

Question 2 Rebalancing to generate growth

Extract 5: China's economic growth misses target

China's economy grew 7.4 percent in 2014, at its slowest pace in 24 years as property prices cooled and companies and local governments struggled under heavy debt burdens, keeping pressure on Beijing to take aggressive steps to avoid a sharper downturn.

A further slowdown in China could hinder the chances of a revival in global growth in 2015, given the major role it plays, in particular for commodities and high-tech. China's property market - a major driver of demand across a range of industries - has proven stubbornly unresponsive to policy support, and lending data from the banking system shows enduring weakness. At the same time, there may be a looming fiscal crisis among debt-sodden local governments, which depend on land sales for most of their revenue. And more companies, especially small property developers, could flirt with default.

Policymakers also are concerned about the potential onset of a deflation aggravated by plummeting energy prices, industrial overcapacity and sluggish demand. Systemic deflation is an economically toxic cycle in which investors and consumers hold off on fresh spending on the assumption prices will drop further in the future. This is cited as a major reason why Beijing will need to put more money into the system.

Nevertheless, the International Monetary Fund's chief economist Olivier Blanchard said slower growth seen for 2015 reflects a welcome decision by the Chinese government to rebalance the economy away from a heavy reliance on investment and exports to a more consumption-based growth model.

Source: Kevin Yao and Pete Sweeney, *Reuters*, 20 Jan 2015

Extract 6: Why China's economy is slowing

Structurally, China's economy faces headwinds. In the long run, growth is a function of changes in labour, capital and productivity. When all three increase, as they did in China for many years, growth rates are superlative. But they are all slowing now. China's working-age population peaked in 2012. Investment also looks to have topped out. Finally, China's technological gap with rich countries is narrower than in the past, implying that productivity growth will be lower, too.

Another important development has been its credit binge. Total debt, including government, household and corporate, has climbed to about 250% of GDP, up 100 percentage points since 2008. This debt allowed China to power its economy through the global financial crisis but also saddled it with a heavy repayment burden. Most worrying, much of the credit flowed to property developers. China's inventory of unsold homes sits at a record high. The real-estate sector, which

previously accounted for some 15% of economic growth, could face outright contraction. From this vantage point, the abruptness of China's current slowdown looks more cyclical than structural.

Whereas previous leaders propped up growth whenever it slowed, Xi Jinping, China's president since 2013, has instead spread the gospel of the "new normal", by which he means less emphasis on growth and faster structural reform. As a result, the central bank has been hesitant to ease monetary policy. Changes to fiscal rules have also made it harder for local governments to spend money.

Source: *The Economist*, 11 Mar 2015

Extract 7: Fears mount that UK's plan to rebalance the economy is failing

Britain's recovery remained on track in the third quarter but fresh figures revealed growth was heavily reliant on the consumer, leaving the government's much hoped-for rebalancing of the economy elusive. Companies have become increasingly concerned about the economic outlook and falling business investment once again leaves the economic upturn in the hands of the consumer.

Exports fell by 0.4%, while imports increased by 1.4%, worsening Britain's trade position. The UK's trade deficit with the rest of the world widened to £11.2bn in the third quarter from £8.9bn in the second. Business investment, which the government is banking on to drive a sustainable recovery, actually fell by 0.7% or £300m compared with the second quarter. On the other hand, household spending, increased by 0.8% over the third quarter, extending the run of growth to 13 consecutive quarters. Services sector output was revised up to 0.8% from an initial estimate of 0.7%, reinforcing the picture of a UK recovery reliant on the consumer.

A spokesman for the Treasury repeated its persistent line that growth in the third quarter was a sign the government's long-term economic plan is working, and that the UK economy was under threat from factors abroad. "The UK is not immune to weakness in the euro area and instability in global markets, so we face a critical moment for our economy. We need to carry on working through our economic plan that is securing a resilient economy and a better future."

Source: Angela Monaghan, *The Guardian*, 26 November 2014

Extract 8: Deflation in the Euro zone is all too close

The euro area is on the verge of tipping into its third recession in six years. The zone's overall inflation rate has slipped to 0.3% and may well go into outright decline next year. A region that makes up almost a fifth of world output is marching towards stagnation and deflation.

Some price falls are welcome. Tumbling oil prices, in particular, have given consumers' incomes a boost. But slowing prices and stagnant wages owe more to

weak demand in the economy and roughly 45 million workers are jobless in the rich OECD countries. Worse, short-term interest rates are close to zero in many economies, so central banks cannot cut them to boost spending.

If Europe is to stop its economy getting worse, it will have to stop its self-destructive behaviour. France and Italy should be allowed to slow the pace of their fiscal cuts; in return, those countries should accelerate structural reforms. Reducing the fiscal deficits has been difficult to achieve because reductions in government spending and increases in taxes depress economic activity. Lower economic activity causes increased transfer payments and reduced tax revenue, offsetting the original fiscal contraction. A cheapening euro would be an important boost for eurozone countries such as Spain, Italy and France that have very large fiscal deficits. Although the lower euro would not change the relative prices among the eurozone countries, it would have a powerful effect because nearly half the trade of the eurozone countries is with countries outside the eurozone.

Source: *The Economist*, 25th October 2014

Table 2: GDP growth rates (Annual % change at constant prices in local currency)

	2010	2011	2012	2013	2014
China	10.6	9.5	7.8	7.7	7.4
UK	1.5	2.0	1.2	2.2	2.9
Euro Area	2.1	1.6	-0.9	-0.3	0.9

Table 3: Inflation rates (Annual % change in consumer price index)

	2010	2011	2012	2013	2014
China	3.3	5.4	2.6	2.6	2.0
UK	3.3	4.5	2.8	2.6	1.5
Euro Area	1.5	3.3	2.5	1.4	0.2

Source of Tables 2 & 3: *World Bank*

Table 4: Government Budget Balance (% of GDP)

	2010	2011	2012	2013	2014
China	-2.5	-1.1	-1.5	-2.1	-2.1
UK	-9.7	-7.7	-8.3	-5.6	-5.6
Euro Area	-6.2	-4.2	-3.7	-3.0	-2.6

Source: www.tradingeconomics.com

Questions

- (a) Which economy in Table 2 shows the least variation in its growth rate? [1]
- (b) (i) Besides the balance of trade in goods and services, state one other component of the current account on the balance of payments. [1]
- (ii) With reference to Extract 5, explain how a trading partner's current account on the balance of payments is affected by China's slowdown. [2]
- (c) How might UK's multiplier size change with the rebalance of the UK's economy? [4]
- (d) Comment on the usefulness of GDP growth rates in measuring UK's standard of living. [4]
- (e) Discuss whether policymakers should be concerned about the onset of deflation. [8]
- (f) Both UK and China are experiencing slow growth and have plans to rebalance their economies. In light of the data, assess the most appropriate policy approaches their governments can adopt to achieve high and sustained growth. [10]

[Total: 30]

(a) Which economy in Table 2 shows the least variation in its growth rate? [1]

China. It shows a decreasing trend that is consistent throughout, with the least fluctuations.

(b) (i) Besides the balance of trade in goods and services, state one other component of the current account on the balance of payments. [1]

Income flows or current transfers of gifts

(ii) With reference to Extract 5, explain how a trading partner's current account on the balance of payments is affected by China's slowdown. [2]

China's real output is falling, demand for high-tech and primary commodities from trading partners which are used to produce manufactured goods falls leading to a fall in export revenue for the trading partner. Assuming current account was initially in equilibrium, c.p. trading partner's current account will be in deficit.

(c) How might UK's multiplier size change with the rebalance of the UK's economy? [4]

1

Re-balancing economy → reduce reliance on consumer demand & increase reliance investment & external demand to drive economic growth.

The plan to reduce reliance on consumption expenditure to boost growth (Extract 3), implies that government will aim to reduce the MPCd of UK where an additional increase in national income will lead to a smaller increase in Cd. achieved via encouraging a higher MPS value which in turn enables higher accumulation of funds for loans, leading to higher investment levels, fulfilling the rebalancing objectives to drive a sustainable recovery. Assuming MPM and MRT remains constant, a higher MPS will lead to a smaller K size, given that $K = 1 / MPW$

Address "might"

However, the K size may also remain the same (or increase) UK government may decide to reduce corporate tax rates as another policy option to lower business cost & boost export competitiveness. Hence, this negates the rise in MPS, resulting in negligible change in MPW causing K size to remain the same or even increase

(d) Comment on the usefulness of GDP growth rates in measuring UK's standard of living. [4]

Usefulness in measuring material well-being

UK's GDP growth rates have been positive which suggests annual increase in GDP. If growth rates are higher than the rate of change in population, GDP per capita will increase. An average citizen enjoys higher purchasing power, thus having greater access to goods and services. Material well-being increases, SoL improves.

Limitations

However, GDP growth rates do not reflect the improvement in non-material well-being. The increase in GDP could have come at the expense of longer working hours and greater stress faced at work, resulting in lower quality of life. Hence, more information is required to give a more holistic assessment of SoL in UK.

Comment on the usefulness

To have a more accurate measurement of material well-being, GDP growth rates is insufficient. Information on population growth is needed for a more accurate

measurement and hence growth in GDP per capita rather than GDP growth rates is a better indicator. Its usefulness is also largely limited as the non-material aspect of SoL cannot be accurately reflected.

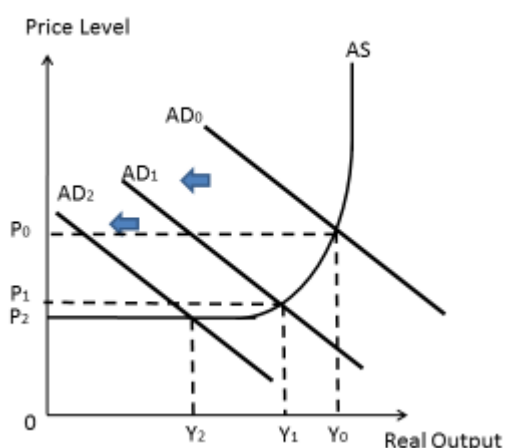
(e) Discuss whether policymakers should be concerned about the onset of deflation.
[8]

Introduction: Define deflation – a period of sustained and inordinate fall in GPL. Policy makers would have to examine the underlying causes and consequences of deflation to decide whether it is a cause for concern.

Thesis: Policymakers should be concerned

Analysis: Underlying cause of falling GPL – “sluggish demand” implies that other macroeconomic goals are not achieved.

Extract 5 suggests that the underlying cause of a deflation can be due to sluggish demand. This implies that total expenditure in the economy i.e. falling AD could be the cause of falling GPL.



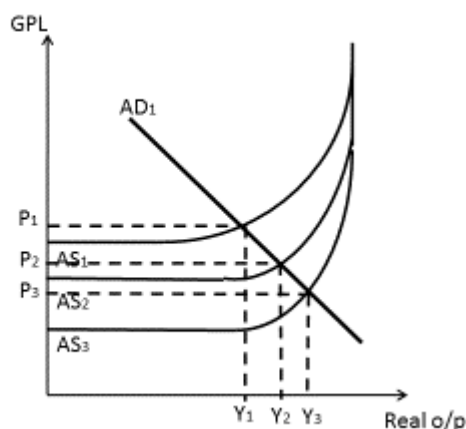
Draw diagram to explain how deflation suggests other macro goals are not achieved → this results in a fall in real output in the economy, and rising demand deficient unemployment. Hence, it signifies that other internal macroeconomic goals are not achieved. This is reinforced by evidence in Extract 8 where weak demand has resulted in '45 million workers jobless'.

Evaluation: Evidence support that policymakers should be concerned to a large extent. Extract 5 explains how falling GPL in one time period will cause ‘investors and consumers’ to hold off spending on the assumption that prices will fall further in the future. Such a spending pattern reinforces the negative impact on economic growth and employment making deflation a greater cause for concern for policymakers.

Anti-thesis: Policymakers need not be concerned by deflation

Analysis 1: Underlying cause of deflation – “tumbling oil prices”

As suggested in Extract 8, 'some price falls are welcomed'. In the case of falling oil prices, this can have positive impact on the economy and the consumers of oil related products such as petrol.



Explain with diagram the impact of falling oil prices → fall in price of raw materials for economies → shift SRAS to the right as P_m falls → falling GPL and increase in Real output instead.

Evaluation: However such positive impact tend to be short term in nature as oil producing economies/firms have the incentive to strategize to raise prices of oil again. Given that oil has $PED < 1$, a fall in price of oil will lead to less than proportionate increase in qty dd for oil, causing a fall in export revenue for oil producing economies. Thus, in the long term, they may choose to restrict oil output in order to cause the price to rise again, eroding any benefits from falling prices.

Synthesis:

Whether a policymaker should be concerned about the onset of deflation depends on the cause and extent of fall in prices. The overall global environment of slowing economic growth as suggested in the case study reinforces the idea that sluggish demand is causing deflation. Hence the onset of deflation is likely to bring about more costs than benefits. Eurozone, China and UK are all experiencing slow growth and inflation rates are also falling, with Eurozone's persistently lowest amongst the three and showing the sharpest decline in 2014 (Table 3). Hence the likelihood of deflation is much higher for Eurozone and hence policymakers in the Eurozone should be most concerned about the onset of deflation.

- (f) Both UK and China are experiencing slow growth and have plans to rebalance their economies. In light of the data, assess the most appropriate policy approaches their governments can adopt to achieve high and sustained growth. (10m)

Introduction

Interpret signpost: Both UK and China are experiencing slow growth. However, China is rebalancing towards greater reliance on Cd for future growth, away from I and X. but UK plans to rebalance away from Cd reliance towards more of I and X for future growth. Governments can consider demand management policies and SS side policies in attaining

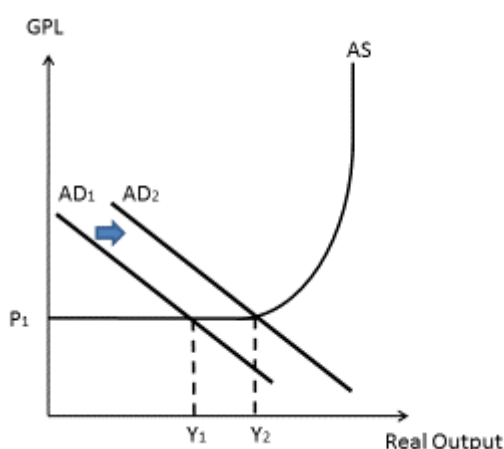
high and sustained economic growth.

Policy 1: Fiscal Policy

1. Analyze how Exp FP works to achieve high and sustained economic growth

(students only need to explain increase in G or cut in T , not both due to exam time constraints)

- A cut in personal income taxes \rightarrow increased $Y_d \rightarrow$ increase purchasing power \rightarrow increase in C_d and hence $AD \rightarrow$ Increase in Real output and NI by a K amount, given that the economy is operating with spare capacity.



2. Evaluation: Compare UK and China's approaches

E.g. Both UK and China have budget deficits as seen in Table 3. The budget deficits have been sustained over the last 5 years showing that it is a long term problem for them. Large budget deficits accumulated may result in lower credit ratings and poor investors' confidence. Hence despite the need to expand the economy, the use of expansionary FP may not be appropriate for UK and China.

Difference: Size of K

The effectiveness of an exp FP policy will differ due to the difference in size of K . Assuming ceteris paribus, Extract 3 suggested that UK has not been very successful in rebalancing the economy implying that the economy is still relatively reliant on C_d as a key driver for growth. Hence, the value of MPS is relatively low also implying a higher K size for UK. Thus in terms of effectiveness of expansionary FP, it would be more appropriate for UK to employ FP than that of China in attaining high growth.

Policy 2: Monetary Policy

Analyze how devaluation works to stimulate growth

Both UK and China may turn to weakening of their currency to boost economic growth in the short term in light that exp FP may not be a viable tool to use.

E.g. a weakening of the pound against other foreign currencies will lead to exports of UK becoming cheaper in foreign currency while imports to UK become more expensive in pounds. Demand for UK exports increase while quantity demanded for imports by UK

households fall. Assuming Marshall-Lerner condition holds, where $PED_x + PED_m > 1$, a devaluation of the pound will lead to an increase in $(X-M)$. AD increases and leads to increase in real output.

Evaluation:

E.g. A weakening of the currency may be ineffective for both countries. Given that the slow growth environment is a global one since major economies like UK, China and Euro are impacted; a fall in relative price of the good may not be able to offset a fall in demand for goods & services around the world due to falling purchasing power rendering a weakened currency ineffective (Extract 3: UK is not immune to the weakness in Euro). Therefore effectiveness of policies to increase growth will also be dependent on the economic growth recovery of other trading partners.

Compare Exchange Rate policy & Fiscal Policy

Underlying cause of slow growth is rising total debt in China's economy as seen in Extract 2. Whereas, there is only evidence to show that UK's debt is largely that of a fiscal debt. This implies that for China, any fiscal policy stimulant for the economy may not be effective, as increase in Y_d or post-tax profits will not be channelled to spending, but rather the repayment of debt. Hence, similarly a devaluation policy might be more appropriate than fiscal policy in the case of China.

Other Policies : E.g. SS Side policy to target sustained long term growth.

Synthesis:

Both UK and China will require SS-side policies in order to achieve sustained growth. However, increases in AS without sufficiently high AD will result in potential growth that is not actualised. Hence, both UK and China should complement SS-side policies with demand-management policies. Given UK's intention to drive growth through X and I , devaluation may help to boost its export competitiveness in the short-term and boost investors' confidence. As for China, its rebalancing may have to take a backseat as it continues to rely on X for growth as its consumers and the government struggle to repay the large loans accumulated. As the loans are reduced, the government may then consider using alternative monetary policy tools such as interest rates to help in achieving growth.

