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A2 GCE ECONOMICS

F585/01/SM The Global Economy

STIMULUS MATERIAL

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- This document consists of **16** pages. Any blank pages are indicated.

Introduction

The start of 2016 saw the global economy in a state of flux. Some of the economies that had seen rapid growth for many years in the new millennium were in the process of slow down, for example China. Some were even suffering recession such as Brazil and Russia. On the other hand others, including India, continued along a rapid growth path. In the developed northern hemisphere it was an equally chequered picture with the likes of the USA, and in particular, the UK showing signs of slow but nevertheless consistent growth, averaging around 2.5% annually, while others such as Germany, France and Italy struggled to achieve an average of 1%. Japan, another leading G7 economy was barely able to average 0.5%.

While the short term picture in the UK was rosier than most, the signs were that the recovery being experienced was more a case of short run increased capacity usage rather than long run growth. The lack of inflationary pressure present in the economy, despite employment numbers being at an all-time high, was indicative of such. With the Chancellor still firmly focused on deficit reduction, it was difficult to see where the necessary investment funds would materialise from in order to pay for, for example, infrastructure projects, so necessary for facilitating long run capacity growth.

The globalised economy of 2016 was far more interdependent than in the past. Uncertainty within large and established markets impacted greatly on the economies of emerging and developing countries. One policy option for nations heavily dependent on the sales of basic commodities was to allow their currencies to depreciate on foreign exchange markets. This could potentially provide a boost to exports, and in consequence, a vital injection into sluggish domestic markets. Alternatively, where appropriate, for example in Brazil, the removal of import barriers was seen as a potential option to solve domestic problems. For, despite the very considerable gains made in that country in terms of greater equality and development, it was experiencing the scourge of stagflation.

Another policy option available to less developed nations is to join the increasing bid to attract foreign direct investment (FDI). This is typified by the Cuban example that is the Special Economic Development Zone of Mariel. This multi-million dollar project to establish a giant free trade zone and container port is a flag ship investment to attract foreign capital investment.

Friday 25th of March 2016 saw the Rolling Stones play a free concert in Havana to an audience of half a million locals. This was the first of its kind in Cuba and it followed hot on the heels of President Obama's visit to the island – the first by a US president in almost 90 years. Both events are seen as significant signs of the opening up of one of the world's last remaining command economies. A major step in its transition will be to attract inward capital investment. A major hurdle will be to try and overcome a lack of business confidence amongst foreign companies considering dipping their toes into, historically, such an overtly communist country.

Pre-release stimulus material

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Extract 1

UK in the Vanguard of Recovery, but Chancellor Sounds a Note of Caution

By the end of 2015 it was clear that the UK, in addition to the USA, was in the vanguard of recovery from the recession which began in 2008–9. Economic growth was faster than that achieved by other developed economies, unemployment had fallen significantly and employment had reached the highest level since records began. The fiscal deficit had also been reduced somewhat. However, the pickup in economic activity had not yet exerted any upward pressure on inflation, which remained stubbornly below its target range. Indeed, prices fell during some months of 2015.

The picture for some European countries is summarised in the figure below.

	Real GDP			Consumer Prices			Unemployment		
	2014	2015	2016	2014	2015	2016	2014	2015	2016
UK	2.6	2.6	2.4	1.5	1	1.6	6.3	5.6	5.4
France	0.4	1.0	1.8	0.6	0	1.0	10.3	10.4	10.2
Germany	1.5	1.5	2	0.8	0.1	1.6	5.0	4.9	4.8
Italy	-0.5	0.6	1.3	0.2	-0.3	1.5	12.8	12.8	12.6
Spain	1.4	2.3	2.5	-0.2	-1.0	1.1	24.3	22.5	20.7
Belgium	1	1.1	1.4	0.5	0.1	1.1	8.5	8.3	8.1
Netherlands	0.7	1.4	1.7	0.3	0.4	0.7	6.9	6.6	6.4
Ireland	4.8	3.5	3.6	0.3	0.3	1.3	11.1	9.6	8.8
Romania	3.0	2.7	2.9	1.4	1.2	2.5	7	6.9	6.8
Poland	3.3	3.2	3.4	0.1	-0.2	1.4	9.1	8.8	8.3
Hungary	3.3	2.4	1.9	0	0.8	2.8	7.7	7.4	6.6

Fig. 1.1 Selected European Economies: Real GDP and Consumer Prices (annual percent change) and Unemployment Rate (percent). 2015 and 2016 projected figures

The general view was that there was no room for complacency with regard to UK macroeconomic performance. The Chancellor of the Exchequer at the time, George Osborne, was keen to highlight potential dangers to further economic progress. He stressed concern over external factors, including stuttering recovery in the Eurozone, the market for 50% of UK goods exported, and slower growth in emerging markets.

Other potential risks include business uncertainty arising from a planned referendum on EU membership, which could compound entrepreneurial pessimism. Most surveys suggest that leaving the EU would have a negative impact on UK GDP. While investment has contributed to the growth of domestic demand, business pessimism prevails amongst manufacturers, casting doubt upon the Chancellor's hopes of "a march of the makers".

The government's plans to achieve a budget surplus by 2019–20 seem to leave little room for the use of expansionary fiscal policy should the growth of demand falter, but if circumstances permit,

there is a very strong case for infrastructure investment, especially given long term real interest rates are low.

Monetary policy continues to support growth through the maintenance of a consistently low Bank of England base rate. Mark Carney, Governor of the Bank, has made clear that a rise in interest rates is unlikely until the UK economy moves much closer to the inflation target. At present, cost pressures are low, and moderating global growth is a drag on UK exports. Furthermore, the Governor has argued that the unemployment rate, which fell to 5.1% in November 2015, might mislead us with regard to the amount of slack in the economy; the output gap. In short, a mixture of factors, on both the demand and supply side, are restraining inflationary pressure.

In light of the Chancellor's desire to rapidly reduce the budget deficit, it is as well that the Bank Governor does not anticipate any rise in interest rates in the short run.

Extract 2

Uneven Prospects for Global Growth in 2016

Six years after the global economy emerged from the deepest recession of the post-war era, a return to robust growth across the world remained elusive. Growth in developed economies was expected to pick up slightly in 2016, while activity in emerging markets and developing economies was forecast to slow for the fifth successive year. Emerging markets and developing economies account for a growing share of world trade.

Accurate economic forecasting can prove difficult and there were several reasons to treat 2016 growth forecasts with caution. In some developed economies, including the USA, monetary policy was expected to tighten, whereas elsewhere e.g. in the UK, such changes were on hold. Emerging markets and developing economies were faced with a range of potential problems, including falling commodity prices, currency depreciation, reduced capital inflows and inflationary pressure.

Country by country analysis would reveal the specific issues and challenges each faced, but it is clear that some common forces were relevant to an explanation of the modest pace of recovery. These constraints on growth were medium and long term factors. They included low productivity growth, high levels of debt in both the public and private sectors, low investment, demographic transition and China's attempts to rebalance its economy.

Low investment helped explain limited improvement in labour productivity, although total factor productivity growth had also been slow. An ageing population also discourages investment. Persistently low investment impacts on both aggregate demand and productive capacity. There was the danger that concerns about over-optimistic growth prospects would dampen business confidence leading to a downward spiral of investment, aggregate demand and productive capacity.

The decision of the Chinese leadership to target lower growth rates and focus on the growth of domestic consumption rather than that of exports and investment, has had a particularly negative impact on low income commodity exporters. While the Chinese economy grew particularly rapidly during the 2000s, these LEDCs benefited from improving terms of trade and invested in productive capacity, which further fuelled domestic growth. They now face a period of readjustment during which output gaps will grow.

In a globalised economy, the 2016 growth prospects for developed, emerging and developing economies are interconnected. If growth prospects weaken for developed economies, the demand for commodities supplied by emerging and developing countries will suffer, lowering their exchange rates and so constraining their capacity to import goods and services from developed economies. However, some emerging and developing countries may actually benefit from currency depreciation.

In order to improve growth prospects countries must pursue policies appropriate to their particular needs. Emerging markets need to anticipate the impact of rising interest rates in the USA. Where the state of public finances allow, developed economies can use both monetary and fiscal policy to assist in the closure of output gaps. Investment in infrastructure would yield significant economic benefits.

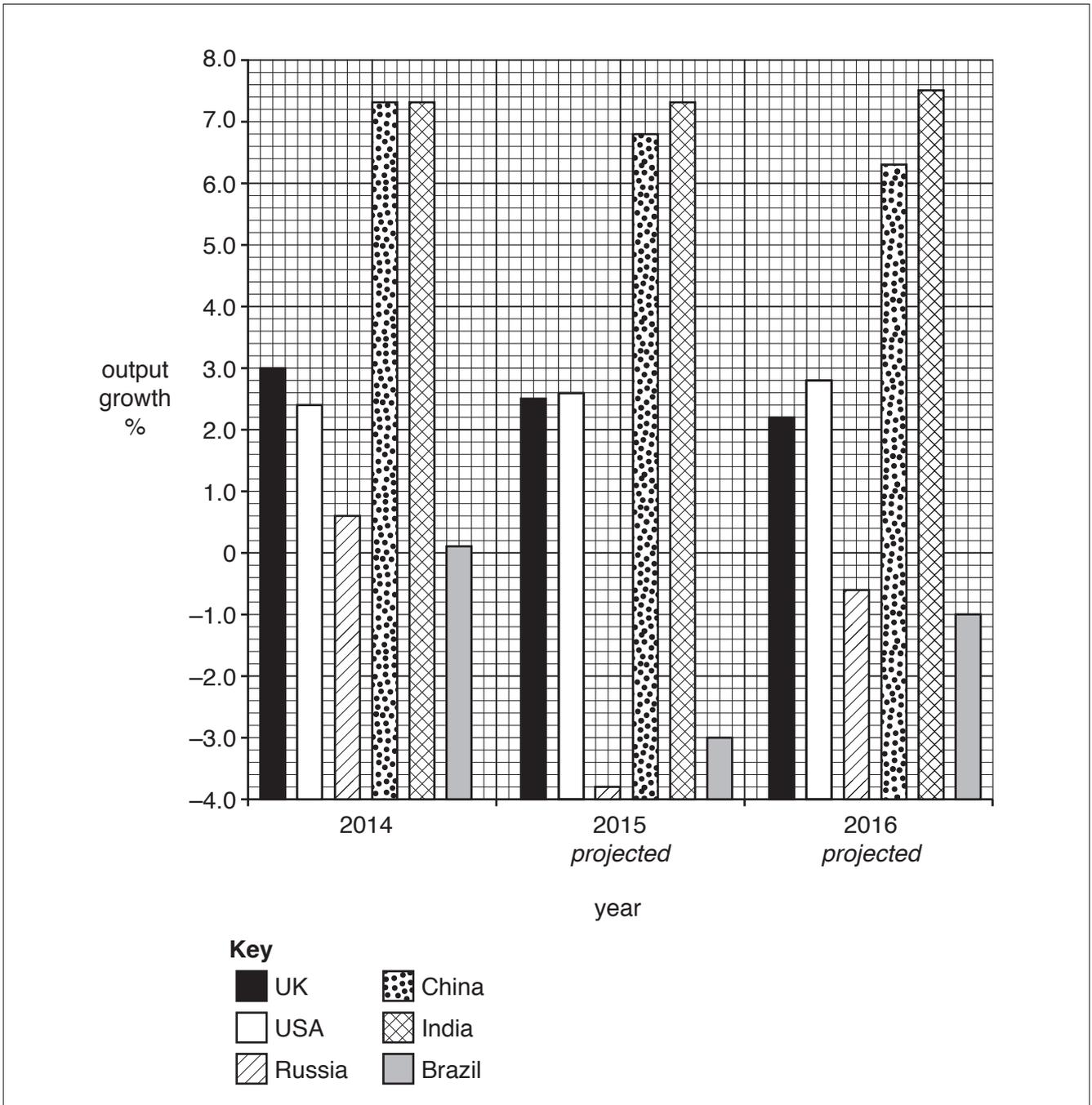


Fig. 2.1 World Economic Outlook: Overview selected world output growth figures.

Extract 3

Brazil

Brazil is both South America's most populous country and largest economy, with a GDP of \$2.4 trillion in 2014. Since the turn of the millennium there have been improvements in a number of development indicators: reductions in poverty, a fall in the Gini co-efficient, improvements in health care provision and a rise in school attendance. However, such progress did not prevent the Brazilian Government from facing serious criticism, both over the need for structural reform and with regard to its current economic crisis.

Between 2000 and 2014, 26 million people were lifted out of poverty and Brazil's HDI score improved from 0.683 to 0.755; the Gini co-efficient fell 6% in 2013 to 0.54. The income of the bottom 40% of the population grew on average 6.1% in real terms between 2002 and 2012, notably faster than the income of the total population. Inequality was gradually being reduced.

Brazil significantly increased educational expenditure from 3.8% of GDP in 2002 to 5.8% in 2010. There was a rise in enrolment across the primary, secondary and university sectors. This significant rise in investment in human capital yielded more modest returns than anticipated. At secondary level, for example, students in both Chile and Mexico achieved higher levels of attainment despite lower levels of public investment. In Brazil, low teachers' salaries led to staff moonlighting and many students dropped-out before the completion of their course.

Other evident weaknesses threaten the achievement of further development gains in Brazil. The Global Competitive Index produced by the World Economic Forum reveals a marked deterioration in Brazil's competitiveness over recent years. In 2012–13 Brazil ranked 48th of 144 countries, but by 2015–16 had sunk to 75th of 140 countries. Particular problems included hiring and firing practices; the effect of taxation on incentives to work and invest; the quality of infrastructure and the burden of government regulation. It can take in excess of 100 days to start a business. It should be no surprise that the informal economy accounted for 16% of GDP in 2014, featuring significantly in the construction and manufacturing sectors. Trade restrictions made matters worse. Brazil is one of the world's most protected economies.

More immediate concerns related to current macroeconomic indicators. At the beginning of 2016, Brazil was experiencing its worst recession in more than a century: GDP fell by around 4% in 2015 and was expected to fall by a further 2.0% in 2016; unemployment was rising and inflation was running at approximately 9%. The fiscal deficit, which was 2% of GDP in 2010, stood at 10% in 2015. Brazil's policy options in the face of stagflation were limited: increasing interest rates to tackle inflation would discourage much needed investment, while cuts in government spending could similarly suppress aggregate demand. One economic commentator remarked that Brazil was "living on the edge" and faced "a period of prolonged adjustment".

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Extract 4

Cuba opens a door to the world

For decades Cuba has operated a planned economy dominated by state-run enterprises; most industries being owned and operated by the government and most of the labour force employed by the state. However, changes are afoot! The exact path remains uncertain, but Cuba's economy is on the move. Bright-eyed capitalists have been thumping the table since President Obama gave the nod to restoring diplomatic relations, an important step to opening up trade links which have been severed since the Communist Revolution that concluded in 1959. This follows a change in economic focus that started in the early years of the new decade when the Communist Party outlined its own tropical perestroika, a forward-looking blend of goals, strategies, and values intended to adapt the island's socialist project to the contemporary global order.

This somewhat remarkable sea change is made evident in the sleepy seaside town of Mariel, northwest Cuba, where a hulking monument to the communist island's evolving economy is rapidly taking shape. It is here that a giant free-trade zone (FTZ) and container port are in the latter stages of construction. The deep-water facility will have an annual capacity of up to one million containers when finished (three times that of Havana's existing port roughly 30 miles away) and 700 meters of berth that it is hoped will host some of the world's largest cargo ships. Partially financed by loans from Brazil and built by Brazilian construction firm, Odebrecht, the port will be operated by Singapore's PSA. The FTZ, meanwhile, aims to attract international companies to Cuba by offering them a low-tax, low-regulation environment in which to manufacture goods.

"What the zone is intended for is to create a special climate where foreign capital is going to have better conditions than in the rest of the country," said Cuba's foreign trade and investment minister, Rodrigo Malmierca Diaz. The \$900 million project mirrors similar developments and FTZs that have sprung up in fast-growing communist nations such as China and Vietnam in recent decades – although experts doubt whether Cuba will follow the same path as the Asian Tigers.

While the ruling Communist Party maintains that state control will take precedence, the ambitious development is the latest in a series of controlled reforms that have been made since Raúl Castro came to power in 2008. The government has already relaxed its control over many sectors, encouraging ordinary Cubans to fill the void with their own private enterprises.

The Special Economic Development Zone of Mariel is a project directed to encourage the nation's sustainable economic development by attracting foreign investment, technological innovation and industrial concentration while at the same time ensuring environmental protection.

It has been conceived as an integral and harmonic whole connected with the rest of the economy. The Zone promotes and protects enterprises, industrial, agricultural, metal-mechanical and tourism projects and all types of activities permitted by Cuban law that use clean technologies and produce added value goods and services based on knowledge and innovation, encouraging the creation of quality employment that intellectually develops human capital within an environment of safety and good professional practices.

The Special Economic Development Zone of Mariel will be a touchstone for technological development in the region, a magnet to attract foreign capital and it will become a place that will provide for the growth of cutting-edge manufacturing and services that are permanently connected to the Cuban economy.

Some of its stated objectives are:

- Attract foreign investment.
- Achieve industrial development that permits generating exports and promotes the replacement of imports.
- Promote the transfer of cutting-edge technology, know-how and managerial skills.
- Generate new sources of employment and long term financing.
- Develop infrastructures and services that provide an efficient business platform, thereby contributing to the success of the investments being established there.

Extract 5

More evidence of a changing Cuba

Unilever and British American Tobacco invest: A new realism in Cuba

The global consumer products company Unilever Plc has just announced a \$35 million investment in Cuba's Special Development Zone at Mariel. Late last year, Brascuba, a joint venture with a Brazilian firm, Souza Cruz, owned by the mega-conglomerate British American Tobacco (BAT), confirmed it would build a \$120 million facility in the same location. Brascuba will be moving its operations from an existing factory to the ZED Mariel site. So far, these are the two biggest investments in the much-trumpeted Cuban effort to attract foreign investment, outside of traditional tourism. However, it reflects a new willingness of Cuban authorities to accede to the corporate requirements of foreign investors. At last the Cuban government appear to grasp that Cuba is a price-taker, and that it must fit into the global strategies of their international business partners. Cuban negotiators can strike smart deals, but they cannot dictate the over-arching rules of the game.

Cuba still has a long way to go before it reaches the officially proclaimed goal of \$2.5 billion in foreign investment inflows per year. Total approvals last year for ZED Mariel reached only some \$200 million, and this year are officially projected to reach about \$400 million. For many potential investors, the business climate remains too uncertain, and the project approval process too opaque and cumbersome. But the Brascuba and Unilever projects are definitely movements in the right direction.

In the design of the new joint venture, Cuba has allowed Unilever a majority 60% stake. Furthermore, in the old joint venture, Unilever executives complained that low salaries, as set by the government, contributed to low labour productivity. In ZED Mariel, worker salaries will be significantly higher: firms like Unilever will continue to pay the same wages to the government employment entity, but the entity's tax will be significantly smaller, leaving a higher take-home pay for the workers. Hiring and firing will remain the domain of the official entity, however, not the joint venture. Similarly, Brascuba will benefit from the new wage regime at Mariel. At its old location, Brascuba considered motivating and retaining talent to be among the firm's key challenges; the higher wages in ZED Mariel will help to attract and retain high-quality labour.

Brascuba believes this is a good time for expansion. Better-paid workers at Mariel will be well motivated, and the expansion of the private sector is putting more money into consumer pockets. The joint venture will close its old facility in downtown Havana, in favour of the new facility at Mariel, sharply expanding production for both the domestic and international markets (primarily, Brazil). A further incentive for investment today is the prospect of the lifting of US economic sanctions, even if the precise timing is impossible to predict. Brascuba estimated that US economic sanctions have raised its costs of doing business by some 20%.

The Unilever and Brascuba renewals suggest a new realism in the country. At ZED Mariel, Cuba is allowing their foreign partners to exert management control, and to hire a higher-paid, better motivated workforce. And thanks to the forward-looking diplomacy of Raúl Castro and Barack Obama, international investors are also looking forward to the eventual lifting of US economic sanctions.

US hotel company Starwood has become the first American firm to agree a deal with the Cuban authorities since the revolution of 1959.

Starwood will renovate and run three hotels in the Cuban capital, Havana. A spokesman for the company said they would be making a “multimillion-dollar investment to bring the hotels up to our standards”. The news comes on the eve of President Obama’s visit to the island – the first by a US president in almost 90 years. The deal is a welcome reminder of how far things have come between the two nations since they decided to normalise ties. Tourism in Cuba is at an all-time high, with a sharp rise in the number of US visitors, especially since travel restrictions were eased by President Obama.

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