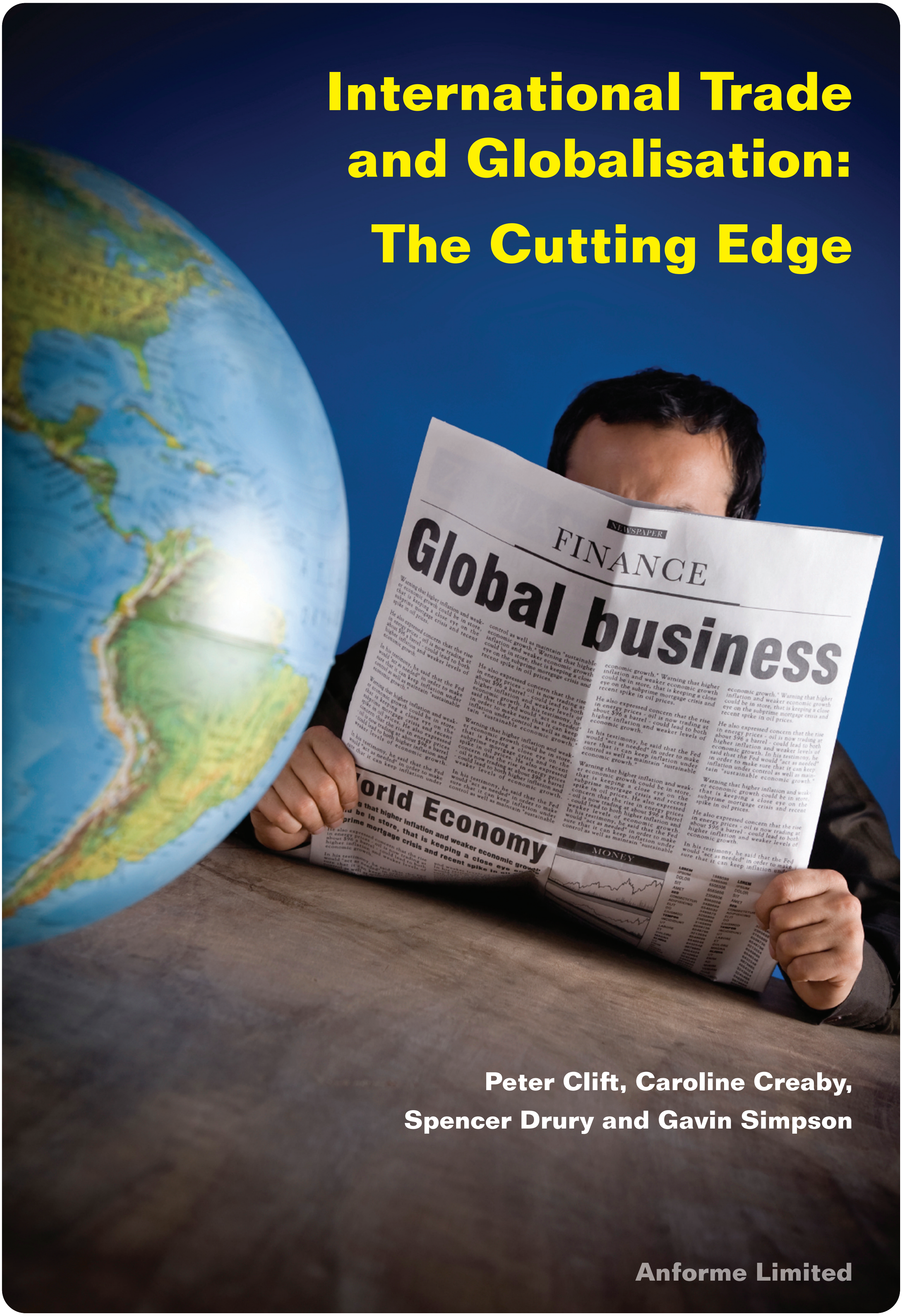
International Trade and Globalisation: The Cutting Edge



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Contents

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Published by Anforme Ltd., Stocksfield Hall, Stocksfield, Northumberland NE43 7TN.
Tel: 01661 844000 Fax: 01661 844111 e-mail: anforme@aol.com www.anforme.co.uk
ISBN 978-1-905504-37-4 March 2010

Topic 1

Chindia: How will the new economic powers change the global economy?

China and India

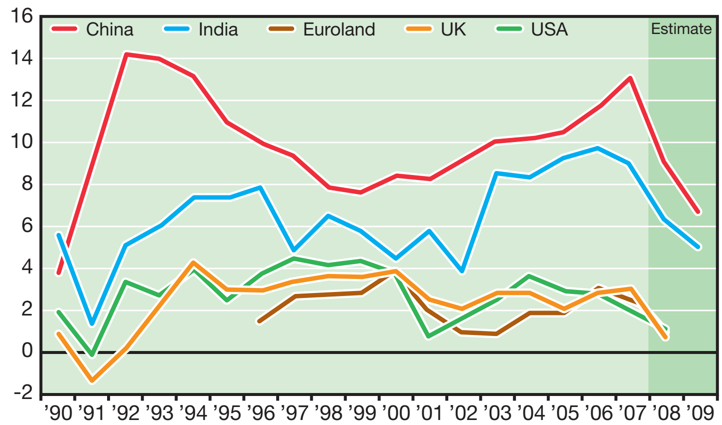
China and India have long been hailed as the future economic superpowers. In 2007, the World Bank estimated China's economic growth at 11.9% and India's at 9%. Not only are these growth rates particularly high but they have been consistently so for over a decade now. What is more, their imposing and increasingly skilled populations as well as developing infrastructure would suggest that their impressive and consistent levels of GDP growth are likely to be sustained for some time yet. In a decade from now, China and India could generate national levels of output never seen before. This Topic seeks to outline how such growth will impact upon the world economy.

What do we mean by the global economy?

The phrase 'the global economy' encapsulates international aspects of economics such as international trade, exchange rates, global prices and world output amongst other indicators. In this Topic we will draw upon the familiar macroeconomic concepts of economic growth, the balance of payments, inflation and employment in order to provide a framework within which to analyse China and India's impact on the global economy.

Economic growth

Figure 1: International GDP growth rates, 1990-2009, %

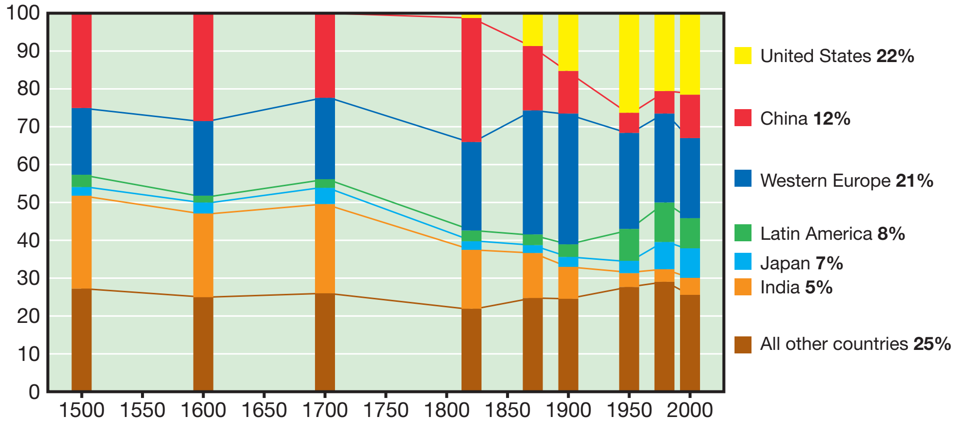


Source: http://www.dbresearch.de/servlet/reweb2.ReWEB?rwsite=CIB_INTERNET_EN-PROD£$rwframe=0

Figure 1 highlights China and India's impressive growth record since the early 1990s. Their growth is consistently higher than the most advanced economies. However, what distinguishes China and India from other emerging economies such as Vietnam (which boasted 8.5% GDP growth in 2007) is that their growth has been so consistently high for so long that the size of their economies now make sizeable contributions to world growth.

Figure 2 highlights China and India's contribution to world GDP over the last century. China, Western Europe and India have been important contributors to world GDP since the 1500s. In more recent times, the USA and Western Europe have been the largest single contributors with respectively a 22% and 21% share in 2000. Both China and India saw a rising share of world GDP between 1950 and 2000. According to Deutsche Bank in 2004, China accounted for 13% of world GDP and India 6%.

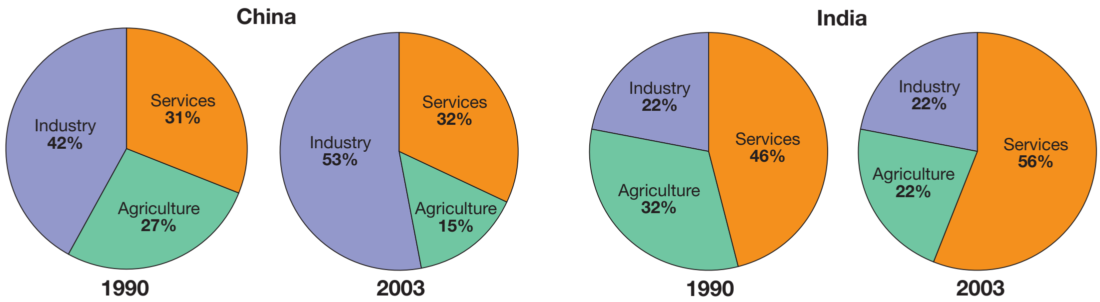
Figure 2: Percentage of world GDP (last 500 years), %



Source: http://www.visualizingeconomics.com/2008/01/20/share-of-world-gdp/

In examining economic growth, it is clear that China's growth is higher and contributes more to world GDP that that of India despite both countries having comparable populations (1.32bn and 1.12bn respectively). One factor that is noticeably different is the economic structure of each nation which goes some way to explaining the GDP growth differential.

Figure 3: Composition of GDP



Source: Deutsche Bank, China and India: A Visual Essay, Deutsche Bank Research, October 2005

Figure 3 shows the changing composition of China and India's economic structure. It highlights that a greater proportion of India's GDP comes from agriculture. Although the income derived from agriculture has fallen in both countries since 1990, India still depends on this sector for 22% of its GDP. Furthermore, *CIA Factbook* data states that 60% of India's workforce is employed in the agricultural sector compared to China's 43%.[1] This data indicates that the agricultural sector in India is not yielding proportionate income relative to the workforce it employs. Thus India's GDP growth rate is being hampered by its reliance on this sector.

As Figure 3 shows over one-half of India's GDP is now earned from the services sector, compared to 32% in China. However, only 28% of the Indian workforce is employed in this

1. https://www.cia.gov/library/publications/the-world-factbook/

sector compared to 32% in China. Had more been employed, India's GDP growth rate would likely be much higher.

An important consideration is how sustainable the current levels of GDP growth are and whether China and India will continue to contribute to world economic growth. From a labour market perspective, both nations are committed to the importance of education.

> ***"Education is the foundation for a vibrant democracy, growth of productivity and income and employment opportunities."***[2]

Educated populations enhance the pool of skilled labour in both countries, boosting productive capacity. Furthermore, research by the US National Academy of Engineers estimated that each year there are 70,000 US engineering graduates compared to 600,000 in China and 350,000 in India. This suggests that not only will China and India possess the ability to provide skilled labour for manufacturing and services but also for potentially high value technological research, an area until now monopolised by more advanced economies.

From a political point of view, both countries are increasing their levels of openness to the world economy which should further enhance opportunities for FDI and growth. In fact India has lagged behind China in its progress toward liberalization but if it becomes more open, its greater political transparency and rule of law could make India a more attractive location for foreign investment in the coming decades which could serve to rival China's growth.

Going forward therefore, it would appear that China and India's impressive growth and contribution to world output is likely to be sustained for some time yet. However, environmentally, both China and India have poor track records and the sustainability of domestic raw materials such as water and timber is questionable. Prudent governance would ensure that environmental resources are developed as much as human and physical ones.

Balance of payments

Figure 4: Value of exports, 1990-2008, US$bn

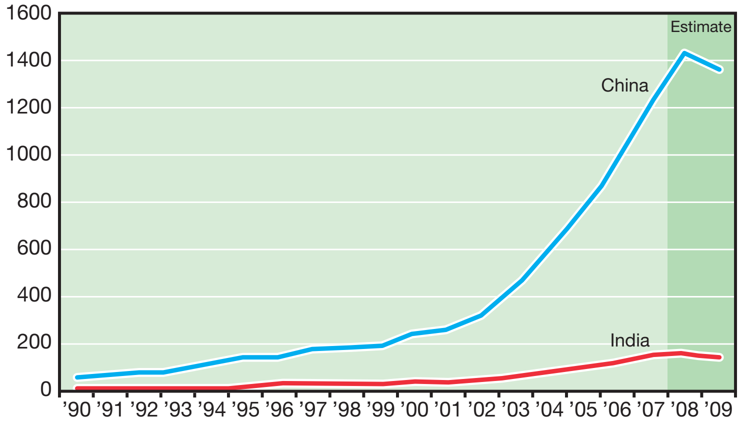


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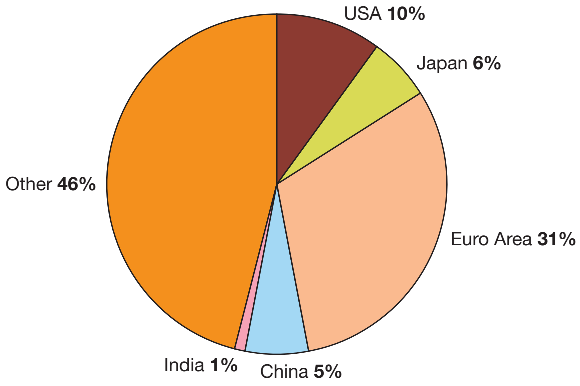
Figure 4 compares the US$ value of Chinese and Indian exports. In the period since 2004, China's export growth has accelerated dramatically, earning approximately $1400bn based on 2008 estimates. Exports have undoubtedly helped to boost China's growth faster than they have in India. China is now a more significant participant in world trade than India. Figure 5 shows that in 2004 China accounted for a 6% share of world exports compared to India's 1%.

2. *India Vision 2020*, Indian Planning Commission.

If China's rate of export growth is sustained, it may not be too long before it overtakes the USA as the world's single largest exporting nation.

Figure 5: China and India – export of goods and services as % of world total in 2004



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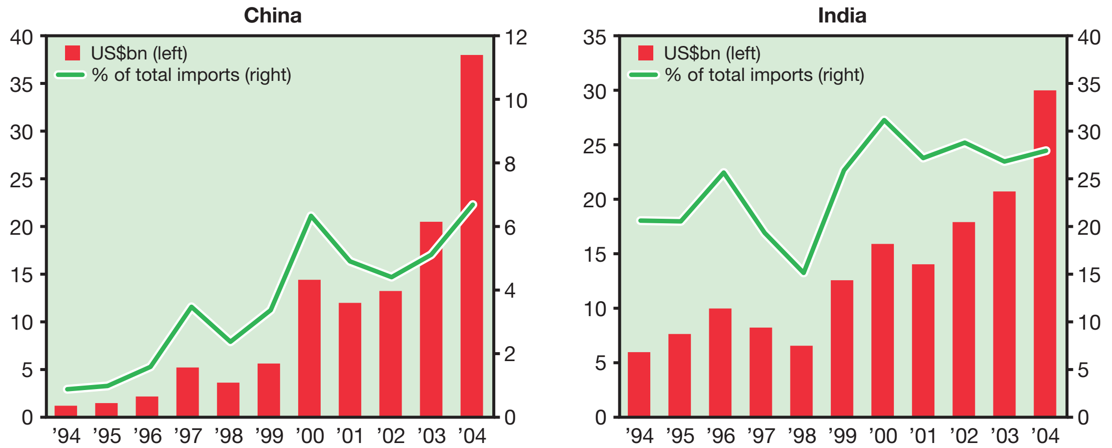
In terms of imports, high levels of growth in China and India have meant both economies have required significant quantities of raw materials to meet the demand of their growing industries. China and India will provide demand for international exporters over the coming decades which will benefit current account balances of those trading with these two countries.

Figure 6: Oil imports



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Oil is a commodity demanded in increasing volumes by both China and India. Figure 6 shows not only the value of oil imports (up to $40bn in China) but also the growing proportion of oil compared to other imports. This will have both positive and negative implications internationally. Negatively, such a large level of demand from both China and India will provide upward support for oil prices. If oil prices are pushed up then this will benefit oil exporting nations.

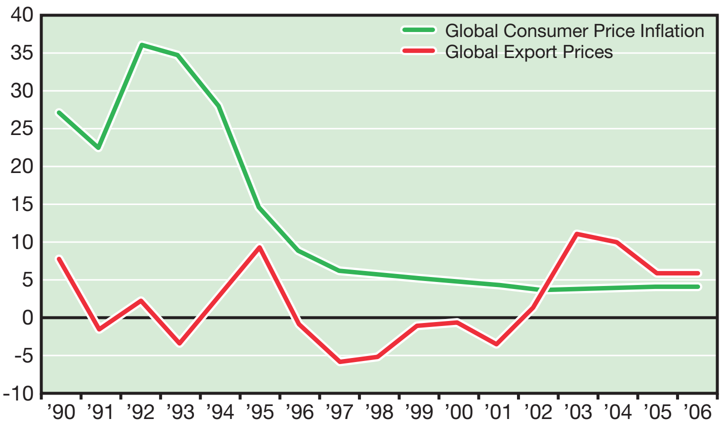
Inflation

Low and stable inflation is considered an essential component of economic stability and prosperity in many advanced economies. Increasing levels of international trade, fuelled particularly by China and India's increased presence in world trade, has been having an effect on international levels of inflation. Trade will affect the level of inflation through several channels. Imported 'final' goods sold to domestic consumers therefore feature directly in the

CPI. Imported raw materials or other inputs affect costs of production and therefore indirectly affect the final selling price of the good or service to be produced.

Figure 7 compares the rate of world inflation since 1990 with an index of world export prices. It is clearly evident that global inflation has fallen from a peak of 36% in 1992 to 6% in 2006. This fall coincides with the downward trend on global export prices until 2001. However, despite export prices rising since 2001, global CPI has remained low. This can be explained by looking more closely at the composition of 'global export prices'. On the one hand, demand for energy and raw materials for industry has been increasing in line with world growth and particularly from China and India. This has led to increases in the price of energy products which is pushing up export prices of these essential goods. However, due to China and India's increased presence in manufactured goods, prices in these markets have been relatively subdued. Therefore a country's level of 'imported inflation' would depend upon its relative dependence on energy compared with manufactured goods. Theoretically, a country could shield itself from increasing energy and commodity prices if it imported proportionately more manufactured goods.

Figure 7: Global export prices (US$) and consumer price inflation, %



Source: http://www.dfat.gov.au/publications/stats-pubs/downloads/world_trade.pdf

According to the IMF:

> ***"Globalization has reduced inflation by an average of a ¼ of a percentage point a year in the advanced economies, with a larger effect of ½ of a percentage point a year in the United States… increased trade openness has reduced relative producer prices in manufacturing by about 0.3 of a percentage point a year over the past 15 years."***[3]

Employment

India and China's significance to the world job market is both significant and controversial. According to Ricardian comparative advantage theory, a country has a comparative advantage when it can produce a good or service at a lower opportunity cost than their trading countries. What is becoming increasingly apparent is that with their large pool of skilled labour, China possesses a significant comparative advantage in manufacturing and India possesses one in services. This would suggest that China and India would specialise in these areas and export their surpluses to their trading partners. What has in fact happened is slightly different: their trading partners have established offices and operations within China and India, utilised their

3. IMF *World Economic Outlook 2006*, http://www.imf.org/external/pubs/ft/weo/2006/01/pdf/c3sum.pdf

respective labour forces and exported the resulting output. This modern phenomenon is an international version of **outsourcing**. According to one observer, the scale of cost savings for UK and US companies specifically of outsourcing to India or China can be as much as "40-50 per cent in some cases – combined with the increasing productivity and flexibility of workers in India mean that the rate of off-shoring is only going to increase."[4] If this trend does continue, it will have significant implications for the world economy. Positively, such cost savings in production will either lead to greater profits being earned, lower prices offered to consumers around the world, or a combination of the two. Increased profit earnings may see firms re-invest and expand production, leading to greater output and employment opportunities, creating a positive multiplier effect in their domestic economies and in China and India also. Lower prices could lead to lower levels of inflation in countries around the world.

However, the trend of outsourcing to India and China does have negative implications also. Firms outsourcing operations previously carried out domestically will ultimately be making labour unemployed in their own countries. Harrison and McMillan have made an important distinction in analysing whether outsourcing necessarily leads to domestic unemployment. They conclude that those firms involved in "horizontal foreign investment" i.e. substituting foreign labour for domestic will lead to lower employment in the US. However, when firms carry out "vertical foreign investment" i.e. foreign outsourcing at a different stage of production, it results in higher US employment.[5] An example of this would be if a firm outsources a primary sector function and exports it back to the US, it provides inputs for secondary manufacture and therefore creates jobs in this sector. However, some would argue that if firms engage in horizontal outsourcing and domestic labour is unemployed, a flexible labour market would be able to find employment in other industries or sectors. The difficulty is that labour market flexibility is difficult to achieve and re-training is time consuming and costly.

Given the scale of unemployment in the US manufacturing industry, a backlash is emerging there against horizontal outsourcing. Save America Manufacturing Act 2003 and The Job Protection Act 2003 are just two US Acts established in order to prevent international outsourcing. This is essentially protectionism in a new guise and although it may help to protect US jobs in some industries it will prevent the benefits of increased global output and lower prices from being reaped.

Given that the unmatched pool of skilled Indian and Chinese labour is not likely to subside any time soon, it might be prudent for all international governments to accept their respective comparative advantages and reflect on which alternative industries their own labour can develop a comparative advantage in and train labour accordingly.

Has the recent global recession had an impact?

It is unlikely that any economy, no matter how closed, will escape the current economic recession unscathed. Both China and India's volume and value of exports are now very high and as such weak external demand is likely to damage export revenues and aggregate demand. The World Bank's *2009 China Quarterly Update* projects Chinese growth will fall to 6.5% in 2009.[6] Given India's proportionately lower levels of exports, the recession may have a less adverse impact than in China.

4. http://yaleglobal.yale.edu/index.jsp, 'Cost Differentials and Labour Flexibility Mean Opportunity for Outsourcing', *Financial Times*, 2004.
5. A.E. Harrison and M.S. McMillan, Outsourcing Jobs? Multinationals and US Employment, *NBER Working Paper*, No. 12372, issued in July 2006, http://www.nber.org/papers/w12372
6. China Quarterly Update 2009, World Bank, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/CHINAEXTN/0,,contentMDK:22102737~pagePK:1497618~piPK:217854~theSitePK:318950,00.html?cid=GS_EAPCQU_106

Summary of the Main Points

- Regarding **growth**, China and India's GDP growth has been consistently high since the early 1990s. Furthermore, their growth is so significant that they now contribute substantially to global GDP. Going forward, it is likely that both countries' productive capacity is likely to increase further. However, the extent of this will depend upon the extent and duration of the global recession.
- Regarding **inflation**, China and India's low wage production is proving to subdue price levels in the markets in which they compete. However, their increasing demand for energy resources and oil in particular is causing upward pressure on prices in these markets. Although it hasn't yet, such energy price inflation may soon impact on global CPI.
- Regarding **trade**, China and India's growth has led to increased demand for imports which is contributing to growth internationally. China and India's increasing exports are providing cheaper input prices.
- Lastly, regarding **employment**, China and India both possess relatively skilled workforces. Their relatively low wages are leading to increasing outsourcing. This is impacting negatively on nations whose labour is less than flexible.

Questions for Discussion

1. Using a PPF diagram, compare the positions of China, India, the UK and the US's output.
2. To what extent do you think China can replace the US as the engine of world economic growth?
3. Explain the possible impacts of rapid Chinese and Indian growth on world inflation.
4. Chindia's export volumes are growing considerably. Explain the possible impact of such growth on Western exporting firms.
5. To what extent are labour costs the key determinant of Western firms choosing to outsource production to China or India?

Topic 2

How does war affect the global economic system?

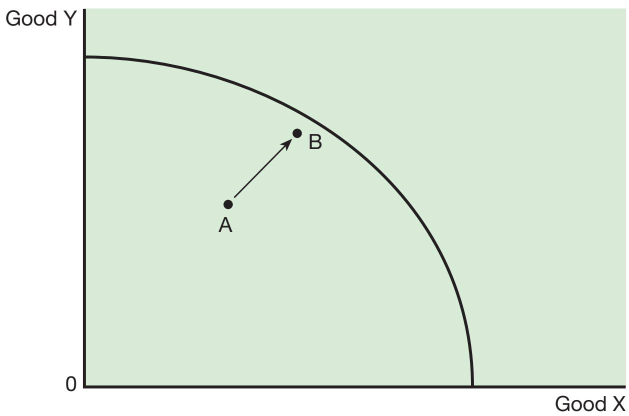
What is war?

War is a general term to describe conflict between two parties. Commonly we think of war as a conflict between two countries but it can be a conflict between two groups of countries e.g. World War II or between two groups within a country e.g. the Rwandan civil war. The extent to which individual economies and the global economic system is affected by war depends on the extent to which each of these countries involved is mobilised in a war effort. This Topic sets out how highly-mobilised war efforts can have positive economic impacts such as increases in employment and real output, particularly if wars come about during an economic downturn. It also argues that when wars require less full-scale mobilisation, as they have in recent years, the net economic effects have tended to be more negative. Moreover, the existence of war, regardless of scale tends to have a positive relationship with international oil prices and a negative relationship with share prices. However, the strength of these relationships are always tempered by a multitude of other price determinants.

Can war be good?

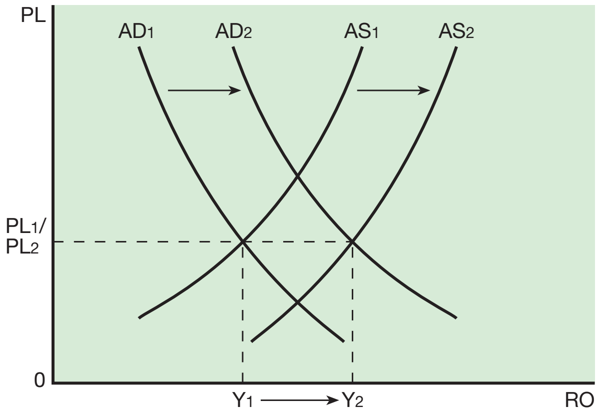
Henry Hazlitt's *Broken Window Fallacy* is a useful starting point to illustrate how war can have a positive effect on an economy.[1] This theory explains that war, like broken windows, will lead to extra business for firms from the Government, greater output and employment and so what may appear to be a drain on economic resources acts as a stimulant and can create a multiplier effect in the economy. Hazlitt's appealing logic is backed up by more conventional economic models of the Production Possibilities Frontier (PPF) and Aggregate Supply and Aggregate Demand.

Figure 1: The PPF



Because World War II helped put an end to the US Great Depression, it has been argued that war can stimulate an economy and achieve economic growth. Significant Government spending in the military provided opportunities for the US armed forces to recruit heavily and give the armament industry the opportunity to expand and employ significant numbers of previously unemployed Americans. Looking at a PPF diagram shown in Figure 1, we can see that since the US's factors of production were more fully utilised, the country could move from their position during the Depression (A) and closer to the frontier (B) resulting in greater output in the economy at no opportunity cost.

Figure 2: AS and AD



Aggregate Supply and Demand analysis illustrates the broader macroeconomic effects of such a Government spending injection into the economy as shown in Figure 2. Firstly, a significant increase in Government spending will shift the AD curve from AD1 to AD2 leading to greater real output and employment. If the economy is at low capacity, as it was in the US during the Great Depression, this growth will arise without inflationary pressure. With more employment in the economy, consumer spending will rise and the other effects of the multiplier are likely to take place. Over time, the AD will shift even further to the right, leading to yet more output and employment. Secondly, the AS curve will be affected. Gearing up for a war effort is likely to see Government spending on infrastructure and the development of industry, increasing the capacity of the economy to produce, shifting the AS curve from AS1 to AS2. Again, this results in greater output and employment and also lowers the price level, staving off the risk of inflation. Thirdly, high production levels in the armament industry are likely to affect the Balance of Payments due to imports of raw materials and trade amongst allies. The net effect on a nation's Balance of Payments is difficult to predict but increased trade is likely to have a positive impact on the global trade.

Is it really all good news?

It is clear that large scale Government injections into the economy can have positive impacts. However, significant borrowing immediately incurs interest which has to be serviced and in addition, '**crowding out**' may be likely to occur. 'Crowding out' occurs if one party borrows extensively from financial institutions, it leaves little else for other domestic business to borrow which may reduce the level of investment in the economy. However, the likelihood of US businesses contemplating expansion during the Great Depression would have been so unlikely that this potential effect would not have been felt.

It would appear that despite the cost of borrowing to fund WWII, the American economy would have benefitted so much from increases in output and employment that the capacity

1. Henry Hazlitt, *Economics in One Lesson*, 2008.

of the economy would have improved leaving it in a healthy financial position to service debts and even pay them off. The growing strength of the USA would have also benefitted trading partners and the global economic system as a whole. Therefore, the impact of highly mobilised war can have positive net effects on the global economy.

Small wars during the good times

The net impact of WWII on the USA economy was positive due to the magnitude of the improvements in unemployment and output. However, we need to consider the net impact of wars in other contexts: when they are small scale and when the countries involved are close to full employment and enjoy high levels of real output. Both the Gulf and Iraq Wars shared these characteristics.

The large scale spending by the American Government into the economy in WWII saw a significant injection to the economy followed by a substantial multiplier since many Americans had jobs for the first time in years which led to substantial increases in consumer spending. The size of Government spending by the USA and the UK during the Gulf and Iraq wars was much less in real terms according to Stiglitz:

> ***"Most analysts put the total costs of the [Gulf] war at less than 0.1% of [USA] GDP, the highest at 0.2% of GDP."***[2]

Therefore the potential of Governments to stimulate their respective economies in a small scale war is much less substantial compared to a large scale war. In addition, the effectiveness of these smaller Government injections has been questioned by Stiglitz:

> ***"Much of that, moreover, includes the usage of munitions that already exist, implying that little or no stimulus will be provided to today's economy."***[3]

Further to this, since neither war required National Service and both the USA and the UK had low levels of unemployment, the impact on employment would appear to be negligible. In addition, since it would appear that involvement in small scale wars does not provide opportunities to increase output or employment as they do in large scale wars, the impact on international trade will be less substantial also. In contrast, the costs of involvement are significant.

As Hazlitt explained in *Broken Window Fallacy*, war leads to extra business for firms, greater output and employment and so what may appear to be a drain on economic resources acts as a stimulant and can create a multiplier effect in the economy. Since increases in output and employment as well as the multiplier effect are unlikely, spending on the war does in fact become a drain. Firstly there is the financial cost.

> ***"Even assuming a considerable drawdown in troop levels, total economic costs of the wars in Iraq and Afghanistan would amount to $3.5 trillion between 2003 and 2017. This is over $1 trillion higher than the recent Congressional Budget Office (CBO) Federal cost forecast for the same scenario, which counted only direct spending and interest paid on war-related debt resulting from that spending."***[4]

2. J. Stiglitz, 'The myth of war economy', *The Guardian*, 22 January 2003.
3. *Ibid*.
4. Schumer and Maloney, *War at Any Price: The Total Economic Costs of the War Beyond the Federal Budget*, November 2007.

Whichever estimate is used, Shumer and Maloney's or the CBO's, the USA is spending a substantial amount of money which will see little benefit to their national output or employment levels. Instead, there will be an opportunity cost in terms of forgone Government expenditure or saving as well as the likelihood of borrowing and the associated interest payments.

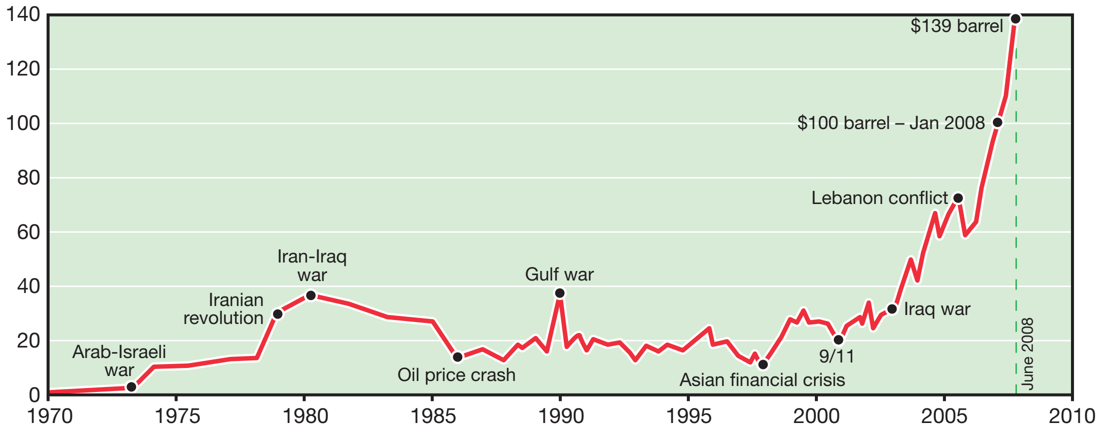
Since the US war in Iraq has generally been funded through borrowing, there is said to be a 'crowding-out' effect on US business investment i.e. since the US government is borrowing extensively from US banking institutions, there are less funds available for US private sector firms to borrow and invest with. However, in recent years the theory of 'crowding-out' has been disputed. Since widespread international capital market liberalisation began in the 1980s, domestic firms have been freely available to borrow from foreign banking institutions if their own domestic firms were heavily lending to the domestic government. Therefore crowding out is not likely to happen as it would have been before WWII. However, bearing in mind the current squeeze in the credit markets as a result of the 2007 sub-prime mortgage crisis, the suggested effects of 'crowding-out' may be realised.

It would appear that the scale of war and the position in the economic cycle are important determinants of the effects of war. The USA benefited from higher output and employment during a large scale war but not a small scale one. Debt servicing and the opportunity cost of war are much starker during full employment when compared to an economy in Depression.

Global impacts

In addition to the effect of war on a national economy, war has wider impacts. The graph below plots oil prices over time and labels significant international wars over the same period. It is clear that it illustrates a strong correlation between the threat and presence of war in oil producing countries and a rise in the price of oil.

Figure 3: Crude oil prices, 1970-2008, US$ per barrel



Source: http://news.bbc.co.uk/1/hi/business/7431805.stm Figures are not inflation adjusted

Supply and demand analysis can demonstrate that disruptions in supply will result in prices rising. If we take the most recent Iraq war as an example, halts to oil production in Iraq since the war began in 2003 will limit the supply of oil to the world market. Figure 4 shows this shifts supply from S1 to S2 to the left, causing the equilibrium price to rise from P1 to P2.

However, the recent Iraq war's impact on prices has been limited; Iraq is only one oil producer out of many internationally so despite the dramatic fall in its own production, the actual effect on world supply is relatively small. In addition, Figure 5 illustrates several influential factors that have been present concurrently with the most recent Iraq war. OPEC quota restrictions and hurricanes in the USA have affected supply while on the demand side, increasing international and Asian demand arguably contributed more greatly to the sharp rise in prices.

Figure 4: Supply disruption

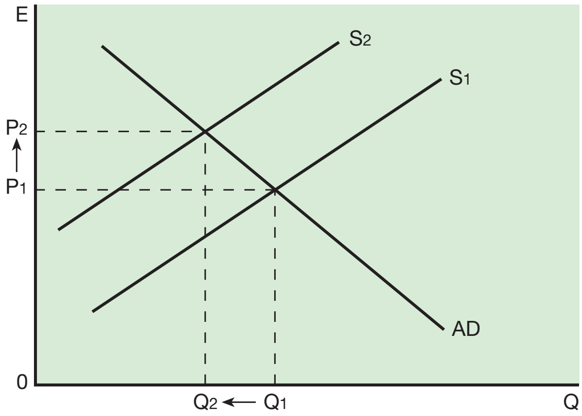
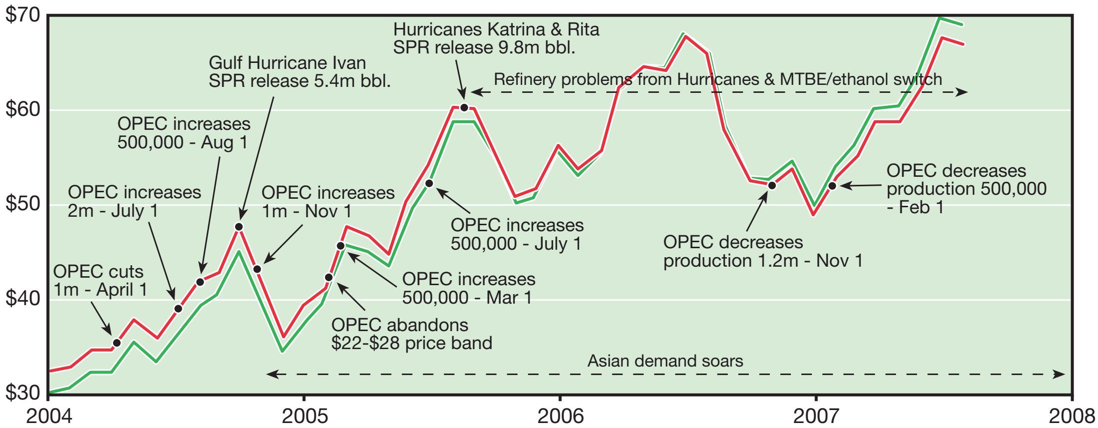
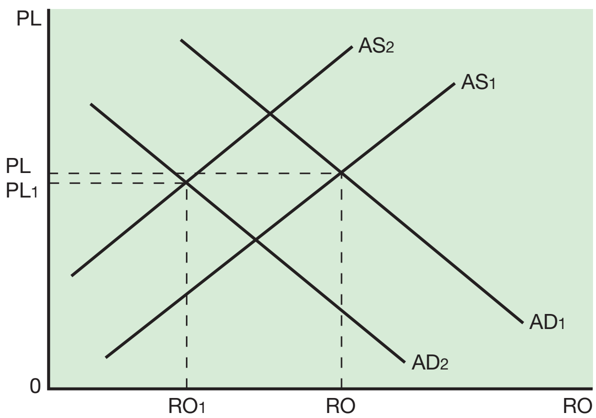


Figure 5: Crude oil price, 2006$ and nominal



Source: http://www.wtrg.com/prices.htm

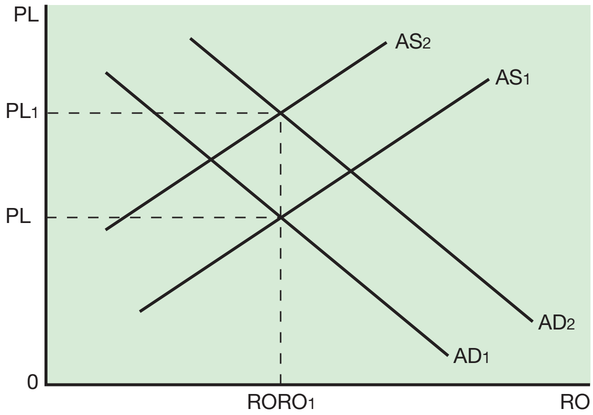
Figure 6: Shifts in AS and AD for oil importers



Despite the existence of a multitude of factors that can disrupt oil prices, war particularly in oil-producing regions does tend to cause upward pressure on oil prices. In terms of the impact on the global economic system, higher oil prices will have differential effects depending on whether countries are net oil importers or exporters. The net oil importers will see an increase in export expenditure and a decline in the Balance of Payments, assuming ceteris paribus.

Since exports are a component of Aggregate Demand (AD = C + I + G + (X-M)), AD will fall from AD1 to AD2 in Figure 6. Coupled with this shift in AD, the increased cost of oil is likely to limits firms' ability to produce and thus limit the economy's capacity shifting AS1 to AS2. The combined macroeconomic impact will be a fall in real output and an indeterminate impact on real prices. Although there may be little inflationary impact, the CPI measure of inflation does include petrol prices and so inflation threats are likely to result.

Figure 7: Shifts in AS and AD for oil exporters



In contrast, the net oil exporters fare better. They see an increase in import revenue and an improvement in the Balance of Payments, assuming ceteris paribus. Since imports are a component of Aggregate Demand (AD = C + I + G + (X-M)), AD will rise from AD1 to AD2 in Figure 7. However, the higher price of oil will still limit domestic firms' ability to produce and thus limit the economy's capacity shifting AS1 to AS2. The combined macroeconomic impact is unclear; there will be an indeterminate effect on real output but the price level will rise.

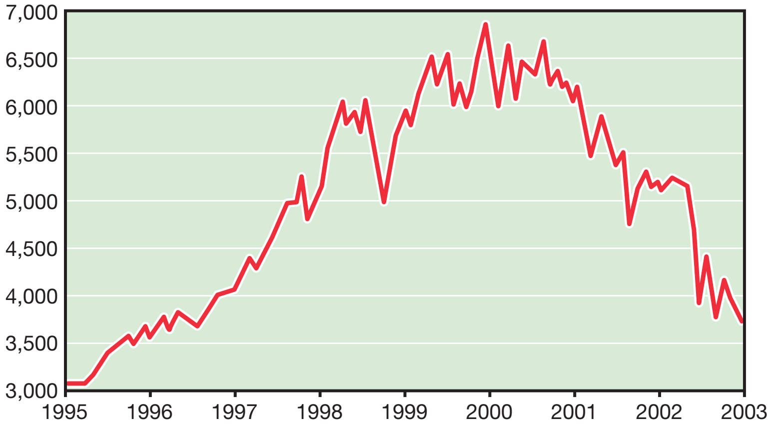
In addition to the oil markets, the financial markets are affected also.

> ***"Markets loathe uncertainty and volatility. War, and anticipation of war, bring both."***[5]

Indeed Stiglitz's arguments are backed up by the performance of the FTSE at the start of the Iraq war. The BBC commented at the time:

> ***"Worry over a possible war with Iraq was the main negative factor driving the market downwards."***[6]

Figure 8: FTSE 100 index, 1995-2003



Source: http://news.bbc.co.uk/1/hi/business/2688731.stm

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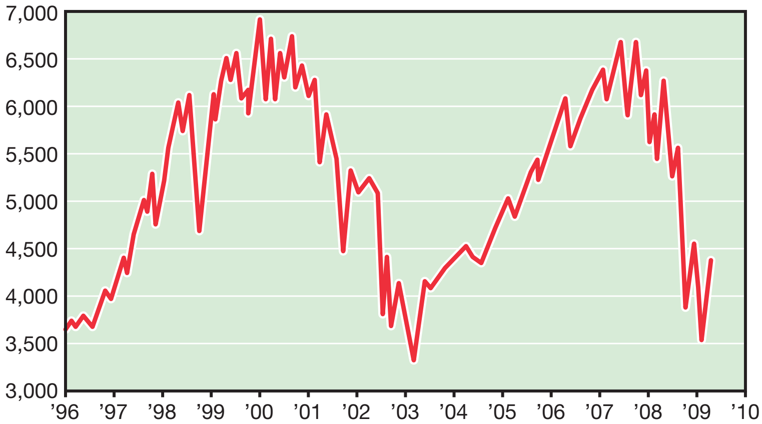
5. Stiglitz, op.cit.
6. BBC News, 23 January 2003, http://news.bbc.co.uk/1/hi/business/2688731.stm

The FTSE Index shows this fall in 2003. Falls in share indices have the potential to have significant effects on economies, if they are sustained. The **wealth effect** describes the theory that when the value of assets (e.g. houses, shares) appreciate, it is likely that asset owners will increase their level of spending since they feel wealthier as their assets have a higher value. Since consumption expenditure is a component of AD, this will lead to an increase in AD and an associated increase in output and employment. The reverse 'negative wealth effect'can happen when share indices and house prices fall. Less confidence in one's wealth and assets will see falls in C and AD. In the UK, consumption expenditure accounts for approximately 60-65% of AD so changes in asset prices as a result of war can have the potential to affect an economy substantially. However, as with oil, there are more determinants to the price of shares than just war, therefore the effects on consumption expenditure will not necessarily be long term. Figure 9 highlights the impact of the decision to go to war with Iraq in 2003 but despite the UK's continued involvement in the war, the FTSE has risen substantially since indicating that war has an effect on share prices but is not the only factor that can have such an effect.

Figure 9: FTSE 100 index, 1996-2008



Source: http://investing.thisismoney.co.uk/cgi-bin/indicator_chart.cgi

Summary

Any war requires substantial Government spending on mobilising the country's war effort. Despite the obvious expense, such spending can have substantial benefits to a country's level of output and employment, particularly if these had previously been low. This was the case in the USA during WWII. It had been suffering from the effects of the Great Depression and the much needed Government injections for the war effort led to a significant multiplier in the economy and the resulting high output and tax revenues meant that the cost of war was not a significant burden to pay off.

The benefits of war spending are not so obvious when the country involved already benefits from high output and employment: such spending does not increase the capacity of the economy and so further output and jobs are not created. This is particularly the case when wars are small scale since they do not require millions of troops and munitions supplies so the impact on output and employment will always be small. As such, the financial burden of war is significant since the Government does not benefit from the effects of the multiplier nor increase in levels of taxation revenue.

War can have substantial effects on the prices of oil and shares. There is a strong correlation between wars involving oil-producing nations and the price of oil rising. However, these price rises are proportional to the relative size of the oil producer and subject to changes if other oil-producing nations vary their output at the same time. There is an impact on share prices but the correlation is less strong than that with oil due to the multitude of factors that affect share prices compared to oil prices.

Summary of the Main Points

- Hazlitt's *Broken Window Fallacy* argues that war, like broken windows, can lead to extra business for firms from the Government, greater output and employment and so what may appear to be a drain on economic resources acts as a stimulant and can create a multiplier effect in the economy.
- WWII's role in lifting the US economy out of a recession provides evidence that a war effort can contribute positively to an economy. Smaller scale wars rarely lead to employment and output benefits that large scale wars do, so in fact the net financial effect of a small war is often negative.
- Depending on the location of the war, it can lead to shocks and price hikes in the oil market. Changes in this market tend to have more severe repercussions internationally compared to other markets.
- War can affect confidence and investment. The FTSE 100 was particularly affected by the UK's decision to enter the Iraq war in 2003.
- The net effect of a war will depend on the scale of involvement from the domestic government.

Questions for Discussion

1. Using AD/AS analysis, explain why involvement in a war can lead to positive macro-economic outcomes.
2. Using data from this Topic, explain the impact that involvement in the Iraq war may have on the US's public finances.
3. Using supply and demand analysis evaluate (a) the impact that war may have on oil prices, and (b) the impact that war may have in share markets.
4. Evaluate whether war can have a positive impact on the world economy.

Topic 3

The global credit crunch

> ***"How stable is an economy where the twin engines of growth are consumer debt and the speculative activities of the City?"***[1]
>
> ***May you live in interesting times…***
>
> A Chinese curse, anon

Introduction

Chancellor of the Exchequer Alistair Darling has done nothing to dispel the fact that the world economy faces unprecedented challenges both in the immediate future as the banking crisis continues, and over the next few years. In the summer of 2008 he claimed that the economic times faced by Britain and the rest of the world "are arguably the worst they've been in 60 years". He added, "And I think it's going to be more profound and long-lasting than people thought."[2] Inflation was rising and slightly outside government targets but not particularly high in historical terms and the UK had yet to succumb to a recession in technical terms. Since then the UK has had a major contraction of GDP (comfortably fulfilling the recession test!), inflation has begun to fall (though not as rapidly perhaps as expected) and unemployment has begun to rise quickly with more doom-laden talk from various commentators. It would be perhaps most accurate to say then that the present situation presents the most uncertain outlook for a considerable time – will the economy quickly recover, towards the end of 2010 as the government hopes? Or will we enter into a depression akin to the Great Depression. The Bank of England's Governor, Mervyn King, has been encouraging all visitors to the Bank to purchase and read John Kenneth Galbraith's *The Great Crash*, about the inter-war economic crisis which the present situation has been compared to. This Topic will attempt to unpick some of the complexities of the present situation and look at some of the root causes of what has come to be called the global credit crunch.

Historical context

The financial sector of the economy, up until the late 1970s, was one of the most heavily regulated sectors in the economy. As part of a general drive to free up 'market forces', by the Thatcher government of the 1980s, there were a number of laws passed to deregulate this sector. It may be too simplistic to blame this deregulation for the present difficulties the banking sector faces – after all the economy has enjoyed a long period of economic growth, part of which at least may be attributed to the UK developing a role as a financial hub. Nor can this be a party political argument – the former head of the Financial Services Authority Lord Turner implied in his review of regulatory practices published in March 2009 of the

1. Larry Elliott, *The Guardian*, 17 September 2007 (at the time of the collapse of Northern Rock).
2. *The Guardian*, 20 August 2008.

pressure placed on him to adopt a 'light touch' in the FSA's approach to the regulation of the banks such as HBOS. Indeed, Gordon Brown himself spoke openly in such terms in the mid-part of the decade.

The net results of this process of loosening the city's shackles were aggressive, now seen as reckless, lending and ever-more complex financial assets, more of which below.

A bridge too far – American sub-prime mortgages

The catalyst, if not the underlying cause, of the present financial crisis has been attributed to structural problems in the US housing market. In essence major mortgage lenders in the US were engaged in ever riskier and riskier lending. This included practices such as lending more than the value of the property being purchased e.g. 125% mortgages, riskier income to mortgage ratios and increasingly less stringent documentation having to be presented to acquire a mortgage. Mortgagees with poor or no credit history were also lent huge sums without a great deal of caution on behalf of the lenders. These practices became particularly problematic as the economy began to slow down in the US and house prices began to stagnate. As people defaulted on their mortgages any assets the lenders might repossess were often worth less than the remaining debt. In fact all these practices were also common in the UK with HBOS seen as perhaps the most culpable in creating home grown sub-prime debt.

Much sub-prime US debt was 'repackaged' into investment vehicles which were bought up happily by UK and other countries' financial institutions, hence the spreading effect of so-called 'toxic debt'. The reckless nature of some US financial institutions can be seen in the sorry story of Lehman Brothers. Just prior to its demise it was 'geared' to the tune of roughly 85%. This means that its borrowing represented 85% of the value of the company, far above an acceptable healthy gearing ratio. The other transmission mechanism from the US financial sector to the UK's financial institutions and thus UK economy has been the drying-up of global liquidity. The liberal nature of global finance has meant that a number of banks' business models were built on the ability to lend from other banks and institutions. Northern Rock, the first domino to fall, had grown rapidly in the UK based on a business model which involved heavy lending from world capital markets. When such lending began to be less and less available as banks began to view debt and each other more cautiously, this business model was exposed – the bank did not have enough liquidity to satisfy either its customers or investors of its long-term viability. The time-line of events leading to Northern Rock's nationalisation in February 2008 is shown in Figure 1.

Figure 1: Northern Rock share price, January 2007 until suspension

Source: Bloomberg, adapted from BBC website, 18 February 2008

Short-selling

Many of the initial steepling falls in bank share prices, particularly that of HBOS, were exacerbated by the practice of short-selling. Short-selling, very simply, involved one investor borrowing shares from another investor for a fee. The short-seller then sells those shares in the hope that they will fall. When they fall they will then buy back the shares at the lower price and return them to the lender. In essence the short-seller is gambling on the price of a share falling, and if this gambling is being carried out on a large scale, any fall in a stock price is exaggerated. There is obviously an incentive here for short-sellers to 'talk down' a stock, and there is some evidence to suggest that HBOS' rapid fall was caused in part by a malicious rumour spread by a hedge fund. This is illegal but very difficult to prove.

Government responses

Government responses to the 'crunch' have been varied but in general terms have recognised the scale of the global crisis and have therefore intervened on a suitably massive and unprecedented scale to support the banking sector and prevent total meltdown. Gordon Brown made efforts at the G20 summit in London in early April 2009 to co-ordinate a global response to the global financial crisis, with some success. The key outcomes from the summit can be summarised as follows:

- US$500 billion for the IMF to aid struggling economies
- US$250 billion to boost world trade
- US$250 billion for a new IMF overdraft facility
- US$100 billion to assist international development banks in lending to poor countries.

These outcomes were achieved despite some differences between the US and UK on the one hand and Germany and France on the other. In essence the mainland Europeans were pushing for stricter regulation and less fiscal stimulation whilst the transatlantic partners were pushing the fiscal package hard.

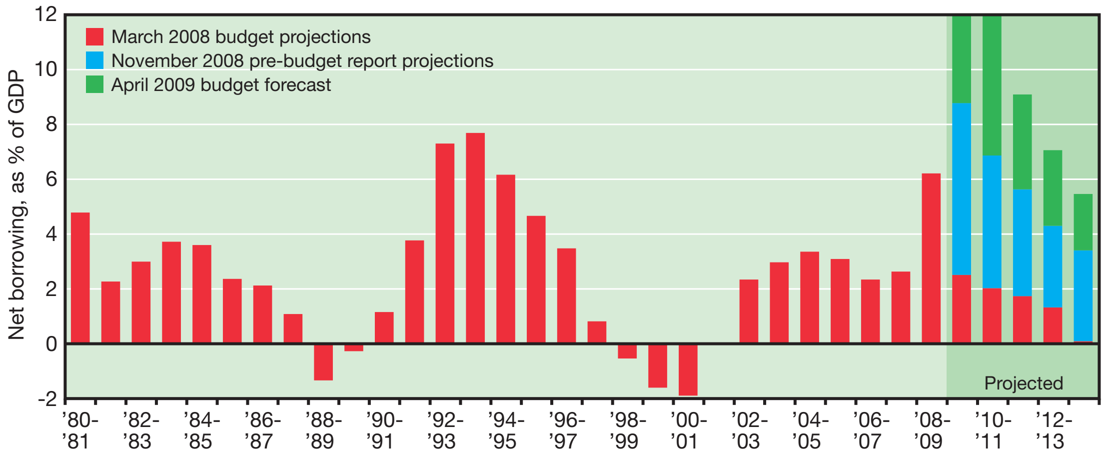
The US's initial response had begun with the bail-out of the two biggest mortgage providers in the US, the colourfully named Fannie-Mae and Freddie Mac for an estimated $200 billion. The stimulus package which passed successfully through Congress pumps a further $819 billion into the US economy through a combination of tax cuts and increases in government spending. In the UK the government's involvement began relatively earlier with the nationalisation of Northern Rock. Subsequently there have been other bail-out measures, including the 'shotgun marriage' of HBOS and Lloyds which has subsequently led to Lloyds being 'pulled under' by HBOS' debts and now being effectively taken over by the government as well. There has also been some understandably angry debates about the sizes of the bonuses for some of the executives of the failed banks, particularly the outgoing RBS Chief Executive Sir Fred Goodwin. The government also cut VAT as a temporary measure in an attempt to stimulate consumer spending.

The aim of the government measures is two-fold. To prevent the failure of the banking sector but also an old-fashioned Keynesian injection of government spending to boost aggregate demand.

The most recent budget in April 2009 begins to lay out what the hangover will be like following the bail-out (and also the underlying trends of large-scale consumer debt and expansionary fiscal policy). Even without the UK government's optimistic growth projections the government accounts do not look good. If growth projections and thus tax revenues are less than anticipated the deficits and public debt levels detailed below could be even worse. The government has begun to demonstrate how it will begin to balance the books with the introduction of a new top rate of tax of 50% above earnings of £150,000. However it has not yet clearly indicated but merely hinted at where the axe will fall in terms of reining in public spending.

The long-term effects of these measures are obviously unknown. With some certainty we can say that the governments own balance sheet does not look healthy and that vastly increased spending coupled with falling revenues will lead to some combination of debt, public sector spending cuts and tax rises in the future. The Office for National Statistics indicated that debt as a proportion of GDP rose to 47.8% in January 2009 the highest level since 1978. Projections of the size of budget deficits in the next five years are much higher still as shown in Figure 2.

Figure 2: UK budget deficits



Source: HM Treasury

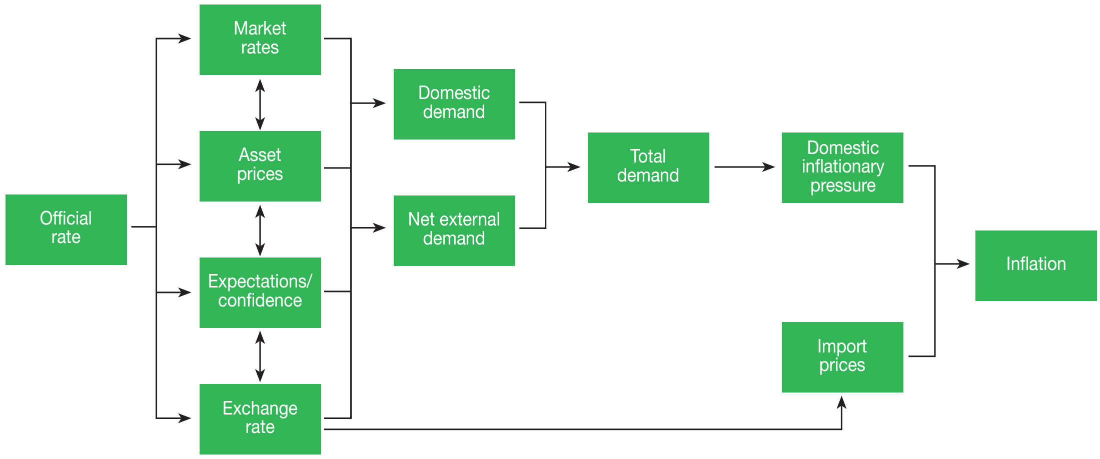
The role of the Bank of England

Interest rates have fallen dramatically to unprecedented levels in the UK. However this has not yet led to falls in market rates as banks have not passed on these rate cuts to consumers. We will now look at why this is and how monetary policy is supposed to work in 'normal' times.

A **transmission mechanism** in economics refers to how, when a variable is changed, it affects other variables on the way to affecting the variable it wishes to change. The Bank of England believes inflation is affected by interest rates via the transmission mechanism as shown in Figure 3. The whole process is seen to take roughly eighteen months, from the change in the base rate to the desired impact on inflation. The aggressive cuts in interest rates in recent times are based on the premise that without such action, inflation is in danger of falling below its 1% floor (remember the Bank's 2% target for inflation + or – 1%) in the future.

There are fears now that this transmission mechanism has broken down. Most obviously changes in the Bank's official rate are not affecting market rates in the desired manner. Normally a change in the base rate will be followed by a similar adjustment to the London Inter-Bank Offered Rate (LIBOR). This is, in effect, the rate at which banks are prepared to lend to each other. All banks, to a greater of lesser extent depend on this money market to create their own loans. The lack of confidence between banks following the numerous bank crises of the last 6 months has meant that such lending remains highly conservative and the LIBOR rate has remained stubbornly and significantly above the base rate, reflecting the increased risk banks see in lending to each other.

Figure 3: From interest rates to inflation – the transmission mechanism of monetary policy

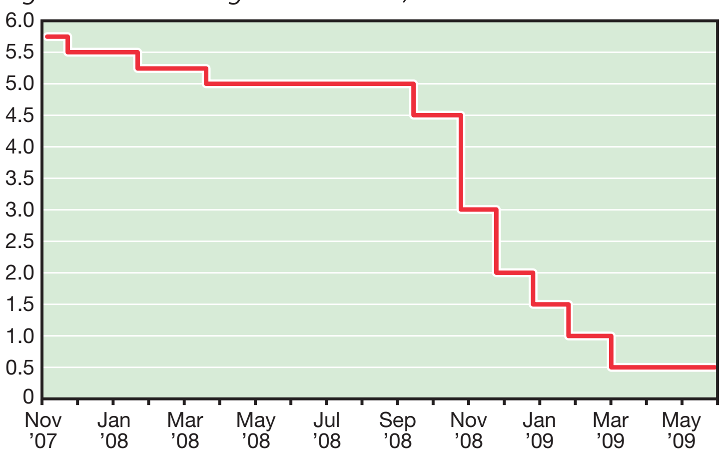


Source: The Bank of England's web-site, April 2009

For consumers this means that rates for personal loans, mortgages etc. remain relatively high (at least compared with the base rate). This then affects other variables in the transmission mechanism, importantly asset prices (house prices) and, most importantly, confidence. Very simply the base rate changes are not leading to increased liquidity in the economy, loans remain expensive and hard to come by, and the contraction in the economy is therefore not being affected by any positive demand-side effect of the base rate cut.

The unwillingness of banks to lend at lower rates has led the Bank of England to undertake the unprecedented measure of what it calls '**quantitative easing**' – in effect printing money. This is normally associated with corrupt and bankrupt governments and hyperinflation (see Germany between the wars and present-day Zimbabwe). However in the present banking crisis it is increasingly supported by a broad range of economists, although not all. Quantitative easing in effect involves the creation of new money by the Bank of England which banks can then use to create loans etc. It was given the go-ahead to inject £200 billion worth of 'new money' into the economy through the banking sector.

Figure 4: Bank of England base rate, %



Source: Bank of England

All this is being done as fears rise over the prospect of deflation. Deflation means in effect that prices are falling throughout the economy. If this were to occur in the UK it would send out incentives to save and not to spend which could potentially worsen any recession. As prices fall, money increases its purchasing power. This, you would think, might increase consumption. However if people have future expectations of deflation, then they have a strong incentive to, in effect, wait and see if prices fall further, thus giving them even greater purchasing power. Likewise as prices fall loans become increasingly onerous as their value increases in real terms.

The Quantity Theory of Money and the Fisher Equation

Quantitative easing has been backed up by the theoretical insights of what is known as the Quantity Theory of Money. This theory was first developed by the economist Irving Fisher. It is a very simple theory which basically says that the amount of money in the economy, multiplied by the amount of times that money circulates round (in effect changes hands), is equal to the price level multiplied by the number of transactions in the economy. In short:

$MV = PT$

Where:

M = money supply
V = the velocity of money
P = the price level
T = transactions (or real national income)

The present crisis has been interpreted by some as being caused by a fall, due to the credit crunch, of the velocity of money. Banks are, in effect, keeping hold of cash rather than lending it (as are businesses) and the money supply is not moving freely around the economy. This is then leading to a falling price level and falling national income (inflation and real GDP are both falling. This is where quantitative easing comes to the rescue. If V is, indeed falling, as evidence seems to suggest, then increasing M, through the process of quantitative easing might help to increase P, thus fending off deflation, and T, thus easing the effects of recession.

Conclusion

The UK faces a major challenge in terms of its strategic direction. The dominance of the City, both in terms of the UK economy and its role as Europe's financial hub are threatened by an era of increased regulation. Tighter regulation would lessen the opportunities for innovation in financial products and services which has attracted investors to the City over the last fifteen years or so. The economy generally has benefited in terms of this investment as city wealth has 'trickled down' into the broader economy. The end of the 'light touch' might force us as a country to ask ourselves a very difficult question of – where now lies the UK's comparative advantage?

The threat of a 1930s style global depression may be over-stated. There are without question similarities between the two eras, with a credit bubble, bank failures etc. but there are also important differences:

1. President Obama is not of the same outlook as President Hoover. The American president at the onset of the Great Depression was committed to small, laissez-faire government and hence was opposed to any government intervention in the economy.
2. China may save us! At the time of the Great Depression the US was head and shoulders above other economies in the world. The growth of the Chinese and Indian economies

means the economic world is more balanced. The Chinese economy, although beginning to slow its rate of growth, may still provide an alternative engine for global growth whilst the US encounters the painful effects of the collapse of its housing and financial markets.

3. Countries are not engaging in protectionism. Despite some mild rhetoric during his successful electoral campaign, the US is unlikely to put up major barriers to trade, and nor is the rest of the world.

It is very clear that the UK economy will undergo a painful contraction over the next year. Unemployment will continue to rise and inflation may well dip below its base level of 1% for a short time. However, given the continuing excess demand in the housing market, as credit begins to ease during the latter part of the year, the housing market should soon pick up, leading to increased levels of consumer confidence and a positive growth by the middle of 2010.

Summary of the Main Points

- The root cause of the credit crunch can be seen to be irresponsible lending by banks.
- In the US sub-prime lending triggered major problems in the US housing market. Problems in the housing markets fed in to the financial sector in part through the packaging of debt and debt insurance into complex financial assets called derivatives.
- The credit crunch has been global in nature due to the interdependent, deregulated financial markets.
- The authorities in most Western economies have responded to the crisis with a major fiscal stimulus and aggressive cuts in interest rates.
- Already there have been severe effects on the 'real' economy, with major Western economies falling into sharp recession.

Questions for Discussion

1. Explain how problems in the US housing market led to problems in the UK's banking sector.
2. How do changes in the financial markets ultimately lead to changes in the 'real economy'?
3. What is the LIBOR rate? What are:
   (a) short-selling?
   (b) quantitative easing?
4. Why have banks not passed on the Bank of England's base rate cuts?
5. Use AD/AS analysis to try and model the effects of the UK's recent fiscal package of government spending and tax cuts. Will it be successful? How will we know? What factors will affect its success/failure?
6. What are the possible impacts of rising government debt?

Topic 4

When the US sneezes does the world catch a cold?

How fundamental flaws in the US economy can hamper global economic growth

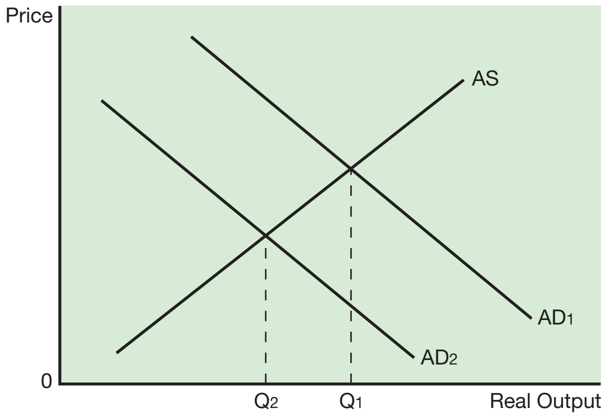
The American economy has come to the end of a period of sustained economic growth. The debate is now how long the US recession will actually be and when and if the economy will return to the healthy growth rates of the Clinton era and the early part of the Bush administration's tenure. The questions this Topic will attempt to answer are what has led the US economy into the present difficulties, how able it is to weather this period of greater challenge and the impact of these uncertainties on the global economy.

How a recession in the US affects the world economy

In economics we talk about transmission mechanisms – in essence the links which lead to one macro-economic variable affecting another. So what exactly are the connections between the US economy and other economies?

A simple approach is to use the familiar AD/AS model. If the US economy was to slow down, then the US would be likely to import less from the rest of the world. The sheer size of the US economy and the huge scale of its current account deficit mean that this could potentially have a significant impact on other economies. Very simply the X-M element of countries which export to the US will worsen, potentially shifting the AD curve in as shown in Figure 1.

Figure 1: A leftward shift in AD



For most countries this is small, relative to other factors such as consumption, investment etc. but should not be seen as insignificant; countries such as Japan and Germany and more recently China and India have grown rapidly following the injection of a positive export element into the circular flow of income.

However, this is dependent on:
- whether the US and the country concerned have high trade volumes with each other
- the size of the X-M element of AD relative to other factors such as investment, government spending etc.

Having said that, even if the one country has relatively little trade, it may trade with countries for whom the US is a major trade partner; they will therefore be negatively affected, albeit in a less direct manner. According to Keynesian theory, these impacts are also likely to be multiplied within the economy concerned. Tables 1 and 2 show the USA's main trading partners for both imports and exports.

Table 1: Main destinations of US exports

US export partners	**Percentage of US exports in 2008 (2007 figures in brackets)**
Canada	20.1 (21.4)
Mexico	11.7 (11.7)
China	5.5 (5.6)
Japan	5.1 (5.4)
UK	4.1 (4.3)

Source: www.cia.gov/library/publications/the-world-factbook/

Table 2: Main sources of US imports

US import partners	**Percentage of US imports in 2008 (2007 figures in brackets)**
China	16.4 (16.9)
Canada	15.7 (15.7)
Mexico	10.1 (10.6)
Japan	6.6 (7.4)
Germany	4.6 (4.8)

Source: www.cia.gov/library/publications/the-world-factbook/

As is evident from the Tables, the countries most linked to the US by trade are their fellow members of the North American Free Trade Association (NAFTA) – these countries are therefore most likely to 'catch a cold' from any US downturn. Of these, Canada has entered into recession albeit not as steep a recession as the US, perhaps due to its bank-lending practices being far more cautious. As a recent article in *The Economist* pointed out, even when the credit crunch was at its worst in January 2009, all of Canada's big five banks were still in profit.[1] Mexico looks to face a much bigger impact, with latest growth figures showing a contraction of -1.6% (annualised growth figure in quarter 4 of 2008. Projections for 2009 are even worse, with the Mexican economy estimated to shrink by -4.4 % compared with -2.9 % in the US.

Interestingly this data indicates that China could also be significantly affected by a US downturn, and this could have knock-on effects on other parts of the world economy which have been buoyed by rapid Chinese growth. One can also see here how the American recession has been transmitted to the European Union; not through any 'special relationship' or interdependence with Great Britain, but more probably via Germany, as German imports to the US declined in value, with subsequent multiplier effects taking place within the US economy.

Table 3 shows the differing exposures of countries to the shrinkage in world trade by looking at the size of their current accounts and the proportion of GDP taken up by current account. The data in Table 3 highlights the differing degrees to which countries are affected by slumps in trade, a factor which partly explains the projections of a much severer recession in Germany

1. *The Economist*, 16 May 2009.

as compared with the UK, despite the UK, with its reliance on financial markets, facing the initial brunt of the credit crunch. The UK is projected to shrink by – 3.7 % in 2009 compared with Germany's -5.2% and Japan's -6.4%.[2]

Table 3: Current accounts for seven countries

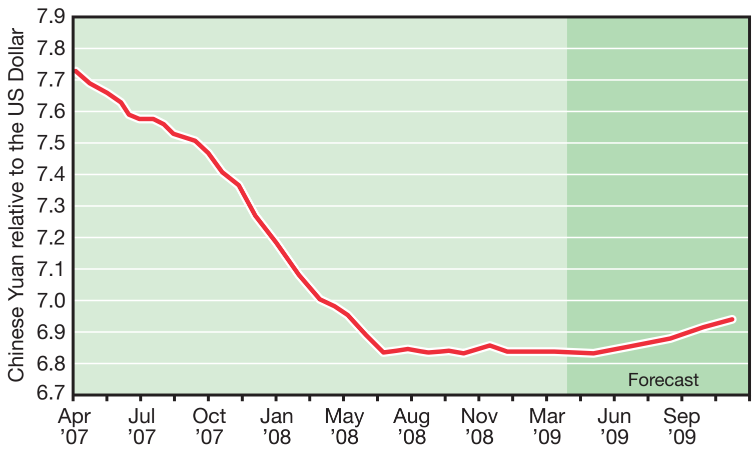
Country	Current account in $bn	Current account as a proportion of GDP
US	-673.3 Q4	-3.3
Japan	+131.8 Feb	+1.6
China	+400.7 Q2	+6.9
UK	-44.6	-1.7
Germany	+206.2	+4.4
India	- 37.5	- 3.0
Russia	+75.4	-1.1

Source: *The Economist*, 9 May 2009

The US current account – sources and effects

One of the reasons why the US recession is viewed with both trepidation and uncertainty is the sheer and unprecedented size of the US current account deficit. The US, it seems, has an insatiable demand for exports from around the world, particularly over this period of economic success, and the fear is that the downturn will lead to export sales drying up for the main exporters to the US.

Figure 2: Chinese Yuan to US Dollar currency exchange rate, past trend, present value and future projection



Source: The Financial Forecast Center – www.forecasts.org

This current account has been fuelled by the economic growth of the last two decades, the consumption boom facilitated by cheap credit and a strong dollar relative to economies such as China. The current account in May 2009 stood at roughly $761 billion dollars a huge figure compared with other countries. This in part reflects the countries propensity to import which with a weakening economy is likely to lessen, leading to exporting countries being left exposed. In recent years the strength of the dollar relative to far Eastern countries has been managed in part by the central banks of countries such as China, who have bought American bonds and other financial assets to keep the yuan relatively low with respect to the dollar. Indeed China

2. *Ibid.*

is comfortably America's largest creditor. Through its central bank and through other, murkier intermediaries Chinese authorities purchases of American liabilities have held up, even despite the global downturn and some major losses (China was exposed in a significant way to the debts accumulated by the discredited US mortgage giants 'Fannie Mae' and 'Freddie Mac'). This policy of keeping the dollar 'artificially high' against the yuan has hardly been popular with US authorities who feel pressure on the Chinese and others to allow the dollar to fall have not met with a great deal of success.

As Figure 2 shows (but do note the axis somewhat exaggerates the movement of the yuan) in recent times the yuan has been fairly stable against the dollar and in no way reflects the shifting terms of trade between the two countries. This is because of the active management of the yuan by the authorities.

The political dimension

There is some evidence to suggest that the US could be moving away from its historic role as the 'defender of free trade'. Although some LDCs may at times doubt the USA's commitment to free trade (or doubt the existence of a level playing field in trade negotiations) there is no doubt that the WTO and its predecessor the GATT have had most impact in reducing trade barriers when America has chosen to throw its weight behind the cause. The 2008 election campaign saw President Obama and his Republican opponent John McCain both make stump speeches that seemed to hint at a movement towards greater protection. At least during his primary campaign Obama rhetoric seemed to indicate a protectionist bent, although this may have been simply to appeal to states such as Michigan which have seen major job losses as a result of globalisation. In office and certainly within the media-hyped first 100 days, there has been little evidence of a definitive movement towards greater protection in terms of tariffs, quotas etc. Bank bail-outs and support for the stricken car industry might, in a different context, also be viewed as protectionist but at the moment do not face much world opposition given the greater fears of a prolonged US downturn.

A significantly more protectionist US administration would be likely to lead to retaliatory protection from other major players such as the European Union (consider previous spats over steel, bananas etc.). This scenario is, however unlikely, with successive US administrations, no matter what their 'commitments' on the campaign trail, tending to see little alternative to the global system of free trade developed over the last sixty years or so. Thus far President Obama seems likely to pursue this same course.

How bad will the US recession be?

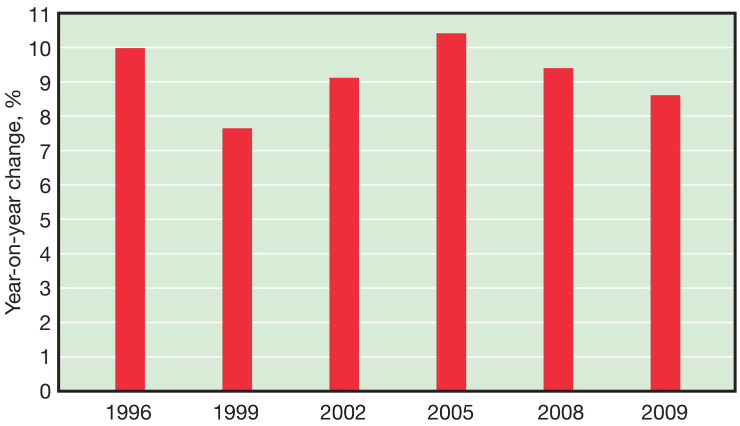
At the time of writing in May 2009, the US economy is still struggling with the after-effects of the puncturing of the US housing bubble and the subsequent banking crisis. '**Bubbles**' are often referred to in financial journals and in effect simply mean unsustainable rises in the price of a commodity or financial asset, often fuelled by speculation and a desire for a 'piece of the action' as prices seem to rise and rise inexorably – another such 'bubble' was the so-called 'dot.com' bubble whereby huge speculation on very new and untested internet-based firms led to massive increases in their prices and an eventual crash. It seems all good things come to an end, and in America, one major cause of the recession has been the collapse of the US housing market. House prices have fallen, new builds are not taking place and mortgage loans have proved scarce, despite the aggressive cuts in interest rates by the Federal Reserve Bank (the US equivalent of the Bank of England). The trigger for this decline, as detailed in the previous Topic, was the issuing of so-called sub-prime mortgages – in effect financial institutions lending funds to people with poor credit histories. As a substantial number of these loans became 'bad loans' leading to housing repossessions etc. this fed into the housing market more generally – 'sub-primers' may have been occupying the bottom rungs of the housing ladder but this had allowed their vendors to move up the housing ladder, and so on. As house prices fell, this led to American consumers feeling less wealthy as their main asset falls in value – a so-called **negative wealth effect**. This has further impacted on consumer spending and confidence – hence the fact that the American economy has slipped into recession.

Linked to this has been the drying up of global credit. Despite concerted action by central banks around the world, with massive bail-out packages and an unprecedented loosening of monetary policy, there has still been a sharp fall in global liquidity (liquidity meaning simply money available in an economy). Inter-bank lending, one of the key factors under-pinning the consumer boom in the West, slowed sharply as banks became more cautious. This entirely understandable caution (with the widespread banking crises in the US and the UK) has led to talk of greater regulation by the financial authorities. This in large part is a case of closing the stable door after the horse has bolted. The regulation may stop reckless lending by banks in the future but cannot impact on the bad loans which have already been made which are now causing banks to tighten their belt. Even now there are concerns, a year on from the start of the crunch that there may be further effects of the 'crunch' as complex derivatives begin to unravel.

There is a direct linkage here between the UK and US economies whose financial sectors are closely linked through flows of capital back and forth through the money markets. The credit crunch in the US has therefore affected UK liquidity and pushed the UK into major recession.

Decoupling

Figure 3: China's GDP growth



Source: www.chinadaily.com

As described earlier, economies would be affected in a variety of ways by a US recession. The other signatories of the NAFTA (Canada and Mexico) would suffer the greatest impact perhaps whereas other countries will be affected in a variety of ways. There is also evidence in recent years of countries lessening their reliance on the US as a destination for their exports.[3] As

3. *The Economist*, 6 March 2008.

economies such as Russia and China have become stronger and begun to develop a broader range of industries and markets, their reliance on export sales to the US has lessened. Their own domestic consumption has increased and they have begun to export to each other. For example 95% of China's 11% increase in GDP in 2007 was made up of increases in domestic consumption. China's exports grew by 5% to US markets but by a whopping 60% to other emerging markets. Having said all that, in the present global climate Chinese growth has already dipped to its lowest level for nearly ten years. Figure 3 shows the expected fall in the growth rate for 2009.

The decoupling effect has perhaps been over-stated, and will perhaps be more evident in future recessions. However the growing strength of China and the other countries in the so-called BRIC group (see Topic 5) are likely to provide alternative engines for world growth in future decades.

An American recession will undoubtedly have negative impact on world economic prospects, at best slowing world growth and at worst leading to a world recession. This impact will be varied with some countries exposed to an American slowdown more than others. Although America's economy is still the largest in the world, other emerging economies have become increasingly influential, as detailed in another article in this pack.

Summary of the Main Points

- The likelihood of a US recession has increased in recent times and the impact of such a slowdown will vary from country to country.
- Other emerging economies such as China and India are increasingly important in determining world economic activity.
- The extent to which countries are affected by the US economy is linked both to the proportion of their exports which are sold to the US and the size of their trade sector relative to GDP.
- The size of any impact on other economies will depend on other factors such as the size of the multiplier effect and the stance of domestic monetary and fiscal policy.

Questions for Discussion

1. Identify the ways in which a recession in the US can impact on other countries economies. Which are most likely to impact on the UK? Why?
2. Explain how the emergence of economies such as China and India may lessen the impact of an American recession on world economic growth.
3. What strategies have the US authorities used to lessen the impact of a US recession? How successful are they likely to be? Why?
4. Explain the process whereby a crisis in the US housing market has impacted on the UK economy.
5. What is meant in economics by a 'bubble' e.g. the housing market bubble?

Topic 5

The economic transition of Russia: Should the West be worried?

"I cannot forecast to you the action of Russia. It is a riddle wrapped in a mystery inside an enigma: but perhaps there is a key. That key is Russian national interest."[1]

Since the dismantlement of the former Soviet Union the Russian economy has endured considerable trauma as it has moved from being a monolithic command economy to a free-market, although one would hesitate to say Western-style, economy. Some would argue that the Soviet Union's version of communism was a far cry from what Marx himself had anticipated as the utopian society. Likewise the free-market economy that is emerging from the remains of a Cold War superpower is not perhaps quite the free-market ideal that its backers in the West anticipated. Should the West be worried about growing economic strength of Russia? – this Topic will attempt to examine this question.

What is transition?

In economics we often hear reference made to **transition economies**; those that are making the often less than linear journey between **command** (centrally planned) economies, to **free-market** (laissez-faire) economies. Russia is one of the largest economies to embark upon this somewhat rocky road. The process of transition can be said to involve four aspects:

1. Privatisation of formerly nationalised industries

This is a process that should be familiar to anyone who has studied recent UK economic history. Industries that were formerly under state ownership (owned/run by the government) are moved into the private sector through their sale, typically on the stock exchange although also in some cases through workers in the industry being given stocks and shares in the newly private corporation. Unfortunately, unlike the relatively orderly process in the UK this process was chaotic and bedevilled by corruption. The process was also on a much bigger and less manageable scale than that which took place in the UK. The UK in the 1980s was already very much a **mixed economy** with a private sector and a stock exchange both well-established over centuries. Russia and the other constituent parts of the old Soviet Union had been centrally-planned, state-owned **command economies** and as such the privatisation process presented a much greater challenge. Also, the pace of change, encouraged by the International Monetary Fund and other influential bodies and countries, meant that Russia's new and weak political and institutional framework proved unable to develop an effectively managed process of change, leading to widespread corruption, with much of the economic infrastructure of the new Russia ending up in the hands of super-rich (and very powerful) economic 'barons' referred to as oligarchs.

1. Sir Winston Churchill, radio speech 1939.

2. The establishment of a legal framework to protect private property

Economics theories concerning **property rights** have increased in terms of influence greatly in recent decades. The Russian experience of attempting to develop enterprises without adequately protected property rights provides a useful case study in this area. With the breaking up of the old Soviet state in which common ownership was the order of the day almost overnight private property became the dominant mode of ownership. Unfortunately without an established legal framework and with the criminal justice system in transition, if businesses wanted to protect themselves from theft they tended to, and continue to tend to, employ the services of organised crime members who have flourished in the vacuum left by a weak state. In local parlance, a business has had to employ the services of a krysha (literally a 'roof') if it wishes to operate without interference from the criminal fraternity. This has been one of the many difficulties attached to operating a successful business in Russia in the post-Soviet era and has led to Russia being graded as a country that is relatively high-risk to invest in.

3. Market deregulation

A key aspect of any free-market economy is the openness of markets to new competition and a robust legal framework in competition law to support this transition. Unfortunately given the lack of effective state institutions in Russia this has not been altogether successful. Markets may have been deregulated on paper but are still burdened by both regulation and the predatory activities of organised crime.

The World Bank ranks the Russian Federation 120th out of 181 countries it rates in terms of 'ease of doing business', below such countries as Nigeria, Lebanon and interestingly many of the other countries of the former Soviet Bloc.[2]

4. Free trade and the deregulation of capital markets

There has been a significant opening up of the Russian economy to international trade and also, in more recent times, substantial increases in foreign investment as the political economy has stabilised under the Putin regime. Significantly for international confidence in the Russian economy, Russia has largely paid off its foreign debt. This has improved the credit-rating of the Russian economy as a whole although some uneasiness remains about the ease of doing business in Russia. Firstly stability has come at the price of an increased stifling of personal freedoms, which the Nobel Prize winner Amaryta Sen has argued is one of the key factors in determining long-term growth. Secondly, as outlined earlier, there is still rampant corruption in the former Soviet Union, with numerous extra costs associated with paying off various officials and the cost of 'protection' increasing firms' costs significantly. The Russian state under Putin also engaged in the seizure of assets owned by oligarchs who had fallen from grace which can hardly add to a sense of confidence in the safety of long-term investments from abroad.

The pain of transition

The Soviet Union may have lacked the efficiency and dynamism of the Western free market economies, particularly as those economies became more complex in the latter part of the twentieth century. However from the point of view of its citizens the Soviet Union did provide a fair degree of social security. Jobs were guaranteed as was a certain basic standard of living, with access to healthcare, education, housing, food etc. guaranteed by the state. The transition to a 'western-style' free-market economy meant considerable hardship for many Russians,

2. www.doingbusiness.org/EconomyRankings.

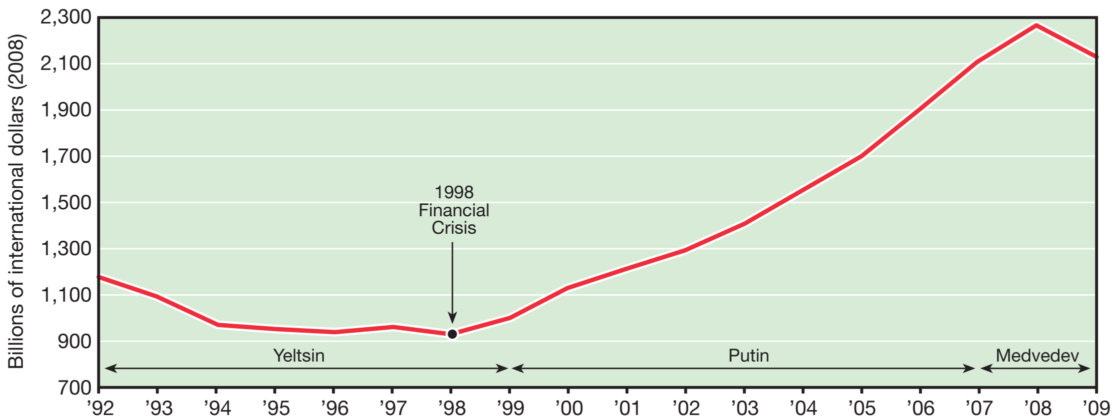
with unemployment peaking around the turn of the millennium. Although figures are notoriously inaccurate, most estimates would say these rates were at least into double digits. According to the World Bank, registered unemployment in Russia in 2009 was 2 per cent; surveys indicate a true rate of between 5 and 6 per cent. Russia both before and after transition has suffered from underemployment which can mask any supposed success of the reduction in the unemployment rate; labour productivity in some areas remains very low.[3]

As commonly occurs during the transitional process, with the initial freeing up of the price mechanism the rate of inflation sky-rocketed. In 1992, the first year of economic reform, retail prices in Russia increased by 2,520 per cent. A major cause of the increase was the decontrol of most prices in January 1992, a step that prompted an average price increase of 245 per cent in that month alone. In 1994 the inflation rate had 'improved' to 224 per cent. This was then brought down over time through tighter monetary policy, and it is a measure of the changing expectations of Russian consumers that mere double-digit inflation has led to some street-protests at the time of writing. Other indicators of standard of living both qualitative and quantitative fell significantly in the post-Soviet era. Life expectancy, specifically for men, plummeted and still lags significantly behind that of women (much of this fall has been attributed to a big rise in alcoholism and specifically the consumption of cheap vodka and the government has run public health campaigns to try and ameliorate this problem). The black market, always in the background even in Soviet times, has thrived in the post-Soviet era. This has led, amongst other things, to less tax revenues for a government already committed to budgetary restraint to stabilise the macroeconomy. Experiments with fiscal policy, such as a **flat rate tax** have been employed to try and encourage firms back into the legal sector.

Happy days are here again...?

Russia has enjoyed almost a decade now of high growth. This has to be seen in the context of the substantial shrinking of the economy during the initial 'shock' phase of transition but is impressive nonetheless. This growth was built initially on oil revenues and supported by the cheap rouble but in more recent times has been complemented by rapidly increasing rates of investment. As Figure 1 shows, the precipitous fall in standard of living, as measured by quantitative methods, has been followed by a steep rise coinciding with the more stable political regime of President Putin.

Figure 1: The Russian economy since the fall of the Soviet Union



Source: International Monetary Fund

3. *Russian unemployment: its magnitude, characteristics, and regional dimensions, Volume 1, A summary*, World Bank website, May 2009.

However the benefits of economic growth have been by no means equally spread. There is a marked difference between the effects of economic growth on the Moscow region and other regions and rural areas. Moscow has become home to some of the world's super-rich and boasts some of the most expensive property in the world, whereas some provincial cities and rural areas continue to suffer from a level of standard of living more akin to some developing economies.

One measure of the level of inequality in a country is the **Gini coefficient**. Put very simply a country with perfect income inequality (i.e. one person has all the countries wealth) will have a Gini coefficient equal to 1, whereas a country with perfect equality (i.e. each person in a country will have an equal share of the wealth) will have a Gini coefficient equal to zero. A related measure is the Gini index which is very simply the Gini coefficient expressed as a percentage (i.e. multiplied by 100).

Table 1 shows that of all the Eastern European transition economies Russia's income inequality has changed the most significantly.

Table 1: Gini index for eight transition economies

Country	Year	Gini	Year	Gini	Year	Gini	Year	Gini
Bulgaria	1989	20.7	1993	31.6	1997	34.4	2006	31.0
Czech Republic	1988	19.8	1992	20.8	1996	25.4	2006	25.0
Hungary	1987	20.9	1992	30.5	1998	24.3	2006	26.2
Poland	1987	23.0	1993	28.4	1998	29.4	2006	33.0
Romania	1989	31.2	1994	26.2	1997	30.2	2006	40.2
Russia	1991	29.9	1993	47.6	1996	50.1	2006	45.1
Slovakia	1987	19.5	1993	20.6	1996	24.6	2006	24.2
Slovenia	1987	19.8	1993	27.6	1996	29.8	2006	30.7

Source: The World Bank web-site (Income Inequality Database)

According to the IMF Russia's GINI coefficient was estimated to have doubled during the first six years of transition as the dismantling of the state led to the rise of the super-rich oligarchs whilst at the other extreme the loss of a viable welfare system cast millions into poverty. These differences can be even more marked when looked at on a regional basis – average incomes in the Moscow region are seven times those of the poorest Russian province, Ingushetia.

Seeming economic success has also seen, according to some observers an increasing 'democratic deficit'. The latest Russian election did nothing to dispel the idea that Russia is at best an unusual democracy. The Russian constitution does not allow more than a two-term presidency, therefore the United Russia Party put forward a new candidate, Dimitry Medvedev, with a certain Vladimir Putin acting as his less-than deferential Prime Minister. Some might argue that this is not the remit of economists, although other economists have attempted to establish that a truly democratic regime is essential to develop a functional modern economy over the long-term. Nothing Medvedev has done since the election has shaken the view, beloved by political cartoonists, that he is little more than a puppet of Putin.

Russia and the West

The Victory Day celebrations in Moscow in May 2008 were the first since the end of the Cold War to involve the parading of tanks and nuclear missiles through Red Square. Many see this as symbolic of attempts by the Russian state to demonstrate that after a period of disorder and weakness it is returning to its place as a major world power. This has followed incidents such as the closing of offices of the British Council in Russia, in essence a reprisal for British actions following the death of the former KGB agent Alexander Litvinenko. This and a previous 'exchange of diplomats' has led to some commentators speculating about the possibility of a new Cold War. Although this has been somewhat over-stated and is not a generally held belief there are key political differences between the West and Russia which potentially stand in the way of fruitful economic partnerships. Russia has faced accusations that it has ridden rough-shod over human rights in recent years. In particular these accusations have been linked to the state of affairs in Chechnya. It has attempted to accuse Western critics of hypocrisy in making such allegations, stating that it, like the West is conducting a war on terror.

There have also been problems more directly related to economic affairs in the way Russia has used its power as a net energy supplier to give it political power over its former satellite states such as Georgia. Given the still less-than stable situation in the Middle East Russia has the potential to continue to exploit this power on a world scale.

On a more positive note Russia represents a huge potential market for Western economies' exports. There has been a huge rise in what might be called the middle classes in Russia with increasingly sophisticated tastes – this is reflected in the fact that property prices in Moscow are amongst the most expensive, if not the most expensive, in the world.

Decoupling and other challenges

At the time of writing in mid-2009 there are concerns that economies such as China, India but also Russia face new challenges as the Western economies seem to be edging closer to, if not a full-blown recession, then at least a slowing down of economic activity. This worry it that Russia may need to find new export markets if it is to maintain its impressive rates of economic growth, in effect **decoupling**, or breaking free from the US economy. However, a closer look at the data seems to indicate that Russia will be affected less than most by this potential threat, given that only 1% of Russian exports make their way to US markets. The Russian economy has benefitted from the booming Chinese economy and its voracious demand – but will be affected by the world slowdown in 2009, albeit with not as pronounced a reduction in GDP levels as in many Western countries. Inflation has also begun to creep up and has reached double-digit levels again[4] – 13.2% in May 2009. Also, despite benefiting from record oil prices, Russia's own oil production seems to be slowing and exports may not continue to provide the same injection into the Russian economy that they have in the past. As mentioned earlier projections (e.g. Economist predictions of -3.0% in 2009 and +2.0 in 2010) indicate that unlike China and India, whose growth levels are predicted positive, but reduced, in the short-term, Russia will fall into recession in 2009, indicating a greater degree of reliance on the Western economic activity that has been so badly hit in the current downturn. In other words Russia is perhaps not as significantly decoupled from the West as commentators may have thought.

In conclusion…

Much of the sabre-rattling that has characterised the foreign policy approach of the Putin government could be seen as being largely for show. As Russia's markets to the world some, particularly the elite and the increasingly powerful middle-classes, have begun to prosper from

4. *The Economist*, May 2009.

the rapid economic growth of recent years and as such inevitably see the benefits in stable economic relations and international trade, despite the odd ‘exchange of diplomats’ as the Russian bear flexes its muscles. In the short term certainly Russia remains dependent on the West for its economic prosperity although this dependency may lessen as it ‘decouples’ from the West and depends increasingly on demand from other member of the BRIC group, particularly China. Russia may well, perversely, represent an opportunity for the West in terms of a potentially huge market to export to, but also a threat if it uses its growing political and economic capital to achieve short-term nationalistic goals.

Summary of the Main Points

- Russia has recovered from the initial trauma of transition and is now increasing its importance as a global economic and political power.
- The Russian recovery has been aided enormously by the exploitation of oil reserves in the context of buoyant demand for oil world-wide.
- Russia’s increasing openness to trade means that they are increasingly linked in to the global economy.
- Difficulties remain in conducting business in Russia due to corruption and a ‘democratic deficit’.
- The re-ordering of the world economy, with the increased importance of Russia within the BRIC grouping, means that Russia may become less dependent over time on the US and Europe as trading partners.

Questions for Discussion

1. How might the West benefit from a stronger Russian economy?
2. Is a ‘genuine’ democracy necessary for sustained economic growth? If not does this matter?
3. How have world oil markets been affected by the increasing importance of Russia as a net oil exporter? What other factors can explain present trends in world oil prices?
4. Discuss the potential costs and benefits both socially and economically of a big gap between rich and poor?
5. Do you think the figures for Russia’s growth, unemployment, inflation etc. can be viewed as reliable data?

Topic 6

Speculators and the FOREX market: Is the Tobin Tax still relevant?

The foreign exchange market

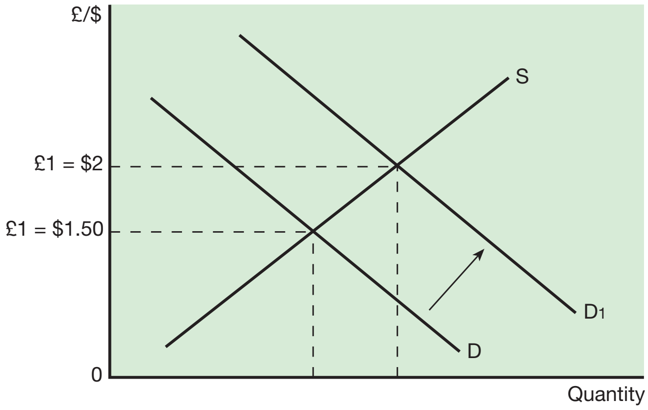
In order for the global economy to work, the buying and selling of currencies has to occur in order that consumers and producers can benefit from trade. For example, if I was to purchase a can of strawberries from Tesco and they were produced in Spain, Tesco would have purchased them in euros. To do this, Tesco would have entered the **foreign exchange market**, to sell £s and to buy €s – they would have had to have carried out a foreign exchange transaction.

The foreign exchange market is an important piece of the economic jigsaw that keeps the world economy ticking along and therefore it is vital that the market works well. In order for a market to work well, the buyers and sellers within the market place need perfect information. In the case of foreign exchange, the rate of one currency against another will be determined by a number of factors. The key determinants are:

- Importing and exporting – Firms and consumers need to buy and sell currency in order to purchase goods from abroad.
- Interest rates – International investors look to find the best place for their money and those with high interest rates normally attract the most attention, as it offers a good return on their savings.
- Economic growth – If a country is growing at a stable rate then, other things being equal, international investors can be expected to see that country as a safe place to buy foreign currency. Although instability creates opportunities for taking risks and therefore getting greater rewards, many investors see stability as an important factor in the exchange rate market.
- Financial institutions – Countries that have stable financial institutions are normally seen as safe places for international investors to leave their money. The independence of the Bank of England was seen to be a key factor behind the strength of the Pound over the past 10 years.
- Foreign direct investment (FDI) – When multinational corporations set up in different countries they need to buy the local currency in order to do so.

As the foreign exchange market is a normal market, these factors will influence the demand and supply of the currency. If we use the £ as an example, as the demand for currency increases (due to an increase in interest rates in the UK or a decrease in interest rates in other countries), there will be an increase in the price and this can be seen in Figure 1. An increase in the demand for the £ has meant that it has got stronger in value or to use the economic term, it has appreciated in value. In this case the £ has got stronger in terms of the $ and this has many implications for businesses and consumers. Therefore it is essential that perfect information is being used to reflect the true worth of a country's currency.

Figure 1: A shift in demand



The impact of movements in the exchange rate

Any major trading nation is hugely affected by movements in the exchange rate. The World Trade Organisation states that the UK is the eighth largest exporter in the world, with $437.8 billion being earned through exports in 2007. It is the fifth largest importer in the world, with $619.6 billion being spent on imports in 2007. It currently has shares in world total exports and world total imports of about 4%.[1] Therefore exchange rate fluctuations are going to impact greatly on British producers and consumers. A large proportion of our trade is within the European Union and with America. This means that the key exchange rates for the £ are with the € and the $.

When the £ is strong or increases in value against other currencies, there are a number of situations that are likely to occur. The main advantage is that it is cheaper for U.K. businesses to import from foreign countries. Over the last 10 years, it has been generally agreed that the £ has been strong and this means that a major reason for the continued low inflation in the country has been due to the strong £. The UK has been 'importing' low inflation. Consumers have obviously benefited from this since import prices on goods have gone down and they can afford more products. Businesses also benefit as their imported input prices have gone down and this gives them the opportunity to make larger profits if they decide to not pass on these lower input prices to the consumers. Secondly, it would be cheaper for UK citizens to travel abroad since the consumer would be getting more for their £. This means they can afford nicer hotels, better restaurants and greater quality souvenirs for their loved ones.

The downside to a strong £ is that foreign businesses are less likely to import from the U.K. because they can trade more goods for their money with a different country that has a currency weaker than the £. This means that the UK is less likely to export goods when the £ is strong; thus, foreign demand for goods will decrease. When this happens, it tends to hurt British companies by reducing their international sales. It can be argued that in order to compete with a strong £, UK firms have to become incredibly efficient and productive to survive and this is good for their long term well-being but generally UK exporters have complained about the continued strength of the £. The knock-on impact of this could be higher unemployment and slower economic growth.

When the £ is weak or decreases in value against other currencies, the reverse situations occur. As other currencies are strong, international firms will be able to purchase more products from

1. http://www.wto.org/english/res_e/statis_e/its2008_e/its2008_e.pdf

the UK resulting in an increase in exports. This should mean that our employment levels should increase due to the increased demand from abroad but also there should be some import substitution for those firms producing within the UK who compete with imports. Overall this should lead to a decrease in the current account deficit.

However, when the £ is weak it costs a lot more for businesses to import. This inflationary pressure could potentially wipe out some of the positives of a weak £. A firm may have thought that they would export more due to a lower price caused by the depreciation but increased costs could mean that they have to increase their prices in order to cover these increased costs. This could be particularly true for the UK as it does have a high marginal propensity to import and therefore the cost of living is likely to rise when the £ is weak. The assumption we also make is that there will be increased demand for UK products and a fall in demand for international goods. This is only true if the **Marshall-Lerner condition** is met. This is where the sum of the price elasticity of demand for imports and exports must be greater than 1. If this does not hold and the sum of imports and exports is inelastic, then depreciation is likely to worsen the current account deficit. It could be argued that with regards to the UK economy this might be the case, due to our heavy dependence on imports.

The falling £ – the silver lining of the recession cloud?

Tourists are also greatly affected by a weak £ as it costs more money to travel abroad but as previously explained, this may be a good point due to import substitution. In February 2009, Ian Smith (the new boss of Pontin's) explained that bookings were up 20% and that 2,000 jobs were being created across the UK.[2] To quote Ian Smith "They've noticed what's going on with the euro and the dollar. Holidays abroad just aren't that attractive at the moment. Sure, you can get a cheap flight to Spain with Ryanair but, once you get out there, you have to pay the equivalent of £3.50 for a bottle of beer. And you can't get very far on one bottle of beer!"[3]

Figure 2 shows that up until July 2008 the pound sterling had been strong against the dollar but then fell during the rest of 2008.

Figure 2: The pound sterling/US dollar exchange rate

Source: www.bbc.co.uk/news

This depreciation in the currency has been having a big impact on the UK economy. In January 2009, retail sales were 6.5% higher than the previous year, despite the downward turn in the

2. http://news.bbc.co.uk/1/hi/business/7866756.stm; http://business.timesonline.co.uk/tol/business/industry_sectors/leisure/article5650488.ece
3. *Ibid.*

economy. It was stated that overseas visitors had been taking advantage of the falling pound. John Bradley, who exports old London taxis to Europe, America and the Middle East, has seen orders for his taxis increase rapidly since the pound lost 12% of its value over 5 months. Tourism is booming due to the weak £ and therefore the depreciation has given a glimmer of hope for an economy that has been in recession.

Figure 3: The pound sterling/Euro exchange rate

Source: www.bbc.co.uk/news

However in February 2009, *The Independent* reported that the 'pound's slump is beginning to push up some shop prices'.[4] The British Retail Consortium (BRC) said that 'Overseas demand for beef due to the fall in sterling drove a 1.8 per cent month-on-month rise in food prices during January.' According to BRC's figures, the annual rate of food inflation reached 7.5% in January. This obviously puts a squeeze on retailers as they seek to persuade price sensitive consumers to part with their money and maintain manageable profit margins.

The role of speculators on the exchange rate

As we have seen, the exchange rate is a vital tool in the workings of an economy and therefore it is essential that the exchange rate is valued correctly. As can be seen at the start, there are a number of factors that influence the exchange rate but the most important should be the purchasing of imports and exports across the global economy. If this was the case, then all current account deficits should be self-correcting due to movements in the exchange rate. If, for example, the UK has a deficit, then we are clearly importing more than we are exporting. This would mean that there is a lack of demand for the £ and therefore the £ would weaken. This means that eventually the UK's exports would be cheaper and imports would become more expensive. Eventually there would be greater demand for our exports and less demand for our imports, thereby improving the current account. It is a self-correcting tool.

However, other factors do influence the exchange rate and one of the key factors that have yet to be mentioned is the role of speculation. To show how powerful speculative flows are here are some statistics that are barely credible. In 1975, about 80% of foreign exchange transactions were to conduct business in the real economy. The remaining 20% were speculative flows, where the sole purpose of trading currencies is to make a profit. Today the real economy is worth 2.5% and speculation is worth 97.5%.[5] In 2007, currency trading was valued at $3 trillion a day. It seems obvious to say that speculators distort the market to such

4. http://news.bbc.co.uk/1/hi/business/7779462.stm
5. http://www.sesrtcic.org/files/article/136.pdf

an extent that you have to wonder whether they are healthy for the market. In a market that needs perfect information, do the speculators help give information or do they create 'noise' within the market? If they distort it to such an extent that it becomes unhealthy, then should something be done about it?

It is clear that the UK economy is a stable economy with strong institutions and strong government (despite recent events) and yet the falling currency has been exacerbated by speculators. This was shown in a report in *The Guardian* in late September 2008 that had the title 'Gamble pays off for speculators after sterling is driven to new low'. The article explained how speculators would make hefty gains from bets they had placed against the pound. It stated that if the £ was valued at €1.1086, then it was a signal for speculators to make profits.[6]

To show how this is achieved, imagine that a trader had purchased £100,000 worth of euros at an exchange rate of €1.14 and sold them at the rate shown above, they would make a profit of £2,800. Most of the time, traders are dealing with vast sums of money and therefore by selling pounds to buy euros, they can start influencing a market and the fall becomes a self-fulfilling prophecy. This is often the charge thrown at speculators, that they can have an undue influence on the foreign exchange markets. Where one leads, others follow. This is particularly true for the big players in the market and the most famous name in recent times is George Soros. He was the man who effectively broke the Bank of England in the early 1990s through currency speculation and betting on the pound falling out of the exchange rate mechanism (ERM), the precursor to entering the euro.

Currency speculators would argue that they are only responding to the market and therefore are informing the market whether the currency is over or under-valued. From this, the markets adjust to the correct levels but potentially at a quicker pace. Another upside about speculators is that they provide liquidity in the market. If, for example, a company wishes to hedge its bets against a falling currency in order to create stability for their finances, who is there to take the other position? It is the speculator who is often there to accept that risk and therefore freeing up the funds for these companies.

Instability and 'the vulture instinct'

As we can see, speculators can play a role in the depreciation of a currency in a moderately stable economy like the UK. Now imagine the potential role they could play in a country that is not as stable. This has been one of the major criticisms of speculators and in particular their actions towards developing countries and weak governments. For example, if a country instigates policies that are deemed unpopular by the international community, traders may wish to sell that country's currency. This mass depreciation in a currency can cause massive instability and can happen very quickly due to the new technology that links markets across the globe. Therefore it is easy for a 'currency crisis' to arise and often it is easy for speculators to make vast profits on these situations, particularly when governments try to defend their currencies against the market.

One of the most high profile cases of speculators having an impact on the global economy can be seen in the Asian crisis that started in 1997. The Thailand economy was the one that started it all but instability soon spread like a virus across the Asian landscape and speculators dived in and took their profits. It created a collapse in the Asian economies and it highlighted for the first time how powerful speculators could be in the new global economy. There had been

6. http://www.guardian.co.uk/business/2008/dec/16/euro-pound-exchange-rate-speculation

warning signs with Mexico two years earlier but it was this attack that became significant because the ramifications of it nearly led to the kind of wholesale global recession that we are seeing now.

The currency crisis in Thailand started after almost 10 years of economic success, as shown by average growth rates of over 8% from 1985 to 1996. During this time, investors poured into the country looking for profit opportunities, mainly within the property sector. At the time the Thai currency (the baht) was pegged to the dollar ($) in an 'adjustable peg' exchange rate system. This was originally done to give the Thailand economy a certain amount of stability and encourage opportunities for export-led growth. It was during 1997 when the 'Asian miracle' within Thailand started to unravel as the economy started to decline but the money kept pouring in for investment opportunities in the property market. Unfortunately there was a lack of demand for the new infrastructure and prices started to plummet. The speculative bubble had burst. Thailand then became downgraded by investors' services and the Stock Exchange of Thailand (SET) Index fell. This flaw in the Thailand economy was spotted by speculators and they realised there was an opportunity to make vast sums of money speculating that the baht would fall in value. They sold the baht in the forward market (which is the equivalent to selling baht short), in the hope that the baht would depreciate in value and they would make a profit buying it back at a lower rate. History shows that in the short run the government defended the baht resolutely by spending their US dollar reserves buying back the baht to keep it pegged to the dollar but in the long run the speculators won when finally the baht had to be floated and in their triumph, a domino effect occurred across Asia. South Korea, Indonesia, Malaysia, Laos, Philippines and Hong Kong were all impacted upon as currencies collapsed under massive speculative flows, even though the majority of these countries had a strong economic base. By July 1997, it appeared that there was going to be a global economic meltdown and the finger was being pointed at the speculators.

This situation was not a one-off and there have been major currency crises in Brazil and Russia since 1997. All of this instability is great for speculators as they can reap spectacular profits but the economic impact can be devastating for the majority of people within those countries as investment falls, growth declines, unemployment rises and greater poverty ensues.

James Tobin and the 'Tobin Tax'

James Tobin was the Nobel Prize winning economist in 1981 who came up with a solution in 1972 that tried to prevent these speculative flows or at least tried to stabilise the foreign exchange markets. The proposal was to tax foreign transactions. It was specifically aimed at speculators who he argued were unproductive. At the same time however, it was also seen as a way of raising revenues for those in the developing world. The original tax rate he proposed was 1% but was subsequently lowered to between 0.1% and 0.25%. The Tobin Tax was intended to slow the flow of capital across borders and thereby enhance monetary policy, and prevent or manage exchange rate crises. Even though it might not seem like it, at 1% the tax was meant to be high in order to change foreign exchange market behaviour. It would also raise a lot of money that would help the developing world. Estimates have suggested that a tax rate of 1% could raise between $17-31 billion globally and that a tax rate of 0.5% could raise $24 billion.

The 'Tobin Tax' received much support in the late 1990s as a way of curbing the increasing power of speculators around the world and was soon adopted by the anti-globalisation movement who saw it as a key weapon in solving some of the economic ills of globalisation.

Any tax would have the effect of slowing down the number of transactions within a market and therefore should lead to increased stability.

One of the first issues is that a Tobin Tax would not discriminate between those in the real economy that needed to trade currency and the speculators. This means that higher costs would occur across the global economy and potentially lead to some mild form of inflation. Another issue is that if it prevented speculators from doing their job, liquidity in the markets could seize up. In order for markets to work, liquidity is needed so that businesses can go about their day-to-day business and many argue that it is speculators taking risks that frees up much of this liquidity. The impact of a lack of liquidity can be seen in the UK at the moment where banks have stopped lending and it has practically ground the economy to a halt. This has been reflected across the globe.

In many respects, the current economic situation highlights why something like the Tobin Tax is needed. Vast sums of capital have flowed round the global community without any restrictions and massive instability has finally followed, leading to a global recession. Speculators have played a role within this, not only in the currency markets but also in the shares and commodity markets. There has been widespread condemnation of their practices and if a tax can slow them down in some way, then it would be perceived to be a good thing. However, in a time of global recession where markets are failing due to liquidity issues, taxing foreign exchange transactions could be a disaster.

The future of the Tobin Tax

Although there was general support for the Tobin Tax across the global community where countries such as France and Canada supported the idea, no country alone was prepared to introduce it. Again, this was one of the issues of the Tobin Tax. In order to introduce it a multilateral approach would be needed but some of the big financial centres were against the implementation of the tax. Individual countries could have introduced it but this ultimately would have knock on effects for their economies as they would become uncompetitive in the global financial sector.

Since James Tobin died on 11 March 2002, his idea continues to be looked at but mostly in other guises.[7] It is no longer being looked at as a way of preventing speculative flows but primarily as a revenue raiser for the developing world. One of the most prominent alternatives in the UK is the Currency Transaction Tax (CTT) and this has found great support within Parliament and supported by pressure groups such as War on Want. Research suggests that a 'Sterling Stamp Duty' (as it has now been renamed) whereby a tax on sterling would be implemented wherever the currency is traded in the world, was feasible and could be unilaterally implemented by the UK government. A sterling stamp duty would be set at 0.005%, much lower than the original Tobin Tax and therefore would have very little impact on the amount of transactions. However, based on £400,000 billion of sterling being traded annually, the tax could raise in the region of £2 billion a year. If all countries introduced a similar scheme, there could be huge benefits for developing countries. The only issue would then be how it would be distributed.

A report written in March 2009 for the BBC website suggested that the global downturn was creating a 'financial tsunami' across the developing world as developed countries are cutting aid budgets in order to help out their own stricken economies.[8] The global slowdown has also

7. See the obituary in *The Economist*, 16 March 2002, p. 98.
8. http://news.bbc.co.uk/1/hi/business/7947017.stm

meant fewer jobs for those from developing countries seeking work in the developed world. This has led to falling remittances (money sent back) which had previously been more than developmental aid. Even though it might be the worst time for the financial sector to introduce a currency transaction tax, it is probably the most vital time for those who need the money the most.

The fact that the world has moved away from trying to create a tax that prevents speculation occurring, probably on the basis that it can't be done, the key question that we must ask is whether this kind of tax is the most effective way of raising revenue for the developing world. There are alternatives, such as 'Special Drawing Rights' (SDR) as proposed by George Soros, a Global Lottery fund and a global Carbon tax but whatever decision gets made, the decision must get made quickly as millions of people continue to die in the developing world each year.

Summary of the Main Points

- Exchange rates have a large influence on the economy as it is one determinant behind the competitiveness of a country's economy. A weak currency is good for exporters but bad for importers and thus a strong currency is bad for exporters and good for importers. It therefore has an influence on the key macro-economic objectives of employment, inflation, economic growth and the balance of payments.
- Speculators have a major influence over foreign exchange markets. Instability can be created by speculators which can have an impact on the global economy. This was shown most prominently with the Asian crisis in the late 1990s.
- The Tobin Tax is a tax on currency transactions. It had a dual-function of preventing instability within the foreign exchange markets and providing funds for the developing world.
- Although supported by many countries across the world, the Tobin Tax was never implemented but alternatives to the Tobin Tax have been suggested. The most prominent of these in the UK is the Currency Transaction Tax.
- There are many alternative suggestions on how the global community can raise revenues for the developing world; these include an SDR, a carbon tax and a global lottery.

Questions for Discussion

1. Evaluate how influential exchange rates are on the competitiveness of a country's economy.
2. Were the speculators to blame for the Asian currency crisis or were there other economic issues at large that led to the crisis?
3. Analyse the arguments for and against the Tobin Tax. Why do you think governments across the world were reluctant to introduce the tax?
4. Examine the implications for the UK economy of introducing a sterling stamp duty.
5. Discuss alternative ways of raising finance for the developing world. Can you suggest any others?

Topic 7

Global warming: A crisis for the global economy?

Introduction

When the Stern Review into the Economics of Climate Change was released with extensive press coverage on 30 October 2006, it prompted Tony Blair to call it, "the most important report on the future ever published by this government".[1] Since then there has been much debate over the figures. Some view his predictions as widely optimistic, such as Richard Tol a leading environmental economist,[2] whilst others argue that they are too pessimistic and that the situation is much worse, such as Mark Lynas, author of *Six Degrees*.[3] No matter what the figures are, the majority of the global community have started to realise that global warming is a major problem and that the consequences are starting to show now. With wildly changing weather conditions and numerous photos of polar bears sitting isolated on a melting iceberg, the global community is starting to realise that change must happen and it must happen quickly.

However, there are problems in how to implement this change. For example, some economists would argue that in order to solve the issue of global warming, economic growth must continue to flourish in order to provide the financial resources to pay for the kind of R&D that is needed to come up with alternatives to our current way of living, that has led to the situation we are currently faced with. There is also the **principal-agent problem** in global warming where those who are going to be most affected by global warming (the younger generation) are reliant on others to deal with the problem. International competitiveness also plays a role in holding back change. Countries do not want to implement policies that may help in the fight against global warming (such as increased aviation tax) as it may lead to cost disadvantages, especially in light of attracting foreign direct investment. Finally, there is the issue of environmental **free-riders** within the global community. There could be an argument that the whole economic system is at fault and we've got to move away from the capitalist agenda and start reverting back to a low carbon subsistence approach.

These are serious issues to consider but the main focus of this Topic is going to be looking at the issue of global warming and how it could potentially impact the UK economy. There will also be consideration given to other areas of the global community, in particular developing countries. It will focus on a variety of problems and try to address those using basic economics but it is not intended to be a thorough guide to global warming. However a further reading list has been included at the end.

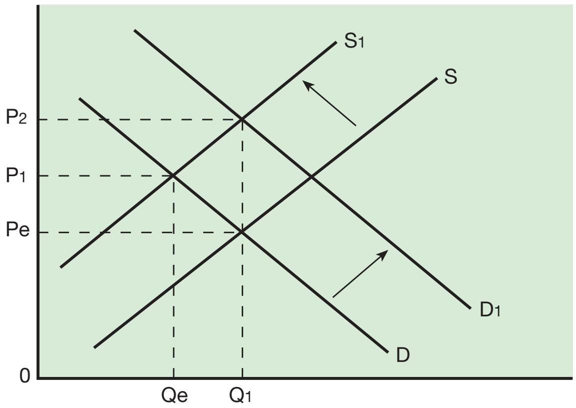
1. www.hm-treasury.gov.uk. For a brief overview of this massive report see 'Stern warning', *The Economist*, 4 November 2006, p.14.
2. Research Professor at the Economic and Social Research Institute, Dublin, www.bbc.co.uk 'Running the rule over Stern's numbers' article, 26 January 2007.
3. M. Lynas, *Six Degrees: Our future on a hotter planet*, Harper Perennial, 2008.

The basic economic (green) problem

At the start of any economics course, students will learn about the basic economic problem, one of scarce resources and infinite wants. As countries have grown wealthier, the strain in this relationship has been on the side of infinite wants, with countries demanding more and more as incomes grew. In the future though, scare resources are going to become even scarcer and this obviously has many consequences for the global economy and the many markets within it.

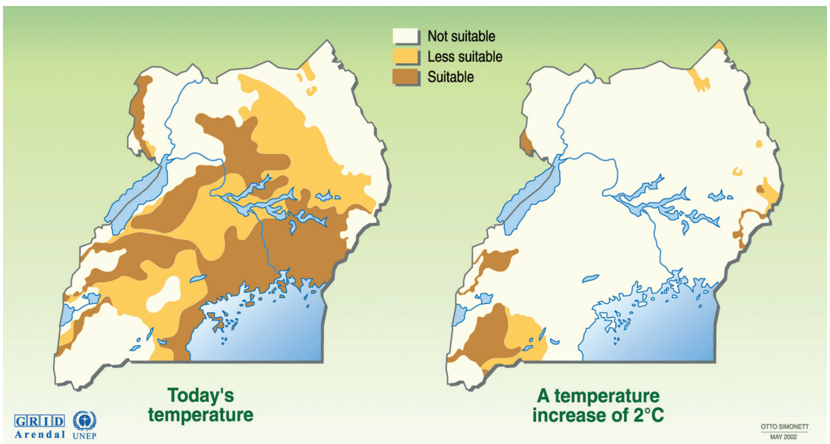
The main issue with regards global warming is the expected increases in water shortages. The paradox is that global warming will also lead to greater flooding and rising sea levels that would lead to millions of people being displaced. The scale of this problem is difficult to predict due to the varying forecasts on future rises in temperature over the coming years but already we know that through our current consumption of greenhouse gases, the global temperature will rise by at least 1° Celsius. The impact of this rise in temperature is expected to lead to mega drought in Western America that could wipe out huge areas of agricultural land. Studies suggest that fresh water availability could fall by up to 30% in some regions. The importance of this on food supply is considerable and can be shown by the basic demand and supply as shown in Figure 1.

Figure 1: Global market for agricultural products



As supply falls (S-S1) due to the increase in unproductive agricultural land, then there will be a rise in the price of agricultural products (P1). Alongside continual growth in populations and incomes across the globe (D-D1), the rise in food prices will be even more exaggerated (P2).

Figure 2: Impact of temperature rise on Robusta coffee in Uganda



Source: http://maps.grida.no/go/graphic/impact-of-temperature-rise-on-robusta-coffee-in-uganda

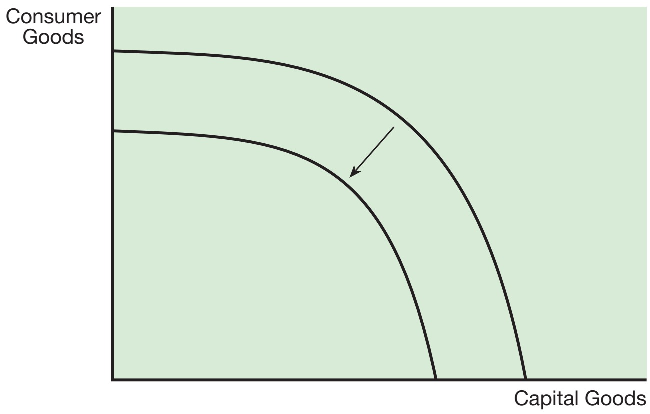
An example of how rising temperatures can impact food and drink markets can be seen in Uganda where robusta coffee is grown. Figure 2 shows how an increase in the global temperature of 2° would lead to a large increase in land being unsuitable for growing coffee.

The main impact of this will obviously be felt by Uganda which will find it harder to earn money in the global economy by exporting coffee. This impact on agricultural land is particularly harmful for developing countries where there is a great deal of primary product dependency. Without decent agricultural land, their economy will greatly suffer but this also has knock-on consequences for the global community.

This is the future for Uganda but in parts of Central Asia the impact of water shortages is already being felt. In Kyrgyzstan (which has lost 1,000 glaciers over the past 40 years) and Tajikistan (where glaciers have shrunk by one third) they are already having farming issues due to water shortages. As we have found out, when resources start to deplete, the most obvious example being oil, conflict often arises.

The Stern Review suggested that extreme weather could reduce global gross domestic product by up to 1% and that a rise of 2-3°C would reduce global economic output by 3%. If the temperature rises by 5°C then up to 10% of global output could be lost, with the poorest countries losing out the most. The simple production possibility frontier diagram can reflect this as shown in Figure 3. As key resources, such as productive land, start to disappear, you would expect to see an inward shift in the PPF which obviously equates to falling growth rates.

Figure 3: The global PPF



Is it a zero-sum game across the global economy?

As many countries suffer from global warming and land disappears, there are other countries that will benefit. If you think about the UK for the past few years, the growing season has been extended and therefore more produce has been grown. Gardeners can start planting earlier and they have also managed to grow a wider variety of fruit and vegetables, lasting much further into the growing year. A Tesco press release in 2005 about strawberries made a similar point: "Thanks to milder winters recently Britain is also enjoying longer fruit growing seasons. The British strawberry season can now last for up to seven months a whole month longer than five years ago when winters were longer and harsher."

According to the International Panel on Climate Change (IPCC), Northern Europe is expected to benefit from increased crop yields, forest productivity and food supplies from the North Atlantic. In Latin America, soybean yields are likely to increase in temperate zones. Temperature rises of 1-2°C are likely to bring benefits to cooler areas such as New Zealand in the form of longer growing seasons.

Aside from food production, there should be reductions in energy demand due to the warmer climates. However, the chance of it being a zero-sum game is very unlikely and that overall there will be a net negative impact on all the areas mentioned above.

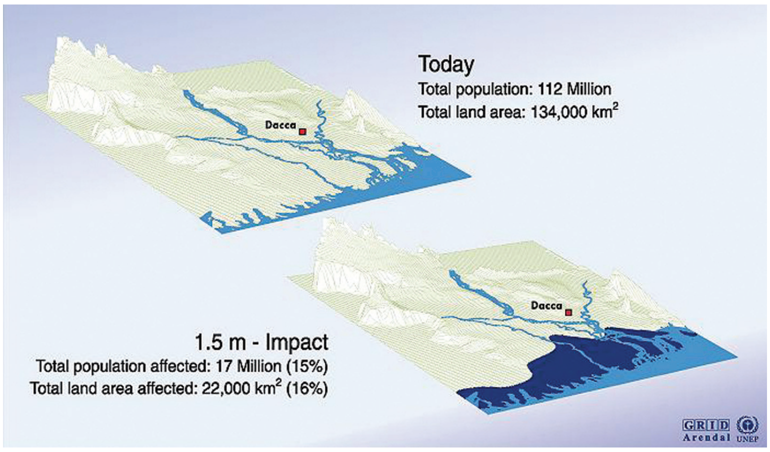
Bangladesh – A look into the future?

The extent of global warming can already be seen across the globe but none more so than in Bangladesh, where rising sea levels have caused major problems. In the last century the world heated up by 0.6°C, according to the International Panel on Climate Change (IPCC). Sea levels rose by between 9 and 20cm and scientists predict further increases of 9 to 88cm by the year 2100.

Bangladesh is situated in the low-lying Ganges River delta and is one of the most densely populated countries on earth. Char Bangla is one of thousands of islands in the mouth of the Ganges and in recent times, living there has become more and more difficult as rising tides have washed homes away and destroyed agricultural production. An 'Unreported World' Channel 4 documentary looked into other areas of Bangladesh that are suffering similar problems, such as South Khali and Kumira – a small village that at the time was underwater from the previous years flooding despite it being the dry season.[4]

Over the past decade, ten million people in Bangladesh have been made homeless due to flooding and 20% of the country is expected to disappear over the next century. This will displace even more people and the mass movement of those moving in-land to more urban areas causes many problems. The creation of shanty towns on the outskirts of cities creates places that are open to disease due to lack of clean water and the resources needed to keep everybody fit and healthy. Over-crowding can cause tension and potential conflicts can arise from those who wish to settle in the more salubrious areas – if there are any. For example, the Channel 4 documentary reported how a man was killed trying to solve a settlement dispute.

Figure 4: Potential impact of sea-level rise on Bangladesh



Source: http://maps.grida.no/go/graphic/potential-impact-of-sea-level-rise-on-bangladesh

Bangladesh offers us an insight into the future. According to the Intergovernmental Panel on Climate Change, made up of leading climate scientists, sea levels have risen some 3.1 millimetres per year since 1993. And the United Nations Environment Program predicts

4. Unreported World, 'The Drowning Country', 7 March 2009.

that, by 2010, some 80 per cent of people will live within 62 miles of the coast, with about 40 per cent living within 37 miles of a coastline.[5]

Immigration – a political hot potato

Already the debate about immigration in the UK is a contentious one but with further movement, it is one that we will have to be looked at in much more detail. At the moment we have migrants who move from country to country for fear of persecution or due to war but in the future there will be a greater build-up of what is known as environmental migrants – those who can no longer live in their country due to environmental destruction.

As many of the problems of global warming have been caused by the developing world, it would be very hard to turn these environmental migrants away but the potential impact is huge. A report written by Javier Solano and Benita Ferrero-Waldner, the EU's chief foreign policy coordinator and the European commissioner for external relations, suggested that Europe must expect substantially increased migratory pressure.

Imagine that the UK's population increases rapidly due to environmental migration. Already we have pressure on housing from greater increases in one-person households, higher divorce rates and those wishing to own second or third homes but add to that mix a large increase in migrants that need to be housed and you can see the problems that lie ahead. The government is consistently looking into areas where they can build more homes to meet the demand but there is a time lag with house building and much NIMBYism over the building of new houses. This all pushes up the cost of housing and the waiting time for social housing which again breeds resentment. In 2007, Margaret Hodge (then Trade Minister) caused a row within the Labour Party over housing entitlement. In her own constituency of Barking, where there is a waiting list of 8,000 families, she argued that British families had a "legitimate sense of entitlement" over immigrants.[6] Barking is an area where the non-white population has doubled since 2001 and the BNP is the second largest party. As more and more environmental migrants hit our shores, we can see the problems that potentially lie ahead.

Housing is not the only issue and the increased burden on our infrastructure will also have to be taken into account. In December 2006, the BBC reported that the cost of translation alone was estimated to be £100 million and this is rising fast. West Midlands police translation costs have trebled to nearly £2 million and there was a similar story in Scotland where costs increased by 43% in two years. In order for immigrants to access public services, translation has to be provided and the biggest increase has been in the NHS where up to £55 million is spent on translation and this is a conservative estimate.[7]

All of this has to be paid for and therefore you would expect to see an increase in taxation in order to pay for this increased government expenditure or face cuts elsewhere.

Every cloud has a silver lining – what are the positives of displacement?

For many years there has been talk of the 'demographic time bomb' across Europe. The European Commission's Green Paper on Demographic Change published in March 2005 said that from 2005 until 2030 the EU will lose 20.8 million (6.8 per cent) people of working age.

5. http://environment.about.com/od/greenhouseeffect/a/rising_sea_leve.htm
6. http://news.bbc.co.uk/1/hi/uk_politics/6673911.stm
7. http://news.bbc.co.uk/1/hi/uk/6172805.stm

By 2030, Europe will have 18 million fewer children and young people than today while there will be two people of working age for every one aged over 65. The average European is currently aged 39 and Europeans, including Russians, make up some 11% of the world's population of 6.7 billion. By 2050 that figure will have shrunk to 7% with the average of Europeans being over 47 and the elderly outnumbering children by more than two to one.

This information suggests that environmental migrants may enlarge and rejuvenate the European population. They also offer a different skill set. Philippe Legrain, author of *Immigrants – Your Country Needs Them* argues that the populations of the developed and the developing world are complimentary in nature.[8] The developing world has plenty of young, unskilled labour and the developed world has an older and skilled labour force. If most of the environmental migrants come from the more vulnerable developing world, then it may not be as problematic as it sounds. Immigrants make markets more flexible and it can be seen as a positive supply-side policy.

Global warming – bad for your health and the economy?

In 2003 the UK had a hot summer where temperatures reached 38.5°C. This was supposed to be a one in a thousand year event but it happened again in 2006. It is expected that by 2040 it is likely to be a one in two year event. In 2003 there were 900 deaths in the UK that were heat related. It doubled London's mortality rate, made crops fail, sent crime figures soaring and raised the risk of new diseases hitting Britain, like bluetongue in cattle.[9]

There are many issues concerning global warming but as can be seen, just on a year-on-year scale, with warming temperatures there are many small practical problems that the government has to be aware of. For example, research from the National Institute of Occupational Safety and Health in the US, estimates that the productivity of the average British worker drops by 8% when the temperature edges above 80°F. As the temperature reaches 100°F, productivity slumps by a massive 62%, depriving the economy of £270m's worth of output every day. Warm temperatures lead to an inward shift in the AS curve.

In France the situation in 2003 was far worse than the UK, where 15,000 deaths were due to 'heat-related conditions' and the total across Europe was 30,000. It is clear that governments have to have strategies in place for the increased summer heat which again costs money. However this is all reactionary policy and governments across the globe must have a concerted effort to pursue preventive policy, to stop global warming occurring. The continued issues concerning the Kyoto agreement and frequent missed targets for carbon emissions makes grim reading. Governments tend to spend more time adjusting targets rather than dealing with the root causes of the problem.

However, the health situation is again mild in the developed world compared to the potential problems faced by the developing world, with increased likelihood of famines caused by droughts and in South Asia vulnerable populations will be exposed to an increase in infectious diseases.

It is also important to think not only of the health implications for us but also the wide variety of species that exist on the earth. The loss of polar ice caps in the Arctic would cause great devastation to the wildlife there. In the Amazonian rainforest, a 1°C rise would lead to the loss

8. Abacus, IEA lecture, 5 February 2009.
9. http://news.bbc.co.uk/1/hi/health/3184187.stm, http://www.dailymail.co.uk/news/article-541748/Were-doomed-40-years-global-catastrophe--theres-NOTHING-says-climate-change-expert.html

of habitat for 63 species. As temperature rises, there is a greater risk of coral bleaching which means species that depend on the coral reef will suffer. The Stern Report suggests that up to 40% of species could face extinction.

Is there another way?

One of the problems that the world is faced with is an economic model that has economic growth as the key indicator for successful economies. Clive Hamilton talks about the 'Growth Fetish' that exists in the world and one has to ask if there is an alternative approach that policy holders should be looking at in order to create a sustainable world, let alone sustainable growth.[10]

Most of what has been predicted in the Stern Report is already expected to occur at a temperature rise of 1° Celsius and according to most scientists and the Stern Report temperatures have already increased by ½° due to carbon emissions. Without any action taken on emissions, there is more than a 75% chance of global temperatures rising between 2° and 3° over the next 50 years and according to Mark Lynas, 3° is the tipping point for rapid increases in global warming which would cause the destruction of the planet.

Technology is often seen as the answer to all problems concerning global warming and in order to invest in the R&D that can help, economic growth is needed within the global economy. This economic growth is causing further problems for the technology to solve and therefore it ends up being an environmental vicious circle. If growth slows down, then there may not be the investment funds to pay for the R&D and so on.

It is clear to see though that global warming is going to be the biggest challenge for economists in the future. There are some positives but overall, the negatives are clear to see and are starting to occur right here, right now.

Further reading

Bjorn Lomborg, *Cool it: The Skeptical Environmentalist's Guide to Global Warming*, Cyan and Marshall, Cavendish, September 2007.

Derrick Jensen and Stephanie McMillan, *As the world burns: 50 simple things you can do to stay in denial*, Seven Stories Press, November 2007.

James Lovelock, *The revenge of Gaia*, Penguin, 2007.

10. Clive Hamilton, *Growth Fetish*, Pluto Press, 2004.

Summary of the Main Points

- Global warming has started to occur and the impact on the global economy has been predicted by a number of computer models. But the extent of global warming over the next century is hotly debated and there are both optimistic and pessimistic models.
- Food supplies are likely to fall as much arable land is lost due to rising water levels and the salinisation of land. Competition for water is likely to intensify and already we are seeing water shortages across the globe.
- Global warming is not all doom and gloom and there are areas that will benefit from warmer temperatures, for example prolonged growing seasons. However, mass displacement is likely to occur and there will be large numbers of environmental migrants that will have to be integrated into other communities.
- Health issues are likely to increase in both the developed and the developing world. The unusually hot summer of 2003 gives us an insight into how Europe struggled to cope with extremely high temperatures.
- The impact on wildlife is likely to be very significant and this can already be seen with dwindling fish stocks.

Questions for Discussion

1. Is global capitalism to blame for global warming or will profits provide the incentives for solutions to occur?
2. Starting with carbon rationing, evaluate the policies for dealing with global warming.
3. Discuss whether environmental migrants could potentially be a blessing in disguise.
4. Analyse the arguments for and against the view that there is little an individual can do to prevent global warming.

Topic 8

The global tax race: An overview of fiscal policy in the UK and around the world

The avoidance of taxes is the only intellectual pursuit that carries any reward.

John Maynard Keynes

The difference between death and taxes is death doesn't get worse every time Congress meets.

Will Rogers

People who complain about taxes can be divided into two classes: men and women.

Unknown

Introduction

Fiscal policy and in particular the levying of taxes has a long and controversial history. For example, it is discussed at some length in the Bible. It had a peculiar impact on some housing of the late eighteenth century (the window tax led to houses being built with smaller and smaller windows). Taxation was a key catalyst of both the American Revolution and the independence struggle in India led by Mahatma Ghandi.

Tax law is incredibly complex and there is a constant cat and mouse game being played out between governments attempting to pin down tax-payers and accountants finding ever more ingenious but 'legal' methods to avoid paying taxes. The history of **tax avoidance** is as long as the history of taxation itself. In recent times there was an (arguably symbolic) attempt to pin down those individuals who earned huge sums in the UK but were non-domiciled (i.e. intended to return overseas 'eventually').

There are a number of key issues any government must consider when developing its tax regime:

- What are its spending plans?
- The incentive and disincentive effects of different taxes, particularly the disincentive effect on workers and firms of taxing wages and profits.
- The state of the economy.
- The political implications of a particular tax.

Different governments around the world face very different political and economic contexts. In some developing countries a major challenge is presented by the relatively small numbers of businesses and individuals who take part in the formal economy and therefore are subject to taxation. A simple tax at a low rate can be key to reducing the disincentives associated with going 'legit'. In fact many countries in the former Soviet bloc in Eastern Europe have addressed the issue of a large-scale **informal economy** by introducing a 'flat tax', more of which later.

Competing for investment

One of the main impacts of globalisation has been the internationalisation of investment. **Foreign direct investment** (FDI) is seen as a key determinant of long-term economic growth and therefore governments around the world enthusiastically court international investment. One of the ways in which they 'pitch' for such investment is via offering tax breaks and 'competitive' rates of corporation tax. Similarly governments attempt to attract rich and talented entrepreneurs to their country by highlighting the low rates of personal taxation. Table 1 illustrates the variability of tax rates around the world.

Table 1: Rates of tax in twelve countries

Country	Corporation Tax %	Income Tax %	VAT %
UK	28	0-40*	17.5
USA	15-35	15-35	– (sales taxes state determined)
Germany	30-33	15-45	19
France	33.33	5.5-40	19.6
China	25	5-45	17
India	30-40	10-30	12.5
Russia	20	13	18
Ireland	12.5	20-41	21.5
Monaco	33.3	0	19.6
Bulgaria	10	10	20
Czech Republic	20	15	19
Sweden	26.3	0-57	25

*From April 2010 there will be a new marginal rate of tax of 50% in the UK for earnings above £150,000 per annum. Source: www.worldwide-tax.com

Table 1 illustrates there is considerable variation between different countries. For example Sweden's top rate of income tax is 57%, compared with zero income tax in Monaco. Corporation taxes (on profits) are similarly variable, with the UK, once having one of the lowest corporation tax rates now being more a 'mid-table' country. Ireland has competed aggressively for FDI in the past two decades, and this is reflected in its low rate. The other trend one can note in the table is the increasing trend for countries (often former Eastern Bloc countries) to operate with a single marginal rate of income on all income levels (a flat tax), rather than the progressive approach with higher incomes being taxed at higher rates above certain thresholds.

Flat taxes

A flat tax is in essence a proportionate tax; a tax where the marginal rate of tax does not vary with income i.e. everyone, rich or poor, pays the same percentage of their income e.g. 15%. Countries in the former Eastern Bloc have operated flat tax rates at relatively low levels for a number of reasons, namely:

- administrative simplicity
- an incentive for both firms and individuals to maximise their productivity
- to try and entice firms from the informal economy into the formal sector (many of these countries have large illegal sectors – low taxes are better than no taxes)
- to compete for FDI

There has even been discussion by some members of the Conservative Party in the UK of the potential benefits of a flat rate of income tax in the UK, although a Conservative government would be unlikely to challenge the recent increase in marginal tax rates to 50% for high earners, despite its historic commitment to low taxes and small government. It will be interesting to see if this debate is re-opened if and when a Conservative government were to take office in 2010.

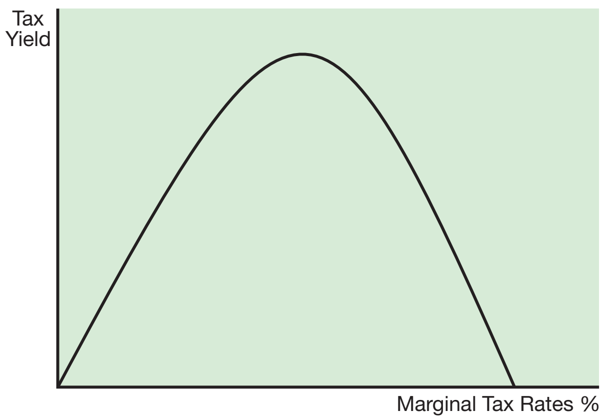
The Laffer curve

> ***"73% of nothing is nothing"***
>
> US Treasury Secretary Andrew Mellon in 1924, quoted in wikipedia.org

In 1924 the top marginal rate of tax in the US was 73%, and yet government tax revenues were low. By 1929 the tax rate for higher income households had been reduced to 24%. Rather than reducing tax revenues, this had the effect of increasing revenues by $281 billion.

This effect of reduced tax rates increasing revenues is illustrated by the Laffer Curve. Although far from being a new concept the economist, Arthur Laffer showed that the disincentive effect to work of higher tax rates can actually lead to lower tax revenues as shown in Figure 1. Obviously if a tax is at 100% then the worker has no incentive to carry out any more hours work when taxed at that rate, but what about 90%? Or 80%? Intuitively these high rates of marginal taxation will also have **disincentive effects**, and if this means a lowering of taxable incomes as people choose not to work, then a tax rise may lead to a fall in tax revenue. In simple terms the government may get more of the pie but the pie will be smaller. The Laffer curve was influential in the decision by Western governments particularly the US and UK to make massive cuts in marginal rates of income tax in the 1980s.

Figure 1



However, the empirical evidence to support the Laffer curve is mixed – the cuts in marginal tax rates in the 1980s did not lead to increased tax revenues in the US or the UK, so perhaps it is only in extreme cases, as in 1920s USA that we will see the Laffer Curve effect in action. Certainly, though, what remains influential is the idea that high marginal tax rates provide disincentives to work and therefore provide a supply-side constraint.

The EU and taxes

Membership of the EU constrains a country's ability to engage in discretionary fiscal policy; European Monetary Union brings even greater restrictions in the form of the Stability and

Growth Pact. EU members are committed, in the interests of developing a genuine free market, to maintaining rates of VAT to within a range of 15-25%. This restricts the ability of countries to lower VAT to boost spending during recessionary periods – the recent reduction of 2.5% by Chancellor Alastair Darling in the UK was limited in part due to this taking VAT to the 15% floor.

When joining up to the Eurozone, countries also commit to other limitations via the Stability and Growth Pact. The two key measures of this pact mean that:

- annual budget deficits are limited to 3% of GDP
- national debt must be lower than 60% of GDP

The reasoning behind this pact is to prevent country's excessive use of tax cuts and government spending. Such 'loose' fiscal policy might unleash inflationary pressures across the zone which would then have to be dealt with via interest rate increases by the European Central Bank (ECB). This would mean that members with more prudent budgets might be 'punished' for the excesses of others. Critics of the pact have pointed to it creating a lack of flexibility to deal with economic cycles, a criticism which has become increasingly voluble during the present economic downturn. Furthermore enforcement of the pact has proved to be somewhat toothless. There was considerable criticism of smaller countries such as Portugal exceeding the key thresholds, but when bigger fish such as France also exceeded the limits the European Commission was somewhat less vehement in its condemnation.

Table 2 illustrates the 'compliance' data for selected Eurozone and EU countries.

Table 2: The Stability and Growth Pact within the EU

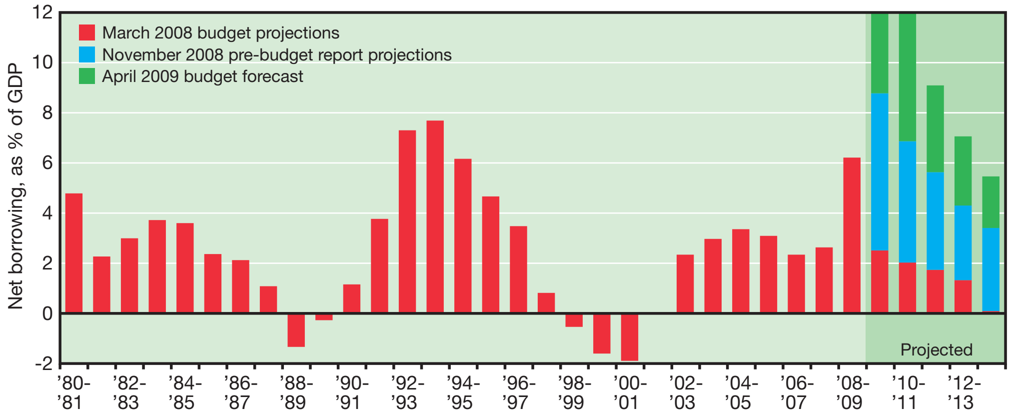
	Annual government deficit to GDP	**Gross government debt to GDP**
Germany	-1.7%	68.9%
France	-3.0%	66.9%
Italy	-1.9%	104%
Portugal	-2.2%	63.5%
Ireland	+0.1%	27.2%
United Kingdom	-4%	44.1%
Eurozone	-2.4%	70.5%
EU27	-2.3%	63.2%

Source: EU, 2006

Table 2 illustrates the problems many countries face in meeting the strictures of the pact. The euro is not on the agenda as far as the UK is concerned but in 2006 at least the UK seemed to be not too far from meeting the criteria. However as we project into the future and various stimulus packages being put together in the UK and across Europe, the Pact may become increasingly meaningless. The projections for debt in the UK illustrate this point. The credit agency Standard and Poor recently downgraded the UK's AAA rating of the UK's economy (i.e. the UK plc as a debtor) on the basis of its projections for fiscal debt. It believes that the UK's fiscal deficits will sit between 7 and 10% of 2009 GDP over the 2009 – 2013 period. It also believes that national debt will reach 100% of GDP in 2013.[1] These estimates are higher than the government's own estimates but are not too far out of line with them.

1. www.economicsuk.com – an excellent web-site developed by the *Sunday Times*' Economics Editor.

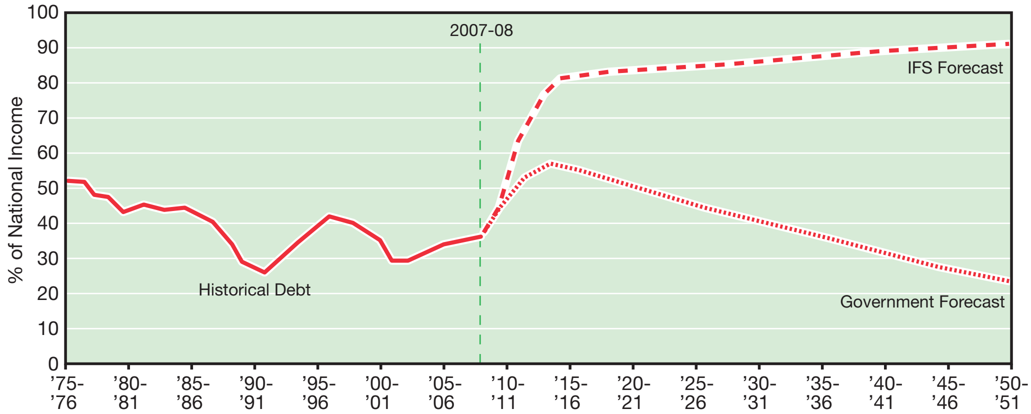
Figure 2: UK budget deficits, net borrowing, as % of GDP



Source: http://news.bbc.co.uk/1/hi/business/8012194.stm

Figure 3 illustrates the marked discrepancy between the government's own (relatively) benign predictions regarding the direction of future public debt and the view of independent commentators, in this case the Institute of Fiscal Studies.

Figure 3: Long-term UK government debt, % of national income



Source: www.economics.uk.com

Good and bad taxes…

Adam Smith was perhaps the first economist to look closely at the various means that government utilised to raise funds. He came up with criteria (or canons as he called them) which could be used to establish whether a tax was a good tax or not. More recently Joseph Stiglitz has attempted to up-date Smith's canons, adding his own version.

Adam Smith's canons of taxation:

- Taxes should be related to ability to pay
- The amount, timing and manner of tax should be certain
- Taxes should be convenient to pay
- Tax revenues should be significantly greater than the cost of administering the tax

Joseph Stiglitz's criteria:

- A tax should increase economic efficiency
- A should be administratively simple
- A tax should be flexible in responding to a changing economy
- A tax should be transparent
- A tax should be fair

Source: J.E Stiglitz, *Economics of the Public Sector*, 3rd Edition, 2000.

It could be argued that by going back to Smith, the Thatcher government might have been able to fend off the Poll Tax revolt, which for many contravened Adam Smith's first canon. Likewise by the end of the Poll Tax revolt, the cost of taking non-payers to court was mounting up significantly to bring canon 4 into question too. Modern payment systems such as Pay As You Earn (PAYE) fit comfortably into Adam Smith's criteria although he might question the over-complication of some other elements of the fiscal regime operating in the last decade or so, as Gordon Brown's micro-management of the tax system, possibly began to weaken the effects of Smith's third canon. The Stiglitz criteria can also be used as a useful analytical tool to look at revenue-raising devices critically. The role of automatic stabilisers in the present economic downturn fits comfortably with this third criterion. The economic efficiency point links well with so-called 'green taxes' aimed at closing negative externalities in line with the producer pays principle.

New Labour and taxation

New Labour has laid out in various policy documents its own objectives for its tax regime:

- To keep the overall tax burden as low as possible.
- To reduce tax rates on income to sharpen incentives to work and create wealth in the economy.
- To maintain a broad tax base – having a range of taxes helps to keep each separate tax rate low.
- To shift the balance of taxation away from taxes on income towards taxes on spending.
- To ensure taxes are applied equally and fairly to everyone.
- To use taxes to make markets work better (including the use of environmental taxes to make both consumers and producers aware of external costs).

At this point in the political cycle as, arguably, the New Labour government enters its death throes, it is a useful exercise to assess the degree to which New Labour has met these objectives (see the discussion question below). Certainly it has proved unable to continue to keep the overall tax burden as low as it would like as we move into a period of recession and tighter budgets; the 2010 50% top rate tax is the clearest example of this failure. Its desire to maintain a broad tax base has opened up the accusation of taxation by stealth. The VAT cut in 2008 challenged the idea that the government is committed to reducing the tax on spending which in itself can be seen as a commitment to a more regressive tax regime in any case, a strange position for a labour government to find itself in. New Labour has also been accused of over-elaboration in its approach to fiscal policy; the various tax credits systems may be laudable in their intention but may be underclaimed due to their lack of administrative simplicity. Most damningly though, the Labour government has broken its own golden rules which were in effect that:

- The government should only borrow to invest.
- Deficits and surpluses should balance over the course of the economic cycle.

The golden rule looks beyond repair as the debt projections shown in Figures 2 and 3 indicated. New Labour would argue this is because of the present, unprecedented economic climate (other commentators were declaring this situation some time previous to the actual appearance of the recession) and the events themselves being global not local in cause. The criticism can be made though, that even if the credit crunch could not be anticipated, it was still naive to expect the benign conditions of the last decade or so to last forever. The intuition underlying the golden rule, that the government should put something aside in the good times was ignored, making the UK, in the view of some independent parties (importantly the

IMF) to be less well-placed to face the global downturn than other countries, though this is just one reason amongst others for this negative forecast.

Conclusions: looking forward

The long-term trend towards cutting marginal tax rates will probably take a good step backward in the medium-term as governments face the pressures of maintaining public spending commitments, funding generous Keynesian-style stimulus packages, whilst also not wishing to increase public debt too much. Future tax increases are likely in the medium-term. Both political parties in the UK are committed to introducing a higher tax rate for the richest in society in the next few years, reversing the trends of the last few decades. However in the longer term countries will continue to compete for global capital, and low taxes will remain one of the means whereby countries attempt to make their countries attractive destinations for FDI; the Global Tax race will resume – will the UK attempt to return to the front of the field where it led the way in the 1980s or will it be content to stay in the middle of the pack? There are strong arguments on both sides…

Summary of the Main Points

- The general trend over recent decades was for marginal rates of direct taxation to fall but the credit crunch and the recession has brought about a reappraisal of fiscal policy.
- The UK government has faced accusations of maintaining its tax revenues by stealth i.e. increasing less noticeable, regressive taxes whilst keeping direct taxes relatively low.
- The UK has moved down the list of countries based on the level of tax as other countries have cut tax rates in recent years.
- The projections of UK national debt point to tighter fiscal policy in the UK for some time ahead.

Questions for Discussion

1. John Maynard Keynes once expressed that one should not worry about the fact that government borrowing has to be paid back in the long run (as we are all dead in the long run!) – to what extent do you agree with this view?
2. Will higher taxes on the richest in UK society inevitably lead to a 'brain-drain'?
3. Should the UK cut tax rates to ensure greater levels of FDI in the future?
4. Identify the arguments for and against the government introducing the new top rate of tax for the richest in society.
5. Assess the following according to Adam Smith and Joseph Stiglitz criteria for a 'good tax':
   - VAT
   - Cigarette duties
   - Income tax
   - Council tax
   - The congestion charge

Topic 9

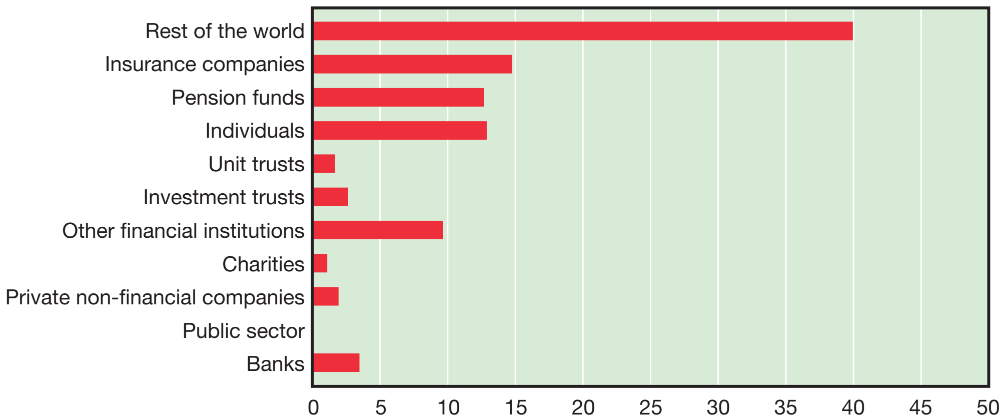
UK for sale

Does it matter if in the future there are no UK-owned firms?

British firms employing British workers to produce goods for British consumers – fine sentiments, but ones which are more unrealistic now than ever before. Many seemingly British firms have substantial numbers of shares owned by foreign investors – more than a third of the FTSE 100 are owned by foreign companies and 10 of the 100 aren't even British. The Abbey bank is actually owned by Spanish firm Santander, Yorkshire Power and Thames Water are owned by German firm RWE and Rover is now part of Chinese firm Nanjing. The UK is increasingly owned by foreign investors – but does this matter?

When foreign companies started buying up large numbers of UK companies in the 1980s, there was considerable concern expressed by politicians and the press that allowing profits from, and control of, our companies to go abroad was potentially a dangerous thing to do. However, today, when UK firms are bought by foreign companies, there is barely a murmur of comment. Maybe it is time to review our relaxed approach to foreign ownership of UK production. Figure 1 shows that foreign investors now hold 40% of UK shares.

Figure 1: Ownership of shares in UK companies



Source: www. statistics.gov.uk

This Topic aims to explore how attitudes have changed, what arguments have been used against the purchase of UK companies by foreign nationals and provide a general overview of the current situation.

Attitudes to foreign ownership of UK firms: a case study

The change in attitudes from the 1980s, when each acquisition of a UK firm was greeted by outraged voices is probably best shown using a timeline for BAS Systems. BAE Systems is the UK's leading defence contractor.

- 1977 – BAE Systems starts life as British Aerospace, formed from various government-owned companies.
- 1981 – British Aerospace is privatised by the Conservative Government as part of its programme to reduce the size of the public sector. The government sells 52% of the company, but limits foreign ownership of shares to a maximum of 15%.
- 1985 – The government sells the remaining 48% of shares in the company, but keeps a special £1 share so it can claim that the company is still under British control and maintains a veto on foreign takeovers of the company.
- 1989 – The limit on foreign ownership of shares is raised to 29.5%
- 1998 – The limit on foreign shareholding is raised to 49.5% with a new 15% limit on the amount of ordinary shares which may be owned by any single foreign investor.
- 1999 – BAE Systems is formed.
- 2006 – Lord Drayson, the government's defence procurement minister states that he is "relaxed" at the prospect of BAE Systems leaving the UK and basing itself in the US.

This timeline suggests a substantial shift in sentiment for a company which originally produced the Spitfires and Hurricanes which fought the Germans in World War Two. The logic of the move to the US is based on the fact that US spending on defence is substantially higher than any other country and the fact that the US has strict rules requiring firms making weapons for the American government to be run by American citizens. BAE's Chief Executive is not even allowed to know the details of American contracts signed by the US arm of the company. It even took intervention by the British government at the end of 2006 to ensure that the contract for the Joint Strike Fighter was run by BAE, as the US government was concerned that technology used in the new plane would be leaked to other countries. It is interesting that in response to what appears to be unfair, asymmetric rules on company ownership and procurement in the UK and the US, Lord Drayson did not argue with the American rules, but suggested that what was important was where the company's skills and intellectual property reside – which he believed would remain the UK.

Arguments in favour of protecting British firms from foreign takeovers?

There are several arguments which economists use against free trade and most of them are applicable to the situation where British firms are being bought up by foreign investors.

National security

This is an argument not based on economics which is frequently used by the American government when the defence industry is considered. The argument suggests that in times of war, certain strategic industries are absolutely vital if the country is to survive. Key examples of this types of industry are the armaments and food sectors. As a result of this argument, the government should ensure that enough domestic (British in this case) firms exist to guarantee that production can be continued in the event of war. The founders of the EU acknowledged the power of this argument when creating the European Coal and Steel Community (ECSC) which was intended to bind together the production of these vital raw materials so that there could be no more wars between the members of the ECSC. Similarly, the Common Agricultural Policy is often defended using this argument as it is claimed that Europe should be self-sufficient in food supplies to avoid being starved into concessions or defeat by other countries.

The weakness of this argument is that almost any industry can be defined as important to national security if you stretch the definition wide enough. Hence recent EU summits have discussed the issue of energy security after Russia cut off supplies to some states – something few had considered them likely to do. Should we now consider water security? In July 2005 France in the guise of industry minister Francois Loos declared yogurt to be a 'strategic' business after rumours of a takeover of Danone by America's Pepsico raised share prices. In addition, the precise costs and benefits resulting from protecting strategic industries are very hard to calculate – clearly consumers will face higher prices, but what are the benefits? Ironically, the British government chose to give defence contracts to BAE Systems for many years as a result of its preference for a British producer rather than a completely open tendering process, which probably contributed to the fact that in 2003 the National Audit Office stated that Britain's biggest defence contracts, most of which were managed by BAE, were on average 18 months late and £3 billion over budget. It is only since it became clear that government was prepared to go elsewhere that BAE's performance appears to have improved.

Protecting a way of life

This argument suggests that a nation may wish to protect certain industries as they preserve a way of life which the government believes are either traditional or have external benefits for the nation. This argument is mainly used when discussing French farmers, where the government believes that their traditions (e.g. in wine and cheese production) need to be protected for future generations. Similarly, there are restrictions on media ownership in France to protect the 'Gallic Cultural Exception' which do not permit foreign ownership of large media organisations. Ironically the strong argument made to protect farming by various European governments as part of the Common Agricultural Policy have allowed many British farmers to benefit and maintain their traditions too.

New industries

This is a popular argument in favour of protectionism, suggesting that a new domestic firm needs to be protected to ensure that it can compete with larger foreign producers or have time to develop its own way of doing things. The logic of protecting a small industry from larger, multinational firms is that the bigger firms will be able to take advantage of economies of scale so only through protecting the smaller firm will it be able to develop. There does appear to be some validity to this argument, with research by Nottingham University published in 2007[1] suggesting that the presence of a multinational increases the chance of a British start-up company going under in the first year. One of the main problems with this argument is defining precisely what is meant by an infant industry as in many cases the transition from an infant to a mature industry happens while protection is still in place.

Protecting jobs in the UK

This argument suggests that protection is worthwhile as it will stop jobs being lost within the UK. This argument seems particularly relevant for manufacturing in the UK at present, where the substantial decline in output since the start of the 21st century has resulted in job losses across the country. In many cases the job losses are due to production being transferred abroad and this happens more easily when multinationals are involved, e.g. in 2007 French car maker Peugeot Citroen closed its Ryton plant near Coventry, causing 2,300 job losses and in 2004 when Terry's of York (owned by a multinational) transferred production of its chocolate from York to mainland Europe.

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1. Conducted by the university's Global and Economic Policy Centre,
see http://www.gep.org.uk/leverhulme/press/press_releases.php, July 2007.

However, there are clear arguments against the protection of jobs by banning foreign ownership of firms. As the UK receives so much investment from foreign firms, any restrictions on foreign ownership are likely to reduce the number of jobs in the UK and any retaliation by other countries could well lead to a fall in demand for British goods and further job losses. Similarly, economic theory would suggest that total job losses may not be that high, as the jobs lost in manufacturing should be converted into others in areas where Britain has a comparative advantage – hence a Labour minister's comment in 2005 that recently sacked Rover workers could find a job at Tesco's, while not sensitive, may have had some economic grounding to it.[2]

Keeping the economy stable

If an economy has protectionist measures in place, it will need to produce a greater range of goods domestically than an open economy, which means that the country will be more stable as falls in demand for any one particular good will not have a disproportionate effect on the economy as a whole. It is possible to see why this argument is attractive when looking at countries which rely on one crop or raw material for the majority of their exports e.g. Brazil and coffee. In the event of a major fall in price, the economy can go into recession as it is not diverse enough. Hence limiting foreign involvement in a country can provide a more diverse range or production within the economy and prevent recessions due to falling prices in certain markets.

Alternatively, a relevant idea is the way in which problems in one economy spread much more quickly around the globe when multinationals are involved. An example of this was the 'contagion' in 1997, where the collapse of the value of the Thai baht quickly spread to other currencies within the region. Further action by speculators and governments led to the collapse of a US hedge fund and a global slump (e.g. following the crisis, the growth forecast for the UK fell by 0.4%). In this case the 'contagion' happened when poor decisions by the Thai government infected the rest of the world, but in August 2007, another potential contagion occurred when the stock markets across the globe went into free fall as a result of rising levels of default for 'sub-prime' loans across the US. In this case the problem was specific to the US, where too many mortgages had been given to people who would not normally qualify for loans. These loans were subsequently divided into separate tranches which were sold to other firms across the globe, spreading the problem when the borrowers started to default on the loans and causing the crash in the value of stocks across the world. In the global market place, a poor regulatory regime in one area can cause a crash across the whole world, but a protected economy which limited foreign ownership may well be able to avoid this sort of instability.

Why do the British allow so many takeovers by foreign firms?

> ***"I believe passionately that our free trade nature, our open corporate society, our refusal to put up the protectionist barriers, have made us the location of choice for investment from overseas."***[3]

For British, US, Canadian and Australian economists, the ownership of a company by a foreign investor reflects an efficient market at work and is to be supported as such. Indeed there is a clear difference in approach between even the most protectionist of these four governments

2. Margaret Hodge as quoted in *The Independent*, 17 June 2005.
3. Digby Jones, then Director-General of the CBI quoted in 'Buy British', *The Daily Telegraph*, 10 October 2006.

and those elsewhere in the world. For example, when Airbus, the aircraft manufacturing subsidiary of the European-owned EADS aerospace group announced that it may have to close plants, the reaction in Europe was markedly different to that which would have occurred in the UK. Firstly, as a reaction to the falling share price, Germany's Daimler-Chrysler announced plans to sell off its large share holding in the company (this would have happened in the UK). This would have left the French government with a 22.5% shareholding and the largest say in where the job losses would occur, so the German Chancellor Angela Merkel acted to ensure that KFW, the German state-owned bank bought up the Daimler-Chrysler shares. At the time Chancellor Merkel commented:

"We want France and Germany to have an equal say in the EADS project."[4]

This markedly different approach, designed to defend German jobs, would be criticised by British economists on a number of fronts.

• *Comparative advantage*

As different nations have different natural advantages, it makes sense if they specialise in the areas where they have a comparative advantage. In the UK's case, there is good evidence that our management of companies is poor (see Topic 10) and foreign ownership and thus management is actually of some benefit to our companies. Indeed the productivity of British workers in foreign-owned companies is higher than those in British owned companies.

A good example of this is the rescuing of the British car industry by Japanese firms over the last twenty years. Under British management, the car industry failed to compete and eventually many of our ineffective car manufacturers were merged to form British Leyland which became the third largest car manufacturer in the world. Unfortunately the merger did not change the underlying ineffectiveness of UK car manufacturers and output collapsed from 1.9m cars in 1972 to 0.9m in 1982. However, Japanese car manufacturers had decided the UK was the right place to invest and Nissan set up its first plant in Sunderland, then Toyota in Derbyshire and Honda in Swindon – all creating some of the most efficient plants in Europe. In 2005 1.6m cars were produced in the UK. Hence it could be argued that foreign ownership and investment saved the British car manufacturing industry – which should be welcomed.

• *The 'Wimbledon Effect'*

The Wimbledon effect refers to the Britain's prestigious tennis championship, which takes place in London each year, but where British competitors seldom feature (a pity Tim Henman retired really). The comparison with Wimbledon, is to the City of London, which after deregulation ('Big Bang') in the mid-1980s became dominated by foreign investment banks rather than British ones. The question arising is does it matter if the City has a large number of foreign-owned firms in it if they add to the skills and capabilities available in financial services and are still based in London? It may be argued that the free movement of capital and labour has given Britain a comparative advantage and it is the reason why London is seen as one of the few genuinely global cities and a rival to New York.

• *UK business culture*

A less obvious argument in favour of foreign takeovers is that UK business culture has changed so fundamentally since the 1980s that large British corporate raiders can no longer exist. In the 1980s, Lords Hanson and White launched a succession of takeover bids to turn Hanson into a multinational conglomerate with a huge range of interests across the world, including chemical

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4. *Spiegel*, Online, 16 October 2006.

factories in the US, electricity supply in the UK and gold mines in Australia. Hanson's products ranged from cigarettes and batteries, timber and toys, golf clubs and jacuzzis to cod liver oil capsules and cranes. By the time Lord Hanson stepped down in 1997, the company was already starting to sell off parts of its business and has now focused in on its core business – heavy building materials. In this case the change in UK governance arrangements and the culture that denigrates the overpayment of chief executives makes it unlikely that a corporate raider similar to Lord Hanson could emerge in the near future.

Should the UK be concerned about foreign takeovers?

In reality, while economic arguments can be made for and against foreign ownership of British firms, there are a few key factors which need to be considered before deciding if an individual takeover is beneficial or not.

The first relates to whether the takeover does indeed add value to the UK economy – it is quite possible that a takeover could shift head office or manufacturing abroad but keep the customers. Such an example would clearly damage the British economy through job losses and potentially tax revenue. Of course, it is hard to know in advance whether a potential takeover is likely to lead to the loss of British jobs and in 2003 a takeover of the British firm Amersham International by GE led to the company's headquarters moving from the US to the UK.

In relation to the previous point, it is fair to comment that many foreign companies buying British firms do pay less tax as a result of being able to move profits around the globe. Unions (among others) have a concern that British firms that become part of a multinational organisation will find that their UK subsidiaries will be the first to be closed down as we have the most liberal employment protection laws in Europe.

However, the most popular argument which is raised by politicians against the increase in foreign takeovers is that British firms cannot take over foreign firms in the same way foreign firms can take over British ones. Alan Duncan when shadow trade secretary said:

> ***"...free markets and international competition are good for British consumers, giving them better services and lower prices, but this only works if we play by the same rules."***[5]

This argument is applied particularly to Spanish companies who benefit from a special law which allows them to offset against tax 30% of the goodwill cost of any foreign corporate purchase. As goodwill is hard to measure as it is not a fixed asset, this means that Spanish firms have a state-subsidised advantage in any bid for another firm, effectively meaning they can outbid other firms. However, it is not only Spain which indulges in protecting their own firms while encouraging purchase of British firms – almost all the examples given previously could serve to demonstrate the fact that the playing field for British firms is completely uneven.

Finally it is worth considering that to economists like Will Hutton, it is the short-term nature of the British stock market which has held back the UK economy. If this is the case then foreign (especially European) takeovers should be encouraged as it will allow British-based firms to make better long-term decisions. A good example of this sort of clash of values was seen in the battle to takeover Alliance Boots in 2007 where Italian businessman Stefano Pessina felt that the shares of the chemists were being consistently undervalued and so arranged for private

5. *The Daily Telegraph*, 11 June 2006.

equity firm KKR to bid for the company. As a European businessman, Stefano Pessina was used to the stockmarket not taking a more long-term view and despite the large number of shares owned by pension funds, the City is not perceived as being good at taking a long-term view.

Summary of the Main Points

- An increasing number of UK-owned companies and shares are owned by foreign investors.
- There are a number of reasons why the UK government might choose to protect British firms from foreign takeover, including national security, protecting a way of life or jobs and maintaining stability in the economy.
- The UK government and economists generally believe that foreign ownership is a positive force in our economy, encouraging competition and giving consumers a greater range of goods at lower prices.
- Arguments that the high level of foreign ownership does not matter focus on the productivity foreign firms achieve and the effectiveness of the UK as a base for foreign investment.
- The largest problem politicians today seem to see in high levels of foreign ownership of UK firms is that there is not a level playing field, i.e. British firms cannot purchase foreign firms as easily as foreign firms can buy British ones.

Questions for Discussion

1. Should the UK government rely on the US to supply our military equipment?
2. Is the French government right to classify yoghurt as a strategic industry?
3. How might the present economic crisis affect the trend in foreign firms increasingly owning UK assets?
4. To what extent do you agree that by allowing foreign ownership of British firms productivity and efficiency will increase?
5. How far, within the UK's commitments to the WTO and EU is it feasible for the UK to prevent foreign ownership of UK firms?
6. Should the UK government prevent foreign firms from buying British firms? If so are there particular sectors where this should apply?

Topic 10

How competitive is the UK in the 21st century?

This Topic aims to examine what is meant by competitiveness, how it is measured, where the UK stands in relation to other countries and which areas have affected the UK economic environment in recent years. As part of this last section, there will be a brief consideration of productivity, where long-term problems have reduced UK competitiveness.

What do we mean by competitiveness?

It is important to be clear what the difference is between the concepts of 'competition' and competitiveness.

'Competition' focuses on the behaviour of firms and whether they choose to exploit their markets in an anti-competitive way. In the UK the Competition Commission is the main body which deals with mergers of large firms, the way firms compete in different markets and regulation of certain industries. For example in July 2007, the Competition Commission concluded that a joint venture between two firms supplying carbon dioxide could damage competition in that quite specialised market.

'Competitiveness' on the other hand refers to the ability of countries, regions or cities to trade in the global market place. It is seen as a broad concept, which has a wide range of factors which contribute to it and government policies which contribute to it. It is frequently suggested that more efficient markets are the key factors determining competitiveness, however it is important to consider a number of others, including output per worker (productivity), education, infrastructure and innovation. An example of the range of factors which policy makers must consider was given by Alistair Darling MP, then Secretary of State for Trade and Industry:

> ***"We must seek competitive advantage by exploiting capabilities that our competitors cannot imitate. The UK has distinctive skills in innovation and creativity that we can draw on to produce high value goods and services. And there are good examples. Some of them household names. Such as James Dyson and his distinctly designed 'bagless' vacuum cleaner. His company is one of the fastest growing in Europe with sales of over £3bn worldwide."***[1]

It is clear from this statement that the concept of competitiveness is vital when considering the process of globalisation and how comparative advantage relates to the real world.

The increasing importance of competitiveness is shown by the fact that both Conservative and Labour governments have been producing reports on this subject since the mid-1990's. See, for example, the recent publication *UK Productivity and Competitiveness Indicators*[2]. A number

1. Keynote speech at the December 2006 Competitiveness Summit.
2. http://www.dti.gov.uk/files/file28173.pdf

of other nations including Ireland, Greece and Croatia have set up special government bodies to deal with the issues relating to competitiveness.

What are the key components of competitiveness?

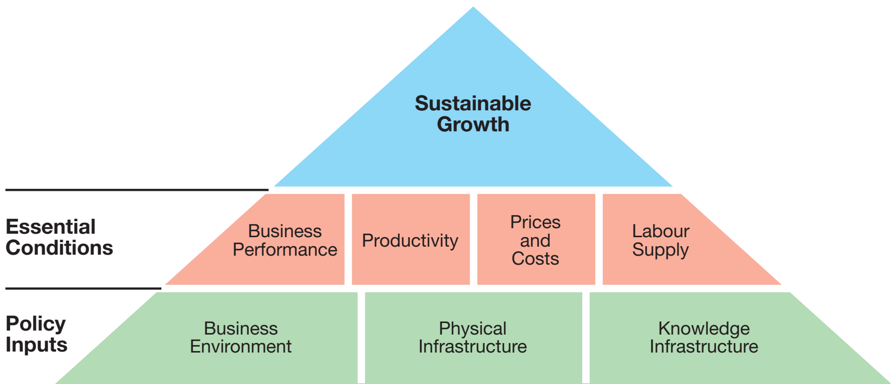
The National Competitiveness Council (NCC) which advises and reports to the Irish Government says that national competitiveness is a broad concept that encompasses a diverse range of factors and policy inputs including education and training, entrepreneurship and innovation, Ireland's economic and technological infrastructure and the taxation and regulatory framework.

For the National Competitiveness Council, the goal of national competitiveness is to provide Ireland's people with the opportunity to improve their living standards and quality of life.

The National Competitiveness Council uses a framework model to understand national competitiveness. It distinguishes between the 'inputs' to national competitiveness – over which policymakers can have greatest control – and the essential conditions for national competitiveness.

The Competitiveness Pyramid illustrates the framework model used by the National Competitiveness Council.

Figure 1: The Competitiveness Pyramid



Source: http://www.competitiveness.ie/aboutus/ourwork/

The policy inputs (the bottom row of the competitiveness pyramid) represent the foundation stones of the economy and are the primary drivers of competitiveness. The NCC believes that it is within these particular areas that policymakers can have the greatest impact on competitiveness. These are:

- Business environment. This includes tax levels, competition & regulation (like the Competition Commission), labour market regulation and how easy it is for firms and individuals to borrow.
- Physical infrastructure. This relates to transport issues like investment in roads, energy prices, the affordability of housing and ICT (e.g. what is the level of broadband usage).
- Knowledge infrastructure. This means education and training at all ages and the investment by both private and public sector in research and development.

The pyramid then outlines a range of intermediate areas, which have to function well if the economy is to remain competitive. These focus on the performance of business in terms of employment and investment, the levels of productivity (output per worker), inflation and changes in the labour supply (e.g. in the UK's case the influx of Eastern European Labour over the last few years).

It is then hoped that as a result of the right economic conditions, any growth achieved will improve the standard of living of the people living in the country through raising incomes and the quality of life.

How has the UK performed in the 21st century?

There are a number of different bodies offering comparisons of international competitiveness, but given the broad range of potential factors which might be considered or measures used, it comes as little surprise that they frequently produce different outcomes. However, it is fair to say that the various rankings for competitiveness do show the UK to be a less competitive economy than it was in 2000. To that extent, the debate about competitiveness relates to the extent and significance of the decline since 2000. The Institute for Management Development in Switzerland places the UK 20th in its competitiveness league for 2007. The World Economic Forum rankings for 2008-09 and 2009-10 are shown in Table 1.

Table 1: League table rankings of competitiveness for twelve economies

Country/Economy	2009-10	2008-09
Switzerland	1	2
United States	2	1
Singapore	3	5
Sweden	4	4
Denmark	5	3
Finland	6	6
Germany	7	7
Japan	8	9
Canada	9	10
Netherlands	10	8
Hong Kong	11	11
Taiwan	12	17
United Kingdom	13	12

Source: http://www.weforum.org/pdf/GCR09/GCR20092010fullranking.pdf

It is clear from these rankings that there is no 'right' way to achieve a competitive economy. The US with its relatively low tax regime was second in ranking in 2009-10 and was beaten only by Switzerland. It appears that each nation can choose its own route to competitiveness which may be based on entirely different factors to those of its neighbours.

In the future, it is expected that mature economies will find themselves moving down the competitiveness rankings as emerging economies like South Korea, China or India improve still further.

What are the causes of the change in UK competitiveness?

Since the beginning of the 21st century, the UK government approach under Tony Blair has been reasonably straightforward, suggesting that while the reforms introduced by Margaret

Thatcher during the 1980s in areas like deregulation, privatisation and competition had a significant, positive impact on UK competitiveness, these changes had achieved all that they could and a new approach was needed. The new approach, which has been linked particularly to Gordon Brown, both as Chancellor and Prime Minister focuses the agenda for competitiveness on productivity growth and improving the innovative sector of the UK economy.

Prior to focusing on the role of productivity in the calculation of UK competitiveness, it is worth suggesting where there have been clear successes and failures of government policy in the 21st century.

Improvements to competitiveness

The main area where there has been a clear improvement since the 1970s, which has been built upon in recent years has been macroeconomic stability. The inflation target (set by the government) allows the Bank of England to use interest rates to maintain a low level of inflation. In addition, the golden rule set by Gordon Brown, requiring the government only to borrow to invest over the course of the economic cycle, and the sustainable investment rule requiring net debt as a proportion of GDP to remain at a stable level below 40%, mean that the economy has been more stable in recent years than traditionally and variations in economic growth and inflation rates have been relatively small. This contribution to a stable economic environment has clearly created a business environment where firms are able and willing to invest. In this respect, the government has also proved willing to support the financial sector and City of London meaning firms have found it easy to borrow, which in turn has encouraged enterprise within the UK economy. On this last measure, UK individuals seem to have a much more positive attitude to taking risks in setting up a business than people in France or Germany, but still lag behind people in the USA.

Reductions in competitiveness

The areas of weakness in the 21st century are also widely agreed upon. These are focused upon regulation and taxation. While there has been a rise in the general tax burden, firms have felt that the complexity of the current system is unfair, particularly to small businesses who find that they do not have the time or resources to keep up with the changes to the tax regime, although even large firms complain that the costs of compliance are too large. In 2007, the tax code, a document which details the tax system in the UK, overtook India's to become the longest in the world. Similarly, the costs of regulation or 'red tape' are seen as unfair, especially as many regulations are regarded as ineffective or needless. The government has recognised the problem with regulations and announced in the 2005 Budget that it would set up the Better Regulation Commission to provide independent advice to government from business about new regulatory proposals. Many believe that a good example of excess regulation in housing is the introduction of Home-information packs – 'Hips' – which impose an extra cost on buying or selling a house without a clear benefit to either party in the deal.

A long-term problem: Productivity

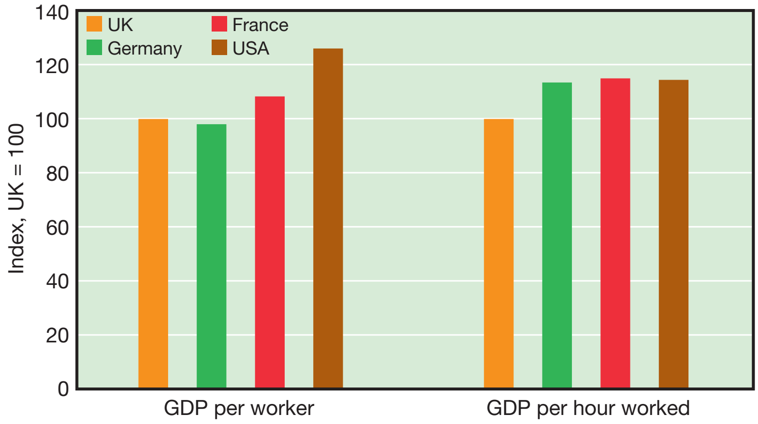
> ***"Productivity is the ultimate driver of living standards and the study by the LSE's centre of economic performance (CEP) said that while there had been some improvement, living standards were being held back by poor skills, low levels of innovation and poor management."***[4]

4. A. Seager, 'Britain narrows productivity gap', *The Guardian*, 25 June 2007.

This quotation underlines two clear areas of concern: skills and innovation. Both education and innovation contribute directly to a long-term problem for the UK – a productivity gap. The productivity gap is the difference between levels of productivity for British workers and those of other developed economies.

The core of the problem is shown in Figure 2.

Figure 2: The productivity gap in 2007



Source: Office for National Statistics, International Comparisons of Productivity

There are two main measures of productivity which are output per worker and output per hour worked. These measures show slightly different things. The output per worker shows the total amount of GDP each worker is responsible for, which means that a hard-working, but less skilled worker can have the same figure as a lazy but more skilled counterpart in another country. A direct comparison of the individuals in each country is offered by the GDP per hour worked figure, which shows how much workers in each nation make in an hour. Note that the figures in this case are index numbers based on the UK figures for 2007.

What these figures show is that French and US productivity per hour are the highest in the four developed countries considered (18% higher than the UK), with the UK worst on this measure. However, if productivity is measured on a GDP per worker basis, the US is the best, 23% higher than the UK, France is second, with productivity 8% greater than the UK and Germany is just below the UK. As with all economics, the problem is working out what this actually means – in this case it means that if a UK worker takes 9 hours to make an item, German workers could produce the same piece in 8 hours and French workers in 7 hours. In other words we are all working longer than the French to produce the same amount of income – suddenly making clear why the Irish government believes that competitiveness and productivity are essential when considering the standard of living. However, this remains a long term problem and there has been an improvement in the productivity gap since the early 1990s, although the latest figures suggest Germany and the US have been improving in relation to British workers over the last few years.

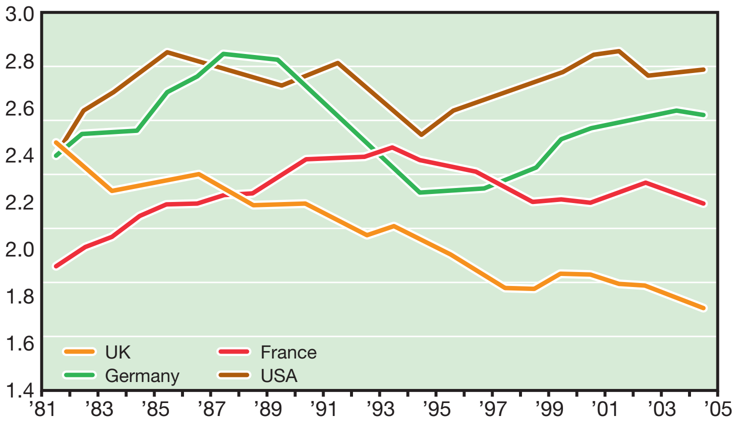
How to address the productivity gap

The UK government believes that there are five drivers of productivity improvement and lists these as investment (as better capital will mean more productive workers), innovation (as exploiting new ideas will lead to greater productivity), skills (better educated workers will produce more), enterprise (more businesses will be more productive) and competition (which will drive workers to make more). This Topic will conclude by focusing on two of these areas, which were identified in *The Guardian* article quoted at the start of this section. These are firstly, Innovation and secondly, Education.

Innovation

The way in which innovation affects productivity is mainly measured through the amount spent on Research and Development (R&D) although the government does have other measures like the number of citations for British institutions in academic journals or the number of US patents taken out. R&D budgets are a reasonable measure of the way productivity is likely to develop as they reflect both the creation of new knowledge and technologies and the spread/use of existing technologies.

Figure 3: R&D performance in four economies as a proportion of GDP



Source: Institute for Fiscal Studies

Figure 3 shows the long-term decline of R&D spending in the UK as a proportion of GDP. This downward trend is a particular concern as both Germany and the US have maintained their level of spending on R&D and in France there has been a substantial increase in the amount spent. Figure 3 suggests that the UK has relatively low levels of innovation, although this may be because we have relatively few large firms in areas which are likely to undertake substantial amounts of R&D (i.e. accountants aren't likely to spend a lot on R&D, but manufacturers may well do). It has been suggested that governments should offer a subsidy to allow firms to increase the amount of R&D they undertake, but as with all subsidies, the funding required to change the behaviour of firms (who undertake the majority of innovation in the economy) is unlikely to be forthcoming. As a result to try and improve the amount of R&D undertaken in the UK, the government has attempted to increase the links between universities and business and introduced an R&D tax credit, available to firms in various sectors.

Education or skills

The education of Britain's workforce is seen as a key factor in the productivity gap between the UK and other countries. In general, higher levels of qualifications are equated with higher levels of skills and higher levels of skills increase productivity and hence competitiveness in the following ways:

- More skilled workers are more efficient and effective, meaning they are more productive.
- More skilled workers generate more innovative ideas making the economy more competitive.
- More skilled workers enable firms to undertake more complex production processes.

On the whole there is a recognised link between education of the workforce and economic growth, and the UK has benefited from a rising number of people staying on in higher education since the early 1990s. The UK is comparable to France or Germany in terms of people who have been educated to a higher (university) level; it lags behind the United States. Where the UK is recognised to have a problem is in the number of people who have intermediate qualifications – which are divided into two categories equivalent to A levels and GCSEs. There has been improvement in this area with the number of people having very poor qualifications falling from 37% in 1996 to 27% in 2003, but this still leaves the UK far behind the US, France and Germany.

Finding a way to raise the level of basic skills across the whole population remains a challenge for the UK if it is to close the productivity gap with its neighbours and so improve our competitiveness.

Summary of the Main Points

- Competitiveness reflects the ability of a country to trade and is increasingly important in the global economy.
- The UK is less competitive than it was in 2000, but the extent of the decline is open to debate.
- The creation of a stable macroeconomic environment has improved the UK's competitive situation, but increased regulation and an overly complex tax code have undermined this process.
- A low level of productivity among UK workers is preventing the UK from competing effectively with the US, France or Germany.

Questions for Discussion

1. What are the difficulties in measuring competitiveness?
2. What measures of competitiveness seem to be the most significant?
3. Investigate the concept of 'a race to the bottom'. How relevant is this concept in the context of competitiveness?
4. What effect will the UK's declining competitiveness have on the UK economy in the long-term?
5. The UK's productivity gap is a long-term problem. Analyse three potential policies which could address this issue and suggest how successful each might be.