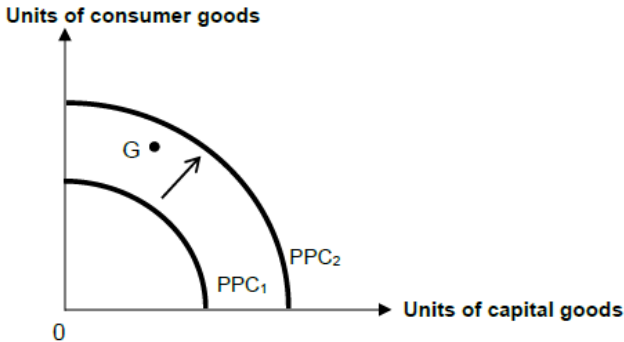


Suggested Answers for 2021 A-Level H2 P1 Qn 2: The Impact of Foreign Direct Investment (FDI) Flows in South-East Asia

(a)	State what is meant by foreign direct investment (FDI) and identify the component of the balance of payments accounts in which FDI is recorded.		[2]
	FDI is long-term capital flow which reflects the sale and purchase of real assets (e.g. manufacturing plants, factories, acquisition of existing firms, equipment, etc.) between a country and the rest of the world. It is recorded in the capital and financial account of the BOP.		
(b)	(i)	Explain the opportunity cost of investment expenditure that uses domestic funds.	[2]
		Opportunity cost refers to the benefits of the next best alternative foregone. funds for investment expenditure, it competes for loanable funds within the country, hence resulting in opportunity costs in terms of consumption expenditure foregone when consumers find it more expensive/harder to borrow from banks.	
	(ii)	Using a production possibility curve diagram, show the impact of infrastructure improvements in a country such as Singapore or Vietnam.	[2]
		 <p>The infrastructure improvements in a country such as Singapore or Vietnam includes an improvement in transport which would improve the efficiency of resources such as labour and capital. This causes the PPC to shift outwards from PPC_1 to PPC_2 as the ability to produce capital goods and consumer goods given infrastructure improvement has increased, reflecting an increase in productive capacity.</p>	
(c)	Explain how the current account of the balance of payments of Singapore or Vietnam is likely to be affected in the long run by increased FDI.		[6]
	<p>The current account of the balance of payments records the value of exports and imports of both goods and services (balance of trade) and international transfers of capital (net income transfers and net current transfers).</p> <p>Increased FDI brings about actual growth and potential growth. As sustained growth is achieved, there is price stability as general price level falls. This improves export price competitiveness. Assuming demand for Vietnam's exports is price elastic, this improvement in export competitiveness will bring about a more than proportionate rise in quantity demanded, hence export revenue (X) rises, improving Vietnam's balance of trade and hence current account balance in the long run.</p>		

	<p>However, the increased FDI also brings about rise in Vietnam's real national income. With greater purchasing power to purchase more goods and services, not only from the domestic market but also from international market. The rise in import expenditure would worsen Vietnam's current account balance in the long run.</p> <p>Or</p> <p>Increased FDI brings about an improvement in production methods, leading to a lower unit cost of production of goods. This increases export price competitiveness, ceteris paribus. If demand for exports is price elastic, this improvement in export competitiveness will bring about a more than proportionate rise in quantity demanded, hence export revenue (X) rises, improving Vietnam's balance of trade and hence current account balance in the long run.</p> <p>On the other hand, increased FDI could result in a worsening of the current account in the long run. As mentioned in Extract 6, China has been the largest contributor to Vietnam's FDI inflows. This mean that owners of FDI will repatriate their profits earned back to their home countries such as China, recorded as an outflow of income transfers. This would worsen current account in the long run.</p> <p>Overall, the impact of increased FDI on the current account of the balance of payment is dependent on the relative impact on balance of trade and outflow of income transfers.</p>													
(d)	Discuss whether broad export diversity or specialisation in a narrow range of exports is more likely to be beneficial for an economy engaged in international trade. (CLT)	[8]												
	<table border="1"> <tr> <td rowspan="3">Approach</td><td>Command Word</td><td>Discuss whether: Balanced answer + EV</td></tr> <tr> <td>Start Point</td><td>Encourage domestic investment vs. Encourage investment from external sources</td></tr> <tr> <td>End Point</td><td>Beneficial for an economy</td></tr> <tr> <td rowspan="2">Content and Context</td><td>Content</td><td>Broad export diversity Specialisation in a narrow range of exports</td></tr> <tr> <td>Context</td><td>Economy engaged in international trade</td></tr> </table> <p>Introduction Both export diversity and specialisation in a narrow range of exports bring about benefits for an economy engaged in international trade.</p> <p>Body <u>Specialisation in a narrow range of exports is beneficial</u> The benefits of free trade is based on the Theory of Comparative Advantage states that trade between nations is beneficial to all if each specialises and trades according to its comparative advantage. A country has a comparative advantage over another in the production of a good if it can produce it at a lower opportunity cost. With specialisation, there is a more efficient allocation of resources and increase in total world output for the same amount of resources. The differences in factor endowments mean that specialisation and trade will make it possible for a country to consume outside its production-possibility curve (PPC) i.e. able to enjoy higher material standard of living.</p>	Approach	Command Word	Discuss whether: Balanced answer + EV	Start Point	Encourage domestic investment vs. Encourage investment from external sources	End Point	Beneficial for an economy	Content and Context	Content	Broad export diversity Specialisation in a narrow range of exports	Context	Economy engaged in international trade	
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Content and Context	Content	Broad export diversity Specialisation in a narrow range of exports												
	Context	Economy engaged in international trade												

With specialisation and trade, the country will now have a larger export market, bringing about higher export volume and hence AD increases. This increases real national income via the multiplier effect, leading to actual growth, as well as lower demand-deficient unemployment as demand for labour increases. This also improves the BOT position. Trade also allows a developing country to obtain imports of higher quality factors of production, thereby increasing the productive capacity of a country, leading to potential growth. Trade allows the sourcing of factors of production from lower-cost economies, leading to an increase in SRAS and lower cost-push inflation.

Broad export diversity is beneficial

However, some countries may be highly specialised in a narrow range of products. As mentioned in Extract 6, Vietnam's exports to the US growing faster than its overall exports. This would mean that Vietnam is dependent on the US to a large extent on the export revenue from these products to buy the imported goods that they need. If US were to impose tariffs on Vietnam's exports to the US, the fall in demand for Vietnam's products will have serious repercussions on AD and hence on her national income and employment, as well as on net exports and hence on current account balance.

Such instability can be reduced by diversifying into the production of a variety of largely unrelated products. According to Extract 5, export diversity refers to the range of goods and services produced and exported, and is measured by the number of different types of products exported. To do this, domestic Vietnamese firms must be protected from foreign competition. Otherwise, they will not be able to compete because of their relative inefficiency due to a lack of comparative advantage. In addition, broad export diversity allows a country to reduce the negative impact on its exports when an import tariff is placed on its selected exports.

Evaluation

Broad export diversity is **more likely** to be beneficial for an economy engaged in international trade than specialisation in a narrow range of exports. This is evident from Extract 5 that trade growth potential is dependent on economic dynamism and export diversity proving that broad export diversity is more beneficial for an economy. This is especially important in the uncertain global climate where there is growing global trade tensions which necessitates an economy's ability to shift its focus to different industries when one is threatened.

Mark Scheme

Level of Response and Descriptors		Marks
L2	Developed analysis of specialisation and broad export diversity is beneficial for an economy engaged in international trade	4-6
L1	Limited analysis of either specialisation or broad export diversity is beneficial for an economy engaged international trade	1-3
Evaluation		
E	Evaluative marks will be awarded for a conclusion reached with respect to a judgement made on whether specialisation or broad export diversity is beneficial for an economy engaged in	1- 2

	international trade													
(e)	Discuss whether a government should encourage domestic investment rather than investment from external sources to improve the standard of living.	[10]												
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Governments should encourage domestic investment instead of investment from external sources to improve the standard of living

An over reliance on investment from external sources would make the economy vulnerable to external shocks. This is evident from Extract 6 where manufacturer consider shifting production to other locations due to US-China trade tensions. This would negatively impact **material standard of living** when investment from external sources is withdrawn which results in a fall in I, AD and multiplied fall in real national income due to the reverse multiplier effect.

The drop in real national output may result in demand-deficient unemployment, further decreasing consumers' material standard of living since they have less money to spend on goods and services. Structural unemployment would also rise if these 'foot-loose' FDIs, like biotech corporations, moved their production out of Vietnam when they find more profitable sources of investment, such as China, which has an abundance of cheap labour and resources including rare earth elements. The rise in demand-deficient and structural unemployment would imply that governments would have less tax revenue available to improve infrastructure, which could result in deterioration of healthcare facilities in less developed countries like Vietnam, further lowering its life expectancy and infant mortality rate and thus lowering its **non-material standard of living**. On the flip side, encouraging domestic investment would be a more long-term strategy as there would be less firms shifting out which would ensure a higher standard of living.

Governments should encourage investment from external sources to improve the standard of living

However, it was mentioned in Extract 6 that Vietnam has engaged in liberalising its economy and Singapore economic dynamism is due to increasing levels of inward FDI. Economic dynamism is important as it meant that the country is developing and innovating in new industries which will make it more resilient to uncertain global trade tensions. A dependence on domestic investment could limit a country's development as there would be less transfer of technology. This is especially the case for Vietnam whose domestic investors may not be competitive to compete in the world market which could limit Vietnam's growth if governments only encourage domestic investment. This has a limiting impact on the standard of living if investment only increase marginally due to the focus on just domestic investment.

Conclusion/Evaluation

Recommendation: The *nature of economy and the government's ability* to manage would determine whether a government should support domestic investment rather than external investment to raise the standard of living.

Criteria - Nature of economy

For resource-rich and comparably bigger countries such as the United States and China, they have decided to be less reliant on foreign sources of investment and have instead concentrated on promoting domestic investment to raise living standards. This may be observed in China, where, despite having an abundance of labour and resources that are highly attractive to external investors, the government has opted to be extremely protective of these resources, instituting extensive laws and bureaucracy to make it difficult for foreign investors to enter the nation.

Criteria - Government's ability

In comparison, the government of Singapore, a comparatively smaller and resource-constrained nation, has chosen to strike a compromise between creating a welcoming climate for external investors and making it easier for domestic entrepreneurs to get licenses to operate businesses. Singapore's success may be shown in the fact that it is ranked 16th in the world for trade growth potential. Singapore's government's ability to maintain the nation competitive in averting an outflow of FDI and supporting future trade growth by increasing infrastructure and ease of doing business has witnessed great progress in her material and non-material standard of living over the years.

Mark Scheme

Level of Response and Descriptors		Marks
L2	For an answer that provides rigorous, coherent and in-depth assessment of the benefits of encouraging domestic investment AND investment from external sources to improve both material and non-material standard of living.	5 – 7
L1	For an answer that has a smattering of points and merely states how encouraging domestic investment OR investment from external sources can improve standard of living OR For an answer that has a smattering of points and merely states how encouraging domestic investment and investment from external sources can improve either material OR non-material standard of living with little economic rigour or many conceptual errors. For an underdeveloped answer that provides a superficial analysis or one lacking in scope.	1 – 4
Evaluation		
E2	For an evaluation that considers which type of investment is best for which type of economy	2 – 3
E1	For an evaluation/judgement that is unsubstantiated.	1