The Shadow Monetary Policy Committee

Editorial Note

The Shadow Monetary Policy Committee (SMPC) is a group of independent economists drawn from academia, the City and elsewhere, which meets for two hours once a quarter at the Institute for Economic Affairs (IEA) in Westminster, to monitor the Bank of England's interest rate decisions and to make rate recommendations of its own. The inaugural meeting of the SMPC was held in July 1997, two months after the granting of operational independence to the Bank of England, and the Committee has met every quarter since.

The Secretary of the SMPC is Professor Kent Matthews of Cardiff Business School, and its present Acting Chairman is David B Smith of Williams de Broë Plc. Other current members of the Committee include: Professor Patrick Minford (Cardiff and Liverpool), Professor Tim Congdon (Lombard Street Research and Cardiff), Professor Gordon Pepper (CASS Business School), Professor Anne Sibert (Birkbeck College), Dr Peter Warburton (Economic Perspectives Ltd), Professor Roger Bootle (Capital Economics Ltd), John Greenwood (Invesco), Professor Peter Spencer (University of York), and Dr Andrew Lilico (Europe Economics).

The document that follows reproduces the IEA Press Release (page 1) and Minutes of the SMPC meeting held on Tuesday 25 January 2005 (page 3). This material appears with the kind permission of the original authors. It has not been edited by Williams de Broë, apart from the addition of margin notes and some minor amendments to achieve consistency with our 'house style'. The opinions expressed in this note are, correspondingly, the views of the individuals concerned and are not a Williams de Broë house view.

We are disseminating the SMPC material because of its inherent interest and as a contribution to the UK monetary debate. The date of the next SMPC meeting will be Tuesday 19 April 2005, with subsequent 2005 meetings scheduled for Tuesday 19 July and Tuesday 25 October. We hope to make the material from the 19 April gathering available around a week or so after it is held.

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The Shadow Monetary Policy Committee

"Hold Interest Rates" says SMPC

7th February 2005 For Immediate Release

The SMPC vote

"Hold interest rates" was the opinion of the IEA's Shadow Monetary Policy Committee (a group of leading economists that meets to monitor monetary policy and comment on other monetary matters), which voted by **seven votes to two to hold interest rates** at its January meeting. One member voted for an increase and one member voted for a decrease.

Conflicting economic indicators, domestically and overseas

Members of the SMPC felt that there had been insufficient time to appraise the results of recent interest rate increases by the Bank of England. It seemed clear that **the housing market was slowing** and **inflation was at the bottom of the target range** but **monetary growth was still strong.** The international and UK economic situation also sent contradictory messages. Some members felt that **domestic considerations alone would suggest that a rate rise was warranted** but the international outlook was weaker.

Rates may have to change later this year

Whilst members wished to see the results of recent increases in interest rates, many members did feel that action might have to be taken later in the year.

Rising inflation may eventually justify rate increase

John Greenwood, (Chief Economist, AMVESCAP) said that, "although inflation is currently below target, it is rising, and monetary growth is uncomfortably rapid. A further rate hike may be needed later in the year".

Rapidly expanding public sector may conceal private weakness

David B Smith (Chief Economist, Williams de Broe) suggested that UK consumer and retail price data had been on the high side of what might have been expected in November and December. People would be concerned if the January figure turns out to be poor. The private sector appeared weak but resources were being taken up by the rapidly expanding public sector.

Next move a cut?

Roger Bootle (Economic Adviser to Deloitte), on the other hand, suggested that a cut in interest rates would be necessary, but not immediately.

Worsening quality of official statistics

The uncertainty reflected in members' views was compounded by a deterioration in the quality of data that was being released by the ONS. This uncertainty suggested that interest rates should be held for now although action might well be necessary later in the year.

Ends

Notes to Editors overleaf

The Shadow Monetary Policy Committee

Notes to Editors

The minutes of the meeting are attached. Minutes of all recent Shadow Monetary Policy Committee meetings are available from **www.iea.org.uk** in the articles section.

The Shadow Monetary Policy Committee, which has shadowed the MPC since its creation, meets quarterly but also conducts a regular e-mail monthly survey of members' views on monetary policy. It publishes this, together with a poll on the committee's view on interest rates, on the Sunday before the meeting of the Bank of England's Monetary Policy Committee.

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Minutes of the Meeting of 25 January 2005

Attendance: Professor Philip Booth (IEA Observer), John Greenwood, Dr Andrew Lilico, Professor Kent Matthews (Secretary), Professor Anne Sibert, David Smith (Chair), Dr Peter Warburton.

Apologies: Professor Roger Bootle, Professor Tim Congdon, Professor Patrick Minford, Professor Gordon Pepper, Professor Peter Spencer.

Media Observer: Allister Heath (The Business)

Chairman's Comments

Serious problems with the government accounts

David Smith began the meeting by commenting on the decision by the ONS to stop publishing seasonally adjusted public accounts data broken down by sub-sector and economic category. This hindered City economists and independent forecasting groups who use such data for forecasting and analysis. The seasonal component is highly variable and makes it extremely difficult to assess and project the state of the government finances in a reliable manner.

The Economic Situation

David Smith then invited John Greenwood to present his analysis of the world and domestic economy.

World Economy – Mixed Fortunes and Solid Growth

US growth potential

John Greenwood referred to his circulated notes and charts (appendix). U.S. growth had slowed to a sustainable rate, growing at its long-term potential of 3-3.5% per year. While net exports continue to be a drag on the economy, the contribution of the other components, personal consumption, private investment and notably government expenditure are strongly positive. The main risk to this scenario is a possible capital outflow from the $ by the Asian and other central banks.

American debt concerns

The indebtedness of the U.S. consumer had continued to rise although it had been offset by de-leveraging of corporate America. Meantime, corporate borrowing has remained very weak and should be a restraining influence on market interest rates. The high level of household debt is undoubtedly one of the reasons why the Fed has been raising rates so cautiously and slowly.

US trade deficit

The widening U.S. trade deficit is an indicator that the $ has not corrected sufficiently. The risk for the world economy is the reaction of the Asian central banks to the deficit and the build up of $ reserves. There are two possible channels of influence. First, the build of reserves will feed into the money supply resulting in overheating of the Asian economies. Second, aggressive sterilisation and rising interest rates which will come to an end when Asian central banks make losses on their holdings of US Treasuries. Policy

reversals can be expected when in the first case, overheating results in inflation or in the second case when losses on sterilisation operations are recorded. The conclusion is that the USA will grow at a robust rate. The main risk is from Asian central banks reversing existing policy. The conclusion is that the USA should continue to grow at a robust rate unless Asian central banks abruptly change their existing policy causing US Treasury yields to rise sharply.

Euro-zone and Japan

Turning to the Euro-zone and Japan, growth is much weaker. Consumer confidence in the Euro-zone has improved but still remains well below previous levels. Real M3 growth figures for the Euro-zone also suggest a weakening in GDP growth. Leading indicators also suggest a resumption of deflation and low growth in Japan.

International growth to slow, but not by too much

In summary, Asia and the Anglo-Saxon economies are healthy but Euro-zone and Japan are anaemic. The growth in the world economy will slow down from last year's level but growth will be solid overall.

UK Economy – Growth at Full Capacity

Mixed picture in Britain

In the context of strong growth in China, other Asia and the USA but weakness in Euro-zone and Japan, the prospects for the UK are solid growth at full capacity. Government sector contribution to GDP growth is greater than in the USA but the UK retail sector is still experiencing falling prices. However, it is probably premature to say that a consumer led slow-down has begun. Labour market indicators suggest a tight market with strong wage growth.

Housing and commercial property

On the housing market, it is only private housing that shows any sign of slowing. Office property and retail property prices are still increasing.

Broad money

M4 growth remains high and is close to 10%. Even if the yield curve is flat, and housing and retail sales are slowing, there is plenty of residual strength elsewhere in the UK economy.

US protectionism

In a comment on John Greenwood's presentation, Anne Sibert said she was concerned that John had ignored the dangers from protectionist sentiment in the USA.

Supply-side concerns

In conclusion, David Smith asked Philip Booth for his comments as the non- voting IEA observer. Philip Booth said that he was concerned about growth and the effects of increased regulation and taxes on the supply side. He also acknowledged the dangers from the monetary side but felt that a change in the rate of interest was inappropriate at the present.

Discussion, Policy Responses and Individual Votes

The rate recommendations of the SMPC members who attended the 25 January meeting, all of whom speak in a personal capacity, are listed in alphabetical order below.

Comment by John Greenwood (Chief Economist, AMVESCAP)

Vote: No Change

There are sufficient islands of strength in the UK economy to suggest that rate hikes may be needed later on this year

John Greenwood said that although there were some initial signs of softening in housing and retail sales, there were plenty of signs of strength elsewhere in the UK economy that warranted the continuation of monetary restraint. For example, the labour market was strong, posting rising wage growth and record low unemployment; office property and retail space were starting to show signs of an upswing; business investment spending was in a recovery phase (despite two softer recent data readings); the deteriorating trade and current account data could be viewed as evidence of strong domestic demand; and government expenditure continued to expand vigorously. Although inflation is currently below target on the CPI measure, it is rising, and monetary growth is uncomfortably rapid. A further rate hike may be needed later in the year, but no action was required at present.

Comment by Dr Andrew Lilico (Europe Economics)

Vote: No Change

Money growth too high but housing weakening

Andrew Lilico said that monetary growth is still too high but on the other hand the pressure on the housing market has begun to ease. These opposing forces suggest that policy should not change for the time being. He voted for no change.

Comment by Professor Kent Matthews (Cardiff Business School, Cardiff University)

Vote: No Change

Domestic factors would justify a rate rise, but external influences suggest a cut

Kent Matthews said that traditional monetarist thinking would have us focus on domestic money supply growth. Looking through the monetarist lens would tell us that broad money growth near 10 per cent a year is not consistent with inflation of less than 2.5%. Even allowing for the slowdown in house prices, there are good arguments from the monetary side to push interest rates up. However, the biggest danger facing the economy may come from the external sector. A dollar crisis caused by a reversal in Asian central bank policy could see a sharper slowdown in the world economy. The Bank could find itself having to lower interest rates sharply in such a scenario. The economy is poised between these two opposing forces. On the one hand, domestic forces push for a rise in rates and

on the other hand, external forces push for a cut. In these circumstances the best policy is to put interest rates on hold.

Comment by Professor Anne Sibert (Birkbeck College)

Vote: No Change

Anne Sibert said that there had been no significant change in international conditions or in domestic conditions that would warrant a change in policy direction. She voted to keep interest rates on hold.

Neither international nor domestic conditions justified a rate change

Comment by David B Smith (Chief Economist, Williams de Broe plc)

Vote: No Change

David Smith said that the UK consumer and retail price data had been on the high side of what might have been hoped for in November and December and people might start to get concerned if the January figure were also poor. He said that he was less hawkish about GDP growth, however, because of the extent to which the alleged expansion in national output depended on suspiciously strong figures for general government output. The private sector seems to be quite weak, and appears to be shedding jobs overall, and not just in manufacturing, and GDP growth and total employment are being propped up by the rapid absorption of productive resources into the public sector. There was no case in economics – or natural justice - for caning the private sector with higher interest rates because the government sector was out of control. He voted to keep interest rates on hold.

Private sector is weaker than is apparent from GDP figures

Comment by Dr Peter Warburton (Economic Perspectives)

Vote: No Change

Peter Warburton said that he was less sanguine about the international economy. The slowdown could be more pronounced than suggested by John Greenwood's commentary. In particular, the flattening of the yield curve will have a negative effect on US corporate profits, cash flow and spending during the course of 2005. On the UK outlook, he said that it was necessary to observe the effects of 4.75% interest rates on the housing market during the Spring, when it is seasonally strong, before a rate cut could be justified. He voted for no change in interest rates.

Weaker international background could justify a cut after the election

Votes in Absentia

The SMPC sometimes allows a small number of votes to be cast in absentia and adds their written submissions to the record of the meeting, particularly where it avoids the possibility of a tied vote. three SMPC members who were unable to attend the physical meeting at the IEA on 25 January cast votes.

Comment by Roger Bootle
(Economic Adviser to Deloitte)

Vote: No Change

''Over the last month, much of the data has been consistent with the idea that the economy is reasonably robust and inflationary pressures are building. But there were notable exceptions, especially the very weak data on retail sales. I fully expect that short-term inflationary pressures will abate and look for more downbeat news to emerge on the housing market. For now, though, the sensible thing is to wait. But before too long, it will be time to cut.''

Cut but not straight away

Comment by Professor Tim Congdon
(Lombard Street Research)

Vote: Raise Rates by ¼%

The move to dearer money during 2004, with base rates reaching 4 ¾% in early August, dampened the housing market and curbed credit growth. Even so the growth of bank credit in the three months to December – when the new higher level of base rates prevailed – ran at an annualised rate of almost 10%. As bank loans create new deposits, it is not surprising that money growth is also running at annual rates of 9% - 10%. Although the real-economy indicators are mixed, another ¼% rise in base rates can be justified.

Raising REPO rate to 4¾% has not slowed credit demand and money growth

Comment by Professor Patrick Minford
(Cardiff Business School, Cardiff University)

Vote: Cut Rates by ¼%:

''The Bank of England's Monetary Policy Committee is now facing its most difficult year to date. It has raised interest rates quite strongly during 2004, apparently driven by concern with the 'housing bubble'. This phenomenon of rising real house prices was not in our view a bubble (ie an irrational movement based on sentiment) but a response to a genuine and worsening supply-demand imbalance. For that reason we argued that it was not appropriate for the MPC to respond to it since the MPC's job is to target inflation and to keep the economy stable, not to respond to particular markets whether housing, peanuts, oil or manufacturing. Unfortunately it did so, while at the same time coyly denying it was doing so.

MPC faces its most difficult year

The reason for its confusions of explanation lay in the disagreements over the housing issue within the MPC- some felt that the MPC had no role responding to housing (for the argument above) others that being a bubble it should try to restrain it somehow or it could lead to a worse crash later on. Such disagreements make honesty hard as they are 'disagreements on what to disagree about'! Hence the failure really to make clear references to housing as the key factor.

Disagreements about disagreements

At any rate that is now history; the MPC raised rates and now there has been quite a sharp reaction, not merely in the housing market but also in consumer spending (with retail sales in December, the crucial Christmas season, down 1% on the previous month). Manufacturing is weak and falling anyway; public spending is being cooled as fast as possible by the Treasury. Investment spending was getting stronger in 2004 but is likely to be dampened both the rise in the cost of capital and by the weakness of consumers.

UK economy has already reacted negatively to higher rates

My view is that there is now, for the first time, a genuine risk of a quite sharp slowdown in demand, even of a recession. The MPC has got itself into an awkward situation where if it lowers rates it will be admitting quite a recent error; central banks hate admitting errors as it damages their authority later on. They are simply 'always right' (according to themselves anyway). Yet this is the precise danger; their unwillingness to cut rates early could allow the weakness to take real hold.

Recession risk?

This worry is compounded by the weakening public finances. If the Treasury fails to hold the line on spending, and so far it has failed, then after the election taxes will have to be raised. Consumers will be even more unhappy at the prospect.

Poor public spending discipline means higher taxes

While I still regard recession as low probability, the risk now underpins my view that rates should be cut gradually as early as possible.''

Cut gradually but soon

Date of Next Meeting

Tuesday 19 April 2005.

Policy Response

1) In a rare moment of unanimity but for differing reasons, the members attending the physical meeting of the Shadow Monetary Policy Committee felt that there were no strong arguments for a change in interest rate policy. However, in their E-mail submissions Patrick Minford argued for a rate cut of ¼%, and Tim Congdon voted for a ¼% increase, while Roger Bootle plumped for no change.

2) On a vote of seven, with only two (offsetting) dissensions, the committee voted to hold rates at the current position.

Appendix

Economic Outlook For 2005 – John Greenwood

Introduction

Forecasts revised down

Since mid 2004 forecasts for global economic growth in 2005 have been modestly revised downwards, mainly due to the expected impact of rising interest rates in the US, the UK and other economies mainly in East Asia, but also due to the anticipated adverse impact of higher oil prices. We expect the normalization of interest rates to slow the generally strong GDP growth rates of 2004 to lower, more sustainable growth rates in 2005. If successful, these "mid-course correction" policies by the central banks should enable the economic upswing to continue with minimal inflation for several years – rather like the extended expansion of the 1990s.

Implications of the price of oil

The oil price impact is more controversial. While geopolitical tensions and terrorism persist in Iraq and elsewhere, the risks of supply disruptions appear to be diminishing. Nevertheless, many believe that higher oil prices must inevitably act as a drag on growth in most of the developed world. That may be so, but the important point is that the rise in oil prices is a *relative* price change, and does not therefore signal a change in the *overall* price level. It does not imply higher inflation, even though we forecast an average oil price in 2005 in excess of $40 per barrel. If consumers spend more on oil and oil products, then they will have less to spend on other goods and services. Hence there will be substitution effects, but there is no need either for a recession or for inflation. Given the current macro backdrop, higher energy prices are restraining activity more than boosting inflation expectations.

Currency movements

Currency movements are likely to play a dominant role in the early part of the year if progress is to be made in resolving the current global macro-economic imbalances.

	2004 Estimate		*2005 Forecast*	
	Real GDP	CPI Inflation	Real GDP	CPI Inflation
U.S.	4.4%	2.2%	3.4%	2.8%
EU-12	1.7%	2.1%	1.6%	1.8%
U.K.	3.2%	2.2%	2.3%	2.4%
JAPAN	3.9%	0.1%	1.4%	0.3%
AUSTRALIA	3.5%	2.4%	2.8%	2.8%
CANADA	2.7%	1.8%	3.3%	2.2%

United States

The expansion has lost some momentum, as is normal in the early stages of a prolonged upswing. Real GDP has slowed from its peak rate of growth of 7.4% p.a. in 2003 Q3 or 5.8% in the last half of 2003

to an average of 3.6% in Q2 and Q3 of 2004. This is in part a slowdown to a more natural or sustainable growth rate in line with the economy's long run potential of about 3.25% p.a., and in part a consequence of the energy price increases of 2004 which will constrain consumers' spending power on non-oil goods and services. In addition, rising mortgage rates and slowing house price increases are likely to limit consumers' borrowing power. Hence with household savings near zero, consumer spending is likely to contribute less to GDP growth in 2005. In the corporate sector profit margins and cash flows remain very buoyant, and, together with slowing productivity growth, should encourage firms to spend more on investment during the year, especially when the weakening US dollar starts to make US exports more attractive. We therefore see investment and export growth (from mid-year) starting to play a larger role in overall GDP growth.

The twin deficits

Government finances have begun to improve as revenues have started to recover, but faster revenue growth has been partly offset by higher spending, especially on defence and homeland security. The Federal budget deficit may have peaked at 4.7% of GDP in 2004, but projected deficits still remain large, implying a continued accumulation of government debt. The external current account deficit is an unprecedented 6% of GDP, leading to steady erosion in the value of the US dollar. While by no means complacent about these twin deficits, we believe that the budget deficit is relatively easy to finance – particularly while the corporate sector is running such large surpluses, and consumers are unlikely to extend their borrowing significantly – while the combination of US dollar depreciation and the recovery of foreign economies should enable the external deficit to peak in 2005.

Lower dollar has not pushed up US core inflation

Core inflation, which increased in the early months of the year, has subsequently fallen back, and there seems little prospect of inflation rising sharply despite the fall in the value of the US dollar. The situation is somewhat similar to the case of the UK in 1981-82 when sterling fell from US$2.10 to $1.10, but inflation showed no significant upturn. We are forecasting a small rise in headline inflation to 2.8% over the year as a whole.

US growth and bond yields

We expect real GDP to grow at 3.4% in 2005 -- slightly above potential -- enabling the Fed to raise rates progressively from their currently "accommodative" level. Initially we expect the Fed funds rate to rise to 3% by May, and then perhaps to pause for a time. Subsequent movements will depend on the strength of the economy, the state of the labour market, inflation, and the shape of the yield curve. It is our view that even if foreign central banks do not continue to support the US dollar or buy US Treasuries, a sharp rise in long-term interest rates is not imminent. We do expect Treasury yields to rise, if only because current yields are too low relative to growth and inflation prospects. The Fed funds rate will also be raised beyond 3% over the next two years.

United Kingdom

UK demand is slowing and likely to become better balanced

Five rate hikes by the Bank of England over the past year have finally started to have a restraining effect on the housing market and the economy more generally. This moderation in growth is desirable as the economy is probably operating close to capacity: unemployment is at record lows and growth has been above potential for an extended period. Forward indicators from surveys by Reuters, GfK and the CBI all indicate further some softening of economic activity ahead. Future growth is likely to be less reliant on household spending and more driven by capital investment, with net exports being much less of a drag as imports slow. A sharper slowdown in consumer spending and housing investment stemming from declines in house prices remains a risk, although it is a smaller risk than at previous house price peaks that coincided with an upsurge in overall inflation.

Rapid government spending increase means higher taxes

As in the US the British budget deficit is wider than desirable (likely to be above 3 per cent of GDP in 2004), and the reason is similar – the failure of revenue to recover. However, government expenditure has been growing more in the UK than in the US. Therefore tax increases will be required to narrow the deficit. Britain also has a current account deficit that is wide, but is not expanding as rapidly as that of the United States. The slowdown in growth prospects and continuing low inflation warrant a pause in monetary tightening, although further tightening may be needed during 2005, in particular due to increasing pressures from the labour market and the recovery of other parts of the property market.

Euro-zone

Euro-zone is facing headwinds

Recovery in the eurozone is facing headwinds due to higher oil prices and a recent renewed appreciation of the euro. We are therefore forecasting another year of mediocre growth in 2005 (1.6%). This will not be enough to absorb fully the economic slack, hence the unemployment rate will remain high at about 8-9 per cent. Inflation is expected to decline to 1.8% in 2005 as the impact of the oil price hike fades and the effects of the appreciating euro are reflected in lower import prices. The problem is that while the euro bears the brunt of the US dollar depreciation, domestic demand is barely self-sustaining and exports will be hit by euro appreciation, damaging overall growth prospects.

ECB now less likely to raise rates

As a result of this economic weakness the ECB is unlikely to raise rates in 2005 as it had previously implied. While economic performance in the periphery has been good, growth in the core countries remains disappointing. The core euro area is still struggling with deep-rooted structural problems that closer integration and monetary union was supposed to address. As yet there has been no visible strengthening of trend growth or any increased productivity. On the contrary, productivity growth in Germany has been declining. The structural reform agenda, required

to move the euro area economy towards the ambitious targets set by the Lisbon summit in 2000, needs to be reinvigorated. Stronger growth is badly needed to help in achieving short-term fiscal consolidation and to deal with the longer term challenges stemming from ageing populations.

Japan

Japan's failure to generate domestic strength means GDP will slow with exports

Japan's export-led recovery has not been followed by any sustained upturn in domestic spending, and consequently there have been increasing signs of weakness as the pace of export growth has slowed. Employment and wage growth have been weak throughout this upturn as, due to the ageing population, more people leave the labour force than join it. The recent slowdown has been led primarily by a slackening of Chinese demand and US IT demand, exacerbated by the appreciating yen. Industrial production has weakened in recent months and the manufacturing PMI hit a 16-month low in November. GDP growth for 2004 (on the old national accounts basis) is likely to be 3.9%, thanks to the strong performance of exports earlier in the year, but we expect a significant slowdown to just 1.4% in 2005, a number that will be even lower on the new chain-weighted GDP accounts basis.

Deflation may be back again

The expansion had been widely expected to bring an end to deflation, as measured by the consumer price index, in the course of 2005, but if domestic demand remains weak and the yen continues to appreciate, this hope may well be dashed again. Our forecast is that the CPI will remain essentially flat in 2005, rising only 0.3%. The Bank of Japan's policy of quantitative easing and zero interest rates is therefore likely to continue well into 2005, and possibly beyond. On the fiscal side the budget deficit remains an uncomfortably large 7.1% of GDP, and government debt now exceeds 140% of GDP. A detailed and credible consolidation plan is necessary for confidence in fiscal sustainability. Further progress in reforming the banking sector would help to sustain the recovery, although some parts of the corporate sector have made impressive progress in restructuring, mainly by cutting costs.

Canada

Canada is running out of capacity, implying higher rates

Real GDP growth has been higher than expected so far this year, and we expect 2.7% for the year as a whole, strengthening on the back of strong commodity prices, a strong currency and easy monetary conditions to 3.3% in 2005. CPI inflation in October was 2.3% year-on-year, and we expect 1.8% for the year as a whole. Next year we expect a modest rise to 2.2% as strengthening domestic demand runs up against capacity constraints. Against this background the Bank of Canada will need to continue raising interest rates towards their neutral level to ensure adherence to the inflation target. The federal government is currently running a fiscal surplus equal to 1.2% of GDP as part of a long-term program to lower indebtedness, a posture that is likely to continue even though federal spending has

been rising and there have been supplementary transfers from federal to lower levels of government.

Australia

Economy likely to slow, probably making rate hikes unnecessary

Real GDP growth remained robust in the first half of 2004, but retail sales, employment growth and home equity withdrawal all weakened slightly in the second half of the year. Nevertheless we expect 3.5% GDP growth for 2004 as a whole, slowing from this elevated rate to 2.8% in 2005. Despite a current account deficit equal to 5.8% of GDP, the currency has been strong, boosted by strong commodity prices, and this should help inflation stay within the Reserve Bank's 2% to 3% target band. Like the Fed the Reserve Bank has been normalizing rates, raising its cash rate from 4.25% in early 2002 to 5.25% at the end of 2003. Given the flatness of the yield curve and our forecast of 2.8% CPI inflation in 2005 it seems unlikely that there would be any need for a further rate hike to safeguard price stability. The government is operating a small fiscal surplus, leaving room for emergency aid to the rural areas if another drought develops.

China and Non-Japan Asia

China will resist foreign pressure to re-value

The fluctuations of China's economy made headlines around the world in a major way in 2004. Surging Chinese demand in the early months of the year drove up commodity prices and shipping rates. In April and May the tightening of monetary policy by the People's Bank of China caused an abrupt correction of steel, chemical and aluminium prices as well as shipping rates, but by September/October China's economy looked to be on course for a soft landing and prices recovered again -- in some cases (e.g. oil) hitting new all-time highs. These were early signals of how important China's economy is going to be in the future global economy. We expect China to record a real GDP of about 9.7% in 2004 and only a marginally slower rate in 2005. China will experience a prolonged period of rapid growth comparable to the period of rapid growth in Japan between 1949 and 1971 when Japanese real GDP averaged 9.4% p.a. for over 20 years. Inflation has been contained at about 4.5% this year and we expect policies to be designed to maintain roughly this rate in 2005. We believe that China will resist pressure from abroad to revalue their currency. Sustained growth with modest inflation implies that China will continue to put upward pressure on global commodity markets, and act as a locomotive for many of the smaller Asian economies in the region.

Smaller East Asian economies

Many of the smaller East Asian economies experienced strong recoveries in 2004, even though momentum decelerated through the year as export growth to China and to the US IT sector slowed down. Domestic demand improved, but it was not strong enough to take over fully from exports as the primary growth driver. In some cases the currency was allowed to appreciate moderately against the

US dollar (e.g. Korea, Taiwan and Thailand), while in other cases the exchange rate was kept very stable (e.g. Malaysia and Hong Kong). Until China adjusts its currency against the US dollar we would not expect the smaller Asian economies to allow very much currency appreciation. We expect another good year of growth in 2005 as the US and Chinese economies continue to provide strong demand for Asian exports. Inflation across the region is low and should not become a problem in 2005.

Conclusion

Anglo-Saxon economies, Continental Europe and Japan

In the Anglo-Saxon economies (US, UK, Canada and Australia) the stage is being set for a prolonged, low-inflation expansion similar to that of the 1990s. The central banks in these economies have been raising interest rates from what were unusually low levels to normal or neutral levels ahead of any serious upturn in inflation. Economic growth will inevitably slow from unsustainably high growth rates at the start of the expansion to lower, but more sustainable growth rates in line with long-term potential growth rates. Elsewhere in the developed world the upswing has either been more muted (as in the euro area) or been largely dependent on external stimulus (as in Japan). In both these two economies structural impediments have impeded a vigorous recovery, and these are now being compounded by currency appreciation. Consequently the outlook for growth in 2005 is much better in the Anglo-Saxon economies where domestic demand is buoyant than in Japan or Europe where domestic demand is still sluggish.

China and Other Asia

In China and the rest of Non-Japan Asia the business cycle upswing has been an amplified version of that seen in the United States -- to whose currency and markets many of these economies and currencies are tied. As the US expansion continues, Asia's recovery will strengthen, gradually shifting from export-led growth to domestic demand-led growth. In the next year or so there is no serious risk of either overheating or currency crisis, but clearly these economies need to engineer a policy of currency flexibility that enables them to avoid the extremes of overheating when the US is booming, or abrupt downturns when the US is cooling. So far in East Asia outside Japan we do not see enough exchange rate flexibility to gain the necessary independence of conditions in the United States.

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