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ADVANCED GCE

ECONOMICS

The Global Economy

F585/SM

STIMULUS MATERIAL

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Turn over

Introduction

A slowdown in economic growth in the UK in 2007 and 2008 brought to an end the longest period of economic stability in the UK and raised fears of recession. Some economists may say that a claim to have abolished 'boom and bust' made by Gordon Brown the UK Chancellor of the Exchequer, and now Prime Minister, should always have been interpreted as running counter to economic reality. The economic cycle has long been understood by economists as a reality which is difficult for economic policy makers to regulate, let alone eliminate.

The economic cycle has a number of consequences for the key macro performance indicators of inflation, employment and unemployment and the balance of payments. Economic policy makers need to ensure that economic growth can be managed to maximise its benefits relative to its costs. This is not an easy task, as shown by the consequences economic growth has had in, for example Vietnam. Much depends on the nature of economic growth and the other factors which affect macro economic performance.

Economic growth is determined by a number of different factors, both in the short and the long run. The importance of international trade is one of these factors. For many developing economies, such as India, international trade has acted as the 'engine' of growth. Such countries have been advised to open up their economies, using their comparative advantage to maximise the gains from trade. However, trends in the terms of trade have not always allowed all developing economies to realise the benefits of international trade based on existing factor endowments. In addition, many economists are sceptical that success in generating high rates of economic growth always delivers economic and human development.

A number of developing economies, such as Vietnam and India, have been fortunate in attracting high levels of foreign direct investment (FDI). Their high rates of economic growth are often attributed to their success in attracting FDI. The benefits of such investment, however can be over-estimated. It is argued that the costs of FDI need to be considered in order to assess the net impact of such investment on individual economies.

Pre-release stimulus material

Extract 1: UK economic growth

Extract 2: The US economy

Extract 3: Inflation tests Vietnam's growth

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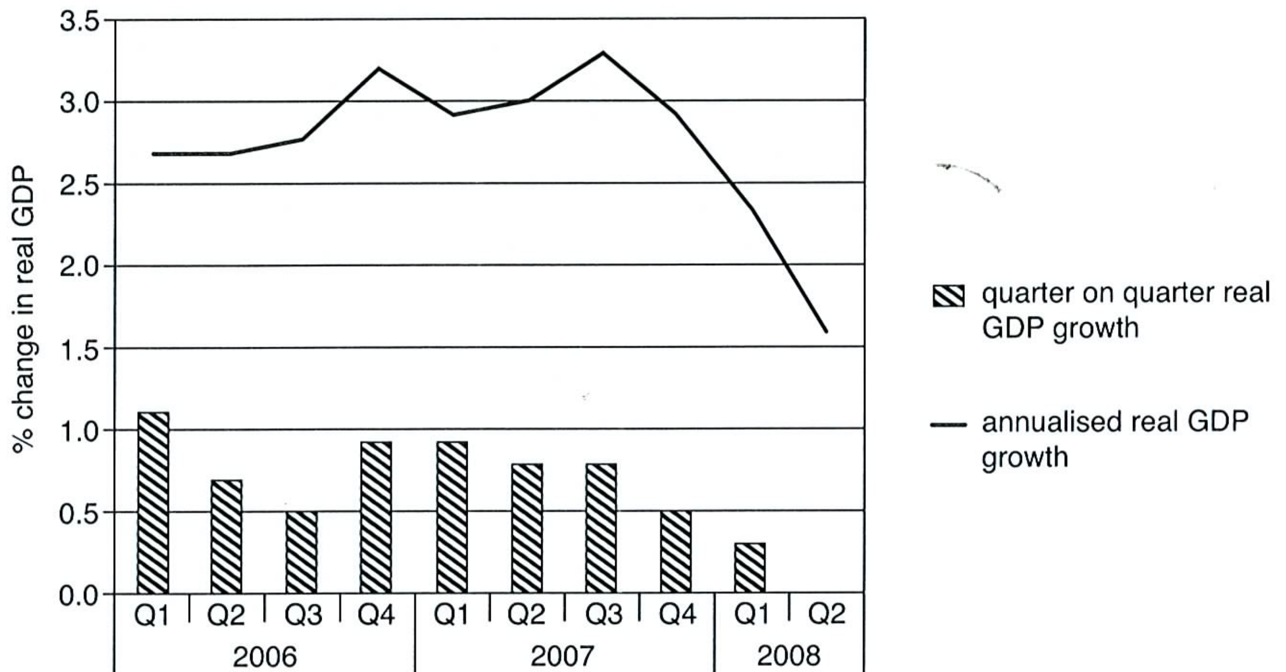
Extract 1: UK economic growth

Presenting his last Budget as UK Chancellor of the Exchequer in 2007, Gordon Brown boasted of ten years of economic success under New Labour. He said that since 1997 the UK had enjoyed the "longest period of economic stability and sustained growth in our country's history". This contrasted with the instability created by the economic cycles of the past. He forecast continued economic growth for the next year and beyond.

A year later, data published by HM Treasury showed that UK economic growth had ground to a halt in the second quarter of 2008 – real GDP growth was 0% in that quarter. The slowdown in economic growth had, in fact, begun after Gordon Brown's last Budget in 2007, as Fig. 1.1 below shows.

Fig. 1.1 UK real GDP growth (quarter on quarter and annualised)



NB quarter on quarter real GDP growth in the second quarter of 2008 was 0%

The halt in economic growth in the second quarter of 2008 raised fears of a recession in the UK. These fears had been expressed throughout 2007 as economic growth slowed down. In February 2008, for example, The Times reported that consumer spending in the fourth quarter of 2007 rose by only 0.2% and that business investment had actually fallen by 0.5% in the same period. Although GDP was rising, fears centred around the fact that much of this growth was generated by the largest build-up of stocks for 20 years.

Operating outside the euro area, UK monetary policy is conducted by the Bank of England. Despite the fall in economic growth, in the first seven months of 2008 there were only two cuts, each of 0.25 percentage points, in the UK interest rate. The Bank of England felt unable to reduce rates further because of the rise in inflation to over twice its target rate of 2%. This contrasted starkly with the aggressive interest rate cuts by the US central bank over the same period.

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Extract 2: The US economy

Economic slowdown and fears of recession during 2007 and 2008 were not confined to the UK.

At the beginning of 2007, the US interest rate was 5.25%. By March 2008, it had been reduced to 2.25%. The US central bank, the Federal Reserve, cut the interest rate twice in the space of nine days in January 2008 – first by 0.75 percentage points and then by a further 0.5 percentage points. The reason? Worries that the US economy was heading for recession.

US economic growth slowed dramatically in the last quarter of 2007 to an annual rate of 0.6%, compared to an annual rate of 4.9% in the previous quarter. Domestic demand in the US economy was weak. In its regular survey of the economy, the 'Beige Book', the Federal Reserve found that American manufacturing firms were struggling with low growth in consumer spending. As a result, firms were laying off workers and cutting back on investment spending. Falling house prices since 2006 had a big effect on the house-building sector, with job losses in construction totalling 346 000. The knock-on effect of these job losses was beginning to be felt in other sectors of the economy such as retailing and manufacturing, both of which lost jobs in early 2008.

A US recession in early 2008 was being staved off by buoyant demand for US exports. This was due to the weak exchange rate of the dollar and high demand for US goods in Asia.

The key question facing policy makers in the US in early 2008 was whether the aggressive cuts in interest rates would be enough to bring the US economy back from the brink of recession.

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Extract 3: Inflation tests Vietnam's growth

In recent years, Vietnam has transformed its centrally planned economy through a series of market-friendly reforms and by embracing globalisation. The impact of this transition has been largely positive and coincided with a period of macro economic stability.

Vietnam's macro economic stability and greater openness has attracted large amounts of foreign direct investment (FDI) by multinational companies, most notably from Korea and Singapore. Annual FDI in Vietnam has increased from US$1.5 billion in 2002 to over US$13 billion in 2007, contributing to rapid industrialisation and export-led growth.

However, Vietnam now faces the challenge of rising inflation as a result of its rapid economic growth. In February 2008, consumer price inflation in Vietnam hit 15.7%. This was the highest rate in East Asia. Inflationary pressures are not unique to Vietnam. Global market forces have raised food and petroleum prices throughout East Asia. But Vietnam's inflation is over double that of its closest competitors, China and Indonesia. Part of the reason for this is the 16.4% rise in housing and construction costs caused by the country's construction boom. The monetary authorities in Vietnam fear that such high inflation will threaten the macroeconomic stability which has contributed to the country's rapid economic growth and development in recent years. Over the last five years, GDP growth has averaged over 8% per annum.

Vietnam's rising inflation has contributed to the growing number of strikes now being experienced in the country. Despite earning wages higher than the national minimum wage, workers have demanded more pay to keep pace with rising prices. There were 50 strikes, in the first two weeks of 2008 alone. In one of these strikes 10 000 workers walked out of the South Korean owned factory which makes shoes for the US multinational Nike.

Vietnam's rapid economic growth has also created balance of payments problems. At the end of 2006, its trade deficit was US$4.8 billion, rising to US$12.4 billion at the end of 2007 and was predicted to approach US$25 billion by the end of 2008.

With macroeconomic stability so clearly at risk, Vietnam may well lose its place in the top ten destinations for FDI.

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Extract 4: Growth, trade and development in India

India, along with China, tops the world's economic growth league and has become the world's leading exporter of IT services. India's IT services firms are market leaders in developing and selling computer software and digital technology. Their products are used by companies such as Virgin, BT and HSBC, providing them with software to manage airline booking systems, telecommunications networks and daily bank transactions respectively. Fig. 4.1 shows the massive growth in the revenue of three of India's leading IT services firms. Employment in India's leading IT services firms has grown too; increasing six fold between 1996 and 2006, as shown in Fig. 4.2.

Fig. 4.1: Revenues of three Indian IT services firms

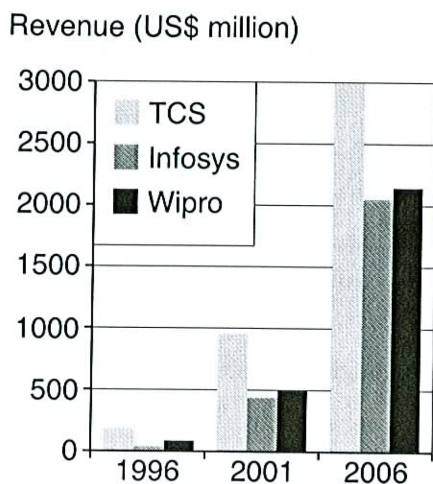
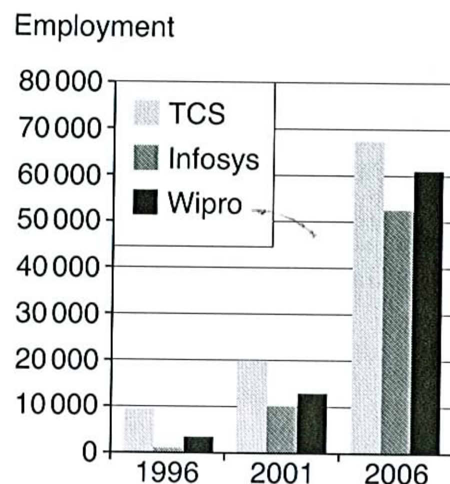


Fig. 4.2: Employment in three Indian IT services firms



India was once thought of as an economy with abundant supplies of natural resources and unskilled labour. Today, whilst about 60% of its labour force is still engaged in agriculture, India's graduate labour force has more than doubled from the mid-1990s and is estimated to be almost 50 million. India turns out around 500 000 engineering graduates each year, of whom almost one third are computer engineers. In comparison, there are around 70 000 students in the USA graduating in engineering each year. India is beginning to rival the USA in the total size of its graduate labour force.

There has been significant economic reform in India since the 1990s. This has involved reduced government regulation of the economy and a greater openness to international trade. The changing structure of India's exports, away from agricultural commodities and minerals, has allowed India to escape the 'development trap' of declining terms of trade. However, this has meant that there has been less benefit for the Indian economy of the rapid rise in international commodity prices from 2006–08. In this period, international commodity prices more than doubled.

In 2006/07, many commentators argued that India's economic success exemplified the benefits of increased globalisation. India's growing middle class displayed their new-found wealth in conspicuous consumption in gleaming shopping malls. Every month there were 5 million more mobile phone users. Entrepreneurship was booming, as was the stock market, and foreign direct investment (FDI) was growing rapidly (by more than 150% in 2006) as foreign multinationals recognised India's potential both in terms of its rapidly growing domestic market and its low labour costs.

Some commentators, however, challenged this view. Kevin Watkins, director of the UN's Human Development Report Office, said that "when it comes to human development, India is trundling along in the slow lane." He draws comparisons with countries that have slower economic growth rates and lower levels of GDP per capita (see Fig. 4.3). For example, he points out that these

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countries have succeeded in reducing infant mortality rates much faster than India. He also draws a distinction between economic growth and development. He cites economic and social inequalities as the main reasons why economic growth, globalisation and FDI have not raised India's level of development. He concludes that "high economic growth has been grafted on to mass poverty".

Fig. 4.3: GDP per capita (PPP US$), life expectancy and Human Development Index (HDI), for selected countries

	GDP per capita (PPP US$)	Life expectancy at birth (years)	Human Development Index (HDI)
India	3452	63.7	0.619
Vietnam	3071	73.7	0.733
Bangladesh	2053	63.1	0.547
Nepal	1550	62.6	0.534

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