

2011 H1 Prelim 2 Q2

(a) (i) Compare the GDP growth of US and China from 2007 to 2009. [2]

Both the US and China experienced a falling GDP growth from 2007 to 2009. However, US slipped into negative GDP growth in 2009 while that of China's was still positive.

(ii) Explain possible reasons for the trends observed above. [4]

US was experiencing a downturn earlier in December 2007 which deepened due to the impact of financial crisis in September 2008. The crisis led to severe loss of investors' and consumers' confidence and hence further contraction in aggregate demand which eventually led to a fall in GDP. China, being dependent on the US and Europe as their export markets and source of FDI, experienced a decline in export growth and FDI inflows and hence GDP growth as well.

China's GDP growth was positive due to their ability to implement the appropriate measures to mitigate the negative impact of the global recession. For example, China's domestic consumption and investment could have offset the decline in export growth, maintaining their aggregate demand at a sufficient level and hence their GDP growth was still positive.

(iii) With reference to the data provided, explain the relationship between GDP growth and unemployment. [2]

In general as GDP growth declines, the unemployment rate rises. This is seen in US and other countries in Europe whereby a recession triggered by a fall in aggregate demand prompts firms to reduce their demand for labour in view of lesser production.

(b) Explain the impact of global recession on the poor countries' balance of payments. [6]

The global recession has adversely impacted the output and national income of many economies. This has affected the poor countries' balance of payments in three different ways.

Firstly, with the global recession, business expectations become weaker as expected returns from investments are lowered. As net private capital flows from developed countries fall, the capital inflows into the poor countries declines, leading to a worsening of the capital and financial account of the balance of payments.

Secondly, with the global recession, production in many economies is reduced and hence the demand for raw materials and intermediate goods for production falls leading to a fall in commodity prices. As mentioned in Extract 3, most poor states are dependent on

commodities as their main sources of export revenue. With the fall in commodities prices and output their export revenue will fall significantly, worsening the balance of trade and hence current account of the balance of payments, *ceteris paribus*.

Lastly, many of these poor countries also export workers to the developed countries. With the falling demand for labour in the developed countries, many of these workers are likely to be retrenched. Hence, they are unable to send back remittances. Some countries depend on them. Now that remittances are falling the current account of the balance of payments of these countries are likely to worsen.

Hence, it can be seen that the global recession is likely to have contributed to quite a significant deterioration of the balance of payments of the poor countries.

Level	Descriptor	Marks
L3	For a well-developed analysis with reference to context	5-6
L2	For an undeveloped analysis with weak attempt without adequate reference to the context	3-4
L1	For a vague answer that has a smattering of valid points	1-2

(c) (i) Describe the changes in the value of Yuan from 2005 to 2009. [2]

The Yuan has appreciated in value from 2005 to 2009, with more significant increase from 2005 to 2008, before stabilizing in 2009.

(ii) Comment on the view that China's inflexible exchange rate regime is the root cause of unemployment in developed countries and the slow recovery in developing countries. [6]

Under its inflexible exchange rate regime it is possible that Chinese authorities have been intervening in the foreign exchange market, thereby holding the value of the Yuan lower to gain an advantage for its exports. A lower value of the Yuan would lower the price of Chinese exports in terms of foreign currency and raises the price of imports in terms of Yuan. Assuming that the Marshall-Lerner condition holds in China, the lower value of Yuan would lead to an improvement in the current account balance, *ceteris paribus*.

Other countries would experience a fall in their export revenue as less of their goods are exported due to their inability to compete with Chinese goods and rise in import spending as their own consumers

may find the Chinese imports cheaper relative to their domestically produced goods. Thus, the other countries would experience a current account deficit as a result. A worsening current account will lead to a fall in aggregate demand and hence reduction in national income and employment. This was suggested to be the main reason contributing to 'unemployment in developed countries and the slow recovery in developing countries'.

China's inflexible exchange rate regimes might not be the main cause of the current account deficits and unemployment or slow recovery as countries with floating exchange rate regimes like Germany consistently had a fairly large current account surplus.

Deficits could also arise due to other reasons like rising import spending from growing demand for more imported raw materials and machinery from developing economies like India.

The appreciation of the Yuan, as seen in Figure 1, and the growing current account surplus of China from 2005 to 2008 also suggest otherwise.

Possibly another factor accounting for the different current account positions is likely to be relative competitiveness of the countries. The growing current deficits, rising unemployment experienced by US could be a result of loss of comparative advantage and hence export competitiveness, while countries that are having current account surpluses like China and Germany are basically more competitive.

Level	Descriptor	Marks
L3	For a well-developed analysis with reference to context and justified evaluation.	5-6
L2	For an undeveloped analysis with weak attempt to evaluate without adequate reference to the context Or Analysis only cover one-sided answer	3-4
L1	For a vague answer that has a smattering of valid points	1-2

**(d) In the light of the issues raised in the extracts, discuss the [8]
desirability of pursuing globalisation.**

The recent global recession has highlighted the downside of pursuing globalization. This has prompted some countries to reassess their stand towards globalization and minimize on the likelihood of a recurrence of the problems they are facing now.

Undesirability of pursuing globalisation

With globalization, economies become more interconnected due to increased openness to trade, capital and labour flows. This has made the economies more vulnerable to the changes in economic conditions in other countries (Extract 1: In the rush to become global, Asia actually increased the region's vulnerability to a global downturn. The more open the economies were, the harder they were hit).

As US and Europe went into recession, the developing economies were adversely impacted in various ways:

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| <ul style="list-style-type: none">• Worsening BOP (Extract 3: due to fall in export revenue, investment flows and remittances) (as explained in part (b))• Slower growth (Extract 1)
Fall in net exports and investments → fall in AD → fall in national income• Rising unemployment (Extract 2) (as explained in a(iii)). It could also result in structural unemployment as the collapse of certain industries in developing economies could have resulted in the massive retrenchment of workers, especially those who are low-skilled, who would not have the skills to take up employment in other sectors of the economy |
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In the long run, there could also be negative consequences:

The recession in some of the developing economies puts further pressure on government budgets due to loss of revenue → slower potential growth
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Massive unemployment → many fall below the poverty line → widening income gap → greater social instability
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Specialisation and free trade seemed to have caused the developed countries to incur current account deficits and higher unemployment (Extract 3)

Desirability of pursuing globalisation

Opening one's economy to free trade is still beneficial for the economies, both developed and developing. Based on the Theory of Comparative Advantage, specialization and trade is mutually beneficial to the countries engaging in it, allowing them to enjoy greater output and higher levels of consumption of goods and services.
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There are other benefits to trade including increased competition. As economies faced more competition from foreign producers, they will constantly seek new technologies, processes and products in order to achieve greater efficiency.

The current account deficits incurred by the various economies is probably a short
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term problem which arising due to the operation of certain economic fundamentals, e.g. shifts in comparative advantage in view of more emerging economies participating in the global markets. Hence, some economies like the US are experiencing adjustment problems due to the loss of comparative advantage in labour-intensive manufactured goods as a result of the significant cost advantage China enjoys in the production of these goods. If proper measures are put in place by these economies to restructure the economy, they will be able to benefit from specialization and trade in the long run as well.

In the long term, as the trading partners of the emerging economies will benefit eventually as the emerging economies will increase their consumption of more goods and services as they become more affluent.

Via the various channels mentioned earlier, e.g. trade and FDI, globalisation has enabled the developing economies to enjoy growth and prosperity and raise the income levels of their citizens for a decade (Extract 3)

Evaluation

Despite the problems encountered in the light of the global recession, there are benefits to be reaped by both parties concerned. Hence, countries should take a long term view by focusing on the changes needed to ensure that their countries remain more competitive and resilient to continue to benefit from globalization.

Level	Descriptor	Marks
L3	For a well-developed analysis with reference to context and justified evaluation.	7-8
L2	For an undeveloped analysis with weak attempt to evaluate without adequate reference to the context Or Analysis only cover one-sided answer	4-6
L1	For a vague answer that has a smattering of valid points	1-3