LIVERPOOL INVESTMENT LETTER

June 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

June 2012

CONTENTS

THE GROWTH HOLE WE ARE IN

The latest data from the ONS continues to defy other general indicators of the state of the economy. The first quarter outturn for GDP has now been revised downwards to –0.3% on the grounds that construction output fell by nearly 5%. The Bank of England is just one example of economic forecasters questioning the reliability of this construction estimate. But in any case we know that these preliminary estimates, even in less turbulent times, are virtually worthless. My colleague Mike Wickens, in work for the House of Lords Economic Committee, found that 'Over the period 1998Q2–2004Q1, 9 of the 19 preliminary estimates of growth were more than one standard deviation away from the final estimate, while only 4 out of 18 of the previous quarter's growth rates were more than one standard deviation away from the final estimate. The assumption of no change in the growth rate gave estimates that were twice as accurate as the worst interim estimate. In other words, over this period, using last period's growth rate gave the best estimate of the current growth rate.' We are still too far from the final estimates over the last few years to be able to do a similar exercise since the crisis. However, the early estimates for recession periods generally get revised up later — the reason being that there is substitution away from activities that are being depressed to newer activities that are less well reported initially.

So let us be guided by the employment statistics and by purchasing managers' surveys which suggest that there is no double-dip but rather that the economy is growing weakly. This is still a poor scenario for a government trying to reduce the public deficit, unless this weakness in growth improves.

The factors frustrating growth here are the same as those frustrating growth in other western economies. Unfortunately these factors will not suddenly go away. For this reason policies need to be orientated towards alleviating their effects.

These factors are:

- the tightness of commodity markets will remain until productivity in the use or creation of raw materials rises. This is what happened in the 1980s in response to the commodity crisis of the 1970s. During the 1980s the demand for commodities was reduced by substitution and additional supplies were found, also usually by new methods of extraction (such as in oil extraction in the North Sea). As a result commodity prices in the 1990s dropped to low levels and this helped to fuel the long boom of the 1990s and 2000s.

- with commodity markets tight, there is a reduction in western living standards for those countries that are net importers of commodities. Thus if a country imports commodities worth 5% of its expenditure, then if the cost of this inclusive of transportation rises by 100%, the loss of living standard is 5%. Real commodity prices roughly doubled between 2005 and 2011 so a number of this order looks about right.

- there is also a change in the structure of production after such an upheaval in relative prices. For example we are seeing substitution away from use of the car and from travel; housing demand is reduced because of the energy costs of larger houses. This is a process going on widely. We can gauge something of its importance from the calculations of 'excess capacity'. Were UK economic structure to be the same as it was pre-crisis, then we would have excess capacity of around 13% today. Actual estimates of excess capacity from surveys of businesses indicate a figure of around 3%. This is telling us that much capacity is now simply irrelevant as it will not ever be used.

- if we assume that over the coming decade technical progress in substituting away from these scarce commodities will be slow, then we can also gloomily note that if the west were to grow faster, this would put further upward pressure on commodity prices and hobble the attempt by reinforcing the factors we have just elaborated. We must hope that this is too gloomy and that technical progress will reduce our commodity dependence faster in the coming decade.

What all this suggests is that, as is now obvious, there will not be a 'cyclical rebound' such as occurs when there is plenty of excess capacity which can quickly be brought on stream as demand recovers. Instead it implies that growth from here will be dependent on productivity growth making

Table 1: Summary of Forecast

		2010	2011	2012	2013	2014	2015	2016
GDP Growth[1]		1.8	1.0	1.4	2.0	2.5	2.8	2.5
Inflation	CPI	3.9	4.4	3.2	2.2	2.0	2.0	2.0
	RPIX	4.8	4.7	3.6	2.8	2.7	2.7	2.7
Unemployment (Mill.)								
	Ann. Avg.[2]	1.5	1.5	1.5	1.3	1.2	1.1	1.1
	4th Qtr.	1.5	1.6	1.4	1.2	1.1	1.1	1.0
Exchange Rate[3]		80.6	81.2	81.0	80.5	80.0	79.7	79.5
3 Month Interest Rate		0.6	1.0	2.3	2.5	2.5	2.5	2.5
5 Year Interest Rate		2.3	2.4	2.7	2.8	2.8	2.8	2.8
Current Balance (£bn)		–30.8	–5.8	–8.1	–7.4	–6.8	–6.2	–5.4
PSBR (£bn)		110.8	121.9	100.6	97.2	89.0	81.6	81.7

[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)

new capacity profitable. We need ‘Enterprise Britain’ to spur growth.

At this point we hit another problem. Our banking system has been tied up in knots by the regulative backlash against banking and finance. While preaching competition the Vickers Commission has proposed higher costs through a new raft of regulation; this is discouraging new entry (competition) and is even discouraging credit growth by existing banks because of the high marginal cost of raising the extra capital to go with it when bank share prices are so low.

By this regulative overkill we are both curbing the growth of our major industry and curbing the growth of SMEs who depend heavily on bank credit. In so doing we curb productivity growth.

Finally, we note another set of problems induced by the pain of the crisis. Popular opinion has turned anti-business and this is reflected in policies designed to please the populace. We have had the 50p top rate, the bashing of bankers, windfall taxes on banks, and a climate of hostility to high pay (and those dreaded bonuses). This has been further complicated by populism on the green agenda which has stopped proper infrastructure provision; thus we have had a veto on the third Heathrow runway, the emphasis on wind farms which are costly and ineffective, the proposal for HS2 which is a white elephant. One sympathises with politicians who have to deal with popular disquiets but in the end if growth is to be achieved which both we and these same politicians need, in order to get our economies working again, then these politicians must be willing to explain the business and growth case.

Three Alibis

Balance sheets and QE

Some economists say growth must be slow because ‘balance sheets are weak’. But this is to confuse cause and effect: balance sheets are weak because growth prospects are poor; hence share prices discount weak growth and so the value of assets is low, and the incentive to invest low with it. We need policies that unlock growth potential and then balance sheets will automatically be strengthened.

These same economists argue that balance sheets would be strengthened by printing more money — Quantitative Easing. This will raise the prices of assets and increase the supply of credit, easing balance sheet problems. However, while it may be that QE does lower interest rates on government bonds, it does not reach the parts of the private sector that credit reaches; SMEs do not issue corporate debt and most do not issue shares either. Unfortunately QE has not triggered any improvement in the supply of credit, essentially because the regulators are choking off this supply anyway by their new heavy-handed interventions. Increasing credit supply seems unattractive to banks if to do it one has to raise extra capital at rock-bottom share prices. QE accordingly has made it easy for large firms and the government to finance themselves; the government has benefited from three years’ financing by printing money but is broke, while large corporations are awash with cash, have easy access to equity markets but see no opportunities for investment. The trouble is that QE has not removed the main roadblock to new activity by SMEs that hold the key to spurring productivity growth and competition.

Demand

Then there are other economists, mostly on the left, who believe the situation can be resolved by ‘injecting demand’ through fiscal loosening. Unfortunately again the situation does not permit this to be done while maintaining government solvency. Just like private households governments are limited by their budgetary flows. Most western governments now have reached the limits of their borrowing capacity in peacetime; to maintain confidence in their solvency they must show plans for rebalancing their books. In this situation a government cannot achieve a good ‘multiplier’ from spending more; this is because the net effect will be to raise interest rates on its and indirectly other debt in the country. The effects of these higher interest rates would dwarf any positive effect from the higher spending, producing a negative multiplier. Alas, when times are bad, governments are as constrained in their spending decisions as households are; when times are good, households are as free to spend strongly as are governments.

The Euro-zone Crisis

Another excuse for inaction is the depressing crisis in the Euro-zone. Much ink has been spilt on this; many of us warned of the dire possible economic consequences of the euro, a half-baked scheme for monetary union created mainly for political reasons. The world banking crisis has cruelly exposed the fault lines in this project, mainly derived from its lack of fiscal union. There is now a struggle within the Euro-zone between North and South about the allocation of the burdens for saving the euro. This struggle is condemning the zone to renewed recession.

What we notice is that, in spite of all the rhetoric about the importance of saving the euro for the fate of the world order, the world is getting along quite well in spite of this endless struggle. Indeed the recession in the Euro-zone is weakening commodity prices which in turn is quite helpful for other western economies. Furthermore, other countries including the UK are increasingly shifting their trade away from the Euro-zone. The UK’s exports to the zone are down 10% on a pre-crisis while its exports to non-euro countries are up 30%. Of course the Euro-zone’s weak demand does reduce demand elsewhere but this shift and the commodity price weakness are compensating factors. The UK is quite capable of growing if its supply-side forces were given the necessary boost, regardless of the problems in the Euro-zone, which will probably take at least a decade to sort out.

Monetary Policy

The gloomy conclusion from all this is that printing more money will not generate growth but instead will keep down the cost of budget deficits. Thus, in conjunction with repressive regulation, it creates what ‘financial repression’ does in developing countries: it enables the government to acquire all of society’s savings cheaply.

This depresses general welfare by reducing the return on savings and capital and so reducing growth. Already savers are protesting against the endless perpetuation of these policies. They allow the government to survive, even though its policies are anti-growth.

The policy conclusion is that we need policies to address the factors stultifying growth. Bank regulation must be eased; other regulations on small businesses also need to be eased. Growth will only come from SMEs; as we see large businesses are just sitting on their cash, seeing no urgency to create new markets. Only SMEs have the hunger to drive competition and new technology.

Assume for one optimistic moment that the coalition government started to do this. Then the mountain of liquidity in the banking system would prove a serious inflationary danger. Already the Bank’s credibility on inflation is in danger of erosion from its persistent under-prediction of inflation.

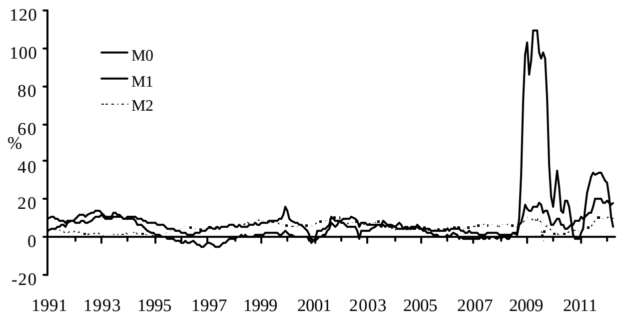
So far we have avoided these dangers in practice because the economy is failing. So we have monetary policy that fails to ignite inflation under economic failure but in the presence of success risks igniting a vigorous inflation.

You might say: ‘well at least monetary policy is not currently doing any damage’. But imagine a Governor who said: ‘We will no longer subsidise government failure to cut deficits and produce growth. We will withdraw QE/excess liquidity; and we will progressively bring inflation under clear control by raising interest rates back towards normal, as is appropriate when demand is approximately equal to supply. Now let government help itself by introducing the right policies for business and so for bringing down its deficits. One of those policies is to loosen bank regulation — and we will take the lead in doing this’

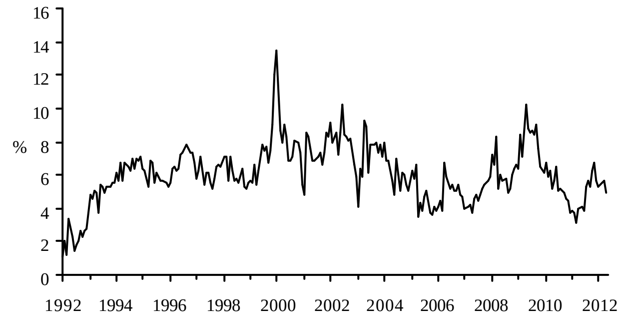
This is the policy we would urge: a robust responsible bank getting in control again and urging good supply-side policies on this divided and failing coalition.

Thus we would now raise rates by a quarter percent with a bias to raise further. For QE we would start the process of withdrawing it — at the rate of say £25 billion per quarter for now; this would eliminate the £325billion liquidity mountain in just over three years. So we would have a bias to speed this up after a year.

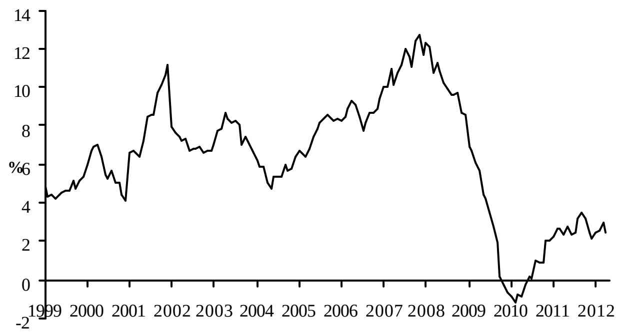
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



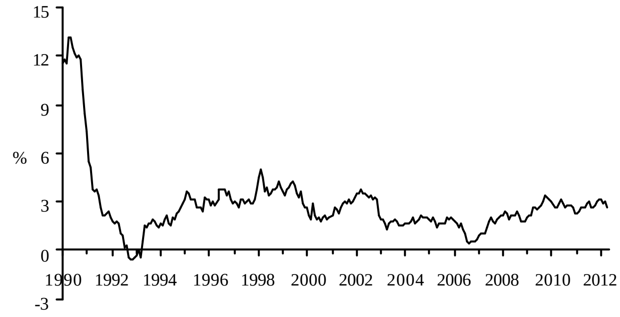
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Recent economic developments

Trade Deficit Rises

Recent trade data showed a larger-than-expected trade deficit in April, ¥520.3 billion up from ¥477.7 billion recorded a year ago and the highest ever for April. Exports grew in April to 7.9% from a year earlier to ¥5.57 trillion, helped by increased shipments of automobiles and auto parts to the US. But imports rose 8.0% from a year earlier to ¥6.09 trillion to move the trade balance to deficit. The run of seasonally adjusted trade deficit in Japan has now extended to 14 months. This is an extraordinary outcome for a country that had recorded a total of eight monthly deficits in the previous 30-year span, all of them since the beginning of the crisis, at the end of 2008.

Japan's trade deficit is the result of the disruption of activities caused by the natural disaster, strong yen and weakness in the global economy. However, most of the deterioration in this period is because of developments on the import side. Of that ¥1 trillion rise in the import bill, about ¥700 billion came from energy products: petroleum, coal and liquefied natural gas (LNG). While a big chunk of that was because of higher oil prices, there was also a substantial rise in volumes. And that was almost entirely due to LNG. LNG import volumes were up by 20% in the past year alone. This was largely a function of the shutdown of nuclear power capacity. At the moment all of Japan's 54 nuclear power plants are currently being shut down.

Analysts say that high prices for LNG and rising imports in Japan, beset by a rapidly ageing population and shrinking manufacturing sector, were likely to generate trade deficits throughout 2012. Energy needs will also pose near-term growth risks. While the GDP numbers for the first quarter of 2012 were relatively solid, rising 1% on a quarterly bases, there is the potential for supply-side disruptions in the peak power-consuming months ahead. In addition, the change in the mix of power generation capacity has not completely showed up in the consumer price index yet. Although electricity prices for households have already been rising, power companies have not yet passed through the increased gas prices into final consumer tariffs.

GDP shows strong growth in first quarter

While the current account is shrinking, Japan's GDP grew at nearly double the US rate for the first quarter of the year, an unexpectedly strong sign of recovery in the wake of last year's devastating earthquake and tsunami. GDP expanded at 1% over the previous quarter, marking the third straight period of growth and the largest rise since last summer's post-earthquake rebound, thanks to strong domestic demand attributed particularly to the acceleration of public-works projects for reconstruction in the areas damaged by the disasters — it is reported that robust public spending has even caused a labour shortage in the construction industry in the disaster areas.

The government spending that has been lifting Japan stands in contrast with Europe and the US where governments have been more focused on curbing debt than on new fiscal stimulus. It is unclear, though, how long Japan itself can continue on that path, with policymakers also focused on trying to boost taxes to rein in the country's sovereign debt which is twice GDP, the highest among industrialized nations, even higher than Greece.

Regarding other components, exports rose 2.9% while consumer spending expanded 1.1%, the fourth consecutive quarterly rise. Rising household spending is mainly associated with higher demand for cars, which got a strong boost from renewed government subsidies to reward buyers of fuel-efficient automobiles.

Looking forward, economists see growth slowing in the current April-June quarter, and whether exports can play a bigger part in shoring up the economy is an open question amid renewed concerns over the European debt crisis.

Japan inflation high

Japan's core consumer-price index (CPI) rose for the third straight month in April on the back of higher energy prices. Core CPI, which include oil prices but excludes volatile fresh food costs, rose 0.2% in April from a year earlier. The modest gain highlights how far away Japan remains from meaningful price increases. Core CPI last rose by more than 0.2% on the year in November of 2008 when it gained 1%. Basically Japanese prices have been stable for a decade, suggesting that implicitly the Bank of Japan may have been targeting a constant price level.

Motohisa Furukawa, Japan's economy minister, said after the release of the data that the country's long-running deflationary trend is gradually easing, though stressed that the government will keep a close watch on prices. "The price trend is becoming favourable", Furukawa said. "But we cannot judge this only by looking at the CPI and I believe Japan remains in a modest deflationary trend".

This suggests that the Bank of Japan (BOJ) will remain under pressure to loosen monetary policy further to beat deflation and shield the economy from any damage from a strong yen. "The BOJ must firmly pursue monetary easing to achieve its 1% inflation goal", said Finance Minister Jun Azumi last week in parliament. Observers do not seem to fear inflation. They anticipate the central bank will add stimulus by July, when its price forecasts will indicate any progress in countering decade-long deflation. However, when one looks at the record of BOJ actions, they appear to imply a flat price level, not 1% inflation, as the target. This seems to be in line with popular wishes, for stability and a safeguarding of the value of money, widely held as a savings medium.

MARKET DEVELOPMENTS

Once again the ongoing crisis in the euro-zone has knocked equities down and pushed up bond prices in the main (safe haven) markets, viz the US, UK, Japan and Germany. Our assessment remains that the European Central Bank will continue to pump money into the tottering South of the zone. Provided the Southern governments show willingness and determination to carry out the reforms demanded by the EU Commission, the ECB and the IMF — the 'troika' — then the ECB will not 'pull the plug' on this financing, even though it has already exceeded €2 trillion. With this 'backdoor rescue mechanism' in place and in daily use, it is hard to see why the euro should collapse, disappear, or lose countries. This implies that the crisis will not be resolved nor will it go away but nor will it explode with a 'Grexit' or a 'Portuxit'. This means that equities will periodically drop on these recurring 'crises' but will recover again on underlying growth, even if weak. Hence we remain with our equity-based allocations.

Table 1: Market Developments

	Market Levels		Prediction for May/Jun 2013	
	Apr 25	**May 29**	**May Letter**	**Current View**
Share Indices				
UK (FT 100)	5719	5391	7675	7343
US (S&P 500)	1391	1332	1565	1512
Germany (DAX 30)	6705	6397	8521	8329
Japan (Tokyo New)	809	727	971	878
Bond Yields (government long-term)				
UK	2.15	1.79	3.40	3.40
US	1.99	1.73	4.00	4.00
Germany	1.73	1.37	4.00	4.00
Japan	0.93	0.86	1.50	1.50
UK Index Linked	-0.09	-0.15	1.40	1.40
Exchange Rates				
UK ($ per £)	1.61	1.57	1.58	1.58
UK (trade weighted)	83.0	83.7	80.2	80.2
US (trade weighted)	80.1	81.9	80.5	80.5
Euro per $	0.76	0.80	0.79	0.79
Euro per £	1.22	1.25	1.25	1.25
Japan (Yen per $)	81.4	79.5	81.0	81.0
Short Term Interest Rates (3-month deposits)				
UK	0.96	1.27	2.50	2.50
US	0.50	0.38	0.60	0.60
Euro	0.72	0.67	2.50	2.50
Japan	0.18	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	2.2	32.00		40.00
US	2.10	2.5	2.0	9.00	−0.77	14.83
Germany	3.70	1.5	1.7	27.00	0.24	34.14
Japan	2.60	1.7	0.0	19.00	−2.67	20.63
UK indexed[2]	−0.15		2.2	−9.00		−6.95
Hong Kong[3]	2.80	7.5	2.0	0.00	−0.77	11.53
Malaysia	3.20	5.2	2.0	40.00	−0.77	49.63
Singapore	3.90	4.4	2.0	25.00	−0.77	34.53
India	1.60	6.5	2.0	4.00	−0.77	13.33
Korea	1.30	3.5	2.0	−19.00	−0.77	−12.97
Indonesia	2.50	6.5	2.0	34.00	−0.77	44.23
Taiwan	4.50	3.5	2.0	34.00	−0.77	43.23
Thailand	3.10	4.4	2.0	26.00	−0.77	34.73

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	1.79	−16.10		−14.31
US	1.73	−22.70	−0.77	−21.74
Germany	1.37	−26.30	0.24	−24.69
Japan	0.86	−6.40	−2.67	−8.21

Deposits: Contribution to £ yield of:

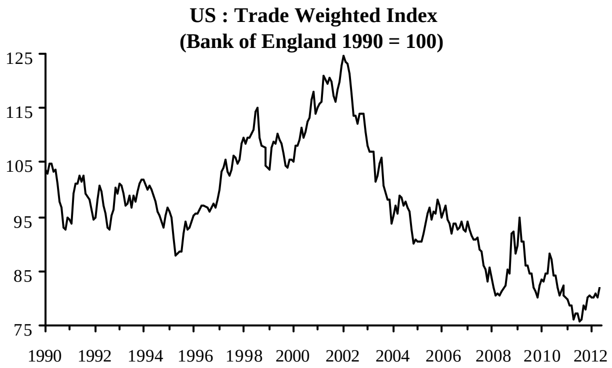
	Deposit Yield	Currency	Total
UK	1.27		1.27
US	0.38	−0.77	−0.39
Euro	0.67	0.24	0.91
Japan	0.25	−2.67	−2.42

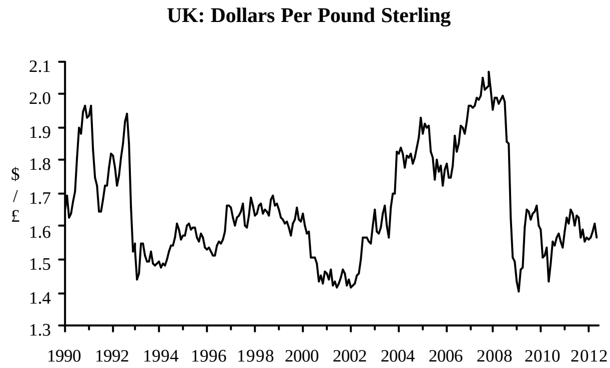
[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

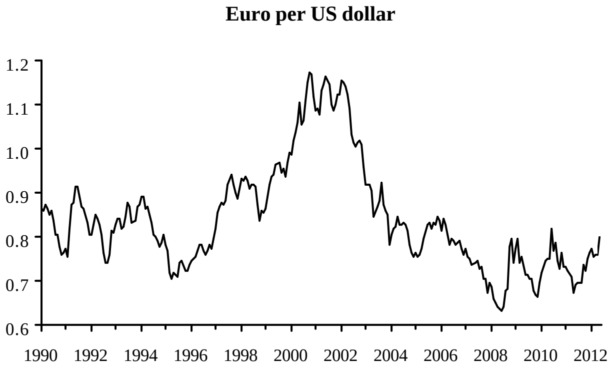
Table 3: Portfolio(%)

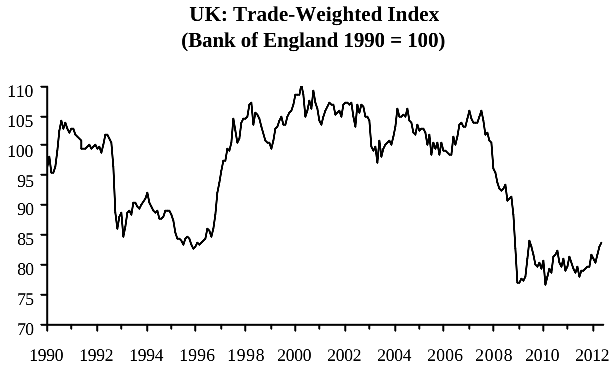
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	May Letter	Current View	May Letter	Current View	May Letter	Current View
UK Deposits (Cash)	10	10	10	10	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-	-
German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

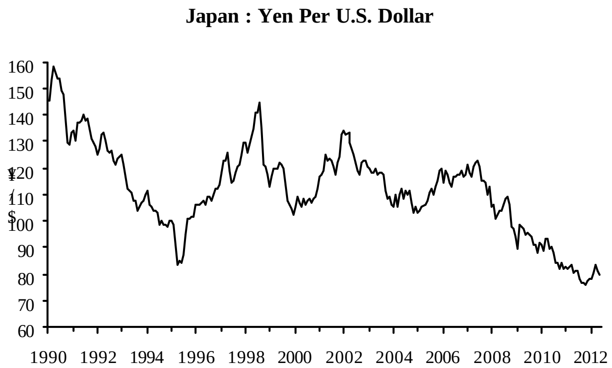
INDICATORS AND MARKET ANALYSIS
FOREIGN EXCHANGE MARKETS[1]







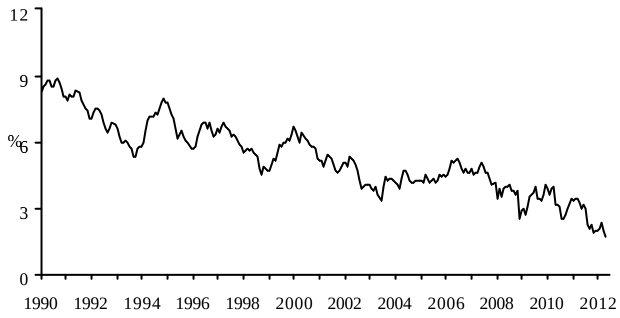




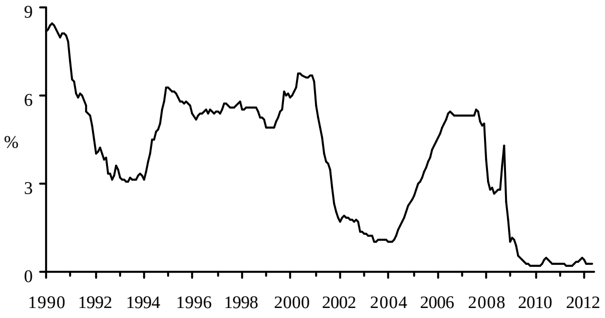
[1] John Wilmot, who has written these sections since this Letter began, is indisposed. We are issuing the charts without his commentary this month. We wish him a speedy recovery.

GOVERNMENT BOND MARKETS

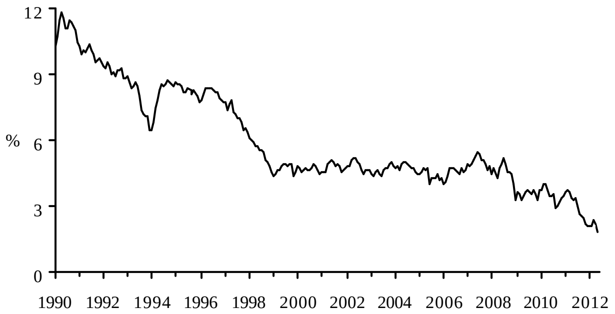
U.S.: Yield on Long-Term Government Bonds



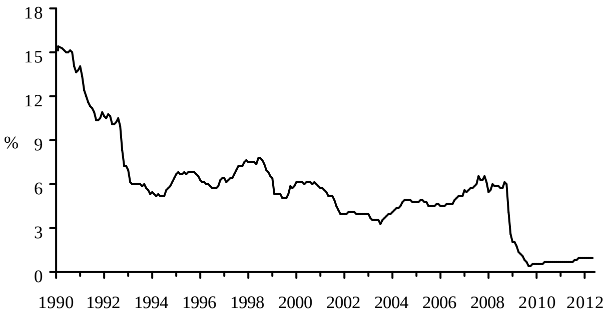
U.S. : 3-Month Certificate of Deposit



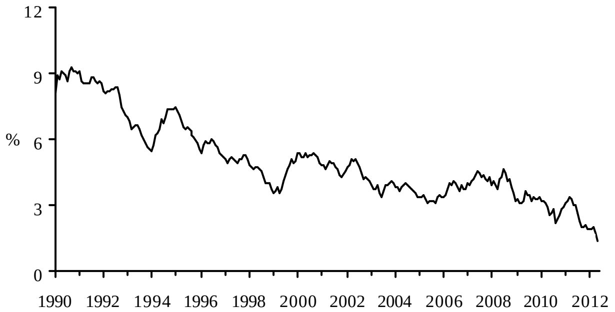
U.K. : Yield on Long-Term Government Bonds



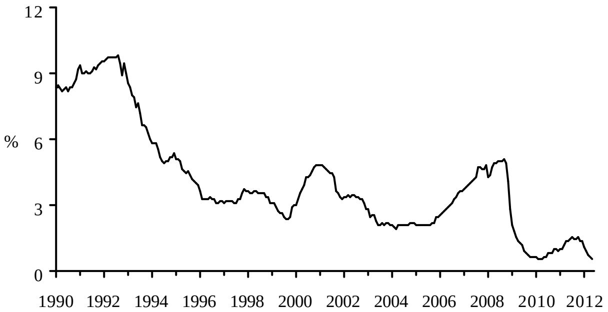
U.K. : 3-Month Interbank Rate



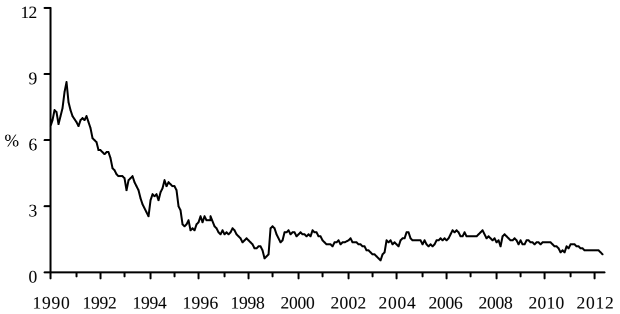
Germany: Yield on Public Authority Bonds



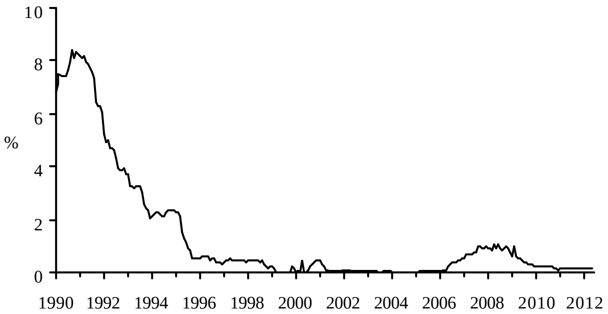
Germany : 3-Month Interbank Deposit Rate



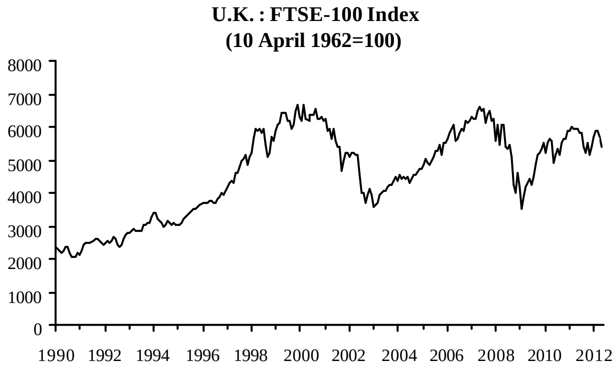
Japan: Yield on Long-Term Government Bonds

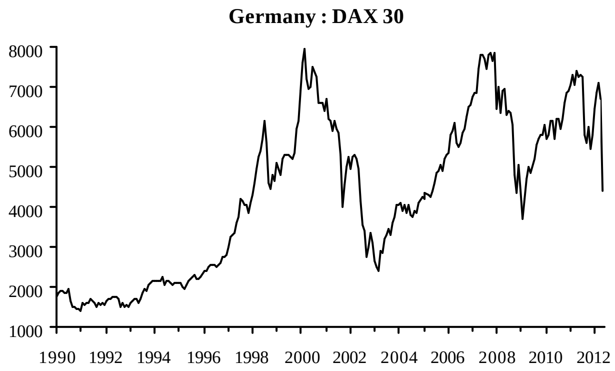


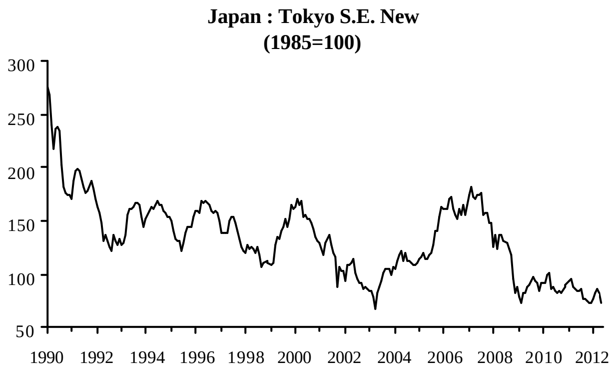
Japan : 3 Month Money Market Rate



MAJOR EQUITY MARKETS







EMERGING MARKETS

Anupam Rastogi

India

The Indian economy is slowing and spluttering and will continue to do so until new government takes over. Behind this economic stagnation is the story of political degradation. The government expects the economy to expand by more than 7% in the fiscal year that began April 1 but foreign investment banks expect India's growth to be around 6.5%. Industrial output contracted by 3.5% in March 2012 and exports have been declining consistently, as demand in Europe for cheap Indian goods has dropped.

The weak local currency is pushing up the import bill for retailers because India imports more than three-quarters of the crude oil it requires. The government has allowed retailers to raise gasoline prices by 11.5%, leading to protests. However, political consideration has forced the government to abandon any immediate increases in diesel and cooking fuel prices.

India's inflation accelerated to 7.23% in April from a year earlier as prices of most commodities rose, adding to the concerns of a resurgence of price pressure. As inflation in India has picked up again, the hopes of Indian business leaders' that the country's central bank would further cut interest rates have got dashed.

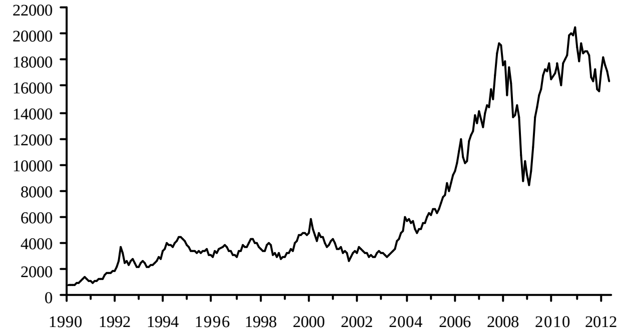
Strong demand for oil and gold has seen Indian imports outpace exports in the past year, even as exports exceed a government target of $300 billion. Weak demand in Europe — where India ships more than 20% of its exports — has contributed to slackening exports. The textile and garment sector — which sells nearly 70% of its goods to the US and Europe — saw exports drop 10% in April compared to the previous year.

The current-account deficit — the difference between exports and imports of goods and services — which is about 4% of gross domestic product, is weighing on the rupee, which has fallen to record lows. The question being asked by all is how low can the rupee go? India's currency is trapped in a vicious cycle: the lower it falls, the harder it is to turn around again.

The trap is that the weak currency hits importers hard, particularly India's oil companies that buy crude overseas and have to sell fuel at state-controlled prices. That in turn leads to bigger government fuel subsidies, stretching the fiscal deficit further. Some expect the rupee to touch a level of 57, or even 60, rupees to the U.S. dollar.

Standard & Poor's, the credit agency, has revised its outlook on the long-term rating of India from stable to negative and warned that it would downgrade India's rating unless the government moved swiftly to bring the country's

India: BSE Sensitive



widening fiscal deficit under control. The crucial monsoon rains are expected to be normal this year.

	09-10	10-11	11-12	12-13	13-14
GDP (%p.a.	7.4	7.5	6.9	6.5	6.5
WPI (%p.a.)	9.5	9.0	7.5	7.5	7.0
Current A/c(US$ bill.)	–14.0	–31.0	–40.0	–35.0	–34.0
Rs./$(nom.)	48.0	49.0	49.5	54.0	55.0

China

China's annual economic growth is likely to dip below 8% in the second quarter and the National Development and Reform Commission (NDRC), the nation's top planning agency, believes that this weakness may continue for a couple of quarters. The World Bank, on the other hand, is more optimistic and expects Chinese gross domestic product to expand by 8.2% in 2012.

Annual consumer inflation has moderated from 3.6% in March to 3.4% in April, while food prices — which are of most concern for China's people and policymakers — rose by 7%, compared with 7.5% in March. Easing inflation potentially gives Beijing more scope to loosen policy to help the economy rebound from a first-quarter slowdown in growth. The moderating inflation rate bodes well for its sovereign credit rating in spite of uncertainty about the world economy.

China is unlikely to loosen credit too much as it tries to strike a balance between economic growth and not reigniting inflation. China wants to rely on domestic demand and structural reforms to support the economy, which faces growing downward pressures. The government is giving many incentives to boost domestic demand. This is not because people are failing to spend more — at nearly 8%, Chinese household consumption growth far outstripped the average for developing Asia last decade — but simply because it could not keep pace with GDP. The government has doled out subsidies for energy-saving home appliances and cars to stimulate consumption. China has also fast-tracked infrastructure investment and restated its intention to boost private sector participation in a wide range of state-controlled sectors, including electricity, oil and natural gas to help underpin growth.

China remains a sought after destination for direct investment. According to a survey, 63% of the companies asked plan to make new investments in China in the next two years.

China's yuan fell against the U.S. dollar to its lowest level in more than five months. The yuan has fallen 1.0% since the start of 2012. On the over-the-counter market, the dollar is selling at premium, indicating that the market expects the yuan to depreciate further.

Internationalization of the yuan is moving fast. It is now the fastest-growing payments currency in the world, according to Swift, the payments system operated by almost 10,000 banks.

Chinese state enterprises are also buying foreign assets. State Grid Corp of China, the world's largest utility by asset size, will buy the Brazilian electricity transmission assets of Spain's Actividades de Construcción y Servicios. China's utility companies have been on a buying spree recently as they seek to expand their international presence and boost revenues.

The US Treasury declined to designate China as a "currency manipulator" even as Mitt Romney, the Republican candidate for President, turned up the heat on the issue by promising to do so on his first day if elected. According to the US Treasury, "the available evidence suggests the RMB (renminbi) remains significantly undervalued" but that China did not meet the "manipulator" definition. The report noted a decline in China's current account surplus and a 12.5% rise in the renminbi against the dollar over the last two years after adjusting for inflation.

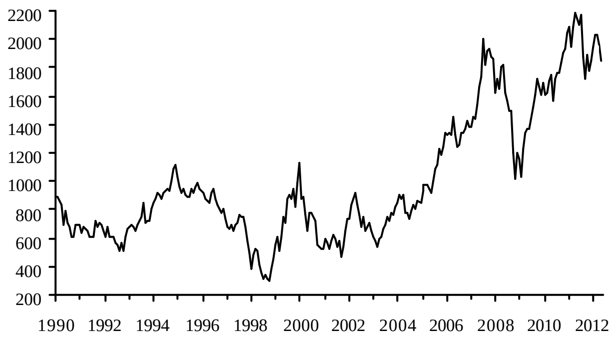
	09	10	11	12	13
GDP (%p.a.)	8.7	10.3	9.2	7.5	7.5
Inflation (%p.a.)	–0.8	5.9	4.3	3.1	3.0
Trade Balance(US$ bill.)	180	183	155	140	130
Rmb/$(nom.)	6.8	6.6	6.3	6.2	6.1

South Korea

Growth in Asia's fourth-largest economy will slow to 3.3% in 2012 from 3.6% in 2011, but pick up to 4% in 2013, according to the OECD. South Korea's growth slowed to 2.8% in the first quarter compared with a year ago. The OECD expects South Korea's economy to gather pace over the coming quarters and advised the country's central bank to raise interest rates to keep inflation within its target. However, the majority of South Korean companies expect overall economic conditions to deteriorate in the second half of this year mainly due to mounting eurozone woes and a slowdown in the Chinese economy.

Inflation moderated to a 21-month low of 2.5% in April. Consumer-price gains were trimmed by government subsidies for childcare and an expanded free school lunch program starting in March. Annual average inflation is seen slowing to 3.0% this year from 4.0% last year. The central bank aims to keep the inflation rate between 2% and 4%.

Korea: Composite Index



The Bank of Korea kept the policy interest rate unchanged at 3.25% for 11 consecutive months after having raised it by a total of 125 basis points — from the record low of 2% — in five steps between July 2010 and June last year.

South Korean exports fell in April for the third time this year, shrinking by 4.7% from a year earlier. The government's projection of about 7% growth in exports for the whole of this year will now need to be lowered. Imports this year are now expected to grow by 6.1%, thus trimming the trade surplus to $25 billion versus $31 billion last year.

The dollar has risen 5.5% against the won since hitting its low for the year in early March. Markets suspect that the authorities sold about $1.5 billion to support the won.

Korea's benchmark stock index has fallen 12% since mid-March amid heavy selling by foreign investors. Foreigners withdrew approximately 4 trillion won from the country's financial markets in May, after having been net investors over the first three months of the year. The Won touched 1,178.60 per dollar in late May.

The foreign ministers of South Korea and Brazil have agreed to increase economic, political and scientific cooperation between the two growing economies.

	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 government has lowered its economic growth forecast for 2012 to 3% as demand for electronic exports dwindled. Industrial production dropped for a second month in April and the jobless rate has increased. Taiwan's economy is passing through a difficult period in absolute numbers, and is expected to improve in the next six months. Taiwan is advised by a local research institute to stimulate its domestic market in the face of weak export demand to ride out the gloomy global economy.

As Ma Ying-jeou starts his second four years as president of Taiwan, his opening up of the economy to China in his first term is presenting the island nation with as many headaches as opportunities. While the lowering of barriers and signing of 16 agreements with China in the last four years have significantly eroded the six decades of hostility between the two countries, the economic benefits have been mixed and future prospects remain uncertain.

Free trade agreements with other countries are beneficial to Taiwan but it is worried about tougher challenges when China and South Korea conclude their free-trade agreement, likely to be in place in two years' time.

In turn, Beijing's willingness to give Taiwan "diplomatic space" is coming to the test as Taipei proceeds with negotiations for free trade agreements with Singapore and New Zealand.

So far Beijing has not leaned on the governments of New Zealand or Singapore to curb the talks, or tried to insist that economic agreements with Taiwan need its stamp of approval.

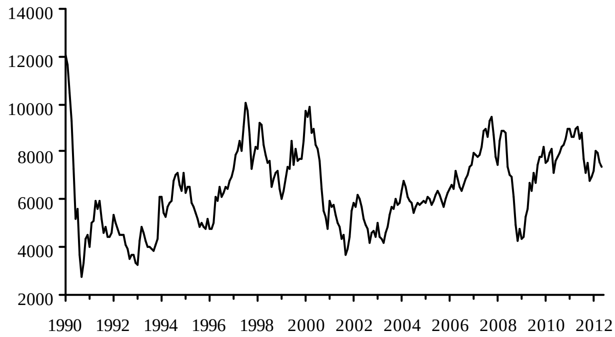
Taiwan's dollar fell to a four-month low as foreign investors sold $3.7 billion more local stocks than they bought. Taiwan's dollar has weakened to NT$29.762 against its U.S. counterpart, the lowest level since January 31, 2012.

	09	**10**	**11**	**12**	**13**
GDP (%p.a.)	–1.9	10.8	4.0	3.0	3.5
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

The country's industrial sector could not perform well due to a strong real and the global slowdown due to the ongoing debt crisis in Europe; Brazil's economy expanded by only 2.7% in 2011. The central bank's policy dilemma has shifted from concerns about inflation toward concerns about growth. Since August 2011, the bank has cut the benchmark Selic base interest rate to a historic low of 8.5%.

Taiwan: Weighted TAIEX Price Index



The government believes that Brazil's inflation will remain on a declining trend despite a sharp increase in prices. Brazil recorded 12-month inflation of 5.1% in April, slowing from 6.5% at the end of December. The government's year-end inflation target is 4.5%.

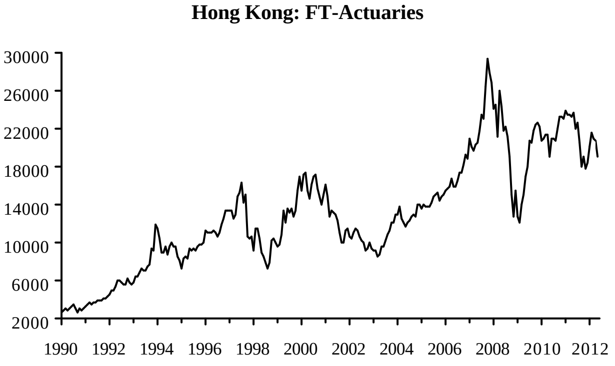
The Brazilian real depreciated against the U.S. dollar in the last six months, and is now hovering at around 2 reals to a dollar. Last July, the real hit a record of 1.53 to the dollar. In order to maintain the competitiveness of Brazil's exports, the government took measures to cool inflows that had been driving up the currency. With new or higher taxes on speculative inflows and crude prices falling, the currency has slowly depreciated. But investors have been fleeing the real on concerns that Greece will exit the eurozone and throw the global economy into disarray again.

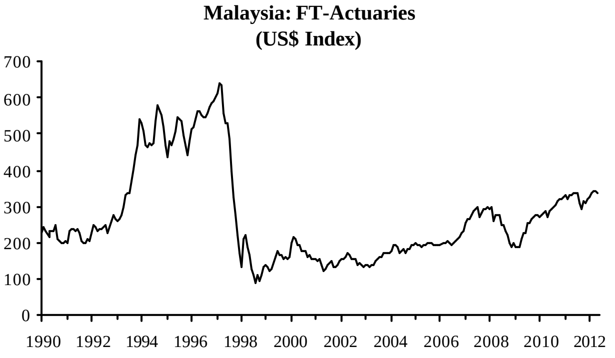
However, Brazil needs dollars to build infrastructure in preparation for hosting the 2014 World Cup and 2016 Summer Olympics. Hence, Brazil's government has deliberately funnelled foreign investment into the bond market. Purposefully, the government has excluded infrastructure bonds from the broader tax on foreign capital. The government also hopes that it will develop a market for long-term financing in the country.

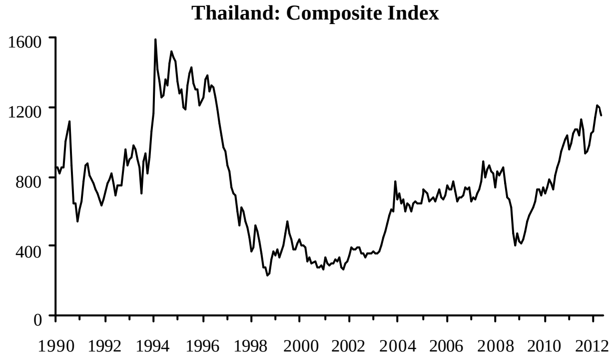
The risk-off trade of investors has witnessed a net $5.2 billion pulled out from the market. The country's main share-price index has plunged 20% since March.

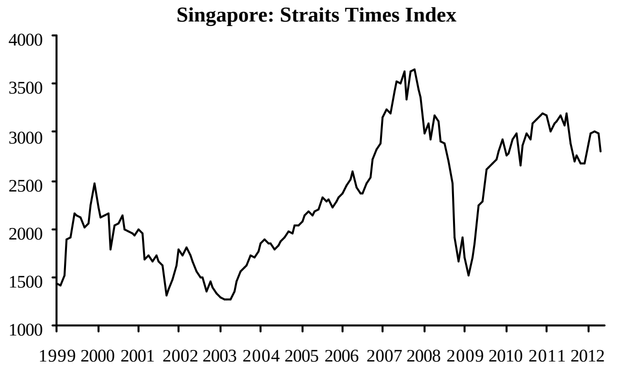
	09	**10**	**11**	**12**	**13**
GDP (%p.a.)	–0.2	7.5	2.7	3.0	3.5
Inflation (%p.a.)	4.1	5.9	6.5	5.6	5.0
Current A/c(US$ bill.)	–20.0	–47.3	–52.6	–60.0	–65.0
Real/$(nom.)	1.8	1.7	1.5	1.9	1.9

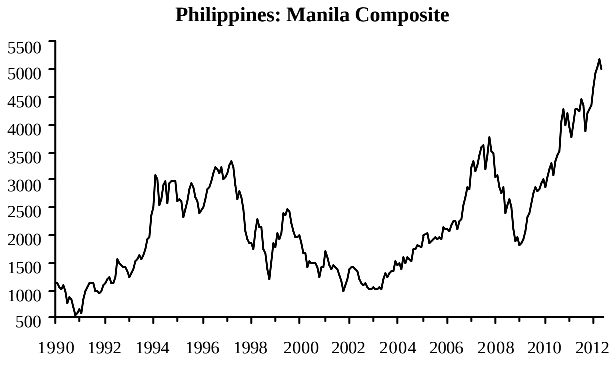
Other Emerging Markets





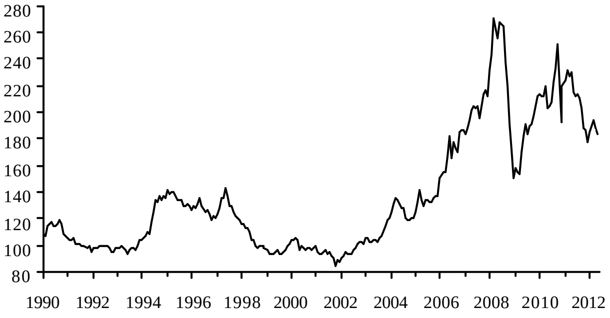




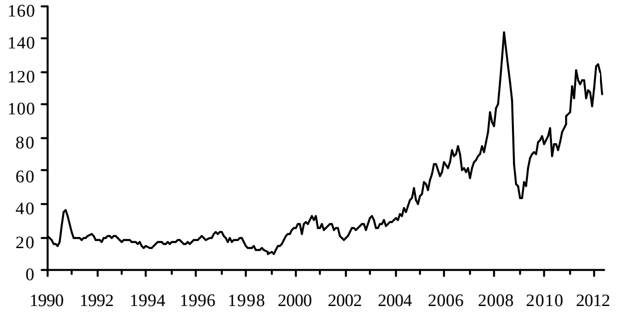


COMMODITY MARKETS

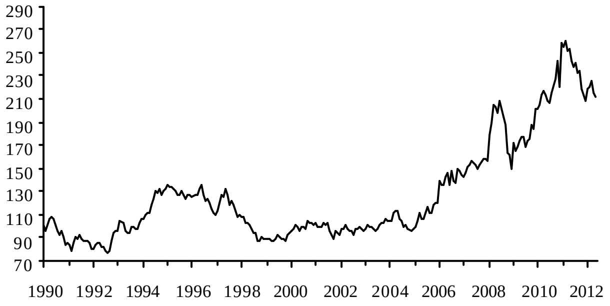
Commodity Price Index (Dollar)
(Economist, 2000=100)



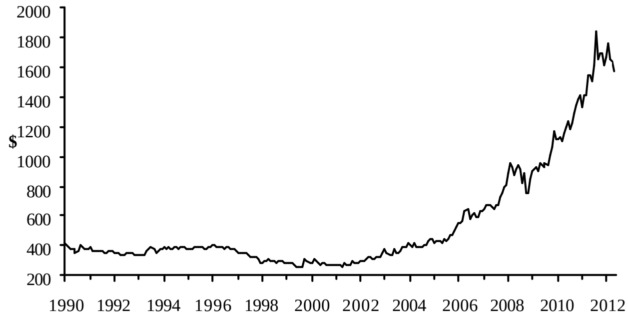
Oil Price: North Sea Brent (in Dollars)



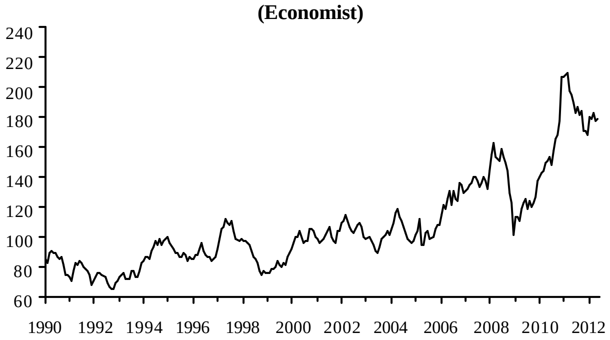
Commodity Price Index (Sterling)
(Economist, 2000=100)



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]
2008	3.3	4.0	5.1	91.2	100.3	3.7	4.3	1.0
2009	1.3	2.8	0.8	80.7	89.5	-3.1	2.0	-0.3
2010	3.9	2.3	0.6	80.6	91.2	-3.8	4.8	-0.5
2011	4.4	2.4	1.0	81.2	94.5	-2.2	4.7	0.1
2012	3.2	2.7	2.3	81.0	95.8	0.1	3.6	0.7
2013	2.2	2.8	2.5	80.5	95.7	0.5	2.8	0.8
2010:1	2.8	2.8	0.5	79.9	89.8	-4.3	4.5	-0.1
2010:2	4.1	2.2	0.7	80.2	90.3	-3.8	5.1	-0.6
2010:3	4.2	1.8	0.6	82.0	92.9	-3.6	4.7	-0.9
2010:4	4.4	2.3	0.7	80.5	91.6	-3.3	4.7	-0.3
2011:1	4.8	2.7	0.8	81.1	93.8	-2.8	5.3	0.2
2011:2	4.5	2.2	0.8	79.6	92.4	-2.5	5.0	-0.2
2011:3	4.2	2.4	1.1	82.2	95.8	-2.0	4.3	0.1
2011:4	4.0	2.5	1.6	82.0	95.9	-1.2	4.2	0.3
2012:1	3.6	2.6	2.0	80.7	95.4	-0.5	3.9	0.5
2012:2	3.3	2.6	2.2	81.3	96.1	0.0	3.7	0.6
2012:3	3.1	2.8	2.5	81.0	95.8	0.4	3.5	0.8
2012:4	2.8	2.8	2.5	80.9	95.7	0.5	3.3	1.4

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)
2008	220.4	3.5	2.8	0.91	138.9
2009	220.2	0.0	4.6	1.53	136.9
2010	225.2	2.4	4.6	1.50	134.8
2011	230.5	2.4	4.7	1.53	132.2
2012	239.9	4.1	4.4	1.47	133.4
2013	249.0	3.8	3.8	1.27	135.5
2010:1	224.2	4.4	4.8	1.57	136.3
2010:2	222.9	1.0	4.6	1.49	133.9
2010:3	225.3	2.2	4.5	1.47	134.3
2010:4	228.4	1.9	4.5	1.46	134.8
2011:1	229.8	2.6	4.4	1.45	133.2
2011:2	228.8	2.7	4.6	1.50	131.5
2011:3	229.9	2.0	4.8	1.58	131.5
2011:4	233.5	2.2	4.8	1.59	132.5
2012:1	237.3	3.3	4.6	1.54	132.8
2012:2	239.1	4.5	4.5	1.49	133.2
2012:3	240.5	4.6	4.3	1.44	133.5
2012:4	242.7	3.9	4.2	1.39	134.0

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
2008	147.3	705312.2	421176.1	253264.5	176727.6	-46562.6	99293.5
2009	140.8	674466.5	405440.7	218144.6	178391.0	-33226.3	94283.5
2010	143.3	686345.3	405565.3	241422.1	180777.4	-42021.1	99398.4
2011	144.8	693331.3	400381.9	236752.2	182398.0	-31348.2	94851.3
2012	146.8	703170.7	401572.0	247757.1	184603.4	-33345.2	97417.6
2013	149.8	717526.3	407987.9	255148.0	187436.1	-33320.4	99720.5
2008/07	-1.1		-1.5	-2.2	3.4		8.7
2009/08	-4.3		-3.7	-13.4	0.9		-5.0
2010/09	1.8		0.0	10.7	1.3		5.6
2011/10	1.0		-1.3	-1.7	0.9		-3.9
2012/11	1.4		0.3	4.7	1.2		2.8
2013/12	2.0		1.6	3.0	1.5		2.4
2010:1	141.9	169929.6	101035.9	54839.4	47326.4	-10076.3	23195.7
2010:2	143.4	171724.0	101994.9	57226.4	43888.6	-9819.2	21566.7
2010:3	144.3	172787.0	101409.9	65728.6	44640.8	-11710.3	27282.0
2010:4	143.6	171904.6	101124.6	63627.7	44921.5	-10415.2	27354.0
2011:1	144.2	172584.4	100688.1	55175.7	47489.5	-7019.6	23749.4
2011:2	144.3	172761.4	99684.3	58473.2	44536.4	-7695.8	22236.7
2011:3	145.6	174351.0	99891.2	61928.1	45087.9	-8312.5	24243.0
2011:4	145.0	173634.6	100118.2	61175.2	45284.1	-8320.4	24622.2
2012:1	145.7	174471.0	100187.7	58861.3	47967.7	-8338.6	24207.2
2012:2	146.2	174997.3	99883.8	62474.5	45027.4	-8332.2	24056.9
2012:3	147.8	176953.2	100387.2	63758.7	45681.0	-8335.7	24538.7
2012:4	147.6	176749.1	101113.3	62662.6	45927.2	-8338.7	24614.9

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)
2008	5.8	1262.4	73.8	33.2	-22.0
2009	10.3	1244.4	127.8	32.4	-26.1
2010	8.3	1333.7	110.8	36.6	-30.8
2011	8.8	1391.3	121.9	43.1	-5.8
2012	6.9	1457.5	100.6	49.6	-8.1
2013	6.4	1519.8	97.2	52.7	-7.4
2010:1	8.1	317.8	25.9	8.4	-6.9
2010:2	10.2	321.7	32.7	8.8	-10.1
2010:3	7.8	335.7	26.2	8.9	-9.7
2010:4	11.3	337.6	38.3	9.2	-4.1
2011:1	4.0	338.7	13.6	9.7	-2.0
2011:2	8.5	339.2	28.9	10.1	-1.1
2011:3	4.7	347.4	16.3	10.4	-2.8
2011:4	12.2	349.5	42.5	11.0	0.1
2012:1	9.6	355.2	34.2	11.6	-4.0
2012:2	6.4	357.8	23.1	12.0	-1.6
2012:3	6.5	363.5	23.7	12.4	-2.8
2012:4	6.7	364.9	24.5	12.5	0.2

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	1.8	1.0	1.4	2.0
Japan	–1.2	–6.3	4.3	–0.7	2.1	1.6
Germany	1.0	–4.7	3.6	3.0	1.1	2.0
France	0.1	–2.5	1.5	1.7	1.0	1.2
Italy	–1.3	–5.1	0.9	0.5	0.1	0.3

Real Short-Term Interest Rates

	2008	2009	2010	2011	2012	2013
U.S.A.	1.8	–1.6	–1.8	–1.7	–1.5	–1.3
U.K.	3.7	–3.1	–3.8	–2.2	0.1	0.5
Japan	1.8	1.1	0.5	0.4	0.4	0.4
Germany	3.5	–0.4	–1.3	–0.3	0.8	0.5
France	3.8	–0.8	–1.4	–0.3	0.9	0.5
Italy	3.1	–0.8	–1.4	–0.3	–0.3	0.0

Real Long-Term Interest Rates

	2008	2009	2010	2011	2012	2013
U.S.A.	2.2	1.3	1.1	1.2	2.0	2.0
U.K.	1.0	–0.3	–0.5	0.1	0.7	0.8
Japan	2.0	1.4	1.1	1.1	1.3	1.5
Germany	3.0	2.3	1.9	1.8	2.0	2.0
France	3.0	2.2	1.9	1.8	2.0	2.0
Italy	2.8	2.2	1.9	1.8	2.0	2.2

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

	2008	2009	2010	2011	2012	2013
U.S.A.	80.1	88.7	81.7	81.8	82.0	82.1
U.K.	87.6	78.2	79.7	82.5	83.7	83.6
Japan	87.9	89.0	80.2	79.8	79.7	80.0
Germany	105.1	105.8	99.3	99.0	99.1	99.0
France	106.4	104.3	101.7	102.0	102.0	102.1
Italy	106.6	105.4	100.5	100.8	101.0	101.1

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

Growth Of Consumer Prices

	2008	2009	2010	2011	2012	2013
U.S.A.	3.8	–0.3	1.8	3.1	2.0	2.0
U.K.	3.3	1.3	3.9	4.4	3.2	2.2
Japan	1.4	–1.4	–1.0	–0.3	–0.2	0.0
Germany	2.6	0.4	1.1	2.3	1.8	1.7
France	2.8	0.1	1.5	2.1	1.6	1.6
Italy	3.4	0.8	1.5	2.8	2.7	2.8

Nominal Short-Term Interest Rates

	2008	2009	2010	2011	2012	2013
U.S.A.	1.5	0.2	0.1	0.3	0.5	0.7
U.K.	5.1	0.8	0.6	1.0	2.3	2.5
Japan	0.4	0.1	0.1	0.4	0.4	0.4
Germany	3.9	0.7	0.4	1.5	2.5	2.5
France	3.9	0.7	0.4	1.5	2.5	2.5
Italy	3.9	0.7	0.4	1.5	2.5	2.5

Nominal Long-Term Interest Rates

	2008	2009	2010	2011	2012	2013
U.S.A.	3.7	3.2	3.1	3.2	4.0	4.0
U.K.	4.0	2.8	2.3	2.4	2.7	2.8
Japan	1.5	1.3	1.1	1.2	1.5	1.5
Germany	4.4	4.0	3.8	3.8	4.0	4.0
France	4.4	4.0	3.8	3.8	4.0	4.0
Italy	4.4	4.0	3.8	3.8	4.0	4.0

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

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

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

* Forecasts based on the Liverpool World Model