Cardiff Business School
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Julian Hodge Bank

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Julian Hodge Institute of Applied Macroeconomics

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Foreword

The main economic pre-occupation over the last few months has been when the MPC will increase interest rates rather than if. As we report in this bulletin, the MPC has a credibility issue. Increases in commodity prices have led to an inexorable increase in inflation, at least until last month's minor fall. As the sole measure of the MPC's success, to have inflation running at around twice the target level is at the least inconvenient. There is a logic to increasing interest rates to choke off the inflationary pressures and some evidence that growth is robust enough to accommodate increased finance costs. However, the impact of tax increases and benefit cuts, which will start to hit this month, have yet to be seen, and the high street has seen some of the worst recorded figures on consumer spending. Allied with a flat housing market and uncertainty of public sector employment, the recent minor dip in inflation may be enough of a fig leaf to postpone interest rate rises for a while.

The global picture is for continued growth, but there are some issues confronting Europe in particular where the banking sector is, yet again, the focus of some concern. Whilst the 'bailouts' of Ireland and Greece reduced the markets' concern about sovereign debt, the issue has not gone away. There is a consensus view that Greece will default on its debt at some point, and Ireland is caught in a difficult position where the cost of the bailout has been at the expense of economic growth, leading to the prospect of continued austerity as Ireland has no real prospect of growing its way out of debt. The recent attempts by the newly elected government to renegotiate the terms of the bailout, particularly the 5.8% interest rate, have met with a frosty reaction. Germany and France both resent the continued low corporation tax rates in Ireland, and it is hard to see how the Irish will achieve more than a cosmetic change to the existing terms. The Irish situation has a real bearing for the UK, not only in terms of the bilateral support given by the Government, but also in trade (Ireland is the UK's fifth largest export market) and in bank exposure (RBS alone is said to have £50bn of exposure to Ireland). With Portugal rejecting its own austerity measures and seeking an EU bailout, there is more pain to come for Europe. Ultimately it is hard to see that recovery in the peripheral EU countries will be achieved without substantial defaults. These will come once bank balance sheets are strong enough to absorb the associated losses and will be a dampener on growth for a while yet.

The Vickers' interim report into banking regulation has interesting implications for the UK economy. The two main proposals are to ring-fence retail banking activities and to further increase capital ratios. The first is an attempt to create a firebreak in the banking system that will protect retail depositors from future financial crises without involving government support. Unfortunately this does not go to the heart of the problem since mutual ownership is not the main determinant of the interconnectivity between retail banking and other banking activities. From a systemic point of view it makes little difference whether e.g. Barclays underwrites its risk with Barclays Capital or Goldman Sachs; the risk is likely to be passed on through the financial system leaving the system exposed to the merits of the particular risk underwritten. The increase in capital ratios also has little to do with systemic risk, merely reducing the chances of individual insolvency (albeit a desirable outcome in itself). It can be argued that the cost associated with additional regulation in protecting the financial system is always worthwhile, but regulation needs to be better targeted than the current proposals. The risk here is that we all incur additional cost for no benefit.

Paul Budd
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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.

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Patrick Minford, Economic Adviser to Julian Hodge Bank

THE EUROZONE CRISIS RENEWS WORLD UNCERTAINTY

As discussions continue over the new structure of euro-zone crisis bail-outs, the euro-zone crisis itself continues to deepen. Germany seeks guarantees against future bail-outs in the form of a tougher Stability and Growth Pact in effect, renamed the 'competitiveness pact'. However, the problem will remain that of the original Pact: that sovereign governments cannot actually be compelled to observe it. 'Sanctions' can in practice not be levied — as other governments will not agree, in case in their turn they would be asked to pay them; but also in a crisis sanctions will only worsen the crisis state's problems. All the Germany's demands are doing is worsening the current crisis as risk premia are ratcheted up on the countries now in crisis.

What Germany has done is underline its unwillingness to bail out its weaker partners. Yet the irony is that bail-outs in crisis times are likely to lead to the bailers getting their money back in the very end. Countries like Ireland and even Greece do have good prospects, even if the short term looks grim. The terms on which Germany and others contribute are set to give the lenders high returns as well. A further point is that the alternative — bankruptcy of one or more PIIGS — would wreck Germany's banking system, not to speak of that of France and other rich euro-zone countries who did the lending to the PIIGS. Another banking crisis in Germany and France would be hard to deal with, coming on the heels of the past banking crisis.

For all these reasons it seems to be in Germany's interests to contribute cheerfully to the bail-out deal and restrict its future demands to those for tighter control of borrowing by weak euro members in future boom times: after all if lending by German and French banks to Greece and Ireland had been kept under observation and some sort of limit, the crisis of these countries would be less.

Why then this constant destabilising behaviour by Germany? It seems it is all for domestic consumption, as German public opinion has rediscovered its original hostility to the euro. German opinion has also hardened into a general euro-scepticism, much like Britain's — a far cry from the policies of Helmut Kohl to 'build Europe as a receptacle for German ambitions', in the bid to create a new respectability for German foreign policy.

One can then see Angela Merkel's remarks as a way of educating German opinion about the risks of not doing the bail-outs enthusiastically. This then enables Germany in the end to go along with the general eurozone deals being made. However this sort of strategy has great dangers in the form of yet bigger bail-outs being needed for other countries down the worry list; first Portugal, then Spain, and after Italy and, perhaps before Italy, Belgium, now a country likely to split up. The more and bigger the bail-outs that are needed the less willing will German opinion be to go along with them. It looks currently like a race between economic stabilisation and German politics, not to speak of politics in the peripheral countries where austerity is causing massive resentment. Our view is that German self-interest will dominate and the bail-outs will be seen to be secure, so that market nerves will calm. But the risks remain severe, as politics has entered an unpredictable phase.

Table 1: Summary of Forecast

		2008	2009	2010	2011	2012	2013
GDP Growth[1]		–0.1	–4.9	1.4	3.1	3.0	2.7
Inflation	CPI	3.0	1.3	4.0	3.8	2.7	2.1
	RPIX	4.0	–0.5	4.4	4.0	3.2	2.8
Unemployment (Mill.)							
	Ann. Avg.[2]	0.9	1.5	1.5	1.3	1.2	1.2
	4th Qtr.	1.1	1.6	1.5	1.3	1.2	1.1
Exchange Rate (2005=100)[3]		91.1	80.6	80.6	79.4	78.2	77.8
3 Month Interest Rate		5.1	0.8	0.6	1.5	2.3	2.4
5 Year Interest Rate		4.0	2.8	2.3	2.6	3.3	3.4
Current Balance (£ Billions)		–23.8	–23.9	–28.7	–18.0	–17.8	–17.4
PSBR (£ Billions)		72.5	129.7	133.7	109.9	82.0	71.0

[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

The strong world recovery has collided with commodity shortage

The slowdown in the world economy from late 2006 was caused by the acute shortage of oil and commodities, which were soaring in price then after one and a half decades of virtually uninterrupted world growth. In our view it was this 'commodities shock' to world productivity growth that, by derailing the growth everyone had pencilled into the prospect, in turn caused various financial situations to turn very sour; the US housing market was one, large quantities of loans for house and other construction was another, and then there were packets of other loans to firms relying on growth. The banking crisis was created out of all this.

The underlying commodity shortage has not gone away, nor have there yet been any serious technological breakthroughs that could ease it. Instead governments around the world have taken strong steps to revive aggregate demand after the crisis and indeed succeeded, beyond perhaps their wildest dreams. The world economy grew at close to 5% last year according to IMF estimates, nearly reaching previous records. It seems clear that recovery to current levels is testing our supply capacity in commodities, even if many developed countries are still operating at high unemployment.

The result of this has been worldwide inflation, led clearly by commodities but not confined simply to them. When commodities rise in price by so much they cause existing plant and buildings to depreciate in value more rapidly than usual, as they are no longer so profitable at these higher prices. They were designed to operate at lower energy and material input prices. Hence, if one thinks of 'capacity' as the amount of plant and related facilities that can profitably be operated, then capacity has fallen, though measuring this is not really possible until much later on when we discover what plants firms have closed, rebuilt etc. Firms are therefore facing capacity shortages much earlier than one might have thought, were it not for this commodity shortage. They are also raising prices accordingly to restore or even enhance their margins as they approach full capacity.

In some countries, mostly in the developing world, wages also are rising because of labour shortages. This is not happening in developed economies where unemployment remains higher than the normal rate; wages are growing weakly at most in these. But this has not prevented inflation rising even in these countries. Inflation is now over the typical 2% target in several developed countries, in spite of their weak labour market. The euro-area average is now 2.4%, with Spain at 3.6% and Greece at 5.2%. The US is up at 1.6% so that the deflation feared by Mr. Bernanke seems far less of a threat.

While labour market weakness is restraining inflation in most of the OECD countries, inflation is therefore a serious problem in India and China, to name the two biggest of the emergers. On top of commodity shortage the pace of growth is creating bottlenecks throughout these two economies and this too is fuelling inflation.

Both countries are attempting to control money growth and the cost of money. But these policies are fatally undermined by extensive foreign exchange intervention holding their currencies down. Reserves are continuing to grow and as they are acquired in the foreign exchange market so home money is paid out in exchange. Stopping this money going to work to stimulate demand growth is a hard task which is being done mainly by controls — on bank reserve ratios, on credit, and even it seems on individual sector prices in the return of a sort of 'wage/price control'. For free market economies this is damaging policy which creates widespread distortions.

Unfortunately the US Fed's new Quantitative Easing piles more money into this process. The money flees to the east where it too is bought by central banks, adding further to their reserves and money supplies.

Overall we face a world economy up against the limits of its growth and with an inflationary headache outside the major OECD countries. Tightening must happen in the emergers and world growth will need to slow from its current heady recovery rate of nearly 5%. The Japanese tragedy has put a new force for slowdown into the equation; but it will not have more than a temporary effect. There has to be world monetary tightening, and soon.

UK monetary policy needs to tighten too

Various commentators have been focusing on the potential weakness of the UK economy as a reason for holding interest rates down, and therefore have been thinking of monetary policy purely in terms of the short term trade-off between inflation and growth. However, this trade-off is dominated in the Bank's remit by the requirement to keep inflation on target over the medium term — this comes ahead of any short-term objectives for growth or unemployment. The inflation target is technically the Bank's only objective; it is to satisfy it and only then if it does so may it look at issues of growth and unemployment.

The problem for the Bank is that it has now failed to satisfy it for three out of the last four years. Hence it has failed to keep inflation on target 'over the medium term'. In the current year and probably next year it will again fail almost certainly, and by a wide margin; hence its failure is now systematic.

What we are witnessing is a nasty outbreak of 'time-inconsistency' in which the Bank argues that it should nevertheless allow this failure to continue because if it were to bring inflation down it would damage growth. It uses weasel words like 'inflation is caused by factors beyond its control'; these words are nonsense since it can perfectly well bring inflation down with the factors that are under its control. Inflation in total is under the Bank's control — full stop. But what the Bank has decided is that inflation above target does not matter compared with growth.

This is a bit like an alcoholic saying that one more drink does not matter because in the medium term he will be sober. But of course an alcoholic ought, if he wants to be cured, to obey rule-based behaviour, viz. in his case do not drink at all. The Bank needs to remember it is subject to a rule, viz. that it has to control inflation to a target systematically, 'over the medium term'. Now of course it says it is doing this by promising to do it in two years' time. But sincerity about the future is not enough. For it to be behaving according to this rule it must be seen on average to achieve its target. This it is not doing and hence inflation expectations are rising and commentators such as Jeremy Paxman on *Newsnight* publicly question whether the target is meaningful and is told by reputable economists that it is 'not binding'.

This is dangerous stuff; far more dangerous than whether growth will be somewhat reduced by money tightening now. Look at it this way. The UK has spent 30-odd years of sweat, lost output and general political capital getting inflation under control and getting agreement from society as a whole that inflation should be kept down at 2% as a primary target of government policy. Ordinary people who do not understand economics have come as a result to accept this as an axiom of economic policy, not to be

questioned. We call this state of affairs 'credibility' of a fundamental economic policy, much as we treat the credibility of the 'rule of law', another basic institution of UK society. We obey and implement laws with a literalness and seriousness that leaves continental observers incredulous; for them EU law for example is partially disregarded, but here it is treated on a par with all our law-because the rule of law is a strong institutional pillar of our society.

The Bank is putting this institutional capital at risk with its casual talk of current trade-offs and its endless violation of its target. It may be — we do not really have a good model of how credibility is created and destroyed — that it will get away with it. Or it may be that it will in a matter of a year or two completely destroy the framework that has been erected with such pain over three decades.

The point is that this risk is just not worth taking. This is why in this particular comment I will not talk about the short-term outlook. I will simply argue on the credibility issue that it is time for the Bank to take no further risks with it and do something. As it happens its first moves to raise rates will not be very painful; but they will be far from a 'futile gesture'. Rather they will be a cheap downpayment on a new direction in which they give notice that inflation will be brought down and in a matter of months not years.

We need a return to rule-based behaviour by the Bank. The next move in rates should be a rise of 0.5%, with a bias to raise further. There should be no further QE, with a bias to reversal.

If we turn to the economic background and ask whether raising Bank Rate would slow the economy materially, we may note that Bank rate has become detached from market rates generally. The banks' cost of funds no longer involves Bank rate to any serious degree. One corollary of this is that raising Bank rate would have little effect on market rates for the initial upward moves.

Broad money growth is still weak and credit growth has stalled. However, these developments may well reflect the unattractive rates on deposit combined with the expensiveness of bank borrowing compared with issuing equity or using internal funds. Yields on financial assets have fallen to where it is now highly attractive to move out of money into risky assets. There seems to be a change of atmosphere in the UK markets — from the 'cash is king' caution of a year ago to a renewed search for yield today. This change is signalling the need to tighten to remedy an increasing psychology of 'loose money'.

The Bank says the exchange rate is an influence explaining the high inflation; not any more as it fell over two years ago. VAT is clearly an influence; while last year's VAT rise has now fallen out of the comparison, this year's has now replaced it. But the big problem with the Bank's position is its reliance on 'excess capacity' to keep inflation from rising. As we have just seen this excess capacity is likely to be exaggerated substantially. Its absence is probably the reason why inflation is above the euro-area's and also above what the Bank expected. Judging from producer surveys firms are planning to push their prices up, not merely to pass through commodity input prices but also to restore or enhance their margins.

Sooner or late unemployment is going to get back to its full employment rate (some 5% on the widely-cited survey measure, and around 3% on the benefit-claimant measure). We are 2% or so above these rates currently. But when this excess disappears, wages will start to accelerate, the more so if inflation expectations continue to rise. The Q4 estimate of GDP has impressed some as evidence of a 'double dip'. But at –0.6% it is at variance with other evidence, from producer surveys, strong manufacturing growth, inflation, and even employment figures which are slowly tending upwards. The ONS first estimates have ignored this sort of data in recent years (out of some sort of new emphasis on 'hard data'), and this has resulted in embarrassingly large and rapid revisions, mostly upwards. On this occasion the snow debacle will give them some cover, as no one really can tell what that did. However, they need to reconsider their methods for these 'flash' estimates of GDP.

All this points to the need for the Bank to raise interest rates and restore its authority over the inflation prospect. In the early stages of raising, it will not exert much negative impact on the economy as Bank Rate is largely ignored in market rates at present. However, it will act as a signal of the Bank's willingness to be politically unpopular in the fight to get inflation back down

Ironically, raising rates may start to make deposits more popular with the markets and so enhance the banks' liquidity and confidence so that their lending might get more aggressive. It also might encourage more banks into the high street and improve competition. This might start to revive lending too.

The government's fiscal correction remains on track. It is having an effect in restraining growth in spending and eliminating some of the inefficiency especially in local government. However, in terms of its effects on the growth in demand, these are quite modest; real public spending is supposed to fall by around 1% a year over the next four years. Public sector employment is due to fall by around 0.25% a year. Allowing for likely slippage in the programme, this is little more than a freeze of current spending and employment, its effects on the economy likely to be modest. What the government now needs to give attention to is the restoration of the economy's supply side. Marginal tax rates need to come down, regulations cut back particularly in the labour market cut back after a decade of Labour's union-friendly activity, and generally a pro-business environment re-established.

Osborne's Budget for Growth: does it deliver?

Thirteen years of Labour rule has left us with a business environment in need of repair. Latterly we got the 50% top tax rate, in blatant contradiction of the promise of 'New' Labour; before it there was the concession to the unions of the '12-week rule', much underestimated in its effect, and the quite unnecessary signing up to the EU's damaging Social Chapter. These are just a few of the more prominently damaging decisions made by Labour, whose primal instincts came more and more to the fore as their tenure in government lengthened. When one adds the gross mismanagement of the public services, with a massive growth in spending (some 50% in real terms over their term) and far too little to show for it in increased output, one is immediately aware of how much there is to put right — far too much for one budget in a single afternoon.

So how did George Osborne do? First we should remember the basically grim economic background. World recovery from the banking crisis was spectacular in 2010, with growth of around 5%. Britain's recovery was nowhere near so strong, in line with most rich countries whose productivity growth cannot match the rapid catch-up by emerging market countries. We grew only 1.6% (the euro-zone managed about the same, 1.7%), a bit more if you adjust for the snow at the year's end. The reason was nothing much to do with the tougher new fiscal plans, as in any case these had hardly started. It was to do with the renewed shortage of raw materials, visible again in their soaring prices. This shortage works primarily on the level and growth of capacity; when raw material prices rise the profitability of plants that use them intensively falls, which can be most accurately described as a fall in the productivity of capital. Think as an example of all those fuel-thirsty aeroplanes now due to be phased out.

Comment usually focuses less on these supply aspects and more on the demand-reducing effects of rising raw material prices. But in fact it is just as well that demand is held back as well since otherwise there would be more inflation. As it is we are seeing firms pass on these raw material price increases and also, given their lack of spare capacity, preserve or even increase their margins. So we observe that UK inflation is some 2% above euro-zone inflation and only a small part of this can be accounted for by VAT increases; the rest seems to be self-inflicted.

Take-home pay adjusted for inflation is being squeezed. With capacity tight and growth slow the supply of workers exceeds the growth in demand, and falling real wages is the response, which is slowly improving the jobs outlook in spite of slow growth. The world economy is currently inflationary and needs to slow down because of the constraint of raw material availability. Monetary policy is being tightened around the world. Soon it will have to be tightened here too if our inflation is to be brought under control like other people's.

This is a tough background for UK households. So naturally Mr. Osborne felt he should alleviate this pain as far as he could; however when you have no spare money it might have been better not to have pretended he could do so. The small switch of oil taxation from the retail end to the withholding tax on producers was a temptation he certainly should have resisted: the tax regime on the oil and gas industry ought to be kept stable since exploration and development of fields is long-term and complex; windfall taxes create distrust for the future.

The rise in the tax threshold Mr. Osborne gave us is a well-judged measure in the context of a flatter tax system designed to promote growth. A higher threshold makes the tax system more progressive and therefore allows higher rates to be lowered while still preserving progressiveness. Here the central issues are the tax on business in the form of corporation tax and the taxes on entrepreneurial income in the form of income and other general tax rates. Cutting corporation tax steadily — to 23% — is a good start.

Reviewing the 50% top income tax rate is not as good as removing it now, but presumably it signals that its end is not far off. Considering it has pushed the overall marginal tax rate on top incomes (including the effects of National Insurance and indirect taxation) to about 67% on my calculations, its abolition is urgent.

The Chancellor's main aim in the future should be to reduce marginal tax rates, especially at the top where the highest entrepreneurial value and effort occurs. But the taxation of such effort takes a variety of forms, often hidden under the guise of regulation. In some countries it is expensive to start a business and to close it; on the whole this is not true here. But regulation of some areas has worsened under Labour and as a result of European directives. The 12-week rule was introduced as a restriction on the ability of employers to dismiss striking workers in breach of their contract until they had been on strike for 12 weeks. Yet this restriction is immensely damaging to small firms which have always had the right to dismiss workers in breach of their contract provided it was done without unfair discrimination.

Then there is the Social Chapter which has placed severe burdens on business — under the Chapter one must consult with unions at every turn. In addition under Health and Safety regulations working time is restricted by the EU; this again is extremely onerous. Then recently there has been the ruling that women must be treated exactly equally with problems for pension provision and much else.

Mr. Osborne has indicated he wants to reduce regulation and by implication European regulation. It is time to be firm and 'just to say no' to European regulative intrusion that does not enhance competition inside Europe. In

practice the EU institutions cannot force us to adopt poor measures. UK common law already provides strong protection for individual rights, stronger and more precisely calibrated than any amount of 'human' or other rights imposed by top-down European regulation. We should refuse to implement aspects of European law that conflict with our own — such as on working time. We should certainly not 'gold-plate' EU measures as has frequently happened to date. A current example is the huge effort to regulate governments' activity within the eurozone to deal with the euro's crisis; we should refuse adamantly to let it have any impact here nor should we be involved in the bail outs of eurozone countries whose problems arise from euro membership.

Let me end with some comments on particular minor Budget proposals. The Chancellor revived 'Enterprise Zones'. These create problems for regions by arbitrarily giving special treatment in specific areas inside the regions, so disadvantaging a neighbouring area. But why should any particular area be singled out? For example some areas are selected because they are poor; but if we reward poverty we are truly on a slippery slope. In the end we need a good tax and regulative system for the whole country, not for some areas favoured for some arbitrary reasons.

Mr. Osborne is also giving more generous investment allowances to manufacturing. This is a poor alternative to tax cuts as it subsidises the wasteful use of capital. It is also discriminatory, in effect directing such subsidy to supposed 'winning sectors'. Again this is just causes waste. Better to return to the principle of neutrality.

Another proposal flagged up is to merge the National Insurance and income tax systems. This is an old chestnut and has repeatedly been dropped after careful review, most notably by Nigel Lawson. The problem is that NI is not applied to those who have retired. Even if the idea of NI, that it contributes to your pension and other social insurance, is largely nowadays a fiction, merging it with income tax that is levied on all income is a huge change that will cause endless problems. NI is largely a tax on employment; partly it is a genuine contribution to a supplementary pension that is usually 'contracted out'. Income tax is a tax on income; the two are different. Merging them would involve treating different sources of income differently and move us further away from a simple tax system. Better to leave NI as what it is, a more or less flat rate employment tax, and try to flatten income tax rates by raising thresholds and lowering top rates.

In this budget George Osborne blew the trumpet for liberating entrepreneurs, a welcome signal. He made a good start in some respects. He flagged up some false trails which he should forget. But the overall sense of direction he gave was much to be welcomed and should lead to an environment that is better for UK business and productivity growth.

THE UK ECONOMY

Vo Phuong Mai Le

Deviating from the path to recovery, the UK economy dipped in the last quarter of 2010. Real GDP decreased by 0.6% in Q4, after rising in the previous 4 quarters.

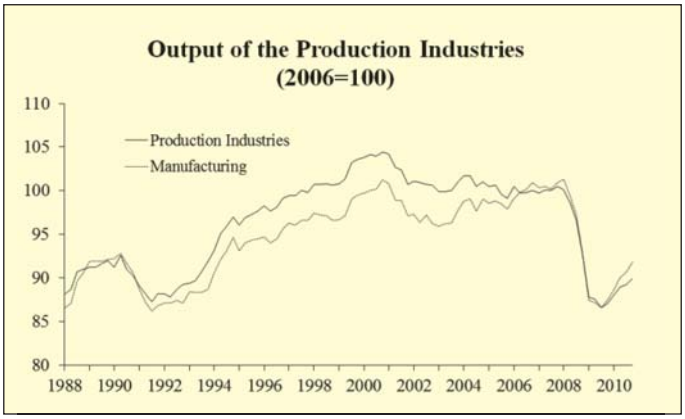
Output decreased across all sectors with the exception of the manufacturing sector. Manufacturing output rose 1.1% in Q4 after 1.1% in Q3. Other indicators signalled that the manufacturing sector remains on the path to recovery due to strong world trade. The CIPS manufacturing index increased from 58.7 in December to 62.0 in January, remaining above the 50-mark for the eighteenth consecutive month (a value above 50 means expansion). According to the CBI's monthly industrial trend survey, manufacturers' expectations for output growth strengthened. In February, 37% predicted an increase, while 14% expected a fall, a balance of 23% (up from 17% in January).

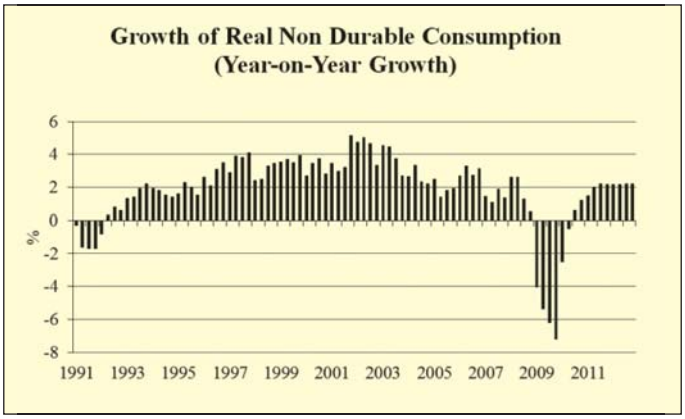
Construction output fell 2.5% in Q4, compared with a rise of 3.9% in Q3. It subtracted 0.2 percentage points from growth. However, there are signs of recovery in the sector. The CIPS construction purchasing managers' index was 53.7 in June, compared to 49.1 in December.

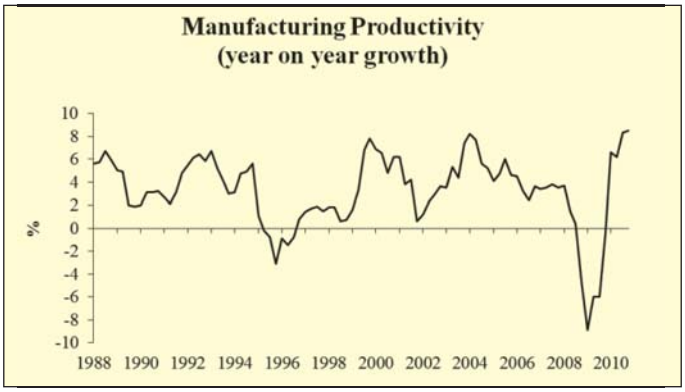
In the service sector, output was down 0.7%. This is consistent with the fall in CIPS services in December to 49.7 from 53 in November. This was mainly affected by bad weather at the end of the year. The output of distribution, hotels and restaurants fell 0.5% in Q4 after an increase of 0.8% in the previous quarter. Output in transport industries and business services also declined by 0.8% and 0.7% (compared to increases of 2% and 1% in Q3 respectively).

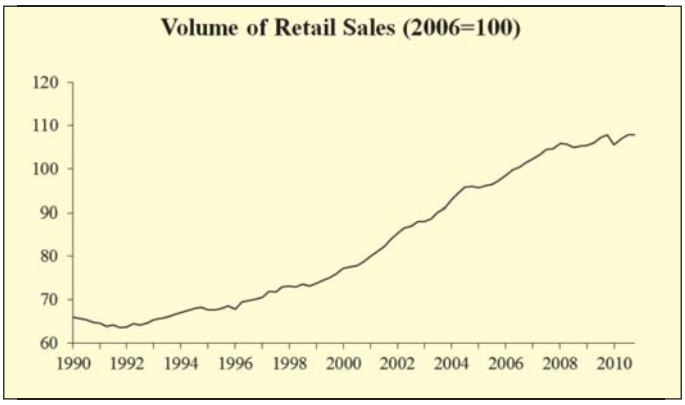
According to the ONS, the deceleration was driven by falls in domestic and foreign demand components: private consumption (down 0.1% after rising 0.1% in Q3), investment (down 2.5% after rising 3.7% in Q3), and net trade (exports increased 3.2%, while imports rose 3.3%). The only positive contribution to GDP growth came from public expenditure, which rose 0.7% in Q4 and the volume of which is 1.2% higher than a year earlier — in spite of the 'cuts'.

The housing market has weakened somewhat. The year-on-year change in the Halifax House Price Index was –2.4% in January 2011. Demand for houses has been affected by the lack of mortgage finance from the banks, especially for first-time buyers, and also by concerns about the economic outlook. Total mortgages approved decreased 10% between November and December. On the supply side, the ratio of









stock to sales is still high despite the weak output of the construction sector and some sellers are holding their properties off the market.

Cost and prices

CPI year-on-year inflation was 4.4% in February, rising from January's 4% and December's 3.7%. This acceleration reflected the introduction of higher VAT of 20% in January and higher prices of energy. The RPIX index (RPI excluding mortgage interest payments) rose from 5.1% in January to 5.5% in February.

CPI inflation has been persistently above its 2% target, the Bank of England predicts that it will increase further in the near term following rises in commodity and import prices. In line with this prediction, firms and households have started revising up their short-term inflation expectations. According to the Bank of England, households' inflation expectation beyond a year ahead in Q4 2010 was registered at 3.2%. In February a balance of 32% of firms (compared with 31% in January) expected they will have to raise prices in the coming quarter. In spite of the existence of some spare capacity — we think much less than the Bank is relying on for its forecasts — higher expectations have started leading to higher wages and prices. Annual factory gate inflation for all manufactured products rose 5.3% in February compared with 4.8% in January. Input price annual inflation rose to 14.6% in February from 14.1% in January and from 12.9% in December. In November average weekly earnings growth rose 2.3% on a year earlier, compared to 2.1% in Q3.

Labour market

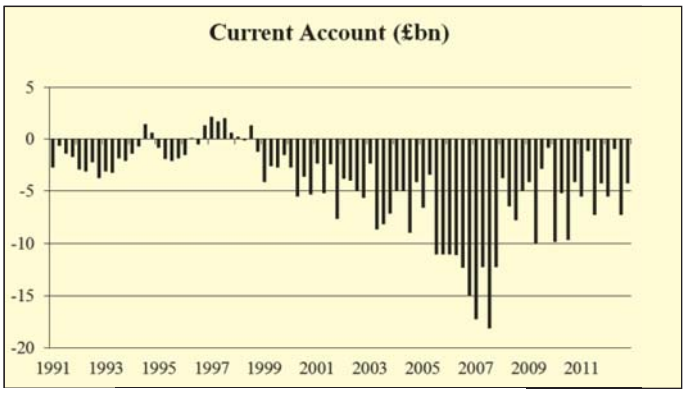
The situation in the labour market is still weak. The employment rate for the three months to December was 70.5%, down 0.3% on the previous quarter. During the same time, the unemployment rate marginally increased to 7.9% compared to 7.8% in the period between July to September. The claimant count rate did not improve. It stood at 4.5%, unchanged on the previous month.

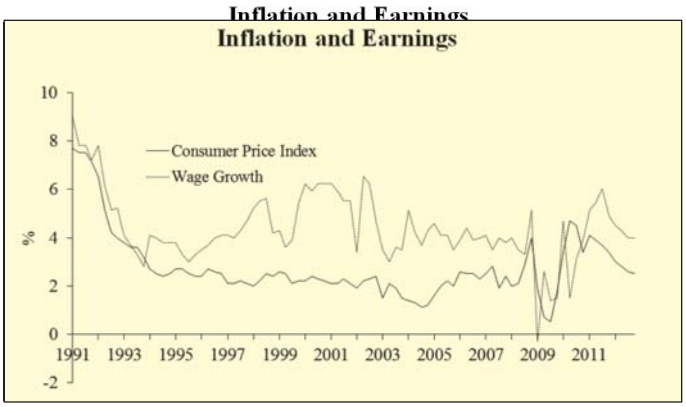
Trade

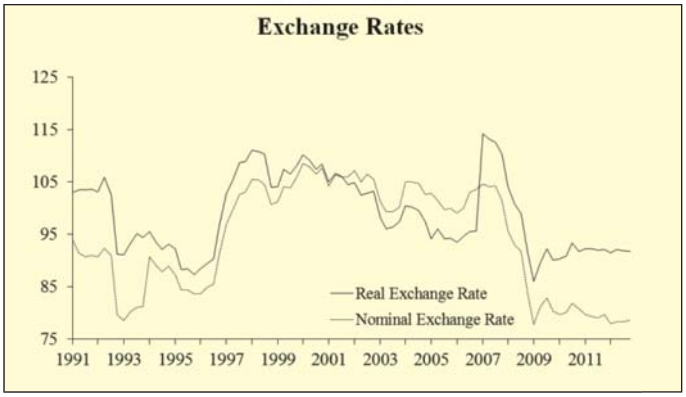
In the third quarter the deficit on trade of goods increased by £3.0 billion to £25.7 billion, the surpluses on services and net foreign income were £13.4 billion and £7.5 billion. Overall the current account deficit rose to 2.6% of GDP, against 1.4% of GDP in Q2. The UK's external position thus worsened; nevertheless sterling's effective exchange rate appreciated 2% between November and February.

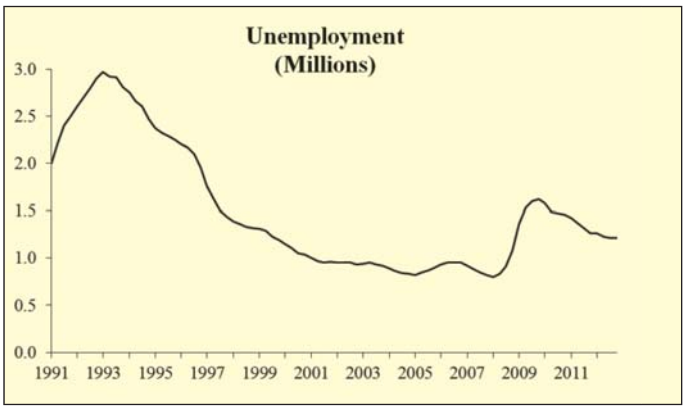
Monetary and fiscal developments

Notes and coins in circulation grew by only 3.2% in January on a year earlier. The year-on-year growth rate of broad money — M4, including bank and building society









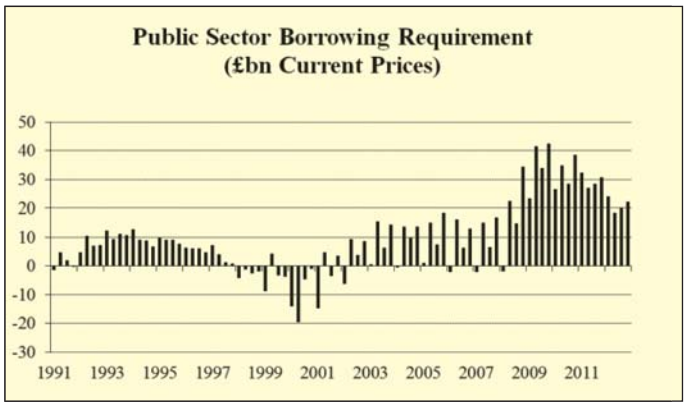
deposits held by households and firms — rose to 3% from 2.3% in Q3. Excluding lending to 'intermediate financial companies,' growth was −1.5%. UK banks continue to squeeze their lending to businesses and households, and high inflation causes negative real yields on broad money holdings. Corporations have easier access to finance through bond and equity markets, and investors seem to be diverting their funds there to find positive real yields.

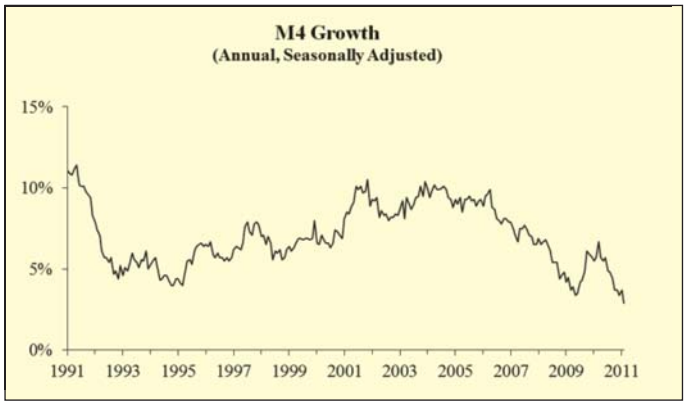
The Bank of England maintained its official lending rate at 0.5% at the Monetary Policy Committee meeting in February. It also maintained the stock of asset purchases financed by the issuance of central bank reserves at £200 billion — a freezing for the time being of Quantitative Easing, with no more but also no unwinding. With inflation more than 2% above its target, the MPC's decision is puzzlingly at variance with its remit of inflation control.

In the fiscal year 2010/2011 the public sector current budget — government income minus spending on current costs — was in deficit of £85.0 billion, compared to a deficit of £91.8 billion in 2009/2010. An increase in government tax revenue due to the economic recovery and alteration of the VAT offset the rise in government spending. Public net borrowing excluding financial intervention was £113 billion in the fiscal year to January, down by £6.8 billion from the same period of 2009/2010. At the end of January, public sector net debt was £876.2 billion or 57.6% of GDP. This compares with £720.9 billion (50.4% of GDP) at the end of January 2011.

The Budget 2011

In his budget Chancellor George Osborne confirmed the outline of his previous projections for the budget deficit. His aim was to deal with supply-side issues. He announced cuts in corporation tax, 1p at once, with 1p a year to follow until it fell to 23%; a review of the 'temporary' top 50% income tax rate to see whether it raised any revenue and if so how much, a move that implies abolition before long; and various smaller items of help to business, especially on manufacturing and R and D. Otherwise there were several measures to alleviate the pressure on household budgets, including a cut in fuel duty and a rise in the income tax threshold. The budget therefore pointed towards a new approach to business, with the aim of creating better incentives for enterprise.





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]
2009	1.3	2.8	0.8	80.6	89.6	-3.2	-0.5	-0.1
2010	4.0	2.3	0.6	80.6	91.5	-3.2	4.4	-0.3
2011	3.8	2.6	1.5	79.4	92.1	-1.2	4.0	0.4
2012	2.7	3.3	2.3	78.2	91.7	0.2	3.2	1.2
2013	2.1	3.4	2.4	77.8	91.6	0.3	2.8	1.3
2010:1	3.4	2.8	0.5	79.7	90.3	-3.6	4.0	0.1
2010:2	4.7	2.2	0.7	80.0	90.8	-3.2	5.1	-0.4
2010:3	4.5	1.8	0.6	81.8	93.3	-3.1	4.7	-0.7
2010:4	3.4	2.3	0.7	80.8	91.6	-2.7	3.7	-0.1
2011:1	4.1	2.4	1.1	79.7	92.2	-1.9	4.3	0.1
2011:2	3.9	2.5	1.4	79.3	92.2	-1.4	4.1	0.3
2011:3	3.7	2.7	1.5	79.0	91.9	-1.1	4.0	0.5
2011:4	3.4	3.0	1.8	79.6	92.0	-0.7	3.8	0.8
2012:1	3.0	3.2	2.1	77.9	91.4	-0.2	3.5	1.0
2012:2	2.8	3.4	2.3	78.3	92.1	0.2	3.3	1.3
2012:3	2.6	3.4	2.4	78.2	91.8	0.4	3.1	1.3
2012:4	2.5	3.4	2.4	78.6	91.6	0.4	3.1	1.3

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)	Long-Run Real Wage Rate[5]	Long Run 'Natural' Level of Unemployment[6]
2009	219.1	1.4	4.7	1.53	135.8	160.7	1.18
2010	227.1	3.3	4.6	1.50	134.8	163.9	1.38
2011	239.3	5.4	4.1	1.34	137.0	165.8	1.20
2012	249.4	4.2	3.7	1.23	139.0	170.3	1.30
2013	258.4	3.6	3.5	1.16	141.1	174.8	1.41
2010:1	224.1	4.7	4.9	1.58	136.1	160.8	1.50
2010:2	226.0	1.5	4.6	1.49	133.2	162.3	1.48
2010:3	228.0	3.1	4.5	1.47	134.0	165.6	1.28
2010:4	230.4	3.9	4.4	1.46	136.0	167.1	1.27
2011:1	235.6	5.1	4.3	1.42	137.5	163.6	1.21
2011:2	238.3	5.4	4.1	1.37	135.2	165.1	1.20
2011:3	241.6	6.0	4.0	1.32	137.1	166.6	1.19
2011:4	241.7	4.9	3.8	1.26	138.1	168.0	1.18
2012:1	246.2	4.5	3.8	1.26	139.5	168.0	1.32
2012:2	248.5	4.3	3.7	1.23	137.2	169.6	1.30
2012:3	251.4	4.0	3.6	1.21	139.1	171.0	1.29
2012:4	251.3	4.0	3.6	1.21	140.1	172.5	1.28

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
5 Long-run equilibrium real wage rate (% of actual) 100=Equilibrium
6 Long-run equilibrium values (millions)

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

	Expenditure Index	£ Million '90 prices	Non-Durable Consumption[2]	Private Sector Gross Investment Expenditure[3]	Public Authority Expenditure[4]	Net Exports[5]	AFC
2008	145.1	694729.2	428524.4	250447.7	176493.3	-52108.8	108627.4
2009	138.0	660862.7	413300.8	205532.9	181442.5	-40858.9	98554.6
2010	139.9	669950.1	411459.6	226489.9	184411.5	-49311.5	103058.7
2011	144.2	690716.1	419538.4	245565.4	177256.0	-45314.1	106328.5
2012	148.5	711260.0	428683.2	265158.8	172451.6	-45233.3	109789.8
2013	152.5	730123.6	438080.7	281310.7	168866.5	-45196.0	112926.6
2008/07	-0.1		0.8	-2.9	3.7		8.7
2009/08	-4.9		-3.6	-17.8	2.8		-9.4
2010/09	1.4		-0.4	10.4	1.6		4.8
2011/10	3.1		2.0	8.5	-3.9		3.7
2012/11	3.0		2.2	8.0	-2.7		3.3
2013/12	2.7		2.2	6.1	-2.1		2.9
2010:1	138.4	165738.4	102022.5	56039.5	48085.4	-12806.5	27602.4
2010:2	140.0	167615.5	102855.7	55413.2	44643.3	-12400.7	22856.1
2010:3	141.0	168808.6	103242.3	59052.2	45446.5	-12769.6	26162.8
2010:4	140.1	167787.6	103339.1	55985.1	46236.3	-11334.8	26437.5
2011:1	143.4	171690.0	103550.2	59989.9	46072.6	-11339.2	26584.7
2011:2	144.3	172776.6	104903.4	62668.5	42857.4	-11335.3	26317.0
2011:3	145.0	173648.2	105495.9	62482.8	43716.1	-11326.3	26719.5
2011:4	144.2	172601.4	105588.9	60424.2	44609.9	-11313.3	26707.3
2012:1	147.5	176629.7	105803.1	64753.9	44653.9	-11307.4	27273.4
2012:2	148.6	177942.6	107187.0	67845.5	41643.1	-11305.8	27427.2
2012:3	149.4	178882.7	107797.7	67386.6	42620.5	-11311.1	27609.8
2012:4	148.5	177805.0	107895.5	65172.8	43534.1	-11308.9	27479.4

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

Financial Forecast

	PSBR/GDP %[1]	GDP[1] (£bn)	PSBR (£bn) Financial Year	Debt Interest (£bn)	Current Account (£ bn)
2008	5.7	1269.0	72.5	33.2	-23.8
2009	10.5	1234.3	129.7	32.5	-23.9
2010	10.2	1318.3	133.7	36.5	-28.7
2011	7.8	1408.8	109.9	42.2	-18.0
2012	5.5	1488.6	82.0	47.2	-17.8
2013	4.6	1559.0	71.0	49.9	-17.4
2010:1	8.3	320.4	26.5	8.4	-9.8
2010:2	10.9	319.2	34.7	8.8	-5.2
2010:3	8.6	328.9	28.3	8.9	-9.6
2010:4	11.7	327.8	38.4	9.1	-4.1
2011:1	9.4	342.4	32.3	9.7	-5.5
2011:2	7.7	346.9	26.9	10.0	-1.1
2011:3	8.1	350.8	28.4	10.3	-7.2
2011:4	8.8	348.1	30.7	10.7	-4.2
2012:1	6.6	363.0	24.0	11.2	-5.5
2012:2	5.0	368.1	18.4	11.5	-0.9
2012:3	5.4	370.9	20.0	11.7	-7.2
2012:4	6.0	367.6	22.2	11.8	-4.2

1 GDP at market prices (Financial Year)

THE WORLD ECONOMY

Recent indicators continue to suggest a firm and self-sustaining global economic recovery. In January the global composite Purchasing Managers Index (PMI) rose to 57.2 from 55.6 in December, the highest level since the series began in 1998.

Input prices have been pushed up by higher food and commodity prices. Besides strong growth, the driving factors have been natural disasters, notably the Japanese earthquake and tsunami, and also unrest in the Middle East. In the OECD inflation is generally under control with weak labour markets and some spare capacity; inflation expectations have remained well anchored. Annual headline CPI inflation in the OECD was 2.1% in December compared with 1.8% in November. Excluding food and energy, annual inflation was 1.2% in December, unchanged from November. In emerging countries, input prices in combination of fast economic growth caused inflation rates to increase continuously.

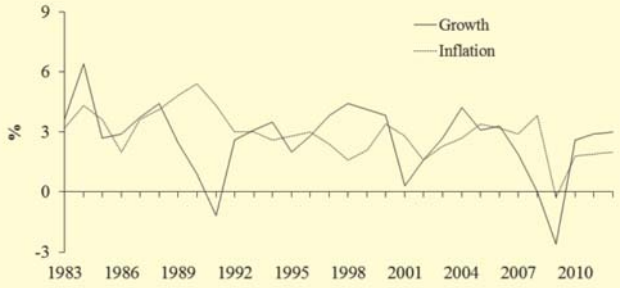
US

The US economy continued to recover. Real GDP increased by 0.8% quarter-on-quarter in Q4 2010, after a rise of 0.6% in Q3. This reflected stronger momentum in consumer spending and investment growth and a positive contribution from trade. Growth was held down by a negative contribution from private inventories. Real personal consumption continued to increase in Q4 to 1.1% quarter-on-quarter, up from 0.6% in the previous quarter. Investment continued making a positive contribution to GDP growth. This was driven by the rebound in residential investment (0.85% after a sharp collapse of 6.8% in Q3) and the continuous expansion in non-residential investment (1.1% increase after 2.5% in Q3).

Net exports added 0.85 percentage points to quarterly growth, as exports grew and imports fell. Real exports of goods and services rose 2.1% quarter-on-quarter in Q4 after increasing 1.6% in Q3. Imports fell 3.4% in Q4 after rising 4.2% in the previous quarter.

The housing market started picking up at the end of 2010, but it is still very weak. Sales of both existing and new home rose 38% and 16% respectively in the period between July and December. In terms of prices, the monthly prices of new home sales collapsed in September and October (falling 12.3%) before recovering in November and December by 8.1%. Existing home prices stayed unchanged in December after a rise of 3.5% in November. The outlook for the housing market is not encouraging. The stock of existing homes is getting bigger: December's stock of homes for sale was 3.6 million (equivalent to 8.1 months of transactions) and the Mortgage Bankers Association survey predicted another 1.9 million foreclosed homes would be added. Higher stock will continue to depress prices. The new homes market is undermined by low priced properties in the existing homes market.

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



USA

	2007	2008	2009	2010	2011	2012
Real GDP Growth (% p.a.)	1.9	0.0	–2.6	2.6	2.9	3.0
Inflation (% p.a.)	2.9	3.8	–0.3	1.8	1.9	2.0
Nominal Short Int. Rate	4.4	1.5	0.2	0.1	0.3	0.5
Real Short Int. Rate	0.6	1.8	–1.6	–1.8	–1.7	–1.5
Nominal Long Int. Rate	4.6	3.7	3.2	3.1	3.2	4.0
Real Long Int. Rate	2.8	2.2	1.3	1.1	1.2	2.0
Real Ex. Rate (1996=100)[1]	83.4	80.1	88.7	81.7	81.8	82.0
Nominal Ex. Rate[2]	89.38	81.72	81.61	82.12	83.97	83.94

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

The labour market has shown some signs of improvement. Non-farm payroll employment rose 36,000 in January 2011, which followed increases of 121,000 in December and 93,000 in November 2010. The unemployment rate decreased sharply for the second consecutive month (9.0% after 9.4% in December and 9.8% in November). This high level of unemployment continues to hold down wage growth. In January hourly wages rose 1.9% year-on-year, after 1.7% in both November and December.

Annual CPI inflation was 2.1% in February 2011; excluding food and energy it was 1.1%. Underlying inflation is currently well below its (unannounced) target of some 2% despite the economic recovery and the loose monetary policy stance. In the March meeting, the Federal Open Market Committee (FOMC) acknowledge the upward pressure on energy and commodity prices, but considered this to have only a transitory impact on inflation. It decided to keep its target range for the Federal fund rate at 0–0.25%. Monetary policy remained accommodating with the absence of inflationary pressures. The FOMC still intends to purchase $600 billion extra of Treasury securities by the end of the second quarter of 2011 and reinvest any repayments of its existing securities holdings. Thus

Quantitative easing is still on a large scale in this second phase ('QE2').

Japan

Even before the recent earthquake, tsunami and nuclear problems devastated the Japanese economy, available data showed a deceleration in economic activity in Q4 2010. Real GDP contracted by 0.3% after a rise of 0.8% in Q3. This setback was driven mainly by weak household spending which fell sharply by 0.7% compared to 0.9% in Q3. Private consumption subtracted 0.4 percentage points from GDP growth. Net exports subtracted 0.1 percentage points due to slower world trade growth and the appreciation of the yen by 7.7% over the second half of 2010. A fall in exports by 0.7% exceeded the 0.1% fall in imports.

Despite this decline, the business climate continued to improve according to the headline leading business indices (rising to 101.4 in January from 100.6 in December) and the Economy Watchers Survey (45.1 in December from 43.6 in November). Private residential investment rose by 3% from 1.8% in Q3. Private non-residential investment rose by 0.9% after 1.5% in the previous quarter. Nevertheless the earthquake and its aftermath have put paid to any such positive sentiment.

The labour market situation improved but is still very weak. The total unemployment rate declined to 4.9% in December from 5.1% in November. Employment growth rose 0.1% in December after falling 0.3% in October and 0.7% in November. The ratio of effective job offers to application was 0.56 in Q4, up from 0.54 in the previous quarter.

The economy is in a mild deflationary phase with prices steadily declining. CPI inflation year-on-year was 0.1% in November after 0.2% in October, driven slightly positive by world commodity inflation. Annual inflation excluding food and energy was –0.6% compared to –0.8% in October.

At the February meeting the Bank of Japan was still optimistic about the economic recovery process, describing the economy as gradually emerging from the current deceleration phase. They believed that the expansion of the global economy would help to promote Japanese exports and growth. On the other hand, they were concerned about rising commodity prices and their effect on inflation. They decided to leave the overnight call rate at 0.1%. Since the earthquake they have injected large amounts of liquidity into the markets. In spite of the regular complaints about deflation from the Bank and politicians generally there is no practical intention to eliminate it by pursuing an inflation target; with people holding large amounts of cash now effectively as a store of value the prospect of creating inflation, which would devalue these savings, has receded.

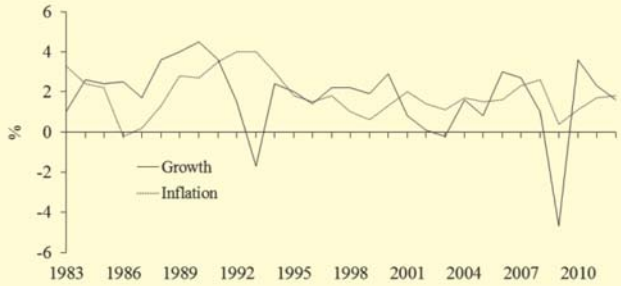
Japan: Annual Growth Rates of Real GNP and Consumer Prices

Japan

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

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

Germany: Annual Growth Rates of Real GNP and Consumer Prices



Germany

	2007	2008	2009	2010	2011	2012
Real GDP Growth (% p.a.)	2.7	1.0	–4.7	3.6	2.3	1.6
Inflation (% p.a.)	2.3	2.6	0.4	1.1	1.7	1.8
Nominal Short Int. Rate	3.9	3.9	0.7	0.4	1.0	1.4
Real Short Int. Rate	1.3	3.5	–0.4	–1.3	–0.8	–0.6
Nominal Long Int. Rate	4.3	4.4	4.0	3.8	3.8	4.0
Real Long Int. Rate	2.8	3.0	2.3	1.9	1.8	2.0
Real Ex. Rate (1996=100)[1]	104.6	105.1	105.8	99.3	99.0	99.1
Nominal Ex. Rate[2]	0.73	0.68	0.72	0.75	0.78	0.78

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

Germany

The economic recovery has continued but at a slower pace. Real GDP rose 0.4% in Q4, after 0.7% in the previous quarter. Real GDP was up 3.5% in 2010 after declining 4.7% in 2009; in Q4 it was still 1.4% below its pre-crisis level. Both domestic and foreign demand contributed positively to the growth rate, though the bad weather at the

end of the year produced a setback for some expenditure categories.

Net exports contributed 0.7 percentage points to GDP growth in Q4 after 0.7 percentage points in Q3. They continued to benefit from the global trade recovery. Export growth of 2.5% exceeded imports growth of 0.9%. Investment in machinery and equipment increased for the 4th quarter in a row, 2.6% (after 5% in Q3). Private consumption increased 0.2% (following 0.5%). Public consumption increased by 0.6% in Q4 (after 1.5%). All of these positive contributions were offset by a sharp decrease in construction investment by 3.9% in Q4, and falling inventory investment knocked 0.4 percentage points off Q4 GDP growth.

Other indicators show that the economy is going to bounce back stronger from the adverse impact of the bad weather conditions, and will continue to gain from the strong world demand outside the eurozone. Manufacturing new orders were up by 1.8% in Q3 and 2.4% in Q4. Manufacturing PMI rose to its highest level ever in February at 62.5 from 60.5 in January. The IFO business climate index increased for the 9th month in a row to 111.2 in February from 100.3 in January. The ZEW expectation index, measuring investor and analyst opinion on trend in future activity increased for four consecutive months to 15.7 in February from 15.4 in January. The impact of the export-led growth and brighter expectations about future activity will continue to boost investment and growth.

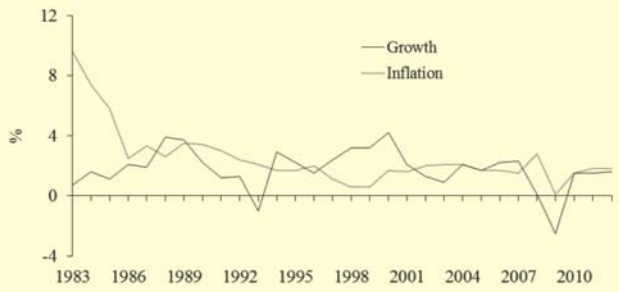
The labour market improved in line with the growth in GDP. The unemployment rate fell for the second month in a row in February to 7.3% from 7.4% in January and 7.5% in December 2010. It was the lowest since 1991. Employment increased by 0.1% month-on-month in December, and it was up by 1% year-on-year.

France

Output has not accelerated at the end of 2010. Real GDP increased by 0.3% in Q4, unchanged from Q3. This reflected the adverse effects of strikes and bad weather on production. Overall, the annual growth rate was 1.5% in 2010, after –2.5% in 2009.

Growth was sustained by robust internal demand (excluding inventory), which contributed 0.7 percentage points to Q4 GDP growth. Household consumption rose 0.9%, due to an 8.8% rise in car sales ahead of the end of the tax incentive scrappage scheme. Total investment rose by 0.4%. Foreign trade also contributed 0.5 percentage points to GDP growth, as exports rose 0.8% and imports fell 1.2%. Inventory investment was the only negative demand factor, subtracting 0.8 percentage points from GDP growth.

France: Annual Growth Rates of Real GNP and Consumer Prices

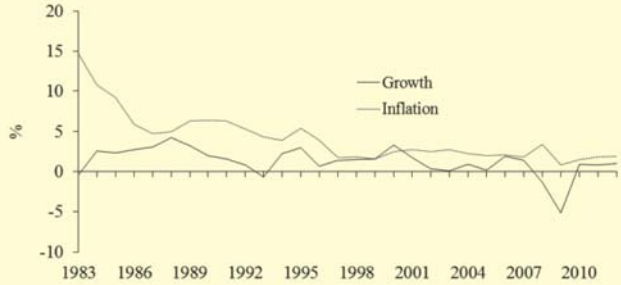


France

	2007	2008	2009	2010	2011	2012
Real GDP Growth (% p.a.)	2.3	0.1	–2.5	1.5	1.5	1.6
Inflation (% p.a.)	1.5	2.8	0.1	1.5	1.8	1.8
Nominal Short Int. Rate	3.9	3.9	0.7	0.4	1.0	1.4
Real Short Int. Rate	1.1	3.8	–0.8	–1.4	–0.8	–0.6
Nominal Long Int. Rate	4.3	4.4	4.0	3.8	3.8	4.0
Real Long Int. Rate	2.7	3.0	2.2	1.9	1.8	2.0
Real Ex. Rate (1996=100)[1]	104.9	106.4	104.3	101.7	102.0	102.0
Nominal Ex. Rate[2]	0.73	0.68	0.72	0.75	0.78	0.78

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

Italy: Annual Growth Rates of Real GNP and Consumer Prices



Italy

	2007	2008	2009	2010	2011	2012
Real GDP Growth (% p.a.)	1.4	–1.3	–5.1	0.9	0.8	1.0
Inflation (% p.a.)	1.8	3.4	0.8	1.5	1.8	1.9
Nominal Short Int. Rate	3.9	3.9	0.7	0.4	1.0	1.4
Real Short Int. Rate	0.5	3.1	–0.8	–1.4	–0.9	–0.4
Nominal Long Int. Rate	4.3	4.4	4.0	3.8	3.8	4.0
Real Long Int. Rate	2.4	2.8	2.2	1.9	1.8	2.0
Real Ex. Rate (1996=100)[1]	105.0	106.6	105.4	100.5	100.8	101.0
Nominal Ex. Rate[2]	0.73	0.68	0.72	0.75	0.78	0.78

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

Production has improved in line with GDP growth and survey data. In Q4 industrial production rose 0.8%. Manufacturing output increased 0.4%. The composite business climate index rose to 105 in December from 103 in November, and increased further to 106 in January 2011. The largest expansion was in the manufacturing sector (the index rose from 100 in November to 108 in January).

Annual CPI inflation increased to 1.8% in December, after standing at 1.6% for the three previous months. The sharp increase of 12.5% in the year-on-year energy prices in December was the main factor driving up the inflation rate. The core inflation rate was 0.7% unchanged from the previous month.

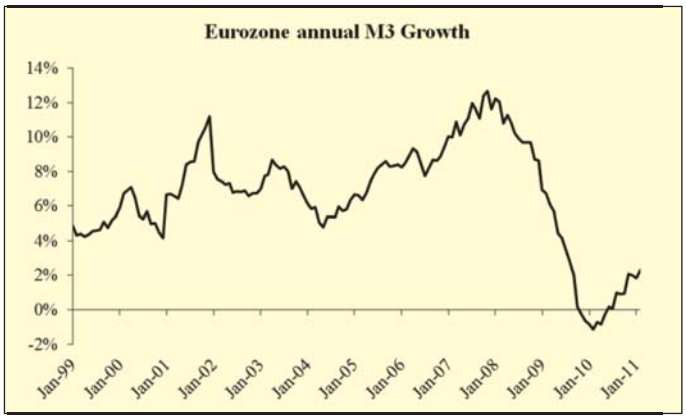
Italy

The economic recovery has continued but moderated. Real GDP rose 0.1%, down from 0.5% in Q2 and 0.3% in Q3. The economy grew 1.1% in 2010, after falling in both 2008 (-1.3%) and 2009 (-5.1%). Private consumption was a major component in falling demand. In November retail sales fell by 0.3% month-on-month and food expenditure fell 0.5%. Net exports also worsened. In December exports rose 21.2% year-on-year, while imports increased 31.5% year-on-year. The trade balance deficit registered at €27.3 billion in 2010, compared to a deficit of €5.9 billion in 2009.

The labour market has not benefited from the recovery. The unemployment rate remained at 8.6% in January, unchanged from December. The employment rate decreased to 56.7% from 57% in December.

Euro-Zone monetary developments

The Harmonised Index of Consumer Prices (HICP) inflation rate was 2.4% in January 2011, up from 2.2% in December. This increase was expected and reflected higher energy prices. The Governing Council of the ECB expects short-term upward pressure on overall inflation due to energy and commodity prices in the next few months. However, inflation expectations over the medium to longer term continue to be firmly anchored at an inflation rate around 2%. At the meeting of the Governing Council on the 3rd February, the key policy rate was left unchanged at 1%.



Broad money (M3) growth year-on-year declined to 1.7% in December, from 2.1% in November. A steeper yield curve caused outflows from monetary assets included in M3 into longer term assets. The annual growth rate of loans to the private sector also declined to 1.9% in December from 2.0% in November. Bank credit growth remained low.

WORLD FORECAST DETAIL

Growth Of Real GNP

	2007	2008	2009	2010	2011	2012
U.S.A.	1.9	0.0	–2.6	2.6	2.9	3.0
U.K.	2.7	–0.1	–4.9	1.4	3.1	3.0
Japan	2.3	–1.2	–6.3	4.3	1.4	2.1
Germany	2.7	1.0	–4.7	3.6	2.3	1.6
France	2.3	0.1	–2.5	1.5	1.5	1.6
Italy	1.4	–1.3	–5.1	0.9	0.8	1.0

Growth Of Consumer Prices

	2007	2008	2009	2010	2011	2012
U.S.A.	2.9	3.8	–0.3	1.8	1.9	2.0
U.K.	2.9	3.0	1.3	4.0	3.8	2.7
Japan	0.0	1.4	–1.4	–1.0	–0.4	0.0
Germany	2.3	2.6	0.4	1.1	1.7	1.8
France	1.5	2.8	0.1	1.5	1.8	1.8
Italy	1.8	3.4	0.8	1.5	1.8	1.9

Real Short-Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	0.6	1.8	–1.6	–1.8	–1.7	–1.5
U.K.	2.9	3.8	–3.2	–3.2	–1.2	0.2
Japan	–0.8	1.8	1.1	0.5	0.4	0.3
Germany	1.3	3.5	–0.4	–1.3	–0.8	–0.6
France	1.1	3.8	–0.8	–1.4	–0.8	–0.6
Italy	0.5	3.1	–0.8	–1.4	–0.9	–0.4

Nominal Short-Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	4.4	1.5	0.2	0.1	0.3	0.5
U.K.	5.9	5.1	0.8	0.6	1.5	2.3
Japan	0.6	0.4	0.1	0.1	0.4	0.4
Germany	3.9	3.9	0.7	0.4	1.0	1.4
France	3.9	3.9	0.7	0.4	1.0	1.4
Italy	3.9	3.9	0.7	0.4	1.0	1.4

Real Long-Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	2.8	2.2	1.3	1.1	1.2	2.0
U.K.	2.3	1.4	0.0	–0.2	0.2	0.9
Japan	2.0	2.0	1.4	1.1	1.1	1.3
Germany	2.8	3.0	2.3	1.9	1.8	2.0
France	2.7	3.0	2.2	1.9	1.8	2.0
Italy	2.4	2.8	2.2	1.9	1.8	2.0

Nominal Long-Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	4.6	3.7	3.2	3.1	3.2	4.0
U.K.	5.0	4.0	2.8	2.3	2.6	3.3
Japan	1.7	1.5	1.3	1.1	1.2	1.5
Germany	4.3	4.4	4.0	3.8	3.8	4.0
France	4.3	4.4	4.0	3.8	3.8	4.0
Italy	4.3	4.4	4.0	3.8	3.8	4.0

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

	2007	2008	2009	2010	2011	2012
U.S.A.	83.4	80.1	88.7	81.7	81.8	82.0
U.K.	98.9	87.6	78.2	79.9	80.4	80.0
Japan	81.2	87.9	89.0	80.2	79.8	79.7
Germany	104.6	105.1	105.8	99.3	99.0	99.1
France	104.9	106.4	104.3	101.7	102.0	102.0
Italy	105.0	106.6	105.4	100.5	100.8	101.0

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

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

	2007	2008	2009	2010	2011	2012
U.S.A.[1]	89.38	81.72	81.61	82.12	83.97	83.94
U.K.	2.00	1.85	1.57	1.55	1.55	1.56
Japan	117.75	103.40	93.56	87.76	87.10	87.00
Eurozone	0.73	0.68	0.72	0.75	0.78	0.78

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

* Forecasts based on the Liverpool World Model

RECOVERY IN EASTERN EUROPE. THE CASE OF ROMANIA

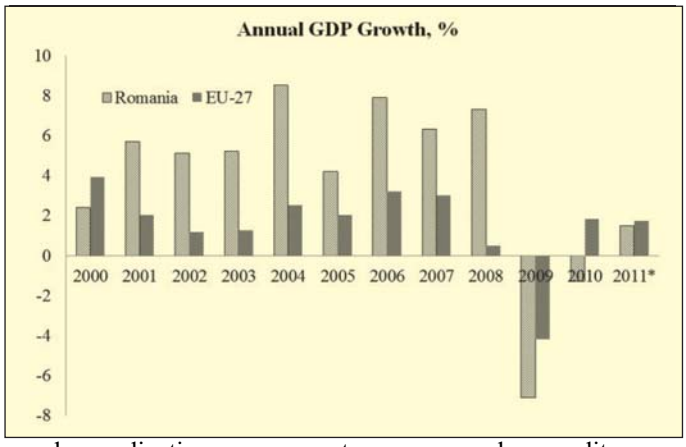
Laurian Lungu

From Boom to Bust

Back in 2008, when the fall of Lehman Brothers triggered what would become a serious global economic crisis, Romania's economy was firing at all cylinders, growing by 7.3% a year. In spite of ominous signs that the economy was heading downhill, the representatives of Romanian political parties, busy preparing themselves for 2008 November presidential election, insisted that the economy would be shielded from the global downturn. Overly optimistic medium term GDP projections by the three main political parties assumed the economy would continue growing strongly, albeit at a slower pace.

Subsequent developments proved how large the disconnect between economic reality and political rhetoric was. The Romanian economy entered into recession in the last quarter of 2008 and, nine quarters later, it still remains there. GDP growth collapsed in 2009 by –7.3% followed by another contraction of –1.3% in 2010. Romania was the first EU country whose ratings were cut, probably a little bit too harshly, to non-investment grade status by two of the main international rating agencies, Standard&Poor's and Fitch. Although Moody's maintained the country's investment grade status, Romania's sovereign credit risk rose at the beginning of the crisis, just when financing needs were greatest.

Given these circumstances Romania was forced to appeal to the IMF. In the spring of 2009 the Romanian authorities signed a €19.95 billion loan agreement with a group of international institutions, led by the IMF. That reduced the uncertainty regarding the rollover of short term debt and forced the government to commit to a series of changes,



such as adjusting government revenues and expenditures, setting up a coherent public sector pay structure, implementing measures addressing fiscal responsibility and reforming the pension sector. In July 2010, in order to achieve end year budget deficit targets, the authorities raised VAT by 5 percentage points, from 19% to 24%, while cutting public sector wages across the board by 25%.

The IMF intervention proved to be salutary. It constrained wasteful public spending and came up with a credible action plan. In spite of continuous bickering among the political parties, the ruling coalition government managed to push through the necessary reforms designed to address macroeconomic balances.

The Current Crisis — An Opportunity to Push Through Changes

The causes of the Romanian contraction can be traced primarily to pro-cyclical fiscal policies. The disruption of trade flows and a significant slowdown in capital inflows

Table 1. Romania. Selected Macroeconomic Indicators:

	2008	*2009*	*2010p*	*2011**	*2012**
GDP (bn. Euro)	136.9	117.5	122	133.2	146.1
Real GDP growth, annual, (%)	7.1	7.1	1.3	1.7	4.2
Nominal gross wages, 12-mth average annual change, eop, (%)	21.2	8.4	2.1	4.7	4.2
CPI Inflation — annual change, eop, (%)	6.3	4.7	8	4.1	3.5
Current Account Balance (% of GDP)	12.3	4.5	4.9	5.5	6.2
Exchange Rate (avg., RON/EUR)	3.68	4.25	4.21	4.15	4.10
Unemployment Rate, eop, (%)	4.4	7.9	6.9	6.5	5.9
Government Budget Balance (% of GDP)	4.9	7.3	6.5	4.4	3.3
Public Debt, eop, (% of GDP)	20.1	30.1	36.0	38.0	35.0

p – provisional; * - forecast values; Q2 – second quarter; S1 – first semester, eop – end of period *Source:IMF, European Commission, local authorities and author's estimates.*

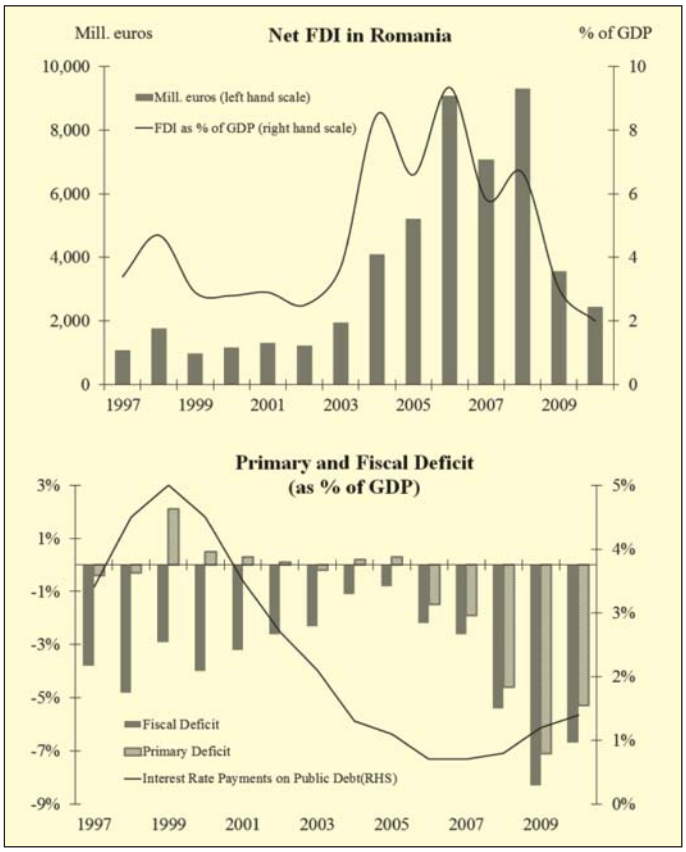
gave a severe blow to an economy whose growth was fuelled by an unsustainable increase in domestic consumption. With almost 25% of the Romanian workforce working abroad, net transfers have been playing an important role in maintaining high consumption. These fell from €4.8bn, or 5% of GDP, in 2006 to €3.4 billion, or 2.8% of GDP, in 2010. The external balance was also forced to undergo a drastic adjustment with the current account deficit shrinking from 13.4% of GDP in 2007 to 4.9% of GDP in 2010.

Although FDI has been following a downward trend in recent years, in line with global tendencies, an improved macroeconomic picture has now emerged, and with it the recent trend is expected to be reversed.

Adjusting fiscal imbalances

For Romania, the current crisis has been an opportunity not only to put its public finances in order but also to improve markedly the way fiscal policy is designed and implemented. Years of public finance mismanagement and fiscal profligacy have created large imbalances which, if left unchecked, would have rendered fiscal policy unsustainable. During the boom years of 2005–2008 fiscal policy was notoriously pro-cyclical. In the face of rising revenues, generated by the spectacular GDP growth, the government at the time embarked on a spending spree by raising pensions and public sector wages. Although government spending on goods and services also rose, pensions and public sector wage increases have been the most damaging because they pushed spending for these categories beyond the level affordable in the long term.

The Romanian pension system was already confronted with a solvency problem even before the emergence of the current crisis. With roughly over 6 million pensioners to 4.5 million employees, the dependency ratio has been greater than one for more than a decade. The public pension fund has been in deficit for most of the time, barring two years of extraordinary economic growth, 2006 and 2007. But it was the rises in the public pensions point — the benchmark used in pensions calculations — starting in early 2006 that precipitated the public sector pension crisis. The pension point more than trebled in real terms between 2006 and 2009. Such an amazing increase in relative terms cannot be sustained unless exceptional productivity increases make such pay-outs possible — an improbable scenario, given the magnitude of the increases required. Financing the public pension fund has been made more difficult by the pensions reforms, initiated a few years ago, which required an increased contribution to private pensions funds in the years ahead. With demographic prospects unfavourable in the medium and long term, measures to tackle the sustainability of the public sector pension fund would involve a mixture of measures. Currently, inflation is eroding the real value of pensions but



more structural changes are needed if the viability of the public pension fund is to be assured.

In 2010, the number of public sector employees was 1.38 million, representing 32% of the total number of employees at the economy-wide level. Romanian public sector employment is massively oversized relative to other EU economies. For instance, public sector employment accounted for 19% of total employment in Italy, 21% in the UK and 26.5% in Poland during the first trimester of 2010. In other EU countries this percentage is even lower.[1] Not only is public sector expenditure on its employees high relative to other countries but the sheer number of these is also high. Romania has one of the largest numbers of public sector employees per 1,000 inhabitants.[2]

The rise of public sector wage costs started around the same period when pensions began to edge up, in 2006. As a

[1] According to the OECD data, in year 2000, public sector employment accounted for 13.1% of total employment in Austria, 14.3% in Portugal, 22.5% in France, 11.6% in Germany, 16.9% in Italy and 14.1% in Spain.

[2] In 2008 in Romania there were approximately 80 public servants for every 1,000 inhabitants. In contrast Italy had 61, Spain 65 and Germany 69.

share of GDP these were maintained roughly constant, to around 5–6% of GDP up until 2006. After that wage costs shot up dramatically, reaching 9.5% of GDP in 2009, before falling to 8.4% of GDP in 2010.

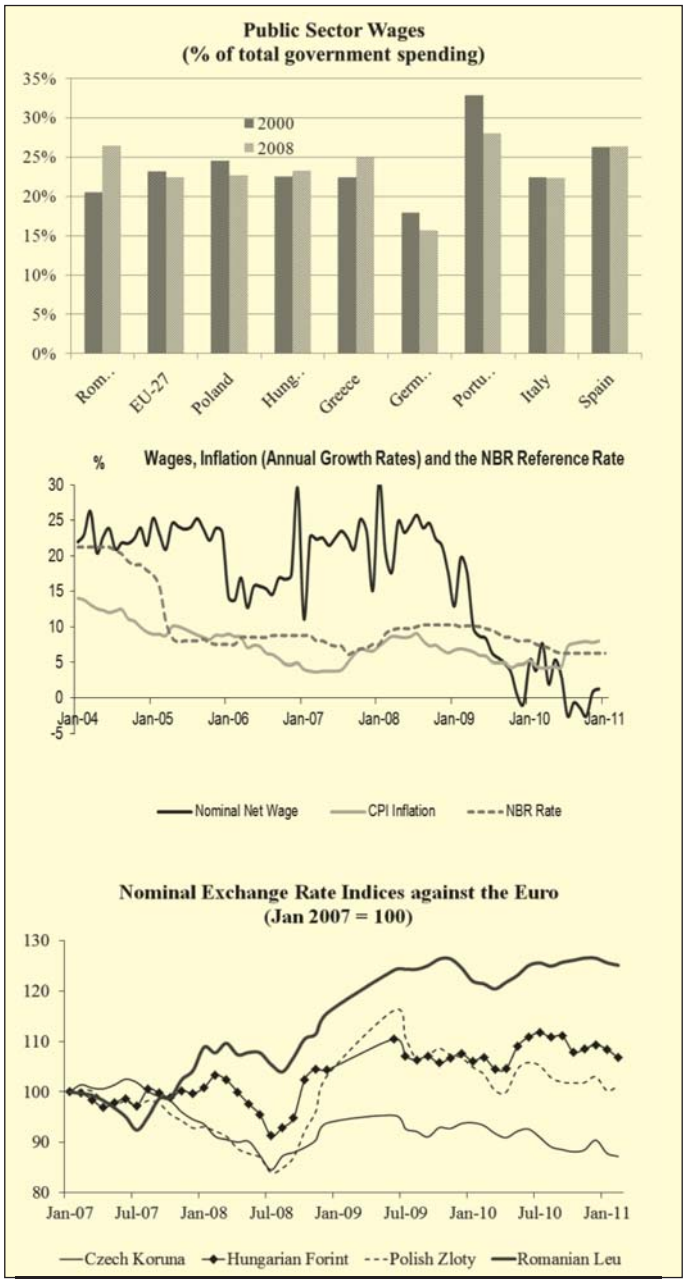
The problems that confront the public sector are twofold: raising efficiency and cutting costs. One criterion in the IMF agreement has been the reduction of the public wage/GDP ratio by some 20% over the next 2–3 years. But the figure needs to be looked at in the broader EU context. As a share of GDP, public sector wage costs in Romania were in fact below the EU-average in 2008 and were comparable with figures observed in other EU countries. The real problem with public sector wage expenditure has been its low productivity. One way to measure that is to look at the share public sector wages have in total government expenditure — a rough measure of the cost of delivering public services. The idea is to differentiate between countries which have 'small' governments, i.e. those where the weight of revenues and expenditures in GDP is small, and countries which have 'big' governments, which, implicitly, have also higher revenue to GDP ratio. This ratio is presented in the Figure opposite, data taken from Eurostat for years 2000 and 2008, next to the values observed in other EU countries.

Between 2000 and 2008, a period when European GDP growth was positive and on a slight upward trend, Romania was the only country in Europe whose share of wage expenditure in total government spending rose significantly, from 21% in 2000 to 27% in 2008. Greece is the only other country where this share rose, but not by such a magnitude. Other developed countries — notably Germany — which paid much closer attention to their fiscal stance managed to reduce their share of wage costs in total expenditure.

Fiscal profligacy has been a characteristic of governments which have poor foresight. As is often the case in emerging markets, fiscal policies adopted in favourable times appear to be implemented with a view that positive shocks are permanent. That is, attention to cyclical adjusted budget deficits is overlooked. Once economic sentiment turns around the resulting gap in fiscal finances poses daunting adjustment efforts.

Forced Deeper Structural Changes

Since the start of the crisis the private sector has shed some 10% of its workforce. However, the unemployment rate remained relatively low — compared to the EU average — in the recent past, dipping below 7% at the end of 2010. For years average economy nominal wage growth has been hovering around 22%, a level much too high to justify productivity increases even after taking into account the inflation effects. In 2010 real wage growth has become negative by quite a large margin, for the first time in more than two decades. This should open the way for private sector realisation of sizable productivity gains at the economy-wide level.



Monetary policy proved to be supportive of fiscal needs. Although the National Bank of Romania officially targets inflation it also pays a heightened attention to exchange rate developments. Even so the Romanian currency, the Leu, appears to have followed broadly the trend observed in the evolution of other regional currencies, the Czech Koruna, Hungarian Forint or the Polish Zloty. During 2009, when government financing needs were high, the NBR reduced its foreign exchange minimum reserve requirements from 40% to 25%. This monetary loosening allowed domestic banks to buy public debt. The NBR's benchmark interest rate was lowered gradually from 10.25% in 2009 to the current level of 6.25%. Even so,

with inflation running at close to 8% deposits real rates in the economy are barely positive.

The financial sector continues to remain relatively sound. Banks operating in Romania have had little exposure to so-called toxic assets. Financial deepening continues to be low, at the end of 2010 the ratio M3/GDP was 40%, compared to little over 100% in the euro zone. The main risk to banks' balance sheets comes via non-performing loans and the exchange rate effect, although the latter has been greatly diminished following the BNR's preference for smoothing out fluctuations in the exchange rate. Thus, overall, the banking system is well capitalised with the NBR supplying the necessary liquidity and most banks were been able to cope with the economic downturn.

What Next?

The current crisis has provided a good opportunity for Romania to sort out its existing imbalances. Important reforms have been initiated in the public sector and political will should play an important role in seeing the necessary legislation implemented. This is widely expected to bring public sector wages and pensions expenditure on a sustainable path.

But the crisis has opened the way for a much broader reform, which both public and private sector desperately need. A new version of the Labour Code is due to be passed during March 2011 by the Parliament. It will make hiring and firing easier and weaken the power of trade unions, especially in the public sector. The public sector's dialogue with the private sector has improved, especially when it comes to discussions over future economic policies. An initiative of the Foreign Investors Council, a Romanian-based NGO, to come up with a programme to re-launch economic growth in the autumn of 2010 has played a large part in improving the quality of the dialogue.

The economy is expected to grow above 1.5% this year and accelerate further in 2012. The macroeconomic stability greatly improved since the inception of the crisis. And the growing potential of the economy is likely to see Romania as an attractive place to invest in the years to come.

However, challenges still remain. Reducing political influence on the decision processes of public sector expenditure programmes would be a priority. This would not only enhance wealth formation for the average citizen but also have large positive spill-over effects in the economy, by building trust in public sector policies and allocating capital more efficiently. Investing in the country's physical infrastructure and accelerating the absorption of EU funds would prove to be equally important measures.

Moreover, next year's autumn Parliamentary elections could see an increase in political risk if the alliance of Social Democratic Party (PSD) and National Liberal Party (PNL) wins a majority. Such an outcome could see some of the unpopular measures taken recently reversed, especially if the economy fails to gather speed by that time.

VIETNAM: DISTORTED AND OVERHEATING

Vo Phuong Mai Le

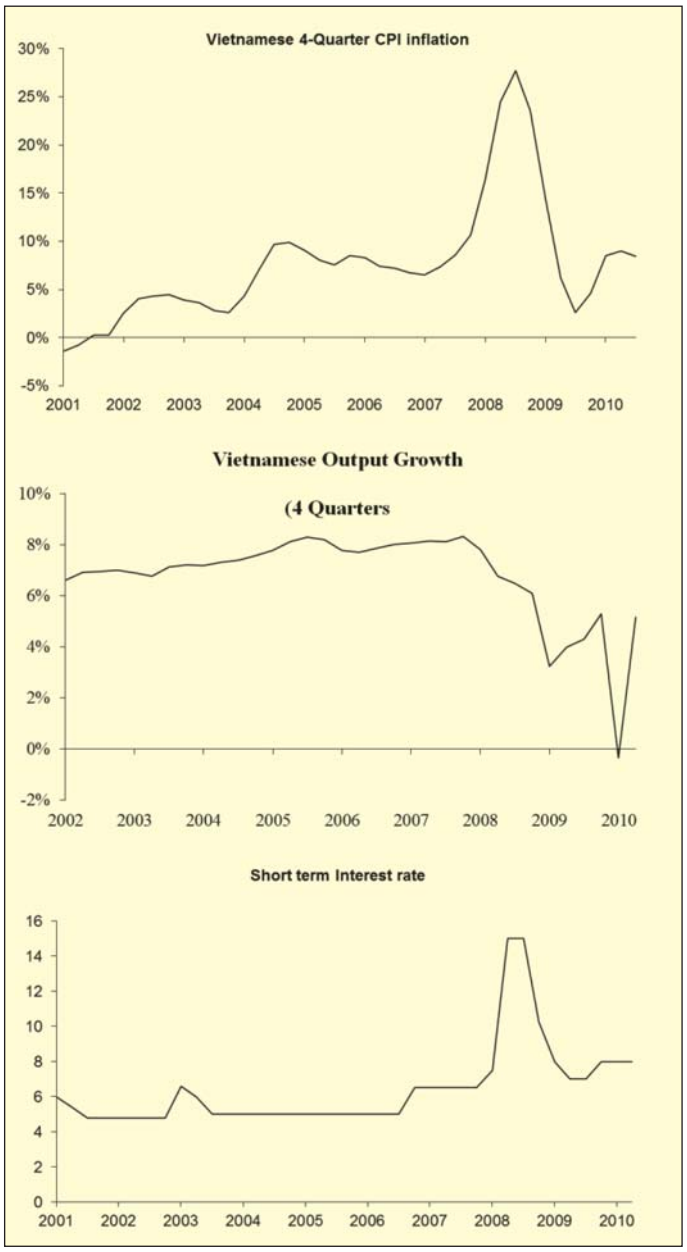
The Vietnamese economy went through a difficult period between 2007 and 2010. The government had to resort to a series of rapid shifts in macroeconomic policy as it fought first high inflation in 2007–mid 2008; then the global slowdown at the end of 2008; and finally fears of a possible currency crisis in 2009–2010. The Vietnamese economy overheated in 2007 and annual inflation rose to a peak of 28.3% in August 2008. The official interest rate was increased sharply in the first half 2008, reaching a peak of 14% in June 2008. However, faced with the global slowdown monetary policy was quickly reversed and the government also loosened fiscal policy. This stimulus caused the trade deficit, putting pressure on the currency and resulted in balance of payments deficit. The government let the dong devalue by 5.5% in November 2009 and another 3.5% in February 2010 and tightened monetary policy as the interest subsidy scheme for short-term loans ended.

Partly as a result of these policies, Vietnam escaped lightly from the financial crisis. Real GDP grew by 5.3% in 2009, the slowest pace since 2000, but it is one of the best performers in developing Asia. Domestic economic growth continued to improve in 2010. Real GDP growth was over 7% (year-on-year) in 2010Q3. However, this success in economic growth conceals looming macroeconomic risks. These need to be faced and addressed to ensure long-run growth and macroeconomic stability.

While these swings in policy may have helped to resolve short term problems, they have undermined the credibility of the central bank and government; this means that in the longer term there will be slower responses to policy changes and this will force the government to implement bigger measures than otherwise. In particular policy swings of this type undermine the crucial confidence of foreign investors in the Vietnamese business environment. This can be seen from the fact that Vietnam has not enjoyed the same surge in foreign capital inflows as the rest of Asia. Signs of strain in the economy include: high inflation (average headline inflation of 2010 is 9.2%, higher than that of 2009), a large trade deficit (about 7% of GDP), low international reserves (only 1.8 months of prospective imports as of end-September) and regular currency weakness.

The government must take steps to restore the confidence of investors and the markets in its policies. How can this be done?

Firstly, we will compare the policy backgrounds of Vietnam and of more developed countries.



Developed and some emerging countries have adopted the inflation targeting framework with an independent central bank, where the nominal anchor function of inflation targets is central. The way this works in practice is that the central bank sets the official interest rate to ensure the inflation target is met. At the end of the settlement day the central banks provide cash to the banking system at its official rate. Thus the official rate is passed throughout the financial system quickly, and influences interest rates for the whole economy. The mechanism channels through the market rates, asset prices and confidence to change the total demand and domestic inflationary pressure, through exchange rates to affect the import prices pressure, and thus

achieves a desirable inflation rate. In general there are time lags before changes in interest rates affect consumer prices, but the effect is rapid if policy is credible. This framework improves the communication between policymakers and the public, providing discipline and accountability of monetary policy. It reduces uncertainty about future inflation, volatility in relative prices, and risks on non-indexed financial instruments and contracts in nominal terms. Thus, it improves planning of the private sector, encourages long-term stability in the economy with sustainable growth and employment. The Great Moderation period in the developed countries reflected the success of the inflation targeting framework. Economies grew with a low inflation rate and low volatility.

On the other hand, the State Bank of Vietnam (SBV) is a government agency that conducts and formulates monetary policy. It has too many targets to achieve given its limited instruments. Its objective is to stabilise currency value and control inflation. It also targets monetary aggregates and credit growth consistent with the inflation target set by the National Assembly. Monetary targeting is based on quantitative theory, which states that nominal spending in the economy is determined by the changes in the quantity of money. The SBV considers both output and inflation in setting its money growth target. The announcement of the inflation goal (e.g. 7% in 2010) shows the importance of inflation in determining policy decisions. However, since the SBV is not independent from the government, who care about output and exchange rates, sometimes the focus on output growth outweighs the importance of price stability. Therefore, monetary and inflation targets might still be missed. Many misses and swings will undermine belief in the central bank's commitment. The SBV has only 2 instruments: open market operations (OMOs) and administrative controls, and they are not effective instruments for the following reasons: conducting liquidity forecasts daily, the SBV uses OMOs (repurchase agreements with different maturity) to cover the gap by setting both OMO rates and amount offered. Thus, the market signals and market expectations cannot reflect fully the liquidity conditions and the policy direction. In addition, the time consuming administrative procedures reduce the last–resort power of the central bank. Any unexpected short-term liquidity shortage is met by repurchase or interbank market transactions leading to volatile money market rates. The minimum deposit rate has created a big gap between it and OMO rates and interbank rates. It makes some banks rely heavily on OMOs and the money market for funding, and thus raises the volatility of the interest rates further, and distorts the function of the banking system, and thus the effect of monetary policy of the total domestic demand.

We now go on to analyse the economic situation in the world and its influence on Vietnam.

As world GDP recovers, food and commodity prices will continue to surge, because of bottlenecks in supply; global inflation will rise. The emerging world is attempting to control their domestic inflation by holding down money supply growth but by intervening in the foreign exchange market to keep their currencies down they push the money supply up: they are buying foreign currency with home money, so putting more home money into circulation, while acquiring more and more foreign exchange reserves. To stop this money stimulating demand, these countries put in place controls on bank reserve ratios, on credit and on individual sector prices; but these in the long term will be ineffectual in preventing inflation but will nevertheless create distortions by preventing markets from working properly. It is to be expected therefore that, faced with these serious inflationary pressures, these policies will change towards systematic tightening of monetary conditions policy and letting currencies appreciate. China has already moved in this direction, slowly letting its currency appreciate against the dollar. It also recently announced a 25 basis point rise in the one-year base lending and deposit rates, taking the lending rate to 5.81% and the deposit rate to 2.75%.

How is Vietnam doing and how will global tightening affect Vietnam's economic performance? Despite the goal of a stable exchange rate target against the dollar within symmetric bands, the parallel market exchange rates have been traded around 10% outside the official band and Vietnam's currency policy closely approximates to a flexible exchange rate regime, where the monetary authority targets inflation. The combination of the global and domestic economic recovery and a surge in global prices can be thought of as positive shocks to foreign consumption and domestic demand and a negative shock to domestic production. According to my model of Vietnam as a small open economy model, if the authorities were following a Taylor Rule, under which interest rates rise in response to rising inflation, and also a flexible exchange rate, the likely responses to these shocks would be higher economic growth, higher inflation and higher interest rates, with falling net exports and a rising currency.

However it seems that the Vietnam government cannot be pursuing such policies since we observe quite different outcomes. Towards the end of 2009, due to the stimulus package, credit growth accelerated, resulting in a deterioration of the trade deficit, a loss in international reserves and devaluations of the dong. Domestic residents shifted their portfolio towards dollars and gold, resulting in a substantial capital outflow on the balance of payments, putting further downward pressure on the dong. The IMF estimated that gross international reserves declined to US$14.1 billion by the end of 2009, equivalent to only about two months of imports. There was a monetary tightening in December finally. But with activity in construction and financial services suffering and the prospect of damaging economic growth, the government

reversed monetary policy, encouraging banks to lower commercial loans and deposit rates, and buying government bonds in the open market to expand the money supply and lower the short-term interest rates. This is the opposite of the policy suggested as appropriate by my model. It seems that the government puts a heavy weight on growth. But the result is that annual headline inflation in December 2010 was 11.75%, higher than the same month of 2009.

The resulting uncertainty undermines the confidence of markets and foreign investors; fearing continued and even rising inflation, Vietnamese nationals continue to shift their portfolios into dollars, gold and property. 10 times more gold is held in Vietnam than in China and two times more than in India according to the World Gold Council. Government economists estimate that about $5 billion in US dollars are held outside the Vietnamese banking system. In this unstable environment, the big state-owned shipbuilding company, Vinashin, collapsed and defaulted on its international loans. This led to a downgrading of Moody's rating of Vietnamese government debts to B1 from Ba3, so making it more costly for the government to borrow.

Moreover, home inflation and tightening monetary policy in other emerging countries are pushing the dong down steadily against neighbouring ASEAN and against BRIC countries. As about 45% of Vietnam's total imports come from these countries, imports become more expensive, with little compensating volume reduction. Hence the trade deficit had risen to about 7% of GDP by the end of 2010. With low reserves the prospect is for further falls in the dong. Despite the fact that it has already lost about one-fifth of its value against the US dollar since mid-2008, the street exchange rate is 10% below the official rate, signalling more falls in the official rate.

The current policies are plainly not working well and should be changed. The main source of instability is the disbelief in the government's commitment to bring down inflation. The government's priority in 2011 should be to re-establish its credibility in the fight against inflation.

To do this, it must show a willingness to contain existing inflation and announce its intentions to the general public. As global commodity and food prices continue increasing, there will be more upward pressure on inflation. Therefore monetary policy must tighten decisively. In November 2009, the SBV raised the benchmark lending rate to 9% from 8% and imposed a 10% tax on gold exports to contain the price of the dong and sustain the supply of gold. The government sets prices on goods such as coal and petrol to keep price rises under control. New rules also allow the government to impose price controls on goods and services produced by companies. But these policies will be ineffectual in stopping inflation while also creating costs to the economy by distorting markets. The same goes for the government's threats to control gold prices and punish speculation.

Yet the government is projecting an average inflation rate of at least 7% over the next 5 years; this is too high for the economy's health, as well as being well above the ASEAN average of 3–4%. Policy rates are therefore not high enough to bring inflation down sufficiently. The SBV needs to raise its official rate further and target a lower inflation rate. Both these actions would reduce credit growth, and domestic demand, they will also shape the private sector' expectations of future inflation. They would bring the inflation rate down and increase the private sector's confidence in the economy. Of course, there would be a short term cost in a slowdown of economic activity; but this would only be temporary and in the longer term low inflation and greater stability will boost investor confidence and growth.

As part of these policies a law should be passed mandating that the central bank publishes data frequently, explains its actions and is accountable for them. Once the economy stabilises and monetary policy establishes its credibility, Vietnam can think of moving toward a more flexible exchange regime. This would protect monetary policy from shocks to the balance of payments.

In other areas of policy, there are also changes needed. On fiscal policy, the government should reduce its public debt to GDP ratio to raise public confidence and create fiscal room in the future. Healthy exports growth, changes to the tax system and reduction in government spending will help to achieve this. According to the IMF, the budget deficit was 5.5% of GDP, a further reduction to under 5% of GDP in 2011 and to 3% of GDP by 2015 could well be achieved, reducing the debt-to-GDP ratio to below 50% of GDP. The government also need to make changes in its own backyard, the state-owned sector: the economy still relies heavily on state-owned enterprises (40% of GDP) and 30%–40% of state-owned commercial banks' loan exposure is to these companies. The government has to increase the quality and efficiency of its investment to maximise the benefits to the economy and avoid another downgrading from the rating agencies. For this it needs to allow competition in the financial sector, bringing greater efficiency to lending decisions, not least on loans to state-owned enterprises. On prudential issues, the government needs to keep monitoring the small banks and to strengthening general financial sector regulation.

Vietnam has the potential to be a promising foreign investment destination with a cost advantage, but it need to re-establish its position by using the right policies to create a long-term healthy and stable economy.

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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