

## Overview

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## Eurozone: Public finances, contrasting positions between the member states

In its autumn forecast, the European Commission estimated that the overall public sector deficit for the euro zone could reach 6.9% of GDP in 2010. Estimates of the scale of measures taken by governments to support their economies were increased to 1.3% of GDP this year and 1.2% in 2010. In the absence of any consolidation, the deficit for the euro zone could still run at 6.4% in 2011. Debt would then stand at 88% of GDP, an increase of more than 20 points compared to 2007. One can estimate that a structural adjustment to the budget of around 2.5 points of GDP will be needed to stabilise the euro zone's government debt in the medium term. However, it is important to take into account the divergent situations between the various member states.

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## Japan: Hatoyama government faces major challenges

The major objective of the Hatoyama government is to transform the economy into one where growth is generated by domestic spending rather than by exports. The government has announced to undo some of the labour and product market reforms such as the privatisation of the Post Office. A major problem for the new government is the rapidly rising public debt. Without any additional measures, the financing of the election promises is likely to widen the budget deficit further. To keep investing in JGBs attractive, a medium-term plan for fiscal consolidation will be required.

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## Editorial

## Productivity gains: The United States ahead

The difference in the responsiveness to the economic cycle between the USA and the euro zone is being demonstrated once again. In the USA the speed of the adjustment of employment to the level of economic activity resulted in productivity gains in the second quarter (6.9% q/q annualised) even though GDP was still contracting. Unsurprisingly, therefore, given the economic recovery, productivity gains accelerated in the USA in the third quarter (9.5% q/q annualised), taking the year on year figure to 4.3%, from 1.9% in Q2.

Philippe d'Arvisenet

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Editorial (continued)

Productivity gains: The United States ahead

Given very modest growth in wages, there was a marked fall in unit labour costs (-5.2% q/q and -3.6% y/y). This gives a strong signal for company profits, as this drop more than offsets the erosion of pricing power (the year-on-year GDP deflator fell from 2.5% in Q3 2008 to 0.7% in Q3 2009). The figures also suggest that there has been a massive reduction in staff numbers, and that this is now likely to return to a more moderate rate.

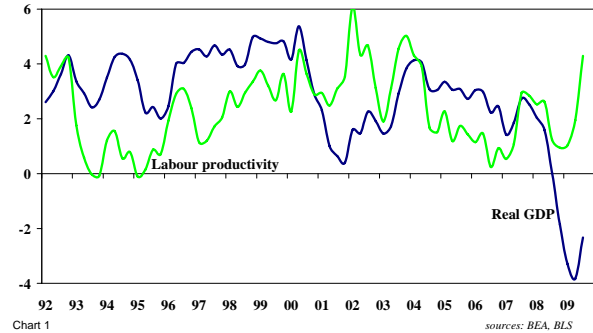
Setting aside differences between countries, the euro zone has seen a very different pattern (Figures 1 and 2). Figures for productivity gains show that the adjustment in staffing levels to cyclical conditions displays more inertia than in the USA (Figure 3 – productivity per head fell by 3.1% y/y in Q2), with the result that unit costs have soared (up 4.8% y/y in Q2 from a peak of 5.8% in Q1 – Figure 4). Given the moderation of domestic prices (the GDP deflator was up 1.1% in Q2 2009, compared to 2.3% a year earlier), this has put pressure on margins and suggests that having been slow to take effect, the adjustment in employment will continue. In the short term at least, this will inevitably hold back growth.

As expected, US growth jumped ahead in the third quarter (3.5% year-on-year). Destocking came to an end and consumer spending was boosted, mainly by support packages for the automobile industry (cash for clunkers) and an upturn in residential real estate investment, driven by measures to help first-time buyers and by lower mortgage rates.

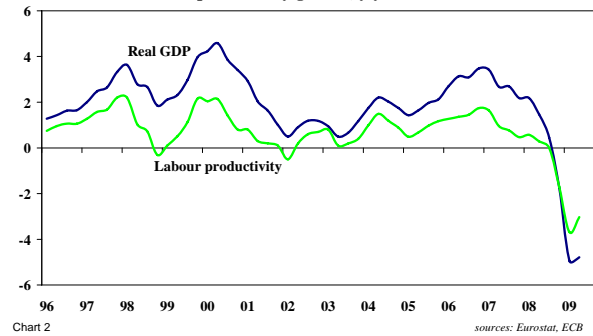
Companies' investment in capital goods and software increased slightly, which was surprising given the scale of unused capacity. It is clear that a recovery in earnings is encouraging investment in modernisation. Conversely, investment in new capacity, which generally lags the cycle, continued to fall, as can be seen in the drop in investment in non-residential real estate (-9% in Q3, after -17.3% and -43.6% in the two preceding quarters).

Economic indicators suggest that growth will remain at respectable levels in the fourth quarter, with a continued favourable effect from stock levels. On this point, the ISM index of purchasing managers in manufacturing industry is clearly in the growth zone at 55.7, from 52.6 in September. This indication is corroborated by trends in durable goods orders, which were up 11.2% annualised in the third quarter for goods excluding planes and defence.

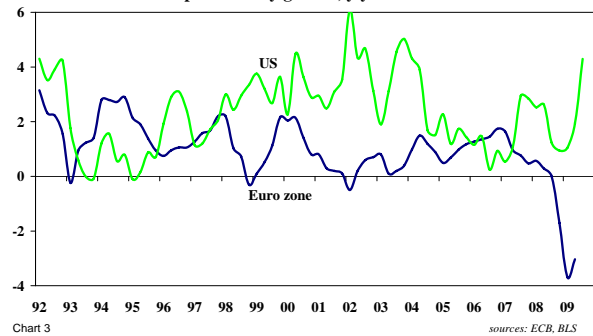
US real GDP & productivity growth, y/y %



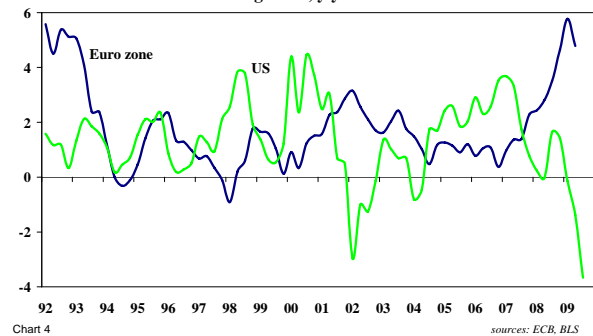
Euro zone: real GDP & productivity growth, y/y %



US/Euro zone: labour productivity growth, y/y %



US/Euro zone: unit labour cost growth, y/y %



The ability of US companies to react to the economic cycle is impressive. Even when GDP was continuing to fall in the second quarter, the US economy was already recording productivity gains. It was not surprising, therefore, that this trend gathered pace in the third quarter, with annualised growth of 9.5% and a year-on-year rise of 4.3%, a new record high. The result was a sharp fall in unit labour costs (-3.6% year-on-year), which points to good trends in company earnings. The weakness of the dollar is also helping, by boosting the competitiveness of American products and also increasing the dollar value of profits generated abroad.

The outlook for consumers is markedly different. The labour market is continuing to adjust, as shown by the fall in employment (down 190,000 last month) and the corresponding rise in the unemployment rate (from 9.8% to 10.2%). This is starting to affect the level of nominal wages at a time when inflation is moving back into positive territory, as the comparison effects from the collapse in oil prices in the autumn of 2008 drop out of the calculation. The increase in purchasing power from earned income is unlikely to help support consumer spending, while the rise in the equity market is not yet sufficient to create a wealth effect powerful enough to offset the negative effects of falling real estate prices and a reduction in lending to individuals. Levels of indebtedness and the worsening employment picture are hitting confidence, and are likely to lead to an increase in savings after the downward correction at the beginning of the summer, which was clearly related to new automobile purchases.

Against this background, and with the rise in consumer spending likely to lose steam, growth will be disappointing next year, once the temporary effects of stimulus measures fade away. It is hardly surprising therefore to note the fall in consumer confidence, as measured by the Conference Board index (47.7 in October, from 53.7 in September and 54.5 in August), nor to see the

government choose to prolong certain measures such as tax credits for first-time house-buyers (to April) and the extension of the period over which unemployment benefits are paid. Meanwhile, the Fed has announced that its MBS purchasing programme will continue into next spring and that interest rates will remain low for a prolonged period.

After five consecutive declines, eurozone GDP rose by a solid 0.4% t/t in Q3. This positive performance was due mainly to industrial sector rebound, which has been highly affected by the global recession, particularly over the turn of the year. Industrial production rose in Q3, with rises of 3.3% in France, 4.4% in Italy and 3.5% in Germany. This improvement is likely to continue, as suggested by the rally in German orders (up 8.9% in Q3, from 5.5% in Q2) and the manufacturing sector PMI figure. For the whole eurozone, it moved into positive territory last month, although there were still sharp disparities between countries (55.6 in France but 46.3 in Spain). The relative inertia of employment levels in the zone has resulted in a lower level of productivity gains and a corresponding increase in unit labour costs (4.8% in Q2) which suggests that the scale of the adjustment still to come is greater than in the USA. This will inevitably have an impact on conditions in the labour market, and thus on consumer spending. Under such circumstances, and with inflation remaining under control, the ECB is likely to hold its refi rate steady over the course of next year. It will, however, begin to prepare its exit strategy and gradually begin to roll back its non-conventional measures from next month, pending clear indications on the changes that will inevitably be made to the details of refinancing over a one-year period.

**Philippe d'Arvisenet**

## Overview

### Exit strategy: Gently does it

The recovery is taking shape, both in the USA and in the euro zone. After the collapse at the end of last year and beginning of this, economic activity first stabilised in the second quarter before returning to growth in the third.

Whilst US GDP grew by 3.5% on an annualised quarter-on-quarter basis in the third quarter (or around 0.9% q/q), the euro zone expanded by 0.4% q/q (around 2.4% q/q annualised), having contracted by 0.2% in the second quarter. There has been a very mixed picture in the performances of the major economies of the euro zone. GDP growth rose sharply in Germany (0.7% q/q, compared to 0.3% in Q2) and in Italy, which also came out of recession (0.6% after -0.5% in Q2), whilst France posted the same rate of growth as in the second quarter, at 0.3% q/q. Spain remains in recession, however, with a contraction of 0.3% q/q following the 1.1% fall in the second quarter. With this growth in the euro zone coming on top of five consecutive quarters of contraction for the region, GDP is still more than 4% down on this point last year.

On both sides of the Atlantic, the recovery is likely to continue over the next few quarters. However the rate of growth is likely to ease for a number of reasons: the rebound generated by the end to destocking will not last, and the effects of fiscal stimulus packages will gradually drop out of the equation; higher oil prices will move inflation back into positive territory in the very near future; and the deterioration of the labour market will continue to dampen consumer confidence.

The fragility of the recovery at a time when inflation is set to remain very low over the next few quarters despite the economic improvement argues for a continuation of highly accommodating monetary policies. In such circumstances the Fed, the ECB and the BoE are all likely to hold their policy rates at low levels for a prolonged period. Similarly, the exit strategies from policies of quantitative easing (for the Fed and BoE) and non-conventional measures (for the ECB) will be very gradual. Central banks will be keen to ensure a continued abundance of liquidity. Thus the Fed has made only marginal cuts to its asset acquisition programme, which has an overall value of USD1,725bn, reducing just the Agency securities envelope from USD200bn to USD175bn. Meanwhile the BoE has increased the ceiling on its asset purchase programme by GBP25bn, taking it to GBP200bn. The ECB has taken the least neutral stance in terms of ending exceptional measures, suggesting a gradual reduction in liquidity, as and when stronger economic growth allows. However, although it seems highly unlikely that the one-year refinancing system (at a fixed rate and equivalent to the assets tendered) will be renewed next year (this was never the intention), Mr Trichet has given no indications of

the ECB's intentions in this area, postponing discussion of the subject until the December meeting. Even so, it seems reasonable to believe that the ECB is unlikely to tighten monetary policy before the Fed does so, given the relative underperformance of the euro zone, the fact that euro rates are already well above those for the dollar and the fact that the strength of the euro against the dollar is putting pressure on EU exports.

Government action to tackle the crisis has meant that the recession has not turned into a depression, but has also increased deficits and pushed total government debt very sharply higher. As a result over the next few years, governments will face the costs relating to an ageing population from a position of considerable strain on public finances. However, in view of the economic conditions outlined above, the temptation to regain some fiscal breathing space too rapidly must be resisted, as to do so could threaten the nascent recovery. Even so, clear fiscal exit strategies need to be drawn up and then implemented over the next few years. Although official global coordination of these looks unrealistic, the widespread fragility of the recovery is likely to impose some sort of *de facto* cooperation. In particular, strategies will need to have credibility with the financial markets in order to avoid any increase in interest rates reflecting a perception that public finances have spun lastingly out of control. Such a perception would also be very likely feed expectations of higher inflation (which in turn would drive long-term rates higher). This vicious circle would increase the risk that central banks would raise policy rates earlier or faster than would be required to deal with the recovery alone. This would be all the more damaging given that a continuation of relatively accommodating monetary policies will ease the task of fiscal consolidation. Lastly, the choice of the ways in which public finances can be put back on a solid footing is crucial. In particular it will be necessary to avoid an increase in savings rates and a decline in consumption.

Finding the right policy mix as economies emerge from recession will be a difficult balancing act.

## Interest and foreign exchange rates

	Thursday 12 November	Thursday 6 November	Highest in 52 weeks	Lowest in 52 weeks		Thursday 12 November	Thursday 6 November	Highest in 52 weeks	Lowest in 52 weeks
Libor 3-month	0.27	0.28	2.24	0.27	EUR/USD	1.4867	1.4882	1.5008	1.2526
10-year US Gvt/Bond	3.44	3.53	3.94	2.07	USD/JPY	90.38	90.51	100.69	87.68
Euribor 3-month	0.71	0.72	4.22	0.71	EUR/JPY	134.33	134.70	138.65	113.08
10-year Bund	3.30	3.35	3.66	2.90	EUR/GBP	0.8992	0.8976	0.9797	0.8281
Libor 3-month yen	0.32	0.32	0.96	0.32	USD/CHF	1.0162	1.0155	1.2244	1.0060
10-year JGB	1.40	1.45	1.56	1.17	EUR/CHF	1.5107	1.5112	1.5831	1.4590

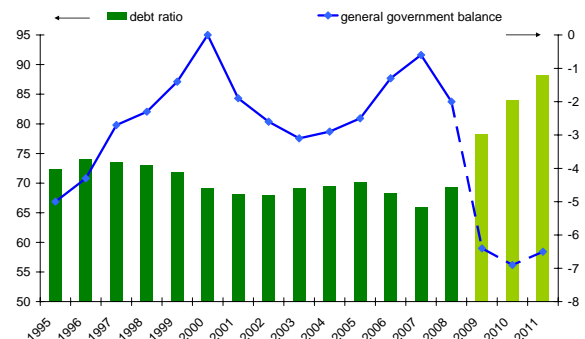
Sources: Financial Times, Thursday's closing prices

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Fiscal balance	(% of GDP)				
Euro Zone	-2.0	-6.4	-6.4	-6.9	-6.7
Germany	0.0	-3.4	-4.9	-5.0	-5.6
France	-3.4	-8.3	-8.2	-8.2	-9.0
Italy	-2.7	-5.3	-5.4	-5.3	-5.6
Spain	-4.1	-11.2	-9.6	-10.1	-9.2

Sources: European Commission (autumn 2009) and BNPP estimates (October 2009)

### 1. Euro zone public finances (% of GDP)



Source: Eurostat and European Commission forecasts (autumn 2009)

Secondly, the stimulus packages introduced by member states have proved to be more generous and costly than expected. Moreover, in some cases they were augmented during the year by measures that will have a permanent effect on budget balances (for instance in France, with the reduction in VAT for restaurants and the reform of the "taxe professionnelle" business tax). All in all, the Commission now believes that discretionary stimulus measures taken by euro zone member states will account for 1.3% of GDP in 2009 and 1.2% in 2010 (compared to 1% and 0.8% respectively six months ago). The total increase in this estimate of 0.7 of a point of GDP is significant.

*business tax receipts. For more on this last point see "France: Further deterioration in public finances in 2010", BNP Paribas EcoWeek 09-38.*

## How to stabilise a debt ratio that could exceed 85% of GDP from 2011?

In its autumn forecasts, the Commission provided its initial estimate of prospective euro zone public finances in 2011. As is traditional, this forecast has been drawn up on the basis of unchanged fiscal policy relative to 2010, but it does take account of the removal of temporary stimulus measures introduced since the recession began. Taken overall, these forecasts are in line with a fairly widely held consensus view that growth will remain relatively weak in 2010 and 2011, and that public finances will have been structurally deteriorated by the recession and the significant adjustment to the growth models of certain countries.

In all, the Commission estimates that unless there are additional consolidation measures, a return to GDP growth of 1.5% in 2011, will not allow more than a marginal reduction in the euro zone's fiscal deficit to 6.4% of GDP, a level that would be totally inadequate in tackling the rise in total public sector debt. Gross debt in the euro zone would thus reach more than 88% of GDP, marking an increase of 20% of GDP on its pre-recession level (see table 2).

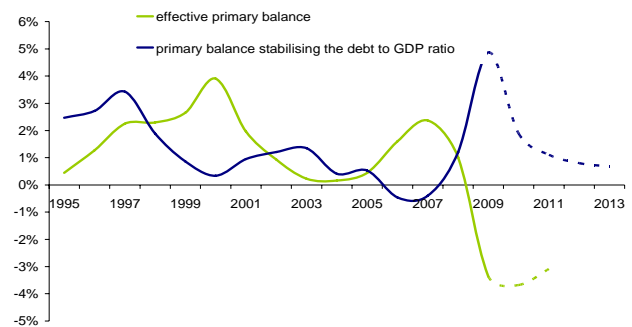
Indeed, growth next year will probably still be too weak to allow any significant tightening of fiscal policy, something that will probably come only in 2011, and then only gradually. This raises the question of the level to which budget deficits must be brought back, within a relatively short time-frame (a few years), to stop the current upward spiral in government debt.

One can show that the primary budget balance  $\tilde{sp}_t$  (excluding debt service costs) needed to stabilise the ratio of government debt in year  $t$  is approximately equal to the product of the debt/GDP ratio in year  $(t-1)$  and the gap between the apparent interest rate paid on government debt in  $t$  and the nominal GDP growth rate in the same year:  $\tilde{sp}_t \approx d_{t-1} \times (i_t - g_t)$ , where  $\tilde{sp}_t$  and  $d_{t-1}$  are expressed as a percentage of GDP. Intuitively one can assert that the primary budget surplus must be sufficient to finance that part of interest payments which is not covered by economic growth.

Figure 2 shows the level of primary surplus that would allow a stabilisation of the debt/GDP ratio in the euro zone, as well as the primary surplus observed in the past and currently forecast. This year, given the contraction of the economy, a primary surplus of around 5% of GDP would have been required to stabilise debt. However, this figure is likely to fall sharply next year, as we return to positive growth. According to our estimates a primary budget surplus of 0.75% of GDP will allow debt levels to be stabilised (see inset at the end of the focus). For the euro zone as a whole, this represents a gap of 3.7% of GDP compared to the primary surplus currently expected (without corrective action) by the

Commission. One can thus estimate that a structural adjustment in public finances of around 2.5% of GDP (difference between the required balance and structural primary balance expected in 2011) will be needed to prevent the debt ratio rising still higher. Once the output gap is closed, a return to growth could produce an improvement of around 1.2% of GDP in the primary surplus.

## 2. Stabilising and actual primary balances in the euro zone (% of GDP)



Sources: BNPP calculations based on European Commission figures (autumn 2009) and BNPP

## Considerable diversity between individual member states

This target seems to fit with the impression given by European institutions that they would welcome the implementation of a structural fiscal consolidation of around 1% of GDP per year from 2011 onwards<sup>2</sup>. However, it is important to take into account the different situations of the various member states.

Figure 3 shows the results of the same analysis for the majority of euro zone member states and shows that the structural fiscal effort required to stabilise debt ratios varies widely from one country to the next, even if one assumes that they all face similar economic prospects (represented by the gap between interest rates and nominal GDP growth rates)<sup>3</sup>.

It is not all that surprising to find Italy and Belgium alongside Germany and Austria in the group of countries where the smallest effort is required (less than 1.5% of GDP), precisely because they have long supported high debt ratios and had already introduced the necessary adjustments to a greater or lesser extent. These countries

<sup>2</sup> Assuming that such a consolidation is introduced from 2011 on, and that despite its scale it allows a relatively swift closing of the output gap, the debt ratio could stabilise, albeit at a level slightly higher than the level forecast (without corrective measures) for 2011.

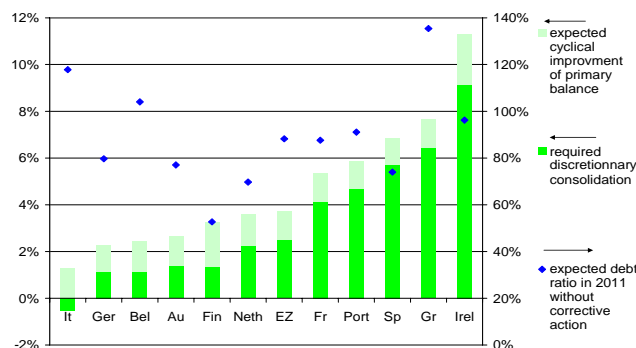
<sup>3</sup> One can conclude that the countries facing the greatest difficulties in their public finances will pay interest rates above the euro zone average or that they will see lower growth or inflation rates than their peers, with the result that the disparities shown in these forecasts will be increased.

were in a phase of debt reduction and were generating significant primary surpluses before the recession (around 2.5% of GDP in 2008 and 3.5% of GDP in 2007 for each of them). Indeed Belgium had generated such surpluses for a number of years. In addition, the absence of any substantial stimulus measures in Italy meant that the deterioration in its primary balance was amongst the smallest in the euro zone (-4% of GDP relative to 2007, against a euro zone average of -5.7%).

As far as Germany and Austria are concerned, it is important to understand why these countries, which have introduced some of the biggest stimulus packages in the euro zone (as a percentage of GDP for Austria)<sup>4</sup>, including a substantial proportion of long-lasting measures, can be in such a favourable position. Their recessions are in line with the euro zone average in the case of Austria, and worse in the case of Germany (we expect GDP to contract by 3.4% and 4.7% respectively, compared to an average of 3.8% for the euro zone). In the first instance, it should be noted that both countries enjoyed relatively sound public finances prior to the recession, with a total deficit of just 0.5% of GDP in 2008 in Austria and a balanced budget in Germany. Secondly, their heavy dependence on international trade leads to more severe recessions than in other, less open economies (notably France). However, a fall in international demand has less impact on fiscal receipts than a fall in domestic demand. The final effect is that the public finances of Italy, Belgium, Germany and Austria (and indeed Finland) will be considerably less affected than those of other euro zone countries by 2011, with budget deficits, increases in debt and debt/GDP ratios all lower than the euro zone average.

The condition of public finances in Portugal and France look fairly alike<sup>5</sup>. Between 2007 and 2011, both countries will see a worsening of public finances both in terms of a widening deficit and an increase in the debt/GDP ratio that will be close to the euro zone average (5.9% and 22.3% of GDP respectively). However, our estimates suggest that these countries will need to put into place measures to produce a structural improvement in the primary surplus of more than 4% of GDP. To a great extent, both countries are suffering from the fact that they went into the recession with their public finances in a much worse state than in other countries (with an overall government deficit of 2.7% of GDP in 2007, against an average of 0.6% in the euro zone).

### 3. Fiscal consolidation required to stabilise debt levels in selected member states



Sources: BNPP estimates based on European Commission figures (autumn 2009)

### 2. Fiscal positions expected in selected member states in 2011

% of GDP	Debt	Fiscal balance	Primary balance	Structural primary balance
Austria	77.0	-5.3	-2.1	-0.8
Belgium	104.0	-5.9	-1.7	-0.4
Finland	52.7	-4.4	-2.9	-0.9
France	87.6	-7.7	-4.7	-3.5
Germany	79.7	-4.6	-1.7	-0.6
Greece	135.4	-12.9	-6.7	-5.5
Ireland	96.2	-14.6	-10.6	-8.5
Italy	117.8	-5.1	0.1	1.3
Netherlands	69.7	-5.6	-3.1	-1.8
Portugal	91.1	-8.7	-5.2	-4.1
Spain	74.0	-9.3	-6.3	-5.2
<b>Euro Zone</b>	<b>88.2</b>	<b>-6.5</b>	<b>-3.1</b>	<b>-1.9</b>

Source : European Commission (autumn 2009)

The biggest fiscal consolidations will need to come in Greece, Ireland and, to a lesser extent, Spain. Two of these have been hit harder than other euro members by a collapse in their domestic real estate markets. The bursting of the property bubble has done significant damage to fiscal receipts, unemployment has climbed steeply and growth prospects for the next few years remain very weak. The situation in Spain appears much less difficult than that in Greece and Ireland, however, not only from the point of view of the structural adjustment required (less than 6% of GDP in Spain on our estimates, compared to 9% in Ireland) but also in terms of the debt/GDP ratio (74% forecast in Spain in 2011, which will remain one of the lowest levels in the euro zone, against 135% in Greece in the absence of any corrective measures).

<sup>4</sup> See for example, *EcoWeek 09-22, "Eurozone: Fiscal policies, the state of play"*

<sup>5</sup> For more details on the Greek and Portuguese economies see *EcoWeek 09-39, "Greece and Portugal: no post-election state of grace"*. However it should be noted that this article was written before the recent sharp correction to estimates of growth (2% from 2.9%) and the government deficit (7.7% of GDP from 5.5%) in Greece in 2008.

### Inset: Details of estimates of the fiscal consolidation required to stabilise government debt levels from 2011

The table below sets out the estimated levels of the primary surplus that will stabilise debt in the euro zone at its 2011 level under different assumptions for growth, inflation and interest rates. Given the scale of the adjustments involved, we have assumed that a surplus of close to, but possibly just below 1% of GDP will be enough to hold the euro zone public debt below 90% of GDP. These calculations serve to provide the data plotted in Figure 2 for the years after 2011.

Euro Zone	Real GDP growth	Inflation	Implicit nominal interest rate on public debt	Gap between interest rate and nominal growth	Debt to GDP ratio in previous year	Required primary balance to stabilize debt ratio
EC forecast for the year 2011	1.5%	1.4%	4.2%	1.3%	85%	1.1%
Selected assumption sets for the following years						
Euro zone 1	2.0%	2.0%	4.50%	0.5%	88%	0.4%
Euro zone 2	1.75%	2.0%	4.50%	0.75%	88%	0.7%
Euro zone 3	1.5%	1.75%	4.25%	1.0%	88%	0.9%
Euro zone 4	1.25%	1.75%	4.25%	1.25%	88%	1.1%

As far as the data shown in Figure 3 are concerned, the primary surpluses needed to stabilise debt in the various member states are calculated under Hypothesis 2, *applied identically for each member state*. Despite the different level of debt in the various members (from 52.7% of GDP forecast for Finland in 2011 to 135.4% in Greece), the level of primary surpluses required varies little, ranging from 0.4% of GDP in Finland to 1% in Greece. The difference between this required rate and the expected primary surplus in 2011 is used to calculate the fiscal adjustment needed to stabilise debt at a level close to that forecast by the Commission for 2011. Lastly, the Commission's estimates of the structural primary deficit allow a distinction to be drawn between the improvement that would come automatically from a return to economic growth and that which will have to come through the use of discretionary measures.

## Focus 2

# Japan: Hatoyama government faces major challenges

§ The major objective of the Hatoyama government is to transform the economy into one where growth is generated by domestic spending rather than by exports.

§ The government has announced to undo some of the labour and product market reforms such as the privatisation of the Post Office.

§ A major problem for the new government is the rapidly rising public debt. Without any additional measures, the financing of the election promises is likely to widen the budget deficit further.

§ To keep investing in JGBs attractive, a medium-term plan for fiscal consolidation will be required.

## A new government

On 30 August, the Democratic Party of Japan (DPJ) obtained a landslide victory in the general election, making an end to more than five decades of almost uninterrupted rule by the Liberal Democratic Party (LDP) (table 2). The following month, a policy agreement was concluded between the DPJ and its tiny coalition allies, the centre-right People's New Party and the leftwing Social Democratic Party.

The new government, which spans a wide ideological range, is led by DPJ President, Yukio Hatoyama. Many of the ministers are well experienced, having started their careers at the LDP. For example, the Finance Minister Hirohisa Fujii was elected to the upper house of parliament (Diet) as a member of the LPD party. He served already as Minister of Finance from 1993-94, as member of the Japan Renewal Party, a predecessor of the DPJ. Another well-known politician is Shizuka Kamei. He left the LDP in 2005 over the postal reform plans of the Koizumi government. He is in charge of financial services and postal issues. Not surprisingly, one of the first acts was the reversal of the privatisation of the post office (see below).

## The programme of the new coalition

The major objective of the new government is to transform the economy into one where growth is generated by domestic spending rather than by export demand. Mr. Hatoyama's election pledges included higher benefits for child-raising families, scrapping highway tolls, and lower petrol taxes.

With respect to social security, the government will abolish the existing cap on spending increases, set at JPY 220 billion. In addition, it will put the public pension system on a firmer footing, and introduce a minimal pension that will prevent poverty among the

elderly. The government intends to increase public spending on health care. The health insurance scheme for people aged 75 and over will be abolished.

Table 1: Economic Forecasts

% y/y	2008	2009 <sup>(1)</sup>	2010 <sup>(1)</sup>
GDP	-0.7	-5.6	1.2
Industrial Production	-3.4	-22.0	12.5
Employment	-0.4	-2.0	-1.5
Unemployment Rate (%)	4.0	5.4	6.3
Consumer Prices	1.4	-1.3	-1.4
Current Account (% of GDP)	3.2	2.5	2.2
General Government Budget (JPY trn) <sup>1</sup>	-33.2	-43.3	-50.9
(% of GDP) <sup>1</sup>	-6.7	-9.0	-10.8
O/N call Rate (%) <sup>2</sup>	0.1	0.1	0.1
3-month Rate (%) <sup>2</sup>	0.7	0.5	0.4
10-year Benchmark (%) <sup>2</sup>	1.2	1.3	1.6
USD/JPY <sup>2</sup>	91	85	101
EUR/JPY <sup>2</sup>	127	131	141

(1) FY, central government (2) end of year

Source: BNP Paribas, Economic Market Monitor, October 2009

Table 2: 2009 General election

	Seats	Gains
Democratic Party of Japan (DPJ)	308	195
Social Democratic Party (SDP)	7	0
People's New Party (PNP)	3	-1
Other	2	0
DPJ-SDP-PNP coalition	320	194
Liberal Democratic Party (LDP)	119	-177
New Komeito Party	21	-10
Japanese Communist Party	9	0
Other	11	-7
Total	480	

The government will also undo some of the labour and product market reform. In the past couple of years, to circumvent the strict employment protection legislation for full-time workers, the share of non-regular workers, of which two-thirds part-time workers, has rapidly increased. These part-time workers earn, on average, only 40% as much on an hourly basis as full-time workers. This part of the labour force has been especially affected by the deterioration of the labour market. The new government has announced a comprehensive revision of the legislation covering these non-regular work contracts.

The privatisation of the post office was one of the hallmarks of the reform policies of the Koizumi government (2001-2006). During his period the post office was split in four parts. The Japan Post Service, for the traditional postal services, the Japan Post Network, to manage the local network, the Japan Post Bank and the Japan Post Insurance. It was the intention that the two latter companies would be listed on the stock market by early 2010 and completely privatised by 2017. The holding company (Japan Post) would also be listed, but the government would hold at least a third of its shares.

Supporters of the privatisation argue that the privatisation of the post office would increase efficiency by improving resource allocation. As the Post Bank concentrates its investment in government bonds, its investment yield in 2006 was only 1.2%. In addition, it would help to develop private financial institutions. Finally it would provide better service at a lower cost. The opponents of privatisation fear that the focus on efficiency would lead to reduced services, in particular in rural areas.

Mr Kamei, who left the Koizumi government because of the postal reforms, has been reversing the process. On 20 October, he decided that Japan Post Holding will reintegrate its postal, financial and insurance services. In addition, the new reintegrated entity will be required to provide the same financial services nationwide, at every branch, regardless of demand.

As minister of financial services, Mr Kamei has also proposed a three-year moratorium on loan repayments by small businesses. However, his deputy at the Financial Services Agency, Mr Otsuka has announced that the moratorium would be voluntary on the part of lenders.

Measures to prevent global warming have a prominent place in the coalition programme. Even before becoming prime-minister, Mr. Hatoyama had announced that he wanted to cut carbon-dioxide and other greenhouse-gas emissions by 25% from 1990 levels by 2020. This plan is very ambitious, as CO<sub>2</sub> emissions are currently more than 8% above the 1990 level. A pre-condition is that the US, India and China also make some commitment to reduce CO<sub>2</sub> emissions.

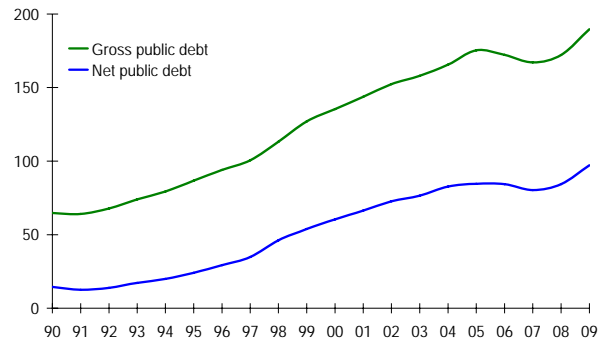
The government has already announced to create 100 000 new jobs in sectors with strong domestic demand such as health care, education, agriculture, forestry and tourism by end March, the end of the fiscal year. However, the authorities have remained rather vague on how these jobs would be created. Given the short period of time, these jobs are likely to be created mainly in the public sector.

### Deficit funding could become more difficult

A major problem for the new government is the rapidly rising public debt. In 1991, gross debt stood only at 61% of GDP. However, as a result of the very accommodative policies pursued under previous governments, the gross debt ratio had increased to close to 200% by end 2008 (chart 1). During the latest economic crisis, the government has further loosened the purse strings. In FY 2009, the

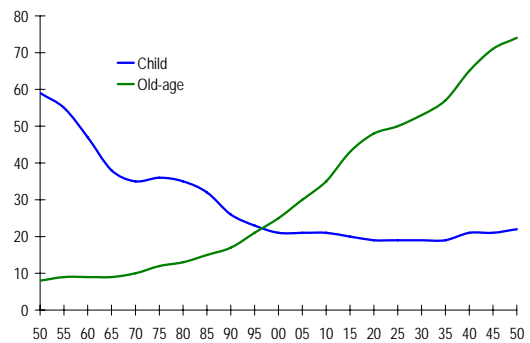
state deficit could reach 9% of GDP, compared with 6.7% in FY2008 (table 1).

**Chart 1: Public sector debt (as % of GDP)**



Source: OECD

**Chart 2: Dependency rates<sup>1</sup>**



Source: United Nations

(1) The dependency ratio is defined as the number of young people (under 15 years of age) or older people (over 64 years of age) as percentage of the people of working age (15 to 64 years).

Without any corrective action, the financing of the election promises is likely to widen the budget deficit further. In particular, the financing of the health care and pension promises against the backdrop of a rapidly ageing population will be costly (chart 2).

Finance minister Fujii has suggested that the consumption sales tax might be raised from its current 5% to finance the ballooning social security costs. However, the coalition programme has ruled this out explicitly during this term of office (four years).

The government hopes to finance its promises partly by curtailing other spending. To find savings, it has already been combing through the supplementary budget of the previous government to find wasteful spending. This has resulted in JPY2.93 trillion (or EUR 22 billion) of savings. Among the scrapped projects is the Centre of National Popular Art, also known as the Manga Museum. But this is unlikely to be sufficient.

By mid October, nearly all ministries have turned in their requests for FY2010. The implementation of the government plans – including the child-care handouts – would require an extra JPY 7 trillion. It is unclear if these extra resources can be found by simply weeding waste. It is likely that the government will have to borrow more in the market.

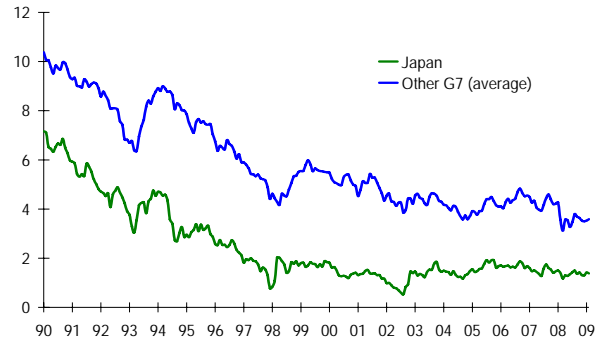
For the moment, the financing of the debt has not resulted in upward pressure on interest rates. On the contrary, long-term interest rates have come down sharply. End October 2009, the benchmark rate for 10-year JGB stood at 1.4% (chart 3). As a result, despite the rising debt, net interest payments have remained remarkably low (at around only 1% of GDP).

This development can be attributed to several factors. First, national savings are high and have a significant home bias. Before 2000, this was mainly due to household savings. However, the household savings ratio has fallen substantially to around 3%. After 2000, this has been offset by increased corporate savings, as firms were deleveraging.

The second reason is that the about 50% of government bonds is held by public sector institutions such as central bank, the Japan Post Bank and the Japan Post Insurance (table 3). The rest of the bonds are relatively concentrated in the financial institutions. The risk-free weighing of government bonds and their safety during deflationary periods. The financial crisis, accompanies with flight for safer assets has put further downward pressure on JGB rates (and that of other government bonds).

However, these favourable conditions are unlikely to last. The ageing of the population may reduce the amount of savings in the economy. Moreover, institutional investors might change their behaviour by looking for higher investment returns. To keep investing in JGBs attractive, a medium-term plan for fiscal consolidation will be required. For the moment, the growing debt problem does not seem to top the government's agenda.

**Chart 3: 10-year government bond yields**



Source: Reuters

**Table 3: Share of JGB holdings (%)**

	Dec 06	Dec 07	Dec 08
Government	14.3	13.8	13.1
of which:			
Public Pension	9.8	11.1	11.7
Central Bank	11.2	9.5	8.3
Financial Institutions	62.2	62.0	64.1
of which:			
Postal Savings	20.3	-	-
Banks <sup>1</sup>	16.3	35.0	36.1
Overseas	5.5	7.0	6.8
Households	4.8	5.3	5.2
Others <sup>2</sup>	2.0	2.3	2.4
Total (in trillion JPY)	391.2	682.4	699.6

(1) Includes Japan Post Bank for Dec 07 and Dec 08

(2) Non-financial corporations and private non-profit institutions serving households

Source: IMF

## Recently released and forthcoming data and surveys

### United States

#### To watch from 16 to 20 November

**Retail sales** fell sharply in September (-1.5% m/m), in response to the ending of the scrappage scheme at the end of August. Consumer spending is likely to have recovered strongly in **October** (1.3% m/m expected, figure published 16 November) due to two main factors: (a) an improvement in automobile sales (unit sales jumped 13.6% m/m); (b) higher spending on petrol (reflecting higher seasonally-adjusted prices). "Underlying" retail sales are likely to remain more or less unchanged, having risen fairly strongly over the last two months. Current conditions do not look sufficiently positive to allow regular growth in non-auto retail sales, as illustrated by the weakening of consumer confidence. Job losses continue to run at a high level, wage growth is slowing and the consequences of the financial crisis are still being felt (negative wealth effect, tighter credit).

**Industrial production** rose strongly for the third month running in September, gaining 0.7% m/m. This improvement is likely to continue in **October** (0.5% m/m expected, figure published 17 November), despite a drop in the number of hours worked in the manufacturing sector. On the one hand, automobile production, which all but ground to a halt over the summer, is continuing to rise. This sector has had a driving role in the good recent performances of the industrial sector. More generally, surveys of the manufacturing sector indicate a fairly sharp rise in production. The national PMI index was 55.7 in October (well above the level of 50 which indicates stable business levels), driven in particular by a leap in the "production" component (from 55.7 to 63.3). The capacity utilisation rate is likely to be around 71% (from 70.5% in September).

**Consumer prices** rose slightly in September (0.2% m/m). A similar increase is expected in **October** (+0.2% m/m, figure due on 18 November), as the result of a limited increase in underlying prices (+0.1%, against a background of lower pricing power for companies and decelerating wage growth) and a sharper rise in energy prices (on seasonally adjusted figures). The disappearance of basis effects from energy prices (which fell rapidly in the second half of 2008) will continue to drive an increase in the inflation rate, from -1.3% to -0.2% from one month to the next (prior to a return to positive inflation next month).

#### From 6 to 13 November

Labour report (non farm sector)				EcoFlash	
		August	Sept.	October	09-450
Employment	m/m, 000	-154	-219	-190	
Manufacturing sector		-55	-45	-61	
Private services		-36	-65	-61	
Unemployment rate	%	9.7	9.8	10.2	
Hourly wages	y/y, %	2.6	2.5	2.4	
Hours worked per week		33.1	33.0	33.0	

Source : Department of Labor - Bureau of Labor Statistics

Trade balance				EcoFlash
USD bn, sa	July	August	Sept.	
Goods and services	-31.9	-30.8	-36.5	
Goods	-42.8	-42.0	-47.6	
Services	10.9	11.2	11.1	

Source: Department of Commerce

Consumer sentiment - University of Michigan				EcoFlash
Indices 1996=100, nsa	Sept.	October	Nov.	
Consumer sentiment	73.5	70.6	66.0	
Current conditions	73.4	73.7	69.6	
Expectations	73.5	68.6	63.7	

Source : University of Michigan

## Eurozone

### To watch from 16 to 20 November

In **October**, consumer prices continued to decline with respect to the previous year, albeit at slower pace with respect to the previous month. According to Eurostat's flash estimate, the **inflation** rate came in at -0.1% from -0.3% recorded in September, remaining in negative territory for the fourth month running. The **final reading** for October (to be released on **16 November**) should confirm the flash estimate. The inflation breakdown should report that energy prices have continued to decline over the year, albeit at a slower pace than in the previous months. This was also due to the recent increase in oil prices which have risen by almost EUR 3 between September and October. Food prices should also have declined. Lastly, core inflation is likely to have remained unchanged at 1.2% or to have slightly moderated. Going forwards, base effects, which have pushed significantly down inflation throughout the summer (with a through of -0.7% in July), begin to have an opposite effects and will push inflation higher during the last months of the year. Moreover, the projected increase in oil prices should also contribute to increase inflation.

### From 6 to 13 November

Eurozone – Gross Domestic Product				EcoFlash
Changes in %q/q, sa, wda	Q1 09	Q2 09	Q3 09*	09-459
q/q	-2.5	-0.2	0.4	
y/y	-4.9	-4.8	-4.1	

Source: Eurostat - \* flash estimate

Eurozone - Industrial Production				EcoFlash
Changes in %	July	August	September	09-456
Total industry *	m/m, sa	0.3	1.2	0.3
	y/y, wda	-15.9	-15.1	-12.9
Germany	y/y, wda	-18.1	-17.8	-13.9
France	y/y, wda	-12.8	-10.2	-9.8
Italy	y/y, wda	-17.9	-18.6	-15.7
Spain	y/y, wda	-17.6	-12.7	-12.5

Source: Eurostat (\*): Ex. construction

Germany – Gross Domestic Product				EcoFlash
Changes in %	Q1 09	Q2 09	Q3 09*	09-457
q/q, swda	-3.5	0.4	0.7	
q/q saar	-13.4	1.8	3.0	
y/y, non-adj.	-6.4	-7.0	-4.8	

Source: Statistisches Bundesamt -- \* flash estimate

Germany – Industrial production				EcoFlash
Changes in %, sa	July	August	September	09-451
Total,	m/m	-1.0	1.8	2.7
	y/y	-16.8	-17.1	-12.8
Manufacturing,	m/m	-1.0	2.1	3.2
	y/y	-19.0	-19.2	-14.3

Source: Bundesbank

Germany- Manufacturing orders				EcoFlash
Changes in %	July	August	September	09-449
Total,	m/m	3.1	2.1	0.9
	y/y	-20.3	-20.6	-13.0
Domestic orders,	m/m	9.5	-0.8	-2.3
	y/y	-14.0	-16.7	-14.0
Foreing orders,	m/m	-2.4	5.0	3.7
	y/y	-25.5	-23.7	-12.1

Source: Bundesbank -- monthly changes are seas. adj.

Germany – Trade balance				EcoFlash
Bn EUR, sa	July	August	September	
Trade balance	12.7	10.6	9.9	
Exports	67.7	65.8	68.3	
Imports	55.0	55.2	58.4	

Source: Statistisches Bundesamt

Germany - ZEW survey				EcoFlash
Index sa	September	October	November	09-454
Anticipations	57.7	56.0	51.1	
Current conditions	-74.0	-72.2	-65.6	

Source: ZEW

France – Gross Domestic Product				EcoFlash
<i>Changes in %, SA-WDA</i>	Q1 09	Q2 09	Q3 09	09-458
q/q	-1,4	0,3	0,3	
y/y	-3,5	-2,9	-2,4	
Private consumption	0,1	0,3	0,0	
Public consumption	0,0	0,5	0,7	
Overall investment	-2,6	-1,1	-1,3	
<i>Non residential</i>	-3,4	-1,0	-0,7	
<i>Residential</i>	-2,2	-2,2	-2,9	
Exports	-7,4	0,6	2,3	
Imports	-6,0	-2,6	0,4	
<i>Contributions (% points)</i>				
Dom. demand exc. stocks	-0,5	0,1	-0,1	
Δ inventories	-0,8	-0,6	-0,1	
Net exports	-0,2	1,0	0,5	

Source: INSEE

France - Industrial production				EcoFlash
<i>Changes in %, SA-WDA</i>	July	August	September	09-453
Overall industry * m/m	0,7	2,8	-1,5	
y/y	-12,7	-10,0	-10,4	
Manufacturing sector m/m	0,7	3,0	-1,6	
y/y	-13,4	-10,7	-11,0	

Source: INSEE -- \* excluding construction

France – Consumer price index				EcoFlash
<i>Changes in % - NSA exc.*</i>	August	September	October	
National Index (CPI) y/y	-0,2	-0,4	-0,2	
m/m	0,5	-0,2	0,1	
Core index * y/y	2,3	2,0	1,8	
m/m	0,4	-0,2	0,1	
HICP y/y	-0,2	-0,4	-0,2	
m/m	0,6	-0,2	0,1	

Source: INSEE - HICP: harmonised index of consumer prices

France – Trade balance				EcoFlash
<i>EUR bn, SA</i>	July	August	September	
Trade balance	-0,7	-2,2	-1,8	
Exports	30,5	28,5	29,1	
Imports	31,3	30,6	30,9	

Source: Customs -- data FOB-FOB

Italy – Gross Domestic Product				EcoFlash
<i>Changes in %q/q, sa, wda</i>	Q1 09	Q2 09	Q3 09*	
q/q	-2,7	-0,5	0,6	
y/y	-6,0	-5,9	-4,6	

Source: Istat - \* flash estimate

Italy - Industrial Production					EcoFlash
<i>Changes in %</i>	July	August	September		09-452
Total industry * m/m, sa	1,9	5,8	-5,3		
y/y, wda	-17,9	-18,6	-15,7		

Source : ISTAT (\*): Ex. construction

Spain – Gross Domestic Product				EcoFlash
<i>Changes in %</i>	Q1 09	Q2 09	Q3 09	09-455
q/q, swda	-1,6	-1,1	-0,3	
y/y	-3,2	-4,2	-4,0	

Source : INE -- \* flash estimate

## United Kingdom

### To watch from 9 to 13 November

In September, **consumer price inflation** surprised on the downside, down from 1.6% in August to 1.1%, its lowest level since September 2004. Core inflation – CPI excluding energy, food, alcoholic beverages and tobacco – was also down, but less markedly, from 1.8% in August, to 1.7%. It should bounce back again in **October** (data to be released on Tuesday 16 November), in line with rising energy prices. In the short run, rising oil prices, the past depreciation of the sterling as well as the hike in the VAT rate due in January, should push inflation above Bank of England 2% target.

According to the **CBI Monthly industrial trend**, the output prospects index bounced back above zero in October for the first time since June 2008, thanks to a substantial destocking that has taken place in recent months. In **November** (data to be released on Wednesday 18 November), this improvement should go on.

In September, volume of **retail sales** was unchanged on the previous month. In **October** (data released on Thursday 19 November), they should have bounced back markedly, in line with the improvement in surveys. According to the CIPS services, the business activity index reached 56.9 in October, the highest level for 26 months and the sixth straight month that the index was above the 50 no-change mark. In the longer run, the sustainability of this upward trend mainly depends on how much household desired savings would increase, given reductions in prospective income and higher taxes, in a context of uncertain employment prospects and falls in financial wealth.

### From 30 October to 6 November

Job market		Ecoflash		
		August	September	October
Claimant count rate		4.9	5.0	5.1
Average earnings *	y/y	1.9	1.8	n.a.
- Private sector		1.5	1.5	n.a.
- Public sector		3.2	2.8	n.a.
- Manufacturing		1.1	1.4	n.a.
Unit Wage costs	y/y	4.8	2.5	n.a.

source: ONS, \* : excluding bonuses, 3-month moving average

## Japan

### To watch from 9 to 13 November

On Monday, 16 November, the Cabinet Office will publish its preliminary estimate for **GDP growth in Q3**. We estimate the economy to have expanded by a strong 0.7%, after 0.6% in the preceding quarter. The economic recovery is mainly driven by the manufacturing sector, which had suffered most during the downturn. The main remaining question is to what extent the upturn is spreading to the rest of the economy. Part of the answer will be provided on Tuesday, at the release of the **tertiary index** for **September**. We expect the index to have gained 0.4%, only slightly more than in the previous month. The improved economic climate prompted the Bank of Japan last month to terminate some of the temporary measures by the end of the year. At that occasion, it also decided on the future of the other supplementary measures (see EcoFlash 09-433). On Thursday, the **Monetary Policy Board** will start its two-day meeting. No important announcements are expected at the end of the meeting.

### From 6 to 13 November

Machinery orders				EcoFlash
Changes in %, m/m, s.a.	July	August	September	
Private orders	-1.5	9.2	-1.4	
Manufacturing	-20.4	4.9	-0.1	
Non manufacturing	-2.8	-0.6	18.0	
Core private orders*	-9.3	0.5	10.5	

Source: ESRI - (\*) Excluding ship building and utilities

## Data Focus 1

### Eurozone, Germany and France: GDP growth (Q3 2009)

Š Eurozone GDP expanded by 0.4% q/q after falling consecutively in the previous 5 quarter. Despite Q3 gain, eurozone GDP is still 4.1% below its Q3 2008 level, signalling that there is still a long road to recovery.

Š Available survey data signal that activity should continue to expand in Q4 at a relatively solid rate. However, risks remain regarding the strength of the recovery in the medium term. The recovery might fade next year once the effects of the one-off measures, will not be felt any longer.

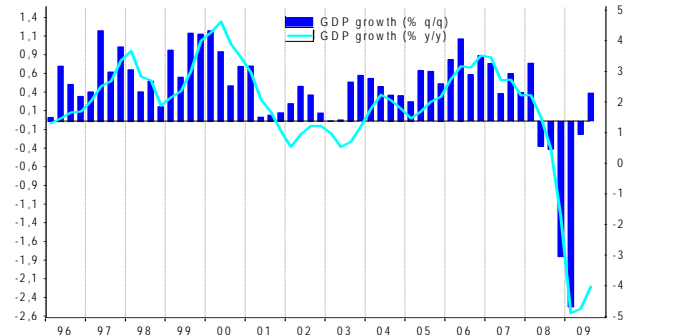
Š According to a preliminary estimate, German GDP increased by 0.7% q/q in Germany in Q3 2009 (+0.4% in Q2 2009). The pace of decrease in GDP eased but activity is still down by 4.8% y/y.

Š The evolution of GDP components is not yet available but according to the Federal statistical office, exports as well as capital formation in machinery and equipment and in construction sustained activity. Imports increased also and led to a build-up in inventories. Nevertheless final consumption expenditure of households had a negative impact on growth.

Š The recovery in French GDP went on during the summer. However, GDP growth did not gain momentum compared with spring: According to the preliminary estimate published by INSEE, GDP increased by 0.3% q/q in the third quarter of 2009, the same rate that was recorded in Q2.

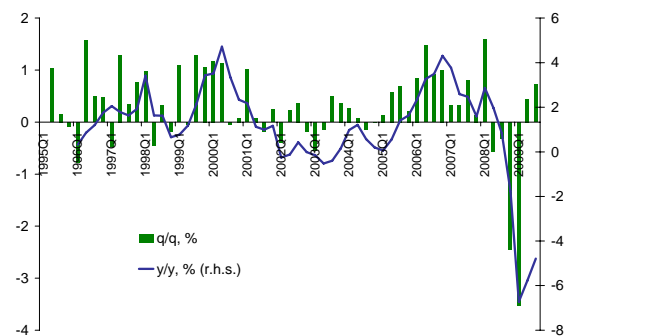
Š Growth was mainly sustained by a sharp rebound in exports. The negative quarterly contribution of changes in inventories moderated substantially in Q3 (-0.1 pp). Household consumption remained stable in Q3 and the fall in total investment was roughly the same as in the previous quarter. The outlook for domestic demand remains weak and this is likely the element that will limit the ability of economic growth to accelerate in the coming quarters.

Eurozone: GDP



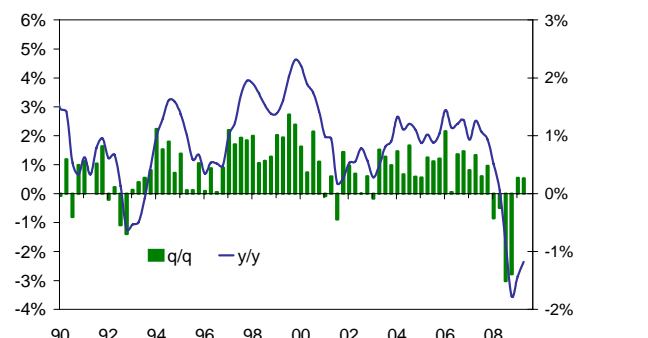
Source : Eurostat

Germany: GDP



Source : Statistisches Bundesamt

France: GDP



Source : INSEE

## Data Focus 2

### France: Inflation (October)

Inflation resumed an upward trend in October, but remained negative (-0.2%)

Š After a pause in September, the rising trend in inflation started in August resumed in October. The inflation rate was -0.2% in October, after -0.4% in September. The monthly increase in consumer prices was 0.1%, both with unadjusted and seasonally adjusted data.

Š By contrast, core inflation rate went on decreasing. The core (seasonally adjusted) price index rose by a meagre 0.1% m/m in October. Core inflation thus declined to 1.8%.

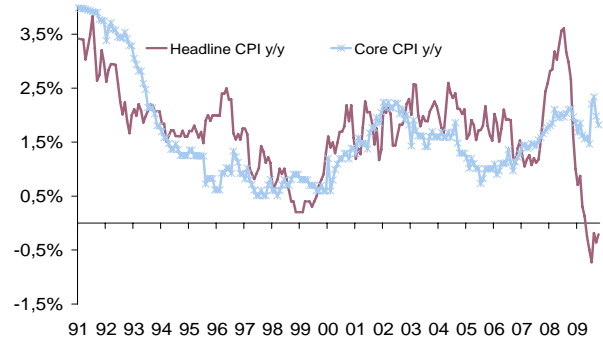
Š Food prices (+0.4% m/m, -0.4% y/y) were pushed higher by a surge in fresh food prices (+4.0% m/m). But, globally, pressures on prices remained weak. Manufacturing prices were down 0.2% m/m in October. Over a year, their decline also reached 0.2%.

Š Prices for services increased by 0.2% m/m due to seasonal tariff and price increases. The inflation rate for services has fallen to 1.9% in October, a lowest since 2001.

Š Energy prices declined by 0.2%, after -0.7% in September. However, due to strong base effects, the inflation rate of energy products recovered substantially, from -14.3% in September to -11.2% in October. This is going to continue and energy prices should contribute positively to the inflation rate in the beginning of 2010 at the latest.

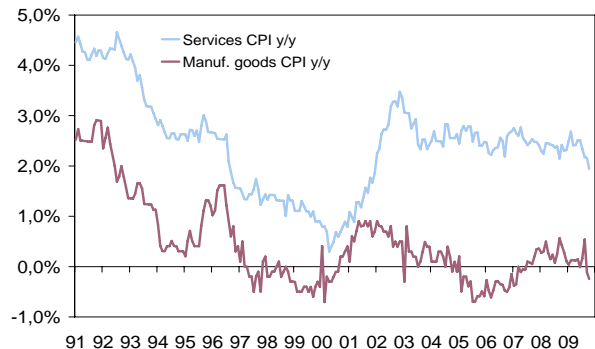
Š Core and headline inflation rates should remain on opposite trends in the coming months. Headline inflation should be back in positive territory before the end of the year while the weakness in domestic demand should further weigh on core inflation in the coming quarters.

Core and headline inflation



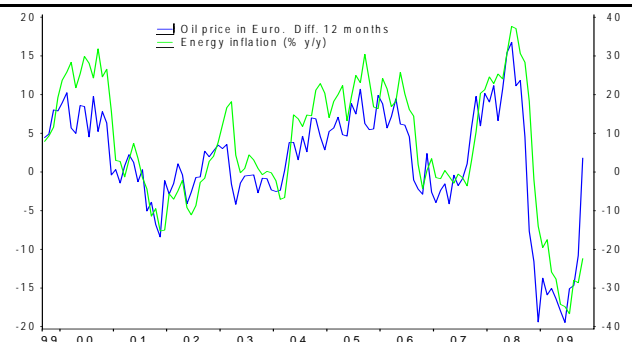
Source : INSEE

Services and manufacturing prices



Source : INSEE

Oil and energy prices



Source:INSEE & Ecwin

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			Overview	No grounds for premature optimism
	17 July	09-27	Overview	Hesitations
	3 July	09-26	Overview	France : The recession leaves its traces on household and non-financial firm accounts in Q1 2009
			Focus 1	United Kingdom : Economic Accounts for Q1 2009
			Focus 2	

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