LIVERPOOL INVESTMENT LETTER

July 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

ISSN 0951-9262

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CONFUSION ON MONEY AND MARKETS

We have a largely new Monetary Policy Committee and it seems to be learning on the job, side by side with a brand new Financial Policy Committee, endowed with 'macro-prudential controls'. The Bank of England is the location of both these Committees, a logical development brought about by the crisis. Before the ill-fated 'Tripartite' set-up created by Gordon Brown in 1997 which split powers over monetary, financial and regulative policy between the Bank, the FSA, and the Treasury, all these powers had been wielded by the Bank in consultation with the Treasury. Hence what has been done now by George Osborne in the wake of the crisis is to return all these powers back to where they once were. The only difference is that their exercise has become more formalised and 'transparent'; also the regulations that are now being implemented are recent and complex.

The conventional view currently is that housing was not controlled by monetary policy in the run-up to the crisis and so requires to be controlled by additional direct intervention. Yet this may well be quite wrong on two main counts:

1) monetary policy could well have been conducted so that the credit and housing boom would have been moderated.

2) direct intervention may create its own costs in the distortion of market behaviour.

Both objections seem to us to be strong.

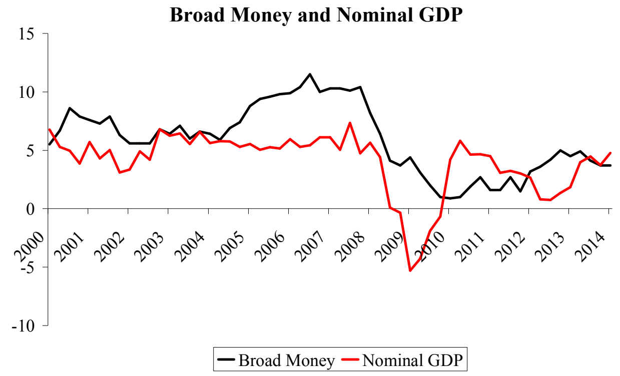
Turning to the present situation we welcome the decision by the FPC to go softly on housing intervention. Their remarks effectively amount to no more than what the mortgage providers themselves and the markets would be doing anyway — namely keeping an eye on the high loan/house-value borrowers. Having said this, these borrowers are in most cases fairly low risk as they have a lifetime of earnings ahead, i.e. high 'human capital'. Intervening against them would be to handicap some of the more dynamic agents in the economy.

At the same time can one discern in the confusion created by the Governor's many conflicting comments on future monetary policy that there is a hardening of the MPC's approach to interest rates and QE? We hope so and for long have been arguing that it is high time to 'normalise' monetary policy. The economy is picking up rapidly at a time when the best estimate of spare capacity is quite low; the labour market is buoyant and not far from the 5% unemployment rate at which, roughly, full employment prevails. It seems rather clear that the economy is no longer in the intensive care that justifies emergency low rates and a massive overhang of official liquidity.

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	2.7	2.6
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)



It is usual in these situations, when memories of the recession are still fresh, for many people to argue against 'premature tightening'. However, this is also a dangerous time to listen to these arguments.

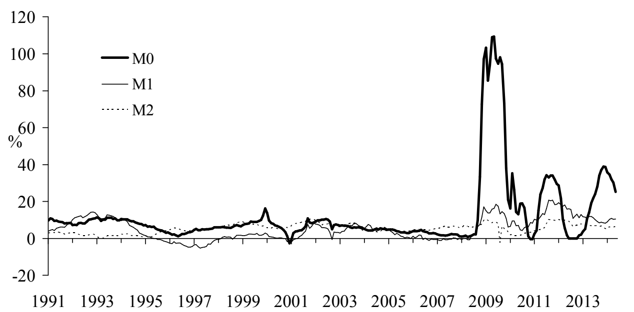
The strongest argument in their favour is the slow growth of the money supply and the glacial growth of credit that is associated with this slow growth. The problem is to interpret these developments. There has been a wave of new regulation which has impacted massively on bank behaviour, forcing banks to shrink their balance sheets aggressively. Now we seem to be entering a phase when firms are finding ways of substituting away from bank credit; the surge in the mortgage market is the only vibrant part of the credit scene, and ironically in view of all the concern being expressed about housing is also low risk-weighted in bank regulation.

Yet one can see from the chart above that while still slow M4(adjusted) growth has picked up in the past year to a pace comparable with that of nominal GDP. So if it is also distorted downwards by substitution due to the new regulatory environment then its message also reinforces the case for monetary normalisation.

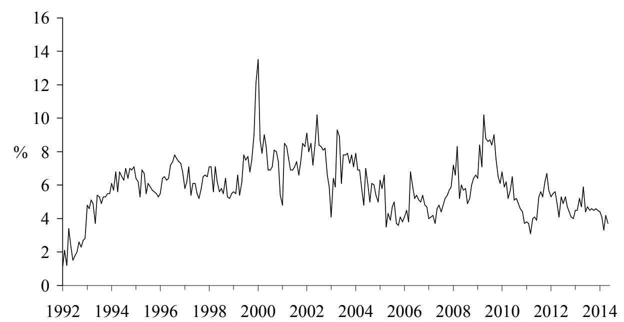
To conclude we favour moving towards a cautious normalisation of monetary conditions, with an immediate rise in interest rates of 0.25% and a move to reducing the Bank's portfolio of gilts. In future months this process should continue.

This normalisation forms part of the worldwide background of recovery from the crisis. World growth is around the 3% mark which is far from the boom conditions (with 5%+ growth) of the mid-2000s. But it is solidly based in the likely cheapness of raw material supplies that should prevail for many years as investment in production and technology respond to the very high prices we have now seen for a decade. We are embarked on a new 'long wave; upturn in the world economy.

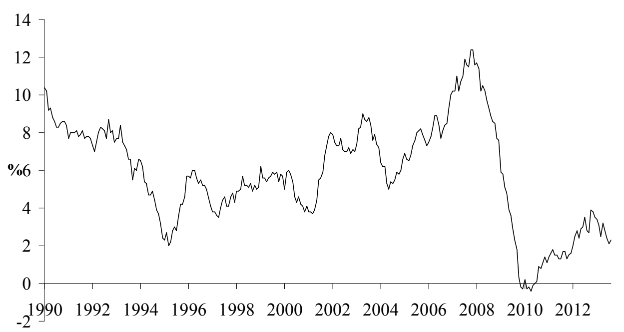
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



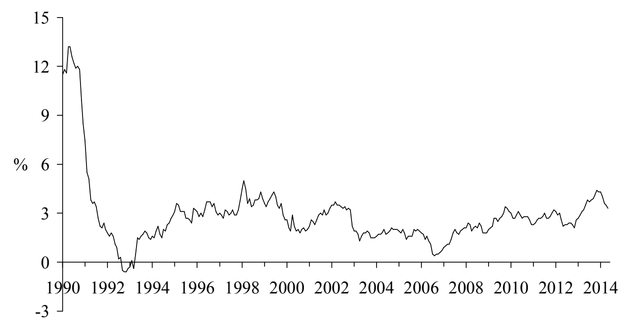
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Abe updates his third arrow strategy

Eighteen months have now elapsed since Prime Minister Shinzo Abe established a set of policies consisting of three pillars, dubbed “the three arrows”. The goal of his policies was twofold: to generate inflation and to increase the pace of economic growth.

So far two of the three arrows have been fired with some reasonable effect. A promise to double the monetary base and to hit an inflation target of 2% in about two years has jolted prices into life. Core inflation in recent months has been running at an increasing rate, albeit largely because of higher imported energy prices as a result of a weaker yen. The second arrow of fiscal flexibility has also flown fairly straight. Last year ¥12 trillion of extra spending helped nudge growth past 1.5%. The last arrow, structural reform, has been delayed owing to differing opinions on which reforms to undertake, and reticence at upsetting entrenched interests. Only last week, after months of intensive discussion, the cabinet come out with a 60-page draft plan which will form the basis of Abe’s third arrow reform update due to be announced on June 27. If the first two parts of Abe’s policy, popularly known as “Abenomics”, are having some success, what can we expect of the third?

When Abe formally unveiled the draft of the revised version of his growth strategy the Nikkei stock average closed down 164.55 points, or 1.08% from the previous day. Still, market reaction was better than in June last year, when Abe announced his first version — that day the Nikkei plummeted by 518 points. The lack of reform implementation is one reason the Nikkei has so far in 2014 underperformed as compared to other Asian indices. And experts say the third arrow is neither strong enough to create a short-term stock rally nor a solution to Japan’s long-term structural problems. “Although Abe proposes bold deregulation in agricultural, medical and labour markets, where politicians with vested interests have long blocked significant reforms, many of the key details remain unclear, in particular how to implement the reforms”, said Hiroshi Watanabe, senior economist at SMBC Nikko Securities Inc..

Among the proposals, the draft plans a cut to the corporate tax rate from 35.6% to less than 30%. The case for corporate tax cuts to bring the business tax rate in line with international standards has been promoted by previous governments but never put into practice — Japan has the second-highest corporate tax rate in the world after the US, which tops out at about 40% after allowing for state and local levies. The government believes that such reductions will encourage firms to increase investment spending and also attract foreign investment, both of which would help boost government efforts to put the economy on a higher growth trajectory. However the draft fails to make specific suggestions on important issues such as what the eventual tax rate would be and how to find revenue to make up for lost tax income — it only states the rate should be reduced “to less than 30% over several years”. Many details are likely to be left for later, people close to the administration said. Currently, corporate taxes are paid by only a small number of large profitable corporations, with the vast majority of companies reporting losses and paying no taxes. This is because the incomes of loss-making companies are not taxed, and due to the “carryover deduction” system in which losses can be used to offset profits in the next fiscal year to reduce the income subject to taxation. Expanding the tax base is considered necessary to collect tax revenue from such companies, but it is seen as unlikely this tactic alone could cover the entire ¥2 trillion to ¥3 trillion expected to be lost if the corporate tax rate is cut by about 5 percentage points as the government envisions. The Finance Ministry is contemplating neutralizing the impact of the sizable corporate tax cut by rolling back various tax incentives and broadening the taxation base. But the business community is not enthusiastic about shrinking tax incentives. “Things that need to be reviewed should be reviewed”, Sadayuki Sakakibara, chairman of the Japan Business Federation, or Keidanren, said recently when asked about tax incentives. At the same time revamping the system to make small companies pay more is likely to anger many supporters of the Liberal Democratic Party (LDP). Some lawmakers expressed concern at a recent tax panel meeting that the party would be viewed as favouring big business at the expense of small companies and consumers.

Another proposal is reform of the management of the Government Pension Investment Fund (GPIF) — the world’s largest institutional investor, with ¥128.6 trillion on its books — which has been under pressure to reduce the proportion that it holds in low-yielding domestic bonds from 60% and put more money into equities and foreign debt. A change of investment focus at the GPIF will inject new life into local equity markets and will weaken the yen. But many of the key details remain unclear, in particular how to implement the reform. The draft cited a “need to review its basic portfolio and strengthen its governance systems” and said changes should be considered “as soon as possible”, including involving more professional money managers in its allocation decisions. Moreover, the GPIF historically has been slow to implement changes so it is unsure how the proposal will materialize.

In the attempt to crack bedrock regulations that have long resisted change, Abe’s draft also contains a broad range of regulatory and structural changes in agriculture, employment, healthcare and other parts of the economy. For instance, non-managerial employees earning at least

¥10 million a year are to qualify for a new pay scheme that rewards them for results rather than hours worked, circumventing rules on overtime. Agricultural cooperatives, seen as a barrier to corporate farming, are supposed to undergo a five-year overhaul. In health care, patients are to have greater freedom to combine nationally insured treatments with out-of-pocket options. Steps are proposed to bring more women and foreigners into a labour force beset by population decline. A new child care certification to be created next fiscal year is meant to help homemakers put their parenting experience to work in looking after other people's children. A tax deduction for dependent spouses, which critics say acts as a disincentive for women to work, is to be revised this year. Foreigners can now work in Japan as part of a vocational training program that has become a source of labour for understaffed companies. The government proposes to expand it into nursing care and other fields and to lengthen the work period from three years to five. Trainees in shipbuilding and construction, the latter an industry facing a serious labour shortage ahead of the 2020 Tokyo Olympics, would be able to stay five to six years. To attract foreign investment, the government will seek to remove barriers to entrepreneurship as, for instance, in the special "strategic" economic zones meant to spearhead deregulation, entrepreneurs will enjoy one-stop filing for paperwork needed to start a business.

But experts say that these are just dozens of miscellaneous measures that look like a jumble of projects which misses critical reform details and, most importantly, do not really aim at deep-reforming vital sectors of the economy. "A growth strategy should be a long-term guiding principle for Japanese economic policies. But the strategy now looks like a list of action plans that bureaucrats can carry out right now", said Takao Komine, professor of economics at Hosei University and former senior official at the now-defunct Economic Planning Agency, a government agency. Komine, echoing many other observers, believes that the aging and rapidly shrinking population is the gravest economic problem Japan faces and that Abe should immediately start addressing it. "Abe is now pledging to help working mothers and help families bear children to increase the low birth rate. But he stopped short of showing how those measures would be financed, although they would probably force the debt-ridden government to cut other social security budgets, such as those for the elderly", Komine said.

And like last year's proposals, this new economic policy agenda is notable more for carefully hedged ambitions than detailed, ironclad commitments, partly because it is a broad strategy statement, not specific legislation, but also because some elements are controversial. "The new elements were mostly ambiguities that will make verification of progress a slow and detailed task — just what markets will find disappointing," said Robert Feldman, Japan economist at Morgan Stanley MUFG Research. The finance ministry, for instance, is keen to keep corporate tax cuts as small as possible, while many rural parliamentarians in Abe's LDP dislike proposals to liberalise the agricultural sector. Indeed, to some observers, the biggest omission in the strategy is an apparent retreat from a radical overhaul of the agricultural sector. An original demand calling for the abolishment of JA-Zenchu, the largest farm lobby and an opponent of the Trans-Pacific Partnership (TPP, a free trade zone encompassing the Pacific rim, another central pillar of Abe's growth strategy), has been dropped. "The third arrow of Abenomics is flying neither high nor fast in Japan's agricultural sector. The Abe administration's agricultural reform program falls far short of what is needed for structural reform of the farm industry", said Aurelia George Mulgan, Professor at the University of New South Wales, Canberra, and expert of Japanese agriculture policy. Last May, Prime Minister Abe announced big plans for agriculture, including doubling agricultural and food exports by 2020, and doubling agricultural and farm village income over the next 10 years . However, only one proposal — the creation of farmland banks in each prefecture — has a limited potential to contribute to structural reform by increasing the size of farms on leased land. In November the government announced a further series of agricultural policy changes. One, in particular, hit the headlines: the scheme to halve the subsidy paid to farm households participating in rice acreage reduction in 2014 and to stop the subsidy altogether in 2018. Abe claimed this reform was the biggest breakthrough in agricultural reform in years. However, "an accompanying increase in the subsidy for farmers who switch to producing rice for livestock feed and other purposes will lead to a decline in the production of staple food rice and thus maintain its price- the hidden agenda of the reform. Keeping the price of staple food rice high will prevent farm consolidation by supporting small farms. When added to the range of new and existing farm subsidies on offer, the total government assistance package will continue to act as a disincentive for inefficient, small-scale part-time farmers to exit the industry", said Mulgan.

While the implementation of the first two arrows of Abenomics has raised a lot of hope, many voices in Japan and abroad are cautioning that its long-term success will actually depend on whether the third arrow will be translated into action. The country's track record of executing on structural reform is not strong, but reform appears to have more momentum than in the past as Abe has a majority in both houses of their parliament and has his own man at the helm at the BOJ but agreeing on the consensual way forward is still the way things happen in Japan and it is naturally a very slow process. David Pilling, a Financial Time commentator said in a recent article "when it comes to structural reform, the Japanese prime minister is less like William Tell, splitting the apple asunder in one go. Instead, he more resembles an apprentice acupuncturist piercing the body politic with 1,000 needles in the hope that one or two might actually do the trick".

MARKET DEVELOPMENTS

The world economy is growing slowly but after the crisis the prospects are set fair for a long expansion as investment in raw material production and technology takes off in the wake of their high prices over the last decade. While monetary policy in the UK and elsewhere will certainly be tightened in the next couple of years this is unlikely to dislodge a strong traditional 'long wave' upturn. Thus the case for equities remains strong. Meanwhile bond yields must return to normal and so end the long bull market in bonds.

Table 1: Market Developments

	Market Levels		Prediction for Jun/Jul 2015	
	May 29	Jun 25	Previous Letter	Current View
Share Indices				
UK (FT 100)	6871	6734	9936	9669
US (S&P 500)	1920	1960	2473	2524
Germany (DAX 30)	9939	9868	13965	13864
Japan (Tokyo New)	1201	1261	1688	1760
Bond Yields (government long-term)				
UK	2.55	2.65	2.00	2.00
US	2.45	2.56	2.10	2.10
Germany	1.36	1.26	1.50	1.50
Japan	0.58	0.58	0.70	0.70
UK Index Linked	–0.17	–0.14	0.10	0.10
Exchange Rates				
UK ($ per £)	1.67	1.70	1.56	1.56
UK (trade weighted)	86.6	87.9	82.3	82.3
US (trade weighted)	86.6	86.3	85.5	85.5
Euro per $	0.73	0.73	0.79	0.79
Euro per £	1.23	1.24	1.23	1.23
Japan (Yen per $)	102.0	102.0	98.0	98.0
Short Term Interest Rates (3-month deposits)				
UK	0.64	0.59	2.10	2.10
US	0.20	0.29	0.70	0.70
Euro	0.27	0.17	0.50	0.50
Japan	0.14	0.11	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	3.30	2.5	2.1	39.00		46.90
US	1.90	2.8	2.0	24.00	8.13	38.83
Germany	2.60	1.5	2.0	37.00	0.98	44.08
Japan	1.80	1.6	2.0	36.00	11.73	53.13
UK indexed[2]	–0.14		2.4	–5.00		–3.04
Hong Kong[3]	2.60	7.0	2.0	7.00	8.13	26.73
Malaysia	2.80	5.2	2.0	53.00	8.13	71.43
Singapore	3.70	4.5	2.0	38.00	8.13	56.33
India	1.40	7.0	2.0	21.00	8.13	39.53
Korea	1.10	4.2	2.0	0.00	8.13	15.43
Indonesia	2.40	6.1	2.0	43.00	8.13	61.63
Taiwan	2.50	3.0	2.0	23.00	8.13	38.63
Thailand	3.20	4.1	2.0	38.00	8.13	55.43

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	2.65	6.50		9.15
US	2.56	4.60	8.13	15.29
Germany	1.26	–2.40	0.98	–0.16
Japan	0.58	–1.20	11.73	11.11

Deposits: Contribution to £ yield of:

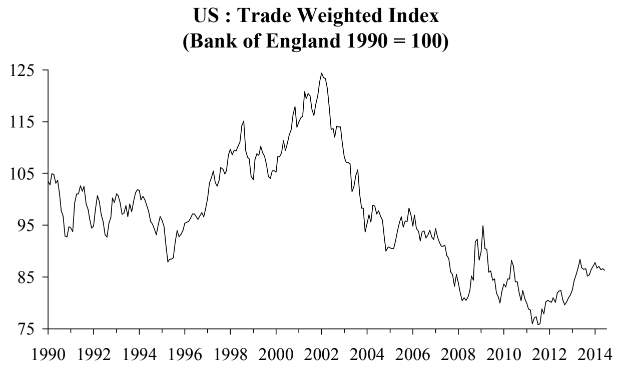
	Deposit Yield	Currency	Total
UK	0.59		0.59
US	0.29	8.13	8.42
Euro	0.17	0.98	1.15
Japan	0.11	11.73	11.84

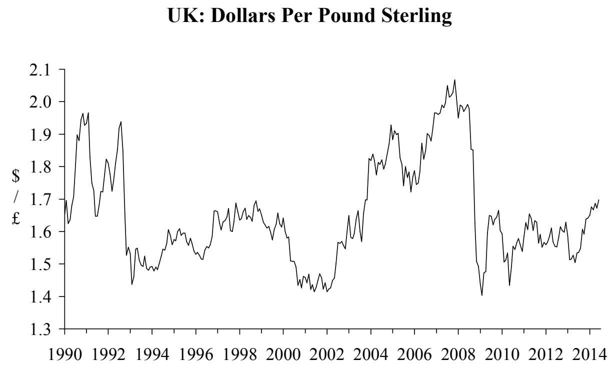
[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

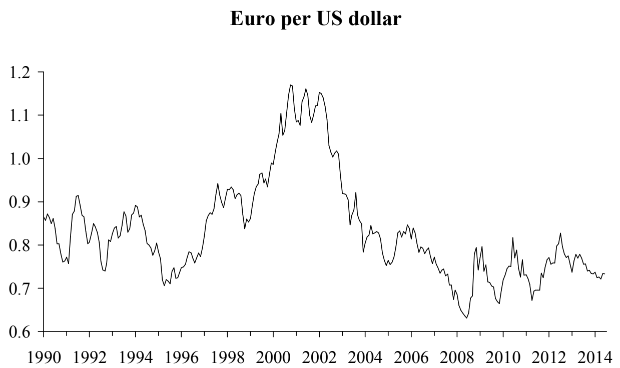
Table 3: Portfolio(%)

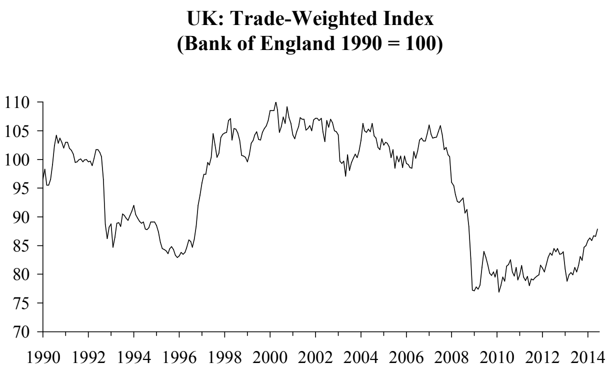
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	June Letter	Current View	June Letter	Current View	June Letter	Current View
UK Deposits (Cash)	5	5	5	5	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-	-
German 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)	-	-	-	-	-	-

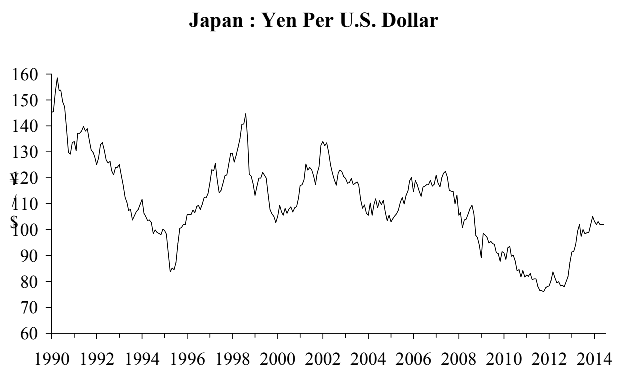
INDICATORS AND MARKET ANALYSIS
FOREIGN EXCHANGE MARKETS







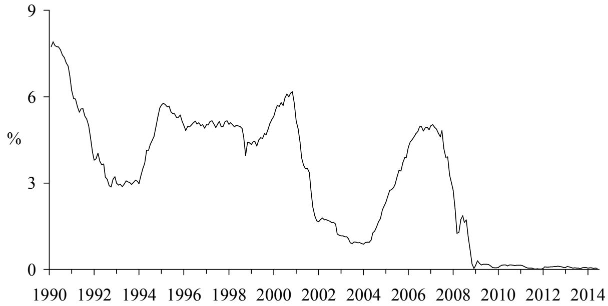




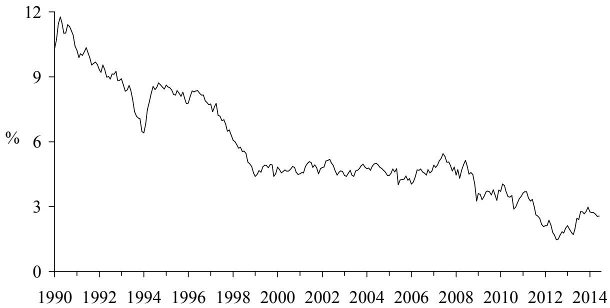
GOVERNMENT BOND MARKETS

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

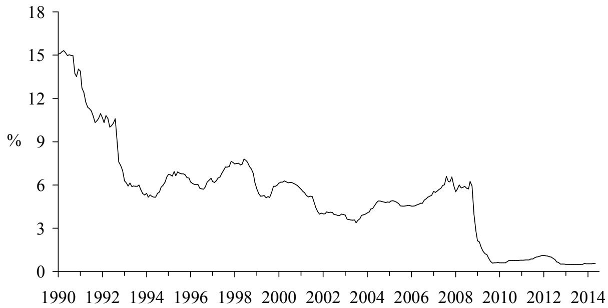
U.S. : 3-Month Treasury Bill



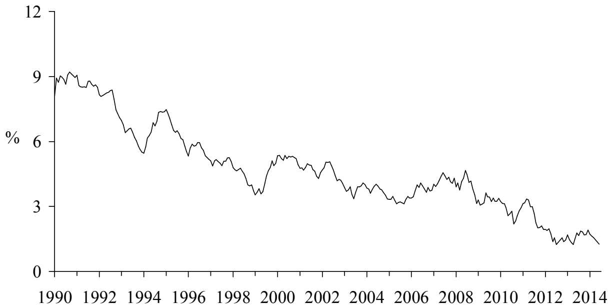
U.K. : Yield on Long-Term Government Bonds



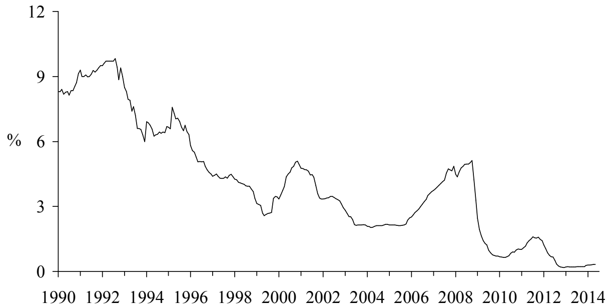
U.K. : 3-Month Interbank Rate



Germany: Yield on Public Authority Bonds

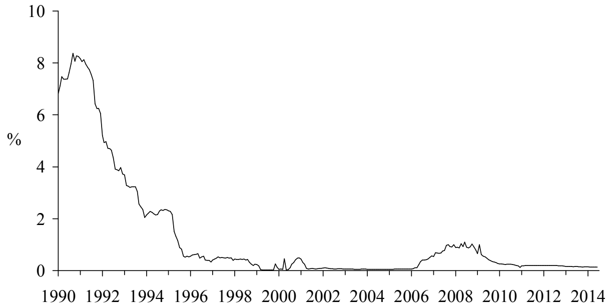


Germany : 3-Month Interbank Deposit Rate

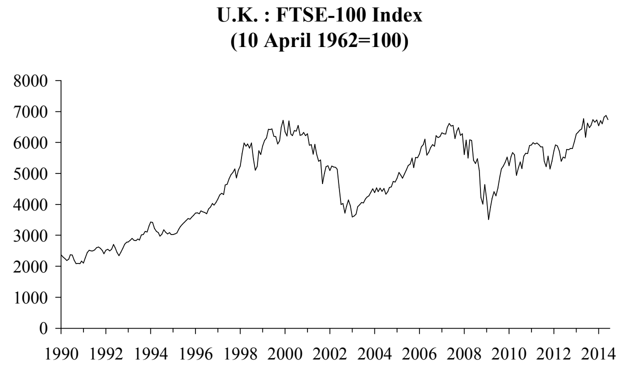


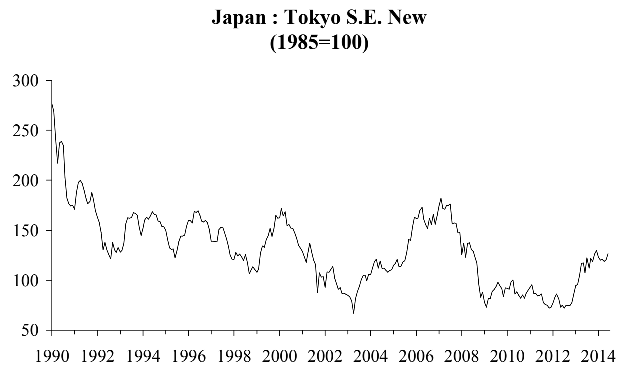
Japan: Yield on Long-Term Government Bonds

Japan : 3 Month Money Market Rate



MAJOR EQUITY MARKETS





EMERGING MARKETS

Anupam Rastogi

India

The Indian economy expanded 4.7% in the last fiscal year. A gradual but uneven recovery is underway and we hope that India will achieve 7% growth rate in one and half years' time. India's electricity output rose 11.2% in May compared to 5.4% in April. This is the fastest growth in the last seven months. There is a gradual improvement in services sector activity as well. However, increasing crude oil prices and a delay in the south-west monsoon will adversely affect growth in the short-term.

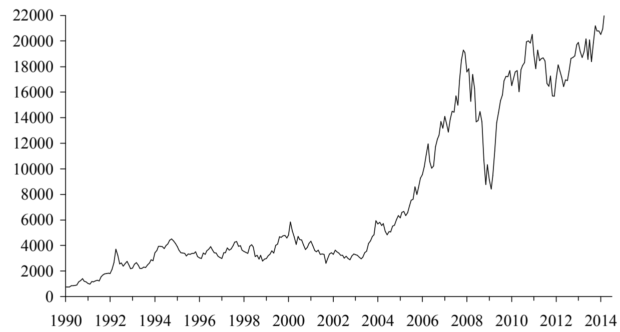
The wholesale price index rose 6.01% from a year earlier in May, faster than the 5.2% increase in April. As the unwinding of subsidies takes place, India may have elevated levels of inflation for some more time. A cut in fuel subsidies as part of fiscal reforms and rise in crude oil prices due to geopolitical tensions will have a cascading impact on general inflation. The consumer-price index inflation rate, which the central bank has started watching, stood at 8.59% in April. The central bank wants the rate to come down to 8% by January 2015 and to 6% a year after that. Until inflation gives way, the central bank is likely to maintain its tight monetary stance. Therefore, the Reserve Bank probably would not be lowering its key interest rate this year. The central bank governor, Raghuram Rajan, believes that keeping inflation in check is the best way to promote sustainable growth. There are many indications that the Modi government will tackle persistent inflation by cutting the budget deficit and by reforming inefficient agricultural marketing networks that restrict food supplies to consumers and push up food prices.

India's merchandise exports grew 12.4% from a year earlier to $28 billion after a 5.3% increase in April. Imports fell 11.4% to $39.23 billion. As a result, India's trade deficit narrowed to $11.23 billion from $19.37 billion a year earlier, although it was wider than April's $10.1 billion.

India's rupee had been strengthening against the dollar and the country's stock market was one of the best-performing markets in the world. The benchmark index has jumped over 20% so far in 2014, its best start to a year in five years and ranking as Asia's top major performer and one of the world's best. Over $8.9 billion has flooded into the country since March, compared to $354 million in the first two months of the year, in the hopes that the new government will step up reforms to lower inflation, improve infrastructure and boost flagging growth that has been at its slowest in a decade.

India's markets regulator has said that government stakes in listed companies must be cut to 75% within three years, in a move set to prompt a spate of disinvestments in state-backed entities that could raise more than $9bn. It is safe to assume that the new government is keen to push forward disinvestment of PSUs. But, any further increase in oil prices could dent valuations, as could a weak monsoon.

India: BSE Sensitive



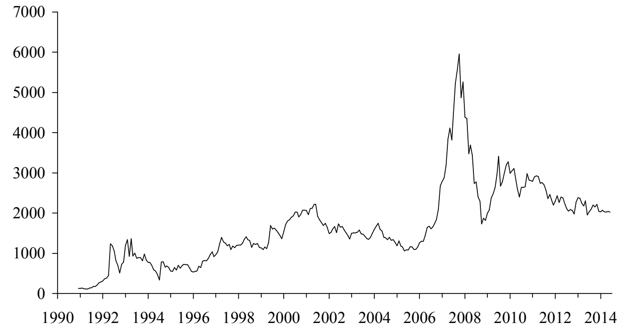
The new government has not disappointed the public at large. It has taken swift action. In the last 30 days in power, the government cleared Rs210 bn worth of projects that were in limbo for a long time. Further, the ministry of road transport cleared Rs400 bn worth of road projects. The government is following efficient governance and prudent economic decision making. Some economic decisions may mean that citizens have to swallow bitter pills in the near term. The Modi government's long-term vision will be rolled out in the forthcoming budget which will be presented on July 10.

The new government this month outlined a plan to improve infrastructure and water supply, and to make investments in high-speed railways. The new administration is looking into allowing more foreign control in other sectors, including defence, railways, construction and online retail through the raising of maximum foreign ownership allowed in companies in each sector. The Department of Industrial Policy and Promotion has circulated a note among ministries which recommends allowing 100% foreign ownership in defence ventures in India. Foreign companies are currently permitted to own only up to 26% stakes in defence companies.

Ironically, Indian President Pranab Mukherjee presented a supply-side revolution of the new government. He, as a finance minister in 2011, had introduced retrogressive tax proposals which undermined confidence of foreign as well as domestic investors. In his new avatar, he declared far reaching liberal intentions of the government. Embracing foreign investment and free trade is the natural extension of a supply-side philosophy, since foreign competition will spur Indian companies to become more productive. The government hasn't articulated a trade-liberalization agenda, but becoming part of global supply chains will create incentives to reduce import barriers. The government is unlikely to name their reforms as a supply-side revolution, but they reprise a proven formula to rejuvenate economy stuck in stagflation. The president's speech promised "rationalization and simplification of the tax regime to make it non-adversarial and conducive to investment, enterprise and growth."

	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: SSE Composite Index



China

There are growing anxieties about China's slowing growth. The Chinese economy expanded 7.4% in the first quarter of the year, down from an increase of 7.7% in the fourth quarter of last year. Economic growth seems to have bottomed out. The non-manufacturing Purchasing Managers' Index rose to 55.5 in May from 54.8 in April and in June also, HSBC China flash manufacturing purchasing managers' index has marginally improved. It is in the plus-50 expansionary state for the first time in seven months.

The consumer-price index advanced 2.5% year-on-year in May after a 1.8% rise in April, according to the National Bureau of Statistics. However, inflation remains well below the government's target of 3.5% for the full year. Keeping in line with the government's intention to provide credit to small businesses, the People's Bank of China has made a "targeted cut" in the portion of deposits that banks need to keep on reserve. It trimmed the rate by half a percentage point for banks that lend to the rural sector and smaller companies. This move will free up more money for banks to lend to small businesses.

China posted unusually high export gains in May, pointing to improving global demand for the nation's goods and weak imports in the same month suggesting weak domestic demand. Exports climbed 7% year over year in May compared to 0.9% growth in April.

China's housing slump is affecting the overall economy now. The dilemma that the government faces is that growth in China can either be robust, or consumption-led, but not both. There are three reasons for this. First, high investment growth in the past few years has added capital and supported labour income and hence consumption. Lower investment growth would weaken that support. Second, consumption-led growth needs a well-allocated stock of capital that can generate consistent returns and income growth. China does not have this as of now. Finally, the historical precedent of Japan and Korea suggests that as consumption as a share of GDP increases the share of investment in GDP falls.

In mid-June, the Chinese currency rose 0.5% against the US dollar over five days, the most since 2011. We believe that the long-term underlying trend of China hasn't changed. The country's current account is still in surplus and its growth rate is still much faster than most countries.

China's central bank announced a package of measures which will give the U.K. a boost in its bid to be a leading centre for Yuan trading. The People's Bank of China has allowed direct exchanges between the yuan and the pound in an effort to expand bilateral trade. Previously, traders have had to exchange the currencies through the U.S. dollar, which added to transaction costs. Further, China Construction Bank, a leading government owned bank, would work as a clearing house for the yuan trade.

China is working seriously to establish a global financial institution which may compete with the World Bank and the Asian Development Bank in future. Beijing has the long standing complaint that multi-lateral institutions such as the World Bank, IMF and the ADB are influenced by the US and its allies.

Many countries across the region and the Middle East have shown interest in the multilateral lender. The new institution would be known as the Asian Infrastructure Investment Bank. It would initially focus on building a new version of the "silk road", the ancient trade route that once connected Europe to China. Most of the funding for the lender would come from China and be spent on infrastructure projects across the region, including a direct rail link from Beijing to Baghdad.

	11	12	13	14	15
GDP (%p.a.)	9.2	7.7	7.7	7.4	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

Supported by global demand, the export led South Korean economy continues to grow at a healthy pace of 4%. South Korea's inflation rate rose 1.7% in May from a year ago — the fastest pace for more than a year due to higher utility costs. Inflation is still well below the central Bank of Korea's target inflation rate of 2.5–3.5%.

The central bank has held its key policy rate at 2.5% since May last year. The market expects an increase next quarter. But, any indication of growth slackening or won appreciation may push it to next year.

The rising won is driven mostly by huge current account surpluses and an upbeat economic outlook of the economy. This is keeping local inflation low but export oriented industries are are losing price competitiveness globally and experiencing shrinking profits from export earnings.

South Korea recorded a decade-high goods trade surplus in April. The goods trade surplus was almost $10.7bn on the back of rising demand for South Korea's ships, cars and smartphones.

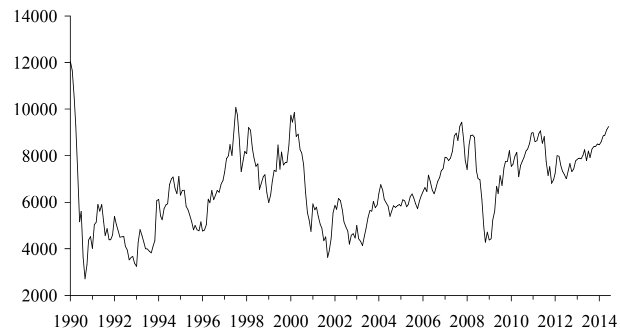
Besides goods trade surplus, other factor pushing won appreciation is capital inflows. Portfolio investment has been a major factor guiding the won. Bond buying has also been strong with overseas sovereign wealth funds and central banks adding billions of dollars to their Korean debt holdings this year.

Recently President Park Geun-hye's government has come under fire. She replaced nearly half of her cabinet ministers, including the finance minister, in her latest attempt to recover from public criticism of the government's handling of the recent ferry disaster and to kick-start her economic plans.

	11	12	13	14	15
GDP (%p.a.)	3.6	2.0	2.8	4.0	4.2
Inflation (%p.a.)	4.0	2.2	1.3	2.5	2.5
Current A/c(US$ bill.)	27.0	44.0	71.0	80.0	80.0
Won/$(nom.)	1100	1100	1100	1020	1000

Korea: Composite Index

Taiwan: Weighted TAIEX Price Index



Taiwan

Taiwan gross domestic product is expected to grow 3% in 2014 compared to 2.11% growth in 2013. Even though exports may grow marginally slower than the previously estimated growth rate of 3.33%, growth of private consumption and corporate investment will drive economic growth in 2014.

Inflation in Taiwan will remain benign, giving the central bank room to keep monetary conditions accommodative to encourage more economic growth. The consumer-price index is forecast to rise 1.53% in 2014, up from 1.07% previously.

Export orders rose 4.7% in May to $38.02 billion, slowing the rate of growth from the 8.9% rate in April. The slowdown was expected as Taiwan's export orders — an early indicator of actual exports — grew at their fastest pace in more than a year in April. May exports were up 1.4% from a year earlier. Imports in May were down 2.3% from a year earlier, to $21.38 billion, after April's 5.80% rise. With exports up and imports down, the trade surplus in May widened to $5.29 billion from $4.43 billion a year earlier. Taiwan's exporters of electronic goods are a little worried because Taiwan's screens have been losing market share to South Korean and Chinese rivals, which have invested heavily in advanced and lower-cost technology for years. TV, computer and smartphone makers in China have also increasingly relied on locally produced panels, and have placed fewer orders on Taiwanese manufacturers.

Never the less, a surge of cash into Taiwan has sent stocks to their highest level since 2007, as enthusiasm grows over the island's technology companies. Global money managers have pumped in $9.6 billion so far this year, more than three times the $2.7 billion total for all of 2013. It is the fastest pace since 2009, and puts Taiwan second only to India among Asian destinations for foreign funds.

	11	12	13	14	15
GDP (%p.a.)	4.0	1.3	2.1	3.0	3.0
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

The Brazilian government is worried about stagflation and public discontent emanating from slow growth and poor governance. Once a dynamic member of the Bric club, Brazil is suffering from the effects of overheating and the eurozone crisis. The Brazilian government plans to announce more measures to help spur industry and boost the slowing economy.

Economic growth this year is expected to be around 1.4% and 2% next year. This would be the fourth year of subpar growth, and there is little hope of a recovery in the medium term.

Brazil's economy is restricted by an imbalance between consumption and investment. The wealth that flooded the country during the past decade's commodity boom was used to create a new middle class of consumers rather than to upgrade the country's roads, ports, factories and machinery. This has left Brazil's economy short of productive capital which could sustain faster growth rates. Despite recent government efforts to draw private investors into the country's infrastructure sector, gross investment in the January to March period contracted 2.1%.

Inflation is running at around 6.5% a year, prompting the central bank to raise its benchmark rate to 11% over the last year. The central bank has hit the pause button on its lengthy monetary tightening cycle, keeping borrowing costs on hold for the time being. The central bank had raised the benchmark Selic rate from 7.5% last April as it struggled to tame soaring inflation caused by food supply shocks and high fuel costs. Brazil's current account deficit stays above 3%. This is not alarming but is a cause of concern in the market.

Disapproval of President Dilma Rousseff, who comes up for re-election in October, is widespread. To bolster the private sector Brazil's Finance Minister Guido Mantega announced that the government will make a tax-credit program for exporters permanent. It will also extend another business credit program valued at 80 billion reais ($36 billion) a year which was set to expire at the end of 2014. The budget for the extension is yet to be decided. The new measures are likely to increase competitiveness of exporters.

A majority of Brazilian public feels that hosting the World Cup has cost too much for a country with shabby infrastructure and many basic needs. The President has tried to answer the disgruntled public by saying that, "We have built, remodelled and expanded airports, ports, roads, bypasses, bridges, rapid transit routes and advanced public transportation systems". This was done "first and foremost, for Brazilians" and these projects "will not go back with the tourists in their suitcases."

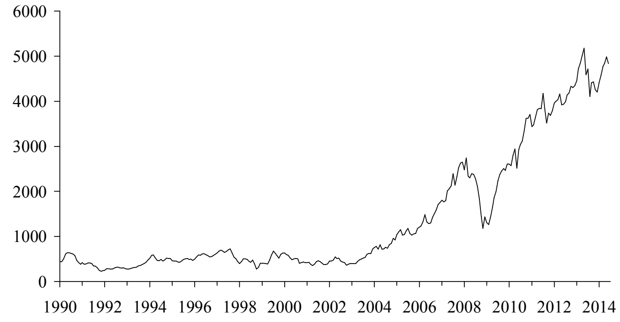
Surprisingly, in the latest poll of Brazilian voters, President Dilma Rousseff has regained advantage over her main contenders in October's presidential election, ending consecutive declines in voters' intention so far this year despite the country's flagging economy performance. Until last year, Ms. Rousseff held a commanding lead in polls, but several years of poor economic activity, inflation pressures, and a series of protests and strikes have impacted her popularity. Brazil's presidential election is set for Oct. 5, with a second round, if needed, scheduled for Oct. 26.

	11	12	13	14	15
GDP (%p.a.)	2.7	0.9	2.5	1.4	2.0
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	2.35	2.4

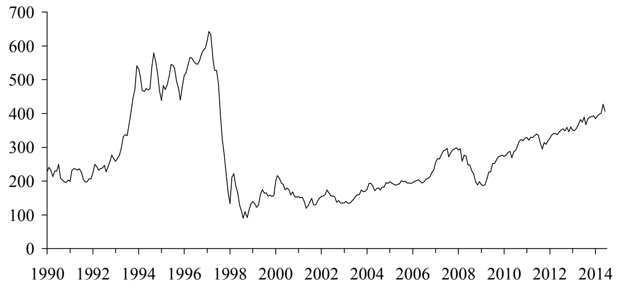
Other Emerging Markets

Hong Kong: FT-Actuaries

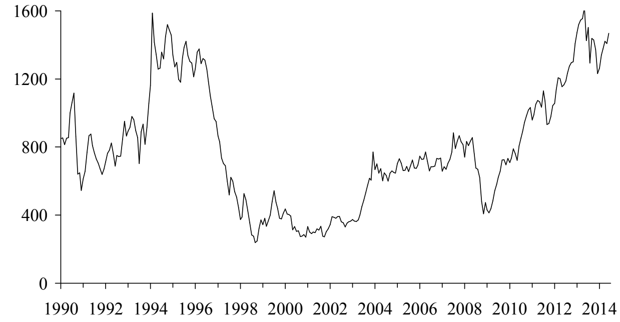
Indonesia: Jakarta Composite



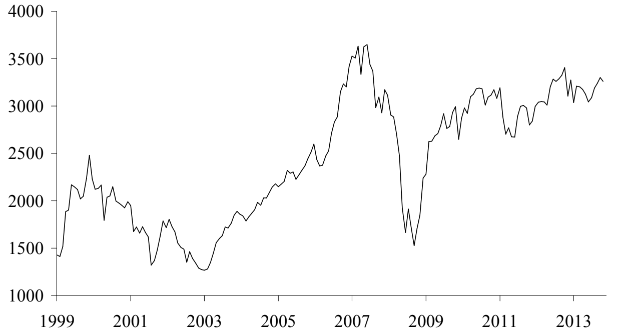
Malaysia: FT-Actuaries (US$ Index)



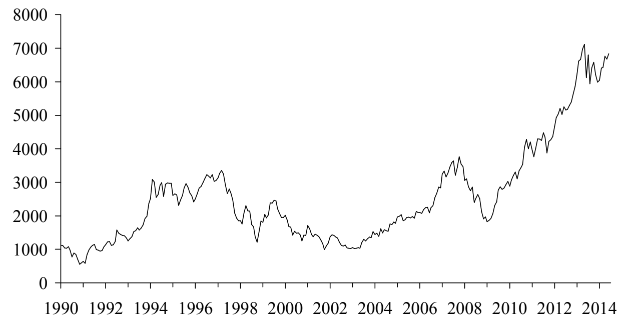
Thailand: Composite Index



Singapore: Straits Times Index

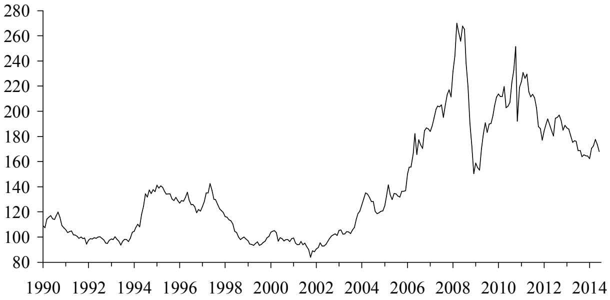


Philippines: Manila Composite

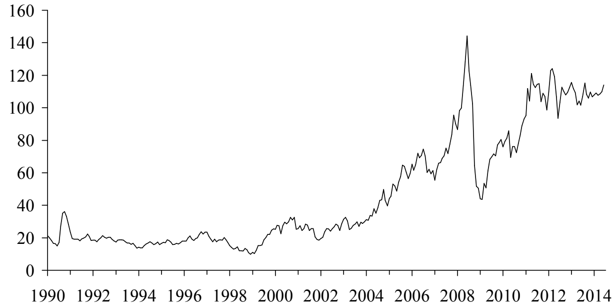


COMMODITY MARKETS

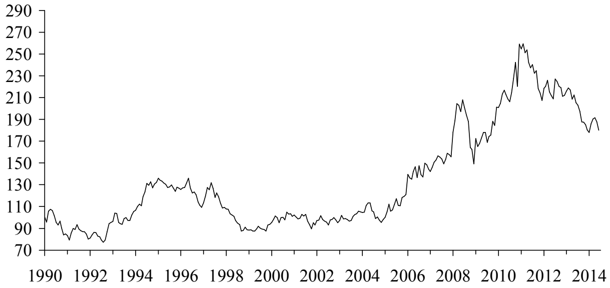
Commodity Price Index (Dollar)
(Economist, 2000=100)



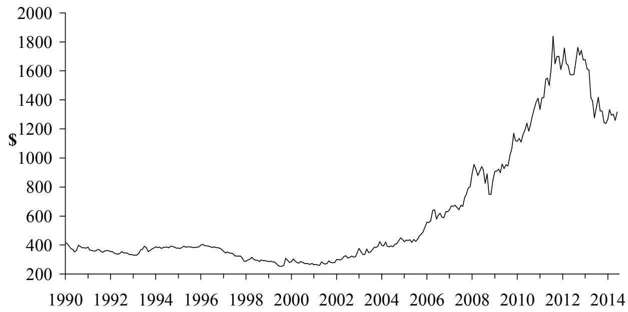
Oil Price: North Sea Brent (in Dollars)



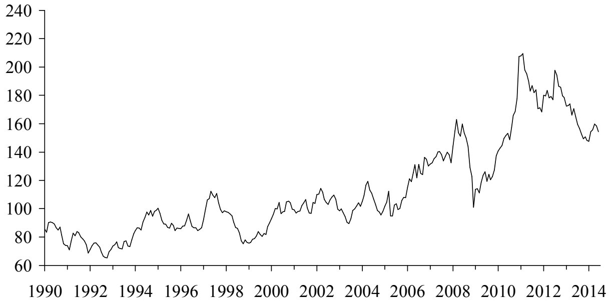
Commodity Price Index (Sterling)
(Economist, 2000=100)



Gold Price (in Dollars)



Commodity Price Index (Euro)
(Economist)



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

	2009	2010	2011	2012	2013	2014
U.S.A.	–2.6	2.4	1.8	2.2	2.2	2.8
U.K.	–3.9	1.7	1.1	0.2	1.7	2.8
Japan	–6.3	4.7	–0.5	1.9	1.8	1.6
Germany	–4.7	4.2	3.0	0.7	0.6	1.5
France	–2.5	1.6	2.0	0.0	0.2	0.7
Italy	–5.1	1.7	0.5	–2.4	–1.8	0.4

Growth Of Consumer Prices

	2009	2010	2011	2012	2013	2014
U.S.A.	–0.3	1.6	3.1	2.1	1.6	2.0
U.K.	1.3	3.3	4.5	2.7	2.4	2.0
Japan	–1.4	–0.7	–0.3	0.0	0.0	2.0
Germany	0.4	1.2	2.0	2.0	1.7	2.0
France	0.1	1.5	2.1	2.0	1.1	1.5
Italy	0.8	1.5	2.8	3.0	1.4	1.6

Real Short-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	–1.6	–3.0	–1.8	–1.9	–1.3	–1.2
U.K.	–0.3	–3.5	–2.8	–1.8	–1.7	–1.6
Japan	1.1	0.4	0.4	0.3	–1.6	–1.6
Germany	–0.4	–1.9	–0.5	–1.5	–1.5	–1.4
France	–0.8	–1.7	–0.5	–1.4	–1.5	–1.4
Italy	–0.8	–2.4	–1.5	–2.6	–2.0	–1.4

Nominal Short-Term Interest Rates

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

Real Long-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	1.3	1.0	0.9	–0.2	0.1	0.6
U.K.	–0.3	–0.2	–0.2	–1.4	–1.0	–0.5
Japan	1.2	0.4	–0.2	–0.8	–1.3	–1.1
Germany	2.2	1.8	–0.1	–0.4	–0.5	–0.1
France	2.2	1.9	–0.1	–0.4	–0.5	–0.1
Italy	1.5	1.2	–0.7	–0.8	–0.6	–0.1

Nominal Long-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	3.2	3.1	1.9	1.8	2.1	2.6
U.K.	2.8	2.4	2.0	0.9	1.2	1.6
Japan	1.3	1.1	1.0	0.8	0.7	0.9
Germany	4.0	3.8	1.8	1.5	1.5	1.9
France	4.0	3.8	1.8	1.5	1.5	1.9
Italy	4.0	3.8	1.8	1.5	1.5	1.9

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

	2009	2010	2011	2012	2013	2014
U.S.A.	88.7	87.4	85.7	90.4	97.3	99.1
U.K.	76.7	88.6	89.8	93.9	92.5	94.1
Japan	89.0	92.0	97.1	98.3	119.7	122.0
Germany	105.8	102.9	105.5	104.3	107.4	108.2
France	104.3	103.1	105.5	104.9	107.9	108.6
Italy	105.4	103.6	106.9	107.4	111.8	113.2

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

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

	2009	2010	2011	2012	2013	2014
U.S.A.[1]	85.98	83.73	78.08	80.90	85.50	85.40
U.K.	1.57	1.58	1.61	1.59	1.55	1.55
Japan	93.54	87.48	79.36	80.51	98.00	98.00
Eurozone	0.72	0.75	0.71	0.78	0.79	0.78

[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