THIS IS A LEGACY SPECIFICATION

OCR
RECOGNISING ACHIEVEMENT

ADVANCED GCE

ECONOMICS

2888/SM

Economics in a European Context

STIMULUS MATERIAL

To be opened on receipt

JANUARY 2009

CUP/T68078

INSTRUCTIONS TO CANDIDATES

- This copy must **not** be taken into the examination room.

INFORMATION FOR CANDIDATES

- This document consists of **12** pages. Any blank pages are indicated.

Testing times for the European Central Bank and the euro

Introduction

As the European Central Bank (ECB) reached the tenth anniversary of its creation in 1998 and the euro approaches the tenth anniversary of its technical birth in 1999, both have come under pressure from critics and have experienced some testing times.

The ECB faces tests in the conduct of monetary policy from the aftermath of a lending crisis in the housing market in America. In the decade up to 2007, house prices in America had more than doubled. There had also been substantial house price increases, due to both demand and supply side reasons, in countries such as the UK, Ireland and Spain. The so-called 'sub-prime lending crisis' in America in 2007 led to a credit squeeze in Europe as financial institutions became more cautious in their lending to homeowners. This is likely to have an adverse effect on real economic performance in countries where the housing market exerts a strong influence on the macroeconomy.

In addition, the election of a new French President, Nicolas Sarkozy, in 2007, added to tensions over how monetary policy in the euro area should be conducted. In his election campaign, Sarkozy had called for an end to the independence of the ECB, arguing that interest rates should be set in consultation with euro area politicians. He suggested that the ECB should not be so focused on price stability. Instead, he argued that the ECB should be given a mandate to focus on creating jobs and economic growth as well as fighting inflation. This has angered German politicians who believe strongly that neither the ECB's independence nor its commitment to maintaining price stability should be watered down. In part, Sarkozy's comments were directly related to the economic problems experienced in France but also to growing concerns about the rising value of the euro against the US dollar.

These concerns and tests come on top of a decline in the popularity of the euro amongst the citizens of the euro area. When euro notes and coins came into circulation in 2002 the balance of opinion amongst citizens of the euro area was that this common currency would be advantageous. In a Eurobarometer survey in 2002, 60% thought that the euro would bring advantages and less than 30% thought it would bring disadvantages. By the end of 2006, however, the percentage believing the euro would bring advantages had fallen below 50% and in Italy, the Netherlands and Greece the majority expressed a negative opinion about the euro. In response to questions about what they thought the effects had been, 93% felt that it had brought price increases in the short run, even though there was a recognition that it enabled consumers to better compare prices across the euro area.

Economists, too, have become more concerned about the future of the euro. Some, including Professor Mike Wickens of the University of York, point out that inflation within the euro area has not converged as economic theory would predict. They argue that this raises questions about the sustainability of the European Union's most ambitious project and whether countries would be better pursuing a monetary policy independent of the ECB. But this would require abandoning the euro, which some economies would be reluctant to do.

Pre-issued stimulus material

Extract 1 **The euro area economy: selected economic indicators Jan 1999 to Jan 2008**
European Central Bank, key euro area indicators

Extract 2 **Changing house prices in Spain and Ireland**
The coming house price crash in Europe, Wolfgang Münchau,
Financial Times, 24 September 2007
The end of the Irish boom, Marc Coleman, EuroIntelligence
28 September 2007

Extract 3 **Aircraft manufacturer 'to produce outside Europe'**
BBC news, 3 December 2007

Germany shrugs off exchange rate worries
Christian Reiermann, Der Spiegel, 30 July 2007

Extract 4 **The ECB's aims and objectives**
European Central Bank, FACTS presentation.

Extract 5 **The sustainability of the euro**
Adapted from How to make the euro more sustainable, Professor Mike
Wickens, EuroIntelligence, 16 July 2007

Extract 1

The euro area economy: selected economic indicators Jan 1999 to Jan 2008

Fig. 1.1 Euro area inflation (annualised % change in HICP)

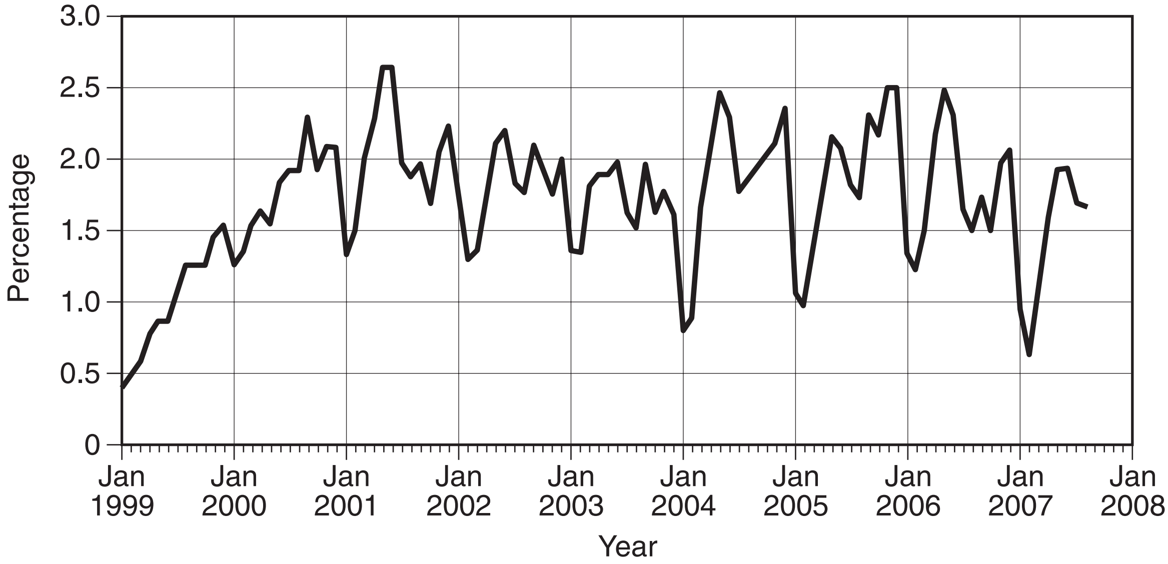


Fig. 1.2 Euro area unemployment rate (%)

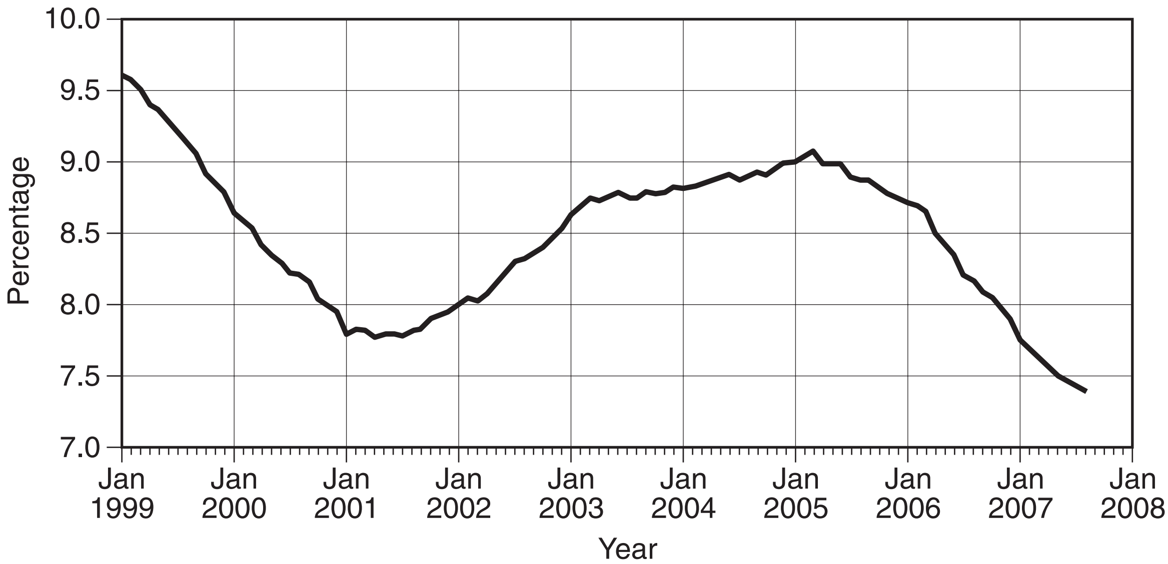


Fig. 1.3 Euro area growth of real GDP

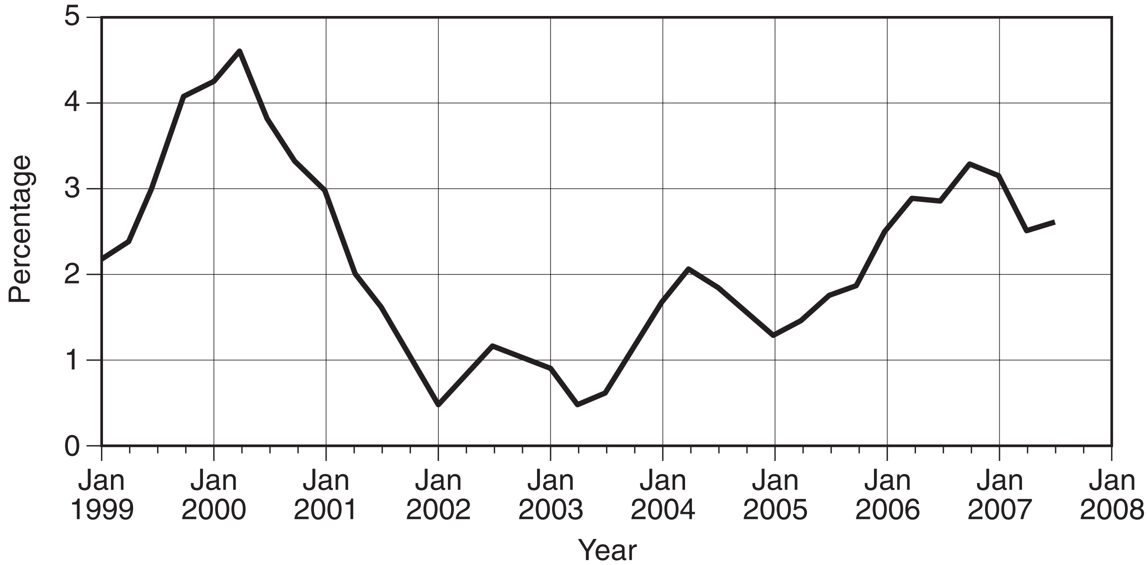
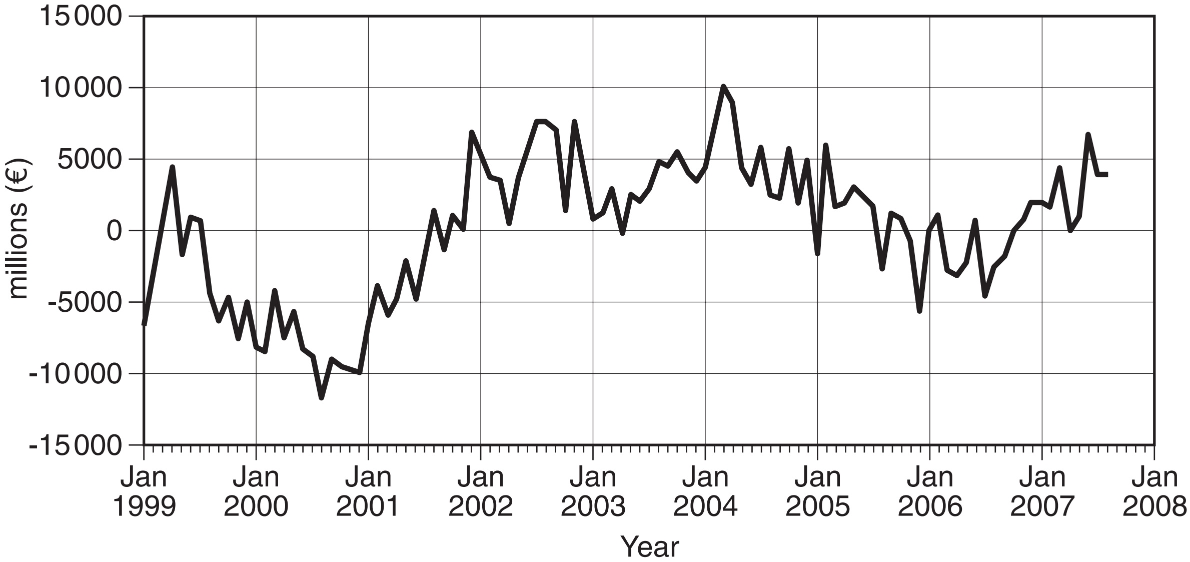


Fig. 1.4 Euro area current account of the balance of payments (€ millions)



Extract 2

Changing house prices in Spain and Ireland

There are several routes which can get us from a credit squeeze to a recession. The property market is one of these routes, at least for some European countries. Since 1999, Spanish house prices have appreciated by 150%, and Irish house prices have increased by 300%. Is this bubble about to burst and, if so, what are the likely consequences?

In a perfect market, where the supply of housing quickly adjusts to demand, the real value of property prices would be broadly stable over long periods. As we all know, property prices can and do rise. There are a number of reasons, both on the demand and on the supply side, for the housing booms experienced in Spain and Ireland. One of these is the availability of credit. In Spain, if you are poor and have no credit rating, it is easier for you to obtain a mortgage than to rent an apartment. In recent years, despite the boom in construction, supply has not kept pace with demand. One reason for the increase in demand is the greater availability of credit.

Since the economies of both Spain and Ireland are heavily dependent on the property market, a house price recession would be bad news. Of course, very aggressive interest rate cuts would help reduce the impact, especially in countries with variable-rate mortgages such as Spain. But unlike 2001, there is much less scope for interest rate cuts this time round. Even if central banks do the maximum in their power to help the property markets, they will probably not give up the pursuit of price stability at a time when oil and commodity prices are reaching new records.

Compared to an EU average of 7%, 14% of Ireland's workforce is employed in the construction sector. One quarter of Irish GDP is directly or indirectly linked to the construction sector and one fifth of all government revenues depend on it. In Spain, construction makes up 17% of GDP, compared to a normal level of around 8% in most industrial countries. A fall in house prices will have an adverse impact on GDP growth and unemployment in both of these economies.

Extract 3

Aircraft manufacturer 'to produce outside Europe'

The head of European aircraft company, EADS, manufacturer of the Airbus, has given his strongest indication yet that some Airbus manufacturing will be moved outside Europe. 'We don't have a choice,' its chief executive Louis Gallois said, describing the strength of the euro against the dollar as 'our main problem'.

Airbus prices its planes in dollars but most of its costs are in euros. The steady rise in the value of the euro against the dollar has hit the value of Airbus' earnings.

All Airbus manufacturing is currently conducted in Europe, particularly in France and the UK, but not exclusively in the euro area. The design of the wings for the Airbus takes place in Filton, near Bristol, and they are manufactured in Broughton, North Wales. Around 14 000 jobs are generated in the UK by Airbus wing production, both directly and indirectly through supplier contracts.

Extract from BBC News at http://news.bbc.co.uk, 03 December 2007

Germany shrugs off exchange rate worries

German industry may be worried about the effect of the record euro-dollar exchange rate on exports, but the government is relaxed. German Chancellor Angela Merkel has been equally laid-back about the soaring euro. Recently asked whether she was concerned about the rising euro, she answered laconically: "All things considered, no."

The French and the Italians may be groaning under the weight of the strong euro, but the German economy continues to grow at a record pace. The good news about the German economy is reason enough for Berlin to turn a deaf ear to French President Sarkozy's complaints that the costly euro is strangling the French economy. "German exports are also transacted in euros, and yet German companies are world champions when it comes to exports," says a triumphant Merkel.

An internal report prepared for German Economics Minister, Michael Glos, seeks to justify the confident mood: "As a result of only moderate wage and price increases in recent years, Germany has significantly increased its competitiveness." Experts call this phenomenon 'real devaluation.' As a result of this restraint on wage hikes, German companies are able to sell their products for less on global markets.

Glos's experts believe that Germany's fixation on the dollar exchange rate is too one-sided. "Effective exchange rates are economically more significant than bilateral exchange rates," they write. The effective exchange rate, to put it simply, reflects the value of one currency against all others. One of the reasons the experts are so confident is that a large percentage of German exports are subject to no exchange rate risk whatsoever. About 40% of German foreign trade is conducted with countries within the euro area. Another 20% of German trade involves European Union member states which are not part of the currency union, some of whom have tied their own currencies to the euro. Besides, they add, exports are not solely dependent on exchange rates.

Some sectors (especially the auto industry) are, however, feeling the effects of the strong euro. Because of the weak dollar, German automakers BMW and Volkswagen each reported declines in their North American profits by several hundred million dollars in 2006. The experts at the German Economics ministry, though, note that an economy benefits as a whole from the appreciation of its own currency, even if individual sectors suffer.

Extract 4

The ECB's aims and objectives

The European Central Bank (ECB) is the organisation responsible for the conduct of monetary policy for the euro area. Its main objective is to maintain price stability. It does this by setting short-term interest rates to influence the economy and ultimately the price level in the euro area.

The ECB has defined price stability as 'a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%'.

The phrase 'below 2%' sets a clear upper boundary for the rate of inflation (as measured by the HICP) which is consistent with price stability. At the same time, aiming for low positive inflation rates 'close to 2%' provides 'an adequate margin to avoid the risks of deflation'. Likewise, the ECB's definition of price stability takes into account the possible presence of measurement problems in the HICP and the implications of differences in the rate of inflation in different countries within the euro area.

Price stability aims to avoid both the problems of high inflation and deflation. In this way, price stability contributes to achieving high levels of economic activity and employment.

Extract 5

The sustainability of the euro

On the surface, the European Central Bank (ECB) has been successful in maintaining price stability – as it defines it.

According to research by Professor Mike Wickens of the University of York, however, when the inflation and output performance of individual countries are examined, this success looks less convincing.

Fig 5.1: Percentage growth of real GDP and the price level in selected EU economies 1999-2006

	Belgium	Denmark	France	Germany	Ireland	Italy	Luxemburg	Netherlands	Portugal	Spain	UK	EU
Price level	14.3	18.6	13.6	4.8	31.0	18.8	22.8	19.9	23.1	29.3	18.0	14.7
Real GDP	16.0	14.9	14.9	10.6	43.8	10.0	32.6	14.6	9.4	27.7	20.0	15.2

What Fig. 5.1 shows is that, whereas some countries in the euro area (such as Germany) have experienced small increases in the price level, others, such as Ireland, have experienced rapid growth in both the price level and real GDP. In general, those countries which entered the euro area with the highest rates of inflation have seen the greatest increase in their price level since 2002. In other words, there has not been the convergence in inflation rates predicted by the advocates of monetary union.

Sharing the same nominal interest rate, countries with high inflation rates benefit from lower real interest rates. Whilst this might explain why they may have higher rates of economic growth in the short run, it suggests that a single monetary policy for the entire euro area is building up problems in the long run. Countries with higher rates of inflation are likely to lose competitiveness over a period of time. This will have an adverse effect on their ability to sustain high rates of economic growth. They will need to find ways to regain their lost competitiveness, even more so because enlargement of the European Union is bringing in countries with lower real wages.

Some economists have questioned whether the ECB is able to address these longer term issues related to the sustainability of the euro. Others have suggested that countries such as Italy would be better leaving the euro and pursuing an independent monetary policy, like the UK.

BLANK PAGE

BLANK PAGE

OCR
RECOGNISING ACHIEVEMENT

Copyright Acknowledgements:

Intro text & Figs. 1.1 – 1.4	Source ECB Statistical Data Warehouse, http://sdw.ecb.europa.eu © European Central Bank, Frankfurt am Main, Germany
Extract 2	Extracts from Wolfgang Münchau, The big economies are only as safe as houses, 24 September 2008, © The Financial Times Limited 2007, www.timesonline.co.uk requested by © holder
Extract 3 (t)	Extract from *EADS 'to produce outside Europe'*, 03 December 2007 © BBC News, http://news.bbc.co.uk. Reproduced by kind permission of BBC News Online.
Extract 3 (b)	Extract from Christian Reiermann, *Germany Shrugs off Exchange Rate Worries*, 30 July 2007, www.spiegel.de
Extract 4	Source European Central Bank, ECB FACTS presentation (can be downloaded free of charge) www.ecb.int
Extract 5	Extract from Mike Wickens, *How to Make the Euro More Sustainable*, 16 July 2007, www.eurointelligence.com