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A joyless recovery: no reason to party

For the financial markets, the past year can be compared to a roller-coaster ride. First headfirst downwards with several terrifying swerves, especially after the collapse of US investment bank Lehman Brothers; then the adrenaline-charged anticipation of the upward climb. Policymakers had to resort to a wide range of monetary and fiscal stimulus measures to come to grips with the crisis. A painful recession proved inevitable, but a depression was averted. Worldwide, there is economic recovery to be seen, and this will continue into 2010. The main factors driving the recovery are the drastic budgetary and monetary stimulus measures and the necessary rebuilding of inventories. The global pickup of producer confidence stands out in this respect. The restored confidence since the second quarter of 2009 is a good example of Keynes' notorious 'animal spirits', although this has yet to be reflected in a real upswing in corporate investment.

In absolute terms, what we are really seeing is a meagre recovery. As yet, it is a recovery that does not have a sustainable growth engine. The financial sector is in the process of restructuring. The US consumer is crippled by high debts and a rapidly deteriorating labour market, while the European consumer is highly anxious about the future. Many consumers are all too well aware that the various stimulus measures will ultimately have to be paid for via higher taxes, increased inflation, or a combination of both. The Asian consumer may afford some relief, but not much

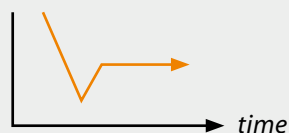
Box 1: Economic alphabet soup

There is often heated discussion on the issue of the shape that economic recovery will take. The letters of the alphabet are bandied around to illustrate the various perspectives: the V-shaped recovery versus the W-shape of the double dip are the most frequently cited; however, the letters U and L are also part of the economic lexicon.

Currently, there are clear signs of recovery in the OECD. The first phase is strong. A wide range of monetary and fiscal stimulus measures have brought about a positive turnaround in confidence and in the dynamic of inventory re-building. Unfortunately, these are just temporary factors, while in the long term, there is an absence of a clear growth engine. It will take time to reduce the global imbalances that have been building up and find the path to sustainable recovery.

In our view, the shape that economic recovery will take looks more like a mathematical symbol: the square root, albeit with a certain artistic licence. The first part of this symbol resembles a V, reflecting plummeting economic activity followed initially by a strong recovery. However, the initial pickup fails to restore production volume to pre-crisis levels, which means the recovery will tail off.

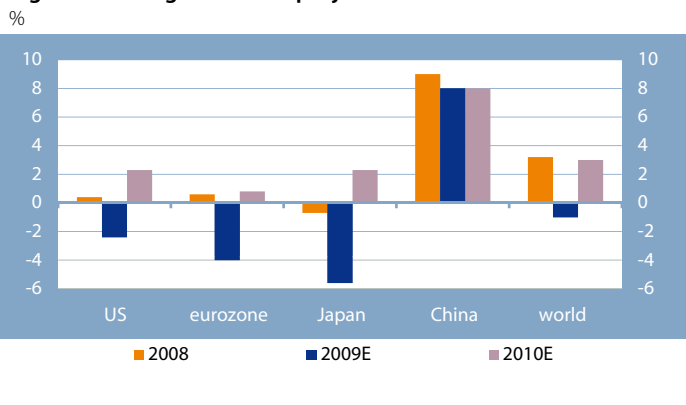
Square-root shaped recovery: artist's impression



The most important realisation is that recovery will not mean a return to the economic boom time of 2002-2006. The economic reality has changed drastically since then. The boom of that period was based on what now transpires to be an unstable structure of easy credit, ever lower risk premiums and liberal lending. On the face of it, government finances appeared strong thanks to the economic upswing, but fundamentally, there were significant weaknesses. Accordingly, the starting point was less favourable than was previously assumed, and governments and central banks have subsequently had to pull out all the stops, in the face of the crisis and the prospect of a deep depression. In doing so, they have borrowed well into the future. We expect to see a gradual correction of the global imbalances. But the price of this is a joyless recovery. It will take years for the loss of wealth to be restored. And the lost growth may never be fully recovered.

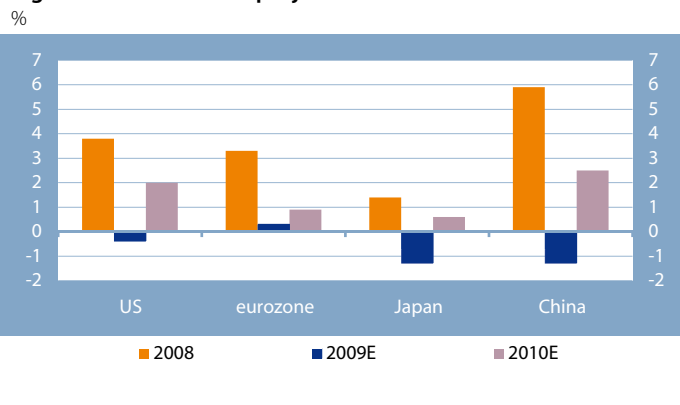
more. Consumers in Asia tend to save a lot, on account of the deficient social security net and poorly developed financial markets. Consequently, economic growth in many countries will be well below the level we might normally expect when emerging from a recession. Yes, a depression has been averted, and a modest recovery is underway, but there will be no party.

Figure 1: GDP-growth and projections



Source: Rabobank

Figure 2: Inflation and projections



Source: Rabobank

Asia: the first to recover

Searching for an economic turn for the better and ultimately for economic recovery, we simply cannot pass by the Asian economy. Looking at regional trends in Asia over the past year or so, a sharp fall in economic momentum can be seen in many countries that continued into the first quarter of 2009. Almost as quickly as growth momentum around the region waned, trends reversed in the second quarter and the outlook became much less bleak (*figure 3*). Several economies in the region recorded positive growth in the second quarter and those that didn't, saw a sharp reduction in the rate of contraction. This improvement is noteworthy because, by and large, it preceded the return to growth recorded in the US in the third quarter of 3.5%, which is the region's main economic partner.

The strongest shoulders bore the largest weights

The countries that experienced the sharpest downturns were the richer economies in Asia. The less developed economies generally experienced much shallower downturns with some e.g., Indonesia, avoiding a contraction altogether. The important difference between the two groups is the significance of the financial sector (ground zero in the recent global downturn) to each economy and the exposure to global demand for higher value manufactured and electronics products. The richer economies in Asia have more developed financial systems that are more intertwined with global financial trends, and are generally more dependent on OECD demand for their manufactured and electronic exports.

There was an additional factor that compounded the above fundamental negatives over the past year or so. As global weakness spread to Asia, some producers, with the memory of financial stress resulting from the Asian financial crisis of the late 1990s and the Dot-com bust of early this decade, acted quickly to reduce costs. Inventories were cut dramatically. Singapore's economy, for example, contracted -9.5% year-on-year in the first quarter of 2009. But private consumption only fell -4.2% in the same period. In Taiwan, GDP contracted -10.1% year-on-year in the first quarter whilst private consumption fell only -1.6%. Consumption is the largest sector of most economies yet these data show that relative stability in consumption in some countries couldn't offset other negatives. We emphasise the role of inventory run-down in under-cutting regional growth. Many producers effectively switched off their machines and supplied customers from inventories. Inventories are a small part of most economies but can be highly cyclical and have far ranging impacts. Output declined precipitously around the region through late 2008 into early 2009.

No more Games

Besides the downturn in the global financial sector and the weakness of global demand transmitted to the region through export channels, there was one other factor that undercut regional growth momentum and this one was home-grown. The Beijing Olympics were preceded by massive renewal and upgrading of infrastructure and also by large scale commercial and residential developments in Beijing and in many of the large north eastern cities. The scale of such activity

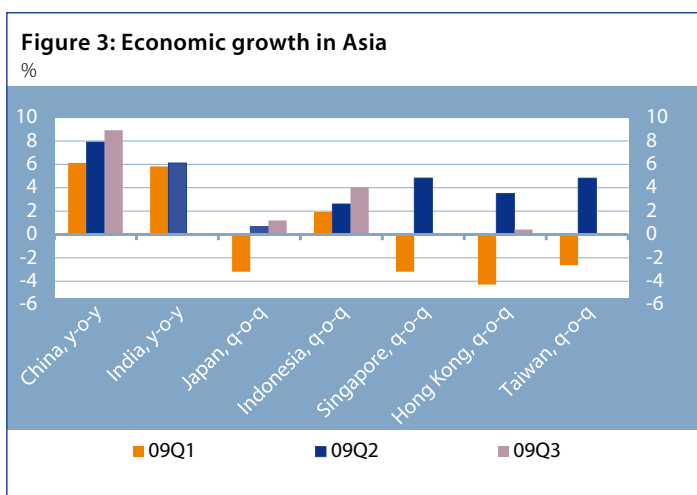
dwarfed the construction of Olympic-specific facilities such as the Birds Nest stadium, etc. For example, whereas Sydney extended a train line by a few hundred metres in preparation for the 2000 Olympics, Beijing expanded its subway system by a factor of three. When the medal tally was in and the glow of China's success had faded, there was significantly less employment opportunity in many cities and this reinforced the weakness coming from export markets. The economy ground to a stand-still in the fourth quarter of 2008 and the first quarter of 2009.

Orchestrated recovery

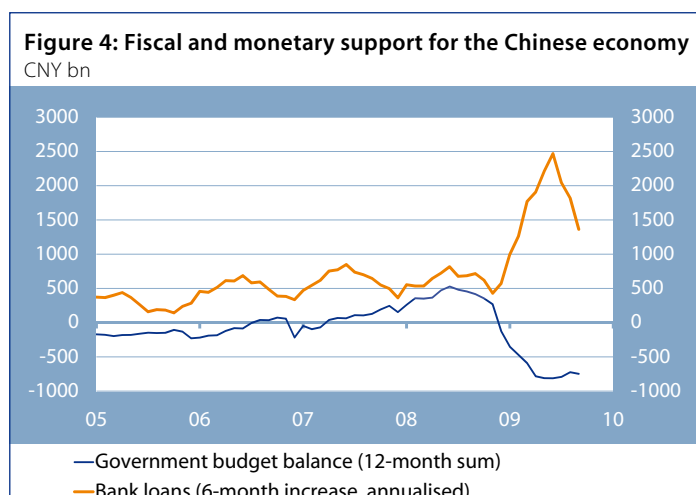
In response to weaker domestic growth, China's government has loosened policy considerably and this has had a rapid impact on China's growth momentum over recent quarters. Whereas in July 2008, on the eve of the Olympics, the central government had a cumulative 12 month budget surplus of CNY480.5 bn, the latest budget numbers show an annual deficit of CNY736.5 bn through the year to September 2009, a sharp deterioration. Government policy has also boosted the economy in other ways through moral suasion on the banking sector. Bank lending increased by an average of CNY307.6 bn in each month from Aug 2007 to July 2008. Then, as the slowing in the economy became apparent, lending accelerated and increased by CNY1.54T (yes, trillion) in each month of the first quarter of 2009. This stimulus is flowing through the economy and contributes to current growth momentum. *Figure 4* shows recent trends in these two indicators.

Growth potential remains intact

Looking ahead, the profile we expect for China is for growth to accelerate further in the fourth quarter of 2009 and the first quarter of 2010 from 3 quarters of robust 8.9% year-on-year rate, but to slow thereafter. This slowing is driven by a reduction in fiscal and bank-driven stimulus. Confidence among policymakers has already increased and concern over potential bad loans down the track has risen. By late 2009, the budget deficit has already shown early signs of improvement. This is also true of growth in bank lending; it too slowed into late 2009. Couple these factors with a modest outlook for demand conditions in China's export markets and we see economic growth losing steam into the middle of 2010 and settling at about an 8% rate.



Source: Reuters EcoWin



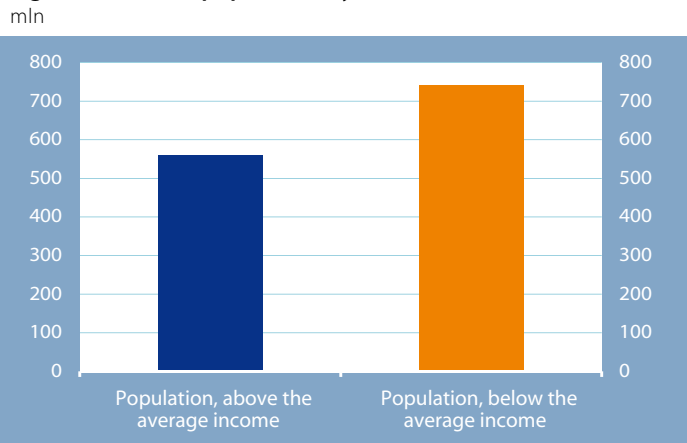
Source: Rabobank

Our point in discussing the variety of negative factors that derailed regional growth momentum through the past year or so is to highlight the transitory nature of several of the elements. The cyclical swing resulting from the Olympics is passing and China's underlying structural positives are re-asserting themselves. The underlying momentum of modernization and urbanization for millions of China's population is captured in *figure 5*. Of China's population, 43% had incomes above the national average of \$3,300 (in 2008) whilst 57% have incomes below. This largely reflects the divide between coastal and inland regions and this chart highlights the scale. There are about 740 million people still to play catch up with their 560 million richer countrymen. We expect the national average income to continue rising over time and we also highlight the scope for development to broaden. Many of the 740m people are still looking forward to the fruits of development spreading from the congested coastal areas to inland provinces. If we think of these people as a stand-alone country of 740m people, it would constitute the third most populous country in the world.

Low-hanging fruit

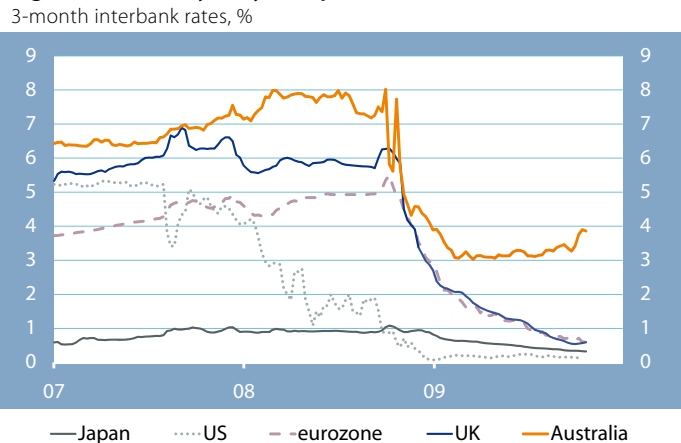
Most economic indicators in Asia's other heavy-weight, Japan, show an economy growing at a robust rate. Whether it be retail spending or industrial production, recent updates show an economy on trend improvement. Alongside the improving domestic economy, the trade sector is participating in normalizing global demand. But the dominant issue overhanging these signs of an improving economy is the depth of the recent recession. The economy contracted 8.4% year-on-year in the first quarter of 2009 and even after returning to quarterly growth in the second quarter of 2009, the economy was 7.2% smaller than the same quarter of the prior year. This was a brutal recession and we characterise the current improving trend as 'the low hanging fruit of recovery'. Japan is merely regaining lost output rather than pushing its own production frontier to new levels. We doubt policymakers at the Bank of Japan (BoJ) will be altering policy for many months as they view recovery through the prism of the recent sharp downturn. On this issue, it is significant that the BoJ only reduced interest rates from 0.5% on the eve of the financial crisis to the current 0.1%. We doubt the men and women on the streets of Japan even noticed

Figure 5: Chinese population by income



Source: Rabobank

Figure 6: Does anybody in Japan notice the stimulus?



Source: Reuters EcoWin

the difference. As such, Japan is in a different position from other major economies that were able to reduce interest rates by significant margins to combat their respective recessions, see *figure 6*. As Japan's output nears its pre-global-recession level, probably not until 2011, we anticipate a return to a lacklustre growth rate. The BoJ is expected to increase rates very tentatively when they do start.

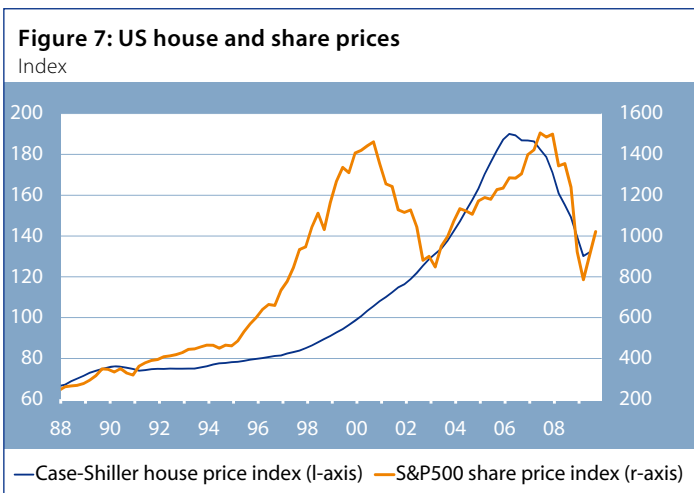
Not decoupled

Accordingly, economic recovery has announced its presence first and most strongly on the Asian continent. But if the rest of the world does not catch up quickly, it looks as though it will miss a lot of the momentum, and Asia is not sufficiently advanced in its development to pull the rest of the world along in its slipstream.

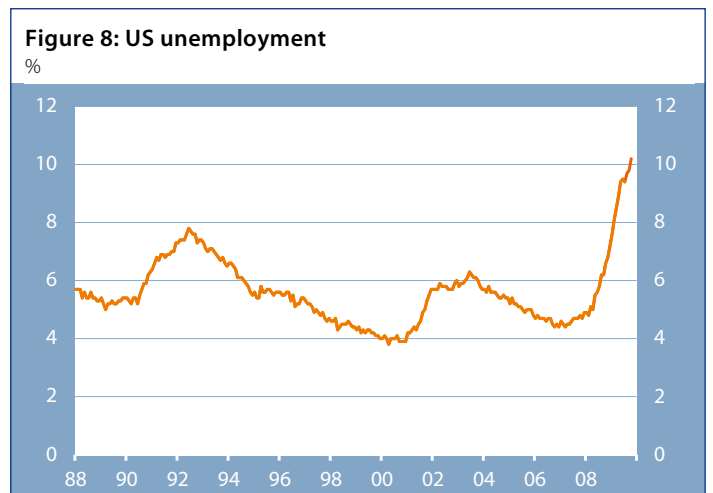


United States: the consumer between a rock and a hard place

In contrast to Asia, the US economy does have the potential to pull the rest of the world along in its wake. And the US economy has found the path upwards, albeit one pitted with bumps and potholes. A difficult path to travel for the economy's main engine, the US consumer, which is still undergoing repairs. After years of extravagant consumption, using borrowed money, the US consumer has run up a hefty debt. This was temporarily offset by a strong rise in the value of homes and share portfolios. Unfortunately, house prices fell by a total of 33%¹ between July 2006 and April 2009, and shares plummeted by as much as 57%² between October 2007 and March 2009 (figure 7). Since then, both house and share prices have started to rise again, but for house prices particularly, a rapid return to pre-crisis levels is unlikely. For home-owners this means that a sizeable share of the wealth loss is permanent. And that is not the only problem for the household budget. The fallout from the recession has affected job security (figure 8). This recession has already seen the loss of over seven million jobs, compared to the two previous recessions when job losses remained limited to 1.3 million (1990-1991) and 1.6 million (2001). The effect on business has been a sharply reduced cost base, which has contributed to economic recovery; but the pain for households remains undiminished (figure 9). Loss of both wealth and job security along with an ongoing high debt burden has forced consumers to save more. The result is a lower contribution by consumer spending to economic growth. Consequently, we expect 2010 to see a modest growth percentage by American standards of 2.3%. However, more restrained consumption is not the only problem facing the US. The extraordinary policy measures taken to combat the recession will continue to impact on the economy for a number of years to come.



Source: Reuters EcoWin



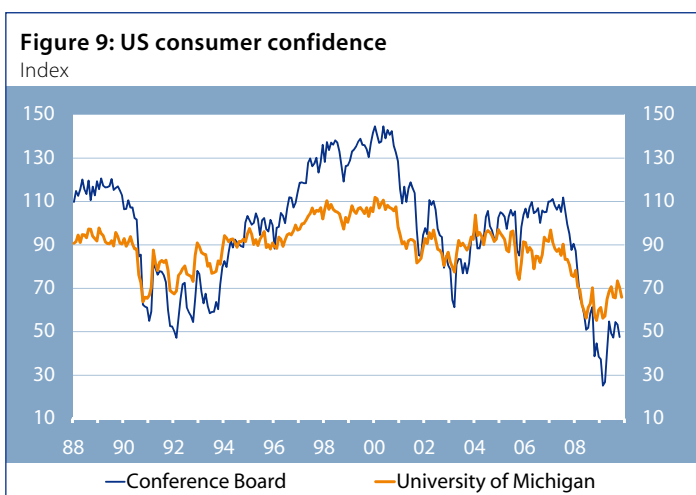
Source: Reuters EcoWin

Mortgaging the future

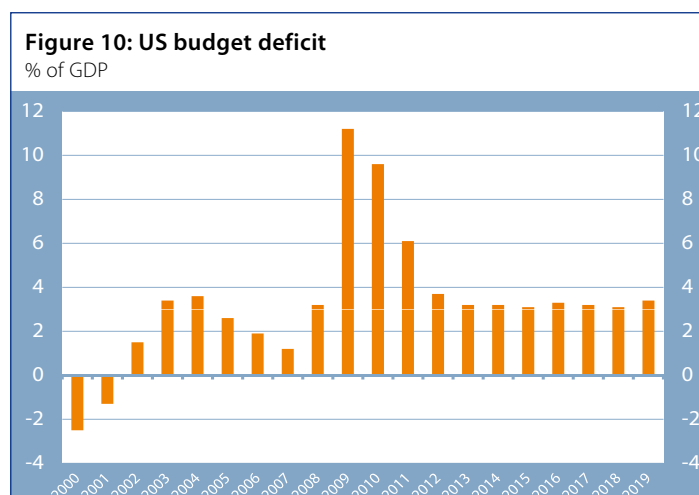
The US government has opted to combat the crisis and the recession with an ambitious financial stability plan of \$700 bn and a massive stimulus package of \$787 bn. There are even calls for an additional economic stimulus package to prevent a drop in the growth rate from 2010 to 2011. However, in our view this is unlikely. If the US government wants to hold onto its AAA status and hence its access to relatively cheap financing on the capital markets, it will soon have to address the severe imbalance in government finances (*figure 10*). It will take years of cutbacks and tax hikes, at the expense of economic growth, to reduce the sky-high budgetary deficit (11.2% of GDP in 2009). In the coming years, America will have to pay the price of its budget policy during the recession and the credit crisis in the form of lower economic growth.

The time bomb under the budget

A complicating factor is that the US budget is not only battling with the costs of the recession, but also with the rising costs of the welfare state. Population ageing and the rising costs of health care are driving up the costs of programmes such as Social Security (pensions and disability insurance) and Medicare (health care for elderly and disabled) more rapidly than the pace of the payroll tax revenues. Consequently, according to projections from the Congressional Budget Office, by 2043 it will no longer be possible to pay for Social Security out of income tax revenues. Funding of Medicare is even more precarious, because of the continuing rising costs of health care. Accordingly, Medicare is predicted to become unaffordable by 2017. Reform can certainly make a contribution to affordability, but the leeway for cost savings in social programmes is very limited. Tax increases would therefore seem inevitable in the long term, but this will have a slowing effect on economic growth.



Source: Reuters EcoWin

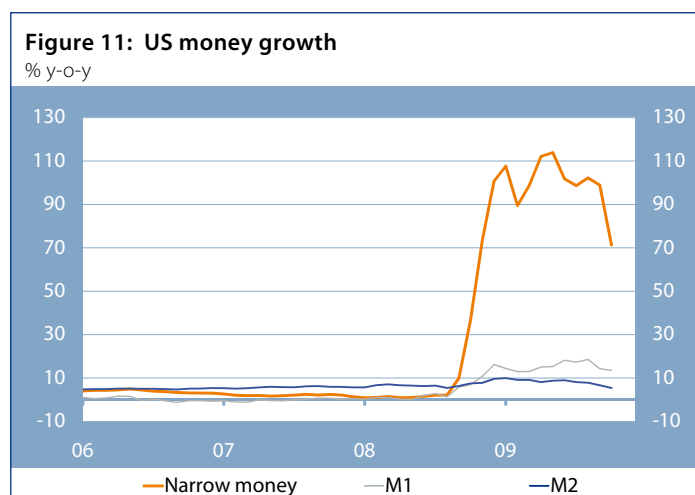


Source: Congressional Budget Office

Inflation tax and new bubbles

The monetary policy experiment of the US central bank will also leave its mark on the economy for the coming years. The Fed has effectively pumped an enormous amount of money into the financial system (*figure 11*). This was done to prop up the banks, keep mortgage rates low and maintain a credit flow for businesses and consumers. Thus the economy was prevented from sinking into a downward spiral. However, the problem remains of pumping the excess liquidity out of the system on time. Although Fed President Bernanke has broadly outlined his exit strategy, a number of important details have yet to be defined. In the meantime, the enormous pool of liquidity in the financial system constitutes a potential inflation threat. Although under normal circumstances there is only a weak association between money growth and inflation, this correlation becomes more marked where there is extremely high money growth. So far, the explosion of the reserves held by the banks with the Fed has not yet resulted in a sharp rise in money creation. However, as the recovery in the financial system advances, money creation will increase.

In order to restrict monetary growth, the Fed will want to mop up the excess liquidity during the coming years. This will be accompanied by a rise in the policy rate, which we expect to reach 1.75% by late 2010, followed by a further rapid increase. However, if the implementation of the exit strategy runs into problems, this could lead to increased money growth and hence additional inflation risks. In that case, the extremely expansive monetary policy pursued, that kept the credit channels open during the recession, could result in an inflation tax for consumers during the recovery. Furthermore, excessive liquidity can also result in new bubbles which could jeopardize financial stability once more during the coming years. As long as the US dollar is used as a 'funding currency' throughout the world for investments in high yielding currencies and emerging markets, these bubbles could be blown around the globe.



Source: Reuters EcoWin

Faulty ignition switch

The longest US recession since the Great Depression is over. But it has left a sting in its tail which will be felt for many years. In the America that is now in recovery, both consumers and government are in the process of trying to balance their books. This process will be accompanied by a lower rate of economic growth than we are accustomed to from the US. In the past, US economic growth tended to be financed by considerable debt accumulation. However, a repeat of that pattern would now be unwise and is unlikely. The growth path now being taken lacks some of the usual momentum, and will therefore be less capable of towing the rest of the world along. In Europe, this time we will therefore have to rely more on our own strength to achieve economic growth.

	2008	2009	2010
Gross Domestic Product	0.4	-2.4	2.3
Household Consumption	-0.2	-0.7	1.0
Corporate Investment	1.6	-18.4	-0.2
Residential Investment	-22.9	-19.7	3.7
Government Spending	3.1	2.1	2.8
Net exports (contribution to growth)	1.2	1.0	0.3
Inventories (contribution to growth)	-0.4	-0.6	0.8
Inflation (%)	3.8	-0.4	2.0
Unemployment (%)	5.9	9.6	10.6

United Kingdom: a recovery that doesn't feel like one

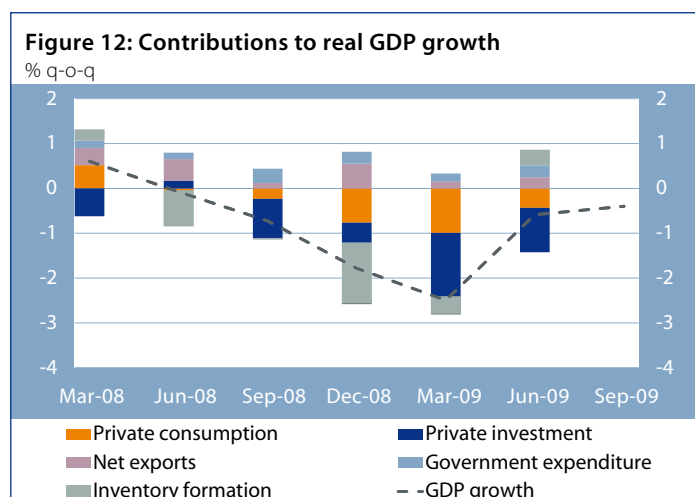
The near 6% contraction of the UK economy in the six quarters to Q309 should be seen in the light of the unprecedented period of 63 quarters of positive growth that preceded it. Nevertheless it marks the longest period of a shrinking economy since comparative records began, underlining the scale of the downturn (*figure 12*).

Britain as *Little US*?

Rising consumer spending was key to the previous record breaking advance in the economy, largely predicated upon mounting property prices and increased leverage generated by cheap and readily available credit. Of course the advent of the credit/banking crisis has seen an end to easy credit and consumers are being forced to deleverage. While it would appear that the residential property markets are rebounding when looking at recent monthly data, the sector remains acutely vulnerable to the spectre of rising unemployment, an eventual turn in the rate cycle and ongoing credit restrictions.

Voting for recovery

Additionally when looking forward to the upcoming year there are a number of recovery hurdles to overcome, including fiscal tightening as the authorities attempt to rein in a burgeoning fiscal deficit. Moreover there are political issues to incorporate ahead of the forthcoming election, to be held by June 2010. The prospects of a change in government remain high, but there are some residual risks of a 'hung' Parliament with no single party in control. That could prove a hugely damaging state of affairs not seen since the early 1970's. Despite these concerns, we have cautious expectations of a modest recovery ahead. The combination of aggressive monetary easing (*figure 13*), allied to a modest fiscal loosening and a substantial weakening in the trade weighted value of Sterling should help provide the foundations for a modest rebound in activity in the coming months.

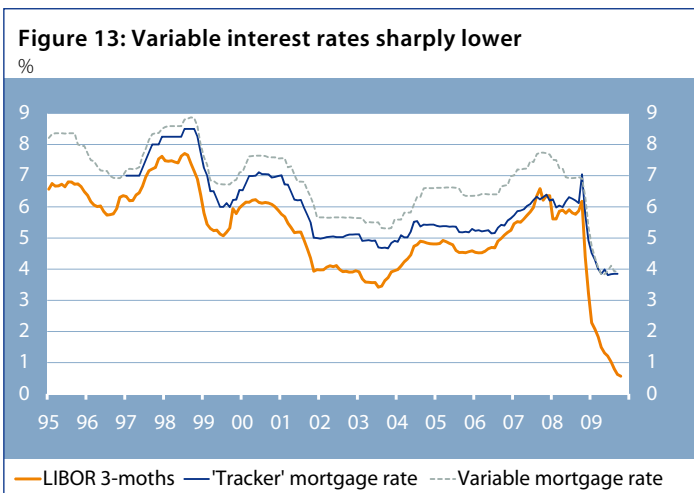


Source: Reuters EcoWin

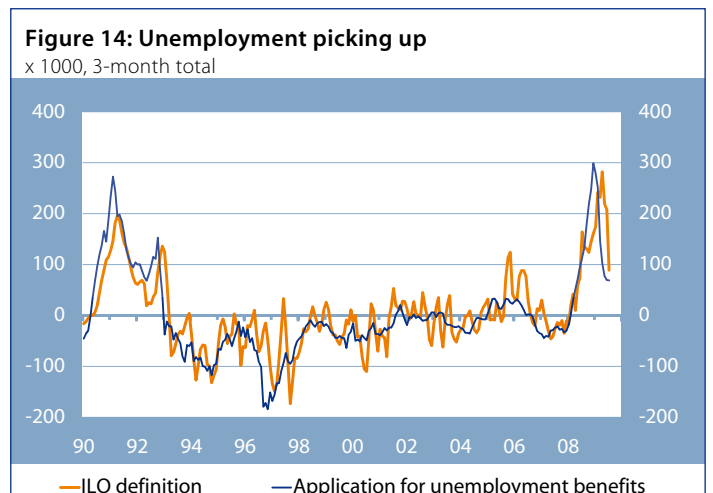
Even as we expect a return to growth in 2010, growth at 1.3% will remain significantly below the 2¼-2½% trend rate, because a deleveraging consumer is both unwilling and unable to return to the prior pace of consumption growth. Naturally such a return and corresponding asset price bubbles aren't optimal in any case. One bright light is the relative flexibility of the UK labour market. During the period of recent economic weakness we have seen a substantial increase in unemployment (*figure 14*), but at least for the period ahead it looks to us that the gloomiest scenarios are overdone, although against our relatively lacklustre growth forecasts the labour market won't truly recover until 2011 at the earliest. The prospect of cautious gains in private spending combined with a small positive net trade contribution leaves moderate grounds for optimism with regard to the overall UK outlook.

Weak sterling may push rate hikes forward

We see a risk of imported inflationary pressure being the flipside of a competitive Sterling which risks a hike coming prior to the end of the first half of the year, while we anticipate rates heading back towards 2% by year end, reinforcing the risks of only a modest recovery.



Source: Reuters EcoWin



Source: Reuters EcoWin

Eurozone: out of recession but minus the sparkle

The eurozone economy has also gone through a deep recession. In the fourth quarter of 2008, the economy contracted in real terms by 1.8% quarter-on-quarter and in the first quarter of 2009 the decline was as much as 2.5%. Confidence among producers and consumers plummeted to record lows in early 2009. Investment retracted sharply and European consumers kept their purses closed. In a remarkable development, even external trade contributed negatively to growth. In previous recessions the contribution of net exports was generally positive for GDP growth, because imports contracted faster than exports. This time round, however, exports were dealt a particularly severe blow by the depth of the recession in world trade.

Pain unequally distributed

Throughout Europe, the recession was not equally severe everywhere (*figure 15*). Large differences are visible in the eurozone, with Slovenia, Finland and especially Ireland hard hit by a sharp correction in the housing market. In Spain, the GDP drop in 2009 appears mild compared to other eurozone countries, but this is deceptive. In recent years, Spain had got used to high economic growth, but growth is currently being strangled by a sharp downturn in house prices. Countries that have failed to address fundamental imbalances (including excessive wage growth) are being hardest hit. Italy is a good example in this respect. But even a relatively healthy economic structure is no guarantee of immunity: Germany, still the so-called 'world champion of exports', has seen a sharp drop in GDP in 2009. This is partly due to external factors, such as the steep decline in demand for capital and durable consumer goods, as well as the country's large-scale interests in Central and Eastern Europe. France, on the other hand, stands out in a positive sense, although it too has been unable to escape a recession. The French economy benefited from substantial state assistance, and from being less dependent on (external) demand for capital goods. In true Gallic style, President Sarkozy intervened with a firm hand in both the financial sector and, importantly for France, in the automobile sector.

Recovery dawns ...

At last, the economic contraction in the eurozone has come to an end. The blow was enormous, but the speed of the recent recovery is also remarkable, and can largely be attributed to the heavy-handed intervention of central banks and governments. Since the first quarter of 2009 we have seen a strong improvement in sentiment on the financial markets, and this has had a positive impact on the economy. The excessive pessimism that prevailed at the end of last year and early this year has turned in a more positive direction, which in itself can be seen as a precursor of economic momentum (*figure 16*): the so-called 'animal spirits' of Keynes. Share prices, which have risen on balance since March 2009, are now contributing to an improvement in consumer confidence.

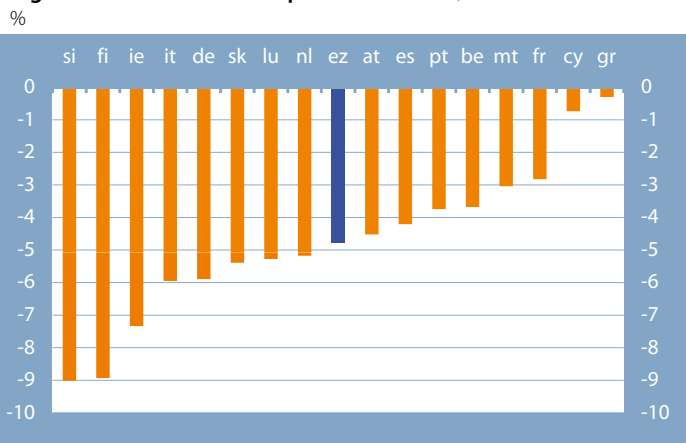
... but a robust recovery cannot be taken for granted

On the whole, the above-cited factors are contributing to a further recovery of growth in the eurozone. There is considerable evidence that 2009 will end with positive economic growth. Indeed, at 0.4% quarter-on-quarter, growth has decidedly turned positive again in the third quarter. Thus, we are leaving the recession behind, but we cannot assume that there will be a continued robust recovery in 2010. In fact, a growth rate of well below the recovery periods of the past is likely. We expect the initial growth momentum to rapidly deflate during 2010. In an extension of our above analysis of Asia and the US, we expect that world trade growth will not make up the deficit accumulated in early 2009 any time soon.³ Furthermore, the potential for European exporters to benefit from world trade recovery is hampered by the sharp rise in the trade-weighted euro exchange rate. Accordingly, a classical, export-driven recovery may seem rather unlikely. Furthermore, the underlying problems in the financial sector have not yet been fully resolved – a danger which the IMF recently again pointed out.⁴ The European banking system still faces the prospect of substantial credit losses. The worst of the mess regarding the US ‘junk mortgages’ may indeed be behind us, but traditional forms of credit are now under pressure as a result of the recession. The IMF singles out medium-sized and small businesses, which account for the bulk of corporate loans in the European banking systems, and where the recession has further increased the threat of credit losses. Furthermore, funding costs for banks have risen, despite the expansive liquidity policy of the central bank, while the potential profit growth of banks is under pressure. The necessity of restoring order to the balance sheets continues to overshadow the sector, which certainly means that any growth momentum for the economy cannot be expected from this quarter.

Limited scope for policymakers

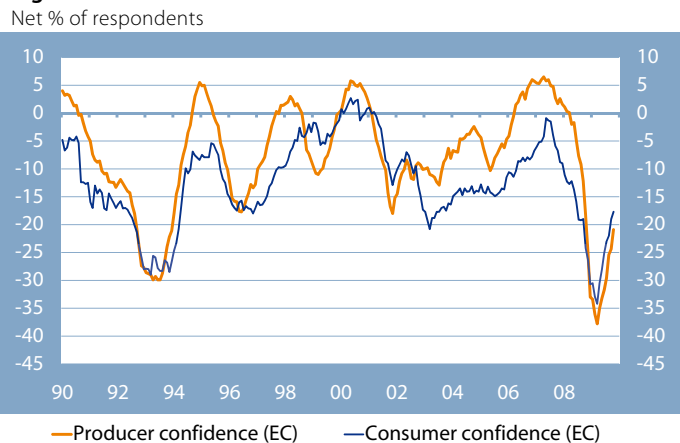
The success of the policy interventions is not without substantial economic risks for the future. After all, central banks cannot keep the liquidity tap open indefinitely. In early November, the ECB intimated its intention to gradually tighten the credit flow. Government finances also need to be tackled in many countries. In general,

Figure 15: Cumulative drop in GDP since Q2 2008



Source: Reuters EcoWin

Figure 16: Sentiment recovers from record low



Source: Reuters EcoWin

governments have not had too many options, and rightly have reacted to the global drop in demand by cutting taxes, speeding up investment in infrastructure and implementing programmes to support the labour market. Specific programmes, such as car scrappage schemes have been effective. Car sales in the eurozone (measured in thousands of cars sold) were over 15% higher in October than a year earlier. Yet, all these stimulus measures incur a substantial debt for the future (*figure 17*). So the challenge lies in gradually exiting the stimulus programmes on time. Gradually, to prevent the economy from slumping back and on time to prevent the poor state of government finances from becoming entrenched. European policymakers do not yet appear to be fully aware of this challenge. Portuguese Prime Minister, Socrates, recently unfolded ambitious plans for large-scale infrastructural investment in his country (€60 bn for the next ten years). In Germany, the new coalition has agreed a hefty tax reduction of €24 bn, without any sign of there being a corresponding spending cut to compensate. And the French government has announced its intention to extend the crisis measures until 2010, in combination with new tax cuts. The picture is clear: although 2010 will show a cyclical recovery, governments are not yet willing to risk loss of momentum in the private sector. Consequently, budget deficits will rise further in 2010, with less room left for manoeuvre.

No traditional upswing in investment

Taking a closer look at our estimates for the eurozone, we see a lag in investment activity. Although the level of investment will rise somewhat during 2010, base effects will ensure that average growth for the year as a whole will remain slightly negative. This is much lower than usual after a recession. Furthermore, part of this growth will still be fuelled by government infrastructural programmes announced in late 2008 and early 2009. In a number of countries the effects of the weak housing market have not yet run their course. Although confidence among European entrepreneurs has improved considerably in recent months, we see this as a relative improvement. Indicators of capacity utilization still show record lows, and although risk premiums in the financial markets have plummeted in recent months, financing conditions for banks and companies remain considerably less favourable than before the crisis. Profit growth for businesses may improve

Table 2: Eurozone key figures

Year-on-year volume changes (%) unless otherwise indicated

	2008	2009	2010
Gross Domestic Product	0.6	-4.0	1.0
Household Consumption	0.3	-0.9	0.8
Private Investment	-0.6	-10.4	-0.4
Government Spending	2.1	2.5	1.6
Net exports (contribution to growth)	0.0	-1.3	-0.1
Inventories (contribution to growth)	0.1	-0.4	0.4
Inflation (%)	3.3	0.3	1.0
Unemployment (%)	7.6	9.4	10.6

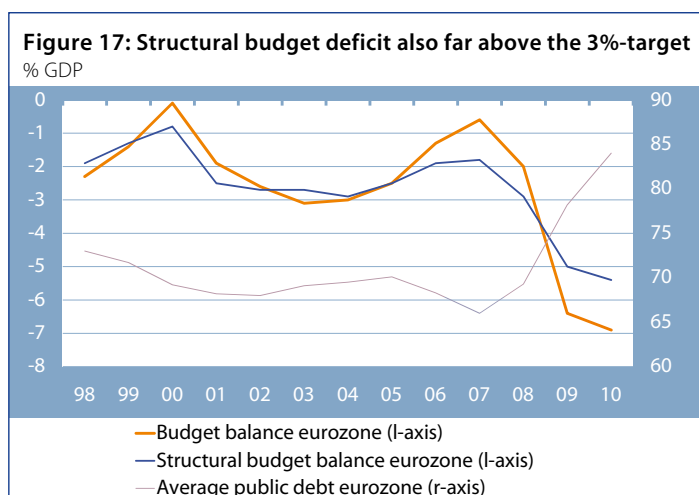
somewhat, now that wage growth in many countries is clearly abating, but profit levels have dropped to a low ebb. Besides greatly increased wage costs, now higher raw materials prices are adding to the downward pressure on profits (figure 18). On the whole, the financial scope as well as the necessity for investment will probably be limited in 2010. Not until 2011 will we be likely to see investment growth return to a 'normal' pattern.

Glimmer of hope for consumers

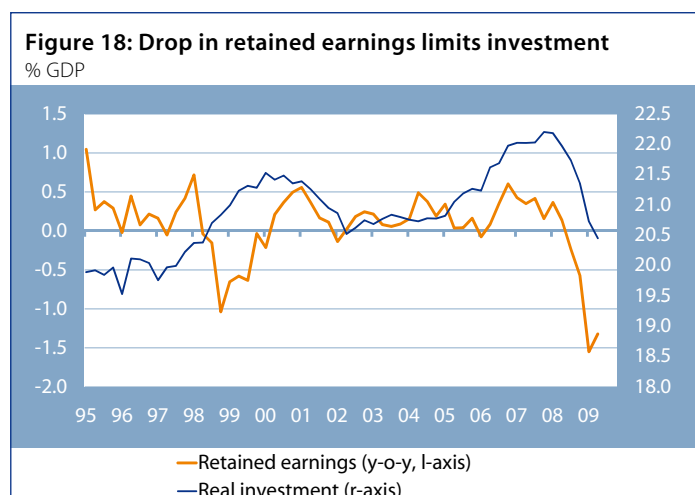
It will be slim pickings for most European households in 2010, with perhaps the occasional sweetener. The main consolation is that inflation has come down considerably in 2009 and is likely to remain subdued in 2010. This will benefit households' real purchasing power. Furthermore, the recovery in the financial markets has led to an improvement in the net financial position of households in recent quarters. This leaves room for a limited drop in the savings rate, which from an international perspective is on the high side (figure 19). The drop in the savings rate might have been steeper, but for the further rise in unemployment, which will be particularly marked in the first half of 2010. Wage development is a different story. Until recently, wage growth was relatively strong in many eurozone countries, as a result of long-term wage agreements that dated back to before the recession. Furthermore, the slide in production was so rapid and sudden that it was impossible for wages to adjust at once. Since then, the situation has changed and we see wage growth dropping substantially in many countries with the pressure of rising unemployment. We expect this pattern to continue through 2010. Accordingly, the prospects for disposable income are relatively dim: both for employment and wage growth, there is little in the way of a silver lining. Tax cuts in some countries may offer some relief, but on the whole we expect no more than a minimal rise in consumption of about 1% in 2010.

New challenges for the ECB in 2010

A major dilemma for monetary policymakers is that the medicine used to combat the crisis (cheap credit) is at the same time one of the catalysts blamed for the development of bubbles in the credit markets, indirectly leading to the crisis. We are not pointing the finger primarily at the ECB in this respect. Monetary expansion in



Source: Rabobank



Source: Reuters EcoWin, Rabobank

the eurozone has - besides the limited covered bonds initiative - mainly consisted in creating liquidity, and provided this is extracted from the system on time, it should have no effects on eventual monetary growth, inflation or the development of new bubbles. However, we do expect that in a calmer economic climate, the ECB will turn its attention to the possible side-effects of the medicine it has dispensed.

No conventional reasons to hurry...

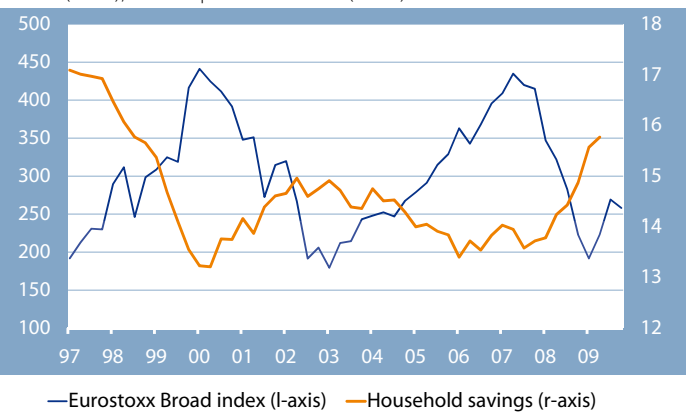
Since October 2008 the ECB sharply reduced its policy rate, culminating in a record low of 1% in May 2009. At the same time, it pursued a policy of monetary expansion, which pushed money market interest rates even lower than the official policy rate (figure 20). In fact, the 3-month Euribor rate fell to below 0.72% in early November. While the economy has clearly found the path to recovery, recent assertions by policymakers, including ECB president Jean-Claude Trichet, give the impression that the ECB is not in any hurry to change its policy any time soon. Economic recovery is still too fragile and the risk of inflation is limited. On the whole we share this view. However, we do envisage some rise in inflation in the coming months, largely on the back of higher oil prices. We expect inflation to average around 1% for 2010. In view of our modest growth projections for the eurozone, the inflation risk for 2010 would appear to tip towards the downward side rather than the other way around.

...but an end to unconventionally low interest rates

That the ECB should nevertheless raise its policy rate in the second half of 2010 is based on the assumption that it regards the current low interest rate as an exceptional measure. We think many ECB council members must be feeling increasingly uncomfortable with an interest rate level of 1% in a recovering economic climate. In fact some of them didn't want to let interest rates fall below 2% in the first place. Furthermore, central banks run the risk of creating new bubbles in the financial markets with their expansive monetary policy (figure 21). Policymakers increasingly seem to realise that it is better for a central bank to be ahead of events than only to step in once the bubble has burst. This is why we expect the ECB to raise its most important rate (the refi rate) by 100 basispoints in the second half of 2010, which will by no means be restrictive.

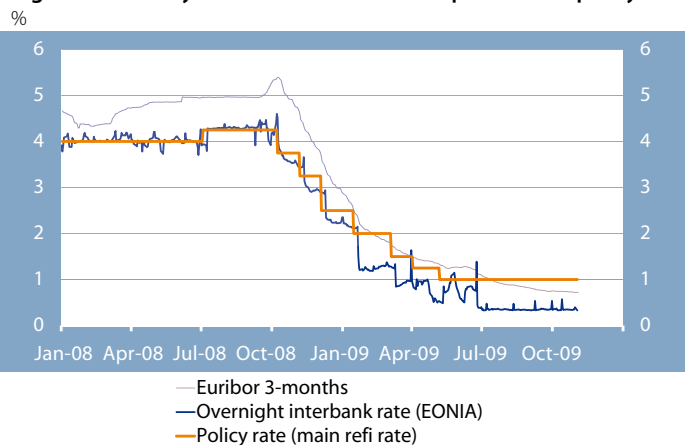
Figure 19: Stock market rally can lower households savings

Index (l-axis), % of disposable income (r-axis)



Source: Reuters EcoWin, Rabobank

Figure 20: Money market interest rates drop below the policy rate



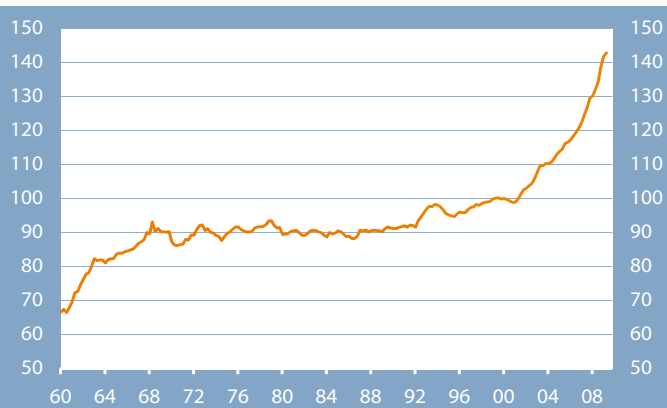
Source: Reuters EcoWin

A change to the provision of liquidity?

However, before it can take this step, the ECB will probably first tackle the excess liquidity in the money market. We expect the spearheads of policy to be aimed in that direction in the first half of 2010. Although an exact plan of action is not known, it would appear inevitable that the ECB must discontinue a number of measures, or else tighten lending conditions. Recent statements by Bundesbank-president Axel Weber point in this direction. Expansive liquidity policy is really based on three pillars: acceptance of a wide range of collateral, a maximum maturity of 12 months for credit extended to banks (formerly three months), and a policy of full allotment of bank's liquidity requests. Because the average credit maturity has shifted markedly towards maximum maturity, there is a danger of new problems in the future (figure 22). In particular, the highly successful liquidity injection of June 2009 (€442 bn), incurs a certain 'roll-over' risk. Moreover, it is difficult to create unlimited 12-month liquidity in an environment where the markets are anticipating a (strong) rise in the refi rate during that term. One possible solution would be to impose a maturity premium on the standard fixed rate. The market will then naturally incline towards the shorter end of the money market curve, particularly if the said premium also gives an indication of the pace of interest rate growth. In any case, we expect liquidity in the money market to decline during the course of 2010, whether by natural means or contrived. This will allow money market rates to rise somewhat in the first half of the year. Market anticipation of policy rate increases may well intensify the upward trend. By the end of 2010 we expect to see a 3-month Euribor rate of about 2¼%.

Figure 21: Growth of broad money (M3) in the eurozone has picked up pace since 2001

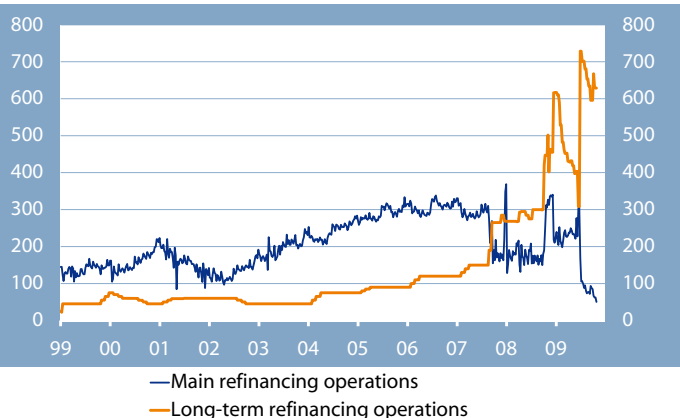
Ratio of broad money and eurozone GDP (index, 1999 = 100)



Source: Reuters EcoWin, Rabobank

Figure 22: ECB loans to the banking sector

% bn



Source: Reuters EcoWin

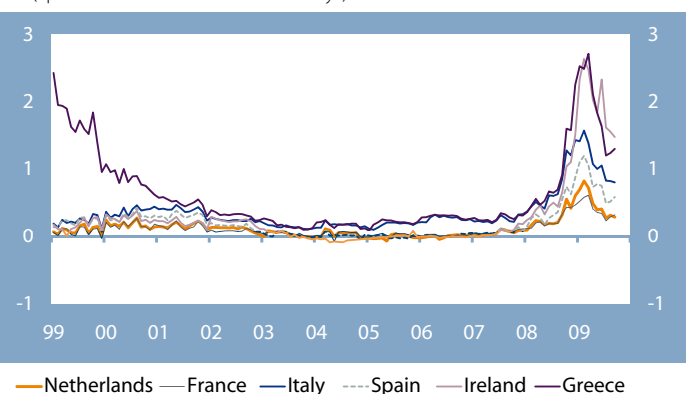
Capital markets: investors venturing out from safe havens

Although 2009 can be regarded as another turbulent year for fixed-income markets, volatility is a relative concept: compared to the previous year, 2009 was an oasis of peace. At the same time, regional divergence needs to be highlighted. In the US on the one hand, we saw strong fluctuations in the yield on 10 year government bonds, from a record low in early 2009 to 4% halfway through the year. In Germany, on the other hand, the 10 year yield kept within a relatively narrow range of between 3.1 and 3.7%. The spreads between various eurozone countries and benchmark country Germany, which in late 2008 were still very wide, narrowed noticeably from the first quarter of 2009 (*figure 23*).

To a considerable extent the correction on the US bond market, and the bond market in general, can be seen as an improvement to the liquidity in the markets and a return to normal prices. In late 2008 and early 2009 the government bond market was overvalued because US Treasury paper (and to a lesser extent German government paper) was functioning as a safe haven for investors. Furthermore, in many countries inflation had slowed considerably as a result of exceptionally large price drops on the commodity markets. Add to this the fear of a global depression, and the historic low levels are somewhat understandable. Yet this analysis does not fully explain why interest rates subsequently rose so rapidly. Raw materials prices recovered in early 2009, and the economic turnaround focussed people's attention on the significant (inflationary) risks attached to America's aggressive monetary and budgetary policy, for which a price must ultimately be paid. However, it is the return of appetite for risk among investors since the first quarter that dominates the picture. Investors were once again prepared to take the plunge, and began to exchange their safe Treasuries and Bunds for higher risk paper, such as shares and corporate bonds. The result was a sharp climb in capital market interest rates until early June.

Figure 23: Sovereign bond spreads (10 yr)

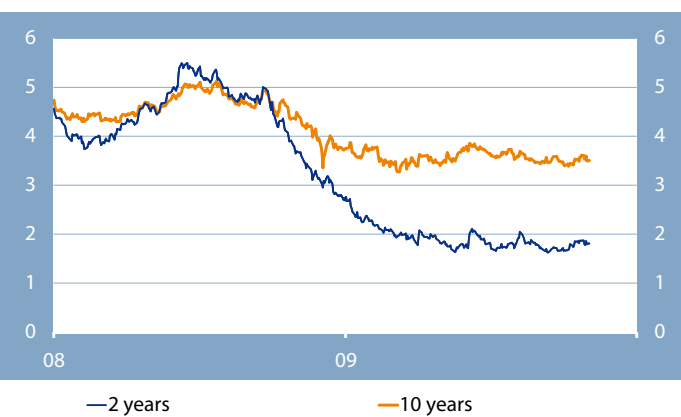
% (spread versus German Bund -10 yr)



Source: Reuters EcoWin

Figure 24: Swap rates in the eurozone

%



Source: Reuters EcoWin

Mixed feelings

In the light of world economic recovery, increased inflation expectations in the market and growing appetite for risk among investors, it is surprising that capital market interest rates have declined since the summer (*figure 24*). Between early June and the beginning of November, the 10-year swap rate in the eurozone has dropped by 30 bps and by as much as almost 60 bps in the US. Uncertainty about the sustainability of the recovery has not fully evaporated from the markets, and the main central banks recently indicated their unwillingness to invoke their exit strategies any time soon. This has kept a lid on shorter term capital market rates. Furthermore, many investors will have “put their money to work” across a broad range of financial securities. And this may explain why the prices of many different investment instruments rose simultaneously. All good for market sentiment, but also worrying, in view of the risks for the medium term and the said reluctance of central banks to restrict monetary policy. The danger is that current low interest rates may spark a tendency towards greater risk-taking.

Box 2: Support measures for the main course, inflation for dessert?

Will the vast array of measures adopted by central banks and governments ultimately lead to an uncontrollable surge in inflation? It may appear strange to discuss uncontrollable inflation at a time when many countries are experiencing almost zero or even negative inflation. But let us weigh up the arguments for and against.

Those in the deflation camp reason that the enormous capacity surplus caused by the crisis in the western economies will continue to exert downward pressure on prices. Furthermore, workers have lost negotiating power due to higher unemployment, and companies' profit margins have been eroded. Weak economic recovery combined with a fundamental rebalancing of the financial sector as well as increased tendency of households to save instead of spend will ensure that the excess capacity will remain in place for a relatively long time. This therefore, it is argued, will contribute further to deflation.

Exponents of the inflation argument envisage large risks in the medium term. The large-scale interventions and liquidity injections from central banks and the enormous governmental stimulus packages to avert a depression have a downside (*figure 25*). These measures increase the risk that once the economy makes a clear turnaround, an uncontrollable surge in inflation could be the result. The theory is that governments and central banks will be too late with their exit strategy. Central banks will remain focussed on supporting the financial sector, as long as the process of debt

reduction is underway. And governments - even if only for political reasons - will be just as reluctant to withdraw their stimulus packages.

Both arguments emphasize extreme scenarios. The deflationists base their arguments entirely on the relationship between excess capacity and inflation (*figure 26*). Analyses do indeed bear out this relationship but the strength of the correlation is heavily influenced by inflation expectations and the underlying confidence that economic actors have in central bank policy. Well-anchored inflation expectations ensure that actual inflation is much closer to the central bank's aims than might be presumed on the basis of capacity utilization. There is another more technical problem: the production potential of an economy is difficult to measure. It is entirely possible that the production (growth) capacity of the economy has declined as a result of the recent crisis, which means that the capacity surplus is smaller than we think. Based on these considerations and on our growth scenario for the global economy, we estimate the risk of deflation in western economies to be still relatively low.

The assumptions of those in the inflation camp are largely based on the highly inflationary effects of the extremely loose monetary policy. The major central banks try to debunk this fear by pointing out that many of their liquidity generating measures will automatically expire once there is no longer any need for them. This assertion also needs to be qualified. To simply discontinue liquidity

Outlook: eventually higher

Although inflation is currently at a low ebb in the western economies, and the risk of downward pressure remains, the business cycle gives rise to expectations of a clear rise in capital market rates, particularly within a six to twelve month period. The global economic recovery certainly underpins this view, although it is as yet far from prodigious. As such, it gives the central banks sufficient basis for discontinuing the extraordinary measures. This will be accompanied by a rise in money market rates which will also push bond yields upwards. In this context we should mention the ending of the Fed's Treasury paper purchasing programme in the US, which should no longer have a downward impact on bond yields. Furthermore, in 2011 the Fed may well have to step harder on the brakes than is now factored in by the markets, which is another reason why we may see bond yields rise more sharply in the US in 2010 than in the eurozone. In addition, from a long-term 'fair value' point of view, we see that bond yields in the western world are currently relatively low, and are an insufficient reflection of the risks attached to greatly increased budgetary deficits, particularly the cyclically-adjusted component.

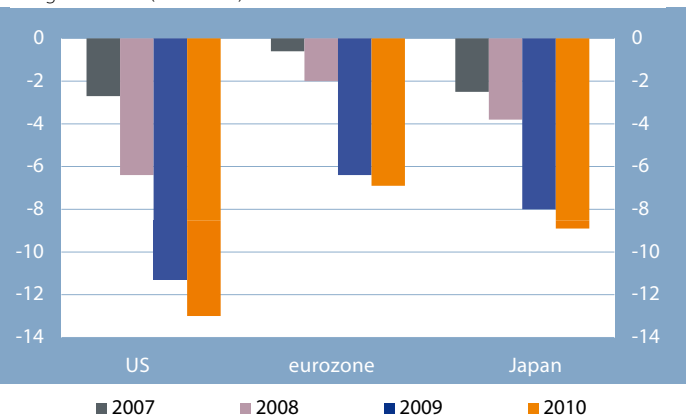
programmes could lead to problems, for instance because it will reveal banks' counterparty risks, which could give rise to renewed deterioration in market circumstances. Furthermore, if the Fed or the Bank of England were to withdraw their unconventional measures, for example by re-selling some of the previously purchased long-term securities, this could result in a significant rise in yields. This prospect alone could induce central banks to postpone the withdrawal of measures. Clearly, therefore, central banks will have to proceed with the utmost caution and will leave measures in place for longer than strictly needed on an economic basis. We regard this as a matter of some concern. Furthermore,

there is a risk that long-term higher inflation – generated by adjusting implicit or explicit inflation goals – may form part of the means to tackle the stacked up government debts.

The support measures have been served up as the main course. Inflation is on the menu for dessert, and in our view has already been ordered. It will take pro-active, tenacious policymakers to ensure that it does not actually reach the table.

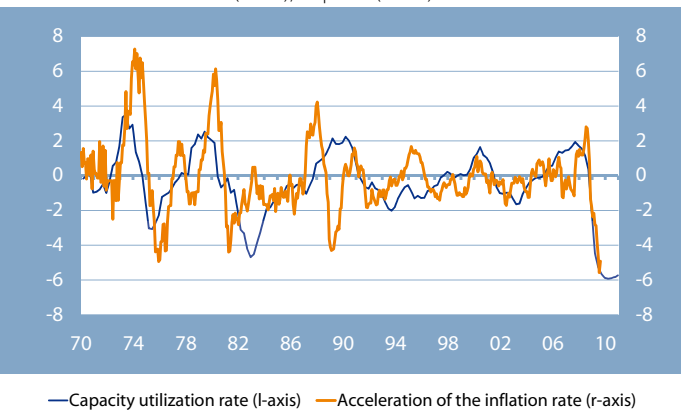
Figure 25: Budget deficits widen further in 2010

Budget deficits (% of GDP)



Source: Europese Commissie, Rabobank

Figure 26: Capacity under utilization puts downward pressure on OECD-inflation % (l-axis), %-point (r-axis)



Source: Reuters EcoWin

Stellar performance credit markets

European credit markets recorded a stellar performance in 2009. Total corporate issuance reached unprecedented levels at €240 billion. Double-digit (low teens for investment-grade and 60% for high-yield) returns have attracted record levels of inflow and spreads have edged back to their pre-Lehman levels with hardly any new issue premiums to speak of. Towards the latter part of the year non-financial issuance has tended to be unrated, borderline investment-grade/fallen angels and pure high-yield. Whilst there are underlying positive fundamentals, 2010 is unlikely to see a repeat of the current year's performance.

A complex field of force

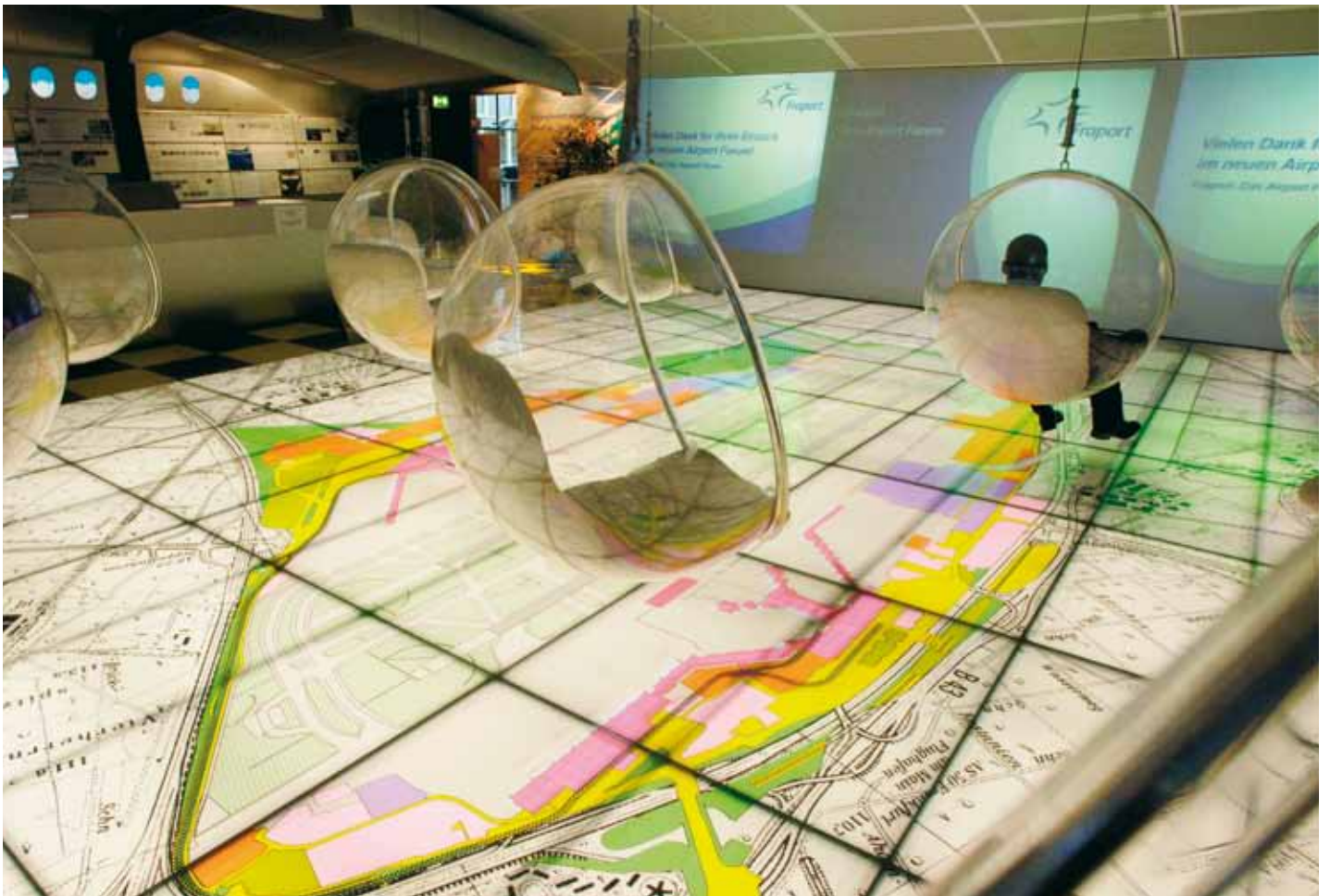
Looking ahead there are many themes which will influence asset allocation and spread-directional trends: (1) economy, corporate earnings and investment willingness; (2) rates and inflation; and (3) mergers and acquisitions. In investment-grade, creditworthiness is expected to remain stable as corporates continue to rein in spending and hoard liquidity. The first leg of the rally in risk assets is being driven by stimulus packages and corporate cost-cutting. Event risk has emerged again more recently (e.g. Adecco/MPS, Kraft/Cadbury) in a variety of corporate sectors.

An appealing alternative to bank credit

On the funding side, the banks' focus on solvency and a higher cost of capital will continue to constrain any meaningful expansion of the loan books. Capital markets will carry on providing good funding opportunities in the investment-grade sector. This also applies to some extent to the better tier of high-yield issuers, fallen angels and good household names. Amongst the lower tier of high-yield, optimism would quickly fade away were the recovery to be drawn out. The default rate has remained within the expected range (likely to peak by the end of 2009), and this is in part the result of a record low interest rate environment, and the previously easy credit conditions of the boom years of 2006-07. Companies have also been able to request waivers to their covenants or restructure, which has helped defuse the potential leverage refinancing bomb, but the 2009 restructurings have also seen minimal deleveraging.

New reality

Many of the large creditworthy corporates have come to the market for refinancing during 2009, and less funding is likely to be required next year. The technical bid for credit remains supportive of spreads in the short-term. The direction spreads will take will ultimately depend on the shape of the economic recovery. As the default rate is expected to continue to decline, credit will likely lose out to equity in a V-shaped recovery, whilst in a slow-growth recovery, where rates would be kept low for longer, tightening could continue at a slow pace. However the quasi-disappearance of the leveraged bid (hedge funds, CDOs, SIVs), the higher cost of capital and allowances for tail risk are likely to constrain the spread tightening in a new world that includes heightened government regulation, lower consumption and slower growth.



FX: a cyclical US dollar bounce amid a structural downtrend

The greenback has been in a structural downtrend for the past 25 years. The broad DXY index, which tracks the US dollar versus a basket of 6 major currencies, more than halved after the peak in 1985.⁵ Periods of extreme short-term negativity have nevertheless been interspersed by cyclical rebounds. Recent examples of that include the bearish periods from the start of 2002 to the end of 2004 and late 2005 to mid 2008 (*figure 27*), both of which were followed by short-term cyclical recoveries, after which broader structural negatives reasserted themselves. But as the financial crisis unfolded we have been treated to a rollercoaster ride in the past 12-18 months as financial dynamics downplayed longer term structural influences.

Torn between the safe haven and the long-haul

In recent history the dollar initially rallied strongly on the basis of a flight to liquidity in the aftermath of the collapse of Lehman Brothers, as investors returned to either default positions or the liquidity and safety at the short end of the yield curve amid fears over the collapse of the financial system. We have subsequently seen the US dollar underperform in an environment of increased risk appetite. Investors began to treat the USD as a funding currency, i.e. investors borrowed “cheap” US dollars to invest in higher yielding currencies. Ignoring medium-term FX fundamentals such as relative growth and interest rate spreads over short-term factors such as risk appetite can only go so far, however. The question therefore is when the market will return to the former and put less emphasis on the latter.

Cyclical dollar recovery 2010

The USD weakness during much of H2 2009, as evidenced by the retreat in the DXY index back towards 2005-2008 cyclical lows, opens the prospect of another short-term cyclical USD bounce in 2010. While such a rebound would be a temporary affair amid long-term structural negatives linked to substantial fiscal and current account deficits, it nevertheless promises to become a meaningful event when looking at stretched market positioning. The answer to the question when the market will return to medium-term FX fundamentals such as relative growth and interest rate differentials lies in no small part with the Fed. Against the backdrop of massive monetary stimulus and record low rates, even a timid recovery should be sufficient to persuade the Fed to hike rates. While we expect the first steps towards interest rate normalization won't begin until August 2010, the mere prospect of FOMC tightening should send shock waves through the market.

When we take a specific look at EUR/USD, a couple of factors stand out. Our forecasts point at a faster flattening in the US curve amid widening long end spreads which will favour the USD, while growth differentials clearly favour the US economy over the eurozone. It is also clear that EUR/USD is also residing at rather painful levels for the eurozone economies, in particular for those economies already

Box 3: Saying Good-bye to the dollar era?

“The dollar is our currency but your problem.” These were the words of one-time US Treasury Secretary John Connally, and they describe the role of the US dollar in the world to this day. The dollar remains the world’s most important currency, much to the displeasure of those who would like to see alternatives, particularly with US politicians scarcely concerned with the weakness of its currency. Despite all the rhetoric in the media, this situation will not change any time soon, although the dollar is certainly steadily losing ground.

The ongoing discussion about significant diversification away from the dollar appears limited to hard talking. If we look at the currency composition of global reserves, we see that 62.7% of these are still denominated in US dollars. To put this figure in context, it must be acknowledged that this share has been on a downward trend in the past ten years from a high of 78%. On the other hand, the currency composition of part of the global currency reserves is unknown. This unknown quantity includes China’s reserves. Rough estimates put Chinese reserves as high as 75% in dollars. If this is the case, the dollar share of total world dollar reserves – with and without publicly known currency composition – is probably higher than the 62.7% reported in the statistics. The Triennial Survey of the Bank for International Settlements (BIS) is also useful for showing how much pull the dollar has lost. Apparently it has not lost that much, because according to the BIS, it is still the world’s most important currency, enjoying a large and stable share in daily currency trading and in the derivatives market.

A strategic withdrawal from the dollar may well be underway, but one that is proceeding at a glacial pace. It will not be years, but decades, before a withdrawal from the dollar is complete. Why is

this? First, because of the sizeable adjustment problem in the surplus countries of the Middle and Far East. Although these countries are uncomfortable with the long-term outlook for the dollar, they have bought so heavily into this currency that they cannot easily divest themselves of it. China is a singular case, with currency reserves in the order of some \$2.3 billion. On account of this mountain of accumulated dollar reserves from the past, a shift from the dollar would be too expensive because of the devaluation that would occur to the existing reserves. A second reason for the slow withdrawal is because the surplus countries mainly stockpile reserves in order to keep their currency artificially low against the dollar. This is to support their own export-led growth strategy. A significant diversification away from the dollar could jeopardize exchange rate policy and ultimately export growth and the growth model. Third, US financial markets still offer liquid investment instruments that are attractive to investors throughout the world, not least to emerging economies that have yet to beef up their own financial markets in order to retain their newly earned wealth.

Taking a long term view, the importance of the dollar is likely to wane. But it would be a mistake to suppose that the dollar’s position will be taken over by a single rival currency. We envisage a multi-polar currency landscape, with an increasing role for the euro, but also for the emerging currencies of China and India, during the further development of their political, economic and financial systems. For the coming years, this bodes for a certain caution with one’s investments, and reducing one’s dollar portfolio would be ill-advised on the basis of presumed diversification away from the dollar. After all, the main players in the game have not yet put their money where their mouth is.⁶

under pressure and who have greater trade exposures outside the euro area. Looking at PPP fair value measures for EUR/USD, we reach an estimate of US\$1.22. It's hardly a perfect measure, but it does tell us something of the scope for a cyclical rebound in the USD.

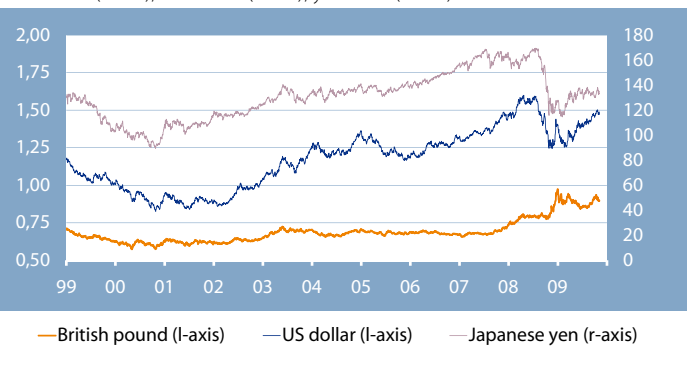
The line of least resistance

We'd also underscore from a structural point of view, looking at global imbalances, the US trade deficit in the year to September of US\$243bn against an annual peak of US\$760bn in 2006, most of which is against Asia, underlining that most of the USD's adjustment should be against the broad spectrum of Asian currencies. We expect to see some adjustment in 2010 in USD/Asia along these lines, but Asian governments remain hesitant for the time being (*figure 28*). That in turn still leaves the euro exposed as the path of least resistance beyond 2010, even as the eurozone economies could do without the burden of a strong currency.

- 1 Based on the Case-Shiller Composite-20 index.
- 2 Based on the S&P 500 index.
- 3 See also the contribution *Globalization at a crossroads: World Trade* in the Special Report that was published in conjunction with this Outlook on 2010.
- 4 See International Monetary Fund (2009), *Global Financial Stability Report: Navigating the Financial Challenges Ahead*, October 2009.
- 5 This index consists of euro (57,6%), yen (13,6%), sterling (11,9%), Canadian dollar (9,1%), Swedish crown (4,2%) and Swiss franc (3,6%).
- 6 See also the contribution *Globalization at a crossroads: Economic Imbalances* in the Special Report that was published in conjunction with this Outlook on 2010.

Figure 27: Volatile FX market

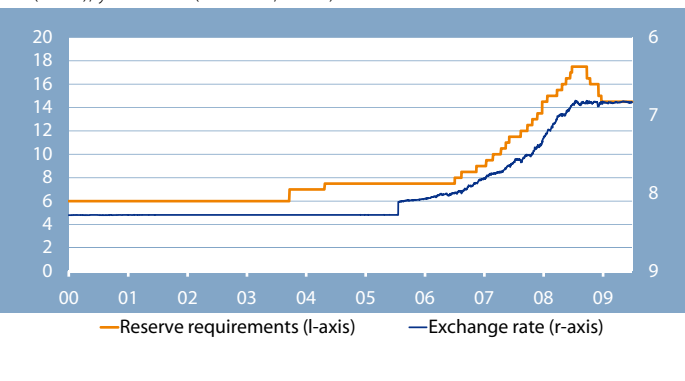
GBP/EUR (l-axis), USD/EUR (l-axis), yen/EUR (r-axis)



Source: Reuters EcoWin

Figure 28: Chinese monetary policy

% (l-axis), yuan/USD (inverted, r-axis)



Source: Reuters EcoWin