**CSQ Practice Test – ASAD Analysis / Economic Growth**

**Question 1:**

**Imbalances in the United Kingdom and China economies**

**Table 2: Government debt (percentage of GDP)**

|  |  |  |
| --- | --- | --- |
| Year | China | UK |
| 2010 | 33.7 | 76 |
| 2011 | 33.6 | 81.6 |
| 2012 | 34.3 | 85.1 |
| 2013 | 37 | 86.2 |
| 2014 | 39.9 | 88.1 |
| 2015 | 42.6 | 89 |

Source: IMF

**Table 3: GDP Composition breakdown by percentage in 2015**

|  |  |  |
| --- | --- | --- |
|  | China | UK |
| Consumption Expenditure | 37% | 65% |
| Government Expenditure | 14% | 19% |
| Gross Capital Formation | 45% | 17% |
| Export Revenue | 22% | 28% |
| Import Expenditure | 18% | 29% |

Source: World Bank

**Extract 5:** **Is the game up for China’s much emulated growth model?**

From the early 1990s, China adopted an export-led strategy that delivered continuously increasing shares of the world market, fed by relatively low wages and very high rates of investment, enabling massive increases in infrastructure. It led to big increases in inequality and even bigger environmental problems, but the strategy seemed to work – until 2008-09, when exports were hit by the global financial crisis.

Yet even then, China, India and other large emerging markets continued to grow. The talk at the time was that they were already dissociated from the west. In reality, China (and much of developing Asia) had simply shifted to a different engine of growth without abandoning the focus on exports. The Chinese authorities could have generated more domestic demand by stimulating consumption through rising wage shares of national income, but this would have threatened their export-driven model. Instead they put their faith in investments to keep growth rates buoyant.

So the “recovery package” in China essentially encouraged more investment, which was already nearly half of GDP. Provincial governments and public sector enterprises were encouraged to borrow heavily and invest in infrastructure, construction and more production capacity. To utilise the excess capacity, a real estate and construction boom was instigated, fed by lending from public sector banks. Total debt in China increased fourfold between 2007 and 2014, and the private debt-GDP ratio nearly doubled to over 280%.

All this comes in the midst of an overall slowdown in China’s economy. Exports fell by around 8% in 2014. Stimulus measures such as interest rate cuts do not seem to be working. As such, the recent devaluation of the yuan is clearly intended to help revive the economy.

However, it will not really help. Demand from the advanced countries – still the driver of Chinese exports and indirectly of exports of other developing countries – will stay sluggish. Meanwhile, China’s slowdown infects other emerging markets across the world as its imports fall even faster than its exports.

A weaker yuan is bad news for export-oriented economies like Singapore, Hong Kong, South Korea and Taiwan as their exports will be more expensive to Chinese buyers. Their exports to other countries will also have to compete against Chinese rivals who have the advantage of a weaker currency.

This is not the end of the emerging markets, but is – or should be – the end of this growth model. Relying only on exports or debt-driven bubbles to deliver rapid growth cannot work for long. For developing countries to truly “emerge”, a more inclusive strategy is essential.

Sources: The Guardian, 23 August 2015 and The Straits Times, 7 January 2016

**Extract 6:** China: Domestic Demand on the Rise

**Rising domestic demand from retail sales**

Since the introduction of cross-provincial travel within China, we have seen retail sales recovering strongly to 0.5%YoY growth in August from -1.1%YoY a month ago. Spending on cosmetics and jewellery rose 19.0%YoY and 15.3%YoY, respectively in August. The tourism business has also brought back jobs in the service sector. The spending power of the population has improved. The favourite spending item, telecommunication products, experienced a jump in sales of 25.1%YoY.

Covid-19 is still having some impacts on spending. For example, catering still experienced a contraction of 7%YoY in August. Though this was an improvement on -11% in the previous month.

**New and old infrastructure led investment growth**

China’s new-infra plan and traditional infrastructure projects in transportation have led overall investment spending. Fixed asset investment (FAI) shrank only -0.3%YoY YTD in August from -1.6%YoY YTD in July. The "computer, telecommunication" category, which represents new-infra investment plans, grew 11.7%YoY YTD, which results in part from China’s push towards self-reliance in technology. Rail transportation investment also grew 6.4%YoY YTD.

These growth numbers are high compared to the headline growth rates, which means these are the engine of investment growth in China currently. We believe this situation will change gradually to a broader growth picture as these engines bring growth to more industries, which will then start to plan their own investment upturn.

**Wider growth in industrial production**

Industrial production growth also picked up to 5.6%YoY in August from 4.8%YoY in July. This was brought about by improvements in production across a broader range of categories than in previous months.

Integrated circuits grew 14.6%YoY and industrial robots grew 13.9%YoY, which again nods towards China‘s increasing self-reliance on advanced technology.

But industrial production shows that growth in manufacturing is still uneven. For example, the production of vehicles remained in a contraction of 9.0%YoY in August, only slightly improved from -9.7%YoY in July.

**External environment is a challenge to growth**

We can see that domestic demand has brought back growth, mainly in retail sales and infrastructure projects, which have in turn led to growth in industrial production. This growth has brought some jobs back to the market. This is indeed the internal growth circulation that China is promoting.

But the dual circulation, that is, both domestic and external growth, is yet to be seen as Covid-19 cases seem to be rebounding in some places outside China, and there is more political tension too, weighing on external demand.

Our forecasts for China's GDP is currently at 0.7%YoY for the whole of 2020, which we are not changing now. We will probably not do so unless there are big improvements or deteriorations in external circulation that would change economic growth materially.

Source: https://think.ing.com/snaps/chinadomestic-demand-on-the-rise/

Question

1. (i) Compare the change in government debt as a percentage of GDP in China and UK from 2010 to 2015. (2)

(ii) Explain how the increase in government debt as a percentage of GDP in China leads to economic growth (8)

1. Based on table 3 and extract 5, it can be observed that the Chinese government is trying to shift the economy from an external-based economic growth model to a domestic economic growth model.
2. Account for the rationality for such a shift on the focus of sources of economic growth. (4)
3. Identify and evaluate the three key factors that determines the success of the shift in the economic shift or focus. (4)

( C) Identify and explain the factors that determines long-term economic growth of an economy. (12)

Meaning of long-term economic growth

Meaning of actual and potential growth

Main body

1. Explain the actual and potential growth is attained (briefly)
2. Briefly draw and explain the diagram
3. AD components – population growth and income level of consumers – affecting consumption expenditurevestment

Government expenditure – increase in tax revenue , interest rate – that affect the level of government spending

Investment – depend rate of return on investment

Export demand – exchange rate

1. AS

Availability of resource – natural endowment, exchange rate

technological development

Political stability

1. Key determinant – political stability – economic activities

Conclusion

Question

a) (i) Compare the change in government debt as a percentage of GDP in China and UK from 2010 to 2015. (2**) (direction and pattern)**

Both China and UK have experienced increase in the government debt as a percentage of GDP.

It is also observed that the government debt as a percentage of GDP is higher for UK than China.

**(ii) Explain how the increase in government debt as a percentage of GDP in China leads to economic growth (8)**

Increase in government debt as a percentage of GDP implies that there is a fiscal expansion in terms of government spending which is greater than tax collected, indicating the need of government to borrow to finance government expenditure as there is budget deficit.  This expansionary impact on the economy will lead to economic growth seen in terms of rise in real GDP via the multiplier process.

When there is an increase in government debt, the rise in government expenditure like higher level of transfer payment or subsidies raise the value of aggregate demand in AD components. consumption will rise as the subsidise increases the level of purchasing power to raise consumption level. Investment will rise as there is higher level of rate of return as infrastructure development helps to raise efficiency and lower the cost of production to raise profitability. To attract more investors increased efficiency of high level of government expenditure on infrastructure development lower cost of production to lower price of exports and thus induce export demand. Consequently, the rise in the value of aggregate demand via the multiplier process to induce a rise in real GDP.

**In the multiplier process**, the initial increase in the aggregate expenditure expands the circular flow of income and then increasing the income of the factor earners which will further expand the circular flow of income with new consumption activities. As long as more consumption activities take place, the circular flow of income will continue to expand at the respective level of economic activities until the withdrawal effect is equal to the initial injections which will cease the expansion of the circular flow of income. Consequently, the national income will increase by several folds, depending on the value of the multiplier which is determined by the sum of the MPW (Marginal Propensity to withdraw - MPS + MPT +MPM).

Y1=Yf₀

Y2

Yf2

ASo

AS1

P1

P2 = Po

GPL

Real GDP

AD1

Y0

ADo

**As seen from the diagram, the increase in aggregate demand from AD0 to AD1 \*will raise Real GDP from Y0 to Y1 but price level will increase from P0 to P1. With corresponding increase in supply, the LRAS will expand from AS0 to AS1, and thus, lowering cost condition to decrease price which will induce increase in AD on a quantity basis. Consequently, the real GDP will increase from Y1 to Y2 while price falls from P1 to P2 without incurring inflationary effect where sustained economic growth is attained.**

However, the rising public debt would mean more payment in public debt and less fund for future economic development as this undermines government spending in the future. The growth of real GDP also depends on the value of increase in government expenditure and the value of multiplier. If both the value of the multiplier and the increase in government expenditure are small, the extent of rise in economic growth.

In sum, the impact of the rise in public debt has an impact on the economy. All government debt can be beneficial or detrimental and it would depend on the nature of the government spending.

**b) Based on table 3 and extract 5, it can be observed that the Chinese government is trying to shift the economy from an external-based economic growth model to a domestic economic growth model.**

1. **Account for the rationality for such a shift on the focus of sources of economic growth. (4)**

Given the circumstances and the economic condition, it is quite rational for China to shift the economics focus from domestic to external demand. First, China is a huge economy with a large percentage of domestic contribution as seen from table 3e capita where the domestic expenditure in terms of consumption and government expenditure is already 51% while most of the gross capital formation is domestic.

As seen from extract 2, the Chinese authority have generated more ‘consumption through rising wage shares of national income.’ Along with the focus in generating more local investment and ‘government expenditure from the provincial government’ together with more lending to boost the local real estate and construction industry. All these domestic activities are based on the rationality that China has a huge population and more affluent consumer market to justify the focus on domestic market**.**

1. **Identify and evaluate the three key factors that determines the success of the shift in the economic shift or focus. (4)**

The factors identified that would influence the success of the shift in the economic focus of the Chinese economy can be seen from the size of market demand, the size of the multiplier and the affluence of the consumer market.

As China is a big economy with large population, its withdrawal effect is low while injection is high, the value of the multiplier is large. This means that the focus on the domestic demand allows the growth of national via a large multiplier.

Furthermore, the large population base would mean that the increase in demand on a quantity basis not only raises the value of national income but the size of quantity demanded which leads to the growth of production and value of national income. As the real output level increases, the demand for labour increases and unemployment level will fall. This is beneficial for the economy as China focuses more on local economy.

Lastly, the higher level of national income would mean that there is high value of construction to fulfill the need in absorbing the demand of real estate market as there is higher level of affluence. This will make it easier to stimulate the growth of the construction industry which is a strong component of domestic investment.

( C) Identify and explain the factors that determines long-term economic growth of an economy. (12)

Meaning of long-term economic growth

Meaning of actual and potential growth

Main body

1. Explain the actual and potential growth is attained (briefly)
2. Briefly draw and explain the diagram
3. AD components –
   1. population growth and income level of consumers – affecting consumption expenditure and investment
   2. Government expenditure – increase in tax revenue , interest rate – that affect the level of government spending
   3. Investment – depend rate of return on investment
   4. Export demand – exchange rate
4. AS components

Availability of resource – natural endowment, exchange rate

technological development

Political stability

1. Key determinant – political stability – economic activities

Conclusion

**Answer:**

**Introduction:**

**Meaning of economic growth, actual growth, potential growth and how it is linked to long-term economic growth**

Economic growth refers to the growth of the production in terms of actual or potential production capacity. Actual economic growth refers to the actualization of resources into monetized products and services which is commonly measured in term of the percentage change in real GDP. Potential growth refers to the expansion of the availability of resources for production which is measured in terms of rightward shift of the long run supply curve and outwards shift of the production possibility curve (PPC). In the long-term economic growth, the economy can introduce policies to expand the resource and production capacity to attain both actual and potential growth. In doing so, there are certain factors that determine the success of the policies and its effectiveness.

Main body

1. Explain how actual and potential growth is attained in the long-term

In achieving the long-term economic growth, there is an expansion of the production capacity where the availability of resources are raised through technology and exploration of resources from the local or external economy. This leads to a rising cost condition, allowing more economic activities to raise aggregate demand to achieve actual economic growth which raises the real GDP via the multiplier process.

1. Draw diagram and description of the diagram.

Y1=Yf₀

Y2

Yf2

AS0

AS1

P1

GPL

Real GDP

AD1

Y0

ADo

As seen from the diagram, the expansion of the availability of resources shifta the potential production capacity with a shift of the LRAS curve from ASf to ASf1 and this implies that the full employment of production shifts from Yfo to Yf, indicating potential growth. This lowers the cost condition and lowers the price level, inducing an increase in economic activities that implies that the aggregate demand components rise from Ado to Ad1 and raise the real GDP from Yo to Y2 via the multiplier process, indicating that economic growth. Thus, we observe how the economy has attained actual and potential growth in the long run.

(please take note that the description of this graph based on sustained growth is different from the description on sustained growth although the graph used is the same)

From the understanding on how actual growth is attained in the long run, the derivation of the factors that determine the success can be explained. First, population growth and rise in income is important to assess whether consumption level can be high enough to create greater utilization of resources as both factors determine the extent of consumption level. The lowering of interest rate is also another consideration if credit consumption plays a big part especially for economy with extensive credit consumption as in Chin and the US. As for investment, the return on investment and political stability determines whether the economy’s level of investment expenditure is high or not. Level of national income determines the tax collection and this indirectly determines the government’s capacity to raise government expenditure. Lastly, the price of export demand which is determined by exchange rate is the factor that sets the success of higher export revenue for the economy.

As for the potential growth, the factors are mainly seen in terms of exchange rate, availability of resources, technological development and political stability. When the economy is a larger economy like China, it has more resources to produce goods and services to attain higher economic growth. However, if the economy is small and needs to import more resources, the appreciation of exchange rate would be helpful in determining the growth of the economy in the long run. The country also depends on technological advancement to raise efficiency and better utilization of resources to expand production capacity. But most of all, the economic stability must be maintained with stable political development which is the most critical factor in setting the growth of the economy.

In sum, the factors affecting the success growth of the long term economy is examined from both AD and AS aspects and the most influential factor is the political stability the economy needs to induce economic activities and develop the framework for economic growth.