PJC 2018 JC 2 H2 Paper 2 Question 5

Singapore's economy expanded a faster-than-expected 1.8 per cent in the last quarter of 2016. Moving ahead, growth remains uncertain. Internally, Singapore has adopted a policy of restricting foreign labour and restructuring towards productivity-driven growth. Externally, higher US interest rate may lead to higher interest rates in Singapore.

Source: Adapted from Channel Newsasia, 3 January 2017

(a) Explain the possible conflicts in government macroeconomic objectives caused by a policy of restricting foreign labour and restructuring towards productivity-driven growth. [10]

(b) Assess the impact of higher US interest rate on Singapore's macroeconomic performance. [15]

(a) Explain the possible conflicts in government macroeconomic objectives caused by a policy of restricting foreign labour and restructuring towards productivity-driven growth. [10]

[10]

<u>Introduction</u>

To achieved a more sustained economic growth, Singapore has adopted a policy of restricting foreign labour and restructuring towards productivity-driven growth. However, in the short run, this might conflict with her other macroeconomic objectives such as price stability and low unemployment.

<u>Body</u>

The policy of restricting foreign labour and restructuring towards productivity-driven growth leads to a healthier BOP and higher economic growth in the long run.

This is because by restricting foreign labour, this will decrease the supply of labour and increase the wage cost. Hence, firms will be incentivise to switch away from labour-intensive methods of production towards more capital-intensive method of production. In addition, Singapore government also encourages firms to make use of better technology in its production by giving more subsidies such as the Productivity and Innovation Credits. This will help to speed up production and increase the labour productivity of firms. With higher labour productivity growth than wage growth, the unit labour cost of firms will fall. This will lead to lower cost of production and hence lower price of exports. Assuming demand for exports is price elastic, the more competitive exports will bring about greater export revenue and hence Singapore's balance of trade will improve.

In addition, higher productivity with the use of better technology will increase the productive capacity of the economy shifting Singapore production possibility curve (PPC) outwards. With both higher AD and AS, Singapore 's will experience a more sustained economic growth.

Thus, a policy of restricting foreign labour and restructuring towards productivity-driven growth aims to promote a more sustained economic growth by reducing firm's reliance on labour and incentivizing firms to use better technology.

However, while the policy of restricting foreign labour and restructuring towards productivity driven growth leads to more sustained economic growth in the long run, it may conflict with the macroeconomic aim of price stability in the short run.

In the short run, it is likely that the restriction in foreign labour will cause wages to rise faster than labour productivity. This is because productivity takes a long time to increase. Efforts to improve the work flow and finding and implementing appropriate technology to speed up the work flow takes time. Hence, in the short run, while the wage cost has increased, labour productivity may not have increased. Hence, unit labour cost will rise. With the higher cost of production, the short run aggregate supply (SRAS) will fall causing the SRAS curve to shift upwards. This will lead to higher general price level resulting in higher cost push inflation.
Hence, in the short run, a policy of restricting foreign labour and restructuring towards productivity-driven growth may conflict with the macroeconomic objective of price stability.
Furthermore, the policy of restricting foreign labour and restructuring towards productivity-driven growth may also conflict with the aim of achieving full employment.
This is because with the restructuring towards productivity-driven growth, firms may adopt more labour-saving technology. This will lead to a falling demand for lower skilled workers and a higher demand for higher-skilled workers. The lower skilled workers may be less educated and thus lack the knowledge and skills to take up jobs take require knowledge of information technology. Furthermore, retraining to equip workers with new skills takes a long period of time and older and less educated workers may also be less receptive towards the use of technology. Hence, this may result in rising structural unemployment.
Hence, while the policy of restricting foreign labour and restructuring towards productivity-driven growth leads to more sustained economic growth, it may conflict with the aim of achieving low unemployment in the economy.
In conclusion, the policy of restricting foreign labour and restructuring towards productivity-driven growth is desirable to in achieving a healthier balance of payments and a more sustained economic growth for Singapore in the future, in the short run, there is likely to be higher inflation and unemployment. Hence, Singapore government should adopt policies to minimize these conflicts so that overall this policy is beneficial to Singapore's macroeconomic performance.

<u>Interpret the Question – Part (b)</u>
(b) Assess the impact of higher US interest rate on Singapore's macroeconomic performance. [15] **[15]**
<u>Introduction</u>
Singapore's economic growth remains uncertain due to the rising interest rate in US. This is because higher US interest rate may cause higher interest rate in Singapore as Singapore is an interest rate taker. However, the higher US interest rate also results in greater capital outflow from Singapore to US. This may result in a depreciation of Singapore dollar which may benefit Singapore. Thus, the net effect of higher US interest rate depends on whether the negative effect of higher Singapore interest rate outweighs the positive effect of a weaker Singapore dollar.
<u>Body</u>
Being an interest rate taker, Singapore interest rate tends to mirror foreign interest rate, particularly US interest rate. Hence, a higher US interest rate will lead to a higher Singapore interest rate.
With higher interest rate in Singapore, this will lead to higher cost of borrowing. Consumers will hence be less willing and able to consume big ticket items on credit. In addition, the opportunity cost of consuming rises and hence consumers are more willing to save rather than consume. Hence, consumption will fall. In addition, with the same expected returns to investment, a higher interest rate will lead to falling profitability of investment. Thus, firms are less able and willing to invest resulting in

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As C and I fall, Singapore's aggregate demand (AD) is likely to fall leading to a multiplied fall in the national income of Singapore due to the many rounds of fall in income-induced consumption.

The effect of a fall in AD on Singapore depends on the degree of resource utilization. If Singapore's economy operates at or near full employment, a fall in AD is actually beneficial to Singapore economy as it brings about a fall in general price level hence causing a fall in demand-pull inflation. However, if the fall in AD occurs when the economy is functioning below full employment, there will be a fall in real GDP and hence resulting in a fall in derived demand for labour causing higher demand-deficient unemployment in Singapore. This may be undesirable for the Singapore economy.

A rise in interest rate may also be undesirable for property buyers who purchase their houses through bank loan. The higher interest rate will result in higher interest payments for their monthly interest payments for their housing loan and hence will have less income to consume. If the interest rate were to rise by a large extent, this may cause a lot of property buyers to default on their housing loans and forcing them to sell off their properties at a loss. If many property buyers end up defaulting on their loans, this may result in rising bad debts of the banks, affecting the liquidity and stability of the financial sector. This is undesirable for the macroeconomic performance of Singapore economy considering that the financial sector is a major contributor to the economic growth of Singapore.

Hence, a rise in interest rate is likely to have negative consequences on the macroeconomic objectives of Singapore economy if Singapore is currently operating below full employment. In addition, depending on the extent of the rise in interest rate, there may be negative consequences on the stability of the property and financial sector of Singapore, hence bringing about negative consequences on the macroeconomic performance for Singapore.

On the other hand, a rise in US interest rate can be beneficial on the Singapore economy as it leads to capital outflow from Singapore to US, thus causing a depreciation of the Singapore dollar.

With a higher US interest rate, investors are more willing to put their money in US banks to earn a higher interest rate. Hence, they will be capital outflow from Singapore to US resulting in a larger supply of S$ in the foreign exchange market. This will cause the S$ to depreciate. With a depreciation of the S$, the price of Singapore export in US$ will fall while the price of Singapore imports in S$ will rise. Thus, quantity of exports will rise while quantity of imports will fall. Assuming Marshall-Lerner's condition hold in which the sum of price elasticity of demand for exports and imports is greater than 1, net exports of Singapore will rise and this is beneficial for Singapore's balance of trade. In addition, the rise in net exports will bring about higher AD and hence national income for Singapore assuming Singapore is currently operating below full employment.

Hence, a higher US interest rate can be beneficial in Singapore as it leads to a weaker S$ which will bring about higher net exports assuming Marshall-Lerner's condition is satisfied.

The net effect of a rise in US interest rate on the macroeconomic performance of Singapore depends on whether the disadvantage of a higher Singapore interest rate outweighs the advantage of a weaker S$.

Given that Singapore has a larger external sector than domestic sector, the weaker S$ is likely to have a strong positive effect on the Singapore economy than the negative effect caused by a higher Singapore interest rate.

However, there are other factors to consider.

Firstly, the central bank of Singapore -Monetary Authority of Singapore – may not allow the S$ to depreciate by a large extent for fear of imported inflation that it may cause. A weaker S$ may cause price of imported raw materials and foodstuff to rise and this may lead to higher cost of production for the import-dependent Singapore economy, causing higher imported inflation. Hence, due to the smaller extent of depreciation of S$, the negative effect of a higher Singapore interest rate may outweigh the positive effect of a weaker S$.

Secondly, the depreciation of S$ may not have a strong positive effect on its balance of trade because the higher US interest rate may lead to even more capital outflow from other emerging economies such as Indonesia, India and Malaysia. These economies may experience a large depreciation in their currencies than Singapore. For example, although the S$ has depreciated against the US$ due to the higher US interest rate, the S$ has actually appreciated against the Malaysian ringgit. This is because the Malaysian ringgit has suffered a greater depreciation than the Singapore $ due to the rise in US interest rate. Hence, in such circumstances, although Singapore exports may gain greater export competitiveness vis-à-vis US goods, Singapore exports may not have lost export competitiveness vis-à-vis the other goods in the other emerging markets.

Hence, the negative effect due to a higher Singapore interest rate is stronger than the positive effect due to a weaker S$.

Conclusion

In conclusion, it is likely that Singapore may suffer a poorer macroeconomic performance due to the rising US interest rate. However, the extent of the negative impact depends greatly on the pace at which the US government increases its interest rate. Given that the US government has been increasing the US interest rate at a gradual pace, the negative effect on Singapore may be minimized. In addition, the Singapore government has also put in place cooling measures in the property markets to prevent excessive speculation in the property market so that when the interest rate does rise in the future, the property buyers will not be negatively affected, hence preventing the property and financial markets from being negatively affected. Thus, overall, the negative impact of the rise in US interest rate on Singapore economy has been minimal.