<u>2017 TJC Preliminary Examinations H2 Economics (9757) Paper 1</u>

CSQ 2 Suggested Answers

(a)	**With reference to Table 2, explain why the Greek government should be concerned about its economy. [4]**
	As seen in Table 2, data indicates Greece suffering from negative economic growth (-0.2%), high unemployment rates (25%) and high public debt (177% of GDP) in 2015. With reference to a government's macroeconomic objectives and the trend from 2011 till 2015, these are causes of concern for the Greek government. <u>Negative economic growth: [2m]</u> Greece has been experiencing negative rates of growth since 2011, with the exception of 2014. [1] This implies that national income has been falling, affecting purchasing power of consumers. This results in a reduction in willingness and ability of consumers to demand goods and services, adversely affecting material standards of living. OR It would also impact producers who may reduce the level of production as inventories start to accumulate. As such, producers may lay off workers as the demand for labour is derived from the demand for their products. This can be reflected in the high levels of unemployment in Greece. <u>High unemployment rates: [2m]</u> Unemployment rates have fluctuated above 20% since 2012. [1] As citizens are unable to find or hold onto a job, this reduces both their material and non-material standard of living. As the unemployed no longer earn income, there is a sharp fall in their purchasing power, hence, their ability and thus level of consumption. This reduces their material standard of living. OR As unemployment rates are high, the expectation of finding a new job tends to be low, resulting in high levels of stress and negative emotions in those who are actively seeking employment – non-material standard of living are adversely affected. OR High unemployment rates may further tax government budget as large amount of resources are spent on unemployment benefits. This further worsens the high public debt in Greece. <u>High public debt: [2m]</u> Greece has been suffering from high public debt of around 170% of their GDP. [1] This is a key constraint on government policy as the Greek government will be restricted in their employment of expansionary fiscal policy to boost the economy and push it out of a recessionary slump or to reduce demand-deficient unemployment. OR It will also restrict government expenditure on providing necessary welfare benefits to low-income households and those unemployed. This reduces the government's ability

	to improve its citizens' standards of living, which should have been a key objective of any government. *Any 2 points for a full 4 marks.*
(b)	**With reference to Extract 5, comment on how the measures demanded under the Greek bailout agreement might impact the Greek economy. [4]**
	Based on Extract 5, Greece has been called upon by the troika to introduce "quasi-automatic spending cuts" in order to achieve their commitment of a "budget surplus of 1% in 2015, rising to 3.5% by 2018". As such, Greece has been told that it needs to improve the sustainability of pension system, implement tax reforms as well as to liberalise the economy. In a nutshell, these requires the Greek government to cut down on spending and to increase it tax revenue. **[1]** This has a clear contractionary effect on the Greek economy as a reduction in pension payments, will result in a fall in aggregate demand (AD). This will also reduce the purchasing power of pensioners, reducing their consumption levels (C). Tax reforms include a removal of tax exemptions for big tourist islands, broadening of the tax base and the revision of taxes to better target the wealthy Greeks. These will bring about an increase in tax revenue, but will depress export revenue (X) since tourism levels will be affected given higher tax rates. Households and firms will also be affected, both experiencing higher tax rates, reducing disposable income as well as post-tax profits. Households will decrease their level of consumption (C) while firms, seeing that investments are less profitable, will reduce their level of investment (I). Given a fall in C, I and X, there will be a combined fall in AD. This fall in national income will further reduce income-induced consumption, resulting in a multiplied reduction in AD (reverse multiplier process). ***[1m for an explanation of any of the contractionary measure – negative impact.]*** As such, while the measures demanded under the Greek bailout may be aimed as achieving a budget surplus, the immediate impact is a contractionary one on the economy, further worsening the current economic growth of -0.2% as seen in Table 2, resulting in a significant cause of concern as demand-deficient unemployment may be exacerbated, further lowing standards of living in Greece. **[1]** This is acknowledge by Prime Minister Alexis Tsipras as he agreed that the measures are "recessionary". However, he is hopeful as these measures are the better of two evils, the other being Grexit. [*A Grexit situation may result in a collapse of confidence in the government and the Greek economy, further worsening the current situation. It will also mean a loss in bailout, resulting in the defaulting of Greece on its debts, which may lead to massive recessionary pressures in the Eurozone (contagion effect), adversely affecting Greece.*] In committing to these measures and liberalising the labour market, it may aid in improving the confidence level of households and firms in the Greek economy, allowing for "inward investment… to flow". Such inflow of capital will aid in revitalising the Greek economy given an increase in I which will increase AD. Stronger confidence in the economy and obtaining the bailout will also improve expectations of the economy, allowing for greater possible foreign direct investments and domestic investment by firms. **[1m for positive impacts of measures]**

	In the short run, measures demanded are recessionary, but they are in place to reduce the fundamental issue faced by Greece – high public debt. •
(c)	**Discuss the possible considerations behind the Chinese government's attempt to rebalance its economy. [8]**
	Question interpretation: • *What is meant by China's attempt to "rebalance its economy"?* • *How will this impact China's economy?* • *Given these impacts, what were possible considerations by the government – taking into account concerns by other economic agents (households & firms)* As seen in Extract 6, China's attempt to rebalance its economy is a "move towards an economy led by consumption and services, rather than one driven by exports and investment, in view of weak external climate and excess capacity". In doing so, it is a deliberate shift away from its traditional drivers of growth, resulting in weaker growth, something that Chinese Premier Li Keqiang has accepted, "as long as enough new jobs were created". In China's rapid rise as an emerging market, a key thrust has always been its strong export demand. With abundance of labour and natural resources, China has comparative advantage in the trading of labour-intensive products and this drove its manufacturing sector to greater heights, especially coupled with a weak currency. The government's willingness to support its export industries can't be overlooked as China developed strong trade surpluses against most of its trading partners, most notably the United States of America. As export quantity (X) increases, this increases the aggregate demand for goods and services, boosting economic growth in China. Apart from strong export figures, China's government was also active in attracting foreign direct investments into the country, as well as to improve government investments (G) internally, developing rural parts of the country to further increase economic capacity. Once again, this increases the investment (I) and government expenditure (G) components of aggregate demand, boosting economic growth in China. G, I and X combined to result in China "experiencing rapid growth for more than a decade". However, with global instability as seen in major economic powers such as the Eurozone and USA, the Chinese government seems keen on reducing the country's exposure to such volatility. USA was badly affected by the 2008-2009 Great Recession, which effectively crippled the world's largest economy, adversely affecting global demand for exports. The Eurozone has to deal with Greece's debt crisis (Extract 5) while ensuring that other weakening countries within the Eurozone continue to sustain. As these major economies look inwards to solve their own issues, it negatively affects China's export figures, hence, a key consideration by the Chinese government would be to reduce China's vulnerability to such external shocks, where China's growth is not dependent on the rise and fall of its trading partners. Years of posting positive growth through increase government expenditure in rural areas has also results in major towns being constructed but these are left barren and unutilised. This is the case of China's "ghost cities", which reflects the excess capacity that was mentioned in Extract 6. It also represents government revenue that can be put to better use in improving infrastructure in key cities or between ports rather than to expand development in rural areas prematurely. As such, another key consideration by the Chinese government in their attempt to rebalance its economy is the excess capacity which reflects poor government budgeting.

However, as China looks to create an economy "driven by consumption", it has proven challenging, with expected growth of "6.3% and 6%" respectively in 2016 and 2017. This has been deemed as a "painful slowdown", coming from the rapid double-digit growth previously driven by exports and investments. While consumption is a component of aggregate demand and maybe able to "support growth in the short run", there are those who believe that "there is little in economic theory that emphasises the expenditure side of GDP as a driver of growth". With the fall in key economic figures – industrial production and retail sales, this further reflects a possible mistake by the Chinese government. Such negative economic sentiments from the private sector may result in a loss of confidence in the economy, further retarding economic growth as firms reduce production and investment in the short run as production and investment projects are expected to be less profitable. Likewise for consumers, who may reduce consumption, seeing how China may be heading towards an economic slowdown. Such expectations can adversely affect the government's plan of rebalancing and is a clear consideration that needs to be accounted for. As national income increases at a slower rate, so will the increase in income-induced consumption, throwing a spanner in the works for China as it aims to depend on consumption as a key driver of growth. A fall in production figures may also reflect slower employment rates, further reducing consumption levels in China.

All that said, the Chinese government would have weighed these various considerations in its move to rebalance the economy. While growth has slowed and is below its official target of "about 7%", it is still positive. As mentioned by Catherine Yeung, this is not a meltdown but a merely a slowdown. Nonetheless, the government needs to stem the loss in confidence in the economy if it wishes to push for stronger domestic consumption figures. A rebalancing towards services will also require adequate support in terms of infrastructure as well as the training of labour. As the skillset required to thrive in the service sector is vastly different as compared to those in the manufacturing sector, deliberate action needs to be taken by the government to reflect a strong commitment to this rebalancing.

<u>Levels of Response Marking Scheme (LORMS)</u>

Levels	Descriptor	Marks
L2	A well-developed answer with consistent demonstration of economic rigour. Makes use of case materials and provides sufficient scope in analysis.	4-6
L1	Answers lack of economic rigour and/or have narrow scope in analysis. Capped at this level if there is no reference to case materials.	1-3
E	Evaluative judgement and comments with synthesis. Possibly on overall impact of perspectives, providing a valued opinion on the government's rebalancing attempt.	1-2

(d) Using an AD/AS diagram, explain how a tight labour market may affect general price levels in Singapore. [4]

A tight labour market implies that the economy is close to full employment and recruitment becomes difficult. This is evident in Extract 7 where "growth in some labour-intensive sectors such as food services may be weighed down by labour constraints". [1]

In order to increase production, firms will have to compete with each other for labour, thus bidding up wages. This results in an increase in cost of production for firms, reducing aggregate supply in Singapore. [1]

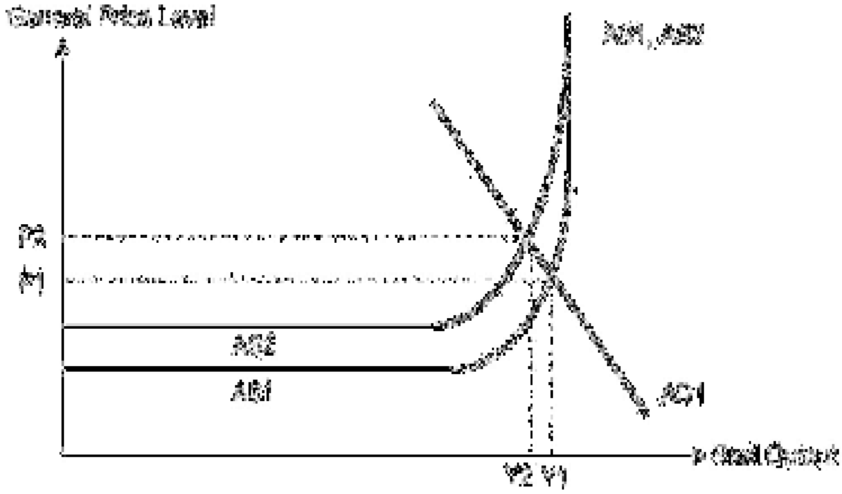

Figure 1: Impact of a tight labour market in Singapore

1m for an accurately drawn diagram.
Candidate can also explain it as a rightwards shift of AD along the upward sloping portion of AS.

A fall in aggregate supply is reflected as an upward shift of the AS curve from AS_1 to AS_2, as seen in Figure 1. Assuming ceteris paribus, the fall in AS will then result in an increase in general price levels from P_1 to P_2. [1]

(e) **In view of the data presented, discuss to what extent Singapore's central bank, the Monetary Authority of Singapore, might have to intervene in the market for Singapore dollars in order to achieve the government's macroeconomic objectives. [10]**

Question interpretation:

- *Given the data presented in the case, what are the issues that may result in Singapore not achieving its macroeconomic objectives?*
- *How can the Singapore dollar be influenced in order to mitigate these issues?*
- *To what extent will MAS's intervention be effective in mitigating these issues?*
- *What are alternative policies that can be implemented in order to achieve the government's macroeconomic objectives?*

A significant macroeconomic objective that seems to be adversely affected in Singapore would be its economic growth. As mentioned in both Extract 7 and 8, "Singapore's economic prospects have softened" and "grew a modest 2 per cent in 2015, the weakest rate of growth since 2009". Extract 7 explicitly lays out the various reasons for Singapore's modest growth, citing reasons across various countries and sectors. In order to achieve stronger growth figures, MAS could provide certain adjustments to Singapore's currency, possibly boosting export figures whilst reducing cost-push inflation in Singapore.

	As a small and open economy that is export-oriented and import-reliant, Singapore is extremely vulnerable to external instabilities. As mentioned in Extract 7, global economy has been weaker than expected in the first half of 2015 and uneven growth is further expected across countries in the second half – "advanced economies are expected to see a gradual pick-up in growth, while the growth outlook of regional economies has generally softened." These global powers have internal issues to handle, with the anticipation of US recover, Eurozone's management of the Greek crisis as well China's rebalancing. As the US, Eurozone and China's economies are projected to have a modest pace of growth, Singapore's export sector may face weakening demand. Key ASEAN economies are also adversely affected by these major economies, posting weaker growth, thus, further affecting Singapore's exports. The combined weaker increase in demand for Singapore's exports has an adverse impact on our aggregate demand and thus, economic growth. Apart from these, other factors also impact Singapore's economic growth, such as sustained low oil prices as well as a tight labour market. As Singapore faces both external and internal pressures, MAS's timely adjustment of the Singapore dollar could aid with improving Singapore's economic growth. It is vital to acknowledge that MAS's objectives tend to revolve around maintaining inflationary pressures in Singapore. However, given the current unstable global economic climate, and weaker global growth, inflation seems to be a secondary concern relative to the weakening growth rates. In order to combat the weakened demand for our exports, MAS could engineer a depreciation of the Singapore dollar *link to (i), allowing our exports to gain price competitiveness as it will be relatively cheaper in foreign currencies. As such, this will help alleviate the softening in the demand for our exports, boosting aggregate demand (AD), thus, improving economic growth. This depreciation will also mean that imports are relatively more expensive in domestic currency, resulting in consumers switching to cheaper local alternatives, increasing consumption (C), further increasing AD and economic growth. However, Extract 7 also makes it clear that external demand is picking up, and "externally-oriented sectors… are likely to support growth in Singapore economy in the second half of the year". We are told that the "US economy recovered in the second quarter" and is "projected to grow at a modest pace". The Eurozone economy is also "expected to improve in the second half of the year" while "stimulus measures implemented by the Chinese government are expected to contain downward pressures on the economy". All these point towards a recovering external sector for Singapore, thus, a less significant impact on Singapore's economic growth in the future. Therefore, any rash depreciation of the Singapore dollar may exacerbate inflationary pressures upon the improvement of export demand in the relevant sectors like "finance and insurance", as well as "wholesale trade". Apart from possibly worsening demand-pull inflation in Singapore, the depreciation may also result in cost-push inflation as cost of imported inputs are more expensive in domestic currency. Given that Singapore is already experiencing a tight labour market – "labour market expected to remain tight", the depreciation would further worsen cost-push inflation, directly contradicting with MAS's objective of reducing inflationary pressures in Singapore. Extract 7 and 8 both present a case of falling oil prices as a key reason for a dip in economic growth in Singapore. As oil prices fall, it "dampen growth in marine and offshore segment" as the demand for marine and offshore services is derived from the demand for oil. Given the low prices, firms that run oil-rigs will start to cut production as it is no longer profitable to drill for oil since drilling for oil results in greater cost of production than revenue. As it continues to dampen growth in the sector, it may result

in loss of jobs as firms cut employment and begin to retrench workers in order to reduce cost of production. As such, this results in a possible fall in national income, further dampening economic growth. In light of this situation, the depreciation of the Singapore dollar will actually further reduce the amount of profits earned by these firms since profits earned in Singapore dollar will translate to lower profits in foreign currency. Thus, MAS's action may adversely affect the marine and offshore industry.

Due to the multi-faceted issues that Singapore faces, there is a limit to the effectiveness of MAS's intervention via changes in the value of the Singapore dollar. On hindsight, instead of a depreciation, maintaining the value of the Singapore dollar, rather than a gradual and modest appreciation, may be sufficient to ease pressures for Singapore exports. Apart from that, there is a need for the Singapore government to consider alternative policies to further strengthen the domestic economy, reducing its vulnerability to external shocks (i.e. global financial market volatility – Extract 8). These policies need to be more targeted in order to influence the relevant sectors that are worse off, rather than a broad depreciation of the Singapore dollar which is clearly blunt and lacking in precision to specifically impact the correct sectors and to tackle the root cause. Pre-emptive policies may also be required, seeing how the recovery of global prospects is fragile. Sentiments in China, the Eurozone, US and ASEAN countries have yet to fully recover and may worsen given certain triggers such as a "sharper-than-expected correction in the real estate market" for China and possible failure of the Greek government to "adhere to the bailout terms".

In conclusion, as Singapore braces itself for its "weakest rate of growth since 2009", the situation is still not all bad as growth is still in the positive region. Given Singapore's unique nature of being a small and open economy, it is inevitable that it will be affected by global forces and the performance of major economic powers. That said, well-targeted policies to stimulate the domestic economy and to build resilience may fare better, rather than an aggressive MAS exchange rates policy. In this sense, the Singapore government has continued to provide GST vouchers to offset the pain of the slowing growth, increased skills retraining and upgrading efforts to increase productivity of labour, increasing their relevance and bargaining power, as well as to bring forward the construction of infrastructure in an attempt to increase government expenditure, boosting AD.

<u>Levels of Response Marking Scheme (LORMS)</u>

Levels	Descriptor	Marks
L2	A well-developed balanced answer with economic analysis that thoroughly explains the possible objective of the government, and thus the extent of intervention by MAS, with clear conceptual understanding, coupled with reference to case material.	5-7
L1	Lacks balance: One-sided answer that rigourously explains how MAS can intervene in order to achieve the objective of the government. **OR** Lacks rigour: Two-sided answer that is not thoroughly explained OR merely lifting evidence from the passage but no clear link to the issues. **OR**	1-4

			Lacks reference to case material and the application to the issues.		
		E	Evaluative judgement and comments based on economic or contextual analysis. Answers are able to synthesise the arguments for and against and come to a stand.	1-3	