2015 RVHS Y6 H1 Prelim II
Suggested Answers for CSQ2

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<tr><td>(a)</td><td>(i)</td><td>Identify the trend of the value of the Canadian Dollar against the US Dollar between January 2013 and December 2013.

The Canadian Dollar depreciated [1] against the USD from January 2013 to December 2013.</td><td>[1]</td></tr>
<tr><td></td><td>(ii)</td><td>Explain the impact of the above trend on Canada’s balance of trade with the rest of the world.

Balance of trade account records the imports and exports of physical goods like raw materials, food and manufactured goods.

With the weakening of Canadian Dollar against the USD, Canada’s exports to the world will be cheaper in terms of USD and imports from the world will be more expensive in Canadian Dollar. Assuming Marshall Lerner condition (PEDx + PEDm >1) is satisfied, Canada’s net exports to the world will increase, leading to an improvement in her balance of trade account with the rest of the world.</td><td>[2]</td></tr>
<tr><td>(b)</td><td colspan="2">With reference to Extracts 1 and 2, explain how high household debt and continued moderation of the housing sector may slow down Canada’s economic growth.

• Continued moderation of the housing sector (Extract 2) signifies a slowdown in residential investment (I)
• It also raises “fears of a US-style crash”, where housing prices drop significantly (Extract 1). The expectation of a drop in wealth (asset price) will slow down consumer spending (C)
• High household debt also makes consumers less willing to spend (Extract 1). This further slows down consumption (C)
• Taken together, the slowdowns in C & I will dampen the increase in AD, hence slowing down the increase in national income (economic growth)</td><td>[4]</td></tr>
<tr><td>(c)</td><td colspan="2">With reference to Extract 1, comment on whether Canada could rely on her energy sector and the U.S. economy to improve her economic performance.

<u>Yes, Canada could rely on her energy sector and the US economy</u>
• A strong energy sector will boost Canada’s export (X)
• As the US economy recovers, US national income increases, enabling it to import more from Canada. This will boost Canada’s export (X)
• The rise in X will raise Canada’s AD, improving her national income and consequently employment. The rise in X also improves Canada’s Balance of Payments.

<u>No, Canada cannot rely on her energy sector and the US economy</u>
• Competition from cheaper US oil will mean lower DD for Canadian energy. This could dampen Canada’s X. This may also discourage I due to weakened DD condition (Extract 1: Suncor Energy scrapped plans for a multibillion-dollar upgrading investment)
• The possibility of US fiscal tightening means US govt may cut govt spending</td><td>[5]</td></tr>
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and raise tax. This will have a contractionary effect on the US economy, making a US recovery less certain and hence reducing Canada's prospects of exporting more to the US

(d) **Extract 4 suggests that Cisco's investment into Canada will be beneficial to Canada's economy. Using AD/AS analysis, explain how foreign direct investments help a country such as Canada, to achieve sustained economic growth.** **[5]**

Sustained economic growth is achieved when there is actual and potential growth in an economy, and that the growth is non-inflationary.

<u>Foreign direct investment will lead to an increase in AD in the short run</u>

- An increase in foreign direct investment will lead to an increase in financial flow into Canada. Since I is a component of AD, an increase in I will lead to an increase in AD from AD_0 to AD_1 (Fig 1).

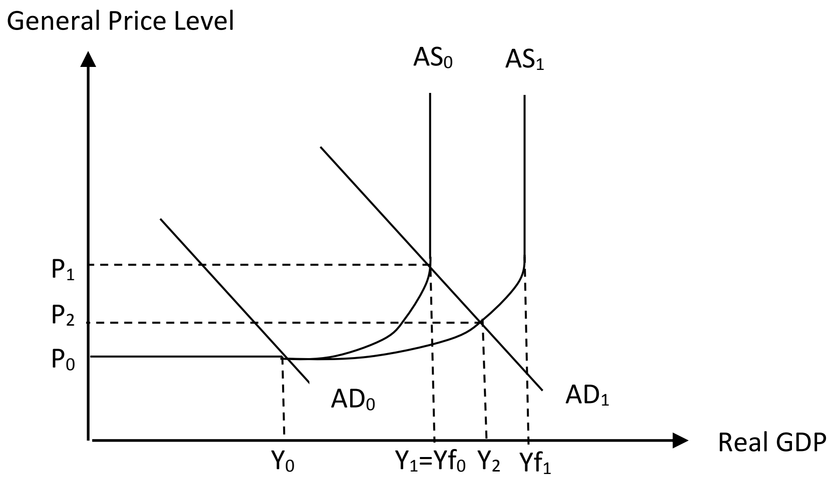
- Due to the multiplier effect, the increase in AD will lead to a multiple increase in real GDP from Y_0 to Y_1 for Canada, indicating actual economic growth is achieved. In addition, Canada's level of unemployment will decrease as more resources are being utilized to increase production.

<u>Foreign direct investment will lead to an increase in AS in the long run</u>

- The increase in investment will lead to an increase in productive capacity. Potential growth is achieved as full employment output level increases from Y_{f0} to Y_{f1}. This is supported by Extract 4 that many of the new jobs will be in engineering and high tech, and the company expects spinoffs in other areas, from manufacturing to services, as a result of its expansion.

<u>Graphical analysis</u>

As illustrated in Figure 1, when AD increases from AD_0 to AD_1 without any increase in productive capacity, the general price level increases from P_0 to P_1 and real GDP increases from Y_0 to Y_1. However, with the increase in productive capacity from Yf_0 to Yf_1, the general price level decreased from P_1 to P_2 and real GDP increases further from Y_1 to Y_2, indicating non-inflationary sustained economic growth.



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<td>(e)</td>
<td>(i)</td>
<td>Explain the impact of fiscal and monetary tightening on Canada’s national income.

Fiscal tightening refers to the cutting of government expenditure (G) in order to reduce aggregate demand (AD). The Canadian government can directly reduce its own spending by cutting down the number of jobs in the public sector as mentioned in Extract 3. When AD falls due to the reduction of G, national income (NY) will fall.

Monetary tightening involves an increase in interest rate so as to reduce AD. When interest rate rises, cost of borrowing increases and consumers are less likely to borrow to purchase big-ticket items. At the same time, people are more encouraged to save because the reward to savings increases. Hence, the level of consumption (C) falls. Also, higher interest rate makes it more costly for firms to borrow. Hence, the level of investment (I) falls. At the same time, higher interest rate relative to other countries causes short-term money inflow, resulting in a rise in exchange rate and strengthens the currency. Stronger domestic currency causes exports to be more expensive in foreign currency while imports become cheaper in local currency. Assuming Marshall-Lerner Condition is satisfied, this will reduce net exports (NX) and reduce AD. As a result NY will fall.</td>
<td>[5]</td>
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<td>(ii)</td>
<td>To what extent do you agree with IMF’s view that Canada’s fiscal and monetary tightening should be “delayed until growth strengthens again”.

Canada’s fiscal and monetary tightening should be delayed because current growth is weak. As mentioned in Extract 1, consumer spending is slowing and businesses are shying away from investments. Besides, export growth is weak due to stiff competition from cheaper-to-produce U.S. domestic oil. Hence, with the current weak level of consumption, investment and exports, tightening now will only slowdown growth further and may even cause growth to turn negative.

Also, austerity (fiscal tightening) done too quickly to reduce fiscal deficit could be self-defeating since a fall in national income implies a fall in tax revenue received by the government. Besides, more workers are likely to be unemployed during this period and more unemployment benefits will need to be paid out, increasing government expenditure instead.

However, it may not be appropriate to delay fiscal and monetary tightening because there are benefits to doing so now. Fiscal tightening now will reduce Canada’s fiscal deficit. This will not only help the country reduce its national debt, but also help to accumulate reserves so that more funds would be available to “absorb future shocks to the economy”. For instance, during times of recession, the government will be able to tap on the funds available to promote growth.

Since Canada’s current growth is weak but has not turned negative yet, there is still room for fiscal & monetary tightening. However, in order to ensure minimal repercussions, perhaps the government can err on the side of caution and choose to delay and observe first before implementing the tightening measures.</td>
<td>[8]</td>
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<tr><th colspan="3">Knowledge, Application, Understanding and Analysis</th></tr>
<tr><td>L3</td><td>Developed discussion on why Canada’s fiscal and monetary tightening should <u>and</u> should not be delayed until growth strengthens again. Answers should be supported with evidence from case data and must include a reasoned stand/judgement.</td><td>7-8</td></tr>
<tr><td>L2</td><td>Undeveloped discussion on why Canada’s fiscal and monetary tightening should <u>and</u> should not be delayed until growth strengthens again.

OR

Developed explanation on why Canada’s fiscal and monetary tightening should <u>or</u> should not be delayed until growth strengthens again.</td><td>3-6</td></tr>
<tr><td>L1</td><td>Smattering of valid points.</td><td>1-2</td></tr>
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