**Essay Question 31**

**Amidst the slow growth in the EU, the persistently high budget deficit and ballooning public debt have become major concerns for many governments in the EU. As a result, they have implemented 'austerity measures' to reduce their budget deficit by raising taxes and cutting back on public spending.**

**(a) Explain what would limit the effectiveness of the austerity measures in the EU. [10]**

Introduction

The aim of the austerity measure is to prevent budget deficit and cut down the public debt and to do so, the government needs to be prudent in government spending and capable in raising tax revenue by creating economic activities that are taxable. There is also a need for the government to ensure that austerity measures will be able to sustain or even raise production, employment and economic growth. However, the effectiveness of these measures is affected by certain economic factors.

Main Body

One such economic factor to consider is the composition of government expenditure, which can be classified as ordinary or developmental governmental expenditure. The cut down in expenditure will not be feasible since the salaries of civil servants cost of welfare and ordinary public spending cannot be reduced easily. If the reduction in spending is for developmental expenditures, the government will able to reduce such public spending but this will undermine the development of the nation. Thus, there is a need to consider the types of government expenditure which the government can reduce to ensure that there is a balance in achieving the aim to cut public debt and budget deficit without compromising development and the proper functioning of the government.

There is also a need to consider the influence of other aggregate demand components and the impact of the austerity measures on these aggregate components. If the aggregate demand components like export demand and private and foreign investment can be raised during this period, the cut down in government will be feasible and will not undermine the economic activities. If the cut in government expenditure will lower down the consumption level as the government expenditure is extensively for transfer payment. Thus such cut is less likely to be feasible as this is not supported by the people.

Another factor to take note is the size of multiplier as the cut down to balance budget or a small surplus may be beneficial as it will still be able to generate adequate expansion of the circular flow of income to raise economic growth and sustain production and employment if the size of the multiplier is large or still equal to one for balanced budget. This will lead to extensive contraction of the circular flow of income if the size of the multiplier is large when the budget is in deficit although it may help to reduce public debt. The fall in economic activities may undermine the economy from raising tax revenue and this may render the effort to cut government expenditure as the lower tax revenue will make it more difficult for the government to reduce public debt.

It is also important for EU to consider the level of private or public saving and the extent of distribution of the saving among the population as this will help the government to consider the areas of government expenditure it may reduce so as not to lower the private consumption level as high level of saving among the group of consumers will enable them to sustain consumption when the transfer payment is reduced and the public expenditure is cut.

In sum, it is not an easy economic implementation when the government in EU attempts to introduce austerity measures as there many economic factors that will undermine such measure. Many sacrifices must be made to ensure that the aims of the austerity measures are met.

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**(b) Discuss the extent to which the austerity measures in the EU will have an adverse impact on the Singapore economy.**

Introduction

The impact of the austerity measures in EU will have an adverse impact on Singapore and this can be observed from how the slowdown of the economic activities in Europe will affect Singapore’s trading and investment activities and the flow of fund. These adverse impacts can be observed from how it lower our economic growth and employment and worsen the inflationary and balance of payment.

Main body

The austerity measure will cause a slowdown in the economic growth of European Union and this will mean a reduction in the standard of living of the member nations. There will be a reduction in the real GDP per capita of the citizens, which will mean the purchasing power of the people will reduce and this will contribute to a fall in import expenditure made by the member nations. As for firms in these economies, they are likely to face bleak business development and there will be lower revenue and profitability will be adversely affected, influencing the firms in Europe to cut down their investments in Asia and thus, Singapore too. As the economic adversity will also mean that the EU may cut their interest rate to stimulate their economic activities, there is likely an outflow of fund from EU and inflow of fund into Asia and Singapore due to interest rate differences.

This adverse development in EU will cause a fall in Singapore’s export demand to the EU and the inflow of foreign direct investments from EU into Singapore will be adversely affected. The adverse development in the EU will **worsen balance of trade and long term capital account**, which undermine production activities while the inflow of fund from EU in terms of hot money will destabilize the short term capital account and the exchange rate of Singapore.

The reduction in export demand and the inflow of FDIs will also contribute to the fall in aggregate demand which will **lower the value of real GDP via the reverse multiplying effect**

. In the multiplier process, the initial reduction in aggregate expenditure contracts the circular flow of income and then reduces the income of factor earners, which will further reduce the circular flow of income with further reduction in consumption activities. As long as consumption activities are reduced, circular flow of income will continue to contract at the respective level of economic activities until the withdrawal effect is finally equal to the initial reduction in aggregate demand, which will cease the contraction of circular flow of income. Consequently, the national income will reduce 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), indicating that there will be **negative growth**.

(Draw diagram and show how the real GDP will be reduced.)

AS

P₀

P₁

GPL

Real GDP

AD0

Y1

AD1

Y0=YF

As seen from the diagram, the reduction in aggregate demand from AD0 from AD1 will lead to a fall in real GDP from Y0 to Y1.

The adverse impact can also be seen from how the **rise in unemployment rate** as the fall in export demand for Singapore and the reduction in the inflow of FDIs will mean that there is lower production level and there will be lower level of demand for labour. With the rise in unemployment rate and the condition of slow economic growth, this will lower **the standard of living as the real GDP per capita falls.**

It is also likely that there will be excessive rise in price level, especially contributed by **asset-based inflation**. Inflow of hot money from EU will raise the money supply in Singapore, lowering down the interest rate to encourage borrowing for speculative activities as seen in property market. This will contribute to the rise in the price of property which are the non-core inflation but are significant in the influence of inflation in Singapore; rising price of property will raise the amount of mortgage payment and this will lead to higher cost of rental which will **aggravate cost-push inflation.** Consequently, price instability sets in.

In this review of the extent of the adverse impact on Singapore, there are several factors to take note. First, Singapore is highly dependent on EU for trade as EU is our largest trading partner and the EU’s main composition of FDIs are mainly in the field of pharmaceutical industries which are Singapore’s key industries. Thus, it is inevitable that Singapore’s economic growth and production level will be affected.

Furthermore, the inflow of hot money from EU and other regions like US as investors look for more lucrative returns on their fund will lead to extensive inflow of hot money. As Singapore is an open market and the financial sector is another key industry, it is difficult to restrict the inflow of hot money and its impact on the property market which are likely to be destabilizing on the price level and social stability.

As Singapore’s market demand is from the international market due to the concentration of MNCs in our production capacity, the negative development in EU will affect the global economy, given its significance. This will affect Singapore’s export demand extensively since it is highly export-oriented, given that trade is 4.5 times to GDP. Thus, the impact on economic growth and employment is inevitable and consequential.

However, it is still possible for Singapore to dampen these adverse impacts as Singapore has been able to diversify the trading dependency with EU by expanding the trading activities with other major trading partners. At the same time, it is also raising the size of domestic market demand through her population growth and development of local enterprises and this will help to raise the local production and employment, thus dampening any adverse impact from EU.

The government of Singapore is also capable to introduce policies like expansionary fiscal policies to help to cushion the unemployment condition with provision of public services. For other problems like inflationary condition, it is able to introduce rues and regulation like Additional Buyers’ Stamp Duty to curb speculative activities. Long term plan like manpower development are also introduced to develop the skills of the workers to raise their skill competency to prepare for problems from EU

Conclusion

In sum, it can be seen that Singapore is greatly affected by the development in EU with issues like austerity measures as Singapore relies extensively on trade and FDIs from EU but the government has attempted to reduce this impact through short and long term policies. It is quite impossible for Singapore to completely shield herself from it but the policies will make it feasible to dampen the impact and make responsive recovery from the adverse situation.