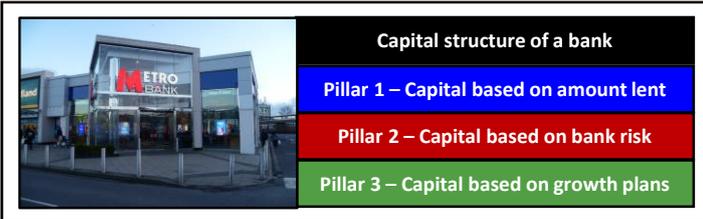


22/03/19

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

**Metro's Choppy Financial Waters**



The UK's most popular high-street bank, based on customer satisfaction, has run into significant financial tailwinds this week as the company was forced to admit to a glaring financial error made in its calculation of how much capital to hold in reserve.

Metro Bank is a relatively recent player to the UK retail banking scene and when it launched in 2010 it became the first new national commercial lender in the UK for the best part of two centuries. As a challenger bank it appealed to customers and businesses with its bright, fresh, innovative and simplistic approach to a market that, still to this day, struggles to shake off the thorny legacy issues of 2008.

However, over the last year, the firm has begun to wilt under investor scrutiny – the company has already lost 80% of its stock market value in the last 12 months. This has seen the firm pick up the unwanted label of being dubbed the second most 'shorted' company that trades its shares on the UK stock market. Shorting is a technical term used for investors when they sell an asset at a higher price, in order to buy that same asset at a lower price later on down the line. When investors lose confidence in a firm and expect further price falls, shorting shares is a popular trading strategy to make money.

Why this fall in confidence? Well Metro Bank announced that there was an error built-in to the model that it used to calculate the required capital levels that need to be held to support its commercial lending. This is deemed as an almost unforgivable mistake for a bank given that banks and high street lenders are only as strong as their capital buffers, regardless of how large their overall balance sheet is.

Banks need to hold capital (financial reserves) in case of an unexpected problem on their balance sheet i.e. borrowers cannot pay back their loans. The capital is injected by shareholders and plugs the financial blackhole on the balance sheet when and if it is needed. Since the financial crash, regulators and central banks have stepped up their efforts to impose stricter capital requirements on banks to prevent any repeat of the devastation of 2008. The total amount of capital a bank must hold is based on the principles of 'three pillars' (see diagram above). A specific amount of capital must be set aside for each of the three pillars.

Define and explain the term 'solvency' in relation to a bank's balance sheet.

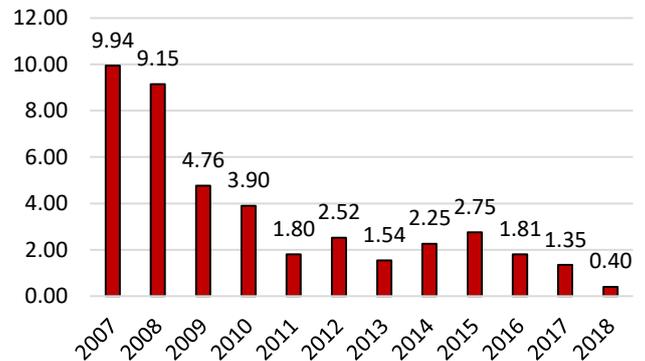
Explain how a bank can fail when it holds insufficient capital levels.

Discuss how capital can prevent a liquidity crisis and bank runs.

5

**China's Fading Current Account Surplus**

China's Current Account Surplus (% of GDP)



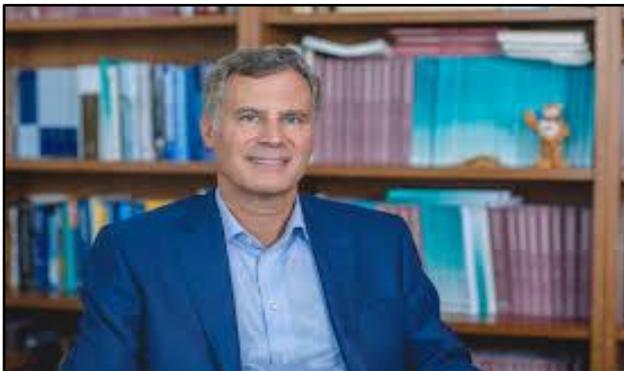
The mechanics of the Chinese economy has been so skewed towards exporting manufactured products that the country is often titled as the "Factory of the World". This has resulted in the country's export orders surging to record highs and the country running an inflated current account surplus since 1993.

However, as we have mentioned before in the Weekly 5, China are attempting to diversify away from their manufacturing roots to become more of a consumption-driven economy rather than an export-led economy. This is natural reflection of the development stage of the Chinese economy after four decades of powerful growth numbers. Chinese citizens are becoming more ambitious and relishing in living the lifestyle that their western counterparts have enjoyed for so long. Taking all of this into account, it should come as no surprise to anyone the current account surplus of China has gradually been falling as the Chinese economy goes through its own metamorphic transformation.

Before the financial crash, the surplus stood at just under 10% of Chinese GDP, it now stands at just below half a percent of GDP. Now this is nothing to be sniffed at given the Chinese economy is still valued at \$15tn, but it represents a dramatic shift in the dynamics of the global trading and financial system. Remember, if China runs a current account deficit, then this must be offset and financed by the rest of the world. Many economists and commentators believe that this rebalance is healthy for the global economy but there are question marks over the suitability and transparency of the Chinese financial system to facilitate this transformation.

Explain how an ageing population, rising Chinese travelers and US trade tensions have each contributed to a fall in the current account surplus.

## Remembering Alan Krueger



Alan Bennett Krueger (1960-2019)

US Economist and Policy Advisor to Barack Obama

Famous for his work on the theory of the minimum wage

This week, saw the sad passing of Alan Krueger at the age of 58. Krueger achieved what many economists set out to achieve in the infancy of their professional lives. He managed to revolutionise the traditional thinking of decades of established economists before him.

Despite having a role and influence in the education sector and pursuing environmental agendas based on his work on the Kuznets curve, his lasting legacy will be the imprint he left on the theory of the labour market. He challenged the traditional macroeconomist view of the expected impact of the imposition of a minimum wage on employment levels.

What exactly did he outline? Krueger looked at a carefully constructed case study of restaurant chains across two different US states. One state paid their workers an increased minimum wage, one state did not. After comparing employment levels across the two US states he found that the employment levels in the state that paid the higher minimum wage was far higher than that of the state did not. He concluded that certain labour market imperfections make this result plausible.

This contradicted mainstream economic theory that minimum wages actually decrease the level of employment in an industry due to the competitive nature of the labour market. He published his work in the book titled "Myth and Measurement" in 1995 and received widespread criticism at the time. However, time is a great healer, and this book is now viewed as an economic masterpiece two decades on.

His academic success earned him widespread acclaim and recognition and he was rewarded with high profile roles in two separate US administrations under Bill Clinton and Barack Obama.

With the aid of a diagram, show how the imposition of a minimum wage is likely to reduce employment in a competitive market.

With the aid of a diagram, show how the imposition of a minimum wage can increase employment in a labour market with imperfections.

Discuss what factors can contribute to imperfections developing in the labour market.

## McDonald's Monopoly



12,000,000 Prizes in 2018

6 MINI Coopers

3 jackpot wins of £100K

11 million apple pies

5 million cheeseburgers

On Wednesday this week, the fast food chain McDonald's rebooted their annual prize competition "McDonald's Monopoly". This campaign will run for a full month until April the 30<sup>th</sup>.

The basic premise of this is that on selected food and drink items there are stickers corresponding to the famous properties and landmarks on a standard monopoly board. If customers manage to obtain the right stickers for a complete line of properties then a prize will be won. The campaign also puts routine "instant-win" stickers on every food item, to give away 50 million food prizes over the course of the campaign.

The re-launch of this campaign has attracted scrutiny from politicians on the basis of protecting public health. Labour MP Tom Watson, who has recently overcome Type 2 diabetes, has criticised the campaign and says it sets a bad precedent and encourages people to eat more fast food in an attempt to win more prizes. This forms part of a collective effort by activists, parents and politicians to clean up the act of the fast food industry.

Another suggestion put forward to encourage people to adopt a healthier lifestyle is to ban junk food advertisements on the television before 9pm. Some say this will help curb the UK's obesity crisis (two thirds of adults are either overweight or obese), whilst others say that more sophisticated approaches need to be taken.

Discuss some of the behavioural factors which contribute to individuals adopting an unhealthy diet and lifestyle

Many behavioural economists suggest that nudges, choice framing and policies to influence social norms are more effective than taxes and product restrictions in combating the UK's obesity problems. Do you agree?

## Chinese Silk Road



In 2013, Chinese President Xi Jinping announced the re-development of the ancient 7,000 mile long trade route dubbed 'The Silk Road'. This will re-build land and maritime trade links across 152 countries.

The Road and Belt Initiative infrastructure project will help upgrade and improve connectivity (ports, roads, bridges and trains) between nations across three continents. China has pledged to invest \$8tn into the infrastructure project to boost trans-Eurasian trade links and facilitate a larger increase in global trade.

The Chinese PM was in Italy for talks this week where it is expected that a deal was signed to facilitate Italy's involvement in this trade route. From Italy's perspective it will allow the country to source and gain access to Chinese products, firms and markets more easily. However, some people are sceptical of this overall project as it is contributing to many countries being steeply indebted to the Chinese government.

To what extent do you agree with the view that trade liberalisation is more effective than foreign aid in improving the rate of development?