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The Global Economy

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- This document consists of **12** pages. Any blank pages are indicated.

Introduction

During the ten years up to 2008, the pursuit of economic stability appeared to rise to the top of the macroeconomic policy objectives of many countries, including the UK. It was felt that it was not enough simply to achieve high growth, low inflation, high rates of employment and low rates of unemployment and to avoid balance of payments problems. Economic stability was seen as a pre-condition for all of the other policy objectives. Various measures, including widespread adoption of inflation targeting by central banks, were put in place to bring about economic stability. Events during 2008, however, brought to an end this era of economic stability.

One of the symptoms of the end of the era of stability was the sharp downturn in economic activity in countries including the UK and the USA. Fears of recession led policy makers to take dramatic action to counter the downturn in the economic cycle. Monetary expansion, through interest rate reductions, was the most immediate and dramatic of the policy reactions to the downturn. Yet there was much comment as to whether this monetary expansion, on its own, would be sufficient to counter the downturn. Many commentators feared monetary policy would be ineffective in the circumstances of late 2008.

Domestic instabilities soon spread to the global economy and the International Monetary Fund (IMF) was called upon to fulfil its role in the world's financial systems. The IMF put in place packages to support a number of countries, including Hungary, whose economic weaknesses had become apparent. These weaknesses were most obvious in their balance of payments positions. Such weaknesses had been responsible for the collapse of currencies, such as the Hungarian forint, in the turmoil of late 2008.

The events of 2008 brought into sharp focus the consequences of the process of globalisation. Globalisation has long been the subject of debate amongst economists, who see both advantages and disadvantages to the process, particularly for developing economies. The extent to which the net impact of globalisation on any one developing economy is positive or negative remains an issue which is still unresolved.

Pre-release stimulus material

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Extract 1

UK economic stability threatened

During October 2008 the 'R' word (recession) featured heavily in commentary on the performance of the UK economy. The National Institute of Economic and Social Research predicted recession. The British Chambers of Commerce said that its members (small and medium sized businesses) were experiencing the effects of recession. Even the Governor of the Bank of England and the Prime Minister acknowledged recession was likely.

Following zero economic growth in the second quarter of 2008, official statistics for the third quarter showed a decline in UK national output. Many economists believed that official statistics for the fourth quarter would show further negative economic growth. This would be enough to confirm the UK's first recession since 1992.

Sixteen years of continuous economic growth in the UK had convinced many people that economic policy makers had delivered an unprecedented period of economic stability. The Labour Government had boasted of its record on economic stability since coming to office in 1997. In his first Budget as Chancellor, Gordon Brown had said:

> *"to avoid a lurch backwards towards the kind of boom-bust instability that brought interest rates as high as 15 per cent in the late 1980s, the Government and the Bank of England took action to ensure economic stability."*

This action included:

- granting operational independence to the Bank of England in the conduct of monetary policy and setting the Bank an inflation target;
- creating a Code of Fiscal Stability in which there were clearly defined rules for the conduct of fiscal policy;
- raising interest rates five times during 1997 to reduce inflationary pressures in the economy.

The downturn in economic activity, the uncertainty in financial markets and the depreciation of the UK exchange rate brought to an end the period of economic stability.

Some economists argued that the breakdown of economic stability had begun in 2007 when UK inflation exceeded the Bank of England's target rate. The downturn in economic activity in 2008, the volatility in financial markets and the depreciation of the UK's exchange rate certainly confirmed the end of an era of stability.

Extract 2

Instability creates macroeconomic policy debate in the UK

The financial and economic crises of 2008 were not confined to the UK. They were global crises. The financial crisis had its roots in over-inflated asset prices, particularly house prices in the USA, and bank lending against these assets to households with poor credit ratings. As interest rates in the USA rose, these households were unable to repay their borrowing, house prices fell and the bank loans made to those with poor credit ratings (so-called sub-prime lending) came to be viewed as too risky. Banks most exposed to these risks began to collapse. The globalisation of financial markets meant that the crisis spread outside the USA. Depositors panicked. In the UK, savers in the Northern Rock bank withdrew £1 billion from their accounts in one day. Globally, banks stopped lending to each other and more banks and financial institutions ran into trouble. Banks merged to avoid bankruptcy, some were part-nationalised and governments world-wide injected cash into the banking system to try to ease the growing credit crunch.

The financial crisis was not the only problem which policy makers had to confront in 2008. As economic growth slowed down many people feared that the global economy would enter recession. Central banks began to reduce interest rates aggressively in response to the economic slowdown. Interest rate reductions were co-ordinated by the world's biggest central banks in October 2008 – the US Federal Reserve, European Central Bank (ECB), Bank of England, and the central banks of Canada, Sweden and Switzerland all made emergency interest rate cuts of half a percentage point. Interest rates in the US fell to just 1%. Shortly afterwards, the Bank of England slashed its interest rate by a further 1.5 percentage points.

However, questions were raised about the effectiveness of monetary policy. It was clear that cuts in central bank base rates were initially having little impact on the rates at which banks lent to each other (inter-bank rates) and so to households and firms. It was not unknown for these rates, such as the three month London Inter-Bank Offer Rate (LIBOR), to remain stubbornly high, if not increase, as central bank rates came down (see Fig. 2.1). As a result, the monetary policy transmission mechanism was weakened.

Fiscal policy measures were advocated as an alternative to monetary expansion. Tax cuts were proposed to encourage a growth in spending. Some governments proposed increased public expenditure. In the UK, the Chancellor of the Exchequer announced that public expenditure plans would be brought forward to help bolster demand in the economy. There was a recognition that public borrowing would have to increase to fund this expenditure and that fiscal rules, such as the 'golden rule', might have to be broken. In addition, negative economic growth would further increase public sector borrowing through its impact on tax revenues and welfare spending. Even before the economic crisis deepened in October 2008, public sector borrowing in the UK had reached record levels. Some forecasters expected UK public sector borrowing to reach £60 billion in the financial year 2008–09.

Economists in the UK were divided on the appropriate response to an economic downturn and negative economic growth. A group of 16 economists wrote a letter to The Sunday Telegraph declaring the UK Government's plans to be "misguided and discredited". Their letter is reproduced below in Fig. 2.2.

Fig. 2.1 The Bank of England base rate and the three month inter-bank offer rate (LIBOR), 1 January 2008 to 20 October 2008

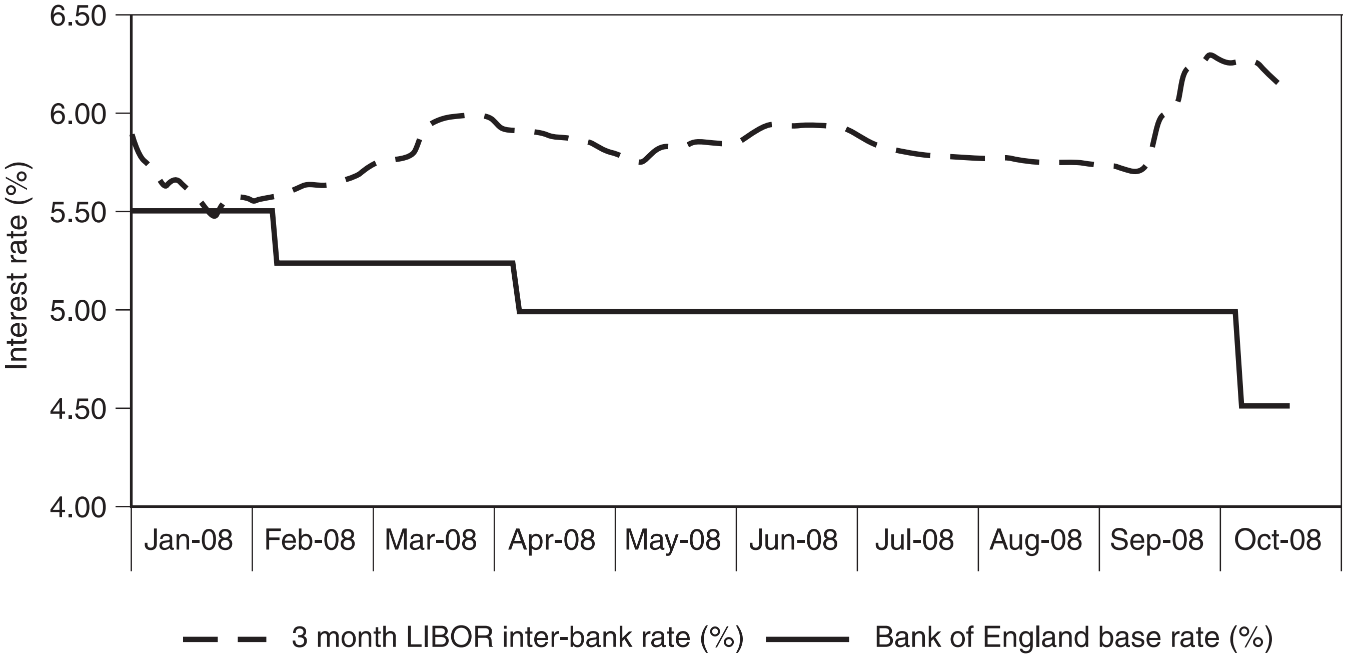

Fig. 2.2 Letter to The Sunday Telegraph by 16 UK economists

Keynesian over-spending won't rescue the economy

Further to your interview with Alistair Darling, we would like to dissent from the attempt to use a public works programme to spend the country's way out of recession.
It is misguided for the Government to believe that it knows how much specific sectors of the economy need to shrink and which will shrink "too rapidly" in a recession.
Thus the Government cannot know how to use an expansion in expenditure that would not risk seriously misallocating resources.
Furthermore, public expenditure has already risen very rapidly in recent years, and a further large rise would take the role of the state in many parts of the economy to such a dominant position that it would stunt the private sector's recovery once recession is past.
Occasional slowdowns are natural and necessary features of a market economy.
Insofar as they are to be managed at all, the best tools are monetary and not fiscal ones. It is inevitable that government expenditure and debt naturally rise in a recession but planned rises in government spending are misguided and discredited as a tool of economic management.
If this recession has features that demand more active fiscal policy, which is highly disputable, taxes should be cut. This would allow the market to determine which parts of the economy shrink and which flourish to replace them.

Extract 3

Countries call on the International Monetary Fund (IMF)

One of the consequences of the global financial crisis was a loss in confidence in the banking system. Just as this causes individuals to withdraw their cash (a ‘run on the bank’), a loss of confidence in a country’s ability to repay its ‘debts’ causes a run on the currency. Capital flight, as it is called, can send a currency into free fall and send countries cap in hand to the International Monetary Fund (IMF).

In early October 2008, the exchange rates of a number of countries collapsed as capital flight took hold. These countries approached the IMF for assistance. According to the BBC’s Business Editor, Robert Peston:

”Queuing up for the intensive care ward are Iceland, Hungary, Pakistan, Ukraine and Belarus, all of which are in discussions about accessing special loans from the International Monetary Fund, the emergency medical service for the global economy. But there has also been a substantial withdrawal of capital from South Africa, Argentina and - most worrying of all - South Korea.”

These countries have, in the past, attracted large amounts of foreign capital as their economies have undergone economic development. This means that they have large external debts. The level of this debt ranged from around US$40 billion for Pakistan to US$100 billion in Hungary, to almost US$200 billion in the case of South Korea. Some countries, though not all, had experienced large and growing current account deficits on their balance of payments. They had financed these deficits by attracting flows of money from abroad. This was all very well as long as those providing the financial capital carried on doing so or did not want it back in a hurry. Not so good when this source of long-term financial capital dries up or the investors want their money back. And that is what happened in 2008 – financial capital was withdrawn from these economies, causing their currencies to depreciate dramatically. For example, Hungary’s currency (the forint) fell against the euro by 15% in October 2008, forcing Hungary’s central bank to raise interest rates by three percentage points in an attempt to halt the depreciation of the forint. Only when the country received loans from the IMF, the World Bank and the EU totalling US$25 billion did the forint recover. These loans were conditional upon Hungary taking steps to reduce its large and significant current account deficit.

South Korea’s situation, however, was different. As one of the world’s major exporters, its current account balance was healthy. Much more so than that of the UK, where there had been a persistent and growing current account deficit for a number of years. It was not surprising, then, that the UK also experienced a fall in its exchange rate during 2008. From August to October, sterling fell 22% against the US$; it depreciated by 14% in October alone. As the UK operates a freely floating exchange rate, the value of sterling is likely to fall as exports are reduced by global economic downturns. But sterling’s exchange rate is also affected by short term financial capital flows. The anticipation of lower interest rates, as part of a monetary expansion, was likely to have been a major factor in sterling’s depreciation in 2008.

The depreciation of sterling was viewed by some economists as a good thing for the UK economy. For others it raised a dilemma for economic policy. These economists argued that a fall in the value of sterling made it more difficult for the Bank of England to reduce interest rates, because of the possible inflationary consequences of higher import prices. Some commentators argued that it was time to abandon inflation targets – at least temporarily – since, perversely, they were undermining the return to economic stability. Others pointed out that the dilemma for economic policy made the case for the UK’s membership of the euro area stronger than it had ever been before.

Extract 4

Globalisation raises fears for developing countries

The financial crisis of 2008 had its roots very firmly in the developed world. However, the nature of globalisation meant that there were concerns that the developing world would suffer consequences too. For example, Shanta Devarajan, Chief Economist of the World Bank's Africa Region, identified three ways in which Africa might suffer:

- a decline in private financial capital flows, which Africa has become dependent on for its infrastructure investment;
- a decline in commodity prices, as the global economic slowdown reduces the demand for commodities such as oil and copper;
- a reduction in flows of aid, as developed economies reallocate public expenditure during the economic slowdown.

In addition, fears were expressed that developed countries could demand debt repayments from African countries. This would inevitably lead to cutbacks in expenditure on health and education in African countries, with severe consequences for economic development.

However, Louis Kasekende, Chief Economist at the African Development Bank (AfDB), considered that African economies would continue to record annual economic growth averaging 6% until 2010. He felt that the impact on Africa of the global financial and economic crisis would be limited in the short term because of its weak integration into the global economy. The signing of an African Free Trade Area agreement would also limit the initial impact of the global economic slowdown.

In contrast, goods and services produced in Asia tend to be traded much more internationally. Asian nations would be worried that a slowdown in the growth of demand in Western developed nations would reduce the demand for their exports and risk the loss of jobs in Asia. China's economic growth, for example, fell throughout 2008, and it was reported that half of China's toy manufacturers had gone out of business. There were calls from China for the USA to reduce its trade barriers in order to open up its market to products from China and other developing countries.

Some economists took the opportunity to express their doubts about the benefits of globalisation for developing countries. Jayati Ghosh, Professor of Economics at Jawaharlal Nehru University, in Delhi, India, said that:

"India is seen as a big success story of globalisation, but only a minority of Indians have benefited materially from the high economic growth. Formal sector employment stagnated; real wages for most workers actually fell; nearly 200,000 farmers committed suicide in the period of 1995-2006 alone; and there was an increase in the number of malnourished children.
So the recent economic growth was not inclusive. But, unfortunately, the coming slump will be only too inclusive, forcing those who did not gain earlier to pay for the sins of irresponsible and unregulated finance, through their own loss of livelihood and reduced living standards."

Others, such as Jagdish Bhagwati (Professor at Columbia University, USA), warned that the benefits globalisation had brought, in terms of greater openness of economies and the gains from international trade, should not be sacrificed by a return to protectionism.

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