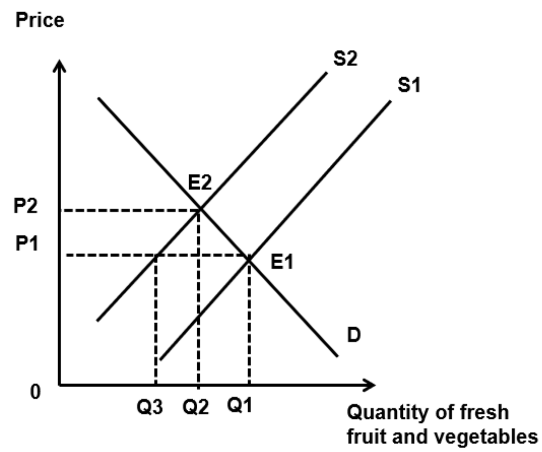
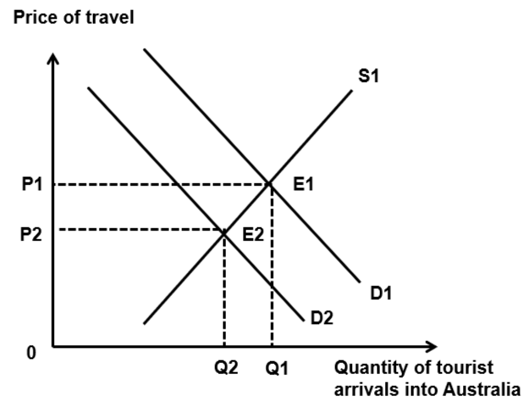
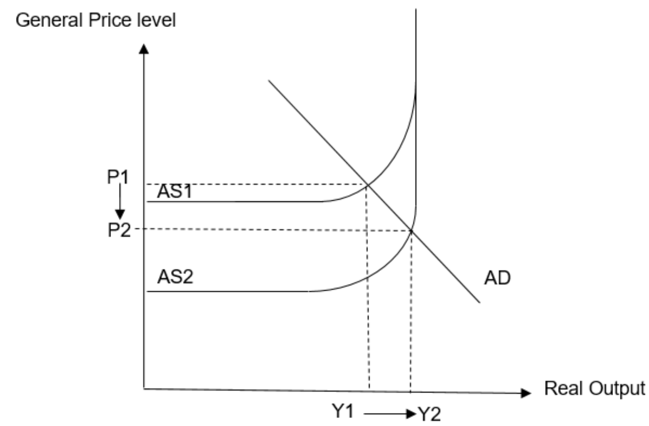
Question 1: Economic problems caused by drought and the coronavirus (COVID-19) pandemic

(a)	Use a supply and demand diagram in each case to explain why:	
	(i)	the price of fresh fruit and vegetables in Australia has risen as a result of the drought. [2]
		The drought in Australia will mean no or insufficient water for the growth of fruits and vegetables. This will lead to a **fall in the supply of fresh fruit and vegetables from S1 to S2** as shown in Figure 1 below. At the original price OP1, there will be a **shortage** of Q3Q1 of fresh fruit and vegetables, and this will exert an **upward pressure on the price** causing it to **rise from OP1 to OP2.** **Accurately labelled diagram – 1m:** **Figure 1:** 
	(ii)	International tourist arrivals into Australia are expected to fall as a result of the bush fires. [2]
		The "smoke haze and uncertainty about safety" due to the bush fires have caused a **change in taste and preference against travelling to Australia**. This will cause the demand for tourist arrivals to Australia to fall. As shown in Figure 2 below, the **demand curve will shift from D1 to D2**. The equilibrium quantity of international tourist arrivals falls from **Q1 to Q2.**

		Accurately labelled diagram – 1m: **Figure 2:** 
(b)	With reference to the data, explain **one** possible reason for the change in Australia's budget balance from February to June 2020. [2]	
	Australia's budget balance changed from a **budget surplus to budget deficit**. This is because the Australian government **increased government spending** as **a fiscal stimulus to boost aggregate demand** so as to help the economy to recover from falling GDP due to the negative impacts of bushfires (Extract 2) and the coronavirus shock (Extract 3). **Assuming no change in government's revenue**, the large increase in government expenditure would cause the budget balance to go into a deficit.	
(c)	With reference to Extract 2, explain why a nominal interest rate of 0.25% in March 2020 would be described as being 'negative' in real terms. [2]	
	Real interest rate is the nominal interest rates adjusted for inflation. [1] With reference to Extract 2, the interest rate is 0.25% and inflation rate is 2.2% as reflected by the change in consumer price index. Real interest rate is negative because 0.25-2.2 = -1.95%. [1] <u>OR</u> Real interest rate is negative as inflation rate is higher than the nominal interest rate.	
(d)	Explain how a negative interest rate is likely to affect savings by consumers and the exchange rate in Australia. [4]	
	Negative interest rates meant that interest rates fall below 0%. This decreases interest earnings and decreases the opportunity cost of spending. [1] This decreases savings by consumers. [1]	

	With negative interest rates, there is also less hot money inflow into Australia [1]. This will lower the demand for Australian dollar which will lower the exchange rate in Australia (i.e. Australian dollar depreciates). [1] OR There is more hot money outflow from Australia seeking for higher interest rates elsewhere. This will increase the supply Australian dollar which will lower the exchange rate in Australia (i.e. Australian dollar depreciates). [1]
(e)	Given the weakening of Singapore's exchange rate, discuss whether a stronger exchange rate would be of overall benefit to Singapore when "the global economy is in deep recession' (Extract 4). [8]
	Introduction: Singapore (SG) is a small and open economy. It is import-reliant due to lack of natural resources and is export-driven due to small domestic demand because of small population size. In general, SG's monetary stance is to have a modest and gradual appreciation of the Singapore dollar (S$) so that its external demand and AD can increase at a non-inflationary pace and to keep imported inflation at bay. However, in times of a global economic downturn such as in the given current economic situation, SG has allowed its S$ to weaken. In this essay, we will discuss whether a stronger exchange rate would be of overall benefit to Singapore when "the global economy is in deep recession'. **Development 1:** **A stronger exchange rate would be of benefit to Singapore when "the global economy is in deep recession'.** As Singapore is highly dependent on imports, a stronger S$ will make imports cheaper in S$. A fall in price of imports means imported raw materials are now cheaper which can lead to a fall in unit cost of production of final goods and services for domestic firms. Hence, firms in the economy are willing and able to increase production at every price level, causing a rightward shift of the AS curve from AS1 to AS2 as seen in diagram below. GPL falls from P1 to P2, hence reducing cost-push inflation and boosting economic growth as real output increases from Y1 to Y2.



Development 2:
A stronger exchange rate would <u>not</u> be of benefit to Singapore when "the global economy is in deep recession'.

However, SG is also highly dependent on exports for growth. When the global economy is in deep recession this would mean that SG's trading partners are likely to face falling GDP. With a fall in income, demand for SG's exports to these countries will fall leading to fall in SG's export revenue. The fall in SG's export revenue will be significant should the income elasticity of demand for these goods be positive and more than 1 as the demand for SG's exports will fall by more than proportionately. Having a strong S$ in such times will cause an even larger fall in SG's X. With a stronger S$, SG's exports will become more expensive in the foreign currency. Assuming PEDx>0, demand for exports in SGD will fall, further exacerbating the fall in export revenue. In addition as imports become cheaper in SGD due to the stronger SGD, domestic households may substitute imports for domestically produced goods and services resulting in a fall in domestic consumption. AD will fall by an even greater extent, worsening SG's economic recession. Hence a stronger S$ may not be of advantage to SG.

Furthermore, in a severe global recession, imported inflation from a weaker S$ may be less of a concern as globally prices of goods and services in general may have fallen due to lack of demand arising from economic uncertainty.

Singapore may also suffer from a BOT deficit as a result of a stronger SGD due to fall in X arising from a fall in price competitiveness of her exports as explained earlier, and a rise in M assuming PEDm > 1 causing a more than proportionate rise in the quantities imported in response to a fall in price of imports in SGD. Assuming Marshall-Lerner condition holds i.e., the sum of price elasticities of demand for imports and export is more than 1, the stronger SGD causes the BOT to decrease to a deficit assuming it was initially in equilibrium i.e. BOT = 0.

	Conclusion: Criterion → Root cause of the recession [CORe] A stronger exchange rate may not be of overall benefit to Singapore when "the global economy is in deep recession' especially when the recession was caused by a fall in aggregate demand. Rather it would be more appropriate for Singapore to pursue depreciation of S$ to stimulate AD. In Extract 4, it is also stated that other countries are also easing their monetary policy. However, a possible need for a stronger S$ could arise should there be rising prices of imports due to supply chain disruptions that could be brought about due to closures of factories and reduced movements of goods to contain the spread of the coronavirus. **Mark scheme:**
(f)	Discuss whether fiscal policy is the most effective way to bring unemployment down in Australia. [10]

Mark scheme (continued):

Level	Knowledge, Skills, and Application	Marks
L2	Well-developed and balanced discussion on whether a stronger exchange rate would be of overall benefit to Singapore when "the global economy is in deep recession'.	4-6
L1	For an underdeveloped answer that is one-sided OR lacks in-depth explanation on how a stronger exchange rate would benefit or not benefit Singapore when "the global economy is in deep recession'.	1-3
Evaluation	Well-explained judgement on whether a stronger exchange rate would be of overall benefit to Singapore when "the global economy is in deep recession'.	1-2

Introduction:

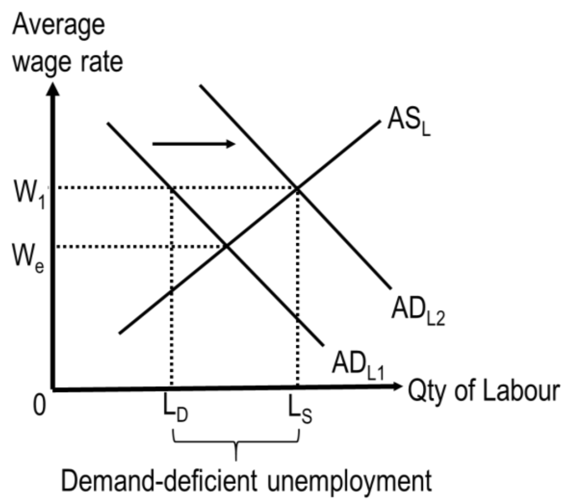
Australia suffered from demand deficient unemployment because of Australian bushfire and COVID 19 pandemic. This brings about negative impacts such as lower income and tax revenue and lower standard of living. The Australian government has introduced expansionary fiscal policy such as increase government spending to enable Australian to achieve this macroeconomic goal of full employment. However, there are other policies that government can adopt to effectively bring the high unemployment down which will be discussed.

Development 1: Explain how expansionary fiscal policy bring unemployment down in Australia.

The Australian government may implement expansionary fiscal policy to increase AD to reduce demand-deficient unemployment in SG. An expansionary fiscal policy refers to a rise in government expenditure (G) and/or a fall in tax revenue (T), which increase AD and hence, aggregate demand for labour (ADL) in the economy. From

Extract 1 & 3, the government billions of dollars to stimulate the economy. With an increase in government expenditure, AD increases since G is a component of AD. This increases the total demand for goods and services in the economy bringing inventories down and stimulating production and a rise in real output by the multiplier effect. As ADL is a derived demand, more workers would be employed at every wage rate and ADL shifts from ADL1 to ADL2, bringing about an increased in workers employed from L_D to L_S as shown in Figure 1 below. This reduces demand-deficient unemployment.

Figure 1:



How well does it work:

(+) This is a direct method because increase in G increases AD directly. **EV [Criterion: Context]:** Hence, it is a suitable policy given the weak confidence level highlighted in Extract 1 which is worsened by the deep global recession in Extract 3.

(-) However, the government will run into a budget deficit due to the larger government spending. **EV [Criterion: Context]:** This is reflected from the increasing budget deficit from Figure 1. The increase in government spending financed by borrowing will result in Australia to suffer from government debt. Increasing government debt level as a % of the country's GDP can lower the country's credit ratings and lower business and consumer confidence further. The fall in C & I will lower AD since C & I are components of AD. This will result in a further increase in unemployment.

Development 2: Explain how interest rate policy bring unemployment down in Australia.

With a fall in interest rates, cost of borrowing decreases which lower opportunity cost of spending. This encourages consumers to increase their consumer expenditure. Furthermore, more investment projects will be taken since expected returns are greater than interest rates. Hence, investment will increase. Since both C&I increases, this causes an increase in AD. As explained earlier, the increase in AD will reduce demand-deficient unemployment.

How well does it work:
(+) Interest rate policy does not worsen government debt. Given the weak economy and large government debt as reflected in Extract 3, there should be greater use of monetary policy tools.
(-) Interest rate policy is dependent on the confidence level of consumers and businesses. **EV [Criterion/Context]:** Given the poor economic outlook due to the deep global recession in Extract 3, it is unlikely that C & I will increase significantly with a fall in interest rates.
(-) There is also a limit to how much interest rate can be cut since once it lowers to zero it is not possible to lower it any further. **EV [Criterion/Context]:** The government will not be able to lower interest rates drastically since interest rates in Australia is close to zero. Having a positive inflation which is higher than the nominal interest rate will mean real interest rate will be negative. This will limit the extent of increase in consumption expenditure and investment expenditure in the economy.

Conclusion: Criterion → Context, Root cause of Unemployment
[CORe] Expansionary fiscal policy is the most effective way to reduce unemployment in Australia in the short run. In light of the poor economic outlook, directly increasing AD via expansionary fiscal policy is likely to see more success than expansionary monetary policy via lower interest rates which is dependent on the confidence level of consumers and businesses. Furthermore, the main source of unemployment that Australia is facing is demand-deficient unemployment due to the drought and COVID-19 pandemic. In addition, fiscal measures can target particular areas concerned unlike monetary policy that has a more general impact as stated in Extract 1. Hence, a targeted approach could be adopted to tackle job losses in the sectors highlighted in Figure 2 which cannot be attained using interest rate policy.

Level	Knowledge, Application, Understanding & Analysis	Marks
L2	Thorough explanation using relevant economic concepts of whether how the fiscal intervention works to tackle unemployment in Australia with an alternative suggested.	4-7
L1	Descriptive explanation with limited or no reference to relevant case materials on how fiscal policy work. May contain conceptual errors.	1-3
	Up to 3 additional marks for evaluation	
E2	Well-explained judgement on which policy is the best based on the context given.	2-3
E1	For unexplained judgement or mere statements without elaboration.	1