LIVERPOOL INVESTMENT LETTER

February 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 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.

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WHEN WILL POLITICIANS UNDERSTAND THAT UNRESTRICTED BANKING IS NECESSARY FOR GROWTH AND INNOVATION?

The latest UK growth figures for Q4 (-0.2%) may well be revised upwards as the manufacturing surveys suggest that the 'hard' figures early in the quarter will be followed by better ones in its later months. Nevertheless the picture is clear: the UK has gone ex-growth.

What is going on? There are the obvious things that have damaged growth: high oil and raw material prices have raised costs of operating capital, they have also made people poorer so that productivity has fallen as measured by living standard per effort, and there are the usual recessionary forces of high unemployment and uncertainty reducing demand.

However, there is one glaring obstacle to growth: the failure of the banks to lend, especially to small and medium size businesses that traditionally rely on banks to launch expansion and innovation. Furthermore the government has only itself to blame for this: it has brought in draconian regulation to stop banks lending and to raise the cost of banking. The regulations include huge new capital requirements, even higher than Basel III which is higher again than Basel II pre-crisis; also the Vickers Report demands have been accepted for 'ringfencing' retail banking — again a huge cost. On top of all this there are daily attacks on bankers, bankers' pay and whatever else they do that makes good copy — some of these attacks come from senior officials like the Governor of the Bank of England.

When one thinks about what is needed for the foreseeable future it is the opposite of this. We need to encourage the reemergence of bank competition after the pounding it has had from the bank crisis, with the destruction of numerous UK bank players — whether the Irish, the Icelandic, or the banks that have been folded into the new megabanks like RBS and Lloyds. Only competition will break the logjam of credit scarcity as for these megabanks the main aim is to rebuild profits with as little risk as possible — so extending credit on expensive terms to solid large businesses and using deposits that are paying next to nothing in interest. We cannot rely on the goodwill of monopoly banks with weak balance sheets to spur new lending to risky SMEs.

But has not Quantitative Easing helped in all this? Alas, the facts speak for themselves. Lending growth is negative and the extra money printed has been deposited with the banks and in turn redeposited at the Bank of England. QE has simply allowed the government to finance 2 and a half years of debt issue at virtually no interest cost. It is possible that without QE things would be worse, but it is difficult to see how — if the banks do not react to QE by lending more

Table 1: Summary of Forecast

		2008	2009	2010	2011	2012	2013
GDP Growth[1]		–1.1	–4.3	1.8	1.0	1.4	2.0
Inflation	CPI	3.3	1.3	3.9	4.4	3.2	2.2
	RPIX	4.3	2.0	4.8	4.7	3.6	2.8
Unemployment (Mill.)							
	Ann. Avg.[2]	0.9	1.5	1.5	1.5	1.5	1.3
	4th Qtr.	1.1	1.6	1.5	1.6	1.4	1.2
Exchange Rate (2005=100)[3]		91.2	80.7	80.6	81.2	81.0	80.5
3 Month Interest Rate		5.1	0.8	0.6	1.0	2.3	2.5
5 Year Interest Rate		4.0	2.8	2.3	2.4	2.7	2.8
Current Balance (£ Billions)		–22.0	–26.1	–30.8	–5.8	–8.1	-7.4
PSBR (£ Billions)		73.8	127.8	110.8	121.9	100.6	97.2

[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

which it is plain that they are not. Lending growth has not budged from the negative for the past year.

A cynic would see in all this what is called Financial Repression in developing countries subject to controls on credit. In this the government ensures that all available savings are channelled into lending to the government at the lowest possible interest rate, preferably the zero rate on newly printed money. However, in the case of the UK government it looks more like cock-up than conspiracy — the government's left hand has not thought about what the right hand wants and regulators are undoing all the efforts monetary policy is making to stimulate lending. Similar things are going on in the US, where again regulators are running amok.

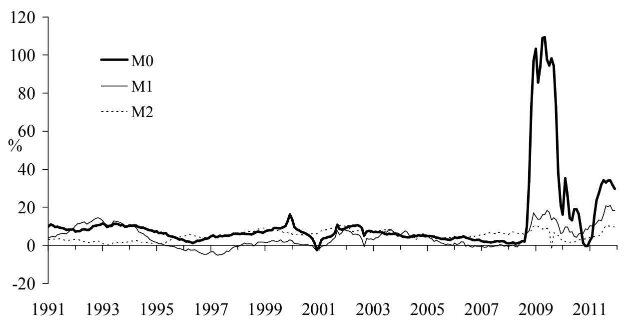
In the eurozone the same is true but of course the situation is dominated by the eurozone crisis now which is crushing lending even further. Unfortunately this crisis is also worsening the credit situation in the UK and the US because of banks' fears for their holdings of euro sovereign debt of the PIIGS.

What regulators cannot seem to grasp is that the time for restraint of banks' lending is in the later stages of economic upswing, not in the depths of recession. Another fallacy in their thinking is that a future crisis can be prevented; history shows that crises are endemic in capitalism because innovation has unknowable results, sometimes bad ones. If banks have participated in an upswing, as capitalism requires them to do for it to work, then in these bad times banks will lose money and some will go bust. The only way of stopping this happening is to stop banks participating altogether; but this will also stop the dynamic upswing. In effect you can stop crises if you abandon capitalism — but that is surely not the aim of any of our governments or voters.

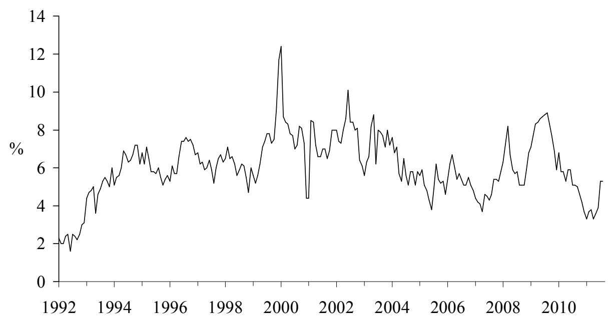
What is needed in place of this regulatory overkill is a system of capital provision that is designed to restrain extreme lending growth in the upswing. Actually we already had this in Basel II which was widely evaded but linked capital requirements to Value at Risk. This could be allied with a stronger response of interest rates to the growth in GDP. With such a system the cost base of banking would be kept low and entry of new banks would be encouraged, restoring competition. The economy would then grow more strongly as SMEs (who form more than 50% of employment) are enabled to be active again.

As matters stand, this overkill and the accompanying eurozone crisis — which bubbles on relentlessly as European politicians fail at summit after summit to resolve it one way (full fiscal bail-out and union) or the other (slough off some of the PIIGS) — are killing off bank lending and with it the recovery. Western growth is in for a long hard slog.

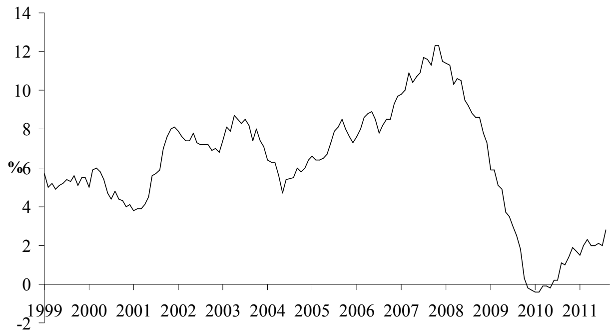
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



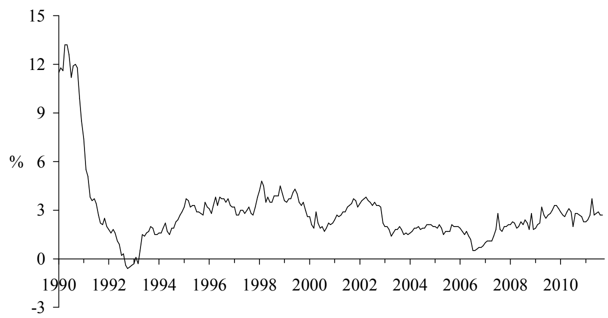
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Japan Approves Record Draft Budget

At the end of last year the Japanese cabinet approved the usual draft budget for the next fiscal year. This time the draft includes spending at ¥90.3 trillion, down slightly from the fiscal year 2011 budget of ¥92.4 trillion. The draft budget does not include spending for reconstruction, much of which has already been allocated in the government's first three fiscal year 2011 supplementary budgets — the last of which was passed by the Diet on November 21 and totalled more than ¥12 trillion.

Two remarkable features of the budget are the huge amount of the social security budget on the expenditure side and, to meet the bills, a continuing heavy dependence on borrowing on the open market via general bond issues. The social security budget, at ¥26.4 trillion yen, accounts for nearly a third of the total, while new bond issues are planned to amount to ¥44.2 trillion, leaving revenues to cover only 51% of spending. The amount is almost as large as that in fiscal 2011, which was the largest ever.

Despite the economic slowdown, anticipated tax revenue of ¥42.3 trillion is an improvement of some ¥1.4 trillion over the previous year, but still less than borrowing. On the expenditure side, debt-servicing costs of ¥21.9 trillion form one quarter of the proposed budget; while spending, set to ¥68.4 trillion, will shrink for the first time in six years after the government delayed appropriations for the nation's pension fund and used supplementary expenditure packages to pay for earthquake reconstruction.

In order to help boost the economy from its long deflationary state, the budget includes what the government calls "Priority Measures to Revive Japan", totalling ¥1.1 trillion. Officials say those measures represent government efforts to balance the need of fiscal reforms and the need of economic stimulus, because the money was made available by scrapping existing budget items they deemed less meaningful. But the total amount is so small that few analysts expect much impact from those measures.

The government will also issue special-purpose bonds, ¥2.6 trillion, which will not be included in the budget's general account. These will be financed through revenues generated by future tax increases, most notably a planned raise in the country's sales tax. Critics argue that the future tax increases and other plans to raise revenues may fail to be implemented due to political opposition, leaving a hole in Japan's already wobbly finances. Indeed, the ruling party has not yet agreed on the increase in consumption tax, which has been planned to be raised to 8% in April 2014 and to 10% in October 2015.

Some MPs of the ruling party (Democratic Party of Japan, DPJ) are urging the prime minister, Yoshihiko Noda, not to rush to make a decision about the tax increase before the potentially negative economic impact is thoroughly examined. But something will need to give, as two of the leading credit rating agencies, Standard & Poor's and Moody's, have already cast doubt on the credibility of Japan's public finances — both agencies downgraded their ratings for Japanese government bonds in 2011 — and they are closely watching to see if the government can compile a credible and sustainable fiscal reform plan.

Tax increases are politically unpopular among the Japanese. In 1989, Prime Minister Noboru Takeshita saw his public approval rating sink when his LDP government introduced the tax at a 3% rate, while in 1998, the ruling party lost an upper house election after Ryutaro Hashimoto's LDP-led coalition government raised the rate to the current 5%. Even this time raising the consumption tax will not be easy for Japan's policy makers as a recent nationwide survey shows — 58% of respondents are opposed to the government's policy of doubling the consumption tax rate.

Analysts and policy makers say raising the sales tax is essential to restore fiscal health and promote the sustainability of the public debt. The OECD has projected that Japan's gross government debt will approach 230% of its GDP in 2013, far higher than that of Greece or Italy, which respectively sparked and deepened the Euro zone crisis. "I think that Japan's budget-making processes and its reliance on public debt have reached their limits", Finance Minister Jun Azumi said at a news conference announcing the budget. However, the fiscal mire Japan finds itself in is not comparable to that faced by Euro zone states. More than 90% of JGBs are held by domestic investors, ensuring Japan has a far higher degree of stability and security than the troubled European nations do. Also, the level of the net public debt is much lower than what the gross figure might suggests, as the government holds a significant amount of financial assets mostly in the social security system. This is made clear enough by the very low interest rates on Japanese government bonds, whatever rating agencies may say. It probably suggests that fiscal consolidation should not be the primary goal of the government — the Bank of Japan forecast the economy will contract in the current fiscal year. Japan needs instead to implement policy aimed at promoting growth through more deregulation and competition.

Noda now faces the challenge of pushing the budget through Japan's divided parliament. While his DPJ has a lower-chamber majority needed to enact the main budget bill, it will need help from the opposition-controlled upper chamber to pass other key budget-related legislation, such as bills to issue bonds. The opposition parties had blocked the passage of a bond bill linked to this fiscal year's budget until late August, forcing the government to delay various spending plans. Noda conceded he might have to dissolve the Lower House and call a general election if his reform drive stalls. "There may be various judgments to make", he recently said, once it becomes clear if the ruling coalition's social security and tax proposals, as well as administrative and political reforms, have succeeded or not.

Economic realities

Japan's public debt is already twice the size of the $5tn economy, and some analysts claim that Japan would be better off outlining a longer-term and more realistic, if tougher, spending plan.

"Rather than patching up numbers to ostensibly meet targets, what's more important is that the government to show exactly how it can maintain fiscal discipline in the medium term," said Takahide Kiuchi, chief economist at Nomura Securities to Financial Times.

Japan is facing a number of economic challenges that are putting pressure on the government and the country's economy.

Heavily dependent on exports for growth, the country is feeling a slowdown caused by the eurozone debt issues and weak expansion in the US.

As a result, the government has forecast that the economy will shrink by 0.1% in the year to the end of March, compared with the 0.5% growth it previously predicted.

The government also said growth in 2012 would be 2.2%, down from the target of as much as 2.9% it forecast earlier this year.

Total government debt is projected to approach 230% of gross domestic product in 2013, according to the Organization for Economic Cooperation and Development, which has warned that such a level will push Japan's public finances further into "uncharted territory."

The projection for Japan is more serious than for Greece or Italy — countries whose fiscal problems have shaken the financial markets and threatened to drag down global economic growth.

Any delay in the fiscal restoration drive could easily hurt investor confidence in Japan's policymaking process, but some economists believe that has already happened and confidence has been depleted.

Credit-rating agencies Standard & Poor's and Moody's Investors Service downgraded Japanese government bonds last year, citing the lack of a credible and sustainable fiscal reform plan as well as political instability. Japan is on its sixth prime minister since September 2006.

The rating actions did not trigger any immediate repercussions in the bond market, such as a spike in borrowing costs, but may have been enough of a surprise for politicians to recognize the reality.

Experts warn that once the eurozone debt crisis is resolved, market participants may turn their attention to the fiscal problems in Japan and start selling JGBs.

The government is taking preventive moves, saying it will seek to double the politically sensitive consumption tax rate to 10% in stages by the mid-2010s and secure funds for swelling social security costs resulting from the increasing number of retirees and elderly people.

Noda, who already faces opposition to the tax hike plan even from within his own Democratic Party of Japan, given that a general election must be held by 2013, is widely seen as challenging the taboo against discussing the universally unpopular tax hike proposal.

With the fiscal 2012 budget due for Diet deliberations early next year, the focus is now shifting to whether the former finance minister can live up to his promise that the government will determine before the end of this month a draft plan for comprehensive tax and social security reforms. The plan is expected to specify such details as the timing and extent of the proposed consumption tax increase.

Few analysts say Japan will soon suffer a eurozone-style debt crisis.

Thomas Byrne, who analyzes sovereign debt risks for Japan at Moody's, argued that Tokyo has the ability to finance its sizable debt at low cost against the backdrop of its relatively big savings rate and limited borrowings in the private sector. He said a huge net income from overseas investments, as well as lower dependence on foreign creditors as buyers of its bonds, differentiate Japan from such troubled countries as Greece.

However, Byrne also said in a recent report that, "Over the long term, key challenges could emerge," adding that Japan's "current policies and growth trends are not containing the rise in debt."

But economic growth is not the only issue Prime Minister Yoshihiko Noda urgently needs to address. He also faces the more fundamental problem of restoring the country's fiscal health, which is the worst among major developed economies.

MARKET DEVELOPMENTS

Sentiment improved in the past month as there seemed to be some improvement in the eurozone crisis. This followed the injection of about €500 billion into the banking system by the ECB. This calmed fears about bank liquidity and encouraged banks to participate in bond auctions for PIIGS; in effect borrowing so cheaply and lending at these bond yields offers an attractive reward for taking the default risk. Yields rose a little on 'safe haven' government bonds as part of this reaction.

Table 1: Market Developments

	Market Levels		Prediction for Jan/Feb 2013	
	Dec 21	Jan 25	January Letter	Current View
Share Indices				
UK (FT 100)	5390	5723	7147	7417
US (S&P 500)	1244	1326	1412	1479
Germany (DAX 30)	5792	6422	7465	8085
Japan (Tokyo New)	726	767	921	958
Bond Yields (government long-term)				
UK	2.07	2.12	3.40	3.40
US	1.96	2.00	4.00	4.00
Germany	1.94	1.94	4.00	4.00
Japan	0.98	1.01	1.50	1.50
UK Index Linked	-0.25	-0.14	1.40	1.40
Exchange Rates				
UK ($ per £)	1.57	1.56	1.58	1.58
UK (trade weighted)	81.6	81.1	80.7	80.7
US (trade weighted)	80.5	80.3	84.0	84.0
Euro per $	0.77	0.77	0.78	0.78
Euro per £	1.20	1.20	1.23	1.23
Japan (Yen per $)	78.0	78.2	87.0	87.0
Short Term Interest Rates (3-month deposits)				
UK	1.07	1.04	2.50	2.50
US	0.42	0.37	0.50	0.50
Euro	1.39	1.18	2.50	2.50
Japan	0.23	0.23	0.40	0.40

Table 2: Prospective Yields [1]

Equities: Contribution to £ yield of:

	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.40	1.8	2.8	25.00		33.00
US	1.90	2.5	2.0	7.00	−1.35	12.05
Germany	3.70	1.1	1.8	23.00	−2.53	27.07
Japan	2.40	2.1	−0.2	23.00	−12.53	14.55
UK indexed[2]	−0.14		2.8	−9.00		−6.34
Hong Kong[3]	2.70	8.0	2.0	4.00	−1.35	15.35
Malaysia	3.20	5.5	2.0	43.00	−1.35	52.35
Singapore	3.60	4.8	2.0	26.00	−1.35	35.05
India	1.40	7.0	2.0	7.00	−1.35	16.05
Korea	1.20	3.8	2.0	−17.00	−1.35	−11.35
Indonesia	2.20	6.2	2.0	28.00	−1.35	37.05
Taiwan	3.60	4.4	2.0	34.00	−1.35	42.65
Thailand	3.00	4.8	2.0	29.00	−1.35	37.45

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	2.12	−12.80		−10.68
US	2.00	−20.00	−1.35	−19.35
Germany	1.94	−20.60	−2.53	−21.19
Japan	1.01	−4.90	−12.53	−16.64

Deposits: Contribution to £ yield of:

	Deposit Yield	Currency	Total
UK	1.04		1.04
US	0.37	−1.35	−0.98
Euro	1.18	−2.53	−1.36
Japan	0.23	−12.53	−12.53

[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	
	January Letter	Current View	January Letter	Current View	January Letter	Current View
UK Deposits (Cash)	15	15	8	8	3	3
US Deposits	-	-	3	3	3	3
Euro Deposits	-	-	5	5	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-	-
German Bonds	-	-	-	-	-	-
Japanese Bonds	-	-	-	-	-	-
UK Shares	15	14	15	14	18	17
US Shares	15	14	15	14	17	16
German Shares	15	14	15	14	17	16
Japanese Shares	10	9	9	8	12	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	2	3	2	3	2	3
Chilean Shares	2	3	2	3	2	3
Mexican Shares	2	3	2	3	2	3
Peruvian shares	2	3	2	3	2	3
Other:						
Index-linked bonds (UK)	-	-	-	-	-	-

PORTFOLIO PERFORMANCE

The charts below, and the Table opposite, measure the performance of the Liverpool Model Portfolio against the FTA Non-financials share index, and the Morgan Stanley World Capital International index, over the period from June 1992 to end-January 2011.

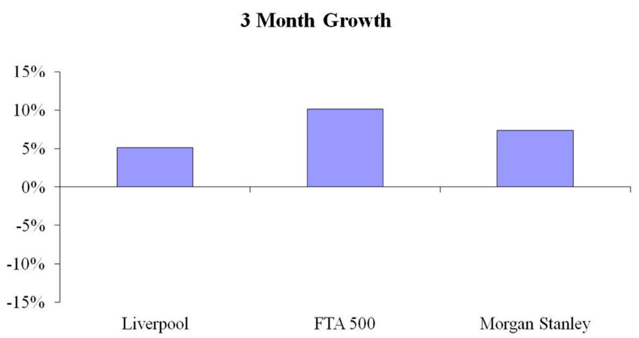
Equity performance has been poor mainly as a result of the eurozone crisis and as the Liverpool portfolio has been heavily weighted towards equities this has damaged the portfolio's relative performance.

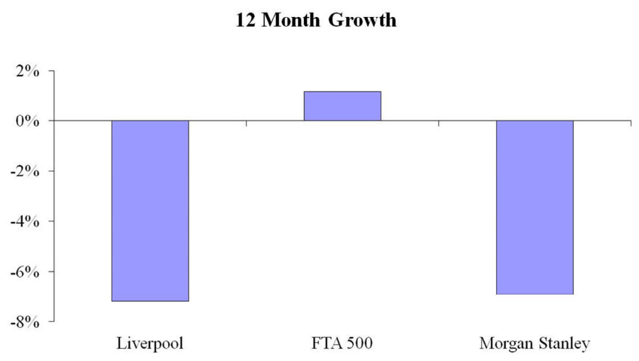
Whether eurozone governments can resolve the crisis is still in doubt but there is now more optimism that once it has its 'binding fiscal pact' Germany will relent and allow the ECB to be more active. Our portfolio is unchanged, on the basis that at some point there will be some sort of resolution, including probably the exit from the euro of a few weaker members.

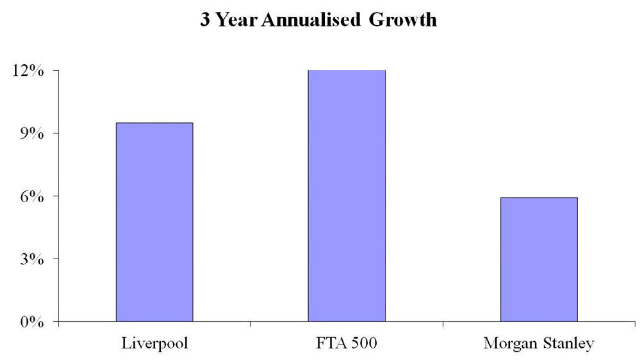
Table 4: Liverpool Portfolio Evaluation (End-June 1992 = 100)

Date	Index of Liverpool Portfolio	FTA Non Financials Index Total Return	Morgan Stanley World Capital International Index Total Return
2005			
1st Jan	243.20	252.89	297.05
Apr	249.35	264.15	298.79
Jul	261.84	278.70	316.89
Oct	284.62	304.68	343.82
2006			
1st Jan	297.46	313.59	365.50
Apr	315.78	334.87	386.04
Jul	302.95	332.52	360.85
Oct	313.66	340.59	371.76
2007			
1st Jan	331.94	361.22	382.93
Apr	343.65	376.53	389.99
Jul	364.54	403.07	403.44
Oct	378.18	401.46	405.04
2008			
1st Jan	394.93	411.25	403.19
Apr	387.93	367.01	365.34
Jul	386.86	381.90	355.90
Oct	399.43	324.99	335.11
2009			
1st Jan	437.80	314.73	323.33
Apr	423.18	294.99	283.79
Jul	440.33	315.62	295.72
Oct	506.73	375.37	355.96
2010			
1st Jan	525.13	408.79	365.52
Apr	562.49	436.43	399.80
Jul	530.11	382.77	351.60
Oct	570.59	435.61	378.02
2011			
1st Jan	618.84	476.51	413.02
Apr	619.56	481.43	420.69
Jul	629.42	494.36	418.86
Oct	546.47	437.69	358.02
Nov	580.57	471.30	380.97
Dec	573.66	476.34	380.48
2012			
1st Jan	574.33	482.11	384.40

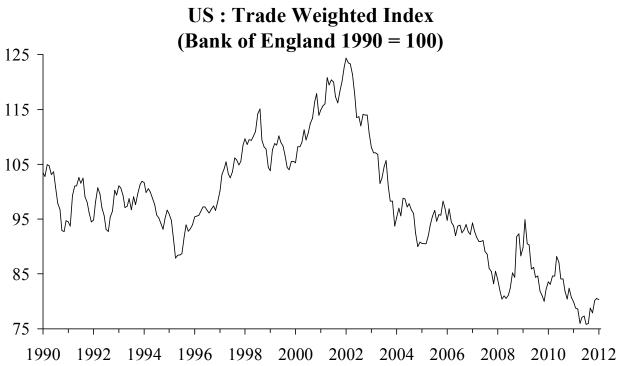
Source: Rensburg Sheppards Investment Management Limited, Liverpool Stock Exchange

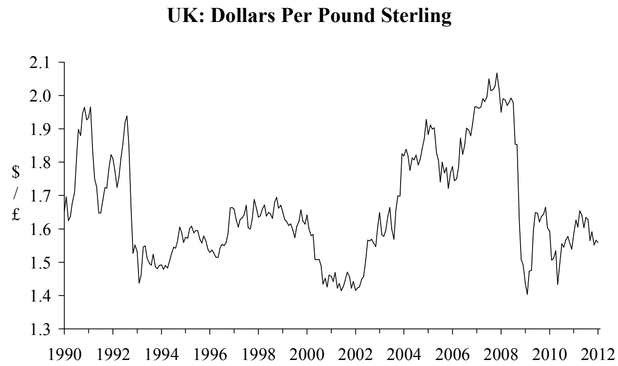


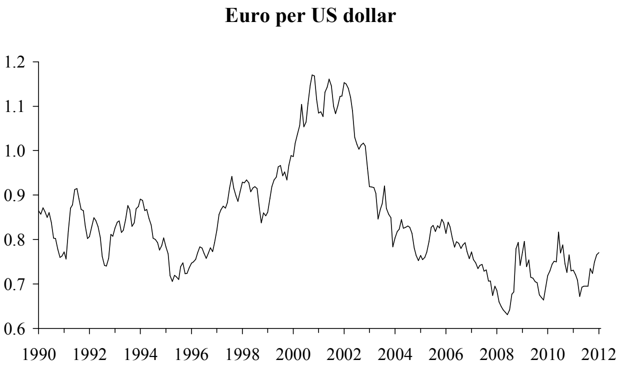


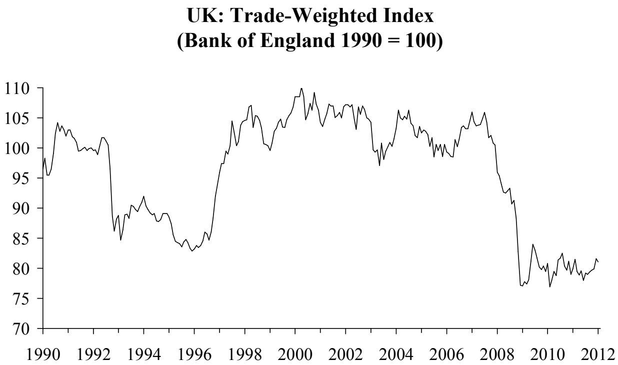


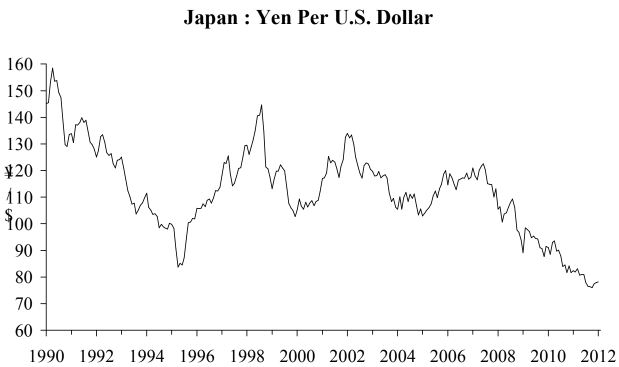
INDICATORS AND MARKET ANALYSIS FOREIGN EXCHANGE MARKETS[1]







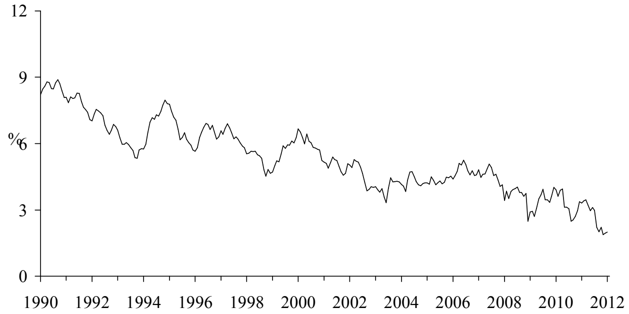




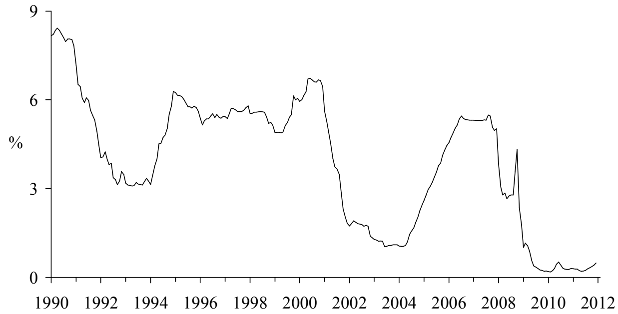
[1] John Wilmot, who has written these sections since this Letter began, is indisposed. We are issuing the charts without his commentary this month. We wish him a speedy recovery.

GOVERNMENT BOND MARKETS

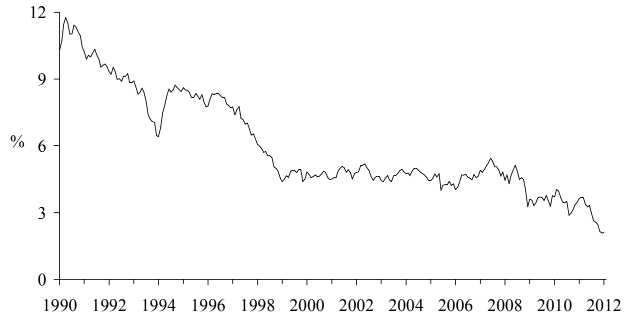
U.S.: Yield on Long-Term Government Bonds



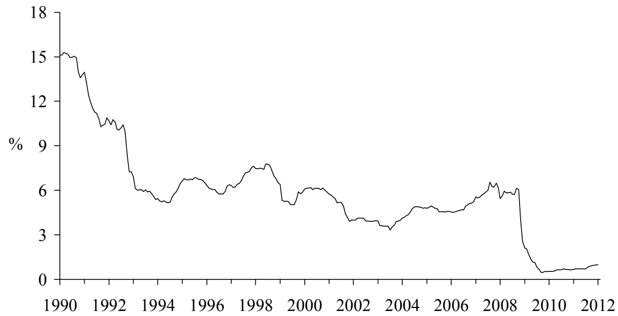
U.S. : 3-Month Certificate of Deposit



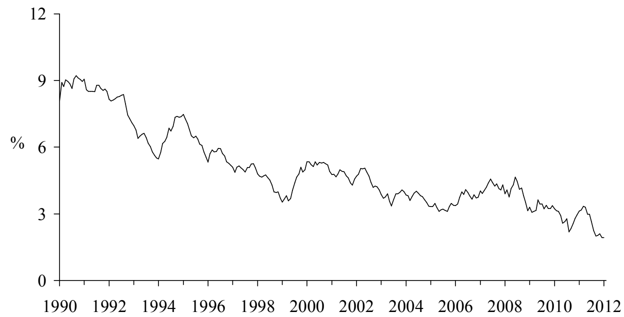
U.K. : Yield on Long-Term Government Bonds



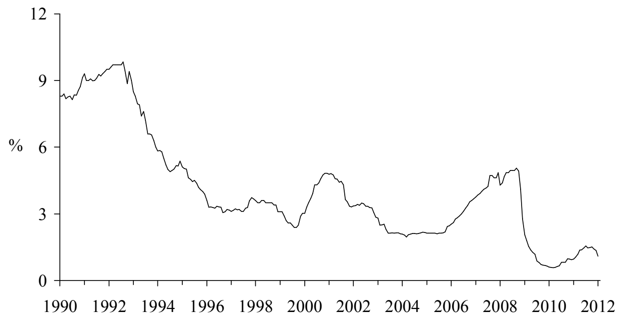
U.K. : 3-Month Interbank Rate



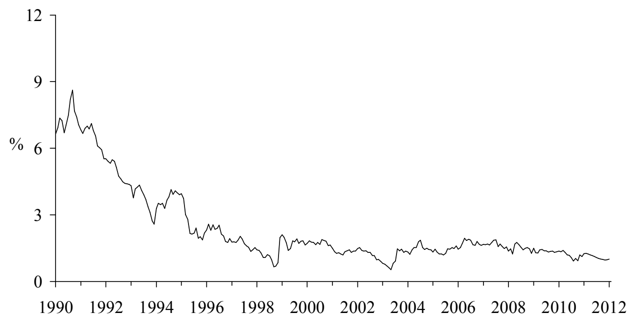
Germany: Yield on Public Authority Bonds



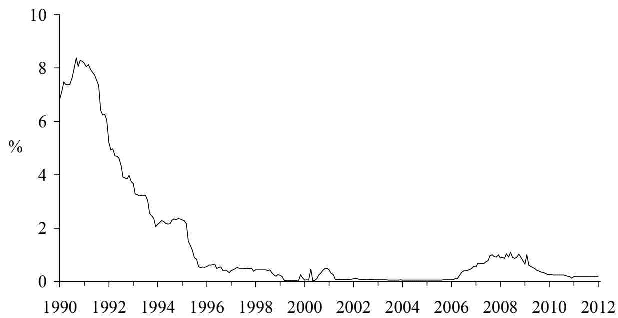
Germany : 3-Month Interbank Deposit Rate



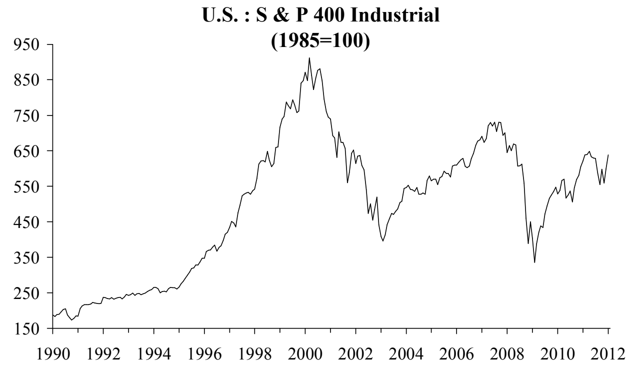
Japan: Yield on Long-Term Government Bonds

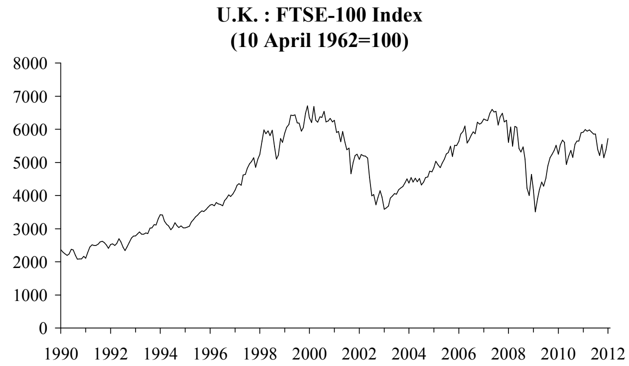


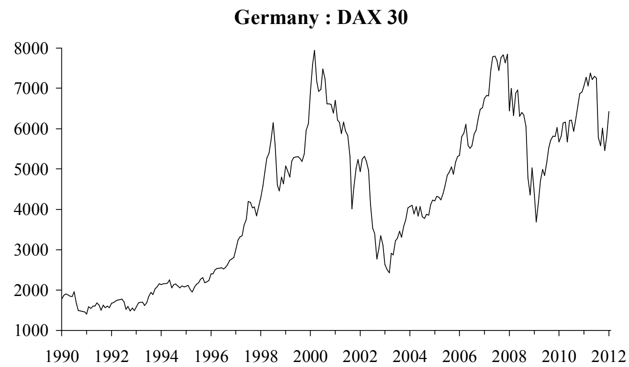
Japan : 3 Month Money Market Rate

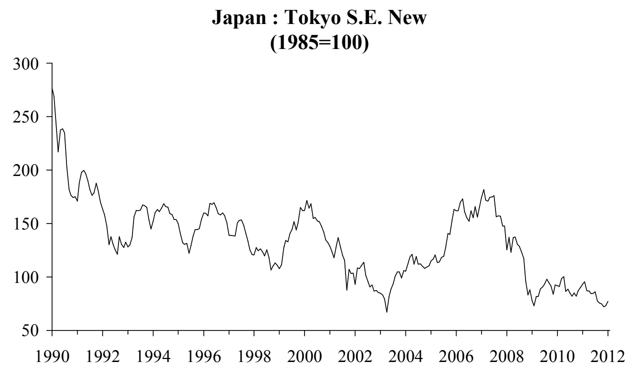


MAJOR EQUITY MARKETS









EMERGING MARKETS

India

India's central bank held its key lending rate steady for a second time, but, in a surprise move, cut the minimum cash reserve requirement for banks by 0.50 percentage point to relieve tight liquidity. This shall inject Rs320 billion ($6.4 billion) liquidity into the banking system. This marks the beginning of a policy shift toward supporting economic growth. The Reserve Bank of India hinted that the cash reserve ratio cut can "also be viewed as a reinforcement of the guidance that future rate actions will be toward lowering" of the main policy rate. This has boosted confidence of foreign investors apart from the fact that in a landmark court case, India's supreme court gave judgement in favour of Vodafone that had threatened to land the UK-listed telecoms business with a $2.9bn tax bill.

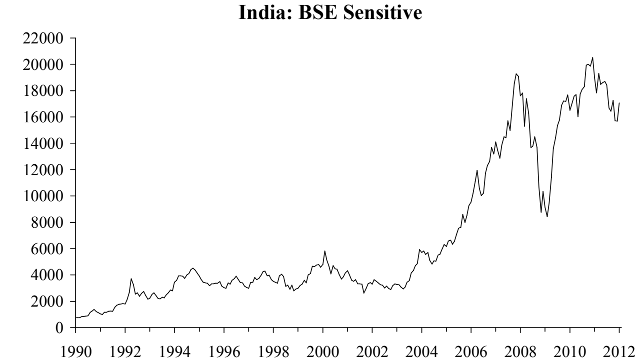
The central bank is expected to keep its lending rate steady till March at least. We expect a quarter-percentage point cut in March. The central bank has also cut its growth forecast for the current fiscal year to 7.0% from 7.6% due to worsening global and domestic economic conditions and maintained its March-end inflation projection of 7%.

India's trade deficit shrank for a second month in December, but bleak export growth prospects due to uncertainty in the euro zone offer little promise of any sharp narrowing in the gap. The trade deficit in December was $12.8 billion, compared with November's $13.6 billion. The deficit had touched a four-year high of $19.6 billion in October. For the April-December period, the gap was $133.3 billion. The current-account deficit is estimated to increase to between 3% and 3.5% of gross domestic product this fiscal year from 2.6% last year.

India's merchandise exports in December totalled $25.0 billion while imports were $37.8 billion. Exports in the April-December period totalled $217.6 billion, on track to meet the full-year aim of $300 billion.

The seasonally adjusted HSBC Purchasing Managers' Index rose to 54.2 in December from 51.0 in November suggesting a growth in manufacturing activity in the coming months.

Consecutive governments have won support from voters by subsidizing utilities and favouring sectors like agriculture. But it seems like the coming Budget can ill afford to tread on the beaten path. If so, then it may risk putting India's economic future into grave risk. India's central bank has issued a stern warning to the government about its fiscal lassitude. Therefore, whether it is cost of electricity, farm subsidies, subsidized pricing of diesel or direct taxes for individuals and corporate, the coming Union Budget, to be presented in March 2012, is unlikely to dole out any generous aid. Both the RBI and the Planning Commission have confirmed that de-controlling diesel prices is a matter



of time. The tight fiscal situation and inability to raise funds through disinvestment have made the government rethink its subsidy policies. Further raising the cost of power is a necessity, given the dire state that India's power generation companies are in.

Indian markets jumped approximately 10% on the back of high volumes and RBI's unexpected move to cut cash reserve ratio (funds that banks have to keep with RBI) and some policy actions which indicate the end of policy paralysis in the country. The FIIs pumped in roughly US$1.5 billion in the markets in the month of January.

	08-09	09-10	10-11	11-12	12-13
GDP (%p.a.)	6.7	7.4	7.5	7.0	7.0
WPI (%p.a.)	5.5	9.5	9.0	7.5	7.5
Current A/c(US$ bill.)	-56.0	-14.0	-31.0	-40.0	-35.0
Rs./$(nom.)	48.5	48.0	49.0	49.5	48.0

China

In China, people celebrated the beginning of the Lunar New Year on January 23 and the start of the year of the dragon according to the Chinese zodiac.

In 2011, China's economy grew 9.2% and is expected to grow 8.5% in 2012. The HSBC China Manufacturing Purchasing Managers Index was 48.8 in December. The Conference Board, the U.S. think tank, has projected a sharp reduction in growth in China in 2012 to 8% and slowing to an average of 6.6% from 2013 to 2016. This prediction is based on a study of the history of other one time growth champions. The authors have argued that China's annual growth rate will begin to "downshift" by at least two percentage points starting around 2015.

China's consumer-price index rose 4.1% from a year earlier in December, marginally lower than 4.2% recorded in November. This has set the stage for a cautious policy loosening to support the slowing economy.

China's trade surplus last year was its smallest since 2005, suggesting it is becoming less reliant on exports. The trade surplus fell to $155.14 billion in 2011, down 14.5% from 2010. The surplus has declined to around 2.2% of GDP from around 3.1% in 2010.

The yuan is expected to continue to appreciate against the dollar, though the shrinking surplus will mean slower appreciation. We expect it to rise around 2% to 3% in 2012, compared with 4.7% appreciation recorded in 2011.

Chinese foreign exchange reserves totalled $3.18 trillion at the end of December, a drop of $20.55 billion from the third quarter of the year according to the People's Bank of China. The decline in foreign exchange reserves may be welcomed by Beijing as evidence that China is rebalancing its trade relationship with the rest of the world. In order to lessen its dependence on the US treasury, China and Japan have entered into an agreement which will promote the use of their currencies for trade and investment. This will reduce costs and risks for their companies — an implicit call for less reliance on the dollar, which is currently their predominant medium of exchange. Japan also confirmed a plan to buy Chinese government bonds, which would mark the first time it has added renminbi-denominated debt to its foreign exchange reserves.

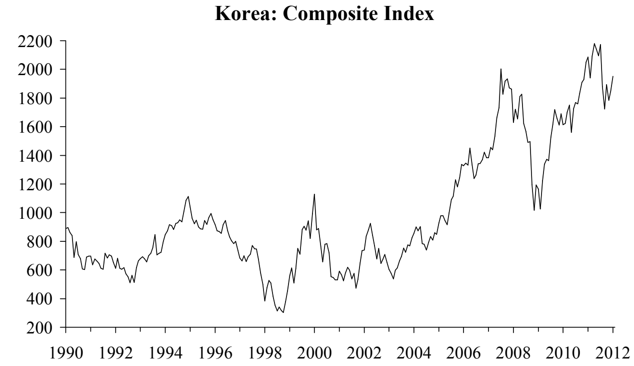
China has also signed currency agreements with Thailand and Pakistan, opening bilateral swap lines worth Rmb70 billion and Rmb10 billion, respectively. These are further attempts of trying to internationalise the renminbi. In another deal, China and the United Arab Emirates signed a multibillion-dollar currency swap deal valued at Rmb35 billion ($5.5bn) to ease bilateral trading.

Property prices in 70 Chinese cities in a government survey fell in December from the previous month, marking the third straight decline after developers cut prices to boost sales amid Beijing's campaign to cool the property market. Foreign direct investment for 2011 was up 9.7% at $116 billion. China attracted investment of $105.7 billion in 2010, up 17.4% from the previous year.

China is predominantly an urbanized country now. China's city dwellers account for 51.3% of the population. With urbanization a key driver of economic growth, it marks an important turning point for the world's second-largest economy — and the markets that depend on it.

Xi Jinping, the man widely expected to become China's top leader at the end of 2012 will meet President Barack Obama on February 14, on his first official visit to the U.S. as vice president.

	08	09	10	11	12
GDP (%p.a.)	13.0	8.7	10.3	9.2	8.0
Inflation (%p.a.)	6.8	-0.8	5.9	4.3	3.1
Trade Balance(US$ bill.)	330	180	183	155	140
Rmb/$(nom.)	6.7	6.8	6.6	6.3	6.1



South Korea

Year-on-year, Asia's fourth largest economy grew 3.4% in the fourth quarter of 2011 compared to 3.5% in July-September. The growth was impacted by sluggish domestic demand and lower exports. In 2011, GDP grew by 3.6%.

The HSBC Purchasing Managers' Index, a closely watched gauge of manufacturing activity, came in at a seasonally adjusted 46.4, down from 47.1 in November. This was the fifth successive monthly reporting of the index below 50, which indicates manufacturers are reducing output. In order to support growth, the finance ministry said that it would heavily front-load this year's budget of around $239 billion in the first half, with 30% of the total earmarked for the first quarter. The BOK may cut the key interest rate to support growth. We expect the Bank of Korea to deliver a 25 basis point cut in the first quarter of 2012.

The country's producer price index rose 4.3% from a year earlier in December, slowing from a 5.1% rise in November. Inflation for the year stood at 4%. But this figure would have been considerably higher had the CPI not been recalibrated in November. The rebasing of the index, which happens once every five years, led to a 0.4 percentage point reduction of the overall inflation figure.

South Korea's trade surplus may shrink to $25.0 billion in 2012 from $33.3 billion last year, as exports growth slows to 6.7% from 19.6% in 2011. Correspondingly the 2012 current-account surplus may reduce to $13 billion from an estimated $27.2 billion in 2011.

South Korea's Ministry of Foreign Affairs and Trade is "deeply concerned" over U.S. anti-dumping investigation. It will urge the U.S. to be fair while dealing with South Korean company Samsung, one of the main accused of dumping white goods in the US market.

South Koreans will choose their new leaders this year in elections for Parliament in April and for president in December. The main issues for voters are economic issues and the present government is keenly aware of that.

	08	09	10	11	12
GDP (%p.a.)	2.2	0.2	6.1	3.6	3.5
Inflation (%p.a.)	5.0	2.6	2.9	4.2	3.8
Current A/c(US$ bill.)	-7.9	42.7	28.2	27.0	13.0
Won/$(nom.)	1250	1200	1150	1100	1100

Taiwan

Taiwan recorded 4.51% growth in 2011 and is expected to slow down to 3.2% in 2012. Exports of electronic products and parts and petrochemicals have been slowing for months, which will continue to weigh on the local economy. Taiwan derives three-quarters of its gross domestic product from exports.

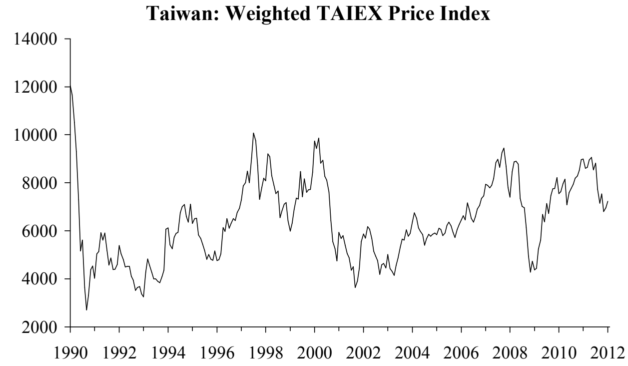
In the closely fought election, President Ma Ying-jeou won a second term. One can interpret his re-election as a renewed mandate to press ahead with the economic opening to China. He won 51.6% of the vote, to Ms. Tsai's 45.6%. This implies that his Kuomintang party emerged with a smaller majority, a sign that he has lost some public backing over worries about a slowing economy and growing wealth disparity.

Ma's second term will not only accelerate the pace of cross-strait opening but also narrow the wealth gap. But Ma is likely to discourage Chinese investments in Taiwan's property market.

	08	09	10	11	12
GDP (%p.a.)	1.9	-1.9	10.8	4.5	3.1
Inflation (%p.a.)	3.8	0.0	1.3	1.2	1.3
Current A/c(US$ bill.)	29.0	16.0	16.0	18.0	20.0
NT$/$(nom.)	32.0	32.0	31.0	30.0	29.5

Brazil

Brazil's economy expanded by about 3% in 2011, a sharp decline from 7.5% in 2010. Brazil is expected to fight the slow down of economic growth by having a more "flexible" monetary policy as the government seeks to ensure economic growth of at least 4% in 2012.



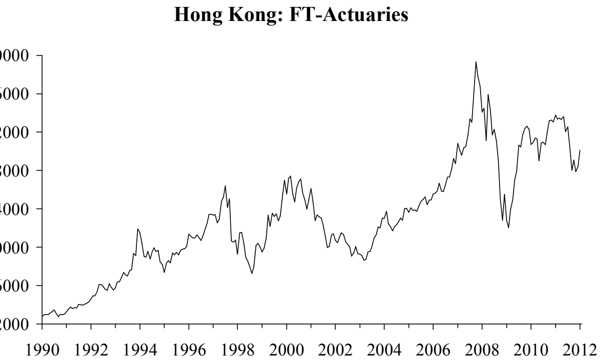
The government will rely on credit expansion, lower borrowing costs, an increase in public investment, policies to prevent the currency from appreciating and a responsible fiscal stance to shore up economic growth amid Europe's debt crisis.

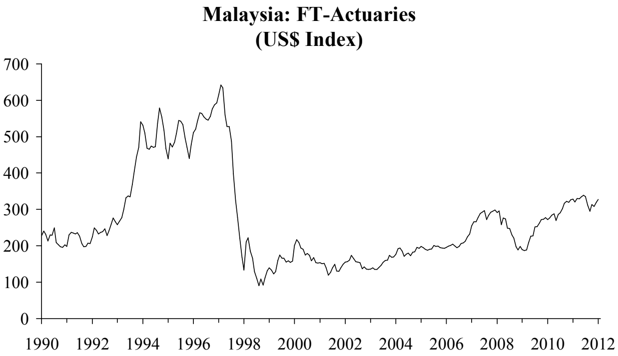
In 2011, Brazil's official Consumer Price Index recorded a growth of 6.5% compared with 5.91% in 2010. This was the upper limit of the target for inflation. In 2012, inflation is likely to be marginally lower with continued global economic uncertainty and come down to 5.5%. The global headwinds are impacting economic growth in Brazil. We expect the central bank to lower the key interest rate. The benchmark Selic base interest rate is currently at 11.0%. By midyear, interest rates may be reduced by 100 basis points. The lower interest rates could help insulate Brazil's economy from a broader global slowdown.

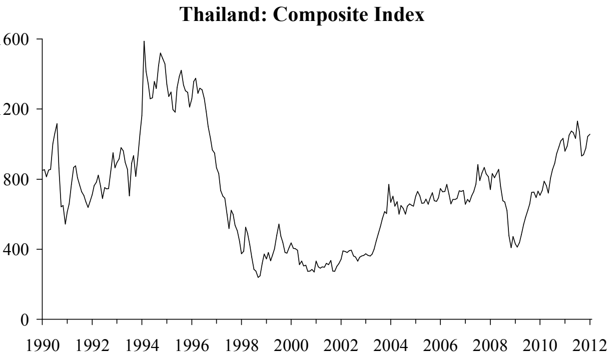
Brazil posted a record current account deficit in 2011 of $52.6 billion, up from $47.3 billion in 2010 according to the central bank. The 2011 deficit was equal to 2.12% of gross domestic product.

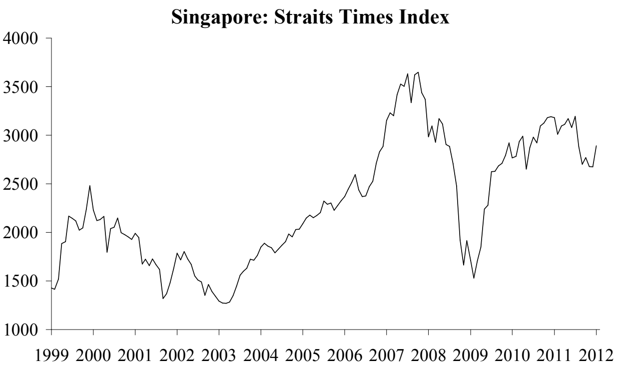
	08	09	10	11	12
GDP (%p.a.)	5.1	-0.2	7.5	3.0	3.0
Inflation (%p.a.)	6.0	4.1	5.9	6.0	3.6
Current A/c(US$ bill.)	-25.0	-20.0	-47.3	-52.6	-60.0
Real/$(nom.)	2.2	1.8	1.7	1.5	1.5

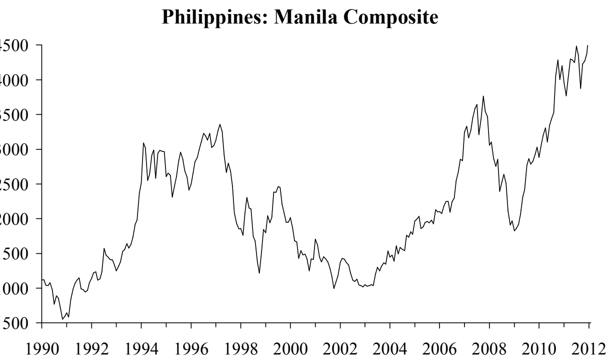
Other Emerging Markets



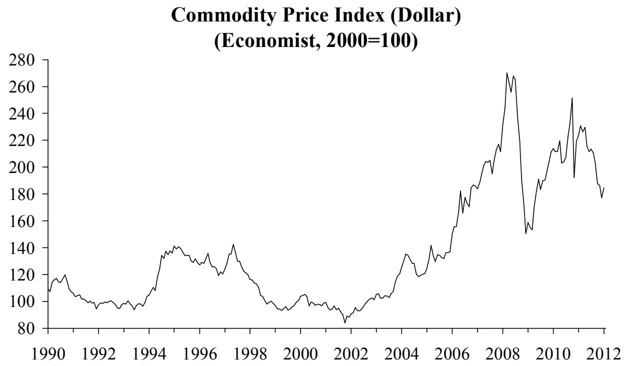


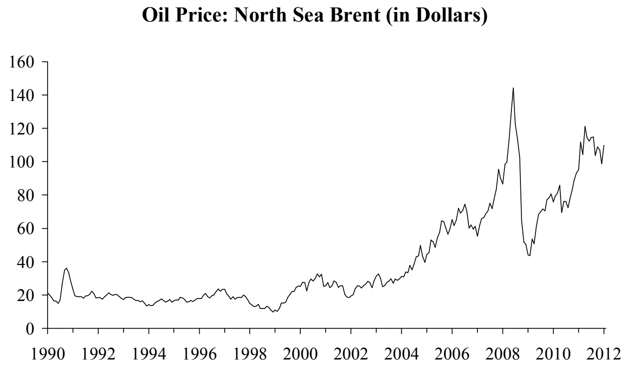


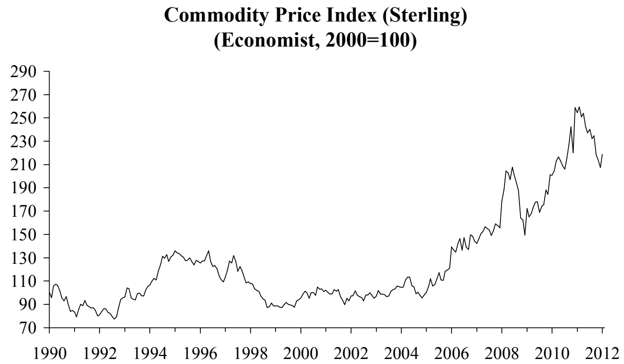


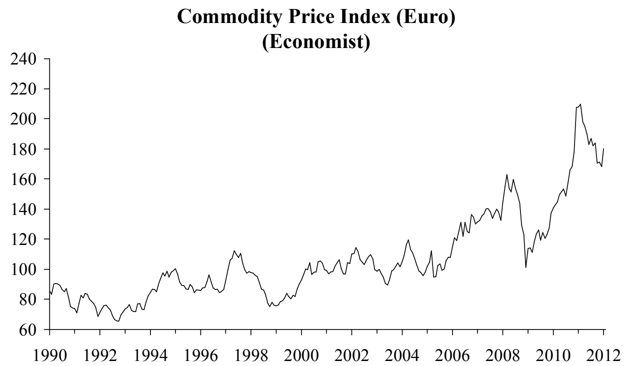


COMMODITY MARKETS









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]
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

	2007	2008	2009	2010	2011	2012
U.S.A.	1.9	0.0	–2.6	2.6	1.9	2.5
U.K.	3.5	–1.1	–4.3	1.8	1.0	1.4
Japan	2.3	–1.2	–6.3	4.3	–0.4	2.1
Germany	2.7	1.0	–4.7	3.6	2.9	1.1
France	2.3	0.1	–2.5	1.5	1.6	1.0
Italy	1.4	–1.3	–5.1	0.9	0.6	0.1

Real Short-Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	0.6	1.8	–1.6	–1.8	–1.7	–1.5
U.K.	2.9	3.7	–3.1	–3.8	–2.2	0.1
Japan	–0.8	1.8	1.1	0.5	0.4	0.3
Germany	1.3	3.5	–0.4	–1.3	–0.3	0.5
France	1.1	3.8	–0.8	–1.4	–0.3	0.5
Italy	0.5	3.1	–0.8	–1.4	–0.3	0.5

Real Long-Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	2.8	2.2	1.3	1.1	1.2	2.0
U.K.	2.3	1.0	–0.3	–0.5	0.1	0.7
Japan	2.0	2.0	1.4	1.1	1.1	1.3
Germany	2.8	3.0	2.3	1.9	1.8	2.0
France	2.7	3.0	2.2	1.9	1.8	2.0
Italy	2.4	2.8	2.2	1.9	1.8	2.0

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

	2007	2008	2009	2010	2011	2012
U.S.A.	83.4	80.1	88.7	81.7	81.8	82.0
U.K.	98.9	87.6	78.2	79.7	82.5	83.7
Japan	81.2	87.9	89.0	80.2	79.8	79.7
Germany	104.6	105.1	105.8	99.3	99.0	99.1
France	104.9	106.4	104.3	101.7	102.0	102.0
Italy	105.0	106.6	105.4	100.5	100.8	101.0

[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

	2007	2008	2009	2010	2011	2012
U.S.A.	2.9	3.8	–0.3	1.8	2.9	2.0
U.K.	2.5	3.3	1.3	3.9	4.4	3.2
Japan	0.0	1.4	–1.4	–1.0	–0.3	–0.2
Germany	2.3	2.6	0.4	1.1	2.3	1.8
France	1.5	2.8	0.1	1.5	2.1	1.6
Italy	1.8	3.4	0.8	1.5	2.7	2.0

Nominal Short-Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	4.4	1.5	0.2	0.1	0.3	0.5
U.K.	5.9	5.1	0.8	0.6	1.0	2.3
Japan	0.6	0.4	0.1	0.1	0.4	0.4
Germany	3.9	3.9	0.7	0.4	1.5	2.5
France	3.9	3.9	0.7	0.4	1.5	2.5
Italy	3.9	3.9	0.7	0.4	1.5	2.5

Nominal Long-Term Interest Rates

	2007	2008	2009	2010	2011	2012
U.S.A.	4.6	3.7	3.2	3.1	3.2	4.0
U.K.	5.0	4.0	2.8	2.3	2.4	2.7
Japan	1.7	1.5	1.3	1.1	1.2	1.5
Germany	4.3	4.4	4.0	3.8	3.8	4.0
France	4.3	4.4	4.0	3.8	3.8	4.0
Italy	4.3	4.4	4.0	3.8	3.8	4.0

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

	2007	2008	2009	2010	2011	2012
U.S.A.[1]	89.38	81.72	81.61	82.12	83.97	83.94
U.K.	2.00	1.85	1.57	1.55	1.61	1.58
Japan	117.75	103.40	93.56	87.76	87.10	87.00
Eurozone	0.73	0.68	0.72	0.75	0.78	0.78

[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