Cardiff Business School
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Julian Hodge Bank

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Foreword

What a difference twelve months makes! 2013 was a transitional year for the UK economy with major uplifts across the spectrum of hard data measures, as well as less tangible, though at least as important, business and consumer confidence indices. It is reasonable to suppose that future economic historians will come to judge 2013 as the point when the UK economy began to emerge from the prolonged aftermath of the 2007/8 financial crisis and move toward a more normal state and trend growth rate.

Naturally there are significant risks which remain; history tells us there always are. But throughout the last century the economy has eventually recovered from wars, oil price spikes and political crises, as well as growing materially through the challenges and opportunities of European integration, a digital revolution and unprecedented globalisation. In this context, whilst the current array of challenges such as the potential unwinding of QE, returning interest rates to 'normalised' levels and addressing public and private sector debt are significant and real, it is important that we do not become too gloomy about the reality of our position. As always, resolving economic and political challenges will become less onerous against a background of improving confidence, investment and GDP growth.

It is of course for the professional economists and academics to undertake research and analysis of the wide range of complex and interrelated commercial, fiscal, monetary and human factors that combine to represent the UK economy. However, from the layman's perspective (as a practising banker in the UK market) I can see a distinct correlation between apparent macro trends and the attitudes of corporate and investor clients. One could endlessly debate the question of whether a general, ephemeral change in the national mood triggers activity which manifests in the hard data, or whether gradually improving data triggers a more upbeat news flow that in turn lifts confidence. However, in either case, or the more plausible scenario where one factor continually feeds and reinforces the other in a positive feedback loop, it is an unequivocally positive and welcome development.

A year ago the tone of much media commentary was very negative and raised genuine concerns for many business owners and investors. The lingering threat of a disorderly collapse of the Euro was still fresh in the mind (conjuring images of a 2007/08 style financial crisis, or worse) whilst day to day news, editorials and blogs speculated on the probability of a triple dip recession. In this context many businesses, even those which were profitable, cash generative and generally comfortable with their own market positioning and performance, felt happier accumulating cash reserves and/or reducing debt. Essentially, there was a widespread feeling that one would not want to be exposed to the financial commitment of a major capital expenditure programme, acquisition of a competitor or entry to a new market at a time of such uncertainty. In Real Estate markets values remained soft and bank liquidity for investment was restricted by regulation and banking sector de-leveraging. For many businesses and investors, it was better to pursue the strategy adopted since the financial crisis – keep overheads tight, manage margin, focus on delivering cash and value from the existing business or portfolio – thereby keeping the business or portfolio intact and afloat until better times arrived. The second half of 2013 has arguably seen us approaching that 'better times' tipping point and whilst it would be an exaggeration to say that there is now a climate of unbridled optimism, it is definitely the case that there is materially less pessimism.

One could certainly be forgiven for thinking, based on spending behaviour, that the UK consumer is feeling considerably more confident. The positive tone of news flow in recent months where debate is now about precisely what sort of recovery we are experiencing, along with the upward revision of various official growth forecasts and strong readings from a plethora of key data measures, reinforces a more optimistic mood. Over recent months, we have seen this manifested in a rising level of approaches from existing and new clients wishing to discuss funding proposals. It is reasonable to assume that if this experience is being replicated more widely across the UK banking market then we could well see rising levels of business investment in the second half of 2014, going someway to delivering more balanced GDP growth.

While London has inevitably lead the way in economic and asset value recovery there has been a notable pick up in our regional markets where major property investors, driven by yield compression in the capital, are seeking quality assets. Similarly, experienced regional operators are seeing long term value creation opportunities in current market conditions.

For all property and business investors there are socio-demographic trends to adapt to – not least the rapid migration of shoppers from physical store to on-line purchasing and the impact this has on retailers themselves and retail-related real estate portfolios. However, addressing market and structural issues of this sort is inherent in running a successful business over the long term, rather than related specifically to the health of the economy.

In summary, while the hard facts of the economy are what they are, one can contend that it is how individual businesses, investors and consumers feel about them that goes a long way to determining how effectively governments can deal with them. Confidence is intangible but also infectious. As it builds, people feel more certain about the future and will structure their investment and spending accordingly. This in turn drives increased business flows, further investment and spending in a virtuous cycle. We are not there yet though my own 'sharp-end' experience and the UK macro data indicators suggest we are certainly gaining traction on the journey. As a UK economy we can certainly look forward to the New Year with considerably more optimism than at any time in the recent past.

Kevin Beevers
Julian Hodge Bank
Director, Commercial Lending

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"One sympathises with politicians who have to deal with popular disquiets but in the end if growth is to be achieved which both we and these same politicians need, in order to get our economies working again, then these politicians must be willing to explain the business and growth case."

Patrick Minford, Economic Adviser to Julian Hodge Bank

COMMON SENSE ON THE CITY BREAKS OUT IN THREADNEEDLE STREET

A joyful sound was heard recently in the City. It was the reaction to a recently rare outbreak of common sense from the Old Lady of Threadneedle Street. Mark Carney, the new Governor, has announced that he and the government welcome the growth of the City in numerous international financial markets, whether in renminbi bonds or sukuks or anything in between. If 'this requires bank assets to GDP to rise to nine times GDP by 2030' so be it, the governor declared; he would welcome it, provided it was backed by soundness and prudence.

With credit at last starting to flow again, so far it is true mainly to mortgages supported by Help to Buy (even if this has not been used by building societies, it has still spurred new competition in the market for low-deposit mortgages) but perhaps also with signs of a trickle into business lending, and the economy also starting to grow confidently mainly because of this renewed credit flow, the politics of growth is beginning to reassert itself. The new governor of the Bank is a pragmatic realist — and this is what we need in that important post. No one really knows how the new banking era is going to be regulated and generally kept safe. Our view is that it requires much more competition and a jaundiced competition eye on the massive beasts of prey that used to prowl Wall Street and the City. We want nimble efficient institutions that need to compete in the marketplace on the basis of reputation for soundness combined with profitability; the old set-up where massive risks were taken on the basis of heavy borrowing where somehow the lenders felt impregnable to risk will go in this new environment where banks are small and will be allowed to fail individually even while the system is guaranteed collectively. This was always the vision of practical economists like Bagehot more than a century ago and it can ride again, reinvented for the modern more complex era.

With such an environment the emphasis can return to self-regulation with the Bank keeping a weather eye, as it used to before the ill-fated tripartite system set up by Gordon Brown. Each bank ought to know itself how much capital it needs to reassure its depositors and bondholders. In all this deposit insurance for the 'little guy' is basically an irrelevance, since the bulk of funds and certainly of marginal funds will be unprotected. Thus we will just have political insurance for small depositors; banks will still have to think about the safety of their main funders, including their bond holders. In conditions of competition that we must now hope will be actively encouraged, banks will have to have quite wide differences in capital back-up. We can leave it to the market, much as we leave airline safety to the market beyond specifying some minimum safety benchmarks. No airline can afford an accident due to negligence; and no bank should be able to afford to risk its reputation for safety either and so will provide necessary capital back-up, just as an airline pays for the best maintenance.

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 CPI	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	2.10	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)

A further ray of light coming from the Bank was the new arrangements for liquidity provision; these will now at last mimic those of the Fed and the ECB so that the Bank will stand behind banks, ready to exchange against liquidity any asset that can reasonably be valued by the market.

The sum total of these new arrangements, taken with the robust approach to Help to Buy and the Funding for lending Schemes, is enormously encouraging. It implies that finally the penny has dropped with our main policymakers (see Box on The battle for regulation) that the economy desperately needs a banking system ready and able to lend if it is to grow and that regulation must accommodate itself to this reality. The 'Taliban tendency' has been put to flight within the Bank.

Looking at the outlook against this background it is at last possible to be reasonably optimistic. We may now start to see credit flowing to business and SMEs in particular, as the banks respond to the greater certainty in the environment. Large businesses are flush with cash and should now start to look at investment plans for the growth ahead. Small firms may do their necessary cheeky work of snatching victory from in front of their lethargic paws. Entrepreneurial Britain may be waking up again. With world commodity prices falling and oil prices steady under the impact of shale oil and gas, reflecting the slowing of the emerging countries as well as new technology and discovery, the background for some growth in real disposable income is there too. It has been growing slowly; it should gather speed, as real wages start to pick up with a tightening labour market. The stage is also set for some tightening of monetary policy once credit growth picks up; interest rates should rise and QE start to be reversed.

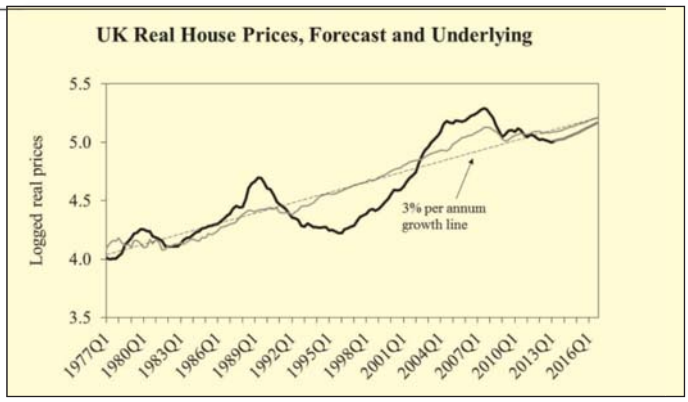
The battle over regulation

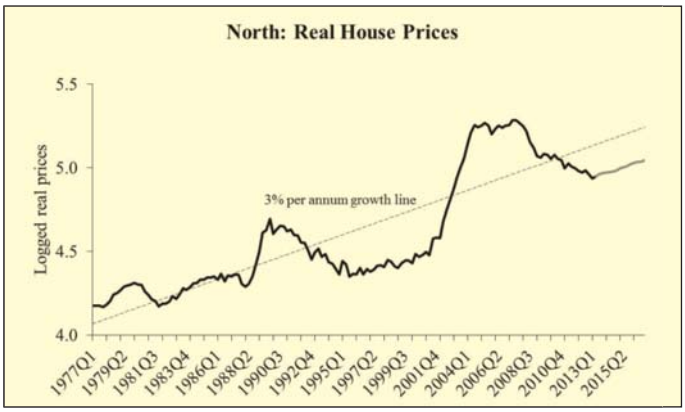
A fault line is opening up between Conservative politicians keen not to bring the economy to another grinding halt and the 'Taliban tendency' among the regulatory establishment, to use Vince Cable's delightful and for once quite accurate phrase.

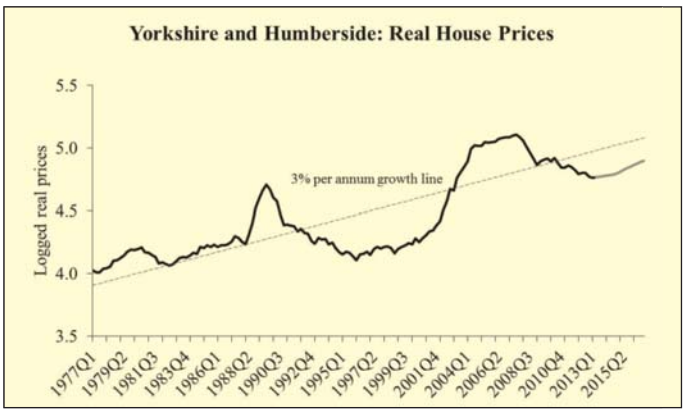
It had begun to dawn on the Conservatives and maybe also the Lib Dems, around a year and a half ago, that the economy's previously glacial recovery had something to do with the lack of credit for small businesses and first-time home buyers. This in turn could be traced to the new regulatory rules, especially the burdensome capital-raising requirements; these, combined with general post-crisis nervousness, were causing the banks to shrink their balance sheets and particularly the 'risky' parts that carried the biggest capital-raising penalty. Longer term these requirements raise the cost of making loans; short term they stopped them altogether. So the Coalition government came up with two ways of undoing the regulations by the back door: 'Funding for lending' and 'Help to Buy', both in effect subsidising loans, respectively to business and first-time house buyers.

It does now look as if the government's desperate measures to get credit going are starting to have a little effect; so far only on mortgages but perhaps soon it will filter through to small businesses. The difficulty is that as fast as these ad hoc measures are brought in and start to have an effect, some regulatory arm of government introduces fresh regulatory shocks on the banks — the most recent case was the sudden imposition of a gross leverage ratio minimum, which caught both Barclays and Nationwide on the hop. This seems to have been the parting gift of poison from the departing Governor. However, subsequently, with the arrival of the new Governor, the thinking has changed again; there seems to have been some subsequent compromises on timing with both institutions and the rhetoric has changed, as we have seen above.

The difficulty of forecasting at present is bound up with these policy contradictions. On the one hand regulation is being lightened ad hoc by special measures such as the Funding for Lending schemes and Help to Buy. On the other the regulators continue gung ho with their programme, egged on by politicians who fail to understand the overall workings of the economy. Then we have monetary policy, attempting to undo the regulative tightness by monetary ease — the latest addition being the new Governor's 'forward guidance'. As we have argued before, this ease has little effect when credit is frozen, other than to bring down returns for savers and reduce the financial pressures on the government to bring down its deficit. On balance our view is now more positive that regulation is retreating before a more pragmatic approach to the banking system.







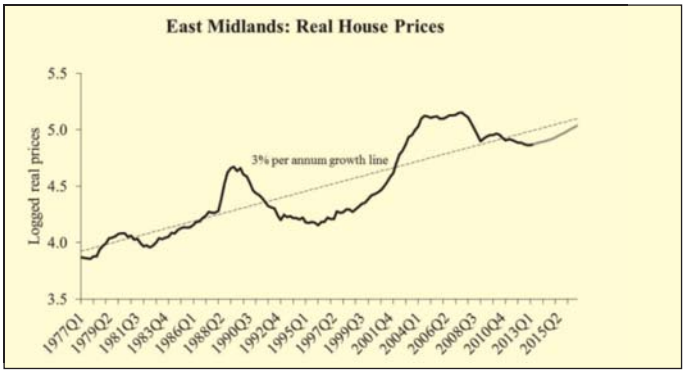
Lending to small businesses has not yet started to recover. But mercifully for the Coalition lending to house buyers has done so with a vengeance and the house market is now starting to recover quite reasonably. London has been strong throughout and must be kept out of this picture — as it is a special market, dominated by an ongoing influx of foreign buyers. But the rest of the country is now improving markedly, if from a low base; real house prices are still well below the pre-crisis peaks. This is true of the national average including London; and strikingly more so for non-London regions of which a few are shown below. In these charts the grey line plots our latest forecasts; the scale is in natural logs so that an upward movement of 0.1 is approximately a 10% rise.

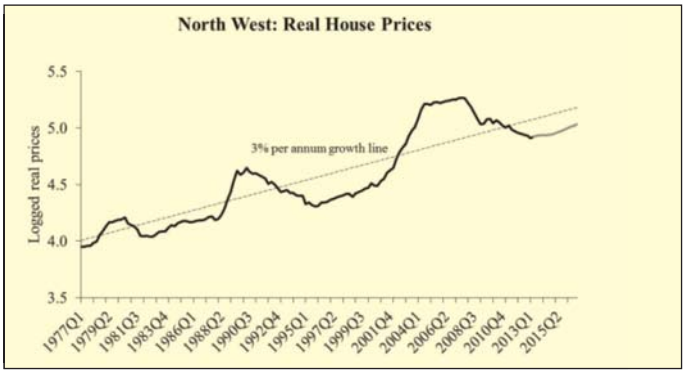
What can be seen from these charts is that on our forecasts at any rate even the whole country average does not get back to the pre-crisis level until after 2016. It is true the market is now turning and it could of course move faster. But it does have a long way to go before it reaches what the usual suspects are calling 'bubble' levels. Indeed all it is doing is remedying extremely depressed conditions as credit once again begins to flow.

While Mark Carney's forward guidance is not in our view of much significance, it is good news that he and the Bank are treating these 'bubble' remarks with scepticism. The moral that should be drawn from these events is not that renewed credit is a bad thing but rather that the regulatory framework should be adjusted to allow it to get back to its old vigour. At this point these various special schemes should be withdrawn.

In practice what seems most likely is that the schemes will be left in place and some lip service paid to the need to monitor developments down the road. What we can say is that the economy is at last recovering as credit starts recovering, at least in parts. A housing recovery is a particularly strong driver of the business cycle. Already construction is growing strongly again, led by housing. We can also expect consumer durable spending to pick up with new house construction. Meanwhile real living standards are levelling off after a long decline; this is the result of steadier raw material prices, improving employment and rising tax thresholds. Investment is picking up also, with large companies sensing that the economy's corner has been turned and new improved capacity will be needed. While export markets in the emerging countries have cooled a bit, those to the eurozone are at last levelling off after their long decline and in some cases improving.

In our opinion, what needs to be done is a severe cutting back of the new regulative capital requirements in favour of a return to a self-regulating regime with the Bank as chief monitoring agent, much as existed prior to the 'Tripartite regime' introduced mistakenly, as we can now clearly see, by Gordon Brown in 1997. Formulaic approaches to capital needs are crude and essentially arbitrary; also when risk-weighted as in the Basel 3 agreement they will penalise lending to SMEs even through collectively these are no more risky socially than lending to blue chips.





A second need is to focus monetary policy back on its old task of 'taking away the punch bowl when the party gets merry' (a classic description due to McChesney Martin at the Fed). This could be achieved by reintroducing money supply or credit growth targets into the conduct of monetary policy, in addition to the long-term inflation target. The problem with inflation targeting on its own has been that inflation does not respond much in the short run to excess credit growth, because of the power of belief that it will be subject to the target. Yet as we have seen, when a credit boom takes hold, it can cause a banking problem to be super-imposed on a recession brought about by the normal forces of capitalism.

With a new Bank Governor having just arrived, one with the confidence of the Chancellor, it now seems that gradually policy is moving in this direction and hence growth will be less restricted by the failure of the credit process. Our forecasts assume that something of this sort will happen and hence we have growth staying in the 2–3% range from now on.

QE continues to advance in the US and is not reversed in the UK

To all these positives can be added the decision by the US Fed to keep monetary conditions continuously loose. The Fed warned recently that it would 'taper off' its programme of buying assets in the market with printed money. However this led to a big sell-off in bond and equity markets all over the world, which took the Fed aback. Fed chairman Bernanke reacted by announcing that the taper is temporarily off the table; and markets have instantly bounced back somewhat.

As in the UK the Fed's programme of asset-buying ('QE3') is really an antidote to the new regulatory mania sweeping Washington as it has London. As this episode of 'taper and then not to taper' shows, it is going to be hard to withdraw this stimulant. For now it is needed to keep some sort of credit growth going in the US, thus offsetting the headwinds from regulation. The Fed, unlike the Bank, buys assets across a wide range of classes and so to some extent competes directly with bank lending by lending direct on mortgages and corporate bonds. The Bank has found that its QE buying of UK government bonds only has had precious little, if any, effect on credit conditions; hence the need for those special schemes.

At some point in the future the banks will be back in the full flow of business; no doubt they will eventually lobby regulators to ease back and as the economy improves their share prices will rise allowing them to acquire new capital more cheaply. Once this has happened QE will need to be reversed rapidly to avoid excess credit and money expansion. But the recent episode highlights the risk that this will not happen quickly enough, given the pressures withdrawal creates.

For now inflation remains muted while growth is picking up. No one in the Coalition is going to want to stop that combination. Meanwhile markets are calm about longer-run inflation, somehow trusting that policy will reverse when needed. While we are not so calm, that is also our basic view.

The sun glinting through the clouds

The second quarter estimate of GDP growth has been raised to 0.7% and the third quarter estimate just out is for 0.8%. The Purchasing Managers' Indices are picking up, retail sales are rising, and the housing market is also strengthening, prompting the usual wails about 'bubbles' even though the market is still in recession! A further set of wails is heard about 'unbalanced growth', as if any growth is generally 'balanced' (except in the steady state).

So far in these figures we have yet to see any pick-up in investment. It has declined on average for much of the past two years, with a slight 0.2% pick-up in the first quarter. With large companies flush with cash and generally improving profits, we have yet to see firms deciding to delay their investment plans no longer. This is where a vigorous small business upturn fuelled by credit and threatening these big beasts' turf would jump-start them out of their complacent torpor.

These estimates of GDP growth come as a relief to UK economy-watchers. Is this a sudden onset of recovery? Not entirely as the service sector has seen growth at just under 2% for a couple of years. But that growth in services was overlaid by weakness in manufacturing, collapse in construction, banking implosion and a decline in North Sea oil. Gradually those negative elements have dissipated. With North Sea oil the government has been in talks with the major companies to give proper assurances that there will be stability in the tax regime for oil; previously the North Sea was treated like a cash cow, with tax being used to collect ad hoc levies, and naturally this produced a decline in new projects. In banking we have had the regulative mania and its recent pragmatic relief as discussed above, and things are finally looking up. Bank profitability has risen, the Lloyds share holdings by the government are being readied for partial sale and in short banking may be turning around.

Then we turn to the housing improvement, spurred by a recent rise in house prices, apparently reflecting the new government schemes, though in fact the lending is now widening across all parts of the banking system, with building societies not using the scheme but lending strongly nevertheless. This has put new life into construction prospects; and construction is now at last growing. Finally, manufacturing is picking up as the euro-zone flattens off into a slower decline and exports are being diverted elsewhere where growth is much stronger.

Looking back at the string of disappointing growth figures since the recovery from the crisis began in late 2009, it seems clear to us that a key element has been the new regulative approach to banking. This has both caused chaos in the banking sector and blocked the credit channel. It has been justified by the need to prevent future crises. But, as we have argued before, the evidence supports the view that the crisis was brought about by much wider factors than banking, even if banking problems made it worse. After 25 years of breakneck world growth there was bound to be a downturn as the world ran out of commodities. So the new bank regulation will not prevent future such crises of capitalism; but as we have seen it can be lethal to growth both by attacking the UK's key growth industry and by killing credit growth. Fortunately as we have seen the coalition politicians and the new Governor appear belatedly to be rectifying matters somewhat and backpedalling from regulative mania.

The good news on GDP is not yet feeding through into the government finances which seem stuck in deficit at around 7% of GDP. This is not sustainable. If clear improvement is not seen soon, further cuts will need to be made; for all the

government's plan A, the fact is that progress with deficit reduction has been very slow.

With so much uncertainty still around, it is premature to get alarmed about excessive monetary slackness. There is a huge overhang of printed money sitting in bank reserves but with the regulatory problems already discussed it is hard to see that being used to extend a lot of credit in the near future. Nevertheless the Bank ought now to be thinking about getting interest rates back to some normal level as the recovery gathers steam. It also should be thinking about how to get the money it has printed out of the system without too much disruption. Carney's forward guidance has been an effort to persuade us that it will not do either of these painful things. But other members of the MPC may well think otherwise if the recovery does indeed stay strong.

Internationally we are seeing the US Fed become more cautious now and the result is rising interest rates on government longer term bonds. This has upset equity markets in emerging countries, especially India. The euro-zone is also at last pulling out of steep decline and the ECB will want to move to interest rate normality too. China is having to tighten money in the face of a massive excess of credit extended during the reaction to the crisis. The world is moving to tighter money, if very slowly at present. The UK will have to do the same, if it is not to look out of line and risk a run on sterling that would destabilise the inflation figures.

THE UK ECONOMY

Vo Phuong Mai Le

GDP

Growth has been strong. Real GDP increased by 0.8% in Q3. This was driven by robust growth across all sectors.

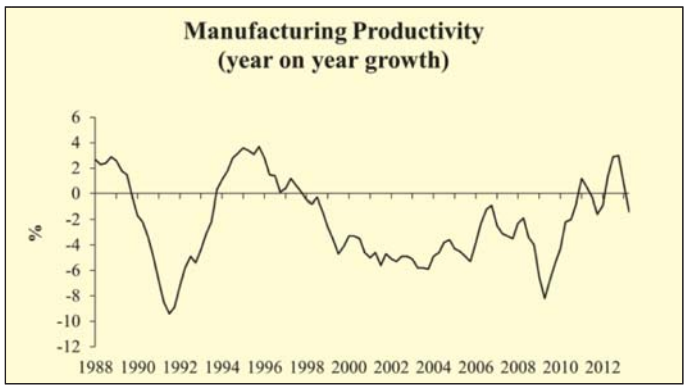
Industrial output rose 0.5% in Q3. It was driven by a rise in the manufacturing sector of 0.9% for the second consecutive quarter. There are signs of further expansion in the sector. According to the Markit/CIPS survey the manufacturing sector expanded October: the index was 56.0 following 56.3 in September.

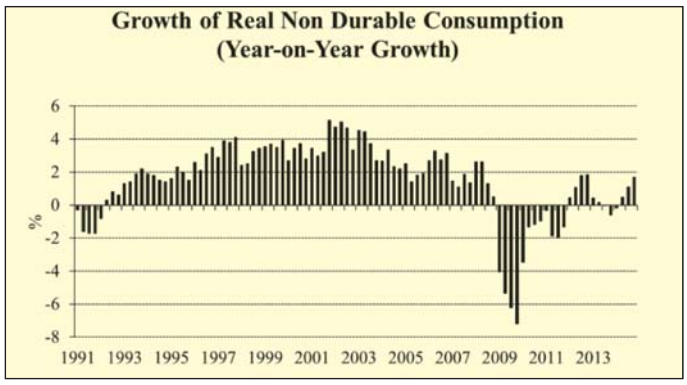
Construction output expanded sharply. It increased by 2.5% in Q3 after 0.9% in Q2. The data indicated that a sharp rebound in the sector's output continued at the beginning of Q4. The CIPS construction purchasing managers' index was reported at 59.4 in October, up from 58.9 in September. It is above the 50 threshold for the sixth month in a row.

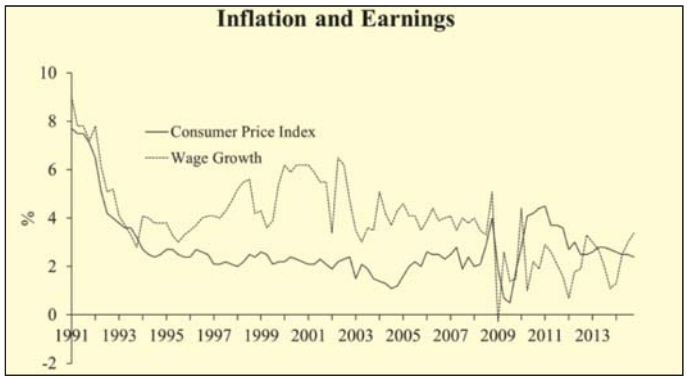
Service sector output was up by 0.7%. According to the Market/CPIS survey, service sector activity is at the highest level since spring 1997. The survey balance came in at 62.5 in October, after 60.3 in September.

According to the ONS' latest estimates, domestic demand contributed positively to growth in Q3. Household consumption expenditure rose 0.8% in Q3 following 0.3% in the previous quarter. Fixed investment rose 1.4% in Q3 after rising 0.8% in Q2. The change in inventories added 0.9 percentage points to Q3 growth after 0.2 percentage points in Q2. Government spending rose 0.5% after rising 0.5% in Q2. The negative contribution to growth came from net exports (which subtracted 0.2 percentage points from Q3 growth, as exports declined 2.4% and imports rose 0.8%).

The housing market picked up further. Both housing market activity and prices have risen since the start of 2013. Both Halifax and Nationwide house price indices were up on a year earlier by 8.1% and 5.8% respectively in October. Housing market transactions rose to 91,000 in September, compared to average of 75,000 per month from 2010 to 2012. As a result of the easing in credit conditions, a reduction in economic uncertainty and the government's Help to Buy scheme, mortgage lending approvals for house purchase rose on average 64,000 each month in Q3. It is an improvement compared to the monthly average of 57,000 in Q2 and 53,000 in Q1.







Costs and Prices

CPI year-on-year inflation was 2.2% in October, down from 2.7% in September. The large fall reflected a fall in fuel and utility prices, and a smaller contribution from university tuition fees. The new index to measure retail prices, called RPIJ rose 1.9%, down from 2.5% in September. The Bank of England sees medium-term inflation expectations as remaining well anchored, with a gradual rise in productivity growth providing downward domestic inflationary pressure. CPI inflation is expected to fall back to around the 2% target over the next year or so. Annual factory gate inflation was 0.8% in October compared with 1.2% in September. Input price inflation was –0.3% in October, against 0.9% the month before. Despite rising employment, wage growth remained relatively weak. In the 3 month period to September

average earnings growth including bonuses was 0.8% on a year earlier.

Labour Market

The labour market continued to improve. Employment growth continued to rise in recent months, while the unemployment rate fell. The employment rate for the three months to September was 71.8%, up by 0.3% from the last quarter. During the same time, the unemployment rate decreased to 7.6% compared to 7.8% previously. The claimant count was 3.9% in October, down from 4.0% in September and 4.2% in August.

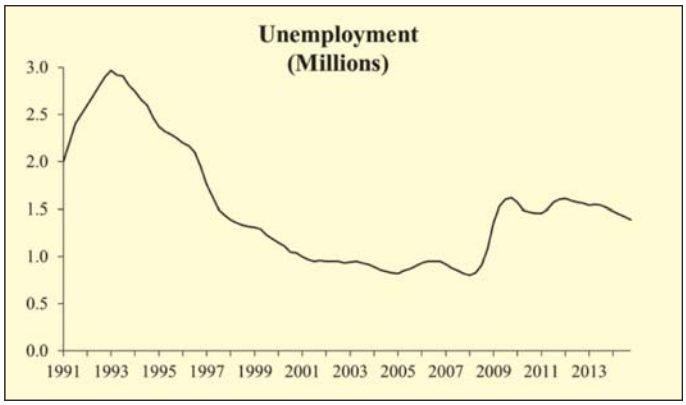
Trade

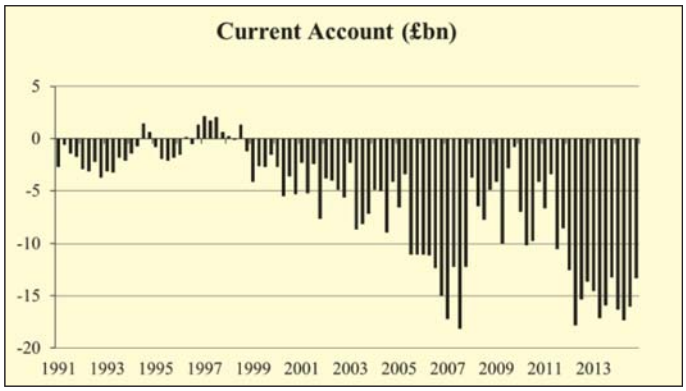
The trade deficit was £8.9 billion in Q3 following a deficit of £5.5 billion in Q2. Exports fell 2.4% in Q3, after a sharp growth of 3.0% in Q2. Imports rose 0.8% in Q3 after a 0.7% rise in Q2.

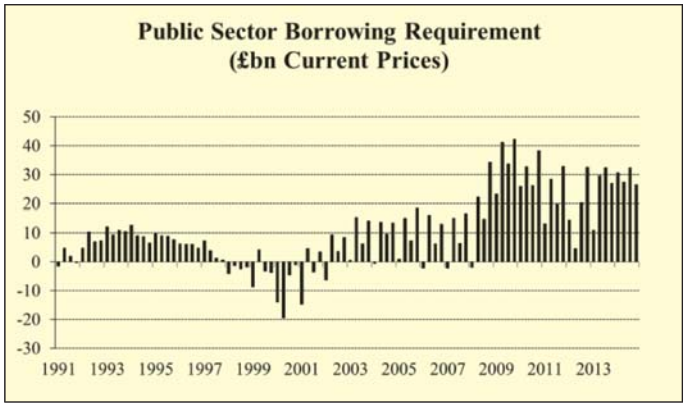
Monetary and Fiscal developments

Notes and coins in circulation grew 4.5% in October on a year earlier, unchanged from that in September. The year-on-year growth rate of broad money — M4, including bank and building society deposits held by households and firms — was 4.3% in Q3, following a rise of 3.5% in Q2.

The Bank of England maintained its official lending rate at 0.5% at its meeting in November, unchanged since March 2009. The stock of asset purchases remained at £375 billion financed by the issuance of central reserves. In August, the Bank of England indicated that it intended to maintain the low official interest rate until unemployment had reached 7% as long as this does not damage price or financial stability. However, the Bank reiterated that reaching the unemployment threshold would not necessarily mean an immediate tightening. It would reconsider the policy stance depending on the outlook for inflation and on other economic conditions.







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	82.6	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	2.50	1.5	0.7	81.0	93.2	–1.9	3.2	–0.7
2014:1	2.60	1.6	0.8	81.3	93.7	–1.7	3.1	–0.6
2014:2	2.50	1.6	0.8	81.2	94.0	–1.6	3.1	–0.6
2014:3	2.40	1.7	0.9	81.3	94.0	–1.6	3.1	–0.4
2014:4	2.40	1.7	0.9	81.8	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	235.1	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	242.1	0.6	4.5	1.54	130.1
2013:2	240.1	2.4	4.4	1.50	132.3
2013:3	242.1	0.8	4.1	1.39	130.8
2013:4	243.8	1.7	4.0	1.37	130.8
2014:1	245.9	3.1	4.0	1.36	130.7
2014:2	246.5	1.6	3.9	1.34	131.1
2014:3	248.8	2.7	3.8	1.31	131.1
2014:4	235.1	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	147.1	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	102040.8	59115.5	46685.8	–7448.6	26217.1
2013:2	146.5	175320.9	101998.8	59299.2	44851.2	–7561.4	23266.9
2013:3	147.6	176705.8	102780.2	63076.6	45074.9	–9666.3	24559.6
2013:4	148.6	177858.6	102637.0	67168.4	42397.4	–9663.9	24478.8
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	1471.7	112.3	48.0	–60.7
2014	7.1	1537.0	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	–17.8
2012:3	7.2	358.6	25.7	11.8	–15.3
2012:4	10.6	364.3	38.6	11.8	–13.6
2013:1	3.8	364.3	14.0	12.0	–14.5
2013:2	9.3	363.3	33.7	11.6	–17.1
2013:3	6.2	369.4	23.1	12.0	–15.9
2013:4	7.6	374.6	28.3	12.3	–13.2
2014:1	7.2	375.2	27.3	12.7	–16.3
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)

Global growth continued to recover. The pace of growth gathered strongly in advanced countries, but it seemed to weaken in emerging markets. The Purchasing Managers' Index (PMI) for global all-industry output continued to increase. It was 55.5 in October, rising from 53.6 in September.

Inflationary pressures continued to be contained. Annual headline inflation in the OECD countries was 1.5% in September, compared to 1.7% in August. The decline was due to lower energy price inflation and a slight decrease in food price inflation. (Excluding food and energy, the annual inflation rate was 1.6% in September, unchanged from the previous month.) This decline in the inflation rate was seen in most OECD countries and large emerging economies.

US

The US economy continued to recover strongly. Real GDP growth rose by 0.7% quarter-on-quarter in Q3, up from 0.62% in Q2. This acceleration reflected continued strong personal consumption (0.4% quarter-on-quarter in Q3, compared to 0.45% in Q2), and both strong non-residential (0.4% quarter-on-quarter in Q3, after a rise of 1.2% in Q2) and residential fixed investment (3.1% quarter-on-quarter in Q3, compared to 4.4% in Q2). The change in inventories and net exports contributed respectively 0.21 and 0.08 percentage points to quarterly growth. Growth was held back by falling federal government spending (-0.42% quarter-on-quarter in Q3, following –0.4% in the previous quarter).

Labour market data gave out mixed signals. In October, job creation was dynamic, but the unemployment rate edged up marginally from 7.2% in September to 7.3%. According to the establishment survey among employers, the market shows no sign of slowing down. Non-farm payrolls were up by 204,000 in October, rising from 163,000 in September. The survey of households showed a rather different picture: a drop of 735,000 in employment between September to October and a shrinking labour force. But it is not regarded as highly reliable for short run movements, being based on a shifting and small sample of households whereas the employers' figures have much wider and relatively constant coverage. Persistent high unemployment still weighs down wage growth. In October average hourly earnings rose 2.2% year-on-year after a rise of 2.0% in the previous month.

Annual CPI inflation decreased further by 0.3% to 1.2% in September. A decrease in energy prices contributed to this decline in the inflation rate. Excluding food and energy annual CPI inflation was 1.7% in September, down from 1.8% in the previous month. The core inflation was supported by continuous growth in shelter and medical care prices. At its October meeting, the Federal Open Market Committee decided to maintain its target range for the federal funds rate at 0% to 0.25%. It expected that this low level will be appropriate for at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is not projected to be above 2.5% and longer-term inflation expectations continue to be well anchored. It decided that it would adjust ('taper') the pace of asset purchases from the current rate of $40 billion per month for agency mortgage-backed securities and $45 billion per month for longer term Treasury securities once it knows more about the progress in economic activity and labour market conditions.

U.S.: Annual Growth Rates of Real GNP and Consumer Prices

	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	–2.6	2.4	1.8	2.2	2.2	2.8
Inflation (% p.a.)	–0.3	1.6	3.1	2.1	1.6	2
Nominal Short Int. Rate	0.2	0.1	0.3	0.1	0.7	0.8
Real Short Int. Rate	–1.6	–3.0	–1.8	–1.9	–1.3	–1.2
Nominal Long Int. Rate	3.2	3.1	1.9	1.8	2.1	2.6
Real Long Int. Rate	1.3	1.0	0.9	–0.2	0.1	0.6
Real Ex. Rate (1996=100)[1]	88.7	87.4	85.7	90.4	97.3	99.1
Nominal Ex. Rate[2]	85.98	83.73	78.08	80.9	85.5	85.4

[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 of the real exchange rate.
[2] The series for the USA is a trade weighted index (1990=100)

Japan

The Japanese economy continued expanding, though the pace of growth was slower. Real GDP grew 0.5% in Q3 after rising 1% in Q2. This increase reflected strong domestic spending. Government investment rose by 6.5% in Q3 after 4.8% in Q2. It contributed 0.4 percentage points to overall GDP growth. Private consumption was boosted by rising stock prices and the anticipated 3 point VAT increase to 8% in April 2004. It rose 0.5% in Q3. House purchases were stimulated. Residential investment increased by 2.7%, adding 0.1 percentage point to growth. The negative contribution to growth came from net trade. It

Japan

	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	−6.3	4.7	−0.5	1.9	1.8	1.6
Inflation (% p.a.)	−1.4	−0.7	−0.3	0.0	0.0	2.0
Nominal Short Int. Rate	0.1	0.1	0.4	0.3	0.4	0.4
Real Short Int. Rate	1.1	0.4	0.4	0.3	−1.6	−1.6
Nominal Long Int. Rate	1.3	1.1	1.0	0.8	0.7	0.9
Real Long Int. Rate	1.2	0.4	−0.2	−0.8	−1.3	−1.1
Real Ex. Rate (1996=100)[1]	89	92	97.1	98.3	119.7	122
Nominal Ex. Rate	93.54	87.48	79.36	80.51	98	98

[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 of the real exchange rate.

Germany

	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	−4.7	4.2	3.0	0.7	0.6	1.5
Inflation (% p.a.)	0.4	1.2	2.0	2.0	1.7	2.0
Nominal Short Int. Rate	0.7	0.4	1.5	0.2	0.5	0.6
Real Short Int. Rate	−0.4	−1.9	−0.5	−1.5	−1.5	−1.4
Nominal Long Int. Rate	4.0	3.8	1.8	1.5	1.5	1.9
Real Long Int. Rate	2.2	1.8	−0.1	−0.4	−0.5	−0.1
Real Ex. Rate (1996=100)[1]	105.8	102.9	105.5	104.3	107.4	108.2
Nominal Ex. Rate	0.72	0.75	0.71	0.78	0.79	0.78

[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 of the real exchange rate

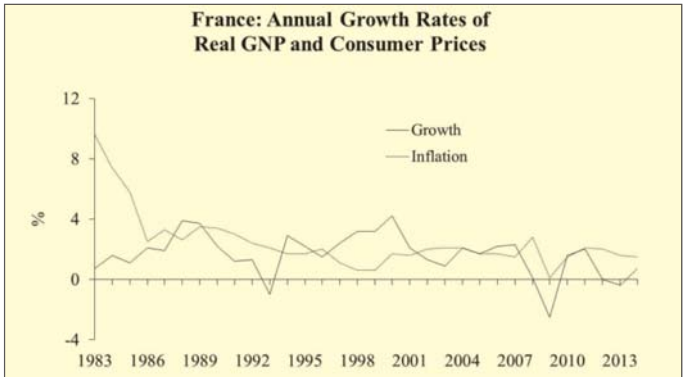
subtracted 0.5 percentage point from the Q3 growth as exports contracted 0.1% and imports rose 2.2%.

Consumer price inflation continued to rise. The headline index moved out of the deflationary territory in June. CPI inflation year-on-year increased to 1% in September from 0.9% in August (though excluding food and energy it remained at 0% in September as in August). At its November meeting, the Bank of Japan left monetary policy unchanged. The Bank of Japan has set a target of 2% inflation since August 2013. To achieve this target, it aims to increase the monetary base at an annual rate of ¥60-70 trillion (13% of GDP) and increase its government's bond holding by about ¥50 trillion per annum.

Germany

The economy continued to expand, but at a slower pace. Real GDP rose 0.3% in Q3 after rising 0.7% in the previous quarter. Domestic demand was the main contributor to GDP growth (0.6 percentage points), while net trade dragged it down (−0.3 percentage points). Exports rose 0.1% in Q3, while imports rose 0.8%. Total private investment increased 1.6% in Q3 after 1.6% in the previous period and contributed 0.3 percentage points to growth. Private consumption was up 0.1% in Q3.

Recent indicators show further signs of expansion. The IFO business climate index rose from 107.4 in October to 109.3 in November, the highest level since April 2013. This survey is consistent with the PMI survey. The PMI composite headline index rose from 53.2 in October to 54.3 in November. It remained above the threshold of 50 that shows expansion for the seventh month in a row.



France

	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	−2.5	1.6	2.0	0.0	−0.4	0.7
Inflation (% p.a.)	0.1	1.5	2.1	2.0	1.6	1.5
Nominal Short Int. Rate	0.7	0.4	1.5	0.2	0.5	0.6
Real Short Int. Rate	−0.8	−1.7	−0.5	−1.4	−1.5	−1.4
Nominal Long Int. Rate	4.0	3.8	1.8	1.5	1.5	1.9
Real Long Int. Rate	2.2	1.9	−0.1	−0.4	−0.5	−0.1
Real Ex. Rate (1996=100)[1]	104.3	103.1	105.5	104.9	107.9	108.6
Nominal Ex. Rate	0.72	0.75	0.71	0.78	0.79	0.78

[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 of the real exchange rate.

The labour market stayed relatively healthy. The unemployment rate was 6.9% in November, unchanged from that of October and September. Employment continued to grow, and was up by 0.6% year-on-year.

France

Real GDP fell 0.1% in Q3 after a rebound of 0.5% in Q2. This reflected a negative contribution from net trade (−0.7 percentage points in Q3 after adding nothing in Q2) and stagnant domestic demand excluding inventories (adding 0 percentage points to the Q3 change in real GDP after +0.4 percentage points in Q2). Consumption was up (0.2% in Q3 after 0.4% in Q2) while investment was down further (−0.6% in Q3 after −0.4% in Q2). A positive impact came from the change in inventories (+0.5 percentage points to Q3, after 0.1 percentage points to Q2); however this rise is likely to be involuntary, suggesting further contraction in output to come.

The recent surveys and indicators show some mixed signs about the outlook for the future. Industrial production declined 0.5% month-to-month in September after a brief rebound in August of 0.9%. The decline was registered across most industries, except for machinery, equipments and electronics. The INSEE business confidence index rose to 95 in September from 91 in August. It remained stable at 95 for October and November, which is below long-term average of 100

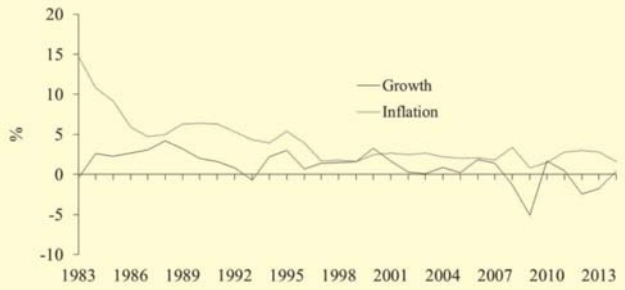
Italy

The recession continues. Economic activity has continued to shrink for nine quarters, but in Q3 activity contracted at its slowest rate for two years. Real GDP fell 0.1% in Q3 following a decrease of 2.2% in Q2. The economy is 9.1% smaller than its pre-crisis peak in Q3 2007. According to recent data, the downturn might be coming to an end, and the economy stabilising, in the final quarter of this year. In October, the Markit's All-Industry PMI Output index was 50, which is consistent with such a flattening off.

Euro zone monetary developments

The Harmonised Index of Consumer Prices (HICP) inflation decreased to 0.7% in October from 1.1% in September. This decline reflected lower food price inflation, a larger fall in energy prices and weakening in services price inflation. On the basis of current futures prices for energy, annual inflation rates are expected to remain low over the medium term, and medium-term inflation expectations stay below 2%. Monetary policy continues to be accommodative. The ECB Governing Council lowered the interest rate on the main refinancing operations of the Euro system by 25 basis points to 0.25% and the rate on the marginal lending facility by 25 basis points to 0.75%. The rate on the deposit facility was unchanged at 0%. Based on the July forward guidance, the Council expects the key interest rates to remain at present or lower levels for an extended period of time. The Council decided to continue with the main refinancing operations as fixed rate tender procedures with full allotment for as long as needed and at least until July 2015. Though the ECB has not embarked on Quantitative Easing, its overall balance sheet has expanded substantially in recent years as it has supported southern euro-zone countries' banks.

Italy: Annual Growth Rates of Real GNP and Consumer Prices



Italy

	2009	2010	2011	2012	2013	2014
Real GDP Growth (% p.a.)	−5.1	1.7	0.5	−2.4	−1.8	0.4
Inflation (% p.a.)	0.8	1.5	2.8	3	2.8	1.6
Nominal Short Int. Rate	0.7	0.4	1.5	0.2	0.5	0.6
Real Short Int. Rate	−0.8	−2.4	−1.5	−2.6	−2	−1.4
Nominal Long Int. Rate	4	3.8	1.8	1.5	1.5	1.9
Real Long Int. Rate	1.5	1.2	−0.7	−0.8	−0.6	−0.1
Real Ex. Rate (1996=100)[1]	105.4	103.6	106.9	107.4	111.8	113.2
Nominal Ex. Rate	0.72	0.75	0.71	0.78	0.79	0.78

[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 of the real exchange rate.

Eurozone annual M3 Growth

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	–0.4	0.7
Italy	–5.1	1.7	0.5	–2.4	–1.8	0.4

Growth Of Consumer Prices

	2009	2010	2011	2012	2013	2014
U.S.A.	–0.3	1.6	3.1	2.1	1.6	2.0
U.K.	1.3	3.3	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	1.6	1.5
Italy	0.8	1.5	2.8	3.0	2.8	1.6

Real Short-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	–1.6	–3.0	–1.8	–1.9	–1.3	–1.2
U.K.	–0.3	–3.5	–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

THE THIRD ARROW OF ABENOMICS

Francesco Perugini

Special economic zones head for approval

Japanese prime minister, Shinzo Abe, has called the autumn session of the Parliament, which was convened on October 15 and is expected to run until early December, the "Growth Strategy Implementation Diet". This is a significant message from the government: it is aiming to pass several important pieces of legislation, including some designed to strengthen Japan's industrial competitiveness which it sees as essential to the success of the "Abenomics" program. The final part of "Abenomics", named "Japan Revitalization Strategy (Japan is Back)", was launched last June. Designed to be the "third arrow" — the first two arrows focused on loosening monetary policy and boosting public spending — the strategy aims at increasing potential growth by reforming the supply side of the economy and promoting regulatory reforms. "Now is the time for Japan to be an engine for world economic recovery", Abe said at the press conference right after the program was announced.

The Revitalization Strategy plan has several key components with target dates and key performance indicators to track and quantify performance. Among them are previously taboo subjects, such as enabling mergers and acquisitions, controversial labour reforms, the reduction or elimination of zombie industries and companies and efforts to improve the low corporate profitability that has long hampered progress in the economy (see box for more details). The plan also includes the creation of National Strategic Special Zones, special areas that are easy to live and work in for foreigners and are free from opportunity-narrowing regulations. The aims of the special zones are to make Japan the third easiest OECD country to do business in by 2020, up from 15th at present, and to double foreign direct investment into the country to ¥35 trillion by the same year. To foster an international business environment, Abe wants to promote deregulation, introduce tax incentives for corporate investment, and make a series of reforms which will let private firms operate public schools, expand the scope of treatment that can be administered by non-Japanese doctors and nurses, facilitate the use of foreign drugs and increase the number of hospital beds. "We'll create an international business environment comparable to cities such as London and New York", Abe said.

However the package of steps does not include bold reforms in areas such as labour mobility which are seen as essential to lure more foreign capital. "Japan should make it easier for companies to lay off workers, otherwise foreign companies, which are no longer able to offer good compensation packages after the financial crisis, will hesitate to make large-scale investments in Japan", said Atsushi Nishiguchi, a consultant at UBS. On the contrary, the government panel recently did not approve a plan to relax the rules for firing workers and decided to extend contract lengths for part-time and contract workers nationwide to increase their job security. Abe had hoped for more sweeping regulatory reforms but bureaucratic opposition to changing long-standing labour regulations proved too powerful to surmount. In particular, a so-called white-collar exemption to allow work schedules exceeding an eight-hour workday and a 40-hour week had been viewed as a signature move that could showcase Japan's commitment to flexible employment options. The plan quickly ran into opposition from the Labour Ministry, which was dead set against creating such a precedent in the special zones. "Such a move could lead to discrepancies in labour protection guaranteed under the Constitution", the ministry warned. "Looking worldwide, there are no examples of core labour rules being relaxed only in economic zones", asserted Labour Minister Norihisa Tamura.

The government aims to submit the bills needed to create the special zones to Parliament in early November, and decide on their exact locations by early next year — details are sketchy at this stage, other than that Tokyo, Osaka and Nagoya could be chosen as bases. Observers believe that at the end the deregulatory blueprint will be far from the sweeping initiative Abe had envisioned. So far there has been no consensus within the government on whether the special zones should allow such radical reforms. The debate is vigorous, confirms Robert Feldman, an economist at Morgan Stanley, who recently presented ideas for the zones to an official working group. "Those who want radical deregulation are pitted against others who prefer to use them in more old-fashioned ways, such as helping particular local industries and attracting foreign investment", he said.

Observers also believe that special zones, which have resulted in boomtowns like Shenzhen, Xiamen and Zhuhai in China, will be a hard sell in Japan. Japan has in the past tried special zones, which allow political and economic experiments not permitted elsewhere in the country, but they did not go anywhere. "There was a lack of co-ordination between the central government and the localities. Abe would need to co-opt bureaucrats, who wield enormous power", says Izumi Devalier, economist at HSBC.

Furthermore, in order to give tangible results the special economic zone has to stand out in contrast with other parts of a country that are not special. The country is already littered with special economic zones. The first group, almost a thousand, was chosen by the government of

Junichiro Koizumi, Japan's reforming prime minister between 2001 and 2006. Most failed, chiefly because central-government bureaucrats rejected many ideas for deregulation for fear of offending vested interests. "Unlike China, which initiated its first special economic zone three decades ago when the economy was closed, it is more difficult for Japan to offer something really special at this stage of its development, as the economy was already market-oriented", said Lok-sang Ho, professor of economics and director of the Centre for Public Policy Studies in China.

More importantly tax breaks, which Abe said were the backbone of special economic zones, would have to differ significantly from the rest of the country for these zones to matter. Japan's top corporate tax rate is 35.64%, excluding a temporary surcharge for earthquake reconstruction, the second-highest among leading industrialized nations after the US. The Tokyo Metropolitan Government offers a special corporate tax rate of 26.9% for foreign companies coming into their own special economic zone called the Tokyo Business Special Zone for Asian Headquarters. But critics say the rules to qualify are too complicated and note that the figure is still much higher than Singapore's 17.0% and Hong Kong's 16.5%. "You're still going to be paying a lot more tax than if you are in Singapore or Hong Kong", said Kenneth Lebrun, chairman of the FDI committee at the American Chamber of Commerce in Japan. "Potential business opportunities are the main factors for companies when deciding whether to come to Japan", he added.

A look at the deregulation package

Along with the creation of special economic zones, the third arrow is designed to reform the labour market and increase productivity in several key industries: three have been identified, agriculture, health and medical care, and energy.

Regarding labour market reform, it includes a plan to raise the labour force participation rate of the 20–64 age group and measures to mobilize the female labour force. To address these issues, the capacity of childcare facilities will be expanded to accommodate 400,000 children by end-2017. The scarcity of such facilities and waiting lists, especially in metropolitan areas, have been discussed for years but never solved. Also, strong support will be given to firms that increase the employment of women and expand the capacity of childcare facilities in their office buildings. The government expect that these measures will rise the labour participation rate of women aged 25–44 by 5 percentage points from the current 68%.

Another important issue is to enhance labour market mobility. To do so, the government will incentivize firms to relocate workers to reduce the mismatch of labour demand and supply in certain regions using subsidies or tax cuts. Facilitating the process of headcount reduction remains the top agenda in this category. However, it will take time to change the current employment system, in which firms face substantial legal barriers to firing full-time workers. Many workers are employed as generalists, meaning employment contracts are not specified for specific skills or functions. As a result, job elimination is not a valid reason for firms to lay off workers. While some progress can be expected, the issue of clarifying the process of headcount reduction will likely still be slow.

Regarding the agriculture sector, various measures have been proposed to increase productivity, to lower production costs, and to induce young people to take up farming and enlarge the scale of farm operation. In particular, according to the reform plan prefectures will establish local agencies to consolidate unused farmland and lend it to firms that engage in agricultural business; the process of examining applications from firms will be transparent — with the central government able to override decisions made by local agencies; the eligibility conditions for applicants will be lowered substantially to prompt firms to apply. However, critics expect more to be done in favour of a sector that remains heavily subsidized and whose production has fallen by ¥3 trillion over the past 20 years. Although Japan joined the negotiations for the Trans-Pacific Partnership (TPP) Agreement last July — a free-trade grouping — the agriculture sector needs to be modernized. The average Japanese farmer is 66 years old, his farm is less than five acres in size, and he is the beneficiary of his share of about ¥5 trillion of annual government subsidies. According to observers it would be advisable, for instance, to undertake domestic reform in the direction of reducing/lifting tariffs, or allowing the entry of non-agricultural firms and encouraging large scale operations. Other measures such as allowing low-cost producing areas/farmers to produce more (rather than imposing quotas) and spurring the exit of high-cost producers are necessary.

However, it is not easy for the government to implement drastic policies because farmers wield political influence, through the national network of local farm co-operatives called Japan Agriculture (JA). With its tight links to the ruling Liberal Democratic Party (LDP) and the agriculture ministry, and employing an astonishing 240 thousand staff in Tokyo and around the country, the JA is probably Japan's most powerful lobby. It campaigns to keep high import tariffs on farm goods: the tariff on rice is 777%, that on butter is 360%, while sugar attracts a 328% levy. Last autumn, when former Prime Minister Yoshihiko Noda raised the possibility of Japan joining the TPP, the farm lobby promptly delivered a counter-petition with 11 million signatures; there is therefore good reason to doubt that the TPP will deliver on agricultural reform.

The health and medical care is also an industry under regulation for which Abe plans to introduce substantial reforms. The plan includes changes to the country's universal health insurance system in order to boost growth by increasing demand for innovative drugs and medical

devices. In particular, the reforms aim to: shorten the approval process for new medicine; expand the scope of advanced medical treatment that is compatible with public health insurance system; promote the commercialization of regenerative medicine; and establish the Japanese version of the US National Institute of Health to promote medical research.

Reformers say the changes would give patients more choice and allow doctors more discretion. However, the Japan Medical Association (JMA), the largest doctors' group in the country, which represents most private practices and local clinics, opposes the reforms of the universal healthcare system proposed by the government. The JMA counters that the reforms would widen the healthcare gap between rich and poor. Critics also question just how much economic growth the changes proposed would generate.

On the energy sector, Abe proposes to deregulate an industry that produces power mostly from fossil fuels, as well as to boost competition among generators and make it easier for wind and solar energy to be distributed to consumers. In theory, deregulation can stimulate competition and cause prices to decline. Empirically, economists have found that the deregulation of electricity industries generally makes power generation more efficient and lowers operation costs. Abe's government has already submitted a bill to Parliament which was supposed to be passed in June 2013. Unfortunately, deliberation on the bill was postponed for an unrelated political reason, but the bill was resubmitted on October 15, and will most likely be passed this fall. Abe's bill calls for three steps toward the deregulation of Japan's electricity industry. First, the government plans to establish an independent system operator (ISO) by 2015. The ISO controls the flow of electricity in the entire national grid and plays an important role in deregulation. Second, the government aims to deregulate the retail electricity market, including the retail market for residential customers, by 2018. This step would allow consumers to freely choose their retail electricity providers. Third, the government plans to unbundle transmission from the regional monopolies by 2020 in order to improve access to transmission lines.

It is clear that the energy sector needs reforming and strategically re-thinking, especially after the tsunami and the Fukushima nuclear power plant disaster. Since the 1990s, there have been three major attempts by the Japanese government to deregulate the electricity market. On each attempt, however, a complete overhaul did not happen because of strong opposition and political pressure from the power companies. The current situation does not look different from the past. Although the regional power companies lost public support, they still have very strong connections with politicians. Power companies have been among the largest monetary contributors to political parties in Japan, and their labour unions have been playing an important role in political discussions. In fact, an explicit goal for unbundling transmission lines, found in the original bill, was replaced with a weak statement because of pressure from politicians who have connections with the regional monopolies.

To Reform, Abe Must Take On Vested Interests

A growth strategy is not new in Japan. In each of the last seven years, a growth strategy paper was issued by the government and many of the items for change have been proposed regularly on each occasion. Each time there has been huge disappointment. Global investors certainly thought so this time too — the Nikkei slid after Abe's much-anticipated speech. Critics say the list of reforms that Abe has put forward contained no surprises, mainly because LDP members, who represent vested interests, notably farmers, doctors and businesses, pressed forcefully to make sure Abe did not announce anything too radical.

Abe knows that deregulation necessarily involves confronting special-interest groups and the ministries and policymakers with ties to them but he is also aware that structural reform is not a choice. Now that he controls parliament, after a landslide victory in last July elections, there is no excuse to delay a structural overhaul of the Japanese economy. He must take on tough vested interests or Abenomics will fail.

Box — Highlights of the Government's New Growth Strategy (Japan Revitalization Strategy)*

Growth Strategy: Aims and Targets	Three main "arrows" make up the government's plan to revitalize the Japanese economy: (1) bold monetary relaxation, (2) flexible application of fiscal stimulus, and (3) a growth strategy for arousing private investment. Together, these policies aim to bring the economy out of its long deflationary spiral. The government is targeting average nominal GDP growth of approximately 3% for the next 10 years, and an average of 2% growth in real GDP. The aim is for an increase of at least ¥1.5 million in per capita gross national income in ten years' time.
Area	Main growth targets included in the Japan Revitalization Strategy
Private sector revitalization	Maximize the potential of the private sector by reducing the burden on corporations through cuts to investment taxes. Capital investment: Back to ¥70 trillion in three years' time. Make it easier for entrepreneurs to start new companies, and for unsuccessful businesses to fail. Increase business startup/closure rate to around 10%, on par with USA and UK. Increase number of SMEs in the black, from 700,000 to 1.4 million (2020) 10,000 new companies to expand overseas in the next five years
Business environment	Establish national strategic special zones to bring in international investment Lift Japan's ranking from 15th to 3rd place among industrialized countries on the Ease of Doing Business Index Review systems to allow foreign doctors to practice in Japan Energize financial and capital markets: Develop the No. 1 market in Asia
Commerce and globalization	Increase FTA ratio from current 19% to 70% (by 2018) Infrastructure spending: Combined total for public and private sectors from approx. ¥10 trillion at present to ¥30 trillion (2020) Export value of SMEs to double from 2010 values by 2020 Cool Japan: Threefold increase in value of overseas sales of broadcast content from ¥6.3 billion at present (2018) Number of foreign tourists visiting Japan: From 10 million in 2013 to 30 million by 2030
Agriculture, forestry, and fisheries	Exports of agricultural, forestry, fisheries products, and foods: from ¥450 billion at present to ¥1 trillion (2020) Value of "sixth-order" industries: Tenfold increase to ¥10 trillion (2020) Double total income of agriculture and farming villages over the next ten years
Employment, women's issues, training	Reduce the number of people unemployed for 6 months or more by 20% in the next five years Percentage of women in work (ages 25–44): Increase from 68% at present to 73% (2020) World university rankings: At least ten universities in the Top 100 within the next ten years Internationally competitive human resources: Double the number of Japanese studying abroad by 2020 (from 60,000 to 120,000)
Energy	Developing the energy industry: Market to be worth ¥26 trillion by 2020 Reform electricity supply systems: Create ¥16 trillion worth of new industry, new employment Introduction of renewable energy: New regulations and reforms of current systems Commercial development of the marine resources that will provide the energy of the future
Healthcare and medicine	Expand the health and preventative medicine market: From ¥4 trillion at present to ¥10 trillion in 2020 Scale of medical market: From ¥12 trillion at present to ¥16 trillion (2020) Establish a national institute of health to exercise central control over medical research and development Lift prohibition on online sales of conventional medical products

* Based on the Japan Revitalization Strategy decided at a cabinet meeting on June 14
http://www.kantei.go.jp/jp/singi/keizaisaisei/pdf/en_saikou_jpn_hon.pdf

Notes

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The Julian Hodge Institute of Applied Macroeconomics

The Julian Hodge Institute of Applied Macroeconomics 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 added urgency by the ongoing discussions about the UK's adoption of the Euro in place of the Pound. The new Institute has aimed to develop research relevant to this important debate.

The Institute embraces the original Liverpool Research Group in Macroeconomics, which is now based at Cardiff Business School and is pursuing a research programme involving the estimation and use of macroeconomic models for forecasting and policy analysis. It is grateful for financial support to the Jane Hodge Foundation, the Economic and Social Research Council, Esmee Fairbairn Charitable Trust, the Wincott Foundation and Cardiff Business School.

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