

2016 RVHS Y6 H1 Prelim II Case Study Q2

Answer **all** questions in this section.

Question 2**Issues for the UK Economy****Table 1: Visible Trade Balance (nominal US\$, billion)**

| | 2011 | 2012 | 2013 | 2014 |
|----------------|------|------|------|------|
| United Kingdom | -149 | -168 | -180 | -202 |
| United States | -740 | -741 | -702 | -741 |

Source: World Bank, accessed on 16th June 2016

Extract 5: Sustaining UK Economic Growth

The widening balance of payments and government deficits will probably sap the optimism generated by rising house prices, dampening both consumer and business confidence. This means that the growth which UK economy is currently experiencing may not be sustained. However, there is a way out of the economic future we are facing but it is not a silver bullet which will solve our problems without creating some hazards along the way.

With trade and balance of payments deficits since 1983, it has been impossible for decades to run the economy at full capacity. This is why we have such slow growth and high unemployment.

To achieve a reasonably substantial but also sustainable rate of growth, we need to switch a significant proportion of our GDP towards manufacturing. To do this, we will need to significantly increase the proportion of our GDP going into investment, which includes increasing corporate investment as well as a government programme to improve our infrastructure.

To make the economy more competitive, we have to get the exchange rate down. In addition, to ensure a big increase in effective and sustainable demand, the reduction in the exchange rate will have to be large enough to make sure that this happens. Moreover, the reduction will have to be permanent for the foreseeable future.

Rapidly increasing demand will then require large scale supply side changes to the economy. There will need to be a major focus on educating and training the labour force for many new opportunities and challenges. There will be big pressures on the infrastructure, requiring substantial increases in investment in everything from road and rail to housing and schools and from high speed internet to airport capacity.

Source: *The Huffington Post*, 30 June 2014

Extract 6: Trends in British Trade

The Office for National Statistics confirmed that the UK's trade deficit in goods and services had decreased from £3.1bn in July to £1.9bn.

Historically, the European Union has dominated in both exports and as a source of imports but gradually this trend is changing. Growth is increasingly being driven less by Britain's traditional partners in Europe and other advanced economies around the world and more by emerging and developing nations like China and Africa.

Richard Lowe, Head of Retail and Wholesale, Corporate Banking, Barclays, says "The increases in trade both to and from China relate largely to the clothing and electronics industries. We are also starting to see imports from India pick up, but the reductions in trade from Japan relate to electronics. Increasing numbers of electronics such as iPhones and other telecommunications devices are now coming from China."

Export of petrol remains as UK's top export product for 2014 but the most interesting change in UK exports for Lowe is the export of medicines and pharmaceuticals. "In this area, the UK is showing a true specialism." Europe remains an important market for British imports, however in terms of growth, the fastest growth since 2006 has been exports to China.

Overall, Lowe believes that Britain's trade deficit is something that needs to be monitored and attended to. As he says: "To achieve long term success, businesses will increasingly need to focus on expansion outside domestic markets."

Source: *The Week*, 11 November 2014

Extract 7: Productivity and Standard of Living

Latest figures from the Office for National Statistics show there was no pick up in labour productivity in the last three months of the year, despite jobs being generated at a healthy clip. Productivity, a measure of what we produce for every hour we work, has been flagging since the recession. According to the head of the government's fiscal watchdog, weak productivity growth represents the "biggest risk" to the UK economy getting back on a stable footing.

Productivity is fundamentally linked to the health of the economy. In the long run, our overall prosperity and standards of living are determined by how efficient we are at work. One of the key measures of our standard of living is take home pay, which has failed to keep up with inflation since the crisis. The Office for Budget Responsibility's Robert Chote has warned of erosion in our living standards if our productivity doesn't increase but wages start rising.

Productivity also matters for monetary policy and the future course of interest rates since inflationary pressures do force the Bank of England to raise interest rates.

Source: *Telegraph*, 7 October 2014

Questions

- (a) Using Table 1, identify how the UK visible trade deficit differs from that of the US for the period from 2011 to 2014. [2]
- (b) Using AD/AS analysis, explain how a widening trade deficit explain the “slow growth and high unemployment” in the UK. [4]
- (c)
 - (i) With reference to Extract 5, discuss the effectiveness of the policies suggested to bring about sustainable rate of growth in the UK. [8]
 - (ii) Explain how the twin deficits in the UK might be corrected by the suggested policies. [4]
- (d) Using Extract 6, explain two factors that have contributed to the change in UK’s pattern of trade. [4]
- (e) Explain, and comment on the claim in Extract 7 that there will be an “erosion in our living standard if our productivity does not increase but wages start rising”. [8]

[Total: 30 marks]

Suggested Answers

- (a) Using Table 1, identify how the UK visible trade deficit differs from that of the US for the period from 2011 to 2014. [2]

UK trade deficit increases over the period while US trade deficit remains relatively unchanged. [1]

UK trade deficit is consistently lower than that of the US trade deficit. [1]

- (b) Using AD/AS analysis, explain how a widening trade deficit explain the “slow growth and high unemployment” in the UK. [4]

A widening trade deficit signifies imports are increasingly surpassing exports, hence dampening any increase in aggregate demand (AD), due to increase in consumption expenditure, investment expenditure or government expenditure.

Without the widening trade deficit, the UK economy should be improving and AD will have moved from AD_0 to AD_1 in Figure 1. However, with a widening trade deficit, the increase in AD will be of a much smaller extent, increasing from AD_0 to AD_2 instead. This leads to a smaller increase in national income of Y_0Y_2 instead of Y_0Y_1 , thereby leading to slower actual economic growth.

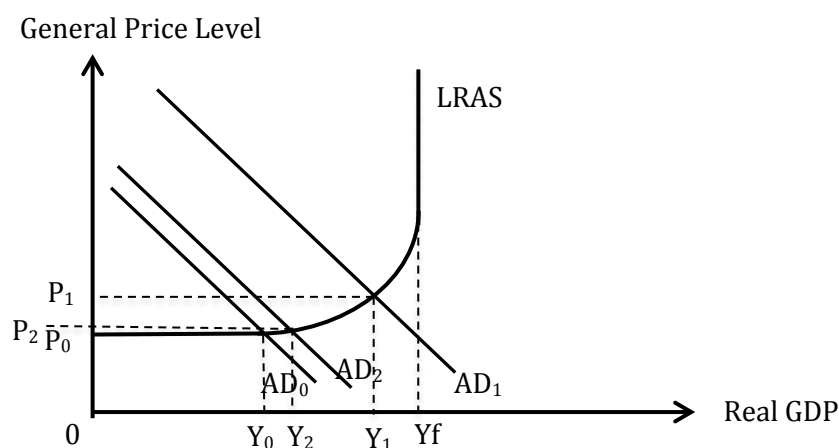


Figure 1: Impact of a weakening trade position

Given that the national income only increase insignificantly, it is unable to help to bring down the high unemployment, causing the level of unemployment to remain high.

- (ci) **With reference to Extract 5, discuss the effectiveness of the policies suggested to bring about sustainable rate of growth in the UK. [8]**

The proposed policies refer to exchange rate policy and supply-side policy.

First of all, it is proposed that the UK pound be allowed to depreciate. With the depreciation of the pound, exports from UK will be relatively cheaper in foreign currencies while imports into UK will be relatively more expensive in terms of pound. This increases the attractiveness of exports while promoting import substitution. Assuming that Marshall-Lerner condition holds, where the sum of price elasticity of demand for exports and imports is more than one, UK's net exports will increase. An increase in net exports will lead to an increase in AD and a multiple increase in NY, thus leading to actual economic growth.

Secondly, supply-side policies are being proposed. More corporate investment are needed, which involves investing in more advanced machineries and automation to increase productive capacity and this will lead to an increase in long-run aggregate supply (LRAS) as quantity and quality of capital increases. Corporate investment can be encouraged through reduction in corporate tax or tax incentives given by the government. At the same time, with the restructuring of the economy, supply-side policies like education and training are also needed to ensure that workers can keep up to pace with the developments in the economy. In addition, a substantial government programme of improvements to infrastructure is recommended. Roads, rails, high speed internet and airport capacity needs to be in place so as to facilitate the expected increase in trade. These improvements to human capital together with increase in infrastructure will lead to potential economic growth and shift the LRAS outwards again. With the increase in long-run aggregate supply, together with the increase in exports and investment leading to increases in aggregate demand, this will lead to sustained economic growth in UK.

Notwithstanding the above, there are factors or reasons that will reduce the effectiveness of the policies above.

Depreciating the pound might not be effective in increasing AD in the short run as the J-curve effect might take place. When devaluation/depreciation is pursued, net exports might worsen initially as the Marshall-Lerner condition might not hold in the short run due to contracts that are in place. However, net exports will increase in the long run when the Marshall-Lerner condition holds.

Supply-side policies to restructure the economy need time to materialise and increase the potential output and NY. The success of education and training also depends on the level of appropriateness of training, personal inclination and attitude of the workers and as such, results may not be guaranteed. Moreover, the government may lack the required information and capabilities to successfully determine the correct industries to assist. If the education and training programmes are not appropriate or if the government identify the wrong industries to help out, productivity might remain unchanged and thus, both actual and potential economic growth might not be achieved.

| Level | Description | Marks |
|-------|--|-------|
| L3 | Developed explanation of how exchange rate policy and supply-side policies bring about a sustainable rate of growth in the UK. | 4-5 |

| | | |
|----|---|-----|
| L2 | Undeveloped explanation of how exchange rate policy and supply-side policies bring about a sustainable rate of growth in the UK. Or A developed explanation on how exchange rate policy or supply-side policies bring about a sustainable rate of growth in the UK. | 2-3 |
| L1 | Smattering of valid points. | 1 |

In addition, up to a further 3 marks for valid evaluative comment. This should focus on the limitations of using these policies to bring about sustainable rate of growth in the UK.

(cii) Explain how the twin deficits in the UK might be corrected by the suggested policies.

[4]

The twin deficits in the UK refer to the widening balance of payments and budget deficits.

As mentioned in part ci above, the depreciation of the pound will lead to an increase in net exports, assuming that Marshall-Lerner condition holds. This will help to reduce the trade deficit and thus, reduce the BOP deficit. As the increase in net exports leads to an increase in AD and NY, tax revenue from PIT or CIT will increase eventually and assuming that government expenditure remains unchanged, this will help to reduce the budget deficit.

Similarly, if the supply-side policies are effective in achieving a sustained economic growth through an increase in AD and LRAS, the trade deficit and BOP deficit will be reduced as export competitiveness will increase with an increase in productivity. Supply-side policies like education and training, if successful, will also help to increase employment level and tax revenue via PIT will increase. If economic growth can be sustained, tax revenue collected by government via PIT and CIT will increase and this will help to reduce the budget deficit.

Explanation on how exchange rate policy and supply-side policies correct BOP/trade and budget deficits. [2 marks for each policy.]

(d) Using Extract 6, explain two factors that have contributed to the change in UK's pattern of trade.

[4]

A country's pattern of trade concerns the composition, direction and volume of her trade.

Extract 6 highlighted that "Growth is increasingly being driven less by Britain's traditional partners in Europe and other advanced economies around the world and more by emerging and developing nations like China and Africa". This change in direction of trade could be due to the rising income in countries like China and Africa. These countries experiences higher economic growth as compared to Britain's traditional trading partners. As such, there will be an increase in demand for imports (which is UK exports) since the demand for imports is income-induced.

Extract 6 also mentioned that “The increases in trade both to and from China relate largely to the clothing and electronics industries...but the reductions in trade from Japan relate to electronics.” China abundance of labour has enabled her to have comparative advantage in labour-intensive industries such as clothing and assembling of electronics components. As such, many of these industries have relocated to China, which resulted in UK importing more from China and less from Japan.

Extract 6 also mentioned that “... the most interesting change in UK exports for Lowe is the export of medicines and pharmaceuticals....the UK is showing a true specialism.” This suggested that UK seems to have gained comparative advantage in the production of medicines and pharmaceuticals because of its increasing pool of skilled labour probably due to training and education. This enables UK to produce medicines and pharmaceuticals at a lower opportunity cost as compared to its trading partners. As such, there is a rise in export of these items.

(Any two factors. 2 mark each.)

Identification of changes in direction/composition/volume of trade [2]

Explain reasons for the change [2]

- (e) Explain, and comment on the claim in Extract 7 that there will be an “erosion in our living standard if our productivity does not increase but wages start rising”.** [8]

Standard of living is a broad concept that refers to the level of well-being of a typical individual or household within the country. It encompasses both the material and non-material aspects of life. Productivity is “a measure of what we produce for every hour we work”.

Rising wages with no change in productivity will also lead to an increase in unit labour cost for firms. Firms will respond to the higher cost by cutting back on production and passing on some of the cost to consumers in the form of higher prices. General price level will increase with the fall in SRAS, allowing consumers to enjoy a lower quantity of goods and services compared to before and hence result in a fall in their material standard of living.

In addition, The Bank of England might adopt a contractionary monetary policy by raising interest rate to tackle inflation as mentioned in extract 7. This rise in interest rate will further dampen domestic consumption and investment when the cost of borrowing increases. The fall in C and I will further reduce aggregate demand and via the reverse multiplier process, a multiple fall in national income. This will further reduce the material aspect of standard of living and cause an ‘erosion in our living standard’.

However, standard of living includes not only the material aspect of life but also the non-material aspect of life. An erosion of the material standard of living is not equivalent to an erosion of standard of living in general since the non-material aspect has to be taken into account. For example, the stagnant productivity could be due to UK workers having a relatively longer leisure time compared to working time. Being less stressful at work would mean that their non-material aspect of standard of living has increased and thus, we cannot conclude that there is indeed an erosion of living standards on average.

If the policies mentioned in part c are successful in stimulating the economy, investment and exports will increase, which will lead to an increase in AD. Both an increase in AD and a fall in SRAS will lead to an increase in general price level. Nonetheless, the impact on real national income depends on the extent of shift of SRAS and AD. If the extent of increase in AD is larger, real national income will increase and material aspect of standard of living might increase instead.

In conclusion, we cannot conclude that the living standards is indeed eroded if there is no change in productivity since more data on the non-material aspect e.g. working hours and work life balance is required. More information on the cause of stagnant productivity and also whether other factors remain unchanged are required so as to make a better assessment on the living standards in both the short and long term.

| Level | Description | Marks |
|-------|--|-------|
| L3 | Developed explanation of how a rise in wages with no change in productivity can erode the material aspect of living. | 4-5 |
| L2 | Undeveloped explanation of how a rise in wages with no change in productivity can erode the material aspect of living. | 2-3 |
| L1 | Smattering of valid points. | 1 |

In addition, up to a further 3 marks for valid evaluative comment. This should focus on the concepts of non-material SOL and/or persistency of the fall/stagnant productivity.