Report on the United Kingdom's Role in the Eurozone Crisis

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The United Kingdom, while not a member of the Eurozone, still plays an important role in its members' economies and in the entire European economic and political leadership sphere. As a key member of the EU since 1973, the UK has a vested interest in the direction the plan of action of the Eurozone takes. However, the economic situation in the UK and the political climate create a situation where the UK cannot rationally commit to being a financier of large bailouts, whether directly or through a large budget measure in future EU budgets. Therefore, the role the UK will (and must) take will be that of an influential but removed party to the situation. While still being an active participant in the international discussion, the UK must insulate itself from the sickness of certain countries' crises, for its own future well-being.

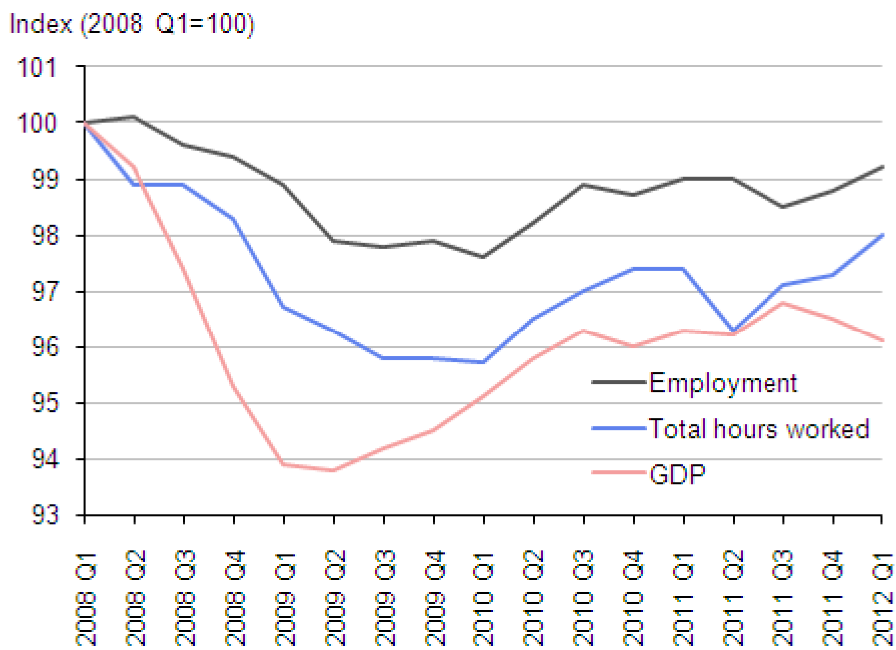
A global financial crisis that hit many countries in 2007/2008 has also greatly affected the United Kingdom's economy. Its emergence was largely due to a loose monetary policy, especially in the US, where low interest rates and trading of risky bonds led to serious market volatility, coupled with global economic imbalances as emerging economies expanded their financial market worldwide. The UK also had a loose monetary policy during pre-crisis periods of 2001 - 2006. It had been striving to stabilize its inflation levels, and also increase real output through steadily decreasing saving rates and default spreads, and increasing current account deficits. However, UK largely ignored the steady increase in the money supply, particularly from broadened financial market involvement with countries such as China and Korea. Moreover, loose financial regulation led to the creation of complex financial products that aim to provide high returns, while keeping their asset values. This heavily contributed to the growth of off-balance sheet risks and risky investments in poorly understood financial products. (Martin & Milas) Currently, the UK is suffering from a large current account budget deficit of about 11.2 billion pounds; this has led to higher taxation and a decline in public spending. A lot of business sectors have been showing a decline in growth and the unemployment rate is high, at 7.9%. GDP growth rate is actually at -0.4%, which is lower than many other countries including the US, Japan, Germany, France, Canada, and G7 (OECD). This suggests that the UK may be heading back into a recession and the Bank of England must be encouraged to start stronger quantitative easing in order to boost the economy up. The main conundrum the UK's economic policymakers face, however, is the most recent trend in employment and GDP. While employment declined with the recession along with GDP as is the general canon of economic analysis, what is most interesting is that while GDP (after recovering) has now begun to flatten out, employment has continued to increase. Usually they move together, so this presents an odd situation. The data shows that employment and GDP have started to diverge over the last 3 quarters. (Grice 1) A likely explanation is that we have seen a dramatic increase in part-time and temporary employment over the last decade or so in the UK, which has somewhat reduced labor productivity. When compared with other large economies, such as France or the US, we see labor productivity in the UK has stayed flat and begun to decline in recent days, while the US and France have seen increases in productivity. (Grice 10) However, overall the UK's experience has been largely similar in that large economies of Europe and the US have seen plateau effects of labor productivity, so that increases in employment have not been able to further increase GDP. Self-employment has also been on the rise in the UK post-recession. (Grice 8) This may be directly related to the fact that there has been a steady increase in involuntary temporary and part-time employees post-recession. (Grice 5) Firms do not want to commit to holding full-time employees and thereby commit to more labor productivity, which would help push up GDP. The UK economy seems to be stagnating, and domestic forces are not helping to stimulate it. But is this something that will persist? OECD estimates suggest that the financial crisis may have actually decreased output potential by around 4% on average in developed economies. Indeed, since 2008, GDP has decreased by as much as 6% than recovered to an overall decline of 4%, staying flat at that level in recent times. (Grice) The UK must look to adjust to this new level of output, or else find some other way to alter the long-run output potential by increasing labor productivity.

As a member state of the EU for since 1973, UK is been heavily dependent on trade within the EU. With 40% of exports sold to EU member states, being part of the EU is pivotal to the creation of jobs, expansion of trading, and protection of interests in the UK (UK Foreign and Commonwealth Office). Hence, the first and foremost objective of the UK as a member state of the EU is to safely preserve their relationship within the EU by playing a leading role in its policy negotiations. However, another significant political goal of the UK is to protect its sovereignty from the EU. The 2011 European Union Act (any future transfers of legislative power from the UK to Brussels would need to be agreed to by the British people in a referendum) is indicative of this. (UK Foreign and Commonwealth Office) The steady increase in EU budgets concerns the UK, as it is not willing to undertake another big funding action. Prime Minister David Cameron has recently declared, “We've not put in place tough settlements in Britain in order to go to Brussels and sign up to big increases in European spending.” As a leader of the Conservative Party that in its ideology opposed joining the EU, Cameron strives to prevent any further financial plague from spreading over to the UK. Despite the concerns that the UK might become isolated, he has been continuously taking defensive actions as the EU moves towards a banking union. The UK currently has a banking system that is well diversified and has a fine structure of cross-border banking flows. The new member states (NMS), on the other hand, show a very low diversification, as they are heavily dependent on a few Western European banks. (CEPR: Cross-Border Banking in Europe) It may be a great upturn for NMS if they can diversify their inflows through the linkage with other big banks, but it will be a huge financial risk for those banks. What is worse is that current EU members who are suffering from sovereign debt crises have the biggest potential to spread the disease to their financial neighborhoods through cross-border financial institutions. The UK fears that its economy will be negatively affected through these countries' default and their consistent calls for national bailouts, a prospect the UK simply cannot abide by, and certainly can't afford given their current economic state.

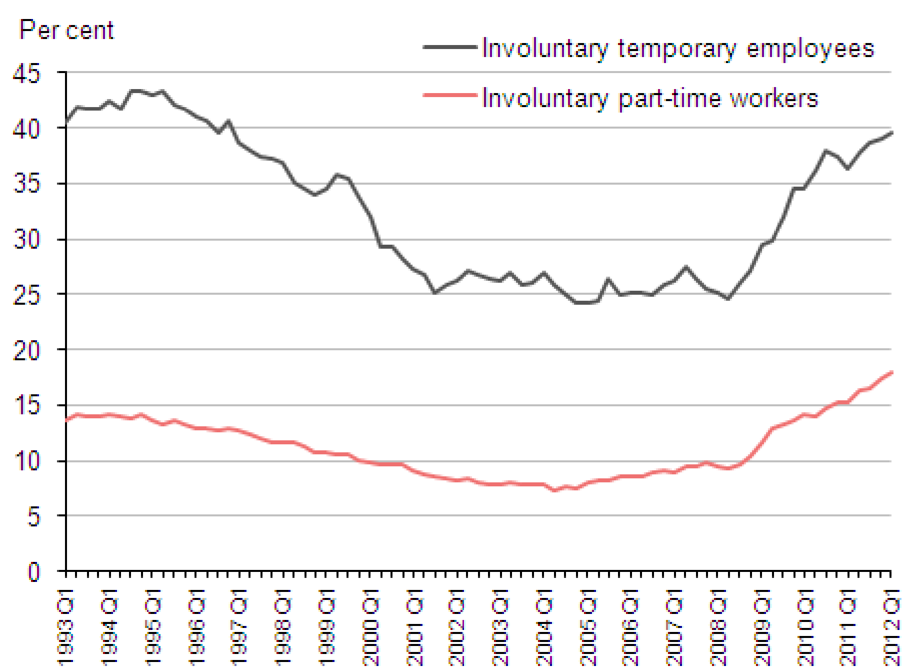
The UK has an interesting role here. While not a Eurozone member, it is a main member of the EU and has significant trade considerations in the EU; as was mentioned before, 40% of UK exports go to the Eurozone. The UK is committed to helping the embattled nations find solutions to their problems; however, this cannot interfere with domestic issues that are more pressing. The government has gotten out of liability to the Eurozone crisis in the EU budget, as is rational given that the UK is not a Euro currency member. The UK has also removed itself from a potential banking union in the EU, while guaranteeing that a single market will still exist for all EU members, which will keep the UK from being excluded from trade; this is key for the UK domestic economy. The UK faces large problems at home, given that a large deficit that must be reduced exists at a time when the economy is starting to stagnate as labor productivity (much like the rest of Europe) plateaus and even declines. This leads the UK to take a somewhat observatory role in Eurozone crisis resolution. The UK seeks to protect its own interests in the area without overcommitting to assistance to struggling countries such as Greece and Spain. In all honesty, as long as the UK's interests in the area are not threatened, (at the risk of sounding cliché) the government has bigger fish to fry back home. The UK will not commit to large bailouts (and has pulled out of any obligation to do so through an EU budgetary measure) of countries and rejects the idea that it is their duty to do so as European neighbors. The prevailing political climate in the UK suggests that it is a poor gambit to get any further tangled in the crisis, with Conservative Party Prime Minister David Cameron firmly sticking to the idea that an EU bailout will not be agreed to on any level. Rather, the countries themselves must pull themselves out of their own holes, and that any financial assistance will not be coming from the UK. When all is said and done, the UK will protect its own.

Charts and Figures

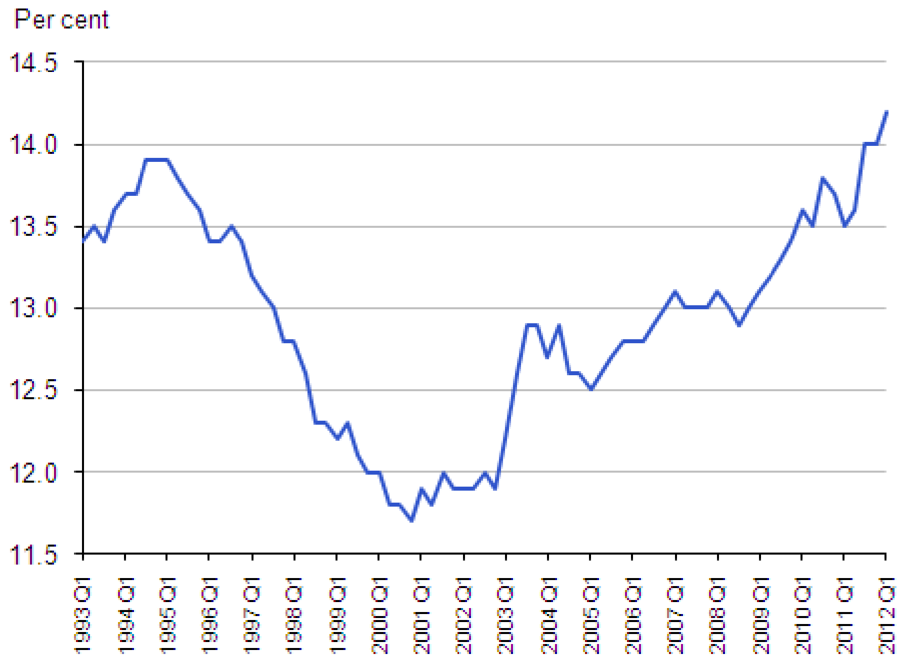
Grice 1: Output, Employment, and Total Hours Worked



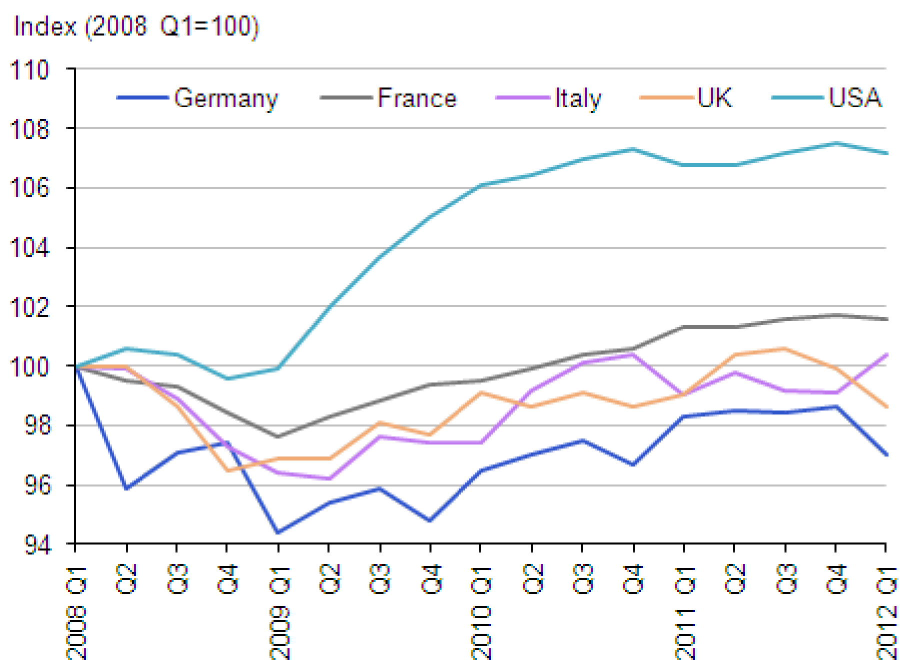
Grice 5: Involuntary part-time and temporary workers as a proportion of total part-time and temporary workers



Grice 8: Self-employment as a percentage of total employment



Grice 10: International comparisons of productivity (Real labour productivity per hour)



Source: Office of National Statistics (UK)

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Addendum to the Report on the United Kingdom's Role in the Eurozone Crisis

October 26, 2012

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This addendum is in response to reports that UK GDP growth has gone positive in the third quarter of 2012, which affects the economic situation in the UK and where the economy seem to be going. Much of this addendum is in reference to the NY Times report, "Britain Pulls out of Recession in Third Quarter" (October 25, 2012). This article reports that "Gross domestic product rose 1 percent in the July-September period". This is not a dramatic increase, as the economy has not reached its pre-recession levels, and a large deficit still exists in the UK. The primary concern of UK policymakers will be to reduce the large deficit that exists and begin to reduce the overall debt the UK has outstanding. In general theory we see that during times of economic boom, that governments contract their spending (or increase revenues) in order to reduce deficits, and vice versa in times of economic downturn. The government may look to reduce its deficit even more actively in the coming months as this data suggests the economy is recovering. This actually supports the argument of our report in that it suggests the government will be even less likely to want to commit to a large bailout in that this presents a great opportunity to fix problems at home, mainly with the deficit. The UK has been pushing austerity lately, and this growth suggests that the austerity push has not been crippling the economic recovery, as critics of David Cameron and the Conservative Party would suggest. But is this new data in Q3 actually that much of an upturn? Or, as we here will argue, is this new data somewhat of an aberration from the overall trend? For one, certain events in Q3 and in Q2 created a situation that made this Q3 growth seem more dramatic. In Q2, extra work holidays due to royal activities reduced output during Q2, which is a sort of artificial lowering of GDP. While one might think that this actually proves Q3's growth is even more dramatic and indicative of the future, we contend that without these royal activities, the economy's growth would have still been flat and stagnant, as we represent the overall trend in our recent report, which has data (Grice 1) that ends with the beginnings of a downward trend in GDP reported in Q1 of 2012. As we know, Q2 had a more flat, but similar trend, which is indicative that the economy was entering another recession. But this Q3 data is upward trending. Therefore, we still conclude that the economy is stagnating. This Q3 upturn is another "wiggle" in the graph that has been going on for the last couple of years. In fact, we contend that this upturn is artificially boosted by another event: the 2012 Summer Olympics in London, which this article indeed claims as a source of the upturn. Our response to this is immediately a conversational “well, there you have it.” This event is obviously concluded. The jobs created by this event are not permanent, and as the article reports, it is estimated that ticket sales for this event alone accounted for a 0.2 percentage point increase in GDP. However, even this is skewed, as although tickets had been sold since 2011, they were counted as a lump sum in Q3 of 2012, which certainly consolidated all of its effects into one burst. This effect should have been spread across all quarters in which it happened, which certainly reduces its real effect overall. This is not to diminish the effect hosting the Olympics had on the economy. It certainly is stimulating, but unfortunately it creates a bit of an illusion of economic upturn. While the economy may not be diving headlong into recession, it is still stagnant, and our argument still holds for the UK. The time is right to fix domestic problems first, and the recent political actions to distance the UK from financial assistance to the troubled Eurozone are still prudent and rational. To diverge from this invites recession and the raising of interest rates, which would surely make real the specter of another dip in the economy. Our assertion that the financial crisis of 2008 lowered long-term potential output for the UK (as stated by the OECD) is still valid. When you unpack this “upturn”, it is simply another fluctuation in an economy that is doing quite a bit of wiggling around its new long-run output level.

Reference Article

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