H2 Prelim Case Study Question 2   United States and the world economy

Suggested Answer

(a) Using Figure 1:

(i) Explain what is meant by purchasing power parity. [1]

Purchasing power parity is the exchange rate that equates the price of a basket of identical traded goods and services in two countries.

(ii) Compare the share of world GDP (at purchasing power parity) of Asia with that of United States and European Union between 1980 and 2006. [2]

Share of world GDP of EU and US are declining while the share of world GDP (at purchasing power parity) for Asia is increasing. [1]
However the rate of increase for share of world GDP (for Asia is much faster than that of the decline of share of world GDP (at purchasing power parity) in EU and US. [1]

(b) Explain two factors that might have caused US dollar to depreciate. [5]

Depreciation of US dollars means that the value of US dollars fall against some of the major currencies as mentioned in the extract such as Euro, Yen, Pounds, and Yuan. [1]

Students are expected to analyse how the factors lead to fall in C, I or X (at least 2)

1. Bleak business climate caused by fall in property prices in US and loss of consumer confidence durable-goods orders both fell more sharply than expected.

Fall in investment & consumption

2. Fall in net exports

The above will lead to probably net fall in the demand of US$ (due to fall in I and C (given large US domestic economy) and rise in SS of US$ → depreciation of US$.

(2 x 2m)

*NB: To gain full marks, students **need** to analyse how the factors affect the demand and supply of US dollar, leading to its depreciation.*

(c) In the light of current problems in United States, do you consider that a reduction in interest rate to be an effective way to achieve her macroeconomic goals? [6]

Problems in United States:

1. Trade deficit (current account deficit)

2. Slowing US economy

3. Depreciating US$

Thesis

Explain how fall in interest rate help to <u>boost US economy</u> -- (Expansionary Monetary Policy)

Will a fall in interest rate help to <u>ease trade deficit</u>?

Explain how fall in interest rate leads to reduction in trade deficit:

Capital outflow → depreciation → exports becomes relatively more competitive → rise in export revenue, fall in import expenditure → reduce trade deficit

Anti-thesis

However, it may depreciates US$ further due to speculation and capital outflow (rise in supply of US$) → <u>conflict</u> of goals (stable exchange rate and high economic growth/improvement in current account)

Fall in interest rate do not necessarily boost economic growth in view of bleak business climate – insufficient rise in C and I

Level	Description	Marks
L3	A developed 2-sided answer with **sound analysis**, **adequately substantiated with reference from the context** Evident evaluation & link to potential conflict between goals.	5-6
L2	An **undeveloped answer** with some analysis with reference to extract.	3-4
L1	Smattering of valid points/ answer. Answer is **descriptive** and **lacking in economic analysis** and reference to the context.	1-2

(d) How far does the data demonstrate that there has been decoupling of United States and the rest of the world? [8]

Thesis

The world has managed to decouple itself from United States.

Asia's growth has been predominantly domestically driven through consumption and investment (instead of net exports).

> In most Asian economies, household savings (average propensity to save) has decreased from 15% of GDP in the late 1980s to 8% today. In addition, the savings rate of Japanese households (Marginal propensity to save) has fallen more sharply than that of American households over the past decade. Although consumption has fallen as a share of GDP and domestic demand (investment and consumption) has grown more slowly than GDP in most Asian countries, both C and I continues to rise.

Although exports account for 40% of China's GDP, but those exports have a large import component; only a quarter of the value of China's exports is added locally. The impact of a slowdown in export growth would therefore be partially offset by a slowdown in imports. China's GDP growth has come mainly from domestic demand, which has been growing by an annual 9% in recent years.

Most Asian economies have small budget deficits or even surpluses. This means they have plenty of scope to ease fiscal policy to support domestic demand so as to offset some of the fall in exports.

However, the main exception is Japan, which has a massive public debt; Taiwan, where domestic demand is worryingly weak, is also constrained by a large budget deficit. South Korea, on the other hand, which has run a budget surplus for seven years, has plenty of scope to ease up.

Anti-thesis

Asia – Current account surplus → contribute much more to world supply than demand – based largely on exporting to America

When United State's NY falls → demand for exports decreases (to what extent??)

Synthesis

In sum, if America suffers a slump, the economies of China and the rest of Asia would slow, but they are unlikely to be derailed. When America sneezes, the rest of the world's economies may no longer catch a cold; but if Wall Street shivers, global tremors will still be widely felt.

Level	Description	Marks
L3	A developed answer with **sound analysis** on whether there is decoupling of US and the rest of the world, **adequately substantiated with reference from the context** and a **valid attempt at evaluation**.	7-8
L2	An undeveloped answer with some analysis on whether there is decoupling of US and the rest of the world OR candidate provide one sided answer (max of 4). Answer tends to be lacking in evaluative comments.	4-6
L1	Smattering of valid points. Answer is on the whole descriptive and lacking in economic analysis and reference to the context.	1-3

(e) Discuss and compare the likely impact of the depreciation of US dollar on any of **two** of the other major Asian economies mentioned. [8]

Japan (more negatively affected in terms OF TRADE)

United States takes only 23% of Japan's exports, down from almost 40% in the late 1980s. However, this understates Japan's total exposure. Japanese firms (like those in South Korea and Taiwan) send a lot of components to China for assembly into goods, which are then exported to America as finished products. On top of this, if a sinking American economy pulled the dollar down with it, this would further squeeze Asian exporters.

Japan has a massive public debt – which means that it is unable to ease fiscal policy to support domestic demand to off set fall in export revenue should there be any slowdown in US economy.

China

It is true that exports account for 40% of China's GDP, but those exports have a large import component; only a quarter of the value of China's exports is added locally. The impact of a slowdown in export growth would therefore be partially offset by a slowdown in imports. China's GDP growth has come mainly from domestic demand, which has been growing by an annual 9% in recent years.

Since 2001 the increase in emerging Asia's trade surplus has added less than one percentage point a year on average to the region's average growth rate of almost 7%. Although domestic demand (investment and consumption) has grown more slowly than GDP over the past year, but the gap has been small in China.

Trade with other major economies such as Europe

Regional trade links within Asia have also deepened, thanks partly to growing Chinese demand. Chinese exports to the European Union are now almost as big as those to America and are growing faster.

EV: True, a weaker dollar would tend to hurt exporters in Europe and Asia. But the impact on those economies could be offset if central banks hold interest rates lower than they otherwise would, thereby boosting domestic demand—exactly what is required for global rebalancing.

Level	Description	Marks
L3	A developed answer with **sound analysis** on the comparison impact of depreciation of 2 selected Asian economies, **adequately substantiated with reference from the context** and a **valid attempt at evaluation**.	7-8
L2	An undeveloped answer with some analysis on impact of depreciation of 2 selected Asian economies, with weak attempt in comparison of the impact. Answer tends to be lacking in evaluative comments.	4-6
L1	Smattering of valid points. No comparison is evident. Answer is on the whole descriptive and lacking in economic analysis and reference to the context.	1-3