Schroders

Economic and Strategy Viewpoint

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Can Japan beat deflation? (page 2)

- **The election of Shinzo Abe as Prime Minister has brought a renewed effort to end deflation in Japan. The Japanese Yen (JPY) has weakened significantly as markets anticipate a step up in the rate of asset purchases and further expansion of the Bank of Japan's balance sheet. The fall in the currency will boost activity in Japan, but given the size of the output gap not by enough to hit the 2% inflation target. We estimate the JPY would have to fall another 10% to achieve this, unwinding much of the appreciation since the financial crisis.**
- **For the rest of the world a weaker JPY means greater competition from Japan and weaker trade performance. Most affected will be the rest of Asia, which has significantly increased its trade with Japan over the past decade. Further out, the main influence is likely to be an increase in capital flows as Japanese savers are squeezed by lower yields and higher inflation. The Yen funded carry trade is likely to return and there is a risk that efforts to resist currency appreciation result in overheating problems for Asia and the emerging economies.**

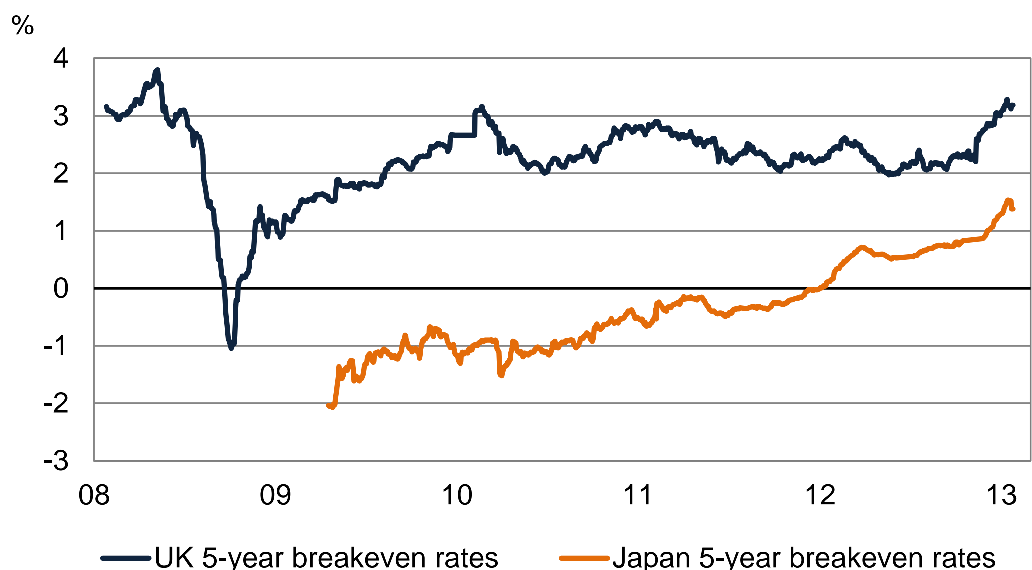
UK: Going nowhere fast (page 8)

- **The Chancellor's fourth budget felt like a case of déjà vu – growth revised down, the deficit revised up, and austerity extended for another year. However, some measures for the corporate sector could be beneficial while measures for the household sector could spur activity in construction and related retail sectors.**
- **The Bank of England's target has been tweaked as a signal that the government wants more activism. However, the bank appears to be hesitant for fear of a loss of credibility as an inflation fighter (see chart), which could drive sterling even lower.**
- **Finally, the labour market continues to surprise. Full-time employees are now dominating the gains in jobs, while the number of self-employed and part-time workers is falling. So are the numbers of people that are inactive. Could this be a sign that the labour market recovery is gathering momentum?**

China: property sector shows signs of overheating (page 13)

- **China is a country that can go from fears of a hard-landing to overheating rapidly, and there are tentative signs that the housing market may be beginning to experience the latter. New restrictions on the sector have been announced, but it would be unwise to rule out more.**

Chart: Inflation expectations rising in UK & Japan on policy changes



Source: Bloomberg. 25 March 2013

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Whilst we tend to focus on the US, Europe and China in our analysis, this month we take a look at Japan. The recent shift in policy could prove to be one of the key developments in the world economy this year as a reinvigorated Bank of Japan tries to bring an end to deflation. We assess whether it will succeed and how its actions may affect the rest of the world.

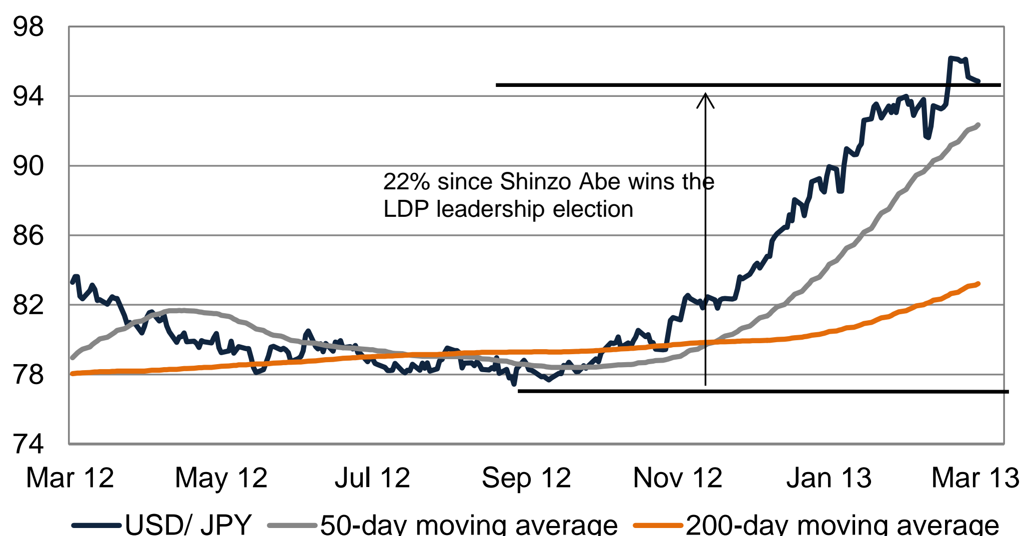
Another economy revamping its monetary policy is the UK. Here the problem is stagflation rather than deflation and we look at the state of the economy and some of the options facing incoming Bank of England governor Mark Carney. Bond Markets in Japan and the UK have pushed inflation expectations higher in response to these changes (see chart front page).

Can Japan beat deflation?

Abe targets the defeat of deflation

The election of Shinzo Abe as Prime Minister has brought a new determination to end the problem of deflation in Japan. This has led to a shift in policy at the Central Bank with the Bank of Japan (BoJ) announcing an increase in the inflation target to 2% and the appointment of a new Governor, Haruhiko Kuroda. The new man will chair the next Bank of Japan policy meeting on April 3/4 and he is widely expected to announce an increase in the Bank's asset purchase programme. He has said "the time has come for a general mobilisation of all policy measures to get rid of deflation". In response the JPY has weakened significantly since the autumn, when it became clear that Abe had a good chance of winning the general election (chart 1).

Chart 1: Significant move in JPY



Source: Thomson Datastream, Schroders. 20 March 2013

The Japanese economy has been shrinking since 1997

The shift in monetary policy will be bolstered by a more "flexible" fiscal policy and a private sector "growth strategy"; however, ending deflation is a tall order for an economy which has experienced falling nominal GDP since 1997. Real GDP has risen about 9% over the past 15 years, but due to price deflation of just over 18%, nominal GDP has shrunk by around 10% (chart 2).

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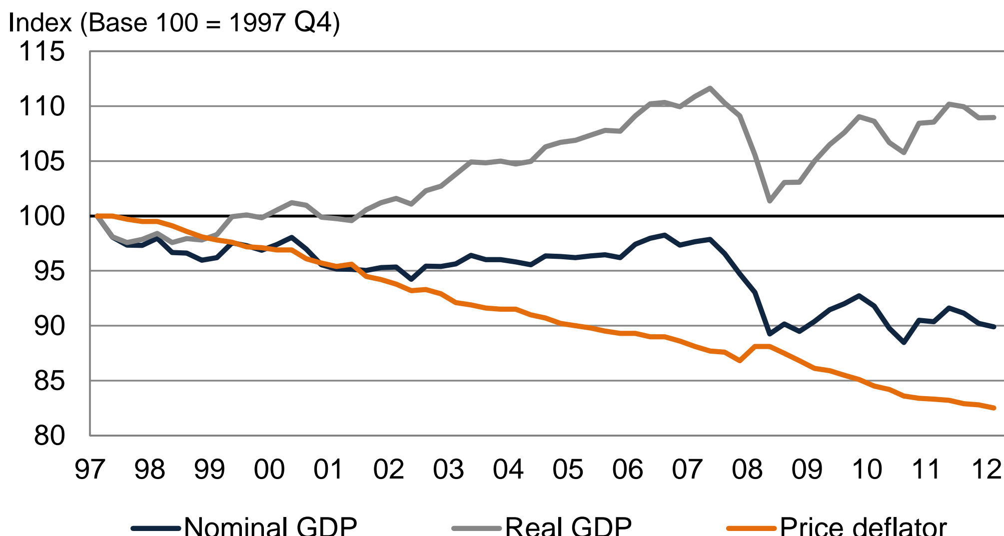
Chart 2: Japan shrinking due to deflation

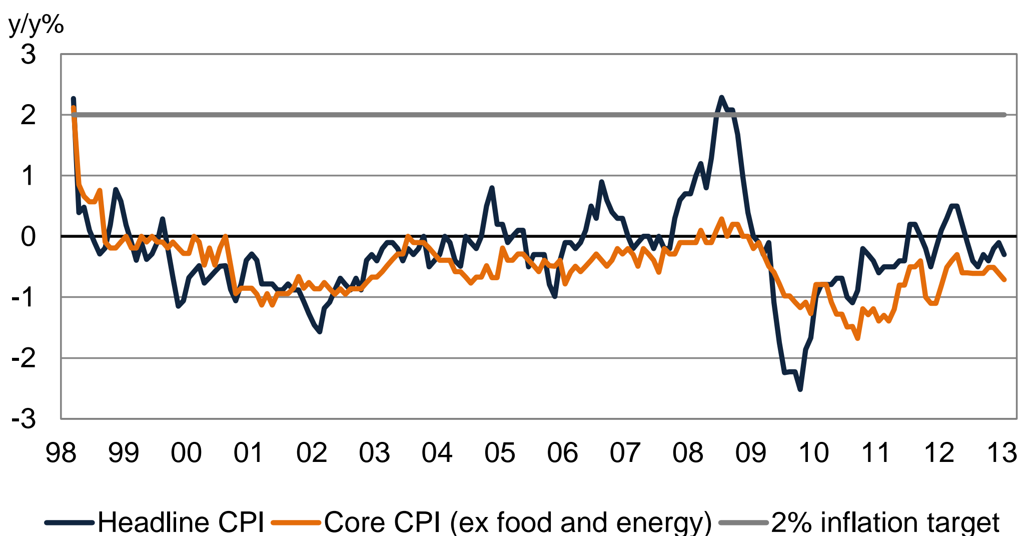


Source: Thomson Datastream, Schroders. 20 March 2013

CPI inflation has rarely hit 2% in the past 15 years

The weakness of prices can also be seen in the CPI with core prices running below zero for almost the entire past 15 years (chart 3). On this basis, inflation would have only hit a 2% target during two brief periods: in 1997 (when the consumption tax was raised), and in 2008 (when crude oil prices were rising sharply).

Chart 3: CPI inflation – headline and core



Source: Thomson Datastream, Schroders. 20 March 2013

The economy has had a persistent output gap

The persistence of deflation ties in with weak growth in Japan which has kept the economy operating below potential. Estimates from the Cabinet Office suggest the economy has only managed to close the output gap on three occasions since 1990 and is currently operating with an output gap of -3.1% GDP (chart 4). Evidence of spare capacity can also be seen in the low levels of capacity utilisation in industry and the relatively high unemployment rate.

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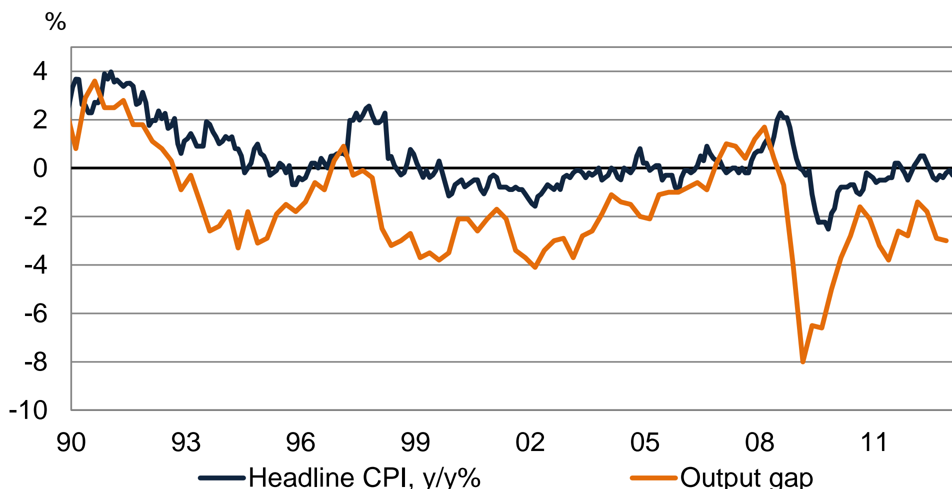
Chart 4: Output gap and inflation, in Japan

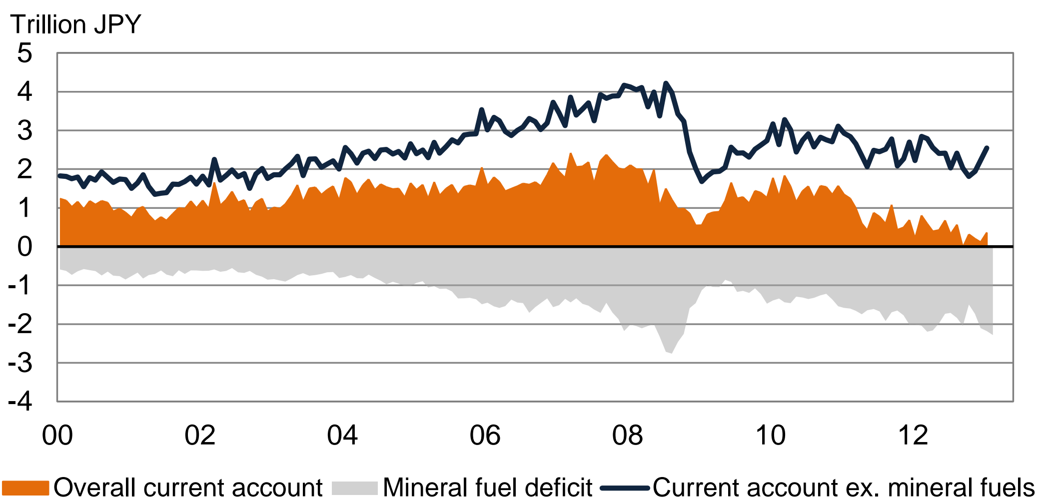


Source: Thomson Datastream, Schroders. 20 March 2013

Trade has been a drag on growth

Disappointingly, the weakness of the economy has occurred alongside a deterioration in the trade position, with the current account surplus disappearing as the trade balance moved into deficit. The move can be largely explained by the increase in the fuel deficit following the decision to halt nuclear power generation after the tsunami in 2011 (chart 5).

Chart 5: Japanese current account and trade balance



Source: Thomson Datastream, Schroders. 20 March 2013

Clearly, the return of nuclear power generation would help improve the current account, however this is many years away and in the meantime the combination of a weak economy and trade deficit is an indicator of a competitiveness problem. Figures from the OECD show that net exports have reduced real GDP growth by nearly 1% in both 2011 and 2012.

From this perspective, one of the key mechanisms for achieving better growth and the end of deflation is through a depreciation of the JPY which boosts activity through higher exports and investment, whilst raising inflation through higher import prices.

As shown above, this has been the clearest manifestation of the change of policy in Japan with investors seeing a direct link from the promised expansion of the BoJ's balance sheet to currency weakness. The question now is whether the fall in the JPY will be sufficient to close the output gap, move economic activity above trend and thus generate inflation.

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Has the Yen fallen enough?

Further devaluation would be needed to hit the inflation target

Our forecasts suggest this will be difficult to achieve in the next two years. Starting from an output gap of -3% GDP and a trend growth assumption of 1% p.a., our forecasts leave the economy with an output gap of -0.6% GDP at the end of 2014. Whilst this is on track to close the gap by 2015, it is based on the assumption that the JPY falls to 100 by the end of this year and 105 by the end of next.

Clearly if the gap is to close faster and inflation to be higher, a further depreciation of the JPY (beyond our assumptions) would be needed. The Cabinet Office estimates that a 10% depreciation of the JPY would provide a 0.6% boost to GDP over three years. In terms of extra GDP growth this would mean 0.25% p.a. for 2 years.

So, whilst the fall in the yen has been significant, it will probably only be sufficient to end deflation rather than generate positive price rises. To achieve this it probably has to fall another 10% and approach levels seen before the Global Financial crisis (GFC) of 2007-08. Against the dollar this would imply somewhere in the 110 to 120 range, or in real trade weighted terms a 10% downward move to bring the currency back to its pre-GFC range (chart 6).

Chart 6: JPY with pre-financial crisis range

Source: Thomson Datastream, Schroders. 20 March 2013 – GFC – Global Financial Crisis

Should the beta from JPY to growth and inflation be smaller, as is quite likely in the current environment of weak global demand and the island dispute with China which has hit exports, then the fall in the yen would have to be greater.

Impact on rest of the world

A weaker yen is deflationary for the rest of Asia

There are two channels of influence on the rest of the world. The first is obviously trade, with the fall in the JPY acting as a deflationary force as those competing against Japan lose market share and experience a deterioration in their net export position. The most affected will be economies in Asia, the region which has been increasing its share of Japanese trade in recent years. For example, China now receives 25% of Japanese exports compared with less than 10% in 2000. Overall, Asia accounts for more than half of Japan's exports whilst the US has contracted from 30% to less than 20% (see chart 7).

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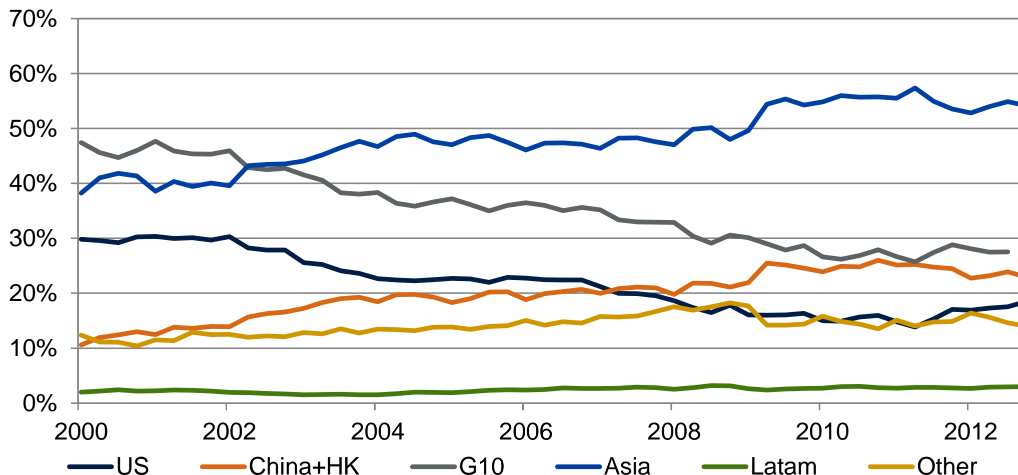
Chart 7: Japan exports by region (% share)

Japanese exports by destination (share of total Japanese exports)



Asia: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, Vietnam

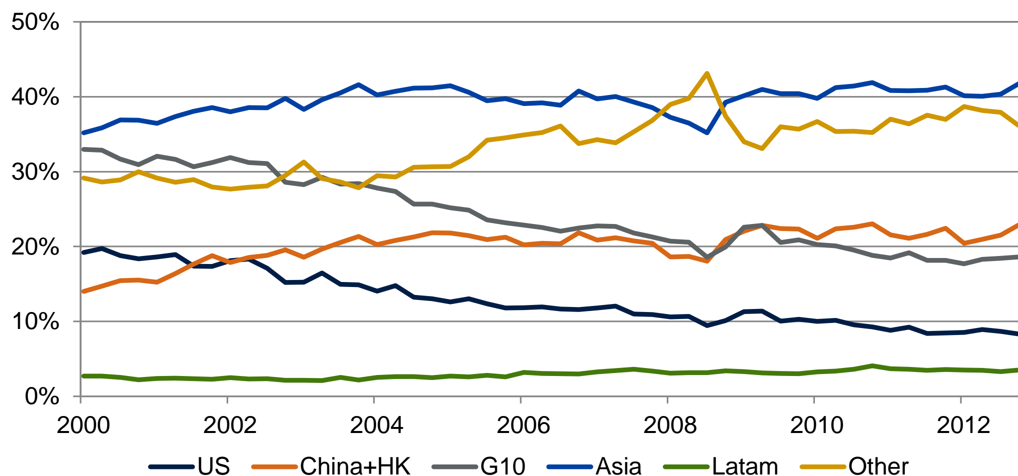
Latam: Brazil, Chile, Colombia, Argentina, Mexico, Peru, Venezuela

Source: Thomson Datastream, Schroders. 20 March 2013

On the import side it is a similar story with Japan increasing its imports from Asia (driven by China) whilst imports from the US and developed G10 have become less important (chart 8).

Chart 8: Japan imports by region

Japanese imports by origin (share of total Japanese imports)



Source: Thomson Datastream, Schroders. March 20 2013.

From this perspective a weaker yen is deflationary for the rest of the world, particularly Asia, and is one reason why Asian equity markets have paused recently. These figures capture the broad trade effects, however they miss the impact felt by companies competing with Japan in third markets. One way of gauging the impact of this is through the weight on the JPY in the trade-weighted exchange rate which takes account of this effect. Asian economies are most exposed, although within Europe the UK and Germany have the highest exposure to the JPY (chart 9)[1]

[1] Note, the Euro area has a higher weight than Germany as it only includes trade outside the region

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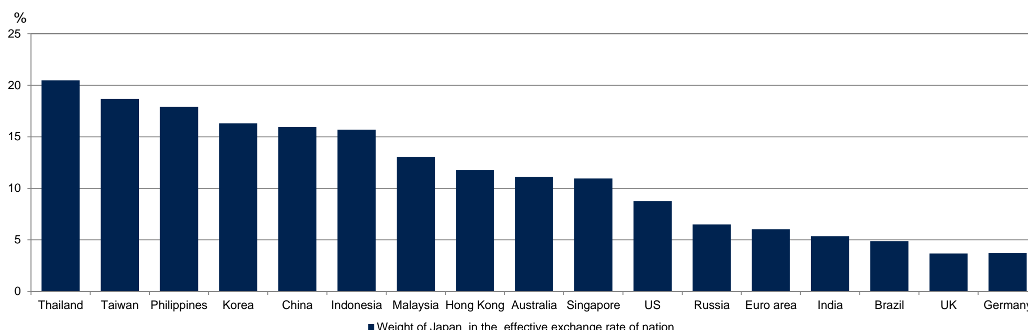
Chart 9: Japanese Yen share of trade-weighted exchange rate basket (Top 10 plus selected majors)



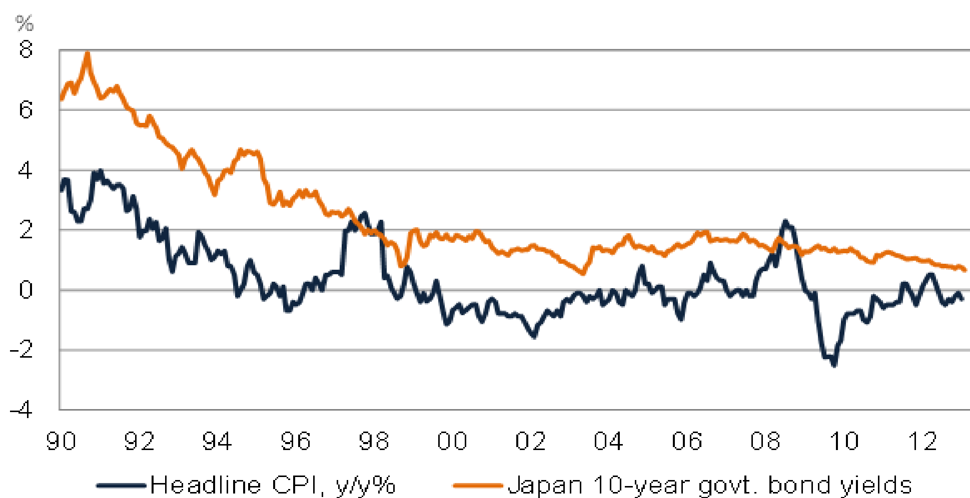
Weights use trade data from 2008-10.

Source: BIS, Schroders. 25 March 2013.

Significant capital outflows from Japan can create problems for the rest of the world

The second channel of influence is through capital flows with funds likely to move out of Japan as the BoJ steps up its efforts to generate inflation. Large scale purchases of JGB's will push down interest rates and as inflation picks up, Japanese savers will find themselves facing negative real interest rates – a marked change from the past (see chart 10). Such a development is likely to prompt a search for yield overseas and the return of the Yen funded carry trade. This will take time to develop as Japanese savers will need to become convinced that the BoJ is going to be successful in creating inflation.

Chart 10: Despite low yields, JGB rates have been above inflation



Source: Thomson Datasteam, Schroders. 20 March 2013

Should we see large capital outflows from Japan this could create problems for monetary policy elsewhere. A country receiving a significant inflow of overseas funds faces a choice: either do nothing and allow the currency to appreciate, or try to offset the inflow with intervention to keep the exchange rate stable. The former will hit growth, whilst the latter runs the risk of destabilising the economy through higher money growth and inflation. Sterilisation operations can be used to offset the monetary effect of FX intervention, however past experience suggests that these can often be inadequate.

A re-run of the Asia crisis?

The Asia crisis of 1997-98 had its roots in such a scenario where rising capital inflows initially led to overheating as central banks resisted currency appreciation, followed by a currency collapse as capital headed for the exits. At this stage we are a long way from such an outcome, but after two or three years of BoJ action the impact could be significant. By that time we might also expect to have seen an end to QE in the US, meaning that the BoJ would be the main driver of global liquidity.

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What happens next?

The next BoJ meeting (April 3-4) is expected to step up asset purchases and bring:

- An extension in the maturity of JGBs purchased under the Asset Purchase Program (APP) to 1-10y from the current 1-3y and a hike in the end-2013 APP target for JGBs to JPY60trn from JPY44trn.
- An increase in the amount of open-ended JGB purchases and a possible frontloading of the operations from the currently scheduled 2014 start.

An increase in purchase of risk assets, a cut in interest rates on reserves and forward guidance on rates and QE are likely to follow in subsequent meetings. It will be important for the BoJ to be seen to be maintaining momentum up to the upper house elections in the summer. As our analysis indicates, they will have to push the JPY lower to achieve their aims on inflation.

UK: Going nowhere fast

Déjà vu – yet another downgrade to growth, the deficit revised up, and austerity extended for another year

No growth. No matter how hard policy makers try to get the UK economy going, the headline GDP figures keep disappointing. This month's Budget was another reminder that without growth, the challenges of repairing public finances become even greater. With the UK on the verge of a historic 'triple-dip recession', we examine where progress has been made, and where the key risks lie in the near future.

Yet another fiscal slip

The Chancellor touted his fourth budget as a budget for "those who want to work and get on" as he presented more tax cuts designed to boost employment, but also to incentivise the unemployed to return to work. The economic significance of the budget measures is small in the near term, but the budget could help raise growth from 2015 onwards. The UK has already been downgraded by one of the main three rating agencies, but that did not tempt Osborne to change tack. Instead, he announced a small re-alignment of priorities between public investment and non-investment spending.

The Budget saw little change in plans despite the UK losing its AAA sovereign debt rating

The Chancellor's manoeuvring given his fiscal constraints was impressive, delivering tax cuts that will satisfy his own party and even his coalition partners. However, he made his loudest call to date for the Bank of England to take a more active role in trying to raise economic growth. The Bank's mandate has been updated to explicitly make the 2% CPI inflation target more flexible, but the Chancellor stopped short of introducing a new target altogether.

The Independent Office for Budgetary Responsibility (OBR) has been forced to halve its GDP growth forecast for 2013 to 0.6% (in line with the Schroders forecast), which in turn triggered a downgrade to its forecast for tax revenues and the budget deficit. Between 2012/13 and 2016/17, the government is now expected to borrow an additional £146 billion compared to last year's budget. Debt as a share of GDP is now expected to fall two years later than the government's target of 2015/16. Worse still, government debt is now expected to be £103 billion higher in 2017/18 - or 7.5% of GDP - compared to the Autumn Statement just four months ago! (chart 11) The forecast for the globally accepted measure of public debt (gross rather than net) has debt rising above 100% of GDP by 2015/16.

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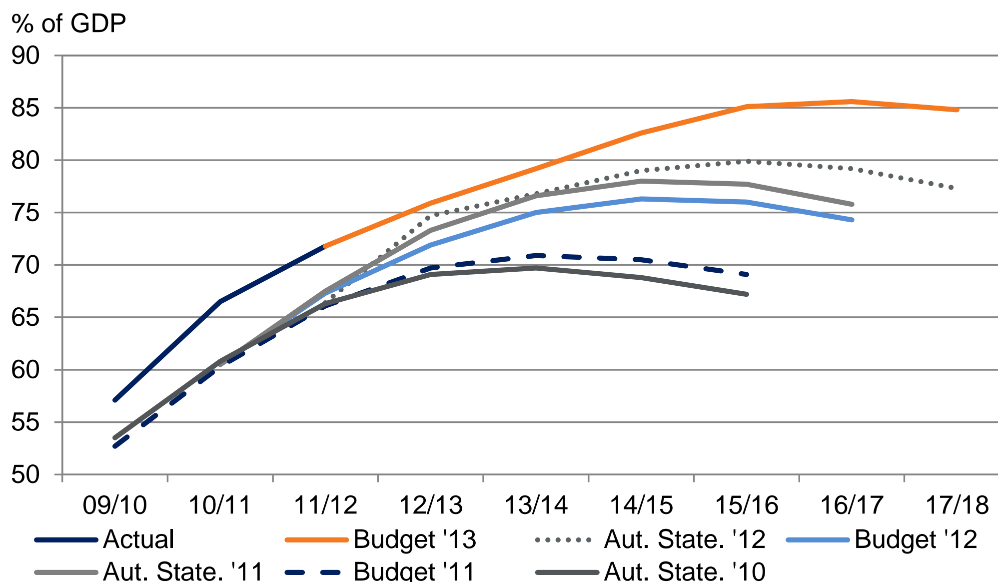
Chart 11: Comparison of past government debt forecasts



Source: OBR. 22 March 2013

Although the budget is fiscally neutral, the impact on the economic outlook is slightly positive beyond 2015

Overall, the policy measures announced are fiscally neutral over the next five years, but do provide a small stimulus between 2014/15 and 2015/16, before spending cuts are envisaged to kick in after the next general election (which may not be this Chancellor's problem by then).

The impact on the economic outlook is slightly positive beyond 2015. The Chancellor's decision to reprioritise public spending away from current expenditure and towards investment spending could help provide a boost from 2015. This will largely depend on whether the cuts in non-investment spending will lead to a fall in services being provided, or whether the cuts can be delivered using efficiency savings.

Moreover, the additional cut to corporation tax will help attract more foreign direct investment, while the introduction of a new national insurance contributions threshold for employer's contributions could help incentivise more hiring. The other notable policy area was the change to government's scheme to help potential house buyers. Through the use of its balance sheet, the government will offer shared equity and mortgage guarantees to help home buyers and home builders. These changes could help spur the housing market, and therefore housing investment and related consumption. For full analysis of the Budget, see the SchrodersTalking Point website

Monetary activism

No major change to the BoE's mandate, but this is a clear indication that the government wants more action…

While the Chancellor outlined his policies for fiscal responsibility and supply side reforms, he made it very clear in the Budget that he expected monetary activism from the Bank of England (BoE) to support the recovery. One could hardly accuse the Bank of being inactive. Possibly a little slow to react during the financial crisis, but since then, the BoE has cut interest rates to record lows and has pumped £375 billion pounds into the economy – or roughly 25% of GDP. In addition, there have been a number of liquidity measures for the banking system. Yet, the Chancellor clearly wants more. The impending arrival of the new governor Mark Carney from the Bank of Canada is seen as an appointment made for that very reason.

Ahead of the Budget, investors had feared that the Chancellor could do away with the 2% CPI target, and perhaps introduce a nominal GDP target instead. However, the fundamentals of the remit remain unchanged, but the Chancellor has now made the BoE's flexible interpretation of the remit more explicit, forcing the bank in future to commit to intermediate targets, and to explain their judgement in the trade-off between meeting the inflation target in the short-term versus stability and growth. In addition, the BoE will conduct a review of unconventional policy including quantitative easing (QE),

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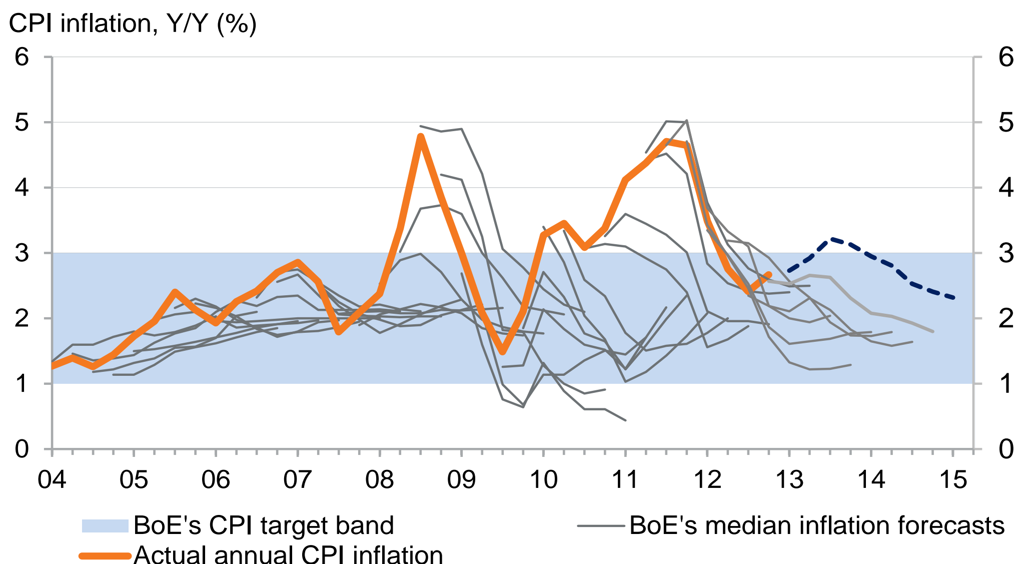
credit easing, and any other options. This is set to include a review of the use of forward guidance for interest rates, which in our view, could have been used without the permission of the Treasury.

…however, the BoE seems reluctant and is concerned about losing its credibility, and causing sterling to fall further

Whilst the Treasury is pushing for more monetary easing, the Bank seems to be reluctant. The minutes from the latest March Monetary Policy Committee meeting showed no change in voting (three including Mervyn King voting for more QE, while the majority voting for no change), but did reveal concern for increased inflationary pressure, partly from the depreciation in sterling, which has contributed to a rise in the bond market's inflation expectations. In addition, the majority of the committee felt that more stimulus could "…lead to an unwarranted depreciation of sterling if it were misinterpreted as a lack of commitment to maintaining low inflation in the medium term." This is a sudden change in communication from the committee which had previously not commented on the value of sterling.

It seems that the bank is finally becoming concerned by the external perception of its desire to meet its own inflation target. Talk of scrapping the target altogether did little to help, but nor does its forecasting record, which has consistently been too optimistic (see chart 12).

Chart 12: Bank of England's inflation forecast record



Source: Bank of England, Schroders. 23 March 2013

Higher inflation ahead caused by the fall in sterling is set to be a key headwind in 2013

Looking ahead, inflation is set to rise once again from 2.8% in February, to over 3% by the summer. As we highlighted in last month's Economic and Strategy Viewpoint, the fall in sterling will increase the price of imports, which in turn will push overall CPI inflation higher. In addition, as 70% of GDP growth historically comes from household consumption, the fall in purchasing power is likely to cause a downturn in household spending and GDP. This led us to revise up our inflation forecast and revise down our growth forecast for 2013. Along with on-going austerity, higher inflation is likely to be one of the key headwinds for the economy in 2013.

Hope from the labour market

Although the macro outlook looks grim, there are signs that at least one part of the economy is performing better. The labour market has been the main surprise over the past two years in an otherwise poor period.

The fear as austerity began was that the cuts in public sector jobs would overwhelm the labour market, and unemployment would rise sharply. Our view has always been that the private sector would more than offset any jobs lost in the public sector, partly because the UK was coming out of recession. The statistics have shown us to be correct, despite last year's double-dip recession.

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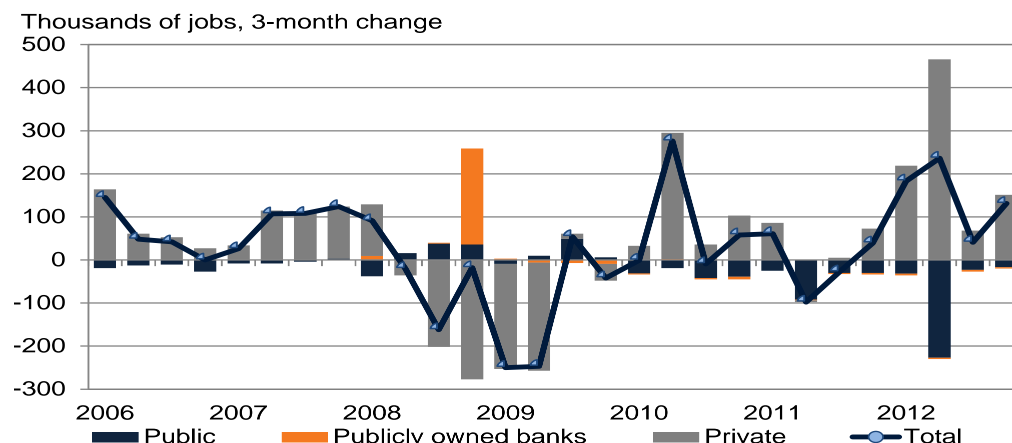
There are some bright spots in the economy – the labour market continues to surprise on the upside

Two and a half times as many private sector jobs have been created in the private sector as the public sector since the start of 2010 (see chart 13).

Chart 13: Public vs. private sector jobs growth



Source: ONS, Schroders. 23 March 2013

The strong performance of the labour market has however raised some concerns. The lack of GDP growth over the period means that productivity must be falling. Indeed the Office for National Statistics (ONS) estimates labour productivity as measured by output per worker to have fallen by 1.7% in the third quarter of 2012 compared to a year earlier. In fact, the fall in productivity is worse when taking into account hours worked – down 2.4% over the same period.

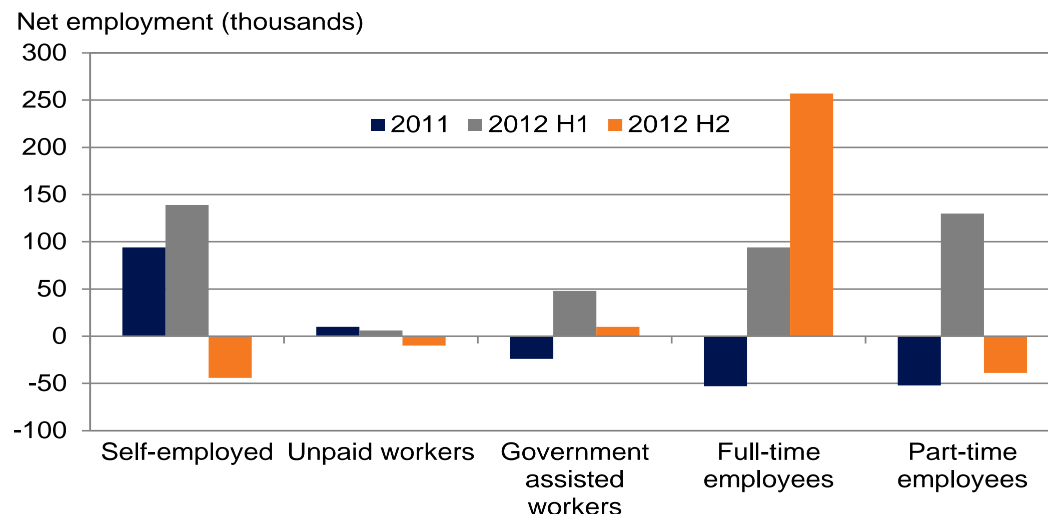
Recent rises in employment have mostly been due to more full-time workers…..

Part of the reason behind the poor productivity has been the type of jobs being created. Rather than full-time jobs, many of the gains in employment were through an increase in the self-employed and part-time workers, but also volunteers and trainees. These clearly contribute to economic growth, but tend to be less productive than traditional full-time work in a company or collective organisation.

The rise in the self-employed and part-time workers could have been caused by underemployment, or the lack of an opportunity to take full-time work. Interestingly, the latest data from the ONS has shown a strong rise in full-time workers over the second half of 2012, but falls in self-employed and part-time workers (chart 13). Not only does this suggest the quality of recent gains in employment has been better, but that the improvements in the labour market are attracting workers who are classified as self-employed and part-timers to take full-time jobs.

….an improvement on previous year dominated by the self-employed and part-timers

Chart 14: Jobs growth now driven by full-time employment



Source: ONS, Schroders. 23 March 2013

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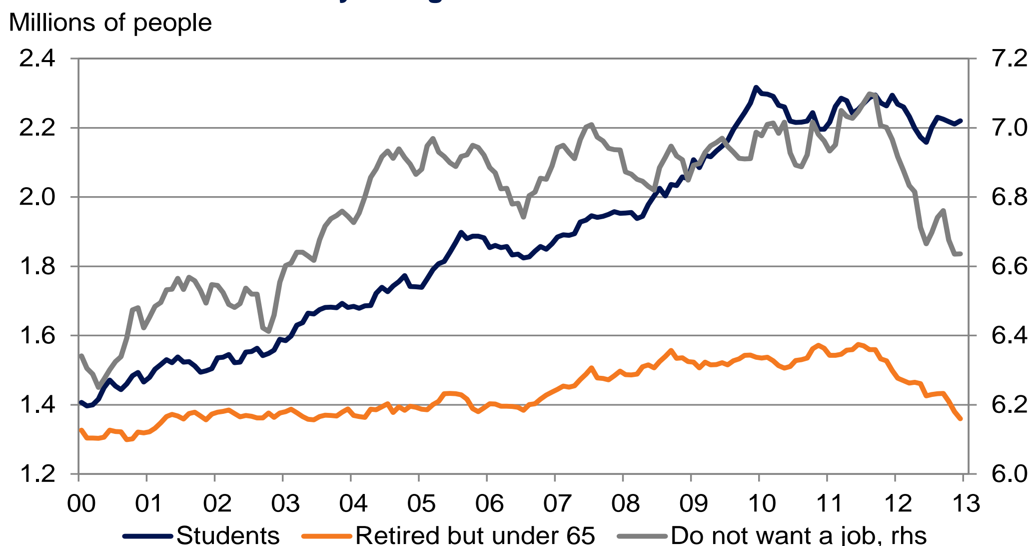
The improvement in the labour market is now also tempting those that have been discouraged from working, back into the labour force. The ONS asks inactive or non-participants in the labour force why they are not active. Putting aside those that are inactive due to health reasons, we see more people re-joining the workforce.

The number of workers that take early retirement, but are under the age of 65, has fallen significantly since its peak in the middle of 2011. This group has historically taken early retirement during recessions, mainly because of a lack of employment opportunities, and have chosen to work post 65+ when the labour market is buoyant.

The number of people leaving the workforce to study has also plateaued recently. Overall, the number of people not active simply because they do not want a job has fallen from just over 7 million people at the end of 2011, to just over 6.6 million at the end of 2012 (chart 15).

Discouraged workers are also returning to the labour market, while less workers are taking early retirement

Chart 15: Labour inactivity falling



Source: Schroders. Updated 23 March 2013

Of course, there are other reasons behind the changes in participation behaviour. One of the key pledges from the coalition government is to make work pay, and reduce the incentive to be unemployed and claim social support payments. At the same time, it has become harder for workers to take early retirement with poor returns being offered by annuities, while students maybe discouraged from study thanks to tuition fees being trebled. What we can draw with certainty from these trends is that the pool of workers is growing, which will increase competition for jobs. This should drive down wages in real terms even further, but also limit the fall in the unemployment rate over the coming months.

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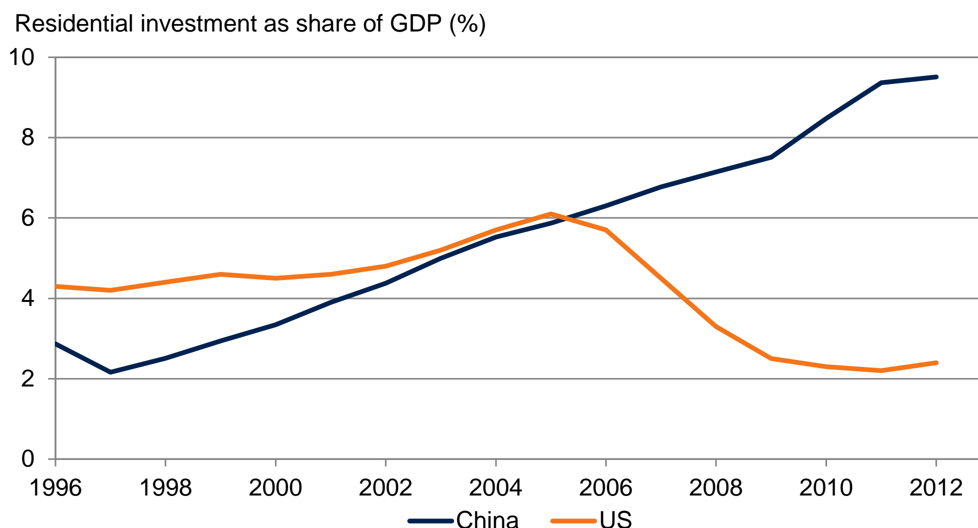
China: property sector shows signs of overheating

At a meeting earlier this year, a participant posed an interesting question. "Why, in China, can we go from fears of a hard-landing to fears of overheating in such a short space of time?" The answer to this is likely to lie in the Chinese property sector, which we regard as the most important area of data to watch, and can swing (with the help of policymaking) rapidly between a slowdown and boom phase, with knock-on effects for the rest of the economy. In the middle of 2012, it was the more positive signs coming from this sector that gave us comfort that a hard landing would be averted. In the early part of 2013, it is the recent strength of this sector that is beginning to cause concern- in China, a buoyant housing sector is welcome, but an exuberant one is dangerous.

The housing sector remains a key driver of the Chinese macro outlook

The housing sector is extremely, and increasingly, important in the development- both social and economic- of China, and thus a key area of focus for policymakers and investors alike. Over the past decade, Chinese residential investment as a share of GDP has doubled, approaching 10% of GDP in 2012 (chart 16). That housing contributes more to Chinese GDP than in the US is no surprise- China is a poorer country than the US (housing is generally a necessity good) with a significant need for more housing stock as part of its urbanisation process. Nonetheless, the divergence between the two recently remains dramatic. Taking into account the industries whose performance is closely related to housing activity (e.g. home furnishings, urban development infrastructure etc.), it is clear that movements in the housing sector are key drivers of the Chinese macroeconomic outlook. Moreover, a significant proportion of local government funding is generated through land sales and real-estate related taxes.

Chart 16: Housing is becoming increasingly important in China



Source: Thomson Datastream, Schroders. 25 March 2013

Since the middle of last year, we have seen the volume of sales pick up markedly, and this has begun to feed through into new housing starts (chart 17), and we expect the momentum we have seen in this area to continue in upcoming months. While this is positive for Chinese activity, it opens up the potential for further tightening of the property sector from authorities keen to avoid creating a bubble, as we have seen prices rise sharply over the past quarter.

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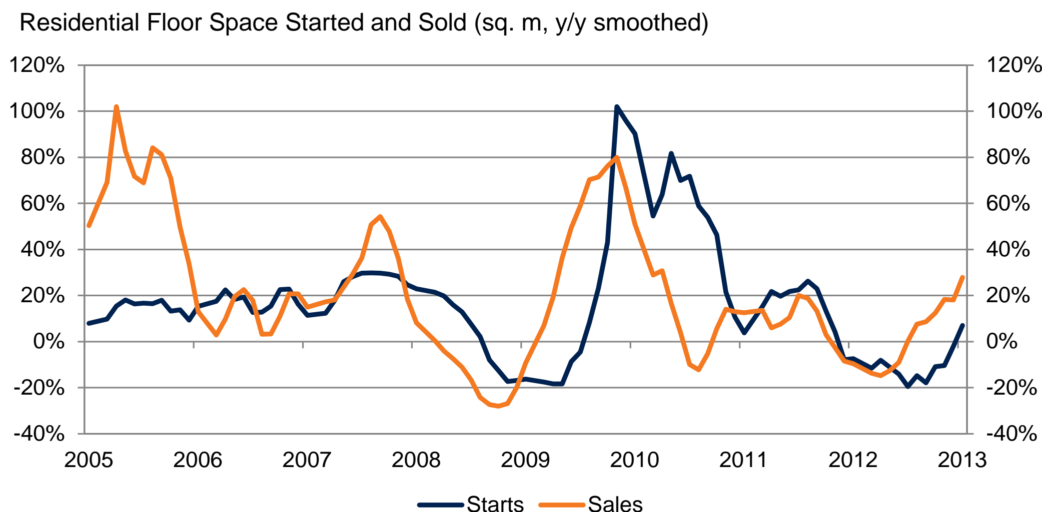
Chart 17: New starts have been improving in line with sales volumes

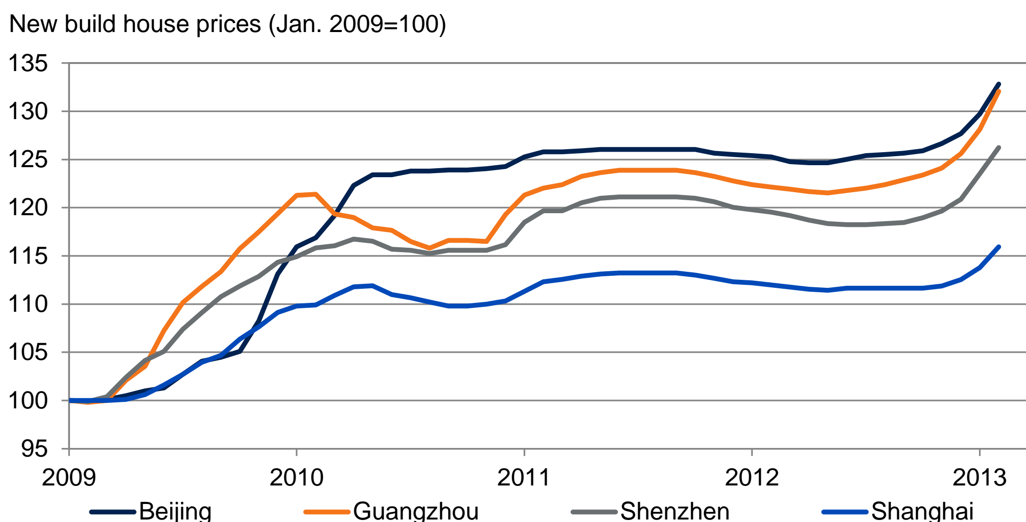


Source: Thomson Datastream, Schroders. 25 March 2013

Prices have risen sharply in the recent months, particularly in the Eastern cities

It is often pointed out that most of the price rises occur in major Eastern cities, such as Beijing and Shanghai, where the supply and demand imbalances are the most acute; thus reflecting fundamentals rather than the precursor to a major speculative bubble. Having been broadly stable since the surge in 2009, however, prices in these cities have risen extremely sharply again over the past quarter (chart 18). While it is true that the lack of housing supply in these areas is a driver, these supply-demand imbalances are not new phenomena, and pace of the recent price increases suggests other factors must also be at play.

Chart 18: Coastal cities have seen sharp price rises in the last quarter



Source: Thomson Datastream, Schroders. 25 March 2013

New tightening measures have recently been announced……

The outlook for policy

In early March, the State Council announced measures to curb the early signs of exuberance in the housing market that had appeared, such as the enforcement[2] of capital gains tax of 20% and increased down payments on second home mortgages in several cities, and it remains to be seen how effective these measures will be. With the new leadership having only recently taken office, it is likely that they will maintain the current stance for the time being to allow time for the measures already

[2] The tax already existed, but was rarely enforced

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imposed to take effect. Indeed, since many of the announced measures are yet to take effect (they will from the end of March), some of the recent activity in the market may well have been purchases and sales brought forward to avoid restrictions.

…..though more may be forthcoming

If these measures prove insufficient to maintain control of the market, however, policymakers have scope for further tightening to squeeze speculative activity and cool the housing market. This could take the form extending minimum down payments for second homes to more cities, further increasing the minimum down payment (currently 60%) or allowing greater flexibility on increasing the lending rate (currently capped at 10% over the benchmark rate of 6%).

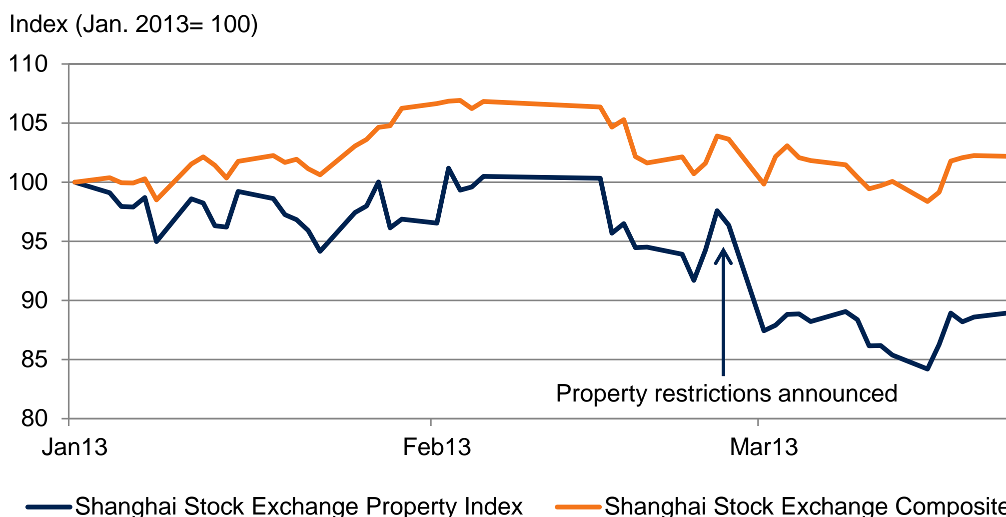
Though we expect property-specific measures to be deployed as the first line of defence, the strength of the housing market also brings monetary policy back into focus. At the recent National People's Congress, in which policy aims for the year are outlined, the official inflation target was reduced to 3.5% from 4%. We expect headline inflation to begin to approach this level as we get towards the middle of the year, as a result of improved activity and unfavourable base effects. While we do not expect imminent tightening of policy if this level is breached, the reduction in the inflation target, combined with the strength of the property market, suggests that the balance of risks has now shifted decisively in the favour of monetary tightening in China. Our baseline forecast remains that no changes will be made either to the headline lending rate or the required reserve ratio for banks, but policymakers may be drawn into using these tools or liquidity measures to cool the property market.

Further tightening measures would place additional strain on Chinese property stocks

Macro and market impacts

As one would expect, Chinese property companies, and those invested in them, will bear the brunt of the impact of further tightening in the sector, as illustrated by the plummet in the Shanghai Stock Exchange Property Index on the day the new measures were announced (chart 19), with the index falling almost 10% in a single day. Anecdotal evidence from business executives at major companies suggests that the lack of certainty over future property policy remains a key concern for 2013, even as the sector's underlying fundamentals improve.

Chart 19: Property stocks have been hit hard by the measures announced so far



Source: Bloomberg, Schroders. 25 March 2013

Further tightening in the property market will also spill over into the broader macro recovery, and could impact growth in the latter half of this year. The tightening enacted in 2011 to curb rising prices undoubtedly fed through to the macro economy, in conjunction with a highly uncertain external environment, in the latter half of 2011 and into 2012, as investors began to become fearful of a Chinese hard-landing. We believe the measures announced so far will have a smaller negative

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impact on growth than last year, though more aggressive measures would likely have a more meaningful impact. To this end, ironically, Chinese housing market data may begin to act as contrarian indicator for overall activity- the better it is, the more likely we see punitive new restrictions which quell growth.

Global assets sensitive to commodity price movements would be hurt by further measures

Assets sensitive to Chinese growth, and in particular to the commodity demand of China, would be negatively impacted by any further tightening announced in the property sector. Base metal prices, already facing dual headwinds of improving supply dynamics and a stronger US dollar (a theme we expect to continue), would likely suffer from a further round of tightening measures in Beijing, and the currencies of countries whose exports are particularly focused linked to these commodities (such as Australia, Chile and Peru) would likely feel the greatest pinch. As mentioned, we expect the impact of tightening on the wider Chinese economy to be moderate compared to what we saw in late 2011 and early 2012. If, however, the clampdown has a stronger than expected impact on the Chinese economy, reigniting fears of a hard landing, global risk assets will suffer more generally as investor sentiment sours in a world starved of growth.

The solution to the persistent threat of housing bubbles in China, in the long-run, lies in wholesale reforms. Reform of wealth management products and the banking sector, allowing savers to earn better real returns on their capital without the need for property market speculation, would certainly be beneficial. An increased supply of housing, especially in those cities with the most chronic undersupply and with the highest rates of urbanisation, is an even more pressing need. These aims, however, are unachievable in the short-run, leaving property restrictions the only option left for policymakers faced with an overexcited housing market. It will continue to remain the key area to observe for China watchers.

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Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2012	2013	Prev.	Consensus	2014	Prev.	Consensus
World	100	2.4	2.4	(2.4)	2.5	3.2	(3.2)	3.1
Advanced*	65.2	1.2	1.0	(1.0)	1.0	1.9	(1.9)	1.9
US	23.6	2.2	2.1	(2.1)	1.8	2.7	(2.7)	2.8
Eurozone	20.4	-0.5	-0.6	(-0.6)	-0.3	0.7	(0.7)	1.0
Germany	5.6	0.9	0.5	(0.5)	0.7	1.5	(1.5)	1.7
UK	3.8	0.0	0.6	(0.6)	0.9	1.3	(1.3)	1.6
Japan	9.2	1.9	1.0	(1.0)	1.2	2.3	(2.3)	1.2
Total Emerging**	34.8	4.6	5.2	(5.2)	5.1	5.6	(5.6)	5.5
BRICs	21.1	5.5	6.2	(6.2)	6.2	6.5	(6.5)	6.4
China	11.4	7.7	8.2	(8.2)	8.2	8.3	(8.3)	8.0

Inflation CPI

y/y%	Wt (%)	2012	2013	Prev.	Consensus	2014	Prev.	Consensus
World	100	2.8	2.7	(2.7)	2.6	2.6	(2.6)	2.8
Advanced*	65.2	1.9	1.5	(1.5)	1.6	1.6	(1.6)	2.0
US	23.6	2.2	1.7	(1.7)	1.8	1.7	(1.7)	2.1
Eurozone	20.4	2.5	1.7	(1.7)	1.7	1.6	(1.6)	1.7
Germany	5.6	2.1	1.9	(1.9)	1.8	1.8	(1.8)	2.0
UK	3.8	2.8	3.2	(3.2)	3.2	3.0	(3.0)	3.0
Japan	9.2	-0.5	0.0	(0.0)	0.0	0.4	(0.4)	1.8
Total Emerging**	34.8	4.5	4.9	(4.9)	4.4	4.5	(4.5)	4.4
BRICs	21.1	4.2	4.8	(4.8)	4.1	4.3	(4.3)	4.0
China	11.4	2.7	3.7	(3.7)	3.2	3.3	(3.3)	3.5

Interest rates

% (Month of Dec)	Current	2012	2013	Prev.	Market	2014	Prev.	Market
US	0.25	0.25	0.25	(0.25)	0.41	0.25	(0.25)	0.56
UK	0.50	0.50	0.50	(0.50)	0.50	0.50	(0.50)	0.56
Eurozone	0.75	0.75	0.75	(0.75)	0.33	0.75	(0.75)	0.50
Japan	0.08	0.08	0.08	(0.08)	0.19	0.08	(0.08)	0.21
China	6.00	6.00	6.00	(6.00)	-	6.00	(6.00)	-

Other monetary policy

(Over year or by Dec)	Current	2012	2013	Prev.		2014	Prev.
US QE ($Bn)	1645	1900	2920	(2920)		3175	(3175)
UK QE (£Bn)	375	375	450	(450)		450	(450)
Eurozone LTRO	NO	YES	YES	YES		YES	YES
China RRR (%)	20.00	20.00	20.00	20.00		20.00	20.00

Key variables

FX	Current	2012	2013	Prev.	Y/Y(%)	2014	Prev.	Y/Y(%)
USD/GBP	1.52	1.60	1.52	(1.52)	-5.0	1.50	(1.50)	-1.3
USD/EUR	1.30	1.25	1.35	(1.35)	8.0	1.30	(1.30)	-3.7
JPY/USD	94.5	82.0	100.0	(100.0)	22.0	105.0	(105.0)	5.0
GBP/EUR	0.85	0.78	0.89	(0.89)	13.7	0.87	(0.87)	-2.4
RMB/USD	6.21	6.20	6.10	(6.10)	-1.6	6.00	(6.00)	-1.6
Commodities								
Brent Crude	108.0	112	115.2	(115.2)	3.3	107.4	(107.4)	-6.8

Source: Schroders, Thomson Datastream, Consensus Economics, March 2013

Market data as at 25/03/2013
Previous forecast refers to November 2012
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets:** Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

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I. Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

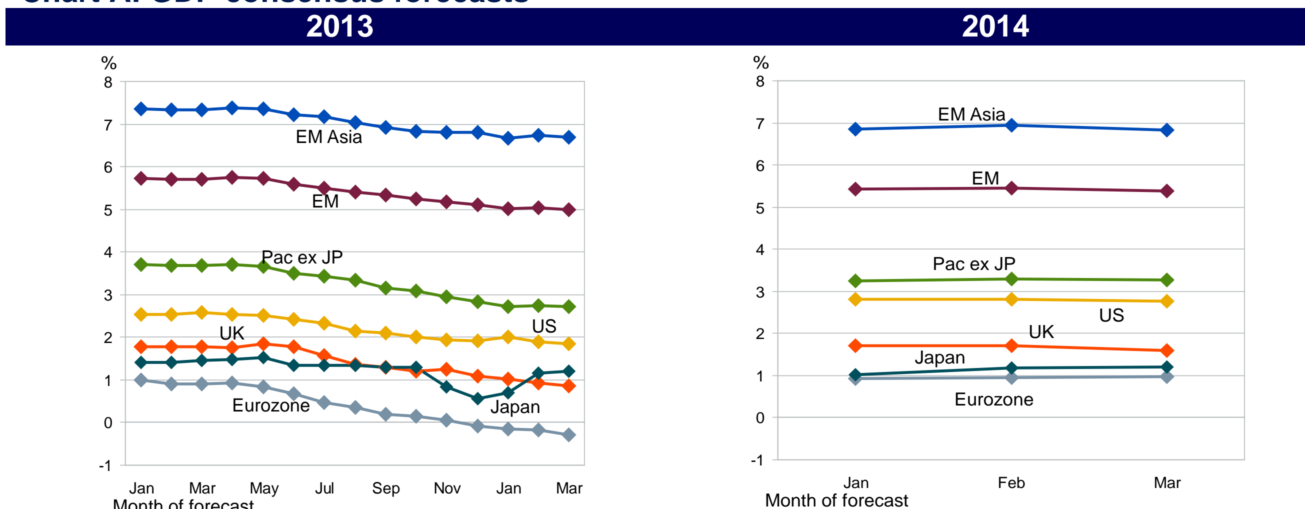
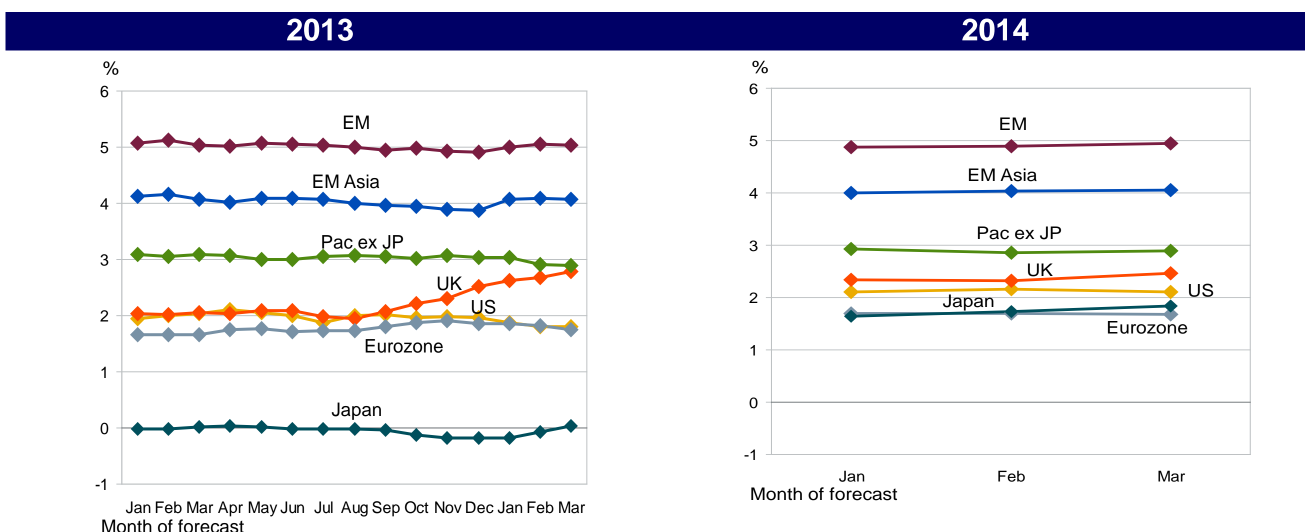


Chart B: Inflation consensus forecasts



Source: Consensus Economics (March 2013), Schroders
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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