CRÉDIT AGRICOLE
CORPORATE & INVESTMENT BANK

# Macro Prospects

FIM RESEARCH

01 April 2010

# The recovery continues while uncertainties still linger

- **The economic climate seems to be stabilising**. In developed countries a partial recovery is currently underway. This is a recovery because indicators show that growth has resumed and probably on a lasting basis. But its partial characteristics can be seen in several areas: bank lending has not yet recovered and consumer spending and construction investment are lacklustre. In emerging countries the prospects are more flattering. GDP growth is forecast to run at around 6% this year and next. For most of these countries inflation is under control, policymakers seek to tighten monetary settings in line with price trends and government budgets are in relatively good shape—all in all, a reassuring and attractive picture.
- Our favourable outlook will not prevent the business community from remaining a little cautious. The feeling of a lack of clarity will not disappear easily. There are three main reasons. **The crisis has taught us that the market did not always know better than everyone else**. This means that a sharp rise in asset prices would not necessarily lead to a greater preference for spending at the expense of saving. However, it is feared that the contrary (falling asset prices) would lead to a net loss of confidence and a downward revision of purchasing intentions
- **Uncertainty over the political/regulatory landscape is dampening 'animal spirits'** that often animate business investment decisions. For example, the financial services sector still does not know what lies ahead in terms of regulatory reform and that will affect its profitability. Other sectors are also confronted by the same kind of uncertainty. For example, in the US firms face uncertainty over how much they will pay for their employees' health care costs given recent health care reform measures.
- **The post-crisis period will demand a great deal from economic policy**. In developed countries, the aim is to simultaneously normalise the very accommodative monetary policy stance that the crisis forced upon us and to nurture economic growth that will initially be on the weak side. In emerging countries the aim is to stop markets spinning out of control and to consolidate the culture of stability that has gradually grown up over the past decade. Much is at stake, and knotty questions will be raised, as to the timetable (when to swing into action?), the preferred tools and the degree to which they should be applied. The markets will be attentive to the credibility and expected effectiveness of the measures undertaken.

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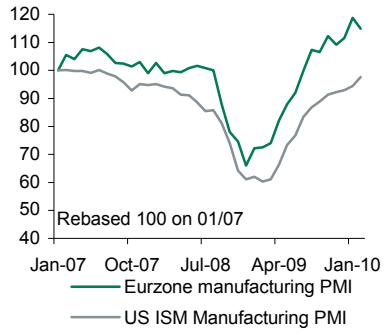
# Special: Market expectations focused less on growth than economic policy

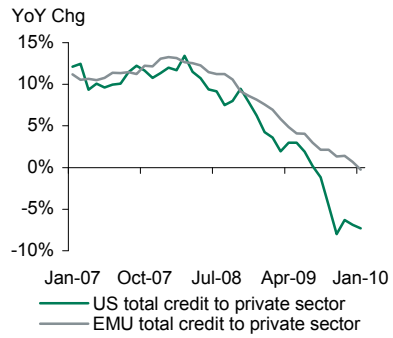
The post-crisis period will demand a great deal from economic policy. Markets will be attentive to the credibility and effectiveness expected of the measures decided. Investors **may have been disappointed by the markets, but that does not mean they will necessarily switch back to absolute confidence in economic policy.**

### US and Eurozone manuf PMI



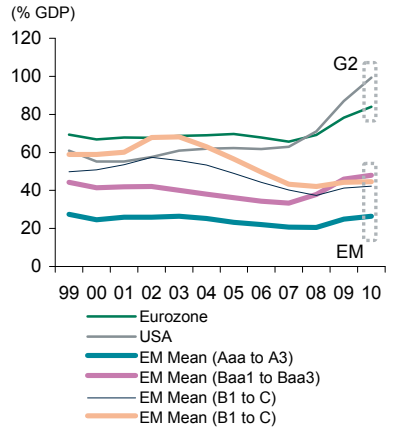

*Source: Bloomberg*

### US and EMU total credit to private sector (EURbn)




*Source: Bloomberg*

### General government debt




*Source: Moody's*

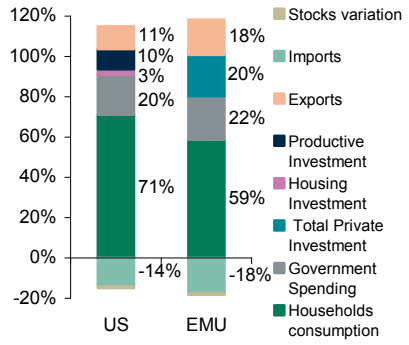
The general diagnosis of the economic climate is that it seems to be stabilising. In developed countries, a partial recovery is currently underway. This is definitely a recovery insofar as the indicators clearly show that growth has resumed, and probably on a lasting basis. This is reflected in the most recent GDP figures for Q3 and/or Q409. It is also true for the findings of business surveys, which are meant to highlight the direction of activity in the months ahead. But the 'partial' characteristic can be seen from several angles. In the first place, while data on the manufacturing sector is sending encouraging signals, aided by a halt in inventory downsizing and a normalisation in world trade, data on consumer spending and construction investment is far more lacklustre. Secondly, lending has not really recovered yet, and uncertainties about the new regulatory framework to be imposed on the banking sector are not helping to drive a spectacular recovery. What is more, the spectacular ballooning of public debt is undermining the image of healthy, sustained growth underpinned by close attention to preserving the main macroeconomic balances. **In emerging countries, the prospects are more flattering.** GDP growth is forecast to run at around 6% this year and next – slightly less initially, slightly more thereafter. Although Asia still takes the lead, with forecasts in excess of 7%, the biggest changes are to be seen elsewhere, with the shift from severe recession in 2009 to honourable growth rates, at least, in 2010. In Europe's emerging countries, for example, performance is forecast to progress from a negative 5.5% to a positive 2.4%. Obviously, this stepped-up or new-found tempo (depending on the region) is still overly dependent on external demand and not enough on domestic spending. But the consolidation of the main macroeconomic balances in most of the countries concerned (with inflation under control, a desire to tighten monetary settings according to price trends, and a relatively flattering situation in the public accounts) reflects an image at once reassuring and attractive.

**This divergence between growth rates in developed and emerging countries could even be accentuated, in terms of the relative attractiveness of the capital markets, by opposing economic policy stances.** In the emerging world, strong growth, low public debt levels and the desire to contain inflation pressures all favour the option of combining tighter monetary policy with an unchanged fiscal stance, which would be likely to translate into upward pressure on real interest rates. Ultimately, hopes of expected high yields should lead to higher capital inflows to these countries.

In the developed countries, the Greek crisis seems to be acting as a catalyst to raise awareness about the need to take measures to re-balance the public accounts as a matter of urgency. This is bound to weigh heavily on a recovery that is already expected to be weak relative to previous experience. Central banks will need to factor this component into their decision-making processes and seem to be confirming that increases in key rates in both the US and Europe will be deferred and incremental when they do come.

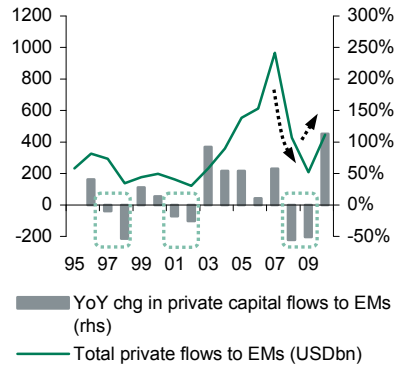
**This contrast between the policy mix of emerging countries versus developed countries strengthens the sense that expected returns will be more attractive in the former than in the latter.** Probably even more fundamentally, the contrast is perceived as being potentially lasting. The combination of fairly strong potential growth (perhaps at around 6%, even if, as seems likely, this notion should be handled with extreme caution) and an apprenticeship in a culture of macroeconomic stability (ie, inflation under control, balanced public finances and healthy external accounts) obviously feeds into hopes of high yields and the idea that the perception of risk in connection with this type of investment is perhaps likely to be revised downwards as time goes by. Especially given that, even if we maintain a somewhat conservative attitude to

**GDP breakdown, 2009**



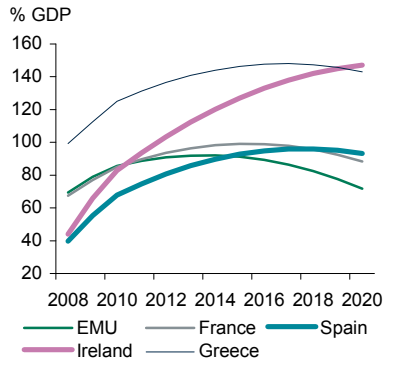

*Source: Crédit Agricole CIB*

**Capital flows to EM**




*Source: Crédit Agricole CIB*

**EMU debt to GDP ratios** (primary balance improving 1% pa)




*Source: Crédit Agricole CIB*

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the stabilisation of emerging country risk, the expression of the risk/return ratio is still very favourable. This is why we should no doubt be gearing up for portfolio allocations weighted more in favour of emerging country assets. Hence the particular insistence on the idea that capital inflows to emerging markets are set to increase markedly.

This new environment, in terms of both the outlook for growth (emphasising the lacklustre nature of growth prospects in developed countries) and the volume of capital inflows (mostly heading for emerging countries), raises weighty questions of economic policy. Two are especially important. **The first mostly concerns the US, Western Europe and probably Japan. How does one simultaneously create the conditions for more economic growth (by ratcheting up the trajectory of potential growth, for example) and resume a more neutral economic policy stance,** ie, find the means of effective public interventionism when, for whatever reason, economic activity again goes into a downturn some time in the future? For more than a few European countries (Spain, the UK and Ireland, to name but three), and also for the US, what drives demand in the next few years ought not to be household consumption or housing investment so much as exports and business investment, notably because households have to consolidate their finances – ie, reduce debt and save more overall. That said, there is only limited room to compensate for this. The proportion of consumption alone in US GDP is currently five times greater than that of exports and business investment combined. A 1% slowdown in the former must be offset by a 5% acceleration in the latter. That target is in no way easy to achieve and there are fears that the pace of growth could be permanently impacted by a rebalancing which, by its very nature, is incomplete. This is surely the message of the German and Japanese experiences. All we can hope for is a new technology shock and the emergence of a new source of supply that will spontaneously generate its own demand. But who can say, here and now, that this will happen any time soon? Unlikely. That said, how do you go about stabilising and then reducing the ratio of public debt to GDP at the same time as you go back to short-term interest rates that are more in line with the expression of monetary neutrality, and also maintain a socially acceptable level of economic growth? A fearful question, indeed. And there are no easy answers. The clarity of economic policy will be low in coming quarters, and the risk of error probably greater than that observed in the past.

**In emerging countries, the prospect of potentially large-scale capital inflows from Western countries raises difficulties of its own.** We should not lose sight of the fact that the capitalisation of most stock markets in emerging regions is small relative to that of more advanced countries. Developed countries account for 70% of global equity market capitalisation, for example, and the proportion is even higher if one looks only (as one should) at the public float. There is thus a real risk of seeing bubbles emerge, the consequences of which would be harmful. While the bubble is forming, it is likely to lead to a loss of price-competitiveness due to currency overvaluation and excessive growth in lending. When the bubble bursts, its impact will range from negative wealth effects to a need to consolidate the finances of economic agents. We should therefore understand the concerns of the people in charge of economic policy and their desire to take measures to avoid triggering this type of mechanism. Capital controls have already been put in place in Brazil and are being considered in several Asian countries, eg, South Korea, Indonesia and Taiwan. Of course, the effectiveness of such controls is debatable, and it would certainly appear that more often than not they impact more the composition of capital inflows than the total amount. What is more, there are other ways of staunching inflows, such as sterilising foreign currency reserves, adjusting the monetary policy stance, and prudential measures. Clearly, the 'toolbox' for managing capital flows into emerging markets is well stocked. But we know less about the extent to which it should be used and whether the range of remedies applied will be effective. Once again, economic policy finds itself in the front line for flagging up potentially destabilising prospects, even if investors cannot be 100% confident about the effectiveness of the solutions implemented.

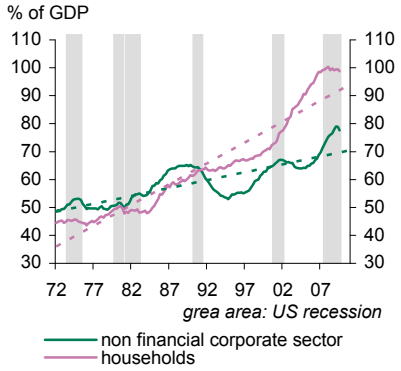
**The crisis has taught us that the market does not always know better than everyone else,** ie, operators taken individually, the people in charge of economic policy, regulators and analysts. The post-crisis period will demand a great deal from economic policy. In developed countries, the aim is simultaneously to

normalise the very accommodative stances that the crisis has forced on us and to nurture a rate of economic growth that will no doubt be weaker, initially at least. In the emerging countries, the aim is to stop markets spinning out of control and to consolidate the culture of stability which has gradually grown up over the past decade. Much is at stake, and knotty questions as to the timetable (when to swing into action?), the tools to prefer, and the degree to which they should be applied will be raised. The markets, for their part, will be attentive to the credibility and effectiveness expected of the measures decided. We can bet that there will be a lack of clarity and that investors will keep a cautious, if not sceptical, eye on things. **People may have been disappointed by the markets, but that does not mean they will necessarily switch back to absolute confidence in economic policy.**

# Monetary Policy: New rules-based policy

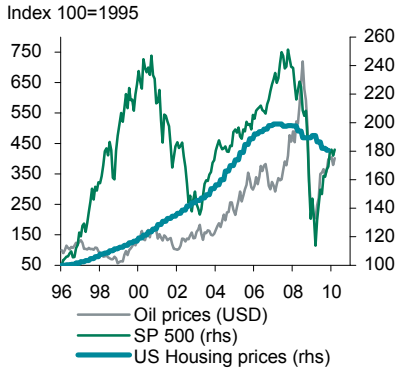
Central banks have won their long fight against inflation and must now gird up to do battle with a new enemy: financial instability.

### US: debt outstanding



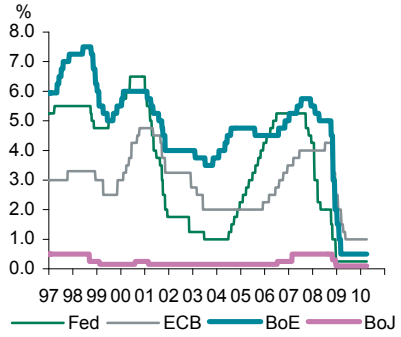

*Source: Federal Reserve, Crédit Agricole SA*

### US: Swing in asset prices




*Source: Datastream, Crédit Agricole SA*

### Key policy rates




*Source: Crédit Agricole SA*

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**Ever since the 1970s combating inflation has been core to central bank strategies, seeing it as the most effective means of simultaneously achieving economic and financial stability.** Targeting inflation came down to combating the chief stigma of cyclical excesses in the real economy, when periods of overheating alternated with recessions in fits and starts. The financial cycle and its accelerator effects were seen only as reflecting these tensions, because, since the markets were efficient, any move in asset prices was supposed to reflect shifts in the underlying fundamentals. **In other words, by stabilising prices it should have been possible to smooth activity cycles and, taking this to its logical conclusion, financial cycles.** This strategy seems to have paid off, since, as hoped, both growth and prices have shown greater regularity, to such an extent, indeed, that the past 15 years have been dubbed 'The Great Moderation'.

**Yet there have been any number of financial instability episodes[1], running counter to the theory that macroeconomic and financial stability complemented each other.** Underlying all these crises is the build-up of massive liabilities, against a backdrop of rapidly increasing asset prices, which were then generally used to collateralise the surfeit of debt, thus triggering feedback loops. Because central banks steer the cost of liquidity, and hence the availability and cost of financial resources, they have often been accused of pursuing overly accommodative monetary policies over excessively long periods, which was believed to have fed asset price bubbles by stimulating the debt leverage underpinning them. The central banks could even be accused of being both arsonists and firemen, since they have systematically come along to put out the flames by acting energetically to combat the pernicious fallout after a bubble has burst, even if that means re-creating conditions favourable to the formation of further financial excesses.

**Central banks are not the only culprits, but the asymmetrical nature of their behaviour – lax while financial imbalances are on the rise, and then active – raises questions surrounding the central idea of carrying more preventive action.**

In theory, interest rates seem to be the preferred tool for combating speculation, since the frenzied search for yields mostly goes in tandem with a steady increase in leverage. But conflicting goals may emerge, as this instrument is also used to manage cyclical fluctuations. In economics, there is a common-sense rule known as 'the Tinbergen Rule', which says that, for an economic policy to be successful, there have to be as many policy instruments as there are objectives.

**The debate is currently focused on the regulatory aspects due to the need to rethink prudential regulation tools at a more macroeconomic and counter-cyclical level in order to thwart, as far as possible, the pro-cyclical character of finance.**

In response to the 2007 financial crisis, the Basle Committee very logically suggested stepping up banks' equity capital in order to improve their ability to withstand a shock. The question of the where you set the limits is primordial in this case. Capital is expensive, which could ultimately lead to an increase in the cost of financing for banks and lower intermediation, with potentially undesirable effects on growth. The rigidity of this rule also runs counter to the desire to apply a counter-cyclical approach, which calls for a more dynamic approach. Another proposal would be to apply a capital surcharge that could vary according to position in the cycle, risk profile, and degree of systemic importance of the financial institutions. But how ready the markets will be to accept a cut in the Tier One ratio during a crisis constitutes the main limit to this idea of counter-cyclical

[1] *Japan (1990), Asia 1997, Russia 1998, USA 2001, until the worldwide crisis of 2007-2009*

capital. It would also be possible to consider a dynamic provisioning policy running counter to cycles in order to encourage banks to provide themselves with a cushion in times of prosperity for use during the lean years[2]. Another possibility being mulled over is to target the asset markets most likely to generate bubbles or to target financial services agents who are subject to less restrictive rules. A reduction in Loan-To-Value ratios during the cyclical upswing could be a useful way of stopping snowball effects in the housing market. To vary matters, margin calls or haircuts applied to secured loans (notably granted to non-bank players) could help limit the excessive leverage that feeds asset bubbles. **This incomplete list shows that the approach cannot be one-dimensional but it also shows that the accumulation of measures, not to mention the difficulty of calibrating them, could prove equally dangerous by inhibiting all risk-taking.** Questions concerning the oversight of non-bank players, the degree of coordination needed for this type of policy at a global level and measures to safeguard liquidity are related issues, not touched on here, but are also especially important to carry through reform of the international monetary system.

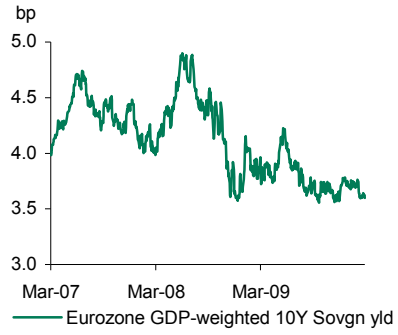
**While it is essential to reform the financial system to make it more stable, that does not mean we have to constrain the entire system with a mass of regulatory measures. Intermediated or not, credit activity is by its very nature risky, but it is indispensable for laying the foundations of future growth. The toolbox must therefore be sufficiently flexible to avoid inhibiting the engine, but sufficiently constraining to avoid tipping into new excesses.**

[2] *This practice, which has existed in Spain since the beginning of the present century, did not stop a major housing/households credit bubble forming, but nevertheless cushioned the shock when the time came to purge bank balance sheets.*

# Interest Rates: Facing the liquidity withdrawal

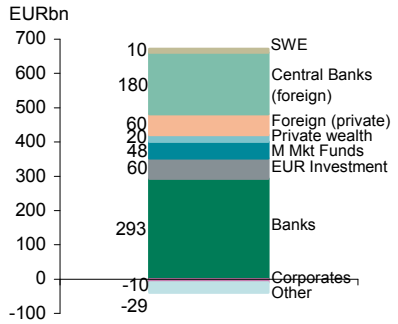
Fixed income markets are at the apex of the liquidity provision, in the next few months central banks will start removing the punch bowl. Eurozone markets face the greatest difficulty in the coming months, yet 10Y yields are seemingly oblivious to the dangers and are at the lows seen in the Great Recession. Our message is to be prudent in Europe in particular.

### GDP weighted average 10Y Eurozone bond yield



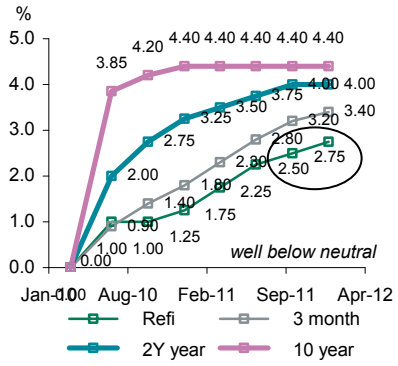

*Source: ECB, Eurostat, Crédit Agricole CIB*

### Estimate of government bond purchasers in 2009




*Source: ECB, Eurostat, Crédit Agricole CIB*

### German Interest Rate Forecasts




*Source: Crédit Agricole CIB*

### The U-turn for global liquidity starts here

**For two years central banks have been spooning liquidity into financial markets** in a desperate attempt to heal the money markets, support banks and reflate the global economy. 2010 is the year in which the Central Banks U-turn and whilst we can guess what the impact upon financial variables will be, we cannot be sure because this is the first time in which the withdrawal of liquidity is being undertaken on a global scale.

In addition, Central Banks are moving from **a situation of copious and overwhelming liquidity to one of simply abundant liquidity this year.** Whilst there is a debate about the prospect of rate hikes this year, there is no debate regarding whether Central Banks take interest rates into restrictive territory – they simply will not.

It could be argued that there are some financial bubbles building up. Equity markets are elevated and bond yields are very low. Indeed, as the first chart on this page shows, if we weight each Eurozone country's 10Y yield by GDP, the result is a yield very close to the lowest ever levels. **Yields are as low as in the baddest days of the Great Recession**. Yet, globally the economic recoveries are gaining momentum and we believe that fixed income investors are staring down the barrel of a gun.

**We are particularly concerned for European fixed income investors at present.** Whilst our forecasts for GDP are stronger in the US, it is fair to say that the ECB is far more likely to do something about the ample liquidity conditions. In fact, the redemption of EUR442bn on 1 July is rather forcing their hand and just under a half of Eurozone government debt has been purchased by the banks in 2009. A quick comparison between what banks bought in 2009 and what they would normally have purchased given the steepness of the yield curve suggests that they bought about EUR200bn more than normal. This EUR200bn was mostly bought because the ECB provided the means to do it but in the next few months, a good chunk of debt will be returned to the banks by the ECB.

Think of it as **an extra EUR200bn of supply for the market in Q3**. Perhaps some banks will try and continue running these positions by funding it from other sources. Other banks will simply sell and we need to understand who will soak this up. At the moment, there is nobody obvious. It is true that private sector foreign buyers have been increasing their purchases but we cannot rely exclusively upon them. We think that 10Y bond yields start rising fast, because in the background the Fed will have stopped its securities purchases and the US market will be getting jittery about tri-party repo or other liquidity withdrawal techniques.

We also think that the ECB starts hiking rates in Q4, or more precisely start removing the emergency stimulus. The ECB will be looking 1-2 years ahead in setting its monetary policy as usual but the market will be concerned about whether it is too far ahead of the curve. For this reason, **we see the European curve flattening quite aggressively in the second half of the year as the signals regarding ECB hikes grow**. The 10Y area of the European curve stops rising rapidly and we have even forecast that 30Y European yields decline marginally. This is what should happen when a Central Bank is "in front of the yield curve", indeed our FX view is that this rate hike sends the EUR weaker for the same reasoning.

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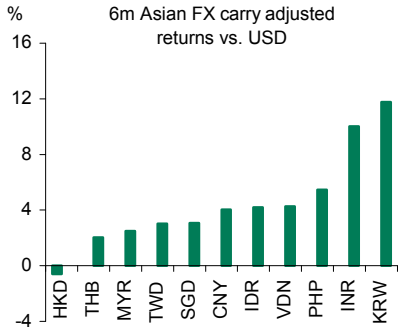
# Exchange Rates: Downgrading the Euro

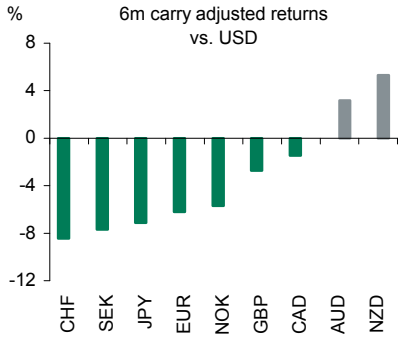
Currency tensions between the US and China will escalate, but the USD could face the greater risk. European woes have lessened but the outlook for the EUR has worsened against most currencies. We have maintained our forecasts for JPY weakness this year, and look for outperformance by the AUD and NZD. USD will recover more strongly in H210.

### CNY revaluation will give impetus for further Asian FX appreciation



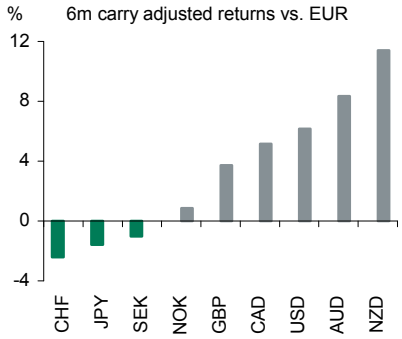

*Source: Bloomberg, Crédit Agricole CIB*

### NZD and AUD set to be the strongest performers over 6mths




*Source: Bloomberg, Crédit Agricole CIB*

### EUR to underperform against most currencies




*Source: Bloomberg, Crédit Agricole CIB*

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**FX tensions between the US and China will garner greater market attention.** For its part China continues to resist calls for CNY revaluation but growing speculation that the US will label China as a "currency manipulator" suggests that the issue will remain very much on the radar screen. It is looking increasingly difficult for the US administration to ignore Congress' calls for stronger action. Moreover, US President Obama's pledge to double US exports within five years will require some USD weakness, but the USD will need to weaken against Asian currencies led by China and not just against the usual culprits such as the EUR. There is little sign of this happening anytime soon. Nonetheless **we expect China to eventually revalue the CNY sometime later in Q210**, which will spur other Asian central banks to allow stronger currencies.

European woes will remain in the spotlight but to a lesser degree than over previous months. A package of further austerity measures from Greece followed by tacit approval by the EU have helped to reduce market concerns. The fact that both USD downside and, conversely, EUR upside has been very limited highlights the many concerns remaining, not just surrounding Greece but also about fiscal/debt problems and weaker growth in other countries in Europe. Consequently **we have revised down our forecasts for EUR/USD**. Whilst there is some potential for appreciation in EUR/USD over the short-term, especially if CDS spreads continue to narrow, we believe than any upside will be limited. Our new forecasts look for EUR/USD to drop to 1.25 by end 2010.

We have also revised our forecasts for the EUR versus other currencies for similar reasons. Both the CHF and SEK have performed more strongly than anticipated. A surprisingly hawkish tone from the Riksbank helped to boost the SEK but we suspect that gains going forward will be more gradual. As for the CHF, **the SNB appears to have lowered its line in the sand for EUR/CHF** with the central bank appearing to be more comfortable with a stronger CHF as the economy improves. We continue to look for EUR/CHF to move gradually higher over the coming months, albeit from a lower starting point. The downward revisions to our EUR/USD forecast allied with the maintenance of our profile for JPY weakness means that **our previous expectations for EUR/JPY appreciation have been scaled sharply back**.

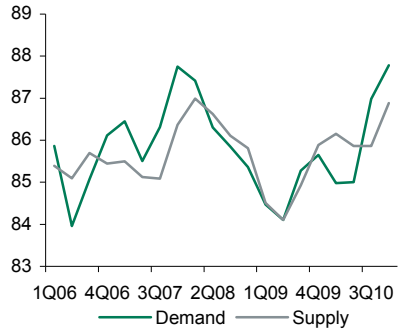
**GBP is the 'weakest link',** having performed worse than the EUR over recent weeks due to a variety of reasons. Over the short-term GBP is set to remain vulnerable, especially ahead of the upcoming UK general election in early May. Nonetheless, with so much bad news already priced in and GBP remaining highly undervalued, any further weakness will provide better opportunities to take long positions for medium term appreciation. Indeed, whilst our forecasts for EUR/GBP have been revised higher for the next 6-months we expect GBP to recover more strongly versus EUR than previously envisaged further out. Against the USD we expect more limited GBP upside than previously predicted, partly as a function of a lower forecast range for EUR/USD. Our new forecasts expect a peak of around GBP/USD 1.55 (June 2011) compared to a peak of 1.63 (Dec 2010), previously.

Further out, **the USD is likely to gain as the US economy gains traction and outperforms** many other major economies, especially the Eurozone. Once again the exceptions will be the AUD and NZD, which are expected to outperform due to higher interest rates, firmer growth and improving risk appetite. We expect these currencies to peak around the end of Q210 at around 0.95 and 0.76, respectively vs USD, with lofty valuations likely to act as a negative factor in H210. Investors willing to take a higher risk will benefit from positioning long NZD and AUD, and short CHF and JPY with other currencies falling somewhere in between. Unfortunately for the EUR it will fall in the lower end of the spectrum over the forecast horizon.

# Energy: A two speed recovery

Oil demand has recovered in developing countries but remains subdued in OECD regions. As we are moving toward the weakest quarter for oil demand prices should be under pressure. We expect WTI prices to fall to USD68/bl in Q210 before rebounding to USD72-76/bl in H210, supported by stock draws from Q310.

**World Oil Supply/Demand (Mbd)**




*Source: Crédit Agricole CIB*

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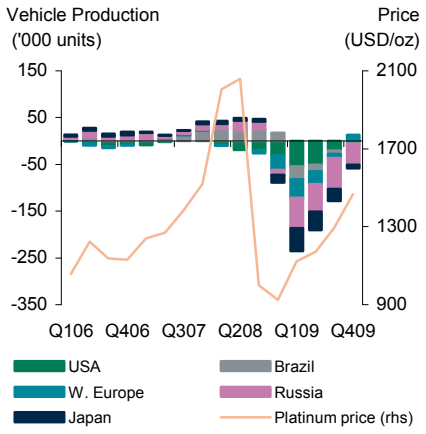
**Regional dynamics are shaping world product markets**. Oil demand is stronger in Asia than in Europe or the US, benefiting from a swifter rebound in economic activity and possibly the transfer of industrial activity to developing economies. Asian demand, however, will do little to clear the Atlantic Basin overhang or support European and US refinery activity. On the contrary, because of the start-up of new refineries last year several big countries have become significant net product exporters. This is the case for China and India where new refining capacity has come on stream in 2009. In 2010 Asia product exports will continue to impact world oil product balances.

At the end of winter demand, **oil product dynamics remain characterised by the legacy of the *Great Recession***. In the past few months, gasoil demand has been impacted more by reduced industrial activity and trade than gasoline demand and a large overhang of gasoil has developed through the summer. **Gasoline demand has resisted the recession better than gasoil demand**. Due to a lack of flexibility, refineries – having to meet gasoline demand – have produced gasoil in excess that has had to be put in storage. At the start of the winter, gasoil stocks in the US and Europe (for a large part in floating storage) were at historically high levels. Since then, cold temperatures have contributed to reduce the gasoil overhang by boosting heating oil consumption. Heating oil, however, remains a small part of total gasoil demand and, without a significant pick-up in diesel demand, gasoil stocks are likely to remain high in the Atlantic Basin through to the end of the year.

# Metals: PGMs are the pick of the precious metals

Metals will perform well this year as demand benefits from stronger global growth; our preference remains for industrial metals over precious. Price performance though will likely be differentiated on the basis of inventory cover and those metals that are supply constrained. PGMs are more exposed to the industrial cycle and are our pick of the precious metals.

**Vehicle production & platinum price**




*Source: CRU, Crédit Agricole CIB*

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**Platinum** and **palladium** (known collectively as PGMs or platinum-group metals) are expected to perform better this year amid stronger global growth which should boost industrial and jewellery usage, both of which were severely undermined last year because of the recession.

Both metals are used in **auto catalysts, the demand for which is likely to be higher on a recovery in global vehicle sales**. Expected stronger growth in gasoline-fuelled cars, which dominate the US and Chinese markets (diesels dominate in Europe), favours palladium in preference to platinum, with a higher loading of the former used in auto catalysts.

**The launch of ETF products in the US backed by physical platinum and palladium** could tighten the PGM market further, given strong investor appetite, and add to significant price strength given the level of interest experienced for similar products in gold and silver.

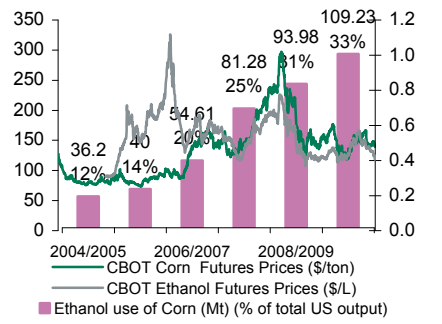
Both metals are **constrained in their ability to increase production**; platinum supply is dominated by South Africa and palladium by Russia. Increasing power costs in South Africa will require relatively high marginal cost production to be developed to meet demand. Sales from Russian state stockpiles have kept the palladium market well supplied but the exact level of these remains a key uncertainty.

Although prices have already made substantial gains from last year's lows, **further upside is likely and we recommend buying the dips**.

# Soft Commodities: Biofuels to push prices in H2

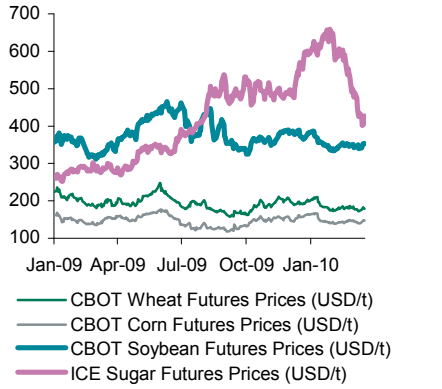
Agricultural prices are currently facing a bearish fundamental situation. But prices should be underpinned by stronger demand along with the improvements in the world's economy. One of the main drivers is expected to be demand for biofuels, made from sugar or corn.

### US corn and Ethanol prospects



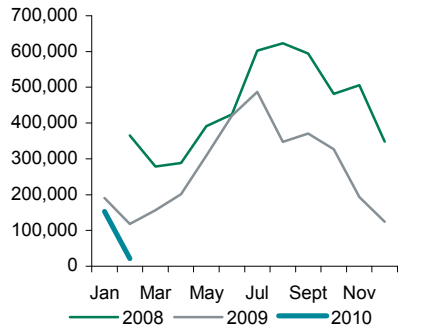

*Source: USDA, Reuters, Crédit Agricole CIB*

### Futures prices




*Source: Reuters, Crédit Agricole CIB*

### Brazili's monthly ethanol exports (Litres)




*Source: Unica, Crédit Agricole CIB*

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## Biofuel demand to push sugar and corn prices higher

**Food inflation is expected to strike back this year** as world demand should grow along with the world economic recovery. The FAO expressed its concerns about a rise in food prices and the world's poorest nations becoming more and more dependant on food imports, while food exports are to become concentrated in only a few countries.

However, **agricultural prices should initially maintain their current downtrend**, due to the bearish fundamental situation, over the next 4-5 months.

Regarding **grains and soybean**, this downtrend is mainly due to a **global oversupply**, with wheat world output pegged at a historic record high of 678Mt, and bumper US and South-American corn and soybean crops weigh on prices. Once the large crops are absorbed by the market demand should lift prices, increasing along with the economic recovery as buyers likely take advantage of low prices.

Regarding **sugar**, despite a world deficit, seen at 9.4Mt this year by the ISO, it has experienced a recent downtrend due to end-buyers not wanting to buy at such high levels. We expect it to continue over the next 4-5 months, but at a softer pace, as the upcoming Brazilian harvest has already seen a 10% YoY increase and Indian crop are likely to increase from 16-17Mt this year to 25Mt next year, according to the Simbhaoli association. **Prices should go up within five months as India is likely to import up to 3Mt** of sugar for its festive autumnal season, the economic recovery should by then be supportive of world demand.

**One of the common and major drivers of this rise in demand will be biofuel production**, which will boost demand for corn and sugar – the two major ethanol producers being the US and Brazil, the US using corn and Brazil sugar.

Brazil has seen its ethanol exports decreasing over the past two years (cf. graphic); 2009/10 ethanol production is down 7.3% YoY to 23.1bn litres (source: Unica) as it became less profitable due to high international sugar prices. The US, on the other hand, has seen its ethanol production grow nearly 20% in 2009 to reach 40.96bn litres (source: RFA).

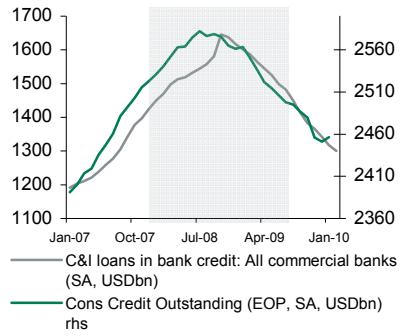
**The US has decided to take advantage of the double opportunity of less profitable sugar-based ethanol and a bumper domestic corn crop to boost its investment in corn-based ethanol production**: 109.23 Mt, or 33% of the US crop, is expected to be used to produce ethanol, a 16.2% YoY increase. 2010/11 Brazilian ethanol production is also expected to increase again to 29.8bn litres (source: Datagro), thanks to a bigger sugarcane crop.

Biofuel production is thus expected to support demand for sugar and corn respectively among the two biggest producers of the two crops, and therefore to give support to prices. Such support is expected to spillover to neighbouring CBOT wheat and soy markets, as they can be used as substitute products for cattle food as well as to produce biofuels.

# US: From Stimulus Measures to Self-Sustaining Growth

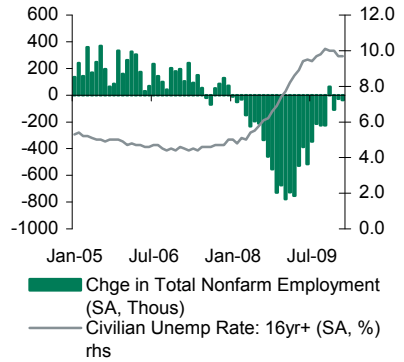
The US economy looks to be on a sustainable growth path. However, the pace of growth will be atypically weak and the elevated rate of unemployment will be slow to decline. Inflation is expected to remain subdued, keeping the Fed funds rate on hold this year. We expect growth to accelerate in 2011.

### Debt Declines



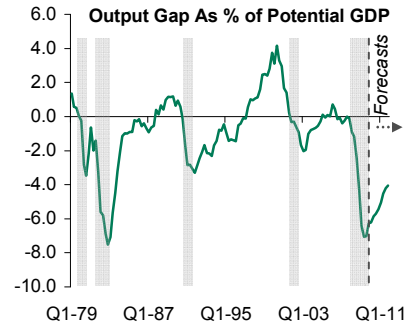

*Source: Federal Reserve Board*

### Employment Stabilisation




*Source: BLS*

### Slack will take time to absorb




*Source: CBO, BEA, Crédit Agricole CIB*

**The shift to self-sustaining growth in private demand will be a crucial transition in 2010-11 as fiscal stimulus turns to fiscal drag and exceptionally accommodative monetary policy is unwound.** The aggressive fiscal and monetary policies implemented last year to counter the worst recession since the Great Depression will continue to be supportive of growth in 2010 but their impact will wane and reverse in 2011. Major headwinds facing the recovering economy this year include: (1) a large negative wealth effect, reflecting the destruction of over USD11trn in household net worth; (2) tight credit availability; and (3) continued uncertainty surrounding the economic and political landscape in 2010.

The wealth effect suggests that as job growth resumes part of the associated increase in income will be saved in order to rebuild wealth, restraining the pace of consumer spending. Households have been deleveraging, as indicated, the declines in consumer and mortgage debt. Hence, consumption spending will be driven by current income rather than by income and credit.

**Reduced access to credit is another damper on demand from households and businesses.** While banks have largely stopped tightening credit conditions, there is little evidence that they are easing lending standards. Bank's tight credit reflects the impact on their balance sheets of past losses, not all of which have been written off. Large firms can get access to capital because they can tap the capital markets but smaller firms cannot and many small businesses use smaller banks (assets less than USD10bn) for their borrowing needs. Unfortunately, these smaller commercial banks carry a disproportionately large share of commercial real estate loans. Given the risks associated with these loans, we suspect that these banks will keep a tight rein on credit for a while, limiting small business growth and employment generation. The latter is key, as small businesses create nearly half of all employment.

**After having lost nearly 8.2 million payroll jobs in the recession, the labour market appears to have stabilised.** Job losses have abated and we look for positive nonfarm payroll gains in the private sector to increase in size throughout the year. However, progress on reducing the elevated unemployment rate will be slow as the improving job market draws more folks back into the labour force.

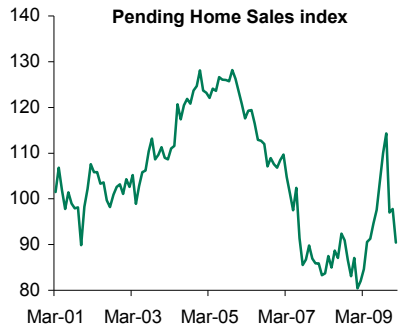
Business investment spending will recover, but at a pace much slower than the 19.0% annualised rate recorded in the fourth quarter of last year. The level of slack in the economy is significant, whether measured by the capacity utilisation rate that is 8 percentage points below the historical norm or the negative output gap, which the CBO estimates near 5 percentage points of GDP. This implies little need to expand current capacity. However, **replacement demand for older capital stock will provide some lift. As the economy improves, firms will invest to upgrade to more efficient capital in order to maintain profit margins,** particularly given the relatively low user-cost of capital. Firms sought to maintain margins during the downturn by squeezing costs, particularly labour costs. As employment recovers with the expansion, firms must seek efficiencies and productivity gains elsewhere.

**Uncertainty over the political/regulatory landscape is dampening the "animal spirits" that often animate business investment decisions.** For example, the financial services sector still does not know what lies ahead in terms of regulatory reform that will affect its profitability. Firms face uncertainty over how much they will pay for their employees health care costs given recent health care reform measures. The same uncertainty may damp consumer spending, as upper income households, faced with an increase in tax bills in 2011, restrain spending.

**The massive drawdown in inventories during the recession has now shifted to a positive contributor to growth.** Indeed, the change in business inventories

added nearly 3.8 percentage points to the 5.6% advance in Q4 real GDP. Smaller positive contributions to growth are expected for all of 2010.

### Homebuyer Incentives Fade

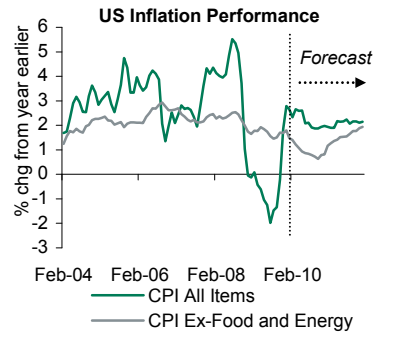



*Source: National Association of Realtors*

**The housing sector remains fragile but is improving.** Activity was boosted by tax incentives for first-time homebuyers, but these will soon expire. The impact of the incentives was evident in the rise in pending home sales, but they have since reversed course. The recovery in the housing sector will be drawn out, in our view. Estimates are that nearly a quarter of all mortgage holders owe the bank more than their house is worth. This is expected to contribute to a continued high level of foreclosures in 2010. This 'hidden supply' will eventually come to the market, suggesting that it will be some time before prices stabilise.

**The moderate 3% growth we expect this year is expected to absorb economic slack, but only slowly. Hence, we believe that core inflation measures will continue to decelerate**, with core CPI dropping below a 1% YoY pace this year. We also look for inflation expectations to remain relatively well anchored. This is very important for the inflation forecast as research indicates that the 'gravitational pull' of inflation expectations on actual inflation has increased sharply since the mid-1990s, while the influence of labour market slack has diminished.[3] We believe that the inflation expectations anchor reflects increased Fed credibility with regards to inflation management.

### Inflation Remains Subdued

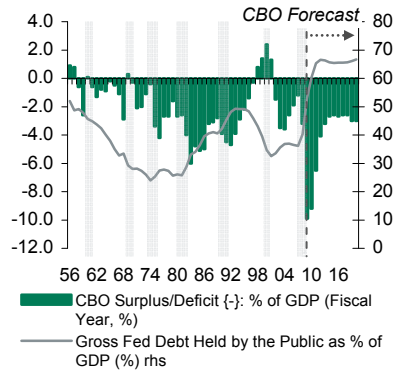



*Source: BLS, Credit Agricole CIB*

**Inflation expectations may be affected by increased uncertainty surrounding current monetary policy actions as we do not have much experience analysing the lagged impacts of credit policies, such as quantitative easing, on aggregate demand or inflation.** This explains why the Federal Reserve has tried to be very clear in explaining that it has the tools (reverse repurchase agreements, term deposits and raising interest paid on excess reserves) to absorb the excess reserves it created during the financial crisis. Keeping inflation expectations anchored is paramount for the Fed

Some market participants fear that huge federal government deficits and the concomitant rising debt load will lead policymakers to debase the currency and repay debts with inflated dollars. However, such a scenario would require the complicity of the Fed and would be contrary to its mandate. Moreover, Mr. Bernanke has explicitly rejected Fed monetization of Treasury debt and rightfully so, as the Fed would lose the inflation fighting credibility earned over the past two decades In our view, the subdued inflation outlook, coupled with a stubbornly high unemployment rate, will lead the Fed to maintain the Fed funds rate in its current 0 to 0.25% range until the spring of 2011.

### Getting the budget back on track?




*Source: CBO, BEA*

**The burgeoning budget deficit raises concerns over the creditworthiness of the US and investors want to see the deficit put back onto a sustainable trajectory**. The US Federal budget deficit ballooned to about 10% of GDP last year and, under current law, the Congressional Budget Office (CBO) projects it will decline to about 2.75% of GDP around the middle of the decade and then begin to drift higher again. The CBO baseline does not take into account the Administration's proposed budget changes. The White House estimates that under its budget submission the deficit will decline to about 4% of GDP by mid-decade. The publicly-held marketable Federal debt outstanding is projected to rise to nearly 73% of GDP in 2015 – up from 40% in 2008 – in the Administration's estimates.

Everyone **knows the solution to the deficit problem. It will require raising taxes and reducing expenditures, particularly on entitlement programs such as Medicare.** Unfortunately, politicians fear they will not be re-elected if they do this and they resort to stop-gap measures that essentially push back the ultimate resolution until some later date. Congress, in our view, will ultimately do the right thing. It may well require a crisis of some sort to force the issue or a bi-partisan commission may offer political cover by proposing a plan to increase taxes and reduce spending, which Congress may either accept or reject but not amend.

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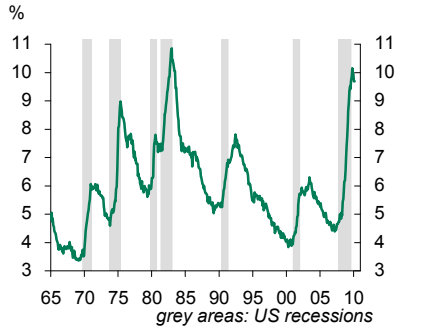
[3] Inflation, Inflation Expectations, Money and Monetary policy. *Joel Prakken. Macroeconomic advisors presentation, March 2010.*

# US Focus: Will the US unemployment rate fall as quickly as it rose?

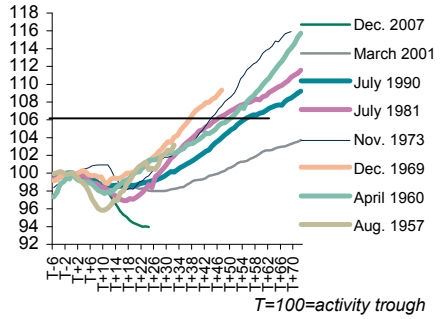
A slow fall in the unemployment rate is likely to follow its sharp rise during the recession. The recovery we expect will not be jobless as in 2001, but jobs will be created in much smaller quantities than is usual in a cyclical upswing and, most importantly, in insufficient quantities to significantly reduce the unemployment rate in 2010.

**US: Unemployment rate**



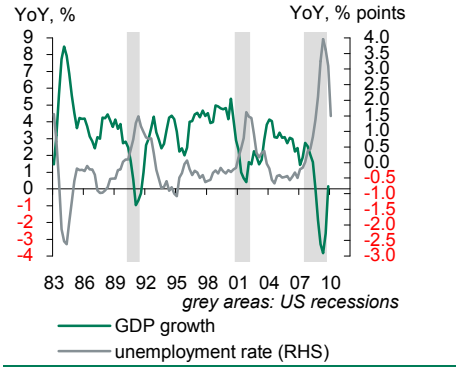

*Source: BLS, Crédit Agricole SA*

**US: Payrolls before, during, and after recession**




*Source: BLS, Crédit Agricole SA*

**US: GDP growth and unemployment rate**




*Source: BEA, Census bureau, Crédit Agricole SA*

During the recession, the unemployment rate rose fast to a high level, rising 5.7 percentage points from its low of 4.4% in March 2007 to 10.1% in October 2009, which, if our forecasts are correct, should be its peak. How far did this increase deviate from Okun's law? Did US firms lay off more workers than necessary relative to the contraction in their activity? What growth rate should we count on to stabilise, at the very least, the unemployment rate? And what chance is there that growth in employment will be insufficient to absorb the increase in the workforce? Answers to each of these questions are still debated, making it even harder to answer the last question, which is: by how much and how fast will the unemployment rate fall over the coming quarters?

## A labour market severely hit by recession

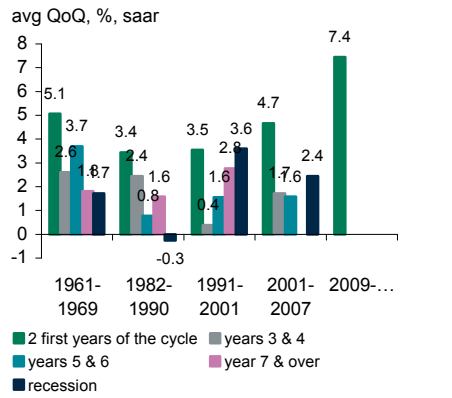
The recession experienced by the United States from end-2007 to mid-2009[4] and the accompanying deterioration in the labour market were the most severe since the Great Depression, with 8.4 million nonfarm payrolls destroyed, unemployment peaking at 10.1% (just one point lower than the record high of the early 1980s) and an under-employment rate at a record high of 17%[5]. The rise in the unemployment rate could have been worse had there not been a drop of slightly more than one percentage point in the participation rate, which fell markedly faster than its slow decline from its peak of 67% in early 2000 and at 64.8% at the start of 2010, it is at its lowest point since the mid-1980s. A disproportionate share of the fall is thought to be due to the exit of the youngest and least-educated, a cycle-related, and hence temporary, adjustment. When the labour market starts to show signs of recovery, these workers will return to swell the ranks of the labour force and the expected fall in the unemployment rate will be slowed.

**A strict application of the original Okun's law shows that the unemployment rate rose more during the H209 than growth suggested.** The best-known formulation of Okun's law states that every percentage point of growth below its trend rate results in a half-point increase in the unemployment rate[6]. But growth was positive in the Q3 and Q4, and significantly above trend in Q4 (by almost three percentage points, with trend growth estimated at 3%). Yet the unemployment rate continued to rise, whereas it 'ought' to have fallen by around 1.5 percentage points. Another calculation method reaches the same conclusion: real GDP was virtually at the same level at end-2009 than at end-2008, a stagnation consistent with a rise in the unemployment rate of around 1.5 percentage points, which in fact came out at twice that. These deviations are not totally abnormal given some likely lags. Moreover, even if the unemployment rate is continuing to rise, the pace of this rise is slowing. If one simply parallels YoY GDP growth and YoY variation in the unemployment rate, the two factors are visibly moving in step.

**The gap between the observed unemployment rate and that derived from Okun's law can be explained by the fact that unusually strong productivity gains were achieved during H209, ie, during the first months of the recovery[7].** An analysis of unemployment inflows/outflows throws additional light on what was fuelling these productivity gains. Did they come from an unusual

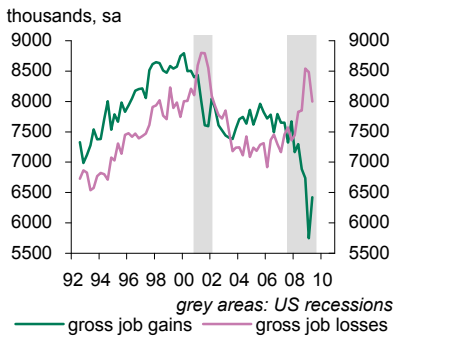
[4] *The date when activity bottomed has not yet been officially published by the NBER but the recession probably ended in mid-2009.*
[5] *U6 definition of the BLS, which also counts those who need work but have given up the search, and involuntary part-time workers.*
[6] *And this relationship is both proportional and symmetrical.*
[7] *M. Daly and B. Hobijn, 2010, "Okun's Law and the Unemployment Surprise of 2009", FRBSF Economic Letter No.2010-07, March 2010.*

### US: Hourly labour productivity gains



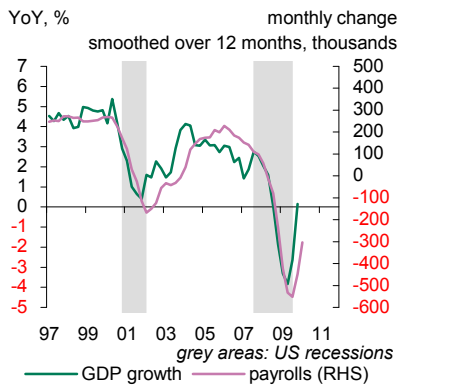

*Source: BLS, Crédit Agricole SA*

### US: Gross private job losses and gains




*Source: BLS (BED survey), Crédit Agricole SA*

### US: GDP growth and payrolls




*Source: BEA, BLS, Crédit Agricole SA*

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increase in lay-offs (a component of so-called "inflows"[8]), an unwarranted drop in new hires (a component of outflows[9]), or a combination of both? According to research by Elsby et al (2010), the 2008-2009 recession differs from previous ones mainly by the continuous and very strong fall in outflows[10]. Trends in inflows (or more precisely, lay-offs) were similar to those of previous big recessions and, as it happens, characteristic of their severity: a sharp ramp-up at the outset, followed by a slowdown.

## The prospect of a slow recovery

What conclusions can be drawn from these results going forward? The unemployment rate does seem to have risen more than the contraction in activity warranted. Logically, this kind of upward adjustment should be corrected very quickly: just as history teaches us that the more severe the recession the stronger the recovery, we would be justified in thinking that the more excessive the rise in the unemployment rate during the recession the faster it should decline during the recovery. The reality is nevertheless more complex insofar as the nature of the recession is as important, if not more so, than its magnitude. The same goes for the unemployment rate, where the nature of the decline depends on what caused it to rise in the first place. And, to be precise, prospects are mixed.

This is because big productivity gains, the ease with which it is possible to adjust hours worked by solely increasing average weekly hours, the substantial proportion of involuntary part-time work and the very lack of vigour of the expected economic recovery all argue in favour of a jobless recovery. What's more, if we consider that activity bottomed in June 2009 and given the fact that employment continues to fall (and the unemployment rate to rise), such a jobless recovery is already a reality. But this situation should not last: a genuine upturn in employment seems to be underway. It is its strength that is the problem, or more exactly, that of the recovery in new hires. To date, we can observe a significant slowdown in lay-offs, which contributes to the slowdown in net job losses, but businesses are being coy about hiring. But they will find it hard to make many more productivity gains and to continue increasing their output they will be forced to hire more and more. The good news is that they have the means to do so. The bad news is the uncertain rate of future growth. There is another cloud on the horizon, also. The very sharp increase in long-term unemployment raises the spectre of a threat that is new to the United States but familiar in Europe, namely the threat of hysteresis.

Our projection is a halfway house between a true jobless recovery like that of 2001, and a real "old-style" cyclical recovery. In our view, **growth will create jobs, but in lesser quantities than in a usual cyclical upturn and, more importantly, in insufficient quantities to significantly lower the unemployment rate in 2010.** If we go along with what Okun's law is telling us about the future, with our marginally above-trend growth figures, the fall in the unemployment rate can only be slow. A 3% GDP growth rate stabilises the unemployment rate with about 150,000 jobs created per month (assuming a monthly 0.1% trend increase in the labour force).

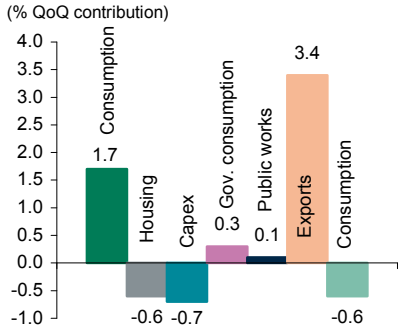
To obtain a faster fall in the unemployment rate the critical threshold of net monthly job gains will need to rise to 250,000, a figure that is achievable with approximately 4% GDP growth, or lower growth but lower productivity gains. This is perfectly within the realm of possibility (and is in fact what we are forecasting for 2011). But that does not detract from the problematic nature of the forecasted slow decline in the unemployment rate. Remember that the value of the Okun coefficient implies that each percentage point of growth in excess of the trend rate goes hand-in-hand with a half-point drop in the unemployment rate. **Given its current level of close to 10%, and applying the reasonable assumption of real annual growth of 3.5% and potential growth of 3%, it will take no fewer than ten years to return to the 5% unemployment level that is deemed normal for the United States!** However that period falls to two years if the unemployment rate target is raised to 7% and assuming real GDP growth of 5% and only 2% of potential growth.

[8] *Those who lost their job, those who quit it, new entrants and re-entrants on the labour market swell the ranks of the unemployed.*
[9] *Those leaving the workforce (because they are discouraged or for some other reason) and those who find a job exit unemployment.*
[10] *See M. Elsby, B. Hobijn, and A. Sahin, "The Labor Market in the Great Recession", a paper prepared for the Brookings Panel on Economic Activity, 18-19 March 2010.*

# Japan: More balanced growth in the years ahead

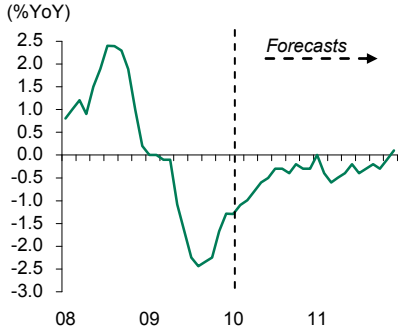
While the economic recovery that started in Q209 has so far been mainly driven by private consumption and exports – both supported by various policy measures at home and abroad – we envisage more balanced growth of the Japanese economy in 2010 with the long-awaited cyclical recovery of capex.

### Contribution to GDP growth



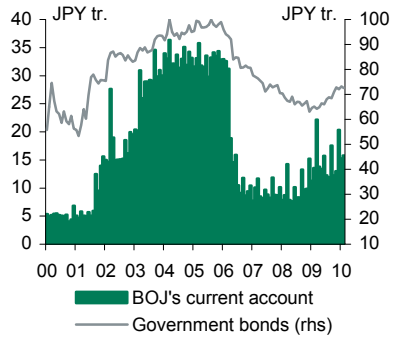

*Source: Cabinet Office*

### Projection for core CPI




*Source: Crédit Agricole CIB*

### Bank of Japan's balance sheet




*Source: Bank of Japan*

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Real GDP growth for 2009 saw a historically large contraction of -5.2% due to the collapse in capex and exports. However, we forecast the economic recovery that started in Q209 will continue in the years ahead and **real GDP growth will recover to +1.9% for 2010 followed by +1.6% for 2011**; thus we expect economic growth to exceed its sustainable growth track of +1.5%. While the recovery phase has so far been mainly driven by private consumption and exports on the back of various economic packages both at home and abroad, we envisage more balanced growth of the Japanese economy in the years ahead.

Expecting real GDP to grow by +1.9% in 2010, **our forecast envisages a capex recovery during the course of the year**. While it has contracted more and for longer than we initially expected due to the collapse in both domestic and foreign demand, the capital stock adjustment is showing signs of completion and the recovery will also be accelerated by steady export growth, a rising capacity utilisation rate, and also the recovery in corporate profits. Furthermore, the combination of accommodative monetary conditions and accumulated liquidity will support the demand for capex among firms. Thus, **our forecast expects a return to positive +0.1% growth for capex in 2010 followed by +4.9% for 2011,** after -19.3% for 2009.

**What the real GDP recovery implies is that there will be less deflationary pressure going forward.** The global recession, which further exacerbated the Japanese economic crisis through a collapse in export demand, resulted in a far wider output gap, which emerged as deflationary pressure. However, above-trend growth in real GDP will ease the output gap and deflationary pressures in the system. This is already clear in representative price indices with core CPI deflation stabilising to -1.3% YoY as of January compared with -2.5% YoY for August 2009. While some degree of deflationary pressure remains due to the lagged effects from a wider output gap than previously experienced, it will continue to ease gradually in accordance with economic expansion, suggesting nominal GDP growth will turn positive for the first time since 2007.

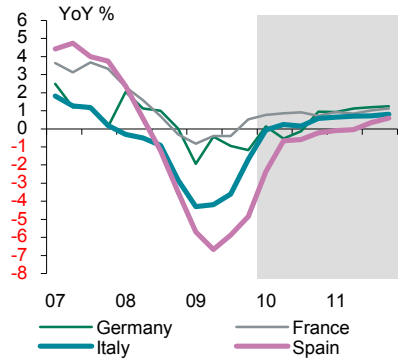
On the fiscal policy front, since the DPJ (Democratic Party of Japan) administration took office in September, a lack of time devoted to creating the budget plan and greater priority given to economic recovery have resulted in another expansionary budget at JPY92.3trn for FY10 following JPY102.6trn for FY09 (inclusive of two supplementary budgets). The **combination of a limited recovery in tax revenues and a large-scale budget will inevitably result in a continued severe government fiscal position**. This in turn requires the government to reduce the budget to such a size as to be consistent with tax revenues. Given the necessity, the government will inevitably have to face the unpopular choice of raising consumption tax. However, an actual hike in the consumption tax rate will take place only after we see more stable and sustainable growth of the economy.

On the monetary policy front, while there has been increasing pressure for the Bank of Japan to take further accommodative measures, **we do not expect the BOJ, which is likely to maintain its optimistic outlook for the economy and the state of deflation, to take similar QE measures as in the past**. The BOJ took its unique QE measures between March 2001 and March 2006 only to end up with sluggish bank lending and a continued decline in the core CPI inflation rate all the while. With this bitter experience deeply rooted in the BOJ's mind, while maintaining the policy interest rate at 0.10% in 2010, it will continue to concentrate on the special 3M fixed-rate lending operations that it started in December 2009. However, with the government continuously taking expansionary fiscal measures, there will be increasing pressure on the political front for the BOJ to increase the amount of outright purchases of JGB.

# Eurozone: Two-speed recovery: centre vs periphery

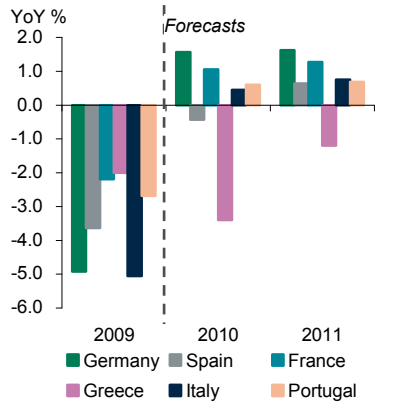
Eurozone growth slowed in Q409, to 0.1% QoQ. The recovery looks set to continue but will be slower, and undermined by the widening contrasts between the different Eurozone member states due to the restructuring of public finances and structural problems. Growth is forecast to come in at 0.9% in 2010 and 1.2% in 2011.

**EMU: domestic demand** (private and public consumption + investment)



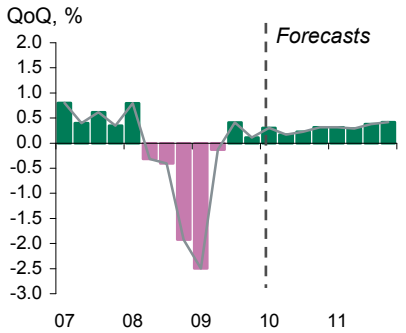

*Source: Eurostat, Crédit Agricole SA*

**EMU: centre versus periphery**




*Source: Eurostat, Crédit Agricole SA*

**EMU: GDP growth forecast**




*Source: Insee, Crédit Agricole SA*

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Eurozone growth marked time in Q409, advancing just 0.1% QoQ compared with 0.4% in Q3. In 2009 as a whole, the Eurozone saw its sharpest contraction in GDP since the end of WWII, at -4.0%.

**The late-2009 slowdown in activity has not fundamentally called our scenario for a recovery in Eurozone economic activity into question.** Confidence survey levels at the end of Q110 are higher than those of Q409, a sign that the pace of activity has picked up. The 'hard' data, for its part, shows a rebound in manufacturing activity.

However, **economic and financial developments in the early part of this year suggest the nascent recovery will be more fragile, more uncertain and characterised by growing contrasts from one country to another.** On the one hand there is the 'centre', comprising Germany, France, the Netherlands and, to a lesser degree, Italy; on the other, the 'periphery', comprising Spain, Greece, Portugal and Ireland. The move towards a 'classic' export-led recovery should no doubt continue, but it will take place much more slowly than we anticipated in our previous forecasting exercise. For full-year 2010, we are forecasting growth of 0.9% (vs 1.2% previously) and 1.2% in 2011 (vs 1.6% previously).

Concerns about the sustainability of the public finances, notably in Greece but more generally in the other so-called 'peripheral' countries (ie, Spain and Portugal), have materialised far sooner than expected. The consolidation of the public finances will therefore occur earlier, and will have an adverse effect on the still-convalescing economies of these countries this year and next. In arithmetic terms, the growth slowdown in these countries will affect the entire Eurozone, as Spain, Greece, Portugal and Ireland account for 17.9% of Eurozone GDP. The contagion will also spread to the other Eurozone economies via intra-regional trade. Although the stability programmes for 2010-13 in other Eurozone economies (notably Germany, France and Italy) point to a more progressive restructuring of public finances from next year, public spending will be cut, and accordingly we forecast a marked moderation in public consumption in 2011.

**Overall, our central projection is based on fairly sluggish domestic demand over the coming quarters.** Against a backdrop of continuing labour market deterioration, with an unemployment rate of 10.5% forecast for end-2010 vs 9.9% in January, private consumption will remain modest, as low incomes will adversely impact households' purchasing power. What is more, private consumption will be penalised by the removal or reduction of government support measures, notably car scrappage schemes and planned tax increases in some countries (higher VAT in Spain and Greece; higher income tax in Portugal).

**The uptick in productive investment will be very modestly paced.** This is because the productivity cycle has been affected by the atypical adjustments in employment levels that occurred during the Great Recession, including the labour hoarding and government measures in favour of short-time working, notably in Germany and to a lesser degree in France. Firms' overcapacity has reached record proportions and domestic demand is sluggish. We are forecasting a proper recovery in productive investment from H211.

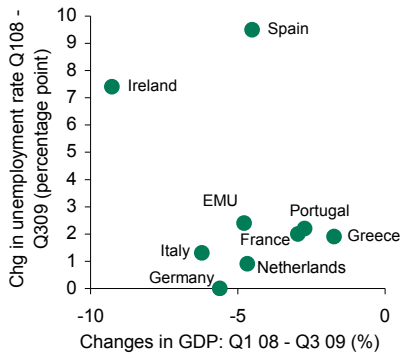
**Foreign trade will be the real engine driving activity.** Exports will benefit from buoyant activity in the rest of the world, especially in the US and emerging countries. The forecast depreciation of EUR should also strengthen the competitiveness of Eurozone exports.

**Finally, the risks to our central case seem relatively balanced.** On the one hand, a general and more marked restructuring of the Eurozone's public finances (notably due to pressure from the financial markets) before domestic demand picks up could send activity spiralling downwards into a double-dip recession. On the other, a bigger bounce in exports could speed up a recovery in investment, employment and domestic demand.

# Eurozone Focus: Cyclical adjustment and unemployment in the Eurozone: core vs periphery

Domestic labour markets seem to have responded differently to the recent economic downturn. The Okun equations suggest that it requires a higher GDP growth rate in peripheral countries to bring the unemployment rate down.

### EMU: changes in GDP growth and unemployment rates




*Source: Eurostat, Crédit Agricole SA*

### Long-period estimates of Okun equations

$\Delta U=\alpha+\beta\Delta \ln(GDP)+\varepsilon$
Sample: Q1 1970 - Q4 2007

| Country | α | β | R² | -α/β |
|---|---|---|---|---|
| **EMU (a)** | **0.26** | **-0.13** | **0.68** | **2.03** |
| | **(9,26)***** | **(-12,92)***** | | |
| **Germany** | 0.18 | -0.06 | 0.28 | 3.04 |
| | (4,82)*** | (-4,91)*** | | |
| **France** | 0.17 | -0.06 | 0.18 | 3.05 |
| | (5,76)*** | (-4,21)*** | | |
| **Italy** | 0.06 | -0.02 | 0.02 | 3.16 |
| | (-1,47) | (-1,51) | | |
| **Spain** | 0.55 | -0.18 | 0.51 | 2.99 |
| | (8,87)*** | (-10,51)*** | | |
| **Ireland** | 0.40 | -0.08 | 0.19 | 4.89 |
| | (3,46)*** | (-4,42)*** | | |
| **Greece** | 0.08 | -0.02 | 0.11 | 4.52 |
| | (1,83)* | (-2,25)** | | |
| **Portugal** | 0.15 | -0.04 | 0.05 | 4.03 |
| | (3,37)*** | (-3,01)** | | |

*T-values are in brackets*

*** (**, *) denotes significance at the 1 (5. 10) %,

*U: unemployment rate; GDP: Real GDP; β=Okun coefficient, -α/β: the growth rate of real GDP that is necessary to reduce unemployment, (a): Sample: Q1 1991 - Q4 2007*

*Source: Crédit Agricole SA*

## Growth and the unemployment rate in the Eurozone during the recent recession

**The scale of the recession in the Eurozone in 2008-2009 raises questions about its effects on the labour market and their persistence.** During the recent recession the unemployment rate increased by 2 points between Q108, when activity peaked and the Q209 low point, whereas GDP fell by 5.2% over the same period. In other words, the increase in the unemployment rate seems to have been fairly modest relative to the scale of the activity downturn. On average, for each 1-point fall in GDP, the unemployment rate rose by 0.4 of a point.

**Differences can be observed from one Eurozone country to another. Domestic labour markets seem to have responded differently to the recent economic downturn**. Two groups stand out. On one side are the so-called "core" countries of Germany, Italy, the Netherlands and, to a lesser degree, France, where unemployment rose at a relatively modest pace despite a sharp drop in GDP. On the other side, are the so called 'peripheral' countries where GDP slumped and the unemployment rate rose more strongly than the Eurozone average, namely Spain and Ireland. Greece and Portugal, for their part, went into recession slightly later than the rest of the Eurozone (in Q408 and Q308 respectively). Unemployment has undoubtedly risen less in Greece and Portugal than the Eurozone average, but more strongly than in most of the core countries, despite the fact that the latter saw a bigger fall-off in economic activity.

## The factors of heterogeneity

Several factors explain the different rates of unemployment adjustment observed from one Eurozone country to the next: (1) Labour market legislation – the degree of protection, the number of employees protected and the proportion of temporary employment (fixed-term contracts, temping) to total employment. (2) Labour market policies: reduction in payroll taxes and overtime and short-time working subsidies. (3) Types of relationships between the social partners: wage bargaining methods (collective, branch level, individual, wage indexation, etc.).

During the recent crisis in particular, several countries implemented employment support policies. Measures to encourage firms to make more extensive use of short-time working schemes helped to limit the fall-off in employment and hence the rise in unemployment, in Germany and (to a lesser degree) France.

**Firms' behaviour also contributed to slowing the rise in the unemployment rate at the time economic activity went into decline.** Despite the fairly bleak business climate, business leaders preferred to keep staff on in the short term. This allowed them to keep their human capital or its know-how within the company and to sidestep recruitment and training costs later on. As the downturn started to bite, firms began by cutting down on temping jobs and fixed-term contracts, and then cut overtime. They next put staff on short time, especially where this solution was encouraged by the public authorities.

## Understanding the differences within the Eurozone.

### What is the growth rate of real GDP that is necessary to reduce unemployment?

The relation between the GDP and unemployment growth rate is generally described in the literature by "Okun's Law". The basic Okun relationship helps to show the correlation between GDP growth and changes in the unemployment rate. In other words, it helps to connect changes in activity levels to those in the unemployment rate. This can be expressed as follows: $\Delta Ut= \alpha + \beta *\Delta GDPt$, where $\Delta Ut$ is the change in the unemployment rate and $\Delta GDPt$ the GDP growth.

The β parameter is known as the "Okun Coefficient". It is negative, so that acceleration in the rate of GDP growth corresponds to a fall in the unemployment

rate. Conversely, a fall or slowdown in economic activity leads to a rise in the unemployment rate. The ratio of "-α/β" gives the GDP growth rate compatible with a stable unemployment rate. Put the other way round, it is a 'critical threshold', ie, the rate of increase in activity needed to sustain a given unemployment rate.

### Recent-period estimates of Okun equations

ΔU=α+βΔ ln(GDP)+ε
Sample: Q1 1997- Q4 2007

| Country | α | β | $R^2$ | -α/β | Δ critical threshold |
|---|---|---|---|---|---|
| **EMU** | **0.19** | **-0.11** | **0.72** | **1.64** | **-0.39** |
| | **(6,78)***** | **(-10,42)***** | | | |
| **Germany** | 0.17 | -0.12 | 0.47 | 1.43 | -1.61 |
| | (3,25)*** | (-4,82)*** | | | |
| **France** | 0.22 | -0.13 | 0.39 | 1.74 | -1.31 |
| | (3,51)*** | (-4,91)*** | | | |
| **Italy** | -0.04 | -0.05 | 0.15 | -0.95 | -4.10 |
| | (-1,54) | (-2,53)** | | | |
| **Spain** | 0.66 | -0.23 | 0.29 | 2.91 | -0.07 |
| | (2,63)** | (-3,59)*** | | | |
| **Ireland** | 0.28 | -0.06 | 0.19 | 4.40 | -0.49 |
| | (4,14)*** | (-4,75)*** | | | |
| **Greece** | 0.20 | -0.06 | 0.08 | 3.27 | -1.25 |
| | (-1,37) | (-2,09)** | | | |
| **Portugal** | 0.23 | -0.10 | 0.17 | 2.37 | -1.65 |
| | (2,56)** | (-2,95)** | | | |

*T-values are in brackets*
*** (**, *) denotes significance at the 1 (5. 10) %,
*U: unemployment rate; GDP: Real GDP; β=Okun coefficient,*
*-α/β: the growth rate of real GDP that is necessary to reduce unemployment.*

*Source: Crédit Agricole SA*

## The long-run calculation of the Okun Coefficient

The table below displays estimates of Okun equations for the Eurozone and the main "core" economies (Germany, France, Italy) and those on the periphery (Spain, Greece, Portugal, Ireland) in 1970-2007.

- According to the results of these estimates, in Germany and France, zero GDP growth during a quarter (β=0) corresponds to an increase in the unemployment rate of about 0.17 of a percentage point over the quarter. The figure is much higher in Spain (0.55 percentage point) and in Ireland (0.4 percentage point);
- The GDP growth rate compatible with a constant unemployment rate is around 3% in France and Germany. Thus, a GDP growth rate higher than this coincides with a fall in unemployment. Conversely, a slower GDP growth rate corresponds to a rise in the unemployment rate. Among the selected countries, Ireland and Greece need the highest growth rates (respectively of 4.9% and 4.5%) to sustain a constant rate of unemployment.
- The value of the Okun Coefficient implies that for every percentage point over 3.1% ("-α/β") there is an associated 0.06-point drop in the unemployment rate in Germany and France ("β"). In Spain, the unemployment rate falls more (-0.2 percentage point) for each percentage point above the critical threshold. The latter is fairly similar to that of France and Germany (3%).

In short, one may observe that stagnating GDP in the core countries, and especially in Germany and France, leads to a more modest rise in the unemployment rate (0.17 percentage point) than in the peripheral countries, and notably in Spain and Ireland (respectively 0.55 and 0.40 percentage point).

## The increase in the Okun Coefficient in the recent period

Estimating the Okun equations for the recent period (ie, 1997-2007) indicates that the characteristics of Eurozone economies have changed (table 2):

- The growth threshold above which the German and French economies create jobs has fallen from 3.1% to respectively 1.4% and 1.7% since the late 1990s. In the peripheral countries, the critical threshold has also fallen: in Portugal, the growth rate needed to stabilise the unemployment rate has fallen from 4% to 2.3%.
- The Okun Coefficient has risen: each percentage point above the critical threshold ("-α/β") is linked to a drop in the unemployment rate of approximately 0.13 of a percentage point in Germany and France, compared with 0.06 of a point previously. In other words, the German and French economies have become more "employment-rich".

All in all, the outcomes of the Okun equations suggest that it requires a higher GDP growth rate in peripheral countries to bring the unemployment rate down.

### How does one explain the rise in the Okun Coefficient since the 1990s?

The rise in the Okun coefficient reflects richer growth in employment in the Eurozone since the 1990s. Looked at differently, this means that per capita productivity has fallen sharply in recent years. On average, in 2000-2007, productivity gains in Germany and France rose by 1% and 1.1% respectively, compared with 1.6% and 1.4% respectively between 1992 and 1999. This phenomenon is also notable in the peripheral countries. In Spain, for example, per capita productivity fell in 2000-2007 (-0.4%) whereas they stood at around 1% throughout the 1990s.

Overall, the slowdown in per capita productivity can be put down to several factors: (1) an increase in the share of activities generating low productivity gains, such as the construction and service industries; (2) employment policies in some countries, such as the mechanisms to foster part-time work and assisted employment in France; (3) increased recourse to temporary employment in the shape of temping or fixed-term employment contracts.

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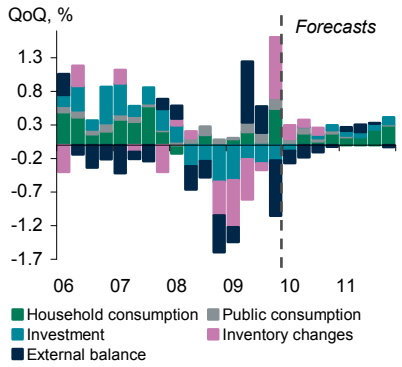
# France: The festivities are over

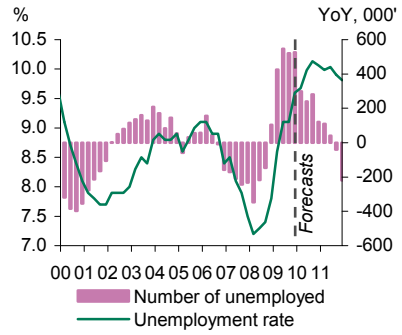
France's GDP growth rate picked up at the end of 2009, at 0.6% QoQ. After that performance, activity is expected to slow to 0.1% QoQ in Q110. Subsequently, it is likely to be restricted by a high unemployment rate, a necessary restructuring of public finances and an atypical productivity cycle. FY GDP growth is forecast to rise by 1.1% in 2010 and 1.3% in 2011.

**France: GDP growth contributions**



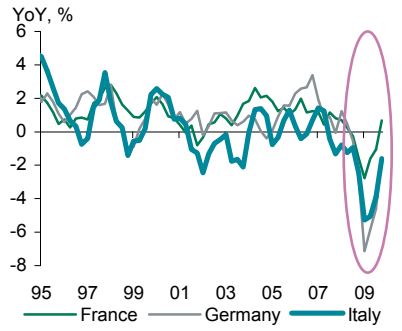

*Source: Insee, Crédit Agricole SA*

**France: unemployment rate**




*Source: Insee, Crédit Agricole SA*

**France: productivity cycle**
(Real GDP/head)




*Source: OCDE, Crédit Agricole SA*

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At the end of 2009 France posted a flattering growth rate of 0.6% QoQ thanks to very buoyant household consumption, up 0.9% QoQ, and a positive contribution from inventories (+0.9 of a percentage point). **This was a fine performance, undoubtedly, but one that should prove to be short-lived, as we are forecasting growth of just 0.1% QoQ in Q110.** The slowdown is due to private consumption, which is likely to stagnate, households having brought forward their car purchases to before year-end in order to benefit from the full car scrappage allowance. Business investment is likely to have a further adverse impact on growth, but to a more limited degree, at 0.4% QoQ, as was pointed out in the latest survey of manufacturing by the Insee. Supply managers should begin to rebuild their inventories (+0.2% QoQ). With regards to external demand, the recent deterioration in manufacturers' perceptions of their foreign orders suggests that exports are unlikely to drive economic activity. Net exports are forecast to contribute a negative 0.2% QoQ. Once this "technical correction" of the first quarter is behind us, we are forecasting modest GDP growth of around 1.1% in 2010 and 1.3% in 2011. **As France emerges from the Great Recession, high unemployment, the need to reorganise public spending and an atypical productivity cycle are all likely to contribute to curb growth.**

**The unemployment rate, which rose to 9.6% in France (metropolitan) in Q4 2009, is expected to continue rising until Q310, peaking at 10.1%. Private consumption is thus likely to remain modest (1.2% in 2010 and 1% in 2011).** In 2010, it will continue to benefit from government support. Conversely, the objective of restructuring public finances should have a slightly negative impact on household consumption in early 2011, when government support measures and a number of tax exemptions are abolished. Dynamic quarterly private consumption growth rates should not be observed until end-2011, on the strength of a foreseeable fall in the personal savings ratio, linked to the drop in the unemployment rate. Inflation, which should be modest throughout the forecasting period, will continue to underpin purchasing power. In line with these modest inflation forecasts, interest rates are likely to remain accommodative throughout 2010, helping to stabilise housing investment.

**While the French stability programme is likely to have only a limited impact on private consumption, as no tax increases have been announced, the situation will be very different in the public consumption sphere, where restrictions are forecast for 2011** (with an annual increase of 0.5% in 2011 compared with 1.8% in 2010). Our forecast also comes with a related downside risk, as the European Commission is sceptical of France's plan to restructure public finances. The measures announced to cut the deficit to 3% by 2013 do not seem to go far enough and are based on over-optimistic growth assumptions (2.5% from 2011). Given the Commission's warning, we may see a sharper reduction in public spending in 2011.

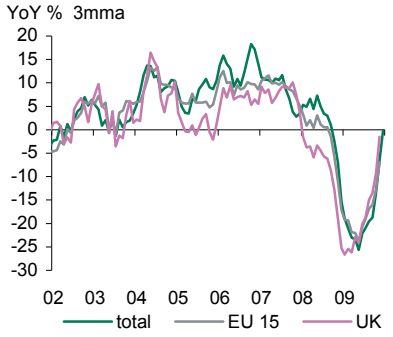
**In view of the modest outlook for demand, firms are likely to opt to regenerate their past productivity gains.** Productivity fell sharply during the recession of 2008 partly as a result of the low adjustment in employment levels. This is now having an adverse impact on the momentum of the recovery by curbing competitiveness, for example. Regenerating these productivity gains is thus becoming a priority. As a result, investment, notably in productivity, should gradually be restored. That said, business investment is unlikely to begin fuelling growth until 2011 (-1.4% in 2010 and 1.5% in 2011), partly because industrial capacity utilisation rates are stuck at a low level and firms' debt ratios are high.

**In an environment where domestic demand is limited, the upswing in the inventory cycle should give a timely fillip to growth in 2010 (+0.8%). On the plus side, we may also be surprised by the contribution from foreign trade, which may positively impact our forecasts (-0.6% in 2010 and 0% in 2011).** It is true that the recent (and premature) emergence of fears about the public finances, notably in Southern European countries, justifies a measure of caution with respect to exports. But, the vigorous recovery in other economies around the world, such as China, could boost France's foreign trade and hence its growth rate.

# Germany: Vices and virtues

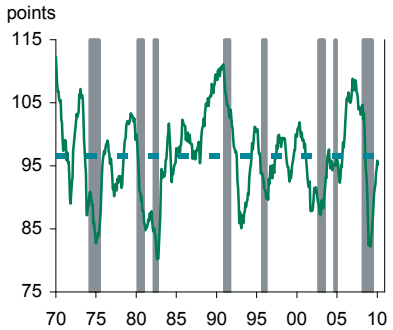
The German model, based on a dynamic and competitive export sector, will demonstrate its effectiveness as the country emerges from the crisis, with growth likely to outperform that of the Eurozone. There is continued pressure on German consumers who, despite government support measures, are unlikely to be very big spenders.

**Germany : exports by destination**



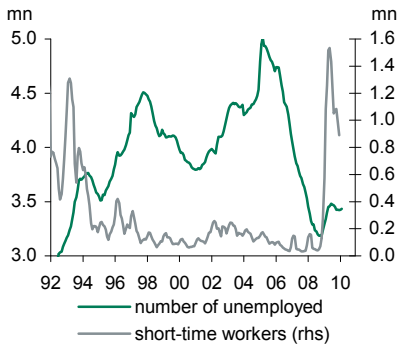

*Source: Bundesbank, Crédit Agricole SA*

**Germany: IFO index** (West Germany before 1990,in gray the recessions)




*Source: Destatis, Cesifo, Crédit Agricole SA*

**Germany: job market**




*Source: Bundesbank, Crédit Agricole SA*

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The German economy, which is more cyclical by its very nature (exports account for 47% of GDP, compared with just 26% in France), is no doubt best-placed in the Eurozone to benefit from the global recovery.

**The German model should demonstrate its effectiveness as the country emerges from the crisis, with economic growth that looks set to outperform the rest of the Eurozone in 2010 (an annual 1.6% for Germany compared to a Eurozone average of 0.9%).** Because of their strong price competitiveness, exporters will be able to lock in their gains in market share. However, although German exports to growth markets, generally found in the emerging market sphere, are likely to generate higher revenues, trade with the Eurozone, which accounts for over 40% of total exports, seems unlikely to make much headway. In particular, some once dynamic markets such as those in Spain, Greece and Ireland (which account for around 5% of exports) will be on a go-slow for the foreseeable future, not counting the fact that other intra-zone markets are not exactly going to stand out for their vigour. Add to that the 6% of goods exported to the United Kingdom and we have a considerable slice of German foreign trade which is very likely to be adversely affected for some time to come.

**The sector-specific segmentation of the German economy is also unlikely to be helpful**. Car sales account for around 20% of exports. German car makers derived maximum benefit from the windfall effect of scrappage schemes. Their performance is notable because they chalked up profits at a time when most of their European peers were posting losses. But now that the schemes have expired the knock-on effects are already being felt, and as a result sales trends are forecast to be sluggish in an environment where household spending is under pressure everywhere due to deleveraging, high unemployment and low availability of credit. Germany is also specialised in capital goods (for around 15%) whereas the excess capacity that is the legacy of the crisis does not argue in favour of a vigorous rebound in this sphere, except for a few promising markets in the emerging sphere. In all, according to our forecasts, exports are likely to increase by 1.4% QoQ on average each quarter in 2010, after marked rebounds of over 3% QoQ at the end of last year.

Although this rate of recovery in exports is not especially rapid, and capacity utilisation rates are still very low, it is highly unlikely that investment spending will pick up significantly even if the sharp correction in 2009 (-8.8% over the full year) calls for an adjustment. **We are forecasting a pick-up in productive investment in Germany over the next two years, with average annual increases of 1.4% and 2.5% successively in 2010 and 2011.**

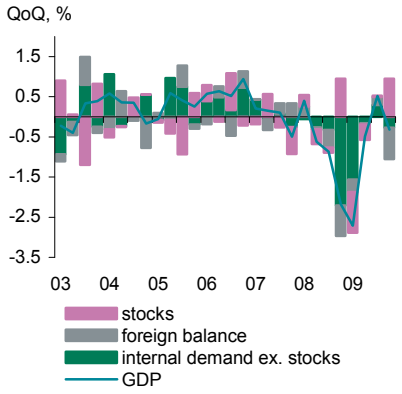
But the German model also has its downsides. The wage austerity needed to preserve competitive gains has long had an adverse impact on household consumption, even during the cyclical upswing. With the crisis, the government has taken action to safeguard jobs in exchange for an easy ride from the trade unions with respect of wage claims – another illustration of the celebrated German social consensus. This shock absorber did not stop consumption from plunging back into the red once the effects of the car scrappage schemes faded, and the recovery looks like it will be heavy going. Of course, **tax cuts worth EUR25bn and the renewal of job support measures in 2010 are positive factors but, conversely the uncertain economic outlook and the relentless, if cushioned, rise in unemployment will have an adverse impact on consumption, which seems likely to rise by less than 1% over 2010 as a whole (excluding the very negative overhang at the end of 2009), and hardly more the next year.**

Above and beyond these cyclical aspects, Germany's fiscal integrity means that, unlike most of its neighbours, it can move into the recovery cycle confidently, and will not have to make too painful and growth-inhibiting a restructuring effort.

# Italy: Back to reality

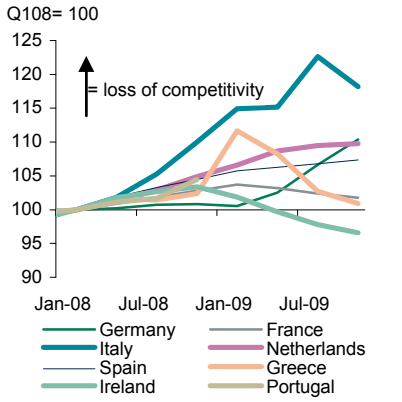
The strong pickup in GDP growth in Q3 had brought about some hope of a dynamic recovery in for the Italian economy. However, the relapse of growth in Q4 has brought expectations back to the reality of the economic situation in Italy. Italian domestic demand remains weak and the export sector is gravely lacking in competitiveness. The recovery is always on track in Italy, but at a slower pace than the rest of the Euro area.

**Italy : contributions to growth**



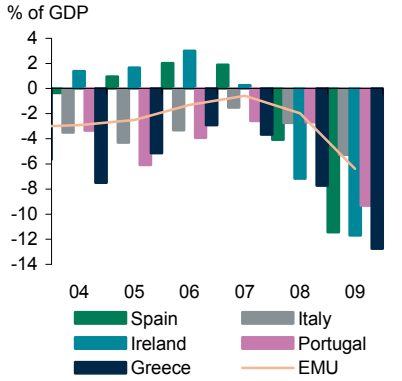

*Source: ISTAT, Crédit Agricole SA*

**EMU: cost competiveness**
(unit labour costs)




*Source: OECD, Crédit Agricole SA*

**Public deficit: Italy is not so bad**




*Source: EU Commission, Crédit Agricole SA*

**After having just emerged from recession in Q309, the Italian economy unexpectedly dipped back into negative territory in the final quarter of the year (-0.3% QoQ).** This contraction was most likely a technical correction from the surprisingly strong growth figures observed in Q3 (revised 0.5% QoQ). In particular, the surge in investment experienced in Q3 (3.9% QoQ), was confronted with a cutback in Q4 (-0.5%). Similarly, household spending dropped 0.1% in Q4 after having bounced forward 0.6% in the Q3. Growth figures could have been far worse in Q4 had it not been for the strong contribution from stocks (0.8 percentage points). The upswing in inventories fuelled the pickup in import demand (3.2% QoQ). However, export demand remained weak, progressing by a mere 0.1% QoQ in Q4. Overall, the Italian economy contracted -5.1% in 2009.

**The setback in the recovery has calmed business and consumer confidence, dampening hopes of a recovery in domestic demand.** The ISAE business climate index rose by 1.6 percentage points in the first two months of Q1, compared to 8.0 percentage points in Q409. The PMI index for both services and manufacturing stagnated in February, but remain anchored in the expansionary zone (above 50). Industrial production results in January were encouraging (2.6% MoM), but production remains well under its pre-crisis level. Furthermore, the capacity utilisation rate remains at a historical low suggesting a slow recovery in investment throughout 2010.

On the consumer side, confidence took a battering in the beginning of 2010. ISAE consumer confidence fell from 111.6 in January to 107.7 in February, its lowest level since July 2009. Household spending had begun to pickup in Q209 thanks to tax incentives (notably the car scrappage programme) and the expansion of the wage-supplementation scheme. **However, with the fading away of stimulus programmes and increasing unemployment pressures, the contribution of private consumption to growth is expected to be limited in the upcoming months.**

**With domestic demand remaining sluggish, the revival of the Italian economy will depend heavily on export demand.** The recovery of Italy's main trading partners will help trade to pickup, but Italy continues to be burdened by a large competitiveness problem. Unit labour costs began to fall in late 2009, but remain firmly above the Eurozone average (118.2 compared to 108.8 respectively in Q4). Labour productivity has been restrainted by the lagged adjustment in the labour market. Wages have remained rigid and employment has decreased less than activity (-1.4% on average during the first three quarters of 2009 compared to -5.1% GDP in 2009). The adjustment in the labour market is therefore essential for Italian companies to regain competitiveness and to boost exports.

**Overall, the fall in GDP growth observed in Q4 does not jeopardise our belief that the Italian economy will continue to recover throughout 2010, albeit at a moderate pace (our forecast: 0.4%).** The austerity measures which are currently weighing on growth in southern Europe should not be as severe in Italy. Although, Italy bears an excessive debt burden (estimated at 115.6% of GDP in 2009), the fact that the authorities only let the budget deficit fall to -5.3% of GDP in 2009 significantly distinguishes it from the other peripheral countries.

In a context of soft domestic demand and weak international competitiveness, growth should continue to remain modest in 2011 (our forecast: 0.7%).

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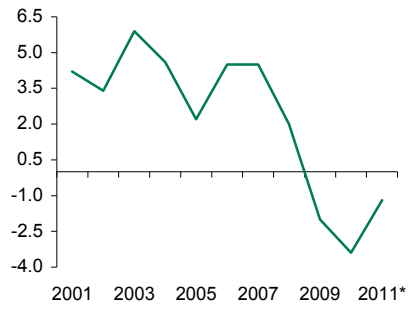
# Greece: A long hard way ahead…

While the endeavour to get public finances under control is strengthened by new fiscal austerity measures, the growth outlook has become much more pessimistic than a few months ago. More effort is needed on the structural front.

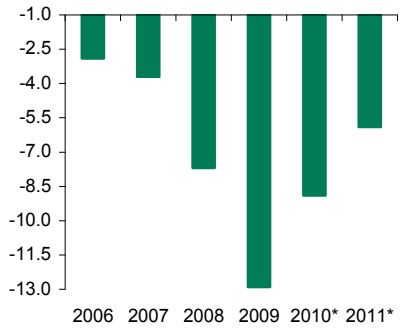
**GDP (at constant prices)**
**Annual % change**




* Projections

*Source: National Statistical Service of Greece, Emporiki Bank*

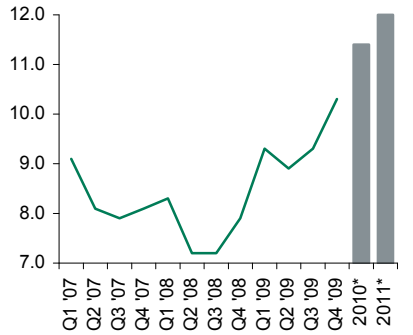
**General Government Balance**
(% of GDP)




* Projections

*Source: Hellenic Ministry of Finance, Emporiki Bank*

**Unemployment rate (%)**




** Projections*

*Source: National Statistical Service of Greece, Emporiki Bank*

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Greece initiated action to more efficiently address its fiscal problems by introducing in early March additional fiscal measures of EUR4.8bn (2% of GDP) evenly split between revenue and expenditure. **The austerity package allowed for default risk to fade and sharp sovereign risk premium hikes to come to a standstill.** But the country is burdened with hefty borrowing requirements (2010: EUR55bn), a substantial part of which needs to be met in the spring to refinance expiring debt while the risk premium is markedly elevated.

**At the same time, tight policies will weigh heavily on growth.** The contraction of GDP in 2009 was sharper (-2%) than initially expected (-1.2%) due to the worse performance of the tourism and shipping sectors. After a short period of upward movement – albeit from very low levels – expectations and confidence indicators are plunging anew in view of the troublesome state of the economy. While the rest of the euro area is exiting the recession, growth in 2010 is set to head lower still.

**Consumer disposable income will suffer a severe blow from higher income taxes and strict income policies** – a freeze on public sector wages and pensions – and additional measures reducing total yearly income (eg, cut in benefits, bonuses). The rise in unemployment, and more costly goods due to increases in certain excise taxes, will also weigh notably on consumer spending. Besides, public consumption is set to markedly fall to support the deficit target.

Regarding investment, the outlook for the construction sector is disappointing. Efforts are underway to boost investment activity with financing from the National Strategic Reference Framework. This will depend on the drawdown rate from EU funds. Moreover, the Public Investment Programme will suffer a cut in expenses linked to the constraint on fiscal expenditure.

**The external sector still looks up and should be a positive contributor to GDP growth but will offset, only to a small extent, the strong negative contribution of domestic demand.** Exports should pick up as the external economic environment recovers, while imports are set to remain subdued. Overall, 2010 could see a fall in GDP of approximately -3.5%.

**Despite the economic decline, inflationary pressures are intensifying indicating chronic structural weaknesses in certain markets**. The headline consumer price inflation is likely to average 3.0% this year (2009: 1.4%) fuelled by one-off increases in indirect taxes. The unemployment rate is also on the rise (Q409: 10.3%) and is set to remain in double digit territory given the further contraction in activity.

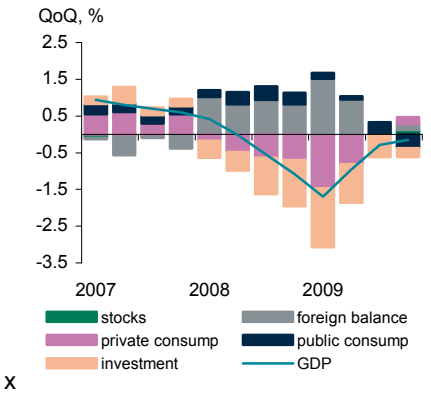
**The recession adds to the downside risks to fiscal efforts as it may challenge the tax revenue target.** The target may also be threatened by a less favourable external environment that could annihilate the positive contribution of net exports to growth entailing an even deeper recession.

Considering that recession and fiscal austerity may reinforce each other, measures to boost investment and underpin growth could help the economy get back on track less painfully in the long term.

# Spain: The austerity trap

Spain remained in recession in the final quarter of 2009. The breakdown in fourth quarter GDP began to show positive signs from both domestic and foreign demand. However, these spouts of growth are being (and will continue to be) continuously dragged down by structural problems linked to the ongoing adjustment in the housing sector and the government's recent urgent need to rebalance its public finances.

**Spain : contributions to growth**

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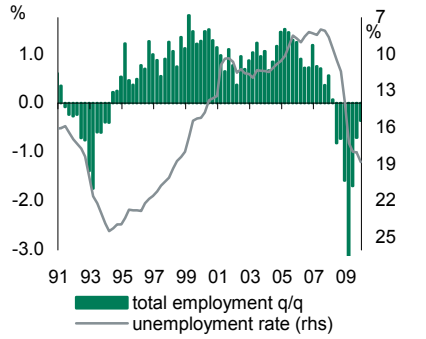
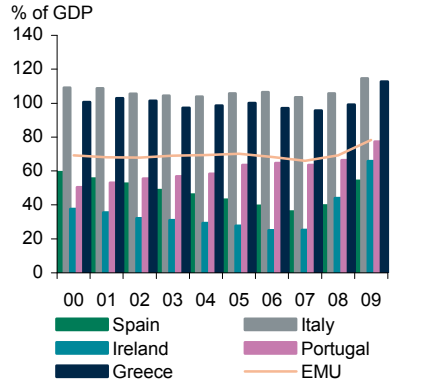
*Source: Datastream, Crédit Agricole SA*

**Spain : employment & unemployment**




*Source: INE, Crédit Agricole SA*

**Spain: Level of Public Debt**




*Source: European Commission, Crédit Agricole SA*

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**The Spanish economy spent the whole of 2009 in recession, with GDP edging down a further 0.1% in the final quarter of the year.** The decline in GDP was slowed by positive contributions from inventory cycles and a pick up in foreign demand. However, after having made a slight improvement in Q3, domestic demand declined again in Q4 (-0.4% QoQ in Q4 after -0.3% in Q3). Although, private consumption slightly recovered (+0.3% QoQ), this was largely outweighed by the plunge in public consumption (-1.7% QoQ). Investment (ex construction) picked up again in Q4 (3.1% QoQ, after 1.8% in Q3), while investment in the key construction sector contracted by a further 2.2%. As a result, total investment shrank 1.0% QoQ. For the year as a whole, Spanish GDP declined a total of -3.6% (compared to 0.9% in 2008 and 3.6% in 2007).

## The trap ahead: austerity in the midst of structural adjustment

Public finances were far from being at the top of the agenda during the crisis. Instead, priority was given to supporting economic growth through various stimulus packages, which led to an astonishing deterioration in the public deficit (a 2.2% of GDP surplus in 2007 to an 11.4% deficit in 2009). Despite having a manageable debt level (55.2% of GDP in 2009 compared to 113.4% in Greece), the fear of contagion from the Greek crisis has pressured Spain to exit its strategy of accommodative fiscal policy and enter somewhat prematurely into a period of tight austerity. **The trouble is that these measures will inevitably have a negative impact on activity which may lead to a vicious circle.** The increase in the VAT rate to be introduced in July will slightly push up consumption in the beginning of the year, but this will have the inverse effect at the end of the year. The cut in pensions and public sector wages, the reversal in income tax benefits coupled with the high level of unemployment (at 18.8% in January), will weigh on consumer morale and disposable income, pushing households to further accumulate precautionary savings. The lack in domestic demand will further press on investment. **Thus by suppressing domestic demand, these austerity measures intended to reduce the budget deficit may actually worsen it by dragging down growth and decreasing tax revenues.** Paradoxically, the austerity plan introduced in January relies heavily on higher tax revenues.

## A laboured recovery ahead

**Confidence surveys have already started to reflect this sentiment.** In February, only one month after the introduction of these measures, consumer confidence dropped five points. Business confidence made slight progress in the industrial and service sectors, but continued to worsen in the construction sector. The PMI index progressed in February, but remains under the symbolic level of 50 indicating that manufacturing activity remains in contraction, as was reflected in the January industrial production results (-2.6 MoM).

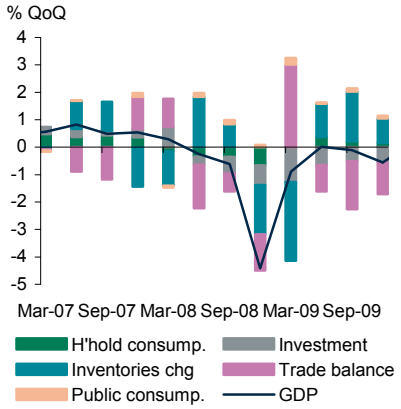
Overall, the weakness in domestic demand is expected to weigh heavily on investment. Inventories are expected to be mildly replenished in the beginning of the year, along with the mild pick up in export demand. **Spain is expected to emerge out of recession in the beginning of 2010, but the recovery will be long and laboured.** Spanish GDP is projected to contract again by -0.4% in 2010 before rising by a modest 0.6% in 2011.

More fundamentally, Spain needs to rethink its growth model. The country must implement structural reforms to improve its competitiveness, and to find new drivers of domestic growth in order to reduce its dependency on the construction sector and help highly indebted agents to clean up their balance sheets. **The risk is that the austerity programme focuses too heavily on the short term, putting at stake these crucial long term issues.**

# Scandies: growth affected by uncertainty abroad

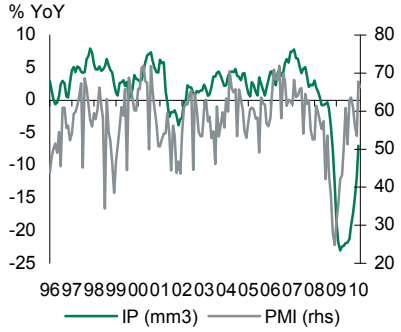
Growth disappointed in Q409 both in Sweden and Norway, triggering less optimistic growth prospects in the first and a prolonged pause of the tightening cycle for the latter. In both cases, uncertainty regarding recovery abroad has downplayed prospects for exports while household consumption has been recovering rapidly.

**Sweden: contributions to growth**



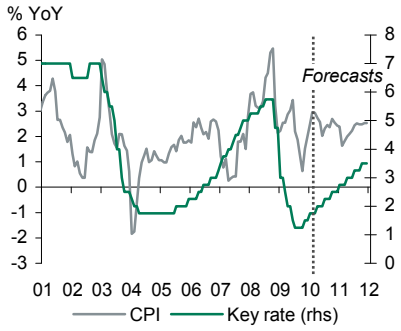

*Source: Statistics Sweden, Crédit Agricole CIB*

**Sweden: industrial production & PMI**




*Source: Statistics Sweden, Crédit Agricole CIB*

**Norway: CPI and key policy rate**




*Source: Statistics Norway, Crédit Agricole CIB.*

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Sweden remained in recession in Q409 posting a drop of -0.6% QoQ in GDP growth. **The trade balance continued to be the main drag to growth.** It subtracted 1.1bp from GDP growth in Q409 as exports continued to fall and imports increased further on the back of improving household consumption. Exports seem to be suffering from low capacity utilisation abroad as they consist mainly of manufactured and investment goods. Competitiveness is threatened by the SEK appreciation as the real effective exchange rate of the SEK appreciated by more than 5% in 2009. The weakness in exports will probably persist in Q110, before improving moderately thereafter as the recovery is gaining momentum in Norway, Germany and the UK, its main commercial partners.

While business investment spending still struggles to restart, falling by 3.3% QoQ in the last quarter, inventories resumed their rebuilding and contributed significantly to GDP growth. **Business confidence is improving, according to the Swedbank PMI survey, suggesting that industrial production should continue to recover, although from historically low levels.** We therefore forecast a gradual improvement in investment starting later this year. Inventories should continue to be the main driver of performance this year, while household consumption growth may be restrained by the significant unemployment rate and prospects for a first rate hike in the summer. On one hand rising house prices stimulate household confidence, but on the other the labour market continues to deteriorate and unemployment is not expected to peak before the end of 2010.

We therefore forecast a gradual decline in core inflation. Additionally, SEK appreciation is likely to continue to exert downward pressure on imported inflation. Conversely, headline inflation, which includes mortgage interest costs, is expected to continue to rise in response to expectations for a repo rate hike "in the summer or early autumn". However, it should remain under the 2% Riksbank target in 2010 and 2011, reflecting our less optimistic views on the economy, at least when compared to the Riksbank. **We see the first move from the Riksbank in September, although some of the more hawkish members of the Riskbank expressed preferences for a July raise with a flatter curve in the longer term.**

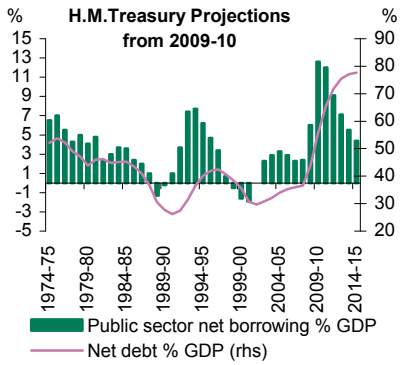
**Following the Norges Bank decision to keep the interest rate unchanged in March, the next hike in Norway now appears likely in May.** The Norges Bank again expressed concern about household debt accumulation at its last meeting and reiterated its view that the interest rate should be brought gradually closer to a more normal level. However, the Norges Bank clearly sounds more cautious about recovery abroad and fears the continuing NOK appreciation which threatens competitiveness. **Further NOK appreciation would prevent the Norges Bank from raising the interest rates too rapidly.** Moreover, its forecasts for inflation have been revised downwards as a result of lower wage prospects and lower capacity utilisation.

According to our forecasts, the negative output gap is likely to continue to exert downward pressure on underlying inflation, probably until the end of 2010. Prices for imported consumer goods are expected to decline as a result of the NOK appreciation from its weak levels since January 2009. **Growth may continue to suffer from extremely high labour costs which dampen business profitability.** Fiscal tightening is necessary in order to reduce deviation from the "4% rule". **Household consumption is likely to continue to be a significant driver of growth throughout the forecast period.** However, the pace of growth in household spending is likely to lessen somewhat in favour of saving, as a result of the tightening monetary policy. Interest rate increases have an immediate effect on the housing market and household behaviour because housing debt in Norway is mainly through adjustable-rate mortgages.

# UK: A promise for growth?

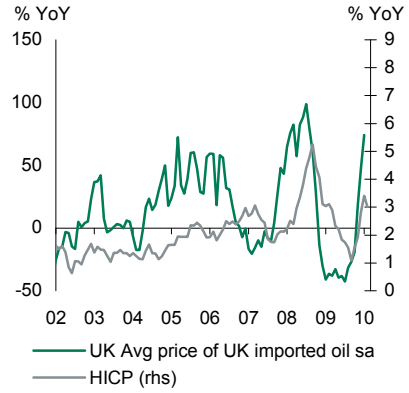
The UK returned to growth in Q409, partly due to stronger household consumption. The trend seems to be gaining momentum, but growth will remain sluggish in the medium term due to the need for a tighter fiscal policy.

### UK: key fiscal aggregates



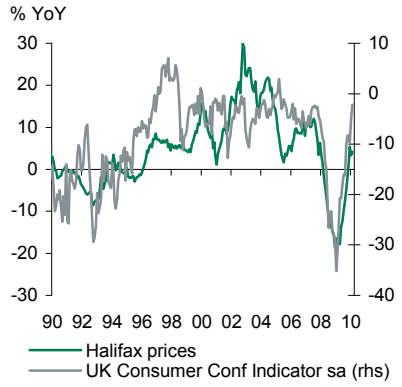

*Source: PBR Dec 2009, Crédit Agricole CIB*

### UK: HICP and average price of imported oil




*Source: NS, Crédit Agricole CIB*

### UK: housing prices and consumer confidence




*Source: ONS, Nationwide, Crédit Agricole CIB*

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The UK emerged from recession in Q409, posting quarterly growth of 0.4% QoQ, although full-year GDP shrank by a record -4.9%. While business investment continued to fall, household consumption picked up as of the second half of 2009, stimulated by exceptionally accommodative monetary and fiscal policies. The improvement in the financial market, and more recently in house prices, has helped to underpin consumer sentiment and gradually ease pressure on private sector balance sheets. The fact that the unemployment rate stabilised at 7.8% during the second half of 2009 may also have helped to sustain household spending. After a difficult month in January, affected by particularly bad weather conditions, retail sales picked up again in February. The upturn in consumption could therefore continue, but seems likely to remain sluggish.

**Uncertainties about the outcome of the General Election, likely to be held on 6 May, and the prospects of budget austerity should have an adverse effect on consumer morale in the coming months.** The main political parties appear to agree on the need to bolster public finances. According to the 2010 Budget, the deficit is estimated at 11.8% of GDP for FY2009-10. **The Treasury pledges to halve deficit in four years without threatening recovery.** However, while the Treasury's 2010 growth forecast is in line with consensus, the 2011 forecast of 3.0%-3.5% is deemed to be overly optimistic. The necessary fiscal measures could therefore prove far tighter than those currently being mooted.

Foreign trade had a negative impact on growth in 2009. While exports did rebound, it was not enough to offset import growth, driven by higher domestic demand. What is more, the weakness of GBP is not having the expected effect, as exporters are seeking to rebuild their margins instead of bringing down their prices. We continue, however, to believe that the external accounts will balance on the strength of a rebound in exports, as recent manufacturing surveys point to a notable increase in export orders.

Even if lending conditions have slightly improved in recent months, lending to households and businesses continues to be limited by the needed adjustments in bank balance sheets. Business investment fell sharply during Q409, partly due to a dearth of credit but more importantly due to the uncertain economic prospects. Changes in inventories, for their part, made a positive contribution to growth in Q409. We should therefore continue to see inventory downsizing, but at an increasingly lower pace, with investment looking to pick up only slowly. **All of which argues for sluggish growth throughout the forecast period.**

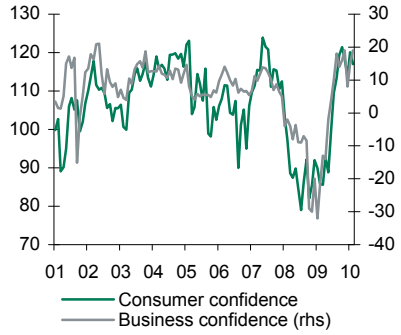
Due to the combined effects of the return to a 17.5% VAT rate in January, higher oil prices, and GBP's depreciation, inflation rose to 3.5% in the 12 months to end-January. **While the weak GBP should continue to push inflation upwards, energy-price variations could result in increased inflation volatility in the short term.** Inflation could remain therefore above target for a while with a potential knock-on effect on inflation expectations. In the medium term, however, deflationary pressures exerted by the substantial margin of spare capacity in the economy left over from the crisis on the labour and goods markets should bring inflation down and under target. This assumption is also central to the inflation forecasts in the BoE's Quarterly Inflation Report from February. The most recently published BoE minutes temper this diagnosis, however, on the basis of the Bank's Agents reports that the scarcity of credit, weak cash flows and economic uncertainty may so far have stopped businesses from cutting their prices. **In view of the doubts about the scale of the disinflation trend over the mid-term, the probability of a future extension of QE seems limited.**

**Even so, with fiscal policy set to be tightened, the BoE is likely to maintain its accommodative policy in order to create a balanced policy-mix. We therefore maintain our forecast for a first increase in the key rates in the first quarter of 2011.**

# Australia: Strengthening confidence

Economic conditions are set to continue to improve, with the economy on track to grow by around 2.5% this year and 3.2% in 2011. Further gradual rate hikes are expected and we look for the cash rate to rise to 5% by end-2010. The outlook for the AUD remains positive over the next few months and we expect it to peak around 0.95 vs USD by mid 2010.

**Consumer and business confidence improve sharply**




*Source: Bloomberg, Crédit Agricole CIB*

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Australia looks set to build on its economic gains over the coming months following a limited weakening during the financial crisis. The labour market has continued to show improvement and together with positive evidence in various surveys, it suggests that **growth will continue around trend**. Credit conditions are likely to ease further whilst investment, especially in the resource sector, is picking up. The housing market is also showing further signs of strengthening, though higher rates will take some of the impetus out of the market. **Australia will continue to benefit from the strengthening in growth in Asia**, especially China and will not suffer from the sub-par growth expected in other major economies. We forecast 2.5% GDP growth in 2010 and 3.2% in 2011.

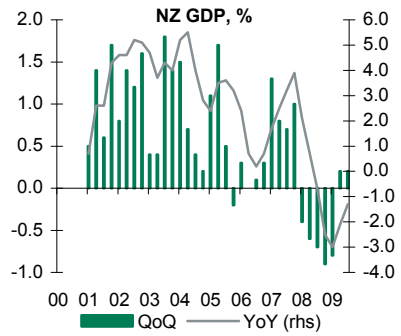
Inflation pressure is picking up but **CPI is expected to be consistent with the RBA's 2-3% target** over the coming months assuming that policy setting are normalised further. The RBA is unlikely to be in any rush to hike rates, especially given the moderation in wage pressures. Nonetheless, **further gradual rate hikes will be necessary to ensure that inflation risks are contained** and we expect the cash rate to rise to a peak of 5.0% by the end of the year.

The **outlook for the AUD remains positive** and we expect it to peak around AUD/USD 0.95 by the middle of the year. Higher interest rates will increase the attractiveness of the AUD as a "carry" currency. However, we look for the AUD to depreciate over H210 as the USD undergoes a general strengthening around the time when Australian interest rates peak.

# New Zealand: Poised for higher rates

New Zealand's economic performance has trailed that of Australia but will be helped by the strength of Asian demand and resilient consumer spending. The economy is set to expand by 2.1% this year followed by 3.1% in 2011. The RBNZ is set to hike rates to 4.0% by the end of this year whilst NZD/USD is likely to peak around 0.76 by mid-2010.

**Economic activity set to strengthen further**




*Source: Bloomberg, Crédit Agricole CIB*

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Economic conditions have continued to improve and the economy is expected to pick up pace over the remainder of the year. Like Australia, NZ is benefiting from strengthening growth in Asia, which is benefiting trade performance. There is also plenty of evidence of improvement in the domestic economy, with labour market conditions stabilising and strengthening consumer activity. **The economy is expected to grow by 2.1% this year and 3.1% next year** though there is a possibility of upward revisions to these forecasts if the pick up in activity continues at the current pace.

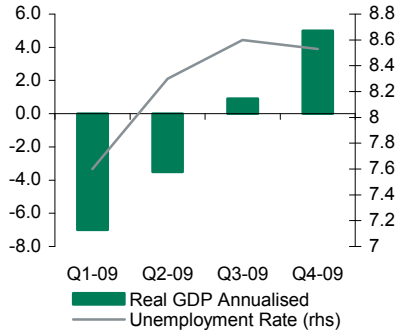
Temporary influences will likely push inflation higher over the short term towards the top of the RBNZ's target range. Nonetheless, **CPI is set to remain within the 1-3% range for the time being**, reducing the urgency to tighten monetary policy too quickly. As the economy strengthens further we expect inflation pressures to increase, necessitating interest rate hikes from around the middle of the year. **We expect the Official Cash Rate (OCR) to be hiked to 4.0% by the end of this year**, with further rate hikes expected over 2011 to a peak of 5.0%.

The **NZD is likely to strengthen further** over the coming months and we look for it to be one of the best performing major currencies, peaking at NZD/USD 0.76 by end Q210. Like the AUD, the NZD will benefit from prospects of higher interest rates, strengthening economic activity, improving risk appetite and firm commodity prices. The NZD is currently better valued than the AUD and offers slightly stronger scope for appreciation.

# Canada: Recovering better than expected

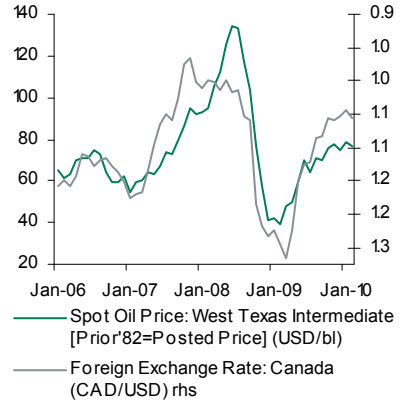
Canadian economic activity rebounded in Q409 and is running a bit ahead of Bank of Canada projections. While some of the recent increase in inflation may be temporary, risks are rising that the Bank of Canada may begin normalising its accommodative monetary policy by as soon as the third quarter.

### Growth Recovery



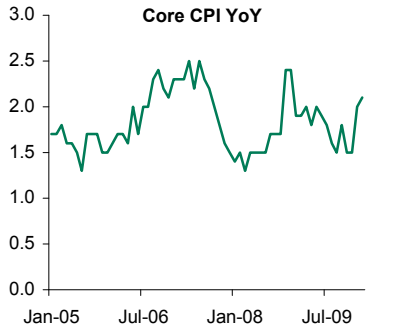

*Source: Statistics Canada*

### Currency Strength




*Source: Haver Analytics, Credit Agricole CIB*

### Inflation to remain in recent range




*Source: Bank of Canada*

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**Real GDP rose at a 5.0% annualised rate in the fourth quarter** of last year – the largest increase since the Q300. Consumer spending grew 0.9% last quarter with strength in spending on durable goods, such as motor vehicles and household furniture. Services spending was up 1.0%. However, weakness was evident in investment spending on plant and equipment (-2.3%), and investment in non-residential structures posted its fifth consecutive quarterly contraction. Exports rose in the fourth quarter while the gain in imports slowed. This contributed positively to GDP growth.

**Canada's recovery seems to be on track, recent data suggests strong momentum into the first quarter.** For example, employment rose by 21K in February, with a strong advance in full time jobs. The February job gains left employment up by 159K since July 2009. The unemployment rate moved down to 8.2% in February. January retail sales were also positive, rising 0.7% in January boosted by home improvement product sales as a home renovation tax credit expired.

The strong Q4 GDP figures are good news for Canada. However, consumer prices have risen over the past two months largely due to higher energy prices. The February all-item consumer prices index rose 1.6% on a YoY basis. However, **the Bank of Canada's February core inflation measure was 2.1%, higher than a year earlier, vs 2.0% YoY in January**. The February increase reflected higher prices for passenger vehicles, as well as for traveller accommodation affected by the Olympics. The latter impact is expected to be short-lived.

With the economy growing faster than Bank of Canada expectations a few months ago **it now seems likely that the Bank, which conditionally committed to keeping its policy rate steady through the end of the second quarter, may begin its rate normalisation process as soon as the third quarter.** The Bank of Canada will be hiking rates before the Fed and will likely begin with modest 25bp moves.

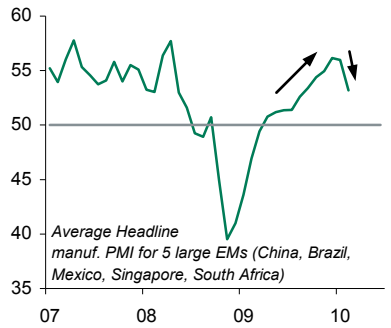
The Canadian loonie is close to parity with the USD. One of the concerns of policymakers was that the strengthening currency would take its toll on exports, most of which are US bound. However, Canadian export-sensitive sectors seem to be adapting fairly well to the currency strength. For example, manufacturing sales in January were up 2.4% – their fifth consecutive monthly gain. **The stronger currency helps Canada by lowering import costs. This appears to be allowing companies to buy new machinery that will help boost productivity and help maintain competitiveness for Canadian producers.** This is a long-term positive for Canada whose cheaper currency took away some of the urgency for businesses to strive for continued productivity gains. As Industry Minister Tony Clement remarked recently, "The new normal is that you don't just relay on a low Canadian dollar as your productivity edge and I think most businesses have gotten that point."

The stronger currency also works to keep imported price inflation low. So the Bank of Canada is not likely to drag its heels on tightening policy in the current setting which points to improving growth prospects south of the border. In addition, **Canada's banking system was less damaged by the global financial crisis than many advanced economies and its government debt situation compares very favourably with its major trading partners**.

# Emerging countries: Who is hiking, and who is not?

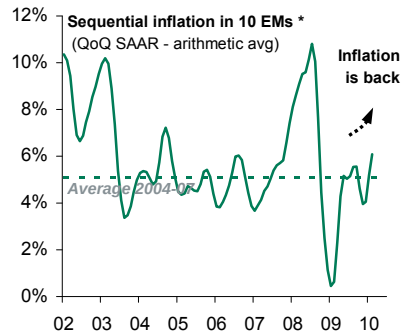
Central bank rates have to increase as inflation is back in many emerging market countries. What we are talking about is a normalisation of monetary conditions, and not the beginning of the strong tightening cycle, though. The number of hikes will likely increase later this year, beginning in Q2 in Asia and Brazil. Latin America will follow. Eastern Europe may lag.

### EM PMIs: what after the recovery?




*Source: CEIC, Crédit Agricole CIB*

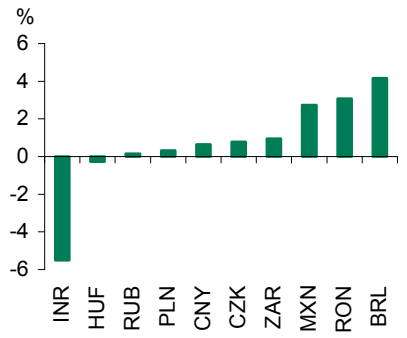
### EM inflation: back to normal




** Brazil, China, India, Korea, Mexico, Poland, Russia, South Africa, Thailand, Turkey*

*Source: Bloomberg, Crédit Agricole CIB*

### Some need to tighten more than others (real rates)




*Source: Bloomberg, Crédit Agricole CIB*

Most emerging markets have continued to recover since the beginning of the year. Not only have stimulus measures kept on supporting economic activity, but recovering global demand has been of benefit to exports. PMIs have remained well above the 50 threshold, reflecting the indication that the EM world has remained in expansion mode.

Still, there seems to have been a little bit of a softer patch in February (see chart). In our view this reflects what happens as **the EM corporate world gets used to the idea that the 'new normal environment'** it has to live in is more challenging than the pre-crisis environment. Actually, we do not expect a double-dip but we do expect a moderation in economic growth in the coming quarters as exports tend to grow less rapidly, as stimulus measures are gradually withdrawn and as central banks begin to hike interest rates on a broader basis.

As a matter of fact, one key feature of this 'new normal' is the return of inflation pressure in emerging markets. One could argue that the recent rebound in inflation is due to a particularly low base last year. This is right. However, beyond the statistical base effect, sequential inflation is also coming back. As illustrated on the left-hand chart, we calculate that the average **sequential inflation for 10 large emerging markets is back to normal** (that is: to its 2004-07 level). By contrast, **policy interest rates are definitely not at normal levels**. So far, among the main emerging markets, only India, Israel, Malaysia and Vietnam have increased their main policy rates.

We are not expecting very large hikes in interest rates in coming quarters. What we expect is more of a monetary normalisation than the beginning of another cycle of strong monetary tightening. However, in our view, **the number of EM central banks to hike rates will increase significantly in Q2**.

**From a geographical point of view, we expect Asia to continue to lead the process.** The two Asian giants have already begun to normalise monetary policies. They began by raising the reserve ratio, and not the main policy interest rates, in the first place. However, India surprisingly hiked its key interest rates in March. In our view China will follow in Q2

China has to cope with rising inflation pressure as well as with the risk of property bubbles. On top of that, the inflation rate is now above the 1-year deposit rates (at 2.70% YoY in February vs 2.25% for the deposit rate). Depositors are now losing money on a real basis – this is an additional reason to raise rates. We expect the PBOC to hike twice later this year (by 27bp each time, as it usually does).

In India, inflation is already flirting with double-digit levels. The RBI began hiking rates in March. Given India's track record in terms of inflation, it is crucial that the central bank manages to cap inflation expectations. In addition, inflation could become a political problem, should it remain high, altering the population's purchasing power. We expect the RBI to hike by a total 125bp in 2010. Interestingly, this would push up the reverse repo rate to 4.5% – which remains below its average historical level (5.5% on average between 2005 and 2008 for instance). In our view, a possible risk on the upside on commodity prices suggests that RBI could hike more strongly in case food prices do not moderate significantly.

**Next to Asia will likely be Latin America**. Monetary tightening is also expected there, as inflation pressure is mounting across the board. It has not reached a threatening level, yet. However, inflation expectations may skid amidst the global and regional recovery. Tightening should be mildly aggressive in the region as real rates are still positive. Brazil is the exception and it will likely take the lead with an impressive 275bp rate hike cycle expected to start in April, according to our forecasts. Both supply and demand sides have shown resilience and the

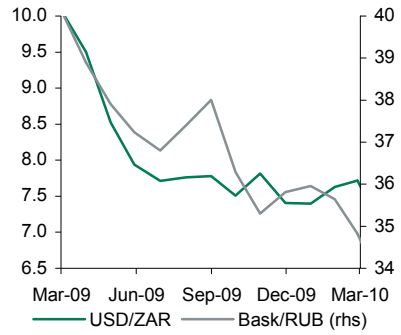
economy is on track to post a stark 5.3% growth in 2010.

Nevertheless, all the central banks are not on the verge of hiking. The outlook is not so bright for all the emerging countries and **the tightening cycle is not yet in the pipeline in Central and Eastern European countries**. Except Poland, they are still lagging the recovery and real rates have remained positive, helping to protect currencies from excessive weakness during risk aversion bouts. The large foreign currency liabilities have limited the scope for rate cuts in some of these economies.

**In some other European markets domestic demand and inflation pressures are tame and so the easing cycle is not yet over everywhere**. This is the case in Russia for instance. The sharp disinflation observed over the past three quarters gives room for further cuts, we believe. Furthermore, the FX goal of the authorities has changed compared with last year. They would now be comfortable with limiting the RUB appreciation in order to support the recovery, and could use rate cuts as a tool to smooth the RUB appreciation and limit the massive capital inflows.

**South Africa may be tempted to keep easing monetary policy as well**, or at least maintain a dovish bias. The economy is still languishing whilst domestic demand – the past main contributor to growth – has showed few signs of recovery. Within this background, the relevance of inflation targeting is under scrutiny and ZAR overvaluation is putting a huge pressure on authorities to err on the soft side.

**FX appreciation: an incentive to cut?**




*Source: Bloomberg, Crédit Agricole CIB*

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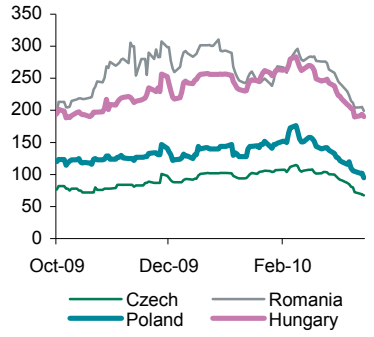
# Central Europe: From risk to politics

The region has ended Q110 in a comparatively strong position, shaking off risk concerns focusing on Greece. Economic recovery is continuing, with Poland still expected to be the regional outperformer. In Q2 attention shifts to politics with the Hungarian elections in April and Czech poll in May. The net result is likely to favour Hungarian markets over Czech.

**10Y CDS indicate a more confident view on CE4**




*Source: Reuters*

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The **region has ended Q110 in a firm position** given the Greek inspired rise in European risk aversion that it had faced. The CE4 CDS have narrowed as has the yield spread to Bunds, suggesting that **investors have renewed confidence** in the region. The laggard appears the Czech Republic with the CZK positing the smallest rise against the EUR and its bond market return not only lagging Poland and Hungary's but also the Eurozone's.

The growth outlook is partly responsible. **Poland remains the outperformer** with growth of 2.3% expected this year, but whilst Romania (1%) and Hungary (-0.3%) will underperform Czech growth of 1.5% there are growing concerns that the latter will suffer disproportionately from sluggish Eurozone growth

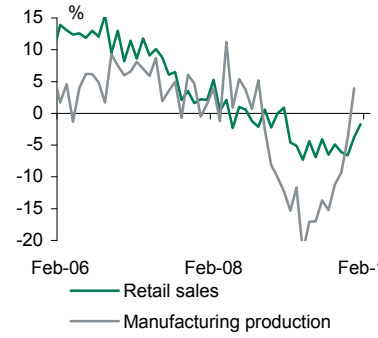
Hence, **central bank policy within the region may be diverging**. Poland sounds increasingly hawkish, although it has been rattled by the strong PLN and even hinted at intervention. Romania should cut rates once more, but at 6.5% nominal rates will remain high. Similarly, Hungary retains an easing bias, but even with rates comparatively high at 5.75% only one more cut is likely. Meanwhile, Czech growth concerns will keep its central bank pegged to just 1% until Q410, adding to the pressure on markets as investors search for yield.

Finally, **elections in Hungary on 11/25 April** should result in a clear victory for the opposition Fidesz party, suggesting a greater ability to pass structural/budget reform, which should bolster the HUF markets. The outcome of the **Czech elections on 28/29 May** is less clear, the likelihood of the Social Democrats requiring support for a collation government may weigh on CZK sentiment.

# South Africa: In the mist

South Africa is finally out of the recession but there is nothing yet to be very excited about. Nothing is certain and with uncertainties lingering the SARB may be tempted to maintain its dovish bias. ZAR valuation seems to be overstretched and we expect a short-term retracement.

**Out of the recession**




*Source: SSA, Crédit Agricole CIB*

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**South Africa, the famous laggard, is out of recession but still languishing**. The recession was partly contained – GDP contracted by 1.4% in 2009 – as was the recovery. Indeed **we only expect a meagre 2.0% GDP**.

Industrial production has been indeed well oriented and domestic demand has shown signs of a come back. Nevertheless uncertainties linger and there seem to be very few elements to get excited about. **South Africa is clearly in the mist**.

**First, risks are skewed to the downside**. Domestic demand drivers remain tepid – high unemployment rate, indebted households and large inequalities. Policymakers have limited room for manoeuvre with fast declining revenues and spending committed to important infrastructure plans. It is all the more worrying since consumption represented two-thirds of GDP.

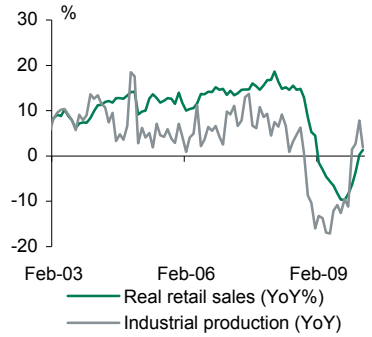
Second, **disinflation trend has not been impressive** despite the sluggish economic environment and the Eskom price hike will likely add 1ppt. The inflation targeting objective is highly discussed and we expect softer rhetoric from the SARB. There is increasing pressures for a dovish stance and **we expect the SARB to err on the soft side to give some impetus to demand.**

**The ZAR outlook is hardly predictable either**. For months, it has been flirting with firm levels and is considered by all measures to be overvalued. With such a sluggish economic background and a dovish monetary policy we still expect a short-term retracement. Should risk appetite return strongly in the emerging world, it should continue to perform. It would leave the authorities in a tricky position. They have pledged many times, with the IMF, for a weaker ZAR. Hence, capital control can be fashionable.

# Russia: Encouraging but…

The past quarter has confirmed the economic recovery and there seems to be further to come. The central bank should continue to cut rates to ease financing conditions and smooth the RUB appreciation. But, RUB and the economy will continue to be vulnerable as few structural reforms have been initiated.

**Encouraging everywhere**




*Source: FSSS, Crédit Agricole CIB*

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**The fragile recovery seen over the last few quarters has turned into a firm rebound and all issues seem to have been cleared up**. Finally growth has posted a 7.9% contraction in 2009, better than expected, and thanks to a stabilisation of oil prices, its foreign exchange rate and the NPL ratio, positive growth should be back in 2010 at 3.5% YoY.

Even fragile domestic demand, which weighed on the pace of recovery, sent some positive signs. Positive real wage growth and a stabilisation in the unemployment rate suggest that there is more to come.

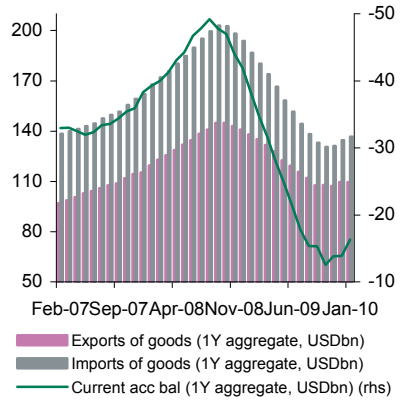
Nevertheless, **such an improvement will likely not alter the dovish central bank stance**. It is true that the CBR is fine tuning, but the easing cycle is not yet over as long as the disinflation trend lasts. Further rate cuts should give some fresh air to indebted households but above all it is a tool to smooth the overly swift RUB appreciation. Indeed, capital inflows have been massive over the last quarter, spurring the RUB rally. The CBR will keep on intervening in FX markets as well, lowering the lower boundary of the basket corridor. Still, sterilisation operations should gain momentum to offset the wall of money.

Admittedly, **the RUB appreciation might be taken as an encouraging sign but it still remains vulnerable whilst the authorities have not really taken the opportunity to initiate structural reforms**. The Russian economy is still poorly diversified, mainly oil-oriented with few manufacturing exports and strong price rigidity. Any oil price swings or an inflation rebound will hence have the same consequence, sending RUB into tail spin and jeopardising the economic recovery.

# Turkey: Recovery still hesitant

After the sharp rebound observed in Dec, the industrial output data for Jan was disappointing. Economic activity looks set to remain sluggish in the short term. Several developments and recent events are making anything else difficult. The current account deficit should also start widening again this year – a timely reminder of how dependent Turkey is on foreign capital.

**Turkey: current account balance**




*Source: CBT*

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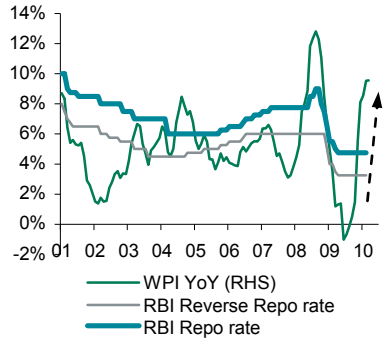
**Industrial production surged 25.3% in the twelve months to December 2009. Setting aside a very favourable base effect, such strong performance had suggested that domestic demand could pick up slightly faster than expected. That still needed confirmation but the January figure did not do this**, with manufacturing output growing 12.1% YoY. In fact, the recovery seems likely to remain hesitant in the short term. Greece's difficulties scuppered the prospects for a European rebound. Unemployment continued to rise at the end of last year. Inflation picked up to 10.1% YoY in February, compared with a low of 5.1% YoY in October 2009. Negotiations between the IMF and the Turkish government on a new aid programme broke off in early March, while relations between the AKP on the one hand, and the army and judiciary on the other have become more tense in recent weeks. Although not raising concern, these new factors create a tad more uncertainty and doubtless do little to foster stronger economic activity.

**Elsewhere, the current account deficit widened to USD2.96bn** in January, six times higher than in January 2009. At an annualised rate, that represents a deficit of USD30-35bn or 4-5% of GDP. Turkey is dependent on foreign finance and is thus sensitive to investor moods. This is nothing new and is not likely to change, either in the short- or even the mid-term. Last year's recovery for the current account balance was no more than the fortunate outcome of a sharp reduction in domestic demand.

# India: Tighter policy mix ahead

Strengthening growth outlook allows the Indian authorities to cautiously tighten the policy mix.

**Inflation: up**




*Source: CEIC, Crédit Agricole-CIB*

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After a disappointing economic growth in Q4, the Indian economy is poised to reaccelerate as the negative impact of the unfavourable monsoon fades and as exports continue to pick up. **We expect GDP growth to reach 7.0% during FY11** (fiscal year that will begin in April 2010).

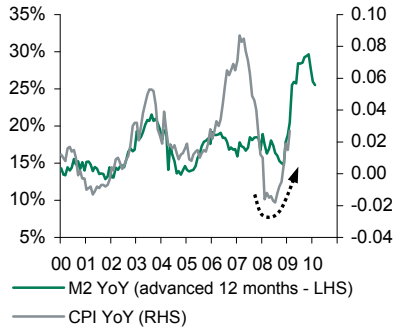
**The FY11 budget, presented earlier this month, is going in the right direction. The government has made notable efforts towards fiscal consolidation.** The central government's deficit is forecasted to decrease from 6.7% of GDP in FY10 to 5.5% of GDP in FY11. Furthermore, the government set a medium term target of 4.1% of GDP for 2013. On top of that, the fiscal plan's credibility relies on both realistic growth assumptions and significant measures such as more disinvestments, a plan to introduce a GST in 2011, the decrease of tax exemptions and the increase in some tax rates (such as the excise tax). This way **the planned reduction in the fiscal deficit may not be made at the expense of the development expenditure**. This is especially welcome, given the need for infrastructure spending in particular.

Still, India faced a growing challenge over the past few months. Inflation (WPI YoY change) accelerated from negative at the middle of last year to almost 10% in February. It may peak in the coming months. However, even if it moderates from the beginning in Q2, the recent sequential inflation numbers suggest that inflation could remain above the RBI's comfort zone later on. **The RBI is likely to increase the reserve ratio and interest rates further (including at next scheduled meeting in April)**. We expect a total 125bp hike in the repo and reverse repo rates in 2010.

# China: CNY appreciation postponed

The politicisation of the CNY issue will likely postpone the resumption of the CNY appreciation. But a CNY move will have to happen eventually, in order to cap the risk of asset price bubbles/inflation.

**Monetary growth fuelling inflation risks**




*Source: CEIC, Crédit Agricole-CIB*

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Political pressure is building up between China and the US on the CNY issue. Closing the NPC, the Chinese PM denied that the CNY is undervalued and repeated the concerns regarding the value of China's USD assets. **Pressure should remain strong ahead of mid-April, when the US Treasury may or may not name China as a currency manipulator.** Because of the politicisation of the CNY issue, we now believe that China is unlikely to move significantly on the CNY before the last part of the second quarter.

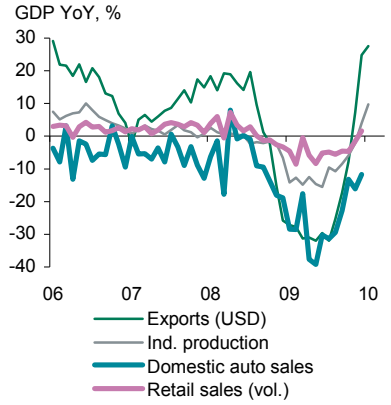
However, the macroeconomic challenges will continue to grow in the meantime. On the back of strong economic growth (10.7% YoY in Q4) and rapid monetary expansion, inflation has accelerated to 2.7% YoY in February, and the risk of property bubbles remains a rising source of concern. There is more. The CNY's peg to the USD itself is fuelling those imbalances, we believe. PBOC is perceived as being behind the curve and many in the financial industry will likely continue to bet on an eventual CNY appreciation. Therefore, **hot money inflows are likely to remain large, fuelling domestic liquidity and the risk of an inflation/property bubble.**

**We believe that China will eventually have to deliver. But it will likely wait for the political environment to become more neutral.** A second factor could delay a CNY move. **The USD brought the CNY with it in its recent climb vs EUR, making it more difficult to resume the CNY appreciation now**, compared with two to three months ago. We now expect the CNY appreciation to resume by the end of Q2 (instead of end-Q1/beg-Q2 previously).

# Mexico: Heavy going

The signs of recovery are visible, but it will not be exceptional as the 2009 decline is unlikely to be completely offset. Once again, however, Mexico will benefit from recovery in the United States, which will probably be sustained during the year by still trailing domestic demand.

**Mexico: catching up**




*Source: INEGI, Banco de México*

**Mexico's economy is picking up, slowly. Most indicators are positive.** In January, exports rose 27.5% YoY and industrial production by 9.7% YoY, rising for the second consecutive month, and in December, even volume retail sales rose by 1.6% YoY, for the first time since August 2008. External demand (which in Mexico means demand from the US) is the main growth engine. Domestic demand is still down. Sales of cars, for example, and construction activity, are still falling.

**Overall therefore, this is a fairly modest recovery.** Even exports are trailing their Q307 level. The fall off in activity was such in 2009, in fact (with GDP shrinking by 6.5%), that Mexico should return to the trend (a modest 3.4%) of 2003-2008. The main risk facing this recovery is that of an inflationary surge that would prompt the Bank of Mexico to hike its key rate. In February, the consumer price index was already up by 4.8% YoY, significantly above the 3.6% of December 2009. Yet growth of 3.5% would not be exceptional for a country with Mexico's resources, although faster growth would call for structural reform in all-too-familiar areas such as taxation, oil and education, although it is highly unlikely that anything will be happening in the short term.

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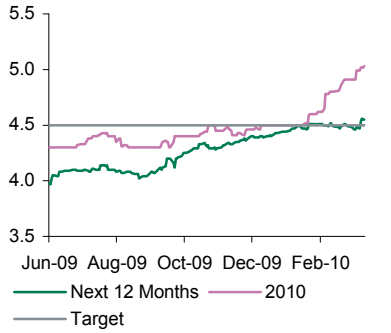
# Brazil: Here comes the hike

The recovery of the Brazilian economy is well under way, but the current pace of growth is clearly unsustainable. Inflation is rising again and so are expectations. This scenario suggests that an adjustment of the monetary policy is imminent and will probably be stronger than previously expected.

**Inflation Expectations are Moving Up (IPCA)**




*Source: BCB*

**The Brazilian economy continued to grow over the last quarter, fuelled as expected by private investments and consumption.** The strength of the recovery so far, and the fact that it is being led by private investments, has reinforced the idea that the country is in the initial stages of a long growth cycle. **Our current forecasts for real GDP growth stand at 5.3% in 2010 and 4.2% in 2011.**

On the other hand, inflation has been surprising on the upside since December. Although most of the pressures on prices are unrelated to demand conditions, they have had some impact on short and medium term inflation expectations. **The rise in inflation expectations, coupled with the growing sense that the output gap is narrowing faster than expected, will probably lead to an interest rate hike sooner rather than later.** We now expect a first 50bp increase on the Selic rate in April rather than June and we also have raised our forecast for the total hiking in 2010 from 11% to 11.5%. In the medium term, however, growth will slow towards sustainable levels creating some room for easing in the second half of 2011.

**The BRL is expected to remain relatively close to its current rate for the next two years.** On one hand, the current account deficit will soar as domestic demand continues to outpace GDP growth. On the other hand, strong growth and a very high real interest rate will maintain the country's appeal as a favoured destination for capital inflows.

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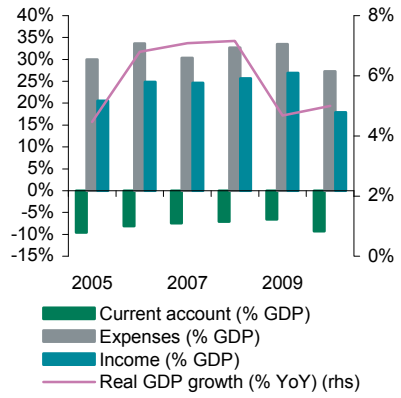
# MENA: 2010 a difficult year for the budget

The fall in tax receipts and higher spending are crippling the budget and, after falling for five consecutive years, public debt looks set to grow in 2010. The government will above all seek to attract foreign investors to finance economic growth.

**Egyptian budget under pressure**




*Source: Datastream, Crédit Agricole SA*

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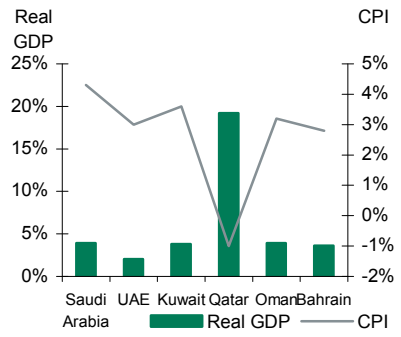
When growth topped 7% in 2007/08, the Egyptian government's aim was to rapidly cut the budget deficit to 3% of GDP. Even so, it could run as high as 9% this year. The fall in tax receipts, the rise in public spending and debt service together explain this marked deterioration. 2010/11 will be a turning point for the budget because, although lower inflation in 2008/09 had provided fiscal room for manoeuvre, this is now almost exhausted. The public accounts are currently caught between a rock and a hard place. On the one hand there is the risk of an uncontrolled rise in necessary spending due to the low rate of economic growth and a forecast re-emergence of food price inflation and on the other the risk that tax receipts – especially those in foreign currencies, which are strongly correlated with global economic activity – will not be restored quickly enough. After falling for five consecutive years, public debt will very probably rise in 2010.

As a result, **the State will not be able to sustain the same fiscal stimulus effort as it did in 2009/10, which will make growth even more sensitive to the global economic climate.** One priority will be to attract large numbers of foreign investors so that it can feed growth and regenerate room for manoeuvre to cope with rising social tensions. More Public Private Partnerships are thus likely to be offered to investors.

# GCC: Gulf economies rebounding, differentiation evident

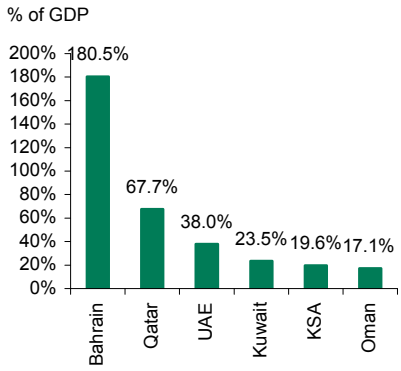
Oil prices within the USD70 range offer ample fiscal stimulus for the Gulf economies. Confidence, bank lending and lack of private sector appetite are a dampener to growth. Inflation is not a major concern so far, as domestic demand is low and the USD firm. Saudi Arabia's macroeconomic outlook is the healthiest in the Gulf and it is now leading the pack.

### 2010 Forecasts



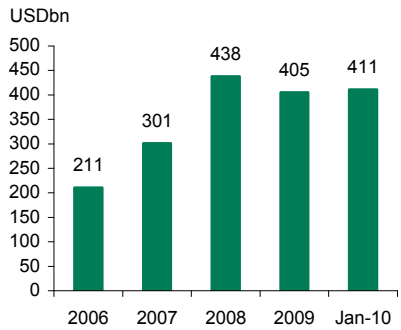

*Source: Crédit Agricole CIB*

### Projected External Gross Debt




*Source: IMF*

### SAMA Net Foreign Assets Development




*Source: SAMA*

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Oil prices averaged USD77 a barrel in the first two months of 2010 and have risen above USD80 a barrel in March, supporting a cautious recovery in Gulf countries. The biggest hurdles facing the oil-exporting region are stagnant banking lending, lack of private sector appetite, uncertainty over the depth of Dubai's debt troubles and the extent of new non-performing loans on bank balance sheets. While 2010 will be a year of cautious recovery, **differentiation is unfolding in the Gulf, and Saudi Arabia holds the healthiest macroeconomic outlook, followed by Abu Dhabi and Qatar.**

**In 2008, Saudi Arabia undertook a USD400bn five-year spending plan, the largest fiscal stimulus package as a ratio of GDP in the G20** according to the IMF, predicated on central bank foreign assets of USD411bn (latest), more than 111% of 2009 GDP. **So far, the state has spent close to one-third, positioning it to easily meet its 2013 target**. While Saudi Arabia posted a small budget 2009 deficit, the state has also reduced its debts since 2002 and should continue this year. Government debt to GDP is estimated to fall to 13.2% in 2010.

Saudi oil export revenues should enable current account and budget surpluses in 2010. **Gross external debt is among the Gulf's lowest and existing government debt is all domestic.** Recently, Saudi Arabia has exhibited no asset bubbles and a new mortgage law (expected by H2) should provide more supply in the medium term for housing and financial intermediation for banks. The Saudi growth story is supported by a population of 25 million, including c.7.5 million expatriates, growing at c.2.5% per year. **Positive trends are visible in bank credit data and foreign trade, with imports and non-oil exports recording their strongest levels of 2009 in December.**

The United Arab Emirates economy is recovering more slowly as a result of a sharp real estate downturn and lower domestic demand. **Abu Dhabi, holder of the bulk of UAE oil reserves, is wealthier and less indebted than Dubai, and is likely to witness GDP growth of 3.8% in 2010 as Dubai's GDP contracts.** However, Abu Dhabi banks and family firms are also exposed to Dubai real estate.

**Qatar is poised for the world's fastest GDP growth in 2010 (c.19.2%) as it brings more natural gas output on stream, but it is still caught in a deflation cycle stemming from property price drops that are likely to continue this year as supply rises.** Qatari consumer prices fell 4.7% in 2009, and deflation in January stood at a 5.7%. The UAE continues to witness low inflation, estimated to average 2.4% in 2010 against 1.6% in 2009. **Elsewhere, inflation is picking up due to accelerating food prices globally and firm rents in some markets.** Saudi inflation rose to 4.6% in February, while in Oman, where inflation fell below 1% late last year, inflation rose to 1.7% in January.

**Kuwait's parliament passed a USD104bn four-year development plan in February aimed at reducing dependence on oil and to stimulate the private sector.** To complement the plan, the central bank cut its benchmark discount rate to 2.5%. These positive measures support our forecast for GDP growth of 3.8% in 2010 after an estimated 2.7% contraction last year. Economic growth in Oman is likely to rise to 3.9% in 2010 from 1.6% in 2009. **Oman, which has been committed to diversification efforts, has been well-insulated from the global financial crisis and Dubai debt.** Bahrain's GDP is likely to grow 3.6% in 2010 as investments, services and tourism strengthen.

# Exchange rate forecasts

| | | 30-Mar | Jun-10 | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 |
|---|---|---|---|---|---|---|---|---|---|
| **USD Exchange rate** | | | | | | | | | |
| **Industrialised countries** | | | | | | | | | |
| Euro | EUR/USD | 1.35 | 1.33 | 1.28 | 1.25 | 1.23 | 1.21 | 1.19 | 1.18 |
| Japan | USD/JPY | 93 | 94 | 98 | 100 | 104 | 106 | 108 | 110 |
| United Kingdom | GBP/USD | 1.50 | 1.49 | 1.49 | 1.51 | 1.52 | 1.55 | 1.55 | 1.55 |
| Switzerland | USD/CHF | 1.06 | 1.11 | 1.16 | 1.19 | 1.22 | 1.25 | 1.28 | 1.30 |
| Canada | USD/CAD | 1.02 | 1.01 | 1.03 | 1.05 | 1.08 | 1.09 | 1.10 | 1.12 |
| Australia | AUD/USD | 0.92 | 0.95 | 0.93 | 0.91 | 0.89 | 0.87 | 0.86 | 0.86 |
| New Zealand | NZD/USD | 0.71 | 0.76 | 0.74 | 0.72 | 0.71 | 0.70 | 0.69 | 0.69 |
| **Asia** | | | | | | | | | |
| China | USD/CNY | 6.83 | 6.70 | 6.60 | 6.50 | 6.43 | 6.35 | 6.28 | 6.20 |
| Hong Kong | USD/HKD | 7.76 | 7.80 | 7.80 | 7.80 | 7.80 | 7.80 | 7.80 | 7.80 |
| India | USD/INR | 45.01 | 43.50 | 42.00 | 41.00 | 40.80 | 40.50 | 40.30 | 40.00 |
| Indonesia | USD/IDR | 9080 | 9100 | 9050 | 9000 | 8975 | 8950 | 8925 | 8900 |
| Malaysia | USD/MYR | 3.27 | 3.28 | 3.25 | 3.22 | 3.18 | 3.14 | 3.09 | 3.05 |
| Philippines | USD/PHP | 45.2 | 44.5 | 44.0 | 43.5 | 43.0 | 42.5 | 42.0 | 41.5 |
| Singapore | USD/SGD | 1.40 | 1.37 | 1.35 | 1.34 | 1.33 | 1.32 | 1.31 | 1.30 |
| South Korea | USD/KRW | 1132 | 1060 | 1020 | 1000 | 990 | 970 | 960 | 950 |
| Taiwan | USD/TWD | 31.8 | 31.2 | 30.7 | 30.0 | 29.8 | 29.5 | 29.3 | 29.0 |
| Thailand | USD/THB | 32.3 | 32.4 | 31.8 | 31.5 | 31.3 | 31.0 | 30.8 | 30.5 |
| Vietnam | USD/VND | 19090 | 19300 | 19400 | 19500 | 19500 | 19500 | 19500 | 19500 |
| **Latin America** | | | | | | | | | |
| Argentina | USD/ARS | 3.87 | 4.06 | 4.18 | 4.31 | 4.37 | 4.42 | 4.48 | 4.54 |
| Brazil | USD/BRL | 1.79 | 1.80 | 1.77 | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 |
| Mexico | USD/MXN | 12.42 | 12.70 | 12.40 | 12.38 | 12.35 | 12.33 | 12.30 | 12.30 |
| **Africa** | | | | | | | | | |
| South Africa | USD/ZAR | 7.39 | 7.90 | 7.85 | 7.80 | 7.73 | 7.65 | 7.58 | 7.50 |
| | TRY/ZAR | 4.84 | 5.49 | 5.53 | 5.57 | 5.56 | 5.54 | 5.53 | 5.51 |
| **Emerging Europe** | | | | | | | | | |
| Poland | USD/PLN | 2.87 | 2.78 | 2.81 | 2.80 | 2.76 | 2.73 | 2.69 | 2.63 |
| Russia | USD/RUB | 29.37 | 30.74 | 31.35 | 31.46 | 31.45 | 30.79 | 29.94 | 29.05 |
| | Basket/RUB | 34.02 | 35.30 | 35.30 | 35.00 | 34.70 | 33.70 | 32.50 | 31.40 |
| Turkey | USD/TRY | 1.53 | 1.44 | 1.42 | 1.40 | 1.39 | 1.38 | 1.37 | 1.36 |
| **Euro Cross rates** | | | | | | | | | |
| **Industrialised countries** | | | | | | | | | |
| Japan | EUR/JPY | 125 | 125 | 125 | 125 | 128 | 128 | 129 | 130 |
| United Kingdom | EUR/GBP | 0.899 | 0.890 | 0.860 | 0.830 | 0.810 | 0.780 | 0.770 | 0.760 |
| Switzerland | EUR/CHF | 1.43 | 1.47 | 1.48 | 1.49 | 1.50 | 1.51 | 1.52 | 1.53 |
| Sweden | EUR/SEK | 9.75 | 9.90 | 9.80 | 9.70 | 9.60 | 9.50 | 9.50 | 9.40 |
| Norway | EUR/NOK | 8.04 | 8.05 | 8.00 | 7.80 | 7.60 | 7.50 | 7.50 | 7.40 |
| **Central Europe** | | | | | | | | | |
| Czech Rep. | EUR/CZK | 25.39 | 24.00 | 24.00 | 22.50 | 22.00 | 21.50 | 21.00 | 20.50 |
| Hungary | EUR/HUF | 265 | 260 | 260 | 260 | 255 | 250 | 245 | 240 |
| Poland | EUR/PLN | 3.88 | 3.70 | 3.60 | 3.50 | 3.40 | 3.30 | 3.20 | 3.10 |
| Romania | EUR/RON | 4.07 | 4.30 | 4.30 | 4.30 | 4.30 | 4.30 | 4.30 | 4.30 |

*Source: Crédit Agricole CIB*

# Interest rate forecasts – developed countries

| | 30-Mar | Jun-10 | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 |
|---|---|---|---|---|---|---|---|---|
| **USA** | | | | | | | | |
| Fed funds | 0.25 | 0-0.25 | 0-0.25 | 0-0.25 | 0-0.25 | 1.00 | 2.00 | 2.25 |
| 3 month | 0.29 | 0.40 | 0.50 | 0.70 | 1.00 | 1.50 | 2.50 | 2.75 |
| 2Y year | 1.05 | 1.90 | 2.75 | 3.25 | 3.25 | 3.50 | 3.75 | 4.00 |
| 10 year | 3.87 | 4.20 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 |
| **Japan** | | | | | | | | |
| Call | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 | 0.50 | 0.50 |
| 3 month | 0.24 | 0.40 | 0.40 | 0.40 | 0.40 | 0.60 | 0.70 | 0.70 |
| 2Y year | 0.18 | 0.20 | 0.20 | 0.20 | 0.30 | 0.50 | 0.60 | 0.60 |
| 10 year | 1.40 | 1.40 | 1.50 | 1.60 | 1.60 | 1.80 | 2.00 | 2.00 |
| **Eurozone** | | | | | | | | |
| Repo | 1.00 | 1.00 | 1.00 | 1.25 | 1.75 | 2.25 | 2.50 | 2.75 |
| 3 month | 0.58 | 0.90 | 1.40 | 1.80 | 2.30 | 2.80 | 3.20 | 3.40 |
| 2Y year | 0.99 | 2.00 | 2.75 | 3.25 | 3.50 | 3.75 | 4.00 | 4.00 |
| 10 year (Ger) | 3.16 | 3.85 | 4.20 | 4.40 | 4.40 | 4.40 | 4.40 | 4.40 |
| **United Kingdom** | | | | | | | | |
| Base rate | 0.50 | 0.50 | 0.50 | 0.50 | 1.00 | 1.75 | 2.50 | 3.25 |
| 3 month | 0.65 | 0.80 | 0.80 | 0.80 | 1.40 | 2.15 | 2.90 | 3.65 |
| 2Y year | 1.18 | 2.20 | 2.75 | 3.25 | 3.50 | 3.75 | 4.00 | 4.00 |
| 10 year | 3.99 | 4.20 | 4.40 | 4.60 | 4.50 | 4.50 | 4.50 | 4.50 |
| **Sweden** | | | | | | | | |
| Repo | 0.25 | 0.25 | 0.75 | 1.50 | 2.00 | 2.50 | 3.00 | 3.00 |
| 3 month | 0.50 | 0.60 | 1.10 | 1.90 | 2.30 | 2.80 | 3.30 | 3.30 |
| 10 year | 3.22 | 4.10 | 4.20 | 4.30 | 4.30 | 4.40 | 4.40 | 4.40 |
| **Norway** | | | | | | | | |
| Deposit | 1.75 | 2.00 | 2.25 | 2.50 | 2.75 | 3.00 | 3.25 | 3.50 |
| 3 month | 2.15 | 2.40 | 2.65 | 2.85 | 3.05 | 3.25 | 3.50 | 3.75 |
| 10 year | 3.77 | 4.60 | 4.70 | 4.70 | 4.80 | 4.80 | 4.80 | 4.80 |
| **Switzerland** | | | | | | | | |
| 3 month | 0.25 | 0.25 | 0.25 | 0.50 | 0.75 | 1.00 | 1.25 | 1.50 |
| 10 year | 1.91 | 2.35 | 2.50 | 2.70 | 2.70 | 2.70 | 2.70 | 2.70 |
| **Canada** | | | | | | | | |
| Overnight Target | 0.25 | 0.25 | 0.75 | 1.25 | 1.75 | 2.25 | 2.50 | 2.50 |
| 3 month | 0.42 | 0.50 | 1.00 | 1.60 | 2.15 | 2.65 | 2.80 | 2.80 |
| 10 year | 3.57 | 3.90 | 4.40 | 4.50 | 4.60 | 4.60 | 4.60 | 4.60 |
| **Australia** | | | | | | | | |
| Cash Target | 4.00 | 4.00 | 4.50 | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 |
| 3 month | 4.48 | 4.60 | 5.00 | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 |
| 10 year | 5.80 | 5.70 | 5.80 | 6.00 | 6.00 | 6.20 | 6.30 | 6.30 |
| **New Zealand** | | | | | | | | |
| Official Cash Rate | 2.50 | 3.00 | 3.50 | 4.00 | 4.50 | 5.00 | 5.00 | 5.00 |
| 3 month | 2.75 | 3.30 | 3.80 | 4.30 | 4.80 | 5.30 | 5.40 | 5.50 |
| 10 year | 6.01 | 6.10 | 6.30 | 6.40 | 6.50 | 6.50 | 6.60 | 6.60 |

*Source: Crédit Agricole CIB*

# Interest rate forecasts – emerging countries

| | | 30-Mar | Jun-10 | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 |
|---|---|---|---|---|---|---|---|---|---|
| **USA** | | | | | | | | | |
| | Fed funds | 0.25 | 0-0.25 | 0-0.25 | 0-0.25 | 0-0.25 | 1.00 | 2.00 | 2.25 |
| | 3 month | 0.29 | 0.40 | 0.50 | 0.70 | 1.00 | 1.50 | 2.50 | 2.75 |
| | 2Y year | 1.05 | 1.90 | 2.75 | 3.25 | 3.25 | 3.50 | 3.75 | 4.00 |
| | 10 year | 3.87 | 4.20 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 |
| **Japan** | | | | | | | | | |
| | Call | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 | 0.50 | 0.50 |
| | 3 month | 0.24 | 0.40 | 0.40 | 0.40 | 0.40 | 0.60 | 0.70 | 0.70 |
| | 2Y year | 0.18 | 0.20 | 0.20 | 0.20 | 0.30 | 0.50 | 0.60 | 0.60 |
| | 10 year | 1.40 | 1.40 | 1.50 | 1.60 | 1.60 | 1.80 | 2.00 | 2.00 |
| **Eurozone** | | | | | | | | | |
| | Repo | 1.00 | 1.00 | 1.00 | 1.25 | 1.75 | 2.25 | 2.50 | 2.75 |
| | 3 month | 0.58 | 0.90 | 1.40 | 1.80 | 2.30 | 2.80 | 3.20 | 3.40 |
| | 2Y year | 0.99 | 2.00 | 2.75 | 3.25 | 3.50 | 3.75 | 4.00 | 4.00 |
| | 10 year (Ge-Fr) | 3.16 | 3.85 | 4.20 | 4.40 | 4.40 | 4.40 | 4.40 | 4.40 |
| **Asia** | | | | | | | | | |
| China | 1Y lending rate | 5.31 | 5.58 | 5.85 | 5.85 | 5.85 | 6.12 | 6.39 | 6.39 |
| Hong Kong | Base rate | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 1.00 | 1.50 | 2.00 |
| India | Repo rate | 5.00 | 5.50 | 6.00 | 6.00 | 6.00 | 6.00 | 6.50 | 6.50 |
| Indonesia | BI rate | 6.50 | 7.00 | 7.25 | 7.75 | 7.75 | 7.75 | 7.75 | 7.75 |
| Korea | Call rate | 2.00 | 2.25 | 2.50 | 2.75 | 3.00 | 3.50 | 3.50 | 3.50 |
| Malaysia | OPR | 2.25 | 2.25 | 2.50 | 2.50 | 2.50 | 3.00 | 3.00 | 3.00 |
| Philippines | Repo rate | 4.00 | 4.50 | 5.00 | 5.00 | 5.00 | 5.50 | 5.50 | 5.50 |
| Singapore | Interbank 3M | 0.62 | 0.80 | 0.90 | 0.95 | 1.00 | 1.40 | 1.80 | 2.20 |
| Taiwan | Redisc | 1.25 | 1.50 | 1.75 | 2.00 | 2.00 | 2.25 | 2.50 | 2.50 |
| Thailand | Repo | 1.25 | 1.50 | 2.00 | 2.25 | 2.50 | 2.75 | 3.00 | 3.00 |
| Vietnam | Prime rate | 7.00 | 10.00 | 10.00 | 10.00 | 10.00 | 10.00 | 10.00 | 10.00 |
| **Latin America** | | | | | | | | | |
| Argentina | 3M deposit | 10.25 | 11.00 | 11.00 | 11.00 | 11.00 | 11.50 | 12.00 | 12.00 |
| Brazil | Overnight/Selic | 8.75 | 9.75 | 10.75 | 11.50 | 11.50 | 11.50 | 11.00 | 11.00 |
| Mexico | Overnight rate | 4.50 | 4.50 | 4.75 | 4.75 | 4.75 | 5.00 | 5.25 | 5.25 |
| **Emerging Europe** | | | | | | | | | |
| Czech Rep. | 14D repo | 1.00 | 1.00 | 1.00 | 1.25 | 1.50 | 1.75 | 2.00 | 2.00 |
| Hungary | 2W repo | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 | 5.75 | 6.00 | 6.25 |
| Poland | 7D repo | 3.50 | 3.50 | 3.50 | 3.50 | 3.50 | 3.75 | 4.00 | 4.25 |
| Romania | 2W repo | 6.50 | 6.50 | 6.50 | 6.50 | 6.50 | 7.00 | 7.50 | 7.50 |
| Russia | Refinancing rate | 8.50 | 8.00 | 8.00 | 8.25 | 8.75 | 9.25 | 9.50 | 9.50 |
| Turkey | Overnight | 6.50 | 6.50 | 6.50 | 7.00 | 8.00 | 8.75 | 9.50 | 9.75 |
| **Africa & Middle East** | | | | | | | | | |
| South Africa | Repo | 6.50 | 6.50 | 6.50 | 7.00 | 7.00 | 7.25 | 7.50 | 7.75 |
| UAE | Repo | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.50 | 2.00 | 2.50 |
| Saudi Arabia | Repo | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.50 | 3.00 | 3.50 |

*Source: Crédit Agricole CIB*

# Economic forecasts

| | Real GDP (YoY. %) | | | CPI (YoY. %) | | | Current Account (% GDP) | | |
|---|---|---|---|---|---|---|---|---|---|
| | 09 | 10 | 11 | 09 | 10 | 11 | 09 | 10 | 11 |
| **USA** | **-2.4** | **3.0** | **3.1** | **-0.3** | **2.2** | **2.1** | **-3.0** | **-3.4** | **-3.6** |
| **JAPAN** | **-5.0** | **1.9** | **1.6** | **-1.3** | **-0.8** | **-0.5** | **2.5** | **4.3** | **4.6** |
| **EUROZONE** | **-4.0** | **0.9** | **1.2** | **0.3** | **1.1** | **1.7** | **-0.6** | **-0.5** | **-0.4** |
| Germany | -4.9 | 1.6 | 1.6 | 0.2 | 0.6 | 1.3 | 5.0 | 4.5 | 6.0 |
| France | -2.2 | 1.1 | 1.3 | 0.1 | 1.3 | 1.6 | -2.0 | -1.9 | -2.0 |
| Italy | -5.1 | 0.4 | 0.7 | 0.8 | 1.2 | 1.8 | -3.3 | -2.3 | -2.1 |
| Spain | -3.6 | -0.4 | 0.6 | -0.3 | 1.5 | 2.5 | -5.1 | -3.5 | -3.0 |
| Greece | -2.0 | -3.4 | -1.2 | 1.4 | 3.0 | 1.7 | -11.2 | -9.8 | -9.6 |
| Norway | -1.4 | 1.6 | 2.3 | 2.2 | 2.5 | 2.3 | 13.8 | 14.0 | 15.0 |
| Sweden | -4.7 | 0.5 | 2.7 | -0.3 | 1.6 | 2.3 | 6.2 | 7.0 | 7.0 |
| Switzerland | -1.8 | 0.6 | 1.6 | -0.6 | 0.7 | 1.0 | 6.0 | 7.0 | 7.0 |
| Canada | -2.6 | 3.1 | 3.0 | 0.3 | 1.8 | 1.9 | -2.9 | -2.1 | -1.6 |
| Australia | 1.7 | 2.5 | 3.2 | 1.5 | 2.1 | 2.2 | -4.0 | -5.0 | -5.0 |
| New Zealand | -1.9 | 2.1 | 3.1 | 1.8 | 2.1 | 2.0 | -6.5 | -6.0 | -6.0 |
| **United Kingdom** | **-4.9** | **1.1** | **1.8** | **2.2** | **2.4** | **1.5** | **-2.6** | **-2.4** | **-2.0** |
| **Asia** | **5.9** | **5.9** | **5.9** | **5.9** | **5.9** | **5.9** | **5.9** | **5.9** | **5.9** |
| China | 8.7 | 9.0 | 9.0 | -0.7 | 3.0 | 3.5 | 6.0 | 5.0 | 5.5 |
| Hong Kong | -2.7 | 5.0 | 5.0 | 0.7 | 1.8 | 3.0 | 12.0 | 9.0 | 9.0 |
| India [(2)] | 7.5 | 7.0 | 7.5 | 1.9 | 5.0 | 5.5 | -1.5 | -1.0 | -1.0 |
| Indonesia | 4.5 | 5.0 | 5.3 | 4.9 | 5.8 | 5.0 | 2.3 | 2.0 | 1.3 |
| Korea | 0.2 | 4.0 | 5.0 | 2.7 | 3.0 | 3.5 | 5.2 | 3.0 | 2.0 |
| Malaysia | -1.7 | 4.0 | 5.5 | 0.7 | 2.0 | 2.5 | 14.0 | 12.0 | 13.0 |
| Philippines | 1.3 | 4.5 | 5.5 | 3.5 | 4.5 | 5.0 | 5.0 | 3.5 | 2.5 |
| Singapore | -2.0 | 5.5 | 6.0 | 0.5 | 2.5 | 3.0 | 12.5 | 15.5 | 14.0 |
| Taiwan | -1.9 | 5.0 | 5.5 | -0.8 | 1.5 | 2.0 | 9.0 | 7.5 | 7.0 |
| Thailand | -2.3 | 4.0 | 4.5 | -0.8 | 2.5 | 3.0 | 6.5 | 4.5 | 5.0 |
| Vietnam | 4.1 | 4.5 | 4.5 | 6.6 | 6.0 | 8.0 | -11.0 | -8.0 | -8.0 |
| **Latin America** | **-2.6** | **4.1** | **3.7** | **6.7** | **5.5** | **5.2** | **-1.4** | **-1.8** | **-2.2** |
| Argentina | -3.0 | 2.8 | 2.5 | 14.8 | 10.0 | 10.0 | 0.5 | 1.0 | 1.0 |
| Brazil | 0.2 | 5.3 | 4.2 | 4.9 | 4.7 | 4.5 | -1.5 | -3.0 | -3.5 |
| Mexico | -6.5 | 3.0 | 3.5 | 5.3 | 4.5 | 4.0 | -2.1 | -1.4 | -2.0 |
| **Emerging Europe** | **-5.4** | **2.8** | **4.0** | **7.8** | **6.2** | **6.4** | **0.9** | **0.6** | **0.0** |
| Czech Republic | -4.3 | 1.5 | 3.0 | 0.5 | 0.7 | 2.0 | -2.0 | -2.5 | -2.8 |
| Hungary | -6.3 | -0.3 | 2.5 | 5.4 | 3.5 | 3.5 | 0.3 | -1.5 | -2.5 |
| Poland | 1.7 | 2.3 | 3.4 | 3.8 | 2.9 | 2.8 | -1.4 | -2.3 | -3.0 |
| Russia | -7.9 | 3.5 | 4.5 | 11.5 | 8.0 | 8.5 | 3.9 | 4.5 | 4.0 |
| Romania | -7.0 | 1.0 | 2.0 | 6.0 | 5.0 | 5.5 | -5.5 | -5.0 | -6.0 |
| Turkey | -5.9 | 3.5 | 4.5 | 6.3 | 8.0 | 7.0 | -2.2 | -3.7 | -4.5 |
| **Africa & Middle East** | **0.3** | **3.5** | **4.3** | **5.1** | **5.0** | **5.5** | **-0.1** | **0.5** | **2.0** |
| Algeria | 2.6 | 4.5 | 4.3 | 5.9 | 4.2 | 4.9 | -2.0 | 1.7 | 0.5 |
| Egypt | 4.7 | 4.8 | 5.5 | 11.8 | 11.0 | 9.0 | -1.5 | -1.0 | 0.0 |
| Kuwait | -2.7 | 3.8 | 4.1 | 4.6 | 3.6 | 4.4 | 22.3 | 29.5 | 22.4 |
| Lebanon | 7.0 | 6.0 | 5.5 | 1.2 | 3.0 | 3.0 | 6.0 | -9.5 | -6.5 |
| Morocco | 4.7 | 4.0 | 4.4 | 1.2 | 2.4 | 2.6 | -3.3 | -5.0 | -3.5 |
| Qatar | 11.0 | 19.2 | 7.2 | -4.9 | -1.0 | 3.5 | 4.5 | 11.9 | 20.3 |
| Saudi Arabia | 0.2 | 3.9 | 4.8 | 5.1 | 4.3 | 4.8 | 0.9 | 2.0 | 9.8 |
| South Africa | -1.4 | 2.0 | 3.5 | 7.1 | 6.6 | 7.0 | -4.8 | -5.2 | -5.0 |
| United Arab Emirates | -3.6 | 2.0 | 3.9 | 1.4 | 2.4 | 4.1 | 4.1 | 4.3 | 5.0 |
| Tunisia | 3.0 | 3.5 | 4.5 | 3.7 | 3.7 | 3.0 | -3.8 | -2.5 | -2.5 |
| **Total** | **-0.8** | **3.6** | **3.9** | **1.2** | **2.7** | **2.9** | **0.4** | **0.2** | **0.3** |
| **Industrialised countries** | **-3.2** | **2.1** | **2.2** | **-0.2** | **1.4** | **1.6** | **-1.1** | **-1.0** | **-1.0** |
| **Emerging countries** | **2.7** | **5.8** | **6.2** | **2.9** | **4.3** | **4.7** | **2.5** | **2.0** | **2.1** |

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

*Source: Crédit Agricole CIB*

# Economic forecasts

| | Government balance | | | Public debt | | |
|---|---|---|---|---|---|---|
| | 09 | 10 | 11 | 09 | 10 | 11 |
| **USA** | **-9.9** | **-10.6** | **-8.3** | **53.0** | **63.6** | **68.6** |
| **JAPAN** | **-11.3** | **-10.9** | **-9.7** | **184.0** | **197.0** | **206.0** |
| **EUROZONE** | **-6.4** | **-6.9** | **-6.1** | **78.4** | **84.3** | **88.8** |
| Germany | -3.3 | -5.5 | -4.9 | 72.7 | 77.0 | 80.4 |
| France | -8.0 | -8.2 | -7.5 | 77.0 | 84.0 | 89.8 |
| Italy | -5.3 | -5.2 | -4.7 | 115.6 | 119.1 | 121.8 |
| Spain | -11.4 | -10.3 | -8.3 | 55.2 | 66.6 | 74.9 |
| Netherlands | -4.9 | -6.2 | -5.2 | 62.3 | 67.8 | 71.6 |
| Belgium | -5.9 | -4.8 | -4.3 | 97.9 | 100.8 | 102.9 |
| Greece | -12.8 | -8.9 | -5.9 | 113.4 | 123.4 | 128.2 |
| Ireland | -11.7 | -11.7 | -11.0 | 64.5 | 78.0 | 86.8 |
| Portugal | -9.3 | -8.8 | -8.2 | 76.8 | 84.9 | 91.7 |
| **United Kingdom** | **-13.3** | **-12.7** | **-10.0** | **70.0** | **83.0** | **88.0** |

*Source: Crédit Agricole CIB*

# Economic forecasts – quarterly breakdown

| | 2009 | | | | 2010 | | | | 2011 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| **Real GDP growth, %** | | | | | | | | | | | | |
| USA (annualised) | -6.4 | -0.7 | 2.2 | 5.6 | 2.7 | 2.9 | 2.5 | 3.0 | 3.4 | 3.5 | 3.3 | 2.6 |
| JAPAN | -3.6 | 1.5 | -0.1 | 0.9 | 0.4 | 0.3 | 0.3 | 0.5 | 0.4 | 0.3 | 0.4 | 0.4 |
| EUROZONE | -2.5 | -0.1 | 0.4 | 0.1 | 0.3 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 |
| Germany | -3.5 | 0.4 | 0.7 | 0.0 | 0.6 | 0.2 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 | 0.5 |
| France | -1.4 | 0.3 | 0.2 | 0.6 | 0.1 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 |
| Italy | -2.7 | -0.5 | 0.5 | -0.3 | 0.2 | 0.2 | 0.2 | 0.3 | 0.2 | 0.1 | 0.3 | 0.3 |
| Spain | -1.7 | -1.0 | -0.3 | -0.1 | 0.0 | 0.2 | -0.2 | 0.0 | 0.2 | 0.3 | 0.3 | 0.3 |
| United Kingdom | -2.6 | -0.6 | -0.3 | 0.4 | 0.6 | 0.5 | 0.4 | 0.3 | 0.5 | 0.5 | 0.5 | 0.5 |
| **Consumer prices, YoY %** | | | | | | | | | | | | |
| USA | -0.2 | -1.0 | -1.6 | 1.5 | 2.6 | 2.4 | 2.0 | 1.9 | 1.9 | 2.2 | 2.2 | 2.1 |
| JAPAN | 0.0 | -1.0 | -2.3 | -1.6 | -1.2 | -0.8 | -0.5 | -0.5 | -0.5 | -0.6 | -0.5 | -0.3 |
| EUROZONE | 1.0 | 0.2 | -0.4 | 0.4 | 0.9 | 0.9 | 1.2 | 1.3 | 1.5 | 1.6 | 1.7 | 1.8 |
| Germany | 0.8 | 0.2 | -0.4 | 0.3 | 0.5 | 0.4 | 0.6 | 0.7 | 0.9 | 1.1 | 1.3 | 1.8 |
| France | 0.6 | -0.2 | -0.4 | 0.4 | 1.1 | 1.3 | 1.4 | 1.6 | 1.6 | 1.6 | 1.6 | 1.5 |
| Italy | 1.4 | 0.9 | 0.1 | 0.7 | 1.2 | 0.9 | 1.5 | 1.3 | 1.8 | 1.7 | 1.8 | 1.8 |
| Spain | 0.5 | -0.7 | -1.0 | 0.2 | 1.1 | 1.4 | 1.6 | 1.9 | 2.4 | 2.6 | 2.6 | 2.6 |
| United Kingdom | 3.0 | 2.1 | 1.5 | 2.1 | 3.0 | 2.4 | 2.1 | 1.7 | 1.1 | 1.5 | 1.6 | 1.9 |
| **Unemployment rate, %** | | | | | | | | | | | | |
| USA | 8.2 | 9.3 | 9.6 | 10.0 | 9.7 | 9.7 | 9.6 | 9.5 | 9.3 | 9.1 | 8.8 | 8.5 |
| JAPAN | 4.5 | 5.1 | 5.4 | 5.2 | 4.9 | 4.9 | 4.8 | 4.7 | 4.7 | 4.6 | 4.5 | 4.3 |
| EUROZONE | 8.8 | 9.3 | 9.6 | 9.9 | 10.2 | 10.3 | 10.4 | 10.5 | 10.6 | 10.6 | 10.4 | 10.3 |
| Germany | 8.0 | 8.2 | 8.2 | 8.1 | 8.2 | 8.4 | 8.6 | 8.8 | 9.0 | 9.0 | 8.8 | 8.6 |
| France | 8.6 | 9.1 | 9.1 | 9.6 | 9.7 | 10.0 | 10.1 | 10.1 | 10.0 | 10.0 | 9.9 | 9.8 |
| Italy | 7.4 | 7.5 | 7.8 | 8.2 | 8.5 | 8.6 | 8.8 | 8.8 | 8.9 | 8.9 | 8.7 | 8.8 |
| Spain | 16.6 | 17.9 | 18.7 | 18.9 | 19.0 | 19.0 | 18.9 | 18.8 | 18.7 | 18.6 | 18.5 | 18.4 |
| United Kingdom | 7.1 | 7.8 | 7.8 | 7.8 | 8.6 | 8.9 | 9.0 | 9.2 | 9.1 | 9.0 | 8.6 | 8.2 |

*Source: Crédit Agricole CIB*

# Commodities forecasts

## Oil price forecasts

| | | 2009 | | | | 2010 | | | | 2011 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| WTI | USD/bl | 43 | 60 | 68 | 76 | 78 | 68 | 72 | 76 | 75 | 70 | 70 | 75 |
| Brent | USD/bl | 44 | 59 | 68 | 75 | 77 | 67 | 72 | 75 | 74 | 69 | 70 | 74 |

*Source: Crédit Agricole CIB*

## Metals forecasts

| | | | 2010 | | | | | 2011 | | | | | Long-term |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 29-Mar | Q1 | Q2 | Q3 | Q4 | Year | Q1 | Q2 | Q3 | Q4 | Year | Prices |
| **Base metals** | | | | | | | | | | | | | |
| Aluminium | USD/t | 2,190 | 2,180 | 2,400 | 2,300 | 2,320 | 2,300 | 2,300 | 2,500 | 2,450 | 2,750 | 2,500 | 2,650 (120c/lb) |
| Copper | USD/t | 7,479 | 7,250 | 7,650 | 7,400 | 7,700 | 7,500 | 7,500 | 8,000 | 8,000 | 8,500 | 8,000 | 4,960 (225c/lb) |
| Nickel | USD/t | 23,569 | 19,700 | 21,000 | 17,300 | 22,000 | 20,000 | 22,000 | 24,000 | 23,000 | 27,000 | 24,000 | 15,432 (700c/lb) |
| Zinc | USD/t | 2,197 | 2,300 | 2,350 | 2,200 | 2,450 | 2,325 | 2,500 | 2,600 | 2,600 | 2,700 | 2,600 | 1,764 (80c/lb) |
| Lead | USD/t | 2,096 | 2,260 | 2,100 | 2,440 | 2,800 | 2,400 | 2,800 | 2,600 | 2,700 | 2,700 | 2,700 | 1,323 (60c/lb) |
| Tin | USD/t | 17,595 | 17,150 | 20,000 | 19,000 | 23,850 | 20,000 | 23,000 | 24,000 | 24,000 | 25,000 | 24,000 | 15,000 (680c/lb) |
| **Precious metals** | | | | | | | | | | | | | |
| Gold | USD/oz | 1,112 | 1,091 | 1,120 | 1,220 | 1,220 | 1,185 | 1,100 | 1,050 | 1,000 | 950 | 1,025 | 650 |
| Silver | USD/oz | 17.1 | 16.7 | 17.0 | 19.8 | 19.0 | 18.5 | 19.0 | 19.5 | 20.5 | 21.0 | 20.0 | 7.0 |
| Platinum | USD/oz | 1,609 | 1,590 | 1,560 | 1,625 | 1,675 | 1,650 | 1,750 | 1,725 | 1,750 | 1,775 | 1,750 | 1,200 |
| Palladium | USD/oz | 462 | 452 | 450 | 470 | 505 | 500 | 550 | 565 | 590 | 600 | 576 | 300 |

*Source: Crédit Agricole CIB*

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