2017 RVHS H1 Prelims II
Question 2 Problems in the European Union (suggested answers)

(a) Compare the patterns of the government debt to GDP ratio in Greece and Germany between 2010 and 2015. [2]

Government debt to GDP ratio in Greece increased while it decreased in Germany. [1]

Government debt in Greece is consistently more than 100% of GDP while that of Germany is less than 100% of GDP. [1]

(b) Extract 7 suggests that austerity measures were imposed on Greece to help reduce its debt. Explain the likely factors that may influence the effectiveness of these measures. [4]

Debt is incurred when the government borrows to fund a budget deficit. Austerity measures aim to increase tax revenue while decreasing government spending. The effectiveness of austerity measures imposed on Greece to reduce its debt is thus dependent on its ability to increase tax revenue and decrease government spending.

1. Consumers and investors' confidence in the Greek economy
If Greece succeeds in decreasing its debt, consumers and investors' confidence might be raised thereby increasing consumption (C) and investment (I) and increasing national income (NY) and employment in the future. This will help to increase tax revenue and reduce government spending, thus helping to reduce the debt / avoid more borrowing and chalking up debt, rendering austerity measures effective.
Or
With a decrease in consumers and investors' confidence when Greece's debt is high, austerity measures may dampen C & I which will result in a fall in tax base and a fall in tax revenue. This reduces the effectiveness of austerity measures in trying to reduce the debt.

2.Ability of the government to reduce government spending
It may be difficult to reduce some forms of government spending such as healthcare. These may be strongly resisted. Hence, failure to reduce government spending with no corresponding increase in tax revenue may mean that the debt is not reduced, rendering austerity measures ineffective.

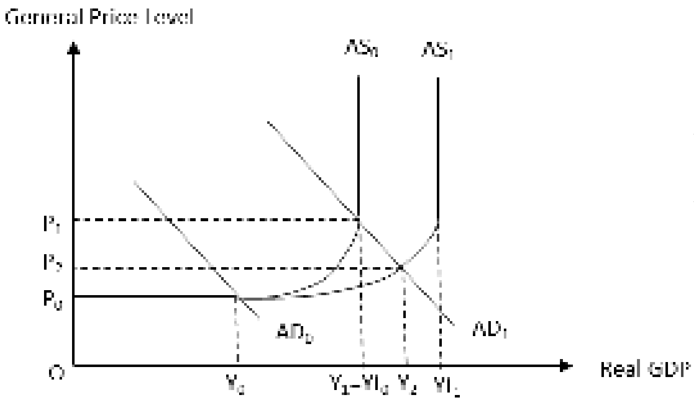
Note: 2 marks for each point well explained.

(c) Extract 5 mentions that German chancellor Angela Merkel had refused to put a cap on refugee numbers into Germany.

(i) With the help of an AD/AS diagram, explain the impact in both the short and the long run of an influx of refugees on the Germany's economy. **[6]**

The influx of refugees will lead to an increase in consumption (C) as they will also be spending on daily necessities within Germany. In addition, in order to house the refugees, the government will need to spent more on public investment expenditure (G) to construct more housing infrastructure. [1] In the short run, the increase in C and G will then lead to an increase in aggregate demand (AD) from AD_0 to AD_1 and a multiple increase in national income (NY) from Y_0 to Y_1, as shown in Figure 1, achieving actual economic growth [1].

In the long run, the refugees will be trained and are ready to join the workforce. This increase in quantity of labour in Germany will cause an increase in long run aggregate supply from AS_0 to AS_1 as shown in Figure 1. [1] Potential economic growth is achieved as productive capacity increased from Yf_0 to Yf_1.



Graph showing short-run impact [0.5], showing long-run impact [0.5]

Figure 1: Impact on Germany's economy

(ii) Explain how Germany's government budget could possibly be affected with the influx of refugees. **[4]**

Government budget position is derived from government revenue minus government expenditure.

<u>Possible impact on government revenue</u>
In the long run, as mentioned in part ci, as more refugees become educated and join the workforce, they will also be contributing income tax. Assuming that there is no change in government's expenditure, government's budget position is likely to improve. [2]

<u>Possible impact on government expenditure</u>
In the short run, government expenditure is likely going to increase as more funds will be spent to build more housing infrastructure for the refugees. Thus assuming no change in government revenue collected, government's budget position is likely to worsen. [2]

Note: 2 marks for each possible impact. To obtain the full 4 marks, both government expenditure and government revenue needs to be mentioned (even if it's assuming that either of them remain constant).

(d) Analyse and comment on whether the problems posed by Germany's trade surplus or Greece's debt will be more serious to the European Union. **[6]**

<u>Thesis: The problems posed by Germany's trade surplus is detrimental to the European Union</u>

<u>Impact on BOP position of Germany's trading partners in the EU</u>

Germany's trade surplus is likely due to its lower cost of production through wage competitiveness as pointed out in Extract 6. This results in lower prices of its export and enabled Germany to divert export demand from other EU countries to its economy instead. These chronic surpluses in Germany are a way of stealing demand from elsewhere and may result in a persistent balance of trade (BOT) deficit for other EU countries.

Secondly, the German regulatory and tax structure is geared in favour of output and exports and against consumption. Taken together, these will lead to a fall in demand for many EU countries' exports leading to a fall in their net exports, worsening their BOT and balance of payment (BOP) position.

<u>Impact on economic growth and unemployment of other EU countries</u>

The fall in net exports will lead to a fall in aggregate demand (AD) and national income (NY) via reverse multiplier effect. This leads to increased unemployment levels in the other EU countries. This may weaken consumer and investor's confidence, lowering consumption and investment, thereby worsening national income and unemployment levels further in the other EU countries.

<u>Impact on economic growth and general price level of other EU countries</u>

To match up to Germany's competitiveness, a few EU countries such as France, Spain and Greece tried to lower their wages as mentioned in Extract 6. The fall in wages will lead to a fall in disposable income, decreasing consumption, leading to a fall in AD and NY. This will lead to a multiple fall in national income via reverse multiplier effect and a dampening/deflationary effect on general price level, which explains the deflationary slump as mentioned in Extract 6.

Anti-Thesis: The problems posed by Greece's debt is detrimental to the European Union

Impact on economic growth, unemployment and general price levels of other EU countries (opportunity cost of lending money to Greece)

As noted in Extract 7, Greece received several bailouts from the EU since 2010 and she has benefitted from a large write-off of debt owed to private banks in 2012. In addition, the true creditors of much of Greece's remaining large debt are German, Dutch, French and other European taxpayers. If Greece were to default on her debt or if the debt is written off as bad debt just like in 2012, it will be of a high cost to other EU countries. This is because the money loaned to Greece will not be recovered and as a result, there will be less reserves and funds available for future government expenditure in other EU countries.

These funds used to bail out Greece could have been used by other EU countries to increase their fiscal spending which will help bring about economic growth in their own country instead. For example, bailing out Greece by other EU countries will limit the amount of funds available for other uses such as building infrastructure, which will then restrict any increase or even lower their AD in the short run and this will also have a negative impact on LRAS in the long run. If AD falls, unemployment levels will increase. At the same time, with a fall in AD, general price level in other EU countries will fall too.

Impact on economic growth, unemployment and general price levels of other EU countries (a fall in investors' and consumers' confidence in other EU countries)

The large debt owed by Greece and the possible risk of default again will result in a contagion impact on other EU countries. These events will reduce investors' and consumer's confidence in other EU countries, resulting in a further fall in I and C, thus decreasing AD and NY, worsening unemployment levels and current deflation in other EU countries as mentioned above.

Synthesis (whether the problems posed by Germany's trade surplus or Greece's debt will be more serious to the EU)

While it is undeniable that Germany "export unemployment to other countries" through its trade surpluses as mentioned in Extract 6, it is important to note that Germany does not only export to other EU countries but also to countries outside of EU as well. Table 2 pointed out that Germany's largest export partner is actually United States, which took up 9.53% of Germany's total exports in 2015. As such, the adverse impact of Germany's trade surplus on other EU countries may be over-amplified.

On the other hand, the debt crisis in Greece seems to be more of a serious threat to EU because the creditors of the Greece's large debt are the other EU countries. The possible risk of default by Greece remains high and these will have a negative impact on the economic growth, employment level and general price level of other EU countries. As such, the trade surplus in Germany may not be that serious to EU as compared to Greece's debt.

Level	Description	Marks
L2	Developed analysis on whether the problems posed by Germany's trade surplus or Greece's debt will be more serious to the macroeconomic aims of other countries in the European Union. Developed analysis: coverage of 2 reasons in total (1 for thesis and 1 for anti-thesis with links explicitly made to other EU countries' macroeconomic goals) as to how the problems posed by Germany's trade surplus or Greece's debt is detrimental to the other countries in the European Union.	3-4
L1	Undeveloped analysis on whether the problems posed by Germany's trade surplus or Greece's debt will be more serious to the macroeconomic aims of other countries in the European Union. Undeveloped analysis as to how the problems posed by Germany's trade surplus or Greece's debt is detrimental to the other countries in the European Union: • coverage of 2 reasons in total (1 for thesis and 1 for anti-thesis without links explicitly made to other EU countries' macroeconomic goals • 2 reasons for thesis or 2 reasons for anti-thesis	1-2
	Evaluation	
E2	An explained comment that is supported with economic analysis.	2
E1	An unexplained comment.	1

(e) With reference to the data, discuss whether benefits will outweigh costs with a less globalized world economy. [8]

<u>Introduction</u>
Definition:
Globalization is the closer integration of countries and people of the world through the ease of movement of goods and services, capital and labour.

<u>**Thesis: Benefits associated with a less globalized world economy**</u>

<u>Positive impact on a country's financial stability and thus, economic growth</u>

As mentioned, with a less globalized world economy, there will be a reduction in the movement of capital globally. As such, the expansion of banking sectors and opening up of capital markets, especially in developing countries, will be slower. This will result in a reduction of speculative hot money flows globally. Hot money inflows into a country will lead to an increase in money supply and as such, interest rates will fall and prompts more borrowing. Even though the increase in consumption and investment will lead to an increase in aggregate demand, these hot money can possibly quickly turn to bust when global investors change their minds and pull their money out of the economy. Money supply will fall drastically and this pushes up domestic interest rates, which many borrowers will then have problems paying off their debt and banks might end up with a large amount of bad debts.

As a result, having less hot money flows will have a positive impact on financial stability globally because a smaller global capital flows leave less room for imbalances which will endanger the development of financial stability. This is especially beneficial for developing countries where their banking sectors and capital markets are still relatively small and undeveloped as mentioned in Extract 8 whereby inflows of speculative hot money can be dangerous.

Positive impact on a developed country's employment level and income gap

With globalization, there might be massive layoffs in developed countries like the US, where labour-intensive jobs like manufacturing jobs get shifted offshore as pointed out in Extract 8. As these labour-intensive industries in the developed economies lose their competitiveness in the production of such goods, they may be forced to shut down. If this is so, this may lead to a substantial degree of structural unemployment (especially in the short term) as retrenched workers may not be able to pick up the relevant skills to take on jobs created in the new industries created.

As such, with a reduction or a slowdown in movement of goods and services, capital and labour, the pace of labour-intensive industries and jobs shifting from developed to developing economies will be slowed down. The extent of structural unemployment faced by developed economies will be less serious. At the same time, workers in these economies will have more time to pick up relevant new skills to take on jobs in new industries created before the labour-intensive industries move out of the country totally.

Anti-Thesis: Costs associated with a less globalized world economy

Negative impact on amount of goods and services that a country can enjoy

Extract 8 mentioned that US has been a big winner from globalisation. First of all, with greater ease of movement of goods and services, consumers in advanced economies such as US have been able to enjoy a wider variety of goods and services. Moreover, by undertaking subdued means of giving domestic firms an unfair advantage in Extract 8, it runs contrary to the law of comparative advantage. By retreating into protectionism, It results in a reduced world output and as such, the goods and services that can be enjoyed by consumers in each country will be comparatively smaller.

Negative impact on a developing country's employment level

Extract 8 also pointed out that globalisation has been a great force to lift people out of poverty in big and low-income economies like China and India. With a less globalized economy, workers in the developing economies where there is a large population, might find it harder to be employed. As such, more people in the developing economies might be unemployed and unemployment rate in the developing economies might increase. This will lead to a fall in consumption as income levels fall and at the same time, aggregate demand and national income falls further which may lead to a deflationary spiral.

Synthesis (whether benefits will outweigh costs with a less globalized world economy)

The benefits enjoyed or costs incurred by developing and developed economies with a less globalized world economy differ.

To conclude, the costs associated with a less globalized world economy should outweigh the benefits. First of all, as Extract 8 pointed out, there is little evidence that free flow of labour lowers domestic wages. Next, with increased globalisation, there will be better allocation of resources which results in increased world output and consumption for all.

Most importantly, the increase in structural unemployment experienced by developed economies with increased globalisation is likely to be evident only in the short run. Better social safety nets like unemployment benefits while equipping the unemployed with new skills through retraining programmes can be put in place to help them to get a job.

To reduce the problem associated with hot money flows, tough regulations and proper controls can be put in place, especially by developing economies, while opening up their capital markets to reduce the occurrence of hot money flows.

Level	Description	Marks
L3	Developed discussion of whether benefits outweigh costs with a less globalized world economy. (Developed discussion includes one well-explained benefits and one well-explained cost, with reference to the extract.)	5-6
L2	Undeveloped discussion of whether benefits outweigh costs with a less globalized world economy or without any reference to the extract. (Undeveloped discussion includes one well-explained benefit and one well-explained cost, without reference to the extract.) Or Developed explanation of two benefits or two costs of a less globalized world economy.	3-4
L1	Smattering of valid points	1-2

In addition, up to 2 marks for valid evaluative comment. Students should come to a reasoned judgement by weighing the benefits and costs of a less globalized world economy and this should be substantiated with economic reasoning and evidences from the extracts. An example of economic reasoning includes whether policies can be undertaken to minimize the costs of a less globalized world economy.