

## 2015 PJC H2 Econs P1 Q2

### Suggested answers:

- (a) (i) Compare the change in China's current account balance with that of US between 2009 and 2013. [2]

Suggested answer

China's current account balance is in a surplus and the surplus fell from 2009 to 2013 whereas US current account balance is in a deficit and the deficit reduces over the same time period.

- (ii) With reference to Table 1 and Figure 1, explain how far the data might show that China has made progress in rebalancing the economy away from export. [4]

Suggested answer

- China's current account surplus worsened from 2009 to 2013, indicating that net exports has likely fallen (Figure 1). Nevertheless Table 3 shows that the growth in real GDP remained relatively stable from 2008 to 2013. This suggests that China's growth could have been supported by domestic consumption instead of exports. [2]
- However, overall consumption has only increase by a mere 1% point of GDP. Hence, China's growth could have been due to a rise in government spending instead of a rise in domestic consumption. In this case, no rebalancing of the economy would have taken place. [2]

- (b) Explain why China's "demographic constraints" is of "immediate concern"? [4]

Suggested answer

Due to its ageing population and declining population growth, the supply of labour is no longer unlimited. This means that there will be a loss of easy availability of abundant cheap labour that fuelled China's massive industrial expansion. This is of immediate concern as this means a fall in potential output and growth and a rise in GPL as represented by a leftward shift of the long run AS curve on a constant AD curve. In order to maintain or increase productivity growth, there is a need for more investment in human capital, research and development, and institutional reforms.

Suggested mark scheme

Explain meaning of demographic challenge – 1m

Explain why it is of concern – 3m

- (c) Identify one injection and one leakage (or withdrawal) shown in the tables that would change if consumption became the "main engine of growth" in China in the future. [2]

Suggested answer

1 injection – Gross capital formation or exports

1 withdrawal – gross savings or imports

- (d) Extract 7 highlights that "when the Commerce Department imposes tariffs on China plywood, it raises prices on the many to benefit the protected few".

Discuss whether the US government's policy of protection for the plywood industry benefits the minority and penalizes the majority? [8]

Suggested answer

In the US, punitive tariff was imposed on plywood imported from China. This has benefited producers and suppliers in the plywood industry in the US.

### Benefits the minority: Causal links for effects of tariff on plywood producers in US

Price of imported plywood from China  $\uparrow$  in USD  $\rightarrow$  quantity demanded for China's plywood  $\downarrow$  as consumers and businesses that used to import China's plywood will switch to domestically produced plywood  $\rightarrow$  domestic plywood producers will have an  $\uparrow$  in revenue  $\rightarrow$   $\uparrow$  in profit (if costs unchanged)  $\rightarrow$  rise in employment in the US plywood industry.

### Penalizes the majority:

1. COP for many other industries (such as construction and woodworking/furniture producers) will  $\uparrow \rightarrow \downarrow$  in SS  $\rightarrow \downarrow$  in equilibrium Q in the respective markets  $\rightarrow$  a  $\downarrow$  in production will lead to a  $\downarrow$  in derive demand for FOPs including labour  $\rightarrow$  rise in unemployment in these markets/industries (higher COP might result in these firms to resort to cutting corners to save costs  $\rightarrow$  adversely affect the quality of their products  $\rightarrow$  consumer welfare will be compromised)

2. Tariff  $\rightarrow$  SS of plywood in the US market  $\downarrow \rightarrow$  shortage  $\rightarrow$  upward pressure on P  $\rightarrow \downarrow$  in consumer surplus (on top of that, according to the extract, the US plywood suppliers already control 80% of market share in the domestic market, their complaint to demand for tariff to protect them will further allow them to exploit their strong market share/ monopoly power)

Hence, due to the fact that plywood is widely used in the United States, households and many industries use plywood. When the US government imposed punitive tariff on Chinese plywood, this will only benefit the producers and suppliers of the US plywood industry. Businesses in other markets which require plywood as FOP, and households will be penalized.

- (e) Extract 4 and 5 describes China's rebalancing as moving away from export-driven growth to consumption driven growth. Assess the impact of such rebalancing on China and her trading partners. [10]

### Suggested answer

In view of the current challenging external environment, there is a need for China to rebalance her economy from export driven growth to consumption driven growth. This move results in both positive and negative impact on China as well as her trading partners.

### **Impact on China**

#### **1. Less vulnerable to external shocks, thus preventing large fluctuations in national income**

In view of the slowing global economy (Extract 4), by reducing the reliance on exports and encouraging domestic consumption, China could mitigate the fall in national income as she will be less vulnerable to external shocks, thus preventing large fluctuations in national income.

#### **2. More stable long-term growth**

Extract 4 mentions that China is suffering from over-investment as many large industries are suffering from excess capacity. While there is ample capacity, there seems to be a lack of demand to utilise the capital goods. Given the poor global economy, the demand for exports may be lacking. Hence increasing domestic consumption will increase the utilisation of the capital goods, bringing about actual growth which is likely to be more stable compared to one relying on external sector. -However, successful rebalancing largely depends on the ability of household consumption to pick up but it has not been able to do that so far.

#### **3. Increase current standard of living**

Increasing domestic consumption increases current standard of living (SOL). As seen in Extract 5, 'with a rise in income.....' and Table 3 Consumption expenditure increases (marginally) from 2009 to 2013. This increases the purchasing power to consume more goods and services, thus increasing the quantitative aspect of SOL. Moreover, rebalancing slows down the economic

growth, which slows down production and leads to less environmental degradation (Extract 4). This may improve the quality of air as less air pollutants are emitted, hence improving the qualitative aspect of SOL. China's aim of rebalancing from export to domestic sector is linked to the appreciation of the Yuan. A stronger yuan will give citizens greater purchasing power to consume imported goods, ceteris paribus. Their material SOL increases with an increase in their ability to consume. Slower growth also mean 'more inclusive growth' implying a narrowing of the income gap as the Chinese tries to promote domestic consumption through various pro consumption incentives especially targeted at the rural poor.

### **Impact on her trading partners**

#### **Gainers – ASEAN and South East Asia**

China's economic rebalancing can be a positive factor for ASEAN's development. As production now cater more for the domestic rather than export sector, there will be less competitive pressures on ASEAN's labour-intensive manufactured exports. More FDI may also find its way back to Southeast Asia. This will allow ASEAN to experience an increase in exports and FDI and hence actual and potential growth.

#### **Gainers – commodities importers**

As China turns inward, Chinese consumers are expected to buy more luxury goods and buy less commodities such as iron ore pellets or copper wire. This fall in demand for commodities will lead to a fall in prices of such commodities, benefiting all importers of such commodities in terms of lowering cost of production.

#### **Improve relationship with the global economy**

A rebalance helps improve relationship with the global economy as this would improve the external balances of trading partners such as the US and reduces tendency of retaliatory actions such as protectionism.

#### **Losers**

Losers of the rebalancing China economy in the global economy are commodities exporters like Brazil and South Africa. A fall in demand for such commodities from China (one of the world leading importer) will lead to a fall in prices and export revenue and hence actual growth for these exporters.

#### **Judgment**

In view of the weak external environment, rising labour cost and a strong yuan, a rebalancing from external to consumption-led growth is more sustainable and desirable, not only for the China, but also for its neighbours. The challenges facing China at the moment is how to bring about this rebalancing successfully.