SERANGOON JUNIOR COLLEGE
JC 2 Preliminary Examination

ECONOMICS
Higher 2

9732/01

Paper 1 **Case Study Questions** 2013

2 hours 15 minutes

Additional Materials: Writing paper

READ THESE INSTRUCTIONS FIRST

Write down your name and civics group 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 any diagrams, graphs or rough working.
Do not use staples, paper clips, highlighters, glue or correction fluid.

Answer **all** questions.

At the end of the examination, fasten all your work securely together.
The number of marks is given in brackets [ ] at the end of each question or part question.

Answer **all** questions.

Question 1 Globalisation and inequity

Extract 1: Car industry running harder

Battered by the European sovereign debt crisis and recession in countries from Italy to Britain, car sales within the EU are on track for a fifth consecutive year of decline. The car industry was also affected by the rising cost of several important inputs such as steel and metals that have further narrowed the profit margins on car production.

Excess capacity problems are rampant in Europe. According to AlixPartners, a business consulting firm, about 30 of the 98 assembly plants in Europe are operating below 70 per cent of capacity. Excess capacities force manufacturers to engage in price-cutting to protect their market shares, resulting in a vicious circle leading to even lower profits. The worst affected markets were France, Spain and Italy where almost 85% of the cars sold are small- and medium-sized cars which already have lower (profit) margins.

The risk of excess capacity, and thus of fierce price competition, is emerging at a time when carmakers are having to invest heavily in new technology. Fortunately they still have plenty of scope to cut costs by standardising both their “platforms” -- the underpinnings onto which the rest of the car is assembled -- and other components under the bonnet that drivers do not see. One reason why Volkswagen has done so well in recent years is that it has taken such standardisation further than most. This has allowed it to offer a broader range of vehicles across its many brands.

AlixPartners predicts that most of the growth in car sales in the coming years will come from such “megaplatforms”, each of which will underpin more than one million cars of all sorts every year. Flexible production lines will be able to turn out cars to fit every niche in the market, enabling makers to offer buyers “mass customisation” of vehicles. Cars are becoming more like smartphones: expensive to develop and market, and with some pricey parts, but cheap to assemble in their millions, with endless variations.

Source: The Economist, 13 April 2013

Extract 2: A new era accelerating toward 2020

A recalibration of the automotive industry value chain is in motion. The marked decline in car sales led to excess capacity in plants around the world and reduced profitability, triggering reduced capacity, resourcing to stronger suppliers, a rash of bankruptcies, and in some cases, the need for government bailouts.

Of course, the crisis will not last forever and short-term sales projections foresee over 70 million units sold worldwide by 2015. While opinions differ about the timing of the turnaround, there is no doubt that the structure of the automotive industry will be deeply transformed. For example, most cars manufactured in 2007 had their primary development in Asia and Europe and this trend is expected to continue into 2015. The move to lower cost regions will be driven partly by lower labour cost in emerging markets. The new pockets of low cost areas within the region will become hubs for car equipment manufacturers at the expense of higher cost exporters such as Spain and Germany, the US and Canada.

Source: www.deloitte.com, 4 August 2009

Extract 3: Mind the gap

The problem of a widening income gap is one that many other countries, including America, Britain, Canada, China, India, have to contend with. And it may be that such a split is inevitable in a globalised world. The experience of rising inequality in these countries over the last two or three decades suggests that it is driven by forces that are at least partly global in nature – namely globalisation and technological change.

Global competition both depresses wages at the bottom and boosts wages at the top. At the low end, salaries of unskilled workers would be kept low because of competition from cheaper alternatives in places like China and India. Meanwhile, at the higher end, workers being deployed to oversee foreign operations will naturally attract higher pay and perks like expatriate allowances. An example of this sort of competition can also be seen in the United States, where a lot of lower-end jobs have been outsourced to cheaper nations.

Many economists now worry that widening income disparities may have damaging side-effects. In theory, inequality has an ambiguous relationship with prosperity. It can boost growth, because richer folk save and invest more and because people work harder in response to incentives. But big income gaps can also be inefficient, because they can bar talented poor people from access to education or feed resentment that result in growth-destroying policies.

Income inequality in Singapore has risen significantly in the last decade. After accounting for government benefits and taxes, its Gini coefficient rose from 0.430 in 2000 to 0.452 in 2010. The Gini coefficient measures the income distribution across a country and is often used as a gauge of the income gap.

The Singapore government has responded to concerns over the widening income gap. It promised more social spending while hiking taxes on luxury cars and investment properties. And in the past few years, it has curbed the inflow of foreign labour, cajoled companies to invest in enhancing productivity, and expanded its skills training programme to "upgrade" workers.

It is also redistributing significantly straight from government coffers to low-income and older workers' pay cheques, through schemes such as the Workfare Income Supplement, the Special Employment Credit and the Wage Credit.

"The Government deserves a lot of credit for really pushing the restructuring this time. There is a lot of resources being put in here," says Institute of Policy Studies research fellow Tan Meng Wah. But economists and experts point to blind spots, and say it remains to be seen if the government's new zeal can keep up with inequality's own momentum.

Adapted The Straits Times, 8 April 2013

Table 1: Changes in wages and salary and value added in the car industry, 2000 – 2007

	Wages and Salary (US$)		Value added per employee (US$)	
	2000	**2007**	**2000**	**2007**
France	28 621	55 461	71 918	104 092
UK	39 253	68 947	51 243	147 442
Japan	66 423	60 558	241 975	290 149

Source: http://www.jetro.go.jp, 2012

Table 2: Top 4 Car sales in the UK, June 2012

Car manufacturer	% of total sales volume
Volkswagen Group	20.0
Ford	12.5
General Motors	11.9
BMW-Mini	11.3
Others	44.3

Source: Automakers & Society of Motor Manufacturers & Traders, 2012

Questions

(a) **(i)** With reference to Table 1, compare the changes in wages and salary and value added per employee in the UK. **[2]**

(ii) To what extent can the information in Table 1 be used to draw conclusions about the relative competitiveness of the car industry in UK and Japan between 2000 and 2007? **[5]**

(b) Explain why there is excess capacity in the EU car industry. **[2]**

(c) **(i)** Suggest one possible reason for the level of concentration of the UK car industry shown in Table 2. **[2]**

(ii) Discuss how an understanding of market structure as evident in the car industry can be applied to explain the EU car firms' competitive behaviour. **[6]**

(d) **(i)** Explain why governments should be concerned with increasing income inequality. **[3]**

(ii) Discuss the view that increasing income inequality is inevitable in a globalised world. **[10]**

[Total: 30 marks]

Questions

(a) (i) With reference to Table 1, compare the changes in wages and salary and value added per employee in the UK. [2]

Both wages and value added per employee in the UK increased.

Refinement:

- However the wages increased at a slower rate (75.6%) as compared to the value added per employee (188%). or
- Increase in wages is 3x that of increase in VA.

(ii) To what extent can the information in Table 1 be used to draw conclusions about the relative competitiveness of the car industry in UK and Japan between 2000 and 2007? [5]

One of the measures of competitiveness is in terms of unit labour costs of production. Unit labour costs refer to the labour costs per unit of output.

Between 2000 and 2007, unit labour costs in the car industry in both UK and Japan have fallen.

However, the unit cost in the **UK car industry has fallen at a faster rate** than that of Japan's.

OR

Unit labour cost in UK car industry was 2.8 times that of Japan's in 2000. However in 2007, it has fallen to only 2.2 times that of Japan's.

Hence, the UK car industry has become more competitive **relative** to that of Japan's between 2000 and 2007.

However, the above data is not sufficient to make an accurate conclusion about the relative competitiveness of the industry in UK and Japan. This is because competitiveness of the industry is not just based on labour cost. There are other costs to consider as well such as rental and costs of machinery and equipment. Also competitiveness can also be in terms of the quality of the cars produced. Therefore we will certainly need more data to make a more accurate conclusion about the relative competitiveness of the car industry in the 3 different countries.

(b) Explain why there is excess capacity in the EU car industry. [2]

The excess capacity is a result of falling demand. The "European sovereign debt crisis and recession" in many countries resulted in a fall in incomes. Since cars is a normal good whose demand is income elastic, a fall in incomes leads to a more than proportionate fall in its demand. This leads to excess stocks or surplus of cars which drives down prices. As a result, firms will reduce production and so they will end up with excess capacity, which means a lower rate of utilisation of the plant capacity.

(c) (i) Suggest one possible reason for the level of concentration of the UK car industry shown in Table 2. [2]

The level of concentration of the UK car industry is relatively high. This could be due to the strong barriers to entry that are present in such industries.

Examples of barriers to entry are the high costs of investment in new technology, R&D and capital investment such as the mega platforms to produce car parts.

Since the amount of investment required for car manufacturing is high, huge economies of scale can be enjoyed over a large range of output level. This means that the firm's minimum efficient scale (MES) of production occurs at a very high output level. Only a few large car producers can achieve lower average cost and operate under decreasing cost conditions. As a result, these firms can charge competitive prices that can deter new competitors into the industry. As a result, the car industry remains highly concentrated in a few large firms.

(ii) Discuss how an understanding of market structure as evident in the car industry can be applied to explain the EU car firms' competitive behaviour. [6]

The car industry is an oligopoly as there are few large firms dominating the industry (4-firm concentration ratio 57.7%).

There is mutual interdependence among the car firms. When one firm lowers its price, rivals will follow. As a result, there only a less than proportionate rise in quantity demanded, leading to a fall in the firm's revenue. However, when a firm increases its price, others will not follow. Hence, the firm will suffer a fall in its total revenue due to a larger than proportionate fall in its quantity demanded. . Therefore, in such a market structure, firms are <u>reluctant to use price cutting strategy</u> to compete with other firms because this strategy is not a sustainable solution.

This mutual interdependence among firms is evident when car manufacturers "engage in price-cutting to protect their market shares, resulting in a vicious circle leading to even lower profits" (Extract 1).

The price cutting strategy is really an attempt to maintain market shares even if it results in lower profits for the firms. Although the theory explained price rigidity in such a market, the price competition can be explained because of <u>the fall in demand for cars leading to excess stocks. Car firms are forced to lower their prices to clear the market.</u> This triggers the price war observed in the EU car industry.

In such a market structure, firms also engage in non-price competition in order to increase their profits. For example, Volkswagen offers a broader range of vehicles across its many brands. This increased variety and choices – "cars to fit every niche in the market, enabling makers to offer buyers "mass customisation" of vehicles" will increase the demand of Volkswagen car and thus revenue. Assuming cost constant, profits thus increases.

An understanding of market structure (kinked demand curve theory) is useful to explain the firm's competitive behaviour as long as <u>demand and cost conditions stay the same or do not change significantly</u>. Since there is a fall in demand, firms are forced to lower prices as well as engage in non-price competition. This however, does not suggest that the theory is no longer valid. In fact, it is still relevant in explaining the strategies adopted by the car producers.

(d) (i) Explain why governments should be concerned with increasing income inequality. [3]

With increased income inequality, it could “feed resentment” (Extract 3) and result in an increased unhappiness amongst the people. As a result, there may be social and political unrest which may affect the consumers’ and investors’ confidence in the country. Consumer spending may be kept low while investor might choose to invest in other countries. The cuts in levels of autonomous consumption and investment would result in a fall in aggregate expenditure that would induce a fall in consumption leading to a multiple fall in national income.

(ii) Discuss the view that increasing income inequality is inevitable in a globalised world. [10]

Introduction

Income inequality refers to the differences in income of the lowest and highest income group of people. A globalised world is one whereby which national markets become increasingly interlinked through international trade and increased mobility of labour and capital.

Body

Globalisation is one of the reasons for the rising inequality in developed countries.

Specialisation in high-skilled exports leads to a rising gap between the skilled and unskilled wages. Moreover, cheap low-skill imports and outsourcing also reduce wages or increase unemployment among the low- or moderately skilled workers—further exacerbating inequality. This was highlighted in Extract 2 where car equipment manufacturers in Europe move to lower cost regions partly driven by lower labour costs.

Globalisation and the development of information technology bring about rapid advances in technology. New technology, in both advanced and developing economies, creates greater demands for those with higher skills. At the same time the demand for lower skilled workers will fall, further causing inequality.

However increasing income inequality can be avoided because of the measures that can be taken to help workers increase their productivity and gain employment.

For example, in Singapore, the government has “curbed the inflow of foreign labour”, especially that of low-skilled labour in order to help those in the low-income jobs retain their employment and to encourage firms to employ local workers. In addition, firms are encouraged to invest in skills training programme to upgrade workers. The intent is to increase labour productivity so that firms are willing to hire these workers at higher wage rates. This will also help to raise incomes at the lower end.

Other measures also include redistributive policies such as to redistribute the income through progressive taxes and welfare benefits. With a more progressive tax system those who earn more will have to pay higher taxes and these tax earnings could be redistributed to the poor through welfare benefits (e.g. unemployment benefits). This would thus reduce the inequality through reducing the income of the higher income group and increasing the income of the lower income group.

Furthermore, increasing government expenditure on infrastructure, education and health can also help to narrow the income gap.

For example, increasing income inequality may not be so evident in countries where level of education is high (e.g. Norway and Denmark). Certain countries have provided their citizens with equal access and opportunities to education through subsidies. This helps level the playing field between the rich and the poor. Through education the poor are now able to escape the cycle of poverty as long as they work hard. With education the poor will also be able to compete for highly skilled jobs and command a higher wage rate. This will thus bring down the income gap between the rich and the poor.

Evaluation:

However even with subsidies there might not be equal opportunities to education. This is because the rich are likely to be able to afford to send their kids for tuition unlike the poor. This gives them an edge over those who are poor. In addition, they could also send their kids for enrichment lessons (e.g. computer classes) which would add further to their advantage and increase the skill gap between the rich and the poor.

Levels	Descriptors
L3	Good analysis of how the problem arises with links to globalization. Measures were well-analysed with good use of examples & evaluated. Insightful, clear and well-reasoned conclusion.
L2	• Reasonable analysis of how the problem arises with some links to globalization. • Measures to address the problem were also adequately explained. • Limited evaluation of the measures. • Response has some balance, considering both sides but with no clear stand. Synthesis is not evident.
L1	Limited analysis of how the problem of inequality arises with/without measures to cope with problem. Conclusion is not evident.

Question 2 Responses to changes in global economic outlook

Extract 4: Macroeconomic developments in Singapore

In 2011, the Singapore economy grew at a more moderate pace, following a record expansion the year before. Since Q2 2011, domestic economic activity slowed discernibly against a volatile backdrop marked by concerns over the Eurozone sovereign debt crisis, faltering external demand and regional supply-side shocks.

Notwithstanding the slowdown in domestic economic growth, overall employment rose by 122,600 in 2011, exceeding the 115,900 gain in 2010. Reflecting the tight labour market, the unemployment rate reached a 14-year low of 2% in 2011. Consequently, wage growth accelerated to 6%, up from 5.6% in 2010. Meanwhile, inflation rose, partially due to global inflation which picked up over the first three quarters of 2011, as oil prices spiked during the MENA (Middle East and North Africa) crisis, where anti-government protests continue to halt production. To make things worse, food prices climbed due to adverse weather conditions.

Source: Monetary Authority of Singapore, *Annual Report* 2011/2012

Table 3: Consumer price index of Singapore (2009 = 100)

	Weights	2010	2011
All items	10000	102.8	108.2
Food	2,205	101.3	104.4
Housing	2,548	102.0	110.5
Transport	1,553	110.3	123.5
Education & Stationery	735	102.7	105.7
Health Care	586	101.9	104.3
Recreation & Others	1,557	101.1	102.5

Source: Singstat

Extract 5: Backlash from Beijing raises fears that China’s economy is slowing down

While Europe's leaders were wrestling with the problem of who will bail out whom last week, the world's other two major trading blocs, the US and China, were gearing up for a potentially damaging trade war.

As China slapped punitive import taxes on gas-guzzling American cars, and complained about what it said were US subsidies, some Beijing-watchers read it as a sign that the government is so alarmed about a looming economic slowdown that it is casting around for someone to blame. The tariffs, ranging from 2% to 21.5%, will be levied on imports of larger capacity cars.

It's not hard to see why China is lashing out. Evidence is mounting that just a few months after Beijing was fretting about its economy overheating and taking action to tame rampant food prices, the most pressing concern now is a so-called hard landing.

Foreign investment in China was almost 10% down in November on a year earlier – the first such decline since 2009. A year ago, all the talk was of China overheating as cheap US capital poured in. Beijing unleashed several measures, including raising reserve requirements[1] for its banks to prevent a credit boom from running out of control. But it failed to anticipate the coming Eurozone slump. The People's Bank of China has already signalled it is switching from reining in the economy to boosting growth.

Source: The Observer, 18 Dec 2011

Extract 6: The global economic outlook for 2012 isn't pretty

The outlook for the global economy in 2012 is clear, but it isn't pretty: recession in Europe, anaemic growth in the US, and a sharp slowdown in China. The US – growing at a snail's pace since 2010 – faces considerable downside risks from the Eurozone crisis. It must also contend with significant fiscal debts and political gridlock. Meanwhile, flaws in China's growth model are becoming obvious. Falling property prices are starting a chain reaction that will have a negative effect on developers, investment, and government revenue. The construction boom is starting to stall, just as net exports have become a drag on growth, owing to weakening US and especially Eurozone demand. Having sought to cool the property market by reining in runaway prices, Chinese leaders will be hard put to restart growth.

They are not alone. On the policy side, the US and Europe, too, have been postponing the serious economic, fiscal, and financial reforms that are needed to restore sustainable and balanced growth.

At the same time, key current account imbalances – between the US, China and within the Eurozone remain large. Orderly adjustment requires lower domestic demand in over-spending countries with large current-account deficits and lower trade surpluses in over-saving countries via nominal and real currency appreciation.

Finally, policymakers are running out of options. Currency devaluation is a zero-sum game, because not all countries can depreciate and improve net exports at the same time. Meanwhile, fiscal policy is constrained by the rise of deficits and debts in countries like US and Europe. But that is the challenge that a fragile and unbalanced global economy faces in 2012. To paraphrase Bette Davis in All About Eve, "Fasten your seatbelts, it's going to be a bumpy year!"

Source: The Guardian, 15 Dec 2011

Table 4: Selected economic Indicators of China, the US and Singapore in 2011

	China	US	Singapore
Current account balance (U.S. Dollars, billions)	360.5	- 467.6	52.8
Current account balance (% of GDP)	5.2	- 3.1	19.8

Source: IMF, World Economic Outlook Database, September 2011

[1] The minimum amount of cash or cash-equivalents that banks are required by law to keep on hand, which may not be used for lending or investing.

Questions

(a) With reference to Table 3:

(i) Describe the trend of Singapore's general price level from 2009 to 2011. **[1]**

(ii) Identify the item which contributed most to the change in the general price level in Singapore in 2011. Explain your answer. **[3]**

(b) 'The People's Bank of China has already signalled it is switching from reining in the economy to boosting growth.'

With reference to the data, discuss whether there are sufficient grounds to support its change in economic focus. **[6]**

(c) **(i)** Using Table 4, compare the current account balance of the 3 economies. **[2]**

(ii) Assess the relative effectiveness of fiscal policy and the abilities of any 2 economies in Table 4 to use this policy to address the slowing economic growth brought about by the Eurozone crisis. **[8]**

(d) Consider whether there are more winners or losers from the imposition of China's import taxes on American cars. **[10]**

[Total: 30 marks]

End of Paper

(a) With reference to Table 3:

(i) Describe the trend of Singapore's general price level from 2009 to 2011. [1]

There is an increase in the general price level.

(ii) Identify the item which contributed most to the change in the general price level in Singapore in 2011. Explain your answer. [3]

- Housing costs contributed the most to the change in the general price level.
- In order to calculate which item contributed most to the change in general price level, we need to consider the increase in the prices of the item itself as well as its relative weightage or contribution of the item to the overall price level.
- Though there was a **12%** increase in transport costs from 2010 to 2011, but given the **weight assigned to the item of 1553**, the increase in transport prices only contributed **1.9%** to the overall increase in general price levels. In contrast, the weight assigned to housing is much higher at 2548, so despite housing prices only increased by 8.5%. Thus, the contribution of housing prices to the final increase in general price level was 2%. Hence rise in housing costs contributed the most to the change in the general price level.

(b) 'The People's Bank of China has already signalled it is switching from reining in the economy to boosting growth.'

With reference to the data, discuss whether there are sufficient grounds to support its change in economic focus. [6]

Introduction

The People's Bank of China believes that Chinese economic growth is slowing down and that the government needs to put in place policies to boost economic growth.

Body

There are some grounds to support the Chinese government's decision to change its economic focus as seen from Extract 5, foreign investment in China was almost 10% down in November on a year earlier. In addition, due to the Eurozone crisis, consumers in the Eurozone would have earn less income and demand for exports from China into the Eurozone would fall. Assuming import expenditure and domestic investment remains constant, net exports and investment would fall, this would lead to a fall in aggregate demand and national income. Chinese citizens would experience a decrease their income, reducing their purchasing power and material standard of living.

In addition, the decrease in national income would cause the tax revenue collected by the government to fall, assuming that the tax rate remains constant. With less tax revenue collected, assuming government expenditure remains the same, the government would be at the risk of a budget deficit. This would cause China to incur foreign debt which may hinder potential growth in future as the government would have to pay back the debt rather than increase government expenditure on infrastructure.

However, China is still at risk of inflation due to an inflow of hot money or "cheap capital" flowing into China. US is suffering from "anaemic growth" and is employing expansionary monetary policy. The increase in money supply in the US has lead to lower interest rates in the US. Thus, US investors seeking higher returns on short-term capital would shift their funds out of US banks and into Chinese banks. This would cause an increase in money supply in Chinese banks, which would lower the cost of borrowing and increase investment and consumption in China. This would cause a rise in aggregate demand and may cause inflationary pressures.

Such inflationary pressures can erode China's export price competitiveness leading to a fall in export revenue. In addition, imports will be relatively cheaper compared to domestically produced import-substitutes and this also leads to a rise in demand for imports and import expenditure. Overall, this can lead to worsening of China's current account balance.

Conclusion

The data provided in the extract is also not sufficient. Without information on the capital account, we cannot ascertain whether the capital account is in deficit or surplus. Thus, aggregate demand may be increasing or decreasing.

(c) (i) Using Table 4, compare the current account balance of the 3 economies. [2]

- Singapore and China both have a current account surplus in 2011 while the US is running a current account deficit.
- While China's current account surplus in absolute terms is greater than Singapore, when expressed as a percentage of GDP, Singapore's current account surplus is proportionately higher than that of China.

(ii) Assess the relative effectiveness of fiscal policy and the abilities of any 2 economies in Table 4 to use this policy to address the slowing economic growth brought about by the Eurozone crisis. [8]

Introduction

The Eurozone crisis brings about problems of worsening balance of payments especially for its major trading partners which in turn translates into slowing economic growth. The ***relative effectiveness*** of fiscal policies depends on the **root cause** of the problem as well as the **conditions** within the 2 economies like Singapore and US. In addition, the ***abilities*** of these 2 economies to use expansionary fiscal policy to address the slowing economic growth brought about depends on the finances of the government as well as if the economy is faced with other prevailing domestic economic problems.

Brief explanation of problems brought about by Eurozone crisis

With concerns over the Eurozone sovereign debt crisis deepening, there is a fall in national income in this region of the world and business activity slowing down or even falling. This leads to a fall in purchasing power by the Eurozone countries that results in a fall in demand for exports from countries like Singapore and US. In addition, the pessimism within the region also leads to a fall in FDI by Eurozone investors into other countries as they may face a fall in funds.

Hence, there is likely to be falls in both export revenue and investment for countries like Singapore and US.

Analysis of expansionary fiscal policy

Expansionary fiscal policy can be used in these 2 countries which include the rise in government expenditure in areas like infrastructure and education. Alternatively, the government can also reduce taxes to boost economic growth. By reducing taxes such as the personal income tax, disposable incomes will increase so that **consumption** will rise. The government can also reduce corporate tax. This will result in a rise in post-tax profits which will induce more **investments**. A rise in government expenditure as well as consumption and investment expenditures will lead to a rise in AE.

At original level of national income, there is a shortage of goods and services. Firms will meet the excess demand by drawing from their stocks or inventory. This means that there is unplanned disinvestment. Thereafter, firms will increase output in the next time period, resulting in a rise in national income, which is equal to the initial rise in injection. Consequently, this rise in incomes will lead to a rise in induced consumption and a rise in withdrawals. The amount of rise in induced consumption is determined by the value of MPC. The multiplier process continues until the total amount of increase in withdrawals equals to the initial rise in injections. Hence, the economy reaches a new equilibrium national income at a higher level.

Evaluation of extent of:

(I) Effectiveness

- Since expansionary fiscal policy aims to raise domestic demand through increasing government, consumption and investment expenditure, it does not clearly address root cause of problem and may be limited in its effectiveness to address falling economic growth. In particular, for a country like Singapore whereby its key engines of growth are external demand and it has a smaller reliance on domestic demand, <u>expansionary fiscal policy are likely to be relatively more ineffective in raising AD for Singapore compared to US</u> which is more reliant on its domestic demand like consumption expenditure.

- The effectiveness of fiscal policy to boost economic growth depends on size of the multiplier. The value of Singapore's multiplier is small due to Singapore's high marginal propensity to save (MPS) and marginal propensity to import (MPM) [Provide reasons].

- Hence, using expansionary fiscal policy to boost economic growth is not very effective in Singapore due to the large withdrawals from the circular flow of income. <u>Therefore, the Singapore government may have to spend relatively more or reduce tax further in order to achieve the desired outcome compared to US which has a larger multiplier size due to its smaller amount of withdrawals.</u>

(II) Ability

- *As seen in Extract 6, US must also contend with significant fiscal debts and political gridlock.* With significant fiscal debts, it means that the US government is already currently facing large budget deficit. This limits the ability of the US government to finance an expansionary fiscal policy as the further government expenditure and reduction in taxes can cause a greater burden on the US government and its citizens to finance the interest payments of these fiscal debts. In addition, the ability to employ fiscal policy may also be further hindered by the political problems of the US government whereby different groups in the governments hold different views which can greatly slow down the policy-making process.
- Singapore, compared to the US, has greater ability to finance an expansionary fiscal policy as it can draw on its budget reserves to

Conclusion

On the whole, though expansionary fiscal policy may not tackle the root cause of the Eurozone crisis, it can help to cushion the extent of the fall in AD in the short term for countries like Singapore and the US. However, the effectiveness of the implementation of fiscal policy differs for different economies based on their characteristics of the country. Hence other policies may need to be further considered like depreciation of its currency for countries like Singapore which is more dependent on external demand. In addition, the ability of the government depends on both the current fiscal position as well as considerations of other economic problems for the country.

(d) Consider whether there are more winners or losers from the imposition of China's import taxes on American cars. [10]

Introduction

As seen in Extract 5, China is imposing punitive import taxes on gas-guzzling American cars, in response to likely US subsidies to protect the US domestic car industry. However, whether there are more winners or losers from the imposition of these taxes on American cars depends on factors like *the* Response from US government as well as the importance of car industry as a proportion of GDP for China and the US

The first group of gainers would be the Chinese economy in terms of an improvement in its current account as well as enjoying actual economic growth in the short run.

With the imposition of China's import taxes on American cars, the price of American imports will rise. Assuming demand for American car imports is price elastic due to the presence of many other substitutes like domestically produced cars as well as imports from other countries, this will lead to a more than proportionate fall in quantity demanded of imports and in turn a fall in import expenditure for China. Assuming export revenue for China is constant in the short run, net exports will rise leading to an improvement in current account.

In addition, the rise in net exports, ceteris paribus, will lead to a rise in AD for China leading to a multiple rise in its national income and hence actual economic growth in China. With the rise in production activities, there is also a rise in derived demand for labour leading to a rise in employment in China as well.

However, the extent of gains to China depends on whether the US government retaliates with its own protectionist measures since such import taxes has a beggar-thy-neighbour effect on the US. The US will suffer a fall in their export earnings due to the import taxes imposed by China. This leads to a fall in their national income and purchasing power, hence they will import less. This will cause a reduction in the employment in the export sector of China that initially imposes the trade barrier. Overall employment in China may not improve with protectionist measures. This may be made worse if the US government decides to retaliate with protectionist measures of import taxes on China which is highly likely as seen in Extract 5 whereby both countries are already gearing up for a potentially damaging trade war.

However, there are also losers with the imposition of these import taxes, in particular, the American economy and car producers will be most directly hit in the short run.

American car producers will suffer a rise in export prices with the imposition of import taxes on them by China. Assuming demand is price elastic, quantity demanded will fall more than proportionately, hence leading to a fall in export revenue for the American car industry. With total cost remaining constant, this will lead to a fall in profits for the American car producers which can lead to a fall in production levels. With this, there can be a fall in derived demand for labour leading to massive unemployment in its car industry.

In the long run, overall US economy may suffer. With the fall in total export revenue for car producers especially if car industry contributes to a large percentage of the US GDP, this can lead to a fall in net exports, ceteris paribus, AD, national income and employment will fall.

The extent of losses for US depends on the price elasticity of demand for American made SUVs. If Chinese consumers perceived American cars to be of better quality or it seems more prestigious to own a foreign car, the demand for American car exports may be price inelastic, leading to a less than proportionate fall in quantity demanded, which may lead to a rise in total revenue. However, this may only be in the short run as Chinese consumers may turn to cheaper substitutes from other developed countries like the Eurozone.

Another group of gainers like to benefit indirectly would be the Chinese government as well as other domestic car producers and related suppliers within the Chinese economy.

Government may gain through tax revenue collected through tariffs – can be used to develop infrastructure or subsidise investment in R&D in the domestic car industry to develop new areas of CA.

Overall, the Chinese economy may gain in terms of economic growth and employment. With import taxes imposed on American cars, Chinese consumers will increase demand for domestically produced vehicles, leading to a rise in production levels and business activity within China. This results in greater optimism within the economy and in turn higher expected profits can be gained. With this, investment expenditure is likely to increase, ceteris paribus, AD increase leading to an immediate rise in national income. Consequently, this rise in incomes will lead to a rise in induced consumption and a rise in withdrawals. The rise in induced consumption can also benefit other suppliers and retailers. The amount of rise in induced consumption is determined by the value of MPC. The multiplier process continues until the total amount of increase in withdrawals equals to the initial rise in injections. Hence, the economy reaches a new equilibrium national income at a higher level.

Extent of benefit for winners depends on the importance of car industry for the Chinese economy in terms of its contribution to the percentage of GDP. The extent of benefit will be greater the larger the contribution of the car industry to the economy in terms of GDP. This is because the spillover effects on related suppliers like domestic suppliers of car spare parts, car maintenance services will benefit more.

On the whole, protectionism is at best a short-term measure which will only benefit a few agents in the economy at the expense of long-term negative impact for consumers and the economy in general – wastage of scarce resources.

Levels	Descriptors
3	▪ Thorough analysis of gains or losses with clear links to macroeconomic or microeconomic goals. ▪ Good balance: - Explained gains **<u>and</u>** losses - Explained impact on China **<u>and</u>** US ▪ Well-explained, consistent attempts at evaluation of extent of gains / losses ▪ Justified and insightful conclusion with an overall stand of whether there are more gains or losses with the imposition of import taxes.
2	▪ Adequate analysis of gains or losses with some links to macroeconomic or microeconomic goals. ▪ Lack of good balance: - **<u>Only</u>** explained gains **<u>or</u>** losses - **<u>Only</u>** explained impact on China **<u>or</u>** US ▪ Some attempts at evaluation of extent of gains / losses ▪ Unsupported conclusion
1	▪ Superficial analysis of gains or losses with no clear links to macroeconomic or microeconomic goals. ▪ Lack of scope: only explained 1 gain or 1 loss to a particular group or economy. ▪ No / superficial attempts at evaluation of extent of gains / losses