H2 Economics Paper 1
Question 2 Marking Scheme

(a)(i) What economic relationship exists between investment and economic growth? [2]

- The higher the level of investment spending, the higher the rate of economic growth
- With higher investment, it stimulates increases in both actual growth in the short run and potential growth in the long run, enabling sustained increases in real national output over time.

(ii) How far is the relationship supported by data shown in table 1? [3]

- Table 1 show that economies generally with larger shares of investment in terms of GDP growth contributions experienced higher average annual GDP growth rates, and vice-versa. For example China and India. However, India's high growth could not be attributed to investment alone. Its relatively high domestic consumption was also a contributing factor to its high growth. Similarly, although Korea and Thailand had low investment, they experienced relatively high GDP high growth.
- This could be attributed to the growth model adopted by the various countries. Growth of a country could be driven by any components of aggregate demand. Korea's GDP growth was led by exports and domestic consumption while growth in Thailand and US were driven more by domestic consumption.

(b) Explain how the revaluation of the yuan would reduce the trade imbalances between the US and China. [2]

- With the revaluation, Chinese exports will be more expensive in USD while imports from US will be cheaper in yuan
- Quantity demanded for Chinese exports will fall while quantity demanded for imports from US will increase
- If the Marshall-Lerner's condition is met, where the sum of price elasticities of demand for exports and imports is greater than 1, size of China's trade surplus with US will fall.

(c)(i) State **one possible** factor that determine the impact on national income of an increase in domestic consumption in China [1]

- Size of multiplier, or
- Size of increase in C, or
- Share of domestic consumption in GDP

(ii) Explain why the growth model of countries like China, which is dependent on investment and exports, is 'unsustainable'. [4]

- Dependence on exports means that these countries' economic performance is inevitably tied to the performance of their major trading partners. With a persistent trade deficit and slow growth in US and Europe, it is unlikely the growth model powered by exporting to these countries is sustainable. The trade imbalance between developed and emerging countries will be a threat to global growth and hence it is not possible for countries like China to continue depending on export-led growth.

- Government-led investment spending may be on wasteful and inefficient projects which do not contribute much towards long-term economic growth and employment growth (table 1). It could also have crowded out private investment spending in more efficient projects that may generate higher rates of economic growth and employment growth.

(d) 'The central banks and finance ministries in the US and Europe have already used up large amounts of their available ammunition. '

With reference to the above statement, assess the policies adopted by the US and European governments in reviving their economies. [8]

- Explain the use of expansionary fiscal policy in the US and UK to stimulate economic growth in the short run
- Evaluate the effectiveness of the policy and the problems that will arise
  - Crowding out effect
  - Consumers are unwilling to spend even as national incomes increase due to poor business confidence (size of MPC is reduced)
  - Worsens budget deficit resulting in an increasing public debt problem (chart 2 and extract 1)

- Explain the use of expansionary monetary policy in US and UK to stimulate spending in the domestic economies
- Evaluate the effectiveness of the policy
  - Poor business confidence → firms will be less responsive to the fall in interest rate
  - Liquidity trap

- Explain and evaluate the effectiveness of the use of quantitative easing in US/asset purchasing in UK to stimulate economic growth
  - Explain that the use of this policy was in response to the central banks' inability to further lower interest rate as it had already approached the zero bound
  - Increased liquidity may not stimulate greater borrowing and spending if business confidence remained low in the US and UK economies
  - Outflow of excess liquidity to Asian countries will reduce the effectiveness of the QE policy

- Evaluation
  - The success of these policies will depend on how the governments of the 2 countries manage it especially in the context of rising fiscal deficit which put them in a dilemma.

L2	Well explanation of the policies adopted by US and UK and the limitations of the policies and problems that arise from the use of these policies	3-4
L1	Mere explanation of the policies adopted by US and UK without examining the problems that could arise from the implementation of these policies	1-2
E2	A reasoned conclusion about the effectiveness of the policies with reference to the context of the US and UK economies	3-4
E1	Some evaluative comments are made regarding the effectiveness of/problems of the policies in the context of the US and UK economies	1-2

(e) With reference to the data and using your own knowledge, discuss whether rebalancing of Chinese economy would reduce dependence of Asian economies on the US and Europe for their growth. [10]

- Explain how the rebalancing of the Chinese economy from a dependence on exports and government-led investment towards domestic consumption will reduce dependence of Asian economies on US and Europe
  - Extract 3: Opportunities for economies in the Asian region as China "becomes a source of regional final demand and of foreign direct investment". Explain.
  - Extract 3: Developing economies in the Asian region can also gain larger market share in low value-added manufacturing and export these goods to the Chinese market as they move away from this sector.

- However, according to extract 2, China's demand for final goods is largely met by domestic producers. This means that opportunities for regional export firms to meet the higher import demand in China for consumption may still be limited in the short term. The result is that Asian economies may still remain dependent on the US and EU markets for its exports, directly and indirectly through supply chain links (Asian firms mainly serve the Chinese export industry rather than the domestic sector).

- Furthermore, there is uncertainty regarding China's ability to shift towards domestic consumption.
  - Figure 1: Share of consumption as a contribution to GDP growth actually fell between 2000 and 2008, while share of investment increased. The higher investment was at the expense of lower current consumption as more savings have to be channeled to finance investment spending. This implies that as long as China continues to depend on government-led investment to drive economic growth, then it is unlikely that consumption will increase sufficiently to drive import demand from Asia.
  - It depends on whether wages are able to increase sufficiently to stimulate consumption spending. This is currently hindered by the slow growth in the advanced economies, which China is still currently dependent on for exports and economic growth.
  - It depends on the success of income-tax reform and the security that the new social welfare schemes could provide to the Chinese. As long as the Chinese feel the need to make provision for their old age, they will save rather than spend.
  - It is also dependent on China's ability to move up the value chain into higher productivity sectors. According to extract 3, it seems that this shift is likely to take a long time.

- Need to acknowledge that US and European countries are large economies with high per capita income and could not be easily substituted by China whose per capita income is still relatively low.

- In the short term, therefore, it may be unlikely that Asian economies will be able to look towards the China economy and reduce their dependence on the US and EU economies.

L3	A coherent explanation of the opposing views presented with close reference to the extracts. Well use of evidences to show that no concrete conclusion could be made. At best, could only make some deductions in the short term. A questioning approach is taken.	8-10
L2	Explanation of the opposing views presented in the extracts. However, answer lacks critical evaluation of the evidences.	4 - 7
L1	Identification of some views presented in the extracts but are mainly paraphrased instead of explained	1 - 3