Economic effects on easyjet

Economics

Coursework Two: Written report evaluating and commenting on the recent developments in monetary, fiscal and exchange rate policy in the UK and abroad and how these impact on easyJet With the newcoalitionGovernment of the Conservatives and Liberal Democrats gaining power in 2010, and almost immediately calling an emergency budget, as the Conservatives promised, declaring their primary objective is to reduce the deficit there have been many changes in fiscal policy and reversal of plans by the Labour Government, there has also been changes in the exchange rate which will have considerable impacts all over the world.

Additionally the Bank of England has looked to make use of monetary policy. All of the changes in the UK, and in Europe will have an impact on easyJet (as easyJet only flies in Europe). The objective is to identify the changes in macroeconomic policies in the UK and abroad, using data and information from The Bank of England, the European Central Bank, the Institute for Fiscal Studies, the Budget, the easyJet corporate report and other various economic sources.

The Main Objectives of Government macroeconomic policy are; sustainable economic growth, stable low inflation, low level of unemployment, and a good position on the balance of payments. It is that final policy that the coalition Government has declared most important.

With the deficit growing year on year, with little sight of changing, and as such they have used fiscal policy drastically recently as, especially the Conservatives in the coalition Government, have looked to reduce the budget deficit with across the board cuts (totalling six billion Pounds) in Government spending, this coupled with the various tax rises are extreme measures which seem necessitated by the extreme economic times we are in. Many believe these actions will lead to a double dip recession, one which it could take the UK many years to recover.

The Government also increased VAT on the 1st of January from 17. 5% to 20% (the highest it has ever been). Although George Osborne (speaking to the BBC on the 4th of January) thinks " targeting VAT is more progressive than increasing income tax or National Insurance" many still believe VAT is a very regressive tax, meaning it is more of a burden on those households with lower income. This graph (compiled by the Institute for Fiscal Studies) shows how the poorest 10% will be hit much harder than the other 90%, seeing a percentage loss of net income more than double that of the richest 10%.

This is because VAT is on goods including necessities, which means a rise in VAT will not deter people from purchases of said goods, so VAT will have a large impact on their percentage net income. Although overall a rise in VAT will have cost the richest 10% more, as their net income is considerably larger they have to capacity to cope better with the rise, and will cause a smaller decrease in their net income. Another rise is in fuel tax, " Given that each penny increase in fuel duty raises an extra ? 00 million for the Exchequer, it is easy to see why the chancellor is tempted to hike rates," said the foundation's director, Professor Stephen Glaister. The Government have increased fuel duty by 0. 76p on petrol and diesel, and the rise in VAT will mean another price increase. The AA estimates that " these increases combined will add approximately 3. 5p to the cost of a litre of both petrol and diesel. " According to HM Tresuary budget report 2010 " The most urgent task facing this country is to implement an accelerated plan to reduce the deficit.

Reducing the deficit is a necessary precondition for sustained economic growth. ” As such another part of the recent fiscal policy changes in the UK was announced in The Budget, that public sector net borrowing would remain at 4 per cent of GDP in five years time, the structural deficit would be 2. 8 per cent of GDP by 2014-15, while the structural current deficit would be 1. 6 per cent. They also set that public sector pay would see a two year freeze, apart for those earning less than ? 1, 000 a year, this is an attempt to stop the rise in wages for the thousands working in the public sector, which will save the Government paying more and more each year and thereby help to reduce the deficit. Yet public sector employees will be hit hard by this policy, as inflation rises – their wages will not, meaning inflation will have a devastating impact on their net income as real prices rise, and taxes are increased. This will lead to public sector employees to purchase less, and thus provide less chance of growth which is one of the main macroeconomic objectives.

However corporation tax will be reduced from 28 per cent to 24 per cent, a reduction that will be spread over the next four years from April 2011. This may encourage businesses to expand as they are paying less tax, which could lead to a decrease in unemployment (one of the primary macroeconomic objectives) The budget also released a plan to “ reduce the main and special rate of capital allowances to 18 and 8 per cent respectively in April 2012. Also capital gains tax will be increased to 28 per cent for higher and additional rate taxpayers” (The Budget), so the higher income households will have to pay a higher than ever before tax.

The Government also intends to freeze council tax for 2011-12 by working with the local authorities, this potentional freeze on council tax will help the poorer level income earners, and could help them to escape thepovertytrap. An increase in tax for the higher level income earners will not only provide moremoneyfor the Government – in an attempt to reduce the deficit – it will also improve the image of the main party in power; the Conservatives whereby they are seen as more favourable to the higher level income earners in the UK.

Another policy instated is, what the Treasury call, “ a reversal of the most damaging part of the planned increase in National Insurance Contributions” by instead of reducing it as Labour had planned, they are raising the threshold by ? 21 a week in April 2011. This will also lessen the burden on the poor, and thus with more available incomes they will spend more, which will be an injection into the circular flow (where the flow of payments in an economy is a circular flow, with injections and leakages, the injections being Government spending, investment etc, and the leakages primarily being saving).

Europe was also been impacted by the recession over recent years, and their fiscal policy must try to combat its negative effects. Before the Recession, many countries in the EU had a large structural deficit. There was an inability to meet fiscal targets, for example the political pressure against tax increases and spending cuts. One country which has particularly been affected is Greece, with the EU average debt as a % of GDP at an already staggering 78. 2%, Greece’s is at 122%. They have been hampered by powerful unions which gained considerable public sector wage increases without corresponding increases in productivity.

Greece has also struggled to raise taxes and decrease Government spending. The depth of the recession has worsened the Government fiscal position much more quickly than expected; tax receipts have fallen while spending on unemployment benefits has increased dramatically. In Ireland they plan to tighten fiscal policy by more than 4% of GDP next year. However economists (Simon Tilford, Centre for European Reform, November 2010) debate whether a tightening of around 1. 5% in 2011 will derail the UK's economic recovery.

Governments usually run a deficit in bad times, and a surplus in good times, yet in these times of recession Germany is running a budget surplus, by making necessary wage adjustments and increases in taxes as they are performing much more strongly than expected. Although The Bank of England was nationalized in 1997 by the then Chancellor of the Exchequer, Gordon Brown, meaning the Government no longer had control over the Bank of England, fiscal policy will have a large impact on the economy and how monetary policy is conducted.

The primary tool of monetary policy is the use of interest rates. However in the UK the base rate was left unchanged at 0. 50% in the January meeting, the 22nd month in a row. The news of an economic slump, the UK economy contracted 0. 5% in the final three months of 2010, has reignited fears of a double-dip recession and has reduced the likelihood of an early rate rise. Yet two of the 9 MPC members voted for a rise in the base rate at the January meeting, a rare split decision. However due to an inflation rise in December the CPI rapidly rose from 3. % to 3. 7%, chances of an early rate increase to control price pressures has raised. The Bank of England predicted in February 2010 that inflation would be at 1. 5% by the end of 2010, which is far of the actual rate of 3. 7%. The MPC must now hope that price pressures will ease so it can stick with low rates and avoid stagflation. However it may be out of their control; global commodity prices have been, and still are, rising fast and Source tradingeconomics. com are now pushing up the cost of UK exports.

The idea of increasing the base rate will encourage saving (a leakage from the circular flow) which will help to decrease spending and therefore inflation. However this could be met with a reduction in growth, or even the economy shrinking. Failing to raise the base rate would seem counter intuitive as the Government CPI target is 2% and inflation it at 3. 7%, well above the 1% band. The Bank of England decided to employ quantative easing by pumping ? 200bn into the system in an attempt to kick-start the UK's economy.

But the GDP shrunk by 0. 5% in the last quarter of 2010, so this policy does not seem to be helping growth. The MPC predicts inflation will continue to rise past 4% in the coming months which will encourage higher pay demands and could start up a wage/price spiral, the rising expectations of inflation means people/workers expect prices to continue to rise, so they are unlikely to accept pay rises less than the expected inflation rate because they want to protect the real purchasing power of their incomes, and this pattern continues.

Monetary policy is greatly restricted in Europe due to the Euro, being a member of the Euro means that individual countries face limitations such as an inability to employ quantative easing or alter the base rate to affect the economy (this is one major factor in why the UK has not joined the Euro, and that the Coalition Government has stated that while they are in term they will not join the Euro). As such the European Central Bank (ECB) has power over setting the base rate, which since 5/7/2009 has been 1%, almost as long as the UK has been at 0. 5%.

The ECB states " maintaining price stability is the primary objective of the Eurosystem and of the single monetary policy for which it is responsible. " This is laid down in the Treaty on the Functioning of the European Union, Article 127 (1). Yet prices in the Eurozone have been very unstable in the past years. However Germany has seen strong signs of improvement, but t this could actually hamper the rest of Europe's growth. The CPI measure of inflation is rising at an annual rate of 2. 2%. That's not as high as the UK, but it's above the European Central Bank's (ECB) target for the first time in two years.

As Germany is the most important and influential economy in the Eurozone when it comes to setting monetary policy, it means the ECB will have heavy pressure to raise the base rate this year, regardless of how the rest of the region is performing. Which is ironic as when the euro was introduced the base rate was set to a level to suit Germany's sclerotic (rigid and unresponsive) economy that was still dealing with reunification. But the cheap money turned the strongly-expanding countries, such as Ireland and Greece, into smaller and floundering economies.

The UK has operated a free floating exchange rate since September 1992, meaning The Bank of England has not intervened in the markets to influence the Pound's value. This means that the Exchange rate is purely market determined which leads to many fluctuations, just in the period from August to January displayed in the graph below. A floating rate can be a tool of macroeconomic adjustment – for example a depreciation in the Pound should increase the net export demand and therey stimulate growth.

However the BoE would hope the gains from a lower exchange rate are not dissolved in the inevitable higher wage demands or export prices. The countries inside the Euro Zone are hoping for a more competitive exchange rate to create an injection of demand into their struggling economies. Floating exchange rates offer a degree of adjustment, so as is the situation now a large trade deficit puts downward pressure on the exchange rate which will help the export sector and control the demand for Euro's to Pound Sterling imports as they become relatively expensive.

Having no exchange rate target means that short term interest rates can be set to meet domestic macroeconomic objectives such as growth or low inflation. However with a floating exchange rate there is less currency stability which can discourage Date (2010-11) Source x-rates, composed on excel trade and investment, this is one of the reasons why currencies were locked within the Euro Zone for the Euro. Any changes in the prices of imported goods and services will have a direct effect on inflation. The Euro is also a floating exchange rate, meaning it's fluctuations in relation to the UK have considerable affects.

An appreciation of the exchange rate (as there has been in January against the Euro) reduces the sterling price of imported consumer goods and durables, raw materials and capital goods. The effect of a changing currency on the prices of imported products will vary by type of import and also the price elasticity of demand which is affected by the degree of competition within specific markets. All companies will be affected by these policies, both UK and abroad, and easyJet is no exception. The current price of jet fuel is “$897 a metric tonne compared with $681 a metric tonne a year ago”, easyJet stated in January 2011.

This increase in fuel tax and price will cost easyJet ? 1. 17 extra per than in 2010, and is expected to double the losses of the company to approximately ? 140 million, as it will for all companies in the airline market. As for the VAT rise, easyJet have announced they may be able to save millions of Pounds in VAT by registering its new budget holiday company outside Britain, with Lowcost Travel, expected to be in Switzerland. This means they will avoid VAT under the Tour Operator’s Margin Scheme. This could save easyJet ? 0 million in VAT for the next three years. Most European markets saw losses or declines in January with concerns that China will raise interest rates again to slow down economic growth in Europe, and easyJet suffered alike with a fall of 16. 19 percent in the FTSE250 after they predicted heavy losses in the first half of 2011. easyJet announced in January 2011 that it, as all other airlines, was hit by the severe weather in Europe in December 2010 and strike action by French air traffic controllers, coupled together this cost easyJet ? 31 million,. asyJet is also set to close its cut services at Luton Airport by a fifth (which sees 5 million passengers each year) with a view to transferring them to profitable bases in continental Europe. The airline also initially price flights from European destinations in Euros, but customers can choose an alternative price in sterling. However, the price in sterling is set at a lower rate, this is because easyJet decided not to use the Mastercard or Visa rates that the most retailers use, and instead set the interest rate themselves - at a much lower level.

Generally the difference between the actual exchange rate and what easyJet offer can be anywhere between 2% and 6%. This generates a lot more income for easyJet by exploiting the exchange rate at the right time, yet it can been seen as a hidden cost, which would not impress easyJet's customers, and in the long run could actually lose them customers. Elasticity of demand measures how a change of the quantity demanded is affected by an income or price of another good change.

As the airline market demand is elastic businesses must be careful with changing prices and must be sure that by decreasing their prices they are still able to increase their market share. easyJet have achieved this, by coming in with very low prices and gaining market share. Another problem facing easyJet is that passenger duty tax increased from ? 10 to ? 11 in November 2010, which again cost easyJet millions. However, despite these setbacks, the airline said revenue in the final three months of 2010 " was up 7. 5% to ? 54 million compared with the same period a year ago". easyJet announced in November 2010 that profits have been " boosted by a rise in passenger volumes and the group said it will pay its first ever dividend in 2012", the airline's chief executive, Carolyn McCall, said " We therefore intend to commence the payment of an annual dividend based on a dividend cover of five times. ” The airline said passenger numbers grew 8% in the full-year to the end of September to 49 million, while profits totalled ? 154 million in the period – against ? 55 million a year earlier. asyJet’s have continued to strengthen with “ market share gains across Europe particularly London Gatwick, Paris Orly (easyJet grew capacity by 22% in France in 2010) and CDG and Geneva” (easyJet corporate reports, January 2011). Additionally in response to growth in Germany, easyJet carried on refocusing its offering, and increased capacity on key business routes out of Berlin. The total fleet plan over the period to 30 September 2013 is as follows: | easyJet A320family| Boeing 737-700| GB Airways A320 family5| Total aircraft5| At 30 September 2010| 182| 8| 6| 196| At 30 September 2011| 202| 2| –| 204|

At 30 September 2012| 214| –| –| 214| At 30 September 2013| 218| –| 2| 220| Note 5: Four ex-GB Airways A321 aircraft exited the fleet in November 2010. Source: easyJet corporate reports, Jan 2011 By eliminating the Boeing and ex-GB Airways sub-fleets it will reduce costs by simplify operations. easyJet plan to complete this by 2012 and they project cost savings of around ? 30 million each year. They are also set to work with the EU on consumer rules to make sure that they have the right balance between the benefits that low costs brings to consumers over its costs to the industry.

The air traffic control strike in 2010 was caused by the economic pressures facing Europe and union concerns about the Single European Sky programme, and easyJet “ expect disruption to continue in 2011” and “ will press for measures to be put in place that alleviate the impact of these strikes and push for faster reform. ” (easyJet corporate reports). There has recently been a saturation in the European and UK airline market.

Competitors have mimicked easyJet's strategy and have introduced competitive brands with similar price strategies that have increased competition, and decreased market share.

The airline market is best classified as having a monopolistic competition market structure, whereby there are many firms will similar, yet differentiated services. Some companies have contrasting services; easyJet and British Airways for example, one with a strategy to keep costs as low as possible by stripping out almost all non-essentials of air travel (ranges in class etc) and one, BA which offers a higher level of service with a higher cost. It also has many business with similar plans and ideas; easyJet and Ryanair for example.

The Herfindahl Hirschman Index (HHI), which measures the degree of competition in one market for the airline market, and is 0. 070210776 (see attached excel document for details). This means that the market is unconcentrated; this indicates that the market is unlikely to have adverse competitive effects, as no companies have a monopoly power. In conclusion, the fiscal policy employed by the coalition Government will have long reaching affects across the economy, including the airline market.

It will also have drastic affects on the population, with many tax rises; VAT and fuel in particular, which will reduce the level of net income for all households. However the rise in the National Insurance threshold will be very positive for the lower income households. As for businesses, the reduction in corporation tax over the next four years will be a welcome policy, yet almost all companies will be affected by the rise in fuel tax, particularly the transport market – easyJet.

The Bank of England will soon have to look further into raising the base rate, the historically low level of 0. 5% will not help any savers (although it helps those with large mortgages, loans etc.), and when they decide to raise the rate it can help combat the continually increasing level of inflation. The exchange rate is left as a free-floating, which it will be for the foreseeable future. This is like almost all countries, so the market controls currencies, which will periodically rise and fall, and deal with the level of imports and exports and their competitiveness. asyJet will undoubtedly suffer great losses due to the fuel rises, which are expected to continue to rise as oil becomes a more scarce resource the supply falls – which will increase the price. They have plans to deal with VAT, and are looking to cut any unnecessary costs across the board to cope with these rises. The further strikes planned by the ATC for 2011 will again cost easyJet millions, but they believe they will be better equipped to deal with these problems.

Any unpredictable, or problems outside their control, snowfall of December and the Icelandic volcanic ash clouds will also cause considerable losses, yet there competitors (and imitators) will see similar losses so it will be highly unlikely that easyJet become less competitive as the airline market continues to combat numerous problems. References Financemarkets. com HM Treasury Budget The European Central Bank website The Bank of England website The easyJet annual, and corporate reports Tutor2u The Institute for Fiscal Studies tradingeconomics. com x-rates. com The Economist