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**An Essential Resource for  
OCR A2 GCE ECONOMICS**

**STUDENT COMPANION**  
**for**

**F585**

**THE GLOBAL ECONOMY**

**June 2011**

***Minimising Workloads, Maximising Performance***

**Analysis of each Extract contained in the Stimulus Material  
Essential Questions for Students to Consider  
Mock Examination Paper, Model Answers & Mark Schemes  
Guidelines for Revision & Examination Technique**

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## **INTRODUCTION & APPROACH**

### **INTRODUCTION**

Every effort has been made to ensure accuracy and comprehensiveness of this document. However, as with any business situation, it is impossible to predict the future and, therefore, it is impossible to provide an absolute guarantee that everything has been included and in the format required by the question paper. The document, by its very nature, has only been able to offer suggestions relating to parts of the OCR A2 Economics Specifications. It represents APT's interpretation of the stimulus material and **should be seen as a resource to stimulate further discussion**. In addition, all figures and calculations should still be checked due to the constraint of the short timescale in which this document has to be produced. To conclude, **the overall document is intended as an aid to the teacher who must retain full responsibility for ensuring proper guidance is given to students**. The very act of comparing the ideas and suggestions contained within this work, against those of the reader, will hopefully offer a deeper understanding of the stimulus material.

In this context, it is hoped that this document contributes to the success of all those students who sit the Global Economy Module F585 examination in June 2011.

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### **APPROACH**

The document includes six main sections, as follows:

- Identification of Essential Topic Areas for Revision. This first section identifies the key areas referred to (directly or indirectly) in the stimulus material in relation to topics listed in the examination board specifications which should form the focus for revision.
- Analysis of Each Extract Contained in the Stimulus Material. This section includes detailed analysis of each extract contained in the stimulus material, including interpretation of the data, identification and explanation of underlying theory, and a glossary of essential terms and additional research, as considered appropriate.
- Questions for Students to Consider. This section contains a range of questions relating to each extract contained within the stimulus material, to encourage students to check, develop and consolidate their knowledge and understanding of the economic topics / concepts raised.
- Mock Examination Paper. This section provides a list of examination-style questions to develop students' awareness of the type of questions asked and their ability to demonstrate the knowledge and skills required to secure high grades within a set time limit. (It should, however, be appreciated that the authors of the case study have no inside information on the examination).
- Model Answers and Mark Schemes. This section provides model answers and mark schemes for each question contained on the above mock examination paper.
- Revision & Exam Technique. This section provides guidelines on how to prepare for the examination, and essential tips regarding examination technique.

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**1. IDENTIFICATION OF ESSENTIAL TOPIC AREAS FOR REVISION**

This first section identifies the key areas referred to (indirectly or directly) in the stimulus material in relation to topics listed in the exam board specifications which should form the focus for revision.

Topics in Specification	Application in the Stimulus Material
<b>Aspects of Synoptic Knowledge</b>	
The application of supply and demand analysis.	Not mentioned explicitly but S and D analysis is implicit in all economic analysis.
Market failure.	
Elasticity of demand.	Not mentioned explicitly but elasticity is implicit when prices and incomes change, in all economic analysis.
Economic systems.	The WTO drive for trade liberalisation is a response to the extensive and various ways in which governments intervene in international trade, often for political and short term reasons, at the expense of the world consumer.
S and D analysis of subsidies and indirect taxes.	The impact of tariffs and subsidies on traded goods on price and quantity.
<b>Unit Specific Content</b>	
<b>Macroeconomic performance:</b>	
Recent macroeconomic performance of the UK.	A comparison with UK performance is implicit in the material.
Economic growth in short and long run; deviation from trend growth and output gaps.	Ext 1 (inc. Fig. 1.1), Fig. 2.1 Economic growth (positive and negative).
Causes of economic growth – short-run (changes in aggregate demand, short-run aggregate supply, the interaction of the multiplier and accelerator, the economic cycle); long-run (changes in long-run aggregate supply, quantity and quality of the labour force, capital stock).	Ext 2 Short run and long run growth. Ext 2 & 3 Supply-side problems. Ext 4 The multiplier is implicit in the reference to gains from trade.
Consequences of economic growth – for inflation, employment, unemployment, the balance of payments, the government's fiscal position.	Ext 2 Impact of growth on PIIGS. Ext 3 Short growth leading to inflation in Spain. Ext 3 Unemployment in Spain. Ext 3 Government deficit in Spain. Ext 4 World growth: impact on income, employment, and trade.
Policy issues – role of fiscal, monetary, supply-side policies in promoting economic stability, growth and international competitiveness; and the role of policy rules, targets and constraints, including fiscal rules, inflation targeting and policy trade-offs.	Ext 1, 2, 3 Monetary policy set by ECB. Ext 1, 2, 3 Constraints on fiscal policy. Ext 2 A loose monetary policy. Ext 2 PIIGS need for supply-side policies. Ext 3 Need for supply-side policies in Spain.
<b>Trade and Integration:</b>	
Absolute and comparative advantage.	Implicit in all analyses of international trade. Ext 2 & 3 Competitiveness, or its absence.
Specialisation and gains from trade.	Ext 2 loss of competitiveness in Single Market. Ext 4 Gains from trade. Trade as an engine of growth.
Terms of trade.	

<p>The pattern of global trade.</p> <p>Alternate exchange rate systems.</p> <p>Purchasing power parity.</p> <p>Exchange rate fluctuations.</p> <p>Causes and consequences of balance of payments problems.</p> <p>Policies to correct imbalances.</p> <p>Stages of economic integration: free trade areas, customs unions, single markets, economic unions, monetary unions.</p> <p>Impact of economic integration: short run – trade creation &amp; diversion; long-run – dynamic effects.</p>	<p>Ext 4 Global trade in the context of world recession; Difficulties of the Doha Round.</p> <p>Ext 1, 2, 3 EMU.</p> <p>PPP is essential for international comparison.</p> <p>PPP theory links inflation and exchange rates.</p> <p>Ext 1, 2, 3 Common monetary policy; The removal of exchange rate fluctuations aggravates problems for PIIGS.</p> <p>Ext 2 &amp; 3 The need for supply-side responses. Constraints on macroeconomic policy is the basis of the problems in Ext 1, 2, 3.</p> <p>The early stages of economic integration are implicitly required; Ext 1, 2, 3 EMU, implications of incomplete economic integration</p> <p>Trade creation v trade diversion is key to understanding the benefits of economic integration.</p>
<p><b>Development and Sustainability:</b></p> <p>Meaning and measurement of development: the relationship between growth and development, GDP per capita, HDI (Human Development Index), economies at different stages of development, common and diverse characteristics.</p> <p>Policies to promote economic development; the role of the market and the state, and international trade.</p> <p>The constraints of development: resource endowment, infrastructure, institutions, finance and savings, and international.</p> <p>The meaning of sustainability; the social, environmental, resource and demographic impacts of growth.</p> <p>The measurement of sustainability; limitations of economic indicators such as GDP, and adjusted economic indicators such as the Index of Sustainable Economic Welfare (ISEW).</p> <p>National and regional policies and international agreements to promote sustainability.</p>	<p>The relationship between poverty reduction and human development, both mentioned in the Introduction but not in the extracts. This indicates a question which takes a critical look at the gains from trade.</p> <p>Ext 4 Trade as the engine of growth and development.</p>
<p><b>The Economics of Globalisation:</b></p> <p>The Characteristics and consequences of globalisation.</p> <p>International financial flows (private, official, short-term and long-term flows).</p> <p>Nature and impact of multinational firms. Foreign Direct Investment (FDI).</p>	<p>Ext 1-4 Global economic crisis.</p> <p>Ext 2 &amp; 3 FDI in PIIGS.</p>

The role and impact of international financial institutions (WTO, IMF and World Bank).	Ext 4 WHO; Ext 3 IMF report on Spanish economy; IMF have also participated in the Greek and Irish “rescues”, although their involvement is not mentioned in these contexts.
International trade negotiations and trade disputes.	Ext 4 Doha Round – the benefits and problems of securing agreement. Dispute between developed and developing countries, especially over trade in agricultural products.

### Examination Advice

The specification for this unit includes both synoptic knowledge that you would have encountered in the previous AS and A2 units and unit specific material. To analyse the issues contained in the stimulus material it is essential to apply the unit specific material relating to recession, macroeconomic policy, economic integration, monetary union and international trade with analysis developed in the previous units, especially in relation to government supply and demand in agricultural markets and price volatility.

Always remember that the pre-released material might provide us with clues as to the likely questions, but examiners are quite capable of asking unexpected questions based on the stimulus material, or of asking expected questions in an unexpected way. Therefore, use the table above to influence your revision, but do not ignore related topics which might also crop up in the examination.

One significant feature of the stimulus material is that there is no reference to the UK. This is because Extracts 1 to 3 focus on the euro area and the UK chose not to join the euro area. But, this **does not** mean that you cannot refer to the UK in your examination answers. In fact, it should be possible to make a comparison or contrast with the euro area countries. When countries joined the euro area they relinquished their national monetary policy and abandoned the exchange rate as a policy weapon. Moreover, there are considerable constraints on the fiscal policy of euro area countries. The UK experienced a recession similar to that referred to in Extracts 1 to 3, but unlike the euro area countries, we have retained some discretion over fiscal and monetary policy and we still have the ability to solve problems by means of exchange rate adjustment. However, bear in mind that although the UK chooses not to adopt the euro, it is to some extent affected by decisions made by euro members.

Extract 4 concerns the benefits of trade and the desirability of a new WTO trade deal. This obviously concerns the UK as a trading nation and a member of the EU, and therefore this particular extract is not confined to euro area countries, or indeed to EU members.

One feature of the stimulus material that should be pointed out is that there is a statement in the final sentence of the Introduction (on page 2), which is not mentioned in any one of the extracts. This is the reference to trade not guaranteeing poverty reduction and human development. Even though it is not mentioned in any extract, **do not** ignore this statement, since it suggests the possibility of a different slant to a possible question on trade.

## 2. COMMENTARY ON THE STIMULUS MATERIAL

### The Introduction (page 2)

The theme for June 2011's paper 4 is recession in the euro area economies. Notice that the UK does not feature in the extracts for the simple reason that, although the UK is a member of European Union, it has not adopted the euro as its currency and therefore is not part of the euro area. Nevertheless, an implicit comparison with the UK's experience is needed, since the theme of Extract 1 is the lack of convergence within the euro area and this was the main, rational economic reason why Britain did not join its EU partners in the single currency.

It is important to read and absorb the introduction to the four extracts contained on page 2 of the pre-released material. The introduction provides a steer to the most important issues in each of the extracts and, at the same time, provides a unifying element to the stimulus material. We can see how the material presented to us starts with the Eurozone as a whole, before first focusing on the four countries that have been grouped together with the unflattering name of the PIIGS, and then focusing on just one of them – namely Spain. In the final extract we move from a focus on internal matters to trade and economic relations with the wider world, especially the developing world.

Each of the paragraphs in the Introduction links to the four extracts.




#### Paragraph 1 / Extract 1:

In this paragraph we are informed that all the countries of the euro area experienced negative growth at some point during the years 2008 and 2009. You will be aware that the official definition of a recession is a period of two consecutive quarters of negative growth. This definition will be important when studying the Figure 1.1, which is part of Extract 1. Although each of the euro area countries did experience negative growth (and all but one, recession) at some point during the two years, the timing, duration and severity of the recession varied from country to country. We will see this more clearly when we analyse Figure 1.1.

We have to ask ourselves why it matters that the timing, duration and severity of the recession varied from country to country. The reason why it is important is that it demonstrates a lack of convergence of economic forces, and therefore the economic cycle, within the Eurozone. As you should know, a feature of a monetary union is not only a single currency but also a single, common monetary policy. Therefore, interest rate policy set for the Eurozone as a whole might be inappropriate for one or more countries.

#### Paragraph 2 / Extract 2:



In this paragraph we are informed that lack of convergence of the economic cycles raises concerns about the sustainability of monetary union in the EU. It should be pointed out that it was a significant economic issue that contributed to Britain deciding to remain outside the euro area. Five countries in particular suffered as a result of the uncompetitiveness of their economies. These are the so called PIIGS (Portugal, Ireland, Italy, Greece and Spain). The problem they face is that because of membership of the euro area:

-  Monetary policy is set by the European Central Bank, rather than nationally.
-  Fiscal policy is constrained by the rules on budget deficits.
-  Exchange rate adjustment, (which in other circumstances provides a solution to uncompetitiveness), is not available to countries that have abandoned their own currencies in favour of the single currency.

Unless the PIIGS tackle their lack of competitiveness, then it is doubtful whether they can remain (or even want to remain) in the euro area. It is worth remembering that the crisis in the Greek economy came to a head one year ago, whereas the crisis in Ireland occurred in the winter of 2010 / 2011 leading up to the Irish General Election of February 2011, which led to a crushing defeat of the ruling party. At the time of writing, there are also serious concerns about the prospects for the Portuguese economy.

**Paragraph 3 / Extract 3:**

In this paragraph and its accompanying extract, we focus on the plight of the PIIGS, and Spain in particular. We learn that, in the early years of the decade, three of the PIIGS enjoyed relatively high rates of economic growth, which resulted from inward foreign investment and negative real rates of interest. Interest rates are set for the euro area as a whole by the European Central Bank. The rapidly growing PIIGS economies derived short term benefit from rates of interest which fell below the inflation rate, resulting in negative rates in real terms (that is, after inflation has been deducted). However, short term benefit created long term problems in the form of declining competitiveness. We know that one price of euro area membership is the relinquishing of the exchange rate as a policy weapon. Fiscal stimulation in the form of a budget deficit was not an option for the PIIGS because:

-  They were already running a high and unsustainable budget deficit and, in some cases, overall debt.
-  Membership of the single currency area involves a constraint over fiscal policy in the form of the Stability and Growth Pact.





**Paragraph 4 / Extract 4:**

After a narrow focus on first the euro area as a whole, then on the PIIGS and on Spain, the final part of the stimulus material moves to the global economy. You should be aware of the significant mistake made by the major economies during the Depression of the 1930s, namely the tendency to resort to protection in the form of import controls by trying to solve national problems through “beggar my neighbour” policies which makes beggars of us all. Instead of resorting to protectionism, Pascal Lamy of the World Trade Organisation (WTO) advocates renewed efforts to reduce trade barriers across the world. These comments from the WTO Director General are hardly surprising since the job of the WTO is to work towards a reduction in trade barriers. However, the final sentence on page 2 points us in the direction of the case for and against trade liberalisation. Classical economic theory points to the advantages of free trade in terms of increased trade, output and income, but we are told that trade liberalisation on its own is not a guarantee of human development and poverty reduction. This begs the questions - what is human development? and why is there no guarantee that the benefits of increased trade will reduce poverty and bring about human development? Also, what other economic features are pre-requisites for human development and the reduction of poverty?























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

**Historical Background**

The development of the European Union conforms to the model of stages of economic integration:



-  Free Trade Area.
-  Customs Union.
-  Single Market.
-  Economic and Monetary Union (EMU).

The timetable for EMU was included in the Treaty on European Union (also known as the Maastricht Treaty), which was signed in 1991. The then 12 members of the EU agreed to proceed with monetary union to take forward the idea of a Single European Market, in the belief that a single market required a single currency, for the full benefits of such a market to be exploited. There was considerable opposition to the adoption of a single currency in the UK. Some of the UK opposition to a single currency was irrational and based on sentiment (eg fear that the monarch's head would not be on euro coins and notes). Some of the opposition was based on the grounds that EMU would mean that we would relinquish political sovereignty over monetary policy, and there were others who accepted the substantial benefits of a single currency but felt that lack of convergence between the UK and the rest of the EU would present difficulties for the British economy. It was for these reasons that the UK (along with Denmark and Sweden) did not join its EU partners in EMU. Before looking at the extract it would be advisable to revise the benefits and costs of the adoption of a single currency.






Benefits of a Single Currency	Costs or Disadvantages of a Single Currency
<ul style="list-style-type: none"> <li> Reduction in transaction costs.</li> <li> Elimination of exchange rate risks and uncertainty.</li> <li> Enlarged market.</li> <li> Expansion of intra-euro area trade.</li> <li> Increased volume of sales.</li> <li> Further economies of scale.</li> <li> Rise in competition and competitiveness.</li> <li> Lower costs.</li> <li> Higher productivity.</li> <li> Increased growth, employment and, therefore, income.</li> <li> Improvement in the supply-side.</li> <li> An end to competitive devaluation.</li> <li> More inward foreign investment.</li> <li> Lower real rates of interest.</li> <li> Greater price transparency.</li> </ul>	<ul style="list-style-type: none"> <li> Loss of sovereignty over monetary policy.</li> <li> The problem of "one size fits all" monetary policy.</li> <li> Devaluation of national currency is no longer available as a policy weapon, to easily maintain competitiveness.</li> <li> Stability and Growth Pact constrains fiscal policy.</li> </ul> <p>The cost of membership is greatest where:</p> <ul style="list-style-type: none"> <li> there is a lack of economic convergence.</li> <li> countries suffer differently from asymmetric shocks.</li> <li> there is lack of flexibility and mobility in factor markets.</li> </ul> <p>Underlying this is a concern that the euro area is not an optimal currency area.</p>

The concept of convergence goes to the heart of the debate on the single currency and it is the background to Extract 1. So, what do we mean by convergence, how is it measured and what are the causes and consequences of lack of convergence?

**Economic convergence** can be defined as the process by which the economies of different countries become similar, and respond in a similar way to economic stimuli. Convergence takes two forms:




-  Monetary convergence, which means similarities in inflation and interest rates.
-  Real convergence, which means similarities in the structure of economies.

Here we are concerned with monetary convergence which was seen as a prerequisite for EMU and the single currency. Unless all the EMU members had similar levels of economic activity, rates of inflation and interest rates, the adoption of the euro would cause major economic upheavals. Concern over the degree of convergence led to the laying of specific conditions for EMU entry. These conditions are known as the **convergence criteria**:

-  Consumer price inflation not higher than 1.5% above that of the three best performing countries in the Union.
-  Interest rates on long term government bonds not more than 2% higher than those in the three lowest-inflation states.
-  Government deficit to be at or below 3% of GDP.
-  Total government debt at or below 60% of GDP.
-  The exchange rate to have been fairly stable in the previous two years.

The Maastricht Convergence Criteria were to be strictly applied as the test of suitability for membership of the euro area, but at the time of assessing suitability for membership, there was some fudging of the criteria. Some countries failed to satisfy all the criteria but were still allowed to join, for political reasons. For instance, Greece failed the criteria at the first assessment but was allowed to join the euro area within a year or so of the creation of EMU. Ironically, at the time of the creation of the euro area, the UK satisfied the criteria better than most countries but had chosen not to join.

The concerns expressed about the lack of convergence suggest that the euro area is not an **optimal currency area**. This is a concept, which although not mentioned in the extracts, underpins the analysis of a single currency. An optimal currency area is one which meets the conditions to avoid the costs of monetary union. These conditions include:

-  A high degree of labour market flexibility.
-  Mechanisms for fiscal transfers.
-  The absence of external shocks that impact differently on different countries (so called asymmetric shocks).

These conditions will help smooth out differences in economic performance that arise from the loss of monetary policy sovereignty. If the euro area is not an optimal currency area, then it is not surprising that the shock created by the global downturn created acute problems for certain countries within the euro area. The concept of optimal currency area (or its absence) also provided a strong rationale for the UK's refusal to join – ie monetary union was desirable, but as the UK was in many ways different from other EU countries, then membership would cause acute problems for the UK.

This historical and theoretical background to the convergence criteria is important because convergence (or the lack of it, even among some major members) is the background to Extracts 1, 2 and 3. The severe recession of 2008 / 9 was the first major test of the euro area, and led to fears that the crisis caused in the weaker euro area economies would lay bare the fundamental differences among many euro economies, and would tear the euro area apart. It also led many people in Britain to be thankful that the UK chose not to join the single currency.

Let us now interpret the information in Extract 1.


## Introduction to Extract 1

Extract 1 deals with the performance of euro area currencies during the recession of 2008-9 and its status as a major world currency. The first two paragraphs set the scene for what is the key third paragraph, which is really a commentary on the data shown in Figure 1.1. The final paragraph of the extract deals with the implications of the phenomenon revealed in the previous paragraph – namely the lack of convergence of the euro area economies.

## The Rise of the Euro (Paragraph 1)





In this opening paragraph we are reminded that EU monetary union - in the form of a single, common currency - dates back to 1999. At this date 11 members of the then EU 15 adopted the single currency whilst Greece joined one year later. Even at the time of Greece's admission to the euro area there was concern expressed about the preparedness of Greece for euro area membership, and the lack of sufficient convergence between the Greek and the euro area economies. For a variety of reasons the UK and 2 other EU member states declined to adopt the Euro.

Since the admission of Greece to the euro area, 12 additional states have joined the EU, although only 4 have adopted monetary union to date. The most recent member states adopting EMU are:

-  Cyprus, Malta, Slovakia and Slovenia. (Be careful not to confuse Slovakia with Slovenia. The former is the Slovak half of the former Czechoslovakia. The latter was formerly part of Yugoslavia and it borders Austria and Croatia).

This means that the majority of the 12 Eastern and South-Eastern European states that joined the EU27 in 2005 and 2007 remain, like the UK, members of the EU but outside the euro area. It should be emphasised that Extract 1 concerns only those EU states that have adopted the euro, and it is tempting to argue that euro members relinquished important macroeconomic policy weapons, which might have alleviated some of their later problems.

The rest of the first paragraph concerns the success of the euro in the international financial system. We are told that:

-  It did not become the soft currency that sceptics feared it would become. A soft currency is defined as a currency which is either not convertible and / or is not widely accepted in payment elsewhere. This means that the euro is a hard currency – ie easily convertible and widely accepted.
-  It is the world's second largest reserve currency after the US\$. A reserve currency is defined as one which countries use as a foreign exchange currency.
-  It is the second most popular (meaning second most used) currency for international transactions, again after the US\$.
-  The euro area economy is the second largest in the world (after the USA), based on Gross Domestic Product at purchasing power parity. You should be aware that a major problem with international comparisons of GDP is that it is affected by the choice of exchange rate used. GDP at PPP uses an exchange rate which is adjusted to take account of price levels in different countries. This gives a more valid comparison since, at PPP, \$1000, for example, would buy the same as its euro equivalent.

### Fluctuations in Economic Activity (Paragraph 2)

In this paragraph we are reminded that the euro area is affected by fluctuations in the rest of the world. This is because the euro area is not a closed economy. Therefore, even though much (if not most) international trade of euro area countries is intra-euro area trade, the 16 members of the euro area do trade with the rest of the world, including the UK and other members of non-euro area members of the EU.

Trading with countries outside the euro area makes the euro area states vulnerable to economic fluctuations that are generated outside the euro area. Moreover, there is imperfect convergence between the euro area economies and this means that the fluctuations in the different euro area economies will vary, both in terms of timing and severity. In the UK, the key macroeconomic policy is interest rates and this is the same within the euro area. But there is one essential difference – in Britain, the UK central bank (ie the Bank of England) sets interest rates, whereas in the euro area they are set by the European Central Bank (ECB).






The ECB sets rates for the euro area as a whole, but the rates set might not be appropriate for a particular country. In simple terms, suppose the problem in the euro area as a whole was overheating leading to inflation, but that specific countries in the euro area were suffering from a downturn in the economic cycle. The high interest rate rises designed to reduce inflationary pressure will aggravate the downturn in the minority of countries experiencing a downturn. These countries require low interest rates to stimulate investment.

### The Degree of Convergence (Paragraph 3)


























This paragraph is a commentary on the data provided in Figure 1.1 and, therefore, should be read with this figure in mind.

Figure 1.1 concerns growth in 15 of the 16 euro area countries and in the euro area as a whole. (No data is provided for Malta, which has a small population and economy and, in terms of its economy, is equivalent to a medium sized city in the UK). Although it is not stated (except in relation to the final column), we can assume that each of the figures in the columns for eight quarters refers to percentage rise or fall in real GDP. The use of the adjective 'real' means that the figures (from which percentage were calculated) were adjusted for inflation.

The commentary in paragraph three is useful in highlighting the different experiences of the onset of negative growth. The euro area as a whole started to experience negative growth in 2008 Q2 but:

-  Only five of the countries listed showed negative growth in Q2 (Ireland, Luxembourg, Germany, Italy and France). These countries, which include the three largest economies in the euro area, led the downturn.
-  Only nine of the countries listed showed negative growth in Q3 (Luxembourg, Germany, Italy, Netherlands, Spain, Austria, Portugal, Belgium, and France).
-  Only 13 of the countries listed showed negative growth in Q4. This left Slovakia and Cyprus continuing to enjoy slow, but still positive growth.
-  The downturn did not engulf all 15 countries listed until 2009 Q1.
-  Thus, for the last three quarters of 2008 some countries had positive growth (albeit small), even though the euro area as a whole recorded negative growth.

The official definition of recession is two consecutive quarters of negative growth and this means that the euro area as a whole was declared to be in recession in the third quarter of 2008. Negative growth started in the second quarter but, in terms of the official definition, we can say that the euro area was pronounced to be in recession in the third quarter. At this point it would be useful to revise our understanding of a recession.

Characteristics of a Recession	Possible Government Action
<ul style="list-style-type: none"> <li> Fall in aggregate demand.</li> <li> Fall in real GDP ie negative output growth.</li> <li> A fall in consumer confidence.</li> <li> Decline in business confidence.</li> <li> Decline in factor cost pressure.</li> <li> Fall in investment.</li> <li> Fall in profits.</li> <li> Fall in capacity utilisation.</li> <li> Short time working.</li> <li> Reduction in inflationary pressure.</li> <li> Rise in unemployment, although after a time lag.</li> <li> Fall in tax receipts.</li> <li> Fall in imports.</li> <li> Rise in government spending on welfare.</li> <li> Rise in government borrowing.</li> <li> Rise in business failure.</li> <li> Destocking.</li> </ul>	<ul style="list-style-type: none"> <li> Tax reductions to stimulate demand.</li> <li> Increased government spending.</li> <li> Reduction in interest rates.</li> <li> Devaluation / depreciation.</li> <li> Quantitative easing.</li> </ul> <p><b>But, remember, for euro area countries:</b></p> <ul style="list-style-type: none"> <li> Monetary policy is in the hands of the European Central Bank.</li> <li> Fiscal policy is constrained by the Stability and Growth Pact.</li> <li> There is no national currency to devalue.</li> </ul>

The euro area as a whole emerged from the downturn in the third quarter of 2009 when positive growth was resumed. However you should notice that in the second half of 2009 growth was at best fragile with Q4 being lower than that of Q3. This raised the prospect of the euro area being plunged into a second period of recession in what has become known as a double dip recession.




Just as there were differences leading and lagging into the recession, so there were differences in the time of emergence from the downturn. For the euro area as a whole, we can say that recovery started very tentatively in 2009 Q3, but again some countries led the way and others followed. Slovenia, Slovakia, Portugal, France and, crucially, Germany (which had already emerged from the downturn in 2009 Q2) led the way, whereas the figures do not show recovery at all in Spain, Cyprus and Greece. Even where there was positive growth, it was only very slight with, therefore, the distinct prospect of being plunged back into a double dip recession. Notice that in the Netherlands, Austria, and the euro area as a whole, positive growth was lower in 2009 Q4 than it was in 2009 Q3. In the case of Italy, Q4 was a period of renewed negative growth and, even more worrying, was the fact that in Germany 0.7% growth in Q3 was followed by stagnation in Q4.

The right hand column of the figure refers to the severity of the recession. The % figure shows the fall in (real) GDP from the peak of the previous boom to the trough or lowest point in the recession. Notice that the countries are ranked in terms of severity of the recession with Ireland suffering the most severe recession and Greece (surprisingly, given the subsequent crisis in the country) suffering the least.

However, it is important to realise that the figure refers to the gap between the high point in the previous boom and the lowest point in the recession. Therefore, if Ireland had previously experienced an intense boom, whereas Greece had only experienced a mild boom, then the fall would have been greater in the case of Ireland and smaller in the case of Greece.

Once again, notice that Germany, the powerhouse of the EU, experienced a more severe contraction than the euro area as a whole. The importance of Germany in EU trade inevitably drags down the euro area average, as well as contributing to recession in the countries that rely heavily on exports to Germany.

From the figure we can draw conclusions about:

-  The timing of recession in each country.
-  The duration of recession in each country.
-  The severity of the recession in each country.

This is summarised in the table below:

Area	Start of downturn (i)	Start of recovery (ii)	Duration in quarters (iii)	Comment
Ireland	08Q1	09Q3	5 out of 6	Severe recession.
Slovenia	08Q4	09Q2	2	Short but intense recession.
Finland	08Q4	09Q3	3	Relatively short but intense recession.
Luxembourg	08Q2	09Q3	5	Long and, at times, severe recession.
Slovakia	09Q1	09Q2	1	Very short but intense downturn in 09Q1.
Germany	08Q2	09Q2	4	The length and severity of Germany's recession contributed to the recession elsewhere in the euro area.
Italy	08Q2	09Q3	5	09Q4 saw a return to negative growth suggesting a double dip recession.
Netherlands	08Q3	09Q3	4	Went into recession slightly later and severity was roughly in line with the euro area average.
Euro area	08Q2	09Q3	5	This should be seen as the benchmark for other countries.
Spain	08Q3	NONE	6	The figures suggest that the recession was less intense than the euro area average, but Spain did not show signs of recovery
Austria	08Q3	09Q3	4	Slightly shorter duration than the average and slightly less intense.
Portugal	08Q3	09Q2	3	Surprisingly shorter and less severe than the average.
Belgium	08Q3	09Q3	4	Slightly shorter duration than the average but less severe.
France	08Q2	09Q2	4	The French recession was relatively mild.
Cyprus	09Q1	NONE	4	Mild recession which started later, but no evidence that it is over.
Greece	08Q4	NONE	At least 4	The figures suggest a mild recession which started later, but Greece was slower to recover from recession.

Notes:





- i. The first quarter of negative growth – It should be remembered that the recession is not “official” until the second quarter of negative growth.
- ii. The first quarter of positive growth after the recession.
- iii. The number of consecutive quarters of negative growth.
- iv. There has been some concern expressed about the accuracy of Greek National Accounting standards, so this recession may have been more prolonged and severe than it seems.

## Causes of Divergence (Paragraph 4)

### Overview




We have seen a lack of perfect convergence between the 15 member states of the euro area listed in Figure 1.1. Although they all experienced negative growth at times over the two years, there were differences in the time at which they started to experience negative growth and the timing of the recovery from negative growth. This means that there were differences in the timing of recession in the countries, and just as important differences in the severity of the recession.

This final paragraph of the extract suggests reasons for the differences between member states over the timing and severity of the downturn. The reasons are differences in:



-  Fiscal response to the downturn.
-  Openness to international trade.
-  Structure of the economies.
-  Competitiveness.

### Fiscal Response to the Downturn

We know that a downturn in the economy impacts on government finances in a variety of ways:

-  Tax revenue falls since factor income and expenditure falls as a result of a downturn.
-  Government spending on welfare rises as more people claim benefit.
-  There is an increasing risk of a government deficit which must be filled by government borrowing.

The passage refers to differences in the fiscal response to the downturn and this suggests that euro area members differed in terms of the speed and willingness to cut the deficit that inevitably results from a downturn. You should be aware that member states of the euro area signed up to a Stability and Growth Pact which requires them to abide by the following rules:

-  A budget deficit of no more than 3% of GDP.
-  A government deficit of no more than 60% of GDP.

Despite the Stability and Growth Pact many of the countries of the euro area exceeded the limit on both the government deficit and public sector debt. This is shown in the following evidence from Eurostat.

#### **Euro area and EU27 government deficit at 6.3% and 6.8% of GDP respectively**





In 2009, the government deficit and government debt of both the euro area (EA16) and the EU27 increased compared with 2008, while GDP fell. In the euro area the government deficit to GDP ratio increased from 2.0% in 2008 to 6.3% in 2009, and in the EU27 from 2.3% to 6.8%. In the euro area the government debt to GDP ratio increased from 69.4% at the end of 2008 to 78.7% at the end of 2009, and in the EU27 from 61.6% to 73.6%.

In 2009, the largest deficits in percentage of GDP were recorded by Ireland (-14.3%), Greece (-13.6%), Spain (-11.2%), Portugal (-9.4%), Latvia (-9.0%), Lithuania (-8.9%), Romania (-8.3%), France (-7.5%) and Poland (-7.1%). No member state registered a government surplus in 2009. The lowest deficits were recorded by Sweden (-0.5%), Luxembourg (-0.7%) and Estonia (-1.7%). For comparison, the UK deficit to GDP ratio was -11.5%.

The government debt to GDP ratio exceeded the 60% laid down in the Stability and Growth Pact in many EA16 countries. The debt ratio in Italy was 115.8%, Greece 115.1%, Belgium 96.7%, France 77.6%, Germany 73.2%, Malta 69.1%, Austria 66.5%, Ireland 64%, and the Netherlands 60.9%. For comparison, the UK debt to GDP ratio was 68.1%.

Source: [http://epp.eurostat.ec.europa.eu/cache/ITY\\_PUBLIC/2-22042010-BP/EN/2-22042010-BP-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22042010-BP/EN/2-22042010-BP-EN.PDF).  
For any up to date statistics on the EU go to Eurostat.

This data shows that:

-  The euro area as a whole did not comply with the requirements of the Stability and Growth Pact.
-  Many individual member states exceeded the limits set out in the Pact.
-  Non-compliance was not confined to countries on the edge of the EU, but applied to the two countries that have always been seen at the heart of the EU – Germany and France.
-  The degree of non-compliance varied from country to country.

A further illustration of the failure to comply with the Pact comes from the Economist's "World in 2011" which says of Ireland: *"Bank rescues and fiscal stimulus pushed the budget deficit towards 27% of GDP in 2010, Europe's biggest. If things go well, that could be almost halved in 2011. If not, Ireland may need a rescue of its own"*. In fact, a bailout package was needed for Ireland following that provided for Greece.

We have seen that the many countries of the euro area flouted their rules on deficit and debt. Those countries continued to run a high deficit during the recession and this gave their economies a fiscal boost, whereas countries that adopted a more restrictive fiscal stance depressed their own economies. The extract suggests that this was a factor in the variations in the timing and severity of downturns in the various euro area economies.

### Openness of the Economy

We need to understand what is meant by openness of the economy. We can think of an open economy which trades freely with other countries, but as the EU is a customs union (free trade area with a common external trade policy and common external tariff), then the EU is an open economy and the member states are equally open. However, openness here refers to relative importance of international trade in a country's economy. The UK is an open economy in that exports account for a high percentage of GDP. In this respect, the UK is more open than the USA. Within the euro area, countries at the heart of Europe (eg Belgium, Netherlands, and Luxembourg) are very open, whereas France has less reliance on international trade.

When there is a global downturn in trade, the countries with the most open economies tend to experience the downturn most rapidly and most severely. The openness of Ireland, Luxembourg, Germany and Italy to international and intra EU might explain why they entered the period of downturn first. Their downturn, and that of the euro area economy as a whole, would be transmitted to the other euro area economies through a reduction in their demand for goods and services from the others. The old saying that *"when America catches a cold, Britain sneezes"* is doubly true in the case of Germany and her close neighbours such as the Netherlands and Austria. Hence, the downturn which led to recession, spread through the euro area and indeed through the global economy.

### Structure of the Economy

The term structure of the economy can mean different things in different contexts. It usually means structure in terms of primary, secondary and tertiary sectors of the economy. We know that development in a European context has meant a shift of resources from the primary sector to the secondary sector and, as the economy reaches a high state of development, a further shift of resources to the tertiary sector. We know that the euro area economies have reached a high state of development, and we would expect each would have followed the UK pattern of the "march through the sectors" from primary to secondary to tertiary. However, the relative importance of the three sectors will vary from one euro area country to another. For instance, it is known that despite industrialisation and the development of tertiary production, France, Spain and Italy retain an agricultural sector, which is large in comparison to, say, Germany, or the UK. Spain, Greece, Portugal and, especially, Malta have a high dependence on tourism.

But what is the relevance of this to the question of convergence and differential impact of the downturn? The explanation is that the impact of a downturn varies between sectors. We know that income elasticity of demand for foodstuffs tends to be low and, therefore, a downturn will perhaps have less impact on an agricultural economy than on an economy specialising in non-necessities. We also know that demand for tourism services is highly income elastic as well as being dependent on real incomes in other countries. Using these examples we could speculate that countries with a relatively large agricultural sector (especially if the product is consumed within the country) will be less affected by the downturn, whereas countries with a large tourist sector will be more affected by the downturn.

## Competitiveness

This is a topic to which we will return in the analysis of Extract 2. International competitiveness is the degree to which an economy is able to succeed in selling its products when there is competition in the market place. If products are homogeneous, then competitiveness rests on price advantage which is, in turn, dependent on being a low cost producer. If the product is differentiated, then there is scope for a firm or a country to be competitive in terms of design, quality, reliability and innovation.

International competitiveness enables domestic producers and exporters to benefit from increased demand at home and abroad. This, in turn, leads to increased output, lower average costs and sales, thus leading to economic growth. If a country is not competitive, its producers and exporters will face strong competition from foreign producers. As a result, exports will decline and imports will rise, thus leading to a fall in aggregate demand and employment, and depressed trading conditions.




But again, what is the relevance of this to the issue of lack of convergence? The explanation is that in a downturn, the uncompetitive economies suffer most. In periods of growth, when the market is expanding in size, then it is possible for even the uncompetitive economies to gain some share of the increased trade. But, as we enter a period of contraction, then there is a more intense struggle over market shares, and the less competitive economies suffer most.

Although these ideas will be developed in relation to Extract 2, it is important to realise that outside the euro area, countries do have an easy way of correcting the problem of uncompetitiveness. This is to devalue the national currency, thus making exports cheaper to foreigners and imports dearer to domestic buyers. This “get out of jail free card” is not available to individual members of the euro area.

## Consequences of Lack of Convergence (Paragraph 4)

### Key Consequences

Imperfect convergence means that:

-  Cyclical fluctuations are not synchronised throughout the euro area.
-  A downturn in some euro areas might coincide with positive growth in others.
-  Monetary policy set for the euro area as a whole might be inappropriate for particular countries.

In a downturn, governments run a deficit and there is a distinct danger of breaching the rules of the Stability and Growth Pact. This undermines the requirement to control government borrowing which is essential for the continued success of the euro as an exchange currency. But, with the relinquishing of monetary and exchange rate policy and constraints over fiscal policy, countries in difficulty are forced to accept the pain of adjustment in terms of deflation and rising unemployment.

### A Two Speed Euro Area

The final sentence of extract 1 raises the prospect of a two speed euro area. What does this mean? We are familiar with the term “two speed European Union” to mean an EU composed of a large number of states, some of which have moved through all the stages of economic and monetary integration, whereas others have remained at an earlier stage. In effect, we have a two stage EU at present with 16 of the 27 member states being part of the EMU. This leaves 11 states that have not adopted the euro and are outside the euro area. Some of these states are recent entrants to the EU and are not ready for monetary union (eg Bulgaria), but the assumption is that when they are ready they will join the euro area. In the case of the UK, Denmark and Sweden, they chose not to join the euro area and have a treaty opt out from EMU. In effect, the UK had to agree not to block EMU but would not be required to join it although we have the right to opt in at any time provided we satisfy the Maastricht convergence criteria. Being part of this outer group means that we do not derive all the benefits of economic integration but, on the other hand, are not constrained over policy in the way others are constrained.

A two speed euro area is more difficult to envisage, since the essence of the euro area is the adoption of a single, common currency.

It might mean relaxing the rules on fiscal policy to assist member states in difficulty although we know, from the recent Irish experience, that financial assistance given to Ireland by the EU and the IMF came at a very high price in terms of severe cuts in the government deficit. A two stage euro area might mean temporary exit or expulsion from the euro area. It is worth remembering that the euro is used as a foreign exchange currency by some countries that are not members of the euro area, or even of the EU (eg Montenegro). Temporary abandonment of the use of the euro as a currency would be problematic in that there would be substantial costs involved in restoring a national currency, not to speak of the worries over the longer term sustainability of the euro project as a whole.

### **Hot off the Press: The eurozone agrees in principle on policy coordination**

On a summit of euro area leaders on 10 March 2011, leaders of the 16 euro area countries agreed on a new Pact for the Euro. This would give members a say over each other's major economic policies. The aim here is to keep countries under firm fiscal discipline.

*"Also under discussion is a new permanent, extended replacement for the €440bn (£379bn; \$614bn) bail-out fund. The markets most keenly want to see signs of progress on the establishment of the new European Stability Mechanism (ESM). At €500bn euros, this would have double the effective lending capacity of the current European Financial Stability Facility (EFSF), which was used in the bail-out of the Republic of Ireland."*

The report on the BBC News website goes on to say:

"Greece and Ireland are also expected to press for easier repayment terms. The newly-elected Irish Prime Minister, Enda Kenny said that *"I've come here...with a strong mandate from the Irish people for an improvement in the terms of the EU-IMF deal"*. His country received €67.5bn in support from the IMF and other EU countries (including the UK). Persistent fears about the levels of debt in some European countries, notably Greece and Portugal, have caused their cost of borrowing to again reach record levels in recent days. Higher spending and lower taxation countries, which also include Spain, have had to pay more to borrow money than more prudent countries. They are all making efforts to get their huge borrowings down, with Portugal announcing fresh spending cuts and tax rises on Friday (March 10 2011) and promising again that its deficit would meet its target of 4.6% this year. (Notice that that this implies they have been given special dispensation to exceed the 3% limit contained in the Stability and Growth Pact).

Meanwhile, Spain, one of the countries the markets fear may next need a bail out, this week had its credit rating downgraded amid fears about the ability of the government to restore its finances and about the cost of restructuring its banks".

Source: <http://www.bbc.co.uk/news/business-12711183?print=true>

*Keep an eye on the BBC News website for further information about changes to the rules relating to the euro zone. In addition, the business page on the website gives access to the blogs of both Stephanie Flanders (Economics Editor) and Robert Peston (Business Editor)*

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

### Introduction





This extract focuses on five of the euro area economies known collectively as the PIIGS. This is a rather unfortunate term for five economies that are proving problematic within the euro area. You will be aware that there was a crisis over the need to offer a bailout to first the Greek economy, and then to the Irish economy. In both cases, financial assistance from the rest of the euro area (and the rest of the EU, as well as the IMF) was conditional on a severe deficit reduction programme in the two countries. We are closer in distance and time to the recent events in Ireland, where the then Prime Minister was forced to introduce an austerity programme and call a general election in which his party was soundly beaten. The other three PIIGS have not suffered an equivalent crisis, but informed commentators speculate that events in Greece and Ireland will be repeated first in Portugal and then in Spain. There has even been speculation about the continued euro area membership of the PIIGSs.

### The Five PIIGS (Paragraph 1)

This paragraph introduces us to the PIIGS which have certain characteristics in common that are likely to make their continued membership of the euro area “challenging”. This really means that there is the distinct possibility that they might be forced out of the euro area, both for their sake and that of the remaining members of the euro area.

Italy was a founding member of the European Economic Community (as the EU was then called) and, in many ways, it is industrialised and developed. However, 150 years after unification, Italy remains divided between the rich industrial north and the poor, rural south. Southern Italy has more in common with other Mediterranean countries like Spain, Portugal and Greece, all of which joined the EEC in the 1980s, and has needed substantial aid from EU Regional Funds. Ireland joined the EEC in 1973 (along with its main trading partner, the UK).

The extract informs us that the five PIIGs had very different economic experiences in the first seven years of the 21<sup>st</sup> century.

-  Ireland, Greece and Spain experienced economic growth, which was above the average for the euro area.
-  Real GDP increased by 18.5% over seven years in the euro area as a whole.
-  Real GDP in Greece and Spain increased by twice as much (ie around 37%).
-  Real GDP in Ireland (the Celtic Tiger) increased by 56%.



This would appear to be excellent news, suggesting that living standards in these traditionally poorer countries were rising to levels found in the rest of Western Europe. However, we should be aware that high levels of growth might indicate overheating, thus leading to inflationary pressure.

The other two PIIGS fared less well over the period – Portugal and Italy had growth rates about two thirds of the euro area average.

This prompts the question: Given the disparity in economic performance, what is the characteristic that unites the five PIIGS? We will find the answer to this question in paragraph two, but before looking at that let us interpret and analyse Figure 2.1.

### Figure 2.1: Annual GDP growth rates for the PIIGS and for the euro area

On this graph we have curves for the euro area as a whole, and for each five PIIGS. To an extent, this merely illustrates what we learned in this extract, paragraph 1, and in Figure 1.1. However, there are differences between the information in Figure 2.1, and in the other sources:

-  Firstly, Figure 2.1 covers a longer period with information going back to 2000 and continuing (presumably as forecasts) to the middle of 2011.
-  Secondly, the information is based on annual growth rather than for quarters of the year.

We can see that, in general terms, the time series move in sympathy with each other. So, for the period before 2008 the curves shows positive growth, and in the period 2008-10 there is evidence of negative growth. However, the fact that the curves do not align perfectly, shows the differences in experience between the PIIGS, and between the euro area and the PIIGS. Points of divergence worthy of particular note are:

- 🌈 The Irish economy (the Celtic Tiger) performed better than the rest (except one year in which Greece outperformed it) during the period before the recession, but the graph shows that Ireland suffered a longer and more severe downturn than the rest.
- 🌈 Greece and Spain outperformed the euro area average in the period before the recession.
- 🌈 As we saw in the text, Italy and Portugal performed less well than the euro area average before the recession and in 2003, Portugal went very briefly into recession and Italy stagnated.
- 🌈 The PIIGS and the euro area as a whole went into recession in 2008-10, although, as discussed above, the duration and severity of the downturn varied.
- 🌈 In the recovery, the performance of the PIIGS was weaker than that of the euro area average, (we can probably ignore the Irish curve rising above the euro area at the end of series – this was probably a forecast which has been overtaken by the recent political and economic crisis in Ireland).

### Lack of Competitiveness (Paragraph 2 and Figures 2.2 and 2.3)

What unites the five PIIGS is lack of competitiveness compared both with the other members of the euro area, and with economies outside the euro area. We saw earlier that international competitiveness is the ability of economies to compete successfully in international markets and to sustain improvements in real output, employment, income and wealth.

Figures 2.2 and 2.3 illustrate the declining competitiveness of the PIIGS, in terms of the two measures of competitiveness used by the European Central Bank.

#### Figure 2.2: ECB index of competitiveness based on output prices

This is a measure of competitiveness (or the lack of it) based on increases in output prices. The starting point for each index is 1999 Q1, when the euro commenced as a currency (although notes and coins only followed in 2002). For each of the five PIIGS, the starting point is 100. In the early years of the euro project the indices fell below 100, meaning that output prices fell, but from 2001/2 the indices rise above 100 indicating a rise in output prices. Moreover, initially there is some evidence of convergence (which is the logical result of economic integration), but the later years of the time series show some divergence. Notice that the rise in output prices was greatest in the case of Spain (the subject matter of Extract 3 and Ireland, which we know was plunged into a severe crisis in the winter of 2010/11). In the case of these two countries, the index of output prices was substantially above that of the other three PIIGS. As the output prices of these countries were rising, we can conclude that the competitiveness of their economies was declining, thus making them more vulnerable to a downturn in the economy.

#### Figure 2.3: ECB index of competitiveness based on unit labour costs

##### What Does Figure 2.3 Tell Us?

This is similar to the other graph, but is based on the unit labour costs alone. This is the labour cost per unit of production. You notice once again that in the early years unit labour costs fell. This either means wage rates fell, or it means labour productivity rose – if wage rates are unchanged but productivity rises, then unit labour costs will fall. The sharpest fall was that for Greece.




After 2002, relative unit labour costs rise and, in 2003, they rise above 100. As the decade progressed, the indices rise at a faster rate and, at the same time, there is greater divergence within the four PIIGS shown (note Portugal is absent from this graph). The sharpest rise in unit labour costs occurred in Ireland followed by Spain. It is noticeable that the recession years of 2008/9 saw a decline in relative unit labour costs, probably because some workers were shed, and those remaining had to accept frozen or, even, lower wages.

The conclusion that we draw from each of the figures is that costs and prices in the PIIGS were rising, and also were probably rising relative to their trading rivals, although strictly we have no evidence here as to how these countries compared with their rivals. However, we know from the text that the competitiveness of the PIIGS was declining, and we assume that output and unit labour costs of the PIIGS were rising faster than elsewhere.









Before looking at why this occurred, let us consider why a decline in competitiveness is a matter of concern.

### **Consequences of Decline in Competitiveness**

The reason why it is crucially important for euro area economies to remain competitive is that:

-  There is free trade within the EU single market.
-  Although there is a common external tariff, the World Trade Organisation works to keep tariffs down.
-  The adoption of a single currency removes the prospect of maintaining competitiveness by manipulation of the exchange rate.

Therefore, uncompetitiveness leads to:



-  loss of export sales.
-  import penetration.
-  a reduction in aggregate demand.
-  a reduction input.
-  a rise in unemployment.
-  a fall in living standards.
-  a vicious downward cycle of demand (downward multiplier).
-  a government deficit as tax receipts fall and welfare spending rises.

### **Causes of the Declining Competitiveness of the PIIGS**

The explanation for declining competitiveness put forward in the extract is the failure of the ECB monetary policy to control inflation in all parts of the euro area. Remember that monetary policy, including interest rates, is set by the ECB and not by national central banks. The ECB sets interest rates for the euro area as a whole on a “one size fits all” basis. The problem is that the interest rates chosen might have been appropriate for the euro area as a whole, but inappropriate for particular countries.

We learn that monetary policy was “too loose” for the PIIGS – in other words, to control the inflation pressure in these countries a tougher monetary policy was needed, and this would have meant higher interest rates. So, three of these countries experienced economic growth in excess of the euro area average and, as inflation was not controlled by a tight monetary policy, the result was overheating leading to a rise in factor costs and prices.

If there was overheating leading to inflation in the UK, then there would be downward pressure on sterling. This is because declining competitiveness leads to:



-  a rise in imports and an increase in the supply of sterling.
-  a fall in exports and a decrease in the demand for sterling.

The Purchasing Power Parity Theory informs us that high relative inflation leads to a fall in the exchange rate. But, the PIIGS are members of the euro area and, therefore, high relative inflation in the PIIGS will not cause a depreciation of the euro. If inflation throughout the euro area was high relative to the rest of the world, then the euro would depreciate but this would not be the case with high relative inflation in individual members of the euro area.

Declining competitiveness of the PIIGS will not lead to depreciation and, as a result, they do not have access to the “get out of jail free card” enjoyed by countries that remained outside the euro area. It means that instead of allowing the exchange rate to take the strain of adjustment, the burden of adjustment falls on the real economy as orders and jobs are lost.

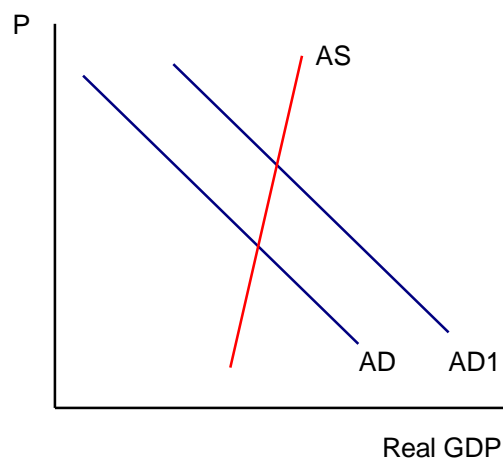
There is a further problem that is mentioned towards the end of the passage. The fast growing PIIGS attracted Foreign Direct Investment (FDI). This inward investment was attracted by the high growth rates especially in Greece, Ireland and Spain, and because these currencies had adopted the euro rather than using their previous national currencies, there was no risk of currency depreciation. Obviously, the euro itself floats against foreign currencies, but the foreign exchange value of the euro is determined by the relative performance of the euro area as a whole – not by the individual performance of any one of the member states.

Therefore, the economic growth (up to 2007) in the fast growing PIIGS was caused by a rise in aggregate demand which, in turn, was caused by:

-  a loose monetary policy leading to negative real rates of interest.
-  inward foreign investment, attracted by significant development potential, and no exchange rate risk.

At the same time as aggregate demand was increasing, the supply-side performance of the economies was “poor”. Again this goes back to the question of the uncompetitiveness caused by rising costs of production, and especially rising unit labour costs.

As we have mentioned aggregate supply and aggregate demand, it is essential to include graphs in our analysis. In the graph below, aggregate demand shifts from AD to AD1, and aggregate supply is relative inelastic. There is some real GDP growth, but most of the demand results in a higher price level rather than higher output.



### Extract 3: The future of the Spanish economy

#### Introduction

We now focus on just one of the PIIGS – Spain. Despite the fact that the crisis in Spain has not resulted in riots in the street (as in Greece), or in political upheaval (as in Ireland), the country is facing a major economic crisis similar to that in the other PIIGS. In view of the large size of Spain compared to Greece, Ireland and Portugal, a crisis in Spain would have more severe implications for the future stability of the euro area than has been the case with Greece and Ireland.




#### Spain and the Recession (Paragraph 1)

If we go back to Figure 1, we see that the % fall in GDP from peak to trough was only 4.7%, which was 0.4 percentage points below the euro area average. This gives the impression that Spain suffered a milder recession than the euro area as a whole, and fared much better than Ireland. This is the “good news”, but the bad news is that as the other euro area economies recovered in 2009, Spain continued to experience negative growth and had not emerged from recession.

One explanation for the slow return to positive growth in Spain is its dependence on the construction sector. You should be aware that capital goods industries as a whole, and construction in particular, tend to experience economic swings, which are more violent than the consumer goods industries. In the case of construction (eg hotels on the Costas), the recession dented confidence and, as a result, investment in new construction dried up, some businesses failed, confidence was lost, and investors became reluctant to risk further capital.

Recovery may also be delayed by the unwillingness of many who benefit by very generous out-of-work benefits, from returning to work.









The statistics quoted towards the end of the paragraph are forecasts or projections. The RR de Acuna & Asociados (Acuna) research group forecast that:

-  Recovery might not begin until 2010 (ie 2-3 years later than other euro area countries and also the UK).
-  The figure of 4.7% understates the true drop from peak to trough which could be 11% (ie greater than that of Ireland).
-  Unemployment could reach 25%.

#### Update on the Spanish economy

For an accessible update on the Spanish economy consult the following page on the BBC News website: <http://www.bbc.co.uk/news/business-12428684>



The BBC reported on 11 February 2011 that:

-  The Spanish economy expanded by 0.2%.
-  The expansion was boosted by exports (prompted by recovery elsewhere).
-  Over 2010 as a whole, the economy contracted by 0.1%.
-  In September 2010 the Spanish government approved an austerity budget deigned to cut the public sector deficit and regain investor confidence.
-  The pension age will rise from 65 to 67.
-  There would be 7.7% cut in public sector spending.
-  Public sector wages would be cut by 5%.
-  Madrid had promised its euro area partners that it would cut its deficit to 6% of GDP 2011 from 11.1% in 2009 (of course, this is still double the 3% limit imposed under the Stability and Growth Pact).

This suggests that performance of the Spanish economy was marginally better than suggested by the forecast from Acuna. Recovery started in 2011 rather than 2012. Nevertheless, the recovery was only slight, and it emphasises the perilous state of the Spanish economy. It also means that even if Acuna's forecasts were over pessimistic, the essential message remains unchanged.

## Fiscal Policy (Paragraph 2)

You should know that a recession leads to a deficit in government finances as:




-  tax receipts fall (a decline in income reduces yield from income tax, a decline in spending reduces yield from VAT, and a decline in profits leads to a fall in corporation taxes).
-  and welfare spending rises (eg more people claim job seekers' allowance).

A recovery should see an improvement in government finances as tax yields rise and welfare spending falls. However, we need to distinguish between a cyclical deficit caused by recession and a structural deficit which does not disappear with recovery. As with the UK deficit, a substantial part of the Spanish public deficit is structural in nature and is, in part, attributable to generous welfare systems. In Spain the unemployed receive 60% of their previous wage for a period of 18 months and the long term unemployed are guaranteed benefits of €420 per month. This added 3% of GDP to the government's benefit. Using the figure of 11.1% of GDP deficit in 2009 (see BBC update), this would suggest that unemployment benefits account for over one quarter of the Spanish public sector deficit. This may explain why even during boom periods, Spanish unemployment has been stubbornly high.

The large size of the Spanish government deficit prevents the government using discretionary fiscal policy to stimulate the economy. In other words, the Keynesian remedy of public works programmes to "prime the pump" of the economy, is not available to the Spanish government.

Moreover, there is no scope for interest rate cuts to boost economic growth. Here we draw parallels with the experience of the UK, where the Bank of England's Monetary Policy Committee has reduced interest rates to a historically low level. In fact, interest rates are lower than the inflation rate resulting in negative rates. There is no scope for any further reduction in interest rates since they have reached the lowest point which is sustainable (ie Keynes' Liquidity Trap). The Bank of England resorted to quantitative easing when interest rates proved impotent to stimulate a recovery, but remember all the time that Spain (and the other 15 countries in the euro area) does not control its own monetary policy. Indeed, even if it did have greater influence in the decision, ECB interest rates are similarly at historically low levels.




Once again we come to the basic fact that euro area membership means that a country:

-  has relinquished the exchange rate as a weapon of policy.
-  has relinquished independence over monetary policy.
-  is constrained in the use of fiscal policy by the Stability and Growth Pact.

## The Imperative of Improvements on the Supply-side (Paragraph 3 and Figure 3.1)

Spain cannot solve her problems by the use of macroeconomic policy and so must consider tackling the root cause of its problems, which are supply-side problems. The reference (in the first sentence) to the need to improve long run growth potential, means shifting the long run aggregate supply curve to the right. This will reduce inflationary pressure and increase output, employment, income, and wealth.

Figure 3.1 is an extract from an IMF report on the Spanish economy. In the report it is stated that despite the economic slowdown:

-  Wage costs are rising above the euro area average, rendering its products less competitive internationally.
-  Unit labour costs (labour costs per unit of output) are rising above the euro average, encouraging a reduction in inward investment.
-  Inflation is above the euro area average.




Clearly, general inflation in the Spanish economy is caused by wage push inflation – that is, increasing wage costs are pushing up prices in general. Inflation and, in particular, wage inflation is caused, in part, by lack of competition and contestability in output markets. At this point, mention should be made of the theory of the firm. You will remember that perfectly competitive firms are price takers, whereas monopolistic firms are price makers. The greater the competition in the market, the less scope there is for suppliers to accommodate cost increases and push up prices. In fact, we take this a stage further by stating that cost push inflation is only possible where markets are imperfectly competitive, and wage push inflation assumes the presence of monopolistic forces in both product and factor markets.

Significantly, it is not just lack of competitiveness in the market, but also a lack of contestability. Contestability is not about the extent of competition that currently exists in the market, but is concerned with the potential for competition. A market might be oligopolistic or, even, monopolistic but still be contestable in that it is relatively easy for newcomers to enter the market.









The IMF report also makes reference to inefficiency in terms of labour markets, meaning that there is also low productivity in Spain. Productivity is a measure of output per unit of input and, in particular, output per employee per unit of time. A firm and an economy can afford to pay high wages if this is matched by high productivity. Similarly, if rising wages are paid for by rising productivity, then they do not add to unit labour costs and are, therefore, not inflationary. However, high and rising wages not matched by high and rising productivity do add to unit labour costs and are, therefore, inflationary.

The IMF reports that Spain must introduce (Supply-side) Policies to improve its international competitiveness, and must reform its product markets to make them more competitive and contestable. Before leaving this topic let us revise supply-side policies.






#### **Supply-side policies are designed to:**

-  influence aggregate supply by improving the productivity of the free market economy.
-  increase aggregate supply by improving the efficiency of factor and product markets.
-  bring about improvements in the economic environment so that the potential growth rate is increased and the level of unemployment is reduced.













#### **Supply-side policies are designed to:**

-  be long term.
-  raise the productivity capacity of the economy.
-  improve incentives.
-  improve the efficiency of resource allocation.
-  shift the aggregate supply curve to the right.
-  reduce inflationary pressure.
-  increase aggregate supply by improving the efficiency of markets.
-  increase the trend growth rate – this is the overall objective.













#### **Supply-side policies in the labour market aim to:**

-  increase the supply and efficiency of labour.
-  improve the skills of the labour force (investment in human capital).
-  promote mobility of labour.
-  remove barriers that prevent wages reaching equilibrium levels.
-  encourage flexible working practices.









#### **Supply-side policies take the form of:**

-  income tax cuts to improve incentives to work.
-  cuts in benefit payments to make voluntary unemployment less affordable.
-  tax relief on income earned from renting out accommodation in order to promote geographical mobility.
-  measures to reduce the power of unions.
-  welfare to work measures.
-  reforms to employment laws.
-  reduced government regulation of the labour market to lower the non-wage costs of taking on workers.
-  encouragement to the expansion of short term contracts and part time labour.
-  investment in education and training to improve the quality of labour.
-  encouragement for profit related pay.
-  encouragement for employee share ownership.
-  changes to the education system to broaden access to further and higher education and to promote vocational training.







#### **Supply-side policies in the product market are designed to encourage the private sector and promote competition by:**

-  market liberalisation.
-  privatisation of state owned firms.
-  contracting out the delivery of public services.
-  deregulation of markets to open them up to competition.
-  tax relief on profits retained by firms for investment purposes.
-  a tougher competition policy.
-  promotion of competition and contestability.
-  the opening up of capital markets.
-  the removal of barriers to the flow of capital.
-  EU single market measures.
-  correction of market imperfections.
-  improving consumer information

**Policies to encourage enterprise involves liberating the supply-side by:**

-  reducing taxation and government spending.
-  lowering corporation tax to increase the profit incentive and to investment.
-  changes to the structure of taxation to encourage factor employment.
-  reduction in government borrowing.
-  investment incentives.
-  incentives to encourage foreign direct investment in Britain.
-  encouraging business start-ups.
-  wider share ownership.

**Consequences – Supply-side policies:**

-  boost the long term trend rate.
-  lead to increasing prosperity in the long run.
-  have the potential to achieve all macroeconomic objectives simultaneously.
-  increase employment.
-  dampen cost push inflation by increasing efficiency.
-  help to improve price competitiveness, thus boosting exports.











**Extract 4: International trade, International trade negotiations and developing economies**

**Introduction**

The final extract widens the scope of our analysis away from the euro area economies to the global economy, but we should not see Extract 4 as somehow detached from the other extracts, since it also concerns the impact of the recession and the ways to return to growth in the global economy. Indeed, given our interdependence, increased global growth has significant and positive implications for all EU countries.



**The World Trade Organisation (WTO) (Paragraph 1)**

The opening paragraph introduces the WTO, which is an international body responsible for negotiating trade agreements and for policing the rules of trade between member states who sign up. The extract informs us that the role of the WTO is to promote international trade, and to ensure that *“trade flows smoothly, freely, fairly and predictably”*. The WTO works to ensure liberalisation of trade by reducing barriers to trade. The barriers take numerous forms: tariffs, quotas, domestic subsidies, prohibitions, discriminatory public procurement practices, administrative measures designed to slow up trade. The WTO ideal is free, unrestricted trade throughout the world. (For more information about the WTO go to the WTO website: [http://www.wto.org/english/thewto\\_e/thewto\\_e.htm](http://www.wto.org/english/thewto_e/thewto_e.htm).)

Aims of the WTO	Functions of WTO
<ul style="list-style-type: none"> <li> To extend free trade concessions to all members.</li> <li> To establish global free trade with reduced barriers.</li> <li> To make trade more predictable by establishing rules.</li> <li> To remove subsidies in order to make trade more competitive.</li> </ul>	<ul style="list-style-type: none"> <li> Forum for trade negotiations.</li> <li> Administering WTO trade agreements.</li> <li> Handling trade disputes.</li> <li> Technical assistance and training for developing countries.</li> <li> Monitoring national trade policies.</li> <li> Co-operating with other international organisations eg IMF and World Bank.</li> </ul>

You might wonder how states can be members of both the WTO (with its commitment to global free trade) and the EU (which is based on free trade between members but a common external tariff against non- members). The WTO is committed to trade creation, whereas one of the unfortunate consequences of the EU is trade diversion. The answer is that the WTO makes allowance for regional economic groups of which the EU is merely one example. However, the regional economics groups are expected to participate in the aims of reducing trade barriers, between all groups and countries. To this end, the EU Trade Commissioners negotiates on behalf of the 27 member states of the EU at WTO meetings.

The case for unrestricted trade is derived from the work of British Classical Economists:

-  Adam Smith - who stressed the benefits of specialisation, which can be more readily exploited in enlarged markets.
-  and David Ricardo - from whom we get the principle of comparative advantage.

Free trade ensures that economies specialise by comparative advantage, thus leading to increased output, growth and living standards for all. From the principle of comparative advantage we derive the notion of mutually beneficial trade. Trade can benefit even countries with an absolute disadvantage, provided they enjoy a comparative advantage in some form of production.

**The WTO Case for Free Trade**

“The economic case for an open trading system based on multilaterally agreed rules is simple enough and rests largely on commercial common sense. But it is also supported by evidence: the experience of world trade and economic growth since the Second World War. Tariffs on industrial products have fallen steeply and now average less than 5% in industrial countries. During the first 25 years after the war, world economic growth averaged about 5% per year, a high rate that was partly the result of lower trade barriers. World trade grew even faster, averaging about 8% during the period.

The data show a definite statistical link between freer trade and economic growth. Economic theory points to strong reasons for the link. All countries, including the poorest, have assets — human, industrial, natural, financial — which they can employ to produce goods and services for their domestic markets or to compete overseas. Economics tells us that we can benefit when these goods and services are traded. Simply put, the principle of “comparative advantage” says that countries prosper first by taking advantage of their assets in order to concentrate on what they can produce best, and then by trading these products for products that other countries produce best.

In other words, liberal trade policies — policies that allow the unrestricted flow of goods and services — sharpen competition, motivate innovation and breed success... Nevertheless, the temptation to ward off the challenge of competitive imports is always present. And richer governments are more likely to yield to the siren call of protectionism, for short term political gain — through subsidies, complicated red tape, and hiding behind legitimate policy objectives such as environmental preservation or consumer protection as an excuse to protect producers.
















Protection ultimately leads to bloated, inefficient producers supplying consumers with outdated, unattractive products. In the end, factories close and jobs are lost despite the protection and subsidies. If other governments around the world pursue the same policies, markets contract and world economic activity is reduced. One of the objectives that governments bring to WTO negotiations is to prevent such a self-defeating and destructive drift into protectionism.”

Source: [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact3\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact3_e.htm)

At this point it is advisable to revise the textbook case for free trade and against protectionist policies.

### The Case Against Protection

#### Protection:




-  imposes substantial costs.
-  distorts the market.
-  restricts consumer choice.
-  raises the cost of living.
-  reduces competitive pressure.
-  ignores the principle of comparative advantage.
-  leads to higher prices for consumers.
-  leads to a loss of economic welfare.
-  results in production inefficiencies.
-  leads to retaliation and to trade wars.
-  reduces access to foreign markets ie import controls act as export controls.
-  has a negative (downward) multiplier effect.
-  causes a misallocation of resources.
-  cushions the inefficient.
-  is, at best, a second best alternative.

Protection to achieve one objective may incur a high opportunity cost.

Other things being equal, there will be a net loss in welfare from restricting trade, with any gain in government revenue or profits being outweighed by a loss in consumer surplus.

Relatively few producers in that country will benefit while millions of consumers will have to pay higher prices.




What is more, restricting trade may have adverse world multiplier effects:

-  It may encourage retaliation.
-  It may allow inefficient firms to remain inefficient.
-  It may involve considerable bureaucracy and, possibly, even corruption.



### Figure 4.1: Pascal Lamy's Speech

This consists of excerpts from a speech made by WTO Director-General, Pascal Lamy, in February 2010. Remember this was at the time when European economies were just emerging from recession. If you refer back to Figure 1.1, you can see that the euro area, as a whole, experienced positive growth of only 0.1% in 2009 Q4, and this was lower than that of 2009 Q3, raising the prospect of the much feared double dip recession. Moreover, we know that at least three of the euro area economies were still in a period of negative growth. The UK officially emerged from recession in 2009 Q4, but the recovery was very fragile.





Lamy stated that:

-  Real GDP in the global economy fell by 2.2% in 2009.
-  Global unemployment reached its highest ever level.
-  World trade contracted by around 12% in 2009 and this was the sharpest decline since the Second World War. (Figure 4.1, Paragraph 1).

The reason for the decline in world trade was twofold:






-  The simultaneous contraction in aggregate demand across all major world economies.
-  The re-appearance of protectionist measures (which the WTO has the responsibility to discourage).

Notice the protectionist measures to which Lamy refers are:

-  Tariffs – import duties which raise the price of imports.
-  Domestic subsidies – which are designed to reduce the price of domestically produced goods.
-  New non-tariff measures eg the exploitation of laws and regulation designed to make it more difficult for foreign goods to enter the market.
-  Anti-dumping actions – measures designed to stop foreign competitors dumping surpluses on the other countries by selling at below cost price. (Incidentally, combating dumping is often regarded as a legitimate reason for imposing import controls, since dumping seeks to rid one country of a surplus by dumping on to others and, thus, in effect, exporting unemployment).




The fall in the volume of world trade occurred because of a combination of expenditure reduction (people and firms bought less because of the recession) and expenditure switching (governments used a variety of measures to encourage buyers to switch from foreign produced goods and services to domestically produced goods and services). Of the two reasons for the decline in world trade, the fall in aggregate demand (expenditure reduction) was of greater significance, although as the head of the WTO, Lamy would argue that the protectionist measures not only encouraged expenditure switching, but also contributed to the depressed state of demand (Figure 4.1, paragraph 2).

Pascal Lamy goes on to comment on the stimulus packages introduced in many developed economies including the EU as a whole, including the UK. What he is referring to here are measures such as those introduced by the Gordon Brown government as it tackled the onslaught of financial and economic crisis of 2008-10. (Remember, Extract 4 is not confined to the euro area economies and, therefore, Lamy's analysis applies to the UK as much as any other developed economy. Therefore, it is legitimate to bring in the UK economy). During the period of the Brown government, the following measures were introduced to stimulate the economy and *“to prevent further deterioration while preparing the path to recovery”*:

-  The Bank of England's MPC reduced interest rates to historically low levels, and it was able to do this because during the recession there was little danger of demand-pull inflation.
-  The Bank of England introduced quantitative easing to increase bank lending.
-  There was a temporary reduction in VAT to 15% to encourage spending.
-  Special schemes such as the car scrappage scheme were introduced to help specific industries.
-  There was an unprecedented bailout of major banks to prevent bank failure and a collapse of the credit system. The bailout took the form of government purchase of shares in major banks, some of which are now substantially owned by the public sector.




During the final years of the Brown government, the public sector deficit grew as a result of the fiscal stimulus. Undoubtedly, there was also a structural element in the deficit, but we should not forget that part of the deficit was cyclical in nature (associated with the automatic stabiliser phenomenon), and was the result of the recession and measures designed to mitigate the worst problems of recession.

Lamy makes the point that the stimulus packages were "at best" temporary and could not continue indefinitely. This is something most informed commentators would agree – in the long run, fiscal stimulus will increase aggregate demand but not aggregate supply and, as a result, it eventually leads to inflation. The other reason why fiscal stimulus cannot continue indefinitely is that it results in high and mounting public sector deficits and debt. The reasons why this is undesirable is that:










-  High public sector borrowing increases the demand for loans, pushes up interest rates, and crowds out private sector investment.
-  A large deficit and debt will affect a government's international credit rating and, if this happens, then future borrowing will be at high interest rates.
-  Public sector debt incurs interest charges which mean that a sizeable and growing proportion of government spending will be earmarked not for education, health or defence, but instead to pay the interest on the national debt.

If a fiscal stimulus can only be used to achieve growth in the short run, then what are the alternative sources of growth? The alternative and, ultimately, more appropriate source of growth is trade. We can identify the benefits of trade as follows:




**Trade seen is a stimulant to short run and long run economic growth:**

-  Exports are an injection into AD.
-  The boost to exports will have multiplier and accelerator effects on equilibrium national income.
-  There will be supply-side improvements from investment and greater factor mobility between countries.



**Trade results in:**

-  an injection in the circular flow of income.
-  an increase in aggregate demand.
-  the multiplier effects of export led growth.
-  the import of new technology.
-  a downward shift in the Long Run Average Cost Curve.
-  employment creation in growth sectors.
-  new capital investment and innovation.
-  contestable domestic markets.
-  the transfer of ideas and best practice.

**International trade means increased competition for producers and therefore:**

-  pressure to keep costs and prices down.
-  dilution of monopoly power.
-  reduction in price discrimination.

**In addition, there will be dynamic efficiency gains as:**

-  trade speeds up the pace of technological change; and
-  economies of scale result in lower LRAC and higher profits.

The final paragraph of the excerpt from Pascal Lamy's speech is a plea to keep trade open and free of restrictions. He makes this plea, not just for the developed countries (the previous paragraphs are an attempt to explain why these countries do have an interest in trade liberalisation), but also for the developing countries who need access and are often denied access to the markets of the developed world.




At this point we need to distinguish between the emerging market economies, which are rapidly industrialising (especially Brazil, Russia, India and China – the BRICs), from the less developed and low income economies with a high reliance on the primary sector.

Ironically, trade liberalisation has gone furthest in industrial goods markets and, as a result, China has benefited from export led growth. But the countries that most need trade liberalisation in the developed world are the primary producing LDCs. They are the lowest income countries with the lowest growth rates and yet they are often denied access to developed markets for their particular products.






The LDCs complain that schemes of agricultural protection (eg the EU's Common Agricultural Policy) deny them access to developed markets for the products in which they do have a comparative advantage. The CAP has traditionally used tariffs against non-union goods as well as subsidies to domestic producers. This has had the effect of diverting trade to sources inside the union rather than creating trade with the rest of the world. As the LDCs cannot sell their primary products in developed markets, they do not generate incomes to buy goods from the developed world. Therefore, Lamy is making a plea for a successful round of trade liberalisation for the benefit of both LDCs and the developed countries. Expansion of trade will be beneficial for all.

## The Doha Round

We learn from the extract that the Doha (Qatar) Round of international trade negotiations dates back to 2001. The slow progress is frustrating, but it should be pointed out that earlier rounds such as the Uruguay Round also went on for what seemed an eternity. The reason why trade talks stall and collapse is that each country (or in the case of the EU, regional economic group) seeks to protect its own vested interests. In simple terms, countries “*want access to other markets but try to protect some of their own vital interests*”. The Doha Round is much broader than past global trade negotiations, and is specifically targeted at addressing the needs of developing countries. The focus of negotiations has been on:

-  Reforming agricultural subsidies.
-  Improving access to global markets.
-  Ensuring that new trade liberalisation in the global economy respects the need for sustainable economic growth in developing countries.

In Extract 4 we learn that China, India, the USA and the UK could not agree on import rules. The developed countries want greater access to the fast growing emerging market economies, which have grown through export led growth, but have restricted access to their own markets. The developed countries are anxious to promote free trade in industrial goods but also practice protection for agriculture. In the case of the EU, this means the much criticised CAP with its import levies, export subsidies, and intervention prices. The CAP was introduced to:

-  make the EEC / EU self-sufficient in foodstuffs.
-  provide a reasonable and stable standard of living for those in rural communities.
-  modernise and raise productivity in agriculture.
-  defend rural communities.
-  and more recently, to protect the rural environment (the “guardian of the countryside” role).









But cynics would argue that it originated in a bargain between German industry and French agriculture back at the time of the founding of the EEC; France provided German industry with access to French markets provided that French agriculture was protected. As with all forms of protection, vested interests are reluctant to give up the protection they have enjoyed.

We know that the CAP has been reformed over recent decades so that a single agricultural payment to farmers has replaced the former system of intervention prices but, nevertheless, Europe's farmers continued to enjoy protection. This means that the agricultural producers of the developing world have only restricted access to EU, and often this means only in terms of agricultural products which do not compete against EU foodstuffs.

### The EU and Doha

To find out EU priorities for the Doha Round consult the European Commission website on <http://ec.europa.eu/trade/creating-opportunities/eu-and-wto/doha/>.

In essence the EU priorities are:

-  To create significant new trade flows by cutting tariffs in both developed and growing emerging economies.
-  To reduce tariffs on industrial goods and negotiating “*common rules on how to address obstacles to trade generated by a too complex and non-transparency regulatory system*”.
-  To improve and clarify the WTO rule book on subsidies that distort the production of industrial goods.
-  To reach an agreement that reforms farm subsidy programs throughout the rich world in line with the EU's 2003 reform of the CAP.
-  Market access for the EU's own processed agricultural products.
-  Improved market access for the services trade.
-  A new set of rules to govern the use of trade defence instruments so that they are not abused.
-  Improved protection of geographical indications eg of Parma Ham, Roquefort cheese.

**Comment:** It would appear that the EU is willing to grant more trade concession to the rest, but only on condition that: other markets are opened up (eg China), action is taken to prevent others using non-tariff barriers to protect their own producers, and countries such as the USA adopt changes to their own agricultural protection. These demands are understandable, but the result is that the long running saga of the Doha Round is set to continue.

## Trade Liberalisation is Not a Guarantee of Human Development and Poverty Reduction

### Introduction

Extract 4 including Figure 4.1 can be summarised as: Because trade liberalisation increases the volume of international trade, leading to economic growth the world needs more trade liberalisation, but vested interests block further moves towards global free trade. Notice that there is no reference to the downside of international trade. We should not be surprised about this since Extract 4 is based on a statement from the head of the WTO, an organisation which is committed to trade liberalisation. But, we must not ignore the comment on the last lines of the introduction (page 2 of the stimulus material) that “*trade liberalisation is not a guarantee of human development and poverty reduction*”. This would suggest the possibility of a question on the disadvantages to some countries at least of trade liberalisation.

### Definitions

First, we need to be clear as to the meaning of the terms **poverty** and **human development**.



**Poverty** is defined as a situation in which income is below the level that would allow someone to enjoy some agreed minimum standard of living. The World Bank defines extreme poverty as living on less than \$1 per day at PPP, and moderate poverty as living on less than \$2 per day at PPP. Poverty reduction can be defined in terms of a reduction in the number of people in the extreme or moderate poverty category.

**Human development** is a broader concept and it combines outcomes that might be valued in the development process – life expectancy at birth, adult literacy rate, school enrolment rates, and GDP per capita at PPP. This measure of the quality of life is expressed in the Human Development Index published by the United Nations.

Notice that poverty is defined in terms of income per head, whereas HD is defined in terms of the quality of life. In practice, both issues are inextricably linked.

### Why does trade liberalisation not guarantee poverty reduction and human development?

Classical trade theory from Smith and Ricardo onwards has always stressed the benefits of specialisation by comparative advantage leading to mutually beneficial trade. So, even if one country has an absolute advantage, all forms of production trade can be mutually beneficial provided:








-  Trade is based on comparative advantage; and
-  The rate of exchange between commodities was better than the domestic opportunity cost between the commodities.

Notice that this does not mean that trade is **always** mutually beneficial. Even Classical Trade Theory allows for the possibility that the benefits of trade can be one-sided, that is, one country gains at the expense of the other. If this is the case, then trade liberalisation might enrich some countries at the expense of others. Obviously, this is the argument used by the more informed Anti-Globalisation protestors who argue that trade liberalisation can mean that the developed world benefits at the expense of the developing world. Before proceeding further let us revise the basic message of the theory of comparative advantage.

#### Comparative Advantage







Comparative advantage is the ability to produce a good relatively more efficiently ie at lower opportunity cost. A country has a comparative advantage over another in the production of a good if it can produce it at a lower opportunity cost, ie if it has to forego less of other goods in order to produce it. A country better at producing both products would choose to specialise where the gap between its output and that of the other country was greatest. Provided the exchange rate is better than domestic opportunity cost, there is scope for each of the parties to derive some benefit from specialising and trading.

#### But trade is not always beneficial:




-  The exchange rate may not always be favourable.
-  Poorer countries may find the terms of trade move against them.
-  Comparative advantage is not permanent; Jobs are lost as well as created, leading to structural unemployment.
-  Trade may create negative externalities.
-  There is a risk of trade dependency.
-  Transport costs should be taken into account.
-  Specialisation in a narrow range of goods makes the country vulnerable to sudden and unpredictable changes in supply and demand conditions.

#### The case for Protection

#### Protection may be needed to:

-  protect strategic and declining industries.
-  protect and nurture infant industries – ie newly established or sunrise industries.
-  prevent dumping and other unfair trade practices - dumping is the sale of products at less than cost price.
-  improve balance of payments.
-  protect the country's industries from unfair low wages.
-  protect domestic employment.

#### Protection is necessary because of:

-  the inflexibility of markets in responding to changes in comparative advantage.
-  the danger of the establishment of foreign based monopoly.
-  the fact that free trade may adversely affect consumer tastes, or may allow the importation of harmful goods and may not take account of externalities.

### **Prebisch – Singer Hypothesis**

The less developed countries are mainly primary producers – a large part of their economy is agriculture, although some also export minerals. One problem faced by the agricultural producers is declining terms of trade in the long run. Remember, terms of trade concern movements in export prices relative to movements in import prices. Declining terms of trade mean that exporting prices are falling (or rising less rapidly) than the prices of imports. This means that each ship of exports buys a smaller volume of imports.

Why should primary producers face long term decline in the terms of trade? The argument is that the demand for basic foodstuffs is both income and price inelastic. This means that any increase in agricultural output will drive down prices. Hence, the agricultural producers of the developing world are penalised for increasing output. At the same time, inflation in the developed world makes imports from the developed countries more expensive for developing countries.

This is the essence of the Prebisch Singer Hypothesis. This can be defined as the argument that countries exporting primary commodities will face declining terms of trade in the long run, and this will trap them in a low level of development as more and more exports will need to be sold to pay for the same volume of secondary sector imported goods. The Prebisch Singer Hypothesis suggests that increased trade could harm developing countries and it is for this reason that many resorted to import controls in the post-colonial period.

Even if increased trade leads to economic growth, there is no guarantee that the benefits of increased real GDP will “trickle down” to the poorest members of the community. In other words, trade might increase GDP and GDP per head, but that does not guarantee the benefits will be enjoyed by all. In fact, there is substantial evidence to suspect that initially, at least, the benefits of growth in a developing country are enjoyed by the urban elites, thus leaving the mass of rural population in poverty.

Trade liberalisation and increased trade will not necessarily benefit the people in dire poverty, at least in the short run. Hence, the number and proportion of people in poverty might remain unchanged, or even rise, following trade liberalisation. Hence, poverty reduction is not guaranteed in the short run.

If poverty is not reduced, then it is unlikely that human development will occur. This is partly because GDP per head at PPP is an important component of the HDI. But also, if poverty persists, it is unlikely that life expectancy, school enrolment or adult literacy (the other components of HDI) will improve.

### **Conclusion**

There is no doubt that the global economy benefits from increased trade and, in that sense, economists should agree with the basic message of Pascal Lamy - that trade liberalisation is in the long term interest of the global economy. However, we have to accept that trade liberalisation does not work to the benefit of the poorest people in developing countries – in the short run at least.

### 3. QUESTIONS TO CONSIDER

#### General

The focus of the exam is to test your command of the toolkit of economic concepts in a global context. You will, nevertheless, also be expected to know and understand about European and other international institutions and their policies, and their significance for economic policy development, economic progress and wider welfare, in the context of the stimulus material.

Before looking at questions based on the stimulus material you should bear in mind the typical structure of assessment which is:

1. Two questions based on knowledge and understanding of economic terms, each worth 4 marks.
2. Two questions requiring economic analysis, each worth 6 marks.
3. Two questions requiring a commentary supported by economic analysis, each worth 10 marks.
4. A final question, usually based around the theme of the extracts, or one that integrates the stimulus material, which requires discussion worth 20 marks.

The purpose of the questions below is not to question spot – many are unsuitable as exam questions. However, they are designed to:

- a) Encourage you to study the stimulus material comprehensively.
- b) Prompt you to pursue your own lines of research and discovery.
- c) Help you identify and, thus, respond to any shortcomings in your understanding of the concepts.
- d) Consider the issues the questions raise from both a macro and a micro economic perspective.
- e) Develop your ability to draw on and use the full range of economic concepts to understand, analyse and evaluate economic problems.
- f) Present economic solutions backed by sound economic analysis and discussion.
- g) Provide you with opportunities to develop higher order skills, necessary to answer examination questions at level 4.

#### Questions

##### Questions Relating to the Introduction, Paragraph 1 and Extract 1:

1. Explain what is meant by economic and monetary union.
2. To what extent does economic and monetary union, represented by the euro, represent an optimal currency area?
3. Explain why it is necessary for interest rates within the euro area to be set centrally.
4. Explain the problems that can arise from a centrally determined interest rate.
5. What is meant by convergence and why does the lack of convergence make it difficult to set interest rates for the euro area as a whole?
6. Explain what is meant by real GDP.
7. Explain the concept of a “soft currency”.
8. Explain the concept of “purchasing power parity”.
9. To what extent does the success of economic and monetary union depend on “convergence in economic cycles”?
10. Discuss the value of a “fiscal response” as a means of addressing an economic downturn.
11. Explain the terms recession and double dip recession.

12. What are characteristic features of a recession?
13. What conclusion do you draw from the data in Figure 1.1.?
14. What is meant by the openness of an economy and why does this vary from country to country?
15. Discuss the extent to which a more open economy may perform better.
16. Why is recession in Germany especially significant for the EU economy?
17. Analyse the reasons given in Extract 1 for differences in the economic performance of the euro area countries shown in Figure 1.1.
18. Why was an emerging two speed euro undermining the viability of monetary union?
19. Explain the Stability and Growth Pact.
20. Discuss the extent to which this type of pact remains relevant.
21. In what ways does membership of the euro area constrain national economic policy?
22. With reference to the data, analyse the reason why the UK did not join the euro area when it was created.

### Questions relating to the Introduction, Paragraph 2 and Extract 2:

1. What is meant by competitiveness and why is a lack of competitiveness seen as a problem?
2. Analyse how the problem of uncompetitiveness in the UK economy can be solved by exchange rate adjustment.
3. Explain the concept of a "loose monetary policy".
4. In what way was monetary policy too loose for the PIIGS and what were the consequences?
5. Explain how, in normal circumstances, inflation results in a reduction in the exchange rate.
6. Explain the advantages and disadvantages for a euro member of having a fixed exchange rate with other euro members.
7. Account for the inward FDI into the PIIGS.
8. Using aggregate supply and aggregate demand analysis explain (i) short term growth and (ii) inflation in the PIIGS.
9. What is meant by a poor supply-side performance?
10. Explain why a poor supply-side performance represents an underlying problem for the PIIGS.
11. Explain the main trends in Figure 2.1.
12. Interpret figures 2.2 and 2.3.
13. Explain the link between competitiveness / uncompetitiveness and productivity.
14. Analyse strategies to increase the competitiveness of a euro area economy.

### Questions relating to the Introduction, Paragraph 3 and Extract 3:

1. Why is Spain's generous welfare system seen as a problem?
2. Why was it necessary for the Spanish government to reduce its budget deficit?
3. Explain the concept of "discretionary spending", and explain why it is important to distinguish it from the remainder of government spending.
4. Why can Spain not expect the ECB interest rates to boost growth?
5. What is meant by real interest rates?
6. Explain the difference between a structural deficit and a cyclical deficit.
7. Analyse ways in which Spain can improve its long run growth potential.
8. Explain the difference between competition and contestability.
9. What is meant by inefficient labour markets?

10. Analyse why it is important to increase (a) competition and (b) contestability in the Spanish economy.
11. Why are the forecasts for the Spanish economy contained in Extract 3 more pessimistic than is shown in Figure 1.1?
12. Discuss the constraints on macroeconomic policy for the Spanish government.
13. Analyse reasons why Spain has inflation above the euro area average, despite its high unemployment.
14. Analyse why Spain's dependence on the construction industry might mean it would not recover from recession with the rest of the euro area economies.

#### **Questions Relating to the Introduction, Paragraph 4 and Extract 4:**

1. Explain the role and importance of (a) the IMF and (b) the World Trade Organisation.
2. Explain the process by which trade barriers have been progressively reduced over a series of years, through a series of "rounds".
3. Why does Pascal Lamy believe there is an "economic imperative" to conclude the Doha Round of trade negotiations?
4. Why is trade seen as such an important source of growth?
5. Why did the volume of world trade fall during the recent recession?
6. Analyse the reasons why national stimulus packages introduced during the recession are "at best temporary".
7. Why has the Doha Round not been completed after ten years of negotiation?
8. Why does the EU have a Common Agricultural Policy and how does it disrupt trade negotiations?
9. What is meant by (i) poverty and (ii) human development?
10. How is human development measured?
11. Explain the relationship between poverty and human development.
12. Using appropriate diagrams, explain the economic consequences of governments using tariffs, domestic subsidies, and other measures to limit import penetration.
13. Why is trade liberalisation seen as the key to promoting growth?
14. Why is trade liberalisation on its own not a guarantee of human development and poverty reduction?
15. Explain (i) the Prebisch Singer Hypothesis and (ii) trickle down.
16. Evaluate the case for and against import controls.