**2017 RVHS Prelims II (Y6 H1 8819)**

**a) Explain the factors that will affect the external value of Singapore dollar. [10]**
**b) Discuss whether exchange rate policy is the best policy to achieve price stability in Singapore. [15]**

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**a) Explain the factors that will affect the external value of Singapore dollar. [10]**

Introduction
The external value of Singapore dollar (SGD) (also referred to as the exchange rate of SGD) is the amount of foreign currency that can be exchanged for SGD. The external value of SGD is determined by the demand and supply of SGD.

Body
One of the factors affecting the external value of Singapore dollar is the amount of goods and services internationally traded. For example, with an increase in income and a change in taste and preferences towards goods and services from Korea like overseas trip to Korea, that will lead to an increase in supply of SGD from $S_0$ to $S_1$ in exchange for Korean Won as shown in Figure 1. At the same time, an increase in demand for Singapore exports like an increase in demand for electrical machinery from Korea will lead to an increase in demand for SGD from $D_0$ to $D_1$ as shown in Figure 1. As seen, it is the intersection of demand and supply of SGD that determines the external value of SGD. As the increase in demand is more than the increase in supply of SGD in this case, SGD appreciates from $E_0$ to $E_1$.

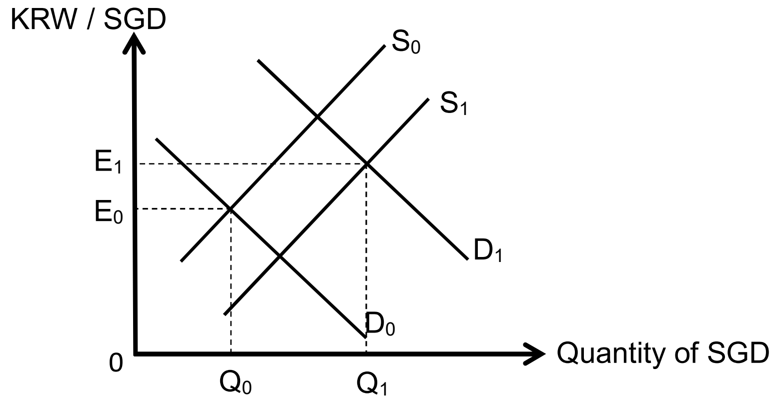

**Figure 1: Determination of the external value of SGD**

Another factor affecting the external value of Singapore dollar is the amount of capital flows into and out of Singapore. As Singapore does not determine her own interest rate and is an interest rate taker, interest rate in Singapore is likely to increase with US interest rates on the upward trend. Comparing to countries where interest rates is lower e.g. Japan, this will lead to hot money inflows into Singapore. This will lead to an increase in demand for SGD and will cause SGD to appreciate.

Another factor is the type of exchange rate regime in Singapore. Singapore adopts a managed float exchange rate regime and the characteristics of Singapore exchange rate are basket, band and crawl. MAS conducts direct interventions in the foreign exchange market to maintain the exchange rate within an undisclosed policy band. For example, if the exchange rate falls below the lower support limit, MAS will then intervene by buying SGD using its foreign reserves, this will increase the demand for SGD in the foreign exchange market so that SGD falls within the band again.

Illustrated above are some factors that will affect the demand and supply of SGD and thus, the external value of SGD.

| **Knowledge, Understanding, Application & Analysis** | | |
|---|---|---|
| **L3** | Developed explanation, with examples, on three factors that will affect the external value of SGD.<br><br>[Developed explanation includes examples given in the context of Singapore and just <u>one</u> diagram explaining how the external value of SGD is determined by the demand and supply of SGD.] | **8-10** |
| **L2** | Undeveloped explanation on three factors that will affect the external value of SGD, with no examples given in the context of Singapore.<br><br>OR<br><br>Developed explanation, with examples, on two factors that will affect the external value of SGD. | **4-7** |
| **L1** | Smattering of valid points; Undeveloped explanation on factors that will affect the external value of a currency, with no reference made in the context of Singapore. | **1-3** |

**b) Discuss whether exchange rate policy is the best policy to achieve price stability in Singapore. [15]**

Introduction

Price stability refers to the situation whereby the general price level of goods and services in an economy either change very slowly or do not change at all. Exchange rate policy is important to achieve price stability in Singapore.

Thesis: Exchange rate is the best policy to achieve price stability in Singapore

Given that Singapore has to import virtually everything, Singapore usually adopts a gradual appreciating stance relative to a basket of currencies. By allowing the SGD to appreciate, imports into Singapore will now be relatively cheaper in terms of SGD, which means that we will now need to pay less SGD for the same amount of imports. This will in turn help to maintain costs of production low for firms who rely on imported inputs and subsequently keep the price of end-products / finished goods competitive. This helps to prevent the fuelling of cost-push inflation and also help to maintain Singapore's export competitiveness given the high import content for the exports. Moreover, in times of demand-pull inflation caused by external factors, keeping a stronger exchange rate is also helpful as it increases the prices of exports in terms of foreign currency and moderates the external demand for our goods and services. Since the Marshall-Lerner condition is satisfied in Singapore, net exports will fall, which triggers a fall in aggregate demand (AD) and thus, helps to curb demand-pull inflation.

More importantly, using the exchange rates is more of a necessity than a choice in Singapore's context. This is because, our openness to capital flows implies that any attempts to change interest rates to tackle inflation will be negated by hot money inflows/ outflows, thus rendering the traditional tools of monetary policy ineffective.

Anti-Thesis: Exchange rate is NOT the best policy to achieve price stability in Singapore

Nonetheless, in the short term, the Marshall-Lerner condition might not be satisfied. This is because it may take some time before importers can really 'benefit' from the stronger SGD. For example, if importers have previously signed long-term contracts to import a certain quantity of goods at a fixed price in Singapore dollars, this implies that the import expenditure to be paid (in terms of SGD) is likely to remain constant even though it could have dropped given that SGD is now stronger.

Another limitation of having a strong SGD is that Singapore's exports will now become more expensive in terms of foreign currency (i.e. less competitive compared to other countries' exports). Even though, this loss in export competitiveness due to the strong SGD will be mitigated by the lower cost of production because of cheaper imported raw materials to some extent, net exports might fall by too much if SGD appreciates by a large extent. The fall in net exports will lead to a fall in AD and a multiple fall in national income (NY). This will have an adverse impact on Singapore's economic growth if we are not experiencing demand-pull inflation. With a fall in national income, unemployment will also increase subsequently.

In addition, exchange rate policy will not really help to tackle inflation if it arises due to internal sources. For example, if there is an increase in domestic wages arising from government policies like an increase in foreign worker levy which results in cost-push inflation, then exchange rate policy will not be able to help. In addition, exchange rate policy will also not help if there is demand-pull inflation which arises due to an increase in domestic consumption and investment because of an optimistic economic outlook.

<u>One other policy to achieve price stability in Singapore:</u>

As exchange rate policy will not really help to tackle inflation that arises due to internal sources, other policies are needed. One alternative policy will be supply-side policies. Supply-side policies aim to increase long-run aggregate supply so as to mitigate the effects of inflation. Examples of supply-side policies include lowering personal income and corporate income tax rates. Lowering personal income tax will attract foreign talent, prevent brain drain and increase the incentive to work while lowering corporate income tax rates attract foreign and local investments. As such, lowering taxes help to raise the aggregate supply (AS) curve in the long run since they increase the quantity and quality of resources. As shown in Figure 2, with supply-side policies in place, AS will increase from $AS_0$ to $AS_1$ and this will help to reduce general price level from $P_0$ to $P_1$ thus reducing any inflationary pressures and achieve price stability.

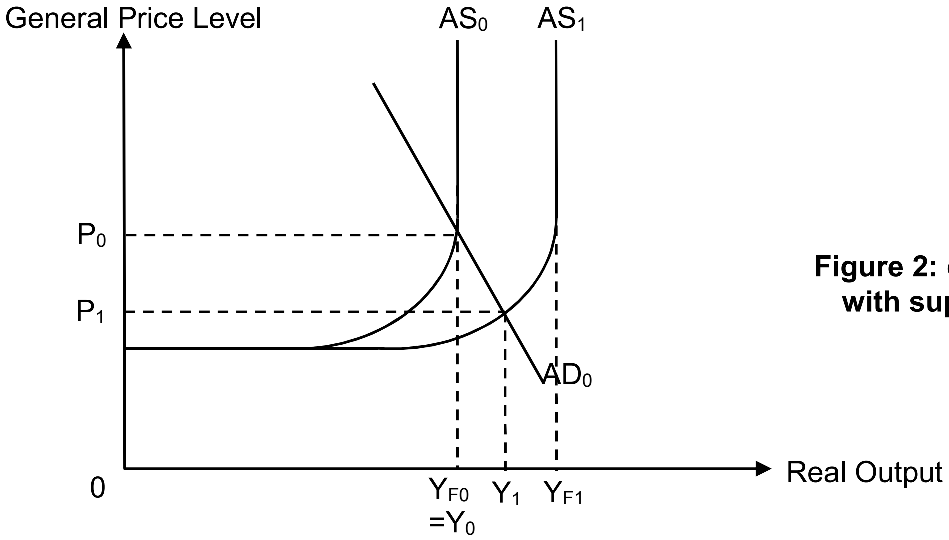


**Figure 2: combating inflation with supply-side policies**

Although supply-side policies can help curb inflation, they are not without limitations. Most importantly, such measures take a relatively long time before its effects can be felt, and even then, the results are not guaranteed. As such, by the time they really take effect, it might be too late to curb inflation in a prompt manner. Also, such measures are likely to be costly for the government to fund and even then, the 'take-up' rate may be unsatisfactory if workers or firms are reluctant to undergo training or undertake R&D to increase productivity.

<u>Conclusion</u>
In sum, our heavy reliance on external trade (and thus exposure to hikes in global commodity prices) as well as openness to financial flows necessitate the use of exchange rates, and in many circumstances, make it the 'best' policy to tackle inflation. Nonetheless, given that inflation is usually multi-faceted in nature, simply relying on the exchange rates may not be the best nor sufficient. Instead, it should be complemented with other policies

that aim to tackle inflation arising from the various sources and achieve price stability in Singapore.

| **Knowledge, Understanding, Application & Analysis** | | |
|---|---|---|
| **L3** | **Developed** discussion for both sides, with good reference to the context of Singapore (relevant examples are provided to substantiate points) + well evaluated limitations. | **9-11** |
| **L2** | Able to explain exchange rate policy and **one** other policy (together with limitations) to tackle inflation. However, explanations did not link to Singapore's context. | **7-8** |
| | Able to explain exchange rate policy and **one** other policy (without limitations) to tackle inflation. | **4-6** |
| **L1** | Smattering of valid points. | **1-3** |

| **Evaluation** | | |
|---|---|---|
| **E2** | Able to provide a clear and meaningful conclusion to the overall issue, indicating the stand on whether the use of exchange rates is the best policy while recognizing that the choice of policy depends largely on the characteristics of the country. In addition, the reasons for arriving at such a conclusion drawn are clearly explained and well justified. | **3-4** |
| **E1** | Able to provide a reasoned evaluation of specific policies but has not addressed the overall issue i.e. has not come to a conclusion whether the use of exchange rates is the best policy. | **1-2** |