

HALKIN SERVICES LIMITED

INTERNATIONAL RISK ANALYSIS AND ASSET ALLOCATION SERVICE

DIRECTORS:

Dr P.J. Warburton
R.M. Aspinall
A.N. Brewer
R.J.W. Catto

Tel: +44 (0)20 8879 6116
Fax: +44 (0)20 8944 6920
email: halkin@halkinservices.co.uk

Company secretary:

Mrs P.A. Ranken
21 Vineyard Hill Road
London
SW19 7JL

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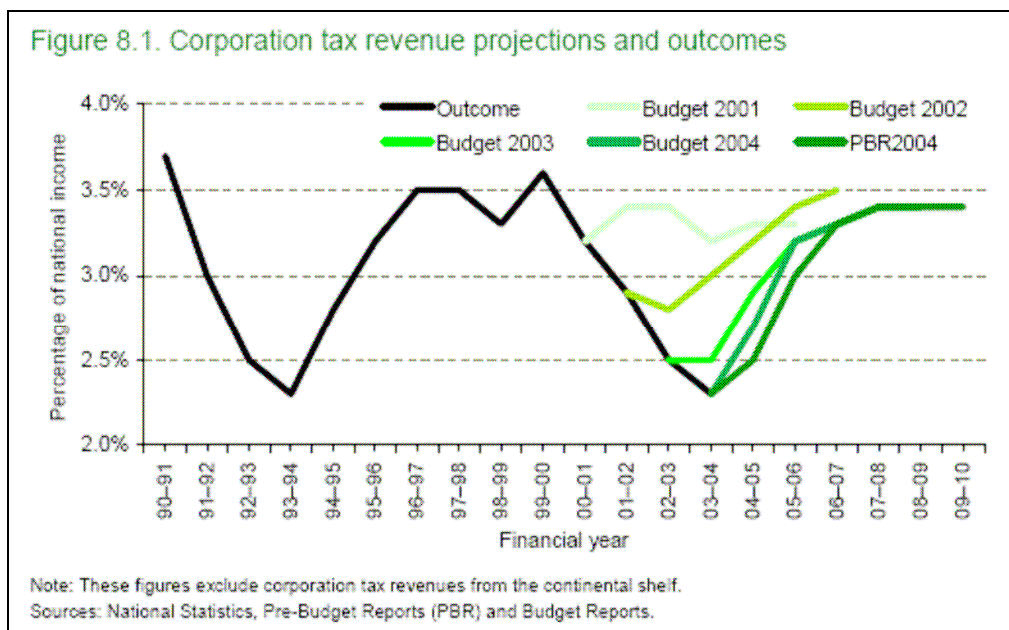
10th March 2005

LABOUR'S 30-YEAR HITCH

Since reading in yesterday's *FT* that "the IMF has urged an early correction to put Britain's public finances on a sound footing", I have been suffering from flashbacks. Tony Plummer, who assembles a splendidly concise Technical Comment for us each week, has created an ingenious wheel chart (view it here: [wheel chart](#)) that encapsulates phases of technological, economic and financial behaviour. The periodicity of the whole wheel corresponds to about 60 years, divided into an inflationary and a deflationary half. On this schema, we have just entered or are soon to enter a deflationary 'bust' phase, which is the counterpart to the inflationary 'bust' of 1974-76. It would be wrong to take the 30-year periodicity too literally, but mention of the IMF's disapprobation sounds eerily familiar. I found the following summary of those times on an encyclopaedia website: "The decade from 1970 to 1979 proved to be a disastrous time to be in government, and faced with a world-wide economic downturn and a badly suffering British economy, the Labour Government would be forced to go to the IMF for a loan to ease them through their financial troubles. However, conditions attached to the loan meant the adoption of a more liberal economic programme by the Labour Government, meaning a move away from the party's traditional policy base."

The approach of yet another Budget speech from Gordon Brown next Wednesday is a powerful reminder of the Chancellor's single-handed determination to reconnect with the Labour Party's traditional policy base and to undermine the liberal economic agenda that delivered great benefits, especially in the 1980s. After the first two years of self-denial, UK public sector current expenditure has risen by 5.6%, 2.7%, 4.3% and 5.3% with planned rises of 5.4% in 2004-05, 6.6% in 2005-06, 5.2% in 2006-07 and 5.5% in 2007-08. Despite a large fall in claimant unemployment, from 1.62m in May 1997 to 813,000 in January 2005, net social benefits will amount to 12.4% of national income this fiscal year, virtually the same as in 1997-98. Through the smoke and mirrors of the Golden Rule, public sector capital expenditure is projected to increase by 31% in 2004-05, 16% in 2005-06, 9% in 2006-07 and 6% in 2007-08. By then, total government expenditure will amount to £579.4bn out of an estimated national income of £1,373bn, or 42.2%, as compared to 37.1% in 1999-2000.

Gordon Brown's response to internal and external criticisms of largesse has been to boast how well the economy is performing under his guidance and to assert a sharply rising profile for government revenues. Yet, the Institute for Fiscal Studies' latest '[Green Budget](#)' predicts that there will be a shortfall of £3bn in the Treasury's Pre-Budget Report estimates of personal income tax receipts in 2005-06 and a £4.4bn shortfall in corporation tax receipts, leading to a budget deficit estimate around £8bn higher than planned. The IFS, whose chart appears overleaf, points to an array of factors at work in the latter case: "Faced with the multiple pressures of tax competition and legal restrictions on national tax laws, the future of corporation tax and in its revenues does not look bright." The IMF is perfectly justified in its assessment. The undershoot in corporation tax revenues is partly a reflection of a seriously underperforming private sector. It is only possible for government spending to shore up GDP growth in the context of a permanent deterioration in the public finances.



THE ‘DITCH BLAIR’ PROJECT

Saturday’s *FT Magazine* carried as its cover story the campaign to call the prime minister to account for misleading the House of Commons over Iraq. It is a reminder that the million or so who marched in protest at the war have not fallen silent, nor have they been appeased by the Hutton and Butler enquiries. In order for the impeachment campaign to have any hope of success, first it must convince the Speaker of the House to grant a debate in which they will be able to address, without being called to order, the question of whether the prime minister was guilty of misleading the House. The chances of success are miniscule, but it may make Tony Blair think twice about his presidential style.

BANKS AND ELEPHANTS

You will all have read the accounts of how, on Boxing Day, elephants headed for higher ground, sensing that the tsunami was on its way, while the tourists lay in the sunshine. I am grateful to Malcolm Tulloch for passing on this parallel from Italy. “Italy’s banks invested heavily in Argentinean bonds. Recently, the Argentine Government defaulted on its debt. To ‘restructure’ it, they swapped the existing bonds for bonds with only 75% of the original value. Italy’s bankers saw it coming so they sold off all the bonds to private individuals ahead of time at a huge profit; that way the losses would be taken by the individuals rather than by the banks. So retirees and pensioners saw their bond portfolio plummet. It is a big scandal over there.”

INDIA’S BUDGET: QUALIFIED SUCCESS OR LOST OPPORTUNITY?

Stephen Roach could not hide his disappointment over the 28th February Budget. “Specifically, the budget fails to step up and attack three major deficiencies in the Indian economy – woefully deficient infrastructure, inadequate national saving and anaemic foreign direct investment.” Instead of an increase in infrastructure spending in the hoped for US\$10-15bn range, the new commitment was of only US\$4.5bn. Stephen reckons that there is unlikely to be much improvement in national saving, currently 28% as against China’s 48%, with estimated public sector deficits of 9.5% of GDP in FY2005 and 8.8% in FY2006. But, as Jon Thorn argues in the latest [ICF](#) newsletter (summarised on page 4), the equity market reacted positively to the Budget because it did not bear the hallmarks of intervention from the Left. The story remains that India is good value, offering scale and growth.

REFLECTIONS ON THE FEBRUARY US PAYROLL REPORT

This was a report that offered something for everyone: stronger payrolls for the equity bulls, a rising unemployment rate for the bond bulls and a monthly standstill for average hourly earnings for the inflation-watchers. Bill King, 7th March, drew our attention to a piece of analysis from the Economic

Policy Institute notes that private sector jobs are still down 477,000 since the start of the recession almost 4 years ago, making this the weakest employment recovery since 1939. (Government sector jobs rose 809,000 in the same period.)

For a further examination of the 'jobless recovery', turn to 'The Mystery of the Awful Economists', the latest commentary in John Mauldin's 'Outside the Box' (it can be found by clicking this [weblink](#)). Barry Ritholtz argues that America's job-creating process has been broken by a combination of extraordinary factors. He cites an under-appreciation of the ongoing influence of excess capacity, the effect of the dividend tax cut in providing an incentive for corporations to transfer working capital out of the firm and the phenomenon of the shell-shocked executives who are reluctant to re-hire. The most striking feature in terms of the market reaction to the report, was the absence of an immediate sell-off in US Treasuries. Whether yesterday's 11 basis point surge in the 10-year yield – to a year's high of 4.5% – was a delayed reaction is unclear. Either way, there are growing indications that the six quarter-point increases in the Fed funds rate have begun to bite. In particular, US bank stocks are coming under fire as the prospect of double-digit earnings growth fades from view.

FINALLY

We look forward to dinner with Simon Hunt on Monday 4th April in the library of the Lowndes hotel. Places are filling up fast, so please register your interest as soon as possible as we are limited to about 18 around the table. Simon is travelling in China at present and will be able to offer unique and timely insights into this remarkable economy. **Please note that there will be no Halkin Letter next week, principally due my travelling commitments.** There will be a Letter the following week, issued later than usual, on Maundy Thursday.

Peter Warburton

PROBING THE MORASS OF EUROPEAN COMPETITIVENESS

The *FT* carried two full-page features this week, taking on the heady task of dissecting Europe's economic woes. By far the more thoughtful was Tuesday's ('In search of an antidote to decline'). The starting point, as always, is (poor) competitiveness. Everyone is agreed about that, but the typical 'European' approach to a cure, especially from Brussels, is to write long reports and formulate finely worded, grandiose schemes that instantly founder on the rocks of national self-interest and downright impracticability. Interestingly, the *FT* comes to a conclusion I share: that, of the major Eurozone nations, it is Germany that has made most progress towards a practical solution – perhaps because Germany's problems are so much greater. (Again, Italy emerges as the real 'sick man of Europe'.)

The article covers much of the same analytical territory as everyone else, identifying demographics, inflexible labour markets, protectionism and poor r&d spending as key elements. Where it offers greatest insight is in the implicit recommendation that Europe's potential for a leap forward lies not so much with the policymakers, but with the corporate sector. Just give companies the scope to compete, and they will do so. This reminds me very much of Japan's predicament as it has evolved over the last decade and a half. Those companies who escaped the domestic policy sclerosis have survived well. Those necessarily tied to the domestic economy have not. Once again it is Germany – whose predicament is often compared with Japan's – that has been bravest in its attempts to break the mould. But the age-old *caveat* applies: "With national elections approaching next year ... reform is likely to take second place temporarily to politics." Germany's companies cannot afford such a pause.

THE (IN)STABILITY PACT (AGAIN)

The EU's finance ministers met again this week, with Germany, France and Italy (with a little UK support) determined to carve out an agreement on a new, less onerous, 'stability pact'. They failed utterly. To simplify: the smaller nations just said 'No'. The stability pact is a thoroughly bad thing, but it is the best fiscal control system available within the nonsense of EMU. If, as seems possible, it will continue in its present form, that will be the least bad of the possible outcomes. For a review of the European press's stinging appraisal, visit *Der Spiegel's* ['Fishwrap'](#).

Robin Aspinall

CHINA: FULL AND FRANK

The 10th National People's Congress is being held in Beijing. Most controversial of the issues discussed so far at the full session, and most-awaited, has been that of relations with Taiwan. "Peaceful national reunification" is one of China's historic tasks, according to the *People's Daily*, which gives a sense of the weight attached to the question.

President Hu has set out a four-point guideline on cross-straits relations. First, "never sway in adhering to the one-China principle". Second, "never give up efforts to seek peaceful reunification". Third, "never change the principle of placing hope on the Taiwan people". Fourth, "never compromise in opposing the 'Taiwan independence' secessionist activities". (Full article: [Guideline](#)).

All this sounds reasonable enough, but there is a sting in the tail. A draft anti-secession law has been put forward, outlining the circumstances under which China would use non-peaceful means to "protect China's sovereignty and territorial integrity". There are three such circumstances: should the "Taiwan independence" forces cause Taiwan to secede from China; should major incidents entailing Taiwan's secession occur; or should possibilities for peaceful reunification be completely exhausted.

The last of those conditions in particular leaves plenty to the imagination, which commentators on the other side of the Taiwan Straits have not hesitated to exploit. The *China Post* (a Taiwanese paper) has two front page articles whose titles alone speak volumes: "China steps up pressure on Taiwan" and "MAC (Mainland Affairs Council) condemns anti-secession law". The first article sees this law as "authorizing an attack if Taiwan moves toward formal independence" (full article: [Pressure](#)). The second article reports a bellicose response from the MAC, the body which handles relations with China, claiming the legislation "gives the (Chinese) military a blank check to invade Taiwan... exposed the Chinese communists' attempt to use force to annex Taiwan and to be a regional power".

Two things are quite clear: China regards Taiwan as part of China; and China is extremely sensitive to anyone (particularly the US) who might see the matter differently. Two things are less clear: whether passing this law indicates a deliberate raising of the stakes; and where we are on Beijing's time scale for declaring possibilities for peaceful reunification exhausted.

INDIA: SOMETHING FOR EVERYONE

"A solid budget for domestic GDP growth with few surprises" was the encouraging verdict on India's 28 February budget by Jon Thorn for the India Capital Fund (1 March, circulated last week). "Broadly neutral... steady as we go... no big winners and no big losers" was the view. Summary: "a lot of good, long term GDP supportive measures which will be positive".

Specifically, the main increases in public spending will be on infrastructure: \$260m will be spent to bring electricity to all villages and similar sums to extend the telephone network to 66,000 villages. Spending is also to rise on health, roads, irrigation and housing. The bottom line: "Voters want gifts and compromise, investors want tough love: we got both".

Robert Brooke

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