H2 Economics 9757 Paper 1

Question 2: Imbalances in the United Kingdom and China economies
Suggested Responses

(a) Compare the change in government debt levels as a percentage of GDP in China and the UK from 2010 to 2011. [2]

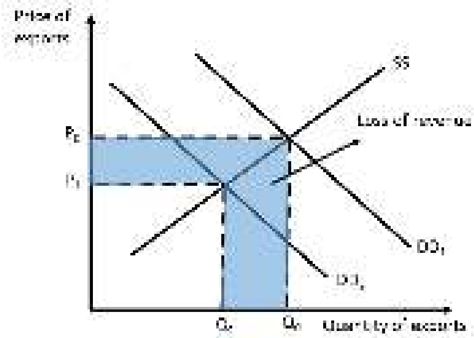
- Direction of change: China's debt levels as % of GDP decreased while UK's increased [1]
- Magnitude of change: UK's change is much larger while China's is an insignificant change. [1]

(b) With reference to Extract 5,

(i) "A weaker yuan is bad news for export-oriented economies like Singapore."

Using a supply and demand diagram, explain how the devaluation of the Chinese Yuan may eventually affect the revenue (in SGD) of a Singapore firm that exports to other countries. [4]

- Singapore goods may be substitute to Chinese goods in other countries [1]
- Devaluation causes Chinese goods to be relatively cheaper in other countries' currency [1]
- Leads to a fall in demand for Singapore's exports. Therefore fall in price, quantity, and total revenue [1]
- Diagram showing shift of demand curve to the left → lower equilibrium price and quantity → lower total revenue [1]



3 marks to explain impact on revenue
1 mark for accurate diagram

(ii) Explain the possible reasons why neither a cut in interest rates nor a devaluation of currency seem to work for China. [4]

Explain why cut in interest rates does not work:
- Interest rate cuts should reduce borrowing costs → stimulate AD
- But <u>ineffective</u> – C was already stimulated through rising wage shares of national income. Further increase in C and I not stimulated by interest rate cuts possibly due to poor confidence in the economy [2]

Explain why devaluation does not work:
- Devaluation of CNY should make Chinese exports cheaper in foreign currency and imports more expensive in CNY → rise in net X → stimulate AD
- But <u>ineffective</u> possibly due to weak demand for China's exports in developed countries as these countries are experiencing slow growth [2]

For answer that explains only how interest rate cuts and devaluation works [1m]
2 marks each for explaining why the policy does not work

(c) With reference to Extract 6, explain how households' standard of living in the UK may be affected if UK interest rates were to rise. [2]

- Rise in interest rate → debt burden rise [1]
- Increase in amount spent to service debt → Purchasing power fall, less ability to consume goods → SOL fall [1]

(d) Assess the effectiveness of the UK government's proposed strategy to boost exports. [8]

Analysis of how UK proposed strategy boost exports.

- (Evidence: boosting productivity, addressing skills deficit, tackling infrastructure obstacles)
  → raise labour productivity (reducing unit labour cost) → improve price competitiveness of UK exports
- (Evidence: innovators access to capital)
  → financial support for innovation → product innovation → niche marketing / branding / non-pricing strategy → reduce PED of UK exports
- Therefore export revenue will increase

Counterargument:
Possible constraints that could cause UK proposed strategy to be ineffective

- Stronger pound (appreciation) will make UK exports more expensive in foreign currency → price competitiveness due to the lower unit labour production cost may be eroded
- Skills training to raise labour productivity may encounter resistance from both employees and employers. Impact on labour productivity can also be seen only in the LT
- Financial support for Innovation requires long incubation period → unpredictable outcome even in LT
- Given UK's debt increasing to almost 90% of GDP, government may not be able to provide adequate financial support for innovation (sustainability of this strategy is questionable)

Possible Judgement

- Proposed strategy seems to be ineffective in the ST as intended outcomes can only be seen in the LT
- Unintended consequences likely to arise → rendering it ineffective
  - Lack of public support
    Skills training to upgrade labour productivity would only be politically acceptable provided government provides subsidy for such training to both workers (cost of training + loss of income during training) and employers (loss of labour service) → requires heavy government funding.
  - Increased Government debt
    Current high UK government debt made strategy (support for innovation and skills training) difficult to sustain in LT (evidence from Table 3)
  - Retaliatory Trade policies of trading partners
    UK trading partners likely to undertake protectionistic measures or exchange rate policies (depreciation) → erode competitiveness of UK exports
- Possible complementary measures to increase effectiveness of proposed measures: Expenditure reducing measures or depreciation of currency.

L2	• Well-developed analysis of how UK's proposed strategy could boost exports AND the constraints that will limit its effectiveness. A balanced answer with supporting evidence e.g. govt debt, strength of pound	**4-6**
L1	• Balanced answer but superficial analysis of how strategy works to boost exports and constraints. • No / Inadequate evidences cited incidentally. • One-sided answer.	**1-3**
E	• Make a reasoned judgement on whether UK strategy to boost exports, is likely to be effective	**1-2**

(e) Discuss the factors that the UK and China's governments should consider in their macroeconomic decisions to rebalance their economies to achieve sustained economic growth. [10]

Meaning of sustained economic growth

- refers to actual and potential economic growth
- continued rise in real GDP and productive capacity

Meaning of rebalancing economy

- China switching to reduce reliance on the export sector as engine for growth and instead to focus on strategies to generate investment-led growth.
- UK switching from reliance on domestic consumption to exports to boost growth

Factors that governments should consider in making macroec **decision** in **rebalancing** economy for **sustained** economic growth

(1) Constraints:

- Govt financial position
  UK –high govt debt position –difficult to sustain policies to boost exports; policies feasible in SR not LR
  China – lower govt debt – redistributive policies to boost C + subsidy for investment - feasible
- Stage of development
  UK – developed country subject to higher tariffs for her exports to other countries → reduce her export competitiveness
- Size of economy
  China having a large domestic economy (large market and factor endowments) would be able to sustain ec growth with reliance on domestic C
- Information
  Both countries – to identify what, who, how much, how long to subsidise
  e.g. which UK sector with comparative advantage

(2) Benefits & Costs of UK and China's rebalancing policy

China

Benefit:

(i) rise in C (domestic C) → improve SOL and also rise in AD, GDP
(ii) Firms leveraging on domestic C → less vulnerable to external shocks → more stable revenue and wage income → sustained economic growth, SOL

Costs

(i)SR – rebalancing – suffer slower ec growth with reduced export growth – opportunity cost – fall in SOL
(ii) Higher C → HH debt…cause the rise in C to be unsustainable → slow down growth in LT.

UK

Benefit

(i) HH debt would be reduced → higher SOL

(ii) Expansion of markets for UK firms → incentivise UK firms to be more innovative and compete in the global market → improve Trade balance → sustained ec growth

(iii) Attract FDI – capital inflow / technology → LRAS productive capacity rise → potential ec growth

Costs

(i) govt policies are targeted at reducing C → overall fall in present SOL in SR (although LR SOL may rise) → slow down growth in SR

(ii) Govt expenditure on export promotion rise → opportunity cost in other sectors of economy → unintended adverse outcome may result

(iii) reliance on export sector for growth → increase country's vulnerability to external shocks.

Possible Judgement

- There will be costs incurred in any rebalancing policies and govt should implement policies to mitigate short term costs of any such policies
e.g. UK in rebalancing to reduce reliance on C and increased reliance on X, would need to implement measures to reduce her vulnerability to external shocks.

- UK having a large domestic market, could still rely on her domestic market for economic growth. But given the high British household debt, the intended outcome of this strategy may not be seen in the ST..

- In rebalancing economy for sustainable growth, a more feasible strategy is for govt to reduce reliance on **any one** sector of the economy; be it domestic market or export sector.

- Govt should not focus on only one sector for sustainable economic growth. Imbalances in any economy are usually not sustainable in LT although small open economies like Singapore, are inevitably more reliant on export sector to stimulate growth. But measures must be put in place for such open economies, especially those with small domestic markets, to reduce their vulnerability to external shocks

L2	• Well-developed analysis of factors that influences governments in their decision to rebalance their economy, taking into account benefits & costs and constraints faced by UK and China • A balanced answer with supporting evidence from both countries e.g. ○ UK household debt, China's debt/GDP ratio ○ govt debt position for UK and China.	**5-7**
L1	• Balanced answer but superficial analysis of factors that influences governments in their decision to rebalance economy. • No / Inadequate evidences cited incidentally. • One-sided answer.	**1-4**
E	• Make a reasoned judgment on the significance of the various constraints, extent of benefits & costs, in a government's decision to rebalance economy for sustained economic growth.	**1-3**