LIVERPOOL INVESTMENT LETTER

August 2012

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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The Julian Hodge Institute was launched in autumn 1999 in a new collaboration between the Cardiff Business School of Cardiff University and Julian Hodge Bank. The aim of the Institute is to carry out research into the behaviour of the UK economy, and to study in particular its relationship with the other economies of Europe. This research has been given especial relevance by the ongoing discussions on the extra powers regularly requested by the European Union and also by the recent crisis in the eurozone.

The Liverpool Investment Letter is written by Patrick Minford and John Wilmot, with the assistance of other members of the Group; in particular the emerging markets section is written by Anupam Rastogi, and the focus on Japan is written by Francesco Perugini. The Investment Letter is published monthly.

The Liverpool Research Group in Economics is pursuing a research programme involving the estimation and use of macroeconomic models for forecasting and policy analysis. The Group is now mainly based in Cardiff Business School, Cardiff University, and is indebted to the School and to the Jane Hodge Foundation for their support. The Group's activities contribute to the programmes being pursued by the Julian Hodge Institute of Applied Macroeconomics. This Liverpool Investment Letter is typeset by Bruce Webb and published on behalf of the group by Liverpool Macroeconomic Research Limited, which holds the copyright, and is available on subscription at £325 per annum.

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UK POLICY FEELS THE PRESSURE

The latest GDP figures have created political turmoil: the coalition is defined by its policy for the economic crisis and so it is a bitter blow to it that growth has apparently turned negative. Since nowadays economics has once again become the stuff of politics, a monstrous storm of ill-informed comment will drench us in the coming weeks. It will be interesting to see the stuff this coalition is made of; will they trim, sack the Chancellor and try a placatory U-turn? If they do, that will rightly be the end of them.

But sage counsels should prevail. These would start with the sheer unreliability of these GDP figures. Past data on first estimates reveals this: but most recently we have seen it for the 2009 figures, at the time so terrible, now revised upwards. In the present context there are many reasons to doubt the pessimism in the estimates for the last there quarters. Employment data is far stronger, showing a rise in jobs of 1.5% over a year ago — even though public sector jobs have truly been cut by 6.5% over that period (that is over 400,000). Hence the private sector has managed a growth of 2% in jobs over this period, in line with the Treasury's plans.

Then there are the Purchasing Managers' indices. These have not been great but have generally remained above 50, indicating some — if weak — growth. The June indices turned worse, though still above 50 apart from construction.

Finally, of course there are the special factors of the Diamond Jubilee and the terrible weather. Usually one would expect statisticians to adjust the numbers for these factors, since they are essentially seasonal. They have not done so and have simply said the 'underlying figures are better'.

Allowing for all these things, the picture is far more one of weak growth than outright recession. We are learning continuously how stubborn the conditions created by the banking crisis are for the resumption of growth. One such — the euro-zone crisis — is a particular drag. Another is the benighted reaction of regulators who have greatly worsened the banking system's capacity and energy; lending to business, especially SMEs, is now in free fall. Further factors are the fall in living standards and the restructuring across sectors being wrought by still stratospheric oil and raw material prices.

Alternative policies?

The cry from Labour and the left is for fiscal stimulus — plan B — in which it is argued that abandoning the plan to get the fiscal deficit down and get debt to stabilise relative to GDP will magically both stimulate GDP and reduce the deficit. The difficulty is that any multiplier on GDP of fiscal stimulus wears off fairly quickly, while the effect on

Table 1: Summary of Forecast

		2010	2011	2012	2013	2014	2015	2016
GDP Growth[1]		2.1	0.7	0.8	2.0	2.3	2.5	2.6
Inflation	CPI	4.1	3.9	2.8	2.3	2.0	2.0	2.0
	RPIX	4.8	5.3	3.5	2.9	2.7	2.7	2.7
Unemployment (Mill.)								
	Ann. Avg.[2]	1.5	1.5	1.5	1.3	1.2	1.2	1.2
	4th Qtr.	1.5	1.6	1.5	1.3	1.2	1.1	1.1
Exchange Rate[3]		80.4	79.9	81.7	81.5	81.0	80.7	80.5
3 Month Interest Rate		0.7	0.9	1.2	1.4	2.1	2.5	2.5
5 Year Interest Rate		2.4	2.0	1.6	2.4	2.6	2.8	2.8
Current Balance (£bn)		–48.6	–29.0	–31.6	–32.5	–32.3	–32.2	–32.0
PSBR (£bn)		110.3	120.1	107.6	97.1	58.0	36.3	20.3

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

the deficit remains permanently. This is true even if there is no worsening of fiscal credibility; if that goes, the multiplier can go negative, and the deficit get worse.

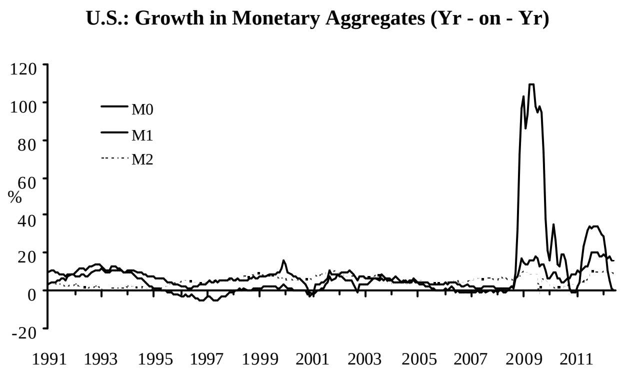
In fact George Osborne has already stretched plan A by rightly refusing to 'make good' the worsening of the deficit due to weak growth. He has also permitted higher infrastructure expenditure, which is temporary and also should ring in future returns for the Treasury. He has therefore allowed the year when the finances reach a sustainable debt/GDP ratio to be delayed, probably now until 2020. But what he cannot do is allow the 'direction of travel' to come into doubt. For credibility there has to be in place a plan that will achieve this under available information; in this sense plan A must always be maintained.

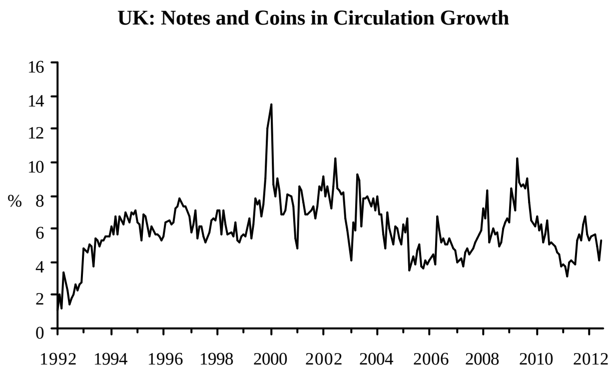
However, there do remain ways in which this government could improve the growth outlook. Start with the banks: regulation needs now to back off the emphasis on safety and raising liquidity and capital; instead it needs to lower banks' costs in these areas and also inject bank competition into the High Street by disposing of RBS and Lloyds in several packages — much as already with the sale of Lloyds branches to Cooperative. It is ironic that this sale was forced by the hated EU — even now at its nadir the EU is capable of doing something right.

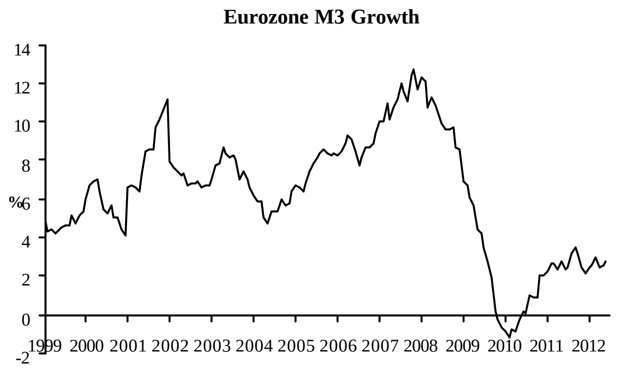
Then the government needs bravely to change tack on business. Instead of carping on about bonuses and high pay, it needs to return to the old Thatcherite rhetoric celebrating entrepreneurs and their rewards. It needs to liberalise regulations in the labour market, as suggested in Adrian Beecroft's Report, and it needs to cut marginal tax rates on business and businessmen, much as was begun by Mr. Osborne in his budget. But we need much more, and much less apologetically.

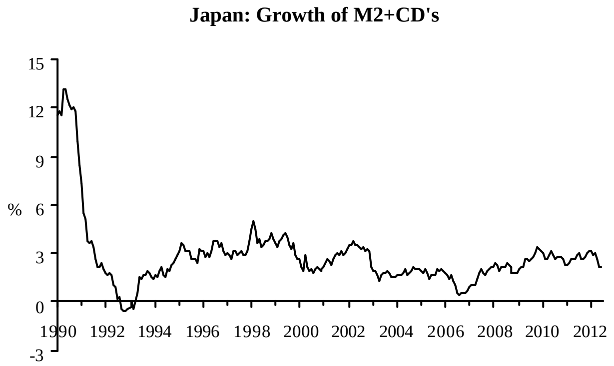
Then other 'rebranded' parts of the government's agenda need to be modified. We need sense on greenery, we need agreement to new airport capacity, we need the abandonment of grand but uneconomic projects like HS2.

The brutal truth is that governments who want growth need to do things that may well prove unpopular with general opinion unless they are clearly explained and promoted with the sort of bravery shown by Margaret Thatcher on such matters.









FOCUS ON JAPAN

Francesco Perugini

Important Changes on the Economic and Political Front

Prime Minister Yoshihiko Noda moved closer to his cherished goal of doubling the consumption tax rate at the end of last month when the Lower House voted to do just that. The bills, which seek to raise the consumption tax in two stages to 8% in April 2014 and to 10% 18 months later, will now be sent to the opposition-controlled Upper House, where its passage in the next few weeks should be guaranteed due to the backing of the two main opposition parties. The increase, if realized, would be the first since the rate was raised from 3% to 5% in April 1997.

But once again the Lower House vote has created a political mess: Ichiro Ozawa, a political heavyweight long seen as a behind-the-scenes power broker, and dozens of other MPs have left the ruling party. They have argued that Noda's tax hike proposal reneges on the Democratic Party of Japan's (DPJ) policy pledges in the 2009 general election through which the DPJ came to power. Of the 289 members of the ruling DPJ in the Lower House, Ozawa mustered 57 votes from among the DPJ against the tax bill which passed by 363 lawmakers voting in favour and 96 against.

A week after the vote, Ozawa with a crew of 49 mostly novice MPs, set sail with a new political party — the fourth of his political career — hoisting anti-tax hike and anti-nuclear flags in a direct challenge to Noda. Based on the motto of the party, Ozawa named it "People's Lives First", which is the slogan the DPJ has used since the Upper House election in 2009. He said in his first speech as leader of the new party "while considering forming a new party, we want to return to the starting point of the change in government and create politics where people can have a choice".

The new party ranks behind the DPJ and Liberal Democratic Party (LPD) in the Lower House. But Ozawa will form a caucus with the nine-member Kizuna Party, nearly mustering the 51 votes needed to initiate a no-confidence motion against the cabinet. In the Upper House, Ozawa's party is the fourth-largest, with 12 seats — enough to submit a censure motion against Noda's cabinet. If the opposition were to unite for a no-confidence vote, they would need only 16 ruling coalition MPs to join them for the motion to pass. In a threat to Noda, Ozawa is angling for support from former Prime Minister Yukio Hatoyama and other tax hike opponents who stayed behind in the DPJ. The new party could weaken Noda's grip on power, but analysts and lawmakers believe its impact will not be so significant given Ozawa's waning influence as a political heavyweight. "Ozawa knows what people want to hear ... (but) it's a popular message by an unpopular man", said a long-time political observer Professor Jeffrey Kingston, director of Asia studies at Temple University in Japan.

While the political outlook has become gloomy, a step towards more activism has been taken at the Bank of Japan (BOJ). Apart from some technical adjustment, the BOJ has refrained from adding more monetary stimulus at the latest Monetary Policy Committee, leaving the overnight call rate unchanged at around 0% to 0.1% and its inflation and growth prospects broadly unchanged for fiscal years 2012 and 2013. However, the news is that the Parliament has approved the nominations of two prominent economists, who stand in support of further monetary stimulus, for the nine-member board which would bring it to full strength for the first time since early April when the five year-terms ended for Seiji Nakamura and Hidetoshi Kamezaki, two members who mostly voted with the majority of the board and were considered as less activist.

Although the appointments must be finalised by the government to take effect, and that is being delayed because the two designated members need more time before leaving their current jobs, the move represents a break with the past, i.e. the tradition of finding replacements from the same backgrounds as those retiring, in this case, two members from the business sector. "If they break tradition, or choose people clearly enthusiastic about beating deflation, that will make an impact on markets because it indicates more easing policies in the future," said Hiromichi Shirakawa, chief Japan economist at Credit Suisse. Analysts also believe that bringing aboard two investment-bank economists may help strengthen the central bank's communication with financial markets. "This means that the government wants the BOJ to review its communication methods with markets and they think the BOJ needs to get better", said Hideo Kumano, chief economist at Dai-Ichi Life Research Institute in Tokyo, referring to the nominations.

Most importantly, over the last few months, the BOJ has been frequently criticised by the government for not doing enough to revitalize the economy, to defeat deflation, to weaken the yen or even to buy government bonds more aggressively, something the BOJ has been reluctant to do for fear of being seen as directly bank-rolling government spending. The appointments of the new members may now tip the balance of the board more in favour of more aggressive monetary easing. "The BOJ has done more in order to combat the uncertain economy. The two nominees have felt the same about the BOJ, and they would make smart additions to the board", said Chotaro Morita, a chief strategist for Barclays Capital Japan.

Among the two members set to join the board, Takehiro Sato, chief economist at Morgan Stanley MUFG Securities has frequently criticized the BOJ for not doing enough to beat deflation. After the BOJ Policy Board meeting in March he said "If the BOJ is unable to even proceed smoothly with further easing measures, it will be unable to achieve its inflation target of 1 percent". The other new member, Takahide Kiuchi, chief economist at Nomura Securities, has called on the BOJ to cut interest rates as part of aggressive monetary-easing measures and to correct the trend toward a strong yen. In a report released early in June, Kiuchi wrote about BOJ Governor Masaaki Shirakawa: "I do not feel his sense of urgency about falling stock prices. The market would highly value a stance of trying new policies".

It is certain that discussions within the Policy Board may become more active now; however it is unclear if the BOJ will be able to implement additional monetary-easing measures in an intermittent manner as a means of pulling the economy out of its deflationary condition. So far BOJ Governor, Masaaki Shirakawa, has been passive about additional measures. Even with two monetary-easing hawks added to the Policy Board, decisions still have to be agreed to by a majority vote of the nine members, so there may not be a sudden change in course on the part of the BOJ. The possibility of a major change in policy course could come next spring, when the terms expire for Shirakawa and two deputy governors.

However, one needs to remember that in spite of the constant worries that have been expressed about deflation, the BOJ's record has been one of price stability in recent years; in fact after modest inflation from 1989 to 1992, the consumer price index since then has been stable (about 100 in 2012 against the same in 1992), a 20-year record of price stability. Given that cash is held in large amounts by Japanese households and firms, it is possible that price stability is what they want. Also real returns on long-term Japanese government bonds are positive assuming price stability, at 1.8% for example for 30-year bonds. This means that the Japanese savings market is unlike the heavily distorted bonds markets in the US and the UK, where yields on long-term government bonds are negative.

MARKET DEVELOPMENTS

The euro-zone crisis continues with no end in sight. Chatter about the euro's imminent break-up is just that: it ignores public opinion in the euro-zone which is currently in favour of soldiering on because of the 'fear of something worse'. Spain is now certain to need bail-out from the main euro-zone funds. The euro-zone is inching its way towards fiscal union but it will take a long time — a decade perhaps. Meanwhile the ECB will act as the major support mechanism; in effect it is already the shadow government of the euro-zone. It will only desist if instructed by Germany and other northern countries; but unless public opinion suddenly changes in these, the consensus will be that the costs of letting the euro collapse dominate the costs of continuing.

So we look for more of the same: a stagnant euro-zone, absorbed by this process. Against the background world growth will shift elsewhere, to the US and emerging countries. The UK should benefit from this as it shifts its trade in this direction.

With bond yields appalling, the only way to obtain yield is from equities which will eventually benefit from this renewed growth.

Table 1: Market Developments

	Market Levels		Prediction for Jul/Aug 2013	
	Jun 27	**Jul 24**	**July Letter**	**Current View**
Share Indices				
UK (FT 100)	5524	5499	8192	8155
US (S&P 500)	1332	1338	1512	1519
Germany (DAX 30)	6229	6390	8235	8384
Japan (Tokyo New)	745	718	892	866
Bond Yields (government long-term)				
UK	1.69	1.46	2.10	2.10
US	1.62	1.40	4.00	4.00
Germany	1.55	1.24	4.00	4.00
Japan	0.81	0.74	1.50	1.50
UK Index Linked	-0.12	-0.11	-0.40	-0.40
Exchange Rates				
UK ($ per £)	1.56	1.55	1.58	1.58
UK (trade weighted)	83.3	84.5	81.3	81.3
US (trade weighted)	82.3	82.4	80.5	80.5
Euro per $	0.80	0.83	0.79	0.79
Euro per £	1.52	1.28	1.25	1.25
Japan (Yen per $)	79.8	78.2	81.0	81.0
Short Term Interest Rates (3-month deposits)				
UK	0.97	0.85	1.40	1.40
US	0.38	0.50	0.60	0.60
Euro	0.63	0.40	2.50	2.50
Japan	0.25	0.25	0.40	0.40

Table 2: Prospective Yields[1]

Equities: Contribution to £ yield of:

	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.80	2.0	2.3	44.00		52.10
US	2.10	2.5	2.0	9.00	−1.74	13.86
Germany	3.80	1.5	1.7	28.00	2.81	37.81
Japan	2.60	1.7	0.0	19.00	−5.38	17.92
UK indexed[2]	−0.11		2.2	−8.00		−5.81
Hong Kong[3]	2.80	7.5	2.0	0.00	−1.74	10.56
Malaysia	3.00	5.2	2.0	38.00	−1.74	46.46
Singapore	3.60	4.4	2.0	22.00	−1.74	30.26
India	1.60	6.5	2.0	4.00	−1.74	12.36
Korea	1.30	3.5	2.0	−19.00	−1.74	−13.94
Indonesia	2.50	6.5	2.0	34.00	−1.74	43.26
Taiwan	4.10	3.5	2.0	30.00	−1.74	37.86
Thailand	3.00	4.4	2.0	25.00	−1.74	32.66

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	1.46	−6.40		−4.94
US	1.40	−26.00	−1.74	−26.34
Germany	1.24	−27.60	2.81	−23.55
Japan	0.74	−7.60	−5.38	−12.24

Deposits: Contribution to £ yield of:

	Deposit Yield	Currency	Total
UK	0.85		0.85
US	0.50	−1.74	−1.25
Euro	0.40	2.81	3.21
Japan	0.25	−5.38	−5.13

[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

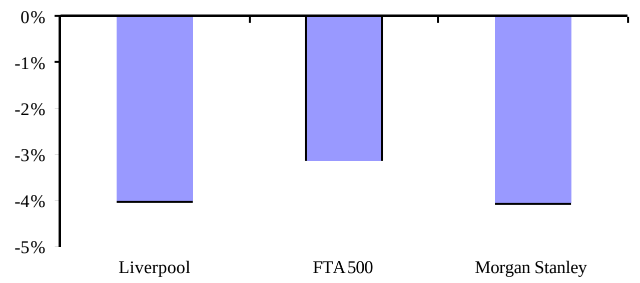
Table 3: Portfolio(%)

	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	July Letter	Current View	July Letter	Current View	July Letter	Current View
UK Deposits (Cash)	10	10	10	10	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-	-
German Bonds	-	-	-	-	-	-
Japanese Bonds	-	-	-	-	-	-
UK Shares	19	19	14	14	17	17
US Shares	14	14	19	19	16	16
German Shares	14	14	14	14	21	21
Japanese Shares	9	9	9	9	11	11
Hong Kong/Chinese Shares	4	4	4	4	4	4
Singaporean Shares	4	4	4	4	4	4
Indian Shares	4	4	4	4	4	4
Thai Shares	3	3	3	3	3	3
South Korean Shares	4	4	4	4	4	4
Taiwanese Shares	3	3	3	3	3	3
Brazilian Shares	3	3	3	3	3	3
Chilean Shares	3	3	3	3	3	3
Mexican Shares	3	3	3	3	3	3
Peruvian shares	3	3	3	3	3	3
Other:						
Index-linked bonds (UK)	-	-	-	-	-	-

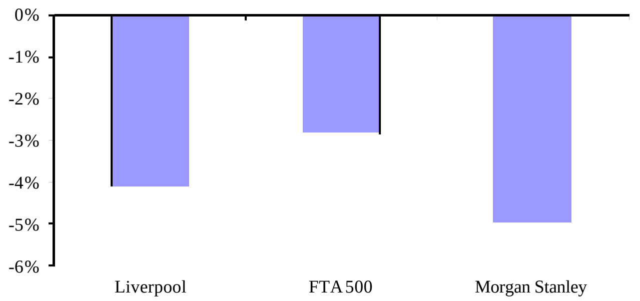
PORTFOLIO PERFORMANCE

The charts below, and the Table opposite, measure the performance of the Liverpool Model Portfolio against the FTA Non-financials share index, and the Morgan Stanley World Capital International index, over the period from January 2005 to end-July 2012.

3 Month Growth



12 Month Growth



3 Year Annualised Growth

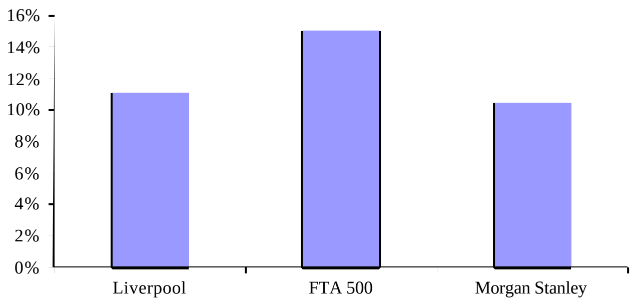
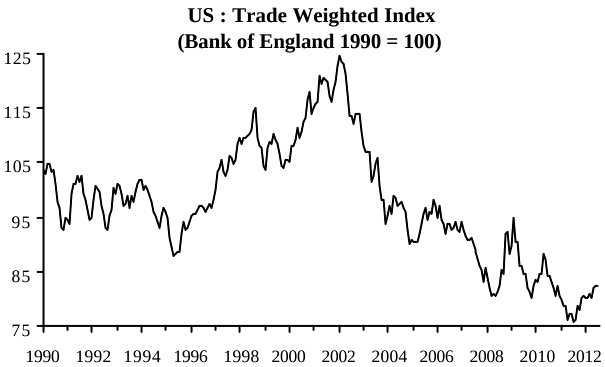


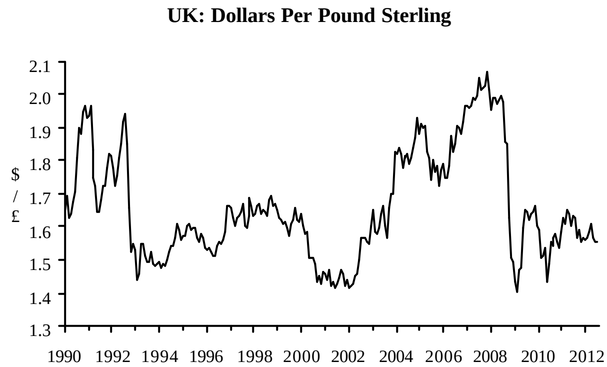
Table 4: Liverpool Portfolio Evaluation (End-June 1992 = 100)

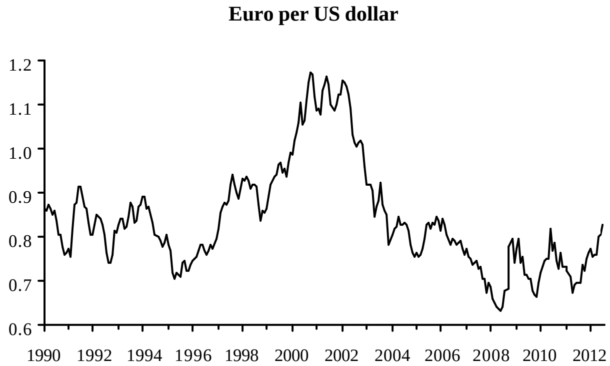
Date	Index of Liverpool Portfolio	FTA Non Financials Index Total Return	Morgan Stanley World Capital International Index Total Return
2005			
1st Jan	243.20	252.89	297.05
Apr	249.35	264.15	298.79
Jul	261.84	278.70	316.89
Oct	284.62	304.68	343.82
2006			
1st Jan	297.46	313.59	365.50
Apr	315.78	334.87	386.04
Jul	302.95	332.52	360.85
Oct	313.66	340.59	371.76
2007			
1st Jan	331.94	361.22	382.93
Apr	343.65	376.53	389.99
Jul	364.54	403.07	403.44
Oct	378.18	401.46	405.04
2008			
1st Jan	394.93	411.25	403.19
Apr	387.93	367.01	365.34
Jul	386.86	381.90	355.90
Oct	399.43	324.99	335.11
2009			
1st Jan	437.80	314.73	323.33
Apr	423.18	294.99	283.79
Jul	440.33	315.62	295.72
Oct	506.73	375.37	355.96
2010			
1st Jan	525.13	408.79	365.52
Apr	562.49	436.43	399.80
Jul	530.11	382.77	351.60
Oct	570.59	435.61	378.02
2011			
1st Jan	618.84	476.51	413.02
Apr	619.56	481.43	420.69
Jul	629.42	494.36	418.86
Oct	546.47	437.69	358.02
2012			
1st Jan	574.29	482.11	384.40
Apr	628.86	495.88	414.96
May	616.90	495.51	402.67
Jun	588.07	462.24	386.65
Jul	603.72	480.40	398.13

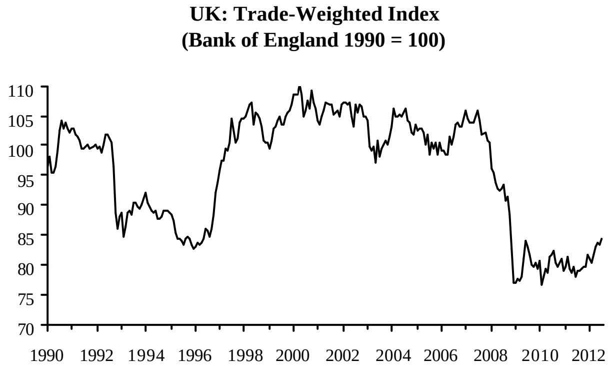
Source: Rensburg Sheppards Investment Management Limited, Liverpool Stock Exchange

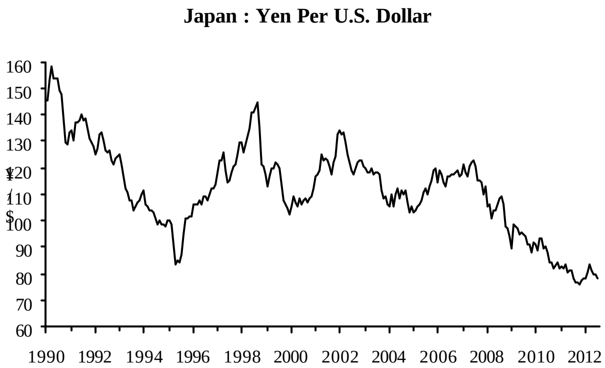
INDICATORS AND MARKET ANALYSIS FOREIGN EXCHANGE MARKETS[1]







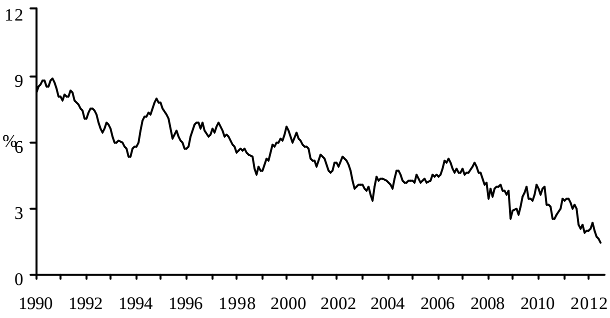




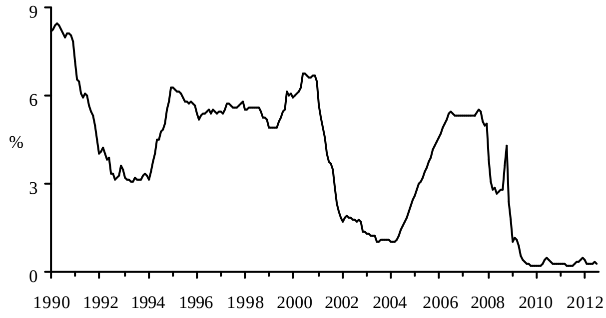
[1] John Wilmot, who has written these sections since this Letter began, is indisposed. We are issuing the charts without his commentary this month. We wish him a speedy recovery.

GOVERNMENT BOND MARKETS

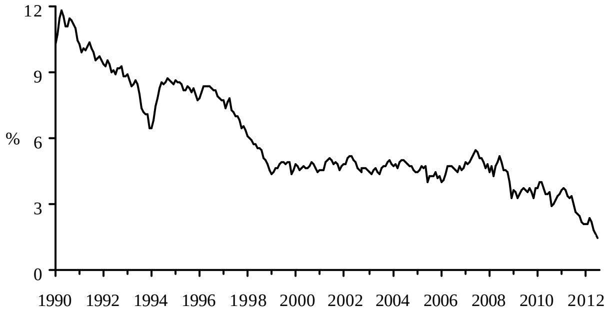
U.S.: Yield on Long-Term Government Bonds



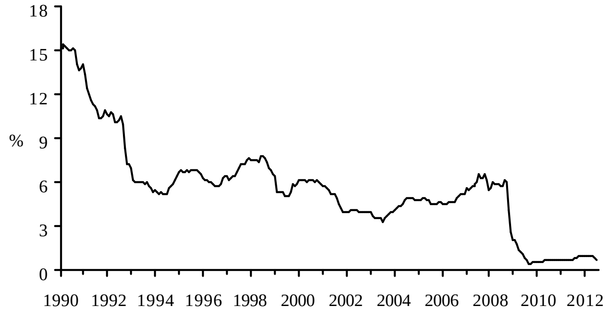
U.S. : 3-Month Certificate of Deposit



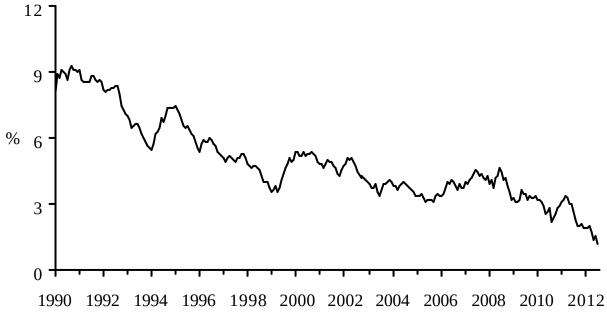
U.K. : Yield on Long-Term Government Bonds



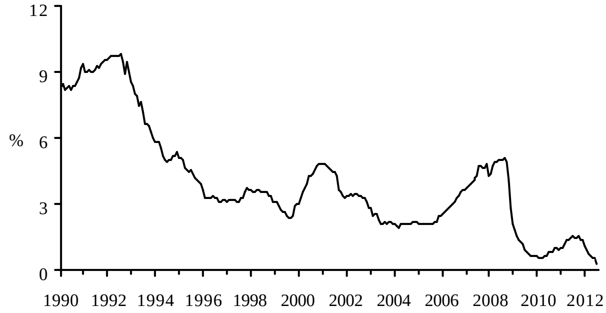
U.K. : 3-Month Interbank Rate



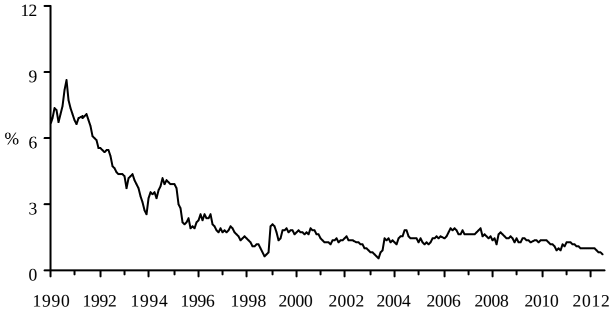
Germany: Yield on Public Authority Bonds



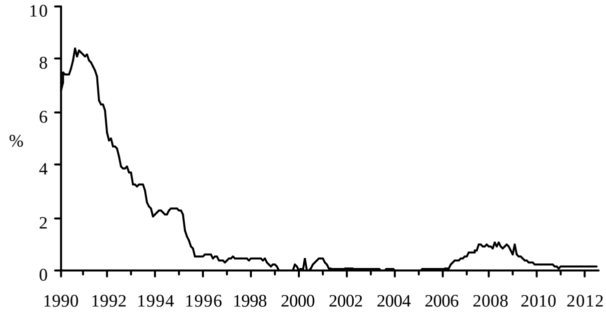
Germany : 3-Month Interbank Deposit Rate



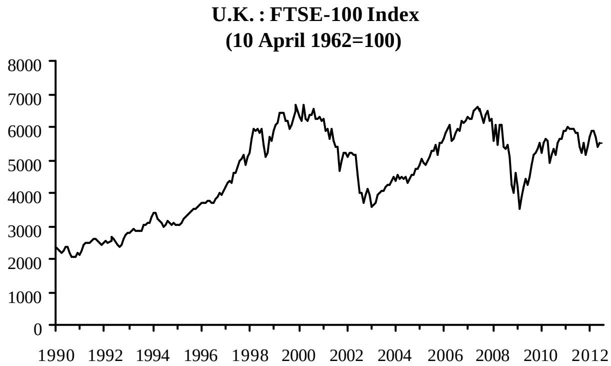
Japan: Yield on Long-Term Government Bonds

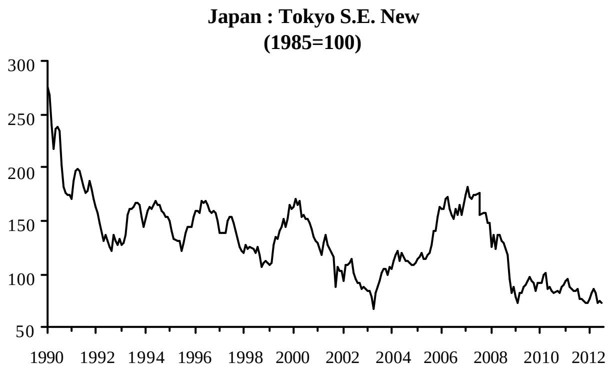


Japan : 3 Month Money Market Rate



MAJOR EQUITY MARKETS





EMERGING MARKETS

Anupam Rastogi

India

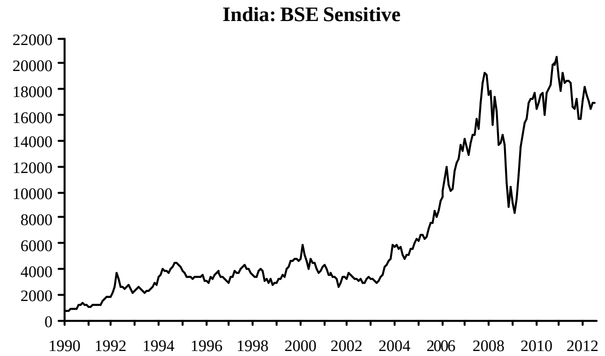
India's growth prospects in near future got a jolt when coalition government partners forced the government to give way on tough reforms related to fuel subsidies and other economic reforms. Most commentators and top economic managers believe that India's potential growth is now between 7%–7.5% and this year GDP is likely to be just about 6%. Next year too growth prospects under this government are no better than the current year estimates. Of course, there are many external factors such as the euro-crisis and below par monsoons but it is the incompetence of the government which is holding back Indian economic growth at present.

India's economy grew 5.3% from a year earlier in the January–March quarter, its slowest pace of expansion in nine years, hurt by slowing export demand and a sharp rise in domestic interest rates over the past couple of years as the central bank tried to rein in inflation. With the monsoon season almost halfway through, India is staring at the possibility of a drought in some regions with rains 22% below a 50-year average so far. The weather department considers a deviation within 4% of the 50-year average as normal.

Credit growth in India has remained healthy and could pick up if the Reserve Bank of India cuts policy rates at its next review on July 31. The slowing down of inflation gives some hope but the public stance of the central bank is that there is no room for easing monetary policy. Inflation in India slowed to its weakest level in five months. The wholesale price index rose 7.25% on year in June, falling fromMay's 7.55% increase.

The current-account deficit widened to 4.2% of GDP in the fiscal year ended March 31, after remaining below 3% since 1991, as export slowed but import remained high because of heavy dependence on imported oil, sending the rupee down to all-time lows in the recent months. India's April–June trade deficit narrowed to $40 billion from $46 billion a year ago as imports during the three months fell 6.1% to $115.3 billion, outstripping weaker exports, which fell 1.7% to $75.2 billion. As the effect of the rupee's decline plays out, the current account deficit could narrow to around 3% of gross domestic product in the fiscal year ending March 2013, from the record high of 4.2% in the preceding fiscal year.

Foreign direct investments in India fell 38% in the April–May period while foreign fund flows swung to a net negative, which reflect the damage of the country's image and bad tax rules that have tried to be implemented in the past few months.



The market is now looking ahead to the Reserve Bank of India's rate-setting meeting on July 31. The RBI still has little room to cut interest rates, particularly after the central bank's governor Duvvuri Subbarao cautioned that price pressures remain way above the threshold level. The Indian rupee fell to its lowest level in nearly four weeks to Rs 56.60 against the U.S. dollar, tracing weakness in the euro. Of course, the weakness in the rupee is also plagued by slowing economic growth and inertia in India's economic reform process.

India's prime minister in his capacity as the finance minster has tried to clear confusion over a controversial set of tax rules. He has set up a four-member group to "vet and rework" the initial set of guidelines released in June. Probably, this is the way to bury the tax rules.

	09–10	**10–11**	**11–12**	**12–13**	**13–14**
GDP (%p.a.)	7.4	7.5	6.9	5.8	6.5
WPI (%p.a.)	9.5	9.0	7.5	7.5	7.0
Current A/c(US$ bill.)	-14.0	-31.0	-40.0	-25.0	-24.0
Rs./$(nom.)	48.0	49.0	49.5	56.0	54.0

China

China's economic growth slowed to 7.6% in the second quarter of 2012. But Beijing has decided to rekindle growth. The central bank has already cut lending rates two times since the beginning of June. The preliminary HSBC China Manufacturing Purchasing Managers Index released last week shows some improvement.

Chinese Premier Wen Jiabao has publically announced that the government's main task is to promote investment, signalling that Beijing now sees supporting growth amid a slowing economy as taking priority over its long-term objective of altering the country's growth model. It also suggests that China is going to have soft landing this year. The one-year yuan lending rate was cut by 0.31 percentage points, to 6% in the first week of July 6. We expect one or two further symmetric interest rate cuts of 0.25 percentage points each and further reduction in reserve requirement ratio in the remaining months of this year to make credit available to businesses.

China's consumer price index rose 2.2% in June from a year earlier, slower than May's 3% rise. The decline in inflation is mainly because of moderating food prices. In the next few months food prices are likely to drop below 2% year on year.

The country's monthly trade surplus rose unexpectedly to $31.7 billion in June from $18.7 billion in May due to weaker than expected imports. Exports rose 9.2% in the first six months of the year, down substantially from 24.0% a year earlier. Imports slowed even more sharply, rising 6.7% in the first half compared with 27.6% a year earlier. For the first half, the trade surplus rose to $68.9 billion from $44.9 billion in the first half of 2011.

Foreign direct investment in China's economy came in at $59.1 billion in the first half of 2012, down 3% year-to-year. To boost FDI, China will cut taxes on the profits that foreign companies take out of the country by up to 50% after rules on withholding taxes were relaxed to encourage more overseas investment. The move will also apply to dividends paid by Chinese listed companies to foreign shareholders through the Qualified Foreign Institutional Investor scheme. In both cases, the lower tax rates will apply only to companies and shareholders based in countries, such as the UK, that have double taxation agreements with China.

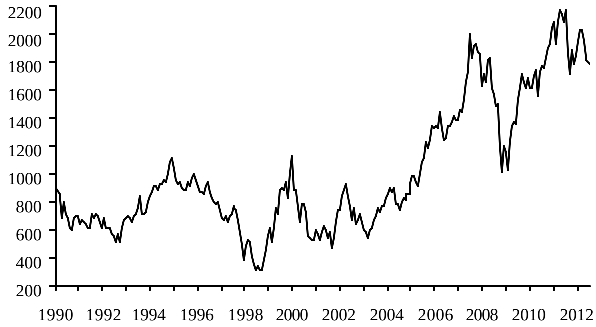
China's outbound investment is booming. Overseas direct investment in the first half came in at $35.4 billion, up 48% year-to-year. That reflects a combination of abundant cash on the books of Chinese firms, and bargains to be had as foreign asset prices remain depressed. China's sovereign wealth fund portfolio shrank by 4.3% on its global investment.

	09	10	11	12	13
GDP (%p.a.)	8.7	10.3	9.2	7.5	7.5
Inflation (%p.a.)	-0.8	5.9	4.3	2.8	2.7
Trade Balance(US$ bill.)	180	183	155	140	130
Rmb/$(nom.)	6.8	6.6	6.3	6.3	6.3

South Korea

South Korea recorded a growth rate of 2.4% on an annualized basis in the second quarter of 2012 — the weakest rate since the third quarter of 2009. The IMF has lowered its forecast of economic growth to 3.25% this year,

Korea: Composite Index



slightly better than the finance ministry forecast for this year of 3.3%.

In response to the economic slow-down, South Korea unveiled a plan in June to boost public spending by more than $7bn this year in the second half of 2012, mobilizing surplus resources carried over from last year and asking public funds and state-run companies to spend more. The additional funds will be mostly spent on infrastructure and public works projects. The export led economy of South Korea is feeling the pinch of cooling demand from the west while domestic consumption remains sluggish due to high levels of household debt.

The central bank is struggling with elevated inflation expectations. Consumers' inflation expectations stood at 3.7% in June, hovering near the top end of the Bank of Korea's 2012 target band of 2% to 4%.

The Bank of Korea unexpectedly cut its benchmark interest rate by 0.25 percentage points to 3% in the second week of July, to support the economy amid growing external uncertainty stemming from Europe's sovereign debt crisis.

The government has cut its 2012 forecast for exports which may increase by only 3.5%, compared with a projection in January of 6.7%. In 2011, Korea's exports grew 19%. However, the current account surplus may not shrink from an earlier forecast. The country's current-account surplus for 2012 is likely to rise to $18 billion mainly due to a shrinking deficit in the balance of services.

	09	10	11	12	13
GDP (%p.a.)	0.2	6.3	3.6	3.0	3.0
Inflation (%p.a.)	2.6	2.9	4.0	3.2	3.5
Current A/c(US$ bill.)	42.7	28.2	27.0	13.0	15.0
Won/$(nom.)	1200	1150	1100	1150	1150

Taiwan

Taiwan's GDP growth for 2012 is expected to be less than 2% reflecting the world's slowing economic conditions. Taiwan's industrial production decreased from last year in June, defying economists' expectations for a modest increase. Industrial production decreased 2.44% on an annual basis. The local economy has been under pressure from both weakening export markets and slowing domestic investments.

The bleak economic prospects which may continue for some time have raised speculation that the central bank may cut interest rate in its next board meeting in late September. In its June 21 meeting, it decided to keep its key interest rates unchanged for the fourth consecutive quarter and left the discount rate at 1.875%.

The consumer price index rose 1.77% year-on-year in June, slightly faster than May's 1.74% increase. However, potential summer typhoons may keep food prices elevated and it remains to be seen if the island's whole-year inflation can be kept under 2% as the government has pledged.

	09	**10**	**11**	**12**	**13**
GDP (%p.a.)	-1.9	10.8	4.0	2.0	2.8
Inflation (%p.a.)	0.0	1.3	1.2	1.3	1.2
Current A/c(US$ bill.)	16.0	16.0	18.0	20.0	22.0
NT$/$(nom.)	32.0	31.0	30.0	29.5	29.5

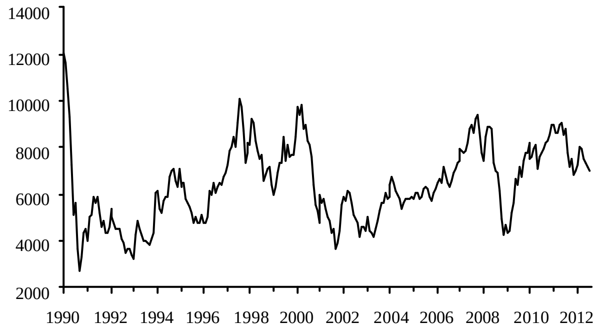
Brazil

Brazil's prosperity in the last decade was based on speedy economic growth rates fuelled by its vast natural resources but growth is sputtering now. The 2012 growth outlook looks bleak and it may well be below our forecast of 2%. We await outcome of the euro-zone crisis.

Brazilian retail sales have been rock solid in the past decade maintaining the growth momentum. In May, retail sales volumes dropped 0.8% — the biggest monthly decline since November 2008. The Brazilian consumer has been one of the main drivers of the country's growth over the past decade, thanks to the rising wages and greater access to credit.

Brazil's central bank has countered the slowness with its eighth consecutive rate cut to a record 8% low but it is not helping the economy. We expect the central bank to cut the Selic rate by at least another 50 basis points at its meeting next month in August.

Taiwan: Weighted TAIEX Price Index



In May, Brazil's annual inflation rate finally fell below 5% for the first time since 2010 — close to the central bank's target of 4.5%.

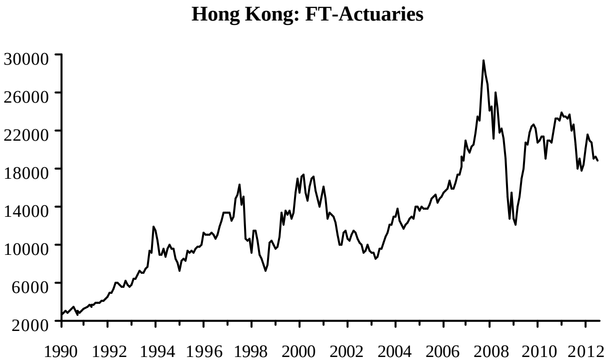
The Brazilian real weakened against the dollar, with investors seeking the safety of the U.S. currency as the euro-zone economic situation continued to deteriorate. The real is tracking the euro's losses against the dollar as Spain's public finances appeared increasingly fragile. The government is in favour of keeping the currency weaker than BRL2.00 to the dollar in order to help exporters. But an exchange rate weaker than BRL2.10 to the dollar impacts domestic inflation adversely as a result of rising import prices. The Brazilian real weakened beyond the BRL2.00 to the dollar in the month of July.

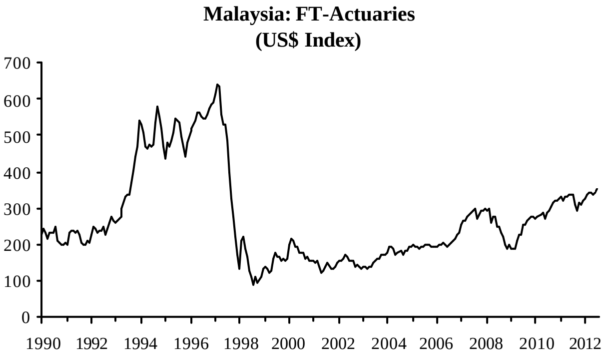
Moody's has downgraded eight Brazilian banks and the country's stock exchange operator as part of its global review of the sector, highlighting the vulnerability of emerging markets to the crisis in the euro-zone. According to Moody's, it had reduced the so-called standalone bank financial strength ratings of eight financial institutions by one to three notches, mostly bringing them in line with Brazil's sovereign rating.

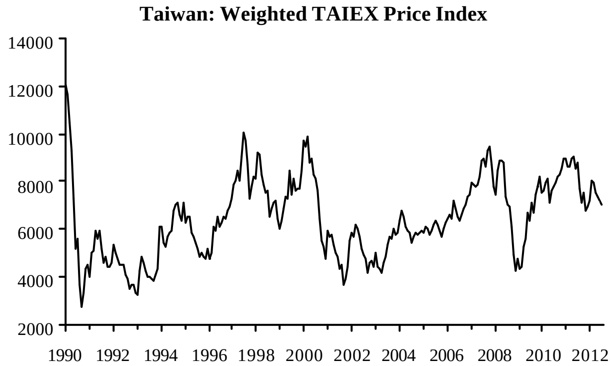
Japanese retail investors have pulled about $30bn out of Brazil in less than a year as concerns deepen over the stagnation of the world's second-largest emerging market economy.

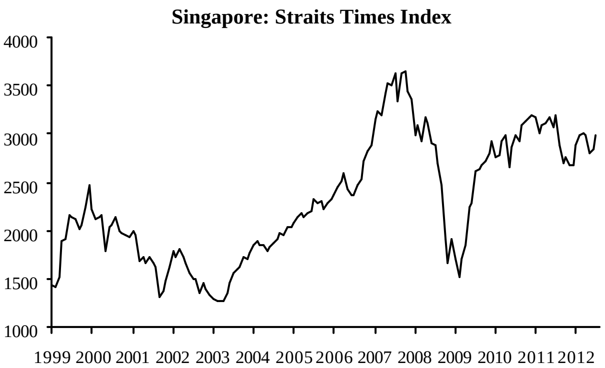
	09	**10**	**11**	**12**	**13**
GDP (%p.a.)	-0.2	7.5	2.7	2.0	3.0
Inflation (%p.a.)	4.1	5.9	6.5	5.6	5.0
Current A/c(US$ bill.)	-20.0	-47.3	-52.6	-60.0	-65.0
Real/$(nom.)	1.8	1.7	1.5	2.0	2.1

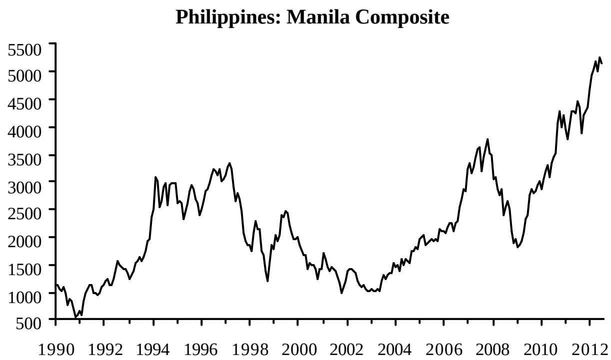
Other Emerging Markets





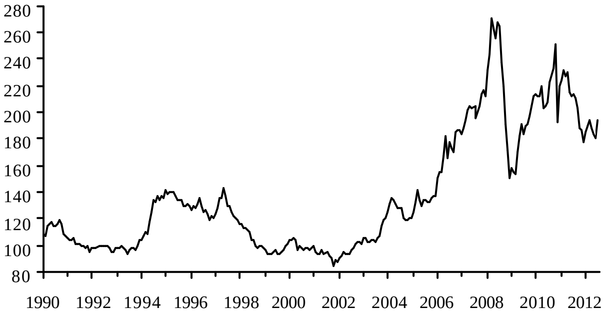




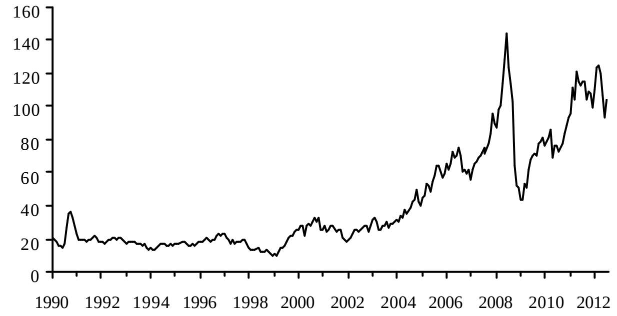


COMMODITY MARKETS

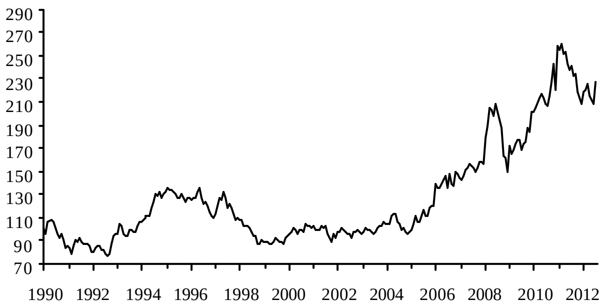
Commodity Price Index (Dollar)
(Economist, 2000=100)



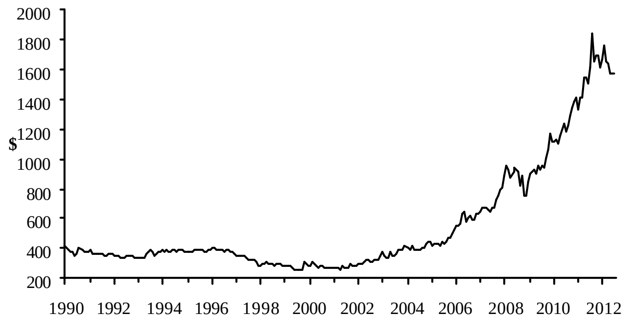
Oil Price: North Sea Brent (in Dollars)



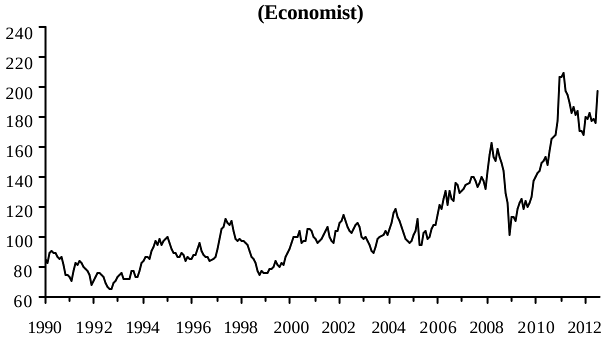
Commodity Price Index (Sterling)
(Economist, 2000=100)



Gold Price (in Dollars)



Commodity Price Index (Euro)
(Economist)



UK FORECAST DETAIL

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

	Inflation %[1] (CPI)	Short Dated (5 Year) Interest Rates	3 Month Int. Rates	Nominal Exchange Rate (2005=100)[2]	Real Exchange Rate[3]	Real 3 Month Int. Rates %[4]	Inflation (RPIX)	Real Short Dated Rate of Interest[5]
2009	1.3	2.8	1.1	80.6	89.3	-0.4	2.0	-0.2
2010	4.1	2.4	0.7	80.4	91.2	-3.8	4.8	-0.3
2011	3.9	2.0	0.9	79.9	92.4	-2.5	5.3	-0.4
2012	2.8	1.6	1.2	81.7	95.4	-1.6	3.5	-0.5
2013	2.3	2.4	1.4	81.5	95.7	-0.7	2.9	0.4
2014	2.0	2.6	2.1	81.0	95.6	0.2	2.7	0.6
2011:1	4.5	2.6	0.8	80.8	93.3	-2.9	5.3	0.2
2011:2	3.7	2.3	0.9	79.4	91.8	-2.8	5.2	-0.1
2011:3	3.7	1.6	0.9	79.2	91.5	-2.7	5.3	-0.7
2011:4	3.6	1.3	1.1	80.2	93.0	-1.5	5.3	-0.9
2012:1	2.6	1.1	1.1	81.1	94.3	-2.0	3.8	-1.1
2012:2	3.1	1.6	1.0	82.3	96.1	-1.9	3.6	-0.5
2012:3	2.9	1.8	1.4	81.9	95.7	-1.3	3.3	-0.3
2012:4	2.7	1.9	1.4	81.6	95.6	-1.0	3.2	-0.1
2013:1	2.4	2.1	1.4	81.5	95.5	-0.9	3.0	0.1
2013:2	2.3	2.4	1.4	81.3	95.4	-0.8	2.9	0.4
2013:3	2.2	2.6	1.4	81.7	96.0	-0.7	2.8	0.6
2013:4	2.1	2.6	1.6	81.4	95.9	-0.5	2.8	0.6

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

Labour Market and Supply Factors (Seasonally Adjusted)

	Average Earnings (1990=100)[1]	Wage Growth[2]	Unemployment (New Basis) Percent[3]	Millions	Real Wage Rate[4] (1990=100)
2009	227.3	0.0	4.6	1.53	141.3
2010	232.4	2.3	4.6	1.50	138.8
2011	237.9	2.3	4.7	1.53	136.6
2012	243.2	2.1	4.6	1.53	135.6
2013	251.7	3.5	4.0	1.34	137.3
2014	262.8	4.4	3.7	1.24	140.6
2011:1	237.6	2.9	4.5	1.46	138.0
2011:2	237.2	2.6	4.6	1.50	136.8
2011:3	238.2	2.1	4.8	1.57	136.1
2011:4	238.8	1.6	4.8	1.60	135.4
2012:1	239.8	0.5	4.8	1.61	135.1
2012:2	242.1	2.1	4.7	1.56	135.4
2012:3	244.3	2.6	4.5	1.51	135.7
2012:4	246.7	3.3	4.4	1.46	136.3
2013:1	247.9	3.4	4.2	1.41	136.4
2013:2	250.6	3.5	4.1	1.36	137.0
2013:3	252.9	3.5	3.9	1.31	137.6
2013:4	255.6	3.6	3.8	1.26	138.3

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

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

	Expenditure Index	£ Million '90 prices	Non-Durable Consumption[2]	Private Sector Gross Investment Expenditure[3]	Public Authority Expenditure[4]	Net Exports[5]	AFC
2009	140.8	674466.5	405440.7	218144.6	178391.0	-33226.3	94283.5
2010	143.8	688577.5	406544.7	238231.9	181470.9	-39127.8	98542.3
2011	144.7	693085.7	400020.3	240745.2	180361.1	-30475.0	97565.8
2012	145.9	698805.6	401772.6	254854.4	182833.9	-32881.9	107764.8
2013	148.8	712538.5	407982.4	260043.9	187329.0	-33205.7	109610.1
2014	152.1	728596.4	417155.4	265696.3	191131.8	-33153.8	112235.9
2009/08	-4.3		-3.7	-13.4	0.9		-5.0
2010/09	2.1		0.3	9.2	1.7		4.6
2011/10	0.7		-1.6	1.1	-0.6		-0.9
2012/11	0.8		0.4	6.1	1.5		11.1
2013/12	2.0		1.5	2.1	2.5		1.7
2014/13	2.3		2.2	2.2	2.0		2.4
2011:1	144.5	172985.8	100710.9	55274.0	47260.2	-6814.0	23445.3
2011:2	144.4	172880.5	100098.9	58650.3	43772.3	-7894.5	21746.5
2011:3	145.2	173866.2	99417.2	64048.0	44431.3	-8082.7	25947.6
2011:4	144.8	173353.2	99793.3	62772.8	44897.4	-7683.8	26426.5
2012:1	144.3	172790.5	100021.7	62533.0	45654.3	-7956.4	27462.2
2012:2	144.0	172361.5	100252.8	61076.7	45598.3	-8306.1	26258.6
2012:3	147.8	176935.9	100386.7	66094.5	45669.6	-8309.4	26902.2
2012:4	147.6	176717.7	101111.5	65150.2	45911.6	-8310.0	27141.8
2013:1	148.0	177154.1	101483.0	62722.2	48586.9	-8307.4	27326.9
2013:2	148.5	177778.4	101479.0	66229.2	45693.1	-8302.0	27320.6
2013:3	149.1	178446.3	101989.4	65774.3	46384.9	-8301.7	27401.8
2013:4	149.6	179159.7	103031.0	65318.2	46664.1	-8294.5	27560.8

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

Financial Forecast

	PSBR/GDP %[1]	GDP[1] (£bn)	PSBR (£bn) Financial Year	Debt Interest (£bn)	Current Account (£ bn)
2009	10.3	1247.8	128.3	32.4	-26.1
2010	8.3	1335.1	110.3	36.6	-48.6
2011	7.3	1394.9	120.1	43.0	-29.0
2012	7.4	1463.3	107.6	48.1	-31.6
2013	6.4	1524.1	97.1	51.6	-32.5
2014	3.6	1591.8	58.0	56.8	-32.3
2011:1	3.9	338.3	13.2	9.7	-6.6
2011:2	8.4	337.4	28.4	10.0	-3.4
2011:3	5.7	349.7	19.8	10.4	-10.5
2011:4	9.3	352.3	32.9	11.0	-8.5
2012:1	5.6	355.5	39.0	11.5	-7.0
2012:2	7.5	355.2	26.5	11.6	-3.8
2012:3	6.8	367.1	24.9	12.0	-11.0
2012:4	7.0	369.2	25.7	12.2	-9.8
2013:1	8.2	371.8	30.5	12.3	-8.0
2013:2	6.2	375.5	23.4	12.5	-3.7
2013:3	6.0	378.9	22.6	12.7	-11.0
2013:4	6.1	382.5	23.1	13.0	-9.8

1 GDP at market prices (Financial Year)

WORLD FORECAST DETAIL

Growth Of Real GNP

	2008	2009	2010	2011	2012	2013
U.S.A.	0.0	–2.6	2.6	1.7	2.5	2.6
U.K.	–1.1	–4.3	2.1	0.7	0.8	2.0
Japan	–1.2	–6.3	4.3	–0.7	2.1	1.6
Germany	1.0	–4.7	3.6	3.0	1.1	2.0
France	0.1	–2.5	1.5	1.7	1.0	1.2
Italy	–1.3	–5.1	0.9	0.5	0.1	0.3

Real Short-Term Interest Rates

	2008	2009	2010	2011	2012	2013
U.S.A.	1.8	–1.6	–1.8	–1.7	–1.5	–1.3
U.K.	4.2	–0.4	–3.8	–2.5	–1.6	–0.7
Japan	1.8	1.1	0.5	0.4	0.4	0.4
Germany	3.5	–0.4	–1.3	–0.3	0.8	0.5
France	3.8	–0.8	–1.4	–0.3	0.9	0.5
Italy	3.1	–0.8	–1.4	–0.3	–0.3	0.0

Real Long-Term Interest Rates

	2008	2009	2010	2011	2012	2013
U.S.A.	2.2	1.3	1.1	1.2	2.0	2.0
U.K.	1.4	–0.2	–0.3	–0.4	–0.5	0.4
Japan	2.0	1.4	1.1	1.1	1.3	1.5
Germany	3.0	2.3	1.9	1.8	2.0	2.0
France	3.0	2.2	1.9	1.8	2.0	2.0
Italy	2.8	2.2	1.9	1.8	2.0	2.2

Index Of Real Exchange Rate(2000=100)[1]

	2008	2009	2010	2011	2012	2013
U.S.A.	80.1	88.7	81.7	81.8	82.0	82.1
U.K.	87.6	77.5	77.3	76.8	79.6	78.4
Japan	87.9	89.0	80.2	79.8	79.7	80.0
Germany	105.1	105.8	99.3	99.0	99.1	99.0
France	106.4	104.3	101.7	102.0	102.0	102.1
Italy	106.6	105.4	100.5	100.8	101.0	101.1

[1] The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation in the real exchange rate.

Growth Of Consumer Prices

	2008	2009	2010	2011	2012	2013
U.S.A.	3.8	–0.3	1.8	3.1	2.0	2.0
U.K.	3.3	1.3	4.1	3.9	2.8	2.3
Japan	1.4	–1.4	–1.0	–0.3	–0.2	0.0
Germany	2.6	0.4	1.1	2.3	1.8	1.7
France	2.8	0.1	1.5	2.1	1.6	1.6
Italy	3.4	0.8	1.5	2.8	2.7	2.8

Nominal Short-Term Interest Rates

	2008	2009	2010	2011	2012	2013
U.S.A.	1.5	0.2	0.1	0.3	0.5	0.7
U.K.	5.5	1.1	0.7	0.9	1.2	1.4
Japan	0.4	0.1	0.1	0.4	0.4	0.4
Germany	3.9	0.7	0.4	1.5	2.5	2.5
France	3.9	0.7	0.4	1.5	2.5	2.5
Italy	3.9	0.7	0.4	1.5	2.5	2.5

Nominal Long-Term Interest Rates

	2008	2009	2010	2011	2012	2013
U.S.A.	3.7	3.2	3.1	3.2	4.0	4.0
U.K.	4.3	2.8	2.4	2.0	1.6	2.4
Japan	1.5	1.3	1.1	1.2	1.5	1.5
Germany	4.4	4.0	3.8	3.8	4.0	4.0
France	4.4	4.0	3.8	3.8	4.0	4.0
Italy	4.4	4.0	3.8	3.8	4.0	4.0

Nominal Exchange Rate
(Number of Units of Local Currency To $1)

	2008	2009	2010	2011	2012	2013
U.S.A.[1]	86.07	85.98	83.73	78.08	80.20	80.50
U.K.	1.85	1.57	1.55	1.61	1.58	1.58
Japan	103.40	93.54	87.48	79.36	81.00	81.00
Eurozone	0.68	0.72	0.75	0.72	0.78	0.79

[1] The series for the USA is a trade weighted index (1990=100); the series for the UK is $ per £

* Forecasts based on the Liverpool World Model