Final Preparation

**CSQ 1 – Lesson 6 – Economic Growth / Inflation / Unemployment**

**Economic Slowdown**

Source: *The Economist*, 8 April 2016

**Extract 2: Low or negative inflation**

Falling prices sound like something to cheer. The emergence of the sharing economy is driving down the price of a taxi ride and a bed for the night. More recently tumbling prices for natural resources, especially oil, have boosted the spending power of consumers from Detroit to Delhi. Mark Carney, the governor of the Bank of England, reckons that falling energy prices are “unambiguously good” for the British economy. Mr Carney is not wrong. Nonetheless, the world is grievously underestimating the danger of deflation. The problem is that aggregate prices are dipping in so many places at once. Deflationary pressures are visible far beyond food and energy, and in countries that cannot claim to be leading the charge towards the new economy. Weak demand, driven by austerity, debt and a lack of economic growth is dragging down prices. In the euro zone, where deflation grips tightest, consumer prices fell by 0.6% in the year to January; Germany, Italy and Spain all saw falls. Prices in Greece have been declining for 23 months. Ultra-low inflation is also widespread. America, Britain and China each have inflation rates of less than 1%. This looks less like a welcome fall in prices than a sign of entrenched weak demand.

Deflation poses several risks. One familiar danger is that consumers will put off spending in the expectation that things will get even cheaper, further muting demand. Likewise, if prices fall across an economy but wages do not, then firms’ margins will be squeezed and employment will stagnate or decline. Neither of these dangers is yet visible; indeed, America and Britain are seeing strong employment growth. A third, well-known risk is debt deflation: debts become more onerous because the amount that is owed does not fall, even as earnings do. This is a big worry in the euro zone, where many banks are already stuffed with non-performing loans.

The least-understood danger is also the most serious, because it is already here. Deflation makes it harder to loosen monetary policy. When inflation is at 4%, the central bank can take real (i.e., inflation-adjusted) rates well below zero, to -4%, by keeping headline rates at zero. But as inflation falls and turns negative, low real rates get harder and harder to achieve, just when you need them most. Most rich-world central banks have already cut their main policy rates near to zero in order to pep up demand. A growing number of European economies are using negative interest rates to encourage spending, although charging people to put money in the bank will eventually prompt them to keep their money under the mattress instead.

All of which means that policymakers risk having precious little room for manoeuvre when the next recession hits. And sooner or later it will—because of a sharp slowdown in China, say, or the effect of a rising greenback on dollar-denominated corporate debt, or from some shock that comes out of the blue. The Federal Reserve has cut its policy rate by an average of 3.9 percentage points in the six recessions since 1971. That would not be possible today. The break-glass-in-case-of-emergency option of depreciating the currency massively against a fast-growing trading partner is of limited use when so few big economies are growing rapidly and prices are falling, or close to it, in so many places. Policymakers should be more worried than they appear to be, and their actions to avert deflation should be bolder. Governments need to boost demand by spending more on infrastructure; central banks should err on the side of looseness. Next month the European Central Bank will start quantitative easing, and about time too, by buying assets and pumping money into the economy.

Source: *The Economist*, 21 February 2015

**Extract 3: Inflation down in Singapore**

The economy could witness a longer stretch of negative inflation this year. The recent falls in the consumer price index were largely due to policy-driven drops in housing rents and car prices and these coincided with sharp declines in global oil prices.

The Monetary Authority of Singapore’s core inflation measure, which strips out accommodation and private transport costs, came in at one per cent, mainly reflecting lower but positive food inflation and services inflation. The labour market remains tight and the economy continues to expand.

Source: *The Business Times*, 24 April 2015

**Extract 4: Negative interest rates**

Negative interest rates have arrived in several countries, in response to the growing threat of deflation. In June the European Central Bank (ECB) announced that it would pay -0.1% on the money banks deposited with it; in September the rate went even lower, to -0.2%. Denmark, Sweden and Switzerland also have negative rates. Banks, in effect, must pay for the privilege of depositing their cash with the central bank. Central banks’ intention of having negative interest rates is to spur banks to lend any reserves that are above the minimum regulatory requirement to willing borrowers, as well as to weaken the local currency by making it unattractive to hold. Both effects, they hope, will raise growth and inflation. In fact, the downward march of nominal rates may actually impede lending. It is difficult to reduce deposit rates below zero while lending rates are falling. Weakened financial institutions, in turn, are not good at stoking economic growth.

Negative rates do not seem to have achieved much on loans. The charges central banks levy on reserves are still relatively modest: by one estimate, Denmark’s negative rates, which were first imposed in 2012, have cost banks just 0.005% of their assets. Indeed, the biggest effect of negative interest rates may be on currencies. Since the ECB introduced negative deposit rates the euro has fallen against the dollar by nearly 20%. After Sweden adopted negative rates, the krona fell to a six-year low against the dollar. It is no coincidence that the central bank with the greatest enthusiasm for negative rates is Denmark’s: its sole objective is maintaining a fixed exchange rate with the euro.

Source: BBC News, 15 February 2015

**Figure 1: Change in consumer prices 2010 – January 2015**



Source: *The Economist*

**Questions**

**(a)** With reference to Figure 1, compare the change in consumer prices of the Euro area with that of Britain between mid-2011 and January 2015. [2]

**(d)** State **two** possible reasons why wages do not fall when prices are falling in an economy. [2]

**(e)** With the help of a diagram, explain the causes of deflation in various economies. [4]

**(f)** Assess whether negative inflation is undesirable to an economy. [8]

**(g)** With reference to the data where appropriate, discuss whether governments should use negative interest rates or another policy measure during a recession with deflation. [8]

[Total: 30]

**CSQ 2 – Lesson 6 – Economic Growth / Inflation / Unemployment**

**Economic Challenges in different economies**

**Extract 1: US hiked interest rate for the first time since 2006**

The US Federal Reserve (Fed) hiked interest rate for the first time in nearly a decade, signalling faith that the U.S. economy had largely overcome the 2008 financial crisis.

The Fed raised interest rate by 0.25 per cent in view of the projected rise in the rate of inflation to 2% in the medium term. With the economy performing well and expected to continue to do so, the Fed committee judges that a modest increase in the interest rate is appropriate. "Policy remains accommodative," Yellen said. "The US economy has shown considerable strength. Domestic consumer spending has continued to rise and investment by firms have risen”.

Adapted from *Reuters,* 16 Dec 2015

**Extract 2: China takes steps to transit to a knowledge-based economy**

China posted its weakest economic growth in the fourth quarter of 2015, adding pressure on policymakers to take more steps to ward off a sharper slowdown that could jolt global markets.

The government could widen the budget deficit to about 3 percent this year as leaders turn to tax cuts and increased spending on infrastructure to support growth. While the government is expected to lean more on fiscal policy to support growth this year, the central bank may still need to ease monetary policy to help cushion the impact of structural reforms on the economy. The central bank has already cut interest rates six times since November 2014 to spur economic growth.

China intends to transit to a knowledge-based economy by encouraging its organizations and people to acquire, create and use knowledge more effectively for greater economic and social development. Strong economic incentives and institutions are required to enable organizations and people to adjust to changing opportunities in flexible and innovative ways.

The government plans to push forward “supply-side reforms” by cutting corporate tax, upgrading the information and communication technology (ICT) and R&D infrastructure and removing barriers to encourage domestic entrepreneurship and foreign direct investment in the services sector. There is a need to establish clear rule of law and property rights. They also strive to privatize big, highly inefficient state-owned enterprises into market-oriented institutions.

In the short term, the critical challenge for China is to ensure a smooth and efficient transition, minimizing unemployment that will inevitably result from the restructuring. Retraining also needs to be provided for millions of workers that may be displaced. Even though literacy rates had soared due to government’s increased spending on education, there is still overemphasis on knowledge transfer rather than the development of imaginative and creative capabilities. This has proved to be a major hindrance to its education reforms.

Adapted from *Asian Development Bank, World Bank & The Guardian, 9 May 2016*

**Extract 3: Singapore faces external headwinds**

While manufacturing remained in the doldrums, Singapore’s economic growth in the fourth quarter of 2015 was supported by public-sector construction activities, and the finance and insurance sectors. With no signs of external demand picking up yet, economists, however, were cautious about the outlook for the coming year despite the better-than-expected fourth quarter performance. Barclays’ economist Leong said: “The US economy is strong but it is offset by China’s growing weakness, precipitated by a weaker ability to import due to the weaker Chinese yuan.”

DBS economist, Irvin pointed out the risks of potential capital flight that could result from further US rate hikes and fears of further economic slowdown in China. “Growth outlook in the next six to nine months will remain tepid before an improvement in the later part of 2016,” he added.

Adapted from *Today, 4 January 2016*

**Extract 4: Singapore’s top export partners**

Singapore shipped US$346.8 billion worth of products around the globe in 2015.

The top 5 export markets are:

1. China: US$47.7 billion (13.8% of total Singapore exports)
2. Hong Kong: US$39.7 billion (11.4%)
3. Malaysia: US$37.8 billion (10.9%)
4. Indonesia: US$28.4 billion (8.2%)
5. United States: US$23.2 billion (6.7%)

*Source:* [*http://www.worldstopexports.com/singapores-top-import-partners/*](http://www.worldstopexports.com/singapores-top-import-partners/)*, 17 Apr 2016*

**Table 1: Macroeconomic Indicators (China)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2011 | 2012 | 2013 | 2014 | 2015 |
| Real GDP growth (% per year) | 9.5 | 7.8 | 7.7 | 7.3 | 6.9 |
| Rate of inflation (%) | 5.4 | 2.6 | 2.6 | 2.0 | 1.4 |
| Unemployment (% of labour force) | 4.3 | 4.5 | 4.6 | 4.7 | 4.8 |
| Government budget balance (% of GDP)  | 0.1 | -0.3 | -0.7 | -1.2 | -2.6 |
| Current account balance (US$ billion) | 136.1 | 215.4 | 148.2 | 219.7 | 330.6 |

**Table 2: Macroeconomic Indicators (United States)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2011 | 2012 | 2013 | 2014 | 2015 |
| Real GDP growth (% per year) | 1.6 | 2.3 | 2.2 | 2.4 | 2.0 |
| Rate of inflation (%) | 3.2 | 2.1 | 1.5 | 1.6 | 0.1 |
| Unemployment (% of labour force) | 9.0 | 8.2 | 7.4 | 6.2 | 5.0 |
| Government budget balance (% of GDP)  | -10.7 | -9.3 | -6.4 | -5.8 | -2.4 |
| Current account balance (US$ billion) | -460.4 | -449.7 | -376.8 | -389.5 | -484.1 |

**Table 3: Macroeconomic Indicators (Singapore)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2011 | 2012 | 2013 | 2014 | 2015 |
| Real GDP growth (% per year) | 6.2 | 3.4 | 4.4 | 2.9 | 2.0 |
| Rate of inflation (%) | 5.3 | 4.5 | 2.4 | 1.0 | -0.5 |
| Unemployment (% of labour force) | 2.9 | 2.8 | 2.8 | 2.7 | 2.8 |
| Government budget balance (% of GDP)  | 1.2 | 1.7 | 1.1 | -0.3 | -1.2 |
| Current account balance (US$ billion) | 60.6 | 49.8 | 54.1 | 58.8 | 57.5 |

Source: *The Economist, World Bank (2015),* [*http://stats.mom.gov.sg*](http://stats.mom.gov.sg)*, 28 Apr 2016*

**Questions**

|  |  |  |
| --- | --- | --- |
| **(a)**  | **(i)** | Compare the change in China’s current account balance with that of the US for the period 2011 to 2015. [2] |
|  | **(ii)** | Explain whether the US should be concerned about the changes to her current account balance. [2] |
|  |  |  |  |
| **(b)** | **(i)** | What conclusion would you draw from Table 2 about the overall economic performance of United States in 2015 compared with 2011? [2] |
|  |  |  |  |
|  | **(ii)** | Comment whether the US central bank’s action of raising the interest rate is justified. [4] |
|  |  |  |  |
| **(c)**  | Explain how the slowdown in China’s economic growth will affect its government budget balance. [4]  |
|  |  |  |  |
| **(d)** | With reference to the data, discuss the likely impact of China’s monetary policy (Extract 2) on the Singapore’s economy. [8]  |
| **(e)** | Assess the effectiveness of China’s supply-side reforms in facilitating a smooth transition to a knowledge-based economy. [8]  |
|  |  |

[Total 30]