

2016 Prelim H2 Case Study 2

Suggested Answers

- (a) (i) **Compare the change in China's current account balance with that of the US for the period 2011 to 2015.** [2]

The current account balance was consistently in surplus for China whereas for US, it was consistently in deficit. [1]

US current account deficit worsened whilst China current account surplus increased from 2011 to 2015. [1]

OR

However, there is a difference in magnitude: China's current account surplus increased substantially (by 142.9%) during the period whereas US current account deficit worsened marginally (by 5.1%). [1]

- (ii) **Explain whether the US should be concerned about the changes to her current account balance.** [2]

US will be concerned about its current account deficit due to the persistence and size of the deficit. If the size of the deficit is large relative to the country's GDP, the country will not be able to service the deficit and over time, the need to borrow rises eventually leading to debt accumulation. [2]

Such debt financing / accumulation implies that the future standard of living of the country will fall as future incomes will need to be used for debt repayments i.e. borrow to finance current consumption at the expense of future living standards. [2]

Any of the above reasons with clear explanation are acceptable to gain full credit.

- (b) **Explain whether the US central bank's action of raising the interest rate is justified.** [4]

The policy was justified to anticipate and prevent imminent demand-pull inflation. Extract 1 'domestic consumer spending has continued to rise and investment by firms have risen' suggested that there will be continued pressure for AD to increase in the successive quarters. Since the economy is operating near the full-employment level, any further increase in AD will lead to a sustained increase in the general price level. [2]

It may not be justified since the rate of inflation of 0.1% in 2015 is low, far from the central bank's 2% target. Moreover, the current account balance has

worsened in 2015 which will also dampen the rise in AD caused by the rise in C & I. [2]

(c) Explain how the slowdown in China's economic growth will affect its government budget balance. [4]

As the economy slowed down from 9.5% in 2011 to 6.9% in 2015, China's government budget balance as a percentage of GDP worsened from an initial budget surplus of 0.1% of GDP in 2011 to a budget deficit of 2.6% of GDP in 2015 or widened the budget deficit to about 3%.

The budget balance has worsened due to a fall in government revenue and a rise in government expenditure. From Extract 6, China's slowdown has 'add pressure on policymakers to take more steps to ward off a sharper slowdown'. This implies that the fall in C, I, G or (X-M) may have been countered somewhat by China's effort to lean more on fiscal policy to support growth this year. This will result in a fall in government revenue as a result of tax cuts. There is also an increase in government expenditure as a result of "increased spending on infrastructure".

(d) With reference to the data, discuss the likely impact of China's monetary policy (Extract 6) on the Singapore economy. [8]

Introduction

China adopted an expansionary monetary policy approach which aims to boost actual economic growth via cutting interest rates (Extract 6: 'Central bank may still need to ease monetary policy'). With lower interest rate, the return to savings will be lower, so households will be encouraged to raise consumption (C) of domestic goods and services and imports.

Impact on Singapore BOP

Current Account Balance

With the lower interest rate in China, consumption of imports from Singapore will rise. Since China is Singapore's top trading partner, demand for Singapore exports will rise and assuming import expenditure remains unchanged, there will be an improvement in Singapore's net export revenue and current account balance.

The impact on the current account balance will be significant since China is Singapore's largest export market, making up 13.8% of total Singapore exports according to Extract 8.

Evaluation

In China, the central bank adopted a managed-float exchange rate regime where it may allow the currency to depreciate in value as a result of the increase in the supply of Chinese yuan in the forex market (short-term capital outflows as

investors search for higher rate of returns overseas) to boost her export competitiveness in view of China posting its 'weakest economic growth in the fourth quarter of 2015'.

Due to the weaker Chinese yuan, the price of Singapore exports in terms of Chinese yuan will increase. So the Chinese consumers will purchase less of the Singapore exports, causing demand for Singapore's exports to fall. This results in a fall in export revenue.

On the other hand, the residents of Singapore will now find imported goods (e.g. China) cheaper in terms of S\$. This leads them to purchase more foreign imports. If demand for imports is price elastic, expenditure on imports (in S\$) will rise as there will be a more than proportionate increase in quantity demanded for imports. With export revenue falling and import expenditure rising, current account worsens.

Higher interest rate in the US means higher returns to savings, so households may save more instead of buying imports from Singapore, so the net improvement in Singapore current account balance may not be significant.

Capital Account Balance

If China buys more exports from Singapore and net export revenue rises, boosting Singapore economic growth since China is her largest trading partner and export revenue is a large component of Singapore GDP, the positive business outlook may spur capital inflows.

Evaluation

However, from Extract 7, there are 'risks of potential capital flight that could result from fears of further economic slowdown in China'. China's economic slowdown may lead to poor business outlook by foreign investors on the Singapore economy due to the country's high dependence on China as an export market. This may result in **long-term capital flows** out of Singapore to other developed markets such as US which has a lower reliance on trade.

From Extract 7, there are 'risks of potential capital flight that could result from further US rate hikes'. As US real interest rate increases, rewards earned by the owners of USD-denominated capital will increase. There will be **short-term capital flows** into the US from Singapore as funds in Singapore chase after the relatively higher rate of returns in USD-denominated financial assets.

Overall impact on BOP

Depends on the impact of China's expansionary monetary policy on its exchange rate which affects price competitiveness of Singapore exports.

Impact on EG, Unemployment & Inflation

Extent of impact on economic growth, employment will depend on the extent of the rise in (X-M). If the net export revenue rises, it will result in a rise in AD and at the initial equilibrium national income level, firms in the export sector will experience a fall in unplanned inventories. Firms will raise production and employment of resources causing the national income to rise by a multiplier and a fall in demand-deficient unemployment.

The extent of the rise in real GDP will depend on the initial state of the economy. From Table 1, Singapore's unemployment rate is at 2.8% in 2015 which suggests that Singapore is operating close to the full employment level. Therefore, the rise in AD is likely to lead to inflationary pressure. However, the impact may be cushioned by 'public-sector construction activities' (Extract 3) which help to boost potential growth.

Conclusion

China easing of monetary policy may result in a rise in purchase of imported goods and services from Singapore, boosting Singapore's trade balance, economic growth, and employment. However, the extent of the impact on Singapore economy will depend on the effect of the fall in interest rate on the Yuan which in turn will affect Singapore's export competitiveness. The rise in US interest rate may also have a negative impact on the Singapore economy since Singapore is an interest rate taker.

(e) Assess the effectiveness of China's supply-side reforms in facilitating a smooth transition to a knowledge-based economy. [10]

Introduction

A knowledge based economy places more reliance on intellectual capabilities like creativity and innovation to produce products that are more knowledge intensive. These products will be of higher value and so generate more exports revenue and economic growth.

Explain the impact of China's supply-side reforms

Impact of corporate tax cuts and infrastructure upgrade and effectiveness

From Extract 7, the cut in the corporate tax would lead to capital accumulation as it encourages both domestic and foreign direct investments (FDI). Local and foreign firms find it more attractive to invest in the country because they are able to retain a relatively larger portion of their profits earned (i.e. higher expected rate of return). FDI in the capital and service industries will help China to transit faster into the knowledge based economy.

The government also directly spends on 'upgrading the information and communication technology (ICT) and R&D infrastructure' which will increase the capital stock and productive capacity.

By boosting G and I, AD will rise, resulting in a multiplied rise in national income, hence achieving actual growth in the short-run. AS will also increase as there is

increased accessibility and connectivity within China and with the rest of the world via an upgrade to the 'ICT and R&D infrastructure'. This will reduce business costs and improve productivity. Moreover, it will enhance the competitiveness of firms and attract FDI to invest in the knowledge-based economy. In addition, the growth in labour productivity from using better machineries and/or technology will raise the output produced per man hour and productive capacity.

However, as China is a large country, an effective ICT infrastructure will be very costly and will take time to develop. Moreover, both domestic entrepreneurs and foreign firms may be hesitant to invest if they are not able to rely on the 'clear rule of law and property rights' to protect the proprietary knowledge created.

Impact of removing barriers to encourage domestic entrepreneurship and FDI and effectiveness

With the removal of barriers such as limits on foreign ownership, complex rules, and regulations to start a new business and screening procedures on inward FDI, both local and foreign enterprises would now find it easier and more profitable (lower bureaucratic costs) to invest in different sectors of the economy, bringing much needed capital, skills, and technology.

The advantage of relying more on FDI in addition to domestic sources of capital accumulation is that FDI not only often brings in foreign capital, but also foreign technology and knowledge which can be transferred to the local workforce and facilitate China's transition to a knowledge-based economy.

Impact of privatization and its effectiveness

From Extract 6, the government 'strive to privatize big, highly inefficient state-owned enterprises into market-oriented institutions'. The profit motive of private firms would lead to greater efficiency in production as these firms would look to reduce costs and develop better quality goods and services to increase profits. Market-oriented institutions will be more competitive as they are profit maximisers as compared to state-owned enterprises which may be X-inefficient as they are less profit-driven. These private firms also have higher tendency to innovate and move into growth industries such as the knowledge based industries.

However, privatisation of state owned enterprises may lead to higher unemployment as excess workers might be laid off to cut costs to stay competitive. In addition, the inefficient state firms may be unable to compete and face a declining industry. This will result in unemployment as firms' demand for labour falls. Thus, the Government will need to come up with retraining program to equip workers with the requisite skills in order to enable them to move into the growth industries such as the knowledge based industries.

Impact of education reforms and effectiveness.

Even though literacy rates had soared with higher spending on education, there is still overemphasis on knowledge transfer rather than the development of imaginative and creative capabilities. To move into a knowledge based economy, it is insufficient to just have the infrastructure but the soft-skills are needed as well. Without the skilled manpower, it will be difficult to move into an economy that relies on knowledge to create value.

Education will improve the skills of the workforce, increase their ability to adapt to new knowledge and improve productivity. However, education takes time and China will have to upgrade its curriculum to focus on imagination and creativity, without which it is difficult to transit into a knowledge based economy.

Conclusion

Whilst the supply side reforms provide some impetus for the transition into the knowledge based economy, more specific policies need to be implemented to enable China to move into a knowledge based economy.

The Chinese government needs to identify the type of knowledge based industries that the country is moving into and provide the institutional supports such as an advanced financial system, good network of high speed ICT infrastructure, educational reforms with a focus on innovation and creativity to develop a pool of skilled workforce. However, there may be huge inertia for state-owned enterprises to embrace the reforms due to their private interests. In addition, these policies often have a long gestation period and require a large financial outlay which will worsen China's budget balance.

Based on the case evidences, the effectiveness of the policies in helping China to transit into a knowledge based economy is limited.