Global Economic Monitor

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Robin Koepke
1-202-857-3313
rkoepke@iif.com

Kristina Morkunaite
1-202-857-3640
kmorkunaite@iif.com

Philip Suttle
1-202-857-3609
psuttle@iif.com

Emre Tiftik
1-202-857-3321
etiftik@iif.com

THE COLLAR AROUND GLOBAL GROWTH

- Global financial markets have been somewhat more upbeat in recent weeks. One explanation for this is that they are anticipating better times ahead, with the global economy poised to accelerate as we approach the third anniversary of the end of the last, severe, global recession. We would caution against outright optimism, however. Sizeable liquidity support from central banks may have taken out the near-term downside risk to the global economy (page 4), but four factors will combine to dampen the upside, leading to a growth outlook that is destined to remain in relatively tight ranges.

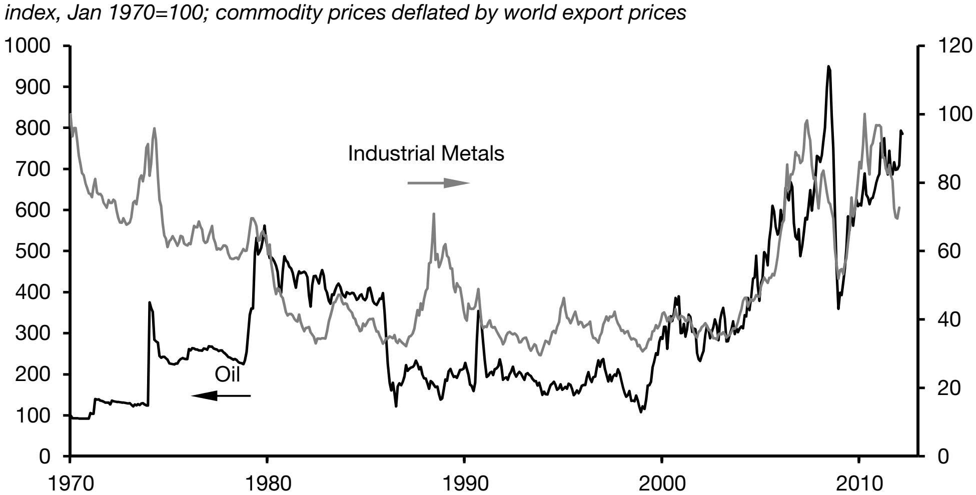
- First, lingering de-leveraging pressures — with private caution amplified by public regulatory policy — are holding back a sustained rebound in private aggregate demand.

- Second, weakness in the Euro Area remains pronounced. Domestic demand is very weak, and the region remains in recession (pages 14-17). Demand weakness is leaking abroad.

- Third, oil prices have gone up again, and are now at levels that proved to be quite negative for the global economy in early 2011 (pages 6-9). The reason for the rise — concerns about unrest in the Middle East and resulting supply disruptions — has typically also been more growth negative than a price spike caused by outright demand strength.

- Fourth, there will be political (and policy) uncertainty beyond oil, as there are important elections throughout 2012 (page 5).

Chart 1
Real Commodity Prices
index, Jan 1970=100; commodity prices deflated by world export prices



The recent spike in the real oil price is relatively modest by historic standards, but has been accompanied by a decline in real industrial metals prices.

Global Overview

WHAT WORRIES US THE MOST

The table below summarizes our main worries about the global outlook. Our objective is to identify issues that should be in focus for country risk managers over the next 12 months or so, and which could have global ramifications. These worries continue to be heavily centered on Europe at the current time.

The main worry now is what happens in the aftermath of the Greek restructuring. Note that this list is far from exhaustive about what *could* go wrong, and does not include many concerns (including rising G7 government debt levels) which will be major challenges over a 3 to 5-year horizon.

Issue	Key Features	What To Watch
Euro Area Concerns		
Portugal: Concern about how market views government debt in aftermath of Greek PSI	▪ Concerns that the very ambitious fiscal target for 2012 will not be met given the deteriorated growth outlook ▪ Country due to return to market borrowing in 2013H2.	▪ Spreads on government bond yields ▪ Implementation of the promised fiscal measures ▪ Assurances from the creditor countries that assistance will be forthcoming if market access is not restored because of adverse external conditions
Greece: Performance in aftermath of completion of second support package and PSI	▪ Uncertainty surrounding General Election (likely late April/early May) and whether resulting new government can keep EU/IMF program on track	▪ Progress in meeting ambitious new fiscal targets ▪ Composition of new government ▪ Progress on structural reform agenda ▪ Prospects for a recovery in latter half of 2012
Spain: Significant fiscal tightening into an already weak economy	▪ New government committed to reducing budget deficit from over 8.5% of GDP in 2011 to 5.3% of GDP in 2012 ▪ With economy contracting, this implies discretionary tightening of about 5-6% of GDP	▪ Full 2012 budget expected to be presented on March 30th. ▪ Unemployment rate: 22.85% and rising (INE quarterly series); 2012Q1 data due on April 27th
Ireland: Promissary Notes and Referendum	▪ Payment on promissory notes due on March 30th (and to fund bank bailout) ▪ Referendum on Fiscal Compact to be held (likely late May)	▪ Economic performance following new wave of fiscal austerity ▪ Opinion polls on referendum ▪ Rise of Sinn Féin in polls
Other Concerns		
Middle East: Rising geopolitical risks could produce new oil price shock/ supply disruptions	▪ Potential conflict between Iran and Western powers over the country's nuclear program ▪ Conflict/incipient civil war in Syria ▪ Challenges in restoring stability to Libya ▪ Political divisions in Iraq	▪ Impact of new sanctions on Iran ▪ Risk of outright military conflict leading to disruption of oil trade through the Straits of Hormuz ▪ Willingness of Saudi Arabia to provide offset ▪ Extent of rebound in Libyan production
Egypt: Risk of currency crisis	▪ Official reserves have fallen sharply to under 3 months of imports ▪ Tourism and FDI very weak	▪ Agreement on a $3.2 billion IMF loan ▪ Presidential election scheduled for late May/June
Ukraine: Unsustainable external position	▪ Large current account deficit ▪ Significant principal repayments in 2012-13 ▪ No access to private capital markets ▪ Current IMF program suspended ▪ Banks very vulnerable to FX decline	▪ Agreement with Russia on natural gas contract ▪ Agreement with IMF on new program ▪ Major repayments due in May ($2.6 bn), June ($1 bn) and August ($1 bn)
Turkey: High external deficit	▪ Large current account deficit (10% of GDP in 2011) ▪ Insufficient net capital inflows to cover deficit ▪ Significant drawdowns from official foreign exchange reserves	▪ Net capital inflows ▪ Official foreign exchange reserves
Venezuela: October presidential elections	▪ Substantial political polarization and weak institutions have increased the country's vulnerability to domestic shocks	▪ Oil production disruption if uncertain political events result in widespread social unrest

Global Overview

GLOBAL GROWTH: ACCELERATING, YET SUB-PAR

- With most countries having reported national accounts for 2011Q4, it is now a fact that the global economy experienced its weakest quarter for activity since the Great Recession ended in 2009Q1 (Table 1). This weak growth came despite 3%q/q, saar, growth in the United States, which was the strongest there since 2010H1.

- The good news is that 2011Q4 most likely represents the low water mark in this mini-cycle, and it seems that the global economy rebounded somewhat in 2012Q1. This rebound is evident in an uptick in purchasing managers' indices across manufacturing sectors (Charts 2 and 3). The bad news is that global growth will remain below trend (which we estimate to be 3.5%) in 2012.

- The rebound in global activity in the early months of 2012 is apt to be most evident across Asia. In part, this reflects a rebound from dislocations resulting from flooding in Thailand in October, which weakened regional activity in Q4. More fundamentally, however, it reflects an upswing resulting from the fading impact of monetary restraint, which had been quite pronounced across the region from mid-2010 through mid-2011. Japan will also benefit from short-term fiscal stimulus associated with post-earthquake rebuilding. Early Q1 indicators from China have been a little weaker than we had projected, suggesting some downside risk to the Q1 Emerging Asian forecast (Table 1).

- The U.S. economy seems to have continued to perform quite well in Q1, although supply-side indicators (e.g. hours worked) have been much stronger than demand-side indicators. Latin American growth is rebounding following six weak months. An acceleration is likely to be most evident in Brazil, where monetary tightening led to virtual stagnation in the second half of 2011. By contrast, Argentina is weaker.

- Weakness is apt to be most persistent in Europe (both mature and emerging) in 2012H1. The main drivers of this softness will be tight fiscal policies and difficult domestic credit conditions, which will particularly hit small and medium sized enterprises, households and property sectors. The ECB has played an important role in limiting the deterioration in regional credit conditions, but banks are now using time bought to retrench, especially cross-border.

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

	11Q1	11Q2	11Q3	11Q4	12Q1
Mature Economies	**0.3**	**0.8**	**2.4**	**0.7**	**1.1**
United States	0.4	1.3	1.8	3.0	2.5
Euro Area	3.1	0.5	0.6	-1.3	-1.0
Japan	-6.9	-1.2	7.1	-0.7	3.0
Other Mature	1.4	1.5	3.1	0.2	0.4
Emerging Economies	**6.9**	**4.6**	**4.9**	**2.8**	**5.4**
Latin America	3.8	4.9	3.0	2.1	3.1
Emerging Europe	4.8	2.6	4.8	2.9	2.3
Asia/Pacific	9.2	5.4	5.7	3.1	7.8
World	**3.1**	**2.3**	**3.3**	**1.6**	**2.9**

Chart 2
G3: Real GDP Growth and Manufacturing PMI
percent q/q, saar *index, 50 = breakeven*

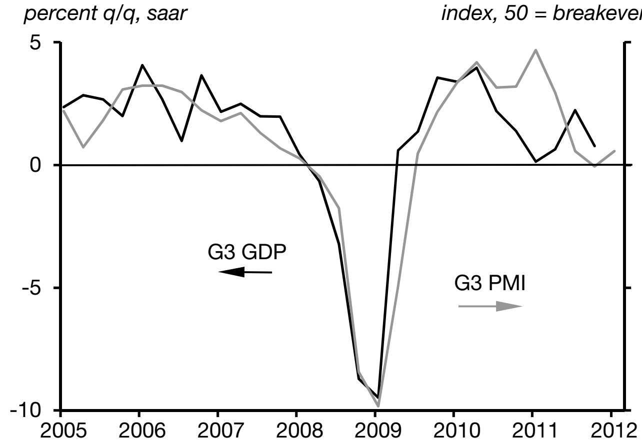
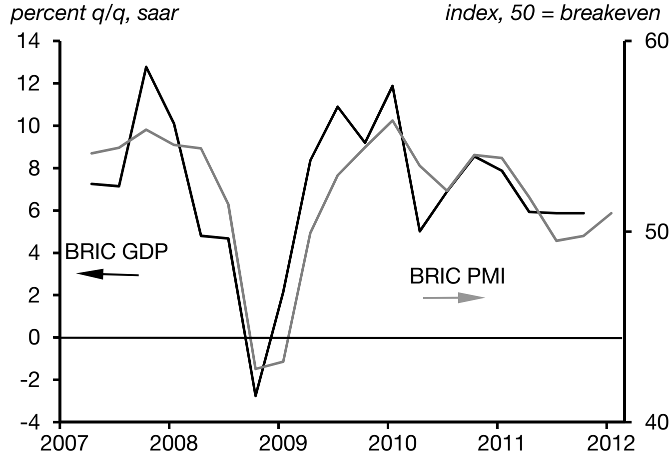


Chart 3
BRIC: GDP Growth and Manufacturing PMI
percent q/q, saar *index, 50 = breakeven*



Global Overview

RECENT MONETARY STIMULUS—A STOCKTAKE

- With short-term interest rates in most mature economies at, or close to, a zero lower bound, additional monetary stimulus inevitably takes the form of additional liquidity injections (Table 2). These are designed to operate in markets well-beyond short-term interest rate markets and, in so doing, encourage banks, investors, households and non-financial businesses to take risks that they might not otherwise undertake.

- The Bank of Japan (BoJ) had been reluctant to undertake aggressive quantity-related stimulus but seems recently to have become more persuaded. On February 14th, it set an explicit inflation target (1%; see page 18), and has announced an increase in its asset purchase program (¥10 trillion, or 2.1% of GDP), concentrated totally on JGBs. (Note that the increase in the APP in October 2011 was also concentrated on JGBs, while the increase in August was spread over a wider array of assets, including corporate bonds and equities). The BoJ has a significant distance to go before it turns these asset purchase plans into reality (Chart 4). But the announcement effect of the BoJ's measures has been quite important. In the five weeks following the BoJ's announcement, the equity market is up about 11%, while yen has depreciated by about 5%.

- The ECB's 3 year LTROs have also been quite powerful in lowering regional financial tensions, with weighted-average Euro Area yields dropping across the yield curve (Chart 5, left panel). The ECB has been loath to call its policies "quantitative easing", but the expansion of the system's balance sheet has, to date, been more extreme than any other major jurisdiction in recent months (Chart 5, right panel). The ECB's balance sheet is also increasingly dominated by claims on borrowers finding it hard to raise money elsewhere: or "qualitative easing". We expect the ECB to cut rates by another 50bp during Q2 and Q3.

- The Bank of England has also undertaken a significant balance sheet expansion in recent months (Chart 5, right panel). The actions of the Fed have been more muted (Table 2). We think that QE3 — another round of MBS purchases — is plausible, however, if (as we expect) the economy fails to accelerate through 2012.

Table 2
G4 Central Banks: Key Measures since July 2011

Date	Type of measure	(Extra) target amount	Date of execution	Amount executed
Federal Reserve				
Sep-11	Maturity ext.	$400 billion	Oct-Jun '12	ca. $250 billion
Jan-12	Extend "exceptionally low" policy rate forecast to late 2014			
ECB				
resumed	SMP	undefined	since Aug '11	€147 billion
Oct-11	CBPP 2	€40 billion	since Nov '11	€9 billion
Dec-11	3-year LTRO	unlimited	Dec'11	€489 billion
			Feb'12	€530 billion
BoE				
Oct-11	APP	£75 billion	Oct-Feb '12	£75 billion
Feb-11	APP	£50 billion	since Feb '12	£22 billion
BoJ				
Aug-11	APP	¥10 trillion	Aug-Sep '11	¥1.8 trillion
Oct-11	APP	¥5 trillion	Oct'11-Jan '12	¥4.2 trillion
Feb-12	APP	¥10 trillion	Jan- Feb '12	¥1.6 trillion

Chart 4
Japan: T-bills and JGBs Held by BoJ's APP
¥ trillion

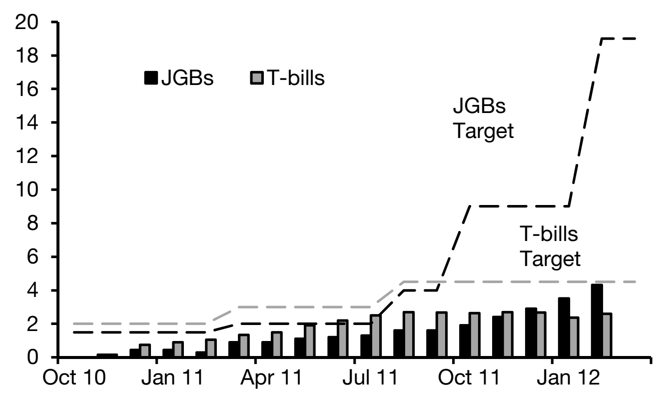
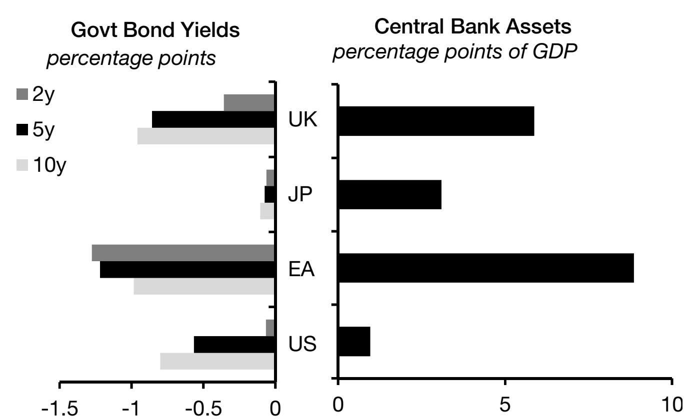


Chart 5
G4: Change from June '11 to March '12



2012: AN IMPORTANT ELECTORAL AGENDA

Elections in Europe will be a focus in the first half of the year; elections in the Americas will dominate the second half. May looks as though it could be quite an important month in Europe. By that time, we should know the nature of the new Greek government, the name of the next French President and whether the Irish people are in support of the new EU fiscal compact. The U.S. election outcome will be an important determinant of economic policies in 2013 and beyond. A major tightening in U.S. fiscal policy looms in 2013, which a lame duck Congress could find tough to reverse in late 2012.

Country	What and When	Main Features
Americas		
Mexico	Presidential/ Legislative Jul 1	▪ The PRI candidate — Enrique Peña Nieto — is ahead in the polls, suggesting that Mexico's traditional party of power is likely to return to presidential power for the first time in 12 years. The other two leading candidates are the PAN's Josefina Vázquez Mota and the PRD's Andres Manuel Lopez Obrador. ▪ Whoever wins the Presidency is unlikely to obtain majority support in the legislature, making necessary reforms hard to achieve.
Venezuela	Presidential Oct 7	▪ President Hugo Chávez has been in office for 13 years and has taken the country radically to the left. ▪ His illness, and sustained poor economic performance (high oil price notwithstanding) raise questions about whether he will win re-election against primary challenger Henrique Capriles.
U.S.	Presidential/ Legislative Nov 6	▪ Democratic President Barack Obama is seeking a second term against the Republican nominee, who will be selected during the party's August 27 convention. Mitt Romney is the current frontrunner ahead of Rick Santorum, Newt Gingrich, and Ron Paul.
Europe		
Greece	Parliamentary Apr/May TBD	▪ Prime Minister Lucas Papademos' technocratic government, formed last November, has achieved its main objective of negotiating a second support program from the Troika and debt relief from the private sector. ▪ Both traditional major parties have seen an erosion in popular support, suggesting that the new government will need to be a multiparty coalition.
France	Presidential (1) Apr 22; (2) May 6 Legislative (1) Jun 10; (2) Jun 17	▪ President Nicolas Sarkozy is seeking reelection, with tighter immigration control being his most divisive issue. Sarkozy has been trailing behind Socialist frontrunner François Hollande, but his standing has begun to improve in recent weeks.
Ireland	Referendum TBD (late May?)	▪ The Irish Supreme Court ruled in 1987 that any changes to an EU treaty must be approved by referendum. ▪ The EU fiscal compact already has the support of the 12 countries it needs to pass. ▪ If Ireland votes yes then they will be eligible for future payments from the European Stability Mechanism, if they vote no then they lose that option. Even if Ireland does vote no the referendum could be held again until they achieve a more favorable result.
Asia		
South Korea	Parliamentary Apr TBD Presidential Dec TBD	▪ The Democratic Unity Party has made a free trade agreement with the U.S. a main campaign issue, with the belief that a 2010 modification to auto tariffs unfairly benefits the U.S.
Middle East		
Egypt	Presidential (1) May 23; (2) Jun 16	▪ The Presidency has been vacant since the overthrow of Hosni Mubarak in February 2011. Muhammad Hussein Tantawi, head of the Supreme Council of the Armed Forces, is acting head of state. The military has promised to return power at the end of June, conditional on the completion of a constitution and democratic presidential election. ▪ Protestors have called for military leaders to transfer power to a civilian authority ahead of their timetable as election delays and accusations of violence raise concern that they will not relinquish power as promised.
African National Congress (ANC)	Party Election Dec TBD	▪ Current party president and President of South Africa Jacob Zuma's ANC term ends in December, the candidate chosen to succeed him will also almost definitely be elected the country's president in the 2014 elections.

SUPPLY WORRIES DOMINATE OIL MARKET

- Oil prices have remained high in recent weeks, elevated by concerns about supply disruptions surrounding Iran. Brent has hovered around $125 per barrel (pb) in the past month, a level not seen since the loss of Libyan supply to the market in Spring 2011. The Brent forward curve is in backwardation as well, suggesting a tighter market.

- It is vary hard to be confident about prices in coming months: in our baseline forecast, we assume that prices will decline quite soon, falling to $115 pb by the end of June, and to $105 pb by the end of the year (Chart 6). The decline could be sharper should some kind of resolution be reached with Iran. On the other hand, an outright military conflict with Iran — even if short-lived and limited in nature — would cause the price to spike upwards. For working purposes, we have assumed an alternative scenario, where prices jump to $155 pb for 2012Q2 (Chart 6). We investigate the implications of this alternative on page 9.

- We expect global crude demand to average around 90 million b/d in 2012, or about 1% over 2011, as China leads emerging market demand, which continues to push global demand growth as OECD demand declines (Table 3).

- On the supply side, OPEC is currently producing at a 3-year high. Output continues to rebound in Libya, and Iraq continues its solid rebound. Furthermore, Saudi Arabia has been willing to increase its supply, by about 0.5mbd relative to 2011 (Table 3). Together, these increases have been enough to offset declines in Iran's production in response to sanctions. Iranian export losses will continue, however, as the July sanction implementation date nears. Non-OPEC outages continue in South Sudan, Syria, and Yemen.

- Crude oil storage continues to build in the U.S. at Cushing, gaining over 9 million barrels since end-2011. OECD stocks remain below the five-year average due to European and Pacific deficits, however. Low global spare production capacity is adding to market tensions. Saudi Arabia still accounts for the bulk of global spare capacity, with small amounts in other OPEC and GCC countries for a total of only around 2.5 million b/d (Chart 7). Saudi Arabia is also increasing strategic stocks near importers to hedge against Iranian supply outages and increased summer demand.

Chart 6
IIF Brent Forecast and High Price Scenario
$ per barrel

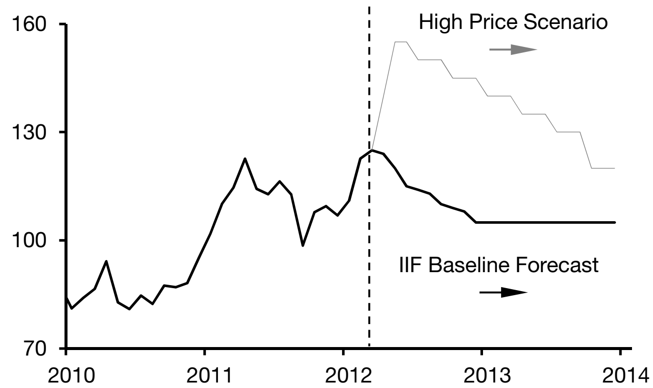
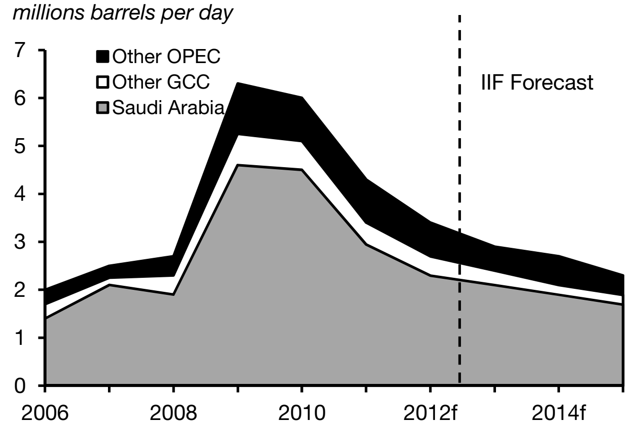


Table 3
Global Demand and Supply
million b/d

	2011	2012	12Q1	12Q2	12Q3	12Q4
Demand (million b/d)	89.1	90.1	88.7	88.8	90.7	91.0
OECD	45.6	45.3	45.8	44.3	45.6	45.6
Non-OECD	43.4	44.7	43.9	44.5	45.2	45.4
Of which: China	9.5	10.0	9.9	10.0	9.9	10.1
Supply	88.5	89.7	89.0	89.2	90.1	90.3
OPEC (crude)	30.0	29.9	30.0	29.5	30.1	30.0
Saudi Arabia	9.3	9.7	9.8	9.7	9.6	9.5
Libya	0.5	1.4	1.2	1.4	1.5	1.6
OPEC NGLs	5.8	6.2	6.1	6.2	6.3	6.3
Non-OPEC	52.7	53.5	52.9	53.5	53.7	54.0
Inventory Change	-0.6	--	--	--	--	--

Source: IEA and IIF estimates.

Chart 7
Spare Productive Capacity
millions barrels per day



OIL PRICES HIGH RELATIVE TO OTHER ENERGY

- In considering the economic impact of these elevated oil prices, it is important to recognize that the effect depends partly on whether high oil prices are accompanied by high prices for other sources or energy. In the past decade, the share of oil in global energy consumption has declined from 38.1% to 33.6% (Table 4). The fall in the share accounted for by oil and nuclear energy has been offset by a rise in the share accounted for by coal and renewables.

- Oil remains the dominant transportation fuel, and the rise of car ownership in emerging economies means that rising gasoline prices will have a growing impact on household budgets there, assuming world prices are passed on.

- We typically think of the United States as being most significantly hit by an oil price rise. To be sure, household real incomes are currently being squeezed by the increase in gasoline prices. U.S. domestic gasoline prices are likely to remain elevated through the summer. The squeeze on the U.S. consumer (and industry) is being dampened, however, since the price of another key energy source — natural gas — has fallen to a multiyear low (Chart 8). Supplies remain ample and the weather mild. Global coal prices have also been quite tame.

- By contrast, natural gas prices in Europe remain far more tied to contracts linking them to the oil prices, which suggests that the latest oil price increase could be more damaging there (Chart 9).

- Japan has suffered a major shock to energy supply in the past year, as much of its nuclear supply has been shuttered. This has led to a sharp rise in energy imports — including oil imports — which leaves the country more exposed to higher oil prices. Indeed, Japanese oil demand was about 0.8% higher in 2011 than in 2010, and a similar growth rate is likely to 2012. This makes Japan a distinct outlier when it comes to OECD oil demand trends.

- Oil-dependent transportation service providers — airlines and shipping companies — are also prone to be hurt by rising costs. Shipping companies will also be squeezed by low freight rates caused by an excess of shipping capacity.

Table 4
World Energy Consumption
percent of total

	1990	2000	2010
Oil	38.8	38.1	33.6
Coal	27.4	25.6	29.6
Natural Gas	21.8	23.2	23.8
Nuclear Energy	5.6	6.2	5.2
Hydro-electricity	6.0	6.4	6.5
Renewables	0.3	0.5	1.3
Total (million tonnes oil equivalent)	100 (8109)	100 (9382)	100 (12002)

Chart 8
U.S.: Oil and Natural Gas Prices
$ per million british thermal units

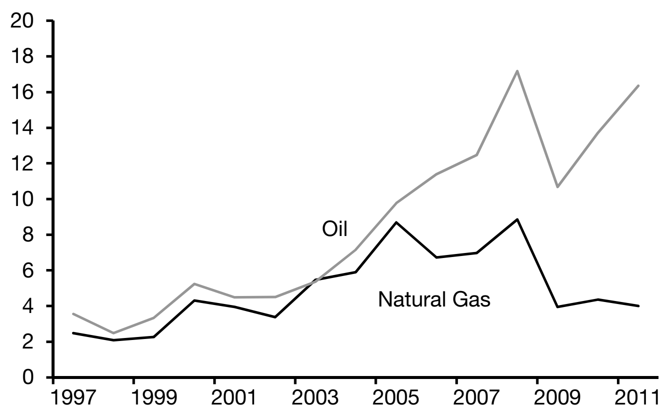
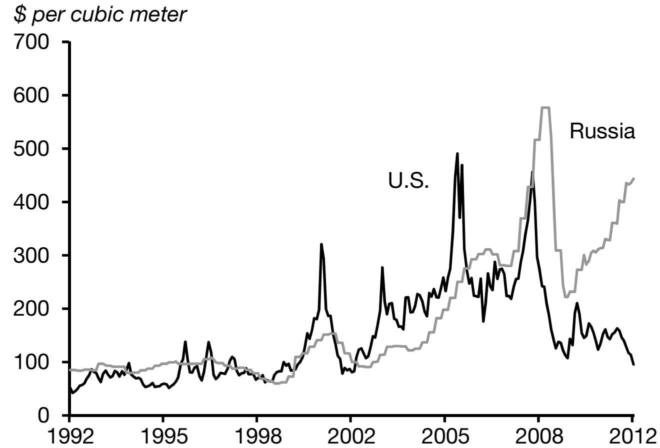


Chart 9
U.S. and Russia: Natural Gas Prices
$ per cubic meter



GLOBAL REDISTRIBUTIVE EFFECT OF OIL PRICES

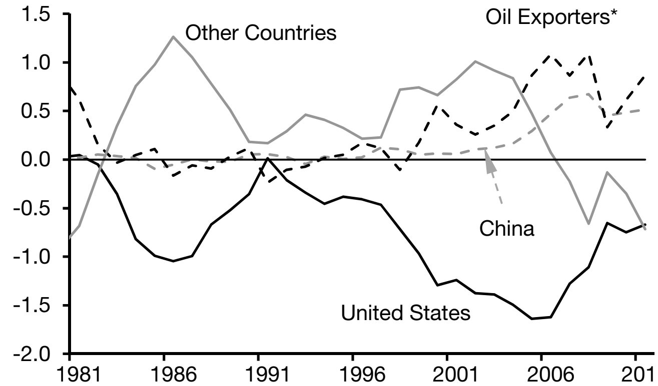
- The increase in the oil price through the early months of 2012 will have implications for global imbalances in coming quarters. Over much of the past decade, the large current account deficit in the U.S. was financed by surpluses in Japan, China and oil-exporting countries (Chart 10). While the surpluses of some of these countries have begun to wane, those of the oil exporters remain large.

- The current account surplus of the oil-exporters reached $607 billion in 2011, as the value of their exports surged (Chart 11). Average oil prices rose by $48 per barrel between 2009 and 2011, leading to a 65% rise in export values over those two years. Oil importing countries were on the other side of this shift. The effect of the elevated energy prices on the current account balance has been most significant in those emerging economies with limited domestic energy sources and strong domestic demand growth, such as Turkey and India.

- One of the reasons that an oil price rise can be deflationary is that gainers raise spending less quickly than losers cut back. This time around, however, many oil producers have been quite quick to raise spending. In Middle Eastern countries, this increase reflects rising social pressures and awareness from governments that a failure to deliver a higher standard of living — especially higher levels of employment for younger people — could lead to political unrest. The result has been a surprisingly limited rise in the overall current account balance of oil exporters, given the rise in the oil trade surplus (Chart 11, right panel).

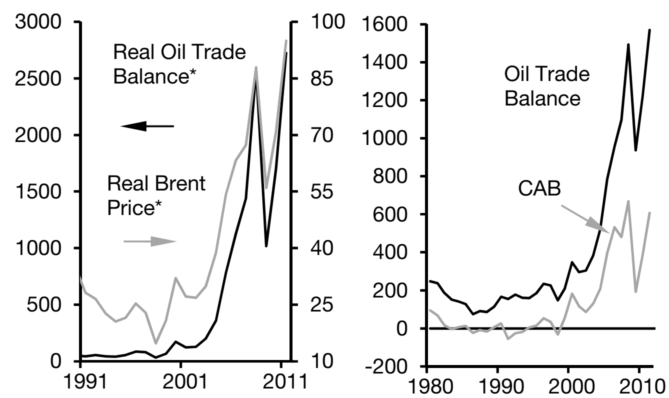
- Using the data aggregated by our Africa/Middle East department, we conduct a sensitivity analysis of the potential impact of oil prices on the current account balance of the GCC countries. Our baseline oil scenario (see page 6) suggests a 5% increase in the GCC current account surplus in 2012 (Chart 12). A scenario with 25% higher oil prices for the next two years relative to our baseline scenario, leads to a 38% increase for next year's GCC surplus. The current account balances of GCC countries are very sensitive to oil price changes. GCC governments tend to save more marginal petrodollars as a buffer stock for periods of low oil prices than other producers.

Chart 10
Current Account Balances
percent of world GDP



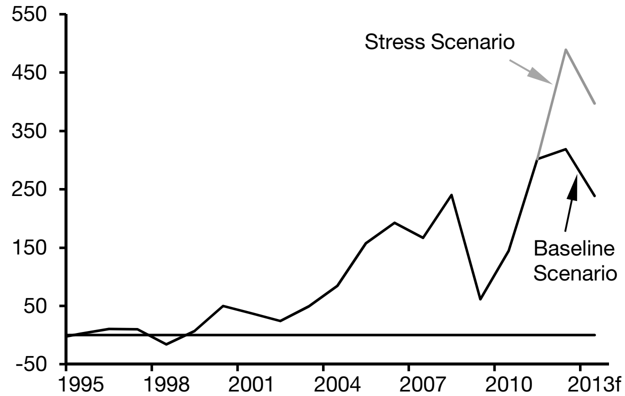
* Oil Exporters: Algeria, Angola, Azaerbaijan, Bahrain, Brunei, Congo, Equator Guinea, Gabon, Iran, Iraq, Kazakhstan, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Sudan, Syria, Trinidad and Tobago, Turkmenistan, UAE, Venezuela, and Yemen

Chart 11
Oil Exporters: Current Account and Oil Trade Balances
$ billion *$ per barrel* *$ billion*



* in 2005 U.S dollars

Chart 12
GCC: Current Account Balance*
$ billion



* GCC Countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates

OIL PRICES WEIGH ON GLOBAL OUTLOOK

- Higher oil prices affect the global economic outlook through a number of channels. Most importantly, they siphon purchasing power away from oil users, reducing consumption and investment. Higher oil prices have an almost immediate effect on headline inflation and, over time, put upward pressure on core inflation. At the same time, higher oil prices result in windfall revenue for oil producers, who may boost spending.

- We have estimated the growth impact of two oil price scenarios using a multi-country model. In our baseline scenario, prices peak at $125 pb. Our adverse scenario assumes an increase to $155 pb during the course of 2012Q2. In our baseline scenario, the cost in terms of global output loss of the rise in prices would be relatively mild, around 0.3% by 2013Q1 (Chart 13). In our high-risk scenario, however, the global expansion would be significantly hampered. Global growth would be around 1% lower in 2012Q4 and 2013Q1. Thereafter, the impact on global growth would subside gradually. These developments could make our global growth forecast for 2012 (3%) and 2013 (3.7%) turn out closer to 2.5% and 3%, respectively.

- Importantly, the impact of higher oil prices on growth depends on how oil-intensive economies are, i.e. how much oil they use to produce one unit of output. The higher the oil intensity of output, the greater the impact of an oil price spike. Generally speaking, countries become less oil intensive as they advance in their economic development, both due to better production technology and because they tend to have smaller manufacturing sectors. As a result, an oil shock today has less severe repercussions on the mature economies than it had in the 1970s and 1980s.

- In the last several years, the oil price has been a bellwether of global inflation developments (Chart 14). In response to the recent oil price increase, we have notched up our inflation forecasts in the mature economies by 0.2 percentage points to 1.6% y/y in 2012 (Chart 15). In EM economies, upward revisions to 2012 inflation in EM Asia and Latin America were partially offset by lower price pressures in EM Europe, leaving overall EM inflation nearly unchanged.

Chart 13
Impact of a Permanent Oil Shock on Global Growth
percent change over a year ago

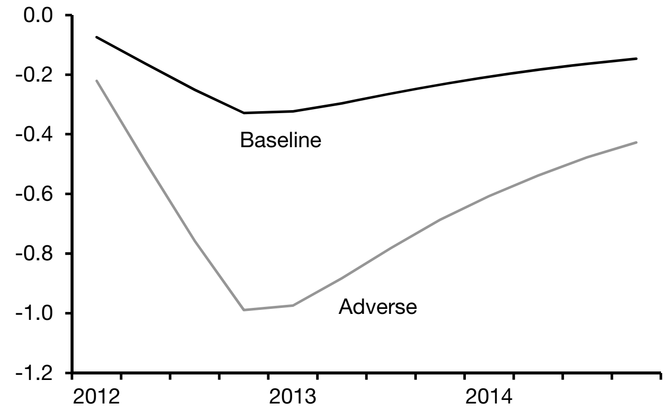


Chart 14
Global Headline CPI and Oil Prices
percent change over a year ago (both scales)

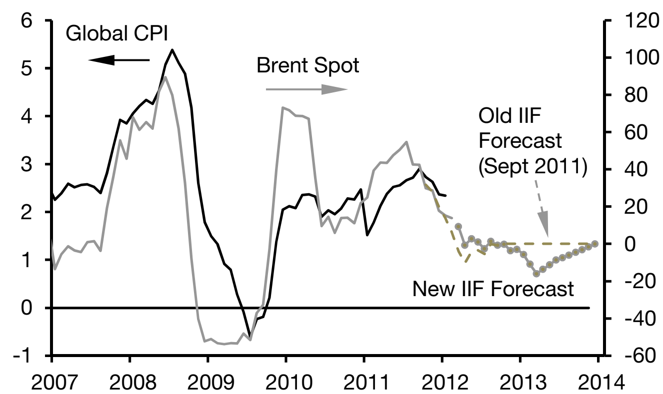
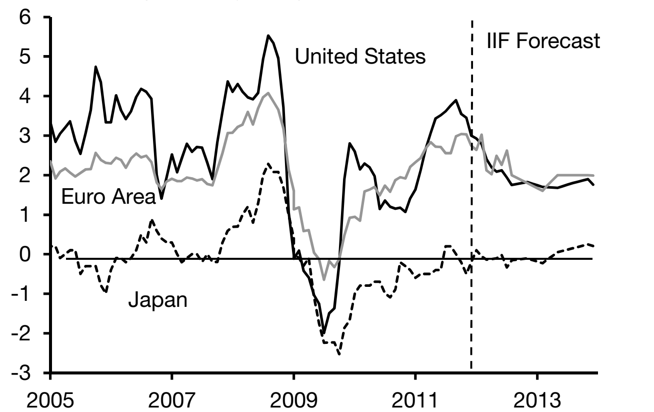


Chart 15
G3: Headline Inflation
percent change over a year ago



LABOR MARKET CONTINUES TO IMPROVE

- In aggregate, U.S. economic data have surprised on the upside in recent months. The economy appears to be gathering some momentum and the chances of a virtuous cycle leading to sustained above-trend growth have increased. However, the picture is somewhat ambiguous as expenditure-based indicators actually point to some slowing in domestic demand. We forecast Q1 GDP growth of 2.5% q/q, saar. While we acknowledge the possibility that growth may disappoint again, we believe the key signal for the U.S. economic outlook comes from the consistent improvements in the labor market since December. Near-term risks to the outlook relate to higher oil prices, which are already weighing on consumer purchasing power (see page 12).

- Private sector employment gains have averaged 250k for the past three months, a significant acceleration from mid-2011. In addition, first-time jobless claims have continued to fall, reaching 355k (4-week ma) in mid-March. Total hours worked through February are tracking 3.6% q/q, saar, over the previous quarter (Chart 16). By itself, this would be consistent with an acceleration in growth from the 3% seen in 2011Q4. However, employment growth in the U.S. has been negatively correlated with productivity growth in the last decade. In other words, rapid employment growth in one quarter tends to be associated with slower productivity growth in the same (and the subsequent) quarter. This could be because new employees need to be trained initially and because job market entrants are probably less skilled on average than those who already hold a job. GDP growth may thus be lower than implied by total hours worked.

- GDP growth in the current quarter is tracking lower than our forecast, but we expect some upward revisions in coming weeks (Table X). For example, personal consumption expenditures (PCE) in January were at the same level as 2011Q4. But strong auto and retail sales in February and upward revisions to retail sales in January mean that PCE growth is probably closer to 2.5-3% q/q, saar. Business investment has also slowed around the turn of the year but is expected to stabilize in February and March. Net trade is likely to make a negative contribution to growth in 2012Q1, mainly due to an acceleration in import growth.

Chart 16
United States: GDP and Total Hours Worked
percent change q/q, saar

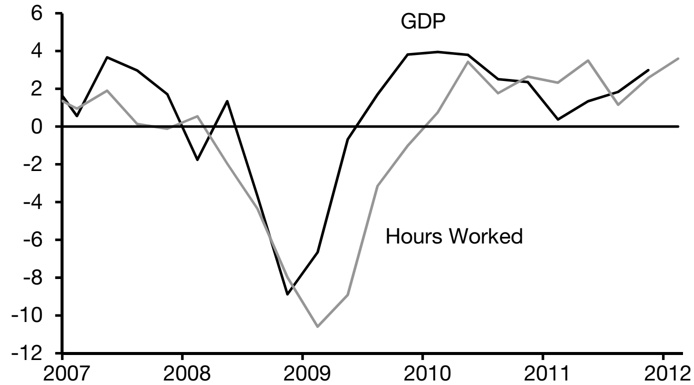


Table 5
United States: Tracking Current Quarter GDP
percent, q/q saar, underlining denotes IIF forecasts

	Q4 11	Q1 12 to date	Data through
Real GDP	*3.0*	*2.5*	-
Consumption			
Real Consumption	2.1	0.0	January
Nominal Core Retail Sales	4.9	5.7	February
Auto Sales (million units, saar)	13.4	14.6	February
Consumption (constant prices, NIPA)	*2.1*	*2.8*	
Investment			
Shipments of Nondefense Capital Goods ex. Aircraft	0.3	-8.9	January
Business Equipment (constant prices, NIPA)	*4.8*	*2.0*	
Nonresidential Construction Put in Place	13.6	0.9	January
Business Structures (constant prices, NIPA)	*-2.6*	*5.0*	
Residential Construction Put in Place	29.6	23.4	January
Residential (constant prices, NIPA)	*11.5*	*15.0*	
Inventory Contribution (% points)	*1.9*	*0.3*	
Trade			
Real Exports of Goods	5.3	8.1	January
Exports of Goods (constant prices, NIPA)	*4.3*	*6.5*	
Real Imports of Goods	5.1	14.8	January
Imports of Goods (constant prices, NIPA)	*3.8*	*7.0*	
Contribution to Growth (% points)	-0.1	*-0.3*	
Memo Items (Supply Side):			
Index of Hours Worked	3.1	3.6	February
Manufacturing Output	5.2	10.9	January

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	11Q3	11Q4	12Q1	12Q2	12Q3	12Q4	Q4/Q4 2011	Q4/Q4 2012	Q4/Q4 2013
Real GDP	3.0	1.7	2.4	2.5	1.8	3.0	2.5	2.5	2.5	2.5	1.6	2.5	2.6
Consumption	2.0	2.2	2.4	2.5	1.7	2.1	2.8	2.6	2.6	2.6	1.7	2.7	2.5
Government Spending	0.7	-2.1	-1.7	-1.3	-0.1	-4.4	-1.0	-1.5	-1.5	-1.0	-2.8	-1.3	-1.3
Fixed Investment	2.6	6.7	6.3	5.5	13.0	4.3	4.9	5.7	5.8	6.0	6.8	5.6	5.3
Business Equipment	14.6	10.2	6.0	5.3	16.2	4.8	2.0	6.0	6.0	6.0	8.9	5.0	4.7
Structures	-15.8	4.4	5.7	5.8	14.4	-2.6	5.0	5.0	5.0	6.0	4.0	5.2	6.0
Residential	-4.3	-1.4	8.2	5.8	1.2	11.5	15.0	5.0	5.5	5.5	3.5	7.7	6.0
Change in Inventories (*$ bn, chained 2000*)	58.8	35.1	51.6	31.7	-2.0	54.3	64.3	55.2	48.9	38.1	—	—	—
Exports of Goods and Services	11.3	6.8	5.5	6.0	4.7	4.3	6.5	6.0	6.0	6.0	5.1	6.1	6.0
Imports of Goods and Services	12.5	4.9	3.6	2.9	1.2	3.8	7.0	2.0	3.0	3.0	3.6	3.7	3.0
GDP Deflator	1.1	2.1	1.7	1.7	2.6	0.9	1.8	1.6	1.4	1.5	2.2	1.6	1.8
Nominal GDP	4.2	3.9	4.1	4.2	4.4	3.9	4.3	4.1	3.9	4.0	3.8	4.1	4.5
Contribution to Changes in Real GDP:													
Domestic Final Sales	1.9	0.0	2.2	2.3	2.8	1.3	2.5	2.3	2.4	2.5	1.4	2.4	2.3
Net Exports	-0.5	0.0	0.1	0.3	0.4	-0.1	-0.3	0.5	0.3	0.3	0.1	0.2	0.3
Inventories	1.6	0.0	0.1	-0.1	-1.4	1.9	0.3	-0.3	-0.2	-0.3	0.1	-0.1	0.0
Trade Balance (*$ billion*)	-646	-738	-793	-730	-181	-186	-204	-205	-196	-188	—	—	—
Current Account Balance (*$ billion*)	-471	-473	-493	-383	-108	-124	-132	-131	-115	-115	—	—	—
as percent of GDP	-3.2	-3.1	-3.1	-2.3	-2.8	-3.2	-3.4	-3.3	-2.9	-2.9	—	—	—
Consumer Prices (*percent* oya)	1.6	3.1	2.1	1.7	3.8	3.3	2.8	2.2	1.7	1.8	3.3	1.8	1.9
Core Consumer Prices (*percent oya*)	1.0	1.7	1.9	1.9	1.9	2.2	2.1	2.0	1.8	1.7	2.2	1.7	1.9
Unemployment Rate (*percent)*	9.6	8.9	8.4	8.2	9.1	8.7	8.3	8.4	8.4	8.3	—	—	—
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	1.20	1.35	1.34	1.30	1.30	1.25	1.20	1.20	—	—	—
¥ per $ (*end of period*)	81.1	76.9	87.0	92.0	77.1	76.9	83.0	85.0	86.0	87.0	—	—	—
Federal Budget Balance (FY, *$ billion*)	-1294	-1297	-1214	-1004	—	—	—	—	—	—	—	—	—
as percent of GDP	-9.3	-8.9	-7.8	-6.2	—	—	—	—	—	—	—	—	—
Industrial Production - Manufacturing	5.4	4.5	5.3	3.4	4.9	5.1	9.5	4.0	3.0	3.5	4.3	5.0	3.6

Table 6

U.S.: Latest Real GDP Growth Forecasts

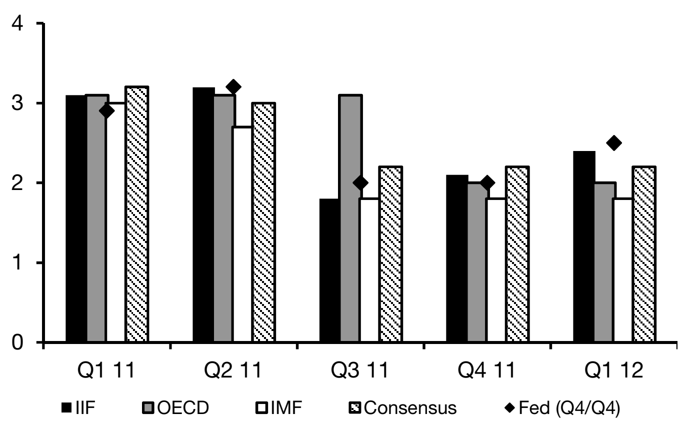
percent

	2012	2013	As of:
		y/y	
IMF	1.8	2.2	Jan 12
OECD	2.0	2.5	Nov 11
Bloomberg Consensus	2.2	2.5	Mar 12
IIF	2.4	2.5	Mar 12
		Q4/Q4	
Federal Reserve	2.2 to 2.7	2.8 to 3.2	Jan 12
IIF	2.5	2.6	Mar 12

Chart 17

U.S.: The Evolution of 2012 GDP Growth Forecasts

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



CONFIDENTIAL

United States

OIL PRICE SPIKE WEIGHS ON CONSUMPTION

- The recent oil price spike has important implications for the U.S. economic outlook. Higher oil prices mean that consumers and industry faces rising energy costs, which tend to reduce consumption and investment. In addition, oil price increases quickly feed into headline inflation and put upward pressure on core inflation over time.

- Oil accounts for 36% of U.S. primary energy consumption, making it the single most important source of energy (Chart 18). Petroleum products are primarily used for transportation, with over 70% of U.S. petroleum consumption accounted for by this sector. The key transmission channel of oil prices to the real economy is thus the gasoline price. Importantly, an increase in the gasoline price has little impact on gasoline consumption (i.e. the price elasticity of demand for gasoline is very low). From August 2010 to April 2011, the gasoline price rose 46.9% (Chart 19). In response, gasoline consumption fell by only 6.4% — an implied elasticity of –0.14.

- An increase in gas prices can thus be thought of as a transfer from consumers to producers (both domestic and international). In 2011, expenditures on gasoline were $428 billion or 2.8% of GDP. If oil prices declined only gradually, as envisioned in our forecast, the additional cost could siphon away $8 billion (0.05% of GDP) in consumer income in 2012. If instead oil prices were to remain at the current level of $125 pb, this would imply a drag of about $25 billion on consumer income this year (0.15% of GDP). The cost in terms of lost output growth would likely be higher due to multiplier effects and due to the direct impact on business investment.

- Gasoline also accounts for a large portion (5 percent) of the consumer price index. Pass-through from oil to gas prices is quite rapid. We estimate that a 10% increase in the average price of Brent oil in one quarter is associated with a 5.8% increase in the price of gasoline in the same quarter and another 1.1% increase in the following quarter. Gas prices are the biggest component of the energy CPI, which is important in driving headline inflation (Chart 20). Over time, higher oil prices also affect items in the "core" CPI, such as airline fares, public transportation, and shipping costs.

Chart 18
U.S.: Energy Consumption by Source and by Sector
Quadrillion BTUs

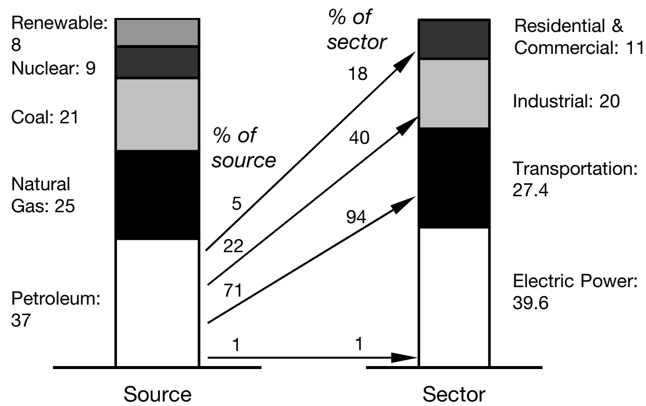


Chart 19
U.S.: Personal Consumption Expenditures on Gasoline
index, 2000=100 *index, 2000=100 (inverted scale)*

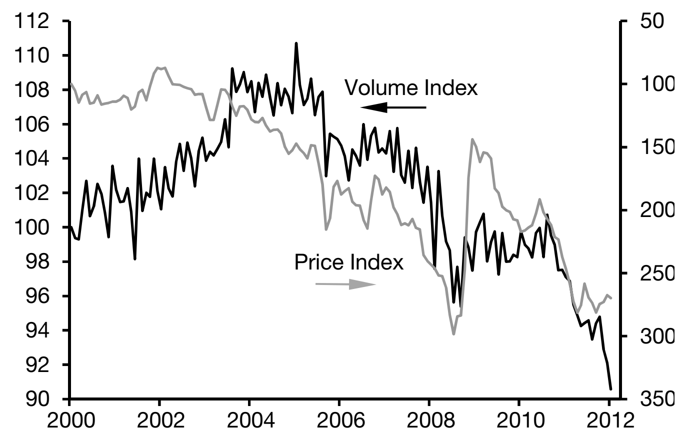
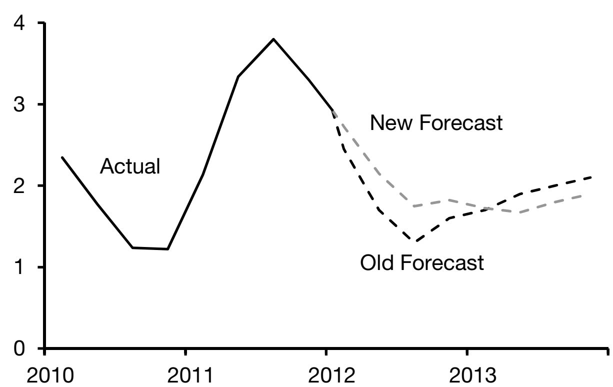


Chart 20
United States: Headline Inflation Projections
percent change over a year ago



United States

HOUSEHOLDS ARE BORROWING AGAIN

- Flow of funds data released in early March showed that balance sheet adjustment has progressed to a new stage: in 2011Q4 households were net borrowers for the first time in four years (Chart 21). This is a positive sign for the outlook for personal consumption. Household deleveraging has accounted for a large portion of the shortfall in aggregate demand since the recession. Though net borrowing has turned positive, it is likely to remain subdued in coming quarters. Housing-related debt is likely to remain on a declining trajectory, although at a slower pace than in recent quarters. By contrast, consumer credit continued its upward trend, rising 6.9% q/q in 2011Q4.

- From a broader perspective on sectoral balance sheets, it is important to recall that households are by far the sector with the most assets and the greatest net worth. During the financial crisis in 2008/9, household net worth declined from $66.8 trillion to $50.3 trillion (Chart 22). A large portion of this decline was due to the drop in the market value of equities and homes. While equities have recently recovered to their pre-crisis levels, home prices as measured by the Case-Shiller home price index actually reached a new trough at end-2011.

- Meanwhile, the financial sector remains firmly in deleveraging mode. Since 2009Q1, the financial sector has reduced outstanding debt by $30 trillion (Chart 23). Banks have been selling assets and reducing leverage to meet stricter regulatory requirements. This has put downward pressure on asset prices over the past several years. It has also meant that banks have been less willing to lend to the real economy, constraining investment and consumption. Following the release of its stress tests on March 13, the Fed approved the capital plans of 15 out of 19 of the largest U.S. banks. For these institutions, this approval could signal an easing in the regulatory pressure that has driven them to shrink their balance sheets.

- A substantial portion of the shortfall in aggregate demand has thus far been replaced by the public sector. In 2012Q1, government debt (including state and local) is likely to have exceeded outstanding debt in any other sector for the first time since 1995.

Chart 21
United States: Debt Outstanding by Sector
percent change q/q

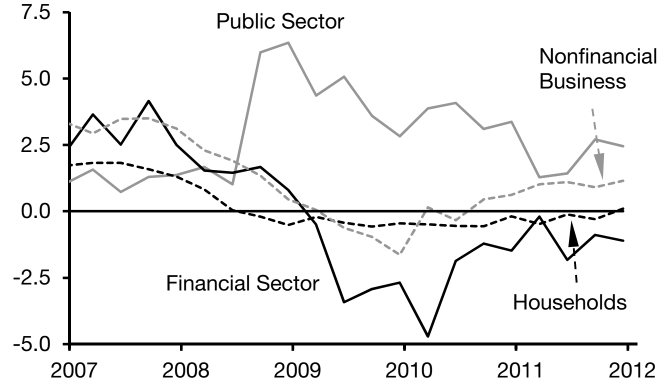


Chart 22
United States: Household Balance Sheets
$ trillion

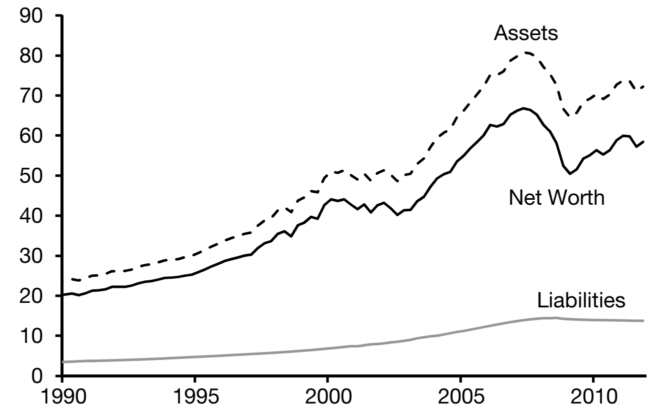
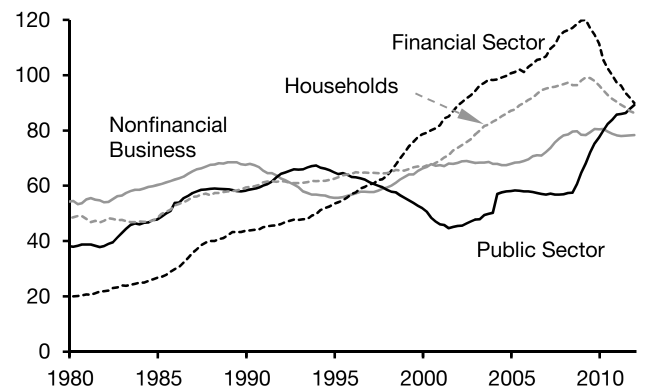


Chart 23
United States: Debt Outstanding by Sector
percent of GDP



EURO AREA: SINKING DOMESTIC DEMAND

- The release of the 2011Q4 GDP breakdown points to a deepening contraction in domestic demand (Chart 24). Its contribution to GDP growth fell to –1.7%q/q, saar, the weakest reading since 2009Q2. By component, fixed investment continues to be particularly weak (declining by 2.6%q/q, saar), reflecting the gloomy economic outlook, tight financing conditions and subdued construction activity (Chart 26). Reversing a short-lived gain in Q3, private consumption declined by 1.7%q/q, saar. Rising food and energy prices as well as declining employment have weighed on real income.

- Cross-country divergences are widening among the four largest economies that constitute 77% of nominal GDP in the Euro Area. Weakness was most pronounced in Spain and Italy against the backdrop of very tight financial conditions, aggressive fiscal austerity and rising unemployment. Domestic spending in France and Germany was relatively resilient, however, with the fiscal stance neutral and bank lending conditions easier.

- Going forward, we expect GDP to contract by 1%q/q, saar, in both the current quarter and next. Most analysts — including ourselves — put a relatively high weight on PMI survey data and these point towards continued mild recessionary conditions. After tentative signs of stabilization in January and February, the (flash) manufacturing PMI fell back to 47.7 in March (Chart 25). Retail sales and industrial production were flat in January following the decline in December. Auto sales declined in January and stagnated in February, with the Q1 average below Q4. It also remains to be seen whether a slight improvement in bank lending in January is the beginning of a trend, which would be needed to boost private consumption and investment (Chart 26).

- Net trade should continue to provide some offset to domestic demand weakness, as imports fall, and the region's overall current account surplus rises. January data points to a higher net export contribution in Germany compared to the previous quarter. The trade balance also improved in Spain, but was below the previous quarter average in France and Italy. The inventory picture is always hardest to monitor in Europe, but a decline seems likely, especially given the tightening in bank lending.

Chart 24
Euro Area: Contributions to GDP Growth in 2011Q4
percent change, q/q, saar

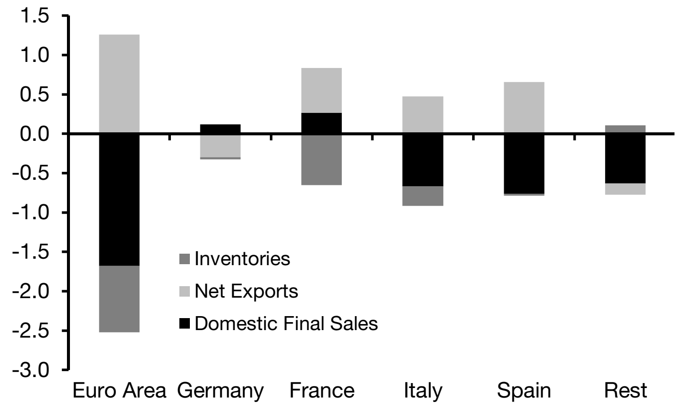


Chart 25
Euro Area: Real GDP Growth and PMI
percent change, q/q,saar *index, 50=breakeven*

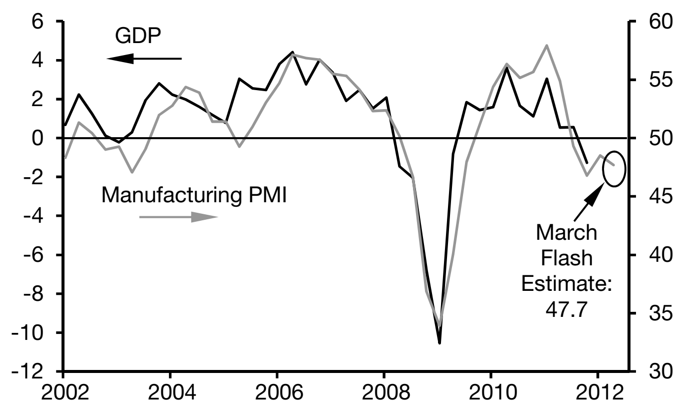
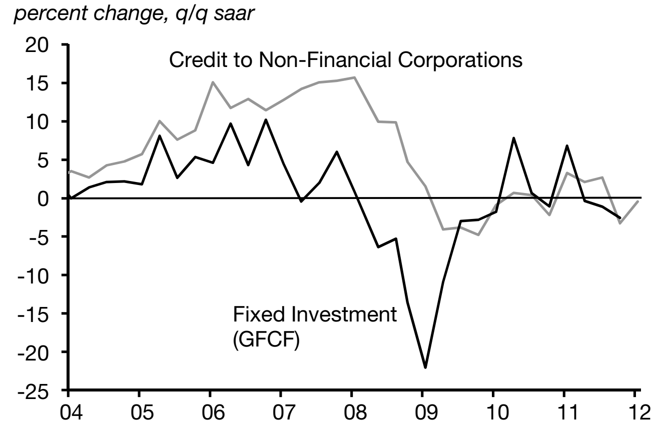


Chart 26
Euro Area: Investment and Bank Loans to Businesses
percent change, q/q saar



Euro Area

EURO AREA FORECAST IN DETAIL

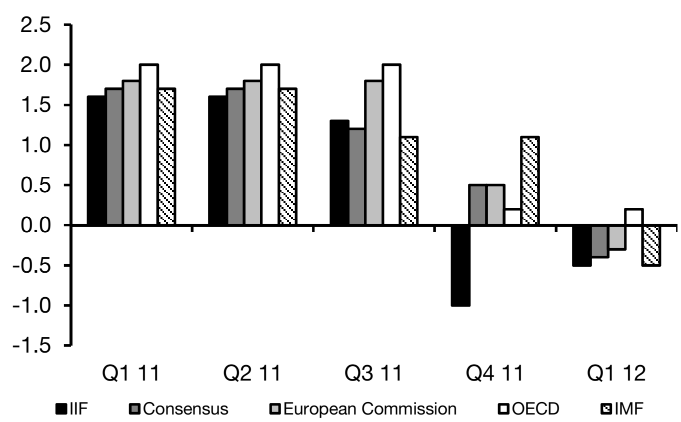
percent change over previous period, seasonally adjusted, at an annual rate, unless otherwise stated

	2010	2011	2012	2013	11Q3	11Q4	12Q1	12Q2	12Q3	12Q4	Q4/Q4 2011	Q4/Q4 2012	Q4/Q4 2013
Real GDP	1.8	1.5	-0.5	1.3	0.5	-1.3	-1.0	-1.0	0.0	1.0	0.7	-0.3	1.7
Consumption	0.8	0.2	-1.0	0.6	1.0	-1.7	-1.5	-1.5	-0.5	0.5	-0.6	-0.8	1.0
Government Spending	0.5	0.1	-0.6	-0.9	-0.7	-1.0	-0.5	-0.5	-0.5	-1.0	-0.3	-0.6	-1.0
Fixed Investment	-0.7	1.6	-1.5	0.5	-1.1	-2.6	-1.5	-1.5	-1.5	0.0	0.6	-1.1	1.4
Exports of Goods and Services	11.1	6.3	2.9	3.8	5.7	-1.4	3.5	3.5	3.5	3.5	3.6	3.5	4.0
Imports of Goods and Services	9.4	4.0	0.8	2.0	2.8	-4.6	2.0	2.0	2.0	2.0	0.6	2.0	2.0
GDP Deflator	0.7	1.4	1.1	1.0	1.5	0.7	1.0	1.0	1.0	1.0	1.5	1.0	1.0
Nominal GDP	2.5	2.9	0.4	2.3	2.0	-0.4	-0.5	0.0	1.0	2.0	2.2	0.6	2.8
Contribution to Changes in Real GDP:													
Domestic Final Sales	0.5	0.5	-1.0	0.2	0.2	-1.7	-1.2	-1.2	-0.7	0.1	—	—	—
Net Exports	0.8	1.0	0.9	0.9	1.3	1.3	0.7	0.7	0.7	0.7	—	—	—
Inventories	0.5	0.0	-0.4	0.2	-1.0	-0.9	-0.5	-0.5	-0.1	0.2	—	—	—
Trade Balance (*€ billion*)	8.7	3.0	18.2	10.9	1.9	7.3	6.1	5.0	3.8	3.4	—	—	—
Current Account Balance (*€ billion*)	-45.7	-29.2	7.3	-0.7	-1.7	-4.0	0.7	-6.6	-12.5	-17.2	—	—	—
as percent of GDP	-0.5	-0.3	0.1	0.0	-0.1	-0.2	0.0	-0.3	-0.5	-0.7	—	—	—
Consumer Prices (*percent* oya)	1.6	2.7	2.4	2.0	2.7	2.9	2.7	2.6	2.4	2.0	2.9	2.0	2.0
Core Consumer Prices (*percent oya*)	1.0	1.4	1.3	1.1	1.3	1.6	1.5	1.3	1.2	1.2	1.6	1.2	1.1
Unemployment Rate (*percent*)	10.1	10.1	10.8	10.8	10.2	10.4	10.5	10.7	11.0	10.9	—	—	—
ECB Refi Rate (*percent, end of period*)	1.00	1.00	1.00	0.50	1.50	1.00	1.00	0.75	0.50	0.50	—	—	—
$ per € (*end of period*)	1.34	1.30	1.20	1.35	1.34	1.30	1.30	1.25	1.20	1.20	—	—	—
Euro Area Budget Balance (*percent of GDP*)	-6.2	-5.6	-4.6	-3.8	—	—	—	—	—	—	—	—	—
Index of Manufacturing Production	7.4	3.6	-2.1	1.1	1.6	-6.7	-2.0	-2.5	-1.5	1.0	-0.2	-1.3	2.0
Index of Capital Goods Production	9.1	9.1	0.0	3.0	9.6	-4.8	-1.0	-2.0	-1.0	4.0	3.6	0.0	4.0
Euro Area Countries Real GDP:													
Germany	3.7	3.0	0.5	1.9	2.3	-0.7	0.0	1.0	1.0	2.0	2.0	1.0	2.1
France	1.5	1.6	0.1	0.9	1.3	0.9	0.0	-1.5	0.0	0.5	1.4	-0.3	1.5
Italy	1.5	0.5	-2.4	0.4	-0.7	-2.9	-2.5	-3.0	-2.5	-1.0	-0.5	-2.3	1.9
Spain	-0.1	0.7	-1.0	1.1	0.0	-1.1	-1.5	-2.5	0.5	0.5	0.3	-0.8	1.9

Table 7
Euro Area: Latest Real GDP Growth Forecasts
percent, y/y

	2012	2013	As of:
IMF	-0.5	0.8	Jan 12
OECD	0.2	1.4	Nov 11
ECB	-0.5 to 0.3	0.0 to 2.2	Mar 12
European Commission	-0.3	1.3	Feb 12
Bloomberg Consensus	-0.4	0.9	Mar 12
IIF	-0.5	1.3	Mar 12

Chart 27
Euro Area: The Evolution of 2012 GDP Growth Forecasts
percent, y/y, forecasts as of the end of quarter



Euro Area

ECB: QUANTITATIVE AND QUALITATIVE EASING

- The highlights of the past three months have been the two 3 -year loans provided by the ECB to the banking sector. Massive, cheap long-term liquidity has had a dramatic impact on the ECB's balance sheet (Table 8), as well as a very positive impact on financial markets. Borrowing costs for distressed sovereigns Italy and Spain fell sharply, bank stocks rallied and interbank market tensions eased substantially (Chart 28). It is yet to be seen, however, whether abundant monetary base is transmitted to the real economy in the form of credit provision to households and businesses. Incoming data on bank lending, which showed tentative signs of stabilization in January, will be closely watched by the ECB.

- In its March policy meeting the ECB ruled out an imminent rate cut. First, the inflation forecast for 2012 was revised up to average 2.4% in 2012, from a forecast of 2% in December. Second, the ECB will take time to assess the effects of the recently adopted measures. We have therefore moved our projection for policy rate cuts into late Q2 (25bp) and Q3 (25bp). We remain of the view that more conventional monetary easing is likely, as the persistence of the recession through mid-year is likely to surprise the ECB.

- The two long-term refinancing operations (LTRO) that were carried out in December and February are unprecedented in several respects. First, they supplied to the market a record amount of over €1 trillion, or more than €500 billion after netting out other maturing ECB facilities and lower participation in subsequent weekly operations. Second, it marked a shift in the average maturity of banks' funding from the ECB, reducing their financial vulnerability in the context of closely intertwined liquidity and solvency problems (Chart 29). Third, the recent extension in eligible collateral enabled more small and medium size banks — which are a key source of credit to small and medium-size enterprises — to participate. A total of 800 banks borrowed in the second LTRO, versus 523 in the first.

- The ECB's liquidity-providing monetary policy instruments have surged in volume by 126% since June 2011 (Table 8). As a share of the total size of the balance sheet, these assets increased from 32% to 48%, accounting 80% of the Eurosystem balance sheet expansion.

Table 8
Eurosystem Simplified Balance Sheet
€ billion, change from 24 June 2011 to 16 March 2012

Assets		Liabilities	
Monetary policy instruments	*+801*	*Monetary policy instruments*	*+768*
MRO	-145	Current account (reserves)	-121
LTRO	+785	Deposit facility	+746
Marginal lending facility	+12	Absorbing operations	+144
Covered bond purchases	+6	Banknotes	+26
Securities Markets Program	+144	Net other autonom. factors	-30
Net foreign assets	+146	Revaluation account	+88
Net domestic assets	-95	Capital and reserves	+2

Chart 28
Euro Area: 3-Month Euribor-OIS Spread
basis points

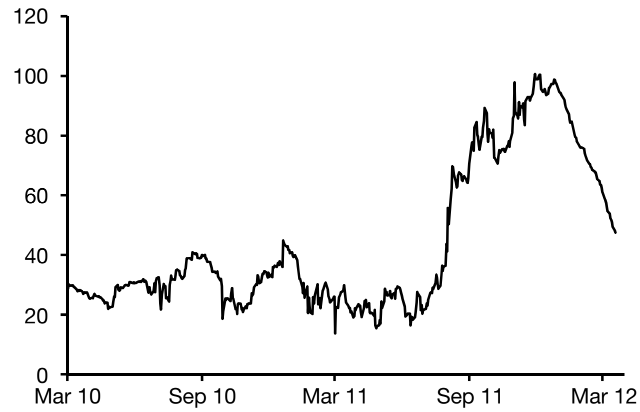
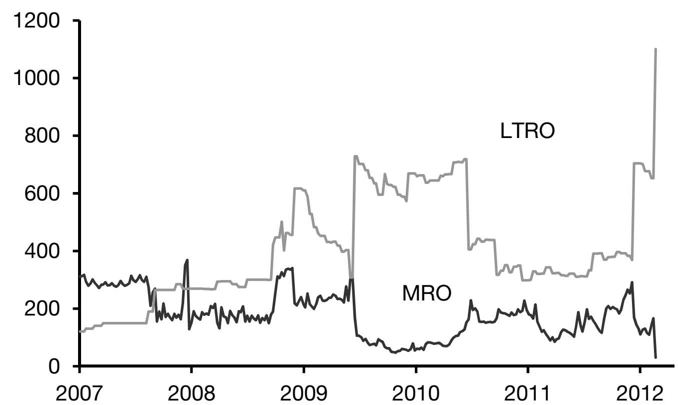


Chart 29
ECB: Liquidity Provision by Maturity
€ billion



Euro Area

EURO AREA PERIPHERY: STRESSES EASE

- The provision by the ECB of €1.1 trillion in three-year funding to European banks via two long-term repo operations (LTRO) has helped reduce financial stresses in the Euro Area periphery substantially. Banks from Italy, Spain, Portugal and Ireland are reported to have taken about €270 billion of the €529 billion provided at the second auction in February. Most of this appears to have been set aside as a cushion to meet future bank refinancing needs. Part of the funding, however, has been used to step up purchases of government bonds in Italy and Spain. The impact of the LTRO on bank lending to nongovernment borrowers, however, is likely to take more time, with no evidence for now that the credit crunch has begun easing.

- The impact of the LTRO on the government bond market appears to have been the strongest in **Italy.** Government bond holdings by Italian banks jumped by more than €30 billion after the first auction through the end of January, more than reversing sizable declines earlier (Chart 30). Large oversubscription at the March 15 bond auction suggests that demand has strengthened further after the second auction. Italian bond yields have fallen sharply as a result, to 4.8% for 10-year maturity from more than 7% before the first LTRO operation, with the decline reinforced by signs that fiscal consolidation remains on track.

- Government bond holdings by banks in **Spain** rose markedly as well, by €24 billion from the first auction through January (Chart 31). This caused bond yields to slip to 4.5% by early February from around 5.5% before the auctions. The second auction has had little impact on yields, however. Yields in fact have risen recently, as market confidence was hit by the government's announcement that last year's fiscal deficit was much wider than targeted and that this year's deficit target is out of reach.

- **Portuguese** banks are reported to have taken €36 billion in both LTRO auctions and **Irish** banks an unidentified but smaller amount. In both countries, however, LTRO funding was used to refinance shorter-term ECB financing, with the overall exposure to the ECB little changed. As a result, there was little impact if any on bond yields (Chart 32). Yields in both countries continued to be driven largely by market perceptions about the compliance with the EU-IMF program and prospects for regaining market access next year.

Chart 30
Italy: Banks' Holdings of Govt. Debt and Bond Yield
12-month percent change *percent*

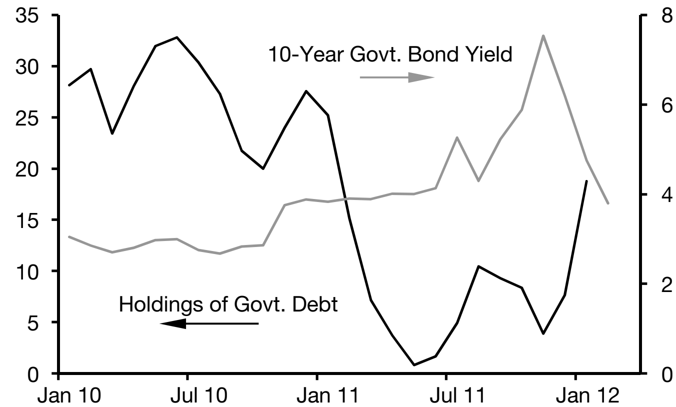


Chart 31
Spain: Banks' Holdings of Govt. Debt and Bond Yield
12-month percent change *percent*

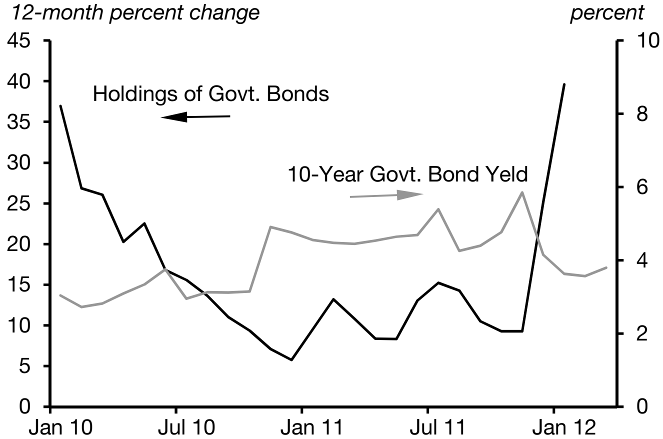
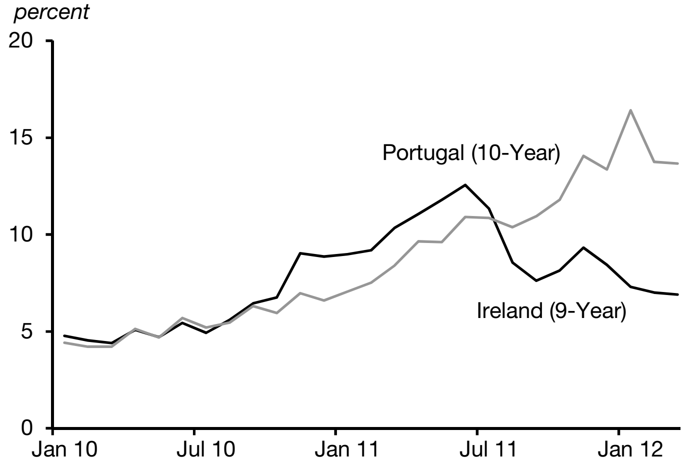


Chart 32
Ireland and Portugal: Government Bond Yields
percent



Japan

SIGNS OF ROBUST REBOUND

- The pessimistic mood that was evident in Japan earlier in the year has given way to optimism, reflecting the success of the BoJ's more accommodative policy stance. In particular, the positive effect of the BoJ's new stimulus program has been quite pronounced in the stock market. The Nikkei 225 index has risen by 11% over the past five weeks. In addition, the yen has depreciated 5.4% against the U.S. dollar since February 14, when the BoJ surprised markets by enlarging the size of its asset purchase program and setting a 1% inflation target. Most encouragingly, this move seems to have been successful in shaping the inflation expectations of market participants. The five-year breakeven rate, a measure of long-run inflation expectations has turned positive (Chart 33). That said, we believe, the BoJ is unlikely to achieve its CPI inflation goal for at least the next two years.

- The positive trend in short-term economic indicators continued to be in line with our growth forecast for Q1 (Table 9). In particular, consumption indicators trended up solidly, in tandem with early signs of improvement in consumer sentiment. Auto sales have increased significantly, reflecting the reintroduction of the government's subsidy program for eco-friendly cars. Given that this program will run out in January 2013, auto sales are likely to continue to boost household spending for the rest of the year. Market sentiment indicators are also heading in the right direction. The latest Reuter Tankan Survey indicated that manufacturing sentiment improved considerably, owing to the depreciation of the yen and the recovery from Thai floods. This week's release of the custom trade report showed that the February trade balance marked an unexpected surplus of ¥33 billion after posting a record deficit of ¥1476 billion in January. Notably, real imports fell 8.6% m/m in February while imports of fossil fuels continued to accelerate, mainly due to the delayed resumption of nuclear power stations. The details of the report, however, are very choppy so that it is difficult to get a reliable signal that would prompt us to alter our fundamental outlook for the Japanese trade balance. Thus, we still expect that Japan's annual trade balance will be in deficit this year, mainly due to increasing energy costs and the continued weak exports.

Chart 33
Japan: Five-Year Breakeven Rate
basis points

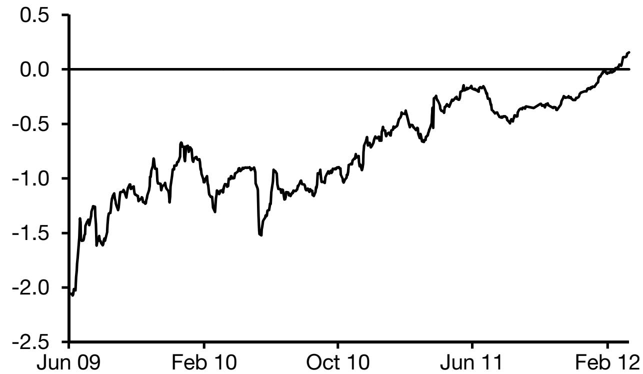


Table 9
Japan: Tracking Current Quarter GDP
percent, q/q saar, underlining denotes IIF forecasts

	Q4 11	Q1 12 to date	Data through
Real GDP	*-0.7*	*3.0*	-
Consumption			
Retail Sales	-4.1	20.5	January
Real Private Consumption	3.5	2.8	January
Auto Sales (million units, saar)	3.1	3.8	February
Consumption (constant prices, NIPA)	*1.4*	*2.0*	
Investment			
Machinery Orders *(Domestic Private)*	-6.1	12.5	January
GFCF (NIPA)	*10.3*	*3.5*	
Inventory Contribution to Growth (% points)	*-1.2*	*0.7*	
Trade			
Real Exports	-14.4	0.0	February
Exports of Goods & Services (const. prices)	*-11.8*	*1.5*	
Real Imports	5.4	-4.5	February
Imports of Goods & Services (const. prices)	*4.3*	*0.0*	
Contribution to Growth	-2.6	0.2	
Memo Items (Supply Side):			
Hours Worked	0.7	-1.4	January
Manufacturing Output	-2.0	23.3	January

Japan

JAPAN FORECAST IN DETAIL

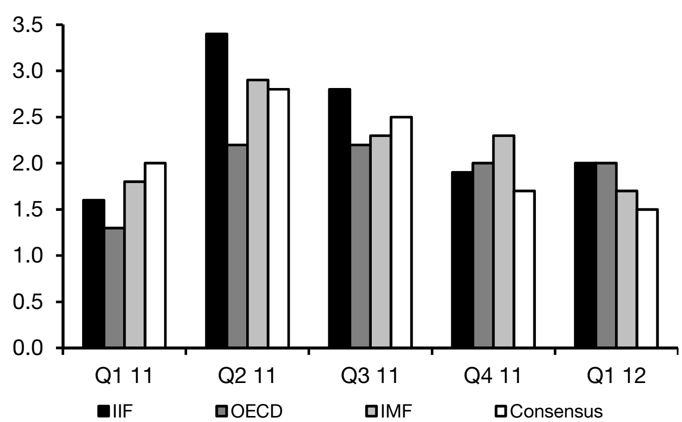
percent change over previous period, seasonally adjusted, at an annual rate, unless otherwise stated

	2010	2011	2012	2013	11Q3	11Q4	12Q1	12Q2	12Q3	12Q4	Q4/Q4 2011	Q4/Q4 2012	Q4/Q4 2013
Real GDP	4.5	-0.7	2.0	1.5	7.1	-0.7	3.0	2.0	1.5	1.5	-0.6	2.0	1.5
Consumption	2.6	0.0	1.6	0.8	4.2	1.4	2.0	0.5	0.8	1.0	0.6	1.1	0.8
Government Spending	2.1	2.1	1.2	1.0	1.1	1.5	1.0	1.0	1.0	1.0	1.9	1.0	1.0
Fixed investment	-0.1	0.6	3.7	1.9	1.7	10.3	3.5	0.9	1.8	1.8	3.3	2.0	2.0
Business	0.8	1.0	5.8	2.9	1.2	20.7	5.0	1.0	3.0	3.0	4.5	3.0	3.0
Government	-0.2	-3.2	-1.2	-1.1	-6.1	-8.4	0.0	0.0	-2.0	-1.0	0.2	-0.8	-1.0
Residential	-4.6	5.1	1.9	1.5	19.1	-2.7	1.0	2.0	2.0	0.0	2.9	1.2	1.5
Change in Inventories *(¥ trillion, chained)*	-1.3	-3.6	-1.4	1.5	-2.6	-4.1	-3.2	-1.5	-0.8	-0.2	—	—	—
Exports of Goods and Services	24.4	0.0	1.6	2.4	38.9	-11.8	1.5	3.0	3.0	3.0	-1.6	2.6	2.0
Imports of Goods and Services	11.1	5.8	4.0	3.4	14.1	4.3	0.0	4.0	4.0	4.0	5.8	3.0	3.0
GDP Deflator	-2.1	-2.1	-1.0	-1.0	-1.3	-0.9	-0.5	-1.0	-1.0	-1.0	-1.8	-0.9	-1.0
Nominal GDP	2.3	-2.8	1.0	0.5	5.8	-1.8	2.6	1.0	0.5	0.5	-2.4	1.1	0.5
Contribution to Changes in Real GDP:													
Domestic final sales	2.0	0.5	1.9	1.1	3.1	3.1	2.1	0.7	1.0	1.1	—	—	—
Net Exports	2.0	-0.7	-0.3	-0.1	3.6	-2.6	0.2	-0.1	-0.1	-0.1	—	—	—
Inventories	0.7	-0.4	0.4	0.6	0.8	-1.2	0.7	1.4	0.5	0.4	—	—	—
Discrepancy	-0.2	-0.1	—	—	-0.4	0.0	—	—	—	—	—	—	—
Trade Balance *(¥ trillion)*	7.93	-1.60	-5.67	-5.96	-0.24	-1.18	-1.36	-1.42	-1.44	-1.45	—	—	—
Current Account Balance *(¥ trillion)*	17.24	9.74	6.46	8.11	2.57	1.86	2.14	1.46	2.12	0.74	—	—	—
as percent of GDP	3.6	2.1	1.4	1.7	2.2	1.6	1.8	1.2	1.8	0.6	—	—	—
Consumer Prices *(percent oya)*	-0.7	-0.3	0.0	0.1	0.1	-0.3	0.1	0.0	0.0	0.0	-0.3	0.0	0.2
Core Consumer Prices *(percent oya)*	-1.2	-1.0	-0.4	0.1	-0.4	-1.1	-0.8	-0.5	-0.5	-0.1	-1.1	-0.1	0.4
Unemployment Rate *(percent)*	5.1	4.6	4.3	4.1	4.4	4.5	4.5	4.4	4.3	4.2	—	—	—
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	76.9	80.0	84.0	77.1	76.9	83.0	81.0	80.0	80.0	—	—	—
Government General Balance *(% of GDP)*	-7.8	-8.9	-8.9	-9.5	—	—	—	—	—	—	—	—	—
Index of Manufacturing Production	16.6	-3.5	8.3	5.3	18.3	-2.1	20.0	10.0	5.0	5.0	-2.4	9.8	5.0

Table 10
Japan: Latest Real GDP Growth Forecasts
percent, y/y

	2012	2013	As of
	Calendar Year		
IMF	1.7	1.6	Jan 12
OECD	2.0	1.6	Nov 11
Bloomberg Consensus	1.5	1.5	Mar 12
IIF	2.0	1.5	Mar 12
	Fiscal Year		
Bank of Japan	2.0	1.6	Feb 12
IIF	2.0	1.5	Mar 12

Chart 34
Japan: The Evolution of 2012 GDP Growth Forecasts
percent, y/y, forecasts as of the end of quarter



DOMESTIC SENTIMENT WEAKENS

- Australia was one of the few mature economies to avoid a contraction in the last quarter of 2011. That said, however, the growth unexpectedly decelerated to 1.7%, saar, in Q4, owing partly to a plunge in business investment and farm inventories together with a slowdown in household consumption.

- It is likely that the mining boom will be the main driver of economic growth for the next several years, if not decades, in tandem with the acceleration of urbanization in China and India. In particular, the ongoing robust demand for commodities from Asia would support favorable terms of trade, lifting national income and reducing the current account deficit. Although the external conditions surrounding the economy look favorable in the long-run, the near-term challenges regarding the domestic sentiment are becoming somewhat more worrisome.

- The main caveat relates to the weak labor market conditions, which have weighed on household income. Employment growth has decelerated significantly over the past six months, partly due to weak business sentiment. The unemployment rate ticked up to 5.2% in February, mainly driven by part-time job losses (Chart 35). Although the Australian government is now preparing to enact a 1% cut in the company tax rate to trigger employment growth, the impact lag of this policy change might be longer than anticipated as businesses are demanding a more comprehensive overhaul of the tax system.

- On the monetary policy side, the key challenge is still to set the appropriate policy mix at a time of escalated global uncertainty and weak consumer confidence. At its last two Board meetings, RBA held its cash rate on hold while Australian banks have been increasing their floating mortgage rates in response to rising funding costs (Chart 36). As a consequence, both mortgage credit growth and other credit growth to the personal sector have slowed recently (Chart 37).

- We now expect the economy to grow around 2.8% in H1 and but accelerate somewhat in the second half as foreign growth improves (especially in China).

Chart 35
Australia: Change in Employment
thousand

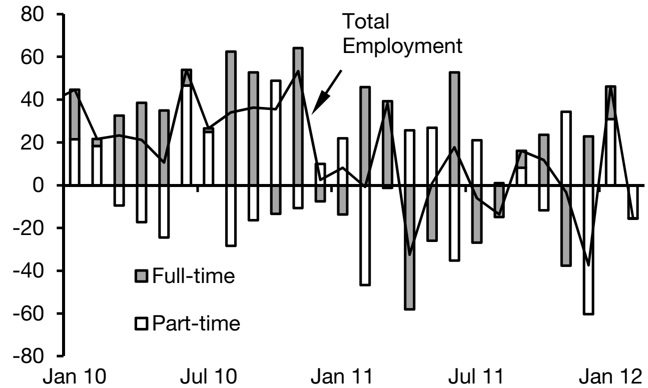


Chart 36
Australia: Cash Rate and Mortgage Rate
percent

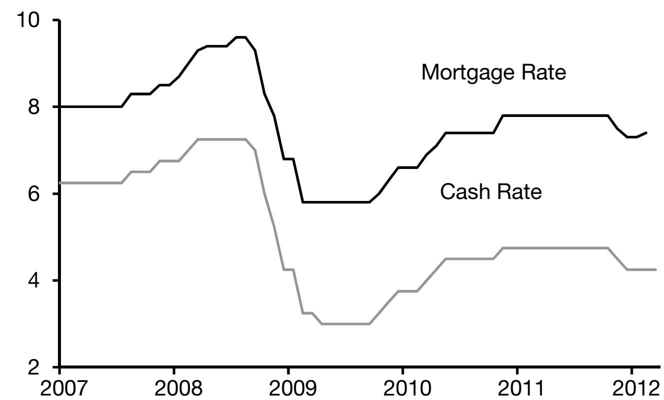
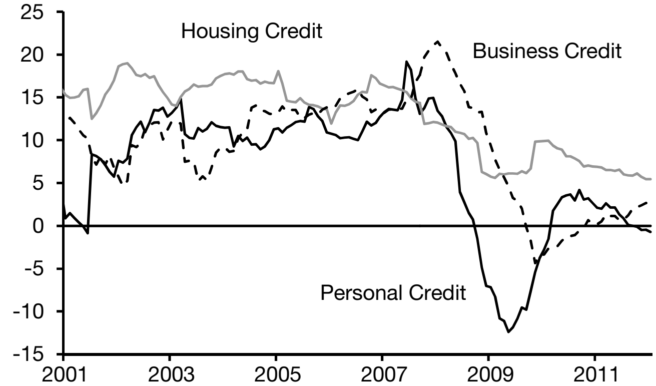


Chart 37
Australia: Credit Growth
percent change over a year ago



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	11Q3	11Q4	12Q1	12Q2	12Q3	12Q4	Q4/Q4 2011	Q4/Q4 2012	Q4/Q4 2013
Australia													
Real GDP	2.5	2.0	3.0	3.4	3.2	1.7	3.0	2.5	3.0	3.5	2.3	3.0	3.5
GDP Deflator (percent, oya)	5.4	4.3	2.0	2.1	3.7	3.2	2.8	1.6	1.6	2.0	3.2	2.0	2.2
Current Account Balance (%GDP)	-2.8	-2.2	-2.1	-2.0	-1.6	-2.3	-2.5	-2.0	-2.0	-2.0	—	—	—
Inflation Target	2.0 - 3.0												
Consumer Prices (*percent, oya)*	2.8	3.4	3.2	3.1	3.5	3.1	3.5	3.2	3.0	3.2	3.1	3.2	3.0
USD per AUD *(end of period)*	1.02	1.02	1.03	1.03	0.97	1.02	1.03	1.03	1.03	1.03	—	—	—
Cash Rate	4.75	4.25	4.25	4.00	4.75	4.25	4.25	4.00	4.00	4.00	—	—	—
Canada													
Real GDP	3.2	2.5	2.1	2.5	4.2	1.8	2.0	2.0	2.2	2.4	2.2	2.1	2.7
GDP Deflator (percent, oya)	2.9	3.3	3.0	2.5	3.5	3.1	3.0	3.0	3.3	2.8	3.1	2.8	2.5
Current Account Balance (%GDP)	-3.1	-2.8	-1.8	-1.6	-0.7	-0.6	-0.5	-0.5	-0.4	-0.4	—	—	—
Inflation Target	2.0 (+/-1)												
Consumer Prices (*percent, oya)*	1.8	2.9	1.8	1.9	3.0	2.6	2.4	2.0	1.5	1.5	2.6	1.5	2.0
CAD per USD	1.00	1.02	0.98	1.00	1.05	1.02	0.99	0.98	0.98	0.98	—	—	—
O/N Rate	0.99	1.00	1.00	1.25	1.00	1.00	1.00	1.00	1.00	1.00	—	—	—
Sweden													
Real GDP	5.8	4.0	-0.5	1.5	3.5	-4.4	-1.5	-0.5	0.5	1.0	1.2	-0.1	2.0
GDP Deflator (*percent, oya)*	1.7	1.0	3.7	5.7	0.9	0.4	3.8	3.4	0.7	7.0	0.4	7.0	5.0
Current Account Balance (%GDP)	6.9	7.2	5.5	6.0	8.6	5.5	5.0	5.5	5.5	6.0	—	—	—
Inflation Target	2.0												
Consumer Prices (*percent, oya)*	1.3	2.6	1.7	1.5	3.0	2.3	2.0	1.8	1.5	1.5	2.3	1.5	1.5
SEK per USD *(end of period)*	6.71	6.89	6.80	6.85	6.87	6.89	6.77	6.70	6.70	6.80	—	—	—
Repo Rate	1.25	1.75	1.75	1.25	2.00	1.75	1.50	1.50	1.25	1.00	—	—	—
United Kingdom													
Real GDP	2.1	0.8	0.0	1.5	2.2	-0.8	-1.0	-1.0	2.0	1.5	0.7	0.4	1.6
GDP Deflator (percent, oya)	3.0	2.3	2.3	2.4	2.4	2.3	2.0	2.5	2.5	2.4	2.3	2.4	2.4
Current Account Balance (%GDP)	-3.3	-2.6	-1.6	-1.2	-4.0	-2.5	-2.5	-1.5	-1.2	-1.2	—	—	—
Inflation Target	2.0												
Consumer Prices (*percent, oya)*	3.3	4.5	2.7	2.0	4.7	4.7	3.3	3.0	2.5	2.2	4.7	2.2	2.0
USD per £ *(end of period)*	1.56	1.55	1.58	1.58	1.56	1.55	1.58	1.58	1.58	1.58	—	—	—
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	—	—	—

Chart 38
Other Mature Economies: Current Account Balance
percent of GDP

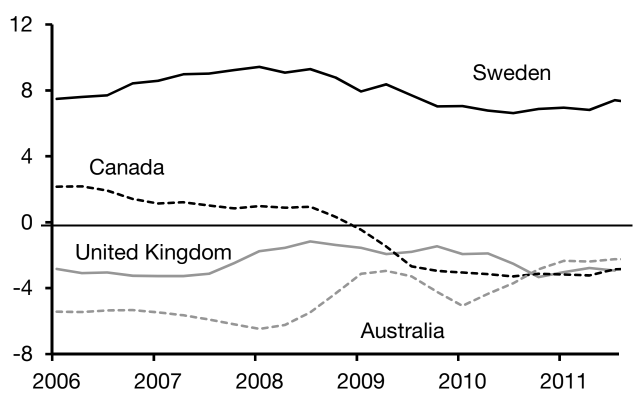
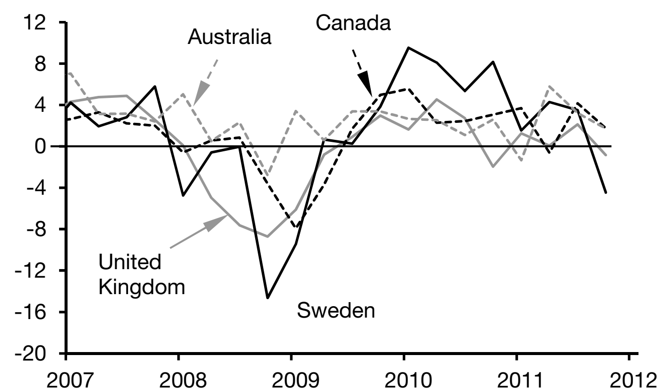


Chart 39
Other Mature Economies: Real GDP Growth
percent, q/q, saar



Emerging Asia

COPING WITH HIGHER OIL PRICES

- The recent escalation in oil prices puts an additional drag on growth in the leading emerging markets in Asia that has been softening on a slacking in external demand and weaker exports. While the impact of higher oil prices varies considerably across the region, the favorable fundamentals in most economies should help limit the adverse consequences. This assessment will become apparent from the muted first-round effects of higher oil prices on inflation and the balance of payments.

- Fuel typically has a weight of around 15% in the inflation indices, but rising oil prices typically trigger higher prices in many key sectors. Nevertheless, the recent increase comes at a time when inflation in the region is moderating with food prices and in the absence of excess demand pressures (Table 11). While there will be some pass-through of higher fuel prices, energy subsidies in many economies also shield consumers from the immediate impact of higher oil prices.

- **India** has had the highest and most persistent inflation in the region, but a gradual drop in the 12-month increase in the benchmark wholesale price index to 7% by February from a recent high of 10% last September prompted the central bank to begin relaxing restrictive monetary measures in early 2012 (Chart 40). The 12-month increase in nonfood manufactured goods prices eased to 5.8% from 8% during the same period.

- Lower inflation also prompted the central bank in **China** to start relaxing monetary policy in late 2011 after a year of tightening. The 12-month increase in consumer prices fell to a 20-month low of 3.2% in February from last year's high of 6.5% in July (Chart 41). The central bank in the **Philippines** has moved more aggressively in easing monetary policy this year as the 12-month increase in consumer prices dropped to a 28-month low of 2.7% in February, below the target of 3-5% for the year.

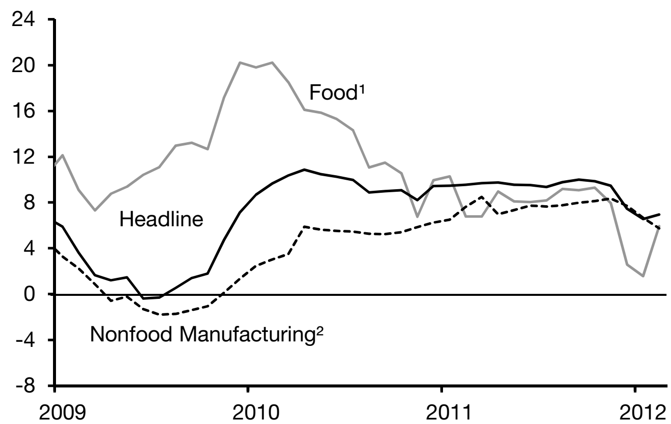
- The central bank in **Indonesia** started relaxing policy last October with the 12-month increase in consumer prices falling to 3.6% in February from a 21-month high of 7% in January 2011. Budget subsidies have shielded the pass-through of higher oil prices, but the central bank has warned that the government's plan to hike administered fuel prices

Table 11
Consumer Prices: February
percent change over a year ago

	Headline		Core	
	2011	2012	2011	2012
China	4.9	3.2	2.0	1.4
India	9.5	7.0	7.6	5.8[1]
Indonesia	6.8	3.6	4.4	4.3
Malaysia	2.9	2.2	2.1	1.8[2]
Philippines	4.7	2.7	n.a.	n.a.
South Korea	3.9	3.1	2.6	2.5
Thailand	2.8	3.4	1.5	2.7

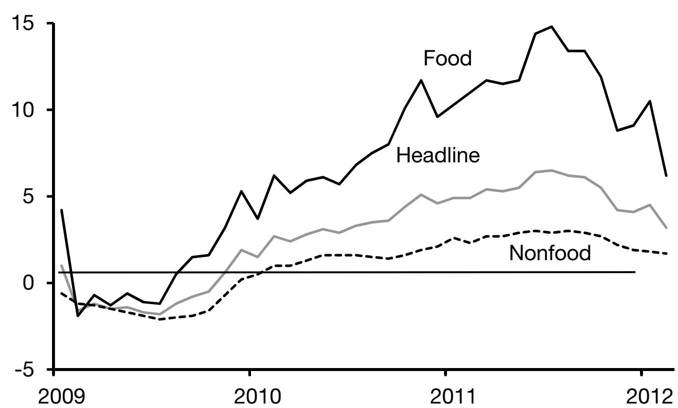
[1]Nonfood Manufacturing [2]Nonfood

Chart 40
India: Wholesale Prices
percent change over a year ago



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

Chart 41
China: Consumer Prices
percent change over a year ago



EMERGING ASIA (CONTINUED)

by 33% from April may temporarily raise inflation back to 7%, before it returns to the target range of 3.5-5.5% in 2013 (Chart 42).

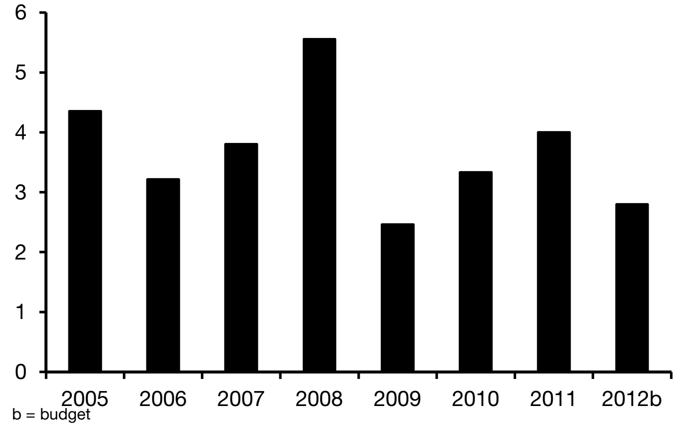
- Devastation from widespread flooding in **Thailand** late last year has made it difficult to gauge the underlying trends in the economy. The central bank has relaxed policy to foster recovery, while the flood-induced inflation was mild and has begun to subside. Headline inflation eased from a recent high of 4.2% in November to 3.4% in February, within the central bank's annual target range of 1.5-4.5%.

- The central banks in **Malaysia** and **Korea** have so far refrained from easing policy. Inflationary pressures remain subdued in Malaysia, with the 12-month increase in consumer prices at 2.7% in January. Extensive subsidies should also limit the first-round impact of higher oil prices. The 12-month increase in consumer prices in Korea eased to 3.1% in February from the previous high of 4.7%, but the authorities have repeatedly stressed concerns about underlying inflationary pressures in holding off on policy easing.

- The prevalence of current account surpluses and large holdings of official foreign exchange reserves should also cushion the impact of higher oil prices on the balance of payments (Table 12). While Malaysia is a net exporter, India is the most exposed, with the current account deficit set to rise from $46 billion in 2010/11 to a record $68 billion in 2011/12, 3.7% of GDP (Chart 43. India imports 75% of its crude oil needs, a $10 per barrel increase in the oil price raises net oil imports by $9 billion a year. While the large deficit makes the balance of payments vulnerable to unpredictable shifts in investor and creditor sentiment, official foreign exchange reserves were $267 billion in February 2012.

- The adjustment brought on by higher oil prices along with a softening in external demand mean somewhat higher inflation and slower growth in the region than what it would otherwise have been. Nevertheless, subdued inflation, small budget deficits, low external debt and large reserve holdings are cushions against an oil price shock.

Chart 42
Indonesia: Total Subsidies
percent of GDP



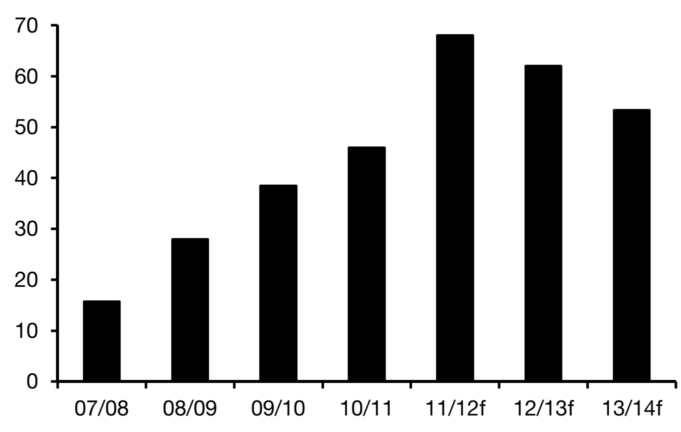
b = budget

Table 12
Trade and Oil Prices: 2011
$ billion

	Current Account Balance	Impact of $10/bbl increase
China	201	-18.0
India*	-68	-9.0
Indonesia	2	-0.5
Malaysia	32	1.3
Philippines	3	-0.8
South Korea	28	-9.3
Thailand	12	-4.0

*Fiscal year ending March 2012
Source: National Sources, IIF Estimates

Chart 43
India: Current Account Deficit
$ billion



HIGHER ENERGY PRICES HURT

- The recent increase in oil prices, if sustained, is likely to have adverse implications for Emerging Europe. Except for **Russia**, the only energy exporter in the region, higher oil prices would result in deteriorating current account balances, rising inflation pressures and would weigh on already subdued growth prospects as households and companies cut back non-energy spending to accommodate a higher bill for the relatively inelastic energy demand. The adverse impact of the rising oil prices will also be reinforced by a similar increase later in the year of already near record-high prices for Russian natural gas, which are linked to those of crude oil and petroleum products with a nine month lag (Chart 44).

- The degree to which individual energy-importing countries will be affected will vary depending on the energy intensity of the economy and the existence of underlying macroeconomic imbalances. Countries with large current account deficits, in particular, are likely to be most vulnerable. Headline inflation is likely to accelerate across the board, but prospects for core inflation will depend on the flexibility of product and labor markets. Unless second-round effects push core inflation up substantially, central banks are unlikely to raise interest rates given weak growth prospects and lax monetary policies in Europe and the U.S.

- **Ukraine** is likely to be most vulnerable in the region, especially to the likely increase in natural gas prices. A $10/barrel increase in oil prices, if sustained, would add $2.6 billion, or 1.8% of GDP to a current account deficit already on track to exceed 8% of GDP in the absence of corrective measures. Without access to capital markets and with the IMF program suspended, a deficit of this magnitude would be unfinanceable, threatening a major financial dislocation unless the authorities tighten demand management sharply and move swiftly with the measures needed to secure renewal of IMF lending (Chart 45).

- The large current account shortfall leaves **Turkey** vulnerable to sustained increases in oil prices as well. According to the central bank, a permanent $10/barrel increase in the price for Brent crude would add 0.4% to headline inflation and $5.6 billion, or 0.7% of GDP, to the current account deficit over a 12-month period while cutting real GDP growth by 0.5 percentage points. With the average price for Brent

Chart 44
Brent Crude and Russian Natural Gas Price
$ per barrel *$ per 1000 cu meter*

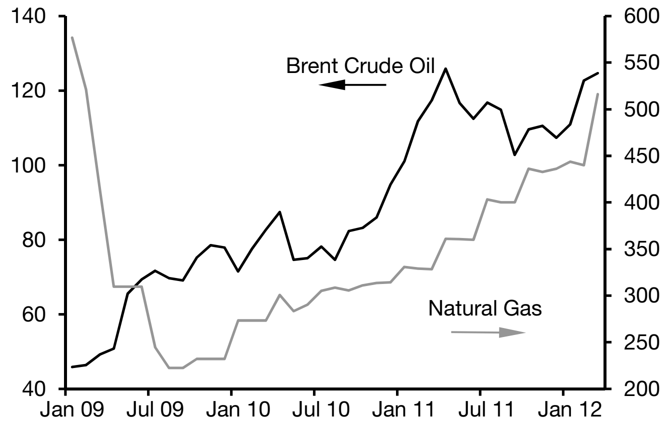


Chart 45
Ukraine: Current Account Balance
percent of GDP

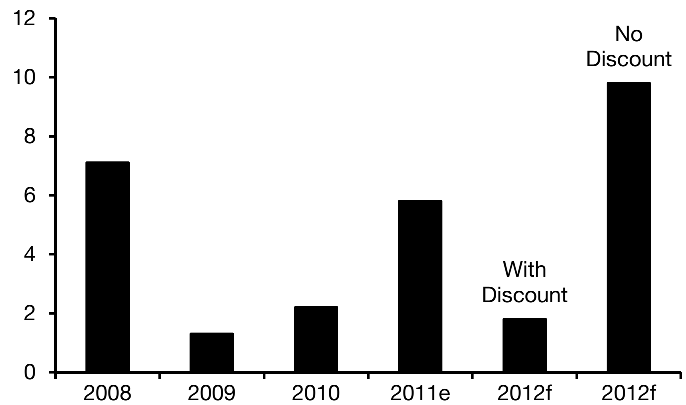
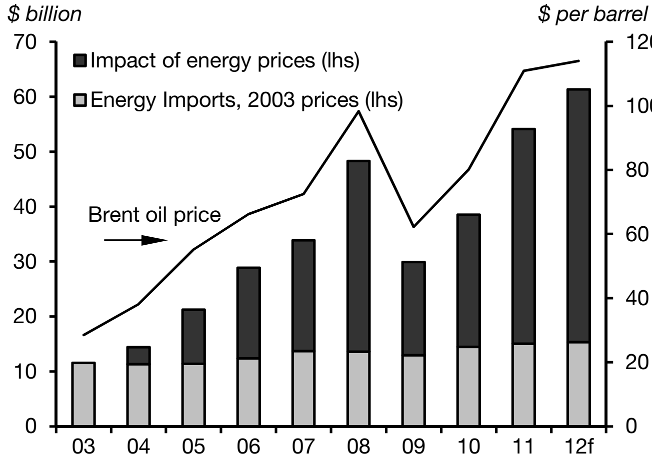


Chart 46
Turkey: Impact of Energy Prices on Imports
$ billion *$ per barrel*



EMERGING EUROPE (CONTINUED)

currently projected to increase to $114/barrel this year from last year's average of $111/barrel, higher energy prices would add nearly $7 billion to merchandise imports (Chart 46). This would leave the current account deficit little changed from last year at near 9% of GDP, despite a likely sharp slowdown in output growth, leaving the lira increasingly vulnerable to shifts in market sentiment.

- In **Hungary**, where depressed domestic spending is likely to keep the current account in surplus this year and next, the inflationary effect of higher energy prices is more of a risk. Reinforced by ongoing forint weakness, the 12-month increase in energy prices rose to 13% in February from a 6% low in July. This added 2.1 percentage points to 12-month headline inflation, which accelerated to 5.9% in February from 3.1% in July (Chart 47). With oil prices likely to remain at elevated levels and natural gas import prices to rise later in the year, headline inflation looks likely to remain above 5% throughout 2012.

- In **Poland**, where there are no signs of macroeconomic imbalances, the $10/barrel increase in oil prices, if sustained through 2012, would add only $2.5 billion to merchandise imports. With part of the increase likely to be offset by higher export prices, the current account deficit is likely to widen only marginally to 2.6% of GDP from last year's 2.1%. The impact of inflation is likely to be modest, too, with energy prices adding 0.3 percentage points to headline inflation (Chart 48). Even then, however, zloty appreciation should help lower 12-month headline inflation to 3% from 4.3% in February.

- While **Russia** should be the big beneficiary from the surge in oil prices (and the forthcoming increase in natural gas export prices), economic performance thus far this year has been disappointing. Even though higher energy export receipts appear to have widened the trade surplus by more than a third to $40 billion during January-February, a similar surge in capital outflows has left foreign exchange reserves little changed since late last year (Chart 49). Sharply higher energy-related revenues notwithstanding, a surge in noninterest spending shifted the federal government to a 3% of GDP deficit during January-February from a 1.5% surplus a year before. growth has all but ceased since the start of the year.

Chart 47
Hungary: Contributions to Headline Inflation
12-month percent change

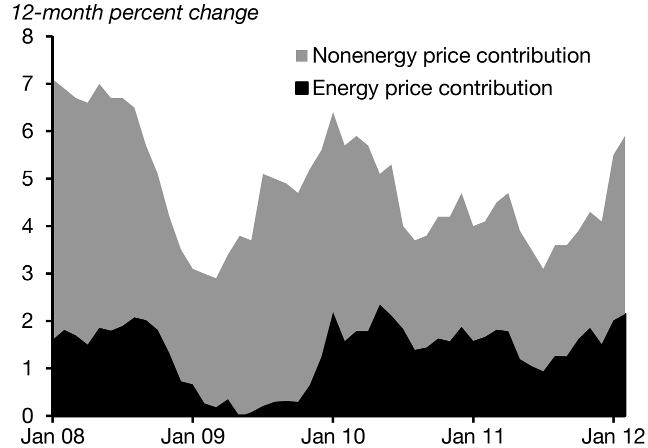


Chart 48
Poland: Headline Inflation
12-month percent change

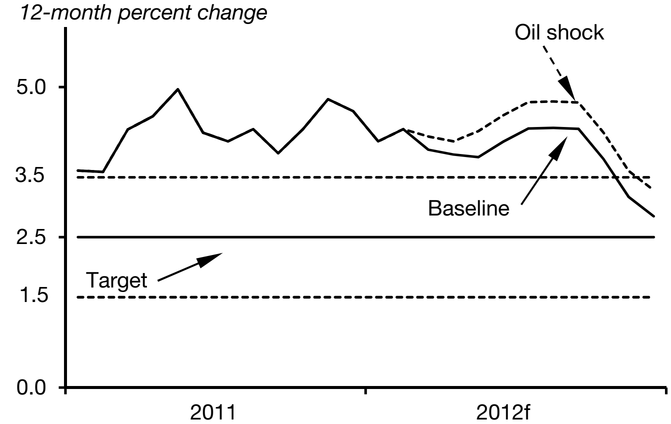
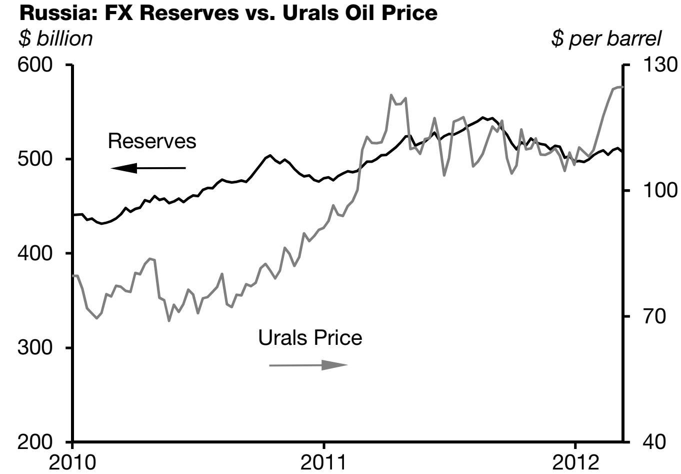


Chart 49
Russia: FX Reserves vs. Urals Oil Price
$ billion *$ per barrel*



1Net of change in taxes, food and energy prices, IIF estimation.

COMMODITIES REMAIN SUPPORTIVE

- Following a period of moderate weakness in the second half of 2011, commodity prices have regained strength in the first months of this year driven by improving prospects for global growth. The rise in prices has been broad-based (Chart 50). Given the heavy concentration of Latin American exports in commodities (with the exception of Mexico), this development, if sustained, will provide additional lift to regional growth and support external trade positions (Table 13). We project regional growth of 3.7% in 2012, up from 4.0% last year.

- With inflation above target in several countries, rising commodity prices are bound to complicate policy efforts to rein in inflation. Two factors should mitigate their adverse effect, however:

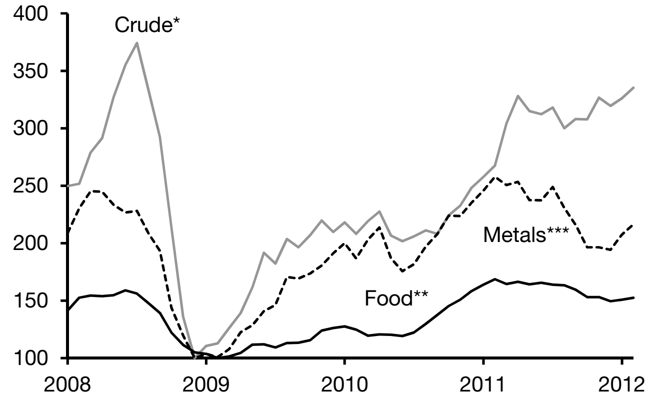
  1. Many countries have in place subsidy schemes to smooth the impact of higher oil prices on transportation and other regulated prices; and

  2. appreciation of local currencies against the dollar.

- With a well-diversified commodity export mix (agriculture, fuel and mining), the net impact of higher commodity prices on **Brazil** is likely to be positive. It will support the external trade position and underpin domestic confidence. Since the country is practically self-sufficient in oil production and the government regulates fuel prices, the short-term inflationary impact of higher oil prices will most likely be mitigated. We expect the government to use all available instruments to delay as much as possible an increase in domestic fuel prices in order to support central bank efforts to contain inflation (Chart 51).

- In **Chile**, a higher copper price will boost savings in the sovereign wealth fund, while in **Venezuela** rising crude oil prices will provide the government with greater ammunition to increase fiscal and quasi-fiscal spending ahead of the October election. With oil accounting for one-third of fiscal revenue in **Mexico**, higher crude prices will support public sector finances, allowing the government to replenish the oil stabilization fund. Higher oil prices are unlikely to translate into higher prices for domestic fuel in the short term, particularly during an election year.

Chart 50
Latin America: Commodity Prices
index (2008-09 crisis low=100)



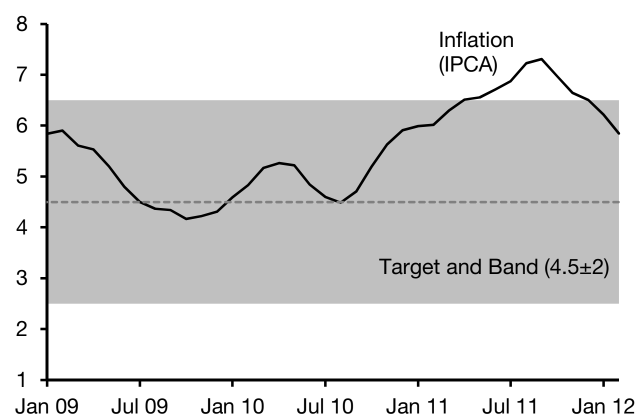
* Simple average of Venezuela and Mexico crude prices;
** UN FAO Food Price Index; ***LME Metals Index

Table 13
Latin America: Export Profile

	Exports (% of GDP)		Commodities (% of Exports)			
	Total*	Commodity	Food	Fuel	Mining	Total
Argentina	17.5	11.3	53.8	8.2	4.1	66.1
Brazil	10.6	6.2	35.0	10.1	18.6	63.7
Chile	33.9	31.3	22.7	0.4	66.4	89.5
Colombia	17.7	10.8	15.3	59.9	1.6	76.8
Ecuador	35.6	28.1	34.2	55.5	0.6	90.4
Mexico	31.2	6.8	6.5	14.1	3.0	23.6
Peru	26.6	19.9	21.7	12.2	52.2	86.0
Uruguay	16.7	14.5	72.9	2.8	0.3	76.0
Venezuela	30.3	27.2	0.1	96.4	1.2	97.8
LatAm	19.3	10.0	20.7	21.2	14.1	56.0

* 2011 IIF estimates, all other data from WTO (2010).

Chart 51
Brazil: Consumer Price Inflation
percent change over a year ago



LATIN AMERICA (CONTINUED)

- In **Argentina**, external accounts are extremely dependent on agricultural commodity prices. This is clearly reflected by an increasingly strong negative correlation between sovereign risk and the international price for soybeans, Argentina's main export (Chart 52). The recent recovery of soybean prices (up nearly 20% in mid-March 2012 from the recent low in late 2011) is increasing the domestic supply of dollars. This is providing temporary relief to an economy that relies heavily on administrative controls on trade and capital outflows to manage dollar supply amid chronic capital flight fueled by macro misalignments.

- In **Colombia**, higher commodity prices for oil, coal, coffee and gold are driving strong export growth. Total goods exports grew 43% between 2010 and 2011, well above the roughly 25% growth seen across the region as a whole. Commodities accounted for 80% of total exports in 2011, and the share of oil in overall exports has risen significantly to over 60% as a result of substantial foreign direct investment (FDI) in exploration and production (Chart 53). Despite higher commodity prices, inflation remained within the target of 3.0% (±1%), reaching 3.6% oya in February. In order to limit credit expansion, stem the potential impact of rising commodity prices on inflation, and entrench inflation expectations, the central bank has hiked the policy rate twice this year to 5.25%.

- **Uruguay's** export base has become increasingly dominated by agricultural goods (around 70% of the total), reflecting not only solid growth of traditional meat exports but also continued diversification into dairy, pulp, rice and soy. These gains, combined with higher global food prices, helped lift exports 20% oya in 2011 and provided a sizeable contribution to GDP growth (Chart 54). Higher food prices have complicated inflationary dynamics, pushing inflation well above target to 8.6% oya by June 2011 and generating significant second-round pressures later in the year. Given Uruguay's dependence on energy imports, sustained increases in energy prices will weigh on public sector finances as the government attempts to mitigate their inflationary impact by suppressing hikes in regulated fuel and electricity prices set by state-run utility companies.

Chart 52
Argentina: EMBIG Spread and Soy Price
basis points *$ per ton*

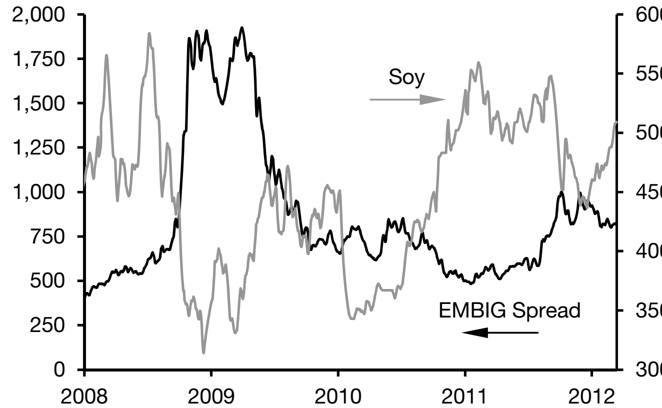


Chart 53
Colombia: Export Composition
percent of total exports

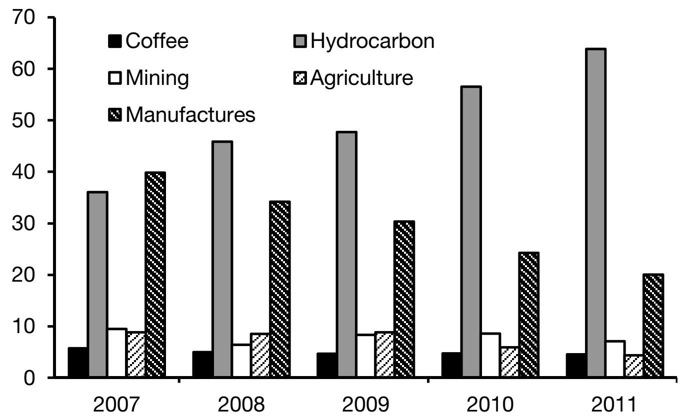
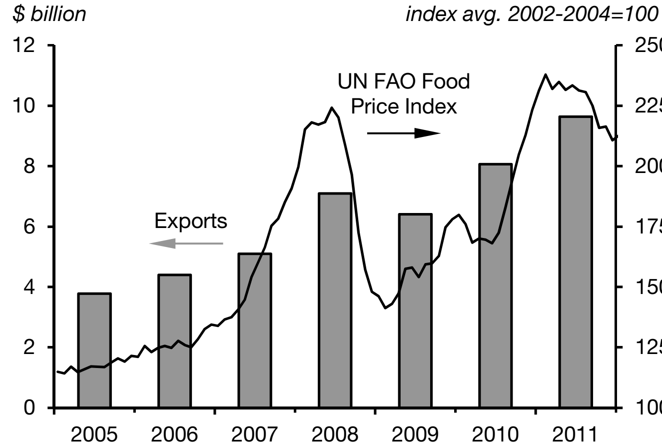


Chart 54
Uruguay: Exports and Global Food Prices
$ billion *index avg. 2002-2004=100*



Africa and Middle East

REAPING THE BENEFITS OF HIGH OIL PRICES

- The **GCC** countries continue to benefit from higher oil prices. Combined real GDP is expected to expand at 4.3%, driven by continued increases in crude oil production (to partly offset production declines in Iran and elsewhere) and public spending. Crude oil production has risen from 14.7 million barrels per day (mbpd) in 2010 to 16.1 mbpd in 2011, and is likely to increase further to 16.9 mbpd in 2012. The combined external current account surplus is projected to rise from $301 billion in 2011 to $319 billion in 2012. Gross foreign assets of the GCC are projected to increase to about $2.2 trillion (against foreign liabilities of $0.5 trillion).

- In **Saudi Arabia**, higher oil prices will widen the current account and fiscal surpluses and contribute to a further increase in the foreign assets (Table 14). Growth is expected to moderate from 6.4% in 2011 to 5.0% in 2012. Oil production is likely to remain around the current level of 10 mbpd throughout 2012, giving an average increase of 6.2% over the previous year. PMI figures of the past few months suggest that private sector activity remains strong. Total government spending is likely to decline slightly in 2012 following an increase of 24% in 2011. However, excluding last year's large one-off spending increase (mainly transfers to specialized credit institutions), the projected increase this year is 11%. Given the projected crude oil production and continued high prices against the small decline in total government spending, the breakeven Brent oil price that balances the budget will decline from $81 per barrel in 2011 to $78 per barrel in 2012 (Chart 55).

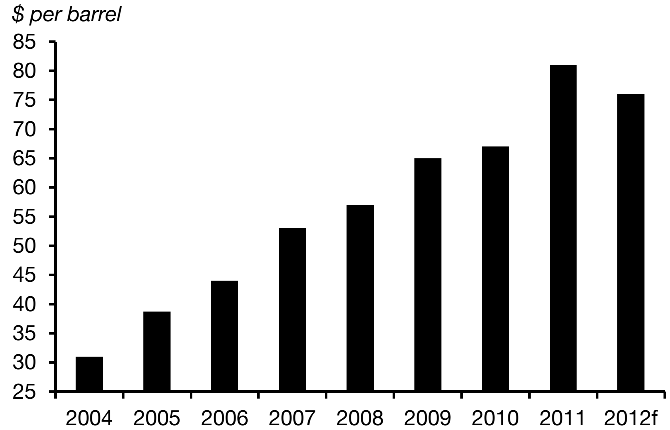
- In the **UAE,** real GDP growth in 2011is estimated at 4.4%, supported by a large increase in crude oil production in Abu Dhabi and strong trade and tourism activity in Dubai. In 2012, growth is expected to moderate to 3.2% and will be driven by a modest increase in oil production and a sizeable increase in public spending in Abu Dhabi (Table 15). Salaries of the federal government employees have recently increased by 35-100%. Spending on infrastructure in Abu Dhabi is expected to rise substantially following the recent decision of the Executive Council to implement several of its large-scale projects. The real estate sector remains weak and some of Dubai's government related entities (GREs) may face challenges in meeting debt repayment obligations.

Table 14
Saudi Arabia: Selected Macroeconomic Indicators

	2009	2010	2011e	2012f	2013f
Real GDP, % change*	0.1	4.0	6.4	5.0	3.7
Hydrocarbon*	-7.8	2.2	9.7	6.2	2.1
Nonhydrocarbon*	3.5	4.6	5.2	4.6	4.3
Consumer Prices, avg, %	5.1	5.4	5.0	4.9	3.5
Fiscal Balance, % GDP	-6.2	5.4	12.8	15.8	10.7
Current Acct. Bal., $ bn	21.5	67.1	142.4	160.3	125.3
% GDP	5.8	15.4	24.5	25.1	19.7
SAMA's Foreign Assets, $ bn	410	445	541	655	735
Crude Oil Production, mbd	8.2	8.4	9.3	9.8	10.0
Saudi Export Crude Price, $/b	63.4	77.7	106.9	110.1	101.0

e = IIF estimate; f = IIF forecast.
* According to preliminary official estimates real growth was 6.8% in 2011. This may be

Chart 55
Saudi Arabia: Breakeven Brent Oil Prices
$ per barrel



f = IIF forecast.

Table 15
UAE: Selected Macroeconomic Indicators

	2009	2010	2011e	2012f	2013f
Real GDP, % change	-3.7	3.2	4.4	3.2	3.3
Hydrocarbon	-8.5	4.6	7.5	4.0	3.0
Nonhydrocarbon	-1.3	2.5	3.0	2.8	3.5
Consumer Prices, avg, %	1.8	0.6	0.9	0.5	2.3
Credit Growth, %	1.2	0.7	3.4	4.0	5.5
Fiscal Balance, % GDP	-12.8	-2.6	6.3	6.2	3.1
Current Acct. Bal., % GDP	3.1	7.5	13.5	14.0	10.4
ADIA's Foreign Assets, $ bn	350	381	437	497	546
Foreign Liabilities, $ bn	100	104	99	98	101

e = IIF estimate; f = IIF forecast.

AFRICA AND MIDDLE EAST (CONTINUED)

- By the end of 2011, **Qatar** had reached maximum capacity for LNG production at 77 million tones, which is more than double three years ago. Real GDP growth, which has been in the double digits since 2006, reached 19% in 2011, while the current account surplus amounted to 30% of GDP. Higher oil prices, to which gas export prices are linked, and a 30% rise in LNG exports (Chart 56) also generated a fiscal surplus equivalent to 8% of GDP. With further LNG production increases subject to a moratorium until 2015, the economy is expected to cool down considerably in 2012.

- **Kuwait's** economy grew by 4.5% last year, led primarily by a rise in oil production to help compensate for lost Libyan supply. This, in combination with high oil prices, has pushed the current account surplus to 35% of GDP. The large increases in oil revenue also generated the largest fiscal surplus in the GCC, estimated at around 22% of GDP. Private sector activity was sluggish as capital expenditures fell short of what was budgeted due to political deadlock. These conditions are expected to continue in 2012.

- High oil prices and increased production at the onshore Awali field created space for the **Bahraini** government to increase public expenditure last year. This helped offset a sharp drop in tourism and related weakness in retail trade. Growth in 2011 is estimated to have slowed to about 2% and a tepid recovery is expected this year. The banking sector weathered the political storm reasonably well and private sector credit growth regained momentum towards the end of the year (Chart 57). High oil prices mean that the budget deficit will have narrowed to about 2% of GDP in 2011, having averaged nearly 6% in the previous two years.

- In **Oman**, which like Bahrain is not tied by OPEC quotas, oil production has risen steadily over the past four years and was up 2.3% in 2011 (Chart 58). Meanwhile, Omani crude prices averaged $103 per barrel in 2011, a 34.4% increase over 2010. Production is projected to rise a further 3.3% in 2012 and the average price in the first four months was up 21.7% from a year ago. This will provide ample funds to increase government expenditure in line with the ambitious Eighth Five-Year Development Plan (2011-2015) while still generating fiscal and external current account surpluses.

Chart 56
Qatar: LNG Exports
million tonnes

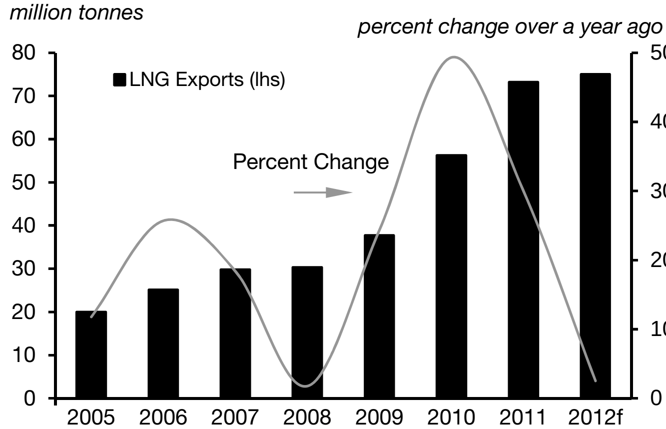


Chart 57
Bahrain: Credit to the Private Sector
percent change over a year ago

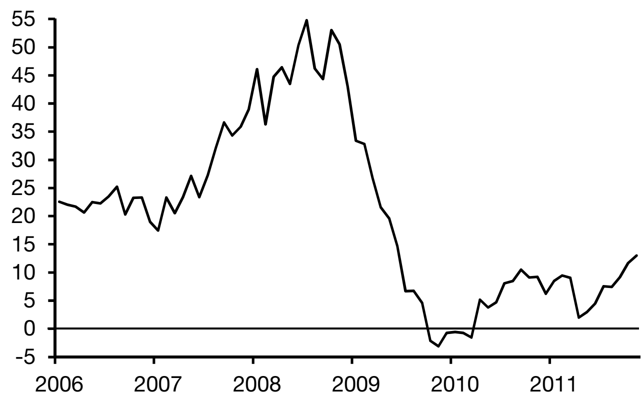
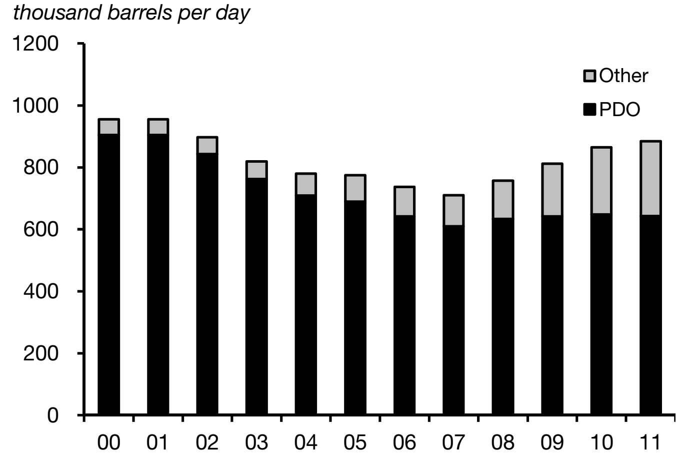


Chart 58
Oman: Oil Production
thousand barrels per day



CHANGES IN IIF FORECAST

- In the mature economies, the only major revision to growth was for Japan, where we upgraded the 2012 outlook to 2.0% (Chart 59). Growth in the U.S. and Euro Area was revised down marginally due to tracking changes to the current quarter. We also notched up our GDP growth forecast for each of the EM regions by around 0.1 percentage point.

- In response to the recent oil price increase and developing tensions in the Middle East, we have revised up our oil price forecast. We project the Brent oil price to decline gradually to $115 pb by the end of 2012Q2. We then expect prices to fall further in 2012H2, stabilizing around $105 pb.

- In line with our revised oil price projections, we have notched up our inflation forecasts in the mature economies by 0.2 percentage points to 1.6% y/y in 2012 (Chart 60). In EM economies, upward revisions to 2012 inflation in EM Asia and Latin America were partially offset by lower price pressures in EM Europe, leaving overall EM inflation nearly unchanged.

- We now expect the ECB to cut its policy rate by 25 basis points in each of 2012Q2 and Q3, leaving the rate at a floor of 0.5% through the end of our forecast horizon (end-2013). Our previous call was for a 50bp cut in 2012Q2.

Chart 59
IIF Growth Forecast: Mature Economies
percent, y/y

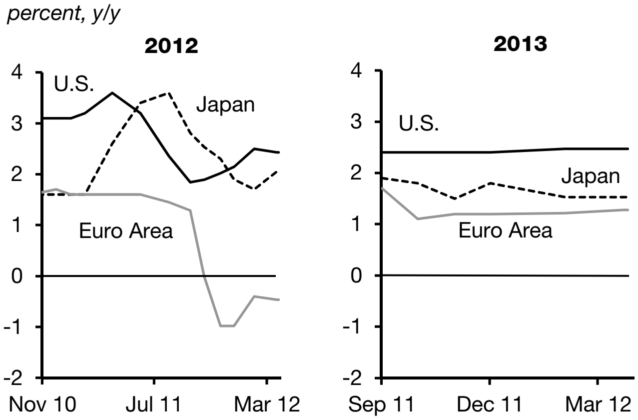


Chart 61
IIF 2012 Growth Forecast: Emerging Economies
percent, y/y

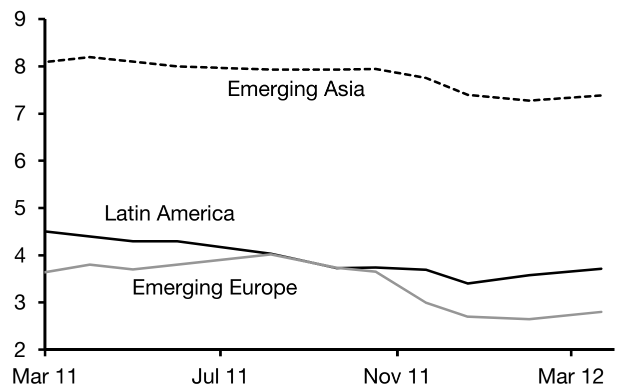


Chart 60
IIF 2012 CPI Forecast
percent change over a year ago, end of period

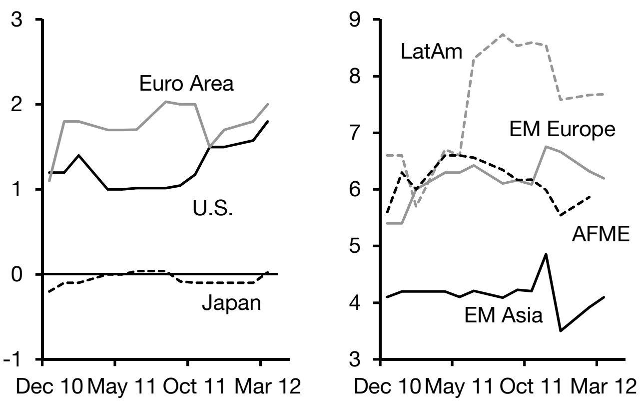
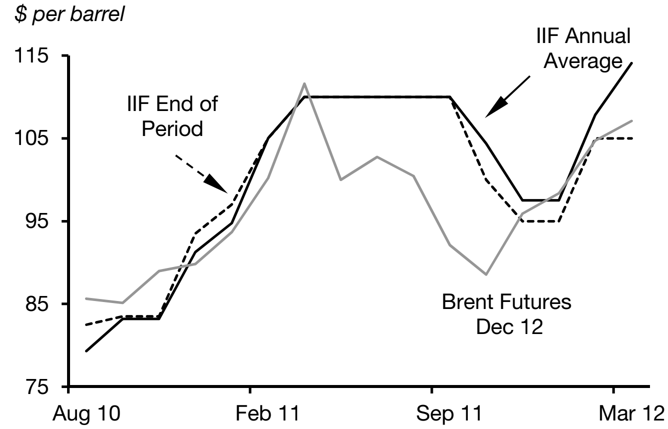


Chart 62
IIF 2012 Oil Price Forecasts
$ per barrel



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THE FORECAST IN DETAIL

Global Output Growth

percent, y/y

	2010	2011e	2012f	2013f
Mature Economies	**2.8**	**1.3**	**1.2**	**1.8**
United States	3.0	1.7	2.4	2.5
Euro Area	1.8	1.5	-0.5	1.3
Japan	4.5	-0.7	2.0	1.5
Other Mature	2.8	1.7	1.0	2.1
Emerging Economies	**7.2**	**6.0**	**5.5**	**6.1**
Latin America	6.2	4.0	3.7	4.5
Argentina	9.2	6.5	3.5	3.0
Brazil	7.5	2.8	3.4	5.2
Mexico	5.5	3.9	3.6	4.0
Emerging Europe	4.5	4.6	2.8	3.5
Russia	4.0	4.0	3.6	4.0
Turkey	9.0	8.5	3.2	4.0
Asia/Pacific	9.1	7.6	7.4	7.9
China	10.4	9.2	8.5	9.0
India	8.4	6.9	7.0	7.5
Africa/Middle East	4.3	4.7	4.0	4.0
South Africa	2.9	3.1	2.9	3.7
World	**4.4**	**3.2**	**3.0**	**3.7**

Based on market exchange rates

Consumer Prices

percent change over a year ago, end of period

	2010	2011e	2012f	2013f
Mature Economies	**1.4**	**2.7**	**1.6**	**1.7**
United States	1.2	3.3	1.8	1.9
Euro Area	2.0	2.9	1.8	2.0
Japan	-0.3	-0.3	0.0	0.2
Other Mature	2.8	3.7	2.1	2.1
Emerging Economies	**6.2**	**5.8**	**5.4**	**5.5**
Latin America	8.1	8.3	7.7	8.7
Argentina	22.9	21.2	22.4	21.4
Brazil	5.9	6.5	5.4	5.7
Mexico	4.4	3.8	3.5	3.7
Emerging Europe	6.8	6.2	6.2	5.8
Russia	8.8	6.1	7.0	7.0
Turkey	6.4	10.4	7.3	6.5
Asia/Pacific	5.3	4.5	4.1	4.1
China	4.6	4.1	3.6	3.5
India	9.7	7.0	6.5	7.0
Africa/Middle East	5.3	5.8	5.8	5.1
South Africa	3.5	6.1	6.3	5.0
World	**3.2**	**3.9**	**3.1**	**3.3**

Exchange Rate

end of period

	26 Mar	Jun 12	Dec 12	Dec 13
¥ per $	82.7	81.0	80.0	84.0
$ per €	1.33	1.25	1.20	1.35

Official Interest Rate

end of period

	26 Mar	Jun 12	Dec 12	Dec 13
U.S. Fed Funds	0.125	0.125	0.125	0.125
BoJ Target	0.10	0.10	0.10	0.10
ECB Refi	1.00	0.75	0.50	0.50

Commodity Prices

end of period

	26 Mar	Jun 12	Dec 12	Dec 13
Oil *($ per barrel)*	125	115	105	105
Copper *(cents per lb)*	388	388	388	388
Gold *($ per ounce)*	1679	1679	1679	1679

Global Current Account Balance

$ billion

	2010	2011e	2012f	2013f
United States	-471	-473	-493	-383
Euro Area	-61	-41	9	-1
Japan	197	122	80	100
Other Mature Economies	-13	68	85	101
Emerging Economies (IIF 30)	363	334	305	55
Africa / Middle East	65	184	201	127
Latin America	-45	-48	-78	-99
Emerging Europe	-1	-16	-24	-112
o/w Russia	71	88	67	-16
Emerging Asia	343	214	206	139
o/w China	305	201	200	140
Other Countries*	-15	-10	13	128

* Includes global discrepancy

