Question 2: UK and EU: A Tale of Two Economies

Extract 4: The Evolution of the Eurozone

The common currency was an outgrowth of efforts that began in the mid-20th century, as Europe reeled from the carnage and disruption of two world wars. In 1957, this vision came closer to being a reality with the signing of the Rome treaty, which established the European Economic Community (EEC), comprising of Belgium, France, Italy, Luxembourg, the Netherlands and West Germany. Step by step, restrictions were eased on work, travel and trade between the expanding list of EEC countries.

The European Union (EU) was established in 1993 and created much of its economic structure and institutions – including setting in motion the process of adopting a common currency, the Euro.

Advocates of the Eurozone rightly argue that it was not just an economic project that sought to improve standards of living by increasing the efficiency of resource allocation, pursuing the principles of comparative advantage, enhancing competition, taking advantage of economies of scale and strengthening economic stability. More importantly, it was a political project; it was supposed to enhance the political integration of Europe, bringing the people and countries closer together and ensuring peaceful coexistence.

Source: The Problem with Europe is the Euro, The Guardian, August 2016

Extract 5: Brexit

Countries band together to promote trade, defend human rights, protect the environment and repel threats. They sign treaties and join international groups, and each time they do, they give up a bit of independence. That happened in a big way with the creation of the European Union (EU), a free-trade zone and global political force forged from different European countries.

Freedom of movement for labour is one of the key principles of the EU. However, this ease of movement has been attacked in the UK, which had an unexpectedly high level of migration from several old Soviet bloc states after they joined the EU. Findings from the British Social Attitudes (BSA) survey revealed that Brexit was the result of widespread concern over the numbers of people coming to the UK that strained public services– millions of whom have done so under the EU’s freedom of movement rules in recent years.

As a result, the people of the UK, in a June 2016 referendum, shocked the world by voting to leave the bloc they'd joined in 1973. The way many Britons saw it, the EU was expensive, out of touch and a source of uncontrolled immigration. They chose what's become known as Brexit.

Adapted from: Bloomberg, December 2017

Extract 6: The Pros and Cons of Leaving the EU

The Eurozone economy is growing twice as fast as the UK's. The Eurozone economy's gross domestic product grew 0.6 percent in real terms in the second quarter of the year — versus 0.3 percent for the UK Contrary to appearances, this is good news for Britain. But it also illustrates what the British economy stands to lose from Brexit.

Some see the contrasting performances of the economies on either side of the Channel — highlighted by the Bank of England cutting its UK growth forecast— as a sign that worries about Brexit are beginning to weigh on British consumers and businesses.

The impact of Brexit is manifold. The pound slumped to the lowest level in 30 years on Friday, tumbling as much as 13 per cent, as investors took flight at Britain's shock decision to leave the EU. The weakness of the pound is fuelling domestic inflation, constraining household spending and hurting European exports to the country.

Furthermore, uncertainty about the terms of a Brexit deal between London and the EU is putting a brake on investment, as "businesses are delaying crucial decisions," said Bert Colijn, senior economist at ING Bank in Amsterdam.

Outside the EU, the UK would lose trade with its neighbours (17 percent of EU exports go to the UK, whereas the EU absorbs 44 percent of UK exports) and reduce its negotiating power with the rest of the world.

It seems the UK can't look anywhere else for hope. The Bank of England cut its growth forecast for this year from 1.9 percent to 1.7 percent, after a similar move by the International Monetary Fund last week. And there are few other available means to boost growth in the short term.

Monetary policy has run its course after a massive easing last year in the wake of the Brexit referendum. "It's easy to forget that the UK economy has relied massively on monetary stimulus in the last year, but that is coming to an end," Moëc noted.

Nonetheless, Brexiters said UK's departure from the EU could more than compensate for those disadvantages because it would be free to establish its own trade agreements. Furthermore, the UK will no longer be bound by the Maastricht Treaty[1] and is now able to use fiscal policy tools with greater flexibility. Currently, the UK's budget deficit is forecast at 3 percent of GDP, unchanged from last year.

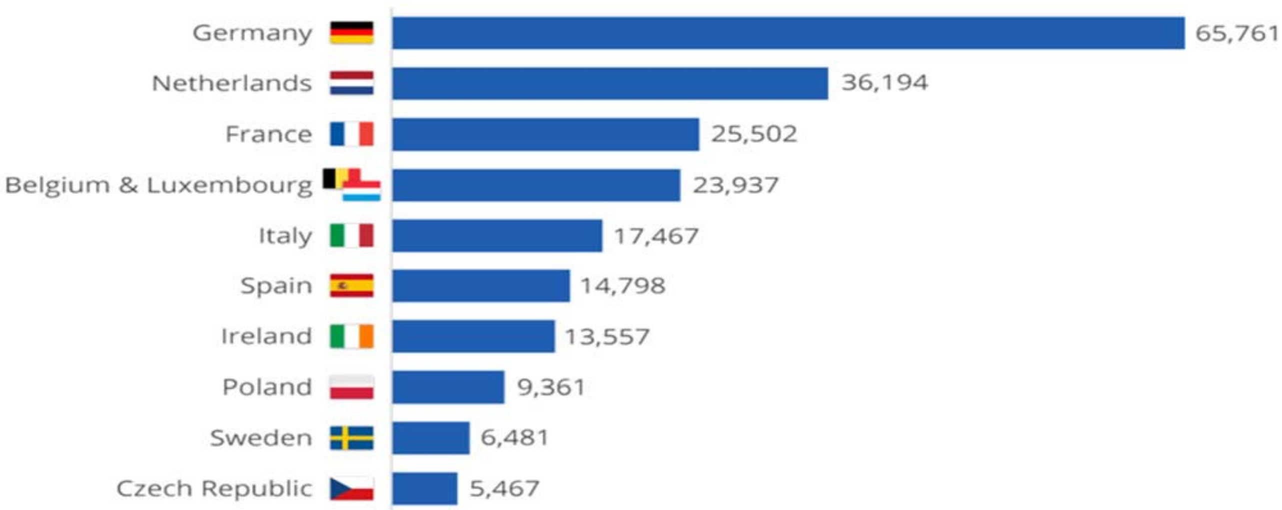
Adapted from: Politico, August 2017

[1]Article 126 of the Maastricht Treaty defines two criteria which Member States' governments should comply. These are: a deficit to Gross Domestic Product (GDP) ratio of 3% and a debt to GDP ratio of 60%.

Figure 3: USD per unit of Great British Pound (GBP)

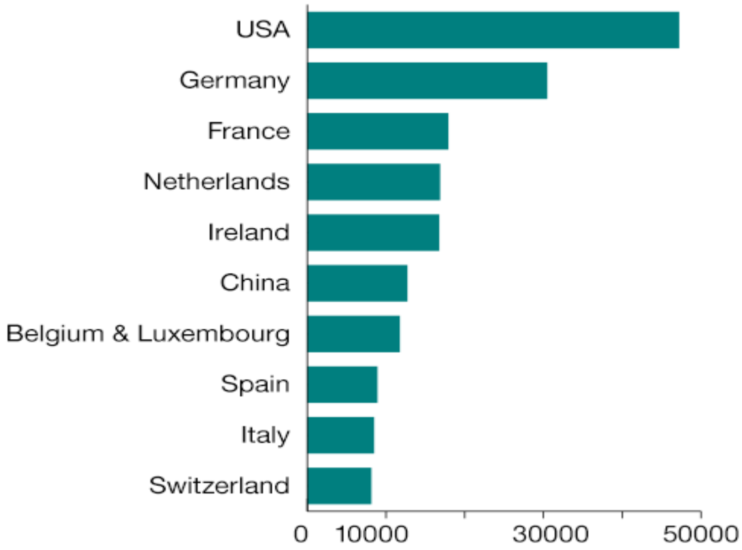
Source: Macrobond, The Independent

Figure 4: Import sources of the UK in 2016, by import value (in million GBP)



Source: Office for National Statistics

Figure 5: Export destinations of the UK in 2015, by export value (in million GBP)



Source: Pink Book, Office for National Statistics

Questions

(a) (i) How does the value of Great British Pound (GBP) in April 2016 compare to its value in May 2017? [1]

(ii) With the aid of a diagram, explain one possible reason for the trend above. [3]

(b) With reference to extract 4, use PPC analysis to illustrate how the following will lead to an improvement in material standard of living:

(i) Pursuing the principle of comparative advantage [3]

(ii) Enhancing competition [3]

(c) Explain why the weakness of Great British Pound (GBP) will hurt European exports to the UK. [2]

(d) With reference to the data, discuss how Brexit is likely to impact the UK economy. [8]

(e) In the light of the issues mentioned in Extract 6, discuss the policy options available to the UK government to achieve its macroeconomic goals. [10]

[Total: 30]

<u>Suggested Answers</u>

(a)(i) How does the value of Great British Pound (GBP) in April 2016 compare to its value in May 2017? [1]

- The Great British Pound has depreciated against USD.
- Falling [0]

(a)(ii) With the aid of a diagram, explain one possible reason for the trend above. [3]

Ext 6: "investors took flight at Britain's shock decision to leave the EU." Supply for pound increases due to capital flight from economy due to uncertainty. As such, people lose confidence in the currency and started selling GBP. Hence, this increases the supply of GBP in the foreign exchange market as shown in the diagram from SS1 to SS2 and this caused the value of GBP to fall from $\$F_1$ to $\$F_2$. [2]

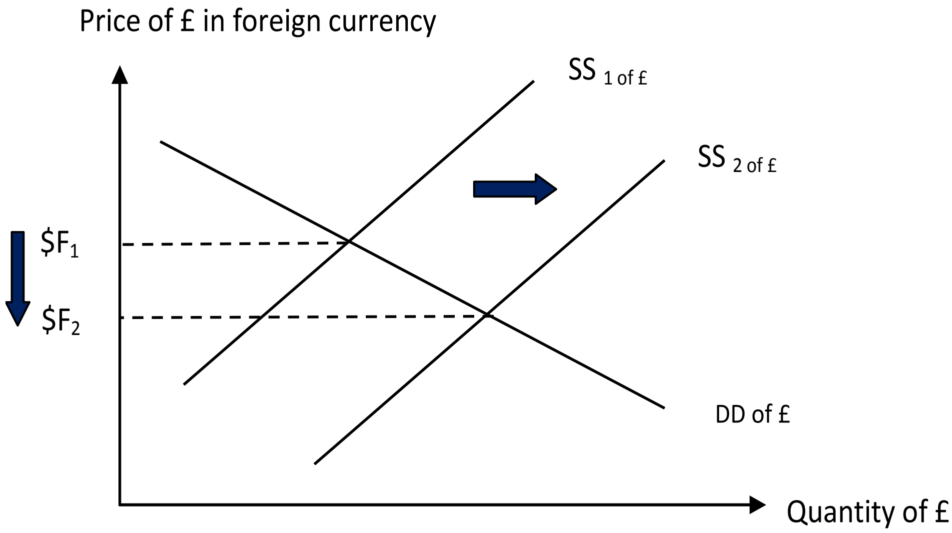


Diagram [1]

- **Alternatively,** students can also explain that demand for GBP falls due to low confidence in the economy.

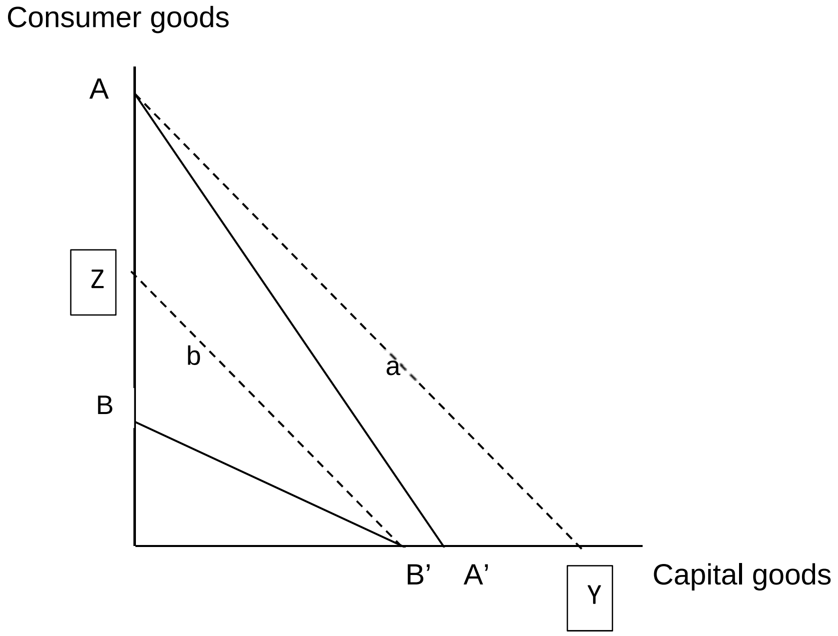
(b) With reference to extract 4, use PPC analysis to illustrate how the following will lead to an improvement in material standard of living:

(i) Pursuing the principle of comparative advantage [3]

Definition [1]

The Principle of Comparative Advantage states that trade can benefit all countries, if each country specialises in the production of goods in which they have a comparative advantage in. A country enjoys Comparative Advantage over another when it can produce a good with a lower opportunity cost in terms of other goods forgone.

Diagram [1]



Explanation [1]

The PPCs of country A (AA') and country B (BB') are shown. Before trade, each country is only able to consume what it produces. This means that its consumption possibilities are restricted to any point on the respective PPCs**. With trade, the new consumption point or possibilities beyond their respective PPCs** (AY for country A and ZB' for country B) is indicative of the gains to each country. Since the quantity of goods and services available to citizens of both countries have increased, there is an increase in material SOL.

(ii) Enhancing competition **[3]**

With increased competition, there is more efficient allocation of resources as countries specialise in producing goods which they can produce more efficiently and at lower cost than other countries. More efficient resource allocation means that the economy is moving from a point within the PPC to a point on the PPC. [1]

[Draw diagram] [1]

Thus, material SOL improve as households enjoy higher consumption level as more output is being produced due to greater degree of division of labour and productive efficiency from specialization. [1]

Alternatively, students can explain that with enhanced competition, firms may have greater incentive to conduct R&D, leading to an outward shift of the PPC. [draw diagram] With more goods and services produced, material SOL increases.

(c) Explain why the weakness of Great British Pound (GBP) will hurt European exports to the UK. **[2]**

Weak GBP→ Price of imports from EU more expensive in terms of GBP [1]

Assuming PEDm>1, import expenditure for UK falls => export revenue for EU falls [1]

(d) With reference to the data, discuss how Brexit is likely to impact the UK economy. [8]

Answer Synopsis: Impacts must include both internal and external impacts, positive and negative impacts.

<u>Intro:</u>

Brexit refers to the leaving of UK from the European Union (EU). This answer will analyse the different impacts of Brexit on the UK economy.

<u>Body 1: Disadvantages</u>

One of the possible impact of Brexit could be the slowdown of the UK economy **due to fall in UK exports.** As mentioned in Extract 6 para 5 "the UK would lose trade with its neighbours (17 percent of EU exports go to the UK, whereas the EU absorbs 44 percent of UK exports) and reduce its negotiating power with the rest of the world." Currently 44% of Britain's exports goes to EU countries and it enjoyed the benefits of some negotiating power with the rest of the world when it was part of the European Union. However, with Brexit, the UK would not only see a fall in its exports to the EU but will also lose trade with its neighbours as it risks losing some of that negotiating power.

EV: Limited impact of fall in X as main trading partner is still USA (Fig 5)

The expected fall in UK's export to EU, may lead to a **fall in investments** in the UK as mentioned in Extract 6 para 4 "businesses are delaying crucial decisions". The result of falling investments in UK as well as outflow of investments from UK leads to a fall in UK's GDP as well as a **fall in UK's potential growth**. The fall in UK's export and investment will lead to a **fall in its AD and hence RNY** (Draw and explain). This could lead to a rise in unemployment as demand for labour decreases when the economy contracts. Moreover, with the fall in both export revenue and FDI, the **BOP** of UK might worsen as well.

The idea of Brexit also lead to the weakening of the GBP and is likely to affect UK's **price stability.** According to Extract 6 para 3, "the weakness of pound is fuelling domestic inflation". Weakening of the currency will make imported raw materials more expensive in terms of GBP leading to imported inflation. (Draw SRAS curve fall leading to falling RNY and increasing GPL).

EV: The impact on price stability might be worse if the EU countries impose protectionistic policies on UK (Fig 4 shows UK mainly imports from EU countries).

<u>Body 2: Advantages</u>

However Brexit may provide UK with the freedom "to establish its own trade agreements with other countries" (extract 6 last para). This may raise UK's exports and investment and hence the slowdown as predicted may not occur.

Moreover, according to extract 5, "Brexit was the result of widespread concern over the numbers of people coming to the UK that strained public services– millions of whom have done so under the EU's freedom of movement rules in recent years." Thus, with Brexit, the reduction in immigration would mean more jobs for British workers. This may lead to higher income and hence rising consumption and hence rising AD thus raising UK's GDP. In addition, the reduction in immigration can help UK to reduce the strain on its public services (Ext 5 para 2), improving SOL.

Evaluation: Overall the negative impacts are expected to outweigh the benefits in the short run due to the uncertainty which leads to fall in X and I. In the long run, if the UK manages to establish more FTAs with other countries, the fall in X and I may be mitigated. However, with rising deglobalisation, UK may not be able to renegotiate better trade deals.

Mark Scheme:

Knowledge, Understanding, Application and Analysis		
L2	• Question requirements are interpreted accurately. • Well-elaborated 2-sided discussion of how Brexit is likely to impact the UK economy. Apart from the negative impacts, must have at least 1 possible positive impact. • Economic analysis is accurate, complete and well supported by contextual evidence. • Appropriate AD-AS diagrams are used to support economic analysis, where relevant. **Well-elaborated negative impact only: max 4m**	4 – 6
L1	• Question requirements are interpreted inaccurately. • One-sided or sketchy answer. • Inappropriate economic concepts, theories and principles are used. Inaccurate economic analysis. • Inappropriate or wrong diagrams are used.	1 – 3
Evaluation		
E	Evaluative comments are well-explained and supported by economic analysis. Unexplained evaluative comments.	2 1

(e) In the light of the issues mentioned in extract 6, discuss the policy options available to the UK government to achieve its macroeconomic goals. [10]

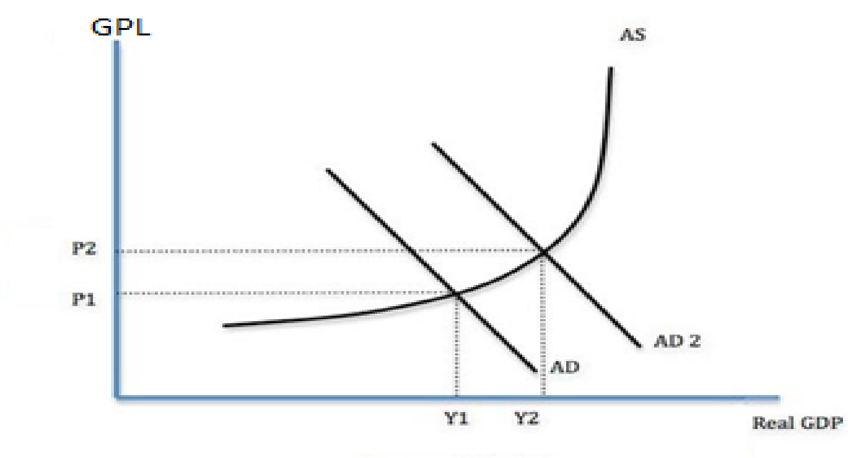
Introduction: Summarise issues faced by UK:

- **Weakened currency and inflation**: Ext 6: "The weakness of the pound is fuelling domestic inflation"
- **Business uncertainty**: Ext 6: "uncertainty about the terms of a Brexit deal between London and the EU is putting a brake on investment"
- **Fall in trade**: Ext 6: "the UK would lose trade with its neighbours (17 percent of EU exports go to the UK, whereas the EU absorbs 44 percent of UK exports) "
- **Slowdown**: Ext 6: "The Bank of England cut its growth forecast for this year from 1.9 percent to 1.7 percent"

Body 1: In view of the problem of an economic slowdown, to increase investments, UK can opt for **demand-led expansionary fiscal policy** through a package of tax cuts and increased government spending.

Tax cuts could include cuts in personal income tax and/or corporate tax.

- A fall in personal income tax would result in consumers having a higher disposable income. With a higher disposable income, consumers could afford to consume more domestically produced goods and services and this would lead to a higher overall consumption expenditure in the economy. Given AD = C+I+G+(X-M), this would lead to increase in the C component.
- A fall in corporate tax would result in firms having a higher after-tax profit. Thus, firms could afford to increase their expenditure on domestically produced capital equipment or intermediate goods and this would lead to a higher overall investment expenditure in the economy. This would lead to an increase in the investment component (I) of the AD function. This would give the domestic investment a boost and can bring back confidence of the domestic investors.
- An increase in government spending refers to government spending on final goods and services such as building more schools and hospitals as well as public transport infrastructures. This would also lead to an increase in the G component of the AD function.

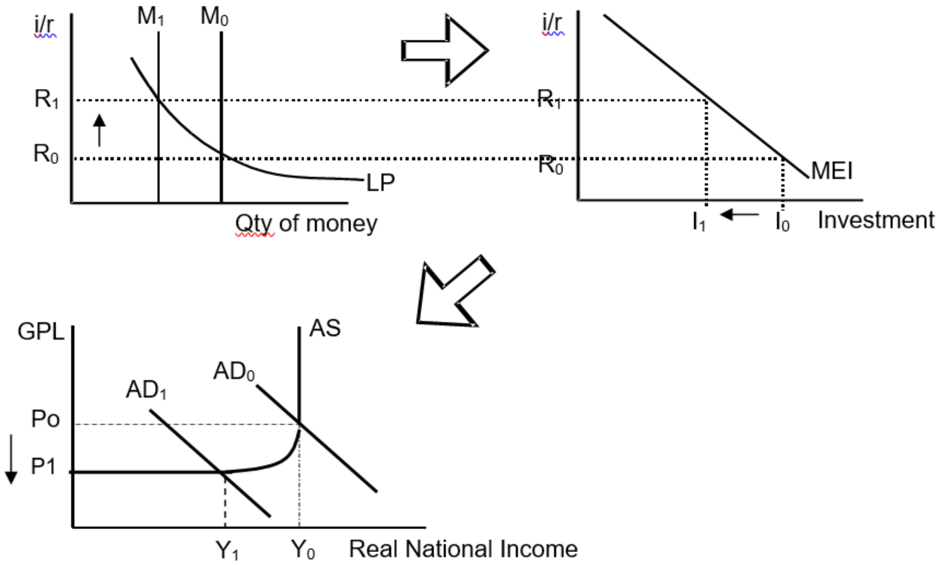


As shown in the diagram above, an increase in C, I and G components would lead to an increase in aggregate demand and the AD curve would shift to the right from AD to AD2. The increase in real GDP would address the slowdown and increase RNY from Y1 to Y2 – hence achieving economic growth which is essential to the UK economy. Since demand for labour is in derived demand, increase in C, I, G component implies more production activities and greater employment opportunities for UK citizens as well.

However, expansionary fiscal policy might fuel the existing inflationary situation and government needs to address the problem separately to mitigate the effects of inflation. Additionally the effectiveness of fiscal policy is contingent on the size of the multiplier. If it is small, fiscal policy may be of limited use in altering AD. UK may have a low multiplier due to a high marginal propensity to tax (MPT). Similarly, UK being a large country, may face the problem of time lags like decision lag, execution lag.

Evaluation: Although EFP puts a strain on government budget, UK would be in a better position after Brexit as it is no longer bounded by the Maastricht Treaty. Previously, UK was unable to continue with EFP if it led to a budget deficit of more than 3% of its GDP.

Body 2: Contractionary MP: To address the problem of increasing GPL, business uncertainty and weakening currency, UK government can couple the expansionary FP with contractionary MP. By reducing the money supply from M0 to M1, it raises the interest rates from R0 to R1. With higher interest rates, the cost of borrowing rises and this reduces profitability, resulting in a fall in investments from I0 to I1. Furthermore, higher interest rates discourage consumption (C) as consumers may now choose to save more instead to earn the higher interest. The fall in I and C reduces the equilibrium level of national income from Y0 to Y1. Contractionary monetary policy also tends to lower the general price level from P0 to P1 as AD falls and will help to **address the rising inflation** of UK.



Additionally, the increase in interest rates will help to **attract hot money, leading to appreciation of GBP to stabilise the weakening currency**. An appreciation signals stability and strength of the economy as investors are guaranteed of their future returns. Moreover, an appreciation reduces the price of imported factor inputs, thereby **reducing imported cost-push inflation.**

Evaluation: Although Contractionary MP may adversely affect economic growth as RNY tends to fall, however in UK's case, it is expected not to have significant adversary effect on economic growth as is evident from **Extract 6 ;** "monetary policy has run its course after a massive easing last year" which shows that investors were not responding to low interest rates." Thus, investments is likely to be interest inelastic. Therefore, even with an increase in interest rates, there will only be a less than proportionate fall in investments.

Note: Although EMP is theoretically possible, however, given UK's weak investment climate, EMP would not be very effective to enable UK to address its issues.

***Note**:* Theoretically, an appreciation can help both imported inflation and can help in stopping the capital flight by inducing confidence in the UK currency. However, the Bank of England follows a flexible exchange rate system and **does not set the exchange rate** but its actions can indirectly affect the value of the pound. Thus, contractionary MP might help through the hot money channel by strengthening the GBP.

Body 3: FTA with other countries: To address the problem of falling trade as mentioned in Ext 6: "the UK would lose trade with its neighbours", UK should aim to have more FTAs with other countries of the world including the EU. FTAs would help UK to achieve her economic aims.

- Define FTA: Legally binding agreement between two or more countries that seeks to reduce or eliminate trade barriers.
- Explain that UK can sign both bilateral and multi-lateral FTAs to expand its exports markets.
- With the lowering of trade barriers against UK's X, UK will be able to leverage and trade according to its comparative advantage and increase both its export volume and value, overcoming its constraints of losing trade with its EU neighbours.
- Increase in X revenue→ Increase AD → more than proportionate increase in NY (briefly explain the k effect) → increase real GDP → increase real national output → increase utilisation of existing resources → actual growth (Illustrate with rightward shift of AD curve)
- With firms increasing production → increase demand for labour, with labour being a derived demand → increase employment.
- Increase in X revenue improves current account of BOP (ceteris paribus).
- By being open to trade, UK can has benefit from its ability to import essential raw materials and food stuff more cheaply than resorting to produce such goods herself where the opportunity cost of doing so would might be high.
- Lower prices on imported inputs → lower COP → Increase SRAS → Increase actual growth, lower GPL, dampening cost-push inflation. (Illustrate with downward shift of SRAS curve)
- Lower COP would also increases UK's X price competitiveness, assuming $PED_X > 1$ → Increase in X revenue and similar effects on raising AD, actual growth and employment.
- By being open to trade, competition from foreign M lowers barriers to entry and forces firm to be cost-efficient and adopt product and process innovation → movement towards productive and dynamic efficiency,
    - Additionally FTAs encourage good relationships with other countries and may lead to an increase in FDI.
- Inward investment via FDI → increase in I component of AD → similar effects on raising AD, actual growth and employment.
- Increase in FDI → helps to build up capital stock and deepen UK's capital intensity. Increases economy's productive capacity and increases potential growth. (Illustrate with rightward shift of LRAS curve)

- Increase in FDI → transfer of technology know-hows and competition effect → encourages innovation, R&D → increases potential growth.
- FDI inflows improves capital account in SR, ceteris paribus improves overall BOP.

Evaluation: However, FTAs take a long time to materialise and other countries might not be agreeable to have FTA with UK as it has lost its negotiation power with the rest of the world after Brexit (Ext 6) and will need time to build up her credibility again.

[SS side policies are also acceptable, e.g. subsidies to address issues like domestic inflation and slow growth.]

Conclusion:
Preferably, UK should use different policies in the short run such as EFP to tackle issues like slow growth and use contractionary MP to address the weakening GBP and inflation. However, in the long term, it is better for UK to undertake SS-side policies for sustained growth. Furthermore, the government can also push for greater trade integrations with other countries such as joining economic cooperation and signing FTAs. These trade policies will invariably help to support the existing demand management and supply-side policies and help the government achieve its macroeconomic aims.

Mark Scheme:

Knowledge, Understanding, Application and Analysis		
L2	• Question requirements are interpreted accurately. • **Two** well elaborated policies using appropriate economic concepts and well supported by contextual evidence. (Must address the **issues mentioned in extract 6** and show clear links how the policies are able to address those issues.) • Appropriate diagrams are used to support economic analysis, where relevant. Only **one policy** discussed, but clearly explains how at least 2 of the issues faced by UK can be addressed- **max 5m**	5 – 7
L1	• Gives **theoretical response** by simply explaining policies without any context to the issues faced by UK. • Addresses only one issue faced by UK. • Inaccurate economic analysis.	1 – 4
Evaluation		
E	Evaluative comments are well-explained and supported by economic analysis. Show good understanding of conflicts between policies. Judgment made is based on the information provided in case material. Unexplained evaluative comments.	2 – 3 1