LIVERPOOL INVESTMENT LETTER

January 2012

Cardiff Business School
Cardiff University

Julian Hodge Institute Of Applied Macroeconomics

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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

The Liverpool Investment Letter is written by Patrick Minford 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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THE NORMAL WORLD OF ONGOING EUROZONE CRISIS

The recent EU summit on the eurozone's problems changed nothing. It merely reinstated the Stability and Growth Pact, with new pious intentions and 'penalties' (which are unenforceable). Looking back over the decade-plus since the euro was introduced in 1999, it is clear with hindsight that the great 'benefits' to southern countries of joining the euro — viz low interest rates on a par with Germany's, enabling much less to be spent on servicing huge sovereign debts — were illusionary. The illusion was that somehow the eurozone was more than the sum of its parts and that the implied solidarity would create de facto bail-out for any country in trouble. Hence for that decade the continuation of Germanic interest rates for these countries.

It took the banking crisis to destroy the illusion, forcing Germany to protect itself against these implicit demands. Now interest rates on the sovereign members of the eurozone reflect their true sovereign risk. The problem for each sovereign country is however that it cannot control its currency's value nor the rate at which it prints money and inflates; these controls are available only if your currency is floating on the exchanges. So where exactly any more are the benefits of being part of the eurozone? Now there is only the cost of being unable to run your economy according to your own needs as the business cycle fluctuates.

This cost-benefit logic is likely to become increasingly apparent to the citizens of all these southern countries as the grim austerity programmes mandated by the new Fiscal Agreement bite ever deeper. Their governments will struggle to maintain legitimacy as they implement these programmes; and leaving the euro will rise up the agenda.

Some commentators — such as Citigroup's Willem Buiter (olim of the Monetary Policy Committee) — frighten us with the stories of the disaster that will occur if the eurozone breaks up. This has little credibility: currency zones have been breaking up for centuries with little more than temporary disruption. Most countries left gold in the 1930s, with beneficial effects as this enabled each country to pursue easier money. In 1870 the Latin Monetary Union (the first 'eurozone') broke up. The Soviet currency bloc broke up with the demise of the Soviet Union. The Asian Crisis of 1988 forced most Asian countries off their dollar pegs: these countries bounced back in the early 1990s.

The UK economy will be affected by the slow growth in the eurozone in prospect in 2012. This slow growth will continue until there is some certainty about which countries will stay in — but this will not arrive until perhaps 2013 as the European elite who gave us the euro will not lightly let it break up. The break up will be forced on it by messy national politics.

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

But a far more important external factor for the UK is the recovery of the US economy which hitherto has been pallid and weak in job creation. Again politics is much of the reason: President Obama is unsupportive of the private sector and the market economy, and his measures — not least Obamacare but also his encouragement of union power — are proving toxic to private investment plans. Another factor is the stand-off in Congress over how to reduce the serious budget deficit. But during 2012 these issues will be resolved by the November Presidential election and the US should start to come out of its torpor; it never pays to underestimate the resilience of the US economy.

During 2011 the emerging market countries have had to tighten their monetary policies to combat inflation. This has led to a deceleration of their recent fast growth. Instead of world growth of around the 4% mark in 2011, it now will probably turn out closer to 3%. But this deceleration has eased up the supply situation in commodities and oil so that their prices have come off their peaks. Meanwhile technology has been devoted to reducing the world's dependence on them.

Overall 2012 looks like being a year of slow growth worldwide, again around the 3% mark. But this will not be a bad thing: it will allow inflation to subside in the emerging market countries and it will allow the balance of commodity net supply to be restored. The world trading system has held up, which is probably the most important development — it was the spread of protectionism in the 1930s that helped create the Great Depression.

Against this background the prospects for the UK are for more slow growth. However if this background leads to good supply-side policies, as there are signs it may, this will not be a bad thing. We have seen the public sector being brought back under control, with the dispute over public pensions now resolved and agreement reached on substantial cuts in public sector wage costs overall. There is a grittier realism around over education and the NHS. The

UK private sector has been through a revolution in its practices since 1979; we now may finally be seeing the public sector being brought into that revolution.

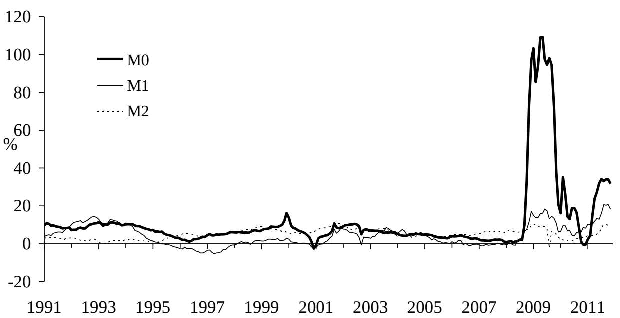
The one area where a lack of logic prevails is over banking. Popular outrage at bankers has spilled over into a badly thought out plan for splitting the banks into retail and investment bodies. This will raise costs without reducing the probability of future crises; whether split or not the banking and financial system is irretrievably tied into a complex internexus which is what forces the need for firefighting by the Bank of England and the Treasury. The right way to limit banking risk is that of the Basel Agreement no. III — under which banks must post higher capital matching their risk profile; this will happen here too, but again the Vickers Report demands absurdly high posting compared with the Basel III requirements, themselves upped from Basel II. Fortunately the government have correctly gauged the need to centralize these crisis and stability functions in the Bank where they always and rightfully belonged until Mr. Brown created his Tripartite system that served us so badly in the banking crisis.

This UK repression of banking serves the economy ill and is one cause of slow growth in productivity — this is after all our major industry and also a key input into the rest of our economy.

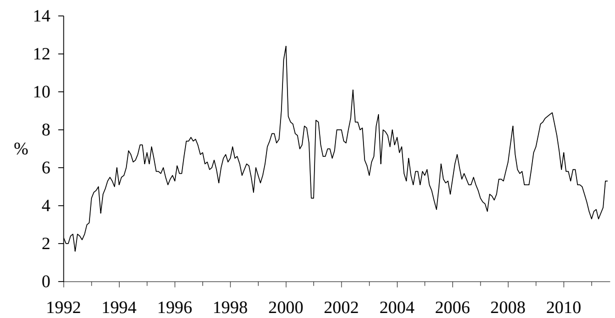
Finally what of monetary policy? The Bank has taken serious risks with its credibility in allowing inflation to rise to over 5%. It may get away with it and inflation looks likely to fall back — though not as much as the Bank optimistically once again forecasts. Essentially the ongoing banking crisis, now reignited by the eurozone crisis, has kept monetary conditions tight for those small business and personal borrowers dependent on the banks. The government has been able to dispose of all or most its debt issue to the Bank through Quantitative Easing; the counterpart money created has simply been redeposited in the Bank by banks nervous of aggressive lending.

The eurozone crisis is likely to continue for the foreseeable future and most European banks are hardly able to borrow from the world wholesale money markets (US banks for example have greatly reduced their lending to them); they have recently borrowed nearly 500 billion euros from the ECB. With this monetary tightness, there is no scope for any UK tightening moves at present. The return to a more normal monetary policy must await the ending of the euro's crisis.

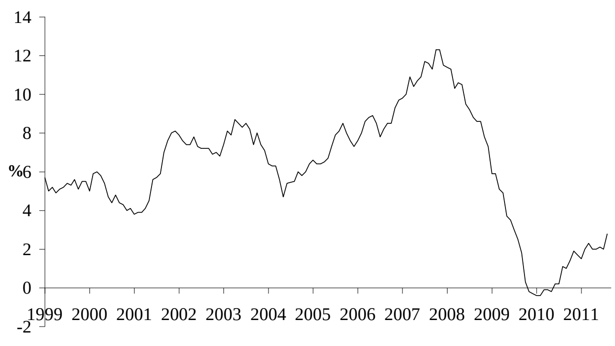
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



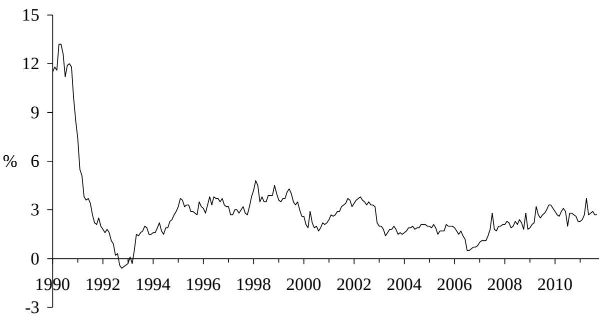
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Despite modest growth, Japanese economy faces further headwinds over the short term.

Japan has returned to growth after three quarters of contraction. The economy rebounded in the third quarter at a slightly slower pace than initially estimated by the government. Gross domestic product grew a revised 1.4% in July-September from the previous quarter, slightly above a median forecast of a revised 1.3% expansion. The downward revision was largely expected by economists following the government's recent statement that it was lowering its capital spending estimate, a key factor in calculating gross domestic product.

The big positive drivers were consumer activity (which contributed 0.7% to growth), construction (0.1%) and net exports (0.6%). Consumption spending rose as confidence recovered and post-earthquake restraint faded; auto sales improved as supply chains were restored; TVs were in demand ahead of a shift to digital broadcasting, as were energy-efficient products from fear of electricity shortages. The housing sector was buoyed by early signs of reconstruction and also a rush to take advantage of the "eco point" programme that initially expired in July (it will be reintroduced after the third supplementary budget) while net exports gained as the export boost from supply-chain recovery outstripped still-strong import volumes.

Private investment grew by 1.7% from the previous quarter, underpinned by the restoration of production capacity; by contrast, public investment fell sharply despite the need to restore damaged roads and bridges. This might be related to political problems slowing the implementation of reconstruction plans.

Manufacturing output grew by 4.3% in the third quarter which brings the production level almost close to that seen before the disaster. However, the third quarter recovery conceals underlying weakness. Industrial production, which was severely hit by the earthquake, fell sharply in September (by 3.3%) after recording small increases in July and August. Key business sentiment indicators such as the manufacturing Purchasing Managers' Index trended sideways from June and July. And most consumption-related monthly indicators drifted a little lower through the quarter.

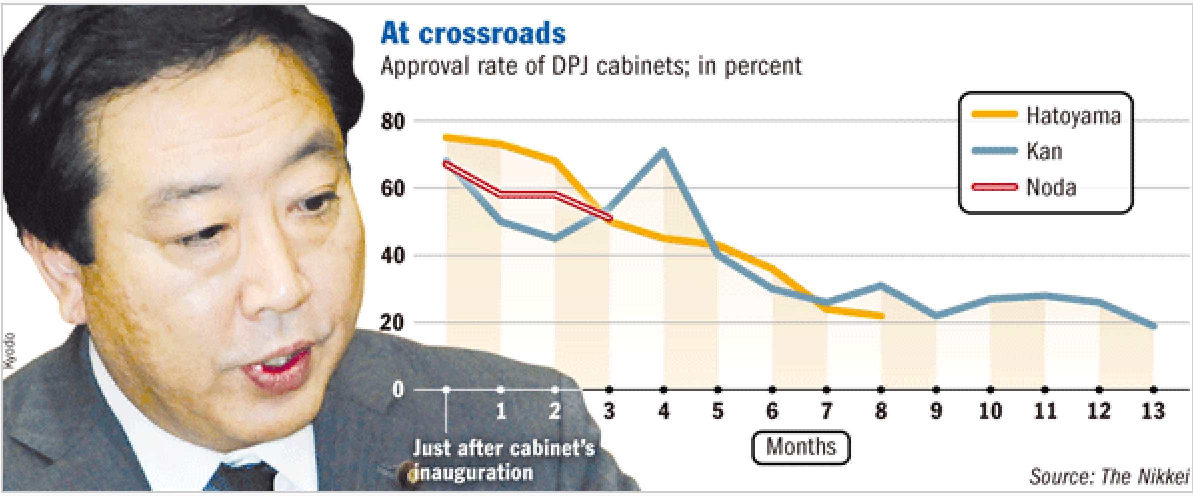
Furthermore, despite the recent surge in activity, employment conditions have been deteriorating gradually since the earthquake. The actual state of the job market is probably worse than the unemployment rate suggests — this has continued to decline since then but disaster areas are not included in the data. Wages have slid since the disaster and a recent government report shows that household spending posted the eighth straight year-on-year drop in October, pointing to weaker consumer spending.

Thus while Japan's economy is emerging from a March earthquake-triggered recession thanks to a steady mending of supply chains, analysts and monetary authorities say a slowdown is inevitable as growth in many overseas economies stutters. "Looking ahead, the economy is likely to feel the impact of global slowdown and flooding in Thailand for the time being. A slowdown is unavoidable", said Bank of Japan (BOJ) Deputy Governor Kiyohiko Nishimura in a recent seminar. Also the Japanese government, while leaving its overall economic assessment unchanged in its monthly report for November, warned about growing downside risks due to the European debt crisis and the flooding in Thailand, a key Southeast Asian production centre for Japanese car and electronics makers — due to the massive flooding in Thailand, Japan's exports to the country posted the first drop in three months, down 5.1% in October after rising 16.1% in September.

Some data have already pointed to a deceleration in the coming quarters. For instance, a recent business sentiment survey showed big Japanese manufacturers turning pessimistic in the three months to December compared with the previous quarter, while Japanese consumer confidence in November worsened from the previous month, suggesting that turmoil from Europe's debt crisis and slowing global growth are weighing on sentiment.

In addition to these factors, there is the usual list of uncertainties that have been hanging over the outlook for some time. One is the persistence of the strong yen, that has forced some firms to move manufacturing operations from Japan to more economically viable countries and have eroded firms' overseas profits on unfavourable exchange rates. The Japanese authorities have in recent months intervened three times in the foreign exchange markets to weaken the yen, but without any perceptibly lasting effect.

A second uncertainty concerns the sustainability of the public debt burden and the difficulty in implementing economic and fiscal reforms because of divided and fractious politics. The public sector debt level has risen above 200% of GDP, the highest among the developed countries. For the moment, the government has been able to finance its debt at low cost as private savings have remained high. However, market sentiment can easily change, as seen in the case of the European sovereigns. The IMF recently warned the Japanese authorities once more that the economy could end up in "an adverse feedback loop from rising yields to deteriorating confidence, diminishing policy space, and a contracting real economy". For the 2012 Budget, government spending will be restrained by the medium-term fiscal framework. This implies that central government spending (excluding reconstruction spending, debt repayment and interest) will be capped at the fiscal year 2011 level. In its latest report, the OECD warns that this will push "Japan's public finances further into uncharted territory". For Prime Minister Noda, whose approval rating is moving on a downward trend similar to that of the two prime ministers from DPJ who preceded him (see the figure), there is no alternative to a progressive raising of the consumption tax from its current 5% to 10%. However, the opposition parties are firmly opposed, while his own DPJ is divided. During the upcoming parliament session on the 2012 Budget, the opposition might take the same hard-line stance as in early 2011, which could force the government to call a snap election. It is politics as usual in Japan.



MARKET DEVELOPMENTS

Financial markets have continued to be dominated by developments in the euro crisis. Unfortunately there is no end in sight to this. So we will have continued turbulence in 2012. Nevertheless, taking a long view that sooner or later the euro must resolve itself into a currency bloc that is sustainable, equities have been oversold and yields on UK/US/German government bonds are low for 'safe haven' reasons — not a trustworthy reason to buy them as they surely in time will rise to levels at which they offer a decent return. Hence we remain with a portfolio dominated by equities as offering the best long-term returns.

Table 1: Market Developments

	Market Levels		Prediction for Dec/Jan 2012/13	
	Nov 23	**Dec 21**	**December Letter**	**Current View**
Share Indices				
UK (FT 100)	5140	5390	6918	7147
US (S&P 500)	1162	1244	1330	1412
Germany (DAX 30)	5458	5792	7144	7465
Japan (Tokyo New)	718	726	911	921
Bond Yields (government long-term)				
UK	2.17	2.07	3.40	3.40
US	1.88	1.96	4.00	4.00
Germany	2.10	1.94	4.00	4.00
Japan	0.97	0.98	1.50	1.50
UK Index Linked	-0.16	-0.25	1.40	1.40
Exchange Rates				
UK ($ per £)	1.55	1.57	1.58	1.58
UK (trade weighted)	79.9	81.6	80.7	80.7
US (trade weighted)	80.2	80.5	84.0	84.0
Euro per $	0.75	0.77	0.78	0.78
Euro per £	1.16	1.20	1.23	1.23
Japan (Yen per $)	77.5	78.0	87.0	87.0
Short Term Interest Rates (3-month deposits)				
UK	1.03	1.07	2.50	2.50
US	0.42	0.42	0.50	0.50
Euro	1.47	1.39	2.50	2.50
Japan	0.33	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	3.70	1.8	2.8	28.00		36.30
US	2.10	2.5	2.0	9.00	–0.89	14.71
Germany	4.00	1.1	1.8	26.00	–2.74	30.16
Japan	2.60	2.1	–0.2	25.00	–12.54	16.96
UK indexed[2]	–0.25		2.8	–9.00		–6.45
Hong Kong[3]	2.90	8.0	2.0	6.00	–0.89	18.01
Malaysia	3.30	5.5	2.0	44.00	–0.89	53.91
Singapore	3.90	4.8	2.0	29.00	–0.89	38.81
India	1.60	7.0	2.0	9.00	–0.89	18.71
Korea	1.20	3.8	2.0	–17.00	–0.89	–10.89
Indonesia	2.30	6.2	2.0	29.00	–0.89	38.61
Taiwan	4.80	4.4	2.0	46.00	–0.89	56.31
Thailand	3.60	4.8	2.0	35.00	–0.89	44.51

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	2.07	–13.30		–11.23
US	1.96	–20.40	–0.89	–19.33
Germany	1.94	–20.60	–2.74	–21.40
Japan	0.98	–5.20	–12.54	–16.76

Deposits: Contribution to £ yield of:

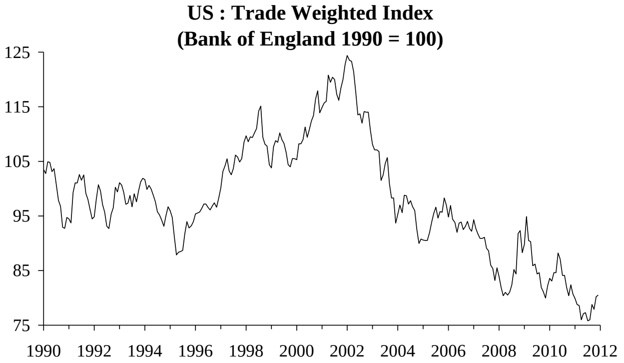
	Deposit Yield	Currency	Total
UK	1.07		1.07
US	0.45	–0.89	–0.44
Euro	1.39	–2.74	–1.35
Japan	0.23	–12.54	–12.31

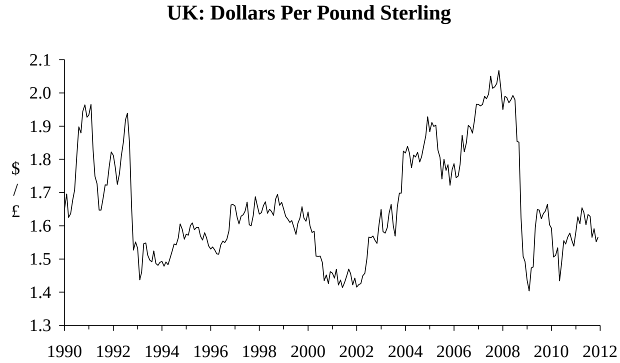
[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

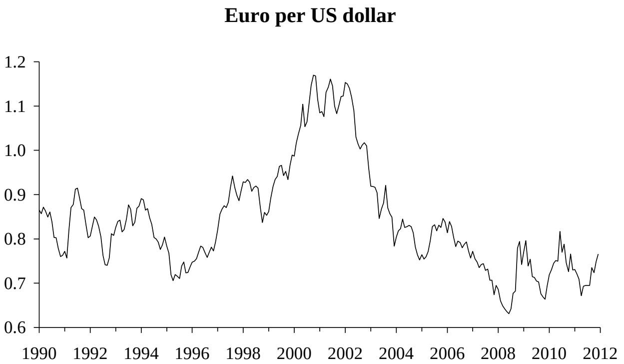
Table 3: Portfolio(%)

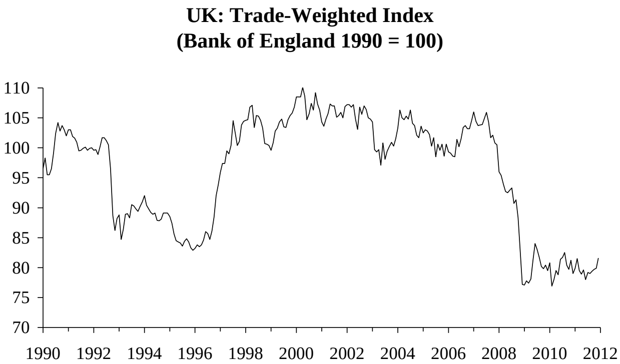
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	December Letter	**Current View**	**December Letter**	**Current View**	**December Letter**	**Current View**
UK Deposits (Cash)	15	15	8	8	3	3
US Deposits	-	-	3	3	3	3
Euro Deposits	-	-	5	5	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
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)	-	-	-	-	-	-

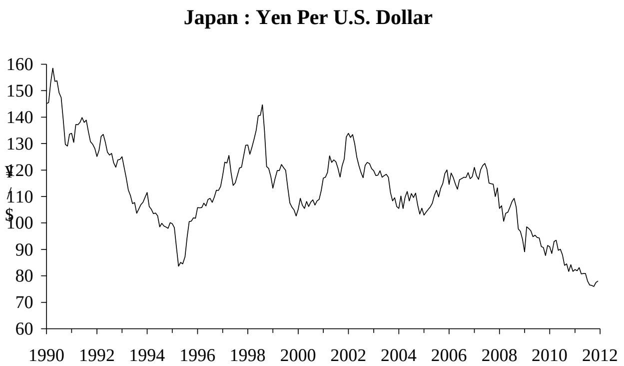
INDICATORS AND MARKET ANALYSIS
FOREIGN EXCHANGE MARKETS[1]







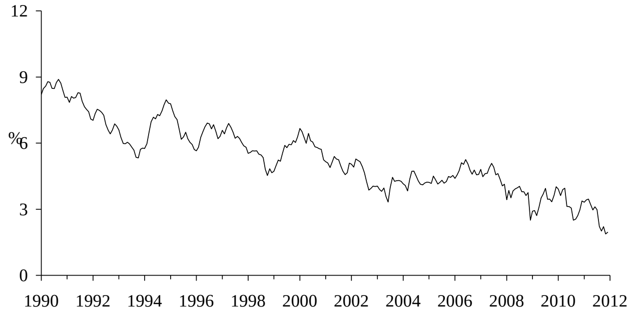




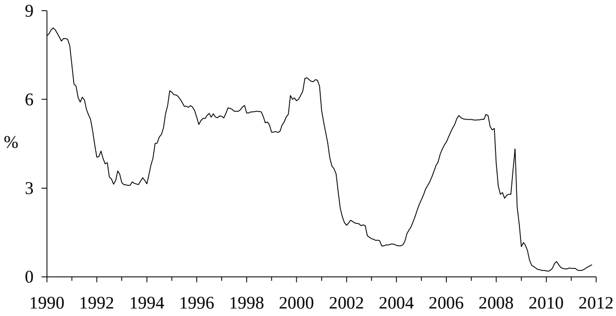
[1] John Wilmot, who has written these sections since this Letter began, is indisposed. We are issuing the charts without his commentary this month. We wish him a speedy recovery.

GOVERNMENT BOND MARKETS

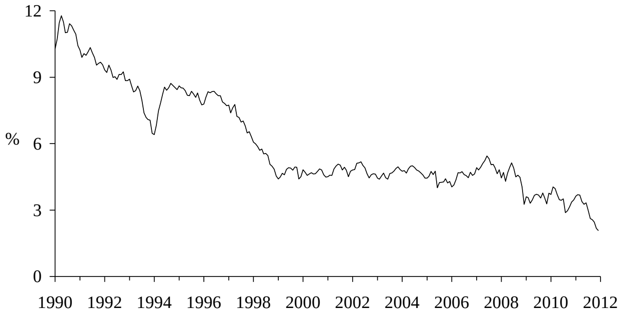
U.S.: Yield on Long-Term Government Bonds



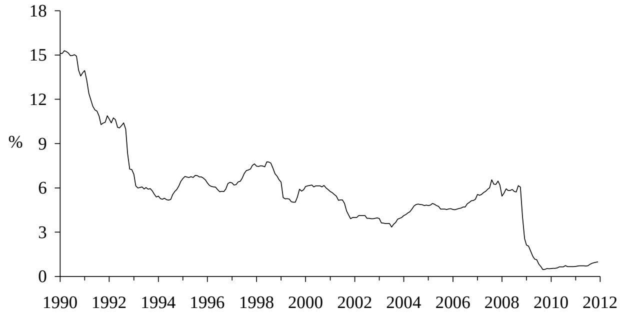
U.S. : 3-Month Certificate of Deposit



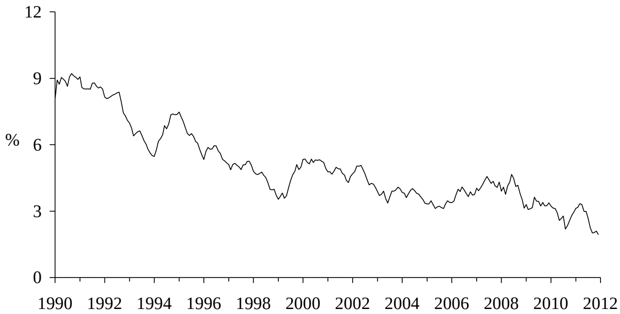
U.K. : Yield on Long-Term Government Bonds



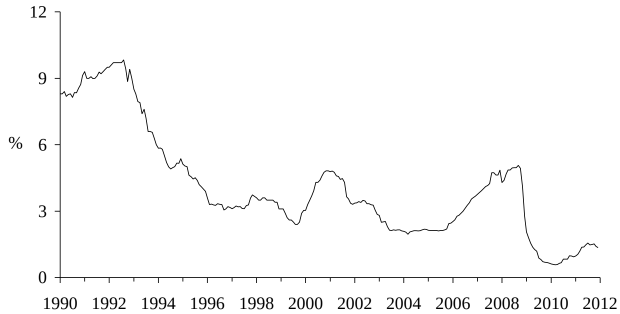
U.K. : 3-Month Interbank Rate



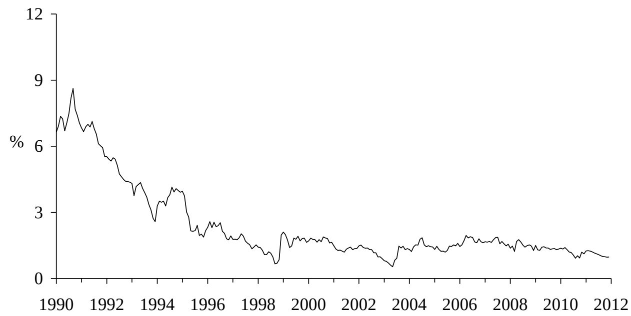
Germany: Yield on Public Authority Bonds



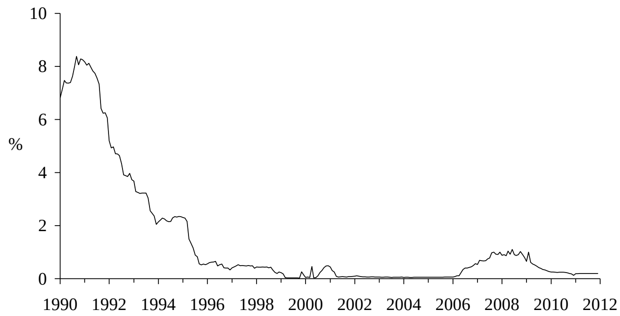
Germany : 3-Month Interbank Deposit Rate



Japan: Yield on Long-Term Government Bonds

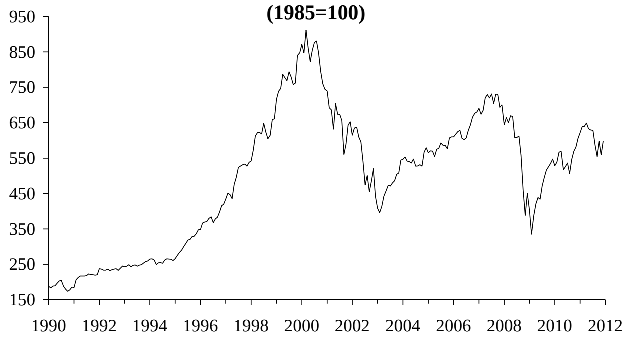


Japan : 3 Month Money Market Rate

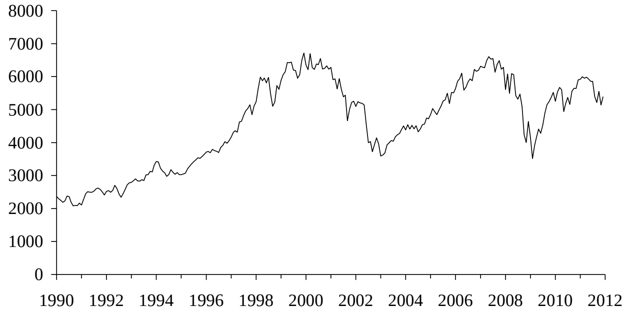


MAJOR EQUITY MARKETS

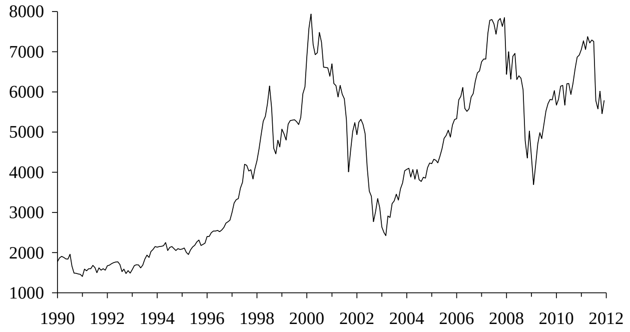
U.S. : S & P 400 Industrial (1985=100)



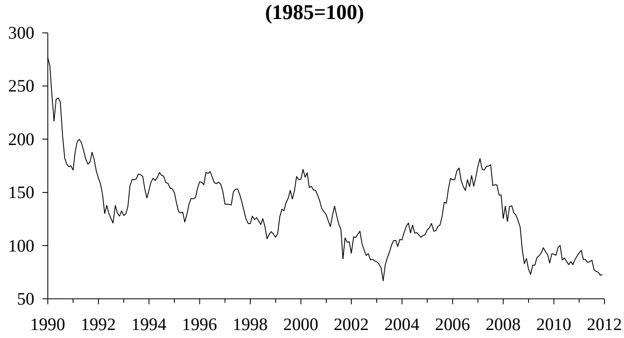
U.K. : FTSE-100 Index (10 April 1962=100)



Germany : DAX 30



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



EMERGING MARKETS

Anupam Rastogi

India

Some policy makers do not learn from others' mistakes. Same holds for policy makers in India. The policy makers have learnt nothing from the Greek and snow-balling debt crisis of Italy. It seems that the 1987–89 era of Indian politics is being re-enacted by the then Prime Minister Rajiv Gandhi's Italian born widow Sonia Gandhi. In spite of strong opposition from a few cabinet ministers she has imposed a Food Security Bill on the nation which shall provide subsidized food to almost 65% of India's population. The subsidy would cost Rs9.3 trillion to the central government when the food grown in the country is plenty. It is anybody's guess what the cost would be when monsoons fail and India becomes a net importer of food. This populist measure may win election for the ruling congress party in 2014 and may enable Mrs. Gandhi to launch her son Rahul Gandhi as PM of India but India's economic growth is all set to hover around 6% in the coming years. With the next election due only in 2014, Delhi faces three years of political drift.

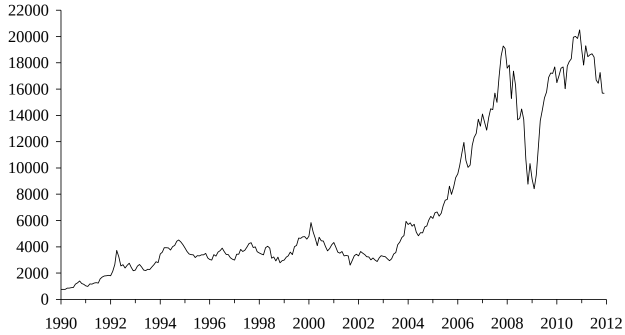
The Indian economy expanded at its slowest pace in more than two years in the July-September quarter, hurt by a deepening euro-zone crisis. Industrial output contracted in October for the first time in more than two years, while economic growth slowed to 6.9% in the July-September quarter from 7.7% during the April-June period. Industrial output fell 5.1 % from a year earlier in October, after a 1.9% expansion in September, dragged down by a contraction in manufacturing and mining production. With the country entering a crucial year of provincial elections, the chances of a turnaround in India in 2012 are slim.

The Indian government expects economic growth to be 7.25%–7.75% in the fiscal year ending March 2012, and admitted that it could miss several fiscal aims because of problems caused by global uncertainties.

November's headline inflation was the lowest in a year, though rising commodity prices and costlier imports due to a weakening local currency kept it above 9% for the twelfth straight month. The wholesale price index-based food inflation rate in the week ended December 3 fell to 4.35% from a year earlier, compared with 6.60% in the preceding week as vegetable prices cooled. India's central bank has left its key lending rate unchanged, snapping a monetary tightening stance that lasted 13 rate increases in less than two years, and has indicated that it may start reversing the policy to reduce the risks to economic growth. It expects inflation to come down to 7% by March 2012.

In mid-November, the rupee fell to its record low of Rs54.29, falling about 22% cumulatively against the U.S. dollar since April 2011. The rupee's rapid decline stems

India: BSE Sensitive



from a combination of high inflation, slowing economic growth and a sizeable current account deficit, expected to reach 3% to 3.5% of gross domestic product this year, up from 2.5% last year. India is a net importer and relies heavily on foreign capital inflows to finance its balance of payments. A depreciation of rupee makes the taming of inflation even more difficult. But, India's weak fundamentals are unlikely to change soon. Until they do, a rebound in the rupee is impossible.

India plans to diversify exports, focusing on manufactured goods, to help cut its trade deficit with China. India's trade deficit with China widened to $23.9 billion in the fiscal year ended March 31, 2011 from $19.2 billion in the previous year.

India shelved recently-announced plans to allow international supermarkets and department stores to enter the country, disappointing retailers and damaging the government's credibility. Prime Minister Manmohan Singh's backtrack on retail-industry reform was embarrassing, but its true costs for the Indian economy are only starting to come into view. In the extended session of parliament, in the last week of December 2011, the government would be locking horns with opposition parties to pass a bill to have a constitutional public ombudsman against corrupt politicians and senior government bureaucrats.

With the MSCI India index down by 37% in US dollar terms so far for 2011, compared with an 18.8% decline in the MSCI Asia Pacific ex-Japan index, the Indian stock market has performed the worst among emerging markets.

	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	9.0	7.5
Current A/c(US$ bill.)	-56.0	-14.0	-44.0	-60.0	-35.0
Rs./$(nom.)	48.5	48.0	49.0	49.5	48.0

China

People's protest in Wukan against local government dealings, in particular involving the village Communist Party chief, Xue Chang, who served at the position for about 40 years swelled so much that senior party leaders had to take note. Wukan — a fishing village of about 20,000 in southern China's relatively prosperous Guangdong province — has become a symbol of an uncertain year for China. The situation did not get out of hand but global economic turmoil and worries about falling housing prices have added to general unease, while a thriving Internet culture has given voice to criticism of how local and central governments conduct business. Wukan villagers have agreed to a peace deal after extracting initial concessions from senior provincial leaders to their immediate demand. Guandong is adjacent to Hong Kong and a thriving export centre in China. The Wukan protest was the most serious case of social unrest in China this year.

China's economic growth is slowing in the face of a likely recession in Europe and a weak recovery in the U.S. The policymakers are wary of the potential for any big capital outflows. This has pushed the Chinese government to kick-start demand as it has done before. Moreover, real estate prices are softening which is likely to strain local government finances. Real estate investments accounted for about 13% of gross domestic product last year. Therefore, growth has replaced inflation as Beijing's top policy concern. The government released a statement after a meeting of the central economic work conference mentioning that fiscal policy in 2012 will be more proactive and monetary policy will be eased on the margin.

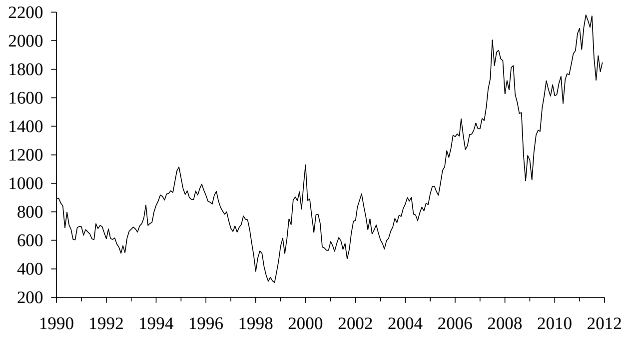
China has already reduced the amount of reserves that big banks must hold, a measure that freed up an estimated $55 billion to $63 billion in the lending capacity of banks. If China continues to lower banks' reserve requirements, it would spark stronger growth in the second half of 2012. This may stoke inflation once again in late 2012. For the time being, Chinese leaders have pledged to step up spending to maintain growth and social stability amid rising global risks.

China has managed to tame inflation. Consumer inflation in November rose 4.2% from a year earlier, compared with a 5.5% increase in October.

China is easing the path for foreign investment flows into the Shanghai stock market. China is reportedly planning to ease restrictions on foreign institutions' direct involvement in China's markets. Foreign fund investments currently count for only about 1% of China's market value.

China's trade surplus narrowed in November, indicating the euro-zone crisis having a real but still limited impact on Chinese exports. China's trade surplus in November fell to $14.53 billion from $17.03 billion in October. Exports rose 13.8% in November from a year earlier, down from October's 15.9% rise. Imports rose 22.1% from a year earlier, down from the 28.7% rise in October.

Korea: Composite Index



China is also considering giving its citizens greater ability to invest overseas directly as part of its efforts to diversify the country's mammoth foreign-exchange reserves. The State Administration of Foreign Exchange, the country's currency watchdog and part of China's central bank, may gradually raise the limit on how much foreign exchange Chinese individuals can purchase every year for the purpose of investing overseas. Currently, Chinese nationals can exchange up to the equivalent of only $50,000 a year into foreign currency. Widening the quota would represent a small but significant step toward opening China's capital account. As of now China tightly controls capital account flows to manage the exchange rate and prevent speculative capital flows.

The yuan broke its continuous upward appreciation and depreciated a little in November. Investors were seen to seek the perceived safety of the U.S. currency amid growing worries over China's slowing economy and weakening exports. The Shanghai Composite has fallen 22% this year.

Chicago Mercantile Exchange Group will allow international investors to use the Chinese currency as collateral for trading in all its futures products from January 2012. The move would allow investors holding renminbi deposits in Hong Kong or other financial centres outside mainland China to use the cash to bet on markets including metals, grains and energy.

	08	09	10	11	12
GDP (%p.a.)	13.0	8.7	10.3	9.0	8.0
Inflation (%p.a.)	6.8	-0.8	5.9	4.8	3.1
Trade Balance(US$ bill.)	330	180	183	150	140
Rmb/$(nom.)	6.7	6.8	6.6	6.3	6.2

South Korea

Once again the South Korean government was forced to slash its growth forecasts for 2011 and 2012 as the deepening euro-zone crisis undercuts the export-driven country's momentum. The government expects the economy to grow 3.8% this year and 3.7% in 2012, down sharply from 4.5% growth predicted for both years previously. The government also raised its 2012 inflation outlook slightly to 3.2% from 3.0% previously. The government acknowledged that risks related to growth now outweigh those linked to inflation. The central bank is expected to start monetary easing in the first half of 2012 to support growth. The central bank has kept its policy rate at 3.25%, where it has stood since a 0.25 percentage point increase in June.

Private consumption is expected to grow 3.2% next year following a 2.5% rise this year, while capital investment is forecast to rise 4.2%, slowing from a gain of 4.5%, according to the BOK's latest forecasts. The government has tried very hard to revive consumption in the economy but the public is not ready to take the bait.

Exports are likely to grow 5.0% next year, slowing sharply from an 11.6% rise this year, while imports are expected to rise 5.2% after climbing 9.3% this year.

The chairman of South Korea's ruling political party resigned amid mounting pressure from members who believed his effort to rehabilitate its scandal-damaged image was too late. The turmoil in the GNP's leadership has implications for the country's business and trade policies. In 2012, voters will choose new lawmakers in April and a new president in December.

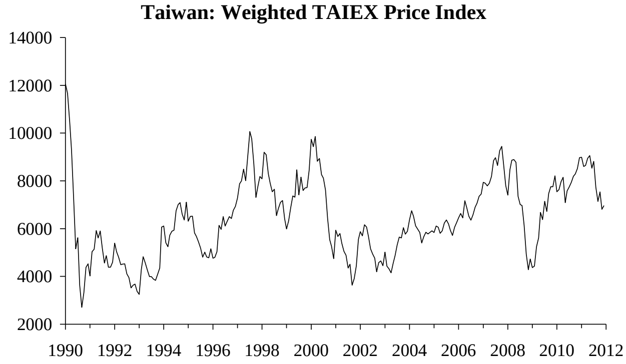
	08	09	10	11	12
GDP (%p.a.)	2.2	0.2	6.1	3.5	3.5
Inflation (%p.a.)	5.0	2.6	2.9	4.2	3.8
Current A/c(US$ bill.)	-7.9	42.7	28.2	16.0	12.0
Won/$(nom.)	1250	1200	1150	1100	1100

Taiwan

The economic growth of Taiwan is expected to slow down in 2012. The government expects GDP to grow 4.56% in 2011 and 4.38% in 2012. Taiwan's consumer price index growth slowed for the second straight month in November. The island's CPI rose 1.01% in November from a year earlier — the slowest growth since a 0.56% on-year increase in October 2010. The October CPI is revised to 1.25% on-year rise. We expect the central bank to keep the key interest rate unchanged at 1.875% in the next quarterly meeting on December 29.

Taiwan is keen to switch its economic focus to the domestic market to fuel job growth to become less dependent on exports. Taiwan's unemployment rate may rise to 4.7% by the end of 2012 because of a strong decline in export orders. The increase in Taiwan's export orders was the least for more than two years in November, putting pressure on the central bank to protect economic growth as it decides on interest rates next week. Orders in November climbed 2.54% from a year earlier, after a 4.38% gain in October.

Taiwan: Weighted TAIEX Price Index



Taiwan President Ma Ying-jeou slipped in the polls for the election to be held in January, setting the stage for a tight contest closely watched in Beijing and Washington.

Taiwan's stock market has fallen 24% this year. It has hit its lowest level since September 2009 amid rising economic scepticism and selling by foreign funds.

	08	09	10	11	12
GDP (%p.a.)	1.9	-1.9	10.8	4.3	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 gross domestic product contracted 0.04% in the third quarter compared with the third quarter a year ago, the slowest growth of the year as global uncertainties finally undermined activity in Latin America's largest economy. If the recession in Europe is deep, there is an outside chance of technical recession in Brazil. The fourth quarter is also looking weak but the effects of fiscal stimulus measures and interest rate cuts should begin to kick in soon. The central bank expects Brazil's economy to end 2011 with a growth of 3.1%, rising to 3.5% in 2012.

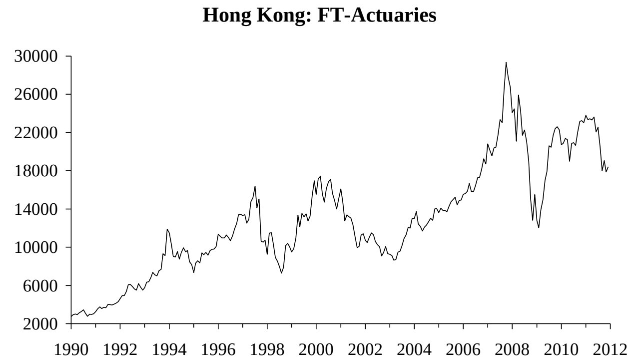
Consumption has also been subdued in the economy. The weakness in Brazilian consumer spending stems from weak sentiment in global capital markets. A more challenging task for Brazil is its low savings which means that it relies on foreign capital and investment to fund domestic consumption and, therefore, it gets affected by the strains in the global economy.

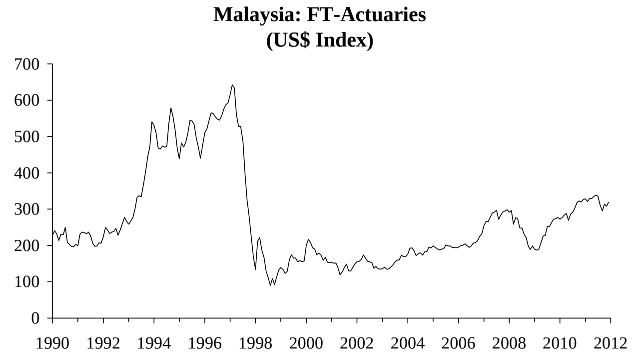
Inflation remains above the central bank's target of 4.5% plus or minus 2 percentage points but has shown signs of easing, falling below 7% to 6.69% in the 12 months to mid-November. Brazil's central bank cut its benchmark interest rate from 11.5% to 11% — the third such 50 basis point cut since August. We expect the Selic rate to fall to 9% by the middle of 2012.

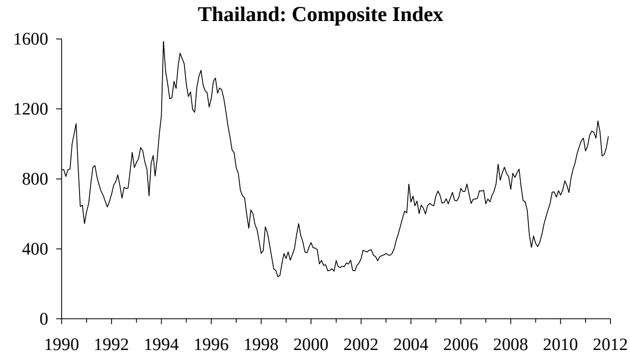
Rio de Janeiro is establishing Latin America's first market for trading a wide range of environmental assets. Backed by the state and city governments, it will trade environmental assets ranging from straight carbon credits to securities related to Brazil's controversial forest code, which requires farmers to maintain certain levels of vegetation on their properties. However, it faces formidable competition from the São Paulo-based exchange, BM&F Bovespa — Latin America's largest bourse and the world's fourth largest by capitalisation — which has a carbon trading programme and as of now is refusing to share its clearing system with rival exchanges.

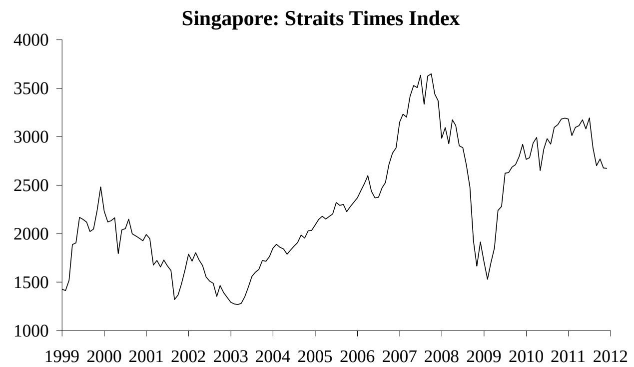
	08	**09**	**10**	**11**	**12**
GDP (%p.a.)	5.1	-0.2	7.5	3.0	3.0
Inflation (%p.a.)	6.0	4.1	5.9	6.0	3.6
Current A/c(US$ bill.)	-25.0	-20.0	-12.0	-50.0	-60.0
Real/$(nom.)	2.2	1.8	1.7	1.5	1.5

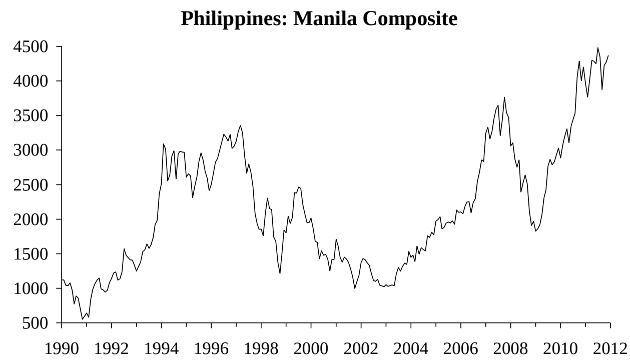
Other Emerging Markets





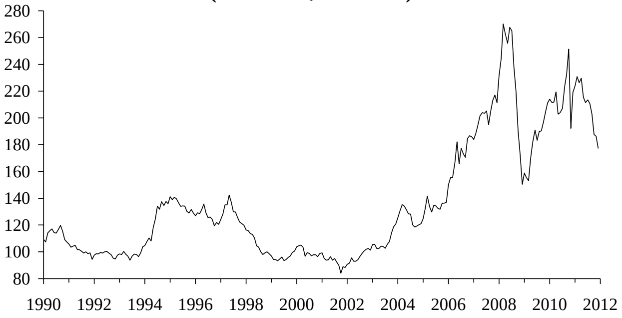




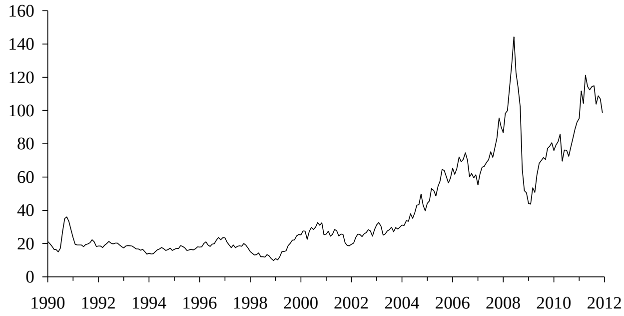


COMMODITY MARKETS

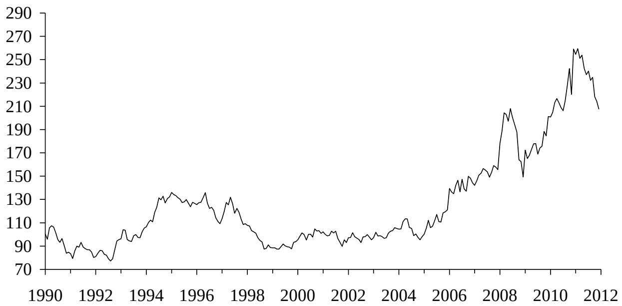
Commodity Price Index (Dollar)
(Economist, 2000=100)



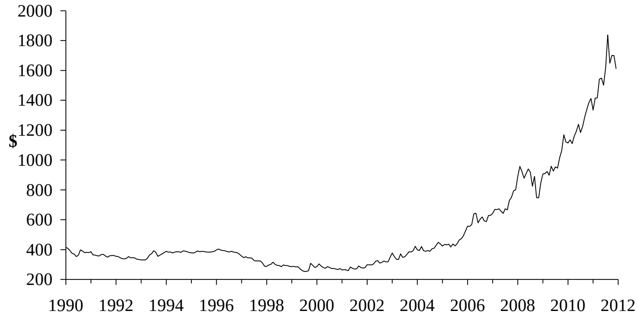
Oil Price: North Sea Brent (in Dollars)



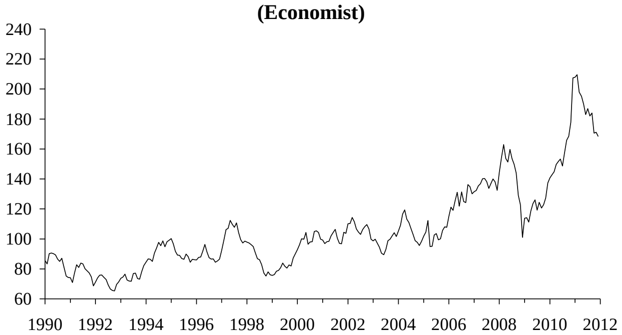
Commodity Price Index (Sterling)
(Economist, 2000=100)



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

	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

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

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

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

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

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

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.

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