

# Global Economic Outlook

11 January 2010

## Contents

Global ..... 2  
 US..... 3  
 Europe..... 5  
 Japan..... 6  
 Australia..... 7  
 Canada..... 8  
 Emerging Markets ..... 8  
 Global Forecast ..... 11

## Overview

**Global Economy** – The normalization of the industrial cycle is powering the global recovery. We continue to forecast a 3.5% increase in global GDP for 2010.

**United States** – US manufacturing activity has recorded its fastest quarterly gain since 1983. Record low inventory levels point to strong growth in 2010.

**Europe** – Growth is likely to surprise on the upside in 2010, but it will probably be unevenly spread across the region. Divergence will be a key theme.

**Japan** – GDP is poised for a modest recovery to 1.9% in 2010 on an improved export-led capex rebound in the second half.

**China** – We have high confidence in Beijing’s ability to fine-tune its monetary exit policy, but financial markets may overreact to the initial move to pull back liquidity.

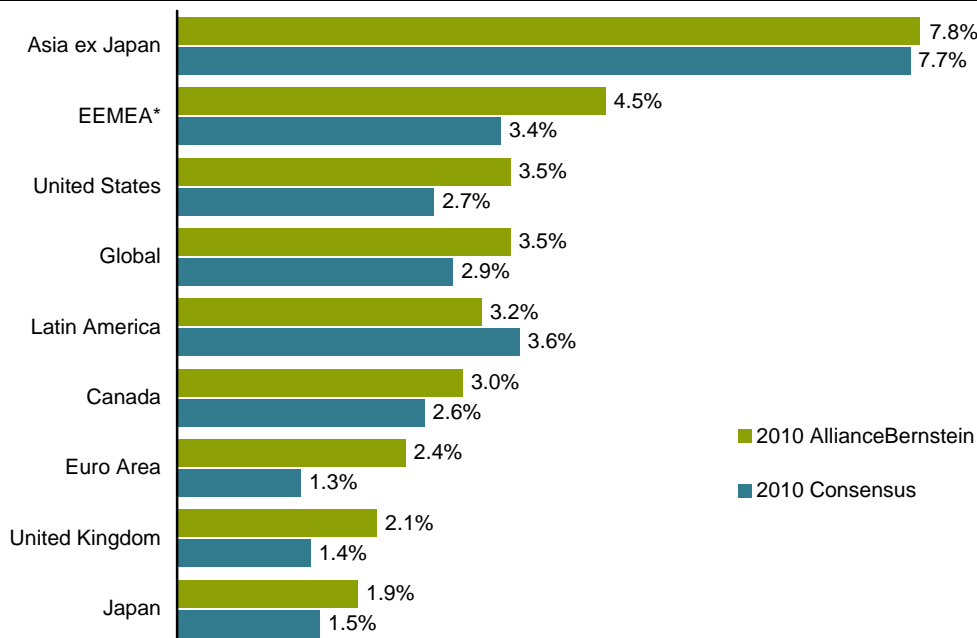
## Global Economic Research

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2010 World Economic Growth Forecasts: AllianceBernstein vs. Consensus



\*Eastern Europe, Middle East and Africa  
 Source: AllianceBernstein

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## Global Outlook

The industrial sector recovery is powering the global recovery

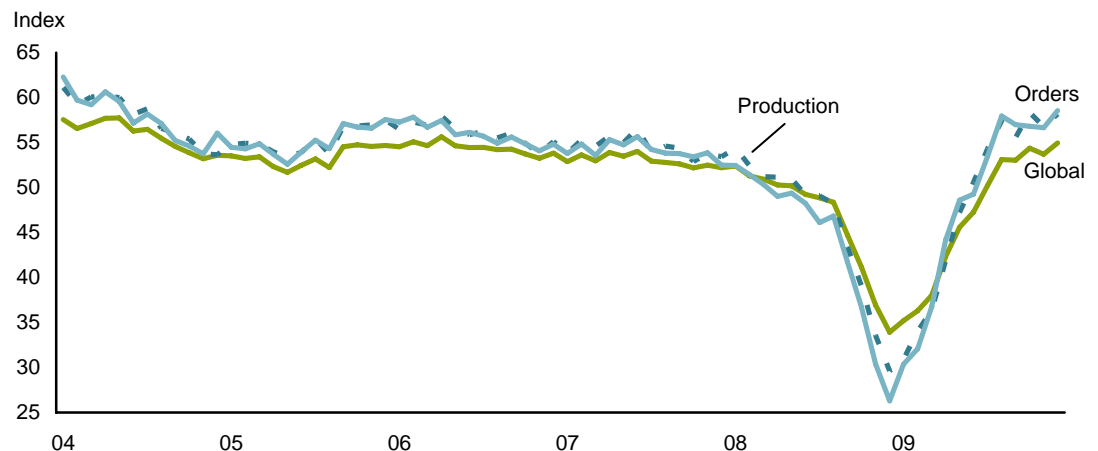
Thanks to the rebound in the manufacturing sector, the global recovery is gathering speed and breadth. In December, the global PMI composite index rose 1.3 points to 55, the highest reading since the spring of 2006, a period marked by relatively fast global economic growth. Importantly, the rebound is being driven by solid gains in new orders and production—the highest levels since 2004—while inventory de-stocking still seems to be continuing on a global basis.

Strong gains in orders and production

The forward-looking aspects of the global PMI report sends a clear message that the global recovery is beginning to exhibit self-reinforcing characteristics that will generate added momentum as it spurs an increase in investment and employment. We believe that a relatively large increase in new orders against a backdrop of flat to declining inventories indicates that manufacturing firms are unable to keep up with the level of demand. In the short term, this is likely to force companies to ramp up production even more in order to meet demand and to begin the process of rebuilding much-depleted inventory positions.

### Display 1: Industrial Cycle Is Powering the Global Recovery

#### Global Manufacturing Purchasing Composite Index



Source: Haver Analytics and Markit

Inventory cycle will provide a big lift to GDP growth

The transition in the global inventory cycle reflects a shift in demand conditions as well as in the operating strategies of industrial companies. Indeed, inventory management trends are directly and indirectly linked to corporate expectations of sales growth as well as expansion opportunities. Historically, as firms begin to intentionally build inventory positions they also start to consider increasing investment plans and adding to payrolls. When this process repeats itself at industrial firms, it leads to higher incomes and spending, which boosts other companies in other industries. And as the process spreads within economies and across economies, it has a self-perpetuating effect on the economic expansion.

We don't expect the normalization of the global industrial cycle to unfold evenly across the globe, and regional disparities will have significant implications for official rates, market interest rates and exchange rates. In some countries, the process has already started. The Reserve Bank of Australia, for example, has already begun to lift official rates and we expect an increase of at least another 100 basis points during 2010. In other countries, like the US, we think the economic rebound will prove to be faster than widely expected due to relatively large fiscal stimulus, record low inventories and a competitive currency, which should enable firms to regain market share at home and around the globe. In Europe,

however, the normalization cycle will be particularly uneven give the large divergence in economic conditions between countries such as Germany and Spain.

Thus, the fact that the industrial and interest rate cycles of commodity-based countries such as Australia are ahead of cycles elsewhere has led to a relative strengthening of their currencies. Yet, as other countries—especially the US—catch up and close the gap, commodity currencies are likely to hold their strength and we don't expect them to post any more incremental gains through the year. Moreover, if our fundamental prognosis for the US and Europe proves accurate, we believe the US currency will regain some lost ground between now and year-end.

Exchange rates will reflect the different pace of recoveries

US manufacturing sector is rebounding at its fastest pace since 1983...

...led by strong gains in shipments and a turn in the inventory cycle

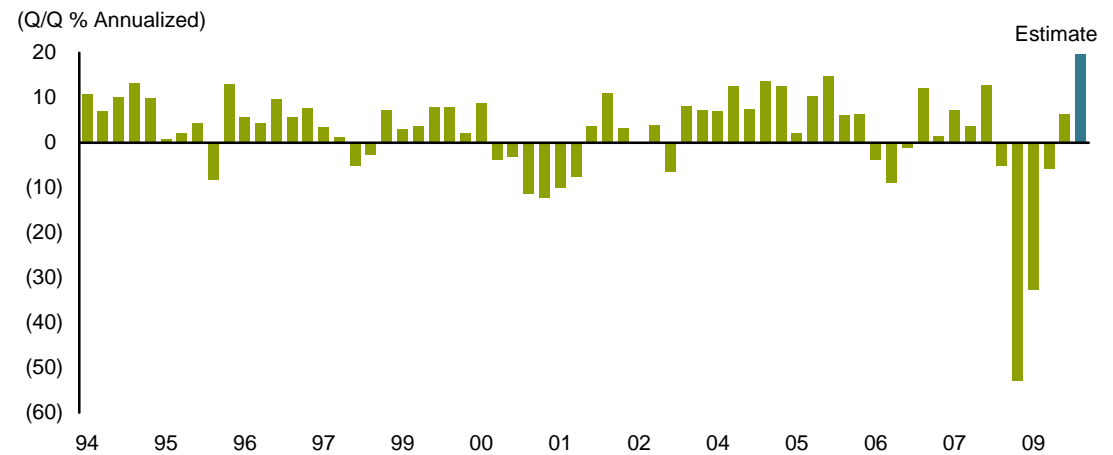
## US Outlook

The US economy has plenty of hurdles to jump in order to return to sustainable growth in 2010. With bad debts mounting at banks, high unemployment and a record pipeline of mortgage foreclosures, it's hardly surprising that most analysts expect a relatively modest economic recovery, echoing the weak rebound that followed the recessions of 1990/91 and 2001.

However, we believe the rapid pace of recovery in the manufacturing sector is starting to increase the chances of a speedy recovery. Indeed, according to preliminary data, we estimate manufacturing activity will post an annualized gain of 20% in the fourth quarter of 2009—the biggest quarterly increase since 1983 (**Display 2**). That year, the US economy enjoyed exceptionally strong GDP growth following the deep and long recession of 1981 and 1982.

Display 2: Robust Rebound for Manufacturing Sector

### US Manufacturing Activity\*



\* Growth in shipments and change in inventories  
Source: Census Bureau, Haver Analytics and AllianceBernstein

The Census Bureau's report on shipments and inventories for October and November confirms the powerful rebound in manufacturing activity, along with several industry reports and the latest ISM manufacturing survey, showing incremental gains in December.

Like the Federal Reserve Board's (FRB) industrial production report, the Census Bureau report on manufacturing shipments and inventories provides a measure of the level of manufacturing activity. But the Census data have an important advantage: they measure the dollar level of manufacturer shipments and inventories, unlike the index of physical volume used by the FRB. This makes it easier to compare the Census report with GDP data, which

Census data confirm strong rebound

are also measured in dollars.

For the Census measures, an estimated level of overall manufacturing activity is based on the level of shipments plus the change in inventory positions. The inclusion of the change in inventory levels is necessary because firms can increase shipments to customers out of existing stock positions. Thus, in order to capture the rise and fall in manufacturing activity using the Census data, dollar changes in inventories must be added to the monthly dollar level of shipments.

According to the Census Bureau, manufacturing shipments rose 1.5% in November, following a gain of 1.5% in October (which had been revised up from 1.2%). Manufacturing strength has also been bolstered by an end to the inventory liquidation of industrial companies. According to the latest Census report, released earlier this week, manufacturing inventories rose 0.2% in November, following an even larger increase of 0.6% in October. That may not seem like a big change, but manufacturing inventories had been contracting at an average monthly rate of 1.1% during the first nine months of 2009. So the swing from large monthly declines to a modest positive accumulation provides a significant boost to overall manufacturing activity—and is an important sign of a developing trend.

In all economic recoveries, the transition in the inventory cycle from record liquidation to steady stock levels and later to higher stock positions tends to make a big contribution to the recovery in manufacturing activity and overall GDP growth. In fact, in past recoveries the swing in business inventories has accounted for about 20% of the first year gain in GDP growth. The recent inventory liquidation cycle was the longest and deepest in the postwar period, which leads us to believe that the inventory cycle may play an even bigger role in the recovery this time around.

How much of a lift can manufacturing expect to enjoy from the shift in the inventory cycle? The ratio of new orders to inventories in the ISM manufacturing survey provides some guidance on future production as the gap reflects a rush to order when demand improves and stock levels are low. At mid-year 2009, this ratio surged to its highest level since the mid-1970s, before slipping for a few months. The index then rebounded sharply during the last two months of the year, indicating that there are plenty of production gains in the pipeline.

That view is substantiated by comparing the ISM new orders index with the level of the customer inventory index. Although the latter series only goes back to 1997, it provides insight into how purchasing managers view the inventory positions of their end-market customers. Importantly, when the customer inventory index hit a record low in December, it lifted the ratio of new orders to the customer inventory index to a record.

Taken together, these indicators suggest that even after the inventory cycle had a substantial effect on the fourth-quarter manufacturing rebound, there is much more to come, since many companies and industries are still operating with relatively lean to record low inventory levels. Every incremental increase in demand will therefore create a multiplier effect on production, as manufacturers need to increase output due to higher sales and inventory requirements. Given the manufacturing sector's relatively large cyclical variability, a strong recovery here should have numerous positive spillover effects and ultimately pave the way to a stronger and broader recovery than current consensus forecasts.

At this writing, manufacturing data available for December point to further gains in shipments and perhaps some modest inventory additions as well. The widely followed ISM manufacturing composite index rose two points to 55.9 in December, the highest reading since April 2006, driven by strong gains in production and a modest increase in inventories. Other industry reports, such as weekly reports on motor vehicle production, steel production

Manufacturing shipments rose sharply in 4Q

The inventory cycle appears to be turning

Customer inventories are at record lows

Manufacturing activity ended 2009 in its strongest position in several years

and rail car volumes, also suggest incremental gains in production/shipment activity in December.

We are particularly encouraged by these indicators, because our estimate of a 20% gain in the dollar value of fourth-quarter manufacturing activity conservatively assumes no incremental gains in shipments and manufacturing inventories for December. Should the bullish industry reports for December prove true, our estimate may turn out to be too low, and when the final data for the fourth quarter of 2009 come in, our estimate for manufacturing growth could turn out even stronger than we currently expect.

## Europe Outlook

Euro-area growth has resumed . . .

The euro-area economy has come a long way over the past year. At the beginning of 2009, the economy was in free fall following the collapse of Lehman Brothers. But aggressive monetary and fiscal stimulus, accompanied by unprecedented steps to underpin the banking sector, has helped stabilize the situation. Growth has now resumed and asset prices are well above their lows.

. . .but the credit crunch has taken a heavy toll

But the credit crunch has taken a heavy toll. Output is still 4.8% below the peak level reached in the first quarter of 2008, and more than four million workers have lost their jobs (not to mention countless others on short working hours). Moreover, much of the financial sector remains on government-sponsored life support. These events have also weighed on public finances. Before the crisis, the euro area was running a budget deficit of 0.6% of GDP. Today, the shortfall is over 6.0% and rising. In some euro-area countries, deficits are significantly higher than this.

Growth is likely to be better than consensus but weak in a global context . . .

We expect the euro-area economy to grow by 2.4% this year. This is modest in a global context but is significantly higher than the consensus expectation for the euro area (1.3%). In our view, the consensus is underestimating the impact of stronger world trade growth, the ongoing support from expansionary monetary and fiscal policy and the tendency for output to rebound quickly after severe downturns. Recent survey data suggest that growth is already running at an annualized rate of 2.0%, very close to its pre-crisis trend.

. . .and is unlikely to be spread evenly across the euro area

Our relatively optimistic view comes with two important caveats. First, output is unlikely to return to its pre-crisis level until the end of 2011, about a year later than in the US. Second, growth is unlikely to be spread evenly across the euro area. For Germany, which is geared to a pickup in world trade growth and where fiscal policy remains expansionary, the outlook is good. But the outlook is less encouraging for Spain and Ireland, as policymakers battle against deflationary forces unleashed by collapsing housing bubbles, and fiscal policies are restrictive (especially in Ireland). Cyclical indicators are already picking up this divergence.

Divergence to remain a key theme

But divergence is not just about the near-term growth outlook. It is a constant feature of the euro-area landscape and is likely to be a major theme for the coming year. Budget deficits, competitive positions, current account balances and debt levels vary widely across the euro area. So, too, does the willingness of governments to impose unpopular measures when required. There is a big contrast, for example, between the radical action taken by Ireland's government and the Greek government's hesitant steps in reacting to economic crisis. This has not gone unnoticed by financial markets or the ratings agencies.

No easy solution to Greece's problems, but a default is unlikely

We continue to think that a default by Greece—or any other euro-area country—is unlikely. But until the government faces up to the gravity of the situation and takes credible steps to put the public finances on a more sustainable footing, sentiment will remain fragile and Greek bonds will remain under pressure. The only positive side effect of the Greek impasse is that it is starting to weigh on the euro, providing some relief for euro-area exporters.

ECB to start reducing support for the banks

It is against this backdrop that the European Central Bank (ECB) is starting to implement its exit strategy. Since the beginning of the credit crisis, the ECB has drawn a clear distinction between liquidity support and monetary policy—so much so that it raised interest rates as recently as July 2008. The same principle is likely to guide policy in 2010. At present, the ECB is providing €751 billion of liquidity to the euro-area banking system, up from about €450 billion before the crisis. Almost all of this liquidity is being provided via long-term repurchase operations and will roll off naturally over the coming year. Technically, this part of the exit strategy is relatively straightforward. The key question is timing. The ECB has already announced that it is ending its use of six- and 12-month tenders. But as the bulk of outstanding repurchase operations still have a residual maturity of at least six months, liquidity is likely to remain ample during the first half of 2010.

Interest rates likely to rise later in 2010

That brings us to interest rates. We have already noted that euro-area output is unlikely to return to pre-crisis levels until late 2011. For some observers, this rules out a tightening of monetary policy this year. In the past, though, the ECB has tended to react more to output growth than to its level. And it's important to remember that rates are currently at emergency lows. Once there is evidence that recovery is firmly established, we believe the ECB will be uncomfortable holding interest rates at record lows and will look to reduce the stimulus being provided to the economy. Timing is uncertain, but we expect this to happen around the middle of the year.

Pivotal election year in the UK

We expect the UK economy to grow by 2.0% in 2010. As with the euro area, this is well above consensus estimates but is unimpressive in a global context. Market attention in 2010 is likely to be focused on monetary and fiscal exit strategies. In this respect, the Bank of England's task is a bit more complicated than the ECB's, as its unconventional policies have included the outright purchase of government bonds. In our view, the Bank is unlikely to try to sell gilts this year, but we do expect it to start raising interest rates. In part, the speed and magnitude of monetary tightening is likely to depend on fiscal policy. This, in turn, may depend on the outcome of the general election which must be held by June at the latest. In our view, the best outcome for the gilt market, and interest rates more generally, would be a clear victory for the opposition Conservative Party, as this would probably lead to an aggressive tightening of fiscal policy. An inconclusive election outcome would have an adverse impact on gilt yields and could lead to the UK losing its AAA credit rating.

## Japan Outlook

Japan's recovery will stay soft but improved exports will prevent a double dip

We expect the Japanese economy to lag the global recovery in 2010, with GDP growth averaging 1.9% compared with -5.4% in 2009. Economic growth is likely to stagnate in the first half before improving in the second half as a continued export recovery leads to firmer industrial production and investment revival.

In the near term, consumption should stay relatively robust thanks to the tax incentives on household spending, while public works will decline due to the partial budget freezes by the new administration. Thereafter, as exports strengthen further amid firmer western demand and capex starts to pick up as companies upgrade equipment, the Japanese economy should gain in growth momentum.

In quarterly terms, we expect real GDP growth of 1.1% (quarter on quarter annualized) and 1.6%, in the first and second quarter respectively. In our view, momentum is likely to improve somewhat in the third and fourth quarters, with economic growth of 1.8% to 2.4%. This, however, will not be sufficient to lift the economy out of a structural deflation path, forcing the Bank of Japan to extend its accommodative policy stance. We maintain our six-month target for JPY/US\$ at 95 (versus current 91.7) and expect the 10-year JGB bond yield to increase slightly to 1.5% (from current 1.36%).

## Australia Outlook

Australia and New Zealand significantly outperformed their industrial country peers during 2009. In considering whether their economies will continue to do as well through 2010, we think six key themes will be in play.

(1) **Growth convergence.** While growth will continue through 2010, the gap between Australia/NZ and their peers will narrow significantly as other economies pull out of their respective slumps. In both countries, stimulatory policy continues to play a role, while a recovery in housing construction is underway in both countries and consumer spending will be helped by improvement in the labor markets. For Australia, support also comes from commodity prices and exposure to China. However, monetary tightening and exchange-rate strength will begin to crimp growth as the year progresses.

(2) **A return of inflation sensitivity.** Core inflation has proved to be a little stickier than expected over the last year. Meanwhile, unemployment appears to be peaking at a much lower level than expected, at under 6% versus expectations of 8.5%-9% a year ago. A higher inflation starting point, coupled with tighter-than-expected labor markets, implies a heightened sensitivity to domestic inflationary pressures. However, against those domestic influences, the stronger Australian and NZ dollars may help damp inflation, and overall we still expect core inflation to drift somewhat lower in 2010. The outcome of this tug of war, however, will be crucial in determining the path of policy rates.

(3) **Monetary tightening, but less aggressive than priced.** The Reserve Bank of Australia (RBA) has already hiked interest rates three times in this tightening phase, and we may well see another move up in February, when the board is next scheduled to meet. After that, we think rates could be on hold for an extended period, perhaps until the fourth quarter: we expect an end-2010 cash rate of 4.25%. The Reserve Bank of New Zealand (RBNZ) assumed a more hawkish tone in its December statement but still seemed to be in no rush to tighten policy. We expect tightening to begin at either the June 10 or July 29 Official Cash Rate Reviews, and a 3.5% cash rate by year-end. This puts the RBA and RBNZ at the less aggressive end of the scale in terms of our forecasts for industrial country policy tightening – and is a sharp contrast to market pricing, where expectations are for the RBA and RBNZ to be the most aggressive.

(4) **Bond yield convergence.** The combination of convergence in economic growth and convergence in policy rates should result in convergence (spread contraction) between Aust/NZ and other global government yield curves.

(5) **Current account deficit improvement proves transitory.** Current account deficits in both Australia and New Zealand narrowed sharply during 2009—a function of softer domestic demand, lower servicing costs on foreign obligations (debt and equity) and some special factors (for example, some lumpy tax-related foreign income flows in New Zealand). As private demand accelerates we expect import volumes to rebound, servicing costs to jump higher and the special factors to drop out, suggesting that a reversal in the deficit improvement is very likely over the next 12 months. We think it could move from 3% to 4% of GDP back to 5% to 7%.

(6) **AUD and NZD to hold up versus US dollar, but tail risks are increasing.** Our forecasts imply strength in the US dollar against other major currencies over the next six months, particularly the euro, pound and Swiss franc. The combination of relatively wide interest-rate differentials and optimism about the commodity price outlook should help the Australian and New Zealand dollars hold their ground against the US currency. But with growth and interest-rate differentials beginning to narrow—particularly in an environment where Fed tightening expectations are likely to be pushed higher, in our view—stability

may be as good as it gets for the Australian and New Zealand currencies against the US dollar. Tail risks appear to be rising, due to a list of factors including market positioning, stretched valuations and the potential for a renewed focus on serial current account deficit runners.

Growth is quite strong, and inflation is a risk

## Canada Outlook

The robust recovery in Canada is continuing with good jobs growth, strong housing and now a rebound in exports. We think fourth-quarter GDP growth probably exceeded 4%.

Fourth quarter housing starts were up nearly 17% from a year ago, and surged 44% in December alone. The less volatile building permits number has been positive when compared with the previous month for eight consecutive months. Retail sales have risen by the same metric for three consecutive months. Meanwhile, exports are finally improving and posted a rebound for two consecutive months, after months of weakness.

Inflation, however, is a potential threat to the recovery. Raw materials prices rose for two consecutive months, and industrial prices jumped by nearly a full percentage point in November from October. The central bank insists on hiking interest rates, and may only shift away from this position late in the second quarter of 2010. The Canadian dollar would likely hit parity if a hiking cycle were to start before the US Fed.

## Emerging Markets Outlook

The regional recovery is strong, and central banks will be in the spotlight

**Latin America:** With a solid recovery in Latin America underway, the focus will begin to shift toward central bank actions to reverse interest rate cuts and how fiscal accounts might recover as tax revenues rise. Another key issue will be whether, and to what extent, external accounts shift to deficits as Latin American growth outpaces other developing regions. **Brazil's** trade surplus was a mere \$78 million in December and \$24.2 billion for the year. Due to strong domestic growth, we expect the Brazilian trade surplus to be less than half of last year's level in 2010. However, the central bank continues to signal that it will increase interest rates slowly. After a strong recovery, industrial production has flat-lined on an absolute basis.

Andean growth is more subject to political uncertainty

In **Argentina**, we expect a strong first half recovery led by record soybean crops harvested in the first quarter. But fiscal accounts still look dicey. Meanwhile, the recent political furor over the central bank and the government's ability to secure dollar reserves in a new fund in order to guarantee debt payments could eventually hurt investor confidence and undermine gains made in dollar reserve accumulation and currency stability. **Mexico's** new central bank head has started his tenure by sounding dovish, and rates are unlikely to be hiked for some time despite administrative measures that may push inflation to 5%. The central bank expects a lackluster economic recovery, and the one-time nature of the hikes will fade in 2011. This leaves the risk that the currency could weaken if the forecast does not pan out.

**Venezuela's** recent devaluation is a positive development for bondholders, although it is unlikely to help economic fundamentals. Inflation is likely to rise, perhaps sharply, and we would not rule out social unrest later this year. **Ecuador** is running down reserves, leaving potential risks unless growth rebounds strongly. **Colombian** growth is still constrained by the effect of Venezuela's turmoil, and political speculation of a potential second reelection bid by President Alvaro Uribe could affect sentiment before the May election.

Asia's bright 2010 prospects depend on markets and

**Asia ex Japan:** The key to Asia's economic performance in 2010 will be the speed and breadth of **China's** efforts to scale back liquidity growth as the country exits the monetary policy settings prompted by the financial crisis. We remain highly confident of Beijing's

policymakers staying calm

ability to fine-tune policy but see a risk of financial markets overreacting when the People's Bank of China begins taking stronger action on the pullback in liquidity. There is, after all, much at stake. The surge in China's credit growth was arguably one of the most powerful economic trends in 2009. It lifted investment demand and asset purchases inside the country and led to increased growth in imports. This effectively translated into a pan-Asia recovery as countries ranging from Japan, South Korea and Taiwan to the ASEAN economies in the southeast increased their shipments to China. Strong credit expansion north of Hong Kong's border generated liquidity inflows from the mainland which triggered the massive rally in prices at the high end of the special administrative region's property market.

However, while China's contribution has been important, it is not the only influence on the region's economic growth. For example, signs of gradually improving western demand and recent export trends are an encouraging development, which should reinforce Asia's recovery momentum in the coming year, in our view. We expect GDP growth in non-Japan Asia to rise to 7.8% in 2010 from about 4.5% in 2009. This projection depends upon economic growth rebounding to 10.2% in China, 7.4% in [India](#) and 5.6% in [Korea](#), as we are forecasting. We expect the [Philippines](#) and [Thailand](#) to lag the recovery due to political uncertainty in both countries: the Philippines is entering a presidential election year and continuing instability in Thailand may affect the country's economic competitiveness.

Inflation risk looks less severe than generally expected

Inflation across the region has been tamer than expected. We increasingly think the likely bounce in energy and food inflation from a low base over the next quarter or two will probably not take Asian policymakers by surprise, because it has been so widely anticipated (assuming, of course, that the bounce is not too big). Importantly, core inflation across the region has remained subdued, running at an average 1% year on year in November (about 2% excluding China) which is significantly lower than the 5% experienced during the oil-price peak in mid-2008 (around 8% excluding China). A narrowing of the output gap (the difference between potential and actual GDP) will boost underlying inflationary pressure. But we think the overall rise in headline inflation to around 3.5% this year should not cause much of a policy panic during the post-crisis normalization process.

India, China and Korea to lead in the tightening cycle

We still expect India, Korea, China and probably [Indonesia](#), to start increasing policy rates in the first quarter ahead of the US Federal Reserve, which is expected to tighten in the second quarter. The rest of Asia, however, can afford to wait until the second quarter. In simple average terms, we expect policy rates to go up by about 100 basis points across the region this year. China, India and Korea will increase by 125–135 basis points, which will be more aggressive than rate rises by ASEAN countries, anticipated at no more than 75–100 basis points. In Singapore, where monetary policy targets the exchange rate rather than the interest rate, we expect the monetary authority to shift to a gradually tightening stance. This will effectively lead to a 5%–7% appreciation of SGD/USD in the coming year.

EEMEA recovery will be stronger than consensus

**Eastern Europe, Middle East and Africa:** Four key macro themes will have the biggest influence on the EEMEA region in 2010. First, as we have argued since last May, real GDP growth is likely to be much stronger than the consensus view. We have maintained our real GDP forecast of 4.5% for 2010, while the consensus forecast has risen steadily from 2.2% in July 2009 to 3.4% currently. There are several drivers of this growth: a continued recovery in exports given the region's high trade dependence; stimulative monetary and fiscal policies; and an expected recovery in the labor markets. These drivers are likely to stimulate new bank lending, which will reinforce the recovery in private sector domestic demand, in line with historic trends in emerging market countries that have experienced credit crises. While the theme of recovery applies to the region broadly, those countries with more highly levered private sectors, such as [Hungary](#), [Ukraine](#) and [Latvia](#), are likely to experience a slower rebound.

Inflation outlook varies by country

Second, there is a mixed inflation outlook. Overall, inflationary pressures are likely to be low because of large negative output gaps (defined as a significant excess capacity of workers and production capacity). However, supply-side inflation—base effects on energy and food prices and administrative price and excise tax increases—is likely to lead to a rise in headline CPI in [Turkey](#) above its target, and to sticky headline inflation in [South Africa](#) and [Russia](#).

Monetary policy outlook also varies by country

Third, the policy outlook varies by country, based on each economy's specific mix of growth, inflation and current policy stance. With respect to monetary policy, we expect Turkey to hike rates first due to the strength of its recovery, its specific inflation dynamics, and its extremely loose real monetary conditions. As we have argued repeatedly, Turkey's real interest rate of nil versus an average of 7.3% during 2003–2008 is not compatible with low and stable inflation, given the expected strength of the recovery. We expect [Poland](#) and South Africa to keep rates on hold until the fourth quarter of 2010, when the economic recovery finally leads their central banks to start to normalize policy. Finally, Russia and Hungary are both likely to continue cutting rates until mid-2010, before pausing in the second half of the year. Russia's central bank seeks to stimulate new lending and domestic demand through lower interest rates. [Hungary](#)'s current tight monetary policy stance, slow recovery and benign inflation outlook all point to further loosening.

Cyclical recovery is positive for sovereign creditworthiness

Finally, the cyclical recovery in growth is likely to lead to improvements in sovereign creditworthiness. These improvements are due to stronger GDP growth itself, more balanced external positions, ongoing banking system de-leveraging, and modest improvements in fiscal positions. While the rising stock of public sector debt weighs against these improvements, our country risk ranking model suggests that under our base-case scenario most countries' creditworthiness will improve this year by one to three notches.

A combination of stronger growth and improved creditworthiness suggests that capital flows are likely to return to the EEMEA region, albeit at reduced levels compared with 2003 to 2007. Moreover, the mix of flows is likely to shift more towards FDI and government borrowing, away from private sector borrowing. This suggests that on balance risk premiums are likely to decline over the course of the year, and currencies will strengthen.

Israel continues rate hikes

In the region's smaller economies, the direction of monetary policy has been mixed. In [Israel](#), the central bank raised interest rates 25 b.p. for the third time in December to a still accommodative level of 1.25%. Inflation in November was 3.8% year over year from 2.9% in October. The central bank cited inflation levels above the 1%–3% target rate and the rise in home prices as the reasons for the decision. We believe that the central bank will continue to hike rates gradually in 2010 as Israel and the global economy continue to recover.

Czech Republic cuts rate one last time

In the [Czech Republic](#), the central bank surprisingly cut the policy rate by 25 b.p. to 1.00% in a divided decision. We believe that this cut was unwarranted considering the outlook for higher inflation and a sustained recovery in GDP. Inflation rose to 1.0% year over year for December from 0.5% in November. The central bank has also lowered its inflation target beginning in January to 2% from 3% previously, which means that inflation is likely to reach the target sooner. As a result, we believe that the central bank will begin to hike rates in the first half of 2010 with strong attention given to ECB policy rate changes.

	Real Growth <sup>1</sup>			Inflation <sup>1</sup>			Official Rates <sup>2</sup>			Long Rates <sup>2</sup>		
	2008	2009F	2010F	2008	2009F	2010F	2008	2009	2010F	2008	2009	2010F
<b>Global</b>	1.5%	-2.3%	3.5%	4.2%	0.8%	2.3%	2.76%	1.68%	2.89%	3.25%	3.84%	4.47%
<b>Industrial Countries</b>	0.4%	-3.2%	2.9%	3.5%	0.2%	2.0%	1.41%	0.59%	2.12%	2.70%	3.62%	4.31%
<b>Emerging Countries</b>	5.7%	1.0%	6.4%	7.8%	3.3%	4.8%	8.00%	5.64%	6.44%	6.09%	5.97%	6.71%
<b>United States</b>	0.4%	-2.5%	3.5%	3.8%	-0.4%	2.4%	0.25%	0.25%	2.00%	2.25%	3.75%	4.75%
<b>Canada</b>	0.0%	-2.5%	3.0%	2.3%	1.8%	2.5%	1.50%	0.25%	2.00%	4.00%	3.60%	4.75%
<b>Europe</b>	0.5%	-3.9%	2.4%	3.4%	0.6%	1.6%	2.41%	0.92%	2.24%	2.97%	3.51%	3.89%
Euro Area	0.5%	-3.9%	2.4%	3.3%	0.3%	1.4%	2.50%	1.00%	2.25%	2.95%	3.39%	3.75%
United Kingdom	0.6%	-4.6%	2.1%	3.6%	2.1%	2.3%	2.00%	0.50%	2.00%	3.02%	4.02%	4.50%
Sweden	-0.5%	-4.3%	2.4%	3.5%	-0.3%	1.2%	2.00%	0.25%	2.00%	2.41%	3.29%	3.75%
Norway	2.1%	-1.1%	3.3%	3.8%	2.1%	2.2%	3.00%	1.75%	3.50%	3.85%	4.14%	4.50%
<b>Japan</b>	-1.2%	-5.4%	1.9%	1.4%	-1.4%	-0.8%	0.10%	0.10%	0.10%	1.17%	1.30%	1.60%
<b>Australia</b>	2.4%	1.0%	3.4%	4.4%	1.8%	2.5%	4.25%	3.75%	4.25%	4.00%	5.80%	6.00%
<b>Non-Japan Asia</b>	6.7%	4.5%	7.8%	6.4%	0.5%	3.5%	-	-	-	-	-	-
China <sup>3</sup>	9.6%	7.7%	10.2%	6.0%	-0.9%	3.5%	5.31%	5.31%	6.66%	2.76%	3.65%	4.50%
Hong Kong <sup>4</sup>	2.5%	-3.2%	4.7%	4.3%	0.8%	3.0%	0.50%	0.50%	1.50%	1.20%	2.65%	3.75%
India <sup>5</sup>	7.8%	6.9%	7.4%	9.2%	1.3%	3.5%	6.50%	4.75%	6.00%	5.26%	7.56%	8.00%
Indonesia <sup>6</sup>	6.1%	4.4%	5.8%	9.8%	4.9%	5.5%	9.25%	6.50%	7.50%	11.80%	9.05%	10.50%
Korea <sup>7</sup>	2.5%	0.6%	5.6%	4.6%	2.7%	3.5%	3.00%	2.00%	3.25%	3.77%	4.90%	5.50%
Thailand <sup>8</sup>	2.6%	-2.9%	3.7%	5.5%	-0.9%	2.5%	2.75%	1.25%	2.00%	2.17%	3.63%	4.50%
<b>Latin America</b>	4.6%	-2.5%	3.2%	8.0%	6.5%	6.5%	-	-	-	-	-	-
Argentina <sup>9</sup>	6.0%	-4.0%	2.5%	25.0%	13.0%	15.0%	-	-	-	23.00%	7.25%	7.00%
Brazil <sup>10</sup>	5.0%	1.0%	5.5%	5.9%	4.4%	4.5%	13.75%	8.75%	10.00%	3.50%	2.00%	2.00%
Mexico	2.0%	-6.5%	3.0%	6.5%	4.0%	5.5%	8.25%	4.50%	5.25%	9.00%	8.20%	8.50%
<b>EEMEA</b>	3.9%	-5.6%	4.5%	10.8%	8.2%	6.8%	12.10%	7.08%	7.75%	9.82%	9.52%	10.78%
Hungary	1.3%	-6.8%	0.5%	6.1%	4.2%	3.7%	10.00%	6.25%	5.25%	8.15%	7.95%	7.20%
Poland	4.8%	1.3%	3.5%	4.2%	3.4%	2.1%	5.00%	3.50%	3.75%	5.39%	6.25%	5.90%
Russia	5.6%	-8.9%	5.4%	14.1%	11.7%	8.6%	13.00%	8.75%	8.00%	8.55%	10.20%	10.50%
South Africa	3.1%	-1.9%	3.3%	9.9%	7.1%	5.9%	11.50%	7.00%	7.50%	7.30%	9.20%	9.10%
Turkey <sup>11</sup>	1.1%	-5.6%	4.7%	10.4%	6.2%	7.6%	15.75%	6.50%	10.50%	16.60%	10.85%	16.00%

## NOTES:

- 1) Growth and inflation forecasts are reported on a calendar year basis.
- 2) Official and long rates are end-of-year forecasts. Long rates are 10-year yields unless otherwise indicated.
- 3) China: Official rates are 1-year benchmark lending rates and 10-year government bond yield.
- 4) Hong Kong: Base rate and 10-year exchange funds yield
- 5) India: Reverse repo rate and 10-year government bond yield
- 6) Indonesia: Intervention rate and 5-year government bond yield

Source: AllianceBernstein

- 7) Korea: Overnight call rate and 5-year government bond yield
- 8) Thailand: 1-day repo rate and 5-year bond yield
- 9) Argentina: Discount bond spread
- 10) Brazil: 2037 bond spread
- 11) Turkey: Long-term rates are 5-year rates.