

**2015 RVHS Prelims II H2 Econs Paper 1 – CSQ 2 [Suggested Answers for other JCs]**

**Question 2 Europe's economic problems**

**(a)(i) Compare the trade balances as a percentage of GDP of Germany with that of Spain, Portugal and Greece from 2010 to 2013. [2]**

- All of the countries mentioned in Figure 1 have experienced a general increase in their trade balances as a percentage of their respective GDP. [1]
- While Germany's trade balance as a percentage of GDP have increased only slightly, countries like Portugal, Greece and Spain have experienced a significant surge in the amount of the trade balances as a proportion to their GDP. [1]

**(a)(ii) With reference to the data, explain how the above trend might be a concern to the economy of Germany in the future. [2]**

- From Figure 1, the trend shows a continued increasing reliance on trade by Germany. This would mean that Germany would continue to be vulnerable to external fluctuations.
- According to Extract 2, certain countries within the Eurozone have implemented austerity measures and this would cause the national income of these countries to fall. As a result, they will have less financial ability to import from Germany. This will cause the external demand for German exports to decrease.
- This will cause the national income to fall via the reverse multiplier effect and jobs might be lost, especially in the export industries.

**(b) Explain how 'cutting the cost of labour' has been the basis of Germany's 'export success in the past few years'. [2]**

- With the cutting of the cost of labour, the cost of production in Germany will generally decrease and this will enhance the export competitiveness in the country. As a result, prices of German exports will become more competitive. [1]
- PED of German's  $X > 1 \rightarrow$  quantity demanded for German exports will rise more than proportionately  $\rightarrow \uparrow$  export revenue [1]

**(c) With reference to Extract 2, explain how Germany's external surplus has made it harder for 'the periphery' to recover from deflation. [6]**

- 'the periphery' refers to the other EU member-states that are suffering from deflation
- Define deflation.
- In extract 2, Germany claimed to have a trade surplus with non-EU members but at the same time, the deficits other member-states in EU have with non-EU members has narrowed over the years, resulting in the Eurozone having a large external surplus now. [1m for evidence] This reflects a high demand for Germany's X and the Euro, which is needed to buy the exports of Germany. As such, this puts pressure on the Euro and it appreciates as mentioned in Extract 2. [1m]
- This causes the price of exports in terms of foreign currency to increase while the price of imports falls in terms of Euro. Assuming Marshall-Lerner condition ( $PED_x + PED_m > 1$ ) is fulfilled, there will be a fall in net exports and thus AD. [1m]

- Germany's surplus also indicates that the German's consumption of imports are low. [1m]  
This could be due to the feeble domestic demand as seen in Extract 2. This causes the exports of the weaker European economies to fall, which then results in a drop in their AD since it's a component of AD. [1m]
- Taken together, there will be a net fall in AD which will then result in a fall in the general price level of the Eurozone periphery. [1m]

**(d) Discuss the extent to which Germany is 'crushed by its export obsession'. [8]**

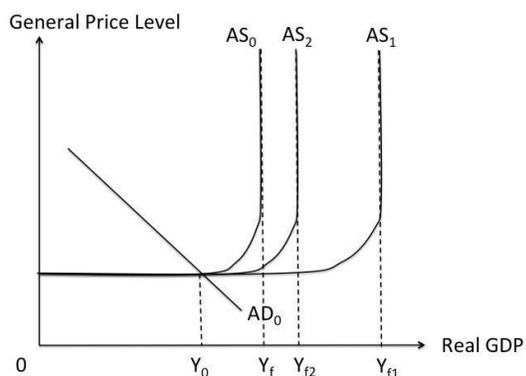
- Germany's export obsession means boosting exports through the fastest way by cutting cost (i.e. wages) of labour.

**Anti-Thesis: Germany is not crushed by its export obsession**

- Germany's approach of boosting exports through cutting the wages of labour is a successful growth strategy.
- As explained in part (b), the cut in wages will help increase export-competitiveness.
- With Germany's export obsession, the cut in wages will lower cost of production and increase SRAS from  $SRAS_0$  to  $SRAS_1$  as seen in Figure 1. And this will increase Germany's national income from  $Y_1$  to  $Y_2$ , leading to actual economic growth. [Draw diagram – Figure 1]

**Thesis: Germany is crushed by its export obsession**

- Because of Germany's obsession with finding the fastest way to boost exports, it is less reliant on R&D (Extract 1) as we see that the total gross fixed investment has fallen steadily in Germany. Due to the lack of R&D, production methods remain the way it is, with little improvement in productivity and this limits the increase in their LRAS from  $AS_0$  to  $AS_2$  instead of  $AS_1$  as seen in Figure 2 and thus, hinders potential economic growth.
- Being too reliant on exports through the cutting of wage labour cost has resulted in the Germans focusing less on investing in human capital. The lack of such investment then prevents it from moving up the value chain. At the same time, it affects the quality of workforce and reduces the attractiveness as a destination for FDI. This decreases the AD and lowers actual economic growth. Furthermore, this limits the increase in their LRAS from  $AS_0$  to  $AS_2$  instead of  $AS_1$  as seen in Figure 2 and thus, hinders potential economic growth.



**Figure 2: Germany's Economy**

- Germany has always relied on cutting the cost of labour (i.e. wages) to keep up its export-competitiveness. But in doing so, this prevents labour from improving its productivity and thus deny workers the opportunity of earning even higher wages.

Reasoned Synthesis

- Students can consider the short run and long run consequences.

<b>Level</b>	<b>Descriptors</b>	<b>Marks</b>
L2	Developed discussion on both the benefit and cost of Germany's export obsession. Such answers should not be points lifted directly from the extract without using any economic analysis (e.g. diagrams).	4 – 6m
L1	Undeveloped discussion on the benefit and/or cost of Germany's export obsession  <i>OR</i>  Mostly irrelevant answers.	1 – 3m
<b>Evaluation</b>	<b>Descriptors</b>	<b>Marks</b>
E2	1 evaluation with justification on the short and long run consequences of Germany's export obsession.	2m
E1	1 evaluation with no justification	1m

(e) **Discuss the economic policies available to the German government that could be an 'answer to Europe's economic woes'. [10]**

*Note: Europe's economic woes refers to the deflation they are experiencing → policies should address the deflation → All policies must linked to how the other economies will improve.*

**Thesis: Germany's Policies could be an answer to Europe's economic woes**

- Expansionary fiscal policy (Extract 2) undertaken by Germany
  - Decrease its VAT (value added tax / consumption tax) to stimulate consumption of imports.
  - Decrease personal income tax which will increase the disposal incomes of Germans. This will result in an increase in consumption of imports by Germans.
  - Decrease corporate income tax to stimulate investment and increase AD. NY increases and German imports increase.
  - Increase in imports by Germans could mean that the other European countries are exporting more to Germany → ↑ export revenue and subsequently next exports. AD rises and NY and GPL increases, decreasing deflationary pressures of the other European countries
  
- SS-side policies by the German Government - structural reforms to ↑ productivity
  - Lower barriers to entry for firms and loosen regulation to encourage creation of firms in the services sector. Increased number of firms/enterprises will increase the demand for labour in this newly created service sector. This may open up employment opportunities for workers in other European economies and increase incomes of these workers. Consumption in the other European economies increases and stimulate the economy, increasing NY and decreasing deflationary pressures.
  - The services sector complements the manufacturing sector [Extract 3]. Building up the services sector may boost productivity in the manufacturing sector and improve the quality of German exports through the provision of cost efficient and innovative service solutions. This allows for wage increases (German workers as well as workers from other European countries) in the manufacturing sector, increasing the incomes of German and other European workers. This increases the disposable income of German workers which will increase the demand for imports. As incomes of other European workers increase, consumption increases. As consumption and exports in these other European economies increase, AD increases, increasing NY and decreasing deflationary pressures.

**Anti-Thesis: Germany's Policies could be an answer to Europe's economic woes**

- Limitations of expansionary fiscal policy
  - Economic uncertainty not just in EU but all over the world may result in German consumers still not consuming despite low unemployment (i.e. they have the capacity to spend) and investors still not investing.
  - Increase in incomes of German workers may not mean that imports increase as German workers may choose to spend their incomes on domestic goods. Thus increases in the incomes of German workers may not help to solve the economic problems of other European countries.
  - Even if the Germans did import more, it may not be from other European countries, but from non-euro member countries. Therefore, the other European countries may not benefit from an increase in the incomes of Germans and deflationary pressures still remain.

- Limitations of supply-side policies
  - The loosening of regulation may not be enough of an incentive to create service based firms as firms may not have the know-how/knowledge to start up a business or confidence in the economy to want to start up a business. This may then no help to boost the German manufacturing industry and there will not be any rise in wages of workers.
  - Germany is said to be lagging in productivity. A shift to a larger service based economy may not improve productivity as the services sector is known for being the sector that holds back productivity.
  
- Justified Evaluation: an assessment of which policy is the best to address Europe's economic woes

<b>Level</b>	<b>Descriptors</b>	<b>Marks</b>
L2	Developed discussion of the policies available to Germany to help solve Europe's economic woes.	4 – 7m
L1	Undeveloped discussion on both the benefit and cost of Germany's export obsession  <i>OR</i>  One sided explanation of the policies available to Germany to help solve Europe's economic woes	1 – 3m
<b>Evaluation</b>	<b>Descriptors</b>	<b>Marks</b>
E2	1 evaluation with justification	2m
E1	1 evaluation with no justification	1m