Question 2

Trade Slump and Deflation

Extract 5: UK slips into deflation as prices fall 0.1%

The UK has officially slipped into deflation for the first time in more than half a century, but economists and policy makers are not concerned, saying that a brief period of gently falling prices is more likely to help growth than harm it.

The UK has been teetering on the brink of deflation for several months because of the slide in global oil prices, falling household incomes and the strength of sterling, which has reduced UK's export competitiveness.

Suneil Mahindru, chief investment officer international equity at Goldman Sachs Asset Management, reacted by saying: "We are not concerned about the UK". Falling prices are "freeing disposable income and many industries, such as retail, are benefiting", he added. UK households have suffered from falling real wages over the past few years. Now that prices of consumer essentials like food and energy are stagnant or falling, many households are finally getting a boost in living standards.

Chancellor George Osborne said the data were good news for family budgets and should not be mistaken for "damaging deflation" — a vicious cycle of falling prices and wages which shrinks an economy. He added that once deflation sets in consumers would expect prices to fall and they would delay spending for as long as possible in order to save money. This would perpetuate the problem and is known as a deflation trap. The deflation trap would lead to falling economic growth.

Source: Adopted from The Financial Times, 19 May 2015

Extract 6: Deflation risk and trade slump cast chill over global economy

The world economy is at risk of slipping into a deflation trap and faces a historic slump in global trade that should serve as a wake-up call for governments around the world. The International Monetary Fund warned on Tuesday that a "broad-based phenomenon" of low inflation, fed by a collapse in commodity prices and faltering demand, risked deteriorating into a full-blown deflation trap, particularly in advanced economies.

The fund's warning, came as the World Trade Organisation forecast global trade volumes would rise only 1.7 per cent this year. This would be the slowest increase since the 2008 financial crisis, and a big reduction from the 2.8 per cent growth it forecast in April. "The dramatic slowing of trade growth is serious and should serve as a wake-up call," said Roberto Azevêdo, the WTO's director-general.

The trend was particularly worrying in the context of an increase in protectionism and anti-globalisation rhetoric seen in the US and around the world, he said, adding: "This is a moment to heed the lessons of history and recommit to openness in trade, which can help to spur economic growth."

The twin warnings highlight mounting concerns over the world economy's slow recovery from the 2008 crisis and the tepid response by policymakers. They also point to two key areas of concern. International institutions are increasingly worried about the potential impact on a fragile global economy of the rise of populist politicians, such as US presidential candidate Donald Trump, and the protectionist policies they put forward.

They are equally frustrated by what they see as the failure of many governments to take tough decisions and their continuing overreliance on central banks and monetary policy to respond to slow growth. The IMF has for years urged governments to adopt more growth-friendly fiscal policies and to push structural reforms to stimulate consumption and investment. Alongside the warning of a deflation trap, the IMF called for governments to target stagnant wages and adopt policies such as raising the minimum wage to boost incomes. Such a response, IMF economists wrote, was particularly necessary in advanced economies, where “the scope of monetary policy to further stimulate demand is perceived to be increasingly constrained” and “policy rates are not far from their effective lower bounds”.

Source: Adopted from The Financial Times, 28 September 2015

Extract 7: MAS 'must remain alert' to signs of slow growth

Singapore's central bank should "remain vigilant" to signs of slow growth in the country and make policy adjustments if needed, the International Monetary Fund (IMF) said. In a statement released yesterday, after a visit here, fund representatives noted that Singapore's growth prospects remain subdued, given a lacklustre global outlook.

The IMF also said the Monetary Authority of Singapore's (MAS) latest move to stop the local currency from rising further against a basket of key currencies was "appropriate", given slowing growth, a weakening labour market as well as low oil prices worldwide. The fund noted that Singapore's economic growth has slowed markedly in recent years owing to both domestic and external factors.

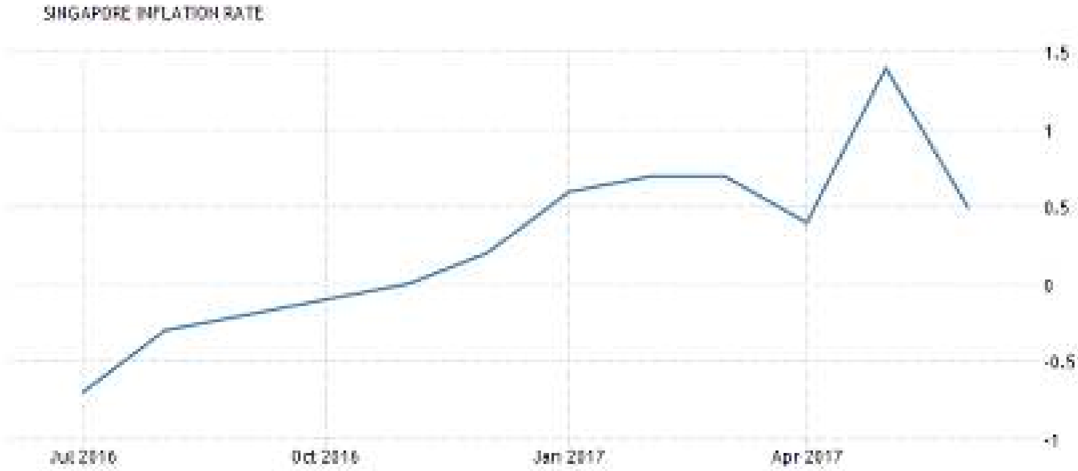
At home, growth is constrained by an ageing labour force, tighter limits on foreign workers and the transition costs of the shift to an innovation-based growth model. On the external front, the outlook for global growth and trade remains subdued, the IMF said. The fund also said Singapore's growth is likely to slow further this year, as the full impact of the slowdown in global trade and capital outflows is felt and companies continue to hold back on hiring and investment. The most important short-term external risk is a sharper-than- expected global slowdown, which could result from weak growth in China, other emerging economies as well as key advanced economies.

Still, the Singapore Government has enough in its coffers to ramp up spending and provide a short-term lift if the economic outlook worsens further, said the IMF. "The authorities are prepared to implement fiscal stimulus through targeted measures, for example providing more income transfers to poor families and seniors and accelerating infrastructure spending," added the fund in its statement.

In the longer run, raising productivity will be essential to Singapore's growth, given slower labour force expansion, the IMF said.

Source: The Straits Times on 11 May 2016

Figure 3: Inflation Rate in Singapore



Source: SingStats

H2 CSQ 2 Suggested Answers

(a)	**Describe the trend in the consumer prices in Singapore between July 2016 and April 2017.**	**[2]**
	• Consumer prices show a falling trend between July 2016 and Oct/Nov 2016 (1m) • before rising from Oct/Nov 2016 to April 2017 (1m).	
(b)	**Using extract 5, comment on whether economies should fear deflation.**	**[4]**
	i. Thesis • Yes economies should fear deflation if the economy is experiencing deflation trap or 'damaging deflation' as mentioned in Extract 5 para 4. Deflation trap is known as 'a vicious cycle of falling prices and wages which shrinks an economy' as 'consumers would expect prices to fall and they would delay spending for as long as possible', leading to a continuous fall in C and fall in AD (Draw) and fall in RNY, leading to 'falling economic growth' . **ii. Anti-Thesis** • No economies should not fear deflation as 'consumer essentials like food and energy are stagnant or falling, many households are finally getting a boost in living standards' as stated in Extract para 3. Thus deflation can benefit households and make groceries more affordable for everyone, especially benefitting the low income groups or unemployed who spend a large proportion of income on groceries / food which is a basic necessity, hence promoting income equity. **iii. Judgement** Whether economies should fear deflation depends on whether the consumers are expecting prices to fall. If consumers expect that deflation is only temporary and economic conditions and prices will eventually improve in the months ahead, then deflation is not a concern. <u>Note:</u> • *Two-sided answer on whether economies should fear deflation (3m)* • *Judgement on the overall SOL (1m)*	
(c)	**Using aggregate demand and supply analysis, explain the causes of deflation in the UK in 2015 as identified in extract 5.**	**[6]**
	Deflation in UK is due to 'slide in global oil prices, falling household incomes and the strength of sterling, which has reduced UK's export competitiveness' as mentioned in Extract 5 para 2 **i. Falling AD (4m)** • Falling household incomes in UK has contributed to fall in purchasing power, leading to a fall in consumption, resulting in a fall in AD. • Furthermore the strength of sterling has led to rise in export prices in foreign currency, since prices in domestic currency has not changed but there is a fall in volume of export revenue falls. (Draw fall in Xrev, via falling DD for exports) • Hence, fall in C and X, will cause AD curve to shift to the left (Draw), leading to fall in GPL.	

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ii. Falling AS (2m)

- Slide in global oil prices will lead to lower cost of production, as oil is factor input which is required in most production process.
- Hence, this will lead to rise in AS and AS curve shift downwards (Draw), leading to fall in GPL.

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<tr><td>**(d)**</td><td>**Using both the case study and your own relevant knowledge, discuss whether "an increase in protectionism and anti-globalisation rhetoric" seen in the US and around the world can be justified in terms of economic theory.**</td><td>**[8]**</td></tr>
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- In anticipation of a deflation trap and falling economic growth, countries it is not uncommon to seen 'an increase in protectionism and anti-globalisation rhetoric seen in the US and around the world.

- By imposing protectionism e.g. tariff (draw tariff diagram), there will be a fall in import expenditure(show on diagram). This will force the locals to turn to domestic consumption as it is relatively cheaper. The rising domestic consumption will give rise to a rise in AD and hence combatting a deflation trap and raise GDP(draw AS-AD).
- Although seem justifiable for the country imposing tariff, the outcome may be counter intuitive due to 'beggar-thy-neigbour' effect. Trading partners whose exports are now having less demand due to the tariff, would face falling GDP. This will result in falling purchase of imports.
- Hence countries that place tariffs in order to raise domestic consumption would face falling export revenue. The extent of the fall in export revenue would depend on the fall in the GDP of the trading partner as well as the responsiveness of demand for exports due to the fall in income. If the export revenue falls more than the rise in consumption, then there will be contraction for the economy that impose the tariff.
- In addition, should trading partner retaliates, it may be counter-productive and it could lead to a lose-lose situation.

- Other areas of consideration would include the impact of the tariff on the allocation of resources. Once a tariff is imposed, there would be a dead weight loss. (Use diagram) and explain.

- Protectionism also goes against the benefits offered by the theory of comparative advantage. (Draw PPC vs CPC diagram).

- Conclusion, although protectionism can help alleviate short term economic problem, in the long run it seem to harm economies. I believe that free trade is essential and hence agree with Roberto Azevêdo, the WTO's director-general who said "This is a moment to heed the lessons of history and recommit to openness in trade, which can help to spur economic growth."

L1	One sided answer on the benefits of protectionism/anti-globalisation or arguments against protectionism/anti-globalisation with the use of economic theory (framework)	1-3
L2	Two sided answer on the arguments for and against protectionism/anti-globalisation. Expected use of economic theory (framework)	4-6
E	Judgement of the justification of protectionism/anti-globalisation	1-2

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	Note : Answers could also focus on anti-globalisation rather than simply protectionism. Explicit dimensions of anti-globalisation must be explained rather than using the generic term anti-globalisation. Eg….reduce mobility of goods and services via protectionism, reduce mobility of labour, reduce mobility of investment.	
(e)	**Discuss whether depreciation of the Singapore dollar would be most appropriate way of responding to slow growth in Singapore.**	**[10]**
	i. Explain briefly the causes of slow growth in Singapore • Domestic causes: Ageing labour force, tighter limits on foreign workers and the transition costs of the shift to an innovation-based growth model. (Extract 7 para 3). • E.g. tighter limits on foreign labour will lead to rising wages and falling SRAS. • External causes: Fall in X and possibly FDI hence AD due to the 'outlook for global growth and trade remains subdued' (Extract 7 para 3) Thesis **ii. Explain how depreciation will increase growth in Singapore** • Assuming M-L condition holds, which is the sum of PED for exports and imports is greater than one, depreciation will lead to rise in net exports. • Hence, this will help increase AD (Draw) and increase RNY. Anti-thesis **iii. Explain the limitations of exchange rate depreciation** • M-L condition may not hold in the SR (give reasons). Hence in the SR, AD may actually fall leading to even slower growth. • Temporary and short-term measure to boost export competitiveness and weaker exchange rate will eventually lead to rise in price of locally produced goods that use imported inputs to go up, leading to cost-push inflation and will eventually erode export competitiveness **iv. Explain how other policies will be more appropriate** • Exchange rate depreciation may not be appropriate as it is unable to target internal causes such as aging labour force which would lead to shrinking size of labour force in the future and fall in productive capacity and fall in LRAS and fall in RNY and Yf. • Hence, 'raising productivity will be essential to Singapore's growth' as stated in Extract 7 last para. • Explain at least 1 measure of SS side policy (e.g. education or retraining) and show how it will help increase growth, especially for potential growth. • Extract 7 para 4 also mentions that "The authorities are prepared to implement fiscal stimulus through targeted measures, for example providing more income transfers to poor families and seniors and accelerating infrastructure spending" • Explain at 1 least measure of the fiscal policy as a DD side policy and show how it will help increase actual growth **v. Explain the limitations of the alternative policies** • Time Lag • Small K	

Conclusion

vi. Take a stand

L1	A brief description of how depreciation will improve growth without considering the causes of slow growth in Singapore .	1-4
L2	Provides a clear two-sided explanation on how depreciation and other measures will help improve growth in Singapore through the use of relevant diagrams. Clear explanation on rise in AS and AD that links to Sg's growth.	5-7
E1	Provides an unexplained judgement on the appropriateness of exchange rate depreciation on improving Sg's growth. Good use of data in considering the appropriateness of exchange rate depreciation on improving Sg's growth.	1 2-3