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UNIVERSITY OF CAMBRIDGE
INTERNATIONAL EXAMINATIONS General

ECONOMICS 9708/43 Paper 4 Data Response and Essay (Supplement) **May/June 2011 2 hours 15 minutes**

Additional Materials: Answer Booklet/Paper

READ THESE INSTRUCTIONS FIRST

If you have been given an Answer Booklet, follow the instructions on the front cover of the

Booklet. Write your Centre number, candidate number and name on all the work you hand in.

Write in dark blue or black pen.

You may use a soft pencil for any diagrams, graphs or rough working.

Do not use staples, paper clips, highlighters, glue or correction fluid.

Section A
Answer **Question 1**.

Section B
Answer any **two** questions.

You may answer with reference to your own economy or other economies that you have studied where relevant to the question.

At the end of the examination, fasten all your work securely together.
The number of marks is given in brackets [ ] at the end of each question or part question.

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Section A

Answer this question.

1 Emerging economies and the way out of a recession

During the recession of 2009 several economists forecast that some emerging (fast developing) economies would perform better than the developed economies. One indicator of this, they said, was the strength of the exchange rate of the currency of some emerging economies against the US dollar. For example, between November 2008 and July 2009, the Brazilian currency rose 11.4% against the dollar and the Indonesian currency rose 10.2%. Another indicator was the forecast growth rate in GDP as shown in Table 1.

Table 1: Forecast growth rate in GDP for selected countries

Forecast Growth Rate in GDP		
	2009 %	2010 %
US	–2.7	+1.4
UK	–3.5	+0.3
Germany	–4.3	+0.3
Japan	–6.5	+0.4
Hong Kong	–5.9	–0.3
China	+6.0	+7.0
Singapore	–7.5	+1.9

Brazil	–1.5	+2.7
Columbia	–1.0	+1.5
India	+5.0	+6.4
Indonesia	–1.3	+0.6

Emerging economies are often dependent on exports to achieve an increase in GDP. Some economists suggested that it would be better for their economic growth if these countries were to concentrate on domestic demand rather than exports.

China, in particular, they said could lead the world out of the recession if it relied increasingly on domestic demand. Indeed, the Chinese government encouraged a shift from export-led industries to programmes aimed at improving the Chinese infrastructure in order to create jobs and thus increase consumption of Chinese goods. Banks were encouraged to make borrowing easier in order to create more credit for consumers and businesses. The government started a massive fiscal stimulus and increased its forecast of GDP to a growth rate of 8.3% in 2009 and 10.9% for 2010 (previous forecast figures were 6.0% and 7.0% as in Table 1).

However, other economists do not accept that there should be an emphasis on domestic demand. They argue that trading links are the strongest evidence of the emerging economies' ability to grow. They state 'no emerging market that adopted an export-led growth model has subsequently needed to break away from it – including China'. China's exports as a percentage of GDP are 32% compared with only 13% for the US. Smaller Asian countries are even more dependent on exports; Singapore's ratio of exports to GDP is 234%, Hong Kong's is 169%. It will be difficult for economies such as these to increase domestic demand and reduce their dependence on export-led growth.

(Source: Financial Times: June 12 2009. *Table source: Economist p105 April 18–24 2009)*

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(a) Explain what is meant by GDP. [3]

(b) The article says that banks were encouraged to make borrowing easier. Explain what this might mean and why the government might have thought this was necessary. [3]

(c) Is there enough evidence in the article to support the view that there has been an improvement in the economic situation of emerging economies? [6]

(d) Identify the **two** policy approaches suggested by economists in the article and discuss whether there is a conflict between them. [8]

(a) Gross Domestic Product or GDP refers to market value of total goods/services produced in an economy during certain time period normally a year. GDP is indicator of economies' national income. Economies having higher GDP have higher national income due to greater stock of goods and services produced in them. Hence economic growth that refers to increase in GDP is considered desirable and is often economies first priority.

(b) Making borrowing easier means lowering economy's interest rates. Lower interest rates reduce

consumers' and firms' borrowing costs and hence encourages them to borrow more for consumption and investment purposes. This higher consumption and investment result in increased aggregate demand which for given aggregate supply boost economy's activity levels. These higher economic activity levels result in higher national income. Countries often resort to expansionary fiscal and monetary policies like reducing interest rates to make borrowing easier to eliminate prevalent recessions.

(c) Emerging economies refers to developing economies that are experiencing high growth rates. Apart from high growth rates case study also state that emerging economies are found experiencing stronger exchange rates. During 2008 and 2009 Brazilian and Indonesian currencies significantly appreciated against US dollar which is seen as beneficial change by some experts. However stronger exchange rates that have most probably resulted from persistent balance of trade surpluses pose serious threat of adversely affecting economies' long run export potential. Hence emerging economies that rely on export-led growth might not overall benefit from stronger exchange rates. This problem however can be tackled through artificial weakening of exchange rates which will prove helpful in restoring economies' products' competitiveness.

Higher economic growth rates will however definitely prove beneficial in terms of improving citizens' living standards. However since much information has not been provided concerning emerging economies growth and development prospects like export and production potential therefore we cannot objectively conclude anything about these economies development prospects. Though until now high proportion of exports as percentage of economies national income has proved beneficial for emerging countries' growth but this might not provide sustained growth because foreign economies suffering from recessions might consider using protectionist tools to limit inflow of cheaper foreign products. Therefore as mentioned in the case study, emerging economies should to some extent consider reducing their reliance on foreign economies because then recession in foreign economies can significantly reduce emerging economies exports which will adversely affect their national income levels. On the other hand encouraging higher local investment and by investing in new products emerging

economies can try boosting their local demand which will ensure their sustained higher national income levels.

(d) Some economist support higher tax rates to achieve higher tax revenue targets. Some other economists are more skeptical about such strategy to increase government tax revenue. Those who support direct relationship between tax rates and tax revenue believe in the idea that aggregate spending following certain increase in tax rates will not fall more than proportionately. Hence if increase in tax rates is greater than fall in aggregate demand then tax revenue being product of tax rates and economic activity is expected to rise. However, this relationship does not need to be always true. Increase in tax rates can fall aggregate demand to fall more than proportionately and therefore total tax revenue might fall. Moreover, it is quite possible that for initial increase in marginal tax rates, economic activity might not fall significantly and therefore tax revenue rise but beyond that optimal tax rates increase in marginal tax rates cause fall in tax revenue.

But a better idea would be to tax people differently based upon their income levels. Since rich people have lower marginal propensity to consume and their consumption does not fall significantly following decrease in their income levels therefore imposing higher tax rates to richer people will not make them to cut upon their consumption significantly but giving tax holidays to less wealthy people will make them consume most of their additional income. Higher aggregate consumption as the result will ensure higher aggregate demand levels. Similarly lowering corporate taxation will make businesses to invest more resulting in higher aggregate demand levels.

Therefore, in short, higher tax rates which adversely affect local economic activity levels might result in higher unemployment and lower national income levels. Therefore, such strategy would never prove beneficial for countries growth. On the other hand, any tax rate that help governments increase their overall revenue and help economy expand should be preferred over the former type even if latter does not achieve more equitable distribution of income and

wealth.