EZY ECONOMICS

THE WEEKLY 5

29/03/19

Here are the five economic stories which have caught our eye this week:

Investors Go Cold Turkey

A developing story at the back end of this week has been the run on the Turkish Lira. Turkey has experienced sharp losses in the value of its currency thanks to the expected political uncertainty from upcoming local Turkish elections. This political period has spooked markets and investors ahead of what could be a considerable period of upheaval.

The currency sell-off started at the beginning of the week and has shown no signs of abating, on Thursday the Lira fell by 5%. Now this might be good news for anyone looking to go on holiday to Turkey but can be deeply damaging to the Turkish financial system if this becomes part of a more sustained trend. A sharp plunge in the Lira is likely to push up the price of dollar denominated debt in some of Turkey's banks and financial institutions. Increased balance sheet pressure on some of Turkey's leading banks can create systemic problems across the real economy. This is the crucial link between the foreign exchange markets, and financial markets and how a currency crisis can turn into a banking crisis before turning into a full-scale economic crisis.

It is important to touch upon some of the policy responses of the Turkish government to shore up the value of the currency. The Turkish central bank has burnt through a third of its stockpile of foreign currency reserves. This is a traditional move used by central banks to stabilise the currency during times of crises.

Unusually the Turkish President has not conformed to another traditional approach to raise interest rates to boost the attractiveness of assets linked to the Lira. He is of the opinion that raising interest rates actually increases inflation instead and can destabilise the situation even further.

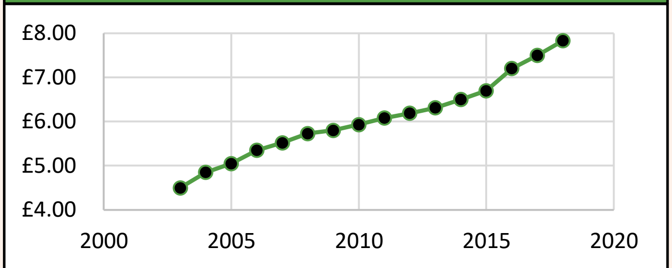
With the use of a diagram, explain how political uncertainty can contribute to a fall in the value of a currency.

Discuss how a central bank can use foreign currency reserves to stabilise the value of a currency.

To what extent do you agree with the view that high inflation is caused by high interest rates?

Going Above the Pay Grade

UK Hourly Minimum Wage (2003-18)



Rate applied to adults over the age of 25.

Since 1999, the UK Government has committed to boost the pay of the lowest paid workers across the economy by offering a national minimum wage. The aim is to legally enforce a pay level that employers cannot go below to enforce higher renumeration standards and to protect workers from being exploited in the labour market.

The minimum wage is applied across all industries and is applied at different levels across different working age groups to reflect their relative experience in the labour market. It is regularly adjusted to account for the changing cost of living across the economy.

In the last two years, the UK labour market has been experiencing a rather rosy renaissance. The number of people employed is at its highest level recorded at 76.1%, whilst the unemployment rate is at its lowest level since 1974 (3.9%). Renumeration is strong as well with average weekly earnings increasing by 3.4%. Despite all of this, the Government is actively pursuing policies to uphold its minimum wage standards relative to the rest of the world.

The chancellor Philip Hammond, has hired a series of labour market experts to conduct a review into the UK's minimum wage policy and the wider implications of introducing a higher minimum wage threshold. The main UK minimum wage level is projected to reach 60% of the median level of UK pay in 2020. Some see this as a positive to help achieve acceptable living standards for all, whilst others question the damaging impact this could have on the lowest paid and overall employment numbers.

Explain how the unemployment rate is calculated in an economy.

Do you agree with the view that raising the minimum wage reduces the incentive for workers to advance in their jobs? Justify your argument with a diagram.

To what extent do you agree with the view that higher wages for the lowest paid encourage firms to make productivity improvements?

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The Great QE Reversal?

During times of economic turmoil the remit for central banks around the world is simple – cut interest rates to lower borrowing costs and discourage saving, stimulate the economy and boost flagging inflation. However, this policy only works in theory when central bankers have the sufficient margin to cut interest rates in the first place. For every interest rate cut that moves the main bank rate perilously close to 0%, the effectiveness of this policy manoeuvre is greatly reduced.

This is exactly what happened shortly after the financial shockwaves of 2008 began to hit the world's major economies. The Bank of England reduced the Bank Rate (the rate of interest at which the BoE charges on loans it makes to other financial institutions) from 5.75% to 0.5% in the relatively short space of 18 months. These were unconventional times and ultra-low interest rates were going to be the "new normal" even for the most advanced economies. Hence the birth of a new monetary policy instrument – Quantitative Easing (QE).

In simple terms, this policy tool consisted of centrals banks releasing new money into the financial system via the acquisition of government bonds and stock market assets. The logic was that that this would push up the value of assets and bonds across the economy and push down yields. Therefore, QE was a "backdoor" policy approach to bypass the traditional monetary policy framework, so that long-term interest rates and borrowing costs could be lowered.

However, QE is very much a cyclical process and those assets and bonds, when purchased by central banks, have to go somewhere so that this policy instrument can be unwound during more certain times. Many central banks around the world have seen the value of their balance sheets swell due to the sustained accumulation of government and corporate assets over time. For instance, the Bank of England has bought £435bn of UK government bonds, whilst the US central bank has seen its balance sheet sky rocket from $905bn to $4.5tn in the space of a decade.

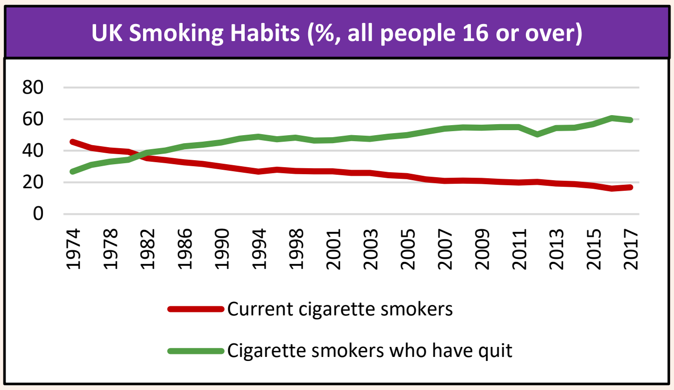
This week, data released from the US central bank seemed to confirm that the pace at which this second phase of QE is likely to unravel at will be protracted and drawn out. The US balance sheet has fallen from $4.5tn to $3.5tn, but warnings about the strength of the global economy have put this phase on hold for the foreseeable future. The fear is that if the US economy dips back into a recession, the central bank may have to make the sharp transition from shrinking the balance sheet to expanding the balance sheet with further rounds of QE. The downside of this unconventional measure is that the process of unwinding large central bank balance sheets has not been attempted before on this scale and therefore many central banks will ere on the side of caution and test the economic waters before doing anything dramatic.

Explain why there is a negative relationship between bond prices and bond yields.

Define and explain the process of Quantitative Easing (QE) in the UK financial sector.

QE is defined as an 'unconventional' monetary policy tool. To what extent do you agree with the view that QE should be extended and used to help central banks control inflation in the future? Justify your view.

A Future Smokefree Generation?



This week a series of proposals were put forward by the British Medical Journal (BMJ) to attempt to influence teenage smoking rates across the UK.

The number of people smoking in the UK has declined from 45% in 1974 to 16.8% in 2018. This downward trend is thanks to a series of enforced policies on the consumption of tobacco such as raising the legal age of consumption from 16 to 18, introducing a ban in public places and imposing stricter advertising and packaging standards on cigarette manufacturers.

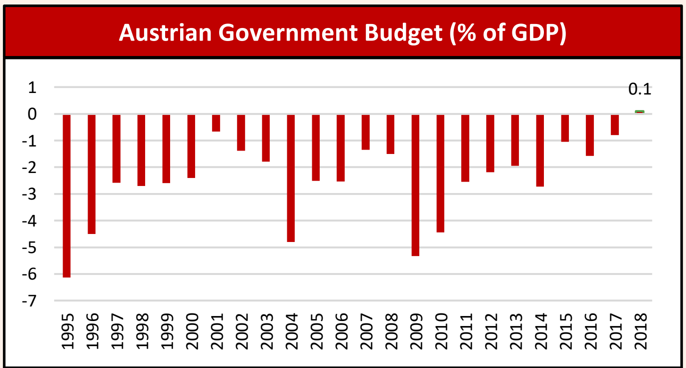
The BMJ suggested shifting the legal age of tobacco purchase back from 18 to 21. The group suggests that two thirds of those that try smoking during their teen years become adult smokers and therefore this move will help disrupt the source of tobacco supply in schools and colleges.

The UK has set itself a public health goal to achieve a smoking rate of 12% by 2020 to move the UK population closer to becoming "smokefree" (5% smoking rate). It is estimated that smoking across the UK costs the NHS about £6bn a year, but the sale of cigarettes themselves actually rakes in £9bn in taxes a year.

Based on the information given, what type of externality are cigarettes and other tobacco related products an example of? Use a diagram to justify your answer.

Contrast the effectiveness of standard economic policies against behavioural policies available to governments to influence the smoking rate in the UK.

The Wait Is Over!



We bring this week's edition to a close with the end of a remarkable fiscal run in Austria.

The Austrian government has run a budget deficit (government spending greater than tax receipts) in each and every year since 1974. In pure economics terms, this means that the Austrian economy and its services have been financed by debt for 43 consecutive years! However data released for 2018 showed that this run has come to an end with the country recording a numerically small budget surplus of 0.1% of domestic GDP which translates into $480m.

Explain how governments can help improve the long-run trend rate of growth by persistently running budget deficits.