# Economic Insights
## Quarterly Economic Outlook
## Q2 2015

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### Introduction

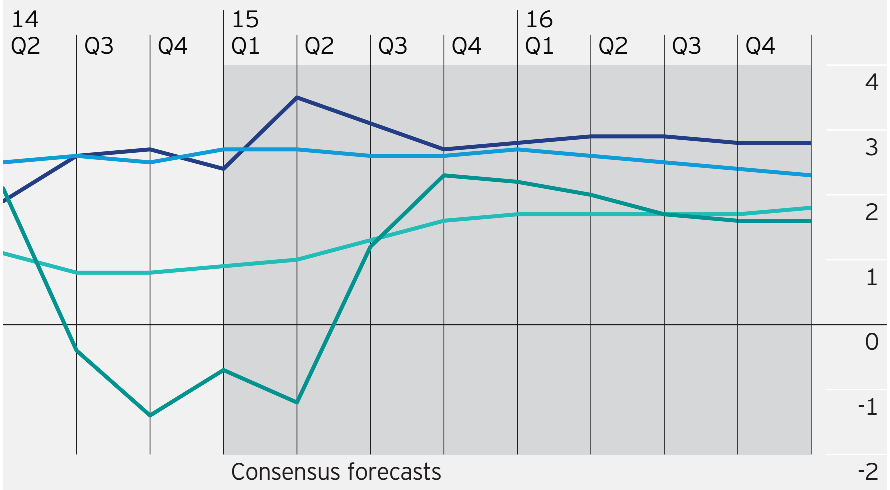
- The marked divergence in the monetary stance of central banks in the US and the UK on the one hand and Japan and the Eurozone on the other has, as expected, increased volatility in the currency, fixed income and equity markets during Q1 2015, and will probably continue to do so through 2015.

- While the US Federal Reserve (Fed) is currently on track to raise interest rates later this year, the decline in UK inflation to 0% almost certainly implies that the Bank of England will raise interest rates later than the Fed. Meantime, the European Central Bank (ECB) and the Bank of Japan will continue with sovereign bond purchases and near-zero policy rates.

- The divergence in central bank policies reflects the wide differences in real GDP growth rates between the US and the UK on the one hand, and the Eurozone and Japan on the other (Figure 1).

Figure 1
**Divergent real GDP growth underlies divergent policies of central banks**
(% change y-o-y)

United States
United Kingdom
Eurozone
Japan




Source: Consensus Economics, March 2015.

- With the decline in oil and other commodity prices in the second half of 2014, headline CPI inflation rates have fallen steeply in almost all major economies. However, the true underlying source of this price weakness is the very slow rates of money and credit growth in most major economies. Only in the US have money and credit growth rates been at normal rates.

- Since it is mainly weak demand, rather than excess supply, that explains the commodity price decline, and it is much harder to revive demand than choke off supply, it is likely that commodity prices will remain subdued for an extended period.

- In the Euro-area, the ECB finally announced on 22 January 2015 that it would adopt quantitative easing (QE - purchases of sovereign bonds by Euro-area central banks) after the CPI had started to register deflation. The plan was implemented from 9 March 2015, and is scheduled to continue until September 2016. The success of the plan will depend on whether the ECB and the central banks buy long-term debt from non-banks.

- Recovery in the UK has continued to be buoyant, although real GDP in Q4 2014 slowed to 0.5% (2.2% annualised). Employment growth has been strong, and unemployment has declined, but real wage increases remain elusive. The main uncertainty over the next few weeks is the outcome of the general election.

- The downturn in Japan prompted by the hike in the consumption tax in April 2014 has eased, but forecasts for growth in 2015 remain subdued, and forecasts for inflation – a key target of 'Abenomics' – are falling well below the Bank of Japan's 2% target.

Figure 2
**Inflation and growth forecasts**

| Consensus economics | 2014 Actual Real GDP (%) | 2014 Actual CPI inflation (%) | 2015 Consensus forecast (Invesco forecast) Real GDP (%) | | 2015 Consensus forecast (Invesco forecast) CPI inflation (%) | |
|---|---|---|---|---|---|---|
| US | 2.4 | 1.6 | 3.1 | (2.9) | 0.3 | (0.1) |
| Eurozone (18) | 0.9 | 0.4 | 1.4 | (1.2) | 0.0 | (-0.9) |
| UK | 2.6 | 1.5 | 2.7 | (2.3) | 0.5 | (0.3) |
| Japan | -0.1 | 2.7 | 1.1 | (1.0) | 0.7 | (0.7) |
| Australia | 2.7 | 2.5 | 2.6 | (2.8) | 1.7 | (2.5) |
| Canada | 2.5 | 1.9 | 2.1 | (2.5) | 0.9 | (1.1) |
| China | 7.4 | 2.0 | 7.0 | (7.0) | 1.5 | (1.5) |
| India | 5.5 | 6.4 | 6.3 | (5.6) | 5.5 | (5.2) |

Source: Consensus Economics, 9 March 2015. The Eurozone expanded to 19 countries on 1 January 2015.

- Among the emerging economies, private estimates of China's growth have continued to fall as exports have disappointed and fixed capital investment has slowed. Increased capital outflows have meant that the central bank, the People's Bank of China (PBC), has had to combat an involuntary tightening of policy due to the outflows with a series of easing measures in the money markets that have not really worked.

- Elsewhere in the Emerging Markets arena, growth has remained weak, notably in Brazil and Russia, where growth rates have slowed to a standstill. India has avoided this fate, but despite revised GDP figures, the economy is not showing the renewed vigour that the new Prime Minister, Mr Modi, had promised.

- The US dollar is likely to remain firm, strengthening further this year for at least three reasons: the recovery of the US economy is ahead of other leading economies, attracting capital inflows; the Fed is on track to hike interest rates during this year and next; and persistently weak commodity prices are expected to undermine the value of the currencies of many commodity-producers.

- My long-standing view has been that the current business cycle expansion would be an extended one. The main reason is that low growth and low inflation would avoid the need for the kind of tightening policies that would bring an early end to the expansion. In addition, the recovery in the US, although already five years old, is only now starting to take on the typical characteristics of a normal recovery: banks are now providing credit instead of the Fed, business investment is recovering and consumer spending is regaining its normal momentum.

## United States

After several years of disappointing performance, US growth returned to a more normal 'recovery' pace in the last three quarters of 2014. The first quarter of 2014 had been adversely affected by unusually cold weather, but growth in the second, third and fourth quarters averaged 3.9% at an annualised rate – in line with the early phases of past recoveries. Henceforth the pace of growth is likely to be more stable at around 2.5% - 3.0%. For 2015 as a whole I expect 2.9% growth. The fundamental reason for this return to normality is that households and financial institutions have largely completed their balance sheet repair process.

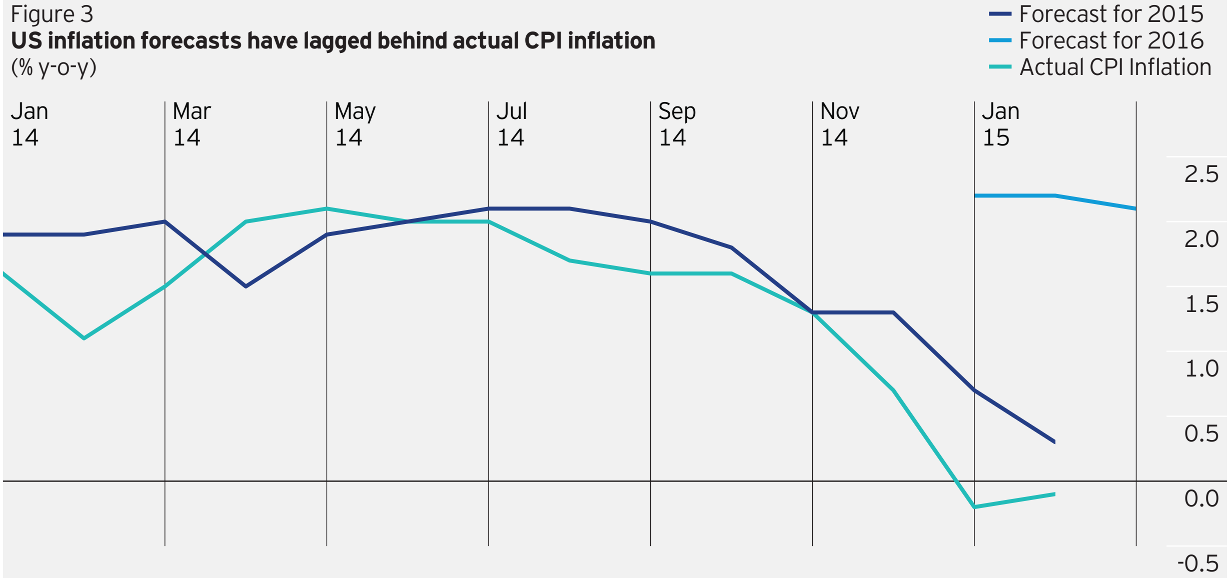
The most encouraging feature of the recovery has been the sustained growth in employment, and the parallel declines in unemployment. For example, non-farm payrolls have increased by an average of 292,000 per month in the six months September-February, while the unemployment rate has fallen from 5.9% to 5.4% over the same period. Even so, the view of many policy-makers, including those on the Federal Open Market Committee, is that there remains considerable slack in the US labour market due to low participation rates reflecting discouraged workers withdrawing from the labour force. (The low Labour Force Participation Rate also reflects structural factors like the ageing of the population.) Going forward it is likely that payrolls will continue to increase as the real GDP strengthens, but probably not at the same pace as over the past six months.

Since the Fed ended its asset purchases in October 2014 commercial banks have continued to create credit through bank loans, thereby ensuring adequate rates of monetary growth. For example, M2 growth was 6.3% year-on-year (y-o-y) in February, while total bank lending grew at 7.7%. This means that there has been a smooth handover of the credit baton to the banking system, although the shadow banking sector has not yet started to grow consistently. Nevertheless, the Fed is now able to contemplate the normalization of interest rates, starting in June or September, depending on the strength of the economy. The long period of extraordinary monetary accommodation will be coming to an end. However, as long as money and credit growth remain ample, the hiking of interest rates should not be confused with a monetary tightening.

Survey measures such as the Institute of Supply Management (ISM) indices have had a mixed performance, mainly due to the strength of the US dollar. Thus whereas the ISM manufacturing index – which reflects some large US exporters – has weakened to 51.5 in March, the non-manufacturing index – which comprises mainly domestic services – has continued at a high level of 56.9 in February. Housing activity has been subdued with starts around one million per month (at annual rates), but house prices have gradually firmed with the S&P/Case-Shiller Index for 20 cities showing an annual increase of 4.6% y-o-y in January. Although there has been a pick-up in re-financing activity thanks to low long-term interest rates, applications for mortgages for home purchases have remained low due to the cautiousness of the banks. After the setback in Q1 2014, private fixed investment has recovered moderately and is approaching its pre-crisis levels for the first time since 2006-07. Overall the economic recovery is on track, but not overheated, and I expect it to remain on this trajectory as long as credit growth continues to be moderate.

Inflation has continued to decline in line with the well-established fact that inflation tends to fall in the early years of a recovery (Figure 3). This has been reinforced by low money and credit growth, the availability of spare capacity and by the steep decline in commodity prices, especially energy prices since mid-2014. Even though the commercial banks have started expanding at a more normal pace, I believe it will still take two years or more before faster money and credit growth feed through to inflation. Against this background I have long been forecasting lower than consensus rates of inflation. For 2015 as a whole I expect 0.1% consumer price inflation in the US.

Figure 3
**US inflation forecasts have lagged behind actual CPI inflation**
(% y-o-y)




Source: Consensus Economics, January 2014 - March 2015.

## The Eurozone

In the Euro-area, the ECB finally announced on 22 January that it would adopt QE, meaning purchases of sovereign bonds by Euro-area central banks. The plan was implemented from 9 March, and is scheduled to continue at a rate of EUR 50 billion per month (in addition to the pre-existing purchases of EUR 10 billion per month of Asset Backed Securities and covered bonds) until September 2016. For a long time conservative members of the Governing Council had resisted the adoption of QE, and only agreed after the CPI had started to register deflation in January 2015.

Although QE has come far too late to prevent deflation, there is no doubt it could convert what is currently an anaemic recovery in the Eurozone to a more vigorous upswing if carried out on a large enough scale and for long enough. The key to success of the plan will depend on its design and implementation. The intention is to buy sovereign and supra-sovereign bonds with a remaining maturity of 2-30 years. However, as the Fed found, buying short-term paper is generally a mistake, and required an extended programme of maturity extension in 2011-12 via sales of short-term paper and purchases of long-term paper (called "operation twist" from the implied twisting of the yield curve). Also, there is the crucial question of the proper counterparties. Since the ECB is committed to buying in the secondary markets, it is important that the authorities buy the securities from non-banks in order to ensure that new deposits are created, thus ensuring faster growth of money and triggering "portfolio re-balancing" effects. If they buy from banks there can be no assurance that additional deposits (or M3) will be created. (This was essentially why the Long-Term Refinancing Operation programme of 2011-13 failed.)

Against this backdrop of important but belated policy innovations by the ECB, the most significant development over the quarter has been the weakening of the euro on the foreign exchange markets. From US$1.21 in January the currency fell to US$1.05 in mid-March, and appears headed for parity against the US unit during the April-June quarter. If demand in overseas economies holds up then this will undoubtedly assist Euro-area exporters to increase their sales and market share, providing a badly needed boost to Eurozone economic activity.

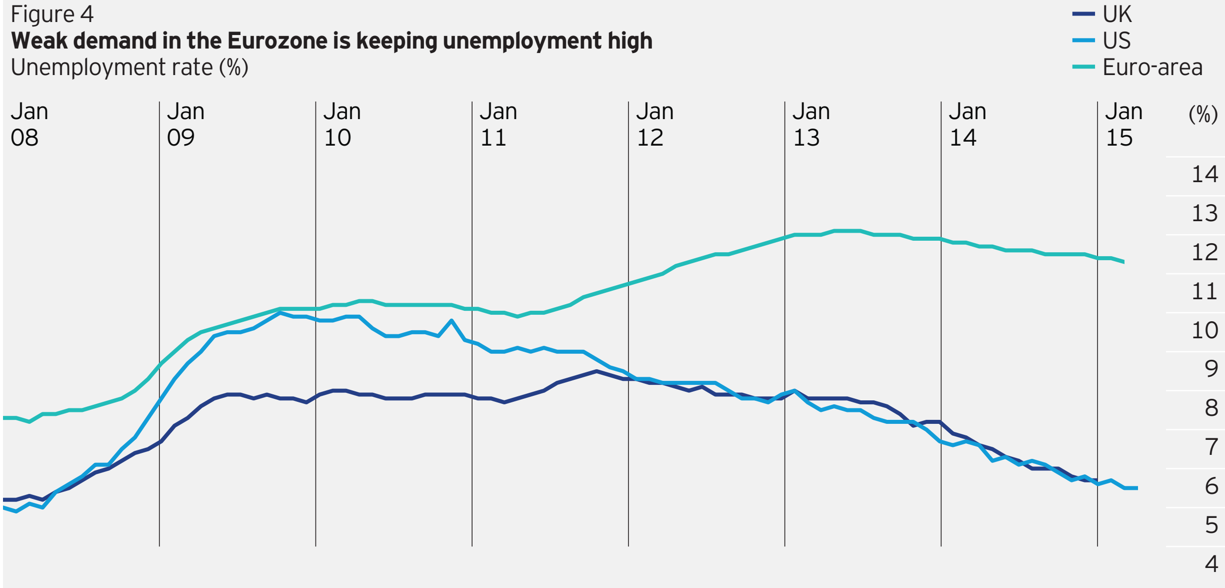
However, the real problem is on the domestic side where deficient demand has kept consumer and business spending weak, GDP growth low, and unemployment high (see Figure 4). This is the underlying explanation for the emergence of deflation in the Eurozone. Thus real GDP grew by only 0.2% quarter-on-quarter in Q3 2014 and 0.3% in Q4. On the basis of constant, chain-linked 2010 prices these growth rates amount to a meagre 0.8% and 0.9% y-o-y respectively – what I have called bumping along the bottom.

The ECB mantra, repeated every month last year at press conferences, that a recovery was just around the corner has turned out to be a mirage. Even so, that optimism has been maintained this year with ECB forecasts raised to 1.5% for 2015 and 1.9% for 2016. Most European economists have followed the ECB with the Bloomberg consensus being 1.3% for 2015 and 1.6% for 2016. My forecast is for 1.2% in 2015.

Nevertheless, some countries within the monetary union have been able to exhibit more vigorous growth. In Germany real GDP growth in 2014 Q4 was 1.6% y-o-y; in Spain it reached 2.0%, more than twice the average of the Eurozone; and in Ireland real GDP growth was a meaningful 4.1% y-o-y. Among the laggards, France recorded a miserable 0.2% y-o-y, while Italy produced an even weaker -0.5%.

Unlike the US or UK, unemployment in the Eurozone has declined only minimally and remains at 11.4%. Some have boasted that the current account is in healthy surplus, but this simply reflects very weak imports resulting from inadequate domestic demand (i.e. sub-normal spending by households, businesses and governments). Viewed correctly, the current account should be adjusted to a 'full employment equilibrium' balance, which would inevitably be substantially lower or possibly even in deficit.

Figure 4
**Weak demand in the Eurozone is keeping unemployment high**
Unemployment rate (%)




Source: Thomson Reuters Datastream, as at 31 March 2015.

## United Kingdom

The recovery of the British economy slowed slightly from an average of 0.7% quarter-on-quarter (2.8% annualised) in the first three quarters of 2014 to 0.5% (2.2% annualised) in the final quarter of 2014. This year has started with gains in consumer spending power due to fuel price declines, but nominal income and employment growth have slowed. Although this would be a respectable growth rate under most circumstances, the fact that this moderation of growth is occurring at a time when the economy is still some distance from its full potential suggests that the recovery is still vulnerable. The weaknesses are both domestic and external. For this reason the Bank of England is now unlikely to raise interest rates or tighten monetary conditions in 2015 since such action would likely cause a significant setback.

For every area of strength in the recovery there appears to be an associated element of weakness or vulnerability. For example, despite big improvements in the labour market, wage growth remains weak. Associated with weak wage growth, there has also been a shortfall in tax revenues. Also, despite an 18% increase in exports of goods and services in real terms since the trough of the recession, the external current account deficit has widened alarmingly. Finally, despite a gradual strengthening of bank balance sheets, money and credit growth remain disappointingly low. This is the fundamental driver behind the fall in CPI inflation to 0%.

The labour market has improved notably in recent quarters. For example, employment continues to rise, reaching 30.94 million in the three months to January 2015, a rise of 617,000 over the year, or up by almost two million since the recession low. Similarly, unemployment has continued to fall, reaching 5.7% of the labour force in January, or 1.86 million persons, a fall of 479,000 over the year. In spite of these favourable trends, youth unemployment among those aged 18-24, although down from its peak of 20% in November 2011, was still at 14.3% in the three months to January. More generally, wage growth remains anaemic. In the latest data average weekly earnings increased 1.6% (excluding bonuses) y-o-y in the three months to January, and by 1.8% when bonuses are included.

The weakness in wage growth for middle and lower income workers is part of a world-wide trend connected with the entry of large emerging economies such as China and India into the global trading system, and cannot be attributed to national UK policies. Although the recent UK wage increases have increased above CPI inflation at current rates, they will need to rise further to ensure sustained real wage growth when inflation picks up again.

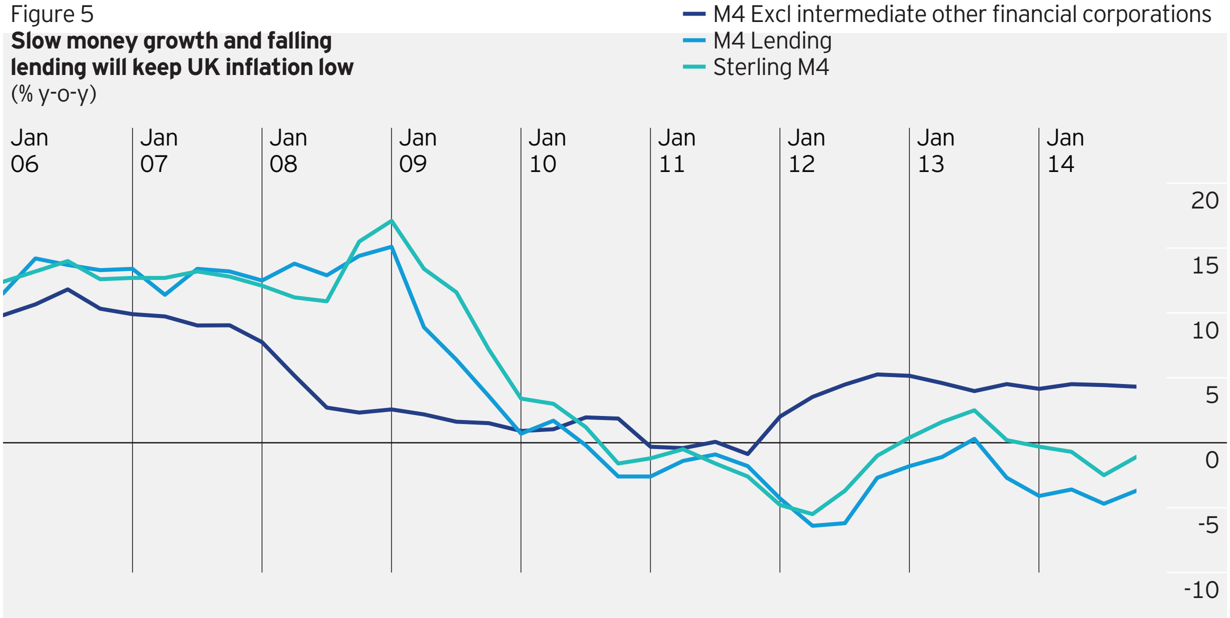
Associated with the weakness in wage growth, tax revenues from income tax have undershot Coalition expectations, thereby causing the budget deficit to remain wider than expected, and the national debt to remain close to its peak levels. (In the Budget there was a token reduction in the overall level of national debt thanks to the sale of Government shares in Lloyds Bank.)

The economy also remains acutely vulnerable to external weakness, especially in the Eurozone, Britain's largest trading partner. In contrast to the United States where the current account has not deteriorated as a percentage of GDP since the start of the current upturn thanks to improvements in competitiveness and the exploitation of shale oil and gas, in the UK both the overall current account and the visible trade deficit are running at record levels. The UK's visible trade balance is running at monthly deficits of £10 billion, while the current account deficit widened to £27 billion in the third quarter of 2014.

Finally, broad money and credit growth remain weak – barely enough to sustain current real GDP growth at the targeted 2% inflation rate. This is despite the two government credit promotion schemes ('Funding for Lending' and 'Help to Buy'), and near-zero interest rates. M4x, the sum of money balances held by households, non-financial companies and non-bank financial companies excluding certain bank-like intermediaries, grew at 4.3% y-o-y in February, while M4, a wider definition which includes the money balances of all financial companies declined at 3.2% y-o-y in February. On the lending side M4 Lending declined at 3.9% y-o-y in February, with loans to households increasing marginally, but loans to financial and non-financial companies declining (Figure 5).

Under these conditions there can be no danger of a surge in credit or GDP growth, or any inflationary outburst. On the contrary, the risks are currently tilted towards slower growth and possible deflation. For this calendar year I now expect 2.3% real GDP growth and 0.3% CPI inflation.

Figure 5
**Slow money growth and falling lending will keep UK inflation low**
(% y-o-y)




Source: Macrobond, as at 31 March 2015.

## Japan

'Abenomics', the formula introduced by the current prime minister to restore growth and moderate, positive inflation in Japan, has been in operation for two years. Given that two years is the normal lag between the implementation of monetary policy and its effects on consumer price inflation, the policy ought by now to be achieving the promised results. Sadly, in all three areas that the policy has been designed to address – inflation, the budgetary position, and growth – the results have been disappointing.

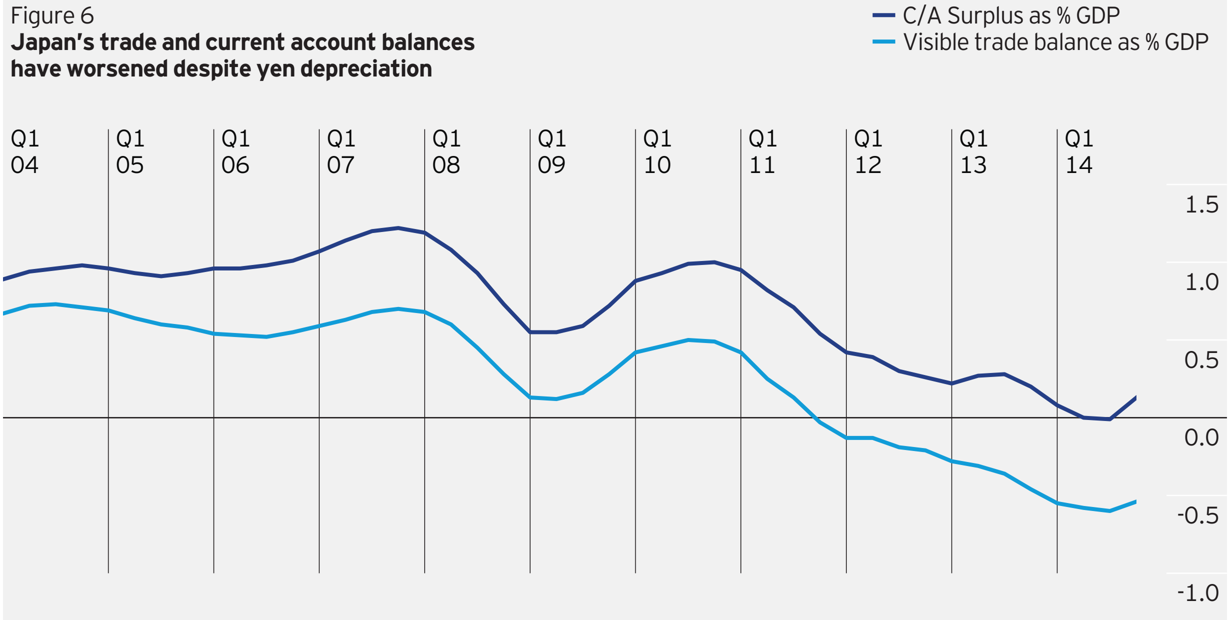
First, on the monetary front, although the Bank of Japan is vigorously expanding its balance sheet and has achieved its target of doubling its size by April 2015 (compared with March 2013), the commercial banks are not actively increasing their loans enough to offset the decline in their holdings of securities. As a result, broad money growth (M2) slowed from 4.2% to 3.1% between January and September 2014, and has remained roughly unchanged in recent months at 3.4%. Since it is broad money, not the Bank of Japan's balance sheet that will determine inflation, it now seems highly unlikely that the authorities will achieve their 2% inflation target. Abstracting from the consumption tax hike, most of the inflation so far can be attributed to the weaker yen and higher imported commodity prices – especially energy products and food items – not stronger domestic demand. This means that after the effects of last April's consumption tax drop out of the y-o-y comparison, inflation should fall back to between 0.5% and 1%. I expect 0.7% for 2015 as a whole, well below the 2% target.

Second, concerning the next 'arrow' – fiscal policy – the imposition of the 3% increase in the consumption tax from April 2014 has lowered the Budget deficit from 9.2% of GDP in fiscal year 2013 to an estimated 7.6% in fiscal year 2014, but at the cost of slowing the growth of the economy. For example, since the consumption tax hike was imposed retail sales have, on average, declined by 0.6% every month, and overall personal consumption expenditure (from the GDP figures) has not recovered from its -5% slump in Q2 2014.

As for the third 'arrow' – structural reform – despite long lists of plans and forecasts generated by government departments as well as by PM Abe's advisers, very little of substance has yet been implemented. The problem is that vested interests such as the farmers, truckers or certain groups of professionals have built strong political lobbies, and the PM has not felt able to confront them. As a result, on each occasion that reforms have been mooted, the administration has ended by backing away, and as a consequence real growth potential has not been lifted at all. The dominant drivers are still the decline in the labour force (connected with the ageing of the population and the fall in birth rates), and the modest growth of productivity (1.4% p.a. since 1990), adding up to only a very modest real GDP growth rate.

Moreover, the deterioration of the external trade and current accounts is continuing to act as a drag on growth, despite the 53% depreciation of the yen against the US dollar since the last quarter of 2012 when Mr Abe was elected Prime Minister. This is due mainly to increased imports of oil and gas to replace the power lost from Japan's nuclear energy plants that were damaged by the Fukushima tsunami in 2011. Despite the currency depreciation, the current account has declined from a surplus of 4% of GDP in 2010 to about 1% of GDP. Meanwhile the trade balance has switched to large and persistent deficits (Figure 6).

Figure 6
**Japan's trade and current account balances have worsened despite yen depreciation**




Source: Thomson Reuters Datastream, as at 31 March 2015.

## China and non-Japan Asia

The Chinese economy has continued to show clear signs of slowdown, even though the official GDP figures imply that there has been no loss of momentum. Real GDP growth in 2014 Q4 was reported at 7.3% y-o-y, but private sector estimates – based on economic data series that in the past have correlated well with GDP – suggest substantially slower growth (Figure 7). Of course China's economic structure has changed in recent years towards a greater share of services in GDP, a shift that is not captured by most 'proxy' growth estimates. Even so, it is doubtful that the Chinese economy has changed so dramatically in the space of six years since the global crisis, implying that the traditional measures should still have considerable relevance.

What is certain is that the Chinese authorities have had much more difficulty managing the economy over the past year or so. In the past they never really steered the economy using interest rates, so adjusting to a situation in which interest rates and the exchange rate are more flexible is proving challenging. Previously the balance of payments could be summarised like this:

**Current Account surplus + Capital Account surplus (inflows) + Errors & Omissions = Change in Reserves**

Effectively, private sector surpluses (the first two items) were matched with large accumulations of reserves (effectively a capital outflow). However, today the current account surplus is much smaller; the private sector is now exporting capital; and hence reserves have to decline to maintain the overall balance at the managed exchange rate. But when reserves are sold for renminbi by the central bank, this has a tightening effect on domestic money markets; effectively the supply of local currency is reduced.

To prevent or moderate such tightening the PBC has had to introduce a series of new easing measures over the past year such as short-term liquidity operations, a standing liquidity facility, a medium term lending facility and re-lending with asset collateralisation. This is in addition to reductions in interest rates and required reserve ratios. In spite of this array of measures, monetary conditions (as measured by the rate of monetary growth) have continued to tighten. In short, despite easing with one hand the obligation to maintain the fixed or managed rate has meant tightening with the other. As a result, China is experiencing an involuntary tightening of monetary policy.

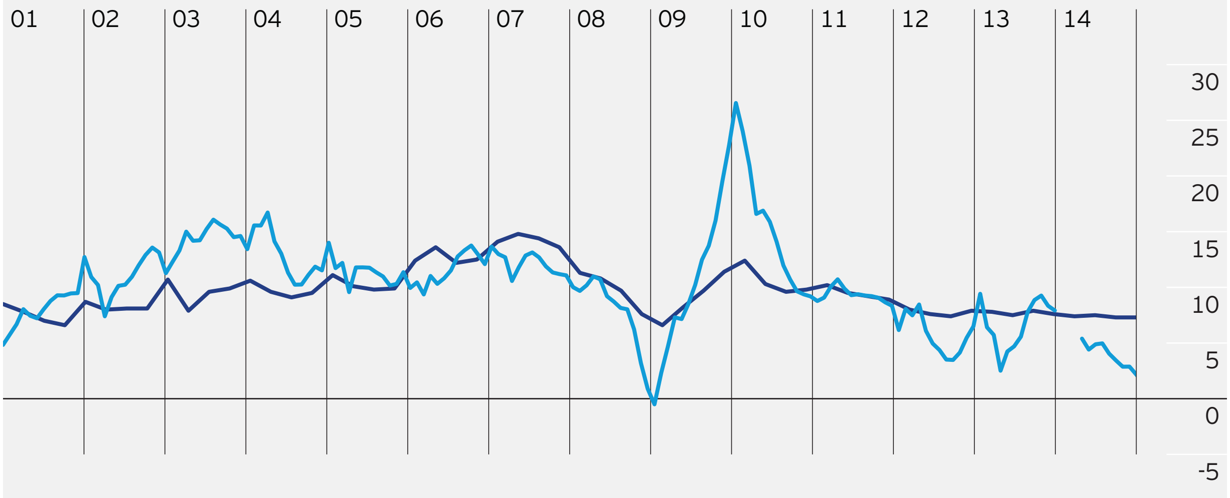
Among the supplementary easing moves the deliberate depreciation of the Chinese yuan from around 6.05 per US$ in January 2014 to 6.27 by early March 2015 was probably the most important. There have also at least two mini-fiscal stimulus programmes and an easing of mortgage lending conditions. However, the prospects for a sustained recovery still depend heavily on the revival of exports to overseas markets where demand conditions are currently weak. For example, the Eurozone, Brazil and India are all major trading partners, but these economies are all experiencing very low growth. As a result China's export growth has continued to be weak despite a freak bounce in February's figures due to the timing of the lunar New Year.

Turning to the domestic economy, housing prices have declined since their peak in 2013, falling by 5% y-o-y in February 2015, prompting the authorities to ease lending conditions. More seriously, there continue to be widespread signs of excess capacity across numerous industrial sectors, adding to credit risks in the banking system. In addition, banks' bad debts have escalated, a number of corporate bond issues have been close to default, and financial reports suggest that credit risks of small- and medium-sized enterprises (SMEs) have increased as a result of the economic slowdown.

I expect China's official real GDP to continue to soften to 7% in 2015 as a whole, but by Q4 2015 the growth rate could have slowed to 6.5%, while CPI inflation is likely to remain low at 1%-2% for the year as a whole. Producer prices will continue to fall.

Elsewhere in Asia the slowdown in world trade is affecting most economies, with only the Philippines and Malaysia achieving growth rates of 6% for 2014, and only India and the Philippines expected to hit 6% in 2015. Inflation rates are also low across the region with only India and Indonesia generally expected to see CPI inflation in excess of 5% in 2015. This follows from the combination of soft domestic demand and currencies that have, by and large, maintained their value against the rising US dollar. As with other emerging economies in Latin America, central Europe and Africa, the entire region is watching and waiting for a stronger upturn in the developed economies, and especially the Eurozone to begin a more vigorous upturn.

Figure 7
**China: Private sector estimates of GDP suggest slower growth**
(% GDP)




* Based on Electricity, Rail Freight and Real Loans
Source: Thomson Reuters Datastream, as at 31 March 2015.

## Commodities

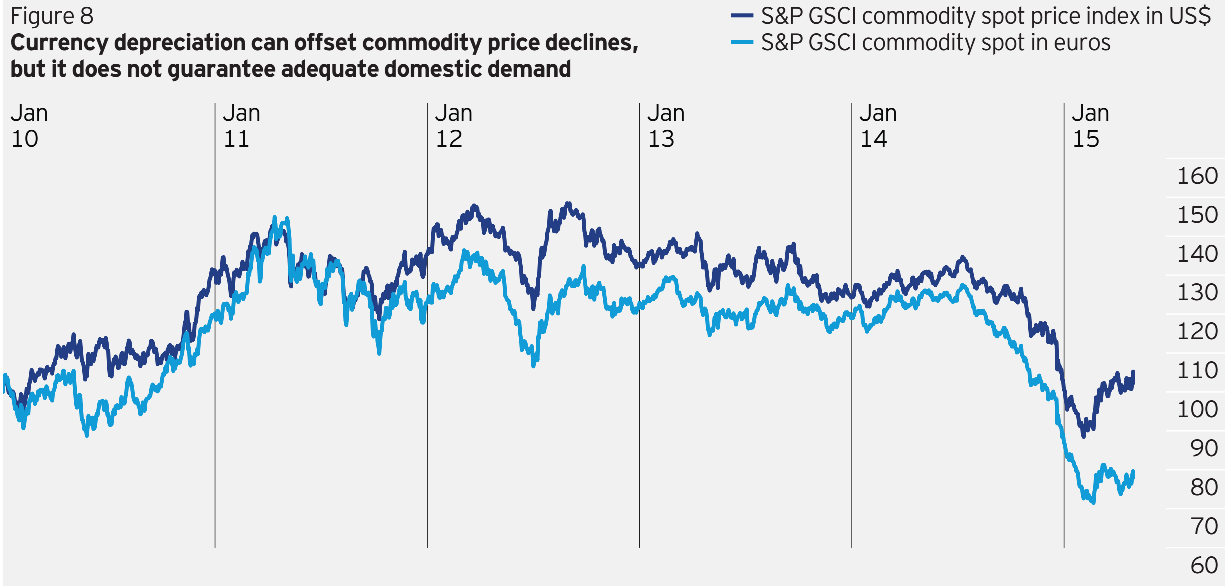
I have been bearish on the outlook for commodity prices for the past year and a half. The second half of 2014 was notable for broad-based falls in a wide range of industrial, precious metal and agricultural commodity prices (see Figure 8). Despite periodic recoveries in the first quarter of 2015, the undertone of weakness has persisted in some of the key industrial commodity markets. For example, iron ore prices – a key Australian export to China – fell from US$113 to US$90 per metric tonne last September, and to US$50 by the end of March. Similarly, the price of landed Australian coking coal in China has almost halved from US$252 per metric tonne in March 2013 to US$132 in March 2015.

The decline in basic industrial commodity prices reflect both weak demand and excess supply. On the demand side, the slowdown of economic activity in China, Brazil, and India and the stagnation in the Euro-area have lowered end-demand. At the same time, developments in specific markets have added to supply. For example, US oil production – mainly shale-oil from North Dakota, Texas and New Mexico – jumped by 1.2 million barrels per day or 16% in 2014, to 8.7 million barrels per day. That was the biggest expansion in US crude since record-keeping began in 1900. In addition, cereal prices (for corn, soya-beans and grain) enjoyed bumper harvests last year in the US and elsewhere. Finally, outflows from exchange traded funds have led to excess supplies of precious metals, weakening the gold price from US$1,320 in July 2014 to US$1,200 per ounce at the end of March 2015. This is all consistent with soft global demand resulting from the sub-par growth of major economies and the growth slowdown in the emerging economies.

It speaks volumes for the weakness of global demand that even the conflicts and supply disruptions due to the advance of jihadist ISIS in the Middle East and increased geopolitical risks in Ukraine have not been sufficient to keep the oil price elevated.

Although central banks have been promoting faster credit and money growth with near-zero interest rates and asset purchases, my view has been that as long as balance sheet repair remains the order of the day among commercial banks and their customers, then rapid growth of credit sufficient to fuel growth of broad purchasing power will not happen. This diagnosis remains intact. A broad surge in commodity prices is, in my view, neither imminent nor likely.

Figure 8
**Currency depreciation can offset commodity price declines, but it does not guarantee adequate domestic demand**




Source: Thomson Reuters Datastream, as at 31 March 2015. January 2010 = 100.

## Conclusion

Weak commodity prices and particularly the decline in oil prices in the last six months of 2014 were widely greeted by analysts and economists as equivalent to a tax cut, from which many concluded that global growth would rebound during the second half of 2015. But what if the decline in commodity prices was more symptomatic of generally deficient demand, itself a result of inadequate growth of money and credit in the major economies? In that case the declines in commodity prices will not be followed by gains in purchasing power by consumers and businesses, and will instead be followed by price-wars among producers, the continuation of low income growth for wage-earners, and the persistence of near-deflationary conditions in major economies.

In my view it is the latter scenario that has turned out to be the more accurate description of current conditions in both developed and emerging economies. The implications for financial markets are that yields on fixed income securities will continue to remain 'lower for longer', while in the equity markets corporate sales growth, profits growth and returns in nominal terms will be constrained to growth rates well below past norms. This is what was meant by the phrase 'new normal'.

While near-zero central bank interest rates have been effective in promoting a wealth effect through higher equity, housing and bond prices, slow growth of broad money and credit, together with low income growth across most major economies, has made it more difficult for households and institutions to repair their balance sheets and restore normal spending growth. For that we need faster growth of money and credit. Meantime there are spill-over effects on emerging economies where exports have stalled and growth rates are slowing. Inevitably, both developed and emerging economies are turning to currency depreciation in the hope that external demand will substitute for inadequate domestic demand. While this may provide temporary relief in some cases, it cannot solve the core problem of deficient domestic demand.