# Global outlook

**Key changes since March 16th 2012**

- Rising bond yields in Spain have stoked fears that Europe's debt crisis may be returning. Markets had been calm since the start of the year, thanks to the injection of more than €1trn into financial institutions by the European Central Bank. Fiscal and growth worries in Spain reversed market sentiment, sent yields higher in Italy and triggered declines in global equity markets. Europe's rescue funds, at present, are not large enough to accommodate a crisis in Spain.
- The Economist Intelligence Unit has raised its 2012 forecast for GDP growth in the US to 2.2% from 1.9%. Consumer spending was buoyant in January and exceptionally strong in February, driven in part by car sales. Our outlook for the US, nonetheless, remains cautious. Disposable personal income has been falling in inflation-adjusted terms, suggesting that strong consumer spending may not continue. The jobs market also softened in March after a strong start to the year.
- We have made a small upward revision to our 2012 forecast for economic growth in China, to 8.3% from 8.2%. China's government is engineering a slowdown in the economy after risks of overheating emerged in 2011. The property market, which was especially frothy, has pulled back to a significant extent. This bodes well for a gradual, managed slowdown from a growth rate of 9.2% last year. China's greatest worry may now be political: infighting among factions at the highest level of government spilled into the open in March.
- We have raised our 2012 forecast for the price of crude oil (dated Brent, the European benchmark) to US$115/barrel from US$110/b. Prices have remained elevated since the start of the year, owing mainly to political risks over Iran's nuclear programme and the onset of sanctions. As the risk of military action fades in the second half of the year and markets are assured of adequate supplies, prices should begin to decline from the current level of around US$120/b.

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**Symbols for tables**

“0 or 0.0” means nil or negligible; “n/a” means not available; “–” means not applicable


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# World growth and inflation

**(Forecast closing date: April 17th 2012)**

**World summary**
(% change)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Real GDP growth (PPP exchange rates)** | | | | | | | | | | |
| **World** | **5.2** | **2.5** | **-0.9** | **5.0** | **3.7** | **3.2** | **3.8** | **4.1** | **4.3** | **4.3** |
| OECD | 2.7 | 0.1 | -3.8 | 3.1 | 1.7 | 1.3 | 1.8 | 2.0 | 2.2 | 2.2 |
| Non-OECD | 9.1 | 6.0 | 3.1 | 7.6 | 6.2 | 5.6 | 6.2 | 6.3 | 6.3 | 6.3 |
| **Real GDP growth (market exchange rates)** | | | | | | | | | | |
| **World** | **4.0** | **1.3** | **-2.4** | **4.0** | **2.5** | **2.2** | **2.7** | **2.9** | **3.0** | **3.1** |
| North America | 1.9 | -0.3 | -3.4 | 3.0 | 1.8 | 2.2 | 2.2 | 2.2 | 2.3 | 2.4 |
| Western Europe | 3.1 | 0.0 | -4.2 | 2.2 | 1.7 | -0.3 | 0.8 | 1.1 | 1.6 | 1.6 |
| Transition economies | 7.5 | 4.6 | -5.7 | 3.4 | 3.8 | 2.5 | 3.3 | 3.7 | 3.9 | 3.9 |
| Asia & Australasia (incl Japan) | 6.3 | 2.8 | 0.6 | 6.8 | 3.5 | 4.2 | 4.5 | 4.5 | 4.3 | 4.3 |
| Latin America | 5.6 | 4.0 | -2.0 | 6.0 | 4.4 | 3.7 | 4.2 | 4.4 | 4.1 | 4.2 |
| Middle East & North Africa | 4.9 | 5.3 | 1.5 | 4.1 | 3.2 | 4.0 | 4.2 | 4.8 | 5.0 | 4.9 |
| Sub-Saharan Africa | 7.0 | 4.8 | 1.2 | 4.4 | 4.4 | 4.0 | 4.9 | 4.5 | 4.8 | 5.0 |
| **Inflation (av)** | | | | | | | | | | |
| **World** | **3.4** | **4.9** | **1.5** | **3.0** | **3.9** | **3.3** | **3.2** | **3.1** | **3.2** | **3.2** |
| OECD | 2.4 | 3.6 | 0.5 | 1.8 | 2.8 | 2.3 | 2.1 | 2.1 | 2.2 | 2.2 |
| **Trade in goods** | | | | | | | | | | |
| **World** | **7.1** | **2.8** | **-12.0** | **14.1** | **5.8** | **4.0** | **5.6** | **6.0** | **6.4** | **6.5** |
| OECD | 6.4 | 2.0 | -12.9 | 13.3 | 5.0 | 2.4 | 4.1 | 5.0 | 5.4 | 5.6 |
| Non-OECD | 10.7 | 6.5 | -8.7 | 14.4 | 7.6 | 5.4 | 7.9 | 7.7 | 8.0 | 7.9 |

Source: Economist Intelligence Unit.

*Three years after the global economic trough, growth has been uninspiring*

Three years after the global economy reached its lowest point in three-quarters of a century, the recovery remains incomplete and the outlook uncertain. On March 9th 2009, the capitalisation of Morgan Stanley's global stockmarket index fell to US$26trn, nearly 60% below its 2007 peak. Today, the value of the world's stockmarkets has yet to return to the pre-crisis level—nor has the confidence of most consumers and businesses. The excesses of the last ten years—the personal debt accumulated early in the last decade and the public debt added during the recession—have saddled many countries with weak economic foundations and little or no resilience to shocks. This has left the US economy, in particular, struggling for a third straight year to lock in faster growth. It has left debt-ravaged Europe in recession and China manoeuvring unsteadily to deflate a bubble. On the brighter side, the global economy will grow again this year and the imbalances that built up over the past decade will continue to unwind. But global growth will be slower this year than last, and a host of risks—from elevated oil prices to war in the Middle East, to the collapse of Europe's single currency—will weigh on confidence and reduce spending and investment.

The brighter outlook for global growth that graced the New Year in January and February is beginning to fade. Political misjudgements in Spain have eroded the recovery in investor confidence that accompanied the injection of more than €1trn into regional financial institutions by the European Central Bank (ECB).

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Spain's bond yields, and those of Italy, are climbing again; although they are not nearly as high as last November, the risk of another sovereign crisis is rising. The US economy unquestionably strengthened in late 2011 and at the start of 2012, but the jobs market looked much less buoyant in March. China's economy remains a stand-out by developed-country standards, but a range of indicators have been weaker this year than many expected.

*The global economy will grow at a slower pace this year than last*

As a result, the Economist Intelligence Unit expects the global economy to grow by 2.2% at market exchange rates in 2012 (down from 2.5% in 2011). At purchasing power parity (PPP) exchange rates, which give more weight to emerging markets, growth will slip to 3.2% (from 3.7% last year). This will be the second consecutive year of declining economic growth, and the most advanced economies will, as a group, expand by just over 1%. By comparison, in 2007, the last year before the recession began, the global economy grew by 5.2% in PPP terms. Absent an asset price bubble, which fuelled growth during the middle years of the last decade, or extraordinary levels of government stimulus—which helped the global economy to grow by 5% in the bounce-back year of 2010—growth rates of 4-4.5% in 2013-16 are probably the best that can be expected, even under the best of circumstances. We believe that the global economy will accelerate from the current pace of just over 3% as the financial sector fully recovers from the recession, the euro zone economies resume growing in 2013, and emerging markets, especially India, return to a more buoyant growth path.

*The euro zone debt crisis is re-emerging*

Two risks threaten the global economy: a return of the euro zone crisis and climbing oil prices. Europe's sovereign debt struggles eased significantly in January after the ECB provided nearly €500bn in low-cost loans—so-called long-term refinancing operations (LTROs)—to the region's banks last December. The effect on sovereign funding markets was dramatic: yields on 10-year Spanish and Italian debt, which had soared above 7% in November, fell back to less than 5% in February and March. Clearly some portion of the ECB's lending to banks had been recycled into sovereign debt markets. Another lending round of just over €500bn in late February sustained the rally. Along with a successful restructuring of Greece's debt—a default, but an orderly one—and progress on a euro-zone-wide fiscal compact, financial markets were encouraged. Equity markets in developed countries enjoyed their strongest first quarter in years, investors' risk appetite returned, and consumer and business confidence in many countries climbed steadily.

Some of those gains are now under threat. The genesis of the new crisis was a series of missteps by Spain's government, including a unilateral decision—following a worse than expected outturn in 2011—to target a higher fiscal deficit in 2012 than had been agreed with euro zone authorities. Although Spain subsequently lowered the target and presented its most extreme budget since the Franco era, the damage had been done. A bond auction on April 4th failed to attract enough interest to pacify investors. By August 10th, Spain's 10-year bond yields had risen to nearly 6%, up by 70 basis points in little more than a week. Although the government seems committed to implementing its austerity budget, any bad news—financial strains at a big bank, an increase in Spain's already sky-high unemployment rate, unexpected tax or spending figures—could trigger a further surge in yields. This could make it very difficult, and

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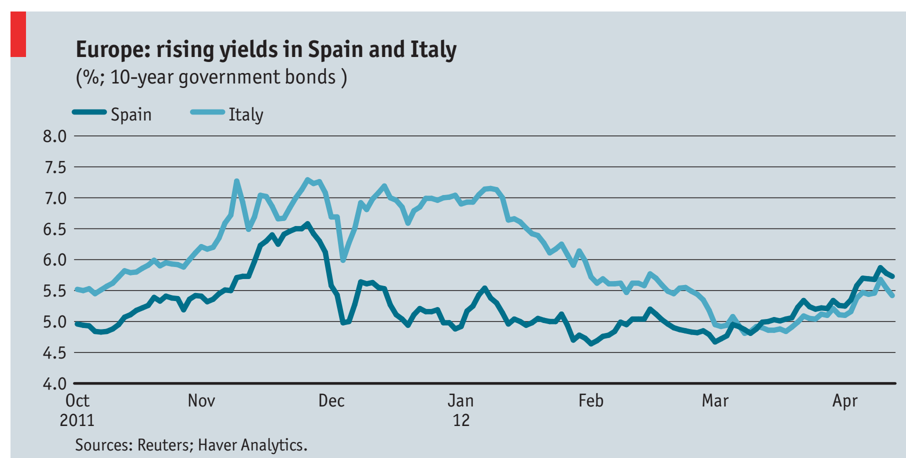
perhaps impossible, for Spain to continue funding itself in the markets. Spain's economy is five times the size of Greece's, and the euro zone's firewall is not currently sufficiently large to deal with a Spanish bailout. If one were to become necessary, it would require much more funding from Germany and France, pushing the euro crisis into a new and much more dangerous stage. A bailout in Spain would also quickly produce contagion effects in Italy's US$2.2trn economy, threatening, yet again, the existence of the euro zone.




*We still expect the euro zone to survive, but dependence on stimulus is growing*

None of this has changed our baseline forecast that the euro zone will survive in its current form for at least the next few years. Nor have we changed our assessment of a 30% risk of a euro zone break-up. Euro zone policymakers have made considerable progress in the past year, and the ECB and its president, Mario Draghi, have been creative, if leisurely, in fulfilling their lender of last resort responsibilities. Although underlying debt levels are still high and austerity measures will sap growth, a number of the most immediate threats—a disorderly default in Greece and a funding freeze among European banks—have been successfully addressed for now. Our most immediate concern is that the effects of the ECB's LTROs are already wearing off, and that markets will want further stimulus. This has been the pattern in the US, where investors have seemingly become addicted to the monetary easing programmes of the Federal Reserve (Fed, the US central bank). When Fed officials even hint that no further interventions are likely, disappointed markets sell off. Weaning investors off of stimulus becomes more difficult the more central banks provide it, and Europe may be entering this stage.

*Europe's economic fundamentals have not improved much in the past year*

Even if the current strains in the euro zone ease, the region's fundamentals look no better than they did a year ago. The periphery is uncompetitive, debt levels remain high, banks across the euro zone are still under-capitalised, austerity measures will exacerbate recession, and a lack of cohesion—and effective governance—within the single-currency zone is as much of a threat to sustained growth and orderly markets as it has ever been. The ECB, despite the recent back-up in Spain's yields, has played a major role in easing funding strains for both banks and sovereigns. Much of the credit for this goes to Mr Draghi, who found a way to ease market pressures without, apparently, violating the euro zone's many constraints on supporting profligate economies. Even at that, Mr Draghi's work is not done; Spain's latest dilemma will test his mettle, as will the

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inevitable push-back from German officials, who were not happy with the first two bank lending packages. We expect Mr Draghi to resist these pressures; although he does not have the freedom of, for example, Ben Bernanke, the Fed's chairman, to intervene aggressively to steady markets, we expect him to keep regional banks, and perhaps sovereigns, relatively well lubricated.

Although Mr Draghi has performed well, he remains surrounded by risk. Issues involving the "fiscal compact"—an agreement to police budgetary spending in euro zone countries—are not resolved, although the size and functioning of the euro zone bailout fund is somewhat clearer than it as a month ago. Deeper than expected contractions in Spain or Italy, a setback to their reform programmes, or a political crisis in Greece—could deflate market confidence in a matter of days. These market developments could race well ahead of any political effort to contain them (much as US officials in late 2008 were unable for many months to contain the crises at Lehman Brothers and AIG, a US insurance company). Yields on 10-year Portuguese debt, for example, rose above 17% at the end of January and were still around 12% in early April, about where they were for most of 2011.

Our other major concern is the price of energy. The rise in the price of crude oil in February and March, tied in part to tensions over Iran's nuclear programme, already appears to be slowing economic growth in some parts of the world, including the US. Oil prices would rise much higher—and the impact on global growth would be far more serious—if Israel were to launch a military attack on Iran's nuclear facilities, which it has threatened to do. Although this is not our baseline forecast, we would not rule out a 30-50% increase in crude oil prices in a matter of weeks—if not days—if military conflict in or around Iran disrupted oil supplies, or even threatened disruption. Our principal assumption is that, even in the absence of military action, the price of oil will remain elevated in the first half of 2012—at or around US$120/barrel for the European benchmark, dated Brent—because of the combined effects of political tensions over Iran, supply disruptions and still-strong demand in developing countries.

*An oil price shock could stop the global economy in its tracks*

The European crude oil benchmark, dated Brent, rose to above US$128/b in early March, its highest level since July 2008. (The price had fallen to around US$120/b by April 10th as weaker economic data from the US and new strains in Europe curtailed investors' expectations of economic growth, and hence the demand for oil.) Higher energy prices have a unique ability to sap economic growth, even for large developed economies like those in Europe and the US that are driven mainly by services, not energy-dependent manufacturing. Even though the US economy is less energy-intensive than it was even a decade ago, petrol is an important—and very visible—expense for most Americans. The euro zone, albeit less energy-intensive than the US, imports a greater share of its crude oil, and rising global energy prices will be particularly damaging during a time of recession. The sharp rise in oil prices in late 2010 and the opening months of 2011 curbed what appeared to be the beginning of a global recovery. In percentage terms, the increase this time has not been as great, but the risk of a genuine oil price shock is much greater. (See Risk scenarios in the next section for a further discussion.)

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Israel, for example, has said that it will not allow Iran to develop a nuclear weapons capability, and has promised military action to prevent this. Iran, for its part, continues to maintain that its nuclear programme is purely for civilian purposes, but the government in Teheran would certainly respond against Israel—and potentially against the US—if Iran were attacked. Military action between Israel and Iran would cause an immediate spike in the oil price; if the US were to be drawn into the conflict—possibly because of an Iranian strike against a US military base or warship in the Middle East—the price would rise even higher. The highest price ever for Brent crude, in nominal terms, was around US$145/b in June 2008, but the price rise could rise by US$30-40/b above this level in the event of military action involving Iran and the US.

*Iran has threatened to close the Strait of Hormuz*

Another risk, albeit less likely, is that Iran closes access to the Strait of Hormuz, through which 20% of the world's oil travels, in retaliation for US and EU sanctions against the regime. Such a move would damage Iran's oil sales as much or more than those of other countries, depriving the government of its main source of income. For this reason, we do not expect Iran to act on its threat. That said, action to block the Strait cannot be ruled out. The US has vowed to reopen the waterway, but this could take several weeks, causing a major disruption to oil flows. Prices would rise sharply, and could approach US$200/b until tensions eased and something approaching normal access returned. While neither of these scenarios—military action against Iran or a disruption to oil transport through the Strait of Hormuz—is part of our baseline forecast, political tensions surrounding Iran's nuclear programme remain uncomfortably high, and could rise as US financial sanctions tighten and the EU's timetable of July 1st for cutting off all purchases of Iranian crude draws closer.

*The US economy was strong early in the year*

The recession in the euro zone is being offset globally by a more promising—if less than stellar—prognosis for the US. The US economy, by almost any measure, remains weak: the unemployment rate is alarmingly high (above 8%), house prices continue to fall and debt levels are elevated. But the US is showing signs of steady progress on many fronts, and in the fourth quarter of 2012 the economy grew at its fastest rate (3%) in six quarters. The hand-off to the New Year appears to have been strong: consumer spending grew at an annual rate of 1.8% in January and by just under 6% in February. This has persuaded us to raise our first-quarter growth forecast, and with that our forecast for the full year. We now expect real GDP in the US to rise by 2.2% in 2012, up from our forecast last month of 1.9%. This is hardly cause to celebrate, especially after the economic collapse in 2009 and the tepid recovery in 2010-11.

*US growth may fade as the jobs market falls back and incomes languish*

Despite the upgrade to our US forecast, we are far from convinced that the recent recovery will be sustained. Unsurprisingly, the labour market softened in March—the economy created a total of just 120,000 jobs, after averaging around twice that many in each of the previously three months. We have argued that the jump in growth in the fourth quarter and the opening weeks of this year represented mostly temporary factors: an unusually mild winter, pent-up demand for durable goods, especially cars, after the summer slump of 2011, and a build-up in inventories. The housing market has been improving, but from an exceptionally low base, and it will contribute only modestly to growth in 2012.

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Most importantly, incomes, which provide the fuel for spending, have been weak; real personal disposable income fell, month on month, in January and February. Rising incomes are essential to support spending; without a rise in incomes, it is difficult to see how strong consumption can continue. For now, consumers are running down their savings—the savings rate fell sharply last month—but this is not a sustainable trend. With petrol prices at close to a record level—gasoline was selling at US3.92/gallon in early April, the highest price ever for this time of the year and just below the all-time record of US$3.99/gallon—consumer and business confidence could easily fade.

*Emerging markets are facing a mixed picture*

The muddled outlook for the US and the near-certain recession in Europe is forcing emerging markets in Asia, Africa and Latin America to adjust to reduced import demand from their biggest customers, and less investment capital. The monetary tightening cycle that was under way in many emerging markets in early 2011 has either come to a halt or gone into reverse as central banks have quickly lowered interest rates. Since late August 2011, Australia, Brazil, Chile, Denmark, the euro zone, Romania, Russia, Serbia, Israel, Indonesia, Georgia, Pakistan, the Philippines, Thailand and Turkey, among others, have all lowered rates. Even China, whose economy grew by 9.2% in 2011 as a whole and by a better than expected 8.9% in the final quarter of the year, lowered the reserve ratio for banks in November and again in February this year. Further reductions are likely, possibly in the next few weeks as evidence of a slowdown in China builds.

The picture for emerging markets is quite unsettled. Industrial production in South Korea, a bellwether for global industrial performance, fell in the final three months of 2011, month on month, but rose solidly in January and February this year, a sign, perhaps, of better international demand. Production in Thailand, Malaysia and Philippines was also generally strong in the opening months of the year. (Data for economies in Greater China are typically skewed in the first two months of the year by the Chinese New Year.) Industrial production appears to be recovering in India but is still falling in Poland as the euro zone crisis sapped demand in many of its best markets. Most noticeably, exports were fading in key Asian economies: overseas sales by Taiwan and South Korea declined year on year in early 2012, as they did in a number of other export-dependent countries. The overall picture, although mixed, is still generally weak as emerging markets acclimatise to weaker demand in Europe, slower growth in China, and a US economy that is unlikely to expand by much more than 2% this year.

Risk appetite will be an important factor for emerging markets in 2012. Early in the year, the stabilisation in the euro zone and improving prospects in the US sent a wave of cash into emerging markets in search of greater returns. But the re-emergence of the European sovereign debt crisis and weaker data in the US have persuaded some investors to take cover. (This is one reason that advanced-economy bond yields are falling again after rising earlier in the year.)

*China will successfully manage a slowdown, but the path could be bumpy*

Speculation continues to grow about how China's government will respond to the economic slowdown that is now under way. After an initial lag, the economic slump in Europe is having a clear impact on the Chinese economy. China's merchandise exports grew by just 9% year on year in the final quarter

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of 2011, half the rate at the start of the year, as demand in Europe and the US weakened. The results in early 2012 were more dramatic: China reported a trade deficit in February of US$31.5bn, the largest ever. Owing to the effects of China's New Year celebration—it does not fall in the same week each year—most analysts combine China's January and February economic figures to get a truer picture of performance. Even with that, China ran a US$4bn deficit at the start of 2012. Exports to the EU fell by 1.8% year on year in the first quarter after rising by 32% in 2010 and by 14% last year (2012 will be the first year in recent history in which China exports more to emerging markets than to advanced economies). March also sent signals of a slowdown: imports, an indicator of domestic demand, rose by around 5%, by far the weakest showing since the global slump in 2009 (discounting months affected by holiday distortions). China's prime minister, Wen Jiabao, hinted in early June that "fine tuning" measures may be announced soon; we expect at least another reduction in the bank reserve requirement, and would not rule out a small interest rate cut.

Our central forecast is that the authorities will manage a gradual slowdown in the economy and keep growth above 8% in 2012 (although the government recently announced a new medium-term growth target of 7.5%). However, there are downside risks, most notably the euro zone recession and the prospect of higher oil prices and the impact that would have on both China and its main export customers. Construction activity was essentially flat in the opening months of the year as the property market cooled dramatically. Industrial production grew by just over 11% in January and February combined, the weakest level since the low point of the global slowdown in the first half of 2009. Credit growth has also been very slow to start the year and is below government targets. We expect the Chinese authorities to engineer a soft landing for the economy, but the chance of a worse outcome cannot be ruled out. That might prompt the Chinese government to implement a major stimulus on a similar scale to that of 2008, especially since a once-in-a-decade leadership reshuffle is due to take place later this year. The spectre of mass lay-offs and labour unrest in China's manufacturing belt could frighten policymakers into abandoning their current prudence. Turning to the policy levers with which it is familiar, the party could sanction another investment splurge on infrastructure projects, funded through a dramatic expansion in bank credit. Certainly, the government has the fiscal capacity to launch another spending programme.

*Another huge stimulus plan in China would be ill-advised*

Although another large stimulus package might stave off a slowdown for one or two years, it would drastically dim the long-term outlook for China's economy. Plans to boost private consumption, implement productivity reforms, and begin exchange-rate and capital-account reform would be suspended. The government's overall debt burden, which has grown considerably since 2008 owing to a dramatic rise in local government liabilities, would mount to dangerously high levels. Three to five years after such a stimulus, as the economy began to cool and other drivers of growth failed to supplant investment, the resulting credit squeeze would prompt a sharp rise in corporate bankruptcies, non-performing loans and unemployment. The consequences for the entire political economy could be calamitous. If China is serious about moving towards a

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more sustainable development model, it should think carefully when weighing its stimulus options this year.

*Political risks in China are becoming more pronounced, and spilling into the open*

China's political environment also bears watching. The recent purging of Bo Xilai, a rising star in the Chinese Communist Party (CCP) and former mayor and party boss in Chongqing municipality, was one of the most dramatic political events in years. In the aftermath of the sacking of Mr Bo, the Chinese blogosphere has been rife with rumours about a wider leadership crisis in China. In the absence of solid evidence, we are assuming that most of these rumours—and particularly those claiming a coup had been attempted—are wild gossip. But the fact that tensions among the country's normally secretive elite are breaking into the open is both a reminder of structural weaknesses in China's one-party political system and a source of potential instability in itself.

*Emerging economies need strong growth in their export markets*

Despite the increasing role of domestic demand in many developing countries, most cannot grow at anything approaching trend rates if economic activity remains chronically slow in the West. Many emerging markets, especially in Latin America and Africa, would also be hurt if the demand for commodities falls, bringing prices down. Many emerging-market commodity exporters have benefited enormously from the improvement in terms of trade that have accompanied rising prices. If commodity prices slump, countries such as Brazil and South Africa are likely to see reduced capital inflows, weaker currencies and slower economic growth.

The effects of the slowdown in the West will be greatest on emerging markets that are significantly exposed to global trade, and on countries that are large commodity producers, as our outlook for raw materials prices continues to be bearish. These negative effects will be somewhat tempered by the slowly rising level of domestic demand in many emerging markets, although we disagree with the view that anything like a complete decoupling of developed and developing economies is at hand. Moderately good performance in most emerging markets will help countries such as Germany and Japan, which depend on rising capital goods penetration into the emerging world to support growth, and highly indebted economies such as the US and the UK, where boosting export growth is vital to help offset the weakness of domestic demand.

## Risk scenarios

Events may diverge from the Economist Intelligence Unit's forecast in ways that affect global business operations. The main risks are represented by the following scenarios.

*Very high risk = greater than 40% probability that the scenario will occur over the next two years; high = 31-40%; moderate = 21-30%; low = 11-20%; very low = 0-10%.*

*Very high impact = change to global annual GDP compared with the baseline forecast of 2% or more (increase in GDP for positive scenarios, decrease for negative scenarios); high = 1-1.9%; moderate = 0.5-0.9%; low = 0.2-0.5%; very low = 0-0.1%.*

*Risk intensity is a product of probability and impact, on a 25-point scale.*

### Positive scenario—Unprecedented policy response after Greek exit prevents contagion to other troubled economies

*High risk; High impact; Risk intensity = 16*

The potential for a near-term Greek withdrawal from the euro zone has diminished following the agreement of a write-down of its debt in early March. Nevertheless, Greece remains insolvent, and the probability of an exit from the euro zone within the next two years remains high, at around 40%. Greece's latest €130bn bailout comes with a host of strings attached

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and, if it becomes politically impossible to fulfil, Greece could find itself ejected from the euro zone at some point in the medium term. In such a scenario, the remaining 16 member states, major central banks and key global institutions would seek to "circle the wagons", providing unprecedented levels of support to other at-risk countries in an effort to prevent a wholesale break-up of the euro zone. In an encouraging development, the provision of over €1trn by the European Central Bank (ECB) in low-cost loans to regional financial institutions in December 2011 and February 2012 has helped to stabilise markets (although Spain's debt was under pressure again in early April). With this as a precedent, euro zone institutions would take whatever steps were necessary to quarantine Greece (including drawing down the newly expanded European Stability Mechanism (ESM), which was boosted to €700bn at the end of March). These measures could provide sufficient reassurance to the markets, leading to an easing of borrowing costs for the euro zone's remaining troubled economies, and providing some breathing space for economic and fiscal reforms.

**Negative scenario—An attack on Iran results in an oil price shock**

*Moderate risk; High impact; Risk intensity = 15*

The risk of a military attack on Iran's nuclear facilities—either by the US or, more likely, Israel—is a distinct possibility, even though the rhetoric from all sides has eased of late. New EU sanctions on Iranian oil exports (and US measures on Iran's central bank) are set to come into force on July 1st, with Iran threatening to close the Strait of Hormuz (through which 20% of all the world's oil passes) in retaliation. Although such a move by Iran would cause a great degree of economic self-harm, it could be prompted to act if Israel, which has maintained an aggressive posture even as the US has sought to distance itself from military action, launched unilateral air strikes. Alternatively, even if Iran sought to confine its retribution to asymmetric measures (for example, by calling on proxies in the region, or launching covert operations against Israeli targets, such as embassies), any military confrontation between Iran and Israel would add markedly to the considerable political risk premium already in the oil price. Indeed, if the US were involved in strikes on Iran, and Iran responded by firing missiles at US military bases on the Gulf peninsula, the oil price could conceivably head towards US$200/barrel. Even in the more benign asymmetric case, the resulting surge in oil prices would weigh on consumer demand in many countries, and would also have a knock-on impact on other commodities, including food prices. Rising inflation could force a sharper tightening of monetary policy than we currently expect, dampening emerging-world growth and choking off growth in developed economies.

**Negative scenario—The global economy falls into recession**

*Moderate risk; Very high impact; Risk intensity = 15*

The risk of a global recession has faded, in line with improving economic data from the US and, crucially, a slight easing of the euro zone crisis. Nevertheless, with the underlying problems in the euro zone still unresolved, US politicians deadlocked over tackling the huge fiscal deficit, oil prices at elevated levels and China's growth decelerating, the danger of a return to recession has not passed entirely. There remains a risk that a combination of policymaking paralysis and geopolitical uncertainty depresses sentiment once again, weakening hiring and spending, and pushing the euro zone deeper into recession as well as triggering a recession in the US. Lacking the scope for more fiscal stimulus, policymakers in developed economies would be unable to respond effectively. Emerging markets would slow sharply as global trade slumped and confidence collapsed, but, with lower indebtedness, would rebound more quickly, reinforcing the shift in global economic gravity to the emerging world.

**Negative scenario—The euro zone breaks up**

*Moderate risk; Very high impact; Risk intensity = 15*

The injection of over €1trn of liquidity into euro zone banks in late 2011 and February 2012 has eased investor jitters, reducing the probability of a financial market shock that could trigger a collapse of the euro zone (which we define as the withdrawal of several countries, including at least one major economy) in the short term. That said, none of the currency zone's fundamental problems has been resolved. Greece, despite its orderly and much-anticipated debt default in March, may fail to abide by the terms of its second EU-IMF loan programme and decide to leave the euro zone, or may be ejected. Equally, although the immediate crisis has eased, pressures have not disappeared. Spain's 10-year bond yields rose by 100 basis points from end-March to mid-April after a political miscalculation by the government. Portugal also remains vulnerable. Exacerbating the situation, the euro zone's bailout fund—despite new pledges of funding—is wholly inadequate

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to rescue larger countries such as Spain and Italy on its own. A series of rolling withdrawals from the euro zone by weakened and highly indebted countries is therefore still possible. Should Portugal, Spain or, less likely, Italy withdraw, others would probably follow, with a smaller euro zone of "core" countries remaining. Such a scenario would be hugely destabilising for the global economy. The weaker former euro zone members would default as their currencies plummeted and funding costs soared, and banks globally would suffer large losses. (See special article on the prospects for the euro zone in the Western Europe section.)

**Positive scenario—Stronger than anticipated US economic growth boosts the global economy**

*Moderate risk; High impact; Risk intensity = 12*

US economic data in recent months have been largely positive. Improving real GDP growth, better than expected employment numbers, surging car sales and a big jump in consumer credit have raised hopes that the US economy is set for a strong rebound. With the surrounding policy environment also encouraging—any major fiscal austerity programme will have to wait until after the presidential election in November 2012, and the US Federal Reserve has pledged to keep rates at near-zero until late 2014—and the euro zone crisis easing, the US economy could grow much faster than we forecast. Under such a scenario, the pick-up in the world's largest economy would not only boost global business confidence, but would also be a major boon for those countries, mostly clustered in Asia but also in Latin America, that rely heavily on the US as a market for their exports.

**Negative scenario—Tensions over currency manipulation lead to a rise in protectionism**

*Moderate risk; High impact; Risk intensity = 12*

Some countries, especially the US, have been blamed by trading partners for weakening their currencies, and the US and China remain at odds over the value of the renminbi. Switzerland's decision last September to set a ceiling on the exchange rate against the euro (in effect, devaluing the Swiss franc) created a precedent, and Japan has intervened since then to lessen the value of the yen. Tensions would rise further if the US were to resort to more quantitative easing (although this remains off the agenda for the time being). Equally, even if a "currency war" is avoided, countries may choose to introduce protectionist measures to overcome other states' perceived currency manipulation—a trend that is increasingly being seen in Latin America, with Brazil and Argentina at the fore. Given the closely integrated nature of the global economy, governments would find it difficult to close off many aspects of trade. Similarly, populist policies could see trade disputes increase with, for example, the recent US, Japan and EU complaint against China for restricting the export of rare earths raising the potential of a tit-for-tat trade war. Large-scale protectionism would seriously slow economic growth.

**Negative scenario—China's economy crashes**

*Low risk; Very high impact; Risk intensity = 10*

China's GDP growth rates have been spectacular, and the world's second-largest economy was among the quickest in the world to rebound to pre-crisis levels. China, by any measure, is key to the global recovery. Yet, the government-induced credit splurge in 2009 led to a construction boom and a surge in property prices, and there is a risk that the authorities' efforts to cool the overheated property market will result in a sharp correction. This danger has, to some extent, dissipated as inflation has fallen and property prices have levelled off. Our baseline forecast therefore is for a "soft landing" in China. Nevertheless, the government seems keen to manage expectations downwards (as demonstrated by its shifting of its growth target down to 7.5%), and risks to the economy remain, including the continued potential of a recession in developed markets that sharply slows China's export growth. China's fiscal position remains strong, but it is questionable whether the government could repeat the massive stimulus deployed in 2009 to stave off another slowdown.

**Negative scenario—The US dollar crashes**

*Low risk; Very high impact; Risk intensity = 10*

Concerns about the massive US fiscal deficit and poor prospects for fiscal consolidation—any sustained fiscal deficit-reduction plan will almost certainly have to wait until after the presidential election in November 2012—could prompt investors to flee from the US dollar, which could experience a large, disorderly devaluation against currencies of major developed countries and emerging markets. The collapse in value of the world's reserve currency—and of US Treasuries—would cause mayhem on financial markets, fuelling renewed fears about the stability of the global financial system. This

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would have a severe adverse impact on the world economy. However, central banks holding dollar assets are unlikely to pull out en masse, which substantially reduces the chances of collapse.

**Negative scenario—Economic upheaval leads to widespread social and political unrest**

*Moderate risk; Moderate impact; Risk intensity = 9*

The global economic downturn has had a severe social impact, which is being compounded by high food and rising fuel prices. The Middle East has experienced unprecedented upheaval, and small-scale protest camps ("Occupy Wall Street", for example) have been set up across a host of Western cities. Instability overall has been limited, but given higher unemployment and poverty, weak growth (or renewed recession), fiscal austerity measures and high commodity prices, protests could yet increase in frequency and intensity and spread more widely. In some cases, this could bring the survival of governments into question. Indeed, even with the global economy recovering, resentment at high and rising income inequality in developed and many emerging economies is unlikely to dissipate anytime soon. The risk is that instability becomes systemic, with political crises in certain countries affecting others through contagion or through the actions of populist new regimes seeking to assert themselves. Widespread social and political unrest would carry a considerable economic and financial cost.

**Negative scenario—The resumption of monetary stimulus leads to new asset bubbles, creating renewed financial turbulence**

*Low risk; High impact; Risk intensity = 8*

The massive monetary stimulus that occurred at the onset of the recession in 2008-09 raised concerns about the formation of new asset bubbles. In response, in 2010 emerging-market policymakers embarked on a wave of monetary tightening in an effort to squeeze inflation and calm frothy property prices. With the euro zone likely to be in a recession for much of this year, central banks in a number of emerging countries have reversed course and are now lowering benchmark rates. Brazil, for example, has reduced its main lending rate five times, and the People's Bank of China has begun to ease the bank's reserve requirement ratio. Elsewhere, Indonesia and Russia have also commenced a loosening cycle. Concerns about the impact of these changes on liquidity have eased somewhat as inflation has dropped markedly (consumer price growth in China, for example, hit a 20-month low in February). Rising oil prices, however, have created a renewed risk of inflation, and there are also signs that investor risk appetite is returning. Should a surge in capital inflows into emerging markets cause asset bubbles to reappear, shocks to the global economy from subsequent market corrections would be likely.

# Regional summaries

**North America: growth and inflation**
(% change)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| **US** | | | | | | | | | | |
| Real GDP growth | 1.9 | -0.3 | -3.5 | 3.0 | 1.7 | 2.2 | 2.1 | 2.2 | 2.3 | 2.4 |
| Inflation | 2.9 | 3.8 | -0.3 | 1.6 | 3.1 | 2.3 | 2.2 | 2.1 | 2.2 | 2.2 |
| **Canada** | | | | | | | | | | |
| Real GDP growth | 2.2 | 0.7 | -2.8 | 3.2 | 2.5 | 1.9 | 2.2 | 2.0 | 2.2 | 2.3 |
| Inflation | 2.1 | 2.4 | 0.3 | 1.8 | 2.9 | 2.3 | 2.2 | 2.3 | 2.3 | 2.3 |

Source: Economist Intelligence Unit.

*The US economy is gaining momentum*

The US economy entered 2012 with considerable momentum, driven by relatively robust consumer spending. On the basis of strong monthly consumption data for January-March, we have upgraded our forecast for real GDP growth this year to 2.2% (from 1.9% previously). We nevertheless expect an economic deceleration in mid-year, following the pattern of 2011 and 2010. The recent pick-up in jobs growth may be fading, and elevated oil prices could easily dampen the economy's momentum.

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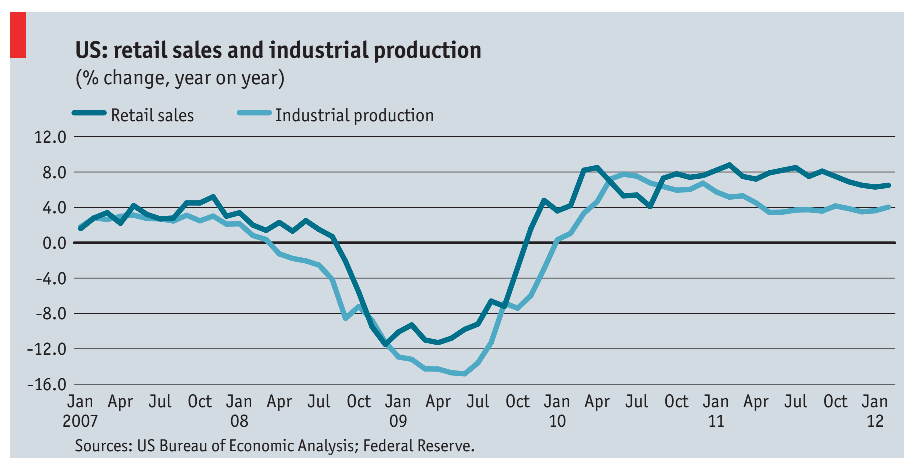
The encouraging start to 2012 followed a 3% annual growth rate in the final quarter of last year, the fastest pace in more than 18 months. Consumer confidence picked up steadily on the back of strong employment gains, and consumers showed an increased appetite for spending and borrowing—consumer credit had its biggest monthly increase in a decade last November, and borrowing was also very strong in December and in January this year. Worryingly, income growth did not come close to matching spending, leading to a marked drop in the saving rate. Drawing down savings is not a sustainable strategy for growth, which suggests that the recent surge will not last, pointing to a deceleration in coming months.




Nevertheless, we forecast a better than average performance for the economy this year than last. A rebound in automotive sales has been instrumental in the strong overall performance. Supply bottlenecks caused by the Japanese natural disaster in March 2011 left dealers short of stock in mid-2011, and pent-up demand meant that vehicle sales in the fourth quarter of 2011 and the first quarter of this year were at their highest since before the recession, albeit with some loss of momentum in March. The residential construction market, which has been in a depression for much of the last five years, is also showing signs of life. Housing starts averaged 702,000 at an annual rate in January and February, the highest level since the last quarter of 2008. Residential investment has subtracted from GDP for six consecutive years, but should make a positive contribution in 2012. A severe austerity drive by state governments is also nearing its end, removing another drag on the economy.

None of this has removed our concerns about the durability of the recovery, which were reflected in March employment numbers. After three straight months of employment gains of more than 200,000, non-farm payrolls rose by just 120,000—too few even to keep up with new entrants into the labour force. Such dips and rises are to be expected in any economic recovery, and the lower figure does not yet imply ongoing weakness. New weekly claims for unemployment benefits have, for example, remained below 400,000 since November 2011. (By comparison, claims were above 600,000 during the depths of the recession and below 300,000 when the economy was performing well in 2006.) None of these figures is strong, especially for this stage of an economic recovery, but they allay fears that the economy is heading back into recession.

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Our concerns about the sustainability of the recovery rest on several foundations. The current improvement could be more a bounce-back from a weak spell in mid-2011 than a genuine sign of sustainable growth. Energy prices are also at elevated levels, and we are increasingly concerned about the potential for a price spike that could severely dampen the recovery. Climbing energy prices played a major role in slowing the nascent economic recovery in early 2011, and the rise in the US benchmark, West Texas Intermediate, from US$90/b in late October to around US$105/b in late March could have further to run. Another reason for caution is the crisis in the euro zone. Even though the medium-term chances of a series of sovereign defaults and a break-up of the single-currency area have receded, the direct impact of faltering economic growth in Europe will still be felt by US exporters.

*Structural issues are still holding back the property market*

Other domestic troubles are far from resolved, although efforts to address them are progressing. Households still have some way to go in their deleveraging efforts, even though the ratio of household debt to GDP fell from 99% during the depths of the recession in early 2009 to 86% in the final quarter of 2011, according to the Federal Reserve (Fed, the central bank). The problem is that the collapse in property prices has eroded the wealth of the household sector: around one-quarter of home owners are now trying to work their way out of negative equity, and more are working to rebuild the net wealth that they lost during the crisis. House prices are still more than 30% below their 2006 peak, and they have fallen for 16 consecutive months, year on year, according to the S&P Case-Shiller index. The ratio of household net wealth to disposable income fell from 657% in 2006 to 499% at end-2011. Until households regain a significant proportion of this loss in net wealth, we expect deleveraging to continue. For this reason, the fall in the savings rate (and the surge in consumer borrowing) in recent months may well be temporary.

After expected growth of 2.2% in 2012, we forecast that GDP will expand by an average of just 2.3% a year in 2013-16. This will be much lower than the annual average rate of 3.2% in the 1990s and also weaker than the pace of 2.7% during the last decade up to the start of the crisis in 2007. For a recovery from recession, when growth usually runs well above trend as idled workers and capital are put back to use, this represents an extremely disappointing performance.

Despite the recent encouragement, a surge in residential construction activity to levels that were normal before the crisis is highly unlikely. The stock of houses on the market in February was equivalent to 6.4 months of demand, down from an average of 10.5 months in 2008 but still above the pre-crisis level of four months. Moreover, there are more than 4m seriously delinquent mortgage loans (90 days or more delinquent or in foreclosure), about 3m more than in a normal market. Many of those homes will eventually be coming onto the market. Residential construction has, understandably, been moribund amid the high level of excess supply. A rebound in property prices looks unlikely, which means that balance-sheet repair will have to come from a prolonged period of spending restraint.

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*Job creation has been better of late, but the unemployment rate is still high*

The labour market remains the Achilles heel of the US economy. Although the unemployment rate fell to 8.2% in March, the decline was the result of a fall in the labour force participation rate (rather than greater job gains). Indeed, the strong job growth between December and February may have been influenced by the mild US winter, which seems to have brought forward construction and other seasonal forms of economic activity. The weaker jobs report in March may have been the start of a rebalancing of the jobs numbers. In any case, we expect only a gradual reduction in the jobless rate over the next six to nine months as more workers rejoin the labour pool. That said, firms are sitting on record levels of cash and have been generating strong profits in recent quarters. If they wish to expand, the funds are available.

Long-term unemployment is a particular concern. The median duration of unemployment was 20 weeks in February and March; in a normal labour market the median period of unemployment is typically less than ten weeks. At the slow rate that we expect job creation to proceed, there is likely to be lasting damage to the potential output of the economy, as more workers become disengaged from the labour force.

*A "fiscal cliff" looms at end-2012*

A deeply partisan mood is undermining Congress's ability to make appropriate fiscal policy, and the approach of a general election means that most significant decisions will have to wait until after the voting. This is unfortunate, as previous budget deals have resulted in a plan that commits the government to fiscal restraint at a time when the sustainability of the recovery is in question. First, the so-called Bush tax cuts will expire at end-2012, having been extended in late 2010. Second, a phased series of automatic spending cuts will begin in early 2013, worth US$1.2trn over the next ten years. These were triggered by the failure of a congressional "supercommittee" (created as part of a deal to raise the debt ceiling in mid-2012) to agree on an equivalent level of phased budget cuts. Third, these cuts will come on top of the almost US$1trn in phased spending reductions agreed as part of the mid-2011 deal to raise the debt ceiling. Fourth, an extension of a stimulus package of payroll tax breaks and expanded unemployment benefits only lasts until end-2012. Finally, the debt ceiling itself will have to be raised by year-end. As a result, something of a "fiscal cliff" looms in early 2013, which has the potential severely to damage the US economy.

Congress will have to address many of these issues after the November election. We expect an agreement to extend most of the Bush tax cuts and to increase the debt ceiling; a further extension of payroll tax breaks and expanded unemployment benefits will be more dependent on the health of the labour market at the time. The automatic nature of the spending and tax changes will give both political parties and the president an incentive to come to an agreement. The spending cuts associated with the debt-ceiling deal and the failure of the supercommittee, worth over US$2trn by the end of the decade, could be modified in terms of their focus, or become more back-loaded, but the magnitude of the cuts is likely to remain. The supercommittee had the scope to target cuts to areas where they would do the least damage to public services and to the real economy, whereas the coming cuts are less discriminating, split evenly between defence and non-defence discretionary

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spending. They will be equivalent to around 0.4% of GDP in 2013 and will build in size thereafter.

If the post-election Congress fails to steer the economy back from the fiscal cliff, we will need to lower our growth forecast for 2013 substantially. The political timetable also dictates that significant fiscal decisions have to be made in a short space of time, increasing the risk of a misstep. It also makes fiscal and business planning decisions more difficult.

Congress has further failed so far to address the long-term problem facing government finances, namely that healthcare costs are set to soar over the next few decades. Without reforms to contain their rise, or higher taxes to pay for them, the government will eventually run into financial difficulty. Under one scenario envisaged by the Congressional Budget Office, public debt will rise to around 150% of GDP by 2030.

*The Fed is searching for ways to stimulate the economy*

Unable to lower its main policy rate any further, the Fed continues to employ unconventional policies to bolster the economy. In September 2011 the Fed indicated that it would adjust its balance sheet by selling US$400bn of shorter-dated Treasuries and purchasing longer-term ones, thus exerting downward pressure on long-term interest rates. It will continue to operate this scheme until mid-2012. The Fed has also been taking steps to increase transparency. In August 2011 the bank suggested to financial market participants that it would keep its main policy rate, the federal funds rate, unchanged at least until mid-2013; on January 25th it pushed the date back to late 2014. It also released for the first time the interest rate forecasts of its Federal Open Market Committee members. By spelling out its expectations that its policy rate will be kept low for so long, the Fed aims to contribute to holding down long-term market interest rates as well. In the light of the Fed's recent comments and the fact that our GDP growth forecasts are below the Fed's, we have moved back our forecast for the first increase in the Fed funds rate from late 2013 to late 2014.

*Another round of quantitative easing seems unlikely*

The Fed has not ruled out another round of quantitative easing (QE), but we do not expect this to happen unless the economy appears to be heading towards recession, and deflation becomes a risk. The last round of quantitative easing, dubbed QE2, resulted in a US$600bn increase in the Fed's balance sheet between November 2010 and June 2011 through the purchase of US Treasuries. The effectiveness of QE2 is in doubt, which seems to have made the Fed chairman, Ben Bernanke, hesitant about a further round. In our view, QE2 contributed to a rise in equity valuations, which, through wealth effects, was influential in the improvement of economic data in 2010. QE2 also helped to depress the value of the US dollar, which boosted net exports. But it was also a factor in the rise in global oil prices, which squeezed disposable income and contributed to slower economic growth in the US in early 2011.

Within the Fed, not all governors have supported the recent stimulus measures. A few were against the decision to defer interest rate rises even until 2013, let alone 2014, and to shift the Fed's holdings of US Treasuries towards longer maturities, fearing that they would stoke inflation. However, inflation concerns appear to be largely unwarranted. Headline inflation is slightly elevated (at 2.7% in March), but this is primarily attributable to commodity price effects and has,

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in any case, fallen for six consecutive months. The Fed's main concern is with core inflation, which by excluding transitory supply-side price shocks provides a better gauge of whether the economy is operating below potential. The personal consumption expenditure core price index rose by 1.9% year on year in the first two months of 2012, suggesting that demand-side inflationary pressures are contained. The high unemployment rate also makes it unlikely that a wage-price spiral will develop.

*Canada is set to slow in 2012*

Canada's economy grew by 2.5% in 2011 and we expect growth to slow to 1.9% this year. Canada's property boom, which has been an important contributor to economic growth in recent years, may be coming to an end. A sustained decline in house prices would create problems for Canada's overleveraged household sector. The level of household debt, which is equivalent to around 149% of disposable income, is among the highest in the OECD, and we expect Canadian households to deleverage over the forecast period. Canada will feel the effects of stresses in the euro zone, which is already in recession, but China is a bigger source of concern given its policy-induced slowdown. China is important to Canada not only as a market in its own right but also through the impact of Chinese demand on the prices of Canadian commodities such as fuel and base metals. The strong Canadian dollar will be a headwind for non-commodity sectors of the economy.

**Japan: growth and inflation**
(% change)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP growth | 2.2 | -1.1 | -5.5 | 4.5 | -0.7 | 1.5 | 1.3 | 1.6 | 1.2 | 0.9 |
| Inflation | 0.1 | 1.4 | -1.4 | -0.7 | -0.3 | 0.1 | -0.1 | -0.1 | 0.2 | 0.5 |

Source: Economist Intelligence Unit.

*A modest rebound in growth is expected in 2012*

Figures for the fourth quarter of 2011 showed that Japan's GDP slipped back from a strong showing in the previous three months and suggest that the economy contracted by 0.7% for 2011 as a whole. Our forecast for real GDP growth in 2012 stands at 1.5%, reflecting the relative weakness in the fourth quarter of 2011 and the apparently slow progress on reconstruction following the tsunami and earthquake in March 2011. Export growth will pick up in 2012, owing partly to a somewhat weaker yen, but will be hampered by the lacklustre external environment. Exports, however, will continue to be a source of support for the economy during the forecast period, underpinned by Japanese companies' operations in fast-growing economies such as China. A recovery in Japan's automotive sector—after the disruption caused by the disasters in Japan and flooding later in the year in Thailand—will support both industrial output and exports. At the same time, imports will be growing strongly, partly because of reconstruction activity in 2012 and also because of Japan's need to import larger quantities of energy to fill the gap left by the closure of nuclear facilities.

*Demographic factors will weigh on the economic outlook in 2012-16*

The ageing of Japan's population is set to accelerate. Increasing numbers of the baby boom generation (who were born in the years following the second world war) are now retiring. Low birth rates in more recent years mean that fewer youngsters will be entering the workforce, while persistent hostility in Japan towards immigration means that there will be no large-scale inward migration to swell worker numbers. The population and, in particular, the labour force

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will contract steadily in 2012-16. Given these unfavourable demographic factors, Japan's disorderly public finances and persistent deflationary pressures, we expect the economy to be stuck in the slow lane, with GDP growth forecast to average 1.2% a year in 2013-16.

*The yen is expected to weaken in the medium term*

The yen weakened against the US dollar between October 2011—when it reached a recent high of ¥75.7:US$1—to ¥83.4:US$1 in mid-March. Part of the weakness reflected less risk aversion on the part of investors, but may also have reflected concerted Ministry of Finance (MOF) action to weaken the currency. The MOF intervened in the market in late October to sell yen, and there have been further, if less overt, signs of official yen sales. In recent weeks, there has been some strengthening of the yen in tandem with a return of risk aversion on the part of investors; the exchange rate stood at close to ¥81:US$1 in mid-April.

We expect the yen to weaken gradually over the forecast period, in part because of a gradual deterioration in the current-account balance as the ageing population draws down savings. Low interest rates in Japan will also continue to encourage the carry trade (whereby investors borrow in currencies with low interest rates and lend in currencies attracting higher ones, profiting from the difference); this will also act as a moderating influence on the strength of the yen. Although the interest rate differential between Japan and the US is likely to remain negligible in the next 18-24 months, from 2014 US interest rates are expected to rise more rapidly than those of Japan, suggesting that the yen will weaken further against the US dollar. Japan is expected to engineer a slight increase in its benchmark overnight call rate (OCR, the main policy rate) in 2015. By this time, the gradual weakening of the yen will be generating some import-price-related inflation. However, increases in the OCR will be very modest given the persistent risk of deflationary pressures re-emerging.

*Our forecasts assume that the proposed consumption tax will not be enacted*

The prime minister, Yoshihiko Noda, who was elected in November 2011, has proposed an increase in the consumption tax—from 5% currently to 10% by October 2015—to help plug the budget deficit. The government ran a fiscal deficit equivalent to 8.9% of GDP in 2011, and we forecast a deficit of 8% of GDP in 2012. We expect the deficit to remain sizeable in 2013-16, averaging 6.9% of GDP a year. Our forecast assumes that the consumption tax increase proposed by Mr Noda's administration will not be enacted: public and parliamentary opposition, coupled with the weakness of the government and expected feeble economic growth, suggest that the government will be unsuccessful in pushing through a reform that would benefit the public finances.

Japan's public debt is expected to rise to around 235% of GDP by the end of 2016. No other developed country has public debt approaching these levels, although the government can still finance itself at very low rates of interest. This partly reflects the composition of public debt, of which roughly 95% is domestically held, and the fact that low interest rates and a sluggish economy over the years have limited alternative investment options.

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**Western Europe: growth and inflation**
(% change)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| **GDP growth** | | | | | | | | | | |
| Euro area | 2.9 | 0.2 | -4.2 | 1.8 | 1.5 | -0.7 | 0.5 | 1.2 | 1.5 | 1.6 |
| EU27 | 3.2 | 0.2 | -4.2 | 2.0 | 1.6 | -0.4 | 0.8 | 1.3 | 1.7 | 1.8 |
| EU15 | 3.0 | -0.1 | -4.3 | 2.0 | 1.5 | -0.5 | 0.6 | 1.1 | 1.6 | 1.6 |
| New members[a] | 6.1 | 4.1 | -3.8 | 2.3 | 3.1 | 1.2 | 2.6 | 3.1 | 3.3 | 3.4 |
| **Consumer price inflation** | | | | | | | | | | |
| Euro area | 2.2 | 3.2 | 0.3 | 1.6 | 2.6 | 2.2 | 1.8 | 2.0 | 2.0 | 2.0 |
| EU27 | 2.4 | 3.5 | 0.8 | 2.0 | 2.7 | 2.4 | 2.1 | 2.2 | 2.2 | 2.3 |
| EU15 | 2.2 | 3.3 | 0.6 | 1.9 | 3.0 | 2.3 | 2.0 | 2.2 | 2.1 | 2.3 |
| New members[a] | 4.1 | 6.1 | 3.1 | 2.9 | 3.9 | 3.3 | 2.7 | 2.8 | 2.7 | 2.8 |

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

Source: Economist Intelligence Unit.

Borrowing costs rose again in Italy and Spain, the two largest economies of the euro area periphery, in March and April, ending a period of relative calm in the euro area's debt crisis since the beginning of 2012. Investors have become particularly concerned about the feasibility of Spain's fiscal consolidation plan during a prolonged recession. Sovereign bond yields in Spain and Italy, respectively at 5.9% and 5.5% for 10-year bonds in mid-April, have not yet reached unsustainable levels, but the upward trend since early March is a cause for concern. Financial tension has drawn renewed attention to the euro area's structural imbalances and to policymakers' prioritisation of deficit reduction over economic growth. We forecast an average euro area contraction of 0.7% in 2012, but the member states with the largest debt burdens are expected to see much deeper contractions, which will worsen their debt-servicing capabilities. The approach of two high-profile elections—parliamentary in Greece and presidential in France, both on May 6th—will bring added political risks to the euro area's economic recovery strategy. A renewed period of financial panic cannot be ruled out.

*Spain may need an EU-IMF loan deal*

Spain looks likely to be the euro area's greatest worry in 2012 and 2013. The budget outturn in 2011 was a deficit of 8.5% of GDP, compared with 6% of GDP expected. In response, the incoming Partido Popular government, led by Mariano Rajoy, revised this year's target to a deficit to 5.5% of GDP, up from 4.4% of GDP. This shook the confidence of investors in Spain's fiscal management; it also annoyed some of Spain's euro area partners which had recently signed up to tough budget targets under a euro area "fiscal compact" designed to restore market confidence in the single currency.

To achieve even this increased deficit target, the government has had to announce severe austerity measures. But Spain's ability to implement these is questionable given that Spain's autonomous regions control a substantial share of fiscal policy. Moreover, whatever the eventual level of compliance with the targets, it is feared that the austerity measures will push the already contracting economy into a deep recession, creating a debt deflation cycle. This is particularly worrying in Spain's case given an already high unemployment rate, excessive levels of private-sector debt and strains in the Spanish banking system, especially the regional savings banks (*cajas*), which are bearing the


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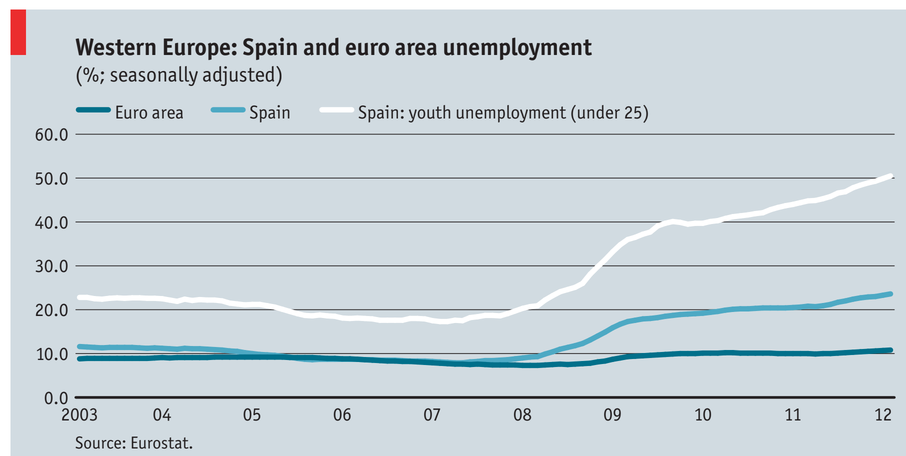
brunt of the real estate adjustment. The government will need to find funds to recapitalise the regional banks and possibly even some of the commercial banks. We currently assume that Spain will meet all its funding needs, including the cost of recapitalising financial institutions, from the markets. But there is a growing risk that Spain will need an EU-IMF loan deal, in which case the financial resources available from both the EU and IMF would probably need to be expanded.




Italy continues to labour under an extremely high public debt burden, of around 120% of GDP in 2012. It is also running a current-account deficit (3.2% of GDP in 2011), which is indicative of a lack of competitiveness. Italy's fiscal position is better than those of its peripheral peers: the deficit was estimated at just under 4% of GDP in 2011 and the primary balance (excluding interest payments) was in surplus. Yet, given that Italy's economy struggles to achieve reasonable growth under the best of the circumstances, investors will remain uneasy about the size of its public debt. As a result, Italy's sovereign bond market will continue to be vulnerable to contagion from other peripheral economies for some time yet. Political issues may be a potential sticking point too. Mario Monti, the technocratic prime minister, has one more year in office before the general election is due, during which he is attempting to reform the rigid labour market and open up protected economic sectors. He still has a coalition of political parties that support his reforms, but they may become less reliable as the reforms have a negative impact on their voters and the election approaches.

*Greece remains a potential source of contagion*

Greece will remain a source of concern and potential contagion. The immediate threat of a disorderly default has receded. Greece secured the largest debt restructuring of all time in March 2012, encompassing €206bn of debt held by private-sector creditors, mostly euro area banks, which have accepted large losses on their holdings worth up to 70% of face value. Agreement on the debt restructuring deal opened the way for approval of a second EU-IMF loan package for Greece for 2012-14 worth around €130bn. But Greece's ability to deliver on the conditions of the package is questionable. In return for continued official financing of deficits, Greece has committed to further austerity measures (public spending cuts, pension reductions and public-sector job culls). For political reasons, following the failure of the first loan programme, the EU

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and IMF will deposit money for debt servicing separately in an escrow account held at the Bank of Greece (the central bank), and a law is to be passed that prioritises debt servicing over other spending commitments. The demanded austerity measures continue to pose the largest risk to adherence to the programme, given the economic distress already prevailing in Greece and the further decline in living standards implied by the new measures.

Our central scenario assumes that having avoided a disorderly default in March 2012, Greece will remain in the euro for at least the next two years. Yet risks exist even to the country's continuation within the euro area in 2012-13: the economy remains in the grip of a deep recession, exacerbated by the external demands for austerity. Greece has a poor track record on implementing reforms—yet these are necessary to allow Greece to raise its economic growth potential in the longer term. A general election will take place on May 6th, which may not return a viable majority government. If far-right and far-left parties perform particularly strongly, political support for fiscal austerity could be hard to marshal. Industrial and social unrest is set to continue. Given the constraints on economic growth from monetary union, uncertainty over Greece's longer-term membership of the euro will persist for the foreseeable future.

*Discord exists within the euro area over how to resolve the crisis*

The difficulty of securing swift reductions in budget deficits amid co-ordinated fiscal austerity across the euro area is likely to become clearer over the next 18 months. As a result, the euro area's overall economic strategy may be undermined in the eyes of the public and of the markets. Some euro area electorates, unaccustomed to such stringent fiscal austerity, may also push back against the prescribed cuts by electing parties that promise a softer touch. The Greek election on May 6th gives voters suffering from two years of severe austerity the chance to vote in parties opposing the cuts. In France, the prospective presidential election winner, François Hollande of the opposition Parti socialiste, has questioned parts of the euro area's fiscal strategy during his election campaign, even if he will struggle to amend it. Conversely, as the German general election approaches in 2013, the German government is likely to become tougher in insisting on deficit reduction in return for its further financial support.

The stage is thus being set for further confrontations over the euro area's economic strategy in 2012 or 2013. If the euro area's fiscal position fails to improve much, peripheral sovereign bonds and the debt and equity of euro area financial institutions will be vulnerable. This would raise the pressure for a change of fiscal strategy, or at least some kind of offsetting action by those countries with strong budget positions. Absent a complete collapse of political support for co-ordinated deficit reduction, however, the German insistence on continued spending cuts is likely to prevail.

*Structural challenges remain daunting*

Much of the effort to resolve the currency union's structural imbalances still lies ahead. European policymakers need to find a way to restore both competitiveness and solvency, without damaging political and social cohesion. The policy response, which is largely shaped by Germany, continues to emphasise fiscal rectitude and structural economic reforms. Both of these are necessary for the long-term survival of the single currency. But in the short term, they could worsen the debt dynamics of the euro zone's weakest members.

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Euro zone countries are tackling their outsized fiscal deficits with austerity measures. In at least some of the euro zone periphery, there is a danger that, in the drive to become fiscally virtuous, fiscal policy will become pro-cyclical, exacerbating recession, and worsening rather than improving debt dynamics. Greece has already demonstrated the difficulty of quickly cutting fiscal deficits amid a severe recession and without the possibility of currency devaluation. Moreover, given that a single monetary policy operates across the euro area, monetary policy is likely to be too tight in peripheral countries to perform its normal macroeconomic stabilisation role of offsetting fiscal contraction, even with record-low interest rates.

Achieving progress with fiscal austerity looks even more daunting in view of the fact that the austerity is being implemented in a co-ordinated fashion, which will depress GDP across the euro area and limit support from external demand. In that context, the signing of the EU's fiscal compact (recently agreed by all member states except the UK and Czech Republic) may prove to be a policy error, because it looks likely to institutionalise pro-cyclical economic policies across the euro area, by enforcing a structural budget deficit of no more than 0.5% of GDP over the economic cycle.

Moreover, there has been little agreement on how to deal with the euro zone's primary structural imbalance: the disparity in competitiveness that has been the source of large current-account surpluses in Germany (and some other core countries) and large deficits in much of the periphery. In a currency union, because devaluation is not an option, competitiveness has to be regained through relative changes in price and wage levels in individual member states. There is an argument for Germany to help other member states by adopting a looser fiscal stance to stimulate domestic demand, rather than forcing a socially and politically painful deflation of prices and wages on the periphery. However, this approach remains politically unacceptable in Germany, because it would be likely to be accompanied by higher price and wage inflation. Discussion of the issue would also confront the country with the reality that the corollary to large German trade surpluses is continued increases in the external indebtedness of its peripheral euro area partners.

*Impact of ECB liquidity provision appears to be wearing off*

Large-scale monetary interventions by the ECB in late 2011 and early 2012 averted the threat of a banking crisis in the euro area, by providing the region's banks with more than €1trn in three-year funding at the ECB's refinancing rate of 1%. In net terms, once allowance is made for banks repaying short-term funding to the ECB, the infusion of liquidity still amounts to a sizeable €500bn. Euro zone banks are using part of the LTROs to cover their funding needs for 2012, when they face €600bn-700bn of long-term bond repayments, but some of the funds also flowed into sovereign bond markets. However, the upward pressure on the sovereign bond yields of Spain and Italy since early March has been accompanied by renewed stresses in bank funding markets that are no longer receptive to unsecured long-term debt issuance by banks of peripheral countries.

*The interaction of the bailout mechanisms is clarified*

In March 2012 the euro area member states clarified the operative details of the euro area's temporary and permanent bailout facilities. The €500bn European Stability Mechanism (ESM), the permanent bailout facility, will launch in mid-

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2012. The schedule for capitalising the ESM was also accelerated so that it would be up to full capacity by 2014, rather than five years after launch as originally planned. To plug the gap until the ESM is fully up to speed, €240bn of unspent capacity from the European Financial Stability Facility (EFSF), the current temporary bailout fund, will remain available until it shuts in mid-2013, adding some reassurance that the full €500bn can be mobilised even in the short term. However, the available amount still looks insufficient to provide a credible backstop to euro zone sovereigns. The €500bn covers the financing needs of Italy and Spain for only around 15 months and is well short of the amounts (ranging from €1trn to €2.5trn) that most private-sector analysts think are needed for an effective firewall. Efforts to increase the firewall by upping IMF resources may founder over the view among emerging-market contributors to the IMF that the euro area is rich and has the resources but not the political will to resolve its problems without outside assistance. The underlying flaw in the bailout funds—that countries like Italy or Spain would be expected to guarantee funds that they themselves might need for a bailout—remains unresolved.

*The euro zone will be in recession in 2012*

The euro zone recorded a quarter-on-quarter contraction of 0.3% in the final quarter of 2011, on the back of widespread fiscal austerity and weakening confidence following months of concern about sovereign debt markets and the banking sector. Even the supposedly stronger countries in the core contracted, with Germany down by 0.2% quarter on quarter and the Netherlands down by 0.7%. France's GDP held up better with a 0.2% expansion. The performance of peripheral economies was considerably worse. The adverse impact of the debt crisis on business and consumer confidence and the tightening of financial conditions in many countries in the region are likely to persist in the first half of 2012, although the ECB's heavy liquidity provision and interest rate cuts by 0.5 percentage points will act to counter falling confidence.

*Fiscal austerity will be a drag on growth*

Core economies should show some resilience in 2012-13, but co-ordinated fiscal austerity across the region will still weigh on growth. Any new financial jitters will also tend to weigh on confidence and detract from spending. We maintain our forecast for a euro zone GDP contraction of 0.8% in 2012. Our forecast for Germany is now for no growth in 2012 (up from -0.3%) and minimal growth (of 0.1%) in France. Stressed economies will suffer deeper recessions, with a contraction of 1.5% in Italy and 2.2% in Spain.

Fiscal tightening will represent a drag on growth. This will be most marked in stressed peripheral countries (Greece, Portugal, Ireland, Spain and Italy), which are under pressure to reduce their deficits quickly. We expect France also to push ahead with fiscal consolidation given the loss of its AAA rating from S&P's and the risk of upward pressure on borrowing costs. (We believe this is the case even if Mr Hollande, the presidential candidate of the Parti socialiste, who is promising increases in public spending, wins the presidency, as opinion polls suggest.) Still-high risk premiums in some markets and the need for banks to build capital buffers by mid-2012 will restrict credit growth, and highly indebted households in many countries will raise their savings rates, dampening consumption. In the event of a break-up of the euro zone (the danger of which has

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receded in the short to medium term), the contraction would be much deeper. Western Europe would face a depression unprecedented in the post-war era.

In 2013 our central forecast is that the region returns to positive growth. But the recovery will be anaemic, at 0.5%. Fiscal policy will remain contractionary as deficit reduction will continue, meaning that governments will not be in a position to offset deleveraging by the private sector. There will continue to be a divergence between financially stronger countries, such as Germany, and weaker ones in the periphery needing to undergo a painful adjustment. We expect growth in the euro zone to pick up from 2014 and to average just over 1.4% a year in 2014-16. Growth at this point will still be limited by the strictures of the recently signed fiscal compact, which will continue to weigh on government spending.

*Elevated inflation looks likely to prevent further interest rate cuts*

We no longer forecast an ECB interest rate cut for 2012, especially as there is a good chance that inflation will remain above target on the back of renewed oil price rises. Although upward pressure on headline inflation from rising commodity prices and strong demand in Germany and other core countries led the ECB to raise its policy rate by 50 basis points in 2011 (subsequently reversed), we expect the ECB to "look through" price pressure from renewed oil price rises. The new ECB president, Mario Draghi, has been quite influential since starting in his position in October 2011, reversing two earlier rate hikes and pushing through two liquidity operations. Mr Draghi noted signs of a stabilisation in activity in the euro zone. In the light of this and the fact that inflation remained above the ECB's target in the first quarter, we no longer expect further interest rate cuts. Depending on how strained sovereign bond markets become during the euro area recession, the ECB may yet have to reactivate its sovereign bond-buying programme, the securities market programme (SMP), or institute another liquidity-providing operation, but it would probably prefer to do neither. We expect the policy rate to remain at 1% in 2012-13, followed by a gradual monetary tightening in 2014-16, taking the key intervention rate to just 2.5% at the end of 2016.

*The UK economy is expected to be weak in 2012*

The UK economy remains in a fragile condition, as highlighted by weak growth of 0.7% in 2011. Given how reliant the UK had become on debt-driven consumption and leveraged expansion of financial services and property, the economy faces a protracted period of subdued activity, high unemployment and declining living standards. The UK will flirt with recession throughout 2012, with real GDP forecast to rise by just 0.2%. Thereafter, we forecast annual average growth of 1.4% in 2013-16, amid volatility and further periods of contracting output. Much will depend on policy developments in the euro zone: the potential for renewed financial turmoil and/or unmanaged sovereign defaults in the bloc represents a significant near-term downside risk. The coalition government will struggle to reconcile its twin aims of deficit reduction and economic recovery, as self-imposed fiscal constraints limit policy options in many areas. Only modest progress will be made in addressing the UK's structural imbalances over the forecast period.


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**Transition economies: growth and inflation**
(% change)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| **GDP growth** | | | | | | | | | | |
| Transition economies | 7.5 | 4.6 | -5.7 | 3.4 | 3.8 | 2.5 | 3.3 | 3.7 | 3.9 | 3.9 |
| East-central Europe[a] | 5.9 | 4.6 | -2.7 | 2.5 | 3.1 | 1.4 | 2.8 | 3.2 | 3.4 | 3.6 |
| Balkans[b] | 5.9 | 5.6 | -6.0 | -0.7 | 1.8 | 0.7 | 2.5 | 3.3 | 3.7 | 4.0 |
| Baltics[c] | 9.2 | -0.5 | -15.5 | 1.2 | 6.0 | 2.0 | 2.8 | 3.4 | 3.6 | 3.7 |
| CIS[d] | 8.8 | 5.0 | -7.2 | 4.6 | 4.5 | 3.6 | 4.0 | 4.3 | 4.3 | 4.2 |
| **Consumer price inflation** | | | | | | | | | | |
| Transition economies | 7.8 | 11.8 | 8.1 | 5.4 | 6.7 | 4.5 | 4.8 | 4.5 | 4.3 | 4.2 |
| East-central Europe[a] | 4.0 | 5.9 | 3.3 | 3.1 | 4.0 | 3.4 | 2.7 | 2.8 | 2.7 | 2.8 |
| Balkans[b] | 8.0 | 8.9 | 4.8 | 4.5 | 5.7 | 3.1 | 3.1 | 3.0 | 3.1 | 3.0 |
| Baltics[c] | 7.2 | 12.1 | 3.1 | 0.9 | 4.4 | 2.8 | 2.8 | 3.0 | 3.2 | 3.4 |
| CIS[d] | 9.8 | 15.7 | 11.7 | 7.2 | 8.5 | 5.4 | 6.3 | 5.7 | 5.5 | 5.2 |

[a] Czech Republic, Hungary, Poland, Slovakia and Slovenia. All members of the EU. Slovenia is a member of the euro zone; Slovakia joined the euro zone in January 2009. [b] Bulgaria, Croatia, Romania and Serbia. Bulgaria and Romania are members of the EU. [c] Estonia, Lithuania, Latvia. All members of the EU. [d] Azerbaijan, Kazakhstan, Russia and Ukraine.

Source: Economist Intelligence Unit.

*Spillover from the euro zone crisis blunts growth*

The troubles in the euro zone, eastern Europe's key export market, have dented immediate growth prospects and raise doubts about the medium-term outlook. The impact of a dip in global growth in 2012 should be less severe on these countries than in 2009, as most have closed or considerably reduced large external imbalances. However, the 2012 recession that we forecast in the euro zone will act as a sharp brake on economic activity in eastern Europe because of weaker trade, investment and financing through the banking channel. Business and consumer sentiment in the region is also fragile. In addition to faltering external demand and the weak outlook for credit, domestic demand remains generally anaemic, given high unemployment, excess capacity in some cases and the inability of governments with considerable budget deficits to splash out on stimulus. These factors point to a slowdown in economic activity in 2012. We forecast that growth in the transition economies will weaken from 3.8% in 2011 to 2.5% in 2012, before picking up to 3.3% in 2013.

External bank loans and foreign direct investment (FDI), both of which helped to drive growth in the pre-crisis years, are likely to be constrained in 2012. Owing to financial strains in west European parent banks, credit growth is already muted and will be squeezed further. Euro zone plans to strengthen their banks' capital adequacy ratios in order to weather the threat from defaults of sovereign bonds will limit lines of financing to countries in eastern Europe. Euro zone banks are expected to increase their capital ratios through a mixture of fund raising, asset sales and reduced lending, which, according to the European Bank for Reconstruction and Development, would lead to "considerable deleveraging" in central and eastern Europe. The "Vienna 2.0" initiative of early 2012 is a positive development, although it does not go nearly as far as the 2009 Vienna Initiative that helped to prevent Western bank flight during the 2009 crisis.

There are both downside and upside risks to our regional growth forecast. If the credit squeeze becomes more severe and external finance is choked off


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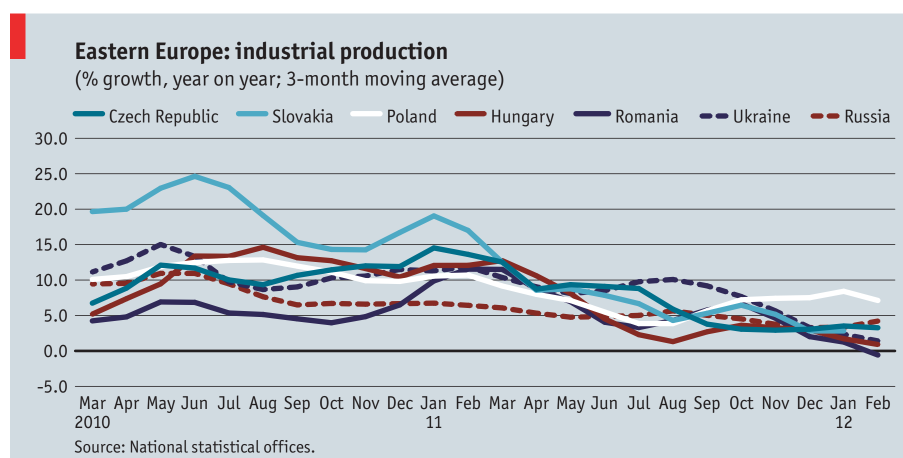
substantially, the spectre of another recession in eastern Europe would rise. As it is, several countries are forecast to tip into recession, including Hungary, Slovenia and Croatia. After a rough ride at the end of 2011, however, currencies and bond markets generally have fared well in the last three months as sentiment regarding the euro improved somewhat. The ECB injected two major doses of liquidity into the European banking sector, first in December 2011 and again at the end of February. This, together with tentative signs of resilience in the German economy, presents some upside risk to our forecasts.

Expansion in eastern Europe in 2014-16 is forecast to pick up to an average of 3.8% annually. This is slow by pre-crisis standards, as credit and wage growth as well as FDI remain relatively subdued. In addition, the question of the sustainability of public debt continues to loom large. The economic crisis revealed structural weaknesses in public finances, and budget deficits widened sharply. Fiscal consolidation will therefore be a dominant theme in 2012 as markets remain sensitive to sovereign weaknesses; fiscal austerity will also limit growth prospects in the medium term.




*Poland shows resilience, but is more vulnerable than in 2009*

In 2011 Poland was again one of the EU's strongest performers, growing by 4.3%. We forecast slower growth, of 2.6%, in 2012. Poland's lower exposure to international trade than other countries in the region reduces its vulnerability to external developments, and it was an exception to the region's poor performance in the last downturn. This time round, however, the government is pursuing fiscal austerity rather than fiscal stimulus, owing to the large budget deficit. In 2013-16 growth will strengthen but will still be slow by pre-crisis standards, reflecting continued high unemployment and tighter government spending. Slovakia’s large automotive sector has been performing well, but weaker external demand will limit growth to around 1.3% in 2012, following an expansion of 3% in 2011. After rising by 2% in 2011, the Czech Republic's economy is likely to stagnate this year or register minimal growth, owing to deepening fiscal austerity and subdued prospects for its diversified exports in its mainly west European markets.

Hungary will slip into recession in 2012 as domestic demand contracts and external financing is constrained. The budget was boosted by one-off measures in 2011 but is set to swing back into deficit in 2012. Investor sentiment, which

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turned sharply against Hungary at the end of 2011, has improved somewhat in 2012 after the government signalled the possibility of fresh talks with the IMF. However, ongoing squabbles with the EU and footdragging on reforms could delay talks until the second half of the year.

The Balkans returned to growth, albeit weak, in 2011. Continued external imbalances mean that a number of Balkan economies remain vulnerable to a new global crisis. The Balkan countries are significantly exposed to fallout from Greece's troubles because of investment, trade, and remittance and banking links. Romania faces tough austerity measures; we expect growth to slow to 1% in 2012 from 2.3% in 2011. Resistance to budget cuts could create further instability. As in Romania, minimal growth is expected in Bulgaria in 2012 after a modest expansion last year. The lev's peg to the euro has limited policy flexibility, forcing the government to maintain a tight fiscal stance. The Baltic states posted robust rates of growth in 2011 as they continued their rebound from deep recessions in 2009, with Estonia, Lithuania and Latvia expanding by around 7.5%, 5.8% and 5.2% respectively—likely a post-crisis peak during the forecast period for these countries. Growth will slip back to around 2% for the group as a whole in 2012.

*Russia's growth will remain below pre-crisis standards*

Russia's growth prospects will continue to depend on world commodity prices, especially for oil and gas. The economy grew by 4.3% in 2011, supported by rising oil prices and a strong harvest, which helped to bring down the inflation rate. Economic growth will decelerate in 2012 as global economic growth slows. Global financial turbulence will also affect investment and consumer expectations in Russia. Part of the reason for the country's relatively robust GDP growth in 2011 was strong growth in agricultural output. This was a bounce-back from a poor performance in 2010 and was thus a one-off. We expect real GDP growth to slow to 3.5% in 2012, but we may raise this forecast if oil prices remain at US$120/b (or higher) owing to fears of a conflict in the Middle East. Given structural problems, growth will stay below pre-downturn levels in the medium term. Impediments to faster growth include sluggish energy output growth, a weak banking sector, insecure property rights, a low share of fixed investment in GDP and bureaucratic interference.

Steel exports and a good harvest boosted the Ukrainian economy in 2011, with growth at 5.2%, but it is set for much slower growth in 2012, forecast at 2.5%, owing in part to weaker steel prices. Ukraine remains vulnerable to an external financing squeeze and may be forced into an even more severe slowdown in order to rebalance its burgeoning current-account deficit.

*Much of the CIS faces political instability*

Vladimir Putin swept to a third term as president in early March following months of protests. The middle classes, angered by cronyism, corruption and alleged electoral fraud at the parliamentary election in December, have engaged in large protests in Moscow and other cities. While the demonstrations have dented Mr Putin's authority, the presidential election also suggests that he continues to enjoy solid support, especially away from the capital. Nevertheless, the popular challenge to Mr Putin's legitimacy will be greater than during his previous presidencies. With this comes a greater risk of political instability. Much will depend on whether Mr Putin addresses the grievances of middle-class Muscovites, rather than simply trying to silence dissenting voices.


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**Asia and Australasia (excl Japan): growth and inflation**
(% change)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Real GDP growth** | **9.3** | **5.5** | **5.0** | **8.4** | **6.4** | **6.1** | **6.8** | **6.5** | **6.6** | **6.5** |
| ASEAN | 6.7 | 4.4 | 1.2 | 7.9 | 4.7 | 4.9 | 5.5 | 5.9 | 5.9 | 5.8 |
| China | 14.2 | 9.6 | 9.2 | 10.4 | 9.2 | 8.3 | 8.5 | 8.0 | 8.0 | 8.0 |
| India | 9.8 | 3.9 | 8.2 | 9.6 | 7.1 | 7.0 | 8.0 | 8.4 | 8.2 | 8.4 |
| **Inflation** | **4.9** | **7.1** | **2.8** | **5.1** | **6.0** | **4.4** | **5.1** | **4.8** | **4.6** | **4.1** |
| ASEAN | 5.6 | 9.9 | 2.6 | 4.4 | 5.7 | 4.4 | 4.7 | 4.6 | 4.9 | 5.2 |
| China | 4.8 | 5.9 | -0.7 | 3.2 | 5.5 | 3.7 | 5.1 | 4.2 | 3.9 | 4.1 |
| India | 6.4 | 8.3 | 10.8 | 12.0 | 8.9 | 7.7 | 7.5 | 7.3 | 7.5 | 8.3 |

Source: Economist Intelligence Unit.

Despite the region's continuing over-reliance on exports to drive economic expansion, which leaves it vulnerable to sluggish demand in the West, Asia and Australia (excluding Japan) will continue to grow strongly in 2012-16. With the exception of Africa and the Middle East, it will be the world's fastest-growing region, expanding by over 6% a year at market exchange rates. Asia's economic fundamentals are sound. Levels of debt (both government and private) are generally low compared with those in the West, and Asian banking sectors came through the global financial crisis in good shape. The region will continue to benefit from China's emergence as an engine of regional growth, particularly as China's middle class expands and the government adopts policies to encourage growth in private consumption. Meanwhile, rising costs in China are prompting companies to seek alternative bases for cheap manufacturing, to the benefit of Asia’s other low-wage countries, such as Bangladesh, Vietnam, Cambodia, Sri Lanka and Indonesia. Also, Myanmar may attract growing inflows of FDI if the recent political and economic opening is sustained.

*The outlook for Asian countries in 2012 is mixed*

Within this positive medium-term picture, there are differences in the short-term outlook for Asian countries. Export-driven economies, such as Singapore, Hong Kong, Malaysia and Taiwan, slowed in the second half of 2011, largely owing to sluggish demand in the West, particularly the EU. Flooding in Thailand in November was also a factor, interrupting supply chains for some electronic components. Recent data suggest that the industrial production cycle in these countries has bottomed and is now recovering. For example, in Malaysia, industrial production rose by 3.9% month on month in February and by 7.5% year on year. While February data in Malaysia and across the region have to be interpreted with caution because of distortions created by the Chinese New Year, the tone of industrial production and survey data in the year to date are indicative of a strengthening of activity. China, where high-frequency data show continued weakness, is an exception in this regard.

China fits into a second group, which also comprises Indonesia, South Korea, the Philippines and India, where domestic factors will be more important than external ones in 2012. Although these economies will be hit by sluggish external demand, and most will experience slower growth, they will be cushioned by an increase in domestic demand. In South Korea's case, the forecast recovery of consumption and investment from somewhat depressed levels in 2011 will be sufficient to drive an acceleration in GDP growth this year.

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Thailand and Australia, which were both affected by flooding in 2011, will post stronger growth in 2012, as output returns to normal levels. Pakistan also falls into this category, as its economy will be buoyed this year by a recovery following the flooding that affected the country in 2010 and 2011.

*Limited monetary easing is in prospect in Asia*

A combination of slower economic activity and a decline in most commodity prices has eased inflationary pressures in recent months. However, we do not expect much in the way of monetary easing by central banks. Even in China, where more cuts in banks' reserve requirements are in prospect, the pace of monetary easing will be gradual. Interest rates in Asia are generally low, making policymakers wary about the risk of asset price bubbles, particularly in a climate of abundant liquidity and capital inflows. In addition, the recent run-up in oil prices will lead to renewed upward pressure on consumer price inflation. Any support that monetary easing will provide to economic growth will thus be limited. But, barring a further escalation of the euro zone crisis (whereby Spain and possibly Italy too would need EU-IMF loan programmes, for which the resources are not yet in place), firms and households in Asia will have fluid access to credit. Also, manageable public debt burdens in most countries in the region mean that governments are able to continue providing support to their economies through fiscal policy, albeit on a more restricted scale than in recent years.

Our view on China, which is of growing importance to the regional and world economy, remains that it will avoid a hard landing. The tone of Chinese data, certainly, remains weak, although policy is providing some support. The People’s Bank of China (PBC, the central bank) has made two cuts in bank reserve requirements since November following a decline in the inflation rate, which fell from 6.5% in the third quarter to 3.2% in February before ticking up again to 3.6% in March. Even after the slight rise in March, inflation remains below the government's 4% target. Policymakers are not, however, focused only on inflation; they want to engineer a deeper correction in the overheated segments of the property market than has yet occurred. This is a wise decision given the havoc wrought by the recent bursting of property bubbles in the US and other Western markets. Although Chinese home-buyers tend to pay mainly with cash, banks are exposed to the sector through lending to developers, and also through the risk of a downturn in the wider economic cycle should a property crash occur. Rising bad loans could necessitate a major recapitalisation of the banks by the state. We believe that policymakers will succeed in preventing such an outcome. But to do so, they will need to loosen policy only gradually. Thus Chinese data are likely to remain weak into the second quarter before picking up in the second half of the year, with the assistance of more monetary easing.

More broadly, the policy stance in China is becoming more consistent with the medium- and long-term goal of shifting the economy away from over-reliance on investment and exports and towards private consumption. A gradual strengthening of the renminbi is part of this change. The shift in the composition of demand will mean that China enters a phase of less rapid growth, as recognised by China's political leaders in March when they lowered the official growth target for 2012 to 7.5%, below the 8% threshold that had long

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been deemed necessary to maintain social peace and public support for the political system.

*There is political discord in China ahead of the transfer of power*

While the government's lowering of the growth target is undoubtedly significant in both political and policy terms, 7.5% may be a floor rather than a target. We have slightly raised our 2012 GDP growth forecast to 8.3% from 8.2%, a view supported by growth of 8.1% year on year in the first quarter. This was the slowest pace since the 2009 global financial crisis and was below market expectations, but it came among signs that the slowdown may have run its course. Bank lending is picking up and private consumption is becoming more of an engine for growth, an outcome that government policy is designed to achieve. High wage increases will continue to fuel private consumption in the rest of 2012, particularly if the trend in inflation remains benign. In addition, although policymakers are displaying caution at present, they may be willing to relax policy more later in the year to ensure that the transfer of power, an event that occurs only every ten years, passes off smoothly.

The risk of a troubled political transition has grown because of discord within the upper echelons of the CCP between those in favour of liberalisation and those advocating a more state-led investment model. A power struggle between these two factions seems to have been the reason behind the purge of Bo Xilai, the former Chongqing mayor and party boss (see World growth and inflation). If the transition does not go smoothly, it could have serious implications for China's growth prospects, at least in the short term. On the assumption that the transfer of power in the autumn proceeds smoothly and that the correction in the housing market will have run its course, we forecast a slight acceleration in growth in 2013. In 2014-16 we expect China's economy to expand by 8% a year.

*Reforms are needed if India is to fulfil its high potential*

Growth in India has slowed, and we forecast an expansion of 7% in the current fiscal year (April-March), down from 7.1% last year. This is well down from growth rates of 9% or more that India was expected to sustain just a few years ago. Slower global growth is partly responsible but domestic policies are also playing a role. In response to high inflation, the central bank has had to tighten monetary policy more than most of its emerging-market peers. This has led to a steep decline in corporate investment, which may also have been deterred by changes in regulatory policy. (The ruling Indian National Congress party's coalition partners forced the government to water down an attempt at liberalising reform last November, when it abandoned plans to allow multi-brand retailers into the country; single-brand companies were eventually allowed to open fully owned stores.)

The root of the problem is the perennial disarray in India's public finances, which are characterised by large structural fiscal deficits and high public debt. These appeared not to matter while the global economy was booming; now that conditions globally are less favourable, they are crowding out the private sector and fuelling inflation. It is unlikely that the current government will have the political will to address these shortcomings, particularly as it suffered a rebuff from voters in state elections in March.

Despite these policy challenges, India has a number of advantages that will support growth. Private savings and investment rates are high and the middle

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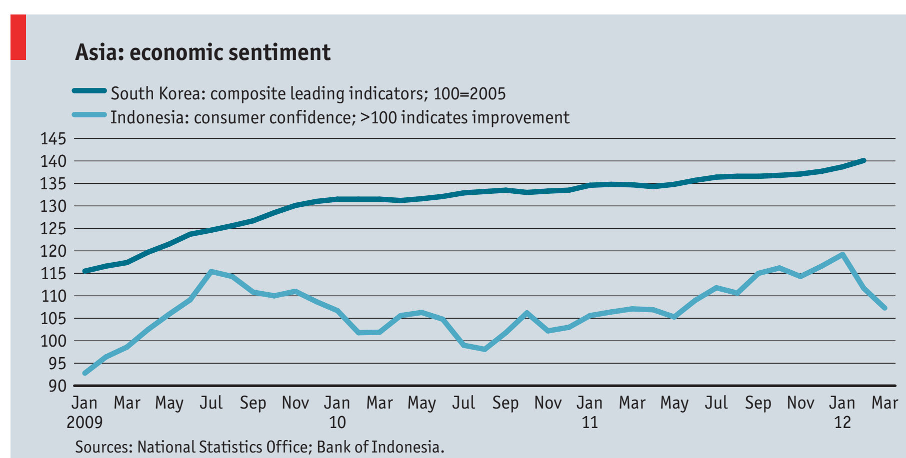
class is expanding rapidly, creating new markets. The dynamic technology sector will take on new business as demand in the West recovers during the second half of the forecast period. We expect Indian GDP to expand by an average of more than 8% a year between fiscal years 2012/13 and 2016/17.

*ASEAN will continue to attract large amounts of foreign investment*

The main economies of the Association of South-East Asian Nations (ASEAN), namely Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam, are expected to post annual real GDP growth averaging 5.6% in 2012-16. These countries, which are benefiting from China's growth, will continue to attract high levels of foreign investment. Indonesia, whose large economy makes it less dependent on external demand than other ASEAN members, is likely to achieve a higher profile in the next five years. By 2016 its economy, measured at market exchange rates, is forecast to be larger than that of South Korea.




Australia's economy will continue to benefit from growth in Chinese demand for mineral imports throughout the forecast period. Any impact from the slackening of demand from China in 2012 will be more than offset by Australia's recovery following the floods that devastated large parts of the country, including key coal-producing regions in the state of Queensland, last year. As a result, real GDP growth is forecast to accelerate to 2.9% in 2012, from 2% in 2011. The Australian economy should continue to expand at around 3% a year in 2013-16. The main domestic risk is the housing market, where prices are falling from their previous frothy peaks. We expect a manageable decline in prices rather than a crash.

**Latin America: growth and inflation**
(% change)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP growth | 5.6 | 4.0 | -2.0 | 6.0 | 4.4 | 3.7 | 4.2 | 4.4 | 4.1 | 4.2 |
| Mercosur[a] | 6.8 | 5.5 | -0.5 | 6.8 | 4.1 | 3.5 | 4.2 | 4.6 | 4.1 | 4.3 |
| Inflation | 5.3 | 7.7 | 5.8 | 5.9 | 6.5 | 6.2 | 6.0 | 5.7 | 5.6 | 6.0 |
| Mercosur[a] | 6.3 | 8.8 | 7.5 | 8.4 | 9.3 | 8.5 | 8.3 | 7.9 | 7.6 | 8.2 |

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

Source: Economist Intelligence Unit.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*Growth will moderate in 2012 before recovering in 2013*

Following a strong rebound in 2010 on the back of a surge in global stimulus, we estimate that growth in the Latin American region slowed to 4.4% in 2011. We forecast a further slowdown to 3.7% in 2012, in a context of outright contraction in the euro zone and below-par growth in the US. From 2013 we expect growth to accelerate and average 4.2% in 2013-16, sustained by continuing sound macroeconomic policies, resilient domestic demand and a recovery of economic activity in the OECD area.

Economic growth in South American countries will continue to be boosted by China's demand for soft and hard commodities exports. Historically low OECD interest rates, coupled with an improving investor perception of the region's potential, will continue to benefit the larger economies and those well integrated to the global financial markets. The episode of global volatility that hit Latin American and other emerging-market currencies in September 2011 (with the Brazilian Real and Mexican peso down by 16.6% and 12.3% respectively against the US dollar in that month) has highlighted the vulnerability of the region to shifts in market sentiment, given its large external financing requirement and the volatility of global portfolio flows. But risky asset markets have registered large gains since the start of 2012, notwithstanding a correction since late March linked to renewed worries about the euro zone and the slowdown in China.

In addition to the risks arising from an uncertain global economic outlook, Latin American policymakers face other challenges. In monetary and credit policy they will have to strike a balance between supporting domestic demand (to offset weak export markets in the OECD) while keeping inflation under control amid price pressures stemming from high food and oil prices. As capital inflows cause currencies to appreciate, manufacturers will struggle to maintain competitiveness. In Brazil, which is set to become a large oil producer and exporter, the problem of "Dutch disease" will be particularly acute.

*The region's strong external balance sheet provides protection*

The region's external balance sheet is stronger than previously. External debt is lower relative to GDP and exports and foreign-exchange reserves are at record levels. Nevertheless, growth in import bills, fuelled by domestic demand and by strong local currencies, will exceed export revenue growth, with resulting large current-account deficits in the region—even for commodities exporters. This situation is particularly problematic for Argentina, for which current-account surpluses have been a pillar of stability in the last decade, given the government's limited access to international capital markets, use of foreign reserves to repay its external debts and vulnerability to capital flight.

*Brazil remains sluggish but is expected to gain momentum during 2012*

Growth in Brazil, the region's largest economy, slowed to 2.7% in 2011. This was the worst performance among the BRICs (Brazil, Russia, India and China), and a sharp slowdown following the 7.5% expansion registered in 2010. The economy remained sluggish in early 2012. In January output contracted by 0.1% month on month, dragged down by a fall in industry. Despite monetary policy easing and targeted tax breaks for some favoured segments, manufacturing will struggle as competitive weaknesses continue to be exposed by a strong Real and, in the short term, there is still an inventory overhang to work through.

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Although industrial output is weak, leading indicators suggest that a recovery will take hold in the coming months. The 14.3% rise in the minimum wage that came into force in January is boosting consumption (retail sales grew by 2.6% in January), and momentum will build as the effects of the ongoing monetary easing cycle will be felt more strongly, and as fiscal policy becomes less restrictive than last year and lending by public banks is boosted. The government is planning a series of measures to boost investment and industrial production. These include tax breaks and measures to increase the availability of credit, particularly from BNDES, the state development bank. By late 2012 we expect GDP to be growing by over 4.5% on an annualised basis, providing momentum into 2013. In 2014-16 we expect growth to average more than 4% annually, supported by job creation, real wage gains and credit. Capacity constraints will ease as investment, financed partly through foreign savings, is projected to grow at almost double the rate of overall GDP growth, attracted by market opportunities, infrastructure projects and huge investments to develop the pre-salt oil reserves and refineries.

Members of the economic team have been voicing concern about the weakness of the industrial sector. Brazilian officials have again talked of "currency wars" as the improvement in investor sentiment following the ECB's liquidity injections led to renewed upward pressure on the Real. On March 7th the Banco Central do Brasil (BCB, the Central Bank of Brazil) stepped up the pace of policy rate reductions to 75 basis points, reducing the benchmark Selic rate from 10.5% to 9.75%. The BCB's decision was controversial, given that the annual inflation rate is running at 5.8%, above the target of 4.5%. Inflation is expected to subside at least until April as administered price pressures are low and producer prices are abating, but there are upside risks thereafter.

The Mexican economy grew by 4% in 2011 and we expect it to expand by 3.4% in 2012. The economy has enjoyed a strong start to the year. Mexico's car industry, in particular, has benefited from a surge in car sales in the US. Mexican manufacturers will benefit from the slightly more positive outlook for the US. Low inflation will support some gains in real wages, but weak job creation will prevent private consumption growth from rising above 4%. Real lending rates will remain low and credit growth is expected to remain firm, but limited banking penetration suggests that credit will fail to stimulate consumption significantly, despite recent efforts to improve credit provision, particularly to consumers. Investment has been strong in early 2012, but this is an election year and the pace is likely to slow considerably after ballots are cast in July.

*Reform is on hold in 2012 while Mexico goes to the polls*

There is no hope of progress on important political and economic reforms (including labour, security, tax, energy and education bills) before the presidential election. Prospects under the incoming president, who will assume office in December, are also uncertain, given the likelihood that the appointee will not command a working majority in Congress (the legislature). But if Mexico were to make progress on these reforms, it would enjoy a faster rate of economic growth over the medium term and gain greater resistance to external shocks. We currently forecast that Mexico's economy will grow by an average of 3.7% a year in 2013-16.


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### In focus: Enrique Peña Nieto's agenda

Although Enrique Peña Nieto, the presidential candidate of the Partido Revolucionario Institucional (PRI) and front-runner in the opinion polls, has avoided presenting detailed policy proposals in his public appearances, he has essentially steered a middle course, thereby reinforcing the impression that he will not be deviating significantly from existing policy if he wins the presidency. As in the preceding administrations, Mr Peña Nieto has repeatedly stated that he is committed to maintaining macroeconomic stability as a precondition for stronger economic growth.

**Competition.** Mr Peña Nieto has stated that promoting greater economic competition is one of Mexico's main challenges. He has also stated that he would allow new companies to participate in industries where there is limited competition and strengthen regulatory institutions to combat monopolistic practices.

**Energy.** Like state oil companies in other countries, Petróleos Mexicanos (Pemex, the state oil company) should be allowed to benefit from associations with the private sector in order to improve production and increase profitability.

**Competitiveness.** He recognises the need to transform the education system—making government spending in that area more efficient and transparent—and the need to invest more in innovation, science and technology. With regard to telecommunications, Mr Peña Nieto argues that the state must strengthen effective competition, technological convergence and the extension of coverage to close the digital gap between Mexico and other countries. He has also accepted the need to find the best way to provide universal access to broadband Internet.

**Fiscal policy.** Mr Peña Nieto would back a thorough fiscal reform that broadens the tax base, reduces fiscal exemptions and privileges, simplifies the tax system and places greater emphasis on value-added tax (VAT).

**Finance.** He has admitted that the banking system is strong and healthy, but that it is not lending enough to encourage development. He would like development banks to grant loans directly to economic agents excluded from commercial banking and increase public expenditure exclusively on labour-generating projects that improve education, health and productive infrastructure. He wishes to promote regulatory changes to the financial system in order to increase loans for productive purposes.

**Infrastructure.** Mr Peña Nieto advocates building multi-modal infrastructure corridors, while strengthening and improving the existing infrastructure of highways, railways, airports and ports.

**Social policy.** One of his key proposals would be the introduction of a universal social security system that provides effective access to health services, pensions for the elderly, unemployment insurance and labour insurance.

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**Middle East & Africa: growth and inflation**
(% change)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Middle East & North Africa** | | | | | | | | | | |
| Real GDP growth | 4.9 | 5.3 | 1.5 | 4.1 | 3.2 | 4.0 | 4.2 | 4.8 | 5.0 | 4.9 |
| Inflation | 9.1 | 13.6 | 6.2 | 5.8 | 8.8 | 8.9 | 7.6 | 7.3 | 7.3 | 6.8 |
| **Sub-Saharan Africa**[a] | | | | | | | | | | |
| Real GDP growth | 7.0 | 4.8 | 1.2 | 4.4 | 4.4 | 4.0 | 4.9 | 4.5 | 4.8 | 5.0 |
| Inflation | 6.6 | 11.0 | 9.0 | 7.5 | 7.7 | 7.8 | 6.4 | 6.2 | 6.4 | 6.5 |

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

Source: Economist Intelligence Unit.

*High oil prices will support regional growth prospects*

Economic growth slowed in the Middle East and North Africa (MENA) region in 2011 as a result of political upheaval and civil unrest. Most of the countries that experienced serious unrest last year, such as Tunisia, Yemen, Bahrain and, most dramatically, Libya, will witness something of a bounce-back in 2012, as the political and economic scene stabilises (albeit to varying degrees). However, those countries that are still convulsed by internal strife, such as Egypt and especially Syria, will continue to suffer economically. In North Africa recovery will be constrained by weaker EU demand, which will lead to lower workers' remittances from Europe and tourist inflows. Offsetting this, regional growth in 2012 will be supported by massive infrastructure and industrial development in Saudi Arabia, expansionary fiscal policy across the Gulf Co-operation Council (GCC) states and high prevailing oil prices.

We expect stronger economic growth in the second half of the forecast period as hydrocarbons output continues to rise, oil prices stabilise at a high nominal level and some of the large infrastructure projects in the GCC countries start to come on stream.

*Iran will seek to buy time at talks with the West*

A key risk clouding prospects for the region is the escalation in tensions between Iran and the West, including Israel, over Iran's nuclear programme (see World growth and inflation: Risk scenarios). At the time of writing, talks between Iran and the seven powers (represented by the US, France, Germany, the UK, China and Russia) are shortly due to resume in Istanbul. From Iran's perspective, going back to talks means that it can show that it is open to negotiation with the global powers and win some diplomatic good behaviour points. But Iran's objective will ultimately be to carry on with its nuclear programme and the talks will be a chance for it to buy time (as the country has done in the past). In this it is likely to be successful, as there appears to be little appetite on either side for an escalation in tensions.

*Regional political risk is high*

Uncertainty about social stability remains. Should another regime fall (for example, in Syria) and the momentum of protests pick up once again, a range of other countries that have yet to experience any serious economic fallout from the Arab Spring—such as Morocco, Algeria and, perhaps more speculatively, Saudi Arabia—could become vulnerable, with negative consequences for their domestic economies. In addition, our current forecast assumes a relatively strong recovery in 2012 for those countries most affected by the unrest, notably Libya, Egypt and Tunisia. However, if the interim leaders in these countries are unable to restore social stability and achieve public acceptance of the new


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political order, widespread unrest may begin again, which in turn would prolong the economic fallout of the Arab Spring to 2012 and potentially beyond.

*Iraq is set to grow strongly, fuelled by rising oil production*

Iraq's GDP growth is forecast at a stellar annual average of 7.9% in 2012-13, driven primarily by rising oil production. Private investment is set to surge, as work on several large oilfield and infrastructure projects gathers speed. Growth will be aided by large increases in government spending; the 2012 draft capital budget is up by almost 35% on the previous year, and with the mounting pressure the government faces to provide basic services, a larger proportion of the allocation is expected to be spent. Oil output, which was initially constrained by outdated infrastructure is set to grow steadily to 4.7m barrels/day (b/d) by 2016, up from about 2.4m b/d in 2010. There are risks to this benign outlook; the security situation is fragile, and a recent spat between the Kurdistan Regional Government and the central government over oil payments demonstrates the scope for further internal strife. In addition, Iran is seeking to extend its regional hegemony and could meddle in Iraqi politics to stir dissent.

*Despite the current challenges, Africa's longer-term prospects are good*

The unfavourable global economic outlook represents the main threat to prospects in Sub-Saharan Africa. Specific risk factors include a reduction of trade credit, declining commodity prices and contracting demand for the region's exports, in addition to falling remittances, aid, FDI and tourism receipts. Any significant slowdown in the pace of expansion in China—a crucial economic partner for Sub-Saharan Africa in terms of trade, aid and investment flows—would be of particular concern. Our assessment, overall, is that this will be a challenging but not disastrous year for prospects in Sub-Saharan Africa. Furthermore, the medium-term outlook for the region remains positive. Growth will be supported by rising external inflows (capital and investment, particularly from Asian sources) and high commodity prices. Economic reform programmes will continue, boosting the role of the private sector in the economy. By 2013-16 the regional economy is forecast to average growth of around 5% a year. Nevertheless, the general operating environment remains difficult in a large number of Sub-Saharan states. Government bureaucracy, corruption, infrastructure bottlenecks, skills shortages and structural difficulties will continue to present major challenges.

*Structural constraints limit the growth potential of South Africa*

In South Africa, economic growth in the early part of the forecast period will be hampered by the uncertain external environment. Prospects throughout 2012-16 will also be clouded by persistent structural constraints, including skills shortages, high unemployment, crime, corruption and inefficient parastatal firms. We expect growth to pick up slightly towards the end of the forecast period, helped by the start-up of new transport networks and power stations (which will boost energy-intensive sectors).

*The prospects for Nigerian growth will improve in the medium term*

Nigeria is expected to enjoy a period of robust economic expansion, averaging around 7% annual GDP growth in 2012-16. While impressive, this is below the double-digit levels required to make a substantial impact on the country's development. The lack of more significant growth is primarily the result of the dire state of Nigeria's infrastructure, notably electricity supply. Growing social unrest is a further threat to wider stability. There will be some increases in oil and gas production as new deepwater oilfields open or expand. Output will, however, be constrained by insecurity and by delays in crucial new legislation

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that has prompted many oil companies to deter investment decisions until the policy environment is clearer.

*East Africa energy discoveries are extremely encouraging*

East Africa has been the focal point of several very promising hydrocarbon discoveries in recent weeks. Large new gas discoveries are good news for Tanzania and Mozambique in particular. For the region's largest economy, Kenya, a promising oil find was reported in March after 30 years of fruitless on- and offshore exploration. The find has prompted local euphoria, but there is no certainty at this stage that it will be commercially viable. The precise size and quality of the deposit will be critical in determining the economic impact, but it could potentially have a substantial effect on the country's balance of payments, budget and growth, although probably not on employment.

## Exchange rates

*The US dollar will gradually strengthen as the euro zone struggles*

The US dollar fell sharply against the euro and most other currencies in early 2012 as improving economic sentiment sent investors flocking to risk assets and away from the greenback, the global safe haven. That pattern has now largely come to an end as investors digest economic news that is more worrying than encouraging. This reinforces our view that the euro will have little or no upward momentum this year as the single-currency zone struggles with recession and sporadic reoccurrences of its sovereign debt crisis. This does not rule out periodic bouts of euro strength, especially if the US recovery disappoints, as we believe it will. We expect the many forces buffetting currency markets to leave the US dollar averaging around US$1.31:€1 for 2012, a middle ground between the weak-dollar pattern of 2011—when the US currency averaged US$1.39:€1—and a rate in the mid-to-low US$1.20s, which might be expected at a time when the euro zone will be in a recession and the US will manage growth of around 2%. The dollar will strengthen later in 2012 and will average around US$1.25:€1 in the latter years of the forecast period.

The extraordinary strains on the euro zone in November and early December 2011 sent risk investors to the sidelines, and led to a surge in the dollar as markets bet heavily on the the global safe haven. The situation began to change when investors realised that the ECB's December liquidity injection into euro zone banks had stabilised regional funding markets. As fears of a euro zone break-up receded—and with it a global recession—investors in January and early February this year ventured again into risky assets, including commodities and emerging-market stocks, bonds and currencies. This resumption of the "risk-on" trade is usually accompanied by a retreat from safe-haven assets, especially the US dollar, which is often used as a funding currency. This led to a fall in the value of the dollar, to nearly US$1.35:€1 in late February from US$1.27:€1 in early January.

The euro has fallen back since then, and it is difficult to make a case for any degree of sustained euro strength. Apart from the weakness of the European economy, monetary policy is more likely to loosen in the next several months in Europe—possibly through bond purchases or further liquidity injections—than in the US, where we believe another round of quantitative easing is not imminent. We also expect the outlook for global growth—and hence for risk


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tolerance—to be weaker than most analysts are expecting. This means that, on most days, the "risk off" trade will dominate, which favours a shift to the relative security of the US dollar and away from the euro. Given the slowing pace of jobs growth in the US and moderately disappointing economic data from China, investors are likely to stay close to the dollar and limit their holdings of both the euro and many emerging-market currencies.

*The Fed is unlikely to launch a new bond-buying programme*

The US dollar was held down for much of 2011 by the possibility of another round of QE by the Fed. Mr Bernanke has disappointed financial markets in recent months by making no clear mention of a new bond-buying programme, although other senior Fed members have hinted in recent weeks that further easing is at least possible. While we do not rule out another round of QE, we believe that Mr Bernanke will need to see evidence of weaker growth and hints of deflation before considering it. Although the US jobs market softened in March, other economic indicators have been in a respectable range, and core inflation, at 2.3% in March, is by no means too low.

*The risk-off trade will weaken emerging-market currencies*

If the risk-off trade is once again taking hold, emerging-market currencies—and capital inflows into developing economies—will soften. This pattern has emerged before. The aversion to risk that took hold in September as the euro zone crisis deepened weighed heavily on many emerging-market exchange rates. Several currencies, including those of India, South Africa, Brazil, Mexico and South Korea, lost more than 10% of their value in a few weeks. Economic growth is slowing in most of these countries as the effects of the euro crisis, the tepid recovery in the US and the slowdown in China spread more widely. Most emerging markets have also begun monetary loosening cycles, which weighed on their currencies, although interest rates in developing economies generally remain far above those in the US, Japan and the euro zone. The slight improvement in the global economic outlook at the start of the year was positive for emerging-market risk and hence the value of their currencies, but those upward moves have, for now, come to an end.

The Fed's trade-weighted exchange value for the US dollar, which compares the value of the US currency against those of America's major trading partners, fell from around 101 at the start of the year to 98 in early March; it has since ticked back up to 99 as global risks have increased and interest in the dollar has re-emerged. If the outlook for the global economy weakens and investors accelerate their move towards US dollar assets, emerging-market currencies will soften. However, all of this would change if the Fed were to take further steps to loosen monetary policy. This would immediately put downward pressure on the dollar, both because of the perceived debasement of the dollar and the expectation that looser US monetary policy would support global growth and hence the appeal of risky emerging-market assets.

*China accelerates moves to internationalise the renminbi*

In an important move for the future of China's currency, on April 14th the Chinese authorities widened the band within which they will allow the renminbi to trade. Since 2007, the government has permitted the renminbi to move within a range of 0.5% of the official daily rate against the US dollar, although China's currency has rarely tested that limit. The band will now be widened to 1%. We do not see this as an attempt to allow a faster appreciation of the renminbi, which—through the "crawling peg" approach—has increased in

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value against the US dollar by around 30% since it was decoupled from the greenback in 2005. Indeed, the generally cautious nature of China's policy-makers would argue against any move that would allow for a rapid rate of appreciation, especially at a time when China's export growth seems to be slowing. Nor do Chinese officials have any intention of giving up control of the currency, at least for now. That said, this move will almost certainly allow for a greater degree of volatility in the exchange rate, permitting market forces to have more influence. The move was welcomed by Christine Lagarde, the managing director of the IMF, and received cautiously positive comments from a US Treasury official. China's government has made it clear in the past year that it is serious about transforming the renminbi into a global currency, eventually to sit alongside the US dollar and the euro. This process will not be rapid, but nor will it be as slow as many analysts expected a year or two ago.

Although the renminbi's value probably remains some way below the level that would be set by a free market, there is a growing sense in foreign-exchange markets that China's currency is no longer guaranteed to rise automatically. Indeed, the renminbi endured one of its periodic downward moves against the dollar in March. While this has happened before, it may become a more frequent occurrence as China's economy fights through a period of slightly slower growth. In addition, owing to the likelihood that China's current-account and trade surpluses will both fall as a proportion of GDP in 2012-16, and given this latest move to widen the trading band, China may be in a good position to resist external pressure to allow a faster rate of appreciation.

We forecast that the renminbi will average Rmb6.25:US$1 in 2012. We believe China's currency will strengthen against the US dollar by an average of 2.4% a year in 2013-16 in nominal terms, partly reflecting higher productivity growth in China than in the US. China's efforts to make the renminbi an international currency may lead it to ease capital controls further, and this too could exert upward pressure on the renminbi's external value.

## World trade

**World trade**
(% change; goods)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| **World trade** | **7.1** | **2.8** | **-12.0** | **14.1** | **5.8** | **4.0** | **5.6** | **6.0** | **6.4** | **6.5** |
| Developed countries | 6.4 | 2.0 | -12.9 | 13.3 | 5.0 | 2.4 | 4.1 | 5.0 | 5.4 | 5.6 |
| Developing countries | 10.7 | 6.5 | -8.7 | 14.4 | 7.6 | 5.4 | 7.9 | 7.7 | 8.0 | 7.9 |

Source: Economist Intelligence Unit.

Following a rebound in 2010, world trade growth slowed in 2011, with momentum stalling particularly from the third quarter. That pattern may be reversing, at least in the short term: according to the Netherlands Bureau for Economic Analysis, global trade in volume terms accelerated to 2.7% in January after a revised expansion of 2.2% in December. That said, we expect global trade overall to grow by just 4% in 2012, after climbing by 5.8% last year.

*Trade finance is likely to tighten this year*

Our forecasts assume some tightening in the availability of trade finance. A recent report from the International Chamber of Commerce and the IMF

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revealed a gloomy outlook for trade finance in 2012. Respondents to the survey indicated a clear division between Asia and Europe. Over one-half of those in the survey expected trade finance in Asia to improve in 2012, whereas only 16% shared this optimism for Europe. Moreover, more than one-half expected trade conditions in Europe to deteriorate in 2012. As the report points out, some of the optimism in Asia may founder, as more than one-half of global trade finance comes from euro area banks. However, as this survey was conducted in January, the full effect from the ECB's liquidity injections, which improved sentiment in the European banking system, may not have been felt at that time. This suggests that trade finance may still have a difficult year, but nothing like late 2008 and early 2009 when the dearth of such funding was an important factor in the collapse of world trade flows.

The survey also points to regulatory concerns owing to the implementation of Basel III banking standards, where close to three-quarters of respondents claimed to have been affected by the process. Of particular concern is the regulatory perspective that trade finance is not a low-risk activity and should be classed similarly to high-risk derivatives and speculative loans. Banks point to the low-risk nature of this type of finance as a reason to exempt it; a database of 5.2m trade transactions conducted between 2005 and 2009, compiled by the International Chamber of Commerce, found that just 0.022% of these transactions ended in default. In an attempt to reduce some of the regulatory burden of Basel III, market participants are exploring the use of derivatives, such as collateralised debt obligations, for trade finance. Such instruments would transfer exposure to third-party investors and away from providers of trade finance.

*Bilateral trade deals are moving ahead*

In the absence of progress on the multilateral Doha round of trade negotiations, countries have turned to smaller and more focused deals. Bilateral free-trade agreements between the US and Colombia, Panama and South Korea were finally approved by the US Congress in early October, and by the president on October 21st, having languished for years in the US legislative process. The agreement between South Korea and the US took effect on March 15th. In November nine countries, including the US, committed to a broad agreement called the Trans-Pacific Partnership in a bid to boost trade in the region. After sealing an investment agreement, discussions on a trilateral trade deal between China, South Korea and Japan are expected to begin formally in May. These are positive steps for global trade, although the difficulty in agreeing a free-trade agreement (FTA) between the EU and India—where industries such as the automotive sector are causing concern—shows the painstaking and politicised nature of these negotiations.

*Protectionist sentiment remains a risk*

Moves that could impede global trade have been increasing of late. India, for example, recently introduced a ban on cotton exports. Indian officials have responded to criticism by announcing that they will scrap the ban, but the outcome of this move remains unclear. Last month, Brazil extended a financial tax on foreign loans to cover any debt that is maturing in up to five years. This tax, set at 6%, originally applied only to foreign loans of up to two years, before being extended to up to three years' maturity at the start of March. Brazil has also raised tariffs on imports and pledged more measures to weaken its currency, the Real. A dispute is also brewing over EU moves to apply carbon

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taxes to all airlines landing in the trade bloc. Non-EU governments are opposing the move, with some threatening retaliatory trade policies. The growing threat of trade disputes and protectionist measures has the ability to undermine the beneficial impacts of the recent FTAs, although the somewhat better outlook for the global economy may serve to blunt these moves.

A bill to provide for identification of misaligned currencies and to require action to correct the misalignment was passed by the US Senate in 2011. The bill is aimed at China, whose currency has been a target of US and European officials for years; they believe China is keeping the renminbi at artificially low levels to gain a competitive trade advantage. The bill has stalled since its passage by the Senate, and there is little prospect of it becoming law because of fears of retaliatory action by China. The US Treasury has said that China does not meet the formal definition of a currency manipulator, but negotiations are under way with Chinese officials to allow more flexibility in the renminbi.

Recent developments may take some of the sting out of the attack on China's currency. China had a cumulative trade deficit for the first two months of 2012, raising the question of whether the renminbi is approaching an equilibrium, or fair value. This would make the notion of gross undervaluation harder to justify. Chinese trade deficits, and similar trade figures for Japan, may signal a major change in the complexion of international trade. With imports forecast to grow faster than exports in China, and trade deficits expected for Japan as well, exporters to the region may see greater opportunities for growth.

## Commodity prices

**Commodity price forecasts**

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Oil prices** | | | | | | | | | | |
| Brent; US$/b | 72.71 | 97.66 | 61.86 | 79.63 | 110.96 | 115.00 | 103.63 | 108.25 | 104.00 | 110.00 |
| **Non-oil commodities**[a] | | | | | | | | | | |
| Total | 20.8 | 12.2 | -22.4 | 24.0 | 26.2 | -11.3 | -1.8 | -1.7 | -0.1 | 2.9 |
| Food, feedstuffs & beverages | 30.9 | 28.1 | -20.3 | 10.7 | 30.1 | -10.1 | -6.0 | -2.7 | 0.4 | 3.6 |
| Beverages | 14.5 | 18.8 | 1.0 | 18.0 | 21.1 | -17.9 | -12.2 | -5.0 | -0.7 | 7.6 |
| Grains | 35.4 | 29.1 | -28.9 | 6.9 | 41.3 | -10.8 | -5.1 | -2.6 | 2.5 | 3.8 |
| Oilseeds | 46.8 | 31.9 | -21.7 | 9.4 | 21.4 | -2.9 | -3.1 | -1.6 | -1.4 | 1.7 |
| Sugar | -32.0 | 30.1 | 29.6 | 24.3 | 23.6 | -9.3 | -7.4 | -2.9 | -5.9 | -2.5 |
| Industrial raw materials | 11.3 | -5.3 | -25.6 | 45.4 | 21.4 | -12.8 | 3.9 | -0.4 | -0.8 | 2.2 |
| Metals | 10.7 | -9.5 | -28.5 | 40.1 | 13.3 | -4.2 | 6.3 | 0.3 | -0.7 | 2.6 |
| Fibres | 18.1 | 2.3 | -11.5 | 42.2 | 43.2 | -33.5 | 2.5 | -5.5 | -3.9 | 2.5 |
| Rubber | 7.0 | 16.4 | -25.6 | 81.0 | 33.3 | -20.3 | -6.3 | 1.5 | 2.1 | 0.0 |

[a] % change in US dollar prices.

Source: Economist Intelligence Unit.

*Commodity prices have risen as the outlook for global growth has improved*

After sharp falls in the final quarter of 2011, commodity prices generally have been positive in 2012, buoyed by data releases showing more a positive growth trend in the US and an improvement in sentiment towards the euro zone. Oil prices have risen more sharply, reflecting the loss of supply from South Sudan, Syria and Yemen, but also reflecting supply concerns related to tensions between Iran and the West. Oil prices will remain hostage to sentiment


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surrounding the outcome of the EU embargo on Iranian oil and the impact of financial sanctions on Iran's ability to find buyers for its oil. Although ECB liquidity injections had a powerful initial impact, this appears to have been wearing off since early March. In the event of a renewed loss of confidence in the euro zone, sharp falls in commodity prices would again be in prospect.

On average, prices are expected to be weaker in 2012, owing to slower consumption growth and, depending on the commodity, some improvement on the supply front. A stronger US dollar will also be negative for commodity prices. However, loose global monetary conditions and a loss of confidence in sovereign creditworthiness, which is encouraging investors to seek return in real assets, will offer some support to prices. Furthermore, if oil prices remain high for a greater part of the year than we currently expect, this will lead to higher production costs for many raw materials, pushing up their price. However, persistently high oil prices also have the potential to derail the fragile global economic recovery, eventually leading to lower global demand and lower global commodity prices. With global demand set to record a greater degree of stability in 2015-16, commodity prices are expected to nudge higher.

**Oil:** Oil consumption growth of just 1.3% is forecast in 2012, reflecting the expected contraction in euro zone economic activity, the dampening effect on demand of high retail prices and unusually warm weather in the northern hemisphere winter. We expect all the growth in demand to be in the non-OECD, with OECD consumption—still nearly 50% of the total—expected to contract by 0.8%. Given that the oil market in Asia in 2011 was marked by destocking, consumption is expected to receive a boost this year from some restocking, particularly by China and India, but this assumes that prices ease back in the second half of the year. Within the OECD, another sharp contraction in EU demand is expected and US consumption is also likely to fall—despite the relatively more robust economic performance—as a result of high retail petrol prices, warm weather in the first quarter and, increasingly, efforts at conservation. The long-term decline in Japan's consumption is being temporarily arrested by the devastation caused by the March 2011 earthquake and the increased use of oil-powered generators, but we expect consumption to contract again by 2013. Global oil consumption will start to pick up in 2013 in tandem with stronger global growth, but will still contract slightly in the OECD as a result of efficiency gains and conservation. In 2014-16 we expect stronger global growth to fuel increases in annual oil consumption of around 2%.

*Non-OPEC output growth will be lacklustre until later in 2012-16*

Global crude oil production growth slowed in 2011, largely reflecting the loss of Libyan supply, but also production problems in the North Sea, Angola, Yemen and Azerbaijan. These losses were offset by increased OPEC production, particularly from Saudi Arabia and Iraq. We expect OPEC production growth to remain strong in 2012 but we have revised down our forecast of global supply this month, to reflect a weak start to the year in North Sea production and a somewhat lower forecast of Iranian production. We believe that the EU embargo on Iranian oil (effective July 1st; see discussion below) will lead to a loss of supply from Iran of about 400,000 b/d in 2012, with a sharper fall of closer to 600,000 b/d in 2013. Iran is expected to find markets, particularly in Asia, for much of the oil it would normally export to Europe, but some dis-

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ruption to supply appears inevitable. Under this scenario, OPEC output would still grow by a brisk 6.6% this year, before slowing to growth of 2.9% in 2013. In the remainder of the forecast period, OPEC's capacity will be boosted by the coming on stream of the massive 900,000-b/d Manifa field in Saudi Arabia, and by rising production in Nigeria, Angola, Algeria and the UAE.

On the non-OPEC front, we expect strong growth in unconventional North American production—the tar sands in Canada and shale oil in the US—in 2012, and output increases are also expected in Colombia, Brazil and Russia. Russian production in January reached a post-Soviet high of 10.36m b/d, although strong domestic demand is curbing export growth. However, total non-OPEC production will be depressed by the loss of oil from South Sudan, Yemen and Syria as well as weak North Sea output. On an annual average basis, non-OPEC output is forecast to grow by a lacklustre 1% in 2012-13. Towards the end of the forecast period, growth in non-OPEC supply will be driven by increases in production in Brazil and some Caspian producers.

*There remains the risk of a severe disruption to supply*

Tensions between the West and Iran over its nuclear programme have escalated since the end of 2011, with EU leaders announcing an import embargo on Iranian oil and the US imposing sanctions on Iran's central bank. Iran has responded to this ratcheting up of sanctions by threatening to block the Strait of Hormuz, through which about one-sixth of the world's oil passes as well as large quantities of natural gas liquids (NGLs) and LNG from Qatar.

At the time of writing, a new round of talks between Iran and the West has been scheduled for mid-April. The stakes are high on both sides: the US government faces an election in November, while Iran has to be mindful of the increasingly severe economic consequences of Western sanctions and its need to retain the support of the population for its nuclear programme. Our current forecast assumes that a military confrontation in the Gulf is avoided, but Iran may seek other ways to retaliate against sanctions, including using its influence in Iraq to slow the rate of expansion of that country's oil output.

Elsewhere in the Middle East, there are additional sources of actual and potential supply disruption. Security or political problems could re-emerge in Iraq following the withdrawal of US military forces. Political stability is also by no means ensured in Libya, as the new political forces jostle for power, and the domestic turmoil in Syria has already led to lower oil production in that country. Yemeni output has also fallen in recent months as a result of damage caused by civil unrest and exports from South Sudan have ground to a halt. The export pipeline from South Sudan runs through the North and is currently closed, following a dispute with the North over pipeline fees. Although Sudan only exports 260,000 b/d, its low-sulphur crude is needed by refineries, particularly in Asia. The disagreement is unlikely to be resolved quickly, and if and when it is resolved, it could take up to six months before output could be fully restored. The loss of output from these smaller producers is expected to remove around 500,000-750,000 b/d from the oil market in 2012.

Outside of the Middle East, Nigeria's oil industry continues to suffer from outbreaks of civil unrest. In early 2012 Islamist violence flared up in the north and there were nationwide demonstrations over a sharp increase in the retail price

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of fuel. Oil output was, however, unaffected. Notwithstanding the risk of civil unrest, we still expect Nigeria's output to rise steadily in 2012-16, primarily owing to the coming on stream of increasing amounts of offshore oil production.

*The high political risk premium in the market is expected to fade later in 2012*

To reflect the huge uncertainties weighing on the global supply picture and the strength in oil prices in recent weeks, we have raised our forecast for oil prices (dated Brent Blend) in 2012 to an average of US$115/barrel. This assumes that prices remain elevated, averaging US$120/b in the second quarter of the year, before slipping in the second half as the fears of extreme disruption to supply are not realised. During the second half of 2012, attention will increasingly be focused on weak consumption growth and some building of stocks. High prices in the first half will be an additional factor curtailing consumption globally. Notwithstanding, loose global monetary conditions and steady, if unexciting, demand growth in the emerging world will support prices. Improved economic growth prospects in 2013 will underpin prices but, on current supply projections, the surplus in the market is set to build, which will mean that prices will struggle to stay much above US$100/b. We forecast further gradual gains in the oil price in 2014-16 as consumption growth picks up and much of the incremental oil will be from higher-cost sources, such as Brazil and Canada.

*Signs that China will avoid a hard landing are supporting metals prices*

**Hard commodities:** Prices for most hard commodities fell sharply—in some cases by as much as 30%—in late September and early October last year, reflecting mounting concerns about slower global growth and indications of a deceleration in China's economy. For the most part, prices have since stabilised or risen on the back of signs that China was moving to loosen monetary policy, improving economic data releases in the US and the positive response to the ECB's liquidity injections. Unless the economies of China and developing countries generally slow more than we forecast, demand growth will continue to support prices in 2012, aided by tight fundamentals in some markets, such as copper and tin. Loose global monetary conditions and the likelihood that investors will be tolerant of risk will also be positive for commodity prices. The biggest risk facing the market is the potential for a collapse in China's property market or the banking system. Some of the heat has already been taken out of the Chinese property market as a result of policy measures to curtail speculation in real estate, but, for now, ongoing government infrastructure and house building projects are sustaining raw material demand. Prices as measured by our industrial raw materials index (IRM, which gives a heavy weighting to copper and aluminium) are expected to fall by an annual average rate of nearly 13% in 2012, before recovering and rising by 4% in 2013. We expect prices to start to strengthen from 2015, partly because of higher oil prices in those years and thus higher production costs for many miners, particularly in the aluminium and steel sectors.

**Soft commodities:** Although agricultural commodity prices fell as part of the general commodity sell-off, our food, feedstuffs and beverages (FFB) index still rose by about 30% in 2011, boosted by the strength of prices in the first half of the year. Supply generally improved in 2011 and a further improvement is likely in 2012-13 (assuming normal weather conditions), and market balances are expected to become more comfortable, allowing prices to ease in 2012, before stabilising in 2013. However, they will remain high by historical standards,

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partly because of the still-low level of stocks, but also because of solid demand growth as a result of population growth, urbanisation in the developing world (and less arable land), and the impact of biofuels production. Given the fragile stock position, any disruption to supplies from individual producers could exert significant upward pressure on prices. In the second half of the forecast period, we expect a positive supply response to contain pressure for higher prices. Partly as a result of recent supply fears and soaring prices, significantly higher levels of investment are going into agriculture globally, and this should start to reap rewards by 2014-16.

**Individual commodity price forecasts**

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| Aluminium (US$/tonne) | 2,638.2 | 2,572.8 | 1,664.8 | 2,173.1 | 2,400.2 | 2,213.0 | 2,362.5 | 2,397.5 | 2,400.0 | 2,450.0 |
| Barley (US$/tonne) | 263.4 | 256.3 | 159.3 | 193.2 | 252.8 | 225.0 | 210.0 | 205.0 | 210.0 | 215.0 |
| Coal (US$/tonne, Australia) | 65.7 | 127.1 | 71.8 | 99.0 | 120.9 | 108.0 | 110.8 | 115.0 | 120.0 | 122.0 |
| Cocoa (US cents/lb) | 88.6 | 117.1 | 131.0 | 142.1 | 135.2 | 111.8 | 113.8 | 117.0 | 125.0 | 130.0 |
| Coffee (Arabica) (US cents/lb) | 123.5 | 139.8 | 143.9 | 196.0 | 271.1 | 216.5 | 178.8 | 164.0 | 160.0 | 170.0 |
| Coffee (Robusta) (US cents/lb) | 86.6 | 105.2 | 74.6 | 77.0 | 109.2 | 90.7 | 72.8 | 64.0 | 60.0 | 80.0 |
| Copper (US cents/lb) | 322.3 | 316.2 | 233.6 | 344.5 | 400.5 | 403.0 | 427.5 | 425.0 | 415.0 | 425.0 |
| Cotton (US cents/lb) | 64.8 | 72.1 | 62.7 | 104.8 | 152.4 | 96.3 | 93.3 | 88.5 | 87.0 | 89.0 |
| Gold (US$/troy oz) | 696.7 | 871.7 | 973.0 | 1,224.7 | 1,568.3 | 1,701.3 | 1,662.5 | 1,033.8 | 875.0 | 850.0 |
| Iron ore (US$/dry metric tonne unit) | 123.0 | 156.0 | 80.0 | 145.9 | 164.1 | 155.0 | 150.0 | 120.0 | 150.0 | 170.0 |
| Lead (US cents/lb) | 117.2 | 95.0 | 78.0 | 97.3 | 108.8 | 104.0 | 109.0 | 112.5 | 120.0 | 125.0 |
| Maize (US$/tonne) | 170.1 | 227.8 | 172.0 | 194.8 | 293.9 | 273.7 | 257.5 | 255.0 | 260.0 | 270.0 |
| Natural gas (US$/mmbtu, Europe) | 8.56 | 13.41 | 8.71 | 8.29 | 10.52 | 10.78 | 10.27 | 10.57 | 10.85 | 10.90 |
| Natural gas (US$/mmbtu, US) | 6.98 | 8.86 | 3.95 | 4.39 | 4.00 | 2.85 | 4.06 | 4.85 | 5.50 | 6.00 |
| Nickel (US$/lb) | 17.0 | 9.6 | 6.6 | 9.9 | 10.4 | 8.1 | 7.9 | 9.0 | 8.9 | 9.4 |
| Oil: Brent (US$/b) | 72.7 | 97.7 | 61.9 | 79.6 | 111.0 | 115.0 | 103.6 | 108.3 | 104.0 | 110.0 |
| Oil: IEA (US$/b) | 72.1 | 96.9 | 61.4 | 79.0 | 110.1 | 114.1 | 102.8 | 107.4 | 103.2 | 109.1 |
| Oil: WTI (US$/b) | 72.3 | 99.6 | 61.7 | 79.4 | 95.0 | 104.3 | 101.6 | 109.9 | 109.2 | 115.5 |
| Palladium (US$/troy oz, London) | 350.3 | 353.2 | 257.4 | 526.3 | 733.5 | 648.0 | 662.5 | 600.0 | 625.0 | 650.0 |
| Palm oil (US$/tonne) | 780.3 | 948.6 | 682.8 | 901.0 | 1,125.4 | 1,079.9 | 1,023.8 | 991.4 | 915.0 | 945.0 |
| Platinum (US$/troy oz) | 1,299.0 | 1,563.2 | 1,204.8 | 1,610.1 | 1,721.1 | 1,594.1 | 1,562.5 | 1,500.0 | 1,600.0 | 1,700.0 |
| Rapeseed oil (US$/tonne) | 969.1 | 1,329.2 | 858.8 | 1,013.0 | 1,368.3 | 1,289.9 | 1,333.9 | 1,280.6 | 1,300.0 | 1,270.0 |
| Rice (US$/tonne) | 335.4 | 676.0 | 566.3 | 507.8 | 558.8 | 551.3 | 528.8 | 502.5 | 520.0 | 530.0 |
| Rubber (US$/tonne) | 2,474.4 | 2,880.8 | 2,142.5 | 3,878.0 | 5,168.3 | 4,117.5 | 3,860.0 | 3,917.5 | 4,000.0 | 4,000.0 |
| Silver (US cents/troy oz) | 1,341.2 | 1,499.9 | 1,469.4 | 2,019.7 | 3,525.7 | 3,255.0 | 3,180.9 | 1,977.9 | 1,625.0 | 1,675.0 |
| Sorghum (US$/tonne) | 162.7 | 207.8 | 151.1 | 165.4 | 268.7 | 230.0 | 190.0 | 200.0 | 225.0 | 230.0 |
| Soybean oil (US$/tonne) | 881.4 | 1,258.3 | 848.7 | 1,004.6 | 1,283.9 | 1,287.3 | 1,240.5 | 1,250.0 | 1,275.0 | 1,280.0 |
| Soybeans (US$/tonne) | 378.2 | 474.9 | 409.8 | 416.5 | 510.3 | 508.5 | 490.0 | 477.5 | 465.0 | 480.0 |
| Soymeal (US$/tonne) | 308.4 | 424.4 | 407.7 | 378.4 | 398.0 | 398.5 | 384.0 | 374.2 | 364.4 | 376.2 |
| Steel (US$/tonne) | 554.8 | 889.1 | 489.2 | 646.7 | 749.6 | 654.6 | 586.7 | 578.3 | 625.0 | 650.0 |
| Sugar (US cents/lb) | 10.1 | 13.1 | 16.9 | 21.1 | 26.0 | 23.6 | 21.9 | 21.3 | 20.0 | 19.5 |
| Sunflowerseed oil (US$/tonne) | 1,021.9 | 1,498.9 | 854.8 | 1,074.4 | 1,360.3 | 1,141.8 | 1,134.8 | 1,207.2 | 1,350.0 | 1,300.0 |
| Tea (US$/kg) | 2.1 | 2.3 | 2.7 | 2.9 | 2.9 | 2.5 | 2.4 | 2.4 | 2.3 | 2.3 |
| Tin (US$/lb) | 6.6 | 8.4 | 6.2 | 9.3 | 11.8 | 11.3 | 12.8 | 11.2 | 10.5 | 10.0 |
| Wheat (US$/tonne) | 268.7 | 340.9 | 234.8 | 242.8 | 329.0 | 285.2 | 272.5 | 262.5 | 270.0 | 280.0 |
| Wool (Aus cents/kg) | 955.3 | 891.5 | 804.3 | 917.3 | 1,279.8 | 925.0 | 1,027.5 | 965.0 | 900.0 | 925.0 |
| Zinc (US cents/lb) | 147.2 | 85.3 | 75.1 | 97.9 | 99.4 | 92.2 | 97.5 | 104.0 | 115.0 | 125.0 |

Source: Economist Intelligence Unit.

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# Global assumptions

**(Forecast closing date: April 17th 2012)**

## Global forecast

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Real GDP growth (%)** | | | | | | | | | | |
| **World (market exchange rates)** | **4.0** | **1.3** | **-2.4** | **4.0** | **2.5** | **2.2** | **2.7** | **2.9** | **3.0** | **3.1** |
| US | 1.9 | -0.3 | -3.5 | 3.0 | 1.7 | 2.2 | 2.1 | 2.2 | 2.3 | 2.4 |
| Japan | 2.2 | -1.1 | -5.5 | 4.5 | -0.7 | 1.5 | 1.3 | 1.6 | 1.2 | 0.9 |
| Euro area | 2.9 | 0.2 | -4.2 | 1.8 | 1.5 | -0.7 | 0.5 | 1.2 | 1.5 | 1.6 |
| China | 14.2 | 9.6 | 9.2 | 10.4 | 9.2 | 8.3 | 8.5 | 8.0 | 8.0 | 8.0 |
| **World (PPP exchange rates)[a]** | **5.2** | **2.5** | **-0.9** | **5.0** | **3.7** | **3.2** | **3.8** | **4.1** | **4.3** | **4.3** |
| OECD | 2.7 | 0.1 | -3.8 | 3.1 | 1.7 | 1.3 | 1.8 | 2.0 | 2.2 | 2.2 |
| Non-OECD | 9.1 | 6.0 | 3.1 | 7.6 | 6.2 | 5.6 | 6.2 | 6.3 | 6.3 | 6.3 |
| **World trade growth (%)** | | | | | | | | | | |
| Goods | 7.1 | 2.8 | -12.0 | 14.1 | 5.8 | 4.0 | 5.6 | 6.0 | 6.4 | 6.5 |
| **Consumer price inflation (%; av)** | | | | | | | | | | |
| **World** | **3.4** | **4.9** | **1.5** | **3.0** | **3.9** | **3.3** | **3.2** | **3.1** | **3.2** | **3.2** |
| US | 2.9 | 3.8 | -0.3 | 1.6 | 3.1 | 2.3 | 2.2 | 2.1 | 2.2 | 2.2 |
| Japan | 0.1 | 1.4 | -1.4 | -0.7 | -0.3 | 0.1 | -0.1 | -0.1 | 0.2 | 0.5 |
| Euro area | 2.2 | 3.2 | 0.3 | 1.6 | 2.6 | 2.2 | 1.8 | 2.0 | 2.0 | 2.0 |
| China | 4.8 | 5.9 | -0.7 | 3.2 | 5.5 | 3.7 | 5.1 | 4.2 | 3.9 | 4.1 |
| OECD[b] | 2.4 | 3.6 | 0.5 | 1.8 | 2.8 | 2.3 | 2.1 | 2.1 | 2.2 | 2.2 |
| **Export price inflation (%)** | | | | | | | | | | |
| Manufactures (US$) | 8.7 | 8.5 | -1.2 | 3.7 | 6.8 | -1.0 | 0.3 | 1.0 | 0.8 | 1.3 |
| **Commodity prices** | | | | | | | | | | |
| Oil (US$/barrel; Brent) | 72.7 | 97.7 | 61.9 | 79.6 | 111.0 | 115.0 | 103.6 | 108.3 | 104.0 | 110.0 |
| % change | 11.2 | 34.3 | -36.7 | 28.7 | 39.3 | 3.6 | -9.9 | 4.5 | -3.9 | 5.8 |
| World non-oil commodity prices (US$; % change) | 20.8 | 12.2 | -22.4 | 24.0 | 26.2 | -11.3 | -1.8 | -1.7 | -0.1 | 2.9 |
| Food, feedstuffs & beverages | 30.9 | 28.1 | -20.3 | 10.7 | 30.1 | -10.1 | -6.0 | -2.7 | 0.4 | 3.6 |
| Industrial raw materials | 11.3 | -5.3 | -25.6 | 45.4 | 21.4 | -12.8 | 3.9 | -0.4 | -0.8 | 2.2 |
| **Main policy interest rates (%; end-period)** | | | | | | | | | | |
| Federal Reserve | 4.25 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.50 | 1.75 | 3.00 |
| Bank of Japan | 0.50 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 | 0.50 | 0.50 | 0.50 |
| European Central Bank | 4.00 | 2.50 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.25 | 2.00 | 2.50 |
| Bank of England | 5.50 | 2.00 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 1.25 | 1.50 |
| **Exchange rates (av)** | | | | | | | | | | |
| US$ effective (2005=100) | 95.0 | 89.6 | 91.6 | 88.7 | 83.3 | 86.3 | 87.7 | 88.4 | 89.3 | 89.6 |
| ¥:US$ | 117.8 | 103.4 | 93.6 | 87.8 | 79.8 | 82.0 | 85.9 | 86.8 | 89.0 | 92.3 |
| US$:€ | 1.37 | 1.47 | 1.39 | 1.33 | 1.39 | 1.31 | 1.29 | 1.27 | 1.24 | 1.26 |
| Rmb:US$ | 7.61 | 6.95 | 6.83 | 6.77 | 6.46 | 6.25 | 6.09 | 5.90 | 5.86 | 5.67 |
| US$:£ | 2.00 | 1.85 | 1.57 | 1.55 | 1.60 | 1.59 | 1.61 | 1.58 | 1.60 | 1.61 |
| C$:US$ | 1.07 | 1.07 | 1.14 | 1.03 | 0.99 | 1.01 | 1.00 | 0.99 | 0.97 | 0.97 |
| ¥:€ | 161.4 | 152.0 | 130.4 | 116.5 | 111.1 | 107.0 | 110.8 | 109.9 | 110.2 | 116.3 |
| £:€ | 0.68 | 0.79 | 0.89 | 0.86 | 0.87 | 0.82 | 0.80 | 0.80 | 0.77 | 0.78 |
| **Exchange rates (end-period)** | | | | | | | | | | |
| ¥:US$ | 91 | 93 | 83 | 78 | 84 | 87 | 88 | 91 | 93 | 91 |
| Rmb:US$ | 7.31 | 6.84 | 6.83 | 6.62 | 6.30 | 6.20 | 6.00 | 5.93 | 5.79 | 5.67 |
| US$:€ | 1.39 | 1.43 | 1.34 | 1.33 | 1.29 | 1.29 | 1.25 | 1.26 | 1.26 | 1.26 |

[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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