LIVERPOOL INVESTMENT LETTER

December 2014

Cardiff Business School
Cardiff University

Julian Hodge Institute of Applied Macroeconomics

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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The Julian Hodge Institute was launched in autumn 1999 in a new collaboration between the Cardiff Business School of Cardiff University and Julian Hodge Bank. The aim of the Institute is to carry out research into the behaviour of the UK economy, and to study in particular its relationship with the other economies of Europe. This research has been given especial relevance by the ongoing discussions on the extra powers regularly requested by the European Union and also by the recent crisis in the eurozone.

The Liverpool Investment Letter is written by Patrick Minford, with the assistance of other members of the Group; in particular the emerging markets section is written by Anupam Rastogi, and the focus on Japan is written by Francesco Perugini. The Investment Letter is published monthly.

The Liverpool Research Group in Economics is pursuing a research programme involving the estimation and use of macroeconomic models for forecasting and policy analysis. The Group is now mainly based in Cardiff Business School, Cardiff University, and is indebted to the School and to the Jane Hodge Foundation for their support. The Group's activities contribute to the programmes being pursued by the Julian Hodge Institute of Applied Macroeconomics. This Liverpool Investment Letter is typeset by David Meenagh and Bruce Webb and published on behalf of the group by Liverpool Macroeconomic Research Limited, which holds the copyright

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IS IT YET TIME TO MOVE MONETARY POLICY TO NORMALITY?

Many in the monetary policy community of the UK are still cautious about raising interest rates and withdrawing QE stimulus. Their reasons are a mixture of traditional fear that so soon after recession the economy will 'slip back' into recession and worries about the pace of money/credit growth which are still weak.

The first of these we can dismiss as quite inappropriate and indeed traditional: it is due to the dominance of recent memory but we know from a lot of evidence that recoveries do not generally 'slip back'. We are now several years into recovery and over a year since we passed the original peak. During this early recovery period there was no slipping back, in spite of scares about 'double' and even 'triple' dips into recession. By now with growth close to 3% the chances of slipping back have disappeared entirely. Remarks by Mr. Cameron about 'red lights flashing' around the world are also wide of the mark, and presumably designed for political effect; world growth is in the 3–4% region, quite typical for this stage of a recovery and fairly healthy in the context of rather recent commodity shortages. Also we would argue that in the next decade the world's economies should avoid the sort of credit boom that occurred in the 2000s and pushed world growth regularly above 5%.

The second set of concerns about money and credit growth are less easily dismissed. It is clear that banks in the UK are still prevented from expanding their balance sheets strongly by regulation as well possibly as internal reorganisation to prevent future meltdowns. In particular small businesses are largely frozen out of bank credit by the new regulations that heavily penalise risk, even though socially such risks are classically diversifiable. Nevertheless it is also clear that QE has driven down yields on government debt and on equities to loss levels where investors are hunting decent returns elsewhere. This has opened up new channels of lending in the form of wealth management groups or trusts and peer-to-peer lending. Statistics on these new channels are naturally hard to come by, but indicators from individual firms operating in these markets suggest rapid, even explosive, growth. Furthermore retained profits of larger corporations are swollen by recovery and the slow expansion of investment. Thus some of the lack of credit growth (viz. to these larger firms) is demand-led. In short we have a situation of growing 'shadow banking'; this is a healthy response to the flat feet of the new bank regulators.

So our judgement on this second set of worries is to point to these new channels through which monetary ease is flowing and to raise the alarm. We think that to go on pouring monetary stimulus into the economy when there is this evidence of natural substitution with recorded credit and money is unwise. It could well as in the past lead to excesses that are only recognised well after the event. It seems extraordinary that so long into our palpable recovery interest rates on safe assets are negligible. This is causing a devil-may-care attitude among investors which is dangerous and unhealthy. It goes against the precept we have gleaned from our research into past crises of the last 150 years: that what is needed is an old-fashioned monetary policy of keeping monetary conditions from either being too cool or too hot: 'taking away the punch bowl when the party is getting merry' and vice versa. Sadly in sophisticated modern economies there is no foolproof statistic on which we can hang our hats. Monetary policy remains an art of interpretation in such a slippery environment. While the defenders of zero rates are honest in attaching themselves to monetary statistics, we thus point to the reality of substitution which has regularly occurred for these in the past decades.

Table 1: Summary of Forecast

		2010	2011	2012	2013	2014	2015	2016
GDP Growth[1]		1.7	1.1	0.2	1.7	2.8	2.4	2.4
Inflation	CPI	3.3	4.5	2.7	2.4	2.0	2.2	2.0
	RPIX	4.8	5.3	3.2	3.2	2.5	2.8	2.7
Unemployment (Mill.)								
	Ann. Avg.[2]	1.5	1.5	1.6	1.5	1.3	1.3	1.2
	4th Qtr.	1.5	1.6	1.6	1.4	1.3	1.3	1.1
Exchange Rate[3]		80.4	80.0	83.1	82.6	83.0	82.3	82.5
3 Month Interest Rate		0.7	0.9	0.9	0.6	1.8	2.1	2.2
5 Year Interest Rate		2.4	2.0	0.9	1.2	1.6	2.1	2.3
Current Balance (£bn)		−40.0	−22.5	−59.2	−60.7	−62.9	−63.5	−62.0
PSBR (£bn)		139.6	118.5	115.0	112.3	109.4	94.6	84.5

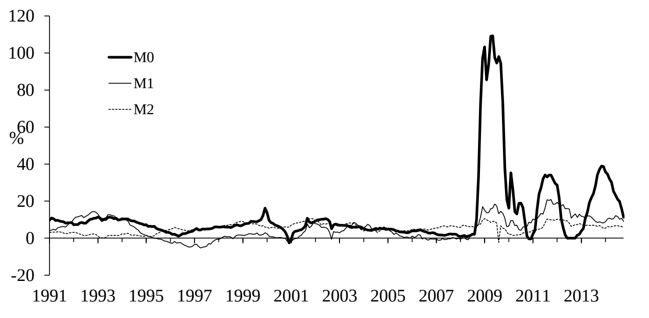
[1]Expenditure estimate at factor cost
[2]U.K. Wholly unemployed excluding school leavers (new basis)
[3]Sterling effective exchange rate, Bank of England Index (2005 = 100)

The UK outlook is good. With the contraction of high productivity sectors, including North Sea oil and banking, there is a productivity challenge. A good response by UK policymakers would be to restore a fair tax environment for the North Sea which has been bedevilled by Treasury opportunism — sad considering that the same Treasury has argued so robustly for low marginal tax rates generally; and to roll back some of the more deformative regulation on banks, one of our most profitable industries for all its recent lapses. The productivity problem seems to be partly mis-measurement by the ONS, now gradually being corrected, and partly this one-off adjustment due to these sectors' falling off; in fact productivity growth in other sectors seems to be continuing at its usual slowish rate.

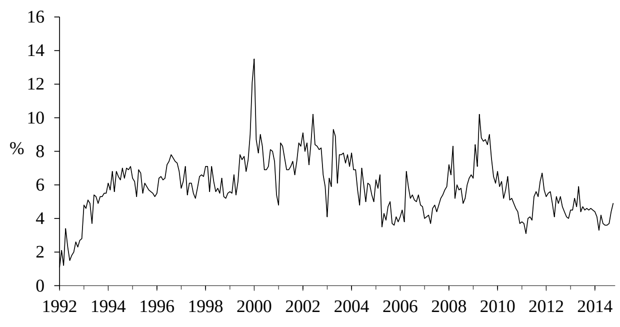
Let us end by commenting on the inflation environment. The fact is that since inflation targeting got under way in 1992 UK domestically-generated inflation has been close to the target rate of 2%. This can be put down to the massive credibility produced by the new institutions, contrary to general expectations that inflation would continue to be volatile and hard to control. What inflation we have had above and below the 2% rate can be seen now to have been due to external inflation rates, mostly from commodities, that the Bank refused to respond to. This remains true today when commodity prices are declining rapidly. What we have discovered from the inflation evidence of the past two decades is that inflation is a poor guide for monetary policy. This yet again illustrates the Lucas critique, echoed in Goodhart’s Law, that once you shift the policy basis and in particular target an aggregate, its behaviour changes and can cause you to miss your true policy targets.

Hence in conclusion we would argue that monetary policy now needs to be returned to normality for reasons of basic monetary prudence; growth is strong and the punch bowl should be slowly withdrawn. Interest rates should go up in regular small steps from now on; and QE should be gradually reversed to restore the Bank’s balance sheet to a state where it is no longer the main holder of the government’s bonds but instead merely a residual holder for reasons of open market operations.

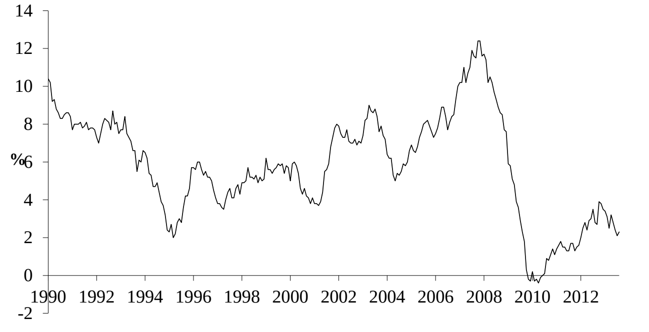
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



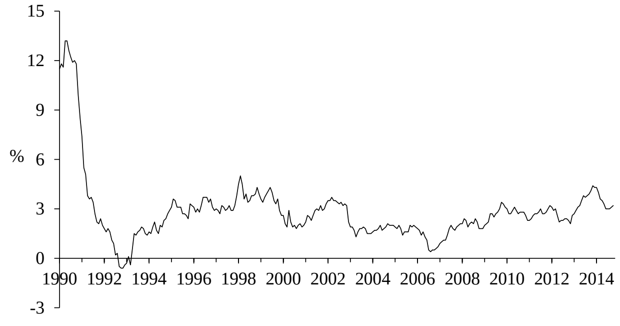
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

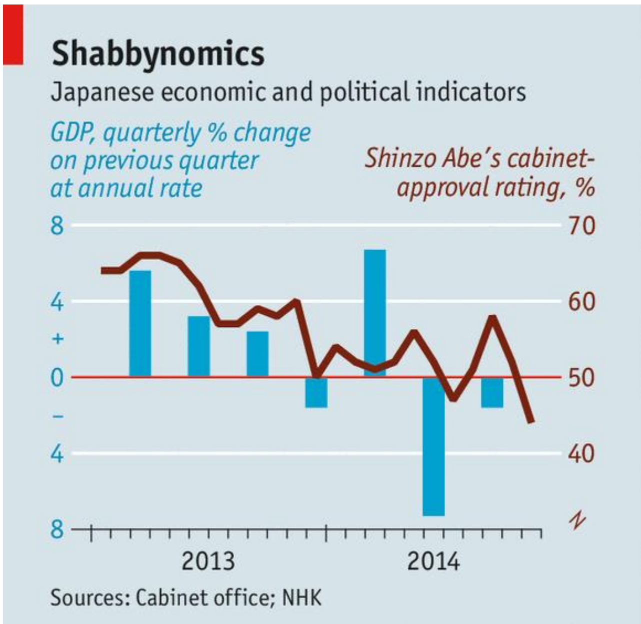
Abe Calls For An Election

Japan's economy unexpectedly slipped into recession in the third quarter, setting the stage for Prime Minister Shinzo Abe to delay an unpopular sales tax hike and call a snap election two years before he has to go to the polls.

The recession comes nearly two years after Abe returned to power promising to revive the economy with his "Abenomics" mix of massive monetary stimulus, spending and reforms. Gross domestic product shrank by an annualised 1.6% in July–September, after plunging 7.3% in the second quarter — the biggest decline since the global financial crisis — following a rise in the national sales tax, which clobbered consumer spending (on a quarter-on-quarter basis, the economy fell 0.4% in the third quarter after a revised 1.9% decrease in April–June). Private consumption, which accounts for about 60% of the economy, rose a less-than-expected 0.4% from the previous quarter, as the April tax increase and unusually cold summer weather hurt households' spending. Capital expenditure fell 0.2%, against a median market forecast of a 0.9% increase. The lack of a pick-up in exports and the prolonged drag from the April tax increase on consumption have dashed policymakers' hopes that the economy would rebound strongly in July–September and head for a moderate recovery.

But Abe decided to call for a snap election and to postpone a planned consumption tax hike originally planned for October of next year, to April 2017, to seek public approval for his tax decision and to get a renewed mandate for his all-or-nothing policies to end two decades of economic stagnation. "I realize this election will be tough, but I need to hear the voice of the people", Abe told a news conference. "I will step down if we fail to keep our majority because that would mean our Abenomics is rejected". Abe's cabinet approval rating goes hand in hand with economic indicators. According to recent opinion polls conducted by the National broadcaster NHK, Abe's government approval rating had fallen 8 percentage points from last month to 44%, the lowest since his government began two years ago (see the chart opposite, from the latest issue of "The Economist").

The immediate reaction to the news of a snap poll was one of bemusement. The public at large, as well as many in the LDP, are asking why now, given Abe is only half way through his term. "Most people understand that it is only for Abe's power", said Jiro Yamaguchi, professor of political science at Hosei University in Tokyo. But the timing is very convenient for Abe. Indeed, the LDP can count on the opposition's disarray. Since its humbling defeat in 2012, the biggest group, the Democratic Party of Japan (DPJ), which had a chaotic three-year spell in power



before Abe's 2012 landslide, has struggled to find candidates foolhardy enough to stand against the LDP in the countryside. Its support has dwindled to under 10%. As the turnout for the December 14 poll is predicted to be low, few analysts expect the DPJ, or any other party, to seriously weaken the ruling coalition's comfortable two-thirds majority in the lower house.

Abe hopes to further consolidate his power and to fend off challengers in a party leadership election scheduled for September next year. This would also strengthen his hand in shaking up his cabinet, which has been battered by scandals and resignations since a reshuffle in September. "By dissolving parliament for an election Abe can clear the slate and once again reshuffle his cabinet", said Michael Cucek, a Tokyo-based analyst and fellow at Temple University Japan. Yet in delaying the consumption-tax rise against the wishes of the powerful finance ministry Abe has shown that he can face down bureaucrats. It is inside the ministries and the LDP that he encounters the most entrenched resistance to his efforts at reform. "The third arrow has never flown at all, facing resistance", from his own conservative LDP, Kenji Eda, co-leader of the opposition Japan Restoration Party, said at a press conference.

At the end of 2012, Abe was returned to power in Japan on a promise to revive his country's ailing economy after a long period of stagnation. Two years on, the prime minister's ambitious mix of economic policies hangs in the balance. Many Japanese hope that if he emerges, as expected, with a renewed mandate, extended for another four years, he may at last muster the courage to get on with badly needed reforms to the labour market and to Japan's agriculture. It is probably too soon to talk about the failure of Abenomics. There are signs of a tentative lifting of Japan's deflationary mindset. However, rather than seeking short term electoral advantage, Abe should throw his weight behind policies to make the labour market more flexible and to press ahead with structural reforms that can send the economy a sustainable growth path.

MARKET DEVELOPMENTS

Equities continue to offer the best prospects as world growth reaches the 3–4% and falling commodity prices act like a tax cut for the developed world.

Table 1: Market Developments

	Market Levels		Prediction for Nov/Dec 2015	
	Oct 31	Nov 28	Previous Letter	Current View
Share Indices				
UK (FT 100)	6546	6723	9466	9721
US (S&P 500)	2018	2068	2599	2680
Germany (DAX 30)	9327	9981	13198	13764
Japan (Tokyo New)	1334	1410	1862	1924
Bond Yields (government				
UK	2.24	1.93	2.00	2.00
US	2.33	2.17	2.10	2.10
Germany	0.84	0.70	1.50	1.50
Japan	0.46	0.42	0.70	0.70
UK Index Linked	–0.44	–0.68	0.10	0.10
Exchange Rates				
UK ($ per £)	1.60	1.57	1.56	1.56
UK (trade weighted)	87.8	86.7	82.3	82.3
US (trade weighted)	93.2	95.5	85.5	85.5
Euro per $	0.80	0.80	0.79	0.79
Euro per £	1.28	1.26	1.23	1.23
Japan (Yen per $)	112.0	119.0	98.0	98.0
Short Term Interest Rates (3-month deposits)				
UK	0.60	0.60	2.10	2.10
US	0.27	0.21	0.70	0.70
Euro	0.04	0.11	0.50	0.50
Japan	0.00	–0.01	0.70	0.70

Table 2: Prospective Yields [1]

Equities: Contribution to £ yield of:

	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.40	2.5	2.1	40.00		48.00
US	1.80	3.0	1.6	25.00	0.38	31.78
Germany	2.50	1.4	1.5	35.00	1.87	42.27
Japan	1.70	1.4	2.0	33.00	17.96	56.06
UK indexed[2]	–0.68		2.4	–5.00		–3.58
Hong Kong[3]	2.50	7.0	1.6	6.00	0.38	17.48
Malaysia	3.10	5.2	1.6	56.00	0.38	66.58
Singapore	3.60	4.5	1.6	37.00	0.38	47.08
India	1.40	7.0	1.6	21.00	0.38	31.38
Korea	1.10	4.2	1.6	0.00	0.38	7.28
Indonesia	2.20	6.1	1.6	41.00	0.38	51.28
Taiwan	2.90	3.0	1.6	27.00	0.38	34.88
Thailand	3.00	4.1	1.6	36.00	0.38	45.08

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	1.93	–0.70		1.23
US	2.17	0.70	0.38	3.25
Germany	0.70	–8.00	1.87	–5.43
Japan	0.42	–2.80	17.96	15.58

Deposits: Contribution to £ yield of:

	Deposit Yield	Currency	Total
UK	0.60		0.60
US	0.21	0.38	0.59
Euro	0.11	1.87	1.98
Japan	–0.01	17.96	17.95

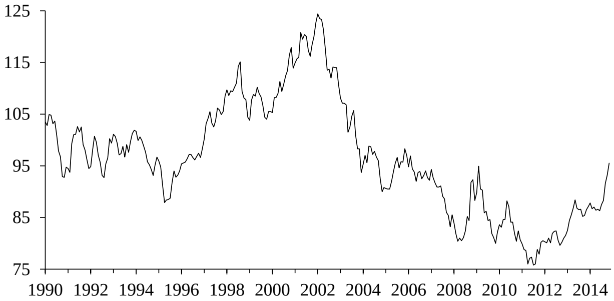
[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

Table 3: Portfolio(%)

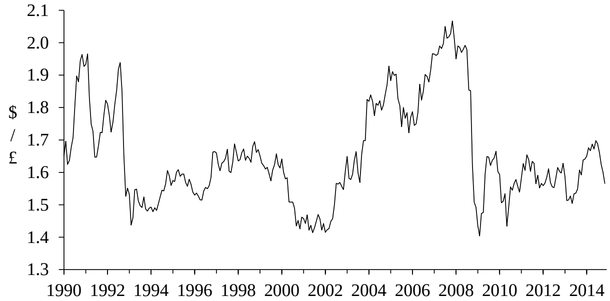
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	November Letter	Current View	November Letter	Current View	November Letter	Current View
UK Deposits (Cash)	5	5	5	5	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-	-
German Bonds	-	-	-	-	-	-
Japanese Bonds	-	-	-	-	-	-
UK Shares	19	19	14	14	17	17
US Shares	14	14	19	19	16	16
German Shares	14	14	14	14	21	21
Japanese Shares	9	9	9	9	11	11
Hong Kong/Chinese Shares	4	4	4	4	4	4
Singaporean Shares	4	4	4	4	4	4
Indian Shares	4	4	4	4	4	4
Thai Shares	3	3	3	3	3	3
South Korean Shares	4	4	4	4	4	4
Taiwanese Shares	4	4	4	4	3	3
Brazilian Shares	4	4	4	4	3	3
Chilean Shares	4	4	4	4	3	3
Mexican Shares	4	4	4	4	3	3
Peruvian shares	4	4	4	4	3	3
Other:						
Index-linked bonds (UK)	-	-	-	-	-	-

INDICATORS AND MARKET ANALYSIS
FOREIGN EXCHANGE MARKETS

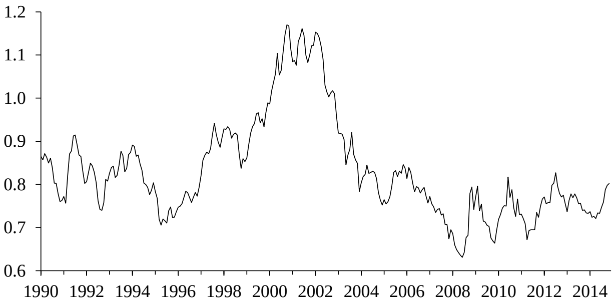
US : Trade Weighted Index
(Bank of England 1990 = 100)



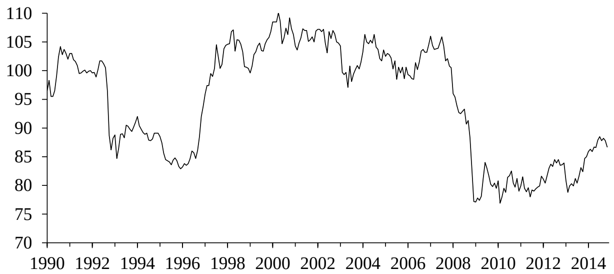
UK: Dollars Per Pound Sterling



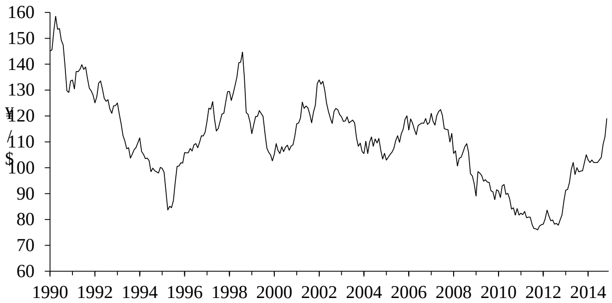
Euro per US dollar



UK: Trade-Weighted Index
(Bank of England 1990 = 100)

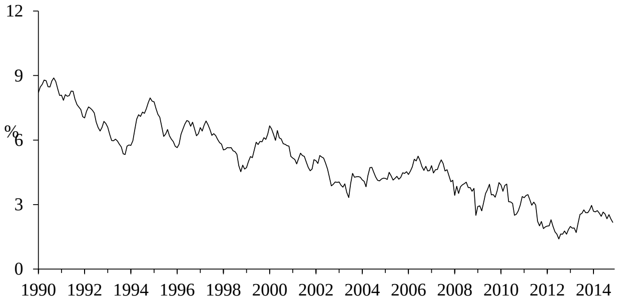


Japan : Yen Per U.S. Dollar

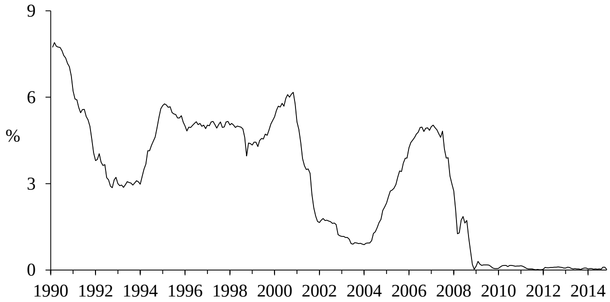


GOVERNMENT BOND MARKETS

U.S.: Yield on Long-Term Government Bonds

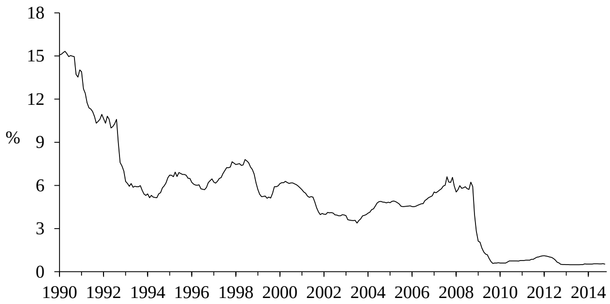


U.S. : 3-Month Treasury Bill

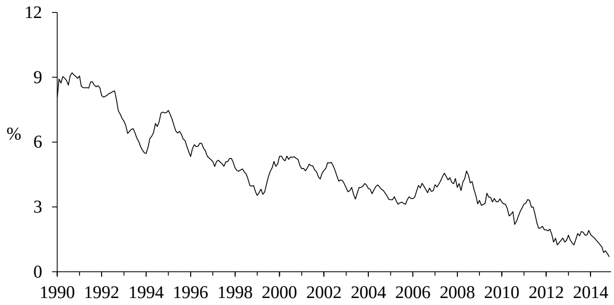


U.K. : Yield on Long-Term Government Bonds

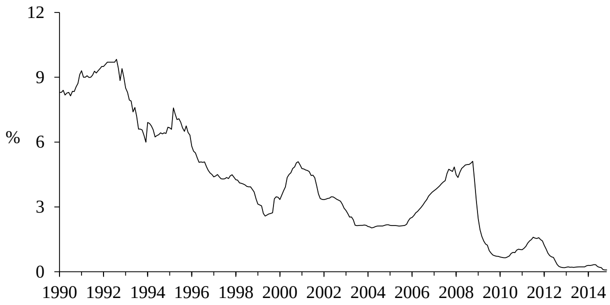
U.K. : 3-Month Interbank Rate



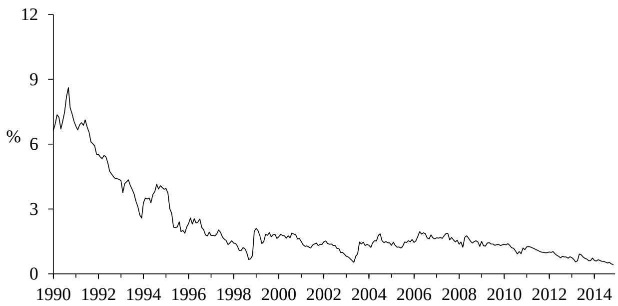
Germany: Yield on Public Authority Bonds



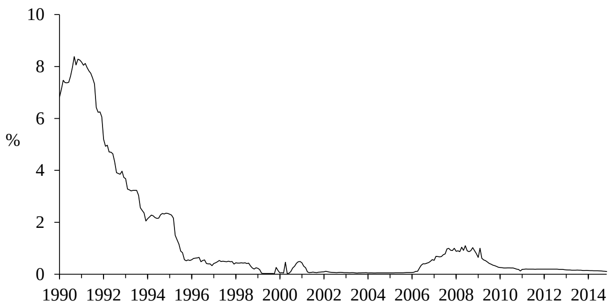
Germany : 3-Month Interbank Deposit Rate



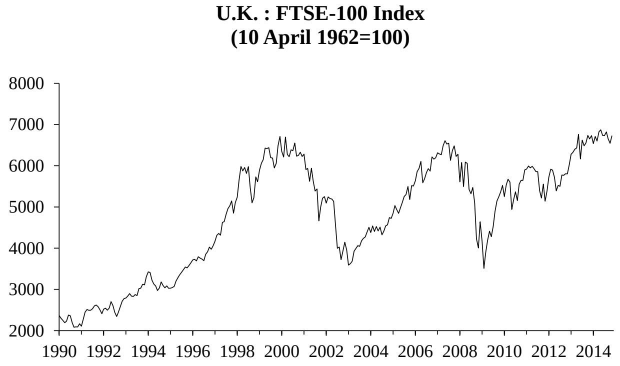
Japan: Yield on Long-Term Government Bonds

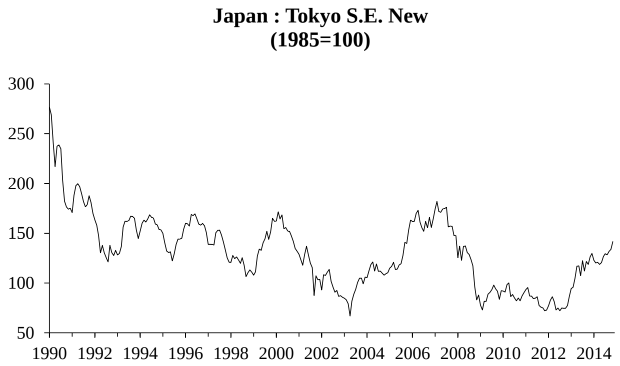


Japan : 3 Month Money Market Rate



MAJOR EQUITY MARKETS





EMERGING MARKETS

Anupam Rastogi

India

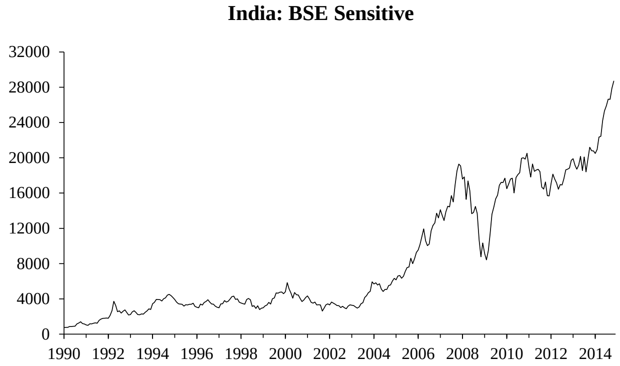
Indian GDP grew 5.3% from a year earlier in the third quarter of 2014. This marks a retreat from the 5.7% year-over-year growth posted in the previous quarter. The manufacturing sector remained flat. But, the HSBC Manufacturing Purchasing Managers' Index (PMI), compiled by Markit, rose to 53.3 in November from 51.6 in October, its highest since February 2013, and the thirteenth consecutive month of expansion in activity.

Even though the newly elected government of Prime Minister Modi has not announced big bang reforms but it is taking baby steps which hold promise of accelerating growth in the near future. Fortunately, Mr. Modi got an early break from a steep drop in oil prices that began shortly after his election. The cost of crude, India's biggest import, has plunged almost 40% since June. That has helped cut consumer-price inflation to 5.5% in October, from 10% in the same month last year, and supported the rupee. Cheaper oil imports also have improved the country's trade balance. This helped Mr. Modi to announce an end to government subsidies for diesel fuel.

The consumer inflation rate fell to 5.52% in October from 6.46% in September and wholesale inflation eased to a new five-year low of 2.10% from September's 2.38%. However, the central bank governor Raghuram Rajan has not eased monetary policy as he wants to drive down inflationary expectations and build a strong foundation for economic growth. In spite of a nudging from Finance Minister Jaitly and demand from industry, he has left interest rates unchanged at 8% for the fifth time in a row at the central bank's bi-monthly policy review meeting on December 2. The central bank also kept other key rates — the cash reserve ratio and the statutory liquidity ratio — unchanged.

However, he said that a rate cut was likely early next year if the inflation momentum — currently on a downward path — continues and if fiscal developments are encouraging. He is worried that the recent decline in inflation is partly due to the base effect and may not be sustained. Second, supply side issues in agriculture have still not been sorted out. Third, interest rate cuts in India will reduce the interest rate differential with the US, which is expected to raise rates next year, which might lead to capital outflows. Finally, rupee has depreciated by some 6%, negating some good effect of crashing of crude oil price as far as Indian crude oil imports are concerned.

India's exports shrunk for the first time in seven months in October, tempering hopes for an export-led recovery. The country's merchandise exports fell 5.04% from a year earlier to $26.09 billion compared to September's exports



of $28.90 billion. Imports rose 3.62% to $39.45 billion, widening the trade deficit to $13.35 billion, from last October's $10.59 billion. Last month's deficit was down from September's $14.25 billion.

The US President Barack Obama will be the chief guest on the Republic Day of India's parade on 26th January. For Prime Minister Narendra Modi, the president's visit will mark both a diplomatic and a political coup. It supplies a fresh burst of momentum to U.S.-India relations, raises Mr. Modi's standing as a global leader of consequence and aligns the prime minister's political base in a way that makes sense for both him and his party.

Mr. Obama's trip to India will be heavy with symbolism. The sight of an American president reviewing India's traditional Republic Day parade of military might not be lost on either of India's longtime adversaries, China and Pakistan, or on its East Asian friends such as Japan. It sends the message that while India may be in a tough neighborhood, it isn't without powerful allies.

This government is eager to promote ease of doing business in India and, therefore, tax related issues with Shell and Vodafone are being quietly buried. Compared to the slow growth in Europe and Japan. India's promise of accelerated growth has set it apart. Foreign investors are pouring money into Indian stocks and bonds. Money managers have poured $16.5 billion into Indian stocks this year, the most of any developing country tracked by the Institute of International Finance. India's S&P BSE Sensex has soared 35% this year, and hitting all time high.

India's new government hopes to raise billions of dollars through selling government stakes in one of the two massive state-run companies. A team of government officials conducted roadshows for Coal India and ONGC in the U.S., Hong Kong and Singapore to promote the share sales and answer investors' queries.

The investment climate in India is very conducive now. PwC, the professional services firm, launched a report called "The Winning Leap", suggesting that India has a chance to grow at 9% a year, create 240m jobs and quintuple the size of the economy to $10tn in the next 20 years. Everyone seems to have rediscovered India's growth potential, and it is once again touted as a secular story to buy and hold.

	11-12	**12-13**	**13-14**	**14-15**	**15-16**
GDP (%p.a.)	6.2	4.5	4.7	6.0	7.0
WPI (%p.a.)	9.0	7.5	7.0	6.5	6.0
Current A/c(US$ bill.)	-40.0	-88.0	-50.0	-50.0	-50.0
Rs./$(nom.)	49.5	54.5	60.0	61.0	62.0

China

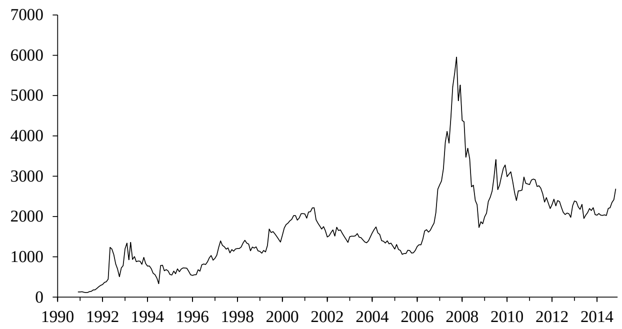
China's economic growth slowed to 7.3% year on year in the third quarter, down from 7.5% in the second quarter and 7.7% for the full year of 2013. Industrial production, fixed-asset investment and retail sales in October point to further weakness in China. China's slowdown is hitting its emerging consumer class as well.

The manufacturing purchasing managers' index, a closely watched gauge of conditions in the sector, fell to an eight-month low of 50.3 in November from 50.8 the month before. Domestically, the real estate downturn remains the key driver of the weakness.

According to a research by Xu Ce of the National Development and Reform Commission, the state planning agency, and Wang Yuan from the Academy of Macroeconomic Research, a former arm of the NDRC, much of China's recent growth has been illusory, the result of reckless lending and wasteful investment. Bridges to nowhere and empty "ghost cities" litter the Chinese landscape. Debt among state-owned enterprises is out of control; chronic overcapacity plagues the steel and shipbuilding industries, among others. They estimated that nearly half the total invested in the Chinese economy in 2009 and 2013 alone, was "ineffective investment".

Faced with growing worries about a slowdown, China's central bank last month cut benchmark interest rates by 0.25 percentage points. More loosening measures may be announced, but these measures will not be enough to perk up the economy as China is undergoing a structural change. The People's Bank of China dropped the benchmark deposit rate to 2.75% from 3%, and the largely symbolic lending rate to 5.6% from 6% in November. At the same time, it gave banks a bit more flexibility on the interest rate they can offer to depositors, as a move toward interest rate liberalization.

China: SSE Composite Index



China turned net capital exporter in October. It invested more overseas than what it attracted in foreign direct investment so far this year. China's outbound direct investment was $81.9 billion in the January–October period compared to total FDI of $95.9 billion in the same period in 2014.

American and Chinese trade negotiators reached an agreement during the Asia-Pacific Economic Cooperation summit to cut tariffs on a wide range of tech products and free up passage of a stalled expansion in the multilateral Information Technology Agreement. The deal will see tariffs cut on new generation of semiconductors (currently at 25%), on Global Positioning System devices and on various medical devices. China will give investors much greater access to its stock market, a big step in Beijing's efforts to lure foreign capital and part of attempts to overhaul its economy. The program allows global investors to invest in a wide range of companies that had been largely cut off from international money, and many of which are expected to benefit from the shift of China's economy from manufacturing toward consumer spending.

The Shanghai-Hong Kong Stock Connect program will allow all investors to buy shares on the Shanghai Stock Exchange, while also permitting wealthy investors in mainland China to buy stocks listed in Hong Kong. The move allows investors access to companies with an overall market value of roughly $2 trillion. Investors will find many limitations. For example, buyers or sellers of Chinese stocks will have to place orders before the trading day starts to meet the requirements of Shanghai's exchange, limiting the ability of investors to react quickly to market-moving events like corporate earnings. The Shanghai Composite has climbed 17% this year, and some investors expect further gains.

	11	**12**	**13**	**14**	**15**
GDP (%p.a.)	9.2	7.7	7.7	7.5	7.0
Inflation (%p.a.)	4.3	2.6	3.5	2.5	2.5
Trade Balance(US$ bill.)	210	214	220	220	200
Rmb/$(nom.)	6.3	6.3	6.2	6.3	6.3

South Korea

South Korea is expected to grow around 3.7% in 2014. Domestic consumer demand, which was supporting economic growth, has slowed down as household debt in South Korea is rising at its fastest pace in seven years. Moreover, an aging population and slower demand for consumer goods in the U.S. is weighing heavily on the South Korean economy.

To give a fillip to the economy, South Korea's central bank has cut interest rates twice recently and may do so again. However, Fitch Ratings believes that worries that South Korea is falling into a deflationary trap are overstated. According to them, the country's economy is on track for a lift in the medium-term. They expect economic growth to accelerate to 3.9% in 2015 from 3.7% this year.

Consumer price inflation has remained around 1% for nearly two years, well below the central bank's 2.5%–3.5% target.

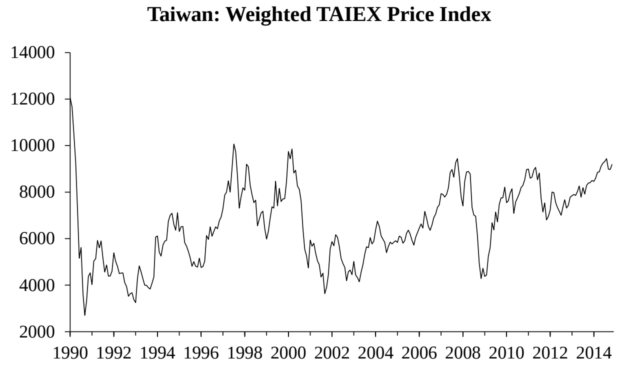
Under the slogan of promoting a "creative economy," President Park Geun-hye is trying to foster an environment where venture firms can flourish by providing financial support to start-up firms. But not much has come out of this.

China and South Korea announced a preliminary free trade deal in November. A closer look shows the pact is far less comprehensive than Seoul's plethora of other FTAs, both, in the items it covers and the speed of tariff reductions. Under the deal, the two sides will continue to impose fixed tariffs on goods worth about $20 billion, nearly one tenth of total trade between Asia's largest and fourth largest economies. Two-way trade totalled $230 billion last year. China is Korea's largest trading partner and takes in a quarter of Seoul's total exports.

The FTA excludes a total of 852 Chinese import items — mostly agricultural goods. In turn, the deal omits 637 Korean items, largely industrial products like cars and steel, or 8% of all Korean goods exported to China last year. South Korea, which has FTAs with most of its major trading partners, is often portrayed as a strong proponent of free trade. But its trading partners raise occasional concerns about Seoul's protectionist tendencies.

U.S. Secretary of Commerce Penny Pritzker, when she was in Korea in October, said, 'American businesses and investors are not fully satisfied with the implementation of the U.S.-Korea free trade deal in place since 2012 and known as KORUS'. She cited non-tariff barriers in the auto, financial and other sectors.

Yen weakness is giving a headache to South Korea. The car and steel industries of Korea were among those damaged by the weak yen. Hence, the won's fall against the dollar was welcomed. The won has appreciated more than 6% against the yen in the last one month.



	11	12	13	14	15
GDP (%p.a.)	3.6	2.0	2.8	3.7	4.0
Inflation (%p.a.)	4.0	2.2	1.3	2.0	2.5
Current A/c(US$ bill.)	27.0	44.0	71.0	80.0	80.0
Won/$(nom.)	1100	1100	1100	1020	1000

Taiwan

In the three months ending September 30, Taiwan's gross domestic product rose 3.78% from the same period a year earlier and was up 0.49% from the previous quarter according to the government. But, Taiwan's exports barely grew in October despite strong overseas sales of mobile-device components, as weaker oil prices weighed sharply on the value of the island's petrochemical exports.

Imports in October fell 1.4% to US$22.28 billion, compared with September's 0.2% rise. October's trade surplus increased to $4.62 billion from $3.5 billion in September.

Taiwan's ruling Nationalist Party loss in local elections is worrisome to China but they have not come out publicly. The voters grew disgruntled over economic uncertainties and a perceived rise in mainland influence over Taiwanese affairs.

The Taiwanese have been watching events in Hong Kong closely. Mr Ma, Taiwan's president, has pressed the virtues of Hong Kong's "one country, two systems" on Taiwan for his own political survival. With thousands in Hong Kong protesting against Beijing's influence, Mr Ma went on television to reiterate his policy of three Nos: no unification, no independence, no use of force. He urged Beijing to allow full-fledged democracy in Hong Kong.

Taiwan is watching carefully trade talks between Seoul and Beijing as Taiwan exports compete with South Korean exports.

	11	**12**	**13**	**14**	**15**
GDP (%p.a.)	4.0	1.3	2.1	3.8	3.6
Inflation (%p.a.)	1.2	1.9	1.2	1.5	1.5
Current A/c(US$ bill.)	18.0	41.7	50.6	57.4	60.0
NT$/$(nom.)	30.0	29.5	30.0	30.5	30.5

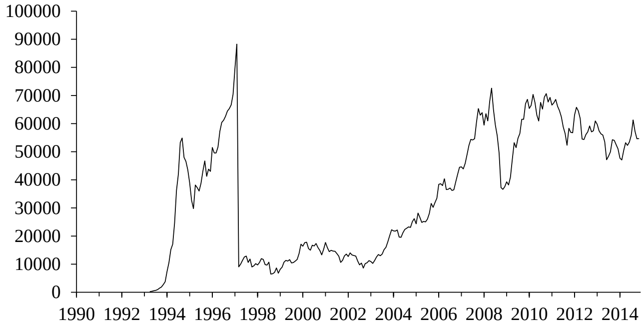
Brazil

Brazil's economy just managed to avoid recession in the third quarter, pushed by government spending, but the insipid growth highlighted the challenge facing the country's politicians. Brazil's economy is facing its worst Christmas since 2003 due to low consumer confidence and a weak currency has plunged imports.

Brazil's economy is likely to grow just 0.2% in 2014, compared with 2.5% last year. On the other hand, inflation will end this year at 6.45%, up from 6.2% previously expected and just below the ceiling of the country's targeted range, which is 6.5%. To contain inflation, the Brazilian Central Bank raised interest-rate last month and that may be followed by more interest rate increase. The Selic rate stands at 11.25% a year from 11%.

To mend the economy, the newly elected President Dilma Rousseff has taken the biggest turn by appointing Mr Levy, a market-friendly finance minister for her second term which begins in January. This signals that Ms Rousseff recognizes the need to change Brazil's economic direction and stop its current problems from growing into an eventual crisis. The market hopes that his appointment would mean the president would rethink populist policies that won her the election but which have run the economy into the ground.

Brazil: Bovespa

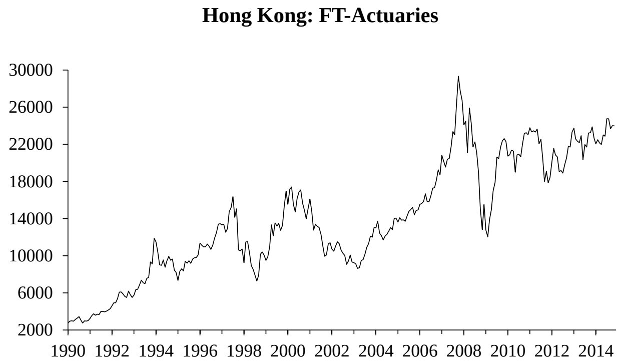


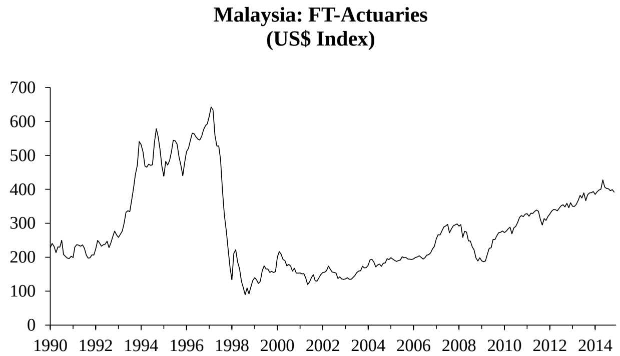
Mr. Levy holds a Ph.D. in economics from the University of Chicago and worked at the International Monetary Fund until 1999. He is known to be a fiscal conservative. Not surprisingly, the opposition leader Aécio Neves, who lost the October election to Ms Rousseff, said that it is like appointing a CIA chief to head the KGB.

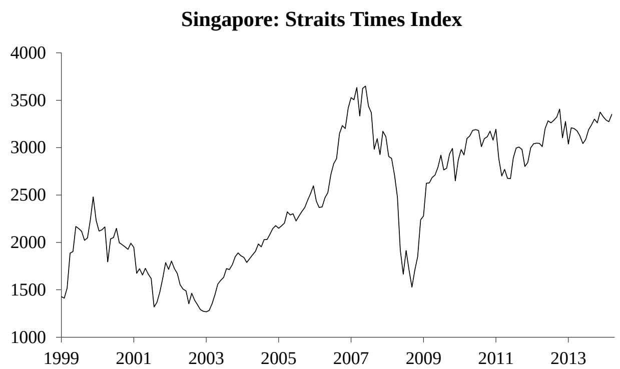
The new finance minister needs to clear up the accounting tricks that have been used to flatter the national accounts and then balance Brazil's books. Besides this he is to protect Brazil's credit rating. It is hoped that Mr. Levy would be able to instil confidence through more conservative policies among investors. The announcement has been cheered by both, the stock market and the currency market.

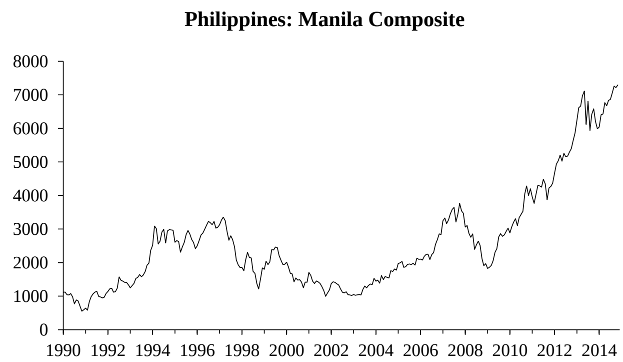
	11	**12**	**13**	**14**	**15**
GDP (%p.a.)	2.7	0.9	2.5	0.2	1.5
Inflation (%p.a.)	6.5	5.8	5.9	6.5	6.0
Current A/c(US$ bill.)	-52.6	-60.0	-75.0	-70.0	-70.0
Real/$(nom.)	1.5	2.0	2.3	2.4	2.5

Other Emerging Markets

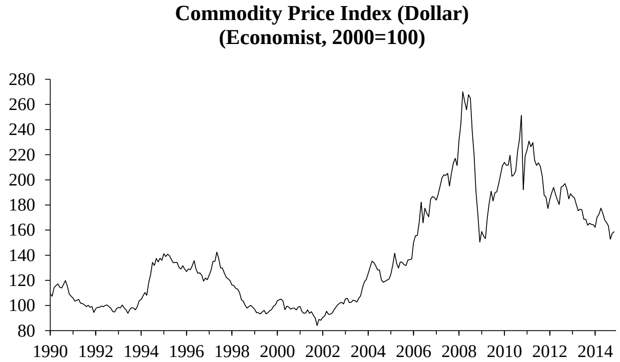


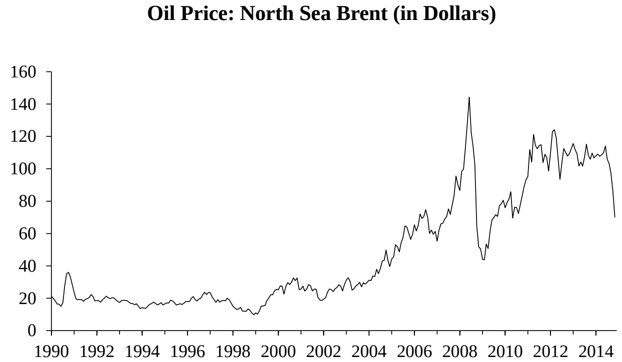


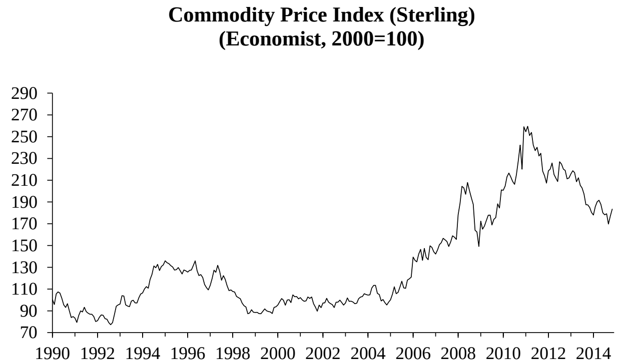


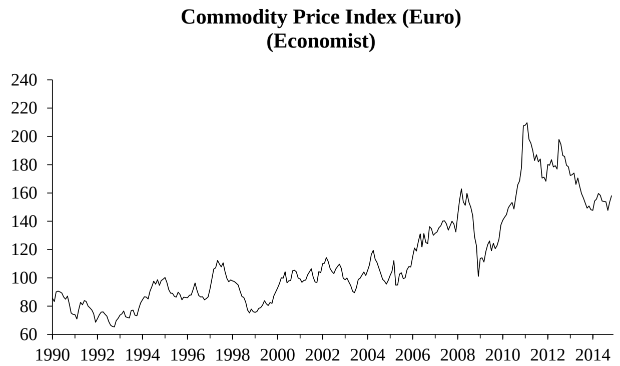


COMMODITY MARKETS









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]
2010	3.3	2.4	0.7	80.4	88.6	–3.5	4.8	–0.2
2011	4.5	2.0	0.9	80.0	89.8	–2.8	5.3	–0.2
2012	2.7	0.9	0.9	83.1	93.9	–1.8	3.2	–1.4
2013	2.4	1.2	0.6	81.4	92.5	–1.7	3.2	–1.0
2014	2.0	1.6	1.8	83.0	94.1	–1.1	2.5	–0.4
2015	2.2	2.0	2.1	82.3	95.4	0.1	2.8	0.1
2012:1	2.7	1.1	1.1	81.2	91.6	–1.9	3.8	–1.3
2012:2	3.1	0.9	1.1	83.1	94.2	–1.4	3.2	–1.4
2012:3	2.5	0.7	0.8	84.1	95.2	–1.8	2.9	–1.6
2012:4	2.5	0.8	0.6	83.6	94.8	–2.0	3.0	–1.5
2013:1	2.6	1.0	0.6	80.3	90.9	–1.7	3.3	–1.3
2013:2	2.3	1.0	0.6	80.6	92.6	–1.9	3.1	–1.3
2013:3	2.4	1.5	0.5	81.2	93.2	–1.5	3.2	–0.7
2013:4	2.5	1.5	0.7	83.5	93.2	–1.9	3.2	–0.7
2014:1	1.8	1.6	1.2	82.9	93.7	–0.9	2.5	–0.5
2014:2	2.0	1.6	1.6	82.8	94.0	–1.1	2.5	–0.4
2014:3	2.0	1.7	1.9	82.9	94.0	–1.2	2.5	–0.4
2014:4	2.1	1.7	2.2	83.4	94.6	–1.2	2.6	–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)
2010	227.1	2.4	4.6	1.50	135.6
2011	232.7	2.5	4.6	1.53	133.5
2012	237.0	1.9	4.7	1.59	132.4
2013	240.2	1.4	4.3	1.45	131.0
2014	246.3	1.6	3.9	1.33	131.1
2015	251.0	2.2	3.9	1.31	133.3
2012:1	236.6	0.7	4.8	1.61	132.6
2012:2	238.1	1.8	4.8	1.59	132.2
2012:3	238.1	1.9	4.7	1.57	132.9
2012:4	236.6	3.3	4.6	1.56	131.8
2013:1	238.2	0.6	4.5	1.54	130.1
2013:2	239.5	2.4	4.4	1.50	132.3
2013:3	240.6	0.8	4.1	1.39	130.8
2013:4	242.5	1.7	4.0	1.37	130.8
2014:1	243.6	3.1	4.0	1.36	130.7
2014:2	245.5	1.6	3.9	1.34	131.1
2014:3	247.4	2.7	3.8	1.31	131.1
2014:4	248.6	2.8	3.8	1.30	131.2

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
2010	143.2	685816.8	412464.1	222982.1	180596.2	–35977.3	94248.2
2011	144.8	693480.0	405707.9	232196.6	179249.7	–24641.9	99032.3
2012	145.0	694345.6	405044.8	241788.1	182996.5	–31204.8	104279.0
2013	147.5	706149.6	409500.3	244931.3	182264.4	-32815.0	102184.0
2014	151.6	725921.8	416052.3	266975.2	176432.0	-38621.8	95765.3
2015	155.3	743343.9	422293.1	285663.4	180489.9	-31157.8	98734.0
2010/09	1.7		0.3	11.0	0.1		8.3
2011/10	1.1		–1.6	3.8	–0.8		4.5
2012/11	0.2		–0.1	2.5	3.0		3.0
2013/12	1.7		1.1	1.3	-0.4		-2.0
2014/13	2.8		1.6	9.0	-3.2		-6.3
2015/14	2.4		1.5	7.0	2.3		3.1
2012:1	145.2	173789.2	101182.0	58927.4	47960.2	–6985.4	27295.1
2012:2	144.5	172990.1	101166.9	58367.1	44720.2	–8453.9	22810.2
2012:3	145.4	174050.5	100983.7	61663.0	45063.8	–7626.9	26033.1
2012:4	145.0	173515.9	101712.2	62830.6	45252.2	–8138.6	28140.5
2013:1	147.7	176743.6	102295.0	59693.5	47768.4	-7067.3	27132.5
2013:2	147.0	175930.9	102279.7	59125.9	44541.3	-7180.1	24182.3
2013:3	147.9	177009.4	102094.5	62464.6	44883.5	-9285.0	25475.0
2013:4	147.5	176465.7	102831.0	63647.4	45071.2	-9282.6	25394.2
2014:1	151.8	181692.4	103931.7	65065.9	46239.8	-9664.1	23431.4
2014:2	151.1	180857.0	103916.2	64447.2	43116.0	-9655.3	23693.8
2014:3	152.0	181965.6	103728.0	68086.4	43447.3	-9650.6	24248.6
2014:4	151.6	181406.7	104476.3	69375.7	43628.9	-9651.8	24391.5

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)
2010	10.5	1319.8	139.6	36.6	–40.0
2011	8.4	1399.3	118.5	43.0	–22.5
2012	8.0	1429.6	115.0	46.4	–59.2
2013	7.6	1482.5	112.3	48.0	–60.7
2014	7.1	1549.3	109.4	52.8	–62.9
2015	5.9	1613.2	94.6	60.3	–63.5
2012:1	5.9	356.4	21.0	11.5	–12.5
2012:2	10.5	350.3	36.7	11.4	–17.3
2012:3	7.2	358.6	25.7	11.8	–14.8
2012:4	10.6	364.3	38.6	11.8	–13.1
2013:1	3.8	364.3	14.0	12.0	–14.0
2013:2	9.3	363.3	33.7	11.6	–16.7
2013:3	6.2	369.4	23.1	12.0	–15.5
2013:4	7.6	374.6	28.3	12.3	–12.8
2014:1	7.2	375.2	27.3	12.7	–15.9
2014:2	6.9	379.8	26.2	13.1	–17.3
2014:3	7.1	384.4	27.3	13.5	–16.0
2014:4	7.1	390.1	27.9	13.6	–13.3

1 GDP at market prices (Financial Year)

WORLD FORECAST DETAIL

Growth Of Real GNP

	2010	2011	2012	2013	2014	2015
U.S.A.	2.4	1.8	2.2	2.2	2.1	3.1
U.K.	1.7	1.1	0.2	1.7	2.8	2.4
Japan	4.7	–0.5	1.9	1.8	1.2	1.3
Germany	4.2	3.0	0.7	0.6	1.7	1.8
France	1.6	2.0	0.0	0.2	0.5	1.1
Italy	1.7	0.5	–2.4	–1.8	-0.1	0.9

Real Short-Term Interest Rates

	2010	2011	2012	2013	2014	2015
U.S.A.	–3.0	–1.8	–1.9	–1.3	–1.9	–1.4
U.K.	–3.5	–2.8	–1.8	–1.7	–1.1	0.1
Japan	0.4	0.4	0.3	–1.6	–1.6	–1.8
Germany	–1.9	–0.5	–1.5	–1.5	–1.6	–1.9
France	–1.7	–0.5	–1.4	–1.5	–0.9	–0.9
Italy	–2.4	–1.5	–2.6	–2.0	–0.6	–0.7

Real Long-Term Interest Rates

	2010	2011	2012	2013	2014	2015
U.S.A.	1.0	0.9	–0.2	0.1	0.8	1.4
U.K.	–0.2	–0.2	–1.4	–1.0	–0.4	0.0
Japan	0.4	–0.2	–0.8	–1.3	–1.4	–1.2
Germany	1.8	–0.1	–0.4	–0.5	–0.8	–0.4
France	1.9	–0.1	–0.4	–0.5	–0.8	–0.4
Italy	1.2	–0.7	–0.8	–0.6	–0.8	–0.4

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

	2010	2011	2012	2013	2014	2015
U.S.A.	84.0	79.8	81.6	82.1	83.0	83.2
U.K.	88.6	89.8	93.9	92.5	94.1	95.4
Japan	79.5	80.6	79.6	63.5	61.1	60.7
Germany	101.3	100.1	96.7	99.0	100.5	100.2
France	103.5	102.9	99.5	100.7	101.7	101.4
Italy	107.4	107.2	105.2	106.9	107.8	107.0

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

Growth Of Consumer Prices

	2010	2011	2012	2013	2014	2015
U.S.A.	1.6	3.1	2.1	1.6	1.9	2.0
U.K.	3.3	4.5	2.7	2.4	2.0	2.2
Japan	–0.7	–0.3	0.0	0.0	2.8	1.8
Germany	1.2	2.0	2.0	1.7	1.1	1.7
France	1.5	2.1	2.0	1.1	0.7	1.0
Italy	1.5	2.8	3.0	1.4	0.3	0.7

Nominal Short-Term Interest Rates

	2010	2011	2012	2013	2014	2015
U.S.A.	0.1	0.3	0.1	0.7	0.1	0.6
U.K.	0.7	0.9	0.9	0.6	1.8	2.1
Japan	0.1	0.4	0.3	0.4	0.2	0.2
Germany	0.4	1.5	0.2	0.5	0.1	0.1
France	0.4	1.5	0.2	0.5	0.1	0.1
Italy	0.4	1.5	0.2	0.5	0.1	0.1

Nominal Long-Term Interest Rates

	2010	2011	2012	2013	2014	2015
U.S.A.	3.1	1.9	1.8	2.1	2.8	3.4
U.K.	2.4	2.0	0.9	1.2	1.6	2.0
Japan	1.1	1.0	0.8	0.7	0.6	0.8
Germany	3.8	1.8	1.5	1.5	1.2	1.6
France	3.8	1.8	1.5	1.5	1.2	1.6
Italy	3.8	1.8	1.5	1.5	1.2	1.6

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

	2010	2011	2012	2013	2014	2015
U.S.A.[1]	83.73	78.08	80.90	85.50	88.60	89.00
U.K.	1.58	1.61	1.59	1.55	1.67	1.67
Japan	87.48	79.36	80.51	98.00	104.50	104.00
Eurozone	0.75	0.71	0.78	0.79	0.74	0.75

[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