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Economics Revision Focus: 2004

A2 Economics

Macroeconomic Developments in the Euro Zone

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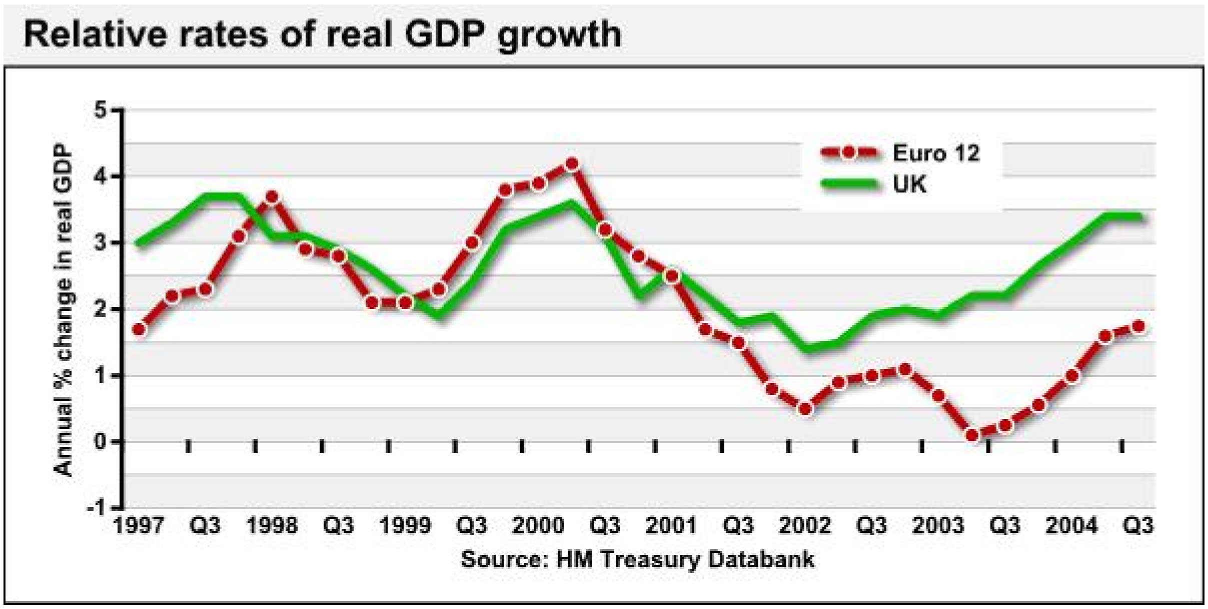
Revision Focus on Macroeconomic Developments in the Euro Zone

A2 Syllabus Requirements

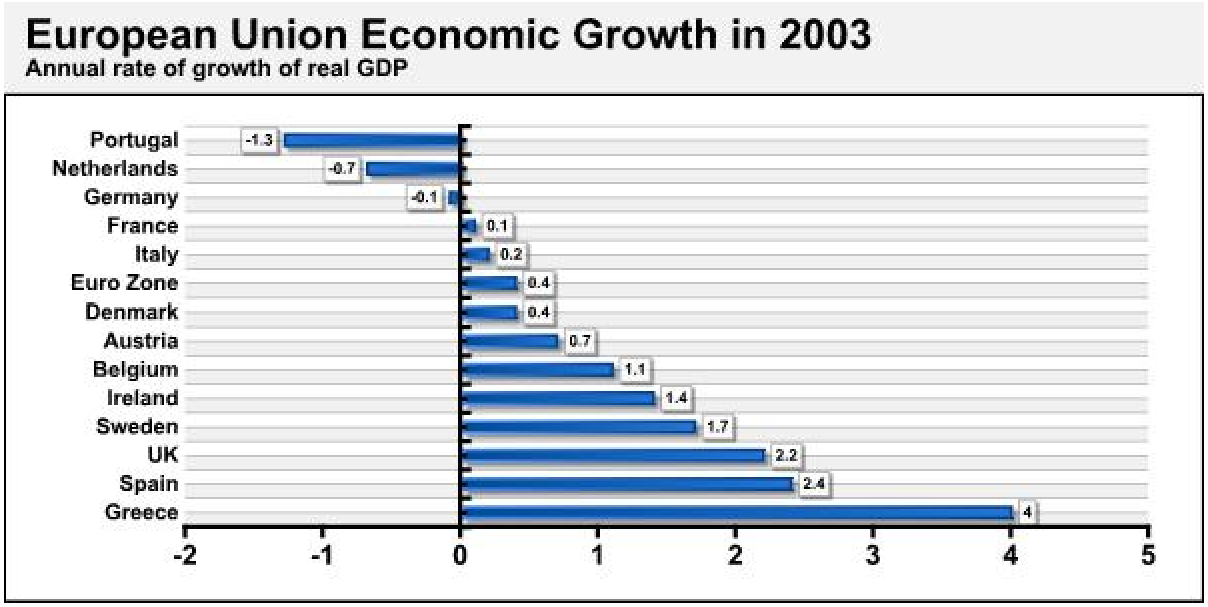
The European Single Currency
Developments in the Euro Zone and the operation of Euro Zone Monetary Policy

Economic Growth

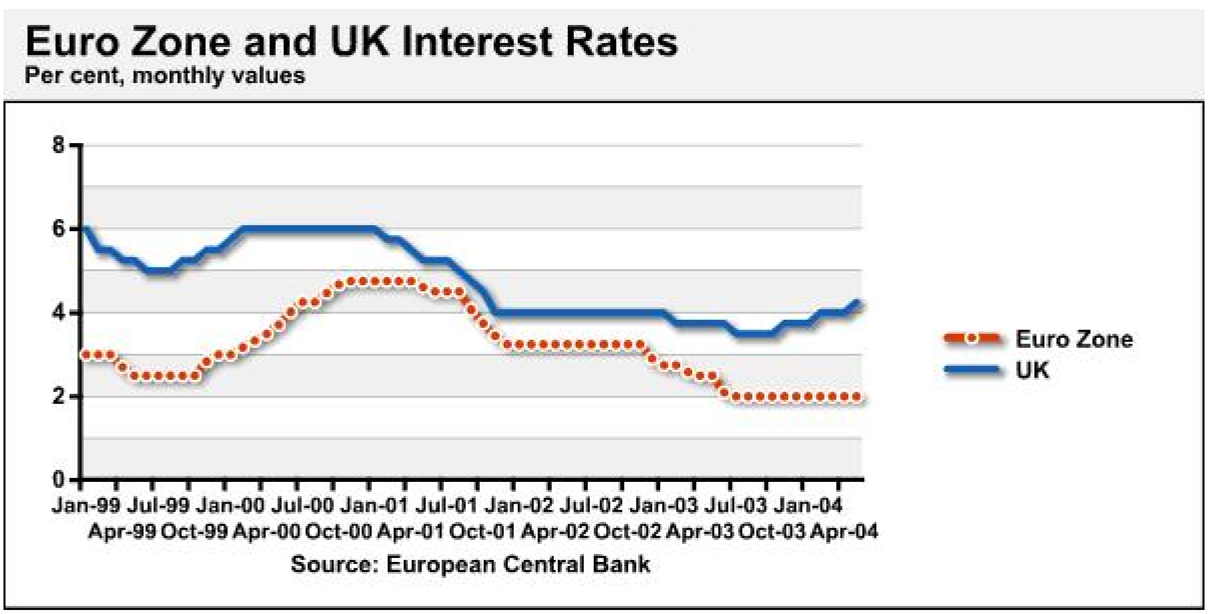


Key points

1. Very slow economic growth for the Euro Zone in the first four years of the new decade
2. UK has out-performed the Euro Zone in terms of GDP growth since 2001
3. Cyclical upturn in both the UK and Euro Zone expected in 2004
4. Three Euro Zone countries experienced recession in 2003 – crying out for lower interest rates
5. There is a sizeable negative output gap in the Euro Zone (actual GDP < Potential GDP)



Interest rates – the ECB's handling of monetary policy



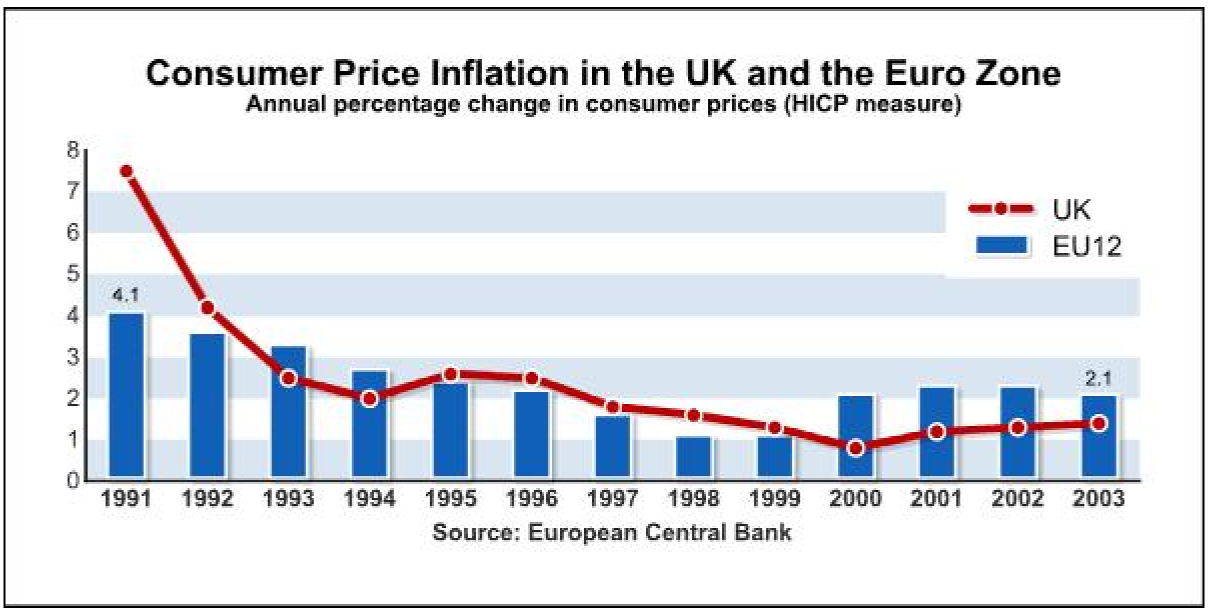
Key points:

1. Euro Zone interest rates have been on hold at 2% for 11 months (up to May 2004)
2. There is little prospect of any further easing of monetary policy since the ECB regards inflation as a threat (higher oil prices, pick up in demand and output in 2004)
3. The ECB is under pressure to cut interest rates as an insurance policy against a global economic slowdown and a rising Euro-dollar exchange rate, both of which will hit European economic growth
4. There is also pressure on monetary policy to stimulate confidence and demand since many European economies are already running sizeable budget deficits and have little scope for further "fiscal policy easing".

5. UK interest rates have been persistently above the Euro Zone for several years – the gap is widening (currently 2.25%) and we are at a more advanced stage of the "interest rate cycle" since the Bank of England is likely to raise interest rates further through 2004
6. Interest rate differential might affect the exchange rate
7. UK growth is stronger (+ a strong housing market too) – good reason for higher UK interest rates – but our inflation is among the lowest in the EU

		ECB Base Interest Rate [%]	Euro/£ Exchange Rate
2001			
	15 May	4.50	1.62
	31 Aug	4.25	1.59
	18 Sept	3.75	1.60
	9 Nov	3.25	1.63
2002			
	5 Nov	2.75	1.54
2003			
	7 Mar	2.50	1.46
	6 Jun	2.00	1.42

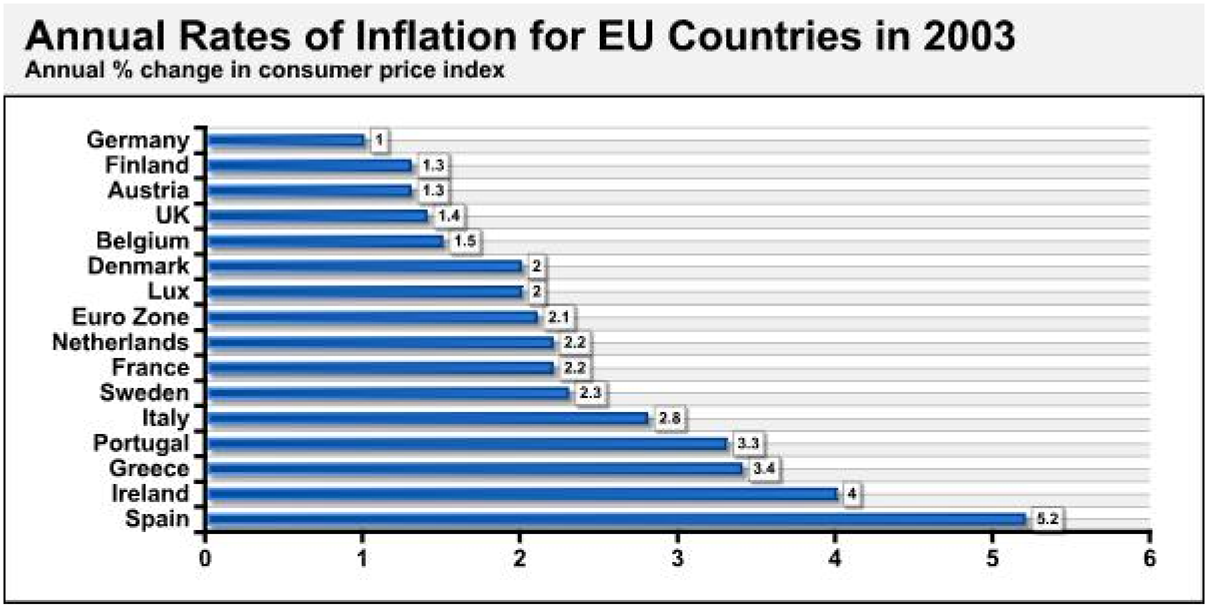
Inflation



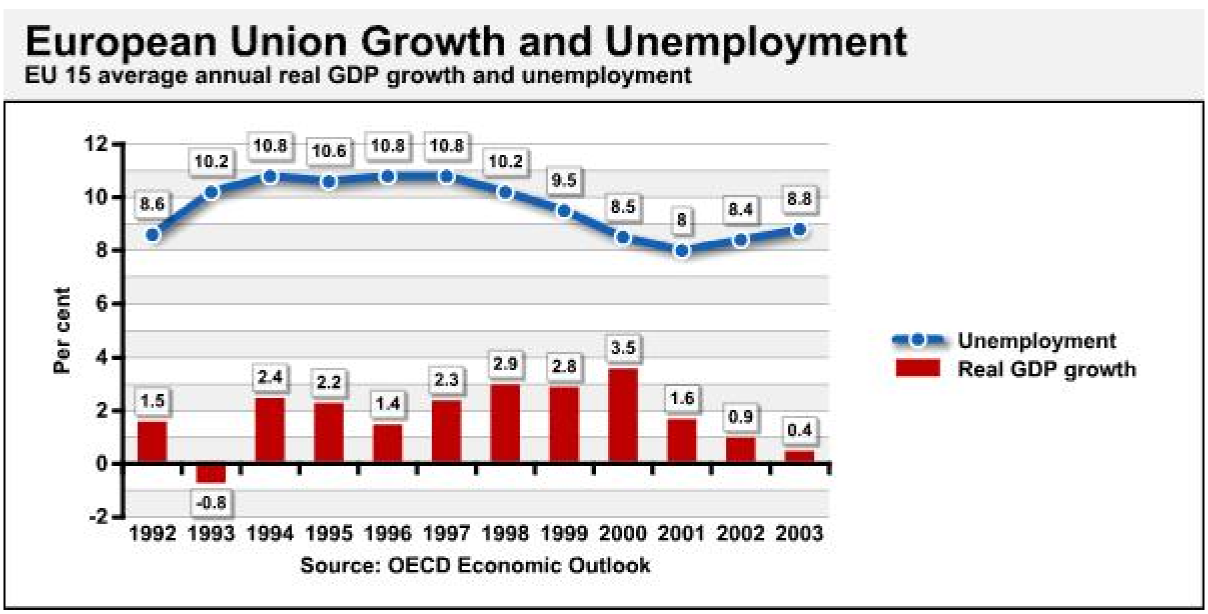
Key points:

1. The inflation target for the ECB is 2% - inflation has been a little above target in the last two years – but with wide variations in inflation rates (see chart below)
2. The UK has had lower inflation than the Euro Zone over the last four years – despite stronger economic growth. The weakness of the Euro in 2000-01 contributed to some inflationary pressure in Europe but the reality is that inflation is not a major problem

3. Germany had the lowest recorded consumer price inflation last year (only 1%) whereas Portugal, Ireland, Greece and Spain all have inflation rates three times or above that of Germany
4. Those countries with high relative inflation rates will experience a gradual erosion of competitiveness – because the exchange rate will not adjust



Growth and Unemployment

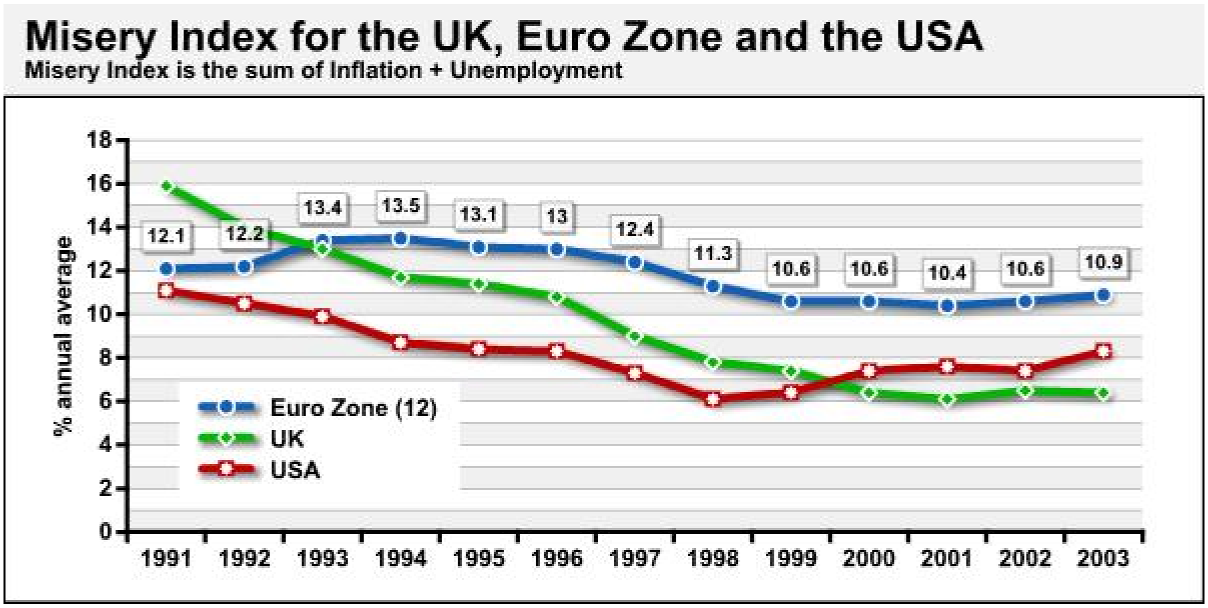


Key points:

1. The weak growth of real GDP has contributed to rising unemployment (currently heading towards 9%). Unemployment in the euro area is well above the UK's 4.7 percent level, and is holding back consumer spending.

2. A full scale recession is not needed for unemployment to rise, merely that output grows less quickly than productive potential / productivity
3. High unemployment is a major economic and social problem for the Euro Zone – it impacts on living standards and is an important factor behind the worsening budget deficit problems faced by many of Europe's leading economies

Misery Index



The U.K. has outpaced the economy of the euro region for the past four years, harming support for the government's ambition of adopting the single currency. The Misery Index is one way of showing this!