Cardiff Business School
Cardiff University

Julian Hodge Bank

Quarterly Economic Bulletin

Julian Hodge Institute of Applied Macroeconomics

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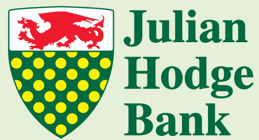
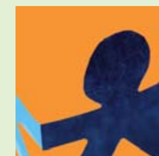
LIVERPOOL MACROECONOMICS RESEARCH LIMITED



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

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

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



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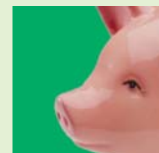
Commercial Lending



Julian Hodge Bank

Commercial Deposits

Contents

UK economic prospects post-election 3

Patrick Minford

The Liverpool Forecast 5

Vo Phuong Mai Le

The UK is growing well again and it is close to or at full employment. Wages are growing faster than inflation again and strengthening steadily. Credit is bypassing the banks, weighted down as they are by the regulative backlash from Whitehall. It is always hard for policymakers to get used to the next boom when it comes, so obsessed are they usually by the bust they have emerged from. One of the problems is that the statistics are generally wrong, because markets have changed channels in the recession. Monetary policy currently is seriously on the back foot; the Bank of England owns nearly 30% of the government's debt and its rates on official paper are virtually zero. Fortunately for it credit rates are still fairly painful for small business borrowers; these rates have never come near the 'zero bound' on official debt. The big problem for monetary policy is: how to get into position for the next typical business cycle fluctuation? Obsessed (wrongly) by 'secular stagnation' it is neither poised to take the wind out of the next boom, nor will it be able to resist the next serious downturn. It needs to get rid of its stocks of government debt and get official interest rates up towards normal.

Meanwhile the world economy is growing at close to 3%. The Keynesian economists at the IMF regard this as a dangerously low rate, compared with heady boom rates of 5% in the 2000s; however, in fact it is a sensibly moderate rate that will not lead quickly again to a raw material shortage. There is room for China and India to grow fairly fast; both have adjustment problems, India with liberalising business to invest, China with liberalising households to consume. The US, the UK and the rest of the Anglo-Saxon world are growing at rates of around 3%. Japan and the euro-zone are struggling to grow at all; neither can generate the competitive institutions that create productivity growth, Japan because of entrenched vested interests, the euro-zone because premature monetary unification is absorbing the energy needed for structural reform. What this adds up to is a world economy growing reasonably, with a long prospective upturn ahead.

UK Costs and benefits of EU membership- an edited introduction to the second edition of 'Should Britain leave the EU?' 14

Patrick Minford

In the ten years since the first edition of this book, much has changed; the EU has acquired a constitution in the form of the Lisbon Treaty and a settled objective of 'ever closer union'. All members must now eventually join the euro. Also, the euro crisis is leading to big centralisation of institutions, at least on paper. In this short edited introduction to the second edition Patrick Minford sets out the renewed challenges for the UK.

Patrick Minford, Economic Adviser to Julian Hodge Bank

"The removal of electoral uncertainty has given the UK economy a substantial boost. There is now the prospect of five years ofcentre-right reforming government, with the reduction of public spending at its heart. Looking back, we increasingly can see that the 'trend' of world output before the crisis was simply unsustainable. It is hard not to be optimistic about the business cycle outlook over the next decade. The post-crisis economy is discovering which sectors can flourish in the new slower-growing world."

UK ECONOMIC PROSPECTS POST-ELECTION

The removal of electoral uncertainty has given the UK economy a substantial boost. There is now the prospect of five years of centre-right reforming government, with the reduction of public spending at its heart. This reduction alone will raise public sector productivity and lead to necessary reform; the public sector is largely incapable of improving performance until resources are reduced. This has always been the Treasury's mantra and it seems to have been demonstrated by the reaction to the cuts so far. For example the police have improved front-line services in spite of large cuts; it seems to have prompted the use of auxiliaries, which are a good innovation. The Department of Defence has been a byword for waste for decades; it may be that now it finally has to sink inter-service rivalries to survive.

Commentators are now wheeling out the EU referendum as the next concern. However this will turn crucially on how the EU reacts to UK demands for reform. If it rejects them outright, as seems most likely, then the majority of UK businesses will turn against the EU and will welcome an Out vote; with business in favour of exit popular opinion will produce an Out result. If the EU accepted the proposed reforms, then the case to leave would be much weakened; it would be difficult to argue against the case for giving the new reformed set-up a chance to work. In Chapter 3 of this Bulletin, Patrick Minford reviews the latest thinking set out in the second edition of his 2005 book 'Should Britain leave the EU?' He argues that leaving the EU together with a new Treaty between the UK and the EU implementing cooperation in areas of mutual interest will bring largescale benefits to the British economy.

The other uncertainty about which there is much muttering is the lack of productivity growth in recent years. Yet with wages growing so weakly until quite recently and falling in real terms there has been little pressure to reduce labour use. This is already changing and will continue to change steadily as the economy's resources get tight.

The outlook for the UK economy shines by comparison with that of euro-zone economies. Yet even there it may well be that the austerity policies pursued on the continent begin to pay dividends as demand recovers.

World growth is running around the 3% mark which is below the heady rates of the 2000s but looks as if it will sustain weak raw material prices for a decade at least. This should allow a long upswing to take a grip on the world economy.

Overall, it is hard not to be optimistic about the business cycle outlook over the next decade. Looking back, we increasingly can see that the 'trend' of world output before the crisis was simply unsustainable. The spiralling prices of raw materials should already have told us that. Also the rising bad debts in certain sectors, led by real estate, should have told us the same. The post-crisis economy is discovering which sectors can flourish in the new slower-growing world.

Table1: Summary of Forecasting

	2011	2012	2013	2014	2015	2016
Real GDP Growth (% p.a.)	1.6	0.7	1.7	2.8	3.0	2.5
Inflation (% p.a.)	3.5	2.1	1.9	1.6	0.6	1.6
Unemployment (Mill.) [1]	1.53	1.59	1.42	1.03	0.77	0.71
Real Short Int. Rate	–2.4	–1.1	–1.3	–1.0	–1.0	–0.7
Nominal Short Int. Rate	0.9	0.9	0.6	0.6	0.6	1.0
Real Long Int. Rate	0.2	–0.8	–0.2	0.2	–0.1	0.2
Nominal Long Int. Rate	2.0	0.9	1.3	1.8	1.8	2.2
Real Ex. Rate (2000=100) [2]	88.7	92.4	81.6	87.1	90.7	90.8
Nominal Ex. Rate	1.61	1.59	1.55	1.65	1.50	1.50
Current Balance (£bn)	-23.2	-53.2	-65.9	-84.2	-77.8	-78.2
PSBR (£bn)	97.9	111.2	92.5	88.6	84.0	79.6

[1] U.K. Wholly unemployed excluding school leavers (new basis, annual average.)

[2] 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.

Can one make any sense of the argument that the world is entering a 'flatlining' period of stagnation? Will real interest rates remain low or even negative? Will nominal interest rates remain stuck at the zero bound? We do not think so. The US is likely to raise interest rates later this year. The UK can hardly fail to follow soon after. Credit growth is weak because of bank regulation; but non-bank credit will surely expand fast and bypass the regulators, precipitating the need to stop the creation of money by governments.

We think it will therefore not be too long before monetary policy returns to a more recognisable form and that the next boom in credit materialises as the new threat to stability.

Common Sense on the financial crisis and its aftermath

We now have three 'monetary policy functions', all lodged at the Bank of England: 'normal' monetary policy, financial stability policy and 'macro-prudential' policy. The first concerns the setting of interest rates. The second concerns the avoidance of financial risk. The third concerns the use of regulatory levers to manage the business cycle in lending and finance.

The assumptions behind all this new paraphernalia are that the recent Great Recession was entirely the fault of the financial system and specifically the banks. Only on this basis would it make sense to interfere so actively in markets and consequent prices, since otherwise all one would need would be normal monetary policy and the usual eye on potential systemic dangers. Furthermore since one would not need macro-prudential intervention one would note that it is highly distortionary of market processes and

for this reason should not be used as it is actively damaging to the economy.

Yet when one looks for evidence that the Great Recession was the result of the financial system, it is extremely hard to find. Several papers claim that financial shocks were what caused it; but on inspection it turns out these studies assumed the very mechanisms that generate this conclusion. In recent work at Cardiff we found that when the same models were estimated so as to fit the data and also to mirror the variety of shocks present, the share of the downturn accounted for by financial shocks is less than a fifth. This work matches work by Stock and Watson who look at the full sweep of relationships in this recession and finds that it was little different in the shocks causing it than previous ones; the Great Recession simply was caused by the same types of shocks as before but on average turning out bigger than usual on this occasion.

When we then turn to just why the financial shocks this time did occur, we are forced to ask whether it was the banks or the central banks themselves that precipitated them. During the second half of 2007 there was a breakdown in the inter-bank market which central banks did little to offset. On the contrary, central bankers spread the blame for the upset then on banks' 'moral hazard'; they ignored their own part in encouraging the prior credit boom and they also forgot their own responsibility to keep the banking system stable. However, from the end of 2007 through 2008 central banks were beginning to restore order in the inter-bank market. The financial crisis erupted with full force in September 2008 with the collapse of Lehman over the weekend of September 13-14th. For reasons that are still not clearly explained the Federal Reserve Board allowed the collapse (Lehman declared itself bankrupt in the small hours of Monday morning), even though there was a huge counterparty problem; and indeed the massive US insurance company AIG immediately collapsed which in turn forced the Fed into a large-scale bailout.

Again it seems that central banks were unwilling to save the banking system because some banks had shown moral hazard. The politicians too entered the game, declaring their disapproval of banks. Yet, approval or disapproval, central banks that terrible weekend should have thought about the banking system and how to save it. Cooperation between central banks was poor; in particular the Bank of England prevented Barclays from being involved in buying parts of Lehman and so contributing to a solution. Why did the Fed and other central banks not defer the Lehman action and search for a less damaging solution? Instead they suddenly threw in the towel over the weekend.

Now it is true that over the next few months central banks and governments put together bailout schemes to clear up the mess. But in retrospect it is puzzling why the mess was allowed to occur in the first place, especially after the great efforts that had been made to stabilise the system after the sub-prime crisis of August 2007 (itself the first conspicuous failure of central bank management).

To summarise all this, we find that over the whole period the financial crisis was just one component of the Great Recession and that this component itself can be put down mainly to central bank incompetence. Yet the new Regulatory framework is put forward as the way to prevent future crises, even though it will only remove a small component of crisis-causing shocks and is also highly damaging to the flow of credit and finance through the economy.

One must hope that in time sense will prevail and the monstrous new system put in place will be somewhat unwound and reduced in scale. The Bank of England has published its ambitious plans for research on these areas; so maybe it will learn the error of these ways from this new programme.

Meanwhile monetary policy is being kept remarkably easy, to try to offset the effects on credit growth of the New Regulation. This is a case of two wrongs not adding up to a right. The difficulty, as we have argued before, is that new forms of credit (so far not reliably measurable) are being created via the internet peer-to-peer network. Plainly the economy is now growing strongly and real wages are starting to rise, reflecting the strength of employment growth.

In the US the Fed is now starting to talk about tightening. We think the Bank will have to do the same here. Once the Fed starts its programme of rate rises, markets will start to view Bank reluctance with concern. So interest rates should start to rise here as in the US before the end of this year. If the Bank refuses to tighten, then it is running risks of losing control of the inflationary process; this does not look a threat today but the fall in commodity prices will soon drop out of the inflation numbers and then the threat will become more apparent.

Monetary targets in the modern era

The inflation target for monetary policy was new in 1992, when introduced here soon after our ejection from Europe's Exchange Rate Mechanism on Black Wednesday. New Zealand had been the first to use one a few years before. The new target has been an undoubted success here in that we have had little inflation ever since its introduction; it has also been highly credible, as evidenced by little drift away from 2% in measures of inflation expectations. Its credibility and its success in keeping inflation stable and low are just two sides of the same coin, since the credibility has stopped any group from making wage settlements or setting price increases at all far away from what 2% would imply.

But, as so often when we make strides in economic policy, a further problem has been revealed about the conduct of monetary policy according to this inflation target. We have seen poor control of credit booms and busts, as illustrated by the boom of the 2000s and the bust of 2007-9. The original idea was that monetary policy would be spurred to

control the boom by surging inflation and the bust by sharply falling inflation. Neither really happened. During the boom inflation stayed moderate; it actually rose during the bust as oil and commodity surged, but this inflationary surge came after the bust and so gave the wrong signal.

What we have seen here is an illustration of how if you change the policy regime, behaviour changes; in this case the key behaviour that changed was the response of inflation to boom and bust. The new policy regime assumed inflation would continue to respond strongly to these but in the event it did not, for the reason we have given that people built the new regime into their behaviour and so moderated their inflation responses.

So the question today is how we should repair our monetary policy target regime and how within it we should respond to an inflation rate that is temporarily zero and maybe briefly goes negative?

Take the question of target first. It seems that what is missing from the previous regime was the old-fashioned response of monetary conditions to the business cycle: what a Fed Governor once famously called 'taking the punch bowl away as the party gets too merry'. This element could be supplied by varying the supply of money, as in Quantitative Easing (QE), to some degree independently of inflation and interest rates. The supply of money is supposed to affect credit and interest rates charged by banks and others like them.

Another idea is to stiffen the response of Bank Rate itself by replacing an inflation target by a target for 'Nominal GDP', or for one element of Nominal GDP, the Price Level. Nominal GDP is defined as the economy's Output times the Price Level. Suppose one wants prices to grow at 2% (target inflation) and output to grow at 3% (target growth). Add the two together to make 5% and record the cumulative growth of both from some initial date, say 2012. Adjust Bank Rate up or down if the cumulative total exceeds or falls short of the cumulative target. The idea is that booms typically generate several years of excessive growth and so the accumulated overshoot would trigger a progressively stronger response from Bank Rate; and vice versa with busts which typically deliver several years of below par growth and inflation. Much the same argument applies if you only did this for the Price level and excluded output from the calculation.

Some experiments with these ideas on models of the economy suggest they would work quite well to restore the old party-pooping responses into monetary policy, while also maintaining the control of inflation that now exists. One could combine a QE rule designed to stabilise credit conditions with such a beefed-up Bank Rate rule.

Against this background we can consider next how to respond to today's 'deflation' combined with strong growth in output and employment. Latest figures suggest that the economy is cumulatively not too far below a reasonable target full-employment level, and may even be moving above it, while the huge rise in QE has pushed asset prices up and encouraged peer-to-peer lending on a large scale. Yet Bank Rate is still glued to the floor and QE remains at £375 billion, a huge holding of government bonds by the Bank of England. We would argue it is time to move both back slowly towards normal.

THE UK ECONOMY

Vo Phuong Mai Le

The first quarter showed a slowdown in growth. Real GDP rose 0.3%, down from 0.6% in Q4 2014. Private consumption only rise by 0.5% and the contribution of net trade was subtracted 0.9 percentage points from the quarterly growth rate, after adding 0.8 percentage points in Q4.

On the production side there was slower growth in the production and services industries and a sharp decline in construction output. Production output growth increased by 0.1% in Q1 down from 0.2% in the previous quarter. Within this, manufacturing output rose only by 0.1% compared to 0.2% in Q4. The Markit/CIPS Purchasing Manager's index (PMI) was 52.0 in May, marginally up from 51.8 in April. Readings above 50.0 signal growth in activity.

Construction output fell by 1.1% in Q1 after a fall of 2.2% in the previous quarter. But there are signs of recovery in the sector. The Markit/CPIS UK Construction Purchasing Manager's index rose to 55.9 in May, up from 54.2 in April. Q1 readings, all well above 50, do not support the gloomy ONS data.

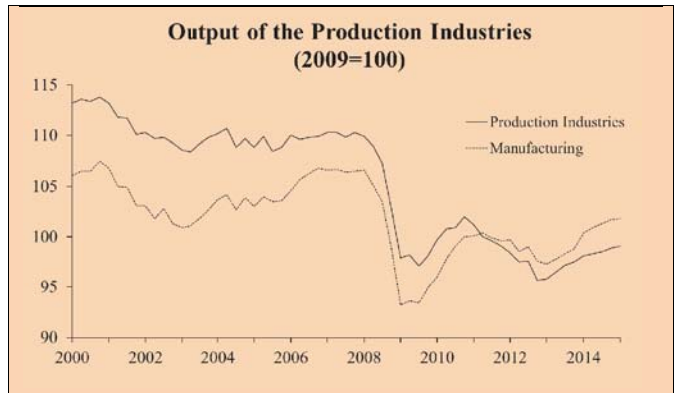
Services output grew 0.4% in Q1 compared to 0.9% in Q4 2014. Looking into the future, services expansion is slowing down but remains relatively strong. The UK Services PMI posted 56.5 in May, down from 59.5 in April.

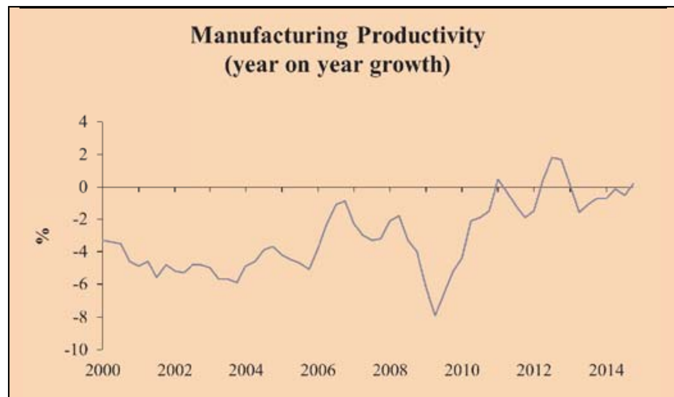
Trade

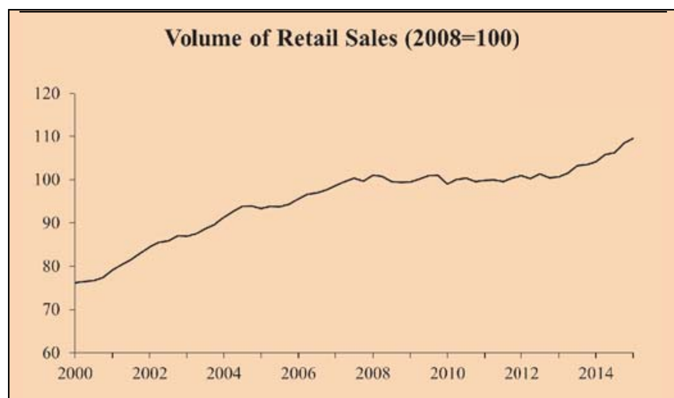
The latest trade data shows that the deficit of trade in goods and services for April 2015 narrowed to £1.2 billion from £3.1 billion in March. Within this the deficit on trade on goods was £8.6 billion, down from £10.7billion. Fluctuations in the trade balance and investment income have been marked since the crisis. The trade deficit should improve as and when euro-zone growth returns. Net investment income may also respond to better euro-zone conditions and hence returns.

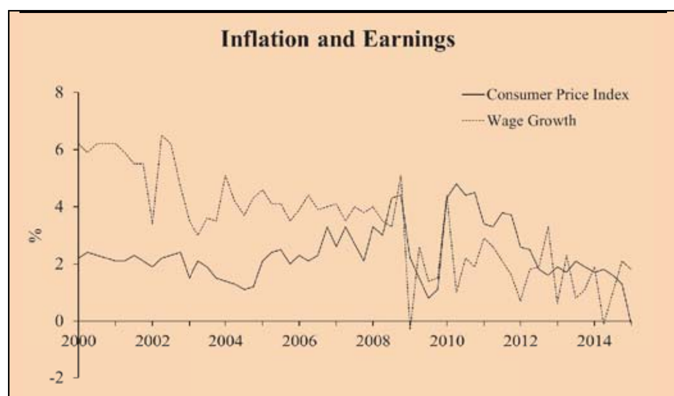
Labour market

The labour market remained strong. The employment rate was 73.5% in Q1 2015, slightly up from 73.2% in Q4. The unemployment rate decreased to 5.5% in Q1 from 5.7% in the previous quarter. The Claimant count rate also improved, standing at 2.4% in Q1 down from 2.7% in Q4. All these figures indicate a labour market essentially at full employment and so we now expect to see wages continue to increase in real terms.





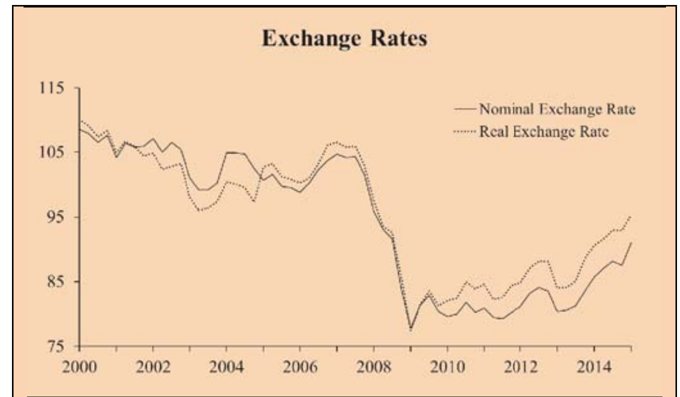


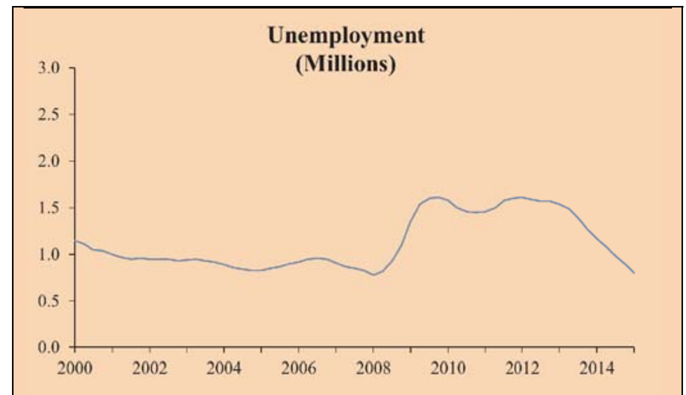


Prices and Costs

The annual CPI inflation rate fell into negative territory. It fell from 0.3% in the year to January 2015 to 0% in February and March, and finally -0.1% in April. This reflected both the cumulative fall in oil prices, and the appreciation of sterling against the euro. However, the core inflation also contributed to this fall. Core inflation fell from 1.4% in January to 0.8% in April. Input price annual inflation continued to slide, falling 11.7% in April, after 12.8% in March. Output price annual inflation for all manufactured products was -1.7% in April, unchanged since February.

With the strength in the labour market, wage growth has now robustly overtaken inflation. The Average weekly earnings increased by 1.9% the Q1, after 2.1% in Q4. Both short and long-term expectations of inflation have drifted downwards but the Bank of England, while closely monitoring them, still considers that both remain broadly consistent with the 2% target.

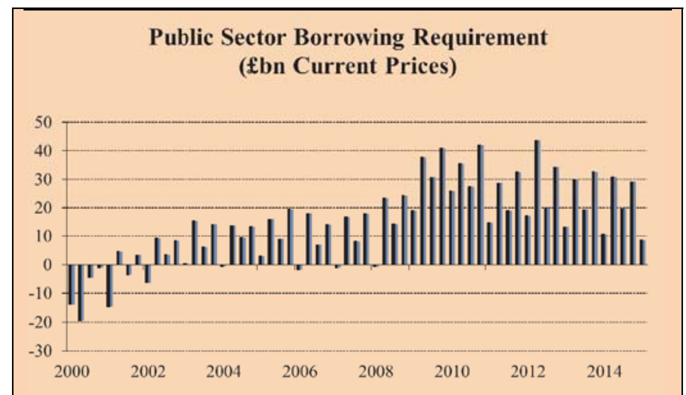


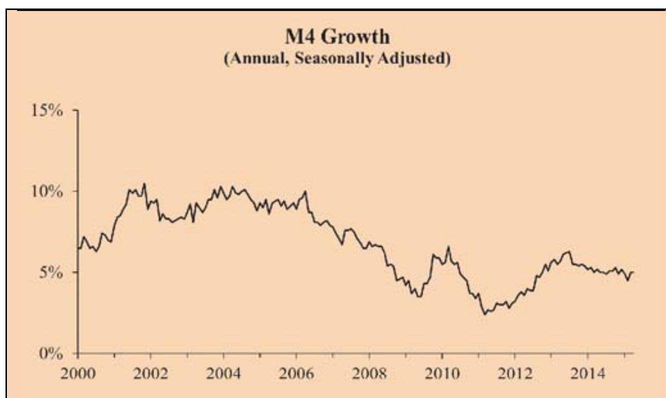


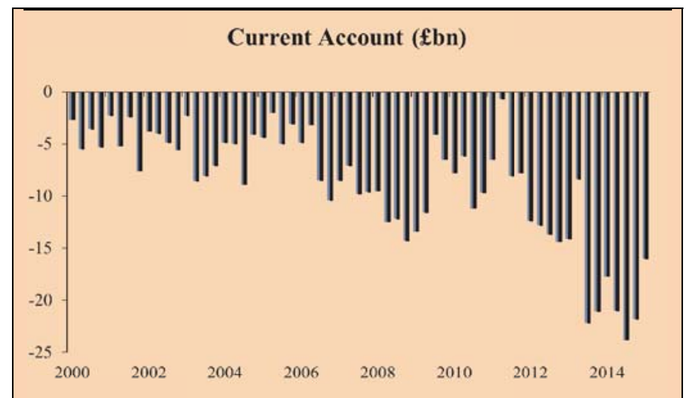
Monetary and Fiscal

In the financial year ending 2015 the public sector borrowed £87.7 billion, compared to £98.5 billion in the previous financial year 2013/2014. Public sector net debt is therefore still on a rising trend. At the end of April, it was £1487.7 billion (80.4% of GDP) compared to £1402.1 billion (or 79.1% of GDP) in the previous year.

The broad money M4 (adjusted to exclude deposits of other financial intermediary corporations, OFCs) increased by £8.8 billion in April compared to the average monthly increase of £5.6 billion over the previous six months. Its annual growth year-on-year in April was 4.2%. The banking sector is accordingly playing little part still in the UK's relatively strong rate of expansion. This suggests that finance is now bypassing the banking sector and increasingly going through other channels, including equities, bond markets, and the new internet peer-to-peer credit companies.







UK FORECAST DETAIL

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

	Inflation %[1] (CPI)	Short Dated (5 Year) Interest Rates	3 Month Int. Rates	Nominal Exchange Rate (2005=100) [2]	Real Exchange Rate[3]	Real 3 Month Int. Rates %[4]	Inflation (RPIX)	Real Short Dated Rate of Interest[5]
2013	1.9	1.3	0.6	81.6	85.6	-1.3	3.1	-0.2
2014	1.6	1.8	0.6	87.1	92.0	-1.0	2.4	0.2
2015	0.6	1.8	0.6	90.7	95.6	-1.0	1.6	-0.1
2016	1.6	2.2	1.0	90.8	95.8	-0.7	2.4	0.3
2017	1.7	2.5	1.6	90.7	95.8	-0.4	2.5	0.4
2018	2.0	2.5	2.1	90.3	95.8	0.0	2.7	0.2
2013:1	1.9	1.0	0.6	80.5	84.1	-1.1	3.3	-0.8
2013:2	1.7	0.9	0.5	80.7	84.2	-1.5	3.1	-0.9
2013:3	2.1	1.5	0.5	81.4	85.3	-1.4	3.2	-0.2
2013:4	1.9	1.7	0.5	83.7	88.7	-1.1	2.7	0.4
2014:1	1.7	1.8	0.6	85.7	90.6	-1.2	2.7	0.7
2014:2	1.8	1.9	0.6	87.1	91.6	-1.0	2.6	1.0
2014:3	1.6	1.9	0.6	88.2	93.0	-0.7	2.5	1.2
2014:4	1.3	1.4	0.5	87.5	92.9	-1.0	2.0	0.6
2015:1	-0.1	1.8	0.5	91.0	95.4	-1.1	1.3	0.7
2015:2	0.5	1.6	0.6	90.6	95.4	-1.1	1.6	0.3
2015:3	0.8	1.8	0.7	90.8	96.0	-0.9	1.8	0.3
2015:4	1.0	2.0	0.8	90.5	95.7	-0.9	1.9	0.3

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

Labour Market and Supply Factors (Seasonally Adjusted)

	Average Earnings (1990=100)[1]	Wage Growth[2]	Unemployment (New Basis) Percent[3]	Millions	Real Wage Rate[4] (1990=100)
2013	238.6	1.1	4.2	1.4	132.1
2014	241.6	1.3	3.0	1.0	131.6
2015	247.5	2.4	2.2	0.8	134.1
2016	255.3	3.2	2.0	0.7	136.1
2017	262.9	3.0	1.9	0.7	137.8
2018	270.9	3.0	1.7	0.6	139.2
2013:1	236.8	0.6	4.6	1.5	131.6
2013:2	240.7	2.3	4.4	1.5	133.3
2013:3	239.0	0.8	4.1	1.4	134.0
2013:4	238.0	1.1	3.7	1.3	134.7
2014:1	241.4	1.9	3.4	1.2	132.4
2014:2	240.4	-0.1	3.1	1.1	131.2
2014:3	241.5	1.0	2.8	1.0	131.3
2014:4	243.0	2.1	2.6	0.9	131.6
2015:1	245.7	1.8	2.3	0.8	134.6
2015:2	245.9	2.3	2.2	0.8	133.5
2015:3	247.6	2.5	2.2	0.8	133.6
2015:4	250.8	3.2	2.1	0.7	134.5

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

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

	Expenditure Index	£ Million '90 prices	Non-Durable Consumption[2]	Private Sector Gross Investment Expenditure[3]	Public Authority Expenditure[4]	Net Exports[5]	AFC
2013	149.7	716792.3	422942.6	280112.3	186839.5	-43986.8	129115.4
2014	153.9	737015.5	427963.1	304158.8	190713.6	-49433.4	136386.5
2015	158.6	759444.4	437481.6	315661.6	193150.9	-45651.0	141194.8
2016	162.6	778752.4	447600.9	324004.5	197878.0	-45648.1	145082.7
2017	166.5	797118.0	458510.3	331200.7	201835.6	-45657.5	148775.7
2018	170.4	815975.2	469801.9	338544.2	205872.3	-45677.8	152572.1
2013/12	1.7		0.8	6.9	-0.8		6.5
2014/13	2.8		1.2	9.2	2.1		6.0
2015/14	3.0		2.2	3.8	1.3		3.6
2016/15	2.5		2.3	2.6	2.4		2.8
2017/16	2.4		2.4	2.2	2.0		2.5
2018/17	2.4		2.5	2.2	2.0		2.6
2013:1	148.3	177519.5	105980.9	63263.4	48156.3	-9136.5	30744.6
2013:2	149.2	178660.4	105506.8	65944.1	45724.2	-8941.9	29572.8
2013:3	150.3	179940.8	105672.5	73909.9	46393.6	-13073.1	32962.1
2013:4	150.9	180671.6	105782.4	76994.9	46565.5	-12835.3	35835.9
2014:1	152.2	182265.5	106436.3	74892.1	48266.6	-12641.4	34688.1
2014:2	153.5	183784.4	106421.7	75257.3	46811.9	-12072.8	32633.8
2014:3	154.5	184921.4	106888.2	77659.4	47749.3	-13346.2	34029.3
2014:4	155.4	186044.2	108216.9	76350.0	47885.7	-11373.0	35035.4
2015:1	157.1	188027.6	108559.6	76022.9	49960.4	-11418.3	35097.0
2015:2	158.9	190219.7	109098.3	80639.9	47084.9	-11415.5	35185.9
2015:3	159.0	190337.9	109639.8	79590.1	47855.5	-11410.3	35336.8
2015:4	159.4	190859.2	110183.9	79408.7	48250.2	-11407.0	35575.2

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

Financial Forecast

	PSBR/GDP %[1]	GDP[1] (£bn)	PSBR (£bn) Financial Year	Debt Interest (£bn)	Current Account (£ bn)
2013	6.0	1550.9	92.5	47.1	-65.9
2014	5.5	1615.2	88.6	51.8	-84.2
2015	5.0	1679.3	84.0	53.9	-77.8
2016	4.6	1752.9	79.6	57.6	-78.2
2017	3.2	1827.4	58.7	62.4	-78.8
2018	2.1	1909.0	39.1	65.4	-79.5
2013:1	3.5	373.6	13.3	11.9	-14.1
2013:2	8.0	374.9	30.0	11.2	-8.4
2013:3	5.0	385.5	19.3	11.5	-22.2
2013:4	8.3	394.8	32.7	11.9	-21.1
2014:1	2.7	395.7	10.6	12.4	-17.7
2014:2	7.8	396.7	31.0	12.8	-21.0
2014:3	4.9	402.8	19.6	13.0	-23.8
2014:4	7.1	408.3	29.2	13.1	-21.8
2015:1	2.1	407.4	8.7	12.9	-16.0
2015:2	8.6	415.2	35.8	13.2	-19.9
2015:3	4.3	418.5	17.8	13.4	-20.2
2015:4	8.0	422.4	33.7	13.7	-21.7

1 GDP at market prices (Financial Year)

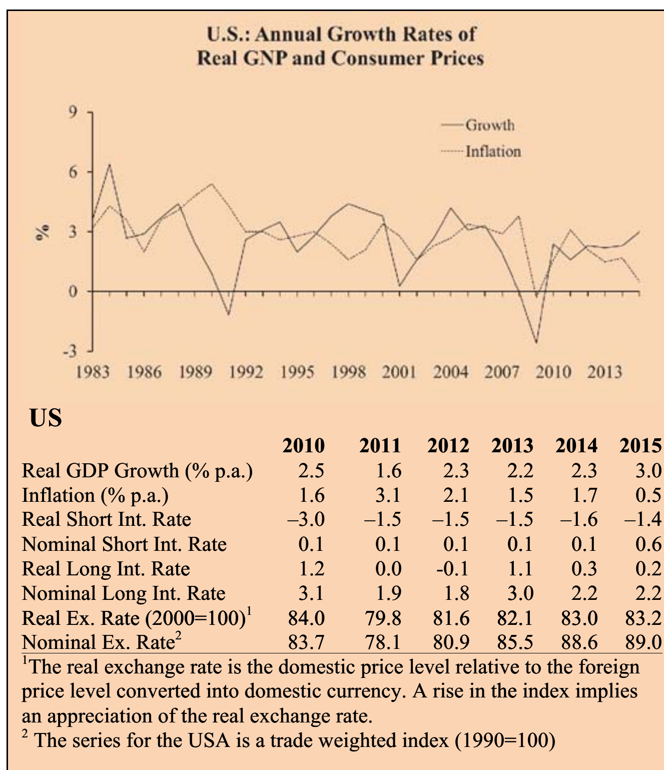
US

Economic activity actually contracted in the first quarter of this year. The quarter-on-quarter real GDP fell by 0.175%, after rising 0.55% in the last quarter of 2014. Real consumption increased 0.45% in Q1, down from an increase of 1.1% in Q4 2014. Real nonresidential fixed investment fell 0.7% in Q1, after rising 1.2% in Q4. Net exports again contributed negatively (almost 0.45 percentage points off GDP growth after 0.25 off in Q4); it was due to a decrease in exports (-1.8%) and an increase in imports by 1.4%.

However, it looks like an aberration due to extremely poor weather; indeed this is such a regular feature of the first quarter that many are complaining that the seasonal adjustments are faulty. Trends in the economy have continued to be strong. Thus the labour market continued to strengthen. Total nonfarm payroll employment increased by 280000 in May, compared with an average monthly gain of 251000 over the previous 12 months. Unemployment rate was at 5.5% unchanged from February.

The economic outlook for the second quarter appears to be for a strong rebound. Though Industrial production remains weak, with its three-month growth rate down to -0.6% in April, surveys in the manufacturing sector indicated that production may have bottomed out. In May, the national manufacturing PMI composite index rose to 52.8 from 51.5 in both April and March. The consumer confidence index rose to 94.6 in June from 90.7 in May. These are all strong positive indicators of ongoing growth.

Annual headline CPI inflation rate increased 0.1% in April, down marginally from 0.2% in March. Excluding food and energy, inflation rose 0.3% in April, up from 0.2% in March. As in the UK, these very low inflation figures will only be temporary.



US

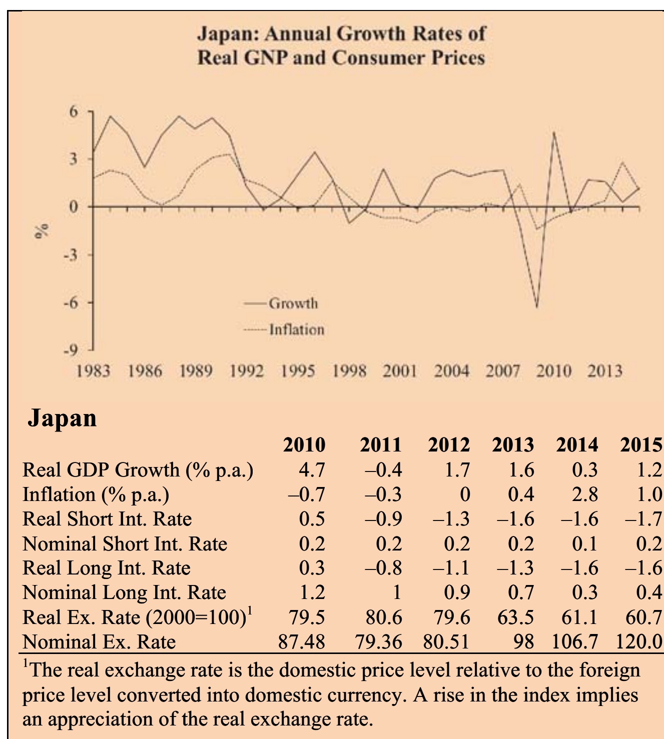
	2010	2011	2012	2013	2014	2015
Real GDP Growth (% p.a.)	2.5	1.6	2.3	2.2	2.3	3.0
Inflation (% p.a.)	1.6	3.1	2.1	1.5	1.7	0.5
Real Short Int. Rate	–3.0	–1.5	–1.5	–1.5	–1.6	–1.4
Nominal Short Int. Rate	0.1	0.1	0.1	0.1	0.1	0.6
Real Long Int. Rate	1.2	0.0	-0.1	1.1	0.3	0.2
Nominal Long Int. Rate	3.1	1.9	1.8	3.0	2.2	2.2
Real Ex. Rate (2000=100)[1]	84.0	79.8	81.6	82.1	83.0	83.2
Nominal Ex. Rate[2]	83.7	78.1	80.9	85.5	88.6	89.0

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

Japan

The economy expanded more than expected. The newly revised real GDP growth was almost 1.0% in Q1 (raised from the first estimate of 0.6%), compared with a rise of 0.75% in the previous quarter. Private consumption rose by 0.4% in Q1, unchanged from the previous quarter. Non-residential investment rose 0.4% in Q1, after 0% in Q4 2014. Net trade subtracted 0.2 percentage points from GDP growth, after a positive contribution of 0.3 in Q4.

Nevertheless these growth figures are simply a rebound from earlier collapse: Japan's real GDP over the past year has fallen 0.9% and on present prospects it will grow less than 1% in 2015 as a whole.



Japan

	2010	2011	2012	2013	2014	2015
Real GDP Growth (% p.a.)	4.7	–0.4	1.7	1.6	0.3	1.2
Inflation (% p.a.)	–0.7	–0.3	0	0.4	2.8	1.0
Real Short Int. Rate	0.5	–0.9	–1.3	–1.6	–1.6	–1.7
Nominal Short Int. Rate	0.2	0.2	0.2	0.2	0.1	0.2
Real Long Int. Rate	0.3	–0.8	–1.1	–1.3	–1.6	–1.6
Nominal Long Int. Rate	1.2	1	0.9	0.7	0.3	0.4
Real Ex. Rate (2000=100)[1]	79.5	80.6	79.6	63.5	61.1	60.7
Nominal Ex. Rate	87.48	79.36	80.51	98	106.7	120.0

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

Labour market conditions improved a little. The unemployment rate fell to 3.5% in Q1, down from 3.6% in the second half of 2014. The number of new job offers picked up (3.1% in Q1 compared with 0.6% in Q4 2014) and the effective ratio of job offers to applicants rose by 3.7%. Japan's problem remains the lack of growth in productivity- the main target of the intended Abe reforms.

Prices continued to fall. Annual CPI inflation rate was -0.1% in Q1, after -0.2% in Q4 2014. Excluding food and energy, inflation was 0%, down from 0.1% in the previous quarter. Nevertheless this has to be seen beside similar figures in the US, which are temporary; so it may well be also that the Bank of Japan is managing to achieve its underlying inflation target.

Germany

The German economic recovery slowed down sharply. Real GDP rose 0.3% in Q1 after 0.75 in Q4. Domestic demand rose 0.5% to support the recovery, while net trade knocked 0.2 percentage points off quarterly growth

May's unemployment rate was 6.4% and job growth remained positive, 1.4% up on a year ago in May. Inflation in May was 0.7%, with the falling euro offsetting low commodity prices. Germany continues to run a large current account surplus of $287 billion over the last 12 months (6.7% of GDP), and a government budget surplus of 0.7% of GDP. The government derides Keynesian policies. This attitude is working well for Germany, especially since the Hartz reforms in the 2000s liberalised the German labour market.

France

Real GDP increased by 0.6% in Q1, after zero growth in Q4. The improvement was mainly due to an upswing in private consumption by 0.8%. Changes in inventories contributed another 0.5 percentage points to growth. But total gross fixed capital formation fell by 0.2% and net trade knocked 0.5 percentage points off growth.

The labour market remained weak. In Q1 the average unemployment rate was at 10.3% of the active population, down slightly from 10.4% in Q4. The employment rate was 64.1% in Q1, down from 64.3% in the previous quarter.

The business climate in manufacturing has improved. The composite indicator increased to 103 in May from 102 in April, above its long-term average of 100. Also optimism was registered in the service sector, its composite indicator increased by 2 points to 94 in May but is still below its long-term average of 100. The picture is mixed and the outlook remains uncertain.

Italy

Economic activity finally expanded in the first quarter: real GDP increased by 0.3%. The main positive contribution

Germany

	2010	2011	2012	2013	2014	2015
Real GDP Growth (% p.a.)	4.1	3.6	0.4	0.1	1.4	1.7
Inflation (% p.a.)	1.1	2.1	2	1.5	1	1.5
Real Short Int. Rate	–1.3	0.1	–0.7	–1.2	–1.4	–1.4
Nominal Short Int. Rate	0.8	1.4	0.6	0.2	0.2	0.1
Real Long Int. Rate	1.2	0.0	–0.3	–0.9	–1.4	–1.7
Nominal Long Int. Rate	2.8	1.8	1.5	1.0	0.5	0.3
Real Ex. Rate (2000=100)[1]	101.3	100.1	96.7	99	100.5	100.2
Nominal Ex. Rate	0.75	0.71	0.78	0.75	0.76	0.90

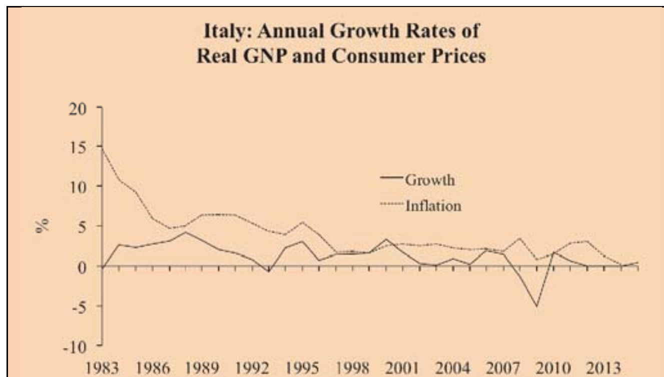
[1]The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation of the real exchange rate.

France

	2010	2011	2012	2013	2014	2015
Real GDP Growth (% p.a.)	1.9	2.1	0.4	0.4	0.4	0.8
Inflation (% p.a.)	1.5	2.1	2	0.9	0.6	0.2
Real Short Int. Rate	–1.3	0.6	0	–0.6	–0.9	–1.3
Nominal Short Int. Rate	0.8	1.4	0.6	0.2	0.2	0.1
Real Long Int. Rate	1.6	0.2	-0.1	-0.7	–1.3	–1.6
Nominal Long Int. Rate	2.8	2.7	1.6	1.6	1.2	1.2
Real Ex. Rate (2000=100)[1]	103.5	102.9	99.5	100.7	101.7	101.4
Nominal Ex. Rate[2]	0.75	0.71	0.78	0.75	0.76	0.90

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

came from investment, rising by 1.5%. But private consumption remained weak, falling 0.1%, as did net trade, with imports growth of 1.4% against zero growth in exports. Over the past year Italy's growth has been 0.1%. Unemployment remains dreadfully high, at 12.4% in April. The outlook remains gloomy, with Renzi's party in Parliament dependent on Berlusconi and no end in sight to the zero-sum politics that have made any sort of reform impossible to carry out.



Italy

	2010	2011	2012	2013	2014	2015
Real GDP Growth (% p.a.)	1.7	0.6	–2.3	–1.9	–0.3	0.4
Inflation (% p.a.)	1.5	2.8	3.0	1.2	0.2	0.2
Real Short Int. Rate	–2.0	0.4	0.0	–0.6	–1.0	–1.4
Nominal Short Int. Rate	0.8	1.4	0.6	0.2	0.2	0.1
Real Long Int. Rate	1.2	0.1	-0.2	0.7	–1.3	–1.6
Nominal Long Int. Rate	2.8	1.8	1.5	1.0	0.5	0.3
Real Ex. Rate (2000=100)[1]	107.4	107.2	105.2	106.9	107.8	107.0
Nominal Ex. Rate[2]	0.75	0.71	0.78	0.75	0.76	0.90

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

Euro-zone monetary policy

The Quantitative Easing programme being pursued by the ECB, which is comparable in its effect on M0 with both the US and UK programmes, is having some observable results in terms of money growth, with M3 growth now reaching 6% on a year ago. The banks are heavily regulated and have reacted by shrinking their balance sheets, particularly loans to SMEs. In the euro-zone furthermore banks are weakened by large holdings of government bonds of Southern European countries struggling with solvency problems; 'stress-testing' these banks is asking for trouble. Nevertheless something of a rebound is now occurring under the impact of QE.

Unfortunately it is hard to see when if ever 'glad confident morning' will arrive in the euro-zone, so deep are the problems created by the euro for handling the sort of crisis that has erupted. Having willed the euro for political reasons, the politicians now are unwilling to allow the solidarity in economic affairs that might just make the project possible. Governments find cooperation hard or even impossible because their home opinion is hostile to it; hence the issuing of bonds jointly guaranteed by all euro-zone governments is essentially off the table. This leaves all the heavy lifting at the euro-zone level to the European Central Bank. But it too is riven with dissent, with the German members and its allies unhappy with QE.

WORLD FORECAST DETAIL

Growth Of Real GNP

	2011	2012	2013	2014	2015	2016
U.S.A.	1.6	2.3	2.2	2.3	3.0	3.0
U.K.	1.6	0.7	1.7	2.8	3.0	2.5
Japan	–0.4	1.7	1.6	0.3	1.2	1.7
Germany	3.6	0.4	0.1	1.4	1.7	1.8
France	2.1	0.4	0.4	0.4	0.8	1.3
Italy	0.6	–2.3	–1.9	–0.3	0.4	1.0

Real Short-Term Interest Rates

	2011	2012	2013	2014	2015	2016
U.S.A.	–1.5	–1.5	–1.5	–1.6	–1.4	–0.5
U.K.	–2.4	–1.1	–1.3	–1.0	–1.0	–0.7
Japan	–0.9	–1.3	–1.6	–1.6	–1.7	–1.8
Germany	0.1	–0.7	–1.2	–1.4	–1.4	–1.8
France	0.6	0.0	–0.6	–0.9	–1.3	–1.7
Italy	0.4	0.0	–0.6	–1.0	–1.4	–1.7

Real Long-Term Interest Rates

	2011	2012	2013	2014	2015	2016
U.S.A.	0.0	–0.1	1.1	0.3	0.2	0.8
U.K.	0.2	–0.8	–0.2	0.2	–0.1	0.2
Japan	–0.8	–1.1	–1.3	–1.6	–1.6	–1.5
Germany	0.0	–0.3	–0.9	–1.4	–1.7	–1.4
France	0.2	–0.1	–0.7	–1.3	–1.6	–1.4
Italy	0.1	–0.2	–0.7	–1.3	–1.6	–1.4

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

	2011	2012	2013	2014	2015	2016
U.S.A.	79.8	81.6	82.1	83.0	83.2	83.0
U.K.	88.7	92.4	81.6	87.1	90.7	90.8
Japan	80.6	79.6	63.5	61.1	60.7	60.4
Germany	100.1	96.7	99.0	100.5	100.2	100.5
France	102.9	99.5	100.7	101.7	101.4	101.7
Italy	107.2	105.2	106.9	107.8	107.0	107.3

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

Growth Of Consumer Prices

	2011	2012	2013	2014	2015	2016
U.S.A.	3.1	2.1	1.5	1.7	0.5	2.0
U.K.	3.5	2.1	1.9	1.6	0.6	1.6
Japan	–0.3	0.0	0.4	2.8	1.0	1.4
Germany	2.1	2.0	1.5	1.0	0.5	1.7
France	2.1	2.0	0.9	0.6	0.2	0.1
Italy	2.8	3.0	1.2	0.2	0.2	0.6

Nominal Short-Term Interest Rates

	2011	2012	2013	2014	2015	2016
U.S.A.	0.1	0.1	0.1	0.1	0.6	1.5
U.K.	0.9	0.9	0.6	0.6	0.6	1.0
Japan	0.2	0.2	0.2	0.1	0.2	0.2
Germany	1.4	0.6	0.2	0.2	0.1	0.1
France	1.4	0.6	0.2	0.2	0.1	0.1
Italy	1.4	0.6	0.2	0.2	0.1	0.1

Nominal Long-Term Interest Rates

	2011	2012	2013	2014	2015	2016
U.S.A.	1.9	1.8	3.0	2.2	2.2	2.8
U.K.	2.0	0.9	1.3	1.8	1.8	2.2
Japan	1.0	0.8	0.7	0.3	0.4	0.5
Germany	1.8	1.5	1.0	0.5	0.3	0.6
France	1.8	1.5	1.0	0.5	0.3	0.6
Italy	1.8	1.5	1.0	0.5	0.3	0.6

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

	2011	2012	2013	2014	2015	2016
U.S.A.[1]	78.08	80.90	86.00	89.40	100.50	100.00
U.K.	1.61	1.59	1.55	1.65	1.50	1.50
Japan	79.36	80.51	98.20	106.70	120.00	120.50
Eurozone	0.71	0.78	0.75	0.76	0.90	0.91

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

* Forecasts based on the Liverpool World Model

UK COSTS AND BENEFITS OF EU MEMBERSHIP- AN EDITED INTRODUCTION TO THE SECOND EDITION OF 'SHOULD BRITAIN LEAVE THE EU?'

Patrick Minford

The central theme of this forthcoming edition is that the European Union has developed economic policies in trade and regulation that do not conform to the liberal model of free markets under the rule of law. Instead they are protectionist and interventionist because of the pressures of political preferences and vested interests. The European Union Treaties proclaim with great clarity that the EU is a political project whose ultimate aim is complete political union and whose journey is guided by the process of 'ever closer union'. While UK politicians have from time to time thought that it was a project for a single market moving towards full competition internally and full free trade internationally, this has not turned out to be correct. Instead the EU has introduced extensive social regulation, has attempted to integrate legal processes across borders, has intervened heavily in fiscal decisions of euro-zone governments, has pursued aggressive policies on climate change without attention to cost effectiveness, and done much else- overall going well beyond and often in contradiction to that free market programme.

As part of these efforts the EU has worked untiringly to create political allies in all EU states within their business, personal and regional structures- in no country more so than the UK. Thus the business beneficiaries of EU protectionism are vocal in their support of the EU- whether in agriculture, manufacturing or services (such as the City). Regions in receipt of EU subsidies are in favour of the EU because of this perceived largesse, even though 87% of these are the usual cost to the UK Treasury since the 'UK rebate' falls by 67% and matching funds of 20% are typically required. At a personal level households receive regular information on how the EU has improved their tourism opportunities, their environment and their general interchange with other European peoples; they are told frequently by pro-EU politicians how they would face uncertainties and loss of jobs outside the EU. As a result the main organs of opinion favour staying in the EU; and the main business groups, regional lobbies and citizen interest groups also lobby for this. It is thus easy to argue that the case for staying in is a 'business' one even though a moment's reflection reminds us that business opinion is not the same thing as the economic interests of UK citizens.

The viewpoint of this book is that of the economist. The book reviews the costs and benefits to UK citizens of the EU, much as the Manchester liberals Cobden and Bright reviewed the costs and benefits of the Corn Laws in the early 19th century; then too a large and powerful business (agricultural) lobby opposed repeal.

This book focuses mainly on the role of trade, the central function of the EU; while this is not we think the major source of costs to the UK, it has been widely misunderstood as an advantage of EU membership because it gives us 'access' to the EU market and to markets with which the EU negotiates trade agreements. This is a fallacy; the book is principally devoted to explaining that this is the case because international trade is about the price at which you can sell your exports and buy your imports. We then go on to explain how the EU is a customs union devoted to raising the prices at which we can buy imports and selectively raising the prices of our exports and that this protectionist strategy, like virtually all such strategies, reduces our welfare.

Because there are so many other facets of EU membership we also devote space to these. We consider regulation, an obvious source of intrusion that many have seen is costly. With the euro-zone bringing about a surge in new controls from Brussels and reminding us that 'ever closer union' must imply that the UK eventually joins the euro, we have added some material on the effects of this. Since the euro-zone crisis it has become apparent that 'bail-out' is a central feature of the euro-zone and indeed of the EU which has forced countries outside the euro such as ourselves to help out too; we have updated our review of the possibilities of the UK being involved in transfers to the rest of the EU in the future. A further topic which we have devoted some space to is immigration, now a central part of the UK political debate and closely linked to the free entry of people from the rest of the EU. Finally, much concern has been expressed about what the world trading environment would be like for a free trading UK outside the EU; we have added sections looking carefully at this. Other than these central issues, we have generally updated the factual background and the review of other work in this edition.

The aim of 'Brexit'- or better 'Breset'

'Brexit' as it is popularly known is therefore the topic of this book. But this conjures up pictures of bad-tempered 'departure' and 'divorce' followed by either a poor relationship with the EU or none at all. However, this is not what we believe to be the alternative to continuing in the

current EU. Let us accept for a start that 'renegotiation' of the current EU Treaties (as summed up in the latest Lisbon Treaty) is not a realistic idea since the changes the UK would require would mean a rewriting of many Treaty areas and these changes in turn would need unanimous agreement from all member states of the EU. While noone can prevent politicians from attempting such a renegotiation of the Lisbon Treaty, its prospect of success is vanishingly small. What we have in mind in this book is something else- a new Treaty between the UK and the EU which for both sides would embed what is good and would eliminate the current sources of endless mutual discontent.

The UK suffers from excessive direct intervention in UK economic and political affairs from the EU. Most of all, it suffers from the uncertainty of what 'ever-closer union' might bring in the way of additional interventions. In the costs we enumerate, the biggest potential costs lie ahead, in the form of possible measures implied by current EU aims. Thus 'opt-outs', such as that we have currently from joining the euro, cannot be considered safe in this longer-term perspective. We already saw how one such opt-out, from the Social Chapter, was ceded by the Blair Labour Government, no doubt as part of some imagined trade-off with benefits to be obtained from Brussels or merely as a way of ushering in 'socialism by the back door'. This event illustrates how easily the UK could be sucked into more and more EU intervention by remaining a member of the EU under the present Treaty; whether it happens by EU pressure or by willing complicity on the part of UK politicians whose agenda of the moment it might suit (but who may later regret the cumulative effect of their actions), there is a ratchet effect at work in this EU relationship as defined in the Lisbon Treaty. That Treaty never surrenders any powers the EU has acquired (the 'acquis communautaire') and hence any surrender from the UK side accumulates its losses of control; each time we surrender, our politicians say 'ah well, it is easier to give in and to stay in than to try to change the beast' and thus it is we find ourselves some forty years since entry into 'The Common Market' in an all-pervading 'European Union' relationship we never seriously dreamt of, let alone intended.

What is needed instead is a new bilateral Treaty which defines a limited relationship, limited in its current and future scope to definite areas of mutual benefit- let us call it a 'resetting' of our relationship with the EU or 'Breset'. As we will see, this will include cooperation in trade and regulation, preserving the best of what we now have of these, while jettisoning the excessive protection and over-regulation (notably in the labour market) and the threats of their future extension which we abhor. Being 'out' of the EU will then imply a far more flexible relationship with the EU in which good shared regulation and trade relationships will be preserved. The fears expressed by many about being 'out' will be seen to be groundless in this perspective.

At the core of our relationship with the rest of the EU lies the Single Market, which is intended to prevent country regulation from acting as a trade barrier, and free trade access throughout the EU's geographical area. Though this does not extend much to services, our key UK sector, it greatly affects our manufacturing industry. As we will see later, the problem with this lies in its high level of protectionism through the EU's Customs Union policies which keep out or restrict imports of non-EU products: it is not only in its well-known Common Agricultural Policy that the EU is protectionist. Somehow therefore we need to extricate ourselves as a major trading nation from the EU's protectionism while preserving the benefits of the Single Market and free trade within the EU. This can be done. In the first place, where the UK feels that product regulations are helpful to industrial integration they can be left alone and protected in a new Treaty. Secondly, where trade barriers are concerned, it is possible for the UK to maintain free bilateral trade with the EU, while also removing trade barriers against other countries, in industries where there is a high degree of integration between the UK and the rest of the EU. This is possible because the way that the EU mainly levies its protection is via trade agreements on access and pricing; so effectively in these highly integrated industries (such as the volume car industry) the UK would continue to price its products in the rest of the EU as it now does. Even though imported products from the rest of the world would drive UK prices down to world levels, these lower prices would not filter through into the rest of the EU.

The idea of a new UK-EU Treaty would therefore be to preserve the existing relationships that achieve virtuous integration. But at the same time the UK would not implement regulations that damaged the economy as a whole. The idea that trade is held up by differences in regulation that have a distant relationship to the trading industry (such as general labour market regulations) is not accepted in WTO judgements or in the theory of trade; differences between countries' institutions are a valid source of cost differences, and contribute to competition. So UK regulations will in general be based on UK judgements of cost-benefit. Nor would the UK adhere to the single market in labour, rather exerting normal immigration controls based essentially on skill points, as in the US 'green card' system. It would withdraw sine die from any potential involvement in the euro or in trans-EU bail-out arrangements. It would agree to mutually advantageous extradition arrangements but not to any pooling of justice systems. It would cooperate with the EU foreign office just as it does with the US State Department. It would join forces with the EU in general talks on trade, such as the one currently going on with the US, where all sides stand to benefit from agreement.

In short the UK will once again become a sovereign country, friendly with its large neighbour just as it is

friendly with countries such as the US, Canada and Australia, and it would agree to close trading and regulatory relationships with the EU as needed for mutual benefit. It is wrong to suggest that such a new Treaty cannot be achieved because of the ill-will generated by our demands, though of course it is possible that negotiations for a new Treaty would break down, at least for a time. In this book we do our costing on the basis of breakdown and we show that it is worth the UK's while to leave even on this basis; essentially leaving without any new UK-EU Treaty would be to adopt a role as a free trading nation in the WTO community, with all our other existing political relationships such as NATO, the OECD and the IMF, and there is absolutely no problem about such a role. But since there is mutual gain to be had, relative to breakdown, in both sides reaching a new Treaty, it is illogical to suggest it will not be achieved- just as it has been achieved between the EU and both Norway and Switzerland. Once all sides realise that departure is going to happen anyway, all bluffing and threats will be removed and realism will produce discussions on a new Treaty. Usually countries, like people, in the end do what is in their interests.

Costs and benefits of EU membership post-crisis

The Eurozone crisis is likely to continue for a number of years, with the European Central Bank acting as a backstop until agreement is reached on a new institutional structure sufficiently reassuring to Northern Europe that its transfers to Southern Europe will have a good chance of being repaid. The UK's exclusion from the euro has meant that it is neither vulnerable to the panic that has engulfed Southern sovereign bonds nor in direct line to make transfers to the crisis-stricken South.

The institutional framework now being developed implies a high degree of monitoring and intervention by creditor countries of debtor countries within the Eurozone. There will be controls on bank behaviour, targets for governments, and new financial taxes. While in principle this will take place within the Eurozone, there will be pressure to extend it to all EU countries on the grounds that other EU members could 'undercut' Eurozone arrangements. The UK will be seen as an offshore competitor with banks, businesses and governments that, being in the Eurozone, are burdened with these controls and regulations. Such competition will be argued to be unfair under the Single Market, for which Qualified Majority Voting applies. It would be easy to extend these things to the UK by majority vote.

Furthermore, the pressures for protection will increase in order to produce as much Eurozone growth as possible, for best prospects of debt repayment. Serious recessions for long periods such as the Eurozone has been undergoing make such pressures intense. The UK suffers at present from the degree of protection for the EU as a whole. This protection will probably increase; even within the EU covert protection against non-euro countries could occur.

At best, the Eurozone will be obsessed with the euro crisis for the coming decade, stalling any progress in liberalising markets and in increasing competition, things that could have lessened costs of membership to the UK. This tendency for the euro to strengthen the drive towards excessive regulation as a way of bolstering the single currency was something widely foreseen at the start of the euro. But the crisis is likely to make this much stronger.

For the UK this prospect is extremely damaging. Even without any change in the status quo the economic costs to the UK of the EU are substantial: the Table below summarises the estimates we now make; we have reviewed our estimates in the first edition in the light more up to date information since. The main change has been the rise of trade with China, which has led to a further wave of protectionism, at the same time as protectionism against older competitors such as South Korea has diminished. Meanwhile EU-inspired social intervention has continued to make inroads into UK life, the latest one being widespread rights for temporary workers. With the changes the euro crisis threatens, these costs have increased towards the upper end of the possible spectrum identified in the Table. Recent work has also identified possible effects on growth, while we include also the effects of eventual joining of the euro on the economy's business cycle volatility.

Table: A survey of costs from EU membership

	(% of GDP)
Net UK contribution	0.5
Costs of Common Agricultural Policy and of EU protection of manufacturing	4.0
Regulations	6-25
Bail-out transfers	2-9
Effects of EU regulations on growth to 2035	0.5% p.a.
Effect of joining the euro on economic volatility	doubling of volatility

Sources: second edition, 2015, of Minford et al, 2005

A contrary and popular argument for the benefits of the EU to the UK revolves around Foreign Direct Investment (FDI). However this argument is entirely fallacious. FDI brings benefits because of technological spill-overs from foreign firms, which raise productivity. The UK economy's productivity is likely to be maximised when comparative advantage is allowed its fullest rein, i.e. outside the EU, under free trade. If this structure implies that industries operating in the UK are more efficient, then less FDI will

be required. But this will reflect the fact that the UK is more productive, not less.

Another argument is that leaving the EU would imply costs of 1-3% of GDP due to the imposition of the EU's Common Tariff on the UK - see Ottaviano et al (2014). This is to be compared with our calculated gain of around 4 per cent of GDP. However, this argument is manifest nonsense, since first we can avoid this outcome by negotiation and secondly it fails to estimate the large gains to be made by moving to free trade with the rest of the world.

A further argument of Ottaviano et al is that there would be 'dynamic' effects of leaving the EU, from reduced investment, technological diffusion, export learning effects, and investment in R&D. However, all these effects assume that there is no expansion in similar opposite effects as trade expands with the Rest of the World. We see here again the omission of the general ROW effects of leaving a customs union. It must also be stressed that estimating these effects is difficult and uncertain; the empirical literature on growth is marked by much elaborate theory but considerable problems in 'identifying' the effects of growth mechanisms in practice.

Probably the most important element for the UK is the extent to which the UK state can establish favourable tax and regulation conditions for competition and entrepreneurship- in this leaving much of the damaging features of EU intervention will be beneficial, regardless of the structure of trade. Here recent work (Minford, 2015) has shown strong evidence that barriers to business affect UK growth. This is identified in our Table above of costs as a factor that could lower UK growth by some 0.5% per annum, as a result of the dynamic effects on entrepreneurship of excessive regulation, especially in the labour market.

It is also said that we would no longer influence EU regulations, which is true. But we do not influence the regulations of any country to which we export and yet our exports are made to conform to them; this is part of our export costs and our influence in the EU has little if any impact on these costs. But by leaving we avoid the massive cost of these regulations to our own production in general, as shown in the Table above. What will happen when we leave is that our exporters will have to continue to observe EU regulations on their products as they do now and as they do for all other countries to which they export; this is simply a normal cost of exporting anywhere. Also under the new suggested UK-EU treaty they could agree to continue to implement these regulations on all their production. As for everyone else (over 90% of GDP) EU regulations will cease to be relevant, lifting both a current burden and a future threat.

It is true that the EU restrains UK politicians from self-damaging acts, such as subsidising particular industries. However, politicians of most parties are now generally aware of the costs of such measures; and also the World Trade Organisation has become more effective in discouraging them. But in any case the costs of such particular actions are relatively minor.

Thus the costs to the UK of being in the EU, already high, are likely to increase under the pressure of the euro crisis. This implies that the case for leaving the EU will become even stronger, to the point where it overcomes the inertial force of the status quo. There is now definitely to be a referendum on whether to remain in the EU on whatever renegotiated terms this government is able to achieve. As can be seen from the figures above, the most desirable option is a new treaty with the EU that largely withdraws from EU joint arrangements but collaborates on particular issues of common interest, such as rights of migration, free capital movements, and possibly trade agreements on particular industries like cars where there is large-scale cross-investment. Of course political cooperation will continue in areas of mutual interest as with all our allies.

Policy Conclusions

In the first edition of this book it was possible to argue that there was some room for doubt about the desirability of the UK leaving the EU. Maybe the EU would improve or maybe UK policies would deteriorate so that the long term balance of advantage could swing back to remaining.

This is no longer possible, in the light of two main factors. First, the EU's approach to economics has decidedly worsened and is continuing to do so under the impact of the euro crisis which rumbles on unstoppably. The second factor is the emergent political hostility to the key economic interest of the UK in its large financial sector. As we can now see, these poor economic policies follow essentially from the poor political economy of the EU, dominated as it is by vested interests.

Allowing for these factors in our calculations makes it impossible to suggest any doubt that economically the UK would enjoy greatly improved prospects outside the EU. As we have already noted many of the fears expressed about trade or business are the result either of misunderstanding or of pure self-interest on the part of those benefiting from EU protectionism or other interventionist measures.

Unfortunately such economic arguments on their own do not carry much weight with a general public suspicious of abstract argument. However the politics of the EU question have now been changed by the rise of the immigration issue on the back of unfettered entry from the EU by migrants from poorer countries; while the well-to-do may sneer that such an issue does not reflect the overall net benefits to the

UK of poor immigrants it does reflect the anxieties of many poorer UK citizens who feel the direct impact of these arrivals on their jobs, communities and public goods. In practice the only way to resolve this issue is to rebalance EU immigration towards the more skilled and to restore control of total EU immigration to the UK government- this cannot be done without leaving the EU.

So it turns out that just as the EU's economic policies have become most threatening to UK interests political developments from EU migration have made it likely that the UK would decide in a referendum to leave the EU. The politics and economics may well have converged.

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