

## 2016 Promotional Exam H2 Case Study Suggested Answers

- (a) (i) Describe the trend of China's nominal GDP from 2011-2015. [2]

**Requirements:**

*Using table 1 as the information source, students are to conclude that because of the positive GDP growth figures over the period, China's GDP is increasing at a decreasing rate.*

- (ii) Using information from the case materials, account for the above trend. [2]

**Requirements:**

- *Students are to infer that China is undergoing "structural change in the economy" (Ext 1, para 2) towards a consumption-driven economy → economic activities promoting economic growth gives greater priority to domestic consumption rather than exports (albeit the absolute figures for the latter could still be a fairly large contributor to China's GDP)*

**Suggested Response:**

- China's growth "new normal" is the consequence of:
  - i. Lower increases in AD overtime (with AS constant)
    - The slower rate of increase in AD was due to a slower X demand rise not adequately made up by the rate of increase in consumption expenditure (the main driving force in China's AD) → causing a subsequently slower cumulative AD rise & growth over time.
  - ii. Lower increases in AS overtime (with AD constant)
    - The effect on China's productive capacity from a consumption-driven growth (from mainly services sector) is relatively lower than manufacturing sector driven growth. (Ext 1, para 3) → with a constant AD, the rightward shift caused by services sector would not be as much in magnitude as it would have been due to the growth in the manufacturing sector.

- (b) (i) Define the term unemployment. [1]

**Requirements:**

*Student are to show ability to recall the definition or provide an accurate description/meaning of the unemployment concept.*

- (ii) Using the information provided, identify and explain the types of unemployment that the Chinese economy is facing. [4]

**Requirements:**

*From appropriate evidence from the case material, students are to show accuracy in conceptual knowledge in matching the identified causes/circumstances in China to the theoretical unemployment types.*

**Suggested Response:**

- China may face demand-deficient unemployment. Assuming the 2016 contraction of China's exports of -2.5% (Table 1) is due to a fall in demand by China's trading partners. China's export sector may face a situation of output surpluses. To minimize the potential fall in revenue & profits for the sector, employers may react to the declining export demand by reducing their demand for labour.
- China faces structural unemployment due to the "rapid structural change" (Ext 1, para 3) of China's main growth sector from manufacturing to services (Ext 1, para 3). This may increase the likelihood that a skill mismatch between the skills job-seekers (new labour market entrants or those retrenched from other sectors, eg. manufacturing sectors) possess and the skills demanded by employers in the services sectors may occur.

- (c) Explain how the following policies may affect economic growth in China:

- (i) cutting interest rates [3]

- (ii) "ramping up taxes" (Extract 3) [4]

**Requirements:**

*Students are expected to illustrate the ability to provide an applied analysis of the impact of the 2 MP & FP measures on the concepts of economic growth (actual & potential).*

**Suggested Response:**

- (i) cutting interest rates [3]

- (a) Affects actual growth:

- In the short term, a decrease in interest rates results in increases in C and I which are components of AD, via the k effect, leads to a rise in RNY and rise in actual growth rates.
  - A decrease in interest rates decreases the cost of borrowing. The decrease in interest rates reduces the returns from savings and lowers the opportunity cost of consumption. This leads to an increase in C.

- In addition, expected profitability increases, leading to an increase in I.

(b) Affects potential growth

- In the longer term, increases in I, brought about by expansionary MP, may also increase AS and thus increase China's potential growth. Assuming China is on the intermediate range of the AS, the measured economic growth (actual growth) rates would rise again, c.p.
- A decrease in interest rates discourages savings, thus, the amount of funds that banks have for lending decreases. This may lead to a decrease in investment level and reduce potential growth.

(ii) “ramping up taxes” (Extract 3)

[4]

(a) Affects actual growth

- High income earners: C and I may fall (due to higher direct/income tax imposed on them; broadening of personal taxes) → AD may fall (albeit slightly)
- Non-high income earners (poor): C and I will rise being beneficiaries of transfer payments from the income redistribution tax policy → AD may rise
- ➔ Assuming the AD rise due to the poor/non-high income earners offsets the AD fall by the high income earners ➔ net increase in AD (& the production of goods & services to meet the demand), RNY rises and actual growth rises.
- The imposition of a indirect/value-added tax on services would effectively raise the cost of production or cost of making the service available to consumers. This may cause economic growth to fall.

Depending on the extent of the shifts, actual EG may increase slightly since the value-added tax may not be substantial

(b) Affects potential growth

- Ramping up taxes to pay of redistribution may adversely affect potential growth. Increase in direct taxes &/or broadening on the personal taxes imposed on other forms of assets owned would discourage investments in the domestic economy as expected returns to investments are seen to be lower. As such the higher income earners may save & invest in other countries with more attractive personal tax rates, leaving a lower availability of funds and investors to benefit the economy.

- (d) **With the aid of an AD-AS diagram, explain why China's rate of inflation did not rise as fast to meet the official target of 3%. [4]**

**Requirements:**

*Students are to illustrate using a diagram & accompanying descriptions, their analytical understanding of how despite a rise in actual (mainly AD rise) and potential growth (commonly AS rise), inflation rates are still below the official target.*

**Suggested Response:**

The inflation rate did not rise to or beyond the official target because China's growth in AD is "persistently weak demand" whereas its ability to produce is fairly high due to "massive overcapacity" (Ext 2, para 2).

Contributing demand reasons

After over three decades of double-digit growth, the "new normal" of slower growth is due to the persistently weak demand brought about by the inevitable weakening of its major growth drivers that necessitates structural change in the Chinese economy. This means that despite experiencing positive growth, AD has been rising at a level that is considered not high enough to cause an inflation rate of beyond 3%, c.p.

Contributing supply reasons

The investments (over this 30-year period influenced by China's double-digit growth) towards enhancing China's infrastructure would eventually lead to a massive ability for China to produce goods and services – increasing its productive capacity enormously. The enormous increases in productive capacity (& AS) would have an effect of causing inflation to fall, c.p.

The increase in AD coupled with a relatively larger increase in productive capacity or AS, would inevitably mean that China experiences surplus at the existing price level causing the GPL to fall – ie. China would experience a non-inflationary growth where GPL does not increase beyond its official target of 3%.

- (e) **Discuss whether sustained economic growth will always lead to a higher standard of living in China. [10]**

**Requirements:**

Students are to show awareness of the concepts of sustained economic growth and standards of living (material & non-material) and be able to reason out their stand on the issue of the impact growth (albeit falling rates) on the standard of living levels in China overtime using the appropriate information provided in the case materials.

### **Suggested Response:**

#### **Introduction**

- (a) Explain that sustained economic growth refers to an increase in both AD and AS overtime resulting in rising RNY over time.
- (b) Define material and non-material SOL.
  - Material SOL: Measures the quantity and quality of goods and services accruing/accessible to each person in the country.
  - Non – Material SOL: Measures the intangibles and focuses on Quality of life.

#### **Body**

##### **Thesis 1: Sustained economic growth can lead to a higher material SOL.**

- Table 1: GDP is increasing: this suggests the increase in income and hence purchasing power of consumers → able to enjoy a greater accesibility to better quantity and better quality goods and services → collective material SOL improves.
- Ext 1: “welfare content” of China’s economic growth will correspondingly increase, yielding better-quality GDP growth China’s economy is switching to consumption driven consumption → suggests increased access to greater quantity and quality of goods and services consumed.

##### **Thesis 2: Sustained economic growth can lead to a higher non-material SOL.**

- Enables economic development - an improvement in the quality of the environment via government developmental expenditure and management policies which facilitates access to a better quality of environment and higher quality healthcare services for the masses.

##### **Anti-thesis 1: Sustained economic growth does not always lead to a higher material SOL.**

- Figure 1: Gini coefficient is increasing. Although GDP is increasing, it does not tell us what happens to income distribution with every period of growth. Gini coefficient is increasing → suggests that income inequality is worsening. Hence not every China resident may experienced an (equal or) increase in SOL.
  - However, if there is an increase in material well-being (albeit unequally), there may be sufficient grounds to suggest that material SOL is higher for all.
- Ext 1: “upper middle class households will double to 100 million in population by 2020”. This shows that many in China has

progressed to a higher income class category overtime – suggesting that an improvement in SOL.

- However, the data can also suggest that the urban rich may be getting richer but the rural poor may have been neglected or experienced no improvement in SOL.

**Anti-thesis 2: Sustained economic growth does not always lead to a higher non-material SOL.**

- Increased production of goods and services using methods that are not environmentally friendly → pollution might worsen → lead to respiratory diseases → fall in quality of life. “Poor air quality in Chinese cities causes significant health complications” which imposes a significant welfare loss or monetary costs to the Chinese government.
- However, there are evidence to suggest that efforts have been taken to “shift” the environmental burdens to places outside China which does suggest measures may be undertaken (although adequate data may not be provided) to mitigate the threat of environmental damage or enhance resource sustainability for future generations.

**Conclusion: Take a stand**

It could be said that the sustained economic growth that China has achieved over the five-year period (or more) has led to a rise in the standard of living of the typical China resident. This is because many people have been and continue to be lifted “out of poverty” if not may have experienced an improvement their welfare being taken care of via income redistribution policies.

However, sustained economic growth does not always lead to a higher overall SOL as growth will always bring about benefits and costs. Although an increase in GDP may indicate that material SOL has improved, other issues such as the implications of widening income gap and unequal income growth) and impact and management of pollution levels (that significantly makes some group worse off than others or the efforts of the government to mitigate such effects) may give a clearer picture whether non-material SOL has fallen.

Moreover, since the rate of economic growth seems to be tapering off, it is unlikely that China is able to continue growing at such high growth rates. As such, the increase in SOL (predominantly material SOL-driven) may have occurred during or until the current period but only time and access to more information will tell if the holistic SOL level continues to rise in China.

The high rate of growth may also be unsustainable as finite resources may be depleted at a rate which affects the future generations. Future growth may be inhibited as such.

Furthermore, sustained economic growth does not imply that the growth is inclusive since we do not know if the growth is broad-based across different sectors. Apart from aiming to achieve sustained economic growth, the Chinese government should also consider the issues of sustainability and inclusivity as well if SOL level is to continue to rise in the future.

### **Mark Scheme**

<b>Level</b>	<b>Descriptors (Knowledge, Understanding, Application and Analysis)</b>	<b>Mark range</b>
L3	For a balanced and well-developed answer which considers both material and non-material SOL. <ul style="list-style-type: none"> <li>• Frequent reference is made to the case material</li> <li>• Some reference is made to the case material</li> </ul>	7 6
L2	For a balanced but under-developed answer which considers both material and non-material SOL.  No reference is made to case material	4-5  Max 4
L1	For an unbalanced but well-developed answer which considers either material or non-material SOL.	1-3
E	Provides a judgement on whether China's SOL has increased or decreased supported by a well-reasoned justification.	1-3