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A2 GCE ECONOMICS

F585/01/SM The Global Economy

STIMULUS MATERIAL

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INSTRUCTIONS TO CANDIDATES

- This copy must **not** be taken into the examination room.
- You should make yourself familiar with the stimulus material before you take the question paper. A clean copy of the stimulus material will be given to you with the question paper.

INFORMATION FOR CANDIDATES

- The following stimulus material has been adapted from published sources. It was correct at the time of publication and all statistics have been taken directly from the published material.
- This document consists of **12** pages. Any blank pages are indicated.

Introduction

In 2011, there was much speculation about the death of the European Union's (EU) single currency, the euro. Some members of the eurozone, such as Greece and Ireland, had built up such high levels of public debt that there was increasing concern that they might have to default. The prospect of years of austerity needed to restore wage and price competitiveness had led to protests in Greece and political instability in Ireland. There was increasing reluctance in France and Germany to continue to bail out countries in debt and the future of the euro looked uncertain.

The history of the birth and growth of the euro dates back to 1999 when the eurozone came into existence. At that time, it was felt that setting criteria for the entry of member states into the eurozone would help create the conditions for the operation of a single currency in Europe. These criteria were designed to create fiscal and monetary convergence of the economies joining the eurozone and included a number of conditions necessary for entry. By 2011, there were 17 members of the eurozone, including five countries which had joined the EU in 2004.

Whilst some countries in the eurozone had clearly not enjoyed the expected benefits of membership, staying out of the EU's single currency was not a guarantee of economic success. The global financial and economic crises of 2007–08 had resulted in severe financial and balance of payments crises in, for example, Latvia.

Despite the uncertainty about the future of the euro, Estonia took the decision to join the eurozone on 1 January 2011. Estonia is widely regarded as one of the most successful economies of Central and Eastern Europe (CEE). It had consistently recorded high rates of economic growth and development until the crises of 2007–08. Whilst openness to international trade and high levels of Foreign Direct Investment (FDI) were important reasons for Estonia's economic success, they were not the only factors responsible for its impressive growth and development.

Despite the country's success in the past and renewed economic growth in 2010, the Estonian government was keen to ensure that future economic growth was consistent with greater sustainable development. The Estonian government had identified a number of areas in which high rates of economic growth had not delivered sustainable development in the past. On many sustainability indicators, Estonia was lagging behind the rest of the EU, including many of the economies which had joined the EU in 2004 and in 2007.

Pre-release stimulus material

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Extract 1

The birth and growth of the eurozone

On 1 January 1999, the eurozone came into existence. It comprised 11 EU countries which permanently fixed their exchange rates by adopting the euro as their currency. Three years later, on 1 January 2002, euro coins and banknotes were officially introduced as legal tender, and after a further six months national currencies were withdrawn.

The UK, Sweden and Denmark have all decided to stay out of the eurozone for the time being. Greece did not join at first because it failed to meet the Maastricht Convergence Criteria. However, on 1 January 2001, Greece became the 12th country to adopt the common currency after it was judged to have fulfilled all the requirements for eurozone entry.

On 1 May 2004, ten new countries joined the EU: Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Estonia, Latvia, Lithuania, Cyprus and Malta. Three years later, on 1 January 2007, a further enlargement of the EU added two new members: Bulgaria and Romania. All of these new members of the EU have agreed to join the eurozone when the time is right for them to do so and when they have met the conditions of entry.

Of the 12 new member states of the EU, five fulfilled the Maastricht Convergence Criteria and became part of the eurozone by 2011.

Extract 2

New EU member states and the euro

When a new country joins the EU, it is expected to treat its exchange rate as a matter of common interest to all members of the EU. This means that it should not pursue competitive devaluations for fear of undermining the EU's single market. However, initially a country is free to decide whether its exchange rate is freely floating or fixed. Once a country has joined the Economic and Monetary Union (EMU), it must join the EU's fixed exchange rate mechanism known as ERM II. It is argued that this prepares them for eventual membership of the eurozone.

Any EU country joining the eurozone must have first met a number of strict conditions. These conditions ensure that the country will have reached a high degree of fiscal and monetary convergence before it finally adopts the euro.

Of the 12 countries which joined the EU between 2004 and 2007, five were members of the eurozone by 2011. Slovenia joined the eurozone on 1 January 2007. It was followed on 1 January 2008 by Cyprus and Malta, on 1 January 2009 by Slovakia and on 1 January 2011 by Estonia.

Of the remaining seven members, only Latvia and Lithuania had joined ERM II by 2011 with a view to adopting the euro. Since joining ERM II, Latvia's economic situation has worsened. As a result of the global financial and economic crises of 2007–08, Latvia needed loans totalling €7.5 billion from the International Monetary Fund (IMF), the World Bank and the EU in order to support its fixed exchange rate against the euro. In a statement issued at the time of the loan in 2008, the IMF said:

"*The current global financial crisis has brought Latvia's vulnerabilities to a head. Years of unsustainably high growth and large current account deficits have combined to create financial and balance of payments crises.*"

The financial and economic crises of 2007–08 substantially worsened the economic situation of many of the new EU members. Their currencies came under speculative attack and became dangerously volatile. Their budget deficits soared. Countries which had borrowed significant sums from Western Europe and were heavily dependent on FDI suffered most. As financial capital fled these economies, their currencies fell in value and the cost of repaying debt escalated dramatically.

Some economists were critical of the way in which CEE economies had sought to achieve economic development since joining the EU. The European Bank for Reconstruction and Development (EBRD), for example, issued a report in 2009 which criticised the CEE economies' reliance on financial integration to promote development. The report stated that "financial integration – in the form of large debt flows and FDI – has been an integral part of the 'development model' of transition countries". The EBRD urged CEE economies to be less dependent on international financial flows and FDI.

Extract 3

Estonia's economic growth and development

Since embarking on the transition to a market economy in 1991, Estonia's economic growth and development have been determined by a range of factors. Its transition to the market economy has been helped by membership of the EU. Its openness to international trade and FDI has also helped it to achieve high rates of economic growth. Estonia's international trade as a percentage of Gross Domestic Product (GDP) was 155% in 2009. In addition, it has one of the most favourable environments for FDI with a 0% tax rate on reinvested profits. However, other factors have also played a role in promoting economic development and growth in Estonia. These include the age structure of its population, the skills and education of its labour force, its geographical position, and its infrastructure. The Estonian currency, the kroon, has been stable thanks to prudent macroeconomic policy which has brought about price stability. Economic reforms have also created a well functioning market economy. As a result of the high rates of economic growth brought about by these economic conditions, the Estonian economy has been dubbed the 'Baltic Tiger'.

Figs 3.1 and 3.2 below show two measures of Estonia's economic performance from 2000 to 2010.

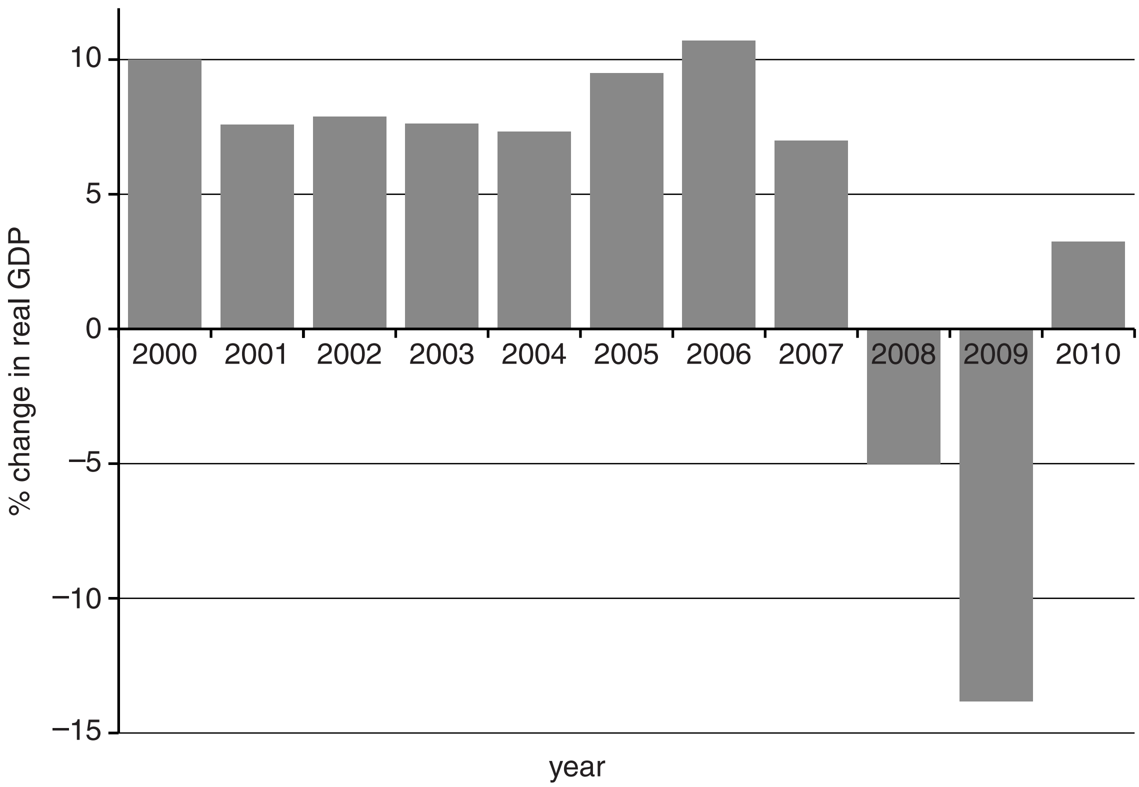

Fig. 3.1 – Estonia's annual economic growth rate (% change in real GDP), 2000–10

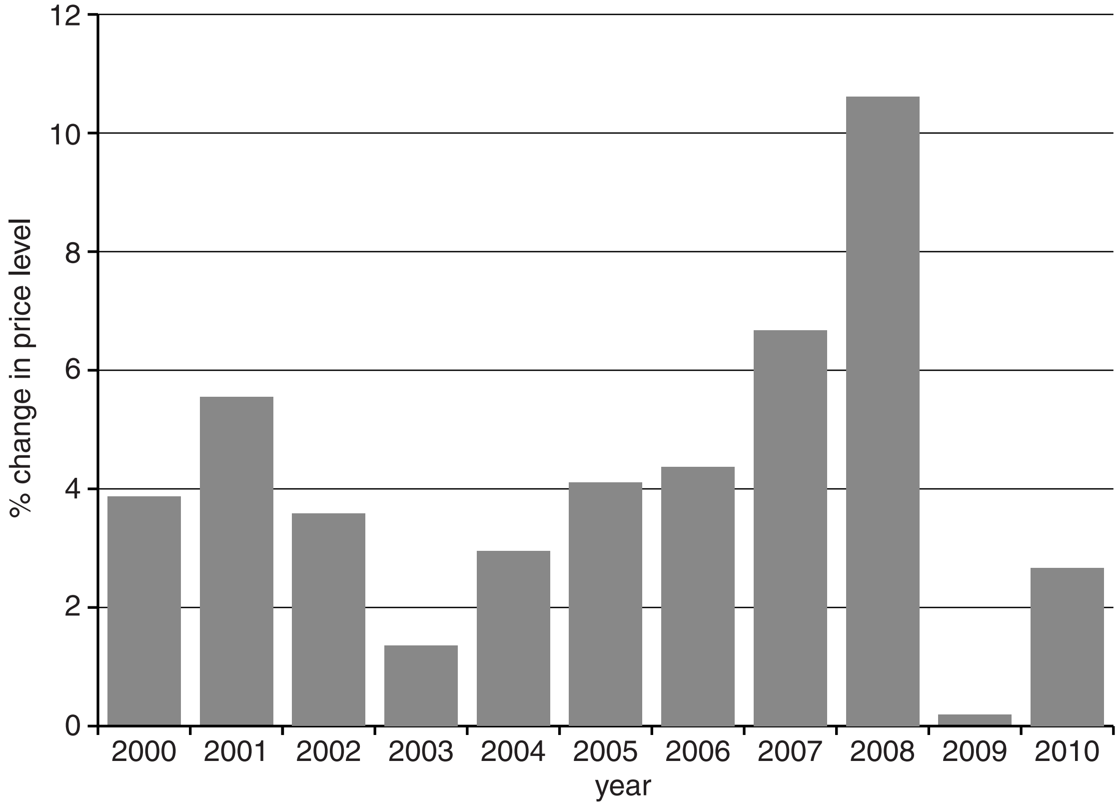

Fig. 3.2 – Estonia's annual inflation rate (% change in price level*), 2000–10

* *as measured by changes in the Harmonised Index of Consumer Prices (HICP).*

Despite all of these favourable conditions for growth, Estonia was not immune from the global economic recession of 2008 as its GDP fell by 5.1% in that year. The economic situation further worsened in 2009 as GDP fell by a massive 14% before a recovery in 2010 led by strong growth in its exports. Some forecasts of economic growth for 2011 were as high as 4.5%, suggesting a strong recovery from recession.

According to data published by Eurostat, living standards in Estonia remain below the average for the EU. Estonian GDP per capita at Purchasing Power Parity (PPP) was 67% of the EU average in 2008. Estonia's Prime Minister wants to raise living standards so that GDP per capita at PPP is in the top five in the EU by 2022. However, GDP per capita hides big differences between different areas of Estonia. It is estimated that over 50% of Estonia's GDP is generated in the capital, Tallinn. The GDP per capita in Tallinn was 172% of the Estonian average and 115% of the EU average.

Many indicators point to a healthy future for the Estonian economy. According to Eurostat, Estonia has the lowest ratio of government debt to GDP among EU countries. Estonia's balanced budget, almost non-existent public sector debt, flat-rate income tax, free trade regime, and its competitive commercial banking sector all bode well for its future economic growth and development. In addition, the government's willingness to significantly increase its spending to support innovation and research and development by businesses in Estonia could help to ensure that high rates of economic growth do not run up against capacity constraints.

Extract 4

The approach to sustainable development in the EU and Estonia

The EU's approach to sustainable development is set out in its Sustainable Development Strategy, adopted by the European Commission in 2001, and amended in 2006 and 2009. The strategy sets overall objectives and concrete actions for seven key priorities:

- climate change and clean energy
- sustainable transport
- sustainable consumption and production
- conservation and management of natural resources
- public health
- social inclusion, demography and migration
- global poverty and sustainable development challenges.

The member states of the EU each have different national strategies which take into account their different characteristics and needs. Estonia is the only EU member state to set out cultural objectives for sustainability. Nevertheless, there are some common features of the sustainability strategies of EU member states, including an agreed approach to environmental and climate issues. For example, the common energy policy of the EU sets the target of decreasing greenhouse gas emissions by 20% and increasing the share of renewable energy by 20% by 2020.

According to Estonia's sustainable development strategy, entitled 'Sustainable Estonia 21', the desired outcome for Estonia by 2030 is a socially coherent, culturally viable and ecologically balanced society with a high level of welfare. Estonia ranks its sustainability against other members of the EU using 78 indicators grouped into four main areas. It believes that this is useful for making policy decisions and choices.

The Estonian government believes that these indicators help to inform decision-making at national, business and individual levels. The government hopes that, instead of ranking among the last five EU member states in terms of most indicators, economic growth and development will become more sustainable. It aims to be amongst the EU leaders in terms of sustainable development in the near future.

The four areas of Estonia's sustainable development strategy are to achieve:

- a coherent society
- growth in welfare
- an ecological balance
- a viable cultural space.

Extract 5

Estonia's progress towards sustainable development

The Estonian government has made an assessment of the progress of the country in relation to the four areas of its sustainable development strategy (see Fig. 5.1).

1. Achieving a coherent society

Achieving a coherent society is one of the basic principles of sustainability. Estonia ranks 25th out of the 27 EU member states in terms of indicators such as relative poverty and income inequality. However, Estonia is in a better position than other member states on average in terms of long-term unemployment, early school-leavers and good broadband Internet connection.

2. Achieving growth in welfare

There is more to achieving growth in welfare than raising levels of GDP, though economic indicators such as GDP per capita are important. In addition to such economic indicators, health and education indicators need to be measured. In 2008, the value of education indicators was, on average, equal to or better than the average in the EU. However, in terms of productivity and health indicators, Estonia is among the last ten EU states. In terms of healthy life years at birth for males (50 years), Estonia is the last in Europe.

3. Achieving ecological balance

Moving towards ecological balance is also one of the basic principles of sustainability. In terms of all indicators of ecological balance, Estonia ranks 23rd among the EU states. The reason is the inefficient use of fossil fuels in electricity production which causes pollution. Estonia is in last place in the EU according to the share of electricity produced from renewable sources (1.5%). In terms of the generation of waste per capita, Estonia is among the last three EU states.

4. Achieving a viable cultural space

Setting the goal of achieving a viable cultural space and measuring progress towards achieving it is unique to Estonia. Traditional values in upbringing, ethics and morals are directly related to culture. In terms of cultural indicators, Estonia ranks eighth among the EU states which is the best result of all four areas of Estonia's development strategy.

Fig. 5.1 – An assessment by the Estonian government of its progress towards sustainable development in each of the four areas of its strategy

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