2006 C 2 BT Essay Marking Scheme

1 "The US economy grew 3.5% last year and China's expanded 9.9%. In Japan, business and consumer spending took over from exports as the main driver of growth."

The Straits Times 1 Feb 2006

(a) Explain the effect of an increase in consumer spending on an economy. [10]
(b) Based on the report above, discuss whether the standard of living in China has increased at a faster rate than that of the US. [15]

Outline:
(a) Explain the effect of an increase in consumer spending on an economy. (10)

Content:
- Define C and state that it is a component of AE
- In Keynesian theory, NI is determined by AE. Thus a rise in autonomous C will lead to a multiple increase in NI through the multiplier process
- Illustrate graphically the multiplier process. With reference to the graph, indicate the multiple increase in NI resulting from an increase in autonomous C
- State the mathematical formula to calculate the size of the multiplier
- Illustrate the multiplier process through a numerical example
  - State the assumptions needed
  - Assume a value for the MPC and the initial injection of C

Acceptable analysis:
Increase in C ⇒ value of MPC increase
⇒ AE curve shift up & slope increases (pivot up)
⇒ size of K increase

Extra Evaluation: Outcome of multiplier process will be **affected by the current state of the economy**

Case 1: With spare capacity: Increase in autonomous C ⇒ desirable as it moves the economy towards equilibrium income at full employment.

- Illustrate using a deflationary gap diagram
- Explain the effect of an increase in C ⇒ an increase in AE will lead to an increase in NI ⇒ closing the deflationary gap

Case 2: Initial equilibrium at or beyond full employment: Increase in C without any an increase in real output ⇒ inflationary pressure ⇒ detrimental

- Illustrate the case of an economy currently at full employment equilibrium income with diagram. After increase in C, ⇒ AE increase ⇒nominal national income increase ⇒ IG
- Real NI remains constant if the current equilibrium NI is at the full employment level or more.

Application to the Japanese economy:

- An increase in C will be beneficial as Japan has been facing a decade long recession. The excess capacity can be removed with an increase in a strong surge of demand. This will give rise to a more optimistic business sentiment, which will raise the level of I to a significant degree and stimulate the Japanese economy out of the recession.

(b) Based on the report above, discuss whether the standard of living in China has increased at a faster rate than that of America. [15]

Outline:

- Define SOL as the social & economic well-being of the people in a country. It includes both the material & non-material aspects of life.
- Value of using national income figures to compare SOL across countries

- Economic well-being: interpret as the material well-being of the people in the country; pertains the quantity & quality of goods & services available for consumption.
- Commonly used indicators for comparing economic well-being : real per capita GDP or GNP (national income statistics)
- Usefulness of national income indicators
- Ceteris paribus, a higher GNP reflects a large volume of output; it means more goods & services available for the people in the country.

- To the extent that real per capita GNP measures the value of goods and services that an average resident is (theoretically) able to enjoy, its change over time can be used to provide a measure of living standards or the economic welfare of the people.
- Hence a large GNP would mean more goods and services for all.

- ***To this extent, we can conclude that a country is "better off" materially compared to another if it has a larger GNP.***
- ***However GNP figures can be misleading if population size and inflation is not taken into account.***
- Explain the use of real per capita GNP to better measure a country's well being.

To capture the changes in the economic well-being of the average resident of the country, national income figures must be converted to real per capita NI as a more appropriate indicator. This involves two adjustments :

(i) Money NI to Real NI
(ii) This figure is then divided by the population to convert to real per capita NI

- **Real GNP per capita also suffers some failures as a measure of material SOL**
  - **Distribution of GNP**
  - **Compositions of GNP**
- **It completely leaves out the non-material aspects**
  - **Intangibles – externalities & leisure**
  - **Non monetary transactions**

- Limitations of using NI statistics for making international comparisons of living standards.

(i) Different treatment of different items
(ii) Difficulty of having different currencies
(iii) Differences in the relative size of the non-monetised economy
(iv) Different composition of the NI
(v) Non-availability of data
(vi) Distribution of Income

- **Limitations of such national income indicators**

(i) Different treatment of different items

-- This arises from different accounting standards across nations which render the basis of comparison dubious.

- **(ii) Difficulty of having different currencies**
- requires conversion to common currency for comparison

-- For comparison of economic well-being across countries, it is necessary to convert the various real per capita GNP values denominated in various currencies to a common currency. Usually the US$ or UK £ is used.

-- To reduce inaccuracies in conversion associated with the use of unreliable market exchange rates, it is common to convert using the Purchasing Power Parity (PPP) rate.

(iii) Differences in the relative size of the non-monetised economy

-- In developed countries, most goods and services are traded for money in the market.

-- In low income countries however, many goods & services are traded on a barter basis; thus cannot be captured in NI figures. A large part of income may also be earned in-kind, which are not reflected in reap per capita figures.

(iv) Different composition of the NI

-- National income indicators usually do not reflect the composition of the country's output.

-- For instance, an increase in military spending by a country would raise NI figures but do not translate into an equivalent higher economic well-beingfor the country. Other egs : capital goods vs consumer goods, amountt of public goods & merit goods

(v) Non-availability of data

-- In many countries, reliable data may not be available because of widespread illiteracy (thus unable to keep proper accounts of output), inaccessible areas that are too remote & costly to survey & false information provided by firms to avoid paying high taxes.

(vi) Distribution of income

-- Generally, an increase in national income which are being distributed more equally will cause the standard of living of the majority of the population to be better off than otherwise.

- **Other indicators**

-- It is common to include other indicators eg NEW or PQLI to compare economic well-being. These include : infant mortality rates & life expectancy (indicate standards of hygiene & health), literacy rates etc.

Conclusion: To a certain extent real per capita GNP can measure whether a country is "better off" in terms of material wealth. However, the non-material aspects of SOL are omitted. Briefly explain alternative indicators such as NEW or PQLI.

- Non-material aspects of SOL eg negative externalities, social well-being such as leisure, family bonding, opportunities for education & upward mobility, development of the Arts & culture, security & crime rates etc must be discussed in greater details.