

Question 2 Suggested Answers

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| (ai) | State the relationship between crude oil prices and the UK inflation rate in Figure 2. | [1] |
| | There is a positive/ direct relationship between crude oil prices and the UK inflation rate. [1] | |
| (aii) | With the help of a diagram, explain why the supply factor rather than the demand factor is more likely to cause a fall in crude oil prices. | [3] |
| | <p>The demand for oil is derived from the demand for goods and services, as oil is a key factor input in the production of many goods. Insipid economic growth has resulted in a small increase in demand for oil, which would raise oil prices. [1]</p> <p>However, supply of oil has increased to a large and significant extent due to surging US production. The increase in global oil producers thus placed downwards pressure on price, which outweighed any increase in prices from a rise in demand. [1]</p> <p>[1m for diagram]</p> <p>Hence, supply is likely to have had a more significant impact on the fall in oil prices.</p> | |
| (b) | Explain why a fall in crude oil prices would impact the economic growth of countries differently. | [4] |
| | <p>A fall in crude oil prices would impact the economic growth of countries differently, depending on whether they were exporters or imports of oil.</p> <p>For exporters of oil like Russia, a fall in the price of oil would result in a less-than-proportionate increase in quantity demanded, as PED of oil < 1 due to a lack of substitutes. Thus, exporters of oil would experience a fall in export revenue (X), which reduces AD and causes a fall in NI, ceteris paribus. The fall in crude oil would thus have a negative impact on economic growth. [2]</p> <p>For importers of oil like China and many European countries, however, a fall in the price of oil is likely to encourage growth. Oil is a key factor of production, so lower oil prices result in a fall in costs of production across the economy and increase SRAS. This would cause a rise in NI, ceteris paribus. [2]</p> | |
| (c) | Explain the impact of Russia's "interest rate hike to 17%" on the rouble. | [2] |
| | <p>A sharp rise in Russia's interest rate would attract capital inflows and reduce capital outflows as investors seek higher rates of return for their short-term investments. [1m]</p> <p>This would increase demand and decrease supply of the rouble on the forex market, placing upward pressure on the rouble, i.e. rouble appreciates. [1]</p> | |
| (d) | Explain why pensioners benefit from a period of deflation. | [2] |
| | <p>A fall in the general price level during a period of deflation implies that there is a rise in purchasing power / internal value of money [1]. Pensioners tend to rely on a fixed amount of savings or fixed incomes [1]. With deflation, they are now able to consume a greater quantity of goods and services with the same amount of money.</p> | |

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| (e) | Discuss the extent to which small firms with high levels of competition are more likely to shut-down than big firms with less competition with the onset of deflationary pressures. | [8] |
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Introduction

Shut down condition for firms: **AR<AVC in the short-run and AR<AC in the long-run** which is probable since Extract 7 mentions on the higher likelihood of bankruptcies.

Body:

(1) Analyse what will lead to firms shutting-down

Revenue Analysis:

| Reasons why revenue is likely to fall | Reasons why revenue is likely to rise |
|---|---|
| Deflationary expectations may cause “households (to) put off consumption in anticipation of lower prices”. Firms would then experience a <u>fall in demand and thus revenue</u> . | However, since deflation is likely to increase export competitiveness of its goods and services and assuming demand is price elastic, the quantity demanded for exports will increase more than proportionate and this will increase the revenue for firms which produce exports. |

Cost Analysis:

Firms will experience a reduction in cost of production due to the lower oil, commodity and energy prices (Extract 7) – fall in variable cost

Impact on profits and shutting-down:

- Firms will be faced with losses if the deflation is severe and households indeed procrastinate their purchase till $TR < TVC$. They may shut-down temporarily in the short-run.
- Only when the situation is permanent till $TR < TC$, the firms may shut-down permanently and exit the market.

(2) Explain why small firms with high levels of competition are more likely to shut-down than big firms with less competition

- The above applies generally to all firms but small firms with high levels of competition, which is monopolistic competitive firms might be more likely to shut-down than big firms with less competition, oligopoly, given that they only earn normal profits in the long-run. So even a small fall in demand can mean making losses. They also do not have excessive past profits for them to cover the losses to keep them in business.
- For larger firms in the oligopolistic market, they have more means/money to do excessive product promotion to woo their consumers to buying their goods. And instead of shutting-down their entire business, they can explore options such as “selling off unprofitable branches” (divestment). This will help the firms to survive.
- It will be relatively harder for monopolistic firms to survive the impact of deflationary pressures.

Evaluate the extent:

- But, whether the monopolistic firms will shut-down depends on the type of good that they sell. If these are necessities and perishables, then it is unlikely for the consumers to “put off consumption in anticipation of lower prices”, hence demand for these goods are unlikely to fall.
- However, if these firms were to sell goods which are not necessities, then it is likely that demand will fall by a greater extent and there will more likely to shut-down than bigger firms, given they only earn normal profits in the long-run and have little means to revive the demand.

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| 4 – 6 | <p>Consolidate (Application and Analysis)</p> <ul style="list-style-type: none"> • Analyses both the impact of deflationary pressures on cost and revenue on firms. |
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| | <ul style="list-style-type: none"> Analyses how small and large firms may be affected differently based on the differing characteristics of market structure and case material. |
| 1 – 3 | Knowledge and Understanding (Description) <ul style="list-style-type: none"> Describes the impact of deflationary pressures on cost and revenue on firms. Lop-sided analysis: Analyses the impact of either cost or revenue on firms. Little or incorrect use of case evidence to analyse impact on large or small firms. |
| 1 – 2 | Evaluative Comment <ul style="list-style-type: none"> Makes a well-reasoned judgement on how consumer’s expectations will affect the profit level of each type of firms. Takes into account the context and circumstances surrounding the case to substantiate the chosen judgement. |

(f) **Discuss whether the UK government should be worried about the impact of domestic and Eurozone deflation on its economy.** [10]

The impact of both domestic and Eurozone deflation on the UK economy may be assessed by considering the impact on UK macroeconomic goals.

Impact of domestic deflation on the UK economy

| Why the UK govt should be worried | Why the UK govt should <i>not</i> be worried |
|--|--|
| <ul style="list-style-type: none"> If deflation persists for an extended period of time, the UK may be caught in a deflationary spiral (‘vicious cycle of falling prices and wages’ in Extract 7). Consumers put off consumption due to expectations of lower prices in the future, causing a fall in C and thus AD. Fall in investment too due to fall in investor confidence due to bankruptcies and the “selling off unprofitable branches”. This lowers real output, i.e. <u>negative growth</u>. It also <u>increases unemployment</u> and causes a further fall in GPL, <u>worsening deflation</u>. Furthermore, the UK government is already running a budget deficit (Table 2) and has ‘huge aggregate indebtedness’ (Extract 8). Deflation may cause the real value of any government debt to increase as the internal value of money rises, making it more difficult for the government to repay its debt. | <ul style="list-style-type: none"> However, given that deflation is primarily due to fall in oil prices (Extract 7), this would reduce costs of production within the economy, causing SRAS to shift right. While GPL falls, there is in fact a rise in production and output, i.e. <u>positive growth</u>, and hence <u>increased employment of labour</u>. Deflation may also improve price competitiveness of exports (Extract 7), which may <u>improve BOP</u>. |

Synthesis / Evaluation:

Whether the UK should be concerned about deflation depends critically on the root cause of deflation. If deflation stems from a fall in costs of production within the economy, as it appears to be given the drastic decrease in crude oil prices, then deflation is largely benign and may even be welcomed as it improves living standards of many households (Extract 7). Moreover, Extract 7 states that “any period of negative inflation is likely to be temporary”, so perhaps it is unlikely that deflation would last long enough for people to develop deflationary expectations which may cause damaging deflation.

Impact of regional (EU) deflation on the UK economy

| Why the UK govt should be worried | Why the UK govt should <i>not</i> be worried |
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| <ul style="list-style-type: none"> Deflation in the EU may have spillover effects on the UK economy. It may reduce | <ul style="list-style-type: none"> Impact of government policies: EU is seeking to reduce deflation via currency depreciation |

export demand for UK goods as EU consumers hold back spending, resulting in a fall in X and thus AD. This lowers real output, increasing unemployment, and resulting in a fall in the UK's GPL.

- It also worsens the UK's current account deficit, as EU goods become cheaper over time, resulting in a more than proportionate increase in quantity demanded for imports and raising the UK's import expenditure (assuming $PED_m > 1$). This effect is reinforced by Figure 3 which shows a sharp worsening of UK's balance of trade deficit with the EU from 2015.
- The current account deficit could also be exacerbated by the EU's decision to weaken the Euro, as an EU policy response to Eurozone deflation.
- Increase in the size of external debt

(Extract 8). This would stimulate economic growth and raise employment in the Eurozone.

- If successful in 'jump-starting the economy', this may reduce the possible negative spillover effects on the UK economy.

Synthesis / Evaluation:

It is likely that the negative impact of regional deflation effects will be felt on the UK in the short run while the positive effects may be experienced in the longer term. However, if the Chief Economist at the British Chambers of Commerce recommends that 'no risks should be taken' (Extract 7) in light of the global uncertainties and UK's fragile recovery, then the UK government should take proactive steps to implement expansionary demand-management policies to counter the short term negative impact of regional deflation.

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| 5 – 7 | <p>Consolidate (Application and Analysis)</p> <ul style="list-style-type: none"> • Balanced and well-developed analysis on the impact of both domestic <u>and</u> Eurozone deflation on the UK economy • Analysis is supported by good use of case evidence, and demonstrates a strong link between economic concepts and evidence raised |
| 1 – 4 | <p>Knowledge and Understanding (Description)</p> <ul style="list-style-type: none"> • Shows an awareness of possible impact of deflation on UK economy but analysis is highly theoretical and lacks application to case context. • Little or incorrect use of case evidence. • Lop-sided analysis, i.e. considers only the impact of domestic deflation on the UK economy. |
| 1 – 3 | <p>Evaluative Comment</p> <ul style="list-style-type: none"> • Makes a well-reasoned judgment on whether the UK government should be worried about the macroeconomic impact of domestic and Eurozone deflation • Takes into account the context and circumstances surrounding the case to substantiate the chosen judgment. |