

8 Economic performance — answers

Test yourself

Test yourself 8.1

In terms of total unemployment, the countries or regions are ranked in terms of the highest unemployment: Euro Area approximately 15%; USA approximately 5% and Japan approximately 3%. In terms of type of unemployment, there was no cyclical unemployment in the USA and Japan, which probably means that the year in question pre-dated the 2008 recession and the subsequent recovery. Within the Euro Area, about two-thirds of the unemployment was structural (approximately 10% of all workers) and one-third of the total unemployed was cyclical unemployment (approximately 5% of all workers).

Test yourself 8.2

A first significant point of comparison is that the indices of industrial production and employment both fell in the recessionary years of 2008 and 2009, respectively from an index number of 102.7 in Q4 2008 to 97.3 million in Q4 2009, and from 28.17 million employed in Q4 2008 to 27.68 million in Q4 2009.

A second significant point of comparison is that the index of industrial production was somewhat volatile after Q4 2009, for example increasing to 100.0 in Q4 2010 and then falling to 98.0 in Q4 2011, whereas employment grew in each year after Q4 2009, for example to 27.79 million in Q4 2010 and then to 27.82 million in Q4 2011.

Test yourself 8.3

Assuming that the data refer to % *increases* in domestic prices (the data are not clear about this), inflation was positive in each 10-year period. This means that statements **A** and **B** are wrong. This leaves statement **C** as the only statement that can be deduced from the data: compared to the 10 years between 1995 and 2005 when the price level rose by 40.5%, in the next 10 years it only rose by 20.4%.

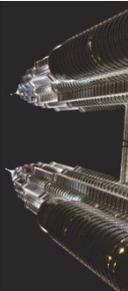
Test yourself 8.4

The reason stems from the fact that the balance of trade is only one component, albeit usually the main component in the overall current balance of the balance of payments. Assuming that 'trade' includes trade in services as well as trade in goods, the trade deficit is smaller than the current account deficit because either or both primary income (mostly investment income) and/or secondary income (current transfers) were also in deficit.

Case studies

Case study 8.1

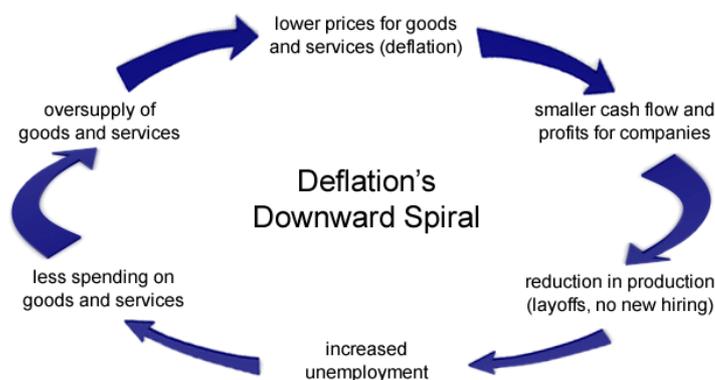
- 1 We cannot as yet provide an answer to this question as we are writing our advice just after Book 1 was published. However, according to BBC News, the UK's economy grew by 2.6% in 2014, the fastest pace since 2007 and up from 1.7% in 2013. In data released on 28 April 2015, the ONS stated that the level of real GDP was 2.4% higher in Q1 (Jan. to Mar.) 2015 compared with the same quarter in 2014.
- 2 In the USA, the NBER, a non-governmental organisation, defines a recession as 'a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales'. In many countries there is no official definition of recession, but



there is general recognition that the term refers to a period of decline in economic activity. Very short periods of decline are not considered recessions. European Union member states use the same definition of a recession as is used in the UK, namely two successive quarters of falling real GDP. However, this definition is often criticised as focusing only on GDP and not on other economic indicators, and for being too much a ‘rule of thumb’.

Case study 8.2

- 1 Lenders benefit from deflation because falling prices increase the real return on their savings. People whose incomes are growing, or who are protected from falling incomes, also benefit because, when spent in the future, their incomes will buy more goods. Delaying spending now, but spending in the future, benefits those who can do this.
- 2 In a period of deflation, the real value of borrowers’ debt rises; this reduces their net wealth and often leads to lower spending. Reduced spending then leads to even more deflation and the process repeats itself. The website *Investing Answers* illustrates a deflationary spiral in the following way:

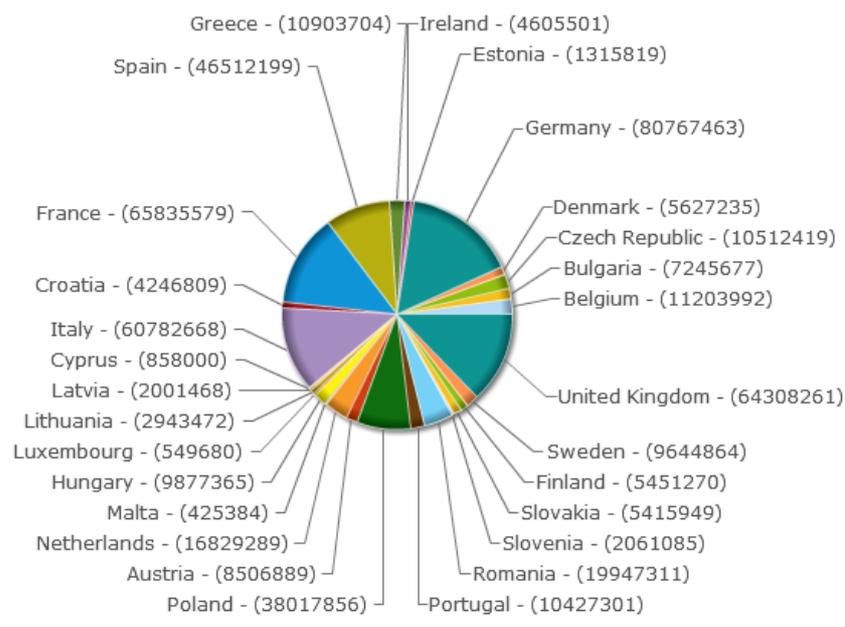
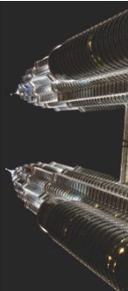


Source: www.investinganswers.com/financial-dictionary/economics/deflation-1160

Case study 8.3

- 1 Price competitiveness refers to consumers wishing to buy goods because the goods’ prices are lower than those charged for similar goods. Quality competitiveness refers to consumers wishing to buy goods because the quality of the goods is better than the quality of similar goods. As the case study explains, cars manufactured in the UK have become more quality competitive in recent years in the world market. There is less evidence that UK cars have become more price competitive, but they are certainly seen by overseas buyers as offering good value for money.
- 2 In 2014, membership of the European Union (EU) provided UK car makers with a market 506 million inhabitants — the world’s third largest population after China and India. The breakdown of EU population in 2014 is shown in the chart below.

Many EU households enjoy high incomes, which means they can afford to buy new cars regularly. Given the lack of tariffs or import duties within the EU’s internal market, the UK’s EU membership has attracted overseas car companies such as Toyota to locate branch factories in the UK.



Source: Eurostat

Case study 8.4

- 1 A first reason was the global collapse in world markets for financial services. A second reason stemmed from the pressure from the UK government on financial services firms to shut down risky operations. This led to a temporary scaling down of investment banking in the UK.
- 2 The UK economy has become ‘unbalanced’ in a number of ways. In the first place, there has been regional unbalance with the economies of London and the Southeast faring much better than regional economies elsewhere in the UK. In the second place, the UK has become too reliant on ‘consumption-led growth’ as the main engine for achieving recovery from recession. Arguably, the economy should be ‘rebalanced’ to promote ‘investment-led growth’ and/or ‘export-led growth’. In the third place, services in general and financial services in particular have grown excessively at the expense of manufacturing.

The UK economy could be ‘rebalanced’ by promoting the growth of manufacturing in a ‘reindustrialisation’ of the UK. This could also help to deal with regional imbalance, since much manufacturing takes place outside of London and the Southeast. George Osborne’s advocacy of the ‘march of the makers’ is an attempt to deal with these twin imbalances. Tighter regulation of the financial services industry is part of an attempt to rebalance growth in financial services against growth in other economic activities, especially manufacturing.

Case study 8.5

- 1 *Reason 1:* In 2014, the UK’s deficit on the current account of the balance of payments grew to its largest ever size. There is little or no evidence of export-led growth taking place.
Reason 2: Export-led growth depends to a large extent on the growth of the world economy. If major markets for UK exports go into recession, or if growth slows down in these markets, export-led growth will be very difficult to achieve.
Reason 3: There is no evidence of UK residents being prepared to sacrifice consumption in order to free resources for their use in exporting industries. And, if anything, the appetite of UK residents for imported goods is continuing to increase.
- 2 Figure 1 below shows the contribution of manufacturing to GDP in the UK between 1995 and 2014:

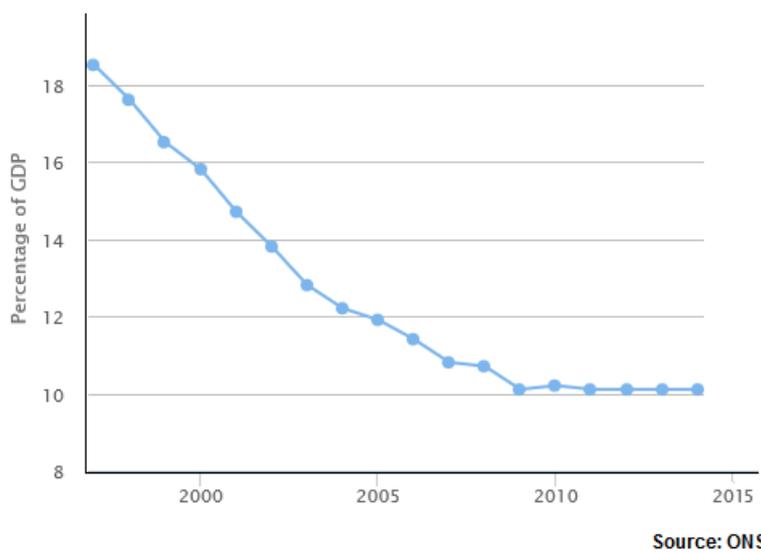
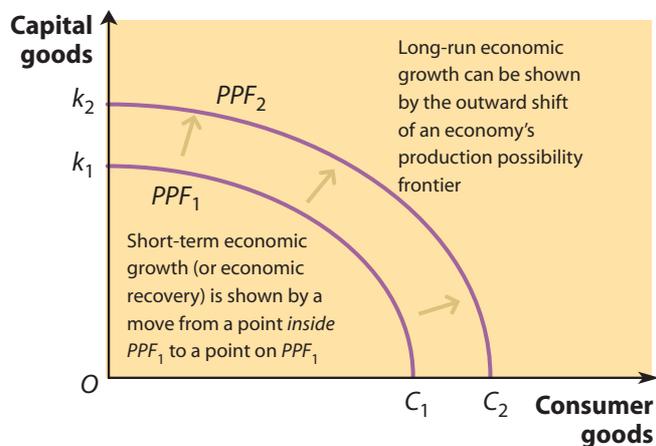


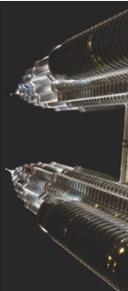
Figure 1 The decline of manufacturing in the UK between 1995 and 2014

The graph shows manufacturing declining from over 18% of GDP in 1995 to around 10% in 2009, where it remained in the years up to 2014. This seems to indicate that a ‘march of the makers’ was not taking place in 2014. However, in an article published in the *Daily Telegraph* on 23 February 2015, in answering the question ‘Is the “march of the makers” rebalancing the economy?’, the newspaper’s industrial editor argued that ‘manufacturing represents just a tenth of Britain’s economic output but this sector punches above its weight and is enjoying a new found importance’. And an article published in the *Financial Times* in March 2015 quoted George Osborne’s first mention of the ‘march of the makers’ in 2011: ‘We want the words “made in Britain, created in Britain, designed in Britain and invented in Britain” to drive our nation forward — a Britain carried aloft by the march of the makers.’ The article went on to argue that ‘there has been more talk than action ... yet delve a little deeper and there are glimmers of hope. Despite all the talk of manufacturing disappearing from the UK landscape, Britain is making roughly the same absolute volume of goods it made in 1978, says the ONS. Indeed, volumes have even risen slightly in the past five years. Numbers employed in the sector may have fallen from 5.5m in 1982 to 2.6m last year, but productivity growth in manufacturing has far outstripped that of the economy as a whole during the past five years.’

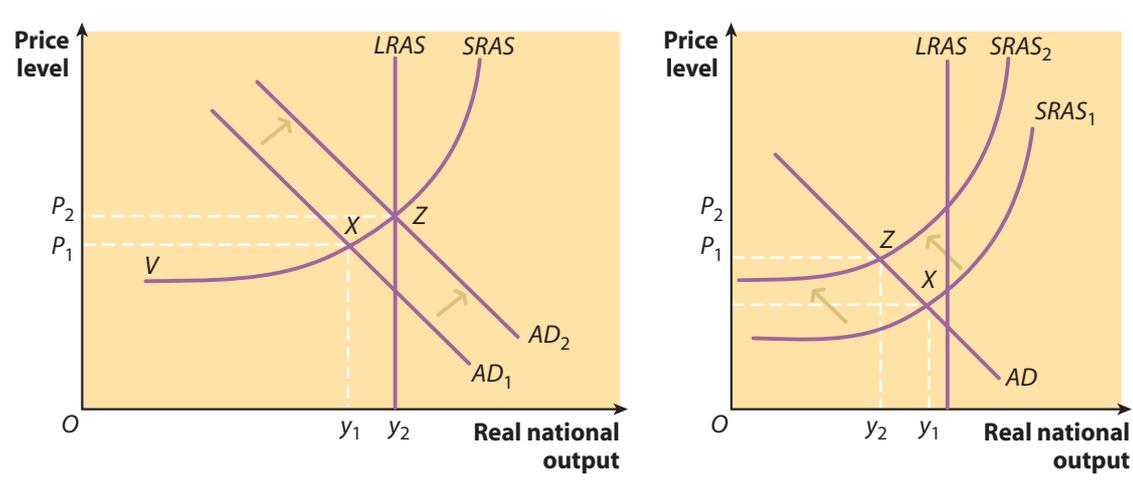
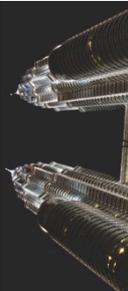
Questions

- Short-run economic growth occurs when the output increases from a point inside the economy’s production possibility frontier towards a point on the frontier. By contrast, long-run economic growth occurs when the production possibility frontier moves outward. The difference between the two forms of economic growth is illustrated in Figure 6.1 in Book 1, which we have reproduced here.





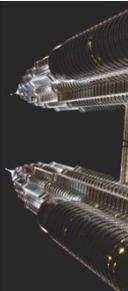
- 2 For fairly obvious reasons, recessions are usually regarded as bad. Output is lost. Basically sound firms go under, labour is unnecessarily unemployed and the human spirit suffers. Crime sometimes rises. Yet there are some good points to a recession. It may inspire innovation as entrepreneurs in businesses that have ailed, and budding entrepreneurs looking for a business opportunity, may become more innovative. Although some well-run businesses go to the wall, economists argue that the main businesses that crash are badly run and use resources inefficiently. A recession weeds these out and frees their resources for more efficient use. In the words of Joseph Schumpeter, the forces of ‘creative destruction’ lead to the bad giving way to the good. A central feature of capitalism is ‘the perennial gale of creative destruction’ through which good comes from the turmoil of recession. According to W. Michael Cox and Richard Alm, writing in the *Concise Encyclopaedia of Economics*, societies that allow creative destruction to operate grow more productive and richer; their citizens see the benefits of new and better products, shorter working weeks, better jobs and higher living standards. However, the economic harm that is a part of long and deep recessions (sometimes called depressions) is arguably much worse than any of the benefits of creative destruction.
- 3 Frictional unemployment is transitional unemployment due to people moving between jobs. It often occurs in the time period during which newly unemployed workers search the labour markets for new jobs which meet their aspirations. By contrast, structural unemployment occurs when there is a long-run decline in demand in an industry, leading to fall in employment. This can be caused by international competition or by goods going out of fashion as new substitute products are developed.
- 4 Different types of unemployment require different forms of government intervention if they are to be reduced. Cyclical unemployment, for example, can possibly be reduced by expansionary monetary policy and/or fiscal policy shifting the *AD* curve rightward. Structural unemployment, by contrast, requires interventionist or non-interventionist supply-side policies to aid the retraining and mobility of labour in industries which are in decline and which have laid off workers. However, if the government increases aggregate demand in the mistaken belief that unemployment is cyclical, when in fact it is structural, inflation may be the main result. It is a bit like a doctor misdiagnosing an illness and prescribing cough medicine when the disease is in fact meningitis. Far from curing the patient, the wrong medicine is likely to be completely ineffective and the patient may well die.
- 5 This question centres on value judgements and people with different views on how the economy should function answer the question differently. To a large extent, the answer to whether it is more important to reduce unemployment than to reduce inflation depends on the size of unemployment and the rate of inflation in the initial position. For example, if a third of the UK labour force were unemployed, but the economy was experiencing deflation (as in a deep recession or depression), most people would argue that reducing unemployment should be the main priority. By contrast, if the rate of inflation is threatening to accelerate out of control at the same time as there is relatively full employment, control of inflation should be the main priority.
- 6 Deflation, in its strict definition, is a continuing and persistent fall in the average price level. Disinflation, by contrast, is a slowing down of a positive rate of inflation, without the price level actually falling. (More loosely defined, deflation is a contraction of aggregate demand, which may of course lead to disinflation rather than a falling price level.)
- 7 The *AD/AS* diagram below illustrates both demand-pull inflation and cost-push inflation.



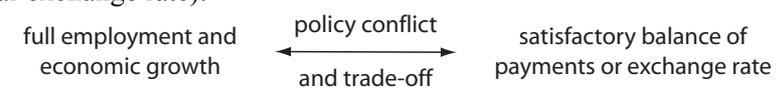
The left-hand panel of the diagram, which is the same as Figure 8.15 in Chapter 8, shows demand-pull inflation, while the right-hand panel, which is the same as Figure 8.16, illustrates cost-push inflation. In both panels, macroeconomic equilibrium is initially at point *X*. The *AD* curve is in the position *AD*₁; real output is at level *y*₁ and the price level is *P*₁. In the left-hand panel, any event that then shifts the *AD* curve to the right — for example, to *AD*₂ — causes the price level to rise, in this case to *P*₂. In this example, real income increases to *y*₂, which is the ‘normal capacity’ level of real income, depicted by the position of the *LRAS* curve. At the price level *P*₁, the economy’s firms are only prepared to produce an output of *y*₁. This means that a higher price level is needed to create the conditions in which firms increase output from *y*₁ to *y*₂. Whereas the initial point of macroeconomic equilibrium had been located at point *X*, macroeconomic equilibrium is now at point *Z*.

In the right-hand panel of the diagram, costs of production increase and shift the *SRAS* curve leftward or upward from *SRAS*₁ to *SRAS*₂. As a result of the shift of the *SRAS* curve to the left, the price level increases to *P*₂, but higher production costs have reduced the equilibrium level of output that firms are willing to produce to *y*₂. As in the left-hand panel, the initial macroeconomic equilibrium was at point *X*, but the new macroeconomic equilibrium is at point *Z*.

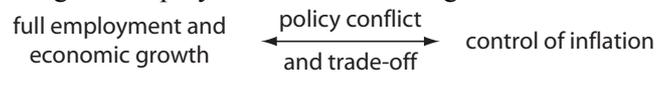
- 8 The UK’s current account is likely to be affected in two ways. In the first place, by adding to productive capacity, the new investment is likely to lead to more UK exports of the goods the new capacity enables to be produced. The demand for imports may also fall if UK-produced goods replace imports in the domestic economy. However, the new investment might generate an investment income flow (a primary income flow) in the opposite direction, as profits are repatriated to the overseas-based multinational corporations that own the UK subsidiary companies.
- 9 A current account deficit means that the country’s inhabitants are enjoying a standard of living boosted by imported consumer goods. In effect, the country is living beyond its means and future generations may have to pay for this. For example, if the current account deficit is financed by loans from other countries, the loans and the interest payments on them will eventually have to be paid back. However, as is sometimes the case in developing countries, a current account deficit that is used strategically to purchase capital goods vital for continuing development may be good for the country.
- 10 The four main conflicts, and their associated policy trade-offs are set out below:



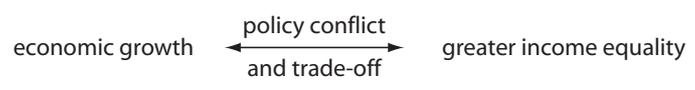
- Between internal policy objectives of full employment and growth and the external objective of achieving a satisfactory balance of payments (or possibly supporting a particular exchange rate):



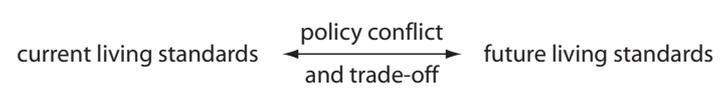
- Between achieving full employment and controlling inflation:



- Between increasing the rate of economic growth and achieving a more equal distribution of income and wealth:



- Between higher living standards *now* and higher living standards in the *future*:



As Chapter 8, page 230 explains, when economic policy objectives are mutually exclusive, it is impossible for governments to achieve all their policy objectives at the same time. The result of this is that governments often trade off between policy objectives, attempting for example to combine *relatively* low unemployment with *relatively* low inflation on the ground that full employment and absolute price stability cannot be achieved together. Page 230 goes on to state that pro-free market economists generally believe that successful supply-side policies, combined with supply-side reform in the private sector, facilitate the production of high-quality goods and services which people, in the UK and abroad, wish to buy. According to this supply-side view, in the long run the sustained economic growth which results resolves short-run conflicts between policy objectives.

