4 (a) Explain the main causes of high inflation rates in Singapore. [10]

(b) Discuss whether fiscal policy is the best policy for the Singapore government to achieve low and stable inflation rates. [15]

a) Explain the main causes of high inflation rates in Singapore. [10]

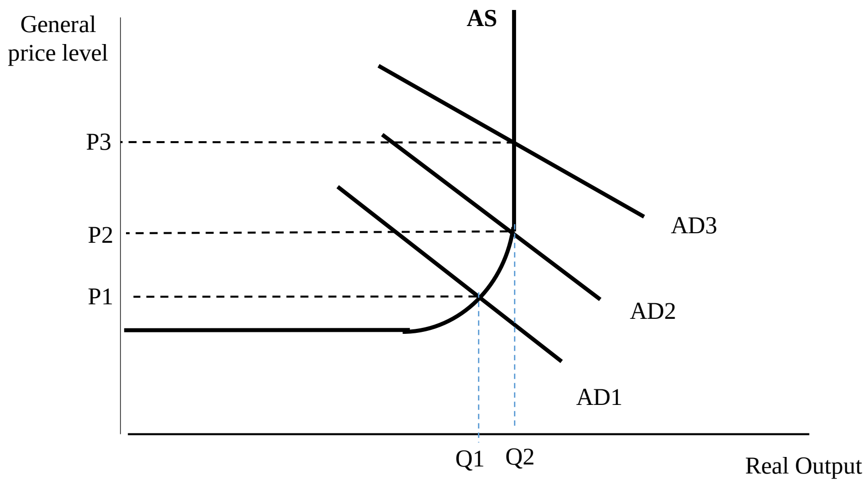
<u>Suggested Approach</u>

Introduction

- Define Inflation and identify the types of inflation – cost-push and demand-pull
- Explain causes of cost-push and demand-pull inflation in Singapore which could be due to both domestic and external factors.
- Context of Singapore:
    - Prone to demand-pull inflation as the economy is operating close to full employment.
    - As Singapore is a small open economy, external demand is likely to be larger than domestic demand, so demand-pull inflation is more likely to be externally driven rather than domestically driven.
    - With no natural resources and a limited land area, Singapore is highly reliant on imports of food and fuel, so cost push pressures are more likely to come with higher prices of such goods.
    - In general, given Singapore's high dependence on imports of food and fuel, Singapore is arguably more susceptible to cost-push inflation rather than demand-pull inflation

Body

(1) <u>Demand-pull inflation</u>



<u>Causes of demand-pull inflation</u>

<u>Rising exports due to growing affluence of trading partners</u>

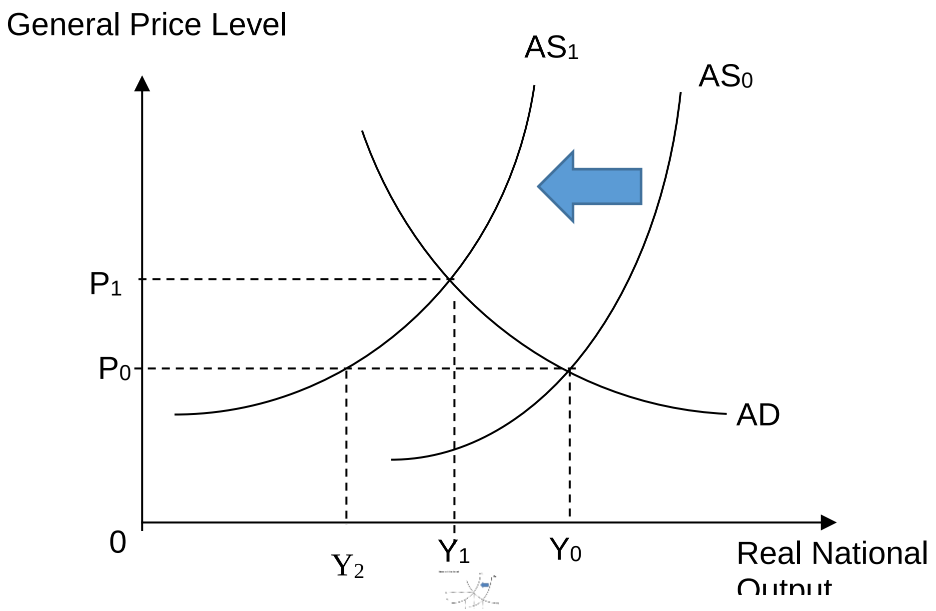
- In an export-oriented economy like Singapore, demand pull inflation is very likely due to strong external demand.
  This could be due to rising global growth or high global expectations and consumer confidence in the global market. High global growth → higher income and hence stronger purchasing power. Also boost business confidence→ boost export revenue and foreign investments into the country → drive up AD and hence GPL.

Government budget deficit (implies expansionary fiscal policy)
i.e. the government's increasing its spending and imposing tax cuts and subsidies, perhaps to stimulate the economy during economic slowdown or to achieve higher economic growth

- Expansionary DD-management policies to increase growth will lead to inflation in the face of structural rigidities in the country. When direct taxes are reduced, consumers have more disposable income, causing consumer expenditure to increase. Lower corporate taxes will attract more investments, thus the increase in consumer expenditure and investment → AD rises, hence this will lead to higher general price levels.

Thus, there is a rise in aggregate demand shown by a rightward shift of AD curve from AD_1 to AD_2. Assuming Singapore is operating near full employment, there will be a shortage of final goods and services which exerts upward pressure on GPL. GPL continues to rise until shortage is eliminated. The persistent increase in the general price level services from P_0 to P_1 depicts demand-pull inflation.

(2) <u>Cost-push inflation</u>



Causes of cost-push inflation

Tight domestic labour market

- Singapore is facing ageing population and falling fertility rates which has led to falling labour force participation. To supplement labour shortages, Singapore has been relying on foreign workers especially for the low-end industries. However, the government has raised foreign worker levies and reduced foreign worker quotas in recent years as one of its productivity-raising strategies.
- Since productivity-raising measures take several years to bring about an overall reduction in production cost, competition for scarce workers in the tight labour market has caused wages and labour costs to rise. Rising unit labour cost in recent years has been caused by wage levels rising more than productivity. Productivity level in Singapore in general has been stagnant.
- Diagram below illustrates the fall in SRAS (leftward shift) due to the rise in wages. As a result, GPL has increased from P_1 to P_2 due to businesses passing on cost pressures to consumers in order to protect profit margins.

Domestic government policies

- Singapore's rising labour costs are mainly due to government policies – higher levy on foreign workers and higher employers' contribution to workers' CPF accounts
- E.g., Singapore tightened foreign worker policies in recent years
- Increase in foreign worker levies + reduction in Dependency Ratio Ceiling (DRC) → higher cost of labour → higher COP → Singapore's falling birth rate and increasing reliance on foreign workers → significant impact expected for increase in COP → passed on in the form of higher prices of g/s → increase GPL significantly
- Heightened restrictions in entry requirement for foreigners → fall in SS of workers in Singapore → drive up wages → higher COP → passed on in the form of higher prices of g/s → increase GPL significantly

(3) <u>Imported inflation</u>

For countries with an open economy like Singapore, inflation is most likely due to external reasons, for example a sudden rise in the cost of crude oil or other imported commodities, foodstuffs and beverages.

- The high inflation in Singapore in 2008 was mainly due to rising oil and food prices, which are mainly imported. The oil and food prices caused global inflation → imported inflation in Singapore as most of the imported goods prices rises due to the rising inflation in the countries they were produced.
- Depreciation of currency → rising import prices in domestic currency → in an open economy heavily dependent on imports, leads to an increase in the prices of imported products such as essential raw materials, components and finished products → rising inflation

<u>Conclusion</u>

The causes of inflation in a country may come from both the demand and the supply-side of an economy and may even arise from internal and external events. The main causes of inflation in different countries may differ from one another depending on factors such as the openness of the economy, the size of its domestic market, the level of dependence on external market and domestic market and even the objectives of the government.

Level Descriptors for Essay Question 4 (a)		Marks
L3	• Conceptually accurate and well-developed explanation on at least 2 causes, how demand and supply-side factors lead to rising inflation in Singapore. • ~~Causes encompasses both domestic and external causes and should consider both demand-pull and cost-push inflation.~~ • Good use and explanation of AD/AS diagrams as conceptual framework • Well-contextualised to Singapore	8-10
L2	• Well-developed analysis of factors contributing to either demand-pull <u>or</u> cost-push inflation **OR** • Undeveloped analysis of factors contributing to both demand-pull <u>and</u> cost-push inflation • Very limited reference to Singapore context	5-7
L1	• Major conceptual errors in analysis • Absence of conceptual analysis	1-4

b) Discuss whether fiscal policy is the best policy for the Singapore government to achieve low and stable inflation rates. [15]

<u>Suggested Approach</u>

Candidates are required to explain how fiscal policy can help Singapore to achieve low and stable inflation rates in Singapore. Even though it can help to mitigate demand-pull inflation. It does not address various source of inflation in Singapore such as imported inflation and persistent labour shortages. Candidates are required to compare the policies in evaluating which is the best policy in achieving low and stable inflation rates in Singapore.

Introduction

- Objective of government: achieve low and stable inflation rates –inflation rates about 1-3%
- Price stability is important to Singapore's economy as it is the basis for maintaining export competitiveness and providing a positive business environment to achieve healthy and sustained economic growth.
- Identify key characteristics of Singapore's economy – highly reliant on exports, capital inflow and foreign talents to sustain economic growth.
- "best policy" –Most effective/Most appropriate for Singapore?

Body

Thesis: Fiscal Policy is an important policy that Singapore can adopt to achieve low and stable inflation rates.

- Contractionary fiscal policy involves dampening AD directly by cutting government spending or indirectly by raising direct taxes to reduce investment and consumption
  - Higher corporate taxes reduce post-tax profit, which lowers investments.
  - Higher personal income taxes reduce disposable income, which lowers consumption.
  - Fall in AD → Fall in domestically-led DD-pull inflation
- For e.g In order to prevent further price escalation in public housing in 2009, a series of measures such as higher property taxes have been introduced to dampen speculative housing demand which would then help to curb rising prices in public housing market.
- However, Contractionary fiscal policy is not useful for Singapore because of a very small multiplier. This is due to a high marginal propensity to save caused by high compulsory social security savings. (i.e. CPF) Singapore also has a high marginal propensity to import resulting from a lack of natural resources. Thus large tax hikes and/or large cuts in public spending are required to achieve a significant impact. Hence such measures are probably too politically unpopular to implement in reality.
- Also, a budget surplus (G<T) causes a net withdrawal from the circular flow of income, AD falls hence depressing economic growth.

Transition: While contractionary fiscal policy is able to curb domestic sources of DD-pull inflation, it does not address external sources of inflation.

Anti-thesis: Fiscal policy may not be the best policy but there are other policies which are effective in helping Singapore to achieve low and stable rate of inflation.

- **Alternative policy 1: Exchange rate policy**

For many years, exchange-rate centred monetary policy has been the standing policy used by the Singapore government to alleviate inflationary pressures. it has been highly effective in curbing imported inflation and externally-led demand-pull inflation.

- With appreciation of Sing dollar, export prices in foreign currency would have increased (since PED for the sum of imports and exports > 1), causing net exports (X-M) to fall. As a result of Singapore relying heavily on external demand due to her small domestic market size, her composition of AD shows that X is one of the key AD components contributing to inflation. Therefore by reducing X and hence AD, externally-led demand-pull inflation can be curbed.
- An appreciation of the exchange rate causes the prices of imported consumer goods to fall, thus households benefit directly from being able to buy such goods at lower prices
- Appreciating the Sing dollar will help to lower firms' cost of importing global commodities and hence reduce their cost of production → stabilizes domestic prices → maintains Singapore's attractiveness to FDI and foreign talents.
- For example, there was a global rise in rice prices in 2011 due to flooding of rice crops in Thailand, one of the world's largest rice producing country. The MAS responded by maintaining a strong Sing dollar and this was effective in keeping rice prices stable in Singapore.

- Nevertheless, as Singapore's export competitiveness will be lowered, appreciation of Sing dollar cannot be overly relied on, especially when there is a need to adopt substantial appreciation of the Sing dollar to address strong externally-led demand-pull inflation.

- *Transition: However, exchange rate appreciation does not address supply-side constraints. In addition, with Singapore moving toward a service-driven economy, exchange rate appreciation becomes less useful. Therefore, supply-side measures should be adopted to increase LRAS at a faster rate so as to accommodate rising AD.*

- **Alternative policy 2: SS-side policies**

The government can increase the productive capacity of the country through encouraging investment, privatization, education and R&D → by improving the skills and knowledge of the workers, rising wage costs due to a tight labour market become less of a concern since there will be an expected increase in productivity in the long term.

- In addition, the government can consider encouraging more women to continue to stay in the workforce or re-enter the workforce even after marriage and child birth → by preventing a further reduction in the size of the labour force, rising wage costs can be restrained → e.g. of such policies: companies providing part-time or flexible working arrangements.
- Productive capacity can be increased through encouraging private investment, skills upgrading, education and R&D. By doing so, rising wages due to a tight labour market becomes less of a concern since there will be an expected increase in productivity in the long run which will help ease rising unit labour cost experienced currently.

EV: However, productivity growth has remained negative despite the implementation of these measures.

- Therefore, perhaps a modification of current supply-side measures is needed rather than constant rolling out of new measures. E.g. The government can increase the Skills Future Credit given to each Singaporean since training cost is often more than the $500 subsidy provided. Measures can also be better targeted at SMEs which need help in raising productivity.

Synthesis

- Fiscal policy is still necessary to put in place to ensure that domestic factors contributing to inflation are kept in check but it cannot be the sole policy instrument used (much less the best policy instrument).
- **The tightness of domestic labour market and greater competition call for a greater emphasis on a range of supply-side measures** to improve productive capacity and quality of domestic production.
- Ultimately, the choice of policy tool for addressing inflation in Singapore is dependent on
  - The dominant root cause of inflation at that point in time → if the bulk of inflation stems from domestic factors, greater focus should be placed on other measures apart from appreciating the Sing dollar.
  - Given that labour shortages and negative productivity growth have persisted for some time, the government should give greater emphasis on supply-side policies and less on the appreciation exchange rate policy.

	Level Descriptors for Essay Question 4(b)	**Marks**
L3	• Balanced and developed analysis in examining whether fiscal policy should be the most important policy in comparison with two other policies, such as exchange rate and supply-side policies so as to address inflation caused by both domestic and external factors • Appropriate use of relevant examples and application to context of Singapore	**9-11**
L2	• Balanced but undeveloped analysis on alternative policies working alongside fiscal policy **OR** • One-sided but developed explanation on the use of fiscal policy in addressing domestically-led demand-pull inflation • Not fully addressing "best" policy • Limited or no use of examples and application to the context	**5-8**
L1	• Answer is mostly irrelevant • Answer not supported by economic reasoning • Conceptual inaccuracies	**1 – 4**
	Evaluation	
E2	• A well-substantiated judgment on the need to combine fiscal policy with alternative policies, although the importance placed on each type of policy may differ, depending on the dominant root cause of inflation in Singapore at that point in time. **E.g. I**f the bulk of inflation stems from external factors, greater focus must be placed on other measures apart from fiscal policy.	**3-4**
E1	• Some attempt at evaluation or making a summative conclusion but not consistently using economic analysis.	**1-2**