LIVERPOOL INVESTMENT LETTER

October 2012

Cardiff Business School
Cardiff University

Julian Hodge Institute of Applied Macroeconomics

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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

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

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

The Group also produces a Quarterly Economic Bulletin which contains forecasts and commentary on the state of the world and British economy. It is available at the following rates: (Corporate and Institutional) £325 per year; (Personal) £90 per year. Special rates are available for teachers and students. Individual issues may be purchased: Corporate and Institutional, £90 per copy; Personal, £60 per copy.

Cheques for subscription to the Liverpool Investment Letter and/or the Quarterly Economic Bulletin should be made payable to Liverpool Macroeconomic Research Limited and mailed to

Mrs Jane Francis
16 Goldsworth Fold
Beckett's Wood
Rainhill
Liverpool L35 9LT

Tel / Fax: 0151 431 5710
Email: janefrancis04@btinternet.com
ISSN 0951-9262

LIVERPOOL INVESTMENT LETTER

October 2012

CONTENTS

DARKEST BEFORE THE DAWN

The steadily improving labour market data suggest that the UK economy is now growing. It seems likely that when we get it in a month or so the third quarter GDP figures will show a good rebound and the process of upward revision of the previous figures will continue. This is why, disregarding the arithmetic implied by the early ONS estimates, we will continue to show growth for the current year.

There have been some side benefits of the poor GDP figures and all the popular talk of 'double dip recession'. These have come in the form of several policy changes, as the coalition have had to focus on ways of delivering growth, at the expense of their previous priorities of the green agenda, anti-banker populism with manic reregulation, and infrastructure decisions designed to make non-economic points (such as HS2 and the denial of the third Heathrow runway). Mr. Osborne has taken charge of the new direction and we now have:

- the new Funding for Lending Programme under which for extra lending the costs will be cut. Also urgent consideration of how business lending can be boosted — perhaps by creating a new business bank, perhaps who knows by spinning off parts of the two behemoth banks under government control as new banks, designed to boost competition and lending on the high street.
- a review of airport provision, opening up the issue of runways from 2015
- a new labour regulation reduction for SMEs based on much of the Beecroft Report.
- a new Cabinet in which the balance has tilted towards ministers who want to deregulate more actively.
- a programme to liberalise planning decisions

How far these measures will make a difference remains to be seen. But with the help as well of a calming of the euro-zone crisis by the ECB's announcement of direct purchases of weak governments' bonds when their yields are threatened by crisis (OMT — Outright Monetary Transactions), we may now see an easing of the great credit freeze-up, which may well be the key factor holding back the recovery.

We still have poor news on the progress of public borrowing. However, there has undoubtedly been a large cutback in public sector employment (allowing for reclassification this is around 600,000 since 2010, or about 10% of the total). Benefit payments have been boosted by indexation to the soaring RPI. But cutting benefit packages as growth strengthens will become easier politically and with employment improving payments should gradually fall back automatically. Also with profits having grown substantially the big corporate tax-gathering season in 2013 Q1 should be a lot stronger. With retail sales finally rising in volume terms at around 3% we should see better VAT receipts.

Table 1: Summary of Forecast

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

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

Now that the government has finally come around to a pro-business agenda, the achievements in other areas are starting to come into focus.

First is the austerity programme.

Second is the reform of the NHS, it is to be hoped finally embedding the 'internal market' started by Mrs. Thatcher.

Third is the strengthening of the new independent schools programme started by Tony Blair; and the associated attempts to raise standards of teaching and examination.

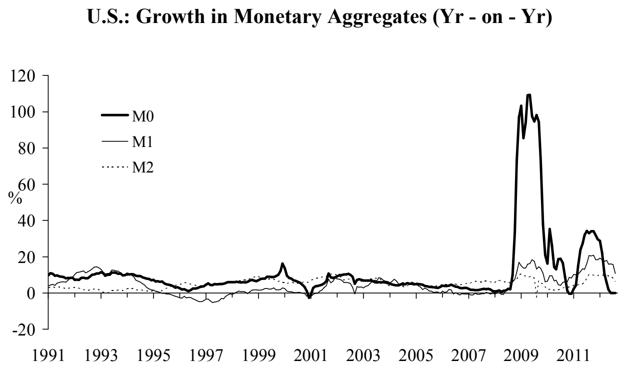
Last but not least, there is the withdrawal of benefits from middle income households under the various attempts of reform the benefit system. The previous tax credit system had begun to pervert the incentives of the better off. Unfortunately there is not in practice much that can be done about the effect of the benefit system on the least well off; pressures to get into the labour market can be increased, people can be pushed into cheaper housing, huge payments to dysfunctional families can be curbed. But in the end political commitment to help the poor ensures that incentives at the bottom are weak. The key is to stop the system before it reaches up to pollute incentives for the middle classes; this is politically possible and economically desirable, even if it produces points just below middle income where marginal withdrawal rates get very high; generally these have little effect on middle class people.

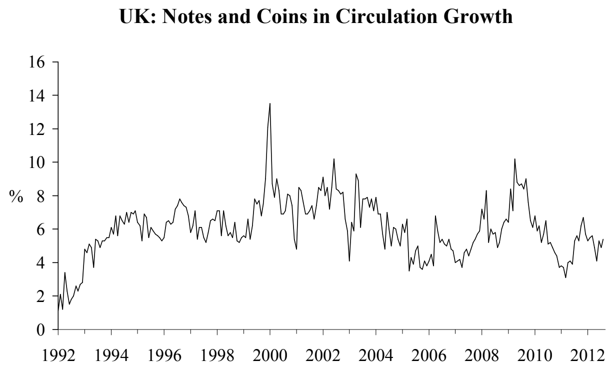
Monetary policy against this background may be able to get back to some normality in the UK. It is clear that growth is gradually returning in line with improving market fundamentals. If lending improves due to the latest moves this will help the process along. As this proceeds it will become increasingly dangerous to leave the vast reservoir of bank liquidity created by QE, let alone to add to it. QE, having so far had the effect mainly of making government borrowing extremely cheap and depressing returns to savers, could start to pose a serious inflationary threat. We could move from credit famine to credit binge rapidly. So the Bank needs to move in good time to withdraw this threat; these things cannot be left until the moment the binge is underway.

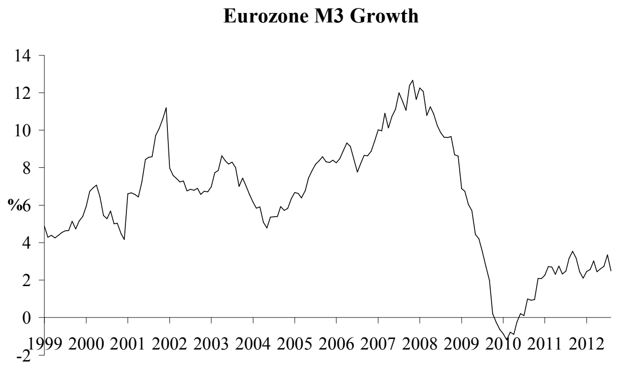
The decision by the Fed to go for QE3, printing $40 billion a month to buy mortgage-backed securities until unemployment comes down, is an astonishing decision which seems to forget the basic tenet of macroeconomics: that monetary ease cannot create employment except when applied temporarily as an attempt to counteract a negative shock. The Fed risks an even worse inflationary threat than here in the UK since its commitment is so bare-faced and open-ended.

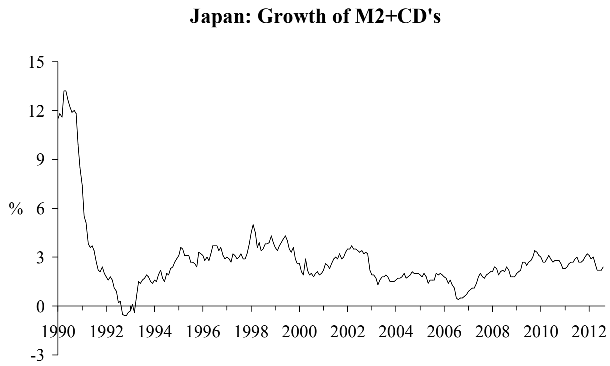
Summing up the situation in the US and the UK, we have a slow recovery and weak growth; bank credit seems to be frozen. We have a huge regulatory reaction to the past crisis which with the euro-zone crisis may well account for this freeze-up. QE seems to have lowered the cost of government funding but not apparently the terms of credit to smaller firms, while it has added massively to bank reserves. It would have been better to tackle the credit problem at its root in the excess regulation; and keep some control on the reserves injection. As it is, both governments are beginning to understand the regulative issues and trying to ease up on them; the US is directing QE directly into the credit market, the UK is subsidising banks' marginal lending costs. There is a desperation now engulfing monetary policy which looks dangerous — much like the desperation that engulfed the Heath government's policies in 1971, with every lever being pulled to target unemployment.

This desperation needs to be curbed. Interest rates should start to rise and QE be stopped and then reversed. The unfreezing of credit should be done by easing of capital and liquidity regulations, on top of the new Funding for Lending scheme.









FOCUS ON JAPAN

Francesco Perugini

Japan unchanged issues

After having revised down growth numbers for the second quarter to 0.2% from its earlier estimate of 0.3% over the previous quarter, the government cut its general economic outlook in the September economic report, due chiefly to weak personal consumption and industrial production. "The economic recovery appears to be pausing due to deceleration of the world economy", it said in the monthly report. The government lowered its economic view for two or more consecutive months for the first time since February 2009, when it issued a fifth consecutive downward revision amid the global financial crisis. The previous report in August said, "The economy is on the way to recovery at a moderate pace, due partly to reconstruction demand", following the March 2011 disaster, while noting "there has been a recent weakening".

Over the last few years, Japan's economic growth has been impacted by both international and domestic factors. The export sector, one of the biggest drivers of growth for Japan, has been hurt by slowing demand from key markets such as the US and the Euro zone. At the same time, growth in Asian countries, such as China and India, which had been faring better than western economies after the global financial crisis, has also slowed further hurting the sector. The government downgrade matches the assessment of private-sector analysts, who forecast a negative growth for the current quarter. Analysts said that the weakness in exports has had a knock-on effect on corporate investment and has dented growth. "Asia, China in particular, is the most important market for Japan right now. The slowdown there is having a negative impact, not just on Japanese growth but also on business sentiment and corporate investment in the country", said Martin Schulz of Fujitsu Research Institute. To make matters worse, domestic demand in Japan has not risen enough to offset the decline in foreign sales which has hit corporate sentiment.

The view of the Bank of Japan (BOJ) is similar: at its last monetary policy meeting on September 19th it cut its assessment of the economy, saying its pickup "has paused" while overseas economies have moved "somewhat deeper into a deceleration phase". That compared with the previous month's view that "the economy was starting to pick up moderately on robust domestic demand".

In addition, the BOJ decided to loosen its monetary policy stance by increasing its asset buying and loan program by ¥10 trillion, with the increase earmarked for purchases of government bonds and treasury discount bills. The BOJ set a 1% inflation target and boosted asset purchases last February to convince markets it was serious about pulling the economy out of deflation. It followed up with another increase in its asset buying pool in April, but has held fire since then.

In the meantime, Prime Minister Yoshihiko Noda easily beat three other contenders in a ruling party leadership election on September 21st and remains Japan's leader a while longer despite growing voter disappointment with his government's performance. Noda, in office a year, won 818 points out of a total of 1,231 points in the vote, suggesting the ruling Democratic Party of Japan (DPJ) has rallied around him even as his approval rating has fallen below 30%.

Noda is now considering a reshuffle of his Cabinet by the end of this month in order "to strengthen its functions". But he must also push through a bill to fund this year's budget amid concern the economy may contract as it struggles to recover from last year's earthquake and nuclear disaster. With the public split over his sales tax increase, Noda also faces the threat of an insurgent political force led by Osaka Mayor Toru Hashimoto. "The leadership race was a distraction," said Ellis Krauss, a professor of Japanese politics at the University of California, San Diego. "Noda's problem is convincing the public that the consumption tax hike was necessary and dealing with a recalcitrant opposition, deciding when to call an election, changing nuclear energy policies, and a troublesome China".

Analysts say the true challenge for Noda is the uphill battle he faces now that he has beaten the three other candidates vying for his seat. On the political side, the current parliamentary situation is uncertain. The upper house — whose approval is needed to enact most bills — is already controlled by opposition parties, while the DPJ still retains its majority in the Lower House. However, if six or more DPJ members chose to quit the party, the DPJ would lose its majority there too: this would mean that any no-confidence motion brought against Noda government would have a strong possibility of passing. So far the impasse has put on hold the passage of key bills, including one to authorize the issuance of bonds to finance 42% of the national budget for the current fiscal year through March.

Most recent surveys show low public support ratings for the Noda Cabinet and the DPJ. Voters appear to be disappointed in the DPJ's inability to deliver promised change to Japan's stodgy politics and are upset with Noda's push to double the sales tax, a step Noda argues is needed to meet increasing social security costs as Japan's population ages and its national debt grows. Polls suggest the DPJ would be badly defeated if elections were held now, and many analysts see the main opposition Liberal Democratic Party winning the most seats in the more powerful lower house, although falling short of a majority. Elections must be called by next September.

MARKET DEVELOPMENTS

The ECB's announcement of its OMT programme whereby it will buy government bonds of troubled countries finally makes explicit what we have long argued: that the euro's survival is guaranteed by the ECB, acting on behalf of the European establishment and mirroring fears all around the euro-zone of chaos if the euro is destroyed. This has removed significant uncertainty from world markets and cleared the way for recovery worldwide, as the euro-zone settles down into a more stable situation — not growth but not implosion. This has strengthened the outlook for equities; the inflation outlook is now more uncertain as the overhang of money is huge everywhere in the West. This confirms that bonds are a poor place to invest. We continue to keep the Liverpool portfolio mainly in equities.

Table 1: Market Developments

	Market Levels		Prediction for Aug/Sep 2013	
	Aug 28	Sep 26	August Letter	Current View
Share Indices				
UK (FT 100)	5776	5768	8508	8496
US (S&P 500)	1409	1433	1600	1612
Germany (DAX 30)	7003	7277	8977	9183
Japan (Tokyo New)	746	743	893	889
Bond Yields (government long-term)				
UK	1.49	1.69	2.10	2.10
US	1.63	1.62	4.00	4.00
Germany	1.35	1.45	4.00	4.00
Japan	0.81	0.78	1.50	1.50
UK Index Linked	–0.12	0.08	–0.40	–0.40
Exchange Rates				
UK ($ per £)	1.58	1.62	1.58	1.58
UK (trade weighted)	83.9	84.5	81.3	81.3
US (trade weighted)	80.6	79.6	80.5	80.5
Euro per $	0.80	0.78	0.79	0.79
Euro per £	1.26	1.26	1.25	1.25
Japan (Yen per $)	78.5	77.8	81.0	81.0
Short Term Interest Rates (3-month deposits)				
UK	0.73	0.84	1.40	1.40
US	0.50	0.35	0.60	0.60
Euro	0.20	0.22	2.50	2.50
Japan	0.33	0.25	0.40	0.40

Table 2: Prospective Yields [1]

Equities: Contribution to £ yield of:

	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.70	2.0	2.3	43.00		51.00
US	2.00	2.5	2.0	8.00	2.17	16.67
Germany	3.30	1.5	1.7	23.00	0.79	30.29
Japan	2.50	1.7	0.0	18.00	–1.86	20.34
UK indexed[2]	0.08		2.2	–8.00		–5.63
Hong Kong[3]	2.50	7.5	2.0	–3.00	2.17	11.17
Malaysia	3.00	5.2	2.0	38.00	2.17	50.37
Singapore	3.50	4.4	2.0	21.00	2.17	33.07
India	1.50	6.5	2.0	3.00	2.17	15.17
Korea	1.10	3.5	2.0	–21.00	2.17	–12.23
Indonesia	2.40	6.5	2.0	33.00	2.17	46.07
Taiwan	3.50	3.5	2.0	24.00	2.17	35.17
Thailand	3.00	4.4	2.0	25.00	2.17	36.57

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	1.69	–4.10		–2.41
US	1.62	–23.80	2.17	–20.01
Germany	1.45	–25.50	0.79	–23.26
Japan	0.78	–7.20	–1.86	–8.28

Deposits: Contribution to £ yield of:

	Deposit Yield	Currency	Total
UK	0.84		0.84
US	0.35	2.17	2.52
Euro	0.22	0.79	1.01
Japan	0.25	–1.86	–1.61

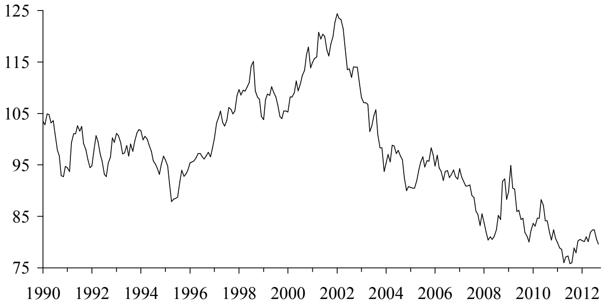
[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

Table 3: Portfolio(%)

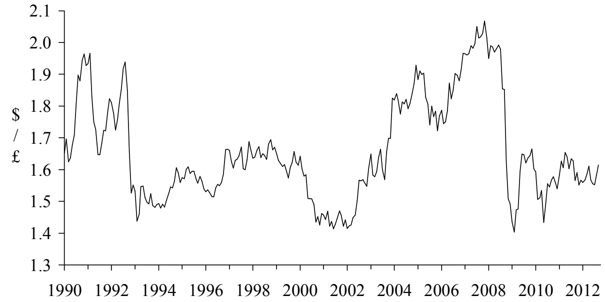
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	September Letter	Current View	September Letter	Current View	September Letter	Current View
UK Deposits (Cash)	10	10	10	10	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds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

INDICATORS AND MARKET ANALYSIS FOREIGN EXCHANGE MARKETS[1]

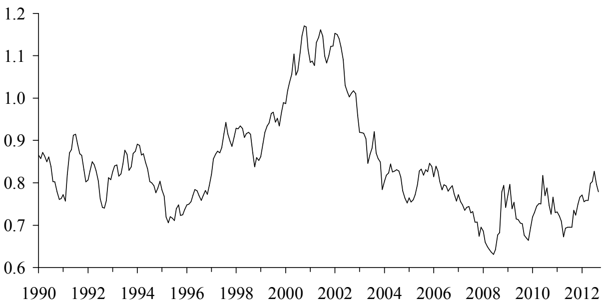
US : Trade Weighted Index
(Bank of England 1990 = 100)



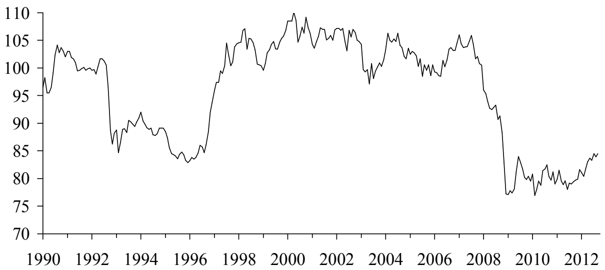
UK: Dollars Per Pound Sterling



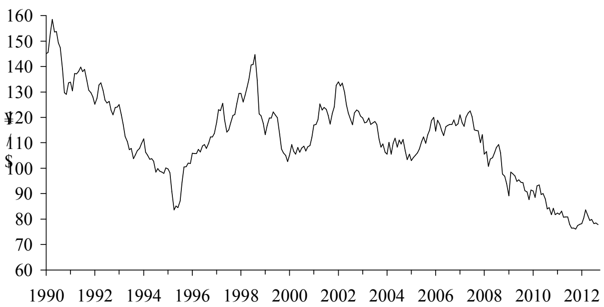
Euro per US dollar



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



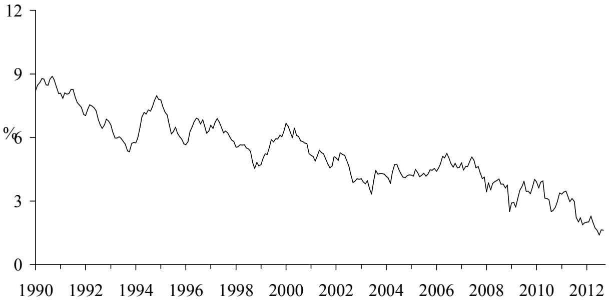
Japan : Yen Per U.S. Dollar



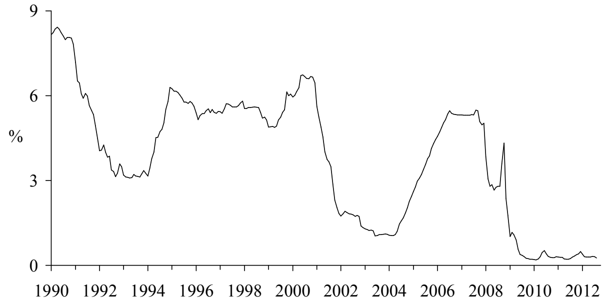
[1] John Wilmot, who has written these sections since this Letter began, is indisposed. We are issuing the charts without his commentary this month. We wish him a speedy recovery.

GOVERNMENT BOND MARKETS

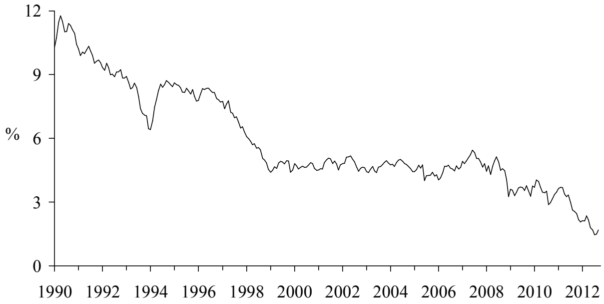
U.S.: Yield on Long-Term Government Bonds



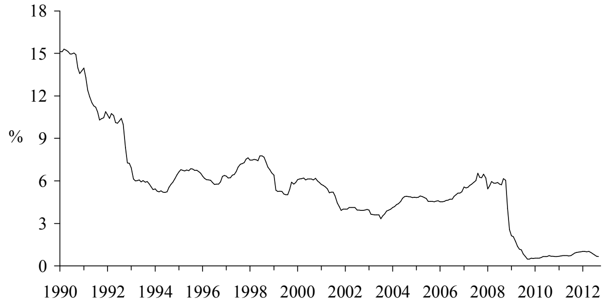
U.S. : 3-Month Certificate of Deposit



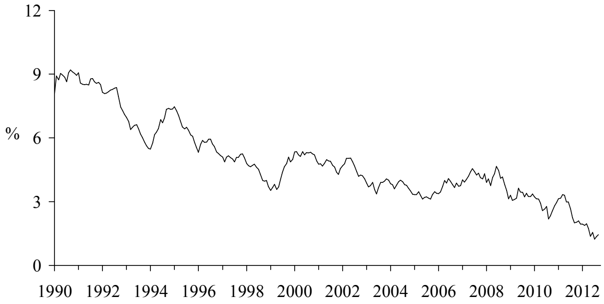
U.K. : Yield on Long-Term Government Bonds



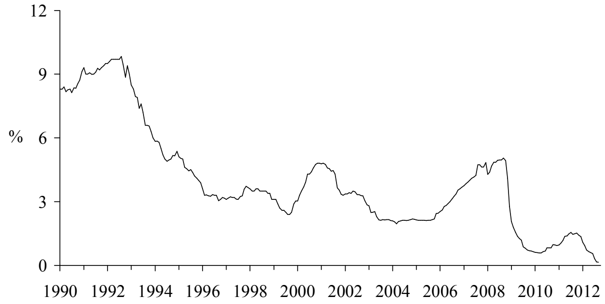
U.K. : 3-Month Interbank Rate



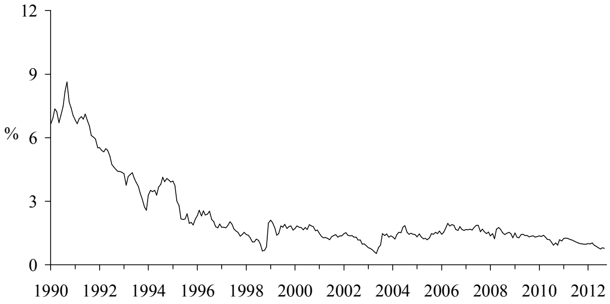
Germany: Yield on Public Authority Bonds



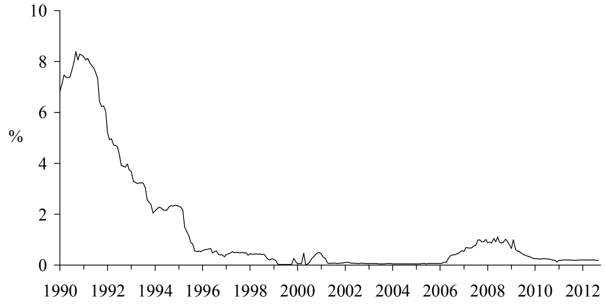
Germany : 3-Month Interbank Deposit Rate



Japan: Yield on Long-Term Government Bonds

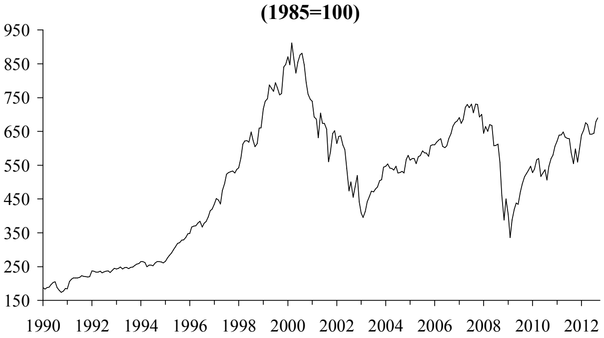


Japan : 3 Month Money Market Rate

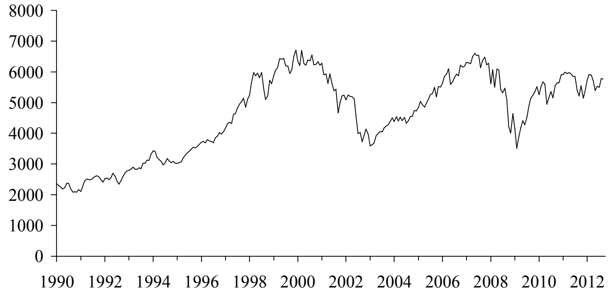


MAJOR EQUITY MARKETS

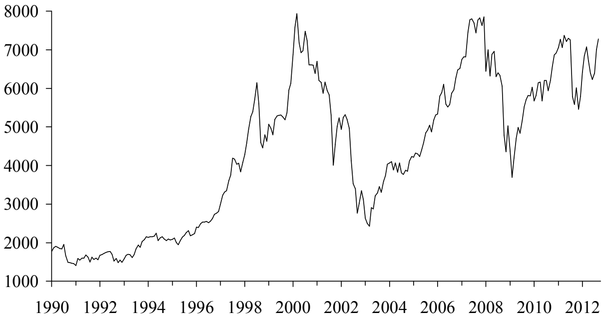
U.S. : S & P 400 Industrial
(1985=100)



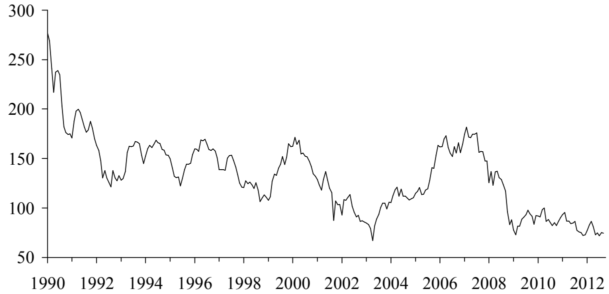
U.K. : FTSE-100 Index
(10 April 1962=100)



Germany : DAX 30



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



EMERGING MARKETS

Anupam Rastogi

India

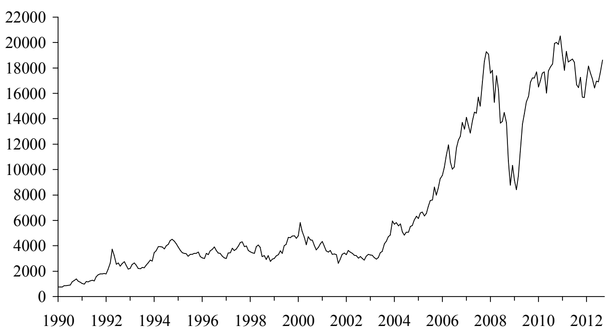
The blitz of economic reforms came as a pleasant surprise to businessmen, economists and politicians. The readers of this letter were informed last month, and the month before, that soon after the Monsoon session there exists a window of opportunity for the government to restart stalled reforms. The government had already put in place a strong pro-reform team led by the Deputy Chairman of Planning Commission Montek Singh Ahluwalia, the Finance Minister P. Chidambaram and former Chief Economist of the IMF and Chicago Business School professor of finance Raghuram Rajan. Soon after reducing subsidies on diesel, so raising the price by 14%, the government faced an opposition-led all-India strike which evoked an insipid response from public. Armed with neutral to mildly positive response from the public and different allies to back the government on the floor of the house, the government announced the following reforms:

First, the cabinet did not reverse the sharp reduction in subsidies for diesel and cooking gas to curb the growing budget deficit. Second, the government allowed foreign investors to build supermarkets and department stores and buy into local airlines, and relaunched the privatization program. Third, the government unveiled a scheme to restructure over $35 billion in debt owed by loss making state electricity distribution companies which are at the heart of power sector reforms in the country. The power distribution companies will now be pressed to take the politically unpopular step of raising prices. Finally, the finance minister lowered the withholding tax on foreign debt taken by corporations from 20% to 5% for the next 18 months. Markets reacted quickly and gained approximately 7% within days. The rupee also appreciated by 6%.

What triggered the government to move out of its policy paralysis mode to pro-active reform is difficult to pin-point, but a sliding economic growth rate, insults heaped on the PM Manmohan Singh — in and out of the parliament — and probably the threat made by the credit rating agencies of downgrading India to a non-investment grade pushed the government to react and react forcefully. India has a BBB– rating with a negative outlook at present. With the revival of the monsoon in the last two months we expect a few reforms in agriculture sector as well.

Singh's government has taken a huge punt on economic reforms. If his government falls when parliament returns from its recess, it will strengthen the belief that good economics makes bad politics. On the other hand, his gamble may well end up having the opposite effect and may pave his party's path to victory in national elections, due no later than 2014. Only time will tell if an electoral setback for Congress in 2014 will be interpreted as a verdict on the ruling party's corruption, indecision and sloth during its tenure.

India: BSE Sensitive



India's GDP grew at 5.5% in the April to June quarter (compared to 5.3% in the previous quarter) after declining in eight consecutive quarters. Standard & Poor's Ratings (S&P) has slashed India's GDP growth forecast to 5.5% from 6.5% for the fiscal year 2012–13. The Planning Commission has also lowered the annual average economic growth rate to 8.2% for the 12th Five Year Plan period (2012–17) from 9%. This is an optimistic target given that the economy is facing headwinds from the world economy.

The wholesale price index rose 7.55% in August from a year earlier, up from July's 6.87% increase. With the increase in diesel prices there may be a knock on effect of 0.5% in three or four months time as higher diesel prices feed into prices of other commodities.

The central bank kept its key lending rate unchanged at 8% for the third consecutive policy meeting. It did, however, cut the cash reserve ratio, or the portion of deposits that banks must set aside to meet withdrawal contingencies, by a quarter percentage point to 4.5%, releasing about 170 billion rupees ($3.14 billion) of liquidity in the banking system. We expect that the central bank in its next meet on October 30 may lower the key lending rate by 25 basis points.

As sentiments have transformed dramatically, global investors have proved especially enthusiastic: buoyed by a sharp increase in global liquidity following recent moves by the US Federal Reserve and the European Central Bank, foreign funds brought more than $1.6 billion into equity markets in the five days following the reform announcements. The influx took the total FII inflow to nearly $14 billion, a sharp contrast to last year, when investors removed money overall. Market expects the Sensex to gain another 10% in 2012. Some analysts have set their sight beyond the heights of the 2007 boom.

	09-10	10-11	11-12	12-13	13-14
GDP (%p.a.)	7.4	7.5	6.9	5.8	6.5
WPI (%p.a.)	0.5	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	52.0

China

China's gross domestic product growth has spiraled down from 11.9% year on year in the first quarter of 2010 to 7.6% in the second quarter of 2012 — the slowest pace since the global financial crisis. Data from the National Bureau of Statistics showed value-added industrial output in China rose 8.9% in August from a year earlier, down from a 9.2% increase in July, and the slowest growth since May 2009.

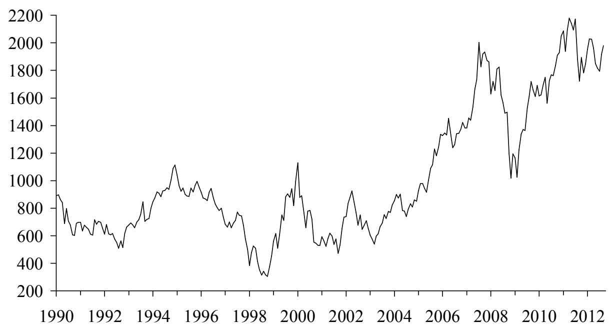
President Hu Jintao warned that China's economy faces "notable downward pressure" and addressed the need to upgrade infrastructure to promote stable growth and recovery. China's omnipotent National Development and Reform Commission approved dozens of infrastructure projects such as subways and highways, which would add up to one trillion yuan ($157.6 billion) of investment over the coming four years. When Mr Xi takes over as general secretary of the Communist party in mid-October, his first task will be to deal with an economy that is slowing faster than many had expected. It is widely expected that Mr Xi would direct spending at softer infrastructure such as health and education. Idea behind this is that if people feel more secure about social provision, their propensity to save will fall and the switch to consumer-led growth will happen faster. At present, 50% of China's growth is contributed by investment.

China's Consumer Price Index rose 2% from a year earlier in August, up from July's 1.8% rise and in line with expectations. The main driver was the price of food, which rose 3.4% from a year earlier, compared with a 2.4% rise in July. China's inflation is likely to pick up in the coming months due to the upswing in global food prices caused by drought conditions in the U.S.

China's exports grew by a 2.7% year-on-year in August, barely improving on July's 1% growth. Decelerating growth is spilling over to labour unrest. A riot in the Hon Hai Precision Industry Co left at least 40 people injured and sparked a response by thousands of police. The incident has put a spotlight on the growing tension in China's factories as companies struggle to meet worker demands for better compensation and work conditions even as economic growth slows.

China's yuan, in recent weeks, has clawed back almost all of the year's losses against the dollar. The strengthening of the yuan — which reached its highest level since April — could bring further pain to Chinese exporters who are already grappling with weakening global demand for their products. A stronger currency makes China's exports more expensive in dollar terms.

Korea: Composite Index



China's purchases from the rest of the world shrank 2.6% year-on-year, the first contraction in a non-holiday month since the end of 2009. Falling prices for imported commodities accounted for some of the dip, but not all of it. Crude oil import volume was down 12.5% year-on-year.

We expect the dollar-yuan pair to close this year between 6.27 and 6.33, generally flat from last year's close. There is a chance that the yuan may appreciate 1% against the dollar in 2013.

China's equity markets are among the worst performing in the world this year. The Shanghai Composite is down about 8% this year so far. The Shanghai market's price/earnings ratio of 11 is at a historic low.

	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

The Korean economy expanded 2.3% in the second quarter from a year earlier, marking the weakest growth since a 1% rise in the third quarter of 2009. In the second half economy is expected to perform better to show an overall growth rate of 2.5% in 2012. The IMF expects the South Korean economy to expand 3.0% this year. We predict that given fiscal incentives, the economy in 2013 will grow by 3%.

In order to keep the economy humming, the South Korean government would continue to run a fiscal deficit next year, pushing out the target of a balanced budget by a year. The government announced a $5.23 billion stimulus package to support economic growth. This is to counter-balance euro-zone debt crisis which hit exports at a time of cooling consumption. The finance ministry has also announced steps including a temporary easing of taxes on consumption and property transactions, and an increase in state credit for small businesses.

The BOK kept its benchmark interest rate steady at 3% at its August rate review after delivering a surprise 0.25 percentage point cut in July. We expect a further rate cut before the end of the year to help revitalize the economy. Private consumption grew just 1.2% in the second quarter of the year while capital investment fell 1.5%.

Overall exports in August fell 6.2% from a year earlier and imports in August fell 9.8%.

Moody's Investors Service raised South Korea's sovereign credit rating by one notch to Aa3 and has also assigned a stable outlook to its latest rating.

	09	10	11	12	13
GDP (%p.a.)	0.2	6.3	3.6	2.5	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	20.0	18.0
Won/$(nom.)	1200	1150	1100	1140	1140

Taiwan

Taiwan's economy has almost come to a halt, with the gross domestic product growing 0.1% during the first half. Growth is expected to be stronger in the second half due to a lower comparison period, and 2012 growth rate may come out to be around 1% in 2012. The downward forecast reflects the fall in China-bound exports. China's slowdown is impacting all those countries which export to China such as Taiwan, South Korea, Hong Kong, Singapore and Japan.

Taiwan and the US will restart their talks over a potential trade agreement, after a few years spent arguing over the island's restrictions on the import of American beef. Taiwan needs the US market now to counterbalance its increasing reliance on China. Taiwan is negotiating a series of agreements to liberalize trade and lift tariffs.

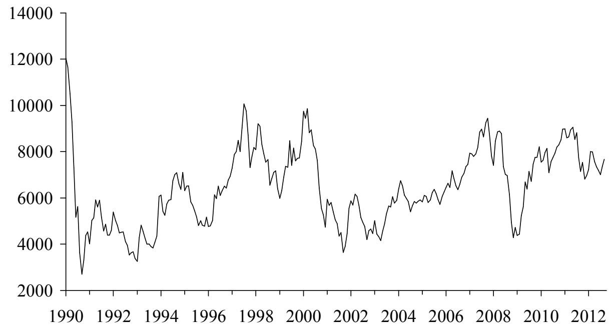
Mr Hu Jin Tao, president of China, has assured Taiwan that better China-Taiwan relations will outlive Mr Hu's presidency. This is an early indication that, in matters of foreign policy at least, Mr Xi will seek continuity rather than abrupt change.

	09	10	11	12	13
GDP (%p.a.)	-1.9	10.8	4.0	1.0	2.0
Inflation (%p.a.)	0.0	1.3	1.2	1.3	1.2
Current A/c(US$ bill.)	16.0	16.0	18.0	20.0	22.0
NT$/$(nom.)	32.0	31.0	30.0	29.5	29.5

Brazil

Brazil's economy has slowed dramatically from 7.5% growth in 2010 to an expected rate of around 1.5% this year. Government expects the economy to rebound and clock 4.5% in 2013. Headwinds for the Brazilian economy are strong and we do not expect growth rate to surpass 3%

Taiwan: Weighted TAIEX Price Index



in 2013. The government has extended to the end of the year tax relief on washing machines, refrigerators and other home appliances while the development bank, BNDES, announced new credit lines for capital equipment to ensure that consumer demand and investments do not dry up. Guido Mantega, Brazil's finance minister, reacted sharply to the suggestion that Brazil suffers from "chicken flight" growth — a reference to the economy's tendency to enjoy high growth spurts followed by growth tumbling down.

Brazil's 2012 year-end inflation is likely to be 5.5% compared to government target of 4.5% plus or minus two percentage points. In 2013 also inflation would hover around 5.5%.

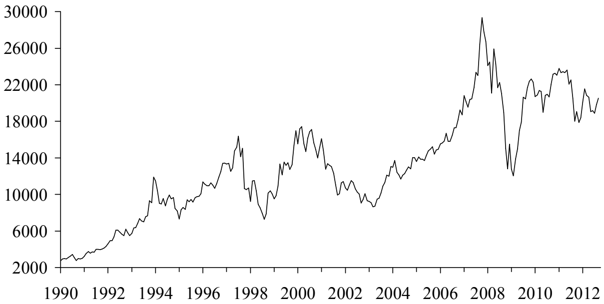
Brazil's central bank has cut interest rates to an historic low even as the government announced fresh steps to try to revive the country's moribund economy. The average forecast is for the benchmark Selic interest rate to reach 7.5%, and signaling further rate cuts would have to be undertaken with "maximum parsimony." Brazil's central bank did not rule out raising its baseline interest rate in 2013 if necessary, to keep inflation within its target range.

The real traded a shade higher than BRL2.0 to the dollar in September. A lower Selic rate helps dissuade some of the short-term capital that seeks out the country's rates, which are still high compared to those in the developed countries. High Selic rate was the cause for the real to touch BRL1.55 per dollar in mid-2011. The government intervened in the foreign exchange market and introduced targeted capital controls at that time. Guido Mantega, Brazil's finance minister, has warned that the US Federal Reserve's "protectionist" move to roll out more quantitative easing will reignite the currency wars with potentially drastic consequences for the rest of the world.

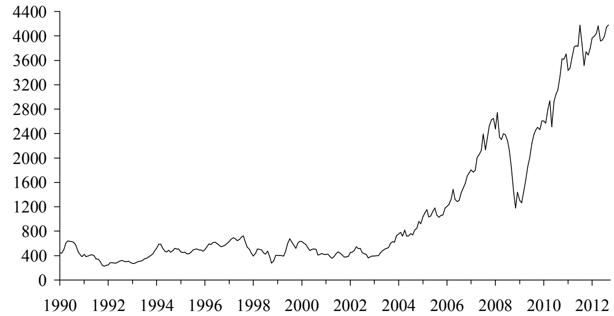
	09	10	11	12	13
GDP (%p.a.)	-0.2	7.5	2.7	1.5	3.0
Inflation (%p.a.)	4.1	5.9	6.5	5.5	5.5
Current A/c(US$ bill.)	-20.0	-47.3	-52.6	-60.0	-65.0
Real/$(nom.)	1.8	1.7	1.5	2.0	2.0

Other Emerging Markets

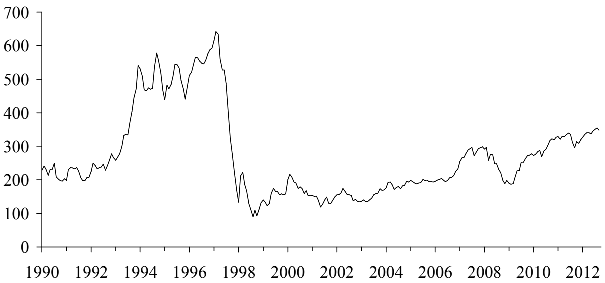
Hong Kong: FT-Actuaries



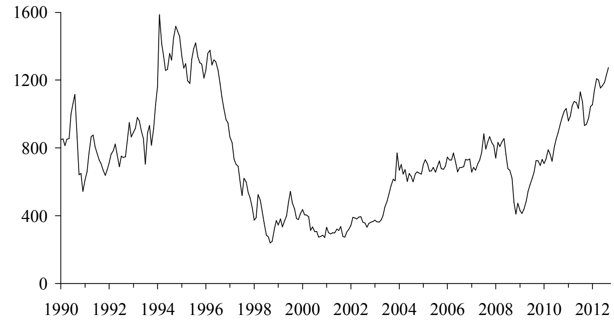
Indonesia: Jakarta Composite



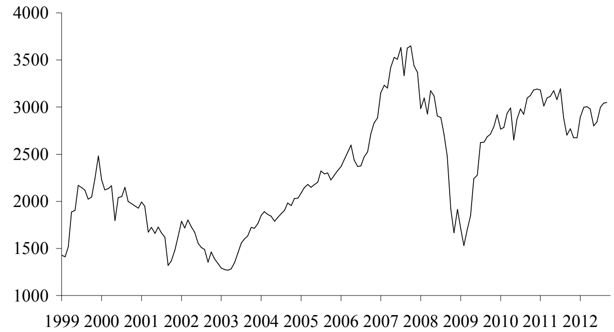
Malaysia: FT-Actuaries (US$ Index)



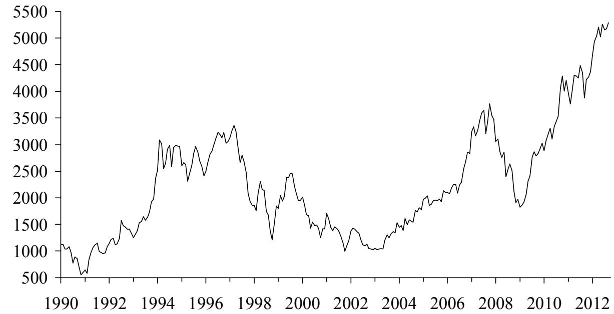
Thailand: Composite Index



Singapore: Straits Times Index

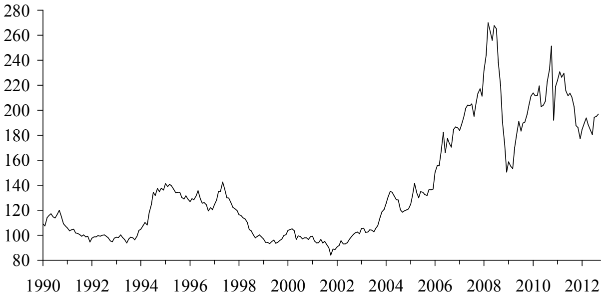


Philippines: Manila Composite

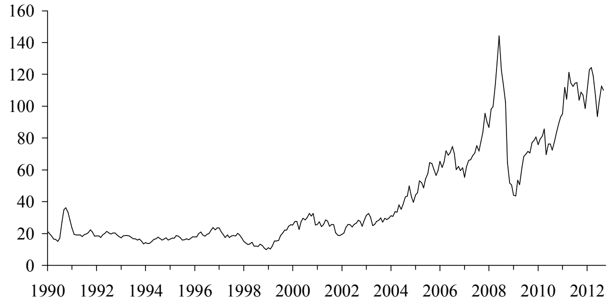


COMMODITY MARKETS

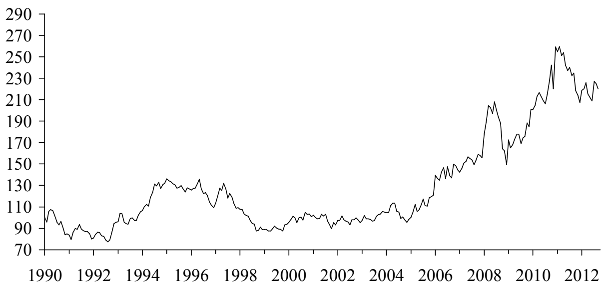
Commodity Price Index (Dollar)
(Economist, 2000=100)



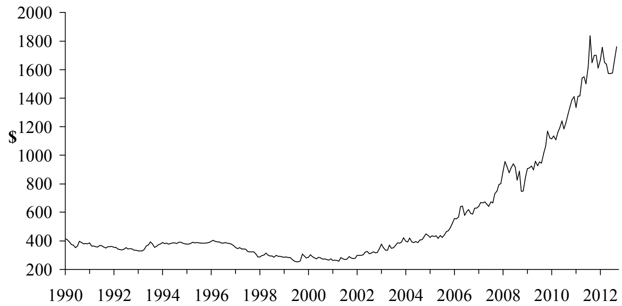
Oil Price: North Sea Brent (in Dollars)



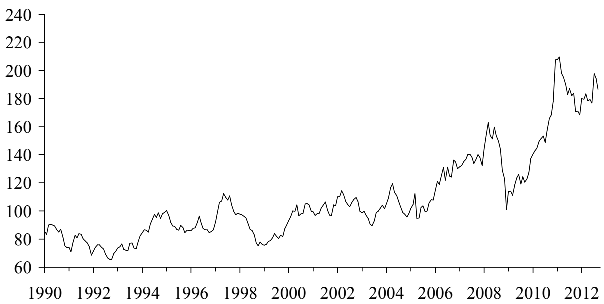
Commodity Price Index (Sterling)
(Economist, 2000=100)



Gold Price (in Dollars)



Commodity Price Index (Euro)
(Economist)



UK FORECAST DETAIL

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

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

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

Labour Market and Supply Factors (Seasonally Adjusted)

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

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

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

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

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

Financial Forecast

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

1 GDP at market prices (Financial Year)

WORLD FORECAST DETAIL

Growth Of Real GNP

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

Growth Of Consumer Prices

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

Real Short-Term Interest Rates

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

Nominal Short-Term Interest Rates

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

Real Long-Term Interest Rates

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

Nominal Long-Term Interest Rates

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

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