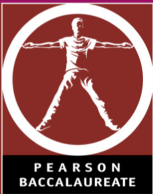


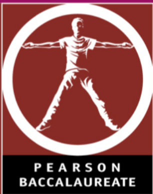
Worksheet 22.3

Managed Exchange Rates in Singapore

Rapid economic growth has put upward pressure on the price level in Singapore recently, leading the government to take action to bring inflation under control. In the first quarter of 2010, Singapores economy grew at an astounding 13.1%. This strong performance was related to the increased demand for electronic components and growth in the pharmaceutical industry.

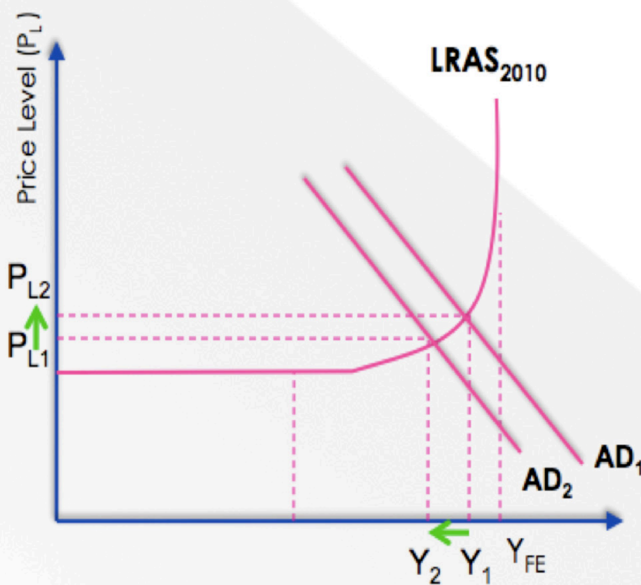
The Singapore government operates a managed exchange rate regime. The Singapore dollar is pegged to a trade-weighted index of five currencies. The exact make-up of the index is kept secret, but the rate is allowed to fluctuate within a four percent target range. This ambiguity leads to less speculation by currency traders, and what is known as a basket, band and crawl method of currency management. Overtime, this has allowed the government to steadily appreciate the currency as demand for exports surged. Since 1980's the value of the Singapore dollar versus the US Dollar has appreciated by nearly 80%.

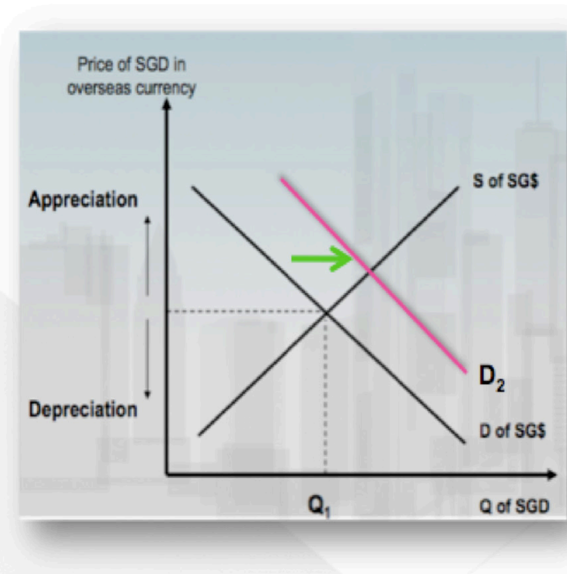
© Pearson Education Ltd 2011. For more information about the Pearson Baccalaureate series please visit www.pearsonbacc.com



This exchange rate mechanism is also how the government controls the rate of inflation in the small city-state. Because Singapore's exports make up over 100% of GDP, a subtle appreciation of the exchange rate leads to less imported inflation and less demand for exports.

Effect of a managed appreciation of exchange rate on inflationary pressure





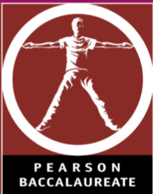
Net Exports fall due to appreciation of exchange rate
Imports – become cheaper to purchase
Exports – less price competitive, QD falls overtime

Appreciation caused by Monetary Authority of Singapore; shifting foreign currency reserves by buying more SDG$ using their foreign exchange reserves from overseas. Demand for SGD$ increases.

Exchange Rate band appreciates by 1.3%

The approach is something that the Chinese government is maybe looking towards. The Yuan is pegged directly to the US Dollar and has been since mid-2007. China has been able to maintain this peg by selling vast amounts of yuan to purchase US Treasury Bonds, and to thereby create large foreign currency reserves. As widely reported, the Chinese government has been under pressure to appreciate the yuan by anything up to 60% compared to the US dollar. How the government achieves this shift is complicated but may lead to a significant loss of export competitiveness and imported inflation.

© Pearson Education Ltd 2011. For more information about the Pearson Baccalaureate series please visit
www.pearsonbacc.com



Questions:

1. What are the advantages and disadvantages of a floating exchange rate?
2. What are the advantages and disadvantages of a fixed exchange rate?
3. What is the common tool used by many governments to control inflation. Why can't all countries use the Singapore approach?
4. Can a country use both Monetary Policy and a managed exchange rate to control inflation? Do trade-offs exist?
5. Evaluate the effects on the Chinese economy of an appreciation of the yuan.

© Pearson Education Ltd 2011. For more information about the Pearson Baccalaureate series please visit www.pearsonbacc.com