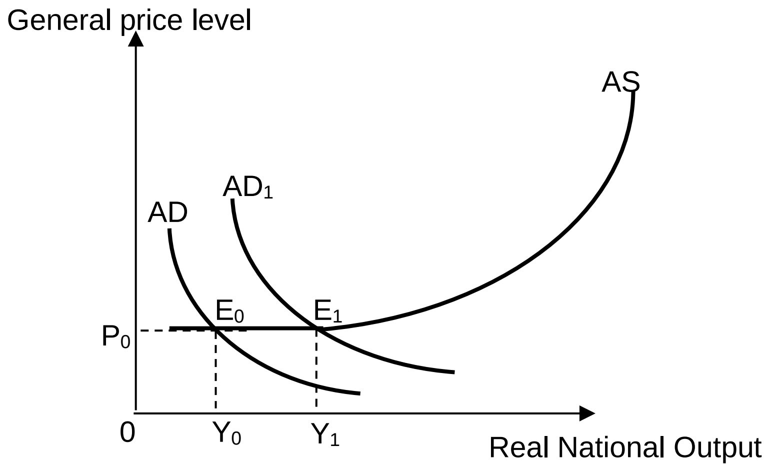
H1 CSQ2 GCE A Level Examinations 2020
Suggested Answers

(a)		**Using the information available, compare the post-2008 performance of Italy and Singapore with respect to GDP, inflation and unemployment.**	**[6]**
		Figure 1 shows a slight fall in GDP of Italy post-2008 to 2017 while Singapore experienced a slight increase in GDP. However, GDP of Italy was always greater than that of Singapore, indicating larger gross national output, which translates to larger amounts of goods and services for consumption and possibly higher material standard of living. Table 3 shows the inflation and unemployment rates of Italy and Singapore. Both countries' inflation rate fell from 2013-2016 before increasing in 2017. Singapore experienced a longer period of deflation in 2015 and 2016 compared to Italy with only a year of deflation in 2016, indicating greater price instability in Singapore which would adversely impact firms' investment decisions and hence economic growth in Singapore. There was consistently high unemployment rate in Italy whereas Singapore's unemployment rate is consistently low throughout 2013-2017, indicating greater efficiency in resource utilisation in Singapore. [**OR**: Unemployment rate in Singapore was consistently lower than the rate in Singapore, by at least 5 times, indicating greater efficiency in resource utilisation in Singapore.]	
(b)	**(i)**	**State the components of aggregate demand.**	**[2]**
		The components of aggregate demand (AD) include consumption expenditure, investment expenditure, government expenditure and net exports.	
	(ii)	**With reference to Extract 4, explain how the US's fiscal policy <u>and</u> the rapid economic growth of China contributed to the US's economic recovery from its 2009 recession.**	**[6]**
		As highlighted in Extract 4, "a modest programme of tax cuts and increases in government spending" contributed to the US's economic recovery. With a decrease in personal income tax rates, disposable income increases, consumers will increase their spending on goods and services, resulting in an increase in **consumption expenditure** and thus AD and real national output. Tax deductibility of interest payments allow for better financing conditions and recovery for many of the US citizens that are experiencing unemployment. With a decrease in corporate tax rates, there is higher after-tax profits for the producers. This may induce them to utilise the higher profits for **investment** projects thus increasing AD and real national output. Since G is a component of AD, an increase in **G** will raise AD. For instance, the US government may increase expenditure on infrastructure to improve the transport network or to provide more funding for building of public institutions such as schools and hospitals. This leads to an increase in AD and in turn increase real national output. With a rapid economic growth of China, there will be higher national income and therefore, higher household incomes. This will increase consumption of imported goods, leading to higher demand for exports in the US. This increase in demand for US's export will lead to an increase in the total revenue of exports. For example. Given that China tries to improve productivity through automation and robotics, it is likely that China would import capital goods such as high-end microchips and machinery from US. US would then experience **an increase in export revenue** and an increase in AD and hence, via the multiplier, increase real national output from Y0 to Y1.	

		 Therefore, the increase in C, I G due to US's fiscal policy and the increase in X due to the rapid economic growth of China have resulted in the US recovery from the 2009 recession. This is reflected by Extract 4 as it was mentioned that the US' GDP had returned to level of 2007 by 2011.	
(c)		**Explain the 'consequences for employment and living standards' Greece will have experienced as a result of its GDP falling significantly.**	**[6]**
		As GDP falls significantly, business confidence as well as household confidence will be adversely affected as firms face falling profits and increase risk of closing down. Firms cut cost by retrenching labour causing unemployment to rise. There will also be less new investments as firms faced excess stocks as households were not spending due to increase fear of being unemployed. Thus with fall in investments and consumption, job creation would be limited and so the number of unemployed increased further. With GDP falling significantly, it would take a longer time for the economy to recover as well. Unemployment would then be prolonged and the consequence would be a rise in structural unemployment as skills become obsolete. Living standards refer to the material and non-material well-being of the population. The unemployed suffered loss in income and for those who were employed, income fell as firms cut wages since there is less demand for labour. A fall in income or loss in income will mean lesser purchasing power, leading to less consumption of goods and service. Hence, there will be a fall in material standard of living for both unemployed and the employed. As more businesses make losses, more shareholders would experience fall in income as no dividends would be paid out. Business owners would also experience fall in income as profits fell. This means that individuals would have less purchasing power and so their material wellbeing fell. This is shown by the fact that there is 'increased use of charitable food donations', indicating that more people were unable to afford the basic necessities of life. In addition, their non-material wellbeing also suffered. The falling GDP forced government to cut back on spending and so people could not access 'closed libraries' and 'care centres' (Extract 6). So there were fewer avenues for them to spend their leisure time.	

(d)		**Extract 6 relates to the policy of 'austerity' adopted, not always willingly, by some governments after the 2008 global financial crisis.**	
	(i)	**Explain the benefits to the economies when governments adopted 'deflationary policies', and comment on whether the deflationary policies were justified.**	**[7]**
		Deflationary policies refer to the government cutting back on spending and increasing tax rates with the intention of cutting down on its net expenditure. **Benefits**The rationale for adopting such a policy by countries like Greece was to reduce their huge debt due to prolonged and large borrowing in the past. When debt is reduced, **credit rating** for the country would increase and this foster greater confidence and so attract greater inflow of investments. In addition, excessive government spending and borrowing also resulted in crowding out effect as interest rates would be driven up due to an increase in the demand for loanable funds, causing investments and consumption to fall. Deflationary policy reverses the situation as less borrowing by the government would drive down interest rates and so stimulating **rise in investments and consumption.** The deflationary policy then is meant to shift government spending to the private sector to increase AD. With the increase in investments and consumption, and through the multiplier process, real GDP increases followed by rise in employment. Thus, the country is able to recover from the recession. In addition, with greater private investments, the country's productive capacity would increase as the inflow of investments in new factories as well as the inflow of foreign talent would increase the quality and quantity of capital and labour leading to an increase in LRAS. The country is not only able to enjoy **actual growth** but **potential growth** as well. **Costs** However, after years of deflationary policy, the evidence did not bear out the benefits of such a policy. For Greece, 'from peak to trough, GDP fell by almost one third'. Besides Greece, other countries like Ireland, Italy and Britain too 'suffered greatly through their austerity policy'. The cut in government spending and rise in taxes would cause investments and consumption to fall due to fall in post-tax profits and disposable income. This causes further fall in AD and thereby **worsening the recession**. This stood in contrast to the US where expansionary fiscal policy was adopted and its recovery was faster and real GDP was back to pre-crisis level. Deflationary policy is not effective if business confidence is severely affected such as during the financial crisis. The decision to reduce debt is not sufficient to create optimism in firms where unsold stocks were piling up and where households fear of unemployment and further fall in income caused them to cut back on consumption. Thus, the deflationary policy aggravated the already falling AD as the intended aim of creating confidence for investors by reducing debt did not materialize thus worsening the fall in GDP. In my opinion, the deflationary policies taken by Greece, Italy and Ireland had incurred both high explicit and implicit costs (Extract 6) and are not justifiable to a large extent. The intended benefit of an increased credit	

		rating due to a better budget position is unlikely to actualised in reality as investors' confidence is mainly based on the health of the economy. If countries continue to suffer the negative impact of their deflationary policies, it might worsen their persistent budget deficits. In particular, the increase in unemployment means more unemployment benefits. In the case of Italy, unemployment remained high during the period 2013 to 2017. Also, a fall in real national output would translate to less tax revenue. Hence, these governments should consider to downsize or abandon such austerity measures before it continues to cause "colossal damage". Countries like Greece or Italy that faces similar budget positions as that of the US might want to follow the US's example to engage an expansionary fiscal policy as data shows that her policy to priortise growth and employment has served her well.	
	(ii)	**Assess the suggestion that, with low interest rates, governments should have 'borrowed to invest instead of adopting the austerity policies'.**	**[8]**
		Thesis: If the government were to 'borrow to invest' in infrastructure for eg building and repairing existing infrastructure, this will increase the country's productivity and productive capacity and thereby increasing the country's potential growth. In the short run, the increase government spending is a direct injection into the circular flow of income i.e directly increases AD and so cause GDP to rise by a multiple due to the multiplier effect. With better infrastructure such as better roads, ports and airports and, power plants, transport and energy cost will be reduced and overall would reduce cost of production and this will attract greater investments and so cause AD to increase further and therefore causing GDP to rise and so helping the economy to recover faster. With such low interest rates, the opportunity cost of using these funds is low in terms of the number of government projects that would have to be forgone as interest payments for financing the loan is minimal. The borrowed funds for huge infrastructure projects would have yielded much higher returns in terms of the benefits mentioned in the previous paragraph. In this case, it is better for the government to borrow to spend so as to create jobs and bring about economic growth, instead of engaging in austerity measures. This is especially so for countries that are suffering from high unemployment such as Italy. This means that the country is operating below full employment, as such, austerity measures will bring about a full blown reversal multiplier effect, leading to multiple fall in real national income. **Antithesis** However, whether such borrowing would indeed stimulate the economy would depend on what the government spend on. If spending is on productive assets, they will yield positive returns which can be used to finance the loan. However, if the borrowed money is spent on unproductive purposes such as ostentatious projects, statues etc to show off or they are being siphoned off by corrupt politicians, the desired effects would not be	

		achieved. Therefore, implementing austerity measures rather than borrowing to boost the economy would benefit more. Borrowing to invest might not be feasible for some governments. In addition, given that these countries have low credit ratings due to their huge debt, there is greater risk of them defaulting on their loans. So they may not be able to obtain funds as easily and also interest rates could be higher. Also, countries with deflation may need to consider whether borrowing to invest is beneficial. For example, in 2016, Italy suffered a deflation (Table 3), this the real interest rate are higher than nominal interest rate, meaning that the real cost of borrowing, given that real interest rates is nominal interest rates adjusted for inflation. Overall, whether governments should borrow to invest in such a low interest rate environment would depend on what they use the funds for. When borrowed funds are huge, even if the interest rate is low, the absolute amount of the interest payment is still very large. For countries like Greece, it may not be able to pay off such debts. Singapore too is taking advantage of the low interest rates to build big infrastructure projects rather than using its reserves or budget surplus where they can invest and get higher returns.	
(e)		**Discuss the view that countries need 'more inclusive growth'.**	**[10]**
		Inclusive economic growth indicates a **rate of growth that is sustained** over a period of time, is **broad-based across economic sectors**, and **creates productive employment opportunities for the majority** of the country's population. **Thesis:** In the case of Singapore, inclusive growth implies economic growth that **takes income distribution into consideration** and does not contribute to worsening income inequality. **P1: Countries need more inclusive growth so that growth is higher and sustained.** As mentioned in the above extracts, income and wealth inequality has been widening in both developed and developing countries. Extract 7 says that the 'richest1% of people in the world had increased their shared of the world's between 2008 and 2017 wealth from 42.5% to 50.1%'.. Even though the US has recovered but growth was still low of about 2.2% and was contributed mainly by high income earners. Technological advances such as the growth of AI, causes the range of workers to be unemployed to increase. Mid-skills jobs are disappearing and this means there are fewer opportunities for progression. Workers are either unemployed or stuck in low paying jobs. With a growing number of people in poverty due to loss of jobs, this will cause consumption which is the main engine of growth for many developed countries to fall. The poor tend to have a higher marginal propensity to consume as compared to the rich so with rising income inequality, there will be a greater fall in AD and causing income to eventually fall. Thus growth is not sustained.	

Potential growth will be adversely affected too. Poverty can generate a vicious cycle whereby people are not motivated to invest in their own education, skills and careers if they perceive their job prospects to be low-paid jobs or no job at all. This will cause the quality of the labour force to decline resulting in lower potential growth. But if growth is inclusive that seeks to help workers to realise their potential, there will be greater innovation, creativity and productivity. This will help to improve the quality of the labour force and thereby increasing potential growth as well.

If there are policies to encourage greater female labour force participation and laws to remove discrimination, the size of the labour force will increase too and this again helps to increase growth.

P2: Inclusive growth helps to reduce the fiscal costs to the government

Poverty drains government resources. With the growth of AI, the unemployed is not just confined to the unskilled workers but also the PMET. There will also be a growing middle class where income declines as well. The government has to increase spending on various types of financial assistance such as unemployment benefits. There is also greater demand for government services. The opportunity costs of this extra spending is the forgone capital goods that could have been developed. Moreover, for poor countries, they may have to increase borrowing to finance such spending. Since such spending on welfare benefits do not generate productive returns, the debt will increase further which can result in an economic crisis like the one experienced by Greece. With inclusive growth where more people have jobs that give a decent pay, not only can government cut down on spending, it also receives more tax revenue which can be used to fund the spending on projects such as improved infrastructure which helps to generate even more growth.

P3: Growth with rising income inequality will result in social unrest and thereby causing slower growth in the future.

Severe income inequality is viewed as unfair to society. Where winners take all and losers are not compensated, there will be a backlashed against globalization. Anti-globalisation will cause world economic growth to slow and thereby resulting in lower standards of living for all concerned.

Thus, inclusive growth not only enables the economy to grow faster but also more vigorously and more sustained.

Antithesis

P4: However, for some countries they need more actual growth rather than more inclusive growth

In 2018, the GDP of countries like Greece and Italy, were still below their 2008 GDP (Extract 4). Extract 6 mentioned that not only the economy of Greece, but that of Ireland, Britain and Italy, also suffered permanent and extensive damage due to the financial crisis and the austerity measures undertaken by their governments. Given their low GDP, it is difficult for these countries to adopt measures to ensure inclusive growth. Supply side policies such as increase spending on improving education and skills of the workforce and spending on R&D would involve big sums of money which they currently do not have due to their budget deficits over the years. As such, it is more important that these countries focus on increasing economic growth by adopting appropriate monetary or/and fiscal policies to help the country regain its economic health such as increasing the GDP growth rate. Industries that the government can encourage should be more traditional labour intensive industries to absorb the unemployed workers. Once the economy starts to expand and with more government revenue, the government can then consider supporting skills upgrading and encouraging the inflow of more wide-ranging industries that allows workers to have better and higher paying jobs which than reduces income inequality.

Focusing on inclusive growth for some countries (including developing countries) will cause growth to fall and the resultant smaller economic pie would make in difficult for the country to have a more equal income distribution. For example, a highly progressive tax structure to redistribute income, will discourage investments and may cause outflow of talent.

A good example of growth being a more important goal rather than reducing income equality is China which was once a poor and undeveloped economy. But over the past 4-5 decades, it embarked on a strategy of rapid economic growth and emerged as the world's 2nd biggest economy and which subsequently lifted millions out of poverty. With its huge reserves from rapid growth, it was able to develop the rural areas in terms of housing, education and health care. China is no longer a country with cheap unskilled workers. It is moving up the technological ladder generating better quality jobs for its people. The same can be said of Singapore as well.

P5: Countries that have already low gini coefficient might not need to have more inclusive growth.

One way to redistribute income to reduce income inequality is through a progressive tax system. However, increasing direct taxes such as income tax rate will create a disincentive to work, this might lead to a fall in quantity of labour. Also increasing corporate tax rates will create a disincentive to invest, resulting in a fall in investment. Both cases will reduce the quality of factor of production leading to a fall in productive capacity, hindering potential growth. This could mean a fall in the future standard of living.

Conclusion

The extent of the need for inclusive growth would depends on the state of the economy and the most urgent economic issue that the country is facing. For many low income countries, it is more important to generate sufficient economic growth to enable them to have inclusive growth in the future. That said, it need not mean that the two are mutually exclusive. Governments have to strike the right balance between the two types of growth. Measures can be adopted at the same time to prevent excessive income inequality otherwise the growth that it achieves in the short run will not be sustained. For most developed countries, they should have

		inclusive growth, without which their growth would come to a standstill and their economies would lose their dynamism. Also countries such as Greece and Italy that have more urgent issues such as falling GDP and rising unemployment should focus on attracting investment to stimulate growth as their weak fiscal positions are likely to limit the effect of any possible expansionary policies. As such, these countries might have to forgo inclusive growth in the short run so as to bring their economies out of recession first. However, in the long run, all countries are likely to need to have more inclusive growth as the global economy evolves. Technological advancement and globalization leading to structural unemployment is likely to be more rampant in countries, leading to wider income gaps. As such, it is important for countries to engage in relevant supply side policies so as to creates productive employment opportunities for the majority of the country’s population.	