

LIVERPOOL INVESTMENT LETTER

January 2013



LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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The Liverpool Investment Letter is written by Patrick Minford, 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.

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<p>Recent talk of raising the inflation target in order to target growth is extremely worrying. It signals a return to past irresponsibility in using monetary policy to target unsustainable growth: this led to the Great Inflation of the 1970s. It was to ensure no return to those unstable policies that the inflation target was introduced in 1992. The weakness of growth has nothing to do with monetary policy and everything to do with ill-thought-out interventions by regulators and populist politicians on top of a world shortage of raw materials that is hampering western industries.</p>	
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PLAYING FAST AND LOOSE WITH MONETARY POLICY AND MONETARY CONTROLS

Heavy monetary breathing having little effect on growth

One of the strange things about the current debate about monetary policy and inflation targeting is how many of the protagonists, from finance ministers through central bank governors to the IMF and the BIS, have forgotten all they were taught about macroeconomics. They seem to believe that monetary policy, now to do with fresh injections of central bank money (QE), can create growth when everyone can fully see the injections from well in advance of the act and long after the original banking crisis has given way to a weak, ‘new normal’, recovery. Yet even the most ‘New Keynesian’ model with long-duration price/wage rigidity does not predict money can boost output much in these conditions. A model on the other hand with a fair degree of price/wage flexibility is definite that no effect at all on output will result.

The main channel through which New Keynesian models see effects on output occurring is through future interest rates being kept low and so stimulating investment, perhaps also consumption. The argument is that the central bank sets interest rates and can influence expectations of where it will set them in future by a special monetary intervention addressed to the future.

Nowadays these models are usually supplemented with a banking sector which charges a premium on its loans that varies with the strength of lending demand. As we have seen, the lending premium has remained stubbornly high in spite of all the monetary stimulus applied.

What we have observed both here and in the US, indeed in most western economies including the northern euro-zone, is weak growth in spite of massive monetary stimulus. Businesses can see little need to invest, consumer spending is growing slightly, government spending is of course restrained; monetary policy is having little effect on any of these sources of demand. Ironically, the one where it might be having most is government where QE, allied to general fear, has brought down the cost of government borrowing to negative real interest rates. But governments are in no mood to commit to new spending levels when they are rightly concerned about long-run solvency.

Accounting for all this weakness is a challenge to our understanding. Some say it is due to ‘deleveraging’; in a literal sense this is true as people and firms are not spending and so running down debt. But it is purely a description not a causal explanation. The question is why they are doing so relentlessly in the face of low interest rates.

Table 1: Summary of Forecast

	2010	2011	2012	2013	2014	2015	2016
GDP Growth ¹	2.1	0.7	0.0	2.0	2.3	2.5	2.6
Inflation							
CPI	4.1	3.9	2.8	2.8	2.5	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	0.9	0.9	1.4	1.8	2.0
5 Year Interest Rate	2.4	1.9	0.8	1.3	1.6	2.0	2.3
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

¹Expenditure estimate at factor cost

²U.K. Wholly unemployed excluding school leavers (new basis)

³Sterling effective exchange rate, Bank of England Index (2005 = 100)

To this the answer most plausibly is that prospective returns on capital are low and expected real incomes growing little because productivity growth is slow and promises to remain so. The deep reasons for this appear to lie first in the massive shift in the terms of trade for oil and raw materials against western consuming countries. Indeed producing countries of the west such as Canada and Australia and of the developing world such as Africa are in much better shape.

The second reason is the regulative backlash against the banking system in the west. This has most effectively blocked the banking channel of monetary policy. It is a commonplace of recent surveys (such as those carried out by the Bank of England through its agents) that SMEs, which account for some 50% of employment and a slightly smaller share of GDP, cannot get loans from the banks on reasonable terms or in some cases on any terms at all. One symptom of this banking channel blockage is the exceptional weakness of broad money growth and the non-existent growth of credit.

Governments and regulators are convinced this regulative tightening is both necessary and will make the economy ‘safe from crises’ in the future. In this they are likely to be quite wrong since capitalism is naturally crisis-prone, since productivity growth is inherently unpredictable and subject to unforecastable and potentially large swings in both directions. Recent Cardiff research suggests that, simply due to these swings, crises of some depth can occur quite regularly and will generally trigger banking problems as well.

While our elite classes get to grips with this reality, their heavy-handed regulative intervention is worsening the economic ‘supply-side’ on top of the weakness induced by the raw material terms of trade shift. Printing money to get over such real supply-side weaknesses will not have much, if any, effect as indeed we are observing in practice.

The inflation target and the ‘let us have a little inflation’ movement

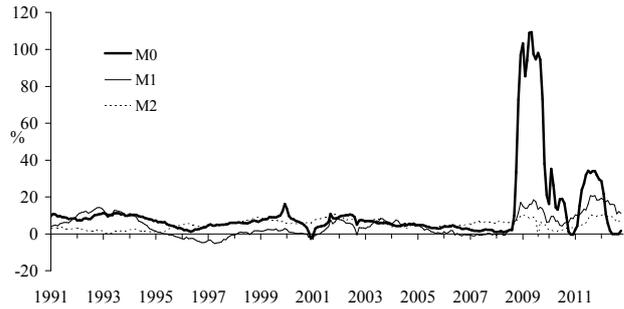
There is increasing talk of raising the inflation target both here and in the US. No less a man than the Bank Governor to be, Mark Carney, has made a high profile speech arguing for some ‘temporary’ raising of the inflation target. He is a bit late in this since the Bank has been indulging in this sport for a few years now, having overshoot its target substantially. His reason for suggesting this is that it will boost growth.

But surely everyone knows the theory of ‘time-inconsistency’ in monetary policy under which the desire of policy-makers to boost growth by creating extra inflation generates inflation without succeeding in boosting growth? The reason for this is that once people begin to think inflation is being used as a tool for boosting growth they will expect the ‘inflation target’ to be regularly breached whenever growth is disappointing. They will then calculate how much inflation will seem worthwhile as the price of getting more growth; this rate will then become the ‘inflation expectation’. Wage inflation will then rise in line with these expectations and fuel this very inflation rate. Growth in employment and output will not increase as the channel of higher competitiveness (lower real wages) will be frustrated.

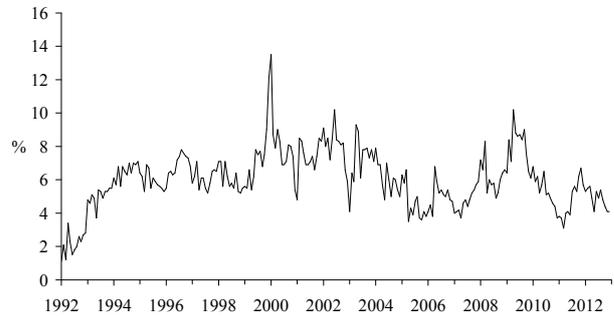
One might add that interest rates too will rise as inflation expectations rise. This will not aid recovery and could harm it. It will indeed mean that the value of government debt falls so that the public debt ratio will fall. This can be thought of as the effect of the ‘inflation tax’. But the whole idea of inflation targeting was to make sure governments did not use this tax rather than orthodox taxation; voters disliked the random redistribution generated by high inflation and that underlay the legislative move to the target.

So far inflation expectations have remained moderately anchored in spite of such loose talk. But authors such as Bennett McCallum and indeed ourselves have warned that time-inconsistent behaviour is a deep problem of political economy. Those of us involved in the public debate have to be constantly on the watch for its recurrence in ever-plausible guises. It seems that the Carney speech is particularly dangerous as it has been welcomed by George Osborne as the ‘start of a debate’. It is a dangerous one as it is one thing to print money when you are committed to reversing it, however that may be, and quite another to have no commitment to reversing it because you are aiming for higher inflation.

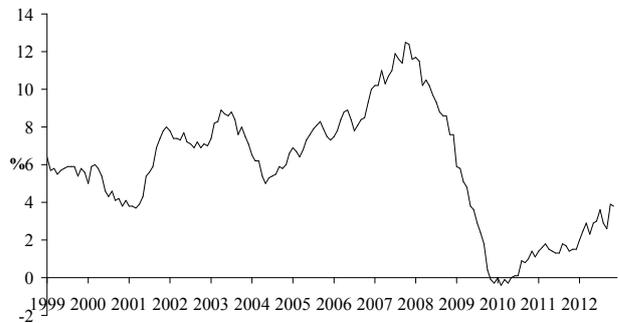
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



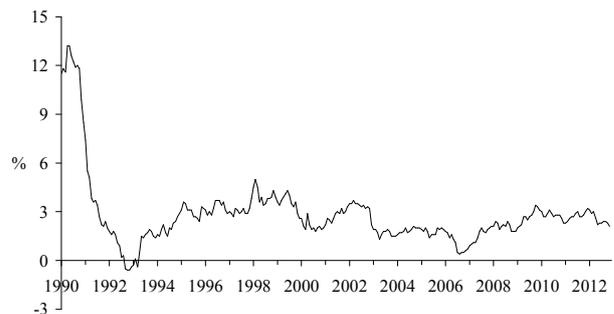
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



Conclusions — the dangers of loose money and loose money talk

In sum, present monetary policy is in my view badly adrift. It needs to be recognised that monetary policy is only a tool of stabilisation in response to shocks. Once the situation has become one of persistently weak growth monetary policy can no longer have much if any effect; it will only drive inflation higher. The only reason the massive loosening of money has had little effect so far on inflation is that first the inflation target is still there, and second that the banking system has largely killed off money creation as fast as it has occurred because of regulative overkill.

Regulative overkill will be with us for some time because of current government fashion. It is undermining growth but we just have to live with that.

Monetary policy so far is not causing much inflation. But it is also not helping growth. All it is really doing is redistributing income from savers to the general taxpayer;

this is politically unsustainable even if economically it is just a transfer and so has no clear welfare implication.

However, were we now to move to a commitment to generate growth by printing as ‘much money as it takes’ and abandoning the inflation target also by ‘as much as it takes’, then matters would be alarming indeed.

Accordingly it is really time to get back to normality in the demands on monetary policy and in its behaviour. QE should stop and be reversed over the next year or so. interest rates should rise towards normal levels, starting with a 0.5% increase forthwith.

For the present, we assume that the inflation target will remain, amid a continuation of ‘muddle as usual’. Hence our forecast has inflation returning to target over time, even if it is unsatisfactorily high for the immediate future.

FOCUS ON JAPAN

Francesco Perugini

Outlook for domestic buying of JGB and Japan fiscal debt (Part III)¹

What about the current account?

Since the total domestic financial surplus is equivalent to the current account surplus, whether private domestic saving is sufficient to cover the government deficit is highlighted by movements in the current account balance.

On a typical textbook approach, (net) national savings, — the aggregate of private savings (households, financial institutions and corporations) and government saving (less capital consumption for the total economy) — is equal to the sum of (net) national investment (less capital depreciation) and the current account, i.e. foreign savings. When net national savings are larger (smaller) than net national investment, net overseas assets accumulate (are drawn down) through the medium of current account surpluses (deficits). In other words, the excess of foreign capital flows overseas (into Japan).

Chart 20 shows that the huge fiscal deficits (negative government savings) have pushed net national savings into negative territory in 2009, even though net savings of the private sector have not decreased significantly in last 20 years. Since net domestic investment is on a downward trend and has turned negative in 2009, and given the outlook for household saving, from the standpoint of the macro balance the only way for the government to continue running fiscal deficit in the future is to borrow from abroad, that is with a positive current account.

Trends of current account main components are plotted on Chart 21.² The current account shows a secular surplus. Most recently, it expanded from 2002 and peaked in 2007 when it reached almost 5% of GDP. Since then it has fallen gradually to below ¥10 trillion, 1.9% of GDP.³ Within this overall pattern, the trade balance has trended down from its late-1990s peak, contracting sharply in 2008 due to the

Chart 20 - Breakdown of Net National Savings (source: MOF)

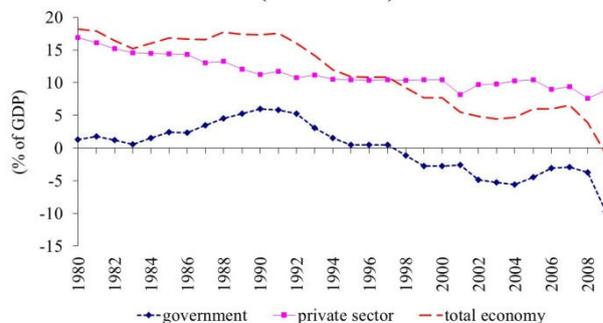
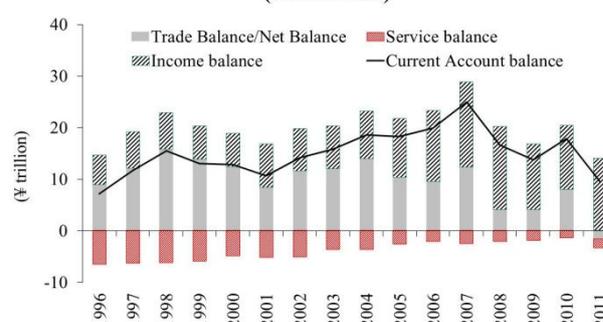


Chart 21 - Current Account structure (source: BOJ)



global demand shock and posting its first annual deficit since 1980 in 2011, as imports grew on the back of nuclear power alternatives and exports were undermined by damage to domestic supply chains and the flooding in Thailand. On the other hand, increasing interest and dividend income, derived from building up a huge amount of foreign assets, have maintained the income account in surplus since the 1980s⁴ and become the main driver of the current account since 2005.

Swing factors in determining whether the current account will slip into deficit territory in the next few years include the strength of the yen, shifts to overseas production, electric power supply shortages, increasing demand for mineral fuels, a rise in the fuel price, changes in foreign interest rates and overseas economic trends. Several private think-tanks have run model simulations with different assumptions to examine Japan's current account outlook. These projections include the possibility that the current account will move into deficit over the medium term due to continuing deterioration of the trade balance despite the

¹ Part I appeared in the November Letter.

² The main components of the current accounts are: 1) the trade account, which includes imports and exports of traded goods; 2) the services account, which includes overseas travel and services such as transportation, communications and finance; 3) the income account, which includes cross-border income from investments (e.g., interest and dividend payments from foreign investments) and employee income; and 4) current account transfers, which include inter-government aid and contributions to international institutions.

³ In the first six months of 2012 it shrank 45% over the corresponding period of the previous year, the largest decline posted in that period since 1985.

⁴ Japan is by far the world's largest holder of net foreign assets, in excess of ¥250 trillion.

steady inflow of portfolio investment income.⁵ As a result, if Japan runs a current account deficit at some point domestic demand might not be adequate to absorb the supply of new JGBs.

Outlook risks and policy implications

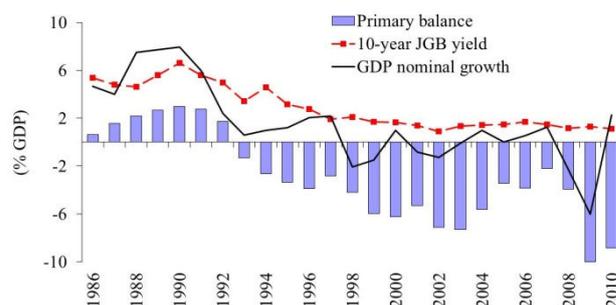
The above discussion shows that although the Japanese government currently has no liquidity problem at all, in the near future there are potential risks for JGB absorption and hence for deficit funding. JGB demand could slow among households because of their shrinking financial surplus, shifting behaviour or rise in risk appetite, and among foreign investors as a result of concerns about the sustainability of the public debt. If this occurs, to attract more investors JGB interest rates will have to rise, possibly triggering a negative spiral in which debt service costs rise and the fiscal situation becomes even more severe.

So far JGB yields have remained low despite the fiscal deterioration. This has been puzzling market participants as well as academics. Low nominal interest rate on JGBs reflects the lower potential growth rate and deeply-rooted deflation expectations. Most importantly, any fiscal risk premium on JGBs has been relatively low or absent.⁶ In other words, investors do not believe a fiscal crisis will occur in the foreseeable future.

With the public debt already on an unsustainable path, a rise in the JGB rate will put further pressure on the ability of the government to pay its debts. Government solvency is generally assessed by looking at whether the debt/GDP ratio is headed for convergence in the future. Assessment is based on the primary balance (fiscal balance minus interest payments), and its relation to long-term government bond yields and nominal GDP growth. When the primary balance is in equilibrium, the only growth in the debt balance is the interest expense (debt multiplied by government bond yields). The balance therefore rises in proportion to yields. As a result, assuming equilibrium in the primary balance, whenever the gap between government bond yields and nominal GDP growth is positive the debt/GDP ratio increases. In other words, the primary balance has to be in surplus to prevent the debt/GDP ratio from rising when yields are higher than the nominal growth rate. However, since the early 1990s the JGB yield has consistently exceeded the nominal GDP growth and the primary balance has been in a stable deficit (Chart 22).

To produce a primary balance and preserve a constant debt/GDP ratio both spending cuts and revenue increases

Chart 22 - Primary balance
(source: IMF, MOF)



are required. And if JGB yields rise and the economy does not revitalize, a larger fiscal adjustment will be necessary.

International organizations claim that the recent consumption tax increases, which will double the tax rate to 10% by 2018, would only moderate the pace of the debt/GDP ratio increase. They suggest to Japanese policymakers that they should further increase the consumption tax rate, curb the growth of non-social security spending, and limit the growth in social security spending. Fortunately, international comparisons show that the tax burden relative to GDP is relatively low in Japan compared with other developed countries so there should be room to raise taxes and social security contributions somewhat. However, spending cuts are extremely difficult to achieve politically, and raising tax, although feasible, is potentially destabilising. After Ryutaro Hashimoto's LDP-led coalition government raised the consumption tax rate to the current 5% in 1998, the ruling party lost the Upper House election and the economy plunged back into deep recession.

The point is that a large fiscal adjustment without growth is extremely difficult to implement. Japan should promote growth with forceful structural reforms and reduce impediments to resource reallocation especially among inefficient sectors of the economy. The list of areas which need a shake-up is as long as it is familiar. The heavily overprotected agricultural sector needs deregulating, and services from transport to power generation need to be opened up to foreign competition. Japanese productivity growth has basically ground to a halt as a result of government policies designed to protect the status quo and stifle competition. This is the reason why the BOJ has long defended its monetary policy stance and argued that alone money growth is no panacea. However, the BOJ's refusal to act more forcefully could have undermined the political will to act on the supply-side issues, as the politicians can pass the blame to monetary policy and its supposed effects in causing a chronic deflation spiral and an excessively strong yen. One way or another Japan seems currently to be stuck in a policy cul-de-sac which can only lead in the end to a fiscal crisis that forces action. A stitch in time could save nine; as the West has seen crisis is a painful context in which to resolve long-standing problems.

⁵ See for instance Shiraiishi, (2010), Kumagai et al. (2012), and Goto and Nordvig, (2012).

⁶ For an analysis on the factors behind the JGB yields stability see Kuwahara (2011).

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MARKET DEVELOPMENTS

The equity markets are reviving and bond markets weakening as worldwide growth revives. As it is centred mainly in the emerging market economies where productivity growth is greatly stronger than in the west, we continue to put a large segment of the equity portfolio in

emerging stock markets. Nevertheless of course the main stock markets also participate widely in world growth through multinational companies. So they remain the core element. Bond markets look massively overbought.

Table 1: Market Developments

	Market Levels		Prediction for Dec/Jan 2013/14	
	Nov 28	Jan 2	Previous Letter	Current View
Share Indices				
UK (FT 100)	5803	6027	8548	8758
US (S&P 500)	1410	1462	1600	1660
Germany (DAX 30)	7343	7779	9267	9661
Japan (Tokyo New)	771	860	923	1003
Bond Yields (government long-term)				
UK	1.77	2.00	2.10	2.10
US	1.62	1.84	4.00	4.00
Germany	1.37	1.45	4.00	4.00
Japan	0.71	0.79	1.50	1.50
UK Index Linked	-0.03	-0.02	-0.40	-0.40
Exchange Rates				
UK (\$ per £)	1.60	1.63	1.58	1.58
UK (trade weighted)	83.6	83.9	81.3	81.3
US (trade weighted)	81.0	81.5	80.5	80.5
Euro per \$	0.78	0.76	0.79	0.79
Euro per £	1.24	1.23	1.25	1.25
Japan (Yen per \$)	81.8	87.2	81.0	81.0
Short Term Interest Rates (3-month deposits)				
UK	0.61	0.58	1.40	1.40
US	0.25	0.38	0.60	0.60
Euro	0.11	0.13	2.50	2.50
Japan	0.12	0.15	0.40	0.40

Table 2: Prospective Yields¹

Equities: Contribution to £ yield of:						
	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.50	2.0	2.3	41.00		48.80
US	2.10	2.5	2.0	9.00	2.95	18.55
Germany	3.10	1.5	1.7	21.00	-1.55	25.75
Japan	2.20	1.7	0.0	15.00	9.85	28.75
UK indexed ²	-0.02		2.2	-8.00		-5.72
Hong Kong ³	2.30	7.5	2.0	-5.00	2.95	9.75
Malaysia	3.00	5.2	2.0	38.00	2.95	51.15
Singapore	3.40	4.4	2.0	20.00	2.95	32.75
India	1.40	6.5	2.0	2.00	2.95	14.85
Korea	1.10	3.5	2.0	-21.00	2.95	-11.45
Indonesia	2.30	6.5	2.0	32.00	2.95	45.75
Taiwan	3.40	3.5	2.0	23.00	2.95	34.85
Thailand	2.80	4.4	2.0	23.00	2.95	35.15
Bonds: Contribution to £ yield of:						
	Redemption Yield	Changing Nominal Rates	Currency	Total		
UK	2.00	-1.00				1.00
US	1.84	-21.60	2.95			-16.81
Germany	1.45	-25.50	-1.55			-25.60
Japan	0.79	-7.10	9.85			3.54
Deposits: Contribution to £ yield of:						
	Deposit Yield	Currency	Total			
UK	0.58		0.58			
US	0.35	2.95	3.33			
Euro	0.13	-1.55	-1.42			
Japan	0.15	9.85	10.00			

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	
	December Letter	Current View	December Letter	Current View	December Letter	Current View
UK Deposits (Cash)	5	5	5	5	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	4	4	4	4	3	3
Brazilian Shares	4	4	4	4	3	3
Chilean Shares	4	4	4	4	3	3
Mexican Shares	4	4	4	4	3	3
Peruvian shares	4	4	4	4	3	3
Other:						
Index-linked bonds (UK)	-	-	-	-	-	-

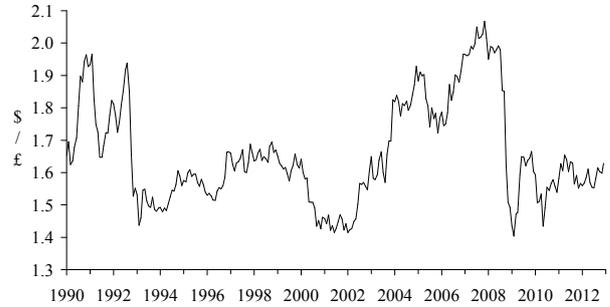
INDICATORS AND MARKET ANALYSIS

FOREIGN EXCHANGE MARKETS

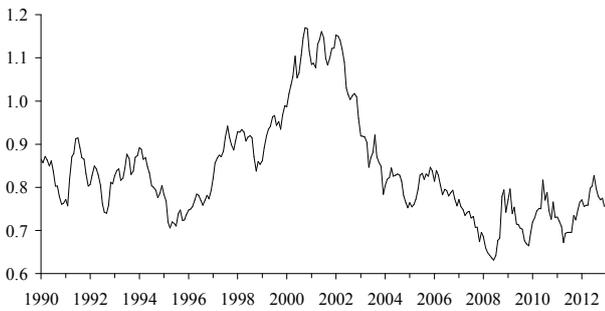
**US : Trade Weighted Index
(Bank of England 1990 = 100)**



UK: Dollars Per Pound Sterling



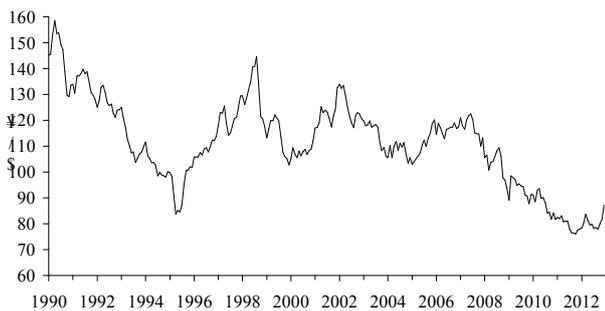
Euro per US dollar



**UK: Trade-Weighted Index
(Bank of England 1990 = 100)**



Japan : Yen Per U.S. Dollar

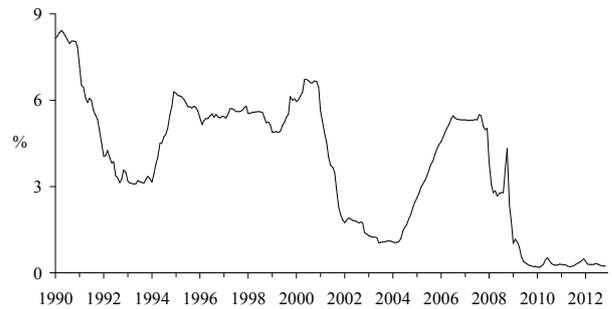


GOVERNMENT BOND MARKETS

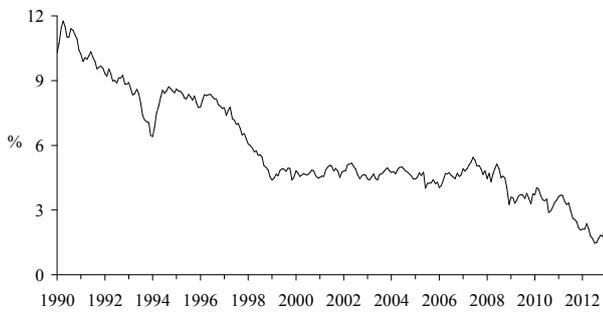
U.S.: Yield on Long-Term Government Bonds



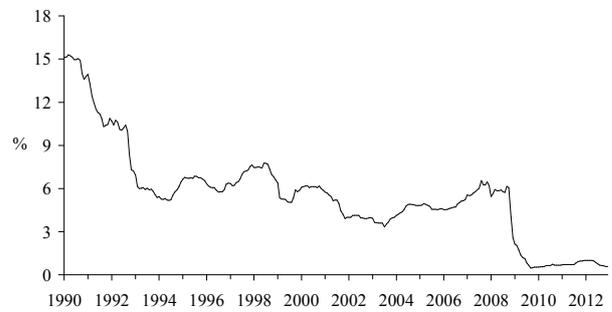
U.S. : 3-Month Certificate of Deposit



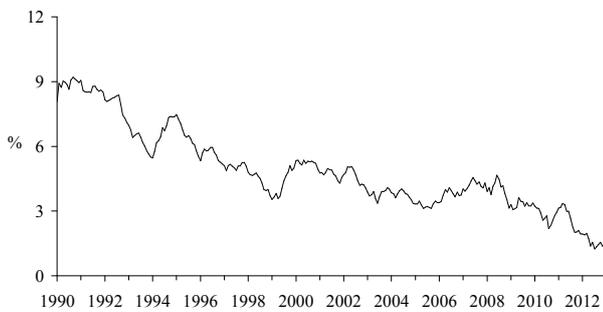
U.K. : Yield on Long-Term Government Bonds



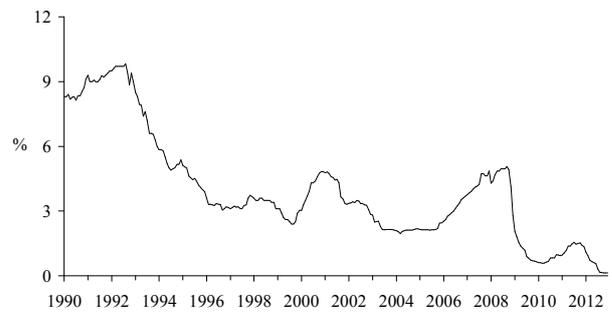
U.K. : 3-Month Interbank Rate



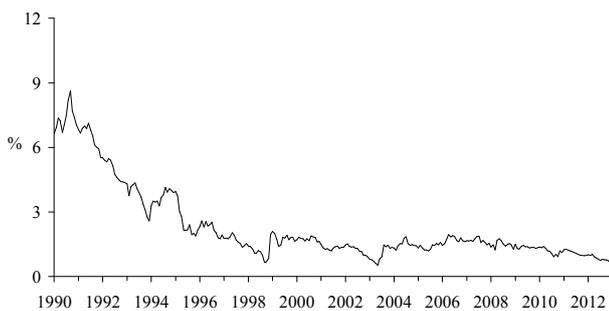
Germany: Yield on Public Authority Bonds



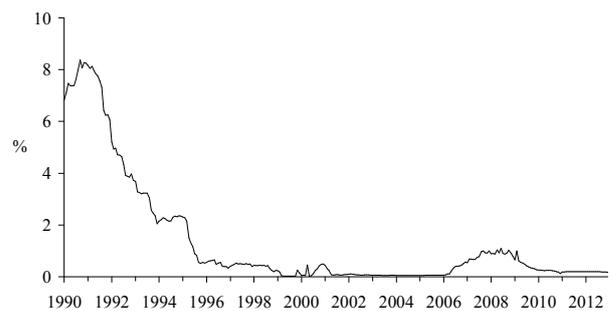
Germany : 3-Month Interbank Deposit Rate



Japan: Yield on Long-Term Government Bonds

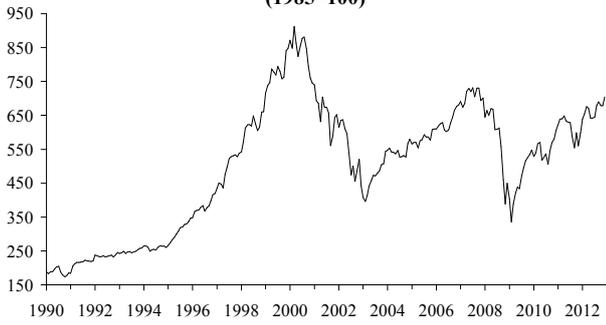


Japan : 3 Month Money Market Rate

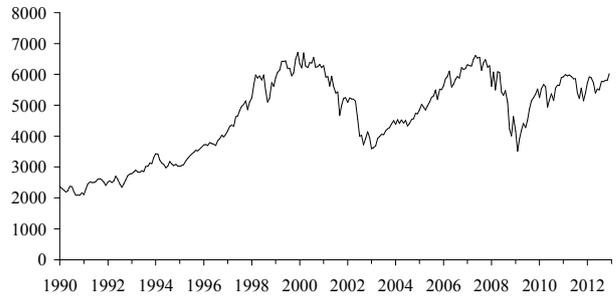


MAJOR EQUITY MARKETS

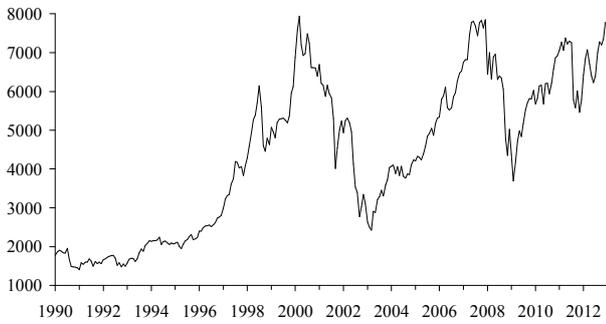
**U.S. : S & P 400 Industrial
(1985=100)**



**U.K. : FTSE-100 Index
(10 April 1962=100)**



Germany : DAX 30



**Japan : Tokyo S.E. New
(1985=100)**



EMERGING MARKETS

Anupam Rastogi

India

India's economy grew by only 5.3% in the first three quarters of 2012, its slowest pace in a decade. In 2013 the economy is forecast to grow by 6.5%. However, Goldman Sachs has projected that growth will return to 7.2% in 2014, and stay there for the following few years as moderation in commodity prices and a gradual reduction in fuel subsidy will help to tame inflation. Stubborn inflation reflects infrastructure bottlenecks arising from weak investment. High fiscal deficits, running between 5% and 6% of GDP since 2009, have crowded out private-sector investment, and a long-term concern with the government's spending is that it does not represent genuine investment, which could improve productivity and curb inflation, so providing room to loosen monetary policy. The government has focused on massive welfare spending, which has led to a big fiscal deficit. The government recently revised its deficit target to 5.3% from the 5.1% budgeted earlier.

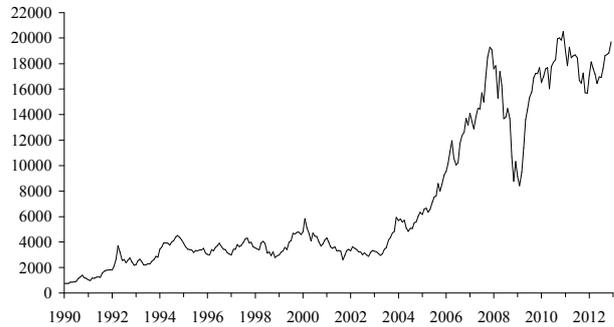
India's wholesale inflation eased for the second consecutive month in November to 7.24% from a year earlier, its slowest pace in 10 months, but it is not providing enough room for the central bank to cut interest rates. The RBI's stated inflation target is 4%–5%.

The central bank governor, Duvvuri Subbarao, said he expects inflation to start moderating from the January–March quarter. He held off pressure from the government and industry to ease monetary policy in mid-December, choosing to keep the key interest rate unchanged at 8.0%, but saying also that RBI may cut rates in January if inflation continues to ease. He surprised the market by holding the cash reserve ratio — the minimum percentage of deposits that lenders must park with the RBI — steady at 4.25%.

India's central bank continues to worry about the weak rupee fuelling inflation. The central bank has warned that risks in the financial system have increased over the past six months as the Asian economy grapples with the slowing growth and sticky inflation. In a report on risks to the stability of the country's financial system, the central bank also flagged early signs of growing leverage in companies with large exposure to the infrastructure sector.

India's balance of payments returned to deficit in the July–September quarter as a surge in foreign investment was insufficient to bridge a record current-account gap, highlighting the fragile state of the economy even as the government takes steps to curb its spending and boost growth. The country's current-account deficit widened to \$22.3 billion, or 5.4% of gross domestic product in the July–September quarter from \$16.4 billion in the April–

India: BSE Sensitive



June period. The current-account deficit — fuelled by the perennial trade gap — is seen as the biggest drag on the rupee, which weakened more than 3% against the U.S. dollar in 2012 following a 16% fall last year. Net foreign direct investment grew to \$8.9 billion from \$3.9 billion in the April–June quarter.

Indian shares were among the world's top gainers in 2012, thanks to the persistent buying interest from foreign funds, attractive valuations, and the government opening the economy to more overseas investment. It gained 25.7% for the calendar year — its biggest annual gain since 2009. The index lost 24.6% in 2011 and gained 17.4% and 81% in 2010 and 2009 respectively.

Buoyed by flows of funds from abroad, a sense of decreasing crisis in the Eurozone and urgency to implement the stalled reforms, the Indian stock market is zooming up. But the reforms will need to prove durable if that is to be sustained. The government's step on retail-sector liberalization, the banking regulation bill, and an amendment to the companies bill are seen in a positive light by the markets.

India's government has postponed the presentation of two bills on insurance and pension sector reforms to the next session of parliament, delaying the government's efforts to further expand its economic overhauls. The bills seek parliament's clearance to increase the limit on foreign ownership in local insurance companies to 49% from 26% and allow up to 49% overseas holding in pension-fund managers. The next session of parliament will start in February.

In the last couple of weeks, a nationwide protest took place for a gang-rape victim whose was assaulted in New Delhi. It has opened the eyes of the government in Delhi the power of social media as the protests did not have any political backing. People are hankering for better governance. Only time will tell whether this was a turning point when the governing class turned from vote-bank

politics to issue-based politics, or continued to follow in its old ways.

	09-10	10-11	11-12	12-13	13-14
GDP (%p.a.)	7.4	7.5	6.9	5.3	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	-35.0	-30.0
Rs./\$(nom.)	48.0	49.0	49.5	54.5	55.0

China

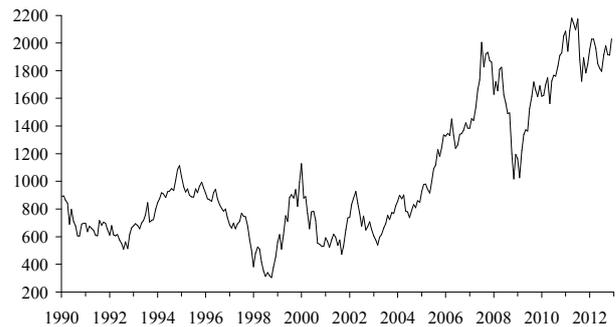
China's economy ended 2012 on a strong note after the HSBC purchasing managers' index for December climbed to 51.5, from 50.5 a month earlier. The index above the midpoint of 50 signals an accelerated pace of expansion. In 2013 the economy is expected to grow just over 7.5%, its slowest pace since 1999, with investment far outstripping household consumption as a share of GDP. With the commodity prices weakening, the Chinese economy may rebound to 8.5% in 2013.

The new leadership is consolidating its power base. Mr Xi Jinping stressed the need to crack down on rampant corruption and bribe-taking within the party and government and to improve social services and environmental protection. However, many issues beyond its borders are going to keep Beijing busy in the coming decade. The biggest challenge for China is whether or not it can co-ordinate the many domestic interest groups to come up with a more effective foreign policy.

On domestic front, China has pledged to speed up reform of its household-registration system as part of its urbanization drive, the strongest indication that the country is preparing to loosen controls on the movements of its rural population. The National Development and Reform Commission, the country's top economic-planning agency, said the authorities "will speed up household registration reform" and "study and set policies to push forward with turning rural residents into urban residents in an orderly manner but without delay." The NDRC said the government would focus on improving the quality of urbanization by investing in urban infrastructure such as sewage and heating systems.

China's commerce ministry has warned that the country may struggle to attract foreign investment next year thanks in part to the rising competition from other emerging economies, after investment flows into the country dropped for the sixth straight month in November. Rising wages in China have threatened the country's status as the world's factory floor, making low-cost destinations in Southeast and South Asia a more attractive prospect for foreign investors. Wages have risen 43% since 2009 and unit labour costs in dollar terms by 22% since 2007. This has wiped out China's cost advantage in world markets and the yuan is no longer undervalued against the dollar. The FDI data showed that the country attracted \$8.29 billion last month, down 5.4% from a year earlier. FDI in the January-

Korea: Composite Index



November period fell 3.6% from a year earlier to \$100 billion.

China is expected to allow foreign investors to trade in the country's nascent stock index futures market by the end of January. China's stock market sluggishness may come to an end as the fear of the US economy going into recession due to the fiscal cliff fades away.

	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	2.2	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's economy, heavily dependent on growth of its exports, has been hit by shrinking demand overseas due to the euro-zone sovereign-debt crisis and a slowdown in China. The government has revised down the country's economic growth forecast for 2012 to 2.1% from its earlier projection of 3.3%. The government has slashed its growth outlook for 2013 down to 3% from its earlier estimate of 4%.

There is some good news for the economy. The current-account surplus totalled \$6.88 billion in November — the highest monthly amount on record — compared with \$4.34 billion in November last year. That brought its total for the first 11 months of the year to well above the Bank of Korea's full-year forecast and lends further support to the won, which has been one of the best-performing currencies in Asia this year. The country ran a surplus of \$40.97 billion, surpassing the BOK's full-year forecast of \$34 billion. The November's trade surplus was due to strong exports of semiconductors, telecommunications equipment and display panels.

Strong current-account surpluses have helped push the South Korean won up 10.6% against the dollar since May, prompting the government to introduce measures in the currency market to rein in the currency, whose strength threatens to hurt the nation's export industry and attract potentially destabilizing capital inflows.

Ms. Park Geue-hye, the president-elect, has pledged to break the chaebols — family-owned conglomerates consisting of complex, interlocking parts spread across multiple business lines — that dominate business. Her victory comes after a closely fought campaign in which she abandoned her party's traditional unstinting support for the family-run conglomerates, or chaebol that her father favoured to drive the economy. Instead, she adopted a softer image, proposing various social-welfare handouts and moderating Mr. Lee's hard-line position on North Korea. Her campaign's theme was "economic democracy", in recognition of the growing dissatisfaction with an economic model based on the mighty chaebol conglomerates. The extreme dominance of manufacturing by a handful of big companies was instrumental in South Korea's stunning industrialisation. However, continued growth requires a more open economic structure. Ms Park vows to enforce competition rules more strictly against the chaebol. She vowed to abandon Mr Lee's liberal use of the presidential pardon. Ms Park promises to make it easier to bring suits against the chaebol for anti-competitive behaviour, and to check their preferential access to funding by restricting their investment in banks.

Kim Jong-eun, the North Korean leader, has called for an end to confrontation with South Korea and expressed a keen desire to develop the North Korean economy in the first televised address by a North Korean leader in 19 years. He has called for reunification of the North and South Korea as well. If Kim II is keen on economic development of North Korea, we may see a new era in Korean peninsula and probably in the world politics.

	09	10	11	12	13
GDP (%p.a.)	0.2	6.3	3.6	2.1	3.0
Inflation (%p.a.)	2.6	2.9	4.0	2.2	2.5
Current A/c(US\$ bill.)	42.7	28.2	27.0	44.0	28.0
Won/\$ (nom.)	1200	1150	1100	1100	1100

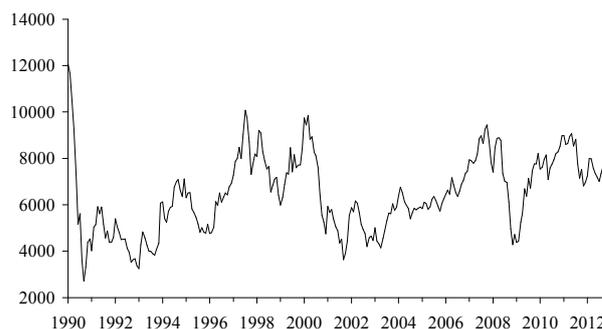
Taiwan

Taiwan's first official gauge of manufacturing activity kindled hopes of a faster recovery for the export-reliant island in 2013. Its manufacturing Purchasing Managers Index rose to 49.6 in November from 46.7 in October, moving closer toward expansionary territory. The government expects GDP to grow 3.15% in 2013, up from 1.13% in 2012, on expectations for a rebound in demand for exports.

Since Taiwan's President Ma Ying-jeou took office in 2008, Taiwan's relationship with China has improved significantly. The two have signed nearly 20 trade and investment pacts, started direct flights between Taiwan and the mainland and made Taipei the first market outside Hong Kong, able to clear renminbi transactions.

Under Mr Ma, many of the regulations that limited Chinese investment in Taiwan or imposed tariffs on Taiwanese goods shipped to China, have been loosened or are under

Taiwan: Weighted TAIEX Price Index



negotiation. Remaining restrictions, such as limits on mainland investment in Taiwan property, are seen as too complicated or politically fraught to change for now. No elected leader would dare to change these laws in a hurry.

	09	10	11	12	13
GDP (%p.a.)	-1.9	10.8	4.0	1.1	2.0
Inflation (%p.a.)	0.0	1.3	1.2	2.0	1.3
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 economy grew a meagre annualised 2.4% in the third quarter, dashing hopes that loose monetary policy and tax breaks could spark a rebound. Brazil's services sector, once the strength of the overall economy, stagnated in the third quarter, and could not offset slow growth in agriculture and industry. The finance sector posted its worst performance since the 2008 financial crisis amid shrinking banking spreads and record overdue payments.

Brazil's efforts to spark growth also haven't resulted in the expected pickup in investments. Fixed capital formation fell 2% in the third quarter, the fifth-consecutive quarterly decline. That left investment at 18.7% of GDP, well below the 22% of GDP target necessary to reach the government's 4% growth target.

Brazil offers huge opportunities for investors as it embarks on infrastructure investments estimated at about \$1trillion, in its preparations to host the World Cup in 2014 and the Olympics two years later. But, loose monetary policy could help the industry to grow 1.1% only in the third quarter of 2012. This too was largely on the back of tax cuts that boosted auto sales.

The government has several grand projects planned, such as expanding Brazil's ports and replacing the power grid. But the state's heavy hand also is part of the problem. Brazil's power supply is also facing power shortages due to an aging power grid — the power lines, transformers and other channels to bring electricity to its users.

In order to maintain export competitiveness without affecting inflation, the government is keen to keep the real trading between BRL2.00 and BRL2.10 to the dollar. Since Nov. 30, the real has strengthened about 4% against the dollar, as the central bank has made a concerted effort to prevent the Brazilian real from weakening further. The central bank sold \$1.85 billion through two currency swaps in the futures market in the last week of December. The central bank expects inflation to end 2012 at 5.7%, before easing back to 4.8% in 2013.

The government's foreign exchange policy has responded to trends in inflation and economic growth in the recent years. Weaker growth prompted a move by the

administration of President Dilma Rousseff to weaken the currency, as it helps drive up demand for Brazilian exports. In late 2010 and early 2011 it started introducing targeted capital controls to prevent dollars flowing into the country. Together with disappointing economic growth and a hefty cycle of interest rate cuts by the central bank, there's been a clear impact. Inflows into Brazil have declined to \$16.4 billion in 2012, down from \$65.3 billion in 2011, according to the central bank.

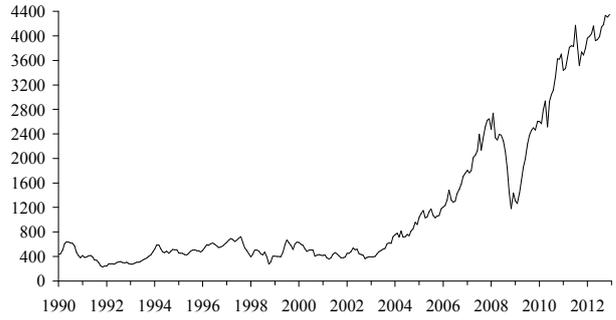
	09	10	11	12	13
GDP (%p.a.)	-0.2	7.5	2.7	1.5	3.7
Inflation (%p.a.)	4.1	5.9	6.5	5.5	5.5
Current A/c(US\$ bill.)	-20.0	-47.3	-52.6	-60.0	-65.0
Real/\$ (nom.)	1.8	1.7	1.5	2.0	2.0

Other Emerging Markets

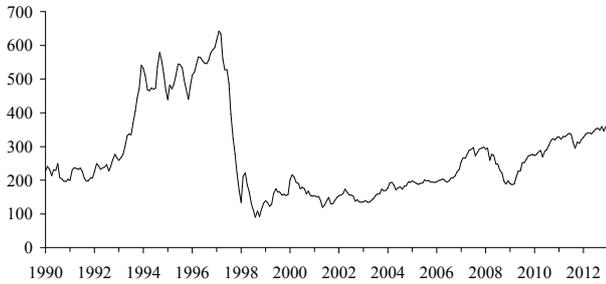
Hong Kong: FT-Actuaries



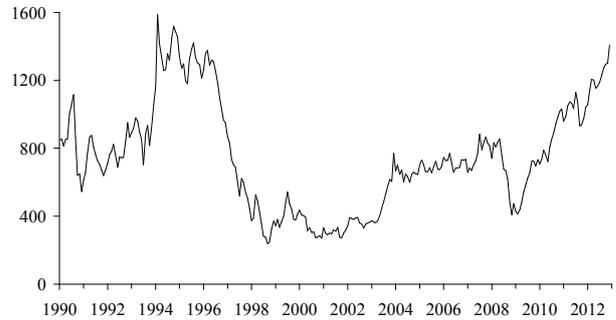
Indonesia: Jakarta Composite



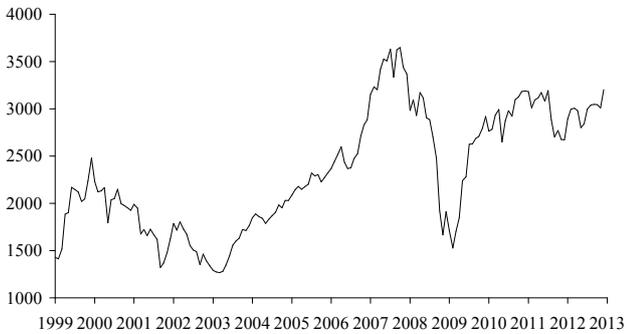
**Malaysia: FT-Actuaries
(US\$ Index)**



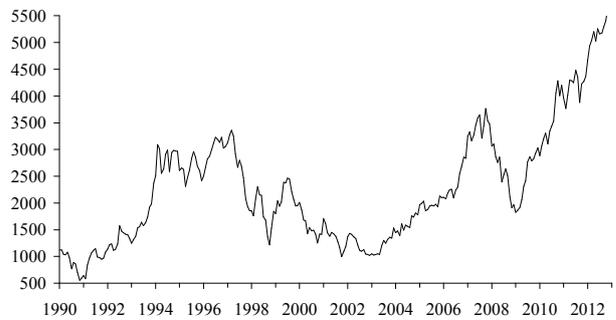
Thailand: Composite Index



Singapore: Straits Times Index

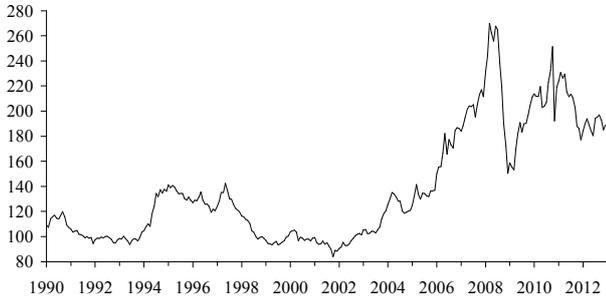


Philippines: Manila Composite

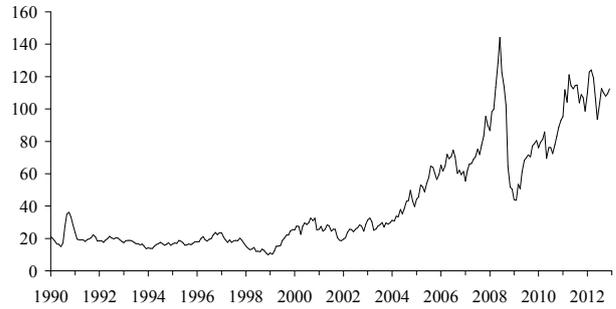


COMMODITY MARKETS

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



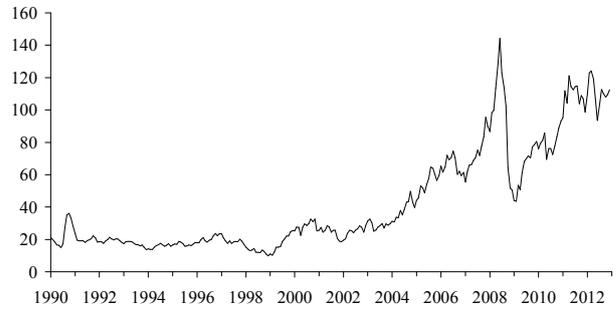
Oil Price: North Sea Brent (in Dollars)



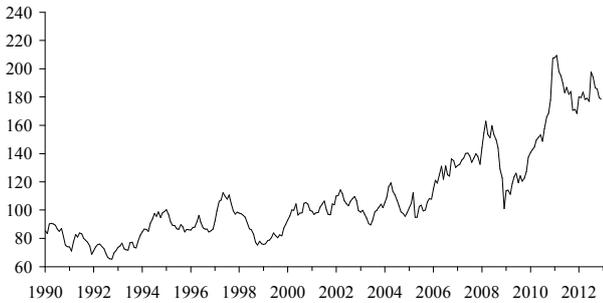
Commodity Price Index (Sterling)
(Economist, 2000=100)



Oil Price: North Sea Brent (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	1.9	0.9	79.9	92.4	-2.5	5.3	-0.8
2012	2.8	0.8	0.9	81.7	95.4	-2.0	3.5	-1.8
2013	2.8	1.3	0.9	81.5	95.7	-1.8	2.9	-1.2
2014	2.5	1.6	1.4	81.0	95.6	-1.3	2.7	-0.9
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	-0.5
2011:3	3.7	1.6	0.9	79.2	91.5	-2.7	5.3	-1.1
2011:4	3.6	1.2	1.1	80.2	93.0	-1.5	5.3	-1.4
2012:1	2.6	1.0	1.1	81.1	94.3	-2.0	3.8	-1.6
2012:2	3.1	0.9	1.1	82.3	96.1	-1.8	3.6	-1.7
2012:3	2.9	0.6	0.8	81.9	95.7	-2.1	3.3	-2.0
2012:4	2.9	0.8	0.6	81.6	95.6	-2.3	3.2	-1.8
2013:1	2.9	1.0	0.8	81.5	95.5	-2.0	3.0	-1.5
2013:2	2.8	1.2	0.9	81.3	95.4	-1.9	2.9	-1.3
2013:3	2.8	1.4	0.9	81.7	96.0	-1.8	2.8	-1.1
2013:4	2.7	1.5	1.0	81.4	95.9	-1.5	2.8	-1.0

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 Product¹ (£ 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	144.9	693847.1	401772.6	254854.4	182833.9	-32881.9	112731.9
2013	147.8	707754.8	407982.4	260043.9	187329.0	-33205.7	114394.8
2014	151.2	724033.2	417155.4	265696.3	191131.8	-33153.8	117140.3
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	0.1		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	145.3	173912.8	100386.7	66094.5	45669.6	-8309.4	29928.6
2012:4	146.0	174782.3	101111.5	65150.2	45911.6	-8310.0	29081.0
2013:1	146.7	175568.8	101483.0	62722.2	48586.9	-8307.4	28915.9
2013:2	147.4	176446.7	101479.0	66229.2	45693.1	-8302.0	28652.6
2013:3	148.2	177381.8	101989.4	65774.3	46384.9	-8301.7	28465.1
2013:4	149.0	178357.4	103031.0	65318.2	46664.1	-8294.5	28361.4

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)	Debt Interest (£bn)	Current Account (£ bn)
	Financial Year				
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	0.1	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

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	2.8
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

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	-2.0	-1.8
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

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	0.9	0.9
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

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	-0.8	-1.8	-1.2
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

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	1.9	0.8	1.3
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

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.

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