

The financial crisis and its aftermath

No 125 - 3rd Quarter 2009
Copy Deadline: June 26, 2009

If we are to believe a certain number of leading indicators (the bounce in the equity markets, the fall in risk premiums, the steepening yield curve, a return to business as usual on the interbank market, more upbeat survey findings), we are close to the bottom of the cycle, marking the end of recession and the start of recovery. But while the indicators may be pointing in the right direction, all the talk right now is about a slowdown in the rate at which activity is shrinking rather than a genuine recovery. **However, the perception of reality has changed over recent months. Central to the change in perceptions is confidence, whose waxing and waning is still somewhat mystifying, but which is one of the forces driving the cyclical upturn.** To convince oneself of this, one only has to see just much of a vicious circle the US economy and financial system got itself into in the post-Lehman distress. Conversely, we could imagine that the simple return of confidence has fired them with a more virtuous momentum.

But confidence alone can't do everything. **The global economy has fed on financial excess that has to be corrected if we are to ensure that growth resumes on a healthier and hence stronger basis.** The surplus growth derived from excessive leverage against a backdrop of rising asset prices, and notably property assets, is not easy to calculate. But one gets the feeling that the dearth of lending and wealth, and the surplus capacity inherited from the crisis will put pressure on the process of acquiring and producing consumer durables, which is the traditional engine driving a vigorous, self-sustaining upturn in activity.

The nascent recovery looks like being sluggish and inflation-free, which is likely to create some challenges. On the central banks front, the drip-feed that is keeping some credit market segments alive should only be removed slowly and it will not be easy, either, to pick the right time to return to more conventional intervention methods. Another consequence of the crisis is that Central Banks' role as guarantors of the financial system's integrity has been reasserted, even if the practical aspects of this function as regards macro-prudential regulation have yet to be fully worked out. At all events, it will take a lot of dexterity to channel agent expectations due to the lack of historical pointers about ways of moving away from existing ultra-accommodating monetary policies. **For states, seeking to clean up the public accounts could also prove dangerous.** Forecasts of a return to balanced budgets are intimately

linked to underlying growth assumptions. These could prove over-optimistic, since there is a lot of talk about reverting to intact potential growth rates, which ignores the probable scars left by the crisis. What's more, the need for greater fiscal discipline will also have an adverse effect on growth. Uncertainty as to how sustainable public debt trajectories are, is thus likely to come back regularly to haunt the fixed-income markets. ■

1 SCENARIO LINES

MARKETS

- 2 –Do central banks move in mysterious ways?
- 3 –Interest rates: Revisiting 4%
- 4 –Exchange rates: Losing faith in the dollar

5 RAW MATERIALS & OIL MARKETS

UNITED STATES

- 6 –Weak recovery with low inflation
- 7 –Recovery in sight, but no done deal

JAPAN

- 8 –Stop contracting at last...

EMU

- 9 –No genuine recovery before 2010
- 10 –Is core inflation under threat?
- 11 –France: Fragile stabilisation in sight
- 12 –Germany: Unprecedented shock and residual risks
- 13 –Italy: Patience, patience... sluggish recovery in 2010
- 14 –Spain: No recovery in the offing
- 15 –Greece: Tough times ahead
- 15 –Portugal: Severe recession

OTHER EUROPEAN COUNTRIES

- 16 –United Kingdom: Light at the end of the tunnel?

OTHER COUNTRIES

- 17 –Emerging countries: Green shoots lacking fertilizer
- 18 –Asia: A self-centred boost
- 18 –India: Post-election optimism
- 19 –Mexico: Sharp recession, urgent reforms
- 19 –Brazil: Last in, first out
- 20 –South Africa: Recession and external deficit
- 20 –Middle East: & North Africa: Fiscal caution bears fruit
- 21 –Turkey: Tempered optimism
- 21 –CEEC: A political argument in favor of the euro

22 FORECASTS

Do central banks move in mysterious ways?

Central banks do not just act: they also communicate about what they do. Transparency in their decision-making has gradually become a necessary norm served by a well-oiled communication policy. But with the crisis, things have changed, challenging a strategy where words sometimes supplant deeds.

In normal times, such a communication strategy is logical. The time has long gone when monetary issues were discussed in secret and when the surprise factor was deemed effective. In recent years, central banks have realised the benefit of maintaining an open dialogue with the public and in particular with the markets. **Greater transparency and improved predictability for monetary policy decisions help to reduce financial market uncertainty and volatility at the same time as they contribute to the rational formation of expectations.** More than deeds, words, and the information they carry, are meant to nudge agent expectations towards the most likely interest rate trajectory. In the case of efficient markets, which adjust instantaneously, this strong anchoring guarantees efficiency and contributes to an improved transmission of monetary policy. In other words, deeds and words echo each other to serve central bank objectives effectively.

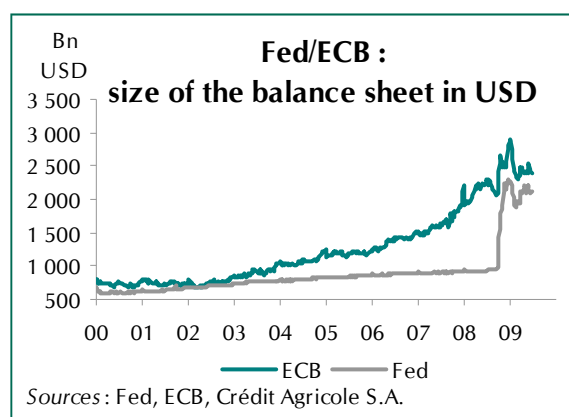
The present crisis has put this central bank communication policy to the test. Disoriented operators have fixed their attention on them in the hope of gleaning a few certainties in a prodigiously uncertain climate. Everything emerging from these institutions has been minutely dissected and analysed. At times this has played a stabilising role, at others it has also catalysed anxieties, proof that communication can be a two-edged sword.

On the one hand, the banks' firm commitment to provide liquidity at all costs in order to ease tensions on the money markets and help banks refinance has without doubt helped to safeguard the core of the system. On the other, their interventions as lenders of last resort or their rescue operations for troubled financial players have shaken the markets with emotive spasms. Hence the run on Northern Rock after the Bank of England admitted releasing emergency aid. The rules of transparency have made recourse to the discount window inoperative as it is deemed to carry too much stigma, forcing the central banks to innovate so that they can continue to play their role as lenders of last resort. We have also witnessed the Fed's powerlessness to prevent the wave of financial panic in the aftermath of the Lehman bankruptcy. Transparency and communication rules that are useful for pursuing conventional monetary policy proved deficient, if not counter-productive, when there was a need to preserve

financial stability. At a time when the role of system guarantor is regaining currency, this raises a number of doubts.

With the crisis, moreover, central banks have shifted into unconventional gear after exhausting all their conventional policy levers. From straightforward intermediaries they have sometimes become full-blown arbiters of trading on markets disrupted by the crisis. How then can they communicate, since this kind of shot in the arm interferes with the elementary rules of the "pure and perfect" competition so dear to the markets? How, too, can they convince people of their complete independence at a time when some of them are buying up sovereign debt? And how can they extricate themselves from the exceptional measures agreed at the height of the crisis and revert to more conventional types of intervention? Each of these questions represents a challenge that the central banks will have to take up. **It is clear that because their communication policy has now moved outside its well-established field, dialogue with the markets is entering a new learning curve.** There are bound to be teething troubles, as shown by the recent market excitement at the idea of a turn of the monetary screw in the US at the end of this year. It is true that any such move is unlikely in an environment over which the threat of deflation still looms (see US Focus), but if fixed-income markets were simply to adjust to such an assumption, it could jeopardise the nascent recovery.

We must hope that the learning process ends up by making central bank communication sufficiently audible and does not transform the open dialogue with the markets into a dialogue of the deaf. ■



Interest rates: revisiting 4%

In the first attempt at 4% by the UST, the market was probably running 6 months ahead of itself, but by the end of 2009 GDP growth should be pushing the zero barrier and so investors can cease talk of changes in the second derivative of growth and start thinking of actual positive changes in output. This should quash much residual talk of deflation and allow a final curve steepening in the US.

Is a 4% UST yield really so high?

The near doubling in US 10Y yields from 2-4% in the first 5 months of this year took many people by surprise. The move to 4% has since retraced but we expect to see it hit and then be breached over the coming year.

There is no doubt that when yields were at 2% they reflected a large deflation threat and that there was a massive risk-aversion trade benefiting bonds. Thus, it did not take much positive news to break the deflation trade and combined with heavy supply, there was little that the Fed could do to prevent a very large rebound in yields. The discussion point is whether they have gone too far. We argue that, so far, the rebound has taken yields closer to where they should be and that even incorporating a view that the economic recovery may be slow and the near term outlook for inflation is negative, we are still talking about a 10Y and not a 2Y yield.

To give an idea of the point of gravity for yields we have taken a medium term approach. Over a long time period, US nominal GDP has almost averaged the same as the 10Y UST yield. It turns out that the real 10Y yield tends to oscillate around trend GDP growth (we use a Hodrick-Prescott filter). We then estimate inflation expectations adaptively using exponentially-weighted core inflation rate. Combining trend growth and our inflation estimate gives us a strong feel as to what a 'normal' 10Y yield should be. **At the moment, it says that something around 4% is normal.** Of course, across the economic cycle the yield will sometimes be above and sometimes below such estimates. Other models we have suggest a current yield level of 3.4% would be normal, although if the ISM indicators continue to rise to around 50 then 4% should be hit by the end of the year.

The recovery is likely to be slow, but we believe that this is what is discounted by the libor futures. Libors usually rise at a pace of at least 50bp per quarter in a hiking cycle, the slope of the current libor futures is less than half this pace even though the starting point is lower. Because of this slow pace of recovery being discounted, we fear that next year the bearish market is likely to be increasingly driven by the front end of the curve.

For 2009 we see a less conventional bear market curve steepening. We note that usually the front end of the yield curve is more volatile, ie in economic recovery a curve flattens and vice-versa. However, this relationship inverts when there is a

deflation threat and this is one of the reasons why the curve has steepened so much recently. There are enough market commentators still talking about deflation to allow a little more curve steepening in response to stronger economic data. Additionally, the Fed is likely to scale down or may even end Treasury purchases, which would expose the bond market to the full-force of Treasury issuance.

Eurozone bond sweet spot at 20Y

We are not unhappy with current valuations for European bonds following the rise in yields since the start of the year. The deflation threat is very remote in Europe. In addition, the size of the securities purchases by the Central Bank is on a different scale compared to the US and UK and so we do not see much in the way of risk-free curve distortions once the covered bond programme kicks off.

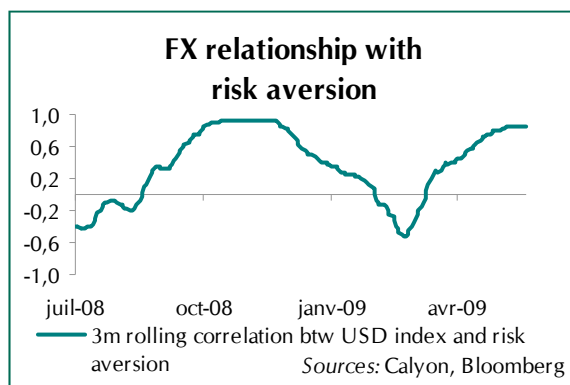
The growth dynamic for the Eurozone looks similar to that in the US, ie a shocking Q1, a bad Q2 with growth nudging the zero barrier in the second half of the year. Thus, it is no surprise that our forecasts entail a grind higher in 10Y yields for the remainder of 2009 and continuing in 2010 as anaemic growth resumes against a backdrop of still heavy bond supply. There are not too many points of the curve that we would buy, except perhaps the 20-25Y maturity spectrum. Globally speaking long bond yields are at fairly similar levels now compared to early 2007. The very long end of the curve has picked up a considerable term risk premium because of the cash flowing into the economy from the expansion of the Central Bank's balance sheets.

A large proportion of the term risk premium is justified because of the additional volatility that such large monetary and fiscal injections imply for GDP and inflation growth. The term risk premium is the price of fear and we believe that the current premium is creating a good level of protection should the inflation rate and growth accelerate more rapidly than the really benign consensus. We would pick the rather odd maturity of 20-25Y as our favourite because at higher tenors, the extra convexity advantage causes yields to decline quite rapidly. ■

Losing faith in the dollar

Currency markets continue to be driven by risk aversion, which will play more negatively for the USD as risk appetite improves. Nonetheless, we look for a slower pace of USD weakness in the months ahead. The EUR will struggle to take too much advantage of USD weakness due to bank worries and expectations of slower recovery.

Currency markets have remained highly correlated with equity market performance and in turn risk aversion, and there is little sign of this relationship breaking down. The USD effectively lost ground over most of the last quarter as a host of factors weighed on the currency. The USD had been a key beneficiary of rising risk aversion due to US investor repatriation and strong safe haven demand for US Treasuries, but **as risk appetite has improved the USD has borne the brunt of pressure.** We expect the USD to continue to weaken over the coming months but believe that the pace of weakness will slow as the currency looks increasingly oversold at present. In the near term we expect the USD to consolidate against most currencies. **Our FX forecasts are mainly predicated on a continued improvement in risk appetite through the remainder of 2009 and into 2010,** which will imply further downside for the USD and further upside for risk currencies.

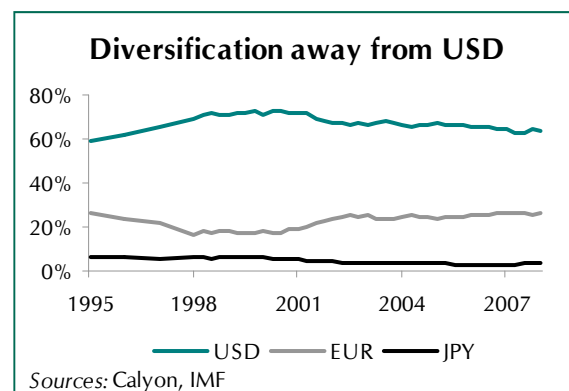


It is not only improved risk appetite that has weighed on the USD. **Many official investors and sovereign names have been reported to be growing increasingly nervous about holding US debt** against the background of massive bond supply to fund the burgeoning US fiscal deficit, potential inflationary impact of US quantitative easing and fears over a downgrade to US credit ratings. The danger to US markets if foreign investors shift rapidly away from US assets is significant. Foreign investors hold around 51% of the USD6.36tn in marketable US government debt outstanding. In 2008 foreign purchases of US Treasuries amounted to 77% of total buying of US securities. A drop in inflows to the US could lead to an acceleration in the pace of the decline in the USD.

A shift away from the USD as a reserve currency is undoubtedly taking place but it will be gradual and an ongoing process. It would be self-defea-

ting for foreign official investors to move quickly out of USD assets. Therefore, **investors should not be in a rush to sell USDs on the basis of fears about diversification alone** given that such fears are overdone. Comments from large reserve holders reflect these issues and even though these same countries are actively looking to reduce their reliance on the USD they will not risk anything that will result in a rapid depreciation in the USD. The USD will continue to weaken as risk appetite improves further over coming months. Further out the prospects of the USD will depend on the ability of both the Fed and the US administration to remove quantitative easing in a timely manner, and reduce the fiscal deficit to a more manageable level. There is no guarantee of either occurring but for now foreign central banks will have to take the gamble and not rush for the exit.

The EUR has managed to capitalise on general USD weakness but is likely to be restrained due to concerns about the pace of economic recovery and the banking sector. Whilst the US economy is set to see positive growth next year, albeit below trend, the Eurozone economy could see another year of decline in 2010. Moreover, the drop in growth in the Eurozone in 2009 is likely to be far steeper than in the US. The EUR has perversely benefited from relative inaction from the ECB as policy has been far more aggressive in the US in terms of quantitative easing, but the flip side of this is that Eurozone economic recovery will be far slower than in the US which in turn will limit the potential for further EUR appreciation to around 1.42 by year end. The JPY has been more resilient and has surprisingly not weakened despite the improvement in risk appetite. We do not expect this to continue and look for the JPY to weaken to 105 by year end. ■



Anticipating a demand-led recovery

Industrial metals have gained around 45%, since hitting a tough run in February, in response to the stabilisation of the global economy and financial markets, with a demand-led recovery being anticipated over the coming months.

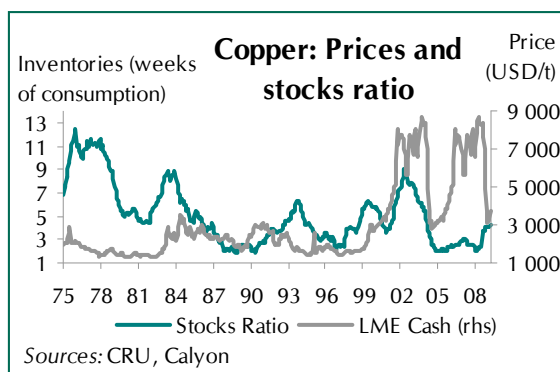
A weakening USD and rising inflation expectations continue to underpin both gold and silver, although improving risk appetite is likely to cap rallies in the short term. The current strength in copper prices is due more to positive market sentiment rather than any discernible improvement in the fundamental picture. Chinese stock building and a shortfall in scrap are important factors accounting for a draw down in refined copper inventories.

Prices recently peaked at just over USD5,300/t (240c/lb), an increase of 70% since the beginning of the year, as stabilisation of the global economy and financial markets (ie, not getting any worse) prompted waves of short-covering and fresh buying. **A pullback to USD4,000/t (181c/lb) is likely over the coming months as there is scope for disappointing macroeconomic data to emerge and demand will slow over the summer period resulting in a rise in inventories.**

A rally towards USD6,000/t (272c/lb) by year-end is indicated, provided we have clear evidence of a sus-

tainable recovery in global economic growth and demand. This would be consistent with copper's role as a barometer of economic strength and a developing world infrastructure metal. Global inventories are likely to peak below the levels seen in previous recessions.

Investors buy copper as a hedge against a falling USD and rising inflation expectations, as well as to get exposure to strengthening global growth. ■



Christophe BARRET
christophe.barret@uk.calyon.com

Oil Market

Recent price rally appears overdone

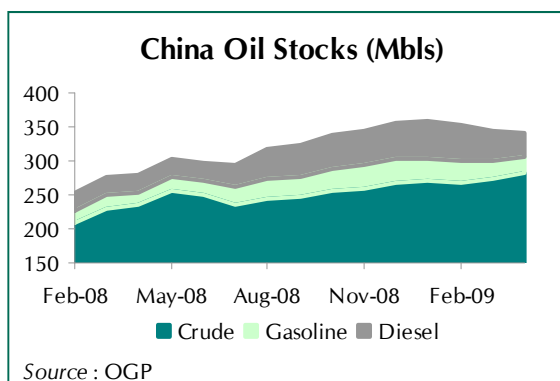
Oil prices remain above USD70/bl, consolidating gains versus April/May levels. Looking at fundamentals, however, the recent rebound in prices appears overdone and we expect prices to return to USD60/bl in Q3 before increasing to USD68/bl in Q409, as balances tighten.

Current fundamentals appear very weak, with high stocks, very weak demand and refiners under pressure. In addition, one of the factors supporting physical crude demand has disappeared: China announced on 3 June that it has stopped buying crude for its SPR (Strategic Petroleum Reserve).

After months of secrecy China started to communicate in regard to its Strategic Petroleum Reserve. Under the SPR programme China bought 100Mbls of crude, mainly sour/heavy grades, at USD58/bl on average. On average, the SPR filling has added 110kbd to Chinese oil demand in the past two and a half years. The buying binge for SPR has come to an end as current capacity is full and will only resume when capacity or the second phase, of which construction has recently started (170Mbls), is completed.

Strong imbalances are developing on the product side. While gasoline remains supported by lower y/y prices and the start of the driving season in the US, gasoil demand remains mediocre. Gasoil demand, closely related to industrial/trade activity, has suffered considera-

bly from the current recession. Gasoil produced in excess goes to stocks, a situation made possible by the prevailing contango on the diesel market (while gasoline is in backwardation), allowing traders and companies to store excess of gasoil in vessels. Refiners, having to meet gasoline demand while not increasing diesel supplies by too much, are put in a very difficult situation and are keeping runs low worldwide. ■



Weak recovery with low inflation

The worst is likely behind us as the US economy begins to stabilize in the second half of 2009. However, stabilization does not mean strong growth. Households need to save more and the impact of deleveraging will dampen the cyclical rebound. The large output gap suggests decelerating core inflation over the next year or so.

The US economy is beginning to stabilize. Initial claims for unemployment insurance have likely peaked and monthly payroll employment losses are expected to diminish in the months ahead, even though the unemployment rate (a lagging indicator) is expected to climb to about 10% this year.

Consumer spending remains soft as households cut back on spending to increase savings. The higher saving rate is a response to the nearly USD14 trillion decline in household net worth between Q2 2007 and Q1 2009 and to the increased risk of a period of unemployment. **Increased savings will eventually restore consumers' willingness to spend and pent-up demand will result in a boost to consumer spending.**

Another sign of stabilization is evident in the housing sector. Home price declines in many markets have increased demand from first-time homebuyers as well as investors who seek rental income. Single-family housing starts appear to have turned and overall residential investment spending is expected to be positive by Q4 despite a decline of over 20% for the year as a whole. Home prices will likely decline further this year as foreclosures increase; however, the rate of decline is expected to slow helped by foreclosure prevention programs implemented by Washington and by the second half of 2010 we look for home price declines near 2%-5% vs. 18% in mid 2009. In non-residential sectors, vacancy rates continue to climb and many smaller regional lenders have significant exposure to the sector, which may see credit availability constrained.

Business investment spending has been weak as firms faced with uncertain demand have tried to reduce costs by cutting or postponing capital spending plans. **Given record low rates of capacity utilization, we do not anticipate a genuine pickup in investment spending until the second half of next year.** The lack of investment does have the pernicious effect of lowering the economy's potential long-term growth. Firms have drawn down inventories significantly and further reductions are ex-

pected for Q2. However, the decline in business inventories is slowing (a positive for GDP growth) and eventually some restocking will be needed as growth revives. This will lead to a pick up in orders and shipments, providing a temporary lift to output. This will be evident in a rising ISM purchasing managers' index.

However, the recovery that we project in 2010 (+1.5%) is well below what one might expect given the historical pattern that severe recessions are generally followed by strong recoveries. We see the business cycle recovery weighed down by the impact of deleveraging. The debt to GDP ratio moved significantly above its long-term trend and will likely take several years to revert.

The policy response to the worst downturn since the great depression has been quite significant. The fiscal stimulus package could add around 1.4 percentage points to growth this year and another point in 2010. The effectiveness of the spending impact may be somewhat reduced by higher interest rates due to concerns over rising public debt to GDP ratio.

The Fed's response has also been very assertive. The expansion of the Fed's balance sheet is unlikely to cause inflation in the near term given the decline in the velocity of money. Moreover, the Fed is committed to removing the exceptional accommodation that they have put in place when appropriate. And the large output gap will take a long time to reduce given the expected sub-par recovery. This large amount of slack will lead to a deceleration in core inflation to under 0.5% in the second half of 2010. **If our inflation expectations are correct, then the Fed may not have to alter the target Fed funds rate for an extended period.** While we see some steepening of the curve as the recovery will reduce the risk aversion that has benefited Treasuries, our inflation forecast suggests that there is a limit to the upside movement in long rates as a sharp rise in real rates could put the recovery at risk for a relapse in 2011. ■

United-States (a)	2008	2009	2010	2008				2009				2010			
				T1	T2	T3	T4	T1	T2	T3	T4	T1	T2	T3	T4
GDP	1.1	-2.8	1.5	0.9	2.8	-0.5	-6.3	-5.5	-1.5	-0.5	0.7	1.9	2.8	2.9	2.7
Private Consumption	0.2	-1.0	1.3	0.9	1.2	-3.8	-4.3	1.4	-0.4	-0.7	0.7	1.9	2.1	1.9	2.4
Equipment and Software Investment	-3.0	-23.4	-3.6	-0.6	-5.0	-7.5	-28.1	-33.7	-28.0	-15.0	-12.0	0.0	5.0	10.0	15.0
Residential Investment	-20.8	-22.1	4.8	-25.0	-13.3	-16.1	-22.7	-38.8	-18.0	-8.0	1.6	2.0	14.0	22.0	21.0
Change in Inventories (b)	-0.3	-0.1	0.4	0.0	-1.5	0.8	-0.1	-2.2	1.3	0.7	0.7	-0.2	0.4	0.6	-0.1
Net Exports (b)	1.4	0.8	-0.2	0.8	2.9	1.1	-0.2	2.4	0.1	0.0	-0.2	-0.1	-0.1	-0.5	-0.6
Saving Rate	1.8	5.6	6.6	0.2	2.5	1.3	3.2	4.3	6.4	5.7	6.1	5.9	7.1	6.6	6.7
Unemployment Rate	5.8	9.2	9.8	4.9	5.4	6.0	6.9	8.1	9.3	9.5	9.9	9.9	9.8	9.8	9.7
CPI (qoq, %)	3.8	-0.8	1.2	4.5	4.5	6.2	-8.3	-2.4	0.5	1.6	1.4	1.3	0.9	1.5	0.6
Current account balance (% of GDP)	-4.9	-3.1	-3.2	-5.1	-5.3	-5.1	-4.4	-2.9	-2.9	-3.1	-3.3	-3.3	-3.1	-3.4	-3.3

(a) annualized

(b) contribution to GDP growth (%)

Recovery in sight, but no done deal

If we are to believe a number of leading indicators in both the financial and real economy sectors, the business cycle could be close to bottoming. However, the exact timing and strength of the recovery remain shrouded in uncertainty

The bottom of the cycle officially marks the end of the recession and the beginning of the recovery. The trough corresponds to the low point in economic activity with the National Bureau of Economic Research making the determination of business cycle peaks and troughs on the basis of four monthly coincident indicators (jobs, income, retail sales and industrial production) and quarterly GDP. The recovery is not yet at hand as activity continues to contract. But the rate of decline has slowed significantly and a number of leading indicators in the financial sector and real economy alike, suggests that the recovery may not be far off.

In the financial sector, the rebound in the equity market, the easing of risk premiums, the steepening of the yield curve and the return to business as usual on the interbank market are all signs of reduced risk aversion. This makes for a better transmission of monetary policy to economic activity, facilitating a virtuous circle. The new-found calm on the financial markets mechanically adds value to assets, with attendant beneficial effects on balance sheets, lending and wealth and hence on economic growth. Thus disruptive risk aversion is followed by constructive confidence.

The signs of a recovery are there, but they need to endure. However, stock markets could relapse as they need continued upside surprises to fuel the rally. And their hopes of a rapid, strong recovery may be overly optimistic. **This is why the recovery is not yet a done deal. Nonetheless the necessary conditions appear to be falling into place.**

The stock market rebound is not the only signal; the steepening yield curve is also a leading indicator of economic recovery. If the increase in long-term interest rates reflects market concerns over ballooning public debt levels and the threat of inflation embedded in the Fed's balance sheet expansion, rather than the normalization of economic activity and dissipation of risk aversion then the signal would be attenuated. However, in our view, the signal is valid insofar as a) monetary policy is ultra-accommodative and its effects have yet to be felt (in addition to those of the fiscal stimulus), b) confidence is returning, c) the credit crunch is becoming less tough, and d) monetary and financial conditions are less unfavourable.

On the real economy front, the strongest signal is the **uptick in confidence. This is a decisive factor in cyclical upswings. Higher confidence levels are favourable to more active spending behaviour.** However, it should be noted that surveys are still at depressed levels. The ISM survey of the business sentiment in the manufacturing sector, in particular, is still a long way from the critical 50-point threshold above which activity in this sector is expan-

ding. The surveys show that the easiest bit of the journey has been travelled, namely to correct the excesses of the post-Lehman sell-off. But will the upturn in confidence be self-sustaining? The answer, provided expectations materialise, is yes. Yet to our mind, this is not guaranteed. The road to recovery is not all mapped out and looks set to be long and convoluted, as there are many brakes on recovery, including higher unemployment, limited access to credit, negative wealth effects and over-capacity. The fall in the numbers of people filing for unemployment insurance benefits, the stabilisation in building permit numbers and the rebound in delivery times should all be added to the list of encouraging, but still timid, changes. We should remember that the level of 500,000 weekly filings for initial unemployment insurance benefits is seen as a critical threshold below which the signal of the end to recession is unmistakable. One must guard against relying on a single indicator but it could be a worthwhile indicator to follow. Still a few signals are still missing, such as an upside trend in weekly working hours in manufacturing, and new orders.

We will be sure that recovery is underway when we see corroborating signals that activity is picking up and that growth is looking healthier, i.e. when we have evidence testifying on the one hand that agents have a new-found ability and desire to spend, and on the other that they intend to spend more actively or are effectively committed to doing so. In the first instance, the lagged indicators come into play, and in the second, the leading indicators.

For the time being, all we are seeing is a slowdown in the rate at which activity is shrinking and not a genuine upturn. And stability is not either synonymous with recovery. But we will probably pick up the signal of recovery before the signal of restructuring. Judging by debt ratios and inventory-to-sales ratios in the trade, manufacturing and real estate sectors, there are still large-scale imbalances to correct. The process of purging these has, nevertheless, begun: the lagging economic index has been falling for some months and at a faster rate than the coincident composite indicator.

Ultimately, predicting a precise date for the trough is still very risky. The outlook for recovery over the coming months in the four coincident indicators is anything but similar, and they are unlikely to materialise simultaneously. We will also probably have to cope with an additional difficulty, namely that of a (third) jobless recovery. **At present, we believe the cyclical trough will come between late 2009 and early 2010.** It is impossible to be more definite. ■

Stop contracting at last...

After losing 8.4% of value-added in a space of 4 quarters, quarterly growth rate is finally to turn positive in Q3 2009 albeit with 0% growth expected for Q2. On the fiscal front, we are of different view from the concern Japan will suffer from the “twin deficit” of budget and current account deficit.

After real GDP contraction posted historical record in Q4 2008 with -3.6% q/q (annualized -13.5%), the record was only to be put to the second place by the following quarters' loss in value-added with Q1 2009 real GDP -3.8% q/q (annualized -14.2%). With the quarterly growth rate staying negative for 4 straight quarters, the size of the Japanese economy shrank by as much as 8.4% compared to the peak in Q1 2008.

The breakdown of the loss in real GDP shows the clear impact of the global economic recession.

Since the previous expansionary period started with January 2002 as a trough, the Japanese economic structure has been that much of economic growth is driven by export that is also supported by the China's participation in the World Trade Organization in December 2001 and accompanying steady demand for capex to support export-driven production. This is well evidenced by looking at the percentage share of capex and exports with the former steadily growing to take up 16.1% of real GDP as of Q1 2008 compared to 13.8% in Q1 2002 and the latter increasing its presence to 16.4% compared to just a 10.4%. With this economic structure and given the collapse in the global demand, capex, compared to Q1 2008, contracted by 20.1% and export by 36.8% thus explaining much of the overall real GDP contraction during this crisis period.

Looking ahead, we expect that quarterly real GDP growth will finally stop contracting in Q2 2009 at zero% growth with rebound in household consumption and exports offset by continued contraction in capex and residential investment. While exports are showing signs of recovery, imports are also picking up and contribution by net exports as a result will not improve much. While our forecast stands that quarterly real GDP growth rate will then turn positive in

Q3 2009 assuming continued recovery in exports, with economic activities expected to stay well below trends or at least take much time to recover pre-crisis levels, labour market conditions will be severely hit by the process as recovery in labour market tends to lag behind pick-up in production and the unemployment rate will go up close to 6% towards the end of 2009.

On the market front, **there appears a rising concern, given the significant impact of global economic recession on the Japanese trade and thus current account surplus, that Japan might suffer from “twin deficits”** of budget and current account deficits with the largest stimulus package's spending expected to weigh on already weak government's fiscal position. **However, our view stands different from the concern and expects the government will have no major problem in financing its deficit.** While current account surplus might become narrower into periods ahead due to less trade surplus and less interest income on foreign bond holdings due to yen's appreciation and accommodative monetary policies globally, remember Japan yet has a huge accumulation of external assets and thus is a “matured creditor nation” with positive net assets position that will create steady income flow.

Also, despite that Japanese debt-GDP ratio is above 170%, given increasing government bond issuance also in other major economies and higher volatility in currency market, do the Japanese investors, famously known as excessive savers, stop buying JGB in consideration for the concern that the government could stop paying interest and redemption? After all, more than 90% of JGB is held by domestic investors and they now have even fewer choices. All in all, while the government sector's deficit is likely to be wider, it will have no problem in financing its borrowing. ■

Japan (a)	2008	2009	2010	2009			
				T1	T2	T3	T4
GDP	-0.7	-6.4	1.7	-3.8	0.0	0.5	0.4
Private Consumption	0.6	-1.1	1.2	-1.1	0.6	0.2	0.1
Investment	-4.0	-19.9	0.6	-8.9	-5.2	-1.2	-0.2
Change in Inventories (b)	-0.2	0.2	0.0	-0.2	-0.1	-0.1	0.0
Net Exports (b)	0.2	-3.7	0.4	-1.4	0.3	0.2	0.1
Industrial Production	0.0	-23.5	9.6	-22.7	9.1	4.9	1.6
Unemployment Rate	0.0	5.3	5.4	4.4	5.1	5.7	5.8
Core CPI (yoy, %)	0.0	-1.1	-0.1	0.0	-1.0	-2.2	-1.1
Public debt (% of GDP)	180	185	190				

(a) annualized

(b) contribution to GDP growth (%)

No genuine recovery before 2010

The recession worsened in the eurozone in the first quarter, with GDP shrinking 2.5% q/q. External support factors and fiscal and monetary stimuli raise hopes that activity will stabilise in the second half of the year, with a gradual recovery in 2010.

The worsening of the recession in Q1, when GDP shrank 2.5% q/q compared with 1.8% q/q in the previous quarter can be put down to the collapse in both domestic demand and exports. Inventory downsizing also adversely impacted the quarterly growth figure (-0.9 percentage point). The fall-off in activity is affecting all the eurozone countries, but it has been particularly severe in Germany, at 3.8% q/q.

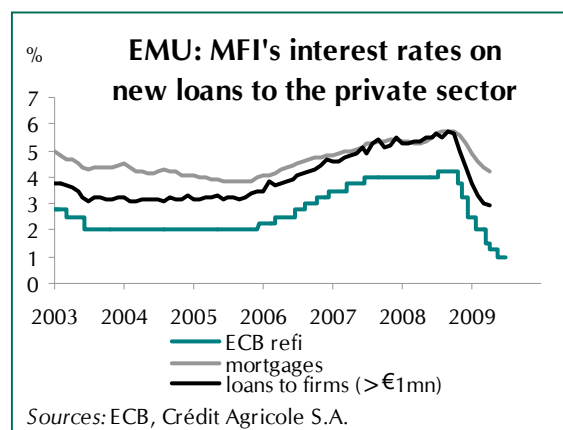
We are forecasting a less marked fall in GDP in Q2, of 0.8% q/q, and we expect to see it stabilise by year-end 2009. The improvement noted in most surveys since April suggests that the business climate is on the mend, although the present level of these indicators actually suggests that activity is still shrinking. By year-end, growth should become slightly positive on the strength of a less negative global environment and fiscal and monetary support measures. In the meantime, cyclical effects could come into play via the rebuilding of inventories and industrial capacities, thereby introducing volatility into the national accounts data. **All in all, GDP is forecast to fall by 4.5% over 2009 as a whole.**

No significant pick-up in activity seems likely this year, insofar as uncertainty remains high and domestic risk factors have stacked up. The bleak outlook for demand, the low levels of confidence and industrial capacity utilisation suggest that business investment will continue to trend down until year-end. Household consumption has every chance of remaining weak as the situation on the labour market is adversely affecting income. The unemployment rate is forecast to stand at 9.5% by end-2009.

The positive effects of support factors should be felt more some time around mid-2010. Exports will benefit from the upturn in global trade, especially in the most open economies. Overall, growth should only come in at a scant annual 0.2% in 2010 given unfavourable base effects.

Despite the severity of the recession, the ECB has consistently rejected calls for a zero interest rate policy and quantitative easing measures along the lines of those applied by the Federal Reserve and the Bank of England. It justifies its overall approach, qualified as "indirect or endogenous credit easing", by the preponderant role of banks in financing a European economy that is still largely intermediated. The ECB cut its main refinancing rate from 1.5% to 1% in Q2, and it is highly likely that it will hold it at this level, which it considers "appropriate", for several quarters. At the same time, it has again extended its measures to enhance interbank liquidity by offering 12-month loans to banks at full allotment. The fall in money market rates has gathered pace and at the end of the chain, the interest rates applied by commercial banks on new loans to the private sector have also significantly decreased.

The ECB also took the markets by surprise by announcing a programme to purchase 60 billion euros-worth of covered bonds, although placing large-scale restrictions on eligible assets. Its aim is to ease banks' mid-term financing constraints and encourage the distribution of credit. Just how effective such measures are, though, is debatable, as is the related exit strategy. ■



EMU	2008	2009	2010	2008				2009				2010			
				T1	T2	T3	T4	T1	T2	T3	T4	T1	T2	T3	T4
GDP	0.6	-4.5	0.2	0.7	-0.3	-0.3	-1.8	-2.5	-0.8	0.2	0.0	0.1	0.1	0.2	0.3
Private Consumption	0.3	-1.0	0.3	0.1	-0.3	0.1	-0.4	-0.5	-0.3	0.0	0.1	0.0	0.2	0.2	0.3
Investment	-0.3	-9.6	-0.3	1.1	-1.3	-1.0	-4.3	-4.2	-1.8	-0.5	-0.2	0.1	0.2	0.4	0.4
Change in Inventories (a)	0.2	-0.7	0.0	0.0	0.0	0.2	0.5	-0.9	-0.6	0.3	0.0	0.0	0.0	0.0	0.0
Net Exports (a)	0.0	-1.4	-0.1	0.2	0.2	-0.7	-1.0	-0.4	0.3	-0.1	-0.1	0.0	-0.1	0.0	0.0
Industrial Production	-1.8	-18.2	-2.9	1.7	-1.9	-2.9	-6.4	-7.8	-4.5	-1.9	-2.3	-0.8	2.5	-0.5	0.5
Unemployment Rate	7.5	9.3	10.3	7.2	7.3	7.5	8.0	8.7	9.2	9.4	9.8	10.0	10.1	10.4	10.4
CPI (yoy, %)	3.3	0.4	1.4	3.4	3.6	3.8	2.3	1.0	0.2	-0.1	0.7	1.4	1.5	1.4	1.3

(a) contribution to GDP growth (%)

Is core inflation under threat?

The slump in inflation has revived deflation anxieties in the eurozone, but the probable fall in the level of potential growth suggests less downward pressure on prices. We are forecasting that core inflation will remain moderate until end-2010.

The eurozone's harmonised index of consumer prices (HICP) continued to fall in the second quarter, reaching the psychological threshold of 0% year-on-year in May, compared with 0.6% in April. This disinflation trend, which is moving faster than initially forecast, can mainly be explained by the powerful base effect engendered by the collapse in oil prices since last summer (-11.6% y/y). Yet although the May figure revived fears of deflation, what we are currently seeing is less an across-the-board fall in prices than a deformation of relative prices, which looks like being short-lived. Energy prices could again contribute to inflation from year-end and base effects could again become unfavourable for food prices also. In view of this, it seems more to the point to consider the trends in core inflation.

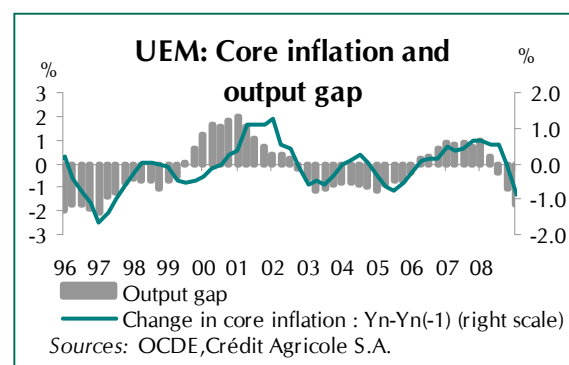
To date, core inflation as measured by the HICP excluding energy, tobacco products and non-processed foods stands at around 1.5%, slightly lower than the levels recorded late last year. In particular, the rate of increase in prices for services (up 2.1% y/y) and non-energy manufactured products (up 0.8% y/y) has been gradually slowing since the start of this year, but these essential inflation components, which respectively account for 41% and 30% of the HICP, show no clear sign of stalling at present. Furthermore, deflationary fears have not materialised in economic agent expectations. While it is true that businesses, households, forecasters and investors are all expecting to see a marked slowdown in the rate of inflation over the next two years, there is no way that inflation rates will remain negative for any extended period of time.

The concerns are no less real for all that, as the fall-off in activity entails a considerable downside threat to core inflation. The overcapacity inherited from the crisis, together with higher unemployment and an extremely negative output gap, will normally drive downward pressures on all prices. The question is, how far?

Over the longer term, one can see a strong correlation between changes in the output gap and changes in core inflation over one year. A negative output gap goes hand-in-hand with a slowdown in core inflation as seen in 1996-1998 and 2003-2006,

with a time-lag of about four quarters. But these changes in the output gap are based, as so often, on the assumption that potential GDP growth is stable at around 2% over the period. Yet the scale of the shock to European economies has probably triggered a reduction in potential GDP via the collapse in investment, capital decumulation and falling productivity. Most international institutions are effectively forecasting a net fall in potential GDP in 2009-2010 whatever the methods used for the estimations (production function or statistical method such as the HP filter). According to the European Commission, France and Germany may shed around 0.4 of a point and Spain 1.4 points. Yet the scale of deflationary pressures applied by the output gap, which in a sense measures the tensions in the productive sphere, will depend on fragile assumptions concerning the level of potential GDP. We can, however, argue that the probable fall in long-term growth will limit downward pressures on core inflation.

The current period is characterised by considerable volatility in headline inflation as well as in core inflation, but on the basis of our own forecasts, the latter should gradually moderate, falling to 1% by end-2009. The transmission of lower energy prices to some sectors is not yet complete, notably as regards the reduction in the cost of intermediate consumption. The slowdown in activity will also lead to moderation in price increases, notably in services. Last, the rate of increase in nominal salaries is also likely to slow rapidly this year. All in all, the presence on non-negligible nominal rigidities in Europe combined with a likely drop in potential GDP means that we are unlikely to see a deflation scenario materialise in the mid-term. ■



Potential GDP estimation (Estimation approach: Production function)										
	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010
France	2.1	1.7	1.7	1.7	1.7	1.6	1.6	1.3	0.9	0.7
Germany	1.5	1.1	1.1	0.9	0.8	0.9	0.9	1	0.7	0.8
Italy	1.5	1.2	0.9	0.8	0.6	0.7	0.9	0.6	0.1	0.5
Spain	3.9	3.6	3.7	3.4	3.3	3	2.9	1.6	0.2	0.2

Source: European Commission

Fragile stabilisation in sight

French growth fell sharply in the first quarter of 2009 (-1.2% q/q). We are forecasting a more modest fall-off in activity in the second quarter and a stabilisation in the second half. Over the full year, GDP is forecast to shrink by 3% in 2009. A modest recovery is expected in 2010 (+0.5%).

Economic activity again contracted sharply in the first quarter of 2009, by 1.2% q/q. Domestic demand again fell due to further falls in investment spending by business and households. Private consumption continued to grow. Foreign trade made no contribution to growth, while changes in inventory levels continued to adversely affect growth.

In the short term, the available data suggest that activity bottomed out in Q1 2009. That said, caution is in order, as the economic situation is still extremely fragile. Confidence surveys point to a further deterioration in activity in Q2, but at a slower pace than in the two previous quarters. For our central projection, we are forecasting that GDP will shrink by around 0.7% q/q in Q2 2009.

Above and beyond this, emerging from the recession is likely to be a delicate matter. By year-end, we expect confidence to improve gradually and the economic deterioration to peter out. A marked rebound in activity levels seems unlikely as the positive effects of the government's support measures are more than offset by a range of negative factors such as weak global demand, sharply rising unemployment, and general uncertainty. We should accordingly be looking at a very sluggish, U-shaped recovery, with virtually no growth at all in the second half. **All in all, over 2009 as a whole, French GDP should shrink by 3% on average.**

The rate of growth in household consumption is set to slow sharply, but should remain at a positive 0.6% in 2009. For one thing, in the short term household purchasing power will benefit from disinflation (0.1% in 2009), from increased benefit payments and the raft of measures enshrined in the recovery plans, such as the car scrappage scheme, or tax cuts for low-income families. For another, the rate of increase in gross disposable income should slow sharply, since lower job creation and rising unemployment (9.5% in Q4 2009) are likely to adversely impact income from activity. As a result,

households will, in all likelihood, step up their precautionary savings, taking the personal savings ratio in 2009 to an average 15.9%, compared with 15.3% in 2008.

Firms' investment spending is set to fall sharply in 2009, by a forecast 7.7%. Industrial capacity utilisation rates have hit record lows and are still falling, and the outlook for demand is unpromising. Corporate profitability has also deteriorated markedly and lending conditions remain difficult. A slight pick-up in capital investment is expected some time in 2010, once activity has stabilised.

Residential investment should also continue to fall, by 6.5% in 2009. The housing market as a whole continues to shrink due, eg, to wait-and-see buyers, general uncertainty and high prices. Even so, in the short term, the new housing market is showing signs of recovery as inventories fall and sales start to pick up on the strength of attractive sales offers from promoters and the fiscally attractive Scellier scheme.

Foreign trade should have a further severely adverse impact on growth in 2009, and a little less in 2010, at -0.8 and -0.4 percentage points respectively. We are expecting a marked drop in exports, especially in 2009 (-10.6%). Imports are unlikely to fall as much (-7.3%), because private and public sector consumption spending continues to grow, albeit slowly.

The scale of the deterioration in the labour market is the main risk surrounding our mid-term central projection. We saw a sharp drop in employment in early 2009, with a fall of 192,000 jobs, mainly in the traded sector, in Q1. Given that employment generally adjusts to changes in activity levels with a certain time-lag, there is the threat of a further deterioration over the coming quarters. This would further impact domestic demand and could compromise the timid uptick in the French economic cycle forecast for 2010 (+0.5% on average). ■

France	2008	2009	2010	2008				2009				2010			
				T1	T2	T3	T4	T1	T2	T3	T4	T1	T2	T3	T4
GDP	0.3	-3.0	0.5	0.4	-0.4	-0.2	-1.4	-1.2	-0.7	-0.1	0.1	0.2	0.3	0.3	0.3
Private Consumption	0.9	0.6	1.2	-0.2	0.0	0.1	0.1	0.2	0.1	0.2	0.3	0.3	0.4	0.4	0.4
Investment	0.6	-6.8	-0.9	1.0	-1.5	-1.0	-2.5	-2.5	-1.6	-1.0	-0.6	0.1	0.2	0.3	0.2
Change in Inventories (a)	-0.3	-1.4	-0.1	0.1	0.2	0.0	-0.7	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0	0.1
Net Exports (a)	-0.3	-0.8	-0.4	0.2	-0.4	-0.2	-0.3	-0.1	-0.2	-0.1	-0.1	-0.1	0.0	-0.1	-0.1
Industrial Production	-3.1	-14.5	-3.5	0.6	-2.1	-1.0	-7.5	-8.4	0.1	-1.0	1.8	-5.6	0.9	-0.5	3.4
Saving Rate	15.3	15.9	15.8	15.4	15.1	15.0	15.8	15.9	15.9	15.8	15.8	15.8	15.8	15.7	15.8
Unemployment Rate	7.4	9.1	9.8	7.2	7.4	7.4	7.6	8.7	9.0	9.3	9.5	9.6	9.7	9.9	10.0
CPI (yoy, %)	2.8	0.1	1.6	2.9	3.3	3.3	1.8	0.6	-0.2	-0.5	0.5	1.4	1.5	1.7	1.7

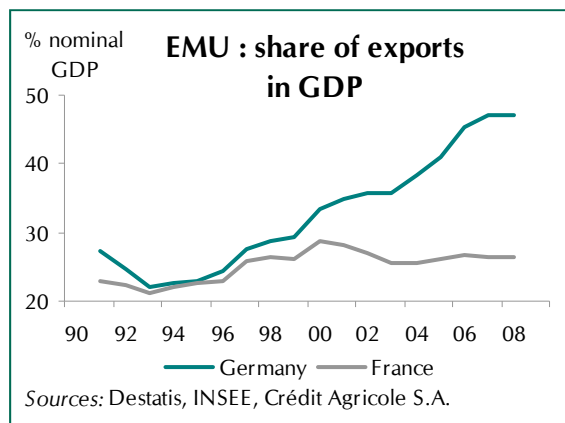
(a) contribution to GDP growth (%)

Unprecedented shock and residual risks

Activity is forecast to stabilise after GDP slumped in the first quarter (-3.8% q/q), but uncertainty remains high. Rising unemployment, the restructuring of the banking sector, and slippage in the public finances could all adversely affect Germany's mid-term growth prospects.

Germany is the country that has suffered the biggest shock in the eurozone. The record 3.8% q/q contraction in activity in the first quarter (an annualised 15.2%) resulted in a 7% cumulated fall in real GDP since early 2008. By way of comparison, activity has shrunk by "only" 3% in France and 4% in the UK.

The collapse of GDP at the start of the year can mostly be explained by falling exports (down 9.7% q/q) and investment (down 7.9% q/q). External demand made a negative contribution to growth for the third quarter running, at 2.3 percentage points. Never in the past had exports seen such a sharp fall over such a lengthy period. The shock is especially brutal for a country like Germany, where the share of exports in GDP, especially to Eastern Europe and Asia, has been growing steadily since the late 1990s.



1— Estimate based on European Commission fiscal multipliers (Economic Forecasts – Spring 2009, box 1.6.1).

The slump in addressed demand and profits (down 15% q/q in Q1) led in return to massive corporate disinvestment. Investment spending on capital goods, at nearly 45% of the total, is in free-fall, down 16.2% q/q in Q1. The rate of capacity utilisation in the industry has continued to fall in 2009, to a record low of 71.5%. In view of this, it seems unlikely that we will see any lasting recovery in investment in the short term, a surmise borne out by business leader investment intention surveys. **In the**

short term, the drop in industrial production, low investment spending and firms' continued inventory cuts could lead to further GDP shrinkage in Q2. The inventory component of PMI and European Commission surveys effectively suggests that down-sizing still has some way to run. The rate of GDP contraction however is set to be more modest than in Q1 in view of the likely stabilisation of net exports.

The main unknown quantity is the household spending profile. Private consumption rebounded by 0.5% q/q in Q1, sustained by one-off incentives of the scrappage scheme type, but the ongoing deterioration in the labour market poses a medium-term threat to household confidence and spending. The economic recovery plan, whose full effects should be felt in the second half as a result of tax cuts and lower social security contributions, should stave off a collapse in consumption.

In all, the fiscal stimulus represents around 1.5% of GDP in 2009 and 1% in 2010, for an estimated total impact on growth of +1.75%¹. **However, the combination of these discretionary measures and the rise in the cyclical component of the deficit driven by the automatic stabilisers threatens to send public spending soaring.** The Finance Ministry is currently forecasting a public deficit of 4.4% of GDP in 2009, compared with a deficit of 0.1% in 2008. However, not only could this forecast prove over-optimistic, but the deficit also threatens to grow still further in 2010, to over 5% of GDP. And according to the European Commission, public debt is also likely to increase rapidly, from 65.9% of GDP in 2008 to nearly 80% in 2010 as a result of bank recapitalisations and public guarantees for new bank emissions via the Soffin (*Sonderfonds Finanzmarktstabilisierung*) market stabilisation emergency fund. The change in German fundamental law does, however, set limits on the public finances by banning regional governments from increasing their net debt from 2020, and by requiring stable federal public debt levels from 2016, except in exceptional cases.

Germany	2008	2009	2010	2009			
				T1	T2	T3	T4
GDP	1.0	-6.1	0.3	-3.8	-0.8	0.5	0.1
Private Consumption	-0.1	0.2	0.0	0.5	-0.2	0.2	0.2
Investment	3.6	-10.6	1.3	-7.9	-1.4	0.5	0.2
GFCF in Capital Goods	5.1	-21.3	0.6	-16.2	-4.0	0.7	0.0
GFCF in Construction	2.0	-4.1	1.7	-2.6	0.0	0.5	0.4
Change in Inventories (a)	0.6	-0.2	-0.1	-0.5	-1.1	0.4	0.0
Net Exports (a)	-0.5	-4.2	0.2	-2.3	1.0	-0.1	-0.1
Industrial Production	0.0	-15.4	2.9	-19.0	-16.7	-15.8	-9.5
Unemployment Rate	7.8	8.5	9.8	8.0	8.2	8.7	9.2
CPI (yoy, %)	2.8	0.4	0.9	0.8	0.3	-0.2	0.6

(a) contribution to GDP growth (%)

Last, the situation of the banking sector, which is in the midst of restructuring, is another weak point in the economy. Despite recent state intervention, German banks could post substantial losses linked to their large-scale exposure to the US property market and their operations in Eastern Europe. The uncertainty is such that estimates of the amount of toxic assets on bank balance sheets range from EUR 200-800 billion. The government's guarantee plan for these assets seeks to clean up the sector's financial situation, but there are grounds for worrying that the process could take longer than planned. ■

Patience, patience... Sluggish recovery in 2010

The fall in GDP gathered pace in the early part of this year as it clocked its worst performance since WWII. In view of recent survey findings, the rate at which the economy is shrinking seems to have been slowing since the spring. But given the burden of structural problems, recovery will be sluggish.

Hard times, mamma mia!

Italy is mired in a deep recession. The shrinkage in GDP, which began in the spring of 2008, has accelerated sharply in the last two quarters. **GDP shrank by 2.6% q/q in the first half of 2009, following on from a drop of 2.1% in Q4 2008, thus posting its worst performance since WWII.** Because Italy's banking sector had scant exposure to toxic assets, its economy has been relatively spared by the first phase of the international financial crisis. On the other hand, it has borne the brunt of the collapse in world trade. Italian exports fell by 11.8% q/q in Q2 2009, after an earlier drop of 7.4% in Q4 2008. In the wake of this, business investment fell markedly. Capital goods spending continued to fall (down 6.8% q/q in Q1, after a fall of 6.9% in Q4 2008) and investment in transport literally collapsed (down 21.2% after an earlier fall of 9.3%). Businesses have also been doing some massive inventory downsizing this quarter, for a -0.4 percentage point contribution to GDP growth, compared with +0.5 in Q4 2008. In light of the European Commission survey, Italian business leaders feel that they have cleaned up their inventory situation, which is in itself good news. On the households front, demand has also shrunk significantly. Despite a high personal savings rate and an increase in real incomes driven by slowing inflation, consumption spending fell 1.1% q/q in Q1 2009, after a drop of 0.9% in Q4. The slowdown in household consumption is due to the deterioration in the labour market. The unemployment rate rose to 7.3% of the workforce in Q1 2009, compared with an annualised 6.8% in 2008. Such weak domestic demand caused the rate of fall in imports to accelerate in Q1, at 9.2% q/q after -5.7%.

Better times ahead, but not before 2010

The rate at which the economy is shrinking seems to have moderated since the spring. The business climate observed by ISAE, PMI, and European Commission surveys has picked up since March/April and early Q2 2009 activity data tend to confirm the improvement. Industrial production saw an increase of 1.1% m/m in April, for the first time in a year. **This positive trend remains fragile, however, and needs to be confirmed over the coming months.** Right now, the risk of a further decrease in confidence indicators cannot be completely ruled out in the present context of large-scale uncertainties about the timing and shape of the global recovery. What's more, balances of opinion are at record lows and are consistent with a further reduction in activity

in Q2 2009, but on a smaller scale than in earlier quarters. Italian firms will be loath to invest over the coming months. Faced with a continuing rise in unemployment, households, too, will be cautious in their spending decisions. The employment indicator in the PMI survey, and that of the European Commission survey of hiring intentions are both forecasting further job cuts. This is why we are forecasting an unemployment rate that could come out at 8.4% by end-2009 and at 8.9% by end-2010. The impact of the deteriorating labour market on household behaviour is particularly severe in Italy because, unlike in most other eurozone countries, many members of the Italian workforce have no unemployment insurance cover if they lose their jobs. In including a 90-day indemnity for jobless people without unemployment insurance in its February anti-crisis plan, the government sought to cushion this dampening effect on household demand. **All in all, we are forecasting that GDP will fall by 5.4% in 2009.** In view of the weak potential for growth (around 1.5%), the burden of public debt (105.8% of GDP in 2008) and the weakness of banks' equity capital, the Italian economy will recover only slowly from the costs inflicted by this crisis. We are also forecasting a sluggish recovery in 2010, at an annualised 0.2%.

Turning to inflation matters, we should see further disinflation throughout 2009. After slowing by 0.8% year-on-year, the harmonised index of consumer prices could dip into negative territory in July and August this year. Over 2009 as a whole, inflation is likely to slow by 1% y/y, after 3.5% inflation in 2008. As signs of recovering activity emerge, inflation is likely to pick up once more in 2010, to 1.7%. ■

Italy	2008	2009	2010	2009			
				T1	T2	T3	T4
GDP	-1.0	-5.4	0.2	-2.6	-0.8	-0.2	0.1
Private Consumption	-0.9	-2.0	0.5	-1.1	-0.2	0.0	0.1
Investment	-2.9	-11.9	-0.2	-5.0	-1.9	-1.0	0.1
GFCF in Capital Goods	-4.7	-14.8	-0.4	-6.8	-2.0	-1.8	0.1
GFCF in Construction	-1.8	-6.2	0.1	-0.8	-1.2	-0.5	0.0
Change in Inventories (a)	-0.3	-0.2	-0.1	-0.4	-0.2	0.0	0.0
Net Exports (a)	0.2	-1.3	-0.1	-0.6	-0.2	0.0	0.0
Unemployment Rate	6.8	8.0	8.8	7.5	7.8	8.1	8.4
CPI (yoy, %)	3.5	1.0	1.7	1.4	0.9	0.7	1.0
Public deficit (% of GDP)	-2.7	-5.2	-4.8	-	-	-	-

(a) contribution to GDP growth (%)

No recovery in the offing

Despite some recent encouraging data (confidence indicators up, unemployment down in May, etc.), the fundamentals of the Spanish economy do not seem to favour a rapid recovery. Growth should come in at -4% in 2009 and -1% in 2010.

In terms of national accounting, there was further bad news for Spain at the start of the year.

Real GDP shrank for the third consecutive quarter in Q1 2009, by 1.9% q/q, the worst quarterly performance since the INE began publishing growth data in 1970. This was due to the continuing housing crisis and a sharp fall in household and business demand. Thus, although construction investment fell for the sixth consecutive quarter, (-2.2% q/q), it is now the collapse in domestic demand that is having the greatest impact on growth. While consumption fell by 1.7% q/q, capital goods investment plunged by 9.3% in just three months. We should, however, note that for the time being, Spain, despite being seen as one of the most fragile and hardest-hit eurozone countries, is still doing better than Germany or the eurozone average. Some data even seem to suggest that the free fall observed at the end of 2008 and in the first quarter of 2009 is coming to an end and that the rate of economic shrinkage is slowing. PMI indices, for example, after bottoming at around 28 at the back-end of 2008 (compared with 57 two years earlier), have rebounded sharply since the start of the year. Running at around 40 in May, they are still in recessionary territory and at record lows, but they nevertheless suggest that the rate of free fall in output (industrial output in particular), could slow in the next few months.

That said, we should not expect a rapid recovery, even so. In fact, although the fall-off in activity is for the time being less important in Spain than in the eurozone, (-3% y/y compared with -4.8% y/y in the eurozone), the correction in the labour market is far more brutal and far faster than in the other countries in the zone. It is a fact that the latest employment data for May showed the first monthly fall in the number of unemployed since March 2008, but the unemployment rate has doubled since the start of the crisis and is now running at nearly 17%. **This is likely to severely handicap Spanish recovery, which seems likely, as a result, to be far less rapid than among its European trading partners.** Faced

with this deterioration in the labour market and with a credit crunch, households will continue to rein in their spending. Although the ongoing price fall (inflation dropped to -0.9% y/y in May, its lowest level since the price index was created) could bring them some relief, the probable rise in the unemployment rate to nearly 20% in 2010 should prompt them to save more. Firms, for their part, faced with gloomy prospects both in domestic and export markets, are likely to continue curbing their investments over the coming quarters.

Elsewhere, the correction to housing investment is likely to continue and average annual growth looks set to fall from 6% between 2000 and 2007 to sharply negative growth between 2008 and 2010 (-8.5% per year on average). This adjustment can be seen in the drastic fall in the number of housing starts (from 72,000 a month at the October 2006 peak to just 13,000 last December, its lowest since 1994). **While this trend is the direct outcome of the bursting of Spain's property bubble which developed over a decade, it has been largely exacerbated by the financial crisis.** Because the crisis makes it more difficult to securitise mortgage loans, the banks have been forced to drastically cut their lending (down 24.3% y/y), triggering a sharp fall in housing sales (down 25.5% y/y). In price terms, the fall is still small (just 6.8% since the Q1 2008 peak) compared with other countries that are experiencing property recessions, like the UK and the United States. But given the increase in unsold housing units, we are expecting a total fall of around 30% by 2011.

It is true that the Spanish government has implemented several large-scale recovery plans, which should boost its deficit to over 9% of GDP, in order to cushion the ongoing shocks. In our view, however, this will not be enough to avoid a massive structural adjustment. Since 1996, property and related sectors have contributed 25% to growth and job creations. A sharply negative contribution from construction investment to growth over at least three or four years, combined with lower consumption due to the return of mass unemployment, points to **growth of -4% in 2009, with further negative growth in 2010 (-1%), and remaining well under 2% at least until 2012.** ■

Spain	2008	2009	2010	2009			
				T1	T2	T3	T4
GDP	1.2	-4.0	-0.9	-1.9	-1.2	-0.7	-0.6
Private Consumption	0.1	-5.5	-1.9	-1.7	-2.0	-1.2	-1.0
Investment	-3.0	-12.8	-4.0	-4.2	-3.3	-1.7	-1.0
GFCF in Capital Goods	-1.1	-18.5	-0.8	-9.3	-4.0	-0.8	-0.3
GFCF in Construction	-5.3	-12.0	-8.0	-2.2	-3.5	-3.0	-2.0
Change in Inventories (a)	-0.3	-0.2	0.2	-0.2	0.5	0.2	0.0
Net Exports (a)	1.2	2.2	0.2	0.4	0.2	0.1	0.0
Unemployment Rate	11.4	18.3	19.3	16.5	18.5	19.1	19.3
CPI (yoy, %)	4.1	-0.4	2.1	0.5	-0.8	-1.3	0.1
Public surplus (% of GDP)	-3.0	-9.2	-6.0	-	-	-	-

(a) contribution to GDP growth (%)

Tough times ahead

Economic growth is plunging (Q1 2009: 0.3%) and unemployment is rising. The outlook is not favourable considering chronic imbalances and slow progress in resolving them.

After more than a decade of robust growth rates, the Greek economy grew by a mere 0.3% y/y in Q1 2009. On a quarterly basis, GDP contracted by 1.2% with investment suffering a severe blow (-6.3%) and private consumption falling marginally (-0.1%). Subdued economic activity has resulted, as expected, in an increase in the unemployment rate (March 2009: 9.2%).

Besides the support package for the banks, which has not been absorbed fully so far, the government has introduced other mitigating measures; an aid package for farmers, tax incentives to bolster the ailing tourism and the private building sectors, as well as a program of state guarantees and interest rate subsidies to support small and medium sized businesses, which are the main driver of the economy. However, as consumption is slowing down and the outlook for the business environment remains dim, demand for loans to finance business activity and purchase of houses is further decelerating and is expected to continue so.

Prospects for the coming quarters are worrisome considering global economic uncertainty and the

economy's persisting imbalances. A fiscal stimulus is prohibited by the swelling public deficit and debt burden. The government has announced cuts in various expenses and a strict incomes policy -providing moderate increases only for low income employees and pensioners- in the hope of reining in primary expenditure. Results are poor so far. Besides, weak growth could exacerbate the fiscal imbalance.

Weaker domestic demand and lower oil prices provide relief for the external sector. The current account deficit shrank in Q1 2009 (-22%) but it is expected to remain well above 10% of GDP this year and the next reflecting the economy's low competitiveness and chronic structural flaws.

The one-seat majority of the government and the uncertainty about the time of next general elections do not guarantee swift policy adjustments for wide-ranging reforms. However, any delays in resolving imbalances will entail a painful and slow recovery to long-term growth potential. ■

Sandrine BOYADJIAN
sandrine.boyadjian@credit-agricole-sa.fr

Portugal

Severe recession

Portugal's GDP contracted sharply in the first quarter of 2009, by 2.4% q/q, compared with -1.4% in Q4 2008. The recession looks set to continue as leading indicators remain down-beat. We are expecting GDP to shrink by 3.9% in 2009.

The Portuguese economy is mired in recession. After shrinking by 1.4% q/q at the end of last year, GDP again fell by 2.4% in Q1 2009. This weakness stems largely from plummeting exports, which plunged 9.1% q/q, after a fall of 1.3% in Q4 2008, carrying business investment along with them (down 7.1%, after 0.3%). Faced with the brutal increase in the unemployment rate, to 8.9% in Q1 2009 after 7.6% in 2008, households have also been very cautious in their consumer behaviour (-0.6%, after 1.3%).

The recession looks set to continue. Leading indicators, notably the European Commission survey, are still showing no signs of an upturn in activity. So long as unemployment remains high (forecast at close to 9.5% by end-2009), consumers will act cautiously. This is why we are expecting GDP to contract by 3.9% in 2009, after a stabilisation in 2008. Recovery will come, but it will be sluggish and unlikely to happen before end-2010. With a

weaker growth carryover at the end of 2009 than in other eurozone countries, GDP should see a further drop of 0.3% over 2010 as a whole.

With the fall in the oil price, prices have come down across the board. The harmonised index of consumer prices again fell, for the third time running, in May, by 1.2% yoy. As a result of depressed demand, inflation looks set to fall over 2009 as a whole, by 0.9% y/y after an annual 2.6% in 2008; it should pick up slightly in 2010, to 1%.

The deterioration in the economic climate will undermine earlier efforts to keep the budget deficit under control. This is now likely to come in at just under 6% of GDP in 2009, compared with 2.6% in 2008. Especially as 2009 will see general elections in Portugal, with Portuguese voters going to the polls in October to elect a new Parliament. ■

Light at the end of the tunnel?

Following a record fall in real GDP over the past nine months, the UK economy is starting to show signs of improving. In our view, though, we should not expect the economy to recover very rapidly in the months ahead.

After shrinking 1.6% q/q in Q4 2008, **UK GDP shrank again by 1.9% q/q in Q1 2009 – its worst performance since 1979.** In the space of three quarters, GDP slumped by a total 4.1%, the biggest fall since quarterly growth figures were first published in 1955. **Domestic demand continued to fall in the early part of the year.** In one hand, consumption saw further falls, of 1.2% q/q, notably due to negative wealth effects as a result of the continuing downtrend in house prices, which fell by 20% between the end of 2007 and early 2009, and to the sharp rise in the unemployment rate, which in April stood at 7.2%, its highest since 1997. In the other hand, capital investment collapsed, shedding 3.8% q/q, largely due the credit squeeze, the high level of corporate spreads, and falling stock prices in the first quarter. **But it is above all the phenomenon of massive inventory downsizing which has contributed most to the record fall-off in UK GDP,** the scale of which (with negative contributions to growth of 1.6% in Q4 and 0.6% in Q1) actually suggests over-adjustment on the part of firms.

The question is, are there grounds for believing in a rapid UK recovery? The latest available data do suggest a rapid improvement in the British situation. PMI indices, for example, after bottoming in late 2008, have rebounded strongly since the start of this year. In the manufacturing sector the index regained over ten points to stand at 45.4 in May, while in services it bounced back nearly 12 points, above the 50 point threshold which equates with expansion. The composite index also seems to suggest zero or slightly positive growth in Q2, while industrial production rebounded in April by 0.3% mom for the first time since February 2008. The housing market was also showing signs of stabilising, as reflected in a sharp recovery in the RICS housing market survey, increased mortgage lending, and stabilising house prices.

However, although Britain could emerge rapidly from recession, partly due to inventory volatility and the possibility of a “technical rebound” for the UK economy, we nevertheless favour a scenario involving a modest contraction in GDP over the coming quarters.

It is true that the effects of the fiscal and monetary stimulus and sterling’s sharp depreciation are starting to make themselves felt. In our view, though, this is not enough to nurture hopes of a very rapid recovery. The UK banking crisis is far from over. Lending restrictions and the sharp rise in the unemployment rate, which could go as high as 9% next year, are likely to adversely affect consumption and could send the still-fragile housing sector tumbling once more. External demand is unlikely to explode despite the competitive advantage of weak sterling. Not to mention the fact that a possible tightening of fiscal policy next year to mitigate currently burgeoning public spending (public debt has already risen from 36% of GDP to over 53% in just two years) could prove disastrous for a convalescent economy. We are still forecasting, therefore, a drop of 4% in GDP this year and a modest recovery in 2010 (+0.7%).

Despite the notable improvements in recent weeks, the BoE itself seems to be every bit as cautious as regards its analysis of the situation, as suggested by the minutes of its most recent meetings. Before it even thinks of increasing its key rate (which in our opinion is unthinkable before the end of 2010), the BoE will first have to put an end to its quantitative easing (QE) policy. Yet at its May meeting, the Monetary Policy Committee (MPC) members unanimously voted to extend the amount allocated to QE from £75 billion to £125 billion. The Bank could even decide to further increase the amount in the months ahead. For the time being, the Treasury has authorised it to acquire up to £150 billion-worth of securities, financing the purchases by printing money, but the MPC members have asked the Governor to write to the Chancellor to ask him to set the limit higher to further extend the Bank’s QE should it prove necessary. The BoE has already acquired £86 billion-worth of assets (including £83 billion-worth of gilts), but if the Governor ask for a £50 billion extension, the Bank could very soon own some £175 billion-worth of gilts – the equivalent of this year’s entire planned UK public deficit, i.e. 12% of GDP, which could make the exit strategy from QE increasingly complicated. ■

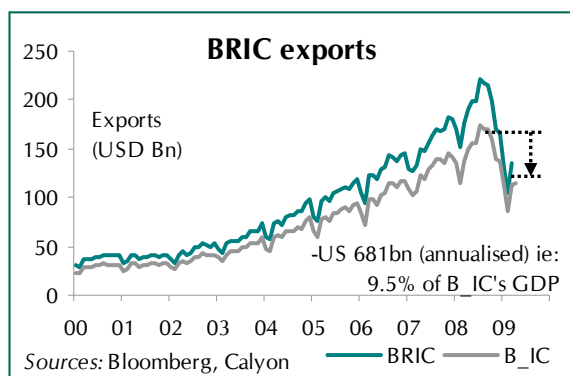
United-Kingdom	2008	2009	2010	2009			
				T1	T2	T3	T4
GDP	0.6	-4.0	0.7	-1.9	-0.8	-0.2	0.3
Private Consumption	0.9	-3.4	-0.7	-1.2	-1.5	-1.0	-0.3
Public Consumption	0.7	5.5	1.3	0.3	0.5	0.5	0.5
Investment	-0.1	-12.7	-1.4	-3.8	-4.0	-2.0	0.0
Change in Inventories (b)	0.0	-1.3	1.1	-0.6	1.0	0.7	0.4
Net Exports (b)	0.0	0.7	-0.1	0.1	-0.2	0.0	-0.1
Industrial Production	-6.1	-11.2	-10.2	-	-	-	-
Average Income (yoy)	1.5	5.4	6.0	5.0	5.2	5.5	6.0
Unemployment Rate ONS	5.8	7.7	9.1	6.9	7.5	8.0	8.5
CPI (HICP, yoy, %)	3.6	1.8	1.5	3.0	2.1	1.1	1.2

(a) contribution to GDP growth (%)

Green shoots lacking fertilizer

EMs have bottomed out. Beyond a possible rebound in market volatility, capital flows should continue to come back into 2010. However, tepid recovery in the G3 implies a mixed outlook for EM exports and GDP growth. EM growth may remain sub-trend in 2010.

Green shoots have blossomed in emerging markets over the past few months. With a few exceptions, PMIs and confidence indices have improved from the dire levels recorded at end-09/beg-10. The most obvious example is China, where the investment surge should allow the economy to reaccelerate later this year despite very weak exports. The factors behind this improvement are two-fold. On the one hand, strong policy reaction has allowed to floor recessions and even in some cases to trigger the beginning of an economic rebound. The significant decrease in policy interest rates has likely helped, although the strong disinflation has actually pushed up real interest rates. Large budget stimulus have likely played a stronger role. For instance, **in the BRICs, stimulus packages have reached as much as 4.4% of GDP in 2009** (weighted average). On the other hand, the moderation of systemic fears, and the gradual normalisation on global financial markets (also thanks to plans to allocate more resources to the IMF), have allowed to lift the liquidity constraint. As a result, EM bond and CDS spreads have narrowed significantly in Q2, corporate debt issuance seems to have reopened since April 2009, and portfolio flows have come back rather strongly to EM equity markets since mid-March.



What next for capital flows? During the past two crisis that hit the EM universe (Asian/Russian crisis and the bursting of the IT bubble), the money leak from EMs has last about two years (1997-1998 and 2001-2002). The same kind of schedule could apply this time. Beyond a possible correction in Q3, as the market may need some time to digest the strong rally seen in Q2, inflows should continue in Q4 and into 2010. **First, the crisis has raised doubts about the US and European financial systems, and may at the end of the day accelerate the rise of emerging markets vs. developed ones**, triggering some flows to

those regions that will likely play an increasing role in global growth in years to come. Second, the banking sector's appetite will likely come back gradually, following the improvement in banks' results seen since so far this year. **Anecdotal evidence already suggests that the competition for market shares is already gaining momentum in some EM regions, like in Asia for instance**, where the competition between "Western" banks and regional banks (including Chinese ones) is intensifying, fuelled by future growth prospects. In its last analysis on "Capital Flows to Emerging Market Economies", the IIF suggests that private flows to EMs could rebound from USD 140Bn in 2009 to USD 373Bn in 2010 (bank flows: from -USD 92Bn to USD 58Bn). In our view, such a projection looks realistic.

However, improved access to financing may not be enough to get growth back to a strong level. **At some point green shoots may lack fertilizers.** As a matter of fact, our G3 scenario stands below consensus. In the US, in particular, we expect GDP growth at only 1.5% in 2010 vs. 2.4% for the consensus. **The tepid recovery we expect in G3 economies will translate into weak exports, depriving EMs from what was a major source of growth for many of them before the crisis.** This is actually the main reason why our 2010 EM growth forecasts stand significantly below trend growth for most of the emerging markets. True, for emerging markets as a whole, we expect economic growth to recover from 1.8% in 2009 to 4.8% in 2010. This looks like a decent rate of growth. However, it is way below the average for 2003-07 (7.6%). In addition, this decent re-acceleration owes a lot to China and India, which should continue to benefit from rather vigorous domestic demand. Excluding China and India, EM economic growth may rebound from -2.3% in 2008 to only 2.5% in 2010. ■

A self-centred boost

China is reaccelerating. The surge in credit in Q1 is fuelling a so-far impressive bounce of investment, which may last into next year. But this boost is self-centered, and will only marginally benefit the rest of the world.

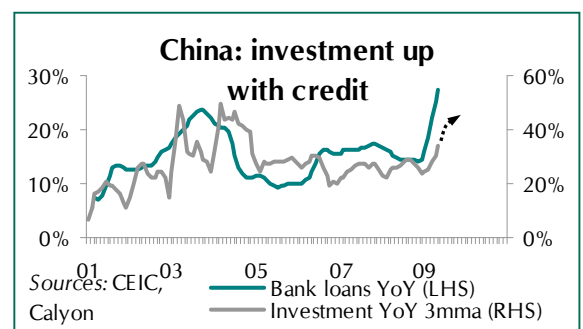
Better than expected data released in recent months suggests that China's economy is re-accelerating. After having slowed to "only" 6.1% in Q1, GDP could rebound to about 8.0% on average in Q2-to-Q4, lifting the whole year's GDP growth to about 7.5%.

The improvement mainly comes from stimulus-driven investment. Investment accelerated from 22% y/y in December 2008 to almost 39% y/y in May 2009. Moreover, the boom in bank loans in Q1 suggests that investment could continue to accelerate and remain strong in the next 3-to-4 quarters. Investment amounting to more than 40% of GDP, such a surge can send GDP growth at 8% despite the still very challenging 2009-2010 export outlook.

Also, the recent acceleration in retail sales, combined with the surge in property sales (+45% YTD y/y in May compared with -19% y/y in 2009), suggests that the stimulus plan is also gaining traction of the household sector. We revise our 2009 GDP growth

forecast from 6.5% to 7.5% and keep our 2010 forecast at 8.0%.

However, it should be noted that this China bounce is very much self-centred. **Chinese imports have remained weak despite the rise in investment. The infrastructure-related stimulus should hardly benefit other economies, apart from commodity exporters.** The China boost will mainly benefit China, and only marginally the rest of the world. ■



India

Cynthia KALASOPATAN
cynthia.kalasopatan@credit-agricole-sa.fr

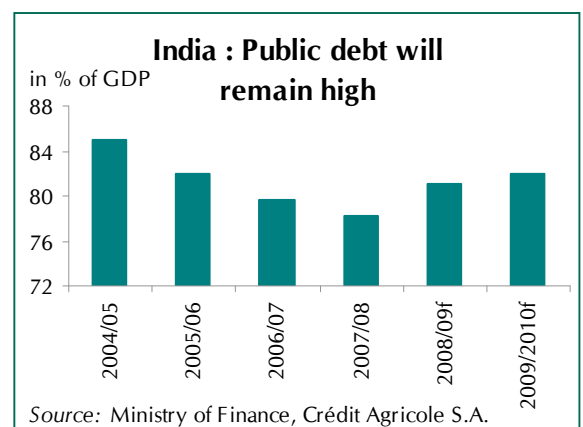
Post-election optimism

The strong mandate of the new government will give a boost to ongoing reforms and capital flows. We have thus revised our growth projection upwards in FY 2010 and 2011. Public finances will still remain the weak point and are expected to worsen slightly this year.

The overwhelming victory of the Congress-led coalition party for a second consecutive mandate has injected optimism in India. Ongoing reforms including privatisation, corporate governance and security issues are expected to be pushed further. Moreover, the enhanced stability of the political climate will attract more FDI and portfolio flows in the short term. This wave of confidence will thus be beneficial to the Indian economy in addition to the fact that it was already expected to rank amongst the best performing economies in the region this year. **We revise our growth projections upwards to 6% in April 2009/March 2010 (FY 2 010) from 5.5% previously and to 7% in FY 2011.**

However, this forecast still marks a significant slowdown compared to 6.7% in FY 2009 and 9% in FY 2008. A further fiscal stimulus can therefore be expected in July (FY 2010 budget) to stimulate growth despite a worsening trend of public debt (81% of GDP in FY2009). In the short term, public debt is

still sustainable as 95% of it is contracted on the domestic market. Once the global crisis tones down, pressure will be strong on the authorities to revert back the fiscal trend in order to prevent crowding-out the private sector. ■



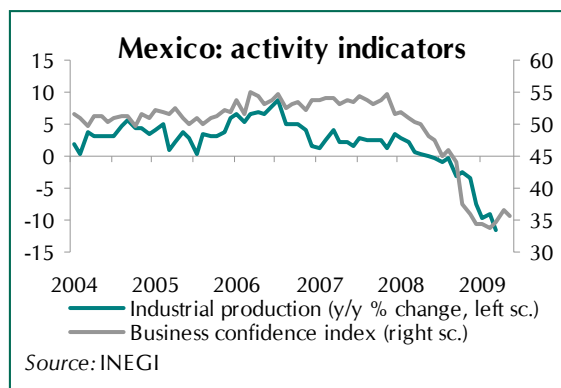
Sharp recession, urgent reforms

The crisis has had a very brutal impact on Mexico's economy and we have again revised our forecasts for 2009 downwards to -5.0%. Mexico also urgently needs structural reform in the areas of taxation, oil and energy to re-launch growth and preserve its sovereign rating.

GDP fell by 8.2% y/y in the first quarter. INEGI's business confidence index, which has been a fairly good leading indicator for activity, recovered in April only to fall slightly again in May, affected, no doubt by the swine flu epidemic. All the indicators confirm the slowdown, with exports, for example, down 32.8% y/y in April.

Standard & Poor's revised Mexico's outlook in May from "stable" to "negative". Mexico is still well within the "investment grade" band (BBB+), but S&P is considering a downgrade if the government does not increase its fiscal room for manoeuvre in 2009. In Mexico, budgetary adjustments have via straight spending cuts, and despite efforts to expand the tax base, non-oil tax receipts still amount to scarcely 10% of GDP. This type of situation is unsustainable in the longer term, especially as oil production is trending downwards. In early June the governor of the Bank of Mexico called for tax reform and regretted the "low productivity in some sectors", a scarcely veiled allusion to the liberalisa-

tion of the oil and energy sectors, and also referred to the risk of a downgrade. This would not be dramatic for the sovereign borrower, but would be costly for firms, which have debt of USD18 billion maturing in 2009 (excluding the finance and trade finance sectors), in a probably weakened environment for MXN. This scenario can, however, be avoided. ■



Vladimir VALE
 vladimir.vale@br.calyon.com

Brazil

Last in, first out

Brazil was severely hit by the crisis on 02H08, but there are good reasons to believe that its recovery will come faster than in most countries. Job losses were only moderate and real labor income is still rising. The local financial system is well capitalized and credit is growing again.

Monetary and fiscal policies are focused in supporting aggregate demand. Although the Brazilian economy has continued to contract on Q1 2009, there are signs that suggest that the worst may be over. **PCE is rising again and will probably lead the recovery.** The relatively mild reaction of the labor market to the crisis and the fact that households are not over indebted are helping to sustain private consumption. Government expenditures will probably accelerate on next quarters, since the primary surplus target was revised down for 2009.

Residential investments will probably recover soon, since there was not a real estate "bubble" in Brazil preceding the crisis. Housing activity has suffered from rising funding costs, but demand is still strong and inventories are not excessive. The main drags on GDP growth will be non residential investments, which are likely to remain depressed as long as the slack on capacity utilization remains high, and net exports, since it depends on commodity prices and

demand. **We currently expect a contraction of 0,5% in 2009 GDP, followed by a growth of 3,7% in 2010.**

The monetary policy response to the crisis was initially timid but, as it became clear that falling commodity prices and the widening output gap would keep prices under control, the BCB has adopted a more dovish approach. **Since January 2009, the Selic rate has been cut by 450 bp and we expect a further 50 bp before the easing cycle is over. However, if the economy rebounds as we expect in 2010, a tightening cycle will start in the H2 2010.** ■

Recession and external deficit

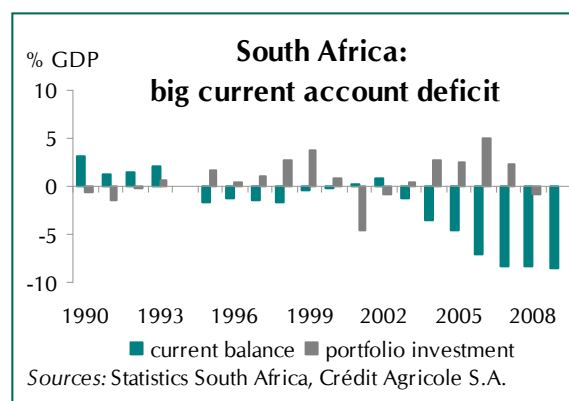
South Africa is in recession. Counter-cyclical monetary and fiscal policies should minimise its scale, but these will help to widen external deficits, which are starting to look worrying.

South African GDP fell by 1.8% then by 6.4% q/q in Q4 2008 and Q1 2009. The current quarter will be no better, as industrial production fell by 21.6% y/y in April. We are forecasting a drop in GDP of at least 4.0% in 2009, prior to a modest rebound in 2010.

The balance of payments is starting to look worrying. Until 2006, its deficit had always been more or less financed by capital inflows. But it has continued to widen, rising to 8.0% of GDP in 2008, and in our view (not the consensus view) it is likely to widen still further in 2009 due to poor external demand and deteriorating terms of trade and base effect, at the same time as financing it will become more difficult. **There are only two possible outcomes: a weakening of ZAR (which would decrease imports rather than stimulate exports) and/or a sharp, painful contraction in domestic demand.** In the medium term, the present level of current account deficit is unsustainable. The reasons for this are well-known: growth is too household consump-

tion driven, the investment ratio is too low, and the South African economy is not competitive enough.

The 22 April elections were a triumph for the ANC. The cabinet formed by Jacob Zuma had a fairly reassuring effect, even if the new duties of the former finance minister, Trevor Manuel, as President of the National Planning Commission, remain unclear. ■



Middle-East/North Africa

Riadh EL-HAFDHI
riadh.el-hafdhi@credit-agricole-sa.fr

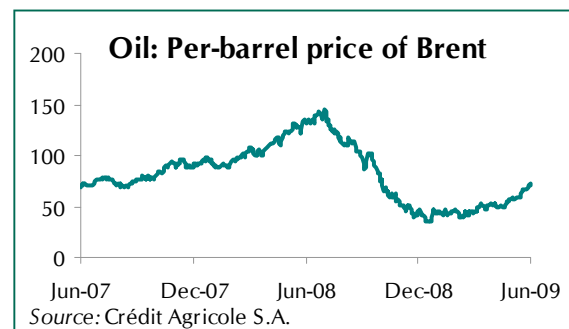
Fiscal caution bears fruit

The fall in oil prices since the 2008 peak has slashed growth rates in the oil producing countries. Some economies were even expected to shrink in 2009, but the rise in prices since January could nevertheless modify things.

Tumbling to less than USD40 per barrel in late 2008, the fall in oil prices raised concerns about large-scale budget deficits in 2009 for the oil producing nations. Some, like Kuwait, Saudi Arabia and the UAE, even seemed likely to see their economies contract. But the price rises over the past four months (the barrel is currently trading close to USD70) could change the situation, with only Iran and Bahrain running a deficit. The same impact has been felt on the current accounts: except in the case of Iran and Oman, they all balance when the oil price is above USD50 per barrel. **If prices were to stabilise around the current level, practically all the oil producing countries would generate relatively comfortable additional reserves, running counter to most earlier forecasts.**

But while the price increases are good news for oil producers and their budgets, the price volatility is not without damaging effects. It had stalled plenty of investment projects in the petroleum sector for all countries in the MENA region. One notable excep-

tion to this is Saudi Arabia, the only country to have maintained all its investment objectives despite the economic crisis. Because Saudi Arabia has been pursuing a resolutely counter-cyclical policy in times of both growth and recession, it has shown its ability to cope with the ups and downs of oil cycles. Other oil-based economies like the UAE, could follow Saudi's example to cope with the inevitable next series of price fluctuations. ■



Tempered optimism

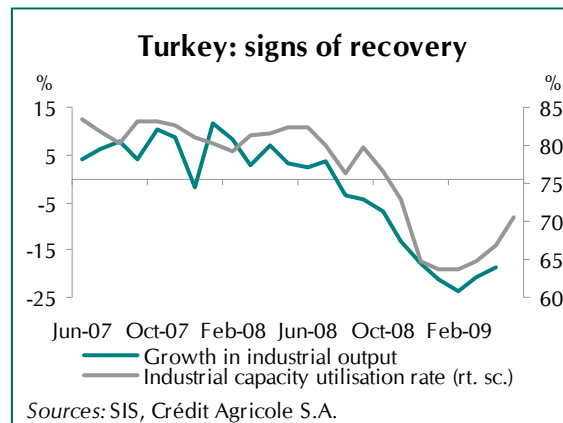
The Turkish economy is doing better, although it remains in fragile health. A relapse is not improbable, especially if the government decides to pursue its fairly expansionary fiscal policy at the expense of an agreement with the IMF and its market credibility.

Signs of stabilisation and even improvement in the Turkish economy are multiplying. The markets have been perking up for three or four months now. The rate of fall in industrial output is slowing. This began in March and continued in April. The industrial capacity utilisation rate has been rising steadily and rapidly since February. And confidence levels among households and (manufacturing) businesses are at a 9-12 month high.

There is a need for cautious confidence, however.

The market rebound has been very rapid, given the outlook for growth, and is running ahead of the still uncertain signing of an agreement with the IMF. It still looks fragile, therefore. The improvement on the economic activity front can be partly attributed to the rebuilding of inventories and temporary, targeted fiscal measures. Because it is not entirely autonomous, growth therefore still looks shaky. The need for external financing also remains considerable in the short term, leaving the Turkish economy vulnerable to any event that might alter market sentiment.

But it is, however, the government's fiscal policy that is undermining the outlook for recovery in the short term. Its policy, which is expansionary and not ringed about by reforms designed to ensure the sustainability of the public finances in the mid/long term, is complicating negotiations with the IMF and could, at the end of the day, generate macroeconomic and financial instability. ■



Christopher KWIECINSKI
christopher.kwiecinski@credit-agricole-sa.fr

CEEC

A political argument in favor of the euro

The interesting feature of the transition is the ever greater decoupling of the economy and financial markets from the politico-electoral cycle among the NMS. The eventual eurozone membership will enhance this process.

The economies and the financial markets of the NMS have been more volatile in recent years than those of older EU members. An interesting research paper by two ECB economists¹ shows that the euro adoption by Italy in 1999 appears to have significantly reduced the destabilizing effects of domestic political events on its financial markets. This finding reflects a narrowing of the risk premium required by international investors in the Italian assets but the authors suggest that a similar approach could be extended to other, politically less stable countries, particularly those in Eastern Europe, which are contemplating replacement of their national currencies with the euro.

Most economic assessments of the EMU membership by the NMS central banks have concluded that benefits would greatly outweigh costs, particularly for small open economies. Adding the political economy argument, if corroborated by the empirical research, would significantly strengthen the case for carrying the economic integration of the NMS with the EU-16 until its logical conclusion, i.e., a monetary union membership. ■

1- "Does it pay to have the euro? Italy's politics and financial markets under the lira and the euro" by M. Fratzscher and L. Stracca, ECB Working Paper No. 1064, June 2009.

Economic Forecasts

At June 26, 2009

	Real GDP (y/y, %)			CPI (y/y, %)			Current Account (% GDP)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
USA	1.1	-2.8	1.5	3.8	-0.8	1.2	-4.7	-3.0	-3.2
Japan	-0.7	-6.4	1.7	1.5	-1.1	-0.1	3.2	1.8	2.9
Eurozone	0.6	-4.5	0.2	3.3	0.4	1.4	-0.5	-0.7	-0.7
Germany	1.0	-6.1	0.3	2.8	0.4	0.9	6.6	4.2	4.5
France	0.3	-3.0	0.5	2.8	0.1	1.6	-2.3	-2.8	-3.1
Italy	-1.0	-5.4	0.2	3.5	1.0	1.7	-3.4	-3.3	-3.0
Spain	1.2	-4.0	-0.9	4.1	-0.4	2.1	-9.4	-6.8	-6.5
Netherlands	2.1	-4.4	0.5	2.2	1.7	1.1	7.5	6.0	5.5
Belgium	1.1	-3.5	0.3	4.5	0.5	1.4	-2.6	-2.5	-2.7
United Kingdom	0.6	-4.0	0.7	3.6	1.6	1.4	-1.9	-1.5	-2.0
Norway	2.5	-0.5	1.2	3.2	1.4	1.9	16.2	13.8	14.0
Sweden	0.6	-3.8	0.7	3.8	-0.2	1.6	7.0	6.2	7.0
Switzerland	1.6	-2.8	0.0	2.4	0.0	0.5	0.9	0.6	0.7
Canada	0.4	-2.3	1.8	2.4	0.5	1.8	0.5	-2.4	-2.2
Australia	2.2	-1.0	0.5	4.2	1.0	1.8	-4.4	-4.9	-5.5
New Zealand	0.4	-2.5	0.6	3.9	1.5	1.4	-9.4	-6.5	-6.0
Asia	6.9	4.3	6.3	7.0	0.8	3.6	4.7	4.1	4.1
China	9.0	7.5	8.0	5.9	0.0	3.0	10.0	7.0	7.0
Hong Kong	2.5	-4.5	3.0	4.3	0.7	1.8	14.2	8.5	9.0
India	6.7	6.0	7.0	9.1	0.8	5.0	-3.1	-0.7	-1.0
Indonesia	6.1	3.0	4.0	9.8	4.9	5.8	0.1	0.0	1.0
Korea	2.5	-5.0	2.0	4.7	2.7	3.0	-0.5	2.5	1.5
Malaysia	4.6	-2.0	3.0	5.4	1.0	2.0	13.0	9.0	11.0
Philippines	4.6	1.0	3.0	9.3	3.5	4.5	1.5	0.5	1.5
Singapore	1.1	-8.0	3.0	6.5	0.0	2.5	14.8	12.5	15.5
Taiwan	0.1	-6.0	4.0	3.5	-0.5	1.5	6.4	7.0	6.5
Thailand	2.6	-3.0	3.0	5.5	-0.8	2.5	-0.1	3.0	3.0
Vietnam	6.2	2.5	4.0	23.1	6.6	10.0	-13.2	-8.0	-5.0
Latin America	4.1	-1.8	2.8	8.5	6.9	5.5	-1.0	-2.0	-1.4
Argentina	7.0	-3.0	1.0	24.0	17.7	12.0	2.3	0.5	1.0
Brazil	5.1	-0.5	3.7	5.7	4.5	4.5	-1.8	-2.0	-1.8
Mexico	1.3	-5.0	2.5	5.1	5.0	3.7	-1.5	-3.3	-2.0
Emerging Europe	4.3	-4.6	0.8	10.4	7.4	6.5	0.3	-1.9	-1.5
Czech Republic	3.3	-3.0	0.2	6.4	1.2	1.5	-3.3	-2.7	-3.0
Hungary	0.6	-5.0	-0.5	6.1	6.0	3.5	-4.5	-4.0	-3.5
Poland	4.8	0.5	2.0	4.2	2.5	2.8	-5.4	-4.5	-4.0
Russia	5.6	-6.5	0.5	14.1	11.0	9.0	6.1	0.5	1.0
Romania	7.4	-4.0	0.0	7.9	6.0	4.0	-0.8	-7.5	-6.5
Turkey	1.5	-5.0	1.0	10.4	6.0	7.0	-5.7	-3.5	-3.5
Africa & Middle East	5.3	0.0	3.1	12.9	5.2	5.2	7.7	-2.4	1.1
Algeria	3.2	3.0	4.5	4.5	4.0	3.5	22.4	4.5	7.0
Egypt	7.2	3.5	4.0	18.3	9.2	7.0	-3.1	-0.8	-2.0
Kuwait	8.5	-0.5	4.5	10.6	7.5	6.0	39.2	15.0	20.0
Lebanon	6.0	2.5	3.0	10.0	3.0	3.0	-11.0	-8.0	-10.0
Morocco	4.9	2.0	3.0	3.9	2.7	2.3	-5.5	-2.5	-2.0
Qatar	13.5	9.5	20.0	15.1	0.0	5.0	19.5	6.0	20.0
Saudi Arabia	4.2	-0.7	3.5	9.9	2.8	3.0	26.2	-7.0	1.0
South Africa	3.0	-4.0	1.0	11.5	7.0	6.0	-8.0	-9.5	-6.0
United Arab Emirates	7.4	-0.5	2.5	20.0	4.5	6.5	14.3	2.0	6.0
Tunisia	4.5	2.0	3.0	5.0	2.8	2.8	-4.2	-2.0	-2.5
Total	2.9	-1.4	2.6	5.4	1.1	2.5	0.6	0.0	0.2
Industrialised countries	0.7	-3.8	1.0	3.3	-0.2	1.1	-1.7	-1.3	-1.3
Emerging countries	6.0	1.8	4.8	8.2	3.0	4.4	3.6	1.8	2.3

Notes:

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

(2) For India: Fiscal year ending in March.

Interest Rate Forecasts

At June 26, 2009

	26-Jun	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
USA							
Fed funds	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
3 month	0.60	0.50	0.50	0.50	0.50	0.60	0.70
2Y year	1.14	1.25	1.45	1.75	2.25	3.00	3.50
10 year	3.58	4.00	4.20	4.20	4.30	4.50	4.50
Japan							
Call	0.11	0.10	0.10	0.10	0.10	0.10	0.10
3 month	0.47	0.60	0.60	0.70	0.70	0.70	0.70
2Y year	0.31	0.45	0.50	0.60	0.70	0.75	0.80
10 year	1.41	1.45	1.45	1.50	1.50	1.60	1.60
Eurozone							
Repo	1.00	1.00	1.00	1.00	1.00	1.00	1.00
3 month	1.14	1.15	1.15	1.15	1.20	1.25	1.25
2Y year	1.34	1.65	1.70	1.80	2.20	2.75	3.25
10 year (Ger)	3.44	3.80	4.00	4.10	4.10	4.20	4.30
United Kingdom							
Base rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3 month	1.20	1.00	0.90	0.80	0.90	1.00	1.10
2Y year	1.17	1.40	1.60	1.70	1.90	2.00	3.00
10 year	3.73	3.90	4.10	4.10	4.30	4.40	4.50
Sweden							
Repo	0.50	0.50	0.50	0.50	0.50	0.50	1.50
3 month	0.96	1.00	1.20	1.20	1.20	1.20	1.30
10 year	3.48	3.75	3.95	4.10	4.10	4.20	4.30
Norway							
Deposit	1.25	1.25	1.25	1.25	1.50	2.00	2.50
3 month	1.79	1.90	2.00	2.10	2.25	2.25	2.35
10 year	4.21	3.75	3.70	3.80	4.25	4.40	4.50
Switzerland							
3 month	0.40	0.25	0.25	0.25	0.25	0.25	0.25
10 year	2.34	2.35	2.35	2.35	2.35	2.50	2.70
Canada							
Overnight Target	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3 month	0.33	0.50	0.50	0.50	0.50	0.50	0.60
10 year	3.42	3.60	3.70	3.85	3.90	4.00	4.00
Australia							
Cash Target	3.00	3.00	3.00	3.00	3.00	3.25	3.50
3 month	2.95	3.40	3.45	3.50	3.55	3.70	4.00
10 year	5.60	5.80	5.90	6.00	6.20	6.35	6.50
New Zealand							
Official Cash Rate	2.50	2.25	2.25	2.25	2.25	2.50	2.75
3 month	3.13	2.85	2.85	2.85	2.90	3.20	3.65
10 year	6.02	6.10	6.20	6.30	6.40	6.50	6.60

Commodities Price Forecasts

Metals		4Q08	2008	1Q09	2Q09	3Q09	4Q09	2009	2010	2011
Aluminium	\$/t c/lb	1,837	2,579	1,366	1,425	1,375	1,515	1,420	1,600	1,800
Copper	\$/t c/lb	3,943	6,968	3,460	4,500	4,000	4,600	4,140	5,000	7,000
Lead	\$/t c/lb	1,257	2,096	1,166	1,400	1,300	1,535	1,350	1,300	1,500
Nickel	\$/t c/lb	10,963	21,146	10,550	12,000	10,000	12,250	11,200	12,000	14,000
Zinc	\$/t c/lb	1,199	1,886	1,183	1,425	1,375	1,555	1,385	1,500	1,600

Oil		T1 08	T2 08	T3 08	T4 08	2008	T1 09	T2 09	T3 09	T4 09	2009	T1 10	T2 10	T3 10	T4 10	2010
NYMEX WTI	\$/BBL	98	124	118	59	100	43	58	60	68	57	70	65	65	75	69
Brent	\$/BBL	97	121	115	55	97	44	57	58	66	56	69	63	63	73	67

Exchange Rate Forecasts

At June 26, 2009

USD Exchange rate		26-Jun	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Industrialised countries								
Euro	EUR/USD	1.40	1.40	1.42	1.44	1.46	1.47	1.48
Japan	USD/JPY	96	101	105	110	112	115	115
United Kingdom	GBP/USD	1.65	1.69	1.75	1.80	1.83	1.88	1.90
Switzerland	USD/CHF	1.09	1.12	1.12	1.11	1.10	1.10	1.09
Canada	USD/CAD	1.15	1.09	1.07	1.03	1.01	1.00	1.00
Australia	AUD/USD	0.80	0.80	0.83	0.84	0.85	0.86	0.86
New Zealand	NZD/USD	0.64	0.64	0.66	0.67	0.68	0.69	0.69
Asia								
China	USD/CNY	6.83	6.83	6.83	6.80	6.70	6.60	6.50
Hong Kong	USD/HKD	7.75	7.76	7.80	7.80	7.80	7.80	7.80
India	USD/INR	48.40	47.00	46.00	45.00	43.00	43.00	43.00
Indonesia	USD/IDR	10,230	10,500	10,000	9,800	9,700	9,600	9,500
Malaysia	USD/MYR	3.53	3.60	3.50	3.42	3.38	3.33	3.30
Philippines	USD/PHP	48.31	50.00	48.30	48.00	47.70	47.30	47.00
Singapore	USD/SGD	1.46	1.50	1.45	1.42	1.40	1.38	1.37
South Korea	USD/KRW	1,284	1,250	1,200	1,160	1,140	1,120	1,100
Taiwan	USD/TWD	32.92	33.50	32.50	31.70	31.00	30.50	30.00
Thailand	USD/THB	34.06	35.00	34.00	33.50	33.00	32.50	32.00
Vietnam	USD/VND	17,802	18,000	17,700	17,500	17,350	17,100	17,000
Latin America								
Argentina	USD/ARS	3.80	3.90	3.90	4.00	4.00	3.90	3.80
Brazil	USD/BRL	1.94	2.00	1.90	1.86	1.84	1.82	1.80
Mexico	USD/MXN	13.20	13.90	13.65	13.30	12.90	12.70	12.40
Africa & Middle East								
South Africa	USD/ZAR	8.00	9.00	8.80	8.70	8.50	8.20	8.10
Emerging Europe								
Poland	USD/PLN	3.21	3.52	3.20	3.02	2.78	2.63	2.50
Russia	USD/RUB	31.13	32.20	31.47	30.82	30.35	30.16	30.04
Turkey	USD/TRY	1.54	1.65	1.55	1.49	1.47	1.45	1.42
Euro Cross rates								
Industrialised countries								
Japan	EUR/JPY	135	141	149	158	164	169	170
United Kingdom	EUR/GBP	0.85	0.83	0.81	0.80	0.80	0.78	0.78
Switzerland	EUR/CHF	1.53	1.57	1.59	1.60	1.61	1.61	1.62
Sweden	EUR/SEK	11.02	11.00	10.70	10.50	10.50	10.00	10.00
Norway	EUR/NOK	9.05	8.50	8.00	7.80	7.80	7.60	7.60
Central Europe								
Czech Rep.	EUR/CZK	25.96	26.50	25.00	24.00	23.00	23.00	22.50
Hungary	EUR/HUF	276	295	280	275	260	260	260
Poland	EUR/PLN	4.50	4.30	4.00	3.90	3.70	3.60	3.50
Romania	EUR/RON	4.21	4.40	4.50	4.40	4.30	4.30	4.30

Publication Manager: Jean-Paul BETBEZE — Chief Edition: Jean-Paul BETBEZE and Isabelle JOB — ISSN 2101-5554

Production and Sub-Editor: Fabienne Pesty — Contact: publication.eco@credit-agricole-sa.fr

Crédit Agricole S.A. — Economic Research Department — 75710 PARIS Cedex 15 — Fax: +33 1 43 23 58 60

This publication reflects the opinion of Crédit Agricole S.A. on the date of publication, unless otherwise specified (in the case of outside contributors). Such opinion is subject to change without notice. This publication is provided for informational purposes only. The information and analyses contained herein are not to be construed as an offer to sell or as a solicitation whatsoever. Crédit Agricole S.A. and its affiliates shall not be responsible in any manner for direct, indirect, special or consequential damages, however caused, arising therefrom. Crédit Agricole does not warrant the accuracy or completeness of such opinions, nor of the sources of information upon which they are based, although such sources of information are considered reliable. Crédit Agricole S.A. or its affiliates therefore shall not be responsible in any manner for direct, indirect, special or consequential damages, however caused, arising from the disclosure or use of the information contained in this publication.

www.credit-agricole.com — Economic Research

Subscribe to our free online publications