Suggested Answers for 2018 Econs H2 Prelims Paper 2

Essay Question 5:

Discuss the extent to which the size of the economy affects a government's choice of macroeconomic policy tools.

Question Requirement:

- Explain what it means by "size of the economy" and how it affects a government' choice of macroeconomic policy tools (interest rate, exchange rate, fiscal)
- Discussing the extent requires students to consider other variables that the government takes into account while making decisions on the choice of macroeconomic policy tools used.
- An overall judgment on the extent to which the size of the economy affects the choice of macroeconomic policy tools, by taking into account all possible variables on balance and certain economic conditions the country may be in.

Introduction:

A government has several macroeconomic policy tools such as interest rate, government spending, tax rates and exchange rates, which it can make use of, to achieve the various macro objectives. How the government decides to use what policy tools takes into account several variables, such as the size of the economy, openness of the economy as well as the current economic condition the country is in. To what extent the size of the economy determines the government's choice of macro policy tools depends on the type of country as well as the current economic condition the country is in.

Point 1: Size of the economy determines the choice of macroeconomic policy tools the government uses

Size of the economy usually refers to the value of Gross Domestic Product (GDP) of the country. This value of GDP is affected by the population size and hence, the overall size of the domestic market. Larger economies such as China and United States of America (USA) tend to have a larger population size and hence, domestic markets, compared to smaller economies such as Singapore. The larger domestic market means that **domestic consumption expenditure (C)** as a proportion of the country's overall Gross Domestic Product (GDP) is **relatively higher** than those of the smaller economies. Therefore, to achieve the macroeconomic objectives such as healthy economic growth, the governments of the larger economies tend to rely more on **manipulating demand-management policy tools such as interest rates and tax rates** to affect consumption spending.

For example, the USA uses the interest rates to achieve economic growth. In times of slower economic growth, the USA may reduce the interest rates so as to reduce the cost of borrowing, hence spurring domestic consumption. It may also reduce the income tax rates, to increase the disposable income and hence, increase C. Since C takes up a large proportion of the USA's aggregate demand, it is effective in helping the government to achieve the macro objectives.

These **larger economies also are able to adopt protectionism tools** to protect its domestic industries and local goods and services from foreign competitors. Examples of protectionism can be seen in the recent trade wars between USA and China, each imposing tariffs on the imports. The use of the protectionism tools is intended to **switch expenditure away from the consumption of imports towards the consumption of local goods and services.**

On the contrary, the domestic consumption (C) of the smaller economies tend to be a smaller proportion compared to other components such as net exports (X-M) and investment (I). For smaller economies, since they do not have a sufficiently large domestic markets, these economies tend to be **more open and reliant on trade and foreign investments**. For the **smaller economies** like Singapore, the governments usually **rely on controlling its exchange rate and supply-side policy tools to enhance the international competitiveness of their products for the external markets**.

For example, as Singapore is a **small country which is reliant on foreign imported inputs**, she adopts a **gradual and modest appreciation of our exchange rate** so as to **reduce imported inflation** and **maintain our exports competitiveness** by keeping cost of production (cost of labour and raw materials) low. Singapore government adopt a **pro-competition stance** by creating conducive environment for local and foreign businesses to set up companies locally. Singapore also encourages businesses to be **innovative and to adopt more research and development (R&D)** through providing more research facilities and monetary support for these companies. At the same time, Singapore also signs **Free Trade Agreements** to encourage more access to larger overseas markets so as to increase our exports-revenue.

While the size of the economy definitely does influence the choice of macroeconomic policy tool that the government uses, it is **not the only variable**. The current economic condition of the country and the constraints of the government budget are also factors that governments take into considerations too.

Note: Students can use the connection between size and the openness (small % of domestic consumption, that's why more reliant on foreign trade) to explain the choice of the macroeconomic policy tool, but is not a must. However, students may also use "openness of an economy" to support that the size of the economy is not the only variable that determines the choice of macroeconomic policy tool.* ***Marks should be awarded according to the argument put forth by students.*

Point 2: Current economic condition(s) and the severity of these economic problems also determine the choice of macroeconomic policy tools

The government also has to take into account the **current economic climate** of the country when deciding which macroeconomic policy tool to use. For example, for larger economies with large domestic consumption spending, while it may be effective to reduce interest rates to encourage more domestic consumption, this **may not work in times of recession.** This is because, recessions **reduces the overall confidence level** of the households and businesses, therefore, even with the lower interest rates, the households may choose to save up for their future, rather than spending it away. **[Evaluation:] If the recession is persistent and severe, the governments may not be able to consistently reduce the interest rates as there is a limit to how low the interest rates can go.** It may have to use other macroeconomic policy tools such as increasing government spending (G), in times of severe recession.

Similarly, even though smaller economies tend to rely on manipulating exchange rates and supply-side policy tools to increase the net exports, it may not work if the global economy is reducing their demand for foreign goods and services due to global economic crisis. In this case, even with a competitive exchange rate, foreign countries may still not buy the exports. These small economies will also have to look at using **expansionary demand-management policy tools** such as increasing government spending (G) to lift the economy out of recession.

On top of this, the governments also have to be mindful of the **current priority(ies)** of the country. **Regardless of the size of economy**, if the country is plagued by **persistent rise in domestic costs** (such as wages, rental and electricity tariffs), the government will have to **make use of supply-side policies** to bring down the cost-push inflation. For example, the governments may have to offer subsidies to encourage greater productivity and innovation. In other cases, the economy could be facing severe structural problems, leading to high and persistent structural unemployment. This will necessitate the government to provide more training courses and training subsidies to quickly and effectively level up the skills training of the people.

Point 3: The use of supply-side policies to boost productive capacity and achieve potential growth should be adopted by all economies, regardless of size.

Regardless of the size of the country, any government should aim to **achieve sustainable economic growt**h, which can be done by achieving both actual and potential growth. Potential growth can be achieved when the country's quantity of resources is increased and/or the quality of resources is improved. If and when the AD is the constantly growing without the simultaneous expansion in productive capacity (LRAS), the country will eventually be suffer from demand-pull inflation, affecting the purchasing power and SOL of the population. This is **especially so for the developed countries**, where they are at a **greater risk of over-heating** as they are usually producing at the maximum productive capacity.

Therefore, this necessitates the need for the government to put in place some supply-side policies to ensure sustainable growth. Supply-side policies can include subsidies on training, skills training, providing greater accessibility to research and development, and deregulating the industry to include more competition. With a greater cost-efficiency and better productivity levels, the country can hope to expand the LRAS, maintaining the general price level and sustain the growth in national income. As such, the adoption of supply side policies should be done regardless of size of the economy, and even more so for developed countries who are nearing to full-employment.

Conclusion:

The size of the economy influences the choice of the macroeconomic policy tools to a large extent **when the country does not face any severe or persistent macroeconomic issue(s).** The size of the economy gives an indication to the government on the **drivers for growth** for their country – domestic consumption for large economies and net exports for small economies, this allows governments to make better decisions in choosing the most appropriate macroeconomic policy tools to achieve the macroeconomic goals. However, in times when the country is facing severe macroeconomic issues such as high inflation rate and/or high unemployment rates, the government may have to make use of other alternative macro policy tools to solve these issues. **Regardless of size and the overall performance of the economy, all governments have to strive to achieve sustainable economic growth in the long-term, as such, the use of supply-side policies is a necessary choice for all economies.**

Marking scheme:

Level	Descriptors	Marks
High L3	*For an answer which:* • *Fulfils **all** criteria in low L3* • *Has a **breadth** of macro-economic policy tools that include **both** demand-management and supply-side* • *Is sufficiently contextualised to **how** large vs small economies chooses the macroeconomic policy tools*	**18 - 20**
Low L3	*For an answer which:* • *Provides balanced and well-developed argument on the extent to which size of the economy influences the choice of macro policy tools* • *Explains other variables that will also influence the choice* • *Good and accurate use of economic analysis*	**15 - 17**
High L2	*For an answer which:* • *Is **either** one-sided **or** under-developed and contains some explanation and link to the "size of the economy"* • *Able to give examples of large vs small economies but **lacks the depth and precision** in how they choose the macro policy tools depending on their size* • ***Other variables** are mentioned but **not adequately explained*** • *Use of economic analysis is **sufficient** and **largely accurate***	**12 - 14**
Low L2	*For an answer which:* • ***Weak in economic analysis and insufficient/minimum link to the size of economy*** • *Largely explains on how the macro policy tools work, but **lacks contextualising it to the size of the economy.*** • *Some use of economic analysis but **contains several inaccuracies***	**9 - 11**
L1	*For an answer which:* • *Vaguely provides some understanding of the 'size of economy'* • *Some economic explanation on how some macroeconomic policy tool works* • ***Some weak and incidental attempts** at linking size of economy to the choice of policy tools*	**5 - 8**
L1	*For an answer which:* • *Has no definition or unpacking on the size of the economy, no use of examples* • *Listing of various economic policy tools but no economic analysis* • *Contains several gross inaccuracies*	**1 – 4**

Evaluation:

Level	Descriptor	Marks
E3	*Good attempt to provide well-reasoned evaluation/opinions, supported with clear explanation/evidence on the overall extent.* *E.g. The size of the economy influences the choice of the macroeconomic policy tools to a large extent* ***when the country does not face any severe or persistent macroeconomic issue(s).*** *The size of the economy gives an indication to the government on the* ***drivers for growth*** *for their country.*	4 – 5
E2	*Some attempt to provide synthesis/conclusion but lack clear substantiation/elaboration* *E.g. The size of the economy would determine the choice of macroeconomic policy tools but is not the only variable to be taken into consideration.*	2 – 3
E1	*Listing of opinion/conclusion, without any substantiation*	1