

ADVANCED GCE
ECONOMICS
The Global Economy

F585/SM

STIMULUS MATERIAL

Thursday 23 June 2011
Afternoon

Duration: 2 hours



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Introduction

The euro area economies all experienced negative economic growth during 2008 – 2009 as the global economic crisis spread. However, the reduction in GDP was not uniform. Some euro area economies entered recession earlier than others, some experienced more severe recessions than others and not all economies had emerged from recession by the end of 2009. The lack of convergence of the economic cycles in the euro area raised questions about the viability of the monetary union which was just over 10 years old.

It was not just the lack of convergence of the economic cycles which raised concerns about the future of monetary union in the European Union (EU). A number of economies appeared to suffer from a lack of competitiveness both inside and outside the euro area. Portugal, Ireland, Italy, Greece and Spain (dubbed the PIIGS) had grown increasingly uncompetitive during their membership of the EU's monetary union. Without implementing measures to tackle this lack of competitiveness many thought that their continued membership of the euro area was unsustainable.

Of the PIIGS, Ireland, Spain and Greece had experienced rates of economic growth above the average of the euro area as a whole up to 2007. In part this was because their economies had attracted high levels of foreign direct investment (FDI). But it was increasingly apparent that much of this growth was short-term in nature, fuelled by negative real interest rates resulting from high inflation and a nominal interest rate set by the European Central Bank and not by their own central banks. In the absence of a freely floating exchange rate against their euro area partners, these economies faced tough decisions in order to improve their long run economic performance. In addition, the PIIGS were constrained in putting in place further fiscal stimulus packages as they faced the problem of high and rising budget deficits.

Whilst fiscal stimulus measures had had an impact on economic growth in the short term, the World Trade Organisation (WTO) called upon developed and developing economies to renew their efforts to further liberalise world trade. Pascal Lamy, the Director-General of the WTO, stated his belief that, in the long term, trade liberalisation was the key to promoting economic growth for developed and developing economies alike. Such a view is strongly supported by economic theory, yet trade liberalisation on its own is not a guarantee of human development and poverty reduction.

Pre-release stimulus material

Extract 1: Recession in the euro area economies 2008 – 2009

Extract 2: Portugal, Italy, Ireland, Greece and Spain – the PIIGS

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Extract 1

Recession in the euro area economies 2008 – 2009

Since its launch in 1999, and the issue of notes and coins in 2002, the euro has established itself as a major international currency. Fears that the euro would be a 'soft' currency have not been realised. In fact, the euro is now the world's second largest reserve currency and the second most popular currency for international transactions. The euro area economy is the second largest in the world, based on comparisons of GDP at purchasing power parity.

The economies of the euro area were not immune from the effects of the global economic crisis of 2008 – 2009. Setting interest rates for the euro area as a whole is difficult when there is a lack of convergence in economic cycles. The European Central Bank (ECB) must make a judgement based on the performance of the euro area economy as a whole.

Fig. 1.1 shows the quarterly growth in real GDP for the euro area as a whole and for its individual economies, except Malta. Despite euro area GDP falling in the second quarter of 2008, only five of the 16 members had experienced negative economic growth. This number rose to nine by the third quarter of 2008 and to 13 by the fourth quarter of the same year. It was not until the first quarter of 2009 that all euro area economies were experiencing falling GDP. Similarly, the end of recession for the euro area economy as a whole came in the third quarter of 2009, yet three economies (Greece, Spain and Cyprus) remained in recession. They were joined by Italy in the fourth quarter as the country looked set to enter a double-dip recession. Not only was the timing and length of the recession different in the various national economies of the euro area, so too was the severity of the recession. Ireland, Luxembourg, Slovenia, Slovakia and Finland all experienced a reduction in GDP from peak to trough significantly above that of the average for the euro area economy as a whole. The fall in GDP in Greece, France and Cyprus was significantly below this average.

Some economists expressed concerns that the national economies of the euro area had not converged. Differences in their economic performance could be only partly explained by differences in the fiscal response to the downturn. Much more important was that economic performance appeared to be affected by differences in their openness to international trade, the structure of their economies and in their competitiveness. As it emerged from recession there were concerns that a 'two-speed' euro area was developing, seriously affecting the viability of the monetary union.

Fig. 1.1 Quarterly real GDP growth in the euro area 2008 – 2009

	2008				2009				% fall in GDP from peak to trough
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Ireland	-1.0	-2.0	0.2	-5.4	-2.1	-0.6	0.3	na	10.5
Slovenia	1.9	0.8	0.5	-4.0	-6.2	0.6	1.0	na	10.0
Finland	0.2	0.9	0.2	-4.1	-4.9	-0.3	0.3	na	9.1
Luxembourg	0.8	-1.6	-0.8	-3.1	-0.9	-2.7	4.2	na	8.8
Slovakia	-2.0	1.6	1.2	0.6	-8.1	1.2	1.6	2.0	8.1
Germany	1.6	-0.6	-0.3	-2.4	-3.5	0.4	0.7	0.0	6.7
Italy	0.5	-0.6	-0.8	-2.1	-2.7	-0.5	0.6	-0.2	6.5
Netherlands	1.0	0.0	-0.7	-1.2	-2.3	-1.1	0.5	0.3	5.2
Euro area	0.8	-0.3	-0.4	-1.9	-2.5	-0.1	0.4	0.1	5.1
Spain	0.4	0.0	-0.6	-1.1	-1.7	-1.0	-0.3	-0.1	4.7
Austria	1.2	0.2	-0.6	-1.3	-2.2	-0.5	0.5	0.4	4.5
Portugal	0.2	0.1	-0.5	-1.7	-2.0	0.5	0.7	na	4.1
Belgium	0.5	0.4	-0.2	-2.1	-1.7	-0.1	0.7	na	4.1
France	0.5	-0.4	-0.2	-1.5	-1.4	0.3	0.2	0.6	3.5
Cyprus	1.2	0.7	0.2	0.1	-0.7	-1.0	-0.8	-0.3	2.8
Greece	0.7	0.6	0.1	-0.7	-0.5	-0.1	-0.4	na	1.7

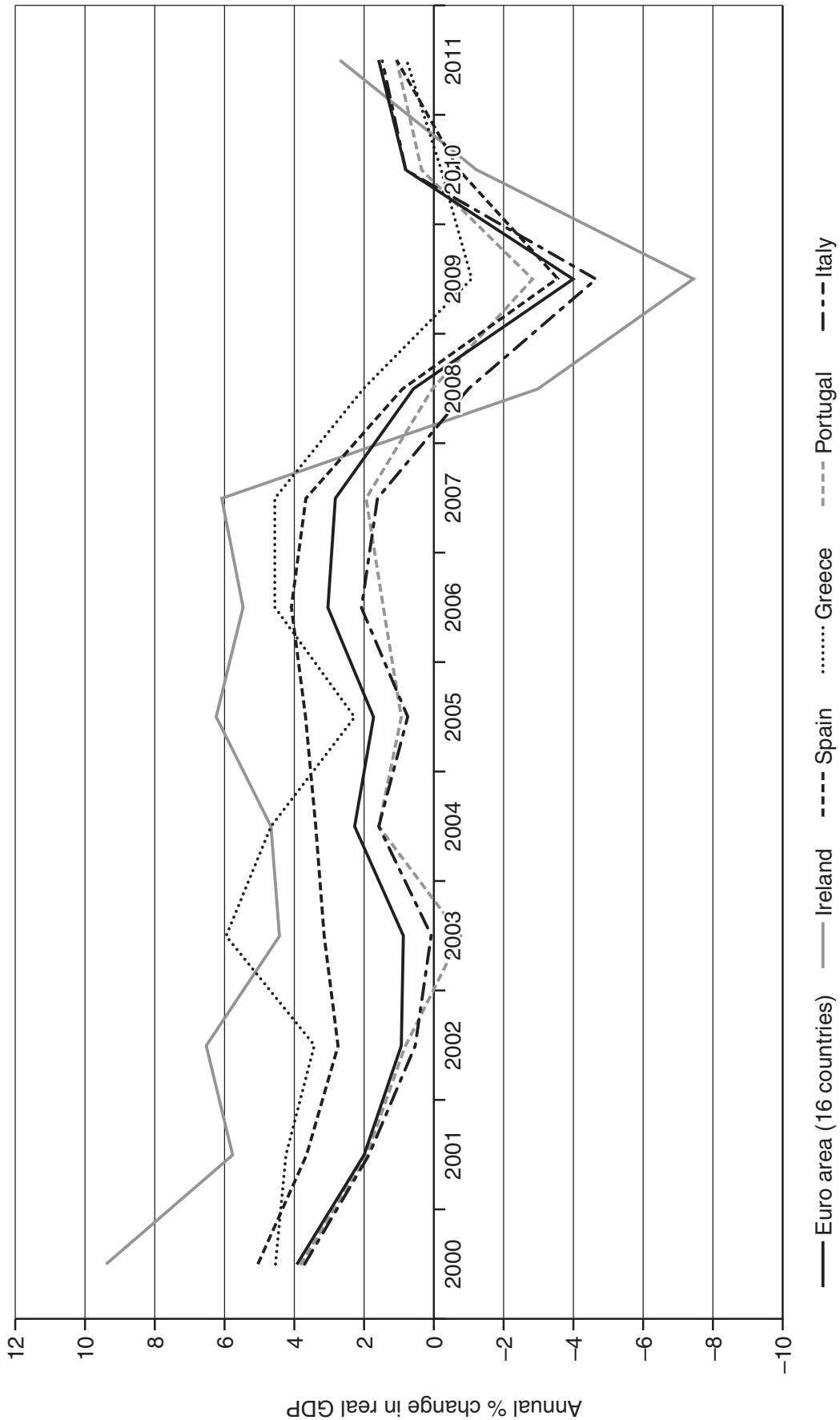
Extract 2

Portugal, Italy, Ireland, Greece and Spain – the PIIGS

Five countries in the euro area are now singled out as countries sharing common characteristics likely to make their continued membership of the euro area challenging. These economies – Portugal, Italy, Ireland, Greece and Spain (the PIIGS) – on the surface look an unlikely grouping (see Fig. 2.1). Economic performance in Ireland, Greece and Spain was strong before the recent recession. All three economies had experienced above average rates of economic growth in the period 2000 to 2007. Over the whole period Greece and Spain had grown twice as much as the average for the euro area as a whole, where real GDP had increased by 18.5%. In Ireland, real GDP had grown by almost 56% over the same period. In comparison, economic growth in Portugal and Italy over the period was about two thirds of the average for the euro area economy.

What unites these five economies is a loss in competitiveness compared to the rest of the euro area and to economies outside the euro area. The ECB produces two measures of competitiveness. One is based on increases in output prices (see Fig. 2.2) and the other on increases in relative unit labour costs (see Fig. 2.3). Both measure changes in the competitiveness of individual economies relative to their main trading partners over time. Both indices show a decline in the competitiveness of the PIIGS since 1999, the year of the launch of monetary union in the EU. Part of this lost competitiveness is due to the failure of ECB monetary policy to control inflation in all parts of the euro area. Effectively, monetary policy has been too 'loose' for Portugal, Italy, Ireland, Greece and Spain. Short term economic growth has come at the cost of high inflation. Part of their decline in competitiveness stems from these economies having a 'fixed' exchange rate against other members of the euro area. High inflation cannot result in a reduction in the 'exchange rate' with other members of the euro area. With the risk of depreciation eliminated, FDI has poured into these fast-growing economies. But these are short term influences on economic growth. The real problem for these economies are the longer term influences on economic growth which come from a poor supply side performance.

Fig. 2.1 Annual GDP growth rates for the PIIGS and for the euro area¹



¹ Annual data shown at the mid-point of each year

Fig. 2.2 ECB index of competitiveness based on output prices for Portugal, Ireland, Italy, Greece and Spain 1999 – 2009 (1999 Q1 = 100)

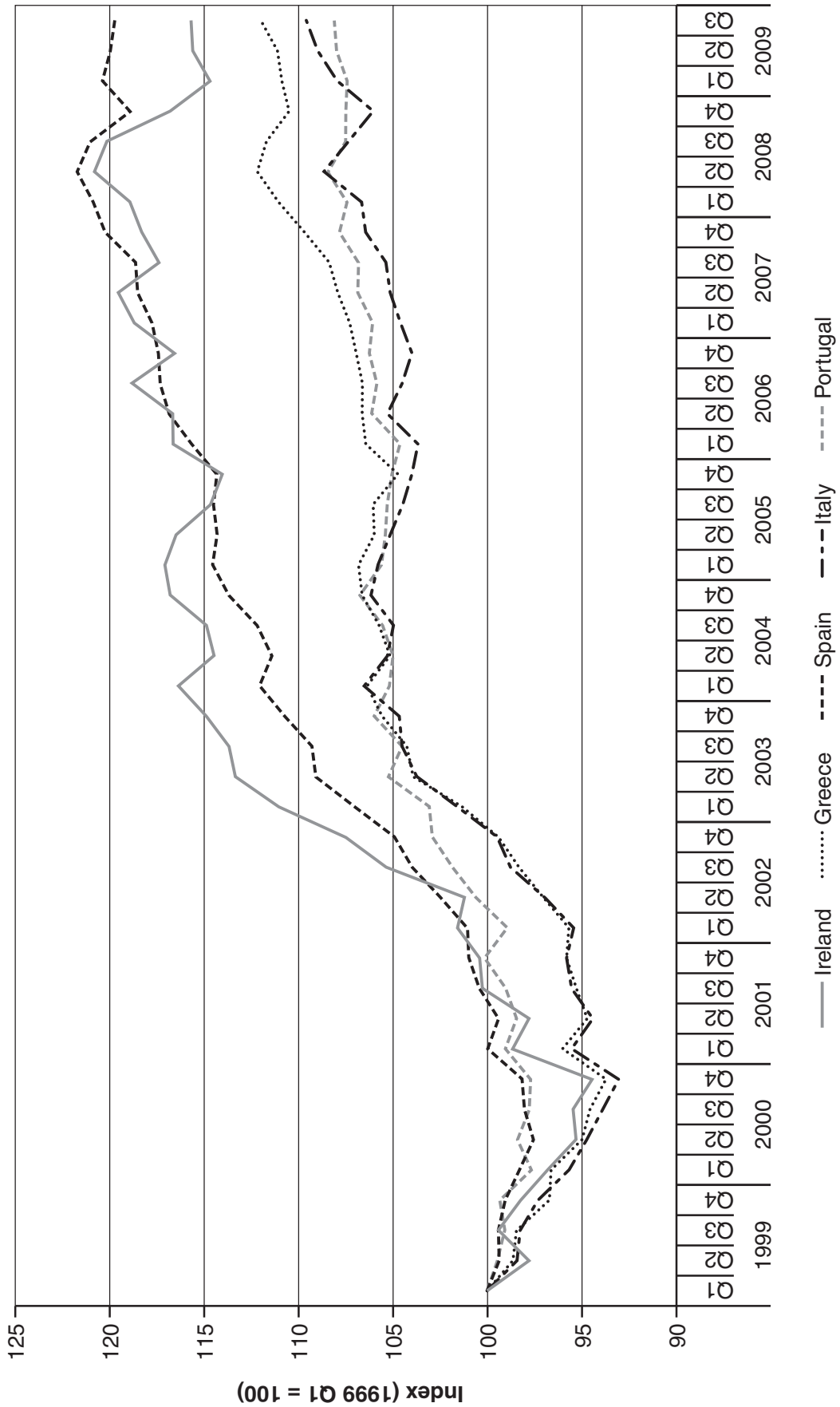
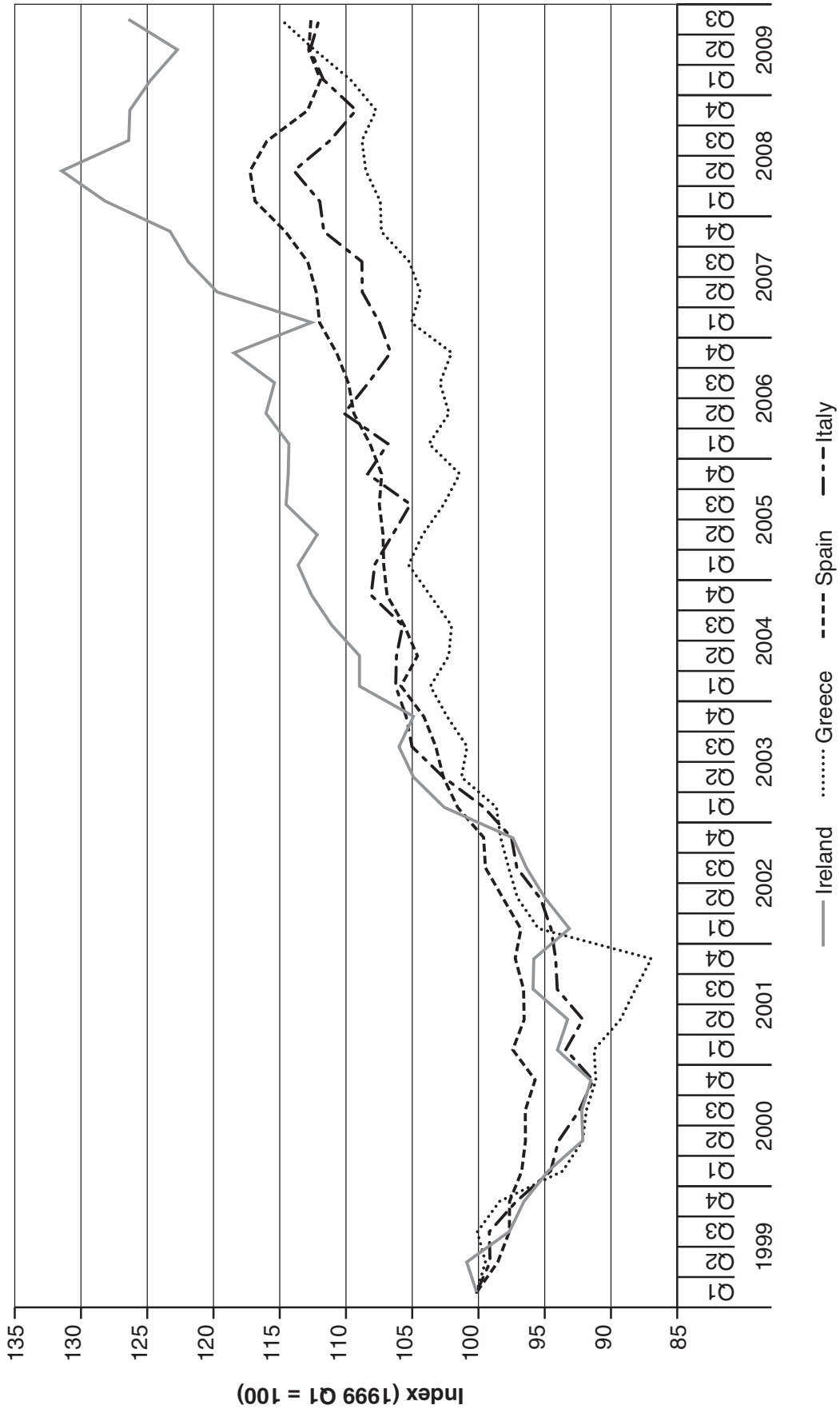


Fig. 2.3 ECB index of competitiveness based on relative unit labour costs for Ireland, Italy, Greece and Spain 1999 – 2009 (1999 Q1 = 100)²



² Data not available for Portugal

Extract 3

The future of the Spanish economy

Up until the end of 2009, the decline in Spain's GDP (4.71% from peak to trough) was less than the average of that in the euro area as a whole (see Fig. 1.1). Yet RR de Acuña & Asociados, a research group in Madrid, predicted that Spain's dependence on the construction industry might mean that it would not recover from recession with the rest of the euro area economies and that, peak to trough, the decline in GDP might be as much as 11%. They suggested that an economic recovery might not begin until 2012 and that, as a result, Spain's unemployment rate could rise to 25%.

Spain has one of the most generous welfare systems in the euro area. Typically, a worker made unemployed in Spain will receive up to 60% of their previous wage for 18 months after losing their job. Fearing the social consequences of rising unemployment, the Spanish government introduced guaranteed benefits of €420 per month for the long-term unemployed. This alone added 3% of GDP to the government's budget deficit. Combined with a reduction in tax receipts, the budget deficit in Spain has required big cuts in discretionary spending and has limited the ability of the Spanish government to continue to use fiscal policy to prevent aggregate demand falling further. Unlike the first decade of its membership of the euro area, Spain cannot expect the ECB interest rate to boost economic growth. With high inflation for much of the last decade, real interest rates in Spain were negative. Spain's GDP growth rarely fell below 3% per annum as a result.

In the next ten years, Spain must turn its attention to improving its long-run growth potential as emphasised not only by research groups such as RR de Acuña & Asociados but also by the IMF. As part of its role, the IMF holds discussions with members every year. A team from the IMF visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies before preparing a report. Fig. 3.1 summarises key aspects of the report published by the IMF on the Spanish economy in March 2009.

Fig. 3.1 Key aspects of a report published by the IMF on the Spanish economy in March 2009

Despite the economic slowdown, wage and unit-labour costs are outpacing those in other euro area countries and inflation remains structurally above the euro area average. This reflects a lack of competition and contestability in output markets, inefficient labour markets, and relatively low productivity.

Spain must introduce policies to improve its international competitiveness. Plans for product market reforms also need to be implemented.

Extract 4

International trade, international trade negotiations and developing economies

Concerns about the impact of the global economic recession are not confined to members of the euro area. Pascal Lamy, Director-General of the WTO, emphasised the importance of international trade in his speech to the European Policy Centre in Brussels on 24 February 2010. The role of the WTO is to promote international trade and ensure that trade flows smoothly, freely, fairly and predictably. Pascal Lamy concluded his speech by stating that there was an “economic imperative” to conclude the Doha Round of international trade negotiations. Fig. 4.1 below reproduces excerpts from his speech.

Fig. 4.1 Excerpts from a speech by Pascal Lamy to the European Policy Centre in Brussels on 24 February 2010

These are not easy times. We know that in 2009, growth of real world GDP was negative, estimated at –2.2%. Furthermore, the global unemployment rate reached its highest level ever. The adverse impact of the recent financial crisis on the world economy in terms of output and employment is undeniable.

World trade has also been a casualty of this crisis, contracting in volume terms by around 12% in 2009 — the sharpest decline since the end of the Second World War. The main explanation for this freefall in trade has been the simultaneous reduction in aggregate demand across all major world economies. To a lesser degree, trade has been adversely affected by some instances of increased tariffs and domestic subsidies, new non-tariff measures and more anti-dumping actions.

In most developed economies, including the EU, stimulus packages have been instrumental in preventing further deterioration in output, while preparing the path to recovery. But the positive impact of national stimulus packages is at best temporary and worries are mounting over the huge budget deficits created by many governments. Economies urgently need other sources of growth. This is where trade can be an important part of the story, both in the short to medium-term and in the long run.

We must, therefore, ensure that trade remains open. But we must also work to keep opening trade through the conclusion of the Doha Round. A Doha deal would provide new market opportunities for developing economies, in particular, through the reduction of tariff barriers and domestic subsidies.

The Doha Round of international trade negotiations was started in 2001. The last talks in Geneva in 2008 collapsed as China, India, the USA and the EU could not agree on import rules. The main issue surrounded agricultural trade and rules which allow countries to protect poor farmers through tariffs in the event of falling prices. The Doha Round of trade talks has tried to ensure that developing countries benefit more from freer trade. But talks have repeatedly collapsed because of a failure of developed and developing countries to agree on the key issues surrounding access to each others' markets. On the one hand, developed economies such as the USA and the EU want their producers to be able to gain greater access to fast-growing markets such as China and India. On the other hand, developing countries want to be able to gain greater access to markets for agricultural products in the USA and the EU. So far, agreement between the developed and developing countries has been illusive.

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