<u>Assess whether a change in the external value of its currency is more likely to have a larger impact on Singapore or USA [15m]</u>

Introduction

The exchange rate measures the external value of Singapore Dollar (SGD) and US Dollar (USD) in terms of how much of another currency it can buy. This value of the currency is determined in the foreign exchange market where billions of $s of currencies are traded every hour.

The value of the USD depends on how strong is demand for the currency relative to supply. The US operates with a floating exchange rate system where the forces of market demand and supply determine the daily value of one currency against another. For example, if overseas investors want to buy into USD to take advantage of higher interest rates on offer in US bank accounts, they will swap their own currencies for USD. This causes an increase in the demand for USD in the foreign exchange markets, and in the absence of other offsetting factors, this will cause an appreciation.

Singapore on the other hand, operates with the managed float exchange rate system. The SGD is traded within a band and MAS intervenes with open market operations to keep the external value of the currency within the band. Given the small and open nature of the Singapore economy and its huge reliance on exports and imports for growth and sustenance, it is likely that exchange rate changes will have a more significant impact on its economy as compared to the US, which holds the world reserve currency and is largely dependent on its domestic consumption and investment for growth.

However, with the US aiming to restructure its economy and boost its export sectors in the medium to long term, the impact of foreign exchange rates on the US economy is likely to increase over time. In this essay we will assess whether a change in the external value of its currency (exchange rate) is more likely to have a larger impact on Singapore or USA.

Thesis (Big Impact on Singapore small impact on USA)

1. Singapore very much smaller domestic market as compared to USA therefore effect will be more. Affects BOP, GDP, Employment.

Appreciation of S$ - price of export increase in foreign currency + price of import decrease in local currency – Marshall Lerner condition – volume of exports drop more than proportionately + volume of imports increase more than proportionately – total revenue from exports drop + total revenue from imports increase – (X-M) (services: tourism / education / medicine) drops – BOT drops – AD falls – fall in NY / employment – fall in GPL (reduce demand-pull inflation)

2. Singapore has high import export content therefore inflation will have more impact.

Price of import decreases in local currency – fall in COP / fall in price of raw materials (reduce cost-push inflation) – increase AS – fall in price of exports in long run – if demand for exports price elastic – BOT improves – NY / N increases

3. Singapore depends a lot on FDI and trade therefore BOP and FDI will be adversely affected.

- MNCs planning to invest in Singapore postpone plans – home currency converted to less S$ - but MNCs decisions dependent on host of factors – huge domestic market, efficient infrastructure, human capital

- MNCs already in Singapore – goods they produce (price of exports increase) less competitive but in the long run may be able to buy imports more cheaply to decrease COP

Anti-thesis (Impact on singapore not so great)

1. Effect depends on extent of appreciation – Singapore government recognizes conflict in policy objectives – while imported inflation lowered but short term export price competitiveness affected – MAS stand: gradual and modest appreciation of S$

2. Appreciation can be a sign of a booming economy and increasing prospects. MNCs may decide to come after all.

3. Whether the change in the currency is short-term or long-term – i.e. is the change in the exchange rate temporary or likely to persist for some time?

4. How businesses and consumers respond to exchange rate fluctuations – price elasticity of demand is important here i.e. will there be a large change in demand for exports and imports?

5. The size of any multiplier and accelerator effects. Singapore small multiplier and hence effects are smaller.

6. When the currency movement takes place – i.e. at which point of an economic cycle. For example, appreciating SGD during economic boom is actually good.

7. Changes in the exchange rate have quite a powerful effect on the economy but we tend to assume ceteris paribus – all other factors held constant – which of course is highly unlikely to be the case

8. Counter-balancing use of fiscal and monetary policy: For example the government can alter fiscal policy to manage AD

9. Time lags – it takes time for demand for exports and imports to change following a movement in the currency. Businesses need to have the capacity and access to credit to expand their production.

10. Low elasticities of demand due to globaliastion: In the short term, the effects of exchange rates on export and import demand tends to be low because of low price elasticity of demand.

11. Business response to the challenge of a high exchange rate: Businesses can and do adapt to a high exchange rate. There are several ways in which industries can adjust to the competitive pressures that a strong pound imposes. Some of the options include:

a. Cutting their export prices when selling in overseas markets and therefore accepting lower profit margins to maintain competitiveness and market share

b. Out-sourcing components from overseas to keep production costs down

c. Seeking productivity / efficiency gains to keep unit labour costs under control or perhaps trying to negotiate a reduction in pay levels

d. Investing extra resources in new product lines where demand is price inelastic and less sensitive to exchange rate fluctuations. This involves producing products with a higher income elasticity of demand, where non- price factors such as product quality, design and effective marketing are as important in securing orders as the actual price.

Conclusion

Singapore tends to have more impact than USA due to it’s small and open economy however there are several ways which the government can mitigate these impact.