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Summary

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Editorial

The economic environment is deteriorating throughout the world, and cycles are synchronous: the idea of decoupling propounded by some economists just a few months ago was definitely no more than a pipe dream. The IMF was projecting, in early October, 3% global growth in 2009 (6.1% for emerging countries). It was led, in early November, to lower its projections to 2.2% for the global economy (5.1% for emerging countries and -0.3% for advanced countries). This forecast looks overly optimistic. Recent cyclical developments have led us to revise our forecasts, which have already been far lower than the consensus since last year, further downwards. Our main scenario predicts GDP will contract by around 2% in the United States, in the United Kingdom as well as in Japan and more than 1% in the euro-zone. All in all, global growth should be only marginally higher than 1% in 2009.

The downturn in economic activity is, naturally, affecting the emerging world. For instance, China, faced with faltering export growth, down to 12.2% y-o-y in Q3 from 19% on an annual average in 2007, has had to interrupt the yuan's appreciation. The slowdown in industrial production and the correction in the real estate sector have led the government, determined to maintain growth close to 8%, to implement a very ambitious fiscal stimulus package (4,000 bn yuan, or 7.5% of GDP, over two years). Undoubtedly, this figure includes programmes for which expenditure had already been earmarked but, nevertheless, the fiscal stimulus is massive. It will likely include welfare measures (health, pensions and education), and is aimed at stimulating the decline in savings while allocating expenditure to improve the situation in the field of infrastructure facilities and housing. It has been furthermore backed by similar stimulus measures decided by the provinces.

The central bank, after three 27-bp rate cuts, decided last month to trim its key intervention rate by 108 bp. The rate on one-year loans was accordingly lowered to 5.58% and the rate on one-year deposits to 2.5%. These decisions were complemented by a further cut in the rate on statutory reserves, lowered by 100 bp for the largest financial institutions and 200 bp for smaller ones. The likely consequence of the slowdown as well as the rapid decline in inflation, down from its 8.7% peak in February to 4.6% in September and expected to drop to 1.6% next year, is that the central bank will press ahead with its monetary easing.

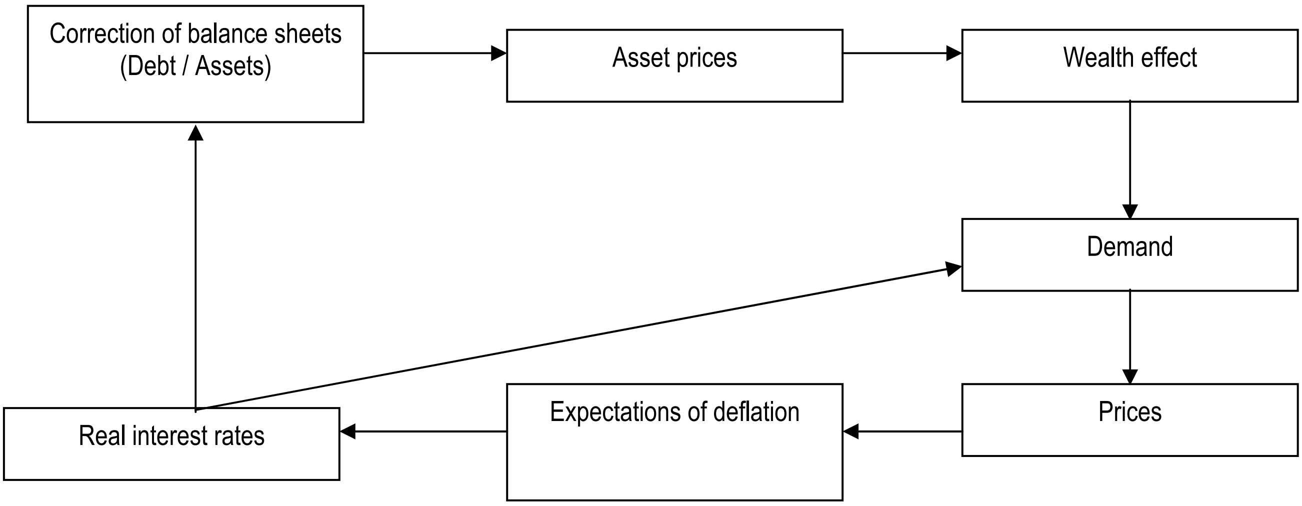
The global economic environment is also marked by the fact that inflation is ebbing very rapidly and fears of deflation have reappeared. The sharp drop in oil prices, due to base effects, will result in the consumer price index declining for a few months next year. The monetary authorities are determined to prevent this dip in inflation from leading to the expectation of a recurring fall in all prices that would fuel bearish expectations and, subsequently, trigger a deflationary spiral (cf. graph below). Indeed, central banks are reacting vigorously. They are seeking to prevent positive real interest rates from further worsening the economic environment against the backdrop of deleveraging and falling into the trap of money-market rates tumbling to zero combined with declining prices, leading to an increase in real rates. For instance, the Bank of England, after slashing its base rate by 150 bp in November, lowered them by a further 100 bp in December, thereby driving its Bank Rate down to 2%, its lowest level low since 1951. The ECB, for its part, cut its refi rate by 75 bp (also on 4 December). In two months, the refi rate has been lowered by 175 bp, lowering it to 2.5%. The Bank of Japan reduced its key rate from 0.5% to 0.3%.

Further rate cuts are likely in the very next few months. The Fed should lower its Fed Funds target rate to 0.5% on 16 December at the next FOMC meeting, while the Bank of England is expected to reduce its base rate to 1%, or even less, by the spring and the ECB will probably act likewise.

Simultaneously, governments are loosening fiscal policy. The new US administration is expected to get Congress to approve a massive (USD 500 -700 bn) stimulus package that will include tax breaks for the middle classes, expenditure on the infrastructure and undoubtedly also measures targeting over-indebted households. The United Kingdom, for its part, has announced a fiscal stimulus programme totalling GBP 20 bn (1.3% of GDP) with notably a cut in the VAT rate from 17.5% to 15% and the decision to bring forward expenditure on public infrastructure. Japan, where room for manoeuvre is restricted because the public debt ratio is already at 180% of GDP, has launched a fiscal stimulus plan in favour of households and SMEs that totals 0.2% of GDP. In the euro zone, the main member countries have announced measures amounting to *circa* 1-1.5% of GDP.

France announced, in early December, a EUR 26 bn plan (1.3% of GDP including 0.8% for public finances) aimed at stepping up investment in infrastructure facilities, stabilising the housing sector, helping companies' cash flow (by front loading tax credits and rebates and paying public market suppliers more rapidly) and, to some extent, supporting consumption (rebate on new-car purchases). In Italy, the emphasis has been put on welfare transfer payments to low-income households and on proactive labour market policies. In Spain, the recently announced EUR 11 bn plan has followed measures that had been previously decided. All in all, initiatives aimed at supporting the economy have climbed to a cumulative total, since the latest general election, of around 4% of GDP.

These measures, as they are combined with the cycle's negative effects on tax revenues, are resulting in ballooning deficits and leading to sometimes huge increases in spreads. The cost of covering 5-year CDS is rising at a rapid pace, and in early December it stood at 110 bp for the United Kingdom (versus 60 bp in mid-November and 8 bp in February), 161 bp for Italy, 106 bp for Spain, 56 bp for France and 43 bp for Germany.



Focus 1: The recession will be deep, in all likelihood, in the United States

Since the early 1950s, the United States has been hit by ten recessions. The latest one began, according to the NBER, in December 2007. With respect to its length, it is already far more severe than mild recessions, such as the ones that occurred in the early 1990s or the recession in 2001 that lasted 8 months. By contrast, deep recessions, for instance the deep recessions in 1973-1975 and in the early 1980s, were characterised by the fact that GDP continued to contract three quarters after they had begun. The current recession, which started one year ago, will drag on and gather momentum in Q4 and early 2009. In terms of how long it lasts, it will be even more severe than the recessions of the 1970s and 1980s.

Until the third quarter, the current recession was muted in terms of the decline in GDP that fell 0.6% in Q4 2007 and 0.5% in Q3 2008 after growing 2.8% in Q2. On a year-on-year basis, GDP was still growing in Q3. However, economic activity is expected to shrink far more markedly in the next few quarters if we draw on recent business cycle indicators. For instance, the manufacturing ISM, a reliable leading indicator, has plummeted in the last few months, after dropping through the 50-mark that separates expansion from contraction in August. It fell to 36.2 in November (with the orders component dropping to 27.9), down to a 26-year low, well under the troughs recorded in mild recessions, e.g. 39.2 in the early 1990s and 41.3 in 2001.

Moreover, the non-manufacturing ISM, down to 37.3 from 44.4 in October and 50.2 in September, has nose-dived to its lowest reading since recordkeeping began.

The financial crisis and the recession have led to a further tightening in credit conditions. The Fed's latest survey of commercial banks, the Senior Loans Officers Survey, showed that the net proportion of banks reporting they had tightened their lending standards jumped from 25% in Q3 2007 to 80.7% in Q3 2008 and rose again, up to 87%, in Q4 for loans to the real estate sector excluding housing. With respect to the same period, the proportion of banks reporting an increase in demand dropped from -28.8% to -30.8% and -55.6%, pointing to a contraction in investment in non-residential construction.

The tightening is just as evident for loans to companies since the net proportion of banks having tightened credit conditions climbed from 25% in Q3 2007 to 57.6% one year later and 83.6% in Q4 2008.

The tightening in mortgage lending standards has of course affected the subprime segment (100%), but also unconventional loans, up to 89.7% from 56.3% in mid-2007, and prime loans (up to 69.2% from 14.3% in mid-2007). Demand is still shrinking, with the balance of answers down to -51.9% in Q4 2008 from -30.5% in Q3 for conventional loans, and -72.4% versus 46.4%

for unconventional loans, whereas the percentage hit -100% for the subprime segment. The profile of answers with respect to consumer loans and credit cards is similar with net proportions of 58.8% for credit cards and 64.2% for other consumer loans, to be compared with3.2% and 26% one year ago, and in this case as well demand is reported to be plummeting, down to -48% in Q4 from -30% in Q3 and -22.4% in mid-2007

Household consumption dwindled to a noticeable extent in Q3, dropping to -3.7%. In October, it fell for the fifth month in a row (down 0.5% in real terms) and retail sales declined 2.8% after tumbling 1.4% in September, leading to a 10.9% contraction at an annualised pace in the last three months for which data are available. The nose-dive in oil prices has not offset, by far, the slowdown in borrowing, the impact of negative financial and property wealth effects[1] and, to an even greater extent, the deterioration in employment. All these factors are weighing on confidence. The consumer sentiment index calculated by the Conference Board stood at 44.9 in November after 38.8 in October and 61.4 in September. One year ago, it was at 87.8. Purchase intentions for vehicles and major household appliances are in a free fall. They dropped from 5.2 to 3.7 and from 32.5 to 23.8 in three months.

The labour market has been hit by an accelerating deterioration since the start of the autumn with payrolls shrinking by a record 533,000 jobs in November. Furthermore, job losses were revised upwards in October by 80,000 to 320,000 and by 119,000 to 403,000 in September. The decline in non-farm payrolls consequently averaged 419,000 jobs over the last three months versus 98,000 in the previous three months. The contraction in employment has resulted in a rapid increase in the joblessness rate, up from 5.5% in June to 6.5% in October and 6.7% in November. It would have risen to 7% if the participation rate had not fallen 0.3 percentage point to 65.8% after remaining flat in the last few months.

While the residential construction sector is still correcting, down 17.6% in Q3, corporate investment fell 1.5% in Q3, after growing 2.5% in Q2. Expenditure on capital goods dropped 5.6% and growth in spending on buildings (structures) fell from 18.4% in Q2 to 6.6% in Q3. The deterioration in the economic environment and profits and the consequences of the financial crisis on credit conditions (cf. *supra*) will noticeably weigh on capital expenditure. Orders of non-defence capital goods excluding aircraft have been steadily shrinking, down 4.1% in October after dropping 3.3% in September and 2.3% in August. In annualised data, in the last three months, they have tumbled 18.5%.

The support provided by external trade is weakening. Admittedly, the volume of imports has sharply shrunk, as a consequence of the deterioration in domestic demand and the dollar's appreciation until the summer. Since exports were booming, this had led to external trade contributing 2.8 percentage points to growth in Q2. Its contribution fell to 1.1 points in the third quarter, due to the rapid slowdown in the rise of export sales, down to 3.4% in Q3 from 12.3% in Q2, because of the impact of the across-the-board deceleration of the global economy. This trend is set to persist in the next few quarters. Accordingly, the export orders component of the ISM manufacturing index has been declining since September, plummeting from 57 in August to 52 in September and 41 in October and November.

Inflation surged to 5.6% in July, its highest level since 1991. The consumer price index fell by 1% in October — its steepest drop since 1947 — taking the inflation rate down from 4.9% to 3.7%. Core prices fell by 0.1% (its first decline since 1982) and core inflation sank to 2.2% versus 2.5% in September. Fears of inflation have been replaced by concern that deflation might be looming. 10-year break-even inflation slumped from 2% in August to 0.6% in November. Household inflation expectations drawn from the University of Michigan survey fell to 2.9% from 5.2% in the spring.

The Fed will likely trim its Fed Funds target rate from 1% to 0.5% at the next FOMC meeting, in mid-December. It has deployed new instruments, such as the purchase of up to USD 500 bn of mortgage-backed securities guaranteed by GSEs (Fannie, Freddie and Ginnie) and USD 100 bn of debt issued by these agencies. In addition, it has created a facility to support the issuance of asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration and allocated USD 200 bn to this facility. The Treasury has decided to allocate the entire TARP programme to capital injections. Lastly, a bailout plan has been implemented for Citigroup. These initiatives by the Fed resulted in 30-year mortgage interest rates dropping sharply to 5.47% at 30 November from 5.98% in the week before the announcement of the Fed's new package and 6.59% during the summer, leading to a surge in applications for mortgage loans, up 112% in a week, with applications for purchases of real estate goods jumping 38% and refinancing applications soaring 203.3%.

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[1] *We will dedicate a forthcoming article to these issues after the publication of the third-quarter Flows of Funds in the United States in mid-December.*

Once the Fed's rates have been cut to 0.5%, an extension of the quantitative easing policy seems likely, aimed at ensuring a decline in long-term interest rates.

Focus 2: Eastern Europe

Eastern Europe overall stands out from the average of emerging countries because of the fragility of their fundamentals that characterise these countries. As a whole, the region's current-account balance has markedly deteriorated in the last few years, with its deficit climbing to 5% of GDP while, the current-account balance of the emerging world in its entirety, excluding China and oil-exporting countries, is in equilibrium. Foreign capital flows have been massive, totalling 8% of GDP in 2007. Lending has been stimulated by extremely loose lending standards and exceeded GDP growth by 14%, on an annual average, between 2001 and 2008, versus 2% at the most in the other major emerging zones. In the Baltic countries, as well as in Hungary, Croatia, Ukraine, Poland, Romania and the Czech Republic, official reserves are lower than 50% of short-term external debt. Unsurprisingly, most emerging countries that have requested IMF aid, Hungary, Ukraine, etc., belong to this zone. As the financial crisis has worsened, exchange rates have dropped in line with the problems encountered in funding deficits — the Institute of International Finance expects bank loans to Eastern European countries to free fall from USD 219 bn in 2007 to USD 155 bn in 2008 and USD 74 bn in 2009 — as well as sometimes the unwinding of carry trade positions (Hungary and Poland). Lastly, short-term interest rates have risen, surging in two months by 800 basis points in Russia, 500 basis points in Ukraine and 250 basis points in Hungary, Romania and Croatia.

Beyond any doubt, the zone is going to be hit by a drastic slowdown in 2009. This is confirmed by the IMF forecasts, published in early November, although they are still relatively optimistic in our opinion, despite a further downward revision from the early October projections. Manufacturing PMI surveys in the Czech Republic and Poland have thus dropped under the 50-mark into contraction territory. Growth in the CIS and in Central and Eastern European countries, after already sharply declining this year (down to 6.9% and 4.2%, respectively, from 8.6% and 5.7% in 2007), will be halved in all likelihood next year, dropping to 3.2% and 2.5%.

These developments are far from neutral for the euro zone. The share of its exports (excluding intra-zone trade) shipped to Eastern Europe has gradually increased to the detriment of sales to the United Kingdom and the United States. Exports to Russia account for 4.9% of total exports, while those to the four main Central European countries (Poland, Czech Republic, Hungary and Slovakia) now total 12% versus 11.5% to the United States (down from 16.5% in the early 2000s) and 14.2% to the United Kingdom (down from 18.7% in the early 2000s). However, growth in exports shipped to Eastern Europe has markedly contracted. After peaking at 35% in Poland and Slovakia in 2006, it recently slowed to 15% and 12%, respectively. Growth in exports shipped to the Czech Republic, in the same period, decelerated from 20% to 10%, and plunged from 15% to less than 3% in the case of Hungary.

The euro zone's exposure to the deterioration in economic conditions in Eastern Europe is not restricted to the real economy. Euro zone's banks total an exposure of USD 1,300 billion to Eastern Europe according to BIS data, while that of Swedish banks amounts to USD 104 bn, i.e. far higher figures than for American banks (less than USD 63 bn). European banks hold USD 3,600 billion in debts on emerging countries, i.e. 14% of their total foreign debts, including 35% on emerging Europe, Turkey and Russia. Notwithstanding, there are significant differences between countries. Austrian banks are the most noticeably exposed, as Eastern Europe accounts for 48% of their foreign debts (70% of GDP), followed by Italian banks (16.5%) and their Swedish counterparts (13.4%) because of their significant exposure to Baltic countries. The respective commitments of French and German banks are far smaller, i.e. 4.1% and 4.5%, respectively, of their external assets. The substantial exposure of Spanish banks to emerging countries is accounted for by their commitments in Latin America (24.6% of their foreign debts).

All in all, the euro zone is exposed to the deterioration in Eastern European economies *via* two channels: on the one hand, the reversal of the cycle and, on the other hand, the huge size of debts held by some banking systems on this region.

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United States

Since September, economic data (in particular on consumer spending, manufacturing and services activity, and employment) have weakened substantially, which suggests that GDP will start to drop much more markedly in the fourth quarter. Due to the plunge in oil prices, deflation, rather than inflation, is now the main fear. Against this background the authorities are cutting interest rates, injecting capital into the financial system and taking many innovative steps to support financial markets and the economy.

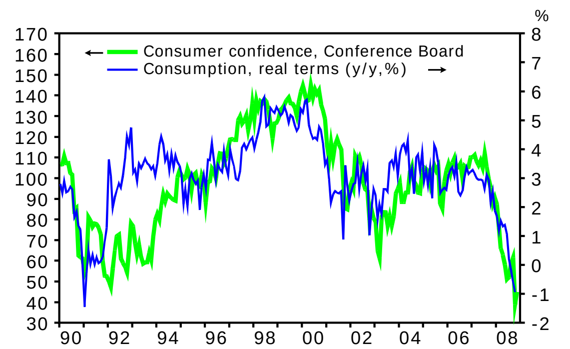
As if a dam broke

The recession is here

The slight contraction of GDP in the third quarter is just the beginning.

The recession, which according to the National Bureau of Economic Research (NBER) began in December 2007, has started to adversely affect US national accounts for the 3rd quarter. After momentarily robust growth last spring, GDP contracted at an annualised rate of 0.5% q/q annualised, the worst performance since 2001. Unsurprisingly, this weakness was the result of declining domestic demand excluding inventories (which subtracted 2.6 points from quarterly growth), while exports and changes in inventories limited the damage by adding 1.1 and 0.9 point to GDP growth respectively. Given the worsening of the financial crisis since September (and its effect on the credit market) and the impressive weakening of the economy over the past few months (in the US as well as abroad), we expect GDP to fall at a considerably sharper pace over the coming quarters.

Consumer spending and confidence



Sources: BEA and The Conference Board

Shrinking demand and supply

Consumption declines.

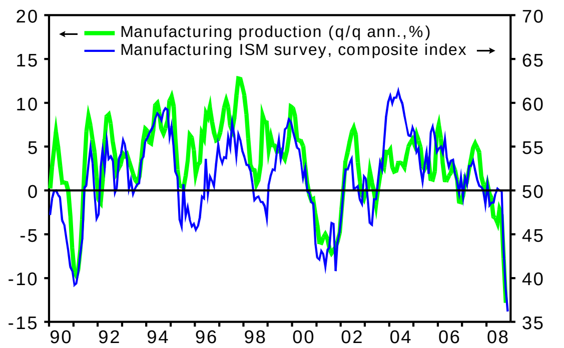
Consumer spending is at the root of the current downward trends. The 3rd-quarter decline of GDP is largely the result of shrinking household consumption, which fell at an annualised 3.7% q/q, the first quarterly contraction since 1991 and the sharpest since 1980. We expect this trend to continue over the coming quarters. The combination of adverse factors at work is indeed rather disturbing, with job losses steadily mounting, home prices still declining, equity markets down sharply and lending conditions increasingly tight. Not only do these factors depress household income, the negative wealth effect, tighter credit conditions and higher precautionary savings related to the increase in the unemployment rate have taken the household savings rate up from 0.6% in August to 2.4% in October. Against this background, real consumer spending was down 0.5% m/m in October, the fifth straight monthly decline. The recent slump of the Conference

Board's confidence index also reflects the current difficulties that households are facing. It fell to 38 in October when the financial crisis took a turn for the worse (its lowest level ever since the index was first compiled in 1967), before recovering to 44.9 in November.

Output and orders fall back, as survey data drop sharply.

Survey data also show that companies are producing and spending less. After dropping 1.2% and 3.7% m/m in August and September respectively, industrial output rebounded 1.3% m/m in October. However, this growth merely reflects a partial correction of the collapse in output that was largely attributable to such temporary factors as hurricanes Gustav and Ike and the strike at Boeing. After adjusting for these temporary disruptions, industrial output is estimated to have declined 0.7% m/m in both September and October. In short, the manufacturing sector is clearly on a downward trend and is not likely to improve over the near term judging from leading indicators and the anticipated repercussions of the financial crisis. On the contrary, survey data suggest that manufacturing activity will plunge further, with the ISM's PMI composite index slumping further in November, to 36.2, its lowest level since 1982 and one that points to a broader drop in general economic activity and not just manufacturing, according to the ISM (i.e. below 41). The weakening of foreign demand for US goods in the wake of the recession's spread to Europe, Japan and other countries and the dollar's appreciation have further dimmed the outlook for manufacturers, since robust exports have cushioned the domestic recession's impact over the past few quarters. With expected demand on the way down and credit conditions now significantly tighter, orders for durable goods have also fallen sharply (by 6.2% m/m in October), as manufacturers cut back on their investment plans. In the services sector the outlook is no brighter. The ISM's composite index for non-manufacturing sectors (NMI) fell further in November, from 44.4 to 37.3 (an all-time low), thus signalling a more marked contraction of activity in the services sector. This is understandable given the slowing of the two main drivers of the demand for services, i.e. manufacturing activity and household consumption.

Manufacturing production and the PMI index



Source: ISM and the Federal Reserve

The housing market shows no signs of improvement.

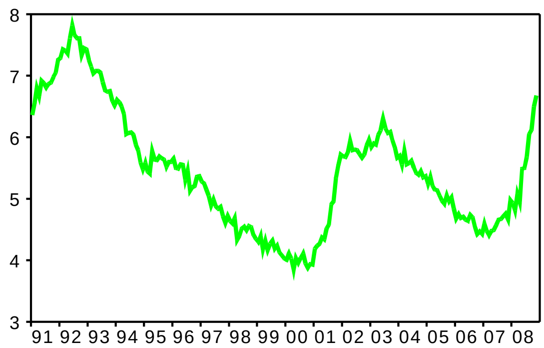
The housing market is also shrinking. Housing starts were down for the fourth straight month in October (by 4.5% m/m) and leading indicators show no signs that the construction sector is likely to improve soon, as building permit issuance also continued to fall and the NAHB's index of home-building confidence fell from 14 to 9 in November, a new historic low. The market for new homes continues to be bloated as sales steadily decline (by 5.3% m/m in October) and the inventory of unsold homes remains at an exceptionally high 11.1 months at the current rate of sales. Existing home sales have been more stable and have been hovering around an annual rate of 5 million units for almost a year. Nevertheless, lower home prices have not succeeded in boosting sales.

Job losses soar

Labour market situation: much worse since September.

As may be expected from bad news on the economic front and the US labour market's responsiveness to economic conditions, the number of job losses has risen sharply in recent months. Whereas monthly job losses until July did not exceed 100,000, the employment situation got considerably worse in September (-403,000 jobs), October (-320,000), and November (-533,000). Even though goods producing industries (construction, manufacturing industry) have also increased job cuts in recent months, services sectors now concentrate the major part of losses, a new feature in the cycle and a sign that the recession has spread to all sectors. The only service sectors that have not been affected are unsurprisingly the public sector, education and healthcare. The labour market's deterioration is also reflected in household survey data, with the jobless rate surging 1.7 point over the past eight months (the sharpest rise since 1982), which brings it to 6.7%, its highest level since 1993. Since economic activity is currently contracting more rapidly than ever, and since hiring tends to lag the economy, we do not expect the employment situation to improve over the next few quarters.

Jobless rate



Source: Bureau of Labour Statistics

When inflation is no longer the problem...

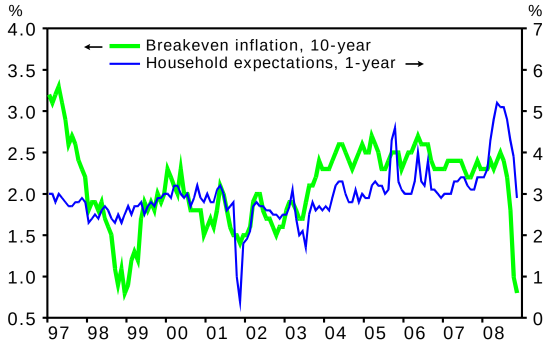
Inflation is no longer a threat...

There has been a drastic change in the inflation landscape over the past few months. After the annual inflation rate reached its highest level in July since 1991 (5.6%), it fell to 3.7% in October and is now expected to be negative in a few months. Inflation developments and expectations have been turned on their head by the plunging price of crude oil, lower prices for agricultural commodities and, beyond this, the recession's impact on the pricing power of companies and the wage-bargaining power of employees. The dollar's appreciation starting in July compounds these domestic factors, since it reduces imported inflation. In short, all of the main inflation drivers are slowing. Thus, not only were plunging energy prices largely responsible for the 1.0% m/m drop in consumer prices in October (the sharpest since 1947), core consumer prices, which exclude energy and food, were also down by 0.1% m/m (the first decline since 1982), causing core inflation to fall from 2.5% to 2.2% m/m. Inflation for 2009 is now expected to average about 0% - which means we would see negative readings in some months.

... whilst deflation fears are mounting.

Instead of high inflation, the main concern is now deflation. This change is reflected in the anticipated 10-year breakeven inflation rate, which has fallen from over 2% in August to 0.6% in November. Over a 5-year horizon, the breakeven inflation rate in November was even negative (-1.4%). According to the University of Michigan's survey, consumer expectations of inflation one year forward fell from 5.2% in May to 2.9% in November. The key question now is no doubt whether inflation's dip into negative territory in 2009 will be only temporary, or whether a spiral of increasing expectations of deflation, weakening demand and lower prices will enable a sustained deflationary process to take root. At the present time, the first scenario is certainly the most likely, since the sharp drop in inflation is still largely attributable to lower energy prices, whereas hourly wages continued to rise at a year-on-year pace of 3.7% in November, and the Federal Reserve's increasingly unorthodox monetary policy measures to support credit markets and lending will help dampen expectations of disinflation or deflation.

Inflation expectations



Sources: Federal Reserve and the University of Michigan

Sweeping economic policy initiatives

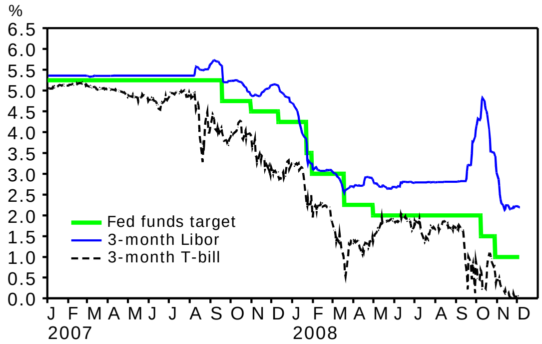
Interest-rate cuts.

Against this background, the Federal Reserve continues to use a variety of tools to contain the financial crisis and the recession. It resumed interest-rate cuts in October, lowering its fed funds target from 2% to 1% in just three weeks with two successive 50 bp cuts, the first in coordination with other leading central banks and the second at the scheduled FOMC meeting. Although now at an historic low the fed funds target is expected to be cut again on December 16, probably by 50 bp. The steps taken by the US central bank and government authorities have narrowed interest-rate spreads from the peak levels seen in October, although they are still inconsistent with the long-term outlook. The spread between three-month Libor and 3-month Treasury bills therefore fell to about 220 basis points in early December, from over 400 bp when yields peaked in October, while the 3-month Libor – OIS spread was down to 180 bp in early December, from its peak of over 300 bp.

Unorthodox measures to support credit markets.

In addition to such traditional monetary policy measures the Federal Reserve has continued to deploy a variety of new tools to support credit markets. One such tool is the Term Asset-Backed Securities Loan Facility (TALF), which is designed to support institutions that lend to small businesses and consumers (by backing student and car loans and credit card debt). Under this program the Fed will lend up to $200 billion to the holders of newly-created securities backed by such credit assets. This program is intended to support the ABS market and thus reduce the cost of credit for consumers and small businesses. Another such initiative involves purchasing up to $100 billion of debt issued by government-sponsored mortgage lenders (Fannie Mae, Freddy Mac and Federal Home Loan Banks), and up to $500 billion of mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. These measures are intended to lower mortgage interest rates and thus support the housing market.

Fed funds target and key rates 3 months forward



Sources: Federal Reserve and Reuters

TARP overhauled and new fiscal stimulus plan in pipeline.

Government officials have also revised their policy initiatives. Above all, the initial version of the Troubled Asset Relief Programme (TARP) was officially abolished, as Treasury Secretary Henry Paulson confirmed that the $700-billion package approved by Congress would not be used to purchase illiquid assets, as initially planned, but to inject capital directly into banks and other financial institutions, and thus support them more directly and easily, since the illiquid assets would not have to be valued. A special bailout plan for Citigroup was also implemented in coordination with the Federal Reserve and the FDIC. It involves an additional capital injection of $20 billion (from TARP and in exchange for preferred shares giving an 8% dividend) and the official guarantee by the Treasury, the FDIC and above all the Federal Reserve (USD 234bn) on a portfolio of some $300 billion of risky assets. As for Barack Obama and his top advisers, they are currently preparing a major fiscal stimulus plan they would like to see adopted as soon as the new administration takes over on January 20. We expect this plan to be significantly larger than that decided in spring 2008 (there has been talk of $500 to $700 billion), with a significant fraction of these funds allocated to infrastructure spending.

A stronger USD.

The US dollar has been rising steadily since August, gaining 2.9% m/m in November against a basket of leading currencies and 4.2% against the euro. The factors responsible for the dollar's strengthening since August include the repatriation of capital from the emerging economies (since they are considered to be riskier), the spreading of the global economic slowdown, the resulting convergence towards lower interest rates and increasing purchases of US government debt. The dollar may continue to strengthen a bit over the coming months.

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United States : Economic Forecasts

	2006	2007	2008(1)	2009(1)	2010(1)	Carry-over for 2008*
Components of Growth (y/y)						
Total GDP	2.8	2.0	1.2	-2.1	0.5	1.5
Domestic Demand ex Stocks	2.6	1.8	-0.1	-3.0	0.5	0.3
Private Consumption	3.0	2.8	0.2	-1.7	1.8	0.5
Public Spending	1.7	2.1	2.8	1.2	1.3	2.8
Fixed Investment	2.0	-3.1	-4.5	-14.6	-8.3	-3.6
Stocks (cont. to Growth)	0.0	-0.4	-0.3	0.0	0.3	-
Exports	9.1	8.4	7.8	-0.6	-0.1	8.0
Imports	6.0	2.2	-3.0	-6.0	1.2	-2.3
Inflation & Labour (y/y)						
Consumer Prices	3.2	2.9	3.9	-0.1	0.5	
Consumer Prices, ex. F + E	2.5	2.3	2.3	1.4	0.6	
Monthly Wages	3.1	3.4	3.0	2.4	2.1	
Unemployment Rate (%)	4.6	4.6	5.7	7.3	8.2	
Employment	1.8	1.1	-0.1	-1.7	-0.7	
Activity & Savings						
Industrial Production (y/y)	2.2	1.7	-1.4	-6.6	-1.1	
Savings Ratio (%)	0.7	0.6	1.7	2.1	1.6	
External Trade						
Trade Balance, USD bn	-753	-700	-670	-585	-630	
Current Account, USD bn	-788	-731	-680	-605	-640	
% of GDP	-6.0	-5.3	-4.7	-4.2	-4.3	

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts * Assuming 0 growth in Q4 2008

United States: Quarterly Profile

	Q3-08	Q4-08(1)	Q1-09(1)	Q2-09(1)	Q3-09(1)	Q4-09(1)
GDP q/q annualised	-0.5	-5.0	-3.4	-2.0	-0.6	0.3
GDP y/y	0.7	-0.5	-1.6	-2.7	-2.8	-1.4
Private Consumption y/y	-0.2	-1.8	-2.7	-2.9	-1.5	0.4
Fixed Investment y/y	-4.8	-7.3	-10.6	-14.7	-17.1	-16.3
Exports y/y	6.2	4.3	2.7	-0.8	-2.3	-1.8
Imports y/y	-3.4	-5.5	-7.1	-6.5	-6.4	-3.9
Industrial Production y/y	-2.6	-4.9	-7.1	-7.7	-6.7	-4.9
CPI y/y	5.3	1.8	0.3	-0.4	-1.3	1.2

Source: BNP Paribas, Economic Research Department q/q quarter-on-quarter change y/y year-on-year change (1) BNP Paribas Forecasts

United States: Financial Variables

	2006	2007	2008(1)	2009(1)	2010(1)
Financial Variables					
Money Supply	4.8	5.7	6.0	5.3	5.7
General Government Budget. USD bn	-248	-162	-455	-880	-1020
% of GDP	-1.9	-1.3	-2.8	-5.8	-6.5
	2006	2007	2008	2009(1)	2010(1)
Interest & FX Rates(2)					
Fed Funds	5,25	4,25	0.50	0.50	0.50
3-month Rate (%)	5,36	4,82	2.19*	1.38	1.00
10-year Bond Yield (%)	4,70	4,04	2.71*	4.10	4.80
EUR/USD	1,32	1,46	1.29*	1.14	1.20
USD/JPY	119	111	93*	98	108

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts (2) End of Period (*) spot rates on December 8, 2008

Japan

Japan slid into recession in the second quarter of 2008. It has felt the full impact of the contraction in activity in the United States, its main trading partner. The economy will only begin to recover gradually in the second half of 2009. Our forecast is for a quasi stagnation of GDP in 2008 followed by a contraction of 1.8% in GDP in 2009. For the moment, the government and the monetary authorities have limited leeway for taking counter-cyclical measures. On the one hand, the level of public debt (around 180% of GDP) rules out any unfinanced fiscal measures to stimulate the economy. On the other hand, the present level of interest rates limits the impact of lowering key intervention rates and argues in favour of further quantitative measures of monetary easing.

The worst has yet to come

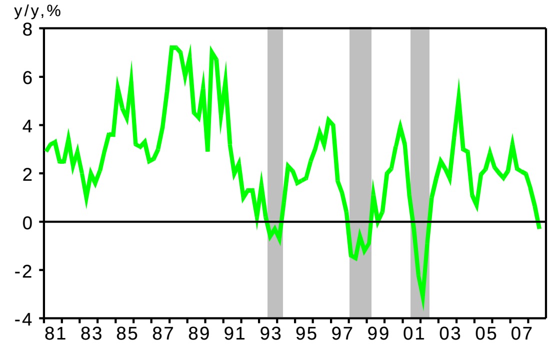
Japan has been in recession since the second quarter

Japan's economic outlook has deteriorated significantly in recent months. We are now expecting GDP to contract by 1.8% in 2009 after a quasi stagnation this year.

Japan has been in recession since the second quarter of 2008.

Third-quarter GDP was down slightly, by 0.5% q/q, after recording a marked decline (1.0% q/q) in Q2. All the surveys confirm the economic downturn. The leading indicator remained virtually unchanged in September at 89.4, close to its lowest point since February 2004. Its present level and that of the coincident indicator (100.9 after 100.7 in August) are consistent with further economic contraction. Also, in November, in its monthly report the government downgraded its appraisal of the economy, noting that it had slowed further since October and notably indicating that exports had declined significantly.

GDP (y/y, as %)



Source: ESRI

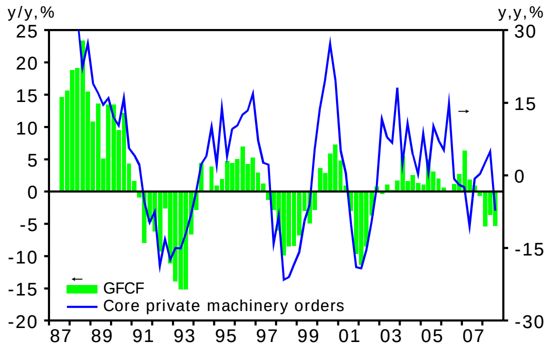
Manufacturing sector is hard hit by the global slowdown.

Industrial output fell by 3.1% m/m in October after growing by 1.1% in September. The transport equipment sector posted a particularly strong fall (5.8%), due mainly to significantly lower demand for vehicles in the United States, Europe and Japan. Moreover, inventories are increasing at a worrying pace. The ratio of stocks to deliveries increased by 3.8% m/m in October. According to METI forecasts, production will plummet in Q4 (-8.5% q/q). All in all, it will be down by 2.4% over the year. The leading indicators and national and international surveys do not augur well for the coming months. Manufacturing PMI dropped further in November, to 36.7 from 42.2 in October. It has remained below the 50-threshold – which separates expansion from contraction – since last March and is currently at its lowest level since the series began in October 2001.

Private consumption looks set to remain lastingly depressed.

Private consumption grew slightly in Q3 08 (+0.3%) after dropping by 0.7% in the second quarter. It is likely to continue to suffer from still high prices (in particular petrol and food) which have reduced household purchasing power, while wages are not rising. The first fourth-quarter data is not encouraging. Household consumption fell by 1.4% in real terms in October. Over the three months from August to October, it fell by 1.7% q/q after remaining virtually stable in Q3 (-0.1%) and declining by 3.3% in the second quarter. Furthermore, over the medium term the deterioration in the labour market will drag on household confidence, which fell to a record low of 29.4 in the third quarter. The job offers-to-job applications ratio dropped from 0.84 in September to 0.80 in October, its lowest level since May 2004.

Capital investment and machinery orders



Source : ESRI

Business investment is expected to contract further in 2009.

Business investment declined in the third quarter for the second consecutive quarter, down by 2.0% in Q3 after -2.1% in Q2 and 0.3% in Q1. Private sector core machinery orders (excluding ships and orders from power plants) plummeted in the third quarter, by 10.4% q/q and fell further in October (-4.4% m/m). In these conditions, business investment could contract by around 2.5% this year and even more significantly in 2009 (-8.1%) compared with growth of 2.3% in 2006 and 5.8% in 2007. Indeed, the uncertain outlook and the excess capacity accumulated in recent years have made firms more cautious, cutting back their investment programmes, notably in the manufacturing sector.

Residential investment will recover very gradually.

Residential investment plummeted in 2007, down 9.1%, following the introduction of more stringent regulations for obtaining building permits in June 2007 (in response to the scandal in 2005 involving fraudulent anti-seismic certificates). The decline continued this year, with a fall of around 8.5%, as the basic conditions for recovery are still not there – household purchasing power is still falling, credit conditions are being tightened and the real estate and stock markets have not yet stabilised. We expect to see only a very gradual recovery as from the second half of 2009.

Exports hurt by US recession.

Lastly, as in the third quarter, net exports cut growth by 0.2pp after a zero contribution in Q2. The global economic slowdown, notably in China and the United States, will continue to drag down exports over the coming months. While Japan and the other developed countries are feeling the full impact of the present crisis, Japanese exports are particularly severely affected by the recession in the United States (its largest trading partner) and by the appreciation of the yen.

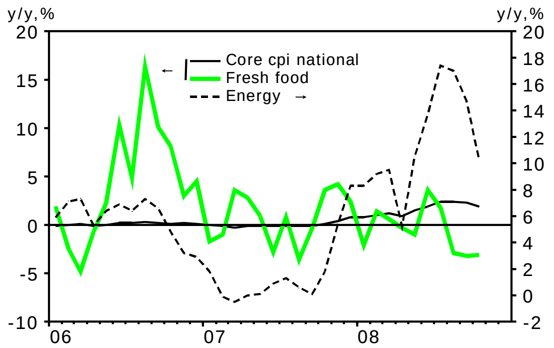
The new government's measures will have only a limited impact on growth.

At the end of October, the Japanese Prime Minister presented the general outline of a stimulus package, which will not however be approved before next April. The measures consist notably of extending some existing measures, due to expire at the end of the present fiscal year in order to 1/ restore confidence in the financial markets (temporary easing of prudential regulations relating to bank equity, repurchase of bank preferred shares, extension of tax exemptions on investments in shares for three years) and 2/ boost household consumption (reimbursement of income tax, regardless of income brackets, increased tax relief on mortgage loans, reduced motorway toll tariffs). The package also provides for a government guarantee for loans to small and medium-sized businesses (by extending beyond 30 March 2009 the recapitalisation structure for regional financial companies, which will provide financing to the credit associations and cooperatives that are the main financial intermediaries for SMEs) as well as additional regional and municipal subsidies totalling respectively JPY1,000 billion and JPY600 billion. All in all, the measures in favour of households and SMEs amount to only JPY5,000 billion, or 0.2% of GDP. Moreover, the delayed implementation of these measures makes it difficult to restore confidence, particularly as there is a possibility that these measures could be financed by raising the VAT rate three years out.

Inflation is falling.

After rising rapidly in the wake of soaring commodity prices, inflation excluding fresh food began to subside, after peaking at 2.4% in July it dropped to below 2% in September. More generally, inflation could drop to below 1% in December and even to below zero in the middle of 2009 (-0.1% on average in 2009). In its latest monthly report, the Bank of Japan considers that prices are “expected to moderate reflecting the declines in the prices of petroleum products and stabilisation in the prices of food”.

Inflation



Source : Ministry of Internal Affairs and Communication

The BoJ has opted for further quantitative measures of monetary easing.

In October, the Bank of Japan decided to cut its overnight rate from 0.50% to 0.30% and its basic loan rate from 0.75% to 0.50%. It considered that the outlook for growth and inflation was darkened by growing economic risk and downside risk on inflation. It revised its GDP growth forecasts for 2008 from 1.2% to 0.1% and for 2009 from 1.5% to 0.6%. It revised its inflation forecast to 1.6% this year and 0.0% in 2009 with a slight rise in 2010 to 0.3%. As it no longer has any leeway to cut its interest rates, the BoJ has adopted additional quantitative measures of monetary easing since September, thereby following the example of other central banks. It has taken several measures designed to restore stability in the financial markets (introduction of refinancing transactions in dollars, extending the range of JGBs eligible for repo transactions and a significant increase in CP transactions). Like the Federal Reserve, it also decided to pay interest on surplus bank reserves deposited with the central bank, at a rate of 0.1%. Lastly, at the beginning of December, at an emergency Monetary Policy Committee, it announced that is was lowering the minimum refinancing credit rating requirement for securities from AAA to BBB-.

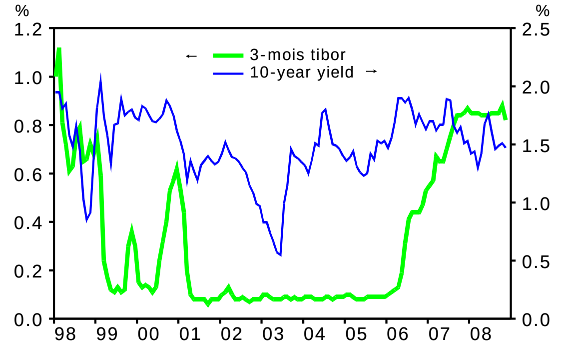
The yen continues to appreciate.

The yen has continued to appreciate since the crisis worsened, driven mainly by the repatriation of Japanese funds and unwinding of carry trade positions. The Japanese currency is likely to continue to appreciate in the absence of any rapid economic turnaround and rise in inflationary expectations linked to monetary tightening. It is unlikely to start to weaken before the middle of next year, dropping below 100 in 2010.

Ongoing tensions in the money market.

Long-term interest rates have fallen since mid-October, due to the initial quantitative measures announced by the Bank of Japan. Short-term interest rates have, however, remained very tight. Notably the 3-Month Tibor reached a 10-year high at the beginning of December, highlighting the ongoing lack of confidence and liquidity in the interbank market.

3-month Tibor and 10-year JGBs



Source: Reuters Ecowin

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Japan: Economic Forecasts

	2006	2007	2008[1]	2009[1]	2010[1]	Carry-over for 2008*
Components of Growth (y/y)						
Total GDP	2.0	2.4	0.1	-1.8	1.0	0.2
Private Consumption	1.5	0.7	0.9	0.0	1.1	0.8
Private Housing Investment	0.5	-9.3	-8.6	-8.1	0.3	-7.9
Private Capital Investment	2.3	5.8	-2.6	-5.3	1.4	-1.8
Public Consumption	0.4	2.0	0.5	0.3	0.8	0.6
Public Fixed Investment	-5.7	-7.0	-6.6	-0.1	-2.0	-6.9
Stocks (Cont. to Growth)	0.4	0.3	-0.2	0.0	0.0	-
Exports	9.7	8.4	4.5	-5.9	2.3	5.7
Imports	4.2	1.5	0.1	-3.1	2.0	0.6
Inflation & Labour (y/y)						
Consumer Prices (excluding fresh food)	0.1	0.0	1.4	0.0	0,4	
Monthly Wages	0.2	-0.7	0.6	-0.6	0,0	
Unemployment Rate (%)	4.1	3.8	4.0	4.4	4,5	
Employment	1.5	0.9	0.0	-0.4	0,1	
Activity						
Industrial Production (y/y)	4.5	2.8	-1.1	-5.3	0.8	
Savings Ratio (%)	3.3	3.0	2.5	2.3	1.8	
External Trade						
Trade Balance, JPY trn	9.5	12.5	6.0	6.1	3.3	
Current Account, JPY trn	19.8	25.0	19.1	19.2	16.0	
% of GDP	3.9	4.8	3.7	3.8	3.1	

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts *Assuming 0% growth from Q4 2008

Japan: Quarterly profiles

	Q3 08	Q4 08[1]	Q1 09[1]	Q2 09[1]	Q3 09[1]	Q4 09[1]
GDP, q/q	-0.5	-0.8	-0.7	-0.2	0.2	0.3
GDP, y/y	-0.3	-1.6	-2.9	-2.1	-1.5	-0.4
Private consumption, y/y.	0.6	0.3	-0.4	-0.2	0.2	0.5
GFCF, y/y	-3.6	-4.5	-7.3	-7.6	-8.1	9.6
Private housing investment ,y/y	-4.8	+3.6	-9.0	-9.0	-8.0	-8.0
Public Consumption, y/y	0.4	0.5	0.4	0.5	0.6	0.6
Public fixed investment, y/y	-5.7	-4.0	-0.1	-0.1	-0.1	-0.1
Exports, y/y	4.2	-2.9	-7.1	-5.5	-7.2	-3.9
Imports, y/y	1.1	-1.8	-3.5	-1.4	-4.3	-3.2
Industrial production, y/y	-1.7	-6.2	-5.8	-7.0	-5.8	-2.6
CPI (core), y/y.	2.3	1.2	0.5	0.0	-0.7	0.0

Source : BNP Paribas, Economic Research Department, q/q : quarter-on-quarter change; y/y : year-on-year change (1) BNP Paribas Forecasts

Japan: Financial Variables

	2006	2007	2008[1]	2009[1]	2010[1]
Financial Variables					
Money Supply (M2 + CD) (y/y)	1.1	1.6	2.1	1.5	1.5
General Government Budget, JPY trn	-21.4	-23.2	-35.4	-38.6	-41.2
General Government Budget, % of GDP	-4,5	-4,5	-6,9	-7,8	-8,0
Interest & FX Rates[2]	2006	2007	2008	2009[1]	2010[1]
O/N call Rate (%)	0.25	0.50	0,30	0.30	0.30
3-month Rate (%)	0.57	0.85	0.94*	0.80	0.65
10-year Benchmark (%)	1.69	1.50	1.39*	1.60	2.20
USD/JPY	119	111	93*	98	108
EUR/JPY	157	163	120*	112	130

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts (2) End of Period (*) spot rates on December 8, 2008

Eurozone

Economic conditions have deteriorated significantly over the recent months. After contracting over the latest two consecutive quarters leading indicators suggest that GDP is likely to contract even more in the coming quarters. Inflation is clearly heading south. At 2.1% in November it was down by almost 2 points with respect to its July's cyclical peak. Lower commodity prices and a widening output gap should continue to push inflation down. Under these conditions, the ECB should continue to ease its monetary policy.

From bad to worse

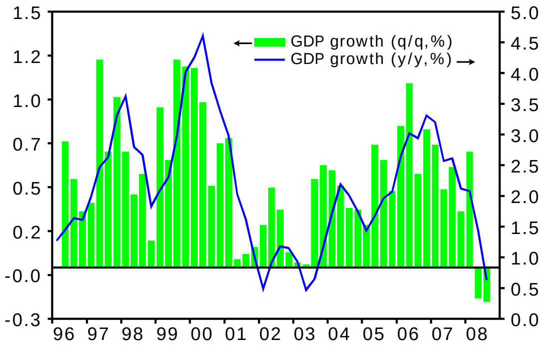
In recession

GDP fell by 0.2% q/q in Q3.

Growth concerns are mounting in the eurozone. According to Eurostat's first estimate, GDP dropped by 0.2% q/q in Q3. This was the second consecutive quarter of negative q/q GDP growth, which means that the eurozone is technically in recession. On yearly comparison, GDP growth decreased to 0.6%, down by 0.8 pp with respect to Q2 performance, and 2.6 pp lower to the cyclical peak (+3.3% y/y) in Q4 06, another sign of the ongoing slowdown in the economy.

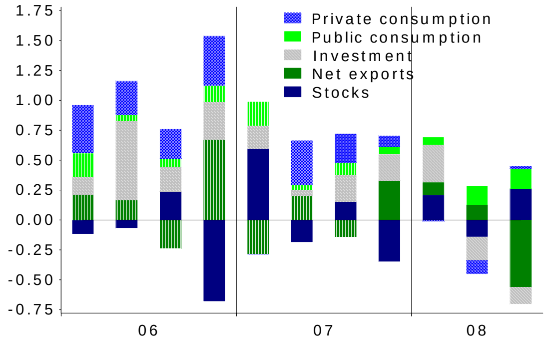
The GDP breakdown reported that the weakness was broad-based. Domestic demand performed badly. After contracting in the previous quarter, private consumption stagnated in Q3, in line with the poor reading of retail sales (+ 0.1% q/q in Q3). Investment was rather disappointing. Following a strong negative correction recorded in Q2 (-0.9% q/q), it fell again in Q3 (-0.6%). The external sector was not in a good shape either. Reflecting the worsening conditions in the international environment, exports increased by a modest 0.4% q/q, while their y/y growth rate decreased to 2.4 from 3.9% in Q3, their lowest rate since late 2003. However, as imports grew by 1.7% q/q, net exports deducted 0.6 pp from q/q GDP growth. Lastly inventories added 0.3 pp to GDP growth.

GDP growth



Source: Eurostat

Contribution to q/q GDP growth



Sources : Eurostat and BNP Paribas

Very dark clouds at the horizon

A GDP fall in Q4.

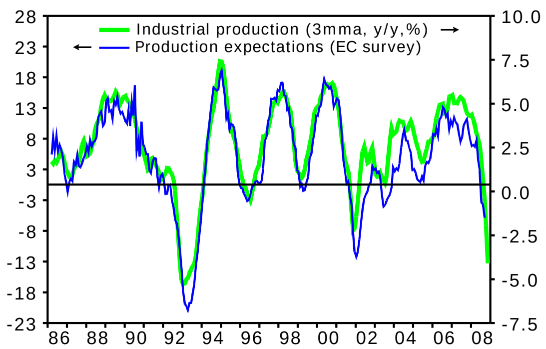
Available survey and hard data for the last quarter of the year, reported that economic conditions have further deteriorated. Reliable leading indicators of the momentum in activity signalled that GDP is likely to contract even more in the coming quarters. The closely watched composite PMI for activity, normally a good leading indicator of GDP growth, plunged to 38.9 in November, a new historical low, and it is now consistent with a fall of some 0.5% q/q in GDP in the final quarter of this year.

Deeper slowdown in the manufacturing than in the services sector.

By sector, manufacturing has taken over as the real driver of the slump in activity, at least for the moment. In November the manufacturing PMI plunged to 35.9, by far the lowest level ever recorded, driven down by decreasing levels of both domestic and external demand (the new export orders fell by almost 7 points). Keep in mind that exports are a key driver for this sector. As the external demand is suffering form the worsening conditions in the international environment, the manufacturing output will probably continue to decline in the near term. On this line, the European Commission survey reported that the industrial production expectations are at their lowest level ever recorded, pointing to further decline of industrial output.

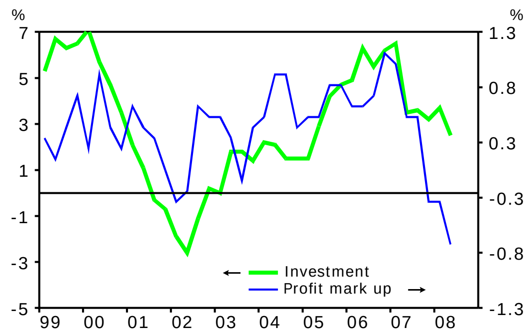
The services sector is not in a good shape either. Both the services confidence indicator (European Commission survey) and the business activity index from the services PMI survey, kept decreasing in November, although at a smaller pace than in the manufacturing sector.

Manufacturing activity should markedly decrease



Source: Eurostat

Decreasing profits point to lower investment growth rates



Sources : Eurostat and BNP Paribas

Strong downward correction in investment.

Under these conditions, perspectives for investment are note encouraging. Firms, facing a softer level of demand, lower capacity utilization, tighter credit conditions and decreasing profits will likely scale back their investment plans. The profit mark-up (i.e. the difference between the gross value added deflator and the unit labour costs), quoted by the ECB in the past as a gauge of investment momentum, have markedly decreased.

Deteriorating labour market conditions.

Survey data signalled that firms are also revising down their recruitment plans. Firms' employment expectations, as measured by the European Commission (manufacturing sector), deteriorated considerably over recent months. The employment index, from the manufacturing PMI survey, showed a similar trend. In November, it fell to 41, its lowest level ever recorded. In Q2 08, the employment growth was already decelerating. As employment lags economic activity, we expect the ongoing employment deterioration to continue and even to accelerate in the coming months. During the 2001/03 downturn, the unemployment rate rose from less than 8% to almost 9% between mid-2001 and mid-2005. Now that we are experiencing not only a slowdown, but a serious recession, the unemployment rate could increase more markedly. We expect the unemployment rate to flirt with 8% by year-end and to rise above 9% at end-2009. In 2010 the unemployment rate could increase further.

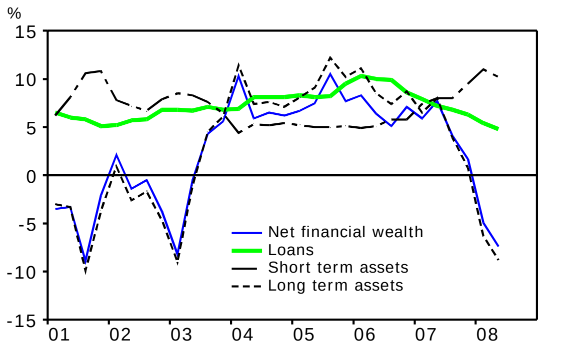
Consumption lacklustre in the coming quarters.

As consumption is particularly sensitive to labour market developments, it should remain lacklustre over the coming quarters. Moreover, other elements, such as tighter credit conditions and falling equity prices are undermining consumption perspectives. In the first half of the year, household net financial wealth has dropped substantially, due essentially to falling prices of shares and equities. As the stock exchange indices continued to lose ground (in November the EuroStoXX 50 index was down by more than 43% y/y and by around 40% with respect to the beginning of the year) household financial wealth should continue to trend down. Even though decreases in net financial wealth have a smaller impact on consumption than a fall in employment or in real disposable income[1], the losses in financial wealth are rather elevated and they are likely to affect consumers' plans over the next quarters.

GDP contraction in 2009.

All in all, we expect GDP to expand by a mere 1% this year, *i.e.* is a sharp deceleration with respect to 2.6% recorded in 2007. Next year GDP could contract by around 1%. GDP growth should not come back to rates close to its potential before the second half of 2010.

Household net financial wealth has drastically decreased (y/y % change)



Source: ECB

Consumers should increase their saving

Sources : Eurostat and BNP Paribas

Inflation heading south

Inflation down to 2.1% in November.

Inflation is clearly heading south. In November it decelerated to 2.1% down by 1.1 percentage points with respect to the previous month and by almost 2 pp with from the July the cyclical peak. Although the breakdown is not yet available, inflation should have benefited from lower commodity prices. In particular, between October and November, the price of a barrel of oil fell by around 19$ (i.e. more than 12€), which should have drastically reduced energy price inflation (around 10% of the headline inflation). Food prices should also have moderated considerably. Moreover, inflation benefited from favourable base effects. In particular energy base related effects should have subtracted around 0.4 pp from headline inflation.

Some upward pressures on core inflation.

By contrast, core inflation should have remained stable at 1.9%. In the near future, core inflation should remain subject to some upward pressures. Producer price inflation, although in moderation, is still relatively high. In October, the latest data available it was 6.3% y/y down from 7.9% y/y recorded in September. The PPI breakdown reported that the slowdown came mainly from the energy component. By contrast, consumer durable goods inflation increased while capital goods inflation was almost unchanged, indicating that some pressures from the core component at the factory gate are still present. Moreover, unit labour costs should continue to increase in the near future, driven up mainly by a rapid decline in labour productivity as it is often the case when the economy slows. Core inflation should remain around 1.8-1.9% over the next two quarters. However, sharply deteriorating economic conditions will help offset these pressures.

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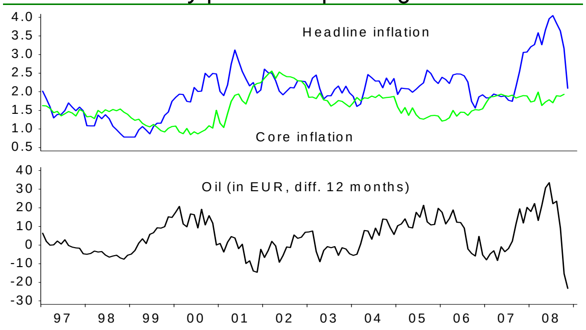
[1] *A 1% increase (decrease) in real net financial wealth would increase (decrease) consumption in the long-run by around 0.08%. Using the two-steps procedure of Engel and Granger, we estimated a consumption function with an error correction (ECM) representation. The estimated equation is the following:* $\Delta C_t = \alpha_i \sum_{j=0}^{2} \Delta RDI_{t-j} + \beta_i \sum_{j=0}^{2} \Delta RNFW_{t-j} + \gamma_i \sum_{j=0}^{2} \Delta rir_{t-j} + \lambda ECM_{t-1} + \xi_t$ *where C is real consumption, RDI real disposable income, RNFW, real net financial wealth and rir real long-term interest rate. Δ means first deference. Consumption, disposable income, and net financial wealth have been deflated using the consumption deflator. Lags are introduced to correct autocorrelations and are tested econometrically (Lags=0; for Δrir and ΔRNFW; and Lags=0;1;2 for ΔRDI). ECM is the stationary long-run relationship among real consumption, real disposable income, real net financial wealth and real long-term interest rate. All the variables are in log with the exception of the interest rate.* $ECM_t \Rightarrow c_t = const + \underset{(45.78)}{0.91} RDI_t + \underset{(9.73)}{0.08} RNFW_t \underset{(-2.96)}{-0.003} rir_t$ *Given that* $\lambda = \underset{(-3.33)}{-0.35}$ *the model is not explosive. Quarterly data from 1999 Q4 to 2008 Q2 are taken from Eurostat and ECB (t-statistics in brackets).*

We expect core inflation to decrease to around 1.5-1.4% at the end of next year and below 1% in the second half of 2010.

Headline Inflation will continue to trend down.

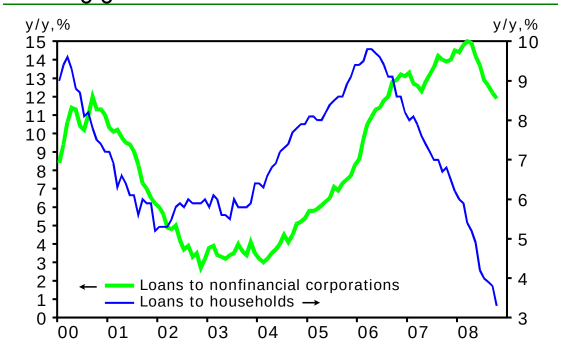
The profile of headline inflation is much more benign. It will probably continue to decrease over the next months, benefiting mainly from favourable energy and food-related base effects and lower commodity prices. In particular, in Q3 09, when the base will be the summer 2008 (in July oil price climbed to 147$ pb), strongly favourable base effects will probably push inflation well below 1%. For next year, inflation should be slightly above 1%, down from an estimated 3.3% for 2008.

Lower commodity prices are pushing down inflation



Sources: Eurostat and Reuters EcoWin Pro

Lending growth



Source: ECB

ECB: carry on cutting

The *refi* rate down to 2.50% on December 4.

At its December decision meeting, the ECB cut the *refi* rate by 75 pb, to 2.50%. Since October the ECB has lowered the *refi* rate by 175 bp. Nevertheless, conditions in the money and credit markets remain rather tense. In October, lending to household continued to decelerate at a high speed, while lending growth to non-financial corporations, although in moderation, remained rather elevated. This trend is likely to continue as the ECB bank lending survey reported that conditions for households and non-financial corporations will tighten further. By contrast, the European Commission Monetary Condition Indicator, which combines changes in real short-term interest rates and changes in real effective exchange rate, reported that conditions are somewhat less tense thanks to the euro deprecation. In October, it was down by more than 2% y/y in real effective terms and by around 7% y/y against the US dollar. This trend is likely to continue in the months to come. As the international environment is weakening, and the global investors' risk appetite is falling, the demand for US "safer" assets will increase, as it is always the case in periods characterized by high levels of uncertainty. This process will weaken the euro.

The *refi* rate to 1% by mid 2009.

Deteriorating economic conditions and improving inflation outlook call for further interest rate cuts. Sharp fall in commodity prices have had a major impact on inflation expectations. Firms' price pressures have been easing over the recent months reflecting lower input prices and softer levels of demand. Consumer inflation expectations one year ahead, derived from survey data have drastically decreased since last summer. These elements, combined with worsening prospects for the labour market, significantly limits risks of second round effects. Under these conditions, the ECB should continue to ease its monetary policy in the months ahead. The *refi* rate could be lowered to 1% by mid-2009.

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Euro zone: Economic Forecasts

	2006	2007	2008[1]	2009[1]	2010[1]	Carry-over 2008 *
Components of Growth (y/y)						
GDP	2.9	2.6	1.0	-1.1	0.7	1.1
Domestic Demand ex Stocks	2.7	2.3	0.9	-0.5	0.4	1.0
Private Consumption	1.9	1.6	0.4	0.4	0.3	0.3
Public Consumption	2.0	2.3	1.6	1.7	1.6	1.9
GFCF	5.5	4.4	1.5	-4.4	-0.2	1.7
Stocks (contribution to growth)	0.0	0.0	-0.1	-0.4	0.0	
Exports(2)	8.1	6.0	3.1	-2.8	2.0	3.4
Imports(2)	7.7	5.3	2.6	-2.3	1.6	3.1
Inflation & Labour (y/y)						
Consumer Prices (HICP)	2.2	2.1	3.3	0.9	1.3	
Core HICP (ex Food + Energy)	1.4	1.9	1.8	1.6	0.9	
Producer prices	5.1	2.8	6.8	0.4	-0.1	
Compensation per employee	2.2	2.3	3.4	2.6	1.7	
Unit Labour Costs	0.9	1.5	3.5	3.2	0.8	
Employment	1.6	1.8	1.0	-0.6	-0.2	
Unemployment Rate (%)	8.2	7.4	7.5	8.9	9.7	
Activity						
Industrial Production (y/y)	4.0	3.5	-0.2	-5.3	0.4	
External Trade						
Trade Balance, EUR bn	-14	22	-38.0	-10.0	-25.0	
Current account, EUR bn	-1	26	-43.0	-25.0	-40.0	
% of GDP	0.0	0.3	-0.5	-0.3	-0.4	

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts (2) incl. intra Euro zone trade * Assuming 0 growth in Q4 2008 onward

Euro zone: Quarterly Profile

	Q3-08	Q4-08[1]	Q1-09[1]	Q2-09[1]	Q3-09[1]	Q4-09[1]
GDP, (q/q)	-0.2	-0.4	-0.5	-0.2	0.0	0.1
GDP, (y/y)	0.6	-0.1	-1.3	-1.3	-1.2	-0.7
Private Consumption, (y/y)	0.0	0.1	0.3	0.6	0.4	0.1
GFCF, (y/y)	1.0	-1.1	-4.1	-4.6	-4.8	-4.1
Exports, (y/y)	2.3	1.2	-1.9	-2.9	-3.7	-2.5
Imports, (y/y)	1.6	1.3	-1.5	-2.0	-3.2	-2.3
Consumer Price Index, (y/y)	3.8	2.4	1.6	0.6	0.2	1.3
Industrial production, (y/y)	-1.3	-3.1	-5.6	-6.2	-5.6	-3.9
Unemployment Rate (%)	7.5	7.8	8.3	8.7	9.1	9.3

Source: BNP Paribas, Economic Research Department q/q : quarter-on-quarter change; y/y : year-on-year change (1) BNP Paribas Forecasts

Euro zone: Financial Forecasts

	2006	2007	2008[1]	2009[1]	2010[1]
Financial Variables					
General government Budget, EUR bn	-114	-55	-129.9	-253.1	-290.9
General government Budget, % of GDP	-1.3	-0.6	-1.4	-2.7	-3.1
Interest & FX Rates[2]	2006	2007	2008	2009[1]	2010[1]
Refinancing Rate (%)	3.50	4.00	2.50	1.00	1.00
3-month Rate (%)	3.73	4.68	3.50 *	1.49	1.50
10-year Bond Yield (%) (3)	3.96	4.32	3.11*	3.70	4.00
EUR/USD	1.32	1.46	1.29*	1.14	1.20
EUR/GBP	0.67	0.73	0.87*	0.78	0.76
EUR/JPY	157	163	1.57*	112	130

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts (2) End of Period (3) German Bund
(*) spot rates on December 8, 2008

Germany

After two quarters of contracting GDP, manufacturing output and exports, Germany's economy is already well into a recession. Nevertheless, survey data show that the country's economy is weakening at a particularly rapid pace. Although the labour market has been resilient so far, we soon expect stagnation and then rising unemployment. We foresee a decline of GDP of over 1% next year.

A recession "made in Germany"

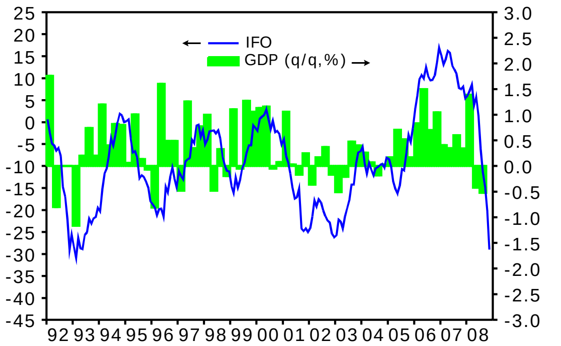
Heavy dependence on exports has exposed Germany to the full brunt of the global economic slowdown.

National account figures for the third quarter of 2008 have confirmed that Germany's economy has already experienced two quarters of substantial contraction, with GDP shrinking 0.4% q/q in Q2 and 0.5% in Q3.

A weaker contribution from exports and sluggish growth of final demand resulted in negative growth in Q3.

Most notably, after two consecutive quarters of decline and a 0.4% q/q drop in Q3, German export growth fell below 2% YoY, down from a peak of over 16% at the end of 2006. The negative contribution of net exports to GDP growth in Q3 was however considerably amplified by a 3.8% q/q surge in imports[1]. In contrast, final demand strengthened over the summer, with household consumption rising 0.3% by volume q/q (after three straight quarters of contraction) and investment spending (which fell 1.4% in Q2) stabilizing over the summer and up 0.1% q/q. Much of this may be attributed to the 0.3% q/q pickup in construction investment, particularly in the non-residential sector. In contrast, spending on equipment and machinery has begun to decline, decreasing 0.5% q/q. Year-on-year, this spending has grown only 1.6%, compared to over 15% growth in mid-2006.

Growth and business climate



Sources: Bundesbank and IFO

[1] *The volatility of imports, which is particularly high in Germany, often coincides with similar changes in inventories (which contributed 0.9 point to GDP growth in Q3). If these variations are excluded, net exports still reduced GDP growth by 0.8 of a point this summer – a movement that will probably be at least partially corrected in Q4.*

Sharp drop in manufacturing expected

Germany's economy has therefore already slowed considerably, with GDP growth now 0.6% YoY vs. 2.7% at the start of this year. However, recent economic data suggest that we may expect less and even negative growth in the fourth quarter of this year and in the first two quarters of 2009. Moreover, the IFO, PMI and European Commission indices of business sentiment show that the economic situation has gotten considerably worse in the fourth quarter, particularly in the manufacturing sector.

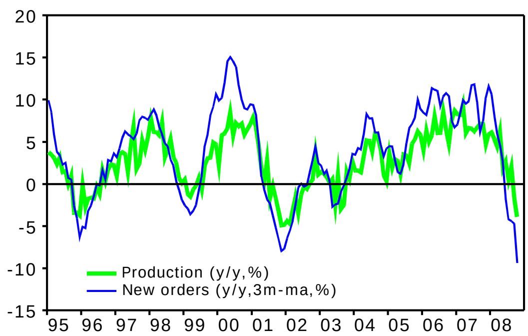
After falling over 7 points in two months (the sharpest drop since Germany's reunification), the IFO index fell to 85.8 in November and could, by the end of this year, fall below its 1993-low of 84.9. Similarly, the survey of purchasing managers in the manufacturing sector points to a much sharper contraction of manufacturing activity in Q4. This is largely confirmed by the most recent data of the Federal Office of Statistics, with October's manufacturing output down by more than 2% m/m, after a nearly 3% monthly drop in September.

An alarming collapse in manufacturing orders.

Most significantly, there has been a veritable collapse in orders for manufactured goods, which have plunged almost 14% over the two months of September and October. Domestic orders were down by over 10% YoY in October, while foreign orders plunged almost 23%. It therefore seems clear that although the euro has over the past few weeks returned to its end-of-2006 level (when exports were growing more than 10% a year by volume), this will do little to cushion the impact of slowing global demand.

Sharp drops in production, as well as manufactured exports are therefore inevitable over the coming months. More specifically, survey data of manufacturing orders – which may very well get worse – suggest that we could soon seen a 10% contraction in manufacturing output YoY.

Manufacturing output and orders



Source: Bundesbank

With net exports, its main growth engine, now sputtering, German GDP is likely to continue to contract sharply over the next few quarters, mainly due to declining exports and investment. Although we believe that things may stabilize somewhat in the second half of next year, we still expect GDP to shrink over 1% in 2009.

Recovery of household consumption is soft and not likely to last

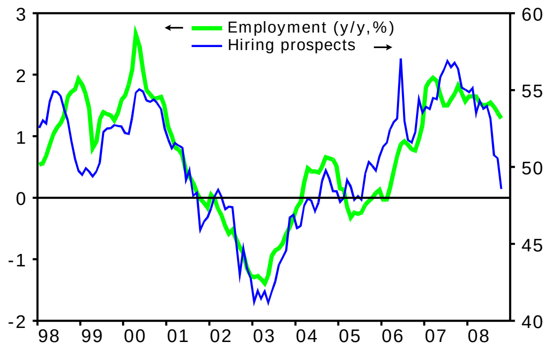
Under these conditions the outlook for consumer spending, which we believe will fall 0.3% in 2008, is still fundamentally weak. However, the rebound in consumption observed in Q3 may be attributed to several factors that could continue to boost spending over the near term.

As in the other euro-area countries, favourable base effects and plunging oil prices have recently weighed on inflation. Annual headline inflation in November was 1.4%, according to Germany's statistics office, and 1.5% according to the EU's harmonized index. This is the lowest level since December 2006, a full percentage point less than in October and two points less than when inflation peaked last July.

Weakening of labour market is inevitable.

Germany's labour market has been exceptionally strong and despite two straight quarters of economic contraction can boast 0.2% net job growth q/q in Q3, 0.3% in Q2 and a decrease in the jobless rate. The number of jobseekers fell once again in November, by 10,000, leaving the unemployment rate stable at 7.5%, its lowest level in over 16 years. Given the current softening of economic activity and hiring intentions, we expect the employment trend to reverse very soon.

Employment and hiring intentions



Sources: Bundesbank and BNPP calculations from Markit data

However, for the time being these labour market and inflation trends have enabled small gains in purchasing power in Q3 and a pickup in consumer spending over the summer with almost no change in the savings rate, which is already quite high at 11.4%. The Gfk index is a good indicator of the current state of consumer confidence – although extremely pessimistic about the economic outlook, German consumers feel that their financial situation is improving and have increased their purchase intentions. Although their sentiment is still quite weak, it improved once again in December.

How long will fiscal discipline be defended?

Will the deepening recession encourage the federal government to adopt more fiscal measures to support the economy?

The strength of job creation may be one reason why German authorities are still quite reluctant to use fiscal stimulus to boost the economy. Another reason may be the upcoming election since healthier public finances have been one of the coalition's major successes. The measures adopted in early November essentially involved granting over fifteen billion euros (0.7% of GDP) in additional credit to KfW to finance economic activity, with much less effort made to increase public investment in infrastructure.

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Germany : Economic Forecasts

	2006	2007	2008(1)	2009(1)	2010(1)	Carry-over for 2008*
Components of Growth (y/y), SA and WDA						
GDP	3.2	2.6	1.3	-1.3	0.9	1.4
Domestic Demand	2.2	1.2	1.1	-1.0	1.0	1.5
Private Consumption	1.2	-0.3	-0.3	-0.4	0.1	-0.4
Public Consumption	0.6	2.2	2.5	2.5	2.0	2.4
Fixed Investment	8.5	4.6	3.6	-5.9	2.4	4.2
Stocks (contribution to growth)	-0.1	0.1	0.1	-0.7	0.0	
Exports	13.1	7.7	4.0	-5.1	1.7	4.3
Imports	12.2	5.2	4.0	-6.8	1.9	5.0
Inflation & Labour (y/y)						
HICP	1.8	2.3	2.8	0.2	1.0	
Core HICP	0.7	1.9	1.3	1.3	0.6	
Unemployment Rate (%)	10.8	9.0	7.8	7.7	8.4	
Employment	0.6	1.7	1.4	-0.4	-0.3	
Activity and Savings						
Industrial Production (y/y)	5.9	5.9	1.1	-5.5	-0.1	
Savings Ratio (%)	10.5	10.9	11.5	11.9	11.9	
External Trade						
Trade Balance, EUR bn	159.4	196.4	179.9	193.6	191.0	
Current Account, EUR bn	141.5	182.9	170.0	191.7	189.6	
% of GDP	6.1	7.6	6.8	7.7	7.4	

Sources : Bundesbank and BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts *Assuming 0 growth from Q3 2008.

Germany : Quarterly Profile (Calendar and seasonally adjusted)

	Q3-08	Q4-08(1)	Q1-09(1)	Q2-09(1)	Q3-09(1)	Q4-09(1)
GDP, q/q	-0.5	-0.4	-0.6	-0.1	0.1	0.1
GDP, y/y	0.8	0.0	-1.9	-1.6	-1.0	-0.5
Private Consumption, y/y	-0.8	-0.4	-0.6	0.0	-0.5	-0.4
Fixed Investment, y/y	4.0	-0.3	-6.4	-6.3	-6.7	-4.2
Exports, y/y	3.2	0.6	-3.9	-5.4	-6.0	-5.0
Imports, y/y	5.2	1.8	-4.3	-5.5	-10.4	-7.0
HICP, y/y	3.3	1.8	0.9	0.1	-0.4	0.5
Core HICP, y/y	1.3	1.3	1.3	1.6	1.3	0.9
Unemployment Rate (%)	7.7	7.5	7.5	7.5	7.7	7.9

Source : BNP Paribas, Economic Research Department q/q : quarter-on-quarter change y/y : year-on-year (1) BNP Paribas Forecasts

Germany : Financial Variables

	2006	2007	2008(1)	2009(1)	2010(1)
Financial Variables					
General Government Budget, EUR bn	-37	3	0	-39	-53
% of GDP	-1.6	0.1	0.0	-1.5	-2.0
	2006	2007	2008	2009(1)	2010(1)
Interest Rates(2)					
3-month Rate (%)	3.73	4.68	3.50*	1.49	1.50
10-Year Bund Yield (%)	3.96	4.32	3.11*	3.70	4.00

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts (2) End of Period
(*) spot rates on December 8, 2008

France

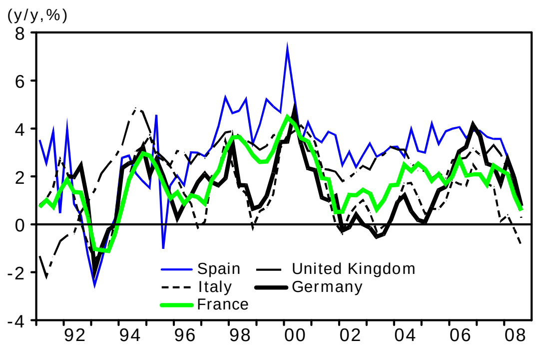
Despite the rebound in Q3, the long-run slowdown in activity remains as severe as in other euro-zone countries. The recent plunge in survey data confirms this diagnosis. The French economy is, accordingly, likely to suffer a deep recession next year, like other countries, despite the economic support measures recently announced.

A gloomy Christmas ahead

Economic activity: following a burst in Q3…

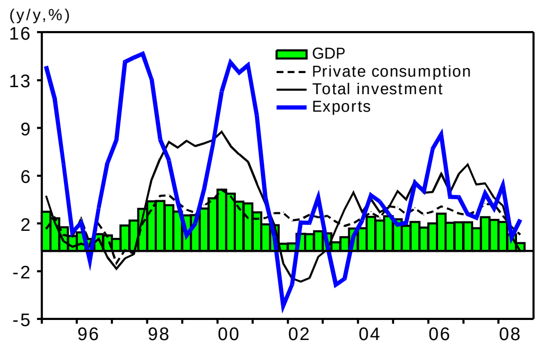
According to provisional figures published by INSEE, GDP put in weak growth in the third quarter of 2008, +0.1% q/q. The detailed breakdown of national accounts shows a slight increase in private consumption (+0.2% q/q), a smaller contraction in investment (-0.3% after -1.5% q/q in Q2), and zero contribution of foreign trade to growth in Q3 (after -0.4 percentage points in Q2).

Growth in major European countries (y/y, %)



Sources: National statistical institutes

GDP and main determinants of demand (y/y, %)



Source: INSEE

This outturn was better than expected and was sorely felt in other major European countries, since Germany and Italy at the same point in time were recording their second consecutive quarter of contraction in activity, and Spain and the United Kingdom their first. However, in annual terms, the slowdown in activity is no less pronounced in France than elsewhere (see above chart). GDP growth, alongside the increase in private consumption, came in at just 0.6% y/y in Q3 (against 2.0% at the beginning of 2008). Over the same period, overall investment was already showing a decline (-0.2% y/y against +3.2% at the start of the year), owing to the early reversal in household investment (chiefly in housing) which fell 3.7% y/y. In fact, the real surprise in the third quarter was a jump in exports (+1.9% q/q in volume terms, following a fall of the same magnitude in Q2), which was not clearly visible in the trade figures (-0.5% q/q in value terms, following -2.6% in Q2). Ultimately, this rebound, which will likely be temporary, meant that foreign trade did not weigh on growth in Q3.

…the winter will be harsh

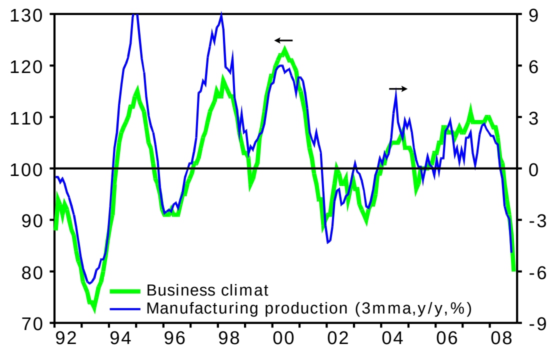
A string of record lows in survey data.

The Q3 accounts illustrate the economic situation in France before the brutal intensification in the financial crisis that started in mid-September. Since the summer, the cyclical situation has worsened dramatically. While the downturn in the property market continues, denting activity in the construction sector, surveys among business leaders point to a sharp drop-off in current and future activity in both the industrial and service sectors. Generally speaking, these surveys have been almost systematically worse than expected. As such, many indicators that make them up (past activity, overall and personal production prospects , order books, hiring intentions etc) have posted record lows, putting in monthly falls of a scale never before seen, or falling to lower levels than those recorded in 1993.

Industrial activity in trouble.

In the manufacturing sector (which has already seen two consecutive quarters of sharply lower output, -0.8% q/q in Q3 after -0.9% in Q2), sectoral data indicate weakness in activity is quite widely spread out, although developments are particularly alarming in the auto sector. After suffering the effects of soaring petrol prices, sales in the sector are now being hit by the general deterioration in households' income prospects. This has prompted households to drastically rein in their buying of vehicles. With global economic activity declining, French manufacturers in the sector have since announced several temporary factory closures, and made employees technically redundant (in the face of an annual fall in output of 20%-30% expected by the end of 2008 for certain major automakers)[1].

Manufacturing activity set to fall markedly



Source: INSEE

In this context, we expect several sharp falls in economic activity in the coming quarters. Notably, the fall in capital expenditure by non-financial companies should be particularly severe next year, while the fall in households' housing investment, in line with the downturn in the real estate cycle, should continue for longer, continuing to weigh on growth in 2010. Overall, economic activity is unlikely to stabilise until some point in the second half of 2009, with GDP falling on average by more than 1% next year.

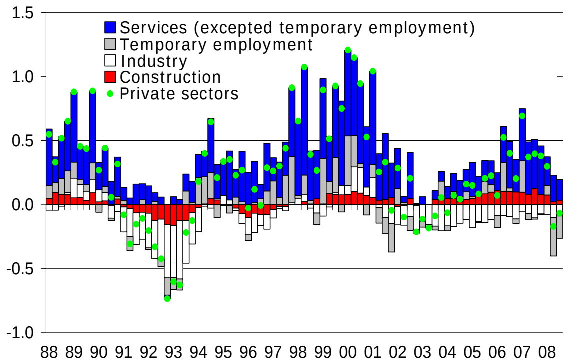
Labour market: this is only the beginning

The reduction in temporary jobs is a forerunner to greater job cuts.

Even though waged employment has already fallen for two quarters (-0.2% and then -0.1% q/q in the market sector), the adjustment in the labour market has only partially run its course, and will likely continue for a long time. So far, companies have largely been adjusting by reducing their temporary workforces. As such, more than 76,000 temporary jobs were destroyed between March and September, mostly in the industrial sector. We can expect a much greater slowdown in hiring (in the service sector) and much larger net destruction of jobs (in the industrial and construction sectors) in the future. Under these conditions, the unemployment rate (8.2% in October, according to Eurostat, a half-percentage point increase on June levels) is set to rise more quickly, to average around 9% in 2009.

[1] *To set these ideas down, a drop of this magnitude (we shall call it 20%) in Q4 for the whole French auto sector (located in France, including equipment companies), would imply a quarterly fall in production of 9%. That would reduce manufacturing value-added by 0.7%, and total value-added by 0.1%.*

Contributions to quarterly changes in employment



Source: INSEE

Inflation: the only present under the Christmas tree

Falling inflation remains the only encouraging aspect of the current outlook. As in other euro-zone countries, the annual growth in prices should have slowed sharply (more than a percentage point) in November. Ultimately, the inflation rate should fall around 1% by the end of 2008, down from a peak in July at 3.6%. In the near term, energy prices will continue to be the main factor in keeping prices tame. In the first half of 2009, the contraction in economic activity should weigh much more heavily than now on underlying inflation, which, at 2.1% in October, was only just beginning to stabilise.

With prices set to grow less than 0.5% year-on-year, deflation fears could take centre-stage again in mid-2009.

Come mid-2009, inflation could stand below 0.5%, fuelling fears of deflation, especially if there is not yet any sign of a rebound in economic activity. In the meantime, people will focus above all on the positive effects that slowing prices have on household purchasing power. Surveys are currently indicating that households view their prospects with respect to standards of living a little more positively than before, despite being conscious of ongoing and future rises in unemployment. All the same, they remain extremely cautious in terms of purchasing intentions.

Stimulus package: priority to investment

Given the severe weakness in growth prospects, the economic support measures recently announced will be welcome.

The stimulus package announced by President Sarkozy at the start of December has been valued at EUR 26 billion (1.3% of GDP). The government calculates the direct cost in terms of the fiscal deficit to be EUR 15.5 billion, or 0.8% of GDP, and its projected effect on GDP growth to be 0.6%.

The first phase provides for more than €EUR 10 billion of additional investment, chiefly by the state (EUR 4 billion) and state-owned companies (EUR 4 billion, which will not affect the central government budget). In view of the spending planned, the main economic sectors to benefit from the acceleration in expenditure initially envisaged beyond 2009 will be public works, construction and the capital goods industries. Moreover, all companies should benefit to the tune of EUR 10 billion as the government speeds up its debt repayment, chiefly in terms of tax (VAT reimbursement, bringing forward public works orders etc). Finally there are measures to encourage households to consume (e.g. bonuses for scrapping old cars) and to invest in housing.

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France: Economic Forecasts

	2006	2007	2008(1)	2009(1)	2010(1)	Carry-over for 2008*
GDP breakdown (y/y)						
Total GDP	2.4	2.1	0.9	-1.1	0.7	1.0
Domestic Demand ex stocks	2.7	2.7	1.0	-0.4	1.0	1.0
Private Consumption	2.5	2.4	1.0	0.8	1.4	0.9
Public Consumption	1.4	1.3	1.6	1.3	1.7	1.5
Overall fixed Investment	5.1	5.0	0.3	-5.4	-0.7	0.7
Stocks (cont. to growth)	-0.1	0.1	-0.1	-0.3	0.0	-
Exports	5.6	3.2	2.4	-4.4	0.0	2.8
Imports	6.5	5.9	2.3	-2.6	1.0	2.6
Inflation & Labour (y/y)						
Consumer Prices	1.7	1.5	2.8	0.8	1.3	
Underlying CPI	1.1	1.5	2.0	1.3	1.0	
Monthly wages	2.9	2.7	3.0	2.8	2.7	
Unemployment Rate (%)**	9.2	8.3	7.9	9.1	9.5	
Private NF payrolls	1.0	1.8	0.6	-1.4	-0.6	
Activity and Savings						
Industrial production, y/y	1.0	1.4	-1.2	-3.6	-1.0	
Savings Ratio (%)	15.0	15.7	15.8	15.9	16.0	
External Trade						
Trade Balance, EUR bn	-27	-40	-56	-52	-55	
Current Account, EUR bn	-12	-22	-38	-39	-45	
% of GDP	-0.7	-1.2	-1.9	-2.0	-2.2	

Sources: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts *Assuming 0% growth from Q4 2008 **Eurostat definition

France: Quarterly profile

	T3-08	T4-08(1)	T1-09(1)	T2-09(1)	T3-09(1)	T4-09(1)
GDP, q/q	0.1	-0.5	-0.5	-0.3	-0.1	0.0
GDP, y/y	0.6	-0.2	-1.1	-1.1	-1.3	-0.9
Private consumption, y/y	0.6	0.2	0.5	0.8	0.8	1.0
Overall fixed investment, y/y	-0.2	-2.6	-5.2	-5.5	-6.1	-4.9
Exports, y/y	2.7	0.8	-3.5	-3.2	-5.9	-4.9
Imports, y/y	1.9	2.0	-1.2	-1.9	-4.2	-3.2
Consumer Price Index, y/y	3.3	1.7	1.1	0.5	0.5	1.3
Unemployment Rate*	8.0	8.3	8.5	8.8	9.7	9.7

Sources: BNP Paribas, Economic Research Department q/q : quarter-on-quarter change; y/y : year-on-year change (1) BNP Paribas Forecasts
*Eurostat harmonised definition

France: Financial Forecasts

	2006	2007	2008(1)	2009(1)	2010(1)
Financial Variables					
Central Government Balance, EUR bn	-38	-41	-49	-84	-80
% of GDP	-2.2	-2.2	-2.5	-4.3	-4.0
General Government Balance, EUR bn	-45	-50	-59	-98	-101
% of GDP	-2.5	-2.7	-3.0	-5.0	-5.0
Interest Rates(2)					
3-month Rate (%)	3.73	4.68	3.54*	1.49	1.50
10-Year Benchmark (%)	3.99	4.44	3.55*	3.90	4.15
Spread versus Bund (bp)	3	11	30*	20	15

Sources: BNP Paribas. Economic Research Department (1) BNP Paribas Forecasts (2) End of Period * spot rates on December 8, 2008

Italy

GDP growth fell into negative territory for the second time in a row in Q3. Current recession is the fourth that Italy experiences since the year 2000 but it is going to last significantly more than previous episodes. With household debt to GDP ratio amounting to just 40%, Italy is better equipped than others to stand the consequences of the international financial crisis. But the opposite holds for the adverse fallout of economic recession as, in Italy, unemployment benefits and other active counter-cyclical labour market policies amount to only 1.3% of the GDP compared to 1.9% in the EU-27 average.

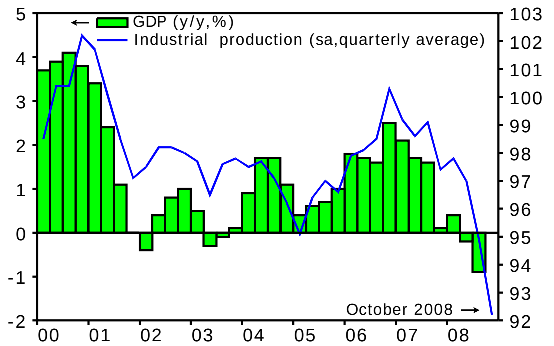
Back in recession

The Italian economy has moved into recession

Further contraction of GDP in Q3 2008 and downward revision to Q2 data.

In Q3 2008, the Italian economy recorded the second consecutive contraction, entering in a technical recession for the fourth time in the last eight years. Real GDP decreased by 0.5% q/q, with Q2 data revised down to -0.4% from -0.3% estimated before. The Italian economy has shrunk for three of the last four quarters. The annual growth rate of GDP dropped to -0.9% from -0.2% in Q2. The carry over for 2008, assuming no GDP growth in Q4, is -0.3%.

Italy: real GDP and industrial production



Source: Istat

The collapse of industrial production has not come to an end

The PMI fell to the lowest level, signalling further contractions in industrial activity.

In the third quarter as a whole, production tumbled by 2.2% q/q, after -0.8% in the previous three months. In October, industrial activity further collapsed by 1.2% m/m. The seasonally adjusted index fell to the lowest level in ten years. The sharpest decrease was recorded in the production of intermediate goods (-2.1%), while activity in the energy sector contracted by 1.7%. Industrial activity has being affected by the weakening of demand and the increasing uncertainty about the outlook. Production is expected to further contract in coming quarters. In September, industrial orders fell for the second consecutive month (-1.5% m/m, after -0.9% in August) constrained by domestic demand (-2.6%). In November, the PMI manufacturing index plunged to 34.9, the lowest level since the beginning of the series in 1997 and well below the 50 threshold which separates contraction from expansion.

Households: the crisis hits confidence

No good news from private consumption ...

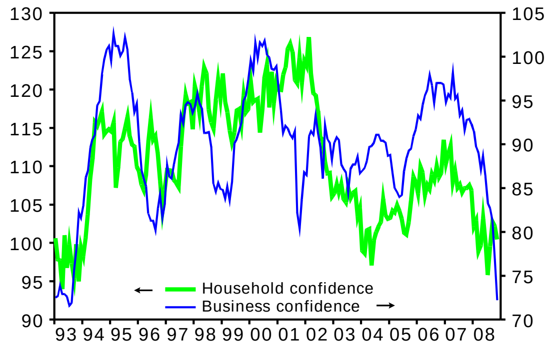
Private consumption, after falling by 0.3% q/q from April to June, slightly rose in the third quarter (+0.1% q/q), adding 0.1% to the overall GDP growth. Despite this moderate rebound, prospects for consumption remain negative. Households expenditure is expected to be disappointing in coming months. From January to October, VAT receipts, referred only to internal transactions, fell in nominal terms by 1.1% with respect to the same period of 2007. In November, new cars registration strongly collapsed (-29.5% y/y). Besides, labour market conditions have deteriorated. In Q2, the number of persons unemployed increased for the fourth consecutive quarters (+3% q/q, after +5.6% in Q1), jumping above 1.7 million, the highest value since the beginning of 2006. The unemployment rate rose to 6.8% from 6.6 in Q2, it was 6.1% in Q2 2007.

... as confidence further deteriorates.

The deterioration of overall economic situation and personal conditions has strongly sapped consumer confidence, which has declined since the beginning of 2007. In November, the ISAE index decreased from 102.2 to 100.4, well below the historical average.

Over recent months, Italian households are getting some relief from lower inflation. In November, the harmonised price index fell by 0.4% m/m. Oil and energy products contributed to this development subtracting an estimated 0.2%/0.3% to the overall Inflation. In November, gasoline price declined by about 10% m/m. On annual basis, inflation decreased by 0.8%, to 2.8% from 3.6% in October. It was 4.2% in August.

Italy: the economic confidence



Source: ISAE

A grim outlook for business investment

Firms scale back their investment expenditures.

Over recent months, several factors have contributed to worsen the outlook for business investments, which collapsed by 1.9% q/q in Q3. According to Bank of Italy estimates based on national accounts, operating profits of companies declined in the twelve months ending in June. This negative trend has been confirmed by latest figures on fiscal revenues. From January to October, corporate income tax receipts fell by 5.2% with respect to the same period of 2007. Besides, business confidence has being affected by growing concerns on domestic and external demand. In November, the ISAE index fell to 72.2, the lowest level in fifteen years. Italian firms are expected to further scale back their investment decisions in coming quarters.

Global recession adversely affects Italian exports.

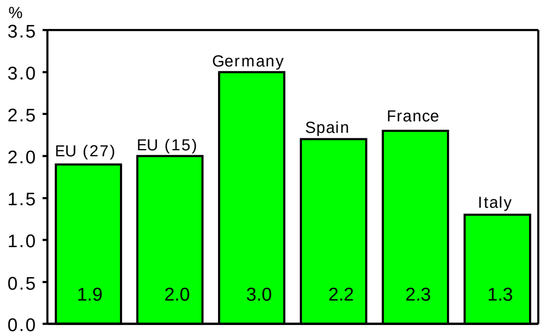
Italian companies are also suffering from the weakening of global economy. The slowdown of demand in the main outlets of Italian products is evident in latest trade balance data. From January to September, exports to Germany and to France slowed (respectively +3.8% y/y and +3.1%), while those to Spain and to the United Kingdom contracted (-4.3% and -4.4%). Italian companies benefited from an increasing demand from oil producer countries, partly offsetting the significant slowdown recorded in some advanced economies. From January to October, exports to OPEC countries rose by about 20%, while those to US decreased by 5.6%. Comparing the first ten months of 2008 with the same period of 2007, exports to non EU countries grew by 7.7%. However, the trend is reversing; exports fell by 3.6% m/m in October.

Further contraction ahead

The anti-crisis Italian package.

In face of the deepening recession the Italian government reacted by approving a fiscal stimulus package aimed mainly at helping low income families with cash handouts and tax breaks as well as a cap on mortgage payments. The country's large public debt prevented Italian authorities from matching the outlays planned by French and German governments. Some 1.3m people will benefit from "social cards" worth €40 a month that can be spent on basic items and utilities while 8m Italians are set to benefit from tax breaks amounting to €2.4bn. Highway tolls will be frozen for the first half of 2009. A new "Social Fund for Employment and Training" will be set and funded with some €1.26bn in order to relieve the adverse consequences of recession on labour markets. The anti-crisis package does not assign specific funds to recapitalise Italian banks, but a previous provision allows the government to underwrite special convertible bonds by banks to raise their Tier 1 capital ratios.

Public expenditure on labour market policies (% of GDP; 2006)



Source: Eurostat

The Italian GDP may fall by 1.2% in 2009.

Looking ahead, further contraction of the Italian GDP is expected in line with the deepening of recession throughout the whole Europe. Our forecast for 2009 has been downward revised to -1.2%. However, a reasonable chance for recovery is set in two years time with a forecast for a +0.7% increase in 2010. On structural ground, Italy looks better equipped than other European countries to face the consequences of the international financial crisis. In Italy the household debt to disposable income ratio amounts only to 40% and is much lower than elsewhere. However, on the same structural grounds, the Italian economy is more exposed to the strains of recession as its welfare system is far less generous than others in terms of unemployment benefits and other out-of-work income maintenance and support. Public expenditure on labour market policies amount only to a meagre 1.3% of national GDP in Italy vis-a-vis 3% in Germany, 2.3% in France and 1.9% in the EU-27 average.

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Italy : Economic Forecasts

	2006	2007	2008[1]	2009[1]	2010[1]	Carry-over for 2008*
Components of Growth (y/y)						
Total GDP	1.9	1.4	-0.4	-1.2	0.7	-0.3
Domestic Demand ex Stocks	1.4	1.3	-0.3	-0.8	0.7	-0.2
Private Consumption	1.1	1.5	-0.4	-0.2	0.4	-0.4
Public Consumption	0.9	1.3	1.1	1.4	1.6	1.0
Fixed Investment	2.7	0.8	-1.6	-4.6	0.8	-1.1
Stocks (Cont. to Growth)	0.4	0.0	-0.5	0.0	0.0	-
Exports	6.5	4.5	-1.0	-3.3	1.5	-0.7
Imports	6.1	4.0	-2.3	-1.6	1.5	-2.2
Inflation & Labour (y/y)						
Consumer Prices (CPI)	2.2	2.0	3.5	1.3	2.1	
Core CPI (ex Food + Energy)	1.6	1.8	2.3	1.9	1.7	
Hourly Wages	2.8	2.3	3.4	2.0	2.8	
Unemployment Rate (%)	6.8	6.1	6.8	7.8	7.8	
Employment	1.9	1.0	0.6	-0.3	0.0	
Activity						
Industrial Production (y/y)	2.4	-0.2	-3.0	-2.8	1.5	
Savings Ratio (%)	11.5	11.2	11.7	12.0	12.0	
External Trade						
Trade Balance, EUR bn	-11.5	-4.0	-3.0	-2.0	-2.0	
Current Account, EUR bn	-38.5	-37.4	-46.0	-40.0	-38.0	
% of GDP	-2.6	-2.4	-2.9	-2.5	-2.3	

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts *Assuming 0 growth after Q3 2008.

Italy: Quarterly Profile

	Q3-08	Q4-08[1]	Q1-09[1]	Q2-09[1]	Q3-09[1]	Q4-09[1]
GDP, y/y	-0.9	-1.0	-2.0	-1.7	-1.0	-0.2
GDP, q/q	-0.5	-0.6	-0.5	-0.1	0.2	0.3
CPI, y/y	4.1	3.0	1.7	1.0	0.9	1.6

Source: BNP Paribas, Economic Research Department q/q quarter-on-quarter change, y/y year-on-year change (1) BNP Paribas Forecasts.

Italy: Financial Variables

	2006	2007	2008[1]	2009[1]	2010[1]
Financial Variables					
Primary Budget, EUR bn	18.6	52.5	31.7	28.5	32.6
% of GDP	1.3	3.4	2.0	1.8	2.0
General Government Budget, EUR bn	-50.0	-24.1	-47.5	-57.0	-57.0
% of GDP	-3.4	-1.6	-3.0	-3.6	-3.5
	2006	2007	2008[1]	2009[1]	2010[1]
Interest & FX Rates[2]					
3-month Rate (%)	3.73	4.68	3.50*	1.49	1.50
10-year Benchmark (%)	4.22	4.66	4.49*	4.30	4.50
Spread over the Bund (bp)	26	33	138*	60	50

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts (2) End of Period (*) spot rates on December 8, 2008

Spain

Spain did slide into recession in Q3 2008. Given a growth model that relied heavily on private indebtedness and construction, the Spanish economy is likely to be particularly severely – and lastingly – affected by the present crisis. Although necessary, the fiscal stimulus measures will not be sufficient. Structural reform is essential to ensure a lasting upturn in activity.

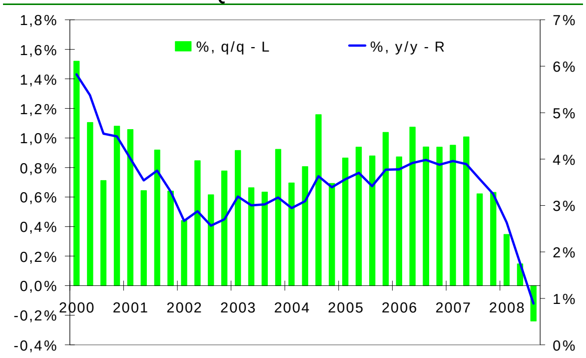
"Ticket no longer valid beyond this point"

GDP contracted in Q3 2008

GDP contracted for the first time since 1993.

After virtually stagnating in Q2 2008, GDP contracted in the third quarter (-0.2% q/q), marking Spain's slide into recession. This is the first contraction in GDP recorded since June 1993. Despite the measures taken by the government to stimulate the economy, household consumption - the main engine of growth up to then - fell sharply, dragged down by soaring unemployment, a drop in disposable income and tighter credit conditions. For its part, investment declined for the second quarter running, affected by the crisis in the construction sector and by the economic slowdown. The decline in imports – in line with weaker domestic demand - nonetheless enabled external demand to make another positive contribution (+0.6 percentage points). We are expecting activity to continue to decline over the coming quarters, with GDP expected to contract by 1.5% in 2009 to compare with growth of 1.3% in 2008 and 3.7% in 2007.

GDP contracted in Q3 2008



Source: INE

A record drop in activity

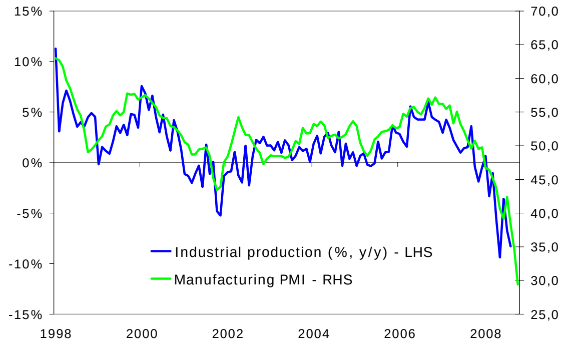
The deterioration in activity is likely to continue.

The industrial production index, adjusted for seasonal changes and calendar effects, has fallen for seven quarters running in year-on-year terms. The production outlook is hardly any brighter. The purchasing manager surveys point to a strong decline in activity over the coming months. The manufacturing PMI dropped to an all-time low of 29.4 in November. It has stayed below the 50 mark – supposed to separate growth and contraction in activity – since December 2007. New orders – a good leading indicator of activity – have also hit an all-time low at 26.5. For its part, the services PMI index also dropped to an all-time low of 28.2, remaining below the 50 mark for the eleventh month in a row. Services activities have notably been hit by the downturn in the real estate market, which has severely affected real estate agents and large property developers, which are now over indebted.

Worsening crisis in the real estate market and the construction sector.

The real estate crisis continues to undermine the Spanish economy. The number of mortgage loans extended and real estate transactions continues to decline steadily. According to OECD data, house prices in real terms dropped by 5.0% y/y in Q3 2008. The downturn in the real estate market has resulted in serious difficulties for the construction sector. Building permits and housing starts continue to decline. This widespread downturn is reflected in the European Commission's construction sector confidence index, which dropped to -31 in November. It has been negative since November 2007. The order book components also remain negative, at -30. Given the inertia of the construction sector, the downward adjustment is likely to be lengthy: the stock of housing for sale now stands at close to one million units. Investment in construction is therefore expected to fall sharply in 2009 and 2010, by respectively 17.5% and 11.9%.

Manufacturing PMI and industrial production



Sources: INE and Markit Economics

Household consumption flounders

Private consumption declined by 1.0% in Q3 2008.

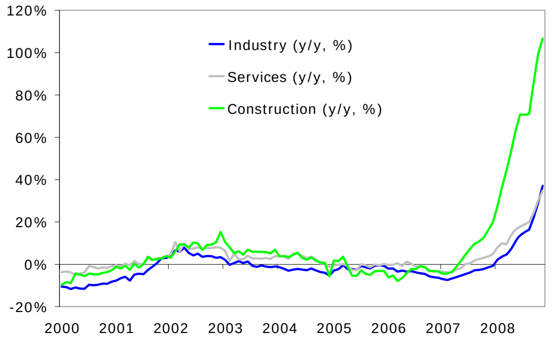
Private consumption declined in Q3, for the first time since 1993. The surge in unemployment, the fall in gross disposable income and the tightening of credit conditions continue – and will continue - to be the main factors weighing on household demand. Against this backdrop, the European Commission's household confidence index fell to an all-time low in October (-44). Household expectations, with regard to both the overall economic situation and employment, are consistent with a pronounced drop in private consumption. Retail sales and new car registrations are therefore likely to continue to decline over the coming months. All in all, we are expecting private consumption to contract sharply, dropping by 2.8% in 2009 to compare with growth of 0.5% in 2008.

Soaring unemployment

Nearly three million people are now jobless.

The economic slowdown has resulted in a surge in unemployment. In November, the number of job seekers climbed by 42.7% year-on-year to nearly three million. At 12.8% of the labour force in October, Spain's unemployment rate is now the highest in the euro zone. Unemployment rose most sharply in the construction sector, up 8.4% m/m, versus 6.5% in manufacturing and 6.0% in services. Unemployment is expected to continue to rise over the coming months in the construction sector – which accounted for 12% of total employment in 2007. Unemployment is also set to rise sharply in the services sector, notably due to the difficulties encountered by real estate agents and property developers. We expect the unemployment rate to climb to 17.0% in 2010 after reaching 15.3% in 2009.

Trend in numbers of unemployed by sector



Source: INE

An inflationary peak, followed by disinflation

The decline in energy prices is expected to curb price increases.

In November, inflation as measured by the harmonised consumer price index dropped to 2.4% compared with 5.3% in July. This was the lowest level recorded since August 2007. Favourable base effects – combined with lower oil and food prices – are the main reasons for the disinflationary trend recorded since the end of the summer and which is expected to continue over the next few months. Inflation is expected to drop to 1.5% in 2009, from 4.2% in 2008. Underlying inflation – i.e. excluding energy and unprocessed food products - is expected to decline at a slower pace, notably due to the mechanism whereby wages are automatically indexed to past inflation. The very pronounced slowdown in activity is nonetheless expected to bring underlying inflation down to 2.0% in 2009, and to below 1.0% in 2010.

Looking beyond the stimulus measures

Structural reform should be accelerated.

Spain's public finances have deteriorated very rapidly. The various stimulus measures launched by the government since the last elections now total close to EUR 40 billion or around 4.0% of GDP. The government has just announced another stimulus package (EUR 11 billion) aimed in particular at shoring up the construction sector and the automobile industry, which have been particularly hard hit by the crisis. The various packages, combined with the operation of automatic stabilisers, could result in a fiscal deficit of around 3.5% of GDP in 2009, after 2% in 2008. But beyond these fiscal stimulus packages – although they are needed in the present conditions – structural reform is essential to ensure a lasting economic recovery. The latest OECD report stresses that Spain must improve the flexibility and mobility of its labour force so as to ensure a better fit with job requirements; increase labour productivity, notably by rapid expansion of higher-level education, and increase competition in product markets in order to achieve productivity gains and raise household purchasing power.

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Spain : Economic Forecasts

	2006	2007	2008(1)	2009(1)	2010(1)	Carry-over for 2008*
Components of Growth (y/y)						
Total GDP	3.9	3.7	1.3	-1.8	-0.1	1.4
Domestic Demand ex Stocks	4.7	4.2	0.6	-4.0	-0.9	0.9
Private Consumption	3.8	3.5	0.5	-2.8	-0.5	0.7
Public Consumption	4.8	4.9	5.5	9.2	8.6	4.8
Fixed Investment	6.8	5.3	-1.9	-13.4	-7.7	-1.1
- Construction	6.0	3.9	-4.6	-17.5	-11.9	-5.0
Stocks (Cont. to Growth)	0.1	-0.1	0.0	-0.0	-0.0	-
Exports	5.1	4.9	3.0	-1.8	2.0	3.2
Imports	8.3	6.2	0.5	-8.7	-1.0	1.1
Inflation & Labour (y/y)						
Consumer Prices (HICP))	3.6	2.8	4.2	1.5	1.1	
Core HICP (ex Food & Energy)	2.8	2.5	2.4	2.0	0.6	
Compensation per employee	6.7	7.1	5.1	1.7	1.3	
Unemployment Rate (%)	8.5	8.3	11.0	15.3	17.0	
Employment	3.7	3.0	-0.2	-3.0	-1.4	
Activity						
Industrial Production (y/y)	3.9	1.9	-4.8	-8.8	-2.7	
Savings Ratio (%)	10.3	10.4	10.6	11.1	11.1	
External Trade						
Trade Balance, EUR bn	-89.7	-99.0	-100.9	-82.8	-79.9	
Current Account, EUR bn	-87.7	-105.9	-110.8	-93.2	-90.4	
% of GDP	-9.0	-10.1	-10.1	-8.4	-8.0	

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts * Assuming 0 q/q growth from Q4 2008

Spain: Quarterly Profile

	Q3 08	Q4 08(1)	Q1 09(1)	Q2 09(1)	Q3 09(1)	Q4 09(1)
GDP, y/y	0.9	-0.2	-1.2	-1.9	-2.1	-1.9
GDP, q/q	-0.2	-0.4	-0.7	-0.6	-0.4	-0.2
HICP, y/y	4.9	2.9	2.4	1.3	0.6	1.6
Core HICP (ex Food & Energy), y/y	3.5	2.6	2.3	2.3	1.8	1.4

Source: BNP Paribas, Economic Research Department q/q quarter-on-quarter change y/y year-on-year change (1) BNP Paribas Forecasts

Spain: Financial Variables

	2006	2007	2008(1)	2009(1)	2010(1)
Financial Variables					
General Government Budget (EUR bn)	17.7	22.0	-17.6	-39.6	-46.6
General Government Budget (% of GDP)	1.8	2.2	-1.6	-3.6	-4.1
Primary Budget (EUR bn)	33.4	34.0	-4.4	-25.5	-30.5
Primary Budget (% of GDP)	3.4	3.4	-0.4	-2.3	-2.7
Interest & FX Rates(2)	2006	2007	2008	2009(1)	2010(1)
3-month Rate (%)	3.73	4.68	3.50*	1.49	1.50
10-year Benchmark (%)	4.01	4.41	3.90*	4.05	4.35
Spread over the Bund (bp)	6	8	79*	35	35

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts (2) End of Period
(*) spot rates on December 8, 2008

United Kingdom

The effect of the financial crisis is being felt in all sectors of the economy. Despite actions by Bank of England (BoE), conditions in the financial markets have remained difficult. Bank Rate is projected to decline to 1% in 2009, but lower rates should not be excluded. The Chancellor has presented a GBP20 billion stimulus package, which is expected to widen the deficit to more than 8% of GDP in FY2009. Nevertheless, economic activity is expected to contract further in the coming quarters.

Most serious financial crisis since the Great War

Credit tightening is increasingly weighing on real economy

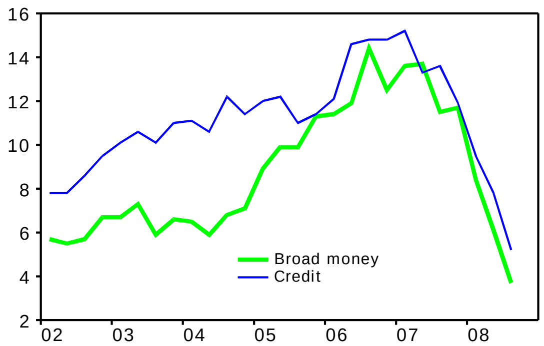
The economy has entered recession due to further credit tightening at home and overseas.

The financial market turmoil is increasingly impacting the real economy. Banks have been deleveraging by securing injections of new capital, by reducing lending, and by selling assets. This process is most evident in a marked slowing in money and credit growth. In Q3, the availability of credit to households as well as to corporations was further tightened according to the Bank of England's credit conditions survey, as banks had become more risk averse. Moreover, increased risk premiums have made long-term funding more expensive. Similar forces have also been hurting the global economy, which largely explains the synchronised nature of the current downturn.

The financial sector has been in particularly hit.

These developments have particularly hit the financial sector. Business services and finance activity declined in Q3 by 0.4%, and business volumes might have further contracted after the collapse of the US investment bank Lehman Brothers in September. The Lord Mayor of the City of London expects that 70 000 City jobs will be lost between late 2007 and early 2009.

Broad money and credit growth are slowing rapidly



Source: BoE, Inflation Report

Households are reluctant to spend because of rising unemployment and falling house prices.

The crisis is being felt well beyond London's financial sector. In the household sector, tighter credit conditions have limited spending. This effect has been amplified by the decline in house prices, which has reduced the collateral that homeowners can use for borrowing. Moreover, the deterioration of the labour market – in Q3 the unemployment rate rose by 5.8% -- has also made households reluctant to spend. The most affected sector is distribution, hotels and catering, with a 1.7% output contraction in Q3.

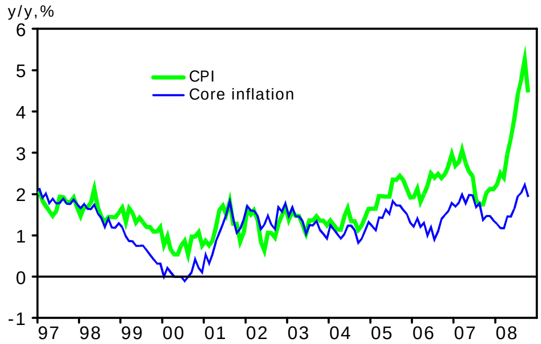
Falling house prices and scarcity of mortgage lending have dampened construction.

Tighter credit conditions have also been weighing on the non-financial corporate sector. This is foremost noticed in the construction sector. The cooling of the housing market and the scarcity of mortgage lending have significantly reduced the demand for new homes. Builders have been reluctant to start new housing projects and building sites have been mothballed to be finished only when there are confirmed buyers. In addition, slower demand has also started to affect commercial property. By contrast, public sector projects continued to provide some support to construction output.

The manufacturing sector has been most affected by the slowdown.

In the manufacturing sector, the negative impact of the crisis, initially mainly felt by building material suppliers, has gradually spread further along the supply chain to, for example, the chemical industry. In addition, manufacturing activity is affected by slowing world demand growth, although moderated by the depreciation of sterling. The only pockets of strength in this sector are firms that are working on public and quasi-public transport investment programmes. Manufacturing activity contracted by 1.3% in Q3 and business cycle indicators point to a further decline in Q4.

Inflation has peaked



Source: National Statistics

Inflation has declined to 4.5% in November. Also wage costs show signs of moderation.

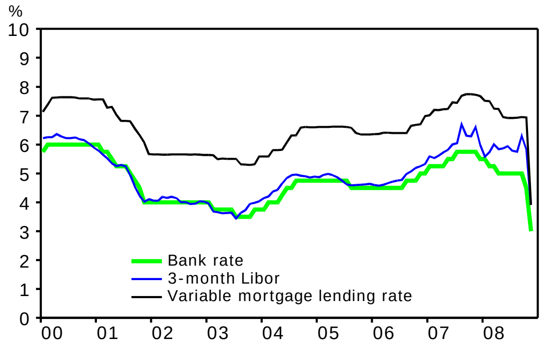
The worldwide slowdown has been translated in falling commodity prices, contributing to diminishing inflationary pressures. In October, CPI inflation fell back to 4.5% from 5.2% in September, largely as a result of lower petrol prices. Also other indicators point to price moderation. In addition to commodity prices, also wage costs are moderating as past labour market reforms have made the wages more responsive to changing macroeconomic conditions. Annual earnings growth including bonuses has been on a steadily declining trend since last April. In Q3, they were 3.3% higher than a year earlier. However, earnings – excluding bonuses have hardly reacted. During the same period, they were 3.6%% higher than a year earlier. This in only marginally lower to what was observed in the first half of the year. However, we have to take into account that most job contracts are reviewed around the turning of the year.

Risk of interest rates close to zero in 2009

More monetary easing to come in 2009, and a further recapitalisation of the banks might be necessary to improve lending.

Conditions in the financial markets have remained difficult, despite actions taken in the United Kingdom and elsewhere to improve their functioning, such as the recapitalisation of the banks, the improvement in liquidity, and the guaranteeing of bank loans. In early December, the BoE's Monetary Policy Commission (MPC) decided to cut again Bank Rate by 100 bp to only 2%, its lowest level since 1951. The MPC feared that leaving Bank Rate unchanged could lead to a serious undershooting of the 2% inflation target, or even to deflation. The latter could happen if bank lending does not return to normal. During his appearance before the Treasury Select Committee, the Governor of the Bank of England, Mervyn King discussed for the first time the possibility of lowering interest rates to 0%. In that case the BoE should consider alternative means to reviving the economy. In our scenario, this is still a major risk. In addition, the Governor suggested that a further recapitalisation of the banks might be necessary to improve bank lending.

Interest rates have been declining rapidly



Sources: BoE and BBA

Stimulus package pushes deficit up to 8% of GDP in FY2009

Chancellor Darling presented a stimulus package worth GBP 20 billion, including a temporary reduction in the VAT rate by 2.5 points.

Given that the budget deficit already stands around 3% of GDP, the room for an expansive budgetary policy is limited. Nevertheless, Chancellor Alistair Darling presented end November a stimulus package worth GBP 20 billion or around 1% of GDP to be implemented between December 2008 and April 2010. The main measures are: a temporary reduction in the VAT from 17.5% to 15% from 1 December until the end of 2009; the bringing forward of capital spending worth GBP 3 billion; this year's increase in the personal tax-allowance as compensation for the abolition of the 10% income tax bracket will become permanent and will be increased from GBP120 to GBP 145. In addition, the package includes a GBP 5 billion package for small and medium-sized enterprises (SME). As part of the recapitalisation scheme, banks that are receiving government funding would maintain the availability of lending to SME's at 2007 levels.

The stimulus package would increase the deficit to more than 8% of GDP in FY 2009. By 2011, taxes should be increased to rebalance the current budget.

The stimulus package is initially financed by extra borrowing. As a result, the public deficit (Maastricht definition) could increase to more than 8% of GDP in FY2009, while the gross debt ratio would be around 60% compared with just over 40% in April 2008. By 2011, when recovery should be well underway, the Chancellor intends to increase the tax burden. The national insurance contributions would be raised by 0.5 points for both employers and employees. Only modest incomes will be excluded by raising the starting point of national insurance. In addition, a new 45% tax band would be introduced. In this way, the current budget should be in balance by 2015/16. A problem with this scenario is that the next general election should be held before June 2010. It looks as if the Chancellor leaves it to his successor to bring public finances back under control again.

A widening of the deficit is necessary to avoid a long and deep recession.

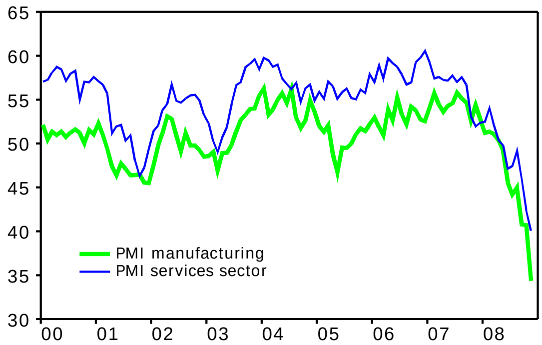
The UK public finances ended up in such unenviable situation because of too accommodative policies during the Blair decade. The OECD estimates that the cyclical adjusted fiscal deficit has been well above 3% of GDP since 2003. If fiscal policy had been much tighter, the UK economy would have been in much better shape. Nevertheless, under the circumstances, the Chancellor took the right decision to stimulate the economy with the objective to avoid a long and deep recession.

A long period of subdued demand ahead

GDP is expected to contract further in the coming quarters. Demand remains mainly driven by the public sector.

Despite the accommodative macro-economic policies, GDP is expected to contract further in the coming quarters. Even though credit conditions could loosen, households are expected to remain reluctant to spend owing to the fall in house prices and the deterioration in the labour market. The widening government deficit and the announced tax increases are also likely to weigh on their spending. As regards the corporate sector, the uncertain outlook combined with high financing costs will dampen capital spending. Investment could fall by about 10% in 2009 and by more than 2% in 2010. Demand is expected to be mainly driven by the public sector and in the course of 2009, by the pick up in overseas demand, partly as a result of the depreciation of the pound.

Business cycle indicators point to deep recession



Source: Markit Economics

Supply growth is set to ease due to the shrinking of the capital stock and a possible decline of the labour force.

The weakness in demand is partly mirrored in a substantial reduction in supply growth. The capital stock could even shrink as a result of plant closures and the decline in capital spending. Moreover, the labour force could decline in the coming quarters, partly as a result of population ageing. In addition, during recessions workers will try to leave the labour force through early retirement and disability schemes. Some workers will withdraw from the labour market as they do not expect to find employment, while immigrants could return to their home countries if they have better chances of finding a job there. All these factors are likely to reduce the potential growth rate of the economy.

The widening output gap and the VAT reduction will dampen prices. CPI inflation could fall back to around 0.5% in 2009.

The output gap is likely to widen as a result of the long period of subdued demand. The sharp slowdown in consumer demand will reduce inflation, in particular in services. In addition, in the distribution sector, retailers might find it difficult to pass on the full effect of the depreciation of the pound. Add to this, the temporary VAT rate reduction by 2.5 point will deduct about 1.2 percentage point from CPI inflation. Lastly, wage moderation will contribute to easing producer price inflation. Many employers anticipate offering below-inflation pay rises next year, and some even might impose a pay freeze. Given heightened perceptions of job insecurity, such pay awards are unlikely to be fiercely contested. As a result, inflation is set to fall sharply in the coming months to be around 1% by end 2009.

The main risks are deflation and a loss in the government's ability to reduce the deficit.

The main short-term risk is that the economy could slide in full-scale deflation. This should be prevented by further cuts in Bank Rate and eventually quantitative easing. In the longer term, the danger is that markets lose confidence in the government, which could trigger a flight from sterling. After the general election, the main task of the new Chancellor will be to bring government finances back under control.

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United Kingdom: Economic Forecasts

	2006	2007	2008[1]	2009[1]	2010[1]	Carry-over for 2008*
Components of Growth (y/y)						
Total GDP	2.9	3.0	0.8	-2.1	0.8	1.0
Private Consumption	2.0	3.0	1.8	-2.4	-0.1	1.9
Public Consumption	1.7	1.8	2.5	3.6	2.6	2.3
Fixed Investment	7.6	7.1	-4.2	-10.0	-2.3	-3.6
Final Domestic Demand	2.8	3.6	0.6	-2.8	0.1	0.9
Exports	10.7	-4.5	1.0	-0.7	2.0	1.2
Imports	9.8	-1.9	0.6	-3.0	-0.3	1.2
Inflation & Labour (y/y)						
Retail Price Index (RPI)	3.2	4.3	4.0	-2.8	0.9	
RPI excluding mortgage interest payments (RPIX)	2.9	3.2	4.2	0.9	1.0	
Consumer Price Index (HICP)	2.3	2.3	3.5	0.6	1.2	
Average Earnings – Excluding bonus	3.7	3.6	3.6	2.3	2.0	
Employment	0.8	0.7	0.6	-3.4	-2.8	
Unemployment Rate (ILO concept)	5.4	5.4	5.7	8.1	9.4	
Activity and Savings (y/y)						
Industrial Production	0.3	0.5	-1.5	-5.1	-1.8	
Services output	3.7	3.7	1.2	-1.5	1.3	
Household Savings Ratio (%)	4.2	2.5	-0.2	1.5	3.3	
External Trade						
Trade Balance, GBP bn	-77.4	-89.3	-93.8	-83.0	-74.7	
Current Account, GBP bn	-50.2	-52.6	-40.1	-33.9	-28.2	
% of GDP	-3.8	-3.8	-2.7	-2.3	-1.9	

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts * Assuming 0 growth in Q4 2008

United Kingdom: Quarterly Profile

	Q3-08[1]	Q4-08[1]	Q1-09[1]	Q2-09[1]	Q3-09[1]	Q4-09[1]
GDP, q/q	-0.5	-0.8	-0.9	-0.5	-0.1	0.1
GDP, y/y	0.3	-1.0	-2.1	-2.6	-2.3	-1.4
Private Consumption, y/y	1.2	-0.1	-1.9	-2.6	-2.8	-2.3
GFCF, y/y	-5.2	-9.9	-11.0	-10.8	-10.1	-8.1
Exports, y/y	-0.4	-0.3	-1.2	-1.2	-0.6	0.4
Imports, y/y	-1.8	-2.4	-3.1	-3.2	-3.2	-2.6
HICP, y/y	4.8	3.5	1.7	0.7	-0.5	0.2
Unemployment (ILO concept)	5.8	6.4	7.2	7.9	8.5	8.9

Source: BNP Paribas, Economic Research Department q/q : quarter-on-quarter ; y/y : year-on-year change (1) BNP Paribas Forecasts

United Kingdom: Financial Variables

	2006	2007	2008 (1)	2009 (1)	2010[1)]
Financial Variables					
Deficit GBP bn	34.2	37.9	52.4	117.1	126.6
% of GDP	-2.6	-2.7	-3.6	-8.0	-8.5
Interest & FX Rates[2]	2006	2007	2008	2009 (1)	2010 (1)
Base Rate (%)	5.00	5.50	2.00	1.00	1.00
3-Month Rate (%)	5.32	5.99	3.31*	1.60	1.50
10-Year Benchmark Yield (%)	4.74	4.59	3.53*	4.05	4.35
Spread over Bund (bp)	78	27	42*	35	35
EUR/GBP	0.67	0.73	0.87*	0.78	0.76
GBP/USD	1.96	1.98	1.49*	1.46	1.58

Source: BNP Paribas, Economic Research Department (1) BNP Paribas Forecasts (2) End of period (*) spot rates on December 8, 2008

Financial Forecasts

Interest rates

		Level at 12/08/2008	Forecasts (end of period) Q1 09	Q2 09	Q3 09
United States	Fed Funds (Fed's target rate)	1.00	0.50	0.50	0.50
	3-month USD Libor	2.19	1.56	1.43	1.26
	10-year T-Notes	2.71	3.10	3.70	3.90
Euro zone	Refinancing rate	2.50	2.00	1.00	1.00
	3-month Euribor	3.50	2.62	1.52	1.46
	10-year Bund	3.11	3.25	3.45	3.60
	10-year OAT	3.65	3.50	3.70	3.80
	10-year BTP	4.49	4.15	4.25	4.40
United Kingdom	Base rate	2.00	1.00	1.00	1.00
	3-month GBP Libor	3.31	1.75	1.65	1.55
	10-year Gilt *	3.53	3.65	3.80	3.95
Japan	Overnight call rate	0.30	0.30	0.30	0.30
	3-month JPY Libor	0.95	0.80	0.80	0.80
	10-year JGB	1.39	1.45	1.55	1.55

Exchange rates

		Level at 12/08/2008	Forecasts (end of period) Q1 09	Q2 09	Q3 09
USD	USD / JPY	93	88	92	96
	GBP / USD	1.49	1.24	1.32	1.37
	USD / CAD	1.26	1.38	1.42	1.37
EUR	EUR / USD	1.29	1.07	1.12	1.14
	EUR / GBP	0.87	0.86	0.85	0.83
	EUR / CHF	1.56	1.34	1.38	1.41

Recent data on interest and exchange rates

	2006	2007	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 SEP	2008 OCT	2008 NOV
INTEREST RATES (*)											
United States											
Discount rate	5.96/6.25	5.86/4.75	6.25/6.25	5.94/5.25	5.03/4.75	3.68/2.50	2.33/2.25	3.68/2.50	2.25/2.25	1.79/1.25	1.25/1.25
Federal Funds	4.96/5.17	5.05/4.25	5.25/5.25	5.18/4.75	4.53/4.25	3.22/2.25	2.08/2.00	3.22/2.25	2.00/2.00	1.54/1.00	1.00/1.00
Prime rate	7.96/8.25	8.05/7.25	8.25/8.25	8.19/7.75	7.53/7.25	6.24/5.25	5.08/5.00	6.24/5.25	5.00/5.00	4.57/4.00	4.00/4.00
3-month Bills	4.84/5.00	4.46/3.39	4.86/4.80	4.43/3.81	3.48/3.25	2.09/1.34	1.65/1.72	2.09/1.34	1.09/0.91	0.65/0.45	0.18/0.04
3-month Libor $	5.20/5.36	5.30/4.70	5.36/5.36	5.44/5.23	5.03/4.70	3.29/2.69	2.75/2.78	3.29/2.69	3.12/4.05	4.06/3.03	2.28/2.22
2-year T-notes	4.82/4.80	4.35/3.09	4.80/4.87	4.39/3.98	3.50/3.06	2.02/1.59	2.41/2.62	2.02/1.59	2.06/1.97	1.60/1.57	1.21/1.00
10-year T-notes	4.79/4.70	4.63/4.07	4.84/5.03	4.73/4.59	4.26/4.03	3.65/3.41	3.87/3.97	3.65/3.41	3.68/3.83	3.78/3.97	3.51/2.92
30-year T-bond	4.88/4.81	4.84/4.48	4.99/5.13	4.95/4.84	4.62/4.48	4.41/4.29	4.57/4.52	4.41/4.29	4.27/4.31	4.16/4.37	4.01/3.44
Germany											
Eonia	2.83/3.69	3.87/3.92	3.86/4.14	4.05/4.16	3.95/3.92	4.05/4.16	4.00/4.27	4.25/4.17	4.27/4.17	3.82/3.59	3.15/2.97
Marginal rate	3.76/4.50	4.84/5.00	4.80/5.00	5.00/5.00	5.00/5.00	5.00/5.00	5.00/5.00	5.23/5.25	5.25/5.25	4.49/4.25	3.93/3.75
repo rate	2.76/3.50	3.84/4.00	3.80/4.00	4.00/4.00	4.00/4.00	4.00/4.00	4.00/4.00	4.23/4.25	4.25/4.25	3.97/3.75	3.43/3.25
Deposit rate	1.76/2.50	2.84/3.00	2.80/3.00	3.00/3.00	3.00/3.00	3.00/3.00	3.00/3.00	3.23/3.25	3.25/3.25	3.23/3.25	2.93/2.75
3-month Euribor	3.08/3.73	4.28/4.68	4.07/4.18	4.49/4.79	4.72/4.68	4.48/4.73	4.86/4.95	4.98/5.28	5.02/5.28	5.11/4.76	4.24/3.85
5-year BOBL	3.59/3.90	4.20/4.14	4.34/4.57	4.34/4.19	4.12/4.14	3.72/3.65	4.32/4.75	4.40/4.21	4.28/4.28	4.21/4.21	3.88/3.88
10-year Bund	3.78/3.92	4.23/4.35	4.35/4.56	4.36/4.34	4.22/4.32	3.94/3.90	4.27/4.61	4.28/4.00	4.11/4.00	3.90/3.87	3.57/3.26
30-year Bund	4.00/4.04	4.44/4.60	4.51/4.71	4.56/4.59	4.53/4.60	4.48/4.54	4.69/4.86	4.70/4.59	4.65/4.59	4.38/4.40	4.15/3.73
United Kingdom											
Base rate	4.65/5.00	5.51/5.50	5.39/5.50	5.74/5.75	5.68/5.50	5.35/5.25	5.03/5.00	5.00/5.00	5.00/5.00	4.61/4.50	3.23/3.00
3-month interbanking	4.70/5.03	5.63/5.41	5.63/5.85	5.87/5.73	5.63/5.41	5.19/5.05	5.06/5.23	5.15/4.85	5.04/4.85	4.23/3.69	2.41/1.90
3-month Libor £	4.85/5.32	6.00/5.99	5.77/6.00	6.35/6.30	6.35/5.99	5.72/6.01	5.89/5.95	5.84/6.30	5.91/6.30	6.13/5.84	4.45/3.91
15-year Gilt	4.45/4.67	4.94/4.60	5.12/5.33	5.09/4.99	4.79/4.60	4.59/4.59	4.98/5.25	4.86/4.72	4.68/4.72	4.81/4.89	4.69/4.44
Japan											
Discount rate	0.24/0.40	0.70/0.75	0.75/0.75	0.75/0.75	0.75/0.75	0.75/0.75	0.75/0.75	0.75/0.75	0.75/0.75	0.74/0.50	0.50/0.50
3-month Libor yen	0.30/0.57	0.79/0.90	0.69/0.76	0.89/1.03	0.96/0.90	0.92/0.91	0.92/0.93	0.90/1.02	0.91/1.02	1.04/0.94	0.91/0.94
10-year JGBs	1.75/1.69	1.68/1.51	1.74/1.87	1.72/1.68	1.57/1.50	1.39/1.28	1.62/1.61	1.52/1.47	1.49/1.47	1.51/1.50	1.47/1.40
France											
10-year OAT	3.79/3.95	4.30/4.44	4.40/4.61	4.44/4.44	4.32/4.44	4.08/4.11	4.47/4.82	4.49/4.36	4.36/4.36	4.19/4.31	3.96/3.68
Spread OAT/Bund	0.02/0.03	0.07/0.11	0.04/0.05	0.09/0.10	0.11/0.11	0.14/0.21	0.20/0.21	0.21/0.36	0.25/0.36	0.29/0.45	0.39/0.43
EXCHANGE RATES (**)											
EUR/USD	1,256	1,371	1,348	1,374	1,449	1,498	1,562	1,505	1,437	1,332	1,273
EUR/GBP	0,682	0,685	0,679	0,680	0,708	0,757	0,793	0,795	0,799	0,787	0,831
EUR/CHF	1,573	1,643	1,648	1,647	1,660	1,601	1,611	1,612	1,594	1,519	1,516
EUR/DKK	7,459	7,451	7,450	7,445	7,456	7,453	7,460	7,459	7,458	7,454	7,448
EUR/NOK	8,050	8,018	8,106	7,918	7,878	7,958	7,940	8,060	8,157	8,593	8,809
EUR/SEK	9,253	9,252	9,257	9,264	9,290	9,400	9,352	9,474	9,564	9,851	10,128
EUR/JPY	146,0	161,2	162,9	161,9	163,8	157,8	163,4	161,8	153,2	133,5	123,3
USD/CAD	1,134	1,074	1,098	1,046	0,981	1,004	1,010	1,041	1,058	1,179	1,219
AUD/USD	0,753	0,839	0,831	0,848	0,889	0,905	0,944	0,888	0,818	0,687	0,656
GBP/USD	1,844	2,001	1,986	2,021	2,044	1,978	1,972	1,893	1,799	1,690	1,529
USD/JPY	116,3	117,8	120,8	117,8	113,1	105,4	104,6	107,5	106,7	100,1	96,9

(*) average and end of period
(**) average on the period

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