

# Quarterly Economic Bulletin

Julian Hodge Institute of Applied Macroeconomics

August 2013

# Foreword

It has been my privilege to introduce the Julian Hodge Bank Limited Quarterly Economic Bulletin for the last five years. It is hard to imagine that any five year period in peacetime will be as traumatic, in economic terms, as the period from 2008 to 2013. Many of the certainties that were the foundation of my time in banking have gone and the world's finances have been transformed by unimaginable government intervention in the sector.

Looking forward to the next five years, which by pure chance coincide with the term of office of the new Bank of England Governor, there are trends which will be interesting to watch unfold. For the UK economy the return to growth, albeit modest, appears to be sustainable, with the overriding caveat that the Eurozone still holds the potential to derail the UK's recovery. The growing confidence in the US has led the Federal Reserve to herald a time when government monetary support will cease and quantitative easing will be unwound. If the UK is successful, the same is likely to be true here. Whilst it is hard to see interest rates rising over the short term, there is a real possibility that in five years' time there will have been some upward movement. The timid approach to public sector cuts in the UK, however, means that the pain of restoring the government's finances will drag on well beyond that five year time horizon.

In the heat of the crisis there was an unfinished debate about the role of banks within society, particularly given the taxpayer's role as lender of last resort. In the event the government, in effect, nationalised two banks and took a stake in a third, but sought to preserve at least the veneer of independence and a capitalist model. This unsatisfactory state of affairs now leaves us with the worst of both worlds. The intervention of regulators in the management of banks, as evident in their stated determination at Barclays to prevent management from considering reducing lending in order to accommodate new capital requirements imposed at short notice, is inappropriate if we believe in the capitalist model. The role of regulator should be to set parameters within which managers decide how best to run the business in the interest of stakeholders. If that is not desirable, then government should consider whether the private sector has any role in banking.

As part of the regulators' requirements, Banks have piled up huge reserves of government bonds. Not just in the UK, but across the world. This concentration of risk has the potential to cause problems, particularly as the interest rate environment changes. Falling bond values will restrict banks' capacity to lend and will act as a drag on recovery.

Amongst the worst excesses of the last few years, none is more egregious than the explosion of payday lending. There can never be

## 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



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

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



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a customer need that is properly met by a loan at up to 5600% APR. This is mis-selling on an industrial scale and the government's review of this blot on society is welcome but overdue. The Church of England's decision to promote credit unions as an alternative is also a welcome move. I hope that the misery and suffering caused by these organisations is brought to a permanent end.

It remains for me to thank Professor Minford and his colleagues for the excellent analysis they provide for us through the medium of these bulletins. The association between Julian Hodge Bank and The Cardiff Business School through the Julian Hodge Institute of Applied Macroeconomics is a valued one, and I look forward to reading the next bulletin as a recipient rather than a contributor. Finally, thank you for your interest in them and your letters to me over the last five years.

**Paul Budd**

Julian Hodge Bank  
Director, Commercial Lending

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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The outlook remains weak for the major economies, as commodity prices remain high and bank regulation, on top of weaker bank balance sheets, bites deeply into bank capacity to lend post-crisis. Recovery in the US is however strengthening; this reflects a more determined effort by the US authorities to recapitalise their banks as well as the greater bank competition and the regional structure of the US banking system. The crisis has also altered the structure of economies, implying little capacity as much capital lies unneeded in contracting sectors. Meanwhile slow growth in advanced economies is taking its toll on fast-growing economies like China that have invested heavily on the assumption of fast-growing export demand. Inflationary pressures are also strong because world dollars are in massive supply as a result of QE. World growth too is therefore slower than the average pre-crisis.

Against this background the need for a reappraisal of monetary and regulative policy is urgent. Excess regulation has held back bank lending even as QE has caused a huge surge in bank reserves. In the US bank lending and money supply growth is finally picking up; it seems too that the Dodd-Frank legislation may not be having too deadening an effect; hence the Fed is talking about ‘tapering QE’ and may soon also have to talk about its withdrawal. In the euro-zone nothing can really be done until the euro itself has been sorted out. But here in the UK steps have been taken through Funding for Lending and the new mortgage subsidy for first-time buyers to ease the pressures on banks; if and when their lending picks up QE will have to be withdrawn here as well if an inflationary revival is to be avoided.

## **Great Depressions Compared** **17**

James Foreman-Peck

The British economy recovered more rapidly from the Great Depression between the world wars than from the current recession — despite the collapse of the international finance and trading system — because the domestic financial system remained robust. The predicament of the British economy today more closely resembles that of the US economy in the decade after 1929. Professor James Foreman-Peck, of Cardiff Business School, explains that for both monetary policy also needed or needs support from substantial fiscal boosts to offset the damage to the financial system.

“One sympathises with politicians who have to deal with popular disquiets but in the end if growth is to be achieved which both we and these same politicians need, in order to get our economies working again, then these politicians must be willing to explain the business and growth case.”



*Patrick Minford, Economic Adviser to Julian Hodge Bank*

# THE ECONOMIC SITUATION

The latest data from the ONS has moved closer to other general indicators of the state of the economy. The first quarter outturn for GDP is set at 0.3%, and 0.6% on a year ago. This seems to be weaker than other data suggest. But in any case we know that these preliminary estimates, even in less turbulent times, are virtually worthless. The Cardiff and York professor Mike Wickens, in work for the House of Lords Economic Committee, found that

‘Over the period 1998q2–2004q1, 9 of the 19 preliminary estimates of growth were more than one standard deviation away from the final estimate, while only 4 out of 18 of the previous quarter’s growth rates were more than one standard deviation away from the final estimate. The assumption of no change in the growth rate gave estimates that were twice as accurate as the worst interim estimate. In other words, over this period, using last period’s growth rate gave the best estimate of the current growth rate.’

We are still too far from the final estimates over the last few years to be able to do a similar exercise since the crisis. However, the early estimates for recession periods generally get revised up later — the reason being that there is substitution away from activities that are being depressed to newer activities that are less well reported initially.

So let us be guided by the employment statistics and by purchasing managers’ surveys which suggest that there was no double-dip (a view that under revised ONS figures is now close to being the official view) but rather that the economy is growing weakly. This is still a poor scenario for a government trying to reduce the public deficit, unless this weakness in growth improves.

The factors frustrating growth here are the same as those frustrating growth in other western economies. Unfortunately these factors will not suddenly go away. For this reason policies need to be orientated towards alleviating their effects.

These factors are:

- The tightness of commodity markets will remain until productivity in the use or creation of raw materials rises. This is what happened in the 1980s in response to the commodity crisis of the 1970s. During the 1980s the demand for commodities was reduced by substitution and additional supplies were found, also usually by new methods of extraction (such as in oil extraction in the North Sea). As a result commodity prices in the 1990s dropped to low levels and this helped to fuel the long boom of the 1990s and 2000s.
- With commodity markets tight, there is a reduction in western living standards for those countries that are net

**Table 1: Summary of Forecast**

	2010	2011	2012	2013	2014	2015	2016
GDP Growth <sup>1</sup>	1.7	1.1	0.2	1.2	2.2	2.4	2.6
Inflation							
CPI	3.3	4.5	2.7	2.7	2.5	2.2	2.0
RPIX	4.8	5.3	3.2	2.5	3.1	2.8	2.7
Unemployment (Mill.)							
Ann. Avg. <sup>2</sup>	1.5	1.5	1.6	1.5	1.4	1.3	1.2
4th Qtr.	1.5	1.6	1.6	1.5	1.3	1.2	1.1
Exchange Rate <sup>3</sup>	80.4	80.0	83.1	82.6	83.0	82.3	82.5
3 Month Interest Rate	0.7	0.9	0.9	0.9	1.6	2.1	2.2
5 Year Interest Rate	2.4	2.0	0.9	1.3	1.8	2.1	2.4
Current Balance (£bn)	-40.0	-22.5	-59.2	-60.7	-62.9	-63.5	-62.0
PSBR (£bn)	112.6	91.0	68.4	119.7	106.0	94.6	74.5

<sup>1</sup>Expenditure estimate at factor cost

<sup>2</sup>U.K. Wholly unemployed excluding school leavers (new basis)

<sup>3</sup>Sterling effective exchange rate, Bank of England Index (2005 = 100)

importers of commodities. Thus if a country imports commodities worth 5% of its expenditure, then if the cost of this inclusive of transportation rises by 100%, the loss of living standard is 5%. Real commodity prices roughly doubled between 2005 and 2011 so a number of this order looks about right.

- There is also a change in the structure of production after such an upheaval in relative prices. For example we are seeing substitution away from use of the car and from travel; housing demand is reduced because of the energy costs of larger houses. This is a process going on widely. We can gauge something of its importance from the calculations of ‘excess capacity’. Were UK economic structure to be the same as it was pre-crisis, then we would have excess capacity of around 13% today. Actual estimates of excess capacity from surveys of businesses indicate a figure of around 3% or less. This is telling us that much capacity is now simply irrelevant as it will not ever be used.
- If we assume that over the coming decade technical progress in substituting away from these scarce commodities will be slow, then we can also gloomily note that if the west were to grow faster, this would put further upward pressure on commodity prices and hobble the attempt by reinforcing the factors we have just elaborated. We must hope that this is too gloomy and that technical progress will reduce our commodity dependence faster in the coming decade.

What all this suggests is that, as is now obvious, there will not be a ‘cyclical rebound’ such as occurs when there is plenty of excess capacity which can quickly be brought on stream as demand recovers. Instead it implies that growth from here will be dependent on productivity growth making new capacity profitable. We need ‘Enterprise Britain’ to spur growth.

At this point we hit another problem. Our banking system has been tied up in knots by the regulative backlash against

banking and finance. While preaching competition the Vickers Commission has proposed higher costs through a new raft of regulation; this is discouraging new entry (competition) and is even discouraging credit growth by existing banks because of the high marginal cost of raising the extra capital to go with it when bank share prices are so low.

By this regulative overkill we are both curbing the growth of our major industry and curbing the growth of SMEs who depend heavily on bank credit. In so doing we curb productivity growth.

Finally, we note another set of problems induced by the pain of the crisis. Popular opinion has turned anti-business and this is reflected in policies designed to please the populace. We have had the 50p top rate, the bashing of bankers, windfall taxes on banks, and a climate of hostility to high pay (and those dreaded bonuses). This has been further complicated by populism on the green agenda which has stopped proper infrastructure provision; thus we have had a veto on the third Heathrow runway, the emphasis on wind farms which are costly and ineffective, the proposal for HS2 which is a white elephant. One sympathises with politicians who have to deal with popular disquiets but in the end if growth is to be achieved which both we and these same politicians need, in order to get our economies working again, then these politicians must be willing to explain the business and growth case.

### **Three alibis**

#### **Balance sheets and QE**

Some economists say growth must be slow because 'balance sheets are weak'. But this is to confuse cause and effect: balance sheets are weak because growth prospects are poor; hence share prices discount weak growth and so the value of assets is low, and the incentive to invest low with it. We need policies that unlock growth potential and then balance sheets will automatically be strengthened.

These same economists argue that balance sheets would be strengthened by printing more money — Quantitative Easing. This will raise the prices of assets and increase the supply of credit, easing balance sheet problems. However, while it may be that QE does lower interest rates on government bonds, it does not reach the parts of the private sector that credit reaches; SMEs do not issue corporate debt and most do not issue shares either. Unfortunately QE has not triggered any improvement in the supply of credit, essentially because the regulators are choking off this supply anyway by their new heavy-handed interventions. Increasing credit supply seems unattractive to banks if to do it one has to raise extra capital at rock-bottom share prices. QE accordingly has made it easy for large firms and the government to finance themselves; the government has benefited from three years' financing by printing money but has to cut back spending to balance its books, while large corporations are awash with cash, have easy access to

equity markets but see no opportunities for investment. The trouble is that QE has not removed the main roadblock to new activity by SMEs that hold the key to spurring productivity growth and competition.

#### **Demand**

Then there are other economists, mostly on the left, who believe the situation can be resolved by 'injecting demand' through fiscal loosening. Unfortunately again the situation does not permit this to be done while maintaining government solvency. Just like private households governments are limited by their budgetary flows. Most western governments now have reached the limits of their borrowing capacity in peacetime; to maintain confidence in their solvency they must show plans for rebalancing their books. In this situation a government cannot achieve a good 'multiplier' from spending more; this is because the net effect will be to raise interest rates on its and indirectly other debt in the country. The effects of these higher interest rates would dwarf any positive effect from the higher spending, producing a negative multiplier. Alas, when times are bad, governments are as constrained in their spending decisions as households are; when times are good, households are as free to spend strongly as are governments.

#### **The Euro-zone Crisis**

Another excuse for inaction is the depressing crisis in the Euro-zone. Much ink has been spilt on this; many of us warned of the dire possible economic consequences of the euro, a half-baked scheme for monetary union created mainly for political reasons. The world banking crisis has cruelly exposed the fault lines in this project, mainly derived from its lack of fiscal union. There is now a struggle within the Euro-zone between North and South about the allocation of the burdens for saving the euro. This struggle is condemning the zone to renewed recession.

What we notice is that, in spite of all the rhetoric about the importance of saving the euro for the fate of the world order, the world is getting along quite well in spite of this endless struggle. Indeed the recession in the Euro-zone is weakening commodity prices which in turn is quite helpful for other western economies. Furthermore, other countries including the UK are increasingly shifting their trade away from the Euro-zone. The UK's exports to the zone are down about 10% on the pre-crisis level while its exports to non-euro countries are up by almost 30%. Of course the Euro-zone's weak demand does reduce demand elsewhere but this shift and the commodity price weakness are compensating factors. The UK is quite capable of growing if its supply-side forces were given the necessary boost, regardless of the problems in the Euro-zone, which will probably take at least a decade to sort out.

## Monetary Policy

The gloomy conclusion from all this is that printing more money will not generate growth but instead will keep down the cost of budget deficits. Thus, in conjunction with repressive regulation, it creates what ‘financial repression’ does in developing countries: it enables the government to acquire all of society’s savings cheaply.

This depresses general welfare by reducing the return on savings and capital and so reducing growth. Already savers are protesting against the endless perpetuation of these policies. They allow the government to survive, even though its policies are anti-growth.

The policy conclusion is that we need policies to address the factors stultifying growth. Bank regulation must be eased; other regulations on small businesses also need to be eased. Growth will only come from SMEs; as we see large businesses are just sitting on their cash, seeing no urgency to create new markets. Only SMEs have the hunger to drive competition and new technology.

Assume for one optimistic moment that the coalition government started to do this. Then the mountain of liquidity in the banking system would prove a serious inflationary danger. Already the Bank’s credibility on inflation is in danger of erosion from its persistent under-prediction of inflation.

So far we have avoided these dangers in practice because the economy is failing. So we have monetary policy that fails to ignite inflation under economic failure but in the presence of success risks igniting a vigorous inflation.

You might say: ‘well at least monetary policy is not currently doing any damage’. But imagine a Governor who said: ‘We will no longer subsidise government failure to cut deficits and produce growth. We will withdraw QE/excess liquidity; and we will progressively bring inflation under clear control by raising interest rates back towards normal, as is appropriate when demand is approximately equal to supply. Now let government help itself by introducing the right policies for business and so for bringing down its deficits. One of those policies is to loosen bank regulation — and we will take the lead in doing this’

This is the policy I would urge: a robust responsible bank getting in control again and urging good supply-side policies on this divided and failing coalition. In the section that follows we discuss the requisite new framework for monetary and regulative policy more fully.

## The monetary policy and regulatory car crash — what has happened and what must we do?

When the history of the Great Recession comes to be written, it will be clear that it was only to a minor extent the fault of ‘greedy bankers’. Yes, of course there were plenty of those; but since when have people not been greedy? ‘Greed and fear’ goes the weary summary of business and market behaviour; what is new?

The fault will be seen to lie with monetary policy’s obsession with inflation targeting, to the exclusion of maintaining general monetary stability, which had been the traditional task of policy. It was the failure to keep monetary conditions stable — for which read ‘keep the money supply on a reasonable growth track’ — that allowed the great credit boom of the 2000s to take hold. Inflation targeting was so successful in stabilising inflation expectations that inflation hardly moved however much or little interest rates were moved. As a result interest rates and bank reserve injection were given latitude to ignore monetary excesses — because inflation was so well controlled.

Out of that failure came the Great Regulative Backlash that followed the crisis when the credit boom crashed. This backlash produced a massive tightening of monetary conditions via the sledgehammer of excess regulation hitting the nut of weakened banks. It has proved impossible for monetary policy to loosen monetary conditions sufficiently to generate a proper recovery, against the contraction engineered by this regulative excess. Official interest rates have been lowered to the zero bound and QE has injected fabulous quantities of excess reserves into the banks, with no perceptible effect on credit growth and a collapse of the money multiplier (the ratio of money supply to cash injected by the Bank).

When we have the right models to analyse these events, we will be able to simulate a counterfactual world in which in the 2000s monetary policy targeted money growth and a credit boom was avoided. Then when the slowdown occurred due to global productivity growth slowing (for this read the world hitting a raw material shortage, forcing commodity prices skywards), the banks would not have been exposed as badly as they were, nor would households have overbought houses. Yes, we would have still had a bad recession but it would have been possible to have a normal recovery, absent any regulative mania developing. Commodity prices would have fallen back, against a background of a lower cumulative level of GDP at the time of slowdown, and recovery would have been brought about by monetary loosening — falls in interest rates accompanied by injections of bank reserves.

Ultimately we should blame us economists not the politicians, because it is we who failed to have these models in time. As Keynes said, the policymakers are merely echoes of the researchers who taught them. We had models in which there was no money, with only (official)

interest rates being used to target inflation; they also contained no interest rates on credit to small businesses and households, the key channel the banks give us. The crisis has taught us now to allow for the imperfection of the monetary channel system; there are different channels and they do not communicate perfectly with each other. Money growth is an indicator of what is going on in the credit channel and what is therefore happening to credit rates to small businesses (which we observe very poorly due to the mass of accompanying charges and conditions, such as arrangement fees and collateral requests) and households. We also lost sight of the damage that can be done by monetary instability.

If we add a money growth target to the inflation target, then we have two key features of the economy being ensured by the central bank: a) the long run inflation environment b) the stability of the monetary environment. In the process output growth should also be stabilised, since output growth will be reflected in money supply growth. A natural pairing of instruments with targets would be for interest rates to react to inflation while the monetary base reacts to the money supply, which it directly affects.

Where does this leave 'macro-prudential' policy (i.e. regulative policy designed to stabilise the economy)? Regulations have the effect of raising the cost of credit — and so the 'credit frictions' in the economy. This is damaging to economic welfare — the only rationale for it is that it reduces the chances of a future banking crisis. But if monetary policy were reset as above this need would be met in that way, at no cost to the economy: one can think of monetary stability as ensuring that the cost of credit is kept at the socially optimal level, allowing for the desired underlying credit friction. Thus in booms it would stop the credit cost falling unnaturally low; and vice versa in slumps. In these circumstances all that regulation should do is set a 'basic' level of regulative constraint on grounds of social 'bank safety' factors — this in turn would supply the underlying desired credit friction. There is no need for regulation to vary 'macro-prudentially'; and this basic level of regulation would be the minimal one required to offset the moral hazard created by deposit insurance. It should not discriminate against 'risky' lending to small businesses. Rather it should be set in relation to the whole bank portfolio's diversified risk level; a minimum capital ratio should be set that would prevail for a band of risk around some normal level on the whole portfolio. In this way we should get away from the cost of funds for loans to SMEs attracting a much higher cost because their individually higher risk causes extra capital to be raised.

## What is to be done now?

As through a glass darkly the coalition and their civil servants in Whitehall and Threadneedle Street have begun to realise that their regulatory actions have blocked the credit channel; so more recently we have had Funding for Lending schemes (FLS) 1 and 2, followed by the Mortgage subsidy for first time buyers. These do appear at last to be

having an effect on the housing market and on lending conditions for small businesses — the ice blocking the credit channel appears to be cracking slightly. The economy appears to be picking up towards moderate growth. This has been helped by less tax-grasping policies towards North Sea oil and gas producers, so that now we are seeing North Sea oil output bottoming out in line with banking and construction, the latter two aided by this credit channel thaw.

It is messy to have regulation combined with policies deliberately offsetting the regulation. Nevertheless systems cannot turn on a dime and so we must be grateful for the easing we have in the regulative backlash.

The implications of this regulative U-turn for monetary policy are that we need now to worry about the return to more normal banking behaviour.

First, we have a massive overhang of bank reserves: the UK monetary base, as measured by Bank liabilities, has expanded to about 8 times its level of 2007. This implies that banks have massive liquidity available for lending should they choose to use it. QE simply must be unwound as soon as practicable consistent with not upsetting markets unduly. Thus as regulation is eased, the QE that was injected in a failed attempt to offset it needs to be unwound.

Second, what of official interest rates at the zero bound? Ronald Mackinnon in persuasive recent work has shown that if central banks swamp the banks with bank reserves at next to zero interest rates, then banks will not use the interbank market for very short term financing; rather they have all they need held with the Bank. QE at super-low rates has thus crowded out the interbank market, which indeed has fallen into relative disuse. The result has been that the banks' 'cost of funds' has borne no relation to Bank rate; to finance their lending banks have borrowed on deposit, including longer term deposits from other financial intermediaries, and this has raised their costs. In addition their costs have risen further through the effect of regulation in forcing expensive extra capital into the funding mix, though this is now being partially offset by the new FLS and Mortgage subsidy schemes.

Thus as QE is unwound Bank rate should be raised to restore the interbank market and reinsert it into the funding mix. This will not tighten monetary conditions as measured by the cost of funds; it will substitute interbank borrowing for banker balances at the Bank. It will restore a normal banking market and drain off bank liquidity that is now dangerously excessive.

These are transitional measures needed to bring monetary policy back on track as the effects of regulation on the credit channel are eased off. In the longer term we need to get credit and money growth back on track; once that is achieved interest rates will be back at normal and QE unwound so that the monetary base too is back at a normal

level of bank reserves. We must hope too that regulation will have been cut back to a much less intrusive level.

To conclude, action needed today is to unwind QE and to move Bank rate up in small steps, initially by 0.5%.

Thus we would advocate now raising rates by a quarter percent with a bias to raise further. For QE we would start the process of withdrawing it — at the rate of say £25 billion per quarter for now; this would eliminate the £325 billion liquidity mountain in just over three years. But after a year this withdrawal should be speeded up.

# THE UK ECONOMY

Vo Phuong Mai Le

## GDP

The economy rebounded in Q1 2013. Real GDP rose 0.3% after declining 0.3% in the previous quarter. The recovery is gathering pace, with surveys suggesting a better outlook for activity in all sectors in Q2.

The main contributor to the increase was the service sector (+0.6% in Q1 after stalling in the previous quarter), which added 0.4 percentage points to growth. The sector also continued to expand in the second quarter according to the Markit/CIPS survey. The index was 54.9 in May, up from 52.9 in April.

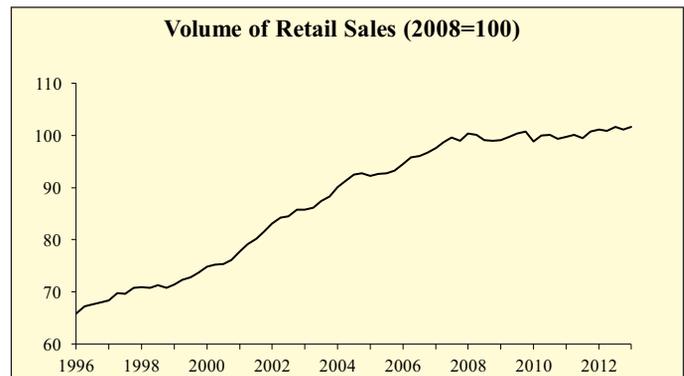
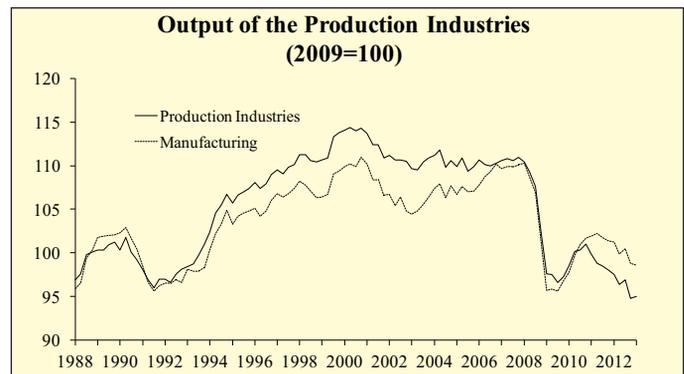
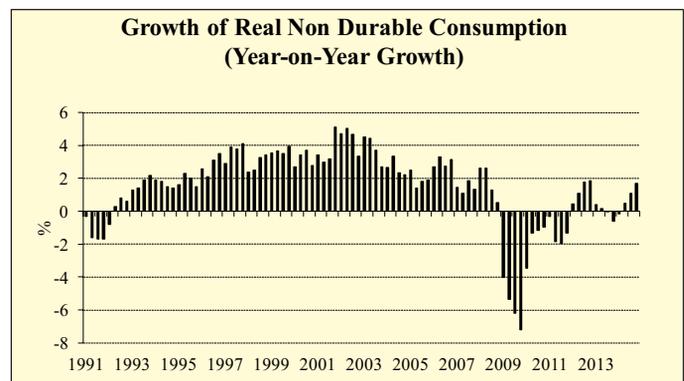
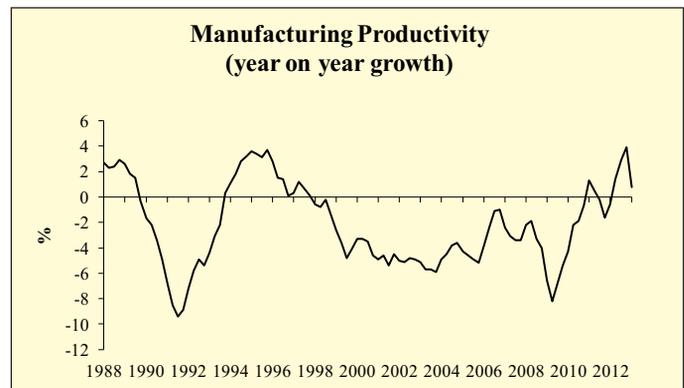
Manufacturing production fell by 0.3% in Q1 following a fall of 1.5% in Q4, but industrial production rose by 0.2% in Q1 after falling 2.2% in the previous quarter. Its rise reflected a rebound in mining and quarrying (+4% in Q1 compared to -10.7% in Q4). Furthermore, the Markit/CIPS manufacturing purchasing managers' index is showing an expansion in manufacturing output in the second quarter of the year. It was up from 50.2 in April to 51.3 in May. It was above the threshold of 50 for the second consecutive month, and at the highest level since March 2012.

Construction output decreased by 2.4% in Q1, after increasing 0.3% in Q4, which was the first rise since Q2 2011. However, the Markit/CIPS construction purchasing managers' index indicates that construction output is now growing. It increased to 50.8 in May from 49.4 in April.

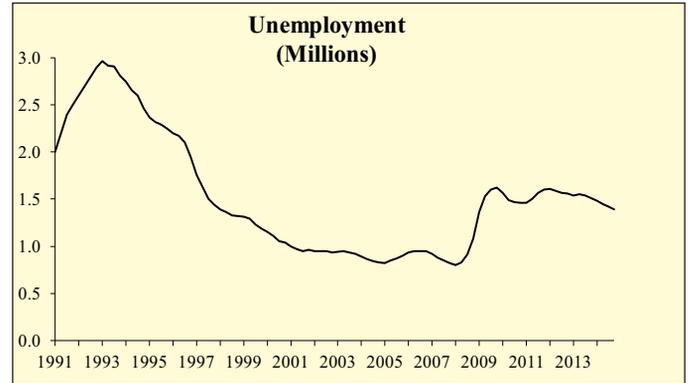
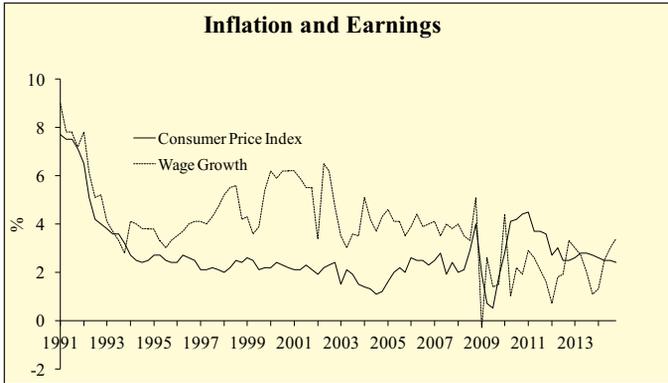
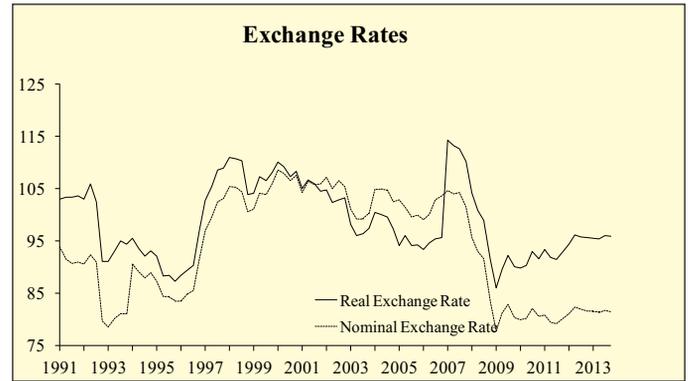
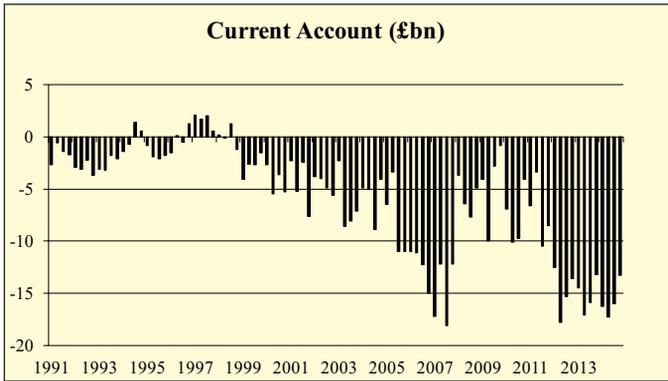
According to the data from the ONS, two domestic expenditure components — private consumption and changes in inventories — contributed positively to growth in Q1. Household final consumption expenditure rose 0.1% in Q1 following 0.4% in the previous quarter. This was the sixth quarterly increase in a row. The change in inventories added 0.4 percentage points to Q1 growth after -0.4 percentage points in Q4. Growth was dragged down by negative contributions from investment (-0.8% in Q1, following -0.2% in Q4) and net exports (subtracting 0.2 percentage points from the Q1 growth, as the decline in exports of 0.8% was larger than the decrease in imports of 0.5%). Government spending remained unchanged in Q1 after rising 0.6% in the previous quarter.

## Cost and prices

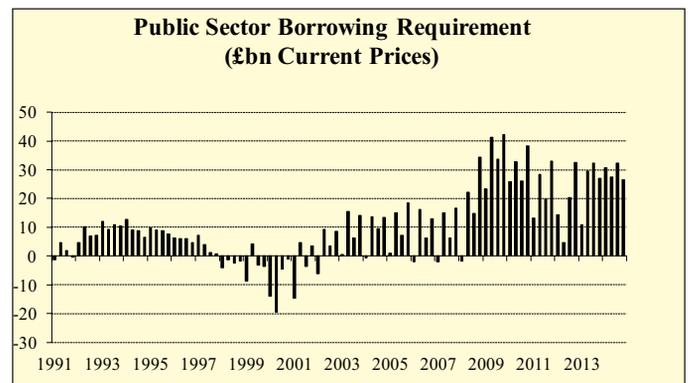
CPI year-on-year inflation was 2.7% in May, up from 2.4% in April. The biggest upward pressures came from transport costs and the clothing and footwear sector. The ONS has introduced a new measure of RPI called RPIJ, which is an improved variant of RPI that meets international standards. RPIJ growth increased to 2.5% from 2.3% in April. CPI



inflation continued to remain above its 2% target. The Bank of England expects inflation to stay above the target for much of the next 2 years. This expectation reflects upward inflationary pressures from the depreciation of sterling at



the beginning of the year and the rise in administered and regulated prices. Despite this, long-term inflation expectations remain well anchored as a revival in productivity growth and spare capacity would provide downward inflationary pressure. Annual factory gate inflation was 1.2% in May compared with 0.9% in April. Input price annual inflation rose 2.2% in May after a fall of 0.1% in the previous month. Despite improvements in the labour market, wage growth remained weak. For the 3 month period to April average earnings growth including bonuses was 1.3% on a year earlier.



**Labour market**

Labour market conditions showed signs of improvement. The unemployment rate remained unchanged at 7.8% for the period of February to April, but employment was up by 24,000 from the November to January period. The claimant count declined for the seventh consecutive month, and was 4.5% in May, the lowest level since May 2011.



**Trade**

The trade deficit was £2.6 billion in April, down from £3.2 billion in March. The deficit on goods was £8.2 billion, and the surplus on services was £5.6 billion.

**Monetary and fiscal developments**

Notes and coins in circulation grew 4.9% in May on a year earlier, compared to 5.4% in April. The year-on-year growth of broad money — M4, bank and building society deposits held by households and firms — fell 0.1% in April, following a rise of 0.3% in March. Excluding

lending to other financial corporations, M4 rose 4.8% in April after rising 4.5% in the previous month.

The Bank of England maintained its official lending rate at 0.5% at the meeting in June, unchanged since March 2009. The stock of asset purchases remained at £375 billion, financed by the issuance of central reserves.

In the fiscal year to May 2013 the public sector current budget — government income minus spending on current cost — was in deficit to the amount of £10.9 billion, compared to a deficit of £22.1 billion in the same period of 2012/2013. Public net borrowing excluding financial intervention was £21.4 billion in the fiscal year to May

2013, down from £24.3 billion for the same period last year. This is good news for the government. At the end of May public sector net debt was £1189.2 billion, or 75.2% of GDP. This is compared to 71.1% at the end of May 2012.

# UK FORECAST DETAIL

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

	Inflation % <sup>1</sup> (CPI)	Short Dated (5 Year) Interest Rates	3 Month Int. Rates	Nominal Exchange Rate (2005=100) <sup>2</sup>	Real Exchange Rate <sup>3</sup>	Real 3 Month Int. Rates % <sup>4</sup>	Inflation (RPIX)	Real Short Dated Rate of Interest <sup>5</sup>
2010	3.3	2.4	0.7	80.4	88.6	-3.5	4.8	-0.2
2011	4.5	2.0	0.9	80.0	89.8	-2.8	5.3	-0.2
2012	2.7	0.9	0.9	83.1	94.0	-1.7	3.2	-1.5
2013	2.7	1.3	0.9	82.6	94.3	-1.6	2.5	-0.9
2014	2.5	1.8	1.6	83.0	95.7	-0.6	3.1	-0.3
2015	2.2	2.1	2.1	82.3	95.4	0.1	2.8	0.1
2012:1	2.7	1.1	1.1	81.2	91.6	-1.8	3.8	-1.3
2012:2	3.0	0.9	1.1	83.2	94.3	-1.4	3.2	-1.4
2012:3	2.5	0.7	0.8	84.1	95.2	-1.7	2.9	-1.6
2012:4	2.5	0.8	0.6	83.7	94.9	-2.0	3.0	-1.5
2013:1	2.6	1.0	0.6	80.5	91.1	-2.0	0.0	-1.3
2013:2	2.8	1.3	0.9	83.2	95.2	-1.6	3.3	-0.9
2013:3	2.8	1.5	0.9	83.5	95.5	-1.6	3.3	-0.7
2013:4	2.7	1.5	1.1	83.2	95.4	-1.3	3.2	-0.6
2014:1	2.6	1.8	1.3	83.6	96.0	-1.1	3.1	-0.3
2014:2	2.5	1.8	1.6	83.0	95.8	-0.6	3.1	-0.3
2014:3	2.5	1.7	1.8	83.1	95.8	-0.3	3.1	-0.4
2014:4	2.4	1.8	1.8	82.4	95.2	-0.3	3.0	-0.2

<sup>1</sup> Consumer's Expenditure Deflator

<sup>2</sup> Sterling Effective Exchange Rate Bank of England

<sup>3</sup> Ratio of UK to other OECD consumer prices adjusted for nominal exchange rate

<sup>4</sup> Treasury Bill Rate less one year forecast of inflation

<sup>5</sup> 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) <sup>1</sup>	Wage Growth <sup>2</sup>	Unemployment (New Basis) Percent <sup>3</sup>	Millions	Real Wage Rate <sup>4</sup> (1990=100)
2010	227.1	2.4	4.6	1.50	135.6
2011	232.7	2.5	4.6	1.53	133.5
2012	237.1	1.9	4.7	1.59	132.5
2013	242.3	2.2	4.5	1.53	131.8
2014	248.5	2.6	4.2	1.43	131.9
2015	256.6	3.2	3.9	1.31	133.3
2012:1	234.7	0.7	4.8	1.61	132.4
2012:2	235.8	1.8	4.8	1.59	131.9
2012:3	237.4	1.9	4.7	1.57	132.5
2012:4	240.5	3.3	4.6	1.56	133.2
2013:1	241.8	3.0	4.6	1.54	133.0
2013:2	242.1	2.7	4.6	1.55	131.7
2013:3	242.0	2.0	4.5	1.54	131.4
2013:4	243.1	1.1	4.5	1.51	131.0
2014:1	245.1	1.3	4.4	1.48	131.4
2014:2	248.1	2.5	4.3	1.45	131.7
2014:3	249.4	3.0	4.2	1.42	132.1
2014:4	251.5	3.4	4.1	1.39	132.4

<sup>1</sup> Whole Economy

<sup>2</sup> Average Earnings

<sup>3</sup> Wholly unemployed excluding school leavers as percentage of employed and unemployed, self employed and HM Forces

<sup>4</sup> Wage rate deflated by CPI

**Estimates and Projections of the Gross Domestic Product<sup>1</sup> (£ Million 1990 Prices)**

	Expenditure Index	£ Million '90 prices	Non-Durable Consumption <sup>2</sup>	Private Sector Gross Investment Expenditure <sup>3</sup>	Public Authority Expenditure <sup>4</sup>	Net Exports <sup>5</sup>	AFC
2010	143.2	685816.8	412464.1	222982.1	180596.2	-35977.3	94248.2
2011	144.8	693480.0	405707.9	232196.6	179249.7	-24641.9	99032.3
2012	145.1	694662.2	405184.0	235764.3	184689.2	-30801.2	100173.9
2013	146.8	702861.9	405176.8	223498.2	188405.4	-30067.7	84149.4
2014	150.0	718141.3	408306.9	241326.9	189177.7	-31205.7	89481.4
2015	153.6	735702.5	414580.1	250992.1	193479.8	-31157.8	92210.8
2010/09	1.7		0.3	11.0	0.1		8.3
2011/10	1.1		-1.6	3.8	-0.8		4.5
2012/11	0.2		-0.1	2.5	3.0		3.0
2013/12	1.2		0.0	-5.3	2.0		-16.0
2014/13	2.2		0.8	8.6	0.4		7.3
2015/14	2.4		1.5	4.0	2.3		3.1
2012:1	145.2	173777.2	101162.8	53040.9	48062.2	-6746.9	21741.9
2012:2	144.4	172906.5	101177.7	59892.9	44993.0	-8401.7	24755.4
2012:3	145.5	174189.9	101200.0	60648.4	45617.7	-7536.4	25739.8
2012:4	145.2	173788.7	101643.4	62182.0	46016.3	-8116.2	27936.9
2013:1	145.5	174253.1	101590.2	48881.4	48201.0	-6636.6	17782.9
2013:2	146.5	175446.1	101360.9	56536.5	45914.8	-7812.6	20545.8
2013:3	147.2	176195.9	101183.7	57185.3	48587.9	-7810.2	22948.1
2013:4	147.8	176966.8	101041.9	60894.9	45701.7	-7808.3	22872.6
2014:1	148.7	177984.2	101428.2	59849.8	46404.1	-7808.4	21893.9
2014:2	149.5	179011.0	101842.3	60408.6	46695.4	-7801.3	22139.1
2014:3	150.4	180074.6	102284.4	58779.4	49462.5	-7797.5	22657.5
2014:4	151.2	181071.5	102752.0	62289.0	46615.7	-7798.5	22791.0

<sup>1</sup> GDP at factor cost. Expenditure measure; seasonally adjusted

<sup>2</sup> Consumers expenditure less expenditure on durables and housing

<sup>3</sup> Private gross domestic capital formation plus household expenditure on durables and clothing plus private sector stock building

<sup>4</sup> General government current and capital expenditure including stock building

<sup>5</sup> Exports of goods and services less imports of goods and services

**Financial Forecast**

	PSBR/GDP % <sup>1</sup>	GDP <sup>1</sup> (£bn)	PSBR (£bn)	Debt Interest (£bn)	Current Account (£ bn)
			Financial Year		
2010	8.5	1319.8	112.6	36.6	-40.0
2011	6.5	1399.3	91.0	43.0	-22.5
2012	4.8	1425.0	68.4	46.9	-59.2
2013	8.1	1471.0	119.7	51.2	-60.7
2014	6.9	1541.7	106.0	56.6	-62.9
2015	5.9	1613.2	94.6	60.3	-63.5
2012:1	4.1	346.6	14.4	11.5	-12.5
2012:2	1.3	353.4	4.6	11.4	-17.8
2012:3	5.7	358.3	20.3	11.8	-15.3
2012:4	8.9	364.3	32.6	11.8	-13.6
2013:1	3.1	349.1	10.9	12.0	-14.5
2013:2	8.2	360.4	29.6	12.5	-17.1
2013:3	8.8	367.0	32.4	12.6	-15.9
2013:4	7.3	370.7	27.0	12.9	-13.2
2014:1	8.2	372.9	30.7	13.3	-16.3
2014:2	7.2	379.2	27.4	13.7	-17.3
2014:3	8.4	383.1	32.4	14.1	-16.0
2014:4	6.9	387.4	26.6	14.2	-13.3

<sup>1</sup> GDP at market prices (Financial Year)

# THE WORLD ECONOMY

The global recovery continued to show signs of improvement, but it remained fragile and fragmented across economic regions. The Purchasing Managers' Index (PMI) for global all-industry output was 53.1 in March, up from 52.9 in February. The pace is expected to be moderate due to continuous negative effects on growth from tight credit conditions, ongoing balance sheet repair and fiscal consolidation in the advanced economies. On the other hand, output growth in emerging economies remained robust.

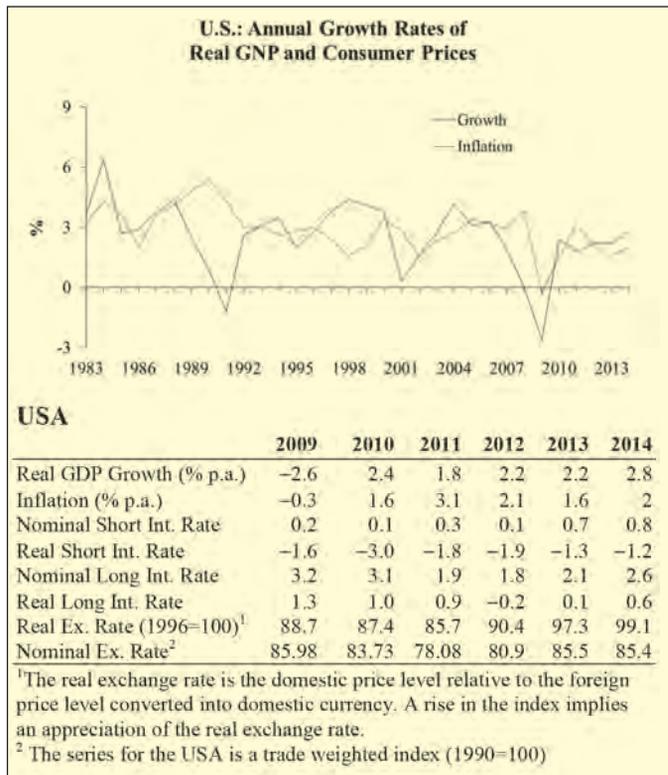
Inflation declined in most advanced economies. Annual headline inflation in the OECD countries was 1.3% in April, down from 1.6% in March. Excluding food and energy, inflation also decelerated to 1.4% in April from 1.6% in March. Inflation elsewhere was mixed. It rose in China and Russia, while was down in Brazil and India.

## US

Real GDP rose 0.625% quarter-to-quarter (QoQ) in Q1 2013, up from 0.1% in Q4 2012. The positive contributions to growth came from strong private consumption (0.8% QoQ compared to 0.45% in Q4), private fixed investment (3.15% QoQ in Q1 after 4.4% in Q4) and a rise in private inventories (adding 0.275 percentage points to the Q1 growth after subtracting 0.325 percentage points in Q4). Negative contributions came from a decline in government spending (-1.0% in Q1 following 2.75% in Q4) and net exports (as an increase of 1.35% in imports dominated a rise of 0.72% in exports). While the government cuts spending dramatically, private sector growth is solid.

The labour market continued to improve. Non-farm payrolls accelerated. They rose 175,000 in May, after 149,000 and 142,000 in April and March respectively. The unemployment rate was 7.6%, marginally up from 7.5% in April, as more joined the labour market. The improvement of the labour market was also associated with the steady rate of average hourly earnings of 2% year-on-year for two consecutive months.

Annual CPI inflation rose to 1.4% in May from 1.1% in April. At this rate, inflation is still low. Slower growth in emerging markets, recession in the euro zone, moderate domestic wage growth and excess capacity kept inflation subdued. Core inflation continued to decelerate. Excluding food and energy, annual CPI inflation was 1.7% in May and April, down from 1.9% in March. At the June meeting, the Federal Open Market Committee kept the target range for the federal funds rate at 0% to 0.25% and expected that this low rate would remain as long as the unemployment rate stayed above 6.5% unless the inflation forecast moved above 2.5% within a 1–2 year horizon. The Federal Reserves will continue to implement the purchase of \$40 billion of monthly MBS and \$45 billion of long-term



Treasuries. However the Federal Reserve Board has confirmed that QE3 is to be slowed down later this year and ended in mid-2014, as both the economic outlook and labour market conditions improve.

## Japan

Economic recovery has returned. Output rose 1.0% in Q1 2013, QoQ, following an increase of 0.1% in the previous quarter. It was driven by domestic and external demand. Private consumption (0.9% in Q1, QoQ, compared to 0.4% in Q4) rose strongly due to a boost in consumer confidence (44.1 in Q1 compared with 40 in the previous quarter), equities gained (by the end of March, Nikkei had gained 43% compared to mid-November 2012) — all of this following the announcement of looser fiscal and monetary policies. Also residential investment rose strongly 1.9% in Q1 ahead of the VAT increase — from 5% to 8% — to be implemented on the 1st April 2014. The other positive contribution came from net trade (adding 0.4 percentage points to growth after deducting 0.1 percentage points in the previous quarter) as a rise of 3.8% in exports dominated a 1% increase in imports. This reflected an improvement in competitiveness for Japanese producers as the yen has depreciated around 20% since November.

The recent surveys and indicators signal continued economic strength in Q2. In April, both leading indicators (99.3 compared with 98.0 in March) and the coincident indicators (94.8 compared to 93.8 in March) were up. Consumer confidence rose to 45.7 in May, the highest level

since May 2007. The improvement in sentiment will continue to support firm domestic demand. The Economy Watchers Survey headline indicator stood at 55.7, showing economic expansion. This is consistent with industrial production that increased 1.7% in April following a rise of 0.9% in March.

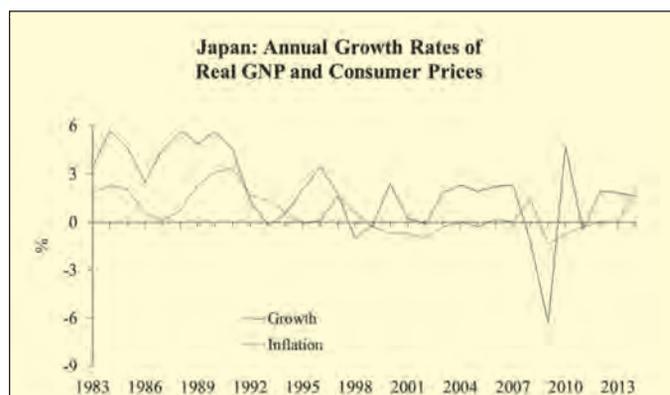
The economy remains in a deflationary state. Annual CPI inflation was -0.7% in April. At the June meeting the Bank of Japan reiterated that it is increasing the monetary base at the annual pace of 60–70 trillion yen — equivalent to around 30% of the monetary base. Japan Government Bond holdings will be increased at an annual pace of 50 trillion yen and the average remaining maturity of the Bank’s Japan Government Bond purchases will be about seven years. The objective of the Bank is to defeat deflation. It will continue quantitative easing to achieve the 2% inflation target.

## Germany

Economic growth bounced back in Q1 2013. It increased to 0.1% after -0.7% in the previous quarter. Private consumption was the main source of this increase. It rose 0.8% after -0.3% in Q4 and added 0.4 percentage points to the quarter’s growth. The other positive contribution to growth came from net trade (adding 0.1 percentage points to growth) as a decrease in exports (-1.8% in Q1 after -2.4% in Q4) was offset by a bigger fall in imports (-2.1% in Q1 following -1.3% in Q4). The biggest negative contribution came from capital investment, down 1.5% in Q1 compared to -0.1% in Q4. It is the fourth consecutive quarterly decrease.

Despite a slow recovery in Q1, the recent economic surveys suggest a gain in growth momentum. The IFO business climate index (105.7 in May after 104.4 in April) suggests that the corporate sector is optimistic and willing to invest. This is also consistent with the ZEW survey. The ZEW expectations index, measuring investor and analyst opinion on the trend in future activity, increased from 36.4 in May to 38.5 in June.

The labour market remained healthy. The unemployment rate was unchanged at 6.9% in April, the seventh month in row close to the lowest level of 6.8% in more than twenty years. Employment increased 0.1% month-on-month in April, and rose 0.7% year-on-year.



### Japan

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

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



### Germany

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

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

## France

Real GDP fell again,  $-0.2\%$  in Q1 2013 after  $-0.2\%$  in Q4 2012. It is the third decrease in the last four quarters. This reflected negative contributions from net trade ( $-0.2$  percentage points in Q1 after adding 0.2 percentage points in Q4) and domestic demand excluding inventories (subtracting 0.1 percentage points to the Q1 change in real GDP following  $-0.1$  percentage points in the previous quarter). Falls were detected across all components of the domestic demand. A positive impact came from the change in inventories ( $+0.1$  percentage point in Q1, after  $-0.3$  percentage points in Q4 2012), but of course this may just reflect rises in unsold goods.

The recent surveys and indicators show some mixed signs of improvement. Industrial production increased 2.2% month-to-month in April after falling 0.6% in the previous month. It was higher than expected and supported by all sectors. This gain is however overshadowed by sluggish business confidence. The INSEE business climate was at 84 in April and May, down from 86 in March, below its long term average of 100. The economic recession may be softening but it is not yet over.

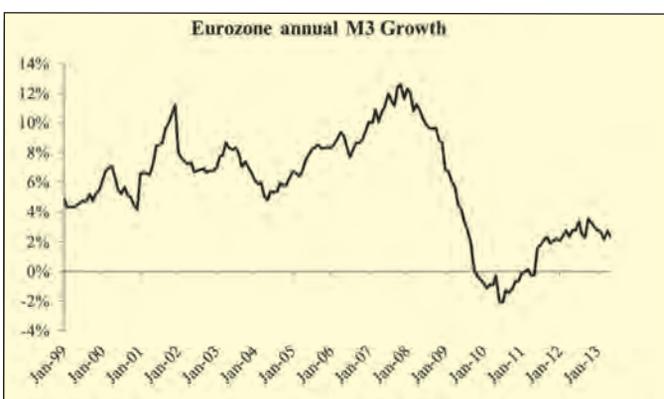
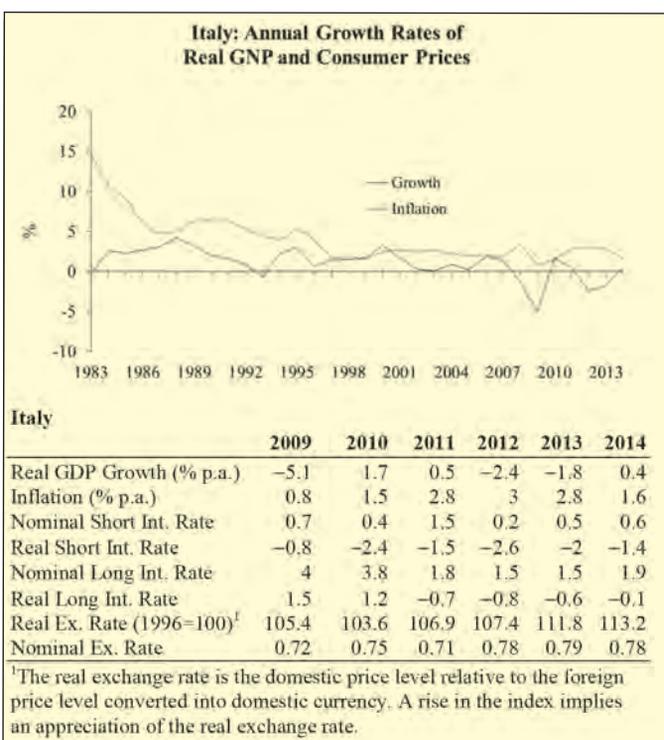
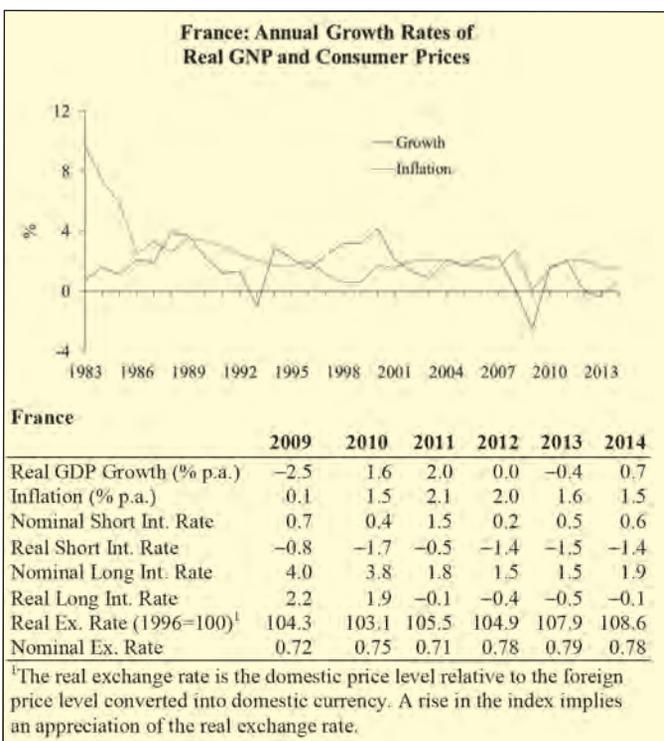
## Italy

The recession continues. Economic activity has continued to shrink for seven quarters. Real GDP fell 0.6% in Q1 2013 following a decrease of 0.9% in Q4 2012. The Markit/ADACI manufacturing Purchasing Managers' Index was 47.3 in May, up from 45.5 in April — well below the expansion value of 50%. Manufacturing output contracted for the 22nd month in a row.

## Euro zone monetary developments

The Harmonised Index of Consumer Prices (HICP) inflation was 1.4% in May, up from 1.2% in April. Low capacity utilisation and slow economic recovery in the euro zone mean that underlying price pressures remain subdued, and medium-term inflation expectations stay below 2%. This is allowing monetary policy to remain accommodative. The ECB Governing Council kept the interest rate unchanged at 1% in the June meeting.

The speed of monetary expansion has slowed. Broad money (M3) growth year-on-year was 3.2% in April, down from 3.6% in Q4 2012. The year-on-year growth of loans to the private sector was  $-1.0\%$  in Q1 following  $-1.3\%$  in the previous quarter. This reflected weak demand from the private sector and continued restrictions on the supply of credit.



# WORLD FORECAST DETAIL

## Growth Of Real GNP

	2009	2010	2011	2012	2013	2014
U.S.A.	-2.6	2.4	1.8	2.2	2.2	2.8
U.K.	-3.9	1.8	0.9	0.1	0.8	2.0
Japan	-6.3	4.7	-0.5	1.9	1.8	1.6
Germany	-4.7	4.2	3.0	0.7	0.6	1.5
France	-2.5	1.6	2.0	0.0	-0.4	0.7
Italy	-5.1	1.7	0.5	-2.4	-1.8	0.4

## Growth Of Consumer Prices

	2009	2010	2011	2012	2013	2014
U.S.A.	-0.3	1.6	3.1	2.1	1.6	2.0
U.K.	1.3	3.7	4.7	2.8	2.8	2.6
Japan	-1.4	-0.7	-0.3	0.0	0.0	2.0
Germany	0.4	1.2	2.0	2.0	1.7	2.0
France	0.1	1.5	2.1	2.0	1.6	1.5
Italy	0.8	1.5	2.8	3.0	2.8	1.6

## Real Short-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	-1.6	-3.0	-1.8	-1.9	-1.3	-1.2
U.K.	-0.3	-3.6	-3.1	-1.9	-1.6	-0.5
Japan	1.1	0.4	0.4	0.3	-1.6	-1.6
Germany	-0.4	-1.9	-0.5	-1.5	-1.5	-1.4
France	-0.8	-1.7	-0.5	-1.4	-1.5	-1.4
Italy	-0.8	-2.4	-1.5	-2.6	-2.0	-1.4

## Nominal Short-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	0.2	0.1	0.3	0.1	0.7	0.8
U.K.	1.1	0.7	0.9	0.9	0.9	1.7
Japan	0.1	0.1	0.4	0.3	0.4	0.4
Germany	0.7	0.4	1.5	0.2	0.5	0.6
France	0.7	0.4	1.5	0.2	0.5	0.6
Italy	0.7	0.4	1.5	0.2	0.5	0.6

## Real Long-Term Interest Rates

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

## Nominal Long-Term Interest Rates

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

## Index Of Real Exchange Rate(2000=100)<sup>1</sup>

	2009	2010	2011	2012	2013	2014
U.S.A.	88.7	87.4	85.7	90.4	97.3	99.1
U.K.	76.7	78.9	80.5	84.4	85.9	85.7
Japan	89.0	92.0	97.1	98.3	119.7	122.0
Germany	105.8	102.9	105.5	104.3	107.4	108.2
France	104.3	103.1	105.5	104.9	107.9	108.6
Italy	105.4	103.6	106.9	107.4	111.8	113.2

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

## Nominal Exchange Rate

(Number of Units of Local Currency To \$1)

	2009	2010	2011	2012	2013	2014
U.S.A. <sup>1</sup>	85.98	83.73	78.08	80.90	85.50	85.40
U.K.	1.57	1.55	1.61	1.59	1.56	1.56
Japan	93.54	87.48	79.36	80.51	98.00	98.00
Eurozone	0.72	0.75	0.71	0.78	0.79	0.78

<sup>1</sup> 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

# GREAT DEPRESSIONS COMPARED

James Foreman-Peck

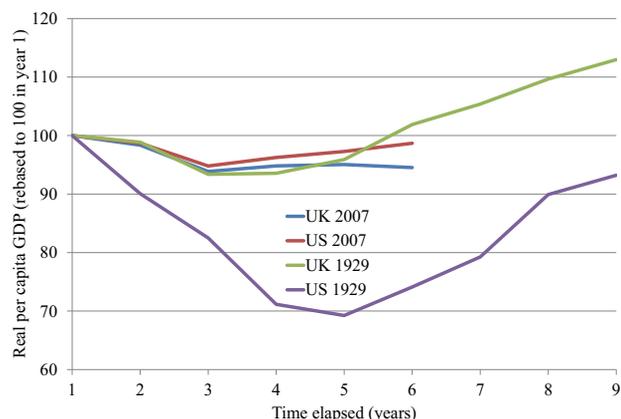
During what has commonly been called the Great Depression, Julian Hodge in his spare time began an entrepreneurial career by selling insurance in the Welsh Valleys. So successful was he that by the 1950s he was ready to fulfil his ambition of creating a bank.<sup>1</sup> The Bank of England told him he would need a guarantee or participation from an established large bank. In the cartelised British market of the time, no bank was likely to offer to cooperate and thereby increase competition that would bite into their profits. Julian eventually out-flanked the barrier by finding a bank in the United States with whom to cooperate, to the surprise of the cartel. His Commercial Bank of Wales was founded in 1971. Other potential entrants, less lucky or ingenious, were unable to participate in the contemporary banking profits.

Equally, or more important, the Bank of England might have contended at the time, was the stability of the British banking system that their entry barriers ensured. But opinion or politics changed, 'light touch' regulation came in, and became progressively lighter. In due course politicians were persuaded for short-term reasons to override sound previous instructions.<sup>2</sup> The recession that began in 2007 or 2008 and still continues in the UK is widely blamed on poor regulation or bad behaviour by the financial system or both. The present discussion aims to cast light on this view and consider remedies by comparing how the US and UK economies fared in the previous great recession and the present one.

## GDP per capita in Two Slumps

Figure 1 compares the two recessions in the two countries. The horizontal axis classifies year 1 as 1929 and 2007. The left vertical axis shows the relative positions of the two countries' GDP per capita from 1929 and the right axis calibrates them from 2007. Most striking is the severity of the US collapse in the earlier period in comparison to the later recession. US GDP per capita did not reach the trough until year 5 after falling more than 30% in the first slump. By contrast, according to OECD annual data the US decline between 2007 and 2009 was only 5.2%.<sup>3</sup> In the earlier recession US output per head needed the outbreak of the Second World War in Europe to recover permanently the 1929 peak.<sup>4</sup> The US recovery from the second Great

Figure 1 Real GDP per capita in Two Slumps



Recession appears considerably stronger, with a 4% rise by 2012, almost offsetting the peak-trough fall of 2007–9.

Britain shows a very different pattern; drops of 6.6% and 6.1% in the first two years of the two recessions. The UK's recent downturn was more severe than that of the US, and comparable to that of 1929. It will be argued below that the earlier slump in the UK was triggered by external events or spillovers and there was no internal financial crisis, in contrast to the US. In year 6 of the present recession Britain's GDP per capita was still lower than at the outset, having hardly risen at all from the 2009 trough. In the duration of the recession, recent UK experience is therefore more comparable to that of the US after 1929. The resilience of the interwar UK is demonstrated by the economy exceeding the pre-recession annual output by year 6. Britain's lack of robustness in the second period differed from the earlier slump because the more recent crisis originated in the domestic financial sector, we will show, and the policy response needs to take this into account.

An obvious source of divergence between the two recessions is the greater size of the government sector, as well as the finance industry, and proactive stabilisation policy in the second period and perhaps also the different nature of the shocks. So first we discuss the shocks that triggered the earlier recession, paying particular attention to money, finance and banking.

## The US and the UK in the Great Depression

Scott Fitzgerald's *The Great Gatsby* (1925) sets the scene for the rising tide of dubious speculation in the US economy of the 1920s. Charles Ponzi, immortalised in US financial literature, emerged from prison in 1925 to join the scams associated with the Florida land speculation boom.

<sup>1</sup> T. O'Sullivan (1981) *Julian Hodge: a biography*, London: Routledge & Kegan Paul

<sup>2</sup> P. Minford (2010) 'The Banking Crisis: A Rational Interpretation' *Political Studies Review*, vol. 8 (1), January, 40-54

<sup>3</sup> OECD Stat Extract: *GDP per head, US \$, constant prices, constant PPPs, reference year 2005. 2012 figure calculated from GDP (same source) and population.*

<sup>4</sup> <http://www.ggd.cnet/maddison/maddison-project/data.htm> (1990 International Geary-Khamis dollars).

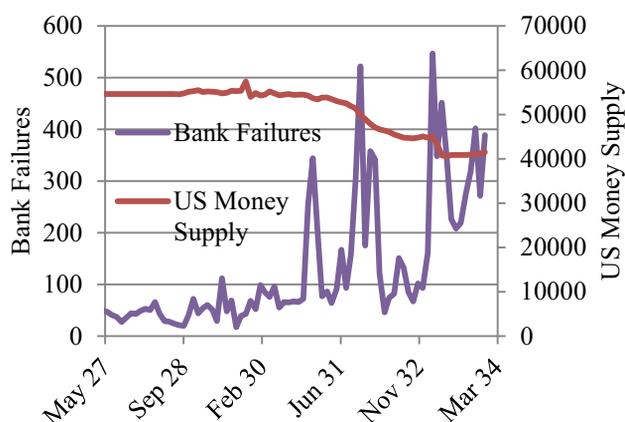
When this ended, banks increasingly supplied brokers with the credit to make loans to speculators buying securities and counting on rises in the Wall Street stock market.<sup>5</sup> In September 1929 the Dow-Jones Industry share price index reached a monthly peak of 691 having risen by a factor of 6 in the previous three years. It then fell to a trough of 46 in July 1932.<sup>6</sup> Holding companies formerly servicing their bond payments with dividends helped the decline as they defaulted. But essentially it was the unwinding of the speculative trading on margins that drove the collapse.

With the bursting of this speculative bubble, investment and consumption fell. By January 1931 domestic spending had dropped by about 5% in response to falling share prices.<sup>7</sup> Although this fall was almost as much as the peak to trough of GDP per capita in the US 2007 recession, it was only the beginning of the earlier Great Depression, for there were eventually wider repercussions. One of the more extraordinary series collected by the US Federal Reserve is the annual number of US bank failures (Figure 2). These failures quadrupled at the end of 1930 and confidence in the US banking system began to evaporate.<sup>8</sup> Over the next two years, the flight from bank deposits and bank lending reduced the US money supply. Consequently prices dropped by more, and unemployment rose as demand collapsed. The present Chairman of the Federal Reserve showed that bank failures and other proxies for risk were highly correlated with the collapse in industrial production.<sup>9</sup>

From 1933 President Roosevelt's New Deal increased Federal Government intervention in the economy and spending. State and local spending and borrowing became less significant. One consequence was that the New Deal provided only a minimal *net* fiscal stimulus to the US economy; counter-cyclical fiscal policy was not really attempted.<sup>10</sup>

US ex-President Hoover, who presided over the onset of the Great Depression beginning in 1929, in his memoirs identified the US banking system as the critical weakness

**Figure 2 US Bank Failures and the Money Supply 1927–1933**



of the system.<sup>11</sup> At the same time he noted that Britain, Canada, Australia and South Africa had no consequential bank failures because they did not try to manage industry or to promote stocks. Their governments gave no guarantees to depositors but the central banks had evolved ways of restraining speculation, he maintained. Had the US possessed a similarly sound financial system and legislation, the credit debacle would not have occurred. By labelling the section of their monumental US monetary history covering this period, 'The Great Contraction', Milton Friedman and Anna Schwartz also pinned most of the blame on the mismanagement of the monetary system.<sup>12</sup>

Herbert Hoover diagnosed the banking system problems as too many small banks, too many regulatory jurisdictions, and an incorrect theory of discount rate and open market operations held by the Federal Reserve- able to encourage speculation but not damp it down or boost economic activity. In addition, larger bank affiliates were speculating in stocks and engaging in stock promotion, indirectly using their depositors' money, and ultimately losing it. All commercial banks were permitted to loan too much on long term mortgages and to over-invest in long term bonds. Only one third of the banks were members of the Federal Reserve System and therefore permitted to get liquidity from the Reserve Banks, which was only available on short loans anyway.

Prudential and regulatory policy clearly needed reform, undertaken by the Banking Act of 1933, which introduced Federal Deposit Insurance to prevent future bank runs. Another element of the Act were the four provisions often known as the Glass–Steagall Act (repealed in 1999). These prohibited commercial banks from participating in investment banking activities or collaborating with brokerage firms.

<sup>5</sup> J K Galbraith (1961) *The Great Crash 1929*, Pelican pp48, 92-3

<sup>6</sup> Data available at <http://business.cardiff.ac.uk/welsh-institute-research-economic-development>, under 'data'.

<sup>7</sup> Elasticities in Table 8 J Foreman-Peck, A Hughes Hallett and Y Ma (2000) 'A Monthly Econometric Model of the Transmission of the Great Depression between the Principal Industrial Economies', *Economic Modelling* 17 515-544. With a short run elasticity of 0.06 and a long run elasticity of 0.07, the Dow-Jones drop from 691 to 168 (not the trough) is about a 76% fall.  $0.76 \times 0.06 = 4.56\%$ ,  $0.76 \times 0.07 = 5.3\%$ .

<sup>8</sup> Surprisingly (as Temin points out) there is no direct statistical effect discernible of the bank failures on the US money supply, though the effects of gold movements are strong P. Temin (1989) *Lessons from the Great Depression*, MIT Press, Appendix B.

<sup>9</sup> B Bernanke (1983) 'Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression', *American Economic Review* 73 257-276

<sup>10</sup> Brown, E.C. (1956). "Fiscal Policy in the 'Thirties: A Reappraisal." *American Economic Review* 46(5): 857–879.

<sup>11</sup> H Hoover (1952) *The Memoirs of Herbert Hoover: The Great Depression 1929-1941*, Macmillan p24

<sup>12</sup> M Friedman and A Schwartz (1965), *The Great Contraction, 1929–1933*, NBER Princeton University Press

The UK economy of the 1920s was apparently much weaker than the US. The British were trying to manage an economy with a debt to GDP ratio of around 200% without capital controls, attempting to restore 'normality' by the 1925 return to the gold standard at the pre-war exchange rate against the dollar. The Bolshevik revolution in Russia had a demonstration effect that encouraged political unrest throughout Europe. Europe in addition continued to suffer from other after-effects of war (reparations and debt controversies) and the Versailles Treaty (redrawing and multiplying national boundaries that fractured traditional economic relations). The General Strike of 1926 was perhaps the peak of Britain's political turbulence.

Britain also had its financial scandals, of which Clarence Hatry's was the most prominent. In the course of buying shares during 1929 using bank finance for a massive amalgamation of steel companies, Hatry's organisation was caught by the fall in share prices and attempted to cover themselves by fraudulent stock issues. On 20 September 1929 when the matter came out, share trading on the London stock market in Hatry's group was suspended. But, critically, there was nothing like the US financial meltdown in the UK; banks did not fail and the money supply held up. In fact in marked contrast to Wall Street, the London stock market index peaked as late as January 1930.<sup>13</sup> The British problem was maintaining the peg to gold when continental Europe was experiencing acute difficulties, and the markets were expecting 'contagion'.

From the beginning of 1931 the UK money supply began falling, continuing for more than a year. On 11 May the Austrian Credit Anstalt bank was officially declared insolvent, triggering bank runs in central Europe. A run on German gold reserves began in June and on 13 July the Darmstadter Bank closed. Three days later Germany introduced foreign exchange controls and a partial bank moratorium was declared until August. On 31 July the May report criticized the sustainability of the UK budget deficit, encouraging gold withdrawals from the country. In September, while the governor of the Bank of England was convalescing, the UK left the gold standard and sterling fell heavily against the dollar and the franc.

The silver lining for the UK, though not for the rest of the world, was that the low interest rates permitted by abandoning the exchange rate peg triggered a strong recovery, including a building boom that has left a legacy of several hundred thousand mock Tudor semi-detached houses throughout the country. With a robust domestic financial system and monetary autonomy, monetary policy did work. At first sight the contrast between the US and UK economic performance is explained.

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<sup>13</sup> Data available at <http://business.cardiff.ac.uk/welsh-institute-research-economic-development>, under 'data'.

## Simulating the US and UK economies in the Great Depression

But institutional and statistical description cannot usually be decisive in explaining recessions and more important in identifying remedial policies. A well-founded economic model is needed. Here we reinforce the provisional conclusions above by reporting simulations of a standard (Mundell–Fleming type) model estimated on monthly data over the Great Depression period.

First we analyse the magnitude and source of the depression. Banking crises lower money multipliers, reducing public confidence in the safety of their deposits, and ultimately cut their spending. Financial crises cause commercial failures and stock price collapses. Therefore an estimation of the effects of financial and banking crises must impose alternative values of money multipliers, bank failures and share prices to those that historically occurred. This simulation sets the money multipliers to the average 1928 level for the US (and for France and to that for September 1930 for Germany). US bank and business failures are assumed not to increase after 1929 and US share prices are fixed at the 1928 average value.<sup>14</sup> The simulations show that, despite the absence of a domestic financial crisis, the effects of financial collapses abroad accounted for most of the loss of output and employment in the UK. Almost all of US GDP decline can be accounted for by domestic financial collapse. Without adequate policies in the US and continental Europe, Britain was forced off the gold standard to the detriment of those remaining on it.

Given that the crises occurred, what was the scope for discretionary fiscal and monetary policy? What could have been achieved with the discount rate and government spending as nationally coordinated policy instruments? Discount rate policy does little to help the US but fiscal policy could have been very effective.<sup>15</sup> Ideally (Nash optimal) fiscal policy in 1929 and 1930 would have raised the government expenditure/GDP ratio by 2.6% in 1929 and 1930. This could easily have been financed and is dwarfed by deficits in the later recession. In this scenario all current account deficits are consistent with each country (we consider the interaction with France and Germany as well) remaining on the gold standard, given the size of reserves. Britain's 1931 current account deficit is reduced from 2.27% to 1.9% — thanks to general self-interested expansion (and UK GDP hardly falls at all). The largest GDP decline in this scenario is for the US in 1932 with a fall of 2.14%.

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<sup>14</sup> J Foreman-Peck, A Hughes Hallett and Y Ma (2000) 'A Monthly Econometric Model of the Transmission of the Great Depression between the Principal Industrial Economies', *Economic Modelling* 17 515-544 esp. Table 12

<sup>15</sup> J Foreman-Peck, A Hughes Hallett and Y Ma (1996) 'Optimum International Policies for the World Depression 1929-1933', *Economies et Societes* 22 4-5 219-242 esp. pp 237-240

The Great Depression could have been avoided. For United States, Britain, France and Germany, abandoning the international commitment to the gold standard was not essential for economic stabilisation. Legislative, ideological and political barriers blocked expansionary monetary and fiscal policies that would have eliminated the depression in the four countries over the critical years 1929-1933.

One lesson from the Great Depression is for European monetary union. What difference would European monetary union (EMU) have made if it had been in place when the Great Depression crises struck? Obviously the economies of the 2000s are not the same as in the 1930s, but similar economic models fit the data generated in both periods. The exact type and strength of shocks to which the world economy was subject between 1929 and 1933 are unlikely to be replicated again but they offer a parable for evaluating alternative arrangements.

Suppose optimal policies were pursued with a common monetary policy instrument in Europe but national fiscal policies, (the characterisation of EMU). We compare these with optimal policies under an alternative floating exchange rate regime from 1929.<sup>16</sup> We assume that Europe floats against the US and there was a common discount rate for the UK, France and Germany. The US loses from this arrangement because it cannot prevent Europe depreciating against it, but Germany suffers the most of the four economies. The problem is asymmetric shocks between countries that must be met with a single policy instrument. Setting this monetary policy instrument to the appropriate value for the weakest economy, ensures that it is set at the wrong value for the other economies. Negative spillover effects from the shocks and inappropriate policies force interest rates and exchange rates higher and displace trade. Fiscal policies are less effective because they cannot be supported by monetary policy. We must conclude that monetary union would be a most unfortunate institution with which to face shocks like those the world experienced between 1929 and 1933.

In summary, fiscal policy could have worked in the US in the Great Depression, but restricting monetary policy in a monetary union is a handicap for responsible policy when there are large asymmetric shocks. The UK could have managed comfortably if the rest of the world had followed good policies over the Great Depression period.

## The 2007 Recession in the UK and the US

The speculation blowing up the bubble that burst in 2007 is generally reckoned to be in US (and British) real estate, initiated by cheap credit financed by abundant Asian savings. 'Sub-prime' borrowers in the US and self-certifying buyers in the UK with 100% (or more)

mortgages acquired property on the assumption that rising prices would more than cover the costs of the loan. These mortgages were packaged with others with better credit ratings and sold on to banks and other financial institutions. The resulting mortgage-backed 'collateralized debt obligations' (CDOs) were not fully understood by the financial industry and therefore were incorrectly priced.<sup>17</sup>

In the US towards the end of 2006, large numbers of mortgages came to the end of introductory low interest rates; 'sub-prime' borrowers therefore experienced greater difficulty servicing their debts. At the same time, US house prices began to drop. With zero or minimal equity in their houses sub-prime owners could walk away without financial cost. Their defaults put pressure on the institutions holding the mortgage-backed CDOs. In particular by summer 2007 there were widespread doubts about the solvency of the huge US mortgage finance agencies Fannie Mae and Freddie Mac. When they received support from the US Treasury, market pressure shifted to other organisations. The collapse of Bear Stearns was a prelude to the general breakdown of Wall Street investment banking in September 2008, especially, of Lehman Brothers. Losses by AIG — a large US insurer — then required US government support of US\$85 billion in return for a 79.9% stake. Merrill Lynch, which held proportionately similar volumes of distressed assets as Lehman Brothers, was acquired by the Bank of America at an enormous discount on the 2007 value.

The failure of Lehman Brothers radically increased market stress internationally. In the United Kingdom, Bradford & Bingley was partly nationalised, Alliance & Leicester was taken over by Banco Santander and Lloyds TSB acquired HBOS. Part of the problem was bank under-capitalisation and excessive distributions. In the middle of 2008 major UK banks had assets of just over £6 trillion and equity capital of around £200 billion. With increasing risks of default this was quite inadequate. In 2009 the Bank of England reported that if banks had distributed one fifth less of their discretionary earnings in bonuses or dividends between 2000 and the slump of 2008, they would have held around £75 billion of additional capital, more than provided by the public sector to prop up the banks during the crisis.<sup>18</sup>

Another contributor was imprudent acquisitions. In May 2007, led by the Royal Bank of Scotland (RBS), a consortium including Santander and Fortis Bank, bid against Barclays with an offer — made up of 79% cash — worth €71.1 billion euros (£48.2 billion) for the Dutch bank ABN Amro. By October 2007 the RBS-led team had won the battle for ABN Amro, but it was a Pyrrhic victory. RBS was obliged to ask shareholders for £12 billion of new capital after £5.9 billion of write-downs in April. This was not enough to keep the bank afloat and in November 2008 the government took a 58% stake in the bank for

<sup>16</sup> J Foreman-Peck, A Hughes Hallett and Y Ma (1995) 'European Monetary Union in the Great Depression: A Counterfactual' in *EMU After Maastricht: Transition or Revaluation* eds D Currie and JD Whitley, Lothian Foundation Press

<sup>17</sup> House of Commons. Treasury Committee. *Banking Crisis: dealing with the failure of the UK banks*. Seventh Report of Session 2008–09.

<sup>18</sup> Bank of England *Financial Stability Report*, December 2009 no 26 p8

£15 billion as part of a huge capital-raising exercise. The following January the Government launched a second bank rescue plan, increasing its stake in RBS to cover losses for 2008, with the majority for write-downs incurred from the ABN Amro acquisition. In February 2009 RBS reported the biggest annual loss in British corporate history; £24.1 billion over the preceding year.

Central banks everywhere responded to the crisis by reducing policy interest rates. They also supplied additional longer-term funding for banks against a wider than usual range of collateral, including through concerted international action. The Bank of England introduced a scheme to enable financial institutions to exchange illiquid assets for UK Treasury bills, intended to improve liquidity and raise confidence. But with this and Bank Rate at 0.5% failing to encourage a recovery, something extra was needed. Using ‘quantitative easing’ the Bank of England created money to buy gilts from institutions. The hope was that these investors would then buy other assets with their funds, such as corporate bonds and shares, thereby bidding up their prices. If it worked, this would lower longer-term borrowing costs and encourage the new issues of shares and bonds. Between March and November 2009, the Monetary Policy Committee authorised the purchase of £200 billion worth of assets, mostly UK Government debt or “gilts”. By July 2012 they had agreed total asset purchases of £375 billion, or about one quarter of GDP.

Financial intermediation accounted for more than 8% of total UK GVA, with profits perhaps twice as much in 2008<sup>19</sup> and the percentages in the US were similar. The financial industry paid a good deal of tax on these earnings. In consequence tax receipts fell with the collapse of the sector. Government spending on the other hand rose, creating the largest peace time deficits seen in the UK and the US. These deficits were boosted by discretionary fiscal policy. From 1 December 2008 in the UK the VAT rate was temporarily cut by 2.5% until January 2010 — and was associated with an acceleration of retail sales growth. OECD figures show a UK deficit in 2009 of 10.8% of GDP and a US deficit of 11.9%.<sup>20</sup> Thereafter these percentages fell but the US deficit to GDP ratio remained above that of the UK until 2012, as did unemployment rates.

In February 2008, the US Congress passed an Economic Stimulus Act giving temporary tax rebates for households and temporary accelerated depreciation for businesses, generating a one year rise in the deficit of just over 1%. A year later as the severity of the recession became more apparent, Congress gave another stronger fiscal stimulus through the American Recovery and Reinvestment Act, estimated to increase the deficit by almost 5% over the first two full budget years. Higher government spending

included expanded unemployment compensation and aid to state and local governments.

These policies seemed to work. In the second half of 2009 there was a strong rise in asset prices internationally. The recovery in the UK stock market was one of the strongest ever. Banks were able to increase their capital ratios; the major UK banks raised more than £50 billion in additional core Tier 1 capital in six months. Core Tier 1 capital ratios, averaging 9.6%, exceeded pre-crisis levels by 2009, but remained low by historical standards.

Although proactive policies brought relief in 2009, thereafter the UK economy stagnated. Banks reduced lending (Figure 3). The monetary base rose strongly in the summer of 2009 and from the Spring of 2012 (Figure 4) in response to successive doses of ‘quantitative easing’. But commercial banks increased their reserves held with the Bank of England rather than making loans. Nominal money supply M4 therefore stagnated, and, as prices continued to rise, fell in real terms.

As for fiscal policy, the prediction for 2013 is for the US deficit to drop to 5.4% of GDP while the UK’s rises to 7.1%. It is likely that contributing to the greater US deficit before 2013 has been the difficulty of achieving political agreement on the fiscal stance. But if so it has been fortuitous, according to the IMF that has recommended the UK follow a less austere fiscal path. The fiscal upshot for both economies is that the debt/GDP ratio is expected to double before recovery is achieved.

## Analysis

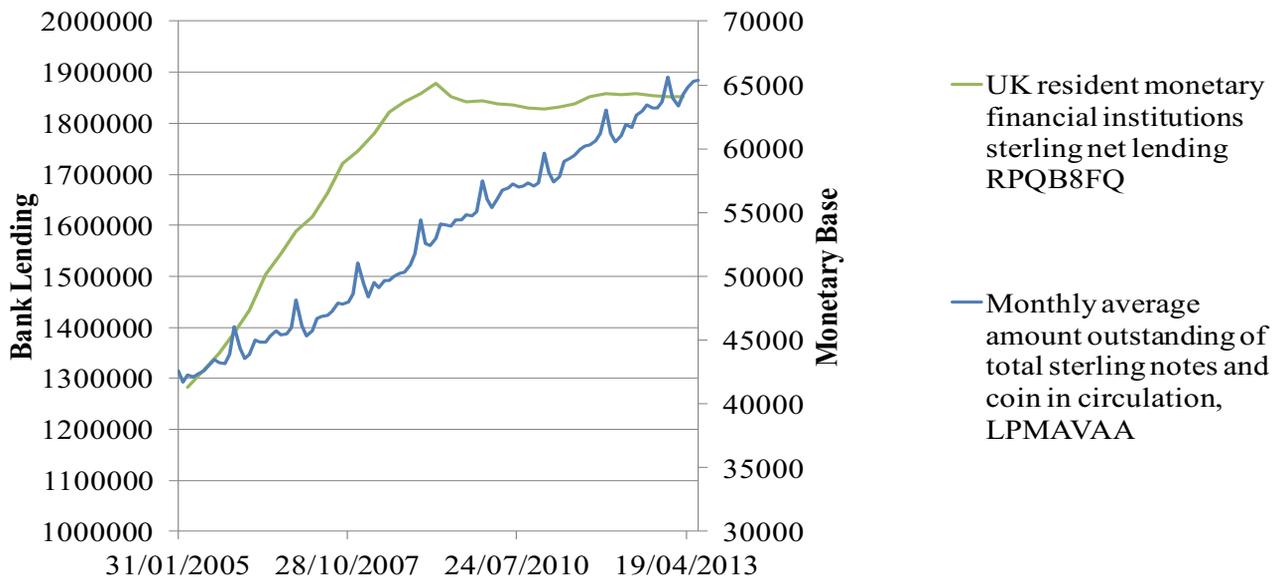
The similarity of the 1929 and 2007 recessions lies in their financial nature for the US in both periods and for the UK in the more recent. Keynes wrote his *General Theory of 1936* with the intention of influencing the Roosevelt US administration, not the British authorities. He saw fiscal policy as the solution to financial or monetary collapse. Simulations reported above show that fiscal policy indeed could have worked to eliminate the US Great Depression. A survey in 2009 of recession experience since 1960 reached a similarly Keynesian conclusion.<sup>21</sup> Recessions associated with financial crises tended to be unusually severe and their recoveries typically slow — 6 quarters to recover the previous peak for ‘big’ economies, and an output loss of almost 5% in a recession lasting almost 7 quarters. Also global slumps — as in the two of interest here — were often long and deep, and recoveries from them were generally weak. Expansionary fiscal policy seemed particularly effective in shortening recessions associated with financial crises and boosting recoveries.

<sup>19</sup> Speech by Andrew Haldane ‘The Contribution of the Financial Sector Miracle or Mirage?’ at the *Future of Finance Conference*, London 14 July 2010.

<sup>20</sup> [http://www.oecd-ilibrary.org/economics/government-deficit\\_gov-dfct-table-en](http://www.oecd-ilibrary.org/economics/government-deficit_gov-dfct-table-en)

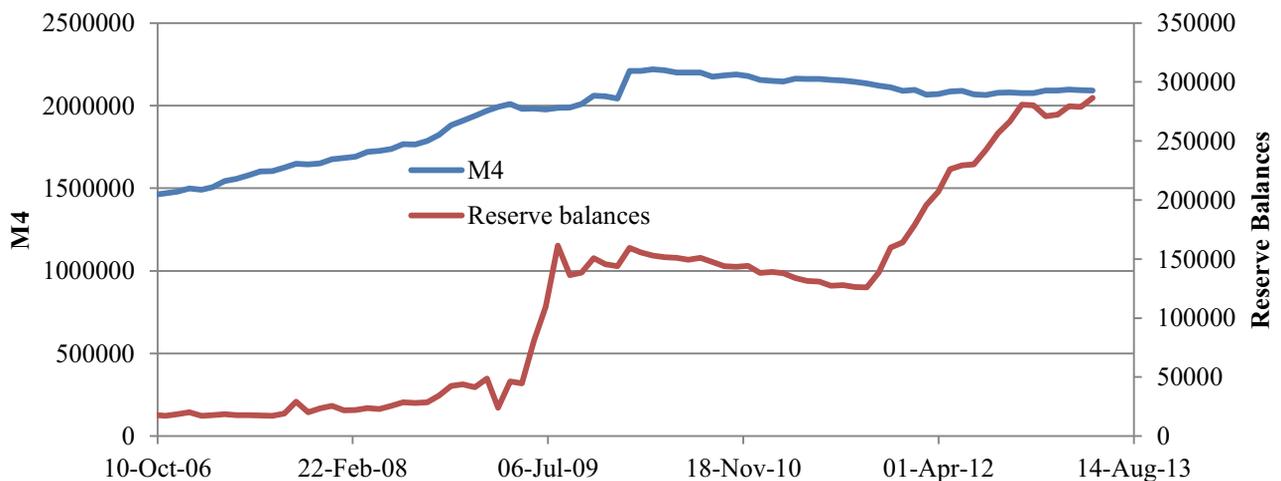
<sup>21</sup> IMF (2009) *World Economic Outlook: Crisis and Recovery*, ch.3, [www.imf.org/external/pubs/ft/weo/2009/01](http://www.imf.org/external/pubs/ft/weo/2009/01)

**Figure 3 Bank Lending in the UK and One Component of the Monetary Base 2005–2013**



Source: Bank of England

**Figure 4 Money and the Key Monetary Base in the UK 2006-2013: Sterling Reserve Balances with Bank of England (series RPWB56A) and Monetary Financial Institutions' Sterling M4 liabilities to private sector (in Sterling millions) (LPMAUYM)**



Source: Bank of England

The differences between the two periods are the current proactive national and international policy, the greater size of government and more pervasive finance in the second recession. The first two dampened the 2007 recession while the third exacerbated it. Judging by manufacturing output, the US economy remains on a moderate growth path, despite the fiscal tightening that the IMF has condemned as excessive.<sup>22</sup> With a looser fiscal position it is reasonably

clear that the economy would be picking up more strongly, as the IMF had predicted (as much as 1.75% per annum faster) before Washington slashed the federal budget in March, adding to the drag on the economy created by tax increases enacted in January 2013. This, together with the stronger US performance with larger proportionate deficits since 2008, points up that a looser fiscal stance is desirable if the UK is to recover 2007 output fairly soon. This the IMF also concluded.<sup>23</sup> Planned fiscal tightening this year

<sup>22</sup> IMF *Concluding Statement of the 2013 Article IV Mission to The United States of America*, <http://www.imf.org/external/np/ms/2013/061413.htm>

<sup>23</sup> <http://www.imf.org/external/pubs/ft/survey/so/2013/CAR052213A.htm>

will be a drag on the economy. In compensation adequately planned capital investment should be brought forward, helping to 'crowd in' private investment.<sup>24</sup>

## Conclusion

Whereas it looks as if the US is coming out of the recession at last, the same is not true of the UK. It seems likely that the relative strength of the US recovery, and its expected retardation this year, has been due first to the larger fiscal stimulus and then its cutback. The value of the 1929 comparison is that it also suggests a related policy response is now appropriate for the UK. The US long and deep depression after 1929 was triggered by financial speculation and weak financial institutions, both public and private, and persisted because of inadequate fiscal stimulus, our simulation shows. When confidence in the financial system is low, and lenders have become highly risk averse — or their expectations highly pessimistic, the systemic problem cannot be overcome by monetary policy alone.

The UK crisis of the interwar years was very different because of more staid financial arrangements. Crisis triggers were pulled abroad — the US downturn and then

the debt crisis on the continent — like current vulnerability to Eurozone crises and stagnation. The most recent financial crisis in UK has been more severe than that of the US in 2007, because the smaller UK is more open to foreign shocks and because of the much greater size of the largest British banks, relative to the UK economy. Monetary policy, such as quantitative easing and the 0.5% Bank Rate, has been ineffective for restoring bank lending. Hence more relaxed fiscal policy is needed despite the prospect of the debt/GDP ratio doubling by 2015 on current policies, shocking as is the unprecedented peacetime increase.

The UK boom between 1950 and 1970 began with a 200% debt/GDP ratio and which was still 65% at the end. Therefore a high debt/GDP ratio, a probable initial consequence of less restrictive fiscal policy, though regrettable does not rule out strong recovery and economic growth. Moreover a stronger recovery of GDP increases tax revenues by more and enhances the ability to service the national debt.

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<sup>24</sup> Though HS2, the high speed rail project, does not seem to come into the category of 'adequately planned'.





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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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