

Sisyphus cannot simply kick the can down the road

Summary

- In an uncharted economic environment, market expectations cannot be very stable. This is especially the case when a structurally weak recovery among the developed countries faces a series of temporary shocks, whose magnitude and length are not precisely known. Policymakers are not really able to send positive messages about managing this 'soft patch' properly. Indeed, room for manoeuvre in implementing new monetary and fiscal stimulus measures is limited. The focus could be more widely used on structural policies. Increasing market dynamism (whether of goods, services, labour or capital) often implies less regulation. In this case, the flip side is more instability. Is this acceptable just a few years after a crisis, one of whose origins is a default in regulation?
- In Europe, refusing the default of a peripheral country's sovereign, at least in the next few years, cannot be the definitive answer to the current issues. A liquidity crisis that lasts too long will morph into a solvency crisis. **This suggests that the policy goal of EU institutions cannot exclusively be ensuring the refinancing of government debt. Starting to create the conditions for future growth now is another 'burning obligation'.**
- Generally speaking, the fundamentals of emerging countries are more solid than those of developed countries. But they cannot remain totally immune to what is happening around them, whether the jump in commodity prices, the supply disruption in relation to the recent dramatic events in Japan, the 'soft patch' in the West or the decline in risk appetite. The relatively constructive medium-term view nevertheless suggests that EM assets could be among those that will react positively as soon as growth begins to re-accelerate in the US and Europe.
- **The uncertain environment in developed economies argues for still-accommodative monetary policy. However, this encourages 'search for yield' behaviour,** which can promote excessive leverage and valuation for some markets, such as high-yield debt in mature economies and corporate debt in emerging countries.

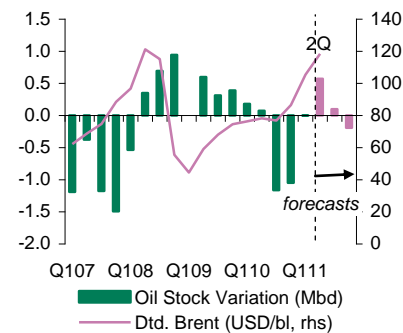
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Special 1: What policy management for the soft patch?

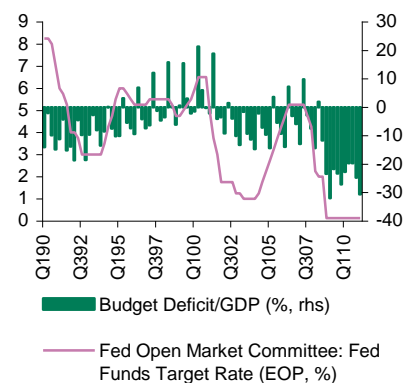
The main risk today is not a return to recession; rather it is the difficulty of knowing whether the economy is growing slowly or quasi-stagnating. In such an environment, confidence is the key element to prevent a dangerous slowdown in activity. Governments could help effectively by launching structural policy initiatives.

Oil price



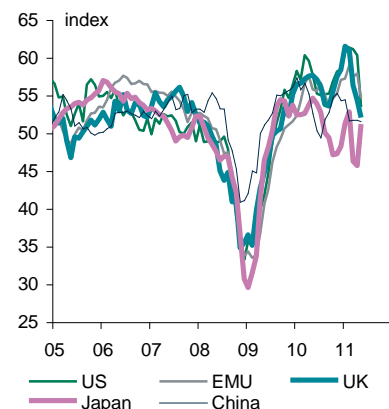
Source: Bloomberg, Crédit Agricole CIB

Deficit to GDP and Fed Funds



Source: FRB, BLS, US Treasury

PMI manufacturing indices



Source: ISM, Markit, Credit Agricole CIB

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The global economy is entering a 'soft patch' and this is particularly the case for developed countries, but nobody knows what the magnitude and duration will be. From a market standpoint three main issues must be addressed: the reason for the soft patch, its main characteristics and the policy response.

There are two reasons for the current 'soft patch': a structurally weak recovery in many developed countries because of the excess of debt accumulated during previous economic cycles, and a series of temporary events. The first factor is determining the growth trend for the next few years. Stabilising housing prices is taking time, as the current experience in the US shows, and the preference for saving, in order to consolidate balance sheets, is weighing down on domestic spending. The recent temporary events have included extreme weather conditions, geopolitical events, the surge in oil prices and supply disruptions following the double Japanese shock (the earthquake/tsunami and subsequent nuclear issues).

It is important to understand that there is a relationship between the two sets of factors: the weaker the growth trend, the more damaging the temporary impediments. For developed countries, the perception of how serious this series of adverse events is differs depending on the initial pace of growth. In the US, for example, losing 1ppt of GDP growth from a 4% trend would be a less tricky issue than losing 1ppt from the 3% recorded in 2010. The main question is how long the soft patch will last. There is a lack of visibility on weather conditions and geopolitical events. The supply from Japan seems to be improving gradually, even if anecdotal evidence cannot draw an exhaustive picture of the situation. **Ultimately, the main trigger, albeit somewhat by default, will be the oil price.** It needs to decline to around USD80/bl to ensure consolidation in economic growth. Even if oil stocks remain relatively high, likely in relation to the geopolitical situation in the Middle East, oil demand is weak. This means that the next developments on the supply side will be key in determining the price level. The recent failure of OPEC to agree on an increase in supply sends a negative message. However, countries such as Saudi Arabia, Kuwait and UAE are willing to increase their output and they have the capability to do so. **The main probability remains in favour of a downward correction in prices in the next few months, but the degree of uncertainty continues to be high.** This could impact negatively the confidence of corporates, households and markets for a while yet.

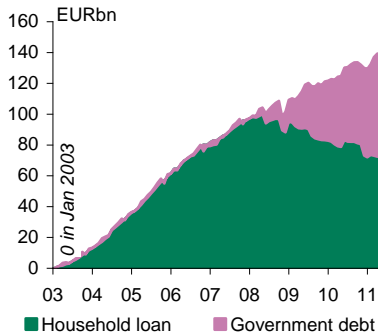
Discussing the right policy answer with this high degree of uncertainty is not an easy task. The timing of the exit from the soft patch is unknown, and room for manoeuvre in implementing new monetary and fiscal stimulus measures is very limited. So what can be done? We likely have to revert to the diagnosis of the current situation – a mix of weak trend growth and a series of temporary shocks. The focus should first be on the former, and **the main tool to strengthen growth potential is structural policies, even if the delays before recording objective signs of improvement are indeed long.** This means, among other things, promoting productive investment, improving the functionality of the labour market and launching serious plans for medium-term fiscal consolidation. This should consolidate confidence, and so bolster resilience and gradually boost growth.

The main risk today is not a return to a recession; it is more difficulty for observers, among them capital markets, to know whether the economy, especially in developed countries, is growing slowly or is quasi-stagnating. In such an environment, confidence is the key element to prevent a dangerous slowdown in activity. Governments could help effectively by launching this type of structural policy.

Special 2: Europe must be better explained to markets

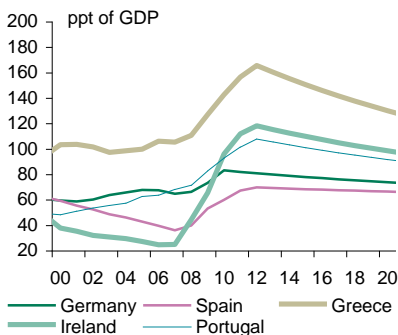
The EU is a 'strange animal' and there are often misunderstandings between officials and markets. The latter are looking for responsiveness and clarity, while the former, with the notable exception of monetary policy, are more in response mode after having been convinced that change will bring greater benefit than the *status quo*.

Ireland: porosity between household and public debt



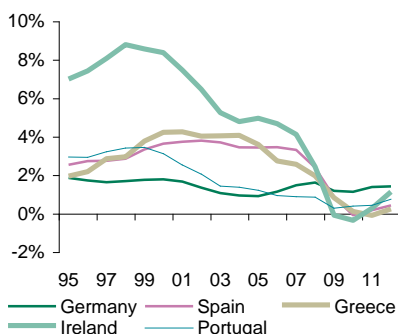
Source: Bloomberg, ECB, Crédit Agricole CIB

Theoretical debt trajectory under new stability and growth pact



Source: Bloomberg, Crédit Agricole CIB

Potential growth (according to OECD)



Source: OECD, Crédit Agricole CIB

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Europe is a Poorly Identified Geopolitical Object. The European Union (EU) is more than a nation state; yet it is not a federation. Should we go along with Vladimir Putin (an expert in these things), who once said, when talking about the EU, that all empires and federations are destined to disappear?

Furthermore, who is able to determine the boundary of the EU? The EU seems to be ensnared in a contradiction: on the one hand the limits of the EU's possible geographic expansion are not known with any certainty; and on the other, effective convergence initiatives can take place only in a coherent economic area.

The EU has a 'curious' *modus operandi*. The EU is moving towards greater integration when the risk of regressing is becoming too great; or, to put it another way, when the cost of doing nothing exceeds the cost of changing. The rate of change, ie, of moving towards greater integration, is therefore largely an unknown quantity. It depends on changes to the environment (which can, of course, be predicted) and on the ability to understand that change will bring greater benefits than the *status quo*. In fact, the EU did not draw up a pre-determined model for itself towards which it could progress. It simply developed an operating principle, that of subsidiarity: the only things that are centralised at EU level are the competencies and powers whose deployment at national level would be demonstrably less effective. The EU is therefore more in response mode than in forward-looking mode. In all events, the whole approach is meant to be empirical. **There is no quest for a collective optimum state to be achieved. All that is needed is to demonstrate that the new organisational model will be superior to the previous one**, which more often than not has not been borne out by events. The Eurozone, for example, is not an optimum monetary zone in the Robert Mundell sense, but its architecture is superior to that of the European Monetary System.

There are at least two main risks inherent in this approach:

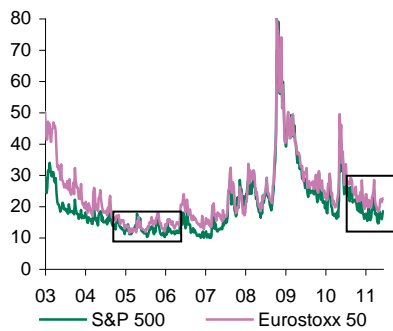
- The realisation of the need to move forward may come too late in the day: was this not the case with the Greek sovereign debt crisis?
- The EU is a 'process' thought of as being, in all likelihood, ongoing. In this respect, any further changes must not lead to blockages, ie, must not prevent the next change required by changes in the environment, about which we know little before the fact. That should be enough to foster a degree of caution.

Economic and Monetary Union (EMU) is an object with a political purpose. It contributes to the process of European integration. We should never forget that the process of European construction has been driven successively by political and economic advances. One example is the increased powers and visibility of the European Parliament at the time the Single Market was launched. EMU is, in fact, considered to be an irreversible process. There is no legal process in place for leaving the Eurozone or being excluded from it.

What are the origins of the Eurozone debt crisis? The trigger was the porosity between private and public debt. Once the former had become excessive, it had a severely negative impact on economic growth, leading to a deterioration in the national accounts. Although private debt levels are largely down to the banking sector, the risk of transferring the debt to the state's books is very real. Where the size of bank balance sheets relative to GDP, is virtually immeasurable (a ratio of 10:1 in Ireland, for example, of which 'only' 3.5x for Irish banks alone), the impact is devastating. Fears linked to these mechanisms cannot remain concentrated only in their country of origin. This is because a significant proportion of public debt is held by economic agents outside the country, including Eurozone banks.

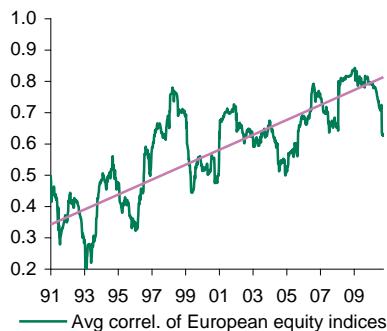
What are the characteristics of the Eurozone? The Eurozone has a single

Equity market volatilities far away from good old times



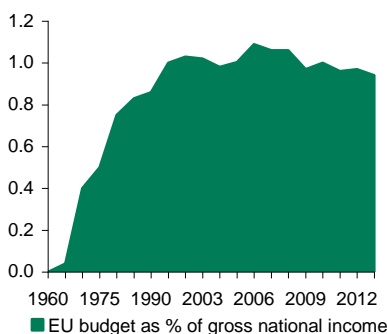
Source: Bloomberg, Crédit Agricole CIB

Financial integration still in process?



Source: Bloomberg, Crédit Agricole CIB

Stagnation of political integration



Source: European Union, Crédit Agricole CIB

currency but very restricted tax and budget federalism (1% of GDP, compared with approximately 20% in most federal states) and a financial regulation system organised at nation-state level. Of course, such organisation may seem somewhat baroque. But was there a convincing alternative when the single currency was launched? Waiting for political integration would have postponed the EUR's launch to an unknown, no doubt far-off, date. In addition, the facts have shown that, regardless of its 'congenital' weaknesses, the Eurozone was a more protective framework than the European Monetary System would have been. Furthermore, this approach corresponds closely to the *modus operandi* described earlier. It is both empirical and experimental. It calls for adjustments, once its weaknesses emerge. What are those weaknesses? A mix of lax controls that have been allowed to go too far in terms of public deficits (Greece), excessive growth in credit relative to economic growth, which excessively swells asset prices and generates large-scale external deficits (Spain, Portugal, Ireland) and a loss of price-competitiveness (Greece or Portugal, to take but two relatively uncontroversial examples).

There are mutual misunderstandings between governments and markets.

For quite a long time, the markets were convinced that, at the end of the day, the Eurozone was a bit like a vast Germany. Interest rate spreads were very narrow, indicating that, regardless of how a state and private agents in many of the member states behaved, country risk had virtually disappeared. Later on, complacency gave way to impatience. As the crisis unfolded (it is no doubt not over yet), the markets demonstrated impatience in the face of what looked like hesitation or procrastination on the part of politicians. Politicians do not have a great deal of time for the markets, even though they very often place themselves in a situation of great dependency upon them. Big announcements and good intentions are found wanting, especially when visibility is decreasing. The markets want responsiveness and clarity. This is how they can form their expectations, and repeat them if they prove profitable. In such cases, it is a win-win game for the two protagonists. In the recent period, it has not always been like that.

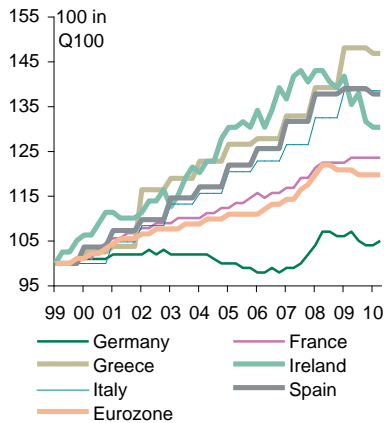
In the recent past, a lot has already been done in order to strengthen the structures of the EU, especially for liquidity management and governance:

- Freeing resources to cope with the liquidity crisis faced by sovereign borrowers in fringe Eurozone countries.
- Strengthening the fiscal pillar of EU governance.
- Creating a macroeconomic pillar for EU governance.

But a lot remains to be done. For the past year and more, the EU has been managing liquidity crises in a certain number of its member states. By its very nature, a liquidity crisis is temporary. The proposed refinancings cannot be permanent nor be allowed to reach astronomical proportions (think of Irish banks' balance sheets, which are ten times the size of the Republic's GDP). A persistent liquidity crisis will morph into a solvency crisis. If the ratio of public debt to GDP is too high, the only courses available are to reduce the numerator (so a default) or increase the denominator (generate more growth in either volume or price terms). Today, the very high level of economic and financial interweaving between EU countries rules out the prospect of a default. We therefore cannot duck the question of how to create the conditions for more growth, first in the fringe countries, and then at a pan-EU level, knowing that more inflation cannot be a deliberate choice. In the past (before the launch of the EUR), successful fiscal consolidation in Europe created the conditions for higher growth through devaluation and sharp cuts in interest rates. The first tool is no longer available, and the second is largely in the hands of EU institutions. It is unlikely that the EU will be able to avoid fiscal transfers to those fringe countries that are seriously short of growth (via a revised channelling of structural funds?). **We should not forget that the economies of Greece, Ireland and Portugal (the countries which have requested EU aid) account for only 6.5% of the economies of the other Eurozone members. If the latter were to transfer 1% of their GDP, the former would receive the equivalent of over 15% of theirs.**

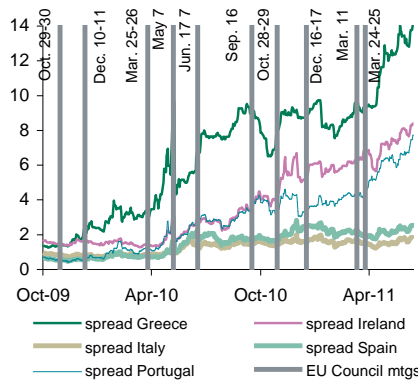
In any case, European history is a history of economic convergence. The divergence observed during the crisis is a mechanism that is unacceptable for an area in the process of greater integration. It is also important that all EU countries take steps to boost their potential growth levels. They cannot content themselves

Unit labour cost



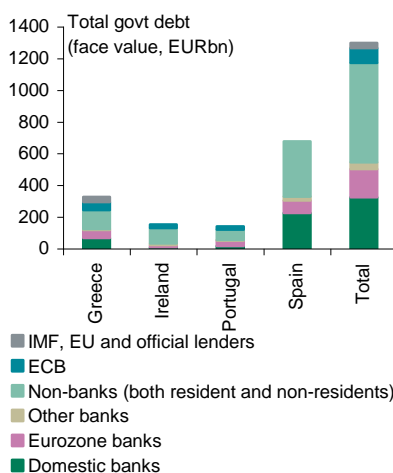
Source: Bloomberg, Credit Agricole CIB

Government bond spreads (10Y) and European Council meetings



Source: Bloomberg, Credit Agricole CIB

Who owns peripheral government debt (end-2010)?



Source: Bruegel Institute, Crédit Agricole CIB

with growth prospects of just 1.5% per year. It is essential to resolutely deploy the Europe 2020 strategy. Taking the logic of the Single Market to the next level also offers promising prospects, especially in the area of services. At the end of the day, at a time when giants are contending on the world stage, Europe will not be able to sidestep a debate on its political and institutional architecture. What is the right degree of solidarity – desired and accepted – inside an area whose economic and financial fabric is so dense?

What are the lessons for the markets?

A shifting institutional and political framework: Europe, as a gathering of nation-states with deep historical roots, is still a political group gradually building up. In this respect, it has more things in common with an emerging country than with the US. This could provide a lack of visibility when Europe has to solve economic issues thanks to institutional adjustments.

We must avoid systematic foreign references. Lately, former sovereign defaults from emerging countries have been highlighted to sustain that default is the only exit for the Eurozone's peripheral countries. However, these cases are very different from each other. The dissimilarities are huge, in terms of the size of the primary budget deficit, the currency in which the debt is labelled or the importance of the government bonds in household savings.

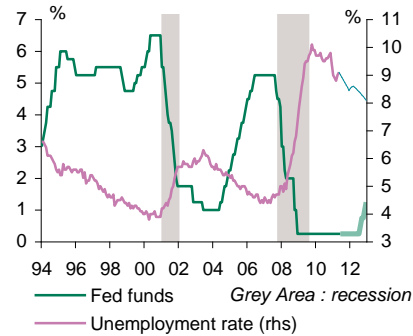
We must clearly segregate the economic and financial integration, which is relatively important (even if it must be improved further), from the political framework, which is still focused on the nation-state principle. There are strong economic and financial interdependences between the Eurozone countries. They compel us to take into account the repercussions for the whole EU of any decision or event happening in a member state. However, the institutional and political frameworks can create a misleading feeling of relative independence between the events occurring in a specific country (especially if its economic weight is limited) and its consequences within the other members.

Let's talk about the deep-rooted trends of the market. The lack of visibility about the institutional and political changes and the slowness of the reaction time argue in favour of structurally unstable expectations. This should lead to higher volatilities in Europe than elsewhere in the developed world. However, the ongoing trend of more political integration in the European Union and in the Eurozone should encourage further economic and financial integration. The capital markets should not avoid this phenomenon, leading to salutary effects in terms of market liquidity and market depth. The rate spreads between peripheral and German bonds are probably exaggerated. The key issue concerns the political signal that will allow a downward correction. Recent prevarication probably affected the EUR's growing status as a reserve currency. However, the EUR should regain it.

Central banks: One for all, and every man for himself

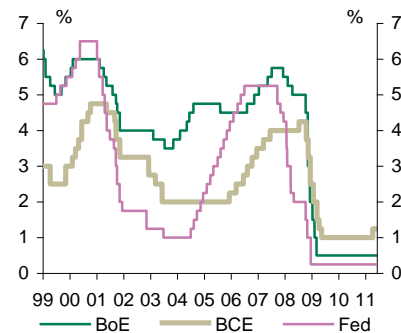
Central banks closed ranks in adversity to stave off the threat of deflation. Faced with the opposite risk, inflation, cracks have emerged in that unity, with considerable differences in the type of response. Each central bank cites its own reasons, but it is hard to believe that they can all be right simultaneously.

US: Fed funds and unemployment rate



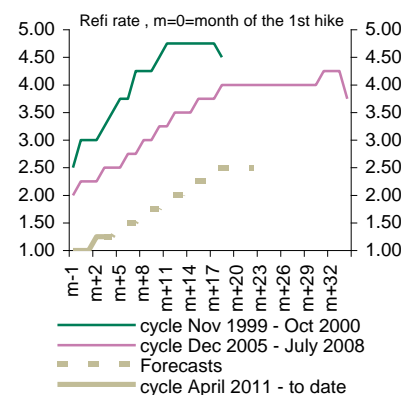
Source: Federal Reserve, BLS, Crédit Agricole SA

Central bank synchronicity: an exception rather than the rule



Source: Central banks, IHS Global Insight, Crédit Agricole SA

ECB: tightening cycles



Source: IHS Global Insight, Crédit Agricole SA

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Confronted with the threat of deflation: a collective, unified response

Crisis... At 7am New York time (1pm in Paris), the Fed and five other central banks, including the ECB and the BoE, announced a co-ordinated 50bp cut in their key rates. That was on 8 October 2008, in the thick of the financial crisis, and the move marked the start of a global cycle of monetary easing that would take the key rates of these three leading central banks to historic lows. As soon as the crisis began in August 2007, the three banks all directed their efforts to the same end by launching lender-of-last-resort initiatives to guarantee liquidity at all costs after the money markets froze. Even after using up all their usual ammunition, all three opted to travel other, more unorthodox paths as they strove to manage the size and structure of their balance sheets to provide more liquidity and scope for financing to markets damaged by the crisis. Although the *modus operandi* of these quantitative easing policies differed according to the more or less intermediated financing structure of their respective economies, the issue was the same in all cases, since the aim was to prevent widening insolvency circles and the risk of triggering a depressionary spiral with recession and deflation feeding off each other against the backdrop of a major credit crunch. And while co-ordination among the central banks was never explicit, it seems to have been self-evident, lending their actions even greater credibility and effectiveness. The sense of having pilots at the controls, ready to act in concert to stave off the worst, helped to stop the markets succumbing to panic, the source of systemic contagion, and also helped to preserve the integrity of the global financial system. Moreover, in a globalised, increasingly interdependent world subject to the same pressures, this collective, uniform response helped to minimise the effects of distortion between markets and regions while contributing to improved visibility.

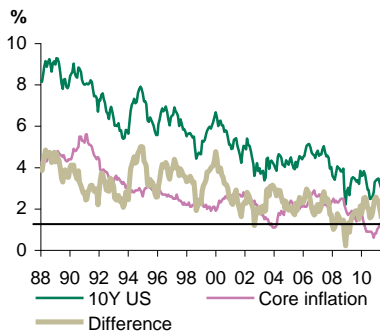
Confronted with the threat of inflation: an individual, varying response

...and crisis exit. On Thursday 7 April 2011, the ECB announced a first increase in its key rate at a time when the Fed was still in monetary easing mode, with a firm programme of asset purchases in place until June, and while the BoE also remained in accommodative mode, maintaining the *status quo* on all fronts, conventional or otherwise. Yet the inflation fears that triggered the ECB's move are, along with surging commodity prices, a global phenomenon, which should logically have led to a more homogeneous response on the part of these same central bankers who were able to close ranks to ward off the opposite threat of deflation. Their respective positions in the cycle do not justify such a difference since in all three cases these advanced economies are growing slowly and have to cope with excessive public and/or private debt in a still-convalescent financial environment. That kind of divergence does, of course, raise questions about a possible error of judgement, since it seems difficult to believe that the Fed, the BoE and the ECB, which all exist in the same world, can all be right at the same time in choosing diametrically opposing options. In a financial environment cruelly lacking in visibility, these differing analyses only add to the confusion and fuel further volatility. They also create distorting effects in a world of excessive global liquidity, which will shortly, and in some cases abundantly, pile into those places where profit (or the prospects of profit) attract it, either geographically or by market segment, at the risk of fuelling new bubbles and/or financial instability.

US Interest Rates: Super-sensitivity of rates

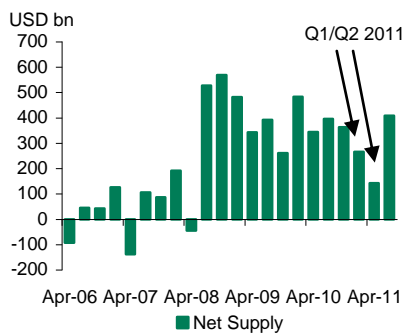
There is little question that the US economic growth pace has faltered – not by a lot – but enough to cause a large downward swing in yields. Two factors explain the large swing, namely the supply-demand dynamic and the lack of tools left to US officials to fight another recession. Without a credible policy response, markets can swing from discounting a reasonable recovery to oblivion very quickly.

Core CPI and 10Y UST yield



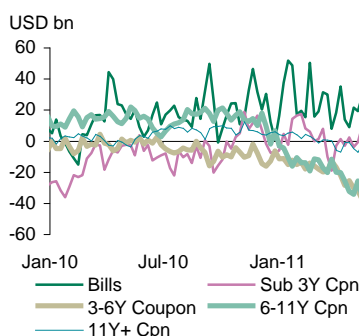
Source: Bloomberg

US quarterly net funding



Source: Bloomberg

US primary dealer positions



Source: Federal Reserve

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Flipping between oblivion and nirvana

A couple of months ago, we were feeling quite content in our forecast for higher yields but, suddenly, US economic data softened. Let us not overplay it, the softening has not been substantial but it is understandable – gasoline prices, weather, flooding and tsunamis. As economists, we are holding our breath to see whether the slowdown turns into something more meaningful, but fixed income markets appear to have largely made up their minds – the worst is coming.

We think that **energy prices were a major cause of the recent soft patch**. WTI climbed from the USD85-90/bbl range in February to peak at around USD114/bbl by late April. The price has retraced quite a lot of the move and we expect a further drop to the mid-80s in Q3/11 that should provide a good kick to growth. Add in the reversal of the supply chain disruptions and other one-off effects and the Q3 outlook seems solid.

In the meantime, **10Y rates are looking stretched**. The core inflation rate gives one of the more basic measures of fixed income valuation. Only once in the past quarter of a century has the 10Y yield been significantly less than 150bp over the core CPI, and this was in the depths of the credit crunch at the end of 2008. Given the immense supply that the Treasury market is soon going to have to absorb without Fed help, we could easily conclude that **10Y Treasury yields should be offering a yield far greater than 150bp over the core inflation rate**.

Indeed, we do conclude that Treasury yields should offer far more yield over core CPI. In the first half of 2011, the Fed will have bought around USD600bn (USD480bn QE2 plus agency reinvestment) of Treasuries, whereas the increase in net Treasury supply will have been a lower-than-expected USD400bn – implying a negative net supply in H1.

The **negative net supply in H111 completely reverses in H2**. To give numbers in Q3, we see positive net supply of USD360bn after taking into account Fed buying. If the economy is climbing out of its soft patch, the combination could quickly reverse the recent 70bp decline in 10Y yields.

What if the economic soft patch is more substantial? The answer to this question is one reason why bond yields have dropped so far, so fast. Imagine that the economy requires that little extra push, where does it come from? There is no obvious benefit from extra quantitative easing, and additional fiscal stimulus cannot be substantial. Thus, **the market is aware that the Fed and Treasury are virtually 'all-in' – to steal a poker analogy**.

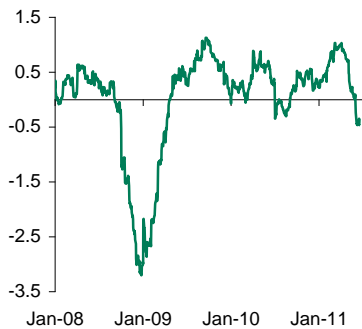
As a result, there is a high probability that, **once the economy begins to weaken, it will spiral downwards**. For this reason, **bond yields are very sensitive to even small changes in the growth dynamic**.

There is one area that may slow the rise in yield that we expect and this is the positioning in the primary dealers. Combining the 3-6Y and 6-11Y coupon positions, there are around USD80bn of shorts. This is equivalent to three weeks' total Treasury supply, so the position is not irrelevant but nor is it likely to be fully covered instantly. We do not see this as standing in the way of a **reasonably large yield rise to around 4% by year-end**.

Eurozone Interest Rates: Bund yields too low after ‘perfect storm’

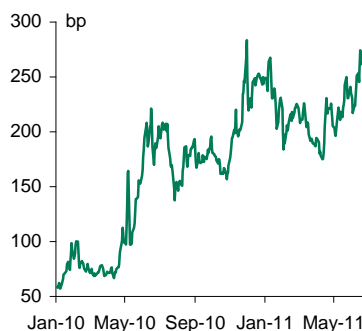
A combination of slowing growth and endless sovereign debt angst has pushed core EGB yields well below their April highs. Unless the H1 economic softness turns into a full-blown double-dip recession, the process of policy rate normalisation will continue, pushing the whole term structure higher. The sovereign crisis remains difficult to read but, outside of Greece, fundamentals are improving.

Economic surprise index



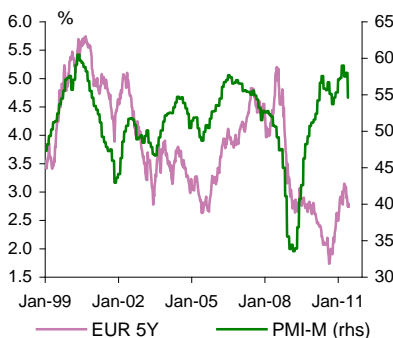
Source: Bloomberg, Crédit Agricole CIB.

Spain-Germany 10Y yield spread



Source: Bloomberg

5Y yields vs PMI-M



Source: Eurostat, Bloomberg

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From their mid-April peaks, European yields have fallen substantially, about 70bp in 5Y and 60bp in 10Y. That substantial **correction erases roughly 40% of the rise in market rates since the end of August 2010**. Such a sharp move generates momentum flows of its own (trend chasers, concession trades). The most important factor behind the bond market rally has been the **string of downward surprises in output data**, while stubborn inflation has been glibly dismissed as an artefact of a spike in oil prices. The global manufacturing PMI fell from 57.0 to 52.9 in the space of four months and, in response, commodities are roughly 11% off their highs and global stocks 7-8% below their highs.

The poor performance of ‘risk’ assets has been partly attributed to economic conditions and partly to the **never-ending litany of bad news regarding the EMU sovereign crisis**. The latest instalment largely stems from the lack of resolution in the Greek situation, where it is obvious that more loans and forbearance from Greece’s EMU partners are needed but where the leading participants are locked in a struggle over the details of private-sector ‘burden-sharing’. The policy impasse has fostered the **re-emergence of clear contagion effects**, with all the ‘periphery’ spreads under pressure, including in the liquid periphery countries of Spain and Italy. BTP- and Bono-Bund 10Y spreads are rapidly approaching the levels set last December.

With recent comments about the Eurogroup-Ecofin meeting in late June possibly failing to agree on a second Greek bailout, the sovereign crisis seems particularly difficult to relate to market timing. Whatever Greece’s ultimate fate, however, we reiterate that **budget progress in Italy, Spain and Portugal is clearly established**, notwithstanding political risk in all of those countries. At regular intervals, the market thinking has been that intra-issuer contagion is inescapable, but this is not necessarily the case (for instance, recall the periphery spread divergence in Q1 of this year). All things considered, however, whether the sovereign debt crisis continues to underpin lower core yields in the coming quarter, or not, remains an open question.

Macroeconomic and policy fundamentals, on the other hand, are rather less unpredictable. While the PMI and other leading indicators have decelerated sharply, output growth across most sectors and in most EMU participants remains positive, corporate profits are solid and productivity growth is also supportive of ongoing output recovery. The supply-side disturbances stemming from Japan and the Middle East are temporary in nature and do not seem capable of derailing that virtuous cycle.

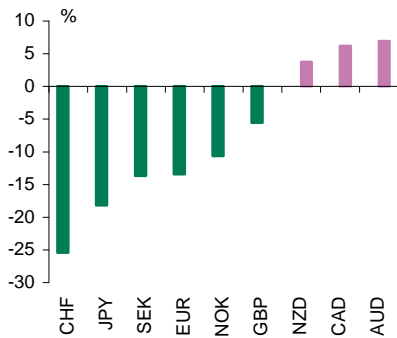
Furthermore, unorthodox monetary policy in a number of countries plus very low (negative) real policy rates in most ‘developed’ currencies suggest that the recent acceleration in inflation cannot be exorcised simply through sideways oil prices. In such a macroeconomic context, **nominal GDP growth**, which should drive bond yields in the medium term, **is going to remain in the 2.5-5.0% range** in large developed economies. In turn, **that is not consistent with current yield levels**, like the 5Y OBL trading around 2.1%. For all those reasons, we retain forecasts that imply significant rises in the term structure of interest rates.

Such an environment is typically consistent with curve flattening. That said, the reduction in term premium over the rally has been substantial, with the back forwards falling by the same order of magnitude as shorter-term rates. Given that uncertainty about interest rates (for instance, as priced by implied volatility levels) remains high, we think that whatever flattening might occur would be at or below the level consistent with a bearish market environment.

Exchange Rates: EUR overly strong

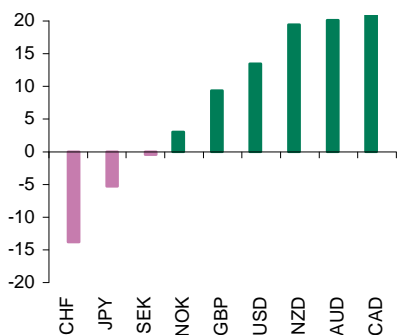
The USD has maintained its weaker tone over recent months undermined by growth worries and lower US bond yields. We do not expect such concerns to persist and continue to look for a USD recovery over H2, especially as the EUR finally succumbs to a build-up of pressures. Once again, we favour commodity currencies to outperform over 12 months.

Commodity currencies to outperform versus USD over 12M



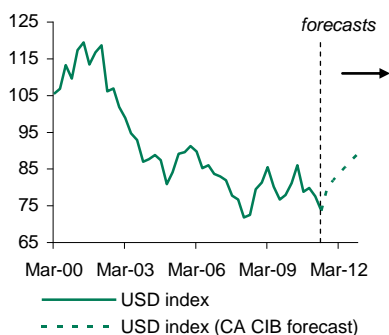
Source: Bloomberg, Crédit Agricole CIB

EUR to lose ground against most major currencies over 12M



Source: Bloomberg, Crédit Agricole CIB

USD index under pressure but a rebound is on the cards



Source: Bloomberg, Crédit Agricole CIB

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USD weakness – the trend in FX markets since the start of the year – remains firmly in place. Global growth worries as well as Eurozone peripheral debt issues are having an impact on FX market dynamics. On the one hand the USD ought to garner support and the EUR should suffer from Europe's problems, but on the other safe-haven demand and growth concerns are keeping US bond yields at very low levels. Overall, **risk aversion and yield attraction are once again fighting to gain dominance in driving currencies.**

It appears that the USD is finding it hard to shake off its funding currency status given the fact that US monetary policy remains ultra-loose even with the Fed completing QE2. Moreover, **recent weakness in US economic data releases has fuelled expectations that the Federal Reserve will take its time in reducing its balance sheet** once QE2 is completed, with some even discussing the potential for QE3. Unfortunately for the USD, relatively low US bond yields generally undermine the currency.

Our stance on the USD is ultimately contingent on Fed policy. The end of QE2 could have significant implications for the USD and many other currencies. It seems unlikely that the Fed will hike policy rates this year but, assuming that current growth concerns dissipate, even a shift in Fed language and a proactive stance in terms of balance sheet reduction could be sufficient to provide the USD with fuel for a more sustained bounce-back, especially as it will likely be associated with higher US bond yields.

The EUR, meanwhile, continues to show impressive resistance despite concerns about peripheral Europe. **A factor helping to support this resilience is the ongoing demand from Asian official investors.** There is also a sense that the FX market is simply becoming fatigued or even complacent about Eurozone peripheral problems. Eventually, these problems will come back to haunt the EUR and we suspect that the currency will be vulnerable to Eurozone tensions for months to come, eventually succumbing to downside pressure.

Similarly, the JPY looks overly strong against the USD at present. Despite fiscal worries, **Japanese bond yields are unlikely to rise quickly and a widening yield differential between the US and Japan will eventually play for a sharply higher USD/JPY.** The other major underperformer in our forecast grid is the CHF. This currency has surprisingly been the strongest performer this year amongst major currencies, having appreciated close to 10% versus the USD. We expect the CHF's performance to reverse course during the rest of the year assuming some normalisation in risk appetite and relatively low Swiss rates.

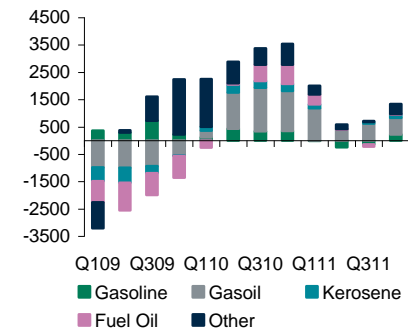
GBP is one currency where even hawkish central bank expectations may not have such a positive impact on the currency, especially given recent weakness in activity data. **The dichotomy between growth and inflation has left GBP vulnerable to a resurgent USD,** especially as expectations of BoE rate hikes have been pared back. Its fortunes against the EUR look rather different, however, and we expect GBP to take advantage of a generally weaker EUR over the coming months, with the currency expected to reverse its recent losses.

The best performers in our forecast grid are the commodity currencies: AUD, CAD and NZD. Admittedly, we do not expect the gains in these currencies to be anywhere near as rapid as over past months, but relatively high commodity prices, yield attraction, relatively positive growth prospects and increased demand from Asian official investors should limit the downside risks even in an environment of a strengthening USD. In contrast, one commodity currency that will do much less well is the NOK – likely to be undermined by lower oil prices. Alongside the SEK the NOK is set to weaken versus USD over the coming months, but will remain resilient versus EUR.

Energy: Will high oil prices be their own cure?

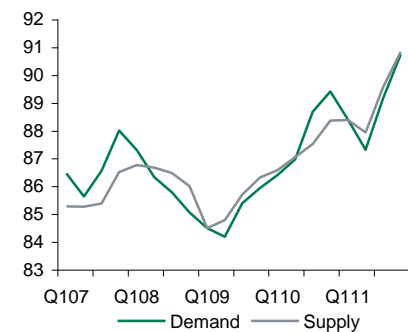
WTI prices appear anchored at around USD95/bl, while Dtd Brent remains close to USD115/bl. Uncertainty regarding supply/demand conditions has kept prices glued to very high levels. We think that oil prices will correct downwards in the coming weeks.

YoY Oil demand growth (kbd)



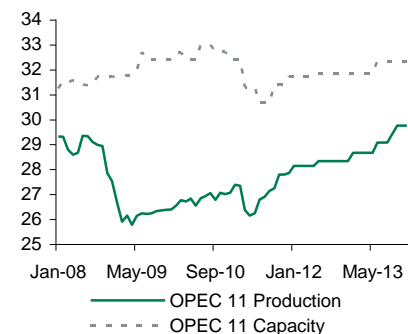
Source: Crédit Agricole CIB

World supply/demand (Mbd)



Source: Crédit Agricole CIB

OPEC production & capacity (Mbd)



Source: Crédit Agricole CIB

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On the demand side, all recent data points towards a weakening in oil demand in recent weeks.

Most economic indicators released have surprised on the downside. In Asia, government policies to fight inflation in fast-growing economies (largely due to oil and food prices close to record-high levels) are starting to cool down economic growth. In China, manufacturing PMI fell to 52 in May, its lowest level in nine months. In India, manufacturing PMI also dipped slightly in May, but the strongest decline was recorded in India's most important sector: services. May service PMI fell to 55.0 from 59.2 in April, its slowest growth in 20 months. South Korea's PMI also dipped to 51.2, its lowest level since November 2010. Other Asian PMIs were also weaker than expected, with the new order component generally reflecting a slowdown in the global economic environment. Indeed, the most worrisome indicators were recorded for developed economies with the ISM US index of manufacturing activity falling from 60.4 in April to 53.5 in May – its lowest since September 2009 – and Markit Eurozone manufacturing PMI for May slowing to 54.6 in May from 58.0 in April. Part of the slowdown is likely to reflect the impact of the Japanese earthquake/tsunami, disrupting the supply chain, and should progressively disappear as Japanese industry comes back on stream. Another part of it, however, is due to the weakening of demand addressed to industries. Higher interest rates and central bankers tightening credit conditions in Asia, as well as the removal of fiscal policy supports in Europe, are taking their toll on economic activity. Private demand is not taking over, as oil and food prices at record-high levels are significantly reducing households' discretionary incomes. Together with the direct impact of high oil prices, the slowdown in economic activity is having a strong impact on oil demand – as has started to show in recent oil statistics.

On the supply side, OPEC surprised the market at its last meeting (8 June) by not reaching an agreement regarding production targets.

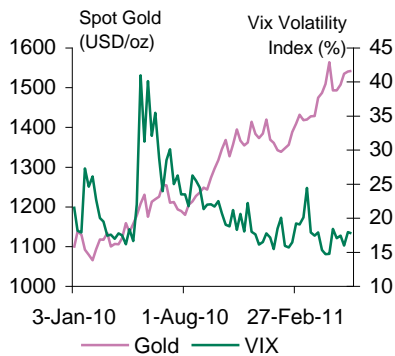
Non-agreement, however, means that previous quotas are suspended and that members can feel free to produce whatever they want. Saudi Arabia has already offered more crude oil to its Asian customers and announced a very significant increase in its oil output in June and July. Kuwait also raised production in June. This should not come as too much of a surprise, as the organisation's production was already at close to 1.5Mbd above quotas and the call on OPEC is expected to rise in H211. Saudi Arabia, whose oil policy is to meet client needs, is likely to make available significantly more oil when refiners increase runs after the maintenance season. In addition, OPEC appears to be under strong pressure from the IEA to increase production in the second half of the year. In the editorial of May's OMR report, the IEA considered (quite rightly, we think) that "[unchanged OPEC production is] unlikely to result in the market stability both producers and consumers profess to seek". Saudi Arabia is well aware of the dangers of having Brent prices above USD110/bl, and appears to be willing to increase supply significantly to reassure oil markets.

With slowing demand and more supply from OPEC we expect prices to go down in the coming weeks. Recent economic indicators appear to confirm the pernicious impact of high oil and food prices on economic growth. The longer it takes for prices to correct, the larger the correction will be.

Metals: Gold closer to the top; aluminium more resilient

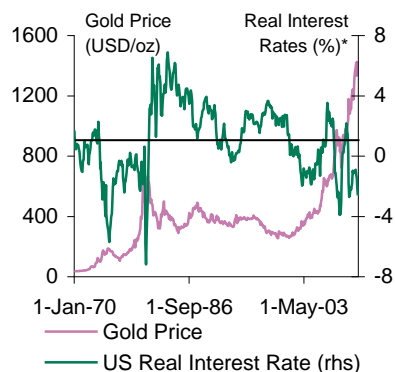
Having increased substantially since the great financial crisis of 2007-08, gold is closer to the top and facing a number of headwinds, but investors still view it as an alternative, if not the ultimate, currency and a hedge against systemic financial risk. Aluminium should remain the most resilient amid global growth concerns as cost-push factors are supportive.

Risk aversion supports gold



Source: Reuters, Crédit Agricole CIB

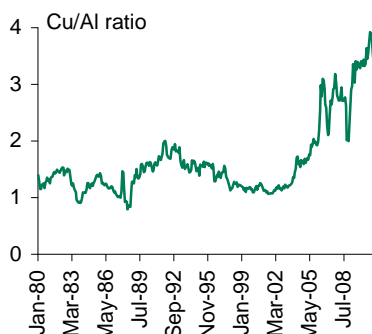
Real interest rates are the key to gold



* Real interest rates are calculated using the US 3M T-bill yield minus US CPI YoY

Source: US Federal Reserve, US Bureau of Labor Statistics, Reuters, Crédit Agricole CIB

Copper/aluminium ratio



Source: Reuters, Crédit Agricole CIB

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Gold: Still bullish, but closer to the top

We believe gold should continue to derive support amid renewed concerns about global growth, as well as Eurozone peripheral debt issues, the deflation/inflation debate and the debasement of fiat currencies. Gold's safe-haven bid seems solid for the time being as investors see it as an alternative, if not the ultimate, currency and a hedge against systemic financial risk. But it has already risen substantially; more than five-fold from USD290/oz at the start of 2000 and 30% in 2010 alone. The rise accelerated during the great financial crisis of 2007-08 as investors feared 'financial Armageddon' and, as a consequence, balance sheet expansion by central banks, especially the Fed. What will happen to gold as balance sheets are reduced and there is no QE3 by the Fed? With 'financial Armageddon' averted and central bank liquidity being withdrawn, albeit very gradually, gold is likely to face headwinds. Another headwind is an expected resurgence in the USD. It seems unlikely the Fed will hike policy rates this year but, assuming current growth concerns dissipate, even a shift in Fed language and a proactive stance in terms of balance sheet reduction could be sufficient to provide the USD with fuel for a more sustained bounce-back, especially as it will likely be associated with higher USD bond yields. Overall though, US real interest rates remain negative and supportive of gold for the time being.

Technically, gold looks to be getting close to the top, which is put at USD1,629 based on Elliot Wave patterns, prior to returning to a floor between USD1,200 and USD1,300.

Base metals: Look for aluminium's resilience in the face of global growth concerns

Aluminium registered global consumption last year in excess of 20%, a marked turnaround from the 8% fall seen in 2008 and the best YoY growth in 30 years. For 2011, global consumption growth should be slower at around 10-11% in the absence of restocking (of a depleted manufacturing supply chain) that was a noteworthy feature of the year before. Nevertheless, this still represents a robust growth rate driven by the transportation (light weighting) and packaging sectors. Furthermore, since the 1970s, the copper price has traded at 1.5-2.0x that of aluminium – it is currently 3.8x as expensive. Aluminium bull factors also include:

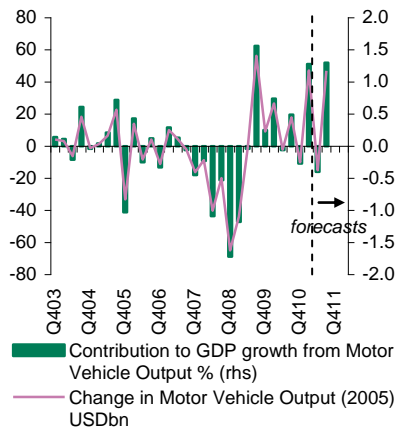
- **Aluminium's competitive price advantage** to that of copper is likely to see inroads being made in the substitution of copper in key sectors.
- The launch of **physically-backed aluminium ETFs**, which could help erode the market of excess supply.
- **Exchange inventories** are no longer building and are falling steadily since peaking in mid-January 2010. Furthermore, at least 70% of LME stocks are tied up in **long-term warehouse financing deals** and are not available to the market.
- **Aluminium is an energy-intensive metal to produce** – power accounts for 30-40% of production costs and prices should be underpinned by elevated crude oil prices. In addition, other input costs such as alumina and coke are also rising.
- The potential **closure of high-cost smelter capacity** in Europe due to onerous power costs, and government-enforced power curbs in China that could result in production cuts/closures amounting to 20% of the total. China accounts for 40% of global capacity and dominates the top half of the industry cost curve.

Global growth concerns could continue to undermine base metals over the short term, but aluminium should prove more resilient given the factors noted above, with the downside seen as more limited. We remain confident about the medium- to long-term fundamentals given still-robust developing-world growth and recommend using any weakness as entry points for initiating new longs.

US: Pick-up in second-half growth

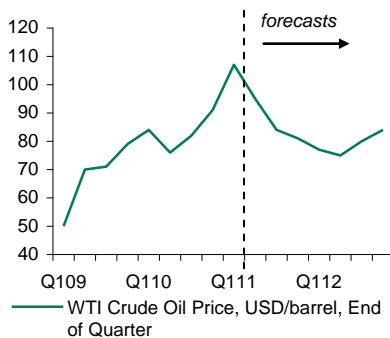
Recent economic figures suggest growth at close to a 2.0% rate in Q2, following a 1.9% pace in Q1. We expect GDP growth to strengthen to about 3% in the second half of the year, aided by a sharp upturn in motor vehicle production and diminished drag from lower energy prices.

Auto production to lift growth



Source: BEA, Macro Economic Advisors

Oil price drop to boost consumer real purchasing power



Source: Dept of Energy, Crédit Agricole CIB

Economic recoveries following financial market crises generally tend to be weaker and take longer to solidify. The US economic recovery weakened in the first half of 2011 with growth averaging around 2% down from 2.9% in the second half of 2010. **Is the current 'soft patch' a temporary lull or does it signal an extended period of sub-par growth?**

We look for real GDP growth to strengthen to about a 3% pace in the second half of 2011. We believe that the rise in global energy prices was an important factor behind the slowdown. This was evident in the deceleration of consumer spending from a 4% pace in the final quarter of 2010 to a 2.2% pace in the first quarter of this year, and we expect further slowing in the second quarter of 2011. To put the impact in perspective, we estimate that the stimulus to growth from the fiscal package (payroll tax cuts and extended unemployment benefits) voted late last year was almost completely offset by the higher energy prices paid by consumers. However, as explained in the *Energy* section of this report, the supply/demand balance for crude is expected to lead to a significant decline in prices later this year with WTI crude oil forecast at USD81/bl by year-end 2011. **The drop in energy prices we project is critical to our forecast as its impact will be similar to a tax cut for consumers, boosting spending.**

Consumers have seen household incomes rise, helped by this year's improved job market conditions and last year's payroll tax cut. Increases in household wealth and past deleveraging efforts have also raised consumers' ability to spend. However, those gains still face significant headwinds from a high level of unemployment and continued soft housing markets.

Strong corporate profits are generally a good indicator of future employment gains, especially as labour remains competitive as indicated by low unit-labour costs. We believe that the employment market will continue to make gains during the balance of the year, lowering the unemployment rate slowly while boosting income growth. However, progress may be choppy as uncertainty over the outlook has increased and firms remain cautious about staffing decisions. The existing level of slack in the labour markets will continue to keep wage pressures relaxed

We see no recovery in housing before 2012. We assume that housing prices will decline another 5% in 2011 but stabilise in 2012. Despite very weak new residential construction, the housing sector continues to suffer from an excess supply of homes for sale, due to ongoing foreclosures. That keeps downward pressure on home prices, which reduces household net worth and consumer spending.

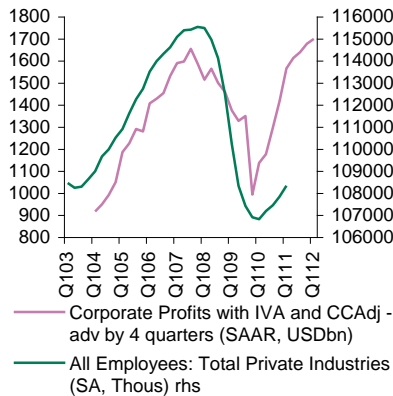
Consumer spending and household net worth are also affected by the equity market's performance. Stocks performed well during the first four months of this year but the market has weakened more recently. The gains likely reflected both strong profit fundamentals and the impact of the Fed's quantitative easing programme, which kept rates very low in order to push investors into more risky asset classes. We assume in our forecast that broad equity market measures end the year with a gain of 6-8%.

Economic growth in the first half of 2011 was also reduced by automotive supply-chain disruptions, due to the catastrophic events in Japan. The Q3 automotive production schedules announced by Detroit suggest an auto assembly rate near 9.6 million units, up from 8.1 million in Q2. **The pick-up in Q3 motor vehicle production could boost growth by more than 1ppt in Q3 after having trimmed an estimated 0.4ppt from Q2 output growth.**

Business capital spending on equipment and software is expected to continue at a healthy pace, reflecting an improving sales outlook and the need to continually increase productivity through the more efficient technologies

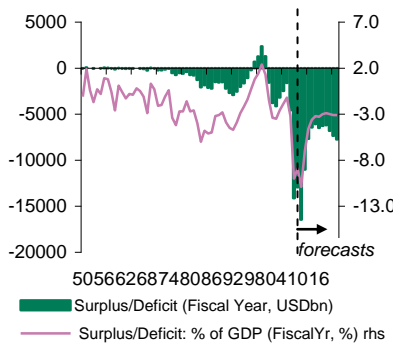
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Profitable firms need to hire



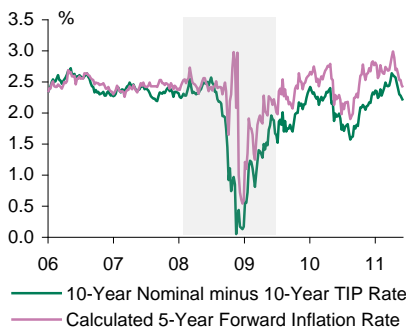
Source: BEA, BLS/Haver

The deficit is not sustainable



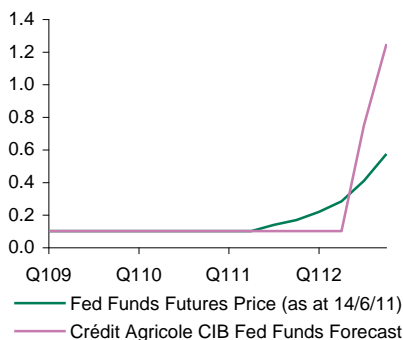
Source: OMB

Inflation expectations anchored



Source: CBO

Cautious rate normalisation



Source: Bloomberg, Crédit Agricole CIB

embedded in newer capital. The financing of such investment has been supported by today's historically low interest rates, strong corporate balance sheets and an increased willingness by banks to make commercial and industrial loans.

The fiscal stimulus package (extending the Bush tax cuts, cutting payroll taxes and extending unemployment insurance) has been a support to the recovery this year but the budget stimulus turns to fiscal drag in 2012 with higher payroll taxes and spending cuts at various levels of government. In our view, **the US federal budget deficit is a long-term problem and credible remedies that would put the medium-term deficit trajectory on a sustainable path need to be adopted now.** A targeted decline in the deficit/GDP ratio, enforced by mandatory changes in spending programmes (discretionary and entitlement) and tax revenues, would be a promising step. However, excessive near-term fiscal restraint, when the recovery remains fragile, could be self-defeating if the economy were to stall. This is a risk to our outlook that we will monitor closely. The budget deal that is struck in conjunction with an increase in the Treasury's debt ceiling limit this summer will help us gauge the fiscal impact on growth in fiscal year 2012.

The Federal Reserve will keep monetary policy accommodative until it is sure that the recovery is established and employment is on a clear improving trend. It can afford to be cautious in hiking rates as long-term inflation expectations appear to be pretty well anchored.

The FOMC large-scale asset purchase plan (QE2) is drawing to a close and the Fed is disinclined to consider additional QE programmes as the trade-off becomes less attractive between the potential inflationary impact and employment creation. However, we expect the FOMC to continue to reinvest the proceeds of its portfolio into Treasuries for most of the balance of 2011.

At some point, early in the exit process, the FOMC will stop reinvesting principal payments from its security holdings, thus passively shrinking the Fed's balance sheet. This would be a modest policy tightening and it would be the first of many steps in pursuit of a normalisation of interest rates. Those steps include changing the "extended period" language in the FOMC statement, followed by draining operations via reverse repos and term deposits at the Fed. The interest rates on excess reserves would eventually be hiked and the Fed funds target thereafter. We believe that this process suggests an unchanged Fed funds rate until Q312. Once the FOMC can assess the impact of rate hikes on the economy and markets, it will likely begin outright sales of securities from its portfolio to bring it back to a normal size.

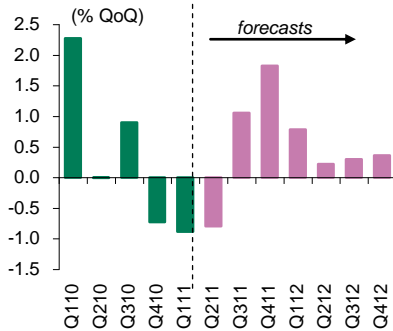
Risks to the forecast

In addition to elevated or rising oil prices and over-zealous near-term fiscal restraint, we see two potential risks to our outlook scenario. Problems in the peripheral countries of the Eurozone could lead to a financial market crisis in Europe that would no doubt spread. A relapse in the US housing market would delay the recovery process, as more households would come under pressure as their mortgages slipped deeper and deeper underwater.

Japan: Divided into two halves

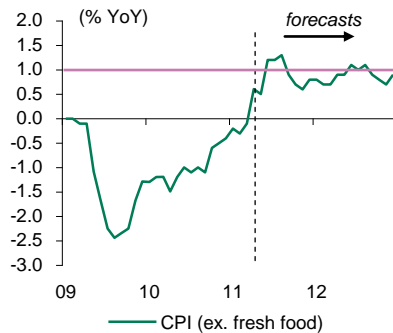
Given the disaster in March, the Japanese economy started off with very weak growth of -0.9% QoQ in Jan-Mar and, with sharply deteriorated consumer sentiment, we expect another contraction in the Apr-Jun quarter. However, as reconstruction demand emerges, the economy will show a V-shaped recovery into H211.

Real GDP projection



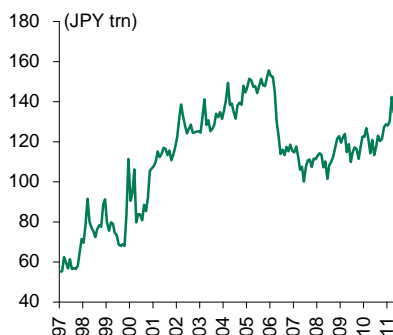
Source: Cabinet Office, Crédit Agricole CIB

Core CPI projection



Source: Ministry of Internal Affairs and Communications, Crédit Agricole CIB

BOJ's balance sheet size



Source: Crédit Agricole CIB

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Given that economic activities completely collapsed following the disaster on 11 March, the **Japanese economy has started off with a sharp contraction, with real GDP growth down 0.9% QoQ in Jan-Mar**. Still, a detailed look at the demand components shows the collapse in March was offset by the recovery up to February, and the contraction in major components looked rather limited with private consumption being down -0.6% QoQ, capex down -1.3% QoQ, and exports up +0.7% QoQ. The largest part of the contraction was a decline in inventory, which lowered real GDP growth by -0.4ppt.

The breakdown as above likely means that there will be another contraction in the Apr-Jun quarter. On the consumption front, while the recent consumer confidence survey suggests that the extreme pessimism that prevailed right after the earthquake is easing, the level of confidence is still not much different from where it stood right after the disaster. In addition, the deteriorated consumer confidence will be exacerbated by worsening income conditions, as shown by a decline in overtime worked hours, and thus private consumption will continue to be a major negative contributor. Coupled with a contraction in capex and exports, **we expect that real GDP will be down 0.8% QoQ in Apr-Jun**.

Looking ahead, though, **we expect that the economy will achieve a V-shaped recovery thereafter**. One of the first signs of green shoots is that industrial production is to show a robust recovery, as suggested by producers' projections into the months ahead. While we still suspect that actual production might not be as strong, those numbers at least suggest that the recovery process is coming in both earlier and stronger than initially envisaged. This will contribute to both the recovery in income conditions and the improvement in consumer confidence, and thus private consumption will become a positive contributor from the Jul-Sep quarter as consumers try to recover the level of consumption.

Furthermore, **the process of economic recovery will be supported by the disaster rescue packages** that are expected to be proposed by the government. Japanese politics avoided a worst-case scenario of calling a general election, which could have delayed the timing of proposing economic packages, by voting down the motion of no confidence against the prime minister. Thus, we continue to expect that there will be a series of disaster-rescue packages proposed by the government in coming months, and those packages will help to recover lost social capital in the form of significantly increased public investment. Coupled with capex among private firms to replace lost and damaged production equipment, gross fixed capital formation will be another factor that will lead the recovery process.

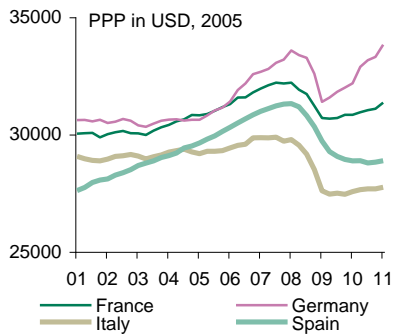
On the price front, recent changes in the core CPI inflation rate have been in line with our view that supply-side problems caused by the disaster would be inflationary, as seen by the sharp rise in food components. With the main inflation measure standing at +0.6% YoY as at April, **we maintain our view that the combination of bottleneck-type inflationary pressures and the lagged impact of energy prices on utility charges will result in the core CPI inflation rate going higher than the +1% threshold needed for the BOJ's exit from the "comprehensive monetary easing"**.

However, **we also maintain our view that the present surge in the inflation rate is not the type of inflationary pressure to which the BOJ would respond with monetary tightening, and the BOJ would prefer to take some time to confirm that the economic recovery is on track**. Rather than envisaging an exit from the comprehensive monetary easing, we still expect that there will be rising pressure on the BOJ to increase the outright purchase of JGBs as the government needs to finance the disaster-rescue packages through increased issuance of government debt.

Eurozone: Abnormal normalisation

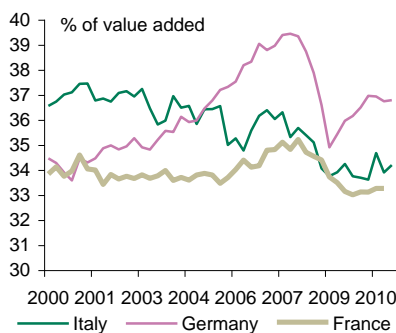
Renewed Eurozone activity is driven by a pick-up in domestic demand. This normalisation of the growth process will be curbed by the continuing quest to make up for lost profitability and by a less accommodative policy mix. But the ECB's yearning for normalisation is nevertheless facing a recovery offering some unusual features, to say the least.

EMU: per capita GDP



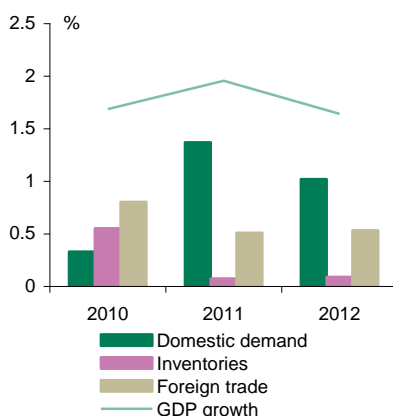
Source: Datastream, Cr dit Agricole SA

Corporate mark-up



Source: DESTATIS, INSEE, ISTAT, Cr dit Agricole SA

Contributions to EMU GDP growth



Source: Eurostat, Cr dit Agricole SA

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Hobbled strength

The strength of the upturn in Eurozone activity in Q111 (+0.8% QoQ), which took most observers by surprise, is all the more surprising as the US economy was posting more disappointing growth than expected, at 0.5% QoQ. The surprise is all the stronger because the consensus forecast was for growth fuelled by the global economy. Yet external demand is lifeless, as shown by the zero contribution from foreign trade to growth, which is, in fact, common to both sides of the Atlantic. **So, it is the strength of domestic demand, which has been growing steadily for the past year, that alone accounts for the rebound in Eurozone GDP.**

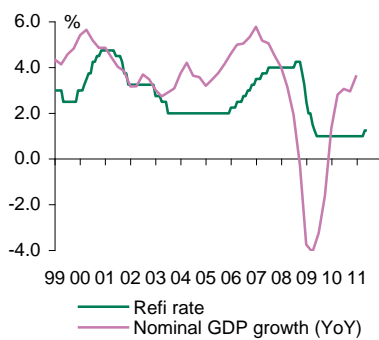
Yet household consumption continues to grow at a snail's pace (+0.3% QoQ), underpinned by the fall in the savings ratio in a high unemployment environment (9.9% in Q111) and eroding purchasing power due to higher inflation, at 2.5% in Q111. **Fiscal austerity, however**, which is already a reality in the countries on the area's periphery, and which was forecast for the more central economies, **is not yet visible in national accounts.** Public consumption rose by 0.8%, postponing until later in the year the adjustments to which Eurozone member states mutually committed in their most recent Stability programmes.

The recovery in investment (up 2.1% QoQ) alone explains half of the growth figure. But that increase on its own is not enough to lift the investment ratio out of the cyclical trough where it has been stuck for the past year, following the massive downward adjustment (-2.8 points of GDP) seen in 2008 and 2009. The rebound in private non-residential investment is a logical response to an upturn in the capacity utilisation rate, again running at trend levels. It is also being driven by moves to rebuild margins and self-financing ratios by non-financial companies, which are at a more advanced stage in Germany than in other large Eurozone countries. **The catch-up in investment in the construction sector following the dip during the winter months has also contributed significantly to the resumption of capital accumulation.** The outstanding 2.9% increase in added value in the construction industry is a reflection of this, but it has already exhausted its potential for boosting activity. The gradual flagging of public investment, notably in Germany, together with the ongoing adjustments in housing and private sector construction, will limit the impetus of recovery.

In view of the ongoing slowdown in global demand, the continued expansion in capital investment can only be driven by the strength of domestic demand, but this itself already seems subject to several limitations: conditions for corporate profitability seem to have been restored only partially, and **the necessary increase in the self-financing ratio will call for further increases in savings while simultaneously ruling out**, except in the case of Germany, **any significant increase in the investment ratio.** The recovery in the productivity cycle looks set to continue, but at a slower pace, as country rankings have not been disrupted. Germany's lead could be curtailed somewhat due to more dynamic job creation and a slowing contribution to growth by a public sector which again contributed to bolstering activity in early 2011, notably via public investment programmes. **The limited potential for improving margins will not be enough to lift employment and wages at the same time: while we expect to see a gradual decline in the unemployment rate from the end of 2011, wages are unlikely to rise very much.** The lagged effects of the oil shock will combine with the inevitable fiscal tightening and a less accommodative monetary environment. Private consumption therefore looks like being sluggish, and will again have to rely on a squeeze on savings.

With survey indicators all pointing to a slowdown in activity, there are very few

EMU: what is a 'normal' level for key rates?



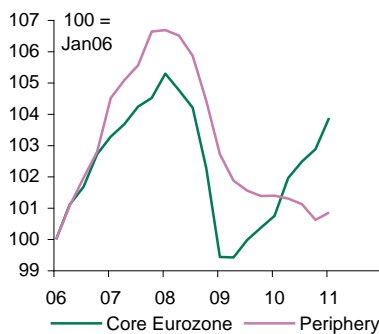
Source: ECB, Eurostat, Credit Agricole CIB

signals allowing any hope of the sort of growth that will rapidly close the output gap widened by the crisis. **Yet, with a forecast 2% growth rate in 2011, the Eurozone looks quite good, but this masks a dip in Q2 and Q3 after the strong start to the year. The forecast pick-up in activity in the second part of next year – at a rate slightly above potential in most of the area’s central economies – is unlikely to be sufficient to bring Eurozone per-capita GDP back to the level of Q108.**

Monetary policy torn between diversity and uncertainty

At first sight, the ECB has entered a ‘normalisation’ cycle of its monetary stance. The first 25bp rate hike in April should be followed, in our central projection, by regular increases every three months taking the ECB’s main refinancing rate to 2.50% by July 2012 (this profile is unchanged since our last *Economics Quarterly*). **In practice, however, this process is ‘normal’ in name only**, so numerous are the differences from a conventional monetary normalisation process. Even the definition of normalisation is a variable geometry among ECB members.

Eurozone real GDP divergence

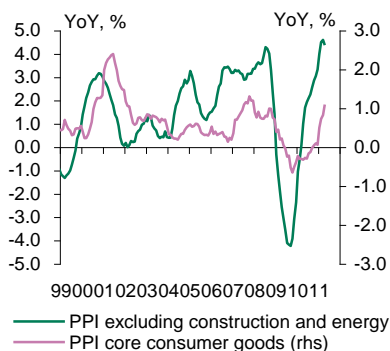


Source: Eurostat, Credit Agricole CIB

Above and beyond the crisis in the public finances and the unprecedented responses provided, willy-nilly, by the ECB, the characteristics of the ongoing economic recovery are equally unprecedented. **Widely varying economic performance between countries is a first obvious obstacle to an ordered normalisation of a single monetary policy in a sub-optimal currency area.** From this angle, most indicators are signalling a stabilisation of intra-zone differences (GDP, unemployment, current accounts), but no reversal of the past trend, even if Spain and Ireland stand out from the group of fringe countries.

Another noteworthy feature of the current tightening cycle concerns the monetary ‘pillar’ and its analysis by the ECB. Annual growth in the M3 broad money aggregate, running at 2% in April, was well below the levels observed in 2005, when it was around 8%, before the first rate hike was delivered in December. If, as we believe, credit supply and demand gradually return to normal, with liquidity bias dissipating and M3 growth exceeding the ECB target in early 2012, at 4.5%, the central bank could find a further justification for future rate hikes.

Pipeline price pressures



Source: Eurostat, Credit Agricole CIB

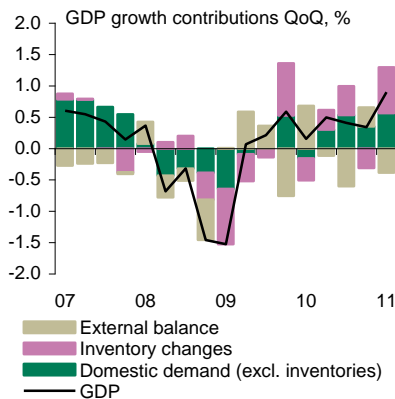
Generally speaking, the downside risks weighing on our macroeconomic projection make the monetary tightening timetable more uncertain. We have left our forecasts for two rate increases in July and October 2011 unchanged, but we cannot completely rule out a pause in early 2012 if tensions in the peripheral countries were to persist, especially as inflation should again converge on its 2% target (or close to it) during the first half of 2012. At the same time, there is no lack of justification for a gradual rise in the ECB’s key Refi rate that is more in line with the economic fundamentals. **This is because one last key difference with previous tightening cycles is the exceptionally low level of key rates** (1.25% nominal, and -1.50% in real terms). ECB staff forecasts, however cautious for early 2012, suggest a “neutral” key rate of 3.00-3.50%. Although these levels are unlikely to be reached before 2013, or even further down the road, **the ECB’s desire to return gradually to a form of normality should not, in our view, be underestimated.**

The normalisation process also concerns non-conventional monetary policy measures, even if, in the meantime, the ECB’s ‘separation principle’ enables it to ensure the stability of the financial sector. The Securities Market Programme (SMP) to purchase sovereign bonds is a dead letter, but has not been officially ended. The unlimited supply of liquidity for banks, offering maturities ranging from one week to three months, has been extended until October 2011 at least. While several members of the Governing Council still intend to return to competitive tenders offering a limited quantity of liquidity, at least for long-term transactions, to do this the banking sector will need to emerge strengthened from the next stress-testing exercise, whose results are due to be published during the summer. **From this angle too, we are still a long way from what might be termed a ‘normal’ situation.**

France: Distinguishing the wood from the trees

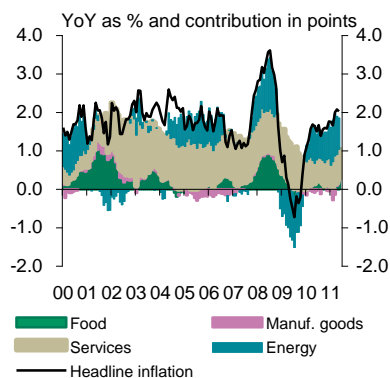
French growth is very unlikely to repeat its Q1 growth performance of 0.9% QoQ. A soft landing for economic activity is foreseeable in the short term. Beyond that, growth should become more self-sustaining, notably due to an improvement in firms' balance sheets and a more marked recovery in employment. Our scenario projects a 2.1% increase in activity in 2011 and 1.8% growth in 2012.

France: good start for French growth in 2011



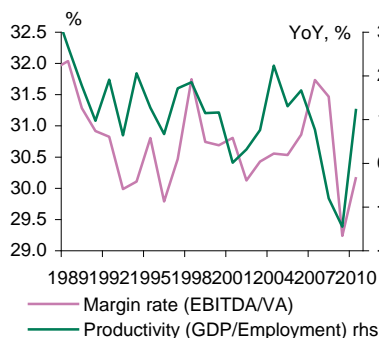
Source: Insee, Crédit Agricole SA

France: rising inflation, which reduces households' purchasing power



Source: Insee, Crédit Agricole SA

France: rebound in productivity, slight increase in margin rate



Source: Insee, Crédit Agricole SA

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Economic activity bounced back in France in Q1, with a flattering 0.9% QoQ growth rate. The result, although undoubtedly encouraging, is nevertheless the outcome of temporary factors. The car scrappage scheme largely sustained activity in the early part of the year as orders placed in December were delivered. A massive push to rebuild inventories – after the substantial weather-related running down of stocks in Q410 – was also a main driver of growth.

It therefore seems difficult to extrapolate much enthusiasm from the strength of Q1 activity. In fact, confidence surveys published since March point to a flagging economy. In May, the business climate in manufacturing was down slightly (down 2 points, to 107), but from a very high level. Household confidence, for its part, was still running well below its long-term trend, at 83 in June compared with 100.

The deterioration in the economic climate should ultimately result in a fall-off in activity. Household consumption will be impacted not only by the abolition of a number of stimulus measures (notably the car scrappage scheme), but also by renewed inflation (forecast at an annual 2.1% in 2011), and the increased fiscal pressure driven by the higher incomes observed in 2010. In addition, private consumption will continue to be penalised by the very slowly receding unemployment rate (forecast at an annual 9.1% in 2011 in continental France), and, as a result, a continually high personal savings rate. In view of these patchy domestic demand prospects, businesses are likely to remain cautious when it comes to investment and inventories alike, especially as commodity price increases continue to put pressure on their margins. The external growth engine is also likely to slow, with the drop in exports caused by the slowdown in the global economy, as well as home-grown structural problems (eg, relatively uncompetitive offerings, squeezed export margins, sluggish target markets) and the strong EUR.

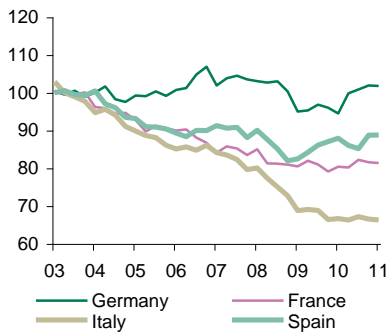
We will have to wait until 2012 before we embark on a more self-sustaining and lasting growth process. Business investment spending should pick up at that point, fuelled by increased use of industrial capacity and a more marked improvement in firms' balance sheets. This will be brought about by: the fall in intermediate costs as a result of the likely correction in commodity prices, the continued rebound in productivity, lower taxes on productive capital as a result of reforms to the business rate (*taxe professionnelle*), and the continuing accommodative nature of ECB monetary policy. Businesses will also need to align their inventory levels with planned production, which implies a slight upward shift to inventory building. With a more marked upturn in employment and slowing inflation, household incomes should improve, helping to sustain private consumption despite the rollout of measures to restructure the public finances (a slowdown in healthcare spending and zero increase in government spending). Conversely, housing investment could fall slightly due to higher house prices and rising mortgage rates. Finally, the expected depreciation in the EUR should help reduce the negative contribution from foreign trade, forecast at -0.1ppt in 2012. Overall, quarterly GDP growth rates should prove more resilient, at around 0.4-0.5% QoQ. This will result in an annual rise in activity of 1.8% in 2012.

This scenario is circumscribed by uncertainties – both downside and upside. Despite a few restocking episodes, business leaders still consider that their inventory levels are not very high, which could result in a more positive contribution to growth than expected from stock variations. Conversely, the continuing uncertainty surrounding the geopolitical and economic environment could fuel a wait-and-see attitude among households and businesses alike, hampering the cycle of self-sustaining recovery.

Germany: Shifts into overdrive

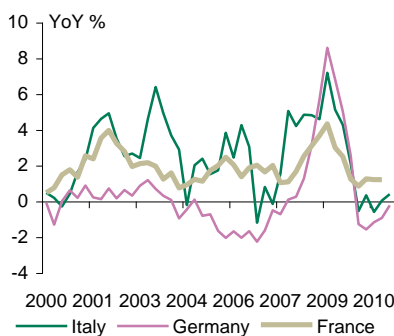
Germany has now put the crisis behind it. But despite an unparalleled performance in Europe, the adjustment still has some way to go in the business sphere. The ongoing improvement in profitability is likely to stave off any overheating on the wages front at the same time as it will allow consumption and private investment alike to firm up.

Export market share, 2003=100



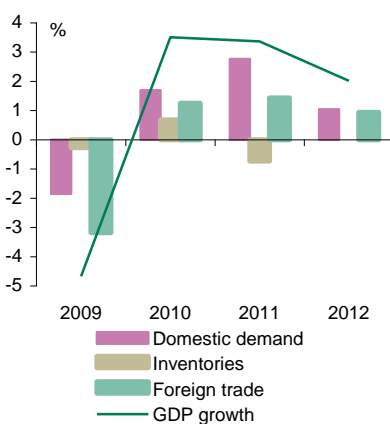
Source: EUROSTAT, Crédit Agricole SA

Germany and major partners : unit labour costs



Source: DESTATIS, INSEE, ISTAT, Crédit Agricole SA

Contributions to GDP growth



Source: Destatis, Crédit Agricole S.A.

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With a Q111 growth rate of 1.5%, unmatched among the industrialised countries, **the German economy** can count on a 2.7% growth overhang for the current year. **It has, therefore, definitively turned its back on the recession**, and GDP has now returned to its pre-crisis level, including by per-capita output. The snapshot presented by the German economy is more flattering than expected in terms of both the intensity of its growth and the strengths driving it. **While the input from trade is strong, with a 0.5% contribution to growth, the contribution of non-inventory domestic demand stands out even more, at 1.4%.** Activity could have been more sustained if demand had not been partially met by continued destocking, leading to a negative, -0.4%, contribution from stocks for the third quarter in a row.

Private spending has firmed up, explaining two-thirds of the dynamism of domestic demand, but the remaining third can also be put down to robust current public spending (up 1.3%) and investment spending (up 6.8%). With the expiry of the recovery plan and, to a lesser extent, the additional consolidation measures voted in the 2011 draft budget, the public component will run out of steam. **Private investment was sustained as much by its productive component (up 4.3%) as by housing (up 6.7%).** The rebound in housing is a logical response following the winter lull in the construction industry. Private capital investment does not seem to have suffered from the end of the accelerated depreciation measure and was stimulated by an increase in the capacity utilisation rate. **The outlook for further sustained growth in investment, including investment aimed at expanding capacity, is intact and should be supported by a return to pre-crisis self-financing ratios for businesses.** This is because, against a backdrop of continuing efforts to restore profitability, the capital investment ratio has recovered only half of the loss sustained since the start of the crisis. We have therefore factored sustained growth in capital investment to return the investment ratio to its 2007 level by the end of our forecasting timeframe.

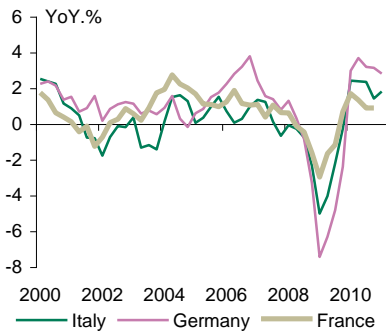
These gains in profitability will be reliant on low increases in unit labour costs, down 0.2% in Q111. Although the productivity cycle will no doubt be constrained by the forecast activity slowdown and accelerating job creation, the pick-up in wages will nevertheless be contained. Ongoing wage-bargaining talks point to an increase in negotiated wages (+2.3% in 2011; +2.2% in 2012) leading to a faster increase in the effective wage (+3.0% in 2011; +2.5% in 2012), which will also be an outcome of the progressive normalisation of working hours. The rise in real disposable income (+0.9% in 2011; +0.5% in 2012) will be hampered by both an increase in compulsory social security contributions and inflation (+2.6% in 2011; +2.1% in 2012). **It is therefore once again by dipping into savings that private consumption will be able, in 2011 and 2012, to show an acceleration relative to its average of the past decade, at +1.4% and +0.8%, respectively.**

A strong export performance (+2.3% in Q111) has helped Germany to regain the market share lost in the collapse of global demand. Although it is demand from fast-growing emerging markets that is allowing Germany to derive the full benefit of strong global demand, no less than 60% of its exports are, nonetheless, taken up by markets in Europe. **Germany will not, therefore, be able to escape the Eurozone growth slowdown built into our forecasts**, and this will be on top of the domestic brake due to the change in fiscal stance. What is more, the May surveys continue to point to a slowdown in activity: the PMI was down for the third consecutive month, while the IFO index stabilised in May. However, the slowdown reflects only the natural progression from a phase of sustained recovery to one that is more contained but more self-sustaining because it is driven by domestic factors. **With a 3.4% increase in GDP in 2011 and 2.0% in 2012, the German economy looks set to see above-potential growth rates out to our forecasting horizon.**

Italy: Cloudy weather

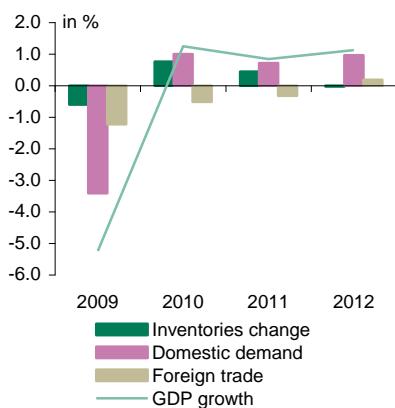
The lack of growth in the first quarter further widened the gap with core Eurozone countries. Italy is between a rock and a hard place, with flagging external demand and domestic demand unable to take up the slack due to negative fiscal impulse.

Italy and major partners : productivity cycle



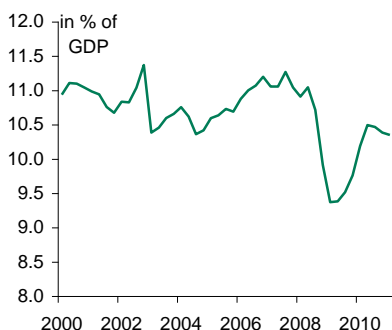
Source: ISTAT, Crédit Agricole SA

Italy : contributions to GDP growth



Source: ISTAT, Crédit Agricole SA

Italy : private non-residential investment rate



Source: ISTAT, Crédit Agricole SA

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While the Eurozone posted strong Q1 growth of 0.8%, Italy's GDP was stuck at 0.1% in Q111, unchanged on the already lifeless end to 2010 (0.1% QoQ in Q4). Such a poor performance is less an isolated occurrence than typical of the Italian recovery phase since the end of the crisis, slightly widening the growth differential with other more dynamic core Eurozone countries. **It is the outcome of zero contributions from foreign trade and domestic demand.**

Above all, it is **investment spending that is bogged down**, with an increase of just 0.1% versus 2.1% in the Eurozone as a whole largely explaining the growth differential. The upward correction in the construction industry following the winter lull was less marked in Italy, and public investment continues to be the adjustment variable in the public accounts. The main difference stems from **the dearth of private sector capital investment. Yet the adjustment phase in Italian firms' profitability conditions does not fundamentally diverge from other large Eurozone economies'**. Despite weak activity levels, the productivity cycle has remained sustained, as employment saw a further fall of 0.8% QoQ. This meant unit labour costs rose very little, which, combined with the resumed upward trend in end-prices, allowed firms to continue rebuilding their margins.

Although supply-side conditions have been partially restored, the scope of the accelerator is restricted by a continuing weak outlook for demand. The gradual return to competitiveness is just enough to slow the long decline in market share, but not sufficient to reverse it. Italian export figures, up 1.4% QoQ in Q111, do not fully reflect the strength of global demand. Domestic demand continues to be hobbled by excess capacity, which limits the accumulation process, with a capacity utilisation rate that remains stubbornly below trend. The gradual deterioration in the business climate perceptible in the ISTAT survey of industry and in the manufacturing PMI in May testifies to the inability of domestic demand to take up the slack created by slowing global demand.

April's uptick in retail sales was not large enough to suggest a rebound in **household consumption, which is seeing sluggish Q111 growth, at 0.2% QoQ, but at the cost of a fall in the personal savings ratio.** Caught between higher inflation (up 2.3% in Q1) and a high unemployment rate (8.1% in April), households are increasingly pessimistic, and the confidence climate was again down in June. Forecast rising unemployment and a planned freeze on public sector pay until 2013 in the 2011 budget will have an adverse impact on wage trends over the next two years. Some 78% of private-sector contracts will remain in force until September 2011, with an in-built 1.7% increase in 2011. We are therefore forecasting a negotiated increase in pay of 2.0% in 2011 and 2.3% in 2012. The effective wage is likely to grow more slowly due to a shift towards more fixed-term employment contracts and temping, to the detriment of long-term contracts when short-time working provisions come to an end.

In the early part of the year, activity continued to benefit from sustained public spending (+0.5%), but the measures announced (a freeze on public sector wages and spending cuts, notably for local government) **will continue to limit Italian household income growth** during the year. What is more, although the supplementary budget does not include too severe a turn of the fiscal screw this year, de facto postponing the lion's share of the adjustments until 2013, it nevertheless does include a cut in pension provision and a lifting of the retirement age. The logical increase in precautionary savings in the face of growing uncertainty, together with trends in disposable incomes, could reduce recourse to what has been the only growth engine, namely private spending.

The risk of budget execution in 2011 is low, and the government should more or less achieve its objectives with a **deficit back at the limit enshrined in the Stability Pact by the end of our forecasting horizon (3.9% in 2011 and 3.0% in 2012).**

Greece: Buying more time

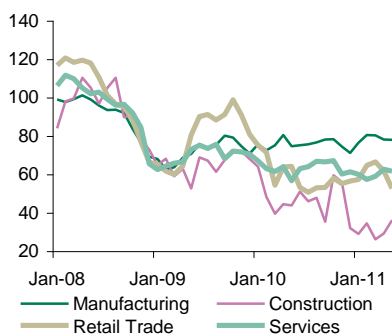
Due to the lack of access to the markets Greece is highly strained in dealing with its financial obligations. The economy should contract more than expected this year (-3.8%) under the weight of new austerity measures to address delays in reforms.

Central government balance (% of GDP)



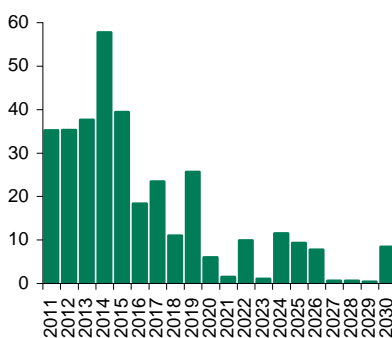
Source: Hellenic Ministry of Finance

Business expectations indicators



Source: Foundation for Economic and Industrial Research

Central government debt (EURbn) redemption schedule (at 31/03/11)



Source: Hellenic Ministry of Finance

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Greece is struggling to keep its fiscal effort on track and overcome the impasse over its financing needs. The higher than initially estimated 2010 public deficit (-10.5% from -9.6% of GDP), due to deeper recession and the slippage in public revenue in the first four months of 2011 (lower by 7% than the budgeted figure), will entail additional austerity measures of EUR6.4bn (c.3.0% of GDP) in 2011 alone to consistently execute the budget and reduce the general government deficit to 7.6% of GDP, as is the target, by the end of the year.

On the other hand, the fiscal adjustment, though remarkable so far and continuing, is anything but adequate to meet the huge borrowing requirements of the country. Underperforming revenues, due to weak economic activity but mainly to still-widespread tax evasion, constitute a major threat to fiscal sustainability. Should they not be dealt with efficiently, they will undermine the effort of achieving satisfactory primary surpluses, which would relieve the hefty burden of the country's debt.

The Medium Term Fiscal Strategy Framework 2012-2015 provides for a boost in tax revenue; however, it will come from one-off rather than structural measures. Hard measures of a total of EUR28bn are included in the programme in return for fresh financial aid to cover the fiscal funding gap until mid-2014. The programme will give Greece breathing space to make up for delays in various reforms (speeding up privatisations, downsizing the public sector, cutting spending further). It must be fully implemented, otherwise – as access to markets is not possible – the country will embark on a painful adventure.

Political consensus, which would enhance the credibility of the country, is still sought after and tensions about the appropriateness of the policy mix accentuate implementation risks.

The economic environment is far from conducive to the effort. The GDP decline moderated to -5.5% YoY in Q111 from -7.4% YoY in Q410. In any case, the stricter fiscal discipline measures and rising unemployment (March 2011 unemployment rate: 16.2%) should further squeeze consumer expenditure this year. Investment is also expected to tumble again as the business climate in major sectors of economic activity remains unfavourable, expectations are very much pessimistic and bank lending is constrained.

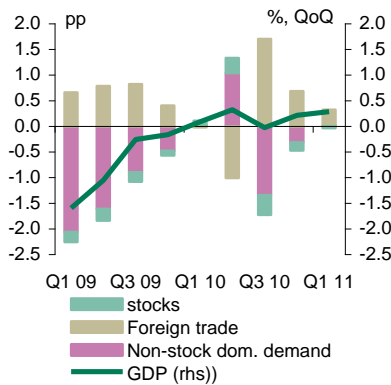
Domestic demand contracting further will keep imports low. Demand for Greek goods from abroad is broadly on the rise, and tourism and shipping performance also show signs of improvement. In Q410 and Q111 in particular the contribution of exported goods to total exports was much stronger than in the previous quarters. Hence, the external sector should work again as a mitigating factor to recession.

Overall, we have revised our growth forecast to around -3.8% for 2011. The beneficial effect on the economy of reforms should start to take hold next year and growth could move into positive territory. Breaking the vicious circle of recession-fiscal austerity is really hard. But turning around the economy and putting it on a firmer footing is essential for any progress on the fiscal front to be sustainable.

Spain: The outlook weakens

Sustained weakness in GDP growth is expected in Spain as the country purges the excesses of the past decade and continues to tighten the fiscal screw. Spain is coping with growing downside risks: the strengthening of the EUR, the risk of spiralling public finances and growing social as well as political tensions.

GDP



Source: INE, Crédit Agricole SA

In Q111 Spain's GDP again showed a very modest increase of just 0.3% QoQ following 0.2% in Q410. Growth was largely export-led (at 5% QoQ after 3.9%). Early Q211 data (PMI, European Commission survey, and industrial production figures in particular) suggests that activity is again flagging, with a drop of 0.2% QoQ forecast for GDP. For 2011 as a whole, we have not changed our forecast of 0.5% annual growth. This year will see the first full-year effects of the austerity measures and of the deployment of structural reforms, notably in the labour market. The shake-out in the construction sector also looks set to continue, at least until the end of next year.

In terms of large-scale structural reforms, the draft bill on wage bargaining, which still has to be approved by the Spanish Parliament, is nevertheless unlikely to lead to the complete removal of inflation-linked wage indexation. **The gradual correction of imbalances and improvements in firms' competitiveness should drive a return to growth, albeit at a lower level than in the last decade** (at 0.9% for GDP in 2012, and around 1.5% in 2013 and 2014) but on healthier, firmer foundations.

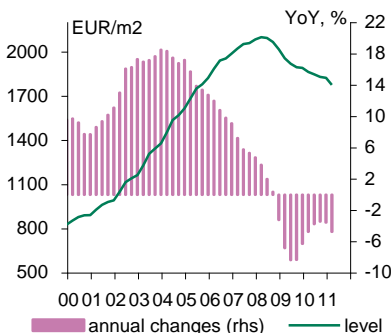
GDP growth



Source: Datastream, Crédit Agricole SA

Although our growth scenario is unchanged compared with that in March 2011, there are more downside risks to the outlook for the Spanish economy at present. The strong EUR could lead to a fall-off in exports, the main engine driving Spain's growth in 2011. In the public finance sphere, although the country's public debt seems sustainable, it could still spiral out of control. Public debt rose significantly during Q111, to 63.6% of GDP compared with 60.1% in December 2010 and 55% in Q110. The government is forecasting that public debt will stand at 67.3% of GDP at end-2011. There is also a degree of uncertainty as to the central government's ability to impose fiscal discipline on Spain's relatively autonomous regions. In 2010, the central government largely met its budget target for a public deficit of 5.9% (5% achieved). The regions, on the other hand, posted a combined deficit of 3.4% of GDP compared with a target of 2.4%. If the regions were to relax their efforts further, it could compromise the target of a reduction in the total deficit to 6% of GDP in 2011. Moreover, the ongoing sovereign debt crisis could further jeopardise the Spanish economy through possible contagion effects. These effects could be transmitted via foreign trade: Portugal's dive into recession is bad news for Spain's exports, as the country is Spain's fourth biggest trading partner. Contagion would also materialise via the banks. In mid-June, the Bank of Spain announced that calls by Spanish banks for financing from the ECB had grown significantly in May, rising 26% MoM to EUR53.1bn, reflecting the difficulties faced by Spanish banks in obtaining refinancing on the open market.

Spain : private property prices



Source: Banque d'Espagne, Crédit Agricole CIB

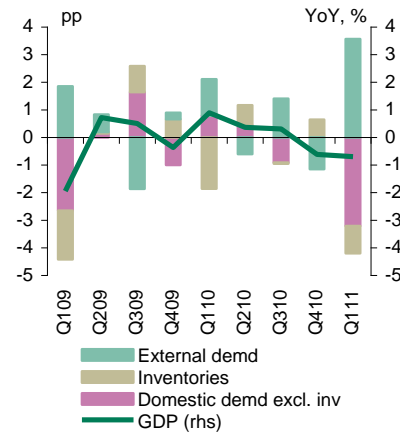
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What is more, a new risk has emerged in recent weeks, namely social unrest. On 15 May, a spontaneous, anti-party movement, *Los Indignados* ('the indignant'), was organised in Madrid. The organisation reveals the social and political gulf between Spaniards who are suffering as a result of the crisis and the political class. The unemployment rate was almost 21% of the workforce in Q111. That figure, which is a national average, masks contrasting situations between regions, such as Andalusia, where unemployment is around 30% of the workforce, and between population groups, with unemployment affecting 44% of under-25s. In regional elections held on 22 May, Spain shifted to the right. But the gains by the conservative People's Party (PP) are less a victory than the outcome of a protest vote. These social tensions could make it more difficult to implement the fiscal austerity plan required by Spain's public finance situation and the markets. Although our growth scenario is virtually unchanged, **the outlook for the Spanish economy is more uncertain than ever in view of growing political and social tensions and a global environment that is itself fraught with considerable uncertainty.**

Portugal: Hard times

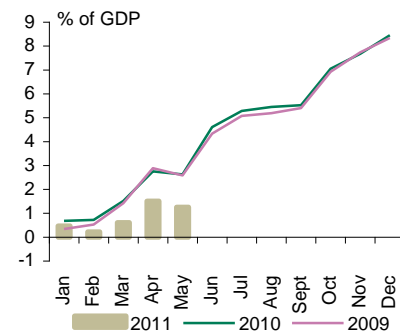
Portugal is the third country to ask for financial help from the European Community and, in exchange, has had to submit a drastic adjustment plan. The immediate outcome of the new austerity regime was that the country plunged straight into a recession, which is likely to last until 2012.

Portugal : GDP and contribution of its components



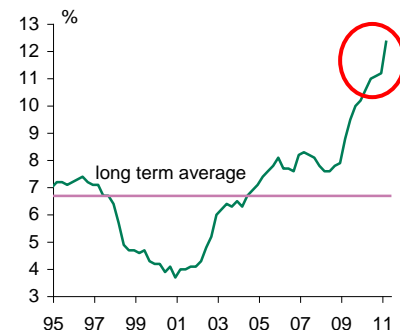
Source: INE, Crédit Agricole SA

Portugal : public deficit



Source: National sources, Crédit Agricole SA

Portugal : unemployment rate



Source: Eurostat, Crédit Agricole SA

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The problems are piling up. The main challenge for Portugal is to dig itself out of the low-growth regime it has been experiencing for the past decade. After that comes the question of the health of its banking system, against a backdrop of heavy private-sector indebtedness. Another more recent concern for the country is the ongoing 'brain drain' as highly educated Portuguese head for the country's former colonies of Brazil and Angola, especially given the lack of visibility about the country's future. The Portuguese economy sank into a technical recession in Q111 as GDP fell 0.7% QoQ after a fall of 0.6% QoQ in Q410. The outlook is scarcely brighter over the next two years.

After Greece and Ireland it was Portugal's turn to call the EU and the IMF to the rescue on 7 April this year. **The aid package totals EUR78bn (45% of GDP) over three years, which should cover the Portuguese state's funding requirements over the next three years.** The package's first instalment came from the European Financial Stabilisation Mechanism (EFSM) and helped to cover the major debt repayments (EUR5bn) of mid-June.

In the framework of the aid package, the public deficit reduction target was significantly eased relative to the programme announced on 11 March this year: the budget deficit is to fall to 5.9% of GDP in 2011, 4.5% in 2012 and 3.0% in 2013, compared with 4.6%, 3.0% and 2.0%, respectively, targeted in March 2011. The conditions tied to the aid package include some of the austerity measures announced in March, which had been rejected by the Portuguese Parliament and triggered the resignation of Prime Minister Jose Socrates. The new plan also includes a privatisation programme, which should bring EUR5.5bn into the Portuguese state coffers, and a EUR12bn financial aid package designed to shore up bank capital. It also includes the implementation of far-reaching structural reforms, especially with regard to the labour market and the education and justice sectors. These should ultimately help to make the country more competitive and enhance its growth potential. **In the meantime, the outlook for Portuguese growth has been revised down significantly. The government is now forecasting a drop of around 2% in GDP in 2011 and 2012.** In view of these "immense economic challenges"¹ and the downbeat business climate indicators such as the European Commission survey and the industrial production index, we are now predicting a harsher recession than initially forecast compared with the previous forecast of -1.7% in 2011 and -0.7% in 2012. This is because Portugal's households are facing a severe deterioration in the labour market, significant cuts to public-sector pay, tighter lending conditions, a sharp, if temporary, increase in consumer prices following January's 2ppt increase in VAT to 23%, and surging commodity prices.

On 5 June, the snap general election gave a victory to the right. The right-wing coalition of the centre-right PSD, which won 39% of the votes, and the rightist Democratic and Social Centre CDS party, which took 12% of the votes, has been formed. That majority should guarantee political stability over the next four years. The leader of the PSD, Pedro Passos Coelho, has undertaken to implement the programme of reforms agreed with the Troika. **The flip side, however, is the very high – 40% – abstention rate in the elections.** This suggests smouldering social tensions.

The foundations of the Portuguese economy are therefore to be reformed, at a cost, for Portuguese society, **whose capacity to accept the changes is hard to call.**

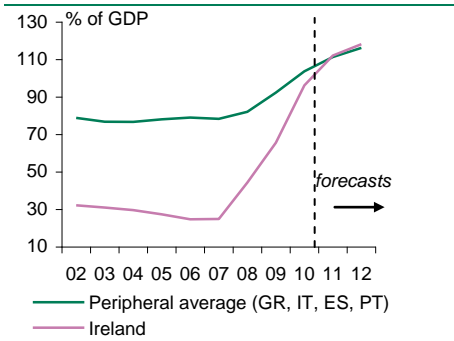
¹ The terms used in the report drafted by the Troika and published by the IMF on 17 May 2011.

Ireland: The risks of uneven growth

According to the IMF, the reform process in Ireland is off to a strong start. However, to restore the long-term sustainability of finances, a full recovery – more balanced between external and domestic demand – will be needed. For now, export-driven growth in activity should continue to give Ireland an advantage over other peripheral countries, but risks remain high as spillovers from the financial sector remain possible and the ongoing risk of contagion from the Greek crisis heightens.

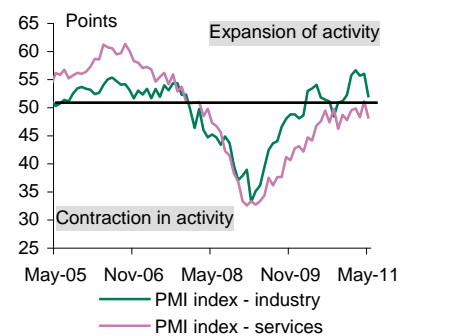
Public debt to GDP ratio

Ireland vs average in the other peripheral countries



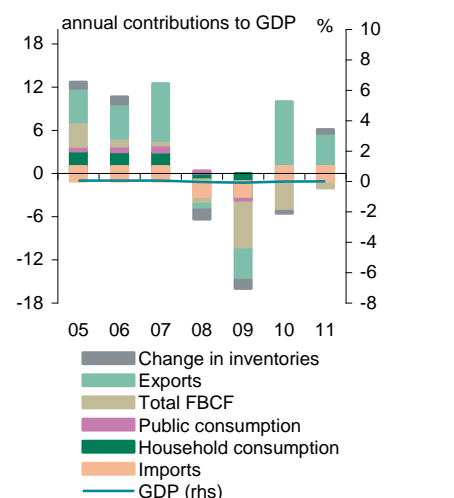
Source: Eurostat, Credit Agricole SA forecasts

Business climate



Source: Reuters, Credit Agricole SA

Contributions to GDP growth



Source: Eurostat, Crédit Agricole SA

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After a strong weather-related contraction in Q410 (-1.4% QoQ), **Irish GDP growth excelled in Q111** (estimated at +1.3% QoQ). The pick-up in global demand bolstered Irish exports (3.8% QoQ), while domestic demand remained once again in negative territory (-0.6% QoQ).

Looking ahead, PMI indices indicate that purchasing managers are expecting a slowdown in production in Q211. In May, the sub-index for manufacturing dropped sharply (from 58.6 to 52.6 points), but remained above the 50 mark, which separates an expansion from a contraction in activity. Export orders increased strongly and at a much faster rate than overall new orders, highlighting Ireland's overreliance on export-led growth. The recovery in domestic demand has been continuously delayed as the economy undergoes a multitude of structural adjustments on the fiscal, banking and housing front.

Credit conditions remain very tough as uncertainty in the financial sector remains high. According to the IMF's spring review, the reform process is off to a strong start, but a lot remains to be done to restore confidence in the Irish banking sector and avoid any further spillovers of past bank debt into public sector accounts. The issue of burden-sharing between the public and private sector remains high on the political agenda. The main challenge, however, remains regaining control of public debt, which ballooned from 44% of GDP in 2008 to an estimated 112% in 2011. The current fiscal consolidation programme to reduce the deficit from 31.9% of GDP in 2011 to 2.8% in 2014 – approved by the IMF and the EU in exchange for EUR85bn financial assistance – is progressively being adopted. Monthly budget figures show that consolidation efforts are on track, but revenue intake remains a matter of concern. Specifically, while corporation tax and excise duties remain ahead of expectations, VAT and income tax receipts have lagged behind. This can be linked to labour market weakness and the overall drop in consumer spending.

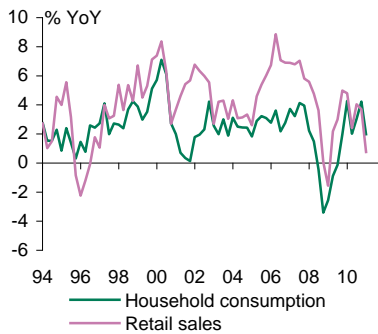
The unemployment rate is set to stabilise in the coming months, but at a high level (15% of the total population). Consumer sentiment remains weak, but encouragingly improved in May for the fourth time in five months. Purchasing power remains highly restrained. As the rise in commodity prices stabilises, the tightening in fiscal and monetary policy increases the challenges facing households, which are currently undergoing a strong deleveraging process.

Overall, after three years of contraction, the Irish economy is expected to make a relatively timid comeback this year, with GDP growth at +0.9% YoY. After a strong growth spurt in Q111, growth should remain moderate in Q211 (+0.6% QoQ). Risks remain skewed to the downside. Export prospects should remain strong but highly sensitive to fluctuations in the exchange rate and global demand. **Fiscal consolidation efforts, thus far, have been in line with expectations, but market sentiment remains very edgy as the Greek crisis continues to unfold. In this context, the financial situation of Ireland remains highly vulnerable to exogenous factors.**

Scandies: Getting busier

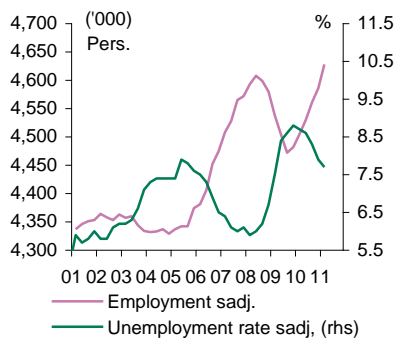
Capacity utilisation and employment are rising at a fast pace. Conditions are being met for GDP to grow organically, in the face of the near-term global slowdown. Monetary policy normalisation, aiming to curb credit demand and house prices, will likely continue but strong domestic currencies argue for a gradual pace of rate hikes.

Weaker Swedish household consumption growth



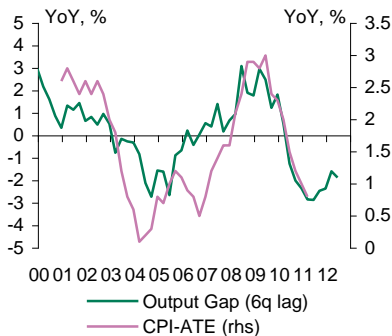
Source: Statistics Sweden, Crédit Agricole CIB

Record level of Swedish employment



Source: SCB, Crédit Agricole CIB

Norway: inflation to rise further



Source: Statistics Norway, OECD, Crédit Agricole CIB

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Sweden steps away from overheating

After a strong start to 2011, growth is slowing as the initial sharp upward move from the depressed levels following the crisis is over and economic policy is becoming less expansionary. The Riksbank has hiked its repo rate at each of its meetings since it embarked on a pre-emptive monetary normalisation process in July last year. As a result, mortgage rates have increased rapidly and consumer confidence has responded negatively. Credit lending to households has slowed down and house price growth has also weakened. Consumption growth (0.4% QoQ) declined to its long-term trend in Q1.

Going forward, the negative wealth effect from increased mortgage costs and higher energy prices should be offset by the positive effect from the labour market improvement, which ultimately should support household consumption. **Employment has reached unprecedented levels**, to a large extent thanks to strong growth in the export-dependent manufacturing sector (mainly hit by the global crisis). The government's reforms – aiming to promote workforce participation, and limit structural unemployment – have resulted in higher labour supply. With the workforce rising, unemployment, although on a downward trend, remains significantly higher than before the crisis, suggesting that there is still slack in the labour market. This will likely limit wage inflation, and facilitate further job creation.

Capacity utilisation is back to normal levels so the Riksbank will likely continue the normalisation of its monetary policy in order to prevent inflationary pressures building up. We forecast the repo rate to reach 2.25% at the end of 2011 and 3.25% in 2012.

Norwegian tightening labour market to generate higher inflation

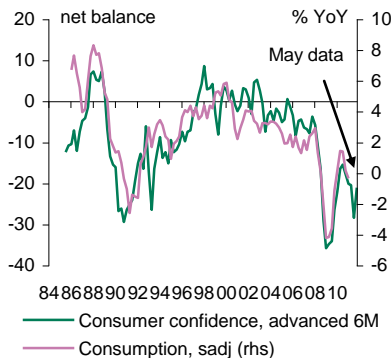
Growth in mainland Norway has strengthened, driven by a sharp increase in petroleum investment and residential construction. Household consumption has been temporarily affected by higher electricity prices but prospects are for growth in consumer spending to re-accelerate, supported by the strong labour market. **Unemployment (2.7%) has fallen quite steeply lately and wage growth has been adjusted upwards.** There are also signs of labour shortages in some sectors, mainly manufacturing and construction, which should exert additional pressures on wage growth ahead.

CPI inflation, although still below target, has been higher than projected by the Norges Bank so far this year due to the rises in the price of fuel and negative base effects for electricity prices. Underlying inflation, however, has been broadly on track, contained by the still-negative, albeit rising, imported inflation and low domestically generated inflation. **Inflation is expected to accelerate in the coming months.** Brisk consumer demand going forward is providing retailers with scope to raise prices in the wake of higher input costs. Together with evidence that growth in house prices and household borrowing are picking up, this suggests that the normalisation of monetary policy will continue, bringing the deposit rate to 2.75% by the end of the year and 3.75% at end-2012.

UK: Under pressure

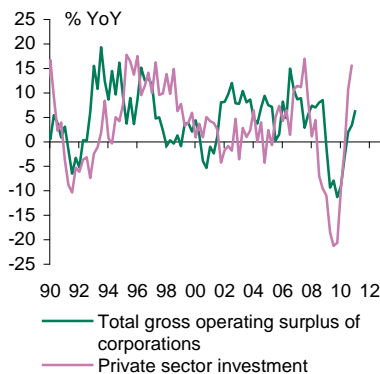
The long-awaited economic rebalancing towards exports and investment seems to be taking place but the weakness of domestic demand remains a worry. Despite an inflation rate likely to come close to almost 5% later this year, monetary policy is on hold. We have pushed back our forecast for the first rate increase to November.

Consumption follows confidence



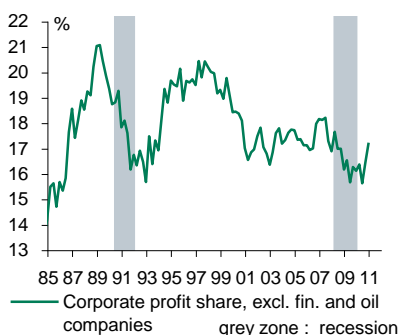
Source: Gfk, ONS, Crédit Agricole CIB

Operating surplus growing rapidly



Source: ONS, Crédit Agricole CIB

Recovering profit margins are consistent with upward pressure on CPI inflation



Source: ONS, Crédit Agricole CIB

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GDP growth was below expectations in Q1, and the breakdown confirmed the weakness of domestic demand.

Fuelled mainly by foreign trade, the 0.5% QoQ increase in GDP barely offset the previous quarter's contraction. In addition, domestic demand fell sharply (-0.9% QoQ). Household consumption saw its worst performance in nearly two years (-0.6% QoQ) despite a 0.3% QoQ rebound in retail sales volumes during the quarter. The increase in VAT at the start of the year and surging oil prices have put consumers' purchasing power under severe pressure in an environment of continued high unemployment and uncertainty on future income. Higher mortgage costs in connection with the eventual start of monetary tightening might have also been anticipated by consumers. The recent rebound in confidence indicators suggests that part of the weakness may be only temporary as households have probably overreacted to government rhetoric on austerity measures. However, even if it is expected to rebound from Q2, consumption looks set to remain weak compared with its long-term growth. Labour productivity, far below the level implied by its pre-recession trend, hints at modest job creation and sub-par earnings growth.

The fall in capital formation observed in Q1 (-4.5% QoQ) was greater than the average contraction during the recession. Demand uncertainty and insufficient net return seem to be the main factors limiting investment. However, the decline in investment looks out of step relative to more upbeat surveys of investment intentions. We believe that **the need to replace obsolete equipment, together with high profitability of businesses and record-low interest rates should boost investment over the coming quarters.** Hence, we continue to expect a relatively high contribution to growth from private investment. In addition, the degree of spare capacity within companies, as suggested by business surveys, seems smaller than measures implied by past trends of potential supply.

Growth volatility will likely persist over the coming months, making it difficult to assess the strength of underlying demand.

We are forecasting a marked slowdown in Q2 due both to the global downturn and to 'special events', such as the additional bank holiday in April for the royal wedding and supply chain disruptions following the earthquake and tsunami in Japan. These effects will likely go into reverse in Q3 and bolster growth, as a proportion of production is likely to be postponed from Q2 to Q3.

We have revised our inflation forecasts upwards, mainly due to energy prices.

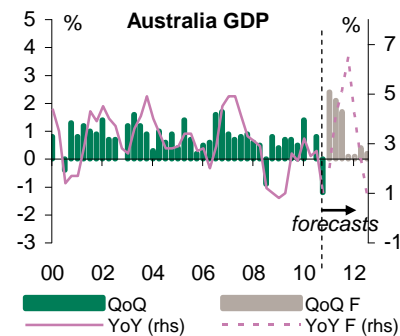
We now expect CPI inflation to average 4.4% this year, and 2.4% in 2012, compared with 4.0% and 2.0% previously. We continue to expect inflation to start declining significantly from the beginning of 2012, but to remain above the BoE target on average next year. After a prolonged period of high inflation, wages growth should pick up, while businesses will likely continue restoring their margins so as to preserve their profitability. **We therefore expect a very gradual tightening to begin in November,** aiming to counter the risk of high inflation becoming entrenched in public inflation expectations.

The risk of stagflation makes the exact timing of the first rate hike uncertain, and the split within the MPC has become more acute recently. However, the downside risks to demand continue to prevail over elevated inflation when setting monetary policy. If the current weakness in demand persists (due to high petrol prices, or a more lasting global slowdown), this will likely result in a delay to the first rate hike. In an alternative scenario, the MPC would likely embark on an additional round of quantitative easing if nominal demand growth sharply decelerates. Our central-case scenario assumes growth will rebound in the second half of the year, as petrol prices cool down and ease some of the pressure on consumers, which would make MPC members more confident about hiking rates.

Australia: Growth to rebound

Following a contraction in Q1, GDP is set to rebound strongly over the coming months and we look for growth of 3.1% and 3.4% in 2011 and 2012, respectively. The RBA has shown a reluctance to hike policy rates further but, given that inflation is likely to move above target, we expect two more 25bp rate hikes in the current cycle.

Growth to return to above-trend over coming months



Source: Crédit Agricole CIB, Bloomberg

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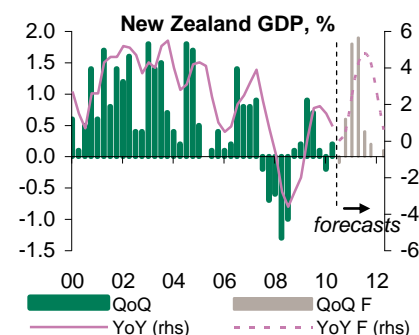
Australia continues to benefit from high levels of terms of trade. Growth in investment continues to be led by the resource sector in the wake of high commodity prices. However, investment outside of this sector is somewhat weaker with households particularly cautious, highlighting the **continued two-tier nature of economic growth in Australia**. The economy underwent a sharp contraction in real GDP in Q1 due to the impact of flooding and cyclones, but reconstruction and rebuilding are likely to boost growth going forward, with GDP likely to return to above-trend over coming months. Overall, we expect GDP growth of 3.1% this year, accelerating to 3.4% in 2012. After a 1.2% QoQ contraction in Q111 we look for a rebound of 2.4% QoQ in Q211.

The RBA continues to label monetary policy settings as “mildly restrictive” and appears to be showing little urgency to hike interest rates any time soon against a background of modest credit growth, softening house prices and a strong exchange rate. The pick-up in weather-related inflation pressures over recent months is likely to prove temporary though increases in utility prices suggest that inflation will not ease quickly. Moreover, wage pressures are likely to contribute to an increase in overall inflation, especially given that the unemployment rate has dropped below 5%. **Our forecasts continue to show inflation above the RBA’s 2-3% target band this year, and we maintain the view that two more rate hikes are in the pipeline.** We remain positive on the AUD, with the currency one of the top performers in our forecast grid. Nonetheless, much of the gain in holding AUD is likely to come from ‘carry’ rather than spot appreciation.

New Zealand: Quickening recovery

New Zealand’s economic outlook has improved since the earthquakes. Surging oil prices and rebuilding activity are likely to push up inflationary pressure in the months ahead, but the strong NZD will likely keep prices in check. As recovery remains fragile, the RBNZ is likely to keep its policy rate unchanged this year but will begin to hike early in 2012.

Recovery to strengthen in H211 as tourism and rebuilding boost activity



Source: Crédit Agricole CIB, Bloomberg

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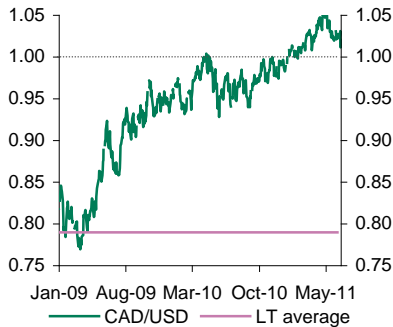
The New Zealand economy took a severe hit from two earthquakes in Canterbury within six months. However, the impact on the rest of the country does not appear to have been too severe. **Recent economic indicators show that the recovery is continuing at a healthy pace**, with tightening labour market conditions and improving business confidence. Exports are buoyant as well, leading to a widening trade surplus. Meanwhile, agricultural production is likely to expand due to a favourable climate this year. Looking forward, **we expect to see an ongoing recovery in H2**, with a pick-up in tourism boosted by the Rugby World Cup (benefit estimated at NZD700m), and ongoing rebuilding activity. Overall, the outlook for the economy has improved compared with the last quarter. Our forecasts for **GDP growth in 2011 and 2012 remain at 2.0% YoY and 3.5% YoY, respectively.**

The RBNZ cut its official cash rate to 2.5% from 3.0% in the wake of the February earthquake in Christchurch. **At the most recent policy meeting, the RBNZ opened the door to higher interest rates**, against the backdrop of rising inflationary pressures driven by surging oil prices and looming rebuilding activity. We expect CPI to rise 3.9% YoY in 2011, which is above the RBNZ’s target band. At the same time, the NZD has climbed to a record-high level, leading to a substantial improvement in terms of trades while keeping import cost-push inflation in check. As the global economic environment remains uncertain, the RBNZ will likely keep rates on hold this year but begin to hike rates in Q112.

Canada: Deferring the inevitable

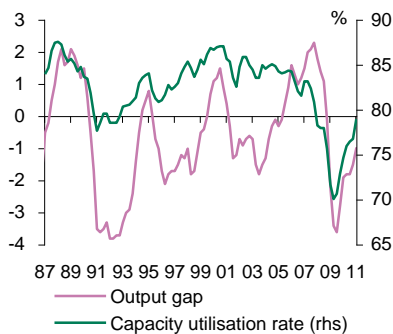
Canada's economy continues to see strong growth, but so does its currency. That was why the BoC once again opted to leave its monetary policy unchanged at its 31 May meeting – it could have resumed the normalisation of its monetary policy begun in June 2010, but it had not prepared the ground. Its May press release does just that, we believe, paving the way for it to resume its rate increases by quarterly 25bp increments; its first move coming likely on 7 September.

Canada: CAD's persistent strength



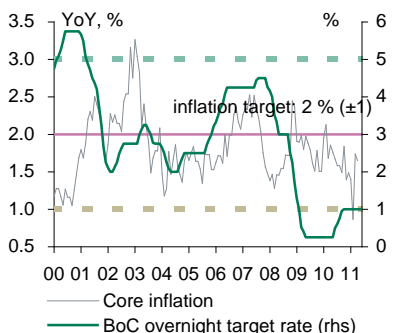
Source: Federal Reserve, Crédit Agricole SA

Canada: Less slack in the economy



Source: Statistics Canada, Crédit Agricole SA

Canada: inflation is no threat



Source: Statistics Canada, IHS Global Insight, Crédit Agricole SA

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At its 31 May meeting, the Bank of Canada (BoC) once again opted to leave its monetary policy unchanged, holding its main key rate at 1%.

In our view, this decision, although widely expected, was a close call. The BoC could, in fact, have resumed normalising its monetary policy nine months after its last move and almost a year after starting the process in June 2010. This is because, despite higher financial stress at end-May than at mid-April, which saw tensions ratcheting up again on the European sovereign debt crisis front and a return to worries about growth, the economic indicators and the tone of the press release from the previous meeting on 12 April seemed sufficiently upbeat to justify a move as early as May. In fact, in an environment where opportunities to normalise interest rates are rare, the whole idea is not to miss them. In our view the BoC had just such a window of opportunity, which it might have been judicious to seize, as it had done in the middle of last year.

The arguments in favour of the *status quo* nevertheless won the day. It is true that the BoC had not prepared the ground, and in these unstable times it is unwise to spook the markets. At its 12 April meeting, it did not change its conclusion by stating “any further reduction in monetary policy stimulus would need to be carefully considered”, thus leaving us in no doubt that it had no intention of hiking rates at its next meeting. **The BoC also explicitly drew attention to the strength of CAD as being able to strengthen the headwinds facing the economy. This “persistent strength” was again emphasised, and must have been a very strong argument against a resumption of the cycle of rate increases. In view of the repercussions it has on the loonie, the BoC cannot afford, at the end of the day, to move long before the Fed.**

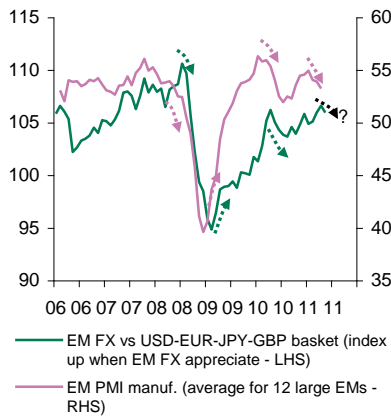
Except that this did not deter it from increasing its rates three times between June and September 2010. That argument thus has its limits, especially as, 12 months down the road, Canadian growth is doing well, if not better, as shown in particular by its pick-up in Q1 to an annualised 3.9% after 3.1% in the previous quarter. True, this is in line with BoC expectations, which is forecasting that the disasters that struck Japan in early March will “restrain growth sharply in the current quarter” due to short-term disruptions in supply. The slowdown in global growth, and in the US in particular, is sufficient justification for holding off a while longer (ie, we are not expecting any change on 19 July, either) but the BoC has scant reason for deferring a resumption of its cycle of rate increases for much longer, as the output gap is well on the way to being closed as early as mid-2012. This is what the BoC is currently forecasting, and its updated forecasts, due to be published on 20 July, should not be much different, while our own growth forecasts are more upbeat (an annualised 2.8% in 2011 and 3.1% in 2012, compared with the BoC's forecast of 2.9% and 2.6%, respectively). What is more, the BoC has, we feel, paved the way for rate increases by concluding its 31 May press release with the following new sentence “To the extent that the expansion continues and the current material excess supply in the economy is gradually absorbed, some of the considerable monetary policy stimulus currently in place will be eventually withdrawn...”. It also points out, evidently, that “such reduction would need to be carefully considered”, which in our view is synonymous with announcing a gradual normalisation of interest rates – something the BoC can afford as inflation is not threatening. Total CPI inflation is expected to converge with core inflation at 2% by the middle of 2012, 2% being the official target.

We are therefore expecting a first 25bp hike at the meeting on 7 September. The BoC will subsequently pursue the normalisation of its monetary policy at a rate of one 25bp increment every quarter, taking its main policy rate to 2.50% by end-2012.

Emerging markets: Pausing for breath

The market soft patch may last over the coming weeks as the impact of recent shocks (oil prices, Japan) is reflected in the hard data and as European sovereign jitters may persist. However, we remain confident that EMs enjoy solid buffers and will remain attractive. The current correction on EM asset prices should lead to attractive levels.

PMI down, FX down?



Source: Bloomberg, Crédit Agricole CIB

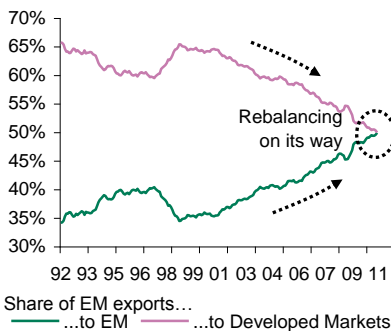
There is confusion. On the one hand, most investors seem to be continuing to buy the EM story. On the other hand, EMs are currently going through a soft patch. In our view, the markets may remain soft in the short term, but should recover afterwards when the current soft patch is fully priced in.

The current soft patch is made up of two main components. Firstly, **the market is pricing in the impact of the negative shocks that have arisen over recent months: mainly high oil prices and the disruption from the Japanese catastrophe.** The surprise comes from the fact that these two shocks no longer make the headlines, whereas by contrast their impact has begun to be visible in the hard data. Secondly, EMs have suffered from a rise in global risk aversion linked with the most recent European sovereign fears.

Soft patch ahead

These sources of uncertainty are unlikely to disappear suddenly. **Their impact will likely continue to be felt in coming weeks, including on FX markets.** The first chart on the left suggests that EM currencies (green line, summarising the exchange rate for 21 large EMs vs a basket of developed currencies) have often weakened following a decrease in PMI indices (pink line). Asian currencies may be more resilient, though.

The EM trade loop



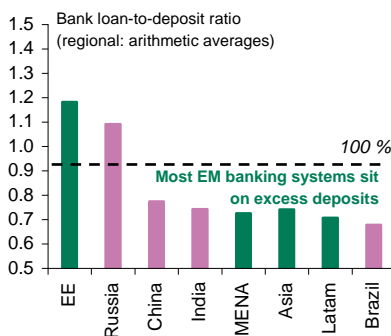
Source: Datastream, Crédit Agricole CIB

Beyond the soft patch

Beyond the soft patch, we remain constructive on the underlying EM story. Once the soft patch is priced in, we believe that EM growth will stabilise and the market will recognise that EMs as an asset class benefit from solid buffers. Firstly, even if this is partly for bad reasons, economic growth remains strong in the US and Europe. This will support EM exports in the months ahead. Secondly, **the EM trade loop keeps on emerging.** Emerging markets increasingly export to each other, which is fuelling a disconnection of EMs from developed markets.

Thirdly, even though the credit risk has increased on average in EMs, most EMs have **only limited balance sheet problems**, compared with developed markets. Finally, inflation worries, which have been bothering some investors recently, are only partly justified in our view. The stabilisation of commodity prices amidst the current soft patch will likely lead to disinflation, later this year

Loan-to-deposit ratios in EMs



Source: Datastream, Crédit Agricole CIB

BRICs on solid footing

The relatively constructive medium-term view we have for EMs can be illustrated by the BRICs. To begin with, **China is decelerating, but slowly.** Investment should moderate looking forward as the need to stimulate activity decreases in a post-crisis world, but private consumption should remain supported. Inflation should peak later this year, allowing the PBoC not to tighten dramatically going forward. We look for GDP to grow by about 9% in 2011 and 2012.

India and Brazil are both facing challenges on two fronts: widening current account deficits and inflation. However, in both cases the current account deficits remain limited (it surprisingly narrowed in India in Q4). Inflation will require further rate hikes in both Brazil and India, but relatively modest ones, we believe. We expect growth to remain strong in India (7.4% in 2011 and 7.8% in 2012). Brazil's economic momentum is weakening, but we expect growth to stabilise later this year (4.0% in 2011 and 4.3% in 2012).

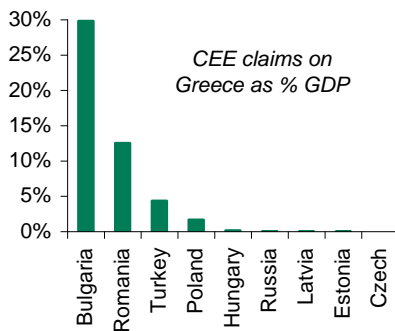
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Russia is to some extent a case apart. Russia's business model can easily be challenged (reliance on oil, gas and metals), but the fact is growth should remain afloat in coming quarters as commodity prices remain high. This may not be a very good reason, but it should allow Russia to grow by 3.7% in 2011 and 3.3% in 2012.

Central Europe: In the front line

Central Europe has made a good start but it is not escaping the global soft patch now. The growth outlook has hardly changed but downside risks are more significant than previously. Fiscal consolidation remains a challenge while a deterioration in the Eurozone debt crisis would place Central Europe under immense pressure.

Banking exposure to Greece



Source: BIS, Crédit Agricole CIB

Central Europe is not escaping the ongoing economic soft patch, and advance indicators point to further deceleration in growth. Nevertheless, it should be temporary and CE4 countries enjoy buffers and are in better shape than last year. **The growth outlook remains well oriented**, even if some risks are looming.

Obviously, the main risks for Central Europe come from a further deterioration of the Greek debt issue and the outbreak of an 'Ouzo crisis'. In this regard, **CE4 countries are likely the most exposed emerging countries** due to their significant trade relationships with the European periphery and their still-fragile banking sector, which would suffer from any new liquidity crisis. Within the region, Bulgaria would be in the front line as foreign claims of the banking sector represent 29.8% of GDP, followed by Romania, which is still suffering from a large current account deficit, though improving. Hungary would be under pressure as well as the government has to implement tough austerity measures. Only **Poland could be seen as a safe haven** and growth could remain slightly positive thanks to the resilient internal demand.

Other significant risks come from the budget financing issue, which is gaining momentum. In Poland, the budget deficit targets do not seem achievable, while in Hungary execution risks of the ambitious fiscal plan are still significant.

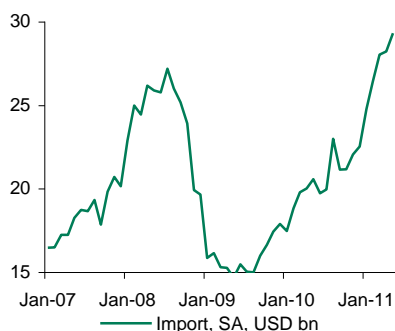
Against this backdrop, **Central European FX should appreciate further but at a more moderate pace**. Portfolio inflows should still be attracted by higher yields as central banks remain on alert, ready to tighten further as inflation edges up.

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Russia: More balanced model of growth needed

Driven mainly by easy monetary policy, domestic demand continues to boom. This is helping the economy to continue to grow (Q111 GDP is up 4.1% YoY), but poses risks for macroeconomic stability: fast import growth increases the vulnerability of external balances to fluctuations in oil prices, bringing the CA breakeven oil price to USD100/bl by year-end.

Booming domestic demand pushes goods import to all-time highs



Source: FSSS, Credit Agricole CIB

At its end-May policy meeting the CBR decided to hike the deposit rate to 3.5% and take a pause, citing that the risks of inflation/economic growth were balanced. But, in fact with the CBR base rate at 3.5% (with headline CPI at 9.6% YoY and median CPI at 6.0%) **monetary policy in Russia remains in accommodative mode**. Retail sales (especially durable goods) and lending growth continue to accelerate.

Strong domestic demand is pushing imports higher and higher each month, with YoY growth rates north of the 40% mark and reaching all-time highs. Such fast import growth is making Russian external balances more vulnerable to oil price fluctuations, **bringing the CA breakeven oil price closer to USD100/bl** of URALS by year-end. At the same time booming demand has already pushed local unemployment to the NAIRU level and, if monetary policy remains accommodative, this may add fuel to the wage-price spiral. Going forward Russia will definitely need a more balanced model of economic growth.

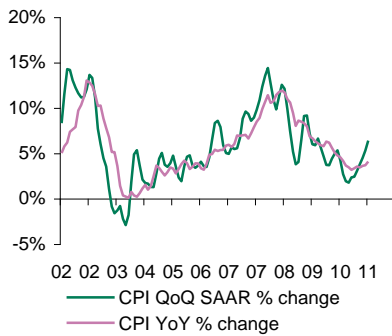
In its recent remarks the IMF pointed out that further tightening of monetary conditions is needed for the CBR to be compliant with its medium-term inflation goals. **Despite the pause in the base rate hiking cycle**, the CBR and Ministry of Finance continue to **tighten liquidity** and this could eventually **lead to much tighter monetary conditions** this autumn, with money market rates going up from the deposit rate (now at 3.5%) to CBR REPO rates (5.50-6.75%). This could help the Russian economy to experience a successful soft landing.

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South Africa: Waking up ... slowly

The economy has accelerated gradually. The recovery should remain slow. However, SARB is becoming a little bit more careful about inflation. Monetary tightening should begin in H2.

Sequential inflation above headline inflation



Source: Bloomberg, Crédit Agricole CIB

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South Africa has lagged most other emerging markets in the recovery. However, there have been signs in Q1 that the economy is waking up. In particular, industrial production has accelerated after the soft patch recorded last year. Another encouraging note: the PMI decreased less than in many other EMs in May. It remains quite high, at 55.1.

Still, **South Africa's wake-up is a slow one**. Consumer demand has been supported by rather significant wage growth. But it remains capped by record-high unemployment rates. We expect GDP to grow by 3.5% in 2011, with a slight risk on the upside.

So far, the sluggish growth in private consumption, combined with FX appreciation, has contributed to keep inflation under control. However, we estimate that sequential inflation has accelerated over the past three months, and now stands well above the headline CPI YoY change (at 6.5% vs 4.2% in April – last available data).

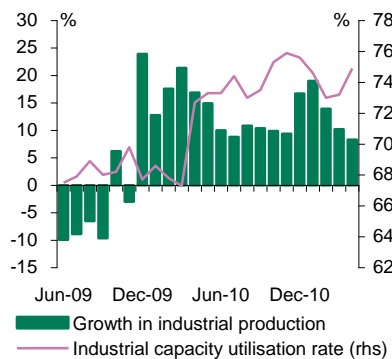
Unless the current global soft patch translates into a double dip (not our central scenario) the **SARB will have to begin hiking interest rates in H2**. We expect a cumulated 100bp hike in the repo rate over the next three quarters (25bp in Q411 and 75bp in Q112).

This would help to support the ZAR, even if the ZAR is already rather high compared with its historical level, in real effective terms. South Africa's trade balance looks good, particularly compared with its track record. This may also fuel the ZAR's resilience.

Turkey: Moment of truth

Ankara continues to defy the laws of financial gravity by keeping rates low at a time of widening current account deficits (8.3% in April). Market confidence in Turkish fundamentals is still strong but now that the general election has come and gone, it is time to make clear economic policy choices.

Turkey: slow growth in industrial production



Source: CBRT, Crédit Agricole SA

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Where are the stable points in the economy? It is far from certain that a rate increase will be able to rapidly absorb the external imbalance. That is because the imbalance is related to structural savings and energy deficits. What is more, the rate of increase in non-energy imports, up 42% YoY in April, is faster than that of exports, at 27%. The financing of the current account balance is dependent on short-term capital, which means that the current account deficit and resulting foreign exchange risk will continue to be factors in the monetary environment.

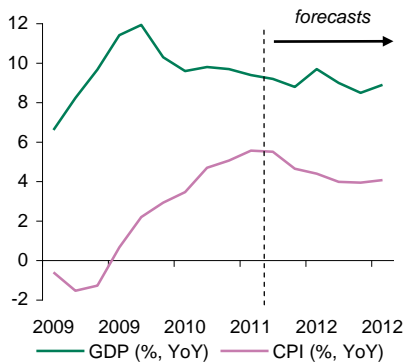
Yet there is considerable confidence in the fundamentals. In the first place because liquidity risk is falling as deposit maturities lengthen. Next, because the banks are profitable: liquidity ratios are running above 100% and doubtful loans at 3.2% of total lending. Finally, because slower growth in industrial production raises hopes that the risk of overheating is receding. The strength of investment and of capital goods purchases also testifies to the quality of domestic demand.

But it will take time for the slowdown in manufacturing to impact the external accounts. And that time can erode the trust placed in the central bank. The temptation to defer rate increases is therefore dangerous, even if it goes hand-in-hand with an active fiscal policy. Otherwise privatisations will be needed to provide stable financing for the current account deficit.

China: Soft landing continues

China is on course to engineer a successful soft landing. The economy is gradually slowing towards a growth rate of about 9% in 2011 and 2012. Combined with tighter monetary and fiscal policy, this will help bring inflation down starting in H2. Such an outlook limits room for rate hikes. The CNY will appreciate faster and reach 6.30 versus the USD by year-end.

China: GDP and CPI to decline



Source: CEIC, Cr dit Agricole CIB

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Chinese policymakers are on course to engineer a successful soft landing.

The economy is slowing, but only gradually, as consumption growth is accelerating. In Q1, it contributed more than investment to GDP growth for the first time since such data was released. Helped by years of double-digit gains in real household incomes, the consumer will partially pick up the baton from decelerating investment and a narrowing trade surplus. Overall, we expect GDP growth to ease from 10.3% last year to 9.3% this year, followed by 9.0% in 2012.

Inflation is likely to continue to be elevated, but should decline gradually starting in H211

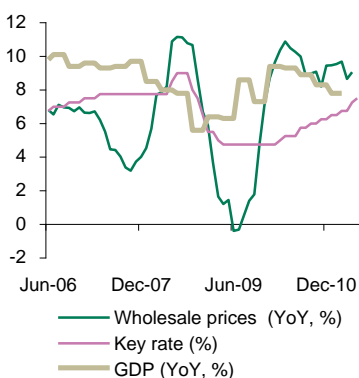
given the slowdown in monetary aggregates and final demand. Tighter monetary policy settings are also contributing. We expect CPI inflation to average 5.3% this year and fall to 4.0% next year. Such an outlook limits room for further rate increases, and we expect only very gradual hikes this and next year. On the other hand, the PBoC will continue to use tighter liquidity and CNY appreciation to control price pressures. We expect USD/CNY to end 2011 at 6.30.

China's ascent on the global stage will continue to be a major driver of global markets. **Internationalisation of the CNY will proceed through the channels of trade, direct investments and bond portfolio flows.** Share of China's trade settled in its own currency should rise from 6% in Q1 to 20% in 2013, leading to an accumulation of CNY in foreign hands. Chinese government debt will gradually find its place in global FX reserves as the country selectively opens its capital account to allow foreign investments in the domestic bond market.

India: Growth in question

The recent deterioration in the macroeconomic environment is starting to adversely affect domestic demand. Inflation, however, hardly seems to be responding to the tightening of monetary policy – a situation not without its risks for growth.

Growth and inflation



Source: CSO, EAC, RBI

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GDP growth came in at 7.8% YoY in the first quarter, its lowest level in five quarters. The underperformance can be largely explained by the fall-off in domestic demand. Exports of goods and services, on the other hand, have proved relatively resilient. Economic activity is starting to register the effects of inflation pressures and consecutive interest rate hikes (275bp since March 2010).

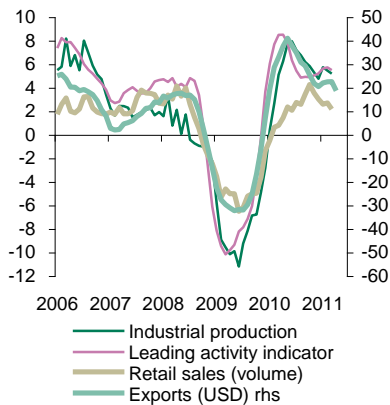
In parallel, inflation is proving sticky, and even rose again in May (9.1% YoY). This was notably because businesses are currently passing on recent production cost increases in their selling prices, a second-round effect. As a result, inflation (food and energy price inflation, initially) is spreading to the whole of the economy. Furthermore, inflation expectations in India are partly formed on the basis of previous price trends, which tend to slow the pace of any deflation process.

Two risks are emerging at this point. One is that inflation, which is also dictated by world commodity price trends – for which visibility is very limited, remains high for the duration, forcing the RBI to tighten its monetary policy more sharply than planned by year-end. The second, in contrast, is that the central bank, due to slowing growth, lowers its guard too early as a result of rising prices. This second case seems unlikely in view of the latest rate increase in June (25bp). But in either case, growth is likely to suffer regardless.

Mexico: 18 months is a long time

Mexico is on the mend, though a political agreement about the necessary structural reforms is going to be increasingly difficult to achieve in the run-up to the 2012 presidential election. One-off agreements between the parties are, however, possible.

Mexico: export-fuelled activity (3M ma, % YoY)



Source: INEGI, BCB

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After rebounding in 2010, Mexico's economy has reverted to a more modest growth rate, posting 4.4% YoY in the first quarter. Activity continues to be fuelled by external demand, and despite a slowdown exports grew by a further 15% YoY (in USD) in April. But domestic demand seems to have flagged once more.

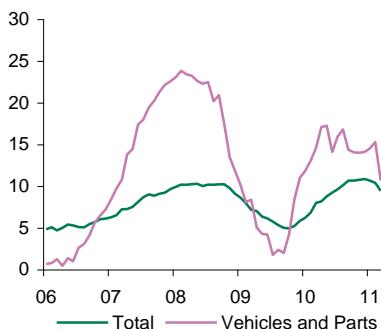
The next major date is political, with the July 2012 presidential election. The successful candidate will be instated in December. Until then, it will be difficult to undertake any large-scale reforms. Stalemate reigns in the Congress due to the lack of a majority party, and the looming decisive election makes co-operation between the PRI (which hopes to win the election) and the ruling PAN more difficult. A major stage on the road to the national election is that of the governor of the State of Mexico, whose 15 million-plus inhabitants vote in July 2011, with the PRI a strong favourite.

Regarding several of the limitations hobbling the Mexican economy, positive signals have been sent by the authorities in recent weeks. The economy's competitiveness should be stimulated by several recent decisions that strengthen competition. There is also a chance, albeit a limited one, that a reform of labour laws will be adopted over the coming months, as a PAN/PRI accord seems possible. President Felipe Calderón has also considered a 'modernisation' of Pemex, including its part-privatisation. But that will (perhaps) be for after the 2012 elections.

Brazil: Slowing down, but not there yet

There are some signs that the measures taken by the government are starting to have some impact. However, inflation remains too high and there are too many risks for the BCB to declare victory at this point. We expect another 25bp hike in July, after which the Selic rate should be kept unchanged at 12.5% for the remainder of 2011.

Retail sales are decelerating



Source: IBGE, Crédit Agricole Brasil

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There are clearer signs that the Brazilian economy is finally slowing down as fiscal and monetary policy adjustments are starting to have some impact on demand. **The signs can be seen in retail sales, industrial production and credit expansion** and are likely to cause domestic inflation to start a very gradual path towards the target. In the short term, the inflation outlook is getting better also due to the decrease in 'imported inflation' associated with commodity prices and to some seasonal effects.

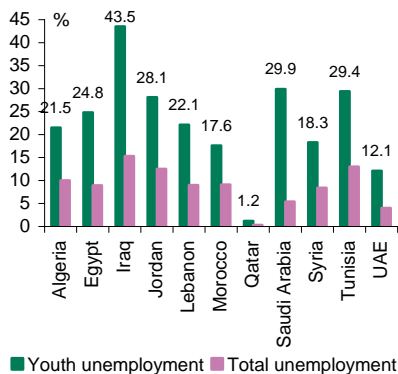
Inflation expectations, in turn, are also falling, a move that reflects not only the abovementioned factors, but also the improvements in communication from the BCB. Since its April meeting, **the BCB has been able to regain part of its lost credibility by reaffirming the Selic rate as its main tool** (de-emphasising the role of macroprudential measures) and its commitment to price stability.

In spite of all that, we still think that **the current hiking cycle is not over** as significant risks to inflation remain. The most important of these is the possibility that the collective wage negotiations that are going to take place in the second half of the year will lead to further pressures on costs and prices. It is also too soon to be sure that the improvement in fiscal policy will remain in place. Finally, the BCB's credibility is still bruised, which increases the risks associated with any perceived hesitation at this point. For all of these reasons, we believe that **the BCB will have to hike again in July and that the Selic rate will reach 12.5%**, at which point the hiking process will be over.

GCC: High oil revenues, higher spending but labour matters

Gulf economies continue to benefit from high oil revenues even as expenditures for all are on the rise in light of extra social costs following the first wave of the 'Arab Spring'. Saudi Arabia's breakeven oil price is estimated at USD88/bl. Unemployment and labour matters have been brought back in by all Gulf countries. Labour is among the top challenges.

Region faces youth joblessness dilemma



Source: International Labor Organization

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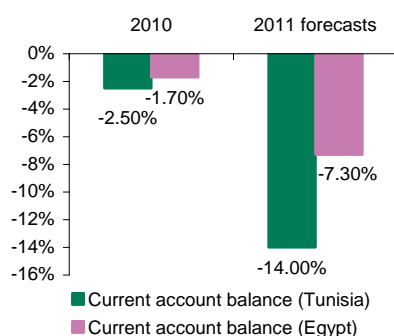
Most of the Gulf oil exporters are enjoying a period of macroeconomic stability predicated on high oil revenues. All have announced extra spending programmes in the form of handouts and programmes as a response to the 'Arab Spring'. **If oil prices average above USD88/bl, Saudi Arabia will record a surplus despite the kingdom's role in providing assistance to Egypt (USD4bn) as well as an estimated USD12bn in addition to soft loans and grants provided to Bahrain, Oman, Morocco, Syria and others in the region.**

Labour has been brought back into the discourse by almost all GCC countries as unemployment, particularly youth unemployment, is seen as a major cause for potential social disgruntlement. All Gulf countries are revamping their labour policies in order to increase nationalisation in the workforce. **The private sector in the Gulf is 88% dependent on expatriates whereas the public sector is almost predominantly made up of nationals.** More than 95% of Qataris find employment in the public sector and fewer than 20% of Omanis work in the private sector. Governments find it hard to limit public sector hiring as oil revenues remain robust. **Over the long term, the cost of providing public sector jobs and other social benefits will become more challenging.** Although regional private sector perceptions exist about a rise in inflation, if nationalisation becomes more dominant, aggregate demand will also increase. **Labour changes will take place only when Gulf economies shift away from a low-wage/low-skills environment and open immigration is curtailed.** Productivity declines are unavoidable over the short term, but over the long term nationals will enter the workforce resulting in higher demand and lower remittances.

Tunisia and Egypt: A particularly dreaded summer

Only months after the overthrow of the regimes of Zine El Abidine Ben Ali and Hosni Mubarak, Tunisia and Egypt will be heading straight into a period of economic difficulty this summer, as unemployment and inflation rise.

Tunisia & Egypt: sharp rise in current account imbalances



Source: Crédit Agricole SA

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Tourism generates close to 7% of GDP in Tunisia and Egypt, and almost double that amount indirectly. The sector allows both countries to half-offset the trade deficits caused by oil and food imports. So far this year, tourist numbers have fallen by more than 50% YoY and hotels are laying off staff or gearing up to do so. Summer also has more challenges in store: Ramadan takes place in August this year, which will no doubt lead to further falls in activity and higher food consumption (food prices have already seen sharp rises, surging 200% YoY in the first quarter of 2011). Social tensions are therefore likely to be stoked by both high food price inflation – especially in Egypt, where it was running at over 20% in May – and the rise in the unemployment rate in the coming weeks. This autumn, there are elections for a constituent assembly in Tunisia and a parliament in Egypt, with campaigns due to kick off this summer. Once again, this will probably disrupt economic activity, tourism and investment plans.

The economic impact of the Tunisian and Egyptian revolutions, following a QoQ fall of over 7% in GDP in Q1, has not yet run its course. **To top up financing requirements – 5% of GDP for Tunisia in 2011 and over 10% for Egypt – financial support from multilateral agencies seems unavoidable in the electoral period now getting underway.**

Exchange rate forecasts

		30-Jun	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
USD Exchange rate								
Industrialised countries								
Euro	EUR/USD	1.44	1.34	1.30	1.27	1.24	1.21	1.18
Japan	USD/JPY	81	90	94	96	98	100	102
United Kingdom	GBP/USD	1.60	1.60	1.59	1.55	1.53	1.51	1.51
Switzerland	USD/CHF	0.84	0.97	1.03	1.09	1.13	1.17	1.21
Canada	USD/CAD	0.97	0.96	0.95	0.94	0.93	0.92	0.90
Australia	AUD/USD	1.06	1.05	1.06	1.07	1.09	1.11	1.12
New Zealand	NZD/USD	0.82	0.80	0.81	0.82	0.83	0.84	0.84
Asia								
China	USD/CNY	6.46	6.36	6.30	6.24	6.18	6.11	6.05
Hong Kong	USD/HKD	7.78	7.77	7.77	7.77	7.77	7.77	7.77
India	USD/INR	44.87	44.80	44.50	43.80	43.10	42.60	42.00
Indonesia	USD/IDR	8608	8500	8460	8420	8380	8340	8300
Malaysia	USD/MYR	3.04	2.98	2.96	2.95	2.94	2.93	2.92
Philippines	USD/PHP	43.4	42.1	41.5	41.2	41.0	40.7	40.5
Singapore	USD/SGD	1.23	1.25	1.24	1.24	1.24	1.23	1.23
South Korea	USD/KRW	1077	1065	1040	1030	1015	1000	985
Taiwan	USD/TWD	28.9	28.4	28.1	27.9	27.7	27.5	27.2
Thailand	USD/THB	30.8	29.4	29.2	29.0	28.8	28.6	28.4
Vietnam	USD/VND	20600	21400	21400	22100	22100	22800	22800
Latin America								
Argentina	USD/ARS	4.11	4.15	4.20	4.25	4.30	4.35	4.40
Brazil	USD/BRL	1.57	1.65	1.70	1.70	1.70	1.75	1.80
Mexico	USD/MXN	11.77	11.50	11.40	11.35	11.30	11.25	11.20
Africa								
South Africa	USD/ZAR	6.84	6.70	6.90	7.00	7.10	7.20	7.30
	TRY/ZAR	4.17	4.32	4.60	4.67	4.67	4.71	4.74
Emerging Europe								
Poland	USD/PLN	2.77	2.89	2.96	3.02	3.06	3.12	3.18
Russia	USD/RUB	27.98	30.96	31.81	30.71	32.29	33.34	34.14
	Basket/RUB	33.53	35.70	36.10	34.45	35.78	36.49	36.90
Turkey	USD/TRY	1.63	1.55	1.50	1.50	1.52	1.53	1.54
Euro Cross rates								
Industrialised countries								
Japan	EUR/JPY	116	121	122	122	122	121	120
United Kingdom	EUR/GBP	0.899	0.840	0.820	0.820	0.810	0.800	0.780
Switzerland	EUR/CHF	1.20	1.30	1.34	1.38	1.40	1.42	1.43
Sweden	EUR/SEK	9.17	9.00	9.05	9.10	9.15	9.15	9.15
Norway	EUR/NOK	7.78	7.80	7.70	7.80	7.70	7.60	7.40
Central Europe								
Czech Rep.	EUR/CZK	24.37	24.00	23.80	23.80	23.60	23.60	23.60
Hungary	EUR/HUF	266	267	265	265	265	265	265
Poland	EUR/PLN	3.99	3.87	3.85	3.83	3.80	3.78	3.75
Romania	EUR/RON	4.22	4.20	4.20	4.20	4.20	4.20	4.20

Source: Cr dit Agricole CIB

Interest rate forecasts – developed countries

	30-Jun	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
USA							
Fed funds	0.25	0-0.25	0-0.25	0-0.25	0-0.25	0.75	1.25
3M	0.25	0.40	0.40	0.45	0.50	1.00	1.40
2Y	0.45	1.25	1.70	1.85	2.00	3.00	3.50
10Y	3.09	3.65	4.10	4.25	4.40	4.60	4.75
Japan							
Call	0.07	0-0.10	0-0.10	0-0.10	0-0.10	0-0.10	0-0.10
3M	0.20	0.34	0.35	0.35	0.40	0.45	0.50
2Y	0.17	0.20	0.22	0.23	0.25	0.25	0.30
10Y	1.14	1.45	1.50	1.50	1.60	1.60	1.70
Eurozone							
Repo	1.25	1.50	1.75	2.00	2.25	2.50	2.50
3M	1.48	1.80	2.10	2.35	2.60	2.85	2.85
2Y (Ger)	1.56	2.50	3.00	3.40	3.40	3.40	3.40
10Y (Ger)	2.99	3.50	4.00	4.20	4.25	4.25	4.25
United Kingdom							
Base rate	0.50	0.50	0.75	0.75	0.75	1.00	1.25
3M	0.83	1.40	1.65	1.65	1.65	1.90	2.15
2Y	0.81	2.15	2.40	2.40	2.65	2.90	3.15
10Y	3.32	4.10	4.30	4.50	4.50	4.50	4.50
Sweden							
Repo	1.75	2.00	2.25	2.50	2.75	3.00	3.25
3M	2.47	2.60	2.85	3.10	3.35	3.60	3.85
10Y	2.91	4.15	4.35	4.45	4.60	4.75	4.85
Norway							
Deposit	2.25	2.50	2.75	3.00	3.25	3.50	3.75
Switzerland							
3M	0.18	0.50	0.50	0.75	1.00	1.00	1.25
10Y	1.71	2.45	2.60	2.85	3.00	3.10	3.25
Canada							
Overnight Target	1.00	1.25	1.50	1.75	2.00	2.25	2.50
Australia							
Cash Target	4.75	5.00	5.25	5.25	5.25	5.25	5.25
New Zealand							
Official Cash Rate	2.50	2.50	2.50	2.75	3.00	3.50	3.75

Note: 3M rates are interbank, 2Y and 10Y rates are government bond yields

Source: Crédit Agricole CIB

Interest rate forecasts – emerging countries

		30-Jun	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
USA								
	Fed funds	0.25	0-0.25	0-0.25	0-0.25	0-0.25	0.75	1.25
	3M	0.25	0.40	0.40	0.45	0.50	1.00	1.40
	2Y	0.45	1.25	1.70	1.85	2.00	3.00	3.50
	10Y	3.09	3.65	4.10	4.25	4.40	4.60	4.75
Japan								
	Call	0.07	0-0.10	0-0.10	0-0.10	0-0.10	0-0.10	0-0.10
	3M	0.20	0.34	0.35	0.35	0.40	0.45	0.50
	2Y	0.17	0.20	0.22	0.23	0.25	0.25	0.30
	10Y	1.14	1.45	1.50	1.50	1.60	1.60	1.70
Eurozone								
	Repo	1.25	1.50	1.75	2.00	2.25	2.50	2.50
	3M	1.48	1.80	2.10	2.35	2.60	2.85	2.85
	2Y (Ger)	1.56	2.50	3.00	3.40	3.40	3.40	3.40
	10Y (Ger)	2.99	3.50	4.00	4.20	4.25	4.25	4.25
Asia								
China	1Y lending rate	6.31	6.56	6.56	6.81	6.81	7.06	7.06
Hong Kong	Base rate	0.50	0.50	0.50	0.50	0.50	0.75	1.25
India	Repo rate	7.50	8.00	8.00	8.00	8.25	8.25	8.50
Indonesia	BI rate	6.75	7.00	7.00	7.00	7.25	7.25	7.25
Korea	Call rate	3.25	3.50	3.50	3.50	3.50	3.75	4.00
Malaysia	OPR	3.00	3.25	3.25	3.25	3.50	3.50	3.50
Philippines	Repo rate	4.50	4.75	5.00	5.00	5.00	5.25	5.25
Singapore	6M SOR	0.29	0.54	0.64	0.71	0.76	1.10	1.34
Taiwan	Redisc	1.75	1.88	2.00	2.00	2.00	2.25	2.50
Thailand	Repo	3.00	3.50	3.50	3.50	3.50	3.75	4.00
Vietnam	Base rate	9.00	10.00	10.00	10.00	9.00	9.00	9.00
Latin America								
Argentina	3M deposit	10.87	11.00	11.00	11.00	11.25	11.50	11.50
Brazil	Overnight/Selic	12.25	12.50	12.50	12.50	11.75	11.25	11.00
Mexico	Overnight rate	4.50	4.50	4.50	5.25	5.50	5.75	6.00
Emerging Europe								
Czech Rep.	14D repo	0.75	1.00	1.25	1.50	1.75	2.00	2.00
Hungary	2W repo	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Poland	7D repo	4.50	4.50	4.75	4.75	5.00	5.00	5.00
Romania	2W repo	6.25	6.25	5.75	5.50	5.50	5.50	5.50
Russia	O/N Deposit rate	3.50	3.75	4.00	4.75	6.00	7.50	9.00
Turkey	1W repo rate	6.25	7.00	8.00	8.00	8.00	8.50	9.00
Africa & Middle East								
South Africa	Repo	5.50	5.50	5.75	6.50	7.00	7.50	8.00
UAE	Repo	1.00	1.00	1.00	1.00	1.00	1.25	1.75
Saudi Arabia	Repo	2.00	2.00	2.00	2.00	2.00	2.25	2.75

Source: Crédit Agricole CIB

Economic forecasts

	Real GDP (YoY. %)			CPI (YoY. %)			Current Account (% GDP)		
	10	11	12	10	11	12	10	11	12
USA	2.9	2.4	2.9	1.7	3.1	2.0	-3.2	-2.9	-2.7
JAPAN	4.0	-0.7	2.9	-1.0	0.6	0.9	3.6	2.7	3.3
EUROZONE	1.7	2.0	1.6	1.6	2.7	1.9	-0.4	-0.4	-0.2
Germany	3.5	3.4	2.0	1.2	2.5	2.1	5.7	5.4	5.4
France	1.4	2.1	1.8	1.7	2.1	1.6	-2.1	-3.0	-3.2
Italy	1.2	0.8	1.2	1.6	2.8	1.9	-3.3	-2.8	-2.4
Spain	-0.1	0.5	0.9	2.0	3.2	2.2	-4.5	-4.0	-3.6
Greece	-4.4	-3.8	0.3	4.7	2.9	1.8	-10.4	-10.3	-7.7
Norway	0.3	0.7	2.2	2.4	1.7	1.8	14.0	15.0	13.1
Sweden	5.4	4.3	2.5	1.2	3.1	2.6	7.0	7.0	7.3
Switzerland	1.6	1.9	2.2	0.7	1.0	1.2	9.5	8.0	9.0
Canada	3.1	2.8	3.1	1.8	3.0	2.1	-3.1	-2.6	-2.3
Australia	2.7	3.1	3.4	2.9	3.5	3.3	-2.6	-3.5	-2.8
New Zealand	1.5	2.0	3.5	2.3	3.9	3.3	-2.3	-2.9	-2.7
United Kingdom	1.4	1.3	1.9	3.3	4.4	2.4	-2.2	-1.6	-1.2
Asia	9.2	7.8	7.9	4.6	6.0	4.6	3.6	2.6	2.3
China	10.3	9.3	9.0	3.3	5.3	4.0	5.2	3.3	2.7
Hong Kong	6.8	6.3	6.5	2.4	4.7	3.8	8.7	10.1	10.5
India	8.5	7.4	7.8	9.5	9.0	6.4	-2.8	-2.9	-2.8
Indonesia	6.1	5.8	5.8	5.1	6.1	5.8	0.9	1.5	1.7
Korea	6.1	5.1	6.0	3.0	4.1	3.6	2.8	2.8	3.1
Malaysia	7.2	4.0	5.5	1.7	2.9	2.5	12.8	11.5	11.6
Philippines	7.6	4.9	5.4	3.8	4.9	4.8	4.4	4.2	3.5
Singapore	14.5	6.7	6.9	2.8	5.6	4.0	22.2	23.8	23.6
Taiwan	10.8	5.8	6.3	1.0	2.4	2.8	9.4	8.2	8.3
Thailand	7.8	4.7	5.7	3.3	4.2	4.5	4.6	3.6	3.9
Vietnam	6.8	5.8	6.2	9.2	17.8	11.5	-5.5	-5.5	-5.2
Latin America	6.6	4.0	4.4	6.8	6.3	6.1	-1.2	-1.7	-1.8
Argentina	7.0	4.0	4.0	17.0	17.0	17.0	1.5	1.5	1.1
Brazil	7.5	4.0	4.3	5.8	5.0	4.5	-2.3	-3.0	-2.8
Mexico	5.3	4.0	4.8	4.2	4.0	4.0	-0.6	-1.0	-1.5
Emerging Europe	4.2	3.7	3.4	7.0	6.9	7.8	0.5	-1.3	-2.6
Czech Republic	2.3	2.3	2.5	1.5	2.3	2.0	-3.0	-2.8	-3.5
Hungary	1.2	2.3	2.5	4.9	4.3	3.5	2.3	1.0	0.0
Poland	3.8	3.6	3.5	2.6	4.3	3.1	-2.6	-4.5	-4.0
Russia	4.0	3.7	3.3	8.8	8.5	11.0	4.8	3.0	0.0
Romania	-1.3	1.5	2.9	6.1	7.0	5.0	-5.8	-6.9	-6.4
Turkey	7.5	5.0	4.0	8.3	7.0	7.0	-5.0	-7.5	-7.0
Africa & Middle East	4.2	4.2	4.3	5.0	5.6	5.2	4.2	4.2	5.3
Algeria	4.1	4.1	4.3	3.9	4.8	4.3	4.2	5.6	4.1
Egypt	5.2	1.9	4.0	11.1	10.0	9.3	0.3	0.4	1.8
Kuwait	3.2	3.5	4.4	4.0	4.2	4.3	32.1	29.1	28.3
Lebanon	7.5	1.3	6.0	4.3	5.6	3.0	-12.0	-15.0	-7.0
Morocco	3.2	3.5	4.4	1.4	3.0	2.7	-5.4	-13.0	-9.0
Qatar	14.0	15.8	6.0	-2.2	2.7	3.9	13.0	29.0	34.8
Saudi Arabia	3.8	5.5	4.4	5.3	5.6	4.1	9.5	9.7	9.9
South Africa	2.5	3.5	4.0	4.3	4.7	5.0	-3.5	-4.0	-4.0
United Arab Emirates	2.0	3.4	3.8	1.0	3.1	3.9	5.5	6.1	7.2
Tunisia	3.4	1.0	3.0	4.4	4.7	5.0	-1.5	-10.3	-3.3
Total	4.9	3.9	4.3	3.2	4.3	3.5	0.6	0.1	0.2
Industrialised countries	2.6	1.9	2.5	1.3	2.6	1.9	-1.0	-1.0	-0.7
Emerging countries	7.6	6.3	6.4	5.3	6.1	5.3	2.5	1.5	1.3

* For UK: HICP; for India: wholesale prices; for China, retail price index; for Brazil: IPCA, for South Africa: CPI-X

** For India: Fiscal year ending in March

Source: Crédit Agricole CIB

Economic forecasts – quarterly breakdown

	2010				2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP growth, %												
USA (annualised)	3.7	1.7	2.6	3.1	1.9	2.0	3.1	3.1	2.7	2.8	3.2	3.3
JAPAN	2.3	0.0	0.9	-0.7	-0.9	-0.8	1.1	1.8	0.8	0.2	0.3	0.4
EUROZONE	0.4	1.0	0.4	0.3	0.8	0.3	0.3	0.4	0.4	0.5	0.5	0.5
Germany	0.5	2.1	0.8	0.4	1.5	0.5	0.4	0.4	0.5	0.6	0.6	0.6
France	0.2	0.5	0.4	0.3	0.9	0.3	0.4	0.4	0.4	0.5	0.5	0.5
Italy	0.6	0.5	0.3	0.1	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Spain	0.1	0.3	0.0	0.2	0.3	-0.2	0.2	0.3	0.3	0.3	0.2	0.3
United Kingdom	0.4	1.1	0.6	-0.5	0.5	0.2	0.6	0.4	0.5	0.5	0.6	0.5
Consumer prices, YoY %												
USA	2.4	1.8	1.2	1.2	2.2	3.4	3.4	3.2	2.4	1.7	1.8	2.0
JAPAN	-1.2	-1.2	-1.1	-0.5	-0.2	0.8	1.1	0.7	0.7	1.0	1.0	0.8
EUROZONE	1.1	1.6	1.7	2.0	2.5	2.8	2.8	2.7	2.2	1.6	1.9	1.9
Germany	0.8	1.0	1.2	1.6	2.2	2.6	2.7	2.6	2.3	1.9	2.0	2.1
France	1.5	1.8	1.8	1.9	2.0	2.2	2.3	2.2	1.6	1.3	1.6	1.7
Italy	1.3	1.6	1.7	2.0	2.3	3.0	3.1	2.9	2.6	1.6	1.9	1.6
Spain	1.3	2.3	2.0	2.5	3.2	3.3	3.2	3.0	2.4	1.8	2.4	2.4
United Kingdom	3.3	3.4	3.1	3.4	4.1	4.5	4.6	4.1	2.9	2.1	2.3	2.3
Unemployment rate, %												
USA	9.7	9.6	9.6	9.6	9.0	9.0	8.8	8.5	8.6	8.5	8.3	8.2
JAPAN	5.1	5.1	5.0	5.0	4.7	4.9	5.1	5.1	5.0	4.9	4.8	4.7
EUROZONE	10.1	10.2	10.1	10.1	9.9	9.9	9.9	9.8	9.7	9.6	9.5	9.4
Germany	7.5	7.2	6.9	6.7	6.4	6.3	6.3	6.2	6.1	6.0	6.0	6.0
France	9.5	9.3	9.3	9.3	9.2	9.1	9.1	9.0	8.9	8.8	8.7	8.6
Italy	8.5	8.5	8.3	8.4	8.3	8.5	8.8	9.1	9.3	9.3	9.2	9.0
Spain	19.4	20.0	20.4	20.5	20.6	20.5	20.3	20.1	19.5	19.0	18.5	18.0
United Kingdom	7.9	7.8	7.9	7.9	7.7	7.9	7.8	7.8	7.7	7.7	7.6	7.6

Source: Crédit Agricole CIB

Economic forecasts

	Government balance			Public debt		
	10	11	12	10	11	12
USA	-8.9	-9.3	-6.9	62.1	68.9	73.4
JAPAN	-9.5	-8.9	-9.2	191.8	202.5	207.2
EUROZONE	-6.0	-4.0	-3.2	85.1	86.4	87.8
Germany	-3.3	-1.7	-1.4	83.2	82.0	81.0
France	-7.0	-5.7	-4.7	82.4	84.6	86.4
Italy	-4.6	-3.9	-3.0	119.0	119.7	121.3
Spain	-9.2	-6.2	-4.9	60.1	67.3	69.9
Netherlands	-5.4	-3.7	-2.2	62.7	64.4	65.7
Belgium	-4.1	-3.8	-3.7	96.8	97.3	99.4
Greece	-10.5	-8.5	-7.5	142.8	156.6	165.8
Ireland	-32.4	-10.3	-8.9	96.2	112.1	118.2
Portugal	-9.1	-6.1	-5.1	93.0	101.8	108.1
United Kingdom	-8.9	-7.8	-5.6	75.6	80.6	82.7

Source: Crédit Agricole CIB

Commodities forecasts

Oil price forecasts

Average prices		2010				2011				2012			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
WTI	USD/bl	79	78	76	85	94	103	86	81	80	73	77	83
Brent	USD/bl	76	78	77	86	105	118	97	92	91	85	89	95

End quarter prices		2010				2011				2012			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
WTI	USD/bl	84	76	82	91	107	95	84	81	77	75	80	84
Brent	USD/bl	80	75	83	93	117	108	95	92	88	87	92	95

Source: Crédit Agricole CIB

Metals forecasts

		30-Jun	2010	2011				2012					Long-term Prices	
			Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4		Year
Base metals														
Aluminium	USD/t	2,503	2,173	2,506	2,606	2,650	2,718	2,620	2,800	3,000	2,900	2,900	2,900	2,650 (120c/lb)
Copper	USD/t	9,312	7,537	9,633	9,140	9,250	9,575	9,400	10,000	10,500	10,150	9,750	10,100	4,960 (225c/lb)
Nickel	USD/t	23,048	21,807	26,905	24,236	22,860	22,000	24,000	23,000	24,000	24,000	23,000	23,500	15,432 (700c/lb)
Zinc	USD/t	2,294	2,159	2,394	2,248	2,200	2,398	2,310	2,400	2,500	2,600	2,700	2,550	1,764 (80c/lb)
Lead	USD/t	2,619	2,146	2,603	2,544	2,593	2,700	2,610	2,800	2,900	2,700	3,000	2,850	1,323 (60c/lb)
Tin	USD/t	25,766	20,364	29,917	28,610	29,000	32,473	30,000	34,000	36,000	34,000	36,000	35,000	15,000 (680c/lb)
Precious metals														
Gold	USD/oz	1,510	1,226	1,386	1,507	1,465	1,440	1,450	1,375	1,300	1,250	1,175	1,275	700
Silver	USD/oz	34.9	20.2	32.0	38.0	36.0	30.0	34.0	27.0	26.0	25.0	24.0	25.5	7.0
Platinum	USD/oz	1,725	1,609	1,790	1,785	1,800	1,905	1,820	1,925	1,950	2,000	2,045	1,980	1,200
Palladium	USD/oz	759	525	788	756	800	855	800	900	950	1,000	1,050	975	300

Source: Crédit Agricole CIB

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