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UNIVERSITY OF CAMBRIDGE
INTERNATIONAL EXAMINATIONS General

ECONOMICS 9708/23 Paper 2 Data Response and Essay (Core) **May/June 2011 1 hour 30 minutes**

Additional Materials: Answer Booklet/Paper

READ THESE INSTRUCTIONS FIRST

If you have been given an Answer Booklet, follow the instructions on the front cover of the

Booklet. Write your Centre number, candidate number and name on all the work you hand in.

Write in dark blue or black pen.

You may use a soft pencil for any diagrams, graphs or rough working.

Do not use staples, paper clips, highlighters, glue or correction fluid.

Section A
Answer this question.
Brief answers only are required.

Section B
Answer any **one** question.

You may answer with reference to your own economy or other economies that you have studied where relevant to the question.

At the end of the examination, fasten all your work securely together.
The number of marks is given in brackets [ ] at the end of each question or part question.

This document consists of **3** printed pages and **1** blank page.

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Section A

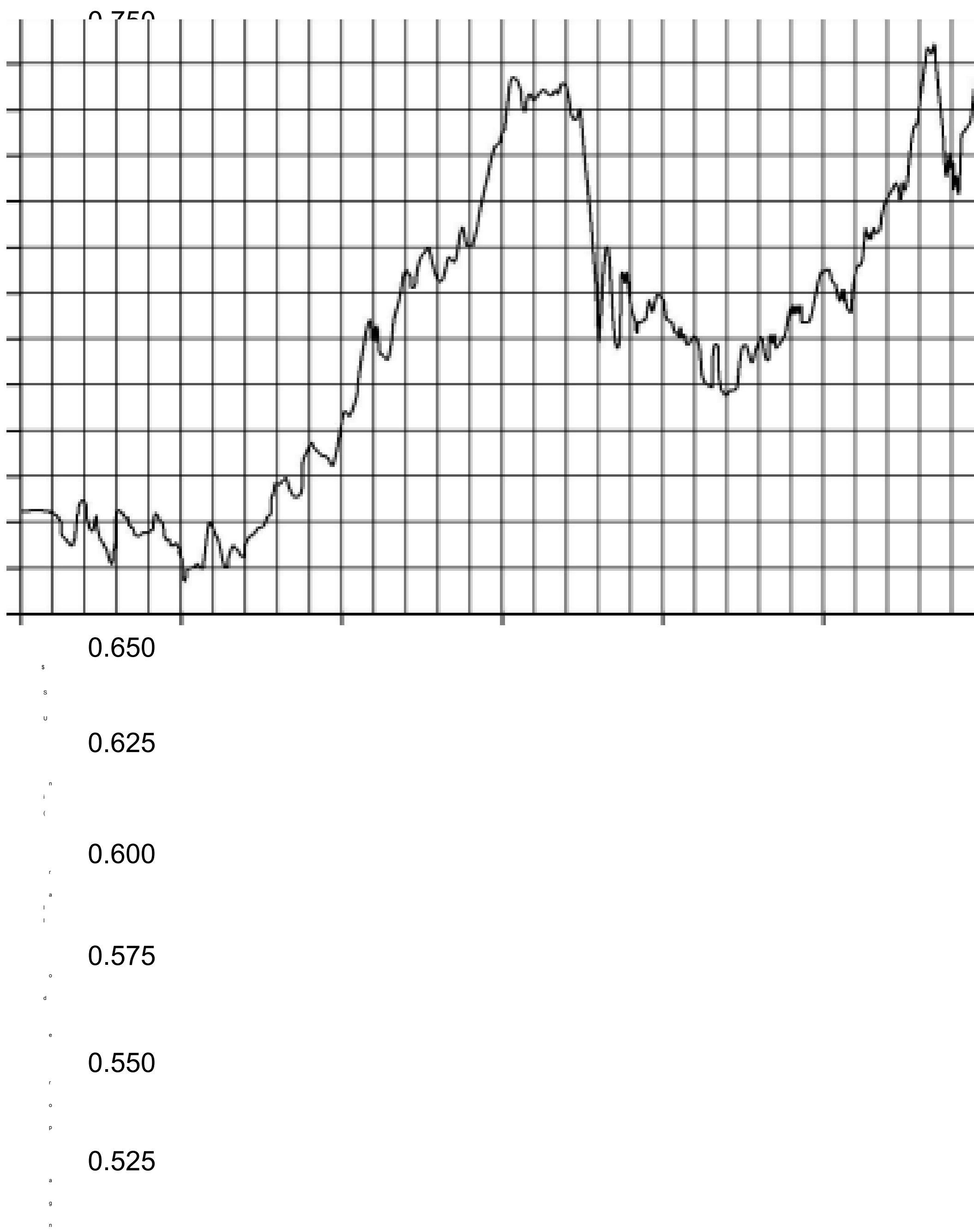
Answer this question.

1 The Singapore Exchange Rate

Singapore is a relatively small, open economy which relies heavily on international trade. The values of both its exports and imports are more than 100% of its GDP. Its largest trading partners are Malaysia, China and the US. In the second half of 2008 its economy faced a sharp downturn, with a large fall in its exports that affected the Singapore exchange rate.

Fig. 1 shows the exchange rate of the Singapore dollar (S$) in terms of the US dollar (US$) between 1980 and 2010.

Fig. 1: The Singapore Exchange Rate 1980–2010



0.500

0.475

0.450

0.425

1980 1985 1990 1995 2000 2005 2010 (Source: Pacific Exchange Rate Service)

Singapore has a unique exchange rate system. The Monetary Authority of Singapore (MAS) uses the exchange rate to maintain price stability and encourage economic growth.

The main features of the system are that:

1 the S$ is managed against a weighted basket of currencies of its major trading partners and competitors,

2 the exchange rate is allowed to move within an undisclosed trading band but not to move outside of it,

3 the trading band is reviewed typically every three months and changed if necessary.

The poor economic conditions in March 2009 caused the MAS to lower the trading band which was the same as a depreciation of the S$.

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(a) Compare the exchange rate of the S$ against the US$ from the beginning of 1980 to the beginning of 2010. [2]

(b) Analyse the possible changes in the demand for and the supply of the S$ that could account for the trends in its exchange rate between 1997 and 2007. [4]

(c) Explain **two** ways in which an appreciating exchange rate can help to reduce inflation. [4]

(d) Using the extract, consider whether Singapore has both a floating and a fixed exchange rate system. [4]

(e) Discuss whether an economy will benefit from a fall in its exchange rate. [6] (a) Singaporean dollar depreciated against US dollar during the period of 1980 to 2010. At the start of 1980 each US dollar could approximately afford 0.475 Singaporean dollars. Till the end of 2010 this exchange rate depreciated to 0.725 Singaporean dollars for each US dollar. This represents approximately 53 percent depreciation in Singaporean dollar.

(b) Reduced demand for Singaporean dollars due to economy's reduced exports or increased supply of this currency due to increased imports would have contributed to Singapore's lower exchange rate. Moreover increased investment by Singaporean nationals in other economies might have resulted in increased supply of country's currency and might have therefore contributed to this reduced exchange rate. On the other hand, reduced foreign investment in

Singapore's economy might have adversely affected country's currency's demand and therefore might have contributed to their depreciated exchange rate.

(c) Appreciation refers increase in currency's exchange rate which basically refers to improved purchasing power of local currency in terms of foreign currency. Appreciation helps economies control foreign induced cost push inflation. Economies often rely on foreign raw materials and capital goods for functioning of their industries and higher exchange rates reduce prices for foreign products in local currencies. This is limits/reduces cost push inflation in local economy. This is why economies at times revalue their exchange rates to artificially increase their value.

Moreover improved purchasing power of local currency in terms of foreign currency means that local consumers will start relying on foreign products by importing more. This will reduce burden on local resources and lower aggregate demand will limit increase in economy's general price level. Hence exchange rate appreciation will limit burden on economy's resources and therefore will limit demand pull inflation in the economy.

(d) Floating exchange rate is when exchange rates are allowed to be free determined through supply and demand of any currency. On the other extreme, fixed exchange rates are when economies try controlling their exchange rate at a specific level. In between these two extreme exchange rate strategies there is one known as managed exchange rates. This is when the exchange rate has both managed and free floating exchange rate. This is when instead of fixing exchange rate at a specific level policymakers determine upper and lower limits for their exchange rates to fluctuate in between but if exchange rate values move beyond these limits then government intervenes to bring the exchange rate back.

(e) Fall in exchange rate is when higher quantities of local currency afford lower quantities of foreign currency. This depreciation in exchange might prove to be beneficial if Marshal Lerner Condition is true. This is when economies' price elasticity of demand for both exports and imports is more elastic and following fall in country's exchange rate results in higher demand for country's exports due to fall in their prices. Similarly higher prices for imported goods mean that now local citizens will be less encouraged to purchase expensive imported goods. If price elasticity of demand for both exports and imports is more elastic then increase and decrease in

prices of imports and exports will result in more than proportionate decrease and increase in economy's imports and exports respectively. Therefore in case of Marshal Lerner Condition economies' balance of trade is expected to improve following depreciation of their exchange rate.

Moreover falling exchange rate is expected to encourage foreign investment in local economy. Increased purchasing power of foreign currency in terms of local currency would make it cheaper for foreign nationals to undertake certain investment in local economy. On the opposite, falling exchange rates would mean that local citizens' investment in foreign economies would become more expensive and therefore reduced outflow of investment from local economy would not adversely affect country's balance of payments position.

Hence depending upon specific economic circumstances exchange rate changes might not always be beneficial or harmful.