

## **SRJC H2 CSQ 2 Suggested Answers**

(a) With reference to Figure 2, compare the UK's trade in goods with trade in services over the period. [2]

- trade in goods is in deficit whereas trade in services is in surplus
- both shows an increasing trend i.e, deficit is getting bigger whereas the surplus for trade in services is getting larger

(b) Explain one possible cost and benefit to the UK economy of its exit from the EU. Assess whether they are likely to occur. [8]

### **Possible cost: 1) Fall in economic growth due to fall in AD**

- As a member of a custom union, UK exports to the EU are not subjected to tariffs
- But now that it exited the custom union, this privilege is withdrawn. UK goods are taxed or subjected to other protectionist measures when sold in the EU as well as in other countries that EU has signed FTAs.

#### Analysis

- A tariff increases the price of UK exports to the EU and other non-EU countries → reduces UK export competitiveness → demand for UK goods likely to be price elastic as there are many substitutes in the EU market → **qty** demanded falls by more than proportionately → **export revenue** falls
- UK will be a less attractive destination for inflow of FDI. Many foreign firms locate production in UK to take advantage of the large EU market but now their exports will be affected by tariffs making their investments less profitable. In addition, cost of production would increase as UK too will impose tariffs on imports raw materials from the EU. This further makes UK exports less competitive.
- Due to the uncertainties with regard to the profitability of firms and the ability to continue to work in the EU, households may cut back on consumption as there is fear of loss of jobs.
- So with fall in C, I and X, AD falls and this will cause economic growth to fall.

### **Other costs**

#### **2) Higher unemployment**

- There could possibly be a rise in demand-deficient unemployment. So when AD falls, firms will retrench workers to cut costs since firms are faced with increase unsold stocks. There is no need to hire additional workers since the demand for workers is a derived demand and the demand for goods has fallen. Over 3 million jobs are linked to exports to the EU and some of these workers will be unemployed.
- In addition, there may be increase in capital outflow due to the uncertainties linked to Brexit. As firms relocate to other countries, more workers will be unemployed.

### **OR 3) higher inflation rates**

#### **Possible Benefits**

1) **Higher economic growth** due to increase in exports and increase in Govt spending

- After exiting the EU, UK need not contribute to the EU → money saved can be used for domestic spending → increase in G → increase AD

- Being in the EU, UK cannot sign FTA with other non-EU member countries on its own which restricts her ability to increase trade **further**
- But after Brexit, UK can choose to sign FTA with those economies which are of benefit to her such as emerging economies like BRICS. China, for eg, is growing more strongly than the EU. Due to the rising middle income class, their ability to spend may be greater than the EU which has been suffering from slow economic growth. UK's trade with the EU has been declining anyway which shows that even though there is free trade, UK is not benefitting from it. Breaking out of EU in search for high growth economies to trade is more beneficial for its exports → increase in exports → increase in AD
- UK may not have benefitted from free trade with EU but may benefit more from free trade with non-EU members. A possible reason could be that the opportunity cost difference for the goods traded between EU and UK may not be that big since they may have similar factor endowments or that UK may be losing comparative advantage in manufactured goods to countries like Germany. But this may not be the case between UK and other countries where the difference in factor endowments may be greater and therefore having FTA with them will give UK exports an edge.
- Overall, with exports and government spending increase, AD increases → higher economic growth

### **Other benefits**

2) There may be increased economic efficiency as UK may not need to abide by rules and regulations imposed by the EU.

Stringent environment standards such as high tax rates set by the EU may increase UK cost of production making her goods uncompetitive in the world market. But now after exiting EU, UK can set its own environmental standards which may be more in line with its own pollution standards and thereby benefitting domestic firms.

OR 3) Brexit will reduce trade diversion for UK.

### **How likely will the UK experience the above cost and benefit.**

In the short run, Brexit is more likely to be negative for the UK economy.

- Regardless, the EU is a huge market which is not easily replaced in the short run.
- (UK would have to negotiate FTA with the EU as well with other non-EU countries which may be a very long and complicated process. The uncertainties with regard to the ability of the UK in signing **favourable** free trade agreements and the extent EU will impose barriers on UK may weigh heavily against firms' decision to invest in the near future.

**(c)** With reference to Figure 3, state and account for the relationship between US economic growth and trade deficit. [3]

When growth rate is high, the trade deficit is large but when growth rate is low, trade deficit becomes smaller. (or increase in growth rate, increase in trade deficit and when growth rate falls, trade deficit falls)

- Trade deficit is where imports are greater than exports
- High ec growth → bigger trade deficit because rise in imports > rise in exports  
High US econ growth rate → large increase in income → increase in purchasing power →  $YED > 1$  (or high YED) or MPC is very high → increase demand for goods and services including imports → import expenditure increases

Export revenue did not increase by as much probably due to foreign YED not as high as US demand for goods or protectionist measures or slower economic growth

- (d) Extract 6 mentions that 'Mr Trump has long argued that the trade deficit hinders economic growth, and that reducing it will accelerate American job creation.'

How does Figure 4 show that President Trump's concern about the US trade deficit and unemployment is unfounded? Explain why this is so. [4]

President Trump thinks that the rising trade deficit will cause rising unemployment.

As US increase its imports, domestic firms will not be able to compete and so domestic production falls causing the demand for labour to fall as it is a derived demand and firms need to cut costs when revenue falls.

However, Figure 4 shows that trade deficit increases, unemployment rate falls.

Possible reasons

- There may be a rise in unemployment in those industries that are producing goods that are close substitutes of imports but there may be rise in production of goods from other industries where cheap imports cannot compete with the US. For example, high tech goods as well as services.
- $(X-M)$  is just one component of AD. There could be rise in both domestic and foreign investments as well as government spending.
- There could be increased capital inflow from those countries that have a trade surplus with the US. If this is long term capital flow in the form of direct investments such as the setting up of plants and offices, more jobs could be created in the US

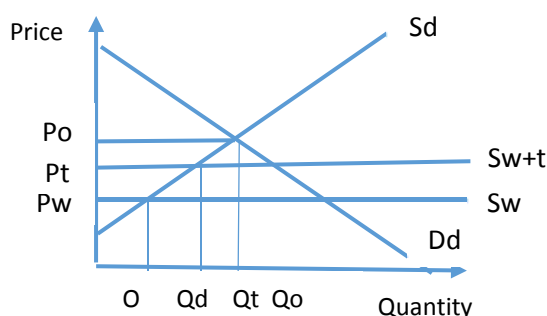
- (e) With the aid of a diagram, explain how a tariff on steel imports will reduce the comparative advantage that a steel exporting country has over the domestic country. [3]

Steel exporting country has a comparative advantage in producing steel means that its opportunity cost of producing steel is lower compared to the domestic country. As  $P=MC$  and MC represents the opportunity cost of producing the good, the difference in opportunity cost is reflected by the different price charged for steel by the exporting and domestic country.

At  $Q_0$ , the opportunity cost of producing steel for the domestic country is  $P_0$  as seen from the  $S_d$  curve. However, for the exporting country, the MC is lower at  $P_w$  as seen from the  $S_w$  curve. The opportunity cost difference which is reflected as price difference is  $P_0P_w$ .

This makes the domestic country's steel uncompetitive. Thus, it imposes a tariff which is a tax on imported steel to reduce this price difference. So when the tariff is imposed, the price of steel now increases to  $P_t$ . The foreign steel is now more expensive by  $P_wP_t$  making it less competitive.

Thus a tariff artificially reduces the comparative advantage the exporting country has over the domestic producers.



- (f) Given that 'Over the years, America's well-being has been furthered by science and technology', discuss whether an improvement in technology or free trade is the key to achieve a higher level of economic well-being for any country. [10]

### Introduction

A country that has a higher level of economic wellbeing is one where its people have more goods and services to enjoy. This is usually reflected by the real per capita income. Wellbeing includes also the non-material aspects of life such as the quality of the environment and leisure. The production possibility curve can be used to represent wellbeing as it shows the various combinations of two goods that an economy can produce when all resources are fully and efficiently utilized with a given amount of resources and a certain level of technology.

### **P1: Trade based on CA will enable a country to consume beyond its PPC and therefore a higher level of economic wellbeing.**

According to the theory of comparative advantage, even if a country has an absolute advantage in the production of all goods, as long as it is able to produce a good at a lower opportunity cost, specialisation and trade will be mutually beneficial to all countries.

Below shows the PPC of the USA and China. The USA can produce more of both cars and wheat but from the slope of the PPC which measures the opportunity cost of producing cars, its opportunity cost is lower than China (1 car to 1 wheat vs 1 car for 4 wheat) and for wheat production, China's opportunity cost is lower. US will then specialise and export cars and China wheat production. To trade, a mutually acceptable terms of trade must be established. This should lie between the two countries opportunity cost. For eg. 1 car = 2 wheat. So if US were to export all her 1000 cars, it will be able to import 2000 wheat, more than if she were to produce itself. Likewise for China. Figure 1 shows the consumption possibility curve above the PPC. This shows that after trade, both China and US are able to enjoy more of both cars and wheat which means a higher level of economic wellbeing.

Non-material wellbeing increases as well as a country can enjoy a greater variety of goods from imports that come from all over the world.

This is confirmed in Extract 2 which said that globalisation which includes free trade, brought more jobs, higher wages and lower prices - not just for richer countries but also for developing and poorer nations. This shows that specialisation and trade improves welfare.

### **P2: Improvement in technology will shift an economy's PPC outward, enabling the country to enjoy more goods and services and therefore a higher level of wellbeing.**

However, improvement in technology could also give the same result. Technological improvements can increase the quantity and quality of resources and thereby increases a country's productive capacity, thereby shifting the production possibility curve outward. With technological advances, productivity can increase, more and better quality resources can be created and there can be new products invented as well. For example, the development of electronics, robotics, biotechnology and especially the globalisation of the internet have all contributed to ongoing productivity growth in the USA. Robots, for eg, are a new type of capital goods which replace human labour and are more efficient as they can be used continuously without having to take breaks. Advances in IT helps to increase efficiency and more goods can be produced in given time period. Advances in technology make it possible for the USA to discover shale oil. Societies today are able to enjoy better modes of transport such as cars, mass rapid transit, aeroplanes which reduce travelling time, more food due to GM food and Green Revolution, more houses built with less material, more land reclaimed for housing and for commercial purposes. All these are the

outcome of technological improvements which shifts the PPC outward allowing the society to enjoy a higher level of wellbeing.

Non-material wellbeing also increases as society has more time for leisure due to higher productivity and development in certain technology also reduces pollution. For eg, the use of solar and wind power replace highly polluting coal generated energy.

**P3: Which is the key in determining welfare is dependent on several factors.**

But between the two, which is the key to a higher level of wellbeing? As analysed above, both increases the wellbeing of a country. However, for some countries, they do not have the factor endowment to develop new technology. For example very poor countries have a high level of illiteracy and lacks a pool of scientists and researchers as well as the necessary infrastructure for research. It is difficult for them to have major new innovations. That is why most of the technological advances come from mainly developed countries like the USA, Japan and Germany as they have the necessary factor endowments. Due to these constraints, for developing countries, trade is the key to a higher level of wellbeing. For example, they can specialise in the production of food products or raw materials if they have in abundance and exchange that for manufactured goods and thereby allowing them to enjoy a higher standard of living.

However, in the long run, a country that has backward technology, through trade, will acquire new technology. Over time, they could adopt the technology of the exporting countries like the US and if they do so, their PPC will shift outwards. Japan for eg used to be very backward but over the years, it learned from the West and eventually it emerged as a country that too has advanced technology.

Secondly, trade is able to increase level of wellbeing in the short run but without technological improvements, well-being is not sustainable as growth itself will not be sustainable. Take the example of the progress Singapore made in terms of standard of living. By the 1980s, Singapore has reached full employment and if there are no technological improvements, with AD rising continuously, inflation will set in and this will cause growth to be unsustainable.

**Conclusion**

In conclusion, for countries that lack the ability to innovate, trade is the key to economic wellbeing in the short run but in the long run, technological advancements will also spread to them and so they too will benefit from it. For countries that have the factor endowments for technological advancements both trade and improvements in technology are both important in increasing welfare