Term 4 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]

**Suggested Answers**

**(a)(i) State the relationship between crude oil prices and the UK inflation rate in Figure 2. [1]**

There is a positive relationship between crude oil prices and the UK inflation rate.

**(a)(ii) With the help of a diagram, explain why the supply factor rather than the demand factor is more likely to cause a fall in crude oil prices. [3]**

The demand for oil is derived from the demand for goods and services, as oil is a key factor input in the production of many goods. Insipid economic growth has resulted in a small increase in demand for oil, which would raise oil prices.

However, supply of oil has increased to a large and significant extent due to surging US production. The increase in global oil producers thus placed downwards pressure on price, which outweighed any increase in prices from a rise in demand.

[Illustrate with a diagram and description]

Hence, supply is likely to have had a more significant impact on the fall in oil prices.

**(b) Explain why a fall in crude oil prices would impact the economic growth of countries differently. [4] ( countries which exports / countries which imports)**

A fall in crude oil prices would impact the economic growth of countries differently, depending on whether they were exporters or imports of oil.

For exporters of oil like Russia, a fall in the price of oil would result in a less-than-proportionate increase in quantity demanded, as PED of oil < 1 due to a lack of substitutes. Thus, exporters of oil would experience a fall in export revenue (X), which reduces AD and causes a fall in NI, ceteris paribus. The fall in crude oil would thus have a negative impact on economic growth.

For importers of oil like China and many European countries, however, a fall in the price of oil is likely to encourage growth. Oil is a key factor of production, so lower oil prices result in a fall in costs of production across the economy and increase SRAS. This would cause a rise in NI, ceteris paribus.

(efficiency of oil usage)

**(c) Explain the impact of Russia’s “interest rate hike to 17%” on the rouble. [2]**

A sharp rise in Russia’s interest rate would attract capital inflows and reduce capital outflows as investors seek higher rates of return for their short-term investments.

This would increase demand and decrease supply of the rouble on the forex market, placing upward pressure on the rouble, causing rouble to appreciate.

Qn – Why raise interest rate? increase price of oil in foreign value – increase revenue fr exports

**(d) Explain why pensioners benefit from a period of deflation. [2]**

A fall in the general price level during a period of deflation implies that there is a rise in purchasing power / internal value of money. Pensioners tend to rely on a fixed amount of savings or fixed incomes. With deflation, they are now able to consume a greater quantity of goods and services with the same amount of money.

**(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]**

Introduction

Shut down condition for firms: AR<AVC in the short-run and AR<AC in the long-run which is probable since Extract 7 mentions on the higher likelihood of bankruptcies.

Main Body

**1. Analyse the factors will lead to firms shutting-down**

Revenue Analysis:

1.1) Reasons why revenue is likely to fall

Deflationary expectations may cause “households (to) put off consumption in anticipation of lower prices”. Firms would then experience a fall in demand and thus revenue.

1.2) Reasons why revenue is likely to rise

However, since deflation is likely to increase export competitiveness of its goods and services and assuming demand is price elastic, the quantity demanded for exports will increase more than proportionate and this will increase the revenue for firms which produce exports.

Cost Analysis

Firms will experience a reduction in cost of production due to the lower oil, commodity and energy prices (Extract 7) – fall in variable cost

Impact on profits and shutting-down

* Firms will be faced with losses if the deflation is severe and households indeed procrastinate their purchase till TR<TVC. They may shut-down temporarily in the short-run.
* Only when the situation is permanent till TR<TC, the firms may shut-down permanently and exit the market.

**2. Explain why small firms with high levels of competition are more likely to shut-down than big firms with less competition**

The above applies generally to all firms but small firms with high levels of competition, which is monopolistic competitive firms might be more likely to shut-down than big firms with less competition, oligopoly, given that they only earn normal profits in the long-run. So even a small fall in demand can mean making losses. They also do not have excessive past profits for them to cover the losses to keep them in business.

For larger firms in the oligopolistic market, they have more means/money to do excessive product promotion to woo their consumers to buying their goods. And instead of shutting-down their entire business, they can explore options such as “selling off unprofitable branches” (divestment). This will help the firms to survive.

It will be relatively harder for monopolistic firms to survive the impact of deflationary pressures. AR < AVC

**Evaluate the extent:**

But, whether the monopolistic firms will shut-down depends on the type of good that they sell. If these are necessities and perishables, then it is unlikely for the consumers to “put off consumption in anticipation of lower prices”, hence demand for these goods are unlikely to fall.

However, if these firms were to sell goods which are not necessities, then it is likely that demand will fall by a greater extent and there will more likely to shut-down than bigger firms, given they only earn normal profits in the long-run and have little means to revive the demand.

**(f) Discuss whether the UK government should be worried about the impact of domestic and Eurozone deflation on its economy. [10]**

**domestic deflation – worry about local consumer and investor confidence which will affect local demand like C and I**

**Eurozone deflation – worry about the foreign consumer and investor confidence which will affect export demand and FDI**

The impact of both domestic and Eurozone deflation on the UK economy may be assessed by considering the impact on UK macroeconomic goals.

**1. Analyze the impact of domestic deflation on the UK economy**

1.1) Why the UK govt **should be** worried

If deflation persists for an extended period of time, the UK may be caught in a deflationary spiral (‘vicious cycle of falling prices and wages’ in Extract 7). Consumers put off consumption due to expectations of lower prices in the future, causing a fall in C and thus AD.

Fall in investment too due to fall in investor confidence due to bankruptcies and the “selling off unprofitable branches”.

This lowers real output, i.e. negative growth. It also increases unemployment and causes a further fall in GPL, worsening deflation.

Furthermore, the UK government is already running a budget deficit (Table 2) and has ‘huge aggregate indebtedness’ (Extract 8). Deflation may cause the real value of any government debt to increase as the internal value of money rises, making it more difficult for the government to repay its debt.

1.2) Why the UK govt **should not** be worried

However, given that deflation is primarily due to fall in oil prices (Extract 7), this would reduce costs of production within the economy, causing SRAS to shift right.

While GPL falls, there is in fact a rise in production and output, i.e. positive growth, and hence increased employment of labour.

Deflation may also improve price competitiveness of exports (Extract 7), which may improve BOP.

1.3) Evaluation

Whether the UK should be concerned about deflation depends critically on the root cause of deflation. If deflation stems from a fall in costs of production within the economy, as it appears to be given the drastic decrease in crude oil prices, then deflation is largely benign and may even be welcomed as it improves living standards of many households (Extract 7). Moreover, Extract 7 states that “any period of negative inflation is likely to be temporary”, so perhaps it is unlikely that deflation would last long enough for people to develop deflationary expectations which may cause damaging deflation.

**2. Analyze the impact of regional (EU) deflation on the UK economy**

2.1) Why the UK govt **should be** worried

Deflation in the EU may have spillover effects on the UK economy. It may reduce export demand for UK goods as EU consumers hold back spending, resulting in a fall in X and thus AD. This lowers real output, increasing unemployment, and resulting in a fall in the UK’s GPL.

It also worsens the UK’s current account deficit, as EU goods become cheaper over time, resulting in a more than proportionate increase in quantity demanded for imports and raising the UK’s import expenditure (assuming PEDm>1). This effect is reinforced by Figure 3 which shows a sharp worsening of UK’s balance of trade deficit with the EU from 2015.

The current account deficit could also be exacerbated by the EU’s decision to weaken the Euro, as an EU policy response to Eurozone deflation.

Increase in the size of external debt

2.2) Why the UK govt **should not** be worried

Impact of government policies: EU is seeking to reduce deflation via currency depreciation (Extract 8). This would stimulate economic growth and raise employment in the Eurozone.

If successful in ‘jump-starting the economy’, this may reduce the possible negative spillover effects on the UK economy.

2.3) Evaluation

It is likely that the negative impact of regional deflation effects will be felt on the UK in the short run while the positive effects may be experienced in the longer term. However, if the Chief Economist at the British Chambers of Commerce recommends that ‘no risks should be taken’ (Extract 7) in light of the global uncertainties and UK’s fragile recovery, then the UK government should take proactive steps to implement expansionary demand-management policies to counter the short term negative impact of regional deflation.