

OCR A2 Economics

Unit F585

The Global Economy

Pre-Release Stimulus Toolkit

January 2010

Supporting study notes analysing and interpreting the F585
stimulus material



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Key Themes in the F585 Pre-Release Stimulus Material

The main themes covered by this case study are:

- 1. The meaning of and consequences of macroeconomic stability**
 - a. Different interpretations of 'recession'
 - b. Monetary policy responses to domestic and external events
 - c. The role of fiscal policy rules
 - d. Inflation targets and the setting of interest rates
 - e. The determinants of exchange rates
 - f. Economic consequences of exchange rate volatility
 - g. Economic effects of commodity price volatility
- 2. The effects of external demand and supply-side shocks on economic activity**
 - a. Causes of the credit crunch
 - b. Over-inflated asset prices and real economic effects
- 3. The extent to which monetary and fiscal policy can be used as counter-cyclical policies to stabilise confidence, demand, output and employment**
 - a. The liquidity trap and the transmission mechanism of monetary policy
 - b. The use of unconventional monetary policy such as quantitative easing
 - c. Debates over the fiscal multiplier
 - d. Keynesian versus Monetarist approaches to macroeconomic policy-making
 - e. Independence for the Bank of England
- 4. Globalisation and the inter-connected nature of financial markets and the real economy**
 - a. The nature of globalisation
 - b. Foreign direct investment flows
 - c. Economic impact of falling commodity prices in 2008-09
 - d. Prospects for African countries
 - e. The distribution of gains and losses from globalisation
 - f. Threats to globalisation – including the return of protectionism and economic nationalism
- 5. The impact of global financial instability on smaller nations many of whom have experienced disequilibrium on their balance of payments**
 - a. The free movement of financial capital around the world – currency instability
 - b. Problems facing Hungary (a country with an unsustainable external deficit)
 - c. Capital flight and exchange rate devaluations
- 6. The consequences of recession for different countries**
 - a. The extent to which individual nations have flexibility in changing macro policies
 - b. Fixed and floating exchange rates
- 7. The changing role of the International Monetary Fund and other international organisations**
 - a. The rising economic power of leading emerging market countries

Analysis: Introduction (Page 2)

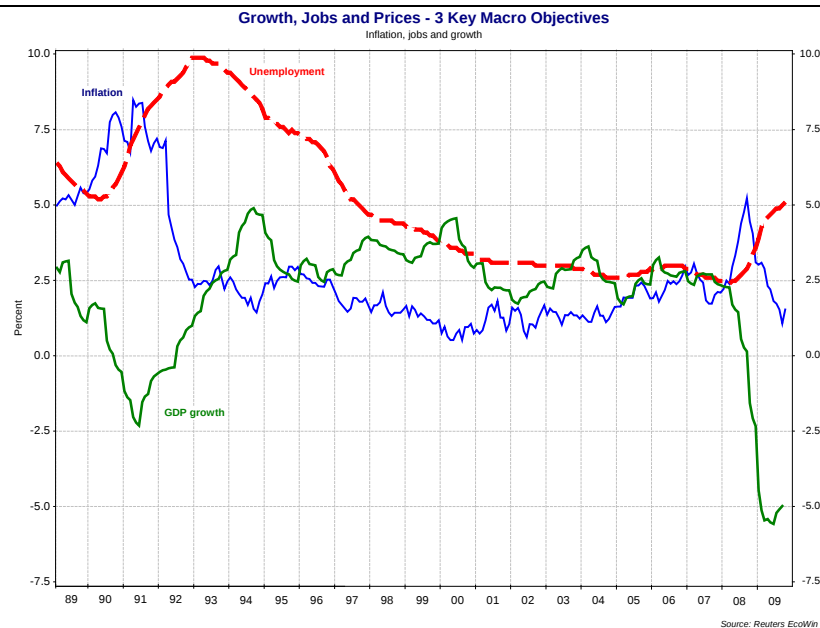
During the ten years up to 2008, the **pursuit of economic stability** (1) appeared to rise to the top of the macroeconomic policy objectives of many countries, including the UK. It was felt that it was not enough simply to achieve high growth, low inflation, high rates of employment and low rates of unemployment and to avoid balance of payments problems. **Economic stability was seen as a pre-condition for all of the other policy objectives.** (2) Various measures, including **widespread adoption of inflation targeting by central banks** (3) were put in place to bring about economic stability. Events during 2008, however, brought to an end this era of economic stability.

One of the symptoms of the end of the era of stability was the sharp downturn in economic activity in countries including the UK and the USA. **Fears of recession led policy makers to take dramatic action to counter the downturn in the economic cycle** (4). Monetary expansion, through interest rate reductions, was the most immediate and dramatic of the policy reactions to the downturn. Yet **there was much comment as to whether this monetary expansion, on its own, would be sufficient to counter the downturn** (5). Many commentators feared monetary policy would be ineffective in the circumstances of late 2008.

Domestic instabilities soon spread to the global economy (6) and **the International Monetary Fund (IMF) was called upon to fulfil its role in the world's financial systems** (7). The IMF put in place packages to support a number of countries, including Hungary, whose economic weaknesses had become apparent. These **weaknesses were most obvious in their balance of payments positions** (8). **Such weaknesses had been responsible for the collapse of currencies** (9) such as the Hungarian forint, in the turmoil of late 2008. The events of 2008 brought into sharp focus the consequences of **the process of globalisation** (10). Globalisation has long been the subject of debate amongst economists, who see both advantages and disadvantages to the process, particularly for developing economies. The extent to which the **net impact of globalisation on any one developing economy** (11) is positive or negative remains an issue that is still unresolved.

Commentary on the Introduction

(1) "Pursuit of economic stability"	The chart shows unemployment, inflation and growth for the UK since 1989. The period 1993-2007 saw low inflation, falling unemployment and steady economic growth and has been termed the Great Moderation. This stability broke down in 2008 as the crisis developed.
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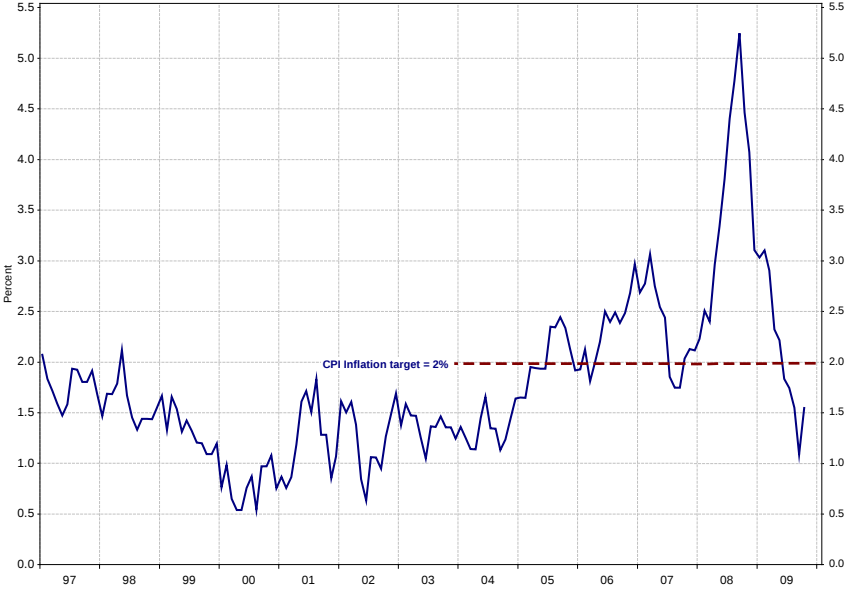


Macro stability can be measured by the **volatility** of key indicators:

1. Consumer price inflation (annual % change in prices)
2. Real GDP growth over one or more business cycles
3. Changes in measured unemployment / employment
4. Fluctuations in the current account of the balance of payments
5. Changes in government finances (i.e. the size of the fiscal deficit or surplus)
6. Volatility of short term policy interest rates and long term interest rates such as the yield on government bonds
7. Stability of the exchange rate in currency markets

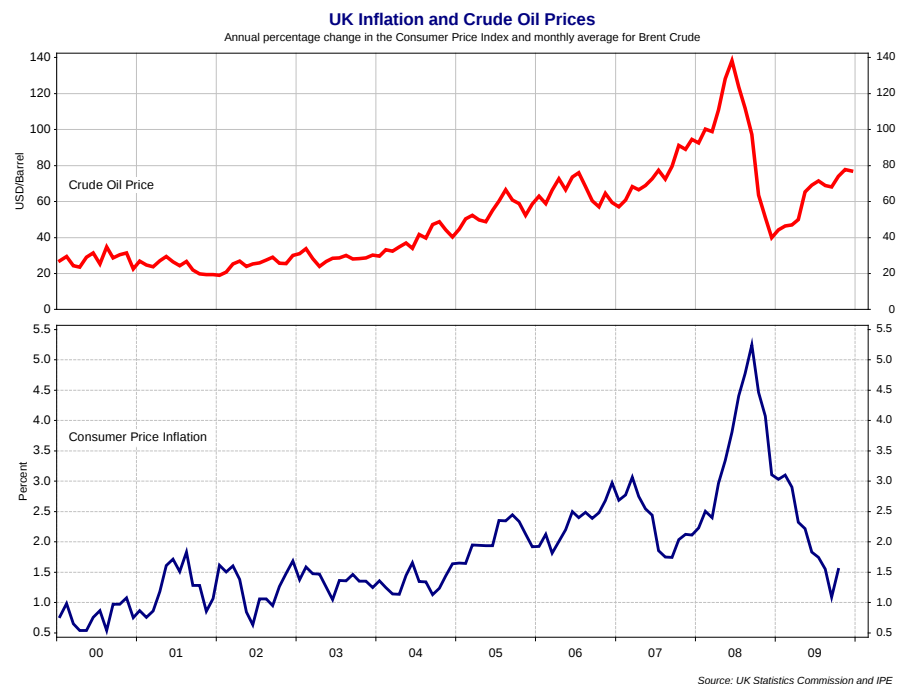
There is no overall measure of macro stability but standard deviations for each of these data series might be used. None of the published extracts provides any firm evidence on macro stability. The table below provides a summary and is taken from the latest World Economic Outlook from the OECD. Data for 2009 is a forecast (Dec 2009).

United Kingdom Macroeconomic Indicators 2006-2009				
	2006	2007	2008	2009
Real GDP (% change)	2.9	2.6	0.6	-4.7
Household spending (% change)	1.5	2.1	1.2	-3.0
Government consumption (% change)	1.6	1.2	2.5	2.8
Gross capital investment (% change)	6.5	7.8	-3.3	-16.1
Exports of goods and services (% change)	11.3	-2.8	1.0	-10.6
Imports of goods and services (% change)	8.8	-0.7	-0.8	-13.3
Unemployment rate (percentage of labour force)	5.4	5.4	5.7	8.0
Government budget balance (percentage of GDP)	-2.7	-2.7	-5.3	-12.6
Short-term policy interest rate (per cent)	4.8	6.0	5.5	1.2
Consumer price inflation (per cent)	2.3	2.3	3.6	2.1
Balance of Payments Current Account Balance (% of GDP)	-3.3	-2.7	-1.6	-2.6

(2) “Economic stability was seen as a pre-condition for all of the other policy objectives”	This is based on the argument that a stable economy provides a framework for an improved supply-side performance i.e. • Stable low inflation encourages higher investment which is a determinant of improved productivity and non-price competitiveness • Control of inflation helps to main price competitiveness for exporters and domestic businesses facing competition from imports • Stability breeds higher levels of consumer and business confidence – sentiment drives spending in the circular flow • The maintenance of steady growth and price stability helps to keep short term and long term interest rates low, important in reducing the debt-servicing costs of people with mortgages and businesses with loans to repay • A stable real economy helps to anchor stable expectations and this can act as an incentive for an economy to attract inflows of foreign direct investment
(3) “Widespread adoption of inflation targeting by central banks”	Consumer Price Inflation for the UK Economy Annual percentage change in the Consumer Price Index  Source: UK Statistics Commission The UK first introduced inflation targets in 1992 following sterling’s suspension from the exchange rate mechanism. The government wanted an inflation target to be the ultimate objective of monetary policy having opted to move to a floating exchange rate system. The European Central Bank (ECB) has targeted 2% inflation since it was created in 1999. The United States Federal Reserve (“The Fed”) has a dual target for inflation and economic growth. Because the Bank of England (BoE) is operationally independent, the UK government sets the inflation target (2%). There is an upper (3%) and lower (1%) band to the target, the lower band reflects the importance attached to preventing the UK economy entering a period of sustained price deflation An inflation target is designed to: 1. Help control inflation expectations 2. Provide a transparent target / anchor for monetary policy 3. Lock in price stability for the economy and enhance confidence

The UK inflation target switched from RPI to CPI in December 2003 – and the inflation target has not so far included **asset prices** e.g. property prices and share prices. For most of the time since the Bank was made independent in 1997, inflation has been within target range. 2008 saw inflation 'overshoots' and an exchange of letters between the Bank of England Governor and the Chancellor! In 2009 retail price inflation started to drop sharply and by the spring it was negative, the first price deflation in the UK since the 1960s. By the end of 2009 CPI inflation was well below the 2% target.

Critics of the inflation target argue that a failure to include asset prices in the chosen measure led to interest rates being too low during the property boom and this caused the asset price bubble to be too strong.



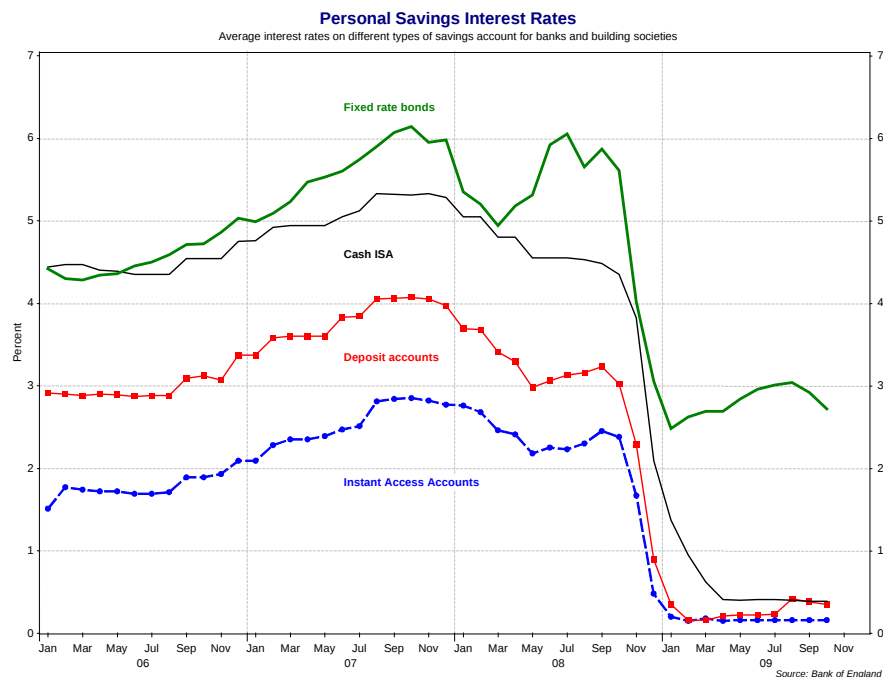
Main reasons for the high inflation of 2008

- In 2008 CPI inflation accelerated to 5% - the main cause was an unexpectedly large rise in global prices of many commodities such as copper, rubber, oil and gas.
- World food prices also soared in 2007-08 – a process known as **agflation**. The UK is a net importer of food and was therefore affected by the rising cost of food products.
- This led to an increase in **cost-push inflation** (i.e. an inward shift of the SRAS curve).
- An increase in **actual inflation** led to a upward shift in **inflation expectations** and the Bank of England feared a return of inflation and a **wage-price spiral**
- Inflation also increased because of:
 - Strong GDP growth led by high levels of consumer spending
 - A depreciating currency (causing higher import prices)
 - Higher indirect taxes

The Bank of England feared a return to stagflation and 2008 was a year when real wages fell as inflation out-paced the growth of pay. In the event, although CPI

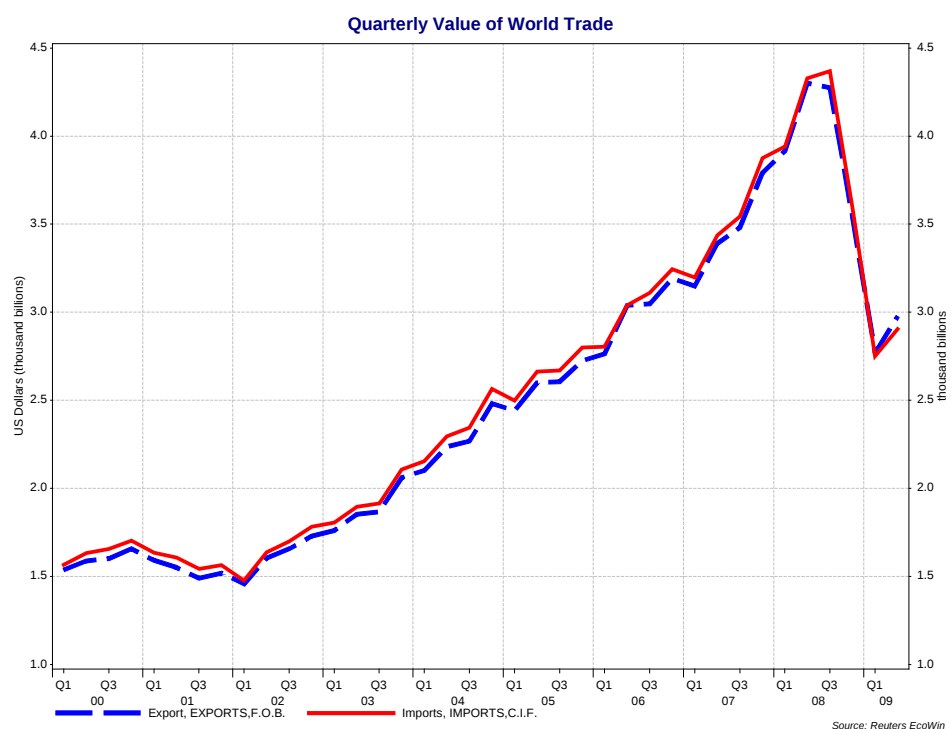
	inflation reached 5% we did not see an explosion in pay claims and higher wage settlements. The main reason was the recession that began in earnest in the autumn of 2008. Rising unemployment has reduced the bargaining power of workers and many businesses have been pressured into seeking pay freezes or wage cuts from their employees.
(4) “Fears of recession led policy makers to take dramatic action to counter the downturn in the economic cycle”	The onset of recession has led to an unprecedented use of macroeconomic policy instruments to stabilise confidence, demand, production and jobs. Most countries have introduced counter-cyclical policies although the scale of the economic stimulus has varied from country to country: Base Interest Rates and UK GDP Growth Percentage, since May 1997 base rates have been set by the Bank of England In the United Kingdom: 1. Policy interest rates have been cut from 5.5% in December 2007 to 0.5% in March 2009 2. The Bank of England has introduced a policy of quantitative easing (QE) worth up to £200bn 3. The government has allowed a sharp rise in the fiscal deficit with government borrowing climbing to over £170bn in 2009-10, equivalent to over 12% of national income 4. Special measures have included the car-scrappage subsidy designed to boost demand for new cars and vehicle production in the UK 5. Many banks have been given bail-outs and some have been nationalised as the government has taken a controlling interest 6. The external value of sterling against currencies such as the US dollar and the Euro has fallen significantly. This depreciation in the exchange rate has similar effects to a reduction in interest rates. Many other countries have introduced stimulus policies designed to revitalise their economies. Most have involved a mixture of monetary and fiscal policy decisions. According to the Brookings Institute from the USA, The total amount of fiscal stimulus in the G-20 countries amounts to about \$692 billion for 2009, which is about 1.4 percent of their combined GDP and a little over 1.1 percent of global GDP. The UK economy's reliance on the service sector and financial

	services in particular, may be one of the reasons why it is still in recession when partners such as France and Germany exited earlier in 2009.
(5) “There was much comment as to whether this monetary expansion, on its own, would be sufficient to counter the downturn”	Is monetary policy becoming less effective? This hints that the transmission mechanism of monetary policy might have broken down. When ultra-low interest rates appear to be ineffective in restoring confidence and spending, this is known as the liquidity trap. For the exam you need to explain how a reduction in policy interest rates can stimulate household and business sector demand and also (through the exchange rate) providing a stimulus to export s. But we do not live in normal times! There are grounds for thinking that – in the short term at least – the impact of monetary policy may have been reduced. Here are some reasons: 1. The continued unwillingness of commercial banks to lend – most banks are de-leveraging i.e. cutting the size of their loan books and being more selective about whom to lend to. 2. Banks have been reluctant to pass base rate cuts onto consumers. Indeed the average cost of a bank overdraft or a credit card loan has increased over the last two years. 3. There is little incentive to lend when interest rates are at low levels 4. Low consumer confidence / expectations means that people are not prepared to commit to major purchases such as a new kitchen – recession has made people risk averse as unemployment rises 5. There remains a huge level of household debt that will need to be paid off including £200bn on credit cards 6. Falling asset prices – average house prices fell sharply during 2008-09 and this has created a problem of negative equity for many thousands of property owners. Negative equity occurs when the market value of a house falls below the outstanding mortgage debt. 7. Lower interest rates have helped bring the value of sterling down – but the world economy has shrunk (global trade is down 10% in 2009) and this has hurt our export sector. 8. Lower interest rates reduce the spending power of millions of people who do not have mortgages but have built up savings in bank and building society accounts.



(6) “Domestic instabilities soon spread to the global economy”

We live in an **inter-connected** world economy.



Globalisation has made the world more **inter-dependent** as trade and investment as a share of world GDP has grown. External demand and supply-side shocks in one part of the world can quickly feed through to other regions. For example the fall-out from the sub-prime mortgage crisis in the United States quickly had consequences in financial markets and the real economies of developed and developing countries. The case study may ask you to explore such connections.

In 2009 global output fell by over 2% and the value of global trade in goods and services declined by over 10%.

(7) “The International Monetary Fund (IMF) was called upon to fulfil its role in the world’s financial systems”



The [International Monetary Fund](#) (IMF) is the central institution of the international monetary system established to promote international financial stability. The IMF was created in 1944 to stabilise exchange rates in an attempt to stop a repeat of the Great Depression. Member nations contribute to a pool that can be used by those with large and structural balance of payments imbalances.

A nation accepting a loan must agree to make economic policy changes dictated by the IMF, designed to remove the causes of the balance of payments crisis. This is called conditionality e.g. a €12.5Bn IMF loan to Hungary in the Autumn of 2008 required government spending cuts to social services and public sector wages to bring about a balanced government budget

The current global economic crisis means a greater need for IMF support particularly in **emerging market economies** hit hard by the downturn in the world demand for their exports. Until recently, the **conditionality terms** imposed by the IMF were so severe that the short term liquidity facility offered by the IMF in October 2008 attracted no takers.

On 2 April 2009, the G20 Leaders agreed to increase the resources available to the IMF through immediate bilateral financing to the IMF of \$250 billion. This increase in resources of the IMF is aimed to support growth in emerging market and developing economies.

The IMF is now offering a new line of credit (known as the Flexible Credit Line) for well-run emerging-market economies. Qualifying countries can borrow and repay over 3 to 5 years significant funds from the IMF to balance their balance of payments.

Recent articles on the International Monetary Fund

[IMF aid for Ukraine and Hungary](#) (BBC news, October 2008)

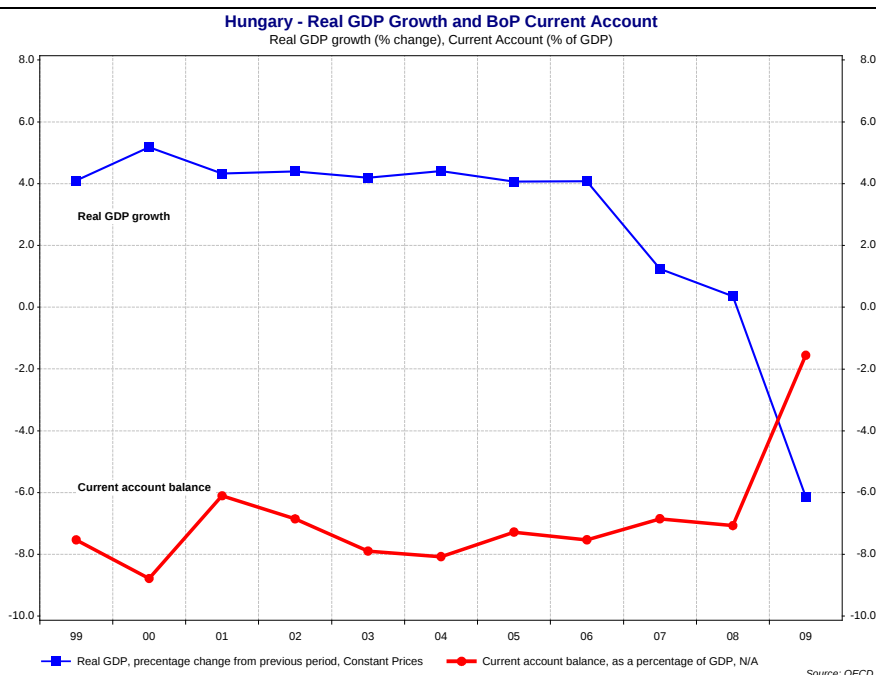
[Pledge for more IMF help for the poor](#) (BBC news, October 2009)

[Q&A on IMF bail-outs](#) (BBC news, Oct 2008)

[Central bankers accuse IMF of failures before the crisis](#) (Times, Oct 2009)

[Guardian articles on the IMF](#)

(8) Hungary (i): “These weaknesses were most obvious in their balance of payments positions”



Hungary is a **new member state** in the European Union – it joined the single market in May 2004 and for several years enjoyed strong GDP growth of 4 per cent or higher, large net inflows of foreign direct investment (FDI) and a significant rise in per capita incomes. However much of the higher consumer spending was financed by borrowed money and an **asset price boom** including property and stocks and shares proved unsustainable. Many Hungarian consumers opted to borrow money in Euros at low interest rates and perhaps did not understand the risks of doing this – especially the uncertain movements of the exchange rate.

Balance of payments disequilibrium:

High domestic spending drew in a much higher level of imports and Hungary's **balance of payments deficit** on the current account grew to more than 7% of her national income in 2004-05 and continued to remain high in 2006 and 2007. The scale of the excess of imports over exports eventually brought about a sharp decline in the Hungarian **exchange rate** as overseas confidence in her economy evaporated.

When the global financial crisis erupted in the late summer of 2008, smaller economies such as Hungary deemed to have experienced unsustainable growth became the target for currency speculators. In July 2008, one Euro bought 230 Forint. By the spring of 2009 the Euro had appreciated so that one Euro bought 315 Forint – devaluation for Hungary of nearly 30 per cent. Since then, and after the intervention of the International Monetary Fund the Hungarian Forint has recovered some ground against the Euro – it was back to 270 Forint against the Euro by the end of the November 2009.

[Hungary's daunting debt mountain](#) (BBC news, Oct 2008)

[Hungary raises interest rates by 3% to support the Forint](#) (BBC news, Oct 2008)

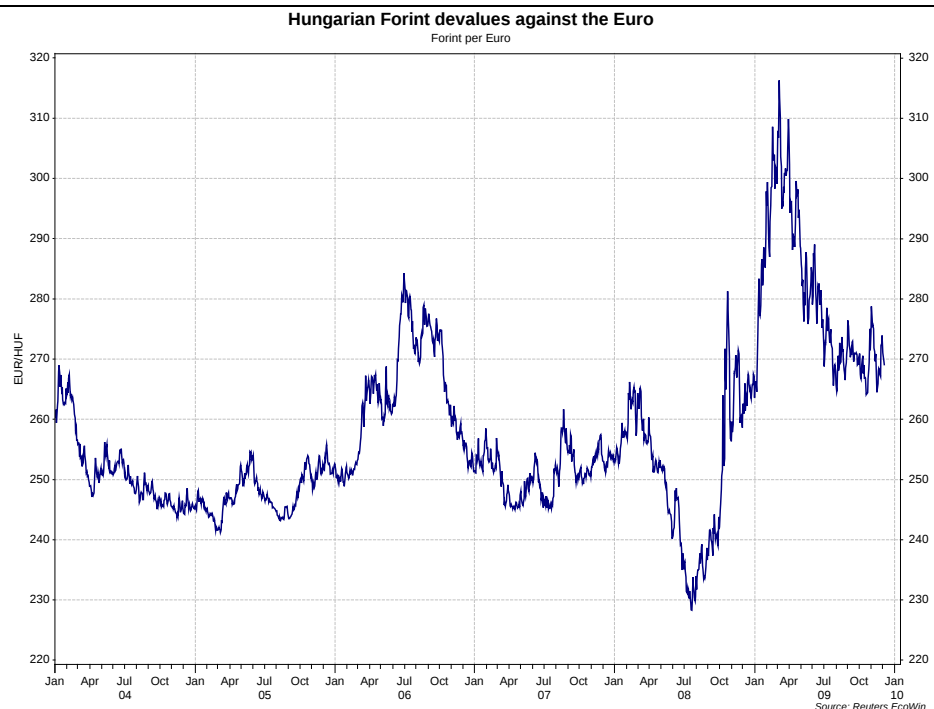
Hungary Macroeconomic Indicators 2006-2009

	2006	2007	2008	2009
Real GDP (% change)	4.0	1.0	0.6	-6.9

Household spending (% change)	0.4	-0.5	-7.8	-5.3
Government consumption (% change)	-7.4	-0.8	0.0	-0.9
Gross capital investment (% change)	1.6	0.4	-6.6	0.2
Exports of goods and services (% change)	16.2	5.6	-11.2	6.0
Imports of goods and services (% change)	13.3	5.7	-18.1	3.0
Unemployment rate (percentage of labour force)	7.4	7.9	9.9	10.3
Government budget balance (percentage of GDP)	-5.0	-3.7	-4.3	-4.1
Short-term policy interest rate (per cent)	7.6	8.9	8.6	6.4
CPI inflation (per cent)	8.0	6.0	4.5	4.0
Balance of Payments Current Account Balance (% of GDP)	-6.8	-7.1	-1.6	-1.8

- Growth slowed sharply in 2007 and 2008 before a full-scale recession hit the economy in 2009.
- Hungary's exports were hit by the recession in the Euro Zone – their major trading partner.
- Falling exports contributed to a decline in fixed capital investment (a negative accelerator effect)
- The devaluation of the forint against the Euro appears to have boosted export volumes in 2009 (up 6% after the collapse in 2008).
- Falling consumer spending and higher unemployment have helped to reduce the current account deficit to less than 2% of Hungarian GDP.
- But at the end of 2009 Hungary has suffered a deep recession and now has more than one person in ten out of work. The value of household wealth has been hit by a sharp fall in house prices.

(9) Hungary (ii) "Such weaknesses had been responsible for the collapse of currencies"



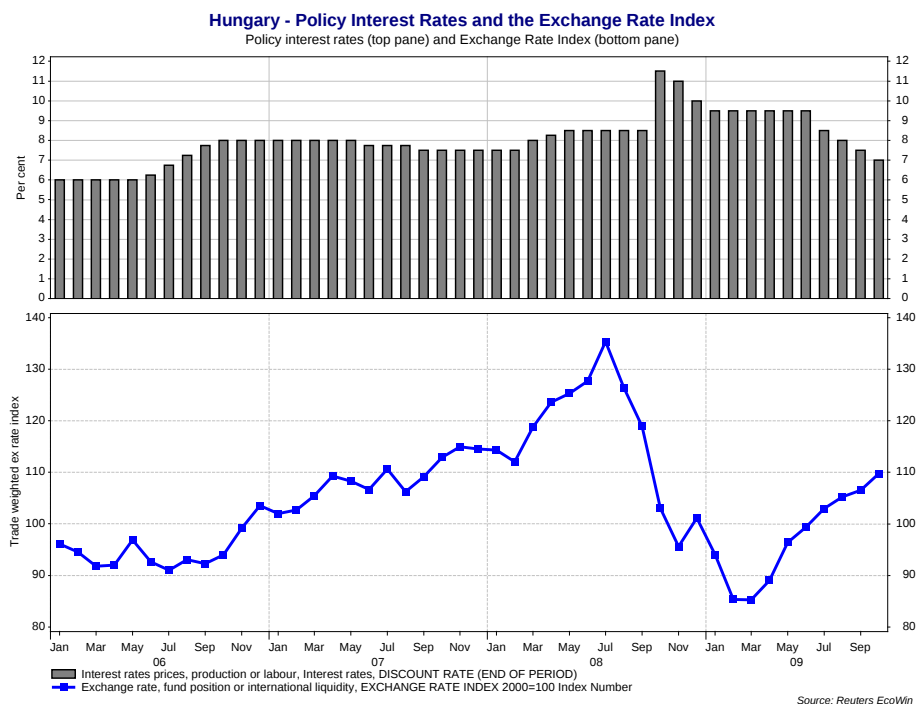
The balance of payments accounts are split into two sections with the current account measuring trade in goods and services and net investment incomes and transfers whilst the capital account tracks capital flows. This includes portfolio capital flows (e.g. share transactions and the buying and selling of Government debt) and direct capital flows arising from foreign investment.

A country's current account is made up of

1. Balance of trade in goods
2. Balance of trade in services
3. Net flows of investment income (i.e. interest, profits and dividends from external assets)

4. Net transfers of private and public sector money from one country to another

Running a sizeable deficit on the current account basically means that an economy is not paying its way in the global economy. There is a net outflow of demand and income from the circular flow of income and spending. The current account does not have to balance because the balance of payments also includes the capital account. The capital account tracks capital flows in and out of a country. This includes portfolio capital flows (e.g. share transactions and the buying and selling of Government debt) and direct capital flows arising from foreign investment.



Hungary's current account deficit was financed by capital inflows (including strong inflows of foreign direct investment) and during 2006 and 2007 this helped to cause an appreciation of the Hungarian currency on a trade-weighted index. The higher currency did not help Hungary's export industries.

But these capital inflows proved to be unstable and once the capital started to flow out the exchange rate came under huge downward pressure.

(10) "The process of globalisation"



	The OECD defines globalization as <i>“The geographic dispersion of industrial and service activities, for example research and development, sourcing of inputs, production and distribution, and the cross-border networking of companies, for example through joint ventures and the sharing of assets”</i> The International Monetary Fund defines globalization as <i>“The process through which an increasingly free flow of ideas, people, goods, services and capital leads to the integration of economies and societies”</i> Globalisation is a process of deeper economic integration that involves: • An expansion of trade in goods and services between countries. • An increase in transfers of financial capital across national boundaries including the expansion of foreign direct investment (FDI) by multi-national companies and the rising influence of sovereign wealth funds (SWFs). • The internationalization of products and services and the development of global brands. • Shifts in production and consumption – for example the expansion of out-sourcing and off shoring of production and support services - production supply-chains have become more international. • Increased levels of labour migration • The entry of countries into the global trading system including China and the former countries of the Soviet bloc. Another way of describing globalisation is to describe it as a process of making the world economy more inter-dependent. Most of the world’s countries are dependent on each other for their macroeconomic health. Linked with this process is a change in the balance of power in the world economy, many of the newly industrialising countries are winning a growing share of world trade and their economies are growing faster than in richer developed nations. All countries have been affected by the credit crunch and decline in world trade, but many emerging market countries have slowed down rather than fall into recession.
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Extract 1: Threats to Economic Stability

UK economic stability threatened

During October 2008 the 'R' word (recession) featured heavily in commentary on the performance of the UK economy. The National Institute of Economic and Social Research predicted recession. The British Chambers of Commerce said that its members (small and medium sized businesses) were experiencing the effects of recession. Even the Governor of the Bank of England and the Prime Minister acknowledged recession was likely.

Following zero economic growth in the second quarter of 2008, official statistics for the third quarter showed a decline in UK national output. Many economists believed that official statistics for the fourth quarter would show further negative economic growth. This would be enough to confirm the UK's first recession since 1992.

Sixteen years of continuous economic growth in the UK had convinced many people that economic policy makers had delivered an unprecedented period of economic stability. The Labour Government had boasted of its record on economic stability since coming to office in 1997. In his first Budget as Chancellor, Gordon Brown had said:

"to avoid a lurch backwards towards the kind of boom-bust instability that brought interest rates as high as 15 per cent in the late 1980s, the Government and the Bank of England took action to ensure economic stability."

This action included:

- granting operational independence to the Bank of England in the conduct of monetary policy and setting the Bank an inflation target;
- creating a Code of Fiscal Stability in which there were clearly defined rules for the conduct of fiscal policy;
- raising interest rates five times during 1997 to reduce inflationary pressures in the economy.

The downturn in economic activity, the uncertainty in financial markets and the depreciation of the UK exchange rate brought to an end the period of economic stability.

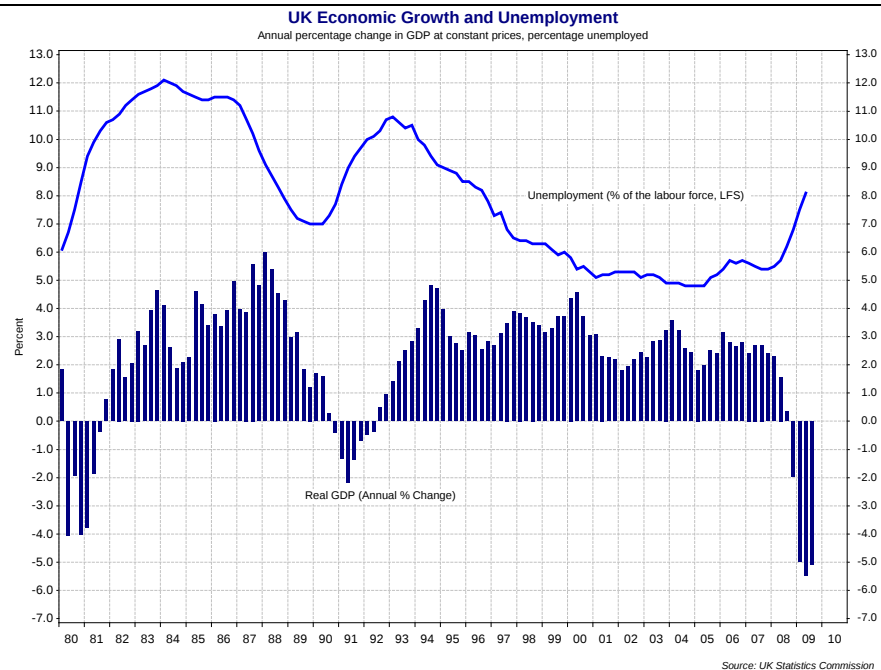
Some economists argued that the breakdown of economic stability had begun in 2007 when UK inflation exceeded the Bank of England's target rate. The downturn in economic activity in 2008, the volatility in financial markets and the depreciation of the UK's exchange rate certainly confirmed the end of an era of stability.

Extract 1: Analysis and interpretation

The meaning of recession	Recession is usually defined as two successive quarters of negative real GDP growth. But this is a narrow definition and there are better ones!
	The National Bureau of Economic Research (USA) defines a recession <i>"as a significant decline in activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators."</i> A depression is worse than a recession and is a persistent downturn

in output and jobs where an economy operates well below its productive potential and where there can be powerful deflationary forces at work

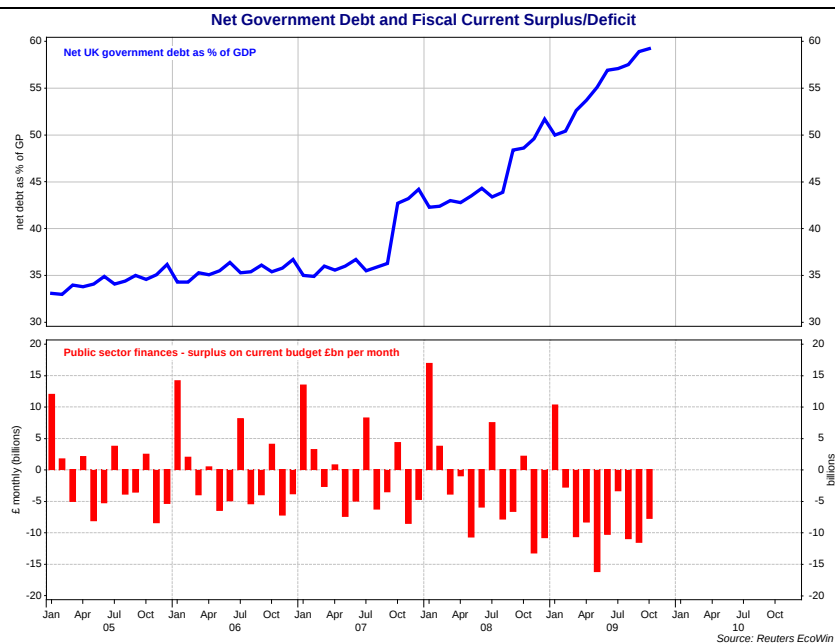
Main causes of the UK recession



The global credit crunch has been hugely significant in causing the UK downturn even though policy has tried hard to prevent it. We have seen

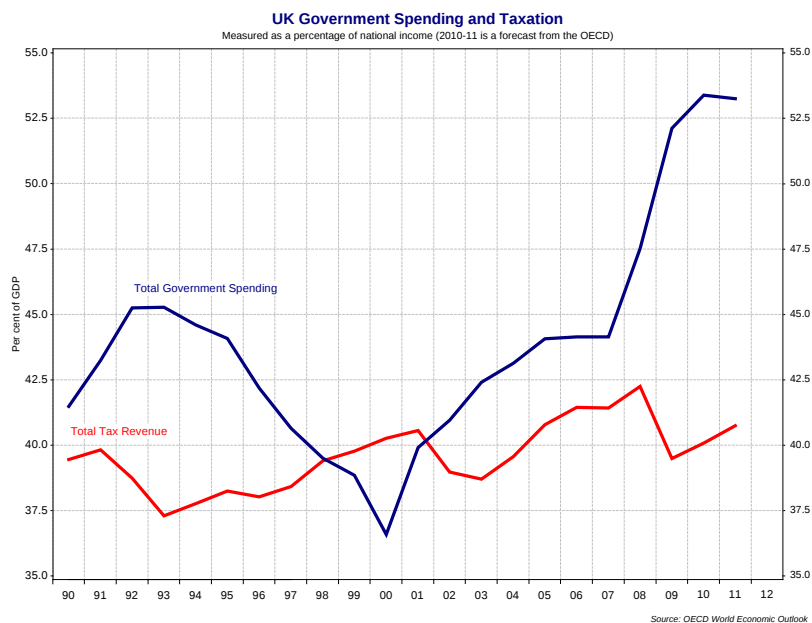
- A fall in several components of aggregate demand (C+I+G+X-M) especially investment and exports
 - A collective loss of confidence – ‘animal spirits’ – recovery cannot happen until confidence returns
 - A weak global economy (the lowest growth for over 60 years) and a contraction in world trade
 - Countries that produce large volumes of ‘cyclical goods’ such as capital goods and products linked to housing have tended to do worse in the downturn
1. The end of the property boom – falling house prices have hit wealth and led to a large contraction in new house building
 2. Reductions in real disposable incomes due to wages rising less quickly than prices
 3. Lagged effects of rising interest rates in 2007-08
 4. A fall in consumer confidence leading to a rise in saving – Keynes called this the ‘paradox of thrift.’
 5. External events – e.g. recession in the UK’s trading partners including USA (15% of UK trade) + Euro Area (55% of UK trade)
 6. UK exports have declined and this has hit manufacturing industry hard (e.g. 1,700 job losses at Corus on Teesside)
 7. Cut-backs in production have led to a negative multiplier effect causing a decline in demand for consumer / household services and lower sales and profits for supply-chain businesses
 8. The credit crunch has caused the supply of credit to dry up affecting millions of businesses and home-owners
 9. Falling profits and weaker demand has caused a fall in business capital investment – known as the negative accelerator effect.

	10. Rising unemployment and a reduction in employment and hours
Independence for the Bank of England	 The Bank of England was made independent in 1997 and the Monetary Policy Committee was created – this is the body that meets each month to set policy interest rates in order to meet the inflation target. • For the first 11 years the monetary policy committee used changes in the price of borrowed money to manage demand and prices. • Aim was for BoE to have an indirect influence on the costs of borrowing and rewards for saving by affecting interest rates on government debt, mortgages, credit cards and corporate debt. • 2009 has brought a change of approach • Series of sudden and dramatic policy rate cuts from 5% in October 2008 to 0.5% in March 2009 • Then the start of quantitative easing – expanding the money supply by purchasing bonds • Key point: Monetary policy now works through price and quantity – an important change
Rules for fiscal policy	The Labour government introduced some fiscal rules when they came to power in 1997. These rules governed how much the state should borrow at different stages of the economic cycle. 1. The Golden Rule – current spending should be financed by taxation over course of an economic cycle. Borrowing is fine to finance investment 2. The Sustainable Investment Rule – net government debt should be kept close to 40% of GDP Both rules have now been dropped and blown out of the water in the light of recent economic events. UK government borrowing is set to reach staggeringly high levels in 2009-10 and beyond. The fiscal deficit will be £180bn in 2009/2010 – equivalent to 12pc of GDP. There has also been a huge rise in government debt – now over £800bn and this will rise further to over 60% of GDP by 2012



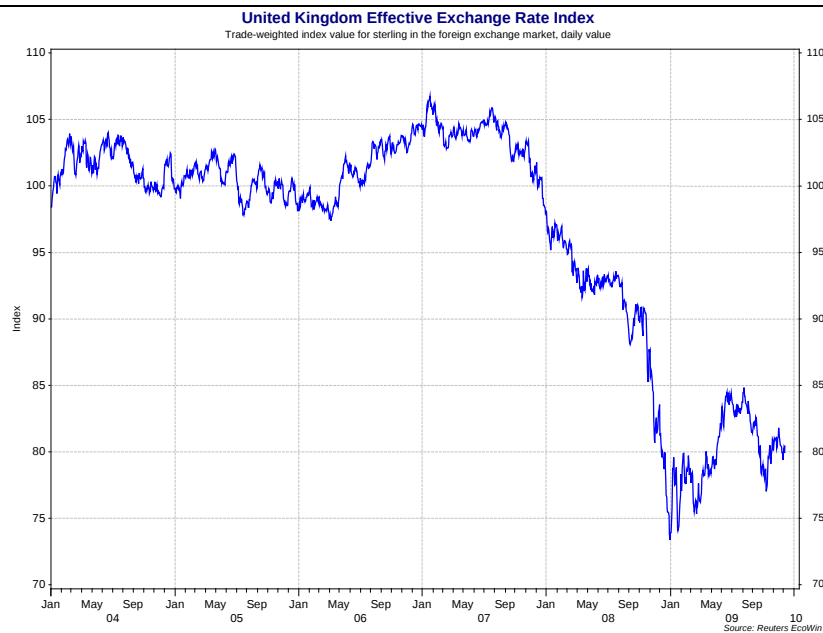
Reasons for the large budget deficit

1. The recession has led to a rise in welfare benefit payments
2. Income tax revenues have been hit by rising unemployment and also by a reduction in real incomes for millions of people in work
3. Sharp fall in business profits hits revenue from corporation tax
4. Housing market downturn has led to lower stamp duty revenues
5. Deliberate fiscal stimulus involving extra government spending and some tax cuts (including temporary cut in VAT to 15%)



The escalating budget deficit and the suspension of the fiscal rules raise important questions about how fiscal policy affects the demand and the supply-side of the economy. The unprecedented borrowing is not fiscal fine tuning - it is an aggressive approach to unusual and difficult economic circumstances!

Reasons for the depreciation of sterling



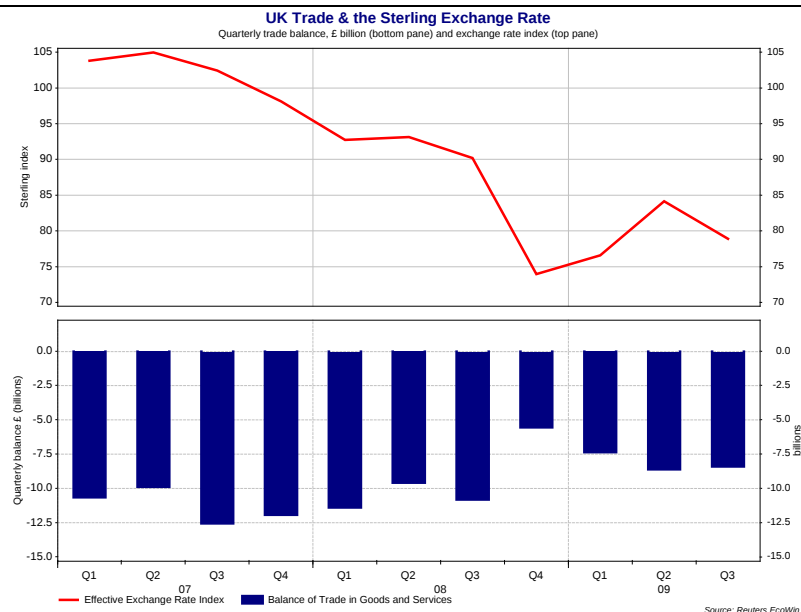
The chart above shows what has happened to sterling's trade-weighted index – a measure of the external value of the pound against a basket of other currencies and weighted according to the proportion of trade conducted in each currency. Sterling's weakness was put down to several macroeconomic factors:

1. **Interest rates:** Steep cuts in official policy rates by the Bank of England
2. **Growth forecasts:** A dramatic weakening of the real economy with growth forecasts being slashed and a realisation that a recession was inevitable. Currency traders decided that the UK was more exposed than most to the downturn in the world economy and the unwinding of the property bubble.
3. **Returns on investment:** Linked with the deepening recession - a downgrading of expected returns from investment in the UK

Macroeconomic benefits of a weaker currency

A fall in the currency represents an expansionary monetary policy and can be used as a counter-cyclical measure to stimulate demand, profits, output and jobs. It ought to bring about an improvement in the balance of trade and, through higher export sales, drive higher demand and output in industries that serve export businesses – the so-called 'supply-chain' effect.

Economists at Goldman Sachs have estimated that a 1% fall in the exchange rate has the same effect on UK output as a 0.2 percentage-point cut in interest rates. On this basis, the 25% decline in sterling in 2007-08 was equivalent to an additional cut in interest rates of between 4 and 5 percentage points – this at a time of domestic and global economic weakness. Without the depreciation in sterling at this time, the recession in the UK would have been much deeper. A cheaper currency provides a competitive boost to an economy and can lead to positive multiplier and accelerator effects within the circular flow



Evaluation points – the limits of currency depreciation

Not all of the effects of a cheaper currency are positive – here are some downsides and risks:

1. A weak currency can make it harder for the government to finance a budget deficit if overseas investors lose confidence. When investors take their money out, this is known as capital flight.
2. Depreciation increases the cost of imports – e.g. rising prices for essential foodstuffs, raw materials and components and also imported technology. This can cause an inward shift of SRAS (and has inflationary risks) and might also affect long-run productive potential.
3. Weak global demand has dampened the beneficial effects of a lower currency – it is harder to export when key markets are in recession and, as the table below shows, some of the economies of the UK's main trading partners have been in deep recession in 2009.
4. If the price elasticity of demand for exports and imports is low, a depreciation of the exchange rate may initially cause a worsening of the balance of trade in goods and services.

Financial volatility and the impact on the real economy – transmission mechanism from the credit crunch



A credit crunch is a **liquidity crisis**. It means that banks become nervous about lending money each other and to personal and business customers. Where they are prepared to lend, they charge higher rates of interest to cover their risk. The result is a big fall in the supply of credit and an increase in the cost of borrowing.

	A credit crunch happens when 1. Financial institutions such as banks and building societies cut the amount that they are prepared to lend to each other – this is a decline in inter-bank lending in the wholesale money markets. In short there is a freezing of the supply of available credit and a rise in the price at which banks lend to each other 2. This increase in wholesale interest rates feeds through to higher interest rates for mortgages and credit cards - making borrowing more expensive for ordinary people and for homeowners. It has become harder for homebuyers to get a mortgage. The lenders are much more selective and cautious about whom they lend to – most mortgages now require a sizeable deposit. 3. It can also make it more difficult for businesses to raise fresh capital through bond issues – forcing many of them to look to the stock markets for streams of new capital e.g. by making use of rights issues. 4. The banks themselves look to improve the asset side of their balance sheets by seeking to raise fresh capital – either by rights issues or by attracting extra savings from depositors. They become more risk averse 5. On the liabilities side of the banks' balance sheets, the lenders cut back on loans – this is a process known as de-leveraging and makes it harder to get a loan. 6. The crunch involves a draining of liquidity in the financial system – driven by worries among investor about where the bad debts are (e.g. bad loans linked to the sub-prime market). The world economy has been affected by the credit crunch – and it is a great case study in how developments in one country can affect other nations – the world economy is highly inter-dependent BBC: Credit crunch a year on: the losers Credit crunch to downturn timeline (BBC news) Guardian special reports on the credit crunch Telegraph special reports on the credit crunch
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Extract 2: Instability Creates Macroeconomic Policy Debate in the UK

Instability creates macroeconomic policy debate in the UK

The financial and economic crises of 2008 were not confined to the UK. They were global crises. The financial crisis had its roots in over-inflated asset prices, particularly house prices in the USA, and bank lending against these assets to households with poor credit ratings. As interest rates in the USA rose, these households were unable to repay their borrowing, house prices fell and the bank loans made to those with poor credit ratings (so-called sub-prime lending) came to be viewed as too risky. Banks most exposed to these risks began to collapse. The globalisation of financial markets meant that the crisis spread outside the USA. Depositors panicked. In the UK, savers in the Northern Rock bank withdrew £1 billion from their accounts in one day. Globally, banks stopped lending to each other and more banks and financial institutions ran into trouble. Banks merged to avoid bankruptcy, some were part-nationalised and governments world-wide injected cash into the banking system to try to ease the growing credit crunch.

The financial crisis was not the only problem which policy makers had to confront in 2008. As economic growth slowed down many people feared that the global economy would enter recession. Central banks began to reduce interest rates aggressively in response to the economic slowdown. Interest rate reductions were co-ordinated by the world's biggest central banks in October 2008 – the US Federal Reserve, European Central Bank (ECB), Bank of England, and the central banks of Canada, Sweden and Switzerland all made emergency interest rate cuts of half a percentage point. Interest rates in the US fell to just 1%. Shortly afterwards, the Bank of England slashed its interest rate by a further 1.5 percentage points.

However, questions were raised about the effectiveness of monetary policy. It was clear that cuts in central bank base rates were initially having little impact on the rates at which banks lent to each other (inter-bank rates) and so to households and firms. It was not unknown for these rates, such as the three month London Inter-Bank Offer Rate (LIBOR), to remain stubbornly high, if not increase, as central bank rates came down (see Fig. 2.1). As a result, the monetary policy transmission mechanism was weakened.

Fiscal policy measures were advocated as an alternative to monetary expansion. Tax cuts were proposed to encourage a growth in spending. Some governments proposed increased public expenditure. In the UK, the Chancellor of the Exchequer announced that public expenditure plans would be brought forward to help bolster demand in the economy. There was a recognition that public borrowing would have to increase to fund this expenditure and that fiscal rules, such as the 'golden rule', might have to be broken. In addition, negative economic growth would further increase public sector borrowing through its impact on tax revenues and welfare spending. Even before the economic crisis deepened in October 2008, public sector borrowing in the UK had reached record levels. Some forecasters expected UK public sector borrowing to reach £60 billion in the financial year 2008–09.

Economists in the UK were divided on the appropriate response to an economic downturn and negative economic growth. A group of 16 economists wrote a letter to The Sunday Telegraph declaring the UK Government's plans to be "misguided and discredited". Their letter is reproduced below in Fig. 2.2.

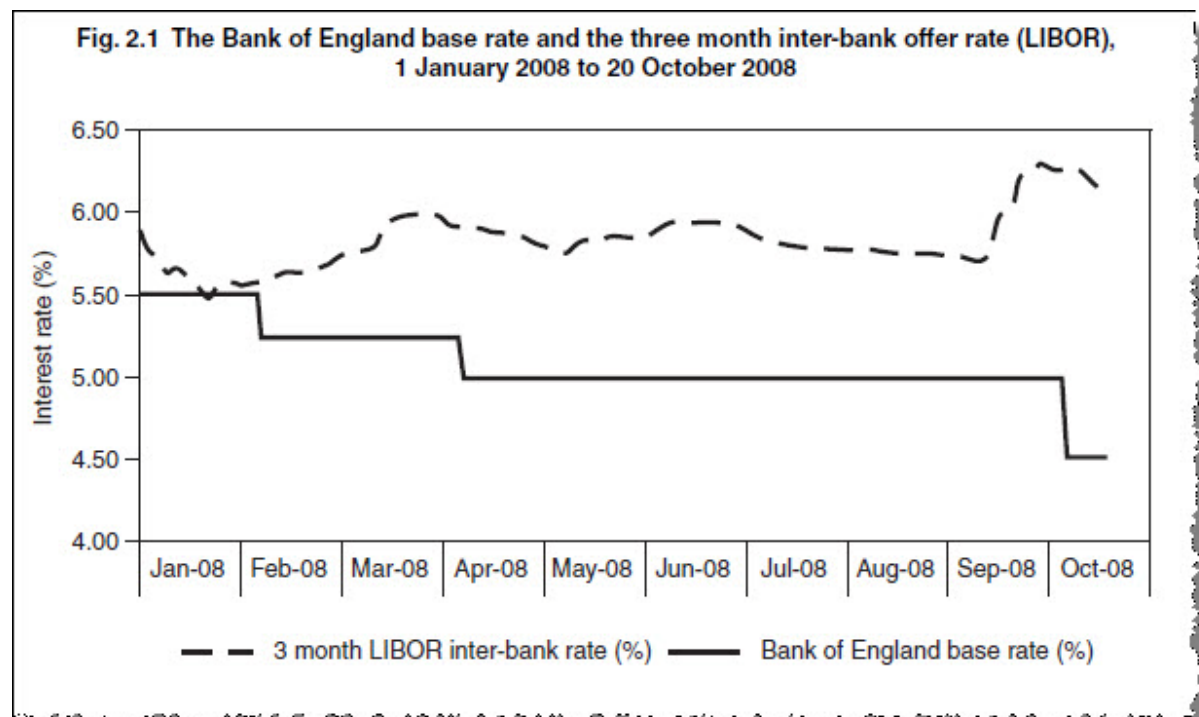
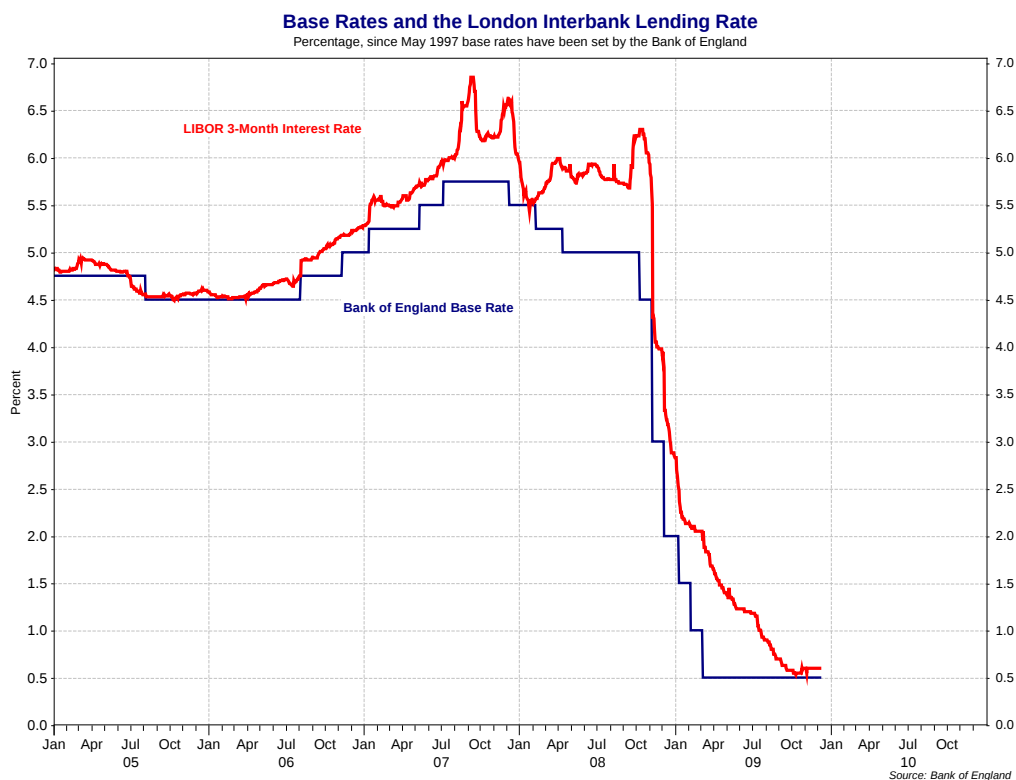
Figure 2.1

Figure 2:1 shows the Bank of England base interest rate (also known as the policy rate). The Bank started cutting interest rates in the winter of 2007-08 but initially moved slowly (cutting only three times over the period shown and in total by just 1 per cent). Their reluctance to cut rates was due largely to fears over accelerating inflation and because they underestimated the impact of the looming global financial crisis on output, jobs and confidence in the UK economy.

The broken line shows the 3-month LIBOR inter-bank rate (%). LIBOR stands for the London Interbank Offered Rate and is used by banks world wide to determine the rate at which they lend to each other - whether that's receiving or giving loans (including 24 hour - 5 year loans). Libor rates are set daily and released at the same time everyday - 11am London time.

LIBOR rates are usually extremely close to the Bank of England's main policy interest rate but the events of the spring and summer of 2008 caused this to change. Notice in the chart how the LIBOR rate stayed at or around 6% despite cuts in policy interest rates by the Monetary Policy Committee; indeed in September 2008 (following the failure of Lehman Bros) LIBOR jumped higher and the gap between policy rates and LIBOR widened to nearly 2 per cent (an unprecedented position). The reason was simple – confidence between banks had evaporated and the price at which they were prepared to lend to each other increased. The gap between the two shown in the chart was indicative of the credit freeze or credit crunch. And for several lenders (notably Bradford and Bingley and Northern Rock), the drying up of funding from the wholesale money markets was to have dire consequences for their futures.

I have updated the chart used in the pre-release stimulus material so that you can see what has happened to policy interest rates and LIBOR during 2009.



The Liquidity Trap

In the 1930s, **Keynes** referred to a liquidity trap effect – a situation where the central bank cannot lower nominal interest rates any lower and where ‘conventional’ monetary policy loses its ability to impact on spending. Paul Krugman has defined the liquidity trap as “a situation in which conventional monetary policy loses all traction.”

When interest rates are close to zero as they are in the UK, the USA and in the Euro Zone, people may expect little or no real rate of return on their financial investment; they may choose instead simply to hoard cash rather than investing it. This causes a fall in the velocity of circulation of money and means that an expansionary monetary policy appears to become impotent. This means that different approaches are called for in order to stabilise demand in an economy on the verge of a depression:

1. Quantitative easing
2. A deliberate expansion of fiscal policy – i.e. higher government spending and borrowing
3. Possible direct intervention in the currency markets to drive the value of the currency lower to boost exports (the Swiss government did this in March 2009)

Quantitative Easing

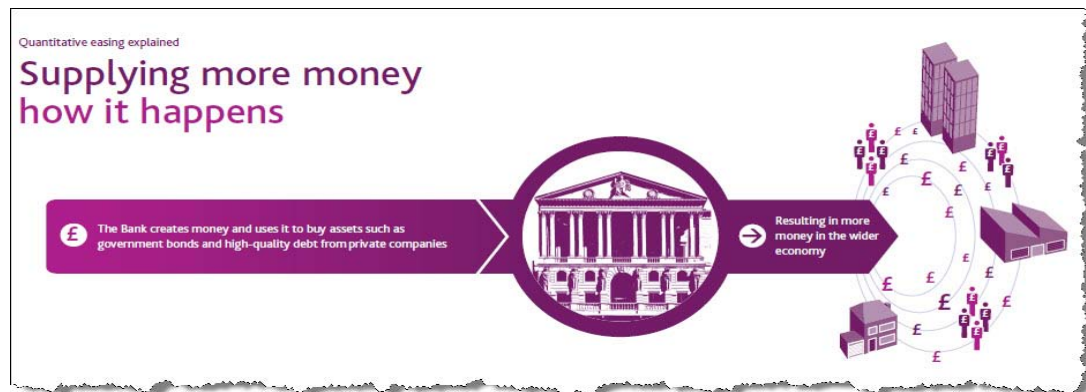
On Wednesday 11th March 2009 the Bank of England started a policy of **quantitative easing** (QE) for the first time. QE is also called as ‘asset purchase scheme’.

The aim of QE is clear – to support the growth of demand in the economy and prevent a period when inflation is persistently below target or becomes negative (deflation).

Rather than acting on the short-term price of money through changes in the policy rate, the Bank of England can use quantitative easing to act on the **quantity of money**. The media call this ‘printing money’

but this is only true in an electronic sense – the Bank will not actually print new £10, £20 and £50 notes in a direct attempt to inject cash into the economic system.

Under this '**unconventional strategy**', the MPC discusses each month how many **assets**, including government bonds, to buy with central bank money. This money is simply created by the central bank and is the equivalent of turning on the printing press. At the time of writing, the MPC is authorised to buy up assets financed by central bank money up to a maximum of £150bn but that up to £50bn of that should be used to purchase private sector assets.



QE is a deliberate expansion of the **central bank's balance sheet** and the **monetary base**. A rising demand for bonds and other assets ought to drive up their price and lead to a fall in **long-term interest rates** (yields) on such assets. (There is an inverse relationship between bond prices and bond yields). If long-term interest rates fall and the banks have stronger **balance sheets** because of BoE purchases under QE, the hope is that this will **stimulate lending** and stronger growth of business and consumer demand in the economy.

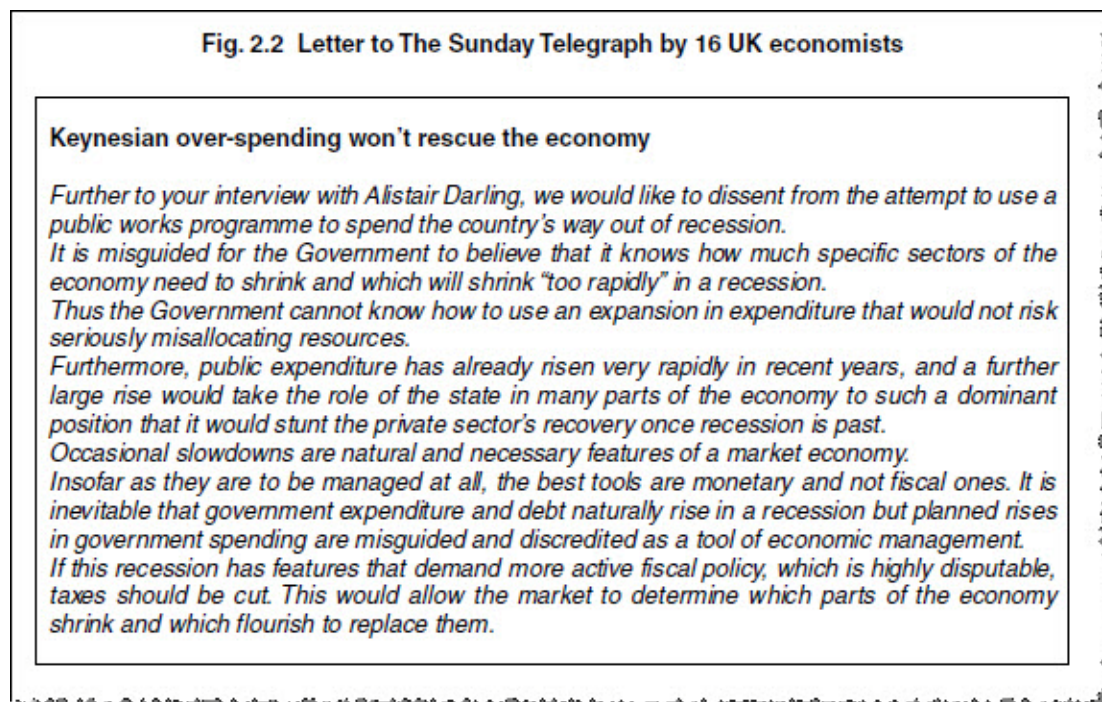
In practice the Bank of England has been purchasing UK government bonds – and with the government having a huge **budget deficit**, there has certainly been plenty of bonds to buy! The evidence on QE so far has been mixed. Asset purchases have improved the **liquidity** of banks and pension funds but some commentators argue that the banks have been happy to 'sit on the cash' and hoard it rather than use it as the basis for new lending to businesses and consumers. Credit availability remains low in the aftermath of the credit crunch and there are plenty of signs that banks and building societies have tightened the conditions on which they are prepared to give out new loans, overdrafts and mortgages. Aims of quantitative easing:

1. Increase the value of cash deposits that commercial banks hold at BoE
2. In theory banks will then be more ready to lend to households and businesses – i.e. it aims to get money flowing round the economy again
3. This should help to relieve the credit freeze and stimulate increased business loans e.g. credit to cover the cost of building up stocks

But

1. If too much money is pumped into the market for too long, inflation could start shooting up
2. There could still be a problem in persuading the banks to engage in more spending – this is the so-called liquidity trap
3. The Bank of England is uneasy about the amount of money it will need to print to keep bond interest rates low.

Figure 2.2



The extract in Fig 2:2 is taken from a letter published in the Sunday Telegraph on the 26th October 2008 by sixteen economists associated with the right-wing free market think tank the **Institute of Economic Affairs**. You [can read the letter here](#). These economists are associated with the Monetarist school of thought in economics and they believe that monetary policy rather than the active use of fiscal policy is the best way to promote economic stability. Their letter provides a potted summary of the arguments against a Keynesian **fiscal stimulus** to demand. In brief:

1. They believe that public works programmes such as infrastructure projects can lead to **government failure** ("misguided attempts", "risk of seriously misallocating resources")
2. They fear that a rising share of government spending as a percentage of GDP will lead to **crowding-out effects** (more below)
3. Slowdowns (and by definition recessions) are natural and necessary features of a market economy i.e. that recessions can have cleansing or restorative effects
4. Fiscal policy is a discredited tool of economic management – either because it is ineffective (see the discussion below about the size of **fiscal multipliers**) or because it risks causing higher inflation in the future which will have damaging economic consequences
5. Tax cuts are preferable to higher government spending as a means of stimulating demand

The key to this extract is to understand where these economists are coming from. Their letter is packed full of **value-judgements** about appropriate macroeconomic policies. They are strongly opposed to the use of **Keynesian counter-cyclical policies** and favour a free-market approach to the economic crisis.

Fiscal policy and the economic cycle

Fiscal policy is the Government's main demand-management tool. Government spending, direct and indirect taxation and the budget balance can be used "counter-cyclically" to help smooth out some of the volatility of real national output particularly when the economy has experienced an external shock.



1. **Discretionary fiscal changes** are deliberate changes in taxation and govt spending – for example a decision by the government to increase total capital spending on road building.
2. **Automatic fiscal changes** (also known as 'automatic stabilisers') are changes in tax revenues and state spending arising automatically as the economy moves through the trade cycle.

Government spending and the crowding out debate

Crowding out is an offset in aggregate demand that results when expansionary fiscal policy raises the interest rate and thereby reduces investment spending. A deficit-financed increase in government spending may drive up interest rates, thereby directing productive resources away from the private sector towards the public sector. Conversely higher spending on public works (such as new motorways or environmental projects) may lead to a lagged rise in the tax burden (taxation measured as a share of GDP) and higher household and business taxes will squeeze demand and stifle enterprise.

Keynesian economists dispute the concept of crowding out. Indeed the 2008 Nobel-prize winning economist Paul Krugman argues that higher government spending and tolerating a bigger fiscal deficit during a recession can in fact lead to "crowding-in effects". According to Krugman, in an economic depression, fiscal deficits crowd-in rather than crowd-out private sector investment.

During the current economic crisis many countries have experienced a spectacular fall in private sector borrowing – government fiscal deficits provide a counter-weight to this. And the fact that real interest rates on ten-year government bonds remain at historically low levels suggests that there isn't an immediate funding crisis for western Governments who have chosen to use a fiscal stimulus as a counter-cyclical policy. Much of the funding for the borrowing – at least in the short term – comes from the rising savings of the private sector of rich advanced nations. We have seen a steep rise in household savings ratios and this means that the USA and the UK will not be overly dependent on the inflow of funds from emerging economies such as China.

However, financial markets do tend to get spooked by governments that run budget deficits on a large scale for several years in succession. For the UK in particular a budget deficit in excess of ten per cent of GDP and the huge rise in gross government debt raises financing issues in the medium term. There is a danger that overseas investors will be reluctant to purchase some of this debt and that the UK government may lose its triple A (AAA) **credit rating**. This would drive up interest rates on government bonds and make the fiscal deficit more expensive to fund – with implications for other areas of state spending.

The debate over the size of the fiscal multiplier

A **Keynesian-style stimulus** is when policy-makers deliberately seek to stimulate one or more of the components of aggregate demand (AD) to boost output, jobs and incomes during a recession.

Keynesians believe that an economy can get stuck at persistently high levels of unemployment with national output below its potential (i.e. operating with a **negative output gap**). When business and consumer confidence is low (**animal spirits** have worsened) there is a danger that high rates of saving can make a recession worse. This is known as the **paradox of thrift**. In this situation weaker demand causes further job losses and can cause **negative multiplier and accelerator effects** particularly in industries that supply components and raw materials to manufacturers and service businesses.

An example of a **Keynesian stimulus** would be to inject extra investment into **public infrastructure projects** financed through higher government borrowing. Keynesians believe that the positive effect on national income and jobs would reduce the risk of a higher budget deficit ‘crowding out’ activity in the private sector. Economist (and former MPC member) [David Blanchflower](#) has been lobbying for a huge public sector investment programme as a way of combating what he fears will be a return to mass unemployment with well in excess of three million people out of work.

Another example would be **tax cuts targeted at lower-income consumers**, targeted at this group because they tend to have a higher marginal propensity to spend any gains in income.

No one knows for sure just how large are the fiscal multipliers from extra government spending or a tax cut – if they are large then a modest fiscal stimulus can have a significant effect on demand. But the likely depth of the recession means that a Keynesian stimulus package will have to be large.

The Economist ran an article on this a few months ago – here is the link [“Much ado about multipliers”](#)

When analysing and evaluating the use of stimulus packages, this framework may prove useful: Consider

1. **Size**—the extent of stimulus relative to GDP
2. **Composition**—i.e. the balance between spending and tax measures
3. **Frontloading**—the speed with which fiscal and monetary policy measures hit the ground and can start having an impact on the components of aggregate demand, production and jobs

Here is a summary of the fiscal policy packages introduced by some countries (source: Brookings Institute)

Country	Size of fiscal stimulus (US dollars)	Size of fiscal stimulus (% of GDP)	Tax share of stimulus (%)
United Kingdom	\$41bn	1.5%	73%
United States	\$841bn	5.9%	35%
Germany	\$130bn	3.4%	68%
China	\$204bn	4.8%	0%
Japan	\$104bn	2.2%	30%

China’s stimulus programme has been skewed heavily towards enormous investment projects whereas the bulk of the easing of fiscal policy in the UK has come from cuts in indirect taxes (e.g. a temporary cut in VAT from 17.5% to 15%).



Several factors affect the likely size of the fiscal multiplier effect.

1. **Design:** i.e. the important choice between tax cuts or higher government spending. Recent evidence from the OECD is that multiplier effects of direct increases in spending are higher than for tax cuts or increased transfer payments.
2. **Who gains from the stimulus?** If tax reductions are targeted on the low paid, the chances are greater that they will spend it and spend it on British produced goods and services. But how soon will they get any benefit from reductions that they notice?
3. **Financial Stress:** At present, fiscal policy is operating in highly unusual and uncertain times. Uncertainty about job prospects, future income and inflation levels might make people save their tax cuts. On the other hand if consumers are finding it hard to get fresh lines of credit, they may decide to consume a high percentage of a boost to their disposable incomes.
4. **Temporary or permanent fiscal boost:** Expectations of the future drive behaviour today ... most of us now expect taxes to have to rise in the coming years. Will this prompt a higher level of household saving and a paring back of spending and private sector borrowing?
5. **Monetary policy response:** In the jargon, does monetary policy accommodate the fiscal stimulus (i.e. there are no offsetting rises in interest rates)? Consider a situation in 2010-2011 when the Bank of England holds policy interest rates close to 1% even if inflationary pressures are rising - this will drive down real interest rates and perhaps boost demand still further. But the central bank has an inflation target to consider and the Bank may start to raise interest rates and limit the impact of the fiscal boost.
6. **The availability of credit:** If fiscal policy works in injecting fresh demand into the economy, we still need the banking system to be able to offer sufficient credit to businesses who may need to borrow to fund a rise in production (perhaps for export) and also investment in fixed capital and extra stocks.
7. **Openness of the economy:** The more open an economy is (i.e. the higher is the ratio of imports and exports to GDP) the greater the extent to which higher government spending or tax cuts will feed their way into rising demand for imported goods and services, lowering the impact on domestic GDP.
8. **Fiscal and monetary policy decisions in other countries:** Modern economics are deeply inter-connected with each other. The UK government has decided to run a huge budget deficit - so what happens to government borrowing and interest rates in the EU, the USA and in many emerging market countries will have an important bearing on prospects for a broadly based recovery in global trade and output which then affects the UK economy

Extract 3: Countries Call on the International Monetary Fund (IMF)

Countries call on the International Monetary Fund (IMF)

One of the consequences of the global financial crisis was a loss in confidence in the banking system. Just as this causes individuals to withdraw their cash (a 'run on the bank'), a loss of confidence in a country's ability to repay its 'debts' causes a run on the currency. Capital flight, as it is called, can send a currency into free fall and send countries cap in hand to the International Monetary Fund (IMF).

In early October 2008, the exchange rates of a number of countries collapsed as capital flight took hold. These countries approached the IMF for assistance. According to the BBC's Business Editor, Robert Peston:

"Queuing up for the intensive care ward are Iceland, Hungary, Pakistan, Ukraine and Belarus, all of which are in discussions about accessing special loans from the International Monetary Fund, the emergency medical service for the global economy. But there has also been a substantial withdrawal of capital from South Africa, Argentina and - most worrying of all - South Korea."

These countries have, in the past, attracted large amounts of foreign capital as their economies have undergone economic development. This means that they have large external debts. The level of this debt ranged from around US\$40 billion for Pakistan to US\$100 billion in Hungary, to almost US\$200 billion in the case of South Korea. Some countries, though not all, had experienced large and growing current account deficits on their balance of payments. They had financed these deficits by attracting flows of money from abroad. This was all very well as long as those providing the financial capital carried on doing so or did not want it back in a hurry. Not so good when this source of long-term financial capital dries up or the investors want their money back. And that is what happened in 2008 – financial capital was withdrawn from these economies, causing their currencies to depreciate dramatically. For example, Hungary's currency (the forint) fell against the euro by 15% in October 2008, forcing Hungary's central bank to raise interest rates by three percentage points in an attempt to halt the depreciation of the forint. Only when the country received loans from the IMF, the World Bank and the EU totalling US\$25 billion did the forint recover. These loans were conditional upon Hungary taking steps to reduce its large and significant current account deficit.

South Korea's situation, however, was different. As one of the world's major exporters, its current account balance was healthy. Much more so than that of the UK, where there had been a persistent and growing current account deficit for a number of years. It was not surprising, then, that the UK also experienced a fall in its exchange rate during 2008. From August to October, sterling fell 22% against the US\$; it depreciated by 14% in October alone. As the UK operates a freely floating exchange rate, the value of sterling is likely to fall as exports are reduced by global economic downturns. But sterling's exchange rate is also affected by short term financial capital flows. The anticipation of lower interest rates, as part of a monetary expansion, was likely to have been a major factor in sterling's depreciation in 2008.

The depreciation of sterling was viewed by some economists as a good thing for the UK economy. For others it raised a dilemma for economic policy. These economists argued that a fall in the value of sterling made it more difficult for the Bank of England to reduce interest rates, because of the possible inflationary consequences of higher import prices. Some commentators argued that it was time to abandon inflation targets – at least temporarily – since, perversely, they were undermining the return to economic stability. Others pointed out that the dilemma for economic policy made the case for the UK's membership of the euro area stronger than it had ever been before.

Loss of confidence in the banking system:

Most commercial banking has the characteristics of a utility. Banks are licensed deposit-takers attracting the retail savings deposits of individuals and businesses. These form the base of their reserves from which lending can take place. The essence of the sub-prime lending crisis is very simple. Banks moved from being relatively risk-averse lenders focusing on standard loans and overdrafts to customers, to casino banks developing ever more complex and exotic securitised loans that were then parcelled up and sold to other financial institutions. The risks and rewards were high when asset prices and the real economies of the leading countries were doing well – but the failure of the financial markets (and the credit ratings agencies) to price risk accurately ultimately lead to a collapse in confidence both among lenders (the credit freeze) and also depositors – hence the “run on the bank” that afflicted Northern Rock plc.

Capital flight

This describes an outflow of money from one country to another as investors lose faith and confidence in their external investments. Typically it happens when a nation’s currency is under strong downward pressure either because of speculative selling or because of fundamental factors such as a recession, poor trade performance or a steep fall in asset prices or interest rates. Another root cause is weakening faith in the creditworthiness of a national government especially when they are running up large budget deficits that might be unsustainable. Foreign investors may choose to withdraw their money if they expect a hike in taxes on their investments.

When capital flight happens the currency is likely to drop sharply as money leaves an economy and there may be little that the central bank can do about this e.g. by intervening in the markets or by raising short-term interest rates.

Robert Peston’s blog mentions the following countries as recent examples of currency instability and suffering a withdrawal of capital – follow the link for a news story about each to build your background awareness:

- Iceland - [why raising interest rates won’t work](#) (BBC, October 2008)
- Hungary – [the rise and fall of Hungary](#) (Guardian, October 2008)
- Ireland – [record decline hits Ireland’s economy](#) (BBC, March 2009)
- Pakistan – [Pakistan asks IMF for rescue loan](#) (BBC, November 2008)
- Ukraine – [banking crisis spurred by collapsing price of steel](#) (Guardian, Oct 2008)
- Belarus – [Belarus to get \\$2.5bn IMF loan](#) (BBC, December 2008)

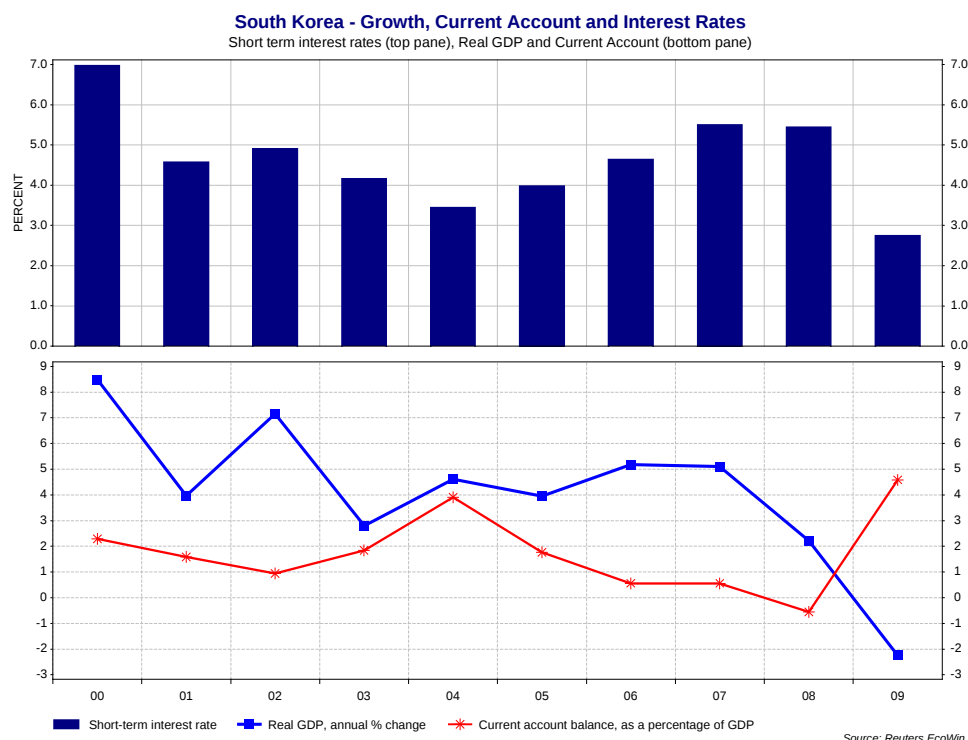
Countries running **current account deficits** on their balance of payments can finance this by attracting net inflows of capital from overseas investors. As the extract makes clear one of the immediate effects of the fall-out from the sub-prime crisis was a reversal of capital flows as investors took fright and decided to hedge against financial uncertainty by switching their money into countries with a safe-haven status currency or in investments such as gold. The result was the current account deficit countries faced a run on their currencies that required international intervention by the IMF and by the World Bank among others. This assistance is usually **conditional** on national governments imposing contractionary fiscal policies to reduce the size of budget and external (BoP) deficits.

South Korea

[South Korea](#) is featured in extract 3 and is portrayed as a country whose balance of payments position was in a stronger position than the likes of the UK and Hungary. Our table below provides background on South Korea for the years 2007-2010 (the 2010 data is a forecast from the OECD).

South Korea Macroeconomic Indicators 2007-2010				
	2007	2008	2009	2010
Real GDP (% change)	5.1	2.2	0.1	4.4
Household spending (% change)	5.1	0.9	0.2	2.9
Government consumption (% change)	5.4	4.2	5.8	3.0
Gross capital investment (% change)	4.2	-1.7	-1.7	3.6
Exports of goods and services (% change)	12.6	5.7	-0.1	13.4
Imports of goods and services (% change)	11.7	3.7	-8.2	15.1
Unemployment rate (percentage of labour force)	3.2	3.2	3.8	3.6
Government budget balance (percentage of GDP)	4.7	3.3	-1.8	0.4
Short-term policy interest rate (per cent)	5.2	5.5	2.6	3.5
CPI inflation (per cent)	2.5	4.7	2.7	2.8
Balance of Payments Current Account Balance (% of GDP)	0.6	-0.6	4.6	1.3

To what extent has South Korea emerged relatively unscathed from the financial crisis? Their economy has flirted with recession but GDP stayed flat in 2009 rather than falling and a strong rebound is forecast for 2010. Unemployment has remained remarkably constant and below 4 per cent of the labour force. The decline in capital investment has been much lower than in other countries. And, although the volume of exports of goods and service dipped in 2009 the OECD forecast suggests that this will be a short-lived effect – exports are set to grow by more than 13 per cent in 2010. Indeed South Korea's current account surplus has grown to 4.6% of GDP in 2009. And the government's budget deficit in 2009 is less than 2% of GDP even after the fiscal stimulus introduced by the South Korean government.



Extract 4: Globalisation Raises Fears for Developing Countries

Globalisation raises fears for developing countries

The financial crisis of 2008 had its roots very firmly in the developed world. However, the nature of globalisation meant that there were concerns that the developing world would suffer consequences too. For example, Shanta Devarajan, Chief Economist of the World Bank's Africa Region, identified three ways in which Africa might suffer:

- a decline in private financial capital flows, which Africa has become dependent on for its infrastructure investment;
- a decline in commodity prices, as the global economic slowdown reduces the demand for commodities such as oil and copper;
- a reduction in flows of aid, as developed economies reallocate public expenditure during the economic slowdown.

In addition, fears were expressed that developed countries could demand debt repayments from African countries. This would inevitably lead to cutbacks in expenditure on health and education in African countries, with severe consequences for economic development.

However, Louis Kasekende, Chief Economist at the African Development Bank (AfDB), considered that African economies would continue to record annual economic growth averaging 6% until 2010. He felt that the impact on Africa of the global financial and economic crisis would be limited in the short term because of its weak integration into the global economy. The signing of an African Free Trade Area agreement would also limit the initial impact of the global economic slowdown.

In contrast, goods and services produced in Asia tend to be traded much more internationally. Asian nations would be worried that a slowdown in the growth of demand in Western developed nations would reduce the demand for their exports and risk the loss of jobs in Asia. China's economic growth, for example, fell throughout 2008, and it was reported that half of China's toy manufacturers had gone out of business. There were calls from China for the USA to reduce its trade barriers in order to open up its market to products from China and other developing countries.

Some economists took the opportunity to express their doubts about the benefits of globalisation for developing countries. Jayati Ghosh, Professor of Economics at Jawaharlal Nehru University, in Delhi, India, said that:

"India is seen as a big success story of globalisation, but only a minority of Indians have benefited materially from the high economic growth. Formal sector employment stagnated; real wages for most workers actually fell; nearly 200,000 farmers committed suicide in the period of 1995-2006 alone; and there was an increase in the number of malnourished children. So the recent economic growth was not inclusive. But, unfortunately, the coming slump will be only too inclusive, forcing those who did not gain earlier to pay for the sins of irresponsible and unregulated finance, through their own loss of livelihood and reduced living standards."

Others, such as Jagdish Bhagwati (Professor at Columbia University, USA), warned that the benefits globalisation had brought, in terms of greater openness of economies and the gains from international trade, should not be sacrificed by a return to protectionism.

This extract is mainly about the **impact of globalisation** on developing countries specifically African nations, the effects of the world recession on Asian **export-led emerging economies** including China and India. Globalisation is a huge topic and the extract covers a lot of ground in a short space.

1. The roots of the financial crisis are said to be in the developed world – for example the sub-prime crisis in the USA which led to a systemic loss of confidence in the international financial system
2. Developing countries said to be exposed to the financial crisis through
 - a. Partial reversal of previous high net inflows of foreign direct investment
 - b. A fall in world commodity prices such as oil and copper
 - c. Cut-backs in overseas aid as developed countries look to reduce their own budget deficits
3. The next paragraph is about **African trend growth** and a possible de-coupling from the world economic crisis because of their weaker integration into the world economy
4. Mention is also made of the establishment of an [African free-trade area](#) (FTA)
5. Asia emerging market economies are said to be more deeply integrated into the world economy and their export-led model has been badly affected by the recession in advanced nations
6. China is singled out in paragraph 5 with specific reference to demands from countries such as the USA for China to rebalance her economy, open her economy to higher levels of imports and look to shift towards higher domestic demand (and consumption in particular) as the main driver for GDP growth in the years ahead.
7. The final paragraph refers to India and the skewed distribution of the gains from globalisation, economic growth and development and also flags up concerns about a [return to protectionism](#) and the possibility of **de-globalisation**.

Interpreting the extract

Causes of the crisis: Are the causes of the financial crisis solely the result of excesses and imbalances in developed countries? Some might argue that the rapid emergence of countries such as China was a longer term cause of the problem. Many developing countries have built up huge trade and current account surpluses because of an excess of domestic savings over investment; a significant amount of these surpluses found their way into the financial markets of richer advanced nations encouraging a fall in long-term interest rates and a boom in asset prices including property. Rapid emerging market growth was also a factor behind the sharp rise in world food and oil prices in 2007-08 which led to increased inflation, higher short term interest rates and the spectacular bursting of the asset price bubble.

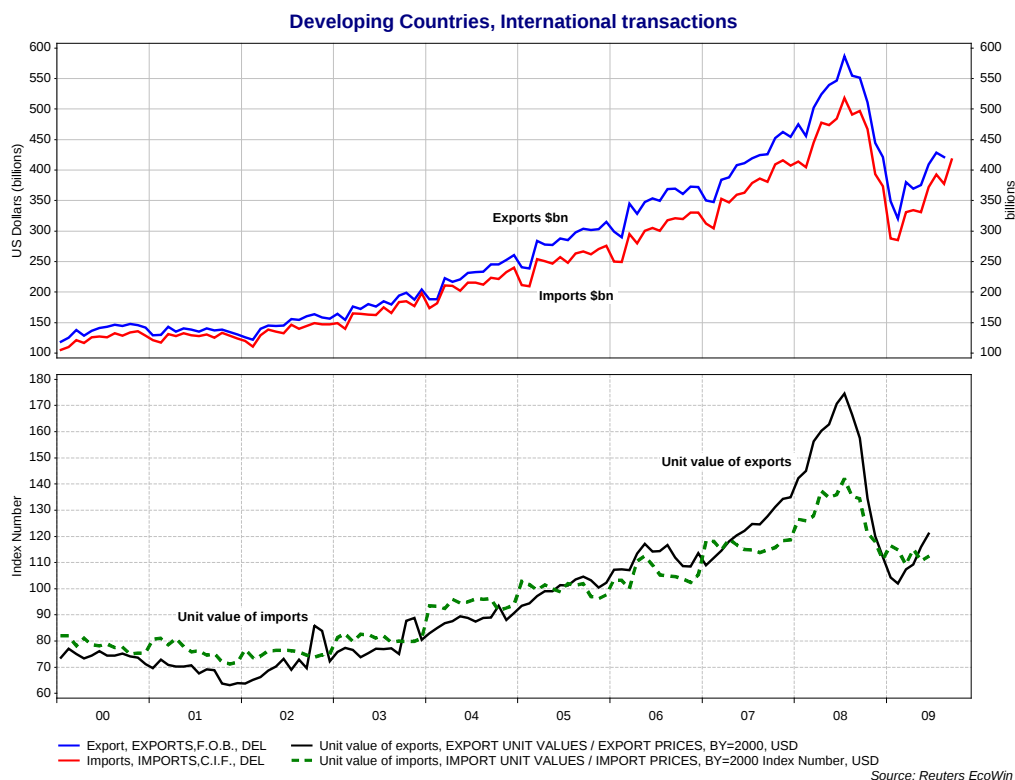
Macroeconomic performance of the African region

For many years Africa appeared to have largely missed out from the beneficial effects of globalisation. The gap in real per capita incomes between Sub-Saharan Africa and emerging market countries grew wider. More recently the region has seen an improvement in her performance helped by the strength of global commodity prices (many African countries rely on exports of primary products as a key source of income and foreign exchange reserves) and a pick-up in foreign direct investment into the continent.

MACROECONOMIC INDICATORS FOR SUB-SAHARAN AFRICA	2007	2008	2009*
GDP at market prices	6.2	4.8	1.0
Private consumption spending	7.1	3.3	0.8
Fixed investment	20.5	12.4	-2.6
Exports	4.1	4.7	-3.2
Imports	11.9	6.6	-3.0
Investment (as a % of GDP)	20.9	21.4	22.3
Exports (as a % of GDP)	35.9	39.3	32.4
GDP per capita, current US\$	1079.4	1240.8	1072.5
Real per capita GDP growth	3.8	2.8	-0.9

Source: World Bank Global Economic Prospects, June 2009 *forecast

Impact of global recession on developing countries:



Open economies, which are highly trade dependent and export only a small range of products to few markets, are affected most by the trade transmission mechanism. This helps to understand the wider economic and social effects of the 2009 global downturn. The recession has affected developing countries in many different ways including the following:

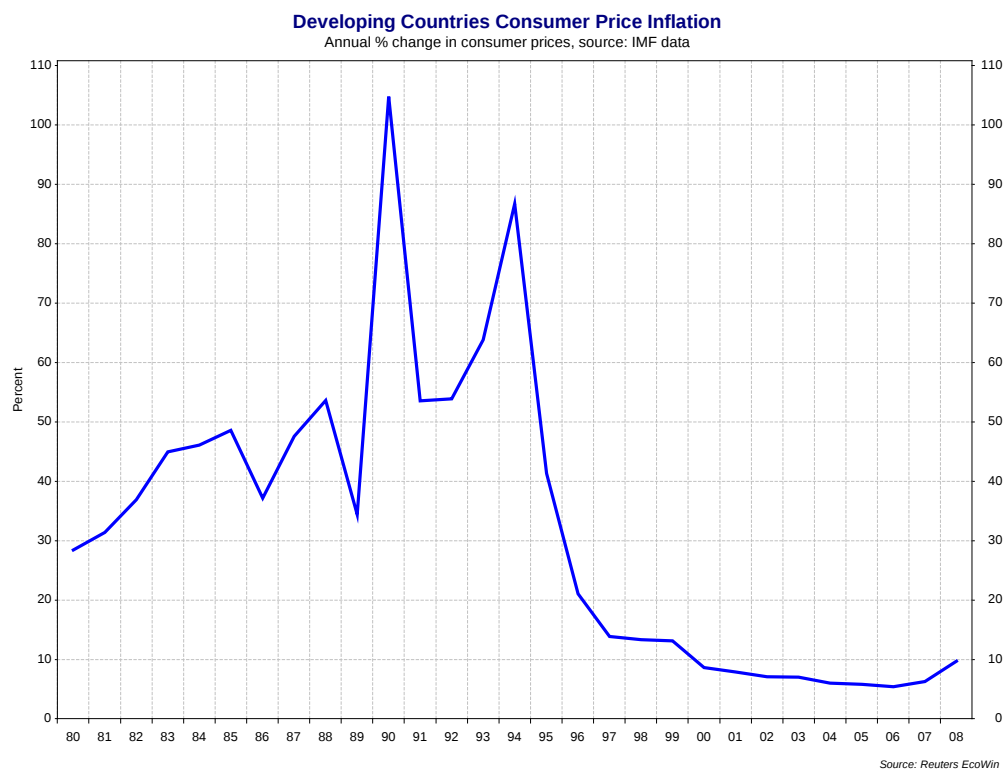
1. Declines in **foreign direct investment** especially reductions in access to loans from banks – some developing countries have set up their own sovereign wealth funds to offset this
2. **Falls in export revenues** due to lower demand (and falling prices) for commodities and a sharp reduction in demand for manufactured goods from many emerging market countries. (This article looks at the [collapse of export earnings](#) in Latin American countries). The previous chart shows the volatility in export prices and revenues for developing countries. Much of the strong GDP growth enjoyed by these nations was due to rising demand for and prices of primary commodities that

improved the terms of trade of developing exporters. This reversed from the middle of 2008 onwards although there is signs of a rebound in export revenue since the spring of 2009.

3. Recession has cut **export prices** – but another key effect has been **increased volatility of prices** – this increases revenue uncertainty for commodity-dependent countries and acts as a barrier against much-needed capital investment
4. A decline in [remittances](#) from overseas migrants working in developed countries – the World Bank has forecast that remittance flows to developing countries will decline by 7-10 percent in 2009. The World Bank estimates that there are over 250 million people living overseas who send some of their earned income back - remittances to all countries topped \$305bn in 2008.
5. A recession in [global tourism](#) – often a significant share of GDP for many poorer nations
6. Rising [food prices](#) has created a huge problem of food poverty – the World Bank called this a silent tsunami
7. **Increased unemployment**, under-employment and loss of income. Many laid-off formal sector workers are forced into low-income jobs in the informal and rural sectors (China is a good example)
8. **Weaker growth and rising unemployment** puts huge pressure on government finances and in many countries there is not a widespread social welfare system as a safety net
9. Some countries have been hit by **multiple macroeconomic shocks**. A good example is [Nigeria](#) – whose export revenues have declined following a 70% fall in crude oil prices, a sharp fall in domestic share prices (which has made funding investment tougher) – both of which contributed to a depreciation of the naira by 20% which has worsened their terms of trade, increased the cost of servicing foreign debts and increased the prices of imported foods.
10. Overall the recession has worsened prospects for developing countries meeting the [Millennium Development Goals](#). The World Bank has estimated that up to 90 million extra people world-wide (62 million in Asia) will live in extreme income poverty (less than US\$1.25 per day) in 2009 as a result of the global economic slowdown

The effects of the recession **vary widely** across the developing world – some countries have avoided recession and have started to recover more quickly than expected – the obvious example here is China, largely as a result of a gigantic fiscal stimulus programme.

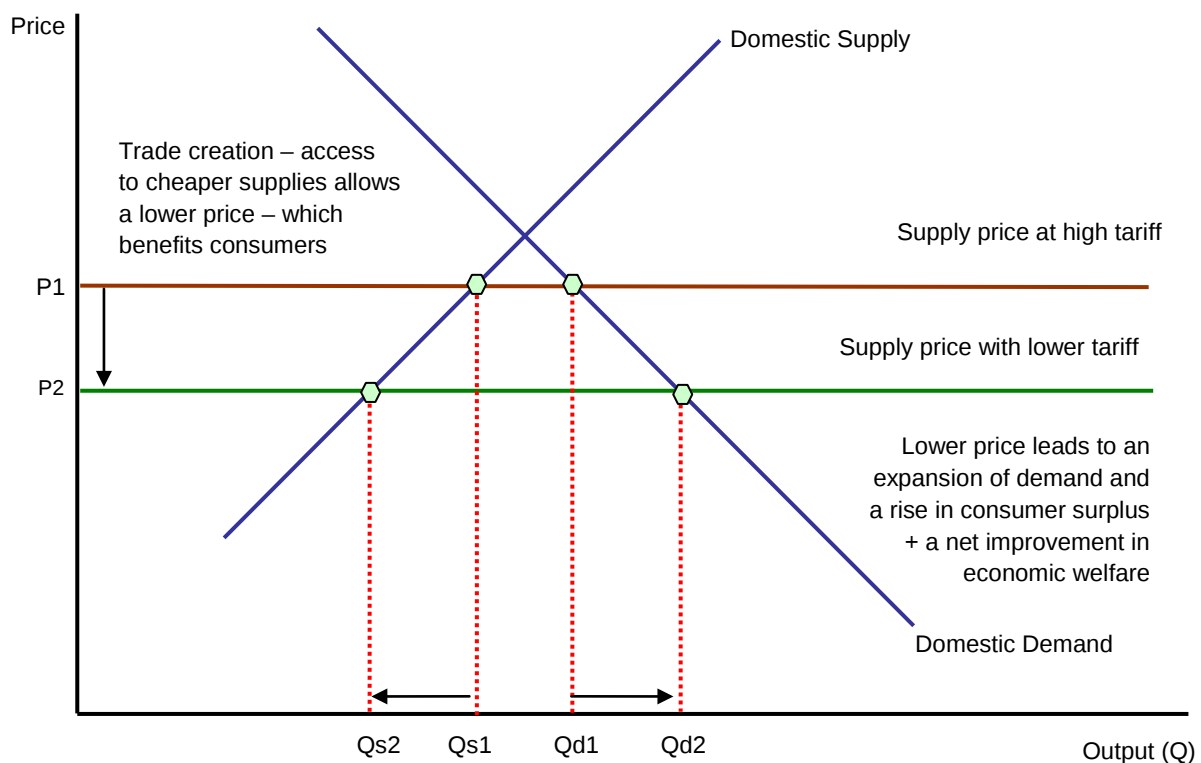
Good analysis here would include understanding the demand and supply-side effects of the world recession on developing nations. For example a **reversal of FDI flows** will affect investment in infrastructure – which impacts directly on aggregate demand and also LRAS and trend growth.



Geographical seepage occurs because of deepened inter-relationships between economies, supply-chains and financial markets across countries. One example is how developing countries that were really not part of the financial bubble and subsequent crisis of 2007-08 are now suffering economically because of the spread of the global downturn. Seepage is partly due to the changing structure of the world economy arising from **outsourcing**. The share of industrial production in GDP in BRIC nations has been rising - indeed more and more industrial production takes place in emerging markets. So when demand for new cars, iPods and other electronic goods dry up from the richer nations the BRIC nations see a dramatic fall in export growth. And developing nations reliant on exporting commodities to advanced economies will suffer from a fall in demand for and price of their output.

Expansion of African free trade areas and special economic zones

[Free trade zones](#) are loose forms of **economic integration** where countries, agree to cut or scrap import taxes (tariffs) in order to lower business costs and remove bureaucracy. They are also known as "special economic zones" and are mostly found in developing economies. The aim is to give a boost to inter-regional trade, especially between raw material producers and manufacturing based economies and to act as a catalyst for stronger economic growth. These zones are also attractive to **foreign investors** as it is cheaper for them to do business there. Increased trade between member nations can lead, under certain circumstances, to an improvement in producer and consumer welfare – this is known as **trade creation**. A trade creation diagram is shown on the next page.



For consumers and capitalists, the rapid expansion of global trade and foreign investment is a normally considered good thing. Textbook theory suggests that increased competition from overseas leads to improvements in static and dynamic efficiency and gains in welfare.

- Trade enhances the division of labour as countries specialise in areas of comparative and competitive advantage.
- Deeper relationships between markets across borders enable producers and consumers to reap the full benefits of economies of scale.
- Competitive markets reduce monopoly profit margins and provide incentives for businesses to seek cost-reducing innovations and improvements in their products.
- The combined effects of these gains in efficiency should be – over time – an improvement in growth and higher per capita incomes.

Are we seeing de-globalisation?

Globalisation is not an inevitable process. 2009 marked a year when global trade contracted for the first time in many years and the term **de-globalisation** started to appear frequently in international economics news coverage. There are many threats to the process of globalisation.

- **The paradox of inequality:** Globalisation has been linked to a widening of inequalities in income and wealth. The paradox is that globalisation has reduced inequalities between countries but widened income and wealth gaps within nations. Evidence for this is a rise in the **Gini-coefficient** for many



developed nations and a growing rural – urban divide growing in countries such as China, [India](#) and [Brazil](#).

- **The return of inflation:** In many ways globalisation has reduced costs and prices for many goods and services. But the driving down of interest rates caused by a glut of global savings allied to fast economic growth rates in emerging market countries led in 2007-08 to a surge in the prices of virtually all traded commodities. Food price inflation is the obvious symptom of this and it placed millions of the world's poorest people at great risk.
- **Bursting of the financial euphoria / bubbles:** A decade or more of strong growth, low interest rates, easy credit created the conditions for a boom in share prices and property valuations in many countries. The bursting of these speculative bubbles prompted the credit crunch and the spreading of contagion from that across the world in 2008-09.
- **Threats to the global commons:** Perhaps the biggest long-term threat to globalisation is the impact that rapid growth and development is having on the global environment. The threat of irreversible damage to ecosystems, land degradation, [deforestation](#), loss of bio-diversity and the fears of a permanent shortage of water afflicting millions of the most vulnerable people are just some of the vital issues facing policy-makers.
- **Huge trade imbalances:** World trade has grown over recent years but so too have trade imbalances. Some countries are running enormous trade and current account surpluses. Whatever the causes, trade imbalances are creating tensions for globalisation. There is growing political pressure towards
 - (1) **Economic nationalism** – where governments block takeovers and mergers of domestic industries and businesses by foreign owned multinationals
 - (2) **Resource nationalism:** Where countries protect their own factor resources such as natural raw materials. And countries with trade surpluses but high levels of import dependency use foreign exchange reserves to buy up the right to import minerals from other countries.
 - (3) **Trade [protectionism](#)** to cut balance of payments deficits and protect output and jobs
 - (4) **Smaller agreements:** There has been a shift away from multi-lateral trade towards bi-lateral trade agreements – a process that will be strengthened after the collapse of the Doha trade negotiations.

The collapse in world trade in 2009

After many years in which the volume and value of global trade in goods and services grew very quickly and the ratio of world trade to world GDP continued to rise, in 2009 there was an abrupt decline in international trade. The World Bank has estimated that global trade will shrink by 10 per cent in 2009 the largest fall since the Second World War. Several factors have combined to cause the slump in trade:

- **A freezing of trade credit** – many exporters have found it difficult to get the finance necessary to pay for making and then transporting products to overseas markets
- **Dominance of manufactured products in global exchange:** The percentage of world trade now accounted for by manufactured durable products has grown over the years but in the current international downturn this is where cancelled orders have been concentrated. Exporting countries such as Germany and Japan have suffered most from the collapse in demand.

- **Export quotas:** Some food-producing countries have taken steps to limit food exports in the aftermath of rising world foodstuff prices. They want to make sure that there is sufficient to eat at affordable prices for their own population first.
- **The vertical disintegration of global production** – there is a misconception that iPods are all made in China. Final assembly might take place there but the broader manufacturing process including components takes place in more than a dozen countries. A slump in demand for consumer durable products and capital goods (e.g. new machinery and technology) has hit supply-chain industries across the world causing a steep decline in intra-industry trade.

In March 2009 the [World Trade Organisation](#) warned of a return to open and hidden forms of import controls by countries struggling to cope with the recession. They found that 17 of the G20 countries had built trade barriers over the last year.

- In the footwear sector, Argentina, Brazil, Canada, Ecuador, the EU, Turkey and Ukraine have enacted or are considering measures designed to slow imports from China or Vietnam
- Australia, Brazil, Britain, Canada, France, India, Russia, and the US were cited for automotive tariffs, subsidies, credits, licences or other changes deemed dangerous to trade.
- Argentina, the EU, Egypt, India, Indonesia, Malaysia, Philippines, Russia, Turkey, the US and Vietnam were listed for protective steel regulation

Guided revision Questions for F585 January 2010

1. Explain how the 2008 credit crunch caused recession in most of the advanced rich economies
2. Using aggregate demand and supply diagrams show how prices and real GDP might be affected by
 - a. A fall in export demand and business confidence
 - b. A rise in the prices of imported raw materials and components
3. Identify and explain some of the economic and social consequences of rising unemployment
4. How can lower policy interest rates help to stabilise demand and output during a recession?
5. Under what circumstances are lower interest rates ineffective as part of monetary policy?
6. Explain what is meant by quantitative easing. Is there any evidence as to whether this strategy by the Bank of England is working to achieve its aims?
7. Is now the right time for the Bank of England to abandon inflation targets?
8. Which economic factors might explain the 20% depreciation in the value of sterling during 2008?
9. In a global recession does a devaluation of your currency improve economic performance?
10. Evaluate the effectiveness of the decisions taken by the Bank of England during the financial crisis
11. The events of recent years support the case for a country having a floating rather than a fixed exchange rate. Discuss.
12. UK government borrowing is expected to be £180bn in 2009/2010 – equivalent to 12 per cent of GDP. Evaluate the possible effect of a high fiscal deficit on UK macroeconomic performance
13. Assess the steps that UK businesses can take to survive the downturn
14. Evaluate the case for and against choosing tax cuts over higher government spending as a form of fiscal stimulus for the economy.
15. Explain the possible relationships between changes in world economic growth and level of commodity prices such as oil and copper.
16. Analyse the importance of infrastructure spending for the growth and development of developing countries
17. Is running a large current account deficit necessarily a cause for economic concern?
18. What are the main policies a government can use to attract foreign direct investment?
19. The IMF often extends emergency finance to countries through conditional loans. Explain what these are and their likely impact on the country concerned.
20. Has China successfully managed to de-couple her economy from the world financial crisis?
21. How can one measure changes in income and wealth inequality? Using extract 4, consider the economic and social effects of a growing income and wealth divide in the Indian economy
22. Many governments have returned to Keynesian economics as a response to the recession. Are they right to do so?
23. Evaluate the longer term costs and benefits of globalisation for developing countries
24. Analyse the likely effects on Chinese-US trade balances of an appreciation in the value of the Yuan against the US dollar
25. Countries with a heavy specialisation in durable goods and hi-tech manufacturing appear to have been most badly affected by the world recession. Can you explain why?
26. “More than \$30bn was injected into Africa in 2007 in the form of FDI, nearly the same level as the \$39bn received in aid. In 2008 global commodity prices rose sharply and then fell.” Explain the possible links between the level of commodity prices and inward investment into the economies of African countries that export a large percentage of their GDP.

Suggested Background Reading

Economic crisis for the Hungarian economy

- [Hungary to get \\$25bn rescue deal from the IMF](#) (BBC news, November 2008)
- [Hungary's daunting debt mountain](#) (BBC news, October 2008)
- [Hungary raises interest rates to support a collapsing forint](#) (BBC news, October 2008)

Stimulus policies during the economic crisis

- [The cost of the financial meltdown: Deficits and spending](#) (BBC news, special report 2009)
- [The IMF on fiscal policy during the economic crisis](#) (Vox Research, Jan 2009)

Interest rates and the UK economy

- [Inflation – causes and effects](#) (Tutor2u revision presentation)
- [Guardian articles on interest rates](#)
- [Is quantitative easing creating more problems than it is solving?](#) (Independent, November 2009)
- [Quantitative easing explained](#) (Bank of England website)
- [Bank raises stimulus to £200bn to end recession](#) (Times, Nov 2009)

Sterling and the recession

- [The exchange rate and inflation](#) (Tutor2u revision blog)
- [The falling pound – a bitter-sweet development](#) (Tutor2u blog, August 2008)
- [Weak pound may not be enough to rescue the economy](#) (Telegraph, September 2009)

Keynesian economics

- [Blog articles on Keynesian economics from Tutor2u](#)
- [BBC biography of Keynes](#)
- [The return of the master – is Keynes still relevant](#) (BBC Newsnight, September 2009) see also [“How relevant are Keynesian ideas today?”](#) (BBC Newsnight, September 2009)
- [Krugman on ‘Keynes, Return of the Master’](#) (Observer, Aug 2009)

Aspects of Globalisation

- [China 'wants to set up factories in Africa'](#) (Guardian, Dec 2009)
- [Guardian articles on the World Bank](#)
- [Guardian articles on globalisation](#)
- [Taking Africa beyond aid](#) (Guardian, August 2009)
- [Free trade zones in Africa](#) (BBC news, August 2009)
- [Europe accused of protectionism](#) (Guardian, May 2009)
- [China and USA head for trade war](#) (Guardian, June 2009)
- [Pros and cons of car firm subsidies](#) (BBC news, July 2009)
- [China warns against protectionism](#) (BBC news, Feb 2009)
- [IMF warns of slow African growth](#) (BBC news, March 2009)
- [South Korea agrees trade deal with the EU](#) (BBC news, Oct 2009)

- [Tutor2u blog articles on the global economy](#)