<u>**2013 H1 Prelim CSQ 2 Suggested Answers**</u>

Extract 4: Slowing down of the BRIC

Brazil, Russia, India and China, was acronymed into the BRIC in 2001 by Jim O'Neill, an investment banker from Goldman Sachs. In 2007 China's economy expanded by an eye-popping 14.2%. India managed 10.1% growth, Russia 8.5%, and Brazil 6.1%. The IMF now reckons China will grow by just 7.8% in 2013, India by 5.6%, and Russia and Brazil by 2.5%. So, what is ailing the BRIC and other emerging markets?

Firstly, the idea that emerging-market economies could fully decouple from economic weakness in advanced economies was far-fetched: recession in the eurozone, near-recession in the United Kingdom and Japan in 2011-2012, and slow economic growth in the United States were always likely to affect emerging-market performance negatively – via trade, financial links, and investor confidence.

Secondly, and most recent, factor is the US Federal Reserve's signals that it might end its policy of quantitative easing earlier than expected, and its hints of an eventual exit from zero interest rates. The era of cheap or zero-interest money that led to a wall of liquidity chasing high yields and assets – equities, bonds, currencies, and commodities – in emerging markets is drawing to a close.

These countries share other weaknesses as well: excessive fiscal deficits, external deficits, above-target inflation, and stability risk (reflected not only in the recent political turmoil in Brazil but also in India's political and electoral uncertainties). Thus, emerging economies with large twin deficits and other macroeconomic fragilities may experience further downward pressure on their growth rates.

Adapted from various sources

Table 1: BRIC's in 2011

Indicator – (%)	Brazil	Russia	India	China
Real GDP Growth	2.7	4.3	7.2	9.2
Inflation	6.6	8.4	8.6	5.4
Unemployment	6.0	6.5	9.8	4.0
Investment/GDP	20.6	23.2	34.4	48.3
Saving/GDP	18.4	28.6	31.6	51.0
Current Account/GDP	-2.1	5.5	-2.8	2.8
Budget Balance /GDP	-2.6	1.6	-8.7	-1.2

Source: The Economist, 29th September 2012

Extract 5: Rupee fall may have triggered inflation, but it also offers a way out of industrial decline

Every dark cloud has a silver lining. Nowhere is this saying more apt than in the case of the falling rupee. It has raised fears of a spike in already high inflation rates and decline in foreign investment flows. But it has simultaneously opened up new possibilities of boosting exports, making India's economy more competitive and aiding a manufacturing revolution. The opportunity offered by the rupee depreciation can be substantial, given that labour costs in China have risen sharply.

Current trends have already made India the cheapest source of auto components. Important industries that can leverage these trends include automobiles, IT, engineering, metals, pharmaceuticals, chemicals, textiles, leather and sports goods. Sustained growth of labour-intensive manufactured products offer great potential for absorbing the growing numbers of workers added to the labour force each year.

The rupee, which has been hurt by a record current-account deficit, has sunk 7.4 percent against the dollar in 2013. In July 2013, India stepped up efforts to help the rupee after its plunge to a record low. The RBI (Reserved Bank of India, India's Central Bank) raised bank rates by 2 percentage points, and plans to drain 120 billion rupees ($2 billion) through open market sales of government bonds. These actions of the RBI will lead to an increase in interest rates.

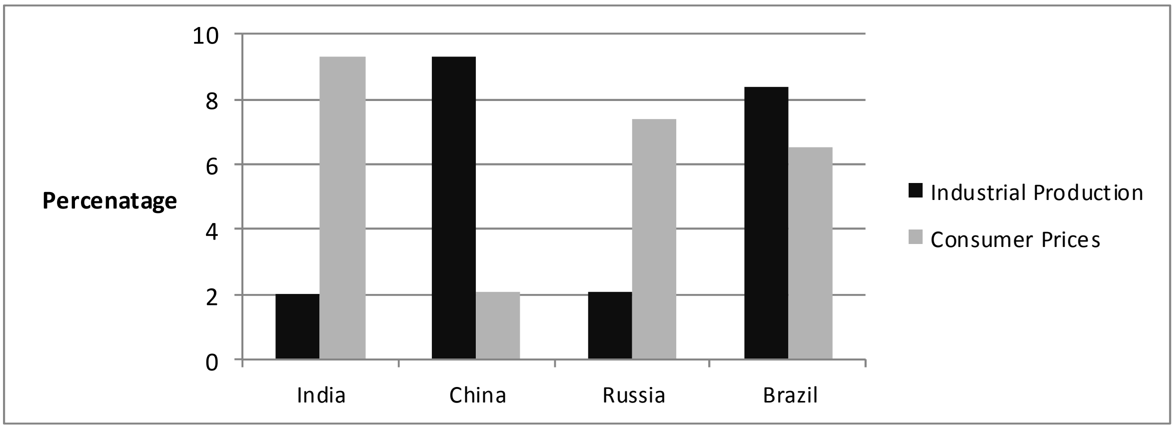
Finance Minister, Palaniappan Chidambaram, told reporters that "these measures in no way affect our commitment to growth. Measures are taken to quell excessive speculation and reduce volatility and stabilize the rupee."

Prasanna Ananthasubramanian, an economist at ICICI Securities Primary Dealership Ltd. in Mumbai exclaimed that "it's quite surprising that the central bank has used these measures to support the rupee at a time when the economy is in such a bad state." India's economy expanded 5 percent in the fiscal year ended March, the slowest since 2003, hurt by moderating investment, easing domestic demand and subdued exports.

Source: India Times, Aug 2013

Figure 1: The BRIC Growth and Inflation rate in March 2013

BRICS: India worst off on Industrial Growth and Inflation



Adapted from The Economist and The Guardian 2012

Extract 6: FDI no panacea for ailing economy

In a bid to shore up India's flagging economy, the government on Tuesday announced opening up foreign direct investment (FDI) in 13 sectors, including petrol and natural gas, insurance, defence production and telecom. The truth is that FDI easing only makes it easier for foreign investors to put their money in India. It doesn't change the fundamentals that determine if they should put their money in India.

A liberal FDI regime can yield results only if domestic economy is revived. The investors, including Indian firms that have been growing in India for decades, are reluctant to risk money due to uncertainties of doing business in India. That Korean steel giant Posco walked out of the biggest FDI deal in Karnataka the day the government announced liberalization of FDI rules is a grim reflection of ground realities. To create an enabling investment atmosphere, the government must remove bureaucratic hurdles, adopt stable fiscal policies and a transparent tax regime. It should allow level playing field for Indian industry and fix a lock-in period for FDI so that money doesn't flow back easily.

Source: The New Indian Express, 18th July 2013

(a) Using Table 1, summarise the economic performance of India compared to that of China in 2011. [2]

(b) (i) Using a diagram, explain why the Indian Rupee appreciated after the Indian government raise the interest rates. [2]

(ii) Explain how this rise in the Indian rupee might affect prices of goods and services in India. [2]

(c) (i) Explain what is meant by the term 'slower growth'. [2]

(ii) Using AS/AD analysis, explain two evidences contained in the data that cause growth rate of BRIC to slow down in the near future. [6]

(d) With reference to the data where appropriate, assess whether on balance the Indian economy would benefit from its 'liberal FDI regime'. [8]

(e) The finance minister of India stated that raising bank rates and having open market sales have 'no way affect our commitment to growth'. Discuss the validity of this statement. [8]

<table>
<tr><td>a</td><td>Using Table 1, summarise the economic performance of India compared to that of China in 2011</td><td>2m</td></tr>
<tr><td></td><td>In 2011, both India’s and China’s real GDP growth was positive but China’s GDP was growing at a higher rate than that of India. India’s unemployment rate was at 8.6% which was more than twice the rate of China’s unemployment rate at 4%. [1m]

Note: Use of other indicators such as the inflation rate or the current balance is acceptable.

China performed better than India in both aspects (real GDP and unemployment rate). [1m]</td><td></td></tr>
<tr><td>bi</td><td>Using a diagram, explain why the Indian rupee appreciated after the Indian government raise the interest rates.</td><td>2m</td></tr>
<tr><td></td><td>India govt Raise i/r → Hot money flows into India to get a better return →DD for Indian rupee rises (as shown in the figure below) → Indian Rupee appreciated [1m]

Explanation indicating a fall in supply of Indian Rupee is also accepted. With rising interest rates in India, Indians would cut down their demand for foreign currency (reducing supply of Indian rupee) to take advantage of the relatively higher interest rates in India.

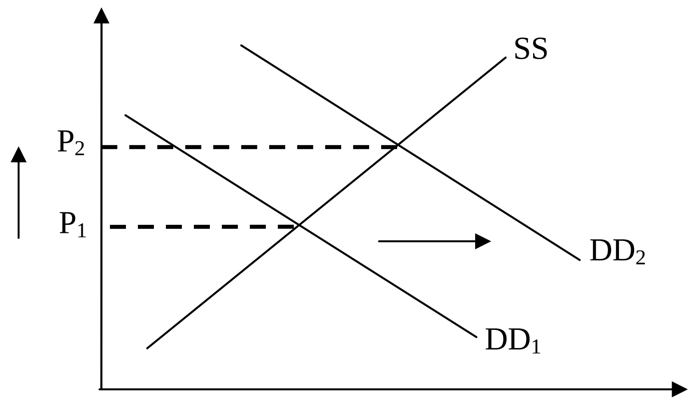
Price of Indian rupee in
terms of foreign currency

Qty of Indian
rupee

Diagram [1m]</td><td></td></tr>
<tr><td>bii</td><td>Explain how this rise in the Indian rupee might affect prices of goods and services in India.</td><td>2m</td></tr>
<tr><td></td><td>(Prices of goods and services in India are indicated by the GPL in India. Hence question requires students to link the appreciation of the Indian Rupee to changes in GPL. Note that GPL is determined by AS and AD)

A rise in the Indian rupee will lead to a decrease in the price of India’s imports (in terms of Indian rupee) and increase the price of India’s exports (in terms of foreign currency).
Prices of imported goods and services in Indian Rupee will be cheaper due to the stronger Rupee. This may lead to a fall in the price of imported factor inputs. The falling Cost of production leads to a rise in AS (Yf remaining unchanged). Hence, prices of goods and services in India will fall. [2m]

OR
Prices of exported goods and services in foreign currency will be more expensive due to the stronger Rupee. A rise in the price of India’s exports in terms of foreign currency will lead to a</td><td></td></tr>
</table>

	fall in quantity demanded of exports and hence, export revenue will fall. This will cause a fall in AD which will lead to GPL falling. **[2m]**	
ci	Explain what is meant by the term ‘downward pressure on their (BRIC) growth rates’.	**2m**
	‘downward pressure on their (BRIC) growth rates’ implies falling growth rates and not necessarily negative growth rates. The implication of falling growth rates is GDP is increasing **(1m)** at a decreasing rate **(1m)**.	
cii	Using AS/AD analysis, explain two evidences contained in the data that could cause downward pressure on the growth rates of the BRIC in the near future.	**6m**
	Evidence 1: Recession in the eurozone, near-recession in the United Kingdom and Japan in 2011-2012 [3m] -Countries in Eurozone face recession → Falling income → Falling purchasing power and they will demand less of BRIC’s exports **[1m]** -UK and Japan are at risk of entering into a recession → consumers are pessimistic of the future → may rather save then to spend → UK and Japan consumers spend less on imported goods and thus, they will demand less for BRIC’s exports **[1m]** - BRIC’s export revenue falls → (X-M) falls, ceteris paribus - AD will thus fall and this will lead to a fall in GDP which will cause growth rate of BRIC to slow down in 2013 *(downward pressure on their growth rates).* **[1m]** *Students can also make use of AD/AS diagram to explain the fall in AD leading to downward pressure on growth rates of the BRIC in the near future.* **Evidence 2: Excessive fiscal deficit [3m]** Fiscal Deficit → government's total expenditures exceed the revenue that it generates **[1m]** In order to finance its expenditure in the future or to reduce the excessive fiscal deficit, the government has to increase tax so as to raise revenue. **[1m]** Hence, an increase in tax (e.g. corporate and income tax) will lead to a fall in purchasing power and hence a fall in investment and consumption expenditure. AD will thus fall and this will lead to a fall in GDP which will cause growth rate of BRIC to slow down in 2013*(downward pressure on their growth rates).* **[1m]** *Students can also make use of AD/AS diagram to explain the fall in AD leading to downward pressure on growth rates of the BRIC in the near future.* *Note: Other evidences in Extract 4 e.g. quantitative easing in the US are also accepted.*	
d	**With reference to the data where appropriate, assess whether on balance the Indian economy would benefit from its ‘liberal FDI regime’.**	**8m**
	<u>i) Explain briefly what is India’s ‘liberal FDI regime”</u> - Refers to the “opening up foreign direct investment (FDI) in 13 sectors, including petrol and natural gas, insurance, defence production and telecom” as mentioned in Extract 6. - This leads to liberalising laws and regulations governing FDI policy which “makes it easier for foreign investors” to set up and own companies in India. - The aim of this policy is to attract capital inflow to help boost India’s “flagging economy”. <u>ii) Indian economy COULD benefit from its ‘liberal FDI regime’ as it helps to achieve macroeconomic objectives</u> **a) Promote Economic Growth** - Increase in FDIs will increase I which will lead to increase in AD since AD= C+I G + (X-M).	

This means AD curve shift to the right from AD0 to AD1 and there will be increase in RNY from Y0 to Y1 and this will lead to actual growth in India.

- Increase in FDI could also lead to transfer of technology and skills, when a new MNC is introduced into the country, new equipment and foreigners would be coming along to train the locals on the operation of the new equipment and maybe better methods of production that could be more efficient in terms of resource allocation or resource usage. This would then convert into increase in productive capacity and this would then cause the LRAS to shift to the right from LRAS0 to LRAS1. This would cause the general price level to fall from P0 to P1 and the real national income to increase from Y0 to Y1. In addition, there is increase in full employment from Yf0 to Yf1 and there will be increase in potential growth. Thus, economic growth is promoted in India.

b) Increase Employment

- Increase in FDI will help generate employment as there will be an increase in production of goods and services when MNCS are set up in India. An increase in production of goods and services would mean that there is a need to employ more workers since labour is a derived demand. Thus, this leads to more jobs being created in India.

c) Improve BOP

- Increase in FDIs will lead to long term capital inflow which involves the purchase of real assets such as manufacturing plant and equipment. This will help improve capital account of India and improve India's BOP position.

<u>ii) Indian economy MAY NOT benefit from its 'liberal FDI regime' as there are **other factors** which will determine the decision of foreign investors to invest in India and thus FDIs may not increase much and there could be **negative effects** of a "liberal FDI regime"</u>

a) FDI may not increase much due to
i) Poor economic outlook in India

- India's poor economic performance as mentioned in Extract 5 where there is "falling rupee" and 'record current account deficit' due to falling exports would lead to "uncertainties of doing business in India' (Extract 6 para 2). As business spending in the private sector is guided by profits, generally the higher the expected returns on investments, the higher would be the investment levels. However, due to the problems faced by India's economy, there will be slower economic growth in India as India is expected to grow by only 5.6% in 2013 as compared to 10.1% in 2011. As such foreign investors may be pessimistic about India's future, i.e. it expects future demand for its goods and their prices to rise very slowly, and they are less inclined to invest. Thus, a liberal FDI policy will be effective "only if domestic economy is revived" as mentioned in Extract 6 para 2.

ii) Poor business environment

- Indian economy may not benefit from its liberal FDI regime if the government does not provide "enabling investment atmosphere" in India for the foreign investors. In India, there is still "bureaucratic hurdles", lack of "stable fiscal policies and a transparent tax regime" which are crucial to attract FDI. Foreign investors will have to worry about red tape and other bureaucratic inefficiencies when conducting business as there will be hassles in which administrative matters are handled. As such, this will slow down business operation, increase cost of production and affect profits earned by the foreign investors. Stable fiscal policies such as transparent tax regime and tax incentives are also

- important in attracting FDIs. Foreign investors will be more willing to invest if there are sound political infrastructure and policy-making procedures.

b) Negative impacts of high FDI
i) Demand-pull inflation
- If India experiences excessive FDI, it may lead to rapid increase in AD and this may causes GPL to rise very quickly and the economy will be operating at full or close to full employment, leading to demand-pull inflation.
ii) Overly dependent on FDI
- There could be massive unemployment in the future if MNCs decide to pull their investment out of India which will lead to falling incomes for the locals. Thus, this will lead to fall in material standard of living as the Indian citizens will have now fall in purchasing power and they can consume less goods and services.
Note: Other reasons such as possible consumer exploitation by giant MNCS or threatening of local jobs are also accepted.
<u>iv) Evaluation: Take a stand on the extent of India benefiting form a ‘liberal FDI regime’</u>

- Indian economy would benefit from its ‘liberal FDI regime’ to a **limited extent** as foreign investors may not be attracted by such policy and thus FDIs will not increase significantly. Liberalizing FDI does not address the fundamental factors which will influence foreign investors in deciding whether to invest in India. It is not sufficient to rely only on a ‘liberal FDI regime’ to attract FDIs in India and boost its economy. In order to enjoy the economic benefits of the liberal FDI regime, the government must implement other supportive policies to attract FDIs as well as solve the domestic economic woes in India. Also, it is important to note that whether FDI policy is effective can also be influenced by external factors e.g. favorable changes in FDI policy elsewhere in other countries. Thus, there can be strong competition for FDIs from other emerging countries such as China and Brazil. Overall, India may experience some inflationary pressures in the short-run but India will have lower prices and enjoy other economic benefits in the long-run.

Marking Scheme

L2	Well-developed answer that thoroughly explains a two-sided answer of how India may or may not benefit from its ‘liberal FDI regime’. Use of data to substantiate points.	**4-6**
L1	One-sided answer that focuses on either how India may or may not benefit from its ‘liberal FDI regime’ or two-sided answer that is sketchy or does not make reference to data provided.	**1-3**
E	A well-developed evaluative judgment on the extent of India benefiting form a ‘liberal FDI regime’.	**1-2**

e	**The finance minister of India stated that contractionary monetary policy have ‘no way affect(ed) our commitment to growth’. Discuss the validity of this statement.**	**8m**
	<u>i) Explain briefly what the statement is about.</u> - It means that adopting contractionary monetary policy by the central bank such as raising bank rates and having open market sales will not lead to fall in economic growth in India. - However, this will contradict with another view by an economist that is presented in Extract 5 which is that adopting contractionary monetary policy is “quite surprising” “ when the economy is in such a bad shape”, implying that the India’s economic growth will be affected by the RBI’s policy.	

ii) Thesis: Adopting contractionary monetary policy will **not affect economic growth a**s achieving stable exchange rates and prices will help promote economic growth

a) Promote exchange rate stability

- Adopting a contractionary monetary will “help quell excessive speculation and reduce volatility and stabilize the rupee” as stated in Extract 5 para 4. Having stable exchange rates is necessary to facilitate international trade and foreign direct investment. Falling exchange rates may signal to investors that the country is weakening this will discourage investment to take place in India. As mentioned in Extract 5 para 4, the rupee has been “plunged to “record low”. As such, this will have negative impact on economic growth as investment is necessary to help boost India’s economy. In addition, excessive speculation will be adverse for India’s economy as it will lead to volatility and instability in the foreign exchange rate and this will affect trade and investment as well. It will be difficult to make business decisions due to excessive fluctuations in the exchange rate. Thus, there will be low investment as well which will affect economic growth.

b) Promote price stability

- In addition, falling Indian rupee will “raise fears of a spike in already high inflation rates” as stated in Extract 5 para 1. This is also supported by Figure 3 which shows that India have relatively high inflation rates in March 2013 which is close to 10% and it is the highest among the BRIC. A weaker exchange rate will mean that the price of imported raw materials and other factor inputs is relative more expensive and this will raise the cost of production of domestic firms who use imported sources. This will lead to fall in short-run aggregate supply and upward shift of SRAS from SRAS0 to SRAS1 (Yf Unchanged). This means that the real national income falls from Y0 to Y1 and GPL will rise from Po to P1. Thus, it is necessary for the government to step up efforts to help strengthen the rupee to ensure that India does not suffer from cost-push inflation as well as slower economic growth.

iii) Anti-thesis: Adopting contractionary monetary policy will affect economic growth as there will be fall in AD

a) Reduce consumption and investment

- Contractionary monetary policy will lead to fall in consumption and investment and fall in AD. Raising banks rates and having open market sales will lead to fall in money supply and rise in interest rates. When the central bank in India sells securities in the open market or increase the bank rate on loans to commercial banks, it will have the effect of lowering money. This fall in money supply (from M0 to M1) raises the interest rates (from R0 to R1). With higher interest rates, cost of borrowing rises and this reduces profitability, resulting in a fall in Investments. Furthermore, higher interest rates discourage consumption (C) as consumers may now choose to save more instead to earn the higher interest. The fall in I and C reduces the equilibrium level of national income (from Y0 to Y1). The contractionary monetary policy also tends to lower the general price level (from P0 to P1) as AD falls (from AD0 to AD1). Thus, contractionary monetary policy will lower economic growth in the country.

b) Reduce export competitiveness

- In addition, there are economic benefits if the government does not tighten its monetary policy and allows the Indian rupee to depreciate rather than appreciate. As mentioned in Extract 5 para 1, the falling rupee will open up “new possibilities of boosting exports, making India's economy more competitive”. A weaker exchange rate would mean that

	exports are relatively cheaper and foreign households will buy more exports. Assuming that demand for exports is price elastic, it will lead to more than proportionate increase in quantity demanded for exports and export revenue will increase. - An increase in export revenue will mean AD will increase and AD curve will shift to the right from AD0 to AD1 and real national income will rise from Y0 to Y1. Thus, having a stronger exchange rate will mean that this will reduce India's export competitiveness which will affect its economic growth. - <u>iv: Conclusion: Take a stand on whether the statement is valid</u> Essentially, whether raising bank rates and having open market sales will affect India's commitment to economic growth will depend on the time period. In the short run, it is likely to see that there is a trade-off as having stable exchange rates and prices will be at the expense of slower economic growth rates. However, this short-term loss could be offset by long term gains and stability which is important to achieve sustained economic growth in the country. However, it is important for the government to adopt other policies such as supply side policies to increase economic growth in India besides stabilisng the exchange rates. **Marking Scheme**	
L2	Well-developed and balanced answer that thoroughly explains why the statement is valid or invalid.	**4-6**
L1	One-sided answer that focuses on either the statement is valid or invalid or two-sided answer that is sketchy or does not make reference to data provided.	**1-3**
E	A well-developed evaluative judgment on the validity of the argument.	**1-2**