

PJC 2018 H2 P2 Question 6

“If Singapore is to continue to benefit from international trade, the government needs to continue to use trade-related economic policies, such as free trade agreements (FTAs) and policies to stimulate export industries.”

- a) Explain the determinants of the pattern of trade between Singapore and the rest of the world. [10]**
- b) Discuss the options available to the government to ensure that it would continue to benefit from free trade. [15]**

Pattern of trade refers to the type and quantity of exports and imports that a country trades with her trade partners. Some of Singapore major imports include labour intensive, lower value consumable products such as food and clothing. Singapore also import electronics, petroleum and chemical products and re-export some of these products as higher value added products to its trading partners. The main determinants of the pattern of trade between Singapore and the rest of the world include resource endowment which would determine its comparative advantage in the type of goods being produced.

Singapore with its small physical size with no natural resources, it does not possess any comparative advantage in the production of labour intensive goods such as textile and agricultural products.

According to the theory of comparative advantage states that a country would be able to benefit from trade by specializing in the production of goods and services in which it can produce at a lower opportunity cost. Singapore with its small physical size and small population size, it does not have any comparative advantage in the production of labour intensive goods and services such as textiles, clothing, food or agricultural products. As such, Singapore does not produce and almost import entirely all its consumable products from countries such as China, Malaysia and the rest of its trading partners which enjoy a comparative advantage in the production of these goods at a lower cost than Singapore.

On the other hand, with its highly educated and skilled labour force, Singapore have a comparative advantage in the production of higher value, knowledge intensive goods and services and traded these goods and services with its trading partners. These include goods and services such as high end electronic products, petrol chemical products, pharmaceutical products as well as medical and financial services to its trading partners.

Hence, leveraging on its resource endowment, Singapore imports mainly goods and services which it does not have a comparative advantage in producing and export goods and services which it has a comparative advantage in producing.

Other than its natural resource endowment, government policies are also one of the determinants of the pattern of trade.

Given the limitation of a small physical size with a small population and no natural resources, and hence its inability to compete with its much better endowed and resources rich countries, the Singapore government has deliberately adopted policies to develop its niches of comparative advantage in the higher value, knowledge based industries. The government has adopted various policies such as tax incentives as well as education policies to ensure a highly educated workforce for the knowledge based industries. Through these policies, the government is able to make Singapore an attractive place for investment and determined the exports of Singapore. For example, although Singapore does not produce any oil, with the appropriate government policies, it was able to develop into one of the world's largest oil refinery centre and an exporter of all oil related and petrol chemical products. Singapore has housed all oil refinery and oil and chemical related industries in the same location some of the offshore islands which has allowed the development of the external economies of scale for these industries being located in the same location. This has helped to lower the cost of production for these industries and increased its productivity and hence allowing these industries to producing and exporting competitive priced products to the world.

Hence, even without the comparative advantage deriving from the endowment of natural resource, Singapore is able to develop its own niches of comparative advantage via appropriate government policies which has determined type of goods and services it export to the rest of the world.

Another factor which has also determined Singapore's pattern of trade is the location and proximity of its trading partners.

Most countries in the world tend to trade a lot more with its neighbouring countries and Singapore is no exception. Singapore largest trading partners tend to be those countries which are in close proximity such as Malaysia and Indonesia, although these countries may not possess the comparative advantage in the production of goods and services that Singapore imports from them. The likely reason is due to the lower transportation costs and lesser time taken for the delivery of the goods. Lower transportation costs and shorter delivery time taken would lower price of the goods and ensure the freshness of the perishable goods. All these would translate into lower prices and better quality products. Examples of such imports are water and agricultural products from Malaysia and natural gas from Indonesia. And due to higher transportation costs, Singapore imports of agricultural products from further apart countries such as Japan and USA tends to be of a higher quality and of a higher price range.

Hence, proximity of its trading partners would determine the type goods imported and exported by Singapore.

In conclusion, there are many factors which determine the pattern of trade with the rest of the world. Other than the 3 factors explained above, other factors which can influence the pattern of trade include trade policies of the government such as free trade agreement with other countries, protectionist measures, taste and preference of the consumers and even the changes in technology can affect the pattern of trade between countries.

For Singapore, with its exports of mainly knowledge based or capital intensive products and import of lower value, labour intensive products which it does not have any comparative advantage in producing, the total value of its exports is higher than its total value of imports, and as such Singapore is still able to achieve a balance of trade surplus ($M > X$).

a) Discuss the options available to the government to ensure that it would continue to benefit from free trade. [15]

Given the nature of Singapore economy – small physical size with no natural resources. Trade, inevitably has become the main engine of growth for the country. It is thus, not surprising that the total value of trade is more than 3 times the real GDP of Singapore. But trade by itself would not guarantee economic growth and development for the country unless it is able to benefit from trade. In order to ensure that it is able to be able to continue to benefit from trade, Singapore needs to ensure that the exports of its goods and services are relevant and competitive to its trading partners. And there are several options which the government can adopt to achieve this aim. Some of these policies such as fiscal and supply side policies required continual and substantial amount of commitment bare continual while some of the policies such as exchange rate policies may be situational in nature.

As stated by the theory of comparative advantage, each country should specialize in the production of goods and services in which it has a comparative advantage and consequently to enable a greater production and consumption of goods and services via trade.

But comparative advantage is a dynamic and revolving concept. With the opening up of countries such as China and Vietnam for trade, Singapore has lost its comparative advantage in the production of low value products to these countries. As such, Singapore needs to continually develop new comparative advantage in order to benefit from trade and one way to achieve this is via the adoption of fiscal and supply side policies.

The Singapore government has been adopting fiscal policy with competitive corporate tax rate to attract investment into Singapore. And this is complemented with a host of other tax incentives such as tax exemption and rebates to attract targeted higher value and knowledge based industries to invest in Singapore and help the economy in developing its comparative advantage in these industries such as the petrol chemical, pharmaceutical and the aerospace industries. Special areas have also been earmarked for the development of these different industries. For example, the Seletar area is designated for the development of the aerospace industry and some offshore islands are designated for the petrol chemical industries. As these industries are concentrated in a certain areas, they are able to reap the benefits of the external economies of scale and lower their costs of production and hence increasing their competitiveness.

Hence, in order to continually develop new comparative advantage for the production of goods and services, the government can adopt fiscal policies

However, with fiscal attract the new industries would not be sufficient to help in developing new comparative advantage and boosting Singapore exports competitiveness. It needs to be complemented with the appropriate supply side policies in the development of the workforce.

The Singapore government has implemented policies to encourage the life-long learning and continually upgrading of the skills of the workforce. One such policy is SkillsFuture where every adult above the 21 years of age are given a credit of \$500 which they can use to offset the training courses they attended. For the companies, training expenses incurred for staff are allowed for tax deduction. Other incentives such as grants are also made available for firms to increase their productivity by upgrading and automating their production.

The development of the skills of the workers is necessary as the economy moves into the production of higher value and knowledge based products. With training, it helps to increase the productivity of firms as the workers acquire new skills in handling the new machinery, hence

lowering cost of production and increasing competitiveness of its exports. It also increases the occupational mobility of workers as the economy develops new comparative advantage as it moves towards the production of higher value goods and services.

Hence, the development of new comparative advantage of the economy is necessary in order for Singapore to continue to benefit from trade and this requires an adoption of a complementary of both the fiscal and supply side policies. And both policies would require a long term and heavy financial commitment by the government. In addition, it also essential for the government in correctly identifying the correct comparative advantage that the economy can develop.

Other than the fiscal and supply side policies, another option that the government can adopt in order to ensure the competitiveness of the country exports and hence benefit from trade is via the exchange rate policy.

The Singapore government has adopted a managed floating exchange rate system where the government allows the exchange rate to fluctuate within a certain band. It allows its exchange rate to appreciate to reduce the prices of imported raw materials to curb imported cost push inflation and reduce the cost of production which can increase the price competitiveness of Singapore's exports.

On the other hand, the Singapore government may opt to depreciate its currency is overvalued against its major trading partners which has reduced the export competitiveness of its goods and services. With a fall in the value of its currency, its exports become cheaper in terms of foreign currency, and this would increase the price competitiveness of a country's exports. And if the demand for the country's exports are price elastic, a fall in price would lead to a more than proportionate increase in quantity demanded and hence boosting the exports of the country.

Depreciating one's currency to increase its competitiveness can only be a short term strategy to boost its exports and benefits from trade. Such a strategy may invite retaliation where the trading partners may impose protectionist measures such as tariffs on the exports of the country. An example would be the frequent trade disputes between the US and China where the Chinese firms have been accused of having an unfair trade advantage due to the manipulation of its currency by the government. A more realistic and long term solution would be for a country to improve the quality or increase the productivity of its production to increase its competitiveness.

Other points that the government can adopt are trade policies such as the signing of free trade agreement with its trading partners.

A free trade agreement is a legally binding agreement between 2 or more countries to reduce or eliminate barriers to trade and investment. FTA would enlarge and secure the necessary markets for Singapore to make up for its lack of a large domestic market. Not surprising, Singapore is a participant to a number of free trade agreements with the different countries. FTA would result in greater trade as well as greater investment flows, hence affecting the economies of participating countries.

However, with the signing of FTA with other countries, it would also open up the Singapore's economy and subject the domestic firms to greater foreign competition. If the domestic firms are not competitive, it may drive out domestic firms, increasing the country's reliance on foreign firms for its economic growth. As such, to complement the signing of FTA, it is necessary that the government also adopt policies (such as supply side policies) to increase the productivity and competitiveness of domestic firms.

In conclusion, given its natural physical limits, free trade is necessary for the survival and growth of Singapore. However, it cannot be assumed that free trade would only bring forth benefits. It should be noted that with free trade, it would not automatically guarantee growth for

the economy and that not all countries would benefit equally from free trade. Thus, it would be necessary that the government adopt appropriate policies to mitigate the negative impact of free trade and ensure that the economy could benefit from free trade.