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Wednesday 20 June 2012 – Morning

A2 GCE ECONOMICS

F585/01/SM The Global Economy

STIMULUS MATERIAL

Duration: 2 hours

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Introduction

In 2011 global inflationary pressures had increased, largely due to increases in commodity prices and the threat of global resource scarcity. In the UK these external inflationary pressures occurred at a time of concern about the weakness of domestic demand following a significant fall in Gross Domestic Product (GDP) in the last quarter of 2010. This raised a dilemma for the Bank of England's Monetary Policy Committee (MPC). In order to ensure that inflationary expectations did not take hold in the labour market, some members of the MPC recommended that interest rates should rise. Others viewed the inflationary pressures as outside the control of the Bank of England and believed that inflation would return to its target rate in the medium term.

The UK was not the only economy struggling to cope with rising inflation. In China, for example, the authorities had indicated that economic growth needed to be curtailed in order to reduce its social and environmental consequences which were threatening the country's sustainable economic development. Indeed, some economists believed that higher inflation might bring more benefits than costs – not least in China itself.

The resource scarcity which had contributed to global inflationary pressures brought about different policy responses both nationally and regionally. The European Union (EU) looked to the correction of market failure through the creation of incentives to bring about resource-efficiency. China had introduced quotas on the export of so-called 'rare earths' and had given a clear indication that exports of certain key raw materials would be banned from 2015. The World Trade Organisation had already been called upon in 2009 to adjudicate in a dispute about China's export quotas on raw materials. China's announcement of a potential ban on the export of certain key raw materials from 2015 threatened to re-open a trade dispute between China and both the EU and the USA.

Pre-release stimulus material

Extract 1: **Dilemma for the Bank of England's Monetary Policy Committee (MPC)**

Extract 2: **Inflation and the re-balancing of the Chinese economy**

Extract 3: **China's economic growth target cut**

Extract 4: **Emerging dispute over China's 'rare earths' export ban**

Extract 1

Dilemma for the Bank of England's Monetary Policy Committee (MPC)

The conduct of monetary policy is not straightforward, but for many years the Bank of England's MPC had a relatively easy task. When inflation was set to accelerate, interest rates could be raised. When the UK's economic growth rate slowed, interest rates could be reduced.

In early 2011, the MPC faced tough decisions on interest rates which divided its nine members. The weakness of the economy, exemplified by a surprise fall of 0.6% in GDP in the fourth quarter of 2010, made an increase in interest rates likely to further weaken the economic recovery. Yet the rate of inflation had risen to over 4%, it had been above its target rate of 2% for too long and was expected to rise further. The three members of the MPC who voted for an increase in interest rates believed that it was better to reduce inflationary expectations sooner rather than later.

One of the members arguing for an increase in interest rates, Andrew Sentance, said shortly after the publication of the minutes of the February MPC meeting:

"In my view, the time [to raise rates] is overdue. We should increase them gradually and slowly if we can. But the risk of delaying interest rate rises too long is that this gradual approach may cease to be an option."

Another member of the MPC, Adam Posen, took a different view. He had voted in favour of further quantitative easing citing policy mistakes in Japan in the year 2000 and dismissing talk of a price-wage spiral:

"I am arguing that it would be a similar mistake for the MPC to try to prove its counter-inflationary toughness just for the sake of chatter about rising inflationary expectations that is not there in the data, nor likely to influence the actual inflation outcome."

The Bank of England's Inflation Report of February 2011 set out the prospects for inflation in the short and medium term (see Fig. 1.1).

Fig. 1.1 Extract from Bank of England's Inflation Report (February 2011)

Inflation is likely to pick up to between 4% and 5% in the near term, and to remain well above the 2% target throughout 2011, boosted by the increase in VAT, higher energy and import prices, and some rebuilding of companies' margins. Further ahead, inflation is likely to fall back as those effects wane and downward pressure on wages and prices from the margin of spare capacity persists. The extent of that fall is likely to be moderated by companies continuing to rebuild their margins and some upward drift in inflationary expectations.

The prospects for inflation in the medium term are highly uncertain. Continued strong global economic growth may lead to further upward pressure on commodity and other import prices. The degree of spare capacity and its impact on inflation will depend on: the strength of demand; the impact of the recession on potential productivity; the performance of the labour market; and the sensitivity of wages to labour market slack. The profile for domestically generated inflation will also depend on the extent and pace of any rebuilding of companies' margins. And inflation will be higher if expectations of inflation continue to rise and these feed through into wage and price-setting.

There remains a wider than usual range of views among Committee members over the outlook for inflation. On balance, the Committee judges that the most likely outcome is that inflation will fall a little below the target from the middle of 2012 but that the chances of inflation being either above or below the 2% target in the medium term are broadly equal.

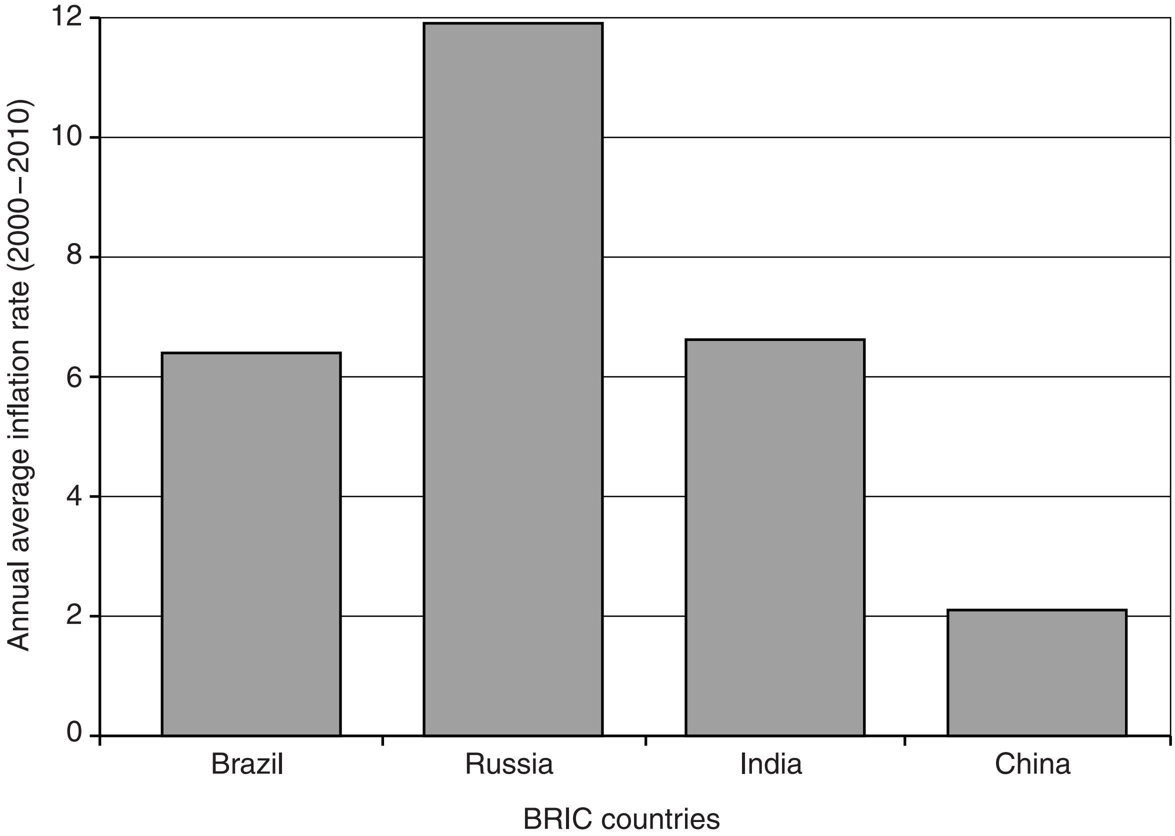
The MPC faced a difficult time ahead. If it did not eventually raise interest rates its credibility for the control of inflation could be put at risk. Yet the Government's fiscal policy was also based around securing credibility by cutting public expenditure and raising taxation to bring down government borrowing. The fear amongst some economists was that pursuing both monetary policy and fiscal policy credibility at the same time might put at risk the economic recovery.

Extract 2

Inflation and the re-balancing of the Chinese economy

One of the common characteristics of developing economies is their tendency to have higher rates of inflation than developed economies. This can arise because of supply-side constraints and the impact of productivity growth in the traded goods sector on wages in the rest of the economy. Developing economies often face a trade-off between economic growth and inflation. Fig. 2.1 shows that this common characteristic is not a universal one, however. Notably, China has achieved a much lower annual average rate of inflation than the other BRIC economies over the period 2000 – 2010.

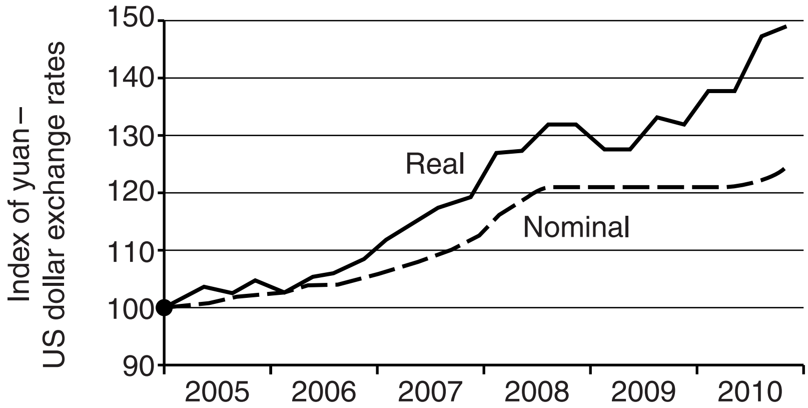
Fig. 2.1 Annual average inflation rates in the BRIC economies, 2000 – 2010



In the space of the twelve months to January 2011, China's rate of inflation more than trebled, however, to reach 4.9%. The cause of this increase in the rate of inflation was, in part, due to higher food prices. In addition, more of China's inflation was coming from rapid wage growth as the growth in its labour force slowed down due to the ageing of its population. Unlike the UK, the increase in China's rate of inflation is considered to be more structural than temporary. It is likely that wage growth in China will outstrip productivity growth for some time to come.

Some economists believe that higher inflation in China may not be such a bad thing, either for China or for the global economy. There are a number of costs normally associated with inflation. However, China's economy is unbalanced. Although investment is high, savings are higher still. The result is an economy driven by external rather than domestic demand, resulting in a large current account surplus. This has meant that China has amassed large foreign currency reserves for which it has little use. Some developed nations, notably the USA, have blamed China's large current account surplus on an undervaluation of its currency, the yuan/renminbi. However, as Fig. 2.2 below shows, there has been a 20% appreciation in the nominal exchange rate of the yuan against the US dollar since 2005. Most attention has focused on China's decision to operate a fixed exchange rate regime against the US dollar since 2008 and its failure to allow the yuan to appreciate significantly since this time. The real exchange rate of the yuan against the dollar tells a different story. Based on purchasing power parity (PPP), the yuan has appreciated by almost 50% against the dollar since 2005 which would suggest that the perceived undervaluation of the yuan is not the root cause of China's large current account surplus. Continued low levels of consumption and high savings have distorted economic growth in China. Higher inflation might be a way in which China can avoid some of the problems of persistent current account surpluses and rebalance its economy more towards domestic consumption.

Fig. 2.2 Nominal and real (PPP) yuan – US dollar exchange rates (2005 Q1 = 100)



Despite the desire to rebalance economic growth, policy makers in China are fearful of inflation getting out of control. Increasing interest rates to control inflation is difficult when an economy operates a fixed exchange rate. But without measures to control inflation there is a danger that inflationary expectations will increase, just as some members of the UK MPC argue. Whether China will try to reduce these expectations by adopting a formal inflation target, or whether it will allow a higher rate of inflation to help it rebalance its economy, remains to be seen.

Extract 3

China's economic growth target cut

In February 2011, the Chinese Prime Minister, Wen Jiabao, announced that China was to lower its annual economic growth target from 8% to 7% for the next five years. In each of the last six years, Chinese economic growth has exceeded the 8% target set by the government, with growth in 2010 reaching 10.3%. The announcement symbolises the government's concern with rising inflationary pressures and questions over the sustainability of China's rapid economic growth, as well as the extent to which rapid economic growth is capable of promoting development. These issues were raised in a question and answer session between the Chinese Prime Minister and Internet users in 2011.

Fig. 3.1 Statements made by Wen Jiabao in the Chinese Prime Minister's online question and answer session with Internet users

"We want to put the emphasis of our work on the quality and the benefits of economic growth. We want the fruits of economic growth to benefit the people. The purpose of economic development is to meet the people's growing material and cultural needs, and make the lives of our people better and better."

"Rapid price rises have affected the public and even social stability. The government has always made a priority of keeping prices at a generally stable level."

"We must no longer sacrifice the environment for the sake of rapid economic growth because such an approach would make our economic development unsustainable."

In order to promote sustainability the Chinese government will need to understand the social, environmental, resource and demographic impacts of growth. Traditional measures of economic growth, such as the change in real GDP, do not measure these impacts and can give a misleading indication of economic welfare. The Chinese government may need to turn its attention to adjusted (composite) measures of sustainability, such as the Index of Sustainable Economic Welfare (ISEW), and to adopt policies to make economic development more sustainable.

Extract 4

Emerging dispute over China's 'rare earths' export ban

Increased global competition for raw materials and the increased environmental 'footprint' of the world's population have been a direct consequence of economic growth, in particular the growth of emerging economies and growth in the global population. Concerned by the implications for the EU, the European Commission began to develop a strategy for raw materials in response to global resource scarcity. In its 'Roadmap to a Resource Efficient Europe' the European Commission laid out the causes, consequences and possible policy responses to a growing global resource crisis (see Fig. 4.1).

Fig. 4.1 Extracts from 'Roadmap to a Resource Efficient Europe' (European Commission, 2011)

The increasing wealth and population growth in a rapidly industrialising world has led to rising demand for resources. Greatly increasing demand for, and pressure on, natural and material resources are now among the key global challenges that we face today, and that is set to become even more acute in the future. These trends have significant consequences for competitiveness, climate change, the global environment and for the quality of life.

Pressure on resources is bound to be accelerated further as the global population heads toward nine billion by 2050. These developments lead to accelerating scarcity, and increasing difficulty of access to key resources, as well as price increases. These trends have major implications for the economic fundamentals of the global economy and, therefore, the relative competitiveness of industry sectors. To remain competitive, the EU economy will have to adjust faster than our competitors to these global trends. At the same time, scarcity increases the risk of disruption by increasing the EU's dependency on some supplier countries, including China.

There are various market failures which prevent the EU's adequately fast transition to a resource-efficient economy. A policy on resource-efficiency is needed to:

- *reduce the current overexploitation of limited natural resources, due to market prices not reflecting future scarcity;*
- *encourage more eco-innovation in the economy by providing better and clearer market incentives;*
- *accelerate the change in the infrastructure needed for greater resource-efficiency, without which the EU will lag behind our competitors.*

In summary, the EU needs to correct the market failures that prevent investment in resource-efficiency or fail to internalise externalities that damage the global resource base.

The EU has been particularly concerned about the impact of increased global demand for a number of raw materials. These raw materials are important components in high-tech industries, in technologies associated with renewable energy and in the reduction of greenhouse gases. Extraction of these raw materials is currently heavily geographically concentrated. For example, China produces 95% of all 'rare earths' (used in hand-held consumer electronics, LCD displays and high performance magnets); Brazil produces 90% of all niobium (needed for steel alloys in gas pipelines and super alloys in high-performance jet aircraft); and South Africa produces 79% of all rhodium (needed for car catalysts).

China, too, responded to the threat of a global resource crisis by announcing that it would ban the export of certain 'rare earths' from 2015. One of these raw materials, neodymium, is used to make high-power, lightweight magnets for the electric motors of hybrid cars, such as the Toyota Prius. With the demand for neodymium outstripping supply, prices have increased five-fold in recent years. China defends its move, which builds on previous export quotas on key raw materials, as part of its move towards sustainable development. These export quotas led to the EU and the USA making a complaint to the World Trade Organisation in 2009. The EU and the USA view such trade restraints as deliberate attempts by China to unfairly advantage its own industries. It is likely that any move by China to further restrict exports will lead to further trade disputes between China and both the EU and the USA.

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