PJC 2016 H2 Prelim Exam Paper 2: Question 1

Question:

Global warming has reduced the harvest of high quality coffee beans. This has affected many independent boutique cafes in Singapore which have grown in recent years due to rising affluence and more sophisticated taste for specialty coffee. In addition, these cafes are also facing soaring rents, alongside labour shortages and stiff competition.

Using economic analysis, discuss the impact these events are likely to have on farmers of coffee beans, consumers of specialty coffee and owners of boutique cafes. [25]

Introduction

These events that are mentioned in the preamble will affect the demand and supply hence affecting the consumers and producers differently through changing the market equilibrium price, quantity, total expenditure and total revenue.

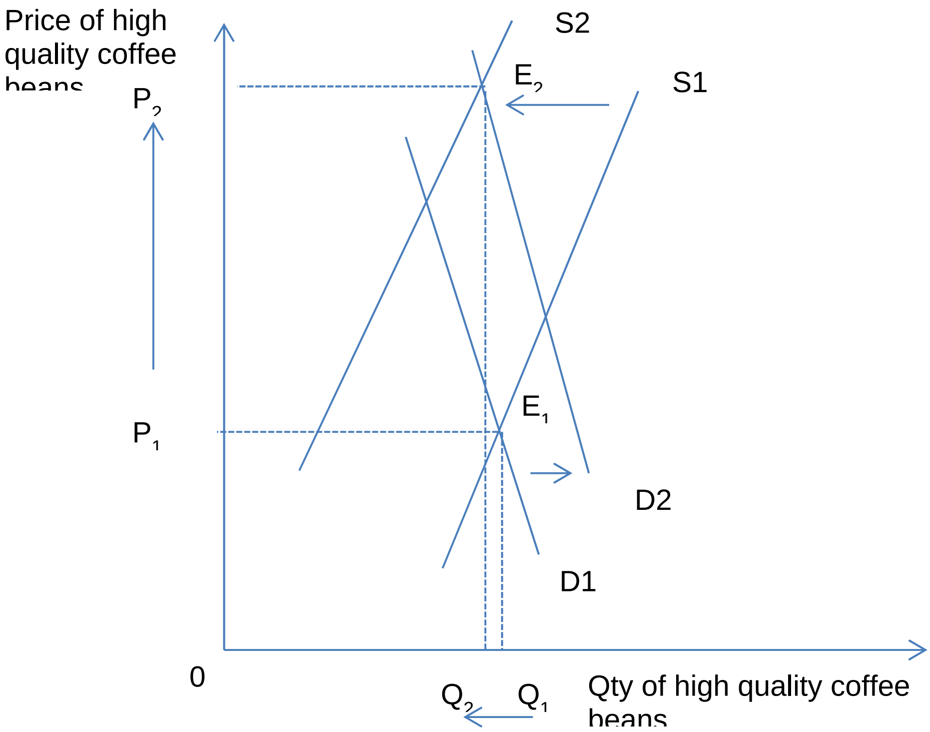
Body Para 1

The farmers of high quality coffee beans are likely to be badly affected by the experience rising total revenue due to the effects of growing taste for high quality coffee beans and global warming. However, the impact on their profits is less certain.

With growing taste for high quality coffee beans, there will be higher demand for high quality coffee beans causing the demand curve to shift rightwards from D1 to D2 as shown in Figure 1. At the same time, global warming reduces the harvest of high quality coffee beans causing the supply of high quality coffee beans to fall, thus the supply curve shift leftwards from S1 to S2 in Figure 1.

The combined effect of a rise in demand and a fall in supply will lead to a sharp rise in the equilibrium price of high quality coffee beans from P_1 to P_2. However, the change in equilibrium quantity is uncertain as a rise in demand will lead to a rise in equilibrium quantity while a fall in supply will lead to a fall in equilibrium quantity. Thus, the effect on equilibrium quantity depends on the extent of change in demand and supply.

Figure 1 Fall in Supply > Rise in Demand for high quality coffee beans



If demand for high quality coffee beans were to rise more than the fall in supply, the equilibrium quantity will rise. This is favourable for the coffee bean farmers as both the rise in equilibrium price and quantity will cause the total revenue to rise for the farmers.

However, if the supply of high quality beans were to fall more than the rise in demand, then the equilibrium quantity will fall from Q_1 to Q_2 as shown in Figure 1. In this case, since equilibrium price rise but equilibrium quantity falls, the effect on total revenue is uncertain.

Evaluation
In this case, the effect on total revenue will depend on the size of price elasticity of demand (PED). Since the demand for coffee beans is a derived demand, meaning coffee beans is a raw material that is demanded to produce the final product, specialty coffee, thus the demand is likely to be price inelastic. Even if the price were to rise, café owners will still have to pay for it as they have no other better substitute. Hence, when the price of high quality beans rise, the quantity demanded will fall less than proportionately. Thus, total revenue for the coffee beans farmers is likely to rise from $0P_1E_1Q_1$ to $0P_2E_2Q_2$.

However, the impact on profits may be less certain because coffee beans farmers may have to incur higher cost in reducing the negative effects of global warming. For example, they may have to water the plants more frequently or replace plants that are affected by global warming. Thus, if the total cost rise faster than total revenue, profits of the farmers need not rise.

In the short run, coffee beans farmers are likely to experience higher total revenue given a price inelastic demand but the impact on their profits is uncertain.

In the long run, if the farmers can engage in research and development and develop coffee seeds that are more resistant to the effects of poor weather, there are likely to experience higher revenue and profits if the taste for high quality beans continues to grow.

Body Para 2

Consumers of specialty coffee will tend to benefit from the growing number of independent boutique café and stiff competition in the market while owners of the café may tend to lose out given rising cost of production and the stiff competition.

With rising affluence, there has been a rise in demand for specialty coffee, the extent of increase depending on the size of YED. Since specialty coffee is likely to be a luxury good with +YED > 1, the demand will rise more than proportionately from D1 to D2 with a rise in the level of income as shown in Figure 2.

The effect on supply of specialty coffee is less certain. With the rising cost of coffee beans, wage cost and cost of rental, this will reduce the ability and willingness of cafe owners to supply specialty coffee. Some café owners who cannot survive the high cost may close down resulting in a fall in supply of specialty coffee.

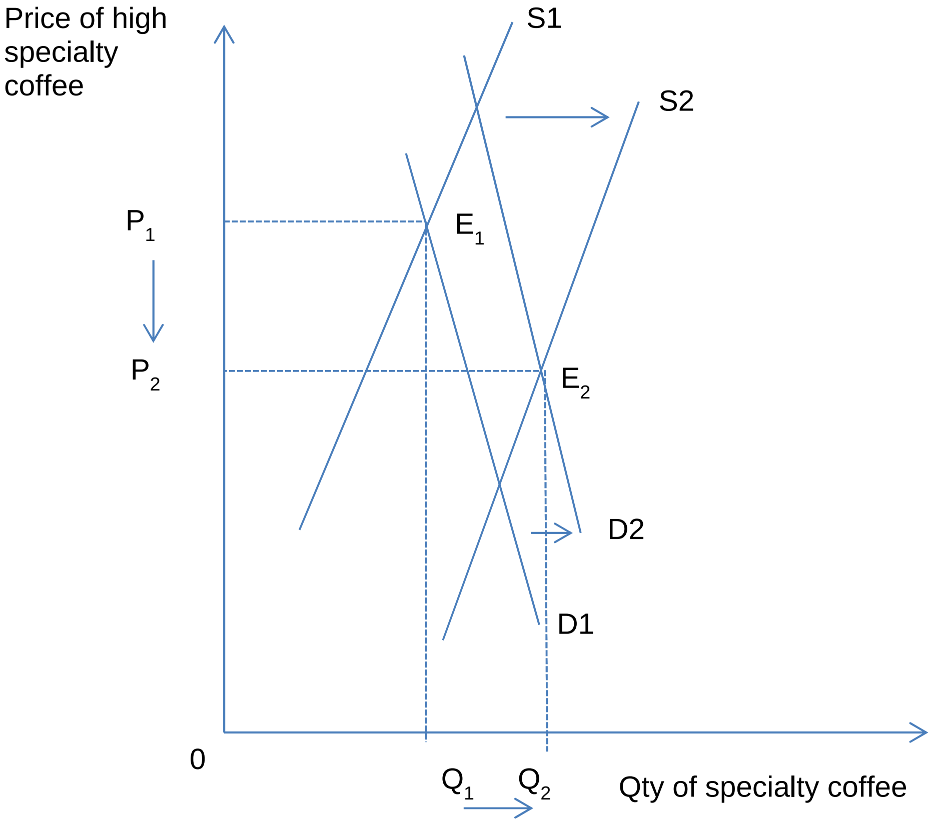
However, in recent years, there has been a growth of new independent boutique cafes as many young Singaporeans aspire to set up their own businesses. Coupled with stiff competition which may force the café owners to increase efficiency and lower their cost of production to stay competitive, supply of specialty coffee will continue to rise.

Overall, if the effect of new café opening up and stiff competition is larger than the rise in cost of production, supply of specialty coffee will still rise from S1 to S2 as shown in Figure 2.

The combined effect of a rise in demand and a rise in supply for specialty coffee will result in an overall rise in equilibrium quantity of specialty coffee while the equilibrium price remains uncertain.

If the demand rises more than the supply, overall equilibrium quantity and price of specialty coffee will rise and this will lead to a rise in total expenditure (TE) of specialty coffee by consumers and a rise in total revenue (TR) of specialty coffee for the café owners. However, if the supply rises more than the demand, overall equilibrium quantity will rise but the equilibrium price of specialty coffee will fall. Thus the effect on TE and TR is uncertain.

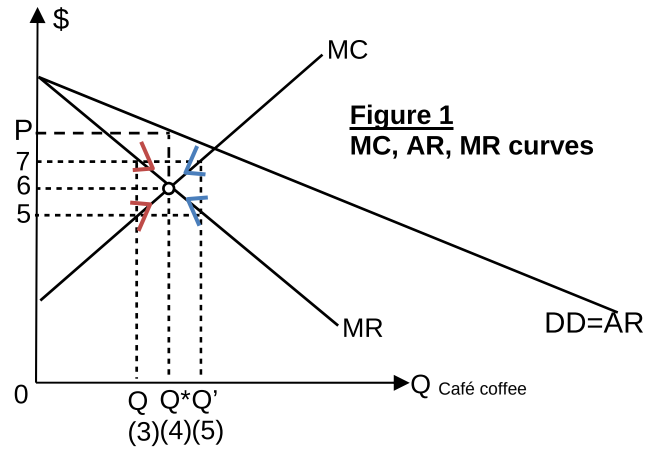
Figure 2: Rise in supply of specialty coffee > Rise in demand



Evaluation

1. The effect on TE and TR depends on the PED of specialty coffee. The PED varies for different groups of consumers. Specialty coffee lovers and middle/high income consumers may have relatively more price inelastic demand due to higher 'addiction' to specialty coffee and they may find the price of a cup of specialty coffee to be a small proportion of Y. Thus when equilibrium price falls, quantity demanded rise less than proportionately and hence their total expenditure falls. On the other hand, consumers who are sensitive to price of specialty coffee e.g. lower income consumers who do not mind the lower quality but cheaper coffee from the neighbourhood coffee shops may have more price elastic demand and hence when equilibrium price falls, quantity demand rises more than proportionately and their total expenditure rises.
2. The effect on the café owners depends on their ability to differentiate their products and adopt efficient methods of production to cut cost. Given stiff competition, close substitutes are available, and hence the café owners face high positive cross price elasticity (CED) for the specialty coffee that they sell. If the competitor café lowers price, the quantity demanded for their coffee will fall more than proportionately causing their total revenue to fall by large extent. To increase TR, café owners will need to differentiate its product to lower the PED so that it can charge higher price than its competitors and quantity demanded fall less than prop causing their TR to rise. Furthermore, with higher efficiency, café owners can cut cost by reducing the number of workers (e.g. waiters) needed, thus enabling them to raise their profits.

Coffee lovers will tend to benefit from the larger number of cafes that are opened and the stiff competition among them as it leads to lower price enabling them to enjoy higher consumer surplus. However, café owners may lose out unless they are able to differentiate themselves from their competitors and adopt more efficient methods of production to cut cost.
Conclusion
Hence, in conclusion, the events affect the demand and supply in the markets for coffee beans and specialty coffee. The events are likely to be beneficial to all the parties if they can overcome the effects of the negative events such as the reduction of harvest due to global warming, the rising cost of production and the stiff competition.

PJC 2016 H2 Prelim Exam Paper 2: Question 2
Question: Profit maximising firms make price and output decisions based on the marginalist principle. Explain how the marginalist principle helps monopolistic competitive firms to maximise profits and discuss the extent to which such firms are likely to be beneficial to society. **[25]**
<u>Introduction</u>
Monopolistic competition is a market structure characterized by many small firms, each with a small market share, selling similar, highly substitutable, differentiated products in a market with low barriers to entry. Firms in theory make decisions using the marginalist principle, considering incremental costs and incremental benefits in their price and output decisions. Firms' decisions and competitive behavior impact consumers and society in terms of allocative, productive and dynamic efficiency, as well as on variety and choice of products to the benefit or detriment of society.
Body Para 1
These firms consider marginal costs and marginal revenues to make decision on price and output for profit maximization. A monopolistically competitive firm such as a cafe is a price setter with a downward sloping, price elastic demand (DD=AR) for its product due to the many close, differentiated substitutes available. The marginal revenue (MR) lies below the AR curve as shown in the figure 1. The firm also faces an upward sloping marginal cost (MC) curve.  **<u>Figure 1</u>** **MC, AR, MR curves** The profit maximizing output is at Q* = 4, where MR = MC. Should the firm produces at output lesser than profit maximizing Q*, for example at Q = 3, where MR > MC. Hence, the firm enjoys additional revenue more than additional cost from the last unit of output. Hence, it can increase profits by increasing output. Thus, there is incentive for a profit-maximising firm to increase output to Q*. Should the firm produces at output higher than profit maximizing Q*, for example at Q' = 5, where MC > MR. Hence, the firm faces additional cost greater than additional revenue from the last unit of output. Hence, it can reduces the fall in profits from the last unit of output, and hence increase profits by reducing output. Thus, there is incentive for a profit-maximising firm to reduce output to Q*. Hence, firms could adjust the output until the profit maximizing output at Q*, where MC = MR, where additional revenue is equal to additional cost at the last unit of output. At this output, there is no incentive for firms to change output any further. Hence, the profit-maximising <u>equilibrium</u> is at Q*, where MC = MR, as illustrated using the marginalist principle.
Body Para 2
Firms in monopolistic competition are allocative inefficient.

As explained, they profit maximize where MC=MR and set price P_E and output Q_E. The MC at output Q_E is MC_E, which is below price, P_E. Thus price exceeds marginal cost and there is allocative inefficiency.

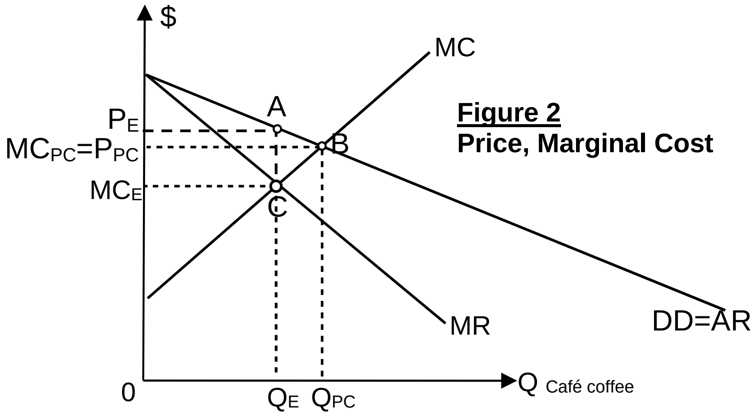


Figure 2
Price, Marginal Cost

Allocative efficiency occurs at output QPC where the curves MC=AR intersect and MC_{PC}=P_{PC}, the price, output and marginal cost that would be achieved in a perfectly competitive market. There is a deadweight loss area of ABC and society's welfare is not maximized as a result of this higher price and lower output compared to the socially optimum Q_{PC}.

Thus monopolistically competitive firms may not benefit society in allocative efficiency compared to perfect competition as P>MC.
However, compared to oligopoly and monopoly, which are also allocative inefficient, the many sellers in monopolistic competition means firms have low market power, and in reality, they tend to set prices only slightly (small extent) higher than MC. Thus, for this reason, between these three more realistic market structures, MC tends to be the least allocative inefficient and is generally regarded to be more equitable in its pricing behavior.

Body Para 3

Also, these firms are beneficial in that they provide more variety and choice to consumers compared to other market structures.

While prices may be slightly higher than MC, the many small firms selling differentiated products offer consumers a wide variety of choices, which benefit consumer welfare. For example, in the hawker food industry, people can choose between chicken rice, noodle soup, pasta, chicken chop, porridge, etc, as small hawker food stalls sell differentiated food products, allowing consumers to eat different types of food that suits their tastes and preferences for each meal. The perfect competition market has a homogeneous product where consumers do not have any choice, while an oligopoly has few large firms for example the 3 telcos of Singtel, Starhub and M1 in Singapore – and there is not that much of a choice / variety. In a monopoly, there is only 1 firm, and again, consumers have no choice and variety.

Thus, monopolistically competitive firms offer consumers the greatest variety and choice, hence bringing great benefit to consumer welfare
The industries where monopolistically competitive firms are most beneficial tends to be those where consumers place a strong value in having choice and variety, such as personalized services like hairdressing, food, fashion etc.

Body Para 4

Monopolistically Competitive firms tend to be productive efficient

Due to the low barriers to entry, when there are supernormal profits made in the short run, new firms will enter the market to erode the market share of current firms until there are only normal profits made again. This intense competition forces firms in such industries to be productive efficient because if they do not keep their costs under control, it causes their average costs to rise, resulting in subnormal profits and they will then have to shut down. This is in contrast with monopoly and oligopoly, where large firms may be X-inefficient because long run supernormal profits and high barriers to entry allow them to continue making supernormal profits even if they are producing with higher average costs as they can just pass on the higher costs to consumers by raising prices without worry of entry of new competitors in the market. This means monopolistic competitive firms tend to produce on the long run average cost curves (LRAC).

Thus, monopolistically competitive firms tend to be productive efficient, benefitting society by ensuring that scarce resources are utilized efficiently.

Body Para 5

However, large firms may be more beneficial with economies of scale (EOS).

Large firms can operate on large-scale production, and reap internal EOS -cost savings like technical EOS or bulk buying EOS which result in lower average costs. For example, a large supermarket can bulk order food products from suppliers and secure cheaper meat and eggs, reducing average costs and this allows them to pass on cost savings to consumers, which would benefit from lower prices compared to small monopolistically competitive firms that operate on a small scale and hence do not have the bargaining power to enjoy lower average costs from bulk buying.

While firms in monopolistic competition are productive efficient, large firms may enjoy internal EOS, which would be more beneficial to consumers if they pass on cost savings and there are lower prices in the market.
Whether larger firms are more beneficial also depends on the presence and scale of internal EOS to be reaped in that industry.

Body Para 6

Firms in monopolistic competition tend not to be dynamic efficient.

Dynamic efficiency involves innovation and research and development (R&D) to develop new products with improvements in quality over time, or technological improvements in the production process to reduce average costs over time. Innovation and R&D requires that firms have the willingness and ability to invest in R&D. The ability to R&D depends on long run supernormal profits, which are present only in an oligopoly or monopoly where there are high barriers to entry. The willingness to R&D depends on the payoff after successful R&D, which tends to be present in oligopolies and monopolies, where imperfect information and patents allow firms to have exclusive ability to produce their product, like Apple / Samsung (smartphones) or Pharmaceutical firms producing medicines. Patents allow them to set high prices to earn supernormal profits as an incentive for R&D.

Since monopolistic competitive firms tend not to have the above two aspects, innovation and R&D will be unlikely and thus, society does not benefit from dynamic efficiency in such markets.
In some industries where innovation is important (tech-firms / medicines), oligopolies would be more beneficial to society than monopolistic competitive firms.

Conclusion

Thus, monopolistically competitive firms in theory use the marginalist principle setting price and output where MC=MR to maximize profits, and the nature of the industry causes them to behave in certain ways resulting in them being unable to achieve allocative efficiency and dynamic efficiency. However, despite that, they do benefit society in terms of choices, variety, productive efficiency and generally low, equitable prices. For products where choice and variety is important to consumers, and where there is limited scope for EOS, it is more beneficial to society to have monopolistically competitive firms.

PJC 2016 H2 Prelim Exam Paper 2: Question 3

Question:

All societies face the problem of scarcity arising from limited resources and unlimited wants.

(a) Explain how price mechanism allocates scarce resources among competing needs in an economy. [10]

(b) Discuss whether it is necessary for the government to intervene in order to achieve an efficient allocation of resources. [15]

a) Explain how price mechanism allocates scarce resources among competing needs in an economy. [10]

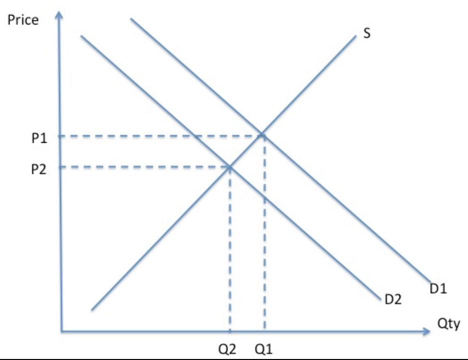
<u>Introduction</u>

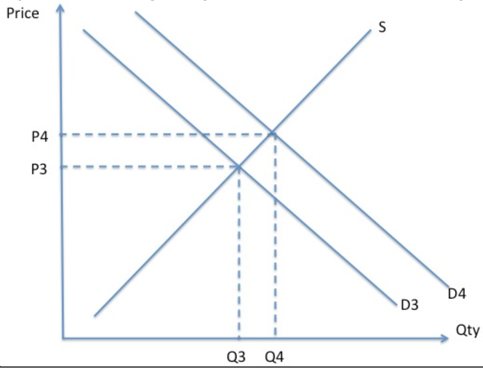
Every economy faces the problem of limited resources and unlimited wants. Price mechanism addresses this problem of scarcity by allocating the economy's resources through answering the three economic questions of what to produce, how to produce and for whom to produce. In the process, consumers and producer interact through forces of demand and supply which brought about the allocation of limited resources to the production of various goods and distributing it to those whom are willing and able to pay – fulfilling some of the unlimited wants of society.

Body Para 1

Due to self-interest, consumers seek to maximise their consumer satisfaction. Consumers signal their choice via the price they are willing and able to pay for different goods and services in the market. Consumers are more willing and able to pay for goods which bring them high satisfaction. Hence the demand for such goods tend to be higher than goods which consumers do not value. Producers, on the other hand, want to maximise profits. They will divert the resources towards production of goods that reap them the highest profits.

For example, with the development of technology and the emergence of 3rd generation (3G)of mobile phones, consumers demand for 2nd generation (2G)of mobile phones fell sharply (D_1 to D_2), and the demand for 3G mobile phones rose sharply (D_3 to D_4) as it now give consumers a higher satisfaction than 2G mobile phones. For 2G mobile phones, at the original price, there would be a surplus, creating a downward pressure on price and equilibruim price would fall to P_2. For 3G mobile phones, the rise in demand would create a shortage at the original price, and the equilibrium price would rise to P_4. Prices signal to profit maximizing electronics producers that they should divert resources from producing 2G mobile phones to produce 3G mobile phones so they can receive a higher price, sell a higher quantity, and receive a higher total revenue. Assuming constant costs – producers seeking self-interest would maximize profits by switching to produce 3G mobile phones.





Thus, price mechanism, through forces demand and supply, allocate scarce limited resources among competing needs in the economy towards the production of goods the society wants – answering the question of "what to produce".

Body Para 2

Profit maximising producers will combine resources in the most efficient way to produce the good so as to minimize costs and maximize profits.

This answers the second economic question of 'How to produce' to fulfill unlimited wants as producers maximize the returns from their limited resources in each market.

In deciding between capital or labor intensive production methods, producers will look at the relative cost of production between the methods. If the price of capital intensive method of production fell due to improvement of technology, the producers will produce switch from labour intensive methods of production to capital intensive methods of production as labour intensive methods of production will not be deemed as more expensive and thus higher cost for the producers. Thus, price mechanism allocate factors of production to meet the competing wants of the economy through their factor costs. The factor with the lower cost factors will be used to bring about the maximum profits for the producers.
Body Para 3
In answering the economic question of 'for whom to produce', price mechanism distributes resources to those with ability to pay. Producers, being profit oriented, will only divert resources to produce for consumers with the 'money votes'. It is only when consumers have the willingness and ability to pay for the good at the equilibrium price, will they be able to purchase the good to meet their wants. Consumers without the ability to pay for the goods will not have any resources diverted towards the goods they desire to have. Thus, under the allocation of price mechanism, resources only go to those who can pay.
Conclusion
Price mechanism allocates resources in the economy among competing wants by answering the economic questions of what, how and for whom to produce. It is through the interaction of consumers and producers that the resources are diverted to fulfil some of the unlimited wants. However, In the real world, price mechanism may not always bring about the most efficient allocation. There are instances of misallocations and these situation render the need for government to intervene.

b) Discuss whether it is necessary for the government to intervene in order to achieve an efficient allocation of resources. [15]

<u>Introduction</u>

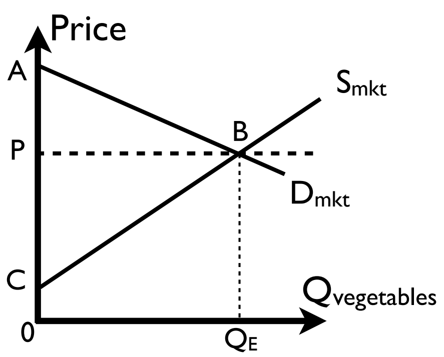
Efficiency is achieved when the markets produce an outcome such that it is impossible to make anyone better off without making someone else worse off. In other words, it is a situation with pareto optimality where there is allocative and productive efficiency. Allocative efficiency is achieved when combinations of goods and services produced maximises society welfare where conditions of MSB=MSC or P=MC are met. Productive efficiency is achieved when there is minimum wastage and firms produce at any point on the LRAC.

Price mechanism can ensure efficiency under the assumptions of perfect competition in all markets, no externalities, private good (the good is not a public good) and perfect information. However, in the real world, these assumptions are never fully present, and government often intervene to correct the misallocation of resources. On the other hand, even though price mechanism may fails, government intervention may still not be always necessary due to possible government failures trade-offs with other government aims and given time, market can often correct themselves.

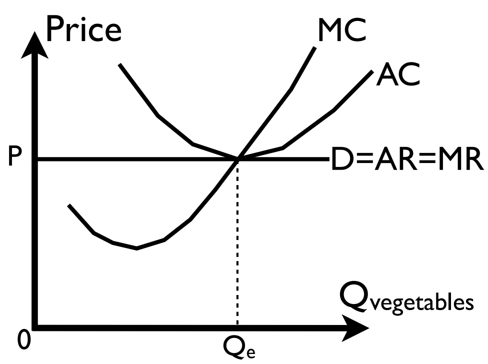
Body Para 1 – perfect competitive mkt

In perfect competitive markets of a private good with no externalities, the price mechanism can achieves allocative efficiency and no government intervention is necessary.

<u>Market for Vegetables</u>



<u>Firm selling Vegetables</u>



With perfect information and no barriers to entry, firms in the market for vegetables are price takers, and take the market price which occurs where demand cuts supply in the market (D_{mkt}=S_{mkt}) at P. They then maximize profits where MC=MR and produce at Q_e. At equilibrium – the price (P) paid by the consumer is equal to marginal cost (MC) of the firm. Welfare to society is maximized (area ABC) and since P=MC, consumers value (P) the last unit of the good the same as it costs (MC) to produce it.

Hence under the assumption of perfect competition of a private good with no externalities and perfect information, no government intervention is necessary to achieve an efficient allocation of resources.

Body Para 2 – public goods

The price mechanism does not allocate resources to produce public goods and government should provide these goods.

Public goods such as national defence are non-rivalry and non-excludable in consumption. Non-rivalry means that the consumption of national defence by an individual does not reduce the quantity available for others. As such the additional cost of providing national defence to another user is zero. Since the allocative efficient condition is P=MC, the efficient price for national defence is 0. This indicates that efficient output level under price mechanism will be zero. National defence is non-excludable which means that it is impossible to exclude non payers from enjoying the good. This leads to a free-rider problem where no one is willing to pay for national defence, and as such, no profit seeking firm would have any incentive to produce national defence since they will not be able to charge a price for the good. This results in a missing market where there is non-provision of public goods.

Given that national defence also confers large positive externalities such as stability, security and increased investment and attractiveness to FDI, these benefits are lost if no resources are allocated to produce this public good.

Despite the huge benefits public goods confer on the economy, it is not produced under free market mechanism. Thus, the government should provide public goods by nationalizing the provision of such goods.

However, nationalization is often plague with the problem of x-inefficiency as the production is not profit driven. When civil servants take over the provision of public good (eg national defence), they may not reduce cost of production to the lowest possible as there is no other firms competing against them. Their bottom line in production is usually not to bring about the maximum profits but to produce a certain quantity with the national budget provided.

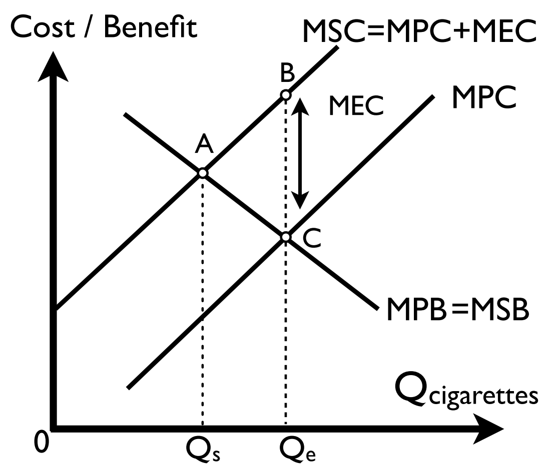
In addition, this problem is compounded by the government, like the free market, lacking the necessary information to provide the correct quantity of public goods. Thus, under government provision, society's welfare will still not be maximize. In weighing the benefits and costs of government provision of public goods, government provision may only be necessary for pure public goods.

Body Para 3 -externalities

The price mechanism also fails in the presence of externalities and government intervention is often needed to correct that.

Externalities are spill-over costs or benefits on third parties who are not directly involved in the production or consumption of a good and these costs or benefits are not compensated for. For example, in the consumption of cigarettes, consumers consider their own marginal private costs (MPC) which is the price they pay for cigarettes and their own health costs, and marginal private benefits (MPB) which is the ability to relax and focus after a smoke. They ignore the marginal external costs (MPC) which are the health costs faced by 2nd hand smokers around them.

In the free market, to maximize their own welfare, consumers consume cigarettes where MPC=MPB at Q_e. This results in a deadweight loss to society of area ABC because the socially optimal (allocative efficient) level of cigarette consumption is at Q_s where MSC=MSB. For every additional cigarette consumed from Q_s to Q_e, there is a higher cost imposed on society than the benefit gained. The free market results in an overconsumption of cigarettes. For goods with positive externalities, the free market results in underproduction / underconsumption due to consumers / producers not taking into account the 3rd party benefits involved in the consumption or production of the good.



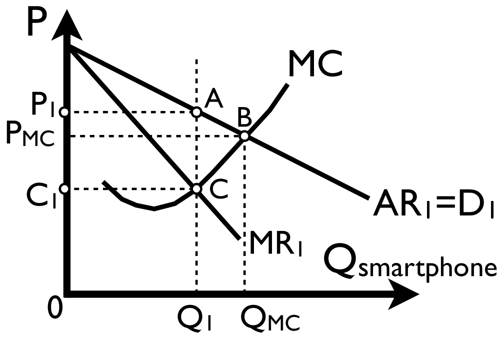
With externalities, the price mechanism fails to allocate resources efficiently and government intervention is often necessary. For goods with negative externalities in consumption (like cigarette consumption), government can intervene with market-based taxes or regulation (like designated zones for smoking). For goods with positive externalities in consumption, market-based subsidy or direct provision can be imposed.

However, government intervention may not be necessary as if the externalities are not significant, the cost of intervention may outweigh the welfare gain. Some of these costs include the monitoring cost for people to follow the rules imposed. This is especially so for a huge country like China as more personnel and thus costs are needed to ensure rules are complied with.

In addition, when the government cannot ascertain the correct amount of tax, it can also lead a tax that is too high, an underproduction of demerit goods and more welfare loss than if no intervention was made. Such intervention can also bring about other unintended consequences like worsening equity as the poor will be paying a larger proportion of their income on tax than the rich. Thus, not all market failure requires government intervention. Degree of necessity in intervention depends largely on how much the costs of intervention outweighs the benefits of intervention.

Body Para 4

When there is market dominance, the price mechanism fails to achieve allocative efficiency and government intervention is often necessary.
Firms with market power face downward sloping demand curves and are price setters. They set price where MC=MR to maximize profits and hence produce at Q_1 and set price at P_1.There is a higher price and a lower quantity as compared to a perfectly competitive market. At Q_1, the marginal cost is C_1. Since P_1>C_1, there is allocative inefficiency. The deadweight loss to society is at area ABC and society's welfare can be improved if more resources are allocated to the production of smartphones at price P_{MC} and quantity Q_{MC} where perfectly competitive market will produce.



With market dominance, market fails to be efficient and government intervention is often necessary. Government can intervene with MC-pricing, AC-pricing or impose an anti-trust law.

However, such intervention may involves tradeoffs with the other aims of the government. For example, anti-trust law can hinder the growth of firms which can contribute significantly to the economic growth and employment of the economy. MC-pricing / AC-pricing can reduce the profits earned and hinder the ability and cut off the incentive of large firms to innovate.

In addition, intervention in monopoly may not be necessary as there is often potential competition. This will ensure the monopoly trim their wastage (nearer to achieving productive efficiency) and not exploit the consumers with an overly high price so as to stay competitive.

Thus, government intervention is not always necessary when market fails with imperfect markets.

Conclusion

Overall, the price mechanism seldom achieves allocative efficiency in the real world since most markets are imperfect and / or possess some form of externalities. The price mechanism also fails in the case of public goods.

In some of these situations, there is a need for government intervention. That said, there are merits to letting the markets decide how resources get allocated in an economy as there is the possibility of government failure or tradeoff of other government aims with too much intervention in the market. The benefits should be weighed against the costs of intervention before government decided if they should intervene or how much they should intervene when free market mechanism fails.

PJC 2016 H2 Prelim Exam Paper 2: Question 4

Governments have a range of different macroeconomic objectives and there are conflicts between the objectives.

(a) Explain how conflicts might arise between the various macroeconomic objectives. [10]
(b) Discuss the view that the government's fiscal and monetary policies should be focused primarily on achieving a low unemployment rate. [15]

a) Explain how conflicts might arise between the various macroeconomic objectives. [10]

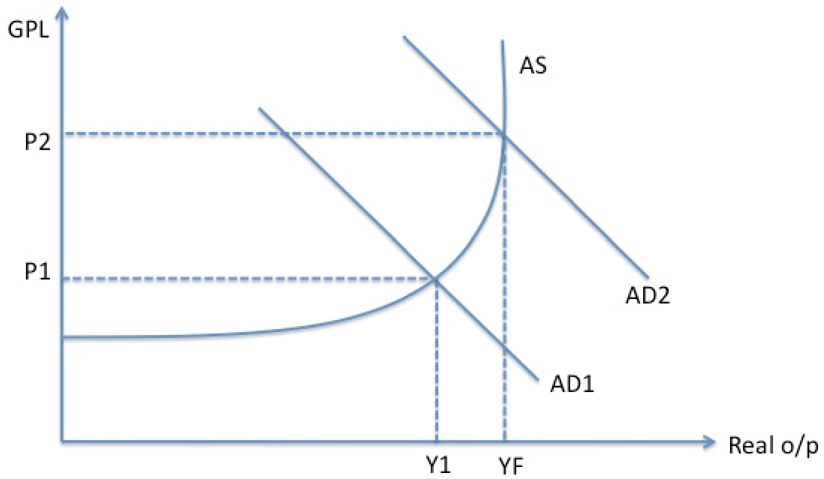
Introduction

Governments around the world aim to achieve the 4 major macroeconomic objects – sustained economic growth, full employment, price stability and long term healthy balance of payment. These aims are important as they promote economic stability within the economy. However, there are conflicts arising between the various macro objectives and thus achieving one aim might result in compromising on other aim.

Body Para 1

If government strives to achieve full employment, it will result in conflict with the aim of low and stable inflation. This is so as in achieving full employment, economy may suffer with rising demand-pull inflation.

To pursue full employment, government will employ expansionary demand management policies such as fiscal policy or monetary policy. As such expansionary policies would increase components of AD such as consumption, investment and government expenditure.



At the original price level P1, resources are not fully employed within the economy. As AD increase from AD1 to AD2, real output would increase and firms will hire more factors of production such as labour. As such, unemployment would fall. However if government continue to pursue for full employment at YF. AD would continue to rise and eventually result in demand-pull inflation as GPL increase from P1 to P2.

Thus there is a conflict between the macro aims of full employment and inflation.

Body Para 2

If government strives to achieve economic growth, it will result in conflict with the aim healthy balance of payment.

Through expansionary policies, higher economy growth will result rising national income. When citizens of an economy experience higher purchasing power, some of these increases in purchasing power could be directed to greater consumption of imported final goods and services, assuming they are normal goods. This increase in import expenditure will lead to a worsening of the balance of trade, and subsequently worsening the current account and hence resulting in BOP to deteriorate.

This is especially so for countries during the early stages of economic development as she has to spend heavily on imports of capital goods. Hence it might only be a short run phenomenon as in the long run when the economy matures and develop, it would not depend heavily on import of capital goods for economic development. Hence it is important to consider the type of imports that are purchased by the economy.

Body Para 3

In achieving high and sustained economic growth, a country may experience greater structural changes as businesses and firms adapt to changing comparative advantages worldwide to remain competitive.

As the economy matures strive to achieve sustained economic growth, it would need to shift towards greater capital-intensive or technology-intensive production. The shift towards greater capital-intensive production could possibly lower the demand for manual labour as firms will choose to replace manual assembling work with mechanization to reduce the need for workers to work on the task. This causes structural unemployment to occur as these workers with low skills get displaced by use of machinery/technology and are unable to find similar jobs elsewhere. Furthermore, as the economy shifts towards technology-intensive productions may lead to some workers' skills and knowledge becoming obsolete, as they no longer have the relevant skills to be employed in the economy.

As such, there is a conflict between the aims of sustained economic growth and unemployment.

Conclusion

These potential trade-offs occur in the short run and are likely to occur depending on the choice of policy tools chosen by the govt and whether the economy is operating very close to full capacity. For example, if the economy is working with a lot of spare capacity then there is not likely to be any conflict with inflation goal since additional resources can be diverted into production without bidding up the prices of these resources.

Interpret the Question – Part (b)
b) Discuss the view that the government's fiscal and monetary policies should be focused primarily on achieving a low unemployment rate. [15]
Introduction
Unemployment refers to people who are registered as able, available and willing to work at the going wage rate in a suitable job but who cannot find paid employment despite an active search for work. Governments try to ensure that unemployment is as low as possible to minimise the negative economic, social and political costs associated with high unemployment. However, it is important for governments to be aware that fiscal and monetary policies should not primarily focus on achieving low unemployment rate as there are limitations to the usage of both policies and policies may be ineffective depending on the root cause of unemployment. Furthermore, low unemployment may not be the most important macroeconomic objective a government is targeting currently as there are other macro problems for the government to manage.
Body Para 1
Fiscal and monetary policies should focus on achieving a low unemployment rate as it has negative effect on the economy. Firstly, high unemployment can put a strain on government finances. With high unemployment, there is increased spending on unemployment benefits and other welfare payments. Furthermore, as more and more workers remained unemployed, government would experience falling tax revenues from income tax and GST collection. This is so as rising unemployment meant more workers losing their source of income and thus unable to contribute towards income taxes. As tax revenue falls, this can be at the expense of government expenditure in other areas. Secondly, high unemployment also affects consumer spending adversely. As high unemployment erodes consumer confidence, the willingness of people to spend declines. Households would build up their savings rather than to spend, as they perceived the future expectations to be bleak. Thus aggregate demand falls causing national income to fall thus recession. Lastly, prevalent unemployment can also lead to social and political unrest. This will destabilize the economy and deter foreign investment, negatively affecting the economic growth. BOP may also worsen as foreign firms pulls out their investments in the economy. Capital account may worsen which thus leads to BOP to deteriorate. For all these reasons having a low unemployment is instrumental to achieving the other macro aims.
Body Para 2
Typically, the main policy tools to address any macroeconomic problem are fiscal and monetary policies. This applies to the problem of high unemployment only if the root cause to unemployment is cyclical in nature. To combat internal causes to cyclical unemployment, central banks can adopt expansionary monetary policy to lower interest rate which would raise consumption (C) and investment (I), as cost of borrowing falls, and AD can shift right and demand for labor increases, reducing cyclical unemployment. This policy is often used by developed countries (US, UK, EU, Japan) due to the relative ease and timeliness for implementation. Another way to address high employment would be to adopt expansionary fiscal policy to shift AD to the right. This can be done by increasing govt spending (G) and reducing taxes (T). However if cyclical unemployment arises from external causes such as falling exports, central banks should instead weaken its currency. Price of exports will fall and price of imports would rise. Assuming Marshal-Lerner condition holds where sum of PEDx and PEDm is greater than one, depreciation would cause net exports to rise. As net export is a component of AD, rise in AD would increase real output and thus rise in demand for workers. Thus fiscal and monetary policies are effective in achieving low cyclical unemployment.
Body Para 3

However, the above policies have their limitations and may not be effective in lowering unemployment rate. The implementation of fiscal policy requires substantial amount of funds which have to come from reserves, taxpayers' pockets and/or borrowing either internally or from abroad. If the funds are derived from increased taxes, then there will be welfare implications as inefficiency is likely to result when increased taxes result in a disincentive to work, save and invest. If it comes from borrowed money, it will mean a debt burden which has to be shouldered by future generations via higher taxes too. Furthermore, when business conditions are bleak, a fall in interest rates may be a necessary but definitely not a sufficient condition in bringing about a higher level of investment spending. Business confidence has to return before investors are willing to launch new businesses. Similarly for consumers who might not want to spend at the lower interest rates when their jobs are at stake in a bleak economy. As such, the much anticipated increase in C and I will only rise to a limited extent. This renders the desired shift in AD unattainable. Hence the output may not increase substantially to necessitate the employment of more workers.
Body Para 4
Furthermore, high unemployment might not be due to cyclical reasons but structural problems. As an economy restructuring in the economy towards higher value-added and knowledge-intensive activities, manufacturers continue to outsource their production and shift their operations overseas to take advantage of the cheaper labour and business costs elsewhere. However, with occupational immobility of such workers due to a lack of educational attainment and skills training, these workers could not find jobs in the high-skilled jobs which Singapore has a comparative advantage in. Hence, there is a skill-mismatch between lower educated job seekers and the new jobs created as a result of the shift towards higher quality or value-added jobs As such, fiscal and monetary policies would be ineffective in dealing with structural unemployment. Supply side policies would be more relevant.
Body Para 5
On the other hand, low unemployment may not be the most important macroeconomic objective a government is targeting. Cost-push inflation was one of the most significant problems for Singapore during 2013 when government announced reduction in reliance of foreign labour via a change in the immigration policies. This has caused significant rise in cost of production for many firms in Singapore resulting in rising cost-push inflation. And currently, many European countries are suffering from rising government debt and are adopting austerity measures in the form of contractionary FP. As such, it can be seen that government's fiscal and monetary policies are not always focus on reducing unemployment but more to tackle economic problems that are most pressing to the economy.
Conclusion
Therefore, fiscal and monetary policies are not solely used to achieve low unemployment rates. They are also used to address the other macroeconomic problems. Whether the government should focus its fiscal and monetary policies primarily on achieving low unemployment rate depends on the most pressing problem and need of the economy currently. As discussed above, in the year 2013, in the context of Singapore, the most pressing concern was high cost push inflation, hence low unemployment rate should not be the primary focus. Also, whether the government should focus its fiscal and monetary policies primarily on achieving low unemployment rate also depends on the effectiveness of such policies in solving unemployment, and this depends on the nature of the economy and the root cause of the unemployment. In a small open economy such as Singapore which has a high marginal propensity to withdraw (mpw) due to its high

marginal propensity to save (as a result of the CPF scheme) and its high marginal propensity to import (because of its lack of resources), the multiplier tends to be very small. This would severely restrict the effectiveness of such policies. Even for reducing unemployment, a government need not only rely on fiscal and/or monetary policies, other policies such as supply side policies should be used when high unemployment is due to structural reasons. Most importantly, what matters is the effectiveness in correcting the high unemployment by considering the root causes of it.

PJC 2016 H2 Prelim Exam Paper 2: Question 5

Question:

We have made skills, innovation and productivity the basis for economic growth and rising real incomes. This is key to keeping our economy vibrant, with a strong core of Singapore-based companies and with every working Singaporean in well-paying, meaningful jobs.

Source: *Singapore Budget Statement 2014*

(a) Explain how economists assess the economic performance of an economy. [10]

(b) Discuss whether further progress in a country's living standards depends on higher productivity. [15]

Introduction

Economists usually assess the economic performance of an economy in terms of how well an economy meets its four macroeconomic aims, namely sustained economic growth, low unemployment, low and stable inflation, and favourable balance of payment in the long run.

To measure how well each aim is attained, economists make use of indicators such as real Gross Domestic Product (GDP), unemployment rate, inflation rate, and balance of payment statement for each of the above aims respectively.

Body Para 1

One way to assess the economic performance of an economy is to examine whether it experiences sustained real economic growth over time.

Sustained economic growth refers to positive and stable growth over the long term. Economists can track this by examining its real GDP and real GDP growth rate over time. Real GDP is the total value of output produced by factors of production (FOP) within the geographical boundaries of a country, regardless of ownership, before depreciation, at base year prices.

Hence, a sustained increase in real GDP over time suggests that more goods and services are produced and available for consumption, with higher real national income (as national output = national income = aggregate expenditure), and thereby enjoy a higher material standard of living.

Hence, one way to assess the economic performance of an economy is to examine whether it experiences sustained economic growth by looking at its GDP statistics over time.

Body Para 2

Another way to assess the economic performance of an economy is to examine whether it experiences non-zero low rate of unemployment compatible with price stability over time.

Labour is one of the factors of production. Low unemployment as measured by the unemployment rate would indicate high degree of resource utilisation in the economy, signaling that the economy is producing efficiently and near its full productive capacity, thereby experiencing less wastage of idle resources.

Hence, one way to assess the economic performance of an economy is to examine whether it experiences non-zero low rate of unemployment compatible with price stability over time

Body Para 3

Another way to assess the economic performance of an economy is to examine whether it experiences low inflation over time. Inflation refers to the sustained inordinate increase in general price level of goods and services in an economy year-on-year, usually by comparing consumer price index (CPI) over time. Too high an inflation rate would cause deterioration of purchasing power and deterioration of the material standard of living. Small and relatively stable increases in the general price level over time are desirable as that means the cost of living increases at an acceptable rate over time and induces consumers to save and firms to invest. With the low inflation, price increase is slight, and if lower than nominal GDP growth, the economy can enjoy real GDP growth (nominal growth less inflation rate) and thus, with more goods and services for all to enjoy and hence improvement in material SOL. In addition, slight & stable price increase may be beneficial for the economy, suggesting that there is healthy demand growth, with slight increase in income, which would spur job creation (as demand for labour is the derived demand for output) and healthy increase in real wage growth and material SOL. Hence, one way to assess the economic performance of an economy is to examine whether it experiences low inflation over time.
Body Para 4
Finally, the last way to assess the economic performance of an economy is to examine whether it experiences favourable balance of payments over the long term. Balance of payment (BOP) is the record of all economic transactions between the residents of the country and the rest of the world in a particular period, usually a year. A favourable BOP refers to the avoidance of large or persistent balance of payments surplus or deficit in the long run. BOP consists of the current account and capital account. A persistent BOP deficit could be caused by a deficit in either account or both. A current account deficit would indicate that residents of the country are consuming more imports than the country is exporting to the rest of the world, in the long run, this would lead to unintended consequences, such as a depreciation of its currency and depletion of its foreign currency reserves. Similarly, a persistent BOP surplus would also lead to unintended consequences such as appreciation of currency or retaliation by its major trading partners, causing a fall in net exports. Hence, one way to assess the economic performance of an economy is to examine whether it experiences favourable balance of payments over the long term.
Conclusion
In conclusion, economists assess the economic performance of an economy in terms of its attainment of the four macroeconomic aims, namely sustained economic growth, low unemployment, low and stable inflation, and favourable balance of payment in the long run, through the use of indicators such as GDP, unemployment rate, inflation rate, and balance of payment statements. An economy which is able to attain the four macroeconomic aims successfully would generally be able to enjoy a higher level of living standards compared to another which does not.

b) Discuss whether further progress in a country's living standards depends on higher productivity. [15]

<u>Introduction</u>

A country's living standards refer to the standard of living (SOL) experienced by its residents; it consists of two components – material SOL and non-material SOL. Material SOL is measured by the quantity and quality of goods and services consumed, while non-material SOL refers to the quality of life in general, including the state of the environmental conditions. Further progress means to enjoy a higher living standard than what is experienced currently.

While higher productivity could increase a country's productivity capacity and make more goods and services available for consumption, thereby improving the material SOL, whether there is further progress in living standards depends on its current level of resource utilisation, and willingness and ability of government to use the extra tax revenue gained to provide more and better quality public and merit goods to improve the non-material SOL.

Body Para 1

Higher productivity could lead to further progress in a country's living standards.
Labour productivity is defined as output per man hour. Through training and re-training, workers could be equipped with the relevant skills to operate more sophisticated machineries and therefore be able to produce more output per man hour, thereby increasing labour productivity.

Assuming the economy is currently near or at full employment output level, Y_f, the economy is unable to grow further or produce more goods and services without an increase in the productive capacity, via an increase in the LRAS. This means that the amount of goods and services produced would stay the same and there could be no further progress in terms of enjoying a higher material SOL.

As such, in order to enjoy higher material SOL, the economy has to increase its productivity so as to increase its LRAS and attain a higher productive capacity to increase the maximum amount of good and services which could be produced and therefore consumed. At the same time, workers need to have higher wages so as to purchase and consume more goods and services. As firms are profit maximisers, they are unlikely to increase wages without first experiencing an increase in labour productivity. Hence, higher productivity is needed to ensure wage growth and hence the higher purchasing power to enjoy the larger amount of goods and services produced.
Therefore, higher productivity could lead to further progress in a country's living standards.

Body Para 2

However, higher productivity might not be the most effective way to bring about further progress in a country's living standards.

Assuming the country has a low degree of resource utilisation, for example if it is currently recovering from recession, there would be a lot of resources which are unemployed and under-employed, including labour. Many households would have members who are able and willing to work at the current wage rate who are unemployed. The most effective way to bring about further progress in the country's living standards would be for the government to implement demand management policies, such as fiscal policy and monetary policy, to stimulate the economy and increase the aggregate demand (AD) for goods and services in the economy. As firms seeks to meet the increased demand for goods and services, they would demand more labour and employ many of the currently unemployed and under-utilised labour. As such, these previously unemployed workers will now earn an income, correspondingly the income of these households will increase. With higher purchasing power, they would be more willing and able to consume more goods and services, thereby rapidly improving their material SOL.

Hence, higher productivity might not be the most effective way to bring about further progress in a country's living standards for a country with a low degree of resource utilisation at the moment.

Body Para 3

While higher productivity could bring about higher material SOL, it does not ensure better living environment conditions or quality of life. With higher productivity, more goods & services would be produced which also meant that more waste would be generated. If these wastes are not properly disposed, it may lead to a degradation of the environment and living conditions. With higher productivity, workers are likely to receive higher wages and firms are likely to earn higher profits. These mean that the government is likely to receive higher tax revenues from income tax and corporate tax. Improvement of the country's non-material SOL would depend on whether the government uses the extra tax revenue gained to provide more and better quality public and merit goods. For instance, for a country which has enjoyed higher productivity in some sectors such as Singapore, the non-material SOL has been impacted in recent years by frequent floods at Orchard Road and many incidences of HDB flat lifts breaking down. These could be improved if the government used the extra tax revenue gained to provide more and better quality public and merit goods, such as widening the Stamford Canal to reduce flooding in Orchard Road. Hence, higher productivity might not ensure higher living standards in the non-material aspect and this would depend on the willingness and ability of the government to use the extra tax revenue gained to provide more and better quality public and merit goods.
Conclusion
While higher productivity could increase a country's productivity capacity and make more goods and services available for consumption, thereby improving the material SOL, whether there is further progress in living standards depends on its current level of resource utilisation, and willingness and ability of government to use the extra tax revenue gained to provide more and better quality public and merit goods to improve the non-material SOL.

PJC 2016 H2 Prelim Exam Paper 2: Question 6
Question: **The world's economies have developed ever-closer links since 1950, in trade, investment and production. Known as globalisation, this process is not new, but its pace and scope has accelerated in recent years, to embrace more industries and more countries.** **Source: BBC News, Globalisation, Key Facts: The Global Economy http://news.bbc.co.uk/2/shared/spl/hi/guides/457000/457022/html/** **Discuss the view that globalisation tends to benefit some countries more than others. [25]**
<u>Introduction</u>
Globalisation refers to the increased economic integration of economies around the world via increased trade and capital flows and international movement of labor. Globalisation might lead to benefits to an economy in terms of the four macroeconomic objectives, consumer welfare and standard of living (both material and non-material well-being). While globalisation has seemed to benefit some countries more than others in the short-run, it ought to benefit all countries in the long-run based on the theory of comparative advantage.
Body Para 1
Globalisation tends to benefit some countries more than others via increased trade flows. Increasing trade activities due to globalization can help an economy to sustain economic growth, lowers unemployment rate and improve balance of payment. If +X>+M, the increase in current account surplus → +net exports i.e. (X-M), a component of AD → Rising AD and multiplier process → higher level of GDP. More jobs are created in the export sector and spillover effects in other sectors. • Some countries benefit more than others because of the nature of the economy. The factor is the degree of openness of an economy (as measured by the trade flow as a % of GDP) which affects the relative impact on AD and NY. A more open economy such as Singapore where exports makes up a larger % of GDP (Singapore's exports is 200% of GDP) is likely to benefit more from globalisation as it leads to +X>+M. However, it also makes it more vulnerable to the unstable economic growth of the member country. Fall in NY of main trading partners. E.g. subprime crisis in US → fall in US NY → US consumers -p.p → less ability to buy g&s, including M from its trading partners → -demand for X for US's trading partners (for all countries that trade with US, e.g. Singapore) → -current a/c bal → -AD, neg growth, +unN. Also –FDI inflows → so fall in (X-M) and FDIs → -ADsg → neg ec growth, +cyclical unN. **[Evaln]** Nevertheless, the Singapore government showed that by implemented effective and appropriate policies, it can mitigate the negative effects of globalisation in the short-run. For instance, Sg government implemented sort-term supply-policies such as Jobs Credit Scheme which subsidises wages and thus reduce firms' costs of production. SRAS shift downwards and real output rises. Firms are more willing to retain the workers to enjoy the wage subsidies thus minimizing unemployment. • Some developed countries suffer a loss of comparative advantage (CA) due to a decrease in the internal efficiency in the country or improved efficiency of the country's competitors. For example, due to higher labor cost, many developed countries suffer loss of CA in L-intensive manufactured goods (e.g. textile and toys) to emerging low-cost developing countries (e.g. China, Vietnam) -> industries in developed countries produce at higher COP and thus P -> -X competitiveness -> -X earnings, +M spending -> +M>+X → increase current a/c deficit. On the other hand, China and Vietnam would enjoy +X>+M and thus gain more in terms of better macroeconomic performance.

[Evaln] Even for developed countries which are losing CA in labor-intensive goods and which have CA capital-intensive goods can benefit from globalisation if their governments are able to implement market interventionist supply-side policies in the long-term to grow new comparative advantages in new industries and to pursue product innovation / improvement. After all, CA is dynamic and changes over time when the key factors determining the relative costs of production are improved. For instance, this could stem from investment in research and development which develop cost-cutting innovations. Investment in physical and human capital (government spending on education and retraining) also leads to higher productivity and competitiveness because of higher quality of its labor force and capital goods, and thus falling cost of per unit of output. Countries which governments enjoying budget surplus would thus benefit from increased trade flows and capital flows. For example, the Chinese government provide subsidies and grants to develop its capital-intensive solar panel industry, even though China's CA dos not lie in capital-intensive production.

Body Para 2

Globalisation tends to benefit some countries more than others via increased capital flows.

Rise in foreign direct investments
→ rise in AD in the short-run due to rise I which is part of AD
→ higher AS in the long-run as inflow of FDI increases productive capacity

Foreign investors invest production plants → goods produced are exported to foreign markets → rising X → rising AD

Both rising AD and rising AS → + impact on sustained economic growth with low unemployment rate and low inflation rate.

- Due to increased competition from low cost economies, many labour-intensive FDI flows out of developed countries (e.g. US, Singapore) to these low-cost economies with CA in L-intensive goods (e.g. China).

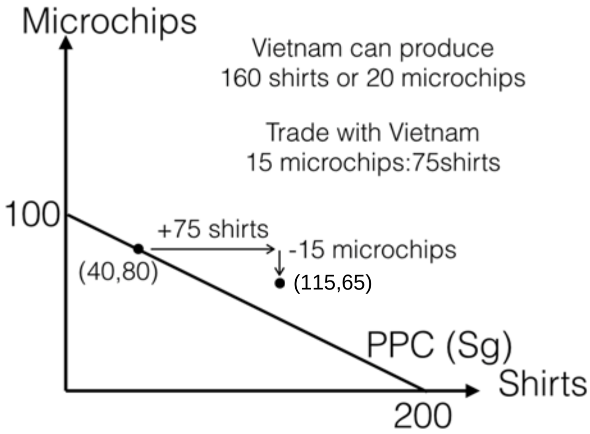
→ Countries with CA in L-intensive prodn e.g. China benefit from net FDI inflows → +FDI, foreign investors invest production plants so more goods produced are exported to foreign markets → +I and +X → +AD, via k, +++real NY. Moreover +FDI → more new capital goods, more transfer of new technology, +productive capacity, +LRAS. Both +AD and +LRAS would lead to sustained ec growth with low unemployment rate and low inflation rate.

→ Developed countries, countries with CA in capital intensive goods would see a fall in the demand for low skilled workers → rising unN of low skilled workers → in reality, factor mobility is not perfect in the short-run → low-skilled workers are unable to take up jobs in the capital and technology-intensive industries such as the multi-media as these countries restructure from the traditional industries to knowledge-based industries → rising structural unN. Retrenched workers from low skilled sectors increases the supply of low skilled labour in Singapore and this drives down domestic wages for low skilled workers. On the other hand, exports (sunrise) industries that sell to the global market would increase the demand for highly skilled workers as the need to produce more output for exports increases. This causes high skilled workers to enjoy higher wages, leading to the income gap between the high and low skilled workers to widen. This can lead to increased income inequality and social and political issues.

[Evaln] The governments in the developed countries could spend on retraining which is effective to reduce structural unemployment. With retraining workers for future jobs → equip workers with relevant skills for the knowledge-intensive industries such as IT and multi-media → reduce job mismatch → improve employability → reduce structural unN. Moreover, retraining workers → increase labour productivity and the quality of the workforce → reduce unit labour cost → increase productive capacity of economy → LRAS shift outwards → COP falls → attract FDI and increase export competitiveness → Px falls → DDx price elastic, Qx rise more than prop → Value of X rise → AD rise → real output rise → higher demand for labour → fall in unN

Body Para 3

Globalisation benefits all countries based on the CA theory, and not just some countries.
The theory of comparative advantage (CA) states that all countries can benefit from trade if they specialise in producing goods where they have a lower opportunity cost. Assume Singapore has resources to produce 200 shirts OR 100 microchips, and factors of production are perfectly mobile, if Singapore produces 40 shirts and 80 microchips, and trades with Vietnam who can produce 160 shirts OR 20 microchips, trading at a mutually beneficial exchange ratio to get 75 shirts for 15 microchips, Singapore can consume 115 shirts and 65 microchips, beyond her production possibility curve (PPC). Singapore specializes in microchips (her CA) while Vietnam specializes in producing shirts (Vietnam has CA). Hence this shows that trade benefits all countries allowing them to consume beyond their PPC. World output is higher with specialization boosting national income, economic growth and standard of living for all countries.



[Evaln] Other benefits of trade besides those of CA theory can be enjoyed by all countries. For example, with globalisation, there will also be an increase in intra-industry trade which is not based on comparative advantage. This type of trade would lead to a greater variety of the same consumer goods and services and thus would cater to the different taste and preference of consumers, hence improving consumer welfare and higher standard of living.

[Evaln] Another benefit of trade is the increased production and economies of scale. With specialization and trade, export industries with CA produce for world markets and hence produce a larger output. Firms can enjoy economies of scale – cost savings from large-scale output. With lower costs, firms can pass on cost savings to consumers and also earn higher levels of profits from increased revenues from sales to other nations. Hence, all firms and countries tend to benefit from increased trade.

[Evaln] Nonetheless, a limitation of the CA theory is that it assumes there are no barriers to trade. In reality, countries do not always trade freely and fairly with one another. Trade restrictions or protectionism can raise the prices of imported goods, making local goods appear cheaper and thus can limit the gains from trade of other countries. Protectionism can also cause other countries to be negatively affected when it leads to beggar-thy-neighbour effects, hence leading to some countries to not benefit from globalisation.

Conclusion

It is true that globalisation has led to some countries tend to benefit more from others, at least in the short run. It is evident that many developed countries are losing out in the globalisation to developing countries because of the loss of CA and lack of competitiveness in labor-intensive production. However, developed countries' governments should respond with appropriate demand and supply policies to grow new CA in new industries in capital-intensive production. This is because based on the CA theory, all countries would benefit from globalisation in the long run.