

## Prelim II – Qn 4

In 2014, the five countries recorded the highest GDP growth rates were Turkmenistan (10.1%), Mongolia (9.1%), Democratic Republic of the Congo (8.6%), Myanmar (8.5%) and Mozambique (8.2%).  
Source: IMF, accessed 18 August 2016

- (a) Explain the potential causes of such high GDP growth rates. [10]  
(b) Assess the likely impact of the high GDP growth rates on these countries. [15]

### Suggested Answer

#### Part (a)

Economic growth can consist of actual and/or potential growth. Actual economic growth is measured as the rate of increase in real GDP whereas potential growth refers to the growth in the production capacity of the economy, which may or may not be present when there is actual economic growth. The high growth rates could be due to any of the following: an increase in aggregate demand (AD), increase in short run aggregate supply (SRAS) or increase in long run aggregate supply (LRAS).

Turkmenistan, Mongolia, Democratic Republic of the Congo, Myanmar and Mozambique are likely to be relatively less developed economies with a lot of unemployed resources. With the opening up of their capital markets to investments in recent years (especially long term capital), they are likely to have attracted Multinational Corporations (MNCs) into the country, which in turn increase the domestic. Since aggregate demand = domestic consumption + domestic investment + government expenditure + net exports, and assuming that the initial equilibrium is at  $Y_0$  and  $P_0$ , the large increase in  $I$  will lead to a large increase in AD from  $AD_0$  to  $AD_1$  and a multiple increase in national income from  $Y_0$  to  $Y_1$  via the multiplier effect, indicating that high rates of actual growth is achieved as shown in Figure 1.

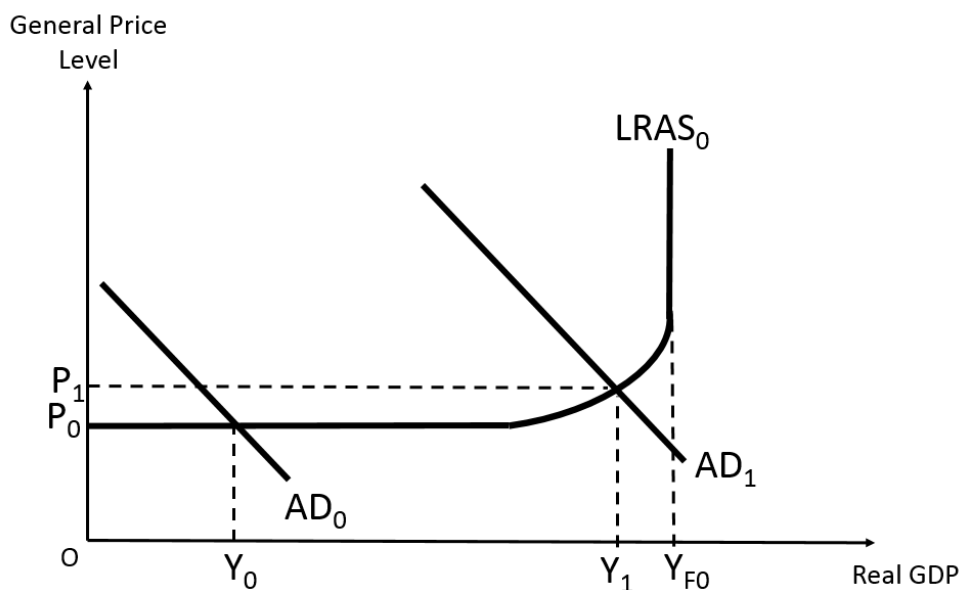


Figure 1: Increase in AD

Furthermore, with increasing government's efforts in developing the infrastructures in the countries to attract investment and facilitate trade, there was a substantial increase in public investment expenditure in the area of transportation where roads were built and transportation infrastructures were developed. This will increase the quality and quality of capital in these countries, increasing the countries' long run aggregate supply from  $LRAS_0$  to  $LRAS_1$  and hence the productive capacity of the countries as shown in figure 2. Assuming the initial equilibrium is at  $Y_0$  and  $P_0$ , actual growth is further achieved with the increase in national income from  $Y_0$  to  $Y_1$  together with the potential growth from  $Y_{F0}$  to  $Y_{F1}$ .

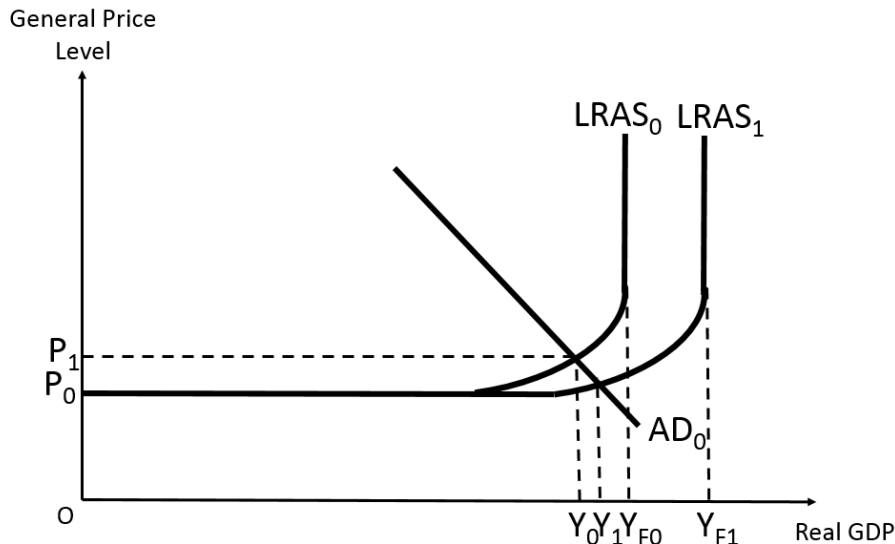


Figure 2: Increase in LRAS

With the recent drop in oil prices, this translates to a fall in cost of production since oil is a factor input used in the production of most goods and services. Thus, the short run aggregate supply will increase from  $SRAS_0$  to  $SRAS_1$  as shown in Figure 3. Assuming the initial equilibrium is at  $Y_0$  and  $P_0$ , the increase in SRAS will cause an increase in national income from  $Y_0$  to  $Y_1$ , boost the economy further.

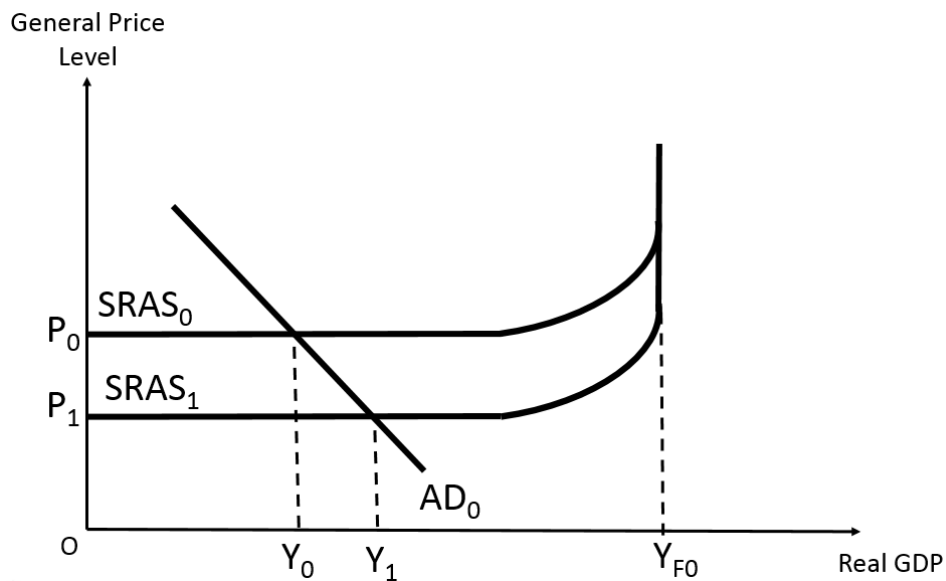


Figure 3: Increase in SRAS

Level	Description	Marks
L3	Developed explanation of 3 different causes ( $\uparrow AD$ , $\uparrow SRAS$ , $\uparrow LRAS$ ) leading to actual growth and/ or economic growth.	8-10
L2	Undeveloped explanation of 2 different causes ( $\uparrow AD$ / $\uparrow SRAS$ / $\uparrow LRAS$ ) leading to actual growth and/ or economic growth.	5-7
L1	Smattering of valid points	1-4

## Part (b)

The countries mentioned in the extract recorded growth rates in the excess of 8% in a period where global growth rates averaged at 4%. The very high growth rates are likely to have both positive and negative impact on these countries. This essay will first explore the various possible reasons contributing to such high growth rates and consequently the impact on both the key economic indicators of the economies.

If economic growth was achieved by an increase in aggregate supply (AS), either in the short run (SR) or the long run (LR), the general price level falls leading to price stability. With reference to Figure 1 and Figure 2, when AS increases from  $SRAS_0$  to  $SRAS_1$ , or from  $LRAS_0$  to  $LRAS_1$ , national income (NY) increases from  $NY_0$  to  $NY_1$  and the general price level falls from  $P_0$  to  $P_1$ . Price stability has a positive impact on an economy because it encourages investment leading to sustained economic growth in the future.

On the other hand, if economic growth was achieved by increase in aggregate demand (AD), there would be potential inflationary pressures in the economy. However, as mentioned in part (a), Turkmenistan, Mongolia, Democratic Republic of the Congo, Myanmar and Mozambique are likely to be relatively less developed economies with a lot of unemployed resources. Thus, it is likely that inflationary pressures may not set in in the immediate future and negatively impact the economy. At the present, these high GDP growth rates are likely to boost investor confidence in the country's economy and this may encourage greater inflow of foreign direct investment which can contribute to sustained economic growth in the future.

Another positive impact that could arise from economic growth is that of increased investor confidence in the economy and consequently an increase in foreign direct investment leading to an improvement in the financial account position in the balance of payments (BOP). In fact, if the economic growth was a result of an inflow in foreign direct investment, it can be seen that investment can positively feedback into the economy in the form of greater investment prospects in the future, ensuring sustained economic growth.

Despite a possible worsening of the BOP position or a larger BOP deficit, large imports of fixed capital for development is not a problem that the government should worry about. Capital accumulation has a positive impact on the economy in the long run as it increases the productive capacity of the economy in the long run. In addition to increasing employment opportunities it also helps the economy to develop industries that they have comparative advantage in so that the economy remains competitive in the world market. The overall impact on BOP is likely to be positive, largely because the increase in demand for imports is a natural consequence of rising NY and since the economies mentioned are only just starting to develop, the potential for growth is very high. This means that investment will increase significantly, and the overall impact on BOP is positive.

Another positive impact that usually accompanies economic growth is that of falling unemployment. Economic growth generates production which increases the number of jobs available in an economy leading to a fall in unemployment. If the economic growth was a result of an increase in foreign direct investment, the increase in employment opportunities may be coupled with transfer of skills and expertise brought in by these multinational companies (MNCs). This augments the existing domestic labour force and increases the productivity of the domestic labour force. Furthermore, an increase in investment can also generate job opportunities for domestic firms as they step in to provide ancillary services to these MNCs. On the flip side, economic growth that results from economic restructuring may increase unemployment as workers in the shrinking industries are retrenched and not able to upgrade their skills fast enough to find employment in the growing industries. Thus, economic growth that results from restructuring can also negatively impact an economy.

High economic growth rates also translates to higher standard of living (SOL) for residents of these countries. However, if development was concentrated in heavy industries and manufacturing or mining which is very polluting, non-material SOL of residents could have fallen instead. Furthermore, the increase in GDP may not be evenly distributed among residents if wage share of GDP is low, and there may not be an improvement in the material SOL for residents. In addition, if economic growth only benefits a small minority of capital owners, income disparity is likely to increase thus negatively impacting equity. With rising income disparity, there is the possibility of social discontent that could threaten political stability. Increase in GDP may also not increase the SOL of local residents if indigenous GDP is low and a large share of GDP goes to foreign companies and employees to be repatriated income back to home country. Thus it is difficult to determine whether the overall impact of economic growth on the economies is likely to be positive or negative.

In conclusion, the rapid rate of economic growth is likely to have an overall positive impact on the economies mentioned above, largely because the countries are very poor and undeveloped. Nevertheless, there needs to be constant monitoring of the impacts of such rapid growth to ensure that the economy grows at a sustainable rate.

Knowledge, Application, Understanding and Analysis		
L3	Developed discussion of the impact of the high GDP growth rates on the countries.	9-11
L2	Undeveloped discussion of the impact of the high GDP growth rates on the countries. Answer lacks scope or is one-sided.	5-8
L1	Smattering of valid points.	1-3

Evaluation		
E2	For an evaluative assessment of the likely impact on the countries based on economic analysis and context.	3-4
E1	For an unexplained judgement, or one that is not supported by analysis.	1-2