RVHS 2014 Preliminary Examinations II Question 5 Suggested Answers

The IMF highlighted that the first line of defence against slowing growth should be to allow the automatic stabilisers to operate, monetary policy easing and measures to ease the flow of credit.

a) **Explain how automatic stabilisers and measures to ease the flow of credit are the first line of defence against slowing growth. [8]**

b) **Discuss whether it is useful to adopt a more aggressive fiscal policy. [17]**

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a) **Explain how automatic stabilisers and measures to ease the flow of credit are the first line of defence against slowing growth. [8]**

Automatic stabilisers or non-discretionary fiscal policy refers to features of government expenditure and taxation that change automatically (without government intervention) to smooth out the level of fluctuations in the economy while measures to ease the flow of credit refer to policies to ensure that credit is still available to borrowers during times of slowing economic growth.

During times of slowing economic growth, certain sectors may see a contraction and as such, workers in these sectors are likely to see their income falling or even lose their income. In these sectors, automatic stabilisers will kick in automatically to reduce the rate of decrease in income. Examples of automatic stabilisers include progressive income tax and unemployment benefits. Progressive income tax takes away a smaller proportion of income as income level falls. An example of progressive income tax is the personal income tax and in those sectors where income is falling, tax payments to government will fall. Thus, the presence of automatic stabilisers acts as a first line of defence as they help to slow down the rate of fall in economic growth.

During times of slowing economic growth, banks are likely to tighten credit as economic outlook turns pessimistic and banks become more cautious over the prospects of loan recovery. As such, availability of credit tends to fall during periods of slowing economic recovery. In view of these, governments tend to row out measures to ease the flow of credit. One example is the special risk-sharing initiative implemented by Singapore during the financial crisis in 2009. The Singapore Government decided to take on a significant share of the risks of bank lending during 2009. Under the special risk-sharing initiative, it includes the New Bridging Loan Programme where Government takes on 80% of the risk for loans made to meet the capital needs of firms and the Trade Financing scheme where Government take on 75% of the risk for loans made to firms for them to fulfill their orders as well as insurance. As such, the special risk-sharing initiative helps viable companies to get the funding that they need to see them through the period of slow economic growth.

Knowledge, Understanding, Application & Analysis		
L3	**Developed** explanation on how automatic stabilisers and measures to ease the flow of credit help during an economic slowdown. Developed → Explanation of key terms, examples and usage of examples to	**7-8**

	explain how it is the first line of defence against slowing growth.	
L2	**Undeveloped** explanation on how automatic stabilisers and measures to ease the flow of credit help during an economic slowdown OR **Developed** explanation on how either automatic stabilisers or measures to ease the flow of credit help during an economic slowdown.	**3-6**
L1	Smattering of valid points	**1-2**

b) Discuss whether it is useful to adopt a more aggressive fiscal policy. [17]

A more aggressive fiscal policy is referring to the use of discretionary fiscal policy, which refers to the deliberate changes in government expenditure and taxes to regulate the level of AD so as to achieve the macroeconomic objectives.

Thesis: It is useful to adopt a more aggressive fiscal policy.

Automatic stabilisers just work like 'shock absorbers' to reduce the severity/magnitude of fluctuations in the level of income but it cannot eliminate them completely. In addition, there is a limit as to how progressive the tax structure is or the level of unemployment benefits. Moreover, if the fluctuations are large, then discretionary fiscal policy will have to be used.

In the case of measures to ease the flow of credit and to ensure that credit is available, it might not bring about an increase in consumption or investment and as such, AD and NY might not increase. One of the reason is that if economic outlook is very bad, firms will not borrow to invest or consumers will not borrow to increase consumption even though credit is available.

Because of the above, it will be useful for discretionary fiscal policy to complement automatic stabilisers and measures easing the flow of credit to ensure that the economy improves.

Because of the limitations of automatic stabilisers and measures to ease the flow of credit, it will be useful for the government to undertake a more aggressive fiscal policy during times where there is slowing economic growth. In this case, an expansionary fiscal policy, where government expenditure is increased and / or taxes is being reduced, should be undertaken. Increasing government expenditure is the most direct way of increasing AD and the government can do this through increasing spending on infrastructure projects like building of transportation networks or government offices. A reduction in personal income tax rates increase disposable income and leaves people with more to spend while a reduction in corporate tax increases after-tax profits, thus encouraging private investment. These causes AD to increase and NY will increase by a multiple. Thus, an expansionary fiscal policy helps to raise the level of output, income and employment.

Anti-thesis: It is NOT useful to adopt a more aggressive fiscal policy.

A more aggressive fiscal policy might not be useful to tackle slowing growth because of the limitations of discretionary fiscal policy.

First of all, if the government does not have sufficient tax revenue to finance her spending, it may have to resort to borrowing from individuals or firms. Government borrowing will increase the demand for money and this pushes up the interest rate, assuming that money supply remains constant. The higher interest rate discourages private borrowing, thus crowding out private consumption and investment. If the fall in private consumption and investment is larger than the increase in government expenditure, then AD will fall instead.

Secondly, the effectiveness of fiscal policy depends on the size of the multiplier too. For small and open economies, an increase in government expenditure may not have a significant impact on income and employment due to a small multiplier, which reduce the effectiveness of fiscal policy. Small and open economies like Singapore have a heavy reliance on imports of raw materials and also basic necessities, thus resulting in a small multiplier. This is compounded if the economy has a high savings rate, which implies that any injections into households or businesses are not fully spent but are kept as precautionary savings. If this is the case, a more aggressive fiscal policy might not be useful.

Last but not least, it might not be very useful to adopt a more aggressive fiscal policy because of time lags. Fiscal policies tend to have a longer implementation lag compared to impact lag. Implementation lags happen as it takes time for policy makers to decide on what policy to be implemented and approval has to be sought before the policy takes effect. By the time an expansionary fiscal policy is decided upon and implemented to cure a recession, an economy may have already recovered and thus, will not be useful.

Besides the limitations of discretionary fiscal policy, it is also not useful to adopt a more aggressive fiscal policy if it worsens other objective of the government. For example, by increasing the NY of the economy and as such improving economic growth, it might actually worsen the balance of payment. An increase in national income might bring about an increase in imports, given that imports is a function of NY. If demand for imports is income elastic, import expenditure will increase, which will result in a worsening of the balance of payments.

<u>Conclusion</u>

To decide on whether it is useful to adopt a more aggressive fiscal policy depends on the rate and length of economic slowdown and also the nature of the economy. In addition, aggressive fiscal policy will be more useful for countries which have a large multiplier and also relative large reserves.

Knowledge, Understanding, Application & Analysis		
L3	**Developed** discussion on whether it is useful to adopt a more aggressive fiscal policy. 'Developed' → Clear explanation on why automatic stablisers and availability of credit are insufficient and how expansionary fiscal policy works for one side of the discussion. On the other side, clear explanation on 2	**10-13**

	limitations of expansionary fiscal policy and also how it worsen other objective of the government.	
L2	**Undeveloped** discussion on both sides of the discussion OR **developed** explanation for one side of the discussion. 'Undeveloped' → Points on each side of the discussion are not well-explained.	**5-9**
L1	Smattering of valid points	**1-4**

Evaluation		
E2	Able to form a judgment on whether it is useful to adopt a more aggressive fiscal policy, based on economic analysis.	**3-4**
E1	Able to make some comments on whether it is useful to adopt a more aggressive fiscal policy but the comments are superficially stated, rather than substantiated with judgment.	**1-2**