OCR
RECOGNISING ACHIEVEMENT

Tuesday 31 January 2012 – Morning

A2 GCE ECONOMICS

F585/01/SM The Global Economy

STIMULUS MATERIAL

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Duration: 2 hours

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Introduction

The much anticipated UK Comprehensive Spending Review was finally revealed by the Chancellor of the Exchequer, George Osborne, on 20 October 2010. The UK recession of 2008–10 had been the deepest and most prolonged in recent memory and it had had a severe impact on consumer and business confidence, on the level of investment and on the public sector finances. The Coalition Government felt that a deficit reduction strategy involving immediate cuts to government expenditure and future tax rises was necessary in order to restore confidence and, ultimately, create an economic environment conducive to investment by and growth in the private sector. The package of cuts announced by the Chancellor amounted to reductions in government expenditure of £81 billion over four years.

One area of spending notably immune from the cuts was spending by the Department for International Development (DfID). This was to increase by 37% in order to allow the UK to meet its international commitment to raise its Official Development Assistance (ODA) as a percentage of GDP. DfID announced reforms to the way in which ODA would be granted to developing countries, in particular to better target aid so that it went to countries most in need. This had not always been the case.

One of the success stories of development, at least in terms of economic growth, has been India. The future prospects for India, particularly on the supply side, looked healthy in 2010. Some predicted that India's economic growth rate would soon exceed that of China. But there were a number of constraints which might limit not only economic growth but also development. Despite market-friendly reforms in the past, there was still much to do to reform the Indian economy in order to achieve future growth and development.

One of the greatest threats in late 2010 to both developed and developing economies alike was the growing global trade and balance of payments imbalances. The causes of these imbalances were disputed amongst the world's major economies and trading nations. The consequences, too, were not clear. The International Monetary Fund (IMF), however, was concerned that there were signs that one possible consequence, currency wars, was already raising a spectre over the global economy.

Pre-release stimulus material

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Extract 1

UK investment and public finances

The financial crisis beginning in 2007 and the subsequent recession had a huge impact on both the level of UK investment and the UK's public finances.

Surveys of business confidence, such as that by the Confederation of British Industry (CBI), showed that business confidence collapsed at the start of the recession in the second quarter of 2008. The CBI Industrial Trends Survey asks manufacturing firms a number of questions about current trends and their expectations for the future, including whether their order books have increased, how optimistic they are and what their expectations are for future output.

Unsurprisingly, in this economic climate, investment fell dramatically in the UK. Total investment (Gross Fixed Capital Formation, GFCF) fell by 18.7% in 2009 Quarter 2 compared with a year earlier. Fig. 1.1 shows the relationship between changes in real GDP and GFCF on a **quarterly** basis.

The impact of the recession on the UK's public sector finances was no less severe, as automatic stabilisers raised government expenditure and reduced tax receipts (see Fig. 1.2). A return to growth would normally have been expected to reduce the cyclical budget deficit. It was, however, commonly believed in 2010 that the UK could not rely on economic growth to reduce the amount of public sector borrowing resulting from the government's budget deficit. The Treasury estimated that as much as two thirds of the UK's deficit was 'structural'. The UK's net public sector debt had breached the previous government's sustainable investment rule, with the result that the UK government was spending £44 billion on debt interest in 2010 (see Fig. 1.3). Hence, the view amongst many economists was that to tackle the deficit and reduce public sector borrowing required a combination of discretionary cuts in government expenditure and increases in taxation.

Fig. 1.1 UK Real GDP and Gross Fixed Capital Formation (GFCF) 2008 Q2–2010 Q2 (% change on previous quarter)

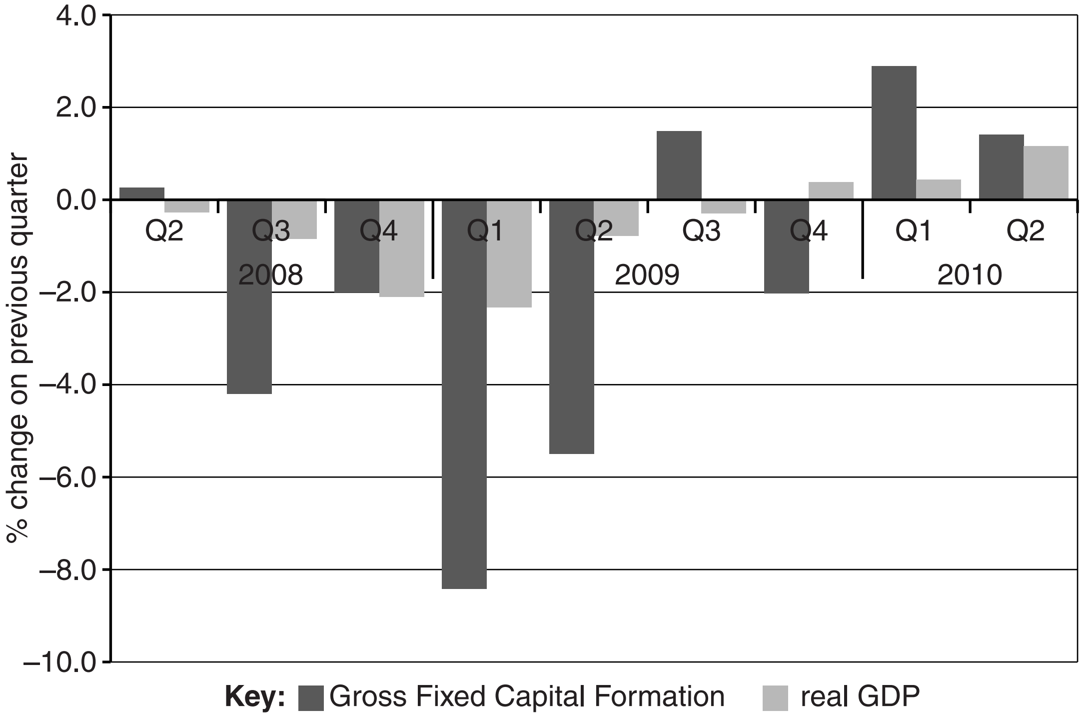


Fig. 1.2 UK public sector net borrowing 2002–03 to 2009–10 (£bn)

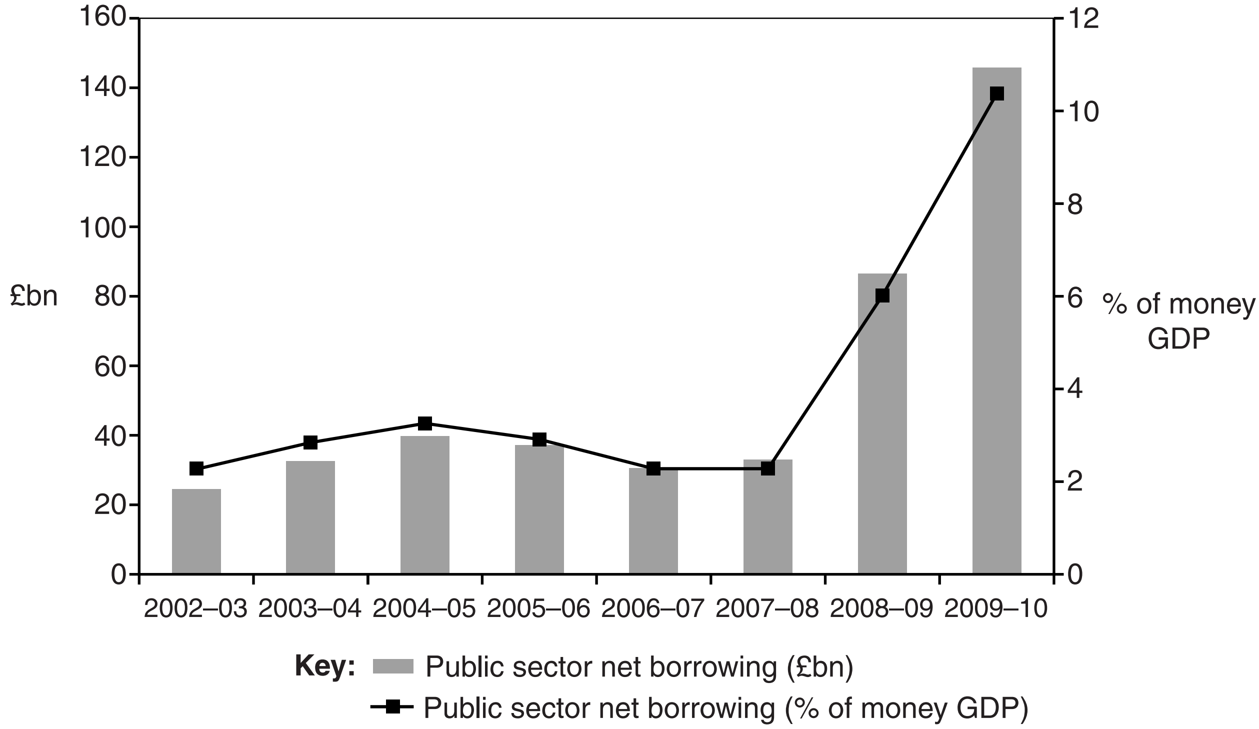
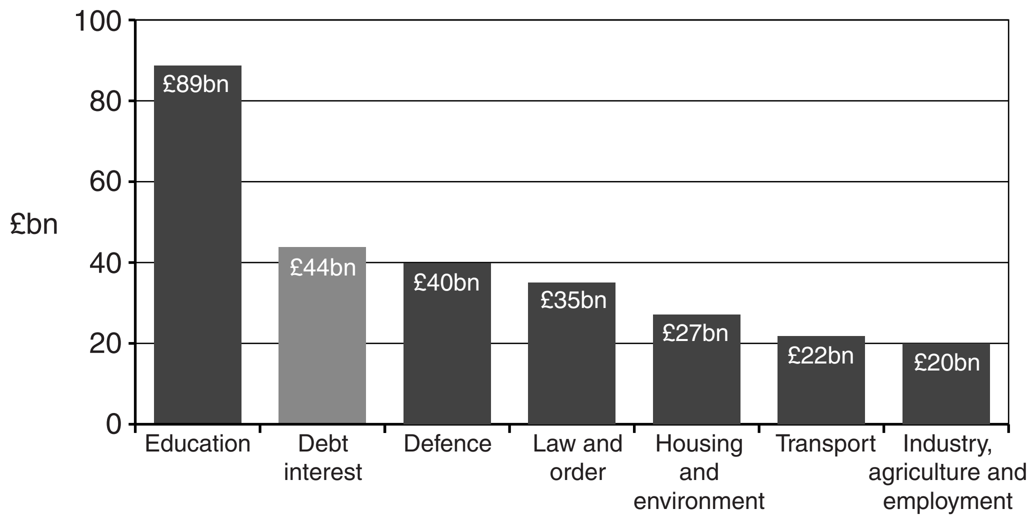


Fig. 1.3 UK government expenditure 2009–10 (£bn)



Extract 2

The UK budget deficit reduction plan

In response to the growing size of the UK budget deficit and rising public sector borrowing, the Coalition Government announced its intention to cut government spending. Its spending plans were announced by the Chancellor of the Exchequer, George Osborne, on 20 October 2010. In total, spending cuts of £81 billion were announced which would take effect over the period 2010–11 to 2014–15.

In his statement to the House of Commons, the Chancellor laid out the need to reduce the budget deficit (see Fig. 2.1). He claimed support from the IMF, the Governor of the Bank of England and business leaders for his deficit reduction plan.

Support for the deficit reduction plan, however, was not universal amongst economists and commentators. Some feared that the nature of the UK's economic recovery was too fragile and that reductions in government expenditure would risk a double-dip recession. Others questioned whether the emphasis on reductions in government expenditure was appropriate because of the national income multiplier. Some commentators suggested that cuts in government expenditure should be balanced by cuts in taxation financed by a higher budget deficit and they viewed the IMF's praise for austerity as 'foolish' (see Fig. 2.2).

There were grounds for optimism in the CBI's Quarterly Industrial Trends Survey of 19 October 2010 but the resilience of the economic recovery to the impact of the deficit reduction plan was not assured. The Office for National Statistics, however, announced that GDP growth in the third quarter of 2010 was provisionally 0.8%, rather than the anticipated 0.4%. This was a welcome sign of a stronger than expected recovery, despite growth being lower than the 1.2% recorded in the second quarter of 2010.

Fig. 2.1 Extracts from George Osborne's statement to the House of Commons, 20 October 2010

We have, at £109 billion, the largest structural budget deficit in Europe. This is at a time when the whole world is concerned about high deficits and our economic stability depends on allaying these concerns. We are paying, at a rate of £120 million a day, £44 billion a year in debt interest.

Last year the IMF warned this country to accelerate the reduction in the deficit and the Organisation for Economic Cooperation and Development (OECD), the Governor of the Bank of England and the CBI all agreed with them.

The emergency Budget in June was the moment when our fiscal credibility was restored. Our market interest rates fell to near record lows. Our country's credit rating was affirmed. The IMF went from issuing warnings to calling our Budget 'essential'.

I can confirm that the spending plans I set out today will achieve a balanced structural current budget and falling national debt by 2014–15.

To back down now and abandon our plans would be the road to economic ruin.

Fig. 2.2 The views of Martin Wolf, Financial Times columnist, 30 September 2010

Adam Posen, a member of the Bank of England's Monetary Policy Committee (MPC), argues: first, that the UK economy now has large excess capacity; second, the big danger is not a resurgence of inflation, but deflation, as happened in Japan; and, third, there is a substantial risk that prolonged weak demand will make temporary losses in output structural and permanent, via weak investment and long-term unemployment. He stated that: "The damage to our economy, our companies and our workforce can be made permanent through inaction by policymakers."

So what is to be done? Since Mr Posen is a member of the MPC he has to focus on monetary policy measures such as quantitative easing. The most effective policy, however, would be for the government to increase its deficit and have this rise funded by the Bank of England. If one accepts Mr Posen's argument that the economy is likely to suffer from deficient demand in the medium term, a simple option would be to proceed with the spending cuts, but slash taxes temporarily and fund the revenue shortfall by borrowing from the central bank. This would give a direct injection of purchasing power into the economy, promoting employment.

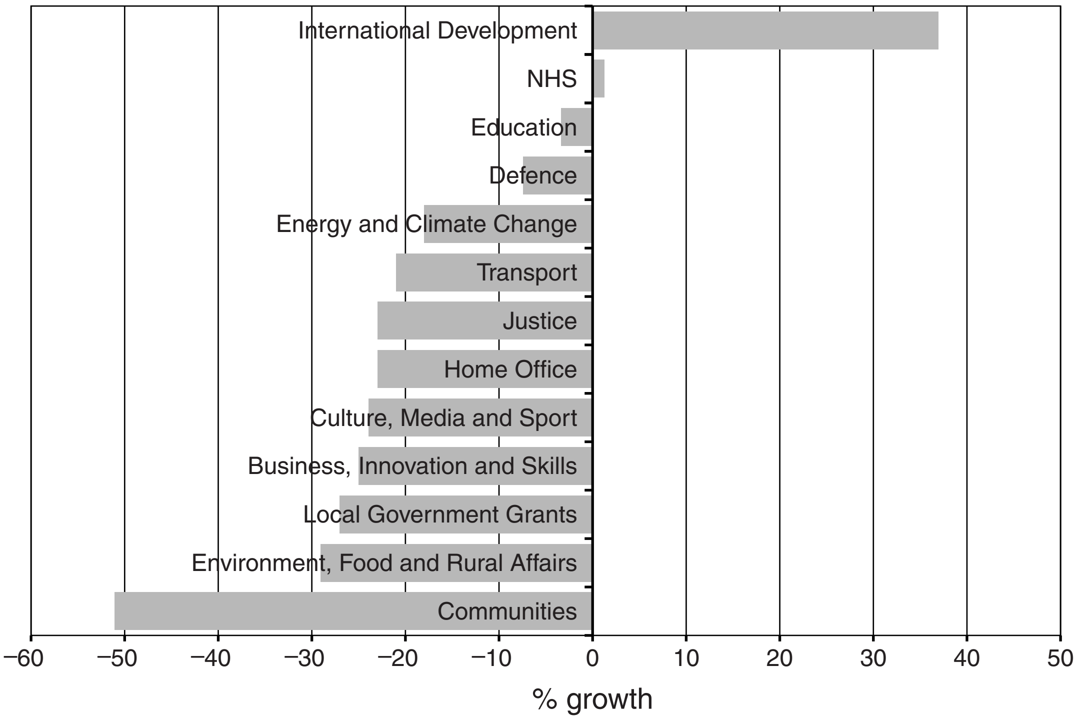
Extract 3

UK Official Development Assistance

Official Development Assistance (ODA) comes in many different forms and represents one of the many financial flows received by developing economies. It can help them overcome some of the constraints on their development.

The UK Comprehensive Spending Review did not involve cuts in spending for all government departments (see Fig. 3.1). Notably, expenditure on international development was planned to increase in real terms from 2010–11 to 2014–15. The Coalition Government sought to increase expenditure on international development in order to meet its commitment to increase UK ODA to 0.7% of GDP by 2013.

Fig. 3.1 Planned real growth in spending by government department 2010–11 to 2014–15



The Department for International Development (DfID) stated that it would use additional expenditure to change the way in which it delivers aid, redirecting funds to projects to combat poverty in developing economies and focus aid where it is needed most. It announced that aid to China and Russia would cease, focusing its efforts on:

- meeting UK commitments to the Millennium Development Goals
- making UK development policy more effective in promoting economic growth in developing economies
- supporting low carbon growth in developing economies
- helping fragile states and countries affected by conflict, particularly Afghanistan and Pakistan.

However, there were no plans to reduce aid to India, the recipient of the largest amount of UK ODA (see Fig. 3.2). UK aid to India has traditionally gone to health and education, climate change and to small industries in Madhya Pradesh, Orissa and Bihar.

Fig. 3.2 Top recipients of UK ODA (2007)

Country	UK ODA (US$m) 2007	GDP per capita (PPP US$) 2007	HDI 2007
India	700	2,753	0.612
Afghanistan	296	1,054	0.352
Nigeria	275	1,969	0.511
Ethiopia	273	779	0.414
Bangladesh	249	1,241	0.543
Tanzania	243	1,208	0.530
Pakistan	229	2,496	0.572
Sudan	203	2,086	0.531
China	201	5,383	0.772

Extract 4

The future of economic growth and development in India

India's GDP per capita may not be as high as China's but its growth rate (currently 8.5% per annum) is predicted to exceed China's by 2013. The reasons for this are to be found in India's supply side advantages. Unlike China, India's workforce is rapidly growing, with the result that it has one of the lowest dependency ratios in the world. By 2020 India's workforce is expected to have increased by 136 million, whereas that in China will have grown by only 23 million. In addition adult literacy rates in 2010, although lower (at 66%) than China's (93%), were rising fast.

The second reason why India's economic growth is likely to outstrip that of China is that there is less state direction of economic activity in India. Since 1991 India has adopted many of the policy prescriptions of the Washington Consensus, including fiscal discipline, wide-scale market liberalisation and privatisation, and trade liberalisation and the encouragement of foreign investment. India has dramatically reduced import tariffs and become more open to international trade. There has been a big surge in exports since India adopted these market-friendly reforms in 1991 with firms such as Arcelor Mittal (the world's largest manufacturer of steel), Tata Motors (owners of Jaguar and Land Rover), Bharti Airtel (a mobile telecommunications firm achieving rapid growth in Africa) and IT services companies such as Infosys, TCS and WIPRO challenging established western multinational companies. Firms supplying the domestic Indian market have responded to international competition by being more innovative. Soon to hit the Indian market is a US$35 laptop developed in partnership with the Indian Institute of Technology and the Indian Institute of Science. Multinational companies, such as Korea's LG, have been attracted by the growing domestic market and have located production in India.

Despite optimism for India's prospects for economic growth and development, there are a number of obstacles which may yet see growth falter and development fail to materialise. These include:

- poor infrastructure – transport infrastructure is notoriously bad; energy supplies are unreliable; and Indian cities are unable to cope with a growing population
- skill shortages – despite growing rates of literacy, a large percentage of the workforce (some estimate up to 40%) remain illiterate; unskilled surplus labour in agriculture coexists with significant shortages of engineers, other graduates and vocationally trained workers
- high rates of malnutrition amongst the under fives – some estimate this to be as high as 50%
- social and political instability – tensions with farmers and local residents created by the expansion of industry, the activities of multinational mining and logging companies and the building of transport infrastructure tend to erupt into violence; and there is little harmonisation between the policies of individual Indian states
- problems in making the best of India's comparative advantage – in particular, foreign companies are less inclined to outsource their activities to India at a time of recession; and other economies have rivalled India's comparative advantage in outsourcing.

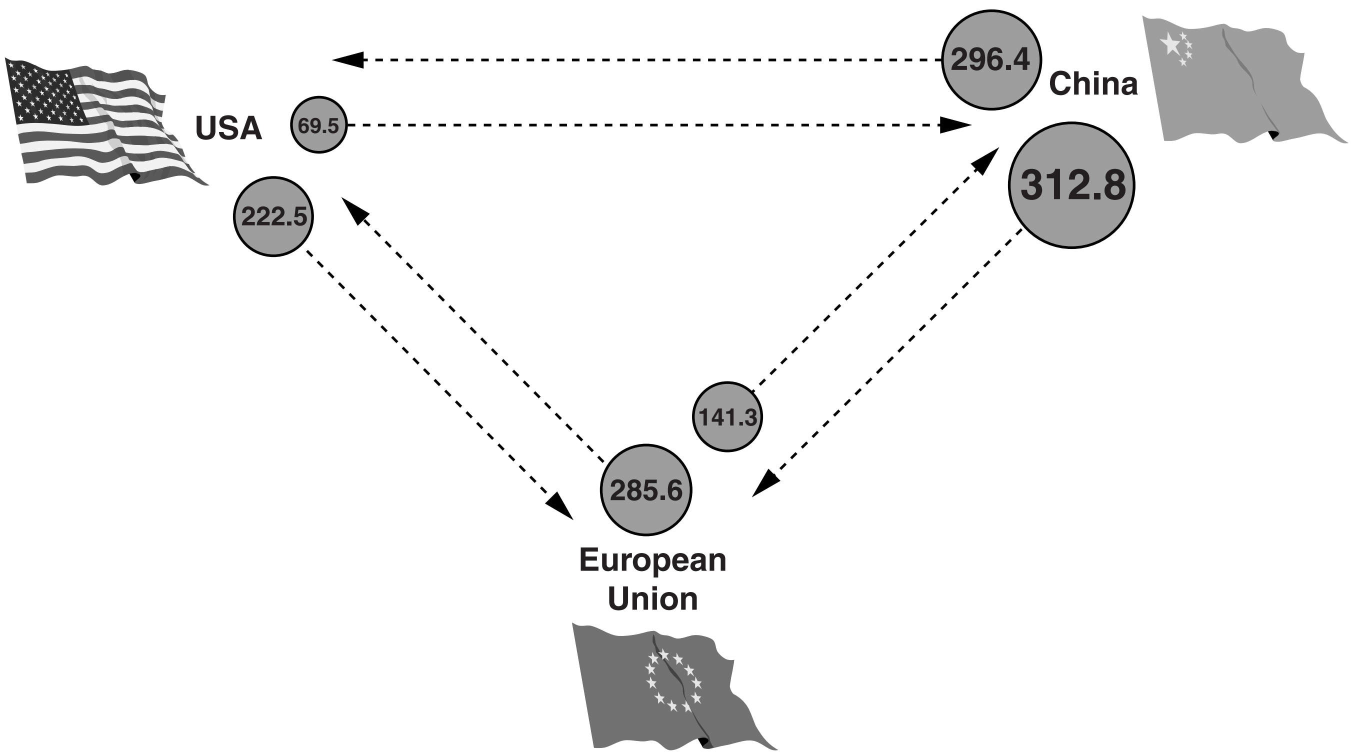
China's state-directed economic growth may yet be challenged by the likes of India, but neither economic growth nor development is guaranteed in India.

Extract 5

Imbalances in the global economy

In addition to high rates of economic growth, one of the features of the Chinese economy over recent years has been its current account surplus with the rest of the world. At the same time the US economy was running large current account deficits year on year. The extent of these imbalances in trade flows can be seen in Fig. 5.1 below. Despite these imbalances on the balance of payments, the exchange rate of the US dollar remained strong and there has not been as much appreciation of the Chinese renminbi (yuan) as might have been predicted by economic theory.

Fig. 5.1 Flows of international trade (US$ billion) 2009



The gross domestic products and the foreign currency reserves of the USA, China and the EU are shown in Fig. 5.2 and Fig. 5.3.

Fig. 5.2 Gross domestic product
in US$ billion (2009)

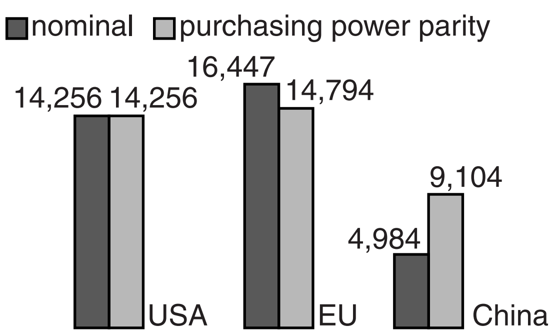
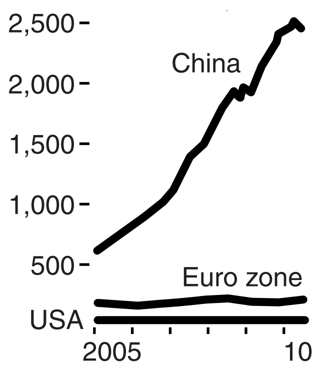


Fig. 5.3 Foreign currency reserves
in US$ billion



The trade imbalances between the US and China are only part of a bigger global picture of imbalances between rich, developed nations and the so-called emerging economies. The world has become divided into ‘deficit countries’ and ‘surplus countries’. Such imbalances were at the heart of fears of a global ‘currency war’ in 2010. In advance of the annual meeting of the IMF and World Bank in October 2010, Brazil’s Finance Minister announced that an ‘international currency war’ had broken out. Subsequently, there was much debate about which countries’ economic policies were most responsible for endangering global economic growth and stability.

The US government accused the Chinese government of deliberately under-valuing its currency by buying foreign currencies, including the US dollar, on the foreign exchange markets. China intervened in the foreign exchange markets by as much as US$1 billion a day from 2005–2010, building up reserves of US$2.5 trillion. According to the US government, the renminbi was undervalued by as much as 20% relative to the economic fundamentals which should determine its exchange rate – China had effectively been subsidising its exports at the cost of US jobs. In 2010, the US House of Representatives passed into law a bill which paved the way for trade sanctions against countries which have ‘a fundamentally undervalued currency’, ‘persistent global current account surpluses’ and very large currency reserves. It was clear that this bill was targeted at China and escalated fears of a trade war between China and the USA.

Emerging economies, on the other hand, argued that in the past the US and other rich developed economies had run large current account deficits by effectively ‘living beyond their means’. High domestic consumption and low savings had created a demand for imports from emerging markets and this was the root cause of global trade and balance of payments imbalances. To resolve these imbalances, emerging economies felt that the USA and other developed nations needed to increase their savings – in other words, reduce their dependence on consumption. Emerging economies feared that loose monetary policy, including quantitative easing in the USA in particular, would cause a depreciation of the US dollar damaging the international competitiveness of emerging economies.

Economists feared that, whatever the causes, these global trade and balance of payments imbalances might endanger the stability of the global economy.