



HWA CHONG INSTITUTION
C2 Preliminary Examination 2016
Higher 1 Economics

Essay Question 4
Suggested Answer

- 4 (a) Explain how benefits to the economy can arise from specialisation and trade.
- (b) Discuss whether specialisation and trade will always improve the standard of living in a country.

Part (a)

Suggested Essay Outline

Introduction

- An economy can benefit from specialisation and trade (exchange) and is explained by the law of comparative advantage.
- The Law of Comparative Advantage states that trade or in this question, exchange, can benefit all countries if they specialise in the goods in which they have a comparative advantage in the production of a good, that is, she can produce the good at a lower opportunity cost than another country.

Body

- State the assumptions

	Production of textiles and cars before specialization and trade		Opportunity Cost of producing 1 unit of		Production with: USA: Partial Specialise with 75% resources in cars and 25% in textile Vietnam: Full specialization in textile		Consumption after trade by exchanging 12T for 12C TOT: 1T:1C	
Countries	Textiles	Cars	Textiles	Cars	Textiles	Cars	Textiles	Cars
USA	20	30	3/2 C	2/3 T	10	45	22	33
Vietnam	15	10	2/3 C	3/2 T	30	0	18	12
World	35	40			40	45	40	45

- Before specialization, USA produces 20 units of textiles and 30 units of cars which means it has to give up 3/2 unit of cars for 1 unit of textile or 2/3 unit of textiles for 1 car.
- On the other hand, Vietnam produces 15 units of textiles and 10 units of cars which means it has to give up 2/3 unit of cars for 1 unit of textiles or 3/2 unit of textiles for 1 unit of car.
- This implies that USA and Vietnam have a lower opportunity cost or comparative advantage in producing cars and textiles respectively.
- Assuming USA will have partial specialization in cars using 75% of resources and 25% of resources in textiles while Vietnam goes into full specialization in textiles. Specialisation will

results in mass production and enable the firms and industry to grow and thus enjoy both internal and external economies of scale.

- USA will produce 10 units of textiles and 45 units of cars and Vietnam will produce 30 units of textiles only.
- These countries will agree to trade if the terms of trade lie between: $\frac{2}{3} \text{ cars} < 1 \text{ textile} < \frac{3}{2} \text{ cars}$ or $\frac{2}{3} \text{ textiles} < 1 \text{ car} < \frac{3}{2} \text{ textiles}$. Terms of trade (TOT) measures the rate of exchange of one good or service. The exact terms of trade will depend on the strength of demand and the relative bargaining powers of the countries involved.
- Assuming they agree on the terms of trade of 1 unit of textiles to 1 unit of cars and exchange 12 units of textiles for 12 units of cars.
- After specialization and trade, USA gains 2 and 3 units of textiles and cars respectively and Vietnam gain 3 and 2 units of textiles and cars respectively. The world output also increases by 5 units each for textiles and cars.
- It is clear that after specialization and trade, both USA and Vietnam gain from trade and consume beyond their PPC.

Conclusion

- Although USA has absolute advantage in the production of both Textile and Cars, USA can benefit from specialisation and exchange if she specialises in producing and exporting the good (Cars) with relatively lower opportunity cost compared with Vietnam and import the good (Textile) with relatively higher opportunity cost compared with Vietnam.

Level	Descriptor	Marks
L3	For an explanation which accurately explain how benefits to the economy can arise from specialisation and trade.	7-10
L2	There is attempt to use Theory of Comparative advantage. However, analysis is not well developed.	5-6
L1	Some attempt to answer the question with conceptual errors <ul style="list-style-type: none"> • Students give benefits of free trade with no reference to CA at all • Some recognition of CA but gave absolute advantage numbers or answer is extremely brief 	1-4

(b) Discuss whether specialisation and trade will always improve the standard of living in a country. [15]

Introduction

Define key terms:

- The standard of living refers to the level of material and non-material well-being of an individual or household. The material well-being is measured by the quantities of goods and services consumed while non-material SOL is measured by factors such as the quality of healthcare and education standards, happiness and stress levels.

The extent to which a country's standard of living will improve depends on a few key factors which are both economic and non-economic in nature, which we will discuss in this essay.

Thesis 1: Specialisation and trade will result in greater flows of goods and services and economic growth and hence countries enjoy an improvement in its material standard of living.

Specialisation and trade has led to a rapid expansion of international trade in goods and services. Countries win when they gain market access for their exports due to trade liberalisation. With trade, the demand for the country's exports by the rest of the world increases. This will result in a rise in export earnings. Assuming that the rise in demand for exports is higher than the rise in demand for imports, there will be a rise in net exports causing the aggregate demand to rise.

Explain and draw AD/AS diagram

The rise in real national output, assuming that population is constant, implies that people in the country are better off because it could be that more goods and services have been produced and made available for consumption. Hence more wants are satisfied. The rise in national income and fall in unemployment will result in higher purchasing power of the people.

Thus, with expansion of trade due to trade liberalisation, most exporting countries enjoy a rise in its material standard of living as a result of trade fostering its economic growth and employment.

Optional pt: Specialisation and trade might also result in inflow of foreign direct investment which will result in a rise in future standard of living.

Greater flow of goods and services may result in transfer of technology.

In the long run, the rise in quantity of capital goods due to the rise in FDI will result in a rise in productive capacity. This will result in a rise in the country's LRAS causing the AS curve to shift from AS_1 to AS_2 rise resulting in a rise in full employment level of real national output from Y_{F1} to Y_{F2} . This results in potential economic growth.

As a result, the country's future living standard can be expected to improve due to the ability to produce more goods and services in the future.

EV: The level of inflow of FDI depends on the country's ability to attract it. Countries whose conditions are not favourable for investments will suffer from an outflow of FDI. Eg. Political instability and poor infrastructure development.

Anti-thesis 1: Specialisation and Trade might result in structural unemployment which will worsen the country's material standard of living.

With **Specialisation and Trade**, large numbers of (mainly low-skilled) workers from China and India enter into the global labour force. This results in the loss of comparative advantage in low-end manufactured goods due to outsourcing of jobs. There will be loss of jobs mainly for low-skilled workers and older workers, thus resulting in structural unemployment due to mismatch of jobs as these workers find it difficult to switch to the sunrise industries due to the lack of skills.

This results in structural unemployment in the country which worsens the SOL.

However, the extent to which a country will suffer from structural unemployment and a fall in material SOL depends on its ability to train workers to take up jobs in the new sunrise industries with the relevant SS- side policies. In Singapore, the government emphasises on continuous upgrading of skills and implemented many training and re-training programmes which increases labour mobility. This enables workers to switch and find new jobs and mitigates the negative impact of structural unemployment that arises from globalisation.

Specialisation and Trade might also cause a country's non-material standard of living to worsen.

Despite the rise in income, due to increase in export earnings and investment, non-material quality of life might deteriorate with more globalisation. The resultant rise in production might increase the level of pollution in a country. For example, forest burning in Indonesia. Despite the rise in FDI in the country which resulted in a rise in income, the Indonesians suffered from the worsening air quality which in turn worsened their non-material standard of living.

The increase in level of output may also mean that workers in some developing countries are working long hours assuming that labour productivity level remains unchanged. This reduces the amount of leisure time reducing quality of life.

Thus there will be a fall in non-material standard of living. The government of the country must therefore intervene by implementing regulations to curb the level of pollution and ensure the welfare of workers is well taken care of in order to lessen these negative impacts. The extent of this negative impact on SOL will be therefore dependent on how the governments of different countries react and prevent pollution from going out of control.

Conclusion

Specialisation and Trade is beneficial because it brings about increased output and income, thereby raising the standard of living of the people. However, in the short run, countries may face some problems like unemployment, pollution and the fall in quality of life. The extent of these impacts also depends on the characteristics and conditions of these countries. Countries may use regulation and supply side policies to address the impacts. This is so that the full benefits of specialisation and trade can be realised while minimising its negative impact.

Level	Descriptors	Marks
L3	<ul style="list-style-type: none">• Sound analysis of the impact (both positive & negative) of Specialisation and Trade on current, future material SOL and	9-11

	Non-material SOL. <ul style="list-style-type: none"> • Examples given are clear and relevant. • Conclusion is reasonably supported. 	
L2	<ul style="list-style-type: none"> • Adequate understanding of the impact of Specialisation and Trade on standard of living with some recognition of the differing impact on different countries. • Shows impact on only 1 form of SOL 	6-8
L1	<ul style="list-style-type: none"> • Splattering of points. • Very weak response to question, with vague understanding of the impact of globalisation on various aspects of standard of living. 	1-5
E2	<ul style="list-style-type: none"> • For an evaluative discussion, or one that is supported by rigorous analysis. • Able to provide a reasonable personal view. 	3-4
E1	<ul style="list-style-type: none"> • For an unexplained judgment, or one that is not supported by analysis. 	1-2