Question 2

The Chinese Economy

Extract 4: China and Currency Manipulation

The subject of whether China undervalues its currency to gain a trade advantage on the United States is a longstanding point of contention between Washington and Beijing.

Critics in the U.S. claim that currency manipulation has cost about 2 million U.S. jobs and hurt manufacturers. China claims that its exchange rates are not the reason for the trade gap and has accused the U.S. of using Beijing as a "scapegoat" for its greater economic woes.

A wide coalition of US trade unions and members of Congress is stepping up pressure on President Barack Obama to confront China over alleged illegal currency manipulation.

Source: Adapted from The Guardian, 20 May 2009 and http://worldnews.about.com

Extract 5: China's Exchange Rate Reform

China's fixed exchange system was discontinued from 2005 and a managed float system was adopted. A move that would increase the value of the Chinese Yuan against the dollar and help ease a trade imbalance, which has cost U.S. jobs. The move would come amid growing complaints that China's undervalued Yuan has made it difficult for manufacturers in the United States and other countries to compete with China's exports.

However, He Weiwen in the Global Times news article states that the US trade woes shouldn't be blamed on the Yuan. He points out that from 1998-2004, the Yuan was fixed at 8.28 to the dollar and China's exports to the U.S. varied from year to year stressing that the Yuan exchange rate doesn't play a significant role in affecting US exports. China also continued to record trade surpluses against the United States after it initiated exchange rate reform in 2005 to allow the renminbi to appreciate 20 percent against the US dollar.

Source: Adapted from http://www.epi.org/news/china and EPI News, April 9, 2010, "China Reportedly Close to an Agreement to Revalue Yuan"

Table 1: Growth of U.S. trade in goods with China (%)

Before Chinese Yuan's reform	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Growth of China Exports to US (%)	14.9	22.3	22.3	22.4	21.8	29
Growth of US Exports to China (%)	7.9	23.4	18.5	15.4	28.2	21.4
After Chinese Yuan's reform	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Growth of China Exports to US (%)	23.8	18.2	11.7	5.1	-12.3	23.1
Growth of US Exports to China (%)	31.3	30.3	17.3	10.8	-0.3	32.3

Extract 6: China's Economic Growth to Benefit All of Asia?

Foreign direct investment (FDI) into the mainland saw its strongest surge in more than two years last month with the US$14.4 billion of capital committed leaving the world's second biggest economy firmly on track to meet the government's target of US$120 billion of inflows this year. It is one of the principal drivers of mainland's breakneck economic growth in the past three decades.

But foreign investment has grown elsewhere too. The ten ASEAN countries saw a record $37 billion of investment in 2005. For some manufacturers, South-East Asia (or India) serves as a hedge against something going wrong in their China operations – be it social unrest, economic problems or a business climate that turns against foreign investment.

However, much investment outside China is in fact dependent on the China boom. So supercharged has the Chinese export machine become that it has sucked in vast quantities of parts and components for final assembly from other parts of Asia – Thailand, Malaysia, Singapore, the Philippines and Indonesia, as well as richer Taiwan and South Korea. Everybody has benefited by Chinese demand for top-notch components and capital goods. In China, the processing and assembly of imported parts and components now accounts for more than half of all exports. It has recently recorded phenomenal growth in exports of high-tech products, principally notebook and desktop computers, DVD players, mobile phones and the like.

For South Korea, Taiwan, Hong Kong and Singapore, trade has also turned from the rich world towards China. So has Philippines and Thailand. Their export to China has increased and that the country at present enjoys surplus trade balance with China. Meanwhile, Chinese tourists made 83 million overseas travels, of which more than 90 percent were to other Asian countries, among which Malaysia, Singapore, Thailand and South Korea were their favorites.

However, the economic growth is not only relying on export. Instead, domestic consumption is going to drive the economy, which will provide other countries with numerous business opportunities. Wang Chuanfu, chairman and president of China's largest rechargeable battery maker, said that his company is a good example of China's vigorous economy. Wang's company had only 20-odd persons when it was first founded but now has more than 30,000 workers. When China becomes rich, the country will create a large amount of business opportunities and make inconceivable contribution to the world economy, said Wang.

With China's rising consumption in recent years, this huge domestic demand is now growing at 9% a year and starting to act as a regional engine of growth, sucking in imports to feed its increasing consumption for products it has no comparative advantage in. The World Bank forecasts that this will be the first year in which China's imports will be growing and becoming the biggest source of import growth in the world. Goldman Sachs, an investment bank, reckons that China's imports for domestic use are now roughly the same as those used in assembling exports, whereas five years ago they were only half as big.

China's reform and opening-up drives over the past two decades have produced one of the most dynamic economies in the world, offering the rest of the world a huge potential market.

Source: Adapted from The Economist, "The export juggernaut" and http://www.china.org.cn

Table 2: Singapore-China Bilateral Trade (S$ Thousands)

Source: IE Singapore

	2008	2009
Imports from China	47,594,565	37,585,345
Exports to China	43,817,922	38,125,119

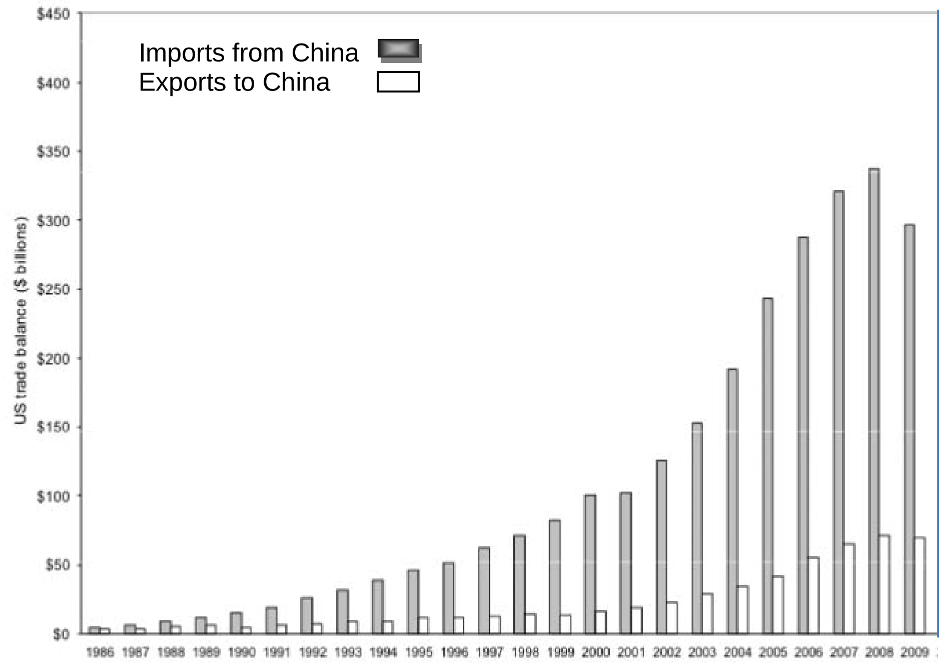
Table 3: Exchange Rate of Singapore Dollar (SGD) vs. Chinese Yuan (CNY)

Year	2008	2009	2010	2011
SGD/100CNY	21.09	20.55	19.53	20.61

Source: Monetary Authority of Singapore

Figure 3

US Trade With China



Annual data from 1986 through 2009

Source: Goldman Sachs Global Markets Institute, Bureau of the Census.

(a) (i) Explain the meaning of balance of payments of a country. [2]

- The balance of payments is a record of all economic transactions between residents of an economy and the rest of the world.
- It comprises transactions in goods and services, income flows, transfers, as well as capital and financial flows.
- It is very useful for assessing the external performance of an economy and for formulating policies connected with it.

(ii) Explain the impact of foreign direct investment on China's balance of payments. [4]

Foreign direct investment (FDI) is a direct investment into production or business in a country by an individual or company in another country, either by buying a company in the target country or by expanding operations of an existing business in that country.

BOP comprises mainly the current account and the capital account.
Capital and financial account :

- Long-term capital flows refers to <u>investments that has maturity of 1 year or more</u>. Such capital flows can be in the form of foreign direct investments (FDIs) and portfolio investments.

- Short-term capital flows refers to <u>investments that has maturity of less than 1 year</u>. Such capital flows are also referred as '*hot*' money flows.

- FDI comes under **direct investment** and it is a credit item i.e capital inflow to China

- Improves BOP. (In the short run)

Current account:
- Record trade in goods, services, income flows and transfers

- When **profits** made by the foreign firms (FDI) are sent out to their parent company abroad, it will be recorded in the current account as a debit item due to income outflows. (In the long run)

In addition,
If the FDI uses **imported materials** for production, a debit item is recorded in the current account as money is sent out of China whereas, FDI which production is **export oriented**, will see a credit item in the current account due to the increase in China's exports, resulting in revenue earned from overseas.

Overall impact on BOP:
Depends on the relative strength of the credit items and debit items. If the credit items exceed the sum of the debit items, there will be an improvement in the BOP.

(b) (i) With reference to Figure 3, describe the trend of US trade balance with China. [2]

In Figure 3, imports from China is greater than exports to China throughout the period indicating that US is having a **trade deficit** with China.

Imports from China is **growing much faster** than the exports to China during the period, hence the trend of US trade balance with China is a **widening** trade deficit.

(ii) Discuss the effects of the "2005 China exchange rate reform" on the US trade balance with China. [8]

From Extract 5 para 1 :
"China's fixed exchange system was discontinued from 2005 and a managed float system was adopted. A move that would **increase the value** of the Chinese Yuan against the dollar.
When the yuan appreciates against the US$, a given amount of yuan is worth more in US$. An appreciation of the Yuan implies a depreciation of the US$

In China,
Px from China in US currency (i.e US imported from China) will be relatively more expensive in US market. while Pm to China (i.e US goods/exports in China) will be cheaper in China market.

In the US,
Effects on **US** trade balance:
Since US exports to China is now relatively cheaper,
Qddx for US will rise proportionately more than its price fall
→Export revenue in US will rise

US imported goods from China is now relatively more expensive,
Qddm from China to the US fall proportionately more than its price rise
→Import expenditure in US will fall

Assume the demand for both exports and imports are **price elastic,** trade deficit US had with China will be reduced.

According to the Marshall-Lerner condition (where the sum of the price elasticity of dd for exports and imports exceeds one), China's appreciation (US depreciation) will improve US trade balance with China

However the Marshall Lerner condition may not hold in the SR due to binding contracts of exports and imports. It is likely to be satisfied in the long run and this means that the trade deficit is likely to worsen before it improves.
(J-curve effect).

Evidence from CSQ :
Fig 3 seems to show the J-curve effect as the appreciation of the yuan (depreciation of US$) after 2005 led to a widening trade deficit up to 2008 before it improved in 2009.

Evidence from Extract 5 (para 2) and Table 1 :
US widening trade Deficit may not be due to the undervaluation of the yuan as "China exports to US ***varied from year to year*** stressing that the Yuan exchange rate doesn't play a significant role in affecting US exports."
In addition, "China continued to have trade surpluses with the US even after appreciation of the yuan after 2005 to allow the renminbi to appreciate 20 percent against the US dollar."
Moreover, % growth of U.S. trade in goods with China in Table 1 is insufficient to conclude that the US exports to China is greater than the imports from China after the appreciation.

Table 1: Growth of U.S. trade in goods with China (%)

Before Chinese Yuan's reform	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Growth of China Exports to US	14.9	22.3	22.3	22.4	21.8	29
Growth of US Exports to China (%)	7.9	23.4	18.5	15.4	28.2	21.4
After Chinese Yuan's reform	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Growth of China Exports to US (%)	23.8	18.2	11.7	5.1	-12.3	23.1
Growth of US Exports to China (%)	31.3	30.3	17.3	10.8	-0.3	32.3

The US trade balance with China may be influenced by other factors and not the exchange rate. For example,

- rising income of USA
- improved productivity of China's exports,
- China export of more higher value added products like notebook and desktop computers, DVD players, mobile phones (Extract 6, 3rd para). There is phenomenal growth in exports of these high-tech products.

The widening of US trade deficit observed in fig 3 could be due to
-rising income in USA that led it to import more, and the improvement in the trade deficit could be due to global crisis in 2009 that reduces its income.
-improved productivity of China exports offsetting the rising Px, hence china's

appreciation may have limited impact on US

The improvement of the US trade deficit in could be due to :
Evidence from Extract 6 :
-the rapid growth/income in China that led to the rising consumption (and not due the rising yuan) in China which results in the increasing imports especially for products it has no comparative advantage.

Evaluation:
The extent of impact on the US economy also depends on the
-magnitude of change/appreciation in the exchange rate
-the extent of the rising imported goods are from USA(Extract 6 mostly mentioned China imports are from Asia)
-fig 3 showed trade deficit worsens from 205-2008 and improves only in 2009, there is insufficient data on how the US trade balance performs after 2009 to see the impact of yuan's appreciation after 2005

A change in the exchange rate is just one factor affecting the US trade balance.

Level	Marks	Descriptors
L1	1-3	Weak/little explanation of how appreciation of Chinese yuan affect US trade balance with little economic analysis or one sided analysis.
L2	5-6	Clear explanation with clear analysis of how Chinese yuan will affect US trade balance with to provide alternative views of Chinese appreciation on US trade balance using some case
E1	1-2	Able to make a conclusive stand and provide justification eg M-L condition may not be met; fig 3 and other factors eg income/productivity affecting Chinese exports to US and/or US imports to China)

(c) Using Table 3, identify the trend of exchange rate between Singapore dollar and Chinese Yuan from 2008 to 2011. [2]

Table 3: Exchange Rate of Singapore Dollar (SGD) vs. Chinese Yuan (CNY)

Year	2008	2009	2010	2011
SGD/100CNY	21.09	20.55	19.53	20.61

Generally, the exchange rate of S$ in Yuan showed gradual appreciation/rising.[1]
Or
Generally, the exchange rate of S$ in Yuan showed gradual appreciation/rising from 2008 to 2010 [1] before depreciating in 2011 (Refinement).

Refinement:
Exchange rate of yuan was the strongest/highest in 2008 (exchange rate of S$ was the weakest/lowest in 2008) [1]
Or

Exchange rate of yuan was the weakest/lowest in 2010 (exchange rate of S$ was the strongest/highest 2010) [1]

(d) Consider the impact of China's growth on the Singapore economy. [12]

China's growth implies rising

- **income**
- **exports**
- **employment opportunities**
- **foreign direct investments**

Positive Impact	Negative Impact
On Spore exports & imports :	
- China presents a big and growing market for Singapore export oriented economy. - Extract 6 para 6 mentioned that consumption level in China is rising and some of these will be in the form of imports (China buying exports from S'pore). - Singapore can export goods and services (e.g. medical services, education, refined oil, tourism) that she has comparative advantage in. - There could also be intra-industry trade to satisfy Chimese consumers' varying tastes and preferences. (that China has no comparative advantage in) - Evidence from Extract 6 para 3 mentioned that China export machine has sucked in vast quantities of parts and components from Asia indicating that Spore can benefit from selling high-end parts and components to China as mentioned in Extract 6…the processing and assembly of imported parts and components now accounts for more than half of all exports in China. The phenomenal growth in	- Cheap imports (e.g. lower end electronic/manufactured prodts from China poses a threat for Spore as it competes directly with similar Spore domestic products causing rising imports from China. The goods are cheap because China has abundant SS of cheap labour, giving it comparative advantage in labour intensive products over Singapore. - In the longer term, when China moved into the production of higher value-added products like desktop computers, mobile phones. Some of these products compete directly with Singapore's exports and will cause falling exports for Spore in the LR.

exports of high-tech products in China has led to more Spore exports to China. Differences in Comparative advantage : China's fast export growth is not at the expense of other countries in Asia due to differing comparative advantages Evidence Table 2 suggested that S'pore's balance of trade with China did improve from a trade deficit to a trade surplus between 2008 and 2009.	
On investment	
Evidence from Extract 6 para 2 indicates that : - FDI has grown elsewhere other than China. ASEAN countries in which Spore is a member, saw a record $37 billion of investment in 2005 - FDI outside China as a hedge against some unforeseen circumstances in China eg social unrest, economic problems or a business climate that turns against FDI. Good Business Environment in Spore : - Singapore does have certain advantages over China like protection of intellectual property rights, clear rule of law for businesses and developed infrastructure.	Closure/relocation of existing firms or FDI choosing China instead of Spore due to the lack of competitiveness or comparative advantage have a negative impact on Spore SR & LR growth. (Evaluation: However, income sent back from China by Spore firms adds to Spore GNP and improve CA in the future)
On macro aims:	
Rising net exports and investment above will raise AD and shift the AD curve upwards and increasing income and creating more jobs, assuming Spore has not reached full employment. In addition, net exports and FDI contribute to the improvement in Singapore's balance of payments.	- In the future, with cheaper imports and China competing with Spore on high-end prodts, Spore will be faced with falling AD and income/BOP - If Singapore loses its comparative advantage in the products we compete with, then, there will be also be structural unemployment as

<table>
<tr><td>(Evaluation: Extent of impact depends on multiplier and the size of increase for AD NY etc)</td><td>firms close down/relocate.

- This will be made worse if Spore loses its attractiveness for FDI.

- In addition, growth of China implies that its citizens with see better job prospects. The inflow of foreign workers from China could reverse. If this happens, it will reduce the availability of cheap FOP for Spore's production, leading to fall in AS and potential economic growth.</td></tr>
<tr><td><u>Diversification to reduce risks:</u>

<u>Evidence from Extract 6 last para:</u>
"China's reform ….. most dynamic economies in the world…offering the rest of the world a huge potential market."

Growth of China opens up a huge market for Singapore and reduced our dependency on the developed nations like EU and USA for its export market. The rise of China provides Singapore with a market to diversify to reduce risk.

For e.g. if USA economy is slowing down, she still have the China market to sell to, thereby reducing the impact of a fall in exports and foreign investment.</td><td></td></tr>
<tr><td colspan="2" align="center">Assess: Is <u>China's growth a threat or benefit?</u></td></tr>
<tr><td colspan="2">China's rise is likely to be a benefit rather than a threat as it has contributed to providing a
cheap source of food products and
cheap inputs
as Singapore lacks natural resources.

The huge potential China market with its rapid growth is sucking in imports to feed its increasing consumption for products it has no comparative advantage allows Spore to sell more of exports such as top-notch components and parts that has contributed to rising AD that increases growth and employment. The threat of China competing with Spore on high end products can be minimized as long as Spore continuously finds niche areas where she excels in and its ability to equip the workers with the appropriate skills and education in this changing world to stay competitive. The structural unemployment can be reduced with education and training to move workers to expanding industries.</td></tr>
</table>

Level	Marks	Descriptors
L1	1 – 3	Little explanation of China's growth on Singapore economy using little or no economic analysis or one sided analysis.
L2	4-6	Some explanation of the impact of China's growth on Singapore economy with some analysis of 1-sided effects (either positive or negative effects or weak 2 sided effects)
L3	7-8	In depth explanation of how China's growth impact Spore with clear analysis of both positive and negative effects and supported with case materials addressing issues such as export growth, employment opportunities, income increases & FDI growth.
E1	1-2	Able to make a conclusive stand with some justification
E2	3-4	Able to make a conclusive stand with strong justification.