

Unit 8 January 2002 Past Paper

1. (a) Use the information in Extract 1, Table 1 to briefly compare the output performance of transition economies from 1989 to 1999.

Output fell in all economies, in some more than others. Output fell the least in Poland by 15.4% and more in Georgia, falling by 76.7%.

Poland recovered from the transition recession quickest reaching its lowest GDP in 1991 while Russia experienced the most prolonged decline in output with Russia's GDP reaching its lowest level in 1998.

The Czech Republic had lowest growth since lowest level of GDP at 1.7% and Albania the highest at 6.6%.

Economies like Poland have recovered best and quickest with an output ratio to pre-transition of 1.28 while Georgia has an output ratio to pre-transition output of 0.46.

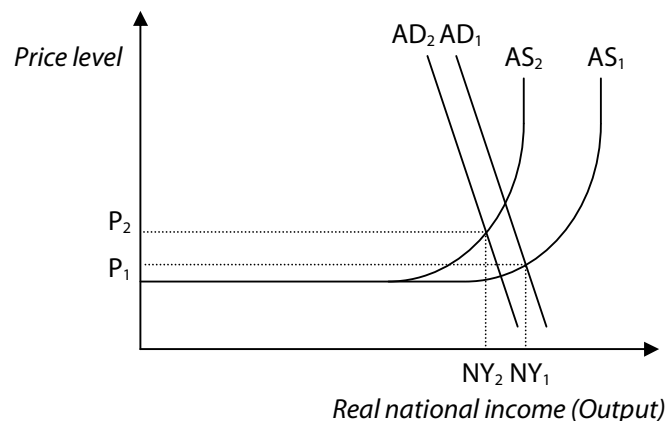
To conclude overall the central and Eastern European group of economies experienced the smallest decline in output and recovered most of their 1989 output by 1999, whereas the former Soviet Union economies experienced the largest decline and recovered less of their output by the year 1999.

(Technique point: write 4 points on the data comparing the highest and lowest values then come to a conclusion).

- (b) Use Extract 2, Figure 1 to analyse the output performance of the Czech economy since 1997.

A fall in the level of GDP in 1997 was caused by a fall in investment. In 1998 this was exacerbated by a fall in consumption. Net exports played a little role in the recession, without these earning the recession would have been more severe.

The fall in investments has a downward multiplier effect because it deters consumers from spending their money as they cannot afford goods and services decreasing demand for goods and services, and businesses investing due to lower business confidence.



Political instability and poorly handled privatisation will cause unemployment to increase and the capacity of the economy to decrease. There will also be a smaller decrease in aggregate demand because consumption will decrease as unemployed workers spend less. This causes a decrease in the level of GDP from NY_1 to NY_2 and a rise in the level of inflation from P_1 to P_2 .

The implementation of a tight monetary policy (high interest rates) to combat high inflation further discourages investment by increasing the opportunity cost and real cost of borrowing for both firms and consumers.

(c) Comment upon the likely consequences for an economy of the trends in output experienced by transition economies.

A fall in the level of employment leads to lower incomes to be spent on goods and services. Government income will be decreased but spending is likely to increase, so the government will experience a budget deficit (as they must fund benefits for the increase number of unemployed, for example).

Inflation is created as the productive capacity of the economy decreases and is worsened as on entering a market based economy workers try to spend very large savings when supply is very inflexible creating very high inflation. Re-organisation within the economy during early transition means a tight fiscal policy must be implemented to control inflation.

This creates lower living standards as consumption and investment both decrease.

The fall in GDP is followed by a slow increase in a recovery period. The use of market based systems and political stability encourages foreign direct investment. This will lead to faster economic growth as the investment will provide incomes which create multiplier effects and stimulate the economy. This will lead to faster economic growth.

The use of market based systems means price and output are determined by the interaction of supply and demand for a product not regulations set by planners.

The length and severity of the recession depend on the effectiveness of policies. It is worthwhile for the government to undergo the structural changes to gain the benefits of faster long run growth and to a greater extent resolving many of the problems associated with the imperfect nature of planning.

2. Using economic analysis, comment upon the government policies that might be used to deal with a current account deficit on the balance of payments, such as that experienced by the Czech Republic since 1997 (Extract 3, Table 2).

The current account records the value of all goods and services imported and exports from an economy. A deficit means that the value of imported goods and services is greater than the value of exported goods and services.

Prolonged and unplanned deficits highlight problems in the economy and need to be corrected. It is the role of governments to intervene and reduce a prolonged deficit.

In the short run the government can withdraw money from official reserves to pay for a deficit in the current account. From the table we can see official reserves have increased slightly meaning the Czech government has not chosen to implement

this policy. It is not easy to replenish foreign currency reserves so governments are not keen to implement this policy.

The government can use supply side policies to relieve the deficit. Firms that are exporting goods can be subsidised so increase their production and be able to charge a lower unit cost, so making exports more competitive and increasing the quantity demanded. (*Diagrammatical analysis may be appropriate here.*) This is likely to resolve the deficit problem but the firm may become inefficient and over-reliant on subsidies in the long run. There is an opportunity cost of government spending and the use of money to subsidise goods for consumption in other economies is not politically popular.

Monetary policy can also be used to decrease the exchange rate, making exports more competitive so increasing demand and decreasing demand for imports. Decreasing interest rates can achieve this as hot money flows out the UK economy causing the supply for pounds to increase and the exchange rate to depreciate.

If demand for imports and exports meets the Marshall-Lerner condition, each being greater than 1 then the proportional change in quantity demanded will be larger than the change in price so the policy will be effective.

Alternatively, a deflationary policy could be implemented by the government. By increasing income tax the disposable income in an economy will decrease so decreasing consumption and demand for imported goods though this is likely to cause unemployment.

The extract suggests deflationary policies have been used so an improvement in the current account can be expected.

Protectionist measures could also be used on goods where the price elasticity of demand is greater than 1 as an increase in the price caused by a tariff or quota would cause demand to decrease by a greater than proportional figure. For example, if the tariff raised the price by 10% the demand for the good or service would decrease by more than 10%.

This policy is ineffective for goods and services with a price elasticity of demand of less than 1 and protectionist measures are politically unpopular, risking retaliation. Also, as the Czech Republic has been a member of the EU since 2004 they are unable to set their own external tariffs.

The extract tells us that the external debt-service ratio has decreased which means the current account may improve as the cost of repayments is declining. This money could be used to pay for the current account deficit.

Alternative supply side measures the government could implement include increasing productivity through investment in education to improve international competitiveness though this is not required here, the covering of three policies with diagrams to explain where appropriate would be satisfactory for full marks. For each policy explain what it is, how it works, the costs and limitations and use data from the data study where appropriate.

- 3. Discuss the effects which foreign direct inward investment (FDI), such as that mentioned in Extract 4 and hoped for in the case of Skoda Plzen (Extract 5), might have on firms, consumers and the economy as a whole.**

Effects on firms

Positives

- Some domestic firms may benefit if they can supply to the multinational they can expand their business so increase their profitability.
- Technology and managerial skills brought to the area may increase the profitability of domestic firms.
- Competition may drive innovation and efficiency making the domestic firms more competitive within the union and globally so more profitable.

Negatives

- Local firms may be unable to compete due to economies of scale negatively effecting local competition. Firms find it hard to compete so either go bust or merge with the multinational.
- Foreign direct investors attract best workers so the local firms are deprived of their well qualified workforce.

Consumer

Positives

- More competition gives greater choice, higher quality and a lower price for the product as a result of allocative and productive efficiency.

Negatives

- Increase the concentration ratio as domestic firms go bust or merge with the multinational leading to market dominance which can be abused as firms have drive to become efficient can supply and inferior quality product and exploit the consumer by charging a higher price and supplying a lower quantity.

Whole economy

Positives

- Increase in employment. More job opportunities cause upward multiplier effects. More spending power increases output so causes a further increase in output.
- Employment increases and greater prosperity causes fewer social problems like crime and people are happier as a result of the positive externalities.
- Balance of payments improved by initial inflow of capital account as the initial investment is a positive figure on the account. The production is likely to result in trade due to trade liberalisation gaining extra foreign currency for the economy which can be used to service debts.
- Increases government tax revenue through taxes on profits and on the economic activity stimulated by the FDI which can be invested in health care, education and infrastructure to improve living standards.

Negatives

- Capital intensive technology causes employment increases to be limited.
- Multinationals exist where strict environmental legislation does not exist and can exploit the natural resources of the economy causing problems like pollution and dumping.

- Profits that the multinationals make and the wages of high paid workers who have moved may be repatriated to the country of origin starving the economy of the extra funds for future investments.

Evaluation

- Consider the long run effects on the economy.
- Effectiveness is dependent on the initial state of the economy.

4. You have recently been appointed to advise the government of Estonia on the costs and benefits of entry to the EU (see Extract 6). Assess the main issues involved.

Benefits

- Trade liberalisation
 - i. Increases the variety of products available
 - ii. Increases internal economies of scale creative competitiveness within the union and globally due to lower costs. This is a dynamic benefit.
- Financial help from the EU
 - i. Allows for improvements to the infrastructure
 - ii. Increases funds available for research and development
 - iii. Creates increased opportunities for co-operation with other EU firms/institutions
 - iv. Gains from the common agricultural policy
- Investment from other firms into the economy from non-EU members to avoid the common external tariff. FDI is also attracted from members who want to set up production nearer to a market to reduce transport costs.
 - i. This creates employment which leads to an upward multiplier effect
- Free movement of labour, especially for businesses, highly skilled labour and managers to improve economic growth.
- Improved infrastructure brings about external economies of scale
- Trade creation

Costs and limitations

- Trade diversion, though this is likely to be outweighed by trade creation. For example when the UK joined the EU in 1973 there was diversion of trade in butter from New Zealand, the lowest cost global producer, to Denmark, the lowest cost producer in the EU, creating a higher cost for consumers.
- Possible abuse of monopoly power
- Loss of control over monetary policy as interest rates are centrally determined by the European Central Bank

It is hard to measure exactly how large the costs and benefits of joining are, but using GDP growth, GDP per capita and the level of employment in comparison to that experienced in other EU economies is a good comparison.