LIVERPOOL INVESTMENT LETTER

September 2014

Cardiff Business School
Cardiff University

Julian Hodge Institute of Applied Macroeconomics

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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Editorial and Research Direction: Patrick Minford†.

Senior Research Associates: Kent Matthews†, Anupam Rastogi, Peter Stoney, Bruce Webb†, John Wilmot.

Research Associates: Vo Phuong Mai Le†, David Meenagh†, Francesco Perugini.

† Cardiff Business School

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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HOW CENTRAL BANKS FAILED IN THE BANKING CRISIS AND WHAT IT MEANS FOR THE FUTURE

It seems hard to argue that central banks were the central factor causing the banking crisis. Yet consider this argument put forward by Anthony de Jasay in a recent book (Economic sense and nonsense — reflections from Europe 2008-2012): the total value of sub-prime mortgages were in the range of $400-600 billion and the losses on them could be gauged at some percentage of this, at some tens of billions. Compare the latest fine just levied on the Bank of America of about $17 billion; not to speak of previous ones on Bank of America and ones of similar order on many other banks levied by the various US regulators. These have made but a dent in current bank profits and are a tiny percentage of total bank assets. So how could sub-prime losses have brought down the world banking system?

Table 1: Summary of Forecast

	2010	2011	2012	2013	2014	2015	2016
GDP Growth[1]	1.7	1.1	0.2	1.7	2.8	2.7	2.6
Inflation CPI	3.3	4.5	2.7	2.4	2.0	2.2	2.0
RPIX	4.8	5.3	3.2	3.2	2.5	2.8	2.7
Unemployment (Mill.)							
Ann. Avg.[2]	1.5	1.5	1.6	1.5	1.3	1.3	1.2
4th Qtr.	1.5	1.6	1.6	1.4	1.3	1.3	1.1
Exchange Rate[3]	80.4	80.0	83.1	82.6	83.0	82.3	82.5
3 Month Interest Rate	0.7	0.9	0.9	0.6	1.8	2.1	2.2
5 Year Interest Rate	2.4	2.0	0.9	1.2	1.6	2.1	2.3
Current Balance (£bn)	−40.0	−22.5	−59.2	−60.7	−62.9	−63.5	−62.0
PSBR (£bn)	139.6	118.5	115.0	112.3	109.4	94.6	84.5

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

De Jasay argues that they could not; and he must be right about that, simply because it is far too small. What brought down the banks was the effective closure of the world's interbank market, so that banks could not borrow from each other to carry out their normal day-to-day operations. This in turn happened because central banks failed in their key duty: to keep open the world system of liquidity of which this interbank market was a central component. The market closed because of a lack of trust between banks: bank A did not know whether bank B had a sound balance sheet, fearing it might be a major holder of sub-prime assets. So it refused credit on the interbank market. This became general. Yet central banks are supposed to stand behind such systems and assure member banks that they will maintain the creditworthiness of participating banks. They did not do this, particularly for foreign banks on the market; for their own banks they may have been willing to offer such assurances but this was not enough. So they failed to coordinate their support of the system.

Instead de Jasay argues that central banks allowed officials in government to spread doubt about banks' solvency and start at once on a tightening of regulation. The initiative moved to bureaucrats who have a vested interest in new controls that enhance their power. They put it about that banks had overreached themselves and that many of them were insolvent. Once this had occurred central banks lost control. When Lehman could not raise money in the marketplace, the Federal Reserve could not persuade enough banks to help it provide the necessary funding. Part of the problem was the unwillingness of the Bank of England to support Barclays' desire to buy a big chunk of Lehman.

So we got a story in which a small global loss spiralled into a snowball that brought down the world banking system. Of course after the collapse of the system bank losses also spiralled in the recession, so apparently validating the bureaucratic claims of massive over-extendedness. But the appearance is highly deceptive.

Replaying history like this might be too simple; there could have been other factors, such as the slowing of the world economy, that were creating broader losses for banks than just on sub-prime mortgages. In our Cardiff research on the crisis we have found that the world business cycle was indeed in trouble, as evidenced by the huge peaks in oil and other commodity prices. It looks as if there was too much credit in the previous boom, allowing it to get rather out of hand and so feed the following bust. However recessionary tendencies are one thing; collapse of world banks is another. We have had plenty of recessions in the post-war period but only in this one have we had a major banking collapse. It points the finger straight at central banking failure.

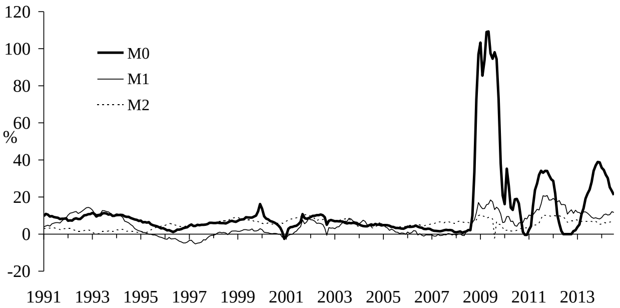
If this is correct, then the huge rise in regulation since the crisis looks quite unjustified. Instead governments should have improved central bank international coordination, and reviewed their ability to support world liquidity. They should have looked at ways of restraining money and credit directly in the boom stage of the cycle. They should also have looked at better rules from managing interest rates. More work we have done suggests that with such rules and firm central bank support of markets economic stability could be hugely increased; intrusive regulation of banks is both unnecessary and sabotages the credit mechanism. As for all these fines levied by all the different, competing US regulators, they too are a damaging bureaucratic intrusion on the banking market. The US itself, having once been supposedly the home of free markets, has become a major intervener in markets worldwide in pursuit of political objectives such as sanctions and popular retribution, with the Dodd-Frank Act too a source of an ever-growing interference in the banking system.

We must hope that this regulative backlash produces its own horrified reaction. It seems that this has happened earliest in the UK where we have had attempts to alleviate the worst effects of regulation with schemes like Funding for Lending and Help to Buy. Our newfound recovery may owe a lot to these attempts. In the US the existence of state and local banks has helped credit to start flowing in spite of the problems of the large money-centre banks. Still the US is suffering from a stuttering recovery which seems closely related to a sharp rise in political uncertainty about future intervention, with a President keener on it than any predecessor. As for the euro-zone it is a tragic tale of the overweening ambition of a small elite who forced monetary union on reluctant nations, and then has followed it up in the crisis with measures that have put the preservation of that union above the interests of the union's citizens, on the pretext that abandoning it would 'create chaos'. Sadly the citizens have bought the lie but their misery is untold. Their banks have had to absorb huge amounts of government debt; and ironically that very debt is undermining their credit status. EU bureaucrats are busy condemning them as 'capital insufficient' which in turn wrecks the credit mechanism of the euro-zone. Its growth has stopped, deflation is moving in, and the crisis is worsening again. The hope is that 'reform' will trigger growth; yet without credit it is impossible to turn reform into growth because the new firms and industries encouraged by reform cannot obtain the means to invest.

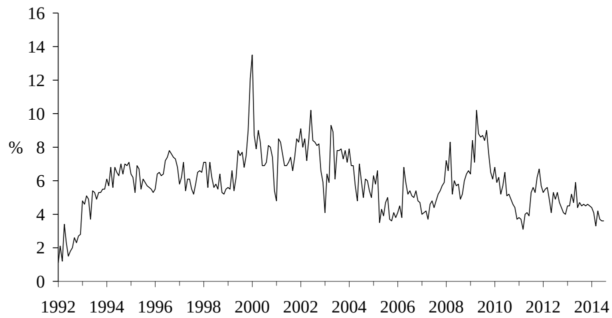
Just as Japan effectively ceased to be an element in world growth over the past two decades, wrecked by a cocktail of deflation, lack of competition and low productivity growth, so the euro-zone is imitating it now. It looks as if it will be written out of the world growth script over the next decade at least. The UK in particular has had to turn to other markets and that will continue. As the FT writer Wolfgang Munchau has frequently observed, the UK may be agonising over in-out referendums on the EU but it has already de facto left. It remains to formalise the new relationship and tidy some difficult loose ends like totally free EU immigration and aggressive EU financial taxation.

World and UK growth will survive the EU's problems, just as they have survived Japan's problems. Our forecasts remain positive for the survivors.

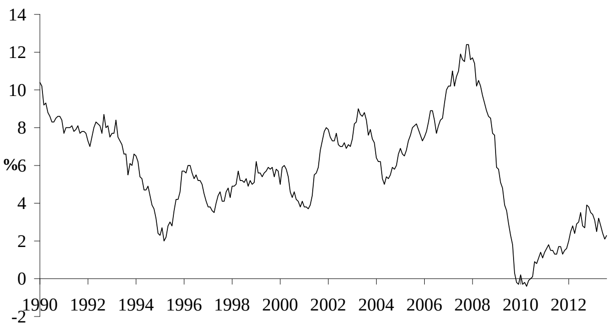
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



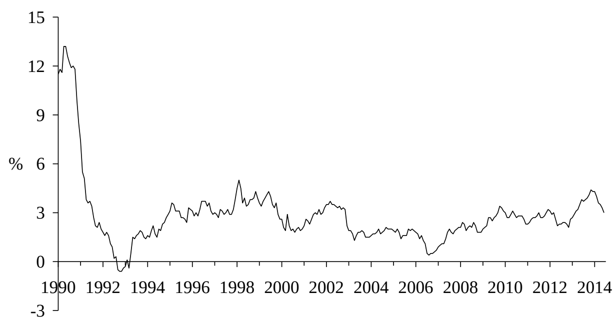
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Japan's GDP Plunged

As widely expected, Japan's economy plunged in the second quarter of the year following the value added tax (VAT) hike on April 1, as households brought their purchases forward to the first quarter. Real GDP declined 1.7% over the previous quarter, after a downwardly revised 1.5% jump in the first quarter, the worst economic contraction seen since the earthquake and tsunami that battered the north-east of the country more than three years ago. This is a far more serious decline than economists were predicting back in the spring.

Looking at demand components, domestic private demand contracted sharply, –3.7%, the largest quarterly contraction since 1974, when inflation surged during the oil crisis. All components softened, but especially private consumption (–5.0%) and housing (–10.3%). The fall in private consumption was much more than expected, and clearly larger than after the 1997 tax hike. As a result, consumer spending in the first half of the year was 0.4% lower compared to the second half of 2013. The decline in consumer spending is partly due to a fall in real disposable income. The depreciation of the yen since November 2012 has fuelled inflation, in particular for energy products. In addition, the VAT hike added about 2 percentage points to the rate of inflation. In the second quarter, the private consumption deflator was 2.6% higher than a year earlier. By contrast, wages have hardly increased. In June, they were only 0.4% higher compared to last year. Public consumption rose 1.4%, but public investment unexpectedly fell (–0.5%).

Another disappointment came from exports, as they declined by 0.4%. However, this was largely a correction after the 6.4% increase in the preceding quarter. Many Japanese companies now produce abroad. That explains why many of Japan's large manufacturers such as car makers reported strong earnings in the second quarter despite lacklustre demand at home.

An even more worrying sign was the rise in inventories. The contribution of stocks to GDP growth amounted to 1 percentage point. The increase in inventories has also been observed in the industrial production statistics. It is partly related to the rebuilding of stocks after their decline in the first quarter. However, it may also indicate that sales disappointed due to the sharper than anticipated decline in household demand and a very weak external environment. In that case it is likely that manufacturers will slow their production in the coming quarters to offload their unwanted stocks. "This doesn't bode well for the July–September quarter. Inventory adjustments will be necessary, meaning production may not grow", said Yasuo Yamamoto senior economist at the Mizuho Research Institute.

Looking forward, there are signs that the effects of the sales tax might be easing. Consumer confidence rose to 41.5 in July from 41.1 in June, according to recent government data released. That was the third straight month of improvement. In addition, the month to month rise in the income growth Diffusion Index (DI), which is thought to represent consumers' assessment of real income, continued accelerating, although the improvement in the standard of living and timing to buy durable goods stalled in July. The weak recovery in the standard of living DI is in line with information on consumers' inflation expectations included in this survey; the percentage of respondents who expect price rises in the next 12 months rose for the first time in four months possibly reflecting the recent rapid rise in gasoline prices and prices of processed foods produced by large firms.

Economic and Fiscal Policy Minister Akira Amari was unfazed by the big contraction. "The backlash will ease down the road", he said at a news conference after the GDP results were announced. He said the economy will return to a mild recovery path after summer. The 12 Japanese private-sector research institutes that provided projections are more upbeat about the rest of the year. They forecast an average of 4.4% annualized GDP growth in the July–September period and a 2.1% expansion in the October–December term, surpassing the potential growth rate of just under 1%.

Against this backdrop, the Bank of Japan is unlikely to change its policy. As long as inflation stays on course to hit the 2% target in early 2016, the BOJ will probably refrain from stepping up the rhythm of its asset purchases. However, in view of the upcoming parliamentary elections, the government might be tempted to ease the fiscal stance further. This would also facilitate the implementation of the 2-point VAT hike in 2015. This would lead to a worsening of the government finances. However, the authorities trust that the financing is not such a problem with the BOJ willing to buy ever more JGBs.

The GDP data need to be put in perspective. Prime Minister Shinzo Abe can point to much that is still going right with his economic strategy. Japanese companies are enjoying historically high profits, thanks in part to the impact of quantitative easing in weakening the yen. After years of crippling deflation, Japan's inflation rate was running at 1.3% on an annual basis in June. But despite this, Abe and his government need to give more momentum to his "third arrow" of structural reform. The Japanese prime minister has time on his hands, with no need to go to the polls until 2016 and an opposition that is in disarray. However, this month's economic data have exposed just how big the task of turning round the Japanese economy has become.

MARKET DEVELOPMENTS

The general world upturn continues and while equity markets may well be a bit ahead of the curve the general prospect remains that growth will continue. This will underpin the equity market long-term. As before growth will centre in emerging markets and so we continue to recommend spreading equity investments across a wide group of these markets.

Table 1: Market Developments

	Market Levels		Prediction for Aug/Sep 2015	
	Jul 31	**Aug 29**	**Previous Letter**	**Current View**
Share Indices				
UK (FT 100)	6730	6820	9732	9793
US (S&P 500)	1931	2003	2487	2560
Germany (DAX 30)	9407	9470	13312	13400
Japan (Tokyo New)	1289	1278	1800	1784
Bond Yields (government long-term)				
UK	2.61	2.37	2.00	2.00
US	2.56	2.34	2.10	2.10
Germany	1.16	0.89	1.50	1.50
Japan	0.54	0.50	0.70	0.70
UK Index Linked	–0.16	–0.43	0.10	0.10
Exchange Rates				
UK ($ per £)	1.69	1.66	1.56	1.56
UK (trade weighted)	88.5	87.8	82.3	82.3
US (trade weighted)	87.5	88.3	85.5	85.5
Euro per $	0.75	0.76	0.79	0.79
Euro per £	1.26	1.26	1.23	1.23
Japan (Yen per $)	103.0	104.0	98.0	98.0
Short Term Interest Rates (3-month deposits)				
UK	0.60	0.75	2.10	2.10
US	0.38	0.35	0.70	0.70
Euro	0.16	0.12	0.50	0.50
Japan	0.11	0.06	0.70	0.70

Table 2: Prospective Yields [1]

Equities: Contribution to £ yield of:

	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.30	2.5	2.1	39.00		46.90
US	1.80	2.8	2.0	23.00	6.08	35.68
Germany	2.70	1.5	2.0	38.00	2.24	46.44
Japan	1.80	1.6	2.0	36.00	11.50	52.90
UK indexed[2]	–0.43		2.4	–5.00		–3.33
Hong Kong[3]	2.50	7.0	2.0	6.00	6.08	23.58
Malaysia	2.90	5.2	2.0	54.00	6.08	70.48
Singapore	3.60	4.5	2.0	37.00	6.08	53.18
India	1.40	7.0	2.0	21.00	6.08	37.48
Korea	1.10	4.2	2.0	0.00	6.08	13.38
Indonesia	2.30	6.1	2.0	42.00	6.08	58.48
Taiwan	2.80	3.0	2.0	26.00	6.08	39.88
Thailand	3.00	4.1	2.0	36.00	6.08	51.18

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	2.37	3.70		6.08
US	2.34	2.40	6.08	10.82
Germany	0.89	–6.10	2.24	–2.97
Japan	0.50	–2.00	11.50	10.00

Deposits: Contribution to £ yield of:

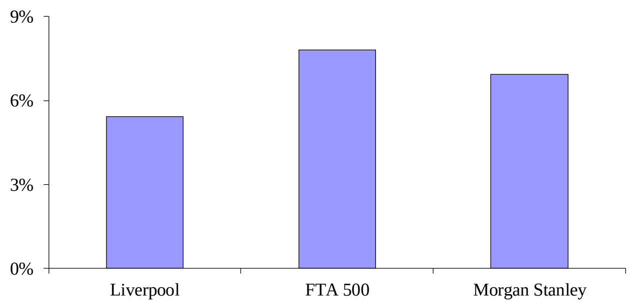
	Deposit Yield	Currency	Total
UK	0.75		0.75
US	0.35	6.08	6.43
Euro	0.12	2.24	2.36
Japan	0.06	11.50	11.56

[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(%)

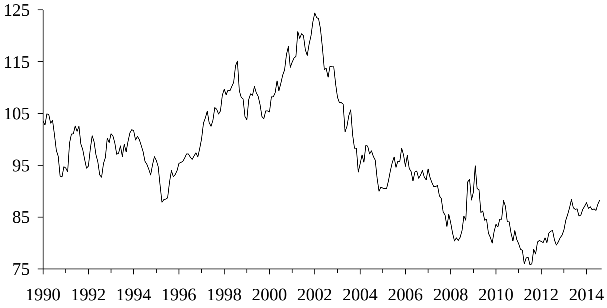
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	August Letter	Current View	August Letter	Current View	August Letter	Current View
UK Deposits (Cash)	5	5	5	5	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-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

3 Year Annualised Growth

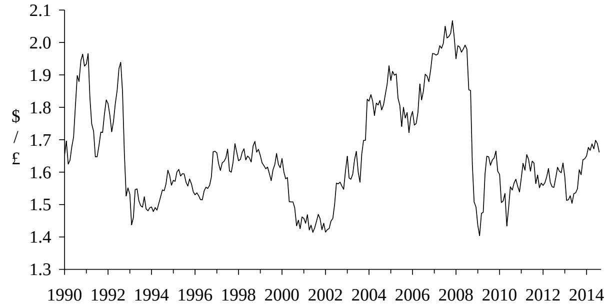


INDICATORS AND MARKET ANALYSIS
FOREIGN EXCHANGE MARKETS

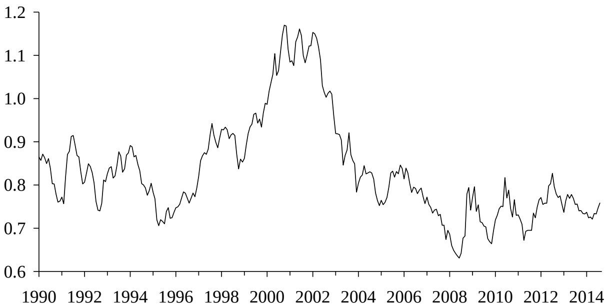
US : Trade Weighted Index
(Bank of England 1990 = 100)



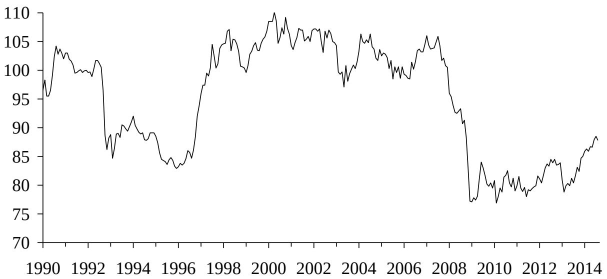
UK: Dollars Per Pound Sterling



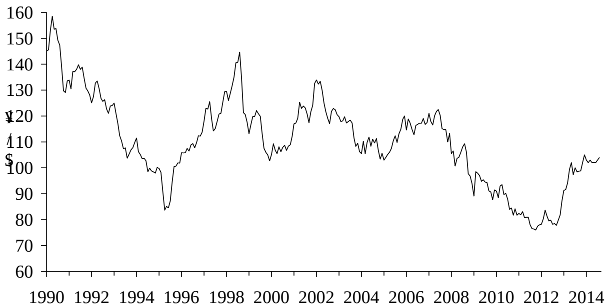
Euro per US dollar



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



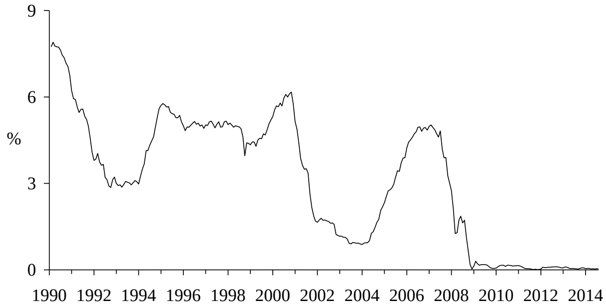
Japan : Yen Per U.S. Dollar



GOVERNMENT BOND MARKETS

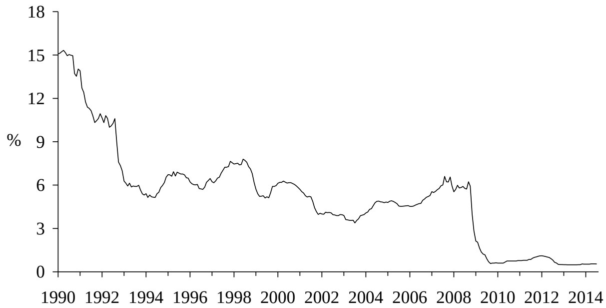
U.S.: Yield on Long-Term Government Bonds

U.S. : 3-Month Treasury Bill



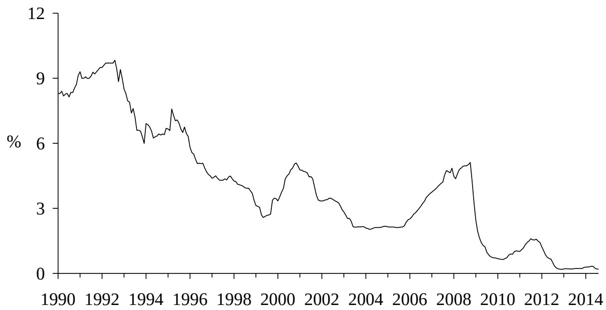
U.K. : Yield on Long-Term Government Bonds

U.K. : 3-Month Interbank Rate

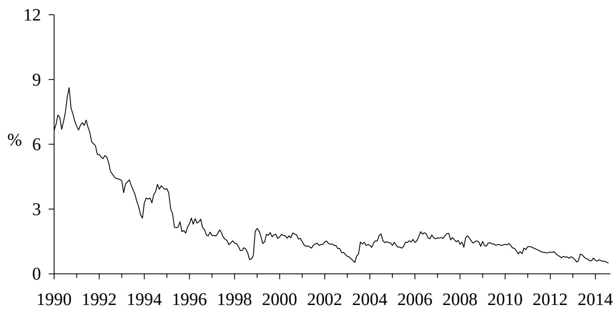


Germany: Yield on Public Authority Bonds

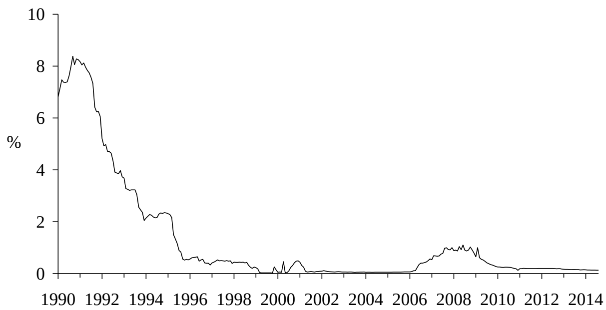
Germany : 3-Month Interbank Deposit Rate



Japan: Yield on Long-Term Government Bonds

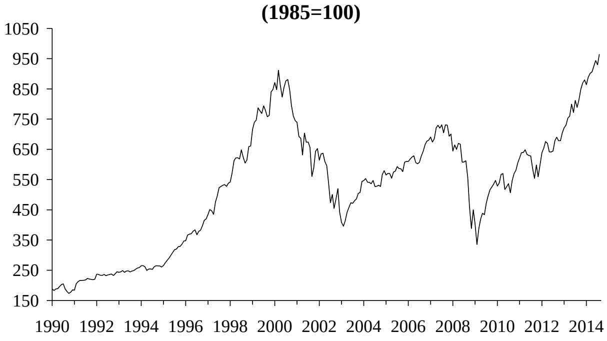


Japan : 3 Month Money Market Rate

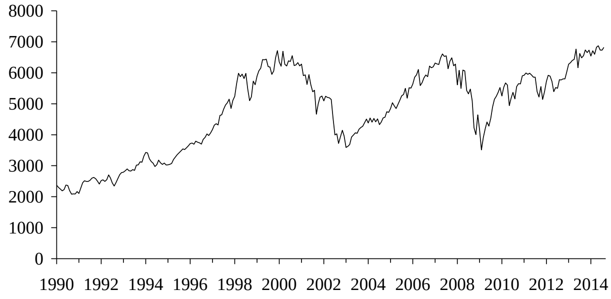


MAJOR EQUITY MARKETS

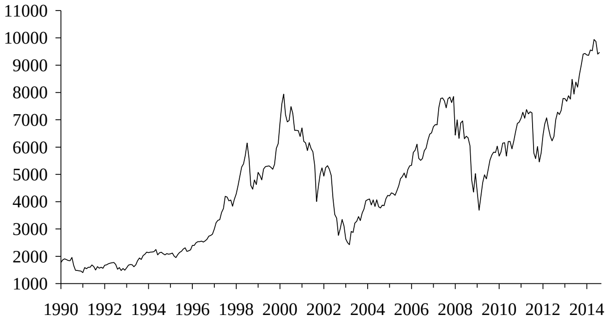
U.S. : S & P 400 Industrial
(1985=100)



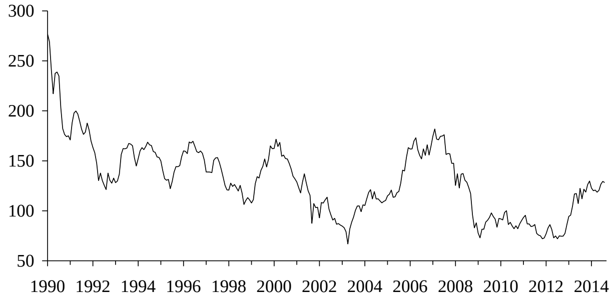
U.K. : FTSE-100 Index
(10 April 1962=100)



Germany : DAX 30



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



EMERGING MARKETS

Anupam Rastogi

India

India has once again become the flavour of the month. The contours of the new government's economic policy are going to be weaved around manufacturing, gender equality and toilets for poor. But, economic growth is to be driven by an export oriented manufacturing sector and investment in infrastructure projects primed by the government. Notwithstanding the killing of the global trade deal by India, the government is going to welcome manufacturing companies to enter the full range of Indian industries.

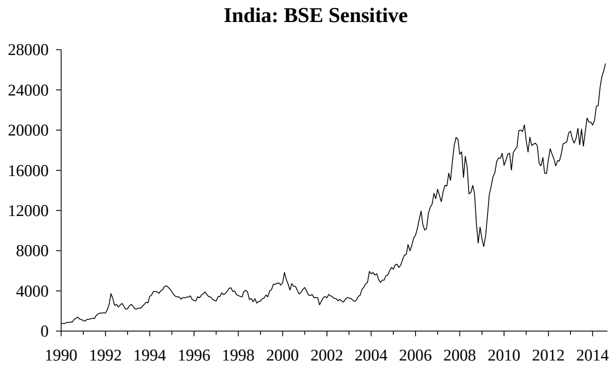
Gross domestic product in the three months ending June 30 grew 5.7% from a year earlier compared to the 4.6% growth in the two preceding quarters, and the highest India has seen in nine quarters. This confirms the upswing and shows that the economy is accelerating. In the fiscal year 2015–16, the economy will grow 7% or more as it is helped by growing exports and falling crude oil prices. As the dragon of inflation gets slain, the falling interest rate would boost investments in the economy.

India's wholesale inflation eased to 5.19% from a year earlier, the lowest level in five months in July, but the inflationary expectations are still quite high. Consumer inflation rose to 7.96% in July from 7.46% in June, largely due to a spike in vegetable prices. The RBI wants consumer inflation to be no higher than 8% by January 2015 and 6% by January 2016 before easing the monetary policy. The Reserve Bank of India left its key policy interest rate unchanged at 8%, citing inflation data that were on a downward path while still being too high for comfort.

The central bank firmly believes that lower inflation will be beneficial for the economy, and the process of cooling prices won't hurt business. Its interest-rate decision will be guided by consumer prices and the government of India seems to agree with the bank. The government is also committed to lower the fiscal deficit sharply this year which is one of the central pieces of the central bank governor Rajan to control inflation.

The Reserve Bank of India prudently chose to leave the repo rate and CRR unchanged at 8% and 4% respectively even as it seemed less perturbed about achieving its January 2015 inflation target of 8%. Following a 50 basis points reduction in the June policy, RBI announced another 50 basis pionts cut in SLR requirement for banks to 22% of NDTL.

India's improving economy has helped make the local currency, the rupee, stronger against the dollar. The RBI is comfortable with the value of the rupee and that the central bank is refraining from direct market intervention. Governor Rajan said, "We […] recognize our inability to manipulate the long-run value of the rupee, and we don't try. … It goes in the direction it wants to go."



Exports were up 9.3% between May and July from the year before, while imports of capital goods expanded in May, June and July after contracting in the past two fiscal years, suggesting companies are stepping up activity. Electricity demand soared an average 11% year-over-year in June and July after barely growing the year before. Sales of cars and trucks have increased, too. The trade deficit has widened to $12.22 billion in July from $11.76 billion in June. However, an exports target of $350 billion is achievable in 2014.

India Inc. has given a big thumbs-up to Prime Minister Narendra Modi, who completed 100 days in office. Leaders of Indian companies say the new government's biggest achievement has been a perceptive improvement in business sentiment, which had hit rock bottom during the previous regime. It has allowed greater foreign ownership in defence companies and opened up railways to foreign investment. It has also moved to lower some bureaucratic barriers to business.

Not only India Inc, foreign companies such as Uber, the smartphone application that connects passengers with cars-for-hire, Amazon, GAP etc. are investing heavily in India. Private equity firms from the US have taken substantial stakes in many start-ups in the last couple of months as they believe that Mr. Modi would turn out to be one of the most businesses friendly Prime Minister India has ever had. Reforms promised by the government in several areas, including with labour laws and financial-market regulations — could "deliver a sustainable growth of at least 7% in a noninflationary manner, once global growth normalizes," according to a central bank report.

The International Finance Corporation, an arm of the World Bank, has launched a $2.5bn rupee bond programme, the largest onshore financing facility in India by an international institution. The IFC facility will finance infrastructure investment in India, and will use both rupee-denominated bonds and swaps to raise funds over the next five years, the group said.

India's stock market has been smitten by Mr. Modi's win in a decisive election in May. The stock market is running at a new all-time highs and it may gain another 25% in next 12 months.

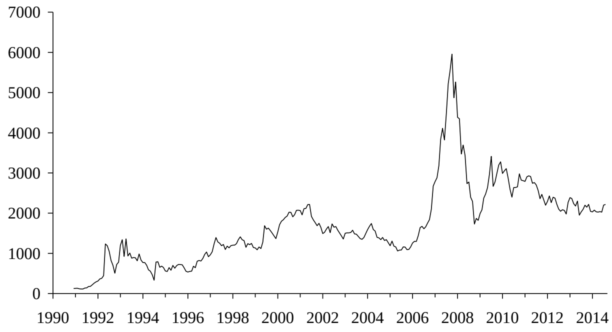
	11-12	12-13	13-14	14-15	15-16
GDP (%p.a.)	6.2	4.5	4.7	6.0	7.0
WPI (%p.a.)	9.0	7.5	7.0	6.5	6.0
Current A/c(US$ bill.)	-40.0	-88.0	-50.0	-50.0	-50.0
Rs./$(nom.)	49.5	54.5	60.0	61.0	62.0

China

Away from economic data coming out of various sources, China is on its way to spiral down from an export-oriented and investment-driven economy to one based on rising demand of domestic consumers. In order to maintain social cohesion, Chinese leadership is wedded to maintain a high employment rate. Therefore, we are not surprised that China would manage GDP growth of 7.5% in 2014 and aims to achieve 7% growth rate in 2015. Over the next 6–7 years, it would achieve 4%–5% growth rate which is sustainable in medium term through free-trade pacts with other countries and exporting infrastructure projects to developing countries.

The economy grew 7.5% year-on-year in the second quarter compared to 7.4% in the first quarter. The HSBC China Manufacturing Purchasing Managers Index fell to 50.3 in August — a three-month low — compared with 51.7 in July. After the slowdown in the economic activity earlier, Beijing rolled out a host of focused fiscal, monetary and administrative stimulus measures such as increased spending in rail, social housing and alternate-energy projects, more credit for farmers and first-time homeowners, and regulatory changes aimed at improving the business climate. However, growth in new lending declined sharply in July after a strong June increase. Housing sales fell by more than 10% in the first seven months of the year. The sharp decline in total credit was due to slower growth in bank loans as well as a decline in nonbank financing activities such as trust financing as Beijing cracks down on the country's ballooning shadow banking activities. New bank lending stands at 385.2 billion yuan ($62.5 billion), compared with 1.1 trillion yuan in June. The situation is projected as alarming due to poor policy communication and opaqueness of policy implementation by the central bank. Not surprisingly, property prices and construction activity continue to fall, posing risks to the banking system, personal wealth and local government finances.

China: SSE Composite Index



The consumer-price index rose 2.3% year-on-year well within the government's tolerance level of 3.5%, suggesting consumer demand remains tepid despite loose monetary policy and government stimulus measures.

China's exports rose 5% in the second quarter, its imports from Asia rose just 1.1%, after shrinking 4.3% on year in the first quarter. The improvement in export growth was broad-based in July, which is likely to be sustained if the US economy continues to expand at a healthy pace. But China's 1.6% contraction in July imports signals continued weakness in domestic demand.

China's politically sensitive trade surplus widened to $47.3 billion in July from $31.6 billion in June. The country's previous monthly trade surplus record was $40.09 billion in November 2008. Exports have been bolstered by a yuan that has depreciated 1.7% against the U.S. dollar this year.

China's gradually improving economic picture should lead to further upward pressure on the currency. The yuan could reach between 6.05 and 6.10 by year-end. The currency has risen for three straight months and had trimmed its loss to 1.4%. It has strengthened beyond the psychologically important Rmb6.15 barrier.

The "mixed ownership" of the state owned enterprises is gaining currency. Beijing hopes that this can nudge state-owned enterprises to be more commercially oriented, making the overall economy more efficient. We doubt that multinationals would be interested in taking the stake because just as the China market opens up, their profit margins are headed down.

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

South Korea

South Korea's central bank has cut its benchmark interest rate by a quarter of a percentage point to 2.25% — its first rate change in 15 months — to boost anaemic economic growth at the risk of exacerbating the nation's heavy household debt burden. The rate cut would accelerate consumption and investment as last month the government announced a $40 billion economic stimulus package that included looser mortgage rules intended to kick-start the housing market.

As part of the stimulus package, the government has announced a series of measures to boost household incomes and consumer spending. The government will offer tax breaks to companies that use their cash reserves to raise wages and return money to shareholders. It also introduced an extra profits tax on company cash hoarders. The idea is that those vast corporate reserves would do more for the economy if they were freed from the corporate balance sheet and put in the hands of workers and shareholders, who can invest or spend them. But, companies may also prefer paying the tax over losing their cash.

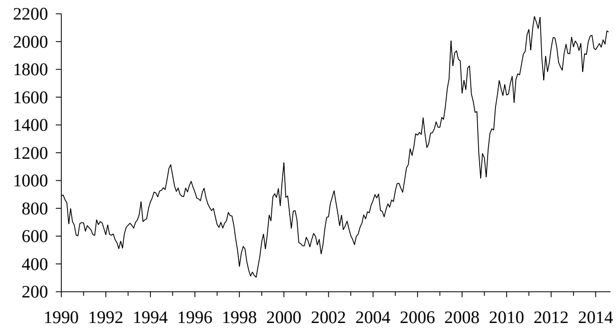
South Korea's exports in July grew 5.7% from a year earlier following a 2.5% gain in June and a 1% drop in May. South Korea's exports to the U.S. rose 13% in the second quarter and climbed 17% to Europe, but fell 3% to China, the country's largest export market. Korea's overall exports climbed just 3% in the second quarter. Imports in July grew 5.8% from a year earlier signifying improving demand at home.

South Korea's competition watchdog is investigating the country's four largest commercial banks over possible interest rates collusion, adding to a growing list of probes globally into the alleged rigging of various financial prices and benchmarks. The Fair Trade Commission sent inspectors to Kookmin Bank, Woori Bank, Shinhan and Hana Bank to look into data related to setting interest rates.

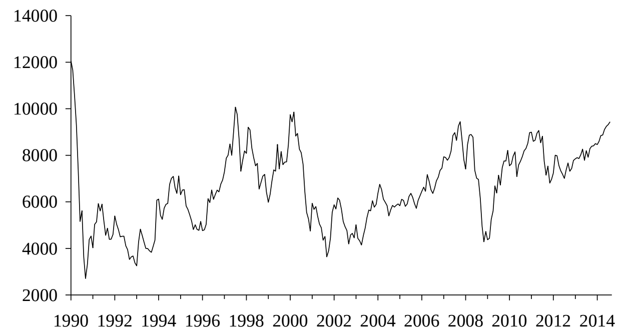
US exchange operator CME Group, Deutsche Börse of Germany and Standard & Poor's have expressed interest in buying a stake in Korea Exchange (KRX) as part of their efforts to expand into Asia. This provides an opportunity to other bourse operators to access one of the region's most active derivatives markets. Western exchanges are keen to expand into Asia, where derivatives markets are still relatively under-developed, compared with the US and Europe.

The Kospi's price-to-book ratio of 1.07 is about 48% cheaper than that of the MSCI All-Country World Index. Its dividend yield is the lowest in the region at only 1.1% versus 2.9% for Taiwan, 3.86% for Hong Kong and 3.19% for China. South Korea has expanded the limit that stocks are allowed to rise or fall in a given day for the first time in 16 years as it seeks to spice up the market.

Korea: Composite Index



Taiwan: Weighted TAIEX Price Index



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

Taiwan

Taiwan's economy outpaced the government's forecast of 2.8% in the second quarter. Taiwan's gross domestic product rose 3.8% from the same period a year earlier, as electronics exports rose, companies stepped up investments and consumers continued to spend. Steady recovery in the U.S. and China and strong global demand for mobile devices catapulted Taiwan's export-reliant economy.

Exports were up 2.9%, compared with less than 1% in the first quarter. GDP may rise more than 3% this year if demand for electronic exports does not ebb. The government expects the economy to grow 3.41% this year, up from previous forecast of 2.98%. After recording the strongest growth in three years in 2014, Taiwan's gross domestic product could rise more quickly at 3.5% next year, according to the government. The industrial production index rose 6.08% in July from June to a record level.

Exports, accounting for two-thirds of GDP, are expected to rise 3.21% this year. It is better than its previous forecast of 3.1% and a 1.41% growth last year. Private consumption will likely grow 2.62% this year and investments by the private sector are expected to rise 4.83% in 2014.

The government expects the consumer-price index to be marginally higher than 1.5% this year but still within the central bank's tolerance of 2%. That means the central bank may keep its monetary policy accommodative to promote economic growth.

Taiwan's leaders are worried about the nation's competitiveness in coming years as China and South Korea plan to finalize a free-trade agreement that will give most South Korean products zero-tariff entry into the mainland. That's a problem for Taiwan because both countries count China as their largest trading partner and their exporters compete head-to-head. Between 50% and 80% of Taiwan's exports — from petrochemicals to steel, textiles to machinery — overlap with South Korea's. The government estimates that a South Korea-China FTA would impact up to $49 billion of Taiwan's exports.

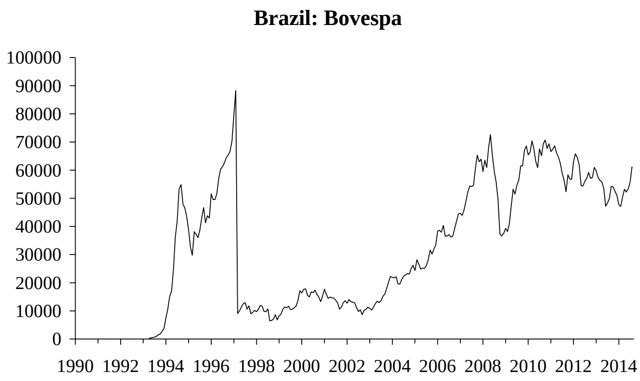
Meanwhile, Taiwan's latest trade pact with China signed last year is in limbo after the student-led "sunflower movement" stymied its ratification by the legislature this spring. Protesters fanned political emotions that Taiwan is in danger of being swallowed up by China as its businesses become increasingly dependent on the mainland.

	11	12	13	14	15
GDP (%p.a.)	4.0	1.3	2.1	3.0	3.0
Inflation (%p.a.)	1.2	1.9	1.2	1.5	1.5
Current A/c(US$ bill.)	18.0	41.7	50.6	57.4	60.0
NT$/$(nom.)	30.0	29.5	30.0	30.5	30.5

Brazil

Brazil's GDP declined to 0.6% in the second quarter following a 0.2% decline in the first quarter. Technically, Brazil has slipped into a recession. The Brazilian economy will grow about 0.5% this year, while inflation declines to 6.5% for the year as a whole, the maximum allowed under the country's inflation-targeting policy. The central bank, between April of 2013 and April 0f 2014, had increased interest rates by 3.5 percentage points to tame inflation.

Brazil's inflation slowed sharply last month, as food prices fell and there was a fall in airfares and hotel rates after the world cup. The primary surplus in the 12 months through June was 1.36% compared to its target of 1.9% of GDP indicating that pressure on inflation will remain for some time.



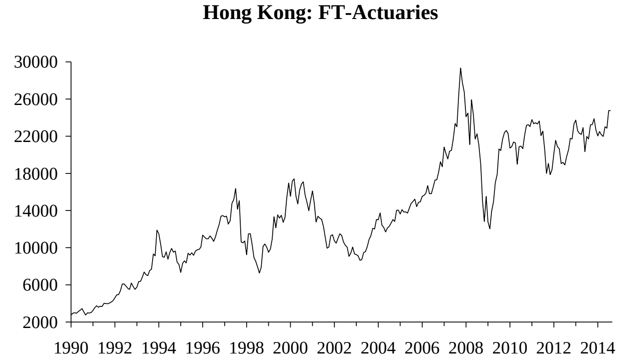
In order to boost demand, the government injected money into the banking system for the second time in less than a month. Further, the central bank eased rules on reserve requirements, freeing up about R$10bn ($4.5bn) for new lending. Just over three weeks ago, it injected R$45bn into the economy by easing compulsory deposit rules and changing the risk calculation of some loans. The finance ministry also created a new tax-exempt bond to boost the mortgage market.

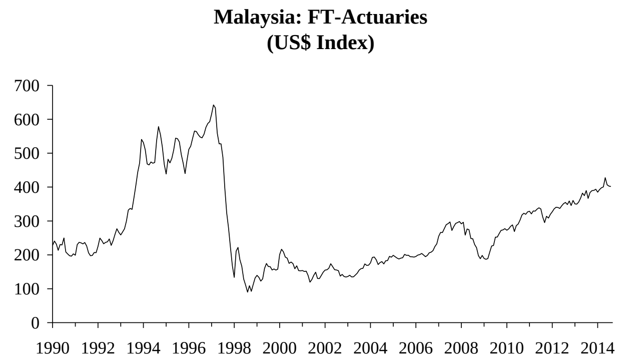
Over the last few months, the nation's political landscape changed drastically. Brazil's Socialist Party is supporting Marina Silva as its nominee for president. She was vice-presidential candidate of Eduardo Campos, who was killed on August 13 in a plane crash. She served as environment minister under Luiz Inácio Lula da Silva, from 2003 to 2008. She left Lula's party to join the Green Party but then quit in 2011.

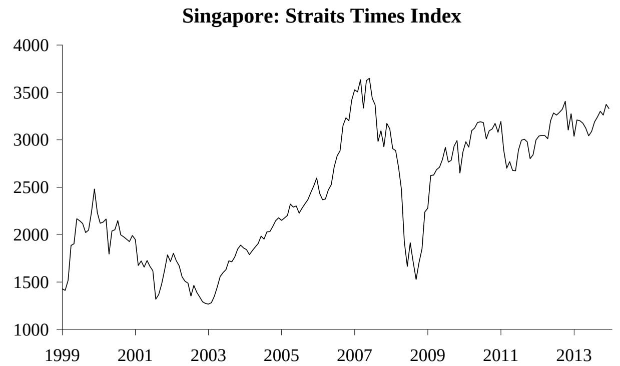
Ms Silva is a committed environmentalist and has publically opposed large hydro-electric projects. She is carefully watched by the agro-industrial lobby. It is believed that she would focus on the environment, education and social issues while delegating much economic authority to whoever would become her finance minister. In an opinion poll carried out in mid-August she may get more votes than Ms Dilma Rousseff in a likely second round. This is making the forthcoming presidential election interesting and the incumbent president Ms Rousseff has a stiff fight on her hand. However, economic policy of the candidates is going to play an important role as inflation has eroded spending power of the common man. So the candidate who puts forward the best economic agenda will have the advantage. With the economy slipping into recession, Ms Rousseff has work cut out for her if she wants to get re-elected in October.

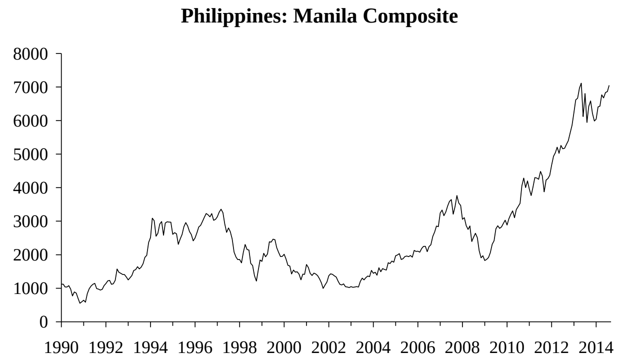
	11	12	13	14	15
GDP (%p.a.)	2.7	0.9	2.5	0.4	1.5
Inflation (%p.a.)	6.5	5.8	5.9	6.5	6.0
Current A/c(US$ bill.)	-52.6	-60.0	-75.0	-70.0	-70.0
Real/$(nom.)	1.5	2.0	2.3	2.30	2.40

Other Emerging Markets



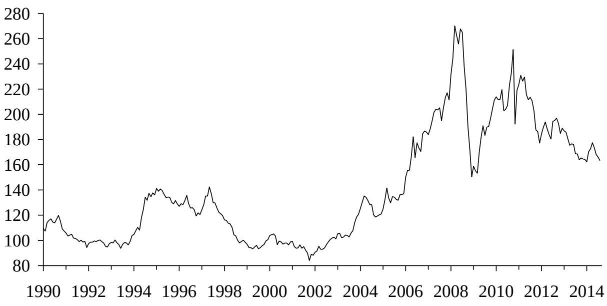




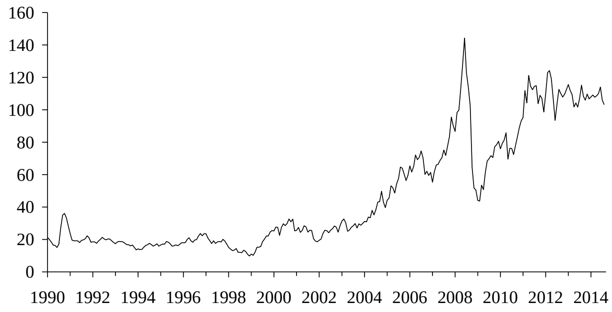


COMMODITY MARKETS

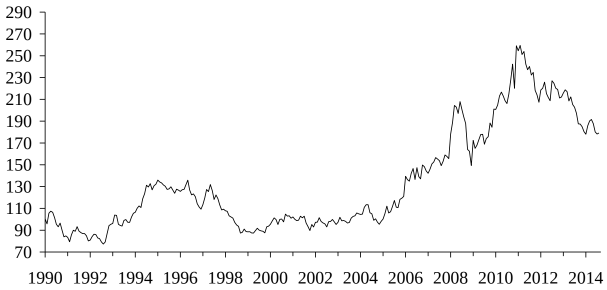
Commodity Price Index (Dollar)
(Economist, 2000=100)



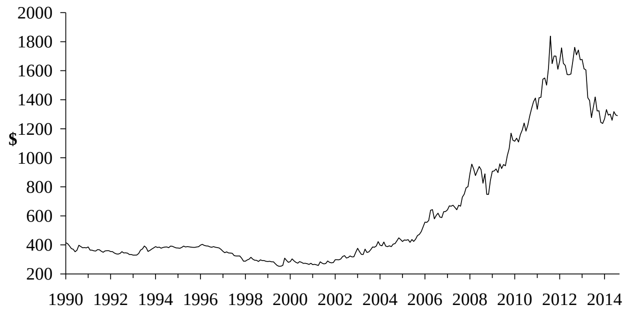
Oil Price: North Sea Brent (in Dollars)



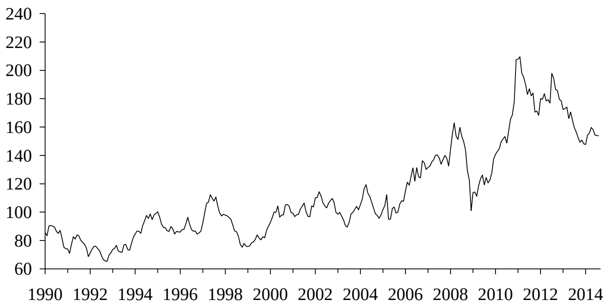
Commodity Price Index (Sterling)
(Economist, 2000=100)



Gold Price (in Dollars)



Commodity Price Index (Euro)
(Economist)



UK FORECAST DETAIL

Prices, Wages, Interest Rates and Exchange Rate Forecast (Seasonally Adjusted)

	Inflation %[1] (CPI)	Short Dated (5 Year) Interest Rates	3 Month Int. Rates	Nominal Exchange Rate (2005=100)[2]	Real Exchange Rate[3]	Real 3 Month Int. Rates %[4]	Inflation (RPIX)	Real Short Dated Rate of Interest[5]
2010	3.3	2.4	0.7	80.4	88.6	–3.5	4.8	–0.2
2011	4.5	2.0	0.9	80.0	89.8	–2.8	5.3	–0.2
2012	2.7	0.9	0.9	83.1	93.9	–1.8	3.2	–1.4
2013	2.4	1.2	0.6	81.4	92.5	–1.7	3.2	–1.0
2014	2.0	1.6	1.8	83.0	94.1	–1.1	2.5	–0.4
2015	2.2	2.0	2.1	82.3	95.4	0.1	2.8	0.1
2012:1	2.7	1.1	1.1	81.2	91.6	–1.9	3.8	–1.3
2012:2	3.1	0.9	1.1	83.1	94.2	–1.4	3.2	–1.4
2012:3	2.5	0.7	0.8	84.1	95.2	–1.8	2.9	–1.6
2012:4	2.5	0.8	0.6	83.6	94.8	–2.0	3.0	–1.5
2013:1	2.6	1.0	0.6	80.3	90.9	–1.7	3.3	–1.3
2013:2	2.3	1.0	0.6	80.6	92.6	–1.9	3.1	–1.3
2013:3	2.4	1.5	0.5	81.2	93.2	–1.5	3.2	–0.7
2013:4	2.5	1.5	0.7	83.5	93.2	–1.9	3.2	–0.7
2014:1	1.8	1.6	1.2	82.9	93.7	–0.9	2.5	–0.5
2014:2	2.0	1.6	1.6	82.8	94.0	–1.1	2.5	–0.4
2014:3	2.0	1.7	1.9	82.9	94.0	–1.2	2.5	–0.4
2014:4	2.1	1.7	2.2	83.4	94.6	–1.2	2.6	–0.3

1 Consumer’s Expenditure Deflator
2 Sterling Effective Exchange Rate Bank of England
3 Ratio of UK to other OECD consumer prices adjusted for nominal exchange rate
4 Treasury Bill Rate less one year forecast of inflation
5 Short Dated 5 Year Interest Rate less average of predicted 5 year ahead inflation rate

Labour Market and Supply Factors (Seasonally Adjusted)

	Average Earnings (1990=100)[1]	Wage Growth[2]	Unemployment (New Basis) Percent[3]	Millions	Real Wage Rate[4] (1990=100)
2010	227.1	2.4	4.6	1.50	135.6
2011	232.7	2.5	4.6	1.53	133.5
2012	237.0	1.9	4.7	1.59	132.4
2013	240.2	1.4	4.3	1.45	131.0
2014	246.3	1.6	3.9	1.33	131.1
2015	251.0	2.2	3.9	1.31	133.3
2012:1	236.6	0.7	4.8	1.61	132.6
2012:2	238.1	1.8	4.8	1.59	132.2
2012:3	238.1	1.9	4.7	1.57	132.9
2012:4	236.6	3.3	4.6	1.56	131.8
2013:1	238.2	0.6	4.5	1.54	130.1
2013:2	239.5	2.4	4.4	1.50	132.3
2013:3	240.6	0.8	4.1	1.39	130.8
2013:4	242.5	1.7	4.0	1.37	130.8
2014:1	243.6	3.1	4.0	1.36	130.7
2014:2	245.5	1.6	3.9	1.34	131.1
2014:3	247.4	2.7	3.8	1.31	131.1
2014:4	248.6	2.8	3.8	1.30	131.2

1 Whole Economy
2 Average Earnings
3 Wholly unemployed excluding school leavers as percentage of employed and unemployed, self employed and HM Forces
4 Wage rate deflated by CPI

Estimates and Projections of the Gross Domestic Product[1] (£ Million 1990 Prices)

	Expenditure Index	£ Million '90 prices	Non-Durable Consumption[2]	Private Sector Gross Investment Expenditure[3]	Public Authority Expenditure[4]	Net Exports[5]	AFC
2010	143.2	685816.8	412464.1	222982.1	180596.2	–35977.3	94248.2
2011	144.8	693480.0	405707.9	232196.6	179249.7	–24641.9	99032.3
2012	145.0	694345.6	405044.8	241788.1	182996.5	–31204.8	104279.0
2013	147.5	706149.6	409500.3	244931.3	182264.4	-32815.0	102184.0
2014	151.6	725921.8	416052.3	266975.2	176432.0	-38621.8	95765.3
2015	155.3	743343.9	422293.1	285663.4	180489.9	-31157.8	98734.0
2010/09	1.7		0.3	11.0	0.1		8.3
2011/10	1.1		–1.6	3.8	–0.8		4.5
2012/11	0.2		–0.1	2.5	3.0		3.0
2013/12	1.7		1.1	1.3	-0.4		-2.0
2014/13	2.8		1.6	9.0	-3.2		-6.3
2015/14	2.4		1.5	7.0	2.3		3.1
2012:1	145.2	173789.2	101182.0	58927.4	47960.2	–6985.4	27295.1
2012:2	144.5	172990.1	101166.9	58367.1	44720.2	–8453.9	22810.2
2012:3	145.4	174050.5	100983.7	61663.0	45063.8	–7626.9	26033.1
2012:4	145.0	173515.9	101712.2	62830.6	45252.2	–8138.6	28140.5
2013:1	147.7	176743.6	102295.0	59693.5	47768.4	-7067.3	27132.5
2013:2	147.0	175930.9	102279.7	59125.9	44541.3	-7180.1	24182.3
2013:3	147.9	177009.4	102094.5	62464.6	44883.5	-9285.0	25475.0
2013:4	147.5	176465.7	102831.0	63647.4	45071.2	-9282.6	25394.2
2014:1	151.8	181692.4	103931.7	65065.9	46239.8	-9664.1	23431.4
2014:2	151.1	180857.0	103916.2	64447.2	43116.0	-9655.3	23693.8
2014:3	152.0	181965.6	103728.0	68086.4	43447.3	-9650.6	24248.6
2014:4	151.6	181406.7	104476.3	69375.7	43628.9	-9651.8	24391.5

1 GDP at factor cost. Expenditure measure; seasonally adjusted
2 Consumers expenditure less expenditure on durables and housing
3 Private gross domestic capital formation plus household expenditure on durables and clothing plus private sector stock building
4 General government current and capital expenditure including stock building
5 Exports of goods and services less imports of goods and services

Financial Forecast

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

1 GDP at market prices (Financial Year)

WORLD FORECAST DETAIL

Growth Of Real GNP

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

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

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

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.

Growth Of Consumer Prices

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

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

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

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