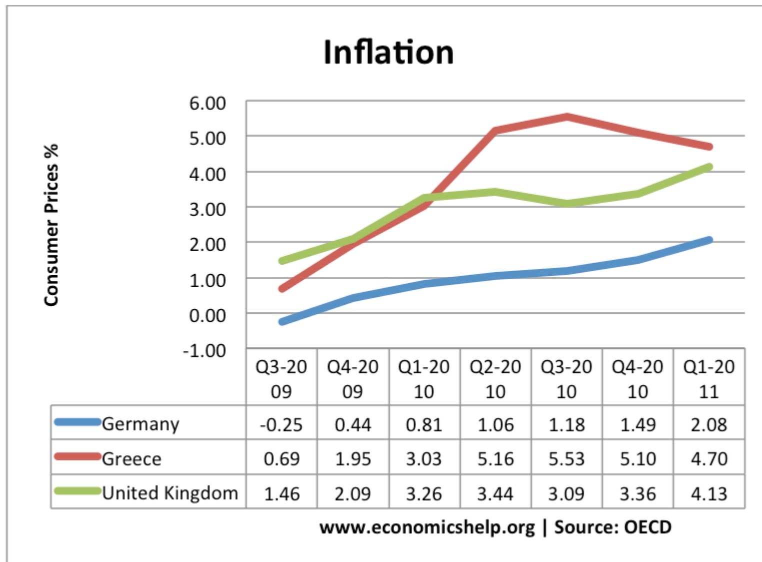
9. The Euro

Source: A Inflation

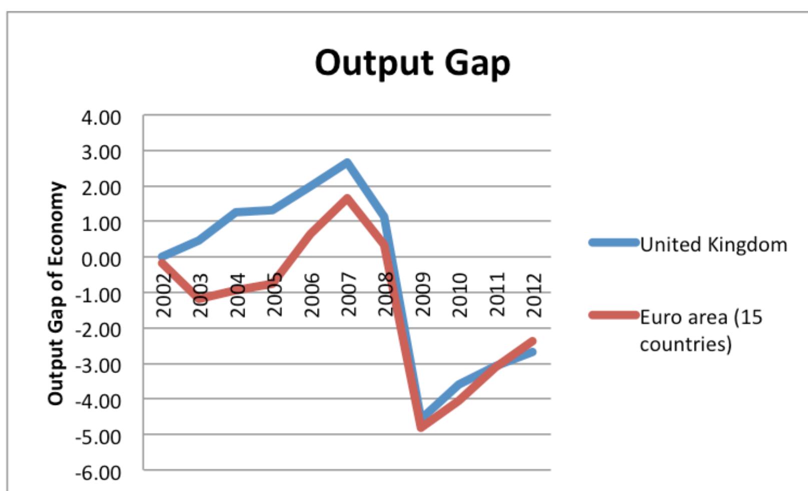


Source B

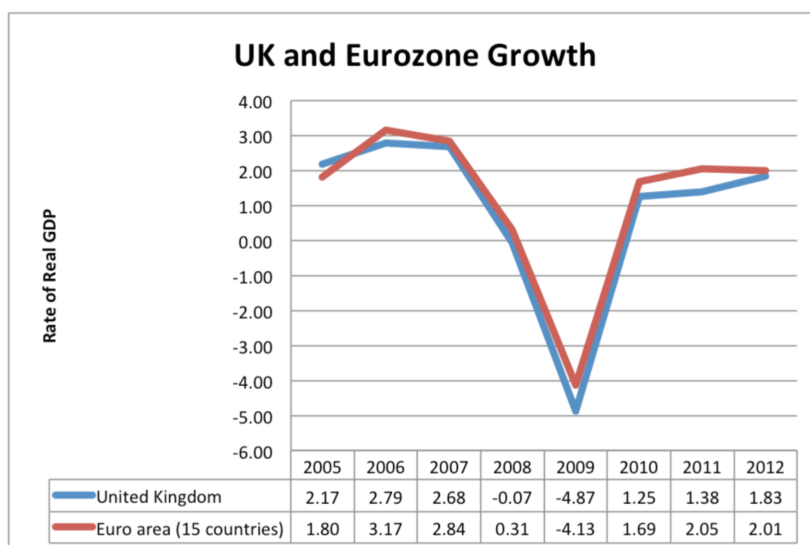
Short Term Interest Rates %

	2005	2006	2007	2008	2009	2010	2011	2012
United Kingdom	4.7	4.8	6.0	5.5	1.2	0.7	0.9	1.6
Euro area (15 countries)	2.2	3.1	4.3	4.6	1.2	0.8	1.3	2.0

Source C



Source D



	2005	2006	2007	2008	2009	2010	2011	2012
United Kingdom	2.17	2.79	2.68	-0.07	-4.87	1.25	1.38	1.83
Euro area (15 countries)	1.80	3.17	2.84	0.31	-4.13	1.69	2.05	2.01

Source: E - UK and the Euro

There is a rare political consensus that the UK is better off outside of the Eurozone. The impact of the financial crisis has shown the limitations of a single currency and common monetary policy. Euro member countries like Greece and Ireland have unexpectedly seen a rapid deterioration in both their credit rating and economic performance. Many argue that by being out of the Euro, the UK has retained more flexibility to deal with the economic downturn. For example, the 20% depreciation in the value of the Pound gave a much needed boost to exports when there was a general slump in demand.

Given the continued importance of the UK housing market and size of outstanding mortgage loans it would be hard for UK to cope with a common interest rate set for the whole Eurozone area.

1) **Using data, explain differences and similarities between the UK and rest of Eurozone economy. (5)**
2) **Explain two possible reasons for the different rates of inflation between the Germany and Greece. (5)**
3) **Examine why the UK Housing market could make it hard for UK to cope with Monetary Union? (6)**
4) **To what extent does the data show that the UK is ready to join the Euro (25)**

1. **Using Data, explain the differences and similarities between the UK and rest of Eurozone economy during the period shown.**

Source D suggests that the rate of economic growth is similar between the UK and Eurozone. The trend is very similar. Both went into recession in 2009, and both recovered in 2011. Since 2008, the output gap is also very similar. However, between 2002 and 2008, the UK had a larger positive output gap, whilst the

Eurozone's output gap was negative for first three years. Short term interest rates are also quite similar, though from 2010-2012, the UK has slightly lower interest rates. Between 2005-08, interest rates were higher.

2. **Explain two possible reasons for different rates of inflation between Greece and Germany.**

Greece has a higher inflation rate than the Germany. One factor could be higher cost push inflation in Greece. In Greece, unions may be powerful and able to bargain for wage increases without higher productivity, leading to inflation. In Germany wage growth could be low due to weak bargaining power of labour. In Greece another possible reason for higher inflation could be higher aggregate demand. If the economy is growing more quickly then it will cause demand-pull inflation. If Germany has slower growth there will not be this inflationary pressure.

3. **Examine why the UK Housing market could make it hard for UK to cope with Monetary Union?**

Monetary union involves a single currency and common monetary policy. This means the ECB will set interest rates for the whole Eurozone including the UK. However, interest rates may not be set for the optimum response to the state of the UK economy. For example, if the UK was growing faster than Europe (e.g. 2002-05) then interest rates may be too low.

In the UK, the housing market plays a key role in the economy. Many householders take out large variable mortgages. This means the amount they pay back every month depends on the interest rate. If the ECB kept interest rates too high then it would become very expensive for UK householders who would see their mortgage payments increase. In this case, it could cause a significant fall in aggregate demand and lower economic growth. In other words the UK is much more sensitive to changes in interest rates than the rest of Europe. More people in the UK buy a house and the UK has a higher rate of variable mortgages. This means if interest rates are a little too high it can have an adverse impact on the UK economy. In the rest of Europe, interest rates are not so critical because more people have fixed mortgages or rent.

A small increase in interest rates can have a huge impact on UK economy but little on the rest of the Eurozone.

4. **To what extent does the data show that the UK is ready to join the Euro (25)**

Joining the Euro, requires economic convergence. It means that the UK economy would have to be able to work with a common interest rate set by the ECB. For this to work the UK would need to be at the same stage of the economic cycle as the rest of the Eurozone. Source D, suggests the economic cycle of the UK and Eurozone is very close, meaning that perhaps they could cope with a single currency and monetary policy.

However, it is important to bear in mind, the UK had a similar rate of economic growth but this was after pursuing its own monetary policy. In Extract E, it mentions that the '*20% depreciation in the value of the Pound gave a much needed boost to exports.*' If the UK had been in the Euro, it would have been unable to devalue the currency and might have seen a much bigger fall in GDP and deeper recession.

Source C shows that the UK had a bigger positive output gap in the period 2002-05. When the UK had a positive output gap, the Euro had a negative output gap. This means that the UK was experiencing higher growth and inflation was a bigger problem. The Eurozone was experiencing slower growth. Because of this UK interest rates were higher than the Eurozone in this period. If the UK had been in the Euro, the UK would have had lower interest rates. This would have caused even faster economic growth, higher house prices and a bigger boom. This boom would have caused even bigger problems in 2007, when house prices fell. This shows that the UK would have been better off with its own independent monetary policy and the ability to set higher interest rates to reduce housing bubbles.

Inflation is not so clear cut, source A, shows the UK currently has higher inflation than Germany suggesting we might need higher interest rates. However, looking at inflation alone may be misleading. For example, the UK could be experiencing cost push inflation due to rising taxes or higher import prices from a devaluation. Therefore, the inflation may not be due to underlying excess demand but just temporary factors. At the moment, inflationary pressure and interest rates of ECB and UK are similar, though there is no guarantee in the future this convergence will continue.

To get a good understanding of whether the UK is ready to join the Euro, it would also be important to consider many other factors such as the flexibility of the economy. Extract E, suggests the housing market could be a real problem because many homeowners have a variable mortgage which takes a high % of their income, this makes it difficult to accept a common interest rate.

Another issue, not mentioned in the extract, is the size of government borrowing. The Maastricht criteria for joining the Euro suggest government public sector debt should be no more than 60%. Yet, since the recession the UK has exceeded this. This level of government debt would be a major problem to joining the Euro as there would be greater concern over the UK's ability to repay debt. For example, the UK could no longer pursue quantitative easing to increase money supply and buy government bonds when necessary. This makes it easier for countries to experience liquidity issues and struggle to finance government debt.

Overall, the data suggests there would be many significant concerns to the UK joining the Euro. The benefits of lower transaction costs, price transparency and stable exchange rate could be dwarfed by inappropriate monetary policy which damages the economy.