

School of economics and management essay sample

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From the Financial Times, May 5 2011: Euro falls as Trichet signals no rate rise The euro retreated sharply from a 17-month peak against the dollar and a 13-month high against the pound as Trichet, president of the European Central Bank, signaled that the interest rate on the main refinancing operations would remain on hold next month. Analysts said the single currency had received support in recent weeks since the ECB, in contrast to the Federal Reserve and the Bank of England, was seen as being ready to tighten monetary policy further in the coming months in a bid to stem inflationary pressures in the eurozone. 1. What's meant with the statement that the single currency (euro) had received support in recent weeks since the ECB was seen as being ready to tighten monetary policy further in the coming months in a bid to stem inflationary pressures in the eurozone? 2. Explain why the euro depreciated against the dollar as Trichet signaled that the euro zone interest rates would remain on hold next month.

3. Explain how the ECB can stem inflation pressure by increasing the interest rate on the main refinancing operations. A month earlier Mr. Trichet explained that the gradual increase in the growth rate of the money stock (M3) might facilitate the accommodation of price pressure (inflation) in the eurozone. 4. Explain how an increase in the growth rate of the money stock can increase inflation pressure in the eurozone. Turning to fiscal policies, Mr. Trichet stated that all eurozone governments should achieve the consolidation targets for 2011 that they have announced. Strict tightening of fiscal policy would help to convince the general public that the corrective policies will be sustained. Confidence in the sustainability of public finances is essential as this will reduce interest rate risk premium and improve the

conditions for sound and sustainable economic growth. 5. What's the meaning of governments conducting a strict tightening of fiscal policy? 6. Explain why achieving the consolidation targets will reduce the interest rate risk premium and why this will improve the conditions for sustainable economic growth.

FRANKFURT/ATHENS, May 12 2011 (Reuters) – Despite bailouts for Greece, Ireland and Portugal, Europe's debt crisis may yet spread to core euro zone countries and emerging Eastern Europe, the International Monetary Fund said on Thursday. The warning came as government sources in Athens said international inspectors checking on Greece's compliance with its EU/IMF rescue package had found problems and were pressing for deeper spending cuts to cover a likely revenue shortfall. "Contagion to the core euro area, and then onward to emerging Europe, remains a tangible downside risk, the IMF said. A Reuters poll of investors and economists showed an overwhelmingly majority believe Greece will restructure its debt, possibly as soon as later this year. Most fund managers expect Athens to pay back less than half of what it owes. The IMF said it stood ready to provide more aid to Greece if requested, but the country that triggered Europe's sovereign debt crisis in 2009 still had plenty of untapped potential to raise extra cash itself through privatizations.

7. Describe how Europe's debt crisis may yet spread to the (healthy) core eurozone countries (like Germany and the Netherlands) if Greece, Ireland and Portugal are not successful in working through their fiscal recovery programmes. In answering this question you should elaborate on the

different causes of contagion risks stemming from debt crisis in the three countries.

From the Financial Times, May 8 2011: due to the crowding out effects caused by the reduction of public spending by the Greek government, public debt is expected to rise from 130 percent of gross domestic product (gdp) in 2010 up to 160 percent of gdp in 2012 initially. It's widely expected that the debt ratio will fall as soon as economic growth is catching up.

8. Explain why a reduction in public spending by the Greek government is (initially) increasing the public debt to gdp ratio instead of lowering it.

From the Financial Times, April 27 2011: Bernanke defence of dollar fails to connect The decision of the US Federal Reserve to cling to near-zero interest rates pushed the dollar close to a three-year low against other major currencies. This policy has kept up interest in the carry trade, where low-yielding currencies such as the US dollar fund purchases of higher-yielding assets, such as Brazilian real estate. This caused the appreciation of Brazilian Real to the US dollar. 9. What's the meaning of carry trade?

10. Explain why the perceived benefits of a) falling interest rates in US, b) increasing interest rates in Brazil and c) the expected appreciation of the Real, may increase the carry trade and the associated risks. 11. Explain why it's difficult for Brazilian policymakers to respond to excess inflows of US dollars. By answering this question, you may explain the incurred costs (the disadvantages for the Brazilian economy as a whole) of the following 4 possible measures: a. The policy makers can allow the exchange rate to

appreciate; b. The policy makers can absorb capital inflows into official reserve; c. The policy makers can lower interest rates to reduce the interest rate differential d. The policy makers can tighten fiscal policy.

From the Financial Times, May 17 2011: The eurozone after Strauss-Kahn
Strauss-Kahn's downfall happens to come at an important moment. The Greek programme has not worked as planned. This is not surprising: it never seemed likely that it would do so. There is a good chance that the same will ultimately prove true of Portugal's €78bn programme. Ireland is definitely not back to health. And even Spain is far from sure to manage the adjustments ahead. The underlying economics of the crises are clear. During the boom years, a number of countries were able to borrow more and on more favourable terms than ever before. They, then, ran huge current account deficits. The latter turned out to be the leading indicator of future crises (the present debt crisis), not fiscal deficits, as Germany's mistaken conventional wisdom would have it. The domestic counterparts of these external deficits could be huge fiscal deficits (as in Greece), huge private financial deficits (as in Ireland and Spain) or a combination of the two (as in Portugal). (See charts above). Indeed, we now know that the distinction between private deficits and debt and public deficits and debt is far less absolute than the fiscal priesthood understands: private debt becomes public debt and private deficits become public deficits very swiftly.

In a crisis, huge external deficits also result in " sudden stops" in the inflow of external finance and so the need for official support, to finance the ongoing fiscal and current account deficits and capital flight. 12. What turned

out to be the leading indicator of the future (debt) crisis – the huge current account deficits or fiscal deficits – and why? A country with a debt-encumbered private sector that is also seeking to reduce a huge structural fiscal deficit has to generate an offsetting improvement in its current account. This is a matter of logic. Consider Portugal. According to the IMF, it had a current account deficit of 10 per cent of gross domestic product last year, a fiscal deficit of 7 per cent of GDP and so an implied private sector deficit of 3 per cent of GDP (see chart). If the fiscal deficit is to be improved without pushing the private sector into greater deficit, the current account must improve sharply. But this entails a surge in competitiveness. The competitiveness challenge confronting these countries is much greater than that facing Germany in the late 1990s.

13. Explain why a country with a debt-encumbered private sector that is also seeking to reduce a huge structural fiscal deficit has to generate an offsetting improvement in its current account. 14. Describe one of the many possible measures these countries can take to increase their competitiveness. Quite apart from financing adjustment, somebody must also bear the losses on past bad lending and borrowing. In its wisdom, the eurozone has decided that the losses of private sector creditors should be socialized and the ultimate burden fall on the taxpayers of deficit countries. The latter will then suffer first a slump and then years of fiscal austerity. The justification for all this is the view, particularly strongly held in the European Central Bank, that the eurozone cannot cope with any defaults, be they on lending to banks or on lending to governments. Again, the distinction between private and public debt dissolves. Such a crisis is hard to resolve.

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How should adjustment be financed? Who should bear the losses? How should panic be minimized? The challenges are enormous. Today's strategy requires ever greater official finance for ever longer periods. Will it be forthcoming? If not, somebody needs to think afresh. With Mr Strauss-Kahn gone, I wonder who will now be able to give the lead. 15. Explain why the debt crisis (of Greece, Portugal, Ireland and possibly Spain) could cause a new banking crisis.