

LIVERPOOL INVESTMENT LETTER

July 2013



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.

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THE MONETARY POLICY AND REGULATORY CAR CRASH

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

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

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

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

Ultimately we should blame us economists not the politicians, because it is we who failed to have these

Table 1: Summary of Forecast

	2010	2011	2012	2013	2014	2015	2016
GDP Growth ¹	1.8	0.9	0.1	0.8	2.0	2.4	2.6
Inflation							
CPI	3.7	4.7	2.8	2.8	2.6	2.2	2.0
RPIX	4.8	5.3	3.3	3.3	3.1	2.8	2.7
Unemployment (Mill.)							
Ann. Avg. ²	1.5	1.5	1.6	1.5	1.4	1.3	1.2
4th Qtr.	1.5	1.6	1.6	1.5	1.3	1.2	1.1
Exchange Rate ³	80.4	80.0	83.0	83.5	82.7	82.1	81.5
3 Month Interest Rate	0.7	0.9	0.9	0.9	1.7	2.1	2.2
5 Year Interest Rate	2.4	2.0	0.9	1.3	1.8	2.1	2.4
Current Balance (£bn)	-37.3	-20.4	-51.9	-52.2	-52.8	-53.0	-52.0
PSBR (£bn)	115.1	94.2	95.4	98.2	84.7	72.2	60.5

¹Expenditure estimate at factor cost

²U.K. Wholly unemployed excluding school leavers (new basis)

³Sterling effective exchange rate, Bank of England Index (2005 = 100)

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

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

Where does this leave ‘macro-prudential’ policy? Regulations have the effect of raising the cost of credit — and so the ‘credit frictions’ in the economy. This is damaging to economic welfare — the only rationale for it is that it reduces the chances of a future banking crisis. But if monetary policy were reset as above this need would be met in that way, at no cost to the economy: one can think of monetary stability as ensuring that the cost of credit is kept at the socially optimal level, allowing for the desired underlying credit friction. Thus in booms it would stop the credit cost falling unnaturally low; and vice versa in

slumps. In these circumstances all that regulation should do is set a 'basic' level of regulative constraint on grounds of social 'bank safety' factors — this in turn would supply the underlying desired credit friction. There is no need for regulation to vary 'macro-prudentially'; and this basic level of regulation would be the minimal one required to offset the moral hazard created by deposit insurance. It should not discriminate against 'risky' lending to small businesses. Rather it should be set in relation to the whole bank portfolio's diversified risk level; a minimum capital ratio should be set that would prevail for a band of risk around some normal level on the whole portfolio. In this way we should get away from the cost of funds for loans to SMEs attracting a much higher cost because their individually higher risk causes extra capital to be raised.

What is to be done now?

As through a glass darkly the coalition and their civil servants in Whitehall and Threadneedle Street have begun to realise that their regulatory actions have blocked the credit channel; so more recently we have had Funding for Lending schemes 1 and 2, followed by the Mortgage subsidy for first time buyers. These do appear at last to be having an effect on the housing market and on lending conditions for small businesses — the ice blocking the credit channel appears to be cracking slightly. The economy appears to be picking up towards moderate growth. This has been helped by less grasping policies towards North Sea oil and gas producers, so that now we are seeing North Sea oil output bottoming out in line with banking and construction, the latter two aided by this credit channel thaw.

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

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

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

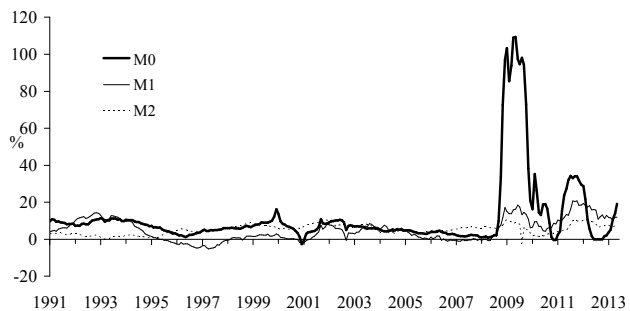
Second, what of official interest rates at the zero bound? Ronald Mackinnon in persuasive recent work has shown that if central banks swamp the banks with bank reserves at next to zero interest rates, then banks will not use the interbank market for very short term financing; rather they have all they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

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

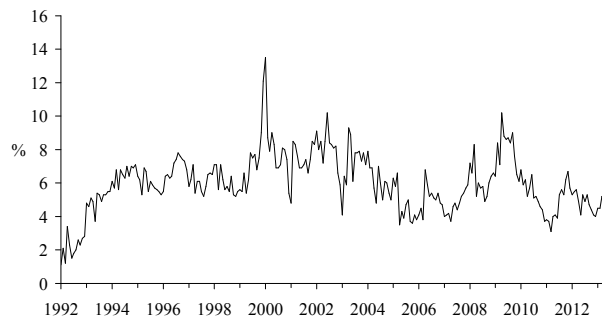
These are transitional measures needed to bring monetary policy back on track as the effects of regulation on the credit channel are eased off. In the longer term we need to get credit and money growth back on track; once that is achieved interest rates will be back at normal, QE unwound so that the monetary base too is back at a normal level of bank reserves. We must hope too that regulation has been cut back to a much less intrusive level.

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

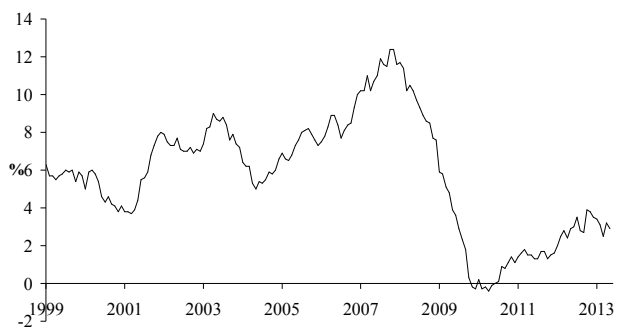
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



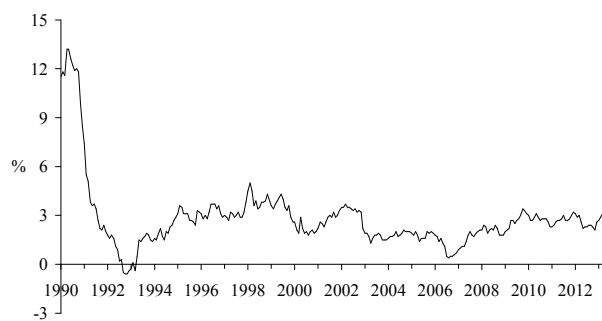
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Abe's third arrow misses mark

Following a speech on June 5, Prime Minister Shinzo Abe launched the third arrow of his economic strategy by presenting a structural reform plan for pulling the country out of its slump. The specific measures described in the plan were in general not new but the speech attracted great expectations amongst international observers because the third arrow was to bring those long-awaited structural reforms Japan needs to boost its long-term economic performance. “Now is the time for Japan to be an engine for world economic recovery”, Abe said. “Japanese business, what is being asked is that you speed up. Do not fear risk, be determined and use your capacity for action”.

However, the plan left many disappointed. Little has been included on the key issues of the labour market, health care, agriculture and broader business deregulation, critics say. Keidanren, a powerful lobby group for big firms which is a strong backer of the LDP, said it is only half a reform. It throws its weight behind labour-market liberalisation, but also opposes more outside oversight of its own members. Insiders say that LDP members — who represent vested interests, notably farmers, doctors and businesses — pressed forcefully to make sure Abe did not announce anything too radical ahead of July's crucial election for the upper house of parliament.

Some observers say the storyline of Abe's speech was to some extent encouraging as it left open the possibility of more meaningful change in the future once the party wins control in the next general election. Abe stressed the importance of the private sector and of regulatory reform. He said the government aims to establish “the best country for corporations to operate in the world” and that this will be the objective of regulatory reform. Abe also discussed the privatization of “government enterprises” in the energy, medical, and infrastructure sectors. Most importantly, he said that this growth strategy is just the beginning, meant to open a window for more meaningful, specific measures that may change the supply-side of the economy.

So far Abe's strategy, named Abenomics, has focused on what he calls the first “two arrows” in his arsenal. The first one involved aggressive monetary policies and a revolution at the Bank of Japan (BOJ). Abe moved to replace the governor of the BOJ, Masaaki Shirakawa, with the president of the Asian Development Bank, Haruhiko Kuroda, who was more willing to implement bold policies — in the past few months Kuroda has engaged in historically unprecedented amounts of quantitative easing and has set out an inflation target of 2%. The second “arrow” was fiscal policy. Abe decided to increase Japan's fiscal spending by 2% of its total GDP with a launch of a fiscal stimulus package worth ¥10.3 trillion.

Structural reform strategy is the most likely of the three to face difficulties. The third arrow policies should raise the economy's potential growth rate through promoting effective investment and deep reform of the supply side of the economy, including the labour market. In particular, the announced measures aim at fostering the health care industry, increasing female participation in the workforce, promoting capital investment, boosting agricultural productivity and spurring entrepreneurship. According to economists at Morgan Stanley, some of the measures, by addressing specific needs within sectors like agriculture and energy, will enhance overall efficiency and productivity. For example, Japan's agricultural sector has a major global opportunity, but is marked by low productivity and a hamstrung distribution system. Proposed measures include Japanese participation in the Trans Pacific Partnership negotiations, easing agricultural land leasing laws and making it easier for corporations to create farms, thereby increasing efficiency and bringing more investment to the sector. However, according to this study, deregulation and reform measures devoted to this sector and to other several key areas such as medical care, education, the tax system and the labour market are not powerful enough.

Regarding the tax system for instance, while the plan includes a range of targeted business tax breaks, it doesn't provide the across-the-board tax relief endorsed by many business groups. Japan's corporate-tax rate is the second-highest of OECD countries after the US, and is more than 10 percentage points higher than the global average.

Critics said Abe is also avoiding unpopular reform in the labour market. The reform includes a plan to raise the labour force participation rate of the 20-64 age group from 75% now to 80% by 2020, and a plan to increase labour-market flexibility. However, rather than allow companies to quickly shed workers deemed unnecessary — a total the government estimates at 4.6 million — it does so with a series of new regulations, such as creating more job-matching and outplacement services, and creating a new category of workers who, once hired, could be let go more easily.

The key question is whether these strategies will be carried out properly. What will motivate the authorities, who remain heavily influenced by vested interests, to shoot the third arrow straight? Over the last two decades we have witnessed Japanese governments campaigning on supply-side measures to enhance the economy's potential capacity, claiming these as the priorities for ending deflation, spurring private-sector investment and reinvigorating businesses. However they came to nothing. One reason advocates give for optimism this time is that Abe appears likely to have more clout, and staying power, than many of his predecessors. His ruling LDP is widely expected to win

a landslide victory in July elections, which would give him solid control of the legislature and an ability to push through his agenda. However, Abe is pushing anyway against adverse trends including a contraction of the working-age population, obsolescence of the capital stock, a decline in capital utilization stemming from industrial “hollowing out”, and a deceleration in technological

innovation. If he does not follow up, as seems likely given the strong political drag of vested interests in the disproportionately powerful rural constituencies, then his monetary and fiscal policy measures will simply result in a more rapid deterioration of the fiscal position, higher inflation and higher interest rates. At this stage there is no basis for assuming otherwise.

MARKET DEVELOPMENTS

The Fed's hints that it will taper off QE has caused a big sell-off in bonds, which has been well expected. It has also upset equity markets which have been buoyed by QE. There must be some uncertainty about equity returns as QE is gradually stopped; QE has boosted equities as investors

have searched for returns on assets other than bonds, which have been so heavily bought up by central banks under the QE programmes. Nevertheless as recovery proceeds equities should still offer good returns, even if there will be bumpy episodes as QE is first turned off and then reversed.

Table 1: Market Developments

	Market Levels		Prediction for May/June 2014	
	May 28	Jun 26	Previous Letter View	Current View
Share Indices				
UK (FT 100)	6762	6165	9122	8835
US (S&P 500)	1660	1603	2112	2049
Germany (DAX 30)	8481	7941	11576	11078
Japan (Tokyo New)	1168	1069	1596	1516
Bond Yields (government long-term)				
UK	1.95	2.46	1.80	1.80
US	2.14	2.54	2.10	2.10
Germany	1.50	1.77	1.50	1.50
Japan	0.91	0.88	0.70	0.70
UK Index Linked	-0.36	-0.11	-0.20	-0.20
Exchange Rates				
UK (\$ per £)	1.50	1.50	1.56	1.53
UK (trade weighted)	79.9	81.2	82.3	82.3
US (trade weighted)	88.4	86.8	85.5	85.5
Euro per \$	0.78	0.77	0.79	0.79
Euro per £	1.17	1.16	1.23	1.23
Japan (Yen per \$)	102.0	97.4	98.0	98.0
Short Term Interest Rates (3-month deposits)				
UK	0.57	0.57	1.70	1.70
US	0.33	0.33	0.70	0.70
Euro	0.15	0.15	0.50	0.50
Japan	0.09	0.15	0.70	0.70

Table 2: Prospective Yields¹

Equities: Contribution to £ yield of:						
	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.70	1.8	2.5	31.00		47.00
US	2.00	2.2	1.6	23.00	-1.99	27.81
Germany	3.30	0.8	1.7	34.00	-4.78	38.02
Japan	2.00	1.6	0.0	35.00	-2.62	41.18
UK indexed ²	-0.11		2.5	-5.00		-2.61
Hong Kong ³	2.70	7.0	1.6	15.00	-1.99	22.31
Malaysia	2.90	5.2	1.6	48.00	-1.99	63.71
Singapore	3.60	3.7	1.6	23.00	-1.99	40.91
India	1.60	6.0	1.6	21.00	-1.99	25.21
Korea	1.20	2.8	1.6	-2.00	-1.99	-4.39
Indonesia	2.60	6.0	1.6	48.00	-1.99	57.21
Taiwan	3.40	2.6	1.6	37.00	-1.99	38.61
Thailand	3.20	4.7	1.6	40.00	-1.99	56.51
Bonds: Contribution to £ yield of:						
	Redemption Yield	Changing Nominal Rates	Currency	Total		
UK	2.46	6.60				9.06
US	2.54	4.40	-1.99			4.95
Germany	1.77	2.70	-4.78			-0.31
Japan	0.88	1.80	-2.62			0.06
Deposits: Contribution to £ yield of:						
	Deposit Yield	Currency	Total			
UK	0.57		0.57			
US	0.33	-1.99	-1.66			
Euro	0.15	-4.78	-4.63			
Japan	0.15	-2.62	-2.47			

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.

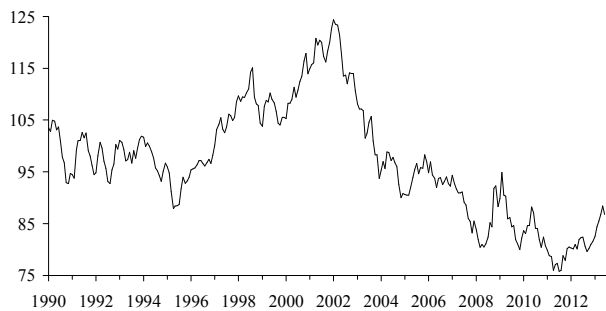
Table 3: Portfolio(%)

	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)	-	-	-	-	-	-

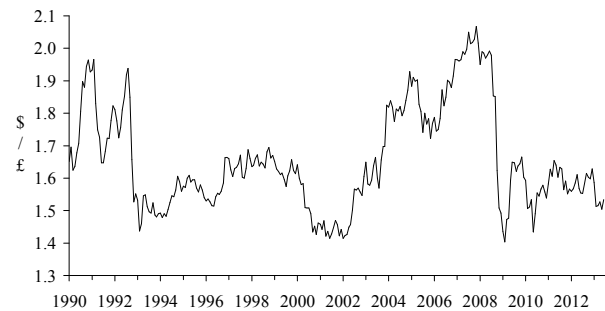
INDICATORS AND MARKET ANALYSIS

FOREIGN EXCHANGE MARKETS

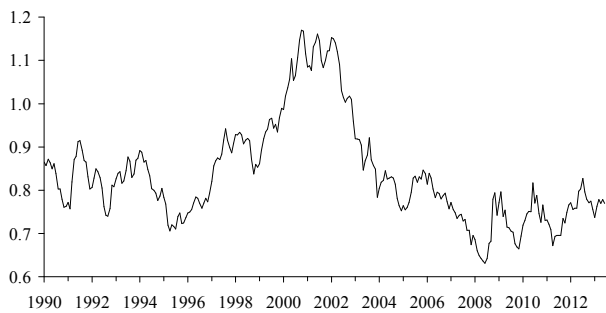
**US : Trade Weighted Index
(Bank of England 1990 = 100)**



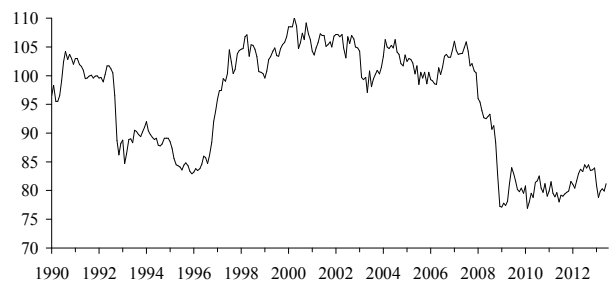
UK: Dollars Per Pound Sterling



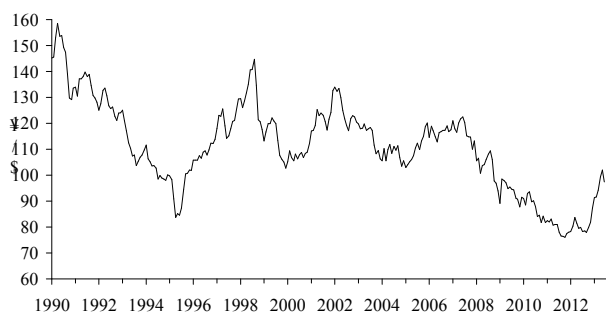
Euro per US dollar



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

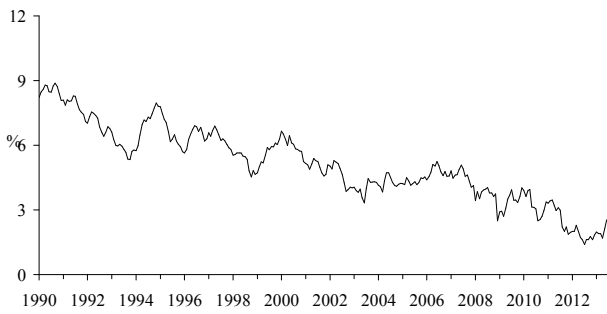


Japan : Yen Per U.S. Dollar

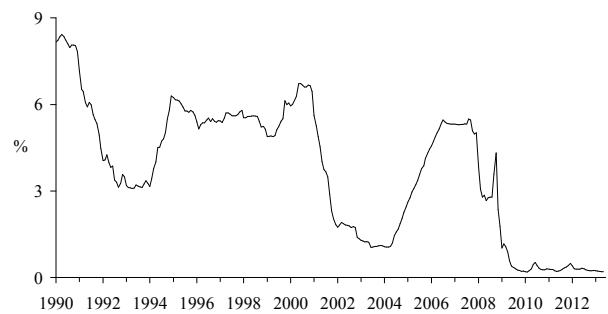


GOVERNMENT BOND MARKETS

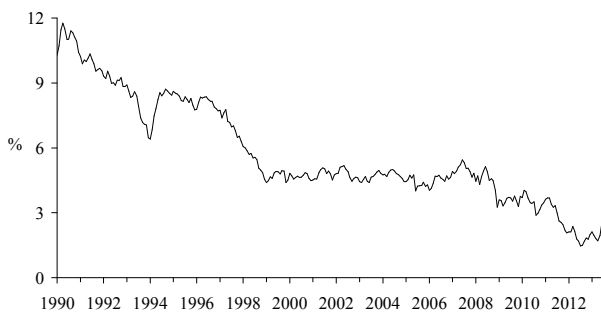
U.S.: Yield on Long-Term Government Bonds



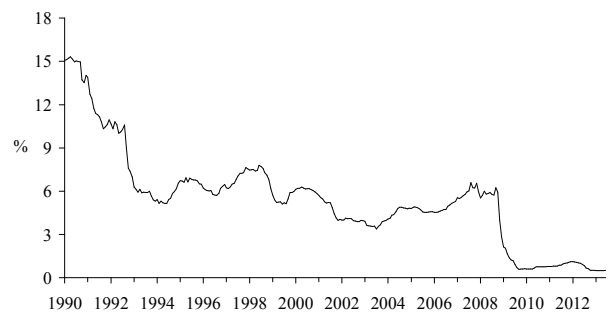
U.S. : 3-Month Certificate of Deposit



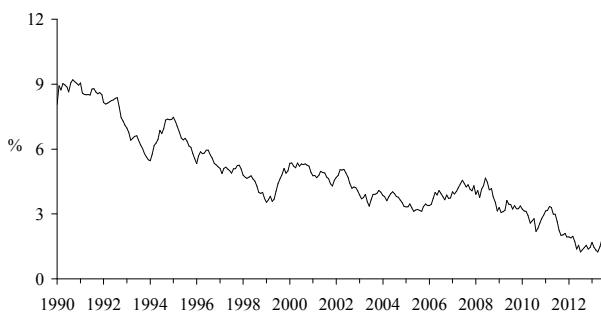
U.K. : Yield on Long-Term Government Bonds



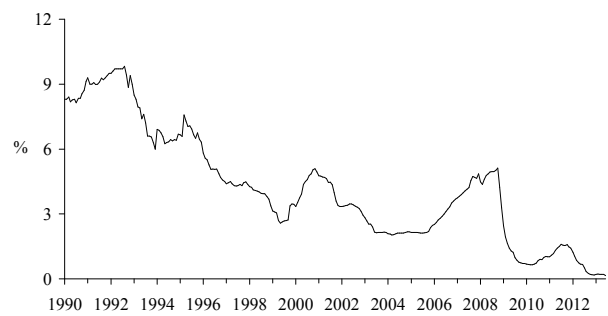
U.K. : 3-Month Interbank Rate



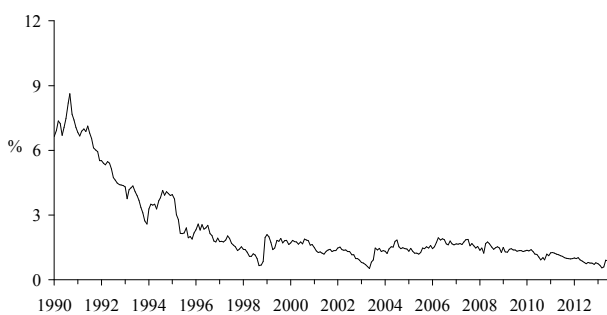
Germany: Yield on Public Authority Bonds



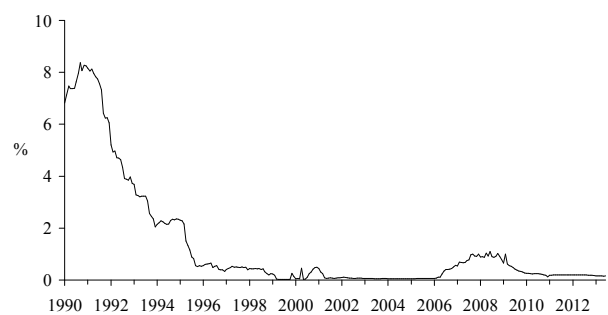
Germany : 3-Month Interbank Deposit Rate



Japan: Yield on Long-Term Government Bonds

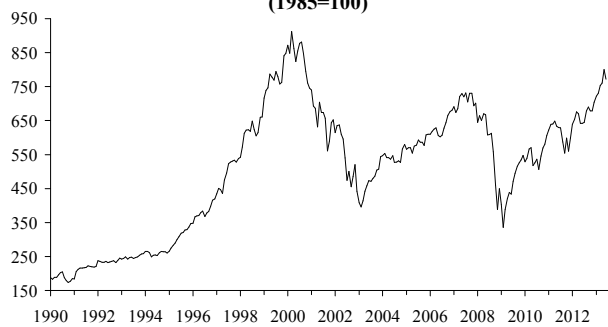


Japan : 3 Month Money Market Rate

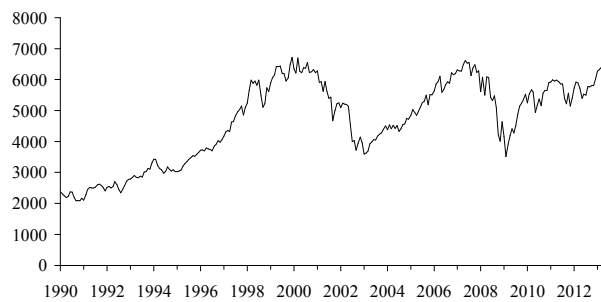


MAJOR EQUITY MARKETS

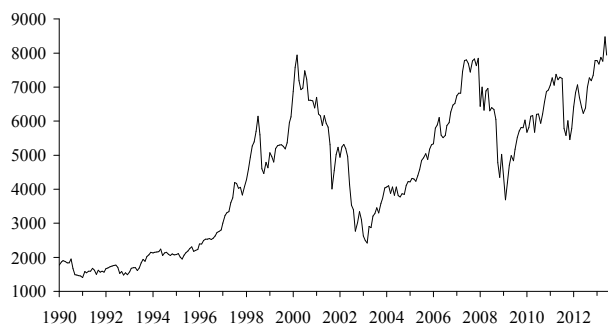
**U.S. : S & P 400 Industrial
(1985=100)**



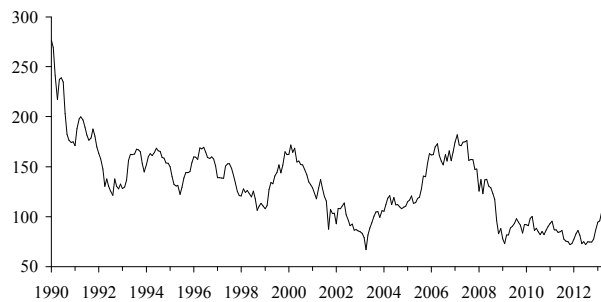
**U.K. : FTSE-100 Index
(10 April 1962=100)**



Germany : DAX 30



**Japan : Tokyo S.E. New
(1985=100)**



EMERGING MARKETS

Anupam Rastogi

India

BRIC countries seem to be falling apart. Commodity based countries such as Russia and Brazil have seen their growth rates reduce sharply. China, which was dependent on exports and investments, has experienced a sharp reduction in growth rate and there may be some more pain to come. India, which was advertised as a domestic consumption story, has also experienced a significant reduction in growth rates. Its five year plan target (2012-17) which was to grow at the rate of 9% per annum, is likely to turn out to be just about 5.5% per annum. For this sorry state no one but India herself has to be blamed for poor governance and ad-hoc policy changes which have discouraged potential investors. It is widely expected that the new federal government which will be in office in less than a year's time would provide a fillip to the economy and new direction.

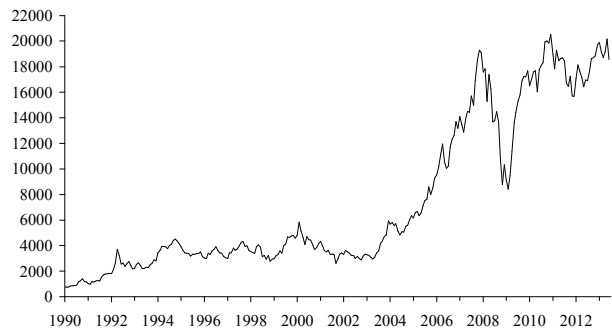
India Manufacturing Purchasing Managers' Index fell to 50.1 in May — the lowest in more than four years — from 51.0 in April. For the January–March period, gross domestic product expanded 4.8%, slightly faster than the preceding quarter's 4.7% growth. India is seeing one of the best monsoons in the last five decades. June rains are 58% above normal and, thus, there is hope that in the current year GDP may grow by 6%.

The present government narrowed its fiscal deficit to 4.9% of GDP in the last fiscal year, below the 5.2% estimate made in the federal budget announced in February. The government finances will improve further as it lowered expensive state subsidies on fuel and raising taxes to curb gold imports, the main driver of India's record-high trade deficit. The finance minister P. Chidambaram has promised new measures in the coming days to revive investment flows, including the increase — or outright elimination — of caps on foreign direct investment in many sectors of the economy. His record of keeping past promise is weak and therefore, markets are likely to wait and watch.

Fitch, the rating agency upgraded the outlook for India's sovereign credit rating from negative to stable, citing New Delhi's progress in reining in the fiscal deficit and moderating inflation.

Consumer price inflation in May was 9.31%, marginally smaller than the previous month's 9.39%, but still high. The wholesale price index, India's main inflation gauge, rose 4.70% from a year earlier in May, compared with the previous month's 4.89% increase. The RBI shrugged off pressure to cut rates to help stimulate growth, citing high

India: BSE Sensitive



inflation due to a weakening rupee, and the country's worsening trade situation, as concerns. The central bank is worried also about inflation at the retail level as well.

India's trade deficit widened significantly in May as imports of gold continued to increase while exports declined, raising fresh concerns about the country's deteriorating economy. The deficit widened to \$20.1 billion from \$17.8 billion in April. The gap was \$16.9 billion in May last year. For the financial year that ended March 31, the deficit stood at \$87.8 billion, or 4.8% of GDP. It widened from \$78.2 billion, or 4.2% of GDP a year earlier. But, in the last quarter of the financial year 2013, the current account deficit shrank from 6.7% of GDP to 3.6% of GDP — good news for the economy if it is maintained in the coming months.

John Kerry, the US Secretary of State, has asked India to ease restrictions on foreign investment and trade, as US companies grow increasingly angry about what they see as India's hostile climate for international business.

The Indian rupee fell to a new low against the U.S. dollar, as global investors pulled out of emerging markets broadly amid concerns over the scaling back of a U.S. program that has injected billions of dollars into the global financial system. The rupee fell to a low of 60.50 for one U.S. dollar despite an attempt by the Reserve Bank of India to stem the fall.

The rupee broke through the psychological barrier of 60 rupees and has fallen more than 11% since the start of May. It is the bond market which is leading the fall and impacting equity market as dollar value of FII holdings erode on value in dollar terms. Foreign institutional investors have pulled around \$3.75 billion from Indian stocks and bonds in June. A falling rupee makes imports more expensive, and can add to inflation within India.

	10-11	11-12	12-13	13-14	14-15
GDP (%p.a.)	7.5	6.2	5.0	6.0	6.0
WPI (%p.a.)	9.0	7.5	7.0	6.0	6.0
Current A/c(US\$ bill.)	-31.0	-40.0	-80.0	-100.0	-60.0
Rs./\$(nom.)	49.0	49.5	54.5	58.0	58.0

China

Chinese leadership is going to be tested for its resolve to change the export and investment oriented economy into a consumption led economy. All indicators are showing that the economy is facing a pronounced deceleration in growth. The HSBC's Markit purchasing managers' index fell to 48.3 in June, below the 50 mark, the lowest since September 2012. The new export orders index also fell to 44.0, from 48.9 in May, signalling a sharp deterioration in foreign demand. At this rate Chinese growth could slow to just about 7% next year. The Chinese economy expanded 7.7% in the first quarter year-on-year from 7.9% at the end of last year.

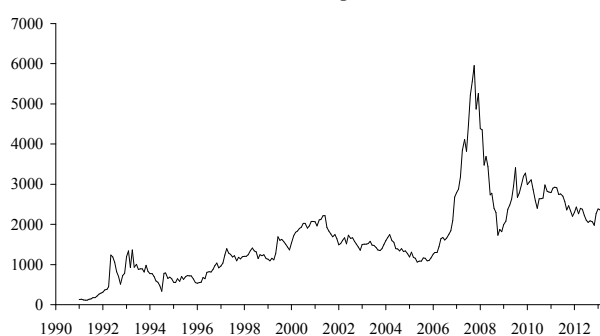
The credit crunch in mid-June, however, caught the eyes of all investors as short-term money market rates soared to 28% compared to average rate of 2% to 3%. The government did not come to the rescue of the financial system in the first two weeks. According to the official Xinhua news, there was no shortage of funds in China's financial system. Further, it pointed out that a combination of speculation and nonbank forms of lending were contributing to the surge in short-term lending rates.

Surging rates have raised concerns about an overstretched financial sector and a growing mismatch between short-term liabilities and long-term assets in the banks. However, the People's Bank of China said that the interest rate volatility in the nation's money market is temporary. Interbank liquidity overall is abundant and risk is largely under control. It seems that the People's Bank of China is keen to develop the money markets as a way to set monetary policy. The past approach was to impose crude controls on how much banks can lend. Now China's monetary policy makers want to use more market-determined means. By steering the rate at which banks can borrow, they can influence the cost of credit throughout the economy. Another reason is that the central bank wants to rein in the growth of shadow finance by constraining the liquidity available to fund new credit extension.

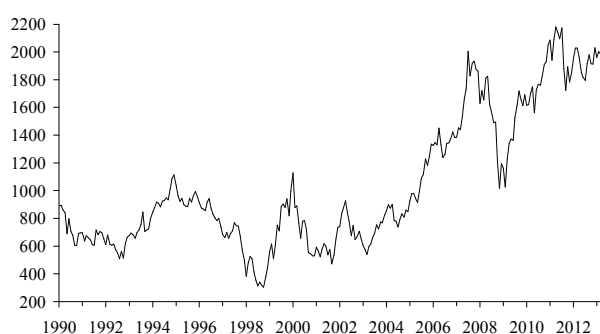
The Chinese central bank promised to provide liquidity support to any financial institution strapped for cash to avoid panic.

There was a severe drop in Chinese exports in May. Exports were up only 1% in May, compared to nearly 15% increase in April, and 24% in the first two months of the year. China's trade surplus widened to \$20.4 billion in May — up from \$18.16 billion in April. China's exporters are also struggling against the accumulated impact of a

China: SSE Composite Index



Korea: Composite Index



stronger yuan and higher wages, both of which have adversely impacted competitiveness.

China's shrinking current account surplus took the heat out of the debate on the yuan. China will soon take the next step toward liberalizing the currency with a wider band for the yuan to trade against the dollar.

The UK and China have formally established a currency swap line, an important step in London's attempt to become a global centre for trading the offshore renminbi. The agreement will initially last for three years and has a maximum value of Rmb200bn (\$32.6bn).

	10	11	12	13	14
GDP (%p.a.)	10.3	9.2	7.8	7.5	7.0
Inflation (%p.a.)	5.9	4.3	2.6	3.5	3.0
Trade Balance(US\$ bill.)	183	210	214	220	220
Rmb/\$(nom.)	6.6	6.3	6.3	6.2	6.1

South Korea

South Korea's economy expanded 0.8% from the previous quarter, or 3.2% in annualised terms, at its fastest pace in a year in the first quarter. Policymakers have warned that the weakening yen will have a delayed effect on local exporters, suggesting that headwinds could grow stronger in the coming months. The won has strengthened 11% against the yen so far this year.

South Korea's inflation touched a 14-year low in May on falling fuel costs and stabilizing food prices. The consumer price index for May rose 1% from a year ago — the slowest rate since September 1999. It marked the seventh straight month that inflation has stayed under 2%. As expected, South Korea's central bank held its base rate steady at 2.5%. The bank would not like to follow an accommodative monetary policy and would like to keep inflation within the bank's target.

Korea's exports of tech products clocked a record US\$15.15 billion last month, up 17.2% from a year earlier. The country's trade surplus in the tech sector also hit an all-time high of \$8.27 billion in May, up 23.6% from the previous year. In the January–May period, the accumulative exports and trade surplus in those products also reached record highs of \$67.97 billion and \$35.07 billion, respectively.

The won has risen over 10% against the Japanese yen this year, putting Korea's exporters at a disadvantage against Japanese competitors. Korea's government has drawn up a 17.3 trillion won supplementary budget to boost economic activity.

The Korean won's depreciation remains smaller than countries like Brazil, Russia, and Australia and the drop in the benchmark KOSPI is still less than countries such as Indonesia and Russia.

South Korea's President is coming under growing pressure from opposition politicians over claims that intelligence agents attempted to influence last year's presidential election in her favour. An investigation is likely to follow soon.

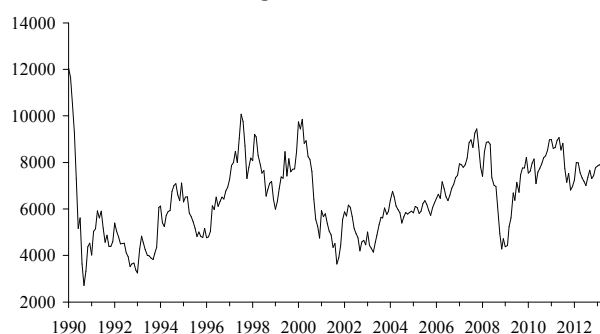
	10	11	12	13	14
GDP (%p.a.)	6.3	3.6	2.0	2.0	2.8
Inflation (%p.a.)	2.9	4.0	2.2	1.1	1.6
Current A/c(US\$ bill.)	28.2	27.0	44.0	28.0	28.0
Won/\$ (nom.)	1150	1100	1100	1120	1150

Taiwan

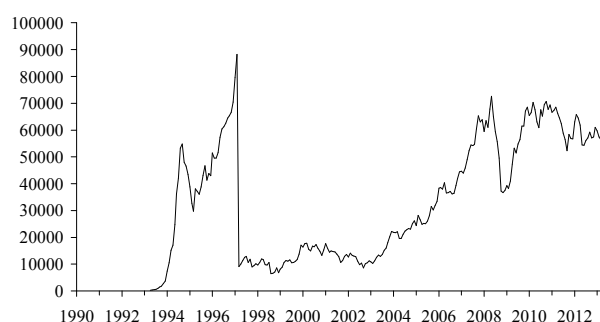
Industrial output was almost flat year-on-year against the expectations of a 1.2% fall. Output was supported by a rise of 2.47% in the production of electronic parts over the last 12 months period. Taiwan's gross domestic product (GDP) growth is likely to be 2.4% in 2013 as its traditional export market — the US — starts improving. But due to the recessionary trend in Europe and China slowing down, the growth rate could be muted.

Taiwan's consumer price index rose 0.74% in May from a year earlier, the lowest monthly increase since February 2012. In the first five months of the year, Taiwan's CPI was up 1.45% year-on-year, and core inflation rose 1.02%, but the WPI fell 3.24%, according to government statistics.

Taiwan: Weighted TAIEX Price Index



Brazil: Bovespa



Taiwan's trade surplus rose 91.7% from a year earlier to US\$4.46 billion. Exports in the first five months totalled US\$124.01 billion, up 1.2% from a year earlier, while imports during the same period totalled US\$112.65 billion, down 0.9%.

Trade barriers between Taiwan and China will be reduced further after the two sides agreed to open up their service sectors reflecting growing trade and economic ties between the two. As the US puts stop to bond buying, Taiwan would not be affected much as it runs substantial current account surplus but it would be hurt by China's reduced growth trajectory.

	10	11	12	13	14
GDP (%p.a.)	10.8	4.0	1.3	2.4	2.6
Inflation (%p.a.)	1.3	1.2	1.9	1.1	1.2
Current A/c(US\$ bill.)	16.0	18.0	20.0	22.0	23.0
NT\$/\$(nom.)	31.0	30.0	29.5	30.0	29.5

Brazil

Brazil is the worst affected country among the BRIC countries because of fall in commodity prices and now the prospect of higher cost of borrowing by the government and corporates. Brazil's economic policy makers are in a dilemma. Public imagination of pains of a growing economy and corruption are caught by the massive public protest which began in São Paulo as a demonstration by

students against an increase in bus fares from R\$3 to R\$3.20 per journey. Economic policy, which was centred on how to trim spending as the currency plunged to its lowest since 2009, has given way to what should be done to maintain social cohesion. The protesters organized through social media, no political party knows yet how to engage with the movement, let alone harness its startling energy.

The protest has snowballed into a general demonstration of discontent with the nation's political classes on both sides of the spectrum. The protesters marched on streets holding placards disparaging the enormous sums spent on the World Cup. The general mood of the public is that they want more money to be spent on education and health.

Ms. Rousseff promised to improve education, health and transportation, but what is beyond her control is ending corruption that leads to leaky investments and enriches few. But, she cannot improve government services using more debt. Her idea is to earmark oil royalties from big new oil finds for education which is not popular with provincial governments. The bill had faced opposition from lawmakers in the past who want the money transferred to the states. Ms. Rousseff wants to import around 6,000 doctors from Cuba and Europe to take care of public health services.

The increase in bus fares has been rolled back but demonstrators returned to the streets in nearly sixty cities and some of the protests have turned violent in recent days. Now the protest movement has expanded beyond that issue to a field of middle class grievances.

The football-mad country is currently hosting the Confederations Cup football tournament in new stadiums built for next year's World Cup. Football fans have had to run for cover from police firing rubber bullets in order to get to games. This has raised questions about whether Brazil can handle hosting the World Cup next year.

The protest has also put Ms. Rousseff re-election chances in peril but still there is enough time for the tide to turn. She has called for a national referendum on overhauling the political system often criticized as unaccountable and corrupt. The nation would vote on whether to convene an assembly to potentially alter the country's 1988 constitution. She also announced other initiatives, including a bill to make political corruption a serious crime.

Brazil's normally glacial Congress voted on a flurry of legislation designed to respond to a broad expression of

national frustration with everything from corruption to inadequate hospitals and crime. The rapid-fire voting, in the last couple of days of June in Congress, underscores how deeply the national protest movement is resonating among politicians, sensing that the political landscape is shifting quickly.

Consumer confidence is ebbing. The FGV seasonally adjusted index touched 112.9 which is the lowest point since March 2010. Brazil's 12-month inflation rate rose to 6.67% as of mid-June from 6.46% in mid-May compared to the government's inflation-target range of 2.5% to 6.5%. The rising inflation is likely to trigger an interest-rate rise, further stalling Brazil's sluggish economic recovery. Brazil's base interest rate is 8.0% and could hit 9.0% before the end of the year. Moreover, the sharp depreciation of the real is bad news for inflation.

Brazil posted a current account deficit of \$6.4 billion in May compared with \$8.3 billion in April. Much of the current account deficit continues to be covered by foreign direct investment, or FDI, which totalled \$3.9 billion in May compared to \$5.7 billion in April. For the time being FDI is holding up well.

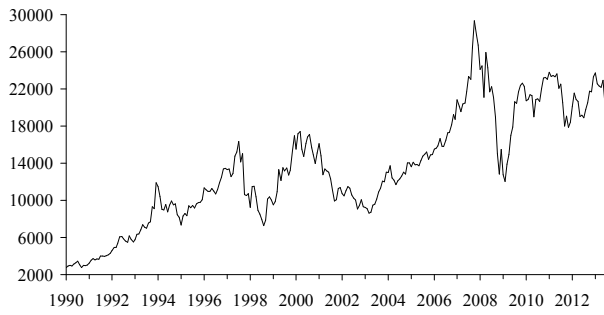
Standard & Poor's, the credit rating agency, has lowered the outlook on Brazil's credit ratings. According to the S&P "Continued slow economic growth, weaker fiscal and external fundamentals, and some loss in the credibility of economic policy given ambiguous policy signals could diminish Brazil's ability to manage an external shock." Brazil's ever growing fiscal expansion is impacting its credit rating.

Brazil's Real has hit a four-year low against the US dollar soon after the protests started. It crossed the key psychological threshold of BRL2.20 as emerging-market assets sold off on expectations for reduced bond-buying by the U.S. Federal Reserve. The central bank intervened in the forex market with a series of five foreign-exchange swap auctions in two weeks. The auctions allow investors to exchange bonds linked to domestic interest rates for debt, indexed directly to the U.S. dollar. The auctions tend to stall depreciation, but not for long. The stock market has hit its lowest levels since the 2009 global recession.

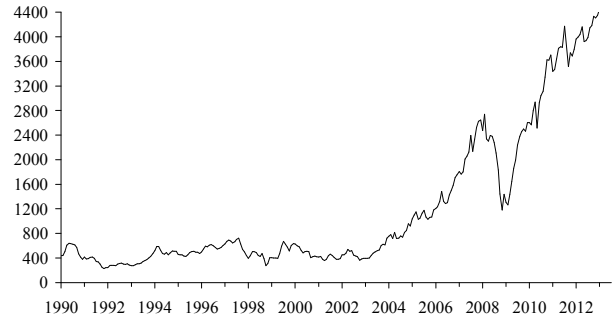
	10	11	12	13	14
GDP (%p.a.)	7.5	2.7	0.9	3.0	3.5
Inflation (%p.a.)	5.9	6.5	5.8	6.0	6.0
Current A/c(US\$ bill.)	-47.3	-52.6	-60.0	-65.0	-60.0
Real/(nom.)	1.7	1.5	2.0	2.1	2.1

Other Emerging Markets

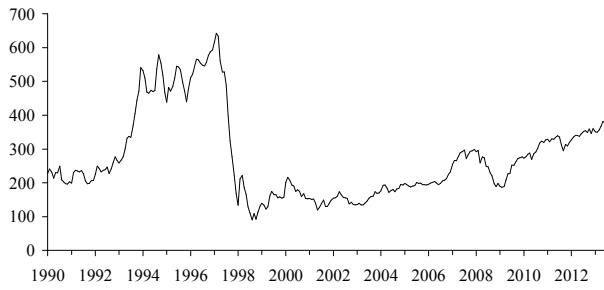
Hong Kong: FT-Actuaries



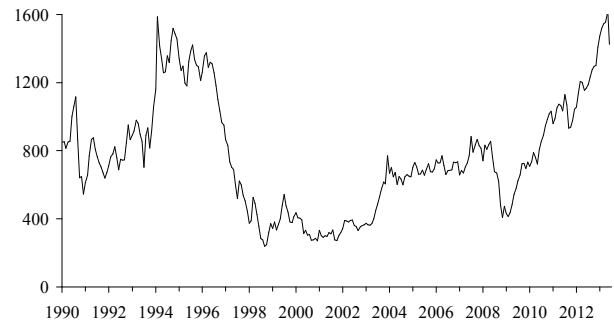
Indonesia: Jakarta Composite



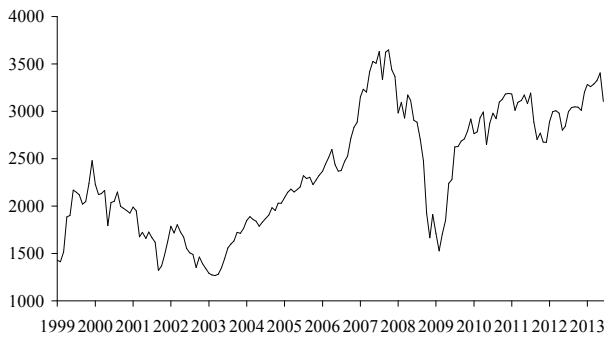
**Malaysia: FT-Actuaries
(US\$ Index)**



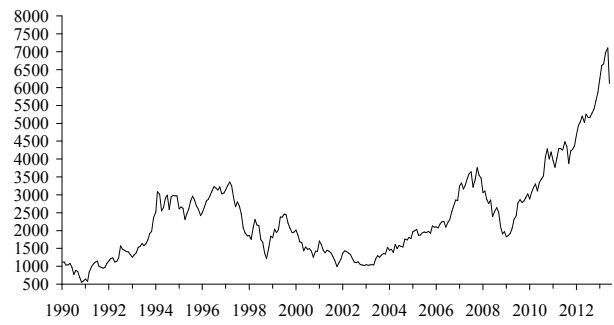
Thailand: Composite Index



Singapore: Straits Times Index

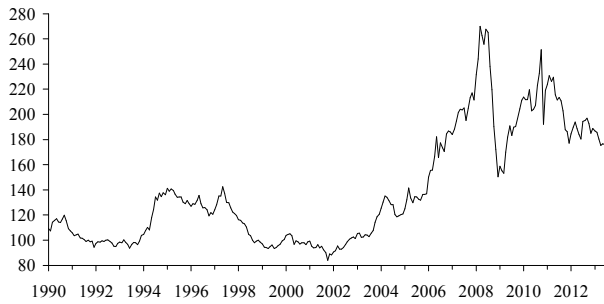


Philippines: Manila Composite

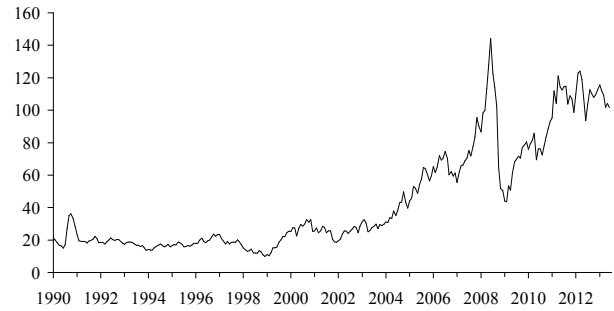


COMMODITY MARKETS

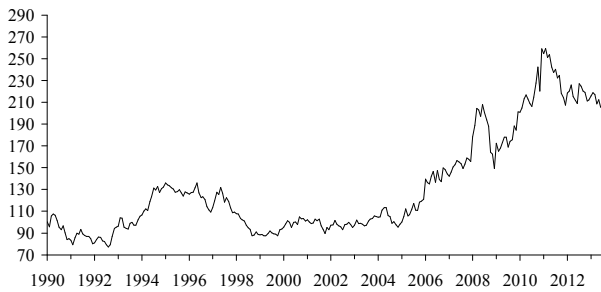
Commodity Price Index (Dollar)
(Economist, 2000=100)



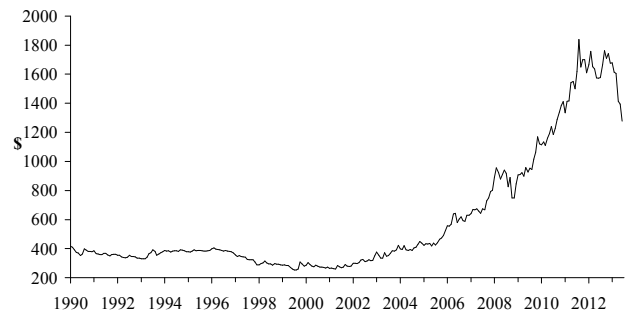
Oil Price: North Sea Brent (in Dollars)



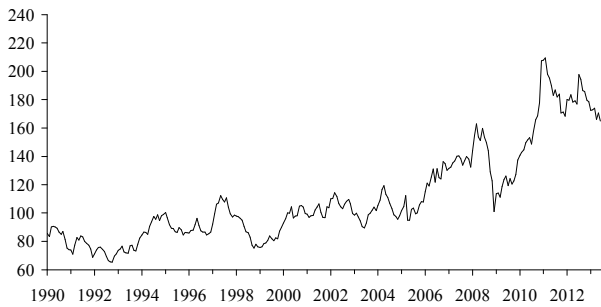
Commodity Price Index (Sterling)
(Economist, 2000=100)



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	3.7	2.4	0.7	80.4	87.9	-3.6	4.8	-0.2
2011	4.7	2.0	0.9	80.0	89.7	-3.1	5.3	-0.2
2012	2.8	0.9	0.9	83.0	94.0	-1.9	3.3	-1.3
2013	2.8	1.3	0.9	83.5	95.7	-1.6	3.3	-0.8
2014	2.6	1.8	1.7	82.7	95.5	-0.5	3.1	-0.3
2015	2.2	2.1	2.1	82.1	95.5	0.1	2.8	0.0
2012:1	2.7	1.1	1.1	81.2	91.4	-2.0	3.8	-1.1
2012:2	3.1	0.9	1.1	83.2	94.3	-1.6	3.2	-1.2
2012:3	2.7	0.7	0.8	84.1	95.3	-2.0	2.9	-1.4
2012:4	2.8	0.8	0.6	83.6	95.2	-2.0	3.3	-1.4
2013:1	2.9	1.0	0.8	83.7	95.5	-1.8	3.4	-1.2
2013:2	2.8	1.3	0.9	83.2	95.4	-1.6	3.3	-0.8
2013:3	2.8	1.5	0.9	83.7	96.0	-1.6	3.3	-0.6
2013:4	2.7	1.5	1.1	83.3	95.8	-1.3	3.2	-0.6
2014:1	2.6	1.8	1.3	83.1	95.8	-1.1	3.2	-0.3
2014:2	2.5	1.8	1.7	82.3	95.2	-0.6	3.1	-0.2
2014:3	2.6	1.7	1.8	82.4	95.2	-0.3	3.1	-0.3
2014:4	2.5	1.8	1.9	82.7	95.8	-0.2	3.0	-0.2

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	136.7
2011	232.7	2.6	4.6	1.53	133.7
2012	236.9	1.8	4.7	1.58	132.4
2013	242.0	2.2	4.4	1.49	131.6
2014	248.9	2.8	4.0	1.37	131.9
2015	257.0	3.3	3.7	1.26	133.3
2012:1	234.7	0.7	4.8	1.61	132.7
2012:2	235.8	1.8	4.8	1.60	132.0
2012:3	237.4	1.9	4.7	1.58	132.4
2012:4	239.6	2.9	4.6	1.56	132.4
2013:1	240.4	2.4	4.6	1.54	132.1
2013:2	242.0	2.6	4.5	1.51	131.7
2013:3	242.2	2.0	4.4	1.48	131.4
2013:4	243.6	1.6	4.3	1.45	131.0
2014:1	245.5	2.1	4.2	1.42	131.4
2014:2	248.1	2.5	4.1	1.39	131.7
2014:3	249.7	3.1	4.0	1.36	132.1
2014:4	252.1	3.5	3.9	1.33	132.4

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 Product¹ (£ 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	145.1	694701.4	411042.6	234029.9	182002.2	-34548.2	97825.1
2011	146.4	701060.5	402885.3	243646.3	177479.4	-23548.2	99402.3
2012	146.5	701719.7	401183.5	249576.1	183170.0	-31081.5	101129.7
2013	148.7	712270.2	404503.8	255592.0	187385.7	-31240.0	103971.4
2014	151.8	726827.7	411964.1	261350.6	191244.9	-31189.9	106537.5
2015	155.4	744363.4	421121.2	267868.0	195837.6	-31120.2	109344.0
2010/09	1.8		0.5	7.6	0.5		0.8
2011/10	0.9		-2.0	4.1	-2.5		1.8
2012/11	0.1		-0.4	2.5	3.2		1.9
2013/12	0.8		0.6	2.4	2.3		6.7
2014/13	2.0		1.4	2.3	2.1		0.6
2015/14	2.4		2.2	2.5	2.4		2.6
2012:1	146.2	175013.2	100300.2	59839.5	47225.9	-6742.4	25610.0
2012:2	145.6	174362.8	100083.3	61272.9	44458.8	-8868.5	22583.7
2012:3	147.0	176010.2	100053.3	64467.5	45567.2	-7659.5	26418.3
2012:4	147.3	176333.5	100746.7	63996.2	45918.1	-7811.1	26516.4
2013:1	147.5	176575.7	100799.5	61159.6	48592.6	-7807.4	26168.6
2013:2	147.6	176695.9	100847.8	64387.0	45700.5	-7814.6	26424.9
2013:3	147.8	176933.2	100899.6	64777.0	46404.9	-7811.4	27336.9
2013:4	148.0	177167.9	100947.5	65268.4	46687.6	-7806.7	27928.9
2014:1	149.2	178552.7	101496.4	62894.2	49472.8	-7807.8	27502.9
2014:2	150.2	179823.2	102046.2	66223.1	46613.4	-7802.0	27257.5
2014:3	151.4	181216.6	102600.6	66062.4	47385.6	-7791.4	27040.7
2014:4	152.1	182614.3	103156.5	66171.0	47773.1	-7788.7	26697.6

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)	Debt Interest (£bn)	Current Account (£ bn)
	Financial Year				
2010	8.7	1336.3	115.1	36.4	-37.3
2011	6.7	1406.4	94.2	42.9	-20.4
2012	6.5	1451.6	95.4	47.0	-51.9
2013	6.5	1519.3	98.2	50.6	-52.2
2014	5.3	1592.8	84.7	55.8	-52.8
2015	4.3	1666.2	72.2	59.0	-53.0
2012:1	4.6	355.1	16.3	11.5	-11.8
2012:2	1.7	351.8	6.0	11.3	-17.4
2012:3	6.2	363.1	22.7	11.8	-12.8
2012:4	9.9	367.2	36.5	11.8	-9.8
2013:1	8.2	369.5	30.2	12.0	-13.9
2013:2	6.2	373.6	23.1	12.3	-15.5
2013:3	5.9	377.2	22.1	12.4	-13.1
2013:4	5.9	382.1	22.7	12.8	-9.8
2014:1	7.8	386.3	30.3	13.1	-14.0
2014:2	5.4	391.4	21.0	13.6	-15.7
2014:3	5.6	395.4	22.1	13.8	-13.2
2014:4	5.6	400.4	22.5	14.0	-9.8

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	1.8	0.9	0.1	0.8	2.0
Japan	-6.3	4.7	-0.5	1.9	1.8	1.6
Germany	-4.7	4.2	3.0	0.7	0.6	1.5
France	-2.5	1.6	2.0	0.0	-0.4	0.7
Italy	-5.1	1.7	0.5	-2.4	-1.8	0.4

Growth Of Consumer Prices

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

Real Short-Term Interest Rates

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

Nominal Short-Term Interest Rates

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

Real Long-Term Interest Rates

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

Nominal Long-Term Interest Rates

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

Index Of Real Exchange Rate(2000=100)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	78.9	80.5	84.4	85.9	85.7
Japan	89.0	92.0	97.1	98.3	119.7	122.0
Germany	105.8	102.9	105.5	104.3	107.4	108.2
France	104.3	103.1	105.5	104.9	107.9	108.6
Italy	105.4	103.6	106.9	107.4	111.8	113.2

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	1.55	1.61	1.59	1.56	1.56
Japan	93.54	87.48	79.36	80.51	98.00	98.00
Eurozone	0.72	0.75	0.71	0.78	0.79	0.78

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