ABN·AMRO Asset Management

MACROECONOMIC OUTLOOK

February/March 2008

All articles are written by (senior) economists of ABN AMRO Bank NV

In tables:

C = consumption
I = investment
G = government consumption
X = export
M = import

UNITED STATES

By Ruben van Leeuwen, Economist

BUSINESS AND CREDIT CYCLES ARE TURNING SIMULTANEOUSLY

	---- GDP -----		C	I	G	X	M	CPI (end of period)	
	yoy	qoq	---------------------- qoq			----------------------		qoq	yoy
2007 (oya)	**2.2**		**2.9**	**-2.8**	**2.1**	**7.9**	**2.0**	**(avg)**	**2.9**
Q1 08	2.1	-0.2	-0.4	-2.2	0.4	0.8	-1.0	0.5	3.7
Q2 08	1.1	-0.1	-0.4	-2.2	0.7	0.8	-1.5	0.3	3.0
Q3 08	0.0	0.1	-0.2	-1.9	0.8	0.6	-1.0	0.2	2.5
Q4 08	0.1	0.3	0.1	-0.2	0.6	0.6	0.0	0.6	1.6
2008 (oya)	**0.8**		**0.0**	**-5.1**	**2.7**	**5.4**	**-2.2**	**(avg)**	**3.0**
Q1 09	0.8	0.5	0.3	1.4	0.5	1.0	1.0	0.6	1.7
Q2 09	1.5	0.6	0.5	1.6	0.5	1.4	1.6	0.9	2.3
Q3 09	2.0	0.7	0.6	1.6	0.5	1.5	1.6	1.1	3.2
Q4 09	2.6	0.8	0.7	1.7	0.5	1.6	1.6	0.7	3.4
2009 (oya)	**1.7**		**1.0**	**2.3**	**2.3**	**4.2**	**2.6**	**(avg)**	**3.0**

Source: Thomson Financial, ABN AMRO Economics Department

Summary
Recent economic data has been in line with our forecast of a recession in the first half of 2008. The continued weakening of the housing market is spilling over into other parts of the economy. The credit crisis is spreading to other corners of the financial system and will have a negative impact on the real economy. We expect a recovery in the second half of 2008, but it is likely to be only very modest. We have thus lowered our growth forecasts for 2008. Inflation increased again in January. This is not a sign of economic strength; it is only more negative news for the real economy. The Federal Reserve is implementing a very active monetary policy. As the credit crisis appears to be far from over and the economy is likely to weaken further, we have reduced our forecast for the fed funds rate to 1.5% by the end of 2008.

Already in a recession?
The economy is moving in the direction of contraction. In Q4 2007, economic growth was only 0.6% qoq on an annualised basis. A recession, which we forecast back in November 2007, is now very close. It is even quite likely that the economy is already in a recession. It is impossible to be exact in this respect, because a recession is officially determined by the private economic think tank NBER. At the earliest, this “official” label is determined six months after a recession has started.

Several economic indicators are suggesting that a recession has already started. In particular, confidence readings, for both consumers and producers, are very low. The University of Michigan’s consumer confidence gauge is at levels similar to those seen in the early 90s—and is continuing to drop. Even though the Conference Board’s consumer confidence indicator is not so negative, the rapid deterioration of the consumer climate is also clearly visible in its numbers.

But the negative surprises in producer confidence have been even more striking in the last few weeks. The ISM non-manufacturing index fell like a rock in January, slumping from 54.4 in December to 41.9. This is by far the biggest drop in the history of this indicator, which started in 1997. On the one hand, it is surprising to see the non-manufacturing sector, which is not as sensitive to the business cycle as the manufacturing sector, performing so badly. On the other hand, it does confirm where the problems in the economy are concentrated. Together with consumers, the financial industry (which makes up a large part of the non-manufacturing sector), is in deep trouble.

The PMI reading for the manufacturing sector edged higher to 50.7 in January. The sub-indices of this survey indicated that production increased. It is not domestic demand that is picking up, however. Instead, the order books for customers from abroad are full. This is the positive element in today’s economic environment. External demand is benefiting from the weak dollar and is acting like a positive automatic stabiliser for the economy. This is also visible in the trade figures. Export growth is high, while the growth rate of imports appears to be decreasing. This is especially the case in real terms.

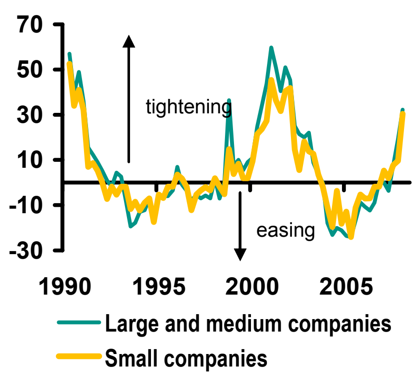
External sector: ray of hope
% yoy

Source: Thomson Financial

Despite record high oil prices, the trade deficit is gradually shrinking. This implies a positive growth contribution from the external sector. However, it will not be enough to keep the economy running.

The perfect storm for consumers has intensified in recent weeks. Inflation edged higher, the weakening of the labour market is gaining momentum and the woes in the housing market are certainly not over, while it is becoming increasingly difficult to secure credit from banks. The change in non-farm payrolls dropped into negative territory in January, with a 17,000 monthly fall. Employment growth (according to the labour market survey) was 0% on a monthly basis in January and was only 0.2% on a yoy basis. Unemployment increased sharply in December to 5.0%, but fell back to 4.9% in January. The employment components in producer surveys suggest that the labour market is unlikely to improve in the coming months. So do the weekly statistics on unemployment claims. We expect more negative payroll numbers ahead. Real consumption growth will probably be negative in the first half of 2008. As a first sign of this, it is likely that real consumption was negative in January. The nominal retail figures (+0.3% mom) surprised on the upside. But as CPI came in at 0.4% mom, the implied real expansion of consumption was negative.

Fed's Senior Loan Officer Survey
Diffusion index (0 = neutral)



Source: Thomson Financial

The data for durable goods orders, a measure of corporate investment, has been mixed in recent months. The readings in the last two months of 2007 were bad, but there was a significant rebound in January. It is not yet clear whether the increase was the result of higher demand from abroad or domestic demand for investment in fixed capital. We believe that the investment climate in 2008 will be negative. The ongoing—and expanding—credit crisis is affecting the provision of credit, even to corporations with relatively healthy balance sheets. This is visible in the Fed's Senior Loan Officers Survey, which indicated that lending standards to a broad range of borrowers have tightened substantially.

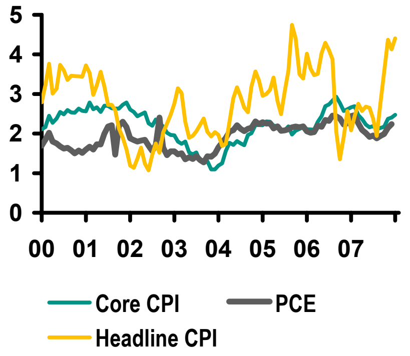
Investment in residential structures continued to be a big burden on economic growth in Q4 2007. This could change in 2008, but the outlook for other investment components, such as commercial property, is much more negative. Fiscal policy will provide an extra stimulus to the economy but it is unlikely to keep growth rates positive in the coming months.

Despite all this negative news, we do see some potential for a modest recovery in the second half of 2008. Nonetheless, we have lowered our growth forecasts. We expect the impact of the credit crisis to worsen, preventing a substantial comeback of the economy in 2008. The business cycle and the credit cycle are turning at the same moment. If these two negative forces mutually reinforce each other, there is a real risk that a more prolonged and deeper recession develops. Unfortunately, the probability of such a scenario is increasing by the day.

Higher inflation realised, lower inflation expected

Admittedly, inflation rates are higher than we had expected. In January, CPI accelerated to 4.4% yoy (0.4% mom). Elevated prices for energy and food are the main reasons for these high numbers. Even so, core inflation, which excludes these two items, increased to 2.5% yoy (0.3% mom). A detailed breakdown shows that services to consumers in particular became more expensive. This is not, however, a reflection of economic strength. It is only a further piece of negative news, because it limits real economic development even more. Moreover, it could hold the Fed back from lowering interest rates to break the vicious circle in the economy. The good news in this respect is that inflation expectations have not increased further. We still expect lower inflation in the coming months, although the high figures for actual inflation have led to a small increase in our inflation forecasts for 2008 and 2009. The poor economic climate will take some pricing power away from producers and retailers. Moreover, the labour market is cooling at a rapid pace, limiting nominal wage growth.

Inflation has not decreased
% yoy



Source: Thomson Financial

Active monetary policy will result in lower rates first

The FOMC is clearly well aware of the weakness of the recent macroeconomic data. But its members are uncertain about the possible impact on the real economy of the expanding credit crisis. Nevertheless, the Fed substantially lowered its growth forecasts at the most recent FOMC. The Fed is playing safe and has indicated that it will err on the side of caution with respect to growth. Better safe than sorry. Worries about inflation have been pushed into the background as far as monetary policymaking is concerned. The Fed aggressively reduced its target rate in January. In only eight days, the fed funds rate was lowered by 125 bps to 3%. This is highly unusual: but is it enough to prevent a painful downturn? Because spreads on consumer and corporate credit are increasing, the rate cuts are not being that effective. The substantial easing is providing some comfort, in the sense that the central bank is willing and ready to try to counter the problems in credit markets and the real economy. But as the situation in both spheres deteriorates, more action is needed. This has already been hinted at by several policymakers, including Fed chairman Ben Bernanke. The minutes of the January FOMC meetings show that some policymakers felt that a prolonged period of lower interest rates was needed. There were also strong references to active monetary policy. The Fed is clearly conducting such a policy right now, but some policymakers have indicated that a reversal of the action will be needed as soon as the economy shows signs of recovery. In our view, this is unlikely in the first half of 2008. Although we acknowledge that active monetary policy should eventually lead to higher rates, it is hard to avoid the conclusion that implementing such a policy in a period of weakening in the real economy and in credit markets will lead first to lower rates. Indeed, we have cut our forecast for the fed funds: we now expect a policy rate of 1.5% by the end of this year.

EUROZONE

By Carsten Brzeski, senior economist

DÉJÀ VU ALL OVER AGAIN?

	---- GDP -----		C	I	G	X	M	CPI (end of period)	
	yoy	qoq	---------------------- qoq			---------------------		qoq	yoy
2007 (oya)	**2.7**		**1.5**	**4.8**	**2.0**	**6.1**	**5.5**	**(avg)**	**2.1**
Q1 08	1.7	0.2	0.3	0.3	0.3	0.9	1.1	0.3	3.1
Q2 08	1.6	0.3	0.3	0.2	0.4	0.9	1.0	0.8	2.7
Q3 08	1.3	0.4	0.3	0.3	0.5	1.1	1.0	-0.1	2.6
Q4 08	1.3	0.4	0.3	0.4	0.5	1.1	1.1	0.4	1.6
2008 (oya)	**1.5**		**1.5**	**1.6**	**1.6**	**4.6**	**5.1**	**(avg)**	**2.6**
Q1 09	1.5	0.4	0.3	0.4	0.4	1.2	1.1	0.7	1.7
Q2 09	1.7	0.4	0.3	0.4	0.5	1.2	1.1	0.8	1.8
Q3 09	1.7	0.5	0.3	0.5	0.5	1.2	1.1	0.1	1.9
Q4 09	1.8	0.5	0.3	0.5	0.5	1.2	1.1	0.7	2.2
2009 (oya)	**1.7**		**1.2**	**1.6**	**1.9**	**4.7**	**4.3**	**(avg)**	**1.9**

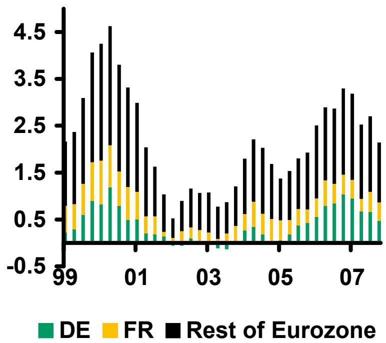
Source: Thomson Financial, ABN AMRO Economics Department

Summary
Despite a significant slowdown in the fourth quarter, GDP growth in 2007 averaged 2.7%. Nonetheless, the eurozone economy looks set to stay at below-potential growth rates for some time, driven by the sharp US slowdown, a weakening UK economy and the ongoing turmoil in financial markets. Increased spreads and further rises in oil prices and the euro exchange rate pose further downside risks to economic growth. A recession, however, seems unlikely, as the eurozone's starting position was considerably better than the US. We expect the eurozone economy to slow down significantly to 1.5% in 2008 and gradually rebound to 1.7% in 2009.

At 3.2%, headline inflation remains at a record high. Given the current level of oil prices, headline inflation can be expected to stay at elevated levels in the coming months, but should sharply drop towards the end of 2008. In the absence of second-round effects and given well-anchored inflation expectations, we expect the ECB to cut interest rates three times in the course of 2008 by a total of 75 bps.

Slowdown is real
Recent data has provided further evidence that the eurozone is slowing to below-potential growth rates, though a soft landing is still more likely than a severe slowdown. According to a Eurostat flash estimate, GDP growth in the fourth quarter of 2007 was 0.4% qoq (2.3% yoy), half the growth booked in the previous quarter.

Eurozone growth
(contribution by Member States)



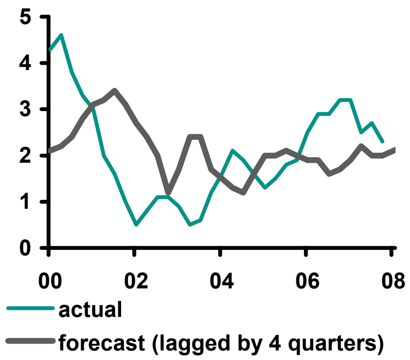
Source: Thomson Datastream

This slowdown masks significant differences between individual eurozone countries. The large member states are suffering, while the smaller countries are holding up well. While Germany and France both suffered a significant deceleration, Spain and the Netherlands were resilient.

A breakdown of national GDP data shows that German growth was driven by capital formation in machinery & equipment and by net exports. Household consumption expenditure contributed negatively. While private consumption also decelerated in France, it was still strong enough to support growth.

Back to the future?
The disclaimer that "past performance is no guarantee of future success" should be rephrased for observers of the eurozone economy into "past failures are no guarantee for future learning". The current situation has many parallels with 2000-2001. At that time, when the US economy was slowing down and stock markets were tumbling, many believed the eurozone was decoupling from the US and would enjoy a long period of domestically-driven growth. This was not the case. While economists back in 2000 were predicting 2001 GDP growth of above 3%, the actual figure was 1.9%, falling further to 0.9% in 2002.

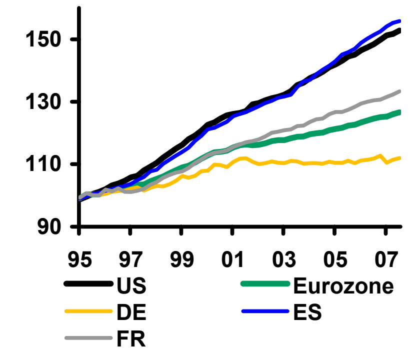
GDP - forecast and actual
(%, yoy)



Source: Bloomberg

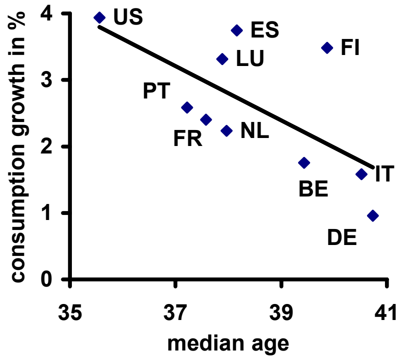
History is repeating itself. In the second half of last year, the decoupling story once again began attracting attention. The main argument put forward to support this theory is solid domestic demand in the eurozone as a whole. Just as in 2001, disappointment is looming.

Private consumption
(index, 1995=100)



Source: Eurostat

Consumption and median age
(average 1996-2007)



Source: Eurostat, US Census

So far, the gap between employment and consumption has suggested that there is some room for consumption to catch up. However, this gap is largely caused by German private consumption which has been lagging the rest of the eurozone for more than seven years. At the country level, member states with strong increases in house prices in the past have experienced more-than-solid consumption growth. With house price cycles turning, consumption growth should also decelerate.

Will private consumption in Germany come to the rescue? We believe the answer is no. There are several reasons why consumption has been and should remain weak. First, while employment growth has been remarkable in recent years, the improvement in wage growth has been much less impressive, which negatively affects purchasing power. Second, concerns about future pension financing and general short-term economic uncertainty might have contributed to subdued consumption. A comparison of the median age of countries and consumption growth reveals a strong link between ageing societies and private consumption growth (see chart).

Finally, part of the growth in German employment is the result of an increase in part-time and/or low-income jobs. Clearly, employment growth in these sectors does not make a strong contribution to private consumption.

All in all, the outlook for private consumption growth in the eurozone does not look bright. Private consumption growth in most eurozone countries is set to decelerate as the business cycle and the housing cycle are past their peak, while it is unlikely to accelerate in Germany.

Outlook remains gloomy

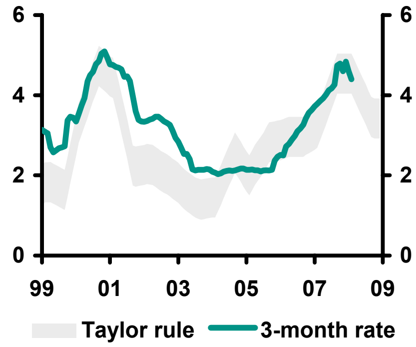
It is hard to identify a factor that could steer the eurozone economy through the stormy weather. Sentiment indicators have been diving since early summer 2007. Private consumption looks increasingly unable to hold up eurozone economic growth, and the positive contribution from net exports is ebbing away. Extra-eurozone exports have declined sharply recently as global growth has slowed and the euro's appreciation has curbed orders for eurozone products. As a result, the eurozone's trade balance has worsened and was negative for the first time since August 2006. In addition, the ECB Bank Lending Survey showed clear signs of credit tightening in all sectors.

All in all, there are no reasons for us to change our main scenario of eurozone growth slowing from 2.7% in 2007 to 1.5% in 2008. With a recovery in the US in the second half of the year and a normalisation of financial markets expected, eurozone growth should rebound somewhat in 2009 to 1.7%.

ECB's tone is softening

Inflation in the eurozone remained at a record-high 3.2% in January. With oil prices around USD 100/bbl, inflation is expected to remain at elevated levels for some time before baseline effects bring down headline inflation substantially towards the end of the year. By 2009, inflation should be around 2%. For this inflation outlook to materialise, it is crucial that second-round effects remain subdued. So far, even wage negotiations in Germany have led to only moderate increases. Spill-over effects in other countries and sectors should remain limited.

Short-term interest rates
Actual and implied by Taylor rule



Source: ABN Amro

The ECB is still trying to balance the need to prevent a severe economic slowdown and the risk of high inflation. At the most recent press conference, ECB president Jean-Claude Trichet softened his tone slightly, emphasizing downside risks to the economic outlook more than before. At its next rate-setting meeting in early March, the ECB will publish its staff projections. In our view, this should be the moment for the ECB to shift its stance and to acknowledge the slowdown of the eurozone economy. With an increasingly deteriorating economic outlook and stable inflation expectations, the ECB should have enough leeway to cut interest rates as early as April. We expect three rate cuts in the course of 2008 totalling 75 bps.

JAPAN

By Hein Schotsman, senior economist

DEFLATION NOT YET BEATEN

	---- GDP -----		C	I	G	X	M	CPI (end of period)	
	yoy	qoq	---------------------- qoq				----------------------	qoq	yoy
2007 (oya)	**2.1**		**1.5**	**-0.2**	**0.8**	**8.7**	**1.7**	**(avg)**	**0.1**
Q1 08	1.0	0.1	0.0	1.3	0.0	1.0	1.1	-0.1	1.0
Q2 08	1.5	0.2	0.1	2.6	0.3	0.0	1.3	0.2	0.8
Q3 08	2.3	1.1	0.3	2.5	0.1	3.0	2.2	0.0	0.6
Q4 08	2.2	0.8	0.3	1.8	0.3	2.0	1.9	0.4	0.6
2008 (oya)	**1.7**		**0.6**	**4.5**	**1.1**	**7.1**	**4.2**	**(avg)**	**0.7**
Q1 09	2.3	0.2	0.2	0.5	0.0	2.0	1.3	0.0	0.7
Q2 09	2.6	0.5	0.1	1.2	0.3	2.0	1.6	0.1	0.8
Q3 09	2.1	0.5	0.2	1.2	0.3	2.0	1.6	0.3	1.2
Q4 09	1.8	0.6	0.3	1.2	0.3	2.0	0.6	0.4	1.4
2009 (oya)	**2.2**		**0.9**	**5.6**	**0.8**	**8.2**	**6.5**		**1.0**

Source: Thomson Financial, ABN AMRO Economics Department

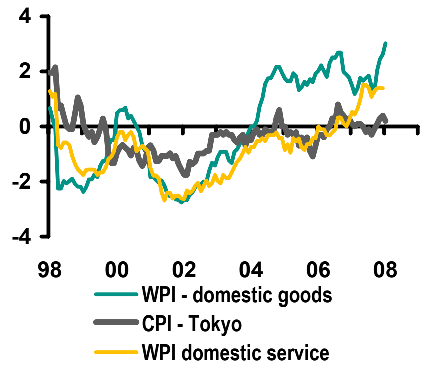
Summary
Q1 will probably be a quarter with no economic growth. The current situation underlines once again the country's dependence on foreign demand. Consumers are taking a wait-and-see approach. And the government is not in a position to contribute through budgetary policy. Unfortunately, given the global slowdown, foreign demand is not a support on which the economy can rely.

In our main scenario, we expect GDP growth to be near zero in Q1 and Q2. Thereafter, growth should pick up again, initially due to a recovery in housing starts and subsequently because of a rise in foreign demand. Downside risks remain high, however.

Deflation is being overcome…
Japan is now emerging from deflation, as shown by the rise in CPI in each month of Q4, after eight months of declining consumer prices. The Bank of Japan's favourite measure of CPI, core CPI excluding fresh food, doubled to 0.8% (yoy) in December. Corporate service prices rose by 1.4% in the same month, mainly due to higher transportation costs. Corporate goods prices rose even faster, jumping by 3.0% in January. Higher fuel and food costs are also bubbling away in the background.

…But the process is not over
Nevertheless, we expect inflation figures to remain low. Second-round effects are unlikely to occur in the near future. We do not expect price increases to induce wage rises in the short run. Deflation has not yet been defeated. Large export-oriented companies are able to pass on cost increases to their suppliers (often SMEs) or to compensate these increases by way of lower bonuses for their employees. This indeed occurred in December, when bonuses were down by an average of 3.6% from a year before. Pay rises are also being held back by the growth in cheap part-time employees, a process that has accelerated since the end of 2006, and by the replacement of expensive baby boomers by cheaper new graduates. The combination of this downward pressure on wages and rising prices means that consumer confidence is at low levels and private consumption is hardly growing at all.

CPI follows development wholesale prices, % yoy

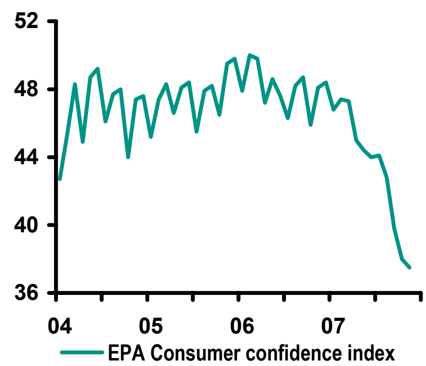


Source: Thomson Financial

But smaller companies are having to deal with price increases. This is reflected in the rise of the corporate price index. They are finding it difficult to pass on these cost increases. If they are suppliers of multinationals, they are afraid of losing orders, and if they operate in the retail market, they fear losing their unconfident customers.

As a result of these dynamics, we do not expect wages or CPI to increase significantly. Moreover, consumers continue to adopt a wait-and-see stance. The country remains dependent on the external sector.

Consumer confidence continues to decline



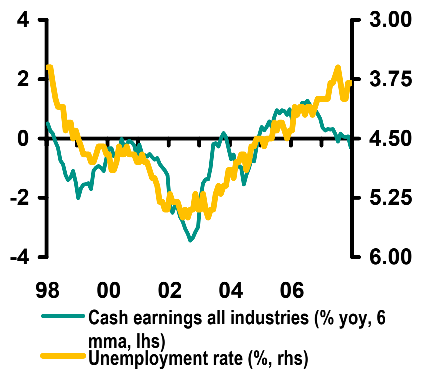
Source: Thomson Financial

Impact of credit crisis
In the coming months, however, we expect the external sector to come under pressure. The indirect effects of the international credit crisis are hurting Japanese companies. They are having to deal with the fall of the Nikkei and

the strong yen (which is hurting the export sector).

Leading indicators have fallen somewhat over the last few months. Moreover, in December, the ratio of job offers to applicants fell. Labour-market related sentiment is worsening among small and mid-sized companies. This is reflected in the deteriorating confidence of consumers with jobs at SMEs.

Tight labour market not reflected in wages

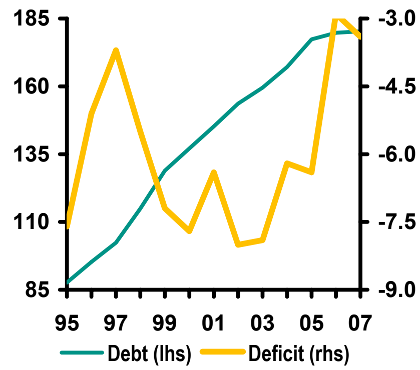


Source: Thomson Financial

No domestic stabiliser

The government is part of the problem, due to a paralysing policy gridlock. Moreover, with government debt at extremely high levels and with the oldest society in the world, old-fashioned government spending is highly unlikely. We remain worried about the long-term prospects for this debt, given that plans in the past to relieve it have not been successful.

General government debt (% GDP): no room for further rise



Source: Thomson Financial

Outlook for GDP components

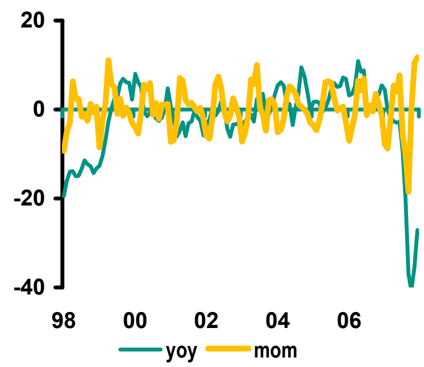
GDP growth was surprisingly strong in Q4 at 0.9% qoq. This was mainly due to the contributions from exports and private investment (both grew by 2.9% qoq). The unexpected acceleration in Q4 will have a positive effect on yoy growth in 2008. We have thus raised our 2008 forecast from 1.5% to 1.7%.

Overall export growth is slowing. Sales to the US are declining. Export growth to China is no longer in the double-digit range. We expect export growth to other major markets to remain firm. Machine-order figures show that private investment growth is likely to be impacted by lower export growth. According to the BoJ, however, corporate profits will remain high. Moreover, as many companies are also having to deal with capacity restraints, we expect private investment to keep rising on a qoq basis.

The normal mechanism leading to increased domestic demand would be a tightening of the labour market. However, such a tightening is not occurring, given the absence of wage rises. Concern about increasing prices is affecting consumer confidence and private consumption.

Finally, the housing market has started to recover from the crash that resulted from stricter building rules. Indeed, the worst seems to be over. The mom figures on housing starts are on the rise again. A full recovery this year could add half a percentage point to GDP growth.

Housing starts: recovery track has started, % 3mma



Source: Thomson Financial

The BoJ's dilemma

Slow growth combined with a shift from deflation to external cost-push inflation is creating a dilemma for the BoJ. Inflation is not being caused by domestic demand pressure. We do not expect second-round effects in the short run. In light of this situation, the BoJ is likely to opt for a wait-and-see approach for a number of months. We do not believe that rate cutting is likely, unless a long-lasting recession develops.

In March, the term of BoJ governor Toshihiko Fukui ends. He will probably be replaced by deputy governor Toshiro Muto. Muto has always voted in line with Fukui, so we do not expect important policy changes after the succession.

UNITED KINGDOM

By Philip Bokeloh, economist

BANK OF ENGLAND CONTINUES TO LOWER INTEREST RATES

	---- GDP -----		C	I	G	X	M	CPI (end of period)	
	yoy	qoq	---------------------	--------------------- qoq	---------------------			qoq	yoy
2007 (oya)	**3.1**		**3.2**	**6.2**	**1.7**	**-4.1**	**-2.0**	**(avg)**	**2.3**
Q1 08	2.3	0.2	0.3	0.4	0.2	0.8	0.7	0.1	2.0
Q2 08	1.7	0.2	0.3	0.4	0.2	0.8	0.7	0.9	2.2
Q3 08	1.3	0.2	0.3	0.4	0.2	0.9	0.8	0.4	2.8
Q4 08	0.9	0.2	0.3	0.4	0.2	0.9	0.8	0.4	1.9
2008 (oya)	**1.5**		**1.9**	**2.4**	**1.1**	**3.9**	**4.9**	**(avg)**	**2.3**
Q1 08	1.2	0.4	0.4	0.6	0.2	1.1	0.9	0.4	2.2
Q2 08	1.4	0.4	0.4	0.6	0.2	1.1	0.9	0.9	2.2
Q3 08	1.6	0.4	0.4	0.6	0.2	1.1	0.9	0.4	2.2
Q4 08	1.8	0.4	0.4	0.6	0.2	1.1	0.9	0.4	2.2
2008 (oya)	**1.5**		**1.5**	**2.1**	**0.8**	**4.1**	**3.5**	**(avg)**	**2.2**

Source: Thomson Financial, ABN AMRO Economics Department

Summary

The credit market turmoil and adverse developments in the housing market are expected to dampen economic activity. As the government has little room to prop up demand, economic stimulus must come from looser monetary policy. The Bank of England has already lowered interest rates.

Markets remain stressed

Financial markets continue to be stressed. Markets for most asset-backed securities, particularly those backed by mortgages, remain largely closed and spreads continue to widen. In money markets, the spread of the interbank rate over the base rate continued to narrow in early January, but towards the end of the month this spread began to widen slightly. Moreover, pressure on banks' balance sheets has continued to intensify.

In addition, there have been downgrades for some major monoline insurers, which are non-bank financial guarantors. As defaults have risen on assets guaranteed by these insurers, there has been mounting concern about counterparty credit exposures, and hence the value of the insurance. Further downgrades are likely. It is possible that banks might have to make provisions against their exposure to bonds guaranteed by the monocline insurers, or take further write-downs on the insured assets. As a result, banks might be pressured to sell some of those assets into an already depressed market. Global equity markets, which had previously been affected less by the developments in credit markets, have fallen sharply and remain volatile.

In response to the financial insecurity and weaker prospects for economic growth, the BoE reduced interest rates by 25 bps to 5.25% on 7 February. Eight members of the Monetary Policy Committee voted in favour of the decision. One member even voted for a 50 bps rate cut.

Credit demand and output

The provisional estimate of GDP growth in the fourth quarter was 0.6% on a quarterly basis, around its post-war average rate. Manufacturing output was reported to have been broadly flat for the second consecutive quarter, while growth in the services sector decelerated to 0.7%.

Business survey data in January generally points to continuing growth, but more forward-looking indicators such as new orders were consistent with slowing activity.

Services survey data also improved, but business expectations were at their lowest level since 2001. Although corporate borrowing in sterling continued to grow robustly, the growth of total credit facilities granted to non-financial companies slowed, which could indicate some financing constraints on future business investment.

Growth in consumption appears to be easing. Although January retail sales jumped by 0.9% in real terms on a monthly basis, retail surveys suggest a further decline in consumer spending. The slowdown in consumption can partly be attributed to the developments in the housing market. Activity in the housing market continues to decline, with mortgage rate approvals reaching their lowest since 1995. A small number of borrowers whose fixed-rate mortgages will be reset in 2008 could face higher repayments, which might affect savings and consumption plans.

In the three months to November, employment was estimated to have increased by 175,000, the largest rise since 1997, and the unemployment rate fell slightly. This lagging indicator reflects the strength of UK economic activity during 2007. By contrast, surveys suggest that employment growth has drifted down in recent months. Most indicators reveal that the labour market is becoming less tight.

Costs and prices

Pay settlements were broadly unchanged. Annual manufacturing input price inflation rose to 11.2% in December. In contrast to previous months, this rise was not driven by higher energy or food prices but rather by imported materials. The rise in import inflation might be an early sign of the consequences of the weakening exchange rate.

Consumer prices are likely to rise sharply in the coming months, given previously announced changes in electricity and gas prices, the upward pressure on oil and food prices and more general pressure on import prices following the recent depreciation of sterling. Short-term measures of inflation expectations remain elevated. The GfK consumer confidence survey reported that perceptions of current inflation had risen over the previous year to their highest level ever recorded in this survey.

Despite these inflationary pressures, the BoE looks set to lower interest rates further. GDP growth is expected to slow down markedly in 2008, as tighter credit conditions and weaker real income growth put a damper on domestic demand. Growth is projected to recover as credit conditions improve and lower interest rates and a weaker sterling begin to have an impact. There is likely to be some spare capacity in the economy, which should ensure that inflation returns to the central bank's 2% target in the medium term.

EMERGING MARKETS

By Serdar Küçükakın and Floris Kleemans

Emerging Asia
Asia is not immune to the economic slowdown in the US. However, we believe the risks to the region in the immediate term are well contained. According to estimates by the Asian Development Bank, the regional equity market has lost only 6% of its value since the beginning of the credit crisis. The external financial position of almost all countries in the region is robust. The substantial amount of foreign reserves in the region also provides a buffer against financial shocks. In addition, the restructuring of the financial system following the Asian financial crisis in 1997 has placed the banking system on a firm footing. Rising investment, underpinned by high corporate earnings, have boosted employment and incomes, which safeguards economic growth against the slowdown in external demand. With exports across the region already under pressure, domestic demand should become the main driver of economic growth.

In China, the snowstorms that hit the central and southern parts of the country led the government to declare twelve regions as disaster areas. These areas together account for almost 60% of China's GDP. The blizzards have paralysed the transportation systems in these areas, damaged the farmlands and greatly reduced the power generation and transport capacity. Inflation, especially food prices, is likely to soar in the short term, given the combination of the snowstorms causing tight supplies and the peak consumption season of the lunar new year in early February.

Even without the snowstorms, China's economy is entering troubled waters. A US-led global slowdown could cause China's export machine to face its most serious challenge since the global slowdown triggered by the bursting of the IT bubble in 2001. Investments, however, have so far not shown any signs of slowing. This is to a large extent insulating the economy from the negative effects of declines in export growth. However, this growth pattern is also making the economy more reliant on investment and therefore less balanced. This is likely to create a significant challenge for the government in the period ahead.

Emerging Europe and Africa
Unlike Asia and Latin America, which are creditor regions, EMEA is hampered by the need to finance large current-account deficits. Excluding Russia and the Gulf Cooperation Council countries, the current-account deficits in the region are substantial: in the Baltic countries, Romania and Bulgaria, they are between 14-25% of GDP; Turkey and South Africa have deficits of 7-8% of GDP; and in Kazakhstan the deficit amounts to 5-6% of GDP. These countries' external financing requirements become even more onerous when debt repayments are added to the picture.

Russia is facing its own unique challenges. The country has had impressive economic growth in the past few years, but this performance was mainly the result of the sharp rise in world market prices for commodities. Given that commodity prices are most likely to stabilise at around current levels due to the global economic slowdown, Russia can no longer afford to rely on high commodity prices for economic growth. The manufacturing sector must improve its competitiveness, which will require substantial investment, including foreign investment. However, foreign investors are likely to be attracted only if the environment for investment in Russia improves. In particular, foreign investors will be monitoring inflation, which must be brought down, and the restructuring of the industrial sector.

In the very near future, we expect Russian economic growth to moderate. In addition to the impact of the global economic slowdown, we expect import growth to outpace the growth of exports due to the ongoing strength in domestic demand and the appreciation of the rouble.

Turkey has enjoyed impressive economic growth for the past six years, with an average growth rate of close to 7%. However, this has led to a huge current account deficit. Together with countries such as Romania, Hungry and Bulgaria, this has made Turkey extremely vulnerable to changes in global flows of capital. In the current financial market turmoil, this constitutes a danger for the economic prospects of the country.

Turkey's economic prospects in the medium term will depend on the government's willingness to continue its reforms. Since 2001, the government has implemented the reforms laid out in its standby agreement with the IMF. With Turkey's IMF lending packages ending in 2008, the EU is likely to become the primary external anchor onto which Turkish leaders will base policy decisions.

South Africa is expected to have grown by around 5% last year, but this growth rate is expected to drop to around 4% this year. Apart from being affected by the global slowdown, the country is also struggling with some internal issues. South Africa has serious problems with its electricity supply, which is causing regular blackouts. Consumer spending is also slowing on the back of tighter financial conditions. One positive factor is growth in investment spending, which is expected to remain high in the double digits.

We expect the slowing of economic growth in EMEA, which was already visible last year, to continue this year. However, the focus on infrastructure investment by governments throughout the region should lead to higher and sustained growth from 2009 onward.

Latin America
Despite the slowdown in the US economy, commodity prices remain strong due to additional demand from emerging markets. Most economies in Latin America continue to benefit from elevated commodity prices, and growth prospects thus remain favourable throughout the region. Domestic demand is also a solid contributor to economic growth.

In Argentina, inflation is becoming a serious concern for the economy. Inflation is now over 20% according to unofficial estimates and is likely to rise further, as wage demands are currently around 30%. With its exchange rate relatively stable, the country is rapidly losing its competitiveness.

Mexico is doing remarkably well given the economic downturn in the US. Some 85% of the country's exports go to the US. In addition, the decline in US building activity is having an adverse impact on remittances to Mexico. Despite these developments, we expect GDP growth to remain in the 2-3% range this year. We believe the country is undergoing some important institutional changes. The public sector is likely to play a more important role in the economy, while the tax base is broadening. The additional funds can be used for infrastructure investments and the expansion of oil production capacity. The current government under President Felipe Calderón is proving to be quite effective in implementing much-needed reforms.

Despite a deterioration in the security situation due to drug smuggling into the US, we believe the economy's trend growth has now increased to around 4% per annum. Once the US economy emerges from the current economic slowdown, we expect Mexico to grow at faster rates than in the past.

CHINA

By Serdar Küçükakın, senior economist

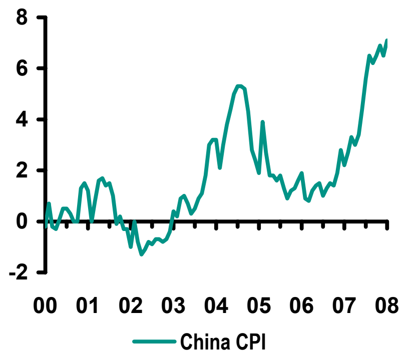
INFLATION RUNNING HIGH

Growth and inflation

Our view on economic growth has not changed fundamentally: we still expect growth to slow slightly to 10.2%, compared with 11.5% last year, largely as a result of the global economic slowdown.

Inflation continue to rise in January, hitting an 11-year high. The spike in inflation was mainly due to disruptions in the supply of food in particular caused by the harsh winter. China is currently experiencing the coldest winter in 50 years. CPI rose by 7.1% year on year in January, up from 6.5% in December. Food prices rose by 18.2% yoy after increasing by 16.7% in December. However, non-food prices still appear to be under control, with an increase of just 1.5% yoy in January.

Inflation
% yoy



Source: Bloomberg

We expect headline inflation to rise further in the coming months, as the full impact of the recent bout of severe weather has yet to be visible in the CPI data. The disruption caused by the storms only started to be felt in the last week of January. In addition, prices received a boost from the lunar new year holiday at the beginning of February. In the run-up to the new year, food prices tend to rise faster than under normal circumstances. This year, however, food prices are unlikely to normalise as quickly as they usually do given the negative impact of the snowstorms.

In the medium term, we expect headline inflation to be sticky through May due to the lingering effects of the supply shocks that have hit the country over the last six months and have kept food prices high. Nevertheless, we continue to believe that price pressures will diminish in the second half of 2008 as the impact of supply shocks dissipates. We have increased our inflation forecast for this year from 4.0% to 4.2%.

Monetary policy

In the previous edition, we reported that the central bank announced it was abandoning its official “prudent” monetary stance, which had been in place for a decade, in favour of a “tight” monetary stance. We argued that this was not a significant departure from the central bank’s actual stance, as numerous hikes in official rates and reserve requirements implied that this tightening stance was already in place. We also argued that this could signal a more aggressive approach to tightening in 2008. Given the current global situation, however, we expect any further monetary tightening to be weighed against the slowdown in the global economy and its effects on China.

Although the Chinese authorities are unlikely to continue to allow the renminbi to appreciate at an annualised pace of nearly 15%, our forecast of a 9% appreciation in 2008 now appears to be somewhat conservative. Even allowing for the likelihood that the authorities will scale back the pace of the renminbi’s rise in the latter part of Q2 and early Q3 due to slower growth and easing inflationary pressures, the currency looks to be on course to appreciate by more than 10% this year. As a result, we now expect the renminbi to strengthen to 6.50 against the US dollar by the end of 2008.

FORECAST TABLE

Macro Forecasts		Real GDP Growth				Inflation			
February 2008		2008		2009		2008		2009	
		AA forecasts	Consensus Economics	AA forecasts	Consensus Economics	AA forecasts	Consensus Economics	AA forecasts	Consensus Economics
United States	24%	**0.8**	2.0	**1.7**	2.7	**3.0**	2.8	**3.0**	2.1
Eurozone	18%	**1.5**	1.8	**1.7**	2.0	**2.6**	2.4	**1.9**	1.9
United Kingdom	4%	**1.5**	1.8	**1.5**	2.0	**2.3**	2.3	**2.2**	2.0
Japan	9%	**1.7**	1.5	**2.2**	2.0	**0.7**	0.4	**1.0**	0.5
Emerging Asia	29%	**8.2**	8.4	**7.7**	8.0	**4.2**	4.3	**3.6**	3.8
Latin America	9%	**3.9**	4.3	**3.9**	4.3	**5.0**	4.8	**4.6**	4.7
EEMEA	7%	**5.5**	5.7	**5.5**	5.6	**8.5**	7.4	**6.7**	6.0
World Economy	100%	**3.8**	4.2	**3.9**	4.4	**3.6**	3.4	**3.2**	2.9

The regions' weights are based on PPP exchange rates
All forecasts are year averages
EEMEA: Emerging Europe, Middle East and Africa

Source: ABN AMRO Economics Department, Consensus Economics