

Economic Rebalancing in China and the UK

Table 1: GDP growth rates (Annual % change at constant prices)

	2009	2010	2011	2012	2013	2014
China	9.2	10.6	9.5	7.8	7.7	7.3
UK	-4.2	1.5	2.0	1.2	2.2	2.9

Table 2: Balances on current account (US\$ billion)

	2009	2010	2011	2012	2013	2014
China	243.3	237.9	136.1	215.4	148.3	219.7
UK	-69.5	-67.7	-43.7	-86.5	-122.3	-151.9

Source of Tables 1 and 2: World Bank

Table 3: Government budget balance (% of GDP)

	2009	2010	2011	2012	2013	2014
China	-1.1	-0.7	0.1	-0.3	-0.7	-1.2
UK	-11.2	-10.0	-7.9	-6.3	-5.9	-5.3

Source: OECD

Extract 1: China Approaching the End of Export-Led Growth Story?

Over the last three decades China has experienced a remarkable transformation. Strong and relentless economic growth was achieved on the back of productive investment, an ample and industrious labour force, relatively low wages resulting in a parabolic rise in exports.

China's growth strategy proved highly successful but its weaknesses became more evident around the time when the global financial crisis erupted and international trade suffered a sudden collapse. Subdued export demand was to a large extent offset by huge domestic stimulus measures and a credit-driven construction boom. The credit-fuelled investment boom helped to maintain economic growth rates close to pre-crisis levels. The flip side of this was a worrying rise in debt levels, inefficient capital allocation, industrial overcapacity and a housing bubble. Moreover, relatively high food price inflation against the backdrop of high income inequality and slowing income growth indicates that a large part of the less well-off population remains vulnerable to price rises.

With prospects for export growth weakening, Chinese optimists hoped for a seamless transition to a sustainable domestic consumption-led growth model. In 2012, the share of household consumption in GDP stood at 36%, which is extremely low by global standards, with a global average of around 60%.

In a bid to encourage consumption-led growth and push the economy to shift away from low-cost manufacturing which is polluting, the government is driving wage growth by gradually increasing minimum wages. The downside of these developments is that wage growth is outpacing labour productivity growth. This is leading to rising real labour costs and a decline in the international competitiveness of Chinese companies, thus affecting employment.

Source: *Euromonitor Research*, 16th March 2014

Extract 2: For China, a Shift from Exports to Consumption

China is in the midst of a major overhaul aimed at weaning its economy off its decades-long reliance on often inefficient state-driven investment and a manufacturing sector that has been highly geared to exporting to the rest of the world. The government has made it clear that it is now prioritising economic rebalancing over short term growth.

Data released underlined just how rapidly the overall economy has been cooling as Beijing has sought, over the past two years, to rein in often poorly allocated lending and close down inefficient or polluting industries. Many analysts expect the pace to cool further this year as Beijing's "tough love" approach to overhauling the economy continues to crimp lending and industrial activity.

Wages have risen as millions of Chinese have moved from the countryside into the cities. And because China is rapidly aging, this means it is gradually getting harder for employers to find and retain workers. That has made life harder for many exporters, who are finding it difficult to deliver goods inexpensively.

For China to generate more domestic consumption, said Richard Ho, who recently founded Athenee, a boutique advisory firm in Shanghai, it needs to foster a more vibrant private sector.

"If you can unleash the power of private enterprise and create a level playing field for private and state-owned businesses," he said, "employment and wage growth can continue — supporting domestic consumption."

Source: *The New York Times*, 20th January 2014

Extract 3: There's Something Very Wrong with UK's Recovery

Britain's economic recovery is leaving the country's manufacturers behind, according to new European Commission figures. The stats show UK investment in equipment has fallen, even as the economy has picked up. Recovery is being driven by the services sector and domestic consumption rather than by manufacturing, business investment and exports. Weak investment in the sector will concern British policymakers who have been looking to rebalance the economy toward exports.

The manufacturing sector has performed particularly poorly despite a shift towards high-tech, advanced manufacturing with global supply chains. What should concern the government is that the Commission's figures show investment in new technology falling well behind international peers. Failure to keep pace could result in the UK becoming less competitive and ultimately impact the future prospects for the sector. This threatens to exacerbate the trend of its declining importance.

The worst news for policymakers is that the traditional currency devaluation for manufacturing no longer appears to have the intended effect. Despite a 20-25% decline in the value of sterling, the cheaper relative prices of their goods did not appear to benefit manufacturers much. Globalisation has turned lots of countries into stopping-points in the manufacture of individual products. Components are imported, augmented and re-exported. This suggests the shift in the manufacturing sector has weakened the impact of currency devaluation.

Source: *Business Insider*, 12th September 2014

Extract 4: UK Policies and Economic Growth

The IMF says that growth has rebounded more strongly than anticipated in the UK on the back of easier credit conditions and increased confidence. But it cautions that the recovery has been unbalanced, with business investment and exports still disappointing. Furthermore, an external shock involving further growth disappointment in emerging market economies could spill over to the euro area and the UK.

In the UK, monetary policy should stay accommodative, and recent modifications by the Bank of England to the forward-guidance framework are therefore welcome. Forward guidance is the term used by central banks to communicate to consumer and investors what their future monetary policy will be and allow them to manage their expectations.

Similarly, the government's efforts to raise capital spending while staying within the budget limit in the medium term should help bolster recovery and long-term growth.

Source: *BBC News*, 8th April 2014

Questions

- (a) (i) Compare the change in China's current account balance with that of the UK between 2009 and 2014. [2]
- (ii) With reference to the data, suggest the reason for the improvement in the UK's budget balance from 2009 to 2014. [1]
- (b) Explain why China's growth is one that is referred to as investment and export driven. [2]
- (c) Explain how creating a level playing field for private and state owned businesses can increase employment. [2]
- (d) Explain why "the traditional currency devaluation for manufacturing no longer appears to have the intended effect." [5]
- (e) Discuss the effectiveness of the policies the UK government has implemented to shift away from consumption-driven to investment-driven growth. [8]
- (f) The data provides an explanation of two different policy approaches to generating economic growth. Assess the economic case for these two different approaches. [10]

[Total: 30]

Y6 H2 Prelim II CSQ2 - Economic Rebalancing in China and the UK

Suggested Answers

(a)

- (i) Compare the change in China's current account balance with that of the UK between 2009 and 2014.
- Difference: China has a current account surplus while UK has a current account deficit. [1]
 - Similarity: Both current account balance decreased. [1]
- (ii) With reference to the data, suggest the reason for the improvement in the UK's budget balance from 2009 to 2014. [1]
- From Table 1, UK GDP growth is increasing [0.5]. This results in increasing government tax revenue which leads to the decreasing government budget deficit [0.5].

(b) Explain why China's growth is one that is referred to as investment and export driven. [2]

Possible evidences

For Both

- Extract 5: Strong and relentless economic growth was achieved on the back of productive investment and parabolic rise in exports.
- Extract 6: China has relied on state-driven investment and a manufacturing sector that has been highly geared for exports for decades.

For investment driven

- Credit-fuelled investment boom helped to maintain economic growth to pre-crisis level.
- Ample and industrious labour force attracts FDI

For export driven

- Ample and industries labour force lead to CA in manufacturing labour intensive goods
- Based on Table 2, current account is consistently in surplus.
- During the crisis, demand collapse

(c) Explain how creating a level playing field for private and state owned businesses can increase employment. [2]

- creating a level playing field increases competition → increases incentive for firms to innovate → increase LRAS [1]
- increase in output → require more factor input such as labour → increase employment [1]

(d) Explain why extract 3 suggests "the traditional currency devaluation for manufacturing no longer appears to have the intended effect." [5]

- Explain how devaluation works: $ExR \downarrow \rightarrow P_X \downarrow + P_M \uparrow \rightarrow MLC \rightarrow NX \uparrow$ [1]
- Global supply chain → components are imported, augmented and re-exported [Extract 3] [1] → price of imports become relatively more expensive with devaluation

- Cost of production increases → Price of exports will rise. [1]
- Net effect: Fall in price of exports due to devaluation may be largely offset by the increase in price to due rising COP [1]
- Overall exports will not rise as much → “weakened the impact of currency devaluation” [1]

(e) Discuss the effectiveness of the policies the UK government has implemented to shift away from consumption-driven to investment-driven growth. [8]

Fiscal Policy

- “government's efforts to raise capital spending” [Extract 4] → expansionary FP (increase G) → development expenditure

Limitations

- UK is experiencing a budget deficit [Table 3] → government has to spend ‘within the medium-term fiscal envelope’ [Extract 4] → increase in G may not be significant (*NB: students must link the G to infrastructure*)

Monetary Policy

- “easier credit conditions” [Extract 4] → regulations eased to enable firms to obtain credit easily (*NB: not decrease in i/r*) → expansionary MP → increase I
- Move to a ‘forward guidance framework’ [Extract 4] → banks aim to calm uncertainty in markets and corporations → build confidence in the market → encourage I

Limitations

- Easier credit conditions may increase C as well → “growth has rebounded more strongly ... but business investment and exports still disappointing” [Extract 4] → can be inferred that the growth is due to C and not I and X
- Effectiveness of ‘forward guidance framework’ in increasing I still depends on the confidence of firms and their expectations regarding the economic outlook → “the recovery has been unbalanced ... external shock involving further growth disappointment in emerging market economies could spill over to the euro area and the UK” [Extract 4]

Exchange Rate Policy

- Devaluation decreases the cost of investing in the UK → increases the rate of return → increases FDI
- Traditional currency devaluation [as explained in part (d)] → $NX \uparrow$ → increases growth prospects and drives I

Limitations

- The “shift in the manufacturing sector has weakened the impact of currency devaluation” explained in part (d)

LORMS		
L2	Developed and balanced analysis on whether the policies are effective, with clear links between policies and investment. Coverage of all three policies is required to achieve the top marks in the level.	6
	Undeveloped but balanced analysis on whether the policies are effective. <i>*FP and MP must be well explained to obtain 5m as exchange rate policy and its limitations have been</i>	4-5

	<i>explained in part (d).</i>	
L1	Developed but one sided analysis.	2-3
	Descriptive answer with no economic analysis and no framework to support.	1

EVALUATION		
E2	Developed judgment that is supported with economic analysis.	2
E1	Unexplained judgment.	1

- (f) The data provides an explanation of two different policy approaches to generating economic growth. Assess the economic case for these two different approaches. [10]

China	UK
<p>1. To make the Chinese economy more resilient / reduce its economic vulnerability due to external factors</p> <ul style="list-style-type: none"> China is experiencing slow economic growth caused by internal and external factors. According to extract 1, <i>“strong and relentless economic growth was achieved on the back of a parabolic rise in exports”</i>. This indicates a high reliance on the external sector (exports) for growth. With the global economic slowdown, demand for China’s exports fell as mentioned in extract 1, <i>“the global financial crisis erupted and international trade suffered a sudden collapse”</i>. Hence, economic rebalancing away from investment and exports allows China be less vulnerable to the external sector for growth in the future. <p>2. To reduce inefficiency and rising debt</p> <ul style="list-style-type: none"> China depended on cheap credit to fuel its investment. According to extract 1, <i>“credit-fuelled investment boom [led to] a worrying rise in debt levels, inefficient capital allocation and industrial overcapacity”</i>. With the cheap credit which lowers the cost of borrowing, investment in infrastructure and construction increases, leading to large overcapacity in the industry. This is seen as a rightward shift of the LRAS without a corresponding increase in AD. Cheap credit also encourages consumers to consumer beyond their means, leading to rising debt levels. 	<p>1. To increase the competitiveness of UK manufacturing sector</p> <ul style="list-style-type: none"> UK investment in manufacturing sector is falling behind other countries. As stated in extract 3, <i>“investment in new technology falling well behind international peers”</i>. This translates to a loss of competitiveness of UKs exports due to loss of comparative advantage and lower productivity. Hence rebalance the economy to investment-driven growth via policies that encourages research and development as well as innovation will raise productivity in the manufacturing sector and directly increase investment. <p>2. To decrease the reliance on consumption driven growth</p> <ul style="list-style-type: none"> Lower export demand from major trading partners caused a slowdown in economic recovery in the UK. As mentioned in extract 4, <i>“external shock involving further growth disappointment in emerging market economies could spill over to the euro area”</i>. Hence the shift toward investment-driven growth will increase export competitiveness as mentioned above. The lower export prices are expected to mitigate the fall in export demand due to slowing growth in other countries. This will increase their export percentage of GDP (lower C percentage of GDP).

<ul style="list-style-type: none"> • Economic rebalancing away from investment and exports will reduce investment levels and thus reduce the industrial overcapacity. The removal of cheap credit, as seen in extract 2 where <i>“Beijing’s tough love approach ... to crimp lending”</i> will moderate the rise in debt levels. • China also depended a lot on state-owned enterprises as well as private firms to drive investment as mentioned in extract 2, <i>“inefficient state-driven investment”</i>. This led to state-driven inefficiencies and wastage of resources. Moving away from an investment-driven economy would result in less state intervention e.g. subsidies, tax exemptions. This lowers the returns to investment and results in a fall investment as projects that were previously viable are no longer viable. This reduces inefficiencies in state-owned and private firms and drives out some firms from the industry as these inefficient firms cannot continue production without government help. 	
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LORMS		
L2	Developed analysis on the reasons for the different policy approaches in both countries.	7
	Undeveloped analysis on the reasons for the different policy approaches in both countries.	4-6
L1	Developed analysis on the reasons for a policy approach by one country.	2-3
	Descriptive answer with no economic analysis	1

EVALUATION		
E2	Developed judgment that is supported with economic analysis.	2-3
E1	Unexplained judgment.	1