Global Economic Forecasts - December 2009

The Royal Bank of Scotland

2 December 2009

Global Economic Forecasts

Waiting for the Asian Policy Adjustment

Contents

This month, RBS Economics provides detailed outlooks for 2010 and new forecasts for 2011: RBS expects global growth to bounce back to 4.1% in 2010, broadly maintaining this pace of expansion in 2011 (4.4%). Global inflation is forecast to double in 2010, from 1.3% to 2.6%, edging up to 3.2% in 2011. Against the backdrop of resilient activity, all major central banks are expected to be well advanced in their normalisation process by end 2011, barring the BOJ. However, the global monetary policy stance is likely to remain very accommodative with a global real rate around 1%.

Focusing on the near-term outlook, Asian growth (excluding Japan) **continues to deliver an impressive performance** relative to Western economies. Perhaps most strikingly, industrial output – in level terms – in non Japan Asia has not only recouped the losses post crisis but has already reached a level in line with the pre-crisis trend (Chart 1). Meanwhile advanced economies have displayed an L shape profile (see again chart below). The fact that Asian trade has not recovered in a similar way (Chart 2) suggests that a large part of the improvement in industrial trends in the region is a result to unprecendented stimuli rather than a revival in foreign demand.

Our Asian team worry most about monetary policy settings there where maintaining heavily managed currencies against the dollar means ceding monetary policy to the US. Inflation risks might be escalating on a combination of rising commodity prices, capital inflows and narrowing output gaps, with broad money growth already running well ahead of nominal GDP. **Those countries with the strongest links to the USD, including Hong Kong, may be in for a boom-bust ride.** Higher rates become self defeating where they merely fuel revaluation-seeking speculative capital inflows. Ultimately, Asia spells considerable '*re-im*balancing' risks for itself and for the global economy. See our latest "Top themes and Trades 2010" for more on that topic and trade implications.

Against the backdrop of this unstable equilibrium, **we believe that sooner or later policymakers will need to accept currency appreciation as a policy tool**, a necessary and integral part of global rebalancing. Our Chief China Economist expects CNY appreciation to resume in mid-2010 and continue through 2011 as the export sector stabilises and capital inflows continue to grow. The risk is that this gradual appreciation will spur even larger capital inflows and accentuate asset bubbles. It is thus key that policymakers take the tough decisions on economic reform and policy tightening next year rather than wait for a recovery in export demand and US Federal Reserve rate hikes.

RBS Economics publications are available on our website

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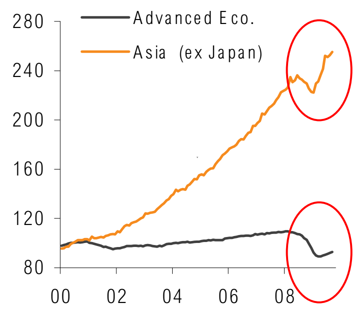
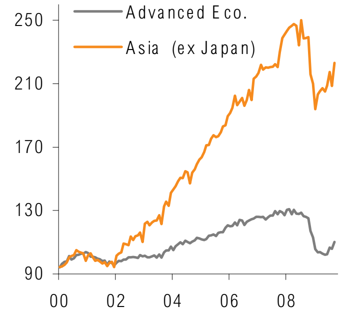
1. Industrial Production
Levels, 100 = 2000, Last obs is Sep



Source: RBS

2. World Trade
Levels, 100 = 2000, Last obs is Sep



Source: RBS

Key regional views

- **United States:** Given the severity of the recession and the early signs of a healthy upturn in the second half of 2009, Stanley and team continue to forecast above-trend growth and substantial net hiring in 2010. On the policy front, they expect the Fed to continue buying agencies and MBS through March 2010 and look for the Fed to begin draining liquidity in the spring of 2010. Their forecast for the first Fed hike in June 2010 remains in place.

- **Europe:** Cailloux and team's GDP and inflation forecasts for 2010 are little changed from last month are is their policy forecasts: a rather sluggish recovery and a modest monetary policy response in both the **euro area** and the UK. Their 2011 forecast - introduced for the first time - sees modest growth in the euro area of less than 1.5% and around 2.5% in the **UK**. By the end of 2011 both the ECB and BOE are expected to have lifted their key policy rates to 2.25% and 2.50% respectively.

- **Latin America:** Berber and team see rising risks of an inflation threat in 2010 as aggregate demand rebounds strongly and food price inflation moves higher.

- **Japan:** Nishioka does not exclude the possibility of a relapse in economic activity in H1 2010 given her expectation of a decline in public investment on the back of the government decision to freeze the FY09 supplementary budget. Deflation is expected to remain entrenched well into 2011. As a result, Nishioka continues to expect further economic support measures from fiscal and monetary authorities in 2010.

- **Non Japan Asia:** Mathur and team now see non-Japan Asia growth in 2010 at close to 8%, about a point higher than last month. They forecast growth in 2011 to be at a strong 7.5% which would keep this part of the world economy at the top of the league. The team continues to highlight the difficulty facing Asian policymakers given strong capital inflows into the region. They do not expect the imposition of stringent capital controls, rather, currency appreciation is seen to be the only possible policy response. In **China**, Simpfendorfer sees sustained growth at around 9% in 2011, only mildly lower than in 2010 – though the risks are skewed to the downside in the medium term due to the composition of growth which remains overly dependent on public and real estate investments and auto consumption. **Australia:** Over the past month, Davies and team have upgraded their outlook with the main change being an increase in the forecast profile for RBA cash rate. They now see the RBA raising rates to 5% by end 2010 and 6% by end 2011.

- **FX:** Overall, Ruskin and team FX forecasts are little changed. Sell a "G4" (USD, EUR, JPY, GBP) basket and buy "a hikers higher yield" basket (AUD, NOK, BRL, INR, IDR) is one trade that still broadly encapsulates the 3 month view. USD strength is seen from H2 2010 into 2011 as Fed policy normalisation starts.

- **Commodities**: As flagged last month, Moore and team reiterate their cautious view about 2010 given the recent sharp decline in Chinese metal imports and the low likelihood of China to increase stockpiles from here. Nickel seems the most exposed and is expected to underperform aluminium.

Key forecast changes

	GDP					Inflation - headline					Policy Rate*				
	2009(E)		2010(E)		2011(E)	2009(E)		2010(E)		2011(E)	2009(E)		2010(E)		2011(E)
US	**-2.5↓**	(-2.4)	3.5		**4.4**	-0.3		3.0		3.2	0.12		3.00		5
Euro area	-3.9		1.0		1.2	**0.3↓**	(0.4)	**1↓**	(1.4)	1.3	1.00		1.00		2.25
Germany	-4.8		1.5		1.5	0.3		**1.2↑**	(1)	1	-	-	-	-	-
France	**-2.3↓**	(-2.2)	1.1		1.2	0.1		**1.6↑**	(1.3)	1.3	-	-	-	-	-
Italy	**-4.7↓**	(-4.6)	**0.9↓**	(1)	0.8	0.8		**1.3↓**	(1.6)	1.3	-	-	-	-	-
Spain	-3.6		**-0.3↑**	(-0.4)	0.8	**-0.3↓**	(-0.2)	**2↑**	(1.6)	2	-	-	-	-	-
UK	-4.7		**1↑**	(0.8)	2.6	**2.1↑**	(2)	**2.3↑**	(2)	1.8	0.50		**1↓**	(1.5)	2.5
Japan	**-5.3↑**	(-5.7)	**1.4↑**	(1.3)	1.5	**-1.3↑**	(-1.4)	**-1↑**	(-1.4)	-0.6	0.10		0.10		0.1
*G-4***	-3.5		2.2		2.8	-0.1		**1.7↓**	(1.8)	1.9	0.44		1.8		3.22
Latin America															
Mexico	-6.5		4.5		3	5.2		4.4		4	4.50		5.50		9
Brazil	**0.0**	(-0.4)	4.5		3.5	4.8		4.3		4.5	8.75		10.75		13
Argentina	0.6		2.9		4	**6.8↑**	(6.1)	**8.4↑**	(7.6)	9.4	-	-	-	-	-
Venezuela	**-2.3↓**	(0.9)	**1.5↑**	(1.1)	2.9	**27.0↓**	(28.4)	29.3		29	-	-	-	-	-
Chile	-1.5		5.0		4.3	1.6		1.4		3	0.50		4.00		6.5
Colombia	-0.3		5.0		4.5	**4.2**	(4.1)	3.9		4	4.00		**7↑**	(4)	10
Peru	1.0		6.0		5.3	2.7		2.0		2	1.25		4.25		7
Australia	**0.6↑**	(0.5)	**2.8↑**	(2)	3.2	1.9		2.5		2.6	**3.5↓**	(3.8)	**5↑**	(4.5)	6
New Zealand	**-0.2↑**	(-1.6)	**2.4↑**	(1.8)	3.2	2.3		**2.6↓**	(2.7)	2.5	2.50		4.50		5
Asia (ex Japan)	**5.5↑**	(5.3)	**7.7↑**	(6.8)	7.5	2.3		**3.2↑**	(3)	4.4	4.27		4.88		5.51
China	**8.5↑**	(8.3)	**9.5↓**	(9.8)	9	-0.8		2.2		5.3	5.31		5.85		6.39
India	**5.2↑**	(5.1)	6.1		6.8	**10.2↑**	(10.1)	**6.4↓**	(7.0)	3.1	3.25		3.75		4.25
Asia (ex China & India)	**-0.7↑**	(-0.9)	**5.3↑**	(4.5)	4.9	**1.9↑**	(1.8)	**2.6↑**	(2.4)	3.7	2.87		3.8		4.69
Hong Kong	**-2.8↓**	(-2.2)	**5.6↑**	(5)	4.1	**0.8↓**	(1.8)	**5.1↑**	(2.4)	7.2	0.5		3.25		3.25
Indonesia	4.3		5.9		6.3	**4.8↓**	(5)	**4.9↓**	(5.2)	6	6.50		8.00		9
Korea	**-0.8↑**	(-1)	**5.9↑**	(4)	4.9	2.7		**1.5↓**	(2.2)	2.5	2.00		3.00		3.5
Malaysia	**-2.6↑**	(-2.8)	**4↑**	(3.3)	5.6	**0.6↑**	(0.5)	**2.9↑**	(1.5)	3.4	2.00		**2.25↑**	(2)	3
Philippines	**1.2↑**	(1)	5.4		5	3.1		**4.8↑**	(4.6)	5.7	4.00		**5↑**	(4.5)	6
Singapore	-2.3		**5.2↑**	(4.9)	5.6	**0.2↑**	(0.1)	**1.7↑**	(0.9)	1.8	-		-		-
Taiwan	-4.7		**5.5↑**	(4.1)	3	**-0.8↑**	(-1)	**-0.3↓**	(-0.1)	1.2	1.25		1.25		1.75
Thailand	**-3.3↑**	(-4)	3.6		5	-0.9		1.8		2.7	1.25		1.25		4
RBS World	**-0.6↑**	(-0.7)	4.1		4.4	1.3		**2.6↓**	(2.7)	3.2	2.1		3.2		4.5

* End period, ** Weighted average based on PPP GDP weightings, World GDP is 78% of IMF world PPP weights
Numbers in bold show forecast changes, numbers in brackets are last month's forecasts when different
Source: RBS

Key revisions:

Growth: The forecast for world growth in 2010 is unchanged from last month. The 2011 forecast introduced for the first time is close to that of 2010 at around 4.5%. The strongest acceleration in 2011 comes from the US economy which is forecast at around 4.5%

Inflation: The global inflation forecast for 2010 is unchanged. In 2011, global inflation is forecast to pick up further to 3.2%. Almost all of the increase in global inflation from 2010 is coming from higher inflation in Emerging economies.

Policy rates: Our global policy rate forecast for 2010 is unchanged at a little above 3% and is expected to rise to 4.5% in 2011. In real terms this would bring global real rates to a little above 1%, a still very accommodative policy stance.

United States: Productivity Will Not Prevent Hiring

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Given solid GDP growth in Q3 and expectations of another significant advance in Q4, there is no longer much debate about whether the recession is over. Instead, the most important disagreement among economists has turned to whether this recovery will be jobless or not. This issue basically boils down to two questions: 1) How fast will output grow? and 2) Given those output gains, will firms have the ability to increase productivity enough to achieve that output growth without adding workers? Thus, productivity becomes a critical piece of the narrative. History teaches us a few things about the pattern of productivity gains during recoveries, but the main conclusion is that productivity gains tend to be fairly uniform across different cycles. Thus, the faster output rises, the more hiring will occur.

Two Provisos

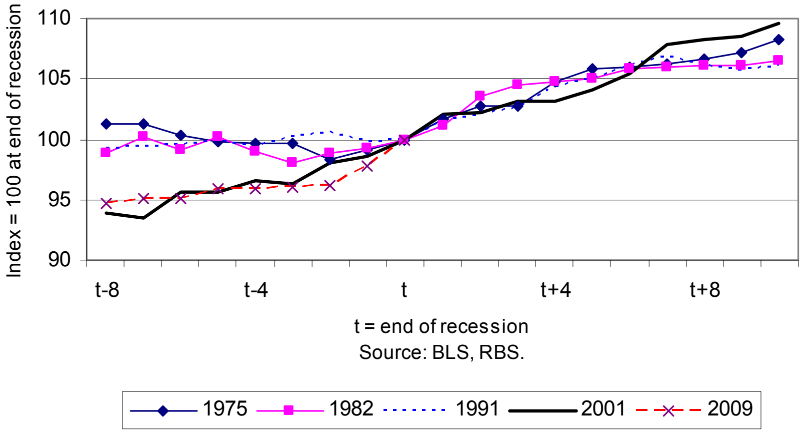
Before launching into a conversation on productivity in past business cycles, it is important to put forth two provisos. First, every cycle is different. There is no guarantee that past patterns will bear out this time, as the U.S. economy is incredibly dynamic.

Second, one must be careful not to overinterpret the productivity data. Between output, employment, and productivity, there are only two degrees of freedom. If we know any two of the three, the third falls out. In the real world, at any given point in time, most businesses probably face productivity as a given and allow output to fluctuate based on demand, so that hiring is the variable that falls out. However, in the data calculations, productivity is the residual. The government measures output and employment, and productivity is derived from them. It is an effort to discuss productivity without making tautological statements (for example, given a certain pace of output rises, employment gains will pick up when productivity slows down). What makes the narrative a little confusing is that the measured productivity numbers are mere residuals, even though in reality, some (unmeasured and unknown) underlying rate of productivity growth represents one of the drivers of business decision-making. That being said, for this exercise, we have to assume that the productivity data correspond closely to the unknown "true" productivity trends.

Conclusions Based on Productivity Data

The chart below shows productivity growth around the end of the last five recessions. The level of productivity for each cycle is indexed to 100 during the quarter when the recession ended (we have penciled in Q3 as the end of the latest recession). The data are quarterly, so the chart goes back two years from the recession end date (thus incorporating the entire downturn in every case) and ten quarters after the cycle turn.

Productivity Growth During and After Recessions



There are three conclusions we would draw from the data.

Conclusion #1: Labor Hoarding No Longer Exists

Years ago, economics textbooks taught that businesses engaged in labor hoarding during recessions. The theory suggested that since good employees are hard to find, firms would be slow to lay off workers that they did not want to lose once conditions improved. If this theory were true, then productivity growth would be sub-par during recessions, as output would fall faster than hours worked, with firms keeping workers around even when there was not enough work to keep them fully occupied. The data appear to bear out this notion for the first three recessions in the chart. Productivity in the 1970s, 1980s, and 1990s recessions was stagnant (i.e. well below the secular trend) through each downturn.

However, the nature of the economy changed some time between 1991 and 2001. In the 2001 recession, firms took a much tougher line toward payrolls, cutting workers quicker and more sharply than in prior downturns. We have sometimes referred to the new reality as “just-in-time employment“. The brutal contraction in employment (incorporating the upcoming benchmark revision, likely approaching eight million judging from the payroll data) attests to the absence of labor hoarding in the latest downturn. Indeed, productivity has tracked closely to the 1999-2001 period.

Conclusion #2: Productivity in Recoveries Always Looks the Same

The most surprising aspect of the above chart is that productivity growth seems to track pretty much the same across the last four recoveries. This is extraordinary given the differences in the cycles. The 1970s and 1980s expansions occurred under the old labor hoarding model of employment and were classic V-shaped recoveries. The 1990s and early 2000s recoveries were much more tepid in terms of growth and employment and the latter occurred under a vastly different hiring mentality. Nevertheless, looking only at productivity growth in these four cycles, one would be hard-pressed to tell them apart (though upon closer examination, the 2001 cycle does show somewhat faster productivity growth than the others, both before and after the turn, a topic to be addressed later).

There are a number of crosscurrents that bear on productivity during recoveries. Firms’ attitude toward payrolls is an obvious one. All else equal, under the old labor hoarding regime, productivity growth should be limited because as output expands, firms will initially just give their idle (or inefficiently used) workers more to do. In contrast, under a just-in-time employment regime, firms will not have to chew through this layer of inefficiency at the early stages of recovery and thus should be able to achieve better productivity gains quickly. We began this examination assuming that this shift in businesses' operations would show through more clearly in the data. However, the pattern of reported efficiency gains looks pretty standard across recoveries under both the old and new regimes. This has to be a blow to the argument that the 2009-2010 recovery will be jobless simply because just-in-time employment produced that type of pattern in the 2002-2003 period.

There are two other obvious forces that bear on productivity during recoveries. First, most firms enjoy economies of scale in their production process (as physical resources like factory buildings, machinery, etc. get more fully utilized). Therefore, as demand picks up from depressed recessionary levels, firms should see their productivity accelerate. The faster growth recovers, the faster productivity should grow, all else equal, at least until the scale of operations gets back to a more normal level. A second force moves in the opposite direction. The greater the change, the more a company's efficiency is disrupted. In particular, when output surges rapidly and firms have to scramble to add workers, it likely takes time to get those new employees trained and up to speed. Thus, the more rapid the change, the greater the temporary drag to labour productivity. The trajectory of productivity growth in the past several recoveries suggest that gains are sharpest early on and begin to moderate as the recovery transitions to mature expansion. This record indicates that economies of scale are the more powerful force in an absolute sense, since productivity growth is almost always above trend in the early stages of the recession. However, the two forces may roughly counterbalance in the sense that productivity growth fails to vary much with the vigour of the recovery.

Conclusion #3: 1990s Productivity Acceleration Is A Special Case

Though in the chart it does not stand out as much as one might expect, the 2001 cycle is somewhat unique because of the once-in-a-lifetime acceleration in trend productivity during the late 1990s and early 2000s. From 1998 through 2003, nonfarm business productivity advanced at better than a 4% clip on average, an extraordinary 6-year run. Although one can certainly debate the pace of underlying productivity currently, there is no question that it is far lower today than in the 2001-2003 period. Thus, the "jobless recovery" in 2002 and 2003, when employment was stagnant despite reasonable real GDP growth (nearly 2% in the four quarters of 2002 and almost 4% in the four quarters of 2003), should be viewed as a special case and not as the benchmark for the current expansion. As discussed above, firms will undoubtedly be very careful about hiring as the economy expands (just-in-time employment holds on the way up as well as on the way down), but RBS believes that firms simply will not have as much of an ability to expand production without adding workers as was the case in the early 2000s. This is a key point of contention among economists (and possibly among policymakers as well) and will constitute a key element of the outlook in 2010.

Implications for the Current Recovery

The consensus view with regards to productivity and employment seems to be that firms have a practically inexhaustible reservoir of productivity-enhancing moves at their disposal. As a result, if employers do not want to add to payrolls, they can simply waive their wands and generate higher productivity growth. To be fair, there is a grain of truth to this story. Firms can work their existing employees harder for a time. Indeed, productivity advanced at a 7% annualized clip in Q2 and even faster in Q3. However, there are only so many minutes in the day, and firms are only going to be able to ride that option for so long before the need to add bodies becomes imperative. It is also true that managers are much more conscious now than they may have been decades ago about squeezing inefficiencies out of the system. Once again, however, there is a finite reservoir of low-hanging improvements that can be adopted, and while we would concede that more can be done from here, it seems doubtful that firms will be able to continue to pull rabbits out of their hats forever. Finally, adding a worker is clearly a last resort today rather than a first resort, as high fixed costs make for a hostile environment for potential hires. For all of these reasons, firms will be less eager to hire in 2010 than in the 1970s and 1980s. However, the time is coming closer (much closer in our view) when firms will simply have no choice but to add to their payrolls if they want to expand to meet demand. This is not 2002. Demand is rising faster and underlying trend productivity is advancing more slowly today than it was then.

Returning to the historical productivity data, in the absence of a big move in trend productivity, as was the case in 2001, efficiency gains tend to be about the same whether a recovery is vigorous, as was the case in the 1970s and 1980s, or tepid, as in the 1990s. This corresponds to our original formulation at the beginning of the discussion that, in the real world, firms face a certain pace of productivity gains in the short term and will adjust employment according to the movements in production required by swings in demand. This suggests that the answer to the “Will they or won’t they hire?” question is simple. The stronger the economy expands, the faster employment will rise. Given the severity of the recession and the early signs of a healthy upturn in the second half of 2009, we feel good about our forecast of solidly above-trend growth in 2010 and thus continue to confidently predict substantial net hiring in 2010.

GDP Update

Relative to our forecasts from roughly a month ago, GDP growth in the next two quarters is little changed. The output gain in the third quarter was pared from 3.5% annualized to 2.8%. Our estimates for the fourth and first quarters remain between 3½% and 4%, and we still look for the economy to gather speed as 2010 progresses (and into 2011).

Monetary Policy

We believe that the Fed will continue to add to the size of their balance sheet by buying agencies and MBS through March 2010, but also it will be readying means to drain liquidity in early 2010, most notably a reverse RP program that is currently being tested. We look for the Fed to begin draining liquidity in the spring of 2010. Meanwhile, given our expectations of solidly above-trend growth, including a resumption of job gains, and a gentle acceleration in core inflation, we look for the Fed to begin to normalize rates beginning in June 2010. with a pace of rate hikes much more rapid than in the 2004-2006 period, not only because the economic fundamentals will dictate a relatively quick move to less accommodative policy but also because efforts to drain liquidity from the money markets (via reverse RPs, paying interest on reserves, term deposits, etc.) will put additional upward pressure on the fed funds rate.

Euro area: the bumpy road ahead

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Since the publication of our last update, the euro area flash GDP estimate for Q3 was 0.4% q/q, marking the end of the deepest and longest recession in the region since WWII (see also Euro area emerges from recession (Q3 GDP), 13 November). Although the first positive quarterly growth rate since Q108 was slightly weaker than expected (RBS/Mkt: 0.6%/0.5%), the country data suggest this will be largely offset by a modest upwards revision to Q2 GDP (to show a smaller contraction of -0.1% q/q from -0.2% q/q previously).

Overall, we have not revised our euro area outlook and continue to expect quarterly growth in Q4 to recover at a similar pace to Q3 and for GDP growth to recover to 1.0% in 2010 (unrevised) and 1.2% in 2011, from an annual contraction of 3.9% in 2009. Nonetheless this would still represent below trend growth as we continue to expect the quarterly pace of growth in H110 to remain subdued as some of the short-term temporary/technical drivers of growth (eg. slower de-stocking, cash for clunkers) fade.

That said, the latest survey data continue to improve ahead of our expectations, with the euro area composite PMI rising to 53.7 in November – its strongest since November 2007. As we noted in Ongoing growth in Q4 signalled (PMI Survey), 24 Nov, the country level data shows France is outperforming Germany, as well as Italy and Spain. In similar vein to last month, we continue to judge that risks to our macroeconomic outlook are skewed towards a slightly firmer recovery, with the latest survey data suggesting that short term industrial strength is likely to continue being a key driver for growth in Q4 (as it likely was in Q3, for more details on the shape of the recovery see Business Cycle Screener: European economy enters "expansion" phase, 01 Dec 2009).

Q3 GDP growth mainly driven by slower de-stocking; demand remains weak

Although a full breakdown of Q3 GDP has yet to be published, the country data suggests the main driver to growth from the expenditure side has been a positive inventory contribution of around 0.5pp (after subtracting 0.7pp in each of the past two quarters), reflecting a slower pace of destocking. By country, this largely reflects a strong positive contribution from Germany (+1.5pp after -2pp in Q2). The contribution from net trade looks to have been broadly flat, as a return of positive quarterly export growth (reflecting the recovery in world trade) looks to have been equally matched by stronger import growth.

Overall though, the latest GDP data have yet to provide any convincing evidence that suggest domestic demand has embarked on a sustainable recovery. Private consumption in the euro area looks to have contracted around 0.3% q/q in Q309 (-1.2% y/y), highlighting the fragility of consumption away from the temporary boost from car sales in view of government scrappage incentive schemes. The decline largely reflects weak private consumption in Germany (-0.9% q/q after strong growth of 0.6% q/q in Q2 and 0.9% q/q in Q1) as the impetus from car sales dissipated, although consumption was also weak elsewhere (cf. flat q/q in France, -0.1% q/q in Spain and -0.4% q/q in the Netherlands).

Private consumption will continue to be restrained by weak labour market dynamics. We continue to expect euro area unemployment to rise from its current 9.8% rate (October) even as our view that the German labour market will continue to surprise by its resilience (eg. see "Insights: German labour market - no sharp deterioration ahead", 21 Oct 2009) continues to be supported by the most recent data (and as well the latest Bundesbank November Monthly Bulletin which noted that a sharp increase in unemployment in the near term is not now expected, a very significant shift compared to a month ago when it still expected a sharp deterioration), due to effective government short-time working schemes.

Despite the relatively muted impact of the recession on official unemployment rates, consumer fears of unemployment over the next 12 months (as measured by European Commission surveys) hit historical highs earlier this year well in excess of the previous historical peak recorded in the 1993 recession. While these fears had been receding, the November EC survey featured a renewed rise in unemployment fears and they remain elevated at levels almost twice their historical average. Unemployment fears are likely to prevent the household savings rate from reversing quickly its recent sharp rise (to 16.5% in Q2, from close to 14.0% just one-year ago).

Investment in the euro area has also remained weak in Q3 (c. -0.4% q/q), as ongoing large declines in France (-1.4% q/q), Spain (-2.3% q/q) and the Netherlands (-2.5% q/q) look to have outweighed a second quarterly increase in Germany (1.3% q/q). However this would be consistent with a slightly less negative annual decline in investment (-10.4% y/y in Q3 vs -11.4% y/y in Q2), suggesting it may be in the process of bottoming-out, albeit at very weak levels. The latest available breakdown of euro area investment (Q2) shows 70% of the weakness is explained by the metal/machinery and transport equipment sectors, which probably explains why the German investment cycle has already turned. The other major drag (about a fifth) is from housing investment, which continues to contract at a substantial pace, albeit slower than a year ago (cf. -2.0% q/q in Q209 vs -3.5% q/q in Q208).

Inflation to rise to 1.0% by year-end; remain moderately positive in 2010/11

The euro area flash November HICP (0.6% y/y, in line with our forecast), confirmed a return to positive annual inflation rates. We expect a further rise in headline euro area inflation to around 1.0% y/y in December. It is important to recognise this relatively quick rise in inflation is being predominantly driven by technical factors (eg. unfavourable base effects) and will not be sustained. We expect inflation to remain around 1.0% in 2010, a sign that inflationary pressures are non-existent in the context of ongoing weak demand (a function of rising unemployment) as well as the absence of any cost pressures due to large spare capacity. Euro area core inflation continues to trend lower and at 1.15% y/y in October is at its lowest since February 2001. Euro area core inflation continues to be dominated by a collapse in some smaller-weighted countries (eg. Spain, Ireland and Greece) offsetting some surprising stickiness in Germany, France and Italy, a divergence which complicates the ECB's job (for more on this, see Upcoming rise in euro area inflation will not be a worry for the ECB, 20 Nov).

ECB to implement phasing out of non-standard measures

The (3rd) December ECB meeting will feature a number of significant decisions and announcements in our view, which should be the clearest sign to date that the ECB is firmly focusing on reducing excess liquidity.

Overall, our core view remains that the ECB will remain on hold over the course of 2010. This view is based on our macro forecasts that while the region will not experience a double dip, the recovery will be sub par. Against this backdrop of soft growth, core inflation and more importantly wage dynamics are likely to ease for the best part of next year. Negotiated wages in the euro area have already slowed by a third since their peak of 3.6% y/y in Q408 to 2.3% y/y in Q3 this year, the lowest reading since Q407. The upcoming wage negotiations in Germany at the end of Q1 will likely seem a very tame outcome. Other factors playing in favour of an ECB refi rate on hold include the appreciation of the currency or the risk of overshooting should the ECB be perceived to act before the Fed. Finally, and perhaps most importantly, we believe that the Council will view the rise in the overnight rate next year (which will be part and parcel of the phasing out of the liquidity measures) as a tightening in monetary policy, thereby postponing the timing of the first increase in the policy rate.

As for 2011, we believe the ECB will embark on a normalisation process of the policy rate which we think will be gradual. We forecast ECB rates to reach 2.25% by end 2011.

UK: 2010 & 2011 – A hard slog

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Economic Growth

Following six successive quarters of contraction, amounting to 6% of GDP, we expect UK growth to resume in the final quarter of 2009, albeit at a fairly anaemic pace (0.2% q/q). This would result in a full-year 2009 contraction of 4.7%, the most severe slump since the 1930s Great Depression. Growth is likely to be sustained in 2010 and 2011, though we are highly sceptical that the economy will expand at the rates projected by the MPC in the November Inflation Report (2.2% and 4.1%). The RBS forecast is for GDP growth of 1.0% next year and 2.5% in 2011. Even with a significant amount of spare capacity, we doubt that the MPC's forecasts can be achieved at this stage given the major headwinds facing the UK economy:

- Household sector: muted pre-tax income growth, ongoing declines in employment, tax hikes and persistently high levels of household debt will constrain household consumption growth (0.8% in 2010 & 1.0% in 2011).

- Government consumption: growth is expected to moderate in 2010 (1.4%) before being reined-in more aggressively in 2011: 0.1% on a full-year basis, with 'real terms' cuts being implemented in H2 2011. Downside risks. For a fuller assessment of UK fiscal policy see: *Insights: UK Pre-Budget Report 2009.*

- Business investment expenditure is expected to begin a cautious recovery in early 2010 but the prevalence of excess capacity across various sectors and uncertainty about the outlook for demand is likely to constrain any near-term rebound. Public spending retrenchment is likely to deal a disproportionately severe blow to capital rather than current spending. Whilst the global economic picture looks a little more buoyant, it seems unlikely that domestically-oriented firms will be launching major capex programmes – historically, private sector investment in the UK tends to be highly pro-cyclical, but is not obviously a leading indicator. GFCF growth is forecast to contract by 2.6% in 2010 before rising by 3.1% in 2011.

- Net exports are forecast to make modest positive contributions to GDP growth of 0.3pp in 2010 and 0.7pp in 2011, but this is not sufficient to plug the gap left by domestic demand. Given that the large depreciation in sterling occurred 12 months ago, the rebound in export volumes to date has been disappointing. Exports are forecast to gain some traction against the backdrop of global recovery but the (sluggish) euro area is by far the UK's largest export market whereas direct trade linkages with fast-growth emerging markets remain small.

- Inventories. This is the potential 'joker in the pack' in terms of the contribution to GDP growth. 2009 saw an unprecedented inventory run-down (we expect inventories to account for almost one-third of the fall in GDP this year). As the stock-cycle turns (initially inventories being reduced at a slower pace and subsequently rebuilt) there is scope to provide a significant boost to the GDP arithmetic and we look for positive contributions of 0.4pp and 0.7pp in 2010 and 2011. Upside risks.

For the UK household, financial and public sectors this has been a 'balance sheet recession'. Consequently, we are sceptical that consumers can just bounce back while shouldering an unprecedented £1.7trn of debt. Conventional monetary policy (the 450bp of Bank Rate cuts between October 2008 and March

2009) has been successful in boosting aggregate disposable incomes. Based on CML data, we estimate that the average median-income mortgage holder has benefited to the tune of c.£2,700 over the past year (though there are major distributional implications – savers have suffered). As generous tracker rate mortgage products expire and borrowers refinance at higher rates (c.4.3%) disposable income, and demand, will suffer.

Labour market

It has been hard to find many positives over the past year. That a 636k decline in employment is one of them is testament to the depth of the recession. It could have been much more brutal. Had the labour market responded in the way that it did during the early 1980s and early 1990s recessions, then we would have been looking at employment having fallen by c.950k by this stage. The main explanation is more flexible remuneration structures and wage restraint (see *Insights:– UK labour market – Is it different this time?*).

Although the latest ONS data showed a fractional (6k) rise in employment in Q3, this was entirely the result of higher part-time and self-employment. The number of full-time employees (probably the best indicator of the underlying state of the labour market) declined by 116k in Q3. In short, whilst there is some evidence of improvement, we suspect we are still some way (9-12 months) from sustained increases in employment. It is notable that even buoyant survey data such as the PMIs continue to signal fairly aggressive layoffs.

Our forecast is for progressively smaller increases in LFS unemployment to a peak of 2.8m, a rate of 8.8%, in H2 2010. Unemployment is then projected to decline only marginally, reaching 2.7m, 8.5% at the end of 2011. In so far as labour-hoarding has been part of the explanation for the comparatively modest fall in employment over the past year or so, there must be a corresponding risk that a revival in GDP growth will not be employment-rich. Sectoral considerations reinforce this conclusion: public sector layoffs are likely (probably more evident in 2011) and sectors undergoing more profound structural changes (eg, financial services) will not be the source of job creation that they were over the past decade.

Inflation

In questioning the BoE's CPI central projection – ie, in forecasting a higher inflation profile – we are cognisant of sounding like a 'flat-earther'. For the record, we do not think that QE has put the UK on 'the road to Harare' or has a meaningful inflation problem. Nevertheless, inflation has proved more stubborn than most (not least the BoE) expected. One of the most remarkable features of this recession (the deepest since the Great Depression in the 1930s) is that CPI inflation fell to a low of just 1.1%. The deflation scare appears to have been exaggerated, at least in a UK context. Our contention is not where CPI inflation peaks in spring 2010 (this will overwhelmingly reflect energy base effects and the reversal of the VAT cut), but rather that the MPC expects it to return to its lows of 1.1% by Q1 2011.

Our forecast is for a more gradual drift lower in CPI (to 1.6% in early 2011). Given that the expected spike in CPI inflation in Q1 2010 is 'in the market', the real test will come in the spring and summer over how quickly CPI retreats. This will, ultimately, determine whether the MPC begins the (probably protracted) process of nudging Bank Rate higher in H2 2010.

Monetary policy

The monetary policy outlook remains highly opaque. In his Treasury Select Committee hearing on 24 November Governor King noted that the Bank *'would,* *over a period of two to three years, engage in both kinds of actions* [Bank Rate rises and a reversal of QE] *. . . The difficult judgment, which is the overriding problem, is to know by how much and when.'* This tells us little about the extent and timing of the withdrawal of policy accommodation. In an environment where the government continues to run sizeable deficits and preside over substantial quantities of new gilt issuance, there seems little prospect of any significant monetary policy tightening via any early reversal of QE. For an assessment of QE and the money and credit data, refer to our *UK Monetary Monitor*.

Our expectation is that the resumption of GDP growth, coupled to stickier inflation, will force the BoE to begin some sort of tentative normalisation of monetary policy settings by nudging Bank Rate higher. We expect only a modest rise in Bank Rate – in effect, policy rates will be playing catch-up with the reality on the ground. And nor could Bank Rate at 1.0% at the end of 2010 and 2.5% at the end of 2011 (our forecast) be regarded in any way as a 'tight' monetary policy stance. UK monetary policy will remain highly accommodative throughout the forecast horizon – the level matters much more than the change in Bank Rate.

Latin America | The seeds of growth and inflation

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Believe it or not economic activity in **Mexico** is rebounding hard. Q3-09 GDP expanded by 2.9% q/q sa, which in annualized terms amounts to 12.2%. The y/y rate remains in negative territory at -6.2% given that levels contracted severely last year due to the global crisis. The global backdrop is improving particularly in the US where RBS expects GDP growth to exceed 3.0% in 2010. This confirms our view that Mexican GDP growth in 2010 will rebound strongly, certainly above potential, at least by 4.5% and possibly higher.

According to President Lula, **Brazil's** GDP will expand by 9% in q/q sa annualized terms during Q3-09. While the actual number will not come out until mid December, there are signs that economic growth is picking up speed, particularly coming from the demand side. Already the Q2-09 print jumped by 7.8% in q/q annualized terms. Retail sales, for instance, accelerated to 5.2%y/y in Q2/Q3-09 from 3.7%y/y in Q1-09 and formal employment has already recovered to pre-crisis levels. In Colombia, Chile and Peru, growth has bottomed out and in the coming months we expect a strong rebound.

Aggregate domestic demand will rebound strongly in Latin America in 2010, and in some cases it already has, supported by still lose monetary and fiscal policies in the region that will likely be phased out completely only until 2011.

Inflation expectations are tame…for now

We should start worrying about inflation now. The combination of strong domestic demand coupled with high food prices could pose a serious risk to inflation during 2010. True, inflation expectations, for the countries in the region that target inflation, remain within each country's target (see table).

	Target 2010	Survey '10 fcast	RBS '10 fcast
Brazil	4.5%+/-2%	4.50%	4.40%
Chile	3.0% +/-1%	2.60%	2.70%
Colombia	3.0%+/-1%	3.96%	3.90%
Mexico	3.0%+/-1%	4.54%	4.50%
Peru	2.0%+/-1%	2.50%	2.10%

Source: RBS Global Banking & Markets

However, food prices are rising rapidly. For example sugar prices have surged 72% since November 2008. Corn and wheat bottomed out in August and since September have started to climb again, gaining above 25%. In sum, while inflation expectations remain in check, they could start increasing early next year.

The countries with more heterodox policy mixes in the region -Argentina and Venezuela- are main beneficiaries of supportive risk appetite and firm commodity prices. However, their rebound in 2010 is likely to be somewhat subdued, as domestic policy frameworks are likely to keep a lid on private consumption and investment.

In Venezuela, after the worse than expected 3Q GDP release, we're revising down our 2009 forecast to -2.3%, from our previous -1%. For 2010-2011, we expect a very subdued recovery, in tandem with increased political polarization and still anaemic private investment and a cautious consumer. The public sector is to offset to a certain extent the weakness in private expenditure, underpinned by recovering oil prices. But it is unlikely that major progress can be achieved in bringing inflation down.

In Argentina, the medium-term economic outlook has brightened, as authorities are finally going ahead with the reopening of the 2005 debt exchange. Ironically, this step is likely to bring about a more lax fiscal policy by the National Government, which should be growth supportive going forward. In fact, as per official statistics, Argentina barely suffered a recession since the international economic crisis began. And (official) inflation is likely to stay within single digits, despite private estimates (and inflation expectations) that put it around 20%.

Japan: Back to the deflation

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Key economic fundamentals:

The Q3 GDP expansion at 4.8% qoq annualised was well above the upper range of market expectations. As expected, fiscal stimuli and stabilisation of overseas demand boosted overall GDP, and the restocking of corporate inventories pushed domestic demand up. Given that public investment will decrease from early next year due to the current government's decision to freeze the FY09 supplementary budget at JPY 2.9 trn, we believe GDP growth may fall into negative territory early next year. After a possible economic soft-patch in H1 2010 we think business activity may gain momentum, helped mainly by overseas demand, especially from emerging economies. Given that the increase in exports was brisker than we had expected early this year, together with the government's announcement of formulating additional economic stimulus packages at least until the end of this year, we raise our 2009 GDP forecast from -5.8% to -5.3%, and from 0.9% to 1.4% for 2010. We believe steady growth will continue in 2011.

Despite this continued positive growth in the coming years, the negative output gap, -6.8% or JPY38trn in 3Q09, is likely to be sustained over many years. If we assume 0.5% potential growth and 2% steady economic growth to continue, it will take until the end of 2013 for the output gap to return to positive territory. On the back of the remaining negative output gap for the forecasting period, we expect core CPI to continue to see negative growth in 2010 and 2011. Also, an appreciation of the JPY would put further downward pressure on CPI.

Policy outlook:

The multi-fiscal stimulus measures and consecutive growth are not enough to persuade the Japanese authorities to proceed towards policy normalisation. On 20 November the government officially declared that Japan was in 'mild deflation', and said it would formulate additional economic stimulus measures by the end of this year, despite mounting fiscal problems. However, we think the government's surprise deflation declaration would be less of a sudden change in its price outlook than a step toward loosening fiscal discipline given the upcoming political schedule – the Upper House election in July 2010 in particular – and fiscal problems hindering policy initiatives.

In an unscheduled monetary policy meeting held on 1 December 2009, the BoJ announced additional easing measures, principally the supply of JPY 10 trn of funds at 0.1% with three months duration and to maintain overnight target rate at 0.1%. On the other hand, a noteworthy development was that the Bank clearly stated the aim of funds-supplying operations: to 'encourage a further decline in longer-term interest rates'. We think this decision aimed to show the BoJ's stance to deal with deflationary and strong yen pressures: proactively but with minimum action.

Given that the government's pressure to call for additional monetary easing measures is likely to continue, the next likely step to be taken by the BoJ would be quantitative measures, such as increased buying of TDB (short term bills) or even JGBs, despite the bank note rule. The reason behind this is the government's severe debt issue.

Despite the new policy measures just announced, we believe that the BoJ will be eventually pushed to take additional monetary easing steps, in response to these pro-active government attempts, for example, increase of Rinban operations to support the government's JGB issuance. However, as these measures failed to combat deflation effectively – especially in the QE periods in 2001-2006 – we think the Bank is more likely to enhance the policy-duration effect by specifying a numerical indicator as the criteria (CPI, for instance) and by defining a recovery range for the indicator (eg, 'increase to above zero steadily' during the QE period) rather than expanding its balance sheet. The enhancement of the commitment policy may be implemented in the third quarter next year, when we are likely to see a contraction of business activity as the effects of fiscal stimulus measures fade. See Top Views & Trades | Japan : Declaration of deflation by government and monetary policy for details.

Asia (Non Japan): Still not there

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We introduce our 2011 forecasts. For non-Japan Asia (NJA) aggregate, we forecast GDP growth at 7.5%, modestly lower than in 2010. This reflects a stabilisation of economic activity following a recovery in 2010. This aggregate forecast is heavily biased by the heavy weightings assigned to China and India, who are likely to deliver superior performance. On an ex-China and India basis, we forecast 2011 growth at 4.9% yoy compared with 5.3% in 2010. Even this forecast masks an uneven pattern - growth in the region's advanced economies (Hong Kong, Korea and Taiwan) is likely to slow after an initially strong recovery. The less developed part of the NJA will continue to grow strongly benefiting from a host of structural issues such as better investment opportunities, consumerism and favourable demographics.

Our forecasts are based on two critical assumptions – the global environment will continue to recover albeit full normalcy will not be restored. Equally, regional policymakers should become more decisive in augmenting domestic demand via re-orienting fiscal policies and allowing for currency appreciation, but are unlikely to have fully attained this transition. As we have written extensively in other reports, rebalancing is a multi-year process. Overall growth can be expected to remain below trend but with a narrower output gap. A more interesting dynamic would be that exports are likely to make a larger contribution to growth in the export oriented economies and vice-versa.

We are forecasting inflation to remain fairly well behaved although the quarterly trend is likely should be accelerating. The full year average inflation forecast is based largely on the consideration that still lingering excess capacity will not allow for demand pull pressures to emerge. Nonetheless, this forecast is subject to considerable risk – should the unsettling combination of rising commodity prices and rapid capital inflow induce even stronger monetary growth, inflation could spring a nasty surprise. Regardless of its nature, headline inflation could end up well above our benign forecasts. In this context, we have factored in higher but tame increases in policy rates – this consideration is built more on the need for central banks to normalise policy rates.

Moving to current trends, we now have Q3 2009 GDP data for most countries. Broadly, the recovery process remains intact albeit the pace of improvement was understandably weaker than in the previous quarter. Leading indicators such as the PMI are also signalling that we are gradually moving from a strong rebound to a more steady state. This pattern is likely to hold but at the same time, should not be interpreted as an upcoming collapse in growth. As we have written before, adequate fiscal capacity and favourable wealth effects have mitigated this risk. At the same time, the inventory-final demand gap has turned less favourable for providing a further boost to NJA exports.

The most pressing issue for investors continues to be capital flow management and the attendant fear of capital controls. Intervention fatigue mainly from rising sterilising costs has led to a tightening of administrative controls on FX inflows. However, we continue to rule out the possibility of stringent capital controls. Malaysia and Thailand's previous experiments with capital controls had produced very unfavourable results; the effectiveness of capital controls has yet to be established and may even deter valuable flows like foreign direct investment (FDI).

So how will policy makers manage these flows? Apart from the above discussed administrative measures, we believe that policymakers will need to accept currency appreciation as a policy tool. This is a necessary and integral component of global rebalancing. Fears over loss of competitiveness are understandably legitimate, but should dissipate, once China revalues the RMB presumably from Q2 2010. The authorities are also likely to consider further tightening of bank lending standards into speculative sectors like property and supply side measures such as an increase in land supply for construction. Overall capital flows are a challenge for NJA policymaker and no one response is likely to suffice.

China: Economic imbalances are key to 2011

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The rebalancing of growth is key to China's 2011 outlook. GDP growth has certainly strengthened markedly in 2009, but mainly because of fiscal stimulus spending. As a result, the composition of growth is lop-sided and overly dependent on public investment, real estate investment, and autos consumption. This imbalance will present a more serious challenge in 2011 absent a strengthening in other growth drivers.

Private consumption is not yet able to plug the growth shortfall. Employment and income growth have stabilized, especially in the interior provinces where fiscal stimulus has had the greatest impact. However, there are structural obstacles to stronger spending, in particular, high precautionary savings. Firms will also face intensifying competition and rising raw material prices, so employment and income growth may yet struggle.

There is an outside chance that policy remains excessively easy in response to a lop-sided economic recovery. If so, asset price bubbles and overcapacity risks will worsen to produce a larger correction in financial markets and economic growth in 2011.

However, the forecast assumes that a combination of modestly stronger export demand and gradual policy tightening will avoid this outcome. It will not reduce the risks entirely, and I would feel more comfortable to see less attention paid to the official "8%" growth target, and more to economic reform. But the upshot is that 2011 GDP is forecast at a steady 9% with the composition of growth marginally improved.

Inflation is a forecast wild-card. I have forecast steadily rising inflation on higher food prices and shortages of production inputs, especially land, youth labour, and raw materials. Food prices are the most difficult to predict, but climate change is causing global volatility in agricultural yields, and the risks are food prices spike on supply shortages. Inflation expectations are not well anchored and could be expected to rise in turn.

I expect CNY appreciation to resume mid-2010 and continue through 2011 as the export sector stabilizes and capital inflows rise. However, the dollar is the largest medium-term influence on the outlook. Europe is now China's largest trading partner, so EUR/USD at 1.60 makes CNY gains more likely, whereas EUR/USD at 1.20 means China will likely argue that the currency is already sufficiently stronger on a trade-weighted basis.

The risk for China is that gradual appreciation will spur capital inflows and worsen asset bubbles. Policymakers are thus likely to find 2011 considerably harder to manage than 2010 in the event that economic imbalances persist. It is thus key that policymakers take the tough decisions on economic reform and policy tightening next year rather than wait for a recovery in export demand and US Federal Reserve rate hikes.

Australia

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Over the past month, we have upgraded our outlook with the main change being an increase in our forecast profile for the cash rate. Previously, we had expected cash to reach 4½% by mid 2009, less than the 5-6% range cited by the RBA as a neutral cash rate as we had assumed that banks would deliver an extra 50bp rise in mortgage rates due to increased funding costs.

Reflecting our work into Australia's potential growth rate, we think that surging population growth, where immigration is at an all-time high, and strong growth in investment, has lifted potential growth from 3 to 3½-4% (actual activity should be simultaneously boosted as increased migration adds to domestic demand). This means that the neutral cash rate should also be higher, which is an issue that recent commentary suggests that the RBA is also grappling with.

With banks yet to deliver any extra hikes, we have raised our target for the cash rate to 5% by end-2010 and are pencilling in 6% for end-2011. If banks do end up raising rates by more than the RBA, we would have to adjust our cash rate profile. In this respect, proposed regulatory changes to bank holdings of liquid assets would increase pressure on bank funding costs further.

For 2011 more generally, we expect a further strengthening in growth as private demand takes the place of public investment, whose contribution to growth should start to pull back as the Government starts to rein in the deficit. Inflation should start to pick up from around the middle of the 2-3% target band as unemployment edges lower.

Over the next few months, we expect another 25bp hike in December, with hikes resuming in February as the RBA Board takes a holiday in January. Q3 GDP should be weak, although there is a strong risk that growth will be revised lower in the first half of 2009, which could see Q3 turn out better than we expect (there are significant measurement problems regarding GDP that the official statistician is yet to resolve). Unemployment should rise a bit more, but not as much as we earlier thought, although Q1 inflation, due in late January, should exceed the RBA's forecast, which looks hard to achieve.

The risks around this outlook relate to the strength of the world economy and the sustainability of the recovery in China. Inflation could prove a problem as it is still tracking above the 2-3% target zone and might be stickier than thought. Initial rate rises are not likely to have much impact on growth as households never reduced their mortgage payments when the RBA slashed rates over 2008-09. As for the currency, it should soon reach parity with the US dollar, but our analysis suggests that its impact on growth is likely to be muted.

New Zealand

Economic recovery is continuing in New Zealand and we think that the RBNZ will soon water down its commitment to keeping rates low, most likely signalling that it will start raising rates around the middle of next year. NZ is lagging Australia, but is benefitting from strength in its trading partners. Growth should pick up over 2010 and into 2011 and higher inflation expectations should see the RBNZ start to withdraw its stimulus. We think that when the RBNZ raises rates, it will be aggressive as it catches up with Australia. A key risk for NZ is the rising exchange rate, which is a negative for growth and buys the RBNZ some time before it needs to lift rates.

FX: From risk sweet spot, to thin air

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Our overall forecast profile remains unchanged. In recent months we have aggressively pushed two parallel themes: First, the 'burden of proof' is on the USD bulls to make a persuasive argument, or the path of least resistance is toward USD weakness; and second, 'the world is a liquidity junkie' with a drip feed running directly through G5 zero interest rate policy to the search for yield and cross asset long risk trades. Since the last forecast update the long risk trade has become more responsive to negative news thanks to year-end repositioning. However, the mix of data and policy pronouncement, all suggest that while inflation pressures are absent G5 policy rates are not going up before H2:10 at the earliest. The liquidity spigot remains in flood.

Short-term leading indicators show only a modest tapering off in growth so far and remain in the risk positive profile, marked by growth that is strong enough to avoid risk aversion, but weak enough to avert G5 tightening. The risk 'sweet spot' is however diminishing. It is difficult to see how the core macro question of our time - whether the recovery is self sustaining - will remain unresolved into H2:10. We assume, that by the middle of next year, growth will just be strong enough for the Fed to shift gear from emergency rates to simply accommodative. If we are wrong I expect it will be in the direction of interest rates remaining low for MUCH longer. Either way the USD should benefit, though it benefits much more from a growth positive Fed tightening story than renewed risk aversion. This is because a withdrawal of Fed stimulus will undermine the USD carry financing role, shift portfolio hedging strategies, and lead to an exodus of risk en masse. In contrast, weaker growth carries with it a risk of renewed QE or at least an extension of existing credit easing in the form of MBS purchases. The most likely scenario is that EUR/USD heads back into nose bleed terrain in the low to mid 1.50s at least through Q1:10, before the thin air catches up with it, on either a turn in risk or rates. If it is a turn driven by weak growth, I expect the turn to be slow and EUR to become the best funding currency from extreme upper 1.50 EUR/USD levels; if it is a turn driven by higher US rates, it will be sharp and dramatic, and the JPY will more definitively become the funder of choice.

The differentiation between countries with policy traction and those that don't remains stark. G5 dominates the will nots, leaving NOK and AUD in such a small select group that bunching of capital flows will encourage their overshoot. Currency appreciation versus the USD will be verbally discouraged within the G10, but in the emerging world will be met with a massive increase in reserves. Quasi currency pegs leave policy in Asia, and elsewhere, hopelessly and inappropriately tethered to the Fed. This tension is building and can only be resolved through large scale sterilisation, higher interest rates and/or eventual currency appreciation. Pressure on the long Asia trade, is best expressed through the KRW, IDR and INR, even if Brazil's flirtation with capital controls points to an alternative developing world approach that we are on full watch for. Individual currency forecasts have been revised slightly but the overall profile remains the same. Sell a "G4" (USD, EUR, JPY, GBP) basket and buy "a hikers higher yield" basket (AUD, NOK, BRL, INR, IDR) is one trade that still broadly encapsulates the 3 month view.

In 2011, deleveraging in financial markets will be well under way and bank's balance sheets will finally be looking healthier. The USD strength seen against the G10 in H2:10 will continue as the Fed moves closer to normalising policy. The rise in long term rates as a result of the withdrawal of QE measures will also play USD positive. Gains will be seen most against those currencies whose central bank's tightened early and aggressively in 2010. The juice will have been squeezed from this differentiation trade, with AUD and NOK the most at risk. Other commodity currencies will also feel the pain as valuations start to look stretched. The one exception in the G10 can be GBP given that UK government finances will be on a much more sustainable path by 2011 but the USD will still have some structural issues.

Commodities – caution for 2010

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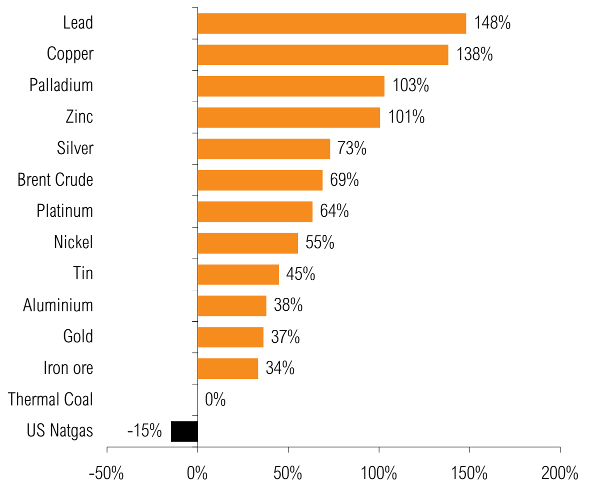
Tailwinds becoming headwinds. Although commodities, particularly metals, have staged a magnificent price recovery in 2009, we are increasingly concerned about strengthening headwinds for 2010. Some of the expected headwinds are of a macro nature, but others are more metals specific and here this year's tailwinds may become next year's headwinds.

Chinese metal imports have fallen sharply. Alongside prompt and radical producer cutbacks, a key driver of the recovery in base metal prices was the massive increase in Chinese imports in H1 09. But these imports have fallen heavily in recent months, to the extent, for example, that China was barely a net importer of aluminium and lead by October. This decline in Chinese demand from overseas has come before a material pick-up in metal demand elsewhere, with the result that exchange stocks have risen sharply in recent weeks and now in many cases represent a serious burden on markets. What is more, we are convinced that much of the increase in Chinese imports went into stockpiles rather than being consumed by local industry.

Potentially burdensome stockpiles. We estimate that since mid-2008 China has stockpiled about 1.25mt of aluminium and 150kt of nickel, with copper and zinc either side of 1mt. Expressed in weeks of world demand these range from two weeks for aluminium to six weeks for nickel. For both copper and zinc the stockpiles are similar in magnitude to global reported inventories (see chart below right). Some of the Chinese inventory is tightly held, notably the copper bought by the State Reserves Bureau, but much of it is more speculative, particularly, we believe, in the case of nickel. It seems unlikely that China will continue to stockpile at current prices and the risk is that material will at the very least finds its way to Chinese consumers in the coming months. Either way, we expect Chinese metal imports to continue to decline into 2010, and it is even possible that in some cases China will revert to a net exporter.

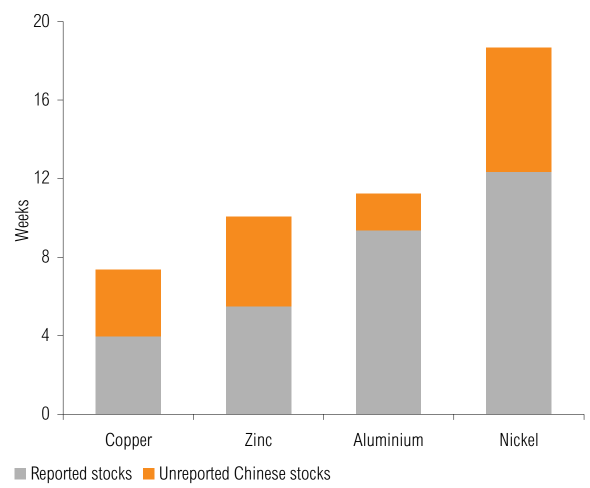
Unequal headwinds. It seems clear that the most onerous Chinese stockpile is that of nickel. Moreover, nickel also has other crosses to bear. It is confronted by proportionately the highest exchange stocks and the greatest overhang of temporarily cut production, and it has a full pipeline of new mines. Although it is the most economically geared metal (mainly used in stainless steel), if we are right in thinking that headwinds will feature highly in 2010, nickel looks the most exposed to them. We expect the nickel price to retreat in H1 10 and to underperform aluminium in particular.

Commodity price performance since end 2008 – more headwinds for base than precious metals



Source: LME; LBMA; Bloomberg, RBS

Reported world stocks and estimated unreported stocks in China, expressed in weeks of consumption



Source: CRU, RBS

Global Forecast Database

December 09

	GDP				Inflation - headline				Policy Rate*				10 year yield*				FX vs USD*			
	2008	2009(E)	2010(E)	2011(E)	2008	2009(E)	2010(E)	2011(E)	2008	2009(E)	2010(E)	2011(E)	2008	2009(E)	2010(E)	2011(E)	2008	2009(E)	2010(E)	2011(E)
US	0.4	-2.5	3.5	4.4	3.8	-0.3	3.0	3.2	0.14	0.12	3.00	5.00	2.25	3.35	5.10	5.80	-	-	-	-
Euro area	0.5	-3.9	1.0	2.5	3.3	0.3	1.0	1.3	2.50	1.00	1.00	2.25	2.75	2.95	3.60	3.65	1.32	1.51	1.35	1.34
Germany	1.0	-4.8	1.5	1.5	2.8	0.3	1.2	1.0												
France	0.3	-2.3	1.1	1.2	3.2	0.1	1.6	1.3												
Italy	-1.0	-4.7	0.9	0.8	3.5	0.8	1.3	1.3												
Spain	0.9	-3.6	-0.3	0.8	4.1	-0.3	2.0	2.0												
UK	0.6	-4.7	1.0	2.5	3.6	2.1	2.3	1.8	0.50	0.50	1.00	2.50	4.10	4.10	4.75	4.75	1.49	1.61	1.53	1.69
Japan	-0.7	-5.3	1.4	2.5	1.4	-1.3	-1.0	-0.6	0.10	0.10	0.10	0.10	1.35	1.35	1.40	1.65	91.30	88.00	96.00	112.00
*G-4***	0.3	-3.5	2.2	3.4	3.3	-0.1	1.7	1.9	0.97	0.44	1.78	3.22	2.42	2.99	4.06	4.42	-	-	-	-
Latin America																				
Mexico	2.0	-6.5	4.5	2.5	5.1	5.2	4.4	2.5	8.25	4.50	5.50	9.00								
Brasil	5.2	0.0	4.5	3.5	5.7	4.8	4.3	4.5	13.75	8.75	10.75	13.00								
Argentina	6.8	0.6	2.9	4.0	7.2	6.8	8.4	9.4	-	-	-	-								
Venezuela	4.8	-2.3	1.5	2.9	31.9	27.0	29.3	29.0	-	-	-	-								
Chile	4.5	-1.5	5.0	4.3	8.7	1.6	1.4	3.0	8.25	0.50	4.00	6.50								
Colombia	3.5	-0.3	5.0	4.5	7.0	4.2	3.9	4.0	9.50	4.00	7.00	10.00								
Peru	9.2	1.0	6.0	5.3	5.8	2.7	2.0	2.0	6.50	1.25	4.25	7.00								
Australia	2.4	0.6	2.8	2.5	4.4	1.9	2.5	2.6	4.25	3.50	5.00	6.00	4.00	5.50	6.00	6.25	0.70	0.97	0.87	0.85
New Zealand	0.2	-0.2	2.4	3.2	4.0	2.3	2.6	2.5	5.00	2.50	4.50	5.00	-	-	-	-	-	-	-	-
China	9.0	8.5	9.5	9.0	5.9	-0.8	2.2	5.3	5.31	5.31	5.85	6.39	-	-	-	-	6.85	6.80	6.50	6.20
Asia (ex Japan)	7.2	5.5	7.7	7.5	6.4	2.3	3.2	4.4	5.22	4.27	4.88	5.51	-	-	-	-	-	-	-	-
ex China and India	3.1	-0.7	5.3	4.9	6.2	1.9	2.6	3.7	4.29	2.87	3.74	4.69	-	-	-	-	-	-	-	-
Hong Kong	2.4	-2.8	5.6	4.1	4.3	0.8	5.1	7.2	0.50	0.50	3.25	3.25	-	-	-	-	-	-	-	-
India	7.4	5.2	6.1	6.8	8.0	10.2	6.4	3.1	6.00	3.25	3.75	4.25	-	-	-	-	-	-	-	-
Indonesia	6.1	4.3	5.9	6.3	9.8	4.8	4.9	6.0	9.25	6.50	8.00	9.00	-	-	-	-	-	-	-	-
Korea	2.2	-0.8	5.9	4.9	4.7	2.7	1.5	2.5	3.00	2.00	3.00	3.50	-	-	-	-	1250.00	1150.00	1300.00	1200.00
Malaysia	4.7	-2.6	4.0	5.6	5.4	0.6	2.9	3.4	3.25	2.00	2.25	3.00	-	-	-	-	-	-	-	-
Philippines	3.8	1.2	5.4	5.0	8.9	3.1	4.8	5.7	5.50	4.00	5.00	6.00	-	-	-	-	-	-	-	-
Singapore	1.1	-2.3	5.2	5.6	6.5	0.2	1.7	1.8	-	-	-	-	-	-	-	-	1.44	1.38	1.40	1.37
Taiwan	0.0	0.0	0.0	0.0	3.5	-0.8	-0.3	1.2	2.00	1.25	1.25	1.75	-	-	-	-	-	-	-	-
Thailand	2.6	-3.3	3.6	2.5	5.5	-0.9	1.8	2.7	2.75	1.25	1.25	4.00	-	-	-	-	-	-	-	-
World**	2.7	-0.6	4.1	4.6	4.6	1.3	2.6	3.1	3.00	2.10	3.20	4.50	-	-	-	-	-	-	-	-

* End period, ** Weighted average based on PPP GDP weightings, World GDP is 77% of IMF world PPP weights

US

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	2008	2009	2010	2011	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
Demand and production	Annual averages				quarter on quarter changes, annualised (except otherwise mentioned)									
Consumers' expenditure	-0.2	-0.6	2.2	3.3	2.9	1.3	1.7	3.0	3.4	3.5	3.5	3.2	3	3
Government consumption	3.1	2.1	2.5	2.0	0.1	2.3	2.2	2.0	1.9	1.9	1.9	1.9	2.1	2.1
Business Fixed investment	1.6	-17.9	1.3	10.6	-4.1	-1.7	1.8	4.5	7.6	10.0	12.3	12.9	10.9	9.7
Residential Investment	-22.9	-20.5	7.6	18.2	19.5	3.0	6.0	10.0	15.0	20.0	20	20	18	15
Stocks*	-0.4	-0.7	1.1	0.2	0.9	2.4	1.7	0.6	0.6	0.3	0.1	0	0	-0.1
Domestic demand	-0.3	-2.6	2.4	4.2	2.7	1.3	2.0	3.2	3.8	4.3	4.5	4.4	4.1	3.9
Exports	5.4	-10.1	9.7	5.9	17.0	14.0	11.0	7.0	7.0	6.0	6	6	6	6
Imports	-3.2	-14.2	8.2	5.1	20.8	11.5	9.5	6.2	6.0	5.5	5	5	4.4	3.8
Net exports*					-0.8	-0.1	-0.2	-0.1	0.0	-0.1	0	0	0.1	0.2
GDP				**2.5**	**2.8**	**3.7**	**3.6**	**3.8**	**4.5**	**4.6**	**4.7**	**4.5**	**4.2**	**4.1**
Memo: GDP % y/y	**0.4**	**-2.5**	**3.5**	**4.4**	**-2.5**	**-0.2**	**2.3**	**3.5**	**3.9**	**4.1**	**4.4**	**4.6**	**4.5**	**4.4**
Industrial production	-2.2	-10.0	3.0	4.5	5.2	4.7	3.0	3.5	3.9	4.4	4.8	4.9	4.8	4.4
Labour Market														
Unemployment rate (%)	5.8	9.3	9.9	8.4	9.6	10.3	10.3	10.1	9.8	9.4	9	8.6	8.2	7.8
Workforce in employment (% chg)	-0.4	-3.8	-0.4	2.5	-2.7	-1.5	0.1	1.3	2.1	2.6	2.7	2.7	2.5	2.1
Nominal wage growth	3.8	2.8	2.3	3.3	2.5	2.3	1.9	2.4	2.6	3.1	3.7	3.7	3.5	3.1
Inflation														
Producer prices	6.4	-2.6	4.0	4.6	4.9	5.0	3.5	3.7	4.1	4.5	4.9	4.9	4.5	4.4
CPI	3.8	-0.3	3.0	3.2	3.6	3.8	3.0	2.4	2.8	3.0	3.2	3.4	3.6	3.4
CPI core	2.3	1.7	2.1	2.8	1.5	1.8	2.1	2.3	2.5	2.7	2.9	3	3	2.9
Finance														
Current account (% of GDP)	-4.9	-2.6	-2.4	-2.3										
Budget balance (% of GDP)	-3.2	-10.0	-11.0	-8.8										
General government debt (% of GDP)	40.8	53.0	61.4	66.0										
Interest rates (end-period)														
Policy rate (%)	0.14	0.12	3.00	5.00	0.07	0.12	0.20	1.00	2.00	3.00	3.75	4.25	4.75	5.00
2 yr yield	0.76	0.80	4.20	5.40	0.95	0.80	1.50	2.70	3.50	4.20	4.60	4.90	5.25	5.40
10 yr yield	2.25	3.35	5.10	5.80	3.31	3.35	4.10	4.70	4.90	5.10	5.40	5.55	5.80	5.80

* Contribution to GDP growth

Euro Area

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	2008	2009	2010	2011	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
Demand and production	Annual averages				quarter on quarter changes, non annualised (except otherwise mentioned)									
Consumers' expenditure	0.3	-1.0	0.4	0.6	-0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Government consumption	2.1	2.5	2.1	1.5	0.5	0.5	0.5	0.5	0.5	0.5	0.3	0.3	0.3	0.3
Fixed investment	-0.6	-10.0	0.7	3.1	-0.4	0.0	0.5	0.5	0.5	0.7	1.0	1.0	0.5	0.5
Stocks*	0.2	-0.6	0.1	0.0	0.5	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic demand	0.7	-1.7	0.4	0.4	0.3	0.4	0.3	0.3	0.3	0.3	0.0	0.0	0.0	0.0
Exports	1.1	-14.5	4.3	4.3	2.0	0.5	1.0	2.0	1.0	1.0	1.0	1.0	1.0	1.0
Imports	1.0	-12.2	3.6	3.9	1.9	0.4	0.9	1.9	0.9	0.9	0.9	0.9	0.9	0.9
Net exports*	0.0	-1.3	0.3	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1
GDP					**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.4**	**0.4**	**0.4**	**0.3**	**0.3**
Memo: GDP % y/y	**0.6**	**-3.9**	**1.0**	**2.5**	**-4.1**	**-1.9**	**0.8**	**1.2**	**1.1**	**0.9**	**1.0**	**1.1**	**1.2**	**1.3**
Industrial production, % y/y	-3.6	-13.5	2.8	2.7										
Labour Market														
Unemployment rate (%, end of period)	8.0	9.9	10.5	10.4	9.5	9.9	10.1	10.2	10.4	10.5	10.6	10.5	10.5	10.4
Workforce in employment, % y/y	1.1	-0.4	0.2	0.8										
Comp per employees, % y/y	3.5	3.0	1.3	1.0										
Inflation %, y/y														
Producer prices	6.1	-4.9	-0.2	0.9										
CPI	3.3	0.3	1.0	1.3	-0.4	0.5	1.0	0.8	1.0	1.2	1.3	1.4	1.1	1.2
CPI core	2.4	1.4	0.9	1.3	1.2	1.1	1.0	0.8	0.8	1.0	1.1	1.3	1.3	1.3
Finance														
Current account (% of GDP)	-0.7	-1.2	-1.3	-0.5										
Budget balance (% of GDP)	-1.9	-5.3	-6.5	-6.5										
General government debt (% of GDP)	69.3	78.3	85.0	89.0										
Interest rates (end-period)														
Policy rate (%)	2.50	1.00	1.00	2.25	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.75	2.00	2.25
2 yr yield	1.90	1.25	1.85	2.85	1.27	1.25	1.20	1.30	1.50	1.85	2.25	2.50	2.75	2.85
10 yr yield	2.75	2.95	3.60	3.65	3.28	2.95	3.10	3.25	3.40	3.60	3.65	3.60	3.55	3.65

* Contribution to GDP growth

UK

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	2008	2009	2010	2011	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
Demand and production	**Annual averages**				**quarter on quarter changes, non annualised (except otherwise mentioned)**									
Consumers' expenditure	0.9	-2.9	0.8	1.0	0.0	0.3	0.3	0.3	0.3	0.2	0.1	0.2	0.5	0.5
Government consumption	2.5	1.9	1.4	0.1	0.2	0.4	0.4	0.3	0.3	0.2	0.0	0.0	-0.2	-0.5
Fixed investment	-3.3	-14.8	-2.5	3.3	-0.3	-1.5	-0.9	0.2	0.4	0.4	0.7	1.0	1.5	2.2
Stocks*	-0.4	-1.4	0.4	0.7	0.0	0.1	0.2	0.0	0.1	0.1	0.2	0.2	0.3	0.4
Domestic demand	0.1	-5.3	0.7	2.0	-0.1	0.1	0.3	0.3	0.4	0.3	0.4	0.6	0.9	1.0
Exports	1.0	-10.6	3.5	4.2	0.5	1.7	1.0	0.9	0.8	0.9	1.0	1.0	1.4	1.4
Imports	-0.8	-12.3	2.2	2.0	1.3	1.2	0.7	0.3	0.3	0.0	0.4	0.7	0.9	1.2
Net exports*	0.4	0.6	0.3	0.6	-0.2	0.1	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.0
GDP					**-0.3**	**0.2**	**0.4**	**0.5**	**0.5**	**0.6**	**0.5**	**0.7**	**1.0**	**1.1**
Memo: GDP % y/y	0.6	-4.7	1.0	2.5	**-5.1**	**-3.2**	**-0.3**	**0.7**	**1.6**	**1.9**	**2.1**	**2.3**	**2.8**	**3.3**
Industrial production, % y/y	-3.1	-10.2	1.0	3.4	-10.4	-6.0	-0.6	0.4	1.8	2.4	2.7	3.1	3.9	4.8
Labour Market														
Unemployment rate (%)	5.7	7.7	8.7	8.8	7.8	8.3	8.5	8.7	8.8	8.8	8.8	8.9	8.8	8.6
Workforce in employment, % y/y	0.8	-1.6	-0.7	0.3	-1.7	-1.7	-1.3	-0.6	-0.7	-0.2	0.0	0.2	0.4	0.6
Nominal wage growth, % y/y	3.4	1.2	1.5	1.9	1.2	1.4	1.2	1.4	1.6	1.7	1.8	1.9	2.0	2.0
Inflation %, y/y														
Producer prices	7.3	0.9	2.0	1.8	-0.4	1.3	1.8	1.6	1.9	2.5	2.8	2.4	1.6	0.7
CPI	3.6	2.1	2.3	1.8	1.5	1.9	2.6	2.5	2.2	2.0	1.7	1.7	1.9	2.0
CPI core	1.6	1.7	2.2	1.5	1.8	2.0	2.7	2.4	2.0	1.8	1.3	1.4	1.5	1.8
Finance														
Current account (% of GDP)	-1.6	-2.2	-1.7	-1.2										
Budget balance (% of GDP)	5.9	12.6	12.8	10.9										
General government debt (% of GDP)	43.2	55.6	66.1	73.8										
Interest rates (end-period)														
Policy rate (%)	0.50	0.50	1.00	2.50	0.50	0.50	0.50	0.50	0.50	1.00	1.50	2.00	2.25	2.50
2 yr yield	1.30	1.50	2.25	3.25	1.00	1.15	1.35	1.50	2.00	2.25	2.75	3.00	3.00	3.25
10 yr yield	4.10	4.10	4.75	4.75	4.00	3.55	4.00	4.35	4.60	4.75	5.00	5.25	4.75	4.75

* Contribution to GDP growth

Japan

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	2008	2009	2010	2011	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
Demand and production	Annual averages				quarter on quarter changes, seasonally annualised									
Consumers' expenditure	0.6	-0.7	1.3	1.3	0.7	0.3	0.2	0.2	0.3	0.3	0.3	0.4	0.4	0.4
Government consumption	0.8	1.0	1.0	0.8	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Fixed investment	-4.0	-17.8	1.0	2.8	1.6	1.0	0.0	0.0	0.7	0.7	0.7	0.8	0.8	0.8
Stocks*	-0.2	-0.2	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic demand	-0.9	-3.4	0.8	1.1	0.8	0.3	0.0	0.1	0.2	0.3	0.3	0.3	0.3	0.3
Exports	2.1	-25.1	10.0	6.8	6.4	3.0	1.0	1.0	1.5	1.5	1.5	2.0	2.0	2.0
Imports	0.9	-15.2	3.1	4.8	3.4	0.0	1.0	1.0	1.0	1.0	1.0	1.5	1.5	1.5
Net exports*	0.2	-2.3	1.0	0.4	0.5	0.4	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
GDP QoQ annualized					**4.8**	**1.1**	**0.3**	**0.7**	**1.3**	**1.5**	**1.5**	**1.8**	**1.9**	**1.9**
Memo: GDP % yoy	**-0.7**	**-5.3**	**1.4**	**2.5**	**-4.5**	**-1.1**	**2.2**	**1.7**	**0.8**	**0.9**	**1.2**	**1.5**	**1.7**	**1.8**
Industrial production, % y/y	-3.4	-21.9	14.5	3.5	-19.2	-5.3	25.3	16.4	9.9	6.3	3.8	2.8	3.2	3.9
Labour Market														
Unemployment rate (%)	4.0	5.1	5.8	5.1	5.5	5.4	5.8	5.9	5.9	5.4	5.3	5.2	5.3	4.8
Workforce in employment, % y/y	0.0	-1.1	-0.3	0.5	-1.4	-0.9	-0.6	-0.4	-0.2	0.1	0.2	0.5	0.7	0.7
Nominal wage growth, % y/y	0.1	-3.3	-2.1	0.4	-3.3	-3.0	-2.5	-2.5	-2.0	-1.5	-1.0	0.0	1.0	1.5
Inflation %, y/y														
Producer prices	4.6	-5.1	-0.6	1.2	-8.3	-4.7	-1.6	-0.4	-0.4	-0.1	0.5	1.0	1.4	1.7
CPI	1.4	-1.3	-1.0	-0.6	-2.3	-1.9	-1.3	-1.1	-0.8	-0.8	-0.7	-0.7	-0.6	-0.6
CPI core	1.5	-1.2	-0.9	-0.6	-2.3	-1.6	-1.3	-1.0	-0.7	-0.8	-0.7	-0.7	-0.6	-0.6
Finance														
Current account (% of GDP)	3.2	2.8	3.5	3.7	3.1	3.2	3.3	3.4	3.6	3.8	3.7	3.7	3.8	3.7
Budget balance (% of GDP)	-6.7	-9.2	-9.1	-8.9										
General government debt (% of GDP)	170.0	181.5	188.4	183.6										
Interest rates (end-period)														
Policy rate (%)	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
2 yr yield	0.25	0.25	0.30	0.30	0.35	0.25	0.25	0.25	0.25	0.30	0.30	0.30	0.30	0.30
10 yr yield	1.35	1.35	1.40	1.65	1.30	1.35	1.35	1.30	1.30	1.40	1.45	1.55	1.60	1.65

* Contribution to GDP growth

Australia

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	2008	2009	2010	2011	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
Demand and production	Annual averages				quarter on quarter changes, non annualised (except otherwise mentioned)									
Consumers' expenditure	2.6	1.2	1.2	2.7	-0.3	0.1	0.4	0.4	0.5	0.6	0.7	0.8	0.8	0.8
Government consumption	4.1	2.5	3.1	3.1	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Fixed investment	9.6	-2.9	5.3	7.9	-0.7	0.9	0.7	2.6	2.8	2.6	1.0	0.9	2.5	2.9
Stocks*	-0.7	-0.7	0.9	0.2	0.4	0.0	0.3	0.2	0.2	0.1	0.0	0.0	0.0	0.0
Domestic demand	4.8	0.2	2.7	4.3	-0.2	0.4	0.6	1.1	1.2	1.2	0.8	0.8	1.3	1.4
Exports	3.8	4.0	4.7	2.9	4.3	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Imports	11.3	-8.2	8.4	8.6	5.9	-0.1	1.1	2.3	2.8	2.7	1.6	1.2	2.3	2.9
Net exports*	-1.8	2.8	-0.9	-1.4	-0.4	0.2	-0.1	-0.4	-0.5	-0.5	-0.2	-0.1	-0.4	-0.6
GDP					**-0.3**	**0.5**	**0.7**	**0.7**	**0.8**	**0.9**	**0.9**	**0.9**	**0.8**	**0.8**
Memo: GDP % y/y	**2.4**	**0.6**	**2.8**	**2.5**	**0.0**	**1.2**	**1.5**	**1.6**	**2.8**	**3.2**	**3.4**	**3.6**	**3.5**	**3.4**
Labour Market														
Unemployment rate (%)	4.5	5.9	6.1	5.8	5.8	5.9	6.1	6.2	6.2	6.1	6.1	5.9	5.9	5.8
Inflation %, y/y														
CPI	4.4	1.9	2.5	2.6	1.3	2.3	2.7	2.8	2.4	2.3	2.4	2.5	2.6	2.7
CPI - underlying	4.2	3.7	2.7	2.6	3.5	3.5	3.0	2.8	2.5	2.4	2.4	2.5	2.6	2.7
Interest rates (end-period)														
Policy rate (%)	4.25	3.50	5.00	6.00	3.00	3.75	4.00	4.50	4.75	5.00	5.25	5.50	5.75	6.00
10 yr yield	4.00	5.50	6.00	6.25	5.30	5.50	5.60	5.70	5.90	6.00	6.00	6.10	6.25	6.25

New Zealand

%, y/y	2008	2009	2010	2011	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
GDP	0.2	-0.2	2.4	3.2	-1.3	0.0	1.3	1.9	2.3	2.7	3.0	3.1	3.2	3.2
CPI	4.0	2.3	2.6	2.5	1.7	2.9	3.1	3.0	2.2	2.1	2.2	2.4	2.6	2.8
Policy rate (%)	5.00	2.50	4.50	5.00	2.50	2.50	2.50	2.75	3.50	4.50	4.75	5.00	5.00	5.00

* Contribution to GDP growth

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Emerging Asia

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	2008	2009	2010	2011	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
GDP		**Annual averages**							**year on year changes**					
Emerging Asia (ex Japan)	7.2	5.5	7.7	7.5	5.7	7.7	8.5	7.5	7.7	7.4	7.4	7.5	7.5	7.6
ex Japan, China and India	3.1	-0.7	5.3	4.9	0.0	2.7	6.1	5.5	5.0	4.9	4.9	5.1	5.0	4.9
China	9.0	8.5	9.5	9.0	8.9	10.5	10.5	9.5	9.5	9.0	9.0	9.0	9.0	9.0
Hong Kong	2.4	-2.8	5.6	4.1	-2.4	2.4	9.2	6.3	4.5	4.4	4.5	4.3	4.0	4.4
India	7.4	5.2	6.1	6.8	4.4	6.3	6.5	5.1	6.5	6.1	6.4	6.7	6.7	7.3
Indonesia	6.1	4.3	5.9	6.3	4.2	4.7	5.4	5.9	5.9	6.3	6.4	6.2	6.2	6.4
Korea	2.2	-0.8	5.9	4.9	0.6	2.4	6.7	6.3	5.6	5.1	4.6	5.9	5.3	3.9
Malaysia	4.7	-2.6	4.0	5.6	-1.2	1.1	4.0	3.6	4.0	4.3	5.1	5.4	5.2	6.6
Philippines	3.8	1.2	5.4	5.0	0.8	1.7	4.4	5.2	5.7	6.1	5.5	4.7	5.1	5.1
Singapore	1.1	-2.3	5.2	5.6	0.6	3.2	4.9	5.1	5.1	5.9	5.9	5.7	5.6	5.1
Taiwan					-3.4	2.6	9.2	6.0	3.9	3.2	3.0	3.1	3.1	3.0
Thailand	2.6	-3.3	3.6	2.5	-2.8	1.8	3.5	3.5	3.7	3.8	4.6	4.7	5.0	5.6
CPI														
Emerging Asia (ex Japan)	6.4	2.3	3.2	4.4	2.0	2.9	4.0	3.9	2.6	2.5	2.8	3.3	3.8	4.5
ex Japan, China and India	6.2	1.9	2.6	3.7	0.4	1.5	2.5	2.6	2.6	2.7	3.2	3.6	3.9	4.1
China	5.9	-0.8	2.2	5.3	-1.3	0.2	1.7	2.2	2.5	2.4	2.7	3.3	4.1	5.0
Hong Kong	4.3	0.8	5.1	7.2	-0.9	2.3	2.9	4.1	5.6	7.7	9.5	9.0	6.6	3.9
India	8.0	10.2	6.4	3.1	11.8	10.8	11.2	9.2	2.9	2.3	2.6	2.9	3.2	3.7
Indonesia	9.8	4.8	4.9	6.0	2.8	2.7	4.4	4.8	5.0	5.3	5.6	6.2	6.0	6.3
Korea	4.7	2.7	1.5	2.5	2.0	2.3	1.8	1.2	1.1	1.7	2.0	2.3	2.6	2.9
Malaysia	5.4	0.6	2.9	3.4	-2.3	-0.2	1.9	3.1	3.2	3.3	3.1	3.2	3.5	3.9
Philippines	8.9	3.1	4.8	5.7	0.3	2.1	3.0	4.2	6.2	5.8	6.1	5.4	5.5	5.7
Singapore	6.5	0.2	1.7	1.8	-0.4	-0.4	0.4	1.9	1.9	2.4	2.1	2.1	1.7	1.2
Taiwan	3.5	-0.8	-0.3	1.2	-1.3	-0.9	1.3	0.2	-1.2	-1.4	-0.2	0.9	1.7	2.2
Thailand	5.5	-0.9	1.8	2.7	-2.2	1.6	2.5	2.9	1.6	0.3	1.0	1.7	3.5	4.5
Policy Rate (%, end of period)														
Emerging Asia (ex Japan)	5.22	4.27	4.88	5.51	4.27	4.27	4.34	4.57	4.80	4.88	5.11	5.23	5.41	5.51
ex Japan, China and India	4.29	2.87	3.74	4.69	2.87	2.87	2.94	3.05	3.40	3.74	4.13	4.38	4.52	4.69
China	5.31	5.31	5.85	6.39	5.31	5.31	5.31	5.58	5.85	5.85	6.12	6.12	6.39	6.39
Hong Kong	0.50	0.50	3.25	3.25	0.50	0.50	0.50	1.25	2.25	3.25	3.25	3.25	3.25	3.25
India	6.00	3.25	3.75	4.25	3.25	3.25	3.50	3.75	3.75	3.75	3.75	4.00	4.00	4.25
Indonesia	9.25	6.50	8.00	9.00	6.50	6.50	6.50	6.50	7.25	8.00	8.75	9.00	9.00	9.00
Korea	3.00	2.00	3.00	3.50	2.00	2.00	2.25	2.50	2.75	3.00	3.25	3.50	3.50	3.50
Malaysia	3.25	2.00	2.25	3.00	2.00	2.00	2.00	2.00	2.25	2.25	2.50	2.50	2.75	3.00
Philippines	5.50	4.00	5.00	6.00	4.00	4.00	4.00	4.00	4.50	5.00	5.50	6.00	6.00	6.00
Taiwan	2.00	1.25	1.25	1.75	1.25	1.25	1.25	1.25	1.25	1.25	1.38	1.50	1.63	1.75
Thailand	2.75	1.25	1.25	4.00	1.25	1.25	1.25	1.25	1.25	1.25	1.75	2.25	3.00	4.00

Latin America

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	2008	2009	2010	2011	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
GDP	Annual averages				year on year changes									
Mexico	2.0	-6.5	4.5	3.0	-8.0	0.3	2.5	4.5	5.0	6.0	3.0	3.0	3.0	3.0
Brazil	5.2	0.0	4.5	3.5	-0.7	3.5	4.0	4.5	4.0	5.5	3.5	3.5	3.5	3.5
Argentina (official data) (*)	6.8	0.6	2.9	4.0	1.4	-0.1	0.7	3.1	3.9	4.0	4.3	4.3	3.2	4.2
Venezuela	4.8	-2.3	1.5	2.9	-4.5	-2.5	-2.4	2.3	4.7	1.3	1.5	2.2	3.6	4.4
Chile	4.5	-1.5	5.0	4.3	-0.5	1.3	4.5	5.0	4.0	6.5	4.3	4.3	4.3	4.3
Colombia	3.5	-0.3	5.0	4.5	-1.0	1.0	4.0	4.5	5.5	6.0	4.5	4.5	4.5	4.5
Peru	9.2	1.0	6.0	5.3	0.3	3.0	5.0	6.5	5.5	7.0	5.3	5.3	5.3	5.3
CPI					**Q3 09**	**Q4 09**	**Q1 10**	**Q2 10**	**Q3 10**	**Q4 10**	**Q1 11**	**Q2 11**	**Q3 11**	**Q4 11**
Mexico	5.1	5.2	4.4	2.5	5.0	4.2	4.2	4.4	4.5	4.5	4.0	4.0	4.0	4.0
Brazil	5.7	4.8	4.3	4.5	4.5	4.4	4.4	4.2	4.3	4.4	4.5	4.5	4.5	4.5
Argentina (official data) (*)	7.2	6.8	8.4	9.4	5.9	7.1	7.9	8.5	8.6	8.6	9.0	9.5	9.6	9.6
Venezuela (**)	31.9	27.0	29.3	29.0	28.7	28.4	28.9	29.5	29.3	29.4	29.2	28.9	29.0	28.9
Chile	8.7	1.6	1.4	3.0	0.3	-1.0	0.0	0.5	2.5	2.7	3.0	3.0	3.0	3.0
Colombia	7.0	4.2	3.9	4.0	3.5	2.0	3.5	4.0	4.0	3.9	4.0	4.0	4.0	4.0
Peru	5.8	2.7	2.0	2.0	1.8	1.2	1.9	2.0	2.1	2.1	2.0	2.0	2.0	2.0
Policy Rate (%, end of period)	**2008**	**2009**	**2010**	**2011**	**Q3 09**	**Q4 09**	**Q1 10**	**Q2 10**	**Q3 10**	**Q4 10**	**Q1 11**	**Q2 11**	**Q3 11**	**Q4 11**
Mexico	8.3	4.5	5.5	9.0	4.5	4.5	4.50	4.50	5.00	5.50	7.00	8.00	8.50	9.00
Brazil	13.8	8.8	10.8	13.0	8.8	8.8	8.75	8.75	9.75	10.75	11.50	13.00	13.00	13.00
Argentina														
Venezuela														
Chile	8.3	0.5	4.0	6.5	0.5	0.5	0.50	1.00	2.50	4.00	5.00	6.00	6.50	6.50
Colombia	9.5	4.0	7.0	10.0	4.0	4.0	4.00	4.00	5.50	7.00	8.50	10.00	10.00	10.00
Peru	6.5	1.3	4.3	7.0	1.3	1.3	1.25	1.25	2.75	4.25	5.70	7.00	7.00	7.00

(*) Official statistics on economic activity and inflation show significant differences with respect to estimates by private analysts.

(**) Inflation for the metropolitan area of Caracas

The Royal Bank of Scotland

RBS GBM FX Forecast Summary

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11
Rates per US dollar												
JPY	98.8	96.3	89.5	88.0	88.0	90.0	93.0	96.0	99.0	102.0	108.0	112.0
GBP*	1.43	1.65	1.60	1.61	1.61	1.55	1.45	1.53	1.63	1.71	1.69	1.69
CHF	1.14	1.09	1.04	1.00	0.97	1.01	1.05	1.07	1.08	1.11	1.13	1.15
AUD*	0.69	0.81	0.88	0.97	1.00	0.93	0.90	0.87	0.85	0.85	0.85	0.85
CAD	1.26	1.16	1.07	1.01	1.00	0.98	0.99	0.99	1.00	1.01	1.02	1.03
ZAR	9.53	7.72	7.54	8.00	7.70	7.50	7.50	7.50	7.00	7.00	7.00	7.00
SGD	1.52	1.45	1.41	1.38	1.38	1.36	1.38	1.40	1.40	1.38	1.37	1.37
KRW	1372	1273	1178	1150	1025	900	1050	1300	1275	1250	1225	1200
CNY	6.83	6.83	6.83	6.80	6.80	6.70	6.60	6.50	6.40	6.30	6.20	6.20
MXN					13.00	12.60	12.50	12.00	12.00	12.00	12.00	12.00
BRL	2.32	1.95	1.77	2.50	1.65	1.70	1.75	1.75	1.80	1.80	1.80	1.80
Rates per euro												
USD	1.33	1.40	1.46	1.51	1.55	1.46	1.38	1.35	1.34	1.33	1.32	1.30
JPY	131.0	135.2	130.9	132.9	136.4	131.4	128.3	129.6	132.7	135.7	142.6	145.6
GBP	0.92	0.85	0.91	0.94	0.96	0.94	0.95	0.88	0.82	0.78	0.78	0.77
CHF	1.51	1.52	1.52	1.51	1.51	1.47	1.45	1.45	1.45	1.47	1.49	1.50
SEK	10.92	10.82	11.61	10.05	9.90	9.80	9.90	9.80	9.50	8.90	8.90	8.90
NOK	8.92	9.02	5.78	8.27	8.10	8.40	8.25	8.10	8.05	8.00	8.00	8.00
PLN	4.63	4.45	4.21	4.20	4.50	4.40	4.35	4.25	4.20	4.15	4.25	4.15
CZK	27.34	25.98	25.24	26.00	27.30	27.30	26.70	26.35	26.00	26.00	26.00	26.00
HUF	307.5	272.2	269.3	275.0	295.0	290.0	287.0	282.0	285.0	290.0	295.0	300.0

* US Dollar per currency unit

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RBS GBM Commodity Price Forecast Summary

Quarterly and annual average commodity price forecasts (last updated 1 October 2009)

	Unit	1QA	2QF	3QF	4QF	2009F	1QF	2QF	3QF	4QF	2010F	1QF	2QF	3QF	4QF	2011F
Aluminium	US$/t	1,360	1,488	1,806	1,925	**1,645**	1,900	2,100	1,900	2,100	**2,000**	2,100	2,100	2,300	2,300	**2,200**
Copper	US$/t	3,435	4,675	5,839	6,350	**5,075**	6,500	7,000	6,500	7,000	**6,750**	7,000	7,000	7,500	7,500	**7,250**
Lead	US$/t	1,159	1,505	1,924	2,225	**1,700**	2,250	2,350	2,150	2,250	**2,250**	2,350	2,350	2,450	2,450	**2,400**
Zinc	US$/t	1,173	1,475	1,756	1,925	**1,585**	1,950	2,100	1,950	2,100	**2,025**	2,100	2,100	2,200	2,200	**2,150**
Nickel	US$/t	10,455	12,986	17,608	17,750	**14,700**	16,000	15,500	14,500	16,000	**15,500**	16,500	16,500	18,500	18,500	**17,500**
Tin	US$/t	11,012	13,538	14,563	16,000	**13,775**	15,500	16,500	15,500	16,500	**16,000**	17,000	17,000	17,500	17,500	**17,250**
Gold	US$/oz	908	922	960	1,010	**950**	1,050	1,000	950	1000	**1,000**	1,000	1,000	950	950	**975**
Silver	US$/oz	12.60	13.76	14.69	17.00	**14.5**	18.50	17.50	16.50	17.50	**17.50**	16.50	17	15.50	15.50	**16.00**
Platinum	US$/oz	1,023	1,172	1,230	1,375	**1,200**	1,400	1,450	1,450	1,500	**1,450**	1,600	1,600	1,500	1,500	**1,550**
Palladium					295	**250**	325	350	350	375	**350**	400	400	400	400	**400**
WTI Crude	US$/bbl	43	60	2.5	75	**62**	75	75	80	80	**78**	85	85	85	85	**85**
Brent Crude	US$/bbl	46	60	69	77	**63**	77	77	82	82	**79**	87	87	87	87	**87**
H Hub Natgas	US$/MMBtu	4.47	3.81	3.44	5.25	**4.25**	5.75	6.25	6.5	6.5	**6.25**	6.50	6.50	6.50	6.50	**6.50**
Iron ore - fines	USc/dltu					**99**					**108**					**117**
Coal - Hard coking	US$/t					**128**					**150**					**150**
Coal - Steaming	US$/t					**69**					**75**					**78**

Source: RBS forecasts

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