J2 June Intensive Revision

**CSQ – Lesson 4 – National Income Accounting / Economics Indicators / How macroeconomics works? / AD-AS**

**The Eurozone Economy**

**Table 1: Annual Unit Labour Costs#, 2010 = 100**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Country** | **2011** | **2012** | **2013** | **2014** | **2015** |
| Germany | 100.7 | 104.0 | 106.0 | 107.9 | 109.9 |
| Greece | 98.7 | 96.7 | 89.6 | 87.3 | 87.6 |
| Eurozone (19 countries) | 100.6 | 102.5 | 103.8 | 104.8 | 105.5 |

# Unit labour costs measure the average cost of labour per unit of output and are calculated as the ratio of total labour costs to real output.

**Table 2: Net trade in goods (value), US$ converted, seasonally adjusted (in billions)**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Country** | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** |
| Germany | 195.82 | 209.71 | 240.95 | 259.56 | 281.94 | 273.33 |
| Greece | -39.12 | -33.87 | -27.75 | -25.70 | -28.29 | -19.55 |
| Eurozone (19 countries) | -26.28 | -38.21 | 100.43 | 198.56 | 235.99 | 267.52 |

Source: OECD.Stat, accessed 20 August 2016

# Extract 1: Is Germany's big export surplus a problem?

Germany's trade surplus – the excess in the value of its exports over its imports – hit another record in 2014. At 217 billion euros ($236 billion), it was Germany's biggest ever. Expressed as a percentage of GDP, Germany's 2014 trade surplus was 7.5 percent.

Why is Germany’s trade surplus so large? Undoubtedly, Germany makes good products that foreigners want to buy. For that reason, many point to the trade surplus as a sign of economic success. But other countries make good products without running such large surpluses. There are two more important reasons for Germany’s trade surplus.

Some economists point to the euro currency as a key reason for Germany's perennial export surpluses. By sharing the euro with a larger population of mostly less competitive economies, German exporters have a built-in benefit: a currency that's permanently weaker than it should be, though it may be still too strong for less competitive economies. That provides an artificial advantage to German exporters.

Second, the German trade surplus is further increased by policies (tight fiscal policies, for example) that suppress the country’s domestic spending, including spending on imports.

In a slow-growing world that is short on aggregate demand, Germany’s trade surplus is a problem. Several other members of the Eurozone are in deep recession, with high unemployment and with no “fiscal space” (meaning that their fiscal situations don’t allow them to raise spending or cut taxes as a way of stimulating domestic demand). The fact that Germany is selling so much more than it is buying redirects demand from its neighbours (as well as from other countries around the world), reducing output and employment outside Germany at a time at which monetary policy in many countries is reaching its limits.

# Sources:

# (i) Ben Bernanke, Germany’s trade surplus is a problem, Brookings Institute, April 3, 2015 and

# (ii) Nils Zimmermann, Is Germany's big export surplus a problem?, DW, April 7, 2015

**Figure 2: Eurozone Debt and Unemployment**

Source: Eurostat, accessed 1 September 2016

**Extract 2: Reconciling fiscal consolidation with growth and equity**

Fiscal consolidation is a policy aimed at reducing government deficits and debt accumulation. Fiscal consolidation complicates the task of achieving other policy goals as it weighs on demand in the short term. A number of fiscal consolidation instruments can enhance the long-term level of output.

**Table 3: Instruments of Consolidation**

|  |  |
| --- | --- |
| **Expenditure Cuts** | **Revenue Increases** |
| Public consumption: education | Personal income taxes |
| Public consumption: health | Corporate income taxes |
| Cash transfers: unemployment benefits | Environmental taxes |
| Subsidies | Consumption taxes (non-environmental) |
| Public investment | Sales of goods and services |

Some revenue measures can also contribute positively to long-term output when they promote more efficient use or allocation of services or resources that were previously inadequately priced. Better pricing the use of environmental services through taxation can lead to welfare gains through improved environmental amenities that are not measured in GDP.

However, spending reductions can bring about potentially large long-term losses in output when they cut into areas such as public goods or growth-enhancing services that are insufficiently produced by market forces. Cuts in health care can also reduce output per capita by reducing productivity. Through its contribution to well-being, health spending is most likely to have additional positive welfare effects that are not measured in GDP.

Most fiscal consolidation instruments are harmful for growth in the short run and aggravate income inequality. In fiscal-crisis countries, the absence of consolidation could translate into a massive loss of confidence triggering economic collapse. If it helps to avoid such extreme scenarios, consolidation may be highly expansionary.

Source: OECD Economic Studies, 05 Feb 2014

**Extract 3: The Eurozone economy – frost in spring**

The once-sickly Eurozone is undergoing recovery which, though feeble, has nonetheless been sustained. More importantly, there are signs that the pace may be accelerating this year.

Despite these promising developments, there is still a concern that the recovery may have come too late and be too weak to avert the onset of deflation. Consumer prices are falling in several peripheral countries, notably Cyprus and Greece, but also now in Spain.

The development has prompted the European Central Bank (ECB) to cut its key interest rate to 0.05%, a new record low.

Sources:

(i) The Economist, 5 April 2014 and

(ii) The Telegraph, 4 September 2014

**Questions**

1. **(i)** Using Table 1, compare the trends in the annual unit labour costs in Germany and Greece. [1]

**(ii)** Explain how the above trends in the annual unit labour costs and one other factor from Extract 1 influenced the countries’ trade balance as shown in Table 2. [6]

1. Identify and explain the relationship between unemployment rate and general government debt as seen in Figure 2. [3]
2. With reference to Extract 2, discuss the impact of fiscal consolidation on living standards in a country. [8]

**[Total: 30]**