

H2 Economics – Essay Model

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Topic: Macroeconomic Policies & Goals

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To be considered successful, an economy needs to achieve low unemployment, low inflation, and stable economic growth.

Discuss whether fiscal policy is the most effective way for Singapore to sustain a successful economy. [15]

The success of an economy is dependent achieving a mixture of macroeconomic goals; the right balance involved a low unemployment, low inflation and stable economic growth. These goals are not mutually exclusive but the means of attaining each of them may sometimes be at odds other goals. In order to sustain a successful economy, the economic policies used to manage it must be selected carefully. Unfortunately, the most effective way for Singapore to sustain a successful economy is not to depend solely on a single type of policy; in particular due to the small and open nature of Singapore's economy, fiscal policy would do little to help Singapore with attaining the macroeconomic goals mentioned.

Fiscal policy should theoretically be able to achieve the macroeconomic goals of low unemployment, low inflation and stable economic growth. Low unemployment is achieved through the use of fiscal stimulus in times of high unemployment. The additional discretionary expenditure by government would raise aggregate demand in the economy and drive up employment, thus allowing the economy to attain a higher level of employment. Likewise the stable economic growth is attained the same way, by managing aggregate demand to ensure that growth is maintained during periods of low confidence and to prevent overheating of the economy when the growth rate appears too high to be sustainable. Automatic stabilizers such as the progressive income tax regime coupled with unemployment welfare benefits help to smoothen out small fluctuations in aggregate demand in the economy while discretionary expansionary or contractionary fiscal policies help to stabilize the business cycles in the economy.

[Diagram of AD-AS with AD increase to increase equilibrium employment and growth; thus national income]

Likewise, fiscal policy can be used to reduce inflation by contracting aggregate demand in order to reduce inflationary pressures and control prices. Unfortunately, the way fiscal policy works may mean that employment has to be traded off for lower rate of inflation. All these anticipated effects of fiscal policy assume that the economy has a sufficiently large multiplier for the injections by the government to make large impacts on national income and employment when applied. It also presuppose that the state of the government's budget is such that it does not suffer from devastating deficits and would not crowd out the private sector when it attempts to finance its policies through borrowing. Unfortunately, while the state of Singapore government's finances is such that it can deliver a large fiscal stimulus, the fact that our economy's multiplier is small would mean that this stimulus would not have a great impact on growth and employment. The high level of imports and high proportion of savings means that the marginal propensity of consumption of the economy is particularly low and since $k=1/(1-mpc)$, our multiplier would be very small.

In addition, fiscal policies are more suited to deal with specific cases of unemployment or inflation. In particular, fiscal policy is most effective in reducing cyclical unemployment, which is associated with the lack of demand during a recession; as for inflation it helps mainly to reduce demand pull inflation and does little for cost-push inflation. That is to say that even if fiscal policy could help to generate employment in short run under the condition of structural unemployment, the unemployment will eventually return and the growth would not be sustainable.

In order to sustain a successful economy, a combination of fiscal, monetary and supply-side policies are thus required. In particular, monetary policies would better be able to fine-tune aggregate demand during short term fluctuations as the adjustment of interest rates can be done quickly through changing money supply. Nevertheless, the interest rate monetary policy cannot be applied in Singapore as a result of our vulnerability to short term capital flows and thus exchange rate monetary policy have to be adopted in its place. As Singapore is heavily dependent on imported goods as factors of production and other necessities, low inflation can be sustained through gradual appreciation of the currency. At the same time, currency depreciation can

be used to raise aggregate demand for our goods since short term depreciation could help to raise competitiveness of our exports and thus drive growth and generate employment.

As for long term economic growth and stability, supply side policies are necessary to help sustain success in the economy. Education and training or re-training of workers has to be put in place in order to maintain flexibility of labour and allow the economy to cope with structural changes. This would enhance the long term level of employment. In addition, regular job fairs and the presence of job placement or matching agencies could also help to reduce frictional unemployment. Low domestic inflation can be maintained in long run through the continuous improvements in productivity and thus enhancement of cost competitiveness that will help to suppress price rises. The productive capacity of the economy must grow continuously in order for increases in aggregate demand to translate into real growth in national output; this increase in aggregate supply can be encouraged through fiscal spending that has supply-side effects such as investments in infrastructure and education.

The sole application of fiscal policy is thus not even an effective way for Singapore to sustain a successful economy due to the small and open nature of the Singapore economy that gives rise to a small multiplier resulting from the high level of leakage through imports. This reduces the impact fiscal policy can have on the Singapore economy though some automatic stabilizers are still in place to help reduce the fluctuations of demand in the economy. The exchange rate monetary policy that Singapore adopts is more significant in achieving those short term aggregate demand management objectives. In long run, the government would sustain a successful economy only through supply side policies that enhance long term productivity and productive capacity of the economy.