

Impact of the recent eurozone crisis on the uk economy essay sample

[Economics](#)



The Eurozone crisis is a major issue among academia and society, which is having a large impact on the world economy. It was triggered by a sovereign debt crisis, which started in some countries from the periphery of the Eurozone (Portugal, Ireland, Italy, Greece, Spain, also known as PIIGS). This later transmitted to the other members of the monetary union and members of the EU as a whole through financial contagion by trading and banking (Andrews and Parlapiano, 2012). The result is negative consequences to these economies (such as recession, increased unemployment and possibility of default). This essay will attempt to explain the reasons behind this crisis and apply the Keynesian income-expenditure model in analyzing its impact to the UK economy. Finally, it will draw some conclusions and the limitations of the research will be pointed out.

The reasons behind the Eurozone crisis are complex and are subject to a thorough research. However, it is widely agreed that it was triggered by the global financial crisis, which started in August 2007 (Soros, 2008).

Economists see the globalization of financial markets and easy access to credits and extremely low interest rates as the background of the financial crisis. Those factors contributed to the creation of housing bubbles in the USA and Europe, which later caused a failure in the money markets. (Taylor, 2009). Investing in real estate seemed to be reasonable as prices were going up immensely.

These assets soon lost their value, but the liabilities of investors did not decrease, meaning that they were unable to pay their debt. Financial contagion meant that financial institutions along the chain were affected.

(Soros, 2008). In attempt to save their banking systems, governments had to <https://assignbuster.com/impact-of-the-recent-eurozone-crisis-on-the-uk-economy-essay-sample/>

increase their debt. Some criticize the EU countries for their aim towards a welfare state and the significant expenditures in the public sector and social services (Carr, 2011). Recently, Stewart (2012) stated that “ public sector workforce ‘ will shrink to record low by 2017’” pointing out that 880, 000 public sector jobs might be cut. This is seen as a move away by the government from the welfare state.

The Keynesian income-expenditure model is school of thought, which attempts to explain macroeconomics and gives an alternative to the classical economics school of thought (Parkin, Powel and Matthews, 2006).

Keynesians share a view, that some wrong decisions in the private sector may cause macroeconomic failure and therefore interference by the governments and the central banks is needed. This is achieved through effective monetary and fiscal policies. This view was first introduced by John Maynard Keynes as a response to the Great depression of the late 20's and the 30's and became largely popular among Western politicians and economist until the 70's. It benefited from resurgence after the most recent financial crisis. (Reddy, 2009). The Keynesian model proposes a multiplier effect, suggesting that a smaller initial change in autonomous expenditure will lead to a larger increase in the equilibrium planned autonomous expenditure, shifting the curve up or down. Aggregate planned expenditure (AE) is the sum of planned consumption expenditure(C), investment (I), government expenditure (G) and exports(X) minus imports (M).

$$AE= C+I+G+X-M$$

In order to analyze the impact of the Eurozone crisis on the UK economy we

will examine how each of the variables of the equation has been influenced by it. The consumption expenditure is vulnerable to changes in the disposable income. The relation between the two is called the consumption function. The disposable income in its turn is equal to the planned equilibrium savings plus the planned equilibrium expenditure. (Parkin, Powell and Matthews, 2006). When disposable income increases, there is a move to the right along the consumption function. There are some factors that can shift the production function itself- changes in interest rates, wealth or expected future disposable income.

Sanchez (2011) states that the increase in the UK household disposable income from 2007 to 2010 is the lowest in thirty years- an average of 0.6% per year. More recent data (seen in Figure 1) is presented by Myers (2012) which shows that real disposable income has fallen by 1.2% in the past 12 months.

Figure 1

Source: http://www.ons.gov.uk/ons/dcp171766_261914.pdf

While there is a small change in disposable income, we will further examine the alternation in consumption expenditure and savings.

Figure 2

Source: http://www.google.com/publicdata/explore?ds=d5bncppjof8f9_&ctype=l&strail=false&bcs=d&nseml=h&met_y=gdp_expenditure_constant_2000_us&fdim_y=gdp_expenditure_component:5&scale_y=lin&ind_y=false&rdim=region&idim=country:GBR&ifdim=region&tstart=9414000000&tend=1271718000000

<https://assignbuster.com/impact-of-the-recent-eurozone-crisis-on-the-uk-economy-essay-sample/>

Figure 2 shows that there is hardly any change in consumer expenditure since the beginning of the crisis.

Figure 3

Source: [http://www.google.com/publicdata/explore? ds=](http://www.google.com/publicdata/explore?ds=d5bncppjof8f9_&ctype=l&strail=false&bcs=d&nseml=h&met_y=ny_gds_totl_cd&scale_y=lin&ind_y=false&rdim=region&idim=country:GBR&ifdim=region&tstart=-306205200000&tend=1303167600000)
[d5bncppjof8f9_&ctype= l&strail= false&bcs= d&nseml= h&met_y=](http://www.google.com/publicdata/explore? ds=d5bncppjof8f9_&ctype=l&strail=false&bcs=d&nseml=h&met_y=ny_gds_totl_cd&scale_y=lin&ind_y=false&rdim=region&idim=country:GBR&ifdim=region&tstart=-306205200000&tend=1303167600000)
[ny_gds_totl_cd&scale_y= lin&ind_y= false&rdim= region&idim= country:](http://www.google.com/publicdata/explore? ds=d5bncppjof8f9_&ctype=l&strail=false&bcs=d&nseml=h&met_y=ny_gds_totl_cd&scale_y=lin&ind_y=false&rdim=region&idim=country:GBR&ifdim=region&tstart=-306205200000&tend=1303167600000)
[GBR&ifdim= region&tstart=-306205200000&tend= 1303167600000](http://www.google.com/publicdata/explore? ds=d5bncppjof8f9_&ctype=l&strail=false&bcs=d&nseml=h&met_y=ny_gds_totl_cd&scale_y=lin&ind_y=false&rdim=region&idim=country:GBR&ifdim=region&tstart=-306205200000&tend=1303167600000)

Figure 3 shows the changes in the savings over time. These numbers are the difference between the real GDP and the actual aggregate expenditure.

There is a strong positive trend, following the business cycles and the disruption that the Eurozone crisis caused is visible. There is a sharp decrease in savings since the start of the crisis- nearly two times from 2007 to 2009. Having in mind the small decrease in disposable income and consumption expenditure from the first two figures, but the nearly two times decrease in savings over these years, we have a strong reason to believe that the consumption function has shifted down largely (shown roughly on Figure A below). This is caused by a fall in the expected disposable income and the lack of funds available to borrowing, which would normally stimulate consumption and savings. (Waddingham, 2012; Ludvigson, 1999) This, in its turn, comes as a result of the instability of the economies and banking systems of the Eurozone countries, which was transmitted through financial contagion to the UK economy. As we previously stated, a small decrease in any of the variables of the aggregate planned expenditure will lead to a greater decrease in the real GDP.

<https://assignbuster.com/impact-of-the-recent-eurozone-crisis-on-the-uk-economy-essay-sample/>

Figure A

Source: Parkin, Powell, Matthews (2006)

Following the Keynesian school of thought, we could suggest that in order to achieve a greater GDP and overcome the current recession, the UK government may use some fiscal policy mechanisms. It can increase its expenditure by borrowing money. Having in mind the multiplier, a relatively smaller increase in government expenditure will result in relatively bigger increase in GDP. Due to the Eurozone crisis, most of the countries in the union have had their credit ratings downgraded. (Flanders, 2012) Although not a Eurozone country and therefore free to conduct its own monetary policy, the UK has been warned that its credit rating might be downgraded as well. (BBC, 2012) Credit ratings downgrades by leading agencies such as Moody's and Fitch are due to high levels of debt in the countries as percentage of GDP. As seen on Figure 4 debt as percentage of GDP for the UK is around 80% at the moment.

Figure 4

Source: http://www.google.com/publicdata/explore?ds=ds22a34krhq5p_&ctype=l&strail=false&bcs=d&nseml=h&met_y=gd_pc_gdp&scale_y=lin&ind_y=false&rdim=country_group&idim=country_group:eu:non-eu&idim=country:fr:de:el:it:ie:pt:es:uk&ifdim=country_group&tstart=798332400000&tend=127171800000

Lower credit rating means that the UK government would have to borrow money at higher interest rates, which will increase its debt even further.

Therefore, it will be costly for the UK government to increase government

<https://assignbuster.com/impact-of-the-recent-eurozone-crisis-on-the-uk-economy-essay-sample/>

expenditures and it would also reflect on personal taxes. (Knight, 2012) This could have some economic consequences such as a further recession because of lack of confidence and prestige of the UK government. The author of this essay suggests that now is a good time for the UK government to increase its expenditures by issuing bonds while the credit rating is still AAA.

The UK's international trade is strongly related to the EU (Waddingham, 2012). Trade with the union account for more than 50% of the UK international trade. Historical background of political and economic relationships between the UK and Ireland mean that a significant part of UK's exports go to Ireland. The real estate bubble, created in the country led to its high debt levels, decrease in GDP and loss of confidence. (Kelly, 2010) Germany and France are also major UK trade partners.

Figure 5

Source: <http://static.guim.co.uk/sys-images/Guardian/Pix/pictures/2012/1/9/1326130640691/UK-Trade-exports-graphic-001.jpg>

The data above shows that there is a slight increase in expenditure for the 2010-2011 period. However, current uncertainty in the Eurozone caused further instability and thus more recent data is required. Following the marginal propensity to import theory, provided by Keynesians and the data in Figure 6, which shows us the decline in real GDP in some major Eurozone importers of UK goods and services, we assume that there has been a decrease in imports in these countries. Therefore, UK exports to these states have been reduced as well. Due to some current loss of

confidence in the EU monetary union countries, UK exports have suffered. The current high inflation in the UK, the rise in price levels and the devaluation of the euro imposes that there is an international substitution. This shifts the aggregate expenditure curve downwards and decreases the real GDP following a move along the aggregate demand line to the left.

Figure 6

Source: <http://epp.eurostat.ec.europa.eu/tgm/graph.do?tab=graph&plugin=1&pcode=tsieb020&uage=en&toolbox=sort> “ Meanwhile, the Eurozone sovereign debt crisis is likely to continue to weigh down on confidence and fuel uncertainty, thereby holding back business investment” (Archer cited in Elliot, 2012) With the labor market in the UK being unstable, inflation levels high, future expected disposable income low (factors for international substitution) and declining export, UK companies do not have the incentive to produce more and invest in production

In conclusion, the Eurozone crisis has a negative impact on the UK economy, which we analyzed using the Keynesian income-expenditure model.

Contributing to the lack of confidence in the EU economy, this crisis brought some major concerns whether the euro will survive. It caused heavy recession among the EU economies and increased debt level, questioning the stability of the union. There have been public debates in the UK to whether it should choose to leave the EU.

This essay is limited in its analysis of the Eurozone crisis impact on the UK economy because it only concentrates on the five variables of the aggregate expenditure equation. It focuses much too heavily on the consumption

<https://assignbuster.com/impact-of-the-recent-eurozone-crisis-on-the-uk-economy-essay-sample/>

expenditure to explain the impact. It uses a Keynesian approach and the author suggests that a comparison with a classical school of thought analysis should be made. It is also worth researching even more thoroughly the reasons behind the crisis and the consequences to the affected countries' economies so that further conclusions on its impact to the UK economy could be made. It is also suggested that the implications of this research in fiscal making policies should be pointed out.

Reference list:

Andrews, W. and Parlapiano, A. (2012); " Europe's financial contagion", Washington Post, Available at: