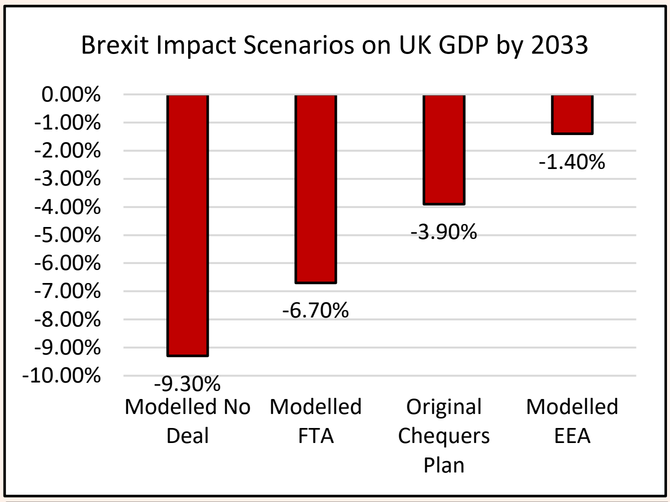
EZY ECONOMICS

THE WEEKLY 5

30/11/18

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

Project Fear 2.0:



This week a series of economic impact assessments were released by the Treasury and the Bank of England. The forecasts highlighted the expected impact that a range of different Brexit scenarios would have on the long-term growth rate of the UK economy.

In both publications a baseline scenario (what is expected to happen to GDP if existing arrangements stayed the same) was calculated and then compared against the corresponding GDP figures under a range of different modelled Brexit scenarios.

The most startling figure was attached to the modelled no-deal scenario. The number crunchers at the Treasury believe that a no-deal Brexit could cause GDP to be 9.3% lower than the baseline figure in 2033. This would be the equivalent of hundreds of billions of pounds being wiped off the value of the output of the UK economy.

The Bank of England reinforced this viewpoint with their own modelled scenario of a no-deal Brexit: 8% drop in GDP, 25% fall in Sterling and house prices collapsing by a third.

These economic forecasts have been attacked by some sections of the media and politicians because of the uncertain Brexit path that the UK will eventually take, if at all.

Explain **two** limitations of constructing long-term economic forecasts regarding the future performance of the economy.

With the aid of a diagram, discuss whether the decision for the UK to withdraw from the traditional EU customs union will either create trade or divert trade.

A Game of Stress:

World GDP	▼	2.4%
China GDP	▼	1.2%
UK GDP	▼	4.7%
Unemployment	▲	9.5%
House Prices	▼	33%
Bank Rate	▲	4%
Sterling Value	▼	27%

This week the results of The Bank of England's Financial Stability Report were made public. The annual tests are officially referred to as "stress tests" as they attempt to assess just how resilient the UK financial system is to crises and whether in fact the sector is sufficiently prepared to combat future headwinds.

Specifically within the report, the UK's biggest banks and financial institutions are rigorously put through their paces to ensure that they have sufficient levels of capital and liquidity. If so, this means they should be able to feasibly maintain a solvent position on its balance sheet - even in the most devastating of circumstances.

Each year the cocktail of economic scenarios that the banks have to prove their resilience against gets more potent. This is a deliberate manoeuvre by the Bank of England to ensure that capital and liquidity positions continue to strengthen over time.

To pass the latest series of tests, banks had to prove that after absorbing credit losses and defaults, their capital ratios would still remain above 7.9%. This year all of the major lenders passed the tests with plenty of margin intact and according to the Governor of the Bank of England this proves the "UK banking system is resilient to deep simultaneous recessions in the UK and the global economies".

Discuss and explain the apparent link between asset liquidity and bank solvency.

To what extent do you agree that bank stress tests can simulate the impact of a financial crisis such as the one seen in 2008?

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Who Audits the Auditer:

Auditing is a technical and specialist profession that requires a trained eye for detail, as well as a developed capacity to absorb, examine and scrutinise the metrics on a collection of financial accounts.

Therefore, it should come as no surprise that this is a market that is dominated by a small number of specialist firms – four in fact: KPMG, EY, Deloitte and PwC. These firms are commonly referred as the 'Big Four' auditing firms, as they current have the responsibility of auditing 98% of all the financial documents belonging to the top end of the market (350 largest UK firms).

Politicians and regulators have been trying to concoct a way of enhancing competition in this market to increase industry-wide auditing standards. This will help avoid some of the high-profile accounting scandals recently associated with the collapse of firms such as Carillion and Patisserie Valerie.

Some of the potential solutions discussed has been the implementation of a forced break-up of these firms into smaller divisions, a market share cap imposed on each of the four firms or even government selection over the firms that audit specific company accounts. However, some larger companies have raised concerns that the auditing of their financial documents could be passed down to less experienced auditing firms.

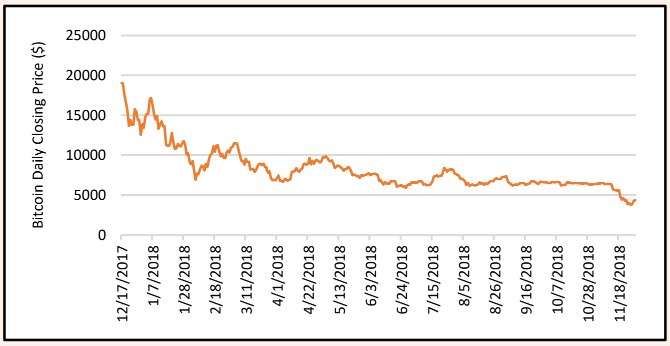
One solution could be the introduction of more competition organically within the market. This week the auditing firm BDO announced that it would be merging with another smaller UK audit firm called Moore Stephens. The decision to do so will create the fifth largest accountancy firm in the market and potentially pave the way for greater competition and choice. However, when you consider that this merged firm will still only stand at 30% the size and scale of KPMG, there is still a long way to go to bring more competition into the market via this approach.

Explain what type of market structure the auditing industry is currently an example of.

Evaluate the impact on dynamic efficiency in the market from a decision to split the largest four audit firms up.

Assess the view that deregulation is the most effective method towards increasing contestability in this market.

Crypto Crash:



Volatility in the cryptocurrency market continued to persist this week. The value of Bitcoin (the largest circulating digital currency) has dramatically plunged below $4,500 amid fears over the uncertain direction the cryptocurrency is heading towards.

Economists and market experts have never been fully convinced by the fundamentals driving this currency, but traders have been reassured by the fixed quota of Bitcoin's (21 million Bitcoins) that can float on the market at any one point in time. This quota is meant to create a finite supply of coins and ensure that the currency offers some store of value ahead to its holders.

However, the ease at which other rival cryptocurrencies can be established has raised question marks over just how safe and stable this currency will be in the future.

Discuss how central bank intervention and regulation would be expected to affect the market for digital currencies.

The Economics of Climate Change:

This week the US Government released a report that attempt to explain the risks posed by climate change to all sectors within the country. The report considered a range of different impact areas such as infrastructure quality, tourism rates, the fisheries industry and the expected health damage on American citizens.

In relation to the economic impact of climate change the National Climate Change Assessment reported that climate change is expected to "increasingly disrupt and damage critical infrastructure and property, labour productivity, and the vitality of communities".

One area the report focuses upon is the impact that rising temperatures are expected to have on the efficiency of generating power. If the efficiency drops this will have knock-on effects for electricity prices and the wider supply chain.

The report goes on to conclude that without global mitigation efforts the cost of climate change to the US economy is estimated to be "hundreds of billions of dollars".

In groups, assess the costs and benefits of imposing remedial climate action on the car industry, the energy sector and manufacturers of electronic products.