Global Economic Monitor

December 2011/January 2012

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THE EURO CRISIS RIPPLES SPREAD

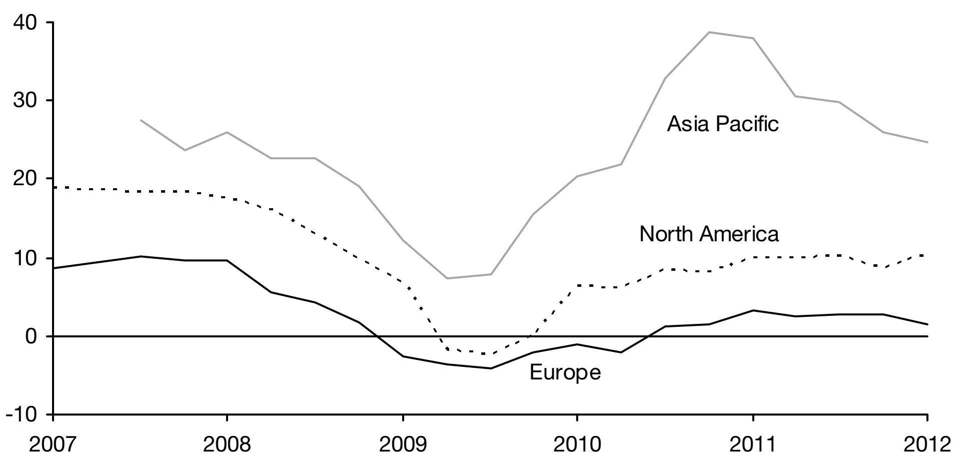
- Our global growth forecasts for 2011-12 continue to edge down, although the overall reduction this month is a modest one: one tenth, to 3.2%, in 2011 and two tenths, to 2.8%, in 2012. Significantly, our downward revisions this month are concentrated in parts of Europe beyond the Euro Area, and in Asia. In both regions, the markdowns affect both mature and emerging economies. While there are many country-specific factors contributing to these revisions, one broad theme is the spread of negative ripples from the economic and financial disruptions in the Euro Area of recent months.

- The Euro Area crisis has elicited significant policy responses. Time will tell whether measures agreed to by Euro Area governments at their most recent December summit will be implemented and, if so, whether they will be successful. In the meantime, however, the ECB has become far more supportive, helping dampen some of the damage inflicted on the region's banking sector by over-enthusiastic EBA stress tests.

- The U.S. economy continues to perform relatively strongly, and we have marked our 2011Q4 GDP growth forecast up to 3.5%q/q, saar. Although we continue to project renewed moderation in 2012H1, a solid private sector domestic expansion may at last now be taking hold, and could be the major global upside surprise in 2012.

- We have extended our global forecast to 2013, when we project growth to accelerate by almost a full percentage point, to 3.7%, led by a broad-based rebound in Europe.

Chart 1
Manpower Survey: Business Hiring Plans
net balance of hirings, 3 months ahead, labor force weighted, seasonally adjusted



The latest hiring intentions survey from a global outplacement firm, Manpower, points to a moderation in European hiring plans, but an uptick from firms in North America.

Global Overview

2011: A SHOCKING YEAR

- A year ago, we were projecting 2011 growth to be 6.2% in emerging economies and 2% in mature economies. In both cases, this implied a moderation from rates achieved in 2010. As 2011 draws to a close, however, even those forecasts look, in retrospect, to have been too optimistic.
- In our defense, 2011 was a somewhat shocking year, in the sense that a number of developments occurred that were either genuinely exogenous to our economic forecast (e.g. the Japanese earthquake and tsunami in March and the Thai floods in September-October), or which were very hard to predict (e.g. social unrest in some Arab economies, leading to higher oil prices through April).
- Oil prices were higher on average in 2011 than we had projected last December: Brent prices will have averaged about $110 per barrel (pb), about $30 pb higher than we had forecast a year ago. Moreover, oil prices were more volatile and an unprecedented gap opened up between Brent and WTI prices (Chart 2). A few years ago, such a sustained divergence would have been inconceivable.
- Asia's importance in shaping the global industrial cycle was highlighted by the role that key exogenous events played in making global IP quite volatile in 2011, especially auto production (Chart 3). Japan's slump in Q2 and rebound in Q3 was especially pronounced and had ripples across the global economy. Events in Thailand were less significant, but have not fully worked their way through the data yet.
- The greatest shock to the global economy came from the surge in tensions across the Euro Area, which reached their peak in November (Chart 4). Greece, Ireland and Portugal had been the epicenter of the region's problems through the middle of 2011. Through 2011Q3, however, tensions began to spread to larger countries in the Euro Area, promoted by four developments: a) the ECB began to tighten (totaling 50 basis points, and now fully reversed); b) the European Banking Authority (EBA) was required to enforce higher core capital ratios on banks, accelerating deleveraging, including sales of public debt; c) policy uncertainty increased: governments fell in Greece and Italy, and leaders began to talk openly of countries leaving the Euro; d) fiscal policies were tightened yet more in weak countries.

Chart 2
Oil prices
$ per barrel

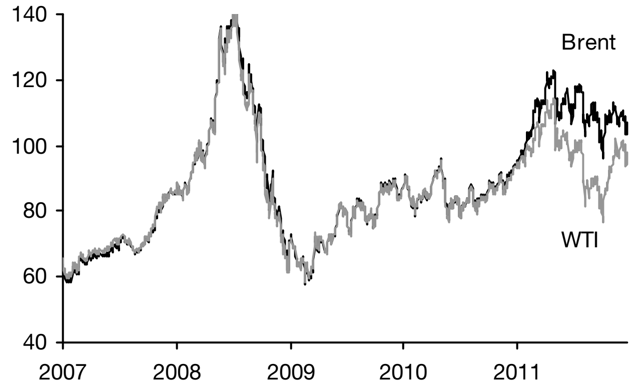
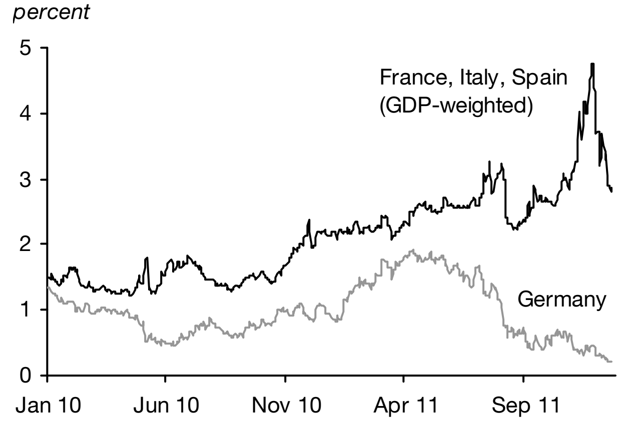


Chart 3
Global Industrial Production
percent change 3m/3m, saar

Chart 4
Euro Area: 2-Year Bond Yields
percent



Global Overview

2012: MAKE OR BREAK YEAR FOR THE EURO

- Global financial market attention is likely to remain riveted on events in the Euro Area in the first half of 2012. Pay attention to the four "R"s—especially in the first half of 2012 —as the region seeks to restore economic and financial stability:

1. Recession: Most importantly, the region has to deal with the economic and financial implications of the recession that we believe is now underway. Recessions tend to strain budget deficits and bank asset quality.
2. Refinancing: There are sizeable debt refinancing burdens in 2012 for both banks and sovereigns. The most challenging is that facing Italy (Chart 5). In our forecast, we assume that all major countries retain market access in the months ahead (and thus pay whatever rates are necessary to sell that debt). Official support (initially through the ECB's SMP and later through the expanded role for the EFSF) is assumed to be forthcoming to temper any rise in spreads.
3. Reform: The rapid passage of the proposed fiscal reforms from the December Summit into a set of Treaty amendments is an ambitious target for Q1 that leaves the region vulnerable to unpredictable political winds.
4. Restructuring: The Greek private sector debt exchange needs to be completed during Q1, as further large repayments loom in March.

- A key feature of our forecast is that these four "R"s can be handled with sufficient agility such that an easing in regional financial conditions in the months ahead promotes a revival in Euro Area growth in 2012H2. This seems to be happening through December, but it is early days yet.

- We have plenty of other concerns, including how unfinished business in the Middle East plays out (especially in Egypt and Syria). We project U.S. domestic demand to remain fairly anemic in 2012, held back by political noise. Given the strength of the U.S. non-financial corporate sector, however, we may be too pessimistic here (Chart 6).

- A major leadership change looms in China (March 2013). With this in mind, we expect financial policies to be eased sufficiently in the months ahead to support another year of solid domestic demand growth. The trough in credit growth should be close at hand (Chart 7).

Chart 5
Euro Area: Maturing Debt for Selected Countries in 2012
€ billion

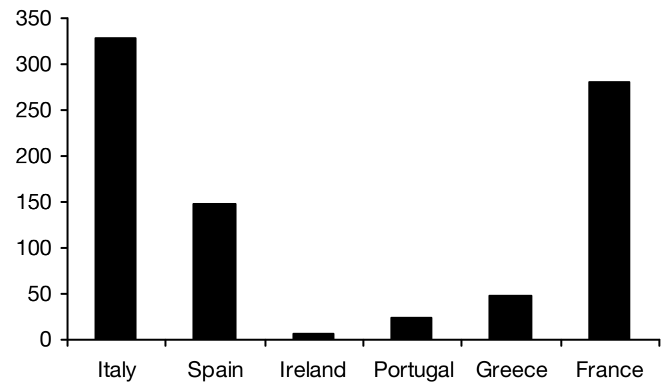


Chart 6
U.S.: Nonfinancial Corporations' Financing Gap
% of GDP, capex less internal funds and inventory valuation adj.

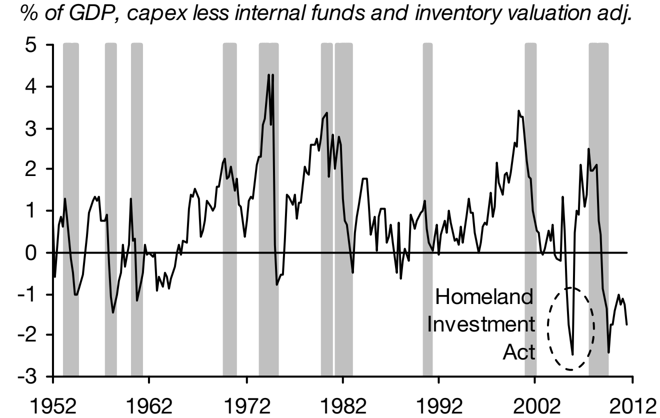
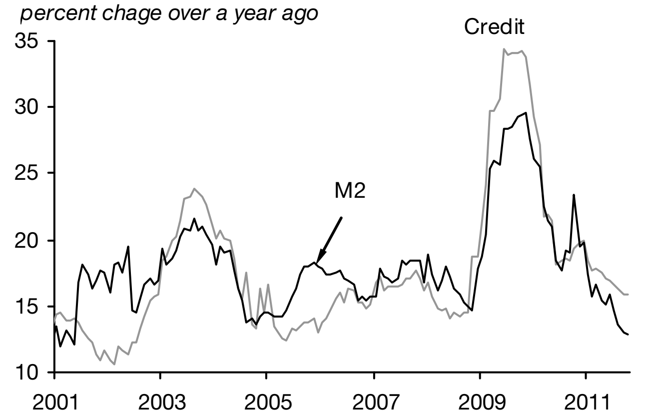


Chart 7
China: Money and Credit Growth
percent chage over a year ago



Global Overview

SHORT-TERM OUTLOOK: MIND THE GAP

- The pace of economic growth in mature economies has picked up somewhat in the second half of 2011 relative to the first. More significantly, however, an important growth divergence has opened up between the United States and the Euro Area (Table 1 and Chart 8).
- Broad-based strength across demand components (including inventory accumulation) has put the U.S. on track for its best GDP growth quarter since 2010Q2 (see Table 6, page 10). We have raised our forecast to 3.5%q/q, saar.
- By contrast, we believe that the overall Euro Area dipped into recession in Q4. Parts of the region (e.g. Greece and Portugal) have been in recession all year, while others (e.g. Italy) began to contract in Q3. Weakness will be sufficiently pervasive across the region in the current quarter for overall GDP to decline by around 2%q/q, saar, in Q4.
- Significantly, problems in the Euro Area seem to have spilled over into other countries in Europe that had been robust earlier in the year (e.g. Sweden and Switzerland). The U.K. has been quite weak all year, and this weakness seems to have become outright recession in the current quarter (see page 22). Emerging Europe has also been affected by the combination of lower demand and tighter credit.
- Asian growth has slowed heading through the second half of the year. The post-earthquake bounce in Japan has faded quite quickly (faster than we had expected), while growth in Emerging Asia has eased. The Asian growth slowdown bears watching (see pages 24-25). We believe that it primarily reflects spillover from Europe.
- Mother Nature has had an unusually important role in shaping the global business cycle in 2011 (e.g. Japan earthquake, Brazilian and Thai floods). It is plausible that what is shaping up to be a warm Q4 in the Northern Hemisphere (especially relative to weather disruptions in December 2010) will provide a (modest) yearend boost.
- Labor market conditions mirror broader economic conditions and provide a useful cross-check confirming the trans-Atlantic divergence noted above (Chart 9).

Table 1
Global Real GDP Growth
percent, q/q saar

	10Q4	11Q1	11Q2	11Q3	11Q4
Mature Economies	**1.5**	**0.4**	**0.8**	**2.3**	**0.7**
United States	2.3	0.4	1.3	1.8	3.5
Euro Area	1.1	3.1	0.7	0.6	-2.0
Japan	0.1	-6.6	-2.0	5.6	-0.5
Other Mature	1.4	1.2	1.6	3.2	0.0
Emerging Economies	**9.7**	**5.4**	**4.6**	**4.7**	**3.3**
Latin America	5.4	4.0	5.0	2.9	2.5
Emerging Europe	16.6	-2.6	4.8	6.1	1.6
Asia/Pacific	8.4	9.5	4.4	4.9	4.4
World	**4.7**	**2.6**	**2.3**	**3.2**	**1.8**

Chart 8
BRIC, U.S. and Euro Area: Manufacturing PMIs
index, 50 = breakeven

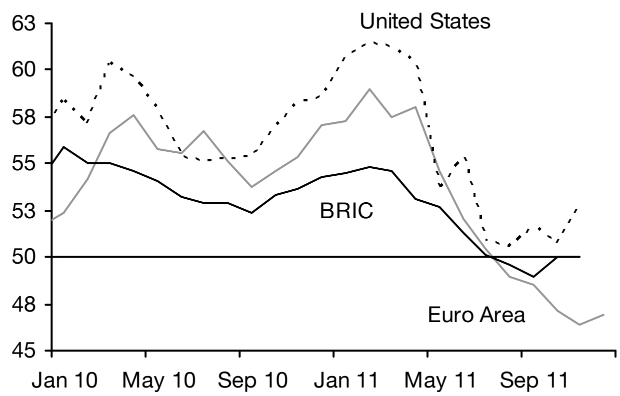
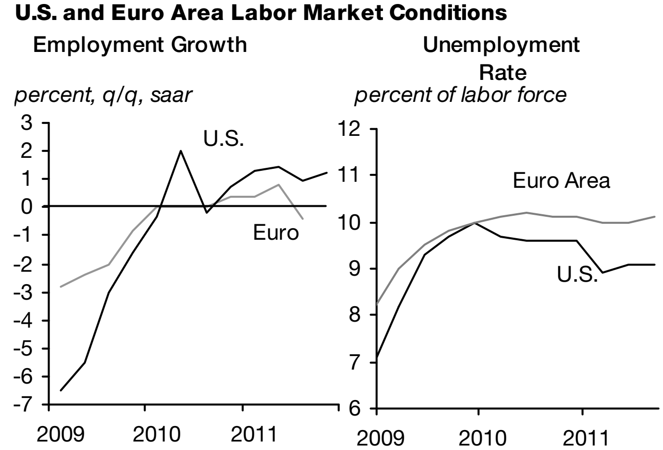


Chart 9
U.S. and Euro Area Labor Market Conditions



Global Overview

INFLATION: ROLL OVER

- Global inflation (as measured by the 12-month change in consumer prices) accelerated from a low point in 2009Q3 to a peak in 2011Q3. The peak in headline inflation is now passed, however, and a fairly uniform fall in inflation lies ahead for at least the next 5-6 months. A new trough should be reached during 2012H2. Unless something goes badly wrong in the global economy, and thus with commodity prices, this trough will be well above that of 2009.

- The main driver of this disinflation cycle is the downdraft in global good price inflation now underway — especially food and energy. A year ago, global energy prices were in the early stage of a major upward move, the peak of which occurred in April 2011. Although the extent and pace of pass-through from global oil prices to headline inflation varies across countries and regions, there remains quite a striking correspondence in global CPI inflation and global oil price inflation, with the latter leading the former by about 3 months (Chart 12). Similarly, the link between global food prices (as measured by the UN FAO food price index) and the food component of global CPI is strong, although that lag is closer to 6 months (Chart 13).

- At least another half year of falling headline inflation should give central banks ample scope to ease further in 2012. This applies particularly to those central banks that have been somewhat concerned about persistently high inflation in 2011, most notably the ECB, Central Bank of Brazil and the PBoC.

Chart 10
Consumer Prices
percent change over a year ago

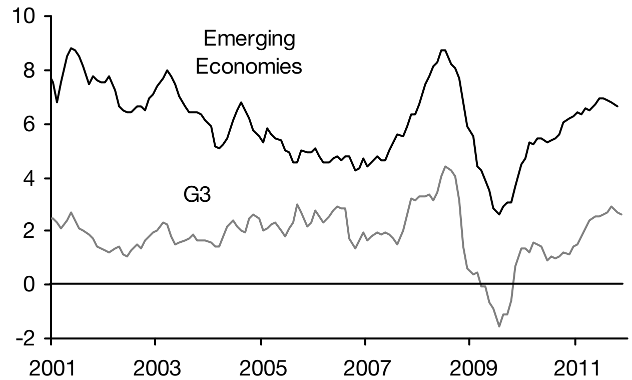


Chart 11
Global Headline Consumer Prices
percent change over a year ago

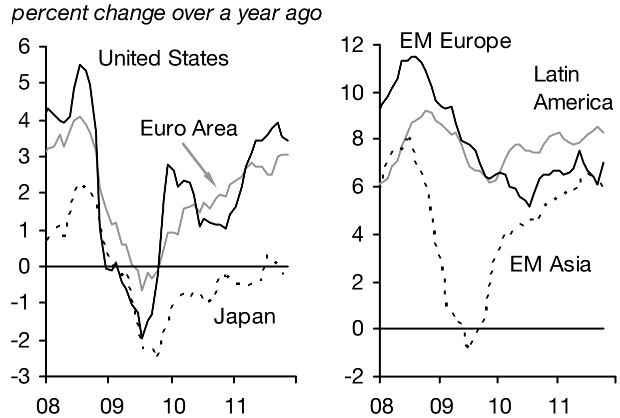


Chart 12
Global Headline CPI and Oil Prices
percent change over a year ago (both scales)

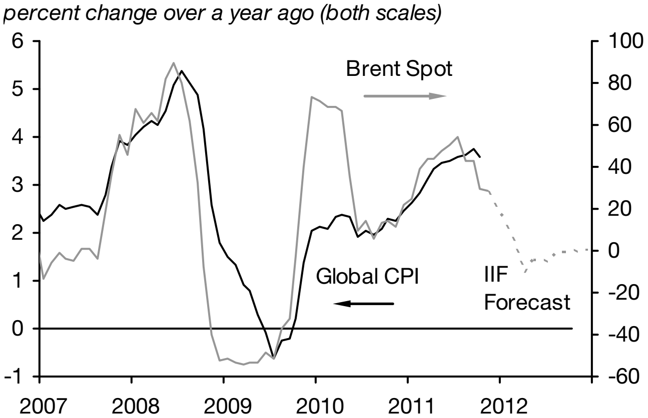
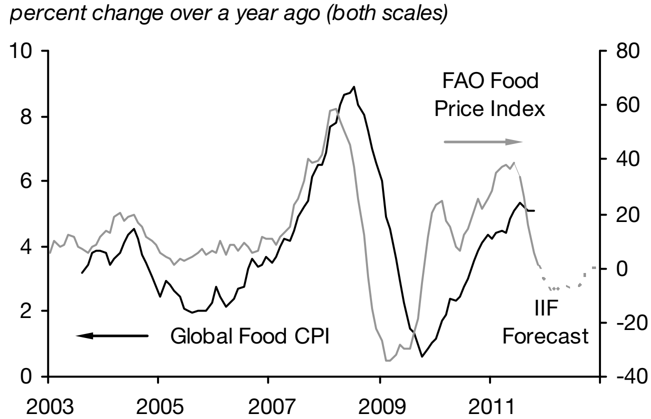


Chart 13
Global Consumer Food Price Inflation and Food Prices
percent change over a year ago (both scales)



WORLD TRADE IMBALANCES NARROW

- There have been significant swings in global external imbalances over recent years. The most pronounced swing has been a rise in the external surpluses of oil exporting and some other commodity producing economies, and a deterioration in the external balances of commodity importing countries. The other dominant trend has been a narrowing in the large U.S. external deficit, offset by smaller surpluses in some other key trading partners.

- The U.S. current account deficit narrowed to $440 billion (saar) in 2011Q3. This was 2.9% of GDP. The deficit fell to 2.7% of GDP in 2009, at the depths of the recession when imports were depressed. What is encouraging about this renewed improvement in the trade balance is that it has come even as the economy has been growing, albeit relatively anemically. We project the U.S. current account deficit to average about $400 billion in both 2012 and 2013, which would imply a gradual reduction relative to GDP.

- Among the industrial economies, the main counterpart to the improvement in the U.S. deficit has been a sharp decline in Japan's trade surplus (Chart 14). In part, this reflects damage to Japan's exports from the March earthquake. Deteriorating terms of trade and a very strong yen have also left their mark. Demographically, Japan's aging population is also be pushing the saving rate lower.

- Two industrial countries — China and Germany — maintain sizeable, albeit reduced trade surpluses (Chart 15). China's nominal GDP is growing far more rapidly than Germany's. In 2011, China's was almost double that of Germany, so Germany's trade surplus is far larger than China's when expressed as a share of GDP.

- Since the onset of the global crisis in mid-2007, the U.S. current account deficit has fallen by about $240 billion, or by about 35% (Chart 16). The counterparts to this U.S. improvement have been broadly based. One problem is that a group that could ill afford to experience a deterioration — the Euro Area excluding Germany — has seen a marked widening in its aggregate deficit. Surplus countries (including Germany) might have been expected to bear more of the brunt of adjustment.

Chart 14
G3: Trade Balance
$ billion , 12-month moving sum

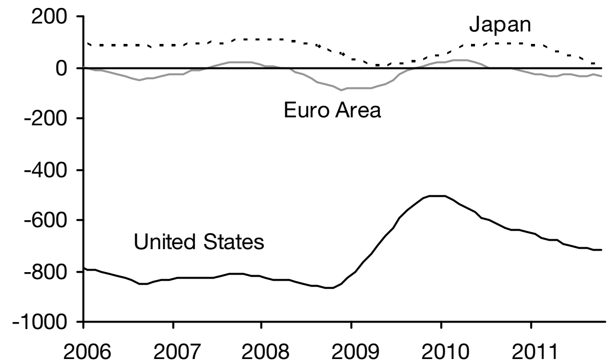


Chart 15
Trade Balance
$ billion, 12-month moving sum

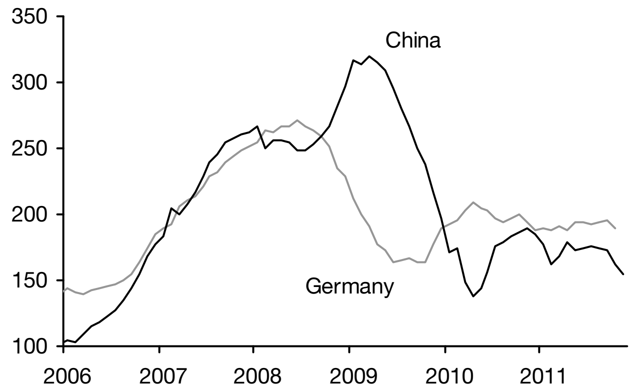
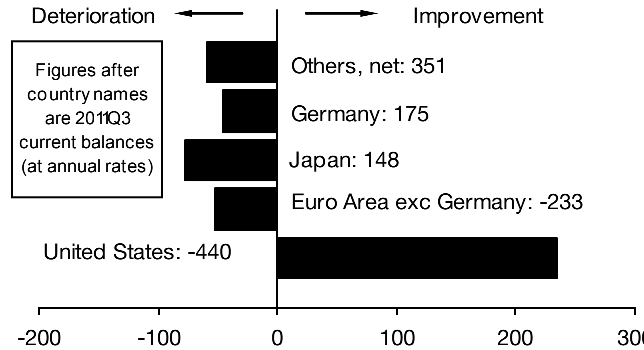


Chart 16
Current Account Balance
$ billion, annualized changes from Q3 2007 to Q3 2011



EM OIL DEMAND IS LIKELY TO REMAIN ROBUST

- Weaker global economic underpinnings have prompted us to trim our global oil demand forecast for the fourth consecutive month. With the slowing pace of economic growth in the Euro Area, global trade is set to deteriorate through the first half of 2012. This will weigh significantly on oil consumption in the transportation and industrial sectors. Thus, we are now projecting global oil demand to increase only by 0.9 mbd in 2012. We have also lowered our non-OECD oil demand projections. Nonetheless, demand will continue to be robust (44.5 mbd) in these countries, especially in the BRIC economies (Table 2)

- On the supply side, we now expect oil production to increase by 0.8mbd in the last quarter of 2011. This is partly because of the faster-than-expected increase in Libyan output and the return of North Sea volumes after completion of seasonal maintenance. North Sea production declined significantly in the second and the third quarter of this year due to exceptionally heavy maintenance in the U.K. and Norway. We believe that the return of U.K. and Norway volumes will contribute 0.4mbd to global oil supply in the near term.

- In the medium and long term, we project that Iraq's contribution to global oil production will increase significantly with an expanded capacity. Iraq used to supply 3mbd on average before the first Gulf War (August 1990). However, during the past two decades Iraq's oil output has been much lower and very volatile (Chart 17). Production now seem likely to increase to above 3mbd in the next couple of years. This increase could be threatened by domestic political decisions, however.

- The price of Brent Oil has edged down somewhat in the past few months (see Chart 2, page 2). We project Brent to decline further to $95 pb by the end of 2012Q2. Robust demand in emerging economies offset weak demand in Europe. According to a simple econometric model, industrial production (a proxy for oil demand) is an important determinant of oil price developments (Table 3). Industrial production in emerging markets is a particularly important determinant. This could be due to higher oil intensity in EMs relative to mature economies.

Table 2
Global Demand and Supply
million barrels per day

	2010	2011	2012	11Q3	11Q4	12Q1
Demand (mbd)	88.3	89.0	89.9	89.4	89.7	89.7
OECD	46.2	45.7	45.4	45.9	46.0	45.9
Non-OECD	42.1	43.3	44.5	43.5	43.7	43.8
BRIC	18.4	19.2	19.9	19.1	19.6	19.6
Supply	87.4	88.3	89.9	88.3	89.1	89.9
OPEC (crude)	29.5	29.8	29.9	29.9	29.9	30.0
Saudi Arabia	8.1	9.0	9.3	9.3	9.3	9.3
Libya	1.6	0.5	0.9	0.0	0.6	0.9
OPEC NGLs	5.4	5.8	6.2	5.8	6.0	6.1
Non-OPEC	34.8	35.7	36.1	35.7	35.9	36.1
Change in Inventories	-0.8	-0.7	0.0	-1.2	-0.6	0.2

Source: IEA and IIF Estimates, *Reported by OECD

Chart 17
Iraq: Crude Oil Output
million barrels per day

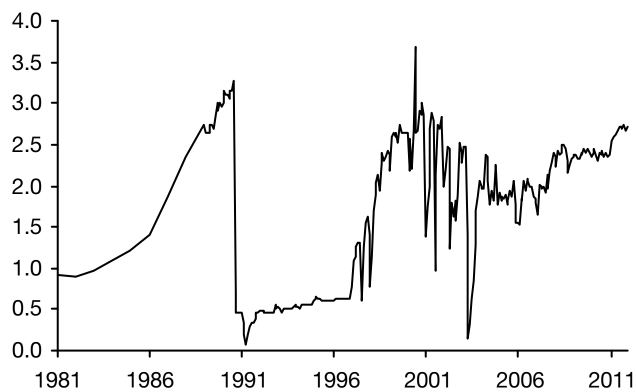


Table 3
Determinants of Brent Oil Price

Explanatory Variable	**Coefficient**
Industrial Production in Developed Countries	1.45***
	(2.35)
Industrial Production in Emerging Countries	6.31***
	(8.70)
Crude Oil Production	-2.02***
	(-2.83)
Intercept	-0.03***
	(-5.14)
Number of Observations	197
Adjusted R-Squared	0.442

Notes: Monthly data, t-statistics are in parentheses.
* Significant at 10%; ** Significant at 5%: ***Significant at 1%

HOT AND CROWDED

- According to the United Nations, world population has reached 7 billion this year, a historic milestone in the growth of global population. Notably, it took only 12 years for the world population to increase from 6 to 7 billion (Table 4). Asia stands out as the main contributor to this increase, accounting for 50% of net population growth (Chart 18). The UN projects that the global population will increase at a slower pace in the 21st century and will stabilize around 10 billion in 2200.

- From an economic perspective, population growth is important to bear in mind for two related reasons. First, population growth over time increases a country's workforce and raises domestic demand. This means that for a given rate of productivity growth, regions with higher population growth experience higher rates of output growth. Over time, population growth is therefore a key determinant of a country's weight in the global economy, for example as a trading partner to other economies. China's ascent in the global economy, for example, was made possible by the combination of population growth and productivity growth.

- Second, it is important to bear that population growth is a factor affecting changes in per capita income, which is a measure of a country's standard of living. Economists tend to be more aware of GDP growth rates than population growth rates. For a given rate of GDP growth, the lower population growth is the higher is per capita income growth. Japan for example is known for its low GDP growth rates. In view of its declining population, however, it is no surprise that its GDP per capita is still one of the highest in the world.

- The UN's projections of the world population stabilizing over the course of this century also imply that ageing will become more and more prevalent globally. Given that life expectancy is on an upward trend globally, a stagnant global population implies relatively few newborns. This means that for some time, the number of retired people will increase much more rapidly than the number of working age people. China is an important example of this process (Chart 19). Continued low fertility rates mean that the Chinese age structure is set to undergo a fundamental transition over the next several decades.

Table 4
Global Population Milestones
people

	Year	Years Elapsed
1 Billion	1804	-
2 Billion	1927	123
3 Billion	20 October 1959	32
4 Billion	27 June 1974	15
5 billion	21 January 1987	13
6 Billion	5 December 1998	12
7 billion	31 October 2011	12
8 billion	15 June 2025	14
9 Billion	18 February 2043	18
10 Billion	18 June 2083	40

Source: UN and USCB Estimates

Chart 18
Contribution of Regions to the Last 1 Billion
billion

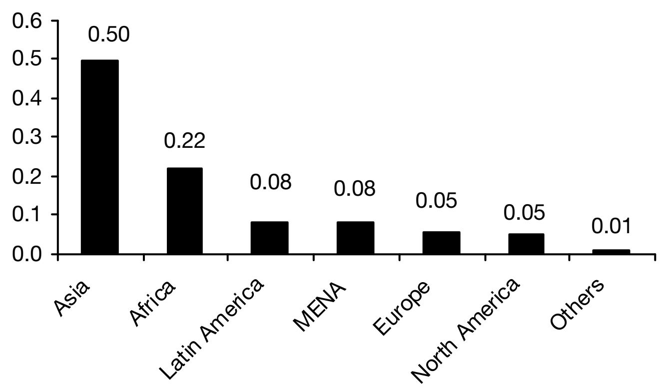
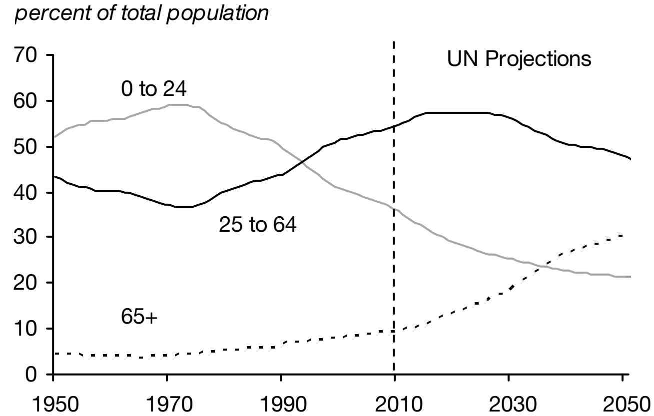


Chart 19
China: Population by Age Groups
percent of total population



YOUTH UNEMPLOYMENT IS A GLOBAL CONCERN

- Global unemployment trends are one of the most striking indicators of the difference in global fortunes between mature and emerging economies. In emerging economies, the crisis was followed by only a short uptick in the unemployment rate. Indeed, most EM countries now have unemployment rates lower than before the crisis (with the exception of the MENA region). In the mature economies, by contrast, unemployment rates increased sharply during the recession and have remained stubbornly high since (Chart 20).

- The rise in unemployment rates during the crisis has been particularly problematic for young people. Youth unemployment is typically higher than for other age groups and has risen even more in recent years. It now stands at 16.8% in the U.S. and 21.4% in the Euro Area, roughly twice as high as the total unemployment rate (Chart 21).

- The details underlying employment prospects for the young are even worse than the aggregate numbers suggest. For example, participation rates have also dropped substantially among young people. In the U.S., the participation rate of teenagers dropped from 41.3% at the onset of the recession to 34.6% in November 2011. This is partly because people have pursued more education, which tends to delay their entrance into the job market. But it also reflects an increasing number of discouraged workers who believe there are no jobs available for them.

- Sustained high youth unemployment comes with a number of economic and social challenges. (1) From a long-term perspective, high youth unemployment reduces the skills and experiences of precisely those who are the most important to the work force in the future. This reduces people's income prospects as well as the potential for economic growth. (2) High youth unemployment can lead to social unrest. In the Middle East and North Africa (MENA) region, for example, young jobless persons were among the disadvantaged parts of the population that rose against authoritarian regimes earlier this year. Indeed, many of the MENA countries have youth unemployment rates in the range of 20-30% (Table 5).

Chart 20
Global Unemployment Rates
percent of labor force

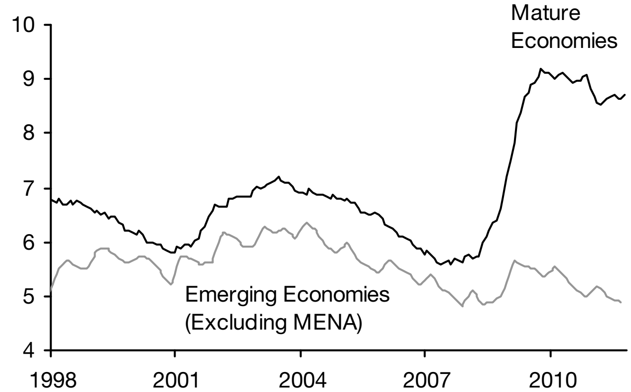


Chart 21
U.S. and Euro Area: Youth Unemployment Rates
percent of labor force, persons under 25 years of age

Table 5
Middle East and North Africa: Unemployment Rates
percent of labor force

	Unemployment Rate	Youth Unemployment Rate
Saudi Arabia	10.2	23.3
Algeria	9.8	21.5
Iraq	15.0	29.8
Egypt	11.9	26.3
Jordan	13.4	29.6
Lebanon	8.0	21.5
Morocco	9.1	17.4
Syria	11.0	23.0
Tunisia	13.5	24.3

United States

Q4 ACCELERATION ON TRACK

- The U.S. economy continues to show improvement relative to earlier in the year. Growth in 2011H2 is likely to average 2.7%, saar, almost a full point above H1. Demand indicators have been quite strong in recent months, pointing to a solid Q4 growth reading, which we now forecast at 3.5%, saar. Nominal core retail sales grew rapidly in September and October, lifting Q4 by 6.6%, saar, over Q3 (Table 6). In combination with the recent slowing in core and especially headline inflation, this should lift real personal consumption expenditures to around 2.6%, saar in Q4.

- Net exports are likely to make at least a small positive contribution to Q4 GDP growth. Through October, exports in Q4 are tracking close to 10%, saar, over Q3 while imports are almost flat. Some of this divergence is likely to close in November/December, especially in light of a weakening global environment.

- A boost from inventories should lift Q4 growth significantly. In Q3, inventories made a large negative contribution to growth of 1.4 percentage points. We expect most of this to be reversed in Q4. There is a considerable degree of uncertainty around the pace of inventory rebuilding, however.

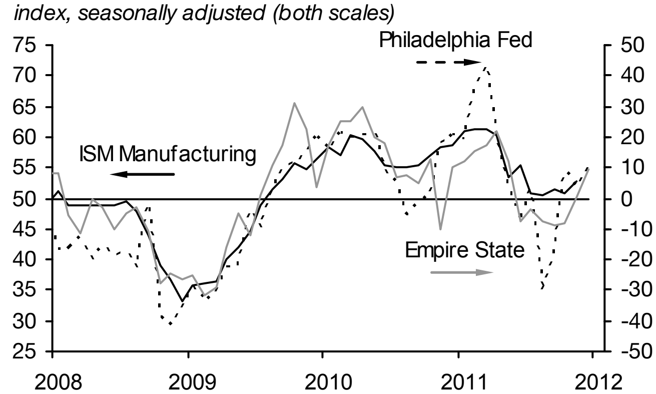
- Manufacturing sentiment has improved further recently. Both the national ISM index and the regional indices are now firmly in expansion territory (Chart 22). This is particularly noteworthy in the context of a broad-based weakening of global manufacturing PMIs.

- Fiscal policy is the biggest immediate concern to growth. Uncertainty still looms large concerning the degree of fiscal tightening in early 2012. Under current law, fiscal policy is on track to deliver a tightening of 2.6% of GDP in 2012. The associated drag on growth would be around 1.8%. The recent controversy over extending payroll tax cuts and unemployment insurance for only 2 months demonstrates how difficult it is for policymakers to reach agreement on such important policy issues. We still believe that both measures will ultimately be extended for the full year, reducing the fiscal drag on growth in 2012 to about 1%.

Table 6
United States: Tracking Current Quarter GDP
percent, q/q saar, underlining denotes IIF forecasts

	Q3 11	Q4 11 to date	Data through
Real GDP	*1.8*	<u>3.5</u>	-
Consumption			
Real Consumption	2.3	2.1	October
Nominal Core Retail Sales	5.1	6.6	November
Auto Sales (million units, saar)	12.4	13.4	November
Consumption (constant prices, NIPA)	*1.7*	<u>2.6</u>	
Investment			
Shipments of Nondefense Capital Goods ex. Aircraft	17.3	2.8	October
Business Equipment (constant prices, NIPA)	*16.2*	<u>3.0</u>	
Value of New Nonresidential Construction Put in Place	22.6	9.7	October
Business Structures (constant prices, NIPA)	*14.4*	<u>5.0</u>	
Value of New Residential Construction Put in Place	-22.4	23.3	October
Residential (constant prices, NIPA)	*1.2*	<u>8.0</u>	
Inventory Contribution (% points)	*-1.4*	<u>1.2</u>	
Trade			
Real Exports of Goods	8.1	9.6	October
Exports of Goods (constant prices, NIPA)	*4.7*	<u>5.0</u>	
Real Imports of Goods	2.2	0.6	October
Imports of Goods (constant prices, NIPA)	*1.2*	<u>3.0</u>	
Contribution to Growth	0.4	<u>0.2</u>	
Memo Items (Supply Side):			
Index of Hours Worked	1.1	3.0	November
Manufacturing Output	4.9	3.5	November

Chart 22
U.S.: Manufacturing Conditions
index, seasonally adjusted (both scales)



United States

UNITED STATES FORECAST IN DETAIL

percent change over previous period, seasonally adjusted, at an annual rate, unless otherwise stated

	2010	2011	2012	2013	11Q1	11Q2	11Q3	11Q4	12Q1	12Q2	Q4/Q4 2011	Q4/Q4 2012	Q4/Q4 2013
Real GDP	3.0	1.8	2.1	2.4	0.4	1.3	1.8	3.5	1.5	2.0	1.7	2.0	2.5
Consumption	2.0	2.2	1.9	2.4	2.1	0.7	1.7	2.6	1.5	2.0	1.8	2.0	2.6
Government Spending	0.7	-1.9	-2.0	-1.4	-5.9	-0.9	-0.1	-1.5	-3.0	-2.5	-2.1	-2.4	-1.0
Fixed Investment	2.6	6.7	6.2	5.3	1.2	9.2	13.0	4.3	4.9	5.5	6.8	5.4	5.1
Business Equipment	14.6	10.1	6.4	5.3	8.7	6.3	16.2	3.0	5.0	6.0	8.4	5.7	4.7
Structures	-15.8	5.0	7.2	5.8	-14.4	22.6	14.4	5.0	5.0	5.0	6.0	5.2	6.0
Residential	-4.3	-1.6	4.5	4.8	-2.5	4.2	1.2	8.0	4.0	4.0	2.7	4.2	5.0
Change in Inventories (*$ bn, chained 2000*)	58.8	30.7	49.1	60.8	49.1	39.1	-2.0	36.7	42.9	48.6	—	—	—
Exports of Goods and Services	11.3	6.8	5.2	5.8	7.9	3.6	4.7	5.0	5.0	6.0	5.3	5.7	5.5
Imports of Goods and Services	12.5	4.9	3.0	4.0	8.3	1.4	1.2	3.0	3.0	4.0	3.4	3.7	4.0
GDP Deflator	1.1	2.1	1.4	1.8	2.7	2.6	2.6	1.0	1.1	1.2	2.2	1.3	2.0
Nominal GDP	4.2	4.0	3.6	4.2	3.1	4.0	4.4	4.5	2.6	3.2	4.0	3.4	4.5
Contribution to Changes in Real GDP:													
Domestic Final Sales	1.9	1.9	1.8	2.2	0.5	1.5	2.8	2.2	1.1	1.7	1.6	1.7	2.4
Net Exports	-0.5	0.1	0.2	0.1	-0.3	0.2	0.4	0.2	0.2	0.1	0.1	0.2	0.1
Inventories	1.6	-0.2	0.1	0.1	0.3	-0.3	-1.4	1.2	0.2	0.2	0.0	0.1	0.0
Trade Balance (*$ billion*)	-646	-732	-716	-740	-182	-191	-182	-177	-177	-178	—	—	—
Current Account Balance (*$ billion*)	-471	-463	-405	-397	-120	-125	-110	-109	-102	-102	—	—	—
as percent of GDP	-3.2	-3.1	-2.6	-2.4	-3.2	-3.3	-2.9	-2.8	-2.6	-2.6	—	—	—
Consumer Prices (*percent* oya)	1.6	3.1	1.6	2.1	2.2	3.3	3.8	3.3	2.3	1.6	3.3	1.5	2.3
Core Consumer Prices (*percent oya*)	1.0	1.7	1.8	2.2	1.1	1.5	1.9	2.1	2.1	1.8	2.1	1.7	2.4
Unemployment Rate (*percent*)	9.6	9.0	8.7	8.2	8.9	9.1	9.1	8.8	8.8	8.8	—	—	—
Fed Funds Rate (*end of period*)	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	—	—	—
$ per € (*end of period*)	1.34	1.30	1.25	1.35	1.42	1.45	1.34	1.34	1.28	1.28	—	—	—
¥ per $ (*end of period*)	81.1	78.0	80.0	82.0	83.1	80.6	77.1	78.0	79.0	79.0	—	—	—
Federal Budget Balance (FY, *$ billion*)	-1294	-1297	-1210	-1000	—	—	—	—	—	—	—	—	—
as percent of GDP	-9.3	-8.9	-7.8	-6.2	—	—	—	—	—	—	—	—	—
Industrial Production - Manufacturing	5.4	4.4	2.9	3.6	7.2	0.1	4.9	4.0	2.0	2.5	4.0	2.6	4.0

Table 7

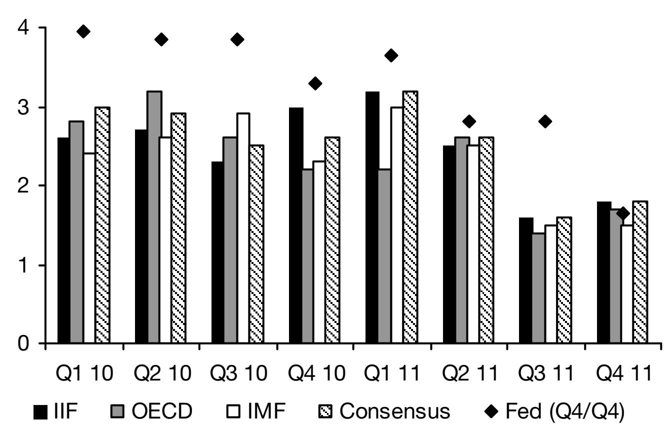
U.S.: Latest Real GDP Growth Forecasts

	2011	2012	As of
		y/y	
IMF	1.5	1.8	Sep 11
OECD	1.7	2.0	Nov 11
Bloomberg Consensus	1.8	2.2	Dec 11
IIF	1.8	2.1	Dec 11
		Q4/Q4	
Federal Reserve	1.6 to 1.7	2.5 to 2.9	Nov 11
IIF	1.7	2.0	Dec 11

Chart 23

U.S.: The Evolution of 2011 GDP Growth Forecasts

percent, y/y, forecasts as of the end of quarter



United States

JOB MARKET: SHORT-TERM GAIN, LONG-TERM PAIN

- Latest high frequency data suggest that recovery of the labor market may be proceeding more rapidly than previously expected. Jobless claims fell to a 3-year low in December, an encouraging sign for near-term employment prospects (Chart 24). Nonetheless, a number of cyclical and structural drags are likely to prevent a breakthrough in 2012. Although the unemployment rate recently declined to 8.6% from 9.0%, we project it to end the coming year around 8.5% (See IIF Research Note: "United States—What to Expect from the Labor Market in 2012").

- Recovery of the labor market is partly held back by cyclical weakness in aggregate demand. Private demand has remained depressed in recent years due to continued balance sheet repair in the household and business sectors (see next page). In addition, there are three main structural factors holding back the recovery. First, mass layoffs in declining sectors created a large pool of unemployed persons with obsolete skills, resulting in a skills mismatch between available workers and job openings.

- Second, rises in unemployment were concentrated in particular regions. Because some regions were much more affected by the crisis than others, the dispersion of economic conditions increased significantly. For example, the burst of the housing bubble particularly affected Nevada, Florida and California, while the collapse in manufacturing activity hit especially Ohio and Michigan (Table 8). These different shocks should have increased inter-state mobility as unemployed persons move to high-employment states. But this process was undermined by factor three, a drop in geographic mobility. The bursting of the housing bubble reduced home equity and made it more difficult for the unemployed to move in pursuit of new jobs.

- An indication that structural factors are holding back employment is found in the Beveridge Curve (Chart 25). This curve shows the empirical relationship between job openings and the unemployment rate. In normal times, a certain job openings rate is broadly associated with a particular unemployment rate. When the Beveridge Curve shifts outward, as seems to have happened since 2009, this indicates that the job matching process has deteriorated.

Chart 24
First-Time Jobless Claims
thousand, weekly & 4-week moving average, inverted scale

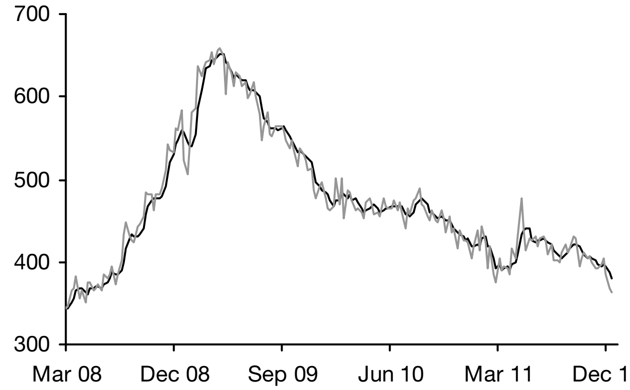
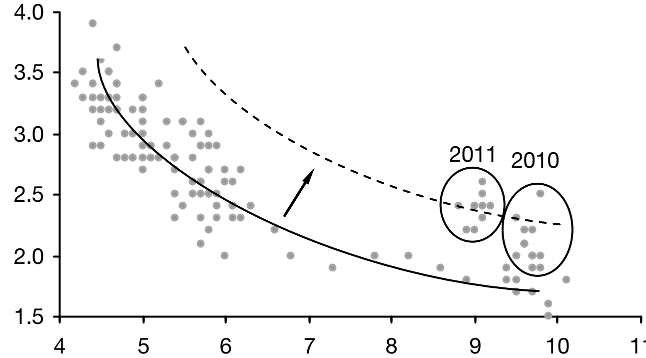


Table 8
U.S. States Most and Least Affected by Housing Bubble
percent

	Foreclosure Rate (2011Q3)	Unemployment Rate (10/2011)
Florida	18.9	10.3
Nevada	13.9	13.4
New Jersey	11.9	9.1
Illinois	11.0	10.1
New York	9.3	7.9
(…)	(…)	(…)
Nebraska	3.2	4.2
South Dakota	2.7	4.5
Wyoming	2.4	5.7
Alaska	2.3	7.4
North Dakota	1.9	3.5

Chart 25
Beveridge Curve (2001-2011 Data)
job openings rate in percent of total jobs (filled and vacant)



United States

HOUSEHOLD BALANCE SHEETS HAVE IMPROVED

- The 2000s saw an unprecedented rise in U.S. household debt. Total outstanding debt rose from $5 trillion in 2000 to over $12 trillion on the eve of the financial crisis in 2008. Housing-related debt accounted for the most of household borrowing, fueling the housing bubble (Chart 26). When the bubble burst, the ensuing financial crisis had a sharp negative impact on households' financial position. Households responded by reducing consumption and increasing savings in an effort to repair their balance sheets. The resulting drop in aggregate demand has been a key factor holding back the economic recovery so far.

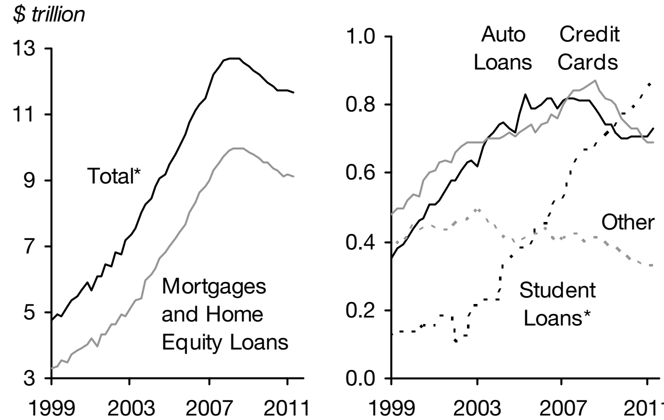
- There are three factors that determine the evolution of outstanding household debt: households' demand for credit, lenders' supply of credit, and debt discharges from individuals filing for bankruptcy. It is quite difficult to determine the relative importance of these factors. There is evidence, however, that all three factors have contributed to the contraction in total household debt after the crisis.

- Filings for personal bankruptcy have fallen recently, but remain elevated (Chart 27). When someone files for bankruptcy, most of the debtor's assets are liquidated to pay off creditors' claims (although some assets are exempt, such as retirement accounts). Then, the person's remaining debts are forgiven (although some debts are exempt, such as student loans). Discharges therefore reduce outstanding debt without directly affecting household consumption.

- It is often difficult to distinguish whether contractions in credit occur because credit demand or credit supply is declining. A factor pointing to declining demand is credit inquiries and mortgage applications, which are usually made when a person wants to obtain a new line of credit. Credit inquiries have declined in tandem with account openings in recent years, suggesting that there may be declining demand for credit (Chart 28). However, some of the decline may be due to reduced solicitations by lenders and/or perceptions of tightened credit standards.

- A factor pointing to lending supply constraints is the Fed's Senior Loan Officer Survey. According to this, credit standards were tightened sharply in 2008 and 2009, but have been on a gradual easing trend since early 2011.

Chart 26
U.S.: Household Debt Components
$ trillion



*Includes IIF adjustments for a statistical break in 2011Q2

Chart 27
U.S.: Personal and Business Bankruptcies
thousands, number of filings per quarter

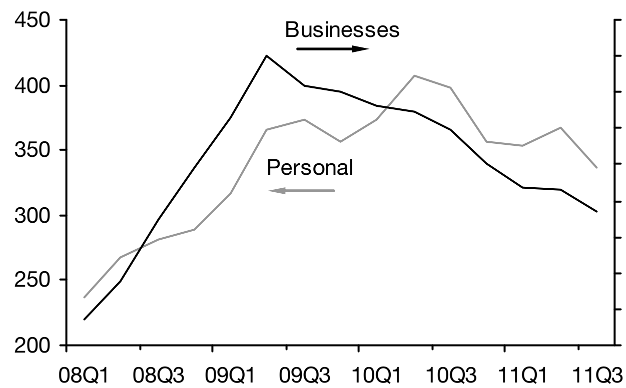
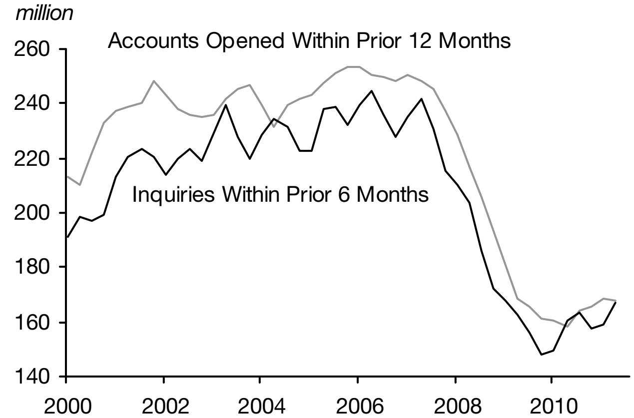


Chart 28
United States: New Credit Accounts and Inquiries
million



Euro Area

EURO AREA: WORST NOT OVER YET

- The Euro Area is ending 2011 on a weak note. We believe the region drifted back into recession in the last quarter of the year after just two-years into the last economic expansion. Although official data is yet to confirm the output contraction suggested by business surveys, there is an increasing recognition of an unfolding recession in the official forecasts. In the past few months the European Commission, ECB, OECD and IMF all have downgraded their growth forecast for the Euro Area. The main debate now is over the depth and duration of the recession.

- Purchasing Managers' Indices (PMIs) remained in contraction territory throughout the fourth quarter, reinforcing our view that a recession in the Euro Area is underway (Chart 29). Manufacturing PMIs were particularly weak, averaging 46.8, while the services PMI came in at 47.1. The good new is that PMIs did not deteriorate further in December, but stabilized instead at around 47 for manufacturing and 48 for services. Similarly, stabilization in industrial production in October is also welcome sign of resilience. This suggests some upside risks to our current forecast (-2% q/q saar), but it is early days yet. We have kept our forecast unchanged, however, because we view the leveling-off in PMIs as consistent with a mild recession. In addition, we look for ongoing fiscal retrenchment to take its toll on demand. Recent policy announcements serve to highlight the persistence of Euro Area fiscal tightening (Chart 30).

- The decline in economic activity is weighing on labor market conditions (Chart 31). Unemployment in the Euro Area rose for a third straight month in October to an all time high of 10.3%, while employment fell in Q3. The aggregate numbers, however, disguise wide divergences across individual countries. The conditions are by far the worst in Greece and Spain, with levels above 18-22% and rising. Although at a much lower level of 8.5%, the unemployment rate in Italy also saw a rise over the three months to October. On a positive note, the unemployment rate in Germany posted a new low of 5.5%, while the French unemployment rate remained stable for the past five months.

Chart 29
Euro Area: Industrial Production and PMI
percent, 3m/3m *index, dev. from 50*

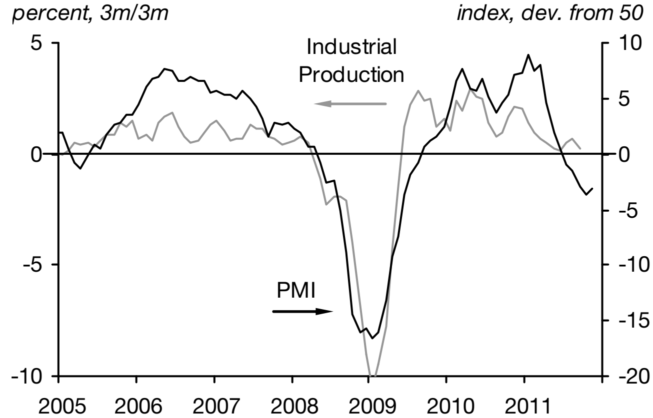


Chart 30
Euro Area: Fiscal Thrust
percent of GDP, change in budget balance from previous year

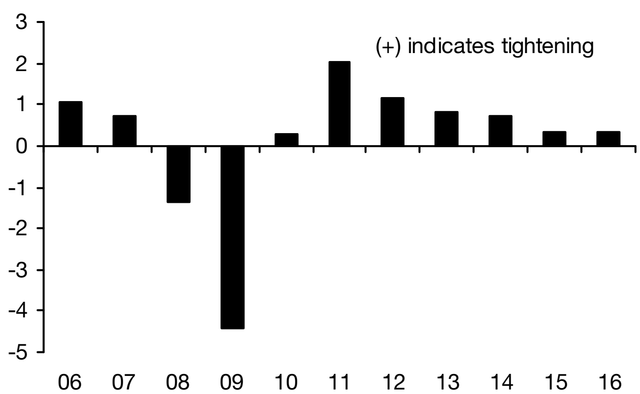
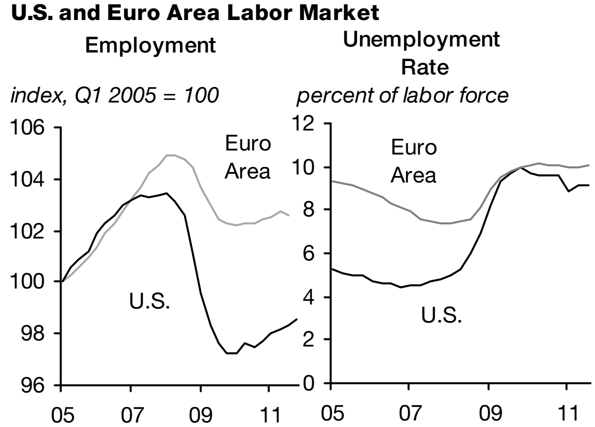


Chart 31
U.S. and Euro Area Labor Market



Euro Area

EURO AREA FORECAST IN DETAIL

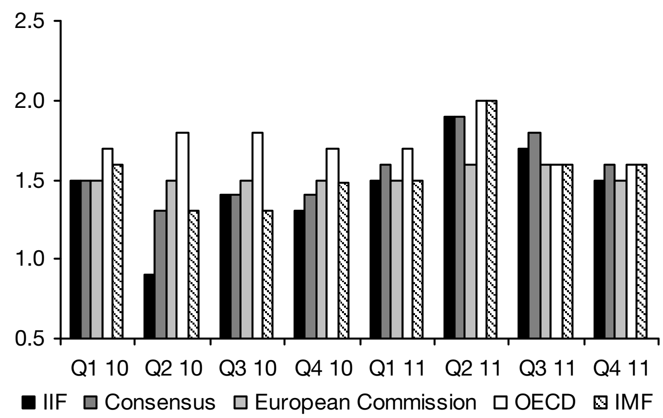
percent change over previous period, seasonally adjusted, at an annual rate, unless otherwise stated

	2010	2011	2012	2013	11Q1	11Q2	11Q3	11Q4	12Q1	12Q2	Q4/Q4 2011	Q4/Q4 2012	Q4/Q4 2013
Real GDP	1.8	1.5	-1.0	1.2	3.1	0.7	0.6	-2.0	-2.0	-1.5	0.6	-0.6	1.7
Consumption	0.9	0.2	-1.5	0.5	0.5	-1.8	1.2	-2.5	-2.5	-2.0	-0.7	-1.3	1.0
Government Spending	0.4	0.0	-0.4	-0.8	0.2	-0.2	-0.1	-0.5	-0.5	-0.5	-0.2	-0.5	-1.0
Fixed Investment	-0.9	2.2	-0.1	1.5	7.8	0.1	0.4	-1.0	-1.0	0.5	1.7	0.4	1.9
Exports of Goods and Services	10.9	6.6	4.4	4.9	6.7	4.6	6.2	3.5	4.0	4.0	5.2	4.5	5.0
Imports of Goods and Services	9.1	4.8	2.6	3.9	4.5	1.3	4.5	2.0	2.0	2.0	3.1	3.0	4.0
GDP Deflator	0.8	1.3	1.2	1.6	1.9	1.9	1.0	1.0	1.2	1.2	1.4	1.3	1.7
Nominal GDP	2.5	2.8	0.2	2.8	5.0	2.2	2.8	-2.0	-0.8	-0.3	2.0	0.7	3.5
Contribution to Changes in Real GDP:													
Domestic Final Sales	0.4	0.6	-1.0	0.4	1.8	-1.1	0.7	-1.7	-1.7	-1.1	—	—	—
Net Exports	0.8	0.9	0.8	0.6	1.0	1.4	0.8	0.7	0.9	0.9	—	—	—
Inventories	0.6	0.1	-0.8	0.2	0.4	0.4	-0.9	-1.0	-1.2	-1.3	—	—	—
Trade Balance (*€ billion*)	8.7	-3.8	8.5	8.5	-1.3	-4.6	0.5	1.0	1.5	1.5	—	—	—
Current Account Balance (*€ billion*)	-45.7	-41.4	3.3	27.6	-10.2	-13.1	-12.3	-1.5	10.1	9.0	—	—	—
as percent of GDP	-0.5	-0.4	0.0	0.3	-0.4	-0.6	-0.5	-0.1	0.4	0.4	—	—	—
Consumer Prices (*percent* oya)	1.6	2.6	1.8	1.9	2.5	2.8	2.7	2.6	2.0	1.9	2.6	1.7	2.0
Core Consumer Prices (*percent oya*)	1.0	1.4	1.3	1.6	1.1	1.6	1.3	1.5	1.4	1.3	1.5	1.3	1.6
Unemployment Rate (*percent)*	10.1	10.1	10.5	10.1	10.0	10.0	10.1	10.2	10.4	10.5	—	—	—
ECB Refi Rate (*percent, end of period*)	1.00	1.00	0.50	1.50	1.00	1.25	1.50	1.00	0.50	0.50	—	—	—
$ per € (*end of period*)	1.34	1.30	1.25	1.35	1.42	1.45	1.34	1.34	1.28	1.28	—	—	—
Euro Area Budget Balance (*percent of GDP*)	-6.2	-4.6	-3.8	-3.5	—	—	—	—	—	—	—	—	—
Index of Manufacturing Production	7.4	4.0	-0.8	1.8	3.8	1.0	2.9	-2.5	-3.0	-2.0	1.3	-0.2	2.0
Index of Capital Goods Production	9.0	9.3	0.0	3.5	5.9	5.1	10.6	-3.0	-3.0	-3.0	4.5	-0.5	5.0
Euro Area Countries Real GDP:													
Germany	3.6	2.8	0.5	1.8	5.5	1.1	2.0	0.0	-0.2	0.0	2.1	0.6	2.2
France	1.5	1.6	-0.1	1.0	3.8	-0.2	1.6	-0.5	-0.5	-0.5	1.1	-0.1	1.5
Italy	1.3	0.4	-2.0	0.6	0.5	1.2	0.2	-4.0	-4.0	-2.0	-0.5	-1.4	1.0
Spain	-0.1	0.4	-2.1	0.1	1.5	0.6	0.0	-3.5	-3.5	-3.0	-0.4	-1.6	0.5

Table 9
Euro Area: Latest Real GDP Growth Forecasts
percent, y/y

	2011	2012	As of:
IMF	1.6	1.1	Sep 11
OECD	1.6	0.2	Nov 11
ECB	1.5 to 1.7	-0.4 to 1.0	Dec 11
European Commission	1.5	0.5	Nov 11
Bloomberg Consensus	1.6	0.5	Dec 11
IIF	1.5	-1.0	Dec 11

Chart 32
Euro Area: The Evolution of 2011 GDP Growth Forecasts
percent, y/y, forecasts as of the end of quarter



Euro Area

THE ECB: THE POWERS OF LIMITS

- The ECB continues to act in a fairly aggressive manner in an effort to temper the Euro Area downturn. It is using both conventional and non-conventional methods. The ECB cut its interest rates for a second straight month in December, back to 1%, the record low that prevailed from May 2009 until April this year (Chart 33). In the context of deteriorating economic outlook, we believe the stage is set for two more 25 basis points (bp) cuts in the first quarter of 2012.

- When the benchmark rate reached 1% in 2009, the Euro Area was already pulling out of a recession, while today this level characterizes an early stage of a decline. There are constraints on future declines, however. The ECB aims to promote interbank activity by keeping an upper/lower margin for rates on the lending/deposit facilities. This margin currently stands at +/-75bp, but has varied from +/-50bp to +/-100bp. Another rate cut of 50bp would require narrowing the corridor to be only +/-25bp, as a zero percent interest rate on the deposit facility does not look very likely.

- In another positive move, the ECB deepened its unconventional measures repeatedly aimed at addressing bank funding pressures. First, the ECB announced two unlimited liquidity operations with a 3-year maturity. Second, it widened eligibility criteria for collateral so as to provide access to liquidity for more (medium-sized) banks. This is to help banks support the real economy by lending to the private sector. Third, in an attempt to release bank liquidity, the ECB lowered reserve requirements from 2% to 1%. The ECB's total assets have increased sharply in the last three months (Chart 34).

- The ECB disappointed markets' hopes for stepped-up buying of sovereign bonds via the Securities Markets Programme (SMP). In the second week of December, SMP buying fell to its lowest pace since its resumption in August (Chart 35). At the same time, ECB president Draghi confirmed that there is a limit to the amount of such purchases (without specifying this amount).

Chart 33
ECB Interest Rates
percent

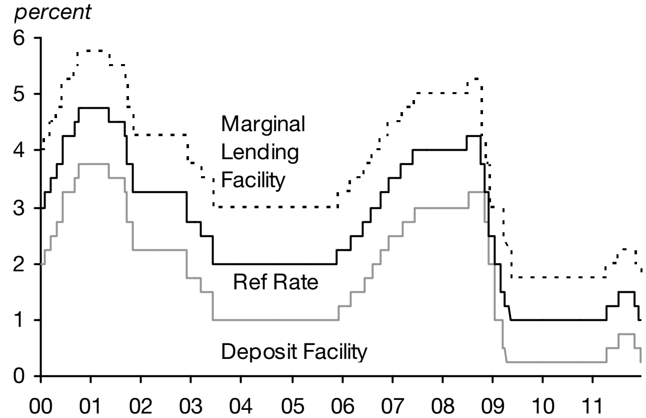


Chart 34
ECB and Federal Reserve: Total Assets
$ billion

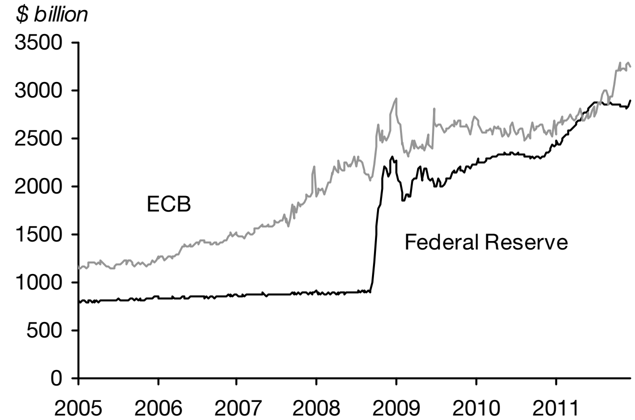
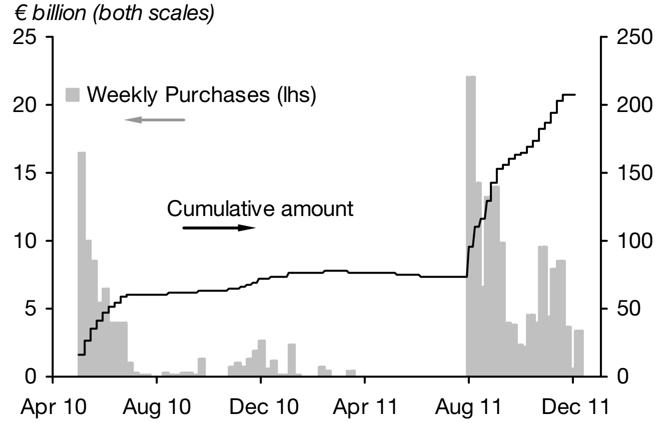


Chart 35
ECB: Weekly and Cumulative SMP Purchases
€ billion (both scales)



SAVING THE EURO AREA: AN UPHILL BATTLE

- With each major resolution package announced by policy makers in 2011, the crisis seemed to take a turn for the worse. Given the time needed to ratify and implement announced measures, policy makers repeatedly found themselves compelled to take additional steps even before prior actions had taken effect.

- A good example is the experience with the European Financial Stability Facility (EFSF), first launched in mid-2010. Equipped with a lending capacity of €255 bn, the EFSF was to help fund sovereigns with impaired access to capital markets (Chart 36). Since then, its mandate has been amended twice. In July 2011, European leaders agreed, among others, to increase its lending capacity from €255 bn to €440 bn. At the October summit, they decided to leverage the EFSF via two complementary steps: (1) by providing credit insurance for a portion of newly issued sovereign bonds and (2) by setting up a special purpose vehicle to attract funding, especially from Asia (Chart 37).

- At the latest December 9 summit, it was agreed to accelerate the transition from the EFSF to the European Stability Mechanism (ESM). The ESM is to enter into force in July 2012 as a permanent fund with paid-in capital. Importantly, its lending capacity, planned at €500 billion, will be greater that of the EFSF. Recent difficulties to auction off EFSF debt suggests that the ESM's success will depend in part on whether it can attract sufficient sources of financing.

- A more fundamental approach announced at the December summit is a new "fiscal compact". While the EFSF-ESM focus on the *financing* of debt and deficits, the fiscal compact aims at *eliminating* deficits in the first place. The plan is to establish a constitutional limit for the structural budget deficit at 0.5% of GDP. Violations of this limit would be sanctioned via an automatic mechanism correcting the budget balance. Critics argue that such a rule is not that different from the 3% deficit limit under the Stability and Growth Pact (SGP). Many countries that violated the SGP were not being penalized (Chart 38). In our view, a fiscal compact is a promising step towards restoring confidence, but only if it is backed by sufficient political commitment—a development that naturally takes time.

Chart 36
EFSF: Lending Capacity
€ billion

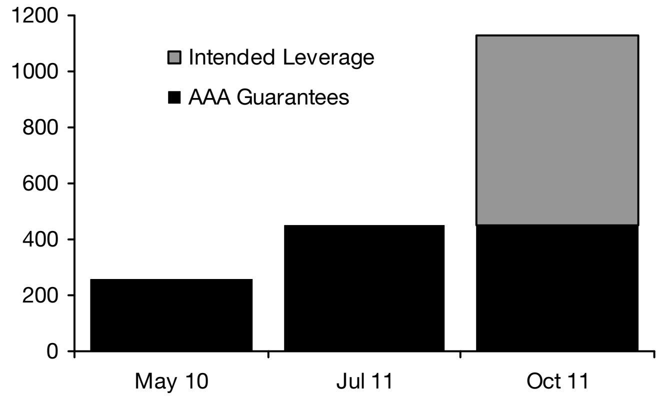


Chart 37
EFSF Bond Issues: Geographical Breakdown
€ billion

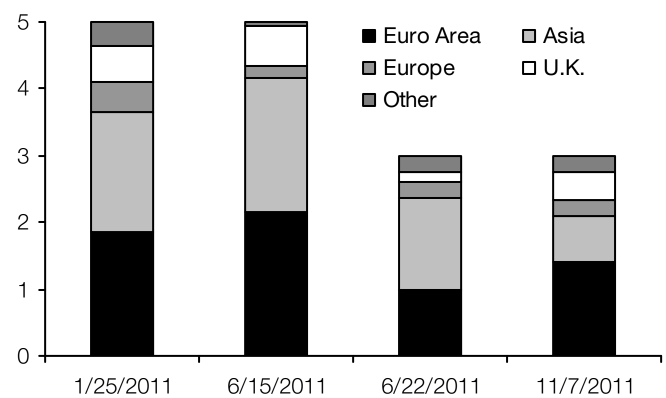
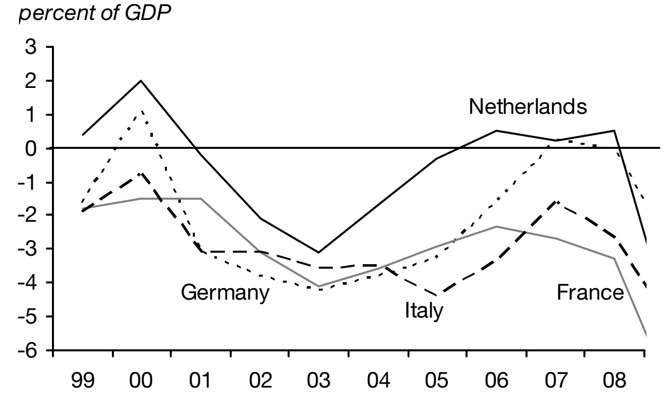


Chart 38
Euro Area: Budget Balances of Selected Core Countries
percent of GDP



Euro Area

EURO AREA BANKS: A FORCED HOME BIAS

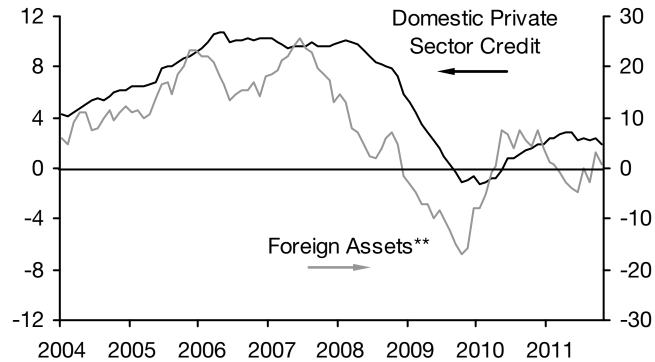
- Euro Area banks' response to the worsening of the crisis has been attempting to de-risk their balance sheet, both for risk management purposes and to meet the demands of regulators. In early December, the European Banking Authority (EBA) announced the updated capital raising requirements for banks to meet the 9% core Tier 1 minimum capital ratio by mid-2012, adding a new twist to the pressure of European banks to de-lever.

- European banks are being strongly encouraged by regulators to cut foreign rather than domestic assets. It is not only regulatory pressure that is forcing such external de-leveraging, however. Funding challenges in foreign markets — for example, the U.S. commercial paper market — have forced banks to downsize their foreign balance sheets. In turn, this has been one way that European banking weakness has been amplified through global markets. The adjustment of domestic credit has, so far, been more measured, with lending to the private non-financial sector continuing to grow, albeit rather feebly (Chart 39).

- In October (the latest available data) net foreign assets of Euro Area banks registered the largest monthly fall in a year (€80 billion), with the reduction in foreign assets double that in foreign liabilities. For the Euro Area as a whole, net inflows from portfolio transactions (i.e. the sum of both net portfolio inflows and outflows on a BoP basis) remains elevated. It is striking how well this series matches the evolution of funds deposited at the ECB (Chart 40).

- The asset class where deleveraging is probably most evident is that of sovereign debt, particularly that of the periphery countries. Data released in December by the EBA along with its latest capital exercise indicate that between December 2010 and September 2011 EU banks reduced their net exposure to GIIPS countries by €50 billion (Chart 41). Persistently high spreads and uncertainty about European authorities dealing with the crisis are likely to exacerbate this trend in the coming months, precisely at a time when many Euro Area sovereigns will need to refinance substantial amounts of debt.

Chart 39
Euro Area: MFI Domestic Loans* and Foreign Assets
percent change y/y, both scales



*Adjusted for the effect of sales and securitization
**Extra Euro Area counterpart

Chart 40
Euro Area: Bank Deleveraging in External Assets
€ billion

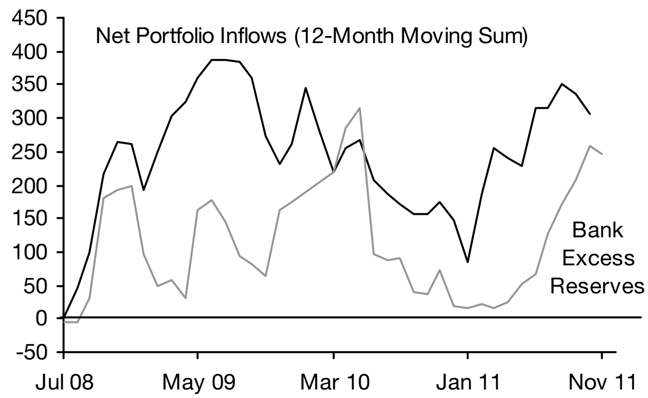
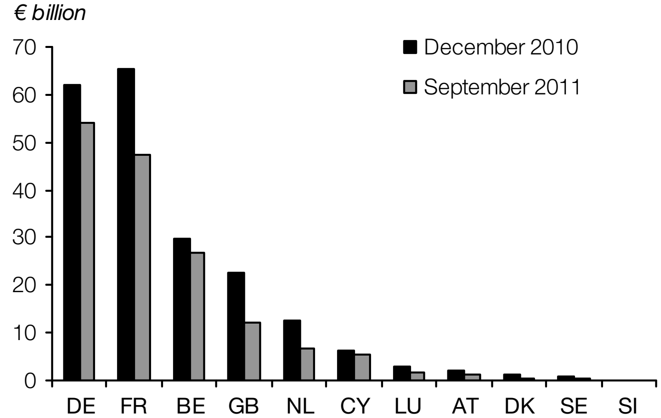


Chart 41
Net Exposure to Sovereign Debt of GIIPS
€ billion



EURO AREA PERIPHERY: PRESSURES MOUNT

- The uncertainty surrounding the European sovereign debt crisis has caused inflows of private capital to all but cease to the Euro Area periphery. Capital flows will continue to be constrained next year as a result of tighter liquidity and accelerated deleveraging as banks strive to raise capital as mandated by the recent EBA stress test. Substantial debt repayments due next year for the corporate sector will intensify debt rollover risks as well.

- **Portugal** has suffered the most among the three countries with EU-IMF programs. With access to foreign markets all but shut since October, Portuguese banks and corporations have been unable to refinance maturing debt (Chart 42). This led the government to step in and bail out state-owned companies unable to meet their obligations, adding 0.5% of GDP to government spending. Domestic banks have been forced to curtail lending and accelerate the deleveraging already mandated by the regulators, exacerbating the contraction in activity. With access to markets unlikely to improve soon, downside risks to growth and the fiscal targets have risen.

- In **Ireland**, the sharply deteriorated market conditions have mainly affected bank recapitalization plans. The inability to sell the insurance arm of Irish Life and Permanent, one of the four remaining banks, will prompt the government to inject €1.2 billion to replace the shortfall. Other banks' plans to seek private capital have been shelved as well (Chart 43). With the limited government guarantee in place, risks to debt servicing by banks remain minimal. As in the case of Portugal, the recent decision by the ECB to provide three-year term funding at more relaxed conditions should help ease liquidity pressures somewhat.

- In **Greece**, where access to markets was lost long ago, the deteriorated market conditions have had limited immediate impact. Domestic banks continue to rely on ECB funding, but the country's low sovereign rating has limited the positive impact of the recent ECB decision to relax collateral requirements (Chart 44). The deterioration of the global growth and liquidity outlook is likely to have a significant longer-term impact. The adverse external environment is likely to lead to a further deterioration in the already weak growth outlook, exacerbating the severe fiscal problems and increasing the already large external financing needs.

Chart 42
Portugal: Net Foreign Borrowing
€ billion

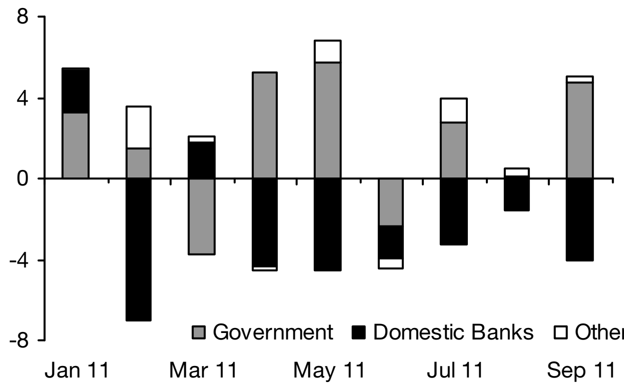


Chart 43
Ireland: ECB Borrowing
€ billion

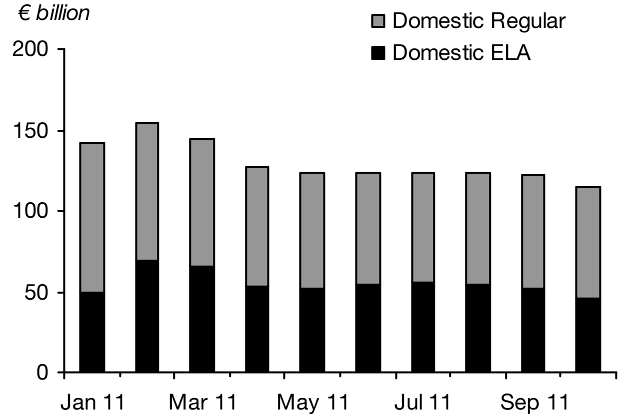
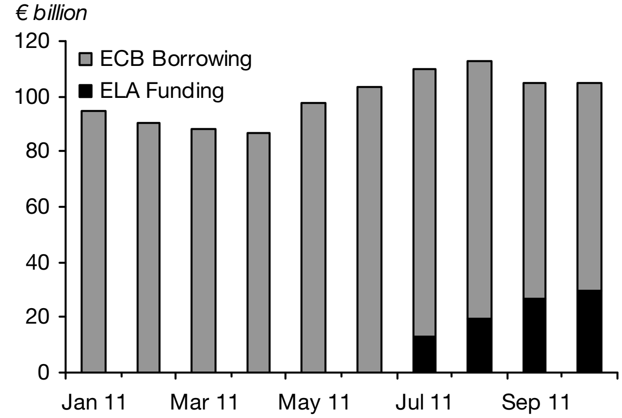


Chart 44
Greece: ECB Borrowing
€ billion



Japan

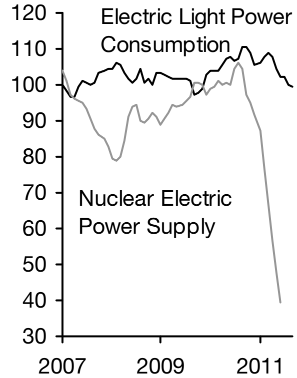
JAPAN'S TRADE SURPLUS: THE END OF AN ERA

- Weak exports have been a feature of Japan 2011. Indeed, it is most likely that Japan's annual trade balance will be in deficit in 2011 for the first time since 1953. Export weakness in the first half of the year was related to supply problems resulting from the March earthquake. More recent weakness, however, reflects problems in Europe, the persistently strong yen and new disruptions caused by the Thai floods. Exports fell 2.6%m/m in November and 4.0% in October. Additionally, import volumes have increased in the second half of 2011, partly due to rising fossil fuel consumption. Following the March earthquake, nuclear electric power supply declined sharply, leading to a significant increase in the demand for fossil fuels from overseas. The volume of LNG imports was up 35%oya in November (Chart 45).

- The BoJ Tankan survey indicates that the most significant recent manifestation of the economic deterioration was on manufacturing. The latest headline index printed a 6-point drop (from +2 to –4) for the large manufacturing firms after a significant rebound (from –9 to 2) in the third quarter of 2011. By contrast, business sentiment among large non-manufacturing firms continued to improve in Q4. Looking ahead, however, both manufacturing and non-manufacturing firms, including the small ones, forecast a deterioration in economic activity in the next three months.

- We are now projecting the Japanese economy to expand by approximately 1.9% in 2012, mainly driven by government-led reconstruction. After long-lasting debates, the Diet enacted the third supplementary budget in late November. This extra budget of ¥12.1 trillion will be financed through tax hikes, spending cuts, sales of public assets and bond issuance. We believe that the positive impact of this budget will likely emerge with a lag in the first half of 2012. Moreover, in early December, Prime Minister Noda has ordered the preparation of the fourth supplementary budget to curb the persistent strength of the yen and the adverse impact of the Thai floods on Japanese firms. Although the details of the budget are not clear yet, it will probably amount to around ¥2 trillion and will be funded by reallocating funds and reducing expenses (Table 10) .

Chart 45
Japan: Electricity Shortage
index, January 1999 = 100, 3mma, seasonally adjusted



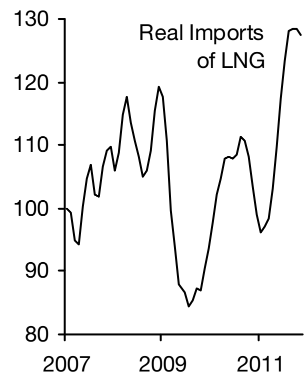


Table 10
Japan: Supplementary Budgets

	¥ trillion	% GDP	
First Supplementary Budget			
Total Expense	**4.015**	**0.84**	**Funding of Budget**
Disaster Relief	0.483	0.10	Spending cuts
Disposal of Waste	0.352	0.07	Reallocating sources
Public Works	1.202	0.25	No bond issuance
Rebuilding of Facilities	0.416	0.09	
Public Financing Prog.	0.641	0.13	
Tax Grants	0.120	0.03	
Other Spending	0.802	0.17	
Second Supplementary Budget			
Total Expense	**1.998**	**0.42**	**Funding of Budget**
Nuclear Crisis	0.275	0.06	Spending cuts
Disaster-Affected People	0.377	0.08	Reallocating sources
Reserve for Reconstr.	0.800	0.17	No bond issuance
Tax Grants	0.546	0.11	
Third Supplementary Budget			
Total Expense	**12.103**	**2.54**	**Funding of Budget**
Rebuilding Efforts			Provisional tax hikes
Disaster Relief	0.094	0.02	Tobacco tax
Disaster Waste	0.386	0.08	Income tax
Public Works	1.473	0.31	Cooperate tax
Public Financing	0.672	0.14	Individual taxes
Tax Grants	1.664	0.35	Spending cuts
Reconstr.Grants	1.561	0.33	Sales of assets
Nuclear Crisis	0.356	0.07	Japan Tobacco Inc.
Prevention Measures	0.575	0.12	Bond issuance
Pension Fund	2.490	0.52	
Others	2.463	0.52	
Type-B Hepatitis Victims	0.048	0.01	
Other Expenses	0.321	0.07	
Fourth Supplementary Budget			
Expected Expense	**2.000**	**0.42**	**Expected Funding**
AIM: Ease the impact of			No bond issuance
Strong yen, Europe's			

Japan

JAPAN FORECAST IN DETAIL

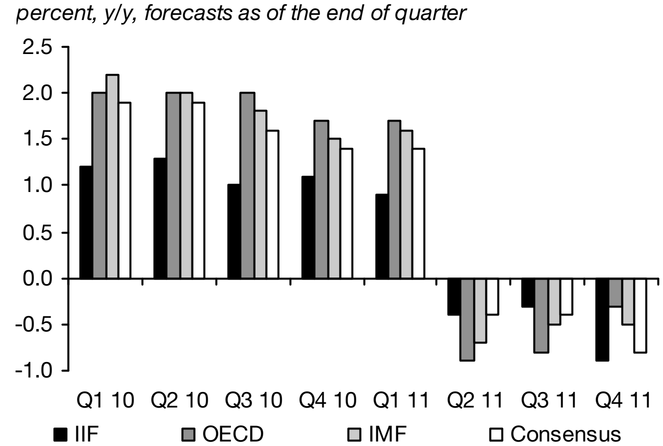
percent change over previous period, seasonally adjusted, at an annual rate, unless otherwise stated

	2010	2011	2012	2013	11Q1	11Q2	11Q3	11Q4	12Q1	12Q2	Q4/Q4 2011	Q4/Q4 2012	Q4/Q4 2013
Real GDP	4.5	-0.9	1.9	1.8	-6.6	-2.0	5.6	-0.5	2.5	2.2	-1.0	2.1	1.6
Consumption	2.6	-0.1	1.4	1.2	-4.9	1.1	3.0	1.8	1.0	1.0	0.2	1.0	1.4
Government Spending	2.1	2.1	1.8	1.4	1.9	2.9	0.9	2.0	2.5	1.8	1.9	1.6	1.7
Fixed investment	-0.1	0.0	4.1	2.4	-2.9	3.4	0.9	3.0	6.5	5.9	1.1	4.4	2.0
Business	0.8	-0.7	1.0	2.0	-3.5	-2.1	-1.6	-1.0	3.0	2.0	-2.0	2.2	2.0
Government	-0.2	-1.4	12.0	2.1	-7.2	29.8	-3.9	15.0	18.0	18.0	7.4	9.7	0.7
Residential	-4.6	6.2	7.3	4.8	7.3	-7.8	22.4	8.0	5.0	5.0	6.9	6.0	4.0
Change in Inventories *(¥ trillion, chained)*	-1.3	-2.8	-2.6	-2.1	-3.7	-3.7	-2.4	-1.6	-2.2	-2.8	—	—	—
Exports of Goods and Services	24.4	-0.2	3.4	3.7	-0.2	-21.7	32.7	-12.0	8.0	5.0	-2.2	5.7	3.0
Imports of Goods and Services	11.1	6.2	5.1	2.8	4.5	1.7	14.9	8.0	4.0	2.0	7.2	2.5	3.5
GDP Deflator	-2.1	-1.9	-1.2	-1.0	-0.4	-3.8	-0.9	-1.0	-1.0	-1.0	-1.5	-1.0	-1.0
Nominal GDP	2.3	-2.8	0.7	0.8	-6.8	-6.1	5.0	-1.6	1.5	1.2	-2.5	1.1	0.6
Contribution to Changes in Real GDP:													
Domestic final sales	2.0	0.4	2.0	1.5	-3.0	1.8	2.1	2.0	2.3	2.1	—	—	—
Net Exports	2.0	-0.8	-0.1	0.2	-0.6	-4.1	2.7	-3.1	0.7	0.5	—	—	—
Inventories	0.7	-0.1	0.0	0.1	-2.7	0.0	1.1	0.6	-0.5	-0.4	—	—	—
Discrepancy	-0.2	-0.3	—	—	-0.3	0.3	-0.3	—	—	—	—	—	—
Trade Balance *(¥ trillion)*	7.94	-1.46	-2.14	-1.34	0.91	-1.25	-0.15	-0.97	-0.79	-0.62	—	—	—
Current Account Balance *(¥ trillion)*	17.16	8.26	8.93	10.73	3.26	1.90	2.59	0.51	2.63	1.93	—	—	—
as percent of GDP	3.6	1.8	1.9	2.3	2.8	1.6	2.2	0.4	2.2	1.6	—	—	—
Consumer Prices *(percent oya)*	-0.7	-0.3	-0.1	-0.1	-0.6	-0.5	0.2	-0.1	-0.3	-0.1	-0.1	-0.1	0.0
Core Consumer Prices *(percent oya)*	-1.2	-0.8	-0.4	-0.3	-1.4	-0.9	-0.5	-0.6	-0.5	-0.4	-0.6	-0.4	-0.3
Unemployment Rate *(percent)*	5.1	4.5	4.3	4.3	4.7	4.6	4.4	4.4	4.3	4.3	—	—	—
BoJ Overnight Call Rate *(end of period)*	0.10	0.10	0.10	0.10	0.1	0.1	0.1	0.1	0.1	0.1	—	—	—
¥ per $ *(end of period)*	81.1	78.0	80.0	82.0	83.1	80.6	77.1	78.0	79.0	79.0	—	—	—
Government General Balance *(% of GDP)*	-8.1	-9.2	-9.5	-9.5	—	—	—	—	—	—	—	—	—
Index of Manufacturing Production	16.6	-3.1	3.6	2.6	-7.8	-15.1	18.3	4.5	2.5	2.5	-0.8	2.6	2.5

Table 11
Japan: Latest Real GDP Growth Forecasts
percent, y/y

	2011	2012	As of
		Calendar Year	
IMF	-0.5	2.3	Sep 11
OECD	-0.3	2.0	Nov 11
Bloomberg Consensus	-0.8	1.7	Dec 11
IIF	-0.9	1.9	Dec 11
		Fiscal Year	
Bank of Japan	0.3	2.2	Nov 11
IIF	-1.9	2.0	Dec 11

Chart 46
Japan: The Evolution of 2011 GDP Growth Forecasts
percent, y/y, forecasts as of the end of quarter



United Kingdom

EXTERNAL WEAKNESS PLUS DOMESTIC AUSTERITY

- The latest business sentiment indicators support our view that the Euro Area crisis is adding a significant new negative hit to the British economy on top of the drag already evident from tighter fiscal policy, and banking sector downsizing. The CBI industrial trends survey showed further weakness in manufacturing sector, led by weakness in export orders. The headline balance of orders series dropped to –23 in December from –19 in November (Chart 47). This softness is also evident in manufacturing PMI data. That series fell to 47.6 in November (Chart 48).

- As expected, inflation eased further to 4.8%oya in November (Chart 48). Core inflation dropped to 3.2%. We currently expect inflation to fall further in the coming months, reaching the BoE's 2% target by the end of 2012, mainly on account of declining global energy prices and the base effect of the January 2011 VAT hike.

- Labor market conditions continue to be weak. The ILO measure of the unemployment rate is hit a 15-year high of 8.3% in the third quarter of 2011, partly because of headcount reductions in the public sector. With the November Autumn Statement pointing to a further reduction in government spending (Chart 49), public sector job losses should be expected to persist in the years ahead.

- Two other recent developments could have negative effects on the economy: First, the Government endorsed the recommendations of the Independent Commission on Banking, now expected to be put into law by 2015. The recommendations, particularly the ring-fencing of a bank's retail activities into a higher capitalized arm, will imply an increase in U.K. bank funding costs that will lead to tighter credit conditions and lower economic growth.

- Second, the U.K.'s actions at the last EU summit left it isolated within the EU, raises concerns that the U.K. could be damaged by loss of business investment focused on European integration.

Chart 47
U.K.: Manufacturing PMI and CBI Industrial Trends
diffusion index, 3-month moving averages

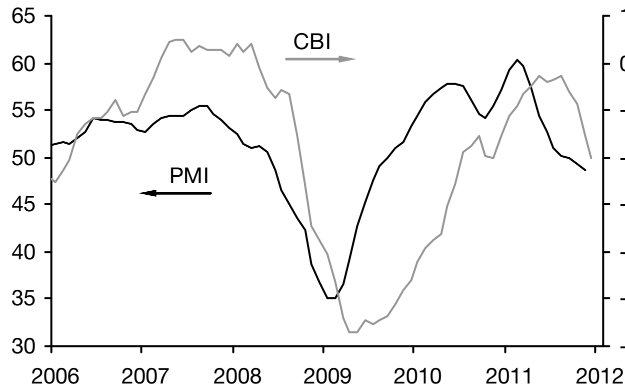


Chart 48
U.K.: Consumer Inflation
percent change over a year ago

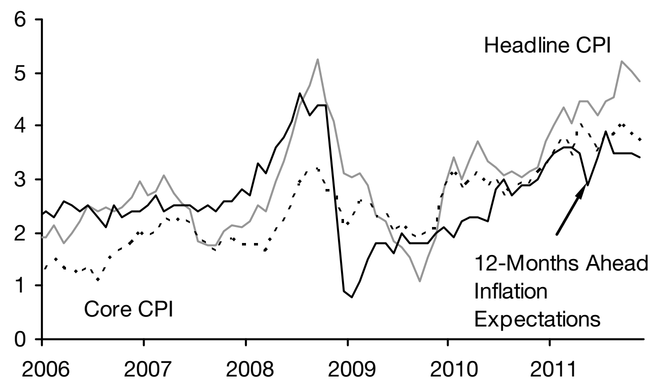
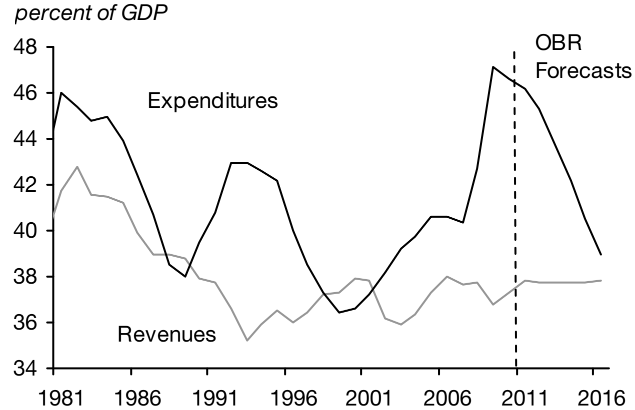


Chart 49
U.K.: General Government Expenditure and Revenue
percent of GDP



Other Mature Economies

OTHER MATURE ECONOMIES FORECAST SUMMARY

percent change over previous period, seasonally adjusted, at an annual rate, unless otherwise stated

	2010	2011	2012	2013	11Q1	11Q2	11Q3	11Q4	12Q1	12Q2	Q4/Q4 2011	Q4/Q4 2012	Q4/Q4 2013
Australia													
Real GDP	2.6	2.5	3.0	3.1	-2.7	5.7	3.9	1.0	3.0	3.5	1.9	3.2	3.0
GDP Deflator (percent, oya)	5.7	4.4	3.6	2.2	6.2	4.0	3.5	4.0	4.1	3.7	4.0	3.0	2.2
Current Account Balance (%GDP)	-2.8	-2.0	-1.9	-2.0	-3.2	-1.9	-1.5	-1.5	-1.5	-2.0	—	—	—
Inflation Target	2.0 - 3.0												
Consumer Prices (*percent, oya)*	2.8	3.5	3.2	3.2	3.3	3.6	3.5	3.5	3.2	3.2	3.5	3.2	3.2
USD per AUD *(end of period)*	1.02	1.01	1.03	1.00	1.03	1.07	0.97	1.01	1.02	1.03	—	—	—
Cash Rate	4.75	4.25	3.75	4.00	4.75	4.75	4.75	4.25	4.00	3.75	—	—	—
Canada													
Real GDP	3.2	2.3	2.1	2.4	3.5	-0.5	3.5	1.5	2.0	2.4	2.0	2.3	2.4
GDP Deflator (percent, oya)	2.9	3.0	2.6	3.0	2.9	3.4	3.4	2.3	2.2	2.3	2.3	3.1	3.0
Current Account Balance (%GDP)	-3.1	-3.0	-2.4	-2.4	-0.6	-0.9	-0.7	-0.7	-0.6	-0.6	—	—	—
Inflation Target	2.0 (+/-1)												
Consumer Prices (*percent, oya)*	1.8	2.9	1.6	1.5	2.6	3.4	3.0	2.7	2.0	1.6	2.7	1.5	1.5
CAD per USD	1.00	1.02	1.00	0.95	0.97	0.96	1.05	1.02	1.02	1.02	—	—	—
O/N Rate	0.99	1.00	1.00	1.25	0.99	1.00	1.00	1.00	1.00	1.00	—	—	—
Sweden													
Real GDP	5.3	4.6	0.8	1.5	2.7	4.2	6.6	-0.7	-0.7	-0.5	3.2	0.1	2.0
GDP Deflator *(percent, oya)*	1.1	2.4	8.3	5.7	0.8	1.3	0.7	6.7	9.9	9.4	6.7	7.0	5.0
Current Account Balance (%GDP)	7.0	7.3	5.0	5.0	8.4	7.0	9.0	5.0	5.0	5.0	—	—	—
Inflation Target	2.0												
Consumer Prices (*percent, oya)*	1.3	2.7	1.6	1.5	2.3	2.9	3.0	2.5	2.0	1.5	2.5	1.5	1.5
SEK per USD *(end of period)*	6.71	6.88	6.85	6.70	6.32	6.33	6.87	6.88	6.88	6.88	—	—	—
Repo Rate	1.25	1.75	1.00	1.25	1.50	1.75	2.00	1.75	1.75	1.50	—	—	—
United Kingdom													
Real GDP	2.1	0.9	0.0	1.4	1.7	0.0	2.3	-1.0	-1.0	-1.0	0.7	0.4	1.5
GDP Deflator (percent, oya)	3.0	2.3	2.1	2.0	2.3	2.5	2.4	2.2	1.9	2.2	2.2	2.1	2.0
Current Account Balance (%GDP)	-3.3	-2.5	-1.5	-1.5	-2.0	-2.0	-4.0	-2.0	-1.5	-1.5	—	—	—
Inflation Target	2.0												
Consumer Prices (*percent, oya)*	3.3	4.4	2.7	2.0	4.2	4.4	4.7	4.5	3.5	3.0	4.5	2.0	2.0
USD per £ *(end of period)*	1.56	1.56	1.58	1.55	1.60	1.61	1.56	1.56	1.56	1.56	—	—	—
Bank Rate	0.50	0.50	0.50	0.75	0.50	0.50	0.50	0.50	0.50	0.50	—	—	—

Chart 50
Other Mature Economies: Current Account Balance
percent of GDP

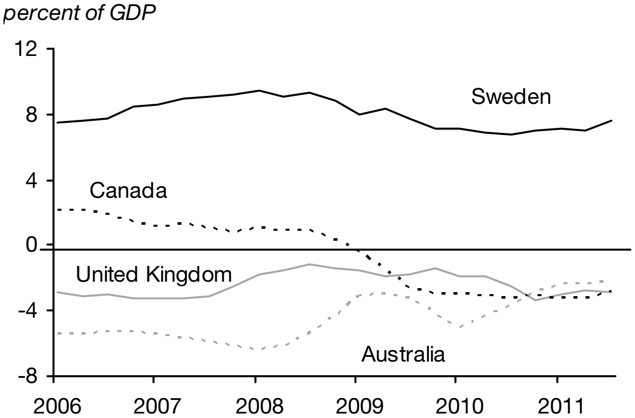
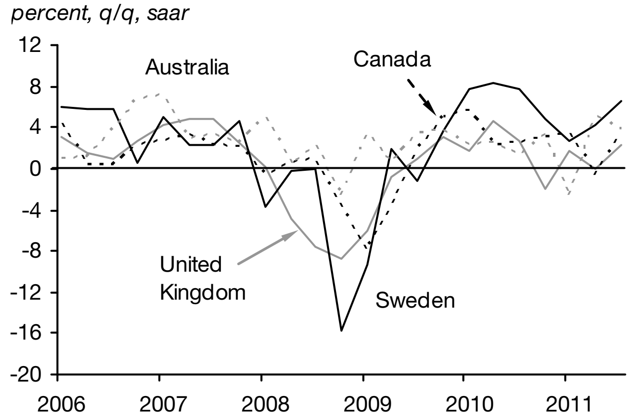


Chart 51
Other Mature Economies: Real GDP Growth
percent, q/q, saar



Emerging Asia

GROWTH MODERATION UNDER WAY

- The renewed European crisis-induced global financial turmoil has sharply diminished capital inflows to the leading Emerging Markets of Asia. This has precipitated a 5-17% depreciation of regional exchange rates, with the exception of **China**, between July and mid-December, along with stepped-up intervention to counter downward pressures (Chart 52). Meanwhile, the weakening in external demand has led to a slowdown in the previous exceptionally strong regional export performance (Chart 53).

- The global headwinds come at a time when economic growth in Emerging Asia was moderating due to the policy tightening since last year aimed at curbing excess demand pressures (Table 12). The fall in inflation brought on by the softening in domestic demand and lower commodity prices is now providing room for monetary policy easing to act as a cushion. Nevertheless, the prospects for subdued capital inflows and unfavorable global conditions mean that regional growth is set to slip from 9.1% in 2010 to 7.7% in 2011 and 7.4% in 2012.

- Slower export growth, lower inflation and increasing evidence that the property market is cooling prompted the Chinese government to refocus attention on sustaining growth (Chart 54, next page). The exchange rate appreciation is being halted and the central bank in December cut bank reserve requirements by 50 basis points, the first reduction in three years. The seminal end-of-the-year Central Economic Work Conference also made clear that bolstering growth should be a policy priority over the near term. Nevertheless, the moderation in economic activity under way is set to slow real GDP growth from 10.4% in 2010 to 9.3% this year and 8.6% in 2012.

- In **India**, after moderating in the first part of the year, industrial production slumped 5% in October from a year earlier, although this partly reflects lost production days due to the festival season and supply disruptions in mining. While services and agriculture are holding up, real GDP growth is likely to fall from 8.5% in the fiscal year ending March 2011 to 7% in 2011/12 and 6.5% in 2012/13.

Chart 52
Asia: Exchange Rate Depreciation
percent change against US$, July 2011-present

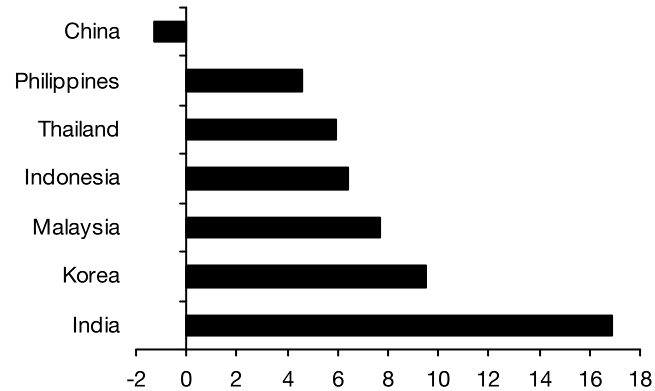


Chart 53
Asia: Exports
percent change from previous year, 3-month moving average

Table 12
Asia: Real GDP
percent change from previous year

		2011		
	2010	Q1	Q2	Q3
China	10.4	9.7	9.5	9.1
India	8.5	7.8	7.7	6.9
Indonesia	6.1	6.5	6.5	6.5
Malaysia	7.2	5.2	4.3	5.8
Philippines	7.6	4.6	3.1	3.2
South Korea	6.2	4.2	3.4	3.5
Thailand	7.8	3.2	2.7	3.5

EMERGING ASIA (CONTINUED)

- While the Indian central bank was on hold in mid-December after increasing its repo or lending rate by 375 basis points to 8.5% between March 2010 and October 2011, lower inflation will allow a shift to an easing stance early next year. The 12-month increase in wholesale prices is on course to fall to 6.5-7% by March from 9.1% in November (Chart 55). Meanwhile, the central bank recently moved to liberalize the capital account and put in place administrative measures to curb foreign exchange speculation. The outlook for a smaller current account deficit and some central bank intervention should also help the rupee bottom out.

- With the balance of risks shifting towards growth, **Indonesia** cut its policy rate by 25 basis points in mid-October, followed by a 50 basis point reduction to 6% in mid-November (Table 13). Thereafter, the central bank paused in December, but may cut the rate early next year once the global turmoil dissipates. The 12-month increase in consumer prices fell to 4.2% in November, which is well within the central bank's target range of 3.5-5.5%.

- In **Korea**, the slowdown in export growth has added to the softening in domestic demand, prompting the central bank to keep policy rates unchanged since midyear. In the **Philippines**, weak exports are also resulting in a fall in real GDP growth, although domestic demand strength and fiscal headroom provide a cushion. In **Malaysia**, monetary policy remains accommodative, with the central bank holding the policy rate unchanged at 3% since May. The government is also moving cautiously to withdraw fiscal stimulus, with the federal deficit planned to fall more slowly from 5.4% of GDP in 2011 to 4.7% in 2012, due to growth concerns and the political cycle. National elections are likely by mid-2012.

- In **Thailand**, the 36% slump in manufacturing in October from a year earlier heralds the sharp retrenchment in the fourth quarter due to widespread flooding. Given the global weakness and the floods, the central bank cut the policy rate by 25 basis points to 3.25% in November. Another reduction is likely early next year with moderate inflation. Meanwhile, in contrast to its peers, the expanded fiscal program and reconstruction should lift growth from 1.5% in 2011 to 5.5% in 2012.

Chart 54
China: Exports, 2011
percent change from previous year

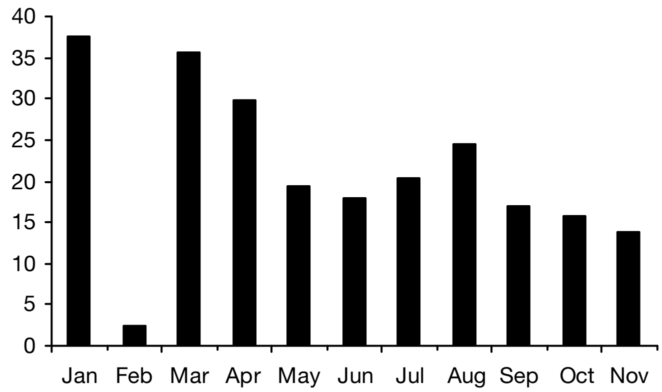
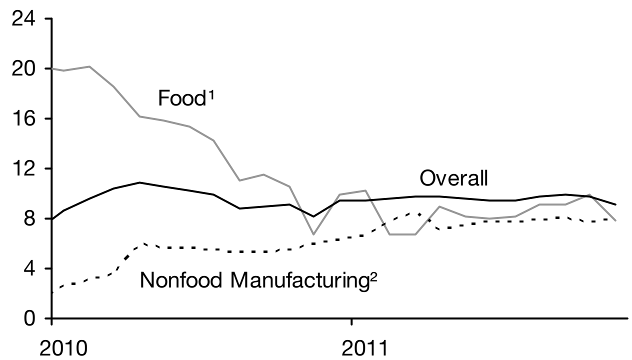


Chart 55
India: Wholesale Prices
percent change from previous year, 2004/05=100



[1] Food articles and food products. [2] Manufactured excluding food products.

Table 13
Asia: Policy Rates
percent per annum

	December			
	2008	2009	2010	2011*
China	5.31	5.31	5.81	6.56
India	6.50	4.75	6.25	8.50
Indonesia	9.25	6.50	6.50	6.00
Malaysia	3.25	2.00	2.75	3.00
Philippines	5.50	4.00	4.00	4.50
South Korea	3.00	2.00	2.50	3.25
Thailand	2.75	1.25	2.00	3.25

*as of Dec16th

Emerging Europe

CAPITAL FLOWS TO SLOW

- The deteriorated outlook for the Euro Area has had a significant adverse impact on Emerging Europe. Capital inflows have slowed sharply or reversed since October. Portfolio equity inflows have reversed, and IPOs and bond issues have been postponed. Sharply tighter funding constraints, including by foreign parents, have led domestic banks to repay external debt in most countries. Countries deemed to have weaker fundamentals and those with high external borrowing have been hit the hardest, with access to foreign capital halted and currencies coming under increased stress. Ukraine and Hungary stand out.

- **Ukraine** is the country at most risk in the region. With IMF lending halted, access to markets lost since October, and a current account deficit of 5% of GDP, financing pressures have intensified. Unwilling to let the hryvnia adjust, the central bank stepped up exchange market interventions and tightened liquidity sharply, pushing interbank rates to 20% (Chart 56). Mindful of next year's parliamentary election, the government has been unwilling to advance the measures needed to restart IMF lending, counting instead on obtaining a larger discount on the import price of Russian natural gas. Even with a sizable price cut, external financing pressures would remain outsized with market access unlikely to be restored unless the IMF program is brought on track.

- Net capital inflows to **Hungary** appear to have reversed since September. Foreign exchange reserves fell to €35.7 billion in November from €38 billion in September, even though the current account is likely to have remained in sizable surplus. Domestic banks have made large net foreign debt repayments, and foreign purchases of forint-denominated government bonds reversed in October and November. Forint weakness prompted the central bank to hike its key policy interest rate by 100 basis points to 7 % in two steps since October, despite ongoing output weakness. Should Hungary be able to secure a credit facility from the IMF and European Commission, market confidence would improve and pressure on the forint would ease, which could prompt the central bank next year to reverse the recent hikes in its key policy rate. (Chart 57).

Chart 56
Ukraine: Interest Rate on Interbank Market
percent

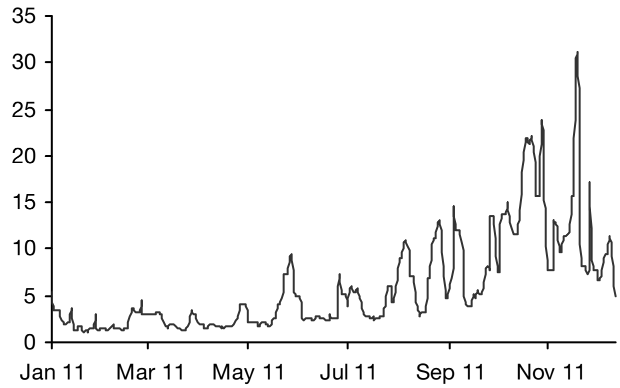


Chart 57
Hungary: Nonresident Holdings of Forint-Denominated Bonds and Exchange Rate
€ billion *forint/€ (inverted scale)*

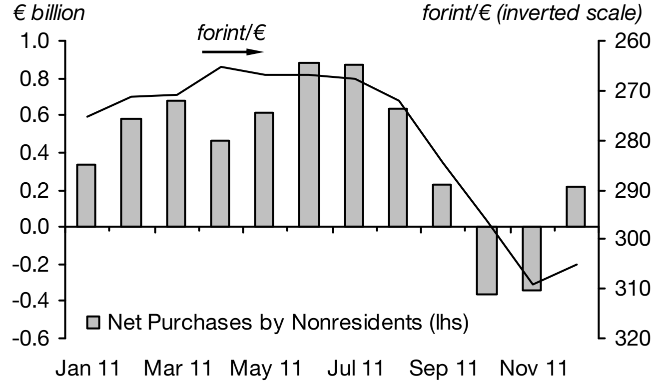
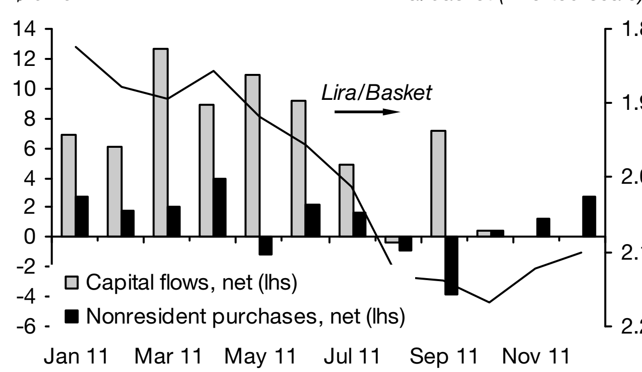


Chart 58
Turkey: Capital Flows, Nonresident Purchases of Lira-Denominated Bonds and Exchange Rate
$ billion *lira/basket (inverted scale)*



Emerging Europe

EMERGING EUROPE (CONTINUED)

- In **Turkey**, net capital inflows have continued, but at a slower pace, rising less than the current account deficit widened during January-October. This mainly reflected a reversal in foreign portfolio equity inflows, sharply smaller net borrowing by domestic banks, and reduced foreign purchases of lira-denominated government bonds. To support the lira, which has weakened 20% against its equally weighted $/€ basket since late last year (Chart 58, previous page), the central bank has sold $9 billion to the market since August, reducing FX reserves from $93 billion to $84 billion. With the current account deficit likely to narrow only slightly next year from around 10% of GDP this year, external financing needs will remain large, leaving Turkey quite vulnerable to shifts in market sentiment.

- Net capital inflows to **Poland** slowed significantly in the second half of 2011, as banks repaid $6 billion of foreign debt during July-October, almost equal to the $7 billion borrowed during January-June. With the fiscal deficit narrowing, net foreign borrowing by the government slowed sharply after September. Foreign direct equity inflows reversed and foreign portfolio equity inflows slowed after July. Nonresidents' demand for the zloty-denominated government securities ebbed in August, as the global risk appetite plunged, causing the zloty to weaken roughly 12% against the euro since late last year (Chart 59).

- In **Russia**, most banks and corporations have lost access to foreign markets since October. Large external debt repayments have caused foreign capital inflows to reverse and combine with large resident outflows to weaken the ruble (Chart 60). Foreign and resident outflows have risen sharply further as political uncertainty intensified since the December 4 Duma election. With uncertainty likely to persist at least until the March presidential election, capital outflows will remain large, continuing to weigh on the ruble.

- Capital inflows have slowed sharply in **Romania** as well. Banks, in particular, made sizable foreign debt net repayments since July as bank liquidity in Europe has tightened. With the current account deficit only slightly more narrow than a year ago at 4.5% of GDP and capital inflows slowing, the leu has come under renewed pressure (Chart 61).

Chart 59
Poland: Nonresident Holdings of Zloty-Denominated Bonds and Exchange Rate

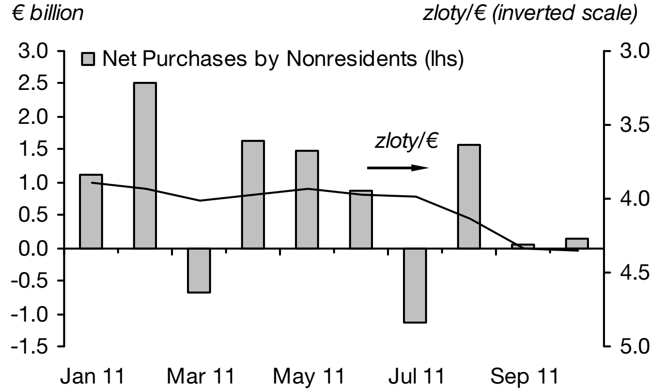


Chart 60
Russia: Exchange Rate and Stock Prices

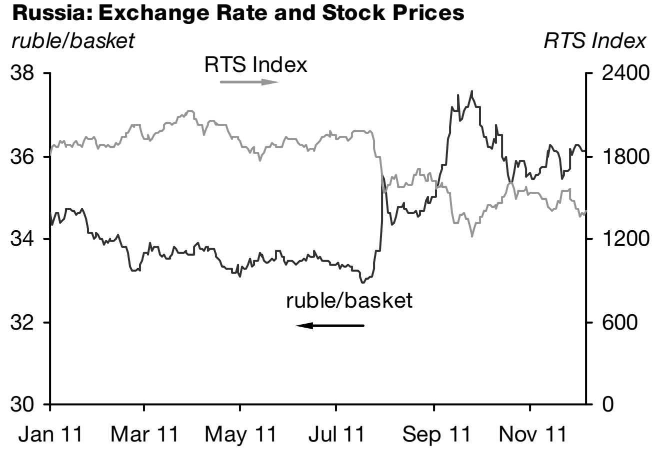


Chart 61
Romania: Exchange Rate

Latin America

SLOWER GROWTH ON THE HORIZON

- Growth prospects in Latin America remain strong but are expected to deteriorate in 2012. GDP growth is expected to decelerate to 3.4% from 3.9% this year (Chart 62) amid a less supportive external environment. With the exception of Brazil, the region's economies showed strong growth momentum through the third quarter. However, the slowdown in Europe and lower commodity prices will drag on economic activity in the coming quarters. Most of the countries in the region are well-prepared to face a global rough patch, counting on relatively strong fiscal positions, sound financial systems and sizable reserves.

- Countries more closely linked to Europe through financial and trade channels face greater downside risks to growth. European banks are the region's largest foreign creditor with claims equal to roughly 20% of bank assets and nearly half in Mexico (Chart 63), and there is a risk they could withdraw a significant amount of liquidity from the region to offset problems at home. However, Latin America remains less vulnerable than other regions to a credit crunch given that most foreign bank lending is done via locally-funded subsidiaries instead of cross-border operations. Reduced demand for Latin American exports will also weigh on growth in 2012. Exports to the Euro Area are low compared to other regions, representing just 2% of the region's GDP. Chile and Peru are more exposed with exports to the Euro Area representing 5.2% and 4% of GDP, respectively (Chart 64).

- In **Brazil**, real GDP growth has come to a halt, reflecting the lagged impact of monetary tightening in the first half of the year and erosion of confidence stemming from uncertainty over Europe. Real GDP growth was -0.2%q/q, saar, in Q3, down from 2.9%q/q, saar, a quarter earlier. With the government increasingly concerned about growth, and barring a deeper-than-anticipated global slump, we expect a policy-driven rebound of the economy next year, which should begin in the second quarter. We forecast growth at 3.0% in 2012, marginally up from 2.8% this year. In 2013, we envision above-trend growth of 5.0% on the back of expansionary macro policies, increased infrastructure investment linked to the 2014 World Cup, and an acceleration in global growth (Chart 65, next page).

Chart 62
Latin America: GDP Growth
percent, y/y

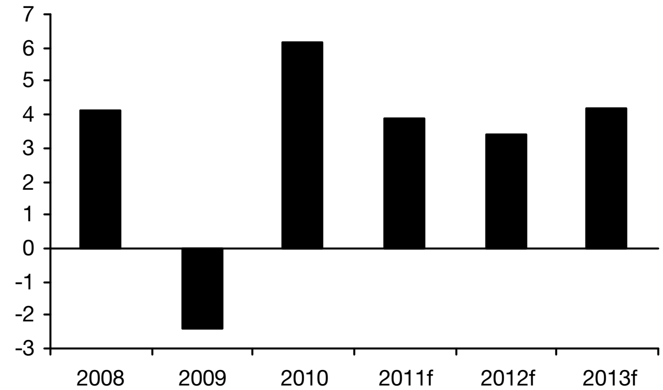


Chart 63
Latin America: Foreign Bank Claims
percent of banking sector assets, June 2011

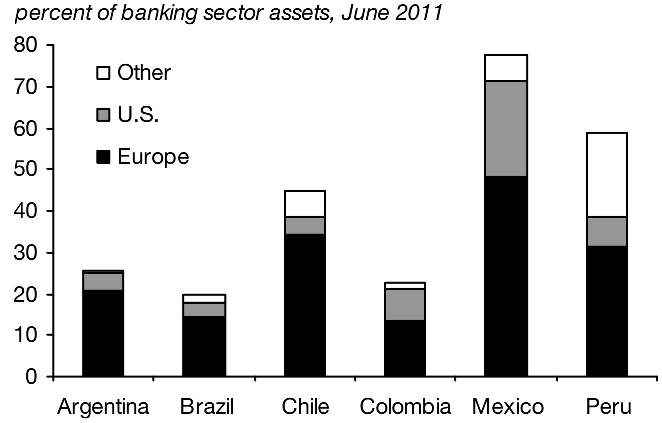
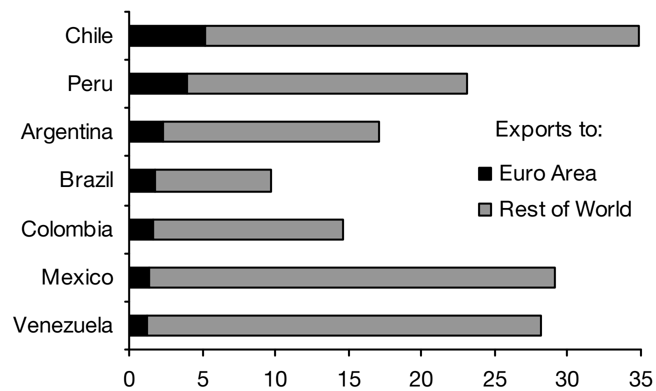


Chart 64
Latin America: Export Exposure to Euro Area
percent of GDP, 2010



LATIN AMERICA (CONTINUED)

- In **Mexico**, economic growth is expected to decelerate closer to trend growth of 3% in 2012. GDP growth for 2011 is forecast to be 4.0% after a strong Q3 that saw growth accelerate to 4.5%oya on robust domestic demand and strong expansion of the agricultural sector, closing the output gap (Chart 66). However, the deterioration in the external environment is increasingly weighing on the outlook for 2012. The industrial sector has started to reflect mild weakness in the second half of the year, while consumer sentiment and business confidence are losing momentum. We expect growth to decelerate gradually in coming quarters, moderating to 3.3% in 2012, before recovering somewhat to 3.5% in 2013.

- With exports accounting for 35% of GDP, **Chile's** economy is one of the most exposed to global weakness. A strong policy framework, robust external position and well-anchored inflation expectations, however, provide substantial scope for countercyclical support. The seasonally adjusted monthly economic activity index (IMACEC) decelerated to 6.3% growth in the twelve months through November, down from a peak of 7.3% in April. The ongoing deceleration reflects the fading of post-earthquake reconstruction-related spending and a weakening world economy. We expect growth to slow to 4.0% in 2012, down from 6.2% this year, but to pick up to 5.0% in 2013 in tandem with strengthening global growth.

- In **Argentina**, market interest rates for *peso*-denominated assets remain high, reflecting tighter monetary conditions. The Badlar deposit rate stabilized at levels close to 19% in mid-December, compared to levels of 12% in early September (Chart 67). Dollar-denominated deposits have fallen almost 20% since new foreign exchange controls were introduced in late October in a bid to stem capital outflows. Administrative controls to suppress the symptoms of mounting macroeconomic imbalances and maintain the current foreign exchange rate policy are expected to continue in 2012. We now expect the economy to grow 3.5% in 2012, down from the previous forecast of 4.4%, amid chronic capital flight, tighter monetary conditions and less supportive external factors (lower soybean prices, slower growth in Brazil and a weaker *real*).

Chart 65
Brazil: GDP Growth
percent, q/q saar

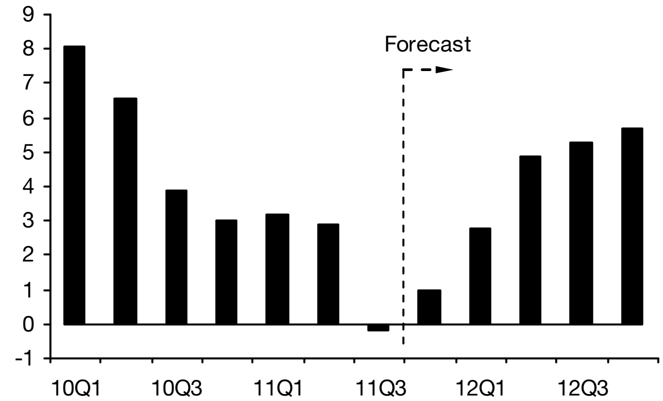


Chart 66
Mexico: GDP Growth and Output Gap
percent change, q/q saar *percent*

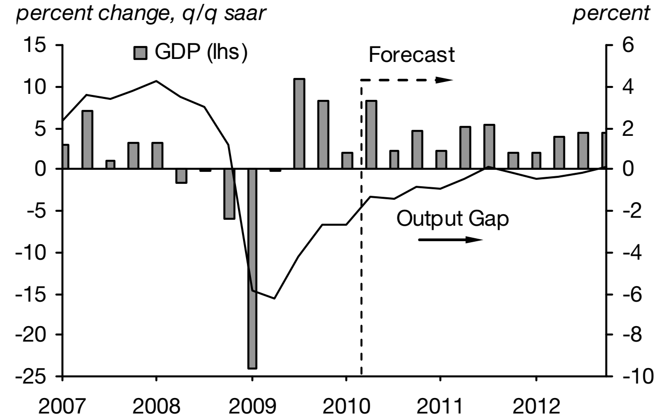
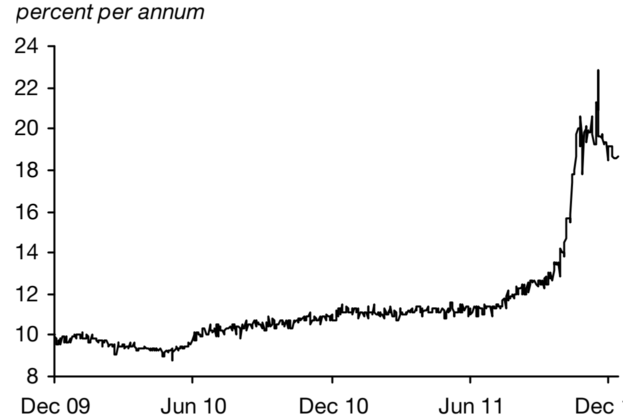


Chart 67
Argentina: Badlar Rate
percent per annum



Africa and Middle East

KEEPING AN EYE ON GOVERNMENT DEBT

- The escalating crisis in the Euro Area has resulted in a sharper focus on government debt in emerging markets. In the Africa/Middle East region, the situation varies significantly between countries. In oil exporting countries, government debt levels are not an issue, with the exception of the UAE where there continue to be lingering concerns over Dubai. In other countries in the Middle East, such as Egypt, Lebanon and Jordan, large budget deficits have resulted in higher debt-to-GDP ratios. Many countries in Sub-Saharan Africa have received debt relief in recent years, which has reduced the debt burden, while prudent fiscal policy over the past decade in South Africa means that the government debt ratio is still relatively modest.

- Concerns have been raised recently that **Dubai** might need further financial support. In particular, Dubai Holding Commercial Operations Group, Jebel Ali Free Zone, and DIFC Investments are all facing refinancing risks. In 2012, GREs need to settle $7.9 billion in debt maturities, in addition to the $5.5 billion worth of bonds falling due (Table 14). To meet this large debt repayment schedule (equivalent to about 12% of Dubai's GDP), the government may seek a combination of refinancing and settlement of some debt. Following the 2010 debt restructuring, a large amount of the debt will mature in 2014-2016. Total public debt, regardless of the residency of debt holders, is about $110 billion, equivalent to 100% of Dubai's GDP. The local banking system's overall lending to GREs is estimated at about $25 billion (equivalent to 9% of total loans).

- In **Egypt**, the fiscal position has deteriorated significantly following the onset of the Arab Spring. A sharp slowdown in growth meant that revenue in FY 2010/11 (July-June) fell nearly 3 percentage points of GDP, and the budget deficit widened to 9.8% of GDP. We expect further deterioration in the current fiscal year, and the deficit could top 11% of GDP if no remedial action is taken.

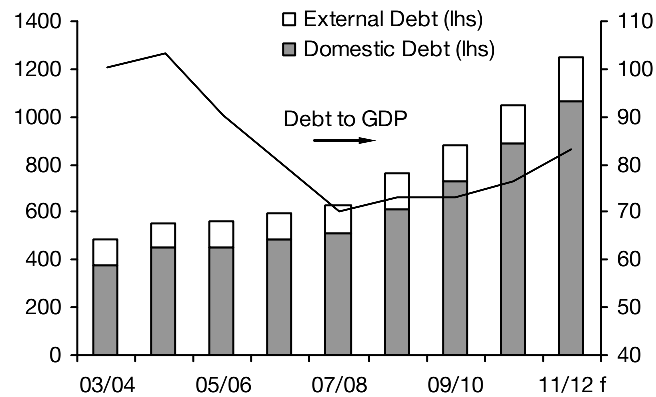
- Financing the deficit is becoming increasingly difficult as funding costs have risen sharply (Chart 68). Local lenders are approaching the maximum amount they are allowed to lend to the government. Support from regional institutions and bilateral donors has helped, but it remains uncertain whether Egypt will access IMF funds. Meanwhile, the

Table 14
Dubai: Breakdown of Debt Regardless of Residency
Billions of U.S. dollars, unless otherwise indicated

	Debt Falling Due				**Total**
	2011	2012	2013	Beyond	**Debt**
Dubai World	4.6	5.0	0.6	25.9	**36.1**
Dubai Holding	2.3	0.5	0.1	10.9	**13.7**
Invest/ Corp.	5.9	4.0	3.0	7.9	**20.8**
Other Dubai	1.6	3.9	2.0	8.3	**16.7**
Total GRE's	14.3	13.4	5.6	53.0	**86.3**
Gov't of Dubai	1.1	0.1	1.8	20.6	**23.6**
Total Dubai Debt	15.4	13.5	7.4	73.6	**109.9**
o/w Bonds	2.5	5.5	3.6	35.8	**47.4**
Loans	12.8	7.9	3.8	37.8	**62.4**
(% GDP)	(13.8)	(11.7)	(6.0)	(67.2)	**(98.7)**

Chart 68
Egypt 3-Month T-bill Rate
percent

Chart 69
Egypt Central Government Debt
LE billion *percent*



AFRICA AND MIDDLE EAST (CONTINUED)

government debt-to-GDP ratio is projected to rise to over 83% of GDP, raising concerns over debt sustainability (Chart 69, previous page). Implementing postponed fiscal reforms is becoming ever more urgent, particularly regarding subsidies, which now absorb 27.5% of total spending and are equivalent to about 8.5% of GDP.

- While **Lebanon's** government debt (130% of GDP) is much higher than other emerging markets and most Euro Area countries, CDS spreads, at around 440 basis points are lower than those of Greece, Italy, and Dubai. Lebanon's government debt ratio has been declining in recent years on the back of robust growth and fiscal restraint (Chart 70), and is mostly intermediated through domestic banks, which have remained well-capitalized, liquid and profitable. Capital inflows from the Lebanese Diaspora and long-term investors from the GCC have been robust in recent years and foreign assets of the central bank (excluding gold), at about $31 billion, far exceed the foreign currency component of the government's debt of $20 billion.

- **Jordan's** gross public debt, at around 67% of GDP in 2010, exceeds the self-imposed limit of 60%. This is despite an improvement in the budget deficit, which narrowed to 5.6% of GDP from 8.9% in 2009. Both domestic and external debt has increased, the latter reflecting Jordan's inaugural $750 million international bond issue in late 2009. The increase in debt, caused by both the global economic crisis and more recently regional turmoil, reversed earlier improvements. Between 2002 and 2008, debt fell from 103% of GDP to 60%, facilitated by privatization, debt swaps and strong growth in nominal GDP. This year, however, we project gross debt to rise further to almost 70% of GDP (Chart 71).

- In **South Africa**, the budget deficit is projected to shrink over the next three years (to 3.3% of GDP in 2014/15), but consolidation will be slower than previously envisaged. The government debt-to-GDP ratio continues to rise, and is projected to plateau at just over 42% (Chart 72). With spending focused on infrastructure, this should not be cause for concern, as long as the government adheres to its plans that would virtually eliminate the primary deficit in three years.

Chart 70
Lebanon: Gross Government Debt
$ billion *percent of GDP*

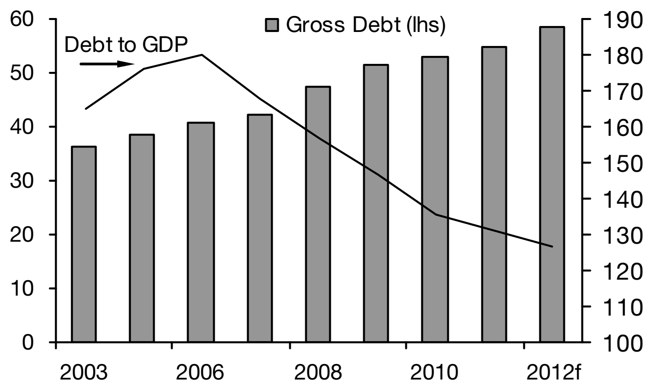


Chart 71
Jordan Public Debt
percent GDP

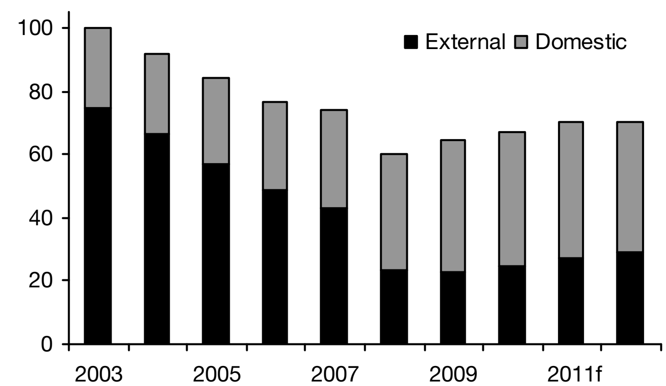
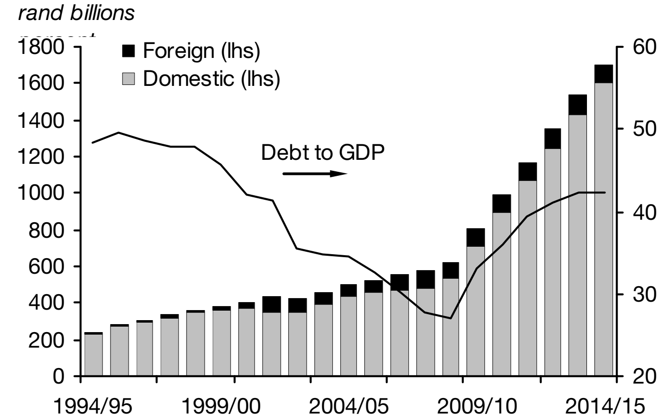


Chart 72
South Africa Government Debt
rand billions



CHANGES IN IIF FORECAST

- This month's changes in forecast have been relatively small for the mature economies, but rather substantive for the emerging ones. Most notably, we downgraded our growth outlook for 2012 across all EM regions by an average of 0.3 percentage points (Chart 73). The largest downward revision was made for EM Asia, especially India. That country is now projected to grow 6.5% in 2012 rather than 7.8% as projected previously.

- We also reduced our inflation forecast for 2012 for a number of emerging market economies (Chart 74). Most of the downward revision was concentrated in China, which is now forecast to experience consumer price inflation of 3.1% next year rather than 5.1%.

- For Japan, we reduced our forecast for 2011 and 2012 growth due to a combination of downward revisions to historical data and weaker new data, especially trade. Our U.S. and Euro Area growth forecasts remained almost unchanged (Chart 75). We revised Q4 U.S. growth up to 3.5% from 3.0% on strong consumption data. For the Euro Area, we maintain our call of a moderate recession.

- We changed our view on the likely trajectory of the euro-dollar exchange rate; we now expect the euro to decline to €1.20 per dollar by the end of 2012Q2 (rather than to €1.25 per dollar as projected previously).

- Our Brent oil price call is unchanged this month (Chart 76).

Chart 73
IIF Growth Forecast: Emerging Economies

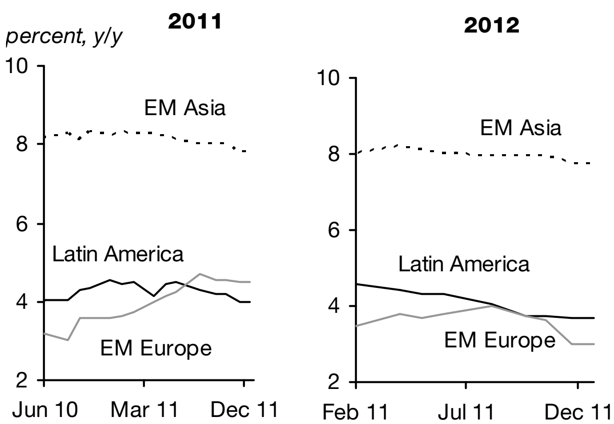


Chart 75
IIF Growth Forecast: Mature Economies
percent, y/y

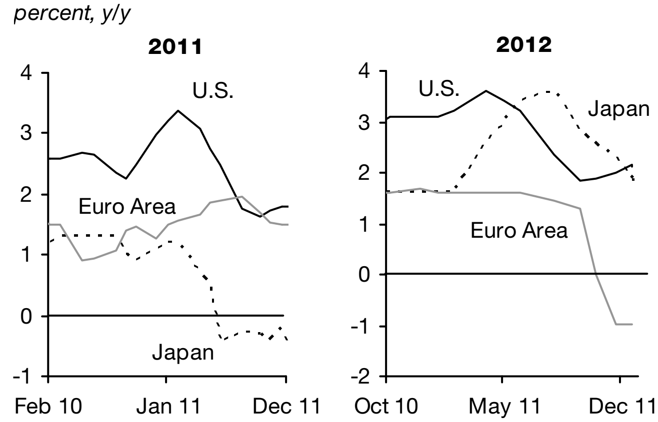


Chart 74
IIF 2011 CPI Forecast
percent change over a year ago, end of period

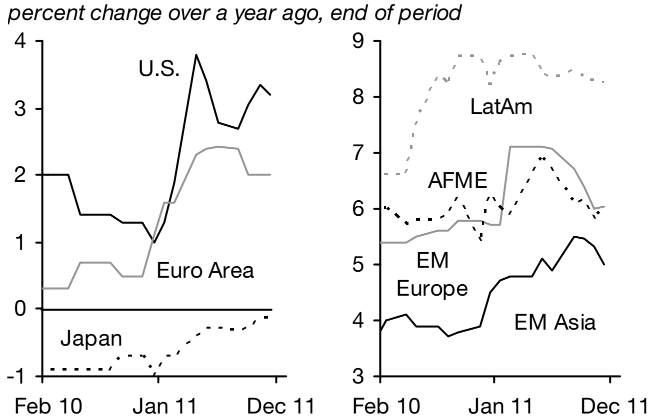
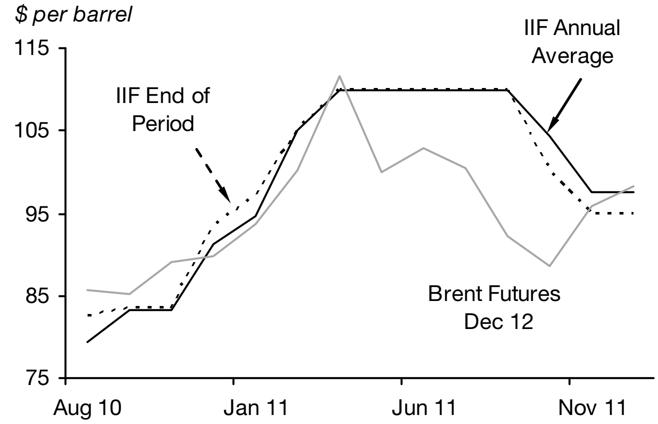


Chart 76
IIF 2012 Oil Price Forecasts
$ per barrel



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Global Economic Monitor

THE FORECAST IN DETAIL

Global Output Growth
percent, y/y

	2010	2011f	2012f	2013f
Mature Economies	**2.8**	**1.3**	**0.9**	**1.9**
United States	3.0	1.8	2.1	2.4
Euro Area	1.8	1.5	-1.0	1.2
Japan	4.5	-0.9	1.9	1.8
Other Mature	2.7	1.8	1.1	2.0
Emerging Economies	**7.2**	**6.0**	**5.4**	**6.1**
Latin America	6.2	3.9	3.4	4.2
Argentina	9.2	6.5	3.5	3.0
Brazil	7.5	2.8	3.0	5.0
Mexico	5.4	4.0	3.3	3.5
Emerging Europe	4.5	4.6	2.7	3.6
Russia	4.0	4.0	3.7	4.0
Turkey	9.0	8.5	3.2	4.5
Asia/Pacific	9.1	7.7	7.4	7.9
China	10.4	9.3	8.6	9.0
India	8.5	7.0	6.5	7.0
Africa/Middle East	4.3	4.6	3.4	4.1
South Africa	2.8	3.1	2.9	3.7
World	**4.4**	**3.2**	**2.8**	**3.7**

Based on market exchange rates

Consumer Prices
percent change over a year ago, end of period

	2010	2011f	2012f	2013f
Mature Economies	**1.4**	**2.6**	**1.4**	**1.8**
United States	1.2	3.3	1.5	2.3
Euro Area	2.0	2.6	1.7	2.0
Japan	-0.3	-0.1	-0.1	0.0
Other Mature	2.8	3.7	2.0	2.0
Emerging Economies	**6.2**	**5.6**	**5.1**	**5.2**
Latin America	8.1	8.3	7.6	8.7
Argentina	22.9	21.7	22.4	21.9
Brazil	5.9	6.5	5.0	5.5
Mexico	4.4	3.6	3.4	3.8
Emerging Europe	6.8	6.3	6.7	5.7
Russia	8.8	6.3	8.1	7.0
Turkey	6.4	10.1	7.5	6.5
Asia/Pacific	5.3	4.2	3.5	3.5
China	4.6	3.6	3.1	3.0
India	9.7	6.5	4.5	4.8
Africa/Middle East	5.3	6.0	5.5	5.2
South Africa	3.5	6.2	5.6	5.0
World	**3.2**	**3.8**	**3.0**	**3.3**

Exchange Rate
end of period

	22 Dec	Jun 12	Dec 12	Dec 13
¥ per $	78.0	79.0	80.0	82.0
$ per €	1.30	1.20	1.25	1.35

Official Interest Rate
end of period

	22 Dec	Jun 12	Dec 12	Dec 13
U.S. Fed Funds	0.25	0.25	0.25	0.75
BoJ Target	0.10	0.10	0.10	0.10
ECB Refi	1.00	0.50	0.50	0.75

Commodity Prices
end of period

	22 Dec	Jun 12	Dec 12	Dec 13
Oil *($ per barrel)*	108	95	95	95
Copper *(cents per lb)*	341	341	341	341
Gold *($ per ounce)*	1608	1608	1608	1608

Global Current Account Balance
$ billion

	2010	2011f	2012f	2013f
United States	-471	-463	-405	-397
Euro Area	-61	-57	4	37
Japan	196	104	113	131
Other Mature Economies	-21	-40	-37	-35
Emerging Economies (IIF 30)	365	324	162	-9
Africa / Middle East	65	174	114	82
Latin America	-45	-45	-90	-113
Emerging Europe	0	-26	-65	-77
o/w Russia	71	83	22	12
Emerging Asia	345	222	203	99
o/w China	305	205	183	95
Other Countries*	-8	132	163	273

* Includes global discrepancy

