Intensive Revision

**Lesson 8 – Essays – Inflation, Unemployment, Aims of Government, Policies – CSQ Q1**

**Oil prices and deflationary impacts on various countries**

**Figure 2: Crude oil prices and UK inflation, 2007–2015**

**-0.1**

Source: OPEC, Office for National Statistics

**Extract 6: Falling oil prices: Who are the winners and losers?**

Global oil prices have fallen sharply over the past seven months, leading to significant revenue shortfalls in many energy exporting nations, while consumers in many importing countries are likely to have to pay less to heat their homes or drive their cars.

From 2010 until mid-2014, world oil prices had been fairly stable, at around $110 a barrel. But since June prices have more than halved. The reasons for this change are twofold - weak demand in many countries due to insipid economic growth, coupled with surging US production.

Russia is one of the world's largest oil producers, and its dramatic interest rate hike to 17% in support of its troubled rouble underscores how heavily its economy depends on energy revenues, with oil and gas accounting for 70% of export incomes. Russia loses about $2bn in revenues for every dollar fall in the oil price, and the World Bank has warned that Russia's economy would shrink by at least 0.7% in 2015 if oil prices do not recover.

For most of Europe and Asia, lower oil prices may be a blessing. With Europe's flagging economies characterised by low inflation and weak growth, any benefits of lower energy prices would be welcomed by beleaguered governments. A 10% fall in oil prices should lead to a 0.1% increase in economic output, say some.

China, which is set to become the largest net importer of oil, should gain from falling prices. However, lower oil prices won't fully offset the far wider effects of a slowing economy. India imports 75% of its oil, and analysts say falling oil prices will ease its current account deficit. At the same time, the cost of India's fuel subsidies could fall by $2.5bn this year - but only if oil prices stay low.

Source: *BBC*, 19 January 2015

**Extract 7: UK slips into deflation**

The UK has officially slipped into deflation for the first time in more than half a century, but economists and policy makers are not concerned, saying that a brief period of gently falling prices is more likely to help growth than harm it.

Prices, as measured by the consumer prices index (CPI), fell by 0.1% because of the slide in global oil prices, which has reduced the cost of imports. It is not just the price of oil that is falling; so are the prices of most commodities. Now that prices of consumer essentials like food and energy are stagnant or falling, many households are finally getting a boost in living standards as purchasing power of incomes rise. Many, including pensioners, should benefit. Moreover, deflation will help the country to fully restore export competitiveness. Bank of England Governor Mark Carney has consistently said that any period of negative inflation is likely to be temporary, and will not morph into the pernicious deflation seen in countries such as Japan.

However, while the data should not be mistaken for “damaging deflation”, Chancellor George Osborne cautioned, “We have to remain vigilant to deflationary risks even when our system is well equipped to deal with them should they arise.” Deflationary expectations create a vicious cycle of falling prices and wages which shrinks an economy as households put off consumption in anticipation of lower prices. This leads to bankruptcies, firms selling off unprofitable branches, higher unemployment and output decline. Meanwhile, the Trades Union Congress general secretary, Frances O’Grady, commented, “The first period of negative inflation in over half a century could signal that there’s something very wrong with the recovery.” David Kern, Chief Economist at the British Chambers of Commerce, said: “(The) recent trade and manufacturing figures have been disappointing, and ongoing global uncertainties, especially in the emerging markets, reinforce our view that the recovery is fragile, and no risks should be taken.”

Source: Various, 2015

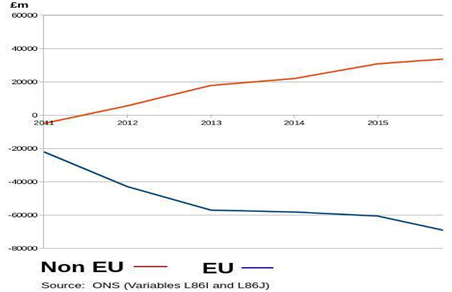
**Extract 8: Eurozone threat to the UK**

Deflationary forces have been kicking up turbulence in Europe. The European Central Bank wants to weaken the euro so Europe will be more competitive with other countries. Currently, the euro has hit an 11-year low against the U.S. dollar. The Eurozone price falls are very bad news for Britain due to the UK’s massive 6% current account deficit. All other things being equal, a weakening euro will widen that deficit further. Or to put it another way, the European Central Bank's putative cure for Eurozone deflation is to export it to the UK. At the same time, the UK has huge aggregate indebtedness (household, business and government debt as a share of GDP or national income). If serious deflation took hold in the UK, she would experience a hideous combination of economic stagnation and growing doubts about her ability to service her huge debts. Hence the President of the European Central Bank’s supposed cure for the Eurozone's economic woes could be toxic for the UK.

Source: Adapted from *BBC News*, 8 January 2015

**Figure 3: The UK’s balance of trade with EU and non-EU countries**

**Goods and services, % of GDP**



**EU**

**Non-EU**

Source: Office of National Statistics

**Table 2: UK Economic Statistics, 2012 – 2015**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | 2012 | 2013 | 2014 | 2015 |
| GDP growth (%) | 1.313 | 1.911 | 3.07 | 2.194 |
| Unemployment (%) | 8.0 | 7.6 | 6.2 | 5.4 |
| Government budget (% of GDP) | -4.97 | -4.91 | -4.01 | -3.15 |
| Current Account (% of GDP) | -3.67 | -4.39 | -4.66 | -4.28 |

Source: OECD; Office of National Statistics

**Questions:**

|  |  |  |  |
| --- | --- | --- | --- |
| **(a)** | **(i)** | State the relationship between crude oil prices and the UK inflation rate in Figure 2. | [1] |
|  | **(ii)** | With the help of a diagram, explain why the supply factor rather than the demand factor is more likely to cause the fall in crude oil prices. | [3] |
| **(b)** | Explain why a fall in crude oil prices would impact the economic growth of countries differently. | | [4] |
| **(c)** | Explain the impact of Russia’s “interest rate hike to 17%” on the rouble. | | [2] |
| **(d)** | Explain why pensioners benefit from a period of deflation. | | [2] |
| **(e)** | Discuss the extent to which small firms with high levels of competition are more likely to shut-down than big firms with less competition with the onset of deflationary pressures. | | [8] |
| **(f)** | Discuss whether the UK government should be worried about the impact of domestic and Eurozone deflation on its economy. | | [10] |

[Total: 30]