pace**: can result in higher cost for foreign investors to set up business ventures in Singapore. This will adversely **affect inflow of FDI, affecting financial account & BOP & job creation => employment opportunities.**

**Evaluation : extent & timing of appreciation**

The adverse impacts on growth, BOP and employment would be reduced if the appreciation is **gradual and modest.**

Moreover, the **timing** of the appreciation is significant. If the inflation rate has turned from negative to positive in 2017 due to **DD pull factors**, GRAMA can help mitigate the inflationary pressure by reducing the rate of dd for Singapore exports (Px will be less competitive). However, if the recovery of export demand is weak and the currencies of major trading partners have depreciated, the move to strengthen S$ will make Singapore’s exports to be much more expensive vis a vis substitutes from countries whose currencies have depreciated. This would dampen the recovery process in the export sectors.

**Synthesis & Conclusion**

Appreciation of S$ would be supported if the source of inflation in 2017 is due to higher cost of imported input. However, if the inflation is mild and dd pull in nature, appreciation by a **large extent** would derail the recovery of the export sectors by making the price of its exports less competitive. The move to appreciate S$ would be **supported only if** it does not cause its exports to lose too much of its price competitiveness. Generally **modest and gradual** **appreciation** would be supported if it can achieve the macro goals of low inflation, growth, employment & healthy BOP when supplemented by SS side policies.