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RECOGNISING ACHIEVEMENT

ADVANCED GCE

ECONOMICS

The Global Economy

STIMULUS MATERIAL

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- This document consists of **12** pages. Any blank pages are indicated.

Introduction

Towards the end of 2009 many developed economies began to emerge from recession, as the 'green shoots' of recovery appeared. Most commentators expected the same would be true for the UK economy, but official data showed a continued reduction in total output. The UK economy had experienced its longest and possibly its deepest recession since the 1930s.

Policy rules, in both the UK and the European Union (EU), came under pressure as a result of the impact of the recession on public expenditure and tax revenues. Though different in their nature, both the UK fiscal rules and those of the EU's Stability and Growth Pact were broken. What had been seen as guarantees of 'fiscal prudence' came to be seen by some as a 'fiscal straightjacket'.

Unsurprisingly in the recession, some countries' exchange rates came under pressure too. In Central and Eastern European economies, the choice of exchange rate regime appeared to have implications for the key macroeconomic indicators – the 'floaters' recording generally better macroeconomic performance than the 'fixers'.

The recovery in global economic growth in 2009 was fragile for a number of reasons. One of these was the dramatic rise in protectionism. It was not just the increase in tariffs that threatened a recovery in world trade, but the much more serious impact of domestic subsidies. Anti-dumping cases lodged with the World Trade Organisation (WTO) increased by 31.5% from 2008 to 2009.

The end of the recession for some economies coincided with an ambitious global summit in Copenhagen in December 2009 to seek agreement on limiting carbon emissions. The aim of this agreement was to make future growth and development more sustainable. Inevitably, there was disagreement between developed and developing countries about what targets should be set and, in particular, what assistance should be made available to the developing world to help it to meet these targets.

Pre-release stimulus material

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Extract 1

Longest and deepest UK recession since 1930s?

Exactly 12 months after the release of GDP figures which confirmed that the UK economy had entered recession, there were high hopes that data for the third quarter of 2009 would confirm the end of a period of falling GDP. These hopes were dashed when, in October 2009, it was announced by the Office of National Statistics (ONS) that UK GDP in the third quarter of 2009 had fallen by 0.4% over the previous three months. The ‘green shoots’ of recovery had not yet emerged. Instead, UK GDP had declined for six consecutive quarters making it the longest recession in the post-war period and, possibly, the deepest if recovery did not begin by early 2010.

Inevitably, commentators drew comparisons between macroeconomic performance in the UK and other economies in the period 2008–2009. By November 2009, the UK was the only major global economy not to have emerged from recession. The USA joined France, Germany and Japan in recording positive economic growth in the third quarter of 2009. The euro area as a whole also emerged from recession in the same period, ahead of the UK.

Figs 1.1 and 1.2 below show that the UK economy was still in recession, despite the Bank of England cutting interest rates earlier and more aggressively than the European Central Bank. Economists believed this was due to the different impact that the financial crisis, which had preceded the recession, had had on the UK economy. Consequently, UK policies to stimulate growth had been less effective than the policies in other developed countries. In addition, the behaviour of UK firms in the recession had made the recession more prolonged, as evidenced by the massive reduction in stocks (inventories). This was most obvious in the car industry where assembly lines were simply closed down.

Fig. 1.1 A comparison of quarterly GDP growth

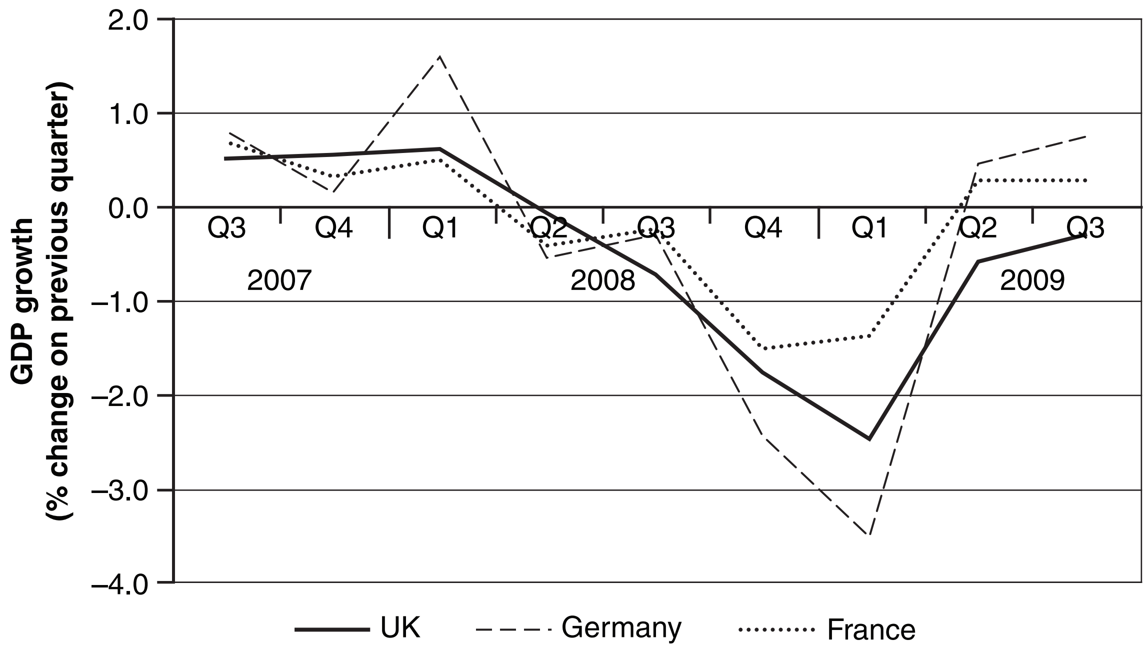
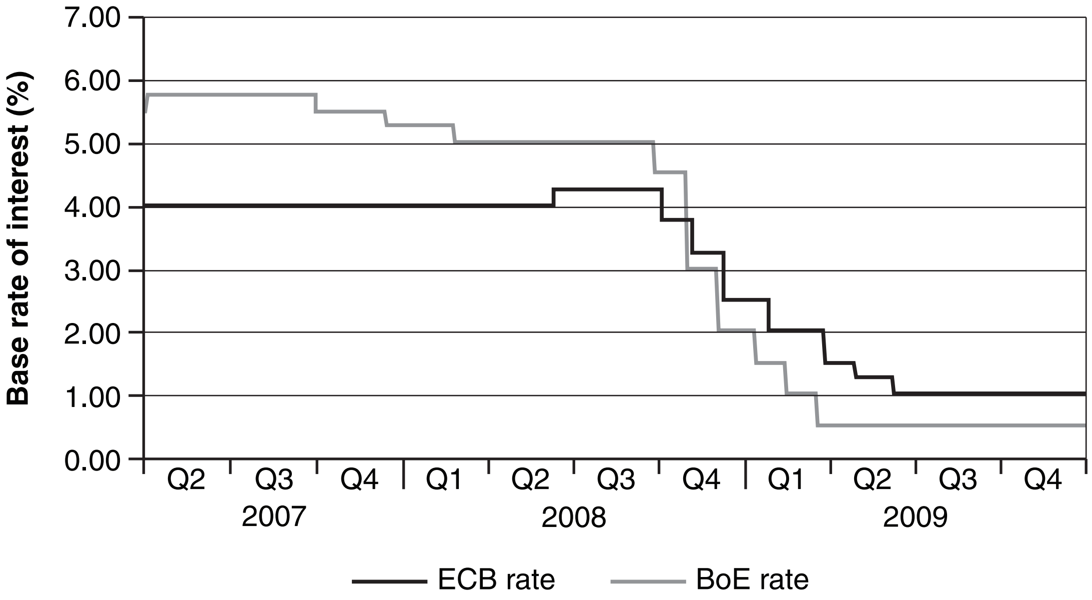
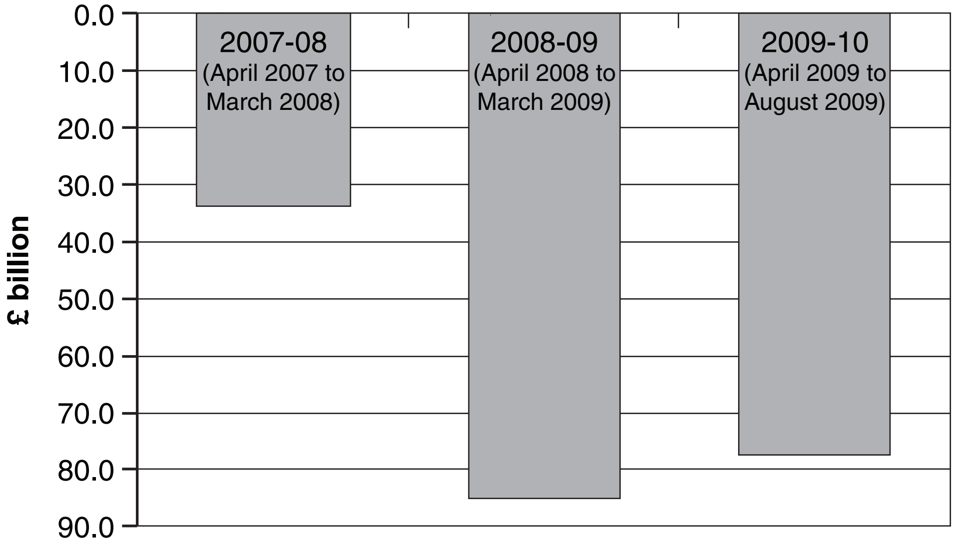


Fig. 1.2 European Central Bank (ECB) and Bank of England (BoE) base rates of interest (%)



Both monetary and fiscal policy in the UK should have helped promote economic growth or, at least, reduced the impact of the recession. The Bank of England base rate was held at an historic low of 0.5% from March 2009. In addition, the Bank effectively created money by buying £125 billion of government bonds back from the private sector: a policy known as quantitative easing. Monetary policy was also eased by the fall in the value of sterling: sterling's effective exchange rate index had fallen by 15% since the start of recession and it had fallen almost 19% against the US$. Fiscal policy was also loosened. The rise in the UK budget deficit (Fig. 1.3) was not just a cyclical rise, as might be expected in a recession. There were discretionary increases in public expenditure and a cut in VAT, adding to the structural (rather than cyclical) nature of the deficit.

Fig. 1.3 UK public sector net borrowing (£bn)



Extract 2

Fiscal rules broken

The state of the UK public finances aroused much debate at the end of 2009. The Chancellor of the Exchequer, Alistair Darling, said that it made economic sense for government borrowing to increase as it had done during the recession. Other politicians accused the Government of being 'irresponsible' in its use of fiscal policy. The fiscal rules, which had governed fiscal policy since 1997, had been breached. Alistair Darling argued that it would be 'perverse' to apply the fiscal rules strictly given the severity of the recession and argued that the 'rules' needed to be flexible. Whilst he conceded that the 'golden rule' and the 'sustainable investment rule' would be broken, he stated that the principles underlying the conduct of fiscal policy (credibility, flexibility and transparency) would remain in place.

Members of the euro area had also struggled to meet the fiscal rules set under the European Union's Stability and Growth Pact (SGP). The European Commission produced macroeconomic forecasts for each member state of the European Union in November 2009 (Fig. 2.1). France's budget deficit was forecast by the European Commission to be 8.3% of GDP by the end of 2009, over two and a half times the limit set by the SGP. The budget deficits for Spain and Greece were forecast to be even greater at 11.2% and 12.7% of GDP respectively.

The European Commission said that:

"*the average budgetary position in the EU had gone from –0.8% of GDP in 2007, the best position in 30 years, to –2.3% in 2008, the year when the financial crisis turned into a full-blown economic crisis. That figure is expected to treble to –6.9% in 2009 and to increase further to –7.5% in 2010. Public debt is set to increase by more than 20 percentage points of GDP in the same period, and to continue rising even after the deficits start coming down.*"

On the basis of the budget deficits experienced by some member states, the European Commission put some countries under its Excessive Deficit Procedure (EDP), setting targets for the reduction in deficits over a number of years.

Fig. 2.1 European Commission macroeconomic forecasts for selected EU member states, 2009

	GDP growth (%)	Inflation Rate (%)	Unemployment Rate (%)	Budget deficit (% of GDP)	Current account deficit (% of GDP)
UK	–4.6	2.0	7.8	–12.1	–2.4
France	–2.2	0.1	9.5	–8.3	–2.3
Spain	–3.7	–0.4	17.9	–11.2	–5.4
Greece	–1.1	1.2	9.0	–12.7	–8.8

Extract 3

Fixers and floaters

The news that the UK remained in recession in the third quarter of 2009 caused the sharpest depreciation in the value of sterling on the foreign exchange markets in six months. On one day of trading in October, sterling fell 1.5% against the euro.

The downturn in economic activity has also tested the exchange rate regimes of a number of Central and Eastern European economies. Two of these, Slovakia and Slovenia, had joined the euro. The other six Central and Eastern European economies which joined the EU in 2004 had adopted either freely floating or fixed exchange rate regimes:

- Poland, the Czech Republic and Hungary operated freely floating exchange rates;
- Estonia, Lithuania and Latvia had a fixed exchange rate against the euro.

Those which adopted a fixed exchange rate regime appeared to have had most problems. Estonia, Lithuania and Latvia had all enjoyed a decade of high growth prior to the recession, in part promoted by significant levels of foreign direct investment. However, the recession experienced by these economies was deep and prolonged. In addition, since the onset of recession, Estonia, Lithuania and Latvia experienced severe balance of payments problems, despite maintaining positive balances on their current accounts. Potential investors feared that these economies might abandon their fixed exchange rate against the euro, consequently capital inflows dried up and capital outflows increased. There were several speculative attacks on the Estonian, Lithuanian and Latvian currencies which made the problems of these economies worse.

Macroeconomic performance for those member states with floating exchange rates was mixed. Poland's GDP was forecast by the European Commission to grow over the whole of 2009, helped by a 30% fall in the value of the zloty on the foreign exchange markets. On the other hand, Hungary had to be bailed out by the International Monetary Fund (IMF) and the 10% fall in the value of the forint did not prevent the recession from being severe. The experience of the Czech Republic was better than Hungary, but weaker than Poland (see Fig. 3.1).

Fig. 3.1 European Commission macroeconomic forecasts for selected Central and Eastern European EU member states, 2009

	GDP growth (%)	Inflation Rate (%)	Unemployment Rate (%)
Estonia	–13.7	0.2	13.6
Lithuania	–18.1	3.9	14.5
Latvia	–18.0	3.5	16.9
Poland	1.2	3.9	8.4
Czech Republic	–4.8	0.6	6.9
Hungary	–6.5	4.3	10.5

Extract 4

The return of protectionism

Whilst it was good news that major developed nations were recovering from recession at the end of 2009, some of the policy reaction to the global downturn was worrying. It had become increasingly apparent that there had been a return to economic nationalism during the recession. Tariffs and quotas had been imposed by some countries on imports and restrictions had been placed on takeovers of national firms by foreign capital. The return of protectionism was also evidenced by the number of anti-dumping cases brought to the World Trade Organisation (WTO), up by one third. Of the 85 cases launched in the first half of 2009, half were against China. More worrying still was the fact that 88 of the 104 anti-dumping cases in the second half of the year were brought by developing countries against subsidised imports.

Barak Obama's presidential campaign at the beginning of the global slowdown raised fears that the USA would turn to protectionism as the spectre of job losses loomed. Obama was quoted as saying:

"*China must change its currency practices. Because it pegs its currency at an artificially low rate, China is running massive current account surpluses. This is not good for US firms and workers, and not good for the world.*"

The US government's fiscal stimulus package contained strong 'Buy American' provisions that limited public sector spending to firms in the USA. In September 2009 the US government imposed 35% tariffs on tyres imported from China – US$1.3 billion of tyres had been imported in the first six months of 2009. China complained to the WTO and announced retaliatory tariffs on imports of US car parts and chicken meat. Such measures were not confined to the USA, however. French President, Nicolas Sarkozy, proposed a 'strategic investment fund' to fight off foreign takeovers; Indonesia introduced licences to limit imports; India and Vietnam introduced tariffs on steel; and Russia imposed tariffs of 30% on cars and 15% on farm machinery.

Just as the global economy emerged from recession, the dramatic rise in protectionism reduced the volume of world trade seriously threatening the global recovery. Both the United Nations (UN) and the Organisation for Economic Co-operation and Development (OECD), forecast that world trade would fall by 15% during 2009 – the first decline for over 20 years.

Extract 5

Making economic growth and development sustainable

As the global economic slowdown and recession neared its end, governments of developed and developing nations met in Copenhagen in December 2009 to seek an agreement to further limit carbon emissions. The Copenhagen summit took place under the United Nations Framework Convention on climate change. The major achievement under the UN Framework was the signing of the Kyoto Protocol in 1997. This protocol set binding targets for the carbon dioxide emissions of the major developed economies and established an important principle with respect to developing economies. This principle was that developing economies would face a lower burden in reducing emissions than developed countries.

The Copenhagen summit was the first step in agreeing a successor to the Kyoto Protocol, which expires in 2012. The task ahead of the participants was monumental. According to the International Panel on Climate Change (IPCC), to ensure that global temperatures were no more than 2% above their pre-industrial levels would require a cut in global carbon emissions of 50% of 1990 levels by 2050. For rich developed nations it was estimated that this would require an 80% reduction in emissions. According to the International Energy Agency, such cuts in emissions would require US$1 trillion a year in investment in cleaner technology. The World Bank estimated that, of this global total, US$475 billion a year in investment was needed in developing countries.

Getting an agreement to reduce emissions was only one problem. How to ensure that countries met their agreements was an even bigger issue. Breaking an international commitment to reduce carbon emissions simply involves having to make bigger cuts in emissions in the next round of negotiations. Economists have suggested that the issues surrounding reaching international agreements to bring about a reduction in emissions can be explained in terms of a range of different market failures.

Some countries, such as France, proposed that a failure to meet agreed targets should result in trade sanctions and tariffs to provide countries with incentives to honour their commitments. Developing countries, in particular, were opposed to such measures at a time of slow growth in global trade. They argued that they lacked the capital to make the investments necessary to reduce carbon emissions. Low levels of development made it difficult for them to reduce emissions. They proposed that developing countries should receive increased capital flows from developed nations. China called for the developed countries to contribute 1% of their GDP per year, about US$400 billion. The African Union asked for US$67 billion a year for Africa alone.

If targets had been agreed at Copenhagen, individual governments would need to make policy decisions on how best to achieve these targets. There are three options:

- regulation;
- carbon-pricing;
- subsidies.

Regulation has a role to play, particularly where markets do not work well. But regulation on its own, however, is unlikely to be able to deliver the reductions in carbon emissions the IPCC estimates require. Economists generally argue that carbon pricing is a much more effective and efficient method of reducing carbon emissions. The only large-scale attempt to use carbon pricing is the EU's Emissions Trading Scheme (ETS), set up in 2005. A study by the Massachusetts Institute of Technology concluded that, in its first three years, the ETS had reduced carbon emissions by between 120 million and 300 million tonnes.

This meant that emissions were 2–5% a year lower than they would have been without the ETS. In comparison, regulation and subsidies are either ineffective or subject to government failure. Most notable has been the policy to subsidise the production of crops for bio-fuels in the USA which has raised global food prices, yet had little impact on carbon emissions.

China, the world's largest emitter of greenhouse gases, is central to the achievement of any global agreement on cutting carbon emissions. Previously, China has resisted cuts in its emissions, arguing that it unfairly limited its economic development. It would seem that China is now more committed to taking action to ensure sustainable development. It has moved away from the single-minded pursuit of economic growth. Part of the reason for this change in approach to economic development has been the undeniable economic and social impacts from increasing air and water pollution in China. Another is the financial capital it has received under the Kyoto Protocol to enable it to produce clean energy and introduce cleaner technologies in general.

In addition, China can see benefits in a shift to more sustainable development. According to Hu Angang, an economist at Tsinghua University, sustainable development provides:

"*a huge opportunity for China. The country will become the largest renewable-energy market, bio-energy market, clean-coal market, nuclear-power market, carbon-exchange market, environmental-technology market, low-carbon economy, exporter of low-carbon products and low-carbon-technology innovator.*"

Because of its level of development, China may lack the capital and technology to take advantage of these opportunities for sustainability. However, it has an abundance of cheap labour and a political system which allows it to take into account the long term benefits and costs of sustainable growth.

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