

Answer **all** questions.

Question 2

Economic Priorities

Extract 5: Financial crisis could turn the tide against unrestricted capital flows

The theory says that free capital flows allow savings to be directed – by the invisible hand of the financial markets – to wherever they will be most profitably employed. In this way, savers get a better return on their nest egg, while underdeveloped economies receive the financial leg-up they need.

Except that isn't what's been happening: instead, for the past decade and more, savings have been pouring uphill from poor countries to rich. Far from nurturing development and improving the standard of living of the poorest, these vast flows of money have created a repeated pattern of boom, bust and financial crisis.

In recent years, several countries have quietly begun erecting breakwaters against the latest tidal wave of capital, driven by low interest rates in the west. Brazil, Argentina and Costa Rica have used various measures, including taxes on purchases of shares and bonds and insisting that short-term investors deposit funds with the central bank for a year, to dampen the stop-go cycle.

One unlikely recent champion of the reintroduction of regulations on capital flows is the Bank of England. The shock of being caught unawares by the vulnerability of the UK's financial system in 2007 and 2008 caused soul-searching in Threadneedle Street, and recent papers and speeches have helped build the case for new thinking.

Adapted from: *The Observer*, 8 January 2012

Extract 6: Counter-cyclical policy responses

An important lesson from the severity of the recent world financial crisis is that policy in various areas will have to be more prudent during upswings and to build in greater safety margins to be able to react to large adverse shocks. For instance, the room for fiscal policy to react to a downturn is constrained by budget deficits and debt at the outset. In general, the poorer the fiscal position the less reactive governments have been and can be in their response to adverse shocks.

Adapted from: Organisation for Economic Cooperation and Development (OECD), 2010

Extract 7: IMF cuts UK economic growth forecast for 2011 to 1.75%

The International Monetary Fund (IMF) has cut its 2011 growth forecast for the UK economy to 1.75%, its third downgrade in a year. The cut cements the widely held view that Britain faces a year of low growth and rising unemployment with little prospect of a job-creating recovery until later in 2012.

The report warns that the downside risks to UK growth have increased as the potential for policy mistakes in the eurozone have risen. The cost of oil and other raw materials, which have jumped 32% over the last year according to the IMF's own index, also pose extra risks.

Source: *The Guardian*, 11 April 2011

Extract 8: South Korea economy

One of the major threats to the Korean economy is the global economy facing a patchy recovery due to continued stiff head winds, such as high-flying commodity prices and currency disputes among advanced economies.

Global economies will continue to fall into two distinctive camps dubbed the “two-speed world.” Western economies and Japan will undergo a slow recovery mode, while developing economies, including emerging market economies, will continue to enjoy robust growth.

Under this new trend, the Korean economy and companies should shift their focus to emerging economies from developed countries to capitalize on the upcoming change triggered by the outcome of the global financial crisis.

“We expect the global recovery to remain a two-track one, with the emerging economies growing much faster than the developed world economies,” Nomura Securities said in its 2011 outlook report. “For the developed economies, the post-crisis world likely means prolonged anemic growth.”

Source: *The Korea Times*, 31 Dec 2010

Table 1: Youth Unemployment Rates, December 2007 to March 2012
(Percentage of total youth labour force (15-24))

Country	December 2007	March 2012
Greece	21.6	51.2
South Korea	8.7	9.5
UK	13.6	21.9

Source: *The Guardian*, 16 May 2012

Table 2: Labour Productivity Annual Growth Rate

Country	2007	2008	2009	2010	2011
Greece	2.8	-1.5	-0.3	-2.8	-0.9
South Korea	5.5	4.3	1.2	6.5	1.8
UK	2.2	-0.8	-2.3	1.8	1.9

Table 3: Gross Domestic Product Annual Growth Rate

Country	2007	2008	2009	2010	2011
Greece	3	-0.2	-3.3	-3.6	-7.2
South Korea	5	2.3	0.3	6.1	3.6
UK	3.4	-1.1	-4.5	2.1	0.7

Source: OECD, 2012

Extract 9: Innovation

Much of the rise in living standards is due to innovation. Today, innovation performance is a crucial determinant of competitiveness and national progress. Moreover, innovation is important to help address global challenges, such as climate change and sustainable development. But despite the importance of innovation, many OECD countries face difficulties in strengthening performance in this area. Indeed, many OECD countries have seen little improvement in productivity performance in recent years despite the new opportunities offered by globalisation and new technologies, especially the information and communication technologies.

Source: OECD, *Innovation and Growth Rationale for An Innovation Strategy*, 2007

Questions

- (a) (i) State the economic relationship that exists between labour productivity growth and economic growth in UK and South Korea. [1]
- (ii) Account for the above economic relationship in South Korea. [2]
- (b) Explain the case for the use of regulations by UK government to manage huge 'capital floods'. [4]
- (c) (i) Compare the youth unemployment rates in Greece, South Korea and UK. [2]
- (ii) Explain the impact in both the short run and the long run of the above situation in Greece or UK. [3]
- (d) Extract 9 suggests that 'much of the rise in living standards is due to innovation.' Discuss the validity of this argument. [8]
- (e) "An important lesson from the severity of the recent world financial crisis is that policy in various areas will have to be more prudent during upswings and to build in greater safety margins to be able to react to large adverse shocks."
- Assess the extent to which the UK government's economic priorities may be adjusted in response to growing youth unemployment? [10]

[Total 30 marks]

-End of Paper-

Suggested Answer:

- (a) (i) State the economic relationship that exists between labour productivity growth and economic growth in UK and South Korea. [1]
Direct relationship
- (ii) Account for the above economic relationship in South Korea. [2]
Students can choose to use PPC model or AD/AS model to explain the direct relationship that exists between labour productivity growth and economic growth in South Korea.

<u>Using PPC analysis:</u>	<u>Using AD/AS analysis:</u>
↑ in labour productivity growth rate <ul style="list-style-type: none"> ▪ Rise in output produced per man hour ▪ Outwards shift of PPC ▪ Higher economic growth achieved by South Korea economy 	↑ in labour productivity growth rate <ul style="list-style-type: none"> ▪ More output with the same amount of input ▪ ↓ unit labour cost of production ▪ Rightwards shift of AS curve ▪ Higher real national income achieved by South Korea economy

- (b) Explain the case for the use of regulations by UK government to manage huge 'capital floods'. [4]

Thinking Process	Theoretical Framework	Evidence from Case
Significance of huge 'capital floods' pertaining to UK economy	<ul style="list-style-type: none"> ▪ Increased the volatility of capital flows in recent years (eg Global Financial Crisis) ▪ These huge waves of capital inflows are in excess of UK economy absorptive capacity & are highly speculative in nature 	2008 Global Financial Crisis
Consequences of huge 'capital floods' (Building the case for the use of regulations)	<ul style="list-style-type: none"> ▪ Complicates UK macroeconomic management and carry risks for financial and economic stability ▪ May lead to exchange-rate overshooting, credit and debt bubbles, inflation and asset price bubbles ▪ In addition, there is a risk of sudden stops and withdrawals of international capital due to heightened risk aversion, which contribute to spreading financial crisis 	(not in case materials: on-going sovereign debt crisis in Europe)
Reasons why UK government choose to re-	<ul style="list-style-type: none"> ▪ Thus, UK government must focus on managing the macroeconomic volatility induced by private financial flows 	Re-introduction of regulations on capital flows by

introduce regulations	<ul style="list-style-type: none"> Capital-account regulation is an effective counter-cyclical macro risk management tool of the domestic financial sector Thus, Bank of England reintroduced the regulations on capital flows 	Bank of England.
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- (c) (i) Compare the youth unemployment rates in Greece, South Korea and UK. [2]
Explicit points of Comparison: One Similarity [1] One Differentiating Pt [1]
 Similarity: Youth unemployment rates in Greece, South Korea and UK rose from Dec 2007 to Mar 2012.

Differentiating Point: The **rate** of increase in youth unemployment rate is fastest in Greece, followed by that of UK and South Korea.

- (ii) Explain the impact in both the short run and the long run of the above situation in Greece or UK. [3]

Short-Run Impact	Long-Run Impact
Unemployment represents wastage of resources as these labour resources should have been fully utilized and fully employment to enable the country to achieve full employment output level. Worsens labour market inefficiency in resource allocation ($Y_e < Y_f$) ↓ in standard of living of the unemployed persons <ul style="list-style-type: none"> Fall in real GDP per capita 	Prolonged periods of unemployment could lead to erosion of skills of those unemployed making it more difficult for them to seek employment. Severe and prolonged unemployment would result in increased government spending on welfare payments and reduced tax revenue due to falling tax base → fiscal balance deteriorates

- (d) Extract 9 suggests that 'much of the rise in living standards is due to innovation.' Discuss the validity of this argument. [8]

Thesis: Much of the rise in living standards is due to innovation	
<u>Firms</u> Process Innovations → minimise unit costs of production → ↑ in total revenue, ceteris paribus, profit levels Product innovations → Dd for product becomes less price elastic → expand market size	<u>Case Materials:</u> Today, innovation performance is a crucial determinant of competitiveness.

<p>Together, results in greater firm's competitiveness → ↑ X → ↑ AD → ↑ in real national income → Rise in material living standards</p>	
<p><u>Consumers</u> Product innovations → Better quality & wider choices of products consumed → material SOL</p>	<p>Case Materials: Today, innovation performance is a crucial determinant ... national progress.</p>
<p><u>Society</u> → use of greener technology → Reduce the degree of negative externalities → Achieve sustainable economic development → Rise in living standards</p>	<p>Case Materials: Moreover, innovation is important to help address global challenges, such as climate change and sustainable development.</p>
<p>Anti-Thesis: Much of the rise in living standards is due to other factors</p>	
<p>Difficulty faced by OECD countries to strengthen their performance in innovation and productivity despite the new opportunities offered by globalisation and new technologies, especially the information and communication technologies.</p> <p>→ Need to continue to strength and enhance their comparative advantage in R&D arena in the respective fields eg pharmaceutical industries.</p> <p>→ Implies increase efficiency in resource allocation (relocate sunset industries and develop sunrise industries based on lower opportunity costs incurred in producing one more unit of output)</p>	<p>Case Materials: Despite the importance of innovation, many OECD countries face difficulties in strengthening performance in this area. Indeed, many OECD countries have seen little improvement in productivity performance in recent years despite the new opportunities offered by globalisation and new technologies, especially the information and communication technologies.</p>
<p>Much of the rise in living standards in the developing economies is largely utilising of previously untapped/unemployed resources.</p>	
<p><u>Government</u> → Rise in real GDP per capita → Rise in income tax and corporate tax revenues</p>	

collected → ↑ in government expenditure on merit goods eg public transport, education and healthcare services → Rise in living standards	
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Level	Descriptor	Marks
L3	For a balanced discussion of the validity of the argument.	7-8
L2	For an answer that presents insufficient reasoned judgment on why much of the rise in living standards is due to innovation or other influencing factors.	4-6
L1	For an answer which merely regurgitates from the lecture notes with no attempt to answer directly to question. <u>OR</u> For an answer with gross misconceptions.	1-3

- (e) “An important lesson from the severity of the recent world financial crisis is that policy in various areas will have to be more prudent during upswings and to build in greater safety margins to be able to react to large adverse shocks.”

Assess the extent to which the UK government's economic priorities may be adjusted in response to growing youth unemployment? [10]

Thesis: UK government's economic priorities may be adjusted in response to growing youth unemployment	Case Materials				
<p>A significant and rising proportion of youth are unemployed. → Wastage of precious human resources → In the longer run, production capacity of the UK economy will expand at a slower rate. Impact is already reflected in the current slow economic growth achieved.</p> <p>Thus, UK government must reprioritise to improve potential economic growth and reduce the adverse negative social impact of this trend.</p>	<p>Britain faces a year of low growth and <u>rising unemployment with little prospect of a job-creating recovery</u> until later in 2012.</p> <table border="1"> <tr> <td>Dec 07</td><td>Mar 12</td></tr> <tr> <td>13.6%</td><td>21.9%</td></tr> </table>	Dec 07	Mar 12	13.6%	21.9%
Dec 07	Mar 12				
13.6%	21.9%				
In view of the challenges of rising youth unemployment, ageing population and a rapidly changing economic environment, only productivity-driven growth can deliver sustainable economic development, and improve UK's standard of living over time.	Low labour productivity				

<p>To mitigate the negative impact of a rising youth unemployment on labour productivity growth, it is important for the UK government to focus on education and retraining of less skilled youth and help them stay relevant and productive in the years ahead.</p>	
<p>Anti-Thesis: UK government's economic priorities may not be adjusted in response to growing youth unemployment</p>	<p>Case Materials</p>
<p>Policies to improve youth unemployment are long-term measures. Thus, the UK government must seek to achieve other economic priorities concurrently to achieve better economic performance.</p>	
<p>Implement demand management policies to boost current economic growth</p> <ul style="list-style-type: none"> ➔ Reduce demand deficient output gap ➔ Increase real national income ➔ Improve employment levels and living standards of the people 	<p>Britain faces a year of low growth and <u>rising unemployment with little prospect of a job-creating recovery</u> until later in 2012.</p>
<p>Currently, UK economy is facing high public debt to GDP ratio</p> <ul style="list-style-type: none"> ⇒ Limits her ability to engage in expansionary fiscal policy ⇒ In particular, UK may lack the political will to implement effective costly long term measures to resolve rising youth unemployment eg revamping of the UK educational system, relocating of sunset industries which have lost their comparative advantage 	<p>Room for fiscal policy to react to a downturn is constrained by budget deficits and debt at the outset. In general, the poorer the fiscal position the less reactive governments have been and can be in their response to adverse shocks.</p>
<p>UK government – build a greater safety margins in order to react to large adverse shocks</p> <ul style="list-style-type: none"> ⇒ UK government may prioritise to implement austerity fiscal measures in order to manage the high debt incurred and reduce budget deficits (or if possible, implement budget surplus) 	<p>The report warns that the downside risks to UK growth have increased as the potential for policy mistakes in the eurozone have risen.</p>
<p>UK economy is facing rising cost-push inflationary pressures</p> <ul style="list-style-type: none"> ➔ As price stability is the cornerstone of sustainable economic growth and development ➔ Thus, managing cost-push inflation should be the key economic priority of the UK government. 	<p>The cost of oil and other raw materials, which have jumped 32% over the last year according to the IMF's own index, also pose extra risks.</p>
<p>What exactly determines the extent to which UK government's economic</p>	

priorities should be adjusted in response to growing youth unemployment?

Judgement based on whether:

- Does this policy conflicts with other goals?
- Is this the most appropriate economic priority given the bigger economic climate?

Level	Level Descriptors	Marks
L2	Able to assess the extent to which the UK government's economic priorities may be adjusted in response to growing youth unemployment.	4-6
L1	Able to provide some valid but underdeveloped points on why UK government's economic priorities may be adjusted in response to growing youth unemployment.	1-3
E2	Evaluation well-supported with justification	3-4
E1	Unexplained evaluation	1-2