Foreword

With the latest financial restructuring in Ireland, and fears about the sustainability of the Spanish, Portuguese and Greek economies, it seems there is no end to the financial crisis or indeed the cost involved. At the same time, it also seems likely that the fiscal cost of the financial crisis will be far lower than originally expected, with the cost to taxpayers in most developed countries amounting to less than 1% of GDP. In the UK, as a result of the increase in value of the government's equity holdings in the banks, it is possible that the UK taxpayer will see a profit from the support provided. The two perspectives look to be irreconcilable.

The history of the financial crisis is already being written about, and has attracted the interest of Hollywood, but as the consequences of the crisis become clearer there are a number of interesting features which may result in those early histories being rewritten. In the UK the initial scale of government support was massive at around 60% of GDP, far higher than most developed countries by virtue of the scale of support required in the asset protection schemes set up to assist Royal Bank of Scotland, HBOS (whose problems could not be contained within the Lloyds TSB balance sheet), and the nationalisation of Northern Rock. Financial outlays have, however, been far smaller. In the UK it is estimated that uncovered fiscal costs amount to 5.4% of GDP, but the market value of the government's shares in RBS, Lloyds Banking Group and Northern Rock, are close to the amount invested.

The accounting view of the crisis, however, is only a small part of the story. The main impact of the crisis is in the indirect cost of reduced economic activity and the increase (as a result of reduced economic activity) of public debt levels. The scale of this indirect consequence of the crisis is a matter of debate, with some cumulative estimates in the order of 23% of GDP. If roughly half of GDP is accounted for by the public sector in terms of tax take, then UK borrowing is about £160bn higher than it would have been without the financial crisis, an inexcusable contribution to our economic problems. However, with total UK debt at around £900bn, this is only a partial contributor to the government deficit, reinforcing the view that government borrowing itself was out of control over the last few years and arguably the main reason for the austerity measures that have now been required.

The other tragedy of the financial crisis is that the reduction in credit availability has accounted for much of the loss of output in the economy and in large part this stems from the regulatory response to the crisis rather than the crisis itself. As an example members of the council of mortgage lenders lent 8 million mortgages between 2005 and 2010. Of these mortgages taken out across the economic cycle, 200,000 are in default. Under the new stress tests, as originally proposed, 4 million mortgages would fail. To cater for a margin of comfort of this magnitude seems cautious to say the least and the consequence is that mortgages are difficult to come by, with first time buyers particularly affected.

When economics students in thirty years time come to study the financial crisis, the role of uncontrolled government borrowing from 2002 to 2007 and inappropriate regulation afterwards will feature high on the list of contributors. The role of the banks and the shadow banking system, however, will be of more interest to Hollywood.

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.

net shortage of houses continues, with prices in some areas growing again fairly strongly — notably in London and the South East.

Costs and prices

CPI year-on-year inflation was 3.2% in September, up from 3.1% in September. It has been above its 2.0% target for 11 months in a row. This reflected the restoration of the standard rate of VAT to 17.5%, past rises in oil prices and the past depreciation of sterling. The largest downward pressures on annual CPI inflation came from food (4.2%, down from 4.9% in September), while the largest upward force came from transport (5.8% up from 5.4% in the previous month). RPIX inflation, excluding mortgages interest payments, was unchanged at 4.6%, unchanged from September. Annual factory gate inflation for all manufactured products rose to 4.0% in October. Input price year-on-year inflation was 8.0% in October, only slightly down from 8.7% in September.

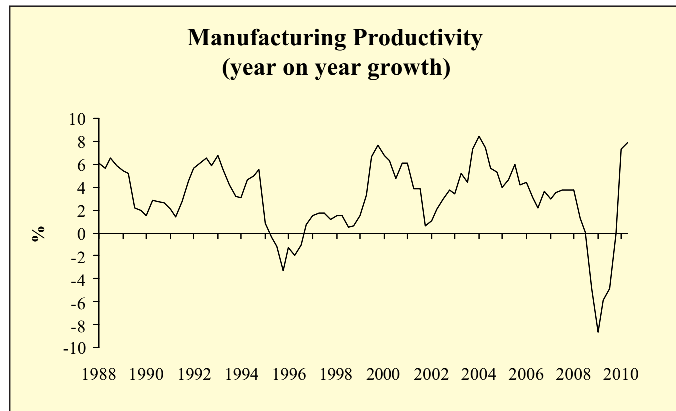
Despite inflation being above its official target for 10 months in a row, the Bank of England still expects that the high inflation to be short-lived and that spare capacity will push the rate down. However, given a coming rise in VAT to 20% and continuing increases in import prices, inflation will clearly take some time to return to the target. The Bank is therefore expecting inflation to remain above 2% throughout 2011 and only reach the target by the end of 2012.

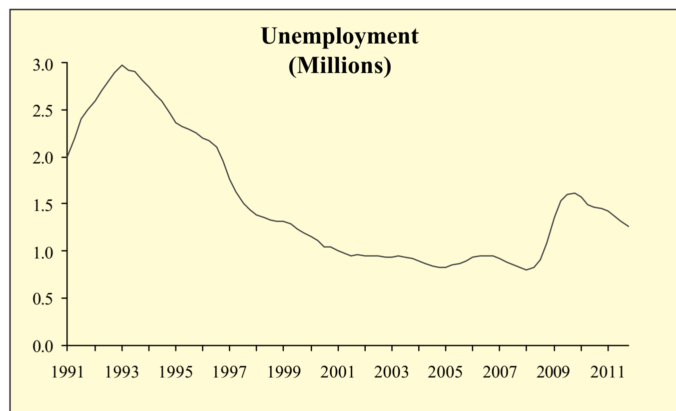
Labour market

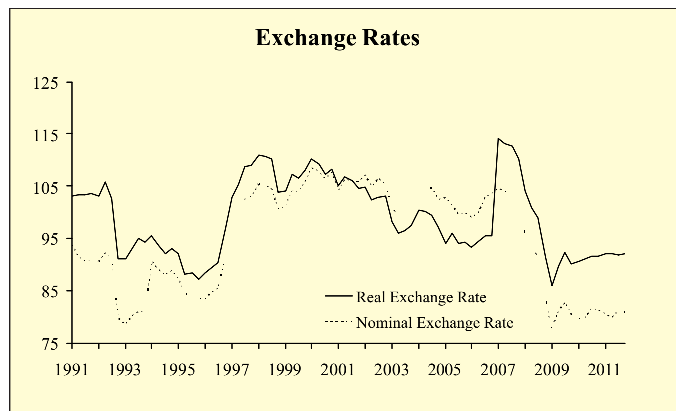
There is improvement in the labour market. The employment rate for the three months to August was 70.7%, up 0.2 on the previous quarter. During the same time, the unemployment rate decreased to 7.7% from 7.8% in the previous quarter. The claimant count rate in October is expected to decrease by 0.3% from September. The labour market has been remarkably resilient and the drop in employment has been considerably less than that in GDP over the recession and the recovery since. The reason seems to lie partly in the willingness of workers to take reduced wage increases, including freezes and even wage drops, as well as to work part-time until the crisis passed. Another reason may be that in a predominantly service economy firms are unwilling to lose skilled workers that understand often-complex service businesses.

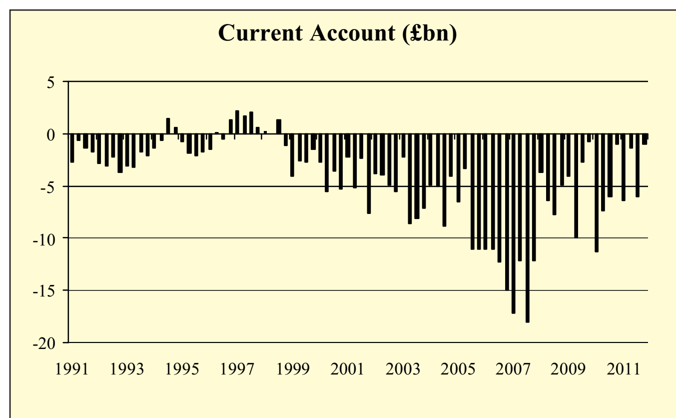
Trade

In the second quarter the deficit on trade of goods increased by £1.2 billion to £23.2 billion, the surpluses on services and net foreign income were £10.5 billion and £6.5 billion respectively, so the current account deficit was £7.4 billion. This is equivalent to –2.0% of GDP, compared to –3.1% of GDP in the previous quarter. Thus there is distinct improvement in the UK's external position, partly reflecting the substantial fall in the pound since the crisis broke.







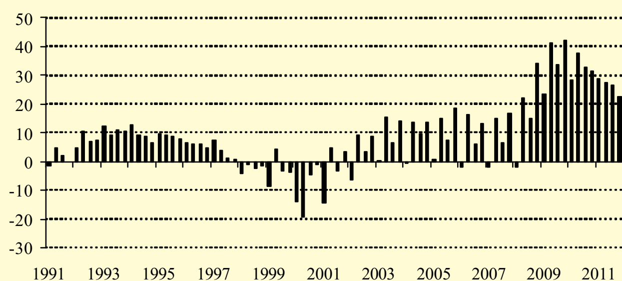


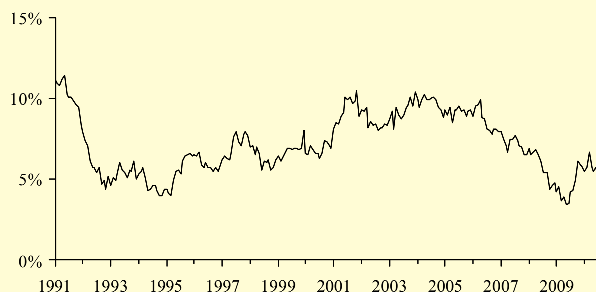
Monetary and fiscal developments

Notes and coins in circulation rose 4.7% in October, down from 5.0% in September; this modest growth reflects the modest growth in consumer spending. The year-on-year growth rate of broad money-M4 (including bank and building society deposits held by households and firms) fell to 0.9% in September from 1.9% in August. Excluding lending to 'intermediate financial companies' its growth fell further to –1.0% from –0.4% in August. UK banks continue to squeeze their lending to businesses and households, in the effort to rebuild their balance sheets; but a more important factor may now be the tiny yield being offered on deposits, which with inflation at over 3% implies negative real yields on broad money holdings. Investors are increasingly looking for positive real yields on risky assets — which of course is the intention of the stimulative monetary policy.

The Bank of England maintained its official lending rate at 0.5% at the Monetary Policy Committee meeting in November. It also maintained the stock of asset purchases financed by the issuance of central bank reserves at £200 billion. The MPC's position is that the risks are high in both directions for inflation and growth. However, once the immediate concerns about the effects of fiscal tightening have dissipated, it may well be tipped towards some modest tightening. Bank Rate is now increasingly irrelevant to decisions by banks, savers and investors; if recovery continues as robustly as at present, it will be necessary to move it towards more normal rates.

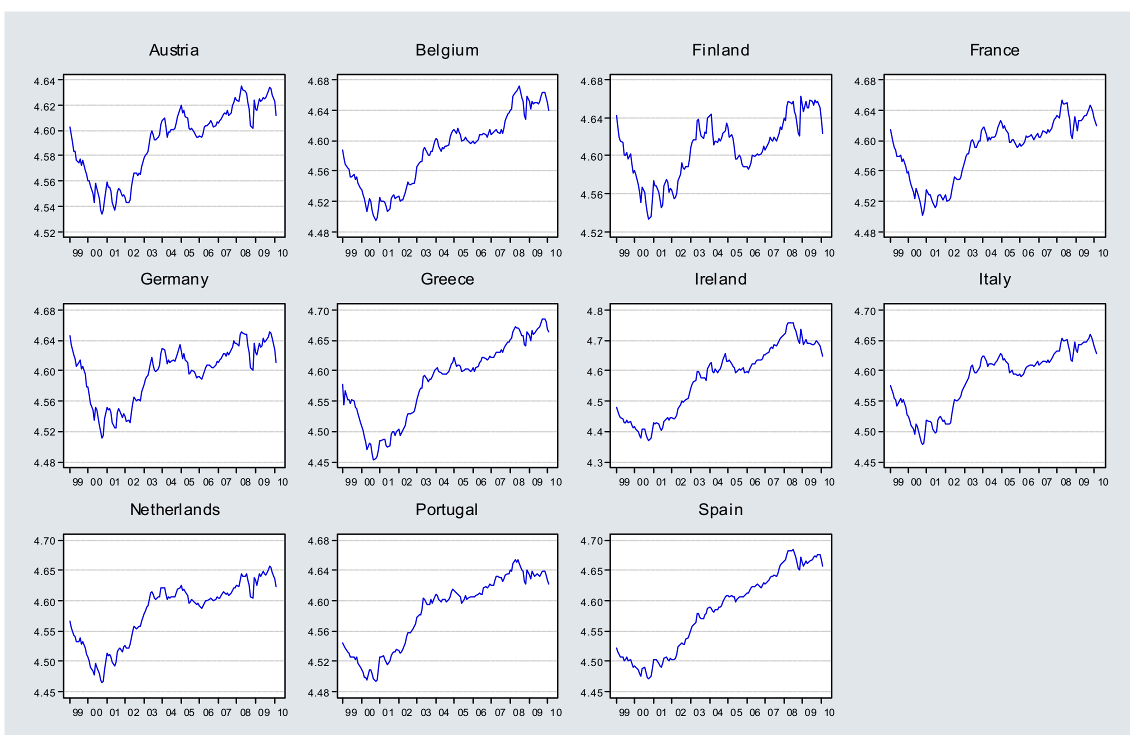
As for fiscal policy, on October 20th Chancellor George Osborne presented his Comprehensive Spending Review. He plans to cut public spending by £81 billion over a period of four years in order to bring the budget deficit back to below 3% by 2015. The cuts will affect all government departments, but with the NHS notionally protected (nevertheless since medical costs rise in real terms the NHS will still be squeezed). It will involve cutting public sector jobs, freezing departmental expenditure, reforming the welfare system and increasing the retirement age. The plan was based on the forecasts made by the Office for Budget Responsibility where the growth of 2010 is expected at 2.3% and higher for subsequent years. The plan will be revised given the new forecasts in late November; 2010 growth looks too high but we too are expecting growth of around 3% subsequently.





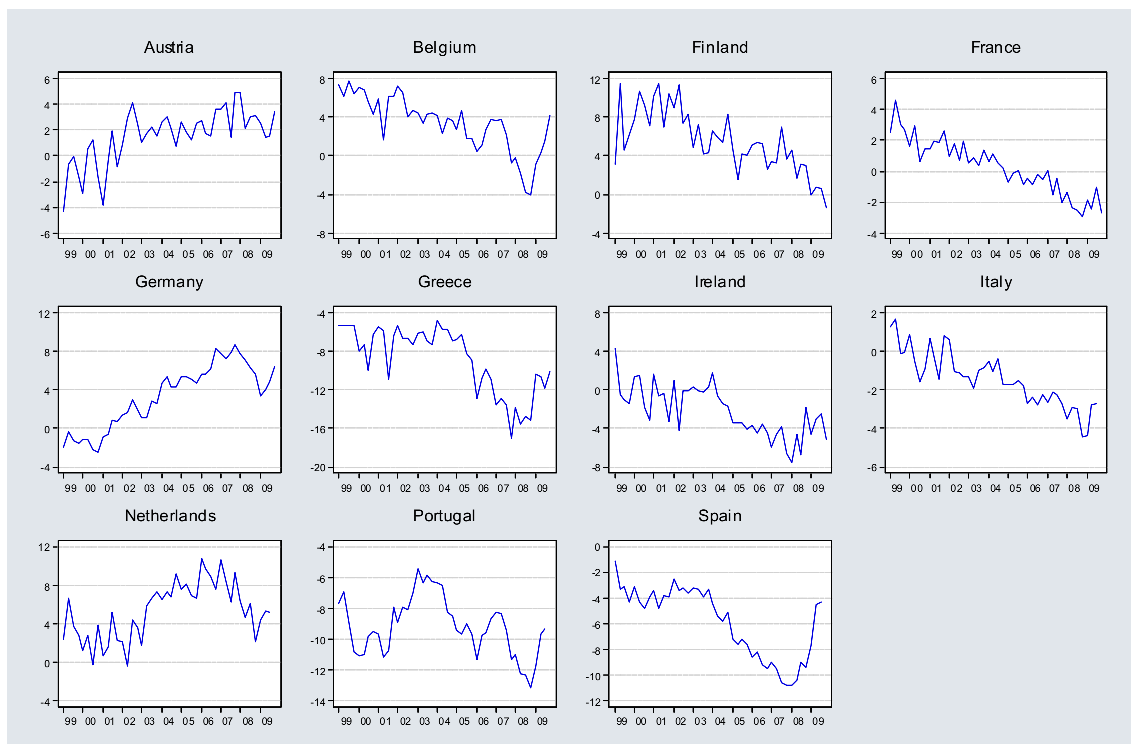
In the fiscal year 2010/2011 the public sector current budget — government income minus spending on current costs — was in deficit by £58.4 billion, compared to a deficit of £62.2 billion in 2009/2010. An increase in government tax revenue due to the economic recovery and implementation of the standard VAT rate offset the rise in government spending. Public net borrowing excluding financial intervention was £73.5 billion in the fiscal year to September, down from £77.4 billion in the same period last year. At the end of September 2010, public sector net debt was £842.9 billion, 57.2% of GDP. This compared to £687.5 billion or 49% of GDP at the end of September 2009. The austerity plan aims to prevent the debt ratio from going over 70% of GDP.

Figure 3: Log real effective exchange rate



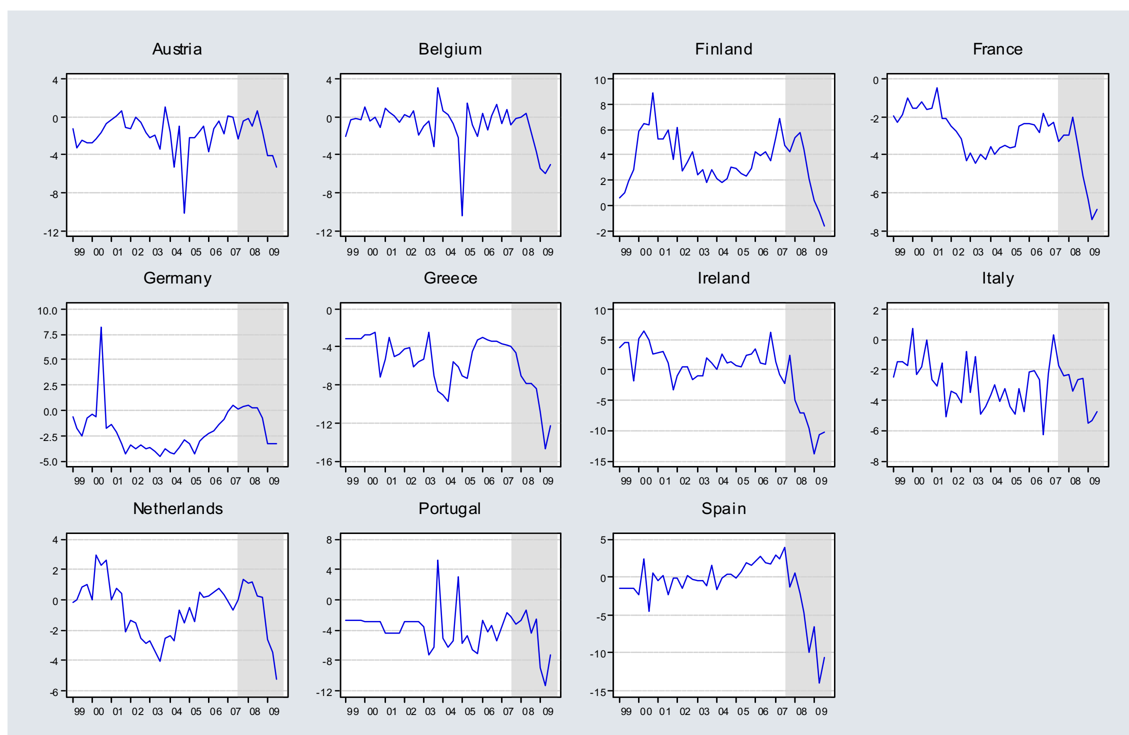
Note: The real effective exchange rate is calculated using consumer price indices. An increase indicates a real appreciation.
Source of data: International Financial Statistics

Figure 4: Current account balance as percentage of GDP



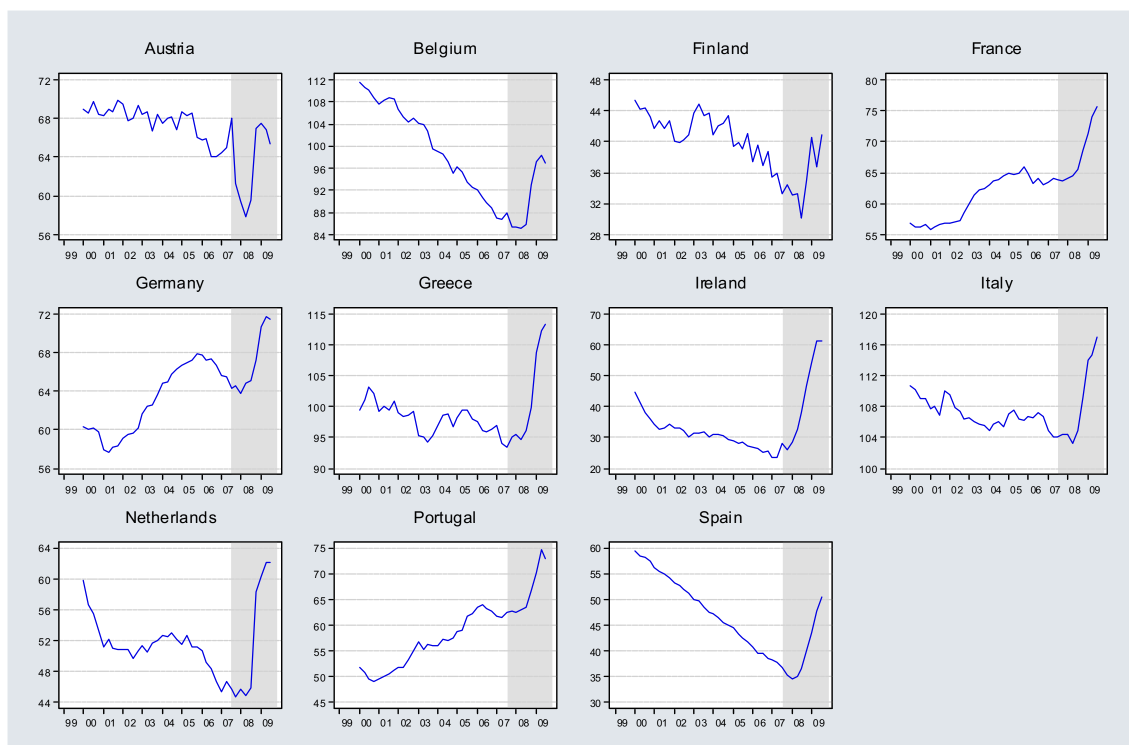
Source of Data: International Financial Statistics

Figure 5: General government net lending or borrowing as percentage of GDP



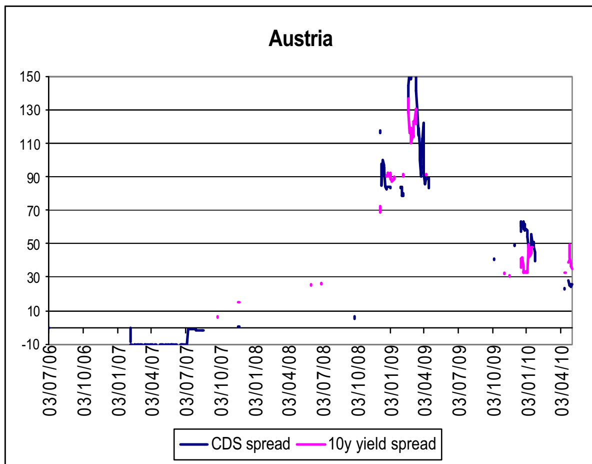
Note: The shaded area corresponds to the period 2007.Q3-2009.Q4. Source of data: International Financial Statistics

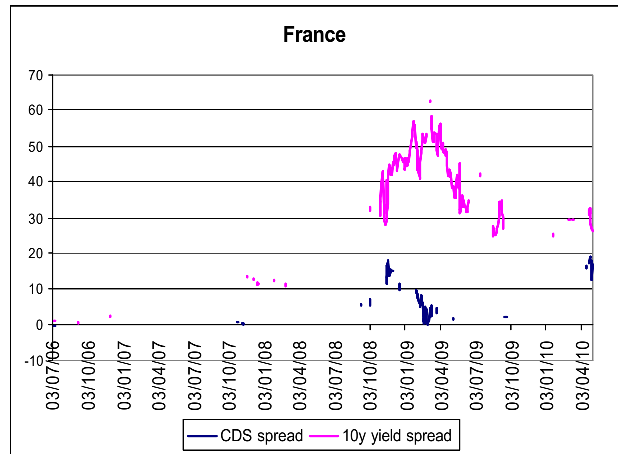
Figure 6: Gross government debt as percentage of GDP

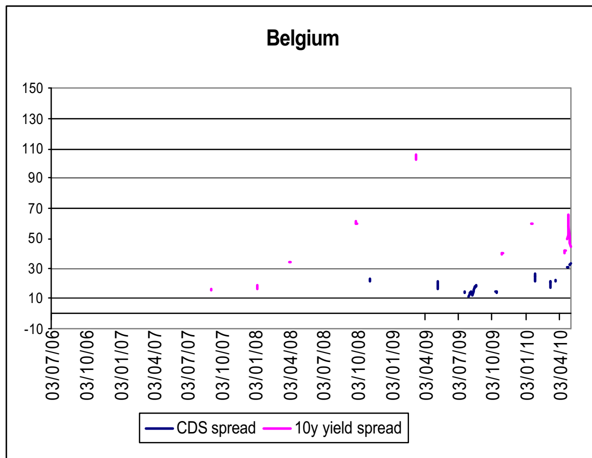


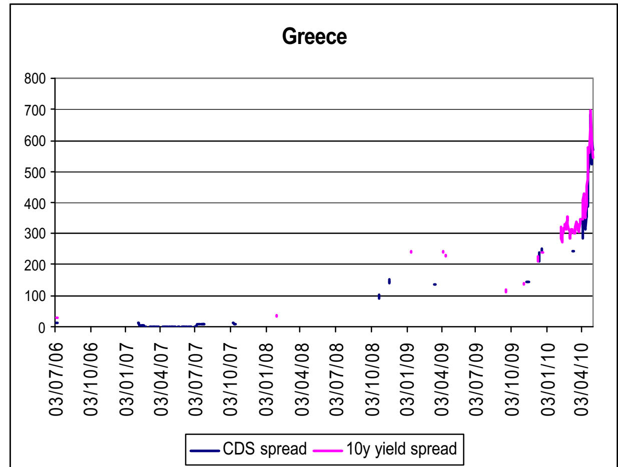
Note: The shaded area corresponds to the period 2007.Q3-2009.Q4

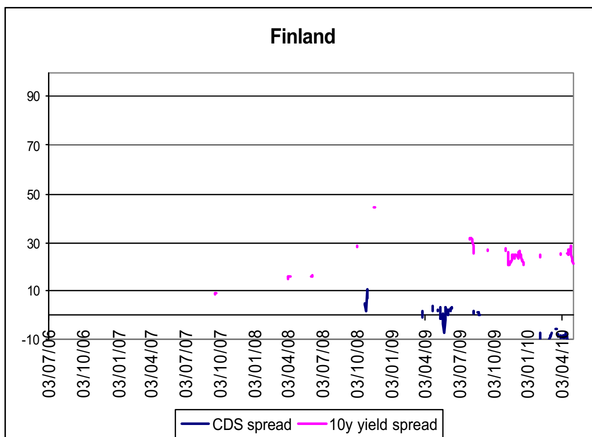
Figure 7: Credit Default Swap spreads and 10-year government bonds yields spreads

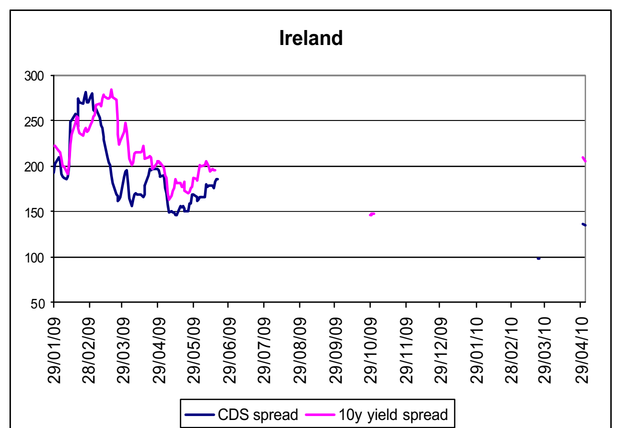


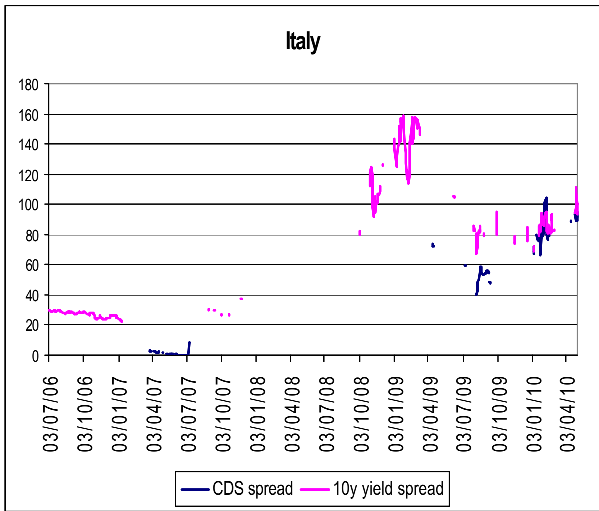


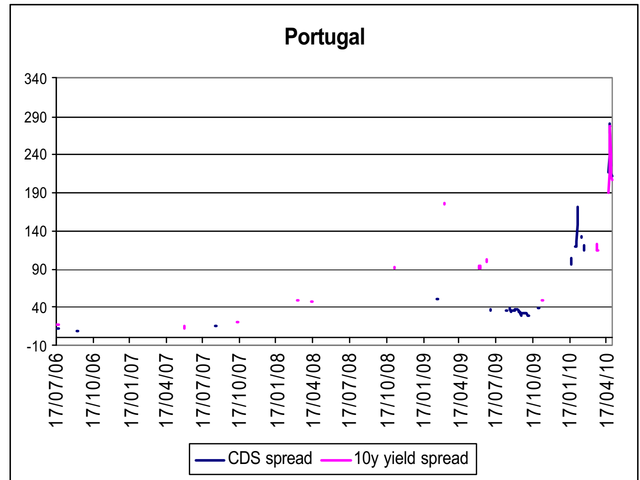


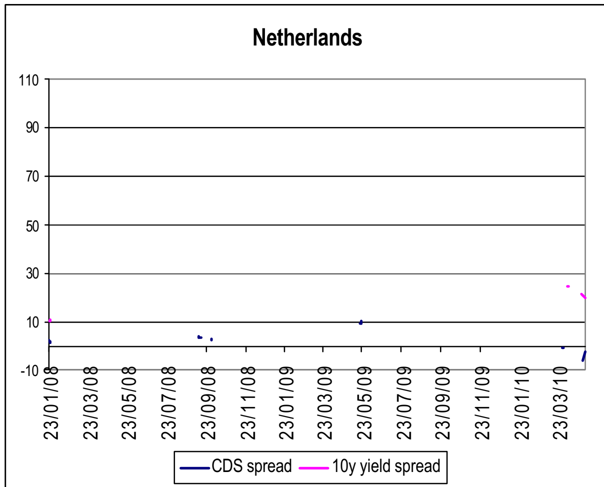


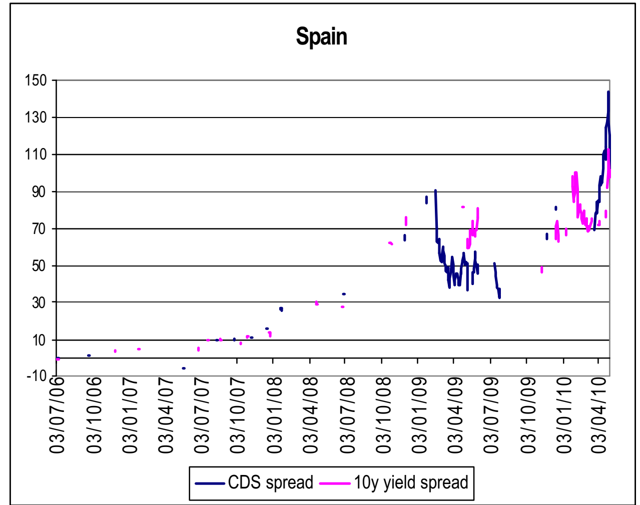












Note: Spreads are calculated versus Germany and are expressed in basis points in the case of the 10-year bond yields and thousands of US dollars (USD) in the case of the Credit Default Swaps (cost of insuring 10,000,000 USD holdings of government debt against default). Source of data: Bloomberg

The Julian Hodge Institute of Applied Macroeconomics

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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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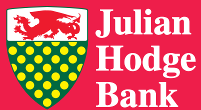

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