

Global outlook

Key changes since October 17th 2008

- The global economic outlook continues to darken. Not only has a stream of poor data provided further strong evidence of the severity of the downturn now under way in most of the developed world, but many emerging markets in key regions are showing signs of mounting strain or are now in outright crisis. As such, the Economist Intelligence Unit has made further downward revisions to its global growth forecasts and now expects expansion of just 0.9% at market rates and 2% at purchasing power parity in 2009. The US, the euro zone, the UK and Japan will all contract in 2009.
- Concerns are also rising about China's resilience to the global downturn, with much recent data pointing to a sharper than expected deceleration in Chinese growth prospects. As a result, we have downgraded our forecast for Chinese real growth in 2009. We have also made steep downward revisions to our forecasts for the transition region, where many economies remain highly vulnerable to continued financial turbulence owing to large external financing requirements. We expect world trade to contract in 2009.
- Global economic recovery will be tepid in 2010 at best. Moreover, at no point over the next five years do we expect growth to recover to the rates that prevailed during the boom years of 2004-07.
- Ongoing financial and asset market woes, coupled with falling commodity prices, will exert significant downward pressure on prices in much of the developed world in 2009. This, in turn, will allow central banks to continue to loosen policy aggressively. We expect the US fed funds rate to be lowered to 0.5% by end-2008.
- The downgrading of global growth prospects has also led us to make further downward revisions to our commodity price forecasts. We now expect oil (Brent Blend) to average US\$65/barrel in 2009 (down by 34% on 2008) and US\$68/b in 2010. Continued deleveraging and risk aversion will also underpin the US dollar in 2009, thus exerting further downward pressure on oil prices during the year.

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The Economist Intelligence Unit

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World growth and inflation

(Forecast closing date: November 6th 2008)

World summary

(%)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP growth (PPP exchange rates)										
World	4.8	4.4	5.0	4.8	3.6	2.0	3.0	3.9	4.2	4.2
OECD	3.2	2.6	3.1	2.6	1.4	-0.1	1.1	2.0	2.5	2.5
Non-OECD	7.7	7.4	8.1	8.4	7.0	4.8	5.6	6.4	6.4	6.5
Real GDP growth (market exchange rates)										
World	4.0	3.5	4.0	3.7	2.4	0.9	2.0	2.9	3.2	3.2
North America	3.6	2.9	2.8	2.1	1.3	-0.3	0.9	2.0	2.3	2.5
Western Europe	2.5	2.1	3.1	2.8	1.1	-0.4	0.8	1.6	2.1	2.2
Transition economies	6.8	5.7	7.3	7.4	6.0	3.0	4.3	4.6	4.7	4.7
Asia & Australasia	5.4	5.0	5.6	5.7	4.0	2.7	3.5	4.2	4.3	4.3
Latin America	5.8	4.5	5.4	5.4	3.3	2.1	3.0	4.0	4.3	4.2
Middle East & North Africa	6.7	5.7	5.5	5.5	6.1	4.6	5.2	5.4	5.5	5.5
Sub-Saharan Africa	5.7	6.5	6.6	6.3	5.0	3.9	4.5	4.9	5.0	4.7
Inflation (av)										
World	2.8	3.0	3.2	3.4	5.2	3.2	2.8	3.0	3.0	3.0
OECD	1.9	2.2	2.2	2.1	3.5	1.4	1.3	1.7	1.8	1.8
Trade in goods										
World	10.8	7.5	9.1	7.4	4.9	-0.5	3.5	4.5	5.2	5.7
Developed countries	7.6	5.8	7.5	4.9	2.5	0.0	2.5	3.3	3.8	4.0
Developing countries	17.4	10.8	12.0	11.8	8.8	-1.3	5.0	6.3	7.1	7.9

Source: Economist Intelligence Unit.

Global growth will slump in 2009

In mid-November the global financial system remained highly stressed, with credit markets characterised by high levels of risk aversion and stockmarkets under continued pressure. Financial market turmoil has triggered massive action by authorities in the US, the UK, the euro area and other countries, so that at least a temporary stabilisation now seems likely in coming months. However, severe damage has already been done to the real economies in both developed and developing countries as deteriorating financial conditions hit economic activity, which in turn is triggering higher defaults and a further weakening of financial conditions. All this augurs ill for the global economy in 2009—the Economist Intelligence Unit now expects the world economy to grow by just 2% in purchasing power parity (PPP) terms next year, the slowest performance since the early 1990s. GDP at market exchange rates (which gives greater emphasis to richer countries and better reflects the exchange rates at which firms trade and repatriate profits) suggests a bleaker picture still, with growth forecast to dip below 1% in 2009—this will be the worst performance since the 1980s. A sluggish recovery will start from 2010, but the lingering after-effects on the global economy of the financial crash of 2007-08 suggests that, over the remainder of our forecast period, the pace of expansion is unlikely to return to the speed that prevailed in 2004-07.

Dramatic falls in financial markets trigger massive rescue packages

Recent policy action to prevent the crisis from worsening further has been aggressive. Early October saw a co-ordinated interest rate cut by major central banks in advanced economies (with the notable exception of Japan, where rates are already extremely low) and then a series of massive rescue packages by key

advanced economies. Also in early October the US government approved, among other measures, the creation of the Troubled Asset Relief Programme (TARP), under which it can spend US\$700bn on buying toxic assets (the target was changed, however, in mid-November to provision of support for consumer credit) and capital injections for banks. EU governments made commitments of around €2trn (US\$3trn) for guarantees for new loans and capital injections for banks. The value of the EU measures is so much higher because they include more instruments where the chance of being repaid is high, while the US measures are targeted more at the core of the crisis, with a higher probability of losses. Apart from the concrete measures, importantly all the major governments made very clear statements that they were prepared to do everything necessary to stabilise the financial system. It seems that this was not mere rhetoric and further measures can be expected if actions so far prove insufficient.

Despite the massive rescue package for the global financial system, key indicators of risk aversion (such as interbank interest rates) are moving only slowly from exceptionally high levels so that, at the time of writing, financial markets were still in very serious crisis mode. Although this could mean that the measures are insufficient, it seems more likely that it will take some time for the markets to unlock—we assume that market stress eases more rapidly in 2009. However, there are a number of further triggers for renewed turmoil. The impact of the credit crisis is increasingly feeding through to the real economy in the US, which should lead to rising defaults on many types of loans, but this has not been fully discounted by financial institutions. Defaults of major non-financial companies could also cause a new panic. The weakening of countries other than the US, including emerging markets, could also send new shock waves through the international financial system. Our central forecast assumes that any new shocks will lead to only temporary flare-ups rather than a further worsening of financial conditions on a global scale. We do not, however, see a full normalisation of financial conditions until 2010 at the earliest.

The US, the euro zone, the UK and Japan will all be in recession

The outlook for the developed world over the short term is poor. In 2009 the US, the euro zone, the UK and Japan will all fall into recession, and all will experience outright full-year contractions in output in 2009 and post only a sluggish return to growth in 2010. In the US, the downturn in the housing market has further to run and house prices will continue to fall steeply. The recent more rapid worsening in financial markets still has to feed through fully to conditions for consumers and non-financial companies. Elevated household debt-service ratios and weaker confidence (particularly as labour market conditions have started to deteriorate rapidly) will also be a drag on private consumption. The euro zone will struggle under a number of headwinds, most importantly much tighter financial conditions, a still strong euro and a number of bursting asset bubbles, notably the housing busts in Spain and Ireland. Reflecting the importance of financial services in driving growth and the severe weakness of its housing market, the UK is forecast to experience the sharpest recession of the major developed economies in 2009. In Japan, the generally weak growth trend, sharply lower exports on the back of recent yen strength and feeble domestic demand will all constrain growth prospects.

Many emerging markets are showing elevated signs of stress

Emerging markets have had a good run in recent years on the back of strong domestic demand and buoyant world trade growth. The environment has, however, changed dramatically in 2008 and will deteriorate further in 2009, as financial conditions worsen, export demand from advanced economies weakens and policymakers are still struggling to bring inflationary pressures under control. Many emerging-market countries are in a relatively strong position to weather the downturn in the US and continued volatility in financial markets. A large number have reduced external liabilities, implemented market-friendly reforms and tried to boost growth potential. However, there are a smaller number of countries—particularly in eastern Europe, but also in Asia—with large external financing requirements and excessive lending growth in the recent past. The risk of contagion from the weaker performers will remain significant while global risk aversion remains so high.

Emerging Asia will remain the world's fastest-growing region in 2009-10 (and to the end of the forecast period), but its openness to trade will leave it highly exposed to the recession in the developed world. The central and eastern Europe region will be hit hard by the weakening of demand in the euro area, to which it is exposed in terms of export and investment inflows. It could experience further economic crises in addition to those already seen in Hungary and Ukraine—the Baltics and the Balkans both look vulnerable. In the major oil-exporting countries of the Commonwealth of Independent States (CIS) and throughout much of the Middle East and North Africa (MENA), the fall in oil prices will dampen domestic demand. Growth in Sub-Saharan Africa will soften more moderately, as it is less integrated in the global financial and commercial system. Latin America will be adversely affected by the downturn in the US and the euro zone, but in the most part the region is not as vulnerable to financial crises, largely reflecting structural improvements made in Brazil, its largest economy, in recent years.

Forecast risks

The risks to the global economy in 2009-10 in particular are exceptional. The most serious of these would be a further deterioration of the financial market crisis or even a failure to stabilise, which would cause even more drastic cuts in lending to households and companies and therefore even greater disruptions to the real economy. The US is particularly vulnerable in this regard owing to the scale of its asset-price crash. Under this scenario, it is highly likely that borrowing demand would also fail to revive over the longer term, as companies and households switch to prioritising debt repayment and cash hoarding over balance-sheet expansion. A prolonged collapse in borrowing demand would also severely limit the effectiveness of fiscal and monetary policy stimulus, putting downward pressure on growth for years to come. This happened in Japan in the late 1990s and was one of the key reasons that Japanese growth remained so poor despite often highly aggressive policy action from both the government and the Bank of Japan (BOJ, the central bank).

Concerns about inflation could give room to fears about deflation

Concerns about inflation have declined in recent months, although headline rates in many countries are still very high. Spreads between US regular and inflation-indexed government bonds imply market inflation expectations for the next five years of just 0.2%. This is almost certainly distorted by differences in liquidity, but fears about deflation will increasingly spread, particularly if

borrowing demand remains weak. Inflation will be dampened by the sharp fall in commodity prices and base effects from high prices earlier this year and, more fundamentally, by the global downturn in demand. There are some concerns that the massive liquidity injections could prove inflationary. However, the high demand for liquidity that prompted the liquidity provision is not a consequence of higher demand for goods and services as banks will be using the money for internal support rather than reinjecting the liquidity into the real economy. Policymakers, at least in the major advanced economies, will be much more on their guard against renewed inflationary pressures. There is a widespread feeling that excessively loose monetary policy earlier this decade made an important contribution to the financial bubble that has now burst. This means that the greater risk is an excessively rapid tightening on the back of the first signs of an economic recovery rather than a renewed surge in inflation as a result of current massive monetary stimulus. Nevertheless, the threat of inflation is not fully banished, as new supply disruptions or shortages could lead to a sharper renewed rise in commodity prices.

There is no doubt that the weakening of advanced economies, the spreading of the financial crisis and the sharp fall in commodity prices (until now an important driving force for growth in commodity-rich countries) will have a substantial impact on emerging economies. In our main scenario, we only forecast a moderate slowdown for most of these countries and only isolated cases of more serious financial problems. But there is a risk that problems in just a few particularly exposed countries could spread to a broad range of emerging-market economies, just as problems at individual, particularly reckless lenders in the US caused a crisis for the whole banking system. There are also concerns that after the earlier rapid expansion, the economies of China and India are shifting to a more moderate growth path. In China, distortions in the financial sector have fuelled overinvestment, particularly in property and basic materials, raising the possibility of a sharp rise in non-performing loans and a collapse in investment, with serious implications for the whole economy. India is suffering from a deteriorating real estate sector and sharp drop in stockmarkets. A slump in commodity prices arising from a sharper than forecast correction in global growth could hit those commodity-dependent countries that have used recent record revenue for lavish spending programmes.

Risks emanate from the Middle East and terrorism

Other main short-term risks are related to geopolitical developments. Violence in Iraq has abated somewhat, but an escalation pitting the US against other regional players remains possible. Iran's growing role in the region will also prolong tensions with the US, and a possible US or Israeli air strike could have serious effects on global oil prices by threatening both oil production and transit in the Persian Gulf specifically.

Terrorist attacks remain a lingering concern in many countries. There is a risk that an increase in the terrorist threat affecting a major economy, particularly if it should involve weapons of mass destruction, will lead to a sharp rise in obstacles to trade (through much tighter border controls). Trade protectionism tends to rise on the agenda during economic downturns and will therefore become a greater concern. The focus will be on targeted measures against specific countries deemed to engage in unfair competition. With the renminbi

still cheap and appreciating only gradually, US and European politicians will continue to call for faster renminbi appreciation, and will increasingly revert to counter-measures such as anti-dumping action.

Regional summaries

North America

%	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
US										
Real GDP growth	3.6	2.9	2.8	2.0	1.4	-0.4	0.8	2.0	2.3	2.5
Inflation	2.7	3.4	3.2	2.9	4.2	0.9	1.1	1.9	2.0	2.1
Canada										
Real GDP growth	3.1	2.9	3.1	2.7	0.6	0.4	1.5	2.4	2.5	2.4
Inflation	1.9	2.2	2.0	2.1	3.0	2.3	2.1	2.2	2.1	1.8

Source: Economist Intelligence Unit.

US GDP will contract in 2009

The outlook for the US economy has weakened significantly since our last forecast. The US contracted in the third quarter of 2008 by an annualised rate of 0.3% and the outlook for the fourth quarter suggests an even poorer performance. Our estimate for real GDP growth in 2008 as a whole remains deceptively mild, at 1.4%, but this is flattered by a strong performance in the first two quarters, particularly from export demand. In 2009, we expect a contraction in the first half and a fall of 0.4% for the year as a whole. The damage to the financial sector caused by falling property prices has spread to other asset classes, and the resulting crisis in financial markets, which reached another crescendo in early October, will exacerbate the impact of tightening credit on already weak domestic demand. By 2009 we expect that the weakened real economy will reinforce falling asset prices and prolong the difficulties of the banking sector.

We expect a gradual recovery to set in from late 2009, but the sluggishness of growth will ensure that expansion remains under 1% in 2010. Some momentum will be regained in the medium term, with annual average growth of around 2.3% in 2011-13. However, potential growth—the maximum pace at which the economy can expand without boosting inflation—has fallen significantly below 3%, and is unlikely to rise in the years ahead. If anything, the long-run dynamics of the US economy point to an even slower growth path: the share of Americans participating in the workforce has, for example, started on a slight downward trend, after decades of steady increases.

US policymakers will continue to take aggressive action

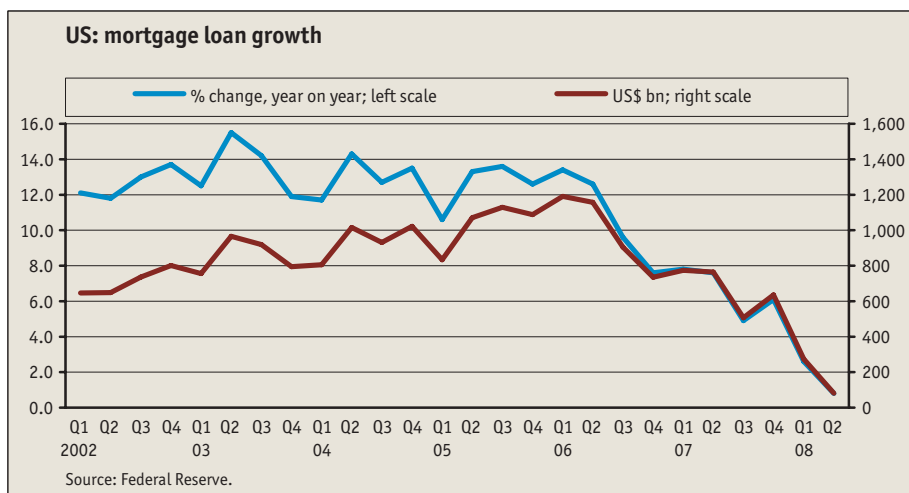
The continuing turmoil in the US financial sector, which began in domestic sub-prime mortgages but in early October brought the entire international financial system to the brink of collapse, has induced the US authorities to take unprecedented action. On October 3rd a bill was enacted that, among other things, established the Troubled Asset Relief Programme (TARP), which set provisions for the government buying up to US\$700bn in toxic assets. Subsequently, some US\$250bn was redirected as capital injections for banks, of which US\$125bn was already allocated to nine major banks. The seizure of these two firms and part-recapitalisation of the banking system should help to stabilise US financial markets. The operation of the government's new

shareholdings, and the conditions they will impose on financial institutions, are still unclear, and longer-term issues remain.

This follows the (effective) nationalisation in September of Fannie Mae and Freddie Mac, two government-sponsored enterprises (GSEs) that between them hold or guarantee around US\$5trn of the US\$12trn of US mortgages, and AIG, the world's largest insurance company. The federal budget deficit tripled in fiscal year 2007/08 (October-September) to 3.2% of GDP. The cost of the financial rescue package, further stimulus measures promised by the president-elect, Barack Obama, and the effect of the economic downturn on tax revenue could push the deficit towards 8-10% of GDP in 2008/09.

We also expect the stimulus from monetary policy to remain aggressive in 2009 and into 2010. Room for policy manoeuvre by the Federal Reserve (Fed, the central bank) will rise owing to falling energy and commodity prices, which will help to exert downward pressure on consumer price inflation in coming months. We expect that consumer prices will rise by just 0.9% in 2009 on average and remain broadly steady in 2010 at just over 1%, well down on the estimated peak of just over 4% in 2008. This, coupled with our own downgrading of US growth prospects for the remainder of 2008 and in 2009, means that we now expect that the Fed will cut its policy rate, the federal funds rate, by another 50 basis points, by end-2008, taking the rate down to 0.5%. Lingering economic fragility suggests that the Fed will then maintain its ultra-accommodative stance until 2010, when tightening will begin. Although the Fed's chairman, Ben Bernanke, will be keen to "normalise" policy as soon as possible, the weakness of the financial system, households and companies will ensure that tightening, at least initially, is modest.

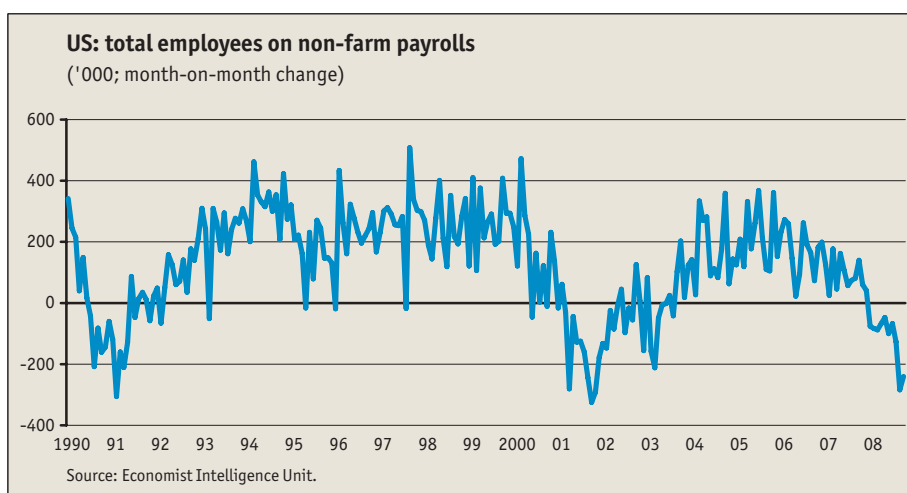
The problems in the real estate sector will continue to weigh on the economy for the rest of the decade, with political attempts to ease the pain for households only likely to be effective at the margin. The sharp decline in house prices and in many cases very high loan-to-value ratios (including piggyback loans that are added to a first regular mortgage compliant with rules giving access to low interest rates) have left many households in a position of negative equity. Under the prevailing "no recourse" rule, where banks can only take over the home but not other assets of the mortgage holder in case of mortgage default, many home owners have little incentive to stay in their home, leading to a rise in foreclosures. These will only add to the stock of unsold homes on the market, which is already very high relative to sales. Demand for housing will continue to weaken in 2009 under the weight of the effective closure of the sub-prime market, stricter lending standards, higher mortgage rates (particularly for so-called jumbo mortgages with a value of more than US\$417,000) and rising unemployment.



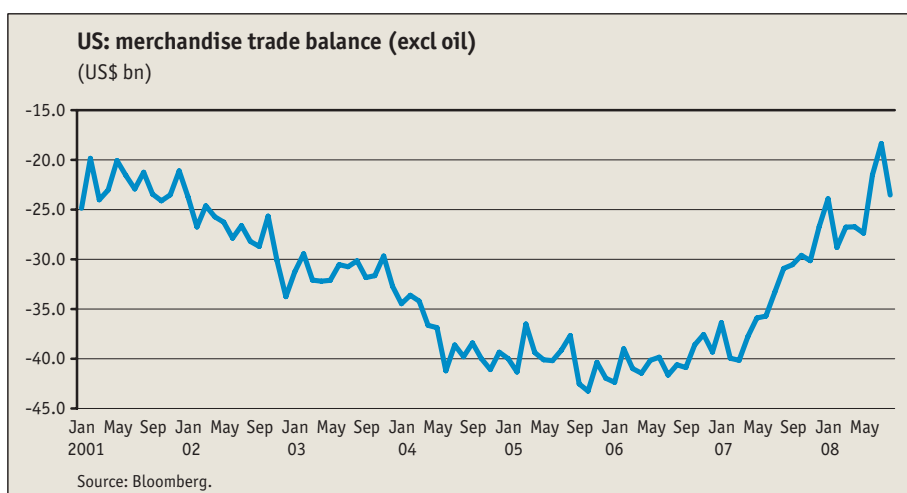
The US savings rate will rise

We expect consumers to raise their savings as their housing wealth—far from expanding at the rapid rate many had expected—declines. Consumer spending will also be depressed by rising borrowing costs for home owners with adjustable-rate mortgages. Other wealth effects will be transmitted through lost value in pension funds, which have been hit hard by the recent precipitous falls in equity values. Where new retirees are members of defined-benefit schemes (for which the level of retirement income is predetermined), the companies that operate them will be forced to meet provisioning shortfalls from their own cashflow, undermining company finances.

The sharp deterioration in labour market conditions since end-2007 also augurs ill for consumer sentiment. In the year to October, total non-farm employment fell by 900,000. Companies have also been slashing working hours, further highlighting the fragility of employment conditions. We expect that unemployment will rise more sharply over the remainder of this year and in early 2009, as the travails in the financial sector start to take their toll on the real economy. The deteriorating labour market also suggests more difficulty ahead for many consumers in meeting debt repayments, and any subsequent rise in defaults will only lead to more problems for the financial sector in the short term, and even tighter credit conditions. We expect US private consumption to contract in 2009 by 0.7%—the first such shrinkage since the early 1990s—following estimated growth of only 0.6% in 2008. Recovery will only begin to gather pace by the second half of 2010, and growth in the medium term will remain subdued compared with that in 2004-07.



Four years of double-digit profit growth led to a surge in corporate investment in 2004-07, but profits will weaken sharply in 2009, as domestic demand declines and productivity growth slows. This tightening in credit conditions as a consequence of the financial turmoil and increased pension provisioning to offset major losses on asset holdings will limit the funds available for capital outlays, and will lead to a slowdown in corporate investment, with no significant recovery likely until 2010. The booming export sector had softened the slowdown in manufacturing in the first half of 2008, but all of the US dollar's weakness in that period has since been recouped and any competitive advantage this allowed has been lost. With a sharp slowdown in world export markets, export growth will be restricted in 2009 to a very moderate 1.3%. However, combined with the steep contraction in US demand for imports, net foreign trade will make a positive contribution to GDP growth in 2009, before returning to near balance in 2010 as domestic demand firms.



Canadian real GDP grew by an annualised rate of 0.3% in the second quarter of 2008, a lacklustre performance after a 0.8% contraction in the first quarter. The outlook for Canada's main OECD export markets is now extremely bleak and export volumes will not grow again until late 2009, despite an improvement in competitiveness as a result of the sharp decline of the Canadian dollar in recent

months. This will continue to hit employment and wage growth, which in turn will feed weaker private consumption. One bright spot was the commodity sector, but the recent drastic falls in oil prices have made planned investments look much less profitable, and commodity-related investment activity and export revenue will not be able to revive the economy. We expect Canadian real GDP growth of just 0.6% in 2008 and forecast that the rate will decelerate to 0.4% in 2009, before rising to 1.5% in 2010.

Japan

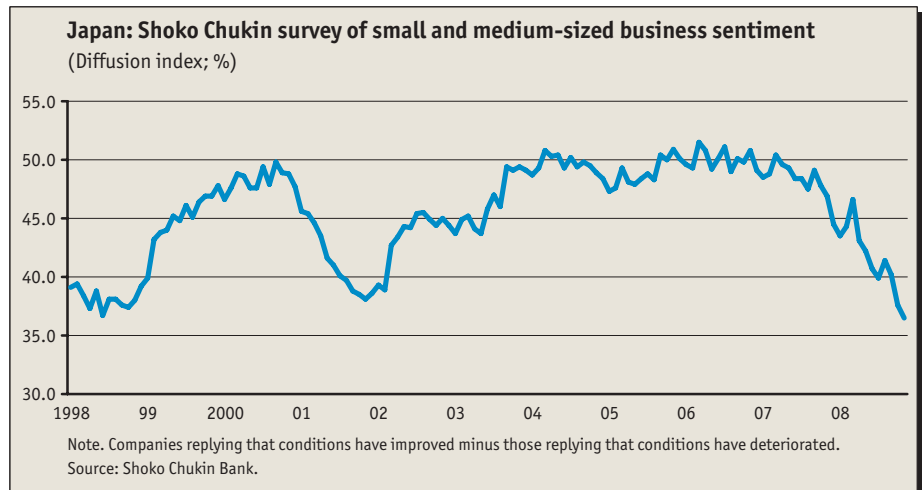
%	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP growth	2.7	1.9	2.4	2.0	0.3	-0.2	0.9	1.0	1.2	1.2
Inflation	0.0	-0.3	0.2	0.1	1.6	0.8	0.8	1.0	1.1	1.1

Source: Economist Intelligence Unit.

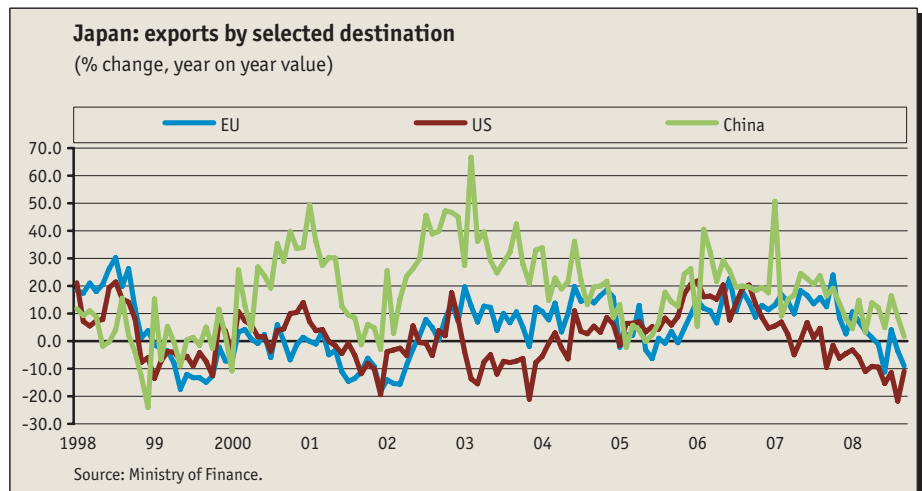
Japan is in recession

The Japanese economy, already weakened by the tightening of building regulations in 2007, which produced a collapse in construction activity, and in early 2008 by the steep ramp-up in commodity prices, is now suffering from the twin shocks of rapid yen appreciation and slumping share prices. The strength of the yen, coupled with the sharp weakening of the key euro zone and Chinese markets, is hitting exporters hard and is one of the reasons for the abrupt deterioration in economic data since the third quarter of this year. The weakness of the stockmarket, meanwhile, is now having a direct impact on companies by limiting their fund-raising abilities and on bank capital adequacy through unrealised losses on their shareholdings. In view of these factors and the continued severe weakness of consumer sentiment, we have again downgraded Japanese growth and now expect real GDP to contract by 0.2% in 2009. Expansion in 2010 will be relatively sluggish, at 0.9%.

The policy response to the slowdown has been relatively muted, largely reflecting the constraints imposed by the dire fiscal position and already ultra-low interest rates. At end-October the government announced a new fiscal stimulus package worth around ¥5trn (US\$500bn), the second package in as many months. The extra spending, which includes cash handouts for households (already tried with little success in 1998), loan guarantees for small and medium-sized companies and extra cash for the banks, is, however, unlikely to provide a significant boost to growth in 2009. At end-October the Bank of Japan (BOJ, the central bank) also cut its target for the overnight call rate from 0.5% to 0.3%. The cut was probably too small to have much of an impact (or to spur a weakening of the yen), but does allow the BOJ scope to cut again, possibly even back down towards the 0% that prevailed with only a brief hiatus between late 1999 and mid-2006—although this is not our central forecast.



Importantly, however, in October the BOJ also announced that it would start to pay interest on excess reserves deposited with it by financial institutions. This increases the bank's freedom of manoeuvre by allowing it to boost liquidity in the system without necessarily reintroducing the zero interest rate policy (ZIRP) that it abandoned in 2006. The risk of a return to ZIRP and quantitative easing would, however, rise if Japan looked as though it was about to slip back into a prolonged period of inflation. The BOJ's latest *Outlook Economic Activity and Prices*, released at end-October, forecasts a range for core (excluding fresh food) consumer price inflation of -0.2% to 0.2% in fiscal year 2009/10 (April-March). This is well below the 1-1.2% range made in July this year and too thin a cushion against a return to deflation.



Western Europe

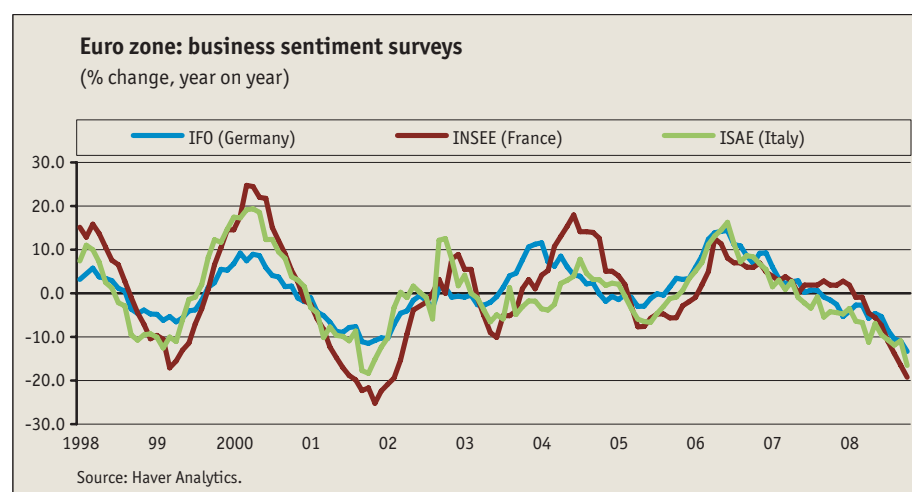
%	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
GDP growth										
Euro area	2.2	2.0	2.9	2.6	1.1	-0.3	0.7	1.5	2.0	2.1
EU27	2.4	2.0	3.2	2.9	1.3	-0.3	0.8	1.6	2.2	2.3
EU15	2.2	1.8	2.9	2.7	1.0	-0.5	0.6	1.5	2.0	2.1
New members ^a	5.6	4.8	6.5	6.2	4.9	2.6	3.3	4.1	4.1	4.1
Consumer price inflation										
Euro area	2.1	2.0	2.0	2.1	3.4	1.7	1.5	1.9	1.9	1.8
EU27	2.3	2.2	2.1	2.3	3.7	2.0	1.6	2.0	2.0	1.9
EU15	1.9	2.0	2.1	2.1	3.5	1.8	1.5	1.9	1.9	1.9
New members ^a	5.6	3.6	3.2	4.1	6.0	4.3	3.2	2.7	2.7	2.7

^a Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia (excluding Malta).

Source: Economist Intelligence Unit.

The euro zone, hit badly by the financial crisis, is in recession

As the financial crisis has worsened further, we have cut our GDP growth forecasts for the euro area substantially. We forecast that the euro area is in a recession and that full-year GDP will contract by 0.3% in 2009 following an estimated expansion of 1.1% in 2008, before starting on a slow recovery in 2010. The euro area, like the US and the UK, is in the grips of a financial crisis that has led to the drying up of interbank lending and a sharp tightening of credit conditions by financial institutions. This has already caused a slowdown in bank lending to non-bank customers (from earlier high growth rates), but a failure to revive the money market would entail a sharp contraction of lending to the real economy. Our central forecast assumes, however, that the massive co-ordinated programmes to bring back stability to the banking system will be successful and that market freefall will be avoided. Governments throughout the region are likely to increase fiscal spending aggressively in order to counteract the downturn.



On October 13th the German government announced a rescue package of €500bn (US\$745bn) and the French government presented a package of €360bn. The total of pledged measures by euro area governments, mostly credit guarantees for new loans and capital injections to financial institutions, now amounts to €1.3trn (roughly 14% of euro area GDP). Markets have reacted very positively to this, reversing some of the dramatic earlier losses, but major

challenges remain. Many euro area countries experienced their own housing booms, and the impact of the expected correction is probably not fully built into banks' balance-sheets. The negative feedback effects from a weakening economy on the financial system, in the euro area and on the global level (many euro area banks are active globally), will also weigh on financial stability, so that a sustained stabilisation after recent exceptional turbulence is far from being assured. Even if the measures, any further action and additional monetary stimulus are successful in calming the situation, the financial sector will remain in a fragile condition and will focus on rebuilding balance-sheets.

This means that growth will be encumbered by a substantial weakening in lending growth, which will affect investment in machinery and construction, and private consumption. But this is not the only challenge. Apart from its impact on the financial sector, the further weakening of real estate markets will also have a direct effect on growth through falls in construction activity. The euro area will also be hit by weaker demand from its major trading partners, as the UK and the US, the euro area's two main trading partners, are particularly affected. Weakness in central and eastern Europe will also hit the region's exporters. The still-strong euro will also undermine export competitiveness. These negative trends will more than offset the positive effect of weakening commodity prices. Confidence indicators have already fallen sharply, bringing the European Commission's overall economic sentiment indicator to a level only just above the last trough in November 2001, which was the lowest since 1994.

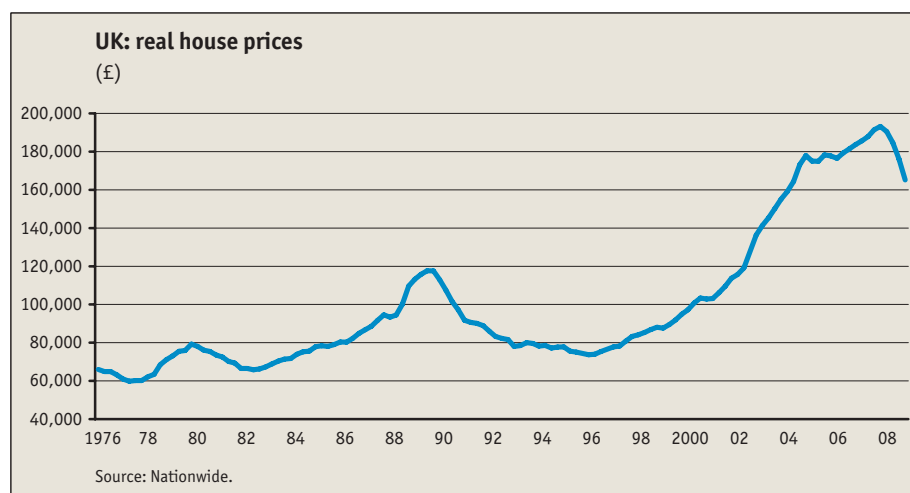
Weakness is evenly spread across the euro area

The financial crisis is affecting the individual members of the euro area in different ways, but it seems that economic prospects are diverging less than could be feared given the large variations in exposures. This means that the risks of a break-up of the euro area remain very small. Spain, for example, seems to be less exposed to problems in the US, but this is offset by the domestic problems of the Spanish housing bust and, now, rising weakness in Latin America. By contrast, Germany will not experience a real estate downturn (house prices are still below the equilibrium level), but the country, still the world's largest exporter of goods, is more exposed to the slowdown in the world economy. In recent years, Germany benefited from strong emerging-market demand for capital goods, a sector in which it has a particular strength. But investment in such goods is likely to be particularly affected by the fall-out of the financial crisis (capital goods purchases are often funded on credit) and a declining need for capacity expansion.

France will suffer from a weakening housing market (although the problems are nowhere near as serious as in Spain), significant global exposure of its financial industry and the hit on its export industry, both inside and outside the euro zone. Italy, meanwhile, has not experienced a housing bubble and its financial exposure seems to be limited (notwithstanding some exposure to parts of eastern Europe). However, its export sector—with its focus on luxury goods—will be hit badly and the country, in any case, still suffers from weak domestic momentum. The weakest performers in 2009 are expected to be Ireland, with a contraction of 2%, Spain, with a contraction of 1.2%, and Italy and France, with a shrinkage of 0.5% each.

The ECB is expected to cut rates further in coming months

In a move co-ordinated with other major central banks, on October 8th the European Central Bank (ECB) cut its policy rate, the refinancing rate, by 50 basis points to 3.75%. Coming only three months after a one-off interest rate increase of 25 basis points, this was an acknowledgement that the financial crisis had turned out much worse than expected and was set to weaken inflationary pressures and growth prospects. The ECB then cut the rate again in November, by another 50 basis points. Signs of fading inflationary pressure and wider evidence of recession will convince the ECB to ease policy further, even if financial market conditions start to stabilise. We expect one more cut, again by 50 basis points, by end-2008, and another two cuts by the same amount in the first quarter of 2009, which would leave the policy rate at 1.75%. A gradual recovery of conditions will lead to a very slow tightening process starting, as in the US, in 2010.

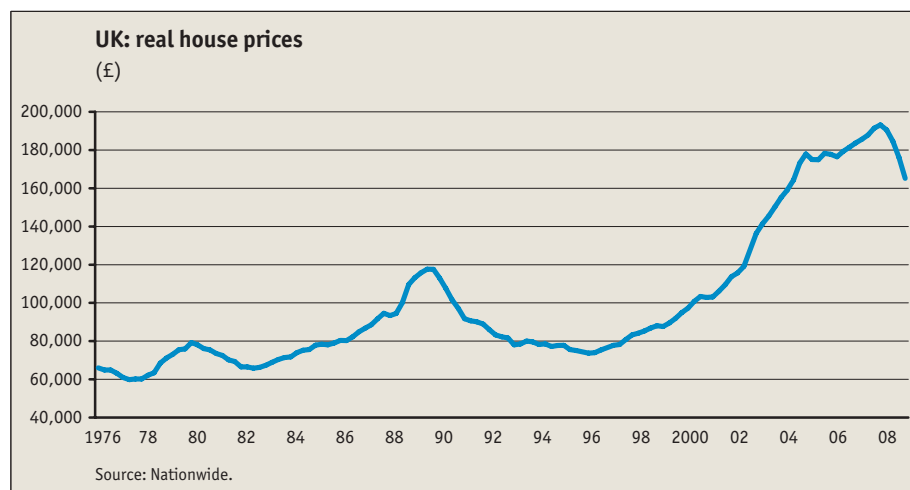


The outlook for the UK in 2009 is for a substantial

The outlook for the UK has deteriorated sharply in recent months, reflecting both the importance of the now severely ailing financial sector in driving domestic growth, the rapid deflation of the UK's housing bubble, which was by some measures larger even than that of the US, and weakness in the key euro zone export market. We now expect that the UK's real GDP will contract by 1.5% in 2009, the worst performance among larger developed countries and the first full-year contraction since the early 1990s, and broadly stagnate in 2010. Massive stabilisation efforts by the government, involving a rescue package worth £400bn (US\$756bn), together with actions by the US and the euro area, will support the UK banking system. However, the measures will not prevent a reduction in credit to households. This, in turn, is aggravating wobbles in the housing market, which may not reach bottom until 2010 or 2011. The difficulties in the housing market are also hurting private consumption, as households adjust their expenditure to lower-perceived housing wealth, and the construction industry. Employment has also started to fall, and we expect the rate of unemployment to rise sharply, topping an average of 9% of the labour force in 2010.

The Bank of England (BOE, the UK's central bank) participated in the globally co-ordinated monetary policy action on October 8th, cutting the base rate by 50 basis points to 4.5%. The BOE then followed this with a surprise 150 basis point

cut on November 6th—the largest rate reduction since 1844—taking the base rate down to 3%, a 53-year low. In view of the likely swift easing of inflationary pressures and the dire broader outlook for the UK economy, we expect that the BOE will make further aggressive cuts to its policy rate, taking the base rate down to 1% by early 2009. As in the US and the euro zone, tightening will start in 2010, but the pace of rate rises will be slow. Although the UK's banks are coming under heavy government pressure to pass lower policy rates onto consumers, we believe that this will have little impact in terms of lending as balance-sheet repair will continue to take priority for the banks possibly until well into 2010. Even if further cuts are passed on in terms of lower lending rates, loan conditions are likely to be so strict that most borrowers will continue to be shut out of the market.



Despite several years of above-trend economic growth, the UK enters this recession with one of the weakest structural fiscal positions of any large developed country. With a budget deficit already estimated at around 5% of GDP in 2008, the government's room for fiscal manoeuvre is limited. We expect that the combination of further measures to stimulate the domestic economy, difficulties in restraining public-sector pay in the run-up to the next general election and a sharp fall-off in tax revenue will nevertheless see the budget deficit widen to around 8% of GDP by 2010. (Recent concerns about the impact of higher public spending on gilt yields suggest, however, that the government may have difficulties enacting even more aggressive fiscal stimulus.) Notwithstanding some narrowing of the deficit improvement from 2011 in line with the gradual pick-up in economic growth, the weakness of the recovery suggests that, structurally, the UK's fiscal position will remain weak. This will also manifest itself in a rapid deterioration of the public debt stock—we forecast that public debt will rise from an estimated 50% of GDP in 2008 to nearly 70% by 2013.

The Turkish lira's weakness raises external debt concerns

The Turkish economy is expected to slow from an estimated 3% in 2008 to just 1.7% in 2009, which would be the worst performance since the Turkish financial crisis in 2001. Turkey has been hit hard by a surge in inflation, which forced the Central Bank of Turkey to raise interest rates by a total of 150 basis points in May-July. More recently, the collapse of the Turkish lira against both the US

dollar and the euro is now raising concerns about the ability of the private sector to service around US\$125bn in external debt. Moreover, more restrictive overall financial conditions and the weakening of demand from western Europe are also casting a shadow over prospects for consumption and gross fixed investment. Confidence in political stability has been greatly boosted by a decision by the Constitutional Court not to ban the ruling party and expel leading members (including the prime minister) from parliament, but tensions will remain a major concern. Turkey will also remain heavily dependent on short-term capital inflows to meet its large external financing needs, making it vulnerable to the current dearth of available funds.

Transition economies

%	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
GDP growth										
Transition economies	6.8	5.7	7.3	7.4	6.0	3.0	4.3	4.6	4.7	4.7
East-central Europe ^a	5.6	4.5	6.3	6.0	5.3	2.9	3.4	4.2	4.1	4.2
Balkans ^b	7.2	4.8	6.7	6.1	6.9	3.5	4.0	4.8	4.5	4.6
Baltics ^c	7.8	9.0	9.7	8.6	0.6	-2.1	2.5	4.0	4.4	4.6
CIS ^d	7.8	6.5	8.0	8.4	7.0	3.4	5.0	5.1	5.2	5.2
Consumer price inflation										
Transition economies	8.2	8.9	7.1	7.5	11.9	9.0	7.0	5.8	5.4	5.3
East-central Europe ^a	5.6	3.6	3.2	4.1	6.0	4.3	3.2	2.7	2.7	2.7
Balkans ^b	8.6	8.4	7.0	5.6	8.9	5.9	4.3	3.4	2.9	2.8
Baltics ^c	3.1	4.2	4.7	7.2	12.2	7.5	5.1	3.8	3.6	3.4
CIS ^d	10.2	12.4	9.6	9.8	15.8	12.2	9.6	7.9	7.4	7.2

^a Czech Republic, Hungary, Poland, and Slovakia. All members of the EU. ^b Bulgaria, Croatia, Macedonia, Romania and Serbia. Bulgaria and Romania are members of the EU. ^c Estonia, Lithuania, Latvia. All members of the EU. ^d Azerbaijan, Kazakhstan, Moldova, Russia, Ukraine and Uzbekistan.

Source: Economist Intelligence Unit.

The transition region is highly exposed to global turbulence

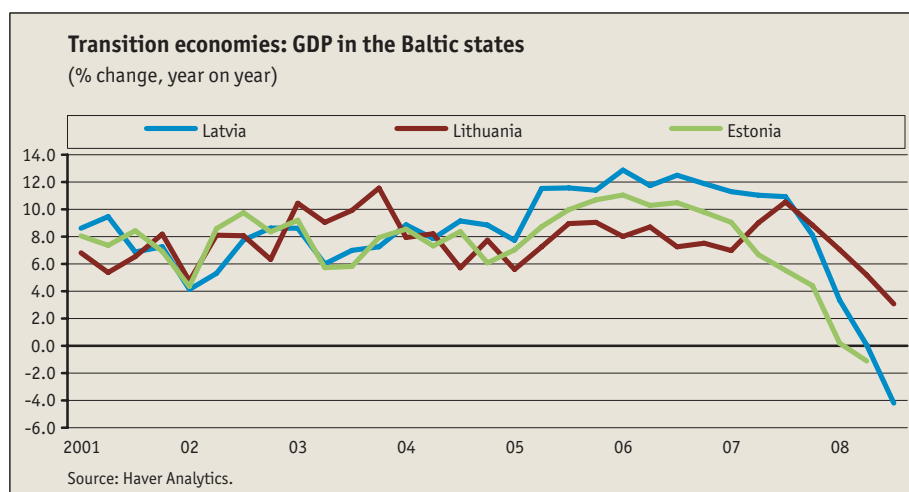
The short-term outlook for the transition region is poor. In the emerging world, this is the region most exposed to the turmoil in global credit markets. We have downgraded our real GDP forecast for the region to reflect this, as well as the fact that the financial crisis is having a significantly stronger impact on activity in the region's main trade partners in western Europe than we had previously forecast. In addition to restricting demand for east European exports, this will also dampen significantly foreign direct investment (FDI) inflows (a key driver of growth in the region over the past decade) and limit even more than had been previously expected the region's access to other forms of external finance. Also, further downward revisions to international commodity prices will affect activity in Russia and other energy exporters in the Commonwealth of Independent States (CIS).

The size of many of the transition economies' external financing needs is a key vulnerability, which now looms very large in the context of the global financial crisis and much more risk-averse attitudes. Policy deficiencies in some countries that have come to the fore have exacerbated this vulnerability. Countries with the largest current-account deficits—notably Estonia, Latvia, Lithuania, Romania, Bulgaria and Serbia—will remain most exposed to sharp corrections. Like Hungary and Ukraine most recently, some of these countries may have to seek

Real estate markets and inflation give cause for concern in the Baltics

funds from the IMF and other official sources in order to meet external funding needs.

The Baltics will deliver the weakest economic performance in the transition region in 2009-10, with an outright contraction forecast for 2009. This largely reflects severe weakness in Latvia and Estonia—both are forecast to contract in 2008, and Latvia will not start growing again until 2010. Lithuania, meanwhile, will grow in 2009, albeit only just. All three of the Baltic countries have large current-account deficits, but the downturn this year will bring a correction in the external position in Estonia and Latvia. However, the levels of external indebtedness remain threatening for these two countries, and even the levels recorded for Lithuania are problematic. The subregion has also suffered from an inflationary pick-up on the back of rising commodity prices and earlier overheating. The difficulty of obtaining external funding in the current uncertain climate will make many firms reconsider their plans for investment. Although the subregion's currency links with the euro have held up well in the circumstances, concerns remain that further global or domestic financial market turbulence could put these arrangements under severe strain.



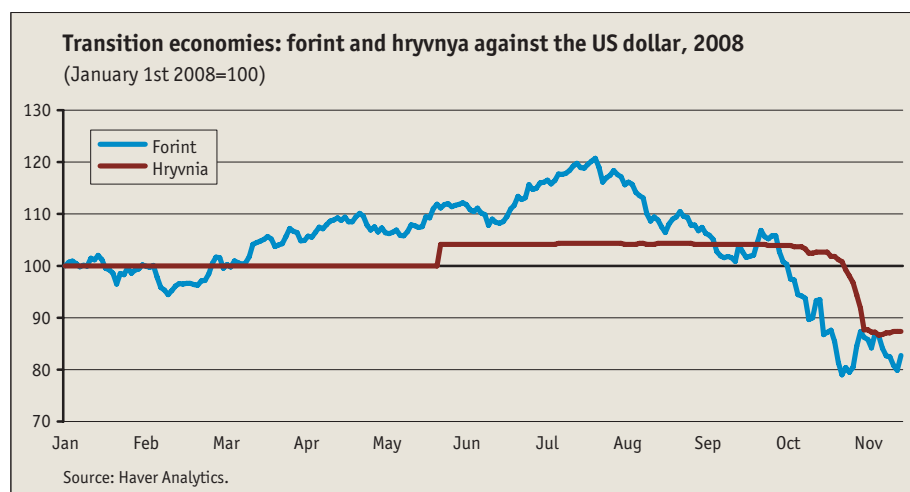
Romania and Bulgaria look overextended

We estimate that growth in the Balkan economies accelerated slightly in 2008, but will decelerate noticeably in 2009 and 2010. The slowdown will reflect a deterioration in export performance and, above all, impeded access to external finance. Tighter economic policy will dampen domestic demand. As noted above, Romania is one of the countries in the region most vulnerable to financial market turmoil, being on course to run double-digit current-account deficits throughout most of the forecast period. Romania also has a large gross financing requirement equivalent to around 30% of GDP. Funding the requirement has been straightforward because of strong FDI inflows, but it will become more difficult as privatisation revenue tails off. In addition, the leu's recent softness against the euro, in which much of its foreign debt is denominated, is also a concern. Bulgaria also looks overextended, with a current-account deficit of well over 20% of GDP and a financing requirement of nearly 50% of GDP.

Growth will also decline significantly, even in the region's strongest economies of central Europe. Although Poland and the Czech Republic, neither of which

looks overborrowed by the standards of the region, looked relatively well placed to weather the current storm, each will see export growth slow sharply as the euro zone moves into recession. The heavy reliance of most countries in the subregion on the automotive industry will take a toll in the context of the global slump in the automotive sector. Hungary is experiencing the greatest immediate difficulties. Its large debt, in particular, left it vulnerable to a loss of investor confidence, and the crisis in global credit markets is curtailing the country's access to international financing. The availability of support from the IMF, the ECB and the World Bank reduces the risk of a banking collapse or sovereign default, but the currency could fall further, and higher debt-servicing costs on foreign debt and reduced lending growth will hit the real economy. Pressure from the IMF to implement further fiscal austerity measures as a condition of Fund help will also exert further downward pressure on growth—we forecast that real GDP growth will contract in 2009.

Ukraine faces a similar problem to that in Hungary and the Baltics: a large external financing requirement that it can no longer meet. Ukraine has also had to negotiate a large IMF bail-out package. Real GDP growth in Ukraine will also contract in 2009. There could also be serious difficulties in Russia and some other former Soviet states, even though current accounts in this subregion are generally in surplus because of previously high oil prices. Banks and companies in Russia have large amounts of external debt falling due and it is unlikely that these lines will be rolled over by creditors. The government has responded by stepping in and providing liquidity from its foreign-exchange reserves. But the Russian state may not have sufficient resources or the appetite to rescue all those seeking funds. Much will depend on the movement in international oil prices—if these fall significantly below our current forecast, Russia is likely to suffer serious difficulties. In any case, even if a financial crisis is avoided, a significant growth slowdown will be unavoidable.



Asia and Australasia (excl Japan)

%	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP growth	7.4	7.2	7.9	8.3	6.6	4.7	5.3	6.5	6.6	6.5
ASEAN	6.5	5.8	5.9	6.4	5.0	2.7	3.8	4.9	5.3	5.5
China	10.1	10.4	11.6	11.9	9.8	7.5	7.5	8.6	8.4	8.2
India	8.3	9.2	9.7	9.0	6.3	6.1	7.2	7.9	8.0	7.9
Inflation	3.8	3.4	3.8	4.7	7.3	5.2	4.1	4.0	4.0	4.0
ASEAN	4.4	6.8	7.6	4.5	9.8	6.6	4.7	4.1	3.9	3.8
China	3.8	1.8	1.8	4.8	6.4	4.0	4.0	4.2	4.1	4.1
India	3.8	4.2	6.2	6.4	7.8	6.7	5.0	5.1	5.2	5.2

Source: Economist Intelligence Unit.

Growth in emerging Asia will slow sharply in 2009-10

Although growth will hold up relatively well in Asia (excluding Japan) in 2009 and 2010 by global standards, at around 5% on average, expansion will be sluggish in comparison with the blistering rates of around 8% notched up at the peak of the recent boom in 2006-07. One reason for this is Asia's high exposure to the global trade cycle in general and the sensitivity of exports to economic prospects for the developed world in particular—the latter, coupled with a steep rise in risk aversion by global investors, has been one of the factors driving down stockmarkets across the region in recent months. We forecast that world trade volumes will contract by 0.5% in 2009, auguring ill for export prospects across the region and hence for investment and employment in export sectors. This will hit Hong Kong and Singapore in particular, both of which have a high degree of exposure to world trade developments, even by the standards of the region. Growth will recover more quickly in 2011-13 as world trade expansion recovers, but, at around 6.5%, growth rates will be muted in comparison with the glory days of 2004-07.

Chinese growth will slow in 2009-10

With the developed world underperforming, the region's performance will depend to a large extent on its most important economy, China. We have trimmed our real GDP forecast for China to around 7.5% in 2009 (from 8% previously) and expect growth to hold steady in 2010 at broadly the same rate. Recent data have, however, raised concerns about China's resilience to the sharp slowdown in global trade and the impact on consumers of the rapidly slowing domestic real estate market. Our growth forecast for 2009 assumes that government spending will play a key role in supporting economic activity in 2009 and 2010; the government's relatively strong fiscal position gives it considerable room for manoeuvre in this regard. Decelerating inflation will also free up the People's Bank of China (PBC, the central bank) to ensure that monetary policy is fully supportive.

The Chinese government's announcement on November 9th of a fiscal spending package underscores the urgency with which the authorities now view the decelerating economy. Worth around Rmb4trn (US\$586bn), a massive 16% of 2007 GDP, the package will be spent on a wide range of social welfare and infrastructure projects to the end of 2010. Exact details are, however, still sketchy. The Chinese government hopes that the size of the stimulus will provide a much-needed boost to the global economy. However, how much of the allocated spending is fresh cash rather than cash from what may have been allocated anyway in future budgets remains unclear. How willing companies are to take advantage of the package's tax breaks on investment in the current

Taiwan and South Korea look particularly vulnerable

climate may also be a moot point. The impact of the infrastructure projects will also take time to be felt, again suggesting that uncertainty over prospects for the Chinese economy will persist at least in the first half of 2009.

In the early part of the forecast period, Taiwan and South Korea will be severely hit by the weakening of the US, to which both are heavily exposed (according to some estimates, a decline in US GDP growth by 1 percentage point lowers Taiwan's growth by 1.1 percentage points, an exceptionally high degree of dependence). Any slowdown in China will also have a significantly negative impact on both economies. Consequently, we have revised down our forecast for Taiwan GDP growth to 1.5% in 2009 as export demand is expected to contract. The importance of the export sector to the domestic economy means that the impact will be particularly severe. In the medium term, business sentiment in Taiwan should benefit from a substantial improvement in relations with the Chinese mainland, following the installation in May 2008 of Ma Ying-jeou as president.

South Korea has been hit by a sharp decline of the won (requiring large-scale intervention on foreign-exchange markets) and economic and financial confidence has deteriorated significantly. Further sharp deterioration was only prevented at end-October by the Fed's move to extend emergency currency swap lines to South Korea as well as Singapore, Brazil and Mexico. The banking sector has a large stock of external liabilities—partly incurred to fund the domestic housing boom of recent years—which will require rolling over and leaves the sector vulnerable in the event that international credit markets remain in effect closed. The new South Korean president, Lee Myung-bak, who has got off to a shaky start, has enacted major tax cuts and fiscal stimulus packages. However, these will only play a marginal role in containing the downturn. We now expect growth to decelerate sharply in 2009 to below 2% and to remain subdued in 2010.

ASEAN will slow sharply in 2009

In 2009-10 the Association of South-East Asian Nations (ASEAN) will experience its weakest growth since the downturn that followed the bursting of the Internet bubble in 2001. We forecast a sharp deceleration in the subregion from an estimated 5% in 2008 to just under 3% in 2009 and only a weak recovery to around 4% in 2010. This poor performance will reflect both ASEAN's general exposure to world trade patterns and, more specifically, the weakening of prices for commodities, which are a core export for many of the subregion's countries. Growth will recover in 2011-13, but in the absence of a strong rebound in commodity prices, expansion is likely to come in at just 5-6%.

Growth in Indonesia, by far the largest country in ASEAN in terms of population and the size of the economy, is expected to slow sharply in 2009 to 2-3%, with stabilisation at around 3% in 2010. Indonesian growth over the past two years or so has been driven largely by buoyant inflows of FDI and its companies typically obtain around one-half of their financing from international sources. However, it is unlikely that these flows will be sustained given tight global liquidity conditions. On the external front, Indonesia will suffer from both lower demand and lower prices, as it is a large commodities exporter (although the export sector remains a relatively small component of GDP in real terms). The recent weakness of the rupiah has forced Bank

Indonesia (BI, the central bank) to implement repeated interest rate hikes in recent months, taking the policy rate to 9.5% by mid-November. It has also led to a rundown in Indonesia's relatively low stock of reserves. BI will probably wait until late in 2009 before starting to cut rates. The approach of presidential and parliamentary elections in 2009 will, however, weaken the quality of policymaking in that year as the various members of the ruling coalition seek to curry favour with the electorate ahead of the polls.

In Thailand, the economy is expected to expand by nearly 5% in 2008, before slowing to just 2% in 2009, largely as a result of weak export demand owing to the economic downturn in the OECD and, to a lesser extent, China. The political outlook remains uncertain, as major street protests led by the People's Alliance for Democracy, a civic group loyal to the king and opposed to the incumbent government, have led to renewed tensions. Nevertheless, we do not believe another coup by the military is likely unless the situation deteriorates into serious violence. (The previous coup, against the then prime minister, Thaksin Shinawatra, whose supporters returned to power after the election in December 2007, was widely seen as a failure and a loss to military credibility.) However, the restoration of political stability is not expected any time soon and this will continue to depress domestic demand in 2009. By 2010 a more stable political environment and the impact of higher public spending in 2009 will help to lift growth. Growth in the Philippines, which reached a 31-year high of 7.2% in 2007, will fall towards 2% in 2009, as the Philippines is hit by the US downturn, owing to its close links through trade and the dependence on remittances of Philippine migrants to the US.

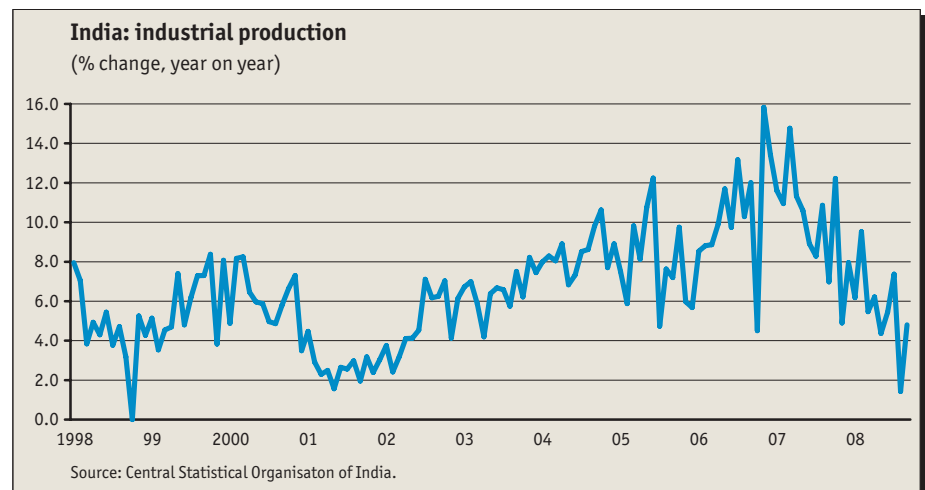
Although almost all emerging markets in Asia have been hit by higher inflation, the problem is particularly acute in Vietnam, where inflation stood at nearly 28% year on year in September, up from 12.6% in December 2007. More than in other Asian economies, an overly growth-oriented monetary and financial policy takes a large share of the blame. The government has now shifted its emphasis on controlling inflation, leading to an increase in the base rate of the State Bank of Vietnam (the central bank) from 8.25% before the first hike in January (which was the first change since December 2005) to 14% in June. As the new policy focus on dampening inflation exerts its toll on growth and Vietnam is likely to see lower export growth as a result of the sharp slowdown in OECD demand, we expect growth to slow to an annual average rate of just under 5% in 2009-10. Furthermore, there are rising concerns about the health of the banking sector. The risks are on the downside for the near term, but in the second half of the forecast period strong supply-side fundamentals will lead to a recovery, with rapid growth of 7-8% a year.

Malaysia and Singapore will be hit by the downturn in the US—their fortunes are highly dependent on world trade growth and Malaysia counts the US as its most important export partner. Growth in Malaysia started to slow this year and is now expected to fall to nearly 3% in 2009. The expected slowdown in export growth will have negative implications for domestic demand. FDI is expected to be particularly weak as multinational companies will be in the process of restoring their balance-sheets and are unlikely to be making forays into new markets. The economic slowdown is expected to lead to a deterior-

ation in Malaysia's fiscal situation as the government maintains an expansionary fiscal stance at a time when revenue is falling. In particular, the expected fall in global oil prices will mean a lower contribution to state coffers from the state-owned oil company, Petronas. In Singapore, we now expect a small contraction in 2009, owing to the country's huge trade exposure and large financial services industry.

Growth in India is likely to slow

The growth outlook for South Asia is also expected to deteriorate, with growth in India forecast to slow noticeably from 9% in fiscal year 2007/08 (April-March) to 6-7% in 2008/09 and 2009/10. Given the relatively small size of exports of goods and services, the impact of the downturn in OECD import demand will be contained. Instead, India is suffering from the liquidity implications of the global financial crisis. By mid-November the country's stockmarket indices had fallen by around 50% since the beginning of the year and equity outflows from foreign institutional investors (FIIs) during 2008 were a net US\$9.9bn, compared with net inflows of US\$17.4bn in 2007. Furthermore, the rupee has been depreciating rapidly against the US dollar, owing to the global dollar liquidity shortage, heavy outflows from FIIs looking to transfer funds home and purchases of US dollars by Indian banks to fund their overseas operations. By early October the rupee had slumped to a six-year low, negating the recent fall in crude oil prices and keeping India's oil import bill high. The Reserve Bank of India (RBI, the central bank) has been intervening heavily to support the rupee, but this is leading to a shortage of rupee liquidity.



The regulators have promised to ease the domestic liquidity crisis. However, at the same time the government is struggling to control inflation, which has soared, partly as a result of the lowering of fuel subsidies but also as a result of supply bottlenecks and the fact that the economy is running above capacity. The RBI started raising interest rates in May and raised its key repo rate by 50 basis points to 9% at its quarterly monetary policy review at end-July. Since then, however, the liquidity squeeze has forced the RBI to start pruning rates back again, most recently on November 3rd when it cut the repo rate by 50 basis points, to 7.5%. Anti-inflation efforts are also being undermined by fiscal stimulus, which is, in turn, raising concerns about the ballooning budget deficit. The prospect of elections due by May 2009 suggests that there is little prospect

of fiscal tightening. In our main scenario, we expect the boom in India to peter out gradually, but the likelihood of a disruptive boom-bust cycle has increased.

Pakistan is mired in an economic crisis

The political situation in Pakistan will remain unstable in 2008 and 2009 despite the resignation of the president, Pervez Musharraf, and the election of Asif Ali Zardari as his replacement. The country's security problems also remain unresolved. The government's focus on political problems is undermining its ability to deal with a rapidly deteriorating economy and security problems in the north-west. Economic prospects have deteriorated sharply, with real GDP growth (by expenditure) expected to slow to 2% in 2008/09, from 6% in 2007/08. Accelerating price rises will depress real wages and thus consumer spending. A surge in inflation—prices rose by 23.9% in September year on year, only a slight easing from the 25.3% seen in August—is also becoming a major concern, prompting a substantial monetary tightening and adding to political stability risks.

The current-account deficit continues to balloon, foreign investment inflows are slowing, foreign-exchange reserves are falling rapidly and the fiscal situation looks increasingly precarious. Pakistan's problems are compounded by difficulties in meeting its external financing needs. In mid-November the government was still in negotiations with the IMF over securing a bail-out loan to meet these liabilities. In the longer term, continued political instability, the general weakness of the government and the global financial turmoil will pose significant risks to the government's ability to mobilise a more direct response to the economic crisis.

Australian growth will be sustained by private investment growth

Australian GDP growth is forecast to slow to around 2.5% in 2008 and more sharply, to 1%, in 2009. This compares with just over 4% in 2007. The weakening mainly reflects a slowdown in private consumption as households are heavily indebted and are suffering from falling property prices. Furthermore, on the external front, the growth in export receipts will be hurt by weaker external demand and lower commodity prices in 2009. The Reserve Bank of Australia (the central bank) has abandoned its earlier concerns about inflation and has been aggressively cutting interest rates, and the government has announced an A\$10bn (US\$7bn) fiscal stimulus package. These measures, most of which take the form of lump-sum cash payments to pensioners and low- and middle-income families, should prevent the Australian economy from falling into recession. Furthermore, although the banking sector will not escape unscathed, the major banks have fairly robust balance-sheets and high levels of capitalisation. However, they are already suffering from their reliance on offshore funding to roll over large external debts. The cost of funding has risen since mid-2007, and this will eat into profit margins. However, the bigger risk is that Australian banks' access to funds dries up. In addition, there is likely to be a build up of non-performing loans at Australian banks as the economy decelerates, corporates default and—the greatest risk—domestic households start defaulting on mortgages in larger numbers.

Latin America

%	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP growth	5.8	4.5	5.4	5.4	3.3	2.1	3.0	4.0	4.3	4.2
Mercosur ^a	7.5	4.8	5.3	6.3	5.5	2.6	3.5	4.1	4.0	3.7
Inflation	6.8	6.3	5.2	5.3	8.0	8.4	6.3	5.6	5.5	5.3
Mercosur ^a	7.8	8.3	6.5	6.3	9.1	10.0	8.1	7.1	7.0	6.7

^a Full members: Argentina, Brazil, Paraguay, Uruguay and Venezuela.

Source: Economist Intelligence Unit.

Latin America will be hit hard in 2009

Recent dramatic falls in emerging-market currencies and equities have demonstrated the extent of the level of integration of the world financial system, and show that the financial crisis that started in US sub-prime lending is now truly global. In Latin America, the largest economies, with flexible exchange rates, have suffered sharp falls in the values of their currencies as cash-strapped external investors look to unwind their foreign-currency positions. Since the end of June the currencies of Mexico, Brazil, Chile and Colombia have all fallen sharply against the US dollar. This also reflects continued weakness in most commodity markets, from which Latin America derives much export revenue, and expectations that the US downturn will deal a severe blow to the economies of Mexico and Central America.

The troubles of developed world banks have so far had only a limited direct effect on the Latin American financial system, although some countries have experienced a sudden scarcity of short-term credit. Moreover, given that many local banks are owned by US and OECD companies, it is inevitable that the problems of the holding companies will affect the normal operation of their subsidiaries, and increase their reluctance to extend new credit. Lower credit growth will result in slower consumption and help to slow the current surge of inflation in most Latin American economies, which has been driven by higher prices for food and energy. Falling commodity prices will also help, although the latter will be offset, to some extent, by the corresponding inflationary pressure of rapid depreciations (or liquidity injections in countries with pegged exchange rates). Real GDP growth in Latin America as a whole is forecast to be much weaker over the forecast period.

A number of Latin American countries have put in place policy improvements that have enhanced their long-term creditworthiness. Most of the larger economies now operate flexible exchange-rate regimes and have accumulated significant foreign reserve cushions, and many have also reduced fiscal deficits and external liabilities. However, the sharp deterioration in prospects for exports and inflows of FDI has raised the risk of volatility, as seen in recent rapid exchange-rate movements. Global credit conditions have deteriorated significantly in the last month or so, and risk aversion has increased, reducing both the supply of new foreign capital and increasing the risk that foreign investors will want to liquidate quickly their overseas holdings. One indication of this is that even in Brazil, the country with the deepest capital markets in the region, short-term credit lines are now falling dramatically. There are increasing concerns over financing requirements, particularly as the region remains highly dependent on external demand and would clearly suffer from a more severe

downturn in the US or, for South American countries, a sharp weakening of the Chinese economy.

Brazil is not immune to the global financial crisis

The events of recent weeks, including a rapid depreciation of the Real, have made it clear that Brazil is not immune from escalating global risk aversion. Investors were initially concerned about weaknesses in smaller institutions, but resulting currency falls have also increased concerns about undisclosed currency liabilities in the corporate sector, and have accelerated the Real's decline. As third-quarter GDP growth slowed only moderately from an average of 6% in the first half, we still estimate growth of 5.3% for 2008 as a whole. However, we expect a marked change in the structure of growth in the final quarter, with investment, private consumption and real imports all slowing sharply. The sharp depreciation of the Real will result in tighter domestic liquidity and much more severe credit conditions, putting pressure on debtors and further depressing the outlook for consumption and investment. Real export growth will slow sharply as OECD demand weakens, but will benefit from the weaker exchange rate. In subsequent years, exports should recover on the back of recent strong capacity expansion in the manufacturing and agricultural sectors. In the shorter term, GDP growth will fall to 2.4% in 2009, with only a moderate recovery, of 3.2%, expected for 2010 (with downside risks, depending on the length and depth of the OECD downturn).

Mexico is badly hit by the US recession

In Mexico, GDP growth is forecast to slow sharply in 2009, to just 0.9%, down from an already weak 1.9% this year—and the downside risks to the 2009 forecast are growing. This primarily reflects the weakening of the US market, which is the destination of 82% of Mexico's merchandise exports. As inflation is running well above its 2-4% official target, the Banco de México (the central bank) could not cut its policy rate at its mid-October meeting, having raised it by 75 basis points since May. The recent heavy depreciation of the peso will have some inflationary impact, but this will be moderated by falling commodity prices, and in our main scenario we expect inflation to ease from the end of this year. This will allow the central bank to start cutting rates in 2009, and together with fiscal stimulus measures, including additional infrastructure spending, this should help to curb the impact of the US downturn.

In the medium term, unsatisfactory physical infrastructure and lack of labour market reform will continue to discourage job growth in the formal sector. Some progress will be made in economic policy; the parliamentary approval of a major pension reform and a fiscal package in 2007 showed that the government was able to get sufficient majorities for controversial reform projects. An energy bill presented to Congress in April 2008 was passed in late October, albeit in a watered-down version. The reform is expected to help to arrest, but not reverse, a decline in Mexico's oil output, which will have a substantial impact on public finances.

In Argentina, a period of buoyant economic expansion, driven by the recovery from the crisis in 2001 and stimulated by lavish public spending, has run out, and growth in 2009 is forecast to slow to just above 2%. Inflationary pressure has risen sharply as output has increased above potential, on the back of stimulatory fiscal and exchange-rate policies. Official inflation figures are kept at around 9% by changes in the methodology and the imposition of distorting

policies, but actual inflation is believed to be much higher, and the resulting erosion of purchasing power will slow private consumption growth. Private investment will also cool amid uncertainty over policy, a fading residential construction boom and crowding out as the government turns more heavily to domestic sources for its financing needs. Public consumption and investment growth will also decelerate in 2009, and energy constraints will act as a drag on growth.

Although Argentina is less exposed to the US than other Latin American countries, and benefits from strong emerging-Asian demand for many of its products, it is exposed to stuttering EU economies and their combination will reduce export growth. Apart from a worsening of the inflationary spiral, which would further erode real incomes and hit private consumption hard, a collapse in demand and in prices for Argentina's export commodities represents a growing downside risk to our GDP growth forecasts. The Argentinian currency has been weakening against the US dollar since September, but the government's recent seizure of public pension assets should give it some ammunition to prevent an even steeper fall-off in coming quarters. Concerns about a hard landing have led to a sharp increase in risk premiums for Argentinian bonds, and a more rapid adjustment is possible, particularly in the light of increased global volatility.

Buoyant GDP growth in Venezuela in recent years has been driven by an oil-fuelled massive fiscal stimulus. But the peak of the boom has now passed, and with oil prices nearly 70% below recent peaks, the economy faces severe problems in 2009-10. Given the political difficulties of cutting spending at a time when the popularity of the president, Hugo Chávez, is floundering, the government is likely to devalue the bolívar early in 2009 to boost the local-currency value of revenue inflows. This will boost inflation, which already stands at more than 30%, the highest of major Latin American countries. We forecast a rate of more than 45% by the end of 2009. This will continue to erode real incomes, which will drag on growth. Meanwhile, the radicalisation of economic policy over the past year, including the nationalisation of private companies and rising concerns about expropriations, will produce a significant contraction in private investment. Combined with continued falls in oil export volumes, we expect a contraction in GDP of 3% in 2009, from growth of an estimated 3.5% in 2008.

Middle East & Africa

%	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Middle East & North Africa										
Real GDP growth	6.7	5.7	5.5	5.5	6.1	4.6	5.2	5.4	5.5	5.5
Inflation	7.0	6.5	7.8	9.1	14.3	9.8	8.6	7.7	7.2	6.9
Sub-Saharan Africa^a										
Real GDP growth	5.7	6.5	6.6	6.3	5.0	3.9	4.5	4.9	5.0	4.7
Inflation	10.2	9.3	6.5	6.8	11.9	8.3	7.2	6.3	5.9	5.6

^a Refers to Angola, Kenya, Nigeria and South Africa only.

Source: Economist Intelligence Unit.

Lower oil prices will weaken growth in the Middle East

Economic growth in the Middle East and North Africa (MENA) will slow sharply in 2009-10 owing to lower international oil prices, collapsing asset prices and reduced access to global credit markets. Growth will be constrained in the oil-producing countries of the Gulf as a result of lower oil output (as part of OPEC's efforts to put a floor under oil prices). This will depress GDP growth in Saudi Arabia in 2009-10, notwithstanding a relatively sound domestic economy. Aside from oil, the region will also feel the impact of the seizing up of global credit markets in late 2008 and the likelihood that credit will be harder to access and more expensive in 2009-10. Many of the region's economies are in the midst of ambitious infrastructure development projects, which, with less international financing available, will lead to an erosion of fiscal surpluses.

Non-oil-producing countries will see inflationary pressures easing as oil and other commodity prices stabilise at significantly lower levels in 2009. However, countries in North Africa and, to a lesser extent, Egypt are particularly exposed to the economic downturn in Europe and the US. This will be reflected in lower demand for exports, lower tourism inflows and lower remittances from nationals working in Europe and the OECD more generally. Global FDI flows are also expected to fall in 2009-10, which could have particularly negative consequences for Egypt. Non-oil-producing countries in the region have also been benefiting from the ample liquidity in the Gulf, through inward investment, tourism and workers' remittances, but these can also be expected to fall in 2009-10.

Iran will suffer more than other producers from lower oil prices

Global oil prices are expected to average just US\$65/barrel in 2009, down from an estimated US\$98/b this year, and to rise only slightly to US\$68/b in 2010. Oil prices in this range will not lead to serious economic damage for most of the region's oil producers—with the exception of Iran—given that a large share of current oil revenue is saved rather than consumed. Consequently, a decline in oil revenue will, to a large extent, be absorbed by a decline in capital flows abroad, rather than a cut in domestic demand. However, there is a risk of dislocation in the region's own financial markets, which could have serious consequences both for growth and for the health of particular markets, notably real estate.

Iran, however, was battling to maintain macroeconomic stability before the recent fall in oil prices. The country is particularly vulnerable on the fiscal front, with low levels of tax coverage (recent attempts to introduce a value-added tax and improve bookkeeping resulted in merchants striking and delays to the plan), high levels of food and fuel subsidies and a dependence on oil-related revenue. The rate of inflation was running at 29% year on year at end-September, and there are signs of overheating in the economy as a result of the expansionary fiscal stance.

MENA will not be immune to the credit crunch

The boom in the Gulf Arab states has depended heavily on flows of credit from international markets, and borrowers are already facing difficulty in rolling over existing facilities, let alone raising new funds. Liquidity is also shrinking in the Gulf's domestic market. The main reasons for the shortage of liquidity are the pricking of the currency revaluation bubble around the middle of this year (there had been a torrent of funds pouring into the Gulf Co-operation Council

currencies in expectation of revaluation) and the sharp slowdown in growth of deposits compared with the increase in loans. Funding from international markets is starting to dry up. Whereas 12 months ago there were some 50 institutions active in the Gulf project finance market, the number of banks now involved is only about ten. Growth in the Islamic finance market has also slowed this year, both because of tougher sharia-compliance criteria and as a side-effect of the credit crunch.

The Gulf authorities are aiming to achieve an orderly moderation of growth. At best, the global crisis will have a salutary effect in taking some of the heat out of the Gulf economic boom. At worst, it will lead to a sharp contraction in business activity, particularly in real estate and infrastructure development, and put some regional financial institutions at risk. Middle East energy exporters will also have to reckon with the prospect of a global slump leading to a collapse in oil prices, which would put their fiscal and external accounts under strain.

Household demand will be weak in South Africa

Concerns about the ramifications of turmoil in global financial markets have added to political concerns to depress the outlook for the South African economy. South Africa's access to capital may be affected both in terms of the cost and availability by tighter global credit markets. On the political front, the business sector had hoped that the ousting of Thabo Mbeki would lead to early elections and a new government. However, instead South Africa now has an interim president and administration that, it is feared, will do no more than mind the shop until the May 2009 elections, at which Jacob Zuma is expected to become president. At a time of international financial turmoil and serious infighting within the ruling African National Congress (ANC), the prospect of policy drift is bad news for business and the economy.

Growth in South Africa is expected to decelerate to 2-3% in 2009 (from an estimated 3.5% this year), as a result of serious electricity shortages and the prospect of formal power rationing in the months ahead, coupled with weaker household demand (after a series of interest rate rises in 2006-07) and the global economic downturn. High inflation limits the opportunity to loosen monetary policy, at least until mid-2009. Power shortages are likely to persist, given the long lead times in commissioning new plant, which will constrain energy-intensive industry and mining.

In Nigeria, the social unrest in the Delta region, which has intensified since April 2008, is likely to depress oil production throughout the forecast period. Despite increased production from new offshore fields, no solution to the troubles of the region is in sight, and the rebel militias are likely to continue their violent campaign, targeting oil production facilities and pipelines. As a result, economic growth in Nigeria will depend on the performance of the non-oil sector. This is likely to slow markedly in 2009, as Nigeria suffers some of the fallout from the global financial crisis. Less access to financing will restrict investment and constrain previously buoyant sectors such as construction. We expect GDP growth to fall from an estimated 6% in 2008 to just 4.6% in 2009, rising to 5.4% in 2010.

In Kenya, a broad-based government of national unity, a grand coalition between the Party of National Unity (PNU), led by the president, Mwai Kibaki, and the Orange Democratic Movement (ODM), led by the prime minister, Raila Odinga, was formed in April, pulling Kenya back from the brink of renewed violence after the disputed election. The unity government will focus increasingly on reforms to improve the business climate and investment in infrastructure. However, political feuding may hamper policy implementation, and corruption will remain a challenge. Real GDP growth, forecast at 2.5% in 2009 (compared with an estimated 3.2% in 2008), will be constrained by the slowdown in developed markets.

Exchange rates

The US dollar maintains its strength into November

The US dollar has continued to defy gravity, buoyed by a combination of investor flight from risky assets in emerging markets and commodities and growing gloom about economic prospects for the euro zone. (Interest rate differentials between the US and the euro zone are also now narrowing rapidly.) The US dollar's resilience in the face of the deepening financial crisis at home and the deteriorating outlook for US public finances has been surprising, but underscores our view that the currency is being held up by growing pessimism about prospects in the rest of the world rather than by confidence in the US per se.

In mid-November the US currency was trading in a range of US\$1.25-1.30:€1, well up from the lows of around US\$1.60:€1 seen earlier in the year and stronger even than its position at the start of the current crisis in August last year. We believe that global "de-risking" will continue to be a key driver of the US dollar's movements over the remainder of this quarter and in the early part of 2009. The US currency will, however, steady against the euro in the latter part of the year as market conditions start to normalise. The sharp narrowing of the US current-account deficit and a reappraisal of prospects in many emerging markets following the current crisis will both favour the US currency over the forecast period. In view of the stresses in financial markets at present, we acknowledge, however, that there is a high risk of greater US dollar volatility than this forecast suggests.



Like the US dollar, the yen has also appreciated on the back of global risk aversion, and by mid-November was trading at just under ¥100:US\$1. We expect that the yen will strengthen further against the US currency over the forecast period and have adjusted our yen:US dollar forecast slightly for 2008 and 2009 to reflect recent movements. Our forecast assumes some stabilisation of the currency at around current levels, but this could prove optimistic in the event of further intense global financial turbulence. We forecast that the yen will average ¥97:US\$1 in 2009 and ¥96:US\$1 in 2009. The yen's movements against the euro will remain volatile, again reflecting investor de-risking—witness the yen's sharp appreciation against the euro, from ¥169:€1 in mid-July this year to around ¥120:€1 by mid-November.

Sterling remains vulnerable

Sterling has fallen sharply against the US dollar since mid-July, trading at around US\$1.50:£1 by mid-November. Against the euro, sterling has been slightly more stable, trading within a relatively narrow band of €1.20-1.25:£1. The UK currency is strained by the country's large current-account deficit, very poor economic prospects, excessive consumer indebtedness, the crashing housing market, a severe hit from global financial turbulence and expectations of still lower interest rates. We expect the currency to weaken further against the US dollar in 2009 as the Bank of England (the central bank) eases policy aggressively, thus closing interest rate differentials with the US, but to remain broadly steady against the euro as the latter unwinds some more of its recent strength.

Chinese reserves accumulation remains rapid

Exchange rates for the US dollar against many emerging-market currencies will remain strongly influenced by central bank interventions. This is particularly the case in China, with the continued build-up of foreign-exchange reserves (which now total around US\$2trn). The Chinese authorities allowed the strengthening of the renminbi against the US dollar to accelerate at the beginning of 2008, to help reduce inflationary pressure. However, a sharp surge in hot money inflows (encouraged by the prospect of further rapid appreciation) and a weakening of economic growth have induced the authorities to reduce the pace of appreciation, and a substantial appreciation of the US dollar against other currencies induced a stabilisation of the renminbi against the US currency. Although we expect the appreciation to resume, the pace will be much slower than at the peak in late 2007 and earlier in 2008.

The sharp fall in commodity prices and the global financial crisis have raised the pressure on other emerging-market currencies across the board. Oil-exporting countries have seen their export revenue shrink substantially, although to historically still high levels. Meanwhile, oil-importing countries will benefit. This applies for example to South Korea, where the currency had been hit by a shift to a current-account deficit following the earlier strength of oil prices. But the country also depends heavily on foreign capital inflows to its banking system, so that the rising tensions in the global financial system have led to a continued fall in the South Korean won. Other countries are also heavily affected by the financial crisis, and the collapse of fixed exchange-rate regimes in some countries has become a high risk. Against a background of elevated global risk perceptions, many emerging-market currencies are likely to remain weak throughout 2009 and into 2010. Many will also see a fall in hitherto high levels of reserves.

World trade

World trade

% growth, goods	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
World trade	10.8	7.5	9.1	7.4	4.9	-0.5	3.5	4.5	5.2	5.7
Developed countries	7.6	5.8	7.5	4.9	2.5	0.0	2.5	3.3	3.8	4.0
Developing countries	17.4	10.8	12.0	11.8	8.8	-1.3	5.0	6.3	7.1	7.9

Source: Economist Intelligence Unit.

Following a sharp acceleration in 2006, growth in world trade weakened in 2007. We expect further weakness in 2008 and 2009—with a contraction likely in 2009—as import demand from the US, the euro area and Japan remains compressed. The tightening of trade finance conditions as a result of the global crisis may also have a significant, if temporary, negative effect on trade. The rate of expansion is forecast to move back to around 6% by 2013, below the peak years of globalisation in 2004-07, but still sufficient to imply rising import penetration. Emerging Asia is expected to see the fastest rates of export growth over the forecast period. Chinese exports will recover relatively quickly (although performance will not match the spectacular growth seen over the past few years, when foreign sales regularly rose by over 20% a year). Trade growth in industrialised countries will remain sluggish in comparison with that of other regions.

World trade talks will not affect trade during the forecast period

At a ministerial conference of the World Trade Organisation (WTO) in Geneva in July, negotiators failed to reach a breakthrough despite initially making some progress. The key reason for the failure was disagreement between the US on the one side, and China and India on the other, on measures to allow developing countries to restrict sharp increases in imports of agricultural products. With a Democrat president set to take office in January next year, a general election in India due in May 2009 and the term of the European Commission ending in late 2009, the prospects of a breakthrough in the near term now appear slim. This is despite the fact that the financial crisis has led to new initiatives to reignite the momentum behind trade negotiations. Even if an agreement is reached over the next two years—it is still unclear whether negotiations will continue—the prospect of ratification would be problematic and implementation would include significant lags. World trade negotiations would therefore not have any impact on actual trade flows over the forecast period.

Even without a new world trade agreement, we expect trade liberalisation efforts to continue to make moderate progress on the bilateral and regional levels—ASEAN, for example, recently concluded a host of free-trade agreements with Australia, New Zealand and India. In fact, the momentum of globalisation is such that further integration of the world's economies seems likely, even without a further boost from a multilateral trade deal. At the same time, however, it is likely that the number of special measures against dumping and other unfair trade practices will increase. The widespread perception that China manipulates its exchange rate to gain global market share means that Chinese exports will be the main target of such measures.

Commodity prices

Commodity price forecasts

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Oil prices										
Brent; US\$/b	38.30	54.44	65.39	72.71	98.44	65.00	68.25	82.00	89.50	80.75
Non-oil commodities^a										
Total	13.5	4.0	31.2	20.8	15.4	-24.0	0.3	0.3	3.4	3.1
Food, feedstuffs & beverages	8.5	-0.5	16.1	30.9	30.2	-26.4	0.8	0.8	4.8	5.8
Beverages	7.2	20.4	8.6	14.5	19.5	-16.7	-8.5	1.9	3.3	5.9
Grains	6.1	-4.8	25.7	35.4	28.0	-28.0	12.2	4.0	5.0	7.0
Oilseeds	13.8	-9.3	3.0	46.4	40.6	-31.2	-12.5	-7.2	6.2	4.0
Sugar	1.0	37.9	49.5	-32.0	30.1	0.2	6.9	4.5	-0.9	-1.7
Industrial raw materials	21.0	10.2	49.6	11.2	-1.0	-20.4	-0.5	-0.4	1.5	-0.7
Metals	37.1	16.5	62.4	10.6	-6.0	-28.1	0.1	2.7	4.6	0.3
Fibres	-10.4	-10.0	6.4	18.1	7.4	4.6	4.7	-6.4	-5.9	-1.1
Rubber	20.3	12.7	38.7	7.0	26.1	-5.2	-9.8	-6.3	-4.0	-6.3

^a % change in US dollar prices.

Source: Economist Intelligence Unit.

Oil prices continue to fall

Oil: Crude oil prices have been in freefall since reaching a peak of US\$147/barrel on July 11th for West Texas Intermediate (WTI). The run-up in prices, which caused WTI to rise from US\$96/b at end-2007 to its mid-July peak, was driven by fears over both short- and longer-term supply, with geopolitical issues dominating short-term concerns and disappointingly weak non-OPEC output driving longer-term fears. The oil market appeared to be ignoring mounting evidence of a sharp slowdown in the US economy this year. Oil prices were also being supported by speculative investor interest, with oil perceived as a hedge against the weakness of the US dollar and rising inflationary expectations. Furthermore, investors regarded the commodity markets as a relatively safe haven, given the ongoing weakness in both equity and bond markets.

The strengthening of the US dollar since July was the catalyst for a turn in the fortunes of oil, although subsequent financial market turmoil has been an additional factor depressing prices. As the financial crisis unfurled, outflows from the commodity asset class soared, partly in a bid to cover losses or margins elsewhere but also as part of the wider deleveraging process. By October, it had also become clear that the financial crisis heralded the start of a sharp global economic slowdown, with significantly negative consequences for global oil demand.

OPEC seems likely to cut production

As oil prices hovered at around US\$100/b, OPEC met on September 9th for the first time in six months. The cartel had repeatedly blamed the speculative interest in the oil market, geopolitical tensions and refinery bottlenecks for the rise in prices in the first half of this year, and had cautioned that supply was more than adequate to meet faltering demand. Against this background, Saudi Arabia—arguably in response to pressure from consuming countries—had steadily increased output by around a total of 700,000 barrels/day (b/d) since the end of last year. At the September meeting, OPEC reiterated its stance that the market was well supplied and called for strict compliance with existing

OPEC quotas. This represents a cut of about 520,000 b/d in OPEC output. However, this failed to stem the decline in oil prices, and on October 24th OPEC held an emergency interim meeting, where it was decided to cut output from OPEC-11 by a further 1.5m b/d from November 1st. (OPEC output in October was already 700,000 b/d lower than its peak in June.)

By early November there were signs that Saudi Arabia was enacting supply cuts, and the UAE and Kuwait also announced measures to limit supply (although the UAE's production is typically low in November because of annual maintenance procedures). OPEC is planning to meet again in December and further cuts are likely. However, compliance is expected to be poor in a falling market, particularly from states, such as Iran and Venezuela, that have factored higher oil prices into their spending plans.

Global oil demand growth will be weak in 2009-10

Despite reduced output from OPEC, we expect the oil market to be oversupplied in 2009, owing to a marked slowdown in demand growth. In the third quarter of this year, global oil demand contracted by 0.3% year on year, according to the International Energy Agency (IEA), with US demand falling by nearly 6%. Given that we expect demand from the EU and Japan to continue their long-term declines and US demand to remain weak, total OECD demand is now expected to contract by nearly 3% in 2008.

A further decline of over 2% is forecast in 2009 as OECD growth remains in the doldrums. We have revised down our forecast of OECD oil demand in 2010 to a further contraction of 1% (previously a rise of 0.2%), in tandem with downward revisions to our forecasts for global growth in that year as the current economic slowdown proves deeper and more prolonged. Further out, despite modestly stronger economic growth, we forecast oil consumption in the OECD growing at an annual average of just 0.4% in 2011-13. Growth in demand will be constrained by the increasing use of ethanol or biofuels in transport fuel and heightened efforts at fuel efficiency, particularly in North America.

Demand growth outside the OECD will also slow in 2009-10 to an annual average rate of 2.8%. We expect the progressive lifting of retail fuel price subsidies in Asian and Middle East countries during this year to have a negative impact on demand. Furthermore, the severity of the downturn in the OECD is likely to lead to markedly weaker GDP growth in the emerging world, thus curtailing growth in the energy and transport sectors. By 2012, we expect growth in oil demand to be recovering in non-OECD countries led by China, India and the Middle East. Growth is likely to be particularly strong in India in the latter half of the forecast period, as rising car ownership boosts demand for transport fuel. As a result, global demand is expected to rise to an annual average of 2% in 2011-13, with non-OECD demand averaging 3.8%.

Growth in non-OPEC oil production is likely to be disappointing

Growth in non-OPEC oil production is expected to be relatively weak in 2008-10. Russian oil production is expected to be broadly flat in 2008-09, before rising modestly in the remainder of the forecast period. In addition, the declines in production in Mexico and Norway have been more severe than expected this year. On balance, we expect non-OPEC supply to rise by an annual average of just 0.5% (excluding the impact of Indonesia becoming a non-OPEC producer

in 2009) in 2008-10, primarily on the back of gains in production in Brazil, the US, the former Soviet Union and China.

OPEC has the potential to increase output

OPEC is well positioned to take up any slack in the market. Saudi Arabia has a number of large projects coming on stream—the 500,000-b/d Khursaniya field, which started pumping in August 2008, and the 1.2m-b/d Khurais field (due to come on stream in 2009), both of which will supply light crude to the market. Iraqi production reached 2.47m b/d in the second quarter of 2009, but production eased in the third quarter to 2.33m b/d, according to the IEA. Iraq appears able to maintain and improve on these levels, barring any resumption of attacks on the distribution network. Nigeria, Angola, Qatar and Libya also have the potential to increase output. However, over the next year, according to our demand estimates, the call on OPEC will be limited.

In the latter half of the forecast period, we expect growth in OPEC supply to average 3.5% a year in 2010-13 on the back of higher output from Nigeria, Angola and Iraq in particular. Saudi Arabia plans to have its 900,000-b/d Manifa field on stream in 2011, but much of this heavy oil will replace declining output from some existing fields. Additional non-OPEC supply is likely from the former Soviet Union (although Kazakhstan's massive Kashagan field looks unlikely to come on stream until after 2013), Brazil and Russia. Canada's ambitious oilsands production is unlikely to see any significant results before 2013.

The risks to supply are on the downside

Geopolitical risk will continue to weigh heavily on our supply forecasts, however. Tensions between the West and Iran over its nuclear programme remain high, a resumption of security problems in Iraq is possible and civil unrest in Nigeria continues.

Investment is likely to be lower

The trend towards "resource nationalism"—with national oil companies accounting for an increasing share of global oil output—has also raised the risk of politically motivated disruptions to supply in recent years. However, the ongoing crisis in global credit markets and the sharp fall in global oil prices could mean that national oil companies will not be in such a good financial bargaining position relative to the multinational oil companies. Nevertheless, it seems likely that investment in the oil industry will fall in 2009-10, partly because lower prevailing prices will undermine the feasibility of many projects, but also because of tighter credit conditions. This is likely to lead to a resumption of concerns about long-term supply once growth in consumption starts to recover in the latter half of the forecast period.

Prices will fall, but will stabilise at a high level

On balance, we expect prices to remain relatively depressed for the remainder of this year, owing to concerns about weak demand and the impact of lower retail price subsidies, particularly in Asia. This will generate average prices for the year of US\$98/b. Prices are expected to continue to fall in 2009 on the back of persistently weak global demand, coupled with healthy growth in OPEC capacity. Stocks are expected to build during 2008-10.

We expect prices to fall to an average of US\$52/b in the first quarter of 2009, before picking up during the year partly owing to supply cuts by OPEC member states and little growth in non-OPEC output. The prospect of some recovery in non-OECD demand in 2011 will propel prices slightly higher in 2010 to an average of US\$68/b.

However, by this time, as signs of a strengthening global economy emerge, we expect renewed market concern about the longer-term supply picture. This will particularly be the case if, as we believe, the oil industry suffers from sharply lower levels of investment in 2009-10 owing to a lack of available liquidity and the higher cost of credit, coupled with relative weak and volatile oil prices. On the demand side, we forecast a further acceleration in growth as oil usage starts to increase in more developing countries (including India), triggering a renewed tightening in the global market.

Speculation has boosted commodity prices

Hard commodities: Following weakness in the second half of 2007, the prices of base metals rallied strongly in the first quarter of this year, hitting new highs. This appears to have been partly the result of steady buying activity by investment funds that have been moving more of their capital into the commodities asset class. Disruptions to supply, including severe snowstorms in China and power shortages at many African and Chilean mines, coupled with rising production costs (particularly energy costs), also contributed to strengthening prices.

Prices subsequently eased owing to signs of a marked downturn in OECD demand and the likelihood that this will spread and dampen growth in the industrialising emerging countries in Asia and the Middle East. Given that the downturn in the OECD is largely consumer-led, the construction and transport sectors have been hard hit, and these are two of the largest markets for base metals. By September, as the credit crisis deepened, the prices of base metals went into freefall.

There appears little prospect of a significant recovery in base metals prices in 2009 given weak global demand, but we do not expect prices to fall much lower than the levels reached in the fourth quarter of this year. Prices are forecast to remain in the doldrums in 2010 as demand fails to pick up significantly. In the medium to longer term, we are more optimistic about the prospect for base metals prices. If economic growth bounces back strongly in the developing world and urbanisation continues, the demand for metals in infrastructure projects, housing and commercial property developments as well as transport needs will be high. Furthermore, like the oil sector, we expect investment in the mining sector to fall sharply in the wake of the ongoing credit crisis and the higher cost of capital. This could mean that supply in 2011-13 will be lower than currently forecast.

Natural rubber prices are also expected to fall in 2009-10 as lower oil prices reduce the price of synthetic rubber and increase its price competitiveness in relation to natural rubber. Our forecast for fibres, particularly cotton, remains relatively bullish. Reduced US cotton plantings (as farmers switch to more lucrative crops, particularly grains) will mean that supply of cotton, and wool to a lesser extent, will continue to lag behind demand. The removal of US quotas on textile imports from China on January 1st 2009 is also expected to boost growth in cotton consumption, despite the wider economic downturn.

Soft commodity prices will fall sharply in 2009

Soft commodities: The food, feedstuffs and beverages (FFB) index rose by 31% in 2007, owing to drought in key production areas, surging biofuel demand, reduced crop acreage, robust growth in Chinese demand and declining stocks.

The index is expected to rise by an average of 30.2% in 2008, with gains early in 2008 only partly offset by falls in the second half of the year.

The early signs are that the harvests for most grains and oilseeds are good, and we therefore expect prices to fall sharply in 2009. Moreover, lower oil prices in the second half of 2008 will start to feed through to cheaper fertiliser costs, and lower transport and distribution costs of agricultural producers. Growth in meat consumption in the emerging world is expected to slow in 2009-10, in line with the slowdown in growth in disposable incomes. As a result, growth in demand for grains and oilseeds for animal feed purposes will decline. However, stocks of many of the world's key soft commodities remain low, and any small disruption to supply could lead to a renewed spike in prices. One of the few commodities that is expected to experience a relatively strong price trend in 2009-10 is sugar, largely owing to demand from the biofuels industry.

In the medium term, we expect a resumption of rising agricultural prices owing to an ongoing structural shift upwards in demand with rising emerging-market consumption, particularly for livestock feed, and the impact of biofuel production. (Biofuel policies in the US and EU have recently been criticised for reducing the amount of foodstuffs available for human consumption, but we do not envisage that the policies will be abandoned during the forecast period.)

There is also ongoing structural change on the supply side of the equation with increasing urbanisation (and less arable land), declining global water levels, low levels of investment and the unpredictable consequences of climate change on weather patterns.

Increased supply will lead to lower beverage prices in 2008-09

Beverage prices rose by just under 15% in 2007, representing the sixth consecutive year-on-year increase. Depleted stocks for robusta coffee and uncertainty about the outlook for the Brazilian crop supported coffee prices, and African crop shortfalls, owing to dry weather, boosted cocoa prices. In 2008 the supply response has been positive, allowing markets to return to balance. As stocks build up, this will be reflected in a decline in prices in 2009-10. As usual, forecasts are vulnerable to climatic changes: the arrival of another El Niño global weather phenomenon could seriously alter production and price prospects, as could a return to civil war in Côte d'Ivoire, which is a major cocoa producer.

Individual commodity price forecasts

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Aluminium (US\$/tonne)	1,720.8	1,899.5	2,594.0	2,661.2	2,790.4	2,125.0	1,941.3	2,000.0	2,125.0	2,200.0
Barley (US\$/tonne)	142.3	131.5	151.2	263.4	264.8	237.5	247.5	230.0	235.0	240.0
Cocoa (US cents/lb)	70.2	69.8	72.1	88.6	116.6	98.0	96.5	90.0	92.0	95.0
Coconut (US\$/tonne)	660.5	627.9	608.5	918.8	1,223.4	842.2	763.6	687.1	724.6	749.5
Coffee (Arabica) (US cents/lb)	80.5	114.9	114.4	123.5	139.7	107.0	95.5	104.0	108.0	115.0
Coffee (Robusta) (US cents/lb)	36.0	50.6	67.6	86.6	106.0	85.9	75.0	78.0	85.0	95.0
Copper (US cents/lb)	129.5	166.8	305.6	322.3	315.5	200.0	203.8	220.0	235.0	225.0
Copra (US\$/tonne)	450.3	413.5	402.5	568.3	814.6	593.5	538.1	484.2	510.6	528.2
Cotton (US cents/lb)	62.0	55.2	58.6	64.8	77.8	86.5	91.3	85.0	80.0	82.0
DRAM chip (all types) (US\$; average selling price)	4.35	3.58	3.74	3.81	3.74	3.74	3.75	3.70	3.75	3.50
Flash memory (US\$; average selling price)	4.65	4.53	4.14	4.45	4.51	4.42	4.42	4.45	4.44	4.45
Gold (US\$/troy oz)	409.5	445.0	604.5	696.7	863.2	707.5	625.0	637.5	590.0	565.0

Individual commodity price forecasts

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Integrated circuits (US\$; average selling price)	1.70	1.66	1.56	1.70	1.71	1.69	1.69	1.59	1.60	1.60
Iron ore (US cents/dry metric tonne unit)	37.9	65.0	77.4	84.7	140.6	119.5	95.6	101.3	105.0	110.0
Lead (US cents/lb)	40.3	44.3	58.4	117.2	99.0	65.0	76.3	78.0	82.0	85.0
Maize (US\$/tonne)	111.7	98.9	123.1	170.1	230.3	168.8	185.0	195.0	210.0	225.0
Microprocessor (US\$; average selling price)	103.55	106.48	96.37	100.00	101.00	98.00	98.00	99.00	98.00	100.00
Nickel (US\$/lb)	6.3	6.7	11.0	17.0	10.6	9.6	11.3	11.0	10.5	10.6
Oil: Brent (US\$/b)	38.3	54.4	65.4	72.7	98.4	65.0	68.3	82.0	89.5	80.8
Oil: Dubai (US\$/b)	33.5	49.2	61.4	68.4	91.3	58.6	61.5	73.9	80.7	72.8
Oil: IEA (US\$/b)	37.9	54.0	64.9	72.1	97.6	64.5	67.7	81.3	88.8	80.1
Oil: WTI (US\$/b)	41.4	56.4	66.1	72.3	102.8	74.0	83.6	87.5	91.3	82.4
Palladium (US\$/oz, London)	240.0	203.5	318.8	350.3	367.3	281.3	325.0	375.0	400.0	415.0
Palm kernel oil (US\$/tonne)	647.5	633.3	583.5	888.8	1,064.5	818.8	812.0	804.1	808.0	810.6
Palm oil (US\$/tonne)	471.3	422.0	478.3	780.3	992.3	674.2	611.3	550.0	580.0	600.0
Platinum (US\$/oz)	845.6	896.2	1,135.0	1,299.0	1,585.0	1,075.0	1,200.0	1,500.0	1,700.0	1,800.0
Rapeseed oil (US\$/tonne)	685.3	669.3	793.8	969.1	1,372.2	993.5	851.9	750.0	800.0	825.0
Rice (US\$/tonne)	244.8	291.0	311.0	335.2	696.2	550.0	450.0	430.0	425.0	435.0
Rubber (US\$/tonne)	1,479.5	1,667.5	2,312.8	2,474.4	3,120.3	2,957.5	2,667.5	2,500.0	2,400.0	2,250.0
Silver (US cents/troy oz)	669.1	733.8	1,156.9	1,340.8	1,496.1	985.0	913.6	932.2	970.7	993.6
Sorghum (US\$/tonne)	117.8	104.3	139.3	185.3	225.3	180.0	175.0	190.0	210.0	225.0
Soybean oil (US\$/tonne)	615.8	544.8	598.8	881.4	1,298.8	853.3	772.2	750.0	800.0	835.0
Soybeans (US\$/tonne)	301.5	267.8	265.5	378.2	536.8	380.2	325.6	300.0	315.0	320.0
Soymeal (US\$/tonne)	259.5	232.5	220.3	320.5	454.8	323.1	276.3	250.0	275.0	300.0
Steel (US\$/tonne)	534.2	504.3	556.0	554.8	900.8	590.0	565.0	662.5	725.0	750.0
Sugar (US cents/lb)	7.2	9.9	14.8	10.1	13.1	13.1	14.0	14.6	14.5	14.3
Sunflowerseed oil (US\$/tonne)	684.3	677.3	658.0	1,021.9	1,554.8	942.6	852.8	890.0	920.0	950.0
Tea (US\$/kg)	1.7	1.6	1.9	2.1	2.4	2.3	2.1	2.1	2.1	2.2
Tin (US\$/lb)	3.9	3.4	4.0	6.6	8.8	7.5	6.9	6.5	6.6	6.7
Wheat (US\$/tonne)	160.8	158.5	200.3	268.7	334.5	238.8	271.3	280.0	290.0	310.0
Wool (Aus cents/kg)	775.3	706.3	752.8	955.3	905.3	872.5	902.5	850.0	800.0	750.0
Zinc (US cents/lb)	47.7	62.6	147.6	147.2	88.5	65.8	80.0	72.0	70.0	75.0

Source: Economist Intelligence Unit.

Global assumptions

(Forecast closing date: November 6th 2008)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP growth (%)										
World (market exchange rates)	4.0	3.5	4.0	3.7	2.4	0.9	2.0	2.9	3.2	3.2
US	3.6	2.9	2.8	2.0	1.4	-0.4	0.8	2.0	2.3	2.5
Japan	2.7	1.9	2.4	2.0	0.3	-0.2	0.9	1.0	1.2	1.2
Euro area	2.2	2.0	2.9	2.6	1.1	-0.3	0.7	1.5	2.0	2.1
China	10.1	10.4	11.6	11.9	9.8	7.5	7.5	8.6	8.4	8.2
World (PPP exchange rates)^a	4.8	4.4	5.0	4.8	3.6	2.0	3.0	3.9	4.2	4.2
OECD	3.2	2.6	3.1	2.6	1.4	-0.1	1.1	2.0	2.5	2.5
Non-OECD	7.7	7.4	8.1	8.4	7.0	4.8	5.6	6.4	6.4	6.5
World trade growth (%)										
Goods	10.8	7.5	9.1	7.4	4.9	-0.5	3.5	4.5	5.2	5.7
Consumer price inflation (%; av)										
World	2.8	3.0	3.2	3.4	5.2	3.2	2.8	3.0	3.0	3.0
US	2.7	3.4	3.2	2.9	4.2	0.9	1.1	1.9	2.0	2.1
Japan	0.0	-0.3	0.2	0.1	1.6	0.8	0.8	1.0	1.1	1.1
Euro area	2.1	2.0	2.0	2.1	3.4	1.7	1.5	1.9	1.9	1.8
China	3.8	1.8	1.8	4.8	6.4	4.0	4.0	4.2	4.1	4.1
OECD ^b	1.9	2.2	2.2	2.1	3.5	1.4	1.3	1.7	1.8	1.8
Export price inflation (%)										
Manufactures (US\$)	9.5	3.6	3.8	4.4	7.1	-3.8	2.0	2.5	2.7	0.9
Commodity prices										
Oil (US\$/barrel; Brent)	38.30	54.44	65.39	72.71	98.44	65.00	68.25	82.00	89.50	80.75
% change	32.7	42.1	20.1	11.2	35.4	-34.0	5.0	20.1	9.1	-9.8
World non-oil commodity prices (US\$; % change)	13.5	4.0	31.2	20.8	15.4	-24.0	0.3	0.3	3.4	3.1
Food, feedstuffs & beverages	8.5	-0.5	16.1	30.9	30.2	-26.4	0.8	0.8	4.8	5.8
Industrial raw materials	21.0	10.2	49.6	11.2	-1.0	-20.4	-0.5	-0.4	1.5	-0.7
Main policy interest rates (%; end-period)										
Federal Reserve	2.25	4.25	5.25	4.25	0.50	0.50	1.25	3.00	4.50	4.50
Bank of Japan	0.00	0.00	0.25	0.50	0.30	0.30	1.00	2.00	2.50	2.50
European Central Bank	2.00	2.25	3.50	4.00	2.75	1.75	2.25	3.25	3.75	3.75
Bank of England	4.75	4.50	5.00	5.50	2.00	1.00	1.50	2.75	4.00	4.75
Exchange rates (av)										
US\$ effective (2000=100)	94.1	92.8	92.4	88.8	83.6	89.6	88.3	86.8	85.2	84.7
¥:US\$	108	110	116	118	104	97	96	96	95	94
US\$:€	1.24	1.25	1.26	1.37	1.46	1.29	1.30	1.33	1.35	1.37
Rmb:US\$	8.28	8.19	7.97	7.61	6.94	6.73	6.52	6.39	6.31	6.24
US\$:£	1.83	1.82	1.84	2.00	1.86	1.63	1.69	1.79	1.81	1.82
C\$:US\$	1.30	1.21	1.14	1.08	1.06	1.15	1.10	1.06	1.03	1.04
¥:€	134	137	146	161	152	125	125	127	128	129
£:€	0.68	0.68	0.68	0.68	0.79	0.79	0.77	0.74	0.75	0.75
Exchange rates (end-period)										
¥:US\$	103	118	119	112	97	97	96	95	95	94
Rmb:US\$	8.28	8.07	7.79	7.29	6.77	6.63	6.42	6.37	6.26	6.23
US\$:€	1.35	1.18	1.32	1.46	1.28	1.30	1.31	1.35	1.37	1.37

^a The 82 countries covered by the Economist Intelligence Unit's Country Forecast service plus Iceland and Luxembourg. ^b Excluding those countries with GDP deflator inflation averaging above 10% during the 1990s.

Source: Economist Intelligence Unit.

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