Eurobank Research

GLOBAL ECONOMIC & MARKET OUTLOOK

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Eurobank EFG

March 2009

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Main Views and Market Strategy:

- The global recession turned out to be much more severe than envisaged in late 2008. With global economic indicators collapsing over the past few months and financial conditions continuing to deteriorate, we have now cut our growth forecasts even further.

- We now expect global GDP to contract by 1% y-o-y in 2009, making the current recession the deepest - and probably longest - one in the post-war period. The recovery will be sluggish, with growth picking up to 2.5% y-o-y in the final quarter of 2010.

- The US recession is expected to deepen, as companies start to deplete inventories at an accelerating pace. As this process has just started, we expect the contraction in economic activity to continue in H1 09, with Q1 09 as bad as Q4 08, or even worse.

- While the recession deepens, statistical evidence is mounting that we may have seen the worst in the US. Although our index of the probability of a rebound of the US economy has increased sharply over the past few months, we feel that it is still too early to call an end to this recession.

- In terms of total GDP loss, we expect the current US recession to be four times more severe than the average post-war II US recession, and twice as severe as the 1981-82 recession.

- As the global recession is expected to deepen, we expect equity markets to remain vulnerable and visit new lows over the next few months.

- Quantitative easing by the Fed will likely push Treasury yields lower in the short-term, but fears of monetization of debt will push inflation expectations upwards, putting increased pressure on the dollar.

- As investors will seek increased protection from inflation, inflation indexed bonds and gold will likely overperform.

Macro Forecasts

	2008	2009		2010	
		Eurobank EFG	Consensus	Eurobank EFG	Consensus
Real GDP Growth (y-o-y average)					
US	1.1	-2.9	-2.4 (-3.7 – -1.2)	1.3	1.8 (-0.9 – 3.5)
EA	0.8	-3.2	-2.2 (-3.6 – -1.6)	0.3	0.7 (-1.0 – 1.6)
Japan	-0.6	-5.5	-5.9 (-8.2 – -1.1)	0.1	0.6 (-5.4 – 2.2)
CPI Inflation (y-o-y average)					
US	3.8	-0.5	-0.6 (-2.2 – 2.9)	1.1	1.8 (-1.5 – 4.5)
EA	3.3	0.5	0.6 (0.0 – 1.1)	1.1	1.6 (0.9 – 2.2)
Japan	1.4	-1.5	-0.9 (-1.8 – 0.5)	-0.8	-0.5 (-1.6 – 1.1)
Short Term Interest Rates (end of year)	Current				
US	0.00-0.25	0.00-0.25	0.25 (0.00 – 0.50)	0.50	0.75 (0.00 – 3.00)
EA	1.50	0.50	1.00 (0.25 – 1.50)	1.00	1.25 (0.25 – 2.50)
Japan	0.10	0.10	0.10 (0.00 – 0.10)	0.10	0.10 (0.00 – 0.10)

Note: Range of forecasts by Bloomberg's survey in parentheses below point estimates.

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Executive Summary

Dimitris Malliaropulos, Olga Kosma, Maria Prandeka

Economic outlook

Since February 2008, we have been consistently revising downwards our global growth forecasts to well below Consensus, as we had made one of the earliest calls for a deep, consumer-led recession in the US[1] . The global downturn turned out to be much more severe than envisaged in late 2008. With global economic indicators collapsing over the past few months and financial conditions continuing to deteriorate, we have now cut our global growth forecasts even further.

The final quarter of 2008 was the worst seen in decades, with an abrupt fall in global output. Both demand and production have dropped sharply with no regions escaping the downturn. Global industrial production declined by 20% in the fourth quarter of 2008, with advanced and developing countries plunging by 23% and 15%, respectively. Global trade has more than halved since end-2007 and is about to report its sharpest contraction in 80 years. The collapse in economic activity is confirmed by global leading indicators and PMI indices which have declined sharply over the past few months. Our global leading indicator[2], which is designed to capture turning points in economic activity, approximately four months in advance, predicts a worsening global economic outlook at least for the first half of 2009 (Figure 1).

Figure 1

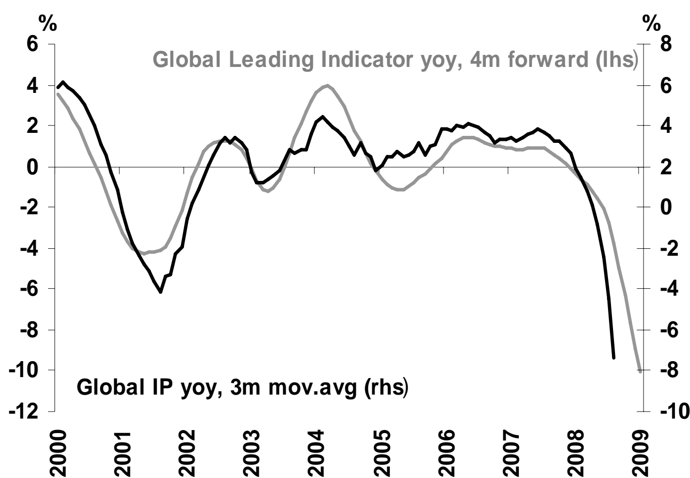
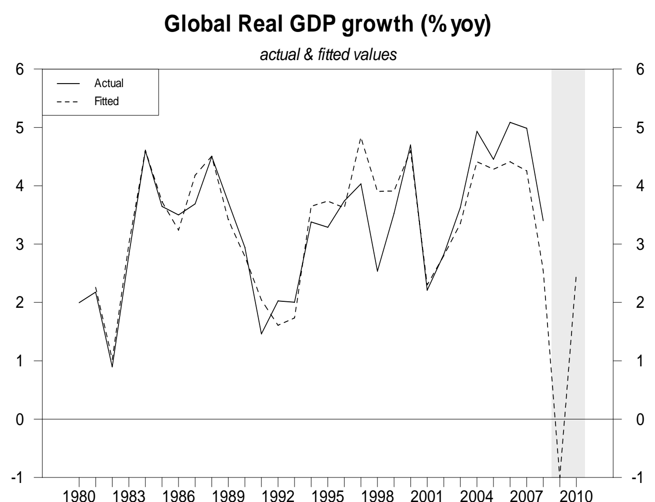


Figure 2



Source: Eurobank EFG model estimates

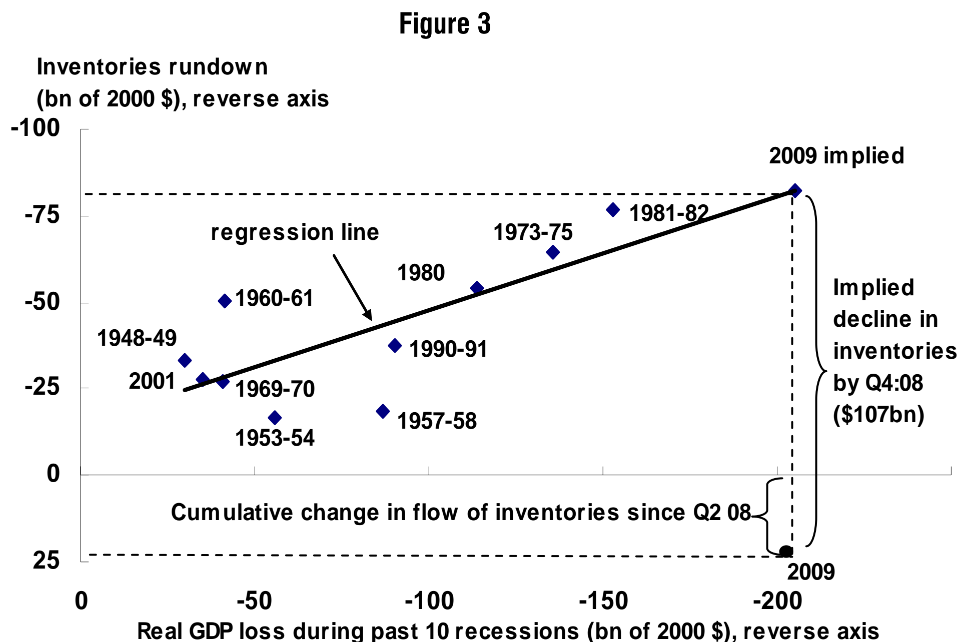
[1] See our "Global Economic & Market Outlook" issues of February and June 2008.

[2] Our global leading indicator is a GDP-weighted average of the OECD Composite Leading Indicators (CLIs) for both developed and developing economies.

We now expect global GDP to contract in 2009, making the current recession the deepest - and probably longest - one in the post-war period. Our projections include a significant deceleration of global GDP growth to -1% y-o-y in 2009 from 3.4% y-o-y in 2008 and a sluggish recovery in 2010, with growth picking up to 2.5% y-o-y (Figure 2).

We expect the current recession in the developed world to persist well until the end of 2009 and to lead to a dramatic deceleration of economic growth in the emerging world. The US recession is expected to deepen, as companies start to deplete inventories. Our research suggest that during previous US recessions, the cumulative decline in the flow of inventories from peak to trough of the business cycle accounts for 62% of the GDP contraction on average. With respect to the outlook of the US economy, it is in our view particularly worrying, that we have not yet seen this inventory rundown during the current recession. In particular, although inventories have declined by roughly $125 bn since the peak of GDP in Q2 08, their rate of decline has been much flatter than the deceleration of GDP over the past two quarters. As a result, the change in the flow of inventories has turned out to be positive at $24.8 bn since Q2 08, whereas GDP has contracted by $205.3 bn. In Q4 08, inventories declined by $25.8 bn, accounting for about 13% of GDP loss during the current downturn, while historical experience suggests that the decline in inventories should have already amounted to nearly $82 bn (Figure 3). Our analysis suggests that, in order to match historical correlations, inventories will have to decline by a total of $107bn over the next few months, suggesting that the economic contraction will likely continue in H1 09, with Q1 09 as bad as Q4 08, or even worse.

Figure 3



While the recession deepens, statistical evidence from various short term leading indicators is mounting that the worst may be over. This is what, in our view, explains the recent rebound of equity markets from the March 9

lows. Although our index of the probability of a rebound of the US economy has increased sharply over the past few months (to 47% currently), we feel that it is still too early to call an end to this recession, as we expect companies to start running down inventories at an increasing pace over the next few months, leading to even deeper cuts in production and increased unemployment. In terms of total GDP loss, we expect the current recession to be four times more severe than the average post-war II US recession, and twice as severe as the 1981-82 recession.

Compared to the US, the Euro area will, in our view, lag behind in getting out of the recession, due to a less aggressive monetary policy and a relatively limited fiscal impulse, as the Stability and Growth Pact (SGP) restricts government spending in a series of member countries. The worst hit economy from the recession among all industrial nations will probably be Japan, where industrial production growth has already fallen to unprecedented levels for more than two decades. In contrast, China is likely to be among the first economies to come out of the current recession, as there are already some signs of improvement in the PMI manufacturing survey over the past three months, while lending standards of Chinese banks are actually being eased rather than tightened. These signs of improvement suggest that China has the potential to become a stabilizing force for the Emerging Asia region in H2 2009 and 2010.

The current recession marks the end of a long-lasting period of strong global growth, increased integration of national economies through international trade and financial globalisation. The abolition of barriers to international trade in goods and services has allowed emerging economies to grow at a faster pace and catch up towards the living standards of developed economies. International capital mobility allowed the financing of large current account deficits in countries such as the US, contributing to an increase in international imbalances. Strong global growth has benefited commodity exporters, as commodity prices surged to historical highs. With inflation remaining at fairly low levels, central banks kept monetary policy relatively accommodative, providing cheap credit and, thus, contributing to the build-up of a real estate, credit and commodity bubble.

These bubbles have now burst, throwing the global economy into its worst recession since the 1930s. Personal consumption in the US and other major industrial countries will be hit hard as a result of negative wealth effects from declining home and equity prices, a surge in unemployment and a severe credit crunch. Business spending will fall sharply, as capacity utilization will continue to trend lower and credit becomes less available and more costly for companies. The collapse of commodity prices and the build-up of labor market slack will lead global inflation substantially lower and, in some countries, to negative territory. Aggressive monetary easing and massive fiscal stimulus, especially in the US, will manage to avert the risk of a serious deflation, but will not be enough to avert a deep and protracted recession as continuing write-downs of bad debt in the banking sector and a new wave of credit losses in consumer loans will prolong the economic downturn.

The takeover of bad debt from the banking sector and the financing of the huge fiscal stimulus needed to combat deflation will leave most developed countries with a very high public debt burden. Government bond yields will have to adjust to higher levels in order to induce private investors to hold the additional debt. Although this process will take some time to occur, given the current high level of risk aversion, bond yields will increase sharply as soon as the global economy shows some sign of recovery. Ultimately, the excessive public debt of developed economies will be monetized to a large extent, leading to higher inflation, higher sovereign credit spreads and weaker currencies in countries with higher budget deficits and public debt-to-GDP ratios.

However, with the banking sector still in a process of deleveraging, the economic rebound in the second half of the year will be rather sluggish in most parts of the world, with some quarters of recovery followed by renewed weakness some quarters later as the effect of economic policy stimuli fades. We expect a sustained recovery to take place in the later part of 2010, when the deleveraging process has run its course and bank lending to the private sector has returned to a normal pace. Given the excessive public debt, one likely scenario is that the global economy may end up with a W-shaped recession as bond yields are likely to increase sharply by early 2010, leading to a crowding out of private investment and, ultimately, a second leg in the economic downturn.

Portfolio Strategy

In line with our macro view, we advise investors to remain conservative, avoiding excessive risk taking. As the global recession is expected to deepen, we expect equity markets to remain vulnerable and visit new lows over the next few months. Quantitative easing by the Fed will push Treasury yields lower in the short-term, but fears of monetization of debt will push inflation expectations upwards, putting increased pressure on the dollar. As investors will seek increased protection from inflation, inflation indexed bonds and gold will likely outperform.

Equities: stay defensive

From its peak in October 2007 to its most recent trough on March 9 (676), the S&P 500 had lost 57%, making the current bear market the largest correction since 1929, when stocks declined by a total of 89%. Over the past three weeks, however, equity markets have rebounded sharply, led by financials, with the S&P 500 gaining 21% and US financials up a stunning 55%. Is this a change in the long-term trend or a typical bear market rally? We continue to believe that the market will trade in a range between 700 and 800 with the near term downside at 650 as the real economy is due to deteriorate further over the next few months. However, given that most economic indicators are at historical troughs (hence, the probability that the worst is over increases), stock markets will increasingly look for positive news, suggesting that the upside potential is also large. Overall, we believe that it is still too early to call for an end of the current bear market but recommend to increase positioning at levels of the S&P below 700.

Government bonds: underweight

The spectre of looming deflation has driven government bond yields to lows not seen for more than fifty years in some economies as panicking investors were seeking protection from equity and credit market volatility in safe assets such as government bonds and cash. Although yields have adjusted upwards since January, government bond markets remain potentially dangerous for investors, given the magnitude of the concerted monetary and fiscal response already taken to re-inflate the global economy.

With the global recession deepening and increasing fears of deflation, investors are likely to continue buying government debt, as they are regarded as risk-free and offer a fixed rate of return at maturity. In addition, the Fed has started to implement a quantitative easing program, buying back Treasuries and mortgage related paper in a bid to lower directly interest rates payable in the broader economy. But, with government budget deficits increasing sharply in 2009 and new issuance of government debt increasing dramatically, governments will likely have to pay substantially higher bond yields in the longer term to encourage investors to buy their debt.

Inflation-linked government bonds continue to be priced for an extended period of extremely low inflation. Given that, in our view, deflation fears are overdone, inflation-linked government bonds will likely do better than fixed-income nominal government bonds over the next few years, even if inflation does not rebound significantly.

Corporate bonds: buy selectively

Last year, corporate bonds suffered most of all asset classes, as investors withdrew their money to seek safety in government bonds and cash. The rush out of corporate bonds has pushed their spreads in early December to 100-year highs, close to their historical peak in 1932. Although there is still a lot of uncertainty about how much further deleveraging has to run, investment grade corporate bonds offer, in our view, equity-like returns over the next one to two years and look currently more interesting than equities.

Foreign exchange

Over the next three months, we expect the US dollar to continue to weaken against the euro as markets will be increasingly worried about the inflationary impact of the Fed's quantitative easing program. We expect the EUR/USD rate to increase to 1.45 in the short term and to fall back to 1.30-1.35 in H2 as the US economy starts to rebound.

II. EFG Macro Model Forecasts

EFG Macro Model Forecasts: US Economy & Markets

	Actual	------------- Forecasts ---------------						
	2008:Q4	2009:Q1	2009:Q2	2009:Q3	2009:Q4	2008	2009f	2010f
GDP q-o-q saar	-6.3	-7.0	-4.0	0.4	1.6	-0.8	-2.2	2.7
GDP y-o-y	-0.8	-2.8	-4.5	-4.3	-2.3	1.1	-3.5	1.3
Consumption y-o-y	-1.4	-1.9	-1.1	-1.5	-0.4	0.3	-1.3	1.0
Labor Market								
Civilian Employment y-o-y	-2.0	-3.0	-3.4	-3.5	-3.5	-0.8	-3.6	-2.1
Civilian Unemployment Rate	7.2	8.1	8.4	9.1	10.1	5.8	8.9	10.0
Inflation								
Headline CPI y-o-y	-0.1	-0.7	-0.9	-0.4	0.3	3.8	-0.5	1.1
Core CPI y-o-y	1.7	1.4	1.3	1.0	0.8	2.2	1.1	1.4
Core PCE y-o-y	1.7	1.3	1.1	0.9	0.8	2.1	1.0	1.3
Interest Rates (% end of quarter)								
Fed Funds	0.13	0.13	0.13	0.13	0.13			
10-y Treasury yield	2.59	2.37	2.36	2.34	2.36			
Spreads (bps, end of period)								
10y-2y Treasury	234	212	211	209	211			
10y Treasury-Bund	-36	-35	-46	-52	-50			
Exchange Rates (end of quarter)								
USD/EUR	1.40	1.27	1.32	1.23	1.29			
Probability of								
Fed Funds Cut	0.44	0.44	0.85	0.85	0.85			
10y-1m Spread to increase	0.96	0.82	0.85	0.81	0.79			
S&P500 to outperform 10-y UST	-0.10	-0.07	0.23	0.22	0.22			
Bund to outperform 10-y UST	0.79	0.50	0.39	0.43	0.49			

Note: All forecasts are based on the estimates of a quarterly econometric model of the US economy and main financial markets. Point forecasts and probability estimates are subject to risks and should be only indicative of medium-term trends of the economy and financial markets.

Probabilities in the bottom part of the table are based on probit model estimates. They range between zero and one. A probability of more than 0.5 suggests that we regard this event as more likely to happen. All numbers in the table are pure model forecasts. They serve the purpose to provide a consistent view of the US economy and main financial markets based on historical regularities.

EFG Macro Model Forecasts: Euro area economy

	Actual	-------------	Forecasts	---------------				
	2008:Q4	2009:Q1	2009:Q2	2009:Q3	2009:Q4	2008	2009f	2010f
GDP y-o-y	-1.3	-3.6	-3.5	-3.0	-2.4	0.8	-3.2	0.3
Consumption y-o-y	-0.7	-1.3	-1.2	-1.0	-0.1	0.5	-1.0	0.4
Labor Market								
Employment y-o-y	0.0	-1.2	-1.6	-1.8	-1.7	1.0	-1.6	-0.9
Unemployment Rate	7.9	8.5	9.0	9.2	9.6	7.5	9.1	9.8
Inflation								
Headline CPI y-o-y	2.3	1.0	0.6	0.3	-0.1	3.3	0.5	1.1
Core CPI y-o-y	2.2	1.8	1.1	0.7	0.6	2.4	1.0	0.7

Note: All forecasts are based on the estimates of a quarterly econometric model of the Euro area economy.

III. Global Economic Outlook

1. The US economy

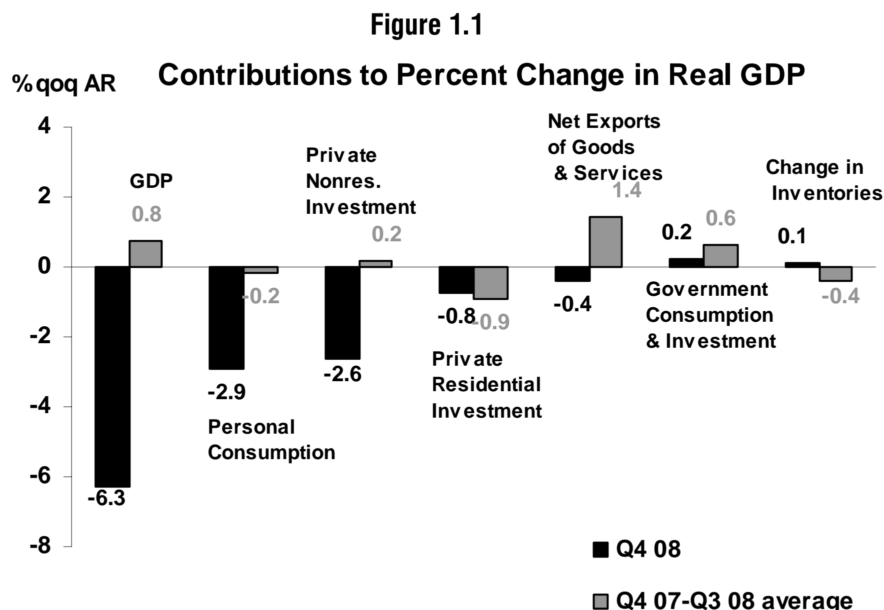
Dimitris Malliaropulos, Olga Kosma

- Real GDP contracted by 6.3% in Q4 08, marking the third sharpest decline since 1960 (Q2 80: -7.8%, Q1 81: -6.4%).
- Looking forward, we expect the economic slump to deepen as companies start running down inventories at an increasingly faster pace. We expect real GDP to contract by 2.9% in 2009 with Q1 the weakest quarter (-7% q-o-q annualized) and a sluggish recovery in H2 09 and 2010, where growth will likely rebound to 1.3%.
- While GDP growth will likely improve in H2, this will not be enough to prevent unemployment from increasing further, enhancing downside risks for consumers.
- Increased unemployment, combined with negative wealth effects from the housing sector and the equity market fall have led to a sharp increase in the personal savings rate, generating a highly disinflationary environment.
- Although we continue to expect future declines in headline inflation in the coming months due to major base effects, the unfolding monetary and fiscal stimulus will, in our view, prevent a sustained deflation.

The recession is deepening

Real GDP contracted by 6.3% q-o-q saar in Q4 08, marking the biggest quarterly drop since Q1 1982 (Figure 1.1). Although a large downward revision from the advance estimate of -3.8% was anticipated (consensus: -5.4%), the 2.4% downgrade of economic activity was significantly worse than Consensus. The downward revisions were mainly led by consumption, business inventories and exports. In particular, private consumption was revised down to -4.3% from -3.5%, reporting the sharpest decline in 28 years. Real fixed investment fell by 23%, driven mainly by investment in equipment, which dropped by about 28%. As far as external demand is concerned, the net trade deficit was revised up to $364.5 bn from $356.4 bn, reversing its positive contribution to real economic activity during the last 1.5 year.

Figure 1.1



Inventory building was substantially weaker than the advance estimate of the Commerce Department. The $6.2 bn increase was revised to a decline of $25.8 bn in Q4 08, reducing inventories' contribution to growth to 0.1% from 1.3%.

The puzzle of inventories

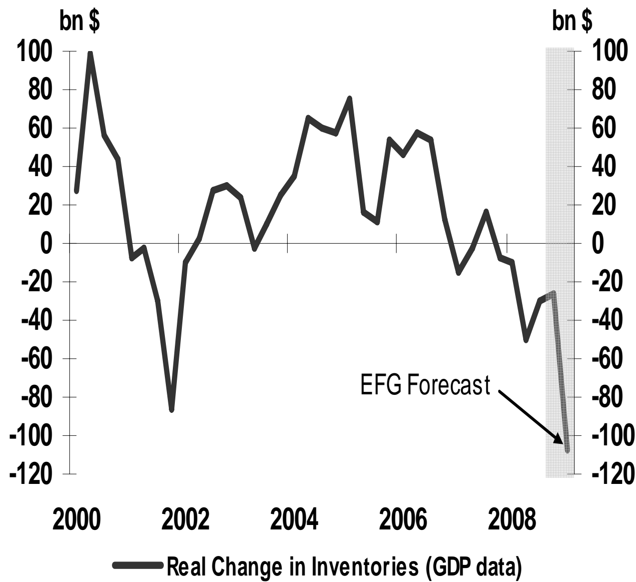
Although inventories are a relatively small fraction of the overall investment sector, they are actually a critical component of changes in GDP over the business cycle. An undesired accumulation of inventories accompanies an economy entering a recession. As consumers reduce their purchases of goods and services, firms reduce production to keep pace with slumping orders and reduce excess inventories. The puzzle with inventories during the current downturn is that up to Q4 08, they continue to have a positive contribution to GDP growth in contrast to historical experience, which suggests that deep recessions are accompanied by a sharp decline in the flow of inventories. We believe that the rundown of inventories has just started and will intensify significantly over the coming months (Figure 1.2). Figure 1.3 shows that, during the past ten US recessions, the loss in real GDP was accompanied by a significant rundown of companies' inventories, measured by the cumulative change in the flow of inventories from peak to through of the business cycle. Shallow recessions, such as the 2001 recession, were accompanied by small changes in the flow of inventories, whereas deep recessions, such as the 1981-82 recession, were accompanied by large changes in the flow of inventories. On average, the decline in inventories during the previous ten recessions accounts for 62% of the GDP contraction (see Table 1.1).

How does the current recession compare with previous recessions in terms of inventory rundown? Although the stock of inventories has declined by roughly $125bn since the peak of GDP in Q2 08, its rate of decline has been flattening whereas the deceleration of GDP was intensifying. As a result, the change in the flow of inventories has turned out to be positive at $24.8bn since Q2 08, whereas GDP has contracted by $205.3bn. As suggested by the regression line in Figure 1.3, the decline in the flow of inventories by Q4 08 should have already amounted to $82bn.

The bottom line is that, in order to match historical correlations, inventories will have to decline by a total of $107bn over the next few months, suggesting that the economic contraction will likely intensify in H1 09. This forecast is rather conservative as it is based on the assumption that all components of GDP with the exception of inventories will stabilize at current levels. With private consumption and investment contracting further, it is clear that the rundown of inventories will likely be much steeper.

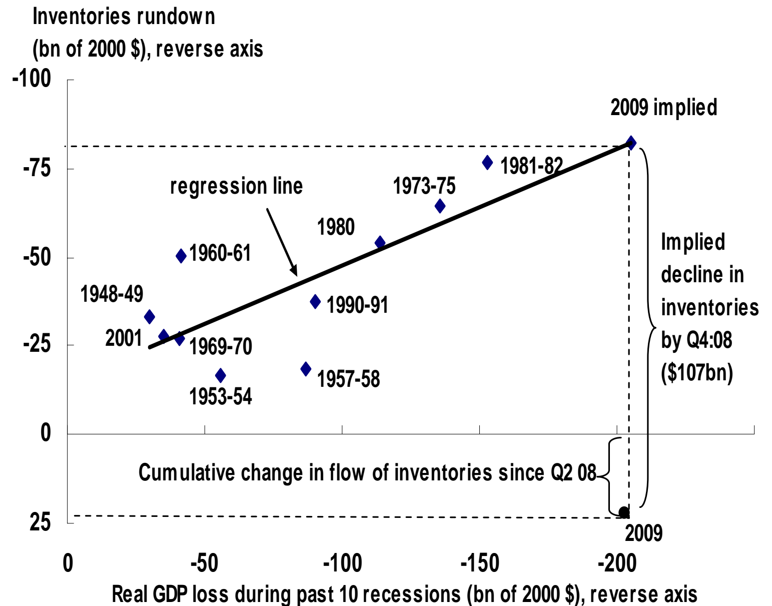
Adding the projected decline in inventories to the decline in GDP so far ($205.3bn), suggests that the total decline in GDP during the current recession will likely amount to (at least) $320bn, compared with an average GDP decline of $78bn (measured in constant prices of 2000) during the past ten recessions and a decline of only $35bn during the 2001 recession. This suggests that the current recession is expected to be the deepest recession ever in the post-war II period measured in terms of total GDP loss (in dollars of 2000), four times deeper than the average recession during this period, and nearly ten times deeper than the 2001 recession.

Figure 1.2



Source: Eurobank EFG estimates

Figure 1.3



Source: Eurobank EFG estimates

Table 1.1
Inventory investment during US recessions

NBER US Recessions	Duration (in quarters)	Decline in real GDP (bn of chained 2000 $)*	Decline in inventories (bn of chained 2000 $)*	Decline in inventories as a % of the decline in real GDP
Q4 48 - Q4 49	5	-29.6	-33.3	113%
Q2 53 - Q2 54	5	-55.7	-16.7	30%
Q3 57 - Q2 58	4	-86.8	-18.6	21%
Q2 60 - Q1 61	4	-41.2	-50.5	123%
Q4 69 - Q4 70	5	-40.7	-27.3	67%
Q4 73 - Q1 75	6	-135.7	-64.3	47%
Q1 80 - Q3 80	3	-113.9	-53.9	47%
Q3 81 - Q4 82	6	-152.7	-76.5	50%
Q3 90 - Q1 91	3	-90.0	-37.2	41%
Q1 01 - Q4 01	4	-34.8	-27.4	79%
Average	**4.5**	**-78.1**	**-40.6**	**62%**
Current	**4**	**-205.3**	**+24.8****	

*The declines in real GDP and private inventories correspond to the largest peak-to-trough decline in real GDP within each recession. The decline in inventories is measured by the cumulative change in the flow of inventories from peak to trough of GDP, i.e. the second derivative of the stock of inventories.
**Cumulative change in the flow of inventories from Q2 08 to Q4 08.
Source: Eurobank EFG estimates

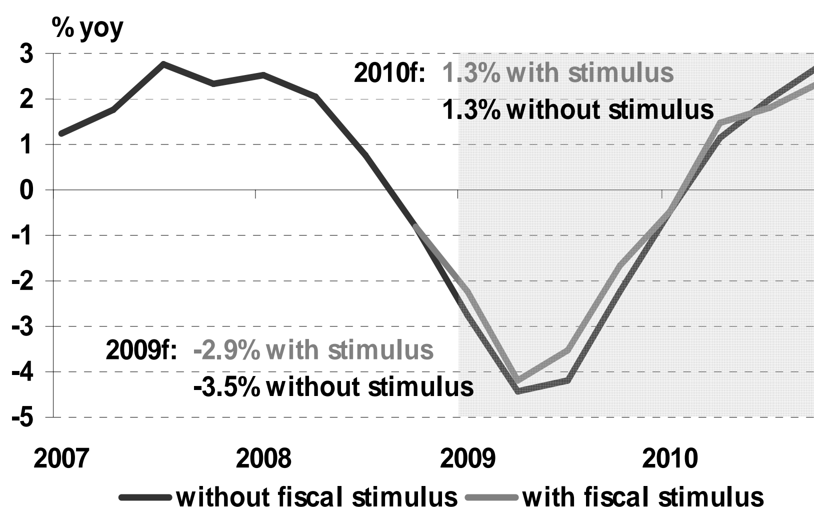
Fiscal policy to the rescue

The steep declines in most of the monthly economic indicators suggest that real GDP will continue to contract, though at a progressively slower pace as the year advances. Inventories rundown will be one of the main driving forces. According to our estimates, real economic activity will contract by 7% in Q1 and 4% q-o-q saar in Q2 09. On a y-o-y basis, the second quarter of the year will be the worst, with a 4.5% decline in real GDP. The current recession has already lasted 12 months -longer than the previous two recession episodes in 1990-91 and 2001, which lasted 8 months each- and is, in our view, by far the deepest recession in the post-war era. We believe that the unfolding monetary and fiscal stimulus will partly support the shortfall in aggregate demand mainly in H2 09, preventing a sustained deflation.

Table 1.2

Total Amount of the Stimulus Package 2009-2019: $789 bn		
	Fiscal Year, in billions of dollars (74% of the $789bn recovery plan)	
	FY2009	**FY2010**
Government Spending	34.8	110.7
Direct Payments to Individuals	83.8	76.8
Tax Cuts	66.3	211.9
Total	**184.9**	**399.4**
% of GDP	**1.3%**	**2.8%**

Figure 1.4



Source: Eurobank EFG model estimates

In particular, the recently approved $789 fiscal stimulus package, which constitutes 5.5% of GDP, will be spent over the next 11 years. 74% of the recovery plan is expected to be spent in FY2009 and FY2010. The three main components of the package are government spending, direct payments to individuals and tax cuts (Table 1.2). Direct government spending will probably be injected directly into the economy, whereas about half of direct payments to individuals and

tax cuts will boost private consumption and the rest is expected to be saved or used to pay off debt. Based on these assumptions, the package is expected to add 0.5% yoy (2.0% qoq saar) in 2009 to real GDP growth. The recovery of the US economy will be rather sluggish, with real GDP growth averaging -2.9% in 2009 and 1.3% in 2010 (Figure 1.4).

Probability of recovery: Is the worst over for the US economy?

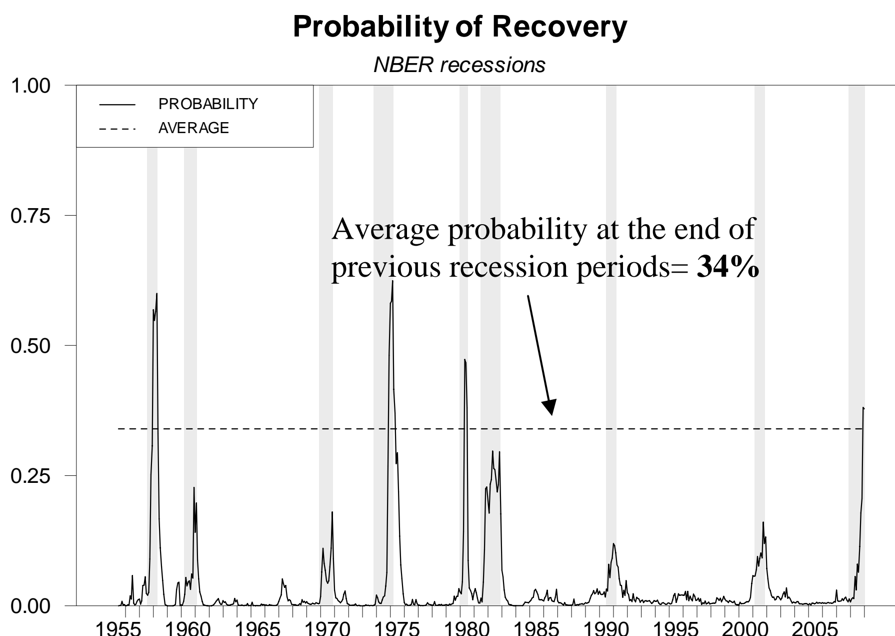
While the economy continues to contract, statistical evidence is mounting to signal that we have likely seen the trough for the current business cycle. Some economic indicators have improved somewhat in January 2009 relative to Q4 08 (such as ISM manufacturing, retail sales, real personal consumption expenditures), suggesting that the second derivative may be now turning positive for the US economy. We run four probit models for four US economic indicators in order to assess the probability that the worst pace of decline is behind us. The economic indicators chosen cover three major segments of the US economy: the manufacturing sector, the labor market and inventories investment. The dependent variable is whether or not we are currently running through the last quarter of the recession, i.e. whether or not we have seen the worst pace of contraction. The explanatory variables are the ISM manufacturing index, the ISM inventories index (manufacturing sector), the annual growth rate of industrial production and the difference between the current month's unemployment rate and the unemployment rate three months ago, respectively. The results of these regressions allow us to calculate the average of all four probabilities and evaluate the chances that the downward trend of economic activity is cooling off. The average probability of a US recovery based on the ISM manufacturing index, the ISM inventories index, the unemployment rate and the industrial production currently stands at 47%, markedly higher than the 34% average probability that the model had forecasted at the end of the previous ten recession episodes (Figure 1.5).

Table 1.3 summarizes the results of our analysis for the individual economic indicators. The unemployment rate provides the most optimistic read, with a probability of almost 75% that the worst for the US economy is over. This high recovery probability stems from the fact that the civilian rate of unemployment currently stands well above the average trough of the last 10 US recessions (8.1% versus 7.6%). Unlike the behavior of the ISM manufacturing index, which acts like a leading indicator for the state of the economy, the labor market lags well behind real economic output. For example, in the 1990-91 and 2001 recession episodes, the unemployment rate reached its trough 1.5 year (on average) after the recession had ended. Therefore, even in the best-case scenario of an economic recovery in H2 09, the labor market wouldn't see any improvement at least until the end of the year.

As far as the ISM manufacturing index is concerned, the current level of the index is equal to the average trough reported in past US recessions. As a result, this indicator implies a 50% chance that the trough of the current business cycle has already passed. It should be noted that the probit model gave a 70% probability of recovery in December 2008 that the ISM manufacturing index had dipped to 32.9, suggesting that we may have seen the trough at the end of 2008. Although the ISM manufacturing index improved for a second consecutive month in February 2009, past readings of the index suggest that we should be cautious about whether we have seen the trough of the index. As shown in Figure 1.6, in five out of the last ten US recessions, the ISM manufacturing index dipped to a cyclical low and then increased over the next

few months, before reaching the trough of each recession. The behavior of the index generates a great deal of uncertainty about whether the manufacturing slowdown has peaked.

Figure 1.5



Source: Eurobank EFG model estimates

One of the most reliable signals of an end to a US recession is, in our view, the industrial production index. The annual growth rate of industrial production has on average reached its trough during the last month of each recession in the post-war period. January industrial production growth sits at its third worst point since 1948, exceeded only by the declines seen in April 1958 and May 1975. The average trough in the last 10 US recession episodes is 8%, well above the 11.2% y-o-y growth rate reported in February 2009. The industrial production index provides an optimistic reading, with a probability of 50% that the recession is ending for the US economy. To increase the probability to 75% that March will actually be the worst month of this business cycle, we would need to see industrial production dropping by 14.6% y-o-y. Further deterioration to a growth rate of about -18.2% would imply a 90% probability of a recovery.

The same procedure has been applied to the ISM inventories index in order to quantify the probability that the worst is over. Given that we have not seen yet the sharp decline in inventories that we expect in a recessionary environment, our probit model suggests that there are only 14% chances that the US economy will recover. Indeed, the ISM inventories index is currently 37, well above the 35.2 average trough of the previous seven recession episodes. The required decline is about 10 points from the latest reading in February in order to see a recovery probability of 50%.

Table 1.3

	Most recent trough	Average trough in the last 10 US recession episodes	Current level (recovery prob.)	50% prob. of recovery	75% prob. of recovery	90% prob. of recovery
Unemployment rate	**8.1%***	7.6%	8.1% (73%)	7.9%	8.1%	8.3%
ISM Manuf	**32.9**	35.8	35.8 (48%)	35.6	32.0	28.5
Industrial Production (yoy %)	**-11.2%**	-8.0%	-11.2% (50%)	-11.2%	-14.6%	-18.2%
ISM Inventories (Manuf)	**37.0**	35.2	37.0 (14%)	26.0	20.0	14.0

*In the case of the civilian rate of unemployment, the number is referred to the most recent peak of the business cycle.
Source: Eurobank EFG model estimates

Figure 1.6

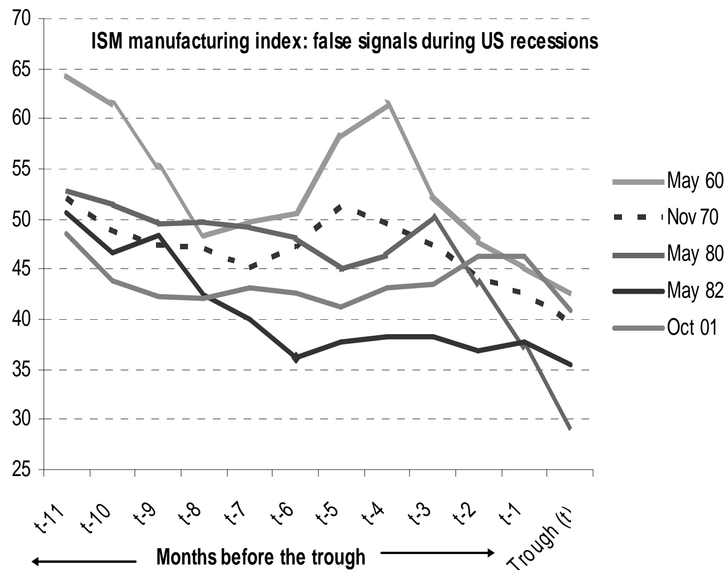


Figure 1.7

Source: Eurobank EFG model estimates

Summarizing our results, we believe that, despite mounting statistical evidence that the worst is over during the current economic slump, it is still too early to declare an end to the current recession Things will likely get worse before they get better, as the depletion of excess inventories over the coming months will drag down companies' investment in fixed capital and economic output.

Labor market deterioration enhances downside risks for consumers

Labor market data continued to disappoint in February, indicating an outright contraction of the economy. Based on BLSs' large survey of employers, non-farm payrolls declined by 651k, higher than the market's expected loss. In addition, huge downward revisions to prior months provide evidence that the rate of deterioration has so far been understated. The unemployment rate jumped to a 26-year high of 8.1% in February 2009 from 7.6% in January, marking a cumulative increase of 3.7% from its most recent trough of 4.4% in March 2007. Looking forward, our job market model suggests that civilian employment growth will decelerate significantly in the following quarters, with the y-o-y change declining to -3.6% in 2009 from -0.8% in 2008 (Figure 1.7). As a result, the unemployment rate will continue to increase into 2009, peaking at close to 10.0% at the end of the year. Should this forecast realize, then the cumulative increase in the unemployment rate from the cycle low will reach 5.6%, the biggest increase ever reported in the post war period.

The sharp deceleration of the labor market intensifies downside risks for consumer spending. Real personal consumption expenditures have been on a downward trend since August 2008 for the first time since 1991, resulting in a 4.3% q-o-q saar contraction in Q4 08. The preliminary GDP estimate for Q4 2008 revealed a hefty 3.0% negative contribution of personal consumption to real economic activity, as a result of negative wealth effects from the slide in housing, tighter credit standards and equity market losses. Despite the upside surprise in January's consumption growth (+0.4% mom) due to seasonal post-holiday discounts, the upward movement will not probably continue in the coming months as labor market losses build up. The savings rate increased gradually to 5% in January 2009 –the highest level in 14 years- although one year earlier it has been hovering around zero. Besides, consumer confidence in February suggests that the risks remain to the downside for Q1 09. The University of Michigan consumer sentiment index fell to 56.3 in February, the lowest level since May 1980, after a temporary rebound in the two previous months. Consumer confidence index of the Conference Board dropped to a record low of 25.0 from 37.4 in January, underlying the disappointing consumer assessment of the economic outlook. Extremely low consumer confidence indicates that retail sales will decline in the following months, offsetting the monthly increase reported in January. According to our estimates, personal consumption will keep contracting through 2009, with the average growth declining to -1.2% from 0.3% in 2008 (Figure 1.8).

Technical deflation ahead due to base effects

Negative wealth effects from the housing sector and the equity market fall reinforce the upward trend in the personal savings rate, generating a highly disinflationary environment. Indeed, after peaking at 5.4% y-o-y in July 2008, headline CPI inflation moderated considerably to -0.2% in January -the lowest level in more than 50 years- as a result of the decline in oil and commodity prices. Core CPI inflation has also decelerated from the recent peak of 2.5% in Q3 08 to 1.7% in January 09.

Figure 1.8

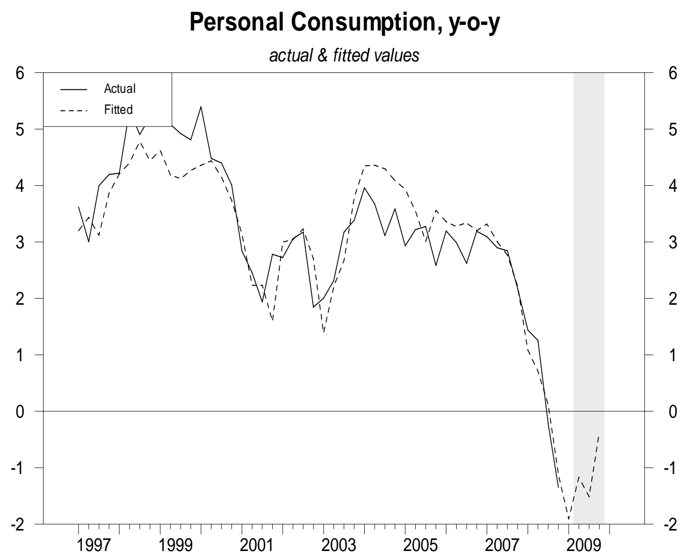
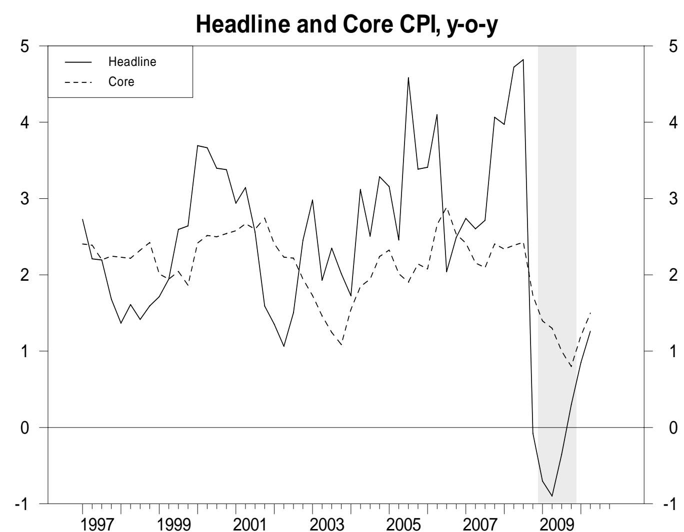


Figure 1.9



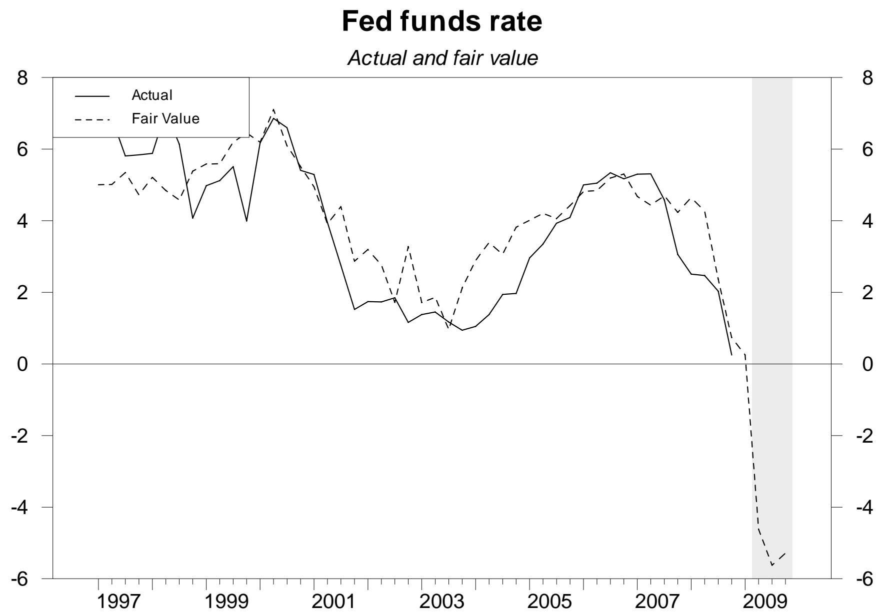
Source: Eurobank EFG model estimates

However, the February inflation numbers showed some return of inflation after two months of negative y-o-y readings. Headline CPI rose by 0.4% m-o-m raising the y-o-y growth to 0.1%, after the biggest monthly drop reported in November 08 of 1.7% since 1947. Furthermore, core CPI increased to 1.8% y-o-y, driven mainly by a rebound in apparel and vehicles. Breakeven inflation rates have bounced sharply and 1-year consumer inflation expectations measured by the University of Michigan climbed to 2.2% in January 09 from 1.7% in December 08. This unexpected rebound in prices is firmly consistent with heavy discounting before Christmas in November and December, which abated in the beginning of 2009. Although energy prices have stopped their downward trend showing some signs of stabilization, we do expect future declines in the annual headline inflation in the coming months due to major base effects. The University of Michigan index of consumer expectations has already eased to 1.9% in February, suggesting that the inflation rebound will probably prove to be only temporary. Headline CPI inflation is expected to moderate significantly to a -0.5% average annual growth rate in 2009 from 3.8% in 2008. Excluding food and energy, we forecast that core CPI inflation will halve in 2009 from 2.2% in 2008, reporting the weakest annual reading since 1958 that the series started (Figure 1.9).

Given the aggressive monetary easing and the major fiscal stimulus plan, we believe that there is little likelihood of a permanent deflationary environment. The FOMC has recently established a target range for the fed funds rate of 0-0.25%, implying that the policy rate will stay close to zero for a long period. Therefore, any further monetary easing will involve quantitative measures to support the financial markets and the economy, such as purchases of longer-term Treasuries, private sector credit instruments and mortgage backed securities. Besides, the FOMC has already announced its decision to purchase government debt for the first time since the early 1960s, as part of an additional $1trn injection into the US economy. These measures come as substitute to standard interest rate policy, as Fed funds

have hit the zero bound. Our model of policy-neutral interest rates, based on the rate of unemployment, median duration of unemployment and inflation suggests that the Fed funds rate ought to be nearly -6% in order to support economic activity and avoid deflation (see Figure 1.10).

Figure 1.10



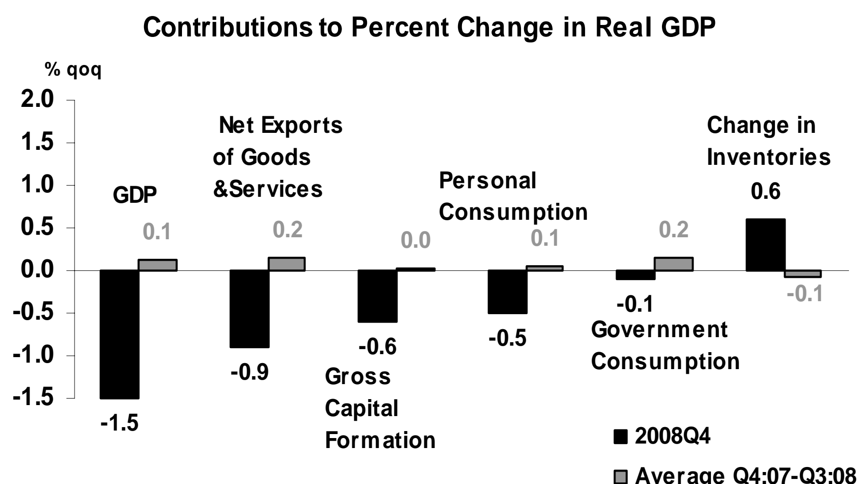
2. The Euro area economy

Dimitris Malliaropulos, Olga Kosma

- The Euro area economy is contracting faster than expected, suggesting that the recession is likely to persist well into 2009. We expect a significant contraction of real GDP growth by -3.2% in 2009 from a growth rate of 0.8% in 2008.
- The implementation of the fiscal stimulus packages in many countries will support activity in late 2009 and will contribute to a modest and gradual recovery in 2010, with real GDP growth hovering around zero.
- Firms have started to adjust labor demand to the slowing domestic demand, reinforcing risks for household spending. Real personal consumption is expected to decline by about 1% in 2009 from an average growth rate of 0.5% in 2008.
- Private investment is severely affected by the economic slump and the correction in construction activity. The cost of capital increase, in combination with the tightening of credit conditions, will probably lead to a drop of about 7% in business investment into 2009.
- The global downswing is been having a negative effect on international trade. Real exports are expected to drop by an average of 7% in 2009, reporting the first annual contraction since euro launch.
- In a deepening recession and a low-inflation environment, we expect further monetary easing to 0.50% by year end. Increasing downside risks to economic outlook and price stability call for more quantitative easing as well.

On the back of the heightened global financial crisis, the euro area has been in a recession since Q2 08, as real GDP has been contracting for three consecutive quarters. The revised GDP release confirmed the 1.5% q-o-q decline in Q4 08, marking a substantial deepening of the Euro area recession. All components of final demand -except stock building- declined, contributing negatively to real economic activity. Negative net trade and contracting business investment were the main factors driving real GDP downwards. In particular, real exports declined by a hefty 7.3% due to weakening global economic activity and the lagged impact of the appreciating euro. Although the recession is largely imported, domestic activity has also decelerated significantly. Gross capital formation subtracted 0.6% from the quarterly GDP growth rate, as businesses face slumping demand, tighter credit conditions and reduced profitability. Real private consumption expenditures fell by 0.9%, while public consumption surprisingly declined by 0.6%. The large build-up of inventories suggests that production will be reduced remarkably in Q1, increasing downside risks for real GDP growth (Figure 2.1).

Figure 2.1



The economic deterioration is broad-based among sectors and countries, with all of the major Euro area economies reporting sharp GDP contractions in Q4 08. The collapse in confidence indicators indicates that the ongoing recession is likely to persist well into 2009. Although the flash Euro area PMI Composite index surprised to the upside, rising moderately to 37.6 in March from 36.2 in February, it is still consistent with GDP contracting by about 1.0% in Q1 09. However, industrial production data suggest that real GDP growth will be considerably weaker. Our estimations point to a 1.7% q-o-q decline in real economic activity in Q1 09. The sharper than expected contraction in economic activity at the turn of the year has urged us to revise downwards our growth forecasts for the whole year. Our baseline projections for 2009 include a negative y-o-y real growth rate in the Euro area of -3.2% from 0.8% in 2008 (Figure 2.2).

Figure 2.2

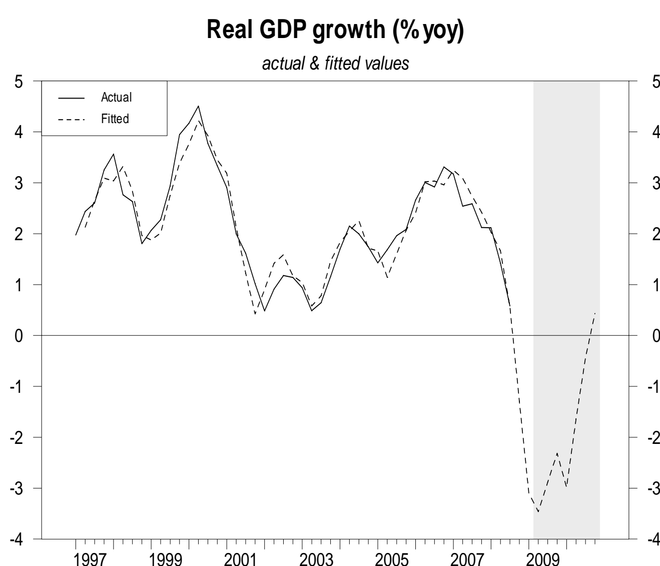
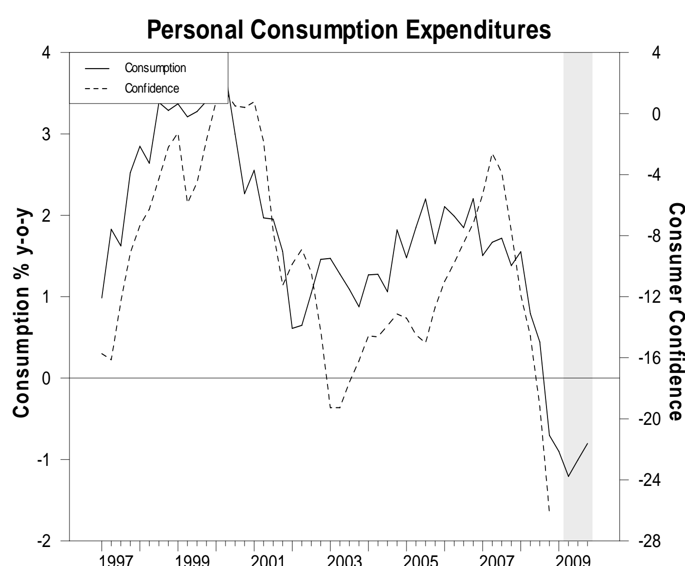


Figure 2.3



Source: Eurobank EFG model estimates

The implementation of the fiscal stimulus packages in many countries (Table 2.1) will probably support activity at the end of 2009 and contribute to a modest and gradual recovery in 2010, with real GDP growth hovering around zero. Besides, the ECB's staff projections have made large downward revisions to its projections for economic activity, emphasizing the severity of the slowdown. In particular, the ECB staff lowered the midpoint for Euro area real GDP growth in 2009 to -2.7% from -0.5% in December, and in 2010 to 0.0% from 1%.

Table 2.1

Eurozone Fiscal Packages (bn €)

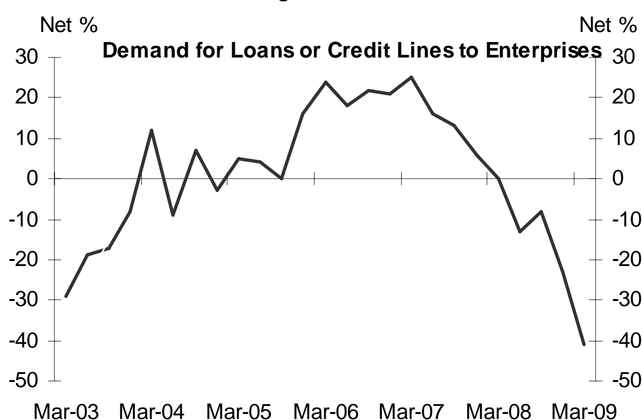
Country	Amount	% of 2009 GDP
Italy	80	4.9%
Spain	49	4.4%
Germany	81	3.2%
Slovenia	0.8	2.0%
France	26	1.3%
Portugal	2.2	1.3%
Netherlands	6	1.0%
Slovakia	0.3	0.4%
Eurozone	**245**	**2.6%**

Domestic and foreign demand is expected to slow down significantly in 2009. According to our estimates, real personal consumption will decline by 1% in 2009 from an average growth rate of 0.5% in 2008 (Figure 2.3). Consumer confidence is at a record low, whereas the unemployment rate has gradually increased from 7.3% in Q1 08 to 8.2% in January 2009, turning into a drag for household spending. Latest quarterly data for employment growth reveal that the number of persons employed in the Euro area fell by 0.3% q-o-q in Q4 08, with the y-o-y growth rate declining to zero from 0.6% in Q3 08. Firms have started to adjust labor demand to the slowing domestic demand, with the Composite PMI employment index falling to a multi-year low of 40.3 in March. Since the labor market usually lags the economic cycle, we expect employment growth to decelerate significantly from 1% in 2008 to -1.6% in 2009, with the average rate of unemployment exceeding 9%.

Meanwhile, private investment is severely affected by the economic slump and the correction in construction activity in some economies. Incoming industrial orders remain in freefall and industrial production is contracting rapidly. Latest available data reported a 22% y-o-y decline in industrial new orders in December 2008, and a 17.3% y-o-y drop in industrial production in January 2009. Besides, the increase in the cost of capital, in combination with the tightening of credit conditions, will probably lead to a drop of 7% in business investment into 2009. Indeed, the picture on the credit front provides evidence of a sharp drop in investment demand. According to the ECB Bank Lending Survey, Euro area reported a remarkable fall in loan demand from corporations and households at the end of 2008 (Figure 2.4).

Much of the downside impetus in the Euro area has come from external demand. The global downswing has had a negative effect on international trade. The recent plunge in capital goods orders over the last couple of months –which declined by a hefty 31% y-o-y– and the collapse of the PMI new orders index to below-40 levels is an indication of a significant deceleration in exports in the coming months. The parlous state of the emerging market economies reinforce the view that Euro area exports of goods and services will remain a drag on economic activity. Real exports are expected to drop by an average of 7% in 2009, after a 1.8% average growth rate in 2008, reporting the first annual contraction since the inception of the series in 1995 (Figure 2.5).

Figure 2.4



Source: European Central Bank

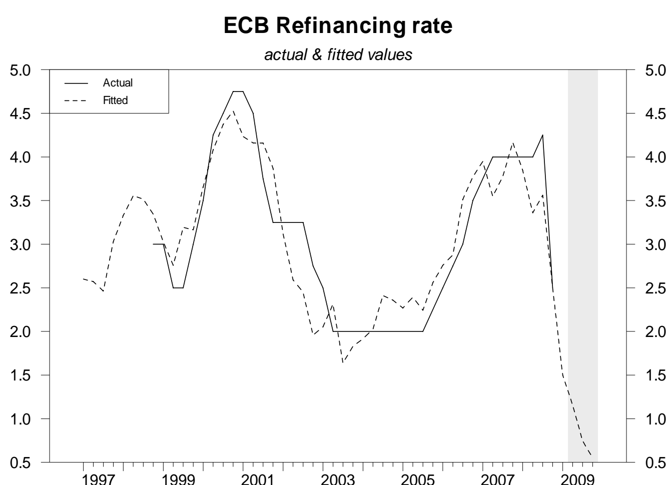
Figure 2.5

Source: Eurobank EFG model estimates

The weakening state of the economy, coupled with the decline in commodity and oil prices, has led to a remarkable decline in euro area inflation. The January HICP inflation came down at 1.1% y-o-y from 1.6% in December, the lowest level in almost a decade. Although the February HICP inflation revealed a slight increase to 1.2% y-o-y fueled by energy and unprocessed food prices, the trend remains on the downside due to base effects caused by past commodity price increases. Input and output prices from the PMI survey have hit rock bottom in March 2009, while EC's measure of selling price expectations in the manufacturing sector has shifted from record highs in July to negative readings since December. We expect euro area inflation to fall to 0.5% in 2009 from 3.3% in 2008, owning to base effects, lower income growth and lower global inflation which will help to alleviate import prices.

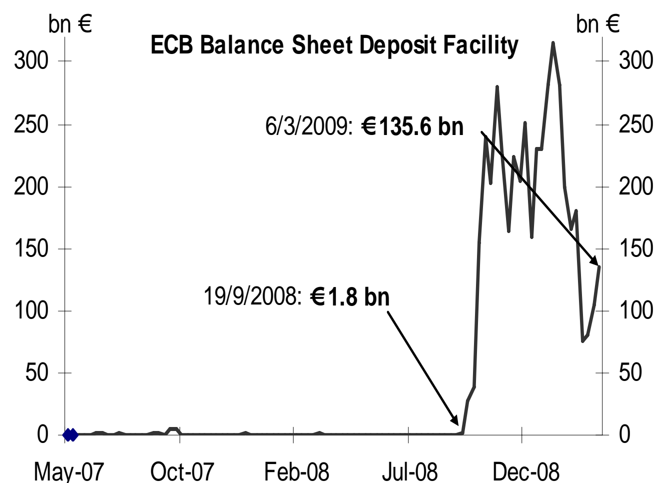
In a deepening recession and a low-inflation environment, the ECB lowered its policy rate by another 50 bps to 1.50% in its March meeting in line with the consensus view. The corridor around the interest rate for the main refinancing operations was kept unchanged so that the interest rate for the deposit facility fell to 0.5% and the marginal lending facility rate to 2.5%. Although President Trichet highlighted that the deposit facility rate currently stands at a very low level, he actually left the door open for additional rate cuts. We believe that further monetary easing by the ECB is in the pipeline, in order to support credit growth and boost the demand side of the economy. We stick to our view that interest rates will probably fall to 1% by Q2 09. Although some Governing Council members have expressed their objections to zero interest rate policy, increasing downside risks to economic outlook and price stability are consistent with the ECB lowering the refi rate still further to 0.50% by the end of 2009 (Figure 2.6). In addition to rate cuts, the ECB will probably use "unconventional" measures to ease financing conditions. The Central Bank has already been using non-standard measures through its supply of unlimited liquidity, which have led to a sharp rise in ECB's balance sheet (Figure 2.7). On additional non-standard measures the Council did not reveal anything in its March meeting, but President Trichet said that they are discussing and studying new measures. With ECB's staff inflation projection of only 0.4% and 1.0% in 2009 and 2010, respectively, the ECB will probably follow in the footsteps of Fed and Bank of England and start buying up government bonds of member countries that face financial problems.

Figure 2.6



Source: Eurobank EFG model estimates

Figure 2.7



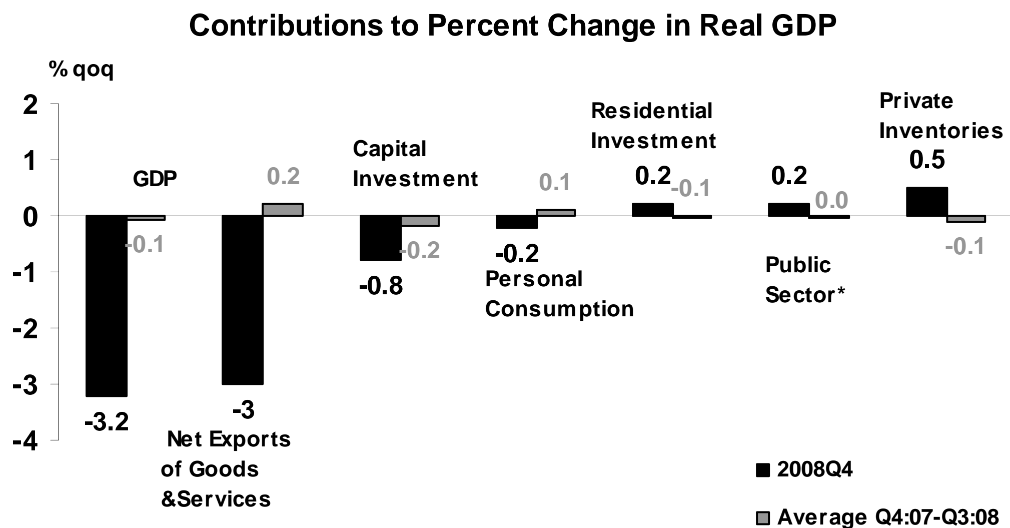
Source: European Central Bank

3. The Japanese economy

Dimitris Malliaropulos, Olga Kosma

- Japan is probably one of the worst-performing economies around the globe due to its dependence on international trade.
- With recessionary features set to be more pronounced through the early part of 2009, we expect real GDP to contract by 5.5% in 2009 from -0.6% in 2008, with a sluggish recovery in 2010.
- The recessionary global environment, in combination with the recent sharp drop in oil prices, suggests that Japan is set to slide back into deflation.
- Compared with other countries, the fiscal and monetary policy response to the deepening recession has so far been sluggish in Japan. The high level of public debt and general government budget deficit limits the size of additional stimulus measures.
- Facing the zero interest rate bound, the BoJ opens the way for quantitative monetary easing, such as the direct purchases of government or corporate debt, to feed into its balance sheet growth.

Figure 3.1



*Public Sector = Government Consumption + Public Investment + Public Inventories

Japan is probably one of the worst-performing economies around the globe. The Japanese economy contracted at a sharper than expected 12.1% q-o-q annualized pace in Q4 08, heading for its deepest recession since the Second World War (Figure 3.1). This was actually the second-biggest drop, following the 13.1% fall during the first oil price shock in 1974. The contraction in GDP was mainly driven by a 13.8% q-o-q plunge in real exports on the back of slower global demand. The external contribution was -11.5%, as imports were surprisingly resilient increasing by 3% q-o-q. The resilient import growth can be partially explained by inventory buildups due to weak sales. Inventory accumulation should not be considered a positive factor for real economic activity, as inventory reductions are expected to be a major drag for GDP growth in the coming quarters. The sharp decline in external demand is having a negative impact on corporate investment, with capital investment plunging 5.4% q-o-q in Q4 08. Real personal consumption expenditures have started to fall (-0.4% q-o-q) and the risks for the Japanese households are on the downside for 2009, given the

deteriorating labor market and the low savings rates. Besides, the JPY2 tr public disbursements that begin in March are not expected to give a sizeable boost to consumption growth.

Japan's main problem is its sensitivity to the global business cycle, i.e. the collapse in demand and international trade. The appreciating yen and faltering global demand have taken their toll on Japanese exports, which declined by an unprecedented 45% y-o-y in January, reporting the sharpest fall since the inception of the series in 1979 (Figure 3.2). Industrial production declined by a hefty 31% y-o-y, since changes in exports' value seem to be highly correlated with production trends. Japanese exports and industrial output are heavily dependent on cyclical industries such as autos and electronics, which are currently facing considerable declines in demand. In this environment, business investment is been exacerbated by the corporate profit squeeze and the weakening export growth. Machinery orders, a leading indicator for capital spending, plummeted by 39.5% y-o-y in January, suggesting that companies will reduce their investment plans in the following quarters.

Figure 3.2

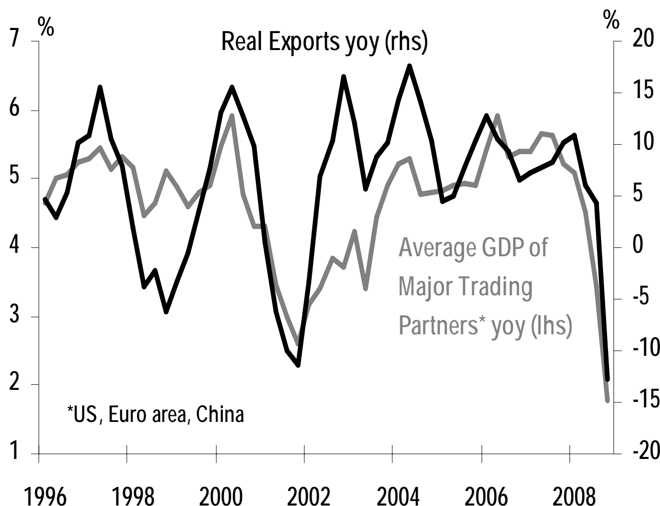
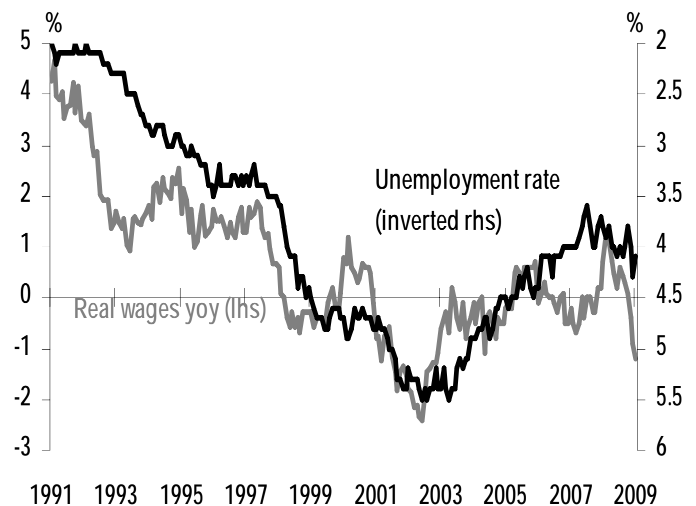


Figure 3.3



The falloff in exports and private-sector capex are leading to deteriorating labor market conditions. The availability of jobs declined to a five-year low in January, with the job offers/applicants ratio falling to 0.67x from 0.73x in December. Although the unemployment rate eased slightly from 4.3% in December to 4.1% in January (Figure 3.3), the seemingly improved unemployment figure could be rather misleading. To qualify as unemployed in Japan, a person must have been looking for a job during the period that the survey was conducted. As a result, unemployed people who have quit the job search amid worsening economic conditions are classified as non-working instead of unemployed. Meanwhile, the new jobs offers, which are used in the business conditions leading indicators, deteriorated to -18.4% from -12% while real wages dropped by 1.2% y-o-y (Figure 3.3).

Worsening labor market conditions and falling asset prices reinforce the gloomy picture for personal consumption. The January household survey revealed a 5.9% y-o-y decline in real personal spending after a 4.6% y-o-y fall in December, while retail sales declined by a hefty 2.4% y-o-y in January. Although consumer confidence recorded a second consecutive marginal improvement in February, it stills remains at the very low level of 26.7. Besides, the consumer confidence index had increased by about 12 units during past Japanese recession periods, while at the moment the index has already marked a cumulative increase of 23 units from its most recent peak in 2006. Looking ahead, we believe that risks are on the downside for consumer sentiment and personal expenditures and expect a private consumption correction that outpaces those of other recessionary episodes (Figure 3.4).

With recessionary features set to be more pronounced through the early part of 2009, we expect real GDP to contract by 5.5% in 2009 from -0.6% in 2008, with a sluggish recovery in 2010. The improvement of Japan's economic outlook is largely dependent on the global economic recovery. The implementation of the fiscal stimulus plan in the US, Euro area and China will probably give a boost to the economy in H2 09 through Japan's export growth. The recessionary global environment, in combination with the recent sharp drop in oil prices, suggests that Japan is set to slide back into deflation. The national core CPI has fallen for five consecutive months to 0.0% y-o-y in January, whereas core consumer prices excluding food and energy recorded its first negative reading since May 2008 (Figure 3.5). Given the downbeat labor market prospects and the negative wage growth, there will be increasing downward pressures on core consumer prices, while energy and food prices will keep pushing headline inflation lower into negative territory.

Figure 3.4

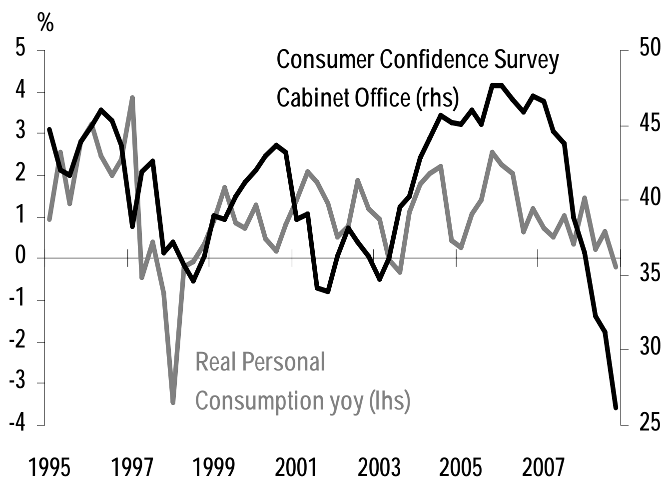
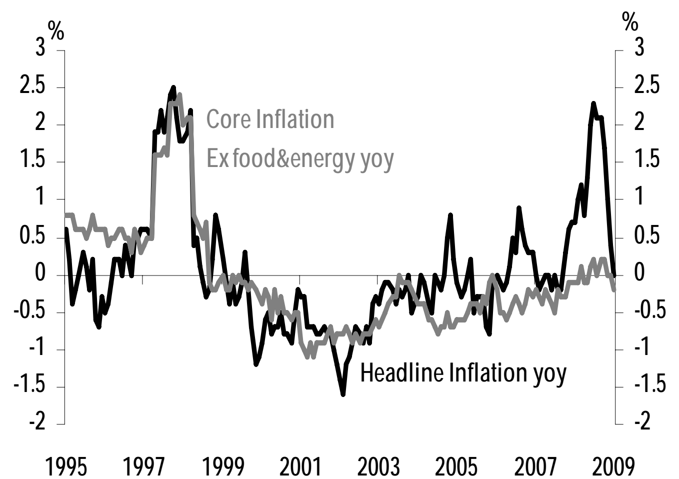


Figure 3.5



The fiscal and monetary policy response to the deepening recession has so far been sluggish. The Japanese government has announced two economic packages, bringing total fiscal measures to $70 billion (only 1.6% of GDP). Although further stimulus measures cannot be ruled out, the high level of public debt and general government budget deficit limits the size of additional stimulus measures. On the monetary policy front, the policy response in Japan has been relatively weak, as the key policy rate had already been very close to zero. Facing the zero rate interest bound, the

BoJ has cut its lending overnight rate to 0.1%, exhausting the conventional monetary tools. The unprecedented contraction in the Japanese economy and the risks of deflation have both urged the BoJ to accelerate its non-conventional easing measures. Following the Fed's deep easing, the BoJ announced further measures of quantitative monetary easing, including the purchase of: government bonds (JPY21.6trn), subordinated debt from Japanese banks (JPY1trn), commercial papers and corporate bonds with maturity less than one year. Although board governor Shirakawa said that he sees limited room for further increases in the Central Bank's purchases of government bonds, we believe that it is likely to see further quantitative easing in the following months, given the limited increase in the BoJ's balance sheet compared to other central banks.

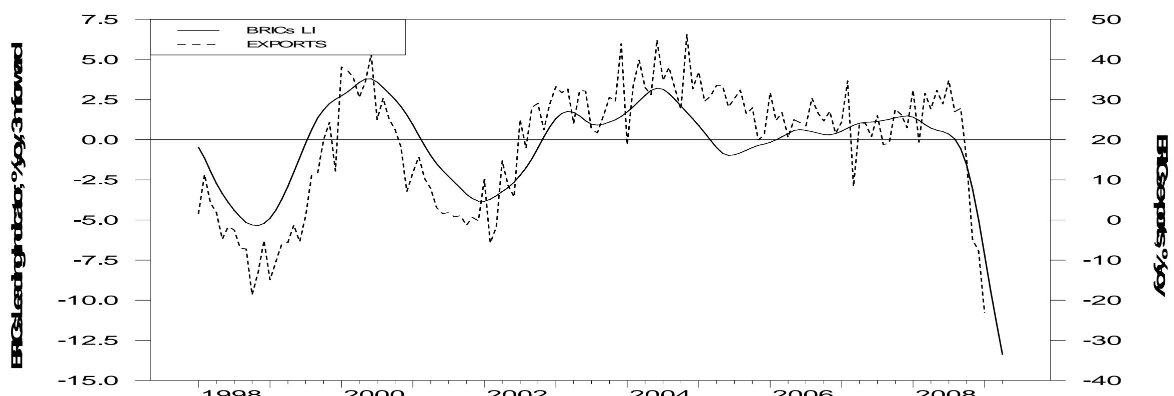
4. Emerging Markets

Dimitris Malliaropulos, Maria Prandeka

- The dramatic weakening of export growth and its spill over effects on the real economy are the main challenges for Emerging Markets economies.
- Emerging Asia is expected to be the first to recover from the current crisis, as the recent turnaround in leading indicators suggests that growth is probably bottoming out.
- Latin America and Emerging Europe are the most vulnerable regions, as they were hit hard by the collapse in commodity prices and the sharp deterioration in capital inflows.

The sharp drop in economic activity in most parts of the developed world has finally taken its toll on Emerging Markets economies. The economic weakness has spread into EMs mainly by hitting exports to the developed world as demand dried up in the US and Europe (in some countries, such as China, exports have contracted sharply) and by impeding external financing. Our BRICs leading indicator continued to deteriorate, suggesting a sharper downturn in BRICs exports for at least the first half of 2009 (figure 4.1). The economies that entered the current global crisis in a relatively strong financial position had the opportunity to apply their own policy responses, most notably government and central bank interventions. Monetary policy has been eased and massive fiscal stimulus packages, designed to increase domestic spending, have been announced, especially by countries with available unused liquidity. China, in particular, has announced a CNY 4 trillion (13% of 2008 GDP) stimulus package to be spent over the next two years. The impact of the global recession on EMs' economies will likely depend on each country's exports structure, as well as the extent of borrowing from abroad and the effectiveness of the fiscal and monetary measures. Emerging Asia is expected to be the first to recover from the current crisis as leading indicators started to improve recently. Emerging Europe and Latin America will probably lag behind Em. Asia, with LA better positioned to weather the storm than Em. Europe, as the region has been less dependent on external financing. Overall, Q1 09 and Q2 09 are expected to be the weakest quarters in terms of real GDP growth, as interest rate cuts and fiscal packages will probably not have a significant effect on the real economy in the short run.

Figure 4.1
BRICs Leading Indicator



Source: Eurobank EFG

Latin America

Since the region is largely dependent on commodities, economic activity in large commodity exporters, such as Brazil, is expected to suffer the most due to the collapse of commodity prices. A sharper fall in these prices represents a substantial risk for the region. Indeed, the Latin America IFO index for export volume for the next six months has declined to its lowest level in Q1 09, suggesting a worsening exports outlook for the first half of 2009 (Figure 4.2). Meanwhile, as the terms of trade deteriorate and external demand weakens, current account balances will shift into deficits and capital inflows will suffer, adding another major risk for the region. In fact, the Latin America IFO economic situation index has fallen below the 5-point-level in Q1 09 for the first time since 2004, indicating expectations of a deteriorating economy (Figure 4.2).

Figure 4.2

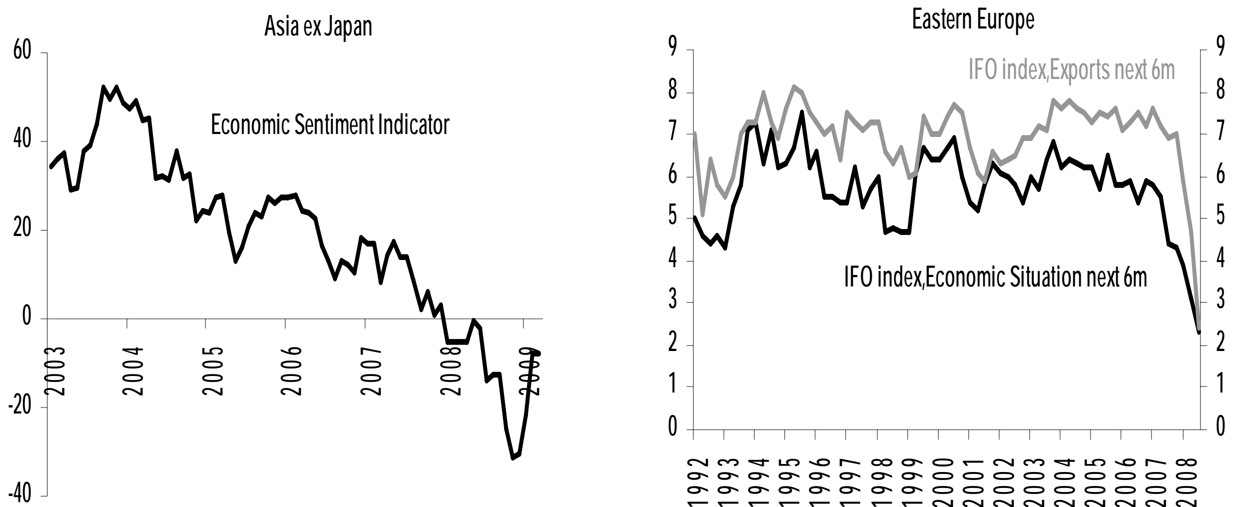
Emerging Asia

The ongoing global slowdown has also dragged down economic activity in the Emerging Asian countries. This is largely confirmed by the recent releases of Q4 08 GDP from Korea and China. Particularly, Korea's economy contracted by 3.4% y-o-y for the first time since 1998, while China's real GDP growth slowed to 6.8% y-o-y, the weakest pace of growth in seven years. Overall, the region faces a number of headwinds entering 2009, including weakening external demand, falling property prices and their dampening impact on investment and consumption growth. However, Emerging Asian countries are better positioned to weather the storm than other regions, due to better external balances. Moreover, easing commodity prices and significant fiscal policy responses are likely to support the region from the contraction of external demand. Indeed, recent economic indicators suggest that growth is probably bottoming out, signalling the recovery of Emerging Asian economies in the second half of the year. In particular, the Asia ex Japan economic sentiment indicator has been increasing since December 2008, suggesting signs of improvement in the Asian economies (figure 4.3, left). China is expected to be the first economy coming out of the current crisis, as strong fiscal and monetary policy response is expected to add about 2 percentage points to real GDP growth in 2009.

Emerging Europe

The impact of the global recession is more apparent in Emerging Europe than in other EM regions, due to the adverse effects of the widespread capital outflows. A rapid slowdown in credit expansion constitutes a major challenge for the region. Moreover, significant currency depreciation threatens to lead to an increase in non performing loans, owing to the prevalent foreign exchange denominated lending. In addition, oil-producing countries, notably Russia, will increasingly suffer from falling oil prices. The latter will prompt further capital outflows and local currency depreciation pressures. Indeed, the Russian economy is heading for its first recession since the 1998 crisis. The Eastern Europe IFO economic situation index has fallen in Q1 09 to its lowest level since the series started in 1992, suggesting that EE will continue to underperform, compared to the rest of the emerging world (Figure 4.3, right).

Figure 4.3



4.1 China Economic Outlook

- Real GDP growth decelerated to its lowest pace in the past seven years in 2008.
- Weakening trend in external demand, manufacturing and real estate investment are the major drags on economic activity.
- Recent economic indicators suggest that the economy is set to slow further in the first half of 2009.
- Strong fiscal and monetary policy response will help China's economy to recover in the second half of this year.

Overview

Tighter credit conditions and collapsing exports have dragged China's economy to its weakest pace of growth in seven years. The combined fiscal and monetary policy actions should help the economy to recover in the second half of 2009. Moreover, although the Chinese economy is in a better position to avoid a hard landing, the risks for economic growth remain significant, as China continues to rely highly on exports. In order to ensure a soft landing for the economy, China's policymakers should steer the economy towards domestic demand.

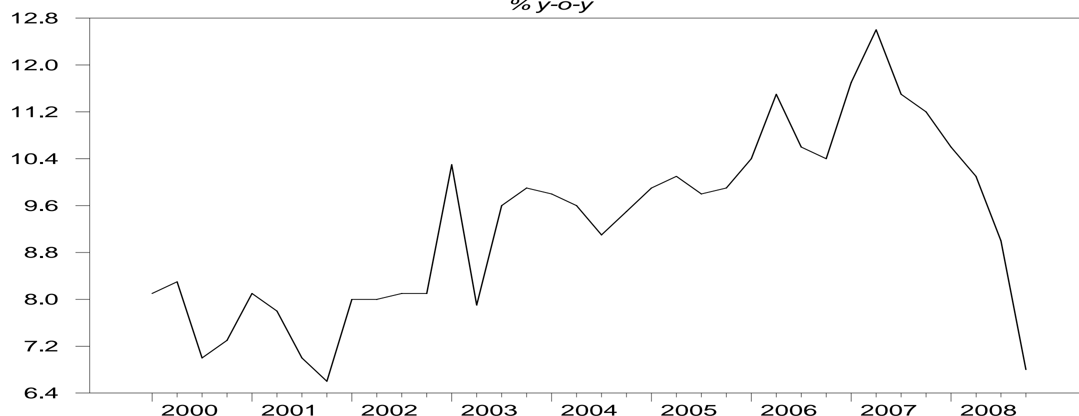
The Chinese economy is experiencing its sharpest slowdown

Real GDP growth decelerated to 6.8% y-o-y in Q4 08, the lowest reading in the past seven years, translating into growth of 9% for 2008 (Figure 4.4). China's growth slowdown was attributable to a combination of weak external demand, manufacturing and real estate investment. Declining exports and the consolidation in local property prices have already weighed on fixed asset investment demand in China. Nominal fixed asset investment increased by 25% y-o-y in 2008. However, when we express fixed asset investment in real terms, using the investment price index, this has in fact slowed below 20% y-o-y in 2008 from an average of around 24% in 2004-07. Moreover, real estate investment growth, which has fallen below 10% in real terms in 2008, is expected to contract in 2009, as firms in the property market adjust their production to the slowing demand and reduced cash flows.

Table 4.1
China Main Economic Indicators and Forecasts

	2007	2008	2009e	2010e
Real GDP (% y-o-y)	13.0	9.0	6.8	8.5
Industrial Production (avg, % y-o-y)	17.5	12.7	7.0	12.0
Inflation (avg, % y-o-y)	4.8	5.9	1.0	2.0
Unemployment rate (avg, %)	4.0	4.2	4.6	4.3
External Balance				
Real Exports of Goods & Services (% y-o-y)	18.0	10.0	-3.0	3.0
Real Imports of Goods & Services (% y-o-y)	15.0	7.0	-5.0	4.0
Trade Balance (% GDP)	7.3	6.8	6.5	6.0
Current Account (% GDP)	11.0	10.0	8.0	7.0
Interest Rates	Dec 2008	Current	Dec 2009	Dec 2010
Lending Interest Rate (%)	5.3	5.3	4.5	5.0
Exchange Rates				
Exchange Rate (USD/RMB, eop)	6.8	6.8	6.8	6.7

Figure 4.4



Recent economic indicators point to a further weakening of growth momentum in H1 2009,…

Meanwhile, the figures from the supply side of the economy validate the pullback in export and investment growth. Industrial production growth slumped to 5.4% y-o-y in November 2008, from an average of almost 18% y-o-y in 2007. Leaving aside the months influenced by the Chinese New Year seasonal distortions, this reading is the lowest since 1991. Meanwhile, the slight increase in industrial production growth to 5.7% y-o-y in December 2008 may indicate that growth is bottoming out, signalling the recovery of China's economy in the second half of the year. The PMI survey shows a slight rebound of confidence in manufacturing, triggered by gains in both new orders and export orders. However, the index remains below the 50-point-level that indicates economic expansion, for a fifth consecutive month.

Consumer indicators suggest that private consumption has so far held up reasonably well, with nominal and real retail sales increasing by 22% y-o-y and 17%, respectively, in 2008. However, the NBS index of consumer confidence eased further to 86.8 in January 2009 from its peak of 98 in June 2007, its lowest level since early 2003, indicating that the short-term outlook for private consumption is particularly weak. The downbeat private consumption outlook is also confirmed by tightening labor market conditions. Employment growth has levelled off and the unemployment rate has edged from 4% in 2007 to 4.2% in 2008. Indeed, weak economic conditions have cost the jobs of 20 million migrant workers. Although the employment index of the PMI manufacturing survey increased slightly to 46.1 in February 2009 from 43 in January, it is still well below its recent peak of 53.4 in March 2008, providing further evidence of more downward pressure on private consumption.

…with net exports being a major drag on economic activity

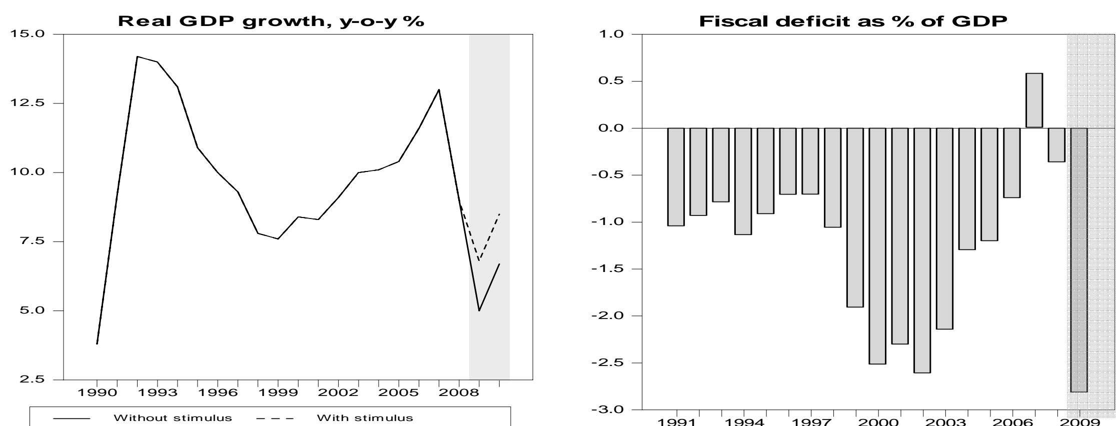
The dramatic weakening of export growth and its spill over effects on the real economy continues to be one of the main challenges for China's economy. Exports contracted sharply in February (-25.7% y-o-y), as demand dried up in the US and Europe. Import growth plunged by an average of 33.6% y-o-y in the first two months of 2009, confirming the dramatic deterioration of domestic industrial activity. However, the trade slump was likely exacerbated by the Chinese New Year effect. Leaving aside the weakness in January, the overall picture still remains weak, but it seems that the

pace of decline is at least abating. Indeed, the PMI new exports orders index increased to 43.4 in February 2009 from 33.7 in January 2009. Moreover, the PMI imports index has increased for the third consecutive month in February 2009 to 41.8 from 39.9 in January 2009. Although this turnaround indicates positive trade prospects, the indexes remain well below the threshold of 50 that indicates contraction. The weaker demand from US and Europe coupled with the slowdown in industrial activity in the OECD countries and the deteriorating consumer and industrial confidence indicators, as well as the strong local currency against the US dollar are likely to reduce real export growth to around -3% in 2009 and 3% in 2010 from 10% in 2008.

The Chinese economy is set to recover in H2 2009, due to a large fiscal stimulus, …

The Chinese government has already announced a CNY4 trillion ($586 billion) stimulus package, to be spent over the next few years. The total size of the stimulus package is about 13% of GDP (2008 GDP), namely 6.5% of GDP per year. About 30% (CNY1.18 trillion) of the total funding will come from the central government, while the remainder will be financed by local governments, commercial banks and businesses. The package focuses mainly on infrastructure-related projects. Assuming that government spending is injected directly into the economy, the stimulus package is expected to add about 2 percentage points to real GDP growth in 2009, with the impact emerging in H2 2009. Real GDP growth is expected to moderate to 6.8% y-o-y in 2009 and recover to 8.5% y-o-y in 2010 (figure 4.5 left). Meanwhile, the growth rate of total government revenue is expected to decline, due to the economic slowdown and tax cuts that are already in place. The latter coupled with the government's generous spending will lead the fiscal deficit to widen further to 2.8% of GDP in 2009 (figure 4.5, right).

Figure 4.5

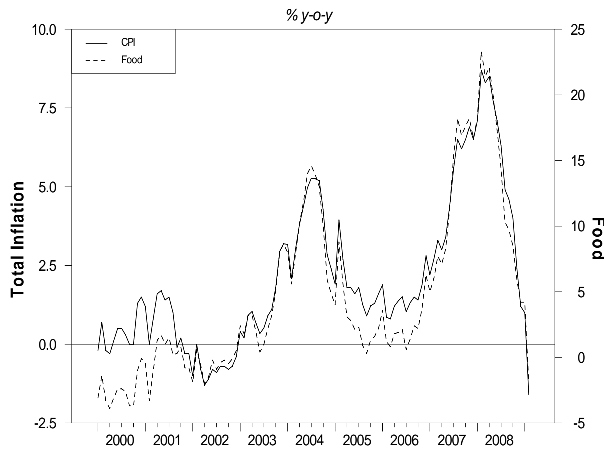


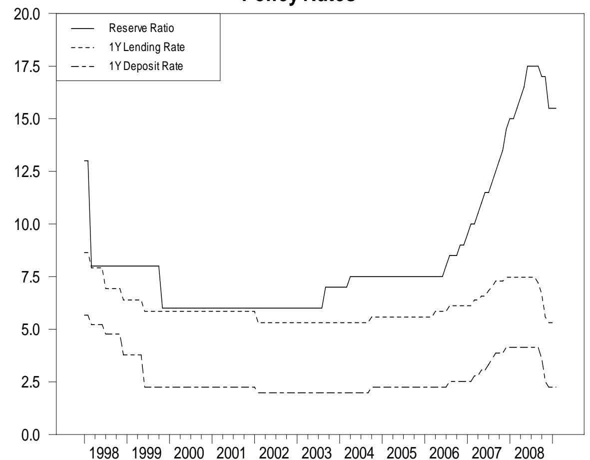
…as well as further monetary easing, prompted by a low-inflation environment

The PBoC has loosened monetary policy in recent months in order to combat the concerns about the slowdown of the economy and the deflationary risks (figure 4.6, right). Looking forward, we expect further cuts in the reserve ratio and the benchmark interest rates to take place in the rest of 2009.

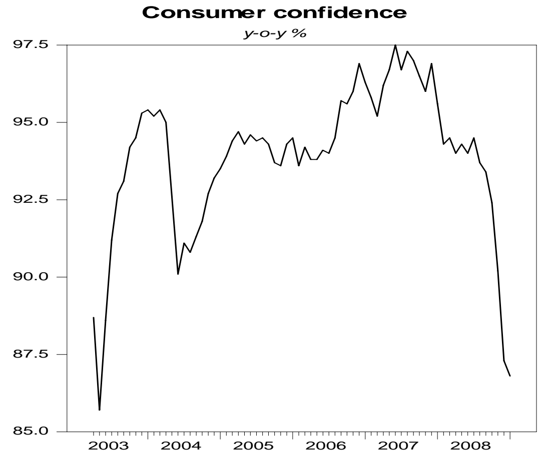
After hitting multi-year highs in 2008, headline CPI inflation declined by 1.6% y-o-y in February 2009, reflecting the weakening state of the economy, the collapse of commodity prices and the fading effect of one-off shocks (figure 4.6, left). As a result, concerns were shifted from rising inflation to the emergence of deflation. Although, we will probably see some months of negative inflation, we believe that deflation will be avoided, with forward looking indicators reinforcing this view. Input prices from the PMI survey showed a further rise in February, while money supply growth rate (M2) accelerated over the past couple of months. Moreover, the stimulus package will also prevent the economy from falling into deflation. We expect headline CPI inflation to fall to 1% in 2009 from 5.9% in 2008.

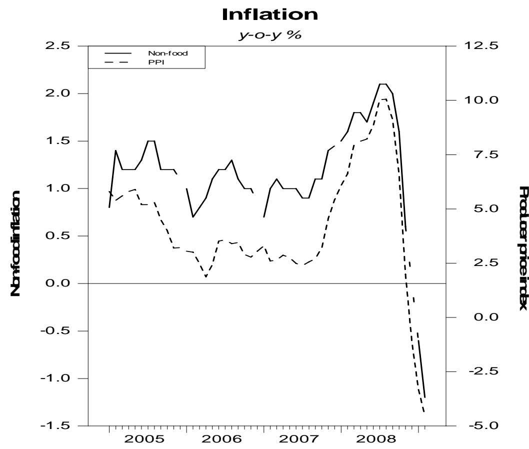
Figure 4.6

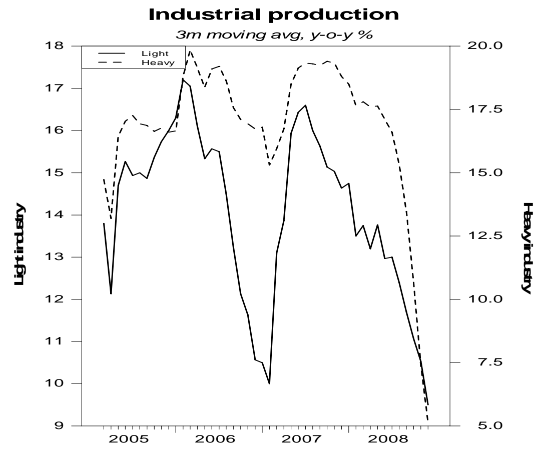


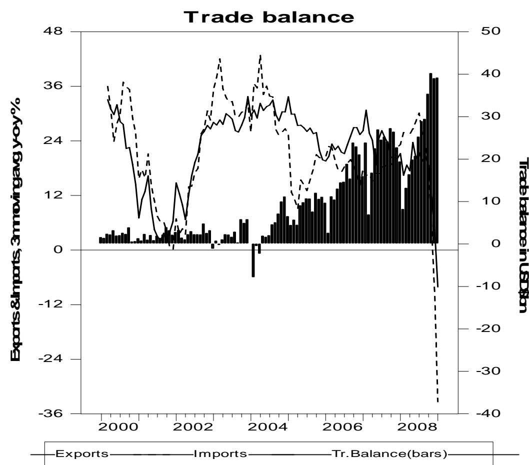


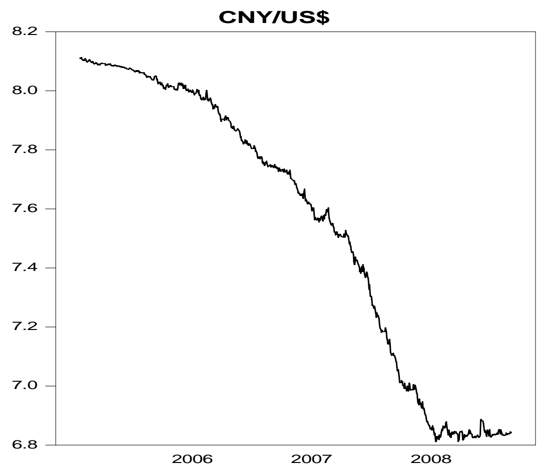
CHINA CHARTS











4.2 India Economic Outlook

- India's economy has slowed sharply in Q4 08 to its lowest level since 2003 (5.3% y-o-y), on the back of a rapid deterioration in the manufacturing, agriculture and exports sector.
- India is in a better position compared with other economies in the region to recover from the global economic slump, given that it is less dependent on exports.
- Benign inflation prospects will allow the central bank to proceed with further rate cuts over the rest of 2009, in order to support economic growth.

Overview

After five years of impressive performance, India's economic growth is slowing down sharply, amid global financial strains and increased risk aversion in the domestic financial sector. In order to reduce downside risks to growth, the government has already unveiled a series of fiscal packages that aims at boosting domestic demand and providing support to exporters. Moreover, the overall deflationary environment gives the Reserve Bank of India room for further rate cuts, adding to the proactive easing measures that the Central Bank has already initiated. Meanwhile, the government's generous spending will boost the fiscal deficit, intensifying downside risks to economic growth, as it limits India's ability to attract capital, as well as to respond to a further deterioration in global economic prospects. Indeed, Standard & Poors has recently downgraded India's sovereign outlook to 'negative' from 'stable'.

India's economy has entered a period of a moderate slowdown,...

Real GDP growth slowed sharply to 5.3% y-o-y in Q4 08, its lowest level since 2003, on the back of a rapid deterioration in the manufacturing, agriculture and exports sector. Commercial banks' reluctance to pass on interest rate cuts to customers, has led to rising lending costs, discouraging consumer spending and investment. Slackening domestic demand alongside tight liquidity conditions made the deceleration most pronounced in the industrial sector, where the pace of growth slumped to 2.4% y-o-y in Q4 08 from an average of 9.4% y-o-y in 2007. The slowdown has also hit the agricultural and services sector, resulting in declining contributions to real GDP growth (Figure 4.7, left).

Table 4.2

India Main Economic Indicators and Forecasts

	2007	2008	2009e	2010e
Real GDP (% y-o-y)	9.2	7.4	4.5	6.5
Industrial Production (avg, % y-o-y)	10.0	4.2	3.0	4.0
Inflation (WPI, avg, % y-o-y)	4.7	9.1	2.0	4.0
External Balance				
Real Exports of Goods & Services (% y-o-y)	7.5	9.5	4.0	7.0
Real Imports of Goods & Services (% y-o-y)	7.7	9.0	3.0	8.0
Trade Balance (% GDP)	-7.0	-10.0	-9.0	-9.0
Current Account (% GDP)	-1.5	-3.5	-2.5	-2.0
Interest Rates	Dec 2008	Current	Dec 2009	Dec 2010
Short Term Interest Rate (Repo rate, %)	6.50	5.00	3.50	3.50
Exchange Rates	Dec 2008	Current	Dec 2009	Dec 2010
Exchange Rate (USD/INR, eop)	48.7	50.4	47.0	46.0

Although real private consumption held up relatively well, growing by 5.4% y-o-y in Q4 08 compared to 6.9% y-o-y in the previous quarter, the outlook seems rather unfavorable for the rest of the year, as tight lending standards and deteriorating labor market conditions erode households' purchasing power. Indeed, given that India is capitalizing on its workforce to become a major exporter of software services, the slowing external demand weighs on software exports and, consequently, on the labor market. Meanwhile, real fixed investment -the fastest growing component of domestic demand- was hit hard by tighter credit conditions, decelerating to 5.3% y-o-y in Q4 08 from 15% in Q3 08 (Figure 4.7 right). Confirming expectations of moderating economic activity, the Dun and Bradstreet composite business optimism index declined by 43.3% y-o-y in Q4 08. Moreover, the latest industrial production figures are actually in line with the downward trend in consumer and investment spending. Indeed, industrial production contracted by 0.6% y-o-y in December 2008 -its first contraction in more than a decade- providing further evidence of a downturn in activity (Figure 4.8). Besides, the PMI manufacturing index has gradually decreased to 44.4 in December 2008 from its recent peak of 61.9 in December 2007. Meanwhile, the index has improved slightly over the past couple of months, supporting the view that economic activity in emerging market is bottoming out in H1 2009.

Indeed, while the near term outlook remains bleak, India is in a better position compared with other economies in the region to recover from the global economic slump, given that it is one of the Asian economies least dependent on exports (total exports account for about 20% of GDP, while China's total exports represent 40% of GDP). On the other hand, the government's generous spending will partly contribute to the stimulation of the economy, as it will constrain its efforts to narrow the fiscal deficit, undermining economic stability. Indeed, the fiscal deficit widened to 6% of GDP in 2008 from 2.5% in 2007. In this vein, we believe that real GDP growth is set to slow to 4.5% y-o-y in 2009 and pick up to 6.5% y-o-y in 2010.

Figure 4.7
Real GDP Growth

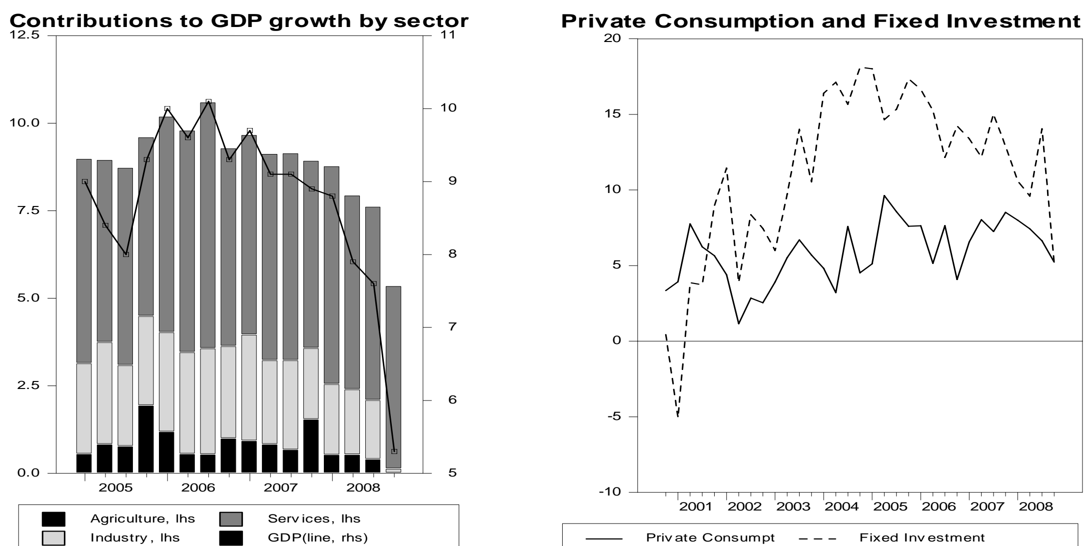
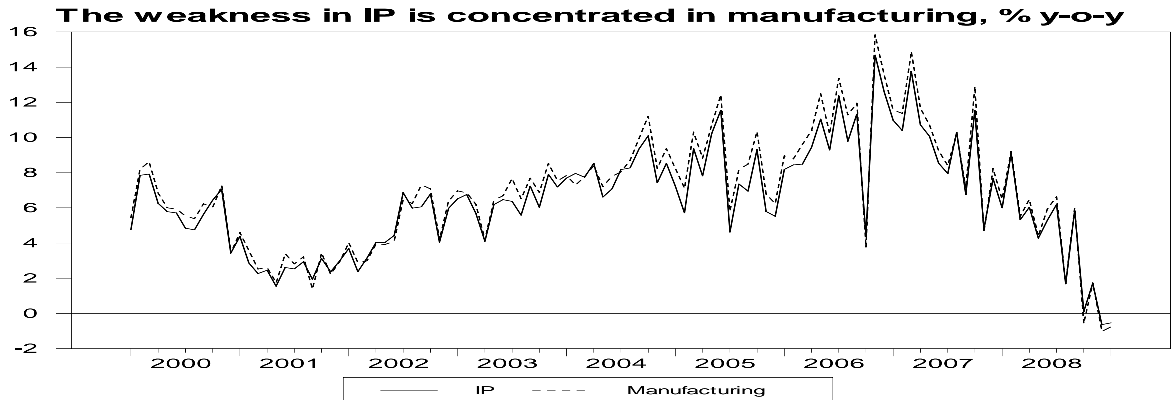


Figure 4.8



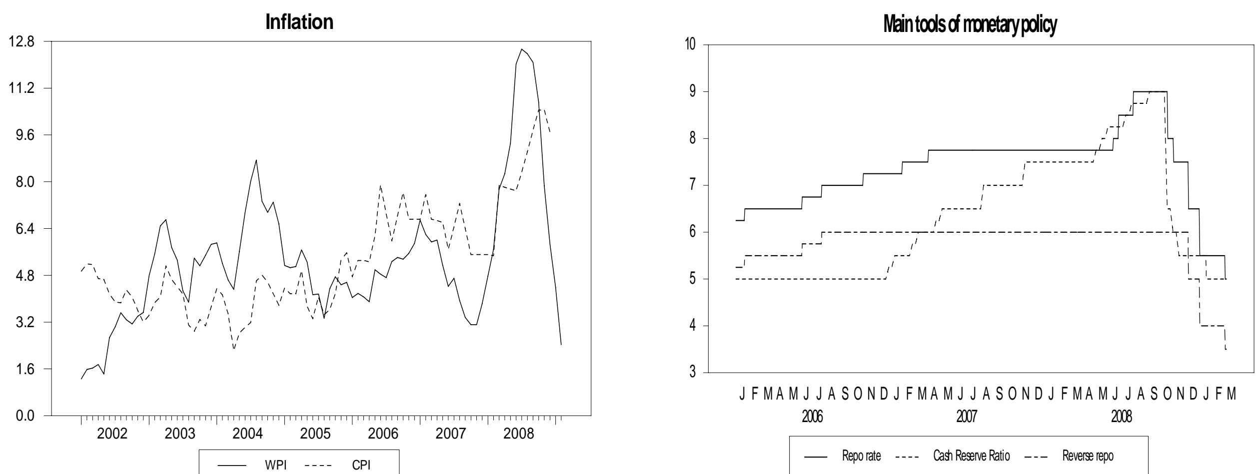
...with exports outlook deteriorating as global economy slows

Although exports have been accelerating during the most part of 2008, incoming data point to a continued weakening outlook for exports. Merchandise exports, in dollar terms, fell sharply for a fourth consecutive month in January 2009, amid dampening demand for India's goods. Indeed, merchandise shipments contracted by 16% in January, the biggest decline since 1998. While exports are likely to remain sluggish for the rest of the year, slowing consumer spending, investment and industrial activity along with easing oil prices will undermine import growth. Thus, downside risks to the trade deficit will be contained, taking away a key concern for India's economy.

Easing inflation supports rate cuts

Inflationary pressures have been sufficiently relieved, with wholesale price inflation (WPI) falling to 2.4% y-o-y in February 2009 from an average of 9.1% in 2008 (figure 4.9, left). Favorable base effects coupled with declining fuel prices will bring inflation further down. In the meantime, given increased concerns over domestic liquidity and macroeconomic stability, the Reserve Bank of India has continued its easing monetary stance. Since October 2008 the RBI has cut the repo rate by a total of 400bps (figure 4.9, right). Benign inflation prospects will allow the central bank to proceed with further rate cuts over the rest of 2009.

Figure 4.9



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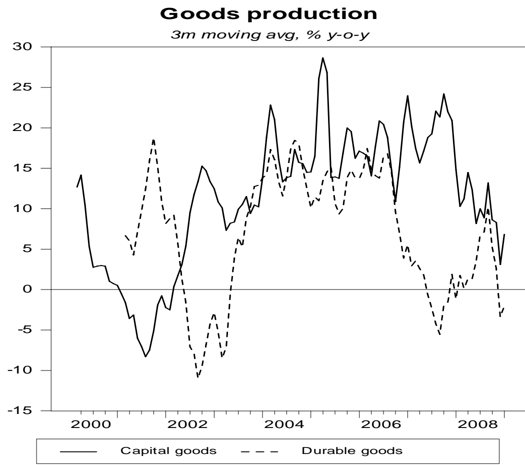
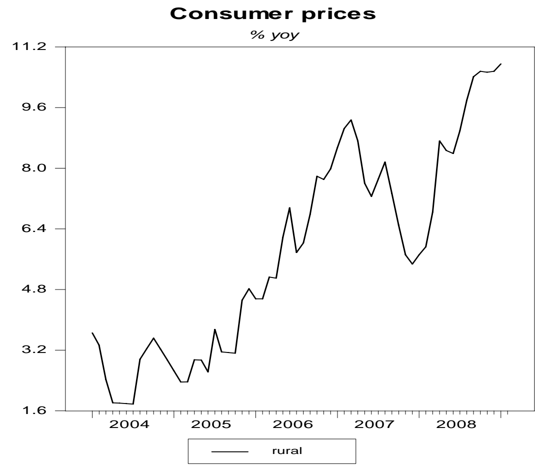
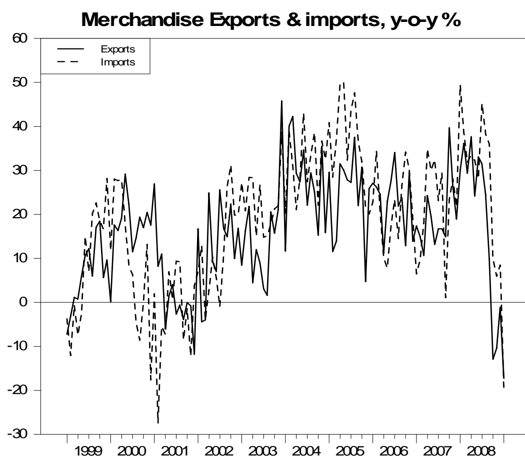
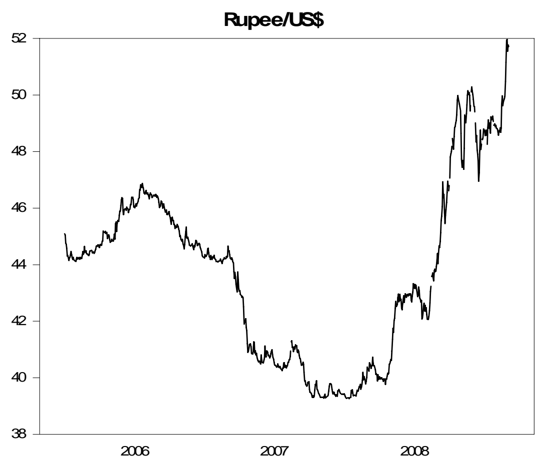
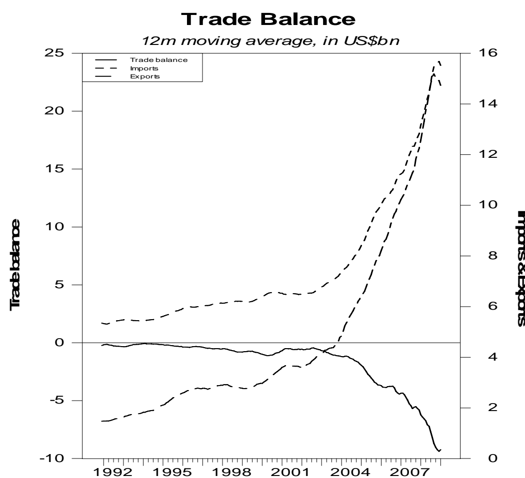
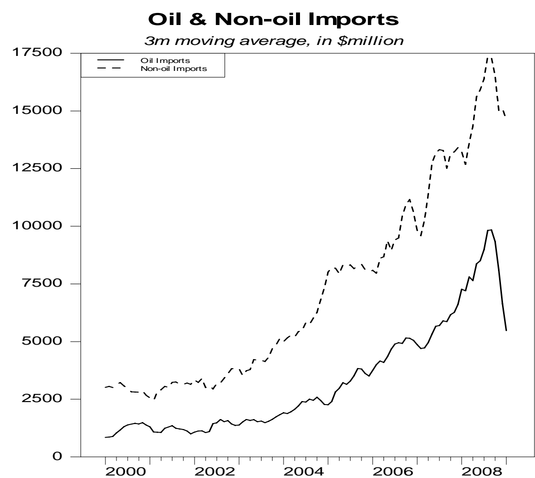












4.3 Russia Economic Outlook

- The Russian economy is heading into a severe recession on the back of falling oil prices, a collapse of private investment and weak capital flows.
- Although the Russian government unveiled various measures in order to foster domestic market liquidity, the intensified liquidity problems in the financial sector have had a significant negative impact on the country's macroeconomic outlook.
- The extent to which the current financial crisis will affect Russia's real economy largely depends on the size of the correction in global oil prices.
- The main issue is whether the economy will manage to rebound sharply in 2010, as it did following the 1998 crisis.
- In our view, the Russian economy is set to recover only modestly in 2010, growing by 1% y-o-y, due to the collapse in global demand.

Overview

In the context of a sharp adjustment in global oil and energy prices, an ongoing global liquidity squeeze and a sharp decline in global economic activity, Russia's business and economic outlook has darkened. Large capital outflows resulted in a stock market slump and liquidity shortages in the domestic money market. Meanwhile, policymakers are confronted with the challenge of providing liquidity support to the financial system at the same time when the ruble has been depreciating against the dollar/euro basket since August 2008. Tighter credit conditions coupled with declining oil prices intensify downside risks for investment and private consumption, suggesting that the Russian economy is heading for its first recession since the 1998 crisis.

Real economic growth is slowing amid global financial turmoil

Confirming a weakening economic outlook, real GDP growth slowed to 5.6% y-o-y in 2008 from 8.1% in 2007, implying no more than 2% y-o-y growth in Q4 08 compared to an average of 7.4% y-o-y in the first three quarters of 2008 (Figure 4.10).

Table 4.3

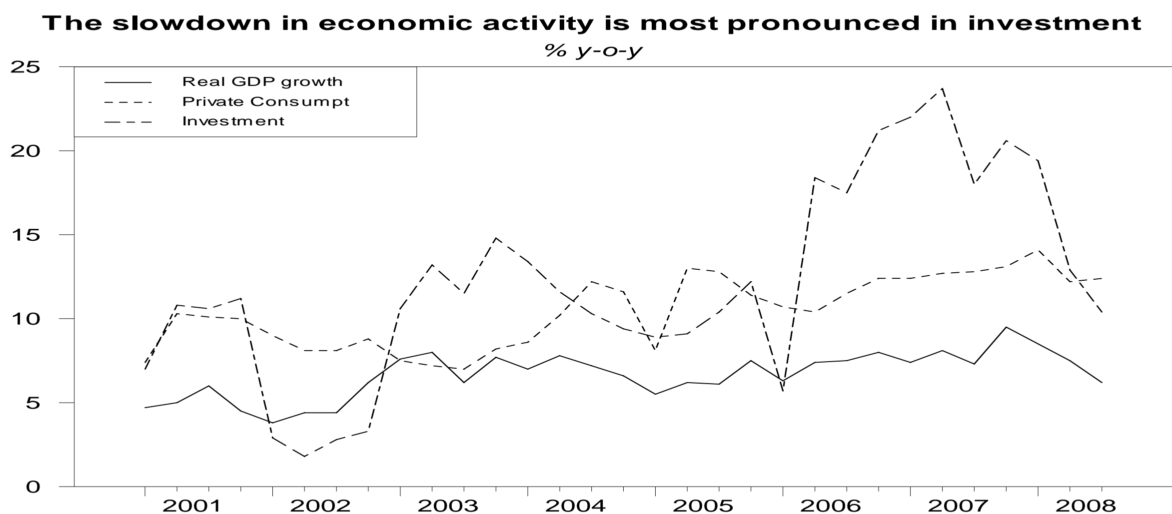
Russia Main Economic Indicators and Forecasts

	2007	2008	2009e	2010e
Real GDP (% y-o-y)	7.4	5.6	-3.0	1.0
Industrial Production (avg, % y-o-y)	6.3	2.7	-8.0	2.0
Inflation (avg, % y-o-y)	9.0	14.1	12.0	10.0
Unemployment rate (avg, %)	6.1	6.3	9.0	9.0
External Balance				
Real Exports of Goods & Services (% y-o-y)	6.2	1.0	-5.0	3.0
Real Imports of Goods & Services (% y-o-y)	27.5	17.0	-10.0	5.0
Trade Balance (% GDP)	10.1	10.5	5.0	7.0
Current Account (% GDP)	6.0	6.0	1.0	3.0
Interest Rates	Dec 2008	Current	Dec 2009	Dec 2010
Refinancing Rate (%)	13.0	13.0	13.0	12.0
Exchange Rates	Dec 2008	Current	Dec 2009	Dec 2010
Exchange Rate (USD/RUB, eop)	29.4	34.7	35.0	35.0

In fact, the slowdown is reflected in several economic activity indicators, with the most pronounced slide witnessed in domestic demand where growth has been dragged down by a halving in real investment spending. Indeed, fixed capital investment growth, which is more prone to volatility in an economic downturn, contracted by 15.5% y-o-y in January 2009 for the first time since the 1998 financial crisis, in the wake of higher borrowing costs, tighter domestic liquidity conditions and increased uncertainty surrounding investors. Figures from the labor market suggest that the short-term outlook for private consumption is particularly weak. In particular, retail sales growth declined by 2.4% y-o-y in February 2009 from an average of 8.4% y-o-y in 2008, owing to higher interest rates and a slump in real wages. In the meantime, the unemployment rate has increased by 3.1 pp in February 2009 since its recent trough in May 2008, while employment growth has been declining by an average of 0.4% y-o-y over the past three months, adding to the pressures already weighing on consumers.

The latest data on industrial activity suggest that production has started to feel the effects from the pullback in consumer spending. Industrial output fell sharply for the fourth consecutive month in February by 13% y-o-y, reporting the worst performance since August 1998, with the weakness concentrated mainly in the manufacturing sector. Meanwhile, although the PMI manufacturing index improved slightly to 40.6 in February from 34.4 in January, indicating that the pace of the decline in manufacturing has slowed, it is still well below its recent peak of 55.3 in January 2008. Thus, industrial production is likely to remain in a negative territory in the coming months.

Figure 4.10



The economy is set to contract by 3% in 2009, with falling commodity prices and downward pressures on the ruble posing significant risks to the growth outlook

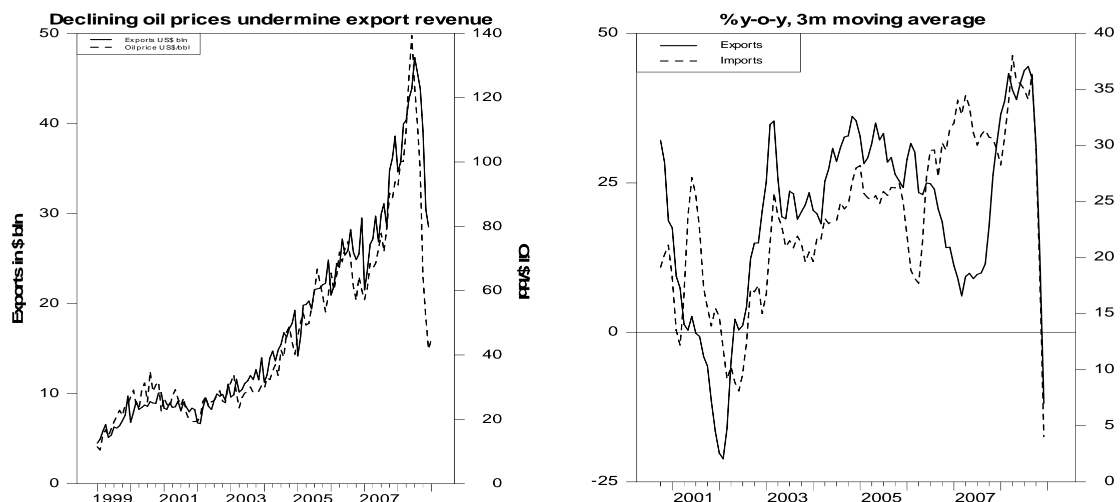
Recently, the Russian government unveiled measures such as tax cuts, allocation of budget funds into the financial system and lower reserve requirements for banks in order to foster domestic market liquidity. But even with liquidity injections, the intensified liquidity problems in the financial sector have a significant negative impact on the country's macroeconomic outlook. Since Russia is one of the world's major oil producers and exporters, its economic outlook is

mainly dependent on the size of the adjustment in global oil and energy prices. The sharp decline in international oil prices has accelerated capital outflows and, consequently, has exacerbated pressures on the ruble. As a result, the Russian Central Bank has intervened in the market to keep the RUB from depreciating too quickly, contributing to a decline in international reserves of more than $200 billion since early August. In order to stem the erosion of foreign reserves and stabilize the RUB, the RCB was forced recently to tighten monetary policy by raising interest rates, constraining its ability to respond to the downside risks to the real economy. Additionally, the decline in international oil prices has a significant impact on fiscal revenues, thus reducing the margin for carrying out expansionary fiscal policy. According to our estimates, should oil prices average 40$/barrel in 2009, real GDP growth seems likely to contract by 3% in 2009 and recover only modestly in 2010, growing by 1% y-o-y. A sharp recovery mainly hinges on a significant increase in commodity prices, a substantial fiscal package and a general improvement in financial and external demand conditions.

Should external demand deteriorate further, our forecasts are skewed to the downside. Indeed, the slowdown of exports is well underway, with Russia's trade activity losing momentum. Exports declined by 43% y-o-y in January 09, on the back of falling oil prices and weakening global demand, following an increase of almost 40% y-o-y in 2008 (figure 4.11). Given that Europe, Russia's main trading partner, is facing its worst slowdown, exports growth will probably remain extremely weak for the rest of the year, adding to concerns for a sharp deceleration of economic growth.

Figure 4.11

Exports & Imports



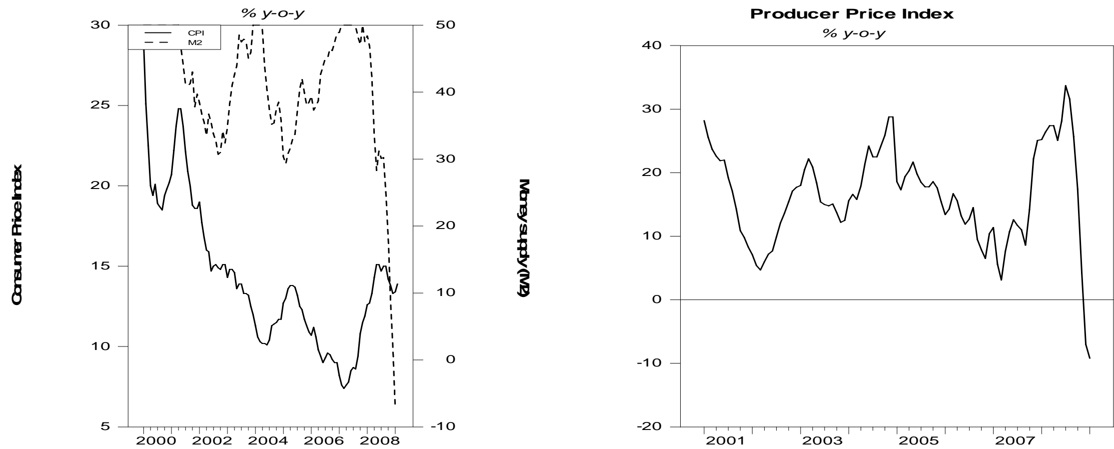
Inflationary pressures remain high

Defying the recent correction in oil prices and the weakening state of the economy, a significant source of risk for Russia's inflation outlook seems to stem from the pass-trough effect from currency depreciation. Indeed, after peaking at 15.1% y-o-y in June 2008, headline CPI inflation moderated only slightly to 13.9% y-o-y in February 2009 (Figure

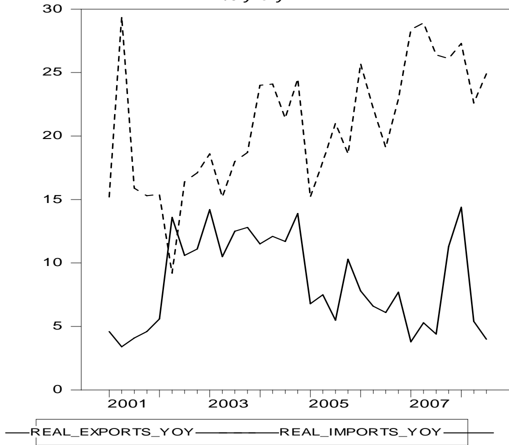
4.12, left). Producer price inflation, an early gauge of inflationary pressures in the economy, may limit only partially the inflationary pressures, given that it has collapsed in recent months from its peak of 33.7% y-o-y in July 2008 (figure 4.12, right). Hence, we expect inflation to remain in double digit territory in 2009. According to our estimates, a decline in average oil prices for Brent to $40/barrel in 2009 will bring inflation down to 12% in 2009 from 14% in 2008.

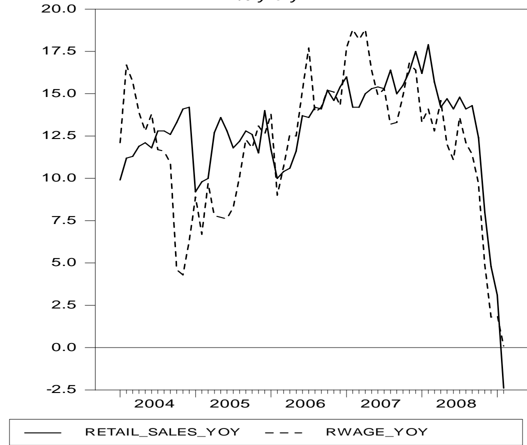
Figure 4.12

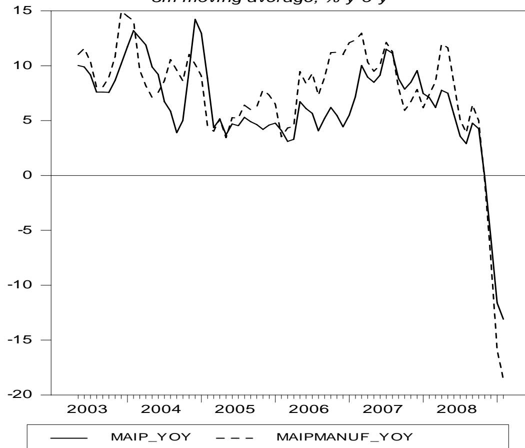
Inflation is still running at double digit rates

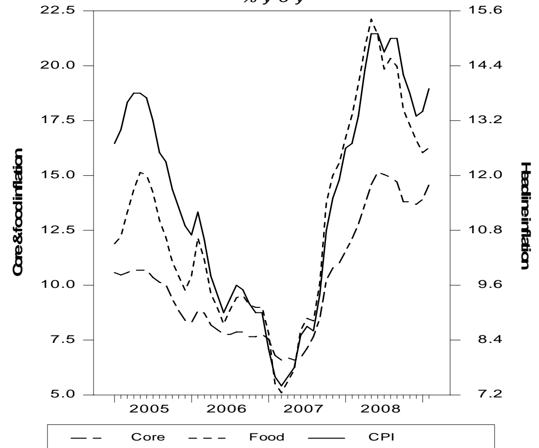


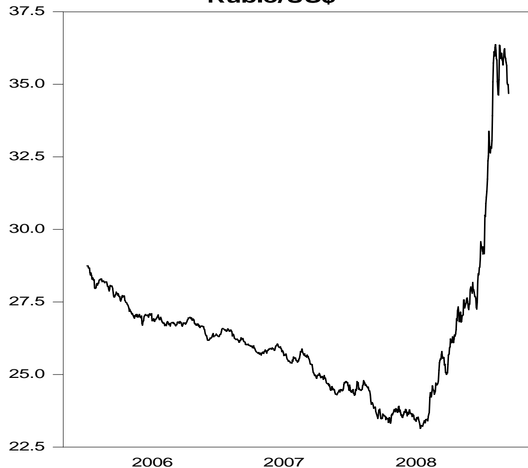
RUSSIA CHARTS

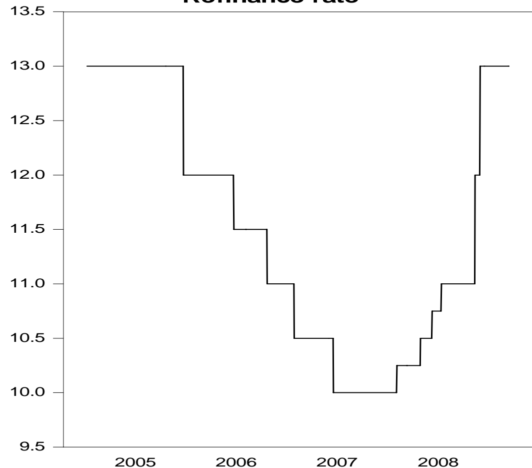












4.4 Brazil Economic Outlook

- Recent economic indicators provide clear evidence that Brazil's economic activity is bound to experience a prominent slowdown.
- The labor market has just started to weaken, suggesting that the worst is still to come over the next few months.
- The slowdown in investment and private consumption growth would be the major drags of economic activity.
- The negative contribution of the external sector to real GDP growth is likely to soften, whereas weakening domestic demand will lead to a huge drop in import growth.
- Ensuing disinflation pressures will allow the Brazilian Central Bank to respond to the downside risks to growth.

Overview

As we have already envisaged in our previous issue (November 2008), tighter credit conditions coupled with growing external risks and a reversal in commodity prices have started to weigh significantly on Brazil's economic growth after the third quarter of 2008. According to a series of poor macroeconomic data, Brazil may suffer a GDP contraction in the first half of 2009 and witness zero growth on a yearly basis. Worsening economic conditions will generate a disinflationary environment, allowing the central bank to proceed with further rate cuts, since the risks are skewed toward a deeper economic contraction.

Increasing signs of a deteriorating economic environment

Although successful macroeconomic policies enhanced the resilience of the economy to the global slowdown, maintaining its growth momentum for the first three quarters of 2008, recent economic indicators provide clear evidence that Brazil's economy is bound to experience a sharp slowdown. Real GDP growth deteriorated markedly in Q4 08, slowing to 1.3% y-o-y from 6.8% y-o-y in Q3 08, in the wake of falling external and domestic demand (figure 4.13, left). Economic activity lost remarkable momentum in Q4 2008, when exports declined by 7% y-o-y and private consumption growth fell to 2.2% y-o-y.

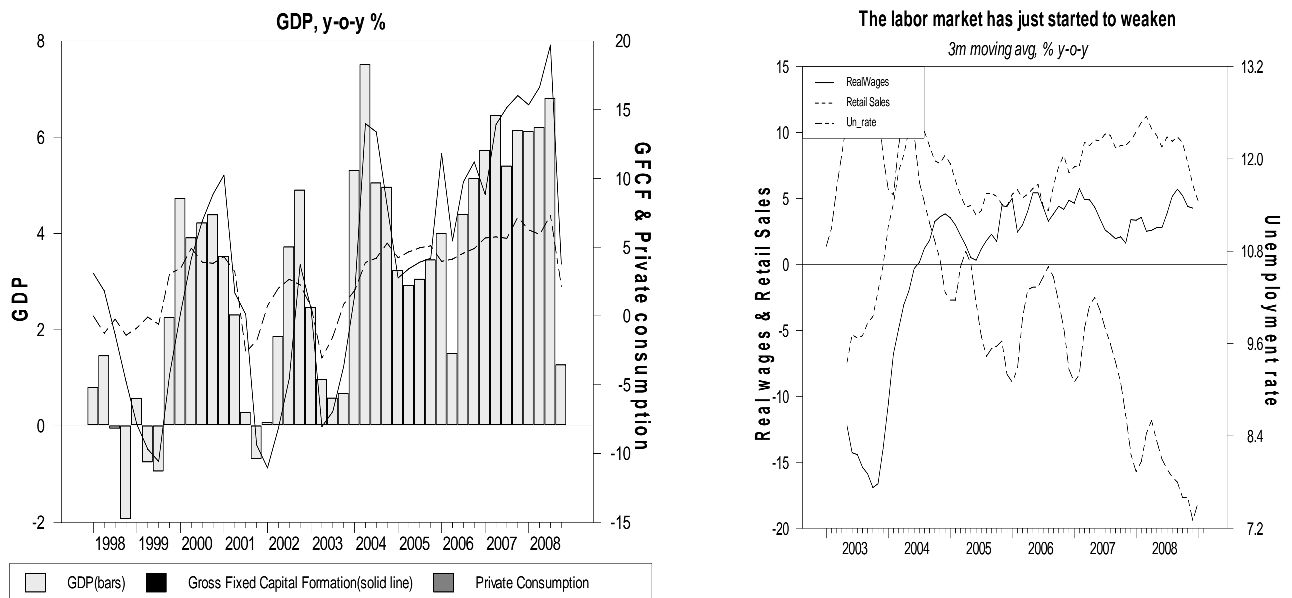
Table 4.4
Brazil Main Economic Indicators and Forecasts

	2007	2008	2009e	2010e
Real GDP (% y-o-y)	5.7	5.1	0.0	3.0
Industrial Production (avg, % y-o-y)	5.9	3.1	-2.0	3.5
Inflation (avg, % y-o-y)	3.6	5.7	4.5	3.5
Unemployment rate (avg, %)	9.3	7.9	10.0	9.0
External Balance				
Real Exports of Goods & Services (% y-o-y)	6.7	1.0	-5.0	5.0
Real Imports of Goods & Services (% y-o-y)	20.8	17.0	-10.0	5.0
Trade Balance (% GDP)	3.0	1.5	0.8	1.0
Current Account (% GDP)	0.1	-1.8	-2.0	-2.0
Interest Rates	Dec 2008	Current	Dec 2009	Dec 2010
Short Term Interest Rate (Selic rate, %)	13.75	11.25	9.50	9.50
Exchange Rates	Dec 2008	Current	Dec 2009	Dec 2010
Exchange Rate (USD/BRL, eop)	2.3	2.3	2.5	2.4

The figures from the supply side of the economy indicate that industrial production has already felt the effects from the tighter credit conditions and the external slowdown. Indeed, industrial production growth marked a cumulative contraction of 35% y-o-y since November 2008. Weak industrial production data suggest that firms have started to meet demand by reducing inventories, undermining investment and employment.

Indeed, the labor market has just started to weaken, suggesting that the worst is still to come over the next few months. The unemployment rate has increased to 8.2% in January 2009 from its multi-year low of 6.8% in December 2008 and is expected to increase further as firms adjust their production. The slack in the labor market is expected to depress wages, which have marked a considerable growth over the past few years. Nominal and real wages have increased by an average y-o-y growth rate of almost 10% and 4%, respectively, in 2008. Given that the labor market is an important driver of household spending and that consumer credit growth has slowed markedly, particularly for car purchases, private consumption is expected to lose its momentum, witnessed during the last few years. Indeed, overall retail sales growth eased to 6% y-o-y in January 2009 from an average of 9.4% y-o-y in 2008 (Figure 4.13, right). The negative outlook of private consumption is also confirmed by the FGV consumer confidence index which has dropped to 96.3 in Februry 2009, its lowest reading since the series started in 2005.

Figure 4.13



Real GDP will be flat in 2009, …

Taking into account the series of poor macroeconomic data, the risk of a real GDP contraction in the first half of 2009 has increased substantially. The slowdown in investment and private consumption growth would be the major drags of economic activity, while the negative contribution of the external sector to real GDP growth is likely to soften, whereas weakening domestic demand will lead to a significant drop in imports. The latter will partly outweigh the deteriorating

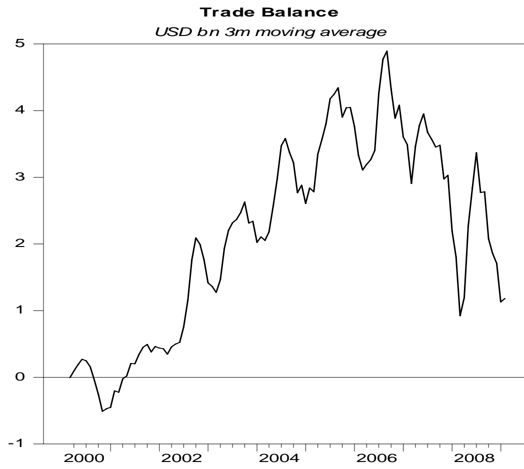
outlook of external demand, containing the widening of the current account deficit. On the budgetary front, fiscal revenue growth fell to zero in December 2008. Given that this downward trend will likely continue in 2009, due to slowing external demand and corporate earnings erosion, the promotion of increased public and private investment in infrastructure may be slowed, allowing the government to meet its primary fiscal surplus target of 3.8% of GDP. Overall, we expect real GDP growth to remain flat in 2009 and rebound to 3% y-o-y in 2010.

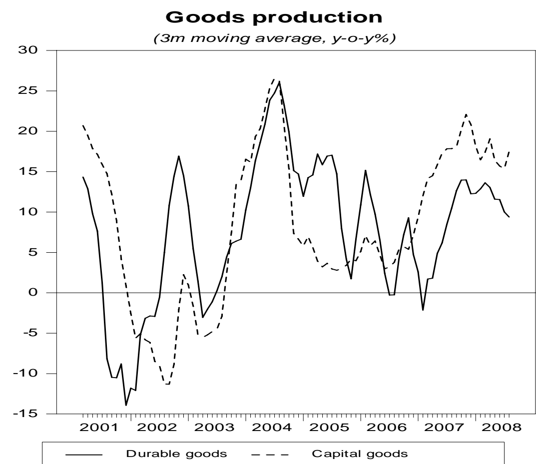
…resulting in lower inflation

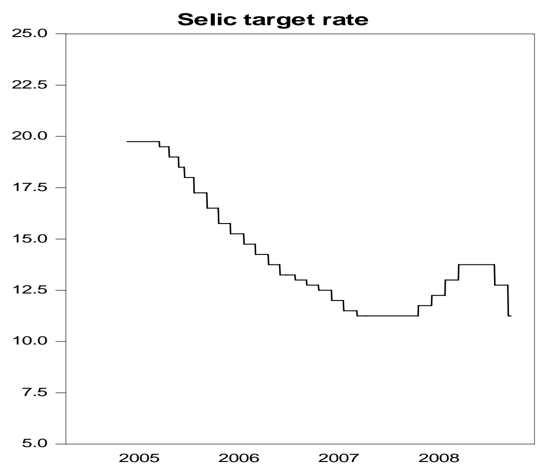
Cooling domestic demand and lower commodity prices are likely to contain inflation pressures, stemming from the pass-trough effect from currency depreciation. Brazil's inflation dropped slightly to 5.9% y-o-y% in February 2009, after having increased steadily since the first quarter of 2008 well above BCB's target rate of 4.5% (figure 4.14). The general economic downturn has led to a downward adjustment of inflation expectations for 2009 to 4.7% from their peaks of 6.0% at the beginning of the year. Thus, we expect inflation to decline to 4.5% y-o-y in 2009, allowing the Brazilian Central Bank to respond to the downside risks to growth. After a decrease of 250 basis points in the Selic interest rate since January 2009, we expect that the BCB should pave the way for more interest rate cuts.

Figure 4.14

BRAZIL CHARTS







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