Cardiff Business School
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Foreword

As Wimbledon fortnight gets underway many people will be casting their minds back to a glorious summer afternoon last year when Andy Murray become the first UK winner of the men's singles tournament for 76 years. I am not suggesting that tennis results be used as an economic barometer but the good weather and sports induced feel good factor did appear to coincide with an uptick in business confidence and activity.

In the twelve months since then virtually all mainstream indicators for the UK economy have shown demonstrable improvement and the broad narrative of economic news has switched from debates on double versus triple recession, to opining on whether the subsequent recovery qualifies as a boom. Commentators, as ever, approach the subject from a broad range of perspectives and put forward some convincing case for both sides of the argument. This debate is not theoretical or arcane as it has a direct impact on that feature most central to businesses and consumers – interest rates.

It is difficult to read a UK newspaper at present without being subjected to a barrage of views on if, when and by how much the Monetary Policy Committee should raise its base rate and the likely peak of the next rate cycle. Additional to this is the debate about how effective the Bank of England forward guidance policy has been, the extent to which it remains credible and whether interest rates themselves, or the much vaunted macro prudential tools, are the answer to avoiding a future, housing led, boom and bust cycle.

Whatever one's personal views on these questions of timing and scale of rises, the inescapable conclusion is that rates must at some point increase from the current level. This will be welcome news for savers who have seen the real value of their savings eroded over the last five years, and will be grudgingly accepted by borrowers.

Whether the first rate rise now falls in 2014 rather than 2015 and whether it is 0.25% or a slightly higher or lower percentage, we should not lose sight of the fact that its is a small increase from a longstanding historical low point. It is really only the fact that the rate could move at all that makes it so newsworthy as its practical significance should be very limited for most existing borrowers. It would be a high risk and inappropriate debt structure that would be compromised by a 0.25% rise from a 0.5% base. Potential new borrowers, particularly for house mortgages, have been exposed to months of media coverage of likely rate raises and tightening income multiples from mortgage lenders etc which can influence behaviour without the authorities having to take actual action.

On the commercial lending side we find that most potential investor and developer clients are fully aware of the impact of potential interest rate rises when they are seeking to enter into a long term financial commitment. There are a range of potential protections available, with fixed rates becoming more popular, though there is still some reticence over the use of derivative hedging products. However, one of the most effective hedging strategies is to ensure that potential interest rates can be accommodated by the proposed capital and debt structure of a new deal so that sensible leverage prevails. It is incumbent upon both lenders and borrowers not to forget this basic fact and thereby ensure that the next rate cycle does not result in needless and entirely foreseeable problems.

Kevin Beevers
Commercial Lending Director
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The UK's growth prospects are brightening, with housing and consumer demand taking the lead. This was kick-started by easing the credit-regulation backlash via the Funding for Lending and Help to Buy schemes. However, instead of welcoming this success, the regulative and policy establishment is now wringing its hands and talking about introducing further, counteractive regulation on housing finance. This would be a mistake, as well as leading to evasion and distortions. Instead monetary policy should return to a somewhat tighter normality.

The 'earthquake' widely anticipated from the UK local and European elections has now occurred. Voters have given notice to the metropolitan elite that they are fed up with their 3-party conspiracy to foist mass immigration and a failing EU membership upon them. No doubt the euro-zone and the EU will shrug off the EU-wide rise of Eurosceptic parties, in federalist business as usual; perhaps a few sops of power will be given back to nation states but it is hard to see that the EU has a reverse gear. However in the UK it is difficult to see any alternative but either a fundamental separating renegotiation or a total rupture between the UK and the EU. The brutal syllogism now dominating UK politics is that immigration must be brought under much lower limits; membership of the EU makes this impossible; therefore the UK must leave the EU.

In the short run this will create economic uncertainty as a business community comfortable in the embrace of Brussels protectionism comes to terms with the move to free trade outside the EU customs union. Further uncertainty attends the question of economic policy under a possible future Miliband government apparently determined to stamp on free markets; but as yet the political odds on that are hard to assess.

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Patrick Minford looks back on the legacy left by the late Margaret Thatcher.

"As a member of the Heath government Mrs Thatcher watched in helpless frustration as the policies failed. She and Sir Keith Joseph decided in opposition to fight for new ones."

Patrick Minford, Economic Adviser to Julian Hodge Bank

THE ECONOMY, THE HOUSING MARKET AND THE NEW POLITICS

The housing market is now recovering strongly; at the same time the economy is also moving into relatively strong growth close to the 3% per annum mark. It is the relaxation of credit conditions brought about by Funding for Lending and Help to Buy that have pushed up the housing market; previously it was frozen by the blocking of the credit channel. It is now a key part of the general UK recovery and coalition politicians will interfere with it at their peril. In this Bulletin we focus particularly on housing as it is so central to the current economic situation.

Yet already cries are being heard from various quarters that there is an uncontrollable 'housing boom'. This is far from the case when one considers how far the market has fallen. It is more a correction than a boom, as one can see from the charts of real house prices below. Even London is only just back to where it was before the crisis. Much of the comment on housing is subject to 'money illusion'— that is, people do not correct for the general rise in consumer prices in evaluating the housing market. Once this correction is made as in our charts, one can see that nationally prices are still well below their previous peaks, between 20 and 40% below depending on the region.

The Bank of England is speaking about housing 'overheating' with a forked tongue. On the one hand there is the Monetary Policy Committee with Governor Carney leading it arguing for continuing monetary ease; this dovish attitude sits uneasily with the strong growth we are seeing in both the economy and housing. On the other hand the prudential regulators are flexing their muscles suggesting they will intervene with special measures on such things as mortgage affordability, via 'caps' of one sort or another. The latter will cause market distortions and ultimately be evaded by the usual market processes. It would be far better to tackle monetary overheating directly by tightening monetary conditions towards normality: they are just abnormally loose at present, given the signs that the excessively draconian bank regulation is being sidestepped increasingly by the government's special measures and the growing internet lending presence.

How vulnerable is the recovery? Until recently exports and investment have been weak; the first related to the euro-zone's continued weakness, the second reflecting uncertainty about recovery. Both may now be giving way to better things: the euro-zone is at last pulling off the bottom. Business surveys suggest that firms are feeling the need to invest as the recovery proceeds. In short the recovery looks sustainable. Furthermore with an election looming the coalition is going to take no risks with any dampening down of the housing market,

In particular real house prices (i.e. after inflation) nationally will recover from their below-trend position gradually over the next few years; we do not foresee a massive boom in prices but rather a steady but unexciting recovery. Much the same is true of UK regions generally — the main exceptions are the London, Northern Irish and Scottish markets which are affected by strong particular factors — London by the strong expansion of City business services, N Ireland by the travails of Ireland post-crisis, and Scotland by the unsettling bid for independence.

Table 3 shows that nationally there has been an improvement in house prices but on the two building society indices they still have not recovered in money terms to their pre-crisis peaks. Table 2 looks at the last three quarters money price rises and reveals that there has been a general recovery in all regions, a bit bigger than we forecast back in mid-2013.

Table 1: Summary of Forecast

	2010	2011	2012	2013	2014	2015	2016
GDP Growth[1]	1.7	1.1	0.2	1.7	2.8	2.7	2.6
Inflation CPI	3.3	4.5	2.7	2.4	2.0	2.2	2.0
RPIX	4.8	5.3	3.2	3.2	2.5	2.8	2.7
Unemployment (Mill.)							
Ann. Avg.[2]	1.5	1.5	1.6	1.5	1.3	1.3	1.2
4th Qtr.	1.5	1.6	1.6	1.4	1.3	1.3	1.1
Exchange Rate[3]	80.4	80.0	83.1	82.6	83.0	82.3	82.5
3 Month Interest Rate	0.7	0.9	0.9	0.6	1.8	2.1	2.2
5 Year Interest Rate	2.4	2.0	0.9	1.2	1.6	2.1	2.3
Current Balance (£bn)	−40.0	−22.5	−59.2	−60.7	−62.9	−63.5	−62.0
PSBR (£bn)	139.6	118.5	115.0	112.3	109.4	94.6	84.5

[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 (2005 = 100)

Table 2: Forecast and Actual Nominal House Price Changes, 2013Q3–2014Q1

	2013Q3–2014Q1		Actual quarterly changes		
	Forecast	Actual	2013Q3	2013Q4	2014Q1
UK	3.62%	6.47%	2.17%	2.06%	2.11%
North	3.61%	3.40%	0.99%	-0.42%	2.82%
Yorks & Hside	2.65%	4.87%	3.26%	2.22%	-0.65%
North West	2.56%	4.45%	2.30%	1.11%	0.97%
East Mids	3.69%	5.17%	2.52%	0.71%	1.87%
West Mids	2.27%	4.37%	1.90%	1.94%	0.47%
East Anglia	4.00%	4.14%	1.60%	0.92%	1.57%
Outer S East	3.72%	7.62%	2.47%	2.84%	2.13%
London	5.32%	11.29%	3.55%	3.45%	3.89%
South West	3.10%	4.98%	1.32%	1.97%	1.60%
Wales	3.04%	4.86%	2.80%	1.86%	0.14%
Scotland	2.67%	2.80%	0.43%	1.14%	1.21%
N Ireland	4.25%	5.90%	0.51%	2.71%	2.58%

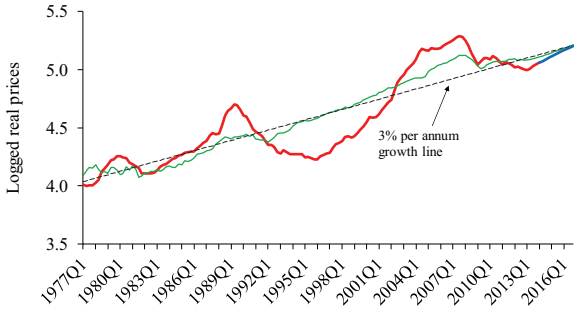
If we look ahead, the charts show the prospects to 2016, which are for a steady recovery, gathering speed through this year and next. They reveal that finally in the latest quarter house prices are overtaking inflation to recover towards their previous trend levels in real terms.

Table 3: Nominal UK House Price Indices (Index = 100 at highest level of series before recession.*)

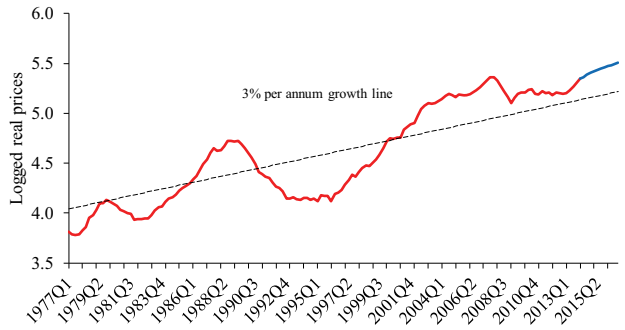
	Nationwide	LSL	Halifax
Mar 2013	88.5	100.9	81.5
Apr 2013	89.0	101.1	83.1
May 2013	90.3	101.1	83.5
Jun 2013	90.8	101.1	84.6
Jul 2013	91.8	101.5	85.5
Aug 2013	91.7	102.2	84.6
Sep 2013	92.5	102.8	85.0
Oct 2013	93.4	103.4	85.8
Nov 2013	93.8	103.8	86.9
Dec 2013	94.5	104.7	85.1
Jan 2014	94.9	105.9	86.1
Feb 2014	95.6	107.1	88.7
Mar 2014	96.9	108.2	88.4

* Nationwide House Price Index peaked at £186,044 in October 2007, LSL Property Services/Acadametrics House Price Comparison Index at £242,485 in February 2008 and Halifax House Price Index at £201,081 in August 2007.

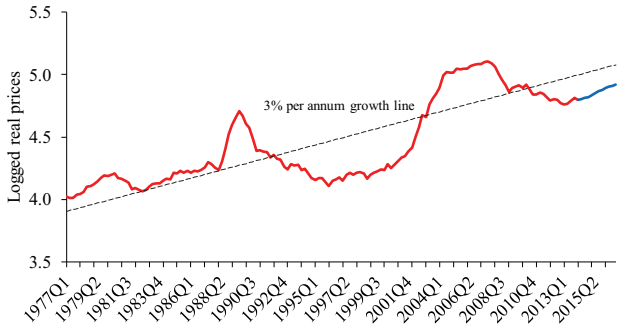
UK Real House Prices, Forecast and Underlying



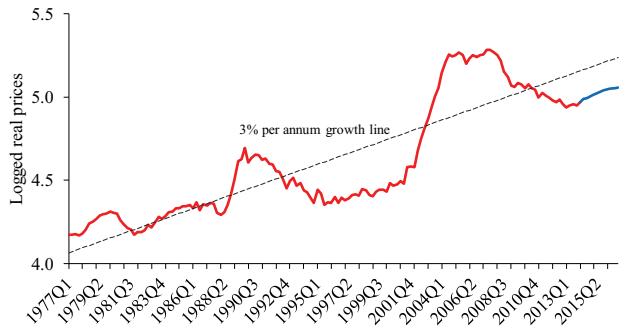
Greater London: Real House Prices



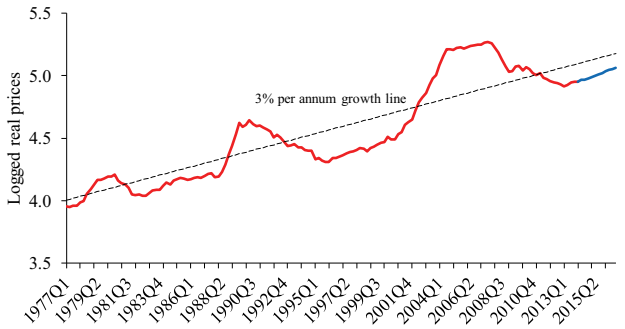
Yorkshire and Humberside: Real House Prices



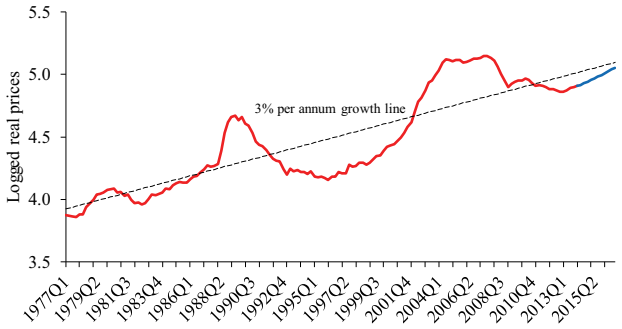
North: Real House Prices



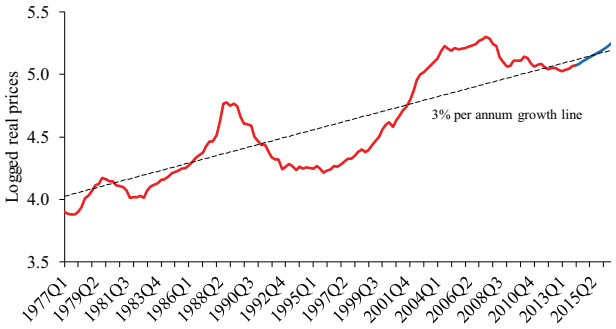
North West: Real House Prices



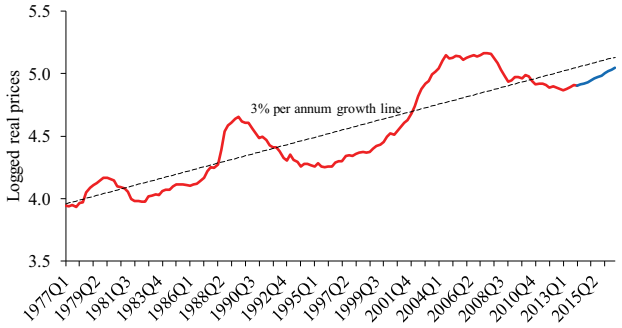
East Midlands: Real House Prices



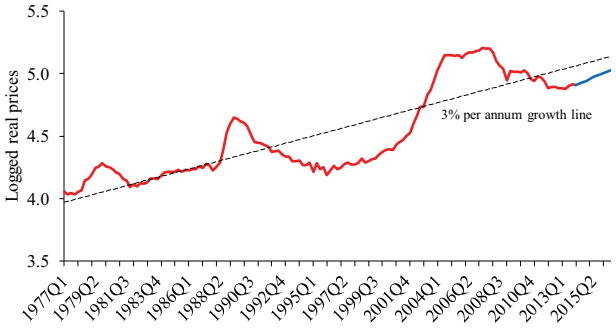
South West: Real House Prices



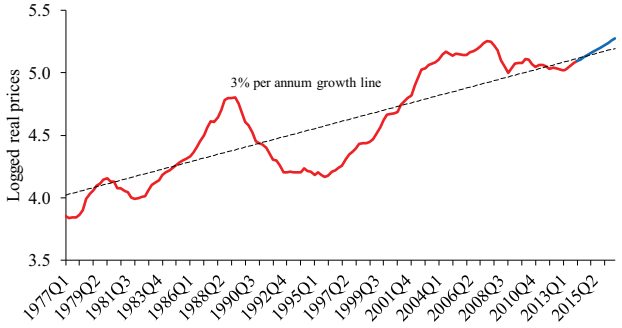
West Midlands: Real House Prices



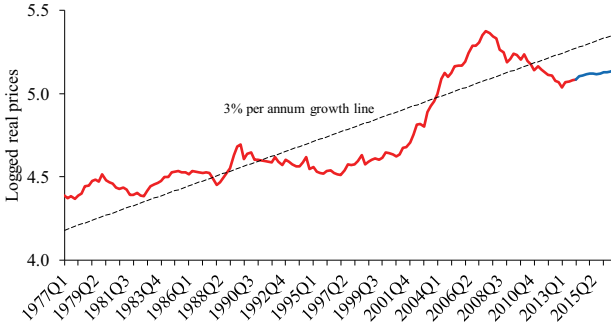
Wales: Real House Prices



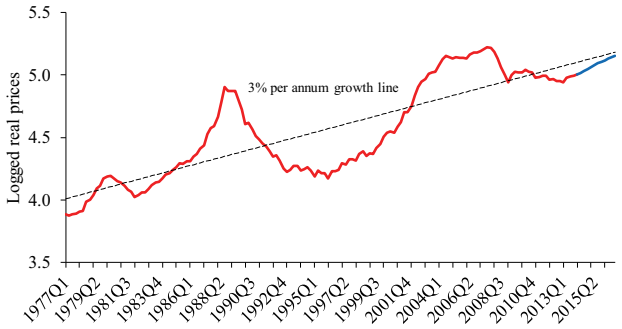
Rest of South East: Real House Prices



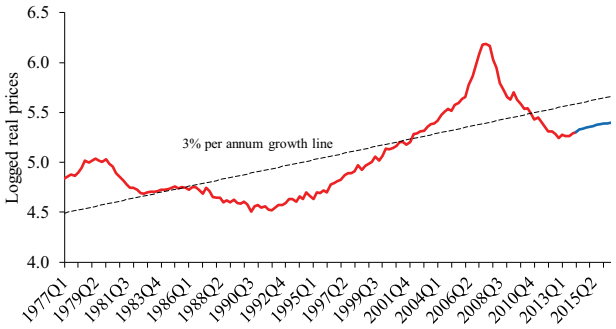
Scotland: Real House Prices



East Anglia: Real House Prices



Northern Ireland: Real House Prices



Time to tighten

The latest data is supporting a UK forecast for 2014 of around 3% growth. Services are growing strongly, business investment is kicking in, and even exports are beginning to look stronger. The housing market boom has triggered tututting noises from the Financial Policy Committee. The current account of the balance of payments has gone to a deficit of over 5% of GDP.

None of this is a reason for embarking on heavy monetary restraint. The current account deficit is partly related to a drop in returns on foreign investments, related to sell-offs in emerging market stocks during the recent 'Fed taper' furore. Anyway measurement of invisible net exports is notoriously unreliable. Real house prices are still well below their past peaks.

The point really is that the data suggest it is time to move away from massive and unprecedented monetary ease. It would be pathetic if the Bank, out of fear of a 'renormalising' of monetary conditions, turned instead to direct controls on house lending for example — which is now being broadly hinted at. We know that such controls distort the market and are liable to be ineffective because of market ingenuities — when money is plentiful it finds its way into many channels.

About the only reason left for not tightening money somewhat in the direction of 'normal' is that bank lending is still being weighed down by the regulative backlash from Whitehall and the international community led by Basel. Yet we know that large corporations are deliberately reducing their take-up of bank loans on grounds of expense. SMEs are another matter but here too there are the stirrings of revolution: 'peer-to-peer lending' is growing rapidly as it becomes better organised and more familiar. SME needs are now high on the political radar and may well get the same Osborne treatment as housing did with Help to Buy. As so often markets are undermining regulation, in this case by bypassing the banking system, in the process building up a 'shadow banking system' in the west, to rival the one in China.

Critical as we have been of the bank regulative backlash, in common with many colleagues on the Shadow Monetary Policy Committee, we do not feel that we can any more use it as a reason for holding back on moving monetary conditions back towards normal. The Bank's ideas on forward guidance, which amount to a desire to keep money as loose as possible for as long as possible, have been a recipe for monetary disaster in past historical episodes. They are the classic cliché of too little too late in tightening that marked so many episodes back in the 1960s and 1970s; each time a Keynesian central bank was reluctant to slow a recovery because it got too close to its political masters, nervously longing for a recovery as strong as possible. Today's politicians and central bankers will scornfully reject any analogy with those highly inflationary periods. But they are foolish to do so, because at the start of the 1960s too there was no inflation to speak of. Our policies today remind one of the excesses of stimulation after the 1970s oil crisis against a 1960s background of low inflation.

Thus again we would suggest that we should move to a raising of Bank Rate, by 0.5% now because of past delays; followed by a bias to further small moves of 0.25% each in the following months. By the end of this year we would expect rates to be over 2%.

Turning to QE, it seems to us that the total Bank holding of gilts must be steadily reduced. There are two main reasons for this. The first is simple monetary arithmetic: bank reserves are excessively high and conducive to poor lending practices. As the recovery turns into boom, banks will be sucked in by these vast reserves. The second is political: too many commentators are attracted by the idea of 'consolidating' the Bank's holdings with the Treasury's debts, on the fiscal grounds that such a 'monetisation' tax would be harmless and reduce the pressure of debt on future spending and taxation. The longer this Bank holding lies around, apparently without dire consequences, the more traction this argument will gain. This directly parallels the arguments of the Weimar politicians before the great hyper-inflation that engulfed them. It is essential in our view that this holding be got rid of fairly fast now to stall such a frightening set of possibilities.

How durable is the recovery?

It has become a cliché of recent commentary to remark that the UK's recovery has been weak, compared with the past and with other economies. We also see that there is a 'productivity puzzle'— productivity has fallen and may still only be weakly rising.

Of course the question is why? The UK economy before the crisis had had strong productivity growth since around 1982. Furthermore it has enjoyed- not really the right word- gruelling supply-side reform more or less continuously since 1979. There has been some recidivism under Labour's tenure between 1997 and 2010 but as many have said, Blair and Brown were in many ways Thatcher's children and the reversals put in place mainly were at the margin — e.g. some slight restoration of union protections, and the establishment of a minimum wage. However the recent evidence from the labour market has confirmed that the UK has considerable wage flexibility, both nominal and real, and that union power is weak even in the public sector. Whether minimum wages are binding on demand for lower-paid labour remains a concern; but it seems that zero hour contracts and part-time work in practice produce a lot of flexibility even at this lower stratum of the market.

Our own view of the current situation is that it is the product of four major shocks:

1. a massive run-up in commodity prices that battered living standards

2. the North Sea, where UK policy attempted excessive and 'time-inconsistent' (ie like Oliver they kept on coming back for more) extraction of revenue

3. bank regulation in response to the crisis; this has hit the banking sector

4. the collapse of the European market for UK manufacturing

All these are familiar points. But as David Smith has noted in the Sunday Times, they account for the fall in productivity and also the strength of employment as due to a shift of UK output composition: the sectors hit hardest were all high-productivity sectors while the service sector which has managed to recover most has absorbed many low-productivity workers.

The middle two factors (oil and bank regulation) were self-inflicted by the Whitehall establishment and there are signs that George Osborne and the Treasury have now understood and are trying to reverse the damage. We have yet another rapprochement with the N Sea industry and we have Funding for Lending and Help to Buy — credit to mortgages is starting to flow. SMEs are still affected by the credit famine; M4 growth remains weak. But life is returning. QE seems to be having an impact via asset prices, private equity and the new fast-growing peer-to-peer lending. The biggest problem remains bank regulation; banks continue to shrink their balance sheets, effectively pulling against the monetary recovery.

Factors 1 and 4 (commodity prices and the euro-zone) are now also reversing. Commodity prices are coming off, under the impact of monetary tightening in emerging markets like China as well as resource productivity growth due to fracking etc. The euro-zone has also hit bottom and is recovering.

The recovery is therefore looking much stronger. What is more it does now include, after the latest ONS data revisions, a resumption of growth in business investment; even net exports are rising, if still weakly. Shadow Monetary Policy Committee members like Trevor Williams and Tim Congdon still stress potential weakness however and the need for monetary ease to stimulate credit and money growth; in this they are at one with Bank Governor Carney and his determination to keep money easy and rates low for the foreseeable future. They seem to have a good point in the sense that the money supply figures support their interpretation.

Our concern remains that the weakness of the money supply is distorted by bank regulation and is 'structural'; that is to say, that there is an artificial block on credit and money creation that is spawning money and asset substitution, while also raising the costs of particular industries and firms. SME businessmen say that the banks will never be trusted again by SMEs and that they are now looking to the new alternative channels of finance. At the same time the interest rate structure is heavily distorted by both regulation and the zero bound policy; this is illustrated by the massive gap that has opened up between rates on official paper and rates on lending to private corporations, particularly SMEs.

We may well be creating the conditions for an asset price boom while diverting this boom away from general credit and money. The recovery could be strong on the back of this boom while money growth remains weak. We are not there yet but we see no reason to delay in heading off such conditions.

Our policy recommendation remains to attack all these distortions as best we can. First, row back on bank regulation: we do not want to create a 'shadow banking sector' in the UK but we already are doing so. Elements of deregulation that would be realistic are to exclude smaller banks from the heavy regulation now binding on all banks; and to exempt SMEs from the Basel risk weightings for several years. Second, restore a normal interest rate structure by raising Bank Rate steadily. Third, operate on the money supply via open market operations (including QE); with the current distortions of the statistics it is hard to know exactly what to do with QE but the overhang looks threatening to us and we would reduce it while being willing to return to the open market as the statistics clarify.

Thus in sum we favour continuation of the special schemes to restore bank credit growth and encourage the banks back into activity; some deregulation aimed at smaller banks and SMEs; a rise in Bank Rate towards 'normality', with upward steps of 0.25% starting now; and a reduction of QE in steps of £25 billion per quarter starting now.

UK politics and implications for economic prospects

Politics is now beginning to impinge on economic prospects as the election is now only one year away. There are two main developments: the rise of UKIP and the threat of new Labour policies.

UKIP's rise can be dismissed as something that will not last into the general election. But this is a complacent reaction. UKIP are offering relief on one of the most pressing issues of the current time in the UK: immigration. Owing to Labour's free and easy approach to this in its government from 1997–2010, and before that the willingness of all three major parties to ignore popular protests against immigration, this issue has now acquired huge importance in the eyes of a large segment of popular opinion. This segment includes both Conservative and Labour voters — probably also Lib Dem voters. The issue also links to EU

membership because this makes control of EU immigration impossible. In brief the agenda of UKIP and their supporting voters on immigration is to put strong limits on immigration of unskilled workers and to permit relatively free immigration of workers for whom the UK has a skill shortage, as well as for 'kith and kin' who have been appallingly treated under the coalition's attempt to tighten inflows. The prospect of this issue being grasped by dint of voters switching to UKIP will act as a powerful magnet for support of UKIP. The EU issue is tightly bound up with it.

How will policy proposals from the other parties react to this? It seems that if they are to stem the flood of departing voters they will need to offer UKIP-style policies: limits on unskilled immigration from all countries and a flexible green card system for skilled workers and relatives. These policies are impossible within the EU and so a creeping commitment to leave the EU seems inevitable.

The business establishment is against leaving the EU, as one would expect because the EU is a protectionist organisation that benefits existing businesses — i.e. those that have expanded due to this protection. Businesses that would benefit from the withdrawal of protection and the consumers that would enjoy the lower world prices also resulting, these two groups either do not yet exist or are largely unaware of these potential benefits. Marshalling them in favour of the argument for leaving and free trade is politically difficult.

However business is powerless in the face of the strong political tide against immigration. So we will see a rise in business uncertainty which will hinder growth in the near and medium term until the new environment outside the EU has been set up and understood.

When institutions change, even if this is for the better, such transitional uncertainty is inevitable. Fortunately it comes against a rising tide of optimism about economic prospects and so should not prevent growth continuing, but merely slow it for a time.

What then of the second factor: Labour's prospects of power on an increasingly shrill anti-business and anti-free-market agenda. Present projections have Labour being the largest party after the general election so its policies must be taken seriously.

There are several points to be made. The first is that given the UKIP factor these projections are highly uncertain. Secondly, it is doubtful that the Lib Dems will do a coalition deal with Labour; even with a new leader, such as Vince Cable, Labour's populist anti-market agenda looks difficult for Lib Dems to swallow. The third point is that Labour's policies are internally inconsistent; thus Ed Miliband talks of market interventions as necessary but 'temporary' because as an economist he knows they make little sense. Therefore even if Labour gains power its policies will be muddled left-centre rather than 'hard left'.

All this adds to the short-term economic uncertainty. Investment plans will be delayed as a result. However growth should continue largely because consumers are confident again. Exports too will continue to recover as the euro-zone improves. Some investment will need to go ahead anyway.

Longer term the most important aspect of the economy is membership of the EU. If 'Brexit' goes ahead, it will represent the final completion of the free market agenda that was begun by Margaret Thatcher. The basic instincts of the UK majority are for free markets and a limited government with a mandate to support only the weak who really cannot manage. These instincts have been offended by an immigration free-for-all; and they have been overridden by EU policies brought in by social democratic continental governments, mostly supported by the EU Commission.

Adam Smith once remarked to a young aristocratic correspondent that 'there is much ruin in a nation'. He meant by this that nations can live through diffciult economic circumstances and emerge stronger at the end. The next few years in the UK will be full of economic uncertainty and a degree of 'ruin'. But within a decade the economy will be likely to be far stronger than it is today.

THE UK ECONOMY

Vo Phuong Mai Le

Economic growth maintained its strong pace in Q1. According to the Office for National Statistics output expanded 0.8% in Q1 following 0.7% in the previous quarter. On a year-on-year basis, real GDP increased 3.1%, the highest rate since Q4 2007. Data and survey suggests there will be solid growth in Q2 2014.

Industrial output increased 0.7% in Q1 after rising 0.5% in the previous quarter. Within the production industries, manufacturing showed the best growth rate. Its output rose 1.4% in Q1 compared to 0.6% in Q4. It is the strongest quarterly growth since Q2 2010. The Markit/CIPS survey also indicated an expansion in the sector: the index rose to 57.3 in April from 55.8 in March.

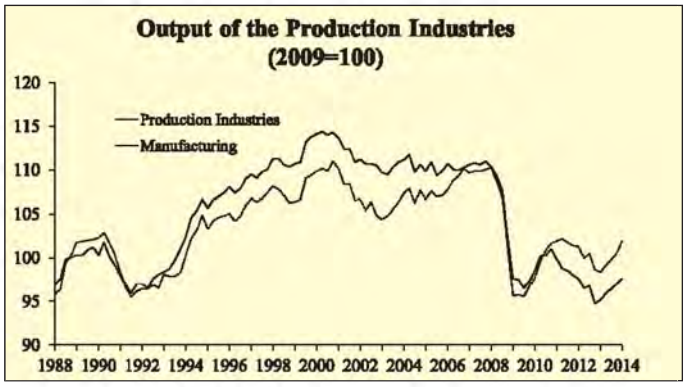
Service sector output increased 0.9% in Q1 after 0.8% in Q4, and contributed 0.7 percentage points to the Q1 growth. The Markit/CIPS survey of purchasing managers index shows a sign of further expansion. In April it was 58.7, up from 57.6 in March.

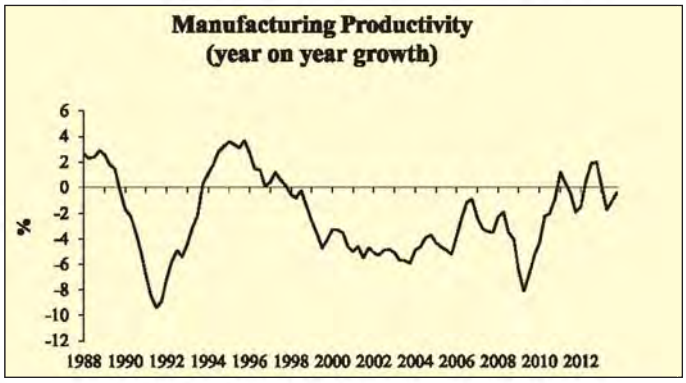
Construction industries grew 0.6% in Q1 after falling 0.2% in the previous quarter. According to the Markit/CIPS survey, construction sector activity continued to expand, but at a slower pace. The index decreased from 62.5 in March to 60.8 in April (above 50 mark means expansion).

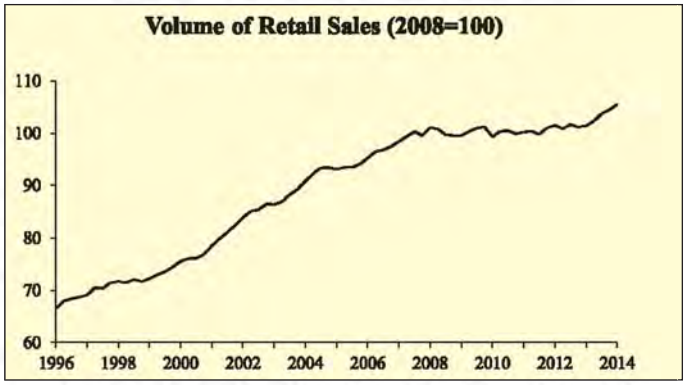
Hence in all three major output sectors the surveys and the data point to strong continuing expansion.

According to latest data on the breakdown of GDP, domestic expenditure components — private consumption, gross fixed capital formation and government final consumption — contributed positively to growth in Q1. Household final consumption increased 0.8% in Q1 after 0.4% in Q4, its tenth consecutive increase. Investment increased 2.2% in Q1 after falling 3.2% in Q4. Government consumption rose 0.1% from 0% in the previous quarter. Net trade had a positive contribution to GDP growth in Q1, as the reduction in imports (−1.1% in Q1 compared to −0.4% in Q4) overwhelmed the decrease in exports (−1.0% in Q1 compared to 2.8% in Q4).

The housing market improved further. Both Halifax and Nationwide house price indices were up on a year earlier by 8.5% and 10.9% respectively in April. As a result of the easing credit conditions, improvements in economic conditions and the government's Help to Buy Scheme, mortgage lending approvals for house purchase rose on average 71,000 a month in Q1 and are expected to reach around 85,000 by Q4 2014.

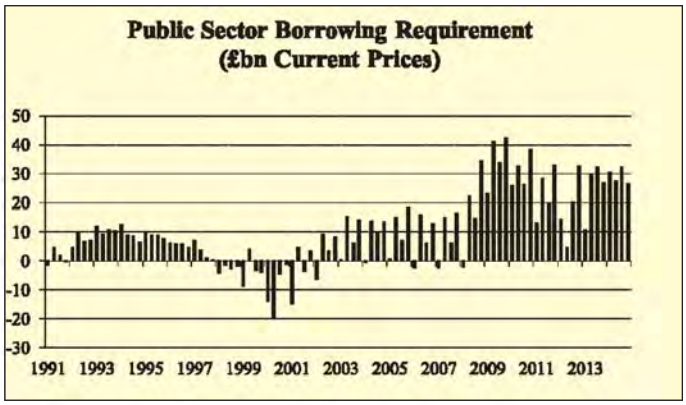


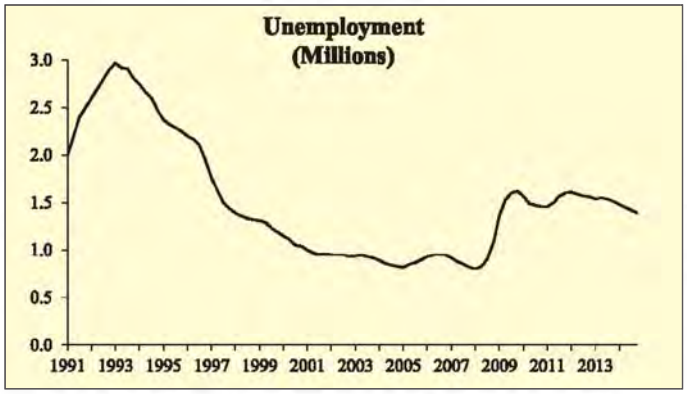


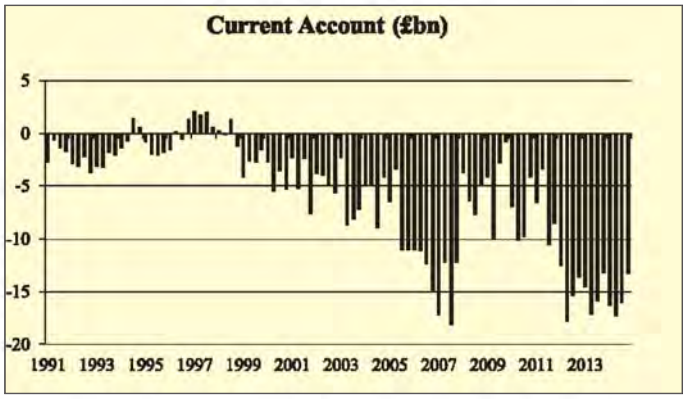


Cost and Prices

CPI year-on-year inflation edged up for the first time since July 2013 to 1.8% after 1.6% in March. The largest upward pressures came from transport costs. RPIJ grew by 1.8%, unchanged from the previous month. Despite this rise in inflation and the strong economic recovery, inflation pressures are contained due to spare capacity and recent currency appreciation. CPI inflation is expected to move nearer the 2% target over coming months. Annual factory gate inflation was 0.6% in April, compared with 0.5% in March. Input price inflation on a year earlier was −5.5% in April, compared with −6.3% in March.







Labour Market

The labour market continued to improve. Employment continued to rise and unemployment continued to fall. In the three months to March, the unemployment rate was at its lowest level since the beginning of 2009. It was 6.8%, down from 7.2% for the period of October to December 2014. During the same time, the employment rate was 72.7%, up by 0.6% from the previous quarter.

Trade

The current account was £22.4 billion in Q4 2013, down from £22.8 billion in Q3.The total trade deficit in goods and services narrowed to £5.7 billion in Q4 from £10.0 billion in Q3. The deficit on net income flows increased to £10.3 billion compared with £5.9 billion in Q3.

Monetary and fiscal developments

Notes and coins in circulation grew 3.4% in April on a year earlier, compared to 4.1% in March. The year-on-year growth rate of broad money — M4, excluding intermediate other financial corporations was up 3.7% in March, down from 3.9% in February. This reflects weak credit growth in spite of the large injection of money by Quantitative Easing (QE).

The Bank of England maintained its official lending rate at 0.5% and the stock of purchased assets at £375 billion (QE) at its May meeting, unchanged since March 2009. It noted that the economy performed well over the past year, the unemployment rate declined to its lowest point, inflation was below the target and there was still spare capacity. Thus, its current policy aims to keep inflation close to the target and at the same time to support the economic expansion. It says it will wait for a reduction in spare capacity before starting to raise the interest rate gradually. However, it is unclear how long it will maintain this attitude in the face of the strengthening growth outlook;

some members of the Monetary Policy Committee have said that they are considering an earlier rise in interest rates than is implied by this 'dovish' announced position.

In the fiscal year 2013/14 the public sector current budget — government income minus spending on current costs — was in deficit of £70.7 billion, compared to a deficit of £85.3 billion for the fiscal year 2012/2013. Public net borrowing excluding financial intervention was £95.2 billion, up by £14.5 billion from fiscal year 2012/13. At the end of April 2014, public sector net debt was £1270.8 billion, or 75.6% of GDP. This is compared to 74.2% of GDP at the end of April 2013.

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 Rate[3]	Real 3 Month Int. Rates %[4]	Inflation (RPIX)	Real Short Dated Rate of Interest[5]
2010	3.3	2.4	0.7	80.4	88.6	−3.5	4.8	−0.2
2011	4.5	2.0	0.9	80.0	89.8	−2.8	5.3	−0.2
2012	2.7	0.9	0.9	83.1	93.9	−1.8	3.2	−1.4
2013	2.4	1.2	0.6	81.4	92.5	−1.7	3.2	−1.0
2014	2.0	1.6	1.8	83.0	94.1	−1.1	2.5	−0.4
2015	2.2	2.0	2.1	82.3	95.4	0.1	2.8	0.1
2012:1	2.7	1.1	1.1	81.2	91.6	−1.9	3.8	−1.3
2012:2	3.1	0.9	1.1	83.1	94.2	−1.4	3.2	−1.4
2012:3	2.5	0.7	0.8	84.1	95.2	−1.8	2.9	−1.6
2012:4	2.5	0.8	0.6	83.6	94.8	−2.0	3.0	−1.5
2013:1	2.6	1.0	0.6	80.3	90.9	−1.7	3.3	−1.3
2013:2	2.3	1.0	0.6	80.6	92.6	−1.9	3.1	−1.3
2013:3	2.4	1.5	0.5	81.2	93.2	−1.5	3.2	−0.7
2013:4	2.5	1.5	0.7	83.5	93.2	−1.9	3.2	−0.7
2014:1	1.8	1.6	1.2	82.9	93.7	−0.9	2.5	−0.5
2014:2	2.0	1.6	1.6	82.8	94.0	−1.1	2.5	−0.4
2014:3	2.0	1.7	1.9	82.9	94.0	−1.2	2.5	−0.4
2014:4	2.1	1.7	2.2	83.4	94.6	−1.2	2.6	−0.3

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)
2010	227.1	2.4	4.6	1.50	135.6
2011	232.7	2.5	4.6	1.53	133.5
2012	237.0	1.9	4.7	1.59	132.4
2013	240.2	1.4	4.3	1.45	131.0
2014	246.3	1.6	3.9	1.33	131.1
2015	251.0	2.2	3.9	1.31	133.3
2012:1	236.6	0.7	4.8	1.61	132.6
2012:2	238.1	1.8	4.8	1.59	132.2
2012:3	238.1	1.9	4.7	1.57	132.9
2012:4	236.6	3.3	4.6	1.56	131.8
2013:1	238.2	0.6	4.5	1.54	130.1
2013:2	239.5	2.4	4.4	1.50	132.3
2013:3	240.6	0.8	4.1	1.39	130.8
2013:4	242.5	1.7	4.0	1.37	130.8
2014:1	243.6	3.1	4.0	1.36	130.7
2014:2	245.5	1.6	3.9	1.34	131.1
2014:3	247.4	2.7	3.8	1.31	131.1
2014:4	248.6	2.8	3.8	1.30	131.2

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
2010	143.2	685816.8	412464.1	222982.1	180596.2	−35977.3	94248.2
2011	144.8	693480.0	405707.9	232196.6	179249.7	−24641.9	99032.3
2012	145.0	694345.6	405044.8	241788.1	182996.5	−31204.8	104279.0
2013	147.5	706149.6	409500.3	244931.3	182264.4	-32815.0	102184.0
2014	151.6	725921.8	416052.3	266975.2	176432.0	-38621.8	95765.3
2015	155.3	743343.9	422293.1	285663.4	180489.9	-31157.8	98734.0
2010/09	1.7		0.3	11.0	0.1		8.3
2011/10	1.1		−1.6	3.8	−0.8		4.5
2012/11	0.2		−0.1	2.5	3.0		3.0
2013/12	1.7		1.1	1.3	-0.4		-2.0
2014/13	2.8		1.6	9.0	-3.2		-6.3
2015/14	2.4		1.5	7.0	2.3		3.1
2012:1	145.2	173789.2	101182.0	58927.4	47960.2	−6985.4	27295.1
2012:2	144.5	172990.1	101166.9	58367.1	44720.2	−8453.9	22810.2
2012:3	145.4	174050.5	100983.7	61663.0	45063.8	−7626.9	26033.1
2012:4	145.0	173515.9	101712.2	62830.6	45252.2	−8138.6	28140.5
2013:1	147.7	176743.6	102295.0	59693.5	47768.4	-7067.3	27132.5
2013:2	147.0	175930.9	102279.7	59125.9	44541.3	-7180.1	24182.3
2013:3	147.9	177009.4	102094.5	62464.6	44883.5	-9285.0	25475.0
2013:4	147.5	176465.7	102831.0	63647.4	45071.2	-9282.6	25394.2
2014:1	151.8	181692.4	103931.7	65065.9	46239.8	-9664.1	23431.4
2014:2	151.1	180857.0	103916.2	64447.2	43116.0	-9655.3	23693.8
2014:3	152.0	181965.6	103728.0	68086.4	43447.3	-9650.6	24248.6
2014:4	151.6	181406.7	104476.3	69375.7	43628.9	-9651.8	24391.5

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)
2010	10.5	1319.8	139.6	36.6	−40.0
2011	8.4	1399.3	118.5	43.0	−22.5
2012	8.0	1429.6	115.0	46.4	−59.2
2013	7.6	1482.5	112.3	48.0	−60.7
2014	7.1	1549.3	109.4	52.8	−62.9
2015	5.9	1613.2	94.6	60.3	−63.5
2012:1	5.9	356.4	21.0	11.5	−12.5
2012:2	10.5	350.3	36.7	11.4	−17.3
2012:3	7.2	358.6	25.7	11.8	−14.8
2012:4	10.6	364.3	38.6	11.8	−13.1
2013:1	3.8	364.3	14.0	12.0	−14.0
2013:2	9.3	363.3	33.7	11.6	−16.7
2013:3	6.2	369.4	23.1	12.0	−15.5
2013:4	7.6	374.6	28.3	12.3	−12.8
2014:1	7.2	375.2	27.3	12.7	−15.9
2014:2	6.9	379.8	26.2	13.1	−17.3
2014:3	7.1	384.4	27.3	13.5	−16.0
2014:4	7.1	390.1	27.9	13.6	−13.3

1 GDP at market prices (Financial Year)

THE WORLD ECONOMY

The global recovery continued. However, the growth dynamics shifted across the regions as activity in the advanced economies continued to strengthen, while economic and geopolitical tensions have dragged down the growth in major emerging countries. The Purchasing Managers Index (PMI) for global all-industry output remained above the expansion threshold of 50. It was 52.8 in April, slightly down from 53.5 in March.

Inflation pressures continue to be contained. Annual headline inflation in the OECD countries was 1.6% in March, up from 1.4% in February. Excluding food and energy, the annual inflation rate was 1.7% in March from 1.6% in the previous four consecutive months. This modest rise in the inflation rate was observed in the majority of advanced and emerging economies.

US

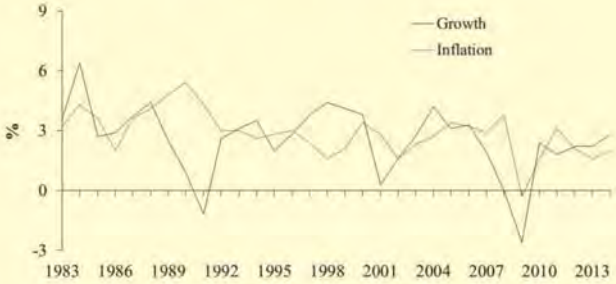
Real GDP growth stalled in Q1 2014 — the official reason given is very bad weather which prevented both production and transport. According to the first estimate by the Bureau of Economic Analysis, it was 0%, down from 0.7% in Q4 2013. This deceleration reflected the decline in non-residential investment (−0.5% in Q1 compared to 1.4% in the previous quarter), the growth in inventory (subtracting 0.13 percentage points from the Q1 growth, compared with −0.025 percentage points in Q4 2013), and a negative contribution from net trade (−0.2 percentage points in Q1, falling from 0.25 percentage points from Q4 2013). These negative contributions to the growth were offset by strong private consumption (0.75% in Q1 after rising 0.8% in Q4 2013).

Labour market conditions, unlike output, continued to recover. Non-farm payrolls employment rose 288,000 in April after rising 203,000 in March. The unemployment rate decreased sharply to 6.3% in April, the lowest level since September 2008. However, this fall reflected a decline in the participation rate (62.8% in April, down from 63.2% in March). In April average hourly earnings rose 1.9% year-on-year, down from 2.1% in March and February.

The housing market recovery has been slow. The month-on-month difference in sales of existing homes was virtually unchanged in March, while new home sales decreased sharply, by 15%, in March. The inventory of unsold homes rose. It would take 5.2 months to sell existing inventory, compared to 5.0 months in February.

Annual CPI inflation rose marginally to 1.5% in March from 1.1% in the previous month. An increase in food and shelter prices contributed to this rise in the inflation rate. Excluding food and energy annual CPI inflation rose to 1.7% in March, from 1.6% in February.

U.S.: Annual Growth Rates of Real GNP and Consumer Prices



	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	−2.6	2.4	1.8	2.2	2.2	2.8
Inflation (% p.a.)	−0.3	1.6	3.1	2.1	1.6	2
Nominal Short Int. Rate	0.2	0.1	0.3	0.1	0.7	0.8
Real Short Int. Rate	−1.6	−3.0	−1.8	−1.9	−1.3	−1.2
Nominal Long Int. Rate	3.2	3.1	1.9	1.8	2.1	2.6
Real Long Int. Rate	1.3	1.0	0.9	−0.2	0.1	0.6
Real Ex. Rate (1996=100)[1]	88.7	87.4	85.7	90.4	97.3	99.1
Nominal Ex. Rate[2]	85.98	83.73	78.08	80.9	85.5	85.4

[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)

Given the improvement in economic conditions, at the April meeting the federal Open Market Committee announced a reduction in the monthly pace of its asset purchases by $10 billion, to $45 billion starting from May. The Committee decided to keep the target range for the federal funds rate at 0–0.25% and it reaffirmed that any change would be considered on the basis of a wide range of information, including measures of labour market conditions, indicators of inflation pressures and inflation expectations, and readings of financial developments.

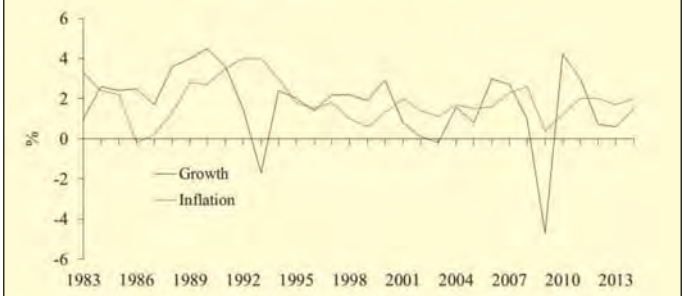
Japan

The Japanese economic recovery continued. Real GDP rose 1.5% in Q1, up from 0.1% in Q4 2013. This reflected a big positive contribution from consumer spending (1.3 percentage points to Q1 GDP growth), which rose sharply ahead of the 3% consumption tax increase on the 1st April. Private consumption rose 2.1% compared to 0.4% in the previous quarter. Other positive contributions came from private non-residential investment (4.6% in Q1 after 1.9% in Q4). A surge in domestic demand resulted in a negative contribution of net trade, as imports growth (6.3% in Q1 from 3.7% in Q4) dominated the rise in exports (6.0% in Q1 from 0.5% in Q4).

Japan

	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	−6.3	4.7	−0.5	1.9	1.8	1.6
Inflation (% p.a.)	−1.4	−0.7	−0.3	0.0	0.0	2.0
Nominal Short Int. Rate	0.1	0.1	0.4	0.3	0.4	0.4
Real Short Int. Rate	1.1	0.4	0.4	0.3	−1.6	−1.6
Nominal Long Int. Rate	1.3	1.1	1.0	0.8	0.7	0.9
Real Long Int. Rate	1.2	0.4	−0.2	−0.8	−1.3	−1.1
Real Ex. Rate (1996=100)[1]	89	92	97.1	98.3	119.7	122
Nominal Ex. Rate	93.54	87.48	79.36	80.51	98	98

[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.



Germany

	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	−4.7	4.2	3.0	0.7	0.6	1.5
Inflation (% p.a.)	0.4	1.2	2.0	2.0	1.7	2.0
Nominal Short Int. Rate	0.7	0.4	1.5	0.2	0.5	0.6
Real Short Int. Rate	−0.4	−1.9	−0.5	−1.5	−1.5	−1.4
Nominal Long Int. Rate	4.0	3.8	1.8	1.5	1.5	1.9
Real Long Int. Rate	2.2	1.8	−0.1	−0.4	−0.5	−0.1
Real Ex. Rate (1996=100)[1]	105.8	102.9	105.5	104.3	107.4	108.2
Nominal Ex. Rate	0.72	0.75	0.71	0.78	0.79	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

Recent data show some signs of deterioration in Q2. The consumer confidence index decreased to 37.0 in April, down 0.5 points from the previous month. The manufacturing PMI fell below the expansion/contraction threshold of 50 to 49.4 in April from 53.9 in March. The Economy Watchers Survey index for current conditions declined from 57.9 in March to 41.6 in April. However, this deterioration is expected to be temporary and linked directly to the effect of the consumption tax rise: as the diffusion index for future economic prospects in April increased to 65.9 from 50.3 in March, the first increase in five months.

Annual CPI inflation has increased gradually since the beginning of the year. It was 1.6% year-on-year in March, up from 1.5% in February. This is moving towards the BOJ's 2% target. The Bank left monetary policy unchanged at its April meeting, continuing its aggressive asset purchase programme so that the monetary base would increase at an annual pace of 60–70 trillion yen (13% of GDP).

Germany

The economic recovery continued. Real GDP rose 0.8% in Q1 after 0.4% in Q4 2014. The main contribution to growth came from strong domestic demand. Foreign trade had a negative effect on growth, with Q1 exports down and imports up.

Recent data show mixed signals about economic activity. The IFO business climate index rose to 111.2 in April from 110.7 in March. The ZEW current conditions index rose to 62.1 in May from 59.5 in the previous month. On the other hand, the future looks less encouraging. Industrial orders declined 2.8% month-on-month in March, the sharpest contraction since October 2011. The ZEW expectations index for May fell to 33.1 from 43.2 in April.

The labour market remained healthy. Employment rose 0.8% year-on-year in Q1 2014. The unemployment rate was unchanged at 5.5% in March. This low unemployment rate stands out among the large countries of continental Europe and reflects the Harz reforms initiated by Schroder's Social Democrat government in the 2000s; as a reformed labour market sinner, Germany now expects those to whom it is lending money in the South to do the same thing.

France

The economic recovery has stalled. Real GDP was flat after a revised rise of 0.2% in Q4. Total domestic demand excluding inventories contributed −0.4 percentage points to the quarter's growth after a positive contribution of 0.2 percentage points in Q4. Net trade contributed −0.2 percentage points from the quarter's growth after +0.3 percentage points in Q4: imports growth (1% in Q1 after 0.5% in Q4) dominated the exports growth (0.3% in Q1 after 1.6% in Q4). The only positive contribution to GDP growth came from the change in inventories, adding 0.6 percentage points.

Recent data and surveys show a bleak future. The INSEE business climate continued to be below its long term average of 100. It decreased from 95 in March to 94 in April. The consumer confidence index lost 3 points between March (88 points) and April (85 points). President

Hollande's popularity is at low levels; his recent 'U-turn' towards more pro-business policies has so far simply added to the confusion about his policy direction. If he sticks to it may gain traction; but the latest attack on GEC's bid for Alstom confirms that protectionist instincts remain uppermost.

Annual CPI inflation in April was 0.7%, up from 0.6% in March. This reflected an increase in core inflation from 0.4% in March to 0.5% in April, while energy and food prices declined. Low German inflation and weak demand growth elsewhere in the euro-zone are fuelling fears that deflation may take hold. However, the ECB has announced plans to combat any such tendencies with new monetary policies, which could include cutting interest paid on bank reserves or Quantitative Easing (though this is currently opposed by German ECB directors).

Italy

Real GDP declined 0.1% in Q1, after a surprise growth of 0.1% in the previous quarter. The breakdown in GDP components is not available, but according to ISTAT, the main contraction happened in industry, while services had no growth and agriculture increased slightly.

The economic outlook continued to look weak. The unemployment rate is persistently high. It was 12.7% in March. The business confidence index decreased to 88.8 in April from, 89.5 in March, far from its average of 100.5. The composite PMI index marginally declined to 53.9 in May from 54.0 in April. The Italian economy is in chronic crisis, with no agreement on policies to liberalise its sclerotic markets and with its politics both polarised and stalemated. It is fashionable to blame M. Berlusconi for his failures to make any reforms in his long dominance of Italian politics but post-Berlusconi matters just look worse. Whether the inexperienced M. Renzi, the mayor of Florence, will be able to galvanise any sort of coalition for reform remains to be seen. Italy, like Japan, may simply be impossible to reform because of huge blocking coalitions of vested interests.

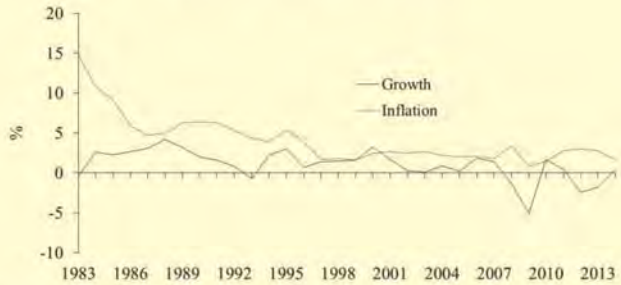
France: Annual Growth Rates of Real GNP and Consumer Prices

France

	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	−2.5	1.6	2.0	0.0	−0.4	0.7
Inflation (% p.a.)	0.1	1.5	2.1	2.0	1.6	1.5
Nominal Short Int. Rate	0.7	0.4	1.5	0.2	0.5	0.6
Real Short Int. Rate	−0.8	−1.7	−0.5	−1.4	−1.5	−1.4
Nominal Long Int. Rate	4.0	3.8	1.8	1.5	1.5	1.9
Real Long Int. Rate	2.2	1.9	−0.1	−0.4	−0.5	−0.1
Real Ex. Rate (1996=100)[1]	104.3	103.1	105.5	104.9	107.9	108.6
Nominal Ex. Rate	0.72	0.75	0.71	0.78	0.79	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.

Italy: Annual Growth Rates of Real GNP and Consumer Prices



Italy

	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	−5.1	1.7	0.5	−2.4	−1.8	0.4
Inflation (% p.a.)	0.8	1.5	2.8	3	2.8	1.6
Nominal Short Int. Rate	0.7	0.4	1.5	0.2	0.5	0.6
Real Short Int. Rate	−0.8	−2.4	−1.5	−2.6	−2	−1.4
Nominal Long Int. Rate	4	3.8	1.8	1.5	1.5	1.9
Real Long Int. Rate	1.5	1.2	−0.7	−0.8	−0.6	−0.1
Real Ex. Rate (1996=100)[1]	105.4	103.6	106.9	107.4	111.8	113.2
Nominal Ex. Rate	0.72	0.75	0.71	0.78	0.79	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.

Eurozone annual M3 Growth

WORLD FORECAST DETAIL

Growth Of Real GNP

	2009	2010	2011	2012	2013	2014
U.S.A.	–2.6	2.4	1.8	2.2	2.2	2.8
U.K.	–3.9	1.7	1.1	0.2	1.7	2.8
Japan	–6.3	4.7	–0.5	1.9	1.8	1.6
Germany	–4.7	4.2	3.0	0.7	0.6	1.5
France	–2.5	1.6	2.0	0.0	0.2	0.7
Italy	–5.1	1.7	0.5	–2.4	–1.8	0.4

Growth Of Consumer Prices

	2009	2010	2011	2012	2013	2014
U.S.A.	–0.3	1.6	3.1	2.1	1.6	2.0
U.K.	1.3	3.3	4.5	2.7	2.4	2.0
Japan	–1.4	–0.7	–0.3	0.0	0.0	2.0
Germany	0.4	1.2	2.0	2.0	1.7	2.0
France	0.1	1.5	2.1	2.0	1.1	1.5
Italy	0.8	1.5	2.8	3.0	1.4	1.6

Real Short-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	–1.6	–3.0	–1.8	–1.9	–1.3	–1.2
U.K.	–0.3	–3.5	–2.8	–1.8	–1.7	–1.6
Japan	1.1	0.4	0.4	0.3	–1.6	–1.6
Germany	–0.4	–1.9	–0.5	–1.5	–1.5	–1.4
France	–0.8	–1.7	–0.5	–1.4	–1.5	–1.4
Italy	–0.8	–2.4	–1.5	–2.6	–2.0	–1.4

Nominal Short-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	0.2	0.1	0.3	0.1	0.7	0.8
U.K.	1.1	0.7	0.9	0.9	0.6	1.8
Japan	0.1	0.1	0.4	0.3	0.4	0.4
Germany	0.7	0.4	1.5	0.2	0.5	0.6
France	0.7	0.4	1.5	0.2	0.5	0.6
Italy	0.7	0.4	1.5	0.2	0.5	0.6

Real Long-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	1.3	1.0	0.9	–0.2	0.1	0.6
U.K.	–0.3	–0.2	–0.2	–1.4	–1.0	–0.5
Japan	1.2	0.4	–0.2	–0.8	–1.3	–1.1
Germany	2.2	1.8	–0.1	–0.4	–0.5	–0.1
France	2.2	1.9	–0.1	–0.4	–0.5	–0.1
Italy	1.5	1.2	–0.7	–0.8	–0.6	–0.1

Nominal Long-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	3.2	3.1	1.9	1.8	2.1	2.6
U.K.	2.8	2.4	2.0	0.9	1.2	1.6
Japan	1.3	1.1	1.0	0.8	0.7	0.9
Germany	4.0	3.8	1.8	1.5	1.5	1.9
France	4.0	3.8	1.8	1.5	1.5	1.9
Italy	4.0	3.8	1.8	1.5	1.5	1.9

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

	2009	2010	2011	2012	2013	2014
U.S.A.	88.7	87.4	85.7	90.4	97.3	99.1
U.K.	76.7	88.6	89.8	93.9	92.5	94.1
Japan	89.0	92.0	97.1	98.3	119.7	122.0
Germany	105.8	102.9	105.5	104.3	107.4	108.2
France	104.3	103.1	105.5	104.9	107.9	108.6
Italy	105.4	103.6	106.9	107.4	111.8	113.2

[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.

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

	2009	2010	2011	2012	2013	2014
U.S.A.[1]	85.98	83.73	78.08	80.90	85.50	85.40
U.K.	1.57	1.58	1.61	1.59	1.55	1.55
Japan	93.54	87.48	79.36	80.51	98.00	98.00
Eurozone	0.72	0.75	0.71	0.78	0.79	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

WHAT DID MARGARET THATCHER DO FOR THE UK ECONOMY?

Patrick Minford

Margaret Thatcher's central achievement was economic

In the 1970s Britain's economy was in serious trouble. Growth slowed because of industrial inefficiency, due to outdated technology and over-manning.

Unemployment was rising as these same industries lost market share at home and abroad. To generate more growth and employment first the Heath and then the Labour governments resorted to fiscal and monetary stimulus, which only produced high inflation; this even reached 25% in 1975 and was pushing up again towards 20% at the end of the decade.

As a member of the Heath government Mrs Thatcher watched in helpless frustration as the policies failed. She and Sir Keith Joseph decided in opposition to fight for new ones. But as Prime Minister she faced overwhelming odds against the success of what in the end turned out to be the greatest economic reform programme of British history.

It is hard now to recreate the thinking of that time among those who shaped British economic policy. To them policy consisted of using stimulative demand policies to obtain growth while deploying wage and price controls to contain inflation.

It never occurred to them that what the economy produces is due to what resources it has and how well it uses them, or that the 'supply-side' forces we now all accept are the key factors; nor that wage and price controls would cut to the heart of our economic freedoms, while inevitably failing to stop inflation.

Before considering how the Thatcher policies evolved, it is important to recreate this thinking in more detail. The prevalent macroeconomic model of the time was one in which inflation expectations were backward-looking and 'adaptive' at a slow rate to actual inflation developments; some argued that they were even immune to economic forces altogether, being set by the 'sociological' forces of union wage demands. With inflation therefore at best reacting modestly to monetary and fiscal policies to contain or reduce it, policymakers argued that such policies if turned against inflation would only increase unemployment. Unemployment was rising in the late 1970s and by 1979 had reached 7%; this was argued to show that there were indeed unemployed resources, so that expansionary fiscal and monetary policy would generate growth. Since it was also desirable to bring down inflation, policies to mollify union demands and to curb wage and price setting by law were seen as the only means to do so.

These ideas are by no means all dead today; with inflation low and wage demands weak, some economists have argued for expansionary fiscal policy as well as unconventional monetary policy in the form of massive printing of money, given that interest rates have fallen close to zero, to stimulate the main Western economies. However, the ideas have mutated after the experience of the last three decades since 1979. No longer is there any support for wage and price controls; nor is inflation considered to be immune to monetary and fiscal policy. The debate today centres rather on exactly what the supply limits might be on the economy and whether demand stimulation can be effective, given solvency limits on governments.

That shift in the debate began with the ideas about policy that Mrs Thatcher put into action, ideas largely shared across the Atlantic by Paul Volcker at the Fed and later President Reagan in the White House.

These ideas sprang from what we can call the 'classical model' revival. In this model (i.e. set of assumed relationships) the economy was driven by its capacity to produce with fluctuations in this and in demand creating temporary movements around 'full employment output'. Apart from natural resources the main driver of capacity was productivity, derived from entrepreneurship, innovation and competition. Capacity in turn dictated the level of unemployment; if workers were willing to offer their labour at rates that produced competitive output, employment and capacity would grow, and unemployment would settle at a low rate. But institutions, such as weak union laws and an over-generous welfare system, which encouraged strikes and unrealistic wage demands, would undermine employment and create an enduringly high rate of unemployment. The role of prices was to equate monetary demand, driven by fiscal and monetary policies, with capacity; this it would do flexibly and rapidly, with expectations of inflation quickly catching up with the market realities — in one version, expectations were 'rational', that is fashioned directly by these realities.

In this model, inflation therefore was caused directly by government policies, while government's supply-side policies, impacting on the institutions of the labour and product markets, would set the prospects for long-term capacity growth and for unemployment. Any government demand stimulus would have little impact on output and at best only temporarily, but a quick and permanent impact on inflation.

These ideas were being rehearsed in the UK against a background of inflation rising towards 20% in 1980 and unemployment rising towards double-digit percentages. The situation in other western countries was a bit better but not in essence much different. What emboldened the new generation of politicians in the 1980s, of whom Mrs Thatcher was the first and the boldest, was the obvious failure of the old policies. Thus there was a willingness to think in terms of the classical model and to try the policies it suggested.

The battle against inflation

The first Thatcher government's task was to bring inflation under control. Its 'monetarism' simply asserted the classical precept that government monetary stimulus, abetted by large government deficits, must push people's demands ahead of the economy's supplies, so creating inflation. Therefore inflation must be cured by restraining such government excess.

The initial effects of this restraint were bound to be recessionary; this in turn brought out fierce opposition to the policy, even in her own Cabinet. 'U-turn' and compromise were suggested to her; she refused because she knew that the electoral cycle is short and to ease up would have left inflation endemic, with the policy seen as a failure and a return to the 1970s regime.

She battled on; money remained tight and the budget was tightened sharply. By the end of 1982 inflation had also dropped sharply and interest rates were no longer in the stratosphere.

The biggest political fight was over the 1981 Budget. This cut the budget deficit at what seemed to be the deepest point of the recession. The knives were out and 364 economists famously joined in the attack on her. I had already been quite heavily involved in the policy debate, and had quite close contacts with the Treasury team of Geoffrey Howe as well as with No. 10. My view was that budgetary toughness was vital to creating confidence in sustained monetary tightness: a large deficit is most cheaply financed by printing money. This was also the view of my mentor and PhD supervisor Alan Walters, who was her personal economic adviser and had pushed for the toughest possible budget. I defended the Thatcher policies against my fellow economists vigorously in a Times article; typically she wrote me a nice personal letter of thanks. Later a joke went the rounds after Michael Foot asked her in Commons questions to 'name two professors of economics' who agreed with her policies. She named Alan Walters and me; but in the car back to No 10 remarked 'thank goodness he did not ask for three!' It was astonishing to me how slowly macroeconomic thinking changed in UK academia even subsequently.

The supply-side programme

Fortunately attempts to get rid of her and reverse the policies failed; the economy recovered well from around that time and by 1983 it was growing robustly.

However, all was not as well as most monetarists had hoped. With all the cuts to subsidies and the other props to our sagging industries, unemployment soared in spite of the recovery.

The defeat of inflation revealed to view the underlying ailment of deep inefficiency. Mrs Thatcher now turned to reform of the 'supply-side'. As we all know, she tackled problem after problem; the solution of each uncovering yet more deep-seated ones behind.

Many think that at the start there was some great plan to do all these things; there never was, because the full extent was not known until the changes started to be made. The policies came out in an order largely dictated by events and political timing: the abolition of exchange controls, privatisation, union laws, competition (especially the City 'Big Bang'), reform of the benefit system, council house sales, rented market liberalisation, local government tax overhaul, the list goes on and few areas of our life went untouched. As we know, one has never finished with the supply-side, because modern government has spawned a mass of distortions in its attempts to meet the demands of 'social justice'. Today the coalition government is trying to reform education and embed the internal market in health care that she began. But as growth falters it realises how much else it needs to sort out — bank regulation, tax, the list goes on.

The results of the Thatcher reforms for the economy can be seen in the figures. The economic growth rate more than doubled; as the service sector boomed, unemployment came down to around 3% and under a million benefit claimants (5% or so on another newer measure, both measures consistent with 'full employment'). A scholarly review of the microeconomic evidence of the effects on productivity can be found in Crafts (2011); as far as macroeconomic estimates are concerned, these are clearly dependent on an agreed model of the economy but both my work (Minford, 1998, Chapter 5) and that of Layard, Nickell and Jackman (1991) with rather different models, agree that equilibrium unemployment was brought down strikingly by the policies. On a crude reading of GDP trends one can see quite clearly in the data how after 1979 the UK growth rate climbed — Figure 1. UK per capita GDP has overtaken that of France and Germany substantially, having greatly fallen behind by 1979 — Figure 2; factoring in the recent crisis, which hit the UK harder than others, has not altered this.

Inflation has now been low for two decades; after a turbulent 1980s when different views of how to conduct monetary policy divided the Conservative government, the policy settled down to a regime of inflation targeting which

has at least been highly successful in keeping inflation down, even if there are aspects that the crisis has revealed need attention (see below). It is a transformation from the 1970s and their hallmark 'winter of discontent'.

Reform on this scale means massive change; and such change is bound to be unpopular. Most of the reforms were accompanied by measures that were aimed at compensating those harshly affected.

Problems of the regions and the UK's changing industrial structure

In Wales as well as many other regions hit by the decline of old industries such as coal, steel and traditional manufacturing, Mrs. Thatcher sanctioned large inward transfers, in addition to the generous Barnett formula for government spending. These transfers were designed to help to kick start new industries; initially inward investment in large manufacturing plants was chased up but increasingly these have been replaced with competitive manufacturing and service activities, especially business services and finance.

Margaret Thatcher is seen by some, especially in harder-hit regions, as the promoter of the 'get-rich-quick', 'me-first' society. But she herself was a non-conformist and saw the creation of business riches as a means to endow the Good Samaritan. Britain in the 1970s could not produce riches; Britain today does (even though we have the banking crisis), and inevitably not every resulting rich person behaves admirably.

But would Wales and other regions rather be stuck with industries which had little or no future? I think the honest answer, even from those who affect to hate Mrs Thatcher, is a resounding No. The truth is she saved the country from economic disaster and turned Britain once more into an engine of economic progress. Even if the first generation affected by industrial decline suffered, I believe they mostly have had the sense to see that new industries will give their children and grandchildren a future.

Did Thatcher cause rising inequality and a crumbling infrastructure?

A related set of complaints concerns rising inequality and a supposed lack of infrastructure investment. The implication in both cases is that the Thatcher government neglected to provide adequately for public goods, whether in the classic physical shape of infrastructure or in the more subtle shape of 'social infrastructure' via income redistribution in cash or kind.

It has become a cliché of modern economic commentary that infrastructure is 'crumbling', as if this is a terrible denunciation of economic policy; indeed the cliché is as widespread in the US and continental Europe as it is in the UK. Yet a moment's reflection tells us that such things as roads and railways need to be analysed carefully for costs

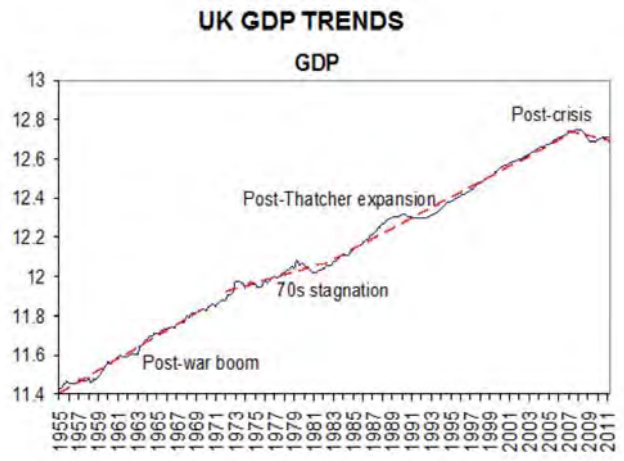


Figure 1: UK GDP; natural logarithm, so that the slope shows the growth rate.

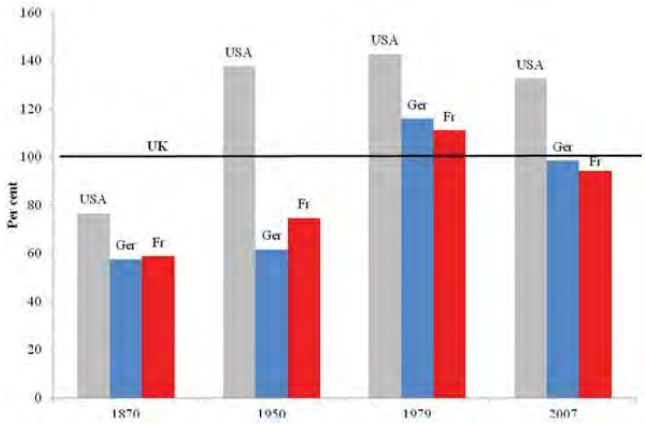


Figure 2: USA, Germany and France GDP per capita (measured in purchasing power terms) expressed as percent of UK

Source: LSE Growth Commission (2013)

and benefits. Take the current example of HS2; this appears to have been pushed as a political commitment to infrastructure, even though now it has emerged that the cost-benefit ratio is around unity- in other words it brings no gains- whereas the usual convention is that measured benefits needs to exceed costs by a good margin to offset the general uncertainty surrounding such schemes. Modern growth evidence such as it is by no means supports the view that infrastructure projects create growth of and by themselves. The LSE Growth Commission (LSE, 2013) pushes the case for more infrastructure investment, and has a point as the coalition government has seemed paralysed by indecision over such things as Heathrow airport. But there is really no evidence that the Thatcher governments held back growth by failing to invest in it. Instead, it appears to have succeeded in achieving growth while containing demands on the public purse from unnecessarily expensive schemes (such as the endless demand for East

Coast rail electrification) — *grands projets* as the French term them.

As for inequality, this has grown worldwide for a long time. The reasons are widely accepted to be a combination of in the first place 'globalisation' whereby fast-growing emerging-market countries such as China, Brazil and India expand their exports and increase competition, driving down western wages in the competing industries; and in the second place technological advance (largely related to computers) that has substituted for existing workers' skills, whether in manufacturing or in service industries. I found that the rise in wage inequality during the 1970s and 1980s was roughly half down to each of these factors (Minford, 1998, Chapter 7). More recently, the trends have apparently continued with as much force.

Governments all over the western world are finding that it is almost impossible to offset these trends through generous social policy and income redistribution. The problem lies in the cost to taxpayers combined with the disincentive effects of generous benefits in or out of work. The Thatcher government, contrary to much popular assumption, was generous in its dispensation of benefits. Rather than cut unemployment benefits it chose in the 1986 Restart programme to enforce re-entry into the labour market; and it expanded the in-work benefits available for low-paid workers. It also, unwisely, turned a blind eye to spiralling disability benefits. Thus if it had a fault it was in laxity. The coalition government has similarly found that there has to be a limit on benefit generosity and is enacting wide-ranging reform to enhance incentives and increase work participation.

One is left at this point with a trade-off: will western countries opt out of growing world trade and technological innovation to protect current generations of workers from rising inequality? Surely not, even if there will be disquiet among these voters. The point is that again, as with industrial restructuring, voters will accept it for the sake of progress for their descendants, even if they are squeezed in the process.

What about the banking sector, regulation and Big Bang?

The deregulation of the financial sector has latterly spawned the argument recently advanced by Ken Livingstone, Will Hutton and other left-wing sophisticates that the seeds of the UK's banking crisis were sown by the Thatcher Big Bang of 1986, under which the City agreed to abandon its rate-setting practices rather than face the Monopolies Commission. Big Bang meant that there was a huge influx of foreign capital into the City and that it became the world's biggest financial centre; the combination of open competition, common law courts and Bank of England supervision within a largely self-regulating system were the prime attractions. Over the succeeding two decades international finance became more and more 'complete', in economists' approving language-meaning that you could pretty much insure any contingency through the intricate operations of these markets. And without them, with instead the old regulated financial world before it, we would not have had a banking crisis. Ergo Mrs T is guilty of the crisis!

Let us leave on one side the international parts of the crisis that plainly she could not have caused — such as the US sub-prime loans and products, US monetary ease in the early 2000s, and the 25-year world boom from 1982 that caused world commodity prices to spike from 2006. The question then is whether the City's deregulated rise necessarily contributed to the UK's own crisis. Clearly it brought many benefits to the UK economy, directly through its net revenues (now 10% of GDP) and indirectly through the enabling provision of credit to businesses and households. But if the crisis is on the other side of the balance sheet, that would be a big negative.

The argument crucially ignores the 1997 decision by Gordon Brown to make the Bank independent on monetary policy and simultaneously strip it of its supervisory role, giving it to the FSA and leaving the Treasury in 'overall' charge under the 'Tripartite' set-up. This was a disastrous decision for the effectiveness of supervision. The FSA (let alone the Treasury) did not have the information the Bank had, and that was needed to do the job. The Bank publicly wrung its hands with its Stability Reports and was ignored in the run-up to the crisis. When the crisis hit, it felt unable to pull traditional levers.

I am confident Margaret Thatcher would never have gone down this road. Nor in fact did John Major or Norman Lamont who instituted the inflation target in 1992, with Bank/Treasury open cooperation in setting interest rates but stopping short of 'independence' which we know is anyway a pretence since the taxpayer stands behind the Bank as guarantor. Today that pretence has been totally stripped away. Thatcher understood that the commitment to low inflation had to come from the political process: government had to be fiscally and monetarily disciplined because this was what the people would vote for when properly presented. This was very much the approach of British monetarists as well.

Practically too she trusted the Bank to supervise other banks and the City because that was its job and inbuilt advantage; naturally cautious, she would never have tampered with this role, with its long history of success. But she did not trust it much over policy because she felt it was too much in the pockets of banks and their customers: in 1980 the Bank, full of Keynesians, strongly opposed her tight money policies, as it worried about the banks' bad loans to manufacturing. Making the Bank independent she would have seen as a usurpation of key political clout by jejune technocrats.

Today that judgement seems right. Had Gordon Brown left the system as it was in 1997 the Bank would have blown the whistle on the banks' excessive risk-taking in a time-

honoured raising of Governor Eddie George's eyebrows and we would have had a better crisis. I would add that since the reaction of the British establishment to the crisis has also been misguided in several ways that Mrs. Thatcher would not have agreed with. First, heavy-handed regulation of the banks has and will continue to block the credit channel, especially to small businesses and households (for whom credit has dried up until recent direct government interventions like Help to Buy have, to some extent, unfrozen the mortgage market). It would be better to move back to the more informal checks previously applied by the Bank within a self-regulating system; and at the same time make monetary policy responsive not just to inflation but also to money and credit growth, as was originally suggested in the Thatcher Medium Term Financial Strategy of the early 1980s. Such responsiveness would head off the sort of credit boom that seriously worsened the later banking crisis. As it was, inflation was so firmly anchored by the new inflation target system that it did not move enough to produce the necessary tightening in the face of credit boom.

Second, the programme of Quantitative Easing that has massively raised bank reserves has only failed to cause an explosion of money and credit today because the same regulative excess has nullified its effect. Mrs Thatcher would have been horrified by the risks of such a policy. With a return to self-regulation by internal bank prudence, QE could be rapidly dismantled and the risk eliminated.

Unfortunately the crisis has ushered back into positions of prominence the very enemies of the free market that Mrs Thatcher managed to side-line through her reforms. These people are fond of controls, regulations and large-scale state interventions that keep them permanently in the public eye. Somehow we have to get rid of their baleful influence again but without her help.

In sum the Thatcher record of reform stands up well. For today's policymakers faced with the never-ending need to attend to the supply side the lessons are that good economic ideas are hard to translate into reality without good politics- the latter being essentially the art of making sure that any policies embarked on have sufficient support to survive. The City Big Bang was an important component of the UK economy's resurgence and she got it right.

Mrs Thatcher the person and political leader

'Mrs T', as inevitably I shall always think of her, swung her handbag thoroughly in a policy world largely dominated by well-bred men who wanted to patronise her. I first met her in 1978 when she was preparing her economic policies and at once admired her intuitive grasp of the economy; she was certainly no technical economist but what struck me then and later was how determined she was to make sure she had understood totally and in her own mental terms the risks she was running with any reform she undertook. She staggered me much later in a Chequers seminar on unemployment, when she attacked my suggestion that unemployment benefits should be curbed by quoting the research of a fellow-economist; bloodied but defiant I found myself explaining to her as our voices rose that the economist in question had changed his mind. Later in the evening as I set off back on the four hour drive to Liverpool she insisted first on personally cooking me an omelette!

It was this hands-on quality, as well as the devotion she inspired in people through her own obvious commitment, that holds the secret to her unique success as a politician in implementing the rebuilding of the UK economy from the ruins of the 1970s. When we look around Europe today and see how many economies have failed to reform themselves in a similar way, and with what dismal results for growth and living standards, we can hardly fail to wonder at the UK miracle of Mrs Thatcher.

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The Julian Hodge Institute of Applied Macroeconomics

The Julian Hodge Institute of Applied Macroeconomics was launched in autumn 1999 in a new collaboration between the Cardiff Business School of Cardiff University and Julian Hodge Bank. 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 added urgency by the ongoing discussions about the UK's adoption of the Euro in place of the Pound. The new Institute has aimed to develop research relevant to this important debate.

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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