

Question 2

Differing Policy Responses to Anaemic Economic Growth

Table 1: Unemployment Rate (%)

	2006	2007	2008	2009	2010	2011	2012
China	4.1	4	4.2	4.3	4.1	4.1	4.1
Japan	4.1	3.8	3.9	5.1	5	4.6	4.3
United Kingdom	5.5	5.4	5.7	7.7	7.9	8.1	8.0

Table 2: Real GDP Growth (%)

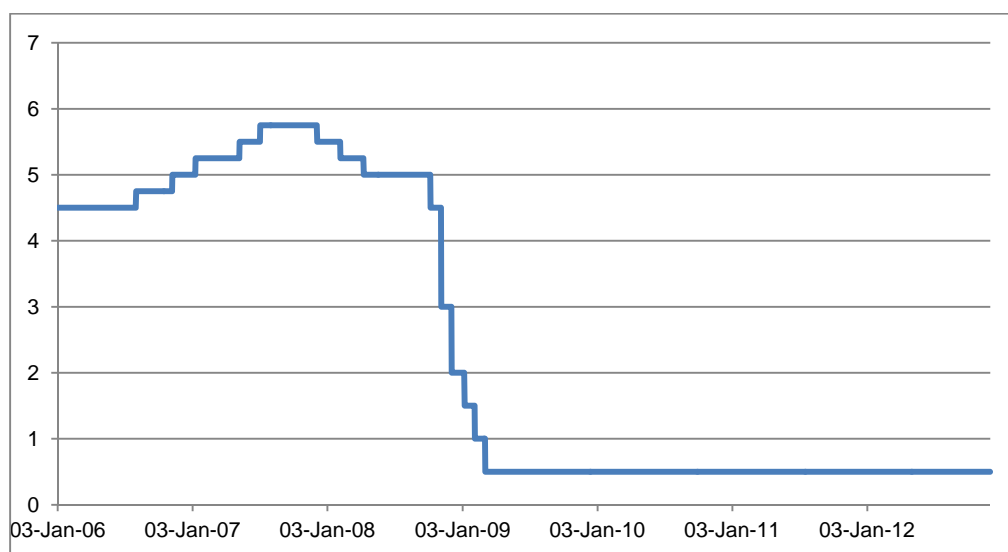
	2006	2007	2008	2009	2010	2011	2012
China	12.7	14.2	9.6	9.2	10.5	9.3	7.7
Japan	1.7	2.2	-1.0	-5.5	4.7	-0.5	1.5
United Kingdom	2.8	3.4	-0.8	-5.2	1.7	1.1	0.3

Table 3: Inflation Rate (%)

	2006	2007	2008	2009	2010	2011	2012
China	1.5	4.8	5.9	-0.7	3.3	5.4	2.7
Japan	0.2	0.1	1.4	-1.3	-0.7	-0.3	-0.0
United Kingdom	2.3	2.3	3.6	2.2	3.3	4.5	2.8

Source: IMF & World Bank

Figure 1: Bank of England Interest Rates (%)



Source: Bank of England

Extract 1: Creeping protectionism in EU trade policy

Developing countries stand to lose out from trade reforms that are pushing the EU towards more protectionist policies, according to a report by the Overseas Development Institute (ODI).

The first reform of the Generalised System of Preferences¹ (GSP) in 30 years, said the report, will see richer developing countries such as India and Vietnam lose trade concessions of up to €257m (£201m). Since 1971, the GSP has ensured that exporters from developing countries pay lower duties on some or all of what they sell to the EU, giving them vital access to European markets. With reform of the GSP, the EU is likely to impose more trade barriers on a range of products and countries where there isn't a reciprocal free-trade agreement with the union.

"Upper-middle-income countries will still be eligible for preferential access to the EU market, but only if they agree to free-trade agreements, not by virtue of their WTO status as developing countries," said Stevens.

The new EU trade policy also has a glaring omission, the EU's common agricultural policy, in which European farmers receive €50bn in subsidies. Such payments and export subsidies aimed at boosting the production and income of EU farmers tend to reduce world prices and the attractiveness of the European market for developing countries.

"Designing a trade strategy in times of economic and financial crisis always carries a risk, and there will inevitably be winners and losers," said Dirk Willem te Velde, head of the ODI's international economic development group. "The clear protectionist trend in the EU's new strategy will not only damage the developing world, but also European economies and consumers."

Source: *www.theguardian.com*, 27 Jul 2012

Extract 2: Japan's economic growth slows

Japan's economy grew at a slower-than-expected annualised rate of 1.4% in April-June, adding to worries over the global outlook, as consumer spending flagged following an earlier rebound from last year's earthquake and tsunami.

The eurozone crisis also took a heavy toll as feeble demand hit Japan's export sector.

Although the pace of growth dropped sharply from a revised 5.5% in the previous quarter, the economics minister, Motohisa Furukawa, struck an upbeat tone, saying in a statement that the economy "continues in an uptrend, led by domestic demand".

However, Nishioka, an economist at RBS Japan Securities, said the risk of worsening deflation was a "pessimistic result" that might prompt Japan's central bank to consider further easing of monetary policy to support growth. Deflation is a chronic problem for Japan and can be a drag on economic growth.

Consumer spending makes up more than half of Japan's economic activity. After the 11 March disaster last year, many Japanese held back on spending and excursions, adding to damage from disruption to manufacturing after many automotive and electronics plants ground to a halt in north-eastern Japan.

¹ The EU Generalised System of Preferences offers generous tariff reductions to developing countries. Practically, this means partial or entire removal of tariffs on two thirds of all product categories.

Robust public investment in reconstruction of housing and other buildings in the devastated region is likely to wane in coming months, further reducing momentum.

Meanwhile, the strong Japanese yen has clobbered exports, and costs for importing fuel to offset lost generation capacity from closed nuclear power plants have mounted.

Japan's economy grew 0.3% in the quarter ending in June, from 1% in January-March. That was lower than economists' forecasts of more than 2%, and translates to a 1.4% expansion in annualised terms.

Source: *www.theguardian.com*, 13 Aug 2012

Extract 4: End of inflation targeting?

Mark Carney, the next governor of the Bank of England, mused on the need for central banks to be creative in the post-crisis world. Growth has been so slow that Carney, said that in certain circumstances policymakers might need to ditch inflation targets and embrace nominal GDP targets instead.

Here's why. In most years, the value of all the goods and services produced in an economy goes up. This is the increase in nominal gross domestic product. Part of that increase is due to the fact things cost more than they did last year, and this is stripped out by statisticians to find how much the economy has really grown.

In the UK and in many other countries, the job of the central bank is to prevent prices from rising too quickly. The Bank of England is obliged by law to try to hit a 2% inflation target. Inflation targeting is straightforward, at least in theory. The Bank of England forecasts the future path of inflation; the forecast is compared with the target inflation rate (the inflation rate the government believes appropriate for the economy); the difference between the forecast and the target determines how much monetary policy has to be adjusted.

Since the slump of 2008-09, this relationship between price stability and economic growth has broken down. The annual increase in the cost of living has tended to be higher in recent years thanks to rising global commodity prices, higher VAT and the depreciation of the pound. The assumption is that if inflation is under control, the economy will expand at its long-term trend rate of growth, which is in the region of 2-2.5%. If you add real growth of 2.5% to 2% inflation then nominal GDP should rise by, say, 4.5% a year.

The Office for Budget Responsibility is forecasting nominal GDP will rise by just 2.2% this year and, with inflation running at 2.3%, that means, the economy is predicted to shrink by 0.1%. Inflation is under control but the economy is struggling.

Now assume the government switches to a nominal GDP target of 4.5%. The Bank would have to adopt a more expansionary monetary policy – perhaps by increasing the size or scope of its quantitative easing programme – in order to boost the value of economic output. Crucially, the split between inflation and real output would not matter: in theory the whole of the 4.5% increase in nominal GDP could be the result of higher prices.

Academics have been discussing the merits of nominal GDP targeting for some time. Carney's intervention suggests policymakers are starting to take notice of the debate. To an extent, this reflects the lacklustre recovery, but there is also a sense that inflation targeting only works well when economic conditions are benign.

Adapted: *www.theguardian.com*, 12 Dec 2012

Questions

- (a) (i) With reference to Table 1 & 2, explain how recession affects unemployment rate. [2]
- (ii) Explain how you might use unemployment rate and real GDP growth to compare economic performance of China with that of Japan. [4]
- (b) (i) Explain the meaning of deflation. [1]
- (ii) Using AD/AS analysis, explain why deflation is a chronic problem for Japan. [3]
- (c) Explain how 'strong Japanese yen has clobbered its exports'. [2]
- (d) With reference to the case study and your own relevant knowledge, do you think central bankers should 'ditch inflation targets and embrace nominal GDP targets'? [8]
- (e) Assess the view expressed in Extract 1 that the 'clear protectionist trend in the EU's new strategy will not only damage the developing world, but also European economies and consumers'. [10]

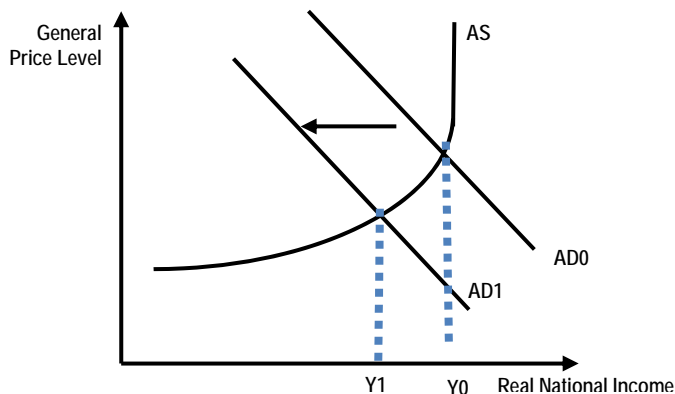
[Total: 30 marks]

Suggested Answer

- (a) (i) With reference to Table 3 & 4, explain how recession affects unemployment rate. [2]

The real GDP growth of both Japan and United Kingdom shrunk from 2008 to 2009. Thus, these economies experienced worsening recession during the time period.

- ➔ ↓ in production
- ➔ ↓ in investment
- ➔ ↑ in cyclical unemployment (as reflected in the unemployment statistics in Table 3)



Marks allocation

1 mark – Stating that recession results in a rise in cyclical unemployment

1 mark – Explain the above using AD/AS model

- (ii) Explain how you might use unemployment rate and real GDP growth to compare economic performance of China with that of Japan. [4]

Unemployment rate in China – fluctuates within a narrow band (0.2%)

Whereas the variations in unemployment rate is greater in Japan

- ➔ Residents in China experiences a more stable standard of living
- ➔ Better labour utilization rate in China, in general ➔ facilitates greater planning of labour training and development

Strong Real GDP growth in China (>9% throughout the period)

- ➔ Strong economic growth, sustained increased in household income ➔ increased material standard of living
- ➔ Also means that government tax revenue ↑ ➔ can lead to increase in infrastructure development ➔ Rise in productive capacity

Anemic economic growth in Japan

- ➔ country losing comparative advantage ➔ ↓ in investment opportunities

Marks allocation

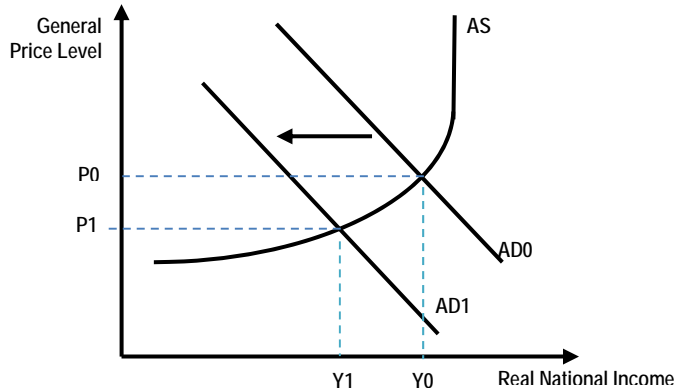
2 marks – Use the economic indicator – unemployment rate – to compare the relative economic performance of China and Japan

2 marks – Use the economic indicator – real GDP growth – to compare the relative economic performance of China and Japan

- (b) (i) Explain the meaning of deflation. [1]

A sustained decline in general price level over a given time period, usually a year.

- (ii) Using AD/AS analysis, explain why deflation is a chronic problem for Japan. [3]



Japan experienced deflation from 2009 to 2011

Over this time period, Japan also suffered from negative output gap (actual real GDP growth < full employment real GDP growth) in 2009 and 2011

- negative consumer and investor confidence level
- ↓ in C (consumers postpone demand as they expect prices to fall further in future)
- ↓ in I (Lower prices can mean reduced revenues and profits for businesses) → higher cyclical unemployment as firms seek to reduce their costs by shedding labour
- Severely limits the effectiveness of any fiscal stimulus
- Economy continued to be trapped in this vicious cycle.

- (c) Explain how 'strong Japanese yen has clobbered its exports'. [2]

Strong Japanese yen

- Yen appreciated
- ↑ in price of Japanese exports
- As Japanese exports are price elastic, this will lead to a more than proportionate ↓ in quantity demand for exports
- Severe ↓ in exports revenue

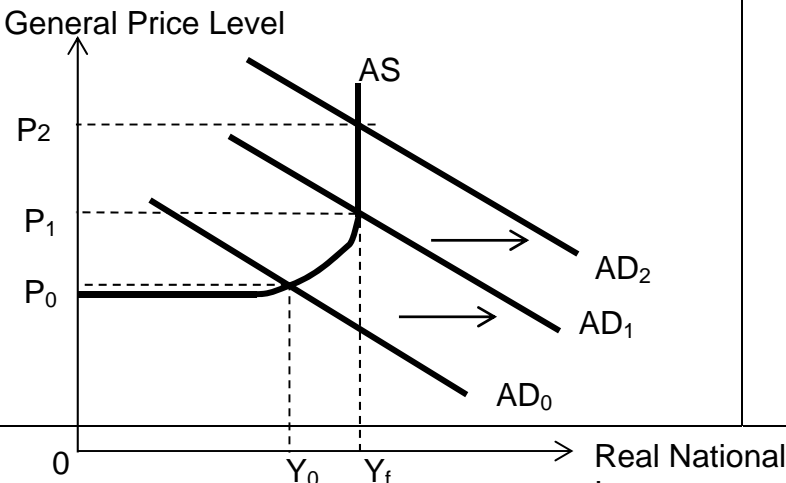
Marks allocation

1 mark – Impact of strong Japanese yen on price of exports

1 mark – Impact of strong Japanese yen on exports revenue

- (d) With reference to the case study and your own relevant knowledge, do you think central bankers should 'ditch inflation targets and embrace nominal GDP targets'? [8]

Marking Scheme

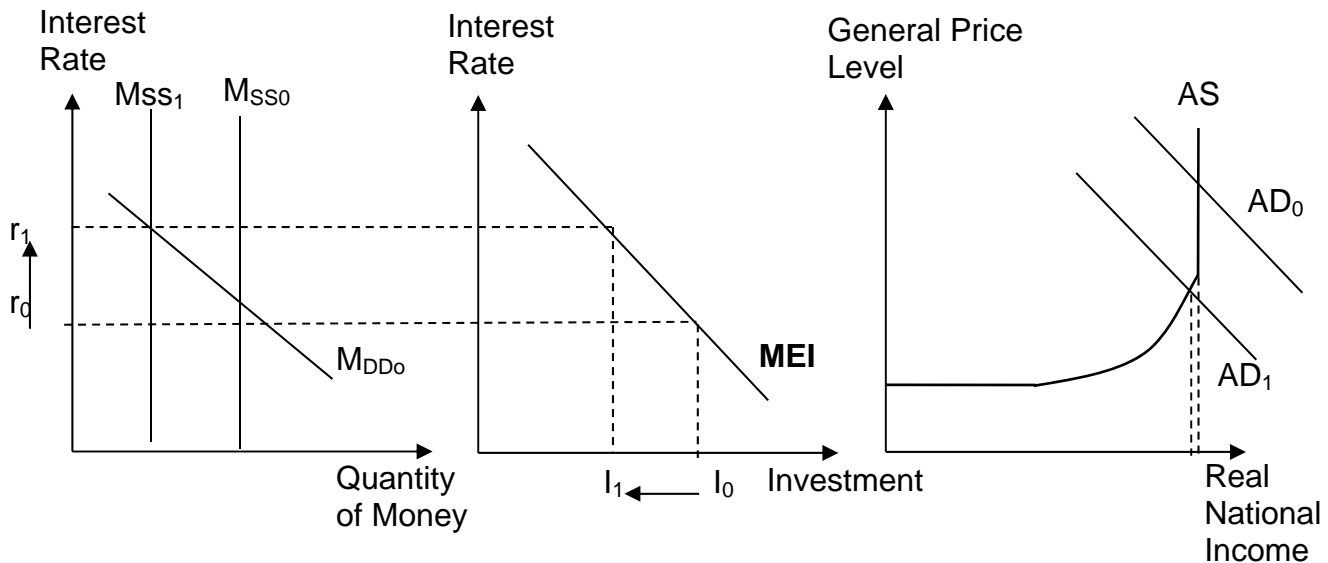
Thesis: Central bankers should 'ditch inflation targets and embrace nominal GDP targets'	
Economic Analysis	Evidence
<p>The relationship between price stability and economic growth has broken down</p> <p>For instance, Central Bank of UK adopted expansionary monetary policy</p> <ul style="list-style-type: none"> ➔ lowered interest rates sharply in 2008, maintained near zero interest rates from 2009 to 2012 ➔ inflation rates was under control (hovered around 2-4%) ➔ However, UK economy still suffered from a recession in 2008 & 2009. Anaemic real GDP growth from 2010 onwards (range from 0.3% to 1.7%) <p>Thus, though inflation is under control, real GDP growth is dismay.</p> <ul style="list-style-type: none"> ➔ Nominal GDP targets will be more suitable for developed economies like UK & Japan ➔ Enable Central Bankers to adopt a more expansionary monetary policy than current inflation target 	<p>Extract 7, para 4, line 1-2</p> <p>Figure 1</p> <p>Table 5</p> <p>Table 4</p> <p>Extract 7, para 6, line 2</p>
Anti-Thesis: Central bankers should continue to focus on inflation targets rather than embrace nominal GDP targets'	
Economic Analysis	Evidence
<p>Explain why countries with strong economic growth & low unemployment, should continue to focus on inflation targets</p> <ul style="list-style-type: none"> ➔ Continuous \uparrow in AD ➔ Demand-pull inflationary pressures <p>General Price Level</p>  <p>0 Y_0 Y_f Real National Income</p>	<p>Table 4 & 3</p>

Price stability is critical for sustained real GDP growth

Use the Keynesian Transmission Mechanism to explain the benefits of inflation targeting.

Eg: Case of China: In 2011, inflation rate is at 4.5% → Central Bank in China should adopt contractionary monetary policy to control the rate of inflation in order to sustain real GDP growth

Table 5



Highlight that if inflation is under control such as China in year 2006
China should conduct expansionary monetary policy to encourage greater economic growth.

Table 5

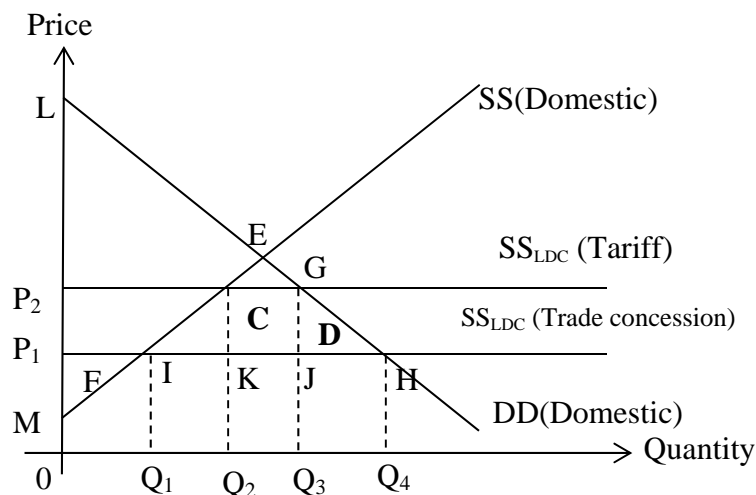
Level	Description	Mark
3	A balanced view with reasoned judgment & strong reference to the case context.	7-8
2	One-sided discussion with some attempt to relate to case materials.	4-6
1	Existence of conceptual errors. Did not address the requirements of the question.	1-3

- ### Marking Scheme

- Trade reforms –
 - Reform of the Generalised System of Preferences
 - reduction in trade concessions for richer developing countries such as India & Vietnam (Extract 5, Para 2, line 2)
 - Imposition of trade barriers for countries with no reciprocal free-trade agreement with EU
- Continued implementing the EU's common agricultural policy – EU farmers receive €50bn in subsidies

Economic Analysis & Evaluation

- ➔ Increase in prices of exports
- ➔ Reduction in exports volume, *ceteris paribus*, fall in exports revenue as ddx is price elastic
- ➔ Fall in production ➔ ↓ trade surplus & ↑ in unemployment
- ➔ Damaging to richer developing countries in terms of adverse impact on Economic Growth, Employment opportunities and slows down the rate of increase in productive capacity



Increase in prices of imports in EU

- ➔ Reduce consumers' surplus & increase cost of living for EU consumers
- ➔ Fall in material standard of living esp lower & middle income households

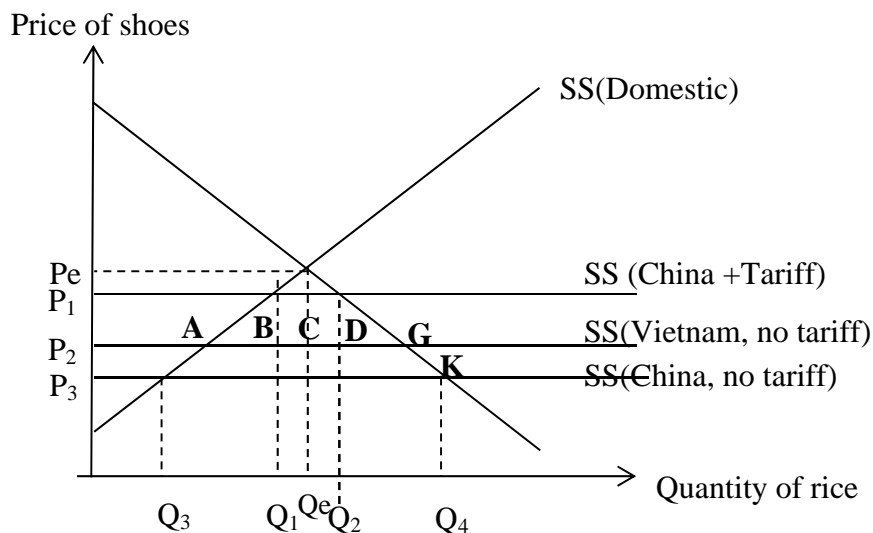
Evaluation

Depends on product category

In cases where richer developing countries have significant comparative advantage in, the impact will be insignificant.

Reciprocal free-trade agreement with the union (Extract 5, para 2, line 6)

- ➔ Leads to trade diversion between FTA countries and non-FTA countries
- ➔ Welfare loss to society



Assume the most efficient shoe manufacturer in the world is China. Before signing FTA with Vietnam, EU has identical GSP on shoe with developing countries, making shoes made in China relatively cheaper than those of Vietnam. After signing of FTA with Vietnam, the removal of tariff makes Vietnam's shoes relatively cheaper than Chinese made ones. Consumers switch to the now cheaper Vietnam's shoes.

Even though consumer surplus has increased by area (A+B+C+D) due to FTA, level of consumer surplus is still lower than that of when market price of rice is at P3 by an area of P2GKP3 – when there is GSP on shoes.

Anti-Thesis: Clear protectionist trend in the EU's new strategy will just damage the developing world, but benefit the European economies and consumers

Economic Analysis & Evaluation

European economies will benefit as removal of trade concession enable domestic producers to compete in a more level playing field.

- ➔ SR - ↑ in domestic production & employment opportunities

Longer run – Domestic firms can use the excess economic profits earned to

conduct R&D → lower of opportunity cost in producing the costs → Rise in comparative advantage

Benefits EU consumers too as there is now greater employment opportunities → higher SOL for some households

Benefits EU government as unemployment benefits ↓ → ↓ G

Evaluation

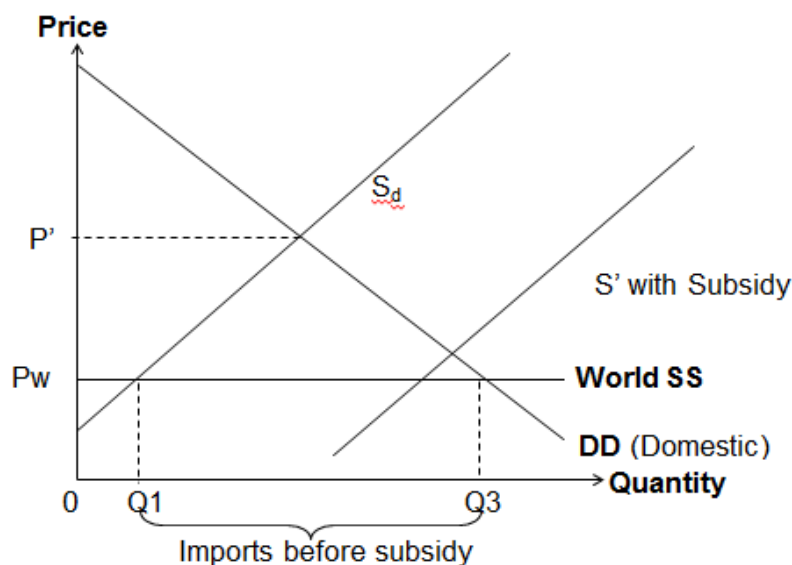
May not address the root cause (could be a lack of international competitiveness)

- Should revise and restructure its economy so as to improve EU international competitiveness.
- Might invite retaliation from trading partners in the long run.
- Make trading partners poorer (in terms of loss of export revenue as a result of protectionism)

Gains from the EU's new strategy – uneven across member countries

(The following pt can be either a Thesis or Anti-Thesis pt)

Continued implementing the EU's common agricultural policy – EU farmers receive €50bn in subsidies



Thesis: Damaging to European economies and consumers

Society: Taxpayers are burdened by the cost of the subsidy which is equal to P_pABP_w

But Consumers: Pay same prices; Same quantity consumed

Anti-Thesis: Benefitting to European economies

Domestic Producers: Artificially increase firms' Price Competitiveness

Higher price received = $P_w + \text{Per Unit Subsidy granted}$

Higher qty supplied

Increase in Total Revenue = TR (fr Crs) + Subsidy

Level	Description	Mark
2	Evaluative assessment of whether protectionist trend in EU is beneficial or damaging to both European and developing economies.	5-6
1	Little attempt to relate to question. Largely listing of protectionistic stance without clear reference to the both European and developing economies.	1-4
Level	Evaluation	Marks
E2	Well-justified evaluation	3 - 4
E1	Some attempt to evaluate but may not be supported by sound economic reasoning	1 – 2