

External Macroeconomic Shocks and Cyclical Fluctuations

A world of demand and supply-side shocks

Oil price falls on economic fears

Oil prices have plunged 10% as yet more bad economic data sent stock markets sharply lower and undermined hopes of economic recovery.

US light crude fell by \$4.61 to \$40.15, while London Brent crude dropped \$4.14 to \$42.21.

Huge losses at US insurer AIG and plans for fund raising by HSBC bank sparked sharp falls in global markets.



Global demand for oil has fallen since last summer

Recession 'could last five years'

A leading economist has warned that the world could face five years of economic slowdown and a 10% decline in output.

DeAnne Julius, chairman of think tank Chatham House, said there was a 40% chance of such a lengthy slowdown.

Speaking at a G20 breakfast seminar organised by BBC News, she said an earlier recovery would depend on plans to restore banking lending.



The economic outlook is cloudy from Canary Wharf's financial towers

UK interest rates lowered to 0.5%

The Bank of England has cut interest rates to 0.5% - a fresh all-time low - and says it will now boost the money supply to help revive the economy.

Interest rates have now been reduced six times since October, and the latest cut from February's 1% was expected.

The Bank said it would expand the amount of money in the system by £75bn - a policy called quantitative easing - in an attempt to boost bank lending.

Bank Governor Mervyn King said the policy would "eventually work".



Bank action 'can stem deflation'

Deflation in the UK will be "short-lived" if decisive action is taken, according to the Bank of England.

Economists expect prices to start declining soon as recession hits business and consumer spending.

Using "more unconventional" monetary policy methods should prevent deflation from taking hold, the Bank said.

After cutting interest rates to a record low of 0.5%, the Bank is exploring alternative ways of boosting economic growth.



The Bank is having to explore other methods beside moving interest rates

Demand shocks

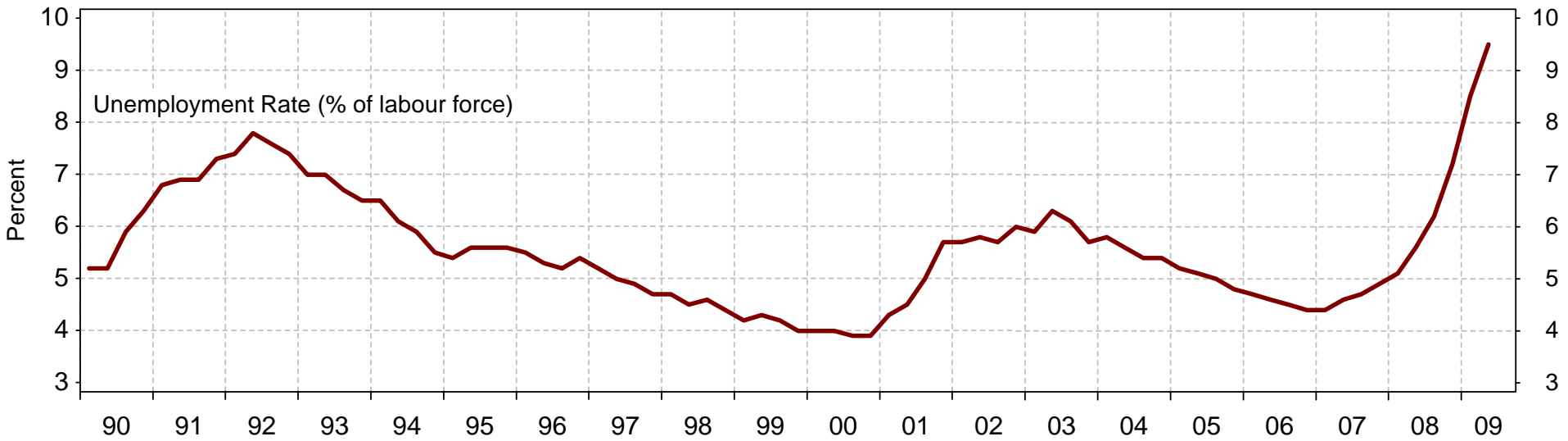
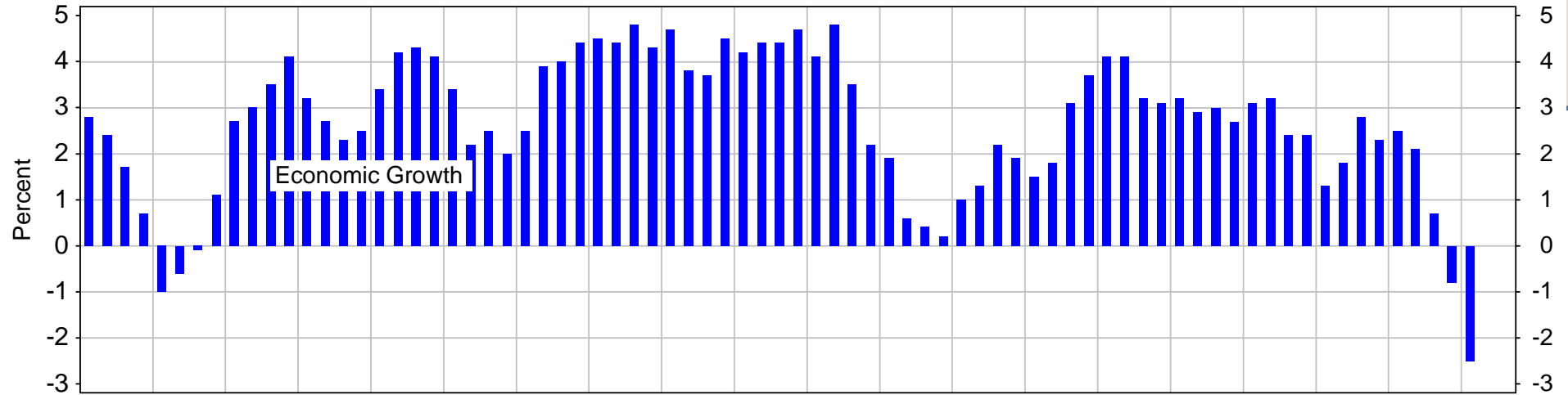
Demand side shocks	Examples to use
These are shocks affecting the rate of growth of demand both in the UK and other countries	

Demand shocks

Demand side shocks	Examples to use
<p>These are shocks affecting the rate of growth of demand both in the UK and other countries</p>	<p>Slowdown or a recession in major trading partners</p> <p>Financial crisis</p> <p>Sharp fall in property or share prices</p> <p>Collapse in consumer or business sentiment</p> <p>Volatility in the exchange rate</p>

United States - Growth and Unemployment

Percentage rate of growth year on year at constant prices



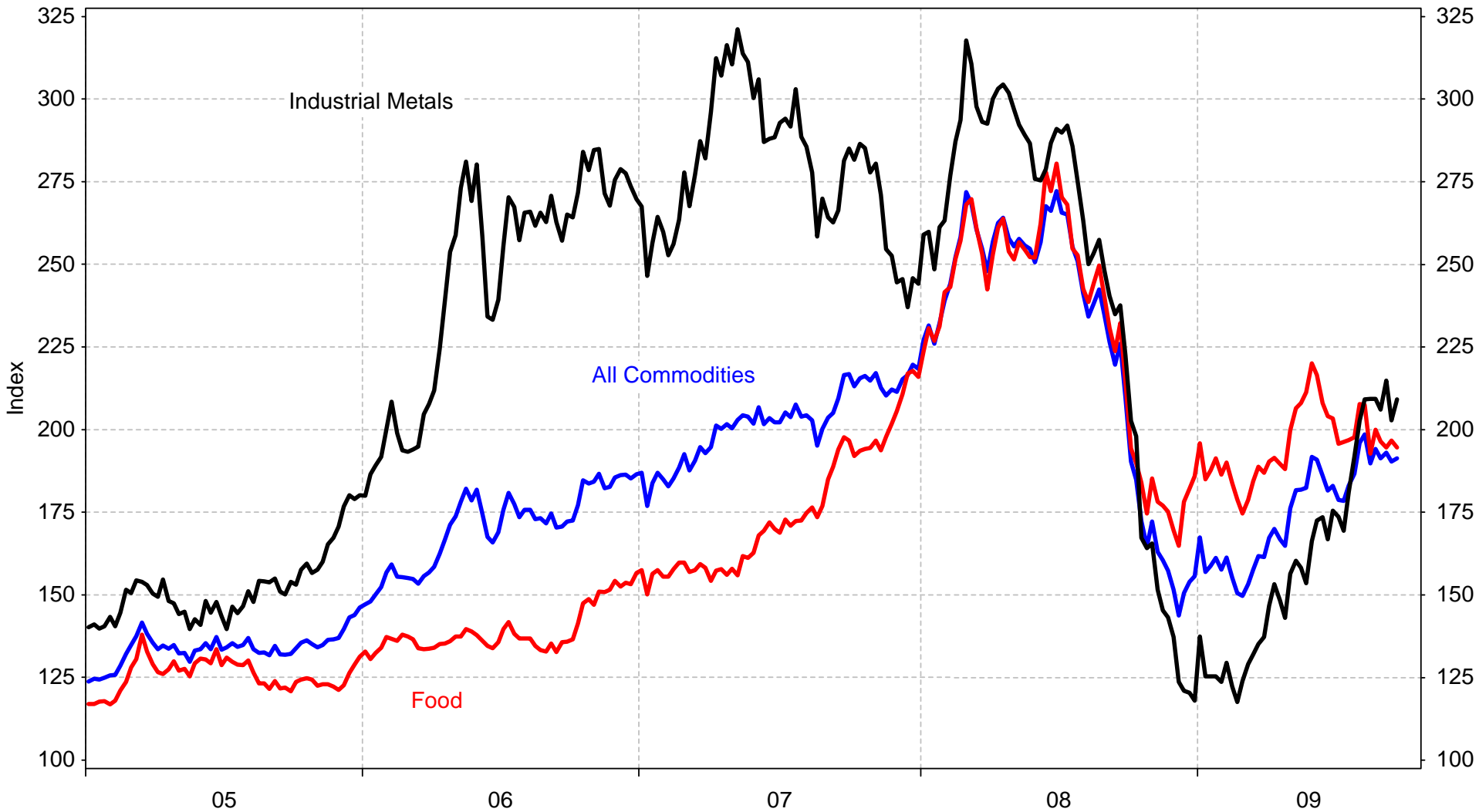
Source: Reuters EcoWin

Supply shocks

Supply-side shocks	Examples to use
<p data-bbox="200 491 625 758">These are shocks affecting costs and prices in different countries</p> <p data-bbox="200 776 672 1105">Can impact directly on SRAS in an economy – but may also have longer term effects on LRAS</p>	<p data-bbox="755 491 1619 605">SRAS = cost of supplying with given technology</p> <p data-bbox="755 619 1715 672">LRAS = productive potential of economy</p> <ul data-bbox="755 748 1715 1048" style="list-style-type: none"><li data-bbox="755 748 1619 801">• Commodity price changes (↑ & ↓)<li data-bbox="755 808 1108 861">• Wage costs<li data-bbox="755 868 1715 986">• Cost of imported raw materials, semi-finished and finished goods<li data-bbox="755 993 1702 1048">• LRAS affected by technology shocks

The Economist Commodity Price Index

Index of Prices 2000=100



Source: Economist Commodity Price Index

Global Food Prices

Weekly index, 2000 = 100



Source: Economist Commodity Price Index

Analysing economic shocks

- Make good use of AD-AS analysis (use your AS economics!)
- Consider short-run and possible longer-run effects
- 1/ First round effects (immediate or short term)
- 2/ Second round fallout (medium term effects – can be positive or negative)

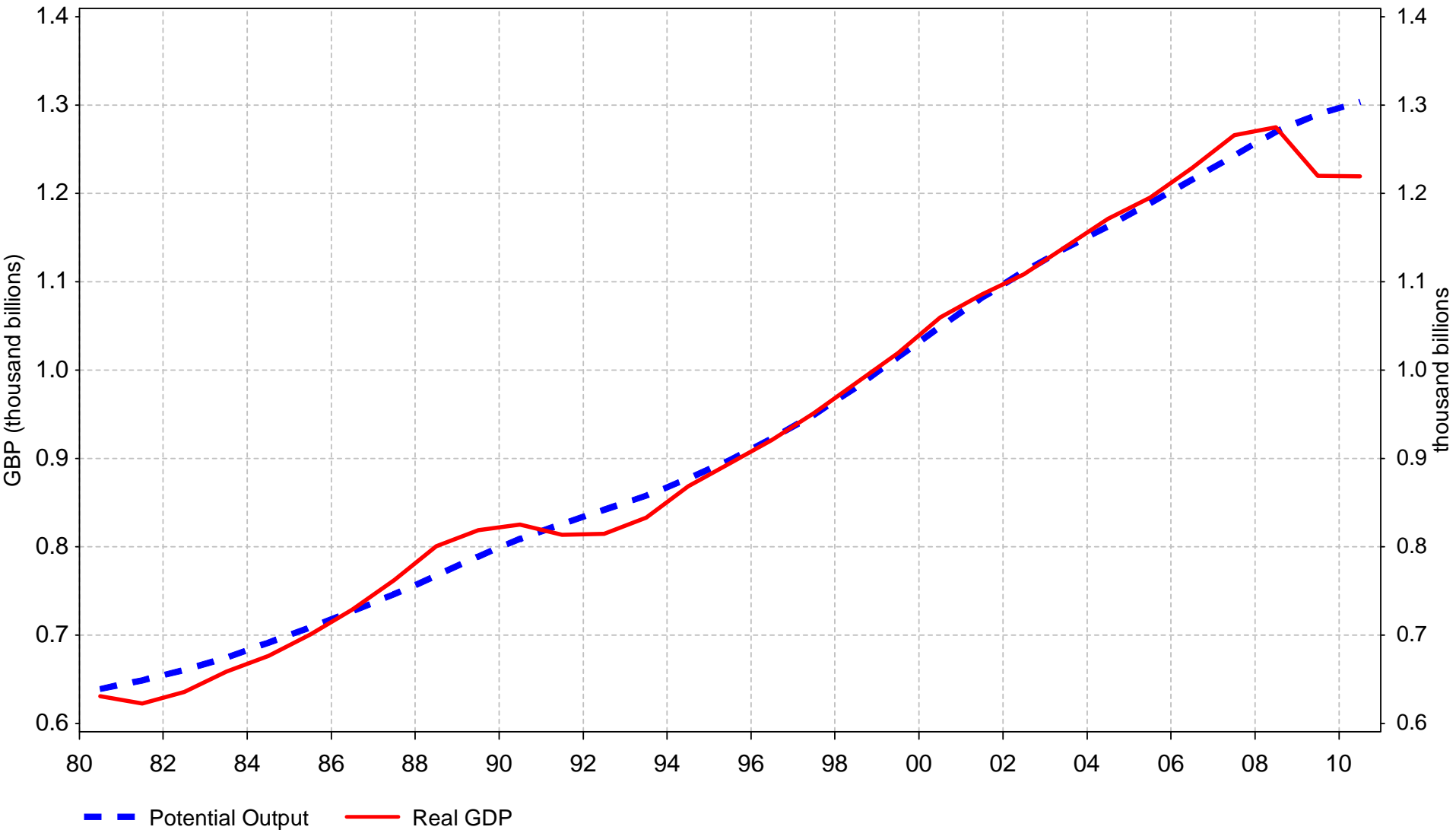
- The impact of higher shocks will vary from country to country
- How big is the shock? Is the shock temporary or more persistent?
- Consider how macroeconomic policy might respond to the shocks
- How much freedom to change policies do countries have?
- Use your economic knowledge – keep up to date!

Economic policies and economic shocks

- All countries experience external shocks
- Can policies help to ‘weather the storm’?
- Such policies are called ‘**stabilisation policies**’
- A combination of policies might be required
- Especially when ‘conventional’ policies seem to be ineffective
- Keynes *“pushing on a piece of string”*

Actual and Potential GDP for the UK

£ thousand billion at constant 2003 prices. Source: OECD



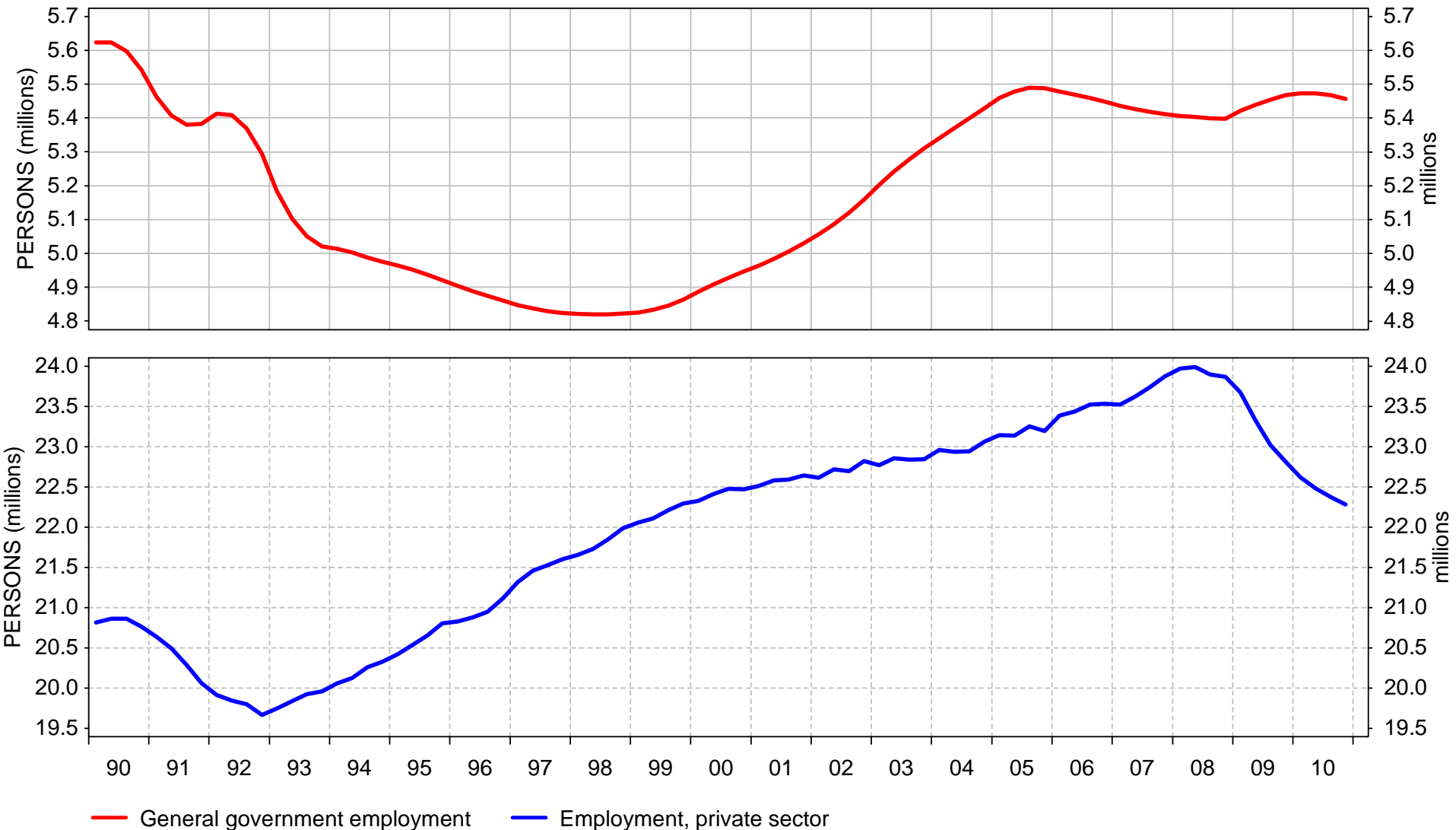
Source: Reuters EcoWin

The Great Stimulus of 2009

- Policy interest rates cut close to zero
- Quantitative easing in the UK of up to £175bn
- Tax cuts (temporary)
- Rise in government spending
 - Bringing forward of some capital spending
 - Special schemes e.g. scrappage and bail outs
 - Maintaining public sector employment as private sector contracts
- Huge rise in the budget deficit
- Large depreciation in sterling exchange rate

Public and Private Sector Employment

Millions, quarterly data, seasonally adjusted, 2010 forecast from OECD



Source: Reuters EcoWin

Stimulating times – the use of counter-cyclical policies

Q&A: Obama stimulus plan

US President Barack Obama has signed into law a slimmed-down economic stimulus plan worth about \$787bn (£548bn) aimed at boosting the US economy. The signing came after weeks of political wrangling which saw the original bill altered by Congress.



Mr Obama has made the stimulus plan his priority

Its passage into law followed warnings from the president that the US could face an economic disaster if radical action was not taken.

Bank keeps interest rates at 0.5%

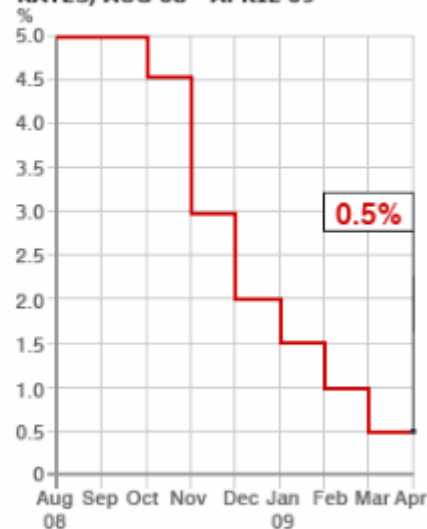
The Bank of England has kept interest rates on hold at 0.5%, in a widely expected move following a number of rate cuts in recent months.

Rates remain at an all-time low after six cuts since October last year, when interest rates stood at 5%.

The Bank is also continuing with quantitative easing, or creating money to help boost lending. It has so far injected £26.4bn into the system.

The Bank and the government are trying to ease the economy out of recession.

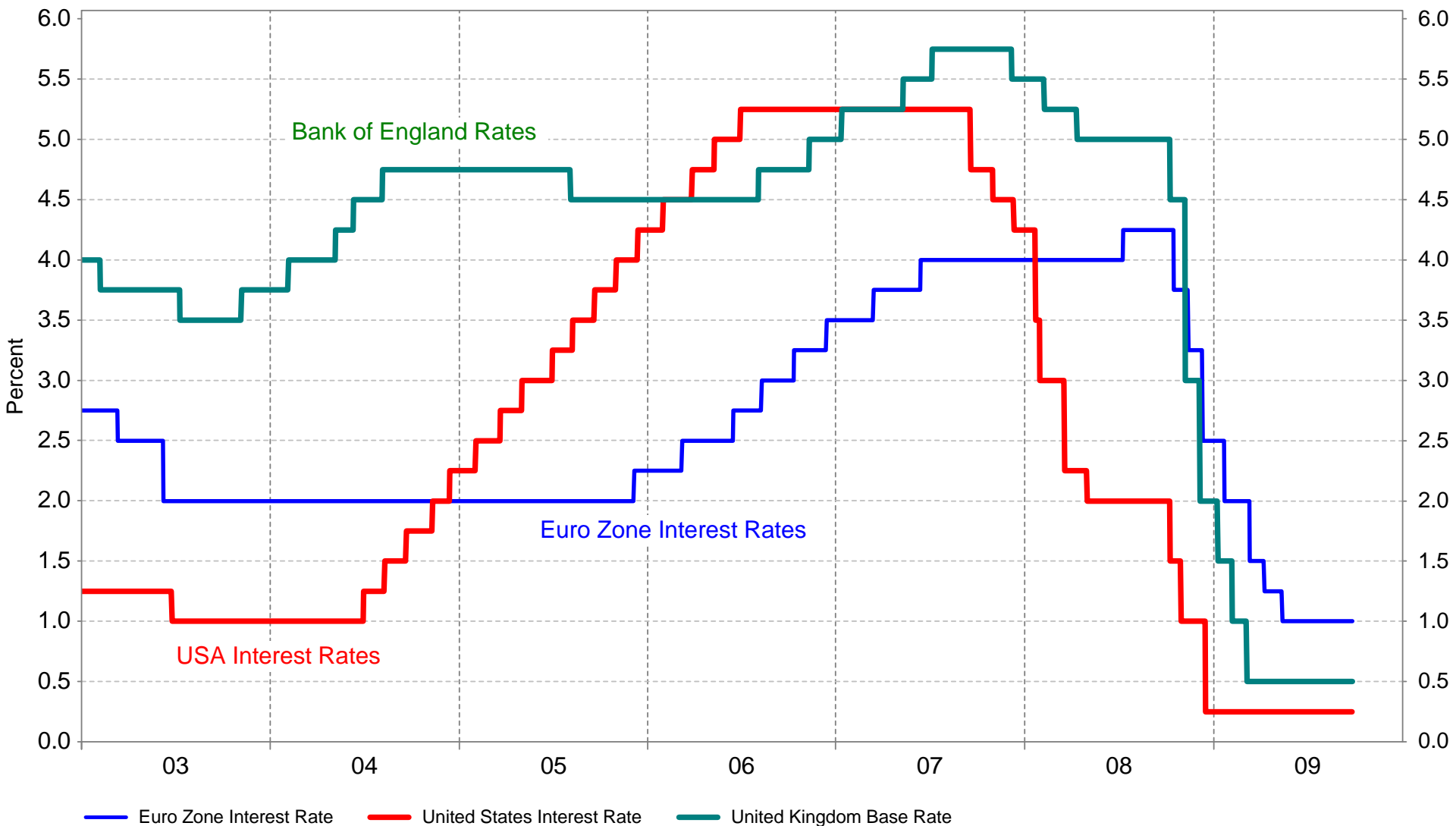
BANK OF ENGLAND INTEREST RATES, AUG 08 - APRIL 09



SOURCE: Bank of England

Interest Rates for the Euro Zone, the UK and the USA

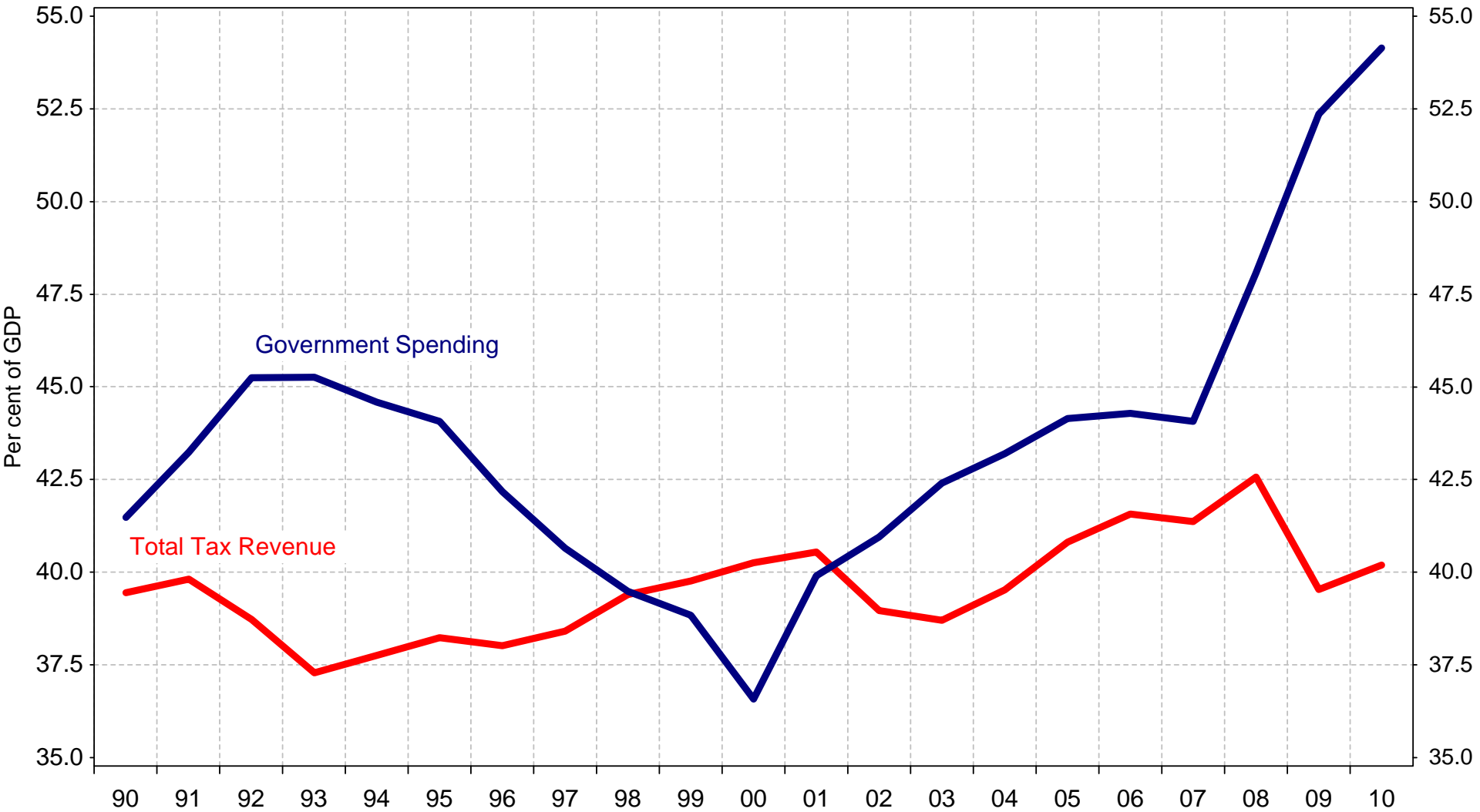
Per Cent



Source: Reuters EcoWin

UK Government Spending and Taxation

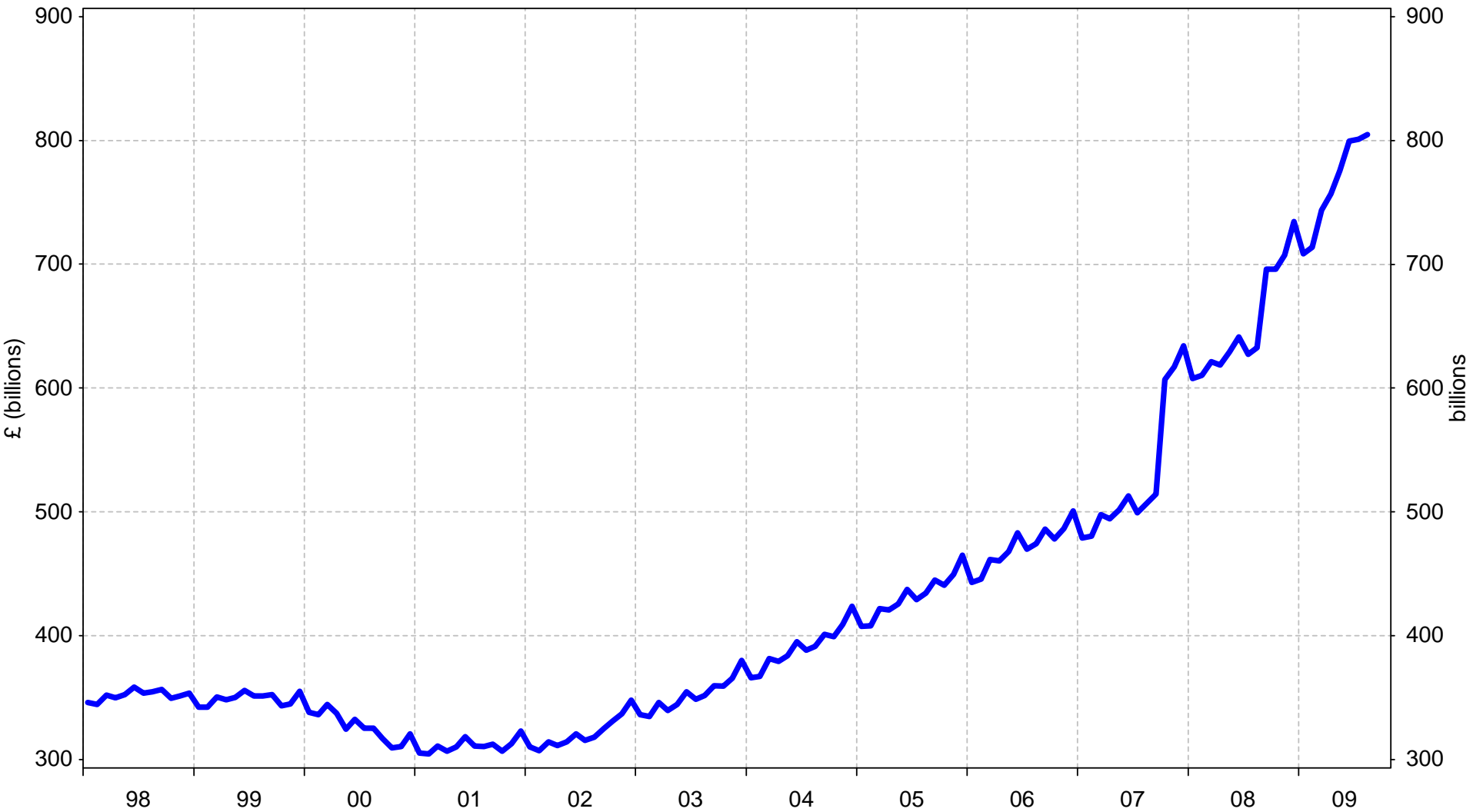
Measured as a percentage of national income (09-10 is a forecast from the OECD)



Source: OECD World Economic Outlook

UK Government Net Debt

£ billion at current prices, monthly data



Source: Bank of England

Evaluation:

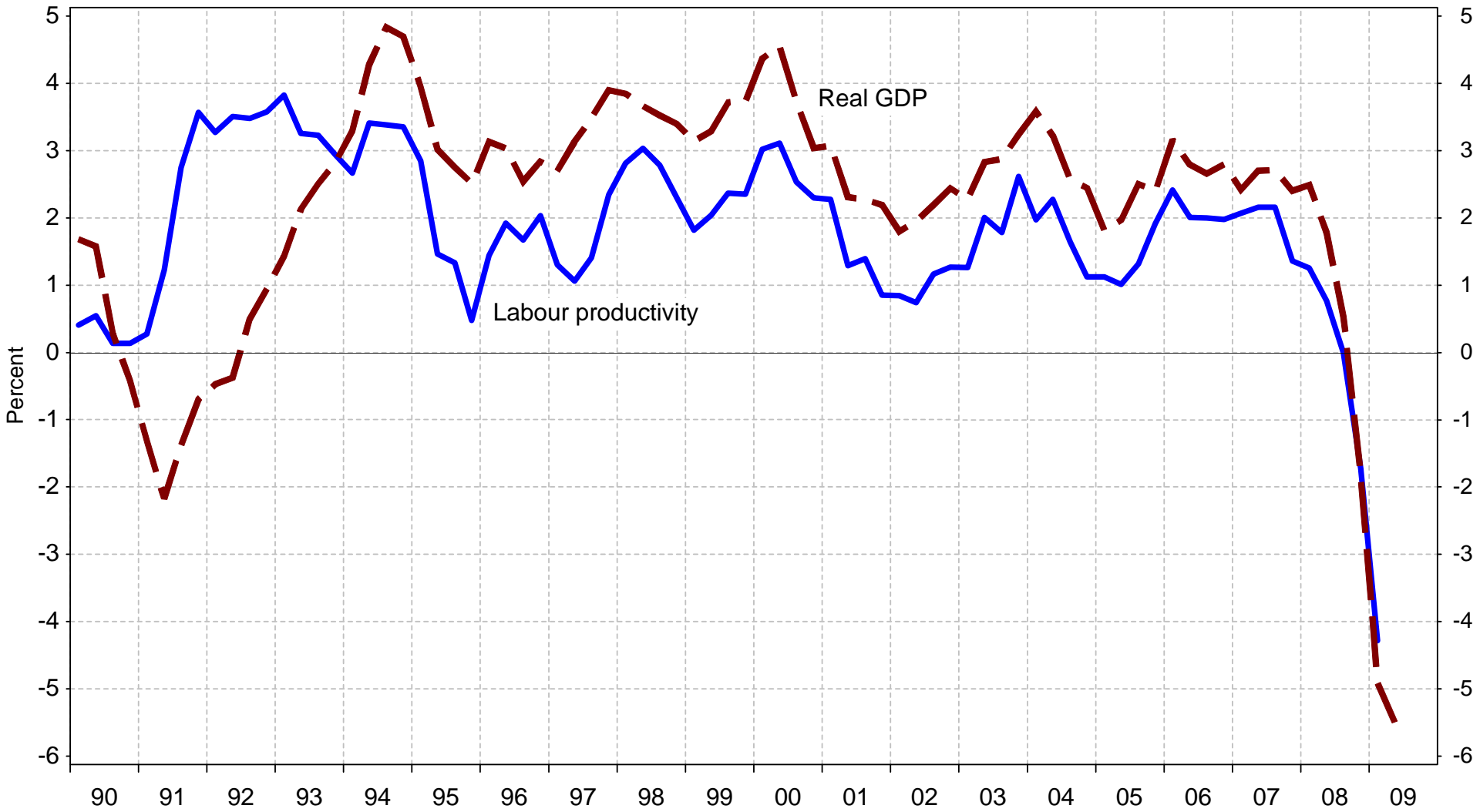
- Sometimes stabilisation policies can be ineffective:
 1. People might save tax rebates instead of spend them
 2. A 'liquidity trap' effect might be seen when interest rates get close to zero
 3. Uncertain time lags from expansionary policies
 4. Uncertainty about the size of fiscal multiplier effects
 5. Risks that a big stimulus to demand might conflict with other macroeconomic objectives e.g. inflation or the trade balance – especially in the medium term
 6. The strength / flexibility of the supply-side of the economy is important in absorbing and responding to shocks

Evaluation: Importance of the supply-side

- Strong supply-side can help weather shocks
 1. Flexible labour markets – skills/mobility/pay
 2. Innovation – source of new demand, less sensitive to exchange rates / global downturn
 3. Capacity – e.g. creating capacity to boost exports to provide an external boost to demand
 4. Productivity and competitiveness
 5. Diversification of the economy – i.e. not overly dependent on one industry / export market

UK Labour Productivity and the Economic Cycle

Annual % change in output per worker for the whole economy



Source: Reuters EcoWin

The Fall Out from the Crunch

- “The Organization for Economic Cooperation and Development predicts the world economy’s potential growth rate will fall to 1.1 percent next year, compared with 2.4 percent in the decade before the crisis. The International Monetary Fund says G-20 debt will reach 82.1 percent of gross domestic product in 2010, almost 20 percentage points more than two years ago and the equivalent of about \$37 trillion.”
- Ken Rogoff (Harvard)

The end of an era of cheap food

- **Demand side**
- Rising per capita incomes
- Demographics
- Speculation
- Weakness of the US dollar

The end of an era of cheap food (2)

- **Demand side**
- Rising per capita incomes
- Demographics
- Speculation
- Weakness of the US dollar
- **Supply-side**
- Increased bio-fuel output
- Desertification
- Export controls from food producing nations
- Climate – drought / el Nino
- Sharp fall in food stocks

Macroeconomic Impact

- **Developed nations**
- Fall in SRAS – e.g. rising costs for food processors
- Spikes in CPI inflation
- Real income effect and food poverty
- Rise in farm incomes
- Pressure on food aid budgets
- Changes to EU CAP
- Changes in diets?

Macroeconomic Impact (2)

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- Changes in diets?
- **Poorer nations**
- Huge rise in food poverty – food prices act as a tax
- Added pressure for deforestation
- Improvement in terms of trade for food exporters
- Deterioration in living standards for food importers
- Return of buffer stocks and other interventions

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