**Essay Discussion – Aims of Government & Policies Part 1 (Set A)**

**Question 1**

**Traditionally, there are four main objectives for an economy to achieve: Full employment, low inflation, a balance of payment equilibrium and sustainable economic growth. However, these objectives cannot be achieved simultaneously. The government has to make a choice between the objectives for the government, because achieving success in one often leads to a failure in another.**

**Discuss how this assertion is relevant in Singapore**

# Question 2 – Priority of Aims - Unemployment

**“84,300 people could not find a job last month. It brought the unemployment rate to 4.8%. This is even higher that 4.3% experienced in the last Asian Crisis in 1997.” The Straits Times, Dec 2003.**

**a) Explain the current level of unemployment in Singapore (10)**

**b) Discuss whether full employment should be the economic priority of the Singapore government. (15)**

**Question 3 -Priority of Aims & Monetary Policy**

**“A low rate of inflation should be the economic priority of the government and it is achieved by keeping interest rates high in the economy.”**

**Question 4 – Aims of government / Policies – Fiscal Policy**

**‘China will increase government borrowing and public spending this year where much of which are spent on infrastructure projects, education and health care.’**

**Assess the macroeconomic aims and other objectives that might be achieved by the Chinese government as it undertakes the above expenditure. [25]**

**Question 5 - Policy – Supply-side Management Policies**

**Are supply-side policies an effective solution to the most significant macroeconomic problem that is currently being experienced in your country? (17)**

**Question 6 – Government Policies and Aims of Government – exchange rate policy**

**The Monetary Authority of Singapore (MAS) operates a manage float regime in which the exchange rate of the S$ is allowed to fluctuate within a band. Exchange rate policy is used extensively by the MAS to manage Singapore’s macroeconomic performance.**

**b. To what extent might the main macroeconomic problems faced by Singapore in recent years be solved by exchange rate policy? [15]**

#### Question 1 – Conflicting nature of aims

**Traditionally, there are four main objectives for an economy to achieve: Full employment, low inflation, a balance of payment equilibrium and sustainable economic growth. However, these objectives cannot be achieved simultaneously. The government has to make a choice between the objectives for the government, because achieving success in one often leads to a failure in another.**

**Discuss how this assertion is relevant in Singapore (25)**

#### (what are the aims of government? (8)/How the aims of government will conflict with each other (10) and is this seen in Singapore?) (7)

#### Introduction

State that the government has the above four objectives to achieve but it may not be easy for it to achieve them, especially when it tries to achieve them simultaneously.

Short profile of current Singapore economic situation

#### MainBody

1. **Define and explain the four main aims and their importance or benefits. (8-10)**

**(definition/measurement/characteristics/importance)**

**Full employment refers to the full utilization of productive resources such as labour.**

* measured in term of the unemployment rate (unemployed / total labour force)
* determines the actual production capacity
* affects the level of government spent on unemployment benefit and the tax revenue, leading to the rise of budget strain which may lead to the rise of debt burden if it requires financing
* may lead to unequal distribution of income and wealth, especially when there is structural unemployment. – segments of workers lost their income in the sunset industries while the workers in the sunrise industries gain higher income

**Price stability (low inflation) – it refers to the stability of the change in price level**

* measured by the consumer price index – which shows the change in the price level over the base year (year-on-year (5%) or base year comparison (105%))
* need to achieve this aim to avoid the problem of higher cost of living and cost of production
* avoid the adverse effects of hyper-inflation (loss of competitive edge, affecting the export demand and the level of foreign direct investment)

**Economic growth refers to growth of the actual and production capacity**

* **actual** production capacity refers to the actualization of resources into monetized products and services which is measured in term of the percentage change in GDP while the **potential** production capacity refers to the expansion of the availability of resources for production which is measured in term of the production possibility curve.
* EG will determine the level of goods and services available to the economy
* It determines the level of nation income which will determine the tax revenue and real per capita income – the level of tax revenue which will determine the level of government expenditure on public goods and services in the nation and the level of real per capita income which will determine the purchasing power will determine the level of standard of living
* EG will also provide the government the revenue to raise infrastructure development to raise the efficiency of the industries to raise the competitiveness of the economy

**Balance of Payment Equilibrium refers to the stability of the balance of trade, balance of payment and exchange rate (BOP surplus – net positive flow – appreciation/BOP deficit – net negative flow – depreciation)**

* external stability is imperative as it will determine the flow of currency which will affect the exchange rate
* exchange rate instability will undermine the determination of trading prices and cost of FDI which will disrupt the trading and investment activities and thus affecting the export demand and investment **(critical to Spore as high export dependency / need for FDI for economic growth**)
* also may undermine the government external debt payment and cost of living for countries that rely a lot on external economy

**1. Conflict between inflation and unemployment (inflation vs growth)**

1. Explain the conflict using AD-AS

To curb unemployment, need to conduct expansionary demand management policy to increase AD, via multiplier will increase national income – production will increase – leading to higher demand for more labour and thus solve the unemployment level but such an expansionary policy will also raise the AD excessively, leading to increase in price level when the economy is operating under rising cost condition.

To curb inflation, need to conduct contractionary demand management policy to lower AD, via multiplier will decrease price level – but such a contractionary demand management policy will also lower the AD excessively, leading to decrease in national income and production which will lead to unemployment.

1. Relate to Singapore (assertion not relevant and why)

* Emphasis on expansion of production capacity, results in both AS and AD shifting outwards. Therefore employment is increased but there is low inflation. (to attain sustainable EG)
* CPF policy and strong Singapore dollar also keeps imported inflation rates low(provide funds for exchange rate management)
* Increase in employment may result in some mild inflation but it is an affordable trade off (Can provide more employment and loss in purchasing power can be compensated with subsidies.)

**2. Conflict between internal and external stability**

1. Explain the relationship

It is difficult for the economy to adjust the interest rate to achieve internal and external stability. Increase in interest rate will help to curb inflation but it will not solve balance of payment surplus as there will be increase in capital inflow, leading to further improvement in BOP. Decrease in interest rate will lead to reduction in unemployment as investment and consumption will increase which will contribute to rise in employment and national income but such a reduction in interest rate will lead to a fall in net capital flow and thus worsen the BOP deficit.

1. Relate to Singapore (assertion is relevant for Singapore)
   * Singapore will experience such situations as the economy relies extensively on the external demand for growth and its reliance on flow of capital as it is main financial centre which will be greatly influenced by the need to stabilize the exchange rate.
   * Productivity increase, technology improvement, cost of cheap imported raw materials made possible by strong Singapore dollar and thus it is more likely to focus more on the need to stabilize the exchange rate (pre-requisite condition for the government to prevent the surface of economic problems like unemployment and to help to attain the main aim of economic growth)

(stable exchange rate – stable trading prices – promoting trading activities – increase prodn n N+)

**3. Conflict between economic growth and unemployment**

1. Explain jobless growth (high level of economic growth with low contribution to employment as the areas of growth confined to capital intensive industries)
2. Relate to Singapore (assertion is relevant for Singapore in short run)
   * Current unemployment is largely structural in nature
   * Our emphasis on productivity is double-edged in effect – it will grow the economy but the economy is likely to lead to technological unemployment (less workers are needed and skill incompatibility will occur)
   * The economy will constantly need to adjust the sectors of the economy to enhance its comparative advantage which will lead to sectoral unemployment as sunset and sunrise industries will occur
   * Demand may come back but does not mean more workers are needed as worker does not have the skills to be employed (skill incompatibility and displacement of workers)
   * Need to equip workers with new skills and also look for new demand which require the new skills

#### Conclusion

It is noted that all aims of the government are of great importance to the government but it will create problems if the aims are to be attained simultaneously. The government needs to look at the constraints and derive an optimal solution which may induce the need for the government to prioritize the aims according to the condition of the economy.

**1) Economic growth vs unequal distribution of income and wealth**

**Rising income for those who can gain from rise in prices / undermine lower income group due to higher prices of resources**

**Provide tax reduction to promote growth – increase the income of the rich and undermine the lower income group**

**Solving unequal distribution of income with progressive taxation – disincentive to work and undermine EG.**

**2) Economic growth vs optimization of resource allocation**

**Excessive production – rise in DWL – undermine optimization**

# Question 2 – Unemployment – Priority of Aims

“84,300 people could not find a job last month. It brought the unemployment rate to 4.8%. This is even higher that 4.3% experienced in the last Asian Crisis in 1997.” The Straits Times, Dec 2003.

a) Explain the current level of unemployment in Singapore (10)

b) Discuss whether full employment should be the economic priority of the Singapore

Government. (15)

**(a)**

# Introduction

* Defn of unemployment
* Formula for unemployment (unemployed / total labour force (active working population)
* State that by examination of the various cases affecting the nature of unemployment**, there will be a better understanding on why the unemployment rate is currently higher than before.**

# Mainbody

1) Explain the causes of unemployment for current situation (2001 -2005)

* technological advancement – increase productivity - technological unemployment (skill incompatibility and displacement of workers)
* economic restructuring - outsourcing
* regional economic restructuring (intensify competition – outflow of FDI)
* demand deficient – decrease in XD and FDI due to global economic downturn)

2) Explain the causes of unemployment for Asian Crisis.(97)

* Systemic factor – failure of the currency system
* extensive currency fluctuation

🡪 affecting dd performance (decrease in XD and FDI – decrease in AD via reverse multiplying effect – decrease real GDP – decrease production and employment

- poor economic sentiment – demand deficient unemployment

**3) Explain why the current level of unemployment is more serious. (degree of difficulty in solving structural and demand-deficient unemployment)**

* Structural unemployment – will take time to eradicate – skill incompatibility
* Systemic factors for Asian crisis is easier to manage as the cause is due to institutional failure but the systemic factor that cause unemployment currently is due to natural factors like SARs and Terrorism

For spore – fall in XD and FDi is beyond the control of S’pore/ increase in local demand is unable to compensate loss in external dd. (cannot solve the fall in XD and FDI due to global economic downturn)

For structural un+ - difficult to solve because of the prolonged time period/ ease of skill development

(easy to solve in the future as workers are more educated and easier in developing new skills)

Strategy to reduce unemployment in 2009

Job credit scheme – subsidize the employers for the wage cost – prevent retrenchment – sustain employment

Re-training Programme – SPUR – to upgrade and equip the workers with new skills to maintain employability

Expand the scope of the economy to create more employment opportunities – solve sectoral unemployment and thus prevent structural unemployment

Qualitative monetary policy – to provide more liquidity for the industries – to prevent the failure of business and thus prevent retrenchment (low interest loan with guarantee from the government).

Expansionary fiscal policy – government will introduce more infrastructural development to increase production and thus induce employment opportunities – the government has also create more public sector employment opportunities through the provision of more public services (employ more public servants).

**Depreciation will not solve fall in external export demand as the reduction in price of export due to depreciation will not induce increase export demand since the fall in export demand is due to decrease in income of foreign consumers.**

**Why govt continues to appreciate? To lower down cost of import and thus cost of living – will help to reduce the burden of workers – enabling them to take wage reduction to sustain employment.**

**(b)**

**Introduction**

Full employment is one of the main objectives that the government will seek to achieve as unemployment can bring extensive adverse effects on the economy. However, whether it is an economic priority when compared with other government objectives, it will depend on the economic situations the country is facing.

# Mainbody

1) Explain the ill effects of unemployment

* opportunity cost of idle resources – lesser output and reduces the production capacity
* loss of tax revenue and rising cost of unemployment benefit🡪budget strain on the economy
* undermine the level of standard of living of the people.
* Undermine the country from achieving its societal objectives of social stability
* May create greater disparity of income – nature of unemployment – structural as in Singapore- therefore affect the unskilled, lower income group more – very difficult to re-employed them.

2) Explain why unemployment is more important than other objectives.

* Unemployment may reduce the production capacity needed to propel economic growth
* Unemployment may not enable the people to overcome inflation due to lower purchasing power.
* Unemployment may create inequality of distribution of income

3) Explain why other objectives can be more important

* External disequilibrium is likely to affect unemployment rather than the other way round
* Fall in Xd 🡪 fall in production 🡪 fall in I 🡪 increase in unemployment
* Exchange rate fluctuation due to the fluctuation in flow of capital 🡪 unstable external prices 🡪 undermine trading activities, investment, external debt 🡪 undermine production 🡪 undermine employment **(stabilizing external market – will enable Singapore to sustain production – it is export dependent)**
* Excessive focus on unemployment may lead to excessive inflation 🡪 fall in real wage of workers 🡪 may not encourage work efficiency 🡪 no real increase in output

Preventing unemployment requires the pre-requisite condition of external stability (exchange rate stability)

# Conclusion

It is valid to a certain extent that full employment should be an economic priority since the effects of unemployment can be quiet detrimental. However, the government may need to stabilize the external fluctuation as these effects can affect employment too.

**Question 3 -Priority of Aims & Monetary Policy**

**“A low rate of inflation should be the economic priority of the government and it is achieved by keeping interest rates high in the economy.”**

- (explain and evaluate the effectiveness of the monetary policy in controlling inflation)

**Introduction**

Define inflation

State that it is one of the main objectives of the government and there are other aims to consider. However, there are certain conditions when price stability is more important than other aims while there are other times when other aims are more important than price stability.

**Main body**

1. **Explain why low rate of inflation is important to government**

# Internal aspect (write briefly)

* Low inflation helps to prevent inequality of distribution of income
* It also prevents rise in cost of living and cost of production.
* It also maintains purchasing power and ability to save.
* It will induce investment, production and employment.

## External aspect(write briefly)

* It helps to maintain international competitiveness due to cost competitiveness
* It helps to prevent the occurrence of balance of trade deficit.
* It helps to prevent fluctuation of exchange rate (depreciation).

1. **Explain why maintaining price stability is most important.**

* It maintains the cost of production so that rising cost condition will not occur and impede economic growth. (achieve sustainable growth)
* It also prevents the failure of businesses as rising cost of production will make it difficult for them to operate and compete with international MNCs
* It will maintain exchange rate of stability, encouraging flow of investment and trading activities and thus ensure balance of payment deficit. (inflation will keep COP low – prevent rise in Px – sustain production)

1. **Explain why other aims are more important than price stability**

* Economic growth will lead to the rise in national income, enabling the individuals to have a higher purchasing power to overcome the effects of rising prices
* Full employment is more important as underemployment will mean the loss of income for some citizens, may become a liability for the country as unemployment benefit is needed. With a source of income, individuals can still overcome the effects of rising prices.
* External stability is more important as it will ensure that there is stable exchange rate to prevent imported inflation, leading to rising cost of living and cost of production.

Part B)

One of the way to curb inflation is to increase interest rate and this will be a form of contractionary monetary policy.

* + 1. Explain how contractionary monetary policy is used to curb inflationary condition

(reduce MS – raise interest rate – increase cost of borrowing – decrease C & I – decrease AD – reverce multiplying effect – decrease price)

* + 1. Explain the limitations of the contractionary monetary policy
* The inability of the central bank to control money supply – liberalization of the banking sector undermining the use of monetary tools
* The presence of inelastic MEI and interest inelastic consumption
* The small value of k

Due to the inadequacy of the contractionary monetary policy, other policies may be used to curb inflation

* + 1. Explain how Fiscal Policy is used to curb inflation

Decrease G – decrease AD via K – decrease nominal NY and P

Increase taxes – decrease disposable income – decrease consumption – decrease AD

Increase corporate tax – decrease profitability – discourage investment – decrease AD

- both via K – decrease in nominal NY and price level

* + 1. Examine the effectiveness of the Fiscal Policy
* Contractionary fiscal policy is effective in controlling inflation as it can dampen consumption by lowering the purchasing power effectively and discourage excessive investment by raising tax to make it less profictable.
* The rigidity of fiscal policy – cannot be curbed for certain necessary form of expenditure.
* It may not be politically favourable
* The small value of the k
  + 1. Explain the use of price and wage control

To set price ceiling and prevent the wage cost and cost of living from rising to lead a cost-push inflation

Effectiveness

It depends on whether the inflationary condition is due to cost-push factors and the ability to government to impose control (ability to work with the trade union)

* + 1. Explain how the government can use SS-side management to increase AS

The government can introduce policies to increase production capacity by increasing productivity (Increase AS (lower COP), better utilization of resources and inducement for greater investment. (expansion of resource capacity – rightward shift of AS)

Manpower Policy

Infrastructural development

Research and Development

Effectiveness

Depends on the effectiveness of the public administrative system and the availability of resources and financing to implement the programmes

* + 1. Explain how the exchange rate policy is used to curb imported inflation

Appreciation of the exchange rate will allow the government to decrease the price of imports (Appn – reduce the PM in local value) but this policy depends whether there is extensive capital inflow.

Very effective for countries which depend on foreign sources of supply of resources.

**Conclusion**

The use of the interest rate can only provide a limited inflation can be curbed.

**Question 4 – Aims of government / Policies – Fiscal Policy**

**‘China will increase government borrowing and public spending this year where much of which are spent on infrastructure projects, education and health care.’**

**Assess the macroeconomic aims and other objectives that might be achieved by the Chinese government as it undertakes the above expenditure. [25]**

**Introduction**

The underlying public spending made by government is part of the fiscal expansionary policy. As a result of the policy, there will be extensive increase in economic activities which will help the Chinese government to achieve the aims. These aims can be divided into macro-economic and micro-economic aims and they are namely, full employment, economic growth, price stability, and equal distribute of income.

**Main body**

**1) State and explain the aims of the government in terms of their importance. (7)**

a) Economic growth/ SOL

b) Full Employment

c) Price stability

d) External equilibrium

e) Equal Distribution of income and wealth

**2) Explain how the above projects will be raise able to AD and raise national income and employment.**

Public spending on infrastructural development, education and healthcare will increase government expenditure which will increase the value of aggregate demand and via the multiplier effect, raise national income and production and employment. ( Increase in real GDP will lead to higher SOL as real per capita income will increase

(Increase in infrastructure will raise production – provision of more employment by government)

In the multiplier process, the initial increase in the aggregate expenditure expands the circular flow of income, increasing the income of the factor earners to further expand the circular flow of income with new transaction. As long as transactions are made, the circular flow of income will continue to expand until the withdrawal effects is equal to the initial injections which will cease the expansion of the circular flow of income. Consequently, the national income will increase by several folds, depending on the value of the multiplier which is determined by the sum of the MPW (Marginal Propensity to withdraw – MPS + MPT +MPM)

**3) Explain how the above projects affect price stability.**

The above expansionary effect will raise AD and price level. If the economy is experiencing deflationary condition, the increase in aggregate demand will not contribute to inflationary condition since there is spare capacity to increase production. However, if the economy is near full employment, excessive increase in AD will contribute to rising cost and inflationary condition.

Nonetheless, price stability can still be attained if the expansionary government spending can contribute to increase in potential growth. Infrastructural development will bring about more transport network to solve the problem of structural rigidities to prevent immobility of resources. Furthermore, government expenditure on education will raise the productivity of the workers and thus increase production capacity.

Thus, such government expenditure will create supply impact, inducing an increase in supply to undermine inflationary condition to ensure price stability.

**4) Explain how the above projects will promote external equilibrium.**

The above projects will induce greater export demand and inflow of Foreign Direct Investment which will lead to inflow of funds to prevent BOP deficit and depreciation of exchange rate which will have adverse consequences on the Chinese economy

As the government expenditure on infrastructural development, healthcare and education will raise the productivity of the workers to raise their export capacity, meeting the surging demand from the global market. This will lead to greater export revenue, promoting balance of trade surplus. (SS-side impact)

Lower cost of production due to higher productivity and greater infrastructural development will attract inflow of FDI which will improve the balance of payment, and thus raising the exchange rate of Yuan. This will promote china’s stability in the financial market.

**5) Explain how the above projects will promote greater equality in distribution of income and wealth.**

More government expenditure on public projects in terms of education and healthcare will raise the welfare of the people and for the poor if the focus of the expenditure is for the lower income group. Besides this, infrastructural development on public transport will make it more convenient and comfortable for the public and thus, raise the standard of living for the people.

**6) Evaluate the extent of the success – state the possible hindrances the government may face in the introduction of such a policy.**

a) The problem of time lag.

Time lag occurs during the recognition, implementation and regulation stage of the fiscal policy will undermine the effectiveness and efficiency of the policy. Consequently, there may be unforeseen problems undermining the results.

b) Crowding out effect (crowding out of fund for private investment and high cost of borrowing)

As the government finances the project by public borrowing, it is likely that it will deprive the private sector the necessary fund for private investment since the public borrowing will reduce money supply in the money market, cutting down credit creation and raising interstate. Faced with a shortage of funds for private investment and a higher interest rate, the level of domestic investment will decrease, undermining economic growth and employment.

Contractionary effect which will undermine the expansionary fiscal policy

c) The value of the multiplier and accelerator

If the value of the multiplier and accelerator is small, the impact on the change in national income will be small and thus, the desired level of effect of the policy is not attained. (High MPS – saving attitude)The value of the accelerator may be small if the economy increase in the income is temporary and limited to a certain group, therefore the increase in induced consumption will be less effective. Consequently, there will be lesser corresponding increase in induced investment to promote economic growth and employment.

d) The cost of financing

As the Chinese government is raising public debts to finance the public expenditure, the cost of financing is another consideration to take note. In the public dept is raised internally, the cost of financing will be passed on to the next generation as it will increase the tax payment for the future generation. If the public debt is raised externally, the cost of financing will decrease the earning of the nations as it is used for debt payment.

e) Rising cost condition/ complexity problem

It is likely that the expanding fiscal policy will lead to rising cost condition where the spare capacity of production is utilized with greater demand for the resources. Consequently, price stability may be undermined as the Chinese government seeks for greater economic growth and employment.

Conclusion

The implementation of a fiscal expansionary policy by the Chinese government as seem in the form of expenditure on education, healthcare and infrastructural development will help Chinese government to achieve the aim of government. However, it is important for the government to take note of the limitations and the possible conflicts it may generate.

**Question 5 - Aims of Government – Supply-side Management Policies**

**Are supply-side policies an effective solution to the most significant macroeconomic problem that is currently being experienced in your country? (17)**

**Introduction**

Singapore is small country with limited resources and is heavily relying on the external market for export demand and foreign direct investment for growth. Due to this peculiar market situation, the country will experience certain economic problems that will undermine the economy from achieving. It is observed that the government of Singapore has often introduced the supply-side policies to solve the macroeconomic economic problems and thus lead the perception that it is best policy to be adopted to solve the macroeconomic problems.

**Main Body**

1. **State the main macro-economic problems that Singapore is experiencing**

**(Why unemployment is the most significant problem?)**

**a) Explain the types of unemployment in Singapore**

**b) Explain why unemployment is a serious problem for the economy**

* Structural unemployment
* Technological advancement – less demand for workers and skill incompatibility
* Sectoral changes – change in the comparative advantage – rising sectors will demand for more workers while the declining industries will decrease in demand for workers
* Demand deficient Unemployment - occur as a result of the fall in export demand and foreign direct investment – what causes the fall in XD and FDI and how it decrease employment
* Unequal distribution of income and wealth
* Certain sectors of the population will gain more than the rest of the population as they are more skilled and possess assets
* It will also occur of structural unemployment
* Undesirable side-effects of economic growth
* Jobless growth – the growth of the industries do not provide a high percentage increase in the level of employment as the growth of the firms are capital intensive based, requiring highly skilful and qualified workers
* Lower income group of the population cannot gain the benefit of the growth

1. **Explain how the supply policies can be used to solve the macroeconomic problems**

* Meaning of the supply-side management policies

(adjustment of the economic structure by expanding resource capacity or by raising the efficiency of production)

* Explain the various ways the supply-side management policies can be used to solve the listed macroeconomic problems faced by the government

Manpower development/infrastructural development/ institutional development) (technological development/ capital development)

1. **Evaluate the effectiveness of the supply-side management policies**

* Strengths of the supply-side management policies

(solve the roots of the problems or deals with fundamental economic problems/ create a more permanent impact on the economy/can create dimensional impact on the economy – raise the skills of the workers which will also raise their Wage rate and thus solve unequal distribution of income)

* Limitations of the supply-side management policies

(time lag/ effectiveness depends on the efficiency of the public administrative system/involves high cost of financing/ faced constraints of the economy)

Weaknesses of the supply-side management policies that can be compensated by other policies

(cannot solve imported inflation/cannot determine the external demand directly)

**Conclusion**

# Question 6 – Policy – Trade Restrictions (Import Substitution)

Many countries have both unemployment and a deficit on their balance of payments. Both of these problems can be cured if the countries produce goods at home whenever they can do so rather than purchase them abroad.

Explain this view and examine its economic justification (25)

#### Introduction

Explain the meaning of unemployment and balance of payment

State that the solution of greater production in the economy means to introduce import substitution strategy to reduce import and increase local production.

#### Main body

* **Define import substitution and how it can be implemented:**
* involves the setting up of local industries to produce goods which serve as substitute of imports;
* needs to identify the industries that have the potential to grow;
* govt. needs to encourage local firms to set up by either providing subsidies to local firms o by imposing trade restrictions on imports
  + **Explain the view – how important substitution solves the problem of unemployment and BOP deficit:**

- As local firms are set up, local production of goods and services increase

🡪 more factors of production are employment and hence the level of unemployment can be reduced.

- With an increase in local production, consumption is diverted from imports to local goods🡪 import expenditure decreases 🡪 ceteris paribus. BOP deficit can be reduced.

* **Discuss whether the measure is justified:**

i) In the short run, import substitution is expected to increase domestic employment and to reduce BOP deficit. The effectiveness of such a measure, however, depends on the following factors:

* price competitiveness of local goods;
* quality competitiveness of local goods; (influence the consumers’ willingness to replace foreign imports with local goods.)

The measure is more effective if consumers consider local products a good substitute of imports.

ii) In the long run, the measure is not very viable due to the following reasons:

* By restricting imports and encouraging local production through govt. intervention, degree of competition is reduced. 🡪 local firms are less inclined to innovate and to engage in R & D 🡪 little incentive to improve the quality of goods and services.
* Loss of consumer surplus due to reduced competition. Consumers may have to pay a higher price for lower quality products. Variety of goods may also be limited.
* Misallocation of resources. Countries no longer specialize in production of goods which they enjoy comparative advantage. Resources are channeled to produce goods that the country has a comparative disadvantage 🡪 lower output and lower level of income compared to free trade situation. Hence, it does not reduce unemployment in the long run.
* **If the balance of trade occupies a small percentage of the BOP, the import substitution strategy is not effective in improving the BOP condition**
* **Depends on price elasticity of export and import demand which will affect the final value of expenditure on exports and imports**

Conclusion -

**Question 6 – Government Policies and Aims of Government – exchange rate policy**

**The Monetary Authority of Singapore (MAS) operates a manage float regime in which the exchange rate of the S$ is allowed to fluctuate within a band. Exchange rate policy is used extensively by the MAS to manage Singapore’s macroeconomic performance.**

**b. To what extent might the main macroeconomic problems faced by Singapore in recent years be solved by exchange rate policy? [15]**

**Introduction**

The exchange rate management policy adopted by the MAS is a floating exchange rate system that seeks to control the exchange rate within a band. In doing so, the MAS will adjust the exchange rate to influence economic activities so as to solve the economic problems faced by the government and thus, achieve the aims of the government.

**Main Body**

**1) Explain the macro-economic problems faced by Singapore in recent years**

In resent years, Singapore faced many internal and external economic which will undermine the government from achieving its desired economic performance.

As it is a small country with limited resources, it is faced with a very limited production capacity, requiring extensive imports of raw materials. The limited pool of labour supply due to a small population also contributes to higher wage level, which includes cost push inflation. Consequently, it is subjected to inflation which will raise the rise cost condition, undermine of economic growth as the export DD and FDI will be lowered due to rising cost condition.

Secondly, the economy is also prone to the condition of unemployment in the form of demand- deficient unemployment contributed by fall in export demand and foreign direct investment because of rising cost of export demand and foreign direct increment.

Thirdly, the government is facing external regional and international competition for export market and FDI as the neighboring countries are offering lower cost production base and lower export price to reduce over export market and level of FDI.

**2) Explain how exchange rate management policies can help to solve the problems.**

a) To curb imported inflation, the MAS can raise the exchange rate by direct intervention through the buying of local currency which increases the demand of the Sing dollar in the forex market. This appreciation of the S$ will enable the importers to lower their cost of import in S$. In doing so, the cost of production in terms of price for raw materials will be lowered, preventing rising cost conduction and inflationary condition to occur. Furthermore, appreciated currency rate helps to attracts more foreign workers to increase supply of labour as their salary in their native currency is higher and thus lower cost of production.

b) To raise external demand and attract investment, the MAS can deprecate the exchange rate by selling of local currency which increase the supply of the Sing dollar in the forex market. This depreciation will lower the price export demand and cost FDI. This will lead to greater production and employment will increase. As Singapore’s industries rely greatly on external demand, the boom in external economy will mean greater production level and solving demand- deficient unemployment.

The lowering of the exchange rate can help to increase Singapore cost competitiveness and thus, aid to raise our capacity in attracting FDI, which will lead to greater production and employment.

**4) Explain the disadvantages of the exchange rate management policies.**

a) May not be able to eradicate inflation if inflation is contributed by demand pull and asset-bared inflation as the rate only affect the purchasing power in external value.

b) The policy is not suitable in solving structural unemployment which requires supply-side adjustment and structure in production.

c) Trade-off exists, making it difficult for the government to manage exchange rate. Depreciation may help to decrease price of exports but it will increase in price of imports, raising cost of production and thus, undermines the benefits gained from depreciation.

**5) Limitation of the exchange rate management policies.**

a) There is a need to have of a large pool of resources to manage the exchange rate. It will increase the opportunity cost of idle resources if such a pool of fund is maintained. (less resource for economic development – deprivation of funds for infrastructural development and investment)

b) Impact on the export demand and import demand is subjected to the marshal-lerner condition. This implies that the exchange rate policy of depreciation cannot work well under the short term.

**Conclusion**