**Question 2: Challenges Facing China's Economy**

**Table 2: China Key Economic and Social Indicators**

| | **2019** | **2020** | **2021** | **2022** | **2023** |
|---|---|---|---|---|---|
| **Nominal GDP Growth (%)** | 7.8 | 3.5 | 12.6 | 5.1 | 4.9 |
| **Population Growth (%)** | 0.35 | 0.24 | 0.09 | -0.01 | -0.1 |
| **Unemployment Rate (%)** | 5.2 | 5.6 | 5.1 | 5.5 | 5.2 |
| **Youth[1] Unemployment Rate (%)** | 12 | 14 | 14 | 18 | 21.3 |
| **Inflation Rate (%)** | 2.9 | 2.5 | 1.0 | 2.0 | 0.2 |
| **Pollution Index (PM2.5 μg/m³)** | 36 | 33 | 30 | 29 | 30 |
| **Life Expectancy at Birth (years)** | 77.3 | 77.9 | 78.2 | 77.9 | 78.6 |

*Source: National Bureau of Statistics of China*

**Extract 5: China's Overcapacity and Deflationary Pressures**

China has an industrial overcapacity problem that is rooted in its long-standing investment-led growth strategy. For decades, economic expansion was driven primarily by large-scale investments in heavy industries. State subsidies, often financed by government borrowing, were channelled into strategic industries such as electric vehicles, solar panels, and batteries that led to repeated overbuilding and duplication of production capacity. As a result, China's economic growth model has long been imbalanced, with policy favouring investment and industrial output over household consumption.

These state subsidies incentivised firms to expand aggressively, even in the absence of sufficient domestic demand. Even as many sectors grapple with excess supply, the government continues to focus on its investment-led growth strategy instead of boosting citizens' incomes and spending. This imbalance has led to excessive production alongside chronically weak domestic demand, creating fear that there will be eventual deflation.

Analysts note that measures are needed to prevent a downward drift in inflation expectations that could undermine business confidence and consumer spending. Economists warn that such a cycle would raise real debt burdens and threaten economic growth. The possible threat of

[1] Youth refers to those aged 16-24.

deflation has again "reared its head" in China, and without a rebalancing toward domestic demand, these ultra-low price pressures – and their painful consequences – may persist.

*Source: Adapted from Reuters, 9 November 2023*

**Extract 6: China's Demographic Decline and Youth Unemployment Crisis**

China's population is now in decline, ushering in a new demographic era with profound economic implications. The National Bureau of Statistics reported that the population fell by 2.08 million in 2023, a 0.15% drop to 1.409 billion people. This was the second consecutive year of shrinkage – the first time China's population has declined since 1961. Decades of the one-child policy and rapid urbanisation have left China with one of the world's lowest fertility rates.

At the same time, China is grappling with a job crisis among its youth. Officially, the youth unemployment rate hit a record 21.3% in June 2023 – the highest since the statistic began and a figure so troubling that authorities suspended the release of youth job data thereafter. Several factors underpin this spike in youth unemployment. A primary reason is the general economic slowdown and cautious business sentiment, leading companies to reduce hiring or offer fewer positions. Furthermore, a mismatch exists between the skills of a growing number of university graduates and the available job market, which is still heavily skewed towards manufacturing and traditional industries, rather than the growing service or high-tech sectors that many graduates are trained for. Meanwhile, the cohort of graduates has swelled to record numbers, intensifying competition. Faced with a shortage of appealing opportunities, many youths have simply opted out. Some pursue further studies; others retreat into inactivity, exemplified by the popular catchphrases of disillusioned youth such as *"tang ping"* ("lying flat") – a rejection of the rat race.

The consequences of these demographic and labour trends are far-reaching. China's working-age population is shrinking just as the burden of supporting a rapidly aging population grows, raising concerns about who will drive the economy and care for the elderly in the coming decades. Moreover, a generation of underemployed youth can become a drag on growth and innovation in the long run.

*Source: Adapted from Reuters, 17 January 2024*

**Extract 7: China's Economic Growth Challenges**

As China grapples with a slowing economy, the government has been compelled to implement targeted fiscal stimulus such as the national trade-in scheme that offers cash rebates to consumers who swap old home appliances, electric vehicles, electronics such as smartphones, tablets, smartwatches and fitness bands for new ones to support growth.

However, these short-term measures have added to already significant levels of public debt. With land sales revenue collapsing due to the prolonged property market downturn, the government are now struggling to service their debts, prompting fears of bankruptcy. At the same time, households remain cautious in their spending, and private investment is subdued, placing more pressure on the government to maintain stimulus. Yet, analysts warn that continued reliance on debt-fuelled growth may prove unsustainable. With rising government debt, it may be harder for the government to respond swiftly and effectively to future economic shocks. Additionally, as more public funds are directed towards servicing debt, fewer resources may be available for long-term investments that could enhance living standards. While the government have acknowledged the need to improve debt management, they are reluctant to adopt strict austerity measures that could undermine fragile economic recovery. This presents a growing dilemma for Chinese policymakers in trying to balance short-term economic recovery with the imperative of long-term fiscal sustainability.

On the external front, China is facing significant challenges as well, primarily from intensifying US-China trade tensions. Several rounds of US tariffs and export controls contributed to a slowdown in China's exports to its largest trading partner, while retaliatory measures further strained bilateral trade flows. Weak export growth reduces the scope for global demand to mitigate China's structural problem of industrial overcapacity. China is now forced to seek new, often less lucrative, markets in the Global South[2]. Indeed, China's exports to the Global South exceeded its exports to all developed markets in 2023, with exports to the US comprising just 15% of total exports, down from 20% in 2018. This strategic shift reflected the diminished ability of the US to pressure China through tariffs as the centre of gravity of China's trade shifted.

*Source: Various*

**Questions:**

| | |
|---|---|
| (a) | With reference to Table 2, explain the relevant indicators that would suggest there was an increase in China's standard of living from 2019 to 2023. [4] |
| | |
| (b) | With reference to Extract 5, explain **two** potential economic consequences of deflation for China. [4] |
| | |
| (c) | With reference to Extract 6, explain how high youth unemployment rate might impact China's government budget and long-term economic growth. [4] |
| | |
| (d) | "This presents a growing dilemma for Chinese policymakers in trying to balance short-term economic recovery with the imperative of long-term fiscal sustainability" (Extract 7)<br><br>Discuss the extent to which China should prioritise "short-term economic recovery" over "long-term fiscal sustainability". [8] |
| | |
| (e) | In light of its macroeconomic challenges, discuss whether "China's long-standing investment-led growth strategy" is still the most appropriate policy to achieve its domestic macroeconomic aims. [10] |

[2] According to UN Trade and Development (UNCTAD), the Global South broadly comprises Africa, Latin America and the Caribbean, Asia (excluding Israel, Japan, and South Korea), and Oceania (excluding Australia and New Zealand).

**Suggested Answers**

(a) With reference to Table 2, explain the relevant indicators that would suggest there was an increase in China's standard of living from 2019 to 2023. [4]

- Standard of living can be measured in material and non-material terms.
- [3m] Material standard of living (MSOL) is defined as the amount of goods and services available for a country's citizen for consumption. With reference to Table 2, **nominal GDP growth is positive and exceeds population growth and inflation rate** from 2019 to 2023. This suggests that **real GDP per capita** has increased from 2019 to 2023. This indicates an increase in **average household incomes** in China and hence **purchasing power**. As such, there is an increase in an average household's ability to consume more goods and services, hence there is an increase in China's **MSOL**.
- [1m] Non-material standard (NMSOL) of living refers to the qualitative aspect of life. With reference to Table 2, either
    - the **pollution index** has decreased from 2019 to 2023. This suggests that there is a **reduction in pollution** due to an improvement in air and/or water quality. This will lead to a reduction in pollution-related diseases and an improvement in health outcomes and hence an increase in China's **NMSOL**.
      OR
    - life expectancy at birth has increased from 2019 to 2023. This suggests that there may be an improvement in public healthcare infrastructure leading to better health outcomes that translate to individuals enjoying healthier and **longer lives**. The improvement in health outcomes thus lead to an increase in China's **NMSOL**.
- Therefore, from 2019 to 2023, there is an increase in both MSOL and NMSOL which suggest that China's overall standard of living has increased.

**Mark Scheme:**

- **[3m] MSOL:**
    - [2m for all 3 indicators used] To identify Nominal GDP Growth > population growth and inflation rate which suggests there is an increase in real GDP per capita
        - 1m – Nominal GDP growth + one other indicator (population growth or inflation rate) (Note: Basically, any GDP variant that is not real GDP per capita. No mark is given if it is just nominal GDP growth.)
    - [1m] To explain how the rise in real GDP per capita suggests the rise in average real household income **OR** purchasing power which leads to a rise in the amount of goods and services that can be consumed and thus, an increase in MSOL. (Note: 1m will still be given for the correct explanation based on the identified indicators even if it is not complete, i.e. not all 3 indicators are identified.)
- **[1m] NMSOL**

- [1m] To identify and explain how the decrease in pollution index or the rise in life expectancy leads to a rise in NMSOL

- Note:
  - If students use inflation rate, no marks will be given for the identification of the relevant indicators. 1m can be given for the correct explanation of how the observed change in inflation rate leads to higher MSOL.
  - No marks will be given for unemployment rate.

(b) With reference to Extract 5, explain **two** potential economic consequences of deflation for China. [4]

**Explain 2 reasons – each reason is worth 2m**

**Reason 1: Negative (actual) economic growth**

- Extract 5 mentioned that deflation may undermine business confidence and consumer spending. This is because households may **expect that prices** may **continue to fall in future** which cause them to **delay spendings**, leading to a fall in consumption expenditure (C). At the same time, firms may **expect that future profits** may decrease due to the projected decrease in spendings by households. As such they may be less likely to expand and invest, leading to a fall in investment expenditure (I). The fall in I and C will lead to a fall in aggregate demand (AD), ceteris paribus.
- **Assuming there is limited spare capacity in the economy**, the fall in AD causes an **accumulation of/increase in their inventories stock**. This signals the firms to decrease production of output. Real national output will fall by a **multiplied times** due to the **reverse multiplier effect** which leads to **negative (actual) economic growth**. (Note: Just a mention of multiplier. Detailed explanation is not required.)

**Reason 2: Increased real debt burden on borrowers**

- Deflation refers to a situation where there is a sustained decrease in general price level (GPL). The decrease in GPL leads to an increase in **purchasing power** of money where the same amount of money can buy **more goods and services**.
- **Nominal debt** (i.e. nominal value of the debt) that the borrower has to pay back is the **same**. But given that the purchasing power of the money has increased, the debt that the borrower has to pay back can be used to purchase **<u>more</u> goods and services**. This means that the **real value of the debt** has increased

**Mark Scheme:**
Reason 1: Negative economic growth [2m]

- [1m] Explain how deflation leads to a fall in C and/or I and thus, AD.
- [1m] Explain how a fall in AD will lead to a fall in RNO & thus, negative economic growth
  - Note:
    - Assumption of the state of economy is not needed to get the 1m.

- If students do not link to negative EG, but there is sufficient/adequate explanation of how RNO falls, 1m can still be given.
- Capped at 1m out of 2m if a student's end point is that deflation will lead to a rise in DD deficient UnE.

Reason 2: Increased real debt burden on borrowers [2m]

- [1m] Explain how deflation leads to the **rise in purchasing power**
  - Note: There is no need for the definition of deflation.
- [1m] Explain the increase in real burden of debts.
  - Note:
    - To get full 1m, students must explain the idea of **more goods & services can be purchased with the same nominal debt.)**
    - No mark will be awarded for stating that the real debt burden increases. For 1m to be awarded, there must be an **attempt** to explain the "real".

(c) With reference to Extract 6, explain how high youth unemployment rate might impact China's government budget and long-term economic growth. [4]

**Explain impacts - each impact is worth 2m.**

**Impact 1: Negative potential economic growth**

- With reference to Extract 6, high youth unemployment rate has resulted in many youths opting to stop looking for employment and exit the labour force either by pursuing further studies or retreating into inactivity.
- As youths exit the labour force, there will be a decrease in the quantity of labour. Furthermore, youths typically represent the most productive segment of the workforce. With a prolonged period out of the workforce, there can be a higher risk of their skills being obsolete and a fall in labour productivity. Hence there can also be a decrease in the quality of labour.
- The decrease in quantity and quality of labour will decrease maximum amount of goods & services that can be produced. Thus, there is a decrease in the **productive capacity** and hence leading to a decrease in LRAS, causing **negative potential economic growth**.

**Impact 2: Worsen government budget position**

- High youth unemployment leads to a decrease in the number of income earners contributing to the government's income tax base, leading to a lower income tax revenue. At the same time, government expenditure may increase as the government may have to increase expenditure on unemployment benefits to support the unemployed youths and subsidies on skills training policies to reduce youth unemployment.

- If youth unemployment persists, the government will face a sustained reduction in income tax revenue from a key demographic that should otherwise be entering peak productivity and earnings and thus should ideally be a major contributor of tax revenue.
- The fall in government revenue and a potential rise in government expenditure will **worsen the government budget position**. OR Given that the China government has already incurred debt, it is likely in a budget deficit. The fall in government revenue and a potential rise in government expenditure will likely **worsen the government budget deficit**.

Note:

- A good answer would demonstrate the consideration of both revenue and expenditure. Even if only one factor is considered, they should assume the other factor remains constant.
- A good answer will ensure the explanation will make clear the consequences are from youth unemployment and not just general unemployment.

**Mark Scheme:**

Impact 1: Negative potential economic growth [2m]

- [1m] Explain how high youth unemployment results in a fall in quantity **or** quality of the labour force. (Note: Either explanation on quantity or quality of labour force will be sufficient.)
- [1m] Explain how a fall in quantity and/or quality of the labour force results in negative potential economic growth
    - Note: If students talk about how youth unemployment can result in negative actual economic growth, 1m can be given if students manage to address the time period – needs to link to long term growth.

Impact 2: Worsen government budget position [2m]

- [1m] Explain how youth unemployment decreases income tax revenue or may increase government expenditure. (Note: Either explanation on revenue or expenditure will be sufficient.)
- [1m] Explain how the government budget position will worsen.

(d) "This presents a growing dilemma for Chinese policymakers in trying to balance short-term economic recovery with the imperative of long-term fiscal sustainability" (Extract 7)

Discuss the extent to which China should prioritise "short-term economic recovery" over "long-term fiscal sustainability". [8]

**Question Analysis:**

| | |
|---|---|
| **Command Word** | Discuss the extent – Balanced perspective with evaluation |
| **Content Keyword(s)** | Benefits and costs of short-term economic recovery – economic growth and fiscal sustainability |

| | |
|---|---|
| | Note: This question is focused on discussing the consequences of economic growth against the consequences of fiscal sustainability. It is not focused on how (policies) can achieve economic growth or fiscal sustainability. |
| **Context Keyword(s)** | China, relevant extracts |

**Introduction:**

- As mentioned in in Extract 5 and 7, China is facing a twin threat of slowing economic growth as well as disinflationary pressures which prompted fears among experts that it may eventually result in deflation.
- In response, the government has introduced targeted fiscal stimulus in the form of cash rebates to increase economic growth but that has contributed to the existing level of public government debt as mentioned in Extract 7.
- As such, this presents a clear dilemma for the government between prioritising short-term economic recovery or safeguarding long-term fiscal sustainability. The Chinese government would therefore be required to weigh the benefits of the two options and choose the option that brings about higher benefits.

**Requirement 1: The Chinese government want to prioritise short-term economic recovery due to the benefits of prioritizing economic recovery.**

<u>#1 Benefits to households</u>

- Given that population growth has been negative in 2023 as evident in Table 2, the increase in economic growth will increase the average household income. With an increase in disposable income, there would be an increase in purchasing power which allows households to increase the quantity and quality of consumption of goods and services, thereby increasing their material standard of living (MSOL).

OR

<u>#2 Benefit to the economy (reduce unemployment) & government budget</u>

- Furthermore, with higher actual economic growth, the increase in real national output will cause derived demand for labour to increase. This will lead to a decrease in demand-deficient employment, especially among the youths, given that there will be more positions in the companies (Extract 6).
- When youth unemployment falls, less youth will opt out (Extract 6) and more likely to stay in the labour force. This means that quantity of resources will decrease by a smaller extent and the maximum amount of resources will decrease by a smaller extent, causing productive capacity and LRAS to decrease by a smaller extent. This can increase China's ability to achieve potential EG if it is able to overcome the shrinkage in labour force. With a fall in youth unemployment, it will make it easier for China to achieve potential EG.
- With more people now earning an income, the government income tax base will increase. This allows the government to collect higher income tax revenue and reduce

the expenditure on unemployment benefits which will help to improve the government budget position and improve fiscal sustainability.

OR

#3 Economic recovery is needed given the macroeconomic problem China is facing

- The Chinese government will likely need to prioritise on increasing actual economic growth in the short term given that China might experience slow economic recovery (Extract 5 & 7). Extract 7 mentions that business and consumer confidence remain low as mentioned in Extract 7. This is because with low business and consumer confidence, consumption expenditure and investment expenditure will likely remain low as consumers may expect future income to remain low while firms may expect future profits to remain low. The challenges of low economic growth is further compounded by the US-China trade tensions which is also mentioned in Extract 7. The ongoing trade restrictions imposed by the US on China's exports have reduced the amount of exports to US. This has led to a significant decrease in export revenue (X) given that US is China largest trading partner. Therefore, the low C, I and reduced X would have significantly reduced the increase in AD. Firms might see a slower fall in unplanned inventory and the production of goods & services might increase at a slower rate. Thus, RNO will increase by a smaller extent and actual EG would have slowed significantly. As such, without government intervention through its fiscal stimulus, China's actual economic growth may continue to remain low. If the Chinese government choose not to prioritise short-term economic recovery, China may experience negative EG in the end. Thus, to prevent negative EG, prioritizing short-term economic recovery is needed.

**Requirement 2: On the other hand, there are benefits to achieving long-term fiscal sustainability.**

- If China prioritises on long-term fiscal sustainability, that will imply that it will work towards the reduction in government debt by reducing government spendings through scaling back the targeted fiscal stimulus mentioned in Extract 7 and state subsidies mentioned in Extract 5.

#1 Increase SOL & prevent future economic shocks

- With a reduction in government debt, it increases China's ability to react to future economic shocks as it has a larger government budget to implement fiscal measures to mitigate the negative impacts from the economic shocks as mentioned in Extract 7. For example, if there is a future pandemic, with a larger budget, it would allow the government to implement substantial fiscal stimulus to cushion against the economic fallouts from the pandemic such as significant increase in unemployment benefits for people whose jobs are affected by the pandemic or to have a substantial increase government expenditure (G) and decrease in income tax and corporate tax. With a sufficient budget and low government debt, the government can significantly increase AD to increase RNO and reduce any potential fall in economic growth. Such measures will thus be able to reduce the fall in household income and hence reduce the fall in MSOL. Furthermore, the government may also have the ability to spend for example on the provision of vaccinations in the face of a pandemic and that can help to protect the population from the negative health impacts of a pandemic and hence reduce the fall in non-material standard of living (NMSOL) among the population.

OR
#2 Improvement in future SOL

- In addition, the improvement in fiscal sustainability reduces the opportunity costs of government debt. By reducing the amount of government debt, it reduces the amount that China needs to pay in future to pay down the debt. If China had to borrow to finance its current spendings, reducing the amount of government debt ensures that it reduces the interest repayments in future. In either scenario, the reduction in payment either for debt or interest repayments would ensure that more of its government budget can be used for long-term investments such as the improvement in public infrastructure like schools, hospital, and roads. Such investments ensures that the government continues to invest in improving the quality of its public infrastructure which ensures continued increase in its productive capacity and hence a continued increase in its LRAS which ensures that China has the capacity for sustained economic growth which ensures a sustained improvement in MSOL. Furthermore, the improvement in public infrastructure will also increase its quality such as better education and healthcare which leads to improved education and healthcare outcomes thereby leading to an improvement in NMSOL.

OR
#3 Short-term economic recovery

- Lastly, a reduction in government debt could enhance both business and consumer confidence. Lower debt levels signal a government's commitment to stronger fiscal discipline and reduce the perceived risk of future tax hikes or inflationary financing, thereby fostering a more stable macroeconomic environment. For businesses, this may encourage greater investment as expectations of policy stability improve. For households, confidence in the government's fiscal position could reduce precautionary saving and support higher consumption. Together, these effects can help boost AD through an increase in I and C which lead to an increase in actual economic growth that helps in the economic recovery.

**Overall Evaluative Conclusion:**

**Evaluation 1: To a large extent, China should prioritise on long-term fiscal sustainability.**

- **[Extent of Government Debt]** In conclusion, China's need to improve long-term fiscal sustainability seems to be more dire than the need for short-term economic recovery. From Extract 7, it is mentioned that the ongoing fiscal stimulus has added to the already significant government debt. Furthermore, due to the property downturn, there is a significant fall in land sales revenue. Coupled with the projected fall in income tax revenue due to the high youth unemployment that is mentioned in Extract 6, it implies that the China may suffer from a significant fall in government revenue to finance its spendings. Further spendings increase the risk that the government may be unable to pay its debt obligations and may pave the way for a government default which will severely undermine the business and consumer confidence which may have a much larger negative impacts on the economy than what China is currently facing. As such, China may have already reached a point where it has a limited scope to pursue further fiscal stimulus. Thus, to a large extent, China should prioritise on long-term fiscal sustainability.

OR

- **[Limited Effectiveness of Fiscal Stimulus]** Given that China already had significant public debt as mentioned in Extract 7, further fiscal stimulus may entail that the government may have to borrow to finance the spendings. As such it may give rise to a potential crowding out effect. China's borrowing of funds may decrease the supply of loanable funds which raises interest rates that decreases the consumers and firms incentive to borrow to finance big ticket items and investment projects. This will lead to further decrease in C and I which have already been undermined by the poor business and consumer confidence which further reduces economic growth. As such China should consider measures to achieve economic recovery without the need to significantly increase further spendings such as focusing on reducing government debt to improve business and consumer confidence to increase economic growth or to look externally and seek more free trade agreements to boost export revenue to increase economic growth as mentioned in Extract 7. Thus, to a large extent, China should prioritise on long-term fiscal sustainability.

OR

**Evaluation 2: To a large extent, China should prioritise on short-term economic recovery.**

- **[Expectations of Economic Outlook]** China may have to prioritise on short-term economy recovery. This is because as mentioned in both Extract 5 and 7 that the current consumer and business confidence remain subdued/low. Therefore, without the government taking the lead and initiative to drive the increase in AD, the economy may risk facing a prolonged slowdown in economic growth and that could also worsen its other macroeconomic problems of the risk of deflation and increasing youth unemployment as evident in Extract 5 and 6. Thus, to a large extent, due to the far reaching negative impacts of low economic growth, China should prioritise on short-term economic recovery.

OR

**Evaluation 3: China need not prioritise one over another.**

- China may not have to prioritise one aim over the other. From the earlier explanation, the achievement of one aim does lead to improvement in the other. When short-term economic recovery is achieved, the increase in economic growth will help to improve government budget position. When there is an improvement in long-term fiscal sustainability, it creates the condition for economic recover.
- **[Priority of the Government]** Perhaps, rather than looking at the issue as one where China has to choose one aim over the other, the issue can be reframed into one where both can be achieved but one may have to be done first than the other and that may depends on the priority of the government. If the slowdown in economic growth is severe, the government should focus on increasing economic growth and fiscal sustainability will improve eventually. If the level of government debt is growing to an

unsustainable level, the government can focus on reducing the level of debt while seeking alternative ways to increase economic growth to ensure economic recovery.

**Mark Scheme**:

| Level | Descriptor | Marks |
|---|---|---|
| L2 | To reach "Analytical" for each requirement:<br>● One well explained benefit of short-term economic recovery (economic growth) or fiscal sustainability using relevant economic tools of analysis with few minor gaps or no gaps in the answers.<br>● Answer must demonstrate the use of the extracts in scoping their answers.<br><br>To reach "Cursory" for each requirement:<br>● One explained benefit of short-term economic recovery (economic growth) or fiscal sustainability using relevant tools of analysis but there are some minor gaps in the answers.<br>● There is limited or no attempt(s) at referencing the extract to scope the answers.<br><br>**A + C or A + A = 6**<br>**A + K/C + C = 5**<br>**C + K / A+0 = 4** | 4-6 |
| L1 | To reach "Knowledge" for each requirement:<br>● For a "high" K, answer demonstrates the appropriate use of economic tools of analysis, but answer contains major gaps.<br>● For a "low" K, answer lacks the use of economic tools of analysis.<br><br>Answer that focus on the explanation of how policies work will be capped at K.<br>● Developed explanation i.e. For growth, it has the explanation of the adjustment effect (how RNO increases) and multiplier – K (2m)<br>● Undeveloped explanation – K (1m)<br><br>**C + 0 = 3**<br>**K + K = 2/3**<br>**K + 0 = 1/2** | 1-3 |
| E2 | Overall judgement is provided on whether the government should prioritise short-term economic recovery or long-term fiscal | 2 |

| | | | | |
|---|---|---|---|---|
| | | sustainability that is well substantiated using conceptual analysis and relevant contexts from the case. | | |
| | E1 | Overall judgement is provided but not well substantiated. | 1 | |

(e) In light of its macroeconomic challenges, discuss whether "China's long-standing investment-led growth strategy" is still the most appropriate policy to achieve its domestic macroeconomic aims. [10]

**Question Analysis:**

| | |
|---|---|
| **Command Word** | "Discuss whether" – Balanced perspective with evaluations |
| **Content Keyword(s)** | "Investment-led growth strategy" – subsidies given to firms to encourage investment to address macroeconomic challenges<br><br>Other relevant policies mentioned in the other extracts to address macroeconomic challenges. |
| **Context Keyword(s)** | China, macroeconomic challenges, relevant extracts |

**Introduction:**

- From the various extracts, we can gather that China is facing a multitude of macroeconomic challenges. From Extract 5, we can see that due to China's long-standing investment led growth strategy, China is at risked of deflation where there is a sustained decrease in general price level (GPL).
- From Extract 5 and 7, we can also gather that China is facing a slowdown in economic growth due to domestic and external challenges. Domestically, consumer and business confidence remain low. Externally, export growth has been negatively impacted due to ongoing US-China trade tensions.
- From Extract 6, China is facing a twin challenge of aging population and high youth unemployment. An aging population coupled with a rising number of youths choosing to leave the labour force may cause China to also face a situation of a decrease in potential growth.
- Therefore, in light of these macroeconomic challenges, China should reassess whether their current policy of long-standing investment in infrastructure and heavy industries is still appropriate for China to achieve its domestic macroeconomic aims of sustained economic growth, low unemployment and low and stable inflation and whether alternative macroeconomic policies should be considered.

**Requirement 1: China's long-standing investment-led growth strategy may still be appropriate in light of the macroeconomic challenges it is facing.**

Explain how China's investment-led growth strategy works and why it is appropriate:

- From Extract 5, China's investment-led growth strategy involves subsidies given to strategic industries like electric vehicles and solar panels. The subsidies given to strategic industries act like transfer payments which either reduce their costs of production or capital investment and thus increase the expected profits from undertaking investment projects. This increases their willingness to invest which leads to an increase in investment expenditure (I).

- Firms' investment in physical capital such as machinery and technology would lead to an increase in productivity. Therefore, the increase in I would lead to an increase in quantity and quality of resources, leading to an increase in productive capacity and hence an increase in LRAS. The increase in LRAS would help China's to increase in potential economic growth.
- increase in I would also increase AD, ceteris paribus. Given that the current investment-led growth strategy has been long standing, it implies that China would have the spare capacity to increase its real national output (RNO). The increase in AD will lead to depletion of inventory stocks, signaling the firms to increase production. In order to meet the increase in production, derived demand for factor inputs such as labour will increase. This will lead to an increase in household income, leading to an increase in induced consumption based on its marginal propensity to consume (MPC) while the rest will be leaked away in the form of savings, taxes or expenditure on imports. The increase in induced consumption will lead to a further increase in AD and this process will continue until the initial increase in injections equals the total withdrawals. As such, the multiplied increase in AD would lead to multiplied increase in RNO, leading to an increase in its actual economic growth. With the increase in actual and potential growth, China would be able to ensure that growth is sustained which is evident in its decades long economic growth.
- As the increase in AD leads to an increase in demand for factor inputs such as labour, demand-deficient unemployment will decrease. This addresses the lack of job for youth (Extract 6).
- The investment-led growth policy may be appropriate given that China's shrinking population due to falling birth rate and aging population and high youth unemployment may lead to a gradual and long-term decrease in the size of labour force which may lead to a gradual and consistent decrease in productive capacity and hence potential economic growth. As such, investment in technology could help to reduce the reliance on labour and mitigate the fall in productive capacity. This would ensure that China is able to increase its potential economic growth even while facing a decrease in the size of labour force.
- Furthermore, given the poor consumer and business confidence mentioned in Extract 5 and 7, C and I remain low. China's investment-led growth strategy therefore is appropriate as it falls on the government to drive economic growth via subsidies given to firms to increase I.

**In-body EV1: However, there can be limitations to its investment-led growth policy that China should consider.**

- Extract 5 mentions that China's state subsidies have led to repeated overbuilding and duplication of productive capacity. As such, it is very likely that the increase in LRAS has significantly outpaced the increase in AD, leading to a problem of overcapacity. Therefore, the aggressive expansion of firms would lead to a surplus of goods and services produced and hence firms will cut prices to get rid of the surplus, leading to a downward pressure in general price level (GPL) and hence deflation if the problem of overcapacity persists.

- Furthermore, Extract 5 highlights that domestic demand remains insufficient. When household spending and consumption are weak, firms face limited incentives to expand production. As a result, the new factories or equipment financed through investment may be underutilised, with spare capacity left idle. In such circumstances, the rise in investment (I) contributes little to sustained increases in output, hence limited increases in income and improvement in material standard of living (MSOL).

Note: Students can also explain how the investment-led growth strategy increases LRAS and SRAS.

**Requirement 2: While China's investment-led growth strategy may still be appropriate, it can consider alternative macroeconomic policies that may be more appropriate to achieve its macroeconomic aims.**

Alternative Policy 1: Policies to increase domestic and foreign demand

Explain how an alternative policy works and it is appropriate:

- As mentioned in Extract 5, China's economic growth model has been imbalanced. Instead of focusing on expanding productive capacity, it may be more appropriate for China to focus on increasing it domestic and foreign demand in order to absorb some of the excess capacity. To increase domestic demand, China can focus on expansionary fiscal policy such as targeted fiscal stimulus in Extract 7. China has introduced a national trade-in scheme that offers cash rebates to consumers to incentivise them to swap old items with new ones. The cash rebates act to lower the cost of purchasing these items which incentivises consumers to consume more, leading to an increase in consumption expenditure (C).
- On the external front, China can pursue more free trade agreements to increase the number of trade partners. This will increase the size of China's external market which can help to shore up the overall demand for China's goods and services, thereby absorbing the industrial overcapacity. With more trade partners, demand for China's goods and services increase, leading to an increase in export revenue (X).
- The increase in C and X will increase AD, ceteris paribus. With spare capacity, the increase in AD will deplete firms' inventory stock and signal firms to increase production. This will lead to a multiplied increase in real national output via the multiplier effect and hence increasing actual economic growth which helps to address the slowdown in economic growth and use up the excess capacity.
- At the same time, the increase in production of goods and services will lead to an increase in demand for labour thereby creating more job opportunities, leading to a decrease in demand deficient unemployment, especially among the youths.
- With the rise in production of goods and services, there will be an increase in the competition for scarce resources leading to upward pressure on factor inputs and hence a rise in the cost of production. Profit maximizing firms are likely to pass on the increase in costs to consumers in the form of higher prices, leading to an increase in general price level (GPL). That can also help to increase the GPL to a healthier level and stave off the worry of a deflation in the economy.

OR

Alternative Policy 2: Policy to reduce structural unemployment

- Besides focusing on economic slowdown, it may be more appropriate for China to also focus on bringing down its high youth unemployment which has been steadily increasing from 2019 to 2023 as evident in Table 2 and Extract 6. China can implement supply-side policies to better address the skills mismatch between the skills possessed by university graduates and the skills demanded by industries. This can be done via policies that include a revised university curricula that aligns closer to the demands of industries and stronger collaboration and better coordination between universities and industries through internships. China can also offer post university training programmes that are subsidised to encourage recent university graduates to gain relevant skills in the manufacturing and traditional industries mentioned in Extract 6 by lowering the costs of these skills training programmes. Through these policies, it can help to reduce the extent of mismatch in skills possessed by recent university graduates and skills demanded by the industries. This will help to decrease structural unemployment among the youths.

**In-Body EV2: However, there are also limitations to the alternative policies.**

<u>Limitations to Alternative Policy 1: Policies to increase domestic and foreign demand</u>

- As seen in Extract 7, just like the investment-led growth strategy, introducing fiscal stimulus to increase domestic consumption can worsen China's government debt. As such this policy may not be sustainable in the long run especially if the government has to borrow to finance the stimulus. Furthermore, there are significant opportunity costs if the government has to sacrifice the future generation's improvement standard of living in order to finance current spending as the interests/debt repayment in the future would deprive the government of funds for investment into improving the country such as improvements of infrastructure.
- The extent of the increase in export revenue is also uncertain. As mentioned in Extract 7, China is now forced to seek new external markets in the Global South but they are often less lucrative and the rise in external demand from these markets may be insufficient to offset the fall in export demand from the US. Thus, export revenue may not experience a rise and may even fall, leading to a limited increase in AD. Hence reliance on external markets may not bring about its achievement of its domestic macroeconomic aims. Furthermore, increasing reliance on external markets may increase the risks and vulnerabilities to external shocks which can have a negative impact on its economy.

OR
<u>Limitations to Alternative Policy 2: Policy to reduce structural unemployment</u>

- Many of the policies such as improvement in coordination between universities and industries as well as the post graduate training scheme take time for the effects to be felt. This is because such coordination and training take time and thus these policies may not be appropriate to tackle the immediate problem of high youth unemployment.

**Overall Evaluative Conclusion:**

- **[Government macroeconomic priorities]** In conclusion, China is facing a multitude of macroeconomic challenges. It would have to consider its macroeconomic priorities in order to assess the appropriateness of the choice of macroeconomic policies. For example, if sustained economic growth is a priority, then it would be appropriate for China to focus on rebalancing its economic growth model by trying to increase both domestic and foreign consumption in order to ensure that the increase in AD is able to keep pace with the increase in LRAS as focusing on investing to expand productive capacity would be insufficient to achieve sustained economic growth.

- That is not to say that its investment-led growth strategy is inappropriate as it is still important to ensure that there is sufficient spare capacity for the economy to grow in order to prevent inflationary pressure. Therefore, it may be a matter of reducing the extent of subsidies given to strategic industries in order to moderate the increase in productive capacity. That can also help to reduce its government debt while some freed up fundings could also be used for other purposes such as to finance the fiscal stimulus to achieve actual growth. This would ensure that China is able to achieve multiple domestic macroeconomic aims at one go.

OR

- **[Government macroeconomic priorities]** With reference to Table 2, China is facing a high youth unemployment rate of 21.3% in 2023 and a trend of disinflation 2019 to 2023 which sparks serious concerns of an impending deflation, China may want to focus on addressing these two macroeconomic challenges as opposed to trying to overfocus on increasing economic growth which may not be of an immediate concern despite signs of a gradual slowdown. Furthermore, resolving these two macroeconomic challenges may also help to improve the consumer and business confidence of the economy which can help to create the necessary conditions to achieve economic growth. As such, policies that focus on addressing the high youth unemployment and disinflation may be more appropriate than policies focusing on increasing investment to tackle the more severe macroeconomic challenges.

**Mark Scheme**:

| Level | Descriptor | Marks |
|---|---|---|
| L2 | To reach "Analytical" for each requirement:<br>● Policy is well explained with the use of relevant economic tools of analysis. There should be few/no minor gaps in the answers.<br>○ For investment-led growth strategy, answer should explain how it can increase AD and LRAS to achieve actual and potential economic growth. Answer can also explain how it increases SRAS and LRAS to achieve actual and potential growth. (Note: If students only manage to explain one type of growth, answer can hit entry A if it is well explained.)<br>● Answer must explain why the policy is appropriate.<br>● Answer must demonstrate the use of the extracts in the choice of the alternative (R2) policy as well as the macroeconomic challenges that are addressed. | 5-7 |

| | | | |
|---|---|---|---|
| | | ○ Possible alternative policy: Trade in scheme to increase C, skills training to reduce structural unemployment or signing of more FTA to increase X.<br>○ Macroeconomic challenges: Low AD due to lack of consumption, threat of deflation and high youth unemployment.<br><br>To reach "Cursory" for each requirement:<br>● Policy is explained with the use of relevant economic tools of analysis. There are some minor gaps in the answers.<br>● Answer does not explain why the policy is appropriate.<br>● There are some references to the relevant extracts to scope the answers. The alternative (R2) policy may not be from the extracts but it should still address the macroeconomic challenges.<br>○ Possible policies: Lowering of income tax rates, Lowering of interest rates or devaluation of currency<br><br>**A + A = 7**<br>**A + C = 6**<br>**A + K/ C + C = 5**<br>**C+K = 5** | |
| | L1 | To reach "Knowledge" for each requirement:<br>● For a "high" K, answer demonstrates the appropriate use of economic tools of analysis but answer contains major gaps i.e poor explanation of the policy or the policy does not address the macroeconomic challenges.<br>○ For e.g. The use of investment-led growth strategy to achieve price stability/low inflation rate.<br>● For a "low" K, answer lacks the use of economic tools of analysis.<br><br>**A+0/ C + K = 4**<br>**C + 0 = 3**<br>**K + K = 2/3**<br>**K + 0 = 1/2** | 1-4 |
| | E2 | ● Clear explanation of the limitations of the policies in affecting its appropriateness<br>PLUS<br>● Overall judgement is provided on which policy that is more appropriate using conceptual analysis and relevant contexts from the case. | 2-3 |

| | | |
|---|---|---|
| E1 | • Limitations of the policies were stated, rather than explained<br>• No overall conclusion provided. | 1 |