LIVERPOOL INVESTMENT LETTER

July 2012

Cardiff Business School
Cardiff University

Julian Hodge Institute of Applied Macroeconomics

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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THE MONETARY U-TURN

The debate over QE has finally become meaningful first with the intervention of Paul Tucker detailing some worries over the effects of regulation on bank lending; second, with the announcements in the Mansion House speeches that the Bank and government would reduce the marginal cost of lending to the banks, in a way related to extra lending.

Frankly this sort of bureaucratic 'incentive' is an abomination — reminiscent of the 'corset' device invented in the late 1970s to persuade banks to limit M3 as it then was. It breeds evasion and what is known as 'fungibility' — i.e. you do what you planned anyway but dress it up as the necessary 'increase'.

Far better to have had a 'mea culpa' from these bureaucrats about their ridiculous plans for regulating the banks. Maybe the new intervention will be a cover for a quiet retreat from these plans. Who knows? But we should not hold our breath. When the Kings, Vickers and Turners of this world are allowed sway over our affairs, they will not relinquish it with much speed. Unfortunately Messrs Cameron and Osborne are like innocents abroad, ignorant and led by the nose on these matters. Their ignorance is not helped by their quasi-religious views on 'debt'. The monetary intelligence of Alistair Darling and even Gordon Brown was of a far higher order.

It is plain that there is a credit drought for SMEs. This part of our economy would otherwise be searching for new business opportunities, instead of just trying to survive. Quantitative Easing has not affected the supply of credit, it is plain. Some say the counterfactual is that credit could have declined further. This is pure invention. It is highly unusual for credit to keep on dropping after the end of recession (I am using general indicators, not the ONS' first estimates, as a guide to the pattern of activity). Furthermore, if one looks at the 'events' of QE injection, it is clear they had no effect on credit growth.

No doubt, as Tim Congdon says, QE has added to M4. Arithmetically, it must; the money is printed and deposited; it then has been held in bankers' balances. Thus it is added to deposits; and also to M0. But the problem is that the M0 multiplier has collapsed because of banks' unwillingness to lend. So the rise in M4 is small. Indeed it is hardly growing.

The only sort of QE that would add to SME lending in these circumstances would be direct use of the QE to buy SME assets or give them loans. However, this would be a bridge too far for the Bank; indeed, even the Fed which has bought all sorts of unorthodox assets (including corporate bonds and mortgages) has balked at going this far. Furthermore, it is not a good idea for the state to lend directly to business in this way, as it lacks the monitoring capacity that banks bring to this task.

Table 1: Summary of Forecast

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

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

The Bank could buy mortgages; this would get it nearer to the credit problem than buying gilts as it now does. The latter simply allows the government to print money to meet its deficit. Some argue that it drives down the yields on gilts. This argument relies on the 'preferred habitat' theory of interest rates by which there is a special demand for gilts for defined purposes; then to induce those demanding gilts to give them up one needs to bid up the price and so lower the yield. However, with the massive supplies of gilts on world markets, many of those holding gilts will be representative world portfolio holders. For them the yield on gilts is set by the rate on world competing bonds such as US Treasuries plus any special UK risk premium. Gilt yields have fallen in line with the world appetite for safe havens. There is no discernable impact from QE 'events' on them.

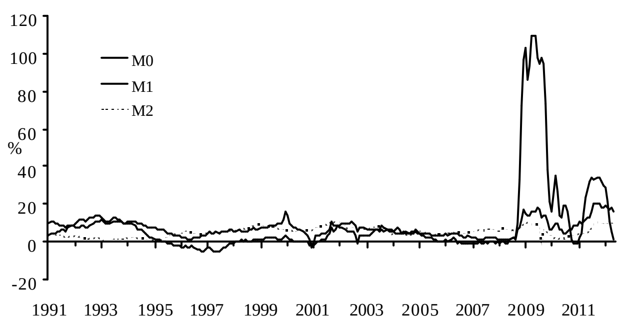
I would support QE purchasing of mortgages and any other unorthodox assets; their purchase could help the credit market to fire up again. But there is no suggestion the Bank will do this.

As for QE purchase of gilts I am opposed to it on three grounds. First, it is of no use for the problem at hand, viz the stimulation of credit and (except trivially) money. Second, it allows the bureaucratic classes to maintain the fiction that they are somehow 'offsetting' their disastrous regulative policies; this relieves the pressures on them to reverse those policies. Third, it substitutes money for bonds in the government's financing, laying up risks long-term for the future control of money and making government dangerously dependent on money printing; in practical terms, when this has to be unwound, the government will face a sharp rise in its funding costs which will create unpopular pressure for further cuts — this will make reversal of QE difficult when it is necessary for monetary control.

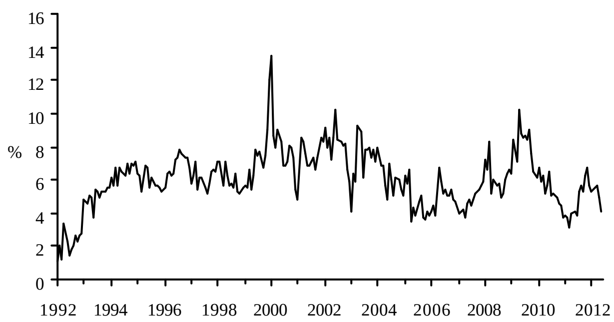
Clearly the endless crisis in the eurozone continues to create monetary uncertainty. Nevertheless there is evidence that the UK economy is managing to grow if only weakly in spite of the eurozone recession. UK exports to non-euro destinations have grown 30% since 2007. While it may seem harsh in current circumstances to argue for a rise in interest rates, we must face the prospect that the eurozone crisis will continue indefinitely. In my view it is time for the Bank to regain control of the interest rate environment. The banks' marginal cost of funds is now just below 4%, way above Bank rate. The Bank is in effect recognising this in its new scheme to subsidise the banks' cost of funds in return for new lending.

What the Bank should now do is raise its Bank rate (i.e. on direct lending to the banks) more into line with market rates, and simultaneously reduce the costs the banks face in terms of liquidity and capital regulations. By such moves it could actually reduce the banks' cost of funds while also getting its own lending rate to a more normal level at which its adjustment up and down would be meaningful again. It would also signal an end to the Bank's hostility to the banking system and the beginning of a new regime that would liberate the banks to lend again, knowing they had the support of the key state player.

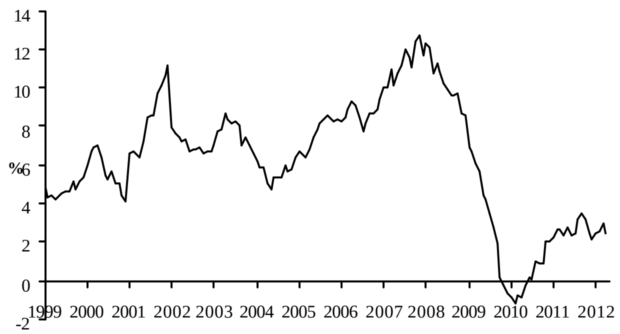
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



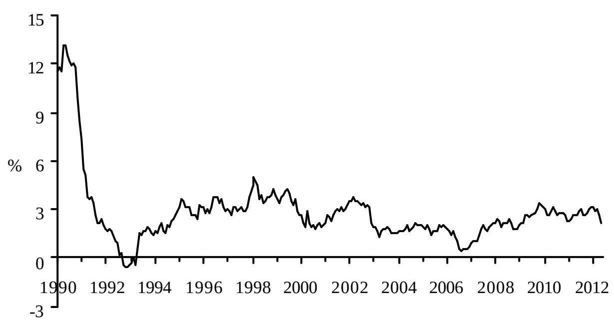
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Lower House passes sales tax hike bill

On June 26, Japan's Lower House of parliament approved a bill to double the national sales tax, giving Prime Minister Yoshihiko Noda his flagship policy for fiscal reform at the cost of a potentially divisive rebellion within the ruling party. The bill passed with 363 lawmakers voting in favour and 96 against. Japan's national broadcaster NHK reported that 57 ruling Democratic Party of Japan (DPJ) members voted against the tax hike in defiance of party leadership, more than expected by several newspapers before the vote but still not enough to kill the bill.

In recent weeks a battle escalated between rival blocs in Japan's ruling party with the revolt being led by Ichiro Ozawa, Noda's biggest rival in the ruling DPJ. Opponents of the plan to double the sales tax over three years say that it will stall economic growth and reduce consumer demand. Ozawa helped create the DPJ but has since fallen out with its leadership and been embroiled in allegations of corruption. He has threatened to bolt before, and his 1993 departure from the Liberal Democratic Party, that previously ruled the country, helped set the stage for the Democrats to rise to power.

Despite the positive result, the vote represents a major setback for Noda, who has struggled since taking office last September to deal with the economic impact of last year's devastating earthquake and tsunami. While stressing on many occasions that "without a tax increase, Japan would go fiscally bankrupt like Greece", Noda has publicly vowed to stake his "political life" on the tax hike plan and now faces the possible end of his premiership. With 57 ruling members voted against, Noda's party has virtually lost its majority in Parliament's Lower House and he would be vulnerable to a no-confidence vote.

The bill, which seeks to raise the sales tax to 8% in 2014 and 10% in 2015, will now be sent to the opposition-controlled Upper House, where its passage in the next few weeks is guaranteed due to the backing of the two main opposition parties which, in return for cooperation, are now demanding that Noda dissolve parliament for an election once the sales-tax-related bills has passed. All eyes are on whether the premier will accept the offer.

The recent political manoeuvring has overshadowed economic debate on the bill. Public opinion seems to be split between those who believe action must be taken to shore up the economy and those who are more concerned about how it will affect their own personal finances — a poll published in the Asahi newspaper on June 6 showed 56% of respondents opposed the sales tax bill, up from 51% a month earlier. There is no common agreement among economists too. Those at the IMF, for instance, claim that the tax hike is crucial to demonstrate a commitment to fiscal reform and sustain investor confidence. They believe that investors and rating agencies would see progress on the tax hike plan as a test of Tokyo's resolve to tackle its public debt that is twice the size of its economy, the highest among industrialised nations. Ratings agency Fitch cut Japan's credit rating last month, citing scant progress in coping with ballooning social security costs and describing Tokyo's fiscal consolidation plans as "leisurely".

Others contend that raising tax is the wrong policy and would bring about disastrous outcomes at a time when the nation is in a deflationary situation and when people are worrying about a global depression. It is said in Japanese political cycles that the Ministry of Finance (MOF) unofficially supported Noda, rather than his rival Seiji Maehara, in the ruling DPJ's presidential election last September. According to this view, the Noda administration is a puppet government of the MOF so that the tax increase is only a government attempt to secure its vested interests.

The state of Japan's public sector balance sheet is, of course, very well known. Fiscal deficits have been running at close to 10% of GDP in recent years, while public sector debt has soared to well over 200% of GDP, the highest among developed countries. Moreover, Japan's reliance on debt in its initial budget for fiscal 2012 hit a new high of 49%. Thus, the MOF is very reluctant to issue new government bonds and is keen to secure financial resources through an increase in the consumption tax to help cover the nation's swelling social security costs as the population ages and fewer babies are born.

However, the fiscal state of the public sector is not so dramatic as to alarm investors with fears of a debt crisis. In net terms, i.e. absent double counting the debt that various domestic government agencies owe each other, such as the Bank of Japan's holdings of government bonds, debt is just about 113% of GDP. Moreover, Japan has the largest savings surplus in the world, and this surplus enables the nation to finance most of the debt domestically and stably at very low interest rates. Nor does Tokyo have any difficulty in paying its interest bills. Thanks to ultra low interest rates, the total net interest on government debt is slightly above 1% point of GDP, much lower than the average ratio that prevails among OECD countries. Overall while debt levels are high, there is no sign that Tokyo's finances are anywhere near a dangerous tipping point that would either endanger bond investors or constrain the government's ability to enact fiscal stimulus.

The real danger from Japan's debt build-up is not a potential crisis in the government-bond market but corrosion in the real economy. The Bank of Japan (BOJ) has showed the ability to keep long-term rates very low for the foreseeable future. But this method of avoiding fiscal crisis causes enormous collateral damage. By lowering the hurdle rate for investment, this action leads firms to pour capital into wasteful projects that temporarily boost demand but end up hurting long-term growth and country productivity level by keeping all the "zombie", unproductive firms in business. Japanese policymakers should give top priority to those supply-side policies which can confer new dynamism to the economy. Not only is the consumption tax the wrong tax at the wrong time, but Noda has totally ignored the primary issue affecting both the budget deficit and a host of other issues: raising Japan's growth rate. Once recovery is in place, that is the time to address the deficit and raise taxes.

MARKET DEVELOPMENTS

Our investment strategy remains the same through the unending euro-zone turbulence. Equities, though still struggling against the crisis headwinds, offer good value or the foreseeable future. Recovery will continue, even though it will seem stuttering and patchy. The best augury is the fall in oil prices, under the impact of the new supply of gas from fracking.

Table 1: Market Developments

	Market Levels		**Prediction for Jun/Jul 2013**	
	May 29	**Jun 27**	**June**	**Current**
			Letter	**View**
Share Indices				
UK (FT 100)	5391	5524	7343	8192
US (S&P 500)	1332	1332	1512	1512
Germany (DAX 30)	6397	6229	8329	8235
Japan (Tokyo New)	727	745	878	892
Bond Yields (government long-term)				
UK	1.79	1.69	3.40	2.10
US	1.73	1.62	4.00	4.00
Germany	1.37	1.55	4.00	4.00
Japan	0.86	0.81	1.50	1.50
UK Index Linked	-0.15	-0.12	1.40	-0.40
Exchange Rates				
UK ($ per £)	1.57	1.56	1.58	1.58
UK (trade weighted)	83.7	83.3	80.2	81.3
US (trade weighted)	81.9	82.3	80.5	80.5
Euro per $	0.80	0.80	0.79	0.79
Euro per £	1.25	1.52	1.25	1.25
Japan (Yen per $)	79.5	79.8	81.0	81.0
Short Term Interest Rates (3-month deposits)				
UK	1.27	0.97	2.50	1.40
US	0.38	0.38	0.60	0.60
Euro	0.67	0.63	2.50	2.50
Japan	0.25	0.25	0.40	0.40

Table 2: Prospective Yields[1]

Equities: Contribution to £ yield of:

	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.80	2.0	2.3	44.00		52.10
US	2.10	2.5	2.0	9.00	–1.61	13.99
Germany	3.90	1.5	1.7	29.00	0.04	36.14
Japan	2.50	1.7	0.0	18.00	–3.14	19.06
UK indexed[2]	–0.12		2.2	–8.00		–5.82
Hong Kong[3]	2.90	7.5	2.0	1.00	–1.61	11.79
Malaysia	3.10	5.2	2.0	39.00	–1.61	47.69
Singapore	3.80	4.4	2.0	24.00	–1.61	32.59
India	1.60	6.5	2.0	4.00	–1.61	12.49
Korea	1.30	3.5	2.0	–19.00	–1.61	–13.81
Indonesia	2.50	6.5	2.0	34.00	–1.61	43.39
Taiwan	4.60	3.5	2.0	35.00	–1.61	43.49
Thailand	3.10	4.4	2.0	26.00	–1.61	33.89

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	1.69	–4.10		–2.41
US	1.62	–23.80	–1.61	–23.79
Germany	1.55	–24.50	0.04	–22.91
Japan	0.81	–6.90	–3.14	–9.23

Deposits: Contribution to £ yield of:

	Deposit Yield	Currency	Total
UK	0.97		0.97
US	0.38	–1.61	–1.23
Euro	0.63	0.04	0.67
Japan	0.25	–3.14	–2.89

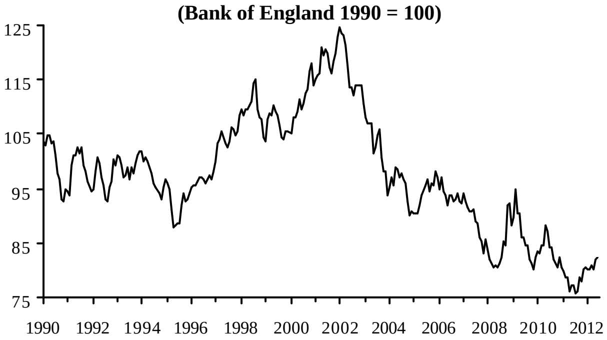
[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

Table 3: Portfolio(%)

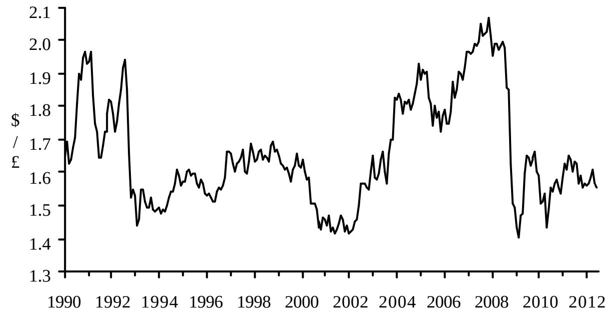
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	June Letter	Current View	June Letter	Current View	June Letter	Current View
UK Deposits (Cash)	10	10	10	10	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-	-
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]

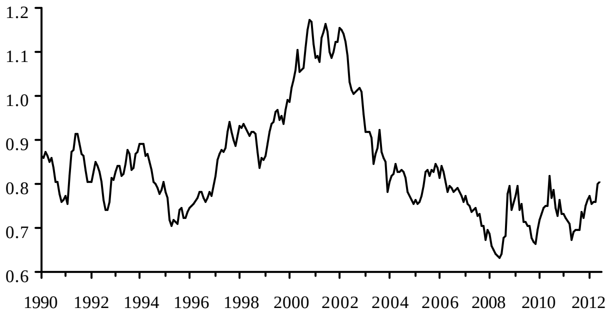
US : Trade Weighted Index (Bank of England 1990 = 100)



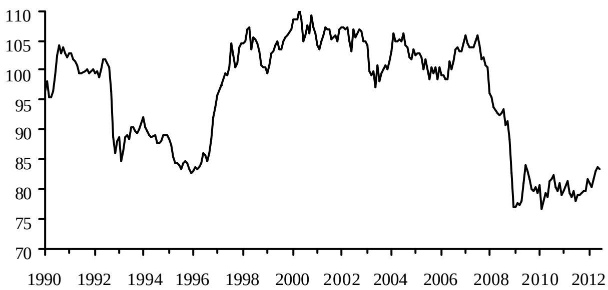
UK: Dollars Per Pound Sterling



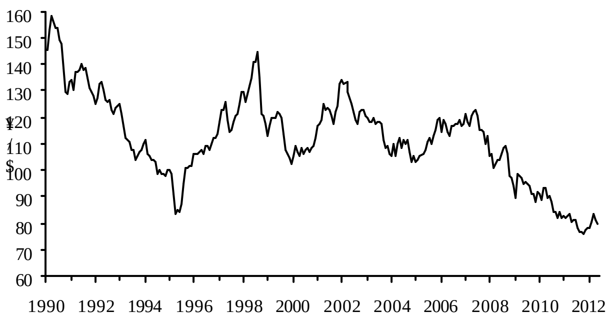
Euro per US dollar



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



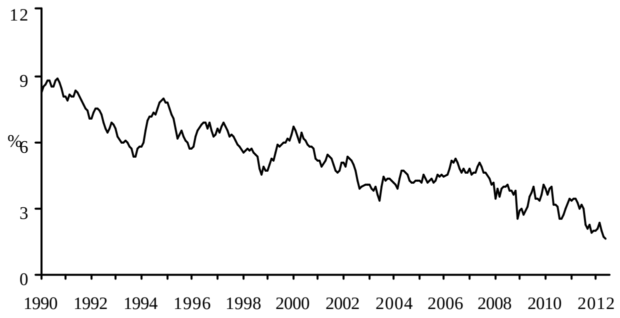
Japan : Yen Per U.S. Dollar



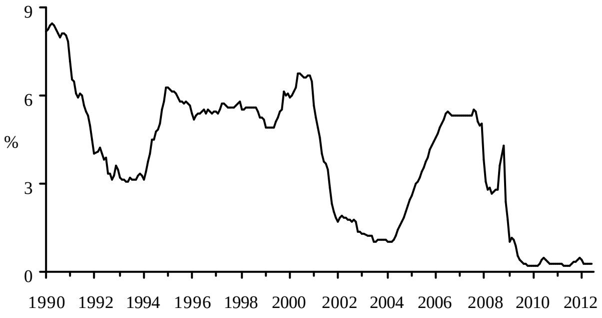
[1] John Wilmot, who has written these sections since this Letter began, is indisposed. We are issuing the charts without his commentary this month. We wish him a speedy recovery.

GOVERNMENT BOND MARKETS

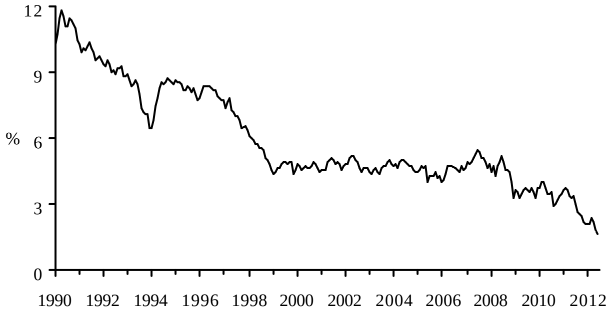
U.S.: Yield on Long-Term Government Bonds



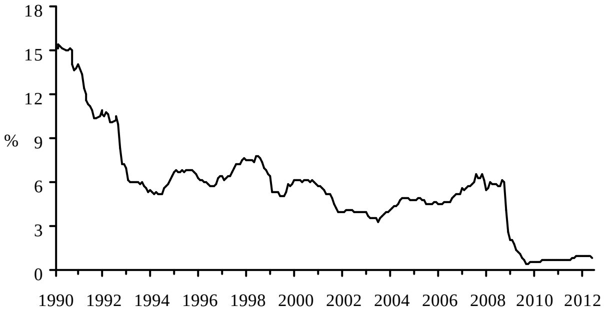
U.S. : 3-Month Certificate of Deposit



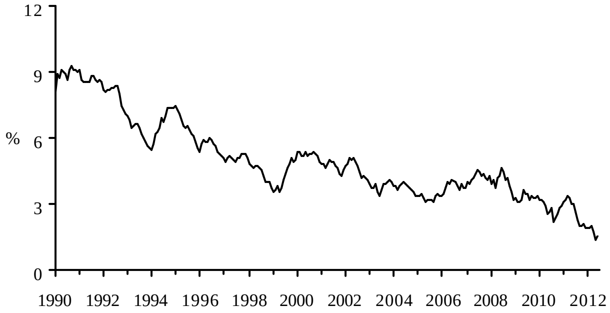
U.K. : Yield on Long-Term Government Bonds



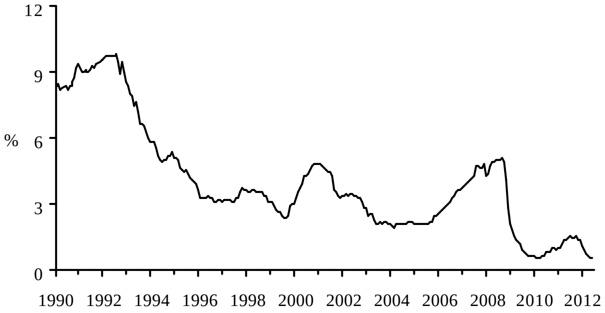
U.K. : 3-Month Interbank Rate



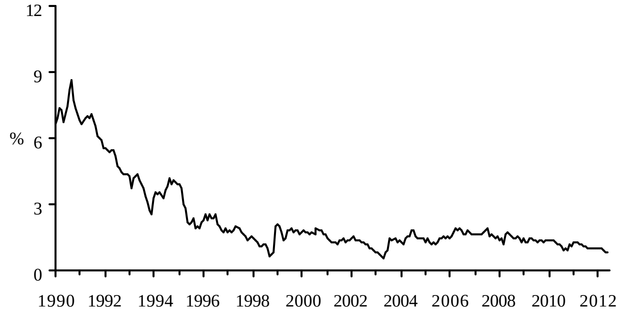
Germany: Yield on Public Authority Bonds



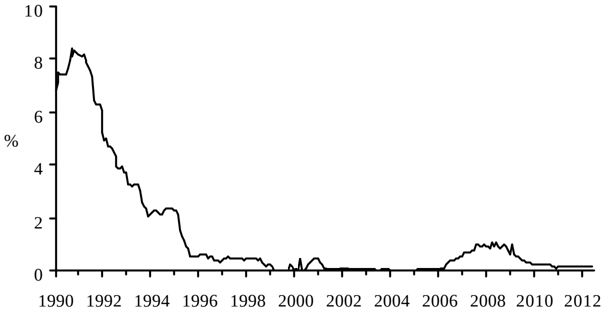
Germany : 3-Month Interbank Deposit Rate



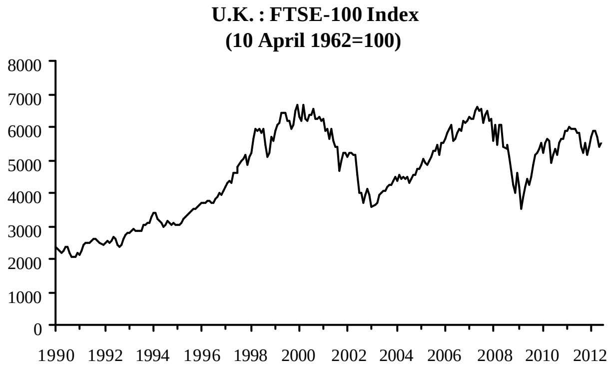
Japan: Yield on Long-Term Government Bonds

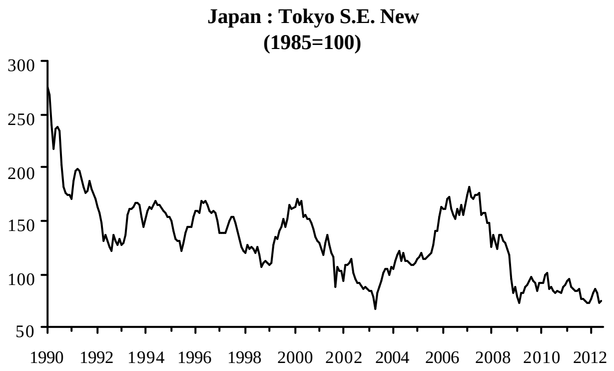


Japan : 3 Month Money Market Rate



MAJOR EQUITY MARKETS



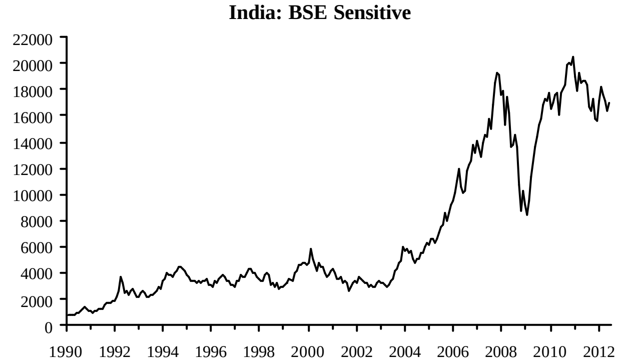


EMERGING MARKETS

Anupam Rastogi

India

India's GDP growth may achieve only 5.8% in 2012–13, down from 9.2% in the same period last year, as the agricultural and manufacturing sectors were hit by sharp slowdowns. Although Delhi often blames the eurozone sovereign debt crisis for its woes, the reality is that the country's difficulties are self-inflicted, as we have noted in previous investment letters. Over the past two years the Congress Party led coalition has stumbled from one crisis to another.



Having cut interest rates by 50 basis points in April, the Reserve Bank of India in its monetary policy review meeting in mid-June left the key interest rate unchanged at 8%, pointing to a rise in inflation in May as a key constraint on the economy. The RBI reiterated that factors other than interest rates were responsible for the slowdown in economic activity. A turnaround in growth, driven only by lower interest rates, is unlikely given the poor investment climate. At present, policy-related risks and uncertainty dominate business concerns.

The wholesale prices index rose 7.55% annually in May, up from 7.23% in April, as food and fuel prices rose 10.74% and 11.53% respectively in April. Retail inflation, measured with the consumer price index, is becoming increasingly important for the central bank, which traditionally focuses more on core inflation when deciding on interest rates.

The Indian rupee continued to fall in June hitting a fresh record low of Rs 57.30 against the dollar on growing concerns over the global economic outlook and bearish sentiment on India's economy. India's government and central bank announced a series of measures aimed at spurring inflows of foreign capital in the last week of June, but the moves failed to appreciably boost the rupee. The rupee has been one of the hardest-hit currencies in Asia, reflecting investor concerns about India's economy, which suffers from high inflation and slowing growth.

Having dropped 25% since early May, Brent crude oil now trades at around $90 per barrel, a level last seen in the fourth quarter of 2010. With the eurozone crisis not going away soon and China's growth slackening, crude oil prices may hit $70 per barrel. This could solve both India's current account deficit and fiscal deficit problems, as the fiscal deficit is caused by subsidies provided on diesel, cooking gas and fertilizers. However, India has to worry about monsoon rain that is now expected to be less than the initial forecast of normal levels.

Finance Minister Pranab Mukherjee is all set to become India's next president, and the PM Manmohan Singh has taken charge of the finance ministry. It is widely believed that controversial tax laws announced in the last budget may be withdrawn quietly, and that an investor-friendly announcement relating to foreign direct investment in the retail, pension and insurance sectors may soon be made.

The rating agency Standard & Poor's has said that India risks losing its investment grade status if a stalemate on crucial decisions such as raising diesel and fertilizer prices and allowing more foreign direct investment into sectors such as retail, pension and insurance continues. However, Moody's Investors' Service has maintained its 'stable' outlook on India's sovereign rating as the growth slowdown and deteriorating business sentiment in the economy are likely to be temporary. This has given the Indian government some much-needed respite as it faces heat after a cut in outlook to 'negative' from 'stable' by Standard & Poor's in April and by Fitch in June, reflecting fading investor confidence triggered by worsening conditions in the economy.

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

China

China's GDP growth in the second quarter is, due to weak global demand, likely to be below 7.5% compared to 8.1% in the first quarter, and is expected to stabilize at around 7.5% in the second half of 2012. Weakness in China's GDP growth may impact on commodity based economies such as Brazil and Australia.

To boost consumer demand, China has introduced a series of stimulus measures such as subsidies on the purchases of energy-efficient televisions and air conditioners, and has also cut banks' reserve requirement ratio and the country's benchmark interest rates. The government reduced the benchmark lending rate to 6.31% for one-year loans — for the first time in the last four years. Banks will also be allowed to lend at a discount of up to 20% below the benchmark; previously, the floor was 10%. The benchmark deposit rate has also been cut to 3.25% from 3.5% for one-year deposits. But the central bank will allow banks to offer depositors rates up to 10% above the benchmark. Effectively, that means banks can pay 3.58% on one-year deposits, slightly more than before the rate cut. These measures are likely to give impetus to investment even further. Investment's share of GDP soared to 49.2% in 2011, up from 36.5% a decade earlier. The share of household consumption fell to 34.9% from 45.3% over the same period.

Inflation has slowed, which will give Beijing additional room to loosen policy and stimulate growth. The country's consumer price index rose 3.0% from a year earlier in May, down from April's 3.4% rise.

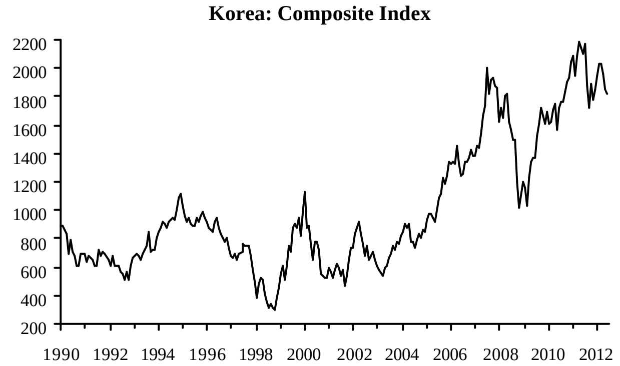
China's exports rose 15.3% in May from a year earlier, significantly up from growth of just 4.9% in April as China's exports to Europe contracted 2.0% in the first four months of the year. Imports climbed 12.7%, compared with April's 0.3% increase.

The Yuan's exchange rate is close to equilibrium, and the dollar may consolidate in a 6.23–6.40 yuan range over the rest of the year. The yuan has fallen 1.2% against the dollar since the start of 2012 and was trading around 6.37 yuan to a dollar in May, well below the central bank's guidance. The appreciation of the yuan has helped reduce China's current-account surplus from 10.1% of GDP in 2007 to a projected 2.3% of GDP in 2012. This has led the IMF to describe the yuan's undervaluation as 'moderately' rather than 'significantly' or 'substantially'.

In continuation with the efforts to liberalize the country's financial sector, China's securities regulator has proposed rules that will ease restrictions and broaden market access for foreign institutional investors. This will lower entry requirements and simplify the approval process for applicants under the Qualified Foreign Institutional Investors program.

The Commission will also allow qualified foreign investors to hold more shares in domestically listed companies and enter the country's interbank bond market. This will help in Beijing's ambition to eventually turn the yuan into a major global currency. China is keen that long-only funds invest in China's bond and equity markets.

Given the size and growth prospects of China's economy, the renminbi could emerge as one of the world's largest and most important currencies, whether for trade or capital markets. This potential has attracted London and the renminbi business may become an important part of the financial ecosystem of London.



	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	3.1	3.0
Trade Balance(US$ bill.)	180	183	155	140	130
Rmb/$(nom.)	6.8	6.6	6.3	6.3	6.3

South Korea

South Korea's economic growth for this year is likely to be around 3.2%, due to the impact of declining demand from Europe. The International Monetary Fund and President Lee Myung-Bak have warned the government that growth in South Korea may slow during the second-half of the year.

South Korea's consumer price inflation was at a 21-month low of 2.5% in May, well within the central bank's range of 2% to 4% for a third straight month. Inflation expectations, though also on a downtrend, remained at 3.7% in May. However, the Bank of Korea kept its benchmark interest rate steady at 3.25% and is maintaining its accommodative stance to help bolster the economy against growing global growth risks.

Exports from South Korea have declined for four out of the five months of 2012. The EU remains a formidable export market for the country and cannot be easily replaced by other export markets, at least in the short run.

Another long-term problem being faced by the Korean economy is household debt, with the amount approaching an unsustainable level. This problem is in the spotlight once again following a new report warning that Korea may follow Spain. Korea's outstanding household debt is equivalent to 81% of its GDP in 2010, similar to Spain's 85% and higher than Greece's 61%. The average figure for OECD countries stands at 73%. Some fear that Korea could become like Spain if more families are unable to meet debt payments because of the tight labour market and other negative economic conditions. However, they ignore the fact that Korea has its own currency and the central bank.

One of the auto-mechanisms — depreciation of the currency — is already working in favour of the economy. The South Korean currency depreciated to 1,177.8 won against the U.S. dollar as of end-May from 1,134.2 a month before.

MSCI has kept South Korea in its ‘emerging market’ bracket and did not upgrade it to ‘developed market’ status. According to the MSCI the major obstacles to an upgrade for Korea are a lack of local currency convertibility and cumbersome registration requirements for foreign investors.

	09	10	11	12	13
GDP (%p.a.)	0.2	6.3	3.6	3.3	3.5
Inflation (%p .a.)	2.6	2.9	4.0	3.2	3.5
Current A/c(US$ bill.)	42.7	28.2	27.0	13.0	15.0
Won/$(nom.)	1200	1150	1100	1150	1150

Taiwan

Taiwan’s economy is suffering from the eurozone crisis as it is one of the region’s most open economies, with an exports-to-GDP ratio of 74%. Its dependence on exports is especially vulnerable to external shocks. Taiwan’s economy may post a GDP growth of just 2% in 2012.

Taiwan’s central bank left interest rates at 1.875%, unchanged since September 2011, in order to remain vigilant over inflation. For the rest of the year rates are likely to remain unchanged.

Taiwan’s exports declined for a third consecutive month in May. Exports fell 6.3% year-on-year in May following a 6.4% fall in April and 3.2% drop in March. However, the trade balance was in surplus by $2.26 billion.

Mr. Ma’s second term in office is getting into trouble and, if he doesn’t find a way to be more assertive with lawmakers, he risks spending the next four years as the lamest of lame ducks.

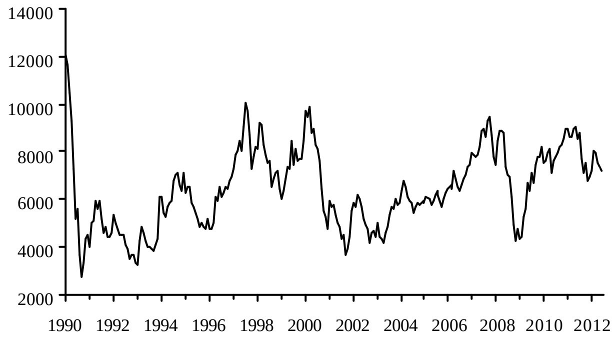
	09	10	11	12	13
GDP (%p.a.)	-1.9	10.8	4.0	2.0	2.8
Inflation (%p.a.)	0.0	1.3	1.2	1.3	1.2
Current A/c(US$ bill.)	16.0	16.0	18.0	20.0	22.0
NT$/$(nom.)	32.0	31.0	30.0	29.5	29.5

Brazil

Gross domestic product in Brazil expanded just 0.2% in the first quarter of this year compared with the last quarter of 2011. Despite massive interest rate cuts and government stimulus measures, the economy is not responding. Brazil’s economic growth in 2010 peaked at 7.5% and posted 2.7% growth last year. In 2012, it is set to grow less than 2% — below the long-term trend of 4%.

In order to give a fillip to the economy, the central bank slashed the Selic interest rate by 400 basis points in less than 10 months to a record low of 8.5%. Despite this, banks have been reluctant to speed up lending because of the steady rise in non-performing loans.

Taiwan: Weighted TAIEX Price Index



The IPCA consumer price index fell to 0.36% in May from 0.64% in April. This may provide some elbow room for the country’s central bank to cut its benchmark Selic interest rate. But Brazilian consumers, who were experiencing record low unemployment and rising salaries, are falling back on their loans. Bad loans in Brazil hit a record high in May, and loans overdue by more than 90 days hit 6%, the highest since records began in 2000. The rise in bad loans is likely to halt the government’s efforts to stimulate borrowing to try to re-ignite the stalling economy.

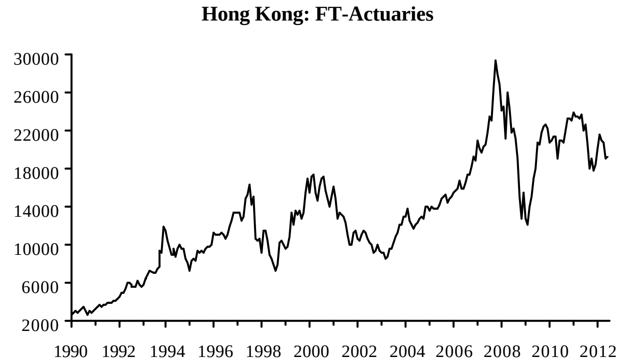
Foreign-exchange flow data released by the central bank confirmed that investors continued to send dollars out of the Brazilian economy at an accelerated pace. There was net dollar outflow in May of $2.59 billion, after posting inflows of $5.99 billion in April. Brazil’s current account stayed steady at roughly 2% of gross domestic product in May. Foreign direct investment outpaced the current account deficit. This is partly the result of Brazil’s government making a deliberate attempt to direct foreign investment into the bond market. Brazil needs dollars to fund the construction of roads, stadiums and other infrastructure in preparation for hosting the 2014 World Cup and 2016 Summer Olympics. The government has excluded infrastructure bonds from the broader tax on foreign capital, saying it hopes to develop a market for long-term financing that is dominated by Brazil’s one state-owned development bank BM&F.

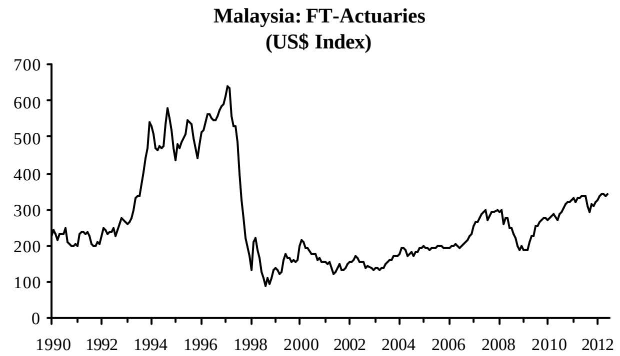
The real is trading in the range of BRL2.05–2.10 to the dollar. The real may depreciate further if crude oil prices fall further.

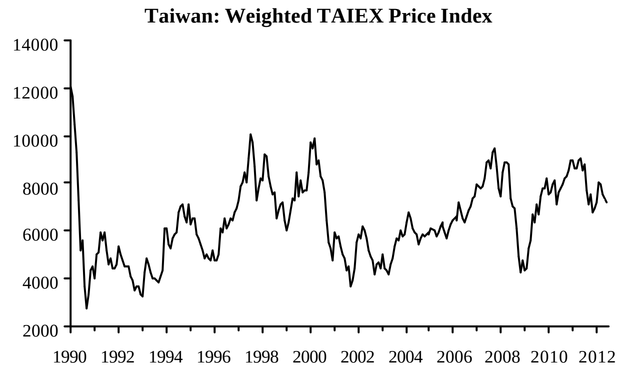
China and Brazil have agreed a currency-swap arrangement that enables each country to access up to $30 billion as part of efforts to build a financial buffer to help guard against a freeze up in global markets. The 10-year deal aims to expand reciprocal investments between the two countries and boost exports of Brazilian manufactured goods to China.

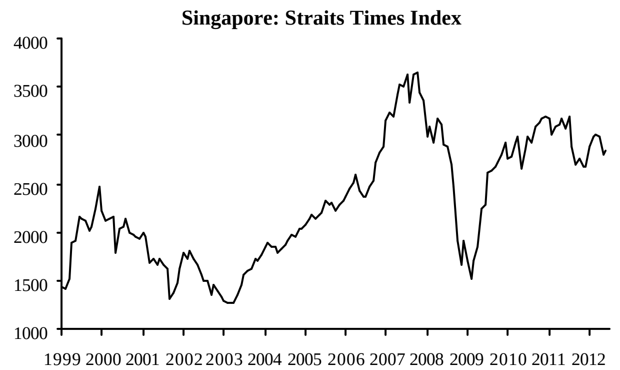
	09	10	11	12	13
GDP (%p.a.)	-0.2	7.5	2.7	2.0	3.0
Inflation (%p.a.)	4.1	5.9	6.5	5.6	5.0
Current A/c(US$ bill.)	-20.0	-47.3	-52.6	-60.0	-65.0
Real/$(nom.)	1.8	1.7	1.5	1.9	1.9

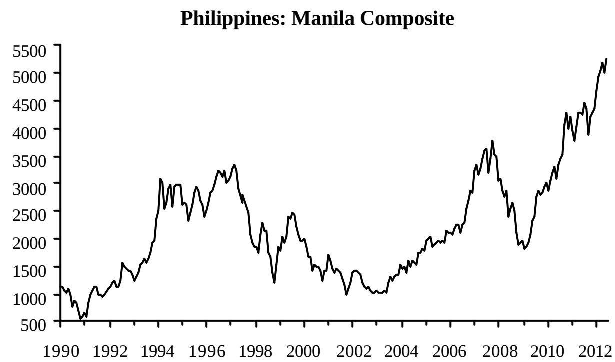
Other Emerging Markets



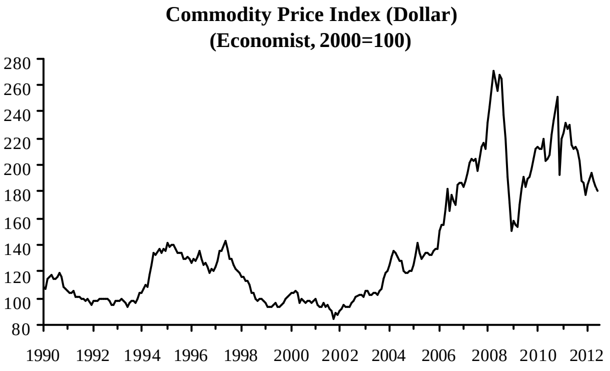


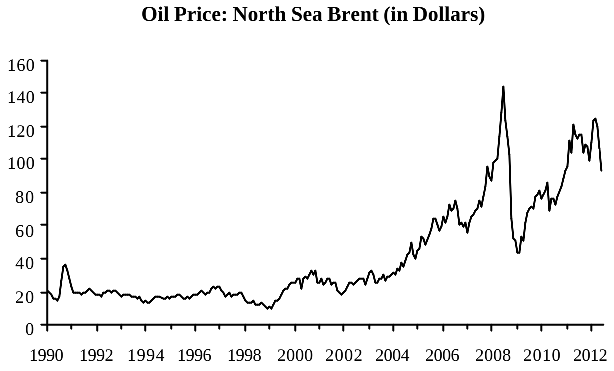


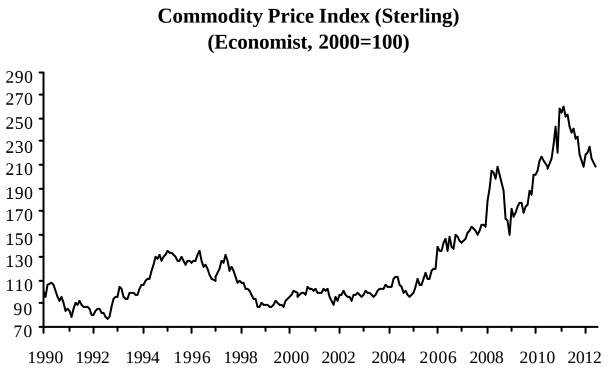


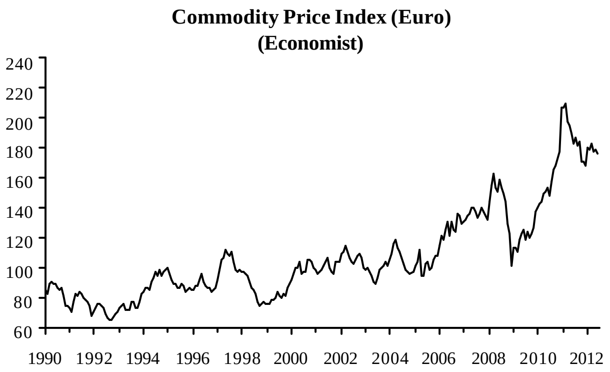


COMMODITY MARKETS









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 in cluding 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