4	The Bank of Korea slashed its benchmark interest rate to a record low of 0.75 per cent in an emergency move following similar actions by the Federal Reserve and other central banks to combat economic damage from the coronavirus outbreak. Source: The Straits Times, 16 March 2020
(a)	Explain the factors that affect Singapore's choice of exchange rate policy as its main policy to achieve internal stability in the economy. [10]
(b)	Discuss whether a fall in world interest rates would have a positive impact on the Singapore's economy. [15]

Part (a)

Introduction

- State that internal stability in an economy refers to the achievement of macroeconomic goals including price stability, low unemployment and economic growth.
- The factors that affect Singapore's choice of exchange rate policy is dependent on the export-oriented and import reliant nature of Singapore's economy as well as the limitations of other macroeconomic policies leading to the choice of exchange rate policy instead as the main policy.

Body

- For a small and open economy such as Singapore, it is an economy that is export-led and import reliant and thus the root cause of its macroeconomic problems are related to trade.

1. Import-reliant Nature of Singapore Economy

- Given that Singapore has limited resources and thus is import-reliant, a root cause of inflationary concerns in the economy is high imported cost of production.
- Given that imported cost of production is a root cause of achieving price stability in Singapore, the use of appreciating exchange rate will be able to effectively achieve a successful economy in terms of price stability.
- With an appreciation of exchange rate, price of imported input will be cheaper in domestic currency. This helps to reduced imported cost of production in Singapore, thus causing an increase in her short run aggregate supply (SRAS).

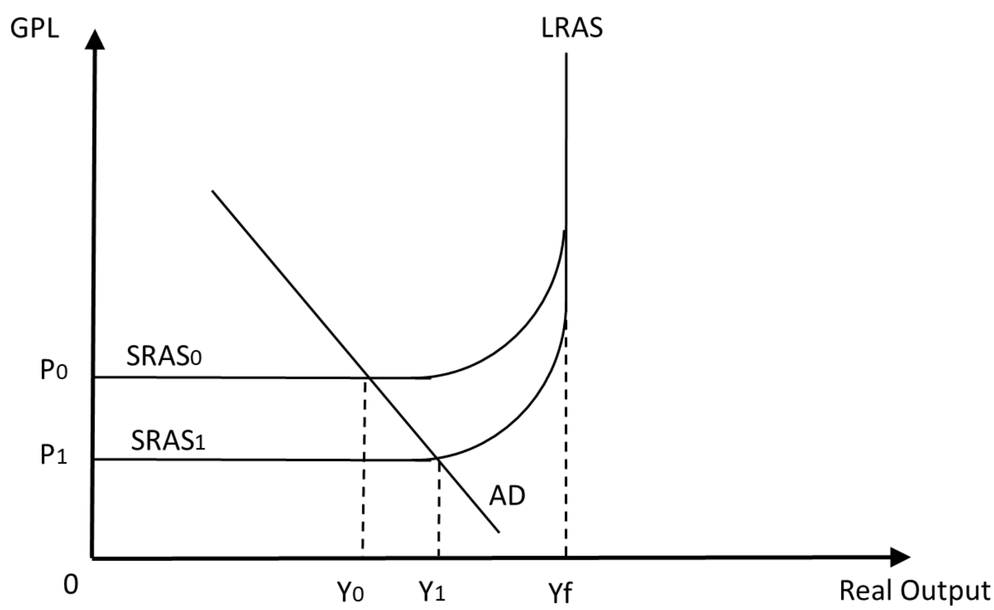

Figure 1: Impact of Appreciation of Exchange rate on Import Price-Push Inflation

2. Export-Oriented Nature of Singapore Economy

- Given that Singapore is a small and open economy and thus export-led, a root cause of economic recession and thus low economic growth is due to depressed net export revenue. Thus, depreciating exchange rate policy can help to address this.
- With a depreciation of exchange rate, price of exports are cheaper in foreign currencies and price of imports are more expensive in domestic currency. Given that Marshall Lerner condition, which is |PEDX + PEDM| > 1, will hold in Singapore context, a depreciation of exchange rate will cause an increase in net export revenue in Singapore.
- The increase in net export revenue thus leads to an increase in aggregate demand (AD) and thus more than proportionate increase in national income via the multiplier process. Thus, actual economic growth is effectively achieved.

3. Limitation of Monetary Policy in Singapore

- Due to policy trilemma, Singapore has to choose two between the three options, namely open capital flow, control of exchange rate or control of interest rate.
- Given the limitation of monetary policy in Singapore, exchange rate policy rather than monetary policy is chosen instead as the macroeconomic policy to achieve its macroeconomic goals.

Singapore as an i/r taker

- Monetary policy is limited in its effectiveness in Singapore's economy. Given the small and open nature of Singapore's economy, Singapore is unable to effectively manipulate its interest rate.
- If Singapore were to increase its interest rate relative to global interest rates, for example from r1 to r0 in figure 2, then short term capital will flow into the economy to gain from the interest rate differential. This short term capital inflow will thus increase Singapore's internal liquidity, and thus increase its money supply. This will lead to a fall in interest rate again. Thus, Singapore is effectively an interest rate taker.

Conclusion

- The factors that led Singapore to choose exchange rate policy as its main policy is due to its export-led, import-reliant nature of its economy.
- In addition, Singapore being an interest-rate taker also limits significantly the use of monetary policy.

Part (b)
Introduction
- State that a fall in world interest rates can have positive and negative effects on Singapore's internal and external stability.
- The fall in world interest rates would affect the economies of Singapore's trading partners and this would in turn affect Singapore internal stability given the small and open nature of Singapore's economy via impact on its net export revenue.
- In addition, given Singapore is an interest rate taker due to the small and open nature of its economy, the fall in domestic interest rates would also affect Singapore's internal stability.

Body
1. Thesis: Positive Impact on Singapore's economy due to fall in world interest rates

a) Explain how a fall in world interest rates might affect the economies of Singapore's major trading partners and in turn affect Singapore's export revenue and its external stability (Balance of Payment).
- A fall in interest rates in economies of Singapore's major trading partners would lower the cost of borrowing for households and firms in the economies. Households would increase consumption expenditure (C) and firms would increase investment expenditure (I). Given AD=C+I+G+(X-M), the fall in interest rates would increase AD which in turn would lead to actual growth and higher national income.
- Given the higher national income of Singapore's major trading partners, there would be an increase in Singapore's export revenue (X).
- The increase in net export revenue would lead to an increase in credit items in current account and thus lead to an overall improvement in Singapore's Balance of Payment position.

b) Given that Singapore is an interest rate taker, explain how a fall in domestic interest rates would affect Singapore's aggregate demand (AD) and might positively affect Singapore's internal stability (Economic Growth and Low Cyclical Unemployment).
- Given that Singapore is an interest rate taker (as explained in part a), domestic interest rates in Singapore would fall as well.
- Therefore, C and I in Singapore would also increase (as explained earlier) as cost of borrowing falls with lowered domestic interest rates. Coupled with the increase in X explained earlier (which has a significant effect on Singapore's AD because X takes up a large proportion of Singapore's AD), Singapore's AD might increases significantly.
- The increase in AD would lead to an improvement in economic growth and fall in cyclical unemployment.

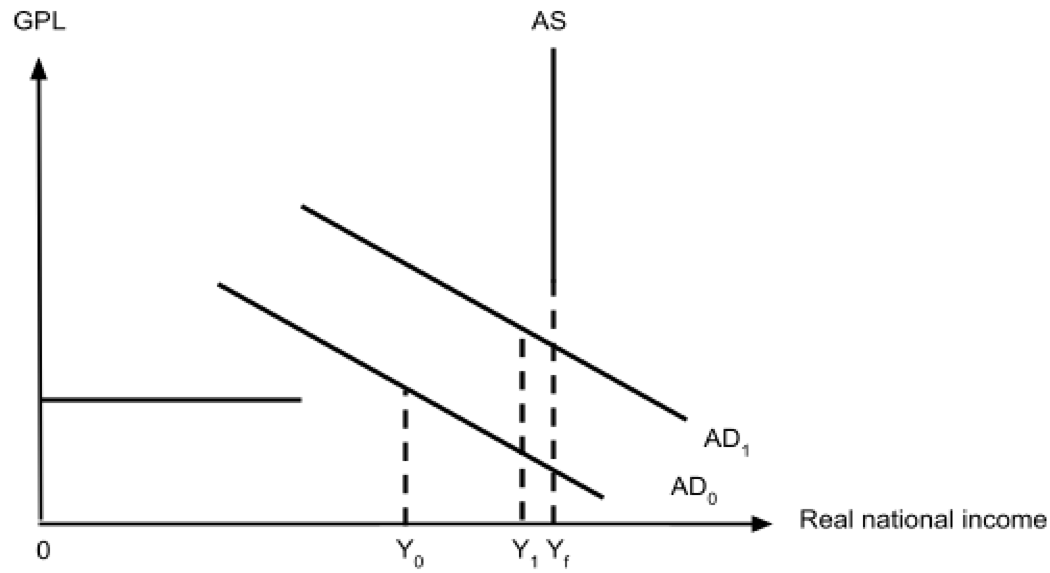

Figure 1: AD-AS (Actual growth in Singapore)

c) Positive Impact on Singapore's internal stability (Potential Economic Growth) due to increase in LRAS
- The increase in investment expenditure would also suggest, for example, an increase in the acquiring of capital assets that would increase Singapore's ability to produce more goods and services in the future. Therefore, Singapore's productive capacity would increase thus increasing Singapore's full employment level of output leading to an increase in Singapore's long run aggregate supply (LRAS).
- Hence, the fall in interest rates would increase Singapore's potential growth. Coupled with the increase in actual growth, Singapore can enjoy sustained economic growth which is non-inflationary.

- Overall, the fall in interest rates can positively affect Singapore's internal and external stability.

2. Anti-thesis: Negative Impact on Singapore's economy due to fall in world interest rates

a) Explain how the increase in aggregate demand (AD) might negatively affect Singapore's internal stability (Price Stability).
   - However, the increase in AD due to lower interest rates may compromise on price stability. If Singapore is operating near full employment level of output at the upward sloping portion of AS curve where there is a lack of/ limited spare capacity, the fall in interest rate might lead to demand pull inflation in Singapore.

b) Explain how the increase in prices of imported inputs in other countries might negatively affect Singapore's internal stability (Import Price-Push Inflation).
   - Trading partners in Singapore may also similarly suffer from demand-pull inflation due to increase in AD brought about the fall in world interest rates.
   - Given that Singapore has limited resources and is import-reliant, higher global prices mean higher price of imported inputs and thus an increase in imported cost of production.

   - Overall, the fall in interest rates can have negative effects on Singapore's internal stability in the long run where most economies may be operating nearer to the full employment output level instead.

c) Explain how the increase inflow of hot money might negatively affect Singapore's External stability (Balance of Payment).

- As world interest rate falls, there will be an inflow of hot money due to the relatively higher interest rates in Singapore in the short term. The inflow of hot money would thus lead to an increase in demand for Singapore dollar (SGD) as residents in foreign countries would need to buy SGD to put money into banks in Singapore. Assuming the supply of SGD remains constant, it would lead to an appreciation of SGD i.e. more foreign currencies in need to buy one unit of SGD.
- Given that Marshall-Lerner Condition where $|PED_x + PED_m| > 1$ holds for Singapore, the appreciation of SGD would lead to a decrease in Singapore's net export (X-M). This would in turn decrease Singapore's AD significantly due to the significance of X to Singapore's AD and thus significantly decrease Singapore's national income and increase cyclical unemployment in the long run.

<u>Evaluation conclusion:</u>

- In conclusion, a fall in world interest rates can have positive and negative effects on Singapore's internal stability.
- Whether or not a fall in world interest rate is likely to have a positive impact on Singapore's economy depends on the macroeconomic condition and the confidence level of consumers and firms.
- It also depends on the existing policies in place that can help Singapore reap the positive effects of the fall in interest rates and/or mitigate the negative effects. If so, it is more likely that the benefits of the fall in world interest rates would outweigh the costs when considering the effects on Singapore's internal stability.