

LIVERPOOL INVESTMENT LETTER

March 2014



LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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

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

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

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<p>The UK recovery looks durable. Investment growth has now kicked in and net exports are up a bit, besides the consumer growth and the improving housing market. The policy challenge remains to cut back on bank regulation and the resulting distortions in the credit/money markets. SMEs should not have to rely in the future just on a shadow banking system of peer-to-peer lenders.</p>	
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HOW DURABLE IS THE RECOVERY

It has become a cliché of recent commentary to remark that the UK's recovery has been weak, compared with the past and with other economies. We also see that there is a 'productivity puzzle' — productivity has fallen and may still only be weakly rising.

Of course the question is why? The UK economy before the crisis had had strong productivity growth since around 1982. Furthermore it has enjoyed — not really the right word — gruelling supply-side reform more or less continuously since 1979. There has been some recidivism under Labour's tenure between 1997 and 2010 but as many have said, Blair and Brown were in many ways Thatcher's children and the reversals put in place mainly were at the margin — e.g. some slight restoration of union protections, and the establishment of a minimum wage. However the recent evidence from the labour market has confirmed that the UK has considerable wage flexibility, both nominal and real, and that union power is weak even in the public sector. Whether minimum wages are binding on demand for lower-paid labour remains a concern; but it seems that zero hour contracts and part-time work in practice produce a lot of flexibility even at this lower stratum of the market.

Our own view of the current situation is that it is the product of four major shocks:

1. a massive run-up in commodity prices that battered living standards
2. the North Sea, where UK policy attempted excessive and 'time-inconsistent' (i.e. like Oliver they kept on coming back for more) extraction of revenue
3. bank regulation in response to the crisis; this has hit the banking sector
4. the collapse of the European market for UK manufacturing

All these are familiar points. But as David Smith has noted in the Sunday Times, they account for the fall in productivity and also the strength of employment as due to a shift of UK output composition: the sectors hit hardest were all high-productivity sectors while the service sector which has managed to recover most has absorbed many low-productivity workers.

The middle two factors (oil and bank regulation) were self-inflicted by the Whitehall establishment and there are signs that George Osborne and the Treasury have now understood and are trying to reverse the damage. We have yet another rapprochement with the N Sea industry and we have Funding for Lending and Help to Buy — credit to mortgages is starting to flow. SMEs are still affected by the

Table 1: Summary of Forecast

	2010	2011	2012	2013	2014	2015	2016
GDP Growth ¹	1.7	1.1	0.2	1.4	2.6	2.4	2.6
Inflation	3.3	4.5	2.7	2.4	2.5	2.2	2.0
RPIX	4.8	5.3	3.2	3.2	3.1	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

¹Expenditure estimate at factor cost

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

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

credit famine; M4 growth remains weak. But life is returning. QE seems to be having an impact via asset prices, private equity and the new fast-growing peer-to-peer lending. The biggest problem remains bank regulation; banks continue to shrink their balance sheets, effectively pulling against the monetary recovery.

Factors 1 and 4 (commodity prices and the euro-zone) are now also reversing. Commodity prices are coming off, under the impact of monetary tightening in emerging markets like China as well as resource productivity growth due to fracking etc. The euro-zone has also hit bottom and is recovering.

The recovery is therefore looking much stronger. What is more it does now include, after the latest ONS data revisions, a resumption of growth in business investment; even net exports are rising, if still weakly. SMPC members like Trevor Williams and Tim Congdon still stress potential weakness however and the need for monetary ease to stimulate credit and money growth; in this they are at one with Bank Governor Carney and his determination to keep money easy and rates low for the foreseeable future. They seem to have a good point in the sense that the money supply figures support their interpretation.

Our concern remains that the weakness of the money supply is distorted by bank regulation and is 'structural'; that is to say, that there is an artificial block on credit and money creation that is spawning money and asset substitution, while also raising the costs of particular industries and firms. SME businessmen say that the banks will never be trusted again by SMEs and that they are now looking to the new alternative channels of finance. At the same time the interest rate structure is heavily distorted by both regulation and the zero bound policy; this is illustrated by the massive gap that has opened up between rates on official paper and rates on lending to private corporations, particularly SMEs.

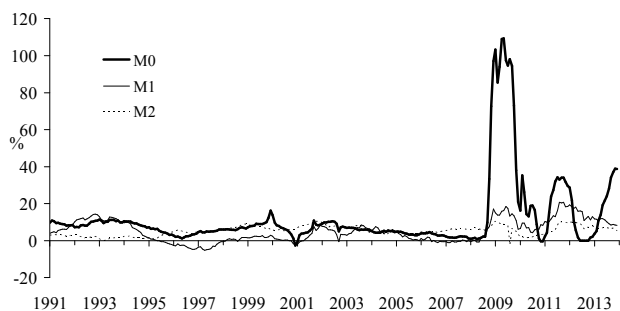
We may well be creating the conditions for an asset price boom while diverting this boom away from general credit and money. The recovery could be strong on the back of this boom while money growth remains weak. We are not there yet but we see no reason to delay in heading off such conditions.

Our policy recommendation remains to attack all these distortions as best we can. First, row back on bank regulation: we do not want to create a ‘shadow banking sector’ in the UK but we already are doing so. Second, restore a normal interest rate structure by raising Bank Rate steadily. Third, operate on the money supply via open

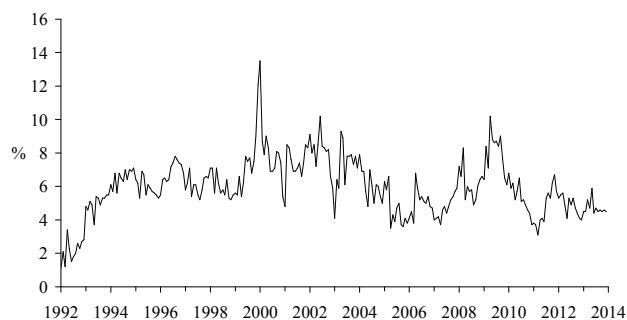
market operations (including QE); with the current distortions of the statistics it is hard to know exactly what to do with QE but the overhang looks threatening to me and we would reduce it while being willing to return to the open market as the statistics clarify.

Thus in sum we favour continuation of the special schemes to restore bank credit growth and encourage the banks back into activity; a rise in Bank Rate towards ‘normality’, with upward steps of 0.25% starting now; and a reduction of QE in steps of £25 billion per quarter starting now.

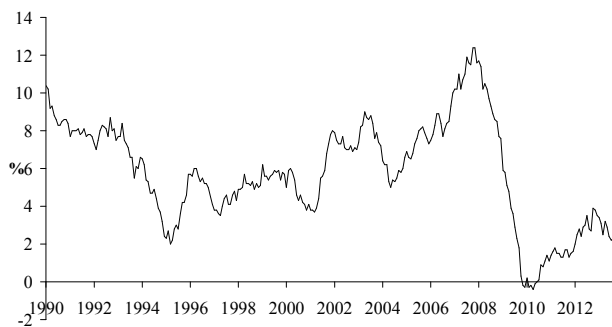
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



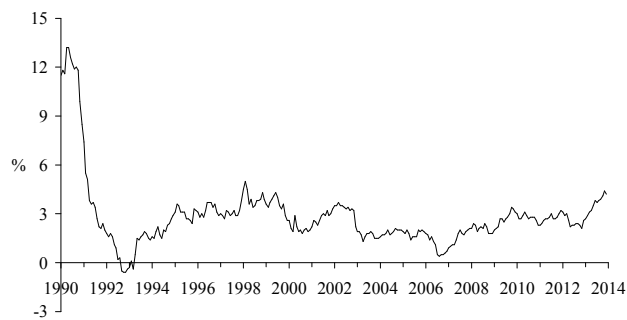
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

GDP Growth Slows Towards End of 2013

First GDP release showed that growth failed to accelerate in the final quarter of last year, remaining just 0.3% quarter-on-quarter, far lower than the 0.7% widely expected by economists, according to a Nikkei business daily survey. The full-year figure (1.6%) only modestly beat Japan's expansion in 2012, before Abe launched his bid to restore the country's fading status as an economic superpower.

In the last quarter of 2013 the economy was mainly driven by consumer demand and public investment. Private consumption rose by 0.5% over the previous quarter and 2.4% compared to Q4 2012. However, the number shows that the so-called "rush buying" — the front-loading of expenses — ahead of the 3-point VAT hike in April hasn't taken off in a consistent way, contrary to expectations. That indicates that a jump in consumption has been limited to some big ticket items, such as automobiles, which rose 11.4% on quarter, and that households remain cautious over rising inflation and the planned tax hike as wages have yet to rise significantly. The VAT hike also encouraged residential investment in the second half of 2013 (+8.9% for the year).

Public investment increased further, stimulated by the implementation of the supplementary budget worth Y10 trillion (or 2% of GDP) adopted in January 2013. Overall, in 2013, public investment increased by 11.4%, thus contributing 0.5 percentage points to GDP growth.

Growth in private non-residential investment accelerated to only 1.3%. Companies have been reluctant to expand their capacity for two reasons. First, they expect that the current boom in consumer demand is only temporary and fear that demand will sharply drop after the VAT hike. Second, enterprises are increasingly off-shoring their activities to other Asian countries to profit from lower wage costs and more dynamic markets. In 2013 as a whole, non-residential investment contracted by 1.4%.

The disappointing GDP growth figure was largely down to the performance of net trade — see the February Focus on this. Despite the massive boost to competitiveness provided by the weak yen, export growth was limp, with volumes up just 0.4% q-o-q, insufficient even to reverse in full the decline the previous quarter. Meanwhile, imports surged for the fourth consecutive quarter, by 3.5% q-o-q, the strongest rate since Q2 2010, to leave net trade subtracting a substantial 0.5 percentage points from GDP growth for the second successive quarter. The weakness of the external sector appears to have been maintained into the start of the 2014. Against this backdrop, it is not surprising that prices

have started to rise. This is partly due to higher import costs. The import deflator was 13.8% higher from a year earlier. This is the main reason that consumer prices (excluding imputed rent) were 0.9% higher from the previous year. Also prices for public investment, which have a relatively low import content, rose by 2.1%.

Overall, GDP fourth quarter figure marked the fourth consecutive quarter of expansion, leaving output up 2.7% compared with a year earlier and 10% higher than its early-2009 trough. In addition, the Nikkei shares index soared 57% over the year, its best performance in more than four decades. There are also some signs of optimism for the near future. For instance, the latest monthly Reuters Tankan survey shows that despite the subdued export backdrop, Japanese manufacturers remained relatively optimistic about current business conditions, with the sentiment index in February close to its almost two and a half year high recorded in January.

However, some economists fear that signs of fragility in overseas demand and the controversial sales tax rise to 8% from 5% — seen as crucial for cutting Japan's eye — watering national debt — would curtail the budding recovery and undercut support for Prime Minister Shinzo Abe's ambitious economic-overhaul program. "The Japanese public has until now supported economic reforms because of rising stock prices and the falling yen", which have worked favourably for the nation's economy, said Ryutaro Kono, chief Japan economist at BNP Paribas. But structural overhauls — such as loosening rigid labour rules and reducing red tape — have made little progress. And with the market now turning unstable, "it could become politically more challenging" to carry out such reforms, which often involve painful changes, Kono said. Most critics argue that the disappointing GDP result is a reflection of the limit of Abenomics. "Fiscal stimulus and monetary stimulus can only do so much without the actual change in the competitiveness of Japanese economy. Only when there is a real change in the competitiveness of the Japanese companies, and a positive change in the long term economic outlook will there be a real change in Japan's growth performance", said Takuji Okubo, chief economist at Japan Macro Advisors.

Eyes are now on the next GDP release and on the Bank of Japan (BOJ) next moves. The slowing economy and the expected tax hike could refuel expectations for additional steps in the coming months by the BOJ to expand its monetary easing measures. "There is a "high probability" that the BOJ will have to cut its growth forecast for the fiscal year starting in April from the current 1.4% and to take additional policy measures", says Takuji Aida, chief Japan economist of Societe Generale.

MARKET DEVELOPMENTS

We are approaching the moment when interest rates will have to go up across the world and monetary stimulus (via ‘Quantitative Easing’, the printing of vast amounts of government money) will have to be cut back. As recovery from the financial crisis has proceeded, equity markets have done well and bond markets too. Bond markets have been going into reverse as the first signs of reduced money printing by the US Fed have become apparent (the ‘taper’). Equity markets in emerging

countries were also affected. But equities in developed markets have remained strong. As money tightens in the coming two years bond markets will take ongoing hits; weaker emerging equity markets will also be hit from time to time. But we think the ongoing growth in the world economy will generally overpower these equity effects. So while we continue to stay out of bonds, we remain committed to the full range of equity markets as now.

Table 1: Market Developments

	Market Levels		Prediction for Jan/Feb 2014	
	Jan 30	Mar 3	Previous Letter View	Current View
Share Indices				
UK (FT 100)	6538	6708	9808	10063
US (S&P 500)	1794	1846	2311	2377
Germany (DAX 30)	9373	9359	13357	13336
Japan (Tokyo New)	1224	1197	1721	1683
Bond Yields (government long-term)				
UK	2.75	1.72	2.00	2.00
US	2.69	2.66	2.10	2.10
Germany	1.72	1.63	1.50	1.50
Japan	0.62	0.59	0.70	0.70
UK Index Linked	-0.01	-0.09	0.10	0.10
Exchange Rates				
UK (\$ per £)	1.65	1.68	1.56	1.56
UK (trade weighted)	85.9	86.3	82.3	82.3
US (trade weighted)	87.8	86.7	85.5	85.5
Euro per \$	0.74	0.72	0.79	0.79
Euro per £	1.22	1.21	1.23	1.23
Japan (Yen per \$)	103.0	102.0	98.0	98.0
Short Term Interest Rates (3-month deposits)				
UK	0.52	0.52	2.10	2.10
US	0.33	0.31	0.70	0.70
Euro	0.36	0.24	0.50	0.50
Japan	0.10	0.14	0.70	0.70

Table 2: Prospective Yields¹

Equities: Contribution to £ yield of:						
	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.40	2.6	2.4	45.00		53.40
US	1.90	2.8	2.0	24.00	6.92	37.62
Germany	2.80	1.5	2.0	39.00	-1.56	43.74
Japan	1.90	1.6	2.0	37.00	10.71	53.07
UK indexed ²	-0.09		2.4	-6.00		-3.69
Hong Kong ³	2.50	7.0	2.0	6.00	6.92	24.42
Malaysia	3.10	5.2	2.0	53.00	6.92	70.22
Singapore	3.80	4.0	2.0	34.00	6.92	50.72
India	1.60	7.0	2.0	23.00	6.92	40.52
Korea	1.20	3.6	2.0	-5.00	6.92	8.72
Indonesia	2.40	5.5	2.0	37.00	6.92	53.82
Taiwan	2.60	2.7	2.0	21.00	6.92	35.22
Thailand	3.40	4.2	2.0	41.00	6.92	57.52
Bonds: Contribution to £ yield of:						
	Redemption Yield	Changing Nominal Rates	Currency	Total		
UK	2.72	7.20				9.92
US	2.66	5.60	6.92			15.18
Germany	1.63	1.30	-1.56			1.37
Japan	0.59	-1.10	10.71			10.06
Deposits: Contribution to £ yield of:						
	Deposit Yield	Currency	Total			
UK	0.52		0.52			
US	0.31	6.92	7.23			
Euro	0.24	-1.56	-1.32			
Japan	0.14	10.71	10.71			

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.

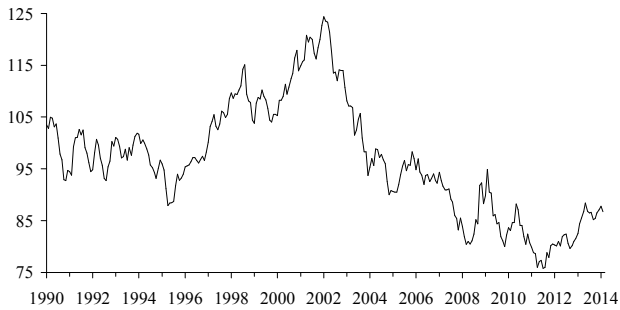
Table 3: Portfolio(%)

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

INDICATORS AND MARKET ANALYSIS

FOREIGN EXCHANGE MARKETS

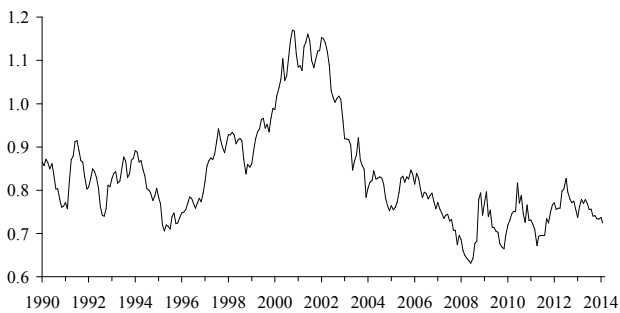
**US : Trade Weighted Index
(Bank of England 1990 = 100)**



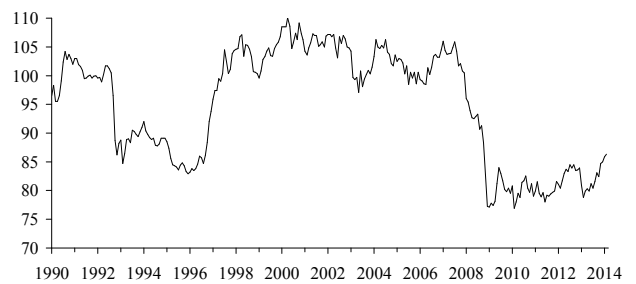
UK: Dollars Per Pound Sterling



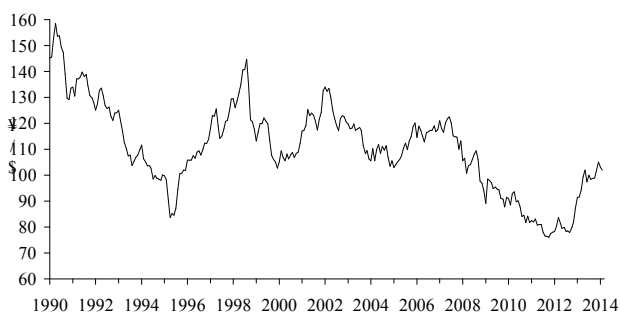
Euro per US dollar



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



Japan : Yen Per U.S. Dollar

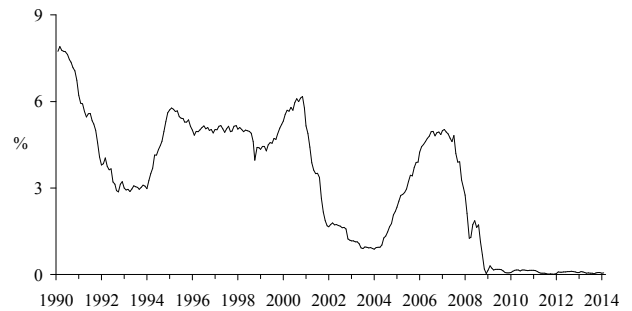


GOVERNMENT BOND MARKETS

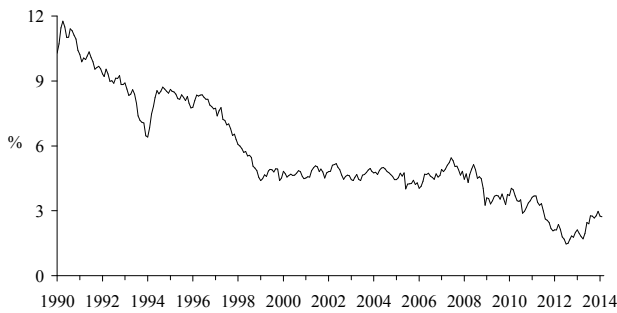
U.S.: Yield on Long-Term Government Bonds



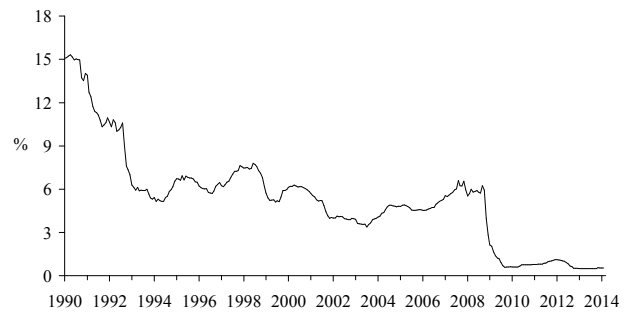
U.S. : 3-Month Treasury Bill



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



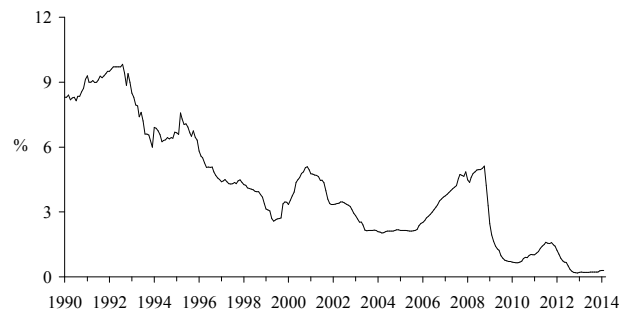
U.K. : 3-Month Interbank Rate



Germany: Yield on Public Authority Bonds



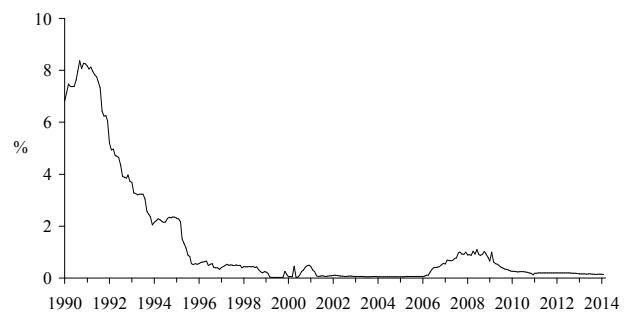
Germany : 3-Month Interbank Deposit Rate



Japan: Yield on Long-Term Government Bonds

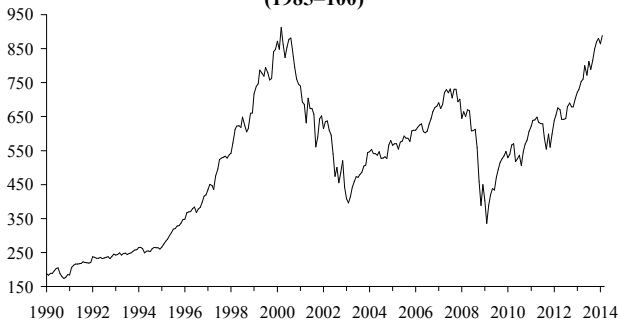


Japan : 3 Month Money Market Rate

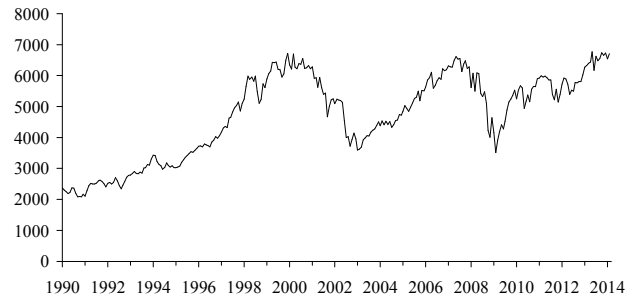


MAJOR EQUITY MARKETS

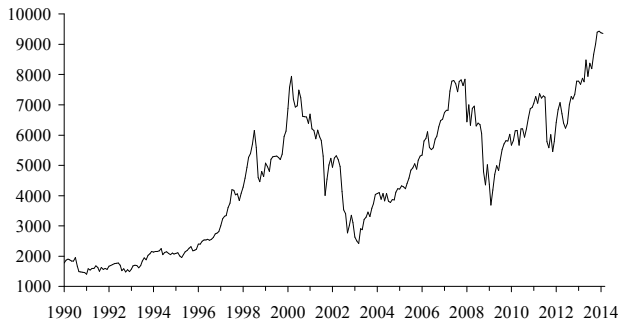
**U.S. : S & P 400 Industrial
(1985=100)**



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



Germany : DAX 30



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



EMERGING MARKETS

Anupam Rasogi

India

India's Election Commission has not declared polling dates for the parliament's election but almost all the political parties' preparations are in full swing. Markets are hoping that the new government will be a right of centre, pro-business government, able to restore India's stuttering economy to the high-growth path many took for granted just a few years ago. The front-runner to become India's next prime minister is Mr. Modi — widely regarded as an efficient administrator and friendly to private enterprise.

Foreign institutional investors and hedge funds have increased their exposure to the Indian market despite an anaemic economic growth rate and heightened consumer price inflation. India's statistics ministry announced that the economy grew by 4.5% in the year ended March 31, 2013, falling short of its target rate of 5%. Economic growth is expected to remain below 5% this fiscal year, dragged down by a contraction in manufacturing output. Output of services, which contribute about 60% of India's GDP, is expected to grow by 6.9% this year, almost the same as the 7.0% expansion in the fiscal year 2012–13. Weak demand, government red tape and the slow pace of structural change to the economy has deterred economic activity. Ratings firms have cited the budget deficit, as well as slowing growth, as weighing on India's debt rating, which they have warned could be lowered if corrective measures aren't taken.

The present government presented vote-on-account to meet government expenditure until the new government comes into power. The government cut some taxes in an effort to boost consumption and lift an anaemic economy ahead of the coming elections, but said it would still manage to narrow its budget deficit this fiscal year. The deficit for the current fiscal year, which ends on March 31, would be 4.6% of gross domestic product, smaller than the 4.9% recorded the previous fiscal year.

The government, however, is using creative budgeting. It has pushed forward payment of 350 billion rupees (\$5.7 billion) of fuel subsidies into the next fiscal year, without which the deficit this year would be 4.9% of GDP. Also flattering is a 40% bump in non-tax revenue, mostly one-off bonanzas from a wireless-spectrum auction which fetched nearly \$10 billion and special dividends from state-owned enterprises.

India's wholesale inflation eased to an eight-month low in January as food prices cooled, comforting authorities struggling to revive the economy just months before

India: BSE Sensitive



national elections. The benchmark inflation gauge WPI slowed to 5.05% year-on-year from 6.16% in December. The cooling prices have strengthened expectations that the central bank may not have to raise interest rates any further. But, consumer price inflation is still running at a more worrying 9.9%.

Moody's Investors Service says that its overall outlook for India's non-financial corporates in 2014 is negative because of the country's weak economy, political uncertainty and the expected gradual scale-back of quantitative easing by the US Federal Reserve. According to Moody's report, India's GDP growth could remain weak, at 5.5% in the fiscal year ending March 2015, as elections delay reforms needed to revive growth.

The growth in India's exports remained weak for the third straight month in January, blowing away hopes of an export-led turnaround in the industry that followed a strong run in the first half of this financial year. In January, exports grew 3.79% year-on-year to \$26.75 billion dollars. But, the shrinking trade deficit — which fell to \$119.9 billion in April–January from \$165.8 billion a year ago — showed that India has managed to contain its runaway current-account deficit. The current-account deficit in the fiscal year ending March is expected to fall to \$50 billion, from \$87.8 billion last year.

India's central bank governor has hit out at the US and other industrialized countries for running selfish economic policies as their recovery leads to turmoil in emerging markets.

Speaking a day after the US Federal Reserve moved to withdraw more of the monetary stimulus, which fuelled strong inflows into developing countries, Raghuram Rajan said that emerging markets had helped pull the world out of the 2008 financial crisis and should not be ignored now. What he is looking at essentially is clearer communication.

He said, ‘central banks should give each other better advance notice of policy changes to avoid further turbulence in global markets’.

There are chances that India may witness below normal rainfall in 2014 due to the emergence of the El Nino effect in the Pacific Ocean, according to weather forecasting agency Skymet. This could spell some bad news for the agricultural sector as low or deficient rains could hurt farm output, thus impacting the overall growth in 2014–15.

	11-12	12-13	13-14	14-15	15-16
GDP (%p.a.)	6.2	4.5	4.8	6.0	7.0
WPI (%p.a.)	7.5	7.0	6.5	6.0	6.0
Current A/c(US\$ bill.)	-40.0	-88.0	-50.0	-50.0	-50.0
Rs./\$(nom.)	49.5	54.5	62.0	64.0	65.0

China

The first quarter of the year, which includes the Lunar New Year holiday, presents a challenge as hard data on economic activity is sparse. The most reliable data is the purchasing-managers index released by HSBC and Markit, which came in at its lowest level in seven months. The index dropped to 48.3 in February from 49.5 in January. Any number below 50 indicates contraction from the previous month. While the PMI suggested a slowdown, unusually strong exports and imports in January, both up around 10% from a year earlier, gave some hope that a recovery in industrialised economies is giving a lift to China. New export orders were the only component of the PMI to improve in February.

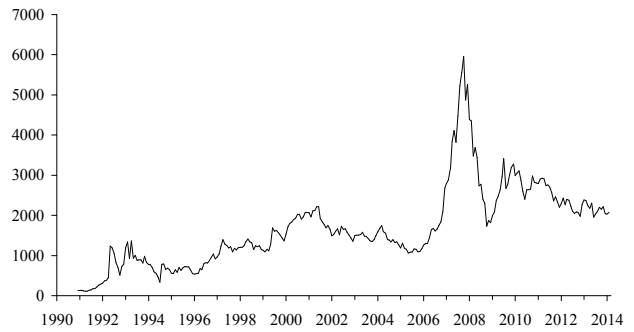
China’s economic growth appears to have slowed significantly at the start of the year, raising questions about the government’s ability to hit its expansion targets without exacerbating strains on the financial system. Last year, Premier Li Keqiang said that China could manage with growth of 7.2% without sending unemployment to unmanageable levels or creating new sources of social unrest. What the target fixed by the government is will be known when the national parliament convenes in June. The Chinese economy grew 7.7% in 2013. It is likely that government will fix a target below 7.7%.

China’s consumer-price index rose 2.5% year-on-year in January. Consumer inflation could pick up somewhat later this year, averaging 3% in 2014, which would be easily within the government’s stated tolerance of 3.5%.

Chinese exports and imports rose unexpectedly in January. We need to wait until March to collate together the figures from January and February for retail sales, industrial output and fixed-asset investment to come to any sensible conclusion.

In order to improve the health of its fragile banking sector, and after three credit squeezes hit the nation’s financial

China: SSE Composite Index



system last year, China has asked banks to keep to hand more cash and other liquid assets. The new rules, which will take effect from March 1, will put in place a new measurement system designed to help gauge the ability of the nation’s banks to resist short-term stress from credit shortages. The new rules require banks to keep what is called liquidity coverage ratio — a measurement comparing liquid assets to total net cash outflows over a 30-day period — at a level of 60% by the end of this year and at 100% by the end of 2018. Banks currently aren’t subject to such a requirement. Chinese authorities are closely watching credit growth and are likely to maintain their tight monetary policy to help cut down on rising risks from shadow banking and bad debt.

In another move, indicative of banks putting a brake on providing credit to the housing sector, Industrial Bank said it had halted some types of property loans until the end of March, when it will unveil new policies. The bank said the move is aimed at “adjusting its asset structure and to better serve the real economy.” New home prices moderated in January, though they were still up 8.98% from the same month last year. Prices were up 9.17% year on year in December.

The current account surplus remained robust though it shrank to \$188.6 billion from \$193.1 billion in 2012. Foreign-exchange reserves stood at a record high, of \$3.82 trillion, at the end of 2013.

The PBOC said that it would expand the yuan’s trading band in an “orderly” manner this year. The Chinese yuan took a dive over the last couple of weeks of February, its first sustained weakness against the dollar since 2012. The sudden slide of the Chinese currency has raised concern that the yuan is nearing levels that could trigger an unwinding of billions of dollars in highly leveraged bets on its appreciation. A portion of the yuan’s recent decline can be attributed to investors looking to get out of trades before losses soar. However, the yuan is likely to gain further in coming months and years, as the economy expands more than 7% a year and accumulates its large trade surpluses

and strong capital inflows. Over a long period of time one can expect a stable yuan, at about 6.1 per dollar, though with bigger swings down the year. In the last few weeks, some of the yuan's weakness can be attributed to investors' concerns about China's slowing economy and latent risks in its financial system. There is also a growing perception that the Chinese central bank has been proactively undermining expectations for the yuan to relentlessly appreciate. With the yuan recently trading closer to the PBOC's dollar-yuan reference rate, conditions are ripening for a widening of the yuan's trading band, whereby the PBOC allows the yuan to move 1% above or below the reference exchange rate. The band was last widened in April 2012, when the permitted deviation from the reference rate was 0.5%. We would not be surprised if Beijing widens the trading band further, and allows a 1.5% or 2% deviation in the next few months. We see it as a part of the internationalization of the yuan.

	11	12	13	14	15
GDP (%p.a.)	9.2	7.7	7.7	7.5	7.0
Inflation (%p.a.)	4.3	2.6	3.5	3.0	2.5
Trade Balance(US\$ bill.)	210	214	220	220	200
Rmb/\$(nom.)	6.3	6.3	6.2	6.1	6.0

South Korea

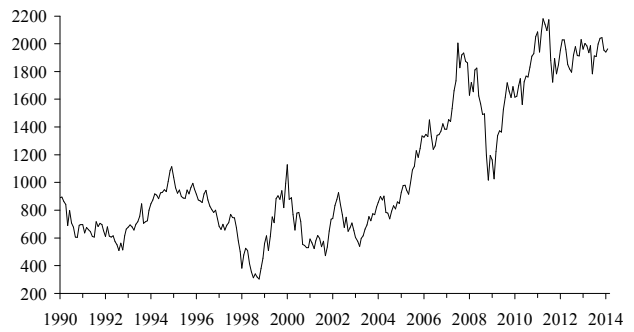
Helped by an international recovery, South Korea's industrial output grew strongly in January as demand from Korea's largest export markets has increased. The Bank of Korea expects the economy to grow 3.8% for 2014 and 4% for 2015.

In 2013, South Korea posted a record \$70.73 billion current account surplus. South Korea is opening other sectors to increase its exports. The export sector is better known for cars and smartphones, yet the country's defence exports have grown at one of the fastest rates in the world over the past few years, led by aerospace. The sector is seeking further expansion, with enthusiastic government backing. Defence exports were a record \$3.4 billion last year, having risen steadily from \$250 million in 2006.

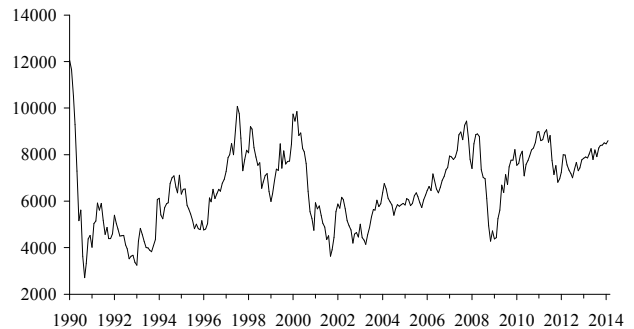
The Korean won has appreciated by 9% against the dollar since early 2012, but it has maintained its economic resilience. However, South Korea is worried about depreciation of the yen against the US dollar and the won. The yen last year fell more than 20% against the won. Hence, the South Korea's finance minister urged Japan to push ahead with structural reforms rather than relying on yen weakness to spur its economy.

President Park Geun-hye marked one year in office in the last week of February with a new push on economic reform, aiming to reduce the country's heavy reliance on exports as a decade's long growth model sputters. At the heart of the package: deregulation aimed at cutting through the red tape that has restrained industries from education to

Korea: Composite Index



Taiwan: Weighted TAIEX Price Index



medical services. Among the changes, South Korea will allow foreign-exchange futures to be traded round the clock and set up a task force to regularly check on deregulation.

In order to sustain economic growth, the government recognizes the need to lift consumption and the services sector and to lower reliance on exports. According to President Ms. Park, regulations are the "biggest stumbling block to investment" and it would not be easy to remove them. The country's Regulatory Reform Committee, tasked with eliminating the country's red tape, says that the number of government rules stood at 15,269, up from 5,114 in 2007. Last year, the government removed 45 unnecessary regulations and created 425 new ones.

	11	12	13	14	15
GDP (%p.a.)	3.6	2.0	2.8	3.8	4.0
Inflation (%p.a.)	4.0	2.2	1.3	2.3	2.7
Current A/c(US\$ bill.)	27.0	44.0	71.0	80.0	80.0
Won/\$(nom.)	1100	1100	1100	1080	1060

Taiwan

The growth prospects of the developing world have brightened economic prospects in Taiwan as exports and domestic demand continue to improve. The government expects a 2.82% economic growth in 2014, slightly lower than the average 3.3% annual growth over the past five years. In 2013, the economy grew 2.11%.

Taiwan's consumer price index (CPI) for 2014 is forecast to rise 1.1% despite a higher than expected increase in January, due to lunar year holidays. In 2013 CPI grew 1.21% mainly due to the lower import price of commodities. Due to contained inflation the interest rate will remain stable.

Taiwan's public debt level is close to its statutory ceiling of 40.6%. Ratings firms in general are comfortable with Taiwan's fiscal position, because of the island's ample foreign-exchange reserves. As of 31st January, Taiwan central bank's reserve assets totalled US\$416.94 billion.

Taiwan's government is considering increasing taxes on high-income earners and financial institutions, as the export-dependent economy is showing more signs of picking up. Finance Minister Chang Sheng-ford said the government is looking at raising the top rate of income tax from 40% to 45% on individuals whose annual taxable income exceeds 10 million New Taiwan dollars (US\$329,161). Additionally, the administration is considering an increase in the business-tax rate on banks and insurers to 5%, a level it was at before the 2008 financial crisis, up from the current 2%. Taiwan is falling in line with other economies in raising taxes on the wealthy.

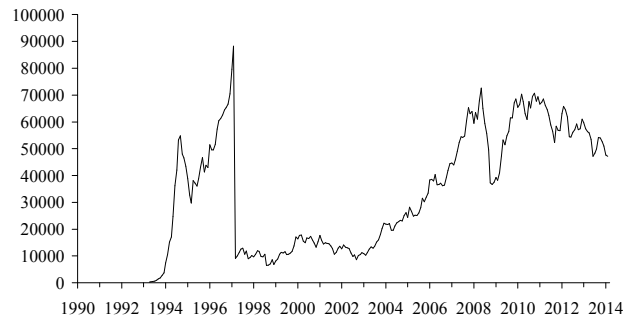
Relations between China and Taiwan took a step forward, after the first high-level formal government meeting between the two sides ended in a cordial tone, potentially opening the door to the political dialogue for which Beijing has been pushing. As expected, the two-hour closed-door meeting didn't result in a concrete agreement. However, political analysts said the significance of the meeting was that it marked the first time China recognised Taiwan's top government officials on matters across the Taiwan Strait, indicating Beijing is eager to start a political dialogue with Taipei. Officials handling cross-Strait affairs have previously met but as representatives of unofficial bodies, not in their official government capacities. This meeting may have set the stage for a meeting between Chinese President Xi Jinping and his Taiwanese counterpart Ma Ying-jeou in future.

	11	12	13	14	15
GDP (%p.a.)	4.0	1.3	2.1	2.8	2.8
Inflation (%p.a.)	1.2	1.9	1.2	1.1	1.0
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 FIFA World Cup 2014 going to be held in Brazil in June was expected to bring economic dividends to the country, but it has turned into a misery, and there are question marks as to whether the venues will be ready in time. Economic growth has weakened over the past two quarters. The central bank's economic activity index fell 1.35% in December from November, dented by a drop in

Brazil: Bovespa



industrial production and weak retail sales. It is probable that economic growth declined in the year's last quarter after contracting 0.5% in the third period, suggesting that the country has entered into a technical recession. The main reason for this is that as China's growth has slowed, and prices for commodities like soy and iron ore that Brazil exports have fallen, the country has found itself without an external engine for its economy. Brazil's economy is likely to grow as little as 1.5% in 2014 compared to the 2.3% estimated growth for 2013.

Inflation is running around 5.6% a year, close to the upper limit set by the central bank and it is unlikely to fall to the 4.5% centre point of the target range any time soon. Brazil's inflation is the result of a supply shock caused by currency devaluation, and the central bank has no choice but to raise rates. As expected, Brazil's central bank raised its benchmark interest rate in its meeting held on February 26th to 10.75% from 10.5%. The bank may raise the rate further to control inflation.

Brazil's main consumer confidence index dropped in February to 107.1 points, down from 108.9 in January — its lowest level since May 2009 — due to the country's tepid economic activity and continued inflationary pressures. The index has a 1–200 point range, with 100 considered an indicator of neutral sentiment. Consumption remains a growth driver, but consumers have accumulated debt with mortgages, new cars and other items and now their budgets are tight. They are insecure about the future and not going to spend now.

Government investment will be limited in 2014 as Brazil comes under the threat of an imminent ratings downgrade, and it was left with no choice except to cut spending. Brazil's government has announced 44 billion reais (\$18.41 billion) in spending cuts as it seeks to meet its primary budget surplus target for 2014, set at 99 billion reais (some \$41.4 billion), equivalent to 1.9% of gross domestic product. In 2013 the primary surplus target was 1.9% of GDP. The budget cuts are aimed at achieving "fiscal consolidation," which will help lower inflation and

support sustained GDP growth, according to the Finance Minister Mantega.

The only good news for Brazil is that unemployment rates remain at record lows and wages are growing. Unemployment in six of Brazil's largest metropolitan areas dropped to an average of 5.4% in 2013, from 5.5% in 2012 and average monthly wages rose 1.8% in real terms.

Private equity and venture capital groups have slashed fundraising for Brazil by more than 70% over the past two years. In 2013 approximately \$2.3 billion was raised to invest in Brazil, down from \$3.6 billion in 2012 and \$8.1 billion in 2011, according to the Latin American Private Equity and Venture Capital Association (Lavca).

The Brazilian central bank has been holding daily auctions of derivative contracts that investors can use as protection against foreign-exchange volatility. The auctions have been widely credited to reduce the volatility of the Brazilian real. Still, the real is trading at around 2.40 to the dollar, compared with 2.00 per dollar a year ago.

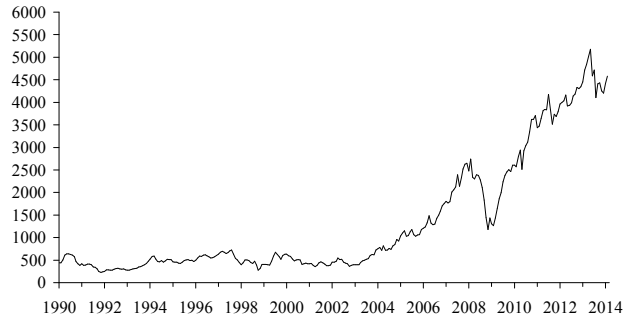
	11	12	13	14	15
GDP (%p.a.)	2.7	0.9	2.3	2.0	3.0
Inflation (%p.a.)	6.5	5.8	5.9	5.6	5.0
Current A/c(US\$ bill.)	-52.6	-60.0	-75.0	-70.0	-70.0
Real/\$ (nom.)	1.5	2.0	2.3	2.4	2.4

Other Emerging Markets

Hong Kong: FT-Actuaries



Indonesia: Jakarta Composite



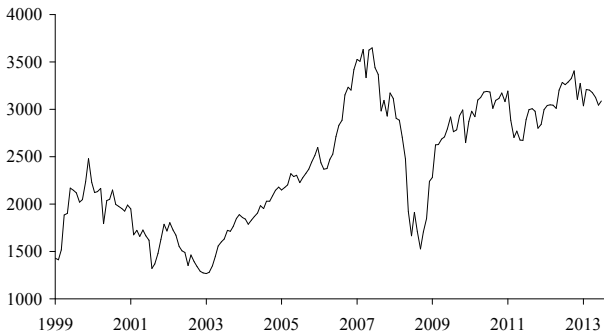
**Malaysia: FT-Actuaries
(US\$ Index)**



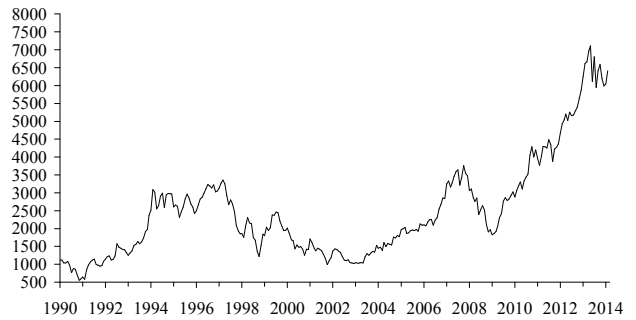
Thailand: Composite Index



Singapore: Straits Times Index

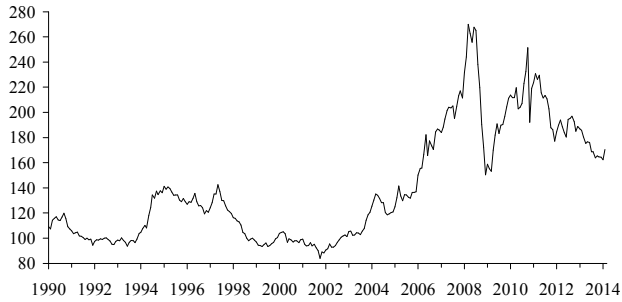


Philippines: Manila Composite

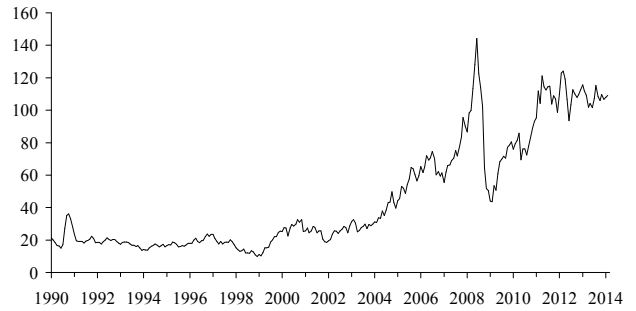


COMMODITY MARKETS

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



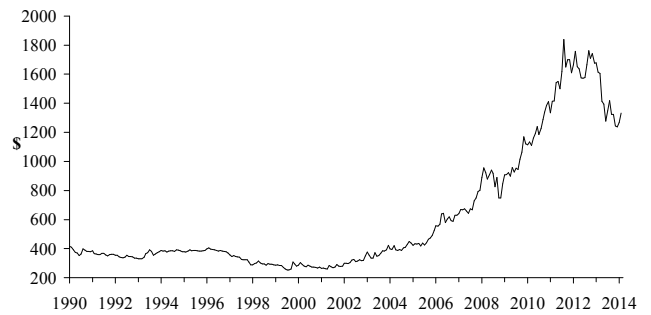
Oil Price: North Sea Brent (in Dollars)



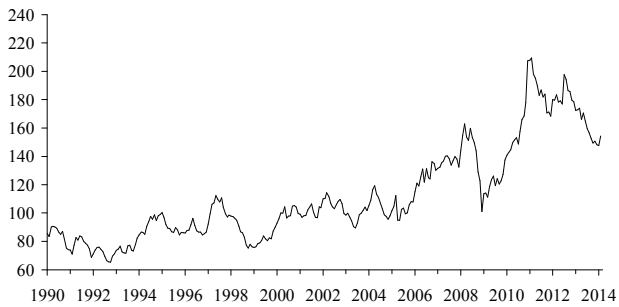
Commodity Price Index (Sterling)
(Economist, 2000=100)



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	2.5	1.6	1.8	83.0	94.1	-1.6	3.1	-0.5
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	2.6	1.6	1.2	82.9	93.7	-1.7	3.1	-0.6
2014:2	2.5	1.6	1.6	82.8	94.0	-1.6	3.1	-0.6
2014:3	2.4	1.7	1.9	82.9	94.0	-1.6	3.1	-0.4
2014:4	2.4	1.7	2.2	83.4	94.6	-1.5	3.0	-0.4

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 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	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	147.1	704061.8	408532.0	244321.9	181864.1	-32814.9	102184.1
2014	150.8	722173.8	414751.1	266188.7	175499.7	-38621.7	95765.2
2015	154.4	735702.5	414580.1	250992.1	193479.8	-31157.8	92210.8
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	1.4		0.9	1.1	-0.6		-2.0
2014/13	2.6		1.5	9.0	-3.5		-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	145.5	174176.5	101809.6	58031.1	47399.5	-7067.3	27132.5
2013:2	146.5	175320.9	101767.6	58214.8	45564.9	-7180.1	24182.3
2013:3	147.6	176705.8	102549.0	61992.2	45788.6	-9285.0	25475.0
2013:4	148.6	177858.6	102405.8	66084.0	43111.1	-9282.6	25394.2
2014:1	149.3	178747.9	103029.0	66015.6	43049.0	-9664.1	23431.4
2014:2	150.2	179820.4	103449.6	66632.0	43319.2	-9655.3	23693.8
2014:3	151.4	181259.0	103898.6	64834.9	45886.2	-9650.6	24248.6
2014:4	152.3	182346.5	104373.9	68706.1	43245.3	-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	1.4	2.6
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	2.5
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