

2014 RVHS H2 CSQ2

- (a) With reference to Table 2, identify how the Russian economy had fared against the other emerging economies. Justify your answers. [3]**

Russia fared the worst of the 3 emerging economies.

The economic growth of Russia was consistently lower than the other two economies with the exception of 2008, which its growth surpasses that of India.

During 2009 financial crisis, the economy was the only one that contracted.

- (b) Explain why increased exchange rate flexibility is a crucial precondition for a more effective interest rate. [3]**

Approach 1

Monetary policy is often used to stimulate growth or dampen inflationary pressure. Suppose the Central Bank desires to increase i/r to dampen inflationary pressure. When i/r increases, it will lead to short-term capital inflow, causing the exchange rate to appreciate. This appreciation leads to exports to be relatively more expensive and imports to be relatively cheaper. Assuming Marshall-Lerner condition is satisfied, net-exports will fall. Hence, the increased exchange rate flexibility enables the exchange rate changes to be more significant and hence enabling a more significant impact on net exports.

- (c) Explain why the robust Russia's public finance might not continue. [4]**

Any 2 of the 3

Approach 1

From Extract 7, it was mentioned that oil prices were forecasted to stagnate and the economy in Europe was stumbling. These might cause a fall in export revenue from the sale of oil and hence a fall in government revenue given that these oil exporters are likely to be state-owned enterprises.

Approach 2

It was stated that government welfare spending was up from 11% of Russian household income in 2007 to 18% in 2011. This increase in welfare spending was likely to continue especially given the ageing population and the poor economic outlook. With higher government spending, the public finance would likely worsen.

Approach 3

Extract 6 pointed out that ageing population, unproductive workers, the reluctance to invest over the long term and concerns about Russia are factors that would dampen AD and reduce the productive capacity of the Russian economy. With this fall in AD and AS, the national income would be adversely affected. As such, the tax revenue derived by the government would fall. In addition, if expansionary fiscal policy or supply side policies were to be implemented, government expenditure would increase. Both of which would worsen the public finance.

(d) State two possible reasons why Russia has not made any commitment to reduce its export tariffs for its energy exports in its agreement with the WTO. [2]

[Any two possible reasons below]

- It is an important source of tax revenue, thereby contributing significantly to the government budget
- To support domestic industries by ensuring there are sufficient supply of the commodities
- To expand Russia's secondary industries via FDI as these foreign firms that have invested in Russia do have access to cheaper commodities.
- To improve terms of trade as the higher price of exports makes it possible for more imports to be exchanged for each unit of export

(e) Discuss whether a rate cut, favoured by the Russian government, is the best policy approach. [8]

• **How a rate cut helps?**

From Extract 7, the Russian government had been pushing the central bank to lower interest rates so as to stimulate the economy. By lowering interest rates, cost of borrowing will fall and investments which were previously not viable now become viable. As such investment level will increase, thereby solving the problem of contracting fixed-capital investment mentioned in Extract 7. The lower borrowing cost also implies that consumers will be spending more on big-ticket items such as cars and computers etc. Furthermore, lower interest rates mean less reward for savings, thus encouraging more consumption and fewer saving. These increases in consumption and investment will translate into an increase in AD which will increase national income and employment level, thereby stimulating the economy.

• **Explain why a rate cut does not help?**

(i) No impact on real national income

However, the Central Bank in Russia had been resistant to the idea of lowering interest rates because they believed that the economy was already growing near its potential since unemployment rate had fallen to 5.3%, well below the natural rate of unemployment as seen in Extract 7. As such, by lowering interest rates, the increase in consumption and investment will only cause an increase in price with little or no increase in real output.

(ii) It does not address the root cause of the problem

However, the fundamental problems which the Russian economy faced are ageing population, unproductive workers, and business executives who are reluctant to invest due to the risks involved. By reducing interest rates or keeping interest rates constant will not solve these issues. Instead, the Russian government should focus on supply side policies such as education and retraining to raise employability of workers and labour productivity so as to ensure the supply of highly skilled workers in the labour market. The training will also help to prevent structural unemployment. As such, policies such as education and retraining will increase potential output and contribute to a faster or sustained economic growth. Nonetheless, the success of skills training and upgrading depends on the level of education, age and personal inclination of the workers. Some workers might resist the idea of skills upgrading or retaining for another job, especially older workers and those with low education. Alternatively, the Russian

government may implement policies such as extending maternity leave to encourage higher women labor force participation in order to increase the quantity of labour thereby increasing potential growth. Nonetheless, overly-generous maternity leave will make employers think twice before hiring women in the first place.

In view of the ageing population, the Russian government could introduce measures to encourage older workers to find work and stay employed. Alternatively, the government could incentivize employers to hire the older workers by subsidizing a portion of their wages. These would help to retain the older workers in the workforce, ensuring that productive capacity does not shrink. However, these measures would require the government to increase their expenditure which may worsen the budget position.

As mentioned in Extract 6, one of the reasons cited for low level of investments in Russia was because of the risks involved in general. Risks involved here may refer to corruption, bureaucratic pressures, political instability etc. When there is political instability, investors are unwilling to invest because their investments are now subjected to higher risks of loss of assets, production disruptions and possibly a run on the exchange rate as well. Also, there could be inconsistency in policy decisions due to conflicts from different political parties. Hence, in order to improve the investment climate in Russia, the government should ensure political stability as well as to be more transparent in corporate governance.

Also, in order to increase the ease of doing business in Russia, the Russian government can deregulate by removing the barriers to entry into various industries or to eliminate or reduction of government regulations of private sector activities. This would also improve the investment climate in Russia, thereby stimulating the economy.

Conclusion

While these measures will increase the attractiveness of Russia as a choice destination for investment, thereby increasing the productive capacity in the longer term, it is to be noted that the effects can only be seen in the long run. Therefore, even though manipulating interest rates may not solve the crux of the problem, it may stimulate investment in the short run and raise the productive capacity in the long run. To ensure it will not cause unnecessary inflation the central bank fear of, the government can perhaps use moral suasion or regulation to influence the type of lending by the banks.

(f) Discuss how far Russia would benefit from its accession into the WTO.

[10]

The benefits Russia would derive from its accession into the WTO can be analysed by examining the benefits of increased flow of goods and services, capital and probably labour between Russia and the rest of the world.

However, there could also be problems faced by Russia or the benefits that Russia gets from joining WTO could be limited too.

Thesis: Russia would benefit from its accession into WTO

With Russia opening its door to trade, Extract 8 mentioned that Russia will lower its tariff on a wide range of products. This will result in lower prices of imports for Russia and thus, **increase the amount of goods and services** that can be enjoyed by the Russians. In addition, the **variety of goods** enjoyed by Russians is likely to increase too.

Besides benefitting the consumers, producers in Russia will also benefit if they rely on imported raw materials for production as the cheaper imported raw materials will mean a **lower cost of production** and thus, results in higher profits for producers.

With Russia's accession into WTO, it also opens up new export markets as producers in Russia are now **better able to export their goods** to more countries given the reduction of import tariffs towards Russian goods. With new and larger markets comes greater volumes of exports and this can help producers in Russia to reap significant **economies of scale** compared to before.

With Russia as one of the world's largest oil producers and home to the globe's biggest natural gas reserves and second largest coal reserves, as highlighted in Extract 8, Russia has the comparative advantage in energy exports and this can result in potentially higher net export revenue and hence, national income. The large amount of energy resources that Russia has is also likely to attract large amount of foreign direct investment (FDI) into Russia as they can avoid incurring higher energy prices.

The increase in investment and exports from the abovementioned points will lead to an increase in employment levels and national income for Russia, thus benefitting the economy. As mentioned in Extract 8, Russian economy is also expected to be more competitive. This comes as a result of the lower cost of production due to the cheaper imported goods, the greater competition on domestic firms given the higher imports as well as the expansion of the productive capacity given the higher FDI.

Anti-thesis: Russia would not benefit as much from its accession into WTO

First of all, although tariffs will be reduced on a wide range of products, **it will not happen all at once**. As a result, the benefits as underlined by the theory of comparative advantage that can be reaped may be limited in the short term.

In addition, with the influx of imports and FDI into Russia, it might be **difficult for the non-commodity domestic sector to compete**. This is evidenced in Extract 9, which certain industries, like the automotive industry, might not be able to survive. As such, this might lead to an increase in **structural unemployment** in Russia.

As for the increase in exports, it is stated in Extract 9 that Russia is **not so interested in boosting its exports** and as such, exports is not expected to increase sharply with Russia's accession into WTO. As such, there might be limited increase in national income and employment in export-related industries in Russia.

Similarly, the expected increase of FDI into Russia cannot be overstated as it is difficult to do business in Russia as evidenced in Extract 7. Moreover, unlike China, which has a large scale, cheap labour force as well as efficient infrastructure/logistics built by public investment, Russia's only advantage lies in its abundance of oil, coal and gas and as such, the overall cost of doing business might not be as low. Last but not least, Russians do not have a fleet-footed economy that will embrace economic or structural reforms quickly as compared to China. Based on the above points, the increase in FDIs might turn out to be limited.

Conclusion with justification

Indeed, the benefit from its accession into WTO is unlikely to be significant until protectionism measures are significantly reduced. However, to ensure the benefits are significant when protectionism measures are significantly reduced, Russia has to embrace the structural reforms to make its economy more competitive to withstand the stronger competition expected.

L3	Developed discussion, with a sound justification as to whether Russia will benefit from its accession into the WTO. 'Developed' – Explains clearly the benefits and challenges that Russia faces for joining the WTO in terms of goods and services, capital and labour (at least 2 benefits and 2 challenges). Sufficient reference is also made to information given in extracts. Finally, a justified conclusion on whether Russia will benefit or not.	8-10
L2	Undeveloped discussion on whether Russia will benefit from its accession into the WTO. Insufficient reference made to information given in extracts. OR Developed explanation on how Russia benefit or do not benefit from its accession into the WTO.	4-7
L1	Smattering of valid points.	1-3