June 2005 Unit 6

Question 4

a) Price differences between Eurozone countries range from approximately 36% for healthcare to 11% for groceries.

One possible reason for the differential is the degree of govt. provision of certain services. For example in some countries healthcare may be provided mostly by the govt. at heavily subsidised prices and would be substantially cheaper than countries where its provided by the private sector.

Secondly account must be taken of relative production costs. For example workers in Germany are among the highest paid in the world which may result in higher prices. This is particularly likely to result in price differentials for non-tradeable services. Hence the differentials for groceries is a lot smaller.

* Alt explanations → differences in other costs such as rentals, fuel.

→ differences in local tax structures eg municipality rates.

b) i) According to Extract 1, 70% of UK households are home owners compared to 40% in Germany. Figure 2 shows that at least in the short run, UK mortgages are mostly on (+60%) variable interest terms while those in the other countries are variable. This suggests that there is an asymmetry to interest elasticity of consumption spending. If the UK joined the €, interest rates would be determined by the ECB. An increase in the interest rate would affect not only more UK households but also by a bigger impact. Household disposable income in the UK net of mortgage payments would fall more drastically compared to say German households. ∴ UK consumption wouldn fall more sharply ~~to~~ causing a larger recessionary impact than in Germany. However in recent years more UK mortgages are being negotiated on fixed interest terms.

ii) For the years shown in Fig 3, UK unemployment has consistently been approximately 4% lower than Eurozone's. The rates move together though.

One reason could be because in the years shown, the UK economy has been performing better than Eurozone's economy. This is partly due to greater economic flexibility and partly, in recent years, due to heavy govt. spending in education and healthcare.

Another reason for relatively low unemployment in the UK is because at least until recently there was significantly more job creation through large inflows of FDI into the UK. However this trend has somewhat reversed itself because FDI now prefers to go to Asian NIC's like India and China.

However Fig 3 must be interpreted with caution because some of the fall in unemployment could have been caused by more part-time work being created. For example instead of 2 people working 10 hours a day we now see 4 people working 5 hours a day. Unemployment has fallen but the number of labour hours employed is unchanged.

iii) Of all the 3 figures, only Fig 4 shows some level of convergence. Interest rates in the UK have moved towards, and in tandem with Eurozone interest rates since 1999. However this convergence must be regarded in light of the relative strength of the £. Since 1996 the £ has continued to appreciate against the € resulting in a dampening of inflation through cheap imported raw materials and finished products as well as cheaper fuel because oil is denominated in USD. As such the Bank of England has not needed to maintain a high interest rate. If the £ depreciates the interest rate convergence may dissappear.

Also Fig 3 shows that UK unemployment is approximately 4% lower than Eurozone rates for any given year. This may indicate that the UK is closer to capacity than the Eurozone and any growth in AD is more likely to cause demand pull inflation through rising wages in UK rather than Eurozone. This would also lead to a loss of convergence as UK interest rates ~~may~~ have to rise above € interest. However UK labour markets are more flexible than those of France & Germany so this problem may not arise.

Finally Fig 5 shows that as of mid 1999, Eurozone inflation rates have risen ~~so~~ above UK's. Although this does mean that UK meets one of the criteria for convergence, it may mean that Eurozone interest rates may at some point rise above the UK's to combat this inflation. However, given the fact that the £ may weaken, its possible that UK's interest rates may also rise thus maintaining the convergence.

c) If the UK chooses to join the € there will be advantages and disadvantages.

Firstly if UK becomes part of the Eurozone, any intra-zone trade will be free of the transaction costs and exchange rate movent risks that are currently present. Currently each time a firm exchanges £ for € they have to pay some nominal charge for the exchange. Also because the £ may move unfavourably against the € they may have to hedge themselves by holding reserves of € and/or purchace foreign exchange insurance. The removal of these issues may attract more FDI into the UK, especially those firms that intend to use the UK as a base entry point into the rest of the EU. Also, if the UK joins the Eurozone, interest rates are likely to fall stimulating demand growth in the UK itself. This may be an additional drawing point for FDI.

However ~~the~~ Extract 1 mentions that the Chancellor believes that joining the Eurozone may be unfavourable because the £ can no longer move to absorb the impact of the large trade deficit. Currently the UK is suffering one of the largest trade deficits mainly due to the strong £ and the lack of comparitive advantage in manufacturing. If the £ fell it could compensate for the relatively high production costs.

When the UK joins the Eurozone, the burden of adjustment will shift to two areas. Either wages must fall relative to global wages or consumer spending must (through an induced recession) fall ~~&~~ lowering import demand relative to export demand. In both cases the Chancellor points out that unemployment may rise. However this may not be a bad idea. If the £ moves to disguise the lack of competitiveness of UK exports, manufacturers have no incentive to become more efficient. Joining the € may force manufactures to focus on cost which may be good for the UK economy in the long run.

Thirdly joining the Eurozone may benefit UK's financial institutions because they become part of a larger financial market. Since this sector has managed to maintain its competitiveness it stands to reason to expect them to gain business from their Eurozone rivals. However the gains from this factor may be minimal because despite the fact the UK has chosen to remain out of the € many financial institutions have consolidated their business in London anyway.

d) Fiscal policy is the use of govt spending and taxation to influence the level of aggregate demand (AD) in the UK. Assume a recession. The govt would cut diret taxes and/or goods & services tax there by increasing the real disposable income of households resulting in a boost to consumption which is the largest component of AD. Coupled with this the govt itself could start spending more boosting AD directly. Through subsequent job creation and respending of additional earnings, AD shifts right causing output to rise.

However if the UK joins the € restrictions will be placed on fiscal policy because the UK will have to meet the conditions of the stability pact. This includes maintaining the govt. budget deficit at 3% of GDP and public sector debt must not exceed 60% of GDP. The former condition will restrict the use of automatic stabilisers. If GDP falls because of a recession, the govt. budget deficit must also fall to maintain the 3%. This means either raising taxes or reducing govt. spending - something many economists regard as fiscal nonsense.

Also the 60% restriction on the public sector debt may prevent the govt from pursuing discretionary fiscal policy - like the current large boost in spending on education and health to absorb workers displaced by the shrinking manufacturing ~~sector~~

sector. Whether this 60% limit will hinder govt spending is debatable because UK public finances are quite healthy relative to much of the EU.