

RAFFLES INSTITUTION
2017 YEAR 6 Preliminary Examination
Higher 3



ECONOMICS

9809/01

Paper 1

21 September 2017

3 hours 15 mins

Additional Materials: Answer Paper

READ THESE INSTRUCTIONS FIRST

DO NOT open this booklet until you are told to do so.

Write your name, index number and CT class on all the work you hand in.
Write in dark blue or black pen on both sides of the paper.
You may use a soft pencil for diagrams, graphs or rough working.
Do not use paper clips, highlighters, glue or correction fluid.

Answer **all** questions in **Section A** and **two** questions in **Section B**.

Begin answering each question on a fresh sheet of writing paper.

At the end of the examination,

- **Fasten** your answer to each question **separately**.

You are advised to spend several minutes reading through Case Study data before you begin writing your answers.

This document consists of **7** printed pages



Raffles Institution

Section A

1 Global Imbalances and Policy Coordination

EXTRACT 1: The German Problem - Why Germany's current-account surplus is bad

When the world's big trading nations convene this week at a G20 summit in Hamburg, the stage is set for a clash between a protectionist America and a free-trading Germany. President Donald Trump has already pulled out of one trade pact, the Trans-Pacific Partnership, and demanded the renegotiation of another, the North American Free-Trade Agreement. He is weighing whether to impose tariffs on steel imports into America, a move that would almost certainly provoke retaliation. In contrast, Angela Merkel, Germany's chancellor and the summit's host, will bang the drum for free trade.

There is no question who has the better of this argument. Mr. Trump's doctrine that trade must be balanced to be fair is economically illiterate. His belief that tariffs will level the playing field is naive and dangerous: they would shrink prosperity for all. But in one respect, at least, Mr. Trump has grasped an inconvenient truth. He has admonished Germany for its trade surplus, which stood at almost \$300bn last year, the world's largest (China's hoard was a mere \$200bn). And the size and persistence of Germany's savings hoard makes it an awkward defender of free trade.

A trade surplus is an excess of national saving over domestic investment. Underlying Germany's surplus is a decades-old accord between business and unions in favour of wage restraint to keep export industries competitive. Such moderation served Germany's export-led economy well through its postwar recovery and beyond. There is much to envy in Germany's model. Harmony between firms and workers has been one of the main reasons for the economy's outperformance. Firms could invest free from the worry that unions would hold them to ransom.

But the adverse side-effects of the model are increasingly evident. It has left the German economy and global trade perilously unbalanced. Pay restraint means less domestic spending and fewer imports. Consumer spending has dropped to just 54% of GDP, compared with 69% in America and 65% in Britain. Exporters do not invest their windfall profits at home.

Can the problem be fixed? Perhaps Germany's bumper trade surplus will be eroded as China's was, by a surge in wages. Unemployment is below 4% and the working-age population will shrink, despite strong immigration. After decades of decline, the cost of housing is rising, meaning that pay does not stretch as far as it used to. The institutions behind wage restraint are losing influence. The euro may surge. Yet the German instinct for caution is deeply rooted. Pay rose by just 2.3% last year, more slowly than in the previous two years. Left to adjust, the surplus might take many years to fall to a sensible level.

It is long past time for Germany to recognise that its excessive saving is a weakness. Mrs. Merkel is absolutely right to proclaim the message of free trade. But she and her compatriots need to understand that Germany's surpluses are themselves a threat to free trade's legitimacy.

Source: The Economist, 8 Jul 2017

Extract 2: Global Imbalances in the New Multipolar Global Economy

The international economy is shifting to a new multipolarity. About half of global growth is now from emerging economies and this is transforming power relations. A key feature of the new multipolar economy is that no single country can on its own assure stability to the international economic system. The U.S. remains no doubt the world's top political and economic power but it is no longer able to exert single-handed management of the world economy, much less against the will of the other leading nations. Because of these great asymmetries in international power distribution, one is induced to view economic relations among major countries as a system dominated by an "oligopolistic interdependence".

In this new framework, leading nations' individual policies can determine multiple equilibrium solutions that are more or less efficient in respect of the whole system but all equally attainable. It is well known that decentralized and non-coordinated interaction among a few countries may not lead to optimal outcomes for the entire world. Independently and autonomously formulated national policies can also turn out just mutually incompatible.

A telling example is the very recent currency war as the Brazilian finance minister called it last September. Every country desires a weaker currency to sustain growth via net export improvement. The trouble is that not all currencies can be weak. If one weakens, another must strengthen. Furthermore, not all economies can have a net export improvement. This zero-sum game in currencies and net exports means one country's gain is some other country's loss and a competitive devaluation war ensues.

The strengthened interdependent oligopoly in international economic relations has thus increased the need for macroeconomic policy coordination and enhanced the potential benefits of cooperation. This enhanced cooperation in the multipolar game is important in many areas including international trade and finance, but it is particularly important in respect to the coordination of macroeconomic policies between major countries and the growth of the world economy.

The coordination of macroeconomic policies has a crucial role to play in ensuring a stable high rate of growth of world effective demand. It is well known that demand and supply are both important factors that contribute to the growth of countries around the world. However, while supply factors depend more closely on domestic structures and national policies autonomously formulated by individual countries, in the present highly interdependent oligopolistic system the growth of effective demand is more closely dependent on the international context as domestic macroeconomic policies are heavily influenced by balance of payments constraints.

To sustain effective demand at the world level, the key problem today is to remove macroeconomic imbalances. Macroeconomic imbalances were one of the key drivers of the recent global financial crisis. The global recession that followed did not remove these huge imbalances. After a temporary narrowing, the latest IMF and OECD projections suggest that world current account imbalances are likely to remain substantial until the middle of the present decade. Along with the large East Asian surpluses, the German and the other European countries' surpluses will probably increase the U.S. current account deficit.

The task of rebalancing is to drain demand from where it is in short supply to economies that tend to suffer from excess demand. The well-known recipe is for the United States to save and export more, while countries like China, Germany and Japan must move in the opposite direction. At the same time, greater flexibility in Chinese and other Asian currencies is an important ingredient of the adjustment.

In the new multipolar system, stable growth assumes the contours of a public good since macroeconomic cooperation in terms of coordination of national macroeconomic policies is not only desirable but also necessary for producing expansionary world demand and avoiding persistent imbalances.

One major problem is that while international institutions that deal with trade and financial issues do exist, they do not for macroeconomic coordination. A first job for coordinating macroeconomic policies is to enhance communications among the players involved by increasing available information, which will create linkages and improve the context of cooperation. In the present multipolar system, there is a lot of uncertainty in the Keynes sense with actors uncertain about the future behavior of other actors. Since the leading actors involved are few in number, uncertainty will easily lead to prisoner dilemma situations in which the best strategy is defection.

Information certainly plays a crucial role in influencing national strategies but it should be viewed more as a precondition for cooperative policies. Cooperation could also mean a close coordination of national policies via reiterated shared decisions on the definition (even in quantitative terms) of objectives and/or instruments of economic policy. In this case, an agreement between national policymakers is required every time. This type of cooperation, though the most frequently advocated in official meetings, is also the most difficult to implement due to the serious constraints it imposes on national autonomies.

Cooperation should take on yet another meaning today as a set of norms and rules (regimes) which countries bind themselves to observing in the implementation of their economic policy strategies, even though they keep their autonomy in making their own policy decisions. The framework outlined should lead countries to take into account existing interdependencies when implementing their policies so to modify their behavior toward greater system stability. It is this last type of international agreement that we need today by restoring some shared rules of the game for international macroeconomic adjustment.

Source: Adapted from https://www.brookings.edu/wp-content/uploads/2016/06/g20_guerrieri.pdf

Extract 3: What Drives Long-Run Economic Growth?

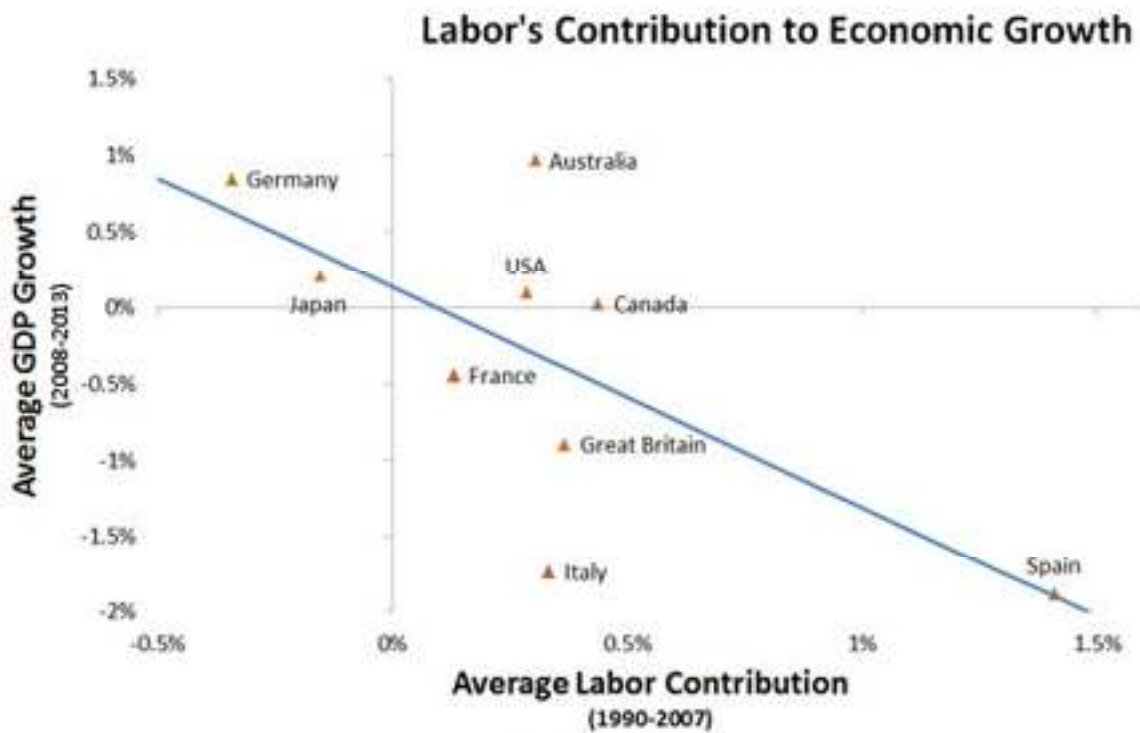
There are three main factors that drive economic growth:

- Accumulation of capital stock
- Increases in labor inputs, such as workers or hours worked
- Technological advancement

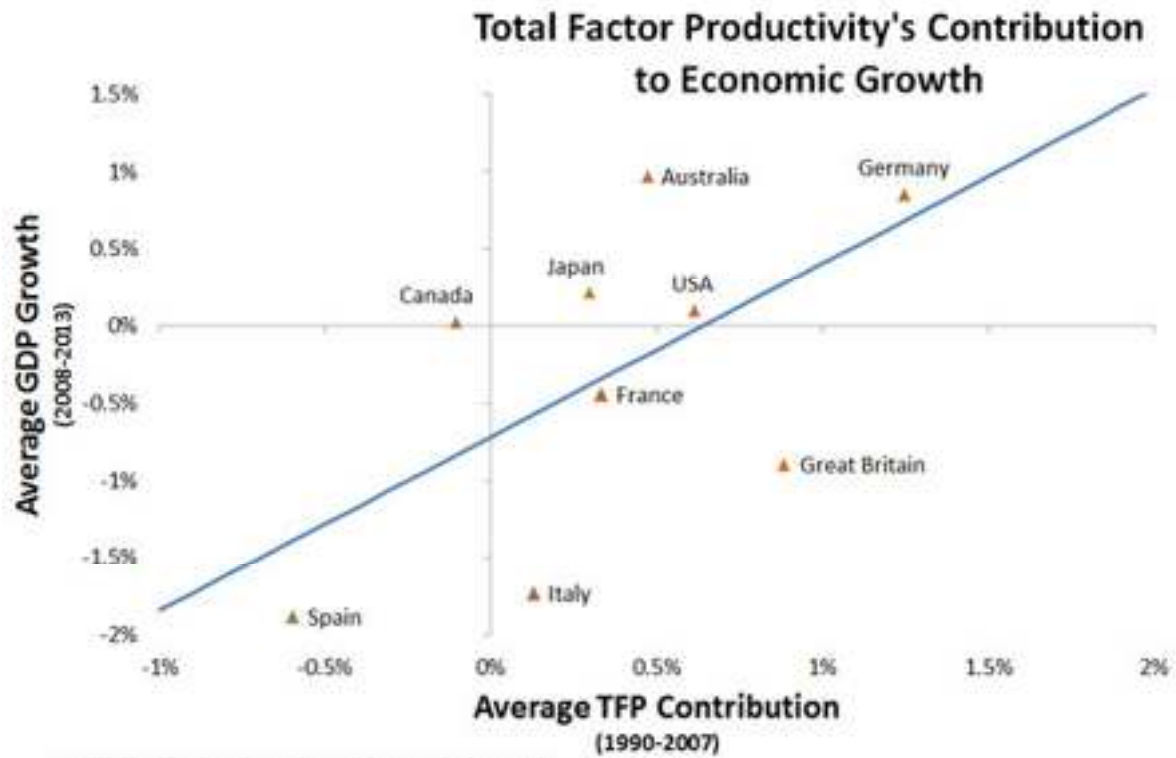
Growth accounting measures the contribution of each of these three factors to the economy. Thus, a country's growth can be broken down by accounting for what percentage of economic growth comes from capital, labor and technology.

This post investigates the relationship between sources of past economic growth and future performances, especially the periods after the Great Recession, among developed countries. We collected data from the Conference Board's Total Economy Database for nine major advanced economies from 1990 to 2013 and performed the following growth accounting exercise: For each country, per capita output growth is first broken down into the respective contributions from capital stock, labor inputs and technological advancements (represented by total factor productivity, or TFP).¹ Next, we divide our sample into two periods: before and after the financial crisis. This allows us to check if drivers of growth relate to the economic performance of a country, especially during or after the recession. Finally, we plot average gross domestic product (GDP) growth after the financial crisis against the average contribution to output growth of labor, capital and TFP before 2007, as shown in the figures below.

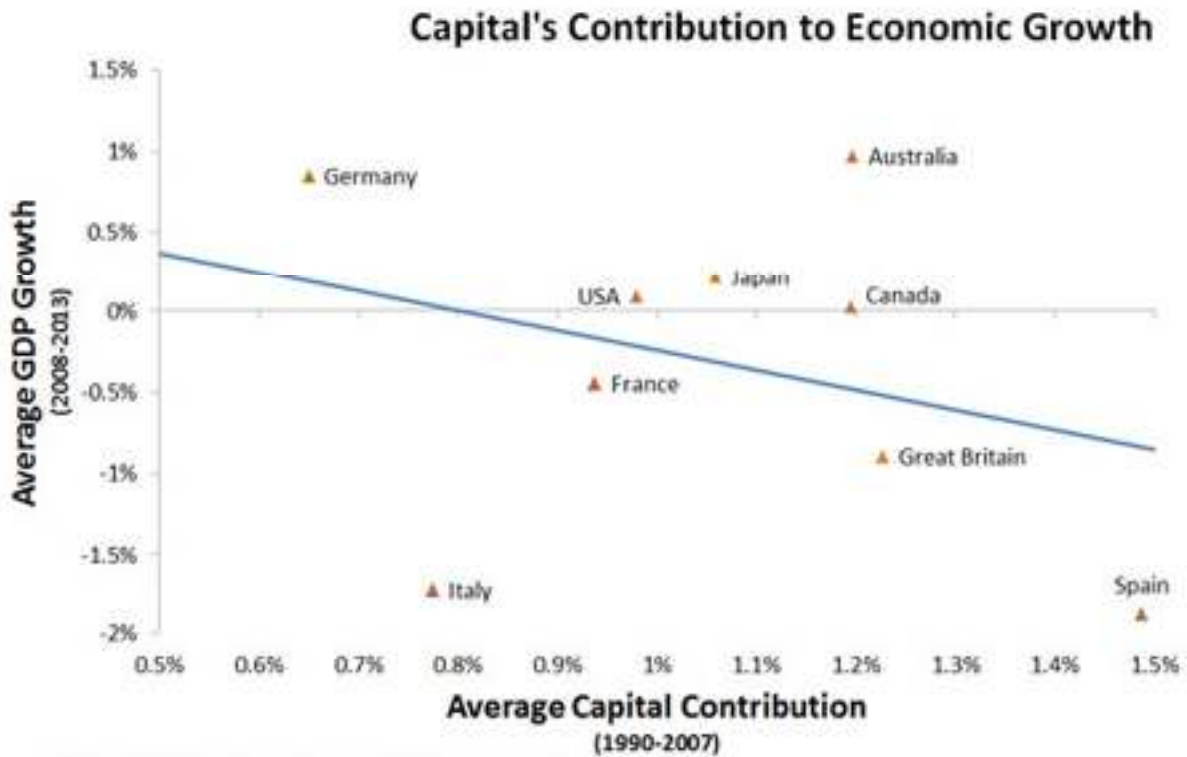
¹ The labor inputs are measured by the total labor hours adjusted by quality of labor (human capital).



FEDERAL RESERVE BANK of ST. LOUIS



FEDERAL RESERVE BANK of ST. LOUIS



FEDERAL RESERVE BANK of ST. LOUIS

Source: Adapted from Federal Reserve Bank of St. Louis website

Questions

- (a) Evaluate the statement “Mr Trump’s doctrine that trade must be balanced to be fair is economically illiterate.” [8]
- (b) Analyse the challenges and feasibility of avoiding currency wars through international policy coordination. [8]
- (c) Comment on whether the data presented in Extract 3 supports growth theory models in explaining the economic performance of developed countries between 2008 and 2013. [6]
- (d) Discuss the impact of persistent macroeconomic imbalances on the development of emerging economies. [8]

[Total:30]

Section B

Answer **two** question from this section.

2 Is behavioural economics a viable alternative to traditional economics? [35]

3 Discuss the view that firms in reality always aim for economic profits and that the strategies adopted by such firms to gain a competitive advantage are likely to result in an inefficient and inequitable outcome. [35]

4 “Information is a beacon, a cudgel, an olive branch, a deterrent – all depending on who wields it and how. Information is so powerful that the assumption of information, even if the information does not actually exist, can have a sobering effect on markets...”

Adapted from Steven D. Levitt & Stephen J. Dubner, Freakonomics

Assess the role that information plays in Economics. [35]

5 Against the backdrop of globalisation, national states are trying to generate as much welfare for their residents as they can, while MNEs try to maximize their value. To what extent is there a conflict of interest? [35]

6 In their quest for healthier growth, governments face major policy challenges. A coherent, structural reform strategy to include objectives like productivity, employment and inclusiveness across a broad range of policy areas, with the support of macroeconomic policies is needed going forward.

Source: Adapted from Economic Policy Reforms 2017, Going for Growth, OECD 2017

Comment. [35]

Copyright Acknowledgements:

Question 1	Extract 1	© Adapted from <i>The Economist</i> , 8 Jul 2017
Question 1	Extract 2	© Adapted from https://www.brookings.edu/wp-content/uploads/2016/06/g20_guerrieri.pdf
Question 1	Extract 3	© Adapted from Federal Reserve Bank of St. Louis website
Question 4		© Adapted from Steven D. Levitt & Stephen J. Dubner, <i>Freakonomics</i> , pp 60
Question 6		© <i>Economic Policy Reforms 2017, Going for Growth</i> , OECD 2017