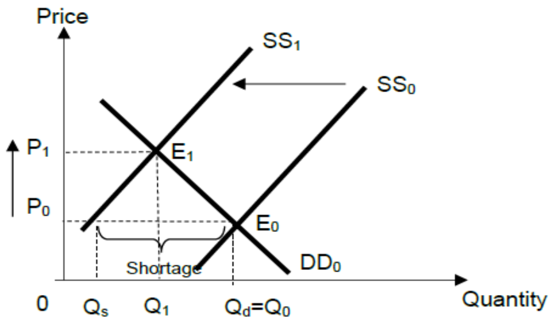
<u>Suggested Answers for 2022 A-Level H2 P1 Qn 1: Economic problems caused by drought and the coronavirus (COVID-19) pandemic</u>

(a) Use a demand and supply 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]

- Australia's lengthy drought has damaged crops (extract 1) thus lowering crop yield and the amount farmers could produce. This caused supply of fresh fruit and vegetables to fall, and this is reflected by a leftward shift of the supply curve from SS_0 to SS_1.

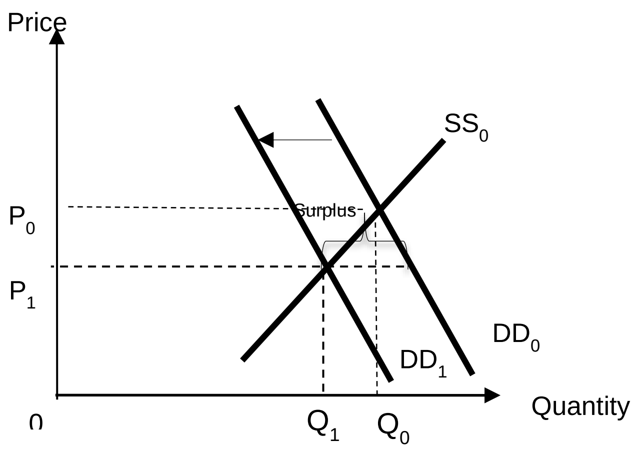


Market for fresh fruit and vegetables in Australia

- At original price P_0, quantity demanded Qd exceeds quantity supplied Qs, creating a shortage that exerts an upward pressure on price. As a result, equilibrium price rises.

(ii) International tourist arrivals into Australia are expected to fall as a result of the bush fires. [2]

- International tourist arrivals into Australia are expected to fall as a result of the bush fires due to a fall in demand. This is because tourists have a change in taste & preference away from visiting Australia as they are concerned with their health and safety caused by the bush fire and the resultant smoke haze (extract 1).



Market for Tourism in Australia

- With a leftward shift of the demand curve from DD_0 to DD_1, a surplus exists at the current market price P_0, causing a downward pressure on prices. As prices decrease, quantity demanded increase while quantity supplied increase until

		quantity demanded equals quantity supplied. Hence, the equilibrium quantity falls from Q_0 to Q_1, explaining the fall in international tourist arrivals into Australia.	
(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 worsened as the budget surplus in February 2020 fell into a budget deficit in June 2020. • This could be due to an increase in government spending to deal with the damages caused the bush fire (extract 1) and to support business and individual during the COVID-19 pandemic (extract 2) Or • This could also be due to a fall in tax revenue as unemployment increase due to the recession caused by the bushfire and COVID-19 pandemic, hence government would be able to collect less income tax and goods and services tax.		
(c)	With reference to Extract 2, explain why a nominal rate of interest of 0.25% in March 2020 would be describe as being "negative" in real terms.		[2]
	• Real interest rate = nominal interest rate - inflation rate • According to extract 2, the inflation rate in Australia in the 12 months to March is 2.2%. Since inflation rate is higher than nominal interest rate (0.25%), real interest rate will be negative at -1.95%.		
(d)	Explain how a negative real interest rate is likely to affect savings by consumers and the exchange rate in Australia.		[4]
	• As real interest rate turns negative, the returns to saving will become negative, hence reducing savings by consumers as the money saved in the bank could be better spent on consumer goods (opportunity cost of saving is higher). • Negative real interest rate will result in outflow of hot money as households seek higher returns in other countries with higher real interest rate. The outflow of hot money will increase the supply of domestic currency, hence there will be a surplus of domestic currency at the original exchange rate, and this create a downward pressure on exchange change. Hence there will be a depreciation of exchange rate in Australia.		
(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'.		[8]

Command	Discuss whether – benefits and costs
Start Point	Strong exchange rate
End Point	Benefit economy – in terms of achieving the four macroeconomics aims
Content	Impact of appreciation of exchange rate on economy, AD/AS analysis
Context	Singapore, global recession

Introduction

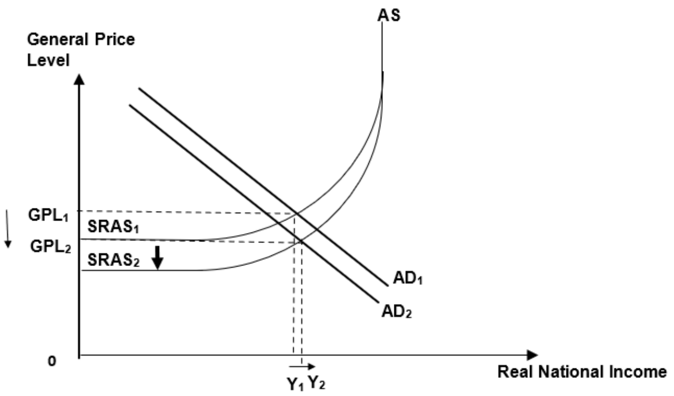
- Exchange rate is the external value of a country's currency in terms of another currency. A stronger exchange rate refers to an appreciation of a country's currency, which means that its external value increases relative to a foreign currency. The same unit of the country's currency can now be exchanged for more units of foreign currency. The impact of an appreciation of the Sing dollar on the Singapore economy could be analysed through the AD/AS framework.

<u>Point 1: A stronger exchange rate might benefit the Singapore economy in terms of price stability.</u>

- A stronger Sing dollar will make Singapore's imports relatively cheaper in domestic currency terms. Cheaper import prices will lower cost of production for firms in Singapore, given the high dependence on imported raw materials and semi-finished materials in their production due to a lack of natural resources. This will shift the SRAS curve downwards, thereby curbing import cost-push inflation. Imported finished goods and services will also become cheaper in domestic terms, thereby alleviating import price-push inflation.

- At the same time, the appreciation of SGD raises export prices in foreign terms. Assuming that PEDx > 1, quantity demanded for exports will decrease more than proportionately and this will lead to a decrease in export revenue. With a fall in price of imports, this encourages citizens to buy more imports and instead switch away from buying domestic goods. Assuming PEDm > 1, this will lead to a more than proportionate rise in quantity demanded for imports and lead to a rise in import expenditure. The appreciation of the SGD therefore reduces Singapore's net exports assuming MLC holds, thereby reducing AD, to curb demand-pull inflation.

- Assuming that the increase in SRAS is greater than the fall in AD, real national income will increase from Y1 to Y2 while GPL will fall from GPL1 to GPL2



Positive effects of appreciation of Sing dollar on Singapore economy

Extent of benefit to the Singapore economy may not be very significant in the face of a global recession

➢ However, given the global economy is in deep recession, the extent of fall in X-M may be very great as foreign consumers may also be reducing consumption of domestic and foreign goods and services. Thus, with the recession and an appreciation of the Singdollar, the extent of fall in X-M may be very large.

➢ Also, with the global economy in deep recession, there is less demand for factors of production and the prices of factors of production globally may be low and the risk of cost-push inflation may not be very large.

<u>Point 2: A stronger exchange rate might harm the Singapore economy in terms of economic growth, unemployment, and balance of trade.</u>

- A stronger Sing dollar might result in negative growth and higher unemployment instead if the decrease in AD is more significant than the increase in SRAS.

- If the increase in SRAS is smaller than the fall in AD, real national income will decrease from Y_1 to Y_2 while GPL will fall from GPL_1 to GPL_2.

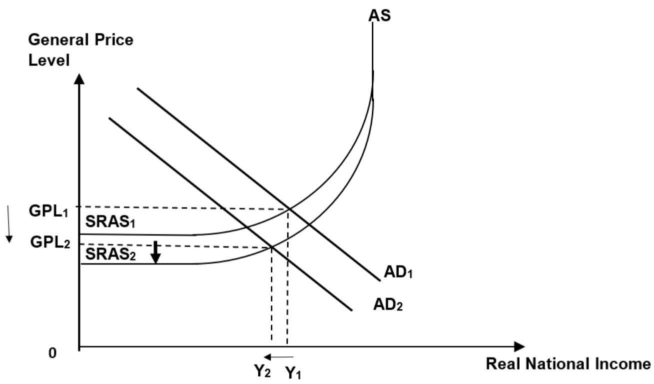


Figure 4: Negative effects of appreciation of Sing dollar on Singapore economy

- The fall in AD is greater due to the global recession, where foreign households would be experiencing a fall in real disposable income, hence demanding less of Singapore's exports, assuming normal goods.

- The fall in real output would means that firms would experience a rise in stocks and inventories, hence reducing production of goods and services. This will reduce the demand for labour since the demand for labour is derived from the demand of final goods and services. Therefore, this caused a rise in demand-deficient unemployment.

- Moreover, the fall in net export revenue would also represent a worsening balance of trade.

Evaluation

- Given that there is a global recession, it is unlikely that Singapore will face with significant inflationary pressure, hence mitigating the need for a stronger Sing dollar to maintain price stability. With a projected fall in GDP by 4% due to business closure, halt in air travel and other measures to contain the COVID-19 pandemic, MAS has eased its exchange-rate centred monetary policy (via zero appreciation) to allows more room for the SGD to depreciate. This would help boost AD to combat the recession, which should be the priority for the Singapore government.

Level of Response and Descriptors		**Marks**
L2	Developed analysis of how stronger exchange rate can result in BOTH positive and negative impacts on Singapore's economy.	4-6
L1	Underdeveloped analysis of how stronger exchange rate can result in either positive OR negative impacts on Singapore's economy.	1-3
Evaluation		
E	Evaluative marks will be awarded for a conclusion reached with respect to a	1- 2

	judgement made on whether a stronger exchange rate would be of overall benefit to Singapore when the "global economy is in deep recession' after consideration of the analysis provided.	

(e) Discuss whether fiscal policy is the most effective way to bring unemployment down in Australia. [10]

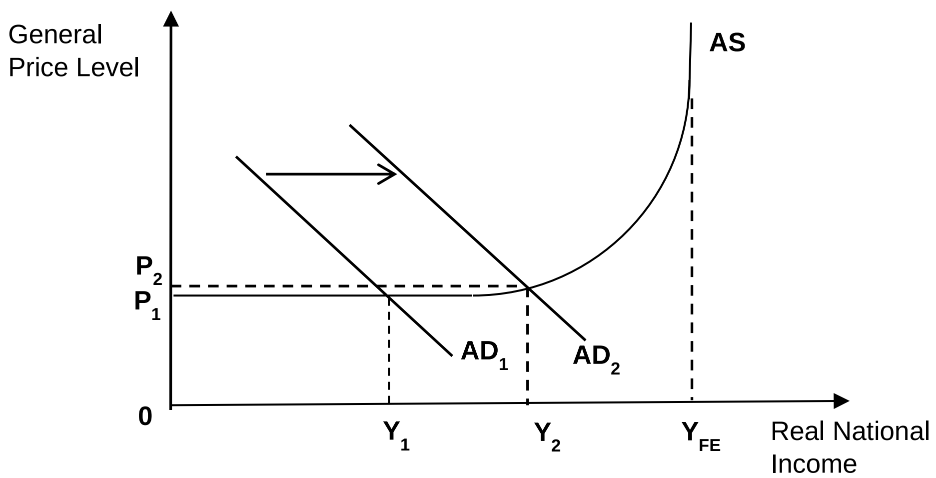
Command	Discuss whether – most effective way
Start Point	Fiscal policy
End Point	Bring unemployment down
Content	Macroeconomic policies, AD/AS
Context	Australia

Introduction

- Australia is facing higher demand-deficit unemployment due to the devasting bushfire and COVID-19 pandemic. As higher unemployment will worsen standard of living of the Australians, the Australia government needs to implement policies such as fiscal policy, monetary policy, and supply-side policies to bring unemployment down.

Point 1: Expansionary fiscal policy is an appropriate policy to bring unemployment down in Australia.

- Fiscal policy (FP) is a demand-management policy that works through the tools of Government expenditure (G) and Taxation (T). The Australian government can implement an expansionary fiscal policy by adopting a budget deficit through increasing G and/or reducing T. For example, the Australia government could increase spending on rebuilding damaged infrastructure caused by the bushfire. As government expenditure is a component of AD, AD will increase. Reducing T via reducing direct taxes such as personal income tax rates will increase households' level of disposable income, which increase purchasing power and translates to an increase in C. Reducing corporate tax rates will increase post-tax profits and encourage firms to increase I. Given that C and I are components of AD, AD will increase accordingly. Hence, expansionary fiscal policy works through an increase in G and/or decrease in T to increase C and I.



Expansionary fiscal policy

- With reference to the diagram above, governments can use expansionary fiscal policy to increase AD from AD1 to AD2, causing real national income to increase from Y1 to Y2. To increase production of goods and services from Y1 to Y2, firms need to hire more factors of production, such as labour. This is because demand for labour is derived from the demand to produce goods and services. Hence, demand-deficient unemployment is reduced.

Intermediate evaluation: Expansionary fiscal policy may be limited in bringing unemployment down in Australia.

- The decrease in direct taxes might not increase C and I significantly due to weak consumer and investor confidence. It was mentioned in extract 1 that the bushfire has further reduced Australia's already weak consumer confidence.

- Furthermore, implementing an expansionary fiscal policy would further worsen Australia's budget deficit (figure 1), incurring higher government debt level. This would affect sustainable growth negatively as future generation have to repay the debt via higher taxes in the future.

Point 2: Supply-side policy is also an appropriate policy to bring unemployment down in Australia.

- Supply-side policies to increase the relevance of skills possessed by the workforce can help to lower the extent of structural unemployment in Australia. Workers who were originally employed in the tourism industry may face unemployment as they are laid off due to the coronavirus affecting tourism adversely. They may, in turn, be unable to find employment in other sectors due to the lack of relevant skills.

- With supply-side policies such as retraining programmes to equip workers who are laid off with the relevant skills to help them to pivot to online tourism programmes, the extent of structural unemployment can be lowered.

Intermediate evaluation: Supply-side policies may be limited in bringing unemployment down in Australia.

- The usage of supply-side policies would compound the adverse impact on Australia's budget deficit brought about by expansionary fiscal policy. At the same time, expenditure on training tends to take up a large quantum, over an extended period of time. In the interim period, the unemployment due to the mismatch of skills is likely to persist, limiting the effectiveness of the policy in tackling structural unemployment in the short term.

Notes: Students can also choose to discuss expansionary monetary policy as the alternative policy

- Given the budget constraint faced by the Australian government, expansionary monetary policy of reducing interest rate could be considered instead. Lower interest rate translates into a lower cost of borrowing for firms, and this leads to a greater incentive by firms to increase their level of investment. Hence lowering interest rate would increase borrowing by firms for investment (I). At the same time, the cost of borrowing for the average household will also fall, increasing consumption expenditure (C) on goods bought on hire purchase or bought using loans for big-ticket items such as property and cars as well as an increase in credit card spending. This would cause domestic autonomous consumption to increase. The combined increase in C and I cause AD to rise from AD_1 to AD_2, leading to an unplanned fall in inventories. Producers will then increase their production level to maintain stock levels at a desired level and will hire more factors of production, including labour, hence reducing demand-deficient unemployment.

Intermediate evaluation: Expansionary monetary policy might not be an appropriate policy to bring unemployment down in Australia.

- Given that the Australian Central Bank has already cut interest rate to a record-low of 0.25% (extract 1), there is little room interest rates to decrease any further. This is known as the liquidity trap. Hence, the Australian government is unable to stimulate the economy with expansionary monetary policy. This is because the interest rate will not fall any lower, C and I will not increase, and the level of AD remains the same.

Evaluation

- Expansionary fiscal policy in terms of increasing government spending is likely to be the most effective to reduce unemployment in Australia. Direct spending by the government can target the particular areas concerned, whereas monetary policy tends to have a more general impact (extract 1). The Australian government could spend more on sectors that experienced more significant job losses such as accommodation and food as well as arts & recreation while providing less support for sectors least affected such as mining and manufacturing (figure 2). Giving targeted support could also potentially help reduce the budget deficit as compared to giving significant support to all sectors.
- The worsening budget deficit might also not be a significant concern as tax revenue from income tax will increase if the fiscal measures could bring unemployment down, helping to achieve fiscal sustainability.

Level of Response and Descriptors		**Marks**
L2	Developed analysis of how fiscal policy and one other alternative policy can bring unemployment down in Australia.	5 – 7
L1	Underdeveloped analysis of how fiscal policy or one other alternative policy can bring unemployment down in Australia.	1 – 4
Evaluation		
E2	For an evaluation that justifies if fiscal policy is the most effective way to bring unemployment down in Australia.	2 – 3
E1	For an evaluation / judgement that is unsubstantiated.	1