LIVERPOOL INVESTMENT LETTER

March 2013

Cardiff Business School
Cardiff University

Julian Hodge Institute of Applied Macroeconomics

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, 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 David Meenagh and Bruce Webb and published on behalf of the group by Liverpool Macroeconomic Research Limited, which holds the copyright

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BRITAIN'S SUPPLY-SIDE PROBLEMS AND CURRENT MONETARY POLICY

It should be reasonably clear by now that the UK has slow growth for 'fundamental' or 'supply-side' reasons. First, the huge rise in raw material prices has impoverished us. Since the Bank of England has done little to stop this raw material inflation passing through into consumer prices, a rough measure of how much living standards have been driven down by this is provided by the cumulated excess of inflation over the 2% target since 2006, which is 7% (2006–2013, assuming inflation this year is 2.8%). This is probably the biggest element in causing the drop in real income; a terms of trade adverse movement of this size is just like a fall in productivity. Essentially it means that, for the economy not to spend permanently more than its income, spending must drop by this amount. Notice that this cannot be offset by higher demand from, say, government because it is permanent; any attempt to do so would lead to excess international borrowing and hence solvency problems.

Along with this there is a consequent fall in output, as permanently lower demand deprives various home-focused industries of their market: housing is the most obvious but other industries particularly affected by high material costs are also hit, notably transportation and travel. Hence we notice that certain sectors, such as volume cars and housebuilding, have great excess capacity. But since demand cannot be stimulated in a general way, this excess is 'structural' and has to be disposed of by accelerated depreciation. This is no doubt why measures of relevant 'excess capacity' (i.e. in other sectors where there is not the structural collapse) are small.

Then we come to the collapse of the UK's two most productive sectors, North Sea oil and banking. This collapse appears to account for the bulk of the fall in labour productivity since the crisis. Both collapses are partly due to circumstances — with the North Sea, exhaustion of extractable reserves and with banking, the crisis itself — and partly due to government actions. With the North Sea our governments have been 'time-inconsistent', constantly changing the rules to squeeze extra income out of the industry; the extractive oil and gas industry no longer has much confidence that any further exploration/extraction efforts will not be milked by our Treasury. With banking, the Coalition government has, as I have argued repeatedly, over-reacted in its new regulative agenda while also failing to restore bank competition; hence the industry is contracting sharply — an avoidable disaster.

Finally, we come to the main side-effect of the banking collapse — the fatal blocking of the credit channel. This is another 'structural' element in our economic situation which is turning out to be non-remediable by monetary means; no amount of QE and bureaucratic schemes like Funding for Lending has loosened this constraint because of course the regulations create massive incentives for bank contraction.

Table 1: Summary of Forecast

		2010	2011	2012	2013	2014	2015	2016
GDP Growth[1]		1.8	0.9	0.1	1.5	2.0	2.4	2.6
Inflation	CPI	3.7	4.7	2.8	2.8	2.6	2.2	2.0
	RPIX	4.8	5.3	3.3	3.3	3.1	2.8	2.7
Unemployment (Mill.)								
	Ann. Avg.[2]	1.5	1.5	1.6	1.5	1.4	1.3	1.2
	4th Qtr.	1.5	1.6	1.6	1.5	1.3	1.2	1.1
Exchange Rate[3]		80.4	80.0	83.0	83.5	82.7	82.1	81.5
3 Month Interest Rate		0.7	0.9	0.9	0.9	1.7	2.1	2.2
5 Year Interest Rate		2.4	2.0	0.9	1.3	1.8	2.1	2.4
Current Balance (£bn)		−37.3	−20.4	−51.9	−52.2	−52.8	−53.0	−52.0
PSBR (£bn)		115.1	94.2	95.4	98.2	84.7	72.2	60.5

[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)

So, like it or not, our situation is one of weak growth forced on us by fundamental constraints. Only supply-side action can change this situation. Apologists for 'demand stimulus' argue that the government could spend more on infrastructure, which is true as borrowing against good long-term projects is not difficult and does not undermine solvency. However infrastructure projects are held up by planning and political hurdles, not particularly by lack of funds. Other apologists point to the effect of the Second World War in stimulating output. Of course a war changes an economy's structure towards the production of armaments and military consumption and a one-industry state can commandeer the means of production and force them to operate a high capacity. But in peacetime the economy is diverse and structural/supply-side issues have to be solved by peace-time policies to get the resources into the right places and permit growth based on market forces.

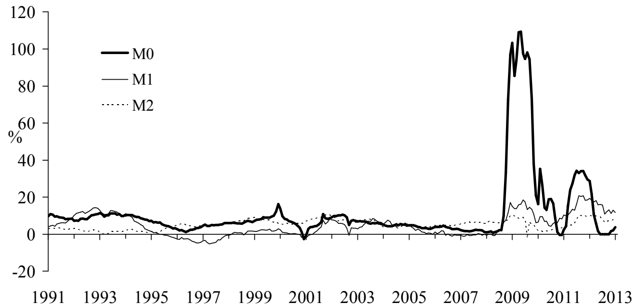
Where does this leave monetary policy? In a difficult place. More QE and ultra-low interest rates is doing nothing to change growth, as one would expect. It is in fact massively distorting the market for savings by creating a privileged borrower, HM Treasury, at the expense of those committed to lending to it (e.g. for pension reasons). It is also subsidising bank profits on their existing balance sheet (by giving banks a large arbitrage profit on the bank reserves produced by QE); and through this subsidy it is distorting credit supply in favour of large existing firms, which seem like 'zombies' to be on bank life-support. It is time to put an end to these distortions and return to a realistic monetary policy that understands its limited capability.

If the government wants to stimulate money and credit, then it should look to the serious loosening of the new regulative framework and also a renewed push for bank competition, perhaps by break-ups of the large Treasury bank holdings into several smaller banks. In my view the ring-fencing debate is an irrelevancy and an intrusion into industrial structure (banks argue persuasively that they need to be able to fulfil multiple functions); what matters is the number of banks and the competition they engender, which has been curbed sharply by the new cartelised set-up.

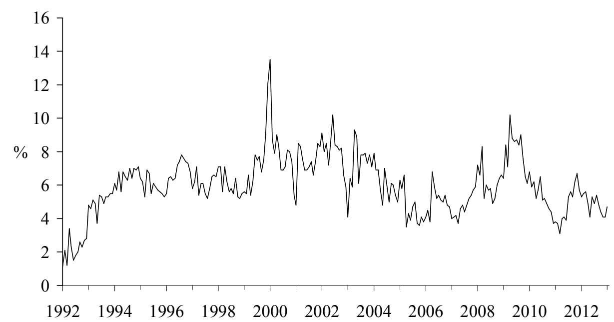
Of course if the government did succeed in this loosening up, the huge overhang of QE would be an inflationary threat as existing bank reserves would be rapidly converted into credit expansion. Far better therefore to unwind this programme while there is still no threat, because the banks are immobilised by regulation.

We recommend a rise in interest rates by 0.5%, no further QE, and a programme to unwind QE, while raising rates to normal levels, over the next two years. However, on present form, none of these will happen in the foreseeable future. Hence it looks as if the UK will continue as a low growth economy with a weak exchange rate and an inflation rate of 3% or more. This will contrast with some improvement in the US situation and an increasingly confident Germany where there is less desire to kick the banks and the success of the Hartz reforms has encouraged the reform agenda.

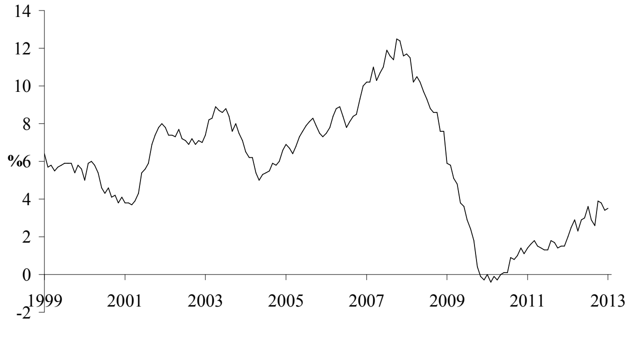
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



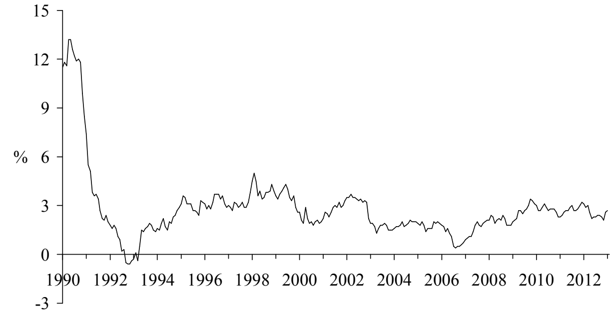
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Abe's growth strategy amid economic recession

Earlier this month, the Japanese government announced that GDP for the October–December period decreased 0.1% in real terms from the previous quarter. The contraction was not a huge surprise, but it represents the third straight quarter of decline, following the −0.1% and −1.0% readings in the second and third quarters respectively — those falls wiped out the sharp rise in the first quarter of 2012. Looking at demand components, earthquake reconstruction is clearly evident in the solid rise in both public investment and housing construction which increased 1.5% and 3.5% from the previous quarter, respectively. But this has been offset by the weakness in private business investment, which fell by 2.6% from the previous quarter for the fourth consecutive quarterly fall, and in net exports, which declined by 3.7%.

In a statement accompanying the data, Economics Minister Akira Amari said that recovery is expected soon, despite the disappointing data. "Japan's economy may show some weakness for the time being. But it is likely to resume a moderate recovery thereafter due to the Bank of Japan's (BOJ) monetary easing, the effect of an emergency economic package, as well as an expected moderate recovery in the global economy", Amari said. The same day, the BOJ policy board upgraded its assessment of the economy, saying it "appears to have stopped weakening". In January, the nine-member board had said the economy "remains relatively weak". Indeed, more up-to-date indicators — the January readings on consumer confidence from the Economy Watchers' Index, for example — clearly show the lift in sentiment.

A widespread consensus has also emerged among observers that the economy will slowly recover this year, thanks to the help of bolder monetary and fiscal stimulus and an improving global economy. They noted that much has changed since the administration of Shinzo Abe, prime minister, took power in December. Even Paul Krugman, the Nobel Prize-winning economist and a long-time critic of the Japanese leading class, has been singing the praises of Japan's new prime minister. The reason is a group of economic policies, known as Abenomics, planned at forcing Japan's economy out of deflation and serial recession.

Abe's proposal is being presented in Japanese symbolism as a "three arrows" strategy: bold monetary policy, flexible fiscal policy and growth strategy. His government has launched a ¥10.3 trillion supplementary stimulus package for new infrastructure and upgrades over the next 15 months, one of Japan's largest ever, and has pushed the BOJ into a more aggressive policy of fighting deflation with a higher inflation target. So far these steps have had the effect of significantly weakening the yen which has plunged 17% against the dollar and more against the euro since its high in November last year. As a result, many companies that depend heavily on foreign sales, such as carmakers, have raised their profit forecasts for the Japanese accounting year through March.

"Schools and roads would be fixed and flood and earthquake defences reinforced", Abe said. "There would be new money for scientific research and renewable energy". However, Japanese governments have a notoriously poor record at spending on infrastructure. Japan is dotted with engineering wonders — the world's longest suspension bridge, the world's longest undersea rail tunnel and the world's largest underground flood control system. In the 1990s, Japanese governments spent over a trillion dollars trying to build their way out of trouble. It did not work.

And now Abenomics may not work either, because Japan already has so much debt — Japanese government debt is the biggest in the developed world, around 230% of GDP — and because of the risk that public spending will be directed to unproductive infrastructure once again. To return to stable, relatively rapid growth, Japan's economy and markets must become more flexible and competitive. Government restrictions, anticompetitive and onerous laws and regulations, multi-tiered, bureaucratic interference and inflexibility, relatively high taxes; all these obstacles to free market exchange and competition have sapped profitability, international competitiveness, and growth from vast swaths of Japan's economy. If these obstacles cannot be substantially lowered or removed it is hard to see how Japan can avoid further economic marginalization and stagnation — Japan has had three recessions in the last six years and counting isolated quarters of decline the country has spent 13 of the last 24 quarters in contraction.

Abe's third arrow was thrown recently with the revival of the Council for Regulatory Reform, a body that had been kept dormant for about three years while the Democratic Party of Japan was in power, and the launch of two new councils, the Council on Economic and Fiscal Policy and the Industrial Competitiveness Council. Much fanfare and hope attended the inaugural meetings of these two new councils which are expected to deliver a stream of policy proposals by the end of June, aimed at revitalized economic and business sentiment.

However as we have seen over the past five to six years, few noticeable achievements have been made as the focus of reform has shifted to agriculture, medical care, education, legal work, employment and other fields where vested interests have put up fierce resistance. Scrums formed by vested interests — which are eager to prevent new players onto their business turf — that have regulatory offices and legislators representing them, have become the bedrock of resistance to reforms. Because it is difficult to shatter the bedrock, Abe must keep a watchful eye on these groups through the council so that his ministers will take the initiative in implementing the reforms needed. However, it is not really possible to be at all optimistic that liberalisation will occur, so powerful is the conservative force of these interests in Japanese politics.

MARKET DEVELOPMENTS

As the world is awash with money, even though the western countries' credit channels are partly blocked , world growth is picking up and the equity markets have done fairly well. Government bonds of the US and the UK have proved fairly immune to downgrades as they, with Germany, remain havens of security. However it is highly unlikely they can appreciate in price and there is a risk of a sell-off if inflation takes more of a hold. Therefore it continues to be the case that equities, especially in emerging markets, are the only game in town.

Table 1: Market Developments

	Market Levels		Prediction for Feb/Jan 2014	
	Jan 31	Feb 27	Previous Letter	Current View
Share Indices				
UK (FT 100)	6277	6326	8876	8945
US (S&P 500)	1498	1516	1685	1705
Germany (DAX 30)	7776	7676	9658	9533
Japan (Tokyo New)	940	954	1078	1094
Bond Yields (government long-term)				
UK	2.11	1.96	1.80	1.80
US	1.98	1.90	4.00	4.00
Germany	1.69	1.47	4.00	4.00
Japan	0.75	0.67	1.50	1.50
UK Index Linked	–0.28	–0.28	–0.40	–0.40
Exchange Rates				
UK ($ per £)	1.59	1.51	1.58	1.58
UK (trade weighted)	80.9	78.8	83.1	83.1
US (trade weighted)	82.5	84.4	80.5	80.5
Euro per $	0.74	0.76	0.79	0.79
Euro per £	1.17	1.15	1.25	1.25
Japan (Yen per $)	91.3	91.6	81.0	81.0
Short Term Interest Rates (3-month deposits)				
UK	0.59	0.59	1.30	1.30
US	0.37	0.23	0.60	0.60
Euro	0.18	0.15	2.50	2.50
Japan	0.13	0.14	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	3.40	1.8	2.6	37.00		44.80
US	2.00	2.5	2.0	8.00	–4.43	14.88
Germany	3.10	1.5	1.7	21.00	–8.12	20.51
Japan	2.00	1.7	0.0	13.00	7.66	28.32
UK indexed[2]	–0.28		2.6	–8.00		–5.68
Hong Kong[3]	2.30	7.5	2.0	–5.00	–4.43	6.08
Malaysia	3.10	4.5	2.0	32.00	–4.43	41.98
Singapore	3.30	2.9	2.0	4.00	–4.43	12.58
India	1.50	6.5	2.0	3.00	–4.43	12.28
Korea	1.10	3.5	2.0	–21.00	–4.43	–14.02
Indonesia	2.10	6.4	2.0	29.00	–4.43	40.98
Taiwan	3.30	3.2	2.0	19.00	–4.43	28.98
Thailand	2.60	4.2	2.0	19.00	–4.43	29.28

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	2.11	3.10		5.21
US	1.98	–20.20	–4.43	–17.84
Germany	1.69	–23.10	–8.12	–28.20
Japan	0.75	–7.50	7.66	4.87

Deposits: Contribution to £ yield of:

	Deposit Yield	Currency	Total
UK	0.59		0.59
US	0.37	–4.43	0.75
Euro	0.18	–8.12	–6.61
Japan	0.13	7.66	11.75

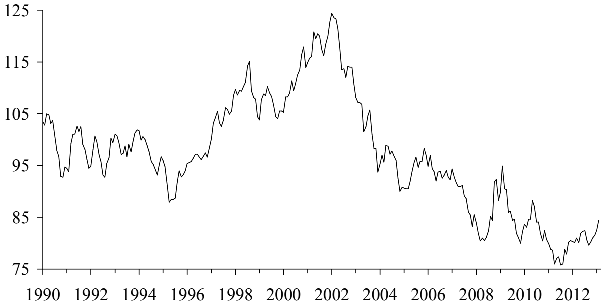
[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

Table 3: Portfolio(%)

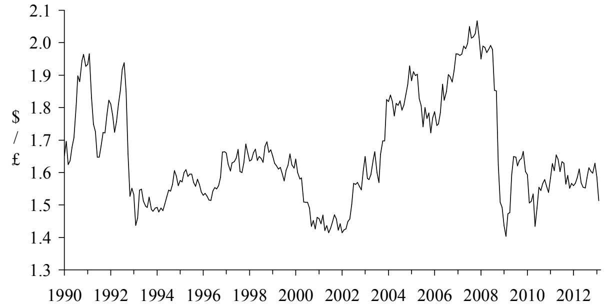
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	February Letter	Current View	February Letter	Current View	February Letter	Current View
UK Deposits (Cash)	5	5	5	5	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-	-
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

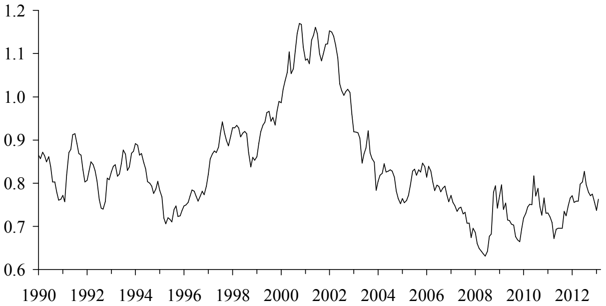
US : Trade Weighted Index
(Bank of England 1990 = 100)



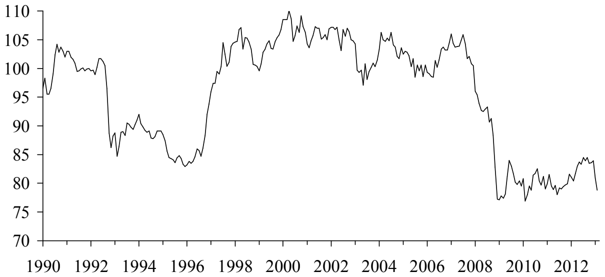
UK: Dollars Per Pound Sterling



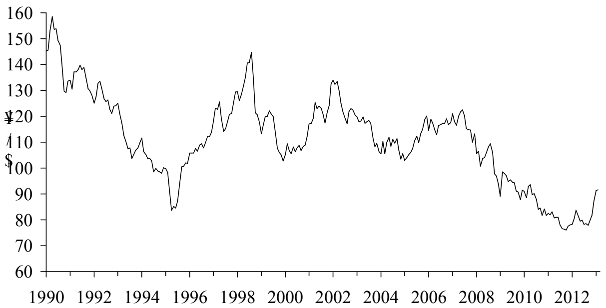
Euro per US dollar



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

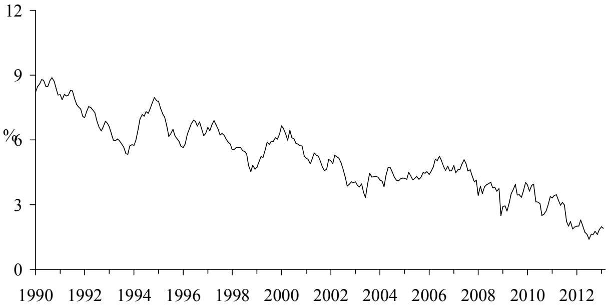


Japan : Yen Per U.S. Dollar

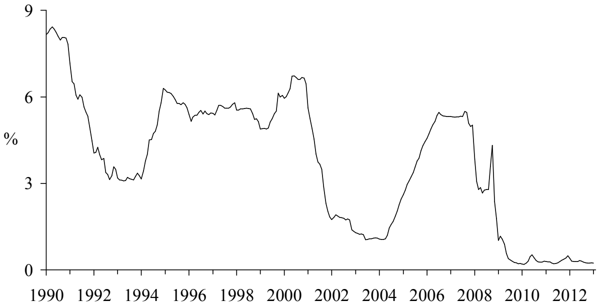


GOVERNMENT BOND MARKETS

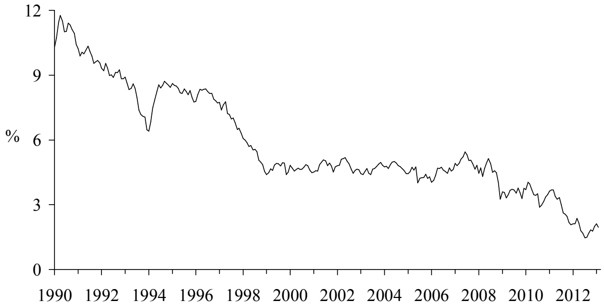
U.S.: Yield on Long-Term Government Bonds



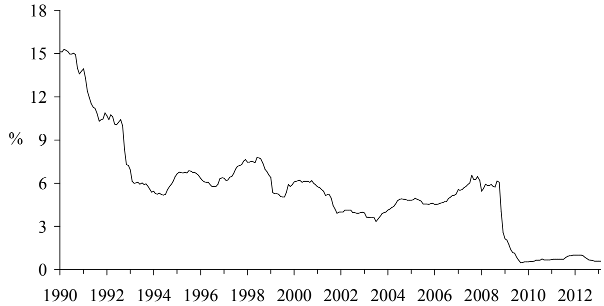
U.S. : 3-Month Certificate of Deposit



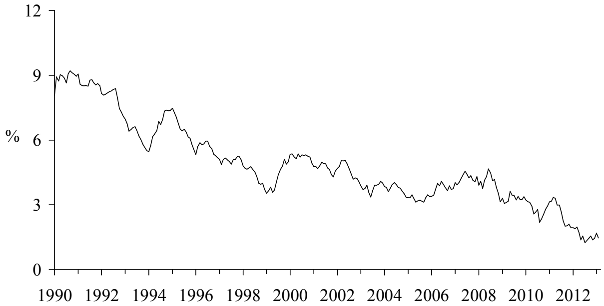
U.K. : Yield on Long-Term Government Bonds



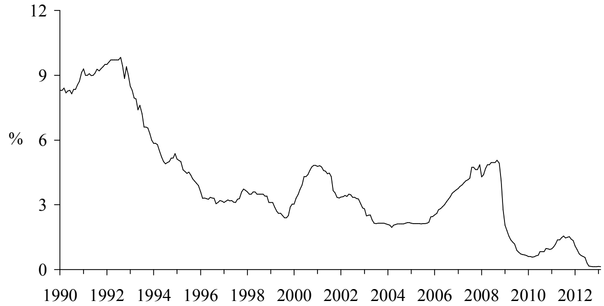
U.K. : 3-Month Interbank Rate



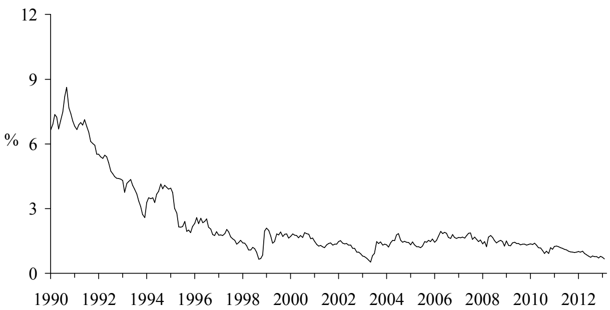
Germany: Yield on Public Authority Bonds



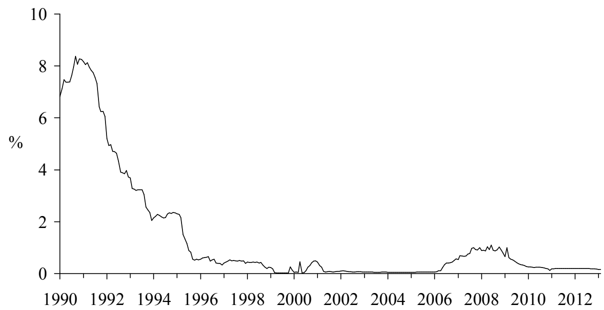
Germany : 3-Month Interbank Deposit Rate



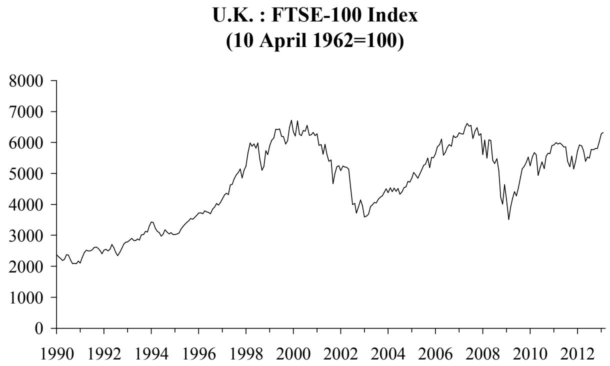
Japan: Yield on Long-Term Government Bonds

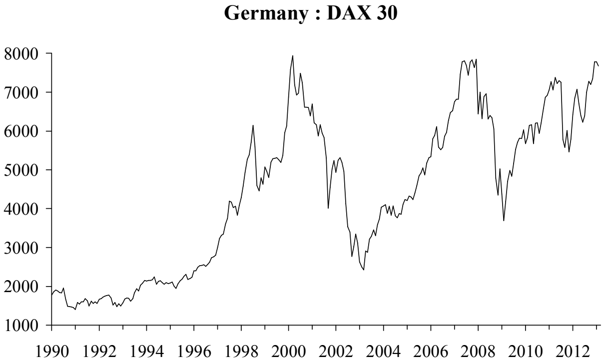


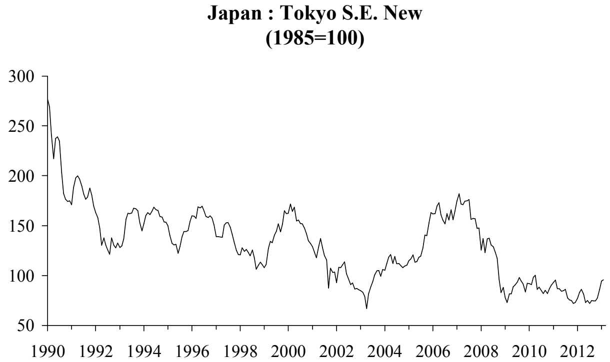
Japan : 3 Month Money Market Rate



MAJOR EQUITY MARKETS







EMERGING MARKETS

Anupam Rastogi

India

India's economic growth has slowed to its weakest in a decade and the government's finances are in tatters. With this background, Finance Minister Palaniappan Chidambaram presented the budget for the fiscal year starting April 1, 2013 on February 28.

Since September the government has taken steps such as increasing the price of heavily subsidized diesel and limiting the supply of cooking gas sold at discounts to reduce subsidy expenses. But Mr Chidambaram has allocated money to a new food-security program which seeks to supply food grains at nearly throwaway prices to about 70% of India's 1.2 billion people. S&P has warned that there was potential for the government to exceed its budgeted spending and thus, as there is little progress in structural reforms, potential for the credit rating of India to be downgraded to junk status. In simple words, populist measures such as job guarantee schemes to villagers, food-security programmes and other national level programmes introduced by the government will remain a drain.

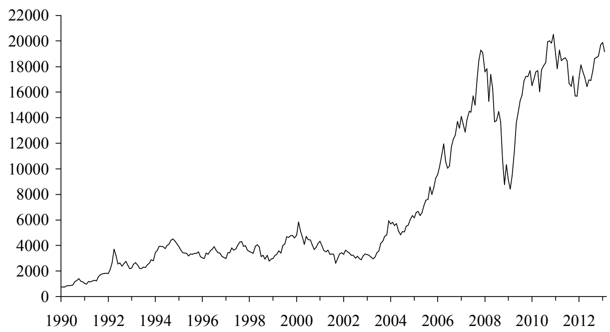
The new budget calls for India to spend 17% more on education and vocational training; 22% more on agriculture, and 24% more on health. It also sets aside an additional $1.8 billion for food subsidies as part of the Congress-led government's scheme to ensure food security and battle pervasive malnutrition, especially in remote rural areas.

This additional revenue would come in part from a 10% surcharge on the 42,800 Indian taxpayers who reported taxable income of more than Rs100 million ($1.8 million) last year. Mr Chidambaram said that the tax surcharge, which is also applicable to companies, would apply for just one year. Not surprisingly, the market gave a thumbs down to the budget and the BSE Sensex closed 1.52% lower on February 28. The finance minister has kept his promise to keep the fiscal deficit to 4.8% on an assumed growth rate of 6.8%. However, the government expects GDP growth this fiscal year to be as slow as 5.0%. Growth is expected to pick up to around 6.5% next year.

India's wholesale inflation in January slowed to 6.62%, the lowest in more than three years, but it still remains well above the 5% that is the Reserve Bank of India's target. This easing in inflation has added demands from industry lobby groups for the central bank to lower interest rates.

India's trade deficit widened in January as a small increase in exports was overshadowed by faster growth in imports. The trade gap widened to $20.0 billion from $17.7 billion in December and $17.6 billion a year earlier. Exports grew for the first time in nine months — by 0.8% to $25.5 billion. Imports expanded at a far quicker 6.1% to $45.58 billion, driven by oil imports which rose 6.9% from a year earlier to $15.9 billion. India's current account deficit has never been higher, hitting a record 5.4% of gross domestic product in the quarter to the end of September last year.

India: BSE Sensitive



All eyes are now set for the general election which is 12-14 months away.

British Prime Minister David Cameron led a delegation of more than 100 businessmen, education specialists and parliamentarians to expand business and trade relationships between India and the UK. Several British banks and insurance companies have businesses in India, but their operations are limited by New Delhi's policies such as caps on new branch licenses and investment.

	10-11	11-12	12-13	13-14	14-15
GDP (%p.a.)	7.5	6.2	5.0	6.5	6.5
WPI (%p.a.)	9.0	7.5	7.0	6.8	6.0
Current A/c(US$ bill.)	-31.0	-40.0	-80.0	-60.0	-60.0
Rs./$(nom.)	49.0	49.5	54.5	55.0	54.0

China

China's growth slowed to 7.8% in 2012, after growth rebounded in the final quarter of 2012, down from 10.4% in 2010 and above the official target of 7.5% for the year. An initial gauge of Chinese manufacturing activity showed a sharp deceleration in February because of weakness in global demand for the country's exports, raising concerns over the momentum of recovery in China.

While China's consumer price index in January was up 2% from a year earlier, slowing from December's 2.5% rate, we expect inflation to start creeping up later in the year if the Chinese economy recovers further and global raw-material prices also crawl up.

China's current-account surplus shrank to 2.6% of GDP in 2012 and its financial account has swung into deficit as funds flow out of the country. The yuan's pronounced rise against the dollar — a central bank initiative — has been key in reducing the surplus as a percentage of GDP.

Exports climbed 25% after a 14.1% rise in December, while imports jumped 28.8%, well ahead of the previous month's 6% increase, according to customs data. Both figures after adjusting for the lunar year holidays were up 12.4% and 3.4% respectively. In absolute terms, China's current-account surplus rose slightly to $213.8 billion in 2012 from $201.7 billion a year earlier, but it is the ratio of the surplus to total GDP that is the most meaningful. China has swung to a $117.3 billion capital and financial-account deficit, from a $221.1 billion surplus in 2011.

Since 2008, China's total public and private debt has exploded to more than 200% of GDP — an unprecedented level for any developing country. The country has to deal with this at some point of time. To begin with, the banks have been asked to restrain from giving further credit to the housing sector.

China's transformation to a domestic-consumption growth oriented economy is underway. Private and government consumption together accounted for more than half of China's output growth in 2011–12, signalling a big shift in the composition of domestic demand. Physical capital investment, the main driver of growth over the previous decade, is no longer the dominant contributor to growth. As for exports, a shrinking trade balance has, in fact, dragged down growth in the past two years. Its trade and current account surpluses have shrunk steadily and markedly relative to their peaks in 2007, when they hit 7.6% and 10.1% of gross domestic product, respectively. In 2012, both of these surpluses were below 3% of GDP.

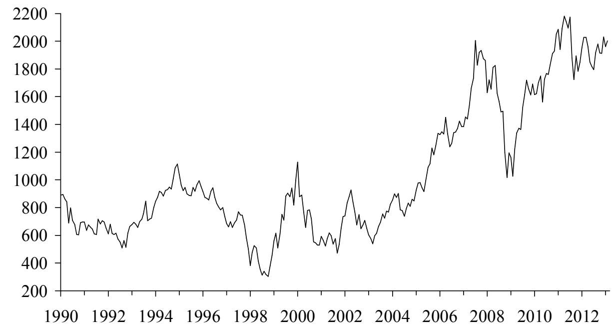
The White House has threatened China and other countries with trade and diplomatic action over corporate espionage cases. On-going efforts by China to make renminbi a world currency got a boost as the IFC has issued its first discount note denominated in the Chinese currency. Further, the Bank of England is in discussions to set up a renminbi–sterling currency swap agreement with the People's Bank of China to spur trade and investment between the two countries and to ensure that London remains a leading offshore hub for renminbi trading. China has set up an estimated 20 swap lines with other countries, including Australia, Singapore, Japan, Malaysia and New Zealand, as part of its efforts to internationalize its currency.

	10	11	12	13	14
GDP (%p.a.)	10.3	9.2	7.8	8.0	7.5
Inflation (%p.a.)	5.9	4.3	2.6	3.5	3.0
Trade Balance(US$ bill.)	183	210	214	220	220
Rmb/$(nom.)	6.6	6.3	6.3	6.2	6.1

South Korea

The central bank slashed its growth forecasts for the country from 3.2% to 2.8% for 2013, while expecting 3.8% growth for 2014. The bank does not expect South Korea's economy to deteriorate further, but the fiscal troubles in advanced nations continue to create downside risks for the Korean economy.

Korea: Composite Index



The central bank kept its benchmark interest rate steady at 2.75% for a fourth consecutive month in February and noted that Japan's expansionary monetary policy posed a challenge for Asia's fourth-largest economy. The bank had cut rates in last July and October. The bank will hold its next rate review meeting on March 14.

Inflation remains subdued and well below the BOK's target range of 2.5%–3.5%. The government has frontloaded about 70% of the 2013 budget spending to the first half of the year, but incoming President Park Geun-hye is expected to expand fiscal spending to boost economic growth.

Bank of Korea Governor Kim Choong-soo said that the central bank is closely monitoring the impact of Japan's policy stimulus on South Korea's economy, and that he hopes that Japan's government won't deliberately try to weaken the yen following the G20's pledge to abstain from such tactics. South Korean exporters compete closely with Japan's and had pressed for talks on the yen at the G20 conference as part of a planned discussion about the effects of global monetary easing.

Seoul, however, wants to remain a passive spectator because the weaker yen may be partly offset by other factors. For instance, South Korean exporters may be among the biggest beneficiaries of Japan's political spat with China that is denting demand for Japanese autos and other products in Asia's largest economy. Also, the weaker yen has raised energy costs for Japanese manufacturers. After the Fukushima natural disaster most of Japan's nuclear facilities are closed and Japan has become increasingly energy-dependent on shipments of liquefied natural gas from overseas. This implies that increase in external demand from the U.S. and China would boost Korean exports.

South Korean President Park Guen-hye begins her term as the country's economy is slowing. She used her inauguration speech to address one of the challenges to her rule: the perception that government and the nation's businesses are stifling many South Koreans' chances for wealth and success. She also addressed perceptions that government regulations show favouritism to the large conglomerates that dominate the economy and said she would end "the misguided habits of the past which have frustrated small business owners."

More than political decisions, what is going to have a far reaching impact on the Korean economy is an ultralow birth-rate and other demographic conditions. By the end of Ms. Park's single five-year term in 2018, the size of South Korea's eligible workforce population will have begun to decline.

	10	11	12	13	14
GDP (%p.a.)	6.3	3.6	2.0	2.8	3.0
Inflation (%p.a.)	2.9	4.0	2.2	2.5	2.8
Current A/c(US$ bill.)	28.2	27.0	44.0	28.0	28.0
Won/$(nom.)	1150	1100	1100	1100	1050

Taiwan

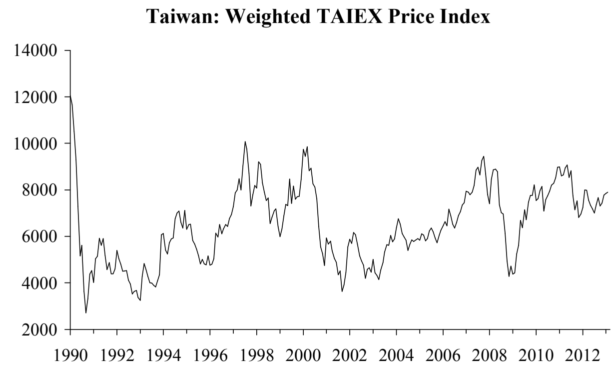
Taiwan's GDP growth accelerated in the fourth quarter of 2012, backed by strong domestic demand and external trade. Taiwan also revised its growth expectations for 2013, citing a possible sharp recovery in exports, which may be short-lived as the recovery is contingent on a stabilizing Europe and recovering Chinese demand. Their revised GDP forecast for 2013 is 3.53% from a previously predicted 3.15% growth. Leading indicators, such as export orders and the purchasing manager's index, also show a trend toward improvement in Taiwan's manufacturing sector.

The consumer price index is forecast to rise 1.31% this year, slower than the 1.93% rise last year.

The statistical agency expects that exports would benefit from growing demand for its electronic products. Taiwan's exports are expected to grow 5.85% this year. The island's export-reliant market has been in doldrums since the onset of the euro-zone crisis in 2010. The slower-than-expected recovery in the U.S., along with weakening China demand and stiff competition from South Korea's booming tech industry, have stunted Taiwan's exports, which were down 2.3% in 2012 from the previous year. The unemployment rate remains high by Taiwan standards, above 4%, and wages have been stagnant for a decade

Taiwan's seasonally adjusted exports grew by 5.2% in January. The finance ministry expects exports to go up by 6.23% year on year to US$319.9 billion, while imports will increase 7.12% to US$290 billion.

Taiwan is keenly watching Japanese Prime Minister Shinzo Abe's push for a weaker yen and unlimited monetary easing in Japan. The New Taiwan dollar has gained about 12% against the yen since mid-November. The competitiveness of Taiwan's exports will take a much



bigger hit if the won starts tracking the yen lower, which is a strong possibility in the near term.

President Ma's popularity has hit rock bottom. Re-elected in January 2012 with 51% of the vote, he now has an approval rating of only 13%. Any cabinet changes are unlikely to affect the continuing economic cooperation and warming ties between Beijing and Taipei as long as President Ma, who is considered China-friendly, remains at the helm. A reshuffle would let Mr. Ma respond to his declining popularity and doesn't suggest there will be drastic changes in domestic or diplomatic policies.

	10	11	12	13	14
GDP (%p.a.)	10.8	4.0	1.3	3.0	3.2
Inflation (%p.a.)	1.3	1.2	1.9	1.3	1.5
Current A/c(US$ bill.)	16.0	18.0	20.0	22.0	23.0
NT$/$(nom.)	31.0	30.0	29.5	29.5	29.0

Brazil

Brazil's economy expanded at a slightly slower pace in December and the GDP grew 0.6% in the third quarter from the second quarter. The central bank expects the country's economy to grow 3%–4% in 2013, up from about 1% last year. We expect the economy to grow by 3.6% this year.

The consumer prices index rose 0.86% compared with December, representing an annualized growth rate of 6.15%. This has raised concerns that Latin America's largest economy is heading towards stagflation. The government and the central bank are keeping a close watch on inflation, and in mid-February, the 12-month figure came in at 6.18%, close to the upper limit of the central bank's target range of 2.5% to 6.5%.

No one expects the central bank to raise rates from their record low of 7.25% when the central bank policy makers meet in the first week of March, but the bank could signal in its monthly policy statement that it is considering rate increases in the future if inflation remains a problem. The central bank may increase the Selic by 0.25 percentage point in April, May and July if the inflation rate does not come under control.

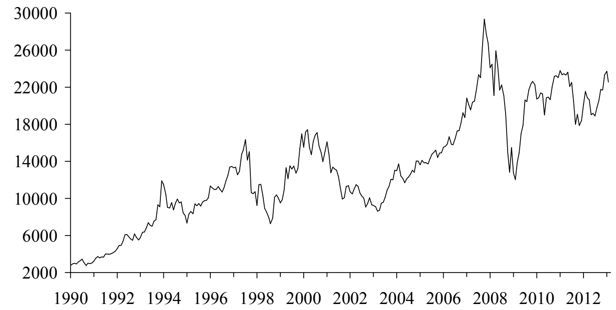
The central bank used market interventions to keep the real trading between 2.00 and 2.10 to the dollar for much of the second half of 2012. The currency has traded anywhere from around 2.14 to 1.95 per dollar since December. It seems that the central bank is using the currency as a monetary policy tool to help the economy recover and combat inflation coming from depreciation of the currency. A marginal increase in the Selic rate would keep the exchange rate within the BRL1.95–BRL2.00 band.

The Brazilian Central Bank sold the equivalent of $1.35 billion in foreign-exchange reverse-swap contracts at an auction in February to contain the real's appreciation against the U.S. dollar. Typically, the auctions help weaken the real against the U.S. dollar by removing dollar-hedged contracts from the market

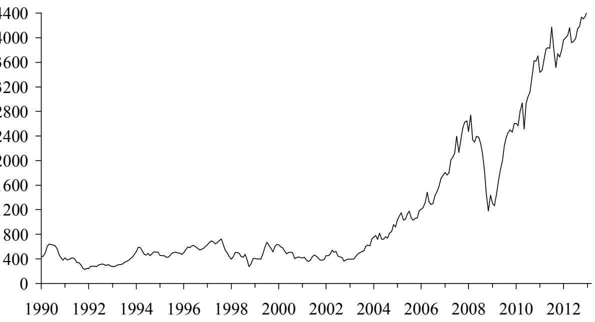
	10	**11**	**12**	**13**	**14**
GDP (%p.a.)	7.5	2.7	1.1	3.6	3.5
Inflation (%p.a.)	5.9	6.5	5.8	6.3	6.0
Current A/c(US$ bill.)	-47.3	-52.6	-60.0	-65.0	-60.0
Real/$(nom.)	1.7	1.5	2.0	2.0	2.0

Other Emerging Markets

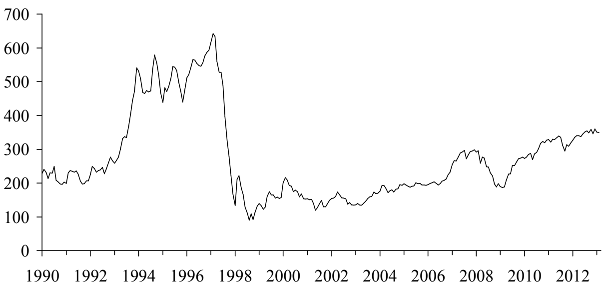
Hong Kong: FT-Actuaries



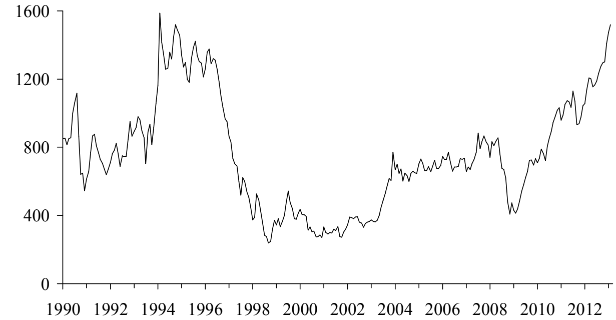
Indonesia: Jakarta Composite



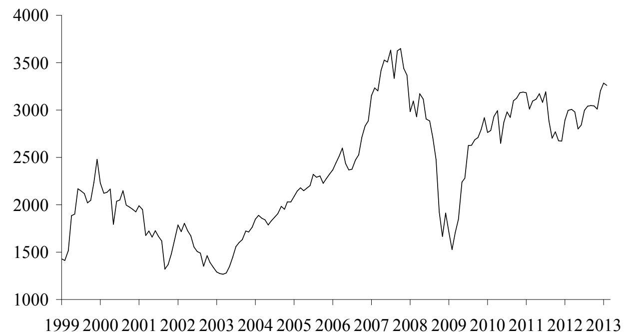
Malaysia: FT-Actuaries (US$ Index)



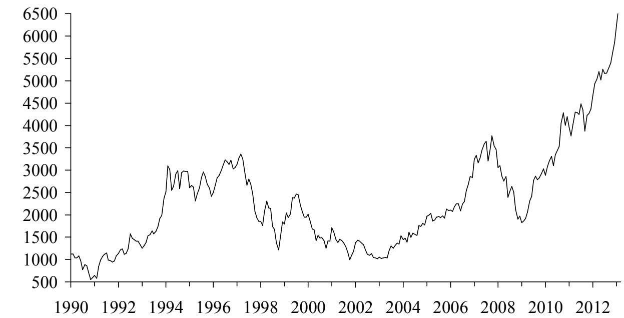
Thailand: Composite Index



Singapore: Straits Times Index

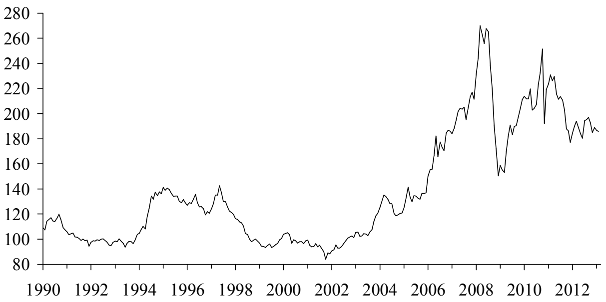


Philippines: Manila Composite

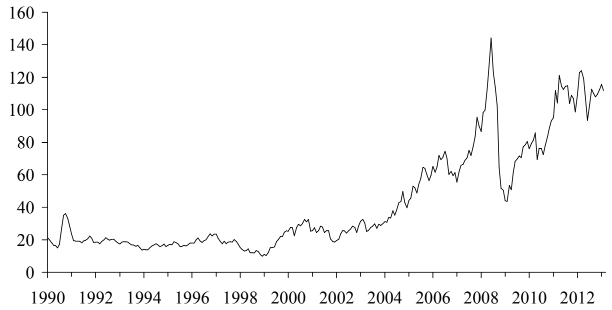


COMMODITY MARKETS

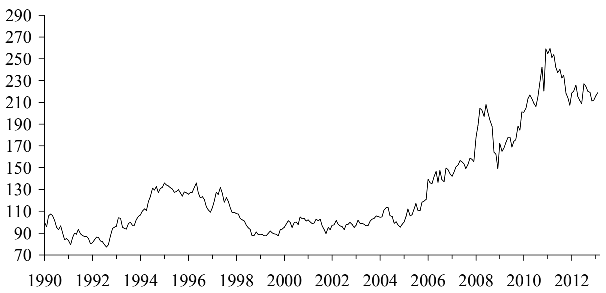
Commodity Price Index (Dollar)
(Economist, 2000=100)



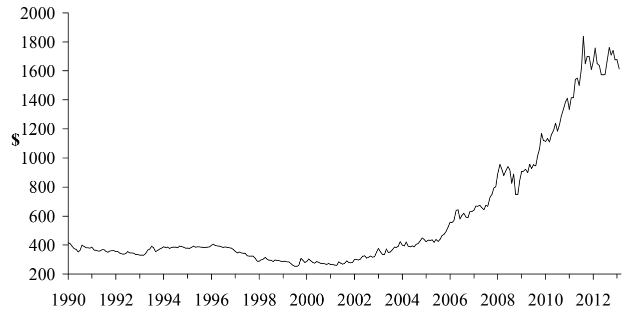
Oil Price: North Sea Brent (in Dollars)



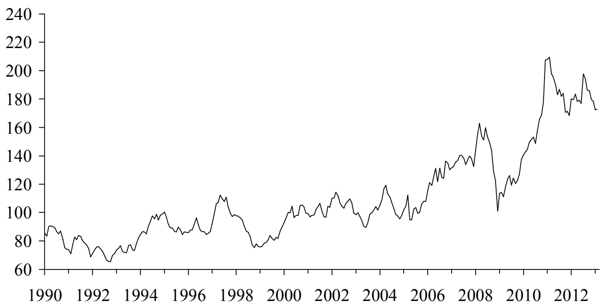
Commodity Price Index (Sterling)
(Economist, 2000=100)



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]
2010	3.7	2.4	0.7	80.4	87.9	-3.6	4.8	-0.2
2011	4.7	2.0	0.9	80.0	89.7	-3.1	5.3	-0.2
2012	2.8	0.9	0.9	83.0	94.0	-1.9	3.3	-1.3
2013	2.8	1.3	0.9	83.5	95.7	-1.6	3.3	-0.8
2014	2.6	1.8	1.7	82.7	95.5	-0.5	3.1	-0.3
2015	2.2	2.1	2.1	82.1	95.5	0.1	2.8	0.0
2012:1	2.7	1.1	1.1	81.2	91.4	-2.0	3.8	-1.1
2012:2	3.1	0.9	1.1	83.2	94.3	-1.6	3.2	-1.2
2012:3	2.7	0.7	0.8	84.1	95.3	-2.0	2.9	-1.4
2012:4	2.8	0.8	0.6	83.6	95.2	-2.0	3.3	-1.4
2013:1	2.9	1.0	0.8	83.7	95.5	-1.8	3.4	-1.2
2013:2	2.8	1.3	0.9	83.2	95.4	-1.6	3.3	-0.8
2013:3	2.8	1.5	0.9	83.7	96.0	-1.6	3.3	-0.6
2013:4	2.7	1.5	1.1	83.3	95.8	-1.3	3.2	-0.6
2014:1	2.6	1.8	1.3	83.1	95.8	-1.1	3.2	-0.3
2014:2	2.5	1.8	1.7	82.3	95.2	-0.6	3.1	-0.2
2014:3	2.6	1.7	1.8	82.4	95.2	-0.3	3.1	-0.3
2014:4	2.5	1.8	1.9	82.7	95.8	-0.2	3.0	-0.2

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)
2010	227.1	2.4	4.6	1.50	136.7
2011	232.7	2.6	4.6	1.53	133.7
2012	236.9	1.8	4.7	1.58	132.4
2013	242.0	2.2	4.4	1.49	131.6
2014	248.9	2.8	4.0	1.37	131.9
2015	257.0	3.3	3.7	1.26	133.3
2012:1	234.7	0.7	4.8	1.61	132.7
2012:2	235.8	1.8	4.8	1.60	132.0
2012:3	237.4	1.9	4.7	1.58	132.4
2012:4	239.6	2.9	4.6	1.56	132.4
2013:1	240.4	2.4	4.6	1.54	132.1
2013:2	242.0	2.6	4.5	1.51	131.7
2013:3	242.2	2.0	4.4	1.48	131.4
2013:4	243.6	1.6	4.3	1.45	131.0
2014:1	245.5	2.1	4.2	1.42	131.4
2014:2	248.1	2.5	4.1	1.39	131.7
2014:3	249.7	3.1	4.0	1.36	132.1
2014:4	252.1	3.5	3.9	1.33	132.4

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
2010	145.1	694701.4	411042.6	234029.9	182002.2	-34548.2	97825.1
2011	146.4	701060.5	402885.3	243646.3	177479.4	-23548.2	99402.3
2012	146.5	701719.7	401183.5	249576.1	183170.0	-31081.5	101129.7
2013	148.7	712270.2	404503.8	255592.0	187385.7	-31240.0	103971.4
2014	151.8	726827.7	411964.1	261350.6	191244.9	-31189.9	106537.5
2015	155.4	744363.4	421121.2	267868.0	195837.6	-31120.2	109344.0
2010/09	1.8		0.5	7.6	0.5		0.8
2011/10	0.9		-2.0	4.1	-2.5		1.8
2012/11	0.1		-0.4	2.5	3.2		1.9
2013/12	1.5		0.8	2.4	2.3		3.2
2014/13	2.0		1.8	2.3	2.1		2.5
2015/14	2.4		2.2	2.5	2.4		2.6
2012:1	146.2	175013.2	100300.2	59839.5	47225.9	-6742.4	25610.0
2012:2	145.6	174362.8	100083.3	61272.9	44458.8	-8868.5	22583.7
2012:3	147.0	176010.2	100053.3	64467.5	45567.2	-7659.5	26418.3
2012:4	147.3	176333.5	100746.7	63996.2	45918.1	-7811.1	26517.8
2013:1	147.9	177029.8	100900.2	61159.6	48592.6	-7807.4	25814.7
2013:2	148.4	177664.5	101049.5	64387.0	45700.5	-7814.6	25658.4
2013:3	149.0	178426.4	101202.4	64777.0	46404.9	-7811.4	26147.4
2013:4	149.6	179149.4	101351.7	65268.4	46687.6	-7806.7	26350.8
2014:1	150.5	180168.3	102004.1	62894.2	49472.8	-7807.8	26397.0
2014:2	151.3	181177.2	102658.7	66223.1	46613.4	-7802.0	26513.8
2014:3	152.2	182248.0	103319.1	66062.4	47385.6	-7791.4	26725.9
2014:4	153.1	183234.3	103982.2	66171.0	47773.1	-7788.7	26900.8

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)
2010	8.7	1336.3	115.1	36.4	-37.3
2011	6.7	1406.4	94.2	42.9	-20.4
2012	6.5	1451.6	95.4	47.0	-51.9
2013	6.5	1519.3	98.2	50.6	-52.2
2014	5.3	1592.8	84.7	55.8	-52.8
2015	4.3	1666.2	72.2	59.0	-53.0
2012:1	4.6	355.1	16.3	11.5	-11.8
2012:2	1.7	351.8	6.0	11.3	-17.4
2012:3	6.2	363.1	22.7	11.8	-12.8
2012:4	9.9	367.2	36.5	11.8	-9.8
2013:1	8.2	369.5	30.2	12.0	-13.9
2013:2	6.2	373.6	23.1	12.3	-15.5
2013:3	5.9	377.2	22.1	12.4	-13.1
2013:4	5.9	382.1	22.7	12.8	-9.8
2014:1	7.8	386.3	30.3	13.1	-14.0
2014:2	5.4	391.4	21.0	13.6	-15.7
2014:3	5.6	395.4	22.1	13.8	-13.2
2014:4	5.6	400.4	22.5	14.0	-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.	–0.9	–3.9	1.8	0.9	0.1	1.5
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.	2.3	–0.3	–3.6	–3.1	–1.9	–1.6
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.	1.3	–0.3	–0.2	–0.2	–1.3	–0.8
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	76.7	78.9	80.5	84.4	85.9
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	3.7	4.7	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

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

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	0.9	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

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