2020 A Level - CSQ 2

<table>
<tr><td>(a)</td><td>Using the information available, compare the post-2008 performance of Italy and Singapore with respect to GDP, inflation and unemployment.</td><td>[6]</td></tr>
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<table><tr><td>(a)</td><td>Most responses attempted to make comparative statements, and ones that covered all three required macroeconomic variables; those made on GDP and unemployment were usually accurate, whereas there was greater variability in accuracy among those on inflation.</td></tr></table>
<u>GDP</u>
GDP of Italy had always been higher than that of Singapore during the post-2008 period. [1] GDP of Singapore has increased post-2008 while that of Italy has decreased. [1]
<u>Inflation</u>
Both Italy and Singapore experienced deflation in at least one year. [1] Singapore experienced a larger magnitude of change in its inflation rate compared to Italy [1] OR Singapore’s inflation rate fluctuated over a larger range than that of Italy OR the highest inflation rate of Singapore is higher than that of Italy and its lowest inflation rate is lower than that of Italy.
<u>Unemployment</u>
Unemployment rate of Italy had always been higher than that of Singapore during the post-2008 period. [1] Unemployment rate of Italy has decreased post-2008 while that of Singapore has increased. [1]
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<tr><td>(b)</td><td>(i) State the components of aggregate demand.</td><td>[2]</td></tr>
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<table><tr><td>(b)</td><td>Almost all candidates were able to identify four components correctly in (i). In (ii), responses varied slightly more in quality, although most were able to explain how both fiscal policy decisions – increased government spending and tax reductions – and the rapid growth in China resulted in increased aggregate demand in the US. Diagrams were often well used to support these explanations, though only the strongest responses showed an awareness of the context, namely recovery from the 2009 recession. It was surprising how many responses showed an awareness of how interest rate changes would also contribute, even though they often incorrectly included them as part of ‘fiscal policy’.</td></tr></table>
The <u>4</u> components of aggregate demand are consumption expenditure, investment expenditure, government expenditure and net exports (export revenue - import expenditure).
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<tr><td></td><td>(ii) With reference to Extract 4, explain how the US’s fiscal policy and the rapid economic growth of China contributed to the US’s economic recovery from its 2009 recession.</td><td>[6]</td></tr>
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With the recession in 2009, it is likely that there is demand-deficiency and excess capacity observed in the US.
<u>Impact of US’s Fiscal Policy on economic recovery (i.e. rise in AEG)</u>
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US adopted expansionary fiscal policy with “tax cuts and increase in government spending”. As government increase spending on infrastructure developments, government expenditure (G) is a component of AD**, AD increases as govt spending increases**. [1]

Tax cuts increases consumption (C) and investment (I) as **disposable income and post-tax profits increase due to fall in income tax and corporate tax**. C and I are components of AD, AD increases. [1]

With the autonomous rise in G, I and C and assuming spare capacity, **the initial increase in AD will trigger successive rounds of expansion in output, income, and income-induced spending, leading to a multiplied increase in real national income**. [1]

<u>Impact of rapid economic growth of China on economic recovery (i.e. rise in AEG)</u>
Rapid economic growth in China lead to a rise in income of the Chinese, causing them to **increase purchasing power and thus higher demand for goods and services**, which includes that of imported goods from the US (**assume normal goods**). [1]

China will also import more factor inputs from the US, such as oil, to make increasing amount of final goods. Therefore, demand for US’ exports increases, **increasing its export revenue** [1].

Assume **constant import expenditure of the US, US’s net exports will rise**, X-M increases, AD increases, leading to a multiplied increase in real national income as explained earlier. [1]

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(c)

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Explain the ‘consequences for employment and living standards’ Greece will have experienced as a result of its GDP falling significantly.

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[6]

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(c) This was generally well answered, with both employment and living standards being correctly addressed by almost all candidates. The main weakness was in responses which suggested that the only people who will have suffered lower living standards were those who happened to become unemployed.

<u>Consequence for employment as a result of GDP falling significantly [2]</u>
As GDP falls significantly, demand for factor inputs including labour will also fall [1] since the latter is derived from the demand for final goods and services. Therefore**, derived demand for labour falls**, causing demand-deficient unemployment to rise. [1]

<u>Consequence for living standards (i.e. mSOL and nmSOL) as a result of GDP falling significantly [4]</u>
Standard of living is defined as the well-being of the average person, both in terms material (access to quantity of goods and services) and non-material (intangible quality of life).

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	As Greece's GDP fell significantly and **assuming that the price level and population remained unchanged**, a lower GDP level would lead to lower real GDP per capita. This would mean that there was a fall in average incomes [1] thus leading to a **fall in purchasing power** (i.e. lower level of consumption of goods and services), proving that **material living standards had worsened**. [1] Fall in GDP also means **less tax revenue** collected by government due to lower income and corporate profits, and leading to **lower govt spending on education, healthcare provisions** such as subsidies, maintenance of public hospitals etc [1] This will lead to a fall in access to quality healthcare and education facilities, causing **non-material SOL to fall as life expectancy / literacy rates are compromised**. [1]	
(d)	**Extract 6 relates to the policy of 'austerity' adopted, not always willingly, by some governments after the 2008 financial crisis.**	
	(i) Explain the benefits to the economies when governments adopted 'deflationary policies' and comment on whether the deflationary policies were justified.	**[7]**
	(d) The responses to **part (i)** were of variable quality, largely reflecting the extent to which they demonstrated awareness of the context or otherwise. Almost all showed knowledge of the working of 'deflationary policies', but the weaker ones explained their purpose in terms of reducing demand-pull inflation, rather than in addressing problems for domestic governments that resulted from the global crisis. However, there were many good responses to the 'comment' element of the question, largely focusing on possible downsides of the policies. **Explain 2 benefits to economies via impact on macro goals [4m]** 'Deflationary policies' will decrease Aggregate Demand via a reduction in its component [AD=C+I+G+(X-M)]. **Benefit 1: Reduce size of government budget deficit for debt-ridden economies** On the other hand, austerity measures are deflationary in nature as it involves a reduction in government expenditure and a rise in direct taxes (contractionary fiscal policy), thereby increasing tax revenue for the government, as evidenced in Extract 6. A fall in government spending with an associated rise in government revenue will improve the government budgetary position (i.e. a reduced size of budget deficit / debt). [1] The rationale for austerity measures undertaken by various governments in 2008 was to reduce the size of government budget deficit/debt to rebuild business confidence/economic sentiments amidst the global financial crisis, as well as the long term fiscal health of government in utilizing fiscal spending - both crucial for long term sustainable/inclusive growth (prudent government spending on green technology or skills-upgrading for disadvantaged groups). [1] **Benefit 2: Boost confidence / economic outlook in the economy** Another benefit of 'deflationary policies' is that they signal commitment of the governments to improve their budget position by reducing public debt, thus restore the stability in the economies. [1]	

	This might lead to improved investor confidence and they will expect higher future rates of returns, thus this can lead to an increase in investment. With the rise in AD, there would be a multiplied increase in RNY via the multiplier effect and in the long term there would be positive actual economic growth. [1] **Comment if deflationary policies are justified [3m]** **Not justified:** Unfortunately, it seems like the benefits of 'deflationary policies' were short-lived because despite the intended improved budget balance, 'cuts in government spending' in economies such as Greece, Italy and the UK meant that their people's non-material SOL worsened since there were not enough funds to support the provision of facilities and amenities 'closed libraries and unused care centres'. In addition, the fall in AD, through fall in G, C and I also meant that the national income was also lower, and assuming that prices remained the same, purchasing power fell suggesting that the material well-being of the people also worsened. This fall in national income also implied a fall in national output and hence fall in employment levels. All in all, the 'deflationary policies' were not justified because they seemed to have worsened the situation in the economies mentioned earlier. OR **Justified:** The need to restore financial stability and business confidence is paramount for the long term growth prospect for Greece, in spite of the recession. This is because the root cause of poor economic sentiment stemmed from the large unsustainable government debt, which discourages private investment and spending as well as the government's ability to develop its economy structurally, "opportunity cost in terms of infrastructure that could have built or repaired" (Extract 6). Therefore, there is a need for the Greece government to prioritise long term growth over the short term negative economic impact.	
	(ii) Assess the suggestion that, with low interest rates, governments should have 'borrowed to invest instead of adopting the austerity policies'.	**[8]**
	Brief Answer Outline: **R1: Benefits of Government borrowing to increase G → achieved Actual and Potential EG.** **Evaluation of R1: Crowding Out effect.** **R2: Costs of Austerity Measures, thus Government should borrow to invest.** **Evaluation of R2: Root cause of large fiscal debt that will render other expansionary policies ineffective.** **Introduction** Low interest rates suggest low cost of borrowing and higher rates of return on	

investment. During times of low interest rates, governments can choose to either finance expansionary fiscal policy through borrowing or to adopt contractionary fiscal policy, (i.e. austerity policies).

R1: Governments should have leveraged on the low interest rates to borrow and spend, instead of austerity measures due to the impact from Global Financial Crisis (GFC)

Macro Problem (Context): The GFC has brought about wide-spread negative impacts across economies around the world with a fall in C, I and (X-M) due to business pessimism, leading to negative growth and rising unemployment. Potential growth and productive capacity will also be negatively affected as the (rate of capital depreciation exceeds rate of investment). Therefore, these impacts will lower both the current and future standard of living for citizens.

Mechanism of Macro Policy: Thus, with the urgency of resolving plummeting growth rates, there is an **immediate need for the government to implement expansionary measures to raise AD and real output** - this can be achieved by extensive borrowing with the lower interest rates by governments to increase government expenditure (expansionary fiscal policy) and raising AD and real national income. This can be illustrated from the figure below, with a rise in AD from AD0 to AD1, resulting in a multiplied increase in RNY via the multiplier. The rise in real output will increase the derived demand for labour for production of these goods and services, thus raising employment levels.

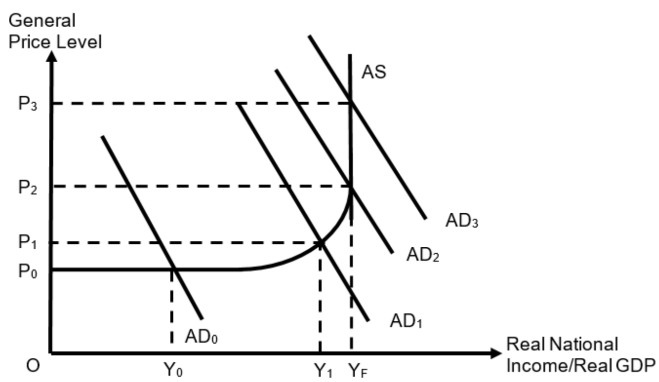


Figure: Effect of Expansionary Fiscal Policy

Pros of Macro Policy: In addition, the lower interest rates will mean lowered cost of borrowing for the government, the government does not have to pay as much interest payments and this is beneficial for countries that are already in dire budget positions and no reserves to use. This would also mean that the investments would become profitable more quickly, therefore borrowing to spend is a feasible option for Greece.

Evaluation 1: The limitations & unintended consequences of expansionary policies render them ineffective

Cons of Macro Policy: Theoretically, the extensive borrowing by the Greece government in funding public expenditure will result in crowding out effects (financial & resource aspects) as competition for limited resources will drive up prices, discouraging further private investments in the economy. Additionally, the continued rise in G might lead to rising inflation as AD increases from AD1 to AD2 and AD3 beyond Yf, with prices rising to P3 eventually. This erodes the purchasing power of consumers and worsens SOL.

OR

Besides, if the government continues to borrow, the future generations will have to bear the cost of the borrowing by paying the interests on the loans undertaken by the government instead of having their tax revenue being used to finance efforts for the economy to achieve economic growth. This would lead to a fall in non-material SOL as the quality of life may fall when the government chooses to cut back on social spending.

R2: Costs of austerity measures and thus governments should have leveraged on the low interest rates to borrow and spend

The cut in government spending and rise in direct taxes under austerity measures will worsen the existing recession, as the fall in autonomous G, I and C will reduce AD, leading to successive rounds of falling output, income, and income-induced expenditures. This will stimulate the economy into a deeper recession with higher demand-deficient unemployment as standard of living of the average person falls further.

The trade-offs of the austerity measures can be evidenced in Extract 6, “closed libraries, unused care centres and increased use of charitable food donations” as well as “infrastructure that could be repaired or built”. These demand-deficient conditions will directly impact the SOL of Greece, especially in the short run.

Evaluation 2: Austerity measures target the root cause of the macro problem thus is more effective in the long term.
Mechanism of Macro Policy and pros: As mentioned in the previous question, the austerity measures address another root cause - the unsustainable growth and size of government budget deficit and debt which affected business confidence and long term growth prospect. Though deflationary in nature and thus worsens the existing recession, cutting G and raising direct T will directly improve the budgetary position and fiscal health of the government, thereby raising confidence in consumers and investors in the economy. This is fundamental for the long-term sustainable growth of Greece.

Evaluative conclusion: Judgement about which policy is better
Stand: Whether the government should borrow to invest or adopt austerity measures during times of low interest rates depends on a few factors like the budget position of the economy and the economic priorities of the economy.

Substantiation (Situation of STRAWS): If the government would like to improve its budget position without causing inflation now and without causing future generations to bear the burden of debt, it might want to pursue austerity policies. However, if it wants to pursue potential economic growth and is confident of the returns on

	investment, it might want to borrow to invest.	

Marking Scheme

Knowledge, Understanding, Interpretation, Application and Analysis			
Level	**Analysis Level**	**Descriptors**	**Marks**
L2	A+A A+C C+C C+K/0 A	Responses in this level will provide detailed analysis on the impacts of expansionary FP from government borrowing and austerity measures, showing excellent ability to describe and explain relevant economic concepts, theories, and principles in a precise, logical, and reasoned manner, with good use of extract evidence.	4-6
L1	K+K K	Responses in this level will have some limited understanding of impacts of expansionary FP from government borrowing and austerity measures. There may be some basic content errors and limited or no application of economic concepts, theories, and principles to the context at hand.	1-3

Evaluation

Level	Descriptors	Marks
E2	One well explained evaluative statement or two weakly explained evaluative statements and a short summative conclusion that addresses the question.	2
E1	One evaluative statement that may be generic, weakly explained or not supported by the arguments presented in the answer.	1

(e)	**Discuss the view that countries need 'more inclusive growth'.**	**[10]**

> **(e)** There were some impressive responses to this question, with a clear understanding of what 'inclusive' growth involves, usually accurately focused on the material presented in Extract 7. Such responses also attempted to deal with the issue of what 'more' such growth might involve. Weaker responses, however, tended to give very limited explanations of the meaning of inclusive growth, often then leading on to non-justified contrasts with other forms of growth. For example, many asserted, without any attempt to justify the assertion or to explain why they viewed it as a mutually exclusive situation, that inclusive growth was undesirable because sustainable growth had a higher priority.

Brief Answer Outline:

R1: Benefit of prioritizing inclusive EG in improving current mSOL for an economy.
Evaluation 1: Costs of slower, inclusive EG on SOL.

R2: Benefit of prioritizing inclusive EG in improving nmSOL for an economy.
Evaluation 2: Other macro priorities should be addressed to improve SOL.

Introduction

Definition: The overarching aim of governments in pursuing satisfactory levels of economic performance lies in improving the SOL of its citizens (defined as the material and non-material well-being of an average citizen).

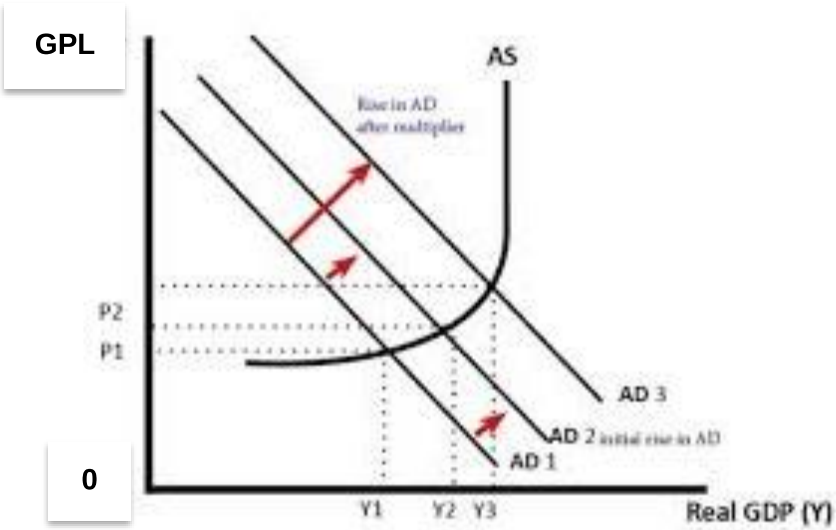
Inclusive growth, being one of the macro goals, implies a sustained rate of economic growth (with sustained growth as the basis) that takes into consideration the income distribution. It is broad-based economic growth that creates productive employment opportunities for the majority of the population and does not contribute to worsening income inequality (measured by Gini coefficient).

While it is an ideal to achieve inclusive growth as a macroeconomic goal for all economies, however, the pursuit of this goal should be prioritized according to the context (stage of economic development) and urgency of macro problems faced, in relation to the resultant impact on the overall standard of living of the citizens in the country.

R1: Countries should aim for inclusive growth so as to increase mSOL

The achievement of inclusive economic growth may help to increase the rate of future economic growth. Governments may issue transfer payments to the poor to achieve inclusive growth. That results in them enjoying higher disposable incomes and the economy will achieve a lower Gini coefficient. Gini coefficient is 0 when there is perfect equality and 1 when there is perfect inequality. Thus, since there is greater income equality now, the Gini coefficient will be closer to 0.

Given a marginal increase in disposable income, lower income households will spend more than high income households, this is because their Marginal Propensity to Consume (MPC) is much higher. As such, when the benefits of growth are shared more equally with the lower income households via transfer payments, and they enjoy a larger disposable income, there is a larger increase in C and AD.



Assuming the economy is not at full capacity, firms will employ more factors of production to increase production of output, which increases RNY from Y1 to Y2. This causes an increase in national income, which will increase income induced consumption and result in a further increase in AD. This trigger successive rounds of increases in national income and income induced consumption. At each round, the increase in both gets smaller. The multiplier process will end when the increase in national income is too small to generate further increase in induced consumption. Thus, the autonomous increase in AD from AD1 to AD2 results in a multiplied increase in RNY from Y1 to Y5..

Evaluation 1: Cost of slower, inclusive EG

Often, to allow for economic growth to occur, the government may have to encourage changes in production, both in terms of goods produced and in terms of the techniques used and the skills required. Rapid economic growth may lead to rapid changes in the demand for different labor skill sets. Thus, to avoid structural unemployment, the government may accept a slower rate of economic growth.

However, if the rate of actual economic growth has slowed; this means that the rise in real national income has slowed. The government's tax revenues may not rise sufficiently to keep up with the increase in social spending to allow for greater inclusivity, or the government may have to incur borrowing to finance the policies; this could lead to a worsening budget position and therefore this may limit the government's ability to fund policies to uplift low-income households.

R2: Countries should aim for inclusive growth so as to increase nmSOL

Rising income inequality will lead to social instability as social stratification will weaken the social bonds between the different groups, eventually negatively affecting the non-material SOL. This is evidenced in Extract 7 where "growing sense of isolation and detachment among people who feel left behind by globalisation".

Countries may also implement policies such as retraining and education for low-skilled workers to learn skills that are currently in demand by employers. Considering the workers who have been 'displaced as a result of technological change' (Extract

7), this would reduce the skills mismatch and allow for greater occupational mobility as workers are more easily able to move into new industries with the relevant skills learnt. This would allow for workers to be more productive; the improvement in the quality of labour will allow for the rise in productive capacity. Assuming the economy is near full capacity, the increase in LRAS will lead to a rise in both actual EG and potential EG.

With the greater productivity in their new jobs, the workers may be able to complete their tasks with shorter timeframe; as such, they may work fewer hours and have more leisure time for themselves. As such, with more leisure hours, the workers will be less stressed and enjoy higher quality of life as life expectancy rises. Thus, nmSOL may improve.

These workers will also continue to enjoy job security, reducing the stress placed on these workers. This would improve the quality of life of the workers and life expectancy rises, thus raising their non-material well-being.

Evaluation 2: Countries should prioritize other macro goals so as to increase SOL
On the other hand, while inclusive growth is indeed important, governments might need to prioritise their approach in addressing more urgent economic problems faced by their economies.

For example, a country faced by a wage-price spiral with sky-rocketing rates of inflation will need to address the hyperinflation to prevent wide-spread loss of confidence in consumers and investors, a critical factor in ensuring sustained growth and satisfactory level of SOL. This may be caused by an initial cost-push inflation. As GPL rises persistently and at a fast rate and assuming income remains constant, the purchasing power of consumers are eroded as the quantity of goods & services attainable falls, leading to worsening of material SOL. Worse still, as observed in Zimbabwe and Venezuela, hyperinflation led to hoarding of goods & services via panic purchases which created social tensions and unrest, thus non-material SOL falls.

Note: Students can also elaborate on causes and consequences of other macro problems, such as recession, deflation, with explicit links to SOL etc.

Synthesis
Stand: While it is indeed important for governments to pursue and need more inclusive growth, whether that should be the priority over other macro goals depends on the existing issues faced and their respective impact on the SOL.

Substantiate - STRAWS (Situation/Context): Governments strive to achieve their macroeconomic goals in order to attain a satisfactory level of SOL for their citizens. For a developing economy / economy faced with recession, the urgency lies in reviving growth to improve SOL. The policies to be implemented should not worsen the income inequality to ensure growth can be as inclusive as possible.

Thus, these government decisions require careful weighing of the trade-offs, short term / long term consequences and the perspectives of different stakeholders - to strive for a balance amidst all considerations.

Marking Scheme

Knowledge, Understanding, Interpretation, Application and Analysis			
Level	**Analysis Level**	**Descriptors**	**Marks**
L2	A+A A+C C+C C+K/0 A C	Responses in this level will provide detailed analysis on costs and benefits of inclusive growth, as well as other macro priorities of the government. The answer shows excellent ability to describe and explain relevant economic concepts, theories, and principles in a precise, logical and reasoned manner, with good use of extract evidence.	4-7
L1	K+K K	Responses in this level will have some limited understanding costs and benefits of inclusive growth, as well as other macro priorities of the government. There may be some basic content errors and limited or no application of economic concepts, theories, and principles to the context of Singapore.	1-3

Evaluation

Level	Descriptors	Marks
E3	One well explained evaluative statement or two generic, weakly explained evaluative statements which are supported by the arguments presented in the answer. and a summative conclusion that addresses the question.	3
E2	One well explained evaluative statement or two generic, weakly explained evaluative statements which may not supported by the arguments presented in the answer.	2
E1	One evaluative statement that may be generic, weakly explained or not supported by the arguments presented in the answer.	1

[Total: 45]