Cardiff Business School
Cardiff University

Julian Hodge Bank

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Julian Hodge Institute of Applied Macroeconomics

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LIVERPOOL MACROECONOMICS RESEARCH LIMITED

Foreword

The overall economic picture in the UK remains little changed, with limited growth and little prospect of increased activity over the next twelve months. There are some disturbing signs that we are unable or unwilling to accept some of the implications of our economic predicament. Prior to the budget it looked possible that the government would undershoot its borrowing requirement by as much as £6 billion from a forecast of about £126 billion. Instead of seeing this as good progress and an opportunity to slow the increase in our rapidly expanding national debt, this was seen as a potential opportunity to spend more on a whole range of measures. This psychology is very much akin to 'maxing out' on a credit card and shows that we haven't understood the scale of problems that confront us. Even on optimistic forecasts we continue to borrow more until 2016 at the earliest when we are projected to have a debt of £1.5 trillion, up from £1 trillion today. This is a terrible legacy to have from years of uncontrolled borrowing.

Equally disturbing are the continued moves to inappropriate regulation of the financial sector. Banks in particular have done little to help their cause. Continued examples of mis-selling, inappropriate remuneration structures and a dismissive culture in some organisations has left the sector open to an aggressive approach from regulators that has little to do with preventing the systemic risks we would all like eliminated. Particularly disturbing is the suggestion that institutions like Prudential and HSBC may leave the UK. In difficult times we want to retain the contribution that the sector can make, whilst adopting prudent and professional measures to make it not only the biggest but the best in the world. It would be a tragedy for the UK to lose its pre-eminence in this sector, and difficult to see how we could establish a similar position in any other sector. Banks have to be involved as part of the solution, not as sole authors of the financial crisis.

The crisis over Greece has been kicked down the road a few more yards by another eye-watering bailout, accompanied by some draconian austerity measures that will be difficult to implement. Whilst the plan is that Greece won't require any further support until 2014, this is based on some Herculean assumptions around growth, cost savings and tax revenue. The economic story of Europe at this point, engaging and disturbing as it is, is less ominous than the political position. Europe was intended to be a vehicle to unite Europe in the broadest sense, to ensure that there never could be another European war. However, the resentment created in both Greece and Germany in particular suggests that, for the moment, Europe is creating bigger divisions rather than healing them. These vacuums have had terrible consequences in the past and it is to be hoped that they won't do so this time.

Within the UK of course, we have our own union debate with the SNP hoping to achieve independence for Scotland. Whilst Scotland only accounts for 8% of UK GDP, the impact of independence has implications for all of us. Many of these issues have not been properly considered. The SNP want a form of currency union in the short term, but this looks very much like a scaled down version of the Eurozone which the majority of the UK don't want. Amongst other things Scotland would have to raise its own debt, which would carry a different coupon to UK debt. It is to be hoped that Edinburgh's reputation as the 'Athens of the North' remains a cultural symbol and not an economic one.

Paul Budd
Julian Hodge Bank
Director, Commercial Lending

Based in the heart of Cardiff, Julian Hodge Bank continues to be one of Wales' leading success stories in the financial services market.

Julian Hodge Bank specialises in providing key products and services to commercial clients. This includes the provision of funding facilities for property developers where the Bank caters for the specific requirements of a client through speed of response and flexibility of approach, rather than the adoption of a "one size fits all" strategy.

These projects are not restricted to the principality however, with clients located across the UK. The Bank has seen its business continue to grow and its client base expand during the last year. Demand for its products and services remains very high in what is still a competitive market place.

Julian Hodge Bank Commercial Lending

Julian Hodge Bank Commercial Deposits

Julian Hodge Institute of Applied Macroeconomics

In May 1999, Cardiff Business School and Julian Hodge Bank announced a major new initiative, the establishment of the Julian Hodge Institute of Applied Macroeconomics. The aim of the institute is to carry out research into the behaviour of the UK economy, and to study in particular its relationship with the other economies of Europe. This research has been given especial relevance by the ongoing discussions on the extra powers regularly requested by the European Union and also by the recent crisis in the eurozone.

The institute's director since it was founded has been Professor Patrick Minford, of Cardiff Business School, who is also the Economic Adviser to Julian Hodge Bank. The institute's staff of researchers are mainly based in the school. Recent research has included studies of whether the UK should join the euro and of the economic costs and benefits from UK membership of the European Union. Some other topics have been the UK's inflation and exchange rate behaviour and the relationship between growth and taxation. The institute also carries on the work of the Liverpool Research Group in Macroeconomics which Professor Minford founded and which has been based mainly in Cardiff for a number of years, producing forecasts and policy analysis of the UK and other major economies.

Contents

Financial Repression in the UK and its Dangers 3

Patrick Minford

The Liverpool Forecast 7

Vo Phuong Mai Le

World economic growth is recovering again as the 2011 monetary contractions in emerging economies have generally come to an end. In developed countries growth remains slow, though here too there some green shoots, particularly in the US. The big problem remains the backlash against banks, in the form of regulative overkill: Dodd-Frank in the US, Vickers and the super-capital demands from the Bank in the UK. When this is combined with the euro-zone banking and sovereign crisis, we have a crippling of the bank intermediation and credit function which may largely explain the poor recovery profile.

Quantitative Easing is having no perceptible effect on credit growth — as the banks simply do not want to expand their capital base when their equity prices are so low. Instead QE is printing money to finance public deficits. This is a dangerous strategy, which is only failing to ignite inflation because with the left hand bank credit is being suppressed by regulation. Regulation needs to be dragged back to realism and QE with it, so that growth can resume without inflation.

The Hungarian Crisis 17

Akos Valentinyi

Hungary reacted to the debt crisis by electing a new conservative government which has taken a number of unorthodox measures; though outside the eurozone its experiences are instructive. Prof. Valentinyi of Cardiff Business School examines them in this piece.

"The illusion was that somehow the eurozone was more than the sum of its parts and that the implied solidarity would create de facto bail-out for any country in trouble."

Patrick Minford, Economic Adviser to Julian Hodge Bank

FINANCIAL REPRESSION IN THE UK AND ITS DANGERS

Superficially it may seem as if the Bank of England is getting away with its policy of allowing inflation to breach the target so badly for two years in a row. Inflation is falling, so far to 3.6%. Most forecasts expect it to fall at least close to 2% over the next year or so. So what is not to like?

There are three main concerns that I have.

The first is the huge extent of 'Quantitative Easing'. The Bank has now undertaken to do £325 billion of QE. This means that nearly three years' budget deficits' worth of finance will have been provided by printing money. This represents about a third of outstanding public debt. Its objective is to stimulate growth by stimulating credit.

The second is that, however, there is no growth in credit and this may now be a key factor in holding back growth in output, since small business credit is in steep decline, as is SME credit to a slightly lesser extent. The SME sector, around half of GDP, is the key source of innovation and competition which in turn spur productivity growth. Productivity growth has stalled.

The third is that there is no mechanism in place for achieving the inflation forecast if events are unfavourable; policy is neglecting the inflation overshoot on the grounds of pure inertia — that by doing nothing inflation will melt away. However, oil prices are now rising again, as world growth recovers, with monetary loosening in China and elsewhere in the developing world, and also with some renewed life in the US economy. Inflation looks yet again unlikely to achieve the Bank's regularly optimistic forecasts of 'melting inflation'.

The credit freeze and regulative overkill:

As I have argued before, the reason for the failure to achieve credit growth lies in the regulative onslaught on the UK banks. This will not achieve its objective of stopping future crises but it is stopping banking doing its job of lubricating the capitalist engine. The bureaucracy, having failed to prevent the crisis, is now taking its revenge on the supposed authors of the crisis, the banks. Yet they seem, on our analysis of the data through the lens of a model with banking processes in it, to be more the victims of crisis than its authors. The fact that some banks needed bail-outs reflects on the slackness of regulators in the run-up to the crisis; these regulators failed to apply 'speed limits' suggested in Basel II, speed limits that some foreign regulators (e.g. Spain and Australia) fortunately did apply. The problem with our UK regulators' revenge is that it is damaging the UK economy and causing, together with QE, what resembles 'financial repression' whereby the nation's savings are directed at the lowest possible interest cost into the government's coffers.

Table 1: Summary of Forecast

		2008	2009	2010	2011	2012	2013
GDP Growth[1]		–1.1	–4.3	1.8	1.0	1.4	2.0
Inflation	CPI	3.3	1.3	3.9	4.4	3.2	2.2
	RPIX	4.3	2.0	4.8	4.7	3.6	2.8
Unemployment (Mill.)							
	Ann. Avg.[2]	0.9	1.5	1.5	1.5	1.5	1.3
	4th Qtr.	1.1	1.6	1.5	1.6	1.4	1.2
Exchange Rate (2005=100)[3]		91.2	80.7	80.6	81.2	81.0	80.5
3 Month Interest Rate		5.1	0.8	0.6	1.0	2.3	2.5
5 Year Interest Rate		4.0	2.8	2.3	2.4	2.7	2.8
Current Balance (£ Billions)		–22.0	–26.1	–30.8	–5.8	–8.1	–7.4
PSBR (£ Billions)		73.8	127.8	110.8	121.9	100.6	97.2

[1]Expenditure estimate at factor cost
[2]U.K. Wholly unemployed excluding school leavers (new basis)
[3]Sterling effective exchange rate, Bank of England Index

A further element in the banking situation is the lack of competition. We now have few banks on the High Street; this lack of competition again suits the government as it both chills lending to the private sector, allowing government credit to take available savings, and it also helps to fatten the profits of the banks the government largely owns, bringing forward the date for selling them at a profit.

Now consider the dangers the Bank is running into. It will eventually no doubt meet its inflation targets if growth continues to fail to recover — because monetary stimulus is neutralised by regulative overkill. Thus it will succeed if it fails.

Now suppose the economy does recover and credit somehow takes off with it. The banks will have a massive amount of liquidity to make loans with — around one fifth of GDP in the form of reserves and other claims held at the Bank. How quickly will the Bank be able to retake control and liquidate its bond holdings?

A scenario for inflation take-off:

Suppose finally that the economy does not recover but that there is a renewed spike in oil and commodity prices as world growth picks up in 2012. The private sector, feeling more buoyant, notices and bids up wages, finally to compensate for huge real wage cuts; the inflation target is regarded as lost. Credit demands rise to pay for these target-busting wage demands. How easy will it be for the Bank to cut its bond holdings when so doing will reduce aggregate demand and return the economy to stagnation?

In the early stages of the Weimar Republic politicians congratulated themselves on their sagacity in printing money to meet their bills. Unfortunately they lost control of expectations and of prices and of the money printing process in one big descent into chaos. I believe it is now time for the Bank to become more traditionally cautious — about QE and its balance sheet and about the breaching of

the inflation target. It is vulnerable to the shocks I have described and needs to become less vulnerable. The eurozone crisis is in remission and can no longer be used as an excuse for permanent loosening of policy; clearly it will stay with us for months, even years, but is now becoming part of the normal background, as I go on to discuss in what follows.

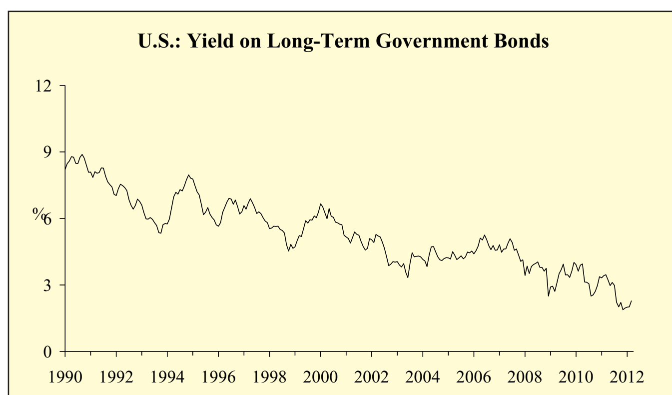
The normal world of ongoing eurozone crisis and ECB backdoor bailout

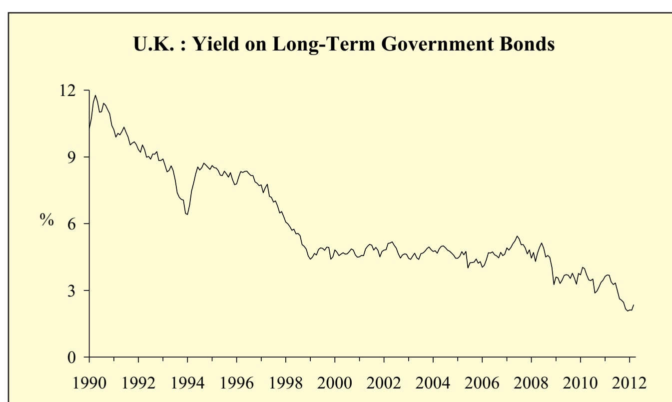
The recent EU summits on the eurozone's problems have changed nothing of any consequence. They have merely reinstated the Stability and Growth Pact, with new pious intentions and 'penalties' (which are unenforceable). Looking back over the decade-plus since the euro was introduced in 1999, it is clear with hindsight that the great 'benefits' to southern countries of joining the euro — *viz* low interest rates on a par with Germany's, enabling much less to be spent on servicing huge sovereign debts — were illusionary. The illusion was that somehow the eurozone was more than the sum of its parts and that the implied solidarity would create de facto bail-out for any country in trouble. Hence for that decade the continuation of Germanic interest rates for these countries.

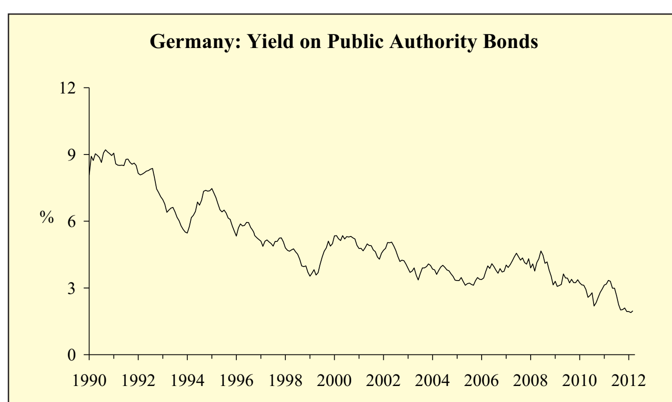
It took the banking crisis to destroy the illusion, forcing Germany to protect itself against these implicit demands. Now interest rates on the sovereign members of the eurozone reflect their true sovereign risk. The problem for each sovereign country is however that it cannot control its currency's value nor the rate at which it prints money and inflates; these controls are available only if your currency is floating on the exchanges. So where exactly any more are the benefits of being part of the eurozone? Now there is only the cost of being unable to run your economy according to your own needs as the business cycle fluctuates.

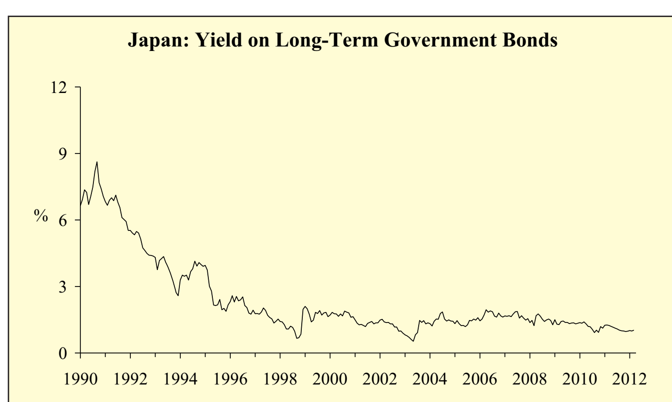
This cost-benefit logic is likely to become increasingly apparent to the citizens of all these southern countries as the grim austerity programmes mandated by the new Fiscal Agreement bite ever deeper. Their governments will struggle to maintain legitimacy as they implement these programmes; and leaving the euro will rise up the agenda.

Some commentators — such as Citigroup's Willem Buiter (olim of the Monetary Policy Committee) — frighten us with the stories of the disaster that will occur if the eurozone breaks up. This has little credibility: currency zones have been breaking up for centuries with little more than temporary disruption. Most countries left gold in the 1930s, with beneficial effects as this enabled each country to pursue easier money. In 1870 the Latin Monetary Union (the first 'eurozone') broke up. The Soviet currency bloc broke up with the demise of the Soviet Union. The Asian Crisis of 1988 forced most Asian countries off their dollar pegs: these countries bounced back in the early 1990s.









For now the active liquidity policy of the ECB has alleviated the crisis. The ECB has lent over €1 trillion to eurozone banks in order to bolster their liquidity. The banks in turn have been encouraged to use this liquidity to buy the sovereign bonds of the countries facing high interest rates, the PIIGS. This they seem to have done and the interest rates faced by these countries have receded.

The eurozone political classes are determined to keep all the PIIGS inside the euro. So far the crisis has been contained; Greece has received its large second tranche of aid and will not need more until 2014. It has been asked to carry out reforms and economies on a massive scale. Similar efforts are being made in the others. However the whole process is on a political knife-edge: while the political elite has one view, the ordinary voters who are being asked for huge sacrifices may take a different view. In the end their view must prevail in democracies.

Hence the crisis will continue on and off until this is resolved one way or the other. The eurozone will grow slowly if at all for some time until this happens. UK policy has to be made on this basis.

Conclusions for UK monetary and macro-prudential policies

So the policy conclusion is that interest rates should be raised at the earliest opportunity. The latest indicators are more positive; a signal needs to be given about monetary intentions. We would raise Bank rate by 0.25%; actual rates are in fact above 0.75% already so little would change in the market but the signal would be understood. We would also abandon the extra £50 billion of QE; merely keep it in reserve and announce that every opportunity will now be taken to run down QE.

On the 'macro-prudential' side, it is time the Bank takes a stand on behalf of the banks in the regulative mess that is now emerging; it must stop overkill — defer Vickers *sine die*, stop the bonus populism (explain that banks are the closest we have to John Lewis) and encourage new bank entry and competition.

We need to encourage the re-emergence of bank competition after the pounding it has had from the bank crisis, with the destruction of numerous UK bank players — whether the Irish, the Icelandic, or the banks that have been folded into the new megabanks like RBS and Lloyds. Only competition will break the logjam of credit scarcity as for these megabanks the main aim is to rebuild profits with as little risk as possible — so extending credit on expensive terms to solid large businesses and using deposits that are paying next to nothing in interest. We cannot rely on the goodwill of monopoly banks with weak balance sheets to spur new lending to risky SMEs.

What regulators cannot seem to grasp is that the time for restraint of banks' lending is in the later stages of economic upswing, not in the depths of recession. Another fallacy in their thinking is that a future crisis can be prevented; history shows that crises are endemic in capitalism because innovation has unknowable results, sometimes bad ones. If banks have participated in an upswing, as capitalism requires them to do for it to work, then in these bad times banks will lose money and some will go bust. The only way of stopping this happening is to stop banks participating altogether; but this will also stop the dynamic upswing. In effect you can stop crises if you abandon capitalism — but that is surely not the aim of any of our governments or voters.

What is needed in place of this regulatory overkill is a system of capital provision that is designed to restrain extreme lending growth in the upswing. Actually we already had this in Basel II which was widely evaded but linked capital requirements to Value at Risk (though this concept needs to be reformed, as VaR falls in the upswing and rises in the downswing, so reinforcing the swings in lending). This could be allied with a stronger response of interest rates to the growth in GDP. With such a system the cost base of banking would be kept low and entry of new banks would be encouraged, restoring competition. The economy would then grow more strongly as SMEs (who form more than 50% of employment) are enabled to be active again.

Finally, what can be done to kick-start lending now? We see the Treasury struggling with a scheme of 'credit easing' which is already bogged down with problems to do with being illegal state aid under EU rules. A simpler route would be to levy a tax (in the form of a negative interest rate, payable to HMRC) on banks' income from balances at the Bank (and also bank holdings of government debt); this could be offset by a reduction in the 'bank levy' or by a simple lump sum transfer to all banks. The measure would therefore be revenue-neutral for both banks as a whole and the Treasury. The consequence however would be that by extra lending to the private sector each bank individually would seek to avoid the tax by switching its Bank balances into lending. Of course we know that at the aggregate level of all banks there would be no change in bankers' balances since the extra credit to the private sector must be matched by extra deposits, which in turn will be redeposited in the banks and thence into bankers' balances. However, this is not the point; each bank will still wish to switch, making such an expansion of credit take place and with it an expansion in bank deposits. Within the banks, those banks that lend most aggressively could succeed in offloading their bankers' balances onto other banks, hence obtaining a net reward from their switching at the expense of others that do less. Until banks can be forced into greater competition and the regulations can be eased off, this negative interest rate measure (which has also been used in the context of foreign depositors in Switzerland for example) can be used to encourage banks into lending.

Final thoughts on the Budget

The fundamental budget plan is correct: to cut spending steadily and raise taxes as needed across a broad tax base, until the government's debt ratio to GDP is stabilized and brought back down towards a less dangerous level of below 60%. The problem has been the lack of policies so far to cut taxes that deter the growth of enterprise. In this Budget the Chancellor, George Osborne, made a start in addressing this problem.

It is never easy to reform tax when there is no spare money to buy out losers. This is the situation today. So George Osborne is to be congratulated on making some progress in changing the tax system in beneficial ways.

First, he managed to cut the damaging 50 pence top tax rate, which HMRC confirmed was raising virtually no revenue. These calculations are tricky since they depend on assumptions about responses to alternative tax structures, but on previous work for the UK, it seems most likely that actually this rate reduced tax revenue because of evasion and negative supply responses, whether by net emigration or by reduced labour supply. HMRC's assumptions were cautious and so found less dramatic effects. But the tax is damaging activity as well; indeed that is how the revenue loss comes about, lowering the tax base, offsetting any gain from the higher tax rate on a constant tax base. So when that is put into the equation it is ludicrous to raise such a small amount of revenue from better-off people in this way.

45 pence is still too high. But the cut is important as a signal of priorities being given to incentives for business and business people. Presumably it will be followed by further reform, we are led to expect.

Second, there was an added 1% cut in corporation tax, with an eventual move to 22 pence; capital allowances are somewhat reduced. This is again very welcome. Capital allowances distort investment decisions towards greater capital-intensiveness; while leaving the marginal tax rate on new profitable projects unaffected, since at the margin the extra activity or business expansion may not use these allowances. Cutting corporation tax does cut this marginal tax rate and so encourages expansion.

Further budget tax cuts come from raising personal allowances to £9000 — this is a Lib Dem priority. It is not really a good idea when one considers it against the yardstick of marginal tax rates. The best schedule of MRTs is flat; a higher personal tax allowance creates a bigger band where it is zero which has to be paid for by higher MRTs elsewhere. 'Taking people out of tax' sounds attractive administratively; but again it is something of an illusion because many of the people 'taken out' go back in for tax credits and welfare benefits.

The costly rise in the allowance is balanced by extra taxes of various sorts: the extra 7% stamp duty band on properties over £2 million is the main one. Another is the freezing of the allowances for pensioners and higher rate bands. On MRT grounds this whole package is poor. Stamp duty in particular is a tax that damages mobility and should in any case be repealed in favour of a proper consumption tax on the imputed rent of owner-occupied housing. But it is mandated by the politics of the coalition and as tax goes is relatively harmless. There has been a big fuss about the freezing of the pensioner allowance but in the context of the full indexation of pensions themselves over the last few years when real wages for other groups were falling dramatically, they have not been badly treated.

The latest news from the economy has been more upbeat, with purchasing surveys suggesting revival, much as they are in the US. The Osborne budget should add to business confidence. With the euro-zone crisis currently relegated to the backburner as a result of the ECB's €1 trillion injection of liquidity into the banking system, it should now be possible, as we argue above, for the Bank to focus on getting interest rates up and unwinding its dangerously high holdings of UK government debt.

THE UK ECONOMY

Vo Phuong Mai Le

Real GDP declined by 0.3% in Q4 2011, after increasing by 0.5% in the previous quarter. However, some data since November 2011 and business and household survey indicators point to an improvement in economic activity in the first quarter of 2012. Hence it looks as if talk of a 'double-dip recession' being imminent was misleading; recovery has proved to be weak and elusive but may now finally be strengthening.

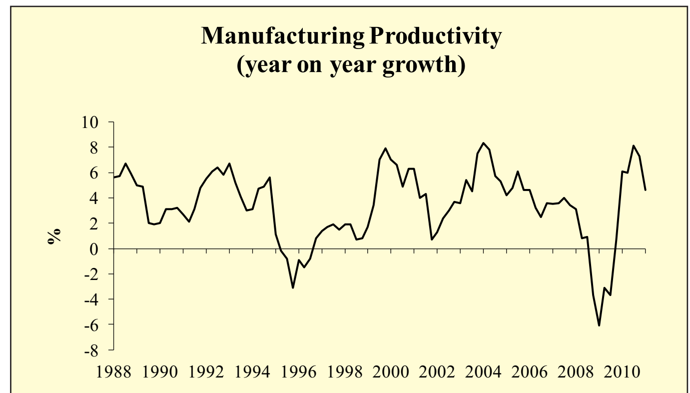
Industrial output fell by 1.3% in Q4, after a rise of 0.1% in Q3. It was mainly driven by the fall in the manufacturing sector of 0.7% in Q3 after a decrease of 0.1% in Q3. However, there are signs of recovery in the sector. According to the Market/CIPS survey the manufacturing sector expanded in the first two months of 2012: the index was 51.2, slightly down from January's eight-month high of 52.0.

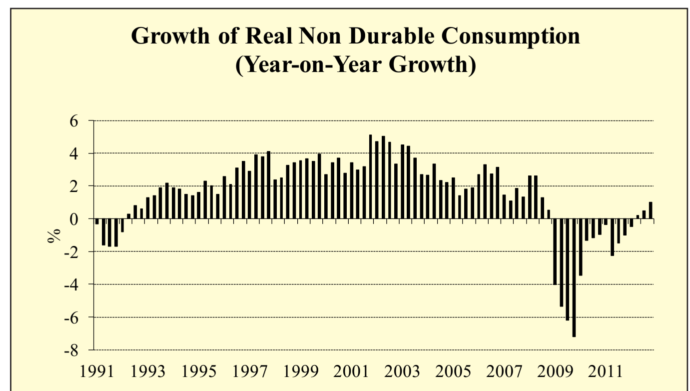
Construction output continued contracting, falling by 0.2% in Q4 after 0.5% in Q3. The sign of recovery comes from stronger expansion of new business. The CIPS construction purchasing managers' index was reported at 54.3 in February, up from 51.4 in January. This is the highest level since March 2011.

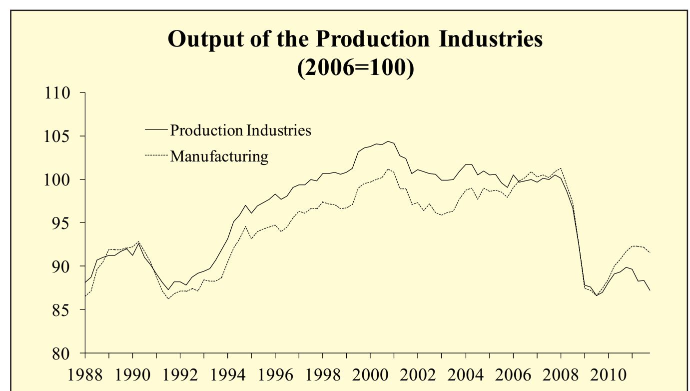
Service sector output fell by 0.1% in Q4 after an expansion of 0.8% in Q3. However, according to the Market/CPIS survey, service sector activity showed a solid monthly increase in February and January 2012. It came in at 53.8 in February, following 56.0 in January.

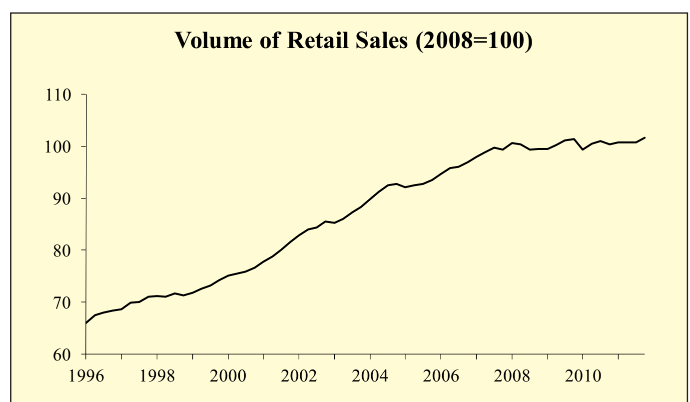
According to the ONS, all expenditure factors, except for fixed investment (down 0.6% in Q4 after a rise of 0.6% in the previous quarter) and business inventories (subtracting 0.3 percentage points from the Q4 growth), contributed positively to GDP growth. Private consumption increased by 0.4% in Q4 after falling 0.1% in the previous quarter. Public consumption rose by 0.5% in Q4, up from –0.5% in Q3. Net exports contributed 0.2 percentage points to GDP growth, as exports rose 1.6% and imports rose 0.9%. The missing ingredient in the recovery remains investment, as businesses remain cautious both about the outlook and about the coalition's attitude to business. This gives context to the pro-business tone of the 2012 Budget in which finally the Chancellor, George Osborne, tried to draw a line under the populist 'bashing' of business and the banks that has so disfigured UK commentary since the crisis.

The housing market shows some signs of improvement. The month-on-month change in the Nationwide House Price Index was 0.6% in February, raising the year-on-year change to 0.9% from 0.6% in January. This reflected an increase in sales. The number of mortgages approved to finance house purchases in Q4 rose almost by 4%.









Cost and prices

CPI year-on-year inflation was 3.4% in February, down from 3.6% in January. Inflation easing reflects the waning impact of the past energy price increases and of the rise of VAT to 20% in January 2011. The RPI rate fell from 3.9% in January to 3.7% in February.

Despite the recent decline, CPI inflation continued to remain persistently above its 2% target. However, the Bank of England Monetary Policy Committee still forecasts that it will return to below target in the medium term due to the excess capacity and the sluggish recovery of economic activity. Annual factory gate inflation was 4.1% in February. Input price annual inflation was 7.3% compared to 6.6% in January. These increases reflected the recent rise in oil prices. Weak labour market conditions kept wage growth moderate. For the period of 3 months to January average earnings growth including bonuses was 1.4% on a year earlier. Nevertheless, recent oil and food price rises threaten once again to derail the Bank MPC's forecast of falling inflation; if so this will be the third year running the Bank's forecast has been highly over-optimistic.

Labour market

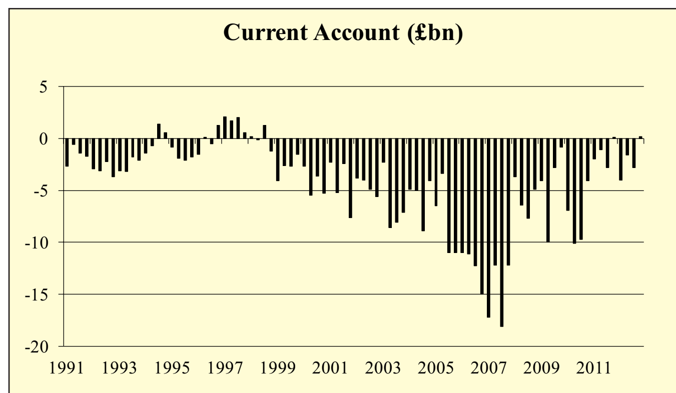
Labour market conditions remain weak. The employment rate for the three months to January 2012 was 70.3%, unchanged from the last quarter. During the same time, the unemployment rate increased to 8.4% compared to 8.3% previously. The claimant count was 5.0% in February, unchanged from January, but up 0.5% from a year earlier.

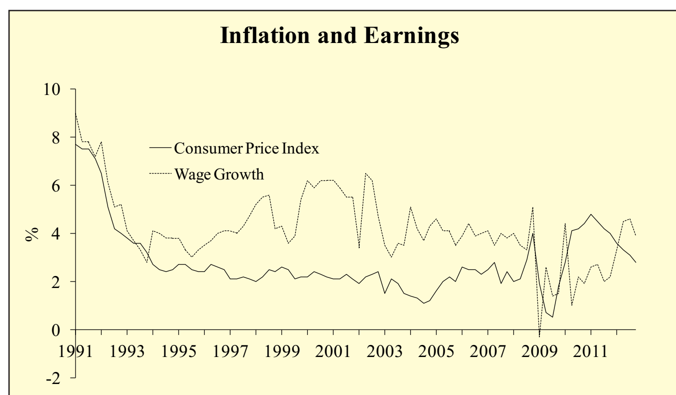
Trade

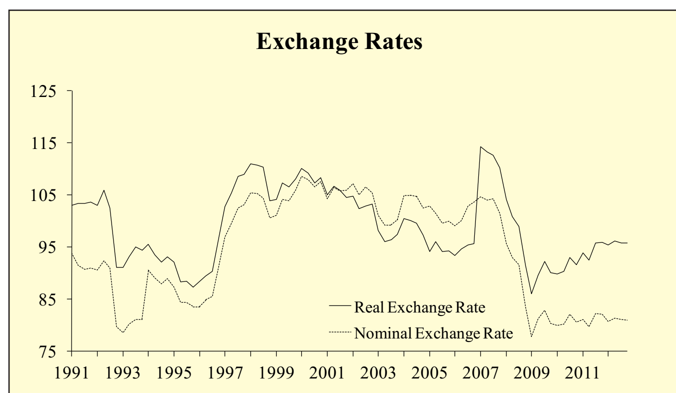
In January the total trade deficit in goods and services widened to £1.8 billion from £1.2 billion in December. The deficit on trade in goods was £7.5 billion compared with £7.2 billion in December. The surplus on trade of services was £5.8 billion in January, down from £6.0 billion in the previous month.

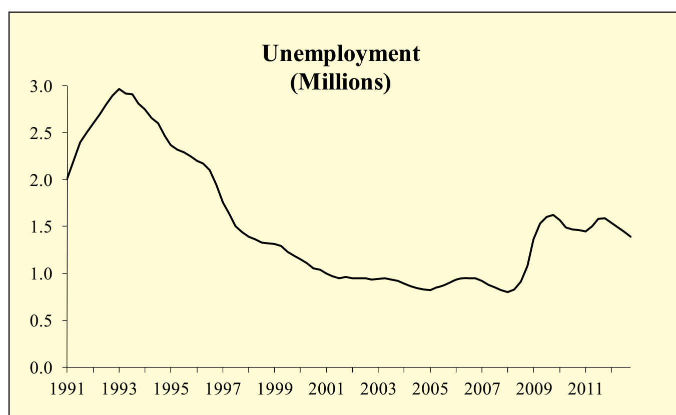
Monetary and fiscal developments

Notes and coins in circulation grew 5.6% in February on a year earlier, compared to 5.4% in January. The year-on-year growth rate of broad money — M4, including bank and building society deposits held by households and firms — was 2.9% in January after 1.3% in December. Excluding lending to 'intermediate financial companies,' M4 increased 0.3% after a few periods of decline. These figures highlight the absence of new banking activity; bank charges remain prohibitive and lending to SMEs is down by 6.1% in November 2011 compared to a year earlier. Credit conditions improved slightly and there were small signs that UK banks were starting to lend more to businesses and households. However, with the draconian demands for extra capital being made by regulators, banks have every incentive to contract their balance sheets given the high cost of raising capital at current bank share prices. This





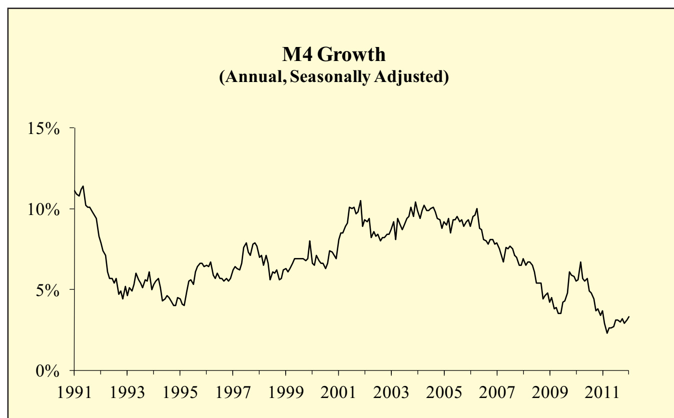




highlights the spectacular bureaucratic stupidity of the new bank regulatory regime, perfectly designed to stop UK growth in its tracks.

The Bank of England maintained its official lending rate at 0.5% at the Monetary Policy Committee meeting in March. In February, the Committee voted to expand the size of its asset purchases financed by issuance of central bank reserves by £50 billion to a total of £325 billion. This takes the size of the Bank's balance sheet to the equivalent of nearly three years of government borrowing, effectively financed by printing money.

In the fiscal year to February 2012 the public sector current budget — government income minus spending on current costs — was in deficit to the amount of £74.9 billion, compared to a deficit of £83.2 billion in the same period of 2010/2011. An increase in government tax revenue offset the rise in government expenditure. Public net borrowing excluding financial interventions was £93.5 billion in the fiscal year to January, down from £109.1 billion from the same period last year; the borrowing requirement came in at £126 billion over the fiscal year 2011–12, exactly on the last Budget forecast. At the end of January, public sector net debt was £2311.6 billion or 147.3% of GDP. This compares to £2234.2 billion (150% of GDP) at the end of January 2011. The fiscal plan to reduce borrowing is approximately on target so far but looking ahead a couple of years it is some two years behind the original projections because of the current weakness in growth.



UK FORECAST DETAIL

Prices, Wages, Interest Rates and Exchange Rate Forecast (Seasonally Adjusted)

	Inflation %1 (CPI)	Short Dated (5 Year) Interest Rates	3 Month Int. Rates	Nominal Exchange Rate (2005=100) 2	Real Exchange Rate3	Real 3 Month Int. Rates %4	Inflation (RPIX)	Real Short Dated Rate of Interest5
2008	3.3	4.0	5.1	91.2	100.3	3.7	4.3	1.0
2009	1.3	2.8	0.8	80.7	89.5	–3.1	2.0	–0.3
2010	3.9	2.3	0.6	80.6	91.2	–3.8	4.8	–0.5
2011	4.4	2.4	1.0	81.2	94.5	–2.2	4.7	0.1
2012	3.2	2.7	2.3	81.0	95.8	0.1	3.6	0.7
2013	2.2	2.8	2.5	80.5	95.7	0.5	2.8	0.8
2010:1	2.8	2.8	0.5	79.9	89.8	–4.3	4.5	–0.1
2010:2	4.1	2.2	0.7	80.2	90.3	–3.8	5.1	–0.6
2010:3	4.2	1.8	0.6	82.0	92.9	–3.6	4.7	–0.9
2010:4	4.4	2.3	0.7	80.5	91.6	–3.3	4.7	–0.3
2011:1	4.8	2.7	0.8	81.1	93.8	–2.8	5.3	0.2
2011:2	4.5	2.2	0.8	79.6	92.4	–2.5	5.0	–0.2
2011:3	4.2	2.4	1.1	82.2	95.8	–2.0	4.3	0.1
2011:4	4.0	2.5	1.6	82.0	95.9	–1.2	4.2	0.3
2012:1	3.6	2.6	2.0	80.7	95.4	–0.5	3.9	0.5
2012:2	3.3	2.6	2.2	81.3	96.1	0.0	3.7	0.6
2012:3	3.1	2.8	2.5	81.0	95.8	0.4	3.5	0.8
2012:4	2.8	2.8	2.5	80.9	95.7	0.5	3.3	1.4

1 Consumer's Expenditure Deflator
2 Sterling Effective Exchange Rate Bank of England
3 Ratio of UK to other OECD consumer prices adjusted for nominal exchange rate
4 Treasury Bill Rate less one year forecast of inflation
5 Short Dated 5 Year Interest Rate less average of predicted 5 year ahead inflation rate

Labour Market and Supply Factors (Seasonally Adjusted)

	Average Earnings (1990=100)[1]	Wage Growth[2]	Unemployment (New Basis) Percent[3]	Millions	Real Wage Rate[4] (1990=100)
2008	220.4	3.5	2.8	0.91	138.9
2009	220.2	0.0	4.6	1.53	136.9
2010	225.2	2.4	4.6	1.50	134.8
2011	230.5	2.4	4.7	1.53	132.2
2012	239.9	4.1	4.4	1.47	133.4
2013	249.0	3.8	3.8	1.27	135.5
2010:1	224.2	4.4	4.8	1.57	136.3
2010:2	222.9	1.0	4.6	1.49	133.9
2010:3	225.3	2.2	4.5	1.47	134.3
2010:4	228.4	1.9	4.5	1.46	134.8
2011:1	229.8	2.6	4.4	1.45	133.2
2011:2	228.8	2.7	4.6	1.50	131.5
2011:3	229.9	2.0	4.8	1.58	131.5
2011:4	233.5	2.2	4.8	1.59	132.5
2012:1	237.3	3.3	4.6	1.54	132.8
2012:2	239.1	4.5	4.5	1.49	133.2
2012:3	240.5	4.6	4.3	1.44	133.5
2012:4	242.7	3.9	4.2	1.39	134.0

1 Whole Economy
2 Average Earnings
3 Wholly unemployed excluding school leavers as percentage of employed and unemployed, self employed and HM Forces
4 Wage rate deflated by CPI

Estimates and Projections of the Gross Domestic Product[1] (£ Million 1990 Prices)

	Expenditure Index	£ Million '90 prices	Non–Durable Consumption[2]	Private Sector Gross Investment Expenditure[3]	Public Authority Expenditure[4]	Net Exports[5]	AFC
2008	147.3	705312.2	421176.1	253264.5	176727.6	−46562.6	99293.5
2009	140.8	674466.5	405440.7	218144.6	178391.0	−33226.3	94283.5
2010	143.3	686345.3	405565.3	241422.1	180777.4	−42021.1	99398.4
2011	144.8	693331.3	400381.9	236752.2	182398.0	−31348.2	94851.3
2012	146.8	703170.7	401572.0	247757.1	184603.4	−33345.2	97417.6
2013	149.8	717526.3	407987.9	255148.0	187436.1	−33320.4	99720.5
2008/07	−1.1		−1.5	−2.2	3.4		8.7
2009/08	−4.3		−3.7	−13.4	0.9		−5.0
2010/09	1.8		0.0	10.7	1.3		5.6
2011/10	1.0		−1.3	−1.7	0.9		−3.9
2012/11	1.4		0.3	4.7	1.2		2.8
2013/12	2.0		1.6	3.0	1.5		2.4
2010:1	141.9	169929.6	101035.9	54839.4	47326.4	−10076.3	23195.7
2010:2	143.4	171724.0	101994.9	57226.4	43888.6	−9819.2	21566.7
2010:3	144.3	172787.0	101409.9	65728.6	44640.8	−11710.3	27282.0
2010:4	143.6	171904.6	101124.6	63627.7	44921.5	−10415.2	27354.0
2011:1	144.2	172584.4	100688.1	55175.7	47489.5	−7019.6	23749.4
2011:2	144.3	172761.4	99684.3	58473.2	44536.4	−7695.8	22236.7
2011:3	145.6	174351.0	99891.2	61928.1	45087.9	−8312.5	24243.0
2011:4	145.0	173634.6	100118.2	61175.2	45284.1	−8320.4	24622.2
2012:1	145.7	174471.0	100187.7	58861.3	47967.7	−8338.6	24207.2
2012:2	146.2	174997.3	99883.8	62474.5	45027.4	−8332.2	24056.9
2012:3	147.8	176953.2	100387.2	63758.7	45681.0	−8335.7	24538.7
2012:4	147.6	176749.1	101113.3	62662.6	45927.2	−8338.7	24614.9

1 GDP at factor cost. Expenditure measure; seasonally adjusted
2 Consumers expenditure less expenditure on durables and housing
3 Private gross domestic capital formation plus household expenditure on durables and clothing plus private sector stock building
4 General government current and capital expenditure including stock building
5 Exports of goods and services less imports of goods and services

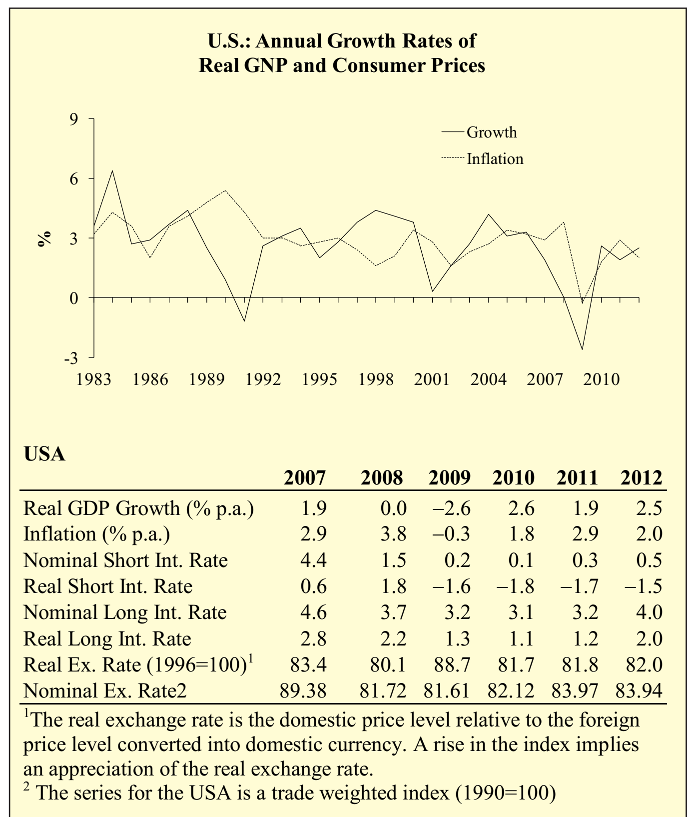
Financial Forecast

	PSBR/GDP %[1]	GDP[1] (£bn)	PSBR (£bn) Financial Year	Debt Interest (£bn)	Current Account (£ bn)
2008	5.8	1262.4	73.8	33.2	−22.0
2009	10.3	1244.4	127.8	32.4	−26.1
2010	8.3	1333.7	110.8	36.6	−30.8
2011	8.8	1391.3	121.9	43.1	−5.8
2012	6.9	1457.5	100.6	49.6	−8.1
2013	6.4	1519.8	97.2	52.7	−7.4
2010:1	8.1	317.8	25.9	8.4	−6.9
2010:2	10.2	321.7	32.7	8.8	−10.1
2010:3	7.8	335.7	26.2	8.9	−9.7
2010:4	11.3	337.6	38.3	9.2	−4.1
2011:1	4.0	338.7	13.6	9.7	−2.0
2011:2	8.5	339.2	28.9	10.1	−1.1
2011:3	4.7	347.4	16.3	10.4	−2.8
2011:4	12.2	349.5	42.5	11.0	0.1
2012:1	9.6	355.2	34.2	11.6	−4.0
2012:2	6.4	357.8	23.1	12.0	−1.6
2012:3	6.5	363.5	23.7	12.4	−2.8
2012:4	6.7	364.9	24.5	12.5	0.2

1 GDP at market prices (Financial Year)

Global growth slowed down last year in response to widespread monetary tightening by China, India and other emerging market countries in 2011. More recently policy there has been eased so that there has been some revival in growth towards the year end. In advanced economies while they are still weak in the aftermath of the crisis, financial market conditions have improved, with the cooling of the eurozone crisis. This has helped to lift business and consumer sentiment. The Purchasing Managers' Index (PMI) for global all-industry output continued to increase. It was 55.5 in February, indicating expansion.

Inflationary pressures continued to subside. Annual headline inflation in the OECD countries was 2.8% in January compared to 2.9% in December 2011. Excluding food and energy, the annual inflation rate was 1.9% in January compared with 2.0% in the previous month. In emerging countries, inflation rates also declined, though they still remain somewhat excessive, for example above 6% in Brazil and around 4% in China.



USA

	2007	2008	2009	2010	2011	2012
Real GDP Growth (% p.a.)	1.9	0.0	−2.6	2.6	1.9	2.5
Inflation (% p.a.)	2.9	3.8	−0.3	1.8	2.9	2.0
Nominal Short Int. Rate	4.4	1.5	0.2	0.1	0.3	0.5
Real Short Int. Rate	0.6	1.8	−1.6	−1.8	−1.7	−1.5
Nominal Long Int. Rate	4.6	3.7	3.2	3.1	3.2	4.0
Real Long Int. Rate	2.8	2.2	1.3	1.1	1.2	2.0
Real Ex. Rate (1996=100)[1]	83.4	80.1	88.7	81.7	81.8	82.0
Nominal Ex. Rate2	89.38	81.72	81.61	82.12	83.97	83.94

[1]The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation of the real exchange rate.
[2] The series for the USA is a trade weighted index (1990=100)

US

The US economy continued to recover. Real GDP increased by 0.75% quarter-on-quarter in Q4, up from 0.45% in the previous quarter. This expansion reflected strong growth in consumer spending and investment, and a positive contribution from the change in private inventories. Growth was held down by a negative contribution from net trade and public spending. Real consumption rose 0.5% quarter-on-quarter, up from 0.4% in the previous quarter. Investment continued contributing positively to GDP growth. This was driven by a very strong rise in residential investment (a 2.9% increase after 0.3% in Q3) and also a continuous expansion in non-residential investment (0.7% after 3.9% in Q3). Change in inventories contributed 0.47 percentage points to the Q4 GDP growth.

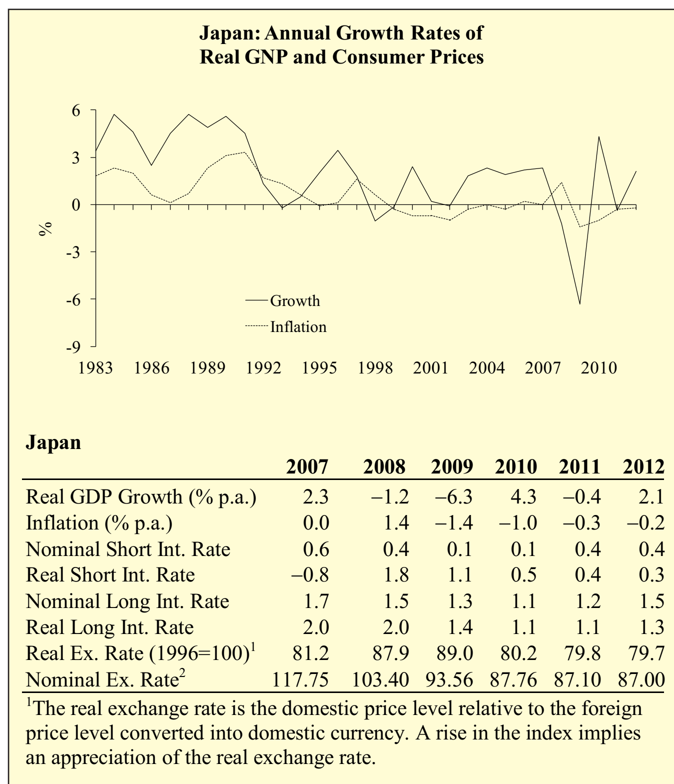
Net exports subtracted 0.02 percentage points from quarterly growth, as imports accelerated (1.1% quarter-on-quarter in Q4 after increasing 0.3% in Q3) and exports remained almost unchanged (1.15% in Q4 compared to 1.18% in Q3).

Labour market conditions improved. Non-farm payroll employment rose 227,000 in February, which followed a strong rise of 203,000 in December and 284,000 in January. These are the first signs that the recovery is moving out of its 'job-less' phase, and has been warmly welcomed in the Obama camp. The unemployment rate decreased to 8.3% in January down from 8.5% in December and 8.7% in November. This is the lowest level since February 2009. The strong employment growth only reduced the unemployment rate marginally because the labour participation ratio rose 0.2 point. Persistent high unemployment still weighs down wage growth. In February average hourly earnings rose 1.9% year-on-year after a rise of 1.8% in the previous month.

The housing market remains weak. According to the S&P/Case–Shiller Home Price Indices, national house prices declined 3.8% in the fourth quarter of 2011. However, there are at last some signs of improvement now, in early 2012. Sales of existing homes rose 4.3% month-on-month in January. The months' supply of inventory of unsold homes fell to 6.1 months in January from 6.4 months in December.

Annual CPI inflation decreased to 2.9% in January from 3.0% in the previous month and 3.9% at the highest level in September 2011. A decrease in food and energy prices contributed to this decline in the inflation rate. Excluding food and energy annual CPI inflation was 2.3% in January, up from 2.2% in the previous month. The persistence in core inflation is explained by increases in the prices of medical care, recreation and education and communication. At its March meeting, the Federal Open Market Committee decided to maintain its target range for the federal funds rate at 0–0.25% and it expected that economic conditions would allow the low federal funds rate levels to persist until at least late 2012. It decided to continue its Operation Twist to extend the average maturity of its securities holdings.

Japan



Japan

	2007	2008	2009	2010	2011	2012
Real GDP Growth (% p.a.)	2.3	−1.2	−6.3	4.3	−0.4	2.1
Inflation (% p.a.)	0.0	1.4	−1.4	−1.0	−0.3	−0.2
Nominal Short Int. Rate	0.6	0.4	0.1	0.1	0.4	0.4
Real Short Int. Rate	−0.8	1.8	1.1	0.5	0.4	0.3
Nominal Long Int. Rate	1.7	1.5	1.3	1.1	1.2	1.5
Real Long Int. Rate	2.0	2.0	1.4	1.1	1.1	1.3
Real Ex. Rate (1996=100)[1]	81.2	87.9	89.0	80.2	79.8	79.7
Nominal Ex. Rate[2]	117.75	103.40	93.56	87.76	87.10	87.00

[1]The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation of the real exchange rate.

The Japanese economy was relatively weak at the end of 2011 after the rebound in the third quarter. Real GDP contracted by 0.2% compared with a rise of 1.7% in Q3. This reflected negative contributions from net exports and private inventories. Weaker external demand, largely due to supply disruptions from the floods in Thailand, resulted in a sharp decline in exports (−3.1% compared with 8.6% in Q3), while imports continued growing (1.0% after 3.4% in Q3). The change in inventories contributed −0.3 percentage points to the quarterly growth. On the other hand, the positive contributions to GDP growth came from private consumption (+0.3% after 1.0% in Q3), total private investment (1.5% compared to 0.7% in Q3) and public consumption (0.3% in Q4).

Despite this setback, the economic climate shows some signs of recovery in early 2012 according to the headline leading business condition indices (which rose to 94.9 in January from 93.8 in December) and the Economy Watchers Survey (which rose to 45.9 in February from 44.1 in January). In January machinery orders rose 21.6% from the previous month. This reflected a strong rebound in overseas orders. They are up 18.8% on the year earlier.

The labour market is recovering though still weak. The total unemployment rate was 4.6%, up from 4.5% in November. Employment remained unchanged in December after a rise of 0.4% in the previous month. The ratio of effective job offers to applications was 0.71 in December, up from 0.69 in November.

The economy is in a mild deflationary phase with prices decreasing. CPI inflation year-on-year was at 0.1% in January 2012, up from −0.2% in December. This increase was driven largely by the increase in prices of food. Annual inflation excluding food stayed unchanged at −0.1% in January. Annual CPI excluding food and energy declined at a slower pace (−0.8%) compared with December (−1.1%). In practice, taking the past decade together prices in Japan have been stable; thus it appears to have succeeded in achieving a zero-inflation price level target.

At its March meeting the Bank of Japan decided to maintain its target for the uncollateralised overnight call rate at around 0−1%. It decided to increase the Growth Supporting Funding Facility by ¥2 billion to ¥5.5 billion to commercial banks. It hoped that these cheap loans would encourage lending to firms who are active in promising areas for economic growth. It extended the deadline of applications for special loans to financial institutions in the disaster areas to the 30th April 2013. These loans are meant to facilitate bank lending once the rebuilding of the Tohoku region gains momentum. In its early meeting in February, it also announced the expansion of its Asset Purchase Program (its QE equivalent) by ¥10 trillion to the total of ¥65 trillion through purchases of Japanese government bonds. It decided to introduce a price stability goal, at 1% in terms of the annual change in the CPI, in the medium to long term; this reference to a new 'inflation target' was greeted with some scepticism, as the phrases used denote a lack of precision and as we have seen the BoJ has not succeeded in hitting any sort of inflation target, rather inflation has simply stopped altogether, with bouts of mild deflation offset by bouts of slight inflation.

Germany

The economy recovery has stalled. It has suffered both from the impact of the sovereign debt crisis in the Euro zone and from the slowdown in global demand. Real GDP decreased 0.2% in Q4, after a rise of 0.6% in the previous quarter. It is the first decrease since Q1 2009. Investment was the only positive contributor to quarterly GDP growth. It increased 1.1% in Q4 after 0.3% in the previous quarter. Private consumption dropped 0.2% in Q4 after a rebound of 1.2% in Q3. Net exports subtracted 0.3 percentage points off the quarter's GDP growth rate, as a decrease in exports (−0.8% in Q4) overweighed the decrease in imports (−0.3% in Q4). Germany thus fell victim to the worsening world climate during 2011.

However, despite this slump in GDP growth, recent indicators show some signs of recovery, in line with the improving tone of world growth we noted above. The IFO business climate index has continued to rise since November 2011 to 109.6 in February from 108.3 in January. It is at the highest level since July 2011. The ZEW expectation index, measuring investor and analyst opinion on the trend in future activity, increased to 22.3 in March from 5.4 in February. This index has risen for the fourth consecutive month.

The labour market stayed relatively healthy. The unemployment rate remained unchanged in February at 6.8%. Employment rose 0.2% month-on-month; and in January, it was up by 1.5% year-on-year.

France

The economy continued to rebound in the fourth quarter. Real GDP rose 0.2% after rising 0.3% in the previous quarter. This firm recovery reflected a strong domestic and foreign demand. Consumption was up 0.2% in Q4 after a rise of 0.3% in Q3. Investment rose 0.9% after 0.4% in Q3. Total domestic demand (excluding inventories) contributed 0.3 percentage points to GDP. Net trade contributed 0.7 percentage points to GDP growth, as exports grew 1.2% (after 0.7% in Q3) while imports declined 1.2% (after 0.3% in Q3).

The recent survey indicators however send a mixed signal about the future state of economy. The composite PMI index rose for the third consecutive mother and hit the expansionary territory at 51.2 in January. Consumer confidence has kept on rising since December's 80 to reach 82 in February. Less encouraging signs came from the INSEE composite business confidence that declined to 91 in January.

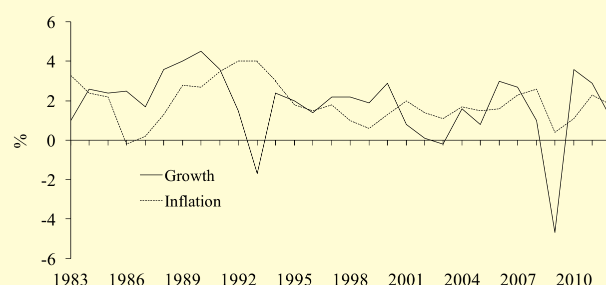
Annual CPI inflation in February was 2.3%, unchanged from January. This reflected the seasonal growth of prices in services and the increase in prices of fuel products and fresh products. The core inflation rate was 1.4% down from 1.5% in January.

Italy

The economy is back in recession, as the eurozone crisis austerity measures start to bite. Real GDP declined 0.7% in Q4, after falling 0.2% in the previous quarter. This reflected weak domestic demand. The only expenditure component that supported GDP growth was overseas demand. Private consumption declined 0.4% in Q4 after rising 0.1% in the previous quarter. Investment decreased 3.8% following −2.0% in Q3. Public spending dropped 0.9% after −0.3% and −0.6% in Q2 and Q3, respectively. In total domestic demand excluding stocks declined 1.2% in Q4, after falling 0.4% in Q3. Change in inventories subtracted 1.5 percentage points from GDP growth. Net trade contributed positively to GDP growth as exports rose (1.3% in Q4 after 5.7% in Q3) and imports fell (−6.1% in Q4 compared with −0.9% in Q3).

Industrial activity declined. Production fell 2.1% in Q4 after −0.4% in the previous quarter. The decline was general across industrial sectors. The outlook is for further gloom. The consumer confidence index was at 91.6 in January, unchanged from December. It was the lowest since January 1996. Business confidence declined to 91.5 in February from 92.1 in January.

Germany: Annual Growth Rates of Real GNP and Consumer Prices

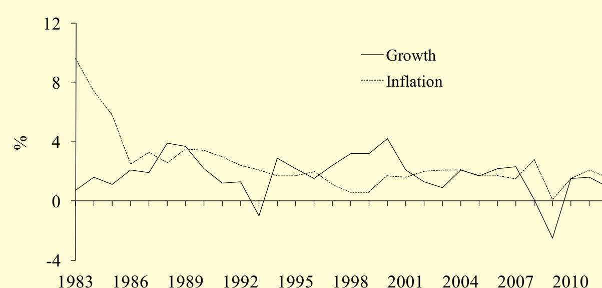


Germany

	2007	2008	2009	2010	2011	2012
Real GDP Growth (% p.a.)	2.7	1.0	−4.7	3.6	2.9	1.1
Inflation (% p.a.)	2.3	2.6	0.4	1.1	2.3	1.8
Nominal Short Int. Rate	3.9	3.9	0.7	0.4	1.5	2.5
Real Short Int. Rate	1.3	3.5	−0.4	−1.3	−0.3	0.5
Nominal Long Int. Rate	4.3	4.4	4.0	3.8	3.8	4.0
Real Long Int. Rate	2.8	3.0	2.3	1.9	1.8	2.0
Real Ex. Rate (1996=100)[1]	104.6	105.1	105.8	99.3	99.0	99.1
Nominal Ex. Rate[2]	0.73	0.68	0.72	0.75	0.78	0.78

[1]The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation of the real exchange rate.

France: Annual Growth Rates of Real GNP and Consumer Prices



France

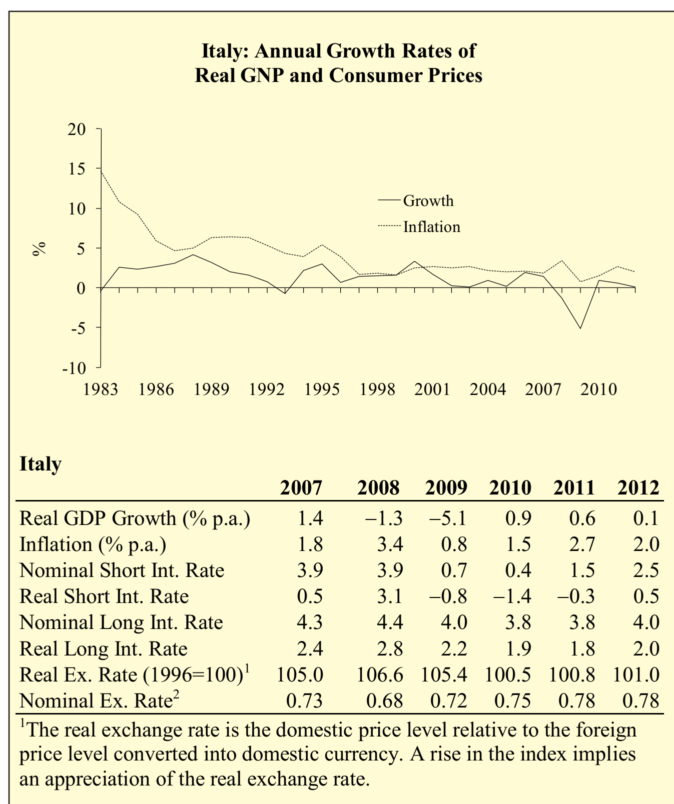
	2007	2008	2009	2010	2011	2012
Real GDP Growth (% p.a.)	2.3	0.1	−2.5	1.5	1.6	1.0
Inflation (% p.a.)	1.5	2.8	0.1	1.5	2.1	1.6
Nominal Short Int. Rate	3.9	3.9	0.7	0.4	1.5	2.5
Real Short Int. Rate	1.1	3.8	−0.8	−1.4	−0.3	0.5
Nominal Long Int. Rate	4.3	4.4	4.0	3.8	3.8	4.0
Real Long Int. Rate	2.7	3.0	2.2	1.9	1.8	2.0
Real Ex. Rate (1996=100)[1]	104.9	106.4	104.3	101.7	102.0	102.0
Nominal Ex. Rate[2]	0.73	0.68	0.72	0.75	0.78	0.78

[1]The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation of the real exchange rate.

Euro–zone monetary developments

The Harmonised Index of Consumer Prices (HCIP) inflation rate was 2.7% in January, unchanged from December. It reflected higher energy and other commodity prices. The Governing Council of the ECB expects the inflation rate to remain above 2% for some months, before returning to below 2%. This expected pattern is based on the weak euro zone and global economic outlook. At the meeting of the Governing Council on the 9th February, the key policy rate was unchanged.

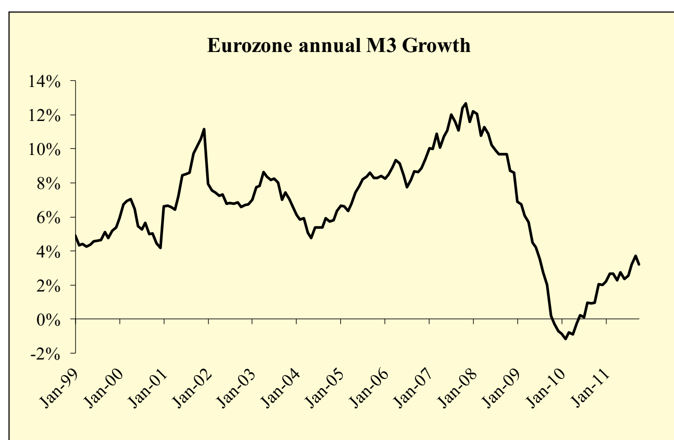
Broad money (M3) growth year-on-year decreased to 1.6% in December from 2.0% in November. The year-on-year growth rate of loans to the private sector declined in December to 1.2% from 1.9% in November. The eurozone banking system suffered from a liquidity drought over the year end as banks refused to lend to each other and overseas banks refused to lend to eurozone banks; this was dealt with robustly by the ECB which lent the eurozone banks €1 trillion for three years. This boost to bank liquidity also brought down yields on the sovereign bonds of the PIIGS, as the banks were encouraged to park their new-found liquidity in this sovereign bond market. The EC under Mario Draghi thus sought to calm two crises in one move; so far this strategy has worked. However, there must be a limit to how much the ECB can expand its balance sheet, as both German politicians and the Bundesbank have expressed concern at the size of Germany's contingent liabilities arising from such expansion.



Italy

	2007	2008	2009	2010	2011	2012
Real GDP Growth (% p.a.)	1.4	−1.3	−5.1	0.9	0.6	0.1
Inflation (% p.a.)	1.8	3.4	0.8	1.5	2.7	2.0
Nominal Short Int. Rate	3.9	3.9	0.7	0.4	1.5	2.5
Real Short Int. Rate	0.5	3.1	−0.8	−1.4	−0.3	0.5
Nominal Long Int. Rate	4.3	4.4	4.0	3.8	3.8	4.0
Real Long Int. Rate	2.4	2.8	2.2	1.9	1.8	2.0
Real Ex. Rate (1996=100)[1]	105.0	106.6	105.4	100.5	100.8	101.0
Nominal Ex. Rate[2]	0.73	0.68	0.72	0.75	0.78	0.78

[1]The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation of the real exchange rate.



WORLD FORECAST DETAIL

Growth Of Real GNP

	2007	2008	2009	2010	2011	2012
U.S.A.	1.9	0.0	–2.6	2.6	1.9	2.5
U.K.	3.5	–1.1	–4.3	1.8	1.0	1.4
Japan	2.3	–1.2	–6.3	4.3	–0.4	2.1
Germany	2.7	1.0	–4.7	3.6	2.9	1.1
France	2.3	0.1	–2.5	1.5	1.6	1.0
Italy	1.4	–1.3	–5.1	0.9	0.6	0.1

Real Short–Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	0.6	1.8	–1.6	–1.8	–1.7	–1.5
U.K.	2.9	3.7	–3.1	–3.8	–2.2	0.1
Japan	–0.8	1.8	1.1	0.5	0.4	0.3
Germany	1.3	3.5	–0.4	–1.3	–0.3	0.5
France	1.1	3.8	–0.8	–1.4	–0.3	0.5
Italy	0.5	3.1	–0.8	–1.4	–0.3	0.5

Real Long–Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	2.8	2.2	1.3	1.1	1.2	2.0
U.K.	2.3	1.0	–0.3	–0.5	0.1	0.7
Japan	2.0	2.0	1.4	1.1	1.1	1.3
Germany	2.8	3.0	2.3	1.9	1.8	2.0
France	2.7	3.0	2.2	1.9	1.8	2.0
Italy	2.4	2.8	2.2	1.9	1.8	2.0

Index Of Real Exchange Rate(2000=100)[1]

	2007	2008	2009	2010	2011	2012
U.S.A.	83.4	80.1	88.7	81.7	81.8	82.0
U.K.	98.9	87.6	78.2	79.7	82.5	83.7
Japan	81.2	87.9	89.0	80.2	79.8	79.7
Germany	104.6	105.1	105.8	99.3	99.0	99.1
France	104.9	106.4	104.3	101.7	102.0	102.0
Italy	105.0	106.6	105.4	100.5	100.8	101.0

[1] The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation in the real exchange rate.

Growth Of Consumer Prices

	2007	2008	2009	2010	2011	2012
U.S.A.	2.9	3.8	–0.3	1.8	2.9	2.0
U.K.	2.5	3.3	1.3	3.9	4.4	3.2
Japan	0.0	1.4	–1.4	–1.0	–0.3	–0.2
Germany	2.3	2.6	0.4	1.1	2.3	1.8
France	1.5	2.8	0.1	1.5	2.1	1.6
Italy	1.8	3.4	0.8	1.5	2.7	2.0

Nominal Short–Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	4.4	1.5	0.2	0.1	0.3	0.5
U.K.	5.9	5.1	0.8	0.6	1.0	2.3
Japan	0.6	0.4	0.1	0.1	0.4	0.4
Germany	3.9	3.9	0.7	0.4	1.5	2.5
France	3.9	3.9	0.7	0.4	1.5	2.5
Italy	3.9	3.9	0.7	0.4	1.5	2.5

Nominal Long–Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	4.6	3.7	3.2	3.1	3.2	4.0
U.K.	5.0	4.0	2.8	2.3	2.4	2.7
Japan	1.7	1.5	1.3	1.1	1.2	1.5
Germany	4.3	4.4	4.0	3.8	3.8	4.0
France	4.3	4.4	4.0	3.8	3.8	4.0
Italy	4.3	4.4	4.0	3.8	3.8	4.0

Nominal Exchange Rate
(Number of Units of Local Currency To $1)

	2007	2008	2009	2010	2011	2012
U.S.A.[1]	89.38	81.72	81.61	82.12	83.97	83.94
U.K.	2.00	1.85	1.57	1.55	1.61	1.58
Japan	117.75	103.40	93.56	87.76	87.10	87.00
Eurozone	0.73	0.68	0.72	0.75	0.78	0.78

[1] The series for the USA is a trade weighted index (1990=100); the series for the UK is $ per £

* Forecasts based on the Liverpool World Model

THE HUNGARIAN CRISIS

Akos Valentinyi[1]

Hungary was the frontrunner of market reforms among the former socialist countries in Central-Eastern Europe. It gradually liberalised its economy in the 1980s. At the beginning of the 1990s, it seemed to be in the best position to converge fast to the European Union both in terms of income level and institutional quality. However, convergence has stalled since 2005. The expansive fiscal policy and the build-up of a large external debt prior to the worldwide economic crisis in 2008 made Hungary one of the most financially vulnerable countries in Europe. Moreover, recent policy measures aiming to improve the fiscal balance and the household financial position have undermined rather than strengthened the security of property rights and that of private contracts. By the end of 2011 Hungary was yet again financially vulnerable and asking the IMF for help.

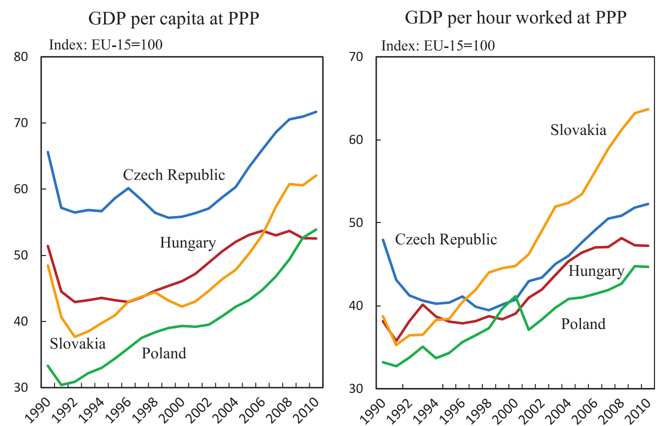
Growth performance

Hungary showed relatively rapid growth in terms of GDP per capita between 1995 and 2004. During this period Hungary was keeping up with its Visegrad peers (the Visegrad Group is an alliance of four Central-Eastern European states: the Czech Republic, Hungary, Poland and Slovakia, formed in 1991 for the purposes of cooperation and to support their European integration.) and it was converging to the old EU countries in terms of GDP per capita. However, since 2005 it has been growing more slowly than its peers and it no longer appears to be converging to the old EU countries. Breaking down the Hungarian growth into the contributions from various factors reveals that its total factor productivity (TFP) has been growing at a relatively slow pace since 1995. Only the faster capital accumulation and the increasing number of hours worked made the Hungarian growth comparably respectable. Unless TFP picks up, we expect Hungary to eventually diverge from the rest of Europe, as margins of convergence through hours worked and capital accumulation gets gradually exhausted. Weak investments in recent years suggest that this process has already started.

[1] This column is based on "The Hungarian Crisis" in The EEAG Report on the European Economy, CESifo, Munich

http://www.cesifo-group.de/portal/page/portal/ifoHome/B-politik/70eeagreport

Figure 1: Convergence to EU15



Source: Total Economy Database. The Conference Board 2011

Labour Market Trends

Labour market trends also suggest that Hungary is different from the other Visegrad countries. In particular, it has a comparatively low employment–population ratio. One of the key questions facing Hungarian policymakers is how to increase labour force participation. Higher employment would increase income in Hungary relative to the old EU member states for a given level of labour productivity. It would also increase the tax base and reduce government expenditure on benefits and pensions.

We discuss two policy instruments in this regard: taxes on labour and a minimum wage. We start with taxes on labour. Hungary's tax wedge, defined as the difference between the total labour cost to the firm and take-home pay as a fraction of the former, was on average the second-highest after Belgium over the period 2000 to 2008. The greater the wedge, the lower the take-home pay for a given total labour cost. Lower take-home wages reduce labour supply at the extensive margin, primarily for younger and older workers. In 2011 the wedge in Hungary declined thanks to the introduction of a 16% flat income tax rate, but it will rise again in 2012 due to the increase in labour-related taxes levied on firms. Evidence suggests that the transfer system or increasing take-home wages are likely to have a significant effect on labour supply at the extensive margin, and hence on participation (see Benczúr et al. (2011)).

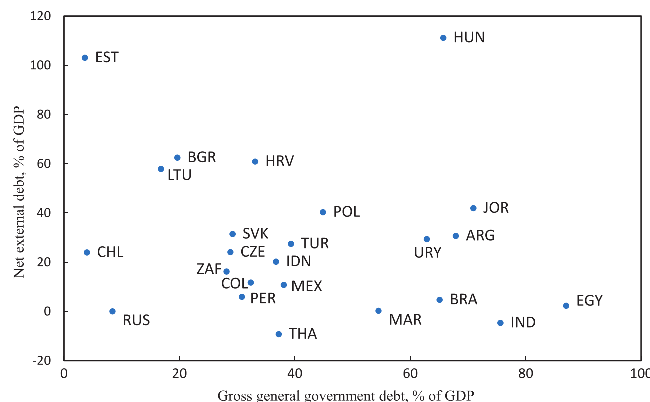
The effect of a minimum wage on labour supply is non-standard in Hungary, as it is in several other Central and Eastern European countries (see Tonin (2011)). The reason for this is that in these countries the minimum wage

interacts with tax evasion. Firms and workers may decide to under-report workers' earnings to avoid taxes and social security contributions. In this case, workers receive cash-in-hand wages in addition to their reported wages. Minimum-wage legislation affects the decision about how much of workers' earnings could be reported, i.e. firms have to report at least the minimum wage. In this case an increase in the minimum wage is equivalent to an increase in labour income tax. This is because a rise in minimum wage increases the fraction of workers' earnings that has to be reported, and hence increases the proportion of these earnings subject to taxation and social security contributions. The evidence suggests take-home wages decline in response due to the minimum wage hike for those workers earning the minimum wage, whose numbers tend to be disproportionately high when the minimum wage interacts with tax evasion. This has a negative effect on labour supply, and on participation (see also Kertesi and Köllő (2002)).

Fiscal Policy

Unlike its peers, Hungary has been under the excess deficit procedure of the European Commission ever since it joined the European Union in 2004. Between 2002 and 2010, the deficit of the general government has either exceeded or been close to 5% of GDP. In addition, fiscal policy is characterised by a strong election cycle, which was only broken by the financial crises in the run-up to the 2010 election. This policy often led to rapid debt accumulation followed by a large fiscal correction, before starting over again. These developments clearly indicate that the Hungarian fiscal institutions are weak. To strengthen the fiscal framework, Hungary set up an independent fiscal council with its own staff to provide forecasts and monitor detailed fiscal expenditures in a transparent way in 2008 (see Calmfors and Wren-Lewis (2011) about the role of fiscal councils). However, when this council was critical of the government's 2011 budget proposal, it was replaced by a three-member panel whose remit is merely to express their broad opinion about the budget bill. In addition, a limit on public debt is now also enshrined in the constitution. Without independent forecasts, analyses of fiscal policy and fiscal transparency, it is unlikely that the new institutional arrangements will eliminate the election cycle and ensure that fiscal policy becomes sustainable. The announcement by the European Commission on 22 February 2012 that it proposes to suspend €495 million of Cohesion Fund for Hungary for 2013 for failure to address excessive deficit, signals that the fiscal policy in Hungary is still viewed as unsustainable.

Figure 2: Public Debt and External Debt in Emerging Markets, 2007



Note: Net external debt = gross external debt – international reserves including gold.
Source: Quarterly External Debt Database at the World Bank, last accessed on 19 October 2011
World Development Indicators, September 2011

Financial Crises and Recent Policy Measures

At the end of 2007 most emerging economies either had high external debt or high government debt. Hungary was the only country with both high external and high government debt. This made Hungary financially very vulnerable. As the 2008 financial crisis hit, Hungary was the first to ask for IMF assistance.

Its past fiscal behaviour explains why public debt was high. One of the main factors driving external debt has been that Hungarian banks borrowed heavily internationally prior to 2008 and offered loans denominated in foreign currency both to households and firms. Borrowing in foreign currency meant a build-up of a large unhedged foreign liability position in the balance sheet of households and firms (see Ranciere, Tornell and Vamvakidis (2010) about the foreign currency loans in general, and Csajbók, Hudecz and Tamási (2010) about Hungary in particular). These liabilities were largely denominated in Swiss francs and, to a lesser extent, in euros. Between September 2008 and March 2009, the Hungarian currency depreciated by 26 and 33% *vis-à-vis* the euro and the Swiss franc respectively. By November 2011, the depreciation *vis-à-vis* the Swiss franc reached 66% relative to September 2008. That has put a lot of strain on many balance sheets.

The Hungarian government aimed to solve the problems of the foreign currency loans. In particular, legislation passed in September 2011 unilaterally changed the terms of all foreign currency loan contracts by allowing debtors to make a one-off repayment of their loans at a discounted exchange rate. The costs of this scheme are to be born entirely by the banks. In mid-December 2011 the

government and the banks agreed on additional arrangements to ease the problems of foreign currency debtors. The cost of these new arrangements was shared between the government and the banks. These arrangements have worsened the banks' capital requirements, which are adjusting to this, among others, by reducing their balance sheet. This implies slow or even negative credit growth in the near future, which has a negative impact on growth.

Hungary's centre-right government, which won a two-thirds majority in the parliament in spring 2010, has embarked on a series of unconventional economic policies. It has introduced taxes on financial institutions, which are an order of magnitude higher than similar taxes being discussed in Europe. It has levied crisis taxes only on sectors dominated by foreign-owned firms. It has introduced a 16% flat rate for personal income tax while raising other taxes on labour, and nationalised private pensions to plug the hole in fiscal revenues created by the flat tax. It has unilaterally changed the private loan contracts between banks and households to ease the strain on households' balance sheets caused by borrowing in foreign currency before the crisis and by the large depreciation of the Hungarian currency since then. These measures have on the one hand introduced new distortions across sectors, and on the other undermined such fundamental institutions as private contracts and property rights. Such measures are unlikely to be conducive to long-term growth.

Lessons from the Hungarian crisis

Firstly, the Excess Deficit Procedure of the European Union was unable to enforce fiscal discipline in Hungary or in other EU member states. The Hungarian crisis indicates that an independent national fiscal watchdog may be an important component of an effective fiscal framework. Such a watchdog could have acted as an effective constraint on fiscal policy in the case of Hungary. If it had not, the Hungarian government would not have abolished it after it criticised the government's budget for over-optimistic assumptions and a lack of transparency.

Secondly, the absence of labour market rigidities does not necessarily ensure good labour market outcomes. Recurrent fiscal problems keep taxes on labour high, which ultimately make take-home wages low. This can have a negative effect on labour supply, and eventually on labour force participation. Minimum wage legislation interacting with tax evasion can have similar effects.

Thirdly, a financial crisis and a perilous fiscal position often lead to government policies that are not conducive to long-term growth. The Hungarian government introduced exceptional taxes on the financial sector, and imposed significant costs on the banks with its policy concerning foreign currency loans. In addition, the Hungarian government also introduced other measures that undermined property rights and private contracts. These measures will likely exert a negative impact on economic growth in Hungary both in the short and in the longer run.

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Notes

Notes

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The Institute embraces the original Liverpool Research Group in Macroeconomics, which is now based at Cardiff Business School and is pursuing a research programme involving the estimation and use of macroeconomic models for forecasting and policy analysis. It is grateful for financial support to the Jane Hodge Foundation, the Economic and Social Research Council, Esmee Fairbairn Charitable Trust, the Wincott Foundation and Cardiff Business School.

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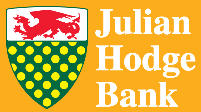

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