**Essay Discussion – Theory of Income and Employment**

### Question 1

a. Analyse the impact of globalization on the components of aggregate demand in an economy. [12]

**Question 2**

a. Explain two possible causes of a reduction in the size of the Singapore’s national income multiplier. [10]

**Question 3**

Discuss how a significant fall in the level of interest rates might affect the components of aggregate demand.

**Question 4**

In 1998, the Japanese economy had contracted by 2.8%. Corporate bankruptcies were at a record high as was unemployment. The government proposed a $198 million fiscal rescue package.

a) Use the multiplier process to explain the effect of the rescue package on the Japanese economy. (10)

1. Discuss whether an increase in public spending is the best way to achieve a sustained increase in national income. (15)

B

**Q1a) Analyze the impact of globalization on the components of aggregate demand in an economy. [12]**

Introduction

The rise of globalization will lead to the proliferation of free trade and flow of investment and fund. As a result of the absence of restriction on global economic activities, it is likely that the economic activities of any would be affected as seen in the impact on aggregate demand on the economy which is constituted by private consumption expenditure, investment expenditure, government expenditure import expenditure and export receipt.

Main body

1. Export demand

Globalization will promote free trade which will lead to increase in export demand as the absence of trade protectionism will mean lower price of exports for the economy. Furthermore, the increase in export demand will allow large scale of production which leads to lower unit cost of production, enable the economy to reduce price of export, further stimulate the export demand. Increase in export demand is possible as national income of importing nations will increase which means a higher level of national income to buy foreign goods.

1. Level of investment expenditure

The rise of globalization will mean that the abolishment of restraint on the inflow of foreign direct investment. Memorandum on the protection of investment and tax incentives for investment will raise the confidence of investors and the rate of return on investment, leading to the growth of investment expenditure, especially for countries like Singapore which relies on FDI. Globalization also allows the flow of fund in term of saving into the country, allowing the reduction of the interest rate due to excess fund available for investment which will help to induce more investment.

1. Private consumption expenditure

Globalization will raise the national income and employment in a nation as a result of higher export demand and inflows of FDI which will increase production in the economy. The rise in national income and employment will mean a high level of disposable income which will induce more private consumption expenditure.

Import of raw materials and inflow of foreign workers due to globalization of the market will lower cost of production, leading to a reduction in price level and thus induces an increase in demand of private consumption.

4) Government expenditure

Higher national income providing more tax revenue to the government will enable the government to embark on the provision of more public expenditure on welfare goods and infrastructure development. Higher degree of competition for FDI from neighbouring countries will induce the need for greater infrastructural development to attract investment. Thus, it can be seen that globalization will promote greater government expenditure.

5) Import expenditure

As the economy removes the trade restriction, the cost of import will be lowered and there will be a greater variety of goods and services for import. Consequently, the level of import expenditure will increase. Furthermore, the increase in export demand and local private consumption expenditure as a result of globalization will lead to the rise in the demand for import of raw materials. Lastly, the rise in national income of the local residents will increase demand for more imports of good and services.

Conclusion

Globalization will create extensive influence of the level of aggregate demand as it changes the nature of production, trade and investment. It is therefore imperative for nations to understand the impact it will create on the economic activities to reap the advantages and avoid the detrimental effects.

**2a) Explain two possible causes of a reduction in the size of the Singapore’s national income multiplier.**

The national income multiplier depicts the change in the value in income as a result of the change in the aggregate demand. It is a very important economic variable that will influence the degree effectiveness of demand management policy whereby its influence is determined by the withdrawal impact seen in the formula.

Main body:

1) State the formula of the national income multiplier.

K(multiplier) = 1

MPS+MPT+MPM

K= change in natural income

change in aggregate expenditure

Form the formula, it can be seen that the increase in the value of the MPS, MPT and MPM will lead to the reduction in the multiplier effect. This is because the withdrawal effects of the MPM (marginal propensity to withdrawal) will cause the contraction of the number of trade transaction cycle which will lead to a fall in national income.

One such source of the fall in the multiplier national income multiplier will be the marginal prosperity to save which measure the change in saving in response to a change in income. The presence of a poor welfare system and greater sense of precautionary need in Singapore will induce greater need to save. This will raise the value of MPS and thus decreases the multiplier.

Similarly, an increase in CPF compulsory saving stipulated legally by the government will raise the MPS and then reduce national income multiplier. The values of MPS can also be affected by high interest rate which means that the opportunity cost of consumption will be higher and thus, this increases the willingness to save.Another cause of a fall in national income multiplier is the rise in the marginal propensity to import (MPM) which measures the change in import in response to a change in national income. The value of MPM depends on the degree of import substitutability depicting whether the extent of the suitability of local goods in replacing imported goods. This would depend on the quality of imported goods and the availability of local goods. The availability of natural endowment would also influence the degree of need for imports. In Singapore, our lack of natural resources would mean that out MPM is very high. Furthermore, a high pace of economic development would raise the MPM as there is strong demand to import for resources for the need of production.

In sum, it can be seen that our national income multiplier can be quite small under the impact of a high value of MPS and MPM which would dampen the multiplier. A small national income multiplier would undermine the effectiveness of the demand magnet policies in influencing economic activities to achieve the aims of government policies.

**Q3. Discuss how a significant fall in the level of interest rates might affect the components of aggregate demand.**

A) Introduction

* Define interest rate
* State the components of aggregate demand
* State that interest rate will affect the AD components as a result of its role in determining the cost of borrowing and its influence on the exchange rate.

B) Main Body

1a) Explain how interest rate will affect the level of Investment in the economy.

* A fall in interest rate will lead to a fall in cost of borrowing
* It will increase profitability and lead to an increase in the level of Investment
* As long as the rate of return (MEI) is greater than the interest rate, investment will increase until interest rate is equal to the level of investment

1b) Evaluate the extent of influence of the interest rate on the level of investment

* The extent of the influence of the interest rate on the level of investment depends on the interest elasticity of investment (MEI)
* If MEI is interest inelastic, the influence of interest rate is not that influential as the level of investment is affected by taxation, market demand, political stability and cost condition which will determine the level of profitability

2a) Explain how interest rate will affect the level of consumption in the economy.

* A fall in interest rate will lead to a fall in cost of borrowing
* This will lower the cost of good sold, especially for luxury goods like property whereby the interest payment is part of the cost of good sold
* Furthermore, a fall in interest rate will reduce the return on saving and thus there will be less saving and more consumption
* Thus, it can be seen that a fall in interest rate will encourage consumption

2b) Evaluate the extent of influence of the interest rate on the level of consumption

* Interest rate may lower the cost of luxury good but the main determinants of the consumption of luxury good is still the expectation of future income,. If the expectation of income is low, a low interest rate may not induce the consumption of the luxury goods as the consumer does not have the means to pay for the goods.
* Besides this, the lower interest rate may not discourage saving and encourage consumption as some of the saving is compulsory and the saver’s precautionary attitude is not affected by lower interest rate. Thus, the extent of interest rate in affecting the consumption is less extensive under such circumstances.

3a) Explain how the interest rate will affect government expenditure.

* Fall in interest rate will lower the cost of borrowing for the government as the government needs not raise the interest rate of their bond to attract the buyers of bonds.
* A lower cost of government expenditure would encourage the government to borrow more to finance their public project and thus increase government expenditure

3b) Evaluate the extent of influence of interest rate on government expenditure.

* However, the level of government expenditure is made on the basis of the cost of financing but the based on the aims of government.
* Increase in government expenditure will be needed if the economy is in need of expansionary effect and the public and industries need
* Lower interest rate will be an influence to encourage government expenditure when tax revenue is low and borrowing is needed

4a) Explain how the interest rate will affect the level of import and export.

* A decrease in interest rate will discourage capital inflow in term of hot money or ST foreign saving and encourage capital outflow which will decrease the demand for the local currency and increase in the supply of the local currency, contributing to a fall in the exchange rate
* The fall in exchange rate will mean an increase in price imports and a decrease in price of exports which will lead to the fall in import demand and a rise in export demand respectively.

4b) Evaluate the extent of influence of interest rate on import and export.

* The influence of interest in the adjustment of import expenditure and export receipts depends on the marshal-lerner condition which will reflect less extensive when the condition is not satisfied (Edx + Edm < 1) This means that import expenditure will not decrease and the export receipts will increase extensively.
* The nature of the exchange rate system is also another factor determining the extent of influence of interest rate on exchange rate. Under a managed or fixed exchange rate system, the exchange rate will not fluctuate extensively and thus the impact of the interest rate is controlled.

Conclusion

Lowering interest rate has an influential impact on the components of aggregate demand but the extent of influence is less extensive under circumstance.

**Q4. In 1998, the Japanese economy had contracted by 2.8%. Corporate bankruptcies were at a record high as was unemployment. The government proposed a $198 million fiscal rescue package.**

1. **Use the multiplier process to explain the effect of the rescue package on the Japanese economy. (10)**
2. **Discuss whether an increase in public spending is the best way to achieve a sustained increase in national income. (15)**

Introduction

The situation of a contracted economy, high level of bankruptcies and unemployment are economic indicators implying that the economy is in recession. When the Japanese government introduces a fiscal rescue package of $198 million final rescue package, it is introducing an expansionary fiscal policy.

Main body

1. Explain how the expansionary fiscal policy can be introduced

Through the expansion of government expenditure –

Through the reduction in tax rate -

1. Explain how the increase in AD will lead to a rise in national income via the multiplier
2. Explain the other effects of the expansionary effects on the economy

Conclusion

**b) Discuss whether an increase in public spending is the best way to achieve a sustained increase in national income. (15)**

Introduction

Increases in public spending will mean the increase in government expenditure on public goods such as infrastructure development. The expansionary effect of government expenditure may bring about the increase in national income but it may not be able to sustain it for long under certain circumstances.

Main body

1. Explain why the increase in public spending will manage to achieve a sustained national income.
   * It is the most direct form of increase in AD and has great impact on the economy
   * Public expenditure usually are long term, its economic effects can last for a few years
   * Some of the goods can contribute to positive externality, enhancing the economic development of the economy
   * Some of the expenditure are part of the institutional development which will help the development of the economy
   * The increase in public expenditure will induce more investment as the public facilities may enhance the productivity of the industries, making it an ideal place for private investment
   * Some of the public expenditure are merit goods will provide tax revenue for the government allowing it to further expand the economy with more infrastructure development
2. Explain why the increase in public spending will not manage to achieve a sustained national income.
   * Increase in public expenditure can be sustained for too long as source of financing will affect the continuation of the public project
   * Financing through loan may deplete the resources available for future public investment, undermining the economy from sustaining the growth of national income
   * Financing the expansionary government expenditure through taxation may discourage investment and creative a disincentive for investment
   * Mismanagement of the public project may also undermine the effectiveness of the expansionary effects

- Time lag

* + Crowding out effects

O

Conclusion