Suggested Response for Essay Question 5

5. When faced with negative economic growth, governments often turn to fiscal stimulus to support their economy. Some governments provide transfer payments such as cash vouchers, while others spend on building infrastructures.

(a) Explain **one** possible demand-side cause and **one** possible supply-side cause of falling national output for a country. [10]

(b) Discuss whether transfer payments are the most appropriate policy tool to overcome negative economic growth for all economies. [15]

(a) Explain one possible demand-side cause and one possible supply-side cause of falling national output for a country. [10]

Command word	Explain – use economic reasoning Start point: AD-AS causes End point: falling national output
Concepts	AD-AS
Context	Open context

<u>Introduction</u>: Framing – unpacking slowdown in economic growth rate as well as the challenges facing Singapore

- National output is measured using real Gross Domestic Product. It is the monetary value of goods and services produced in a country, in a given period of time.
- Falling national output suggests negative economic growth rate
- It can be due to changes in the aggregate demand which measures the total demand of all goods and services by economic agents within a country at each price level, as well as aggregate supply which shows the total output of goods and services (national output) that all firms in a country could produce at each general price level, given the current level of resources and technology.

<u>Requirement 1: Explaining how demand-side factors could have caused a drop in national output.</u>

<u>Changes in domestic government policies (e.g. tax rates or interest rates hikes)</u>

Government may implement contractionary monetary policies such as raising interest rates. Higher i/r leads to higher cost of borrowing and greater returns to savings. This means that households may be more inclined to save, rather than spend, **leading to a fall in consumption expenditure (C) ➔ lower AD**

At the same time, a higher interest rates could lead to previously profitable investments to be less profitable now since a greater proportion of revenue needs to be paid as higher i/r. This may cause firms to invest less ➔ **lower investment expenditure (I) ➔ lower AD.**

Weak global demand / foreign countries' govt policies

Globally, countries are still grappling with the COVID-19 virus and are slow to recover in terms of tourism and production. Countries like the United States of America (USA) are also suffering from a higher unN rate due to massive job losses ➔ poorer income growth

Weaker income growth in foreigners ➔ less likely for foreigners to spend on imports (assume M is positive XED) ➔ this would **affect a country (trading partner)'s export revenue** significantly (X) ➔ fall in AD.

The fall in AD will see **firms cutting back on production** in reaction to the falling revenue earned. As such, they **cut back on hiring of workers** and even retrench workers to cut losses ➔ higher unN ➔ **lower demand for workers hence lower wages** ➔ **further reduce** consumption spending, AD falls even more and the reverse multiplier process will continue until no further reduction in C. This means that the **national output will fall by a multiplied amount.**

Requirement 2: Explaining how supply-side factors could have caused a drop in national output

Supply-chain disruptions leading to rising cost of production or/and low productivity improvement

Supply-chain disruptions in terms of labour markets as well as raw materials ➔ higher unit COP ➔ lower SRAS

Pass on higher costs to consumers in terms of higher GPL

Cuts back production as they have difficulties securing labour and essential FOPs like food, commodities and even oil.

Conclusion

- Falling national output can be caused by a drop in both AD and AS, often time, these factors are inter-related.
- Falling national output have severe implications on other macro objectives such as unemployment and balance of trade position, hence it is important that governments put in place policies to reduce the fall.

Level	**Knowledge, Application, Understanding and Analysis**	Marks
L3	• **Well-developed analysis** on **both** the demand **and** supply factors that caused a fall in national output including: - Good use and explanation of AD/AS as conceptual framework - No major inaccuracies - Content is relevant	8-10

	- Start and end point is clearly explained, no missing elaboration.	
L2	• **Developed but one-sided** explanation on **either** the demand **or** supply factors that caused a fall in national output. Or • **Under-developed** analysis on **both** the demand **and** supply factors: **-** Conceptual framework of AD/AS is used but there are several inaccuracies **-** start and end point not entirely clear, some incoherence in the answers	5-7
L1	• Descriptive answer without any conceptual framework • Answer contains many inaccuracies.	1-4

(b) Discuss whether transfer payments are the most appropriate policy tool to overcome negative economic growth for all economies. [15]

Command word	Discuss whether – use economic reasoning to provide balanced argument on the **appropriateness** of the use of transfer payments to increase RNY across **all economies** Start point: transfer payments End point: raise national output
Concepts	AD-AS
Context	Open context – all economies To consider the differing characteristics of the economies

Introduction:

Define what is transfer payments. Cash vouchers, subsidies that are not linked to economic transactions, but part of government's planned expenditure (part of the government budget)

When economic output is falling ➔ country is in recession, loss of jobs and a possible fall in national and household income ➔ worsens standard of living, hence the government needs to implement policies to help overcome this.

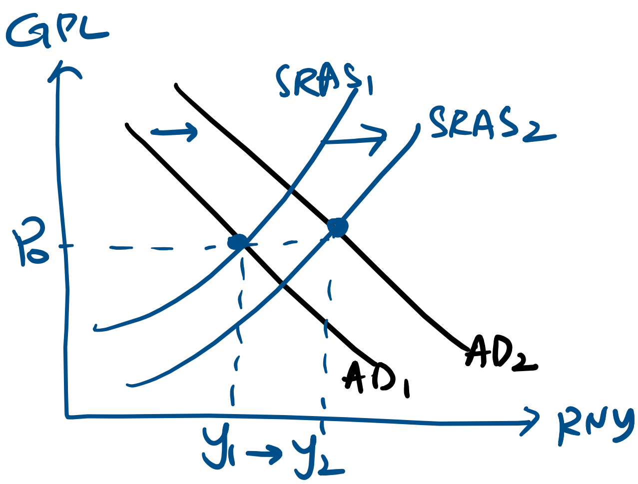
<u>Requirement 1: Transfer payments can be appropriate for some economies to increase real national output</u>

Transfer payments can also include subsidies to firms to **offset the rising unit cost of production** (e.g. Wage Supplement Schemes) ➔ **lowering unit COP** ➔ **increase SRAS from SRAS1 to SRAS2** and hence, increase RNY since firms are able to produce more with a lower unit COP.

Transfer payments can also include **grants on innovation** (e.g. to offset firms' innovation/ R&D costs) ➔ greater ability to earn more profits since costs is lower ➔ higher ability to invest ➔ I increases

Transfer payments: **subsidies to households** (e.g. GST vouchers , Rediscovery Vouchers, CDC vouchers) ➔ greater ability to consume as **the out-of-pocket expenses is lower** ➔ higher C

(multiplier process😊)Both the increase in C and I can lead to an increase in AD, from AD1 to AD2 ➔ firms react by producing more ➔ increase in real national income ➔ as they require more FOPs to increase production, they pay more for the FOPs ➔ leading to higher income earned by FOPs ➔ stimulate further induced consumption ➔ AD increase further and hence, RNY increase further. This multiplier process will lead to a multiplied increase in RNY from the increase in transfer payments by government.



(Part of Evaluation) This policy tool will be **appropriate** for:

1) **Countries with larger multiplier size** ➔ RNY increase by a **bigger** amount ➔ **faster** to get out of recession and government **does not need to spend as much** to raise RNY sufficiently. Countries with small multiplier size will need to spend more on transfer payments in order to raise the RNY to the same extent.

2) **Countries whose government budget in a healthy surplus** ➔ transfer payments require government budget ➔ without the budget, governments may have to borrow to finance the transfer payments ➔ leading to accumulation of public debt, which means that any economic growth benefits are likely reduced as part of it has to go towards repaying the debt. (Accepted response include crowding out effects too ➔ negate by the fall in C and I due to higher interest rates)

(Part of Evaluation) **Transition / Limitations of Transfer Payments linking it to its appropriateness:**

However, the use of transfer payments requires substantial amount of government budgets and is likely to be **unsustainable in the future**, without raising direct taxes to fund this spending. Therefore, **regardless of the type of economies, the use of transfer payments is unlikely to be the only policy tool that is appropriate to use for all economies.**

At the same time, for countries with smaller multiplier size due to their relative openness to trade and/or with less government budget, transfer payments are even less appropriate, hence other expansionary tools such as exchange rates or interest rates may be more appropriate.

(Note to students, the limitations of the policy need to be associated with the appropriateness of the policy, and marks are awarded based on the linkages, rather than stating the limitations)

Requirement 2: Other alternative policy tools such the use of exchange rates may be more appropriate for some economies.

Alternative would be to **depreciate the currency**, in order to raise RNY

Depreciation ➔ **cheaper X prices** in terms of foreign currencies and more expensive M prices in terms of local currency ➔ **assume ML condition holds**, the qty demanded for X will increase more than proportionately while qty demanded for M will drop more than proportionately ➔ (X-M) increase and hence, increase AD.

(OR: to reduce interest rates ➔ lower COB and higher returns to savings ➔ stimulate C and I since the rates of returns to investments likely to be higher with lower COB for firms and households have greater ability to return the loans with lower COB ➔ AD increases, and hence RNY.)

With an increase in AD ➔ RNY will increase by a multiplied amount via the multiplier process.

(Part of Evaluation) The alternative policy will be more appropriate for:

1) **more open economies** ➔ tend to be **more trade reliant** ➔ rely on external markets to grow economy ➔ % of (X-M) as GDP is relatively higher than C and I (as a percentage of GDP). This means that the increase in (X-M) is able to increase AD more and hence RNY more and faster.

2) Countries **whose RNY falling is due to weak external demand** ➔ targeting the root cause of negative economic growth

Note: Supply-side policies may not be so suitable in this case as it tends to take a longer time to see effects. In cases where economic growth is negative ➔ this is a relatively severe macro issue, cannot afford to implement such a long term policy.

(Part of Evaluation) **Limitations of Exchange Rate depreciation and link to appropriateness of the policy**

(Note to students, the limitations of the policy need to be associated with the appropriateness of the policy, and marks are awarded based on the linkages, rather than stating the limitations)

However, a depreciation in the currency may not be so feasible for economies that rely on external imports for FOPs. The cheaper currency can raise its unit COP, which reduces the exports competitiveness and hence, the increase in RNY may not be so significant.

Overall conclusion: (note to students: limitations of transfer payments can be used in the conclusion)

Transfer payments alone cannot be the best policy tool for all economies as it is not sustainable in the long term and different economies face different constraints and

different characteristics. Furthermore, transfer payments do not guarantee that AD will surely increase as firms and households may be hit by negative pessimism, which limits how much they invest and spend respectively. That said, it will still be an effective and appropriate tool for countries in the **short term**, especially for those government budgets that are in **surplus** and have a relatively higher domestic consumption and investment as a proportion of their GDP.

However, **open economies** whose trade component plays a bigger role, manipulating the exchange rates can be a more appropriate policy tool as it is able to achieve the increase in RNY faster.

In most countries, governments would rather **increase more components of the AD as much as possible**, hence a more effective and appropriate approach will be to **combine both** transfer payments and the other expansionary monetary policy tools to ensure that the national output can be increased **faster**. **In the long term,** governments also need to implement supply-side policies once the AD and SRAS start to increase, to ensure that the economic growth is sustained.

Level	**Descriptors**	**Marks**
L3	**Both requirements well-analysed** **1. how transfer payments can be appropriate** to increase RNY **and** **2. how an alternative policy may be more appropriate** to increase RNY **Well-analysed** includes: - Correct start and end point (policies – to overcome falling national output) - Correct use of AD-AS framework - Diagram(s) is/are used in explanation - No major conceptual errors	**8-10**
L2	**Only** one requirement is well-analysed or Two links are somewhat explained but **<u>not</u>** well-analysed Explanation includes: - Some gaps in explanations - Inconsistent / inaccurate use of concepts - Diagrams drawn but are not used in explanation	**5-7**
L1	Major conceptual inaccuracies Irrelevant use of concepts	**1-4**
Evaluation		
E3	Both transfer payments and alternative policy are evaluated (i.e. appropriateness are considered using limitations and/or context of countries) AND a summative conclusion / recommendation is provided on both requirements.	**4-5**
E2	Both transfer payments and alternative policy are evaluated (i.e. appropriateness are considered using limitations and/or context of countries) but **<u>no</u>** summative conclusion / recommendation is provided.	**2-3**

E1	A brief attempt at evaluating the policy but stated, rather than explained No comparison made at all	**1**