



BNP PARIBAS
CORPORATE & INVESTMENT BANKING

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Global Outlook | December 2009

Two-Speed World





INSERT: The Outlook for Markets

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Table 1: Economic Forecasts

| GDP (% y/y) | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|---|------|--------------------|--------------------|--------------------|--------------------|--------------------------------------|--------------------|--------------------|--------------------|--------------------|-------------------|--------------------|--------------------|--------------------|--------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| US | 0.4 | -2.5 | 2.2 | 2.5 | 3.3 | -3.3 | -3.8 | -2.5 | -0.3 | 2.1 | 2.6 | 2.3 | 2.0 | 2.0 | 2.4 | 2.7 | 2.9 |
| Japan | -0.7 | -5.2 | 1.5 | 1.4 | 1.6 | -8.6 | -7.0 | -4.5 | -1.0 | 2.5 | 1.9 | 0.8 | 0.7 | 0.9 | 1.3 | 1.6 | 1.7 |
| Eurozone | 0.6 | -3.8 | 1.3 | 1.5 | 2.5 | -4.9 | -4.8 | -4.0 | -1.6 | 1.2 | 1.6 | 1.3 | 0.9 | 1.0 | 1.2 | 1.7 | 2.0 |
| World ⁽²⁾ | 3.1 | -0.9 | 3.6 | 3.7 | 4.4 | -2.3 | -2.0 | -0.9 | 1.4 | 3.8 | 3.9 | 3.5 | 3.3 | 3.4 | 3.5 | 3.8 | 4.0 |
| Industrial Production (% y/y) | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| US | -2.2 | -9.9 | 2.6 | 3.1 | 4.8 | -11.6 | -12.9 | -9.6 | -5.3 | 1.0 | 4.2 | 3.0 | 2.3 | 2.0 | 2.6 | 3.4 | 4.1 |
| Japan | -3.4 | -22.1 | 14.3 | 4.2 | 5.0 | -34.6 | -27.8 | -20.1 | -3.8 | 27.1 | 18.0 | 10.5 | 4.8 | 3.2 | 3.9 | 4.6 | 5.2 |
| Eurozone | -1.7 | -14.1 | 4.6 | 0.9 | 3.6 | -17.7 | -18.2 | -15.0 | -5.1 | 5.9 | 7.0 | 4.1 | 1.3 | -0.3 | 0.2 | 1.4 | 2.4 |
| Unemployment Rate (%) | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| US | 5.8 | 9.3 | 10.8 | 10.0 | 8.6 | 8.1 | 9.3 | 9.6 | 10.3 | 10.6 | 10.8 | 11.0 | 10.7 | 10.4 | 10.1 | 9.8 | 9.5 |
| Japan | 4.0 | 5.1 | 5.3 | 4.9 | 4.1 | 4.4 | 5.2 | 5.5 | 5.3 | 5.3 | 5.3 | 5.3 | 5.2 | 5.1 | 5.0 | 4.8 | 4.7 |
| Eurozone | 7.6 | 9.4 | 10.5 | 10.5 | 9.8 | 8.8 | 9.3 | 9.6 | 9.9 | 10.2 | 10.4 | 10.6 | 10.6 | 10.6 | 10.5 | 10.4 | 10.3 |
| CPI (% y/y) | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| US | 3.8 | -0.3 | 2.1 | 0.9 | 0.8 | -0.2 | -0.9 | -1.6 | 1.5 | 2.5 | 2.6 | 1.9 | 1.5 | 1.2 | 1.0 | 0.9 | 0.6 |
| Japan | 1.4 | -1.3 | -1.8 | -0.8 | -0.7 | -0.1 | -1.0 | -2.2 | -2.0 | -1.6 | -2.1 | -1.9 | -1.4 | -1.2 | -0.6 | -0.7 | -0.8 |
| Eurozone | 3.3 | 0.3 | 1.3 | 0.7 | 0.7 | 1.0 | 0.2 | -0.4 | 0.5 | 1.2 | 1.2 | 1.3 | 1.5 | 1.0 | 0.8 | 0.7 | 0.5 |
| Interest Rates⁽³⁾ | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| US | | | | | | | | | | | | | | | | | |
| Fed Funds Rate (%) | 0.25 | 0.25 | 0.25 | 0.75 | 3.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.75 |
| 3-month Rate (%) | 1.43 | 0.30 | 0.45 | 1.25 | 3.50 | 1.19 | 0.60 | 0.29 | 0.30 | 0.30 | 0.30 | 0.40 | 0.45 | 0.50 | 0.55 | 0.65 | 1.25 |
| 10-year Rate (%) | 2.22 | 3.25 | 3.75 | 4.75 | 5.50 | 2.67 | 3.54 | 3.31 | 3.25 | 3.25 | 3.00 | 3.30 | 3.75 | 4.00 | 4.25 | 4.50 | 4.75 |
| Japan | | | | | | | | | | | | | | | | | |
| O/N Call Rate | 0.10 | 0.10 | 0.10 | 0.25 | 0.75 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 |
| 3-month Rate (%) | 0.74 | 0.45 | 0.35 | 0.35 | 0.85 | 0.65 | 0.56 | 0.54 | 0.45 | 0.45 | 0.45 | 0.40 | 0.35 | 0.30 | 0.25 | 0.25 | 0.35 |
| 10-year Rate (%) | 1.18 | 1.40 | 1.70 | 2.10 | 2.20 | 1.35 | 1.36 | 1.31 | 1.40 | 1.40 | 1.50 | 1.60 | 1.70 | 1.80 | 1.90 | 2.00 | 2.10 |
| Eurozone | | | | | | | | | | | | | | | | | |
| Refinancing Rate | 2.50 | 1.00 | 1.00 | 1.25 | 3.00 | 1.50 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.25 |
| 3-month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 | 1.51 | 1.10 | 0.75 | 0.70 | 0.60 | 0.60 | 0.65 | 1.10 | 1.25 | 1.50 | 2.00 | 2.25 |
| 10-year Rate (%) | 2.95 | 3.10 | 3.50 | 4.25 | 4.75 | 3.00 | 3.38 | 3.22 | 3.10 | 3.10 | 2.90 | 3.20 | 3.50 | 3.75 | 4.00 | 4.25 | 4.25 |
| FX Rates⁽³⁾ | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| EUR/USD | 1.40 | 1.54 | 1.40 | 1.47 | 1.45 | 1.33 | 1.40 | 1.46 | 1.54 | 1.48 | 1.42 | 1.38 | 1.40 | 1.42 | 1.44 | 1.45 | 1.47 |
| USD/JPY | 91 | 85 | 108 | 118 | 111 | 99 | 96 | 90 | 85 | 90 | 97 | 100 | 108 | 110 | 115 | 120 | 118 |
| EUR/JPY | 127 | 131 | 151 | 173 | 161 | 131 | 135 | 131 | 131 | 133 | 138 | 138 | 151 | 156 | 166 | 174 | 173 |
| EUR/GBP | 0.96 | 0.92 | 1.00 | 0.91 | 0.90 | 0.92 | 0.85 | 0.91 | 0.92 | 0.88 | 0.91 | 0.95 | 1.00 | 0.94 | 0.93 | 0.92 | 0.91 |
| GBP/USD | 1.46 | 1.67 | 1.40 | 1.62 | 1.61 | 1.43 | 1.65 | 1.60 | 1.67 | 1.68 | 1.56 | 1.45 | 1.40 | 1.51 | 1.55 | 1.58 | 1.62 |
| Current Account (% GDP) | Year | | | | | General Government (% GDP) | | | | | Year | | | | | | |
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | | |
| US | -4.9 | -3.5 | -4.4 | -4.3 | -4.3 | US ⁽⁴⁾ | -3.1 | -11.0 | -10.2 | -8.5 | -6.9 | | | | | | |
| Japan | 3.2 | 2.7 | 2.9 | 3.2 | 3.1 | Japan | -6.7 | -10.6 | -9.1 | -8.9 | -8.7 | | | | | | |
| Eurozone | -1.6 | -0.8 | -0.8 | -0.7 | -0.6 | Eurozone | -1.9 | -6.5 | -6.9 | -6.4 | -4.9 | | | | | | |

Footnotes: (1) Forecast (2) Country weights used to construct world growth are those in the IMF World Economic Outlook

Update, April 2009 (3) End Period (4) Fiscal year Figures are y/y percentage change unless otherwise indicated

Source: BNP Paribas



Table 2: GDP and CPI Forecasts (% y/y)

| | Real GDP | | | | | CPI ⁽¹⁾ | | | | |
|---------------------------|----------|---------------------|---------------------|---------------------|---------------------|--------------------|---------------------|---------------------|---------------------|---------------------|
| | 2008 | 2009 ⁽²⁾ | 2010 ⁽²⁾ | 2011 ⁽²⁾ | 2012 ⁽²⁾ | 2008 | 2009 ⁽²⁾ | 2010 ⁽²⁾ | 2011 ⁽²⁾ | 2012 ⁽²⁾ |
| US | 0.4 | -2.5 | 2.2 | 2.5 | 3.3 | 3.8 | -0.3 | 2.1 | 0.9 | 0.8 |
| Eurozone | 0.6 | -3.8 | 1.3 | 1.5 | 2.5 | 3.3 | 0.3 | 1.3 | 0.7 | 0.7 |
| Japan | -0.7 | -5.2 | 1.5 | 1.4 | 1.6 | 1.4 | -1.3 | -1.8 | -0.8 | -0.7 |
| China | 9.0 | 8.7 | 9.6 | 8.4 | 8.6 | 5.9 | -0.6 | 3.9 | 5.3 | 3.9 |
| Eurozone Countries | | | | | | | | | | |
| Germany | 1.0 | -4.8 | 1.6 | 1.7 | 2.5 | 2.8 | 0.3 | 1.2 | 0.6 | 0.6 |
| France | 0.3 | -2.3 | 1.5 | 1.9 | 2.5 | 3.2 | 0.1 | 1.5 | 1.0 | 1.2 |
| Italy | -1.0 | -4.8 | 0.8 | 1.1 | 1.3 | 3.5 | 0.8 | 1.1 | 0.6 | 0.7 |
| Spain | 0.9 | -3.6 | 0.0 | 1.1 | 2.8 | 4.1 | -0.2 | 1.3 | 0.2 | 0.1 |
| Netherlands | 2.0 | -3.9 | 1.1 | 1.5 | 2.0 | 2.3 | 1.1 | 1.6 | 1.1 | 1.0 |
| Belgium | 0.8 | -3.1 | 1.2 | 1.5 | 2.0 | 4.5 | 0.0 | 1.2 | 1.3 | 1.2 |
| Austria | 2.0 | -3.6 | 1.2 | 1.8 | 2.5 | 3.2 | 0.5 | 1.2 | 0.7 | 0.8 |
| Portugal | 0.0 | -3.0 | 0.4 | 1.1 | 1.8 | 2.7 | -0.9 | 0.5 | 0.7 | 0.7 |
| Finland | 1.5 | -6.3 | 0.5 | 2.2 | 3.0 | 3.9 | 1.2 | 1.8 | 1.5 | 1.5 |
| Ireland | -3.0 | -7.4 | -0.8 | 2.5 | 4.1 | 3.1 | -1.6 | -0.8 | -0.6 | -0.4 |
| Greece | 2.0 | -1.1 | -0.2 | 0.9 | 1.6 | 4.2 | 1.3 | 1.7 | 1.2 | 1.0 |
| Slovenia | 3.6 | -7.5 | 2.0 | 3.2 | 4.9 | 5.2 | 0.8 | -1.3 | 0.8 | 2.3 |
| Slovakia | 6.4 | -5.4 | 2.7 | 3.6 | 5.6 | 3.9 | 0.6 | 0.1 | 1.1 | 1.5 |
| Other Europe | | | | | | | | | | |
| Denmark | -1.2 | -4.7 | 1.1 | 1.8 | 2.4 | 3.4 | 1.3 | 1.8 | 0.8 | 0.9 |
| UK | 0.7 | -4.5 | 2.0 | 1.6 | 1.8 | 3.6 | 2.1 | 2.1 | 0.8 | 0.9 |
| Sweden | -0.5 | -4.3 | 2.3 | 3.3 | 3.6 | 3.4 | -0.4 | 1.0 | 3.2 | 3.6 |
| Norway | 1.7 | -1.0 | 2.6 | 2.9 | 3.5 | 3.8 | 2.2 | 1.8 | 2.3 | 2.7 |
| Switzerland | 1.8 | -1.5 | 1.4 | 1.9 | 2.2 | 2.4 | -0.5 | 1.0 | 0.5 | 0.5 |
| Russia | 5.9 | -8.0 | 3.8 | 4.1 | 6.4 | 14.2 | 11.3 | 9.4 | 8.2 | 10.1 |
| Ukraine | 2.1 | -13.3 | 2.7 | 4.5 | 6.0 | 22.3 | 13.6 | 11.0 | 9.5 | 6.5 |
| Poland | 5.1 | 1.3 | 2.2 | 3.5 | 4.4 | 4.1 | 3.6 | 2.6 | 1.4 | 1.3 |
| Hungary | 0.8 | -6.6 | 0.4 | 3.0 | 3.6 | 5.6 | 4.1 | 2.3 | 1.3 | 1.6 |
| Czech Republic | 2.7 | -4.8 | 1.3 | 3.3 | 5.3 | 6.0 | 0.9 | 0.9 | 0.5 | 1.2 |
| Bulgaria | 6.1 | -5.4 | -0.9 | 1.6 | 2.6 | 12.0 | 2.2 | -2.3 | -0.1 | 1.7 |
| Romania | 7.4 | -7.3 | 1.5 | 1.8 | 4.4 | 7.7 | 5.5 | 3.4 | 3.2 | 3.2 |
| Turkey | 0.9 | -5.5 | 3.5 | 4.0 | 4.5 | 10.4 | 6.2 | 7.4 | 6.5 | 6.4 |
| Asia | | | | | | | | | | |
| India | 9.0 | 6.7 | 6.2 | 7.6 | 7.2 | 9.1 | 1.8 | 5.2 | 3.1 | 3.7 |
| South Korea | 2.3 | 0.4 | 5.4 | 3.3 | 4.0 | 4.7 | 2.8 | 3.0 | 3.0 | 2.6 |
| Indonesia | 6.1 | 4.2 | 5.2 | 5.8 | 6.0 | 9.8 | 4.8 | 4.9 | 5.3 | 5.6 |
| Taiwan | 0.1 | -3.1 | 5.8 | 3.6 | 4.2 | 3.5 | -0.7 | 0.6 | 0.4 | 1.2 |
| Thailand | 2.6 | -3.5 | 4.5 | 5.0 | 5.5 | 5.5 | -0.9 | 1.9 | 1.9 | 2.0 |
| Malaysia | 4.6 | -3.0 | 5.0 | 5.2 | 5.5 | 5.4 | 0.8 | 1.9 | 1.3 | 2.0 |
| Hong Kong | 2.4 | -3.1 | 4.8 | 5.2 | 5.5 | 4.3 | 0.5 | 1.8 | 1.4 | 1.7 |
| Singapore | 1.1 | -2.4 | 5.5 | 5.8 | 6.5 | 6.5 | 0.1 | 2.0 | 1.0 | 1.5 |
| Phillipines | 3.8 | 1.5 | 4.3 | 4.9 | 5.0 | 9.3 | 3.2 | 3.4 | 3.3 | 4.0 |
| Other Countries | | | | | | | | | | |
| Australia | 2.4 | 1.4 | 3.7 | 2.6 | 3.9 | 4.4 | 1.8 | 2.6 | 2.7 | 2.5 |
| Canada | 0.4 | -2.5 | 2.1 | 2.9 | 3.2 | 2.4 | 0.3 | 1.5 | 1.4 | 1.2 |
| Latam | | | | | | | | | | |
| Brazil | 5.1 | 0.0 | 4.1 | 4.6 | 5.2 | 5.9 | 4.3 | 4.0 | 4.0 | 4.5 |
| Mexico | 1.3 | -6.5 | 4.0 | 3.2 | 2.8 | 6.5 | 3.9 | 3.9 | 3.2 | 3.6 |
| Argentina | 8.8 | -1.8 | 3.2 | 4.0 | 3.5 | 7.2 | 6.9 | 14.2 | 10.5 | 7.8 |
| Chile | 3.2 | -1.6 | 5.5 | 4.4 | 5.3 | 7.1 | -0.9 | 2.6 | 3.5 | 3.6 |
| Colombia | 2.4 | -0.8 | 2.4 | 4.3 | 4.0 | 7.7 | 2.4 | 3.6 | 3.9 | 4.2 |
| Venezuela | 4.8 | -1.2 | -2.0 | -1.0 | 1.4 | 30.9 | 27.0 | 33.1 | 40.9 | 38.5 |

(1) HICP where available, India WPI (2) Forecast

Source: BNP Paribas



Summary: Two-Speed World

■ Global growth will return in 2010 but it will be uneven. EMKs will far outshine the advanced economies.

■ Near term in the advanced economies, the bounce in activity will last a little longer than we previously thought, but headwinds will result in a soft patch next year in the G7.

■ The main pressures on domestically generated inflation in the G7 are for a decline.

■ EMKs generally have less spare capacity and face upside inflation risks much sooner than the West.

■ Monetary policy needs vary widely. EMKs will need to tighten much sooner than the G7.

■ We do not expect any rate hikes from the ECB, BoJ or Fed next year. We think many people are wrong to expect moves too early, given fragile growth and weak inflationary threats.

■ Watch the liquidity management by central banks very closely as it will be a major driving force for markets next year.

■ A reluctance to see exchange rates rise means EMKs risk overheating in the form of asset bubbles and/or inflation.

■ The USD may stage a recovery against the EUR next year, but will weaken against currencies in Asia. A notable exception is Japan, where fiscal woes are weighing.

■ The main bond markets are expected to trade sideways over the coming months, but we think the consensus is too pessimistic in expecting yields to rise too much too soon.

■ Global growth returns...

- The bounce in global activity continues. We expect that, after contracting by almost 1% this year, global GDP will bounce back to 3.6% growth in 2010. This is below the average of 4.8% from 2004-2007. However, given the financial crisis we have been through, this is remarkably close to the trend rate of about 4% in global growth (and bear in mind that potential growth may have fallen because of the recession). By 2012, we believe that global headwinds will have abated enough to see global growth above 4%, but still below the 5% seen in 2006 and 2007. It's a global recovery but not a global boom.

| Table 1: GDP (% y/y) | | | | | |
|----------------------|------|------|------|------|------|
| | 2008 | 2009 | 2010 | 2011 | 2012 |
| World | 3.1 | -0.9 | 3.6 | 3.7 | 4.4 |
| G7 | 0.2 | -3.4 | 1.9 | 2.1 | 2.7 |
| US | 0.4 | -2.5 | 2.2 | 2.5 | 3.3 |
| Japan | -0.7 | -5.2 | 1.5 | 1.4 | 1.6 |
| Eurozone | 0.6 | -3.8 | 1.3 | 1.5 | 2.5 |
| UK | 0.7 | -4.5 | 2.0 | 1.6 | 1.8 |
| Canada | 0.4 | -2.5 | 2.1 | 2.9 | 3.2 |
| Other Advanced | 1.4 | -1.1 | 2.7 | 2.7 | 3.5 |
| Asia Ex-Japan | 6.7 | 5.2 | 7.7 | 6.9 | 7.2 |
| CEE & Russia | 5.5 | -5.7 | 2.9 | 3.8 | 5.8 |
| Latin America | 4.0 | -2.1 | 3.6 | 4.1 | 4.3 |

Source: BNP Paribas

| Table 2: Contributions to Global Growth | | | | | | |
|---|---------|-------------------------------------|------|------|------|------|
| | Weight* | Contributions to Global Growth (pp) | | | | |
| | | 2008 | 2009 | 2010 | 2011 | 2012 |
| World GDP (% y/y) | 100.0 | 3.1 | -0.9 | 3.6 | 3.7 | 4.4 |
| G7 | 41.9 | 0.1 | -1.4 | 0.8 | 0.9 | 1.1 |
| US | 20.6 | 0.1 | -0.5 | 0.5 | 0.5 | 0.7 |
| Japan | 6.3 | 0.0 | -0.3 | 0.1 | 0.1 | 0.1 |
| Eurozone | 15.7 | 0.1 | -0.6 | 0.2 | 0.2 | 0.4 |
| UK | 3.2 | 0.0 | -0.1 | 0.1 | 0.1 | 0.1 |
| Canada | 1.9 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 |
| Other Advanced | 3.6 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 |
| Asia Ex-Japan | 24.7 | 1.7 | 1.3 | 1.9 | 1.7 | 1.8 |
| CEE & Russia | 8.2 | 0.5 | -0.5 | 0.2 | 0.3 | 0.5 |
| Latin America | 8.6 | 0.3 | -0.2 | 0.3 | 0.4 | 0.4 |

Source: BNP Paribas, IMF WEO October 2009

Note: *Weights based on the PPP valuation of country GDPs

■ ...but unevenly

- The longer the global rebound builds, the clearer it becomes that the challenges in different economies, or groups of economies, are diverging. We expect about three-quarters of global growth in 2010-2012 to come from emerging markets. China will contribute twice as much to global growth as the US, while Brazil and India together will contribute more than the eurozone and Japan taken together. It is clearer than ever that these are structural shifts that will change the way global markets work – as is clearly the case with commodities.
- While the West struggles with a contraction of credit, rising unemployment and the prospect of declining core inflation, some other economies have little spare capacity (e.g.



South Korea), are worried about inflation (China) and fret too much about liquidity causing asset bubbles (a whole range of economies from Brazil in the west to Taiwan in the east).

- Fiscal prospects also vary, with some advanced economies facing considerable challenges (Japan, the US, the UK, Greece and Ireland stand out) while the position elsewhere looks much more comfortable (e.g. Australia and China).
 - Even within economies, there are big divergences, with the manufacturing sector having a lot more upward momentum than overall GDP. German industrial production in September was some 10% up from the April low, while retail sales (excluding vehicles) were down over 2%. Corporate sectors in some economies (the US stands out) are in a very favourable cash flow position, while households are striving to re-jig balance sheets and are struggling with the effects on household incomes of the cost cutting that has benefited the corporate sector.
- **Current bounce overstates underlying strength**
- As we have pointed out before, a lot of the current upward momentum in manufacturing follows from the sector's previous undershoot. Normal relationships between GDP and manufacturing suggest that manufacturing should have fallen by about 10% from peak to trough. The actual fall was nearer 20%. Thus a strong correction is currently showing up in inventories, exports, manufacturing production and some areas of investment. Statistical models suggest that, on a global scale, this upward momentum will continue for some time. However, past relationships were, on average, based on broader demand for manufactured goods (for consumption, for investment) and less on inventories than this time around, so the model may be too optimistic. Nonetheless, we expect the good news to continue in the short term.
- **Q3 growth was a bit weaker than expected in the US and Europe**
- It seems that the bounce in activity will last a little longer than we had expected. This is despite (or, more accurately, because) GDP growth in the US and Europe came in a bit weaker in Q3 2009 than we had forecast in our last *Global Outlook*. US growth in Q3 has been revised down to 2.8% saar compared with the 3.6% we forecast last time. However,

the composition was more positive for future growth – Q3 growth relied less on inventories than we had reckoned, giving a better prognosis for Q4 2009 and Q1 next year. However, European growth for Q3 as a whole was a bit softer than we had reckoned – again we suspect because of one-offs – so we have revised up our forecast for the next couple of quarters.

■ **Soft patch delayed by a few months**

- Our concerns remain that the bounce in manufacturing will fade next year, along with the impetus from massive fiscal and monetary easing and one-off stimulus measures (e.g. cash for clunkers programmes). Deleveraging by households and in the financial sector is creating strong headwinds. Thus we foresee a soft patch, but the surveys suggest that it is likely to arrive a bit later than we had previously thought. Together with a shift in growth from Q3 to Q4 2009, this timing gives us a better average picture for 2010 growth than previously. The fundamental story – that we will hit choppy growth waters after the current bounce – remains.

■ **Labour markets a drag on consumption**

- We continue to worry that consumer spending will remain subdued. In the US, the rate of job losses is weakening but we are probably still almost a year away from the beginning of a decline in unemployment – from a peak of around 11%. Payrolls will be boosted early next year by the hiring of three to four hundred thousand temporary workers for the census, so we may see a positive payrolls print before the end of Q1.
- In Europe, job losses have lagged the US and job creation will probably only occur from H2. With poor prospects for real wage growth, we expect consumption to be more or less flat. Virtually all the growth we see in the eurozone next year is forecast to come from exports – illustrating that the recovery is very far from becoming self-sustaining in 2010. The fragility of the recovery also underlines that it would be very risky for the ECB to raise rates.

■ **Inflation risks vary across countries**

- Vastly differing fundamentals – not just in terms of growth but also in terms of levels of spare capacity – mean that inflation risks vary. Australia has the lowest output gap it has ever had at the bottom of a cycle – unemployment is maybe only 0.5 of a percentage point above the rate consistent with stable inflation.



- In contrast, output gaps in the big advanced economies are huge canyons – for example US unemployment is over 5 percentage points above equilibrium. China’s explosive credit and money growth at the start of this year seems likely to boost inflation to 5% by the middle of next year, while very weak monetary growth rates in the US and eurozone signal real risks that they will follow Japan down the deflation route.
- **Inflation the risk in EMKs, deflation in the G7**
 - Thus we see a very varied pattern of inflation risks across the world. We judge these as low in advanced economies because there is so much slack. Hawks in various central banks worry that relative price shifts (such as a surge in oil prices) could unanchor low and stable price expectations and push us into an era of stagflation. Such an outcome is possible, but unlikely in our view, given massive spare capacity, a downward trend in core inflation and generation highs in unemployment. Low wage growth and improving productivity as growth picks up should result in declining core inflation in the US and the eurozone.
 - The greater probability is that, in the US and the eurozone, core inflation will trend down towards zero and maybe beyond over the next two years. Central banks do not want to acknowledge the deflation risk because they do not want to lower inflation expectations and therefore bring about what they fear. The collapse of money multipliers in Western economies means that fast growth in central banks’ balance sheets is not translating into accelerating (or in some economies even positive) credit growth. Since inflation is a monetary phenomenon, weak broad monetary growth argues for deflation not inflation. In a way, the pressures from commodities may even be welcome in that they could help economies to avoid deflation.
- **Divergence between economies = need for divergent monetary policy**
 - Naturally, these divergences in growth and inflation outlooks mean that the appropriate settings for monetary policy vary around the world. Some countries’ central banks (such as Australia’s, Norway’s and Israel’s) have already hiked, while others are using or thinking about using administrative measures (China, Hong Kong, Singapore) to tighten selectively. We think others will soon hike rates (e.g. South Korea, India) while the central banks of advanced countries will keep rates flat for much longer than the market expects – no policy rate hikes in the US, eurozone or Japan until late 2011 is our view.
- **EMK monetary policy – frequently too loose**
 - There has been much talk of the USD carry trade and bubbles. Our view is that monetary policy is appropriately loose in the US, the eurozone and Japan. When the banking system is still damaged, when many households want to reduce leverage, and when many corporates do not need to borrow, monetary policy cannot work through the credit channel so it has to work through asset valuations. The point of adding liquidity to markets, of buying securities and of putting policy rates close to zero is to encourage return-seekers to bid up asset prices, so that wealth and spending eventually rise. Of course, you can have too much of a good thing and bubbles are rarely good news in the long term. However, the recent increases in asset prices in advanced countries seem to be liquidity led rather than credit led. Such rises are less dangerous for being less leveraged.
 - Things may be different in emerging markets, however. Because growth prospects are better in emerging markets, and because rates are above those in the G7 and may rise before G7 rates rise, pressures on emerging market currencies are for a rise. With growth in export markets subdued, many EMKs are resisting an appreciation, or further appreciation, of their currencies. Reserve accumulation has accelerated. Effectively, this pegging or dirty floating is importing appropriately soft US monetary conditions into an inappropriate environment of faster growth and greater inflation threats. Monetary policy eases when FX reserves rise (FX accumulation is one form of QE). Higher reserves present the wherewithal to expand credit. Authorities that intervene signal their reluctance to tighten policy to the market, making assets more of a one-way bet.
 - Easing policy during a robust upswing with limited spare capacity is a recipe for one or both of asset price appreciation and inflation. Too many EMKs are taking too many risks with this. Capital controls, which will probably be worked around, are just an admission that authorities want too-soft monetary policy. In our opinion, it is not the job of the Fed to compensate for other countries’ too-easy monetary policy by setting US policy rates too high. Unless and until FX rates in EMKs are allowed more fully to reflect the fundamental



differences between the economic conditions in those countries (especially in Asia) and the US, the bigger will be the risks of bubbles and inflation.

■ **Key G7 central bank issue is liquidity, not policy rates**

- While policy rates are not the main issue, this by no means indicates that markets can ignore central banks – they will be very busy trying to manage expectations over the coming couple of years to buoy growth expectations while keeping inflation expectations anchored. Moreover, there is the issue of exiting from extraordinary liquidity measures.
- When people talk of “exit strategies”, they often fuse the issues of exit from low interest rates and exit from exceptional liquidity provision. While the two are not entirely separate, it does appear that many central banks, but not all, have in mind at least a partial separation. The Central Bank of Chile has been the most explicit about this, saying it will progressively phase out its long-term repo (currently 180 days) over the next six months, while saying it is also likely to keep rates at 0.5% until late in Q2 2010, maybe beyond.
- Mr Trichet would be reluctant to commit in a similar way, but has effectively confirmed that the fixed-rate full-allotment twelve-month repo due in December will be the last – i.e. that liquidity withdrawal will start soon. However, he also indicated that it was not the ECB’s intention to move EONIA away from the deposit rate and towards the refi rate (i.e. liquidity and interest rate policies are, at this stage, separate).

■ **Liquidity withdrawal policy: “suck it and see”**

- How much and how soon will the ECB cut back the current level of liquidity? We do not know and, probably, neither does the ECB. Most likely, liquidity withdrawal will be gradual. Should signs of financial stress reappear as liquidity is withdrawn, then further steps will be more cautious.
- However, it is our view that over the course of the year the ECB will want to be in a position where the Main Refinancing Operations will be what they claim to be – the main operations of the ECB – and that the overnight rate will be close to the refi rate. There will be no formal rate hike, but monetary conditions will be tightened.
- The Fed’s liquidity operations are also evolving. Purchases of Treasuries have ended

and the various facilities (e.g. special liquidity measures aimed at money markets) will be run down by the end of the year. By contrast, purchases of MBS and Agency debt will continue until the end of March. The Fed’s balance sheet will expand (to USD 2.5trn according to NY Fed President Bill Dudley), financed by an increase in excess reserves. While the Fed is to trial using reverse repos, it does not have plans to mop up the excess liquidity it is going to create over the coming four months or so. Whether or not that remains the case depends on how the increase in liquidity affects markets.

- Will the Fed really stop buying MBS after March? We expect so. As long as the rise in mortgage rates is not too large (which we would take to mean not more than about 50bp), then there will be no more subsequent purchases. That is now our base case.

■ **Extra liquidity supply drying up next year**

- How will an end to additional liquidity from the Fed, BoE, ECB and others, and the prospect of some withdrawal, affect markets? Well, if the Fed is not buying mortgages, someone else will have to, leaving fewer funds to go into competing assets. Consequently, rates on a range of assets should rise and mortgages should rise by the most. We would not expect this to show up much in March or April – the market knows well in advance what is going to happen – but it may have a progressive effect over time. Much will depend on the global economic context.

■ **Could risk appetite be dented?**

- China will see inflation rise next year – to perhaps 3% in Q1 and 5% in Q2. Tightening moves, in addition to current administrative measures, will probably take the form of higher reserve requirements and (less likely due to the hot-money implications) higher interest rates. Chinese tightening, more rate hikes in the “fast movers” and less liquidity could, when combined with the soft patch we see coming, add up to a more nervous period for risk markets.

■ **USD to rally against EUR next year**

- Thus, we see the USD as likely to have something of a rally next year – from a peak we see of 1.54 against the EUR this year to a low point of 1.38. Once the soft patch is over and growth looks more sustainable, then the USD will begin to soften against the EUR towards the end of next year.



- Over the medium term, we expect the USD to be soft against the EUR – there has to be a refocus of growth away from domestic demand and towards net trade, especially if fiscal policy tightens. We see the JPY as likely to suffer against the greenback as concerns about fiscal sustainability rise, and reflecting the dynamics of the Japanese current account.
- **Choosing the least lame horse**
 - To a great extent, arguing about which of the USD, EUR or JPY will do best is merely choosing between the currencies of underperforming economies – it is like choosing the best horse in the glue factory yard.
- **RMB to stay pegged until H2 2010**
 - We expect Asian currencies (excluding the JPY) to perform solidly against the greenback over the coming year. Many Asian currencies are undervalued. Long-term fundamentals look positive. Growth looks good compared with the G7 countries, and capital flows will be from west to east. Asian countries will hit full capacity long before the US does, and inflationary pressures will build. The resulting expectations of Asian rate hikes will strengthen Asian currencies.
 - Will the RMB be allowed to rise against the USD? In the immediate period ahead, we think not. Export industries in China are suffering from low export-market growth and some are receiving support from tax rebates. Expanding export markets and rising inflation in China lessen external obstacles to an appreciation and strengthen the internal argument in favour of it. Thus we expect a managed appreciation to start in Q3.
- **G7 bonds under competing forces**
 - In terms of bond markets in the G7, our view is that competing forces will be at play over coming months:
 - Growth is strong at present but will probably soften as the effects of government stimulus fade.
 - In terms of inflation, headline inflation will rise over coming months due to base effects but core inflation is likely to continue to drift down.
 - Future supply prospects are for heavy issuance from G7 issuers but, at present, EMK reserve accumulation – much of which is recycled into Western bond markets – is back at its highs.
 - Interest rates in G7 economies will be kept on hold for a lot longer than the market expects, while rate hikes elsewhere in the world will remind the market that the only way for Western rates is up in the longer term.
 - On central bank liquidity policy, although the Fed and BoE will keep buying securities for a few more months, the end is in sight and some central banks are leading in setting out their plans for withdrawing liquidity.
- **More upbeat on bonds than the consensus**
 - In the short term, there is a conflict of forces that we believe will keep rates more or less trapped in a range. Our view, however, is that the market is too pessimistic in pricing in rate hikes too soon. We believe that the consensus expectation of a rise in yields over the next three or four months will be proved wrong – the consensus on the bond market is too pessimistic.
 - Longer term, we expect more sustainable growth. Although US and Western European inflation is forecast to grind lower over the next year to eighteen months, we expect a narrowing of output gaps, higher inflation in EMKs and higher commodity prices, together with super-soft policy rates, to condition bond markets to expect that the US and Europe will not suffer from Japanese-style persistent deflation. As private sector investment picks up and competes with public borrowers for funds, and as debt/GDP ratios rise, we expect the trend in bond yields to be up.



Risk Scenarios

Tables 1-9 show our forecasts for the major economies under three variations to our base case. As usual, we have outlined an upside risk relative to the base case (i.e. the recovery is more vigorous than we have assumed) and a more pessimistic, double-dip scenario (i.e. after a period of recovering growth around the turn of the year, economies begin to contract again). Given the uncertainties surrounding unconventional monetary policy easing, we have also included a third scenario of stagflation (i.e. resumed contraction in activity accompanied by rapid inflation). We have apportioned probabilities to each of these alternatives to the base case, to which we apportion a 50% probability.

■ Double dip (15% probability)

Under this scenario, growth continues to rebound in the near term. However, the expansion proves short-lived and the contraction of GDP resumes in mid-2010.

In this scenario, the ending of liquidity injection programmes and quantitative easing results in rising market interest rates, particularly on mortgages. Higher mortgage rates will apply a brake on the tentative recovery in the housing market. Likewise, renewed headwinds for commercial real estate will present a fresh burden on banks' capital. Equally, political and economic constraints make it hard for Obama to pass a further stimulus package – making the fiscal situation less supportive.

These effects would exert a brake on the recovery just when the short-term boost to growth from the reverse of destocking is disappearing. An adverse feedback loop could exacerbate the situation. More specifically, rising unemployment and an interruption in the recovery in the housing market and other asset prices will feed back into the financial sector once more.

Even on the assumption that most economies have seen their potential growth rates shrink, another phase of contracting output will mean that output gaps will widen sharply again toward double-digit territory. Similarly, renewed increases in unemployment will widen the overshoot relative to the NAIRU. Both intensify the downward pressures on underlying inflation, making a spell of persistently negative inflation all the more likely. The spell of deflation would be deeper and more prolonged than our base-case assumption. The pick-up in oil prices that we have assumed in our base case would be delayed and there is the potential for a further decline in the near term.

Under this scenario, the Fed would be likely to leave the funds rate at 0.25% indefinitely, and the ECB would lower the refi rate to 0.5%. With central banks committing to keep policy rates this low for a long period, short-term bond yields would stay below 1% and 10-year yields would fall to around 2% initially, before rising on the back of surging issuance.

Table 1: US Economic & Financial Data – Double-Dip Scenario

| US | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|------------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| GDP (% q/q ann) | 0.4 | -2.5 | 1.3 | 0.1 | 2.2 | -6.4 | -0.7 | 2.8 | 3.3 | 2.0 | 0.0 | -0.5 | -1.0 | -0.5 | 0.0 | 1.0 | 2.0 |
| CPI (% y/y) | 3.8 | -0.3 | 1.5 | -0.3 | 0.5 | -0.2 | -0.9 | -1.6 | 1.5 | 2.5 | 2.0 | 1.0 | 0.5 | 0.0 | -0.5 | -0.5 | 0.0 |
| CPI (Ex F&E) | 2.3 | 1.7 | 0.8 | -1.1 | -0.8 | 1.7 | 1.8 | 1.5 | 1.8 | 1.6 | 1.0 | 0.5 | 0.0 | -0.5 | -1.0 | -1.5 | -1.5 |
| Fed Funds Rate (%)(²) | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| 2-Year Rate (%)(²) | 0.77 | 0.75 | 0.70 | 1.75 | 2.50 | 0.80 | 1.12 | 0.95 | 0.75 | 1.00 | 0.70 | 0.60 | 0.70 | 0.80 | 1.00 | 1.25 | 1.75 |
| 10-Year Rate (%)(²) | 2.22 | 3.25 | 2.00 | 3.25 | 5.25 | 2.67 | 3.54 | 3.31 | 3.25 | 3.25 | 2.50 | 2.25 | 2.00 | 2.25 | 2.40 | 3.00 | 3.25 |
| EUR/USD ⁽²⁾ | 1.40 | 1.54 | 1.30 | 1.45 | 1.35 | 1.33 | 1.40 | 1.46 | 1.54 | 1.40 | 1.30 | 1.25 | 1.30 | 1.32 | 1.35 | 1.40 | 1.45 |
| USD/JPY ⁽²⁾ | 91 | 85 | 112 | 120 | 105 | 99 | 96 | 90 | 85 | 93 | 101 | 108 | 112 | 115 | 120 | 123 | 120 |

Table 2: Eurozone Economic & Financial Data – Double-Dip Scenario

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|--------------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| GDP (% y/y) | 0.6 | -3.8 | 0.5 | -0.6 | 1.4 | -4.9 | -4.8 | -4.0 | -1.6 | 1.1 | 1.3 | 0.5 | -0.8 | -1.2 | -1.2 | -0.6 | 0.4 |
| HICP (% y/y) | 3.3 | 0.2 | 0.8 | 0.1 | -1.0 | 1.0 | 0.2 | -0.5 | 0.3 | 1.0 | 1.0 | 0.7 | 0.7 | 0.3 | 0.1 | 0.0 | -0.1 |
| CPI (Ex F&E) | 1.8 | 1.4 | 0.2 | -0.8 | -1.5 | 1.6 | 1.6 | 1.3 | 1.1 | 0.8 | 0.4 | 0.0 | -0.4 | -0.7 | -0.9 | -0.9 | -0.8 |
| Refinancing Rate (%)(²) | 2.50 | 1.00 | 0.50 | 0.50 | 0.50 | 1.50 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| 2-Year Rate (%)(²) | 1.74 | 1.25 | 0.75 | 1.40 | 2.40 | 1.23 | 1.38 | 1.28 | 1.25 | 1.25 | 0.90 | 0.70 | 0.75 | 1.00 | 1.10 | 1.20 | 1.40 |
| 10-Year Rate (%)(²) | 2.95 | 3.10 | 2.00 | 3.00 | 5.00 | 3.00 | 3.38 | 3.22 | 3.10 | 3.10 | 2.50 | 2.00 | 2.00 | 2.00 | 2.25 | 2.75 | 3.00 |
| EUR/JPY ⁽²⁾ | 127 | 131 | 146 | 174 | 142 | 131 | 135 | 131 | 131 | 130 | 131 | 135 | 146 | 152 | 162 | 172 | 174 |

Table 3: Japanese Economic & Financial Data – Double-Dip Scenario

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-----------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| GDP (% y/y) | -0.7 | -5.5 | 0.1 | -0.3 | 1.2 | -8.4 | -7.2 | -5.4 | -1.0 | 2.4 | 1.3 | -0.4 | -1.0 | -1.1 | -0.6 | 0.1 | 0.5 |
| CPI (% y/y) | 1.4 | -1.3 | -1.9 | -1.6 | -1.5 | -0.1 | -1.0 | -2.2 | -2.0 | -1.6 | -2.3 | -2.1 | -1.7 | -1.8 | -1.3 | -1.6 | -1.6 |
| CPI (Ex F&E) | 0.0 | -0.7 | -1.6 | -1.9 | -1.8 | -0.2 | -0.6 | -0.9 | -1.2 | -1.5 | -1.6 | -1.6 | -1.7 | -1.8 | -1.9 | -2.0 | -1.8 |
| O/N Call Rate (%)(²) | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| 2-Year Rate (%)(²) | 0.40 | 0.20 | 0.40 | 0.60 | 1.00 | 0.41 | 0.32 | 0.25 | 0.20 | 0.20 | 0.20 | 0.30 | 0.40 | 0.45 | 0.50 | 0.55 | 0.60 |
| 10-Year Rate (%)(²) | 1.18 | 1.40 | 0.85 | 1.40 | 1.20 | 1.35 | 1.36 | 1.31 | 1.40 | 1.40 | 1.10 | 0.90 | 0.85 | 0.85 | 0.90 | 1.00 | 1.40 |

Footnotes: (1) Forecast (2) End period

Source: BNP Paribas
Alan Clarke

December 2009



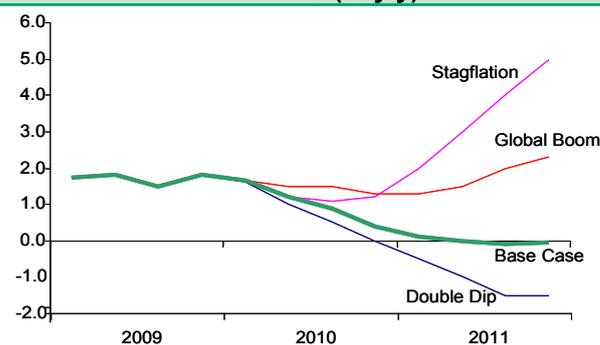
■ **Stagflation scenario (20% probability)**

Under this scenario, GDP contracts in a similar way to the contraction seen in the relapse scenario in the near term, although the subsequent pace of decline is mildly less severe than our worst-case scenario. At the same time, inflation sharply re-accelerates, despite the persistent output gap and unemployment above the NAIRU.

A catalyst for such an outcome would be a crisis of confidence in both fiscal and monetary policy. A loss of faith in central banks' ability to prevent accelerating inflation would weaken the USD and intensify capital flows into emerging markets. This would further fuel excess liquidity in Asia and Latam.

The mix of global growth would be more heavily weighted towards emerging markets than in our base case. Given that growth in these economies tends to be more energy intensive, this will exert further upward pressure on commodity prices. A surge in oil through the USD 100/bbl threshold would be perfectly reasonable. Such a jump in oil would bear down on disposable incomes and profits in the developed world, exacerbating the drag on growth.

Chart 1: US Core Inflation Under Different Risk Scenarios (% y/y)



Source: Reuters EcoWin Pro, BNP Paribas

The fallout of such a situation is likely to see further upside for gold, a weaker USD and an upward shift in longer-term inflation expectations. This situation is likely to force the Fed and other central banks to respond via higher interest rates even though domestic fundamentals are still painfully weak.

Table 4: US Economic & Financial Data – Stagflation

| US | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-----------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| GDP (% q/q ann) | 0.4 | -2.5 | 1.3 | 0.1 | 2.5 | -6.4 | -0.7 | 2.8 | 3.3 | 2.0 | 0.0 | -0.3 | -0.9 | -0.3 | 0.4 | 1.2 | 2.2 |
| CPI (% y/y) | 3.8 | -0.3 | 3.9 | 6.5 | 4.3 | -0.2 | -0.9 | -1.6 | 1.5 | 2.5 | 3.2 | 4.5 | 5.5 | 6.0 | 6.5 | 6.7 | 6.7 |
| CPI (Ex F&E) | 2.3 | 1.7 | 1.3 | 3.5 | 4.0 | 1.7 | 1.8 | 1.5 | 1.8 | 1.6 | 1.2 | 1.1 | 1.2 | 2.0 | 3.0 | 4.0 | 5.0 |
| Fed Funds Rate (%) ⁽²⁾ | 0.25 | 0.25 | 0.75 | 5.00 | 5.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.75 | 1.50 | 2.50 | 3.50 | 5.00 |
| 2-Year Rate (%) ⁽²⁾ | 0.77 | 0.75 | 3.50 | 6.50 | 4.50 | 0.80 | 1.12 | 0.95 | 0.75 | 1.00 | 2.00 | 2.75 | 3.50 | 4.00 | 5.00 | 6.00 | 6.50 |
| 10-Year Rate (%) ⁽²⁾ | 2.22 | 3.25 | 5.00 | 8.00 | 6.50 | 2.67 | 3.54 | 3.31 | 3.25 | 3.25 | 3.65 | 4.50 | 5.00 | 5.50 | 6.50 | 7.50 | 8.00 |
| EUR/USD ⁽²⁾ | 1.40 | 1.54 | 1.60 | 1.40 | 1.30 | 1.33 | 1.40 | 1.46 | 1.54 | 1.58 | 1.60 | 1.65 | 1.60 | 1.55 | 1.50 | 1.45 | 1.40 |
| USD/JPY ⁽²⁾ | 91 | 85 | 78 | 90 | 95 | 99 | 96 | 90 | 85 | 85 | 83 | 80 | 78 | 75 | 80 | 85 | 90 |

Table 5: Eurozone Economic & Financial Data – Stagflation

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-------------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| GDP (% y/y) | 0.6 | -3.8 | 0.7 | -0.4 | 1.8 | -4.9 | -4.8 | -4.0 | -1.6 | 1.2 | 1.5 | 0.7 | -0.6 | -1.0 | -1.0 | -0.4 | 0.6 |
| HICP (% y/y) | 3.3 | 0.3 | 1.7 | 4.4 | 4.5 | 1.0 | 0.2 | -0.4 | 0.5 | 1.2 | 1.5 | 1.7 | 2.6 | 3.0 | 4.0 | 4.9 | 5.7 |
| CPI (Ex F&E) | 1.8 | 1.4 | 0.8 | 3.0 | 4.0 | 1.6 | 1.6 | 1.3 | 1.1 | 0.8 | 0.8 | 0.6 | 0.9 | 1.5 | 2.5 | 3.5 | 4.5 |
| Refinancing Rate (%) ⁽²⁾ | 2.5 | 1.00 | 2.00 | 4.50 | 4.50 | 1.50 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.50 | 2.00 | 2.50 | 3.00 | 3.50 | 4.50 |
| 2-Year Rate (%) ⁽²⁾ | 1.7 | 1.25 | 3.00 | 5.50 | 4.50 | 1.23 | 1.38 | 1.28 | 1.25 | 1.25 | 1.25 | 2.00 | 3.00 | 3.80 | 4.50 | 5.00 | 5.50 |
| 10-Year Rate (%) ⁽²⁾ | 3.0 | 3.10 | 4.20 | 7.50 | 6.50 | 3.00 | 3.38 | 3.22 | 3.10 | 3.10 | 3.00 | 3.20 | 4.20 | 5.00 | 6.00 | 7.00 | 7.50 |
| EUR/JPY ⁽²⁾ | 127 | 131 | 125 | 126 | 124 | 131 | 135 | 131 | 131 | 134 | 133 | 132 | 125 | 116 | 120 | 123 | 126 |

Table 6: Japanese Economic & Financial Data – Stagflation

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|----------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| GDP (% y/y) | -0.7 | -5.5 | 0.6 | -0.3 | 1.3 | -8.4 | -7.2 | -5.4 | -1.0 | 2.4 | 1.3 | -0.4 | -1.0 | -1.1 | -0.6 | 0.1 | 0.5 |
| CPI (% y/y) | 1.4 | -1.3 | -1.1 | 1.6 | 1.8 | -0.1 | -1.0 | -2.2 | -2.0 | -1.6 | -1.7 | -1.0 | 0.0 | 0.5 | 1.6 | 1.9 | 2.2 |
| CPI (Ex F&E) | 0.0 | -0.7 | -0.8 | 1.3 | 1.3 | -0.2 | -0.6 | -0.9 | -1.2 | -1.5 | -1.0 | -0.5 | 0.0 | 0.5 | 1.0 | 1.5 | 2.0 |
| O/N Call Rate (%) ⁽²⁾ | 0.1 | 0.10 | 0.10 | 0.75 | 1.50 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.20 | 0.50 | 0.75 |
| 2-Year Rate (%) ⁽²⁾ | 0.4 | 0.20 | 0.70 | 1.40 | 2.00 | 0.41 | 0.32 | 0.25 | 0.20 | 0.20 | 0.40 | 0.60 | 0.70 | 0.80 | 1.00 | 1.20 | 1.40 |
| 10-Year Rate (%) ⁽²⁾ | 1.18 | 1.40 | 1.80 | 2.60 | 3.00 | 1.35 | 1.36 | 1.31 | 1.40 | 1.40 | 1.50 | 1.60 | 1.80 | 2.00 | 2.20 | 2.40 | 2.60 |

Footnotes: (1) Forecast (2) End period

Source: BNP Paribas



■ Global boom scenario (15% probability)

Our base-case forecasts assume that while the worst of the recession is past, the economy is not about to revert to growth rates persistently close to or above average.

However, there is a risk that the reversal in output from the previous plunge, which we are currently experiencing, morphs into an enduring global boom. Under this scenario we would expect to see global GDP growth higher than 5% y/y. The array of stimuli already delivered is more effective and takes effect more quickly than we have assumed. In addition, the recent bounce in leading indicators carries more momentum. In other words, the PMIs, having already broken through the 50 threshold, continue to rise at their recent pace and well into expansion territory.

The mix of growth is likely to be skewed more towards emerging markets. In particular, Asian policy

authorities would resist foreign exchange-rate appreciation, fuelling continued strong liquidity growth. Policymakers normalise policy only gradually, despite rising inflationary pressures. The emphasis on emerging economies' growth will exert upward pressure on oil and commodity prices.

As well as higher commodity prices than in our base case, this outcome would mean that the output gap is not as wide, and unemployment would peak at a much lower level than we have assumed. Core inflation would continue to decelerate slightly further during 2010, before upward momentum returns during 2011.

Higher commodity prices and plentiful liquidity threaten to foster excessive inflation and asset price bubbles (particularly equities). In turn, this could result in belated tightening in monetary policy, which could run the risk of eventually provoking a bust.

Table 7: US Economic & Financial Data – Global Boom Scenario

| US | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-----------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| GDP (% q/q ann) | 0.4 | -2.4 | 3.9 | 5.5 | 3.4 | -6.4 | -0.7 | 2.8 | 3.3 | 3.5 | 5.0 | 6.0 | 6.5 | 6.0 | 5.0 | 4.0 | 4.0 |
| CPI (% y/y) | 3.8 | -0.3 | 2.8 | 2.9 | 2.0 | -0.2 | -0.9 | -1.6 | 1.5 | 2.5 | 3.2 | 2.9 | 2.7 | 2.6 | 2.8 | 3.1 | 3.1 |
| CPI (Ex F&E) | 2.3 | 1.7 | 1.5 | 1.8 | 1.3 | 1.7 | 1.8 | 1.5 | 1.8 | 1.7 | 1.5 | 1.5 | 1.3 | 1.3 | 1.5 | 2.0 | 2.3 |
| Fed Funds Rate (%) ⁽²⁾ | 0.25 | 0.25 | 2.25 | 5.00 | 5.50 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.75 | 1.50 | 2.25 | 3.00 | 4.00 | 4.50 | 5.00 |
| 2-Year Rate (%) ⁽²⁾ | 0.77 | 0.75 | 3.75 | 6.00 | 5.75 | 0.80 | 1.12 | 0.95 | 0.75 | 1.75 | 2.25 | 3.00 | 3.75 | 4.25 | 5.00 | 5.50 | 6.00 |
| 10-Year Rate (%) ⁽²⁾ | 2.22 | 3.40 | 5.75 | 6.50 | 6.50 | 2.67 | 3.54 | 3.31 | 3.40 | 4.00 | 4.40 | 5.00 | 5.75 | 6.00 | 6.25 | 6.50 | 6.50 |
| EUR/USD ⁽²⁾ | 1.40 | 1.54 | 1.38 | 1.45 | 1.40 | 1.33 | 1.40 | 1.46 | 1.54 | 1.46 | 1.40 | 1.34 | 1.38 | 1.40 | 1.42 | 1.43 | 1.45 |
| USD/JPY ⁽²⁾ | 91 | 85 | 110 | 118 | 105 | 99 | 96 | 90 | 85 | 92 | 99 | 104 | 110 | 113 | 117 | 120 | 118 |

Table 8: Eurozone Economic & Financial Data – Global Boom Scenario

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-------------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| GDP (% y/y) | 0.6 | -3.9 | 2.5 | 4.0 | 3.0 | -4.9 | -4.8 | -4.1 | -1.6 | 1.5 | 2.4 | 2.9 | 3.2 | 3.9 | 4.2 | 4.1 | 3.8 |
| HICP (% y/y) | -3.8 | 0.3 | 1.6 | 2.6 | 2.0 | 1.0 | 0.2 | -0.4 | 0.5 | 1.2 | 1.6 | 1.6 | 2.2 | 2.3 | 2.6 | 2.7 | 2.7 |
| CPI (Ex F&E) | 0.3 | 1.4 | 0.9 | 1.7 | 1.8 | 1.6 | 1.6 | 1.3 | 1.1 | 0.8 | 0.9 | 0.8 | 1.0 | 1.3 | 1.6 | 1.8 | 2.0 |
| Refinancing Rate (%) ⁽²⁾ | 1.4 | 1.00 | 2.00 | 4.00 | 5.00 | 1.50 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.50 | 2.00 | 2.50 | 3.00 | 3.50 | 4.00 |
| 2-Year Rate (%) ⁽²⁾ | 1.0 | 1.30 | 3.75 | 4.75 | 5.25 | 1.23 | 1.38 | 1.28 | 1.30 | 1.50 | 2.25 | 3.25 | 3.75 | 4.00 | 4.25 | 4.50 | 4.75 |
| 10-Year Rate (%) ⁽²⁾ | 1.3 | 3.10 | 5.25 | 5.75 | 6.25 | 3.00 | 3.38 | 3.22 | 3.10 | 3.25 | 4.00 | 4.75 | 5.25 | 5.40 | 5.60 | 5.70 | 5.75 |
| EUR/JPY ⁽²⁾ | 127 | 131 | 125 | 126 | 124 | 131 | 135 | 131 | 131 | 134 | 133 | 132 | 125 | 116 | 120 | 123 | 126 |

Table 9: Japanese Economic & Financial Data – Global Boom Scenario

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|----------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| GDP (% y/y) | -0.7 | -5.2 | 3.0 | 2.9 | 2.5 | -8.4 | -7.1 | -4.4 | -1.0 | 2.9 | 3.2 | 2.8 | 3.2 | 3.3 | 2.9 | 2.7 | 2.4 |
| CPI (% y/y) | 1.4 | -1.3 | -1.4 | 0.0 | -0.1 | -0.1 | -1.0 | -2.2 | -2.0 | -1.6 | -1.8 | -1.5 | -0.8 | -0.7 | 0.1 | 0.2 | 0.2 |
| CPI (Ex F&E) | 0.0 | -0.7 | -1.1 | -0.4 | -0.2 | -0.2 | -0.6 | -0.9 | -1.2 | -1.5 | -1.1 | -1.0 | -0.8 | -0.7 | -0.5 | -0.2 | 0.0 |
| O/N Call Rate (%) ⁽²⁾ | 0.10 | 0.10 | 0.10 | 1.00 | 2.00 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 | 0.50 | 0.75 | 1.00 |
| 2-Year Rate (%) ⁽²⁾ | 0.40 | 0.20 | 1.00 | 1.60 | 2.50 | 0.41 | 0.32 | 0.25 | 0.20 | 0.20 | 0.70 | 0.90 | 1.00 | 1.25 | 1.40 | 1.50 | 1.60 |
| 10-Year Rate (%) ⁽²⁾ | 1.18 | 1.40 | 2.20 | 2.50 | 3.00 | 1.35 | 1.36 | 1.31 | 1.40 | 1.40 | 1.90 | 2.00 | 2.20 | 2.20 | 2.30 | 2.40 | 2.50 |

Footnotes: (1) Forecast (2) End period
Source: BNP Paribas



Global Liquidity

■ Emerging markets' FX reserves are rebounding

- Global narrow liquidity has rebounded from its lows in the past few months, thanks to a surge in emerging markets' FX reserves.
- The disruption to international trade and capital flows during the financial crisis caused a sharp slowdown in foreign exchange reserve accumulation in emerging markets. However, having come to a standstill in the early part of this year, growth in reserves is now running at 50% on a three-month annualised basis – its fastest rate in more than five years.
- The disproportionate regional driver of that recovery has been Asia ex-Japan, whose countries number six of the ten largest holders of foreign reserves in the world.
- Narrow money in the developed world is also growing again, thanks mainly to the US, where the central bank has expanded bank reserves by a further USD 200bn to compensate for a winding down of the Treasury Supplementary Financing Facility.

■ In advanced economies, there is still no sign of an acceleration in broad money...

- Although narrow liquidity in the advanced economies jumped some time ago, there is still little sign of that translating into a pick-up in the growth of broad money. Our broad liquidity aggregate across the G7 is growing by less than 5% y/y (Chart 2), its slowest rate of growth since August 1995. As a result, the money multiplier across the advanced economies remains moribund with no sign of a recovery.
- There has been a particularly significant deceleration in broad money growth in the eurozone, which was the disproportionate driver of broad liquidity across the developed world before the crisis. M3 growth there has slowed by nearly 11 percentage points since the start of 2008 to 2% y/y in September – its joint-slowest rate on record.
- Much has been made of the surge in broad liquidity in China. Incorporating it into our measure lifts the rate of broad money growth considerably, but there is still a significant deceleration in the aggregate measure (Chart 2).

■ ...or credit growth

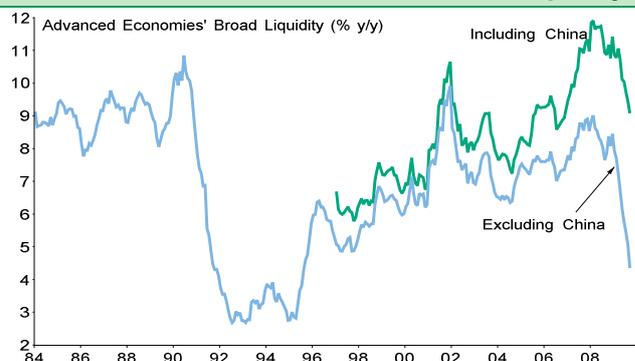
- On the asset side of the balance sheet, the counterpart to a slowdown in the growth of broad money has been a sharp deceleration in the growth of credit to the private sector.

Chart 1: Global Narrow Liquidity



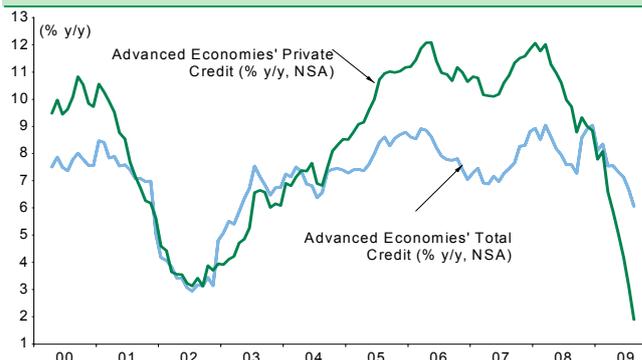
Source: Reuters EcoWin Pro, BNP Paribas

Chart 2: Advanced Economies' Broad Liquidity



Source: Reuters EcoWin Pro, BNP Paribas

Chart 3: Advanced Economies' Credit



Source: Reuters EcoWin Pro, BNP Paribas

- In contrast, the downward trend in total credit growth is much more modest, reflecting increased lending to governments and highlighting the risk of government borrowing crowding out private sector borrowing.



FMCI Update

■ FMCI Model Details

The Financial and Monetary Conditions Index gives a summary of how tight or slack monetary policy is in an economy by looking beyond the nominal interest rate and exchange rate. Specifically, the index is a weighted sum of the following components:

- Equity prices (% y/y);
- The government yield spread (3m-10y rates);
- Real corporate bond yield;
- Money supply growth;
- Real interest rates;
- TED spread proxy; and
- Real effective exchange rate (deviation from trend).

The weighted sums are then normalised so that their mean equals zero and their standard deviation is one. The result is that a reading below zero represents relatively loose financial and monetary conditions and vice versa.

US

- The US FMCI fell further during October, by 0.3 of a point, to stand 0.8 deviations below the long-term average.
- Equities rose in year-on-year terms for the first time since December 2007. This was the main driver of the loosening in US financial and monetary conditions in October.
- Our forecasts for the policy rate, bond yields, exchange rates and inflation suggest the US FMCI is likely to fall further until the end of 2009, mainly driven by the real Fed funds rate turning negative. The index will remain well below the long-run average until at least end-Q3 2011, although an appreciation relative to trend in the effective USD exchange rate and the real Fed funds rate becoming less negative will push the index gradually higher from 2010 onwards.

Eurozone

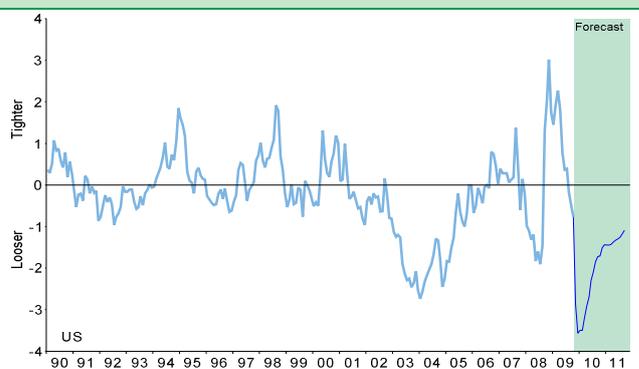
- The eurozone index fell by 0.4 of a point, to stand 0.8 standard deviations above the long-term average during October.
- This was driven by an increase in equities (in % y/y terms), as in the US, and lower real corporate bond yields.
- Our forecasts suggest the eurozone FMCI will trend lower until late 2010 due to a negative real policy rate and a depreciation relative to trend in the effective EUR exchange rate in the second

Table 1: FMCI (Standard Deviations From Avg)

| | Oct | Sep | Aug | Jul | Jun | High Since 1990 |
|-----------|------|------|------|------|------|-----------------|
| US | -0.8 | -0.5 | -0.2 | 0.4 | 0.4 | 3.0 |
| Eurozone | 0.8 | 1.2 | 1.2 | 1.6 | 1.6 | 3.3 |
| Japan | 0.6 | 1.2 | 1.3 | 1.4 | 1.1 | 2.8 |
| UK | -0.9 | -0.7 | -0.1 | 0.3 | 1.0 | 3.9 |
| Sweden | -0.5 | 0.3 | 0.4 | -0.2 | 0.0 | 4.0 |
| Norway | -0.5 | -0.3 | 0.0 | -0.6 | -0.5 | 4.4 |
| Canada | 0.8 | 1.1 | 1.5 | 1.1 | 1.0 | 2.2 |
| Australia | 1.1 | 0.9 | 1.1 | 0.8 | 1.0 | 3.0 |

Source: BNP Paribas

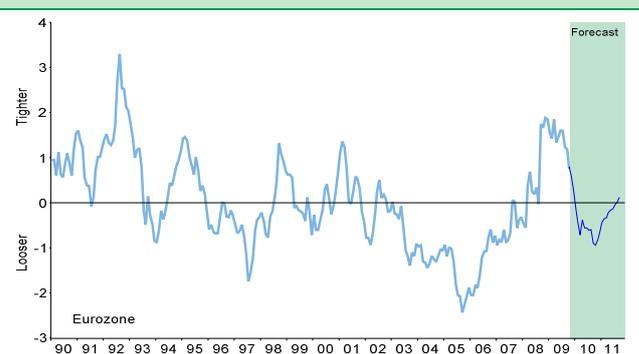
Chart 1: US FMCI



Source: BNP Paribas

SD from average

Chart 2: Eurozone FMCI



Source: BNP Paribas

SD from average

half of 2010. Thereafter, the index is likely to rise in 2011 to stand broadly in line with the long-run average by Q3 2011, driven by an increase in the real policy rate and an appreciation relative to trend in the effective EUR exchange rate.



Japan

- The Japanese FMCI fell during October, by 0.6 of a point, to stand 0.6 standard deviations above the long-term average.
- This reflects the increase in equities (in % y/y terms) and the depreciation relative to trend in the effective JPY exchange rate.
- The Japanese FMCI is now 1.1 points lower than January's recent high. Although financial and monetary conditions are still tight, at 0.6, the index is lower than its counterparts in the eurozone, Canada and Australia.

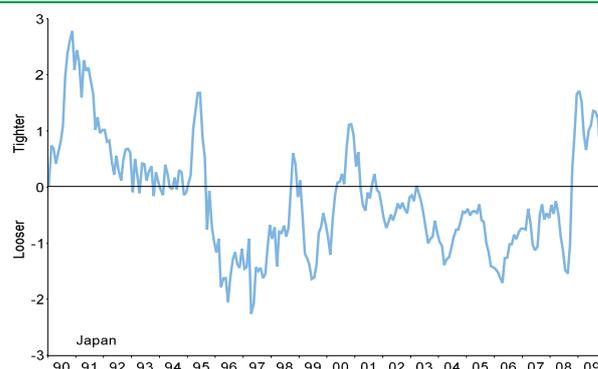
UK

- The UK FMCI fell by 0.2 of a point during October, to stand 0.9 standard deviations below the long-term average.
- This mainly reflected the increase in equities (in % y/y terms) and a slower pace of decline in house prices (in % y/y terms) which more than offset the appreciation relative to trend in the effective GBP exchange rate.
- The UK FMCI is now pointing to the loosest financial and monetary conditions among the main advanced economies. Looser financial and monetary conditions are reflected in economic data, for example in rises in surveys such as the CIPS, which have been more pronounced than their counterparts in some other advanced economies.

Sweden

- The Swedish FMCI fell significantly during October, by 0.8 of a point, to stand 0.5 standard deviations below the long-term average.
- An increase in equities (in % y/y terms) and the depreciation relative to trend in the effective SEK exchange rate were the drivers of the loosening.
- At -0.5, the index is now 4.5 points lower than its all-time high reached in November 2008. The loosening since November last year helps to explain the improvement in surveys including the manufacturing PMI. Also, given its correlation with hard economic data, the index suggests a pick-up in industrial production in the coming months given lags.

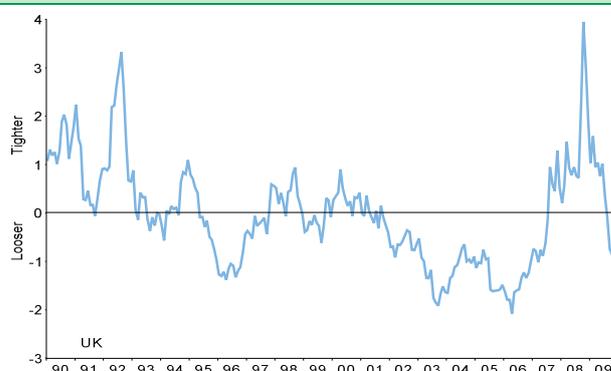
Chart 3: Japanese FMCI



Source: BNP Paribas

SD from average

Chart 4: UK FMCI



Source: BNP Paribas

SD from average

Chart 5: Swedish FMCI



Source: BNP Paribas

SD from average



Norway

- The Norwegian FMCI fell by 0.2 of a point during October, to stand 0.5 standard deviations below the long-term average.
- As in the other advanced economies, the increase in equities (in % y/y terms) was the main driver of the loosening, which offset the higher real policy rate after the 25bp rate hike at the end of October.
- The index is now 4.9 points below its all-time high reached in September 2008. This helps to explain why the Norwegian economy fared well through the crisis, with the Norges Bank being the first European central bank to start its hiking cycle in October.

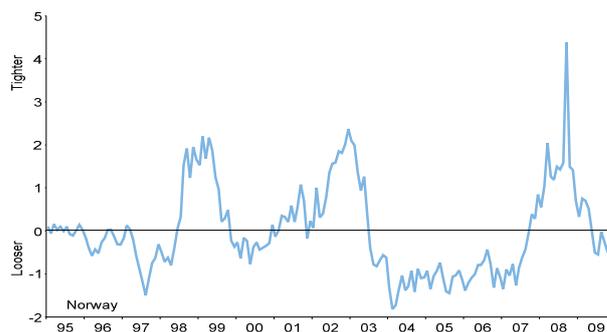
Canada

- The Canadian FMCI fell by 0.3 of a point during October, to stand 0.8 standard deviations above the long-term average.
- The increase in equities (in % y/y terms) more than offset the higher real corporate bond yield over the month.
- The Canadian FMCI is just 1.3 points below its recent peak in September 2008, pointing to one of the tightest financial and monetary conditions among the major advanced economies.

Australia

- The Australian FMCI rose during October, by 0.2 of a point, to stand 1.1 standard deviations above the long-term average.
- The appreciation relative to trend in the effective AUD exchange rate, the widening in the Ted spread proxy and higher real policy rate after the 25bp rate hike in October offset the increase in equities (in % y/y terms).
- At 1.1, the index points to the tightest financial and monetary conditions among the main advanced economies. Moreover, the 25bp rate hike at the beginning of November will serve to boost the index by 0.1 of a point.

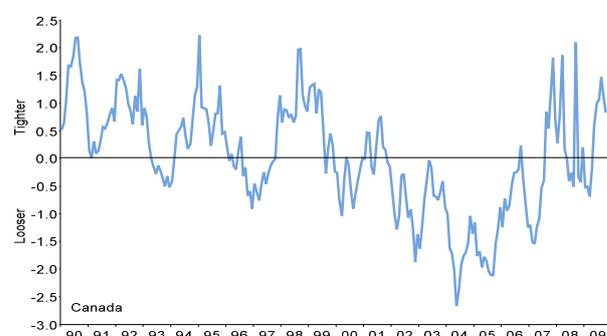
Chart 6: Norwegian FMCI



Source: BNP Paribas

SD from average

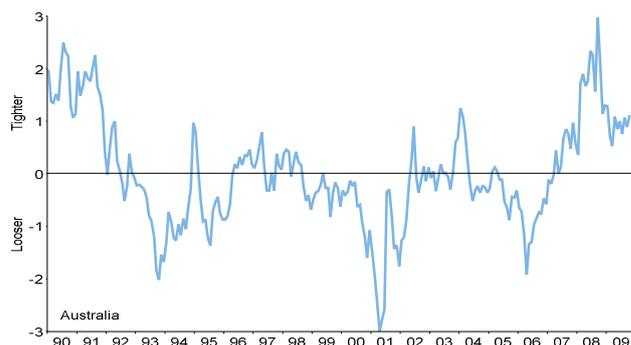
Chart 7: Canadian FMCI



Source: BNP Paribas

SD from average

Chart 8: Australian FMCI



Source: BNP Paribas

SD from average



US: Headwinds Ahead

■ **Activity: after the worst recession since WWII, GDP rebounded in H2 2009. However, headwinds will impede growth in 2010**

- A smaller decline in business inventories than in Q2 provided a 1 percentage point boost to GDP growth in Q3. Smaller drops in stocks are forecast to add a further 4.5 percentage points to total GDP growth in Q4 2009 and Q1 2010.
- However, the slowdown in inventory liquidation, resumption in housing investment and massive fiscal stimulus can only carry economic growth so far. Future growth will depend on the consumer, who is tied by rising joblessness, past indebtedness and a lack of access to credit.
- While the most cyclical components of the economy – housing and industrial production – have rebounded, both industries are still reducing their payrolls, as are the non-cyclically sensitive private industries.
- Small businesses are especially sensitive to rising employment costs and, since they account for 40% of new jobs, their reluctance to hire will weigh heavily on employment. As is usual at the start of expansions, when businesses delay hiring and use their excess supply of inputs to increase output, non-farm productivity is soaring – rising 4.3% y/y – which will push profits up.
- We expect employment to rise in Q1, especially as the federal government employs staff for its decennial census (we expect 400k temporary workers to be hired until Q3). However, we forecast that the weakness of job growth will cause the unemployment rate to rise to 11%.
- High unemployment will depress wages in the coming years, capping consumption. Moreover, households are heavily in debt and banks have tightened credit standards and are increasing credit card rates for credit-worthy consumers ahead of legislation on consumer credit lending. The lack of access to credit will further inhibit spending and encourage savings, as will households' past wealth losses.
- Meanwhile, investment in commercial real estate should continue to spiral downward as vacancy rates and delinquencies rise. Banks will have to build sizeable reserves to cover delinquencies.
- In addition, the bulk of the tax rate stimulus is past, transfers for unemployment insurance are sustaining income for the long-term unemployed and the small proportion allocated to infrastructure has yet to be spent. Federal government spending has contributed significantly to recent growth, though mostly for

defence, and transfers to state and local governments. More federal help will be necessary to support state and local budgets.

■ **Inflation: core inflation will decelerate**

- Higher crude oil prices have delayed a deceleration in headline inflation and, to a lesser extent, core inflation. However, the large and persistent negative output gap will weigh heavily on core prices and we expect core inflation to decelerate close to zero from Q4 2010.
- Inflation expectations are expected to slowly follow headline and core inflation down from current levels during 2010.

■ **Policy: more stimulus will be needed to keep the present economic momentum from stalling**

- The Fed is expected to keep monetary policy stimulative throughout 2010 and most of 2011 by maintaining its present low Fed funds rate and enlarging its balance sheet until at least Q1 2010. The Fed will purchase agency issued MBS and debt issues through March, raising its assets to an estimated USD 2.5trn. Further MBS purchases may be needed to stabilise the mortgage market. The Fed will face a difficult balancing act in trying to arrest a fall in inflation expectations while, in doing so, avoiding spooking markets and sending bond yields soaring.
- As in past recoveries, the removal of the present and prospective future stimulus will not begin until well after the unemployment rate begins to decline and inflation expectations rise. Thus rates will be kept on hold next year.
- More federal stimulus is expected in Q1 2010 when the administration has to cope with rising unemployment in an election year. Congress, which will also be under pressure to reduce the surging federal budget deficit, is likely to provide stimulus through a number of small measures.
- After rising to an estimated record high of around USD 1.5trn in FY2010, the deficit should decline in FY2011 as revenues rise with faster economic growth and due to the end of the fiscal stimulus.
- Long-term interest rates will be subject to conflicting influences next year. Disinflation, a drop in inflation expectations and disappointing economic growth should keep Treasury yields low for most of the year. However, as GDP growth reaccelerates late in the year, the competition for funds between financing a bloated federal deficit and private-sector demands is likely to raise long-term rates.



US: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-------------------------------|-------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Components of Growth | | | | | | | | | | | | | | | | | |
| % Q/Q SAAR | | | | | | | | | | | | | | | | | |
| GDP | - | - | - | - | - | -6.4 | -0.7 | 2.8 | 3.3 | 2.9 | 1.3 | 1.7 | 2.3 | 2.7 | 2.7 | 2.9 | 3.3 |
| Dom. Demand ex Stocks | -0.4 | -2.6 | 1.4 | 2.4 | 3.4 | -6.4 | -0.9 | 2.7 | 1.4 | 1.6 | 1.1 | 1.5 | 2.1 | 2.3 | 2.8 | 3.2 | 3.3 |
| Private Consumption | -0.2 | -0.6 | 1.5 | 2.2 | 2.8 | 0.6 | -0.9 | 2.9 | 1.8 | 1.4 | 0.8 | 1.6 | 2.2 | 2.2 | 2.5 | 2.6 | 2.7 |
| Public Consumption | 3.1 | 2.2 | 3.4 | 2.6 | 2.7 | -2.6 | 6.7 | 3.1 | 2.9 | 3.3 | 3.4 | 3.1 | 2.9 | 1.9 | 2.4 | 3.0 | 3.0 |
| Residential Investment | -22.9 | -19.9 | 11.1 | 13.3 | 13.7 | -38.2 | -23.2 | 19.5 | 15.1 | 17.0 | 11.3 | 6.7 | 9.4 | 15.1 | 17.5 | 16.6 | 14.2 |
| Non-Residential Investment | 1.6 | -18.1 | -4.8 | -0.3 | 5.7 | -39.2 | -9.6 | -4.1 | -5.4 | -4.4 | -4.8 | -4.6 | -2.2 | -0.5 | 1.7 | 4.0 | 4.8 |
| Stocks (Cont. to Growth) | -0.4 | -0.4 | 1.0 | 0.2 | 0.2 | -2.4 | -1.4 | 0.9 | 1.2 | 3.0 | 0.4 | 0.0 | 0.3 | 0.5 | -0.1 | 0.2 | 0.2 |
| Exports | 5.4 | -10.8 | 5.0 | 5.8 | 5.7 | -29.9 | -4.1 | 17.0 | 1.3 | 5.2 | 3.4 | 6.2 | 4.6 | 6.6 | 6.9 | 5.8 | 4.5 |
| Imports | -3.2 | -14.8 | 6.0 | 5.7 | 6.7 | -36.4 | -14.7 | 20.8 | -0.1 | 12.2 | 4.5 | 3.6 | 5.3 | 5.9 | 5.9 | 8.7 | 5.3 |
| GDP (% y/y) | 0.4 | -2.5 | 2.2 | 2.5 | 3.3 | -3.3 | -3.8 | -2.5 | -0.3 | 2.1 | 2.6 | 2.3 | 2.0 | 2.0 | 2.4 | 2.7 | 2.9 |
| Industrial Production (% y/y) | -2.2 | -9.9 | 2.6 | 3.1 | 4.8 | -11.6 | -12.9 | -9.6 | -5.3 | 1.0 | 4.2 | 3.0 | 2.3 | 2.0 | 2.6 | 3.4 | 4.1 |
| Savings Ratio (%) | 2.7 | 4.4 | 3.7 | 5.0 | 6.2 | 3.7 | 5.4 | 4.5 | 4.0 | 3.9 | 3.7 | 3.4 | 3.6 | 4.4 | 4.9 | 5.1 | 5.4 |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Inflation & Labour | | | | | | | | | | | | | | | | | |
| CPI | 3.8 | -0.3 | 2.1 | 0.9 | 0.8 | -0.2 | -0.9 | -1.6 | 1.5 | 2.5 | 2.6 | 1.9 | 1.5 | 1.2 | 1.0 | 0.9 | 0.6 |
| CPI (Ex F&E) | 2.3 | 1.7 | 1.0 | 0.0 | 0.4 | 1.7 | 1.8 | 1.5 | 1.8 | 1.7 | 1.2 | 0.9 | 0.4 | 0.1 | 0.0 | -0.1 | 0.0 |
| Core PCE Deflator | 2.4 | 1.6 | 1.1 | 0.2 | 0.5 | 1.7 | 1.6 | 1.3 | 1.5 | 1.5 | 1.2 | 1.0 | 0.6 | 0.3 | 0.2 | 0.1 | 0.1 |
| Producer Prices | 6.4 | -2.7 | 1.8 | 1.4 | 1.2 | -2.2 | -4.0 | -5.1 | 0.6 | 2.3 | 2.1 | 1.4 | 1.5 | 1.7 | 1.6 | 1.3 | 0.9 |
| Monthly Wages | 3.0 | 1.7 | 1.4 | 1.5 | 2.2 | 2.1 | 1.8 | 1.6 | 1.4 | 1.4 | 1.4 | 1.3 | 1.3 | 1.4 | 1.5 | 1.5 | 1.6 |
| Employment | -0.4 | -3.7 | -0.7 | 1.3 | 1.8 | -3.1 | -3.9 | -4.2 | -3.7 | -2.3 | -0.9 | -0.1 | 0.5 | 1.0 | 1.1 | 1.4 | 1.6 |
| Unemployment Rate (%) | 5.8 | 9.3 | 10.8 | 10.0 | 8.6 | 8.1 | 9.3 | 9.6 | 10.3 | 10.6 | 10.8 | 11.0 | 10.7 | 10.4 | 10.1 | 9.8 | 9.5 |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| External Trade | | | | | | | | | | | | | | | | | |
| Trade Balance (USD bn, sa) | -696 | -497 | -601 | -622 | -655 | -92 | -129 | -138 | -137 | -147 | -150 | -150 | -153 | -153 | -153 | -157 | -158 |
| Current Account (USD bn, sa) | -706 | -543 | -642 | -658 | -684 | -104 | -141 | -150 | -148 | -158 | -161 | -160 | -163 | -163 | -163 | -166 | -167 |
| Current Account (% GDP) | -4.9 | -3.5 | -4.4 | -4.3 | -4.3 | -2.9 | -4.0 | -4.2 | -3.0 | -4.3 | -4.4 | -4.4 | -4.4 | -4.3 | -4.3 | -4.4 | -4.3 |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|--|------|--------------------|--------------------|--------------------|--------------------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Financial Variables | | | | | | | | | | | | | | | | | |
| Money Supply | 6.9 | 8.8 | 5.6 | 5.7 | 5.7 | 9.4 | 8.7 | 9.8 | 7.3 | 5.3 | 5.7 | 5.7 | 5.7 | 5.7 | 5.7 | 5.7 | 5.7 |
| Gen. Gov. Budget (USD bn) ⁽²⁾ | -436 | -1570 | -1500 | -1300 | -1100 | -449 | -305 | -331 | -450 | -425 | -300 | -325 | -400 | -375 | -250 | -275 | -350 |
| Gen. Gov. Budget (% GDP) ⁽²⁾ | -3.1 | -11.0 | -10.2 | -8.5 | -6.9 | -7.5 | -9.9 | -11.0 | -10.7 | -10.4 | -10.3 | -10.2 | -9.8 | -9.3 | -8.9 | -8.5 | -8.1 |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|--|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Interest & FX Rates⁽³⁾ | | | | | | | | | | | | | | | | | |
| Fed Funds Rate (%) | 0.25 | 0.25 | 0.25 | 0.75 | 3.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.75 |
| 3-Month Rate (%) | 1.43 | 0.30 | 0.45 | 1.25 | 3.50 | 1.19 | 0.60 | 0.29 | 0.30 | 0.30 | 0.30 | 0.40 | 0.45 | 0.50 | 0.55 | 0.65 | 1.25 |
| 2-Year Rate (%) | 0.77 | 0.75 | 1.30 | 2.60 | 4.25 | 0.80 | 1.12 | 0.95 | 0.75 | 1.00 | 0.90 | 1.15 | 1.30 | 1.50 | 2.00 | 2.25 | 2.60 |
| 5-Year Rate (%) | 1.55 | 2.25 | 2.70 | 3.75 | 4.90 | 1.67 | 2.56 | 2.31 | 2.25 | 2.25 | 2.05 | 2.35 | 2.70 | 2.90 | 3.25 | 3.50 | 3.75 |
| 10-Year Rate (%) | 2.22 | 3.25 | 3.75 | 4.75 | 5.50 | 2.67 | 3.54 | 3.31 | 3.25 | 3.25 | 3.00 | 3.30 | 3.75 | 4.00 | 4.25 | 4.50 | 4.75 |
| EUR/USD | 1.40 | 1.54 | 1.40 | 1.47 | 1.45 | 1.33 | 1.40 | 1.46 | 1.54 | 1.48 | 1.42 | 1.38 | 1.40 | 1.42 | 1.44 | 1.45 | 1.47 |
| USD/JPY | 91 | 85 | 108 | 118 | 111 | 99 | 96 | 90 | 85 | 90 | 97 | 100 | 108 | 110 | 115 | 120 | 118 |

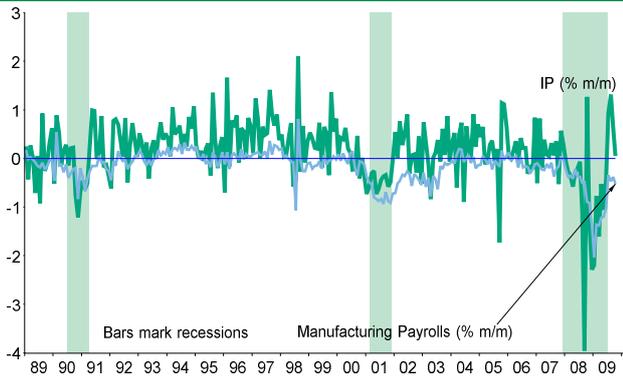
Footnotes: (1) Forecast (2) Fiscal Year (3) End Period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



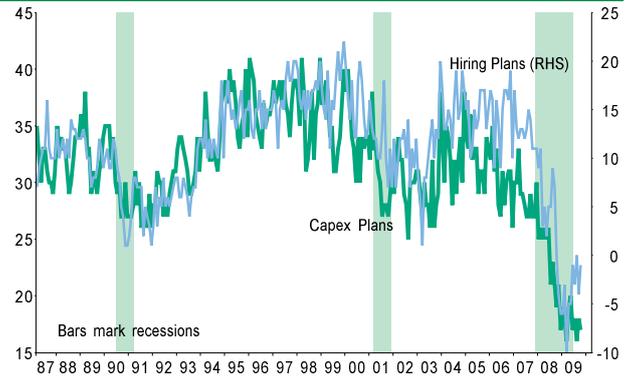
Chart 1: IP vs. Manufacturing Payrolls



Source: Reuters EcoWin Pro, BNP Paribas

Industrial production has rebounded sharply, along with the return of global trade, but manufacturers continue to cut jobs.

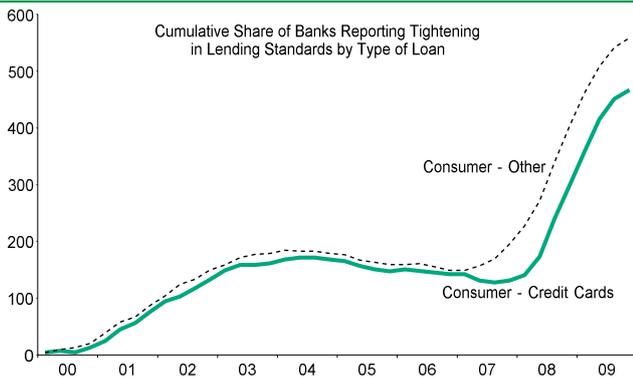
Chart 2: NFIB Survey



Source: Reuters EcoWin Pro, BNP Paribas

Small businesses typically account for 40% of all new jobs, but they are very wary about hiring now, due to the costs of proposed legislation.

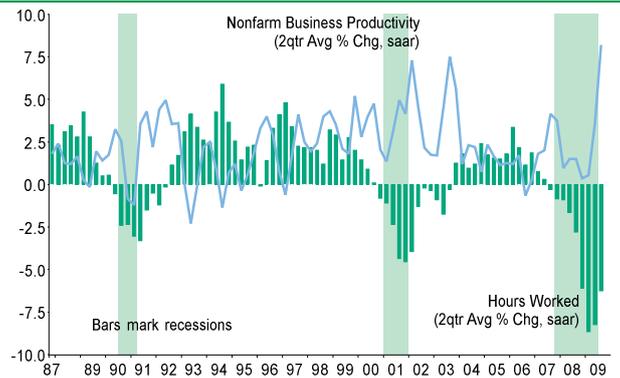
Chart 3: Credit Standards Are Getting Tighter



Source: Reuters EcoWin Pro

Banks continue to raise credit standards for all types of borrowers, especially consumers, since they are preparing for new legislation that will create a consumer protection agency.

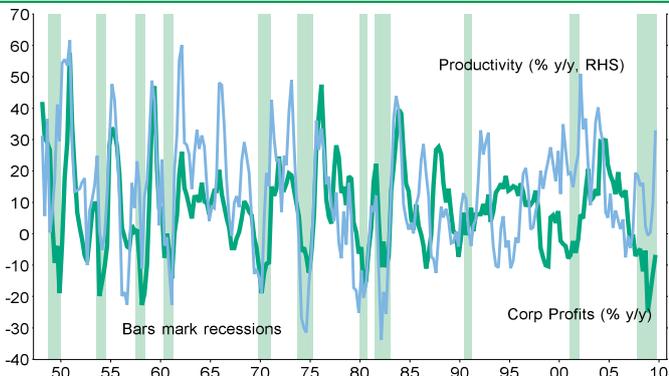
Chart 4: Productivity is Soaring as Firms Demand More from Workers in a Weak Labour Market



Source: Reuters EcoWin Pro, BNP Paribas

Businesses are cutting hours and jobs ruthlessly even though output has begun to expand. This is causing productivity to soar.

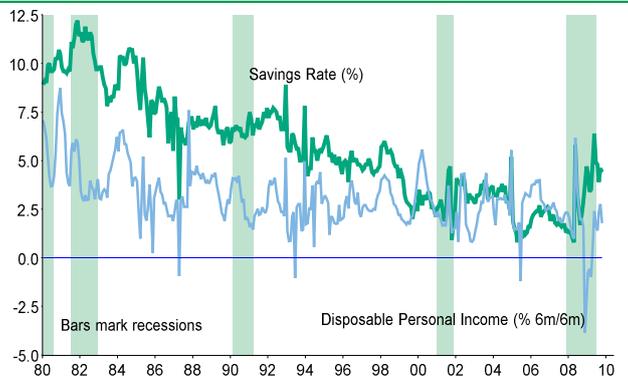
Chart 5: The Surge in Productivity Will Push Profits Up



Source: Reuters EcoWin Pro, BNP Paribas

Soaring productivity growth will increase corporate profits significantly, as typically happens at the start of new expansions. Domestic profits increased 18.3% in H1 2009 and should have continued to rise rapidly in H2.

Chart 6: DPI Growth Too Low to see Further Rise in Savings

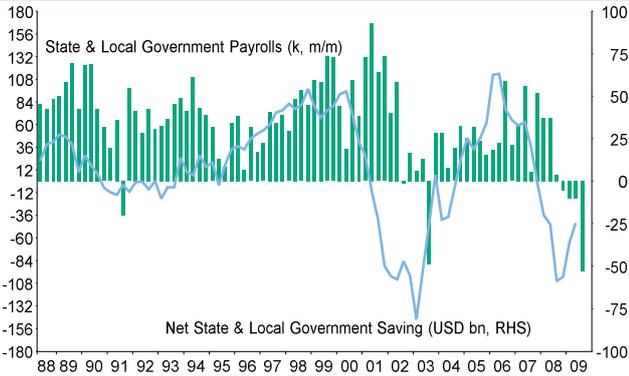


Source: Reuters EcoWin Pro, BNP Paribas

Apart from a brief surge in Q2, when the reduction in the tax rate became effective, disposable personal income has not increased fast enough for the household sector to substantially increase its savings rate.



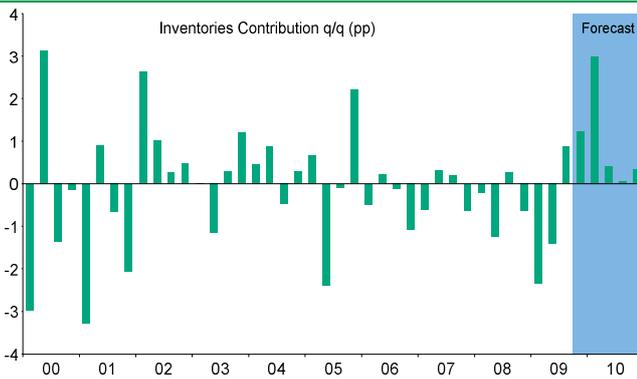
Chart 7: State and Local Government Payrolls (k)



Source: Reuters EcoWin Pro

State and local budget deficits widened to extreme levels at the end of Q2 2009, causing local governments to increase layoffs of teachers and other government workers. Federal transfers moderated the pain.

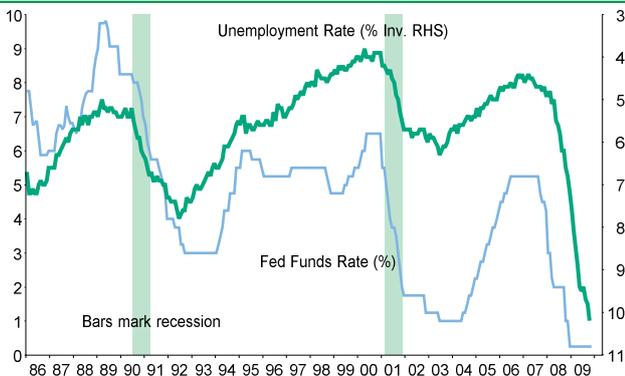
Chart 9: Contribution to Real GDP Growth From Changes in Business Inventories



Source: Reuters EcoWin Pro

Smaller declines in business inventories in the next few quarters will produce a very large contribution to GDP growth. By mid-2010, this positive boost to growth will fade away.

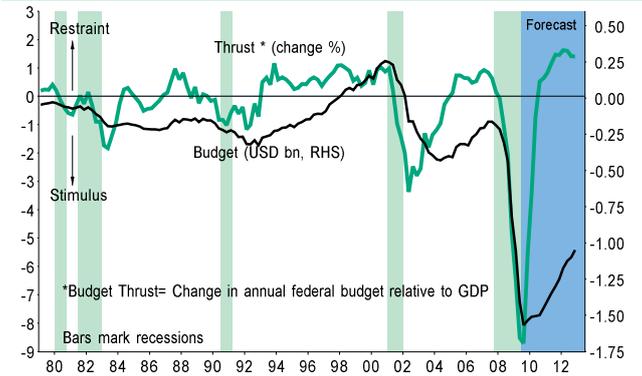
Chart 11: Fed Funds Rate Increases Follow the Fall in the UR



Source: Reuters EcoWin Pro

The Fed never begins to raise the Fed funds rate until well after the unemployment rate begins to decline. We predict that the UR will peak in Q3 2010 and therefore expect low funds throughout 2010 and most of 2011.

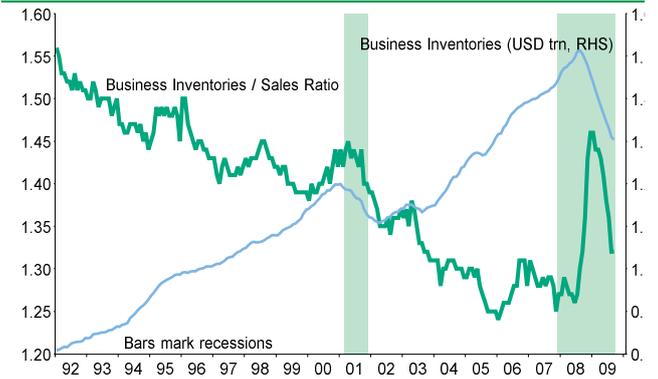
Chart 8: Fiscal Thrust Without Another Stimulus Package



Source: Reuters EcoWin Pro, BNP Paribas

The federal deficit expanded at a record rate in 2009, creating a large fiscal thrust. By 2011 the stimulus will be past and the reduction in the federal deficit will begin to restrain growth.

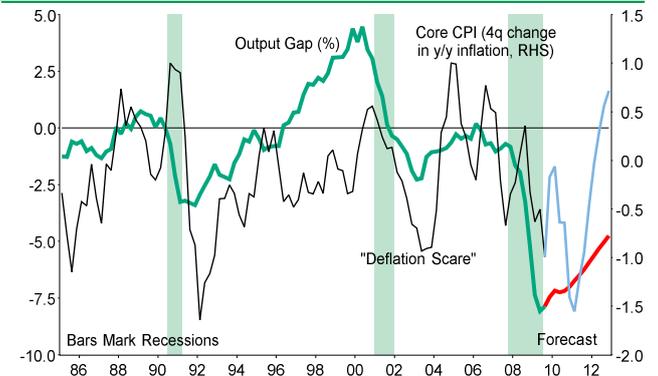
Chart 10: Inventory-Sales Ratio Has Declined But Inventories Remain Relatively High



Source: Reuters EcoWin Pro, BNP Paribas

Business inventories have fallen rapidly recently but remain relatively high. However, inventory-sales ratios have fallen faster and will soon be at a cycle low.

Chart 12: Output Gap vs. Core CPI Inflation Momentum



Source: Reuters EcoWin Pro, BNP Paribas

The present negative output gap is expected to persist over the next two years and drive year-on-year core inflation lower over the period.



Eurozone: In Recovery

- **Activity: the rebound in manufacturing has further to go but, with consumer demand set to stay weak, the momentum is likely to fade**
 - GDP expanded in Q3 on a q/q basis for the first time in six quarters, in line with our expectation of a manufacturing-driven rebound in activity. A similar pattern is likely in Q4 as the excessive fall in industrial output at the height of the financial crisis continues to unwind (Chart 1).
 - The bigger picture for the eurozone remains challenging, however, and the recovery path is likely to be uneven. The measures that have been temporarily supporting growth, such as car purchase incentives, will soon expire and there are numerous headwinds to growth, including the weakness in the labour market.
 - Rising unemployment will continue to weigh on consumer expenditure which, stripping out the incentive-driven boost to car sales, remains very weak. Retail sales, for example, declined in six consecutive quarters to Q3 (Chart 2).
 - While the pace of job losses has begun to slow, unemployment will rise further as labour markets in some national economies have not adjusted fully to the plunge in output. Productivity growth has deteriorated markedly as a result.
 - As in the business sector, consumer confidence has rebounded due to concerted policy stimulus. But surveys of willingness to spend remain much lower than the assessment of the wider economy (Chart 4). This is similar to the recovery in the mid-1990s, which ran into a soft patch. A repeat is likely in 2010 as stimulus measures fade.
 - With real income growth for households in 2010 hit by falling employment, lower compensation and rising headline inflation, private consumption will remain weak, weighing on investment. Profit and capacity utilisation trends (Chart 5) point the same way. Exports will be the main stimulus for the recovery in the short term.
 - **Inflation: the downward trend in core inflation is expected to continue**
 - We expect core inflation to continue to slow at broadly the same pace as in the past few months until the end of 2011. This view implies it will turn negative in 2011.
 - Business surveys continue to support this conclusion. Despite a significant improvement in activity expectations, businesses remain extremely cautious about their own price outlook (Chart 7), consistent with the high levels of unutilised capacity.
 - The slowdown in core inflation (from 1.9% in December 2008 to 1.2% in October) materialised in spite of resilience in the growth of unit labour costs. Against this backdrop, it is significant that those economies that have seen a quicker adjustment in employment and wages, such as Ireland and Spain, have also witnessed a more marked slowdown in core inflation.
 - We expect the downward trend in the growth of unit labour costs to spread, as high unemployment starts to take its toll on wage dynamics while productivity rebounds. This should strengthen downward pressures on core prices throughout the eurozone, especially in the more labour-intensive service sector.
 - Higher commodity prices remain a significant upward risk for headline inflation. In our central scenario, we assume that oil prices will broadly stabilise at current levels but further liquidity-induced rises in the short term cannot be ruled out. But even in the risk scenario, we doubt the shock could have significant second-round effects given the state of the labour market.
 - Risks of generalised increases in administered prices, which we emphasised in the previous *Global Outlook*, have probably diminished in the short term, as it is increasingly clear that efforts to lower budget deficits are not on the cards for 2010. But such measures remain a source of potential upward pressures on prices thereafter.
- **Policy: a muted recovery and low core inflation suggest no refi rate hikes any time soon but the unconventional stimulus will be reduced**
 - Monetary and financial conditions remain tight in the eurozone despite low interest rates (Chart 11), partly due to the high exchange rate. The exceptional weakness of money supply and bank lending are also contributing (Chart 12). In this context, we continue to believe that hikes in the ECB refinancing rate will not be delivered for some time. The poor state of public finances and the need for credible fiscal consolidation is a further support for this view.
 - The ECB is, however, beginning the exit strategy from some of its unconventional policy initiatives and the first step in this process will be to reduce the maturity of its refinancing operations, starting with the end of the 1-year LTROs in December. Given the importance of the financial sector to the sustainability of the recovery, the withdrawal from the ECB policy of enhanced credit support is likely to be gradual.



Eurozone: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Components of Growth | | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | -2.5 | -0.2 | 0.4 | 0.6 | 0.3 | 0.2 | 0.1 | 0.2 | 0.4 | 0.5 | 0.6 | 0.6 | |
| GDP | 0.6 | -3.8 | 1.3 | 1.5 | 2.5 | -4.9 | -4.8 | -4.0 | -1.6 | 1.2 | 1.6 | 1.3 | 0.9 | 1.0 | 1.2 | 1.7 | 2.0 | |
| Final Domestic Demand | 0.5 | -2.3 | 0.4 | 1.2 | 2.3 | -2.8 | -2.6 | -2.5 | -1.4 | 0.0 | 0.3 | 0.6 | 0.8 | 1.0 | 1.1 | 1.3 | 1.5 | |
| Private Consumption | 0.3 | -0.9 | 0.4 | 0.9 | 2.0 | -1.4 | -0.9 | -0.9 | -0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 0.6 | 0.8 | 1.0 | 1.2 | |
| Public Consumption | 2.1 | 2.5 | 2.4 | 1.8 | 1.4 | 2.6 | 2.5 | 2.4 | 2.4 | 2.4 | 2.2 | 2.4 | 2.4 | 2.2 | 1.9 | 1.7 | 1.4 | |
| Fixed Investment | -0.6 | -10.5 | -1.4 | 1.4 | 4.3 | -11.2 | -11.4 | -11.0 | -8.2 | -3.4 | -1.6 | -0.7 | 0.1 | 0.9 | 0.9 | 1.6 | 2.3 | |
| Stocks (Cont. to Growth, q/q) | 0.1 | -0.6 | 0.4 | 0.2 | 0.0 | -0.6 | -0.6 | 0.0 | 0.2 | 0.2 | 0.2 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 | |
| Exports ⁽²⁾ | 1.0 | -13.9 | 4.8 | 4.5 | 6.5 | -16.8 | -17.7 | -14.4 | -6.2 | 4.6 | 6.8 | 4.5 | 3.4 | 3.4 | 4.3 | 4.9 | 5.6 | |
| Imports ⁽²⁾ | 1.0 | -12.2 | 3.6 | 4.6 | 6.4 | -12.8 | -14.4 | -13.4 | -8.1 | 0.8 | 4.9 | 4.4 | 4.2 | 4.3 | 4.5 | 4.7 | 5.1 | |
| Industrial Production | -1.7 | -14.1 | 4.6 | 0.9 | 3.6 | -17.7 | -18.2 | -15.0 | -5.1 | 5.9 | 7.0 | 4.1 | 1.3 | -0.3 | 0.2 | 1.4 | 2.4 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Inflation & Labour | | | | | | | | | | | | | | | | | | |
| HICP | 3.3 | 0.3 | 1.3 | 0.7 | 0.7 | 1.0 | 0.2 | -0.4 | 0.5 | 1.2 | 1.2 | 1.3 | 1.5 | 1.0 | 0.8 | 0.7 | 0.5 | |
| Core HICP | 1.8 | 1.4 | 0.5 | -0.2 | 0.3 | 1.6 | 1.6 | 1.3 | 1.1 | 0.8 | 0.5 | 0.4 | 0.3 | 0.0 | -0.2 | -0.3 | -0.2 | |
| Producer Prices | 6.0 | -5.2 | -0.3 | 0.8 | 2.4 | -2.0 | -5.7 | -7.8 | -5.0 | -1.4 | -0.2 | 0.1 | 0.4 | 0.4 | 0.7 | 1.0 | 1.1 | |
| Comp. per Employee | 3.2 | 1.6 | 1.4 | 1.3 | 2.3 | 1.8 | 1.6 | 1.4 | 1.7 | 1.9 | 1.5 | 1.1 | 0.9 | 1.0 | 1.1 | 1.4 | 1.5 | |
| Productivity | -0.2 | -2.1 | 2.1 | 1.0 | 1.6 | -3.7 | -3.0 | -2.0 | 0.4 | 2.7 | 2.7 | 1.8 | 1.1 | 0.9 | 0.8 | 1.1 | 1.3 | |
| Unit Labour Costs | 3.4 | 3.7 | -0.7 | 0.2 | 0.7 | 5.7 | 4.6 | 3.4 | 1.3 | -0.8 | -1.2 | -0.7 | -0.2 | 0.1 | 0.3 | 0.3 | 0.2 | |
| Employment | 0.8 | -1.8 | -0.8 | 0.5 | 0.9 | -1.3 | -1.8 | -2.1 | -2.0 | -1.5 | -1.1 | -0.5 | -0.2 | 0.1 | 0.4 | 0.6 | 0.7 | |
| Unemployment Rate (%) | 7.6 | 9.4 | 10.5 | 10.5 | 9.8 | 8.8 | 9.3 | 9.6 | 9.9 | 10.2 | 10.4 | 10.6 | 10.6 | 10.6 | 10.5 | 10.4 | 10.3 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|-----|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| External Trade | | | | | | | | | | | | | | | | | | |
| Trade Balance (EUR bn, sa) | -55 | 22 | 10 | 10 | 15 | -11 | 3 | 15 | 15 | 10 | 3 | 0 | -3 | 0 | 2 | 3 | 5 | |
| Current Account (EUR bn, sa) | -143 | -75 | -75 | -70 | -60 | -37 | -12 | 0 | -26 | -25 | -10 | -15 | -25 | -20 | -15 | -15 | -20 | |
| Current Account (% of GDP) | -1.6 | -0.8 | -0.8 | -0.7 | -0.6 | -1.7 | -0.5 | 0.0 | -1.1 | -1.1 | -0.4 | -0.7 | -1.1 | -0.9 | -0.6 | -0.6 | -0.9 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|----------------------------|------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | |
| Financial Variables | | | | | | | | | | | | | | | | | | |
| Gen. Gov. Budget (EUR bn) | -175 | -576 | -622 | -588 | -466 | - | - | - | - | - | - | - | - | - | - | - | - | |
| Gen. Gov. Budget (% GDP) | -1.9 | -6.5 | -6.9 | -6.4 | -4.9 | - | - | - | - | - | - | - | - | - | - | - | - | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|--|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Interest & FX Rates⁽³⁾ | | | | | | | | | | | | | | | | | | |
| Refinancing Rate (%) | 2.50 | 1.00 | 1.00 | 1.25 | 3.00 | 1.50 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.25 | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 | 1.51 | 1.10 | 0.75 | 0.70 | 0.60 | 0.60 | 0.65 | 1.10 | 1.25 | 1.50 | 2.00 | 2.25 | |
| 2-Year Rate (%) | 1.74 | 1.25 | 1.50 | 2.75 | 3.75 | 1.23 | 1.38 | 1.28 | 1.25 | 1.25 | 1.25 | 1.50 | 1.50 | 1.75 | 2.25 | 2.50 | 2.75 | |
| 5-Year Rate (%) | 2.35 | 2.20 | 2.50 | 3.50 | 4.25 | 2.24 | 2.51 | 2.42 | 2.20 | 2.20 | 2.10 | 2.35 | 2.50 | 2.75 | 3.15 | 3.40 | 3.50 | |
| 10-Year Rate (%) | 2.95 | 3.10 | 3.50 | 4.25 | 4.75 | 3.00 | 3.38 | 3.22 | 3.10 | 3.10 | 2.90 | 3.20 | 3.50 | 3.75 | 4.00 | 4.25 | 4.25 | |
| EUR/USD | 1.40 | 1.54 | 1.40 | 1.47 | 1.45 | 1.33 | 1.40 | 1.46 | 1.54 | 1.48 | 1.42 | 1.38 | 1.40 | 1.42 | 1.44 | 1.45 | 1.47 | |
| EUR/GBP | 0.96 | 0.92 | 1.00 | 0.91 | 0.90 | 0.92 | 0.85 | 0.91 | 0.92 | 0.88 | 0.91 | 0.95 | 1.00 | 0.94 | 0.93 | 0.92 | 0.91 | |
| EUR/JPY | 127 | 131 | 151 | 173 | 161 | 131 | 135 | 131 | 131 | 133 | 138 | 138 | 151 | 156 | 166 | 174 | 173 | |

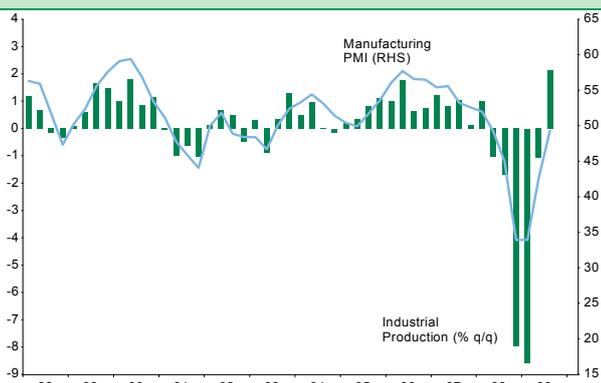
Footnotes: (1) Forecast (2) Includes intra-eurozone trade (3) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



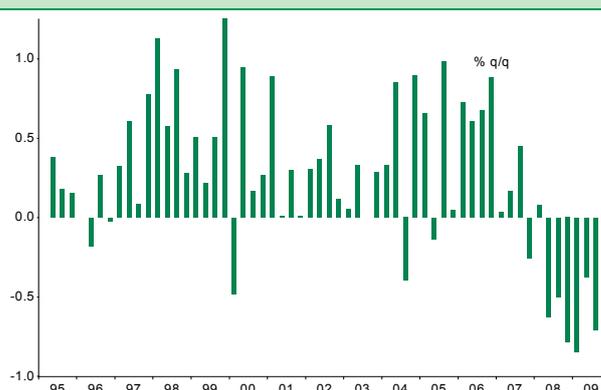
Chart 1: PMI & Production



Source: Reuters EcoWin Pro

The reversal of the excessive collapse in industrial production at the height of the financial crisis is the main driver of the current rebound in GDP growth.

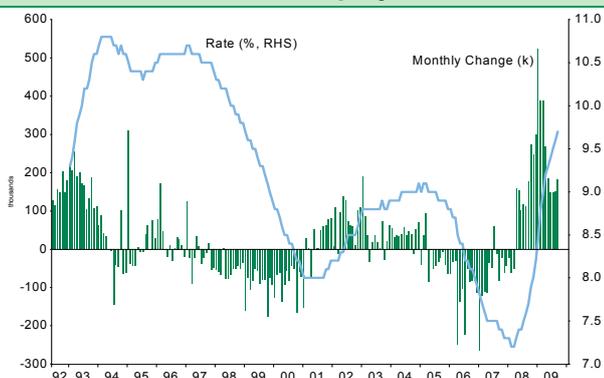
Chart 2: Retail Sales



Source: Reuters EcoWin Pro

The underlying trend in consumer spending remains weak, with retail sales contracting for several quarters.

Chart 3: Unemployment



Source: Reuters EcoWin Pro

Unemployment will continue to rise into 2010 as the labour market continues to adjust to the plunge in output, but the rate of increase is moderating.

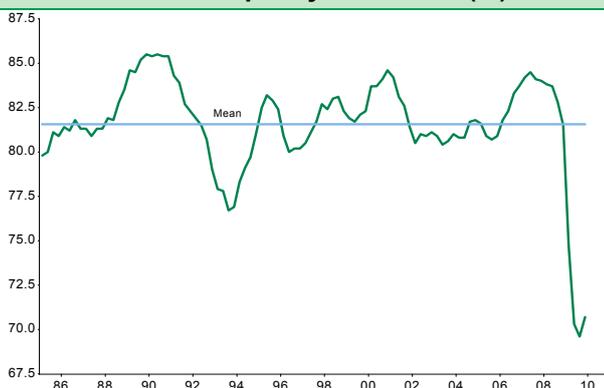
Chart 4: Consumer Sentiment by Sector



Source: Reuters EcoWin Pro

Consumer confidence about the economic outlook has improved markedly but the willingness to make major purchases remains comparatively low.

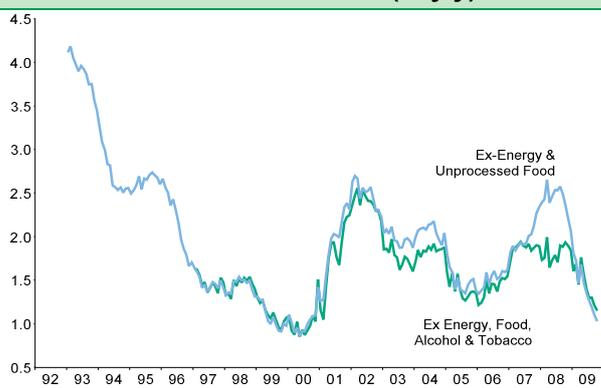
Chart 5: Capacity Utilisation (%)



Source: Reuters EcoWin Pro

Capacity utilisation has plunged to exceptionally low levels. This, combined with the deterioration in corporate profits and the likelihood that final demand will remain weak, will weigh on investment.

Chart 6: Core HICP (% y/y)

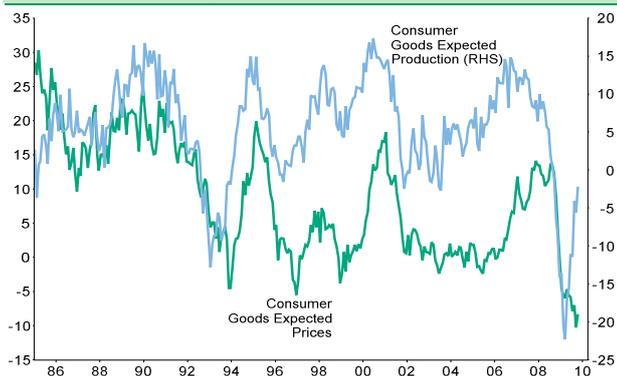


Source: Reuters EcoWin Pro

Core inflation has been slowing sharply in the past few months. We expect this trend to continue.



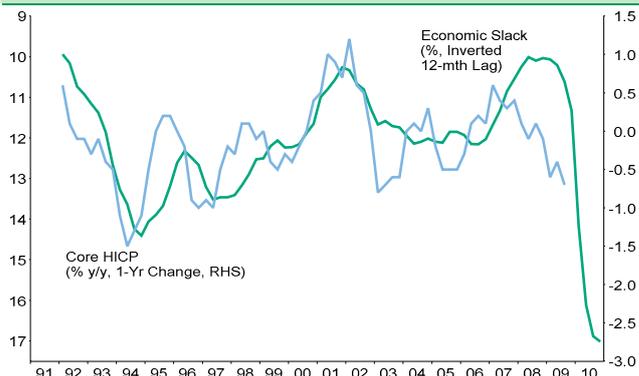
Chart 7: Expected Prices vs. Production



Source: Reuters EcoWin Pro

Despite a significant improvement in confidence, businesses' price expectations remain subdued and close to their historical lows.

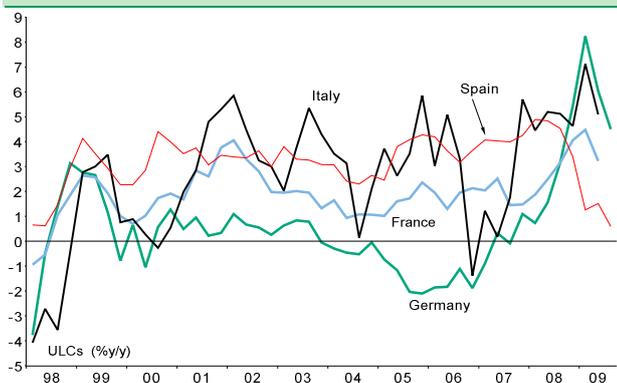
Chart 8: Slack vs. Core HICP



Source: Reuters EcoWin Pro

Measures of economic slack point to a further slowdown in core inflation.

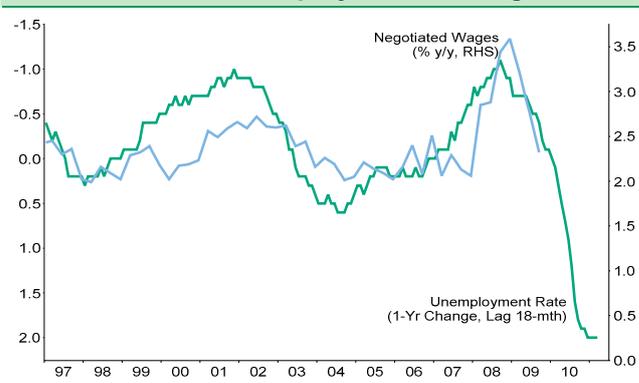
Chart 9: ULCs



Source: Reuters EcoWin Pro

Growth in unit labour costs has remained robust...

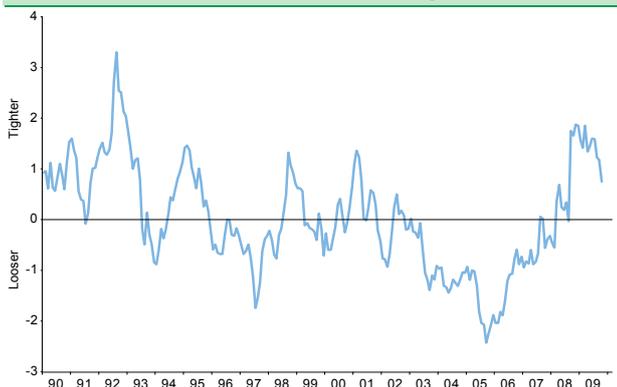
Chart 10: Unemployment vs. Wages



Source: Reuters EcoWin Pro

...but these trends will reverse soon as high unemployment starts to take its toll on wage dynamics while productivity rebounds.

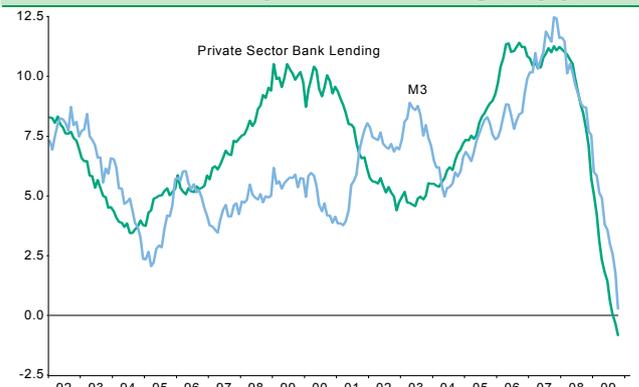
Chart 11: Financial & Monetary Conditions



Source: Reuters EcoWin Pro

Financial and monetary conditions in the eurozone have eased but they remain tight, related to the strong exchange rate and the weakness of money and credit growth.

Chart 12: Money & Bank Lending (% y/y)



Source: Reuters EcoWin Pro

M3 growth is exceptionally low, while the year-on-year rate of increase in bank lending to the private sector has turned negative for the first time in the series' history.



Japan: Unable to Match the Rest of Asia

- **Activity: our forecasts have been revised up slightly given relatively strong exports**
 - The Japanese economy has been rebounding since Q2, but we believe that a self-sustaining recovery is not underway given that the main drivers to date are, both at home and overseas, the end to inventory destocking and fiscal stimuli.
 - Industrial production has picked up in the past few months but in September it was still 22% below February 2008's peak. The worst now appears to be over for export-related sectors, but returns on capital remain very low, forcing firms to curb capital spending and reduce fixed costs by lowering wages and laying off workers.
 - For autonomous economic growth, corporate earnings must recover and the improvement must spread to household income. However, worker compensation seems set to continue to fall. Hence we expect the economic recovery in 2010 to be modest.
 - With the current recovery likely to falter as the fiscal stimulus fades and inventory restocking is completed, we expect Japan's economy to hit a soft patch in Q2 2010. Stronger growth is unlikely to resume before Q4 2010.
 - With China and other Asian economies performing better than expected, export growth will probably be one of Japan's few strengths for the time being. However, US and European consumers' increasing price-consciousness in the post-bubble era is restraining demand for Japanese manufactured products, with manufacturers in other Asian countries the main beneficiaries. Japan's international competitiveness has also been hit by the yen's strengthening since the autumn of 2008, enabling the booming Asian economies to race further ahead.
 - The unemployment rate looks to have peaked in July. A significant rise may have been avoided due to both the withdrawal of the elderly unemployed from the labour market and a significant decline in wages. Nominal wages are no longer exhibiting significant downward rigidity, and real wages have thus fallen sharply, in line with declining labour productivity.
 - Japan's potential growth rate may now be well below 1%. Japanese non-manufacturers have struggled with low labour productivity growth over the past twenty years, while manufacturers have seen their productivity growth slow on excess production capacity. Manufacturers will thus have little incentive to accumulate new capital stock in the next few years.
- **Inflation: deflation set to continue**
 - The nationwide core CPI registered another big decline in September, falling 2.3% y/y. While the economy continues to recover, a huge gap between supply and demand suggests there is little prospect of deflationary pressure easing soon. The employment climate is no longer deteriorating so rapidly but falling household incomes have made consumers increasingly budget-conscious, forcing more and more firms to adopt low-price strategies. Deep-rooted deflationary expectations in the household and corporate sectors will probably prove difficult to shake.
 - The pace of core CPI deflation is likely to slow from November as prices of petroleum products stop showing such sharp year-on-year declines. This is merely a technical development, and we expect the inflation rate to remain below -1% y/y as deflationary pressure continues to spread.
 - The government plans to abolish the provisional (higher) gasoline tax rate in FY 2010, which would lower the core CPI by around 0.53 of a percentage point in FY 2010 and 0.4 of a percentage point in CY 2010. However, the government could introduce an environment tax instead, in which case CY 2010's CPI could be boosted by 0.4 of a percentage point. The CPI could also receive a 0.64 of a percentage point boost if a higher tobacco tax doubles the price of a twenty-cigarette pack to 600 yen, but this appears unlikely at present.
- **Policy: ultra-low interest rate policy to remain**
 - The BoJ will stop purchasing commercial paper and corporate bonds by end-December and will terminate its Special Funds-Supplying Operations to Facilitate Corporate Financing at end-March. However, as the BoJ forecasts three years of negative CPI inflation through FY 2011, we expect its ultra-low interest rate policy to remain in place for the foreseeable future.
 - In theory, long-term interest rates are determined largely by the equilibrium real interest rate (approximately equal to the per capita potential growth rate), the expected long-term inflation rate and the fiscal risk premium. Long-term JGB yields have remained range-bound over the past year despite a sharply lower potential growth rate and much weaker inflation expectations, suggesting that the fiscal risk premium has increased as financial markets start to discount a lower probability of Japan's fiscal deficits being sustainable in the long term.



Japan: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|--|-------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Components of Growth | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | -3.2 | 0.7 | 1.2 | 0.4 | 0.2 | 0.0 | 0.2 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 |
| GDP (% q/q annualised) | - | - | - | - | - | -12.2 | 2.7 | 4.8 | 1.6 | 1.0 | 0.1 | 0.7 | 1.2 | 1.7 | 1.7 | 1.7 | 1.7 |
| GDP (% y/y) | -0.7 | -5.2 | 1.5 | 1.4 | 1.6 | -8.6 | -7.0 | -4.5 | -1.0 | 2.5 | 1.9 | 0.8 | 0.7 | 0.9 | 1.3 | 1.6 | 1.7 |
| Domestic Demand ex-Stocks | -0.7 | -3.0 | 0.5 | 0.7 | 1.5 | -2.0 | -0.1 | 0.4 | 0.6 | 0.0 | -0.2 | -0.0 | 0.1 | 0.3 | 0.3 | 0.3 | 0.3 |
| Private Consumption | 0.6 | -0.6 | 0.4 | 0.3 | 1.0 | -1.1 | 1.0 | 0.7 | 0.1 | 0.0 | -0.3 | -0.1 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 |
| Government Expenditure | -0.6 | 2.3 | -1.1 | -0.2 | 0.6 | 0.7 | 1.2 | 0.1 | -0.2 | -0.6 | -0.5 | -0.5 | -0.4 | 0.3 | 0.2 | 0.2 | 0.2 |
| Private Capital Spending | -3.9 | -18.0 | 3.0 | 4.1 | 5.4 | -8.2 | -4.2 | 1.6 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| Stocks (Cont. to Growth) | -0.2 | -0.2 | 0.3 | 0.0 | 0.0 | -0.4 | -0.7 | 0.4 | 0.2 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Exports | 1.8 | -25.0 | 13.7 | 10.4 | 9.0 | -21.6 | 6.4 | 6.4 | 3.0 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Imports | 0.9 | -14.6 | 7.3 | 7.5 | 10.9 | -14.0 | -4.2 | 3.4 | 3.0 | 2.0 | 1.5 | 1.5 | 1.5 | 2.0 | 2.0 | 2.0 | 2.0 |
| Industrial Production (% q/q) | - | - | - | - | - | -22.1 | 8.3 | 7.4 | 6.2 | 2.9 | 0.5 | 0.5 | 0.8 | 1.3 | 1.3 | 1.3 | 1.3 |
| Industrial Production (% y/y) | -3.4 | -22.1 | 14.3 | 4.2 | 5.0 | -34.6 | -27.8 | -20.1 | -3.8 | 27.1 | 18.0 | 10.5 | 4.8 | 3.2 | 3.9 | 4.6 | 5.2 |
| Savings Ratio (%) | 1.6 | -0.1 | -0.9 | -0.8 | 0.3 | - | - | - | - | - | - | - | - | - | - | - | - |
| Inflation & Labour | | | | | | | | | | | | | | | | | |
| (% y/y) | | | | | | | | | | | | | | | | | |
| CPI | 1.4 | -1.3 | -1.8 | -0.8 | -0.7 | -0.1 | -1.0 | -2.2 | -2.0 | -1.6 | -2.1 | -1.9 | -1.4 | -1.2 | -0.6 | -0.7 | -0.8 |
| CPI (Core) | 1.5 | -1.3 | -1.6 | -0.8 | -0.7 | -0.1 | -1.0 | -2.3 | -1.7 | -1.4 | -1.9 | -1.6 | -1.4 | -1.2 | -0.6 | -0.7 | -0.8 |
| US-Like Core CPI ⁽²⁾ | 0.0 | -0.7 | -1.4 | -1.1 | -0.8 | -0.2 | -0.6 | -0.9 | -1.2 | -1.5 | -1.4 | -1.4 | -1.4 | -1.2 | -1.2 | -1.1 | -1.0 |
| Monthly Wages | -0.3 | -4.0 | -2.5 | -1.0 | 0.0 | -3.0 | -4.6 | -3.6 | -4.4 | -3.1 | -2.5 | -2.2 | -2.0 | -1.6 | -1.2 | -0.8 | -0.4 |
| Employment | -0.4 | -1.6 | -0.8 | 0.0 | 0.5 | -0.8 | -2.0 | -1.8 | -2.0 | -1.9 | -0.5 | -0.4 | -0.4 | -0.2 | 0.0 | 0.1 | 0.2 |
| Unemployment Rate (%) | 4.0 | 5.1 | 5.3 | 4.9 | 4.1 | 4.4 | 5.2 | 5.5 | 5.3 | 5.3 | 5.3 | 5.3 | 5.2 | 5.1 | 5.0 | 4.8 | 4.7 |
| External Trade | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | |
| Trade Balance (JPY trn sa) | 4.0 | 3.7 | 6.7 | 9.1 | 9.0 | -2.0 | 5.6 | 5.8 | 5.2 | 5.6 | 6.3 | 7.0 | 7.8 | 8.3 | 8.8 | 9.3 | 9.9 |
| Current Account (JPY trn, sa) | 16.4 | 12.9 | 13.9 | 15.5 | 15.0 | 7.2 | 15.8 | 14.9 | 13.8 | 13.6 | 13.8 | 14.0 | 14.2 | 14.7 | 15.2 | 15.7 | 16.2 |
| Current Account (% GDP) | 3.2 | 2.7 | 2.9 | 3.2 | 3.1 | 1.5 | 3.3 | 3.1 | 2.9 | 2.8 | 2.9 | 2.9 | 3.0 | 3.1 | 3.2 | 3.3 | 3.4 |
| Financial Variables | | | | | | | | | | | | | | | | | |
| (% y/y) | | | | | | | | | | | | | | | | | |
| Money Supply (M2) | 2.1 | 2.6 | 3.0 | 3.4 | 3.8 | 2.1 | 2.6 | 2.8 | 2.9 | 3.0 | 3.0 | 3.0 | 3.1 | 3.2 | 3.3 | 3.4 | 3.5 |
| Gov. Budget (JPY trn) ⁽³⁾⁽⁴⁾ | -33.2 | -50.7 | -43.2 | -42.2 | -41.2 | - | - | - | - | - | - | - | - | - | - | - | - |
| Gov. Budget (% GDP) ⁽³⁾⁽⁴⁾ | -6.7 | -10.6 | -9.1 | -8.9 | -8.7 | - | - | - | - | - | - | - | - | - | - | - | - |
| Interest & FX Rates⁽⁵⁾ | | | | | | | | | | | | | | | | | |
| | | | | | | | | | | | | | | | | | |
| O/N Call Rate (%) | 0.10 | 0.10 | 0.10 | 0.25 | 0.75 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 |
| 3-Month Rate (%) | 0.74 | 0.45 | 0.35 | 0.35 | 0.85 | 0.65 | 0.56 | 0.54 | 0.45 | 0.45 | 0.45 | 0.40 | 0.35 | 0.30 | 0.25 | 0.25 | 0.35 |
| 2-Year Rate (%) | 0.40 | 0.20 | 0.45 | 0.90 | 1.40 | 0.41 | 0.32 | 0.25 | 0.20 | 0.20 | 0.25 | 0.35 | 0.45 | 0.55 | 0.65 | 0.80 | 0.90 |
| 5-Year Rate (%) | 0.71 | 0.70 | 1.00 | 1.50 | 1.60 | 0.78 | 0.71 | 0.60 | 0.70 | 0.70 | 0.80 | 0.90 | 1.00 | 1.20 | 1.30 | 1.40 | 1.50 |
| 10-Year Rate (%) | 1.18 | 1.40 | 1.70 | 2.10 | 2.20 | 1.35 | 1.36 | 1.31 | 1.40 | 1.40 | 1.50 | 1.60 | 1.70 | 1.80 | 1.90 | 2.00 | 2.10 |
| USD/JPY | 91 | 85 | 108 | 118 | 111 | 99 | 96 | 90 | 85 | 90 | 97 | 100 | 108 | 110 | 115 | 120 | 118 |
| EUR/JPY | 127 | 131 | 151 | 173 | 161 | 131 | 135 | 131 | 131 | 133 | 138 | 138 | 151 | 156 | 166 | 174 | 173 |

Footnotes: (1) Forecast (2) US-Like Core CPI: CPI excluding food (but including alcoholic beverages) and energy (3) FY (4) Central government

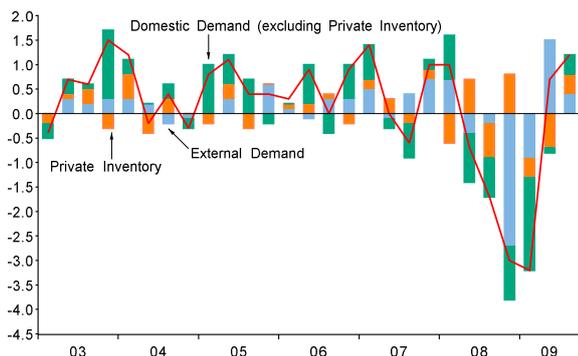
(5) End period

Figures are quarter-on-quarter percentage changes unless otherwise indicated

Source: BNP Paribas



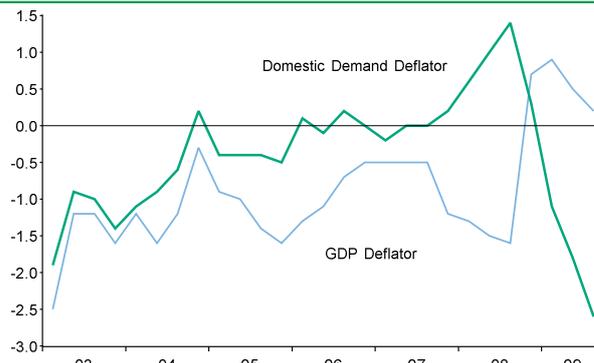
Chart 1: Contribution to Real GDP (% q/q)



Source: Cabinet Office, BNP Paribas

Led by a revival in exports, stimulus-driven consumption and inventory rebuilding, real GDP grew a robust 4.8% q/q (annualised) in Q3.

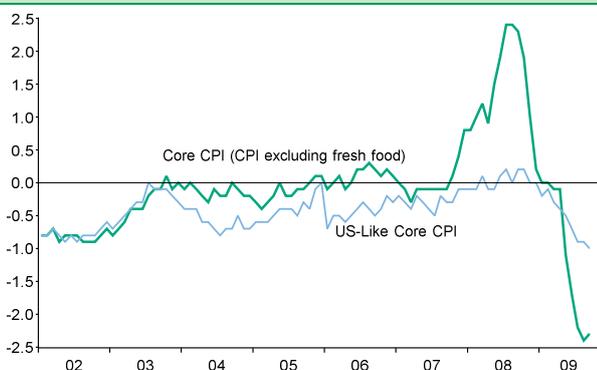
Chart 2: GDP Deflator (% y/y)



Source: Cabinet Office, BNP Paribas

The domestic demand deflator declined by a steep 2.6% y/y in Q3, with the drop accelerating from a 1.8% fall in Q2. The increase in the GDP deflator slowed to 0.2% y/y from 0.5% in Q2.

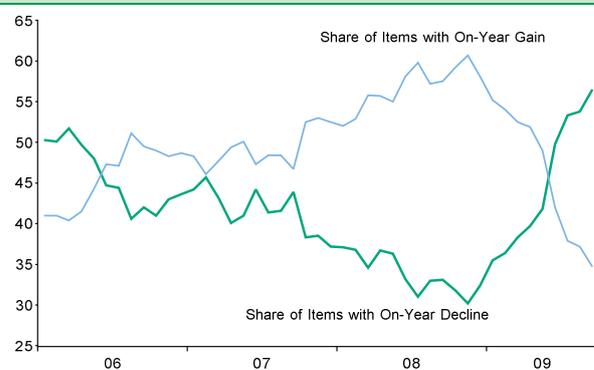
Chart 3: Core CPI (% y/y)



Source: MIC, BNP Paribas

The core CPI plummeted 2.3% y/y in September, as prices of petroleum products fell sharply after their surge last year. The US-style core CPI is also falling, as prices decline for a broad range of goods and services because of the widening supply-demand gap.

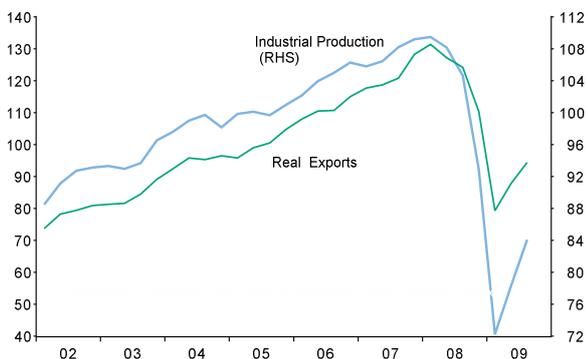
Chart 4: Share of CPI Gainers vs. Decliners (% y/y)



Source: MIC, BNP Paribas

The percentage of items in the CPI registering price increases is falling while the percentage registering price declines is mounting. Almost 60% of the goods and services in the CPI are now cheaper than a year ago.

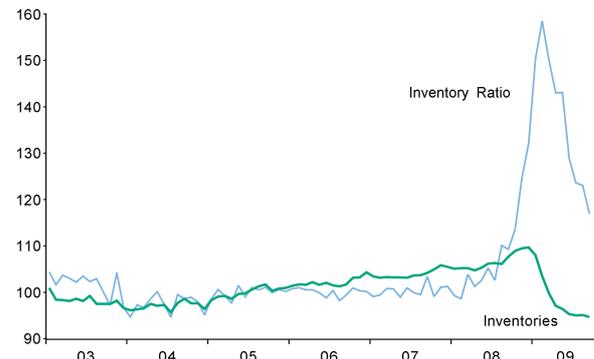
Chart 5: Real Exports and Industrial Production (2005=100, sa)



Source: MOF, BoJ, METI, BNP Paribas

Thanks to the end of inventory liquidation and fiscal stimulus, as well as the upturn in emerging economies, production and exports are continuing to recover.

Chart 6: Inventories and Inventory Ratio (2005=100, sa)

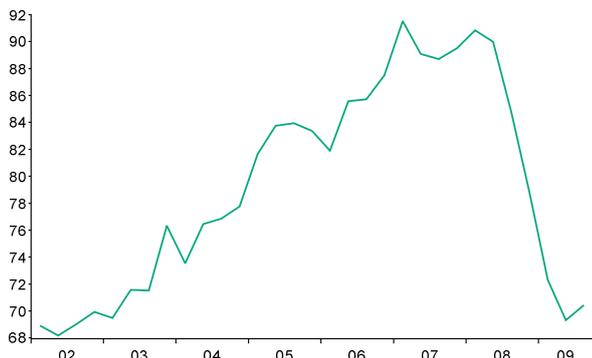


Source: METI, BNP Paribas

The inventory ratio remains well above the pre-crisis level, but it continues to fall as shipments recover. The actual level of inventories is stabilising.



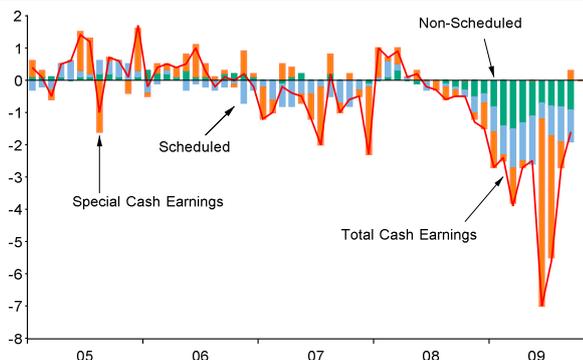
Chart 7: Real Private Capital Investment (JPY trn, saar)



Source: Cabinet Office, BNP Paribas

After plunging 24% from the peak, capex has now started to recover as corporate confidence has recovered from its extreme low. However, the large amount of excess capacity in the economy will preclude a strong rise in capex.

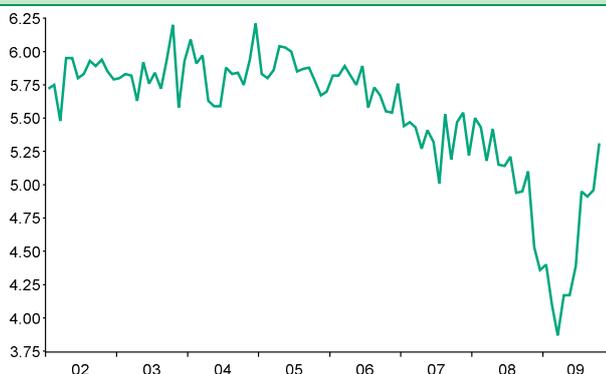
Chart 9: Total Cash Earnings (% y/y)



Source: MHLW, BNP Paribas

Total cash earnings fell sharply during June to August because of a reduction in summer bonuses. We expect another steep drop in total cash earnings around December, when winter bonuses are paid.

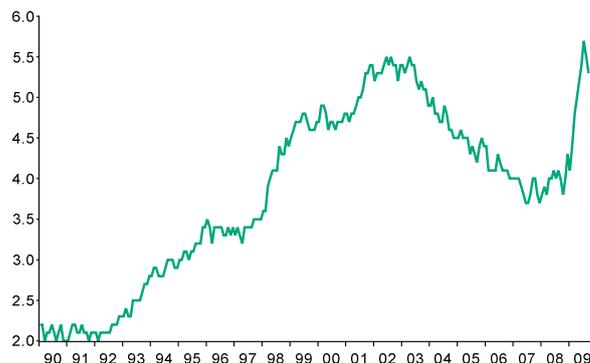
Chart 11: New Car Sales (mn, saar)



Source: Japan automobile Dealers Association, BNP Paribas

Car sales have recovered to the pre-crisis level, thanks to tax cuts and subsidies for eco-friendly cars. A further pick-up is possible through Q1, but we fear a payback thereafter as those measures expire.

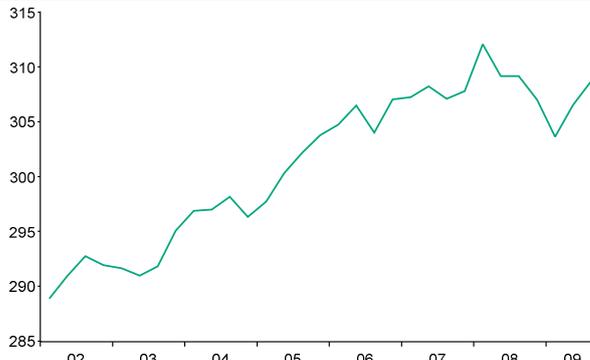
Chart 8: Unemployment Rate (% sa)



Source: MOF, BNP Paribas

In September, the unemployment rate fell for the second straight month to 5.3%. Declines in wages, including sharp decreases in bonuses, have lessened job cuts.

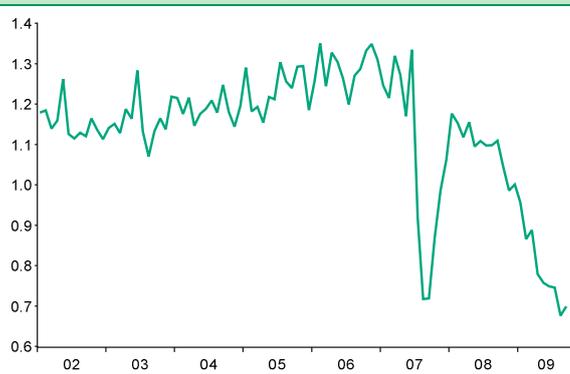
Chart 10: Real Consumption (JPY trn, saar)



Source: Cabinet Office, BNP Paribas

Consumption has been recovering since the spring thanks to the government's stimulus measures. However, this is unlikely to lead to a sustainable recovery because household income continues to decline.

Chart 12: Housing Starts (mn, saar)



Source: MLIT, BNP Paribas

Annualised housing starts are running below 700,000, a record low. In August, starts totalled 676,000 annualised and in September they amounted to 699,000.



China: Policy Adjustment

■ Activity: domestic demand is booming

- Spurred by an unprecedented policy stimulus – both monetary and fiscal – the Chinese economy has been in a strong V-shaped recovery since March. From its low of 6.1% y/y in Q1, GDP growth picked up to 8.9% in Q3. With a further pick-up to 10.7% y/y expected in Q4 given the economy's current momentum, we forecast 8.7% growth for 2009 as a whole, easily achieving the 8% official target.
- Inevitably, growth has been dominated by domestic demand and particularly fixed asset investment (FAI). The lion's share of stimulus has shown up in government-led infrastructure investment, financed by an unprecedented surge in bank lending. Infrastructure spending has boomed by around 60% year-to-date compared with 33% for total FAI.
- While infrastructure spending has been key, growth in domestic demand is increasingly broad based. Rebounding housing sales have fed through into construction activity, producing a V-shaped recovery in property investment. Excess capacity has ensured that manufacturing capex has remained sluggish but consumption has held up well.
- Private consumption has slowed slightly in line with softer personal income growth but, boosted by government purchases, the rise in real retail sales has accelerated to around 17% y/y.
- The acceleration in domestic demand growth has helped set in train an increasingly powerful recovery in industrial production. From a low of 5.4% y/y last November, the rise in industrial production accelerated to a twenty-month high of 16.1% in October.
- The strength of the bellwether PMI indicator, particularly the wedge between new orders and inventories, points to further strength in industrial production in the final months of the year. Sceptics should note the pick-up in electricity output growth to 9.5% y/y.
- Strong domestic demand growth has increasingly boosted imports, particularly those not associated with the processing trade. This effect was initially masked by sharp falls in import prices, particularly of commodities. The restocking of raw materials has been key to the surge in imports but, given the scale of raw material imports in the early months of the year, import growth should progressively fade although China's underlying demand for commodities should stay robust.

- Helped by a revival in global demand and a fall in the trade-weighted RMB, exports are recovering, posting annualised growth of 24% in the six months to October. A full recovery will probably take until the end of 2010. Overall, net trade sliced 3.6 percentage points off total GDP growth in the first nine months of 2009. While it remains volatile on a monthly basis, the trade surplus has dropped by around a third.
- Growth prospects for 2010 are strong but the composition of growth will shift. The continued recovery in exports should diminish net trade's drag on growth. Infrastructure spending will decelerate although property capex should add significantly more to growth despite an expected policy tightening aimed at cooling the property sector. With manufacturing capex still subdued, total FAI growth should decelerate sharply to 23% y/y. Consumption growth should remain solid. GDP is forecast to rise by 9.6%.

■ Inflation: upside risks

- Mild deflation persists despite increasingly unfavourable base effects thanks to overcapacity in key industrial sectors. Econometric evidence suggests that M1 money supply growth is the single most important driver of CPI inflation, boosting prices with a lag of six to nine months. At 32.0% y/y in October, excess domestic liquidity poses significant upside risks to inflation.
- Proxy measures of inflation expectations, such as the wedge between demand and time deposits, look to be rising as asset prices boom. We continue to forecast an acceleration in CPI inflation to almost 5% by mid-2010 and have raised our 2011 inflation forecast to 5.3%.

■ Policy: on the move

- Policy-tightening measures since the summer have been relatively limited although moral suasion appears to have helped cool bank lending somewhat.
- Since the State Council meeting in October, a more decisive policy shift seems to be underway. We expect the following sequence of tightening measures: a more aggressive sterilisation of excess liquidity via PBoC bills, further regulatory pressure on banks and the adoption of quantitative targets at the CCP in December. Formal tightening by the PBoC is expected next spring and we target rate hikes of 27bp in both Q2 and Q3 2010. This mix should ensure that growth in bank lending cools significantly to around 17% in 2010.



China: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|---|------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Components of Growth⁽²⁾ | | | | | | | | | | | | | | | | | | |
| Total GDP | 9.0 | 8.7 | 9.6 | 8.4 | 8.6 | 6.1 | 7.9 | 8.9 | 10.7 | 10.5 | 10.1 | 9.5 | 8.4 | 8.1 | 8.3 | 8.5 | 8.6 | |
| Consumption | 15.8 | 9.8 | 10.8 | 10.2 | 10.4 | 9.7 | 9.7 | 10.0 | 9.8 | 11.6 | 11.1 | 10.7 | 10.0 | 10.0 | 10.2 | 10.3 | 10.2 | |
| Capital Formation | 20.5 | 14.6 | 18.7 | 16.5 | 16.2 | 12.7 | 15.8 | 14.7 | 14.2 | 24.8 | 21.5 | 17.4 | 15.5 | 14.3 | 15.4 | 16.2 | 18.6 | |
| Exports | 17.2 | -14.2 | 8.0 | 9.0 | 10.6 | -19.7 | -23.5 | -20.2 | 6.8 | 8.2 | 8.5 | 7.7 | 7.8 | 8.2 | 8.7 | 9.0 | 9.7 | |
| Imports | 18.7 | -10.7 | 12.0 | 9.5 | 8.6 | -30.9 | -20.4 | -12.2 | 25.7 | 12.3 | 12.8 | 11.6 | 11.6 | 8.7 | 9.2 | 9.5 | 10.3 | |
| Industrial Output | 12.9 | 11.0 | 12.0 | 11.0 | 11.5 | 5.1 | 9.1 | 12.4 | 15.0 | 13.4 | 12.9 | 11.8 | 10.4 | 10.1 | 10.8 | 11.2 | 11.8 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Inflation | | | | | | | | | | | | | | | | | | |
| CPI | 5.9 | -0.6 | 3.9 | 5.3 | 3.9 | -0.6 | -1.5 | -1.3 | 0.9 | 2.0 | 4.4 | 4.7 | 4.5 | 4.8 | 5.2 | 5.4 | 5.8 | |
| PPI | 6.9 | -4.9 | 5.4 | 5.8 | 5.0 | -4.6 | -7.2 | -7.7 | 0.1 | 4.6 | 4.8 | 5.9 | 6.3 | 5.5 | 5.9 | 5.7 | 6.1 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|----------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| External Trade | | | | | | | | | | | | | | | | | | |
| Trade Balance (USD bn) | 296 | 213 | 190 | 201 | 325 | 62 | 35 | 39 | 77 | 60 | 28 | 31 | 71 | 64 | 29 | 33 | 76 | |
| Current Account (USD bn) | 426 | 320 | 313 | 328 | 379 | 94 | 52 | 59 | 174 | 99 | 45 | 52 | 117 | 104 | 47 | 53 | 124 | |
| Current Account (% GDP) | 9.7 | 6.8 | 5.8 | 5.1 | 5.4 | 9.7 | 4.8 | 5.2 | 11.8 | 9.1 | 3.6 | 3.9 | 6.9 | 8.4 | 3.2 | 3.4 | 6.1 | |
| Memo: Nominal GDP (USD bn) | 4399 | 4660 | 5331 | 6251 | 7013 | 962 | 1085 | 1142 | 1472 | 1084 | 1245 | 1311 | 1690 | 1238 | 1450 | 1546 | 2017 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|--|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Financial Variables | | | | | | | | | | | | | | | | | | |
| Gen. Gov. Budget (% GDP) | -0.4 | -3.5 | -3.1 | -2.7 | -2.6 | - | - | - | - | - | - | - | - | - | - | - | - | |
| Foreign Reserves (USD bn) ⁽³⁾ | 1946 | 2460 | 2726 | 2969 | 3158 | 1954 | 2132 | 2273 | 2460 | 2544 | 2583 | 2627 | 2726 | 2803 | 2838 | 2877 | 2969 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|--|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Interest & FX Rates⁽³⁾ | | | | | | | | | | | | | | | | | | |
| Official Interest Rate (%) | 5.31 | 5.31 | 5.85 | 6.12 | 6.66 | 5.31 | 5.31 | 5.31 | 5.31 | 5.31 | 5.58 | 5.85 | 5.85 | 5.85 | 5.85 | 6.12 | 6.12 | |
| USD/RMB | 6.83 | 6.83 | 6.62 | 6.42 | 6.22 | 6.84 | 6.83 | 6.83 | 6.83 | 6.83 | 6.83 | 6.72 | 6.62 | 6.57 | 6.52 | 6.47 | 6.42 | |

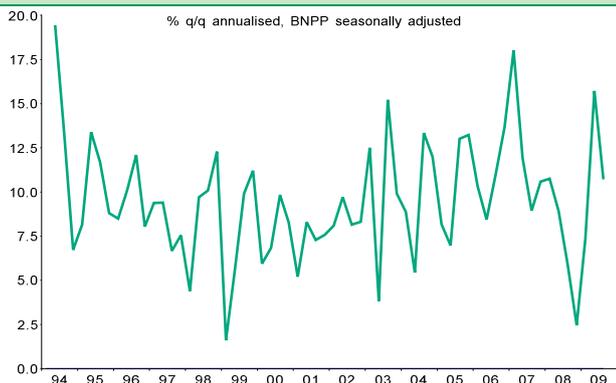
Footnotes: (1) Forecast (2) Forecasts of GDP and industrial output growth are in real terms but, in the absence of data, forecasts of consumption, investment, exports and imports are in nominal terms (3) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



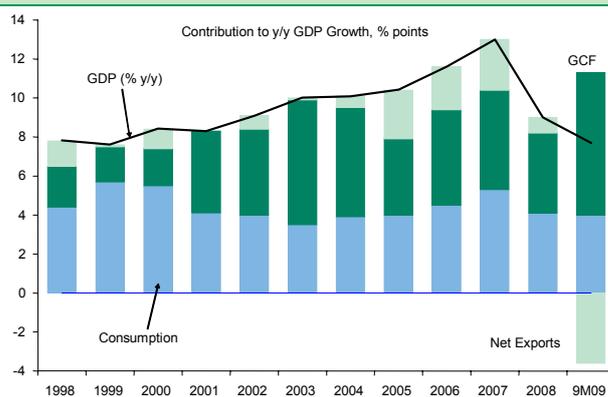
Chart 1: GDP – I



Source: BNP Paribas, Reuters EcoWin Pro

We estimate that seasonally adjusted GDP growth decelerated slightly in Q3 to 10.7% saar from Q2's blistering 15.7% rate. In year-on-year terms, growth picked up to 8.9%. With a further acceleration expected in Q4, 2009 growth is now seen at 8.7%.

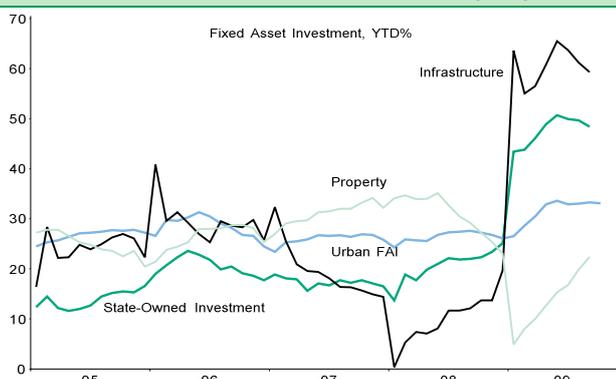
Chart 2: GDP – II



Source: BNP Paribas, Reuters EcoWin Pro

China's growth this year has been dominated by domestic demand, which has grown even more briskly than in the boom years of 2006/07. Of 2009's 7.7% YTD GDP growth, domestic demand added a huge 11.3pp while net trade sliced off 3.6pp.

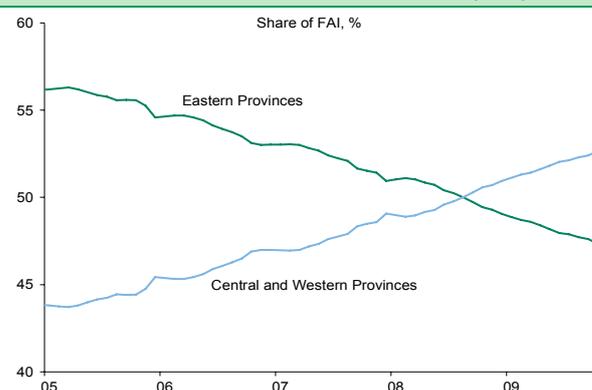
Chart 3: Fixed Asset Investment (FAI) – I



Source: BNP Paribas, Reuters EcoWin Pro

Domestic demand's unprecedented strength has been led by FAI, which has accounted for 7.3pp of domestic demand's 11.3pp contribution to YTD GDP growth. In nominal terms, FAI has surged by 33.1% YTD with infrastructure spending the strongest.

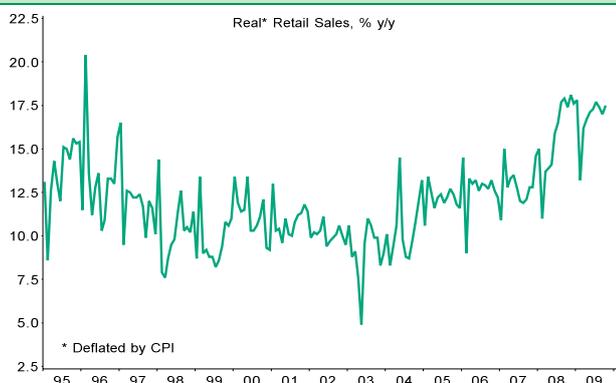
Chart 4: Fixed Asset Investment (FAI) – II



Source: BNP Paribas, Reuters EcoWin Pro

Infrastructure FAI's enormous 59.3% YTD growth has fuelled concerns about "bridges to nowhere" but, importantly, the much less developed central and western provinces are now receiving the lion's share of FAI, not the more developed coastal regions.

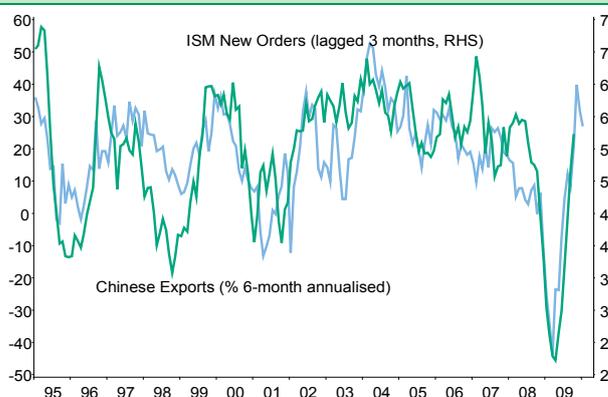
Chart 5: Consumer Resilience



Source: BNP Paribas, Reuters EcoWin Pro

Consumer demand has added around 4% to YTD GDP growth, roughly in line with its historical contribution. Aggressive policy stimulus and the revival in asset prices have stabilised consumer trends. Real retail sales growth has actually accelerated.

Chart 6: Export Recovery In Train

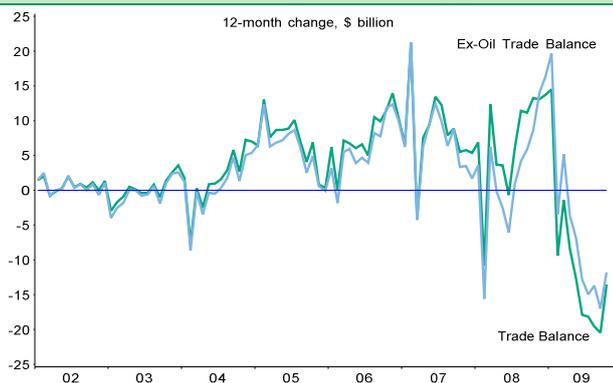


Source: BNP Paribas, Reuters EcoWin Pro

China's export slump began to bottom out towards the end of Q1 after a disastrous 31% plunge in just eight months. In line with the strength of the bellwether ISM survey, an accelerating recovery is under way. As of October, exports were 16.3% off their 2008 peak.



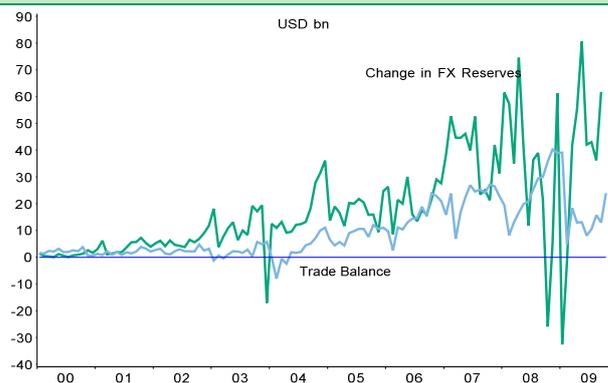
Chart 7: Trade Surplus – Sharply Lower



Source: BNP Paribas, Reuters EcoWin Pro

The combination of a sharp reduction in exports, surging domestic investment demand and a partial recovery in commodity prices has worked to narrow the trade surplus sharply in recent months although it remains volatile month to month.

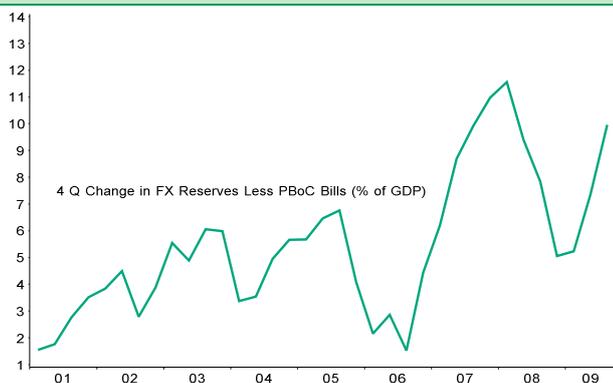
Chart 8: FX Reserves – I



Source: BNP Paribas, Reuters EcoWin Pro

Despite smaller trade surpluses, the rate of increase in FX reserves has remained rapid as China's better-than-expected economic performance and positive interest rate differentials have fuelled a return of substantial hot-money inflows.

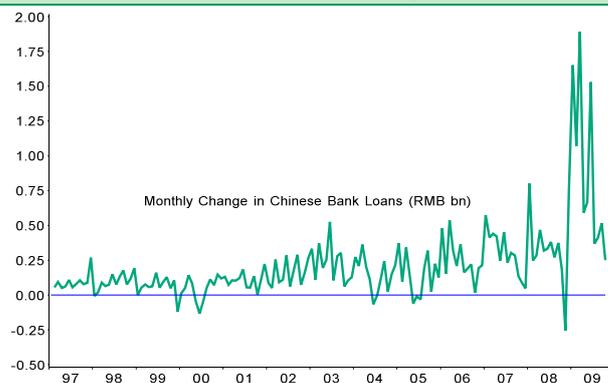
Chart 9: FX Reserves – II



Source: BNP Paribas, Reuters EcoWin Pro

With barely any PBoC bill sales this year, the bulk of this year's increase in FX reserves has been left unsterilised. Relative to GDP, the unsterilised increase in reserves over the past year is now approaching the highs seen in late 2007 and early 2008.

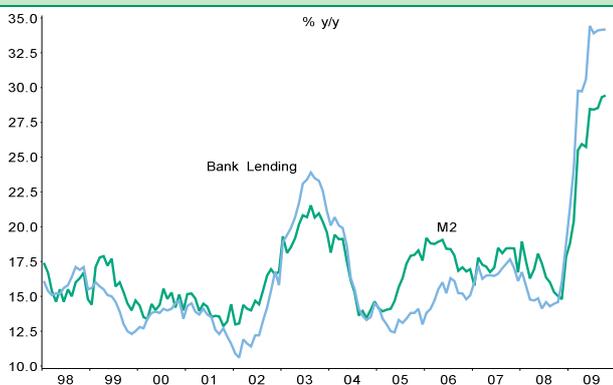
Chart 10: Bank Lending Cools



Source: BNP Paribas, Reuters EcoWin Pro

Regulatory tweaking and intense moral suasion from the authorities has seen the torrid pace of bank lending begin to subside with banks advancing "only" RMB 253bn in October.

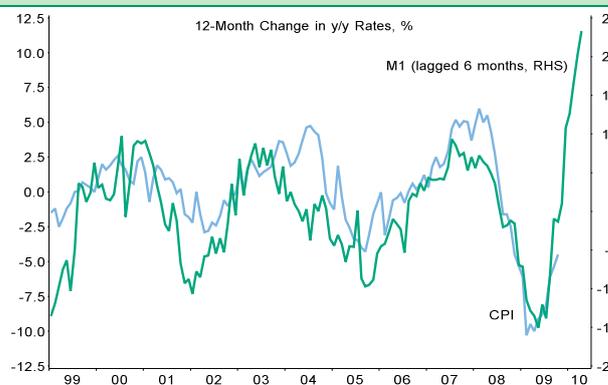
Chart 11: Money Matters



Source: BNP Paribas, Reuters EcoWin Pro

Bank lending still ballooned by an unprecedented 34.2% y/y in October – far above the increase in nominal GDP. Its counterpart has been a similarly breakneck pace of money supply growth, with M2 up 29.4% y/y and M1 jumping 32% y/y.

Chart 12: Upside Inflation Risks



Source: BNP Paribas, Reuters EcoWin Pro

Econometric evidence suggests that M1 money supply growth is the single most important driver of CPI inflation. M1's surge points to a rapid return of inflation by early 2010. We continue to forecast CPI inflation will run at close to 5% y/y by mid-2010.



Germany: Strong for Now

■ Activity: not as good as it looks

- The German economy is recovering well from its deep recession. However, there are reasons to question the sustainability of growth.
- The strong bounce in German activity is being driven by the manufacturing sector. Output collapsed in the immediate aftermath of the financial crisis, but has subsequently rebounded. Factory orders have risen by about 20%.
- Exports have been an important part of the recovery, reflecting an improvement in conditions globally. Domestic demand has been patchier.
- Domestic capital goods orders surged in Q2 and Q3, pointing to a rise in investment in Q4. More recently, though, capital goods orders have weakened again, suggesting investment will be less robust in early 2010.
- Consumer spending has been disappointing of late. After a strong start, the car purchase scheme has run out of steam and its end is likely to weigh on consumption for a few quarters.
- Moreover, the substantial slack in the labour market, masked by the stability of unemployment, but clearly demonstrated by the drop in the number of hours worked, will put downward pressure on wages and spending.
- There is even scope for the current strength of exports to fade. Underlying demand conditions in traditional export markets remain soft and Asian and Latam markets are not yet large enough to fill the hole.

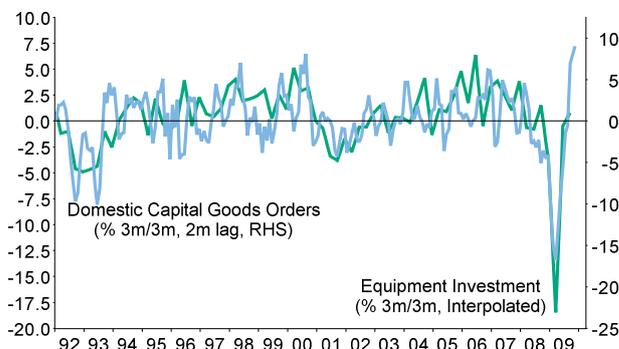
■ Inflation: slow grind lower

- German core inflation has been relatively stable, in contrast to the slowdown seen elsewhere in the eurozone, but recently started to shift down.
- This reflects the better domestic demand performance in Germany and the need for other countries within the eurozone to deflate versus Germany in order to improve their competitiveness.
- However, there are downward price pressures in Germany. There is spare capacity in the labour market and, while output has recovered somewhat, it remains well below previous levels.

■ Policy: modest additional stimulus

- The new government has announced further fiscal stimulus plans. Taxes will be cut by about 1% of GDP in 2011, in addition to the previously announced cuts in 2010. This means the budget deficit will reach around 5-6% of GDP in 2011.

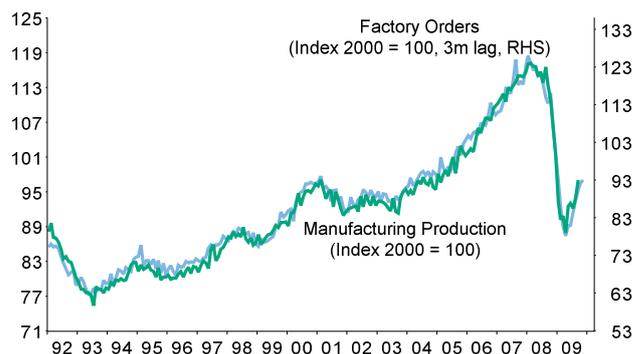
Chart 1: Equipment Investment and Orders



Source: Reuters EcoWin Pro

The industrial sector has been key to the bounce in German activity. Equipment investment has recovered strongly.

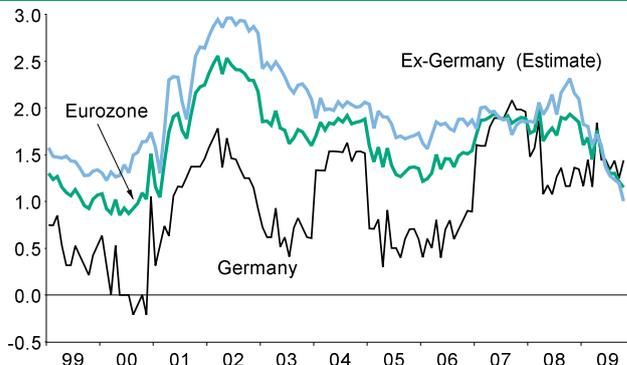
Chart 2: Manufacturing Orders and Production



Source: Reuters EcoWin Pro

Factory orders have risen strongly, leading to a marked rebound in production. However, the economy is still operating well below potential.

Chart 3: Core Inflation (% y/y)



Source: Reuters EcoWin Pro

Spare capacity will drag German core inflation down. But inflation elsewhere will slow more sharply, as other countries need to deflate versus Germany.



Germany: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|---|------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Components of Growth⁽²⁾ | | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | -3.5 | 0.4 | 0.7 | 0.8 | 0.4 | 0.1 | 0.1 | 0.2 | 0.7 | 0.5 | 0.4 | 0.6 | |
| GDP | 1.0 | -4.8 | 1.6 | 1.7 | 2.5 | -6.7 | -5.8 | -4.8 | -1.6 | 2.4 | 2.1 | 1.4 | 0.8 | 1.1 | 1.5 | 1.9 | 2.2 | |
| Domestic Demand ex. Stocks | 1.0 | -0.9 | 0.7 | 1.7 | 2.1 | -1.7 | -0.4 | -1.0 | -0.1 | 1.1 | 0.6 | 0.7 | 0.5 | 1.0 | 1.5 | 1.9 | 2.3 | |
| Private Consumption | 0.2 | 0.5 | -0.3 | 1.4 | 1.5 | 0.2 | 1.4 | 0.1 | 0.4 | -0.4 | -0.8 | 0.0 | 0.0 | 0.8 | 1.2 | 1.6 | 2.1 | |
| Public Consumption | 2.0 | 2.7 | 2.9 | 2.0 | 1.4 | 2.7 | 2.5 | 2.5 | 2.9 | 3.2 | 3.0 | 2.8 | 2.6 | 2.2 | 2.2 | 2.0 | 1.8 | |
| Fixed Investment | 2.3 | -8.0 | 1.7 | 2.3 | 4.6 | -11.2 | -8.4 | -7.8 | -4.6 | 3.5 | 2.2 | 0.9 | 0.0 | 0.5 | 1.9 | 3.0 | 3.8 | |
| Stocks (Cont to Growth, q/q) | 0.5 | -0.6 | 0.9 | 0.2 | 0.0 | -0.3 | -2.0 | 1.5 | 0.0 | 0.4 | 0.3 | 0.1 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | |
| Exports | 2.4 | -14.4 | 5.9 | 3.7 | 8.0 | -17.5 | -18.3 | -15.5 | -5.5 | 7.2 | 8.6 | 5.3 | 2.6 | 1.9 | 2.8 | 4.3 | 5.7 | |
| Imports | 3.9 | -8.5 | 6.5 | 4.5 | 7.7 | -7.9 | -11.6 | -10.2 | -4.2 | 4.2 | 11.5 | 6.4 | 4.2 | 2.9 | 3.4 | 4.9 | 6.6 | |
| Industrial Production | 0.0 | -15.4 | 7.1 | 2.2 | 3.9 | -20.0 | -19.2 | -15.6 | -6.0 | 9.2 | 10.3 | 6.5 | 2.7 | 1.6 | 1.7 | 2.4 | 3.1 | |
| Savings Ratio (%) | 11.3 | 11.4 | 11.6 | 11.7 | 11.2 | 11.4 | 11.2 | 11.3 | 11.6 | 11.7 | 11.8 | 11.6 | 11.4 | 11.9 | 11.8 | 11.5 | 11.4 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Inflation & Labour | | | | | | | | | | | | | | | | | | |
| HICP | 2.8 | 0.3 | 1.2 | 0.6 | 0.6 | 0.8 | 0.3 | -0.4 | 0.5 | 0.8 | 1.0 | 1.2 | 1.5 | 1.3 | 0.7 | 0.4 | 0.1 | |
| Core HICP | 1.3 | 1.4 | 0.7 | -0.2 | 0.3 | 1.3 | 1.6 | 1.3 | 1.2 | 0.9 | 0.8 | 0.7 | 0.5 | 0.4 | -0.3 | -0.5 | -0.5 | |
| Compensation | 3.7 | -0.2 | -0.8 | 0.0 | 2.0 | 1.0 | -0.1 | -0.6 | -1.2 | -0.6 | -0.7 | -1.1 | -1.0 | -0.8 | -0.4 | 0.3 | 1.0 | |
| Real PDI | 0.9 | 0.5 | 0.1 | 1.5 | 1.0 | 0.4 | 0.6 | 0.4 | 0.6 | 0.2 | 0.1 | 0.1 | -0.1 | 1.0 | 1.1 | 1.6 | 2.1 | |
| Employment | 1.4 | -0.1 | -1.7 | -1.0 | 1.2 | 0.4 | 0.1 | -0.3 | -0.7 | -1.1 | -1.6 | -1.9 | -2.0 | -1.8 | -1.3 | -0.7 | -0.1 | |
| Unemployment Rate (%) | 7.8 | 8.1 | 8.9 | 9.6 | 8.8 | 8.0 | 8.2 | 8.2 | 8.1 | 8.4 | 8.8 | 9.1 | 9.4 | 9.6 | 9.7 | 9.6 | 9.4 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-------------------------------|-------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| External Trade | | | | | | | | | | | | | | | | | | |
| Trade Balance (EUR bn, sa) | 176.6 | 124.2 | 112.1 | 94.5 | 95.7 | 24.6 | 31.3 | 33.2 | 35.1 | 31.8 | 27.6 | 26.8 | 25.9 | 24.4 | 23.6 | 23.3 | 23.3 | |
| Current Account (EUR bn, nsa) | 165.3 | 109.3 | 102.2 | 86.0 | 91.4 | 17.4 | 27.7 | 31.2 | 33.0 | 27.8 | 24.5 | 25.5 | 24.4 | 20.4 | 20.6 | 23.1 | 21.9 | |
| Current Account (% GDP) | 6.6 | 4.5 | 4.1 | 3.4 | 3.5 | 2.9 | 4.6 | 5.1 | 5.4 | 4.5 | 4.0 | 4.1 | 3.9 | 3.3 | 3.3 | 3.7 | 3.5 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|----------------------------|------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|---|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | |
| Financial Variables | | | | | | | | | | | | | | | | | | |
| Fed. Gov. Budget (EUR bn) | -12 | -55 | -65 | -72 | -53 | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Gen. Gov. Budget (EUR bn) | -3 | -96 | -119 | -141 | -100 | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Gen. Gov. Budget (% GDP) | -0.1 | -4.0 | -4.8 | -5.6 | -3.9 | - | - | - | - | - | - | - | - | - | - | - | - | - |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-------------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Interest Rates⁽³⁾ | | | | | | | | | | | | | | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 | 1.51 | 1.10 | 0.75 | 0.70 | 0.60 | 0.60 | 0.65 | 1.10 | 1.25 | 1.50 | 2.00 | 2.25 | |
| 10-Year Rate (%) | 2.95 | 3.10 | 3.50 | 4.25 | 4.75 | 3.00 | 3.38 | 3.22 | 3.10 | 3.10 | 2.90 | 3.20 | 3.50 | 3.75 | 4.00 | 4.25 | 4.25 | |

Footnotes: (1) Forecast (2) Calendar and seasonally adjusted (3) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



France: So Far, So Good

■ Activity: should continue to do well

- Economic indicators suggest that France is emerging from the recession earlier than most other eurozone countries. Given that the inventory cycle is more advanced than elsewhere, production at the end of 2009 and the early part of 2010 will prove relatively robust.
- Some of the reasons why France outperformed in the recession will continue to support economic activity in the upturn. In particular, the housing market has not been as weak as elsewhere. But the lack of competitiveness and the large share of the public sector in the economy will, over time, lower French growth below the eurozone average.

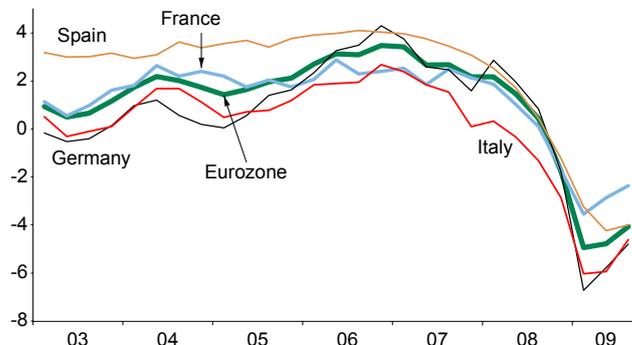
■ Inflation: wages the main disinflationary force

- Headline inflation is being pushed higher by base effects on energy prices. Moreover, since fresh food prices fell more sharply than is usually the case during the summer, some catch-up is likely on these items.
- Wage rises fell to 2.0% y/y in Q3, a percentage point lower than a year earlier and the lowest rate since 2000 when employers restrained wages to cope with the cut in the number of working hours.
- Due to the moderation in wage growth, core inflation is declining and this trend is likely to continue for at least a year. However, administered prices will be hiked from 2010 in order to reduce the budget deficit which may mask the declining trend of core inflation.

■ Policy: reversal in deficit not scheduled before 2011

- The fiscal packages implemented by the government since the crisis started have been very effective in limiting the adverse impact of the global crisis on French activity. A number of these measures are temporary and their impact will disappear in 2010 and 2011.
- The special borrowing programmes, set up to finance new investment aimed at boosting the potential growth rate in the long run, will lead to a further rise in the budget deficit in 2010.
- The deficit should start to decline in 2011 and the fall should be brisk over the following couple of years. The numerous, though small, tax increases approved by the government and Parliament show policymakers' concern about the size of the budget deficit and the rise in the level of public debt.

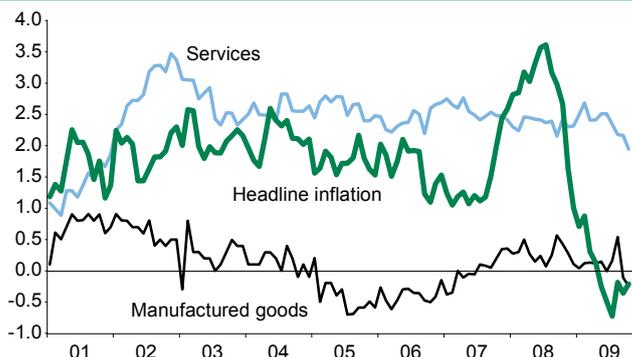
Chart 1: GDP (% y/y)



Source: Reuters EcoWin Pro

Although quarter-on-quarter GDP growth was lower in Q3 in France (0.3%) than in Germany (0.7%), Italy (0.6%) and the eurozone (0.4%), France is still doing better in year-on-year terms.

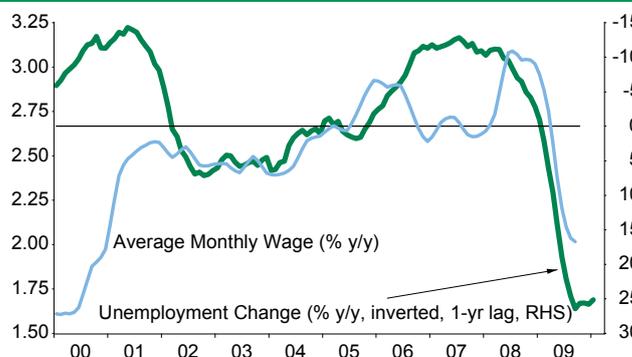
Chart 2: CPI (% y/y)



Source: Reuters EcoWin Pro

Core components of the CPI should continue to see a sharp moderation in inflation, although headline inflation should return to positive territory from November.

Chart 3: Wages vs. Unemployment Change (% y/y)



Source: Reuters EcoWin Pro

Rising unemployment has put substantial downward pressure on wage increases; this trend will continue for some time.



France: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|---|------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Components of Growth⁽²⁾ | | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | -1.4 | 0.3 | 0.3 | 0.6 | 0.4 | 0.3 | 0.4 | 0.4 | 0.5 | 0.5 | 0.6 | 0.6 | |
| GDP | 0.3 | -2.3 | 1.5 | 1.9 | 2.5 | -3.5 | -2.9 | -2.4 | -0.3 | 1.5 | 1.5 | 1.7 | 1.5 | 1.6 | 1.8 | 2.0 | 2.2 | |
| Domestic Demand ex Stocks | 0.9 | -0.8 | 1.0 | 2.0 | 2.6 | -1.1 | -0.8 | -0.9 | -0.4 | 0.4 | 0.7 | 1.2 | 1.5 | 1.6 | 1.9 | 2.1 | 2.3 | |
| Private Consumption | 0.9 | 0.6 | 1.1 | 1.9 | 2.4 | 0.5 | 0.7 | 0.5 | 0.7 | 0.9 | 0.9 | 1.3 | 1.4 | 1.6 | 1.8 | 2.0 | 2.2 | |
| Public Consumption | 1.0 | 1.5 | 2.3 | 1.4 | 0.9 | 1.2 | 1.4 | 1.5 | 1.8 | 2.5 | 2.4 | 2.2 | 2.1 | 1.7 | 1.5 | 1.3 | 1.2 | |
| Fixed Investment | 0.5 | -7.0 | -1.0 | 2.6 | 4.6 | -7.7 | -7.4 | -7.5 | -5.7 | -3.0 | -1.8 | -0.1 | 0.9 | 1.5 | 2.3 | 3.0 | 3.6 | |
| Stocks (Cont to Growth, q/q) | -0.2 | -1.5 | 0.7 | 0.6 | 0.2 | -0.8 | -0.6 | -0.1 | 0.5 | 0.3 | 0.2 | 0.2 | 0.1 | 0.2 | 0.2 | 0.1 | 0.0 | |
| Exports | -0.5 | -10.6 | 4.1 | 4.3 | 6.9 | -15.5 | -13.0 | -10.5 | -3.5 | 5.0 | 4.9 | 3.4 | 3.1 | 3.3 | 4.1 | 4.5 | 5.2 | |
| Imports | 0.6 | -9.9 | 4.3 | 6.4 | 7.3 | -10.1 | -11.4 | -11.2 | -6.8 | 0.8 | 4.8 | 5.8 | 5.7 | 5.8 | 6.4 | 6.6 | 6.9 | |
| GDP Unadjusted(3) | 0.4 | -2.4 | 1.5 | 1.9 | 2.6 | -3.9 | -3.0 | -2.4 | -0.3 | 1.5 | 1.5 | 1.7 | 1.5 | 1.6 | 1.8 | 2.0 | 2.2 | |
| Industrial Production | -2.4 | -11.2 | 5.6 | 3.3 | 4.0 | -15.6 | -14.7 | -11.0 | -3.0 | 5.9 | 7.4 | 5.1 | 4.1 | 3.4 | 3.2 | 3.3 | 3.3 | |
| Savings Ratio (%) | 15.3 | 16.4 | 16.6 | 16.9 | 17.0 | - | - | - | - | - | - | - | - | - | - | - | - | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Inflation & Labour | | | | | | | | | | | | | | | | | | |
| HICP | 3.2 | 0.1 | 1.5 | 1.0 | 1.2 | 0.7 | -0.2 | -0.5 | 0.4 | 1.5 | 1.5 | 1.6 | 1.5 | 1.1 | 1.1 | 1.0 | 0.9 | |
| Core HICP | 1.8 | 1.4 | 0.5 | 0.4 | 0.9 | 1.6 | 1.5 | 1.5 | 1.0 | 0.8 | 0.4 | 0.3 | 0.3 | 0.3 | 0.4 | 0.5 | 0.6 | |
| Monthly Wages | 3.0 | 2.2 | 2.2 | 2.5 | 2.7 | 2.8 | 2.2 | 2.0 | 2.0 | 2.0 | 2.3 | 2.3 | 2.4 | 2.4 | 2.4 | 2.5 | 2.6 | |
| Private NF Payrolls | 0.3 | -2.1 | 0.2 | 0.7 | 1.3 | -2.2 | -2.4 | -2.1 | -1.6 | -0.3 | 0.3 | 0.4 | 0.4 | 0.5 | 0.6 | 0.7 | 0.9 | |
| Unemployment Rate (%) | 7.9 | 9.6 | 10.5 | 10.5 | 10.3 | 8.9 | 9.4 | 9.8 | 10.2 | 10.3 | 10.4 | 10.5 | 10.6 | 10.6 | 10.5 | 10.5 | 10.4 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| External Trade | | | | | | | | | | | | | | | | | | |
| Trade Balance (EUR bn, sa) | -54 | -37 | -44 | -55 | -60 | -14 | -10 | -5 | -8 | -10 | -11 | -12 | -12 | -13 | -14 | -14 | -14 | |
| Current Account (EUR bn, sa) | -44 | -40 | -44 | -53 | -55 | -13 | -10 | -7 | -9 | -10 | -11 | -12 | -12 | -13 | -14 | -13 | -13 | |
| Current Account (% GDP) | -2.3 | -2.1 | -2.2 | -2.6 | -2.6 | -2.7 | -2.1 | -1.5 | -2.0 | -2.0 | -2.2 | -2.4 | -2.4 | -2.6 | -2.8 | -2.6 | -2.5 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-----------------------------|------|--------------------|--------------------|--------------------|--------------------|------|----|----|-------------------|------|----|----|----|------|----|----|----|---|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | |
| Financial Variables | | | | | | | | | | | | | | | | | | |
| Gen. Gov. Budget (EUR bn) | -56 | -141 | -140 | -115 | -90 | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Gen. Gov. Budget (% GDP) | -2.9 | -7.3 | -7.1 | -5.7 | -4.3 | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Gen. Public Budget (EUR bn) | -66 | -158 | -177 | -151 | -125 | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Gen. Public Budget (% GDP) | -3.4 | -8.2 | -9.0 | -7.5 | -6.0 | - | - | - | - | - | - | - | - | - | - | - | - | - |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-------------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Interest Rates⁽⁴⁾ | | | | | | | | | | | | | | | | | | |
| 3-Month (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 | 1.51 | 1.10 | 0.72 | 0.70 | 0.60 | 0.60 | 0.65 | 1.10 | 1.25 | 1.50 | 2.00 | 2.25 | |
| 10-Year Rate (%) | 3.41 | 3.45 | 3.90 | 4.50 | 5.00 | 3.62 | 3.73 | 3.64 | 3.45 | 3.60 | 3.40 | 3.65 | 3.90 | 4.15 | 4.35 | 4.55 | 4.50 | |
| Spread Over Bund (bp) | 46 | 35 | 40 | 25 | 25 | 62 | 35 | 25 | 35 | 50 | 50 | 45 | 40 | 40 | 35 | 30 | 25 | |

Footnotes: (1) Forecast (2) Calendar and seasonally adjusted (3) Unadjusted for calendar effects (BNP Paribas estimate) (4) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



Italy: Taking Stock

■ Activity: fragile recovery

- Q3's sharp recovery in industrial activity does not appear to have been associated with stock rebuilding (Chart 1), suggesting that the manufacturing sector's momentum will continue. However, the rebound in production was at odds with persistent weakness in final demand once the impact of the government incentives for auto purchases is allowed for. Statistical distortions due to seasonal factors probably played a part, pointing to some payback in Q4.
- In the medium term, the recovery looks fragile. Despite an improvement in overall confidence, household surveys continue to show extreme caution in purchasing plans, as well as in the assessment of labour market conditions. We assume that the savings ratio will gradually correct the sharp rise that followed the financial crisis, but a combination of higher unemployment, slower wage growth and higher headline inflation will weigh on consumer spending.
- Firms' propensity to invest remains low, in tune with the unusually high level of unutilised capacity. Investment spending is forecast to contract again in 2010, although at a slower pace than in 2009.
- Finally, improved global conditions point to a positive contribution from net trade, but recent evidence suggests that exporters continue to lose market share due to unfavourable productivity trends. This will limit the boost from external demand.

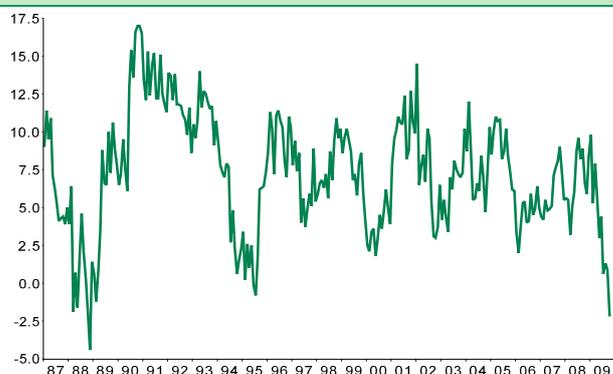
■ Inflation: trending lower

- Unfavourable productivity trends and resilience in wages have kept growth in labour costs high, limiting the downside for core inflation. Falling employment has now started to take its toll on wage dynamics. Consistent with survey evidence, we expect core inflation to keep slowing, at broadly the same pace as in the eurozone as a whole.

■ Policy: lower spread

- The sharp worsening in public finances mainly reflects cyclical factors (as shown by the 3% y/y decline in revenues from January to September) while government discretionary intervention has been limited. This puts Italy on a better footing than a number of other eurozone countries. However, given persistently low growth, the government's fiscal targets from 2011 onwards look particularly challenging.

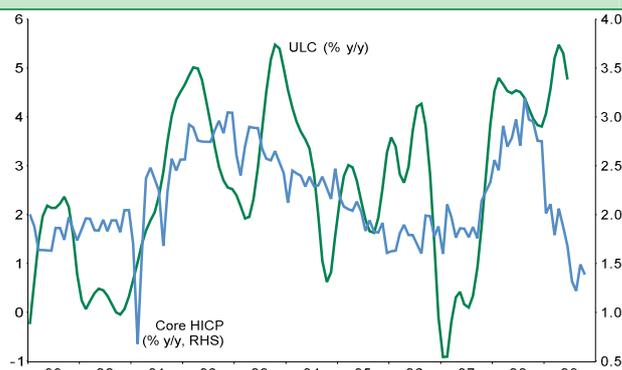
Chart 1: Stocks of Finished Manufactured Products



Source: Reuters EcoWin Pro

Business surveys suggest stocks are still well below desired levels. Stock rebuilding will maintain the momentum in activity over the next few months.

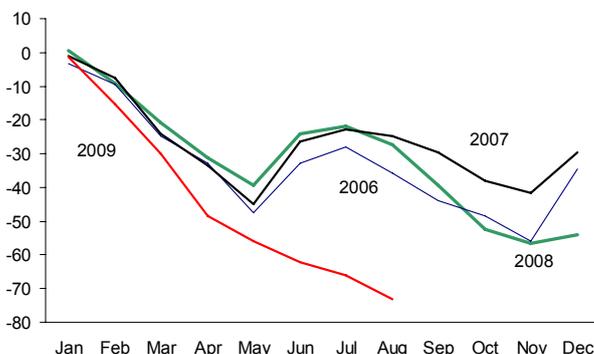
Chart 2: Core HICP vs. ULCs



Source: Reuters EcoWin Pro

Growth in unit labour costs has remained high, as resilience in wages has been combined with a sharp cyclical fall in productivity. But these trends are reversing.

Chart 3: State Sector Borrowing Requirement (EUR bn)



Source: Reuters EcoWin Pro

In the first seven months of 2009, the SSBR amounted to EUR 73bn compared with EUR 27bn over the same period of 2008.



Italy: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | | |
| Components of Growth | | | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | -2.7 | -0.5 | 0.6 | 0.3 | 0.2 | 0.1 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | | |
| GDP | -1.0 | -4.8 | 0.8 | 1.1 | 1.3 | -6.0 | -6.0 | -4.7 | -2.4 | 0.5 | 1.2 | 0.8 | 0.8 | 0.9 | 1.0 | 1.2 | 1.2 | | |
| Domestic Demand ex. Stocks | -1.0 | -3.4 | 0.0 | 0.8 | 1.3 | -4.2 | -4.0 | -3.7 | -1.9 | -0.2 | -0.1 | 0.1 | 0.3 | 0.6 | 0.8 | 0.9 | 1.0 | | |
| Private Consumption | -0.9 | -1.8 | 0.4 | 0.7 | 1.2 | -2.7 | -1.8 | -1.9 | -0.8 | 0.5 | 0.3 | 0.4 | 0.4 | 0.5 | 0.6 | 0.7 | 0.8 | | |
| Public Consumption | 0.6 | 1.6 | 0.8 | 0.7 | 0.9 | 1.0 | 1.7 | 1.8 | 1.9 | 1.8 | 0.6 | 0.5 | 0.4 | 0.5 | 0.6 | 0.7 | 0.8 | | |
| Fixed Investment | -2.9 | -12.9 | -2.1 | 1.5 | 2.2 | -13.0 | -15.4 | -13.9 | -8.8 | -4.6 | -2.4 | -1.2 | -0.2 | 0.8 | 1.8 | 1.7 | 1.6 | | |
| Stocks (Cont. to Growth, y/y) | -0.3 | -0.2 | 0.2 | 0.1 | 0.0 | -0.4 | -0.2 | 0.1 | -0.3 | 0.2 | 0.6 | -0.1 | 0.1 | 0.1 | 0.0 | 0.1 | 0.1 | | |
| Exports | -3.7 | -19.4 | 3.9 | 6.6 | 6.7 | -21.9 | -23.9 | -19.8 | -11.2 | 1.3 | 5.7 | 4.7 | 4.0 | 5.2 | 6.8 | 7.4 | 7.2 | | |
| Imports | -4.5 | -15.2 | 1.3 | 5.7 | 6.4 | -16.8 | -18.1 | -15.6 | -10.0 | -0.9 | 2.4 | 1.4 | 2.3 | 4.2 | 5.8 | 6.6 | 6.3 | | |
| Industrial Production | -3.3 | -17.7 | 1.2 | 3.1 | 4.7 | -21.2 | -22.9 | -16.0 | -9.8 | -0.8 | 3.2 | 0.2 | 2.1 | 2.8 | 2.9 | 3.0 | 3.5 | | |
| Savings Ratio (%) | 9.3 | 11.2 | 9.9 | 9.8 | 9.6 | - | - | - | - | - | - | - | - | - | - | - | - | | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | | |
| Inflation & Labour | | | | | | | | | | | | | | | | | | | |
| HICP | 3.5 | 0.8 | 1.1 | 0.6 | 0.7 | 1.4 | 0.9 | 0.1 | 0.8 | 1.2 | 1.0 | 1.1 | 1.1 | 1.0 | 0.8 | 0.5 | 0.2 | | |
| Core HICP | 2.2 | 1.6 | 0.6 | -0.3 | 0.3 | 1.6 | 1.8 | 1.4 | 1.6 | 1.3 | 0.8 | 0.5 | 0.0 | -0.2 | -0.3 | -0.3 | -0.4 | | |
| Monthly Wages | 3.5 | 3.1 | 1.8 | 1.2 | 1.4 | 3.8 | 3.1 | 2.5 | 3.1 | 2.2 | 2.1 | 1.8 | 1.4 | 1.2 | 1.3 | 1.2 | 1.0 | | |
| Employment | 0.8 | -1.3 | -1.6 | 0.0 | 1.0 | -0.9 | -1.2 | -1.4 | -1.7 | -1.8 | -1.9 | -1.6 | -1.2 | -0.6 | -0.2 | 0.2 | 0.6 | | |
| Unemployment Rate (%) | 6.8 | 7.7 | 9.2 | 9.6 | 9.0 | 7.3 | 7.4 | 7.8 | 8.4 | 8.8 | 9.1 | 9.3 | 9.6 | 9.6 | 9.6 | 9.6 | 9.5 | | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|----------------------------|-------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | | |
| External Trade | | | | | | | | | | | | | | | | | | | |
| Trade Balance (EUR bn) | -8.1 | -3.0 | -1.8 | 2.2 | 10.2 | -6.7 | 0.9 | 2.7 | 0.0 | -6.4 | 1.2 | 3.0 | 0.3 | -5.4 | 2.2 | 4.0 | 1.3 | | |
| Current Account (EUR bn) | -53.6 | -48.4 | -47.2 | -41.2 | -31.2 | -18.8 | -12.3 | -4.5 | -12.8 | -18.5 | -12.0 | -4.2 | -12.5 | -17.0 | -10.5 | -2.7 | -11.0 | | |
| Current Account (% of GDP) | -3.4 | -3.1 | -3.1 | -2.6 | -1.9 | - | - | - | - | - | - | - | - | - | - | - | - | | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|----------------------------|-------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | |
| Financial Variables | | | | | | | | | | | | | | | | | | | |
| Gen. Gov. Budget (EUR bn) | -43.0 | -82.0 | -83.0 | -82.0 | -73.0 | - | - | - | - | - | - | - | - | - | - | - | - | | |
| Gen. Gov. Budget (% GDP) | -2.7 | -5.4 | -5.4 | -5.2 | -4.5 | - | - | - | - | - | - | - | - | - | - | - | - | | |
| Primary Budget (EUR bn) | 37.9 | -8.8 | -7.5 | 0.5 | 16.9 | - | - | - | - | - | - | - | - | - | - | - | - | | |
| Primary Budget (% GDP) | 2.4 | -0.6 | -0.5 | 0.0 | 1.0 | - | - | - | - | - | - | - | - | - | - | - | - | | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|-------------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | | |
| Interest Rates⁽²⁾ | | | | | | | | | | | | | | | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 | 1.51 | 1.10 | 0.75 | 0.70 | 0.60 | 0.60 | 0.65 | 1.10 | 1.25 | 1.50 | 2.00 | 2.25 | | |
| 10-Year Rate (%) | 4.38 | 4.10 | 4.40 | 4.75 | 5.25 | 4.39 | 4.44 | 4.03 | 4.10 | 4.15 | 3.95 | 4.15 | 4.40 | 4.55 | 4.70 | 4.85 | 4.75 | | |
| Spread over Bund (bp) | 143 | 100 | 90 | 50 | 50 | 139 | 106 | 81 | 100 | 105 | 105 | 95 | 90 | 80 | 70 | 60 | 50 | | |

Footnotes: (1) Forecast (2) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



Spain: Turning Slowly

■ Activity: the recovery will be lacklustre

- Unlike other large eurozone economies, Spain remained in recession in Q3 and is only likely to break free of it in early 2010. Even then, growth will remain lacklustre.
- Conditions are improving, but from a very low starting point. Although, in GDP terms, the recession is not especially deep relative to other countries, the collapse in final domestic demand has been spectacular – about 9.0% in total.
- The housing sector remains in deep recession. Housing investment is still chasing housing starts lower; a further 40% fall seems likely.
- Elsewhere, there are more signs of life. Consumer confidence has picked up markedly, but is still inconsistent with a rise in consumption.
- This should change gradually next year as the pace of decline in the labour market continues to ease, pushing confidence up slowly.
- In the first half of 2010, consumption should benefit from pre-VAT hike spending, boosting overall growth. However, once the tax increase is implemented, consumption should fall back and activity may contract for a quarter.
- Improved business confidence points to better outcomes for non-housing investment, as does a sharp narrowing of the corporate sector deficit. The non-financial corporate sector is still a heavy net borrower, but far less than before.

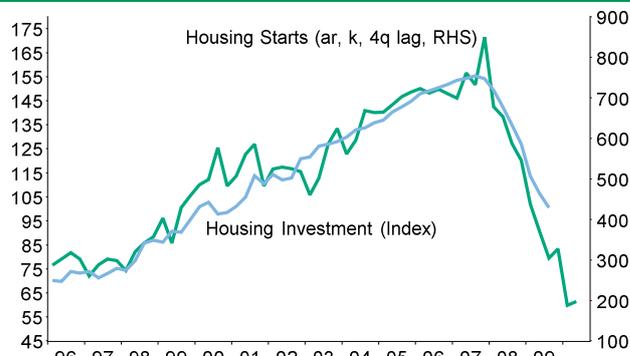
■ Inflation: strong downward pressure

- There has been a significant change in inflation dynamics in Spain. Formerly deemed a high inflation European country, Spain is on the brink of core deflation.
- The change has been driven by the collapse in domestic demand and the hollowing out of the labour market. Weak demand has squeezed margins and aggressive cuts in employment have slowed the growth in unit labour costs.
- Aside from a VAT-hike induced spike in mid-2010, downward pressure on Spanish core inflation will remain for some time to come.

■ Policy: attempting to tighten

- With the budget deficit set to balloon into double digits as a percentage of GDP this year, the government plans to start tightening policy early. The aim is to tighten policy by 1% in 2010 by raising VAT and some other taxes. This should lead to a narrower deficit, but not markedly so given continued weakness in the economy.

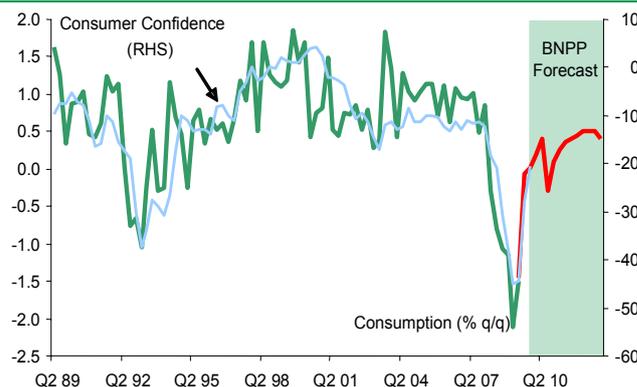
Chart 1: Housing Investment and Starts



Source: Reuters EcoWin Pro

Housing starts still signal a substantial further decline in housing investment.

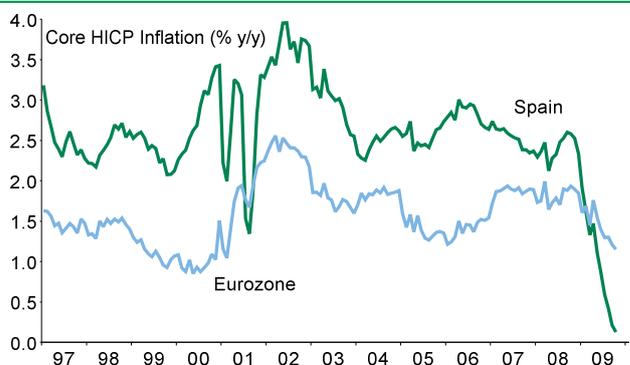
Chart 2: Consumer Spending and Confidence



Source: Reuters EcoWin Pro

Consumer confidence has improved, pointing to better consumption numbers ahead. The VAT hike will introduce some volatility.

Chart 3: Core Inflation



Source: Reuters EcoWin Pro

The domestic collapse in Spain's economy has led to a dramatic change in pricing behaviour.



Spain: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Components of Growth | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | -1.6 | -1.1 | -0.3 | 0.0 | 0.2 | 0.3 | -0.2 | 0.1 | 0.3 | 0.4 | 0.5 | 0.6 |
| GDP | 0.9 | -3.6 | 0.0 | 1.1 | 2.8 | -3.2 | -4.2 | -4.0 | -2.9 | -1.1 | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 1.4 | 1.9 |
| Domestic Demand ex Stocks | -0.7 | -6.5 | -0.9 | 0.9 | 2.9 | -6.3 | -7.5 | -6.6 | -5.4 | -2.6 | -0.6 | -0.4 | 0.0 | 0.2 | 0.4 | 1.2 | 1.9 |
| Private Consumption | -0.6 | -5.0 | 0.0 | 0.9 | 1.9 | -5.2 | -5.9 | -4.9 | -3.8 | -1.3 | 0.5 | 0.3 | 0.4 | 0.5 | 0.4 | 1.1 | 1.5 |
| Public Consumption | 5.5 | 5.5 | 7.4 | 5.6 | 2.9 | 6.4 | 5.2 | 4.9 | 5.4 | 6.3 | 7.7 | 7.9 | 7.4 | 6.8 | 6.1 | 5.2 | 4.4 |
| Fixed Investment | -4.4 | -15.9 | -8.4 | -2.5 | 5.6 | -15.1 | -17.2 | -16.2 | -14.8 | -10.9 | -8.3 | -7.7 | -6.4 | -5.2 | -4.0 | -1.6 | 0.8 |
| - Construction | -5.5 | -11.8 | -15.1 | -7.8 | 4.9 | -11.3 | -11.8 | -11.5 | -12.6 | -13.9 | -15.0 | -16.2 | -15.1 | -13.0 | -10.0 | -6.2 | -2.2 |
| - Other | -2.7 | -21.3 | 1.9 | 4.4 | 6.3 | -20.3 | -24.4 | -22.6 | -17.8 | -6.3 | 2.1 | 5.5 | 6.5 | 5.4 | 3.8 | 3.9 | 4.5 |
| Stocks (Cont. to Growth, y/y) | 0.1 | 0.1 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Exports | -1.0 | -11.9 | 4.8 | 3.3 | 6.7 | -16.9 | -15.1 | -11.1 | -3.7 | 6.5 | 6.2 | 4.4 | 2.4 | 2.1 | 2.8 | 3.6 | 4.6 |
| Imports | -4.9 | -18.3 | 1.6 | 2.8 | 7.2 | -22.6 | -22.0 | -17.0 | -10.7 | 0.8 | 3.3 | 1.5 | 0.7 | 0.9 | 2.0 | 3.3 | 4.8 |
| Industrial Production | -7.6 | -15.9 | 1.8 | 0.5 | 3.0 | -21.1 | -18.2 | -15.4 | -7.7 | -0.5 | 2.2 | 3.2 | 2.3 | 0.8 | -0.1 | 0.4 | 1.1 |
| Savings Ratio (%) | 12.9 | 18.6 | 14.6 | 11.8 | 10.3 | - | - | - | - | - | - | - | - | - | - | - | - |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Inflation & Labour | | | | | | | | | | | | | | | | | |
| HICP | 4.1 | -0.2 | 1.3 | 0.2 | 0.1 | 0.5 | -0.7 | -1.0 | 0.2 | 1.0 | 1.1 | 1.4 | 1.6 | 1.1 | 0.6 | -0.3 | -0.7 |
| Core HICP | 2.4 | 0.8 | 0.2 | -0.7 | -0.5 | 1.6 | 1.1 | 0.4 | 0.1 | -0.1 | -0.2 | 0.7 | 0.6 | 0.2 | -0.2 | -1.3 | -1.4 |
| House Prices | 0.7 | -7.7 | -8.5 | -6.8 | 0.0 | -6.8 | -8.3 | -8.0 | -7.5 | -7.6 | -8.0 | -9.1 | -9.2 | -8.4 | -7.7 | -6.1 | -4.7 |
| Compensation of Employees | 5.3 | -2.8 | -1.0 | 0.9 | 2.1 | -2.0 | -2.8 | -3.4 | -3.0 | -1.4 | -1.4 | -0.7 | -0.3 | 0.2 | 0.8 | 1.2 | 1.4 |
| Employment | -0.6 | -6.7 | -2.7 | 0.4 | 1.8 | -6.4 | -7.1 | -7.1 | -6.1 | -4.3 | -3.2 | -2.0 | -1.2 | -0.4 | 0.1 | 0.7 | 1.2 |
| Unemployment Rate (%) | 11.3 | 18.1 | 20.1 | 19.8 | 18.8 | 17.4 | 17.9 | 17.9 | 19.1 | 20.4 | 20.2 | 19.7 | 20.1 | 20.7 | 20.1 | 19.0 | 19.2 |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|----------------------------|--------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| External Trade | | | | | | | | | | | | | | | | | |
| Trade Balance (EUR bn) | -94.1 | -50.6 | -55.9 | -56.4 | -56.3 | -14.0 | -10.1 | -13.2 | -13.3 | -13.0 | -12.6 | -15.0 | -15.3 | -14.2 | -12.6 | -15.2 | -14.4 |
| Current Account (EUR bn) | -104.4 | -58.3 | -54.8 | -49.8 | -47.0 | -21.2 | -11.6 | -12.2 | -13.4 | -15.1 | -11.7 | -13.3 | -14.7 | -15.6 | -10.4 | -11.3 | -12.4 |
| Current Account (% of GDP) | -9.6 | -5.6 | -5.2 | -4.6 | -4.2 | -8.2 | -4.4 | -4.8 | -4.9 | -5.9 | -4.3 | -5.2 | -5.3 | -6.0 | -3.8 | -4.4 | -4.4 |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|----------------------------|-------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| Financial Variables | | | | | | | | | | | | | | | | | |
| Gen. Gov. Budget (EUR bn) | -44.6 | -117.5 | -102.9 | -88.6 | -69.2 | - | - | - | - | - | - | - | - | - | - | - | - |
| Gen. Gov. Budget (% GDP) | -4.1 | -11.2 | -9.7 | -8.2 | -6.2 | - | - | - | - | - | - | - | - | - | - | - | - |
| Primary Budget (EUR bn) | -27.2 | -96.6 | -80.6 | -61.4 | -33.3 | - | - | - | - | - | - | - | - | - | - | - | - |
| Primary Budget (% GDP) | -2.5 | -9.2 | -7.6 | -5.7 | -3.0 | - | - | - | - | - | - | - | - | - | - | - | - |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-------------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Interest Rates⁽²⁾ | | | | | | | | | | | | | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 | 1.50 | 1.00 | 1.00 | 0.70 | 0.60 | 0.60 | 0.65 | 1.10 | 1.25 | 1.50 | 2.00 | 2.25 |
| 10-Year Rate (%) | 3.82 | 3.80 | 4.30 | 4.70 | 5.20 | 4.06 | 4.14 | 3.81 | 3.80 | 4.05 | 3.85 | 4.05 | 4.30 | 4.45 | 4.60 | 4.75 | 4.70 |
| Spread over Bund (bp) | 87 | 70 | 80 | 45 | 45 | 106 | 75 | 59 | 70 | 95 | 95 | 85 | 80 | 70 | 60 | 50 | 45 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



Netherlands: Facing a Budgetary Hangover

■ Activity: uncertainty limits expansion

- Strong trade and financial linkages have made the economy very vulnerable to the global downturn. GDP is projected to contract by close to 4% in 2009. A modest expansion of around 1% is expected for 2010.
- The deterioration in labour market conditions has been limited by the government-subsidised part-time unemployment scheme.
- The fall in financial asset prices and uncertainty in the housing market have been weighing on private consumption by pushing up the savings ratio.
- Growth in credit to non-financial corporations has decelerated sharply due to tighter lending conditions and reduced demand for credit. By contrast, mortgage lending is still growing rapidly despite the reduction in the number of houses sold.

■ Inflation: energy price hike partly offset by slowing labour costs

- Energy price cuts have been largely responsible for the recent fall in inflation. The projected increase in oil prices will lead to a partial reversal of these price cuts in the coming quarters.
- Against the backdrop of deteriorating labour market conditions, the government has asked the social partners to freeze the wage contracts. Nevertheless, the main trade union, FNV, will ask for an increase of 1.25% in the upcoming wage negotiations.
- The main domestic inflation risk is an increase in local taxes and levies to shore up the budgets of the municipalities.

■ Policy: coalition agrees on raising the retirement age

- Effective government intervention has prevented the collapse of the financial sector. As a result, the debt-to-GDP ratio has increased by 8.5 percentage points. The nationalised banks ABN AMRO and Fortis will be merged. The new entity is not expected to be privatised before 2011.
- The government has agreed to a EUR 1.8bn savings plan for 2011, conditional on economic growth. Its implementation might be hampered by the general election in that year.
- The coalition has reached agreement on a medium-term fiscal consolidation plan. The raising of the mandatory retirement age from 65 to 67 is strongly contested by the opposition and trade unions.

Netherlands: Economic Forecasts

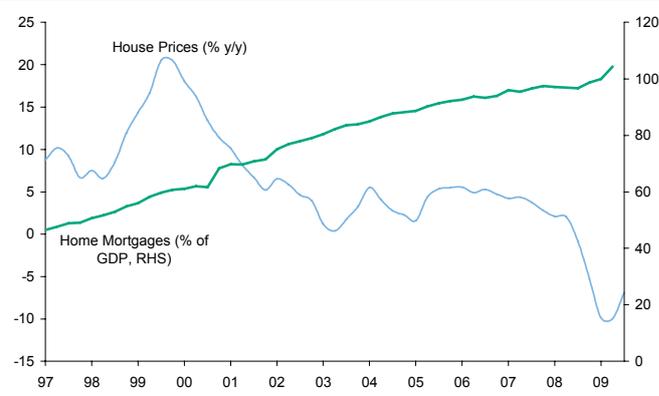
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--------------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 2.0 | -3.9 | 1.1 | 1.5 | 2.0 |
| Dom. Demand ex. Stocks | 2.3 | -3.2 | -0.6 | 1.2 | 1.6 |
| Private Consumption | 1.3 | -2.5 | 0.2 | 0.7 | 1.5 |
| Public Consumption | 2.0 | 3.0 | 1.5 | 0.5 | 0.2 |
| Fixed Investment | 4.9 | -12.0 | -5.5 | 3.5 | 4.0 |
| Stocks (Cont. to Growth) | 0.4 | -0.5 | 0.5 | 0.0 | 0.0 |
| Exports | 2.7 | -10.0 | 6.0 | 5.0 | 6.5 |
| Imports | 3.7 | -10.5 | 5.0 | 5.0 | 6.5 |
| Industrial Production | -0.7 | -8.7 | 5.1 | 1.6 | 3.3 |
| Savings Ratio (%) | 7.0 | 10.0 | 9.5 | 9.3 | 8.9 |
| Inflation & Labour | | | | | |
| CPI | 2.5 | 1.2 | 1.3 | 1.0 | 1.0 |
| HICP | 2.3 | 1.1 | 1.6 | 1.1 | 1.0 |
| Core HICP | 1.1 | 1.1 | 1.4 | 0.5 | 1.0 |
| Contract Wages | 3.5 | 2.8 | 1.5 | 1.0 | 1.5 |
| Employment | 1.9 | -0.1 | -1.2 | 0.0 | 0.7 |
| Unemployment Rate (%) | 3.9 | 4.8 | 6.3 | 6.5 | 6.3 |
| External Trade | | | | | |
| Trade Balance (EUR bn) | 38.8 | 34.1 | 32.2 | 40.3 | 42.9 |
| Current Account (EUR bn) | 28.5 | 31.1 | 32.2 | 37.8 | 41.9 |
| Current Account (% GDP) | 4.8 | 5.5 | 5.5 | 6.4 | 6.9 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (EUR bn) | 4.2 | -25.7 | -34.8 | -28.4 | -17.0 |
| Gen. Gov. Budget (% GDP) | 0.7 | -4.5 | -6.0 | -4.8 | -2.8 |
| Interest Rates ⁽²⁾ | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 |
| 10-Year Bond Yield (%) | 3.55 | 3.45 | 3.90 | 4.50 | 5.00 |
| Spread over Bund (bp) | 61 | 35 | 40 | 25 | 25 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated.

Source: BNP Paribas

Chart 1: Indebted Homeowners Face Falling Prices



Source: Statistics Netherlands, De Nederlandsche Bank, NVM

The high level of household indebtedness is largely related to the favourable tax treatment of mortgage interest payments. Even though mortgage default rates have remained very low, defaults remain a serious risk for the economy.



Belgium: Inflation to Remain Volatile

■ Activity: recovery likely to be relatively slow

- As we had expected, the recovery started in Q3 2009 with a 0.5% q/q rise in GDP. However, although 2009's recession was a little shallower in Belgium than in the eurozone in general, the economic recovery seems to have less momentum in Belgium.
- Given the huge accumulation of inventories in 2007 and 2008 (at a pace of 1.0% of GDP per annum), the inventory adjustment that has started in 2009 is likely to continue over the coming quarters but at a slower pace.
- So far, the rise in the unemployment rate has been modest. Thus consumption growth should gradually return to trend and be the main driver of overall GDP growth.

■ Inflation: very volatile

- The inflation rate remains very volatile. The increase in oil prices in year-on-year terms, especially over the first half of 2010, will push inflation higher and back above the eurozone average.
- Indirect tax hikes, particularly on petrol, will also push inflation higher in 2010.
- However, Belgium's wage indexation mechanism means that 2009's seven-month period of price declines will cause the next general wage adjustment to be postponed, probably well into 2011.
- Core inflation is likely to trough in late 2010 or early 2011.

■ Policy: dominated by drive to reduce debt

- Although the government coalition remains fragile due to the absence of an agreement over federalism, a guideline for budgetary policy has been agreed. The main goal is to reduce the budget deficit to prevent public debt from ballooning. It took Belgium fourteen years to reduce public debt from 140% of GDP to 88% and policymakers are not ready to lose, in just a few years, the benefits of fourteen years of orthodox budgetary policy.
- Nevertheless, only the least politically challenging measures have been agreed and, given the divisions within the government, setting economic policy will remain difficult. The nomination of Herman Van Rompuy to the EU Presidency and his replacement as Belgian PM on 25 November by former PM Yves Leterme makes the coalition even more fragile.

Belgium: Economic Forecasts

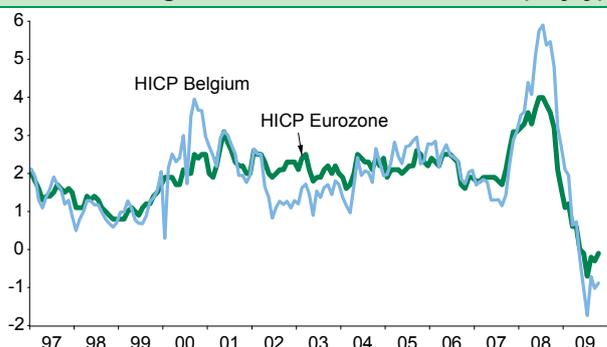
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--------------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 0.8 | -3.1 | 1.2 | 1.5 | 2.0 |
| Dom. Demand ex Stocks | 3.5 | -1.7 | 1.2 | 2.2 | 3.0 |
| Private Consumption | 1.0 | -1.6 | 0.9 | 1.3 | 1.8 |
| Public Consumption | 3.3 | 1.7 | 1.3 | 1.2 | 1.2 |
| Fixed Investment | 3.9 | -3.9 | -1.4 | 1.2 | 2.5 |
| Stocks (Cont. to Growth) | -0.2 | -1.1 | 0.5 | 0.2 | 0.2 |
| Exports | 1.4 | -12.0 | 2.0 | 2.5 | 4.9 |
| Imports | 2.7 | -11.6 | 1.9 | 2.5 | 5.0 |
| Industrial Production | -0.5 | -12.0 | 3.2 | 2.0 | 3.5 |
| Savings Ratio (%) | 8.3 | 10.2 | 10.4 | 10.4 | 10.2 |
| Inflation & Labour | | | | | |
| HICP | 4.5 | 0.0 | 1.2 | 1.3 | 1.2 |
| Core HICP | 1.8 | 2.1 | 0.8 | 0.2 | 0.8 |
| Wages | 3.5 | 2.7 | 1.0 | 1.5 | 1.8 |
| Employment | 1.5 | -1.2 | -0.6 | 0.3 | 0.6 |
| Unemployment Rate (%) | 7.0 | 7.8 | 8.3 | 8.1 | 7.8 |
| External Trade | | | | | |
| Trade Balance (EUR bn) | 4 | 5 | 4 | 3 | 3 |
| Current Account (EUR bn) | -8 | -6 | -7 | -8 | -8 |
| Current Account (% GDP) | -2.4 | -1.8 | -2.0 | -2.3 | -2.2 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (EUR bn) | -4 | -17 | -22 | -19 | -15 |
| Gen. Gov. Budget (% GDP) | -1.2 | -5.0 | -6.5 | -5.5 | -4.0 |
| Interest Rates ⁽²⁾ | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 |
| 10-Year Bond Yield (%) | 3.77 | 3.60 | 4.05 | 4.60 | 5.10 |
| Spread over Bund (bp) | 82 | 50 | 55 | 35 | 35 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas

Chart 1: Belgian and Eurozone Inflation (% y/y)



Source: Reuters EcoWin Pro

Belgian inflation is usually much more volatile than the eurozone average, largely due to volatility in energy prices. This is because energy, particularly heating oil, is subject to lower taxes in Belgium, meaning that oil price fluctuations exert a greater influence on the end price of energy.



Austria: On the Road to Recovery

■ Activity: GDP rebounded in Q3 2009

- GDP increased by 0.9% q/q in Q3 2009. The rise, the first since Q2 2008, followed drops of 0.5% q/q and 2.6% q/q in Q2 and Q1 respectively. In year-on-year terms, the fall in GDP eased but activity was still down by 2.4%.
- Private consumption has continued to expand since the beginning of the year thanks to a slowdown in inflation and to the fiscal stimulus, both of which have supported purchasing power. However, a renewed rise in inflation and an increase in the unemployment rate will restrain consumption in the coming quarters.
- Exports rose by 1.4% q/q in Q3 2009, thanks to a rebound in GDP growth in Austria's main trading partners, boosting industrial production. Moreover, firms have cut their inventory levels in recent months and are now responding to demand by increasing output. However, once exports reverse their plunge which reflected the collapse in world trade during the financial crisis, we expect export growth to ease in 2010.
- Investment increased by 1.3% q/q in Q3 (after increasing 0.1% q/q in Q2 2009). Nevertheless, it should be weak over the coming quarters because of low capacity utilisation and corporate profits, and tighter credit conditions.
- GDP is forecast to decline by around 3.6% in 2009 and increase by a modest 1.2% in 2010.

■ Inflation: still weak

- Because of the plunge in energy prices from 2008's levels, headline inflation has fallen significantly since the start of the year and was negative during the summer. However, oil prices have risen sharply in recent months, which will fuel inflation from Q4 2009 onwards.
- However, core inflation will fall over the coming quarters because of the low rate of capacity utilisation.

■ Policy: rise in the fiscal deficit

- We forecast a fiscal deficit of around 4% of GDP in 2009 because of the discretionary stimulus and the impact of economic weakness on automatic stabilisers.
- The deficit is forecast to widen further in 2010 to 5.3% of GDP. The tax base will decrease and social expenditure should continue to rise in the wake of the increase in the unemployment rate.

Austria: Economic Forecasts

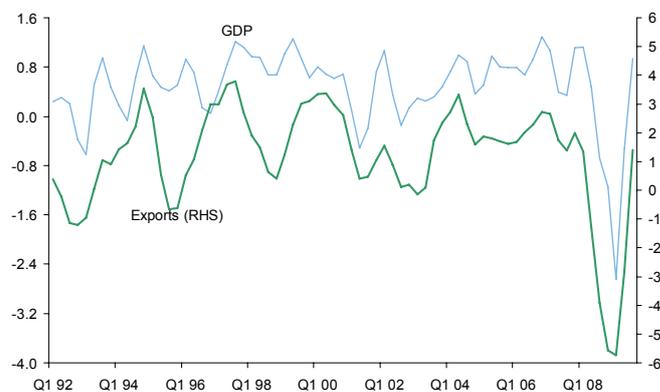
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--------------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 2.0 | -3.6 | 1.2 | 1.8 | 2.5 |
| Dom. Demand ex Stocks | 1.0 | -0.7 | 0.8 | 1.1 | 1.9 |
| Private Consumption | 0.5 | 0.4 | 0.3 | 0.8 | 1.6 |
| Public Consumption | 3.0 | 0.7 | 1.2 | 0.5 | 1.0 |
| Fixed Investment | 0.5 | -4.4 | 1.8 | 2.1 | 3.7 |
| Stocks (Cont. to Growth) | -0.3 | -0.1 | 0.1 | 0.2 | 0.2 |
| Exports | -0.4 | -12.9 | 2.4 | 3.9 | 4.0 |
| Imports | -1.6 | -11.1 | 1.9 | 3.1 | 3.6 |
| Industrial Production | 1.6 | -10.3 | 2.1 | 2.3 | 3.9 |
| Savings Ratio (%) | 13.0 | 13.9 | 13.6 | 13.4 | 13.7 |
| Inflation & Labour | | | | | |
| HICP | 3.2 | 0.5 | 1.2 | 0.7 | 0.8 |
| Core HICP | 1.8 | 1.7 | 0.7 | 0.1 | 0.4 |
| Employment | 1.4 | -1.5 | -0.8 | 0.4 | 1.6 |
| Unemployment Rate (%) | 3.9 | 4.7 | 5.5 | 5.6 | 5.4 |
| External Trade | | | | | |
| Trade Balance (EUR bn) | 12.6 | 11.2 | 11.1 | 12.7 | 13.8 |
| Current Account (EUR bn) | 9.0 | 5.5 | 5.3 | 6.3 | 8.3 |
| Current Account (% GDP) | 3.2 | 2.0 | 1.9 | 2.2 | 2.8 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (EUR bn) | -1.1 | -10.9 | -14.8 | -13.7 | -11.5 |
| Gen. Gov. Budget (% GDP) | -0.4 | -4.0 | -5.3 | -4.8 | -3.9 |
| Interest Rates ⁽²⁾ | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 |
| 10-Year Bond Yield (%) | 3.85 | 3.55 | 3.90 | 4.45 | 4.95 |
| Spread over Bund (bp) | 91 | 45 | 40 | 20 | 20 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated.

Source: BNP Paribas

Chart 1: Austrian GDP and Export Growth (% q/q)



Source: Eurostat

Exports underpinned GDP growth in Q3 2009. Nevertheless, once exports have reversed their previous plunge, the pace of increase in exports will ease over the coming year.



Portugal: Lacklustre Upturn

■ Activity: out of recession

- The economy grew more strongly than expected in Q3 2009 (by 0.9% q/q, after 0.3% in Q2). The larger increase was mainly the result of a reduction in the drag from falling investment and deterioration in external trade. However, we remain cautious about the medium-term outlook.
- Private consumption is expected to stagnate in 2010, undermined by a higher unemployment rate, tight credit conditions and low consumer confidence. As a result, precautionary saving will increase further. Conditions are improving slightly, but the recovery will be gradual.
- Despite a recent improvement in world trade, the outlook for demand and profits remains poor. In addition, the capacity utilisation rate still stands at a historically low level. In this context, business confidence will take time to recover. Investment is not projected to rise until 2011, after a fall of close to 5% in 2010.
- Exports are expected to follow the improvement in world trade. However, Portugal will continue to suffer from weaker demand from Spain, its main trading partner (which takes 25% of Portugal's exports). All in all, the contribution from net trade to GDP is forecast to continue to improve in 2010.

■ Inflation: downward pressure

- Headline inflation is projected to turn positive in early 2010, thanks to the progressive removal of favourable base effects linked to energy and food prices. Nevertheless, Portuguese inflation will remain below the eurozone average in 2010.
- Portugal is now experiencing negative core inflation. Core prices are projected to keep falling in 2010 and 2011. Low domestic demand, higher unemployment and low capacity utilisation rates will put pressure on wages and selling prices.

■ Policy: deficit to exceed 7% of GDP from 2010

- The Socialist party of Prime Minister José Socrates came out ahead in the latest legislative election, but lost its absolute majority. It is now seeking to pursue an anti-recession policy based on public investment.
- Coupled with the effect of the automatic stabilisers, these discretionary measures are likely to take the public deficit up to just over 7% GDP in 2009, from 2.6% of GDP in 2008.
- The European Commission has urged Portugal to correct its excessive deficit in a medium-term framework, with a deadline of 2013.

Portugal: Economic Forecasts

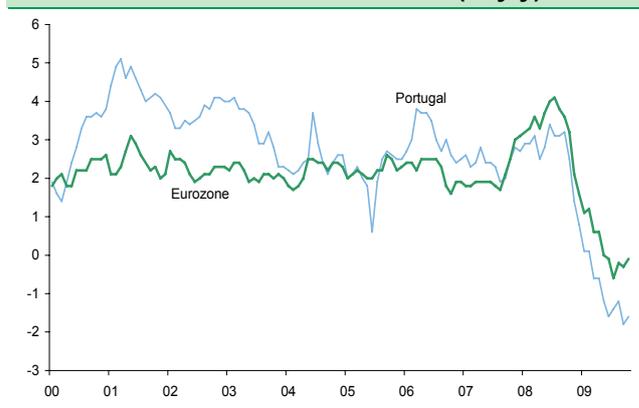
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--------------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 0.0 | -3.0 | 0.4 | 1.1 | 1.8 |
| Dom. Demand ex Stocks | 1.3 | -3.9 | -0.2 | 0.9 | 1.9 |
| Private Consumption | 1.7 | -1.0 | 0.3 | 0.7 | 1.5 |
| Public Consumption | 0.7 | 1.5 | 1.0 | 1.1 | 0.5 |
| Fixed Investment | 0.5 | -16.5 | -3.2 | 1.4 | 4.6 |
| Stocks (Cont. to Growth) | 0.3 | -0.5 | 0.2 | 0.1 | 0.0 |
| Exports | -0.5 | -15.5 | 0.2 | 2.8 | 4.5 |
| Imports | 2.7 | -13.6 | -0.3 | 2.0 | 4.2 |
| Industrial Production | -4.1 | -8.9 | -3.5 | 1.1 | 3.2 |
| Savings Ratio (%) | 9.4 | 9.7 | 11.0 | 10.6 | 7.7 |
| Inflation & Labour | | | | | |
| HCPI | 2.7 | -0.9 | 0.5 | 0.7 | 0.7 |
| Core HCPI | 1.6 | 0.6 | -0.2 | -0.1 | 0.1 |
| Employment | 0.5 | -2.7 | -1.8 | 0.0 | 0.8 |
| Unemployment Rate (%) | 7.6 | 9.3 | 9.7 | 9.3 | 8.8 |
| External Trade | | | | | |
| Trade Balance (EUR bn) | -21.4 | -18.0 | -17.5 | -17.2 | -17.5 |
| Current Account (EUR bn) | -20.2 | -16.8 | -16.3 | -16.0 | -16.3 |
| Current Account (% GDP) | -12.1 | -10.5 | -10.1 | -9.8 | -9.7 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (EUR bn) | -4.3 | -12.6 | -12.6 | -13.6 | -13.8 |
| Gen. Gov. Budget (% GDP) | -2.6 | -7.9 | -7.8 | -8.3 | -8.2 |
| Interest Rates ⁽²⁾ | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 |
| 10-Year Bond Yield (%) | 3.96 | 3.85 | 4.40 | 4.75 | 5.25 |
| Spread over Bund (bp) | 101 | 75 | 90 | 50 | 50 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated.

Source: BNP Paribas

Chart 1: Headline Inflation (% y/y)



Source: Eurostat

Inflation is projected to turn positive in early 2010, thanks to the progressive removal of favourable base effects linked to energy and food prices. Nevertheless, Portuguese inflation will remain below the eurozone average in 2010.



Finland: Delayed Recovery

■ Activity: recovery lags the improvement in Finland's main trading partners

- The economy contracted for the fifth consecutive quarter in Q3. In September, the monthly output indicator showed a fall of almost 12% y/y, following a decline of around 7% in June.
- Although the recovery is likely to start later than in other eurozone countries, the outlook is improving given brighter prospects for global growth as exports represent more than 40% of GDP. The pick-up in the eurozone is particularly important, given that the region represents around a third of Finland's foreign trade.
- Economic surveys suggest that the upturn in services and the manufacturing sector will be very gradual. Industrial output fell 4.6% q/q in Q3 and as Finnish industry specialises in investment goods, it is dependent on a tangible recovery in capacity utilisation rates in the country's main export markets.
- Conversely, consumer confidence has steadily recovered from its lows in December last year and is now markedly above its long-term average. However, confidence remains vulnerable to worsening conditions in the labour market.

■ Inflation: downward pressures on prices

- Inflation, measured by the harmonised consumer price index, has steadily decreased since last year, when it hit a peak of almost 5% y/y in August 2008. Despite the recent upturn in oil prices, the inflation rate has continued to decline, falling below 1% in October.
- The fall in inflation from 1.1% y/y in September to 0.6% in October was largely due to a cut in the value-added tax on food from the beginning of October. Nevertheless, excess capacity and weak domestic demand should continue to weigh on core inflation. Core inflation was 1.9% y/y in October and is trending down to 1% next year.

■ Policy: fiscal consolidation will come in due course

- Considerable fiscal easing, which will continue into next year, and the ongoing economic weakness have weighed on public finances.
- The budget deficit still looks mild in comparison with deficits in most other eurozone countries. However, the move from a structural surplus of 4% of GDP in 2008 to a deficit of 2% of GDP in 2010 is one of the sharpest of the region and will need to be corrected in due course.

Finland: Economic Forecasts

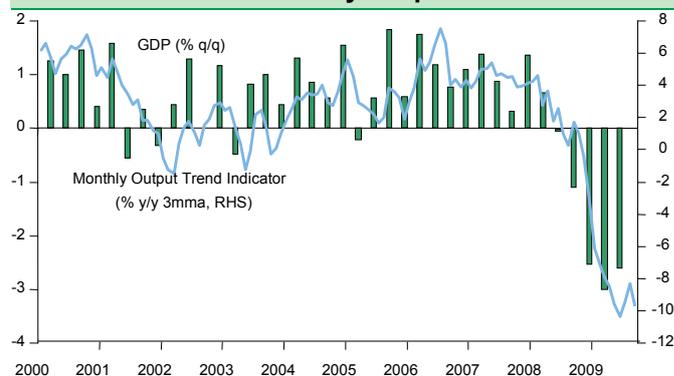
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|-------------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 1.5 | -6.3 | 0.5 | 2.2 | 3.0 |
| Dom. Demand ex Stocks | 1.7 | -3.3 | -0.1 | 1.9 | 2.9 |
| Private Consumption | 2.6 | -3.6 | -0.1 | 0.8 | 2.5 |
| Public Consumption | 0.3 | 1.2 | 1.2 | 1.1 | 1.6 |
| Fixed Investment | 3.0 | -14.0 | -3.7 | 2.6 | 3.2 |
| Stocks (Cont. to Growth) | -0.2 | -0.7 | 0.4 | 0.2 | 0.1 |
| Exports | 2.0 | -20.0 | 1.0 | 3.4 | 3.7 |
| Imports | 1.5 | -17.0 | 1.5 | 3.7 | 4.2 |
| Industrial Production | 0.5 | -14.0 | 2.5 | 3.0 | 3.5 |
| Savings Ratio (%) | -2.1 | 0.5 | 3.0 | 3.5 | 3.2 |
| Inflation & Labour | | | | | |
| CPI | 4.0 | 0.2 | 1.2 | 1.8 | 1.8 |
| HICP | 3.9 | 1.2 | 1.8 | 1.5 | 1.5 |
| Core HICP | 1.8 | 1.3 | 1.0 | 0.5 | 1.0 |
| Employment | 1.8 | -2.8 | -0.9 | 0.5 | 0.5 |
| Unemployment Rate (%) | 6.4 | 9.0 | 10.3 | 9.5 | 9.2 |
| External Trade | | | | | |
| Trade Balance (EUR bn) | 6.2 | 4.0 | 4.4 | 4.2 | 3.9 |
| Current Account (EUR bn) | 3.8 | 2.8 | 2.7 | 2.8 | 3.7 |
| Current Account (% GDP) | 2.0 | 1.6 | 1.5 | 1.5 | 1.9 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (EUR bn) | 7.8 | -5.3 | -6.4 | -5.5 | -1.9 |
| Gen. Gov. Budget (% GDP) | 4.2 | -3.0 | -3.6 | -3.0 | -1.0 |
| Interest Rates⁽²⁾ | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 |
| 10-Year Bond Yield (%) | 3.48 | 3.40 | 3.75 | 4.35 | 4.85 |
| Spread over Bund (bp) | 53 | 30 | 25 | 10 | 10 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas

Chart 1: GDP and Monthly Output Trend Indicator



Source: Statistics Finland

The recovery in the Finnish economy lags the improvement in the country's main trading partners in the eurozone. This delay is mostly attributable to the fact that the domestic industry specialises in investment goods, global demand for which depends on a marked increase in capacity utilisation rates.



Ireland: Struggling On

■ Activity: past worst, subdued recovery ahead

- The recovery in Ireland is likely to be subdued relative to developments elsewhere in Europe.
- The ongoing adjustment in house prices and the high level of both unemployment and debt are weighing on consumers' confidence, which will limit their participation in the recovery.
- Further fiscal tightening will also drag on growth.
- The contraction in private sector credit and the downward trend in the money multiplier highlight the risk that banks also impede the recovery by keeping the supply of credit tight. It is crucial that the financial system is fixed.

■ Inflation: deflation deepening

- The process of regaining competitiveness continues to proceed at a staggering pace. Headline inflation has fallen by nearly 3pp more than in the eurozone over the past fifteen months.
- This process has further to go. Ireland lost around 20% of its competitiveness relative to the eurozone over the last decade and consumer prices started the adjustment around 20% higher in level terms than the euro average.
- The implications of this speed of adjustment are not uniformly positive. With such high household debt levels, deflation increases the real burden of debt and is prolonging the fall in house prices. Both trends are putting the banks under more pressure.
- The risk remains that Ireland slips into a long period of deflation.

■ Policy: further tightening ahead

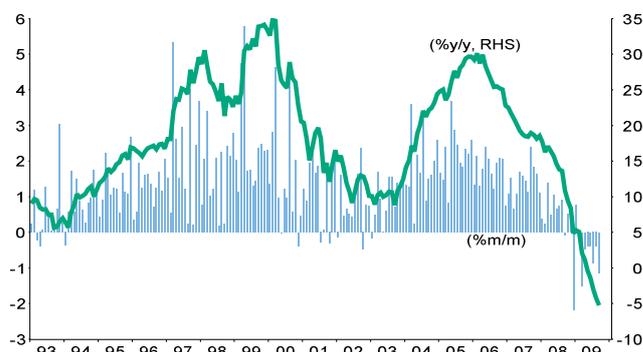
- The government is committed to finding an additional EUR 4bn of savings in December's budget – the fifth round of measures to date.
- There is recognition that public expenditure – which is bloated relative to tax receipts – should take the burden of a future adjustment, with a third of the savings to come from the public sector wage bill.
- NAMA should begin transferring loans from banks by early 2010. Eurostat has reportedly made a preliminary decision to allow the agency's liabilities to remain off balance sheet in the calculation of national debt.
- EUR 54bn in payments for loans would have added around 30pp to the gross national debt-to-GDP ratio, pushing it above 100% by the end of 2010.

| Ireland: Economic Forecasts | | | | | |
|--------------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
| Components of Growth | | | | | |
| Total GDP | -3.0 | -7.4 | -0.8 | 2.5 | 4.1 |
| Dom. Demand ex Stocks | -4.6 | -11.8 | -3.6 | 1.4 | 3.5 |
| Private Consumption | -0.9 | -7.6 | -1.6 | 1.5 | 3.2 |
| Public Consumption | 2.6 | -0.2 | -1.2 | 0.3 | 1.9 |
| Fixed Investment | -15.6 | -28.8 | -11.2 | 2.0 | 6.1 |
| Stocks (Cont. to Growth) | 0.5 | -0.8 | 0.0 | 0.0 | 0.0 |
| Exports | -1.0 | -2.2 | 1.2 | 4.2 | 5.3 |
| Imports | -2.0 | -7.8 | -1.6 | 3.4 | 4.8 |
| Industrial Production | -1.5 | -2.0 | -0.5 | 3.0 | 5.0 |
| Inflation & Labour | | | | | |
| CPI | 4.1 | -4.4 | -0.7 | 0.1 | 2.7 |
| HICP | 3.1 | -1.6 | -0.8 | -0.6 | -0.4 |
| Core HICP | 1.6 | -1.3 | -2.0 | -2.1 | -1.2 |
| Employment | -1.1 | -8.0 | -3.0 | 0.5 | 1.5 |
| Unemployment Rate (%) | 6.3 | 11.7 | 13.4 | 13.8 | 13.1 |
| External Trade | | | | | |
| Trade Balance (EUR bn) | 28.6 | 37.4 | 41.5 | 44.1 | 47.3 |
| Current Account (EUR bn) | -9.4 | -4.5 | -2.5 | -1.0 | 1.0 |
| Current Account (% GDP) | -5.2 | -2.7 | -1.5 | -0.6 | 0.6 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (EUR bn) | -13.2 | -19.5 | -19.5 | -16.0 | -11.5 |
| Gen. Gov. Budget (% GDP) | -7.3 | -11.8 | -12.0 | -9.7 | -6.7 |
| Interest Rates ⁽²⁾ | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 |
| 10-Year Bond Yield (%) | 4.44 | 4.90 | 5.40 | 5.25 | 5.75 |
| Spread over Bund (bp) | 149 | 180 | 190 | 100 | 100 |

Footnotes: (1) Forecast (2) End Period

Source: BNP Paribas

Chart 1: Private Sector Credit



Source: Reuters EcoWin Pro, BNP Paribas

The ongoing contraction in private sector credit and a falling money multiplier highlight the risk that the financial sector impedes growth.



Greece: No Easy Way Out

■ Activity: in recession since Q4 2008

- After the sharp downward revision of the national accounts data, it turned out that the economy has been in recession since Q4 2008. Unlike other eurozone economies, Greece remained in recession in Q3 2009 (when GDP fell 0.3% q/q) and we do not see an easy way out.
- Private consumption is projected to continue to contract in 2010, undermined by a fall in employment, deceleration in wage growth, tight credit conditions and rising inflation. As employment continues to fall, we expect the recovery in consumption in 2011 to be gradual and shallow.
- In spite of the expansion of public investment, gross fixed capital formation will be restrained by the downturn in the housing sector, tightening of credit conditions and the poor outlook for demand and profits.
- Exports (mainly shipping and tourism receipts) are expected to be boosted by the improvement in world trade. Given the sharp fall in domestic demand, the contraction in imports is likely to continue in 2010. As a result, the contribution of net exports to GDP growth will be positive.

■ Inflation: well above the eurozone average

- In 2010, headline inflation will jump to 1.7% from 1.3% in 2009, thanks to higher oil prices and new taxes on fuel, mobile phones, lotteries, cars and luxury boats. Inflation is expected to remain well above the eurozone average.
- Due to the weakening of activity, core inflation is forecast to decelerate for a long period, reaching 0.4% in 2011. However, we do not expect it to turn negative, given rigidities in domestic markets.

■ Policy: unsustainable fiscal position

- The budget deficit has been revised up sharply following spending overruns and tax shortfalls. The deficit should narrow in 2010 due to the expiration of some one-off measures.
- At its current level, the deficit is unsustainable. We have assumed fiscal consolidation will start in 2011 by broadening the tax base, fighting tax evasion and improving tax collection. In the long term, measures are needed to contain pension spending and roll back early retirement.
- The main risk to the forecast is a loss in confidence in the pace of fiscal consolidation by the financial markets. Concern about the growing deficit has already led to a widening of interest spreads.

Greece: Economic Forecasts

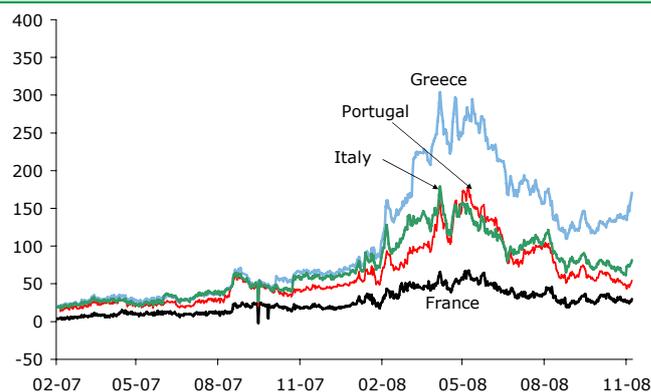
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--------------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 2.0 | -1.1 | -0.5 | 0.5 | 1.8 |
| Dom. Demand ex Stocks | 0.3 | -4.2 | -1.3 | 0.6 | 1.7 |
| Private Consumption | 2.3 | -2.4 | -1.1 | 0.3 | 1.1 |
| Public Consumption | 0.6 | 1.9 | 1.0 | 0.8 | 1.2 |
| Fixed Investment | -7.4 | -16.5 | -4.8 | 1.8 | 5.2 |
| Stocks (Cont. to Growth) | 1.0 | -0.5 | -0.1 | 0.0 | 0.0 |
| Exports | 4.0 | -11.9 | 1.5 | 2.8 | 4.5 |
| Imports | 0.2 | -20.4 | -2.7 | 2.6 | 3.3 |
| Industrial Production | -4.1 | -9.5 | 0.0 | 2.3 | 3.5 |
| Inflation & Labour | | | | | |
| HICP | 4.2 | 1.3 | 1.7 | 1.2 | 1.0 |
| Core HICP | 3.1 | 2.3 | 1.0 | 0.4 | 0.6 |
| Employment | 1.1 | -1.3 | -0.8 | -0.3 | 0.8 |
| Unemployment Rate (%) | 7.6 | 9.3 | 9.8 | 10.0 | 10.6 |
| External Trade | | | | | |
| Trade Balance (EUR bn) | -44.0 | -38.6 | -34.1 | -30.1 | -26.5 |
| Current Account (EUR bn) | -34.8 | -31.3 | -28.3 | -25.6 | -23.2 |
| Current Account (% GDP) | -13.8 | -10.1 | -9.6 | -9.6 | -9.2 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (EUR bn) | -19 | -31 | -30 | -29 | -28 |
| Gen. Gov. Budget (% GDP) | -7.7 | -12.7 | -12.0 | -11.5 | -11.0 |
| Interest Rates ⁽²⁾ | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 |
| 10-Year Bond Yield (%) | 5.20 | 5.25 | 5.60 | 5.25 | 5.75 |
| Spread over Bund (bp) | 226 | 215 | 210 | 100 | 100 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated.

Source: BNP Paribas

Chart 1: Spreads versus German Bunds (bp)



Source: Reuters EcoWin Pro

The upward revision to official estimates of the public deficit explains the recent widening of Greek government bond spreads vis-à-vis German Bunds. Besides general risk aversion, Greece is being penalised for its high level of government debt and its unfavourable long-term fiscal outlook. As a result, the cost of financing has risen sharply.



Slovenia: Uncertain Recovery

■ Activity: uncertain recovery

- Our forecasts for both the profile and structure of GDP are little changed since the publication of the last *Global Outlook*. We expect the Slovenian economy to shrink by around 7.5% y/y this year and to post only a modest recovery in 2010. This recovery is premised on the pick-up in external demand, which should continue to boost net exports.
- After rising for two months, economic sentiment fell again in October. The decline has been driven mainly by a weakening of consumer confidence, which is not surprising given the current deterioration in labour market conditions and outlook.
- We expect the crisis feeling to intensify over the next several months, as unemployment will continue to rise, even though the recession in industry and exports is bottoming out.
- We forecast that final domestic demand will continue to fall in 2010, albeit at a slower pace than this year, with investment remaining particularly weak.
- We therefore also expect a further widening of the trade and current account surpluses.
- The heavy reliance on the car sector increases the risk for the economy over the medium term and we expect soft growth readings throughout the forecast period.

■ Inflation: deflation ahead

- Since late spring, Slovenia has been flirting with HICP deflation.
- Despite the fact that the most recent headline inflation numbers have been (barely) above zero, dwindling demand pressure argues for negative inflation ahead.
- We expect both the headline and the core HICP to fall by around 1.0% y/y next year.
- Deflation will increase the real rate of interest, which could hurt the medium-term investment outlook.

■ Policy: wide fiscal deficits

- We expect this year's fiscal deficit to exceed the official target of 5.9% of GDP – largely since we expect a deeper fall in nominal GDP.
- We forecast only a small reduction of the budget shortfall next year, as the economic recovery will remain shallow and extremely fragile.
- Thus we forecast gradual deficit reductions only from 2011 onwards. However, the fiscal gap will exceed 3% of GDP until 2012 at least.

Slovenia: Economic Forecasts

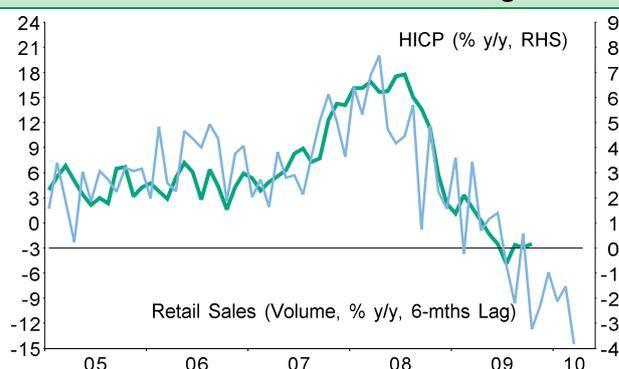
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--------------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 3.6 | -7.5 | 2.0 | 3.2 | 4.9 |
| Dom. Demand ex Stocks | 3.7 | -8.4 | -1.8 | 1.6 | 3.6 |
| Private Consumption | 2.2 | -2.0 | 2.0 | 2.1 | 3.1 |
| Public Consumption | 3.7 | 3.0 | 2.8 | 3.5 | 2.9 |
| Fixed Investment | 6.6 | -29.1 | -12.2 | -0.5 | 5.4 |
| Stocks (Cont. to Growth) | 0.2 | -3.8 | 1.2 | 0.5 | 0.5 |
| Exports | 3.4 | -15.2 | 6.8 | 7.7 | 11.5 |
| Imports | 3.8 | -21.3 | 2.0 | 5.5 | 9.7 |
| Industrial Production | 2.6 | -17.2 | 2.0 | 2.8 | 6.4 |
| Savings Ratio (%) | 11.9 | 8.2 | 11.2 | 11.6 | 11.1 |
| Inflation & Labour | | | | | |
| HICP | 5.2 | 0.8 | -1.3 | 0.8 | 2.3 |
| Core HICP | 4.9 | 1.6 | -1.0 | 0.7 | 2.0 |
| Employment | 3.0 | -2.0 | 0.1 | 1.2 | 1.7 |
| Unemployment Rate (%) | 4.4 | 5.8 | 6.2 | 6.0 | 5.6 |
| External Trade | | | | | |
| Trade Balance (EUR bn) | -2.65 | -0.23 | 0.28 | 0.57 | 1.02 |
| Current Account (EUR bn) | -2.29 | 0.08 | 0.20 | 0.41 | 0.73 |
| Current Account (% GDP) | -6.2 | 0.2 | 0.5 | 1.1 | 1.9 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (EUR bn) | -0.67 | -2.29 | -1.91 | -1.67 | -1.30 |
| Gen. Gov. Budget (% GDP) | -1.8 | -6.3 | -5.1 | -4.4 | -3.3 |
| Interest Rates ⁽²⁾ | | | | | |
| 3-Month Rate (%) | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 |
| 10-Year Bond Yield (%) | 4.57 | 4.30 | 4.65 | 4.85 | 5.35 |
| Spread Over Bund (bp) | 162 | 120 | 115 | 60 | 60 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated.

Source: BNP Paribas

Chart 1: Deflation Risk Growing



Source: Reuters EcoWin Pro, BNP Paribas

Falling consumption and a weak consumption outlook point to increased deflation pressure ahead.



Slovakia: Lower Long-Term Growth Outlook

■ Activity: bottoming out, shallow recovery ahead

- We have made only minor changes to our GDP forecast for 2009-2010 since the publication of the last *Global Outlook*. We expect the Slovak economy to contract by nearly 5.0% this year and to grow close to 3.0% in 2010.
- Next year's GDP acceleration will be led by net exports, with final domestic demand lagging.
- However, there are two main downside risks to the export-driven recovery scenario. First, the end of many schemes supporting car sales in Western Europe is likely to weaken demand in the car sector next year. For Slovakia, which is a significant car producer and exporter, this could be very bad news, since we do not expect the local cash-for-clunkers subsidy to offset fully a deterioration in foreign demand.
- Second, Slovakia's competitiveness versus most of its regional peers has suffered since the introduction of the euro, with the deterioration exacerbated by the strong EUR/SKK peg and weakening of Central European currencies.
- In 2011 and 2012, we expect a faster recovery in GDP growth, premised on our expectations for economic developments in Slovakia's main trading partners. But we have revised our long-term growth profile down, mainly due to a softer investment outlook. This primarily reflects higher real interest rates given deeper and longer-lasting deflation in Slovakia than previously forecast.

■ Inflation: at the brink of deflation

- In October, the core HICP fell 0.8% y/y while the headline index dropped by 0.1% y/y.
- Meanwhile, the registered unemployment rate has increased to 12.5% – a rise of 4.9 percentage points over just twelve months. The rise in unemployment points to the absence of demand pressure for some time. Hence we expect deflationary pressure to rise, possibly quite markedly, over the next several months.

■ Policy: wider deficit as elections approach

- We expect the fiscal deficit to reach 6.5% of GDP in 2009 and to decline only modestly in 2010, which is a parliamentary election year. We expect the general government shortfall to also remain well above 3% of GDP during 2011-2012.
- However, a looser fiscal stance is the only tool that policymakers still have at their disposal to cushion the economic malaise.

Slovakia: Economic Forecasts

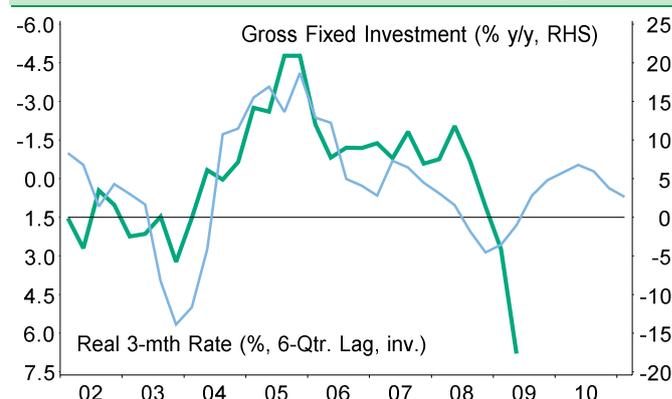
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--------------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 6.4 | -5.4 | 2.7 | 3.6 | 5.6 |
| Dom. Demand ex Stocks | 6.1 | -4.4 | 0.8 | 3.2 | 5.0 |
| Private Consumption | 6.2 | -0.4 | 0.6 | 1.3 | 3.9 |
| Public Consumption | 4.3 | 2.8 | 5.3 | 4.1 | 4.5 |
| Fixed Investment | 7.0 | -16.2 | -2.0 | 6.8 | 7.8 |
| Stocks (Cont. to Growth) | 0.5 | -2.2 | 1.4 | 0.0 | -0.1 |
| Exports | 3.6 | -19.3 | 6.9 | 8.2 | 13.7 |
| Imports | 3.8 | -18.4 | 5.9 | 7.4 | 11.9 |
| Industrial Production | 3.2 | -13.7 | 3.3 | 5.0 | 7.4 |
| Inflation & Labour | | | | | |
| HICP | 3.9 | 0.6 | 0.1 | 1.1 | 1.5 |
| Core HICP | 4.6 | 0.5 | -0.6 | -0.1 | 0.7 |
| Employment | 3.2 | -1.7 | -1.2 | 0.8 | 1.5 |
| Unemployment Rate (%) | 7.7 | 11.1 | 12.7 | 12.6 | 12.1 |
| External Trade | | | | | |
| Trade Balance (EUR bn) | -0.43 | -0.17 | 0.99 | 1.67 | 2.76 |
| Current Account (EUR bn) | -3.87 | -3.27 | -2.69 | -2.17 | -1.34 |
| Current Account (% GDP) | -5.8 | -5.2 | -4.1 | -3.2 | -1.9 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (EUR bn) | -1.48 | -4.13 | -3.56 | -3.14 | -2.89 |
| Gen. Gov. Budget (% GDP) | -2.2 | -6.5 | -5.5 | -4.6 | -4.0 |
| Interest Rates ⁽²⁾ | | | | | |
| 3-Month Rate (%) | 3.00 | 0.70 | 1.10 | 2.25 | 3.50 |
| 10-Year Bond Yield (%) | 4.65 | 4.15 | 4.55 | 4.80 | 5.30 |
| Spread Over Bund (bp) | 170 | 105 | 105 | 55 | 55 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated.

Source: BNP Paribas

Chart 1: Real Interest Rate is Rising



Source: Reuters EcoWin Pro, BNP Paribas

Deepening deflation pressure will increase the real interest rate, which will restrain investment and GDP over the medium and long term.



Denmark: Slow Recovery

■ Activity: recovery from low levels

- As the economy has been weaker than expected, we have had to revise down our 2009 GDP forecast. There are, however, some signs of an improvement that suggest that policy action is having an impact on the economy.
- The recovery is likely to be relatively slow. Despite measures to stimulate spending, high debt levels, a further increase in unemployment and the impact of the fall in house prices on household wealth will limit the increase in private consumption.
- New export orders are still low compared with the past few years but the recent improvement points to better prospects for growth, given the large share of exports in GDP. However, expected fiscal tightening is likely to restrain growth in Denmark's main trading partners, posing downside risks to Danish exports.
- The stock of houses for sale remains high, which should continue to put downward pressure on housing investment. Combined with a historically low level of capacity utilisation, this points to a further fall in overall investment.

■ Inflation: moderation in core inflation

- A marked fall in productivity has kept unit labour costs high to date. But as employment lags growth, a faster rise in output should lead to an increase in labour productivity in the coming quarters.
- In addition, a rise in unemployment is likely to see wage growth moderate further. Together with the weakness of domestic demand, these developments in the labour market should put downward pressure on core inflation.
- Core inflation started to moderate in mid-summer. Although headline inflation is set to increase due to expected higher energy prices, we see core inflation trending lower next year and in 2011.

■ Policy: on hold until Q4 2011

- Given our forecasts for the ECB refi rate, we expect the Danish central bank to keep its policy rate on hold, at 1.25%, until Q4 2011.
- Recently, higher money market spreads to the eurozone seem to be driven by the deposit rate differential vis-à-vis the ECB. If wide spreads lead to a significant strengthening of the krone, there is room for a further very small reduction in the deposit rate.

Denmark: Economic Forecasts

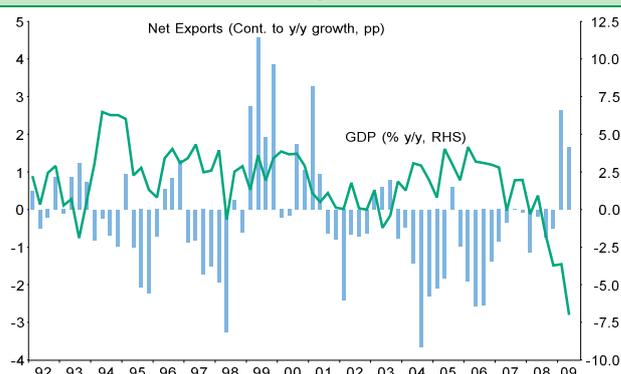
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--|------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | -1.2 | -4.7 | 1.1 | 1.8 | 2.4 |
| Dom. Demand ex Stocks | -0.9 | -4.7 | 0.9 | 1.8 | 2.1 |
| Private Consumption | -0.2 | -5.0 | 1.6 | 1.4 | 2.2 |
| Public Consumption | 1.5 | 2.3 | 1.2 | 1.2 | 1.0 |
| Fixed Investment | -5.1 | -12.1 | -1.0 | 3.5 | 3.6 |
| Exports | 2.2 | -10.2 | 1.2 | 3.4 | 4.1 |
| Imports | 3.4 | -14.0 | 0.4 | 2.9 | 3.8 |
| Manufacturing Production | -0.2 | -14.7 | -1.0 | 3.1 | 5.3 |
| Inflation & Labour | | | | | |
| CPI | 3.4 | 1.3 | 1.8 | 0.8 | 0.9 |
| Earnings | 4.4 | 3.3 | 2.6 | 2.3 | 2.7 |
| Unemployment Rate (%) | 1.8 | 3.6 | 5.4 | 5.8 | 5.5 |
| External Trade | | | | | |
| Current Account (DKK bn) | 38.0 | 42.0 | 30.0 | 29.0 | 27.0 |
| Current Account (% GDP) | 2.2 | 2.5 | 1.7 | 1.6 | 1.5 |
| Financial Variables | | | | | |
| Gen. Gov. Budget (DKK bn) | 59.5 | -39.0 | -88.0 | -65.0 | -46.0 |
| Gen. Gov. Budget (% GDP) | 3.4 | -2.3 | -5.1 | -3.7 | -2.5 |
| Interest & FX Rates⁽²⁾ | | | | | |
| Lending Rate | 3.75 | 1.25 | 1.25 | 1.50 | 3.25 |
| 10-year Bond Yield (%) | 3.36 | 3.50 | 3.75 | 4.60 | 5.10 |
| Spread over Bund (bp) | 41 | 40 | 25 | 35 | 35 |
| EUR/DKK | 7.44 | 7.46 | 7.46 | 7.46 | 7.46 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated.

Source: BNP Paribas

Chart 1: Net Exports and GDP



Source: Reuters EcoWin Pro

Over the past two quarters, net trade contribution to year-on-year GDP growth was positive, as exports contracted less than imports.



UK: Slow Progress

■ Activity: not out of the woods yet

- Survey indicators have surged and we expect the increase to translate into an expansion of GDP during Q4, confirming that the economy has finally emerged from recession.
- We expect accommodative financial and monetary conditions to support a further improvement in surveys and a temporary period of GDP growth at, or even slightly above, the potential rate.
- However, the bounce is the result of favourable tailwinds which will subside by the middle of 2010. We expect significant headwinds to dominate thereafter, particularly due to the likely fiscal tightening after the general election (which must be held by early June 2010).
- These should prompt a soft patch in activity, with q/q GDP growth slowing to just above zero. With growth returning below trend, we expect continued job losses and slowing wage inflation.

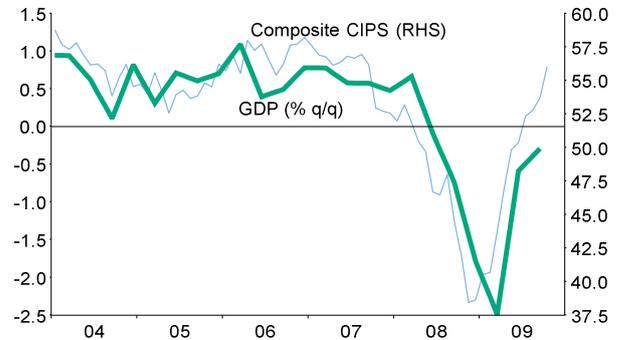
■ Inflation: surging in the near term

- We expect CPI inflation to surge in the next few months. This will reflect a combination of the reversal of the temporary VAT cut as well as energy-related base effects. We expect the inflation rate to briefly exceed 3%.
- A likely second VAT hike after the election will help to maintain inflation close to target during 2010.
- Thereafter, unemployment significantly above the NAIRU and a still-massive output gap are likely to exert renewed downward pressure on core inflation, taking headline inflation below 1%.
- For RPI inflation, the acceleration in the coming months is likely to be even sharper. This is the result of the housing components and mortgage interest payments in particular.

■ Policy: pause in QE likely in February

- The BoE appears to be phasing out its quantitative easing programme. We believe the better course would be to expand the programme. However, the data coming out in the coming months will probably argue against this. We expect the MPC to announce a pause at its February meeting.
- We continue to believe that Bank Rate is unlikely to rise in either 2010 or 2011. Sharp fiscal tightening and the adverse reaction of the bond market when QE is paused are likely to prevent a rate hike either side of the election. The soft patch in activity and renewed downward trend in inflation are likely to prevent rate hikes in 2011.

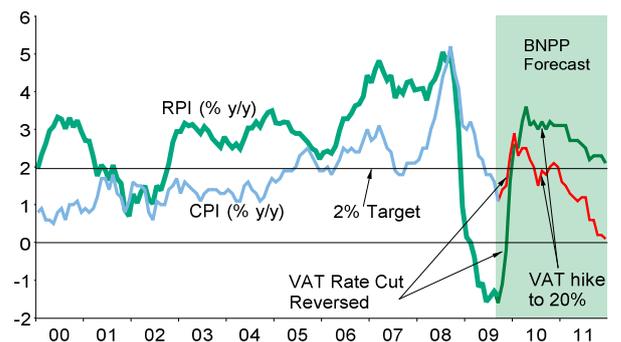
Chart 1: Composite CIPS vs GDP



Source: Reuters EcoWin Pro

The CIPS surveys have surged. Although the credibility of the surveys has been called into question since Q3 GDP disappointed, we continue to believe that they point to an expansion of output.

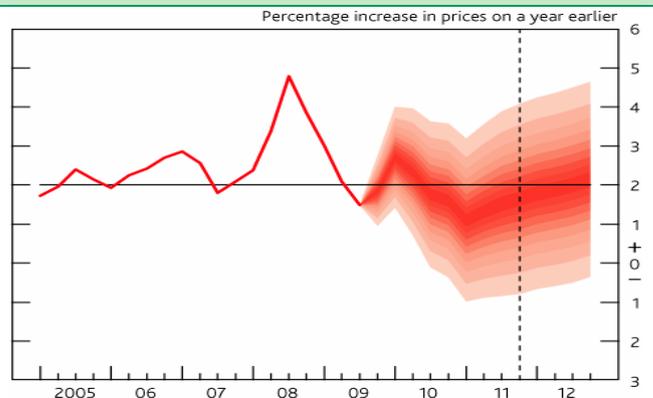
Chart 2: UK CPI vs RPI Inflation



Source: Reuters EcoWin Pro, BNP Paribas

UK inflation is about to surge, largely due to the reversal of the December 2008 VAT hike.

Chart 3: BoE CPI Projection (Market Rate Expectations)



Source: Bank of England

The BoE's projection shows that if Bank Rate is raised in line with market expectations, inflation will undershoot target for the next 3 years. That suggests the market is ahead of itself.



UK: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-----------------------------|------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽²⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Components of Growth | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | -2.5 | -0.6 | -0.1 | 0.5 | 0.7 | 0.9 | 0.7 | 0.4 | 0.3 | 0.2 | 0.2 | 0.4 |
| GDP | 0.7 | -4.5 | 2.0 | 1.6 | 1.8 | -5.0 | -5.5 | -4.9 | -2.7 | 0.5 | 2.0 | 2.8 | 2.8 | 2.4 | 1.8 | 1.2 | 1.2 |
| Household Consumption | 1.4 | -3.0 | 1.6 | 1.3 | 1.4 | -3.1 | -3.7 | -3.4 | -1.9 | 0.2 | 1.7 | 2.3 | 2.4 | 2.0 | 1.4 | 1.0 | 0.9 |
| Investment | -3.1 | -13.9 | 0.1 | 1.1 | 2.4 | -12.2 | -17.2 | -14.3 | -11.9 | -4.6 | 1.2 | 2.0 | 1.6 | 1.4 | 1.1 | 1.0 | 1.0 |
| O/w Business | 0.2 | -18.2 | -0.7 | 1.6 | 3.0 | -9.8 | -21.8 | -21.7 | -19.5 | -10.8 | 0.4 | 4.4 | 3.3 | 2.6 | 1.7 | 1.1 | 0.8 |
| General Gov. Consumption | 3.5 | 2.1 | 2.0 | 0.6 | -1.3 | 2.3 | 2.2 | 2.2 | 1.7 | 2.1 | 2.1 | 2.0 | 1.8 | 1.4 | 0.8 | 0.3 | -0.2 |
| Domestic Demand | 0.7 | -5.1 | 2.4 | 1.4 | 0.9 | -6.0 | -6.3 | -5.4 | -2.7 | 0.7 | 2.5 | 3.2 | 3.0 | 2.4 | 1.6 | 1.0 | 0.8 |
| Exports | -0.1 | -10.7 | 3.0 | 7.5 | 6.9 | -11.0 | -13.0 | -11.4 | -7.4 | 0.4 | 2.8 | 3.5 | 5.1 | 6.4 | 7.5 | 8.0 | 8.0 |
| Imports | -0.5 | -12.3 | 4.2 | 6.2 | 3.7 | -14.0 | -15.1 | -12.9 | -7.0 | 1.3 | 4.8 | 5.0 | 5.6 | 6.0 | 6.5 | 6.6 | 5.9 |
| Services Output | 1.3 | -3.3 | 2.4 | 1.6 | 2.0 | -3.5 | -4.2 | -3.6 | -1.9 | 0.8 | 2.5 | 3.2 | 3.0 | 2.5 | 1.7 | 1.2 | 1.1 |
| Industrial Production | -2.9 | -10.0 | 1.2 | 0.5 | 0.5 | -12.4 | -11.7 | -10.3 | -5.6 | -0.3 | 1.0 | 2.1 | 1.8 | 1.4 | 0.6 | 0.1 | -0.1 |
| Disc. Savings Ratio (%) | -2.7 | 3.2 | 4.0 | 4.0 | 4.8 | 2.0 | 3.5 | 3.6 | 3.8 | 4.0 | 4.2 | 4.0 | 4.0 | 4.0 | 4.1 | 4.0 | 3.9 |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Inflation & Labour | | | | | | | | | | | | | | | | | |
| RPI | 4.0 | -0.6 | 3.3 | 2.6 | 3.2 | -0.1 | -1.2 | -1.4 | 0.3 | 3.1 | 3.6 | 3.2 | 3.1 | 3.0 | 2.7 | 2.3 | 2.3 |
| RPIX | 4.3 | 1.9 | 3.2 | 2.3 | 2.0 | 2.4 | 1.4 | 1.3 | 2.5 | 3.6 | 3.4 | 2.9 | 2.8 | 2.7 | 2.4 | 2.1 | 1.9 |
| HICP | 3.6 | 2.1 | 2.1 | 0.8 | 0.9 | 3.0 | 2.1 | 1.5 | 1.9 | 2.6 | 2.2 | 1.7 | 1.8 | 1.4 | 1.1 | 0.7 | 0.1 |
| HICP (ex-VAT) | 3.7 | 2.6 | 1.5 | 0.6 | 0.9 | 3.6 | 2.6 | 2.0 | 2.1 | 2.2 | 1.8 | 1.0 | 1.0 | 0.9 | 0.7 | 0.6 | 0.2 |
| Core CPI | 1.6 | 1.7 | 2.0 | 0.4 | 0.5 | 1.5 | 1.6 | 1.7 | 2.1 | 2.3 | 2.1 | 1.7 | 1.7 | 1.0 | 0.7 | 0.2 | -0.4 |
| Core CPI (ex-VAT) | 1.6 | 2.1 | 1.1 | 0.1 | 0.5 | 2.0 | 2.1 | 2.2 | 2.0 | 1.6 | 1.4 | 0.6 | 0.6 | 0.4 | 0.1 | 0.1 | -0.3 |
| Employment | 0.7 | -1.6 | 0.1 | -0.4 | 0.0 | -1.1 | -2.1 | -1.6 | -1.5 | -0.8 | 0.2 | 0.4 | 0.4 | 0.1 | -0.4 | -0.7 | -0.6 |
| Unemployment Rate (ILO, %) | 5.7 | 7.7 | 8.0 | 8.8 | 9.0 | 7.1 | 7.8 | 7.8 | 7.9 | 8.0 | 7.9 | 7.9 | 8.1 | 8.4 | 8.7 | 8.9 | 9.0 |
| Headline Avg. Earnings | 3.5 | 1.1 | 2.7 | 2.6 | 3.3 | -0.5 | 2.5 | 1.2 | 1.1 | 4.4 | 1.8 | 2.2 | 2.3 | 2.5 | 2.5 | 2.6 | 2.9 |
| Avg. Earnings Ex-Bonuses | 3.7 | 2.2 | 2.3 | 2.0 | 2.8 | 3.0 | 2.4 | 1.7 | 1.6 | 2.0 | 2.3 | 2.4 | 2.3 | 1.9 | 1.8 | 1.9 | 2.2 |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|------------------------------|-------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| External Trade | | | | | | | | | | | | | | | | | |
| Trade Balance (GBP bn, sa) | -93.4 | -79.5 | -69.5 | -54.0 | -41.0 | -20.8 | -19.9 | -19.5 | -19.0 | -18.5 | -18.0 | -17.0 | -16.0 | -15.0 | -14.0 | -13.0 | -12.0 |
| Current Account (GBP bn, sa) | -25.1 | -30.5 | -17.0 | -9.0 | -2.5 | - | - | - | - | - | - | - | - | - | - | - | - |
| Current Account (% GDP) | -1.7 | -2.2 | -1.2 | -0.6 | -0.2 | - | - | - | - | - | - | - | - | - | - | - | - |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|----------------------------|------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| Financial Variables | | | | | | | | | | | | | | | | | |
| PSNB (GBP bn, FY) | 90.0 | 190.0 | 205.0 | 175.0 | 144.0 | - | - | - | - | - | - | - | - | - | - | - | - |
| PSNB (% GDP) | 6.3 | 13.6 | 14.0 | 11.6 | 9.5 | - | - | - | - | - | - | - | - | - | - | - | - |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|--|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Interest & FX Rates⁽³⁾ | | | | | | | | | | | | | | | | | |
| Bank Rate (%) | 2.00 | 0.50 | 0.50 | 0.50 | 2.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| 3-Month Rate (%) | 2.77 | 0.60 | 0.60 | 0.90 | 2.75 | 1.65 | 1.19 | 0.54 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.70 | 0.90 |
| 10-Year Rate (%) | 3.02 | 3.50 | 4.40 | 5.05 | 5.45 | 3.16 | 3.68 | 3.59 | 3.50 | 3.85 | 3.90 | 4.20 | 4.40 | 4.65 | 4.90 | 5.05 | 5.05 |
| Spread Over Bund (bp) | 7 | 40 | 90 | 80 | 70 | 16 | 30 | 37 | 40 | 75 | 100 | 100 | 90 | 90 | 90 | 80 | 80 |
| EUR/GBP | 0.96 | 0.92 | 1.00 | 0.91 | 0.90 | 0.92 | 0.85 | 0.91 | 0.92 | 0.88 | 0.91 | 0.95 | 1.00 | 0.94 | 0.93 | 0.92 | 0.91 |
| GBP/USD | 1.46 | 1.67 | 1.40 | 1.62 | 1.61 | 1.43 | 1.65 | 1.60 | 1.67 | 1.68 | 1.56 | 1.45 | 1.40 | 1.51 | 1.55 | 1.58 | 1.62 |

Footnotes: (1) Forecast (2) Although preliminary Q3 data have been released, we expect upward revisions (3) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



Sweden: Recovery Has Begun

■ Activity: further signs of recovery

- Low interest rates, fiscal measures and relatively low household debt levels have led to a further rise in economic activity in recent months.
- However, the recovery is from very low levels. Moreover, although global imbalances have started to correct, this process has further to go and is likely to have an impact on the Swedish economy, as exports account for around 50% of GDP, which makes us cautious about the extent of the recovery ahead.
- That said, the turnaround in the global economy suggests better prospects for exports and, in turn, investment. A recent upward trend in surveys such as the manufacturing PMI and an increase in new export orders point to an increase in exports.
- Given an improvement in the economic outlook, the rise in unemployment is likely to be less than previously forecast, limiting the fall in consumers' incomes. Together with low interest rates, higher incomes should support private consumption next year and be the biggest driver of growth.

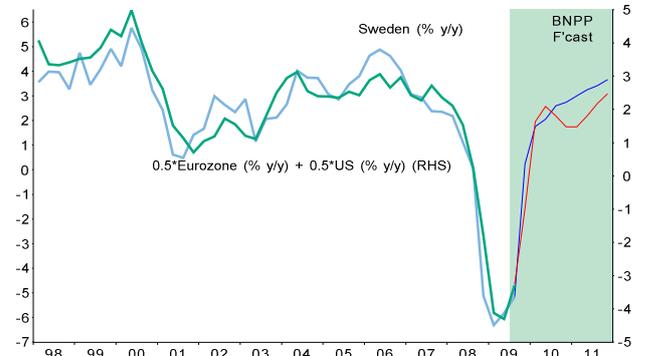
■ Inflation: core inflation to trend lower

- Headline inflation will rise in the next couple of months due to base effects, but CPIF inflation, a measure of CPI with fixed mortgage interest rates, will fall in 2010.
- A low policy rate, weak currency and a fall in productivity, which led to higher unit labour costs, helped to keep core inflation high until now.
- A further increase in unemployment will put downward pressure on wages. This, together with an improvement in productivity and a still-wide output gap, suggests that the risk to inflation is still to the downside.

■ Policy: rates on hold

- Although there is a growing divergence between the Executive Board members on the speed and extent of the recovery ahead, the Riksbank's general view is that the recovery has begun, but it will take time.
- Therefore, the Riksbank is maintaining its cautious stance and intends to keep the repo rate at its low of 0.25% until autumn 2010. We agree with this central assessment. Given further signs of improvement in activity, we expect the first rate hike to be delivered in Q3 2010.

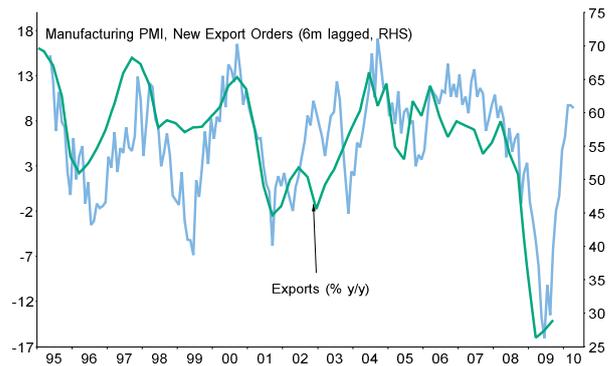
Chart 1: Swedish GDP (% y/y)



Source: Reuters EcoWin Pro, BNP Paribas

The forecast recovery in international activity supports a marked improvement in Swedish GDP trends.

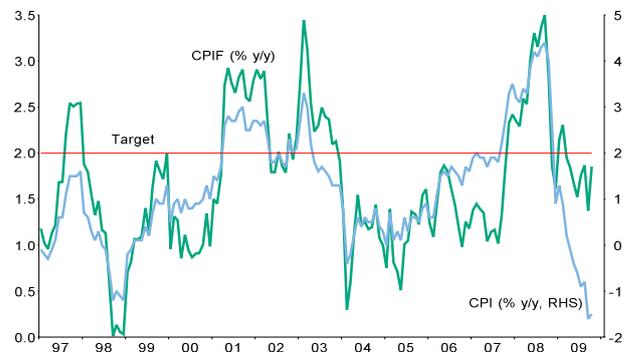
Chart 2: New Export Orders and Exports (% y/y)



Source: Reuters EcoWin Pro

The rise in the new export orders sub-index of the manufacturing PMI, which is now well above the 50 breakeven level, is consistent with an increase in exports in the coming quarters.

Chart 3: CPI and CPIF (% y/y)



Source: Reuters EcoWin Pro

Headline inflation is likely to have reached its trough in September. However, CPIF inflation should trend lower given the considerable amount of spare capacity in the economy.



Sweden: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|-----------------------------|------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | | |
| Components of Growth | | | | | | | | | | | | | | | | | | | |
| Real GDP (% q/q) | - | - | - | - | - | -0.8 | 0.3 | 0.2 | 0.6 | 0.7 | 0.6 | 0.7 | 0.7 | 0.9 | 0.8 | 0.9 | 1.0 | | |
| GDP | -0.5 | -4.3 | 2.3 | 3.3 | 3.6 | -6.3 | -5.8 | -5.2 | 0.2 | 1.8 | 2.1 | 2.6 | 2.7 | 3.0 | 3.2 | 3.4 | 3.7 | | |
| Domestic Demand ex Stocks | 0.5 | -2.9 | 0.7 | 2.3 | 2.8 | -3.7 | -3.5 | -2.9 | -1.6 | -0.3 | 0.3 | 1.2 | 1.7 | 2.1 | 2.3 | 2.4 | 2.5 | | |
| Private Consumption | -0.4 | -0.9 | 1.9 | 2.5 | 2.8 | -2.7 | -1.4 | -0.4 | 1.2 | 1.8 | 1.6 | 2.1 | 2.2 | 2.3 | 2.4 | 2.5 | 2.6 | | |
| Public Consumption | 1.1 | 2.3 | 1.3 | 1.2 | 0.8 | 2.6 | 2.3 | 2.2 | 2.1 | 1.2 | 1.3 | 1.2 | 1.5 | 1.5 | 1.3 | 1.1 | 0.8 | | |
| Fixed Investment | 2.2 | -14.0 | -3.4 | 3.6 | 5.8 | -13.2 | -15.1 | -14.7 | -12.8 | -7.6 | -4.8 | -1.3 | 0.7 | 2.4 | 3.5 | 4.1 | 4.6 | | |
| Exports | 1.5 | -13.3 | 3.3 | 5.8 | 6.3 | -16.0 | -15.2 | -14.1 | -7.3 | -0.8 | 2.7 | 5.9 | 5.6 | 5.4 | 5.7 | 5.9 | 6.2 | | |
| Imports | 3.3 | -14.9 | 3.9 | 4.6 | 6.2 | -17.5 | -17.5 | -13.8 | -10.3 | 2.8 | 4.4 | 4.0 | 4.5 | 4.3 | 4.6 | 4.6 | 4.9 | | |
| Industrial Production | -3.5 | -18.8 | 0.7 | 4.3 | 6.0 | -22.4 | -22.3 | -17.4 | -12.2 | -6.5 | 1.3 | 3.7 | 4.3 | 3.6 | 3.7 | 4.6 | 5.1 | | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | | |
| Inflation & Labour | | | | | | | | | | | | | | | | | | | |
| CPI | 3.4 | -0.4 | 1.0 | 3.2 | 3.6 | 0.8 | -0.5 | -1.2 | -0.7 | 0.2 | 0.4 | 0.9 | 2.3 | 2.6 | 3.0 | 3.5 | 3.8 | | |
| Core CPI (CPIF) | 2.7 | 1.9 | 1.3 | 1.8 | 2.0 | 2.1 | 1.7 | 1.6 | 2.0 | 1.4 | 1.0 | 1.1 | 1.8 | 1.8 | 1.7 | 1.7 | 1.8 | | |
| Wages & Salaries/Hour | 4.9 | 2.9 | 1.8 | 2.8 | 3.3 | 3.3 | 4.4 | 2.1 | 1.9 | 1.8 | 1.7 | 1.6 | 2.1 | 2.6 | 2.6 | 2.8 | 3.1 | | |
| Employment | 1.1 | -2.4 | -2.7 | 0.3 | 1.1 | -1.2 | -2.2 | -2.8 | -3.4 | -3.6 | -3.4 | -2.6 | -1.0 | -0.3 | 0.2 | 0.5 | 0.6 | | |
| Unemployment Rate (nsa, %) | 6.2 | 8.3 | 10.1 | 9.7 | 9.3 | 7.9 | 9.0 | 8.1 | 8.4 | 10.3 | 10.5 | 9.8 | 9.8 | 10.9 | 10.7 | 8.9 | 8.2 | | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|----------------------------|-------|--------------------|--------------------|--------------------|--------------------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | | |
| External Trade | | | | | | | | | | | | | | | | | | | |
| Trade Balance (SEK bn) | 105.8 | 95.6 | 102.2 | 164.1 | 186.2 | 25.0 | 35.4 | 19.6 | 15.6 | 17.6 | 33.8 | 23.9 | 26.8 | 25.4 | 46.3 | 43.2 | 49.2 | | |
| Current Account (SEK bn) | 196.9 | 231.9 | 250.6 | 274.3 | 313.4 | 54.7 | 67.9 | 56.7 | 52.6 | 55.0 | 56.5 | 68.9 | 70.3 | 60.9 | 62.0 | 77.2 | 74.2 | | |
| Current Account (% of GDP) | 6.2 | 7.6 | 8.0 | 8.3 | 9.0 | 7.5 | 8.6 | 7.9 | 6.6 | 7.3 | 7.0 | 9.3 | 8.4 | 7.8 | 7.3 | 9.9 | 8.4 | | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|----------------------------|------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | |
| Financial Variables | | | | | | | | | | | | | | | | | | | |
| Gen. Gov. Budget (% GDP) | 2.5 | -2.3 | -3.0 | -1.7 | -0.8 | - | - | - | - | - | - | - | - | - | - | - | - | | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | | |
|---|-------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | | |
| Interest and FX Rates ⁽²⁾ | | | | | | | | | | | | | | | | | | | |
| Repo Rate (%) | 2.00 | 0.25 | 1.00 | 2.50 | 4.00 | 1.00 | 0.50 | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 | 1.00 | 1.25 | 1.50 | 2.00 | 2.50 | | |
| 3-Month Rate (%) | 2.48 | 0.48 | 1.32 | 2.80 | 4.30 | 1.13 | 0.95 | 0.53 | 0.48 | 0.50 | 0.53 | 0.78 | 1.32 | 1.57 | 1.83 | 2.30 | 2.80 | | |
| 10-Year Bond Yield (%) | 2.43 | 3.20 | 3.90 | 4.85 | 5.25 | 3.00 | 3.48 | 3.33 | 3.20 | 3.30 | 3.15 | 3.55 | 3.90 | 4.20 | 4.50 | 4.80 | 4.85 | | |
| Spread over Bund (bp) | -52 | 10 | 40 | 60 | 50 | 0 | 10 | 11 | 10 | 20 | 25 | 35 | 40 | 45 | 50 | 55 | 60 | | |
| EUR/SEK | 10.92 | 10.30 | 10.10 | 9.30 | 9.70 | 10.92 | 10.81 | 10.20 | 10.30 | 9.90 | 10.00 | 10.20 | 10.10 | 10.00 | 9.80 | 9.60 | 9.30 | | |
| USD/SEK | 7.81 | 6.69 | 7.21 | 6.33 | 6.69 | 8.25 | 7.71 | 6.96 | 6.69 | 6.69 | 7.04 | 7.39 | 7.21 | 7.04 | 6.81 | 6.62 | 6.33 | | |

Footnotes: (1) Forecast (2) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



Norway: Brighter Prospects

■ Activity: growth to improve further

- We expect the recovery in GDP to continue in 2010.
- The 2010 Budget, which revealed a stimulus of around 0.5pp to mainland GDP next year, should ensure that the recent improvements lead to a sustained recovery. Financial and monetary conditions, which are among the loosest of the major advanced economies, should also support mainland investment.
- Also, a recovery in global growth suggests that export prospects should improve. With higher oil prices, we expect an increase in oil investment next year. Together, these will boost growth further.
- Better than expected developments in the labour market and a moderation in inflation are expected to provide some additional support for household spending. This view is already supported by the increase in consumer confidence, which moved back into positive territory in Q3.

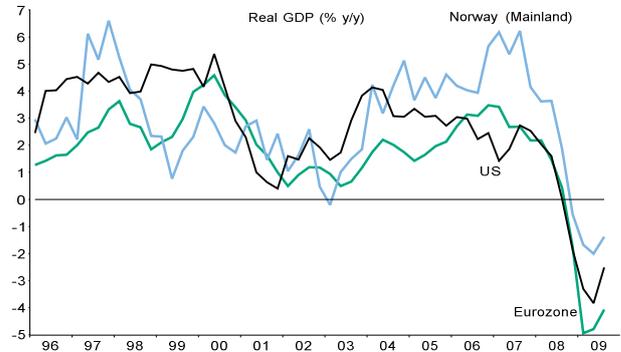
■ Inflation: below target

- Both headline and core inflation fell below the Norges Bank's target of 2.5% y/y due to the combination of the lagged impact of economic weakness and the strength of the krone.
- Core inflation will continue to trend lower. But as there is not as much spare capacity in the economy as elsewhere, and the labour market has been much more resilient than forecasters had expected, the moderation in core inflation is unlikely to be as marked as in some other advanced economies.

■ Policy: rate-hiking cycle has started

- The Norges Bank increased its policy rate by 25bp to 1.50% at its October meeting, becoming the first European central bank to start its hiking cycle.
- The Norges Bank's rate projections suggest it is likely to take a cautious stance in hiking, delivering rate hikes gradually to assess the impact of such increases on the domestic currency.
- We believe the Norges Bank will stick to its policy projection. But the intended rate hikes are unlikely to be sufficient to tighten overall financial and monetary conditions. This will lead to growth operating above potential, building inflationary risks. Therefore, risks to the policy outlook lie to the upside.

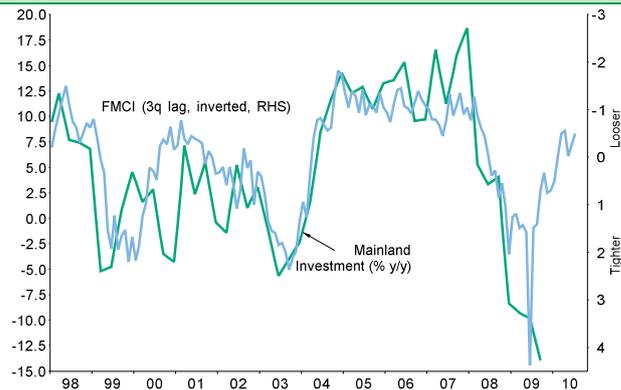
Chart 1: Norwegian Mainland GDP (% y/y)



Source: Reuters EcoWin Pro

Extensive policy measures helped the economy to fare relatively well through the financial crisis, with the decline in GDP less than the drop seen in most other advanced economies.

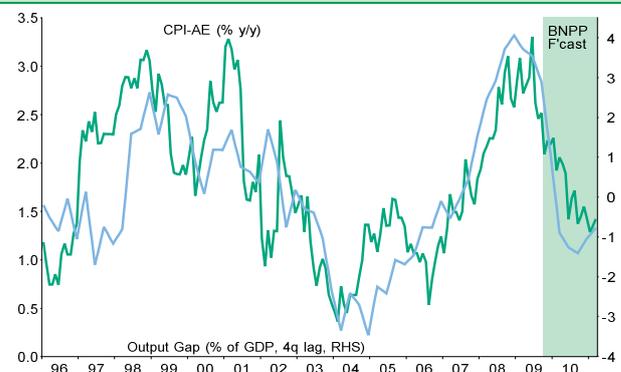
Chart 2: Investment and FMCI



Source: Reuters EcoWin Pro

The loosening in financial and monetary conditions suggests investment will pick up, with higher oil prices providing an additional support.

Chart 3: Output Gap and CPI-AE (% y/y)



Source: Reuters EcoWin Pro, BNP Paribas

Although the output gap is not as wide as in other advanced economies, it has already started to lower inflation.



Norway: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-----------------------------|------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Components of Growth | | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | -0.7 | -0.9 | 0.9 | 1.0 | 0.3 | 0.6 | 1.2 | 1.0 | 0.7 | 0.4 | 0.4 | 0.4 | |
| Mainland GDP (% q/q) | - | - | - | - | - | -0.9 | 0.3 | 0.5 | 1.3 | 0.4 | 0.5 | 1.2 | 1.0 | 1.0 | 0.7 | 0.7 | 0.7 | |
| GDP | 1.7 | -1.0 | 2.6 | 2.9 | 3.5 | -1.1 | -2.3 | -0.7 | 0.2 | 1.2 | 2.8 | 3.1 | 3.2 | 3.5 | 3.4 | 2.6 | 2.0 | |
| Mainland GDP | 2.1 | -1.0 | 3.0 | 3.5 | 4.2 | -1.7 | -2.0 | -1.4 | 1.3 | 2.5 | 2.7 | 3.5 | 3.2 | 3.8 | 4.0 | 3.4 | 3.0 | |
| Domestic Demand ex Stocks | 1.8 | -0.7 | 2.4 | 3.4 | 3.9 | -1.4 | -0.6 | -1.0 | -0.1 | 1.5 | 1.6 | 3.0 | 3.6 | 3.7 | 3.5 | 3.3 | 3.1 | |
| Private Consumption | 1.1 | -0.2 | 3.0 | 3.1 | 3.7 | -2.8 | -1.1 | 1.0 | 2.3 | 3.2 | 3.0 | 2.7 | 3.1 | 3.2 | 3.0 | 3.0 | 2.9 | |
| Public Consumption | 4.1 | 5.8 | 3.3 | 2.2 | 1.8 | 5.0 | 5.9 | 6.1 | 6.4 | 4.6 | 3.4 | 2.8 | 2.4 | 2.3 | 2.2 | 2.1 | 2.0 | |
| Fixed Investment | 1.3 | -7.8 | 0.4 | 5.3 | 6.6 | -4.3 | -5.5 | -11.0 | -10.4 | -4.8 | -3.0 | 3.7 | 6.0 | 6.1 | 5.8 | 5.1 | 4.4 | |
| Exports | 0.9 | -4.3 | 2.5 | 4.0 | 2.9 | -5.4 | -9.6 | -0.9 | -1.2 | 2.7 | 5.2 | 1.6 | 0.6 | 2.8 | 4.5 | 4.4 | 4.3 | |
| Imports | 2.3 | -10.8 | 4.4 | 4.8 | 4.2 | -13.7 | -11.3 | -12.5 | -5.3 | 3.6 | 3.0 | 5.4 | 5.4 | 5.3 | 5.4 | 4.9 | 3.8 | |
| Manufacturing Production | 2.9 | -6.0 | 1.3 | 2.7 | 3.7 | -4.2 | -10.1 | -7.2 | -2.5 | 0.8 | 1.5 | 2.6 | 0.3 | 2.2 | 2.6 | 2.7 | 3.3 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|-----|-----|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Inflation & Labour | | | | | | | | | | | | | | | | | | |
| CPI | 3.8 | 2.2 | 1.8 | 2.3 | 2.7 | 2.4 | 3.1 | 1.8 | 1.5 | 1.8 | 1.8 | 1.8 | 1.9 | 2.0 | 2.2 | 2.4 | 2.6 | |
| Core CPI | 2.6 | 2.6 | 1.7 | 1.9 | 2.7 | 2.8 | 3.0 | 2.4 | 2.1 | 2.1 | 1.8 | 1.6 | 1.4 | 1.3 | 1.7 | 2.1 | 2.6 | |
| Wages & Salaries | 5.1 | 3.3 | 3.0 | 4.3 | 4.7 | 4.1 | 3.5 | 2.9 | 2.8 | 2.7 | 2.7 | 3.0 | 3.5 | 3.9 | 4.3 | 4.5 | 4.5 | |
| Unemployment Rate (sa, %) | 2.5 | 3.2 | 3.6 | 3.3 | 3.1 | 3.1 | 3.1 | 3.1 | 3.5 | 3.7 | 3.7 | 3.6 | 3.5 | 3.5 | 3.2 | 3.3 | 3.1 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|----------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| External Trade | | | | | | | | | | | | | | | | | | |
| Trade Balance (NOK bn) | 460 | 306 | 251 | 315 | 376 | 94 | 67 | 76 | 69 | 47 | 72 | 79 | 54 | 64 | 89 | 93 | 68 | |
| - Ex-Oil (NOK bn) | -139 | -135 | -209 | -219 | -214 | -32 | -34 | -29 | -40 | -48 | -48 | -49 | -64 | -51 | -50 | -51 | -66 | |
| Current Account (NOK bn) | 496 | 378 | 383 | 449 | 511 | 75 | 95 | 104 | 103 | 81 | 103 | 108 | 91 | 98 | 120 | 124 | 107 | |
| Current Account (% of GDP) | 19.5 | 15.4 | 14.8 | 16.5 | 18.0 | 12.3 | 16.4 | 17.7 | 15.4 | 12.7 | 16.6 | 17.5 | 12.9 | 14.6 | 18.3 | 19.0 | 14.4 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|----------------------------|------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | |
| Financial Variables | | | | | | | | | | | | | | | | | | |
| Gen. Gov. Budget (% GDP) | 18.6 | 7.4 | 6.5 | 11.5 | 12.9 | - | - | - | - | - | - | - | - | - | - | - | - | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|--|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Interest and FX Rates⁽²⁾ | | | | | | | | | | | | | | | | | | |
| Repo Rate (%) | 3.00 | 1.50 | 2.75 | 3.75 | 5.00 | 2.00 | 1.25 | 1.25 | 1.50 | 2.00 | 2.25 | 2.50 | 2.75 | 3.00 | 3.25 | 3.50 | 3.75 | |
| 3-Month Rate (%) | 3.97 | 2.00 | 3.23 | 4.15 | 5.38 | 2.97 | 1.96 | 1.94 | 2.00 | 2.50 | 2.75 | 3.00 | 3.23 | 3.45 | 3.65 | 3.90 | 4.15 | |
| 10-Year Bond Yield (%) | 3.89 | 4.00 | 4.90 | 5.90 | 6.20 | 3.81 | 4.19 | 4.19 | 4.00 | 4.20 | 4.10 | 4.55 | 4.90 | 5.20 | 5.50 | 5.85 | 5.90 | |
| Spread over Bund (bp) | 94 | 90 | 140 | 165 | 145 | 81 | 81 | 97 | 90 | 110 | 120 | 135 | 140 | 145 | 150 | 160 | 165 | |
| EUR/NOK | 9.72 | 8.40 | 8.20 | 7.50 | 7.50 | 8.92 | 9.02 | 8.44 | 8.40 | 8.10 | 8.30 | 8.30 | 8.20 | 8.10 | 7.80 | 7.60 | 7.50 | |
| USD/NOK | 6.95 | 5.45 | 5.86 | 5.1 | 5.17 | 6.73 | 6.43 | 5.77 | 5.45 | 5.54 | 5.85 | 6.01 | 5.86 | 5.70 | 5.42 | 5.24 | 5.10 | |

Footnotes: (1) Forecast (2) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



Switzerland: Enjoying the Bounce

■ Activity: leading indicators are surging

- Switzerland is proving one of the principal beneficiaries of the rebound in global activity.
- Leading indicators are surging, pointing to a substantial rise in GDP at the turn of the year.
- We remain sceptical about the sustainability of these dynamics and do not expect this momentum to continue.
- But the economy is better positioned than most to recover over the coming years. There are no pernicious debt dynamics to overcome, and the banking system will not impede growth – regional banks have picked up the slack from the Big Two institutions and growth in mortgage lending has actually been accelerating through the crisis.

■ Inflation: flirtation with deflation should prove temporary

- Headline inflation will rebound over the coming quarters on commodity price base effects, but core inflation should continue to grind lower as it responds to the slowdown in activity with a lag.
- A flirtation with negative core inflation should prove temporary, however. Given the absence of a credit crunch, the glut of narrow liquidity in the economy represents a more significant risk to medium-term price stability than elsewhere in Europe.

■ Policy: strong franc the hurdle to a hike

- The SNB has been one of the most aggressive easers of policy over the past twelve months – the percentage increase in the monetary base has roughly matched that of the US.
- This loose policy is looking increasingly inappropriate given the shallowness of the downturn and the strength of the rebound in activity.
- With the economy proving robust to the Swiss franc's strength, and the monetary implication of unsterilised intervention no longer desirable, we believe the SNB may become more reluctant to keep on intervening to prevent an appreciation of the Swiss franc.
- This may be formalised in a relaxation of this commitment to prevent a rise in the currency, to allow a limited amount of appreciation as a substitute for a rate hike.
- We expect rate hikes to follow, but the strength of the exchange rate is a hurdle that must be overcome first.

Switzerland: Economic Forecasts

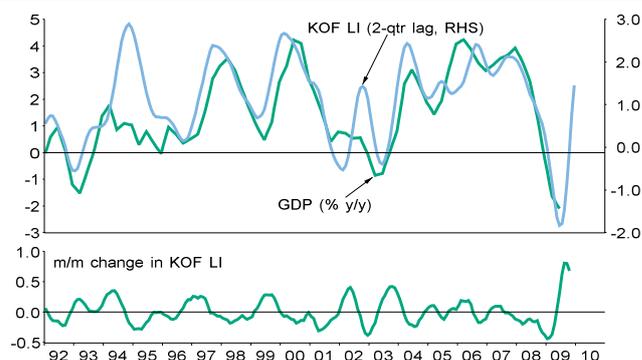
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|---|------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 1.8 | -1.5 | 1.4 | 1.9 | 2.2 |
| Dom. Demand ex Stocks | 1.1 | 0.1 | 0.9 | 1.6 | 1.9 |
| Private Consumption | 1.7 | 0.8 | 0.5 | 1.2 | 1.5 |
| Public Consumption | -0.1 | 2.5 | 1.8 | 1.6 | 1.2 |
| Fixed Investment | 0.4 | -3.1 | 1.6 | 2.9 | 3.2 |
| Stocks (Cont. to Growth) | -0.7 | 1.5 | -0.7 | 0.0 | 0.0 |
| Exports | 2.9 | -12.0 | 3.7 | 5.5 | 6.5 |
| Imports | 0.4 | -8.4 | 1.3 | 5.8 | 6.8 |
| Industrial Production | 1.5 | -9.3 | 0.8 | 3.7 | 4.0 |
| Savings Ratio (%) | 11.9 | 11.2 | 10.4 | 9.7 | 9.9 |
| Inflation | | | | | |
| CPI | 2.4 | -0.5 | 1.0 | 0.5 | 0.5 |
| CPI (Ex-Petrol) | 1.6 | 0.8 | 0.2 | 0.3 | 0.5 |
| Nominal Wages | 2.1 | 1.7 | 1.0 | 0.9 | 1.2 |
| Unemployment Rate (%) | 2.6 | 3.7 | 4.5 | 4.5 | 4.3 |
| Financial Variables | | | | | |
| Current Account (CHF bn) | 13.0 | 46.0 | 48.0 | 51.0 | 56.0 |
| Current Account (% GDP) | 2.4 | 8.6 | 8.9 | 9.1 | 9.7 |
| Interest & FX Rates ⁽²⁾ | | | | | |
| 3-Month Rate (%) | 0.66 | 0.25 | 0.75 | 1.75 | 2.25 |
| 10-Year Bond Yield (%) | 2.23 | 1.85 | 2.50 | 3.25 | 3.50 |
| Spread over Bund (bp) | -72 | -125 | -100 | -100 | -125 |
| EUR/CHF | 1.49 | 1.52 | 1.56 | 1.57 | 1.63 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated.

Source: BNP Paribas

Chart 1: KOF Leading Indicator & GDP



Source: Reuters EcoWin Pro

Switzerland is proving one of the principal beneficiaries of the rebound in global activity. This momentum cannot be sustained but Switzerland is better positioned than most to recover.



Russia: Bouncing Along the Bottom

■ **Activity: there are signs of a recovery, but the growth outlook is fragile, with both investment and employment likely to remain weak**

- Recent activity indicators suggest that the pace of contraction of GDP has moderated. However, the economy is still bouncing along the bottom, with domestic demand particularly weak.
- Given our forecast for the oil price, we expect a more significant improvement in GDP in late 2009 and in 2010. However, the growth outlook for the next several months will remain very fragile.
- Although higher energy commodity prices point to a stabilisation or even an improvement in the Russian financial markets, we do not expect the banking sector to start lending rapidly again any time soon.
- Credit growth for the private sector will remain weak, which suggests that investment growth will be fairly slow.
- Prolonged weakness in corporate capital spending points to a further deterioration of labour market conditions. Falling employment and a sharp slowdown in wage growth will restrain consumption well into 2011.

■ **Inflation: the inflation rate has dropped sharply over the past several months. We expect further disinflation ahead, given the absence of demand pressure**

- The slump in GDP, deterioration of labour market conditions and plunge in PPI readings (due to the fall in oil prices in late 2008/early 2009) have led to a sharp drop in inflation.
- We expect further disinflation ahead, as a widening of the output gap will further limit demand pressure on prices.
- The slowdown in the growth of unit labour costs points to a single-digit inflation rate in late 2009 and during 2010.

■ **Policy: loose fiscal stance remains the main policy tool supporting the real economy**

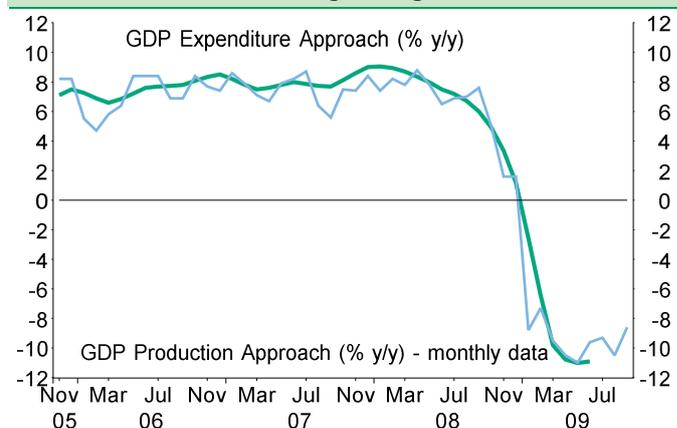
- Thanks to stronger commodity markets, market interest rates have declined since the spring. But since risk aversion in the banking sector remains high, we do not expect this to translate into faster credit growth.
- An accommodative fiscal stance remains the main policy tool to cushion the real economy. We expect the budget deficit to remain large in 2010 at least.

| Russia: Economic Forecasts | | | | | |
|--|-------|---------------------|---------------------|---------------------|---------------------|
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
| GDP (% y/y) | 5.9 | -8.0 | 3.8 | 4.1 | 6.4 |
| CPI (% y/y) | 14.2 | 11.3 | 9.4 | 8.2 | 10.1 |
| Current Account (% GDP) | 6.3 | 4.0 | 6.4 | 5.5 | 4.2 |
| Intl. Reserves (USD bn) ⁽²⁾ | 427 | 450 | 585 | 710 | 855 |
| Budget Balance (% GDP) ⁽³⁾ | 4.8 | -7.9 | -5.9 | -5.0 | -4.1 |
| 3-Month Rate (%) ⁽²⁾ | 22.50 | 7.20 | 10.40 | 10.60 | 9.60 |
| USD/RUB ⁽²⁾ | 30.53 | 28.56 | 27.97 | 24.76 | 26.75 |

(1) Forecast (2) End Period (3) General Government

Source: BNP Paribas

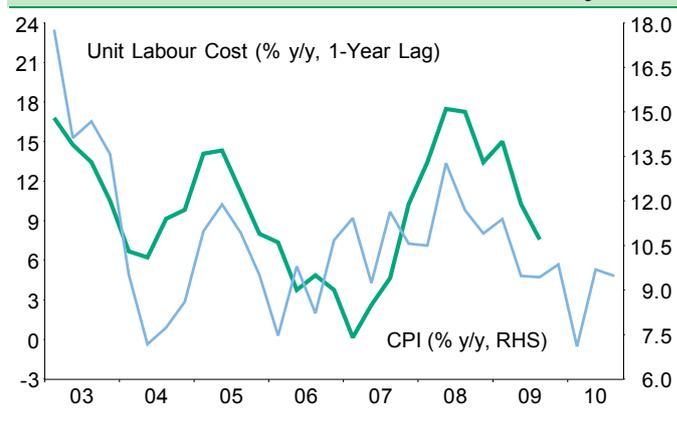
Chart 1: Bouncing Along the Bottom



Source: Reuters EcoWin Pro, BNP Paribas

Recent monthly production data signal a deceleration in the pace of contraction of GDP to a single-digit rate. But we do not expect a rise in GDP in year-on-year terms before 2010.

Chart 2: Inflation Moderation Under Way



Source: Reuters EcoWin Pro, BNP Paribas

The decline in the growth of unit labour costs points to further disinflation ahead. In the absence of demand pressure, we expect the inflation rate to fall below 10% from late 2009 onwards.



Ukraine: Devaluing Itself Out of Trouble

■ Activity: net exports to drive the recovery

- Economic activity has continued to rebound across the board, albeit from very low levels. After reaching 30% y/y earlier in the year, the fall in industrial production had moderated to 6.2% y/y in October.
- Although GDP fell 15.3% y/y in Q3, the steep year-on-year decline reflects a high base level in Q3 2008. According to the central bank, Ukraine has now come out of recession, growing by 3.7% and 4.5% q/q in Q2 and Q3 respectively.
- As real wages contracted by 10.3% in the first ten months of the year, consumers are largely unable to support the recovery. However, consumption remains broadly stable in nominal terms.
- Moreover, investment is in the doldrums, having halved this year to now constitute only about 11% of GDP.
- The weakness of domestic demand means net exports will probably be the main driver of the recovery well into 2010. The current account has recently moved into surplus as exports have surged and the consumption of imported goods has fallen sharply.

■ Inflation: down

- Consumer inflation fell further to 14.1% y/y in October. Given the absence of demand-side pressures, we forecast that CPI inflation will continue to fall over the coming years.
- The PPI currently signals deflation, but we expect it to recover given rising export prices and a weak local currency.

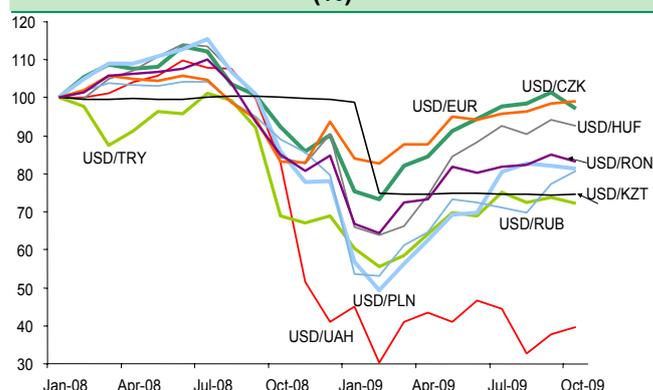
■ Policy: continuing to hit a wall

- The third programme review by the IMF is likely to be postponed due to a lack of consensus among the Ukrainian authorities. The IMF will resume talks once the election cycle is over.
- The first and second rounds of presidential elections are due on 17 January and 7 February respectively. They could be followed by local council elections (and possibly early parliamentary elections) on 30 May.
- Public finances are in disrepair, with budget revenues in the first ten months of the year just 62% of the annual target. Furthermore, potential sources of financing (such as external lending) are drying up due to political uncertainty.

| Ukraine: Economic Forecasts | | | | | |
|------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
| GDP (% y/y) | 2.1 | -13.3 | 2.7 | 4.5 | 6.0 |
| CPI (% y/y) | 22.3 | 13.6 | 11.0 | 9.5 | 6.5 |
| Current Account (% GDP) | -7.2 | -1.4 | 1.6 | -0.8 | -0.1 |
| Budget Balance (% GDP) | -1.1 | -8.8 | -6.7 | -2.4 | -1.0 |
| Base Rate (%) ⁽²⁾ | 22.0 | 10.0 | 9.0 | 8.0 | 7.0 |
| USD/UAH ⁽²⁾ | 7.8 | 8.4 | 8.7 | 7.5 | 7.2 |

(1) Forecast (2) End Period
Source: UkrSibbank

Chart 1: Ukrainian Currency vs. Selected Peers (%)



Source: Reuters

The Ukrainian currency has fallen far further than other CEE currencies. A cheap currency facilitates import substitution and boosts exports.

Chart 2: Baltic Dry and IP (% y/y)



Source: Bloomberg, SSC

The rebound in Ukrainian industrial production is also backed by an improvement in global trade.

- As a result of the currency's depreciation, banks face issues with the quality of their assets, which will translate into higher provision needs. For example, loans that are 90 days overdue now amount to 11% of the banking system's credit portfolio.

IMPORTANT DISCLOSURE:

This analysis has been produced by JSCIB UkrSibbank and has been reviewed, but not amended, by BNP Paribas. BNP Paribas owns an 82% controlling stake in JSCIB UkrSibbank. This analysis does not contain investment research recommendations.



Poland: Beauty and the Beast

■ Activity: data confirm recovery

- Poland is the only European economy that has managed to avoid a recession in 2009. But this remarkable performance is clouded by the rapid rise in the budget deficit and the level of public debt.
- Recent data confirm that a recovery took place during Q3 2009. We have therefore revised up our full-year GDP growth forecast to 1.3% y/y.
- Given a stronger demand assessment for the economies of Poland's main trading partners, we have also raised our growth profile for the next three years although a stronger zloty points to a downside risk to net exports by early 2010.
- But since the rise in unemployment is already accelerating and the outlook for the labour market remains grim, we expect consumption to remain weak throughout the forecast period.
- We also expect poor fiscal policy to weigh on Polish markets and the economy in coming years.

■ Inflation: substantial disinflation ahead

- Despite the rise in GDP this year, we expect the output gap to widen to some 3% of potential in 2010-2011. This will result in substantial disinflation from early 2010, when the impact of the zloty's depreciation from Q1 2009 will fade.
- We are also forecasting a lower CPI profile in the near term since expectations of higher food prices in Q4 2009 have not been met.

■ Policy: sharp deterioration of fiscal outlook

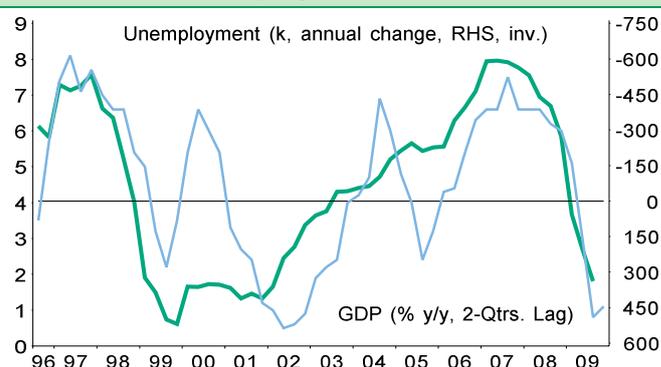
- The current Monetary Policy Council will be reshuffled in early 2010. The new MPC will be in no rush to change interest rates.
- Our inflation forecasts suggest that – fundamentally – there is still room for further rate cuts. However, surging fiscal deficits and a growing risk to bond markets argue against further easing.
- The government has proven unwilling and unable to tighten fiscal policy, despite a relatively strong economic performance. The risk of breaching the important public debt-to-GDP ratio of 55% in 2010 is high, especially as privatisation receipts fall short of the target.
- In order to lessen this risk, but not to tighten policy, the government is trying to modify the pension reform launched in 1999. But the proposal to reduce employees' contributions to

| Poland: Economic Forecasts | | | | | |
|---------------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
| GDP (% y/y) | 5.1 | 1.3 | 2.2 | 3.5 | 4.4 |
| CPI (% y/y) | 4.1 | 3.6 | 2.6 | 1.4 | 1.3 |
| Current Account (% GDP) | -5.2 | -0.8 | -0.6 | -1.3 | -1.6 |
| Budget Balance (% GDP) ⁽²⁾ | -3.5 | -6.1 | -6.5 | -4.2 | -3.5 |
| Base Rate (%) ⁽³⁾ | 5.00 | 3.50 | 3.50 | 3.75 | 4.50 |
| EUR/PLN ⁽³⁾ | 4.12 | 3.98 | 4.05 | 4.00 | 3.50 |

(1) Forecast (2) ESA-95 (3) End Period

Source: BNP Paribas

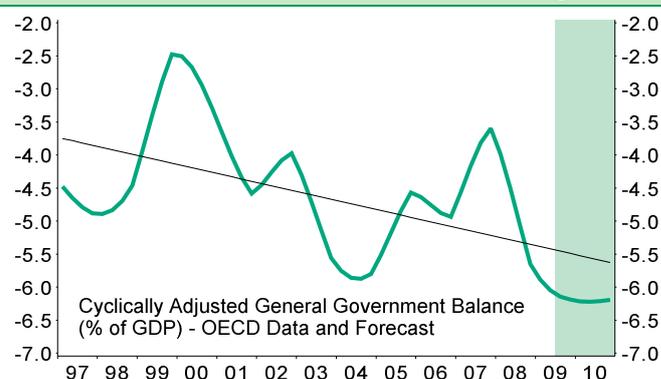
Chart 1: Unemployment Will Rise Further



Source: Reuters EcoWin Pro, BNP Paribas

Poland needs growth of about 4% y/y to stabilise unemployment. Our GDP forecasts thus point to a weakening of the labour market ahead.

Chart 2: Public Finances on a Deteriorating Trend



Source: OECD, Reuters EcoWin Pro

Since 2008, the cyclically-adjusted fiscal balance has been on a deteriorating trend again. The government must tighten policy by 2011 at the latest.

private pension funds and at the same time to increase their share of financing of the state-run system, is merely postponing problems.

- The government will have to implement proper fiscal tightening measures by 2011 at the latest. Given rising debt-servicing costs, we expect tax and quasi-tax hikes rather than substantial spending cuts.



Hungary: Enforced Master of Discipline

■ Activity: in line with previous forecast

- Our GDP forecasts are little changed since the last edition of the *Global Outlook* although we now expect slightly stronger net exports and less domestic demand.
- The change in net exports is the main reason why we expect GDP growth in 2010 and why our GDP call for next year is more optimistic than official forecasts.
- However, the deterioration in the labour market and a tight policy mix will restrain consumption spending until 2011 at least.
- The rise in net trade will not only be driven by the relative weakness of domestic consumption and investment, but also by increased external competitiveness – thanks to a weaker currency and contained unit labour costs.
- We are therefore upbeat on the outlook for both the trade and the current account. The current account surplus posted in Q2 2009 is a clear signal that the much-needed rebalancing of the economy is taking place.

■ Inflation: deflation risk in late 2010

- Since the VAT hike in July, the headline and core inflation rates have continuously surprised to the downside. We believe this is a clear manifestation of the huge amount of slack in the economy.
- We expect demand pressure to remain absent for the next eighteen months at least, suggesting sharp disinflation from the summer of 2010 onwards.
- Assuming there are no supply-side shocks and/or a massive currency fall, there is a rising risk of deflation by late 2010 and in 2011.

■ Policy: more rate cuts in the near term

- Stronger risk appetite globally has allowed the NBH to deliver large rate cuts. We expect the easing cycle to be continued until early 2010 – just before parliamentary elections are held.
- We expect the policy rate to be cut to 5.50% by February and further easing to be delivered from August onwards, when the new government will formulate its fiscal and economic policy proposals, and CPI readings will collapse.
- Despite a deep recession, Hungary has met the budget deficit targets agreed with the IMF. While we see a risk for some slippage on the fiscal accounts in both 2009 and 2010, we do not think any slippage will be substantial.

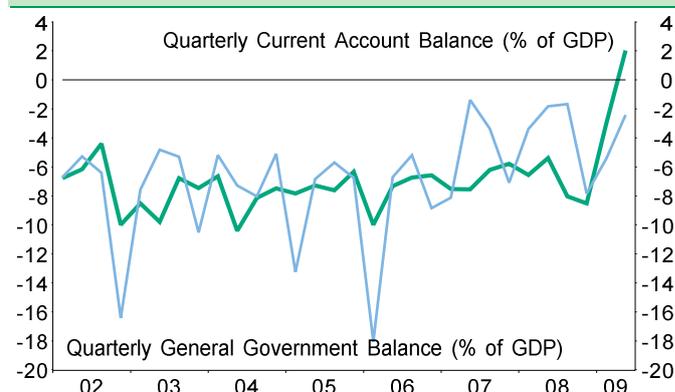
Hungary: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|---------------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 0.8 | -6.6 | 0.4 | 3.0 | 3.6 |
| CPI (% y/y) | 5.6 | 4.1 | 2.3 | 1.3 | 1.6 |
| Current Account (% GDP) | -7.1 | -2.3 | -1.4 | -0.8 | 0.5 |
| Budget Balance (% GDP) ⁽²⁾ | -3.7 | -4.1 | -4.3 | -3.2 | -3.0 |
| Base Rate (%) ⁽³⁾ | 10.00 | 6.00 | 4.50 | 5.50 | 6.00 |
| EUR/HUF ⁽³⁾ | 264 | 260 | 265 | 260 | 250 |

(1) Forecast (2) ESA-95 (3) End Period

Source: BNP Paribas

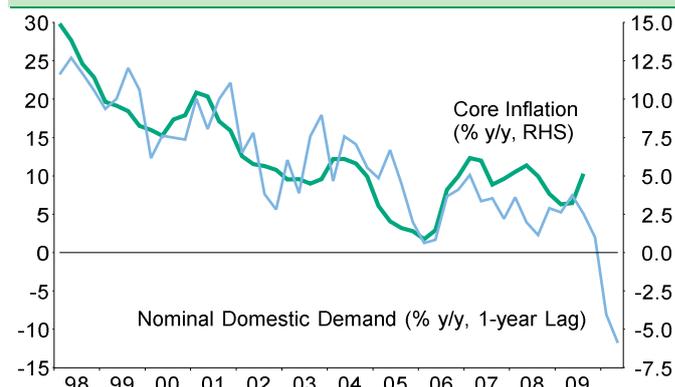
Chart 1: Twin Deficits. What Deficits?



Source: Reuters EcoWin Pro, BNP Paribas

The substantial reduction in the fiscal deficit since 2007 has helped to reduce the current account gap. We expect more rebalancing of the economy.

Chart 2: No Demand Pressure



Source: Reuters EcoWin Pro, BNP Paribas

There is no demand pressure in the Hungarian economy. As the impact of the VAT hike fades in July 2010, inflation will collapse.

- We do not expect the new government to divert from the fiscal tightening route. A more supportive cyclical backdrop should support continued efforts to reduce budget deficits and public debt in coming years.



Czech Republic: Inflation Worry Premature

■ Activity: final domestic demand will lag the recovery in GDP

- Production and retail sales suggest that the economic recovery remains very shallow and fragile. We have thus further reduced our GDP forecast to a decline of close to 5.0% in 2009.
- In 2010 we expect a rise in GDP, but only thanks to a strengthening of net exports and inventories' contribution to GDP.
- Final domestic demand will continue to contract until late next year with investment undermined by low capacity utilisation and the credit crunch, while personal consumption will be hit by a further deterioration of the labour market and tighter fiscal policy next year.
- The unwinding of schemes supporting demand for cars in many Western European countries is a particular risk for the Czech car industry and, given its importance, for the broader economy.
- Although the economy will remain cyclically weak over the next several months, we are not worried about its fundamentals. In particular, low public and external debt reduce the risk that the economy will be hit by financial market volatility. In this respect, the Czech Republic is, and will remain, the safe haven in Central and Eastern Europe.

■ Inflation: deflation to persist despite higher taxes

- Following the sharp moderation in core inflation seen since April, the headline rate of inflation also turned negative in October.
- We do not agree with the Czech National Bank that price falls will be temporary. In 2010-2011 the output gap will widen to unprecedented levels (at least since the move to a market economy), with the risk that deflation will persist.
- Given the expected indirect tax hikes next year, we have raised our 2010 inflation forecast above zero. But we do not share the official view that headline inflation will rise above the 2% target by the turn of next year. In 2011 we expect a further fall in the core CPI and headline inflation to remain below 1.0% y/y.

■ Policy: tighter fiscal policy agreed – softer monetary stance needed

- The fiscal-tightening package aims to reduce next year's budget deficit to slightly above 5.0% of GDP. We think this is achievable and expect the government to be formed after next year's election to stick to spending cuts and tax hikes.

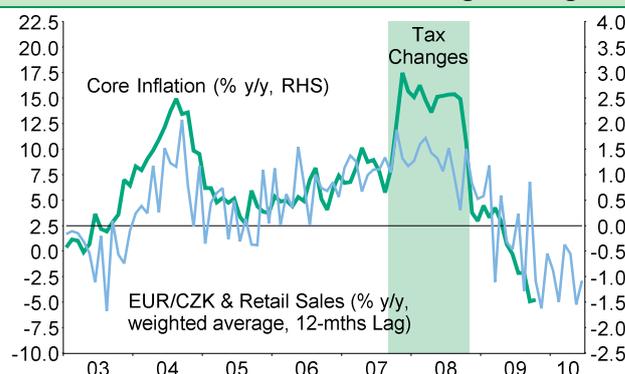
Czech Republic: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|---------------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 2.7 | -4.8 | 1.3 | 3.3 | 5.3 |
| CPI (% y/y) | 6.0 | 0.9 | 0.9 | 0.5 | 1.2 |
| Current Account (% GDP) | -3.1 | -2.3 | -1.0 | -0.1 | 0.9 |
| Budget Balance (% GDP) ⁽²⁾ | -2.0 | -7.5 | -5.0 | -4.2 | -2.4 |
| Base Rate (%) ⁽³⁾ | 2.25 | 1.00 | 1.00 | 1.25 | 2.75 |
| EUR/CZK ⁽³⁾ | 26.75 | 26.90 | 25.80 | 24.70 | 23.50 |

(1) Forecast (2) ESA-95 (3) End Period

Source: BNP Paribas

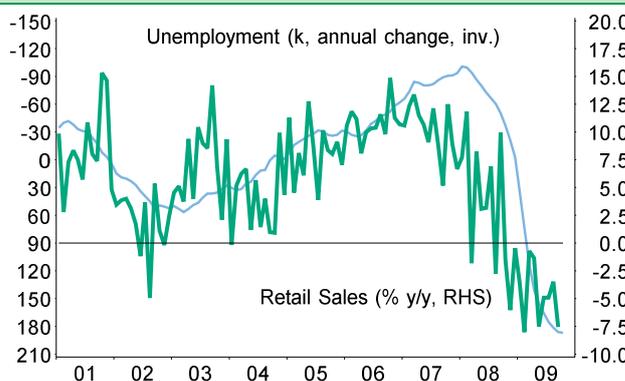
Chart 1: Deflation Could be Long Lasting



Source: Reuters EcoWin Pro, BNP Paribas

Falling demand pressure and a relatively strong exchange rate point to the risk that deflation will persist for a long time.

Chart 2: Consumption to Remain Weak



Source: Reuters EcoWin Pro, BNP Paribas

The deterioration of the labour market has undermined consumption. Next year, tighter fiscal policy will add to the headwinds.

- In light of tighter fiscal policy, further monetary easing would be beneficial. Since the scope for rate cuts is already nearly exhausted, we expect policymakers to focus on other tools, including the currency. Verbal intervention in October was not followed by action and the koruna resumed its appreciation trend.



Bulgaria and Romania: On a Back Foot

■ **Bulgaria: the recession is deepening and deflation lies ahead. We expect only a weak recovery from 2011 onwards. Bulgaria is not ready for EMU and the eurozone**

- Recent data on industrial output and retail sales suggest that the year-on-year decline in GDP has deepened. Capacity utilisation has continued to fall sharply, which bodes ill for the investment and labour market outlook.
- The new government has opted for tight fiscal policy and (nearly) balanced budgets ahead, despite the depth of the current recession.
- This policy will further reduce aggregate demand in the economy, so we are also forecasting a further fall in GDP next year, and the subsequent recovery to be extremely shallow. We also expect price falls.
- Despite a deflationary environment, the depreciation of the real effective exchange rate will be mild under the currency board regime. This suggests that a further large improvement in net exports can only be achieved if domestic demand continues to contract well into 2011.
- Bulgaria aims to enter EMU early next year (not before end-January). We remain sceptical that this will be possible given the low level of real convergence and the further structural reforms that are needed.

■ **Romania: deepening recession suggests that the fiscal target for 2009 will be missed. Political uncertainty is also undermining the medium-term fiscal outlook**

- The deepening recession suggests that Romania will fail to meet its fiscal targets agreed with the IMF this year. While there has been a substantial re-balancing in the private sector, manifested by a rapid narrowing of external deficits, the fiscal position has deteriorated sharply.
- Political uncertainty since the break-up of the government coalition in October is also clouding the medium-term fiscal outlook.
- The inability to move ahead with a tighter budget for next year has prompted the IMF to stop its review and delay the disbursement of funds.
- External support will be needed, however, given that next year's economic recovery will be weak.
- A reduction of the budget deficit and pressure on public debt clearly require strong leadership. Therefore, if the current parliament proves unable to recreate a government majority, early elections in 2010 appear likely.

Bulgaria: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|---------------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 6.1 | -5.4 | -0.9 | 1.6 | 2.6 |
| CPI (% y/y) | 12.0 | 2.2 | -2.3 | -0.1 | 1.7 |
| Current Account (% GDP) | -25.4 | -10.3 | -9.5 | -9.5 | -9.4 |
| Budget Balance (% GDP) ⁽²⁾ | 1.8 | 0.0 | -1.6 | -0.1 | 0.0 |
| 3-Month Rate (%) ⁽²⁾ | 7.61 | 7.10 | 5.60 | 6.10 | 5.70 |
| EUR/BGN ⁽³⁾ | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |

(1) Forecast (2) General Government (3) End Period

Source: BNP Paribas

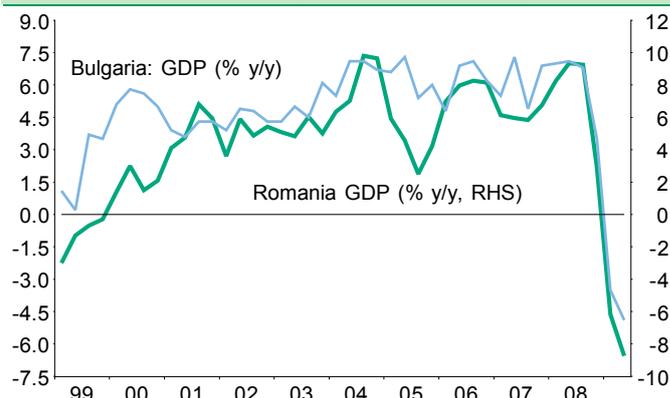
Romania: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|---------------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 7.4 | -7.3 | 1.5 | 1.8 | 4.4 |
| CPI (% y/y) | 7.7 | 5.5 | 3.4 | 3.2 | 3.2 |
| Current Account (% GDP) | -12.2 | -5.3 | -4.1 | -3.8 | -4.2 |
| Budget Balance (% GDP) ⁽²⁾ | -5.4 | -8.8 | -5.1 | -3.9 | -2.9 |
| Base Rate (%) ⁽³⁾ | 10.25 | 8.00 | 6.50 | 7.00 | 7.50 |
| EUR/RON ⁽³⁾ | 4.03 | 4.15 | 4.35 | 4.00 | 3.90 |

(1) Forecast (2) Central Government (3) End Period

Source: BNP Paribas

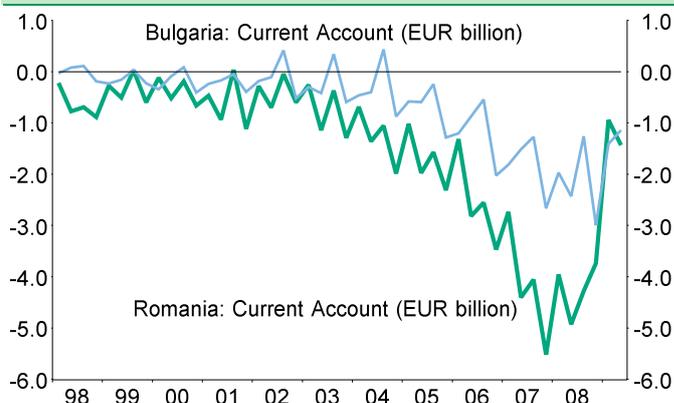
Chart 1: Deep Economic Slump



Source: Reuters EcoWin Pro, BNP Paribas

GDP is contracting sharply.

Chart 2: Rebalancing of External Accounts



Source: Reuters EcoWin Pro, BNP Paribas

Deepening recessions have reduced external imbalances.



Turkey: Recovery Remains Feeble

■ Activity: 2010 is likely to be a year of bouncing back and muddling through

- After a strong rebound in Q2, growth indicators have since shown that the recovery is slowing. The labour market and consumer sentiment remain weak and unemployment is expected to increase in the coming months due to seasonal factors, further weakening domestic demand.
- The recovery in industrial production is gradual. The volume of credit, despite continued rate cuts by the CBT, remains broadly flat. Low capacity utilisation rates and a decline in income are limiting demand for loans while the government's financing needs continue to absorb the banking system's resources.
- Confidence and external financing will have to improve markedly for robust and sustainable growth to return. In an IMF-less scenario, weak policy anchors, tight external financing conditions and a weak labour market will preclude a strong recovery. Accordingly, we continue to forecast a fall in GDP of 5.5% in 2009, followed by 3.5% growth in 2010 on the back of a modest pick-up in domestic demand, base year effects and a build-up of inventories.

■ Inflation: set to exceed CBT's forecast in 2010

- Although the weakness of the economy and global disinflation helped inflation to moderate to 5.1% y/y in October, the annual inflation rate is likely to reaccelerate in 2010 as base effects dissipate, tax incentives are rolled back and retailers try to rebuild margins.
- In 2010, if commodity prices continue to rise, the inflation outlook will be more challenging. In addition, the government's Medium-Term Economic Programme (MEP) seems too reliant on increases in excise duties and administrative prices to put the government's finances back in order. Thus, we look for year-end inflation of around 6% in 2009 and 7% in 2010, about 1.5 percentage points higher than the CBT's latest inflation forecast for 2010.

■ Policy: Turkey has a difficult external and domestic financing outlook in the absence of an IMF programme

- As outlined in the inflation report, the CBT's baseline scenario assumed limited further easing and then constant rates until end-2010. Following November's cut, additional easing in December depends on inflation, developments in the volume of credit and economic activity, and

Turkey: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 0.9 | -5.5 | 3.5 | 4.0 | 4.5 |
| CPI (% y/y) ⁽²⁾ | 10.4 | 6.2 | 7.4 | 6.5 | 6.4 |
| CPI (% y/y) ⁽³⁾ | 10.1 | 5.8 | 7.0 | 6.3 | 6.0 |
| Current Account (% GDP) | -5.7 | -2.1 | -3.4 | -3.5 | -4.0 |
| Budget Balance (% GDP) | -1.8 | -6.3 | -5.6 | -3.8 | -2.7 |
| Base Rate (%) ⁽³⁾ | 15.00 | 6.25 | 8.00 | 9.25 | 8.50 |
| USD/TRY ⁽³⁾ | 1.52 | 1.48 | 1.63 | 1.68 | 1.75 |

(1) Forecast (2) Average (3) End Period

Source: TEB Research

Table 1: External Financing (USD bn)

| | 2009 | | | | 2010 |
|---------------------------------|------------|-------------|-------------|-------------|-------------|
| | Sep | Jan-Sep | Oct-Dec | Total | |
| Outflows | 5.9 | 44.2 | 15.6 | 59.9 | 63.8 |
| Current Account Deficit | 0.9 | 8.6 | 4.4 | 13.0 | 22.9 |
| Debt service (MLT) | <u>5.0</u> | <u>35.6</u> | <u>11.3</u> | <u>46.9</u> | <u>40.8</u> |
| Public | 1.2 | 5.6 | 0.8 | 6.3 | 7.8 |
| Private | 3.7 | 30.0 | 10.5 | 40.5 | 33.0 |
| Inflows | 5.9 | 44.2 | 15.6 | 59.9 | 63.8 |
| FDI (net) | 0.3 | 5.2 | 2.8 | 8.0 | 10.0 |
| Portfolio (private equity; net) | -0.3 | -0.2 | 1.5 | 1.3 | 2.0 |
| Borrowing (MLT) | <u>3.9</u> | <u>26.2</u> | <u>11.3</u> | <u>37.5</u> | <u>40.0</u> |
| Public | 0.6 | 6.0 | 3.0 | 9.0 | 7.0 |
| Debt Securities | 0.3 | 2.8 | 2.7 | 5.5 | 5.0 |
| o/w: TRY-securities (net) | 0.3 | -0.9 | 0.9 | 0.0 | 2.0 |
| Private | 3.3 | 20.2 | 8.3 | 28.5 | 33.0 |
| Short-term (net) | -1.1 | -6.1 | 0.0 | -6.1 | 1.8 |
| Currency and Deposits | 2.7 | 12.3 | 0.0 | 12.3 | 0.0 |
| Errors and Omissions | 0.4 | 6.2 | 0.0 | 6.2 | 0.0 |
| Reserve use | 0.0 | 0.7 | 0.0 | 0.7 | 0.0 |
| Financing Gap | | | | | 10.0 |
| Private Sector MLT r/o (%) | 87 | 67 | 79 | 70 | 100 |

Source: CBT, Turkstat, TurkeyDataMonitor, TEB Research

Turkey does not have a comfortable external financing outlook for 2010.

exchange rate moves. We expect the CBT to start increasing its policy rate in H2 2010 to contain inflationary expectations.

- The CBT also announced that it will start to purchase government bonds in 2010, with the details to be announced in December. We expect bond purchases to be roughly equal to the amount of bonds maturing in 2010 (TRY9bn) and thus to be liquidity neutral. However, given the changeable global backdrop, the CBT's communication strategy will be important to avoid exacerbating inflation expectations.
- Turkey has a difficult external and domestic financing outlook for 2010. The government's MEP is based on optimistic fiscal revenue assumptions and its external financing remains vague. Given the fluid global backdrop, and in the absence of a strong policy anchor – such as an IMF programme – Turkey could find it difficult to finance its BoP and achieve strong growth.

IMPORTANT DISCLOSURE:

This analysis has been produced by Turk Ekonomi Bank A.S. ("TEB") and has been reviewed, but not amended, by BNP Paribas. BNP Paribas is an indirect shareholder of TEB with a 42.125% stake. This analysis does not contain investment research recommendations.



Australia: It's Hot Down Under

■ Activity: star performer

- The recovery in the Australian economy is progressing well. We expect the reacceleration in GDP growth to continue in the next few quarters, consistent with the surge in consumer confidence and in key business surveys.
- But the favourable tailwinds that the economy has enjoyed in recent quarters (such as the boost to disposable income from cuts in mortgage rates) are beginning to fade. This suggests that quarterly GDP growth will moderate slightly during 2010.
- However, with far less of an overhang from the financial crisis – and given Australia's exposure to the rapid recovery in Asia – the moderation in growth will be far less severe than in other major industrialised economies.

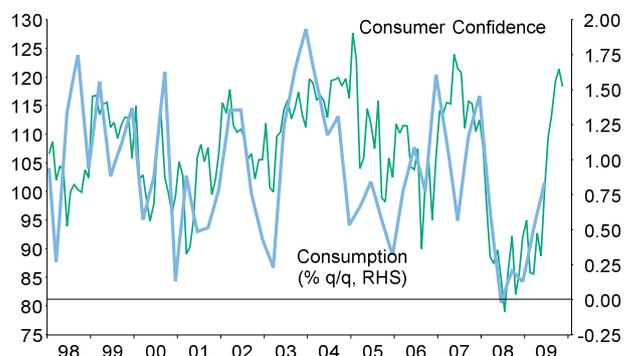
■ Inflation: slowing, but not for much longer

- The Australian economy only contracted in quarter-on-quarter terms for one quarter and the trough in year-on-year GDP growth was 0.3%. As a result, the output gap is very small.
- Furthermore, the surprising resilience of the labour market has meant that the unemployment rate is only slightly above the NAIRU.
- Although both the output gap and level of unemployment point to a continued moderation in underlying inflation, the pace and extent of the decline will be less than elsewhere.
- A slower pace of output growth in 2010 means that the output gap is unlikely to turn positive for some time. So a reacceleration in underlying inflation is a little way off.
- However, given the resilience of the economy during the downturn, robust pricing power is likely to mean that any jump in upstream input costs, such as from energy, feeds more easily into second-round increases via core components of the CPI.

■ Policy: gradual hikes, risk of more rapid ones

- The RBA took out considerable excess insurance against the risk of a more severe contraction. This insurance is no longer required, so the RBA has begun to gradually withdraw it.
- Recent RBA statements suggest that this gradual pace of tightening will continue. However, hawkish commentary from the Governor has raised the possibility that the board could pick up the pace at some stage.
- The situation does not warrant restrictive monetary policy at this stage, just a withdrawal of excess accommodation.

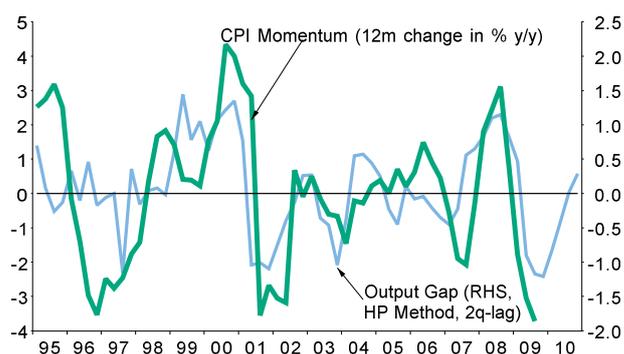
Chart 1: Consumption vs. Consumer Confidence



Source: Reuters EcoWin Pro

Disposable income has benefited from a loosening in fiscal policy and sharp falls in mortgage interest payments. Both have helped confidence to surge and we should see consumption improve further.

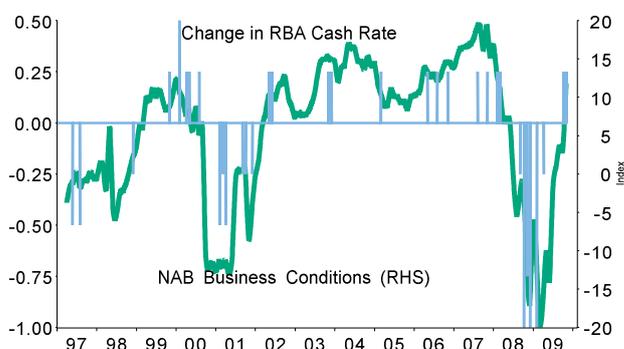
Chart 2: Inflation Momentum and Output Gap



Source: Reuters EcoWin Pro

The Australian output gap is fairly narrow compared with the gap in other industrialised economies. This means the downward pressure on inflation is less intense than elsewhere.

Chart 3: NAB Survey and Change in RBA Rate



Source: Reuters EcoWin Pro

The NAB survey is at a level typically associated with interest rate hikes.



Table 1: Australia Economic & Financial Data

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | |
|--|-------|--------------------|--------------------|--------------------|--------------------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ |
| Components of Growth | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | 0.4 | 0.6 | 1.0 | 1.1 | 1.1 | 0.9 | 0.6 | 0.4 | 0.5 | 0.7 | 0.8 | 1.0 |
| GDP | 2.4 | 1.4 | 3.7 | 2.6 | 3.9 | 0.3 | 0.6 | 1.3 | 3.2 | 3.9 | 4.2 | 3.7 | 3.0 | 2.5 | 2.3 | 2.5 | 3.1 |
| Dom. Demand ex Stocks | 4.4 | 0.9 | 3.1 | 2.7 | 4.1 | 0.9 | 0.7 | 0.5 | 1.4 | 3.4 | 3.3 | 3.1 | 2.6 | 2.4 | 2.4 | 2.7 | 3.2 |
| Private Consumption | 2.2 | 2.3 | 4.6 | 2.8 | 3.8 | 0.8 | 1.7 | 2.7 | 4.2 | 5.0 | 5.1 | 4.6 | 3.5 | 2.8 | 2.5 | 2.6 | 3.0 |
| Public Consumption | 3.7 | 2.3 | 2.0 | 1.6 | 2.3 | 2.9 | 2.6 | 1.9 | 2.0 | 2.3 | 2.0 | 2.0 | 1.8 | 1.6 | 1.5 | 1.5 | 1.6 |
| Fixed Investment | 9.1 | -2.7 | 0.8 | 3.3 | 5.7 | 0.0 | -2.3 | -4.5 | -4.0 | 0.9 | 0.4 | 0.8 | 1.2 | 2.0 | 2.8 | 3.6 | 4.6 |
| Stocks (Cont. to Growth) | -0.6 | -0.7 | 0.7 | 0.1 | 0.0 | -1.7 | -1.1 | -0.9 | 0.8 | 0.8 | 1.0 | 0.7 | 0.5 | 0.4 | 0.0 | 0.0 | 0.0 |
| Exports | 3.9 | 1.5 | 1.8 | 1.4 | 6.8 | 2.0 | 1.0 | 1.0 | 2.0 | 3.0 | 2.0 | 1.0 | 1.0 | 1.2 | 1.5 | 1.5 | 1.5 |
| Imports | 10.4 | -0.6 | 1.9 | 1.5 | 7.6 | -7.6 | 2.1 | 0.8 | 2.4 | 2.5 | 2.5 | 1.0 | 1.5 | 1.5 | 1.5 | 1.5 | 1.7 |
| Industrial Production | 2.4 | -2.6 | 4.3 | 2.9 | 2.5 | -3.5 | -3.8 | -2.9 | -0.3 | 3.3 | 4.3 | 4.8 | 4.6 | 4.0 | 3.0 | 2.5 | 2.2 |
| Savings Ratio (%) | 2.4 | 3.8 | 5.0 | 4.2 | 4.0 | - | - | - | - | - | - | - | - | - | - | - | - |
| Inflation & Labour | | | | | | | | | | | | | | | | | |
| CPI | 4.4 | 1.8 | 2.6 | 2.7 | 2.5 | 2.5 | 1.5 | 1.3 | 2.1 | 2.7 | 2.8 | 2.5 | 2.5 | 2.6 | 2.6 | 2.7 | 2.9 |
| Unemployment Rate (%) | 4.3 | 5.6 | 5.3 | 4.6 | 4.3 | 5.3 | 5.7 | 5.8 | 5.7 | 5.6 | 5.5 | 5.1 | 4.8 | 4.7 | 4.6 | 4.5 | 4.4 |
| External Trade | | | | | | | | | | | | | | | | | |
| Trade Balance (AUD bn) | -3.6 | 2.9 | 4.5 | 2.5 | 0.5 | - | - | - | - | - | - | - | - | - | - | - | - |
| Current Account (AUD bn) | -50.0 | -40.0 | -35.0 | -20.0 | -10.0 | - | - | - | - | - | - | - | - | - | - | - | - |
| Current Account (% GDP) | -4.2 | -3.3 | -2.7 | -1.5 | -0.7 | - | - | - | - | - | - | - | - | - | - | - | - |
| Financial Variables | | | | | | | | | | | | | | | | | |
| Gen. Gov. Budget (AUD bn) | -32.0 | -55.0 | -45.0 | -30.0 | -15.0 | - | - | - | - | - | - | - | - | - | - | - | - |
| Gen. Gov. Budget (% GDP) | -2.7 | -4.5 | -3.5 | -2.2 | -1.0 | - | - | - | - | - | - | - | - | - | - | - | - |
| Interest & FX Rates⁽²⁾ | | | | | | | | | | | | | | | | | |
| Cash Rate | 4.25 | 3.75 | 5.25 | 6.00 | 6.00 | 3.25 | 3.00 | 3.00 | 3.75 | 4.25 | 4.50 | 5.00 | 5.25 | 5.50 | 5.75 | 6.00 | 6.00 |
| 3-Month Rate (%) | 4.83 | 4.25 | 5.50 | 6.25 | 6.20 | 3.67 | 3.50 | 3.30 | 4.25 | 4.75 | 5.00 | 5.25 | 5.50 | 5.75 | 5.90 | 6.10 | 6.25 |
| 10-Year Bond Yield (%) | 4.00 | 5.45 | 6.25 | 7.15 | 7.25 | 4.61 | 5.62 | 5.45 | 5.45 | 5.65 | 5.40 | 5.70 | 6.25 | 6.50 | 6.85 | 7.10 | 7.15 |
| AUD/USD | 1.41 | 0.96 | 0.82 | 0.92 | 0.90 | 0.69 | 0.81 | 0.88 | 0.96 | 0.92 | 0.86 | 0.84 | 0.82 | 0.85 | 0.87 | 0.89 | 0.92 |

Footnotes: (1) Forecast (2) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas

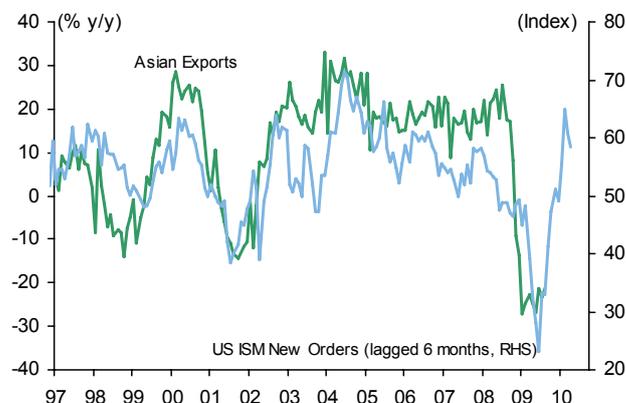


Asia: Rate Hikes Needn't Derail Recovery

■ Activity: faster rise in exports does not signal decoupling from the rest of the world

- Since June, Asian export growth has rebounded strongly, led by South Korea and Taiwan. By September, South Korean and Taiwanese exports had jumped 63% and 54% respectively from their January trough.
- In addition to a fall in demand from Asia's main markets, the previous sharp fall in Asian exports reflected a collapse in global trade financing. As a result, manufacturers had to dip into their inventories, causing inventory levels to also plunge.
- We agree with the IMF which, in its latest report on the region published in October, argued: "just as the US downturn triggered an outsized fall in Asia's GDP because international trade and finance froze, now their normalisation is generating an outsized Asian upturn." Given that exports are the main driver of the recovery, the rebound in economic activity has been fastest in the export-dependent Asian economies that were the most severely hit at the end of 2008.
- Asia's export recovery primarily reflects the economic rebound in the US. There has been a sharp rebound in the US ISM new orders which remains a key leading indicator for Asian exports (Chart 1). This correlation makes it difficult to argue that the Asian economies have truly decoupled from the US.
- Moreover, China is expected to grow even more strongly in 2010 and there is still a strong correlation between Asian exports to China and China's exports to the US given that Asian exports to China are still mainly intermediate exports with the US as the final destination.
- Among the ASEAN economies, we expect Singapore to post real GDP growth of 5.5% y/y in 2010. We have revised up our 2009 forecast from -3.5% to -2.4% on the back of the faster rebound in the global economy. For the island economy, we expect the opening of the two integrated resorts next year to help boost overall growth. GDP in neighbouring Malaysia is expected to expand 5% y/y next year on the back of stronger consumption spending. The economy should also benefit from a pick-up in exports as Malaysia's exports-to-GDP ratio, at 104%, remains one of the highest in the world.
- Indonesia's economy should expand by 5.2% y/y in 2010 on the back of buoyant domestic demand as interest rates remain low for another year. We expect credit growth to rebound as

Chart 1: Export Recovery



Source: CEIC

The Asian export cycle remains closely correlated to the US ISM new orders, showing that Asian exports remain closely correlated with the US economic cycle.

Chart 2: Still Dependent on the US



Source: CEIC

China and the rest of Asia continue to be dependent on US end demand.

Table 1: Head-On Competition with China (correlation coefficient of exports with Chinese exports)

| | 2000 | 2004 | 2005 | 2006 | 2007 | 2008 |
|-------------|------|------|------|------|------|------|
| Taiwan | 0.53 | 0.51 | 0.44 | 0.4 | 0.38 | 0.37 |
| Korea | 0.43 | 0.56 | 0.54 | 0.54 | 0.51 | 0.51 |
| Singapore | 0.41 | 0.49 | 0.46 | 0.42 | 0.38 | 0.32 |
| Malaysia | 0.44 | 0.57 | 0.6 | 0.63 | 0.58 | 0.43 |
| Thailand | 0.51 | 0.66 | 0.69 | 0.66 | 0.64 | 0.58 |
| Indonesia | 0.36 | 0.32 | 0.2 | 0.16 | 0.11 | 0.07 |
| Philippines | 0.33 | 0.43 | 0.42 | 0.42 | 0.24 | 0.27 |
| India | 0.22 | 0.07 | 0.08 | 0.08 | 0.07 | 0.06 |
| Vietnam | 0.28 | 0.18 | 0.17 | 0.18 | 0.22 | 0.22 |
| Mexico | 0.45 | 0.47 | 0.4 | 0.37 | 0.32 | 0.34 |

Source: UN

The higher the correlation, the greater the similarity with China's exports. It does not pay to compete head-on with the Chinese juggernaut.



banks expand their branches into the outer islands. While Thailand has done well, we remain concerned on the political front and over the fact that Thailand's exports are competing head-on with China (Table 1).

- Domestically, the rapid and comprehensive policy response has also clearly played a role in the economic recovery for the Asian economies. This was made possible by the region's better fiscal positions than elsewhere, and sounder banking and corporate balance sheets.
- Overall, while we expect growth to strengthen further in the region, we believe that the rate of recovery will be slower than during past cycles as we expect the recovery in the US to be lacklustre.

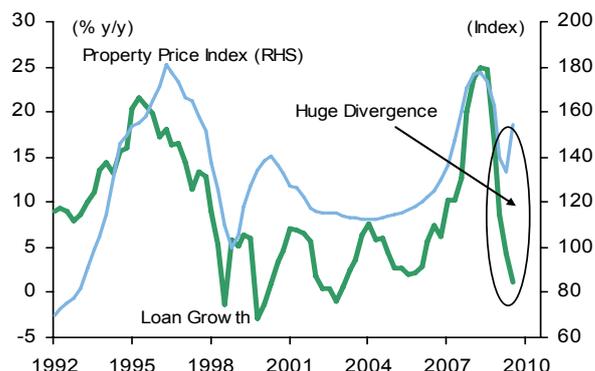
■ **Inflation: unlikely to accelerate sharply**

- We reiterate our view that while inflationary pressures have bottomed out, they are unlikely to accelerate rapidly and cause central banks to tighten monetary policy sharply in 2010.
- There are several reasons for this. First, the recovery in 2010 will be more muted than during previous recoveries, limiting demand pressure.
- Second, the amount of slack in Asian economies remains large as measured by the region's output gaps and unemployment rates. Although off August's peak, Hong Kong's unemployment rate, at 5.6% in September, remains high by historical standards.
- The key risk lies with the outlook for commodity prices, particularly food prices as food is the largest component in the region's CPI basket.

■ **Policy: do not be afraid of the first rate hikes**

- Just as policymakers have had to cut rates sharply, inject huge amounts of liquidity and implement massive fiscal spending in the past nine months to avert a disaster in the global economy, we expect it would take massive rate hikes to derail the economic recovery that is under way in Asian economies.
- For this reason, we reiterate that investors should not be unduly alarmed by the initial rate hikes. On the contrary, hikes should be seen as a signal that policymakers have become a lot more confident about growth prospects.
- There is concern that policymakers may begin to tighten aggressively as economies overheat and inflationary pressures show tentative signs of accelerating, but we do not see this translating into a surge given their large output gaps
- On the contrary, some Asian central banks are currently using non-monetary policy instruments to cool sectors that they deem to be overheating or showing signs of developing a bubble.
- In Singapore, the government scrapped the interest absorption scheme for home purchases

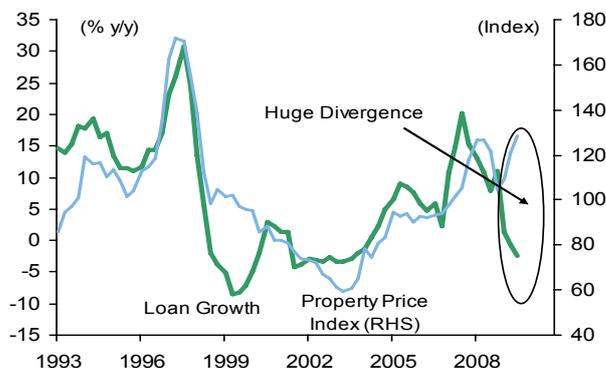
Chart 3: A Divergence Between Singapore's Property Market and the Credit Cycle...



Source: CEIC

The divergence between the property cycle and credit growth argues against higher interest rates in Singapore.

Chart 4: ...With a Similar Picture in HK



Source: CEIC

The even sharper divergence in HK suggests that foreign buyers are now key players in the property market. They are less susceptible to higher interest rates.

and reinstated the confirmed list of government land sales to cool the property market. The former makes it more expensive to buy property while the latter will increase the supply of land.

- Likewise, Hong Kong has tightened the conditions for down payments on luxury homes and is discussing whether to increase the supply of land for housing development.
- We believe that such selective measures aimed at specific areas of the economy that are showing signs of overheating are a better option than raising interest rates, which would affect the whole economy. Indeed, outside the property sector, Hong Kong and Singapore's economies are just showing early signs of a turnaround. While we expect credit growth to recover in the coming months, a premature tightening could undermine the recovery. Charts 3 and 4 show that credit ex-housing loans in Singapore contracted by 3.3% y/y in September, the third consecutive month of contraction. In HK, it fell 4.5% y/y in Q3 for the second consecutive quarterly decline.



Regional Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| Asia ex-Japan | | | | | |
| GDP (% y/y) | 6.7 | 5.2 | 7.7 | 6.9 | 7.2 |
| CPI (% y/y) | 6.6 | 0.7 | 3.8 | 4.0 | 3.5 |
| Current Account (% GDP) | 5.2 | 4.9 | 3.9 | 3.5 | 3.9 |
| Asia ex-Japan, ex-China | | | | | |
| GDP (% y/y) | 4.7 | 2.1 | 6.0 | 5.6 | 5.9 |
| CPI (% y/y) | 7.2 | 1.8 | 3.6 | 2.8 | 3.2 |
| Current Account (% GDP) | 1.2 | 3.2 | 2.2 | 2.1 | 2.5 |

(1) Forecast

Source: BNP Paribas

Indonesia: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--|-------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 6.1 | 4.2 | 5.2 | 5.8 | 6.0 |
| CPI (% y/y) | 9.8 | 4.8 | 4.9 | 5.3 | 5.6 |
| Current Account (% GDP) | 0.1 | 1.0 | 1.2 | 1.4 | 1.6 |
| Budget Balance (% GDP) | 0.0 | -2.5 | -1.7 | -1.3 | -1.0 |
| Interest Rate (%) ⁽²⁾ | 12.13 | 7.20 | 7.65 | 8.25 | 9.10 |
| Official Benchmark Rate (%) ⁽²⁾ | 9.25 | 6.50 | 7.00 | 7.50 | 8.50 |
| USD/IDR ⁽²⁾ | 10950 | 9200 | 8600 | 8200 | 8000 |

(1) Forecast (2) End Period

Source: BNP Paribas

Taiwan: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--|-------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 0.1 | -3.1 | 5.8 | 3.6 | 4.2 |
| CPI (% y/y) | 3.5 | -0.7 | 0.6 | 0.4 | 1.2 |
| Current Account (% GDP) | 6.4 | 8.2 | 8.9 | 9.1 | 9.0 |
| Budget Balance (% GDP) | -1.7 | -5.1 | -5.0 | -3.7 | -3.0 |
| Interest Rate (%) ⁽²⁾ | 1.78 | 1.30 | 1.70 | 1.90 | 2.30 |
| Official Benchmark Rate (%) ⁽²⁾ | 2.00 | 1.25 | 1.75 | 2.00 | 2.50 |
| USD/TWD ⁽²⁾ | 32.82 | 31.50 | 30.00 | 29.00 | 29.00 |

(1) Forecast (2) End Period

Source: BNP Paribas

Thailand: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--|-------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 2.6 | -3.5 | 4.5 | 5.0 | 5.5 |
| CPI (% y/y) | 5.5 | -0.9 | 1.9 | 1.9 | 2.0 |
| Current Account (% GDP) | -0.1 | 4.8 | 6.5 | 5.3 | 3.2 |
| Budget Balance (% GDP) | -1.1 | -5.5 | -4.5 | -2.5 | -1.5 |
| Interest Rate (%) ⁽²⁾ | 2.95 | 1.40 | 2.00 | 2.50 | 3.00 |
| Official Benchmark Rate (%) ⁽²⁾ | 2.75 | 1.25 | 1.75 | 2.25 | 2.75 |
| USD/THB ⁽²⁾ | 34.93 | 33.00 | 32.00 | 31.00 | 31.00 |

(1) Forecast (2) End Period

Source: BNP Paribas

Malaysia: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--|------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 4.6 | -3.0 | 5.0 | 5.2 | 5.5 |
| CPI (% y/y) | 5.4 | 0.8 | 1.9 | 1.3 | 2.0 |
| Current Account (% GDP) | 17.5 | 13.6 | 13.3 | 14.8 | 15.0 |
| Budget Balance (% GDP) | -4.8 | -7.4 | -5.6 | -3.4 | -2.7 |
| Interest Rate (%) ⁽²⁾ | 3.37 | 2.15 | 2.50 | 2.90 | 3.25 |
| Official Benchmark Rate (%) ⁽²⁾ | 3.25 | 2.00 | 2.25 | 2.75 | 3.00 |
| USD/MYR ⁽²⁾ | 3.46 | 3.34 | 3.20 | 3.10 | 3.10 |

(1) Forecast (2) End Period

Source: BNP Paribas

Hong Kong: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--|------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 2.4 | -3.1 | 4.8 | 5.2 | 5.5 |
| CPI (% y/y) | 4.3 | 0.5 | 1.8 | 1.4 | 1.7 |
| Current Account (% GDP) | 14.2 | 11.2 | 9.8 | 10.3 | 11.0 |
| Budget Balance (% GDP) | 0.3 | -3.7 | -3.5 | -2.0 | -1.0 |
| Interest Rate (%) ⁽²⁾ | 0.95 | 0.20 | 0.40 | 0.55 | 2.40 |
| Official Benchmark Rate (%) ⁽²⁾ | 0.50 | 0.50 | 0.50 | 0.50 | 3.25 |
| USD/HKD ⁽²⁾ | 7.75 | 7.80 | 7.80 | 7.80 | 7.80 |

(1) Forecast (2) End Period

Source: BNP Paribas

Singapore: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|----------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 1.1 | -2.4 | 5.5 | 5.8 | 6.5 |
| CPI (% y/y) | 6.5 | 0.1 | 2.0 | 1.0 | 1.5 |
| Current Account (% GDP) | 14.8 | 10.5 | 14.7 | 15.8 | 16.6 |
| Budget Balance (% GDP) | -0.8 | -2.5 | -0.4 | 1.6 | 3.3 |
| Interest Rate (%) ⁽²⁾ | 0.96 | 0.70 | 0.90 | 1.20 | 1.50 |
| USD/SGD ⁽²⁾ | 1.44 | 1.38 | 1.34 | 1.30 | 1.30 |

(1) Forecast (2) End Period

Source: BNP Paribas

Philippines: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|--|-------|---------------------|---------------------|---------------------|---------------------|
| GDP (% y/y) | 3.8 | 1.5 | 4.3 | 4.9 | 5.0 |
| CPI (% y/y) | 9.3 | 3.2 | 3.4 | 3.3 | 4.0 |
| Current Account (% GDP) | 2.7 | 3.2 | 3.9 | 3.9 | 4.3 |
| Budget Balance (% GDP) | -0.9 | -3.1 | -2.3 | -2.0 | -1.2 |
| Interest Rate (%) ⁽²⁾ | 5.3 | 4.3 | 4.8 | 5.3 | 5.9 |
| Official Benchmark Rate (%) ⁽²⁾ | 5.50 | 4.00 | 4.50 | 5.00 | 5.50 |
| USD/PHP ⁽²⁾ | 47.49 | 46.00 | 44.00 | 42.50 | 42.00 |

(1) Forecast (2) End Period

Source: BNP Paribas

All interest rates are 3-month interbank, with the exception of Taiwan, where the rate is for 3-month CP.



India: Inflation Nation

■ Activity: shrugging off the monsoon

- Economic activity has continued to surprise on the upside as the recovery in the industrial sector has quickened, business confidence has firmed and exports have picked up. However, non-food bank credit, which the RBI sees as a key sign of a sustained recovery, remains sluggish.
- The disappointing monsoon represents a significant downside risk to the economy, with the drought in many regions likely to see agricultural output (17% of GDP) falling by over 2% in FY 2010. But spillover effects on the wider economy should be modest with fiscal measures supporting rural income, financial conditions still highly accommodative and liquidity ample.
- While an even larger drop in agricultural output remains a downside risk, stronger global growth and better-than-expected industrial production mean our FY 2010 and FY 2011 GDP growth forecasts have been nudged up by around 0.25 of a percentage point.

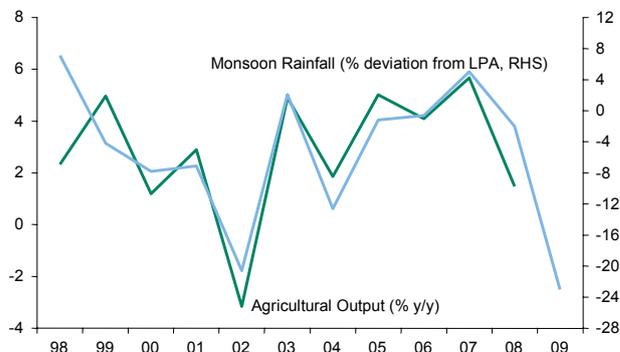
■ Inflation: food price shock

- Drought has pushed up food prices sharply. Food inflation, which accounts for 26% of the WPI, has surged to 14.5% y/y. Although core (ex-food and energy) pressures are limited, the WPI has moved rapidly out of deflation and looks on course to rise by 6.5% y/y by end-March next year – almost exactly in line with the RBI's new higher inflation forecast.
- Despite the WPI's recent bout of deflation, CPI inflation is already in double digits and risks moving higher in the short term despite a deceleration in the growth of currency in circulation, traditionally a key driver of the CPI.

■ Policy: moving towards the exit

- While inflation trends are very uncomfortable for the RBI, it sensibly recognised in its October policy review that hiking rates cannot control food prices and there is little it can do to lower inflation near term. However, an early hike could crystallise downside risks to growth and provoke an unwelcome rise in the INR at a delicate cyclical juncture for the economy.
- The RBI's policy compromise was to signal that policy tightening is now imminent by discontinuing some liquidity support programmes. The first rate hike should arrive in January and we target 125bp of rate hikes in 2010. Backsliding on fiscal consolidation could prompt more tightening.

Chart 1: Monsoon Risk



Source: Reuters EcoWin Pro, BNP Paribas

This year's disappointing monsoon, which saw rainfall 23% below normal, will dent agricultural output, which is still worth some 17% of Indian GDP.

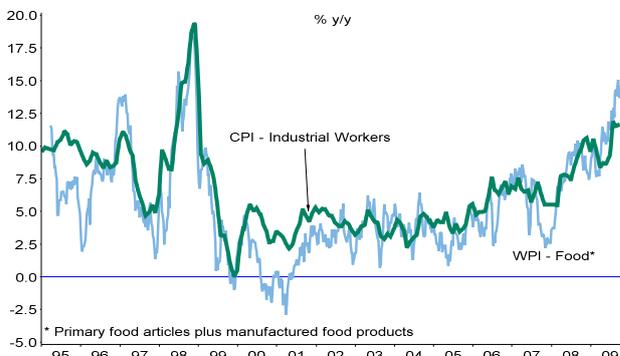
Chart 2: Industrial Revival



Source: Reuters EcoWin Pro, BNP Paribas

With fiscal measures supporting rural income, providing some offset to the impact of the drought, we have nudged up our GDP forecasts on the back of rising business confidence, a pick-up in exports and the acceleration in industrial production growth.

Chart 3: Inflation – Food Shock



Source: Reuters EcoWin Pro

The drought has inevitably seen food prices spike sharply, raising already worryingly high CPI inflation further. The RBI recognises that tighter policy can do little about food prices in the short term.



India: Economic & Financial Forecasts

| | Fiscal Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-------------------------------------|-------------|--------------------|--------------------|--------------------|--------------------|------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Components of Growth | | | | | | | | | | | | | | | | | | |
| GDP | 9.0 | 6.7 | 6.2 | 7.6 | 7.2 | 5.8 | 6.1 | 6.6 | 6.0 | 6.2 | 7.1 | 6.9 | 8.5 | 7.8 | 7.4 | 7.0 | 7.1 | |
| Final Domestic Demand | 9.3 | 6.3 | 4.7 | 8.7 | 6.8 | 6.2 | 3.3 | 4.0 | 4.1 | 7.2 | 10.8 | 8.7 | 8.3 | 7.2 | 6.0 | 7.3 | 6.9 | |
| - Private Consumption | 7.6 | 2.9 | 4.6 | 7.6 | 4.4 | 2.7 | 1.6 | 3.0 | 5.5 | 8.0 | 10.0 | 9.0 | 7.0 | 5.0 | 3.0 | 4.9 | 4.7 | |
| - Public Consumption | 7.6 | 20.2 | -1.2 | 3.0 | 3.0 | 21.5 | 10.2 | 9.0 | -12.0 | -4.0 | 2.0 | 2.0 | 4.0 | 3.5 | 3.0 | 3.0 | 3.0 | |
| - Fixed Investment | 13.1 | 8.2 | 6.9 | 12.2 | 11.9 | 6.4 | 4.2 | 4.5 | 8.0 | 10.5 | 15.0 | 10.0 | 12.0 | 12.0 | 12.0 | 12.0 | 12.0 | |
| Exports | 2.8 | 12.8 | -0.8 | 15.3 | 11.7 | -0.8 | -10.9 | -5.5 | 3.3 | 10.0 | 25.0 | 11.0 | 12.0 | 12.5 | 12.0 | 12.0 | 12.0 | |
| Imports | 7.5 | 17.9 | -6.4 | 19.5 | 9.0 | -5.7 | -21.2 | -11.5 | -4.5 | 11.5 | 45.0 | 16.0 | 13.0 | 11.0 | 9.0 | 10.0 | 9.0 | |
| Net Trade (Cont. to Growth, y/y) | -1.3 | -1.8 | 1.6 | -1.6 | 0.1 | 1.3 | 3.0 | 2.4 | 1.9 | -0.6 | -3.7 | -2.1 | -1.0 | 0.0 | 0.6 | -0.5 | 0.0 | |
| Industrial Production | 8.5 | 2.7 | 7.9 | 8.1 | 7.9 | 0.5 | 3.8 | 8.8 | 9.6 | 9.2 | 8.7 | 6.8 | 9.2 | 7.9 | 7.9 | 7.4 | 7.9 | |
| Agriculture & Allied Activities | 4.7 | 1.8 | -1.2 | 6.3 | 3.7 | 2.6 | 2.9 | -1.3 | -3.2 | -2.5 | 3.3 | 4.3 | 9.8 | 6.6 | 3.9 | 3.7 | 3.1 | |
| - Agriculture & Forestry & Fishing | 4.9 | 1.6 | -2.2 | 6.3 | 3.4 | 2.7 | 2.4 | -2.8 | -4.0 | -3.5 | 3.0 | 4.3 | 10.0 | 6.5 | 3.5 | 3.0 | 3.0 | |
| - Mining & Quarrying | 3.3 | 3.6 | 6.9 | 6.4 | 6.1 | 1.6 | 7.9 | 9.6 | 5.5 | 5.3 | 5.5 | 4.0 | 8.0 | 7.5 | 7.5 | 8.0 | 4.5 | |
| Industry | 8.5 | 3.9 | 8.0 | 8.6 | 8.5 | 1.4 | 4.8 | 8.4 | 9.5 | 9.2 | 9.2 | 7.6 | 9.5 | 8.2 | 8.5 | 7.9 | 8.7 | |
| - Manufacturing | 8.2 | 2.4 | 8.0 | 8.4 | 8.3 | -1.4 | 3.4 | 8.9 | 10.0 | 9.5 | 9.0 | 7.0 | 9.5 | 8.0 | 8.0 | 7.5 | 8.5 | |
| - Electricity, Gas & Water Supply | 5.3 | 3.4 | 8.0 | 7.4 | 6.0 | 3.6 | 6.2 | 7.4 | 9.5 | 8.7 | 8.0 | 7.0 | 7.5 | 7.0 | 7.0 | 6.5 | 5.0 | |
| - Construction | 10.1 | 7.2 | 8.0 | 9.5 | 9.8 | 6.8 | 7.1 | 7.8 | 8.5 | 8.7 | 10.0 | 9.0 | 10.0 | 9.0 | 10.0 | 9.0 | 10.0 | |
| Services | 10.9 | 9.7 | 8.0 | 7.6 | 7.7 | 8.6 | 7.8 | 8.0 | 8.3 | 7.8 | 7.4 | 7.3 | 7.6 | 7.9 | 8.0 | 7.5 | 7.9 | |
| - Trade, Hotel, Transport & Comm. | 12.4 | 9.0 | 7.8 | 7.4 | 7.9 | 6.3 | 8.1 | 8.0 | 8.0 | 7.3 | 7.0 | 7.0 | 7.5 | 8.0 | 8.5 | 7.0 | 8.0 | |
| - FIRE & Business Service | 11.7 | 7.8 | 9.2 | 9.8 | 9.8 | 9.5 | 8.1 | 8.8 | 10.0 | 9.9 | 9.5 | 10.0 | 9.5 | 10.0 | 9.0 | 10.0 | 10.0 | |
| - Community, Social & Personal Ser. | 6.8 | 13.1 | 6.9 | 5.5 | 5.1 | 12.5 | 6.8 | 7.0 | 7.0 | 6.8 | 6.0 | 5.0 | 5.6 | 5.5 | 5.5 | 5.5 | 5.5 | |
| Memo | | | | | | | | | | | | | | | | | | |
| Non-Agriculture GDP | 9.9 | 7.8 | 7.9 | 7.8 | 7.9 | 6.4 | 6.9 | 8.1 | 8.5 | 8.1 | 7.9 | 7.3 | 8.1 | 8.0 | 8.1 | 7.6 | 8.1 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Inflation | | | | | | | | | | | | | | | | | | |
| WPI | 9.1 | 1.8 | 5.2 | 3.1 | 3.7 | 3.0 | 0.5 | 0.0 | 3.8 | 6.4 | 6.0 | 4.3 | 4.2 | 4.1 | 3.2 | 2.6 | 2.6 | |
| Core WPI (ex. Food & Energy) | 8.5 | -0.2 | 4.0 | 2.0 | 3.7 | 2.5 | -1.0 | -2.2 | 0.0 | 4.2 | 4.2 | 3.9 | 3.7 | 2.6 | 2.0 | 1.7 | 1.7 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|----------------------------|--------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|---|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | |
| External Trade | | | | | | | | | | | | | | | | | | |
| Trade Balance (USD bn) | -134.1 | -74.5 | -103.9 | -121.0 | -127.5 | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Current Account (% of GDP) | -3.2 | -1.2 | -3.2 | -3.5 | -2.4 | - | - | - | - | - | - | - | - | - | - | - | - | - |

| | Fiscal Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|-----------------------------|-------------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|---|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | |
| Financial Variables | | | | | | | | | | | | | | | | | | |
| Cen. Gov. Budget (INR tn) | 1.2 | 3.1 | 3.8 | 3.7 | 3.7 | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Cen. Gov. Budget (% of GDP) | 2.7 | 6.2 | 7.0 | 6.2 | 5.5 | - | - | - | - | - | - | - | - | - | - | - | - | - |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|--|-------|--------------------|--------------------|--------------------|--------------------|-------|-------|-------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Interest and FX Rates⁽²⁾ | | | | | | | | | | | | | | | | | | |
| Repo Rate (%) | 6.50 | 4.75 | 6.00 | 7.00 | 7.50 | 5.00 | 4.75 | 4.75 | 4.75 | 5.00 | 5.50 | 6.00 | 6.00 | 6.25 | 6.50 | 6.75 | 7.00 | |
| 3-Month Rate (%) | 8.45 | 4.20 | 5.85 | 7.20 | 7.60 | 7.07 | 4.35 | 4.26 | 4.20 | 4.50 | 5.10 | 5.80 | 5.85 | 6.20 | 6.55 | 6.85 | 7.20 | |
| USD/INR | 48.58 | 46.00 | 42.00 | 38.00 | 38.00 | 50.56 | 47.74 | 47.72 | 46.00 | 45.00 | 44.00 | 43.00 | 42.00 | 41.00 | 40.00 | 39.00 | 38.00 | |

Footnotes: (1) Forecast (2) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



South Korea: Red Hot

■ Activity: blistering growth extends into 2010

- GDP growth ran at a blistering double-digit annualised pace in Q2 and Q3. The recovery was initially driven by the fiscal stimulus, which spurred brisk government and construction spending. Consumer demand, and machinery and equipment spending have now taken over, helped by buoyant asset prices and increasing falls in industrial spare capacity.
- Powered primarily by a rebound in tech goods, industrial production now exceeds its pre-crisis level. Further gains are likely as the inventory cycle turns in earnest and exports continue to revive as global industrial demand picks up and the KRW remains highly competitive.
- Risks to growth are skewed to the upside in the short term. In particular, stocks remain unusually lean relative to rebounding sales and could easily add around 4 percentage points to GDP growth in the next few quarters.
- The growth momentum will inevitably fade in 2010 as the boost from inventories levels off. But policy settings will remain supportive. We have once again revised up our GDP growth forecasts to 0.4% in 2009 (from 0%) and 5.4% in 2010 (from 4.6%).

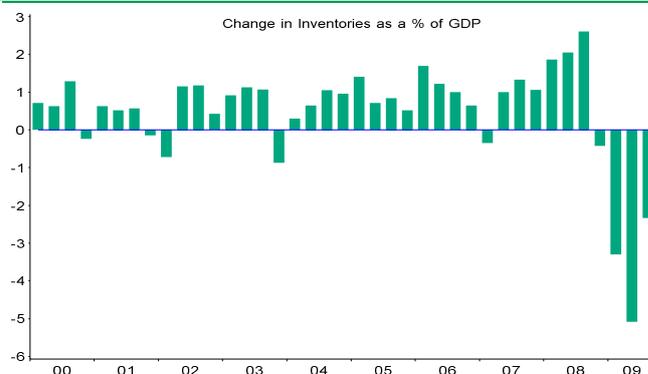
■ Inflation: well contained

- Inflation is currently well below its 3% target on both a headline and a US-style 'core' basis. But medium-term inflation risks are building. The low level of unemployment and the fact that the manufacturing sector's operating ratio is normalising suggest that slack in the economy is limited. We expect the output gap to turn positive by Q1 2010, implying steady upward pressure on core inflation.
- However, econometric evidence suggests that the trade-weighted KRW accounts for around 60% of the variance in inflation on a three-year horizon. KRW appreciation should therefore largely cap any building up of domestic price pressures.

■ Policy: normalisation required

- The inflation outlook suggests there is no pressing need to tighten policy but, at 2%, the policy rate is simply too low and set for an emergency that has long passed. The Bank of Korea is accordingly expected to follow the RBA's lead and progressively normalise the level of interest rates. We target 150bp of rate hikes by end-2010 with the first move now likely to arrive early next year. Fiscal policy is set to remain supportive to growth.

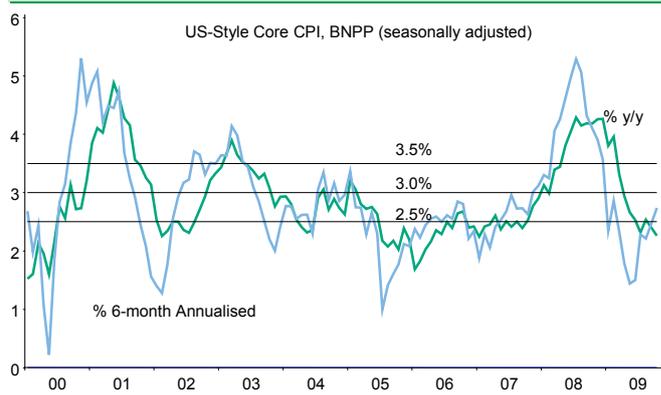
Chart 1: Taking Stock



Source: Reuters EcoWin Pro, BNP Paribas

With inventories still falling by some 2.3% of GDP in Q3, the inventory cycle will skew risks to industrial production and GDP to the upside for the next few quarters.

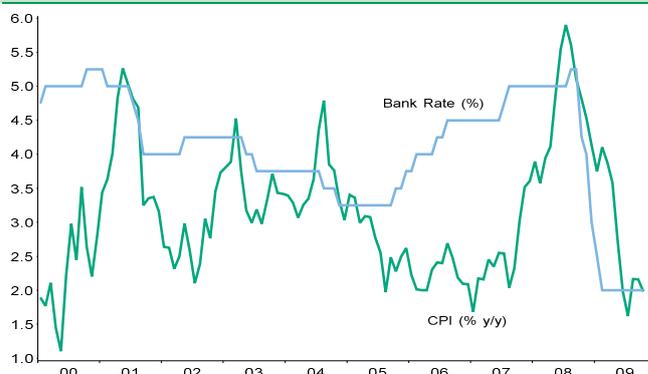
Chart 2: Core Inflation Contained



Source: Reuters EcoWin Pro, BNP Paribas

Our bespoke US-style measure of core inflation remains well below target. KRW appreciation should cap pressures from a positive output gap next year.

Chart 3: Rates Too Low



Source: Reuters EcoWin Pro, BNP Paribas

At 2%, policy rates are close to zero in real terms and are set for an emergency that has long passed. The longer rates are kept abnormally low, the greater the risks to medium-term stability.



South Korea: Economic & Financial Forecasts

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|----------------------------------|------|--------------------|--------------------|--------------------|--------------------|-------|-------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Components of Growth | | | | | | | | | | | | | | | | | | |
| GDP (% q/q) | - | - | - | - | - | 0.1 | 2.6 | 2.9 | 2.0 | 0.8 | 0.6 | 0.6 | 0.6 | 1.0 | 0.9 | 0.8 | 0.8 | |
| GDP | 2.3 | 0.4 | 5.4 | 3.3 | 4.0 | -4.4 | -2.3 | 0.5 | 8.0 | 8.7 | 6.5 | 4.0 | 2.7 | 2.8 | 3.2 | 3.4 | 3.6 | |
| Domestic Demand ex. Stocks | 0.6 | 0.5 | 2.8 | 2.8 | 3.2 | -3.5 | -0.4 | 0.4 | 5.5 | 5.3 | 2.2 | 1.7 | 1.9 | 2.3 | 2.8 | 3.0 | 3.2 | |
| Private Consumption | 0.9 | 0.3 | 3.0 | 3.8 | 3.5 | -4.4 | -0.8 | 0.6 | 5.8 | 5.8 | 2.5 | 1.6 | 2.2 | 3.0 | 3.6 | 4.2 | 4.3 | |
| Public Consumption | 4.2 | 5.7 | 0.2 | 1.3 | 2.0 | 7.4 | 7.0 | 5.0 | 0.0 | 0.2 | -0.6 | 0.4 | 0.9 | 1.1 | 1.3 | 1.4 | 1.4 | |
| Fixed Investment | 1.5 | -3.9 | 6.2 | 3.0 | 3.4 | -7.5 | -3.4 | -2.2 | 5.8 | 7.5 | 3.3 | 2.7 | 1.8 | 1.5 | 1.9 | 1.7 | 2.1 | |
| Stocks (Cont. to Growth, y/y) | 0.8 | -4.2 | 3.1 | 0.1 | 0.0 | -5.0 | -6.9 | -4.9 | 0.4 | 3.5 | 5.5 | 2.9 | 0.6 | 0.4 | 0.2 | 0.0 | 0.0 | |
| Exports | 5.7 | -0.4 | 12.1 | 9.6 | 11.8 | -10.8 | -3.7 | 0.9 | 13.0 | 20.7 | 11.2 | 8.8 | 9.1 | 9.4 | 9.6 | 9.7 | 9.5 | |
| Imports | 3.7 | -8.0 | 14.9 | 9.9 | 11.5 | -18.2 | -13.6 | -8.7 | 10.7 | 23.3 | 16.2 | 11.6 | 9.9 | 10.3 | 10.1 | 9.8 | 9.6 | |
| Net Trade (Cont. to Growth, y/y) | 1.0 | 3.1 | -0.1 | 0.5 | 1.0 | 2.6 | 4.1 | 4.2 | 1.7 | 0.5 | -0.9 | -0.4 | 0.3 | 0.3 | 0.5 | 0.6 | 0.6 | |
| Industrial Production | 3.0 | -0.5 | 11.7 | 3.2 | 4.7 | -15.9 | -6.4 | 2.3 | 20.7 | 25.7 | 13.6 | 6.7 | 3.4 | 3.0 | 3.1 | 3.2 | 3.4 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|------------------------------|------|--------------------|--------------------|--------------------|--------------------|------|-----|-----|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Inflation | | | | | | | | | | | | | | | | | | |
| CPI | 4.7 | 2.8 | 3.0 | 3.0 | 2.6 | 3.9 | 2.7 | 2.0 | 2.5 | 2.8 | 2.8 | 3.1 | 3.2 | 3.1 | 3.0 | 2.9 | 3.0 | |
| Core CPI (ex. Food & Energy) | 3.9 | 2.8 | 3.0 | 3.1 | 2.8 | 3.7 | 2.7 | 2.4 | 2.2 | 2.6 | 3.1 | 3.1 | 3.2 | 3.1 | 3.1 | 3.1 | 3.1 | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|----------------------------|-------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | |
| External Trade | | | | | | | | | | | | | | | | | | |
| Trade Balance (USD bn) | -14.3 | 38.6 | 23.5 | 21.1 | 25.9 | - | - | - | - | - | - | - | - | - | - | - | - | |
| Current Account (% of GDP) | -0.7 | 4.8 | 1.8 | 1.3 | 1.7 | - | - | - | - | - | - | - | - | - | - | - | - | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|----------------------------|------|--------------------|--------------------|--------------------|--------------------|------|----|----|----|------|----|----|----|------|----|----|----|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | |
| Financial Variables | | | | | | | | | | | | | | | | | | |
| Gen. Gov. Budget (KRW trn) | 11.9 | -47.3 | -30.5 | -23.8 | -12.7 | - | - | - | - | - | - | - | - | - | - | - | - | |
| Gen. Gov. Budget (% GDP) | 1.2 | -4.5 | -2.7 | -2.0 | -1.0 | - | - | - | - | - | - | - | - | - | - | - | - | |

| | Year | | | | | 2009 | | | | 2010 | | | | 2011 | | | | |
|--|------|--------------------|--------------------|--------------------|--------------------|------|------|------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | Q1 | Q2 | Q3 | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | Q1 ⁽¹⁾ | Q2 ⁽¹⁾ | Q3 ⁽¹⁾ | Q4 ⁽¹⁾ | |
| Interest and FX Rates⁽²⁾ | | | | | | | | | | | | | | | | | | |
| 7-Day Repo Rate (%) | 3.00 | 2.25 | 3.50 | 4.00 | 5.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.50 | 3.00 | 3.50 | 3.50 | 3.50 | 3.50 | 3.75 | 4.00 | |
| 3-Month Rate (%) | 3.93 | 2.95 | 4.00 | 4.40 | 5.45 | 2.43 | 2.41 | 2.75 | 2.90 | 3.30 | 3.50 | 3.90 | 4.00 | 4.00 | 4.10 | 4.25 | 4.40 | |
| USD/KRW | 1262 | 1150 | 1050 | 1000 | 1000 | 1372 | 1273 | 1175 | 1150 | 1120 | 1090 | 1070 | 1050 | 1030 | 1020 | 1010 | 1000 | |

Footnotes: (1) Forecast (2) End period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas



Canada: Outperforming

■ **Activity: credit growth should support domestic demand, but the economy remains vulnerable to weakness in US economic activity**

- While its large export sector implies that Canada remains inexorably tied to developments in the US, conditions in the Canadian economy continue to improve and the outlook appears brighter than south of the 49th parallel.
- What distinguishes Canada from most other advanced economies is that Canadian consumers can still readily obtain credit.
- In addition, the Canadian housing market is rebounding. The pick-up in house prices should support consumer confidence.
- Labour market indicators appear mixed. Employment has been volatile in recent months, but the underlying momentum is trending upwards. In spite of this, private sector, full-time jobs remain elusive. Indeed, the recent pick-up in employment has been largely driven by higher self-employment, hiring in the public sector and increases in part-time positions.
- While domestic fundamentals have improved more rapidly than in the US, around one-third of the Canadian economy remains painfully exposed to still-sluggish US demand and CAD strength.

■ **Inflation: risks are skewed to the downside**

- The pick-up in house prices is expected to exert upward pressures on CPI shelter costs. However, the lagged effect of the Canadian dollar's appreciation will depress core goods prices.
- Further expected increases in unemployment suggest that wage pressures will ease well into 2010, capping upward pressures in service prices.
- On balance, risks to inflation appear skewed to the downside, due to the large amount of excess capacity.
- We expect core inflation to move below the Bank of Canada's inflation target range of 1% to 3% by late 2010.

■ **Policy: monetary policy on hold**

- Given weak inflation prospects, we expect the Bank of Canada to extend the horizon of its "conditional commitment" to leave interest rates unchanged at 0.25% until the first half of 2011, well beyond the current pledge to leave rates unchanged "until the end of Q2 2010".

Canada: Economic Forecasts

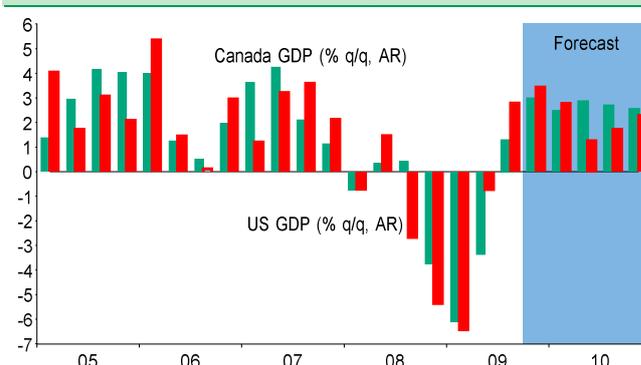
| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|---|------|---------------------|---------------------|---------------------|---------------------|
| Components of Growth | | | | | |
| Total GDP | 0.4 | -2.5 | 2.1 | 2.9 | 3.2 |
| Dom. Demand ex Stocks | 2.6 | -1.8 | 2.3 | 3.0 | 3.3 |
| Private Consumption | 3.0 | 0.0 | 2.4 | 2.7 | 3.1 |
| Public Consumption | 4.8 | 3.9 | 5.9 | 3.5 | 2.2 |
| Fixed Investment | -0.8 | -13.9 | -3.2 | 3.5 | 5.5 |
| Stocks (Cont. to Growth) | -0.2 | -1.0 | 0.5 | 0.1 | 0.0 |
| Exports | -4.7 | -14.2 | 3.9 | 5.6 | 5.8 |
| Imports | 0.8 | -15.4 | 5.2 | 5.9 | 5.5 |
| Industrial Production | -5.3 | -12.0 | 2.9 | 3.6 | 4.0 |
| Savings Ratio (%) | 3.7 | 4.8 | 5.7 | 5.1 | 3.8 |
| Inflation | | | | | |
| CPI | 2.4 | 0.3 | 1.5 | 1.4 | 1.2 |
| Core | 1.7 | 1.7 | 1.4 | 1.2 | 1.2 |
| Unemployment Rate (%) | 6.2 | 8.3 | 9.2 | 8.7 | 7.6 |
| External Trade | | | | | |
| Trade Balance (CAD bn) | 24.4 | -30.3 | -35.8 | -38.8 | -40.5 |
| Current Account (CAD bn) | 8.1 | -45.0 | -52.0 | -55.0 | -56.7 |
| Current Account (% GDP) | 0.5 | -2.9 | -3.3 | -3.3 | -3.3 |
| Financial Variables | | | | | |
| Gen Gov Budget (CAD bn) | -2.3 | -27.4 | -26.6 | -24.4 | -18.2 |
| Gen Gov Budget (% GDP) | -0.1 | -1.8 | -1.6 | -1.5 | -1.0 |
| Interest & FX Rates ⁽²⁾ | | | | | |
| Call Rate (%) | 1.50 | 0.25 | 0.25 | 1.25 | 3.00 |
| 10-Year Bond Yield (%) | 2.69 | 3.30 | 3.80 | 4.95 | 5.50 |
| USD/CAD | 1.22 | 1.03 | 1.15 | 1.04 | 1.09 |

Footnotes: (1) Forecast (2) End Period

Figures are year-on-year percentage changes unless otherwise indicated

Source: BNP Paribas

Chart 1: Canada Should Outperform the US in 2010



Source: Reuters EcoWin Pro, BNP Paribas

Ongoing growth in consumer credit, brighter prospects in the labour market and a rebound in the housing market suggest that Canadian GDP growth will outpace the rise in US GDP next year.



Brazil: Great Moderation

■ Activity: where are the engines of growth?

- The long-term outlook for Brazil is benign. The global crisis's limited damage to local balance sheets and the country's strong balance of payments will encourage the flow of global savings into Brazil's markets. The hosting of the World Cup in 2014 and the Olympics in 2016 are just two examples of the plentiful investment opportunities that will be available. However, there are growth headwinds to be managed in the short term.
- Exports, especially of manufactured goods, continue to underperform. Against this backdrop, employment conditions in the manufacturing sector remain weak. Total wage growth continues to moderate, limiting the upside of consumption. Meanwhile, fixed investment in 2010 will be limited by the amount of spare capacity there is in the economy, postponing more robust growth in investment until 2011.

■ Inflation: balance of risks remains benign

- The low utilisation of resources, strong exchange rate, well-anchored inflation expectations and reduction in backward-looking price setting will keep the inflation rate below the 4.5% official target next year.
- For 2011, based on our scenario of limited pressure on resource utilisation next year (we see the unemployment rate running in the 8% area in 2010, containing wages), we expect the inflation rate, which lags output, to remain anchored in the 4.0% y/y area.

■ Policy: keeping the monetary stimuli

- Although the growth outlook for 2010 is not super bullish, we see little room for a further fiscal stimulus. One reason for this is the 2010 budget's target of an effective primary surplus of 2.4% of GDP, topping the 2% estimated for 2009. A more informal constraint is the debt dynamic. The reduction of the primary surplus has helped to put upward pressure on the debt-to-GDP ratio, bringing it back on to the market's radar screen. The public sector is highly exposed to the weak USD (we estimate the net exposure at USD 170bn, resulting in a 0.1% increase in the debt-to-GDP ratio for each 1% fall of the USD). We therefore see a lack of room for manoeuvre on the fiscal side, as we expect the USD to remain weak against the BRL.
- In light of the headwinds for economic growth in 2010 and limited room for additional fiscal stimuli, we expect the CB to keep monetary policy loose (i.e. no rate hikes next year).

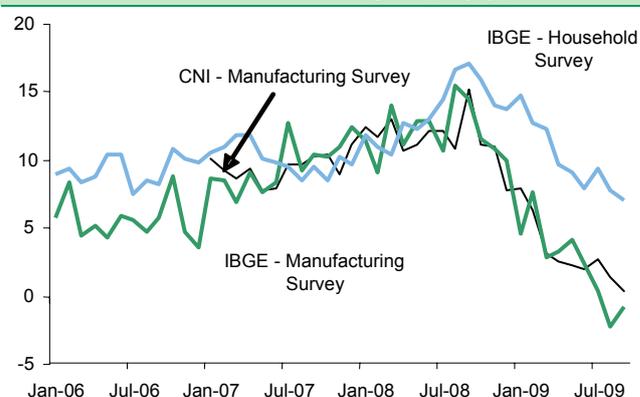
Brazil: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|----------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| Real GDP (% y/y) | 5.1 | 0.0 | 4.1 | 4.6 | 5.2 |
| CPI (% y/y) | 5.9 | 4.3 | 4.0 | 4.0 | 4.5 |
| Trade Balance (USD bn) | 24.7 | 25.3 | 18.0 | 15.1 | 13.6 |
| Current Account (USD bn) | -28.3 | -23.6 | -37.9 | -43.8 | -52.0 |
| Current Account (% GDP) | -1.8 | -1.5 | -2.0 | -2.2 | -2.4 |
| Budget Balance (% GDP) | -2.0 | -3.9 | -2.4 | -2.0 | -2.4 |
| Interest Rate (%) ⁽²⁾ | 13.75 | 8.75 | 8.75 | 9.75 | 10.75 |
| USD/BRL ⁽²⁾ | 2.31 | 1.70 | 1.75 | 1.85 | 1.90 |

(1) Forecast (2) End Period

Source: BNP Paribas

Chart 1: Total Wages (% y/y)



Source: IBGE / CNI

Total wage growth continues to moderate, mainly due to the weakness of the manufacturing sector, which is facing fierce competition from foreign producers. This will limit the pace of recovery in consumption in 2010.

Chart 2: Brazilian Financial and Monetary Conditions Index



Source: BCB

The lack of fiscal room to provide further economic stimuli will force the CB to maintain loose monetary conditions in 2010. We do not see room for monetary tightening next year in light of the headwinds that are hitting exports, consumption and investment.



Mexico: Licking its Structural Wounds

■ Activity: recovery driven by industrial sector

- The economy troughed in Q2 2009 and is now recovering, albeit at a tentative pace. The industrial sector appears to be climbing from its lows, helped by an auto sector that benefited from the US cash-for-clunkers programme and the relocation of North American production to Mexico.
- Leading indicators of activity as well as business surveys – both in the US and locally – point to a recovery in industry, especially with inventory rebuilding due to kick in in earnest in coming months. But the performance of the service sector, which is much more dependent on domestic demand, is less certain.
- The service sector suffered a larger decline than expected during the crisis due to the dependence of some sectors on a domestic oil industry in marked decline. The service sector was also undermined by the weakness of consumption, brought about by the surge in unemployment, the fall in real wages and a sharp fall in the availability of credit. Consumer confidence is currently at a record low.
- We still think the economy is set for a significant bounce in 2010, largely due to developments in the industrial sector. However, we recognise that, as in the US, the recovery will be fragile.

■ Inflation: tax-induced acceleration ahead

- Inflation continues on its gradual downward trek. Although both headline and core inflation remain above the CB's 3% +/-1% target, the large output gap is starting to weigh not just on services but also on merchandise goods, which until recently had experienced rising inflation due to the peso's sharp depreciation.
- In 2010, a combination of public sector tariff adjustments and higher indirect taxes will boost inflation. But we see this as a one-off effect with few second-round consequences for inflation.

■ Policy: economic weakness should preclude rate hikes

- We do not think that the CB should react to the tax-induced acceleration in inflation in 2010. Rather, the weakness in domestic demand warrants unchanged monetary policy next year, contrary to the 100bp of hikes priced in by the market.
- After much haggling, Congress approved a tax reform worth about 1.1% of GDP to compensate for the effects of falling oil production. While not

Mexico: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|----------------------------------|-------|---------------------|---------------------|---------------------|---------------------|
| Real GDP (% y/y) | 1.3 | -6.5 | 4.0 | 3.2 | 2.8 |
| CPI (% y/y) | 6.5 | 3.9 | 3.9 | 3.2 | 3.6 |
| Trade Balance (USD bn) | -17.3 | -11.9 | -16.5 | -19.5 | -23.8 |
| Current Account (USD bn) | -15.8 | -11.1 | -14.7 | -19.3 | -24.9 |
| Current Account (% GDP) | -1.8 | -1.2 | -1.5 | -1.8 | -2.2 |
| Budget Balance (% GDP) | -0.1 | -0.2 | -0.8 | -1.2 | -0.9 |
| Interest Rate (%) ⁽²⁾ | 8.3 | 4.5 | 4.5 | 6.0 | 6.0 |
| USD/MXN ⁽²⁾ | 13.65 | 12.75 | 12.50 | 12.50 | 12.00 |

(1) Forecast (2) End Period

Source: BNP Paribas

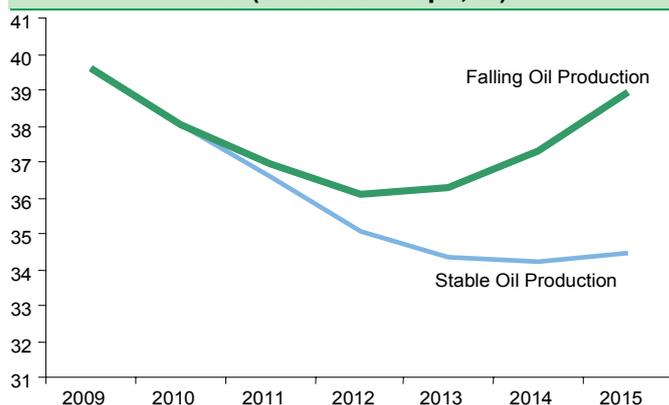
Chart 1: Manufacturing vs. US ISM Manufacturing (%)



Source: Reuters EcoWin Pro

The US ISM points to an unequivocal recovery in Mexican manufacturing.

Chart 2: Approved Reform Public Debt-to-GDP Ratio (Oil at USD 75pb, %)



Source: BNP Paribas

The government may have underestimated oil prices in its tax reform. Assuming USD 75pb for Mexican crude instead of USD 60pb, the public debt-to-GDP ratio may not balloon even under falling oil production. The rating agencies may object to the quality of the reform, though.

perfect, it was still a respectable effort in the midst of Mexico's worst recession for thirty years. At the time of writing, however, it is unclear whether the reform is enough to placate the rating agencies with their threats of downgrades.



Other Latam: Growth Re-Emerging

■ Argentina: back in the game?

- A global pick-up in economic activity, increased risk appetite and the government's willingness to address its creditor hold-out situation have all improved sentiment in the economy.
- Underlying problems remain, however. The statistical agency continues to under-report inflation and, by extension, to overestimate real economic growth. In addition, the government's fiscal accounts remain structurally weak, with spending growth substantially outpacing the rise in revenue. With the primary budget surplus disappearing, regaining access to markets for funding remains a must.
- But that is just what the government is working on. And in a world flush with liquidity and searching for yield, Argentina – for all its faults – now looks a better bet than in the past. No wonder private capital flows have turned positive, halting the peso's slide and allowing the CB to rebuild international reserves once more.

■ Chile: all growth engines on

- The economy is showing unequivocal signs of recovery, led by a surge in mining and, to a lesser extent, industry. The service sector remains more sluggish, but the increased willingness of retailers to extend consumer credit supports the government's rosy picture for the economy.
- From a demand standpoint, we could see growth bolstered by a recovery in inventories, which took an unusually large hit in the downturn. We think part of this process is explained by China's unprecedented build-up in copper stocks, which is only now being met by higher mining production.
- Our bullish outlook on growth is also based on the large, Asian-style policy stimulus, both fiscal and monetary, put in place by the authorities. While the authorities will start to normalise fiscal and monetary policy in 2010, we expect policy to remain expansionary through 2011.
- On the monetary front, the CB has started to phase out its short-term liquidity facility and has indicated that it expects to start hiking rates in Q2 2010. However, it has also indicated that the market is pricing in too many rate hikes in H2 2010. This denotes some understandable nervousness on the part of the authorities about inflation's ability to return to target. We think that pressure on both food and energy prices, added to a narrowing in the output gap, should lead to a rise in inflation.

■ Colombia: robust but challenged

- The Colombian economy has shown signs of both strength and weakness during the crisis.
- In terms of strengths, the economy has again demonstrated its ability to avoid a large drop in economic activity. In this cycle, Colombia has particularly benefited from ongoing investment in the mining sector, which has also maintained FDI at a remarkably high level. Government spending on infrastructure has also helped.
- In terms of weaknesses, the growing diplomatic and commercial rift with Venezuela will knock as much as a percentage point off GDP this year. Moreover, despite the CB's loose monetary stance, M3 growth is decelerating sharply. And the government's fiscal deficit is again approaching 5% of GDP.
- After pausing in the summer, the CB cut interest rates once more in September and announced a permanent injection of liquidity of COP 3trn (USD 1.5bn) in October, through the purchases of both Treasury securities and the USD. We think a further peso appreciation would be met with increased FX intervention.
- There is little pricing power in the economy at the moment. However, el Niño is expected to put upward pressure on inflation in H1 2010.

■ Venezuela: trouble ahead

- Watch what the authorities do, not what they say. And what they are doing right now suggests that the government's fiscal constraints are increasingly binding, and that a devaluation may be on the cards.
- The Chávez administration has expressed its desire to reduce the gap between the official and the parallel exchange rate by acting on the latter as a means to reduce inflationary pressures from imports. Over the past two months, the government and PDVSA have issued a combined USD 8bn in dollar-denominated debt locally, and a further USD 3bn is planned shortly. These issues allow the private sector to obtain dollars and provide cheaper financing for the government.
- But this policy has its limits, namely the external market's appetite to buy this much debt. The government has also loosened CB regulations to allow more direct financing of public sector entities. The recent electricity shortages have been met with rationing rather than increased spending.
- These actions all suggest fiscal problems and the risk of a corrective devaluation ahead.



Argentina: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|----------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| Real GDP (% y/y) | 8.8 | -1.8 | 3.2 | 4.0 | 3.5 |
| CPI (% y/y) | 7.2 | 6.9 | 14.2 | 10.5 | 7.8 |
| Trade Balance (USD bn) | 13.1 | 15.8 | 14.4 | 12.7 | 9.2 |
| Current Account (USD bn) | 7.1 | 8.2 | 5.3 | 2.3 | -3.1 |
| Current Account (% GDP) | 2.4 | 3.1 | 2.0 | 0.9 | -1.1 |
| Budget Balance (% GDP) | 1.3 | -1.3 | -0.8 | 0.4 | 0.2 |
| Interest Rate (%) ⁽²⁾ | 19.8 | 12.0 | 14.0 | 14.0 | 16.0 |
| USD/ARS ⁽²⁾ | 3.45 | 3.80 | 4.20 | 4.50 | 4.90 |

(1) Forecast (2) End Period

Source: BNP Paribas

Chile: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|----------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| Real GDP (% y/y) | 3.2 | -1.6 | 5.5 | 4.4 | 5.3 |
| CPI (% y/y) | 7.1 | -0.9 | 2.6 | 3.5 | 3.6 |
| Trade Balance (USD bn) | 8.8 | 13.6 | 17.4 | 18.4 | 18.4 |
| Current Account (USD bn) | -3.4 | 1.1 | -0.4 | -0.6 | -1.4 |
| Current Account (% GDP) | -2.0 | 0.7 | -0.3 | -0.3 | -0.7 |
| Budget Balance (% GDP) | 5.2 | -4.3 | 0.4 | 0.8 | 1.3 |
| Interest Rate (%) ⁽²⁾ | 8.25 | 0.50 | 2.50 | 5.00 | 5.00 |
| USD/CLP ⁽²⁾ | 636 | 500 | 530 | 535 | 545 |

(1) Forecast (2) End Period

Source: BNP Paribas

Colombia: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|----------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| Real GDP (% y/y) | 2.4 | -0.8 | 2.4 | 4.3 | 4.0 |
| CPI (% y/y) | 7.7 | 2.4 | 3.6 | 3.9 | 4.2 |
| Trade Balance (USD bn) | 0.5 | -0.1 | -3.2 | -3.2 | -2.8 |
| Current Account (USD bn) | -6.9 | -5.8 | -10.0 | -10.2 | -9.6 |
| Current Account (% GDP) | -2.9 | -2.5 | -3.7 | -3.8 | -3.6 |
| Budget Balance (% GDP) | 0.9 | -2.4 | -4.4 | -3.1 | -3.3 |
| Interest Rate (%) ⁽²⁾ | 9.5 | 4.0 | 4.5 | 6.0 | 6.0 |
| USD/COP ⁽²⁾ | 2246 | 1900 | 2000 | 2100 | 2200 |

(1) Forecast (2) End Period

Source: BNP Paribas

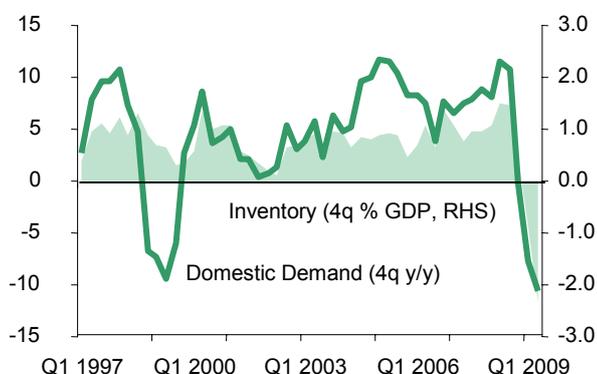
Venezuela: Economic Forecasts

| | 2008 | 2009 ⁽¹⁾ | 2010 ⁽¹⁾ | 2011 ⁽¹⁾ | 2012 ⁽¹⁾ |
|----------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| Real GDP (% y/y) | 4.8 | -1.2 | -2.0 | -1.0 | 1.4 |
| CPI (% y/y) | 30.9 | 27.0 | 33.1 | 40.9 | 38.5 |
| Trade Balance (USD bn) | 45.4 | 10.1 | 20.5 | 25.0 | 21.5 |
| Current Account (USD bn) | 39.2 | 2.3 | 11.2 | 13.7 | 9.2 |
| Current Account (% GDP) | 11.3 | 0.7 | 4.6 | 7.2 | 6.2 |
| Budget Balance (% GDP) | -2.5 | -5.0 | -5.0 | -5.0 | -5.0 |
| Interest Rate (%) ⁽²⁾ | 19.8 | 12.0 | 14.0 | 14.0 | 16.0 |
| USD/VEF ⁽²⁾ | 2.14 | 2.14 | 3.00 | 3.90 | 5.07 |

(1) Forecast (2) End Period

Source: BNP Paribas

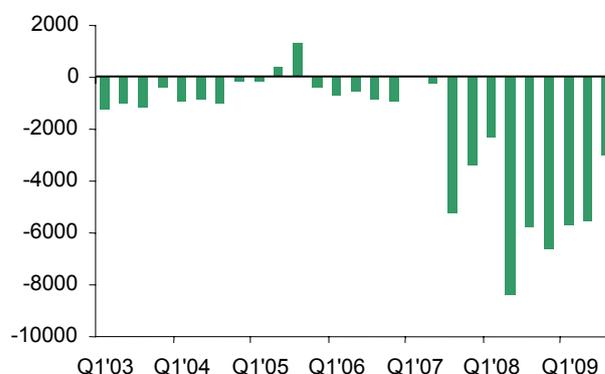
Chile: Domestic Demand Growth v. Inventory (%)



Source: BNP Paribas

Chile's plunge in domestic demand during the crisis was largely explained by a sharp correction in inventories, one that should now start to reverse. We think China's stockpiling of copper may have had something to do with this.

Argentina: Net Private Capital Flows (USD mn)



Source: BNP Paribas

With risk appetite improving globally and the government making the right noises on debt restructuring, private capital is flowing back into Argentina and net capital flows may have turned positive in August. This is allowing the peso to stabilise and the CB to rebuild reserves, while bank deposits are growing and local interest rates are falling.



Oil: Inflated Asset

Oil crosses USD 80/bbl as USD weakens

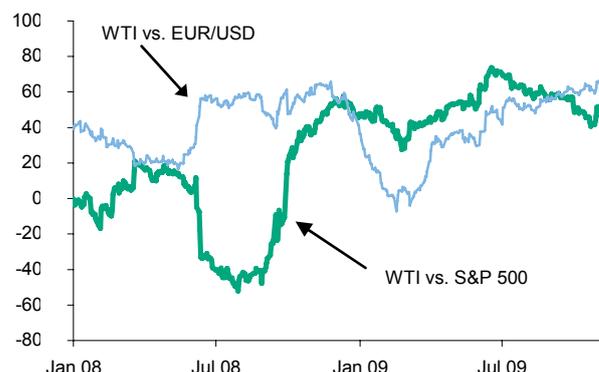
- Oil prices have trended higher although the market fundamentals have shown few signs of tightening. Oil stocks remain high on a volume and demand cover basis. On a year-on-year basis, the growth in oil demand for the end of 2009 and in 2010 is now expected to be higher in emerging markets such as China and the Middle East. However, supply growth outside the OPEC cartel has also seen its performance revised upwards, at least through Q1'10 –specifically in Russia, which has been hitting new post-Soviet Union highs in production. Similarly, the US Gulf of Mexico, in the absence of a hurricane season this year, has seen supply recover quickly from 2008. At the same time, OPEC's resolve about stated supply cuts has weakened since a peak in compliance at the end of Q1'09. Still, NYMEX WTI has firmed, closing at USD 81.37/bbl on 21 October, easing to around USD 79/bbl at the time of writing.
- Risk appetite resumed after successful stress tests of US banks and as volatility metrics such as the VIX for equities declined. The US is the biggest foreign equity investor globally and cheap funding in USD has created a catch-22 situation whereby the quest for higher yield or returns outside the US has left the USD to weaken. With oil trading correlated inversely with the USD and positively with equities, buying interest in oil – as in other commodities – has risen.
- As the USD is the currency of international settlements, its use in carry trades will have a greater effect on USD-denominated assets than the JPY did when it was used in carry trades. At the same time, with low nominal interest rates and rising longer-term inflation expectations, either because of liquidity conditions or concerns about high levels of sovereign debt, weaker real interest rates are likely in the future. This makes oil, gold or equities attractive alternatives for unleveraged cash to move into. As for oil specifically, floating storage has kept excess supply off the market, allowing oil to trade more like an investment than a consumption asset.
- With ongoing USD weakness and low interest rates, we revise our average Q4'09 view to USD 77/bbl from USD 66/bbl. This has a limited impact on our 2009 forecast average, which is now at USD 62/bbl versus USD 59/bbl previously. We continue to see a correction, given the high level of stocks, a firming USD in Q1'10, a moderation in the pace of economic recovery in the advanced economies, and a weaker OPEC

Table 1: BNP Paribas Crude Oil Price Forecast

| | WTI | Brent ⁽¹⁾ |
|----------------------|-------|----------------------|
| Q1 09 ⁽²⁾ | 43.31 | 45.72 |
| Q2 09 ⁽²⁾ | 59.79 | 59.90 |
| Q3 09 ⁽²⁾ | 68.24 | 68.87 |
| Q4 09 | 77.00 | 75.00 |
| Q1 10 | 73.00 | 73.00 |
| Q2 10 | 78.00 | 79.00 |
| Q3 10 | 81.00 | 80.00 |
| Q4 10 | 90.00 | 90.00 |
| 2008 ⁽²⁾ | 99.75 | 98.52 |
| 2009 | 62.00 | 62.00 |
| 2010 | 81.00 | 81.00 |
| 2011 | 91.00 | 91.00 |

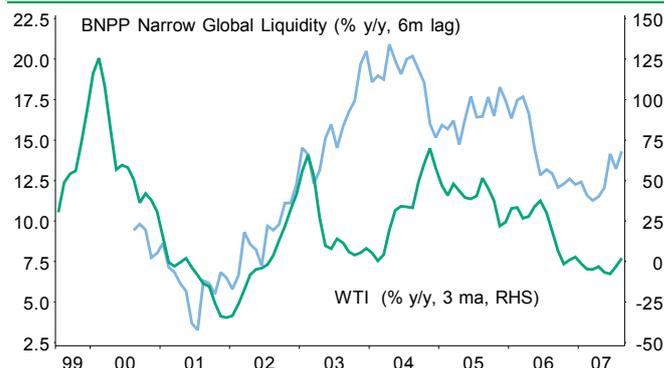
Source: BNP Paribas ⁽¹⁾Brent is derived from an assumed spread. 2011 is based on the forward curve spreads at the time of issue. ⁽²⁾Actual values

Chart 1: Cross-Asset Correlation Holding (%)



Source: Bloomberg, BNP Paribas. Correlation in daily returns, 60 days.

Chart 2: Liquidity and Oil Prices



Source: Reuters EcoWin Pro, BNP Paribas

commitment to stated supply cuts. Oil will most likely trade within a wide band over the next six months, checked on the upside by bearish short-term fundamentals, but finding support above a fundamental equilibrium level as liquidity remains plentiful. We still see a strong second half for 2010, particularly given prospects for stronger growth in oil demand from Q3 onwards. We



expect oil to average USD 81/bbl in 2010 versus USD 78/bbl in our previous view.

■ **Liquidity trumps fundamentals**

- In March, the Fed shifted its policy focus from the cost of money to its quantity, in order to shore up asset values due to concerns about deflation. The rise in oil prices has gone hand in hand with an increase in equity prices. While unconventional monetary policy measures will unwind, interest in USD funded carry trades will remain high and/or un-leveraged cash will seek a home as long as policy interest rates stay near zero. The FOMC statement for October maintains that rates will remain "exceptionally low" and for an "extended period". This situation suggests that retrenchments in the oil price will be capped in magnitude and/or duration. There is still cash on the sidelines and volatility remains relatively contained.

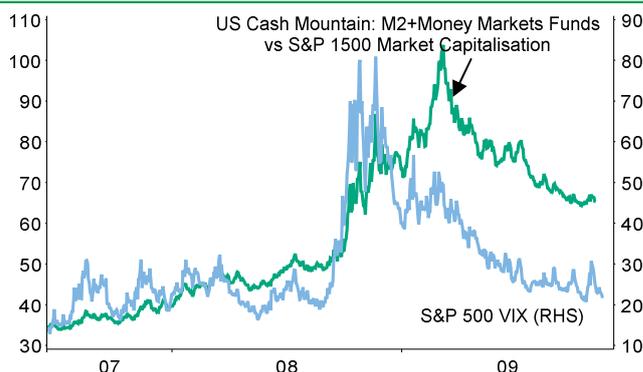
■ **Oil fundamentals improving in 2010**

- Cyclical indicators have firmed across the globe as manufacturing has rebounded more strongly than expected from an earlier undershoot relative to GDP. While industrial production may see large sequential percentage gains, private consumption, labour markets and broken credit channels still give cause for concern about the sustainability of the pace of recovery in advanced economies. This leaves emerging markets to drive growth in oil demand. Asian economies have indeed rebounded faster than expected, notably China due to a massive fiscal and monetary stimulus. However, extending de-coupling arguments to all emerging markets seems premature.
- In 2009, oil demand is expected to contract by approximately 2mn b/d in the OECD while non-OECD countries see growth of 600k b/d. In 2010, OECD demand growth is expected to be flat or even declining, leaving emerging markets to account for all the 1.2 mb/d or more growth in world oil demand. While our fundamental balance (Chart 4) improves in 2010, notably from Q3 onwards, in the short term the distillate market is unlikely to support crude prices (as it did in winter 2007-08) given a large overhang in stocks. The inventory wall in crude is also sizeable, largely due to depressed utilisation rates in refining. Equally, spare production capacity in OPEC is above 6mn b/d, which may be augmented over the course of 2010 from the return of long idled capacity in Nigeria.

■ **Not losing sight of a potential correction**

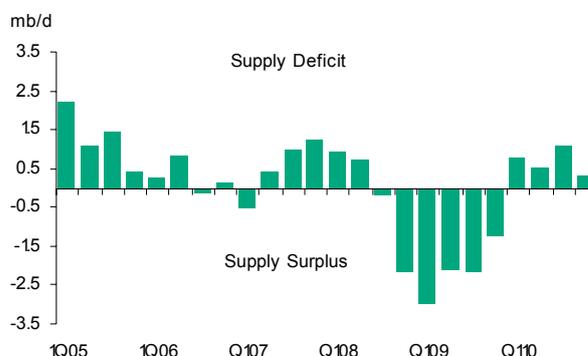
- The market is not losing sight of a potential correction. Interest has risen considerably for put options with strikes between USD 60/bbl and USD 70/bbl. Open interest on the NYMEX floor

Chart 3: Cash and Volatility (%)



Source: Reuters EcoWin Pro, BNP Paribas.

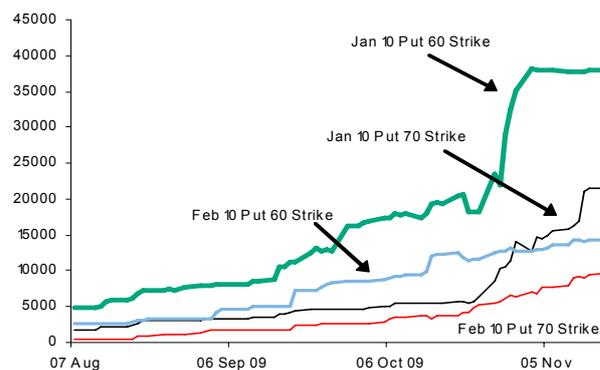
Chart 4: Fundamental Balance*



Source: IEA Oil Market Report, BNP Paribas.

*y/y non-OPEC supply growth less y/y global oil demand growth

Chart 5: NYMEX WTI Put Option Open Interest



Source: Bloomberg, BNP Paribas.

for January 2010 delivery for USD 60/bbl strikes reached 37,981 contracts by 16 November. Given the overhang in distillate supplies, a mild winter could lead to a repeat of the price correction seen in winter 2006-07, when falling oil prices prompted increased sales of futures to hedge out-of-the money puts, exaggerating the price correction. WTI fell from USD 67/bbl at the end of December 2008 to a low of USD 58.60/bbl by mid-January.



Gold: The Sky's the Limit

■ Gold at a record high

- Against our expectations in the previous *Global Outlook*, the gold price has continued to rise, reaching successive record highs. At the time of writing this article, gold was trading near USD 1,147/oz. Contrary to our previous forecast, the market has held on to its record net long positions built up during the summer months and no significant liquidations, either on the COMEX or in ETFs, have been seen.
- The gains in price have come despite relatively subdued inflows into ETFs in Q4'09. These total around 25 tonnes quarter-to-date. In the same vein, net non-commercial futures positions on the COMEX have risen only modestly, given the price gains. Since end-September, they are up 2.9% to 238,060 contracts on 10 November 2009.
- A number of factors have combined to push gold prices higher. While a large producer's announcement that it would buy back its gold hedges prompted a level shift in mid-September, USD weakness, a rise in inflation expectations and concerns over the pace of the economic recovery have sustained a rally in prices. In October, the impact on market psychology of the Indian central bank's purchase of 200 tonnes of gold from the IMF at above USD 1,000/oz also helped to push prices higher.

■ Concerns about the value of the USD and the levels of public debt

- Worries about the current and future value of the USD have been one of the major drivers of the gold rally. The inverse short-term correlation between gold prices and the USD has tightened more than we expected, and with EUR/USD trading higher, gold has risen accordingly.
- Longer term, concerns are mounting about the implications of the large expansion of the Federal Reserve's balance sheet (roughly USD 1trn since summer 2008). Also, public debt levels in OECD countries are increasing, raising concerns about fiscal sustainability. Gold may be incorporating a risk premium against the possible debasement of the USD and/or country default risk.

■ Expected real yields have fallen

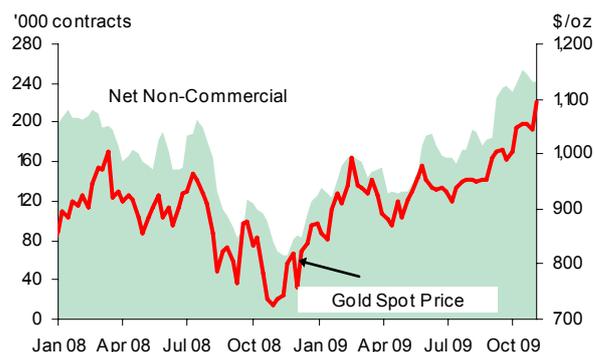
- US inflation expectations have risen, as shown by the 5- and 10-year breakeven rates, which have risen to 1.64% from 1.25% and to 2.16% from 1.71% respectively since end-September. With little upward pressure on nominal bond yields, expected real returns have weakened, lowering the opportunity cost of holding gold relative to bonds.

Table 1: Price Forecasts (USD per ounce)*

| Q4'09 | Q1'10 | Q2'10 | Q3'10 | Q4'10 | 2009 | 2010 |
|-------|-------|-------|-------|-------|------|------|
| 1105 | 1100 | 1040 | 1020 | 1040 | 975 | 1050 |

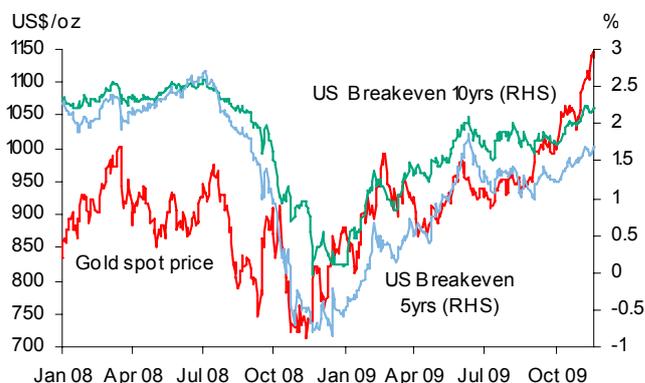
Source: BNP Paribas *Period average

Chart 1: Net Non-Commercial Positions vs. Price



Source: Bloomberg, BNP Paribas

Chart 2: Inflation Expectations vs. Gold Price



Source: Bloomberg, BNP Paribas

■ Outlook

- We have revised our forecasts for the gold price higher for the rest of 2009 and 2010. We maintain a softer patch in our profile mid-2010 as the USD rebounds, liquidity on the markets declines as unconventional monetary policy unwinds and some profit taking takes place. Physical demand is expected to remain relatively weak. However, any moves in the price back towards USD 1,000/oz will be bought into.
- Caveats remain: profit taking will depend on just how comfortable the market is with the extent of the net long positions it has built up. In addition, the potential diversification policy of central banks towards gold will be closely monitored by the market.



Key Central Bank Dates

| Date | Country | Event |
|-----------------|-------------|--|
| December | | |
| 1 | Australia | RBA Rate Announcement |
| 3 | Eurozone | ECB Rate Announcement and Press Conference |
| 8 | Canada | BoC Rate Announcement |
| 10 | UK | BoE Rate Announcement |
| 10 | Eurozone | ECB Monthly Bulletin |
| 10 | Switzerland | SNB Rate Announcement |
| 14 | UK | BoE Quarterly Bulletin |
| 15 | Australia | RBA MPC Minutes |
| 16 | Sweden | Riksbank Rate Announcement |
| 16 | Norway | Norges Bank Rate Announcement |
| 16 | US | FOMC Rate Announcement |
| 17 | Eurozone | Governing Council Meeting (No Rate Announcement) |
| 18 | Japan | BoJ Rate Announcement |
| 23 | UK | BoE MPC Minutes |
| 24 | Japan | BoJ Monetary Policy Meeting Minutes |
| January | | |
| 6 | US | FOMC Minutes |
| 7 | UK | BoE Rate Announcement |
| 14 | Eurozone | ECB Rate Announcement and Press Conference |
| 19 | Canada | BoC Rate Announcement |
| 20 | UK | BoE MPC Minutes |
| 21 | Eurozone | ECB Monthly Bulletin |
| 21 | Canada | BoC Monetary Policy Report |
| 26 | Japan | BoJ Rate Announcement |
| 27 | US | FOMC Rate Announcement |
| 29 | Japan | BoJ Monetary Policy Meeting Minutes |
| February | | |
| 2 | Australia | RBA Rate Announcement |
| 3 | Norway | Norges Bank Rate Announcement |
| 4 | UK | BoE Rate Announcement |
| 4 | Eurozone | ECB Rate Announcement and Press Conference |
| 5 | Australia | RBA Monetary Policy Statement |
| 10 | UK | BoE Inflation Report |
| 11 | Eurozone | ECB Monthly Bulletin |
| 11 | Sweden | Riksbank Rate Announcement and Monetary Policy Report |
| 16 | Australia | RBA MPC Minutes |
| 17 | UK | BoE MPC Minutes |
| 17 | US | FOMC Minutes |
| 18 | Japan | BoJ Rate Announcement |
| 18 | Eurozone | Governing Council Meeting (No Rate Announcement) |
| 23 | Japan | BoJ Monetary Policy Meeting Minutes |
| March | | |
| 2 | Australia | RBA Rate Announcement |
| 2 | Canada | BoC Rate Announcement |
| 4 | Eurozone | ECB Rate Announcement and Press Conference |
| 4 | UK | BoE Rate Announcement |
| 11 | Switzerland | SNB Rate Announcement |
| 16 | Australia | RBA MPC Minutes |
| 16 | US | FOMC Rate Announcement |
| 17 | Japan | BoJ Rate Announcement |
| 17 | UK | BoE MPC Minutes |
| 18 | Eurozone | Governing Council Meeting (No Rate Announcement) |
| 23 | Japan | BoJ Monetary Policy Meeting Minutes |
| 24 | Norway | Norges Bank Rate Announcement and Monetary Policy Report |

Source: BNP Paribas

Release dates as of 27 November 2009



G7 Long-Term Economic Forecasts

Table 1 on the page opposite provides our forecasts for the main economic and financial variables for the major economies over the next ten years. The global economy has emerged from recession more quickly than expected. Nonetheless, the extraordinarily sharp drop in the major economies' GDP around the turn of 2008/2009 means that most economies have generated a large negative output gap. This has already been manifest in sharp increases in unemployment with further rises likely until growth returns to potential. Both influences will exert a sharp brake on core inflation, which in a number of cases is likely to fall close to negative territory during 2011.

The fading of support measures, fiscal tightening and a financial system that is not firing on all cylinders means that it is going to be a long time before the output gap closes in most economies. Likewise, it will take most of the next decade for unemployment rates to fall back to pre-recession levels. Hence, inflation pressures will remain moribund over most of the coming decade.

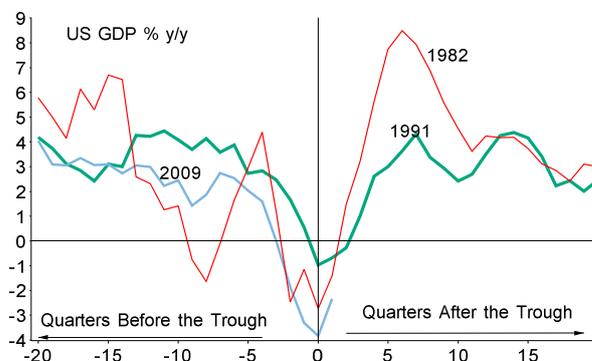
One exception to the above forecast of limited price rises is likely to come in the form of a temporary surge in inflation once the recovery fully takes hold in 2013. We expect the combination of Asian-led commodity price increases and a sharp rise in inflation expectations to contribute to a spike in inflation in developed economies. However, an aggressive monetary policy response and a persistent output gap should ensure that the rise in inflation is short-lived. The tightening of monetary policy will also mean that the economy has to suffer another spell of sluggish growth as central banks seek to re-establish their credibility and inflation expectations are brought back under control.

■ US

We believe that the economy is set to expand at a reasonable pace over the next six to nine months. Unfortunately this is likely to be temporary and growth will hit a soft patch by late 2010. We expect growth to eventually accelerate to around 4.5% y/y during 2013, helping unemployment to head back down. This is likely to be accompanied by headline inflation of more than 4%. We expect this inflation rate to provoke an aggressive response from the Fed, taking the funds rate up to 6%, temporarily choking off the rebound in growth and lowering inflation back towards 2%.

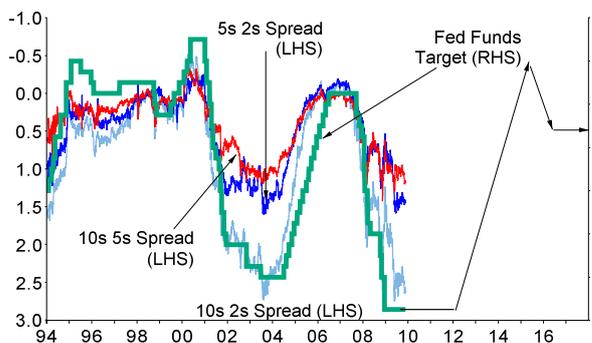
Once this interruption has passed and central bank credibility has been restored, interest rates can be reduced. This easing will allow growth to exceed potential slightly for a short time, finally helping to close the output gap. In turn, this will facilitate a reduction in the unemployment rate back to the NAIRU and help to restore inflation to more desirable levels.

Chart 1: Past Troughs in US GDP



Source: Reuters EcoWin Pro, BNP Paribas

Chart 2: US Spreads



Source: Reuters EcoWin Pro, BNP Paribas

Eurozone

A less aggressive policy stimulus means that the eurozone recovery is likely to be less vigorous than the recovery in the US. It will take longer to return to the economy's potential growth rate (mid- to late 2011). Moreover, even once above-trend growth is achieved, it is likely to be around a percentage point slower than in the US. One positive outcome of this slow growth will be that inflation is less likely to be a problem in the eurozone than in the US. A Taylor rule approach suggests that the tightening in monetary policy will not have to go as far as in the US (we expect the ECB's Refi rate to reach 4.5% during 2013 – around 150bp lower than the peak in Fed funds, given lower inflation and lower neutral rates in the eurozone).

■ UK

Aggressive policy easing suggests the UK economy will enjoy a robust expansion in the next few quarters. However, the UK's fiscal position is worse than most. This means a sharp tightening in fiscal policy starting in late 2010 will hold back the recovery in the economy and the restraint will last several years.



Long-Term Forecasts

Table 1: Long-Term Forecasts

| | Year | | | | | | | | | | | |
|---------------------------------|------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| | '08 | '09 ⁽¹⁾ | '10 ⁽¹⁾ | '11 ⁽¹⁾ | '12 ⁽¹⁾ | '13 ⁽¹⁾ | '14 ⁽¹⁾ | '15 ⁽¹⁾ | '16 ⁽¹⁾ | '17 ⁽¹⁾ | '18 ⁽¹⁾ | '19 ⁽¹⁾ |
| US | | | | | | | | | | | | |
| GDP (% y/y) | 0.4 | -2.5 | 2.2 | 2.5 | 3.3 | 4.5 | 2.0 | 3.0 | 3.0 | 3.0 | 3.0 | 2.5 |
| CPI (% y/y) | 3.8 | -0.3 | 2.1 | 0.9 | 0.8 | 4.0 | 2.5 | 2.0 | 1.8 | 2.2 | 2.0 | 2.0 |
| Core CPI (% y/y) | 2.3 | 1.7 | 1.0 | 0.0 | 0.4 | 2.5 | 2.2 | 2.0 | 1.6 | 2.0 | 2.0 | 2.0 |
| Unemployment Rate (%) | 5.8 | 9.3 | 10.8 | 10.0 | 8.6 | 7.5 | 7.5 | 7.0 | 6.5 | 6.0 | 5.5 | 5.0 |
| Fed Funds Rate (%) | 0.25 | 0.25 | 0.25 | 0.75 | 3.00 | 6.00 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 |
| 3-Month Rate (%) ⁽²⁾ | 1.43 | 0.30 | 0.45 | 1.25 | 3.50 | 6.00 | 4.75 | 4.75 | 4.75 | 4.75 | 4.75 | 4.75 |
| 2-Year Rate (%) ⁽²⁾ | 0.77 | 0.75 | 1.30 | 2.60 | 4.25 | 5.50 | 4.75 | 5.00 | 4.80 | 4.90 | 5.00 | 5.00 |
| 5-Year Rate (%) ⁽²⁾ | 1.55 | 2.25 | 2.70 | 3.75 | 4.90 | 5.75 | 5.00 | 5.25 | 5.10 | 5.15 | 5.10 | 5.10 |
| 10-Year Rate (%) ⁽²⁾ | 2.22 | 3.25 | 3.75 | 4.75 | 5.50 | 6.00 | 5.25 | 5.75 | 5.50 | 5.40 | 5.25 | 5.25 |
| EUR/USD ⁽²⁾ | 1.40 | 1.54 | 1.40 | 1.47 | 1.45 | 1.42 | 1.33 | 1.25 | 1.23 | 1.20 | 1.27 | 1.33 |
| USD/JPY ⁽²⁾ | 91 | 85 | 108 | 118 | 111 | 114 | 109 | 103 | 110 | 115 | 105 | 112 |
| Eurozone | | | | | | | | | | | | |
| GDP (% y/y) | 0.6 | -3.8 | 1.3 | 1.5 | 2.5 | 3.5 | 2.0 | 2.5 | 2.5 | 2.0 | 1.5 | 1.5 |
| CPI (% y/y) | 3.3 | 0.3 | 1.3 | 0.7 | 0.7 | 2.3 | 1.5 | 1.8 | 2.0 | 2.0 | 1.8 | 1.8 |
| Core CPI (% y/y) | 1.8 | 1.4 | 0.5 | -0.2 | 0.3 | 1.5 | 1.5 | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 |
| Unemployment Rate (%) | 7.6 | 9.4 | 10.5 | 10.5 | 9.8 | 8.5 | 8.0 | 7.5 | 7.0 | 7.0 | 7.0 | 7.0 |
| ECB Refinancing Rate (%) | 2.50 | 1.00 | 1.00 | 1.25 | 3.00 | 4.50 | 3.50 | 3.50 | 4.00 | 4.00 | 4.00 | 4.00 |
| 3-Month Rate (%) ⁽²⁾ | 2.89 | 0.70 | 1.10 | 2.25 | 3.50 | 4.50 | 3.60 | 3.75 | 4.25 | 4.25 | 4.25 | 4.25 |
| 2-Year Rate (%) ⁽²⁾ | 1.74 | 1.25 | 1.50 | 2.75 | 3.75 | 4.75 | 3.60 | 4.00 | 4.25 | 4.50 | 4.50 | 4.50 |
| 5-Year Rate (%) ⁽²⁾ | 2.35 | 2.20 | 2.50 | 3.50 | 4.25 | 5.00 | 4.00 | 4.60 | 4.70 | 4.75 | 4.75 | 4.75 |
| 10-Year Rate (%) ⁽²⁾ | 2.95 | 3.10 | 3.50 | 4.25 | 4.75 | 5.40 | 5.00 | 5.10 | 5.20 | 5.10 | 5.00 | 5.00 |
| EUR/JPY ⁽²⁾ | 127 | 131 | 151 | 173 | 161 | 162 | 145 | 129 | 135 | 138 | 133 | 149 |
| Japan | | | | | | | | | | | | |
| GDP (% y/y) | -0.7 | -5.2 | 1.5 | 1.4 | 1.6 | 2.4 | 1.0 | 2.2 | 2.0 | 1.7 | 1.6 | 1.6 |
| CPI (% y/y) | 1.4 | -1.3 | -1.8 | -0.8 | -0.7 | 1.5 | 0.7 | 1.0 | 1.2 | 1.0 | 1.0 | 1.0 |
| Core CPI (% y/y) | 0.0 | -0.7 | -1.4 | -1.1 | -0.8 | 1.0 | 0.7 | 0.7 | 1.0 | 1.0 | 1.0 | 1.0 |
| Unemployment Rate (%) | 4.0 | 5.1 | 5.3 | 4.9 | 4.1 | 3.7 | 3.7 | 3.2 | 3.0 | 3.0 | 3.0 | 3.0 |
| O/N Call Rate (%) | 0.10 | 0.10 | 0.10 | 0.25 | 0.75 | 1.50 | 0.50 | 1.50 | 2.50 | 2.50 | 2.50 | 2.50 |
| 3-Month Rate (%) ⁽²⁾ | 0.74 | 0.45 | 0.35 | 0.35 | 0.85 | 1.75 | 0.75 | 1.75 | 2.75 | 2.75 | 2.75 | 2.75 |
| 2-Year Rate (%) ⁽²⁾ | 0.40 | 0.20 | 0.45 | 0.90 | 1.40 | 2.00 | 1.00 | 2.25 | 3.00 | 2.75 | 2.75 | 2.75 |
| 5-Year Rate (%) ⁽²⁾ | 0.71 | 0.70 | 1.00 | 1.50 | 1.60 | 2.00 | 1.50 | 2.35 | 3.10 | 3.00 | 3.00 | 3.00 |
| 10-Year Rate (%) ⁽²⁾ | 1.18 | 1.40 | 1.70 | 2.10 | 2.20 | 2.20 | 1.90 | 2.50 | 3.25 | 3.25 | 3.25 | 3.25 |
| UK | | | | | | | | | | | | |
| GDP (% y/y) | 0.7 | -4.5 | 2.0 | 1.6 | 1.8 | 3.8 | 1.7 | 2.2 | 3.0 | 3.0 | 2.7 | 2.7 |
| CPI (% y/y) | 3.6 | 2.1 | 2.1 | 0.8 | 0.9 | 4.0 | 2.7 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Core CPI (% y/y) | 1.6 | 1.7 | 2.0 | 0.4 | 0.5 | 3.0 | 2.3 | 1.7 | 2.0 | 2.0 | 2.0 | 2.0 |
| RPI (% y/y) | 4.0 | -0.6 | 3.3 | 2.6 | 3.2 | 4.6 | 1.5 | 3.0 | 2.5 | 2.5 | 2.5 | 2.5 |
| Unemployment Rate (%) | 5.7 | 7.7 | 8.0 | 8.8 | 9.0 | 8.0 | 7.9 | 7.7 | 7.2 | 7.0 | 6.8 | 6.5 |
| Base Rate (%) | 2.00 | 0.50 | 0.50 | 0.50 | 2.50 | 6.00 | 4.00 | 4.00 | 4.50 | 4.75 | 4.75 | 4.75 |
| 3-Month Rate (%) ⁽²⁾ | 2.77 | 0.60 | 0.60 | 0.90 | 2.75 | 6.00 | 4.00 | 4.25 | 4.75 | 5.00 | 5.00 | 5.00 |
| 2-Year Rate (%) ⁽²⁾ | 1.05 | 1.35 | 1.50 | 2.50 | 4.00 | 6.00 | 4.00 | 4.75 | 5.00 | 5.00 | 5.00 | 5.00 |
| 5-Year Rate (%) ⁽²⁾ | 2.43 | 2.50 | 3.20 | 4.25 | 4.85 | 6.05 | 4.60 | 5.50 | 5.50 | 5.25 | 5.25 | 5.25 |
| 10-Year Rate (%) ⁽²⁾ | 3.02 | 3.50 | 4.40 | 5.05 | 5.45 | 6.10 | 5.25 | 5.50 | 5.75 | 5.50 | 5.50 | 5.50 |
| EUR/GBP ⁽²⁾ | 0.96 | 0.92 | 1.00 | 0.91 | 0.90 | 0.87 | 0.84 | 0.82 | 0.79 | 0.79 | 0.83 | 0.87 |
| GBP/USD ⁽²⁾ | 1.46 | 1.67 | 1.40 | 1.62 | 1.61 | 1.63 | 1.58 | 1.52 | 1.56 | 1.52 | 1.53 | 1.53 |

Footnotes: (1) Forecast (2) End period

Source: BNP Paribas



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Global Bonds: Entering the Exit

OVERVIEW

■ Mixed environment to favour a narrow trading range

We do not expect the markets to face a markedly different economic environment in the months ahead than they face now. The rebound in activity from extremely depressed levels will continue and could even persist for slightly longer than we expected a few months ago. However, we still expect the economic rebound to stall during next year, giving way to limited growth across the board. While base effects are leading to upward revisions to growth rates, the long-term trend remains subdued.

Meanwhile, core inflation will continue to decelerate and inflation expectations are likely to subside and then become anchored at a low level. In addition, government budgetary positions are worsening and will not improve in 2010. Growth is too modest for budget deficits to narrow. Financing needs are increasing sharply and financing programmes will weigh on bond markets.

However, as government-guaranteed bond activity is declining as conditions in the financial sector have improved, the short and medium-term areas of the govies sector will not be challenged by other bonds offering higher yields and almost the same quality. Against this backdrop, government bonds will remain healthy, though with little room for a strong rally in the early months of 2010. Mixed conditions are likely to lead to a relatively narrow trading range at the start of the year. Conditions will improve in Q2, favouring lower yields and flatter curves.

Central banks will have to deal with their exit strategies from accommodative policies, but recent comments have made it clear that they will proceed cautiously, keeping monetary policies accommodative for a while. Central banks will not remove liquidity as rapidly as they provided it to money markets. Extensions of asset purchase programmes are still on the agenda in the US and in the UK, and the ECB will maintain some of the non-standard measures seen since the end of 2008.

Fears in the money markets of an early tightening in liquidity conditions have gradually subsided. However, it is certain that, unless economies suffer a severe setback or another liquidity crisis, next year will see excess liquidity partially and gradually removed from the system. The very front end of money market curves is likely to steepen in these conditions, while the back end of money market curves will gradually flatten.

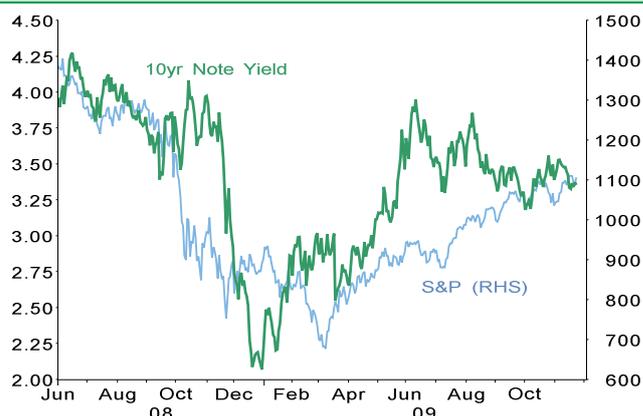
Just as the rise in liquidity allowed volatility to fall to relatively low levels, the reduced availability of liquidity during next year will probably prevent volatility from easing further. This will have implications for spreads

Table 1: Yield Forecasts End-Q1 2010 (%)

| Current 24 Nov. 2009 | USD | | EUR | | JPY | |
|-------------------------|-------|--------|-------|--------|-------|--------|
| | Curr. | End Q1 | Curr. | End Q1 | Curr. | End Q1 |
| 2-year | 0.77 | 1.00 | 1.32 | 1.25 | 0.25 | 0.20 |
| 5-year | 2.16 | 2.25 | 2.36 | 2.20 | 0.60 | 0.70 |
| 10-year | 3.34 | 3.25 | 3.26 | 3.10 | 1.30 | 1.40 |
| 30-year | 4.26 | 4.20 | 3.97 | 3.80 | 2.20 | 2.25 |
| Spreads | | | | | | |
| 2/5-year (bp) | 139 | 125 | 104 | 95 | 35 | 50 |
| 5/10-year (bp) | 118 | 100 | 90 | 90 | 70 | 70 |
| 10/30-year (bp) | 92 | 95 | 71 | 70 | 90 | 85 |
| 2/10-year (bp) | 257 | 225 | 194 | 185 | 105 | 120 |
| 10yr swap spd | 10 | 10 | 20 | 20 | 10 | 10 |

Source: BNP Paribas

Chart 1: Govvies Have Been Resilient in Recent Months



Source: Reuters EcoWin Pro

and the compression seen in 2009 looks unlikely to maintain its pace.

The removal of liquidity will also have implications for other asset prices. The equity and commodity markets benefited from the high liquidity conditions. The usual arbitrage between stocks, commodities and bonds driven by liquidity/risk assessment faded as markets were flooded by cheap liquidity. As these conditions recede, risk assessment will become more important, which factor alone suggests better conditions for bonds than for equities.

EUROPE

■ The ECB will keep liquidity cheap in the near term

The ECB has made it clear that “not all the measures” taken to provide very high liquidity to the eurosystem will be maintained next year. However, this statement should not be viewed too negatively. In fact, it suggests that several (probably most) non-standard measures



will be maintained next year. Among these, very short-term liquidity is likely to remain easily available for banks, especially given the prospect of the EUR 442.2bn sharp fall in liquidity at the end of June. The MRO and some term LTROs should be maintained under current conditions (fixed rate and full allotment) for months. In addition, the covered bond purchase programme will be conducted until June, providing markets with roughly EUR 30bn of additional liquidity.

As far as other aspects of liquidity policy are concerned, the ECB has already started to change conditions for the next few years. The rating requirements on ABS to be eligible assets for open market operations will tighten slightly from March 2010, and the tightening will be extended in 2011.

While the amount of excess liquidity should be gradually reduced, there is no room for the ECB to tighten rate policy. The refi rate is anchored to 1% for a long time as subdued growth and low inflation expectations will prevent the ECB from raising rates next year.

■ The front end under steepening pressures

As far as the 1y liquidity-providing operation is concerned, the December operation is the last to offer banks the opportunity to ensure they have sufficient liquidity until at least the end of June 2010, and a significant part of their needs for the next nine months. Firm demand at the tender means that there will be no pressure at all on very short-term liquidity during the early months of 2010. However, conditions should gradually change further out along the money market curve.

Indeed, while 1y liquidity is guaranteed to be available at no more than 1% until the end of this year, this maturity will be exposed to market conditions from early next year and changes in the ECB's monetary policy. This is why the 1-2y segment of the money market curve has steepened significantly over the past few months. Going into early 2010, upward pressures on short-term rates will develop on shorter maturities, leading to a steeper Eonia curve on the 6-18m segment. This is likely to reduce basis paying interest.

OIS/BOR spreads have benefited significantly from the high level of liquidity to tighten from their wide levels at the start of the year. A limited compression on the back of the last 1y tender is possible as far as the 3m OIS/BOR spread is concerned. But the period of a strong spread compression is over and, at best, a stabilisation of spreads should be expected in the early months of 2010.

■ Bond curve will flatten, but the move will be gradual in the early months

Steepening pressures across the curve developed for longer than in previous monetary policy easing cycles, as liquidity policy took the lead after the ECB stopped cutting rates. Usually, when central banks end their

Chart 2: Bullish or Bearish... But Flatter in 2010



Source: Reuters EcoWin Pro

rate-cutting cycle, the bond market curve stabilises and flattening pressures gradually emerge. This was certainly not the case this time, as the ECB increased the availability of liquidity after it stopped cutting rates. Along with the prospect of rates being kept on hold, the extra liquidity allowed carry trades to develop on the money market curve, and this spread through the rest of the curve, preventing the 2-30y segment of the curve from flattening significantly. Compression phases were temporary and only driven by short-lived concerns about monetary policy.

In the meantime, the fundamental environment continues to favour flattening. Core inflation continues to moderate and, as a result, real short-term rates are gradually rising. This is a strong driving force for flattening pressures.

In addition, from a portfolio management standpoint, whatever the sentiment about the market's direction going into next year (and the gradual adoption of exit strategies) it makes sense to implement barbell strategies. The long end offers yield while the front end could perform well, along with a gradual increase in money-market rates. Such behaviour will also exert flattening pressures on the bond market curve.

Finally, as we expect stock markets to lose momentum in the coming months, pension funds should be stronger receivers at the back end of the bond market curve. This will lead the curve flatter. By the end of Q2 2010 we expect the 2-10y benchmark spread to compress to 165bp from 194bp currently.

■ Spread narrowing is running out of steam

Most of the spread moves in both 2008 and 2009 were driven by liquidity/volatility conditions. With no further increase of liquidity next year and given that a further significant reduction of volatility looks unlikely, spread narrowing will run out of steam. As far as swap spreads are concerned, there could be further limited tightening at the short end (2y area) and up to the belly of the curve.



As far as intra-EMU sovereign debt spreads are concerned, additional factors to be taken into consideration are budget deficits, debt levels and credit quality. In that respect, countries exposed to a downgrade of their ratings could come under pressure in the coming months. Greece, Ireland and Portugal may be exposed to such pressures in the early months of next year.

■ **Supply will be a key factor in Q1 2010**

In 2009 we saw a total eurozone supply of around EUR 935bn, a 40% increase from the level in 2008. However, we expect even greater supply in 2010 as budget deficits remain under pressure. We forecast gross supply of EUR 968bn, which represents a 3% increase from 2009. In 2010, redemptions will decrease for the first time since 2006, by EUR 28bn compared with 2009, while deficits will remain quite high at around EUR 500bn. Net supply is expected around EUR 448bn, an increase of 16% versus 2009. These figures include the French National Borrowing programme of EUR 22bn.

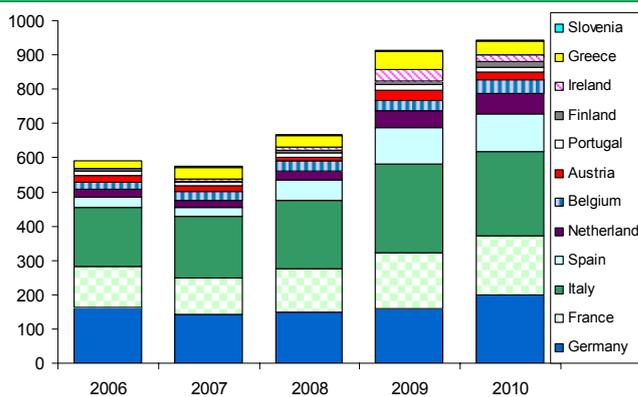
The breakdown of the total supply should include a re-balancing towards bonds away from T-bills, as we expect much smaller issuance of T-bills in 2010. Within bonds, the breakdown by maturity should show an increased share of longer maturities as expectations of monetary tightening will increase during the course of 2010. The trend towards longer maturities has already been established in the second half of 2009. We also expect to see an increase in linker issuance due both to increasing demand and in order to boost liquidity in linkers. A diversification of the investor pool and the currently attractive level of the EUR/USD basis have boosted issuance in the USD in the second half of 2009. Foreign issuance should increasingly be considered an option by eurozone sovereign issuers in 2010.

■ **Inflation: higher supply in 2010. Demand to improve?**

After a strong summer with a further normalisation in breakeven levels and ASW discounts, EUR breakevens have fared poorly in Q4. Recent supply outcomes have been lacklustre with demand waning for the product, at least temporarily. 30y EUR breakevens look particularly stretched (in the 2.30-2.50% area), while the 10y remains attractive in the cash inflation curve – the 10/30y segment has flattening potential ahead. At around 2%, 10y EUR cash breakevens look fairly valued – in line with their historical average and the 10y average of HICP inflation. European sovereign inflation supply is likely to rise by 50% in 2010, after dropping by 20% in 2009, which should help liquidity to improve further. Nevertheless, inflation-linked supply as a proportion of nominal issuance will remain below 2008 levels.

GBP and especially USD linkers have outperformed EUR ones significantly as we expected, due to the

Chart 3: More Supply Ahead



Source: BNP Paribas

continued LDI demand and product inflows, respectively. The pace of the move since early October suggests some tactical consolidation at least. We prefer real yields to breakevens in Europe, given the expected slowdown in core inflation and lower monetary stimulus relative to Anglo-Saxon countries. In the UK, we stay positive on very front-end real yields and breakevens ahead of the sharp rise in RPI inflation but are more neutral on richer 10y+ maturities.

■ **EUR GAMMA: long tenor implied vol to decline further**

Implied volatility in gamma space is trading at the lows of the year: 6m2y, 6m5y, 6m10y, 6m20y and 6m30y have shed 33%, 37%, 40%, 51% and 56% respectively. On the other hand, the implied gamma surface is still trading rich relative to delivered volatility. In addition, at current levels it is still around 47% above the lows of the past ten years. In this context, it is important to highlight that long-tenor options are currently the richest on the swap curve with 6m30y implied vol trading at 147% versus 6m realised vol. In contrast, 6m2y implied vol is trading at par.

Investors will also look at the shape of the forward curve in order to choose between a long or short vol risk exposure: the forward term structure at the front end is still rather steep. Forward term structures progressively flatten as a function of the rate maturity. Indeed, the forward term structure of the 30y swap looks quite flat.

Thus, given the relative value of the gamma points and the shape of the forward curves, it follows that executing long vol trades at the front end and short vol trades at the long end in gamma space is the optimal strategy from a carry perspective. In particular, shorting 6m30y straddles currently earns an upfront premium of around 854 cents (mid). The lower and upper breakevens are 3.50% and 4.48% while the 30y swap has traded in a historically tight 3.82-4.15% range since mid-May. Back testing this strategy suggests that, under current market conditions, the trade works well from a carry/terminal perspective: the flat 30y forward curve implies that little delta hedging is required.



US

■ **Stable monetary policy to support bonds...**

The Fed continues to reiterate its intention to keep rates steady for a long time. This stance is driven by the gradually deteriorating employment picture, slack in the economy and the attendant disinflation backdrop, lack of credit flow, and the still-shaky housing market, despite the normalising of financial markets. By keeping short rates practically at zero, the Fed is attempting to channel cash into riskier assets thereby repairing the balance sheets of both consumers and financial companies.

As long as this policy is in place – and we see no reason why it should change in early 2010 – we expect cash to chase higher-yielding instruments. This suggests that spread products in general will continue to benefit, mitigating widening pressures in the meantime. In addition, in the search for yield, investors are likely to extend further out along the rates curve, supporting intermediate and long maturities. Also creating an ideal backdrop for the duration extension move is the range-bound low-vol environment and downward trend in core inflation.

■ **...but the end of MBS purchases is looming**

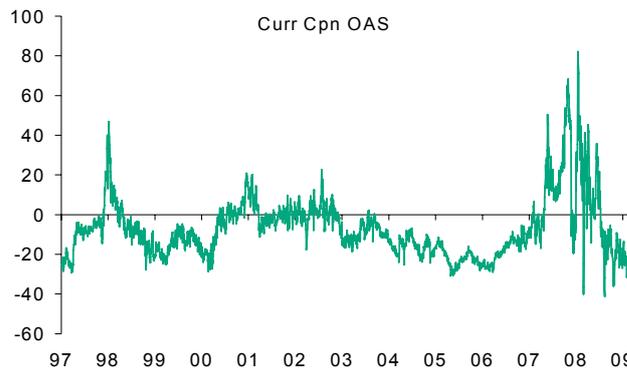
A key driver for the rates market in 2010 is likely to be the termination of the Fed's MBS purchase programme. We expect mortgages to tighten into the year-end, although with spreads more volatile. But, by and large, mortgage spreads have been in a narrow range for the past few months (Chart 4). We do not expect a large buyer to take the place of the Fed if the programme is terminated as scheduled. Given that spreads are pretty much in an equilibrium at present, mortgage spreads are likely to widen significantly if the Fed stops buying.

Convexity flows could put significant pressure on both the mortgage and the rates market in general. We have seen this before, notably in the summer of 2003 and more recently this past summer: as rates sell off, durations extend, and to offset this effect, originators and servicers end up paying fixed in swaps. A mortgage-led sell-off continues to be a risk scenario on the termination of the Fed's programme.

Payer skew has thus been quite popular among mortgage investors. With prepayments continuing to surprise to the downside at low mortgage rates, call risk has been low, a trend that is expected to continue. Structurally, the need for receiver skew thus continues to be muted. As shown in Chart 5, the ratio of payers versus receivers in 1y10y is near record levels.

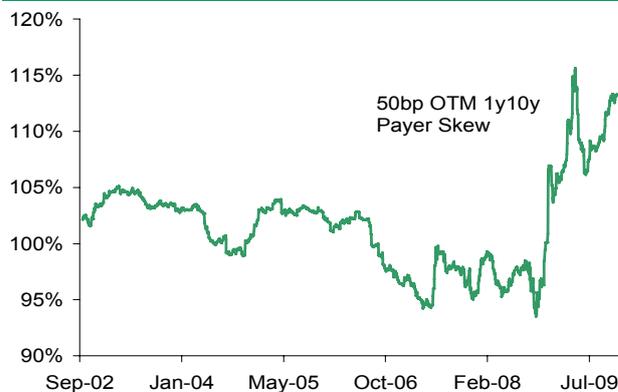
A brisk sell-off would probably choke off any recovery in the housing market. That would have a negative impact on the outlook for the economy. With that prospect, investors should find Treasuries attractive if the 10y rises to the high 3% area in conjunction with the end of MBS purchases. In other words, the sell-off is likely to be short-lived as buyers re-emerge, taking

Chart 4: Fed's Purchases Keeping MBS OAS at Historically Tight Levels



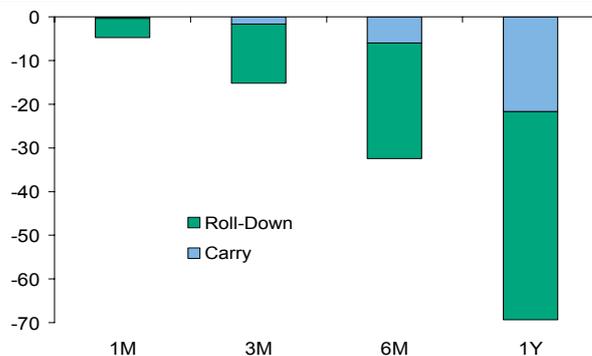
Source: BNP Paribas

Chart 5: Payer Skew Remains High



Source: BNP Paribas

Chart 6: Carry/Roll-Down in 2s10s Swap Flatteners



Source: BNP Paribas

rates back down to the low 3% area. It is also not unreasonable to expect that the Fed will support the mortgage market further if rates rise significantly.

In summary, rates should be contained, with a flattening being the longer-term trend. The problem will be – as it has been for quite some time – that flatteners are negative carry positions. For instance, swap 2s10s has -33bp carry over six months (Chart 6). We have shown in previous reports that it is possible to structure trades that benefit from a flattening of the curve, while avoiding the cost of carry. These positions are different from traditional flatteners, of course, but have a general



composition of being short the 1-8y and 20y sectors, and long the 12y. The butterfly structure in the trade allows one to circumvent the negative carry of flatteners, while still maintaining exposure to a flattening of the curve.

■ **Spreads are likely to remain tight well into Q1**

Swap spreads have been on a downward path thanks to receiving flows related to corporate issuance, as well as increasing Tsy issuance. Our central scenario does not call for higher rates or higher spreads, although the likelihood of both coming about at the same time is strong (Chart 7). Thus we favour conditionally buying spreads in a sell-off (i.e. sell Tsy puts versus buying swap payers). The 5y sector is an appropriate maturity to consider because the risk scenario of an MBS-led sell-off would directly hit this sector.

The Fed reduced the size of its agency debt purchases from USD 200bn to USD 175bn, and roughly USD 20bn of purchases remain until the end of Q1 2010. The Fed plans to continue purchases on a weekly basis until switching to bi-weekly at some point in Q1. The agency market reacted to these events with wider spreads across the curve. We think the phasing out of the purchase programme should be largely priced in at this point. For carry seekers, we prefer the short end (2-3y sector) as this sector should continue to be well supported with the Fed on hold and the sector's higher liquidity. Investors could consider buying bullets outright or paying fixed in a forward-starting matched-maturity OIS as either a short-term carry/roll-down trade, or as a hedge against early rate hikes.

In mortgage prepayments, we continue to expect call risk to be muted and extension risk to remain significant. Refinancing has shown considerable burnout, and unless we test new rate levels, it is difficult to see an appreciable increase in prepayments, particularly as mortgages are likely to widen once Fed purchases end. Over the past few months, however, modifications have increased the upside risk to prepayments for credit-impaired collateral. While 2009 has been the "year of the up in coupon", we expect the carry for the up in coupon to erode gradually in 2010. Net issuance has been on a declining trend as non-agency and agency refinancing has declined. This trend should continue, and blunt some of the impact of the Fed's exit.

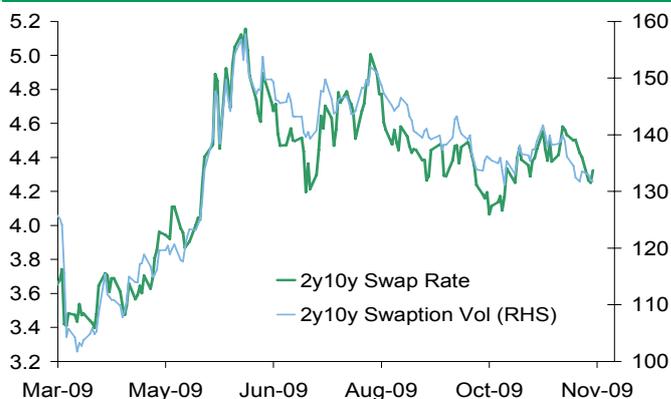
TIPS continue to enjoy strong domestic and overseas demand as investors grow increasingly concerned about the prospect of high inflation. It also helps that four out of the last five CPI (NSA) prints have been higher than expected. Breakevens have enjoyed a very strong run since October, with 5y and 10y BEs widening by 43bp, and the 20y by 35bp. Although valuations are starting to look rich, demand is very supportive of the product and there is no supply for the remainder of the year, while next year's supply is below expectations. We are neutral on BEs but prefer the 20y

Chart 7: Directionality of Swap Spreads to Rates



Source: BNP Paribas

Chart 8: Directionality of Implied Vol to Rates



Source: BNP Paribas

area, which is lagging in both real yield and inflation space, offering good structural value at least in real yields. We also feel that longer maturities may be less susceptible to low CPI prints, as near-term disinflation pressures are likely to be offset by upside inflation pressures during the recovery.

■ **Volatility flows reveal investors' concerns**

As Chart 8 shows, when rates have risen (typically indicating an improving economic outlook and higher chance of rate hikes), short-expiry gamma vol has increased to reflect heightened concern about rate volatility. With the Fed on hold and the short end range-bound, gamma vol has dropped to such an extent that 3m10y vol is now just 5bp shy of its lowest level since the end of 2007. This should leave gamma vol with limited room to decline further, as concern about an eventual rise in rates should persist.

In contrast, longer-expiry vega vol, such as 5y5y, has traded near the high end of its range throughout the crisis and is not showing signs of declining significantly. 5y5y has generally ranged from 85bp to 135bp throughout the crisis and currently stands at 125bp. The need for a long-term hedge against higher rates is due to the considerable uncertainty about the course of long-term rates under the influence of factors such as the overall economy, deficits, inflation and dollar moves.



JAPAN

■ Rebound after plunge in Q4

The JGB market has had a bumpy ride during Q4. Between mid-October and mid-November, yields rose sharply, with the 10y yield rising from 1.24% to 1.48%, as the curve bear steepened. The drivers of this move included:

- US bonds' correction downward due to equities' strength after positive Q3 corporate earnings;
- The MoF's sounding out of primary dealers on an increase in JGB issuance due to the drop in tax revenues; and
- Concerns about the DPJ government's fiscal management, with issuance of financial resource bonds expected to exceed JPY 50trn in the current FY and a reduced likelihood of issuance being held below JPY 44trn as promised in the DPJ's manifesto.

Swaption volatility in particular soared, since overseas investors' strong concern about Japan's worsening fiscal position has provoked a "sell Japan" theme. From mid-November, however, fears of a decline in prices have gradually receded, since the Fed reiterated its intention to maintain its policy rate at a low level for a long period. JGBs have also enjoyed huge domestic buying, leading to a sharp rebound led by bond futures.

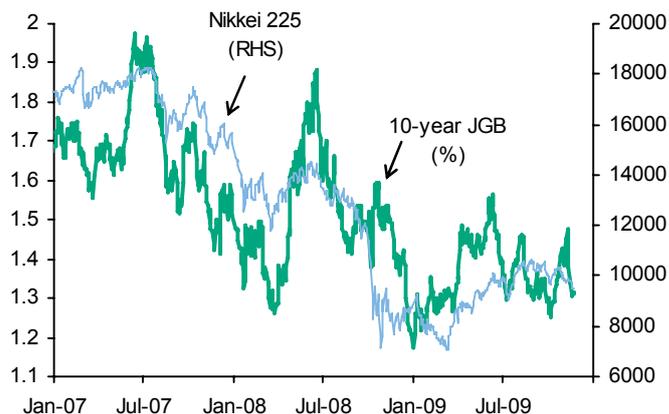
■ Limited room for long yields to fall

In the coming months, the bond market will essentially be a tug of war between persistent deflation pressures and worsening corporate finances on the one hand and the deterioration of JGB supply-demand conditions on the other. The long-term rate is unlikely to rise significantly, as the recent sharp decline in bond prices was met by strong demand from investors. Even so, Japan's fiscal situation has deteriorated further due to deflation pressure in the real economy. Moreover, GDP surprised to the upside in Q3, growing at an annualised rate of 4.8%, and GDP is expected to expand in Q4 for the third straight quarter. Thus, the Japanese economy is showing unexpected firmness, helped by the robustness of other Asian economies, suggesting that there is limited room for the long-term rate to fall. Moreover, concern about a worsening of the fiscal balance is expected to persist for months to come, as the market is likely to focus on the fiscal management difficulties facing the DPJ, particularly when the Diet discussion on the FY 2010 budget approaches its final stages early next year.

■ Steepening pressure to prevail

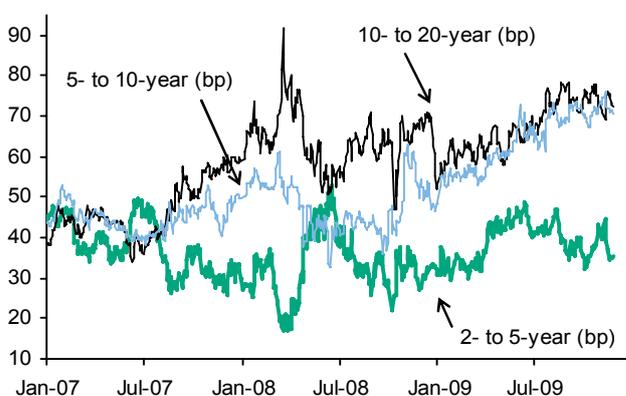
In the current context, steepening pressure is likely to prevail. While Japan will continue to enjoy a current account surplus and abundant liquidity, Japan's trade account moved into the red last year because of the stalling of the world economy and higher oil prices. The surplus on the investment income balance, which is the foundation of the current account surplus, is expected to shrink because of falling foreign interest rates. The decline in savings caused by the rise in the average

Chart 9: JGB Yield and Stock Price



Source: BNP Paribas

Chart 10: JGB Curves



Source: BNP Paribas

age of the Japanese population is the main fundamental factor behind these phenomena. The retirement of Japan's baby boomer generation has started to promote a shift from savings to consumption and capital expenditure. In other words, investors need to prepare for an unexpected deterioration of supply-demand conditions after each JGB auction.

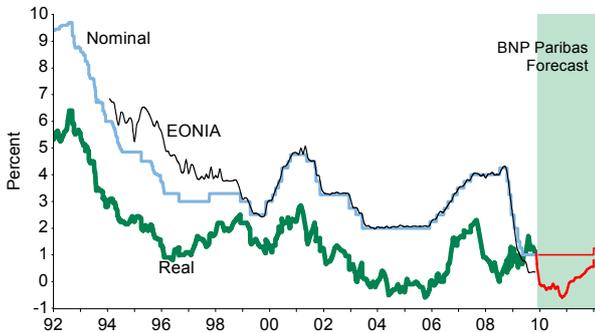
■ Swap spreads will normalise, while linkers should recover gradually

Swap spreads will normalise, albeit gradually. The inversion of JGB/swap spreads in the super-long end is expected to correct, as position adjustments progress. However, the pace of normalisation will be slow, since downward pressure on swap rates will remain due to businesses' intention to reduce long-term liabilities and ongoing concern about the worsening of JGB supply-demand conditions. On the other hand, conditions in inflation-linked JGBs are improving thanks to the reflationary policy measures adopted by the major governments. Although the rebound in linkers has been slower in Japan, where deflationary pressure is stronger than in other countries, linkers will face tailwinds from a possible moderation in the year-on-year fall in the core CPI after the recent rise in oil prices.



Eurozone Rates: Medium-Term Forecasts

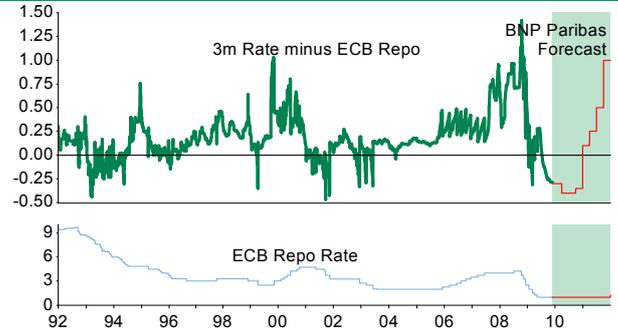
Chart 1: ECB Policy Rate (%)



Source: Reuters EcoWin Pro, BNP Paribas

We expect the ECB to leave the refi rate unchanged until Q4 2011, as inflation remains well below 2%.

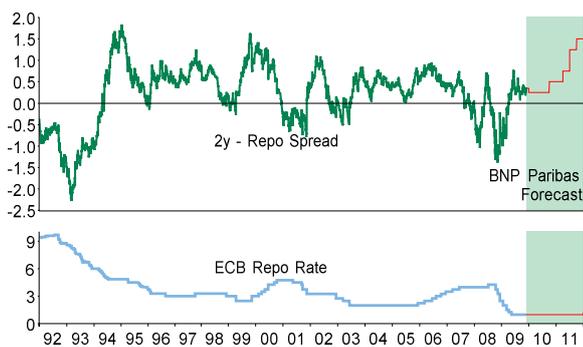
Chart 2: 3-Month Rates and ECB Policy (%)



Source: Reuters EcoWin Pro, BNP Paribas

The ECB deposit rate is 75bp below the refi rate. This has pushed 3-month interest rates below the refi. We expect a re-widening in the spread during 2011 in anticipation of hikes.

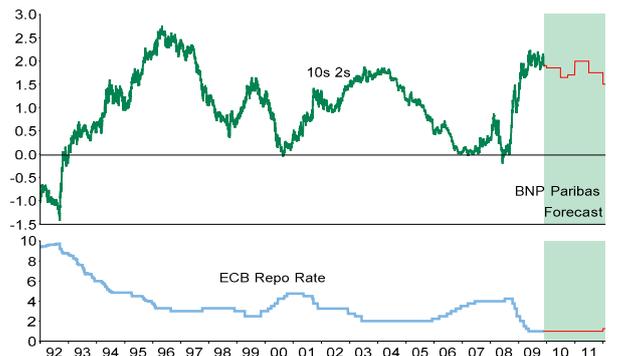
Chart 3: 2-Year – ECB Policy Spread (%)



Source: Reuters EcoWin Pro, BNP Paribas

We expect the spread between the 2-year and the refi rate to be broadly stable until late 2010 before steepening in anticipation of ECB rate hikes during late 2011.

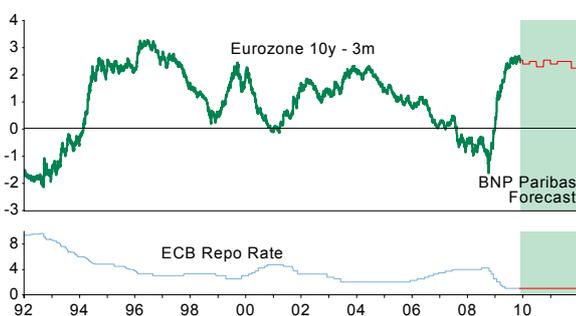
Chart 4: 10-Year – 2-Year Spread (%)



Source: Reuters EcoWin Pro, BNP Paribas

The 10-year – 2-year yield differential is likely to flatten into mid-2010 as the recovery loses momentum.

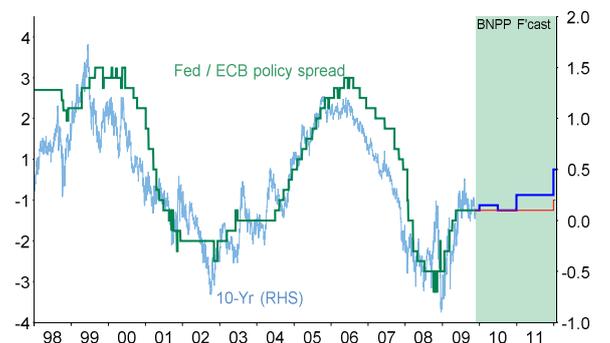
Chart 5: 10-Year – 3-Month Spread (%)



Source: Reuters EcoWin Pro, BNP Paribas

We expect the 10-year – 3-month differential to narrow slightly as the 10-year yield falls back in light of deflation fears around mid-2010. The spread is likely to re-widen further as the possibility of ECB rate hikes approaches.

Chart 6: US – Europe 10-Year Spread (%)



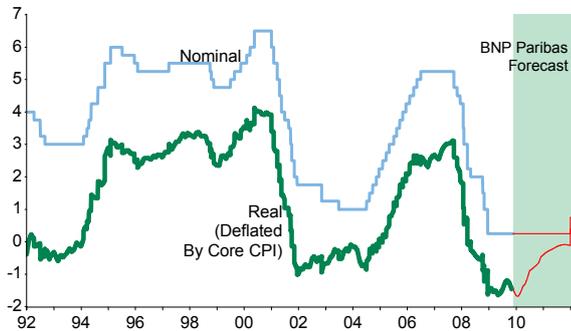
Source: Reuters EcoWin Pro, BNP Paribas

EGBs are likely to outperform US Treasuries. The US will see higher issuance than the eurozone and is more likely to emerge more strongly from recession, while the eurozone is at greater risk of deflation.



US Rates: Medium-Term Forecasts

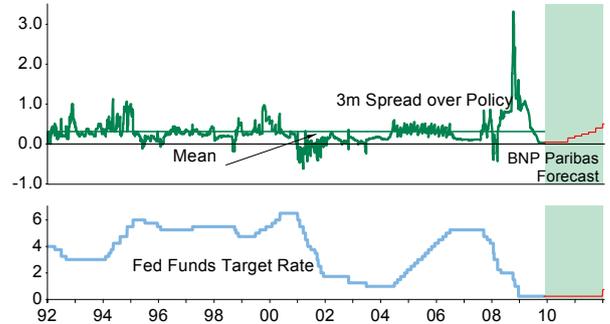
Chart 1: Fed Funds Target Rate (%)



Source: Reuters EcoWin Pro, BNP Paribas

With the Fed funds rate on hold until H2 2011 and inflation falling, real interest rates are about to start rising sharply.

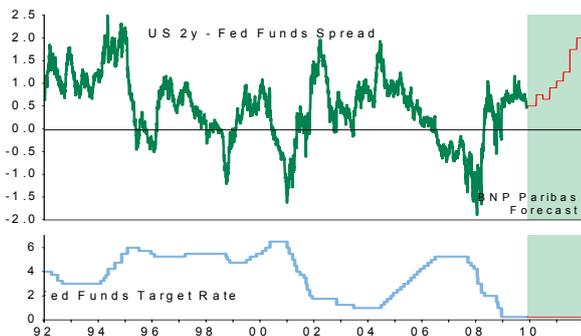
Chart 2: 3-Month Rates and Fed Funds (%)



Source: Reuters EcoWin Pro, BNP Paribas

The spread between the 3-month rate and the Fed funds rate is likely to remain around current low levels in the near term before rising gradually during 2011 as interest rate hikes approach.

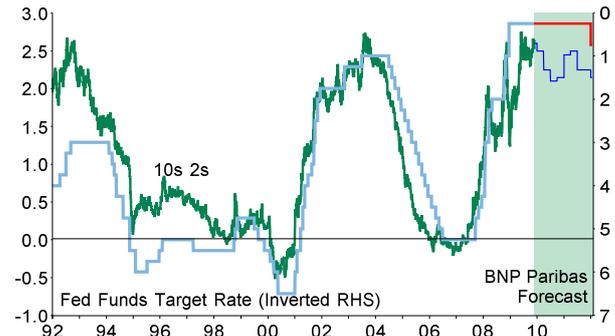
Chart 3: 2-Year – Fed Funds Spread (%)



Source: Reuters EcoWin Pro, BNP Paribas

We expect the spread between 2-year yields and Fed funds to remain close to current levels over the next six months. Thereafter, we expect the spread to re-widen as the market prepares for interest rate hikes in 2011.

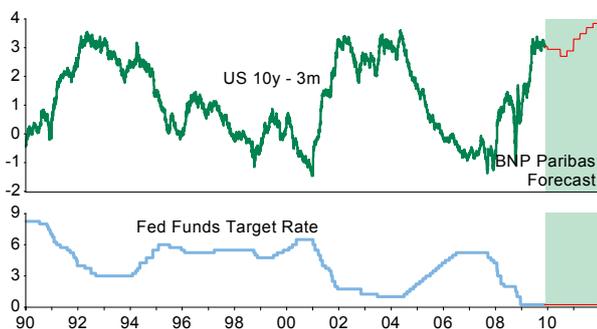
Chart 4: 10-Year – 2-Year Spread (%)



Source: Reuters EcoWin Pro, BNP Paribas

We expect the 10-year – 2-year spread to narrow in the near term as the risk of deflation bears down more on 10-year yields. We expect the curve to re-steepen as the recovery gains momentum.

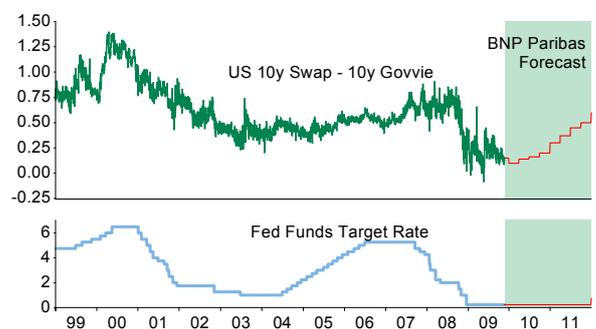
Chart 5: 10-Year – 3-Month Spread (%)



Source: Reuters EcoWin Pro, BNP Paribas

We believe that the widening in the spread between 10-year bond yields and the 3-month rate has run its course and expect the spread to narrow slightly in the near term. We expect the spread to widen again during 2011 as Fed rate hikes approach.

Chart 6: 10-Year Swap Spread (%)



Source: Reuters EcoWin Pro, BNP Paribas

The swap spread to Treasuries is directional. We expect spreads to be broadly stable near term before rising yields from late 2010 drag swap spreads higher.



Credit: Still Attractive, Value in Financials

■ The big picture – relatively positive for credit

The global economy has bounced back due to stimulus measures as well as cheap and easy liquidity provided by the central banks. Growth and inflation in the G7 will remain below par due to structural headwinds such as unemployment, wage deflation, lack of lending, highly leveraged consumers and corporates, including banks, and significant output gaps. Growth in emerging markets will continue to outshine the G7.

The timing and pace of withdrawal of liquidity facilities will be the key challenge for the G7 in 2010. Central bankers will be carefully looking for a delicate balance between the risk of causing a major repricing in financial markets, and that of creating another financial bubble and possibly commodities inflation.

Based on our assessment of fundamentals, valuations and technicals, and assuming no major policy-related mishaps, we believe conditions remain positive for investment-grade credit to outperform government bonds and equities.

The liquidity premium within credit has come down significantly from 275bp to 72bp, with the long-term average at 62bp (Chart 1). We expect a slow grind down in spreads coupled with periodic bouts of volatility. With central banks keeping interest rates on hold, the search for yield has led to robust supply-demand technicals within credit, supporting our positive outlook. A gradual withdrawal of liquidity will affect leveraged instruments, such as high yield and equities, to a greater extent than it will investment-grade credit, and decompression across asset classes, sectors and rating categories could develop as a key theme during 2010.

For non-financials, we note that event risk, which is negligible at the moment, could be on the increase due to low rates and plentiful liquidity, a fact that may encourage company managers to undertake equity-friendly initiatives (dividend increases, share buybacks and debt-financed M&A). We see better value in financials, where the event risk is primarily a function of ongoing losses, which are well understood by the market, and which we believe to be manageable over the medium term, especially for European banks. Within financials, most of the remaining value is in subordinated debt, where the possibility of maturity extension and coupon deferral continues to attract a sizeable risk premium.

■ Valuations – credit versus government bonds

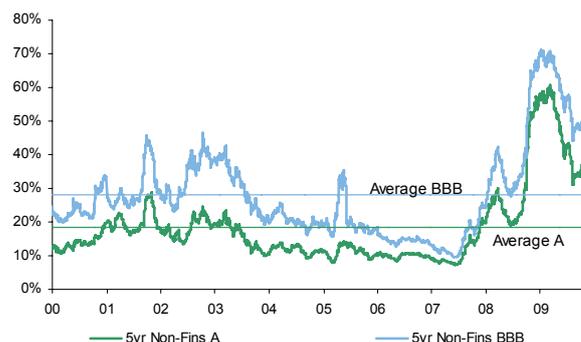
With nominal growth in the eurozone not expected to exceed 3%, we believe investors will continue to buy investment-grade credit. The spread-to-yield ratio (a measure of relative attractiveness between

Chart 1: The Liquidity Premium Has Shrunk



Source: BNP Paribas, iTraxx, iBoxx

Chart 2: IG Credit Still Offers Value Versus Government Paper (spread to yield ratio)



Source: BNP Paribas, iBoxx

Table 1: Credit Yield Versus Dividend Yield (%)

| Index | Credit / Dividend Yield (%) |
|-----------------------------|-----------------------------|
| EUR Corporates yield | 4.39 |
| USD Corporates yield | 5.56 |
| DJ Stoxx 600 dividend yield | 3.36 |
| S&P 500 dividend yield | 2.25 |

Source: BNP Paribas, iBoxx, Bloomberg

government paper and credit spread products) reveals that the additional compensation investors receive to take credit risk is still sizeable (Chart 2).

From a default risk standpoint, long-term investors will also note that BBBs continue to offer a large premium, as they are priced for a 5-year cumulative default rate of about 12%, when the long-term average has been about 2%, with a peak of 5.8%.

■ Credit versus equities

Credit continues to offer better value than equities when evaluated from a credit-yield versus dividend-yield perspective (Table 1). Also, from a historical perspective, stocks' dividend yield remains well



below the long-term average, implying that equities are relatively expensive (Chart 3).

Looking at valuations from an implied growth point of view, credit is pricing in growth in the 1.5% to 2% range (Chart 4), while equities are pricing in an expansion of roughly 5% – based on expected operating earnings growth of more than 20% in 2010.

■ Credit versus equities – a sector view

Table 2 provides a comparison of credit yield versus dividend yield and it is evident that telecoms, utilities, oil and gas and healthcare offer better value in equities than in credit, and investors should take a cautious stance towards these sectors.

Going into 2010, we are changing our asset allocation to underweight on utilities and telecoms, due to tight valuations that leave no room for earnings disappointment, as well as some concern about event risk. On the other hand, we have increased allocation to steel and mining, where spreads are still attractive, and reduced the construction sector to market weight, where most of the rally is done.

Financials offer significantly better value in credit across the capital structure and especially in subordinated debt, where we retain a significant overweight (Chart 5).

Table 2: Credit Yield* And Dividend Yield (%)**

| | Credit yield | Dividend yield |
|--------------------|--------------|----------------|
| Telecoms | 4.01 | 6.18 |
| Utilities | 3.95 | 5.43 |
| Oil and Gas | 4.02 | 4.42 |
| Insurance (Snr) | 4.49 | 3.64 |
| Healthcare | 3.57 | 3.62 |
| Construction | 4.42 | 3.27 |
| Retail | 3.93 | 3.05 |
| Travel and Leisure | 5.01 | 3.05 |
| Household goods | 3.85 | 2.99 |
| Food and Beverage | 3.58 | 2.95 |
| Chemicals | 3.75 | 2.81 |
| Industrial goods | 4.30 | 2.61 |
| Banks (Snr) | 3.76 | 2.38 |
| Basic Resources | 4.40 | 1.39 |

Source: Bloomberg, iBoxx

*IG EUR iBoxx **DJ Stoxx 600

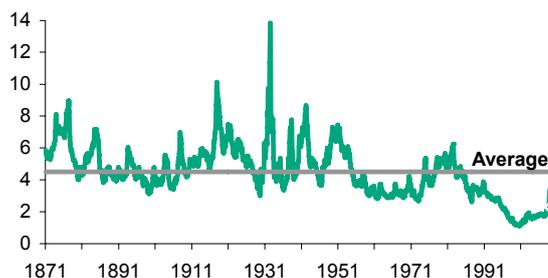
Table 3: Model Portfolio Allocation

| Overweight | Neutral | Underweight |
|-------------------|------------------|---------------|
| LT2 Banks (▲) | Senior Banks (○) | Utilities (▼) |
| Snr Insurance (▲) | T1 Banks (○) | Telecoms (▼) |
| Sub Insurance (▲) | | Cyclicals (○) |
| Non-Cyclicals (○) | | Autos (▼) |

(▲) increased allocation, (▼) lowered allocation, (○) no change

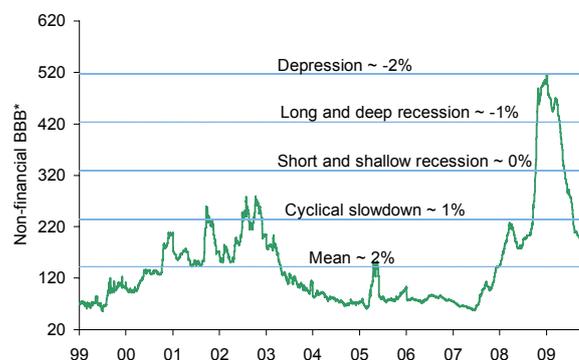
Source – BNP Paribas

Chart 3: S&P 500's Dividend Yield (%)



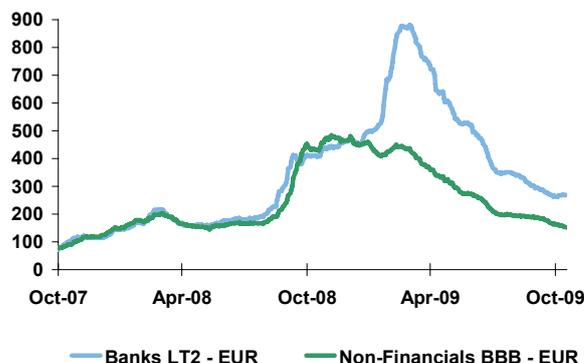
Source: Shiller

Chart 4: Credit is Modestly Overvalued



Source: BNP Paribas, iBoxx

Chart 5: Value in LT2 Banks Versus BBBs



Source: BNP Paribas, iBoxx



FX: Trading When Liquidity is Reduced

■ Global liquidity has weakened the USD

Big currency moves have always been driven by developments in global liquidity. At times when global liquidity expands, the USD tends to weaken and when global liquidity shrinks, the USD tends to appreciate. Global liquidity has recently been substantial as Western central banks have expanded their balance sheets and Asia's accumulation of currency reserves has resumed, reaching a record pace in the autumn of 2009. At the same time, the main Western capital markets have been offering zero returns on deposit holdings, leaving investors no choice other than to look for greater returns in higher yielding markets.

■ The PBOC and Fed are in the driving seat

During the financial crisis the US saw capital inflows as investors sought shelter from the turbulence on global markets. US money market and deposit holdings reached USD 9.5trn, representing a substantial pool of non-leveraged USD liquidity. This pool of liquidity helped global financial markets – including emerging markets – to rally, pushing the USD lower at the same time. In Q1 2010, the expansion of central banks' balance sheets will come to an end, while Asia will come under increasing political pressure to allow the region's currencies to appreciate. In Q2 China may allow the RMB to move higher, which will reduce global liquidity, suggesting, in turn, that commodities, equities and other risky assets will correct lower. This correction will encourage investors to move back into their home currencies and – since most of the boom in assets seen in 2009 was funded out of the USD – the USD should benefit from investors' reduction of their asset holdings.

■ Funding crisis main risk to bullish USD outlook

However, the biggest challenge for 2010 will be to keep inflation expectations under control while also getting credit flowing. Should inflation expectations become un-anchored early and the flow of credit remain slow, the Western world could enter a funding crisis. Such a crisis could see currencies of countries with huge foreign funding needs collapse and related bond yields rise, at least temporarily. If this were to happen, the USD would certainly trade sharply lower, representing the biggest risk to our positive USD forecasts. However, BNP Paribas projects US core inflation will remain far below 2% well into 2011. As it becomes clear that inflation will not rise sharply, those currencies that are currently pricing in such an increase will correct lower.

■ Trading currencies on the back of Chinese inflation

China is key to the global economic recovery. BNP

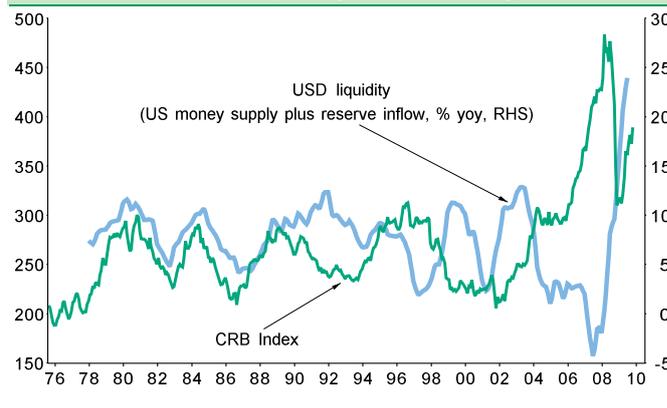
Table 1: BNP Paribas' End-Quarter Foreign Exchange Forecasts

| | Spot* | Q1 '10 | Q2 '10 | Q3 '10 | End 2010 | End 2011 |
|---------|-------|--------|--------|--------|----------|----------|
| EUR/USD | 1.50 | 1.48 | 1.42 | 1.38 | 1.40 | 1.47 |
| USD/JPY | 89 | 90 | 97 | 100 | 108 | 118 |
| USD/CHF | 1.01 | 1.01 | 1.04 | 1.11 | 1.11 | 1.07 |
| GBP/USD | 1.66 | 1.68 | 1.56 | 1.45 | 1.40 | 1.62 |
| USD/CAD | 1.06 | 1.07 | 1.09 | 1.13 | 1.15 | 1.04 |
| AUD/USD | 0.92 | 0.92 | 0.86 | 0.84 | 0.82 | 0.92 |
| NZD/USD | 0.73 | 0.72 | 0.70 | 0.68 | 0.65 | 0.69 |
| EUR/JPY | 133 | 133 | 138 | 138 | 151 | 173 |
| EUR/GBP | 0.90 | 0.88 | 0.91 | 0.95 | 1.00 | 0.91 |
| EUR/CHF | 1.51 | 1.50 | 1.48 | 1.53 | 1.56 | 1.57 |
| EUR/SEK | 10.32 | 9.90 | 10.00 | 10.20 | 10.10 | 9.30 |
| EUR/NOK | 8.39 | 8.10 | 8.30 | 8.30 | 8.20 | 7.50 |

Source: BNP Paribas

*25 November

Chart 1: USD Liquidity Drives Risky Assets



Source: Reuters EcoWin Pro

Paribas forecasts that China's GDP growth will reach 8.7% in 2009, much stronger than the consensus expectation at the start of the year. However, a sustainable rebalancing of the global economy is dependent on a pick-up in China's private demand while the rise in GDP has been driven by rebounding exports and public spending, with fiscal injections accounting for 4.5 percentage points of this year's GDP growth. Of course, China is in a fiscally strong position and its private sector has generated substantial savings, suggesting that it will be able to develop domestic demand strength. However, the transition from a supply- towards a demand-driven economy will take time and is unlikely to be smooth.

Moreover, China's move from being supply to demand driven suggests a structurally higher inflation rate, and this process will be fuelled by the excessive liquidity added to the system by the authorities over the past year, especially as China's capital account is not as open as elsewhere. At some point, China will have to



absorb this liquidity and will have to tighten its monetary conditions. It can do so by either allowing its exchange rate to appreciate or using domestic measures such as increases in minimum reserve requirements or interest rates. One way or another, China will reduce the provisions it has made to local liquidity (via money supply and credit growth) and international liquidity (via currency reserves). Chinese monetary policy has an important impact on the supply of global capital. Once China starts to reduce its monetary accommodation, liquidity conditions will suffer, real yields will have to increase, volatility will rise to a higher long-term equilibrium and equity markets will have to offer higher earnings (lower PE ratios) to attract investors. Investors' reduction of their holdings of risky assets, which are largely funded out of the USD, will be supportive for the USD.

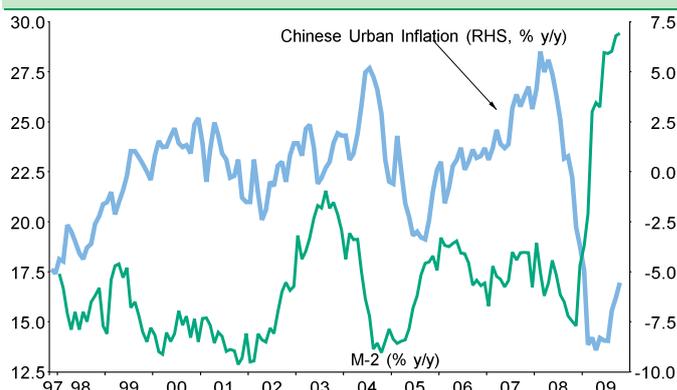
■ **JPY up for now, but will face a lot of trouble ahead**

Meanwhile, our bullish JPY call has worked out, even though Japan has been trapped in deflation. However, the JPY story never related to relative economic strength or current account shifts. The JPY's performance has been entirely driven by the need to manage the country's USD 8trn of foreign assets. The currency risk of this portfolio has been managed by increasing currency hedges when hedging costs are low and reducing the currency hedge when currency hedging costs are high. The US and other Western central banks have now kept interest rates ultra-low for over a year, suggesting that most of the currency hedging, and the support it provides to the JPY, has already been completed.

Although US inflation expectations have risen to the levels last seen before the Lehman collapse, the Fed has remained relaxed about inflation. This is probably for very good reason as actual inflation rates are expected to subside again, driven by lower shelter costs and excess capacity. Hence, US bond yields have little reason to rise and are expected to trade around 3% on 10-year Treasuries in the first half of 2010. Next to currency hedging costs, USD/JPY is still heavily influenced by yield differentials. US bond yields near 3% will do little to encourage Japanese investors to move funds into the US explaining our forecast that USD/JPY moves in the first half of 2010 will be relatively modest.

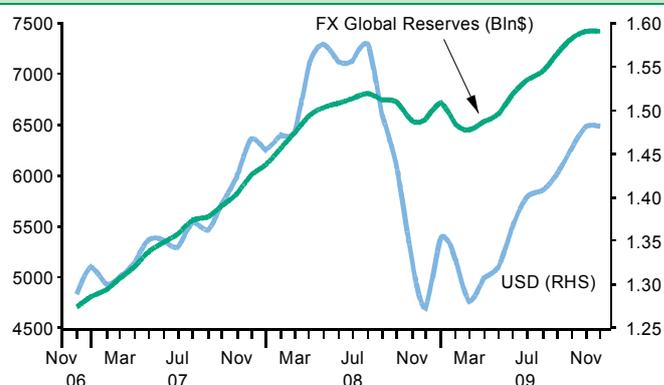
However, longer term, sharper currency moves are expected. Japan's fiscal position may have already passed the point of no return, with public sector debt exceeding 200% of GDP. Interest rate payments represent more than 25% of tax revenues, which explains why Japan's FinMin is very sensitive to yield increases. If JGB yields doubled, Japan would have to spend 50% of its tax receipts on interest payments. Moreover, the situation will deteriorate further. Thus Japan will have to ensure that there is enough demand for all the bonds being issued by the Japanese

Chart 2: China Will Have to Reduce Accommodation



Source: Reuters EcoWin Pro

Chart 3: Global Currency Reserves are Rising Once Again



Source: Reuters EcoWin Pro

authorities. As 93% of all bonds are issued domestically, domestic savings are very important. But for Japan to maintain its high savings ratio, the Japanese economy will have to remain in deflation.

This implies that JPY weakness will become a big issue once inflation picks up outside of Japan or bond yields rise due a change of the global capital demand-supply picture. Reduced supply of Chinese capital will increase the price for capital globally, possibly substantially should the RMB appreciate. Moreover, at the same time as China has to withdraw its accommodative policy, Western central banks may have already stopped adding to their balance sheets. While some of the globe's demand for capital was funded by central banks' quantitative easing efforts in 2009, central banks' supply of capital will ease or in some cases even reverse in 2010 when monetary authorities return to more prudent policy approaches. All other things being equal, the cost of capital will increase. When capital costs outside of Japan rise, the JPY will weaken across the board. Thus we forecast sharper JPY moves in the second half of 2010.

■ **Cyclical currencies will correct lower**

Cyclical and commodity currencies are inversely related to the USD's performance and this will not



change next year. When the USD starts rising, these currencies will fall, irrespective of their fundamental situations. Often, positioning in these currencies is extreme and when the liquidation trade occurs, some of the previous star performers in the currency market will be hit hard. The AUD falls into this category.

In 2009 the AUD has outperformed its commodity currency peers, especially the CAD. Some of the AUD's outperformance has reflected the BoC's attempts to talk the CAD down and the wide interest-rate differential between the two currencies. However, commodity markets will face a more challenging environment next year as the change in global liquidity conditions undermines the otherwise bullish outlook. China remains important to commodity price trends, and not only from a demand perspective. When China starts to absorb liquidity or allows the RMB to appreciate, commodities will be hit. The relationship between the level of the RMB and commodity prices is complicated. At first glance it might be argued that the rise of the RMB might cheapen commodity imports for China and hence work in favour of commodities. However, the rise of the RMB will indicate that China is tightening, which will eventually reduce China's final demand. More important will be the impact the rising RMB will have on global bond markets. Once the RMB appreciates, instead of importing deflation, the globe will import inflation from China. Rising bond yields will increase the opportunity costs of holding commodity inventories, pushing commodity prices and related currencies lower.

■ **EUR: trading lower from excessive year-end levels**

The ECB has been relatively conservative in the expansion of its balance sheet, but we have become increasingly nervous about the outlook for the EUR. Over the past year, the ECB has allocated liquidity to the banking system by accepting weak collateral, ensuring that weaker banks have adequate funding. However, the ECB has sent signals that excessive liquidity provisions will have to end, suggesting the focus on credit divergences will return. If this credit divergence were limited to the institutional level it would not be a problem. However, we expect sovereign credit spreads to widen. Public debt has risen to unsustainable levels in EMU's peripheral countries and sovereign credit default spreads have started to blow out again. The widening of sovereign spreads within EMU will soon restart discussion about institutional and regulatory shortcomings within the eurozone. From investors' point of view, the widening of intra-EMU spreads increases uncertainty, especially for bond investors. This increase in uncertainty suggests that the current record portfolio inflows will not only slow, but will probably reverse, weakening the EUR next year.

However, the EUR's decline could start from a fairly overvalued level as the end of this year could see a

substantial repatriation of assets onto EMU banks' domestic balance sheets. This repatriation-related demand will be supportive for the EUR. Banks that have received state aid will be regulated by the European Commission for competition. Some German Landesbanken have been reviewed and asked to reduce their balance sheets by 40% and to concentrate on an entirely domestic business model. In total, Landesbanken have EUR 2.2bn of assets under administration, 20% of which are held outside of the eurozone. The repatriation of these funds in December could cause the EUR to start 2010 from quite a high level.

■ **Sterling: don't get pulled in**

While most of our currency projections have played out in Q4 2009, we misjudged sterling. Rate expectations have picked up early as the housing market has developed signs of life, the labour market has stabilised after the sharp increase in unemployment in the spring, orders and production have picked up and inflation has accelerated, driven by higher import prices. Our GDP projections suggest that the UK will outpace the eurozone for most of next year and with UK headline inflation likely to exceed 3% in January, it is not surprising that rate expectations have moved in favour of sterling. Hence, EUR/GBP will massively undershoot our previous expectations for Q4 2009 and Q1 2010, and we have revised our forecasts accordingly.

However, our medium-term projections remain bearish on sterling as the current rebound in the economy is dependent on expansionary monetary and fiscal conditions. An economy that has suffered from excessive debt and consumption will not get out of the crisis by generating conditions for even greater consumption, with potentially rising property prices providing the necessary collateral for equity withdrawal. An economy running at a 70% consumption-to-GDP ratio will not be put on a sustainable growth path by this policy approach and it may even sow the seeds for a sterling collapse, against which recent sterling volatility may look like a walk in the park.

For 2010 and 2011 our rate projections diverge massively from market expectations, with the consensus expecting rate rises in the second half of 2010 and in 2011 while we expect rates to remain on hold throughout the period. Public debt has reached a level where rating agencies are threatening to remove the UK's triple A rating, which suggests that the incoming government will have to implement a massive fiscal consolidation programme. Fiscal tightening will depress economic conditions late in 2010 with the risk of a double dip developing in 2011. In addition, while the housing market has started to rebound, the house price-to-income ratio is well above long-term sustainable levels. Low interest rates have helped, but with real disposable income unlikely to pick up for years, the housing market will be at the mercy of bond yields and would be hard hit by an early rise of rates.



Asian Markets: Re-Rating & Asset Bubbles

■ Re-rating of Asia

The rebalancing call by policymakers and the enlargement of the G7 into a G20 grouping confirms that the power bases of global economies are shifting. The emerging powers of the East, not least China and the large domestic economies of India and Indonesia, are seeing portfolios being rebalanced in favour of emerging markets, with Asia a central investment theme. This theme will remain in 2010 and the re-rating of Asia will maintain capital inflows, keeping currencies supported.

■ 2010 forecasts intact

We therefore stay positive on Asian currencies in 2010. Our FX forecasts are largely unchanged, except for slight upward revisions to our forecasts for the IDR, INR, MYR and SGD. These currencies have continued to advance against a beleaguered USD, with the USD undermined by the likelihood that US rates will stay low and by structural domestic issues that could hamper a recovery in the US economy. In contrast, Indonesia and India continue to benefit from their growing domestic economies, while export growth has benefited export-oriented economies such as Malaysia and Singapore. On top of all this, Asia has more room to provide a monetary and fiscal stimulus than the G3, and these considerations will continue to support asset prices in Asia.

■ RMB to appreciate more in 2010

We have also raised our appreciation call for the RMB in H2 2010 as sustained growth in China, coupled with better external conditions, increases policymakers' comfort with a return to a floating exchange-rate peg. Such a shift is not expected to happen until Q3, but the degree of RMB appreciation has been raised to 3% by the end of 2010. An extended period of strong growth and reduction of deflation pressures should increase the Chinese authorities' comfort with currency strength.

■ Dealing with asset bubbles

As we write, further capital controls in Asia have become a real threat, as stock markets and property prices continue to surge. Some form of tax on hot money flows, as seen in Brazil, remains a distinct possibility for some countries, including Hong Kong, India and Taiwan. Meanwhile, Indonesia could restructure withholding taxes and Korea could manage FX speculation. After all, one of the lessons learnt from both the Asian and the credit crisis is that what comes in can also go out, and policymakers want to limit the destabilising forces of capital shifts, but not to reverse capital inflows.

Table 1: BNP Paribas' End-Quarter Foreign Exchange Forecasts

| | Spot* | Q1 '10 | Q2 '10 | Q3 '10 | End 2010 | End 2011 |
|---------|-------|-----------|-----------|-----------|-------------|-------------|
| USD/SGD | 1.38 | 1.37 | 1.36 | 1.36 | 1.34 | 1.30 |
| USD/MYR | 3.39 | 3.31 | 3.28 | 3.26 | 3.20 | 3.10 |
| USD/IDR | 9475 | 9000 | 8800 | 8700 | 8600 | 8200 |
| USD/THB | 33.23 | 32.70 | 32.50 | 32.30 | 32.00 | 31.00 |
| USD/PHP | 46.92 | 45.50 | 45.00 | 44.50 | 44.00 | 42.50 |
| USD/HKD | 7.75 | 7.80 | 7.80 | 7.80 | 7.80 | 7.80 |
| USD/RMB | 6.83 | 6.83 | 6.83 | 6.72 | 6.62 | 6.42 |
| USD/TWD | 32.18 | 30.70 | 30.50 | 30.30 | 30.00 | 29.00 |
| USD/KRW | 1156 | 1120 | 1090 | 1070 | 1050 | 1000 |
| USD/INR | 46.36 | 45.00 | 44.00 | 43.00 | 42.00 | 38.00 |
| USD/VND | 17880 | 17300 | 17000 | 16700 | 16500 | 16000 |

Source: BNP Paribas

*24 November

■ Relative performers and underperformers

While a re-rating of the region is taking shape, investors are likely to be more discriminating in their investment picks, as stock valuations look rich and credit spreads tight. The current consensus is for China to continue on its recovery path, and large domestic economies, such as India and Indonesia, to perform well. Capital inflows into these countries, together with improving current account balances (as exports rise), should maintain the outperformance in their currencies (IDR and INR). We see the KRW moderating from its sharp rally this year, though it will still emerge stronger against the USD. The positive carry of the KRW against the USD, and further upgrades in its sovereign rating and/or inclusion in global bond indices, are factors that will maintain investment flows into the country, buoying the KRW.

The currencies that will underperform are the SGD and THB. With no changes in the SGD's nominal effective exchange rate expected, the SGD continues to look expensive, limiting the room for an outperformance of the currency. In the case of the THB, the fact that ex-PM Thaksin has taken refuge in Cambodia opens up a host of potential political and confidence issues that will keep foreign investor flows into Thailand subdued compared with flows into the rest of the region.

■ Asian exit strategies a continual re-calibration

With curves pricing in a high degree of rate hikes, it will be no surprise to see opportunistic receivers come back into play if risk taking moderates. Until bank lending is normalised, we expect the withdrawal of monetary and fiscal stimuli to remain cautious. This is against the backdrop of a normalisation of policy rates that favours payers as yields correct. We recommend curve flatteners in RMB and KRW.



CEEMEA: Exit and Liquidity Issues

■ Fiscal and liquidity risks in CEE

Improvements in the external accounts of CEE countries cannot hide the fact that fiscal and liquidity risks remain high. The high level of liquidity has helped to finance fiscal deficits, with limited spillover into the absolute and relative level of yields, but we see risks mounting as liquidity is now being withdrawn.

Nevertheless, we believe sentiment towards risk and emerging markets will remain relatively strong, which should keep currencies supported as the recovery takes hold and economic data improve.

The German tax cuts are likely to provide additional impetus, but we fear European banks will gradually reduce liquidity support to CEE, which is a significant concern. The ECB's signal that liquidity windows will be narrowed is an important consideration, and the European Commission's push to regulate state aid to banks will force some banks to reduce their investment in CEE, curbing flows to the region.

Furthermore, the commitment of multilateral institutions (EBRD, EIB, World Bank) under the Vienna Initiative seems to be weakening as they now expect – and agree with – lower rollover ratios for banks' credit lines to the region.

We remain positive on Hungary and continue to expect good fiscal behaviour, but the forthcoming elections could create some uncertainty and gains may be more limited. We continue to expect deflation fears in the Czech Republic to affect the CZK and see it underperforming, while Romania's IMF programme will remain unconfirmed until the political situation improves – which might require an early general election.

Poland's fiscal policy will become a focus in the middle of 2010 as we expect privatisations to disappoint. The renewal (or lack thereof) of the IMF's flexible credit line could lead to a repricing of Polish risk.

■ Russian economy remains fragile

The Russian economy remains fragile, despite strong oil prices, and we continue to see its banking sector dragging on economic growth. This leaves the economy dependent on the strength of oil prices.

Ukraine will draw investors' attention as it heads into a presidential/general election at the start of 2010, with repercussions for the IMF programme and its credibility globally. We view the situation as particularly fragile and see banks as the natural adjustment variable in the process – with potentially negative effects on the rest of Europe.

Table 1: BNP Paribas' End-Quarter Foreign Exchange Forecasts

| | Spot* | Q1 '10 | Q2 '10 | Q3 '10 | End 2010 | End 2011 |
|---------|-------|-----------|-----------|-----------|-------------|-------------|
| EUR/PLN | 4.12 | 3.92 | 4.20 | 4.35 | 4.05 | 4.00 |
| EUR/CZK | 25.87 | 26.00 | 26.20 | 26.20 | 25.80 | 24.70 |
| EUR/HUF | 268 | 255 | 280 | 278 | 265 | 260 |
| EUR/RON | 4.27 | 4.30 | 4.30 | 4.40 | 4.35 | 4.00 |
| EUR/RSD | 94.40 | 92.0 | 105.0 | 95.0 | 93.0 | 87.0 |
| USD/RUB | 28.81 | 29.61 | 31.12 | 29.89 | 27.97 | 24.76 |
| USD/UAH | 8.04 | 8.98 | 8.63 | 7.95 | 7.04 | 5.91 |
| USD/TRY | 1.50 | 1.48 | 1.53 | 1.58 | 1.55 | 1.50 |
| USD/ZAR | 7.46 | 8.00 | 8.20 | 8.30 | 8.50 | 8.20 |
| USD/EGP | 5.45 | 5.72 | 5.64 | 5.55 | 5.46 | 5.14 |
| USD/ILS | 3.77 | 3.55 | 3.60 | 3.80 | 3.75 | 3.60 |

Source: BNP Paribas

*24 November

■ BoP struggling in Turkey

Funding the current account deficit is a challenge, due to corporates' and banks' limited rollover ratios and small inflows into the equity market. Meanwhile, the bond market is not supported by non-resident investors, preventing significant lira strength. However, the focus will be monetary policy, which might have to respond to upward pressure on commodity prices that could affect inflation expectations.

■ Intervention to curb rand's gains

Despite the strength of commodities, we expect the rand's gains to be curtailed by more vigorous SARB intervention. We also expect discussion about inflation targeting to have a negative effect on the currency.

■ Rising oil prices benefiting Middle East

The Middle East is benefiting from USD weakness and the rise in oil prices, which are reviving local economies. However, we remain wary of the banking sector, which is yet to digest a rise in non-performing loans. It seems that Saudi banks have been spared while the other Gulf banks are yet to take stock of their losses, which explains the relative outperformance of Saudi Arabia. In Egypt, we continue to expect the currency to perform well as external accounts improve, but we expect inflation to pose a challenge to the CBE.



Latam Markets: Weathering the Storm

■ Latam markets should trade firmly although 2010 will be a challenging year for global markets

Our generally upbeat view for Latam markets is based on the continued recovery of the Chinese economy and the support it will give to commodity prices and thus Latam's terms of trade. In addition, in light of the poor growth outlook for the advanced economies, global liquidity conditions will remain loose. Excess liquidity will keep money flowing into high-yield emerging market assets, resulting in a positive flow of funds into Latam capital accounts.

■ While the base scenario is quite positive, the road will be bumpy

While global liquidity will remain high, the pace of liquidity injection will slow as the Fed's, ECB's and BoE's balance sheets stabilise. This could burst bubbles in the global markets. Volatility will rise during this correction, which we expect to take place in Q2 2010, when a number of liquidity lines mature in advanced economies and inflation in China will start to accelerate. This is the rationale for our expectation of a correction in currencies in Q2 2010. However, as the region benefits from robust fundamentals and there is no evidence of any bubbles developing, we expect the correction in Latam to be limited.

■ Local interest-rate curves are pricing in too much tightening too soon in Latam

Yields at the short end of local curves will move lower in the coming quarters as economic growth disappoints and market players postpone their expectations of rate hikes. Thus, local curves will remain steep for now, but we see room for a flattening in early 2010. The long ends of Latam curves are just too cheap for a global economy that will face strong headwinds and which is still facing an imbalance due to excess savings and a lack of assets to invest in (banks are not lending, keeping the production of securitised assets subdued). We believe that receivers in the long end of local curves in Latam offer a good risk-return trade-off.

■ The BRL's rally is over

Brazil's strong balance of payments will allow the BRL to remain firm during 2010. However, the currency now looks expensive in relation to the country's terms of trade. Moreover, the government has shown its strong commitment to limiting the BRL's appreciation (for example the new tax on foreign portfolio investments). The local bond curve as a whole is cheap. The short end of the curve is pricing in 400bp in rate hikes next year despite the prospect of lower inflation and the heavy headwinds facing the Brazilian economy. We expect the CB to keep rates unchanged next year.

Table 1: BNP Paribas' End-Quarter Foreign Exchange Forecasts

| | Spot* | Q1 '10 | Q2 '10 | Q3 '10 | End 2010 | End 2011 |
|---------|-------|--------|--------|--------|----------|----------|
| USD/ARS | 3.80 | 3.89 | 4.20 | 4.10 | 4.20 | 4.50 |
| USD/BRL | 1.72 | 1.75 | 1.90 | 1.80 | 1.75 | 1.85 |
| USD/CLP | 489 | 505 | 530 | 525 | 530 | 535 |
| USD/MXN | 12.91 | 13.00 | 13.75 | 13.10 | 12.50 | 12.50 |
| USD/COP | 1,967 | 1,900 | 2,100 | 2,050 | 2,000 | 2,100 |
| USD/VEF | 2.14 | 3.00 | 3.00 | 3.00 | 3.00 | 3.90 |
| USD/PEN | 2.88 | 2.85 | 2.95 | 2.90 | 2.85 | 2.80 |

Source: BNP Paribas

*24 November

■ MXN is undervalued

The MXN is fundamentally cheap and is only waiting for a sustainable recovery in global manufacturing for it to appreciate more permanently. Some pressure on the MXN may arise from the fact that the CB will remain on hold longer than the market is pricing in. But we expect the benign balance of payment flows to prevail, leading the currency to test new highs. The local bond market is also cheap in light of our forecast for interest rates.

■ Fundamentals are favourable for the CLP

The strong copper market, a fundamentally sound economy and the likelihood that the CB will be among the earliest in the region to hike rates will support the CLP. However, we expect the CLP's appreciation to be capped by more aggressive intervention.

■ ARS is likely to be stable in the short term

The ARS stabilised somewhat in Q3 2009 due to an increase in risk appetite and the government's willingness to address its creditor hold-out situation. However, fiscal imbalances will keep the ARS on its long-term depreciation trend next year.

■ Good fundamentals, including strong FDI, will not be enough to lead to a further rise in the COP

The COP's upside is limited in light of the deterioration of trade relations with Venezuela and signs that the authorities are discussing ways to manage currency strength. As in Mexico, we expect the CB to be more dovish than the markets are pricing in, capping the COP's move, but indicating that local bonds are cheap.

■ Devaluation of the VEF lies ahead

High inflation has led to a rise of the VEF in real terms, adding to pressure on the economy. The nominal exchange rate will have to be adjusted. With the recovery in Latam likely to be relatively modest, the VEF's move should come sooner rather than later.

■ BoP strength should lead to rise in the PEN

The terms of trade are gradually improving and foreign investment in infrastructure projects continues.



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