

## Question 2

### Crisis in United Kingdom and Spain

**Table 2: Spain Key Economic Indicators**

	2009	2010	2011	2012	2013*
Gross domestic product, constant prices (% change)	-3.8	-0.2	0.1	-1.6	-1.3
Inflation (% change)	-0.2	2.0	3.1	2.4	1.8
Unemployment rate (%)	18.0	20.1	21.7	25.0	26.9
Current account balance (US billion \$)	-70.4	-62.3	-55.4	-14.8	19.4
Government Net Debt (% of GDP)	42.5	50.1	58.6	73.5	80.8
Government budget balance (% of GDP)	-9.3	-8.1	-8.1	-6.3	-4.9

\*Estimated figures.

**Table 3: UK Key Economic Indicators**

	2009	2010	2011	2012	2013*
Gross domestic product, constant prices (% change)	-5.2	1.7	1.1	0.2	1.4
Inflation (% change)	2.1	3.3	4.5	2.8	2.7
Unemployment rate (%)	7.5	7.9	8.0	8.0	7.7
Current account balance (US billion \$)	-31.4	-61.9	-36.0	-93.9	-69.2
Government Net Debt (% of GDP)	62.4	72.2	76.8	81.6	84.8
Government budget balance (% of GDP)	-10.3	-8.4	-6.0	-5.8	-4.0

\*Estimated figures.

Source: International Monetary Fund, 2013

#### Extract 5: Spain set to reveal its pain in its books

Spain, a Eurozone behemoth, is in the crosshairs of Europe's financial crisis. The country is suffering from soaring borrowing cost (for the sovereign bond), a banking system leaking cash and unemployment rates at devastating levels. The Spanish economy is the Eurozone's fourth-largest -- after Germany, France and Italy -- making up around 11% of the bloc's GDP.

After Bankia, the country's fourth largest bank, asked for a €19 billion state intervention to prevent bankruptcy, the situation in Spain has developed like a perfect storm, with money being pulled out of the country. This leaves Spain in a precarious financial state, driving investors away and making

it more likely to need a bailout by seeking financial support from International Monetary Fund (IMF) or European Union (EU).

The mood of the markets may, ultimately, dictate Spain's ability to pull itself from its financial hole. Investors already twitchy about the prospect of a "Grexit" -- a Greek exit from the euro -- will react badly to further bad news out of Spain. Greece has been swallowing austerity medicine to cut government spending and raise taxes as part of the bailout deal with IMF and EU since 2010. But its economy has slid further into recession, and initial hopes it could detach itself from external life-lines within two years now look wildly optimistic.

As with other fragile countries within the euro bloc, Spain cannot benefit from an independent monetary policy. Spain has focused on cost cutting and labour reforms in November 2011. Spain has also been under pressure to implement austerity measures to try and combat its debt crisis.

If governments implement austerity measures too soon they risk snuffing out demand and recovery, but delays could provoke a catastrophe with inflation and high interest burdens to service countries' debt.

Source: Cable News Network, September 2012

#### **Extract 6: U.K. budget deficit unexpectedly swells on spending gain**

Britain's budget deficit unexpectedly widened in November as spending surged and a drop in income-tax receipts depressed government revenue, prompting warnings that Britain could lose its top credit rating.

"There has to be a very real danger that at least one of the credit rating agencies will strip the U.K. of its AAA rating (a measure of credit rating) over the coming months," said Howard Archer, an economist at IHS Global Insight in London. Fitch Ratings said letting the debt goal slip weakened the credibility of the fiscal regime and Standard and Poor's lowered its outlook to negative from stable, citing weak prospects.

The pound remained lower against the dollar, down 0.2 percent on the day.

Source: Cable News Network, 21 December 2012

#### **Extract 7: Bank of England steps up stimulus**

The Bank of England stepped up its economic stimulus, announcing an increased bond-buying program designed to jolt the struggling British economy out of a double-dip recession. The £50 billion, or \$78 billion, in additional stimulus comes on top of £325 billion already pumped into the economy by the Bank of England over the past several years.

Noting that the British economy was already in recession, with corporate earnings down and consumers and companies reluctant to spend, stimulus measures had "to work harder and harder," Graeme Leach, chief economist at the Institute of Directors said. "The end result is that we could see another £50 billion on top of this, within a few months."

Britain's banking crisis wrecked government finances, prompting London to embark on its biggest austerity program since World War II. Meanwhile, the economic outlook has been worsened by the

crisis in the euro zone economy, which has sapped global confidence and decreased demand in key trading partners.

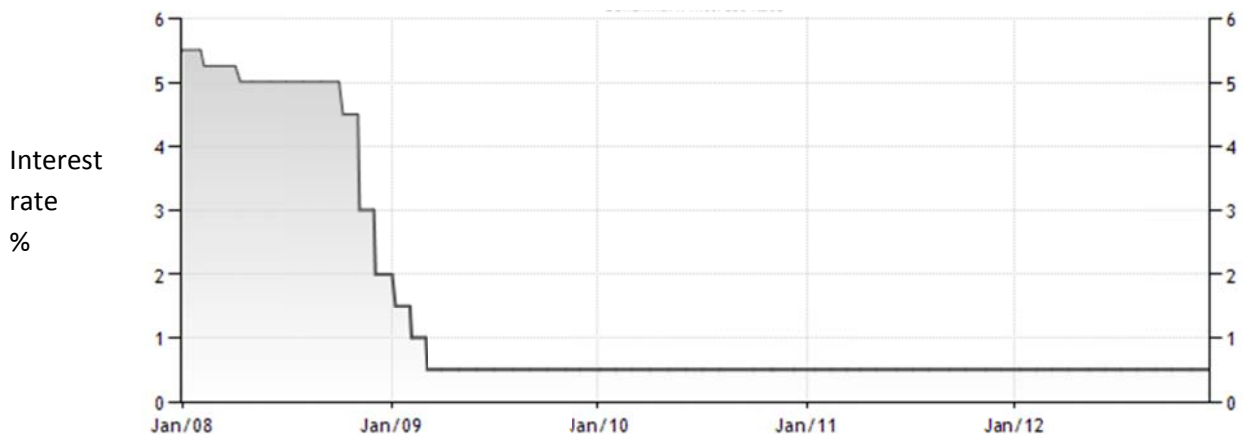
The program of spending cuts and tax increases appears to have persuaded the financial markets that the government intends to tackle its huge budget deficit and permitting the government to borrow cheaply. But the austerity measures have also reduced consumer confidence and household spending, compounding the downturn. Government departments, with the exception of health and education, would be subject to further spending cuts, and public-sector pay caps would be extended.

Finance Minister George Osborne said the government's policy of fiscal discipline and active monetary policy would eventually bear fruit.

The U.K. economy risks falling into a triple-dip recession in the first quarter of 2013 as domestic demand remains depressed by austerity measures and falling real incomes and exporters feel the impact of the Eurozone crisis, despite a weaker currency.

Sources: New York Times, 5 July 2012 and Cable News Network, 20 March 2013

**Figure 2: Bank of England interest rates**



Source: Bank of England

### Questions

- (a) (i)** What is the difference between real GDP growth and nominal GDP growth? [1]
- (ii)** Identify the economy which is projected to have a higher growth in nominal GDP in 2013. [1]
- (b) (i)** Describe the trend in the UK's government net debt from 2009 to 2012 shown in Table 3. [1]
- (ii)** With reference to the data, account for the above trend in the UK's government net debt. [4]
- (c) (i)** Explain how the credit downgrade affects the external value of pounds. [2]
- (ii)** Explain how this change in external value of pounds might affect the prices of goods and services in the UK. [3]
- (d)** Discuss the impact of Eurozone crisis on the UK's balance of payment. [8]
- (e)** To what extent can Spain adopt the policies used by the UK to achieve her macroeconomic aims of sustained economic growth and low unemployment? [10]
- [Total: 30]

## CSQ2 Answer to Questions

**(a)** (i) What is the difference between real GDP growth and nominal GDP growth? (1)

Real GDP (growth) has been adjusted for inflation while nominal GDP (growth) has not been adjusted for inflation (1) OR (Real GDP growth measures annual % change in real GDP where) real GDP measures national income at constant prices while (nominal GDP growth measures annual % change in nominal GDP where) nominal GDP measures national income at current year prices (1)

Note in marker's report: A significant number failed to score because they were careless in expression and stated the opposite of what they really meant. For example, some stated that nominal GDP accounted for inflation when they really meant that it included changes in price.

(ii) Identify the economy which is projected to have a higher growth in nominal GDP in 2013. (1)

United Kingdom.

**(b)** (i) Describe the trend in the UK's government net debt from 2009 to 2012 shown in Table X. (1)

There is an increasing trend in the UK's government net debt.

(ii) With reference to the data, account for the above trend in the UK's government net debt to GDP. (4)

3m on one reason for higher government spending and one reason for lower tax revenue:

Low growth → low consumption spending → lower sales tax revenue.

High/increasing UN → lower income tax revenue

High/ increasing UN → higher UN benefits → higher government spending.

[If reasons for only why higher government spending and no reason for why lower tax revenue (and vice versa), max. 2m.]

1m on why higher net debt:

With  $G > T$ , needs to borrow to finance the spending → higher debt.

**(c)** (i) Explain how the credit downgrade affects the external value of pounds. (2)

Expects pounds to fall in future (1m) → dd for pounds fall (1m) → pounds depreciate.

OR

Expects pounds to fall in future OR no confidence in the UK economy → British/ investors sell financial investment products that are denominated in pounds (1m) → ss of pounds increases (1m) → pounds depreciate.

(ii) Explain how this change in external value of pounds might affect the prices of goods and services in UK. (3)

Depreciation of Pounds:

- price of imports increase, price of exports decrease (1m). DD for M fall, dd for X increase.

Assuming M-L condition holds, NX increases (1m), AD increases → GPL in UK increases. (1m)

OR

- price of imports, including M of raw materials, increase (1m) → COP increase (1m) → GPL in UK increases (1m).

**(d)** Discuss the impact of Eurozone crisis on the UK's balance of payment. (8)

Extract "leaves Spain in a precarious financial state, driving investors away"

- crisis → loss of confidence in economy → short money outflow to UK → improves UK capital account.

Extract "economic outlook has been worsened by the crisis in the euro zone economy, which has sapped global confidence and decreased demand in key trading partners"; Table: worsening of current account deficit in 2012.

- Fall in X → fall in X revenue. Assuming M expenditure same → worsens current account deficit

Evaluation:

Capital may not flow from Eurozone to the UK as UK economy remains weak. Capital may flow to emerging or Asian countries instead. UK capital account may not improve.

L3 5 - 6	Answer on how crisis affects BOTH capital account and current account.
L2 3 - 4	Answer on either capital account or current account but not both OR answer on how crisis affects both capital and current account but answer is undeveloped. Max 4m if answer only on current account. Max 3m if answer only on capital account.  No ref to extracts, max. 3m.
L1 1 - 2	Very undeveloped answer and/or without economic analysis.
E 1 - 2	Take a stand with reference to data. Without reference to data, max 1m.

**(e)** To what extent can Spain adopt the policies used by the UK to achieve her macroeconomic aims of economic growth and low unemployment? (10)

Thesis: Policies used by UK can achieve economic growth and low UN

1. Austerity measure

Reduce G and increase tax → confidence in the financial market → confidence in the economy → stop the fall in C and I → maintain actual economic growth and employment levels.

OR

Reduce G and increase tax → better credit rating → able to borrow cheaply → less need to increase tax in future → sustained economic growth.

Evaluation: "But the austerity measures have also reduced consumer confidence and household spending, compounding the downturn"

- Reduce G, e.g. on pension OR higher tax rates → fall in C → fall in AD --> fall in GDP via k → low growth and worsens UN.

Anti-thesis:

(i) Policies used by UK cannot achieve economic growth and low UN

1. Lower interest rate from Figure X

- Lower interest rate → lowers cost of borrowing → stimulate  $C_d$  and  $I_d$  → higher AD → higher real GDP and employment;

“As with other fragile countries within the euro bloc, Spain cannot benefit from an independent monetary policy”

- Spain is part of EU and does not have an independent monetary policy. Interest rate for Eurozone is determined by the European Central Bank.

2. OR Quantitative easing

Central bank pumps money into the economy directly by buying assets - usually government bonds or private securities from private commercial banks or financial institutions - using money it has simply created out of thin air. The institutions selling those bonds (commercial banks or other financial institutions such as insurance companies) will then have "new" money in their accounts, which then boosts the money supply. The companies who sold the bonds may use the proceeds to invest in other companies or lend to individuals. The hope is that with banks, pension funds and insurance firms now more enthusiastic about lending to companies and individuals, the interest rates they charge fall, so more money is spent and the economy is boosted.

“As with other fragile countries within the euro bloc, Spain cannot benefit from an independent monetary policy”

- Spain is part of EU and does not have an independent monetary policy. Any decision to pump money into the economy has to come from European Central Bank.

Evaluation: If most major countries in Eurozone are facing negative growth, Central Bank of Europe is likely to adopt a loose monetary policy such as lowering interest rate and/or quantitative easing and Spain will benefit from it. However, if firms or consumers remain pessimistic about the future, they will borrow to spend or invest even if interest rate lowers or if commercial banks want to lend more with quantitative easing.

(ii) Other policies Spain can use (2m)

1. “Cost cutting and labour reform”

- Ss-side policies. Labour reform → increase productivity → lower COP → increase SRAS → increase actual economic growth and employment.

Stand: Given the high debt incurred by Spain government, short-term pain from austerity measures complemented with ss-side policies are probably necessary to have sustainable growth.

L3 5 – 6	Developed and balanced answer. Thesis on how austerity measure can achieve growth and lower UN. Anti-thesis on why monetary policy used by UK cannot be adopted by
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	Spain and development on one other policy that Spain can use.
L2 3 - 4	Undeveloped and/or unbalanced answer.  No ref. to extracts, max. 3m
L1 1 - 2	Very undeveloped answer and/or without economic analysis.
E1 1 - 2	Evaluative comments about policies that can or cannot be adopted by Spain.
E2 3 - 4	Evaluative comments about policies that can or cannot be adopted by Spain. And take a stand with reference to data.