

Global Economic Outlook

August 2011

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Overview

Global Economy – Growing fears of a US recession and the spreading European sovereign debt crisis raised concern about the global economic recovery after an abrupt slowdown in the second quarter.

United States – S&P’s downgrade of the US credit rating and subsequent market turmoil have weakened confidence in the outlook for a stronger second half. In the first half, real GDP growth was less than 1% annualized.

Europe – Key cyclical indicators have weakened further, reducing the need for any additional near-term tightening from the ECB.

Japan – “Phase 1” of Japan’s recovery has almost come to a close, and attention is turning to longer-term issues, including the risk that manufacturers may seek to relocate outside Japan.

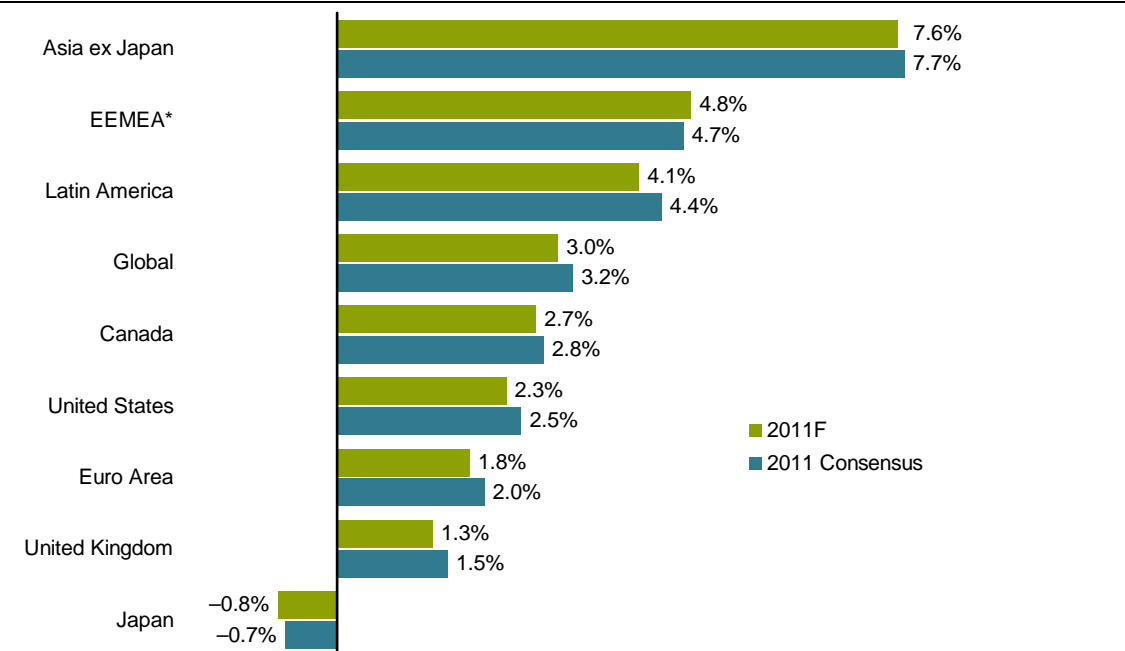
China – Manufacturing activity appears to be slowing and input price pressure is easing rapidly, according to recent PMI data.

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AllianceBernstein vs. Consensus World Economic Growth Forecasts



*Emerging Europe, Middle East and Africa

Source: AllianceBernstein

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Global Outlook

Markets in turmoil amid European instability and US recession fears

Continued instability in the European debt markets and fears of a double-dip recession in the US threw global financial markets into turmoil in early August. At the nexus of this upheaval was the widespread view that US and European governments lack the political will to resolve the critical fiscal and economic issues facing their nations. Downward US GDP revisions and weak manufacturing data exacerbated the problem.

Sharp slowdown in growth—concentrated in emerging markets

Global real gross domestic product (GDP) growth slowed in the second quarter, running well below our estimates. According to preliminary data, we estimate that global real GDP advanced at an annualized rate of 1.9% in the quarter, more than one percentage point below the growth rate in the first quarter. We were surprised by both the size of the slowdown and the source of weakness. Approximately two-thirds of the GDP growth slowdown occurred in emerging markets, where the combination of tighter monetary conditions and rising commodity prices have started to dampen demand growth.

Developed economies have also slowed and underperformed relative to our expectations. In the US, real GDP grew 1.3%, at least 1.5 percentage points below our forecast made a few months ago. Growth in the euro area looks to have slowed to 0.7% in the second quarter, far below the 3.4% recorded in the first quarter.

Weakness carries over into early 3Q, as global PMI drops sharply

The global slowdown has been visible in purchasing managers' surveys that monitor manufacturing and service sector activity. In the second quarter, the global composite index fell to 52.2, a five percentage point decline from the first quarter. The index fell further in July, dropping to 50.6. Although the sharp decline was somewhat influenced by a sharp plunge in Japan, all major world economies experienced some deceleration between the first and second quarters, and that weakness has also spilled over into the third quarter.

Despite the broad-based growth disappointments in the second quarter, we still forecast a pickup in global GDP to around 3.5% in the second half. In our view, most of the acceleration in growth will be centered in the developed economies, which is an important development that would result in more global balance while reducing incremental pressure on commodity prices. According to our industry analysis, commodity prices—especially oil—are much more sensitive to growth in emerging markets than they are to growth in developed economies. That's because many emerging economies are less energy efficient and also rely heavily on commodity-intensive industries for much of their growth.

Until now, the global GDP recovery has been led by emerging markets, which was a key theme in our macroeconomic outlook. Indeed, during the first two years of the global recovery, emerging-market economies accounted for an unprecedented 60% of the cumulative gain in real GDP. Yet, while emerging-market demand has helped drive growth, it has also damaged growth by fueling commodity prices.

Stable commodity prices and reduced risks of sovereign defaults should improve growth prospects

Meanwhile, the European and US fiscal crises have created an atmosphere of gloom in financial markets. We think the packages passed aren't big enough to undo all the problems, but they should reduce the risks of default and improve the growth outlook at the margin.

We continue to forecast a recovery, but it will almost certainly remain bumpy and we have also significantly reduced our expectations for GDP growth. Yet interest rates in developed economies remain at historically low levels, yield curves are very steep, corporate profitability is high, debt is low and liquidity is strong—all factors that are historically consistent with economic recovery.

US Outlook

S&P credit rating downgrade shakes markets

The downgrade of the US credit rating to AA+ by Standard & Poor's has undermined confidence in the economic recovery and in efforts to repair fiscal imbalances. Equity markets posted their sharpest declines since 2008 as fears mounted that the US may be on the verge of a double-dip recession. Given the scale of the turmoil, we are reconsidering our economic growth forecasts for the rest of 2011.

US economy expanded less than 1% in 1H

Real GDP growth increased by 1.3% in the second quarter, well below consensus estimates, while first-quarter growth was revised down to 0.4% from the previous estimate of 1.9%. Several factors led to a weaker-than-expected first half. Supply disruptions and ongoing spending cutbacks at state and local governments played a role. But the spike in inflation dealt the biggest blow to the US economy.

A sharp rise in prices—driven by higher commodity prices—restrained growth in 1H

During the first half of 2011, nominal GDP advanced at an annualized rate of 3.5%, or 0.5% below the 4% annualized pace in the second half of 2010. However, the slowdown in real GDP growth was much more severe, decelerating to 0.8% during the first half of 2011—a drop of 1.7 percentage points from the 2.5% gain in the second half of last year as a sharp acceleration in prices reduced the volume gains in the economy.

According to preliminary data, GDP prices increased at an annualized rate of 2.6% during the first half, the sharpest rise in almost three years. Most of the surge in domestic prices was directly and indirectly linked to a very large rise in import and commodity prices. Import prices increased at an annualized rate of 16% during the first half of 2011, reflecting the surge in all types of finished and unfinished goods and supplies. The 40% jump in the price of oil was the most damaging to economic growth.

QE2 contributed to spike in commodity prices

While unrest in the Middle East and North Africa fueled the surge in oil prices during the first half, we think the sharp rise in import/commodity prices was also partly tied to the decision by the Federal Reserve to embark on quantitative easing (QE2) in November 2010. At the margin, this led to a weaker US dollar and higher commodity prices on a global basis. The surge in domestic inflation following the QE2 experiment should be a reminder that countries can not inflate their way out of financial crises. We believe that, monetary authorities should beware of considering additional quantitative measures even if the economy underperforms relative to growth expectations.

New mix growth drivers are still in place...

On a positive note, the GDP data indicate that the US economy is still being driven by the “new mix” growth drivers of exports and investment. In the second quarter, real merchandise exports rose 6.8%, following a 10.6% increase in the first quarter. During the same period, capital spending rose by 5.7%, following a gain of 8.7% in the first quarter. Yet, consumption and housing activity remain weak, with almost no real growth in consumer spending in the second quarter, and no net gain in residential investment during the first half.

...but a sustainable cycle needs more domestic demand growth

The dramatic shift in the contributions to growth is consistent with our new mix thesis, but a more sustainable recovery needs the domestic sectors to play a bigger role now as the economic recovery starts its third year. In addition, the protracted fiscal debate clearly hurt economic activity during the summer months. Despite the disappointing first quarter, we still believe that the backdrop for growth is undeniably solid, with robust liquidity flows and substantial pent-up demand. But policymakers must hit all the right buttons for growth to reaccelerate. Before the recent volatility, we expected GDP growth to accelerate modestly to an annualized rate of between 3% and 3.5% during the second half, driven by a strong rebound in motor vehicle production. But we are now reviewing our forecasts because of the sharp deterioration in confidence triggered by recent events.

Europe Outlook

Attention switches from politics to economics

In recent weeks, financial markets have focused mainly on political developments in the euro area. But the sovereign-debt crisis has an economic dimension as well, and recent data have been disappointing. So far, fiscal adjustment in the periphery has taken place against a backdrop of relatively strong growth in core Europe. Should the recovery in these countries falter, an already difficult task would become even more daunting.

Recent indicators have been weak

Business surveys provide the most timely insights into cyclical developments in the euro area. The composite purchasing managers' index (PMI) fell to 50.8 in July, the third straight drop for this important survey and the lowest reading since August 2009. Based on the past relationship between the composite PMI and economic growth, the July data suggest that the euro area is currently growing at a quarterly rate of around 0.2%, much lower than the first quarter's 0.8% rate of expansion.

Data still consistent with modest positive output growth . . .

There are several ways to interpret the latest PMI data. In our view, the trend growth rate of the euro-area economy is probably not much higher than 0.4% a quarter at present. This implies that the strong expansion in the first quarter was unsustainable, and that a slowdown was inevitable as the global manufacturing cycle transitioned from a powerful recovery phase to a more moderate pace of expansion. The economy has also had to cope with significant headwinds, such as higher oil prices, supply disruptions from Japan and a stronger exchange rate. Indeed, it was these three factors that led us to downgrade our expectations for euro-area growth at the beginning of April. In this context, the recent decline in the PMI should not be that surprising.

. . . but the speed of the decline in some indicators is a concern

But it's not that simple. While the level of the PMI is broadly consistent with our second- and third-quarter growth forecasts, of 0.2% to 0.3%, the speed of the decline is worrying. Since April, the composite PMI has fallen by seven points. Only once in its 13-year history—in late 2008, following the collapse of Lehman Brothers—has the composite PMI experienced a steeper decline than this. For now, we regard the decline in the PMI as signaling a moderation in the underlying pace of output growth, exacerbated by a number of temporary factors, rather than as evidence of a more serious economic downturn.

Some of the factors weighing on growth may be temporary

Several factors caution against an overly negative interpretation of recent data. First, other survey data have not been as weak as the composite PMI. Second, some components of the PMI do not confirm the very downbeat message from the headline series. For example, the employment component has fallen by less than a point since April and actually rose slightly in July. This may be because the employment PMI tends to lag the headline series slightly, but it may also be significant that big drops in the headline PMI in the past have tended to be accompanied by sharp declines in the employment component. The fact that this has not happened on this occasion might indicate that companies think the current weakness in demand may be temporary.

Policymakers need to be careful not to create additional hurdles

So where does this leave us? While the pace of decline in the PMIs is clearly a concern, we believe a broader view of the data, and the temporary nature of some factors weighing on output growth, suggest that this is more likely to be a soft spot than a serious economic downturn. Still, this is a fragile moment and policymakers' decisions will be vital. In this respect, governments must ensure that the sovereign-debt crisis does not spill over into a wider economic and financial event. And while we understand the European Central Bank's desire to move interest rates back towards more "normal" levels, there's no need for haste, in our view, at such a delicate stage of the business cycle.

Japan Outlook

“Phase 1” of Japan’s recovery has almost come to a close . . .

It is now clear that the Japanese economy is recovering from the March 11 earthquake and tsunami at a faster pace than many analysts had expected in the disaster’s immediate aftermath. Many indicators on the production side of the economy have risen sharply in recent months. Industrial production, for example, rose by 4% in June after a 6% rise in May, and firms expect output to increase a further 5% in July and August—an outcome which would basically take overall production back to pre-earthquake levels. This is especially impressive given that companies face some constraints by economy-wide power conservation initiatives. The picture of an expanding manufacturing sector is reinforced by the message from business surveys: for example, July’s PMI of 52.1 made Japan one of the few economies in the world to record an increase in this key index last month.

. . . and attention is turning to longer-term issues, including “hollowing out” risks

Attention is now shifting to longer-term issues. What are the implications of the earthquake on the outlook for the Japanese economy beyond the next few quarters? One key concern is the risk of further significant departure of Japanese production facilities offshore, or a “hollowing out” of the manufacturing sector. While this would not be a new phenomenon, the fear now is that this trend may accelerate, with the earthquake acting as the trigger for many companies to reconsider their location in Japan. There are four main worries driving this theme.

The first concern relates to supply-chain vulnerability. The natural disaster highlighted just how vulnerable global production is to the disruption of one link in a manufacturing process. To reduce these risks, many companies worldwide are considering producing and sourcing inputs from a range of locations. But Japanese firms are clearly facing more immediate pressure on this issue. Second, power conservation efforts have been successful at staving off blackouts and averting the worst fears about Japan’s electricity supply situation, yet longer-term concerns remain. In particular, question marks persist over the likely path for nuclear generation capacity. The third worry is the dysfunctional state of Japanese domestic politics. Importantly, the passage of a third (and largest) supplementary budget—containing the bulk of the disaster reconstruction measures—is therefore in doubt, as are steps aimed at addressing Japan’s longer-term growth and fiscal challenges.

Last, the level of the currency continues to be a key concern. When measured on a real-effective-exchange-rate basis, the yen does not look too far from its “normal” or average level. But with the nominal bilateral exchange rate against the US dollar within a hair’s-breadth of record highs, the yen is widely perceived to be quite overvalued. This perception was recognized in early August, when the Ministry of Finance intervened in the currency market and the Bank of Japan launched further monetary easing.

Together, these factors are increasing the longer-term risk for economic growth. So although we have left our forecast for GDP growth in 2012 unchanged at 3.4%, the combination of these worries with more uncertainty about the general global environment suggests that the likelihood of further economic weakness has increased.

Australia/New Zealand Outlook

Sharp difference between Australian and NZ monetary policy outlooks

Markets are increasingly expecting monetary policy action in both Australia and New Zealand. At this writing, over 100 b.p. of cuts were expected from the Reserve Bank of Australia (RBA)—a very sharp contrast to the 75 b.p. of hikes expected from the Reserve Bank of New Zealand (RBNZ). In both economies, we think that pricing looks too aggressive after a sharp shift in sentiment over the past month.

In Australia, the “two speed” nature of economic growth continues to be a key theme. On the

one hand, the mining sector is booming, while on the other hand, consumers and non-mining tradables sectors are getting squeezed by a high Australian dollar and relatively high interest rates. We continue to think that this tension will ultimately lead to stronger aggregate economic growth and rising inflation risk. Indeed, core inflation readings have been higher than expected over the past two quarters. So while the RBA has resisted hiking rates because of global uncertainty, we still expect the next cash rate move to be up, not down.

In New Zealand, business confidence has improved, first-quarter GDP was stronger than expected (with upward revisions to the fourth quarter) and inflation has been higher than expected. These developments have contributed to an expectation that the “insurance” cut in rates put in place by the RBNZ immediately after the earthquake in February is no longer required. We’re not so sure. There are still very few solid economic data that give us a picture of the post-earthquake environment. And disentangling the impact of the earthquake on data from the underlying cyclical pickup remains difficult. To us, this suggests a need for caution and delayed action, which is why our tightening outlook over the next year or so is less aggressive than market pricing. But with the RBNZ seeming to validate the consensus view regarding the removal of the “insurance”, we have brought forward into the fourth quarter our forecast for the timing of the first move.

Canada Outlook

Economic activity in Canada appears to have paused in the second quarter. Car assemblies slowed after the Japanese disruptions, and do not seem to have bounced back as fast as we earlier thought. The Ivey index of business conditions was less buoyant than at the end of the first quarter, and the broader ISM index in the US that leads Canadian activity has slowed.

Still, we expect a rebound in the months ahead. Employment gains continued through June and hiring plans are strong. Capital goods imports also look solid, and the latest business survey reported strong machinery and equipment investment planning. Lastly, interest rates are low and credit conditions were reported to be loosening to the easiest conditions in over a decade, according to the Senior Loan Officer Survey. On balance, although economic growth was weaker than we expected in the second quarter, the slowdown probably had little impact on annual growth, which we still project at about 2.8% for 2011.

If growth bounces back, Canada’s economy is poised to reach full capacity next year, which would increase inflationary risks. Business surveys already report preliminary signs of labor and general capacity pressures. The Bank of Canada’s latest Monetary Policy Report said core inflation would be at or near the target rate of 2.0% from now on, earlier than it had previously expected. So, the drop in core inflation to 1.3% in June gave significant relief to a situation that otherwise implied a need for prompt rate hikes, as does recent weakness in US growth. On balance, however, we still think two rate hikes will be needed this year.

Our argument in favor of increasing policy rates earlier than we initially thought is driven by a renewed rise in home prices that seems to be developing. Although we see the need for higher rates to curtail a housing advance and rising mortgage debt, the instantly rising Canadian dollar has helped to alleviate some of the pressure for a rate hike by offsetting inflation and limiting growth opportunities. In this regard, the currency was most recently boosted by the return of global bond investors to Canadian markets, as they bought C\$11 bil. in May after purchasing less in February–April. In addition, the announcement of a smaller but psychologically significant Chinese investment in a struggling oils sands operator also helped push up the Canadian currency.

Despite slowing indicators we expect a rebound in 2H

Inflation pressures remain balanced, but could increase on capacity constraints

Additional rate hikes will help ease housing sector pressures

Emerging Markets Outlook

Brazilian confidence weakens, but economic fundamentals remain strong

Latin America: Brazilian confidence, for both business and consumers, continues to weaken. We have not seen concrete signs of an economy-wide slowdown, however, as formal job gains remain buoyant, and car sales are holding up. Some segments of domestic industry may be feeling the full brunt of Brazil's overvalued exchange rate because of a surge of cheap imports, but overall spending seems resilient.

Inflation has eased, but will likely pick up in 2012

Complaints from industry about the rising currency would certainly explain the harsh response of policymakers in taxing additional new derivatives market positions after the real rose to a multiyear high this month. Meanwhile, strong capital goods imports point to easy credit and solid demand from industry and export sectors. Consumer credit and spending do not seem to be deeply constricted despite a deliberate effort to cut them back to make room for industrial credit. In this mixed situation, inflation has been slowing because of temporarily lower fresh foods and fuel prices, but is widely expected to pick up again next year as several underlying inflation trends show little signs of diminishing. The central bank may pause in its rate hike cycle soon, pointing to slower headline inflation, but the question of how it will react to renewed inflation next year is open.

Mexican Central Bank remains neutral amid mixed growth indicators

In Mexico, business and consumer confidence has also weakened. Auto assemblies have rebounded fully after a short but sharp contraction in April, but the second-quarter average level of activity is still likely to be down from the first quarter. GDP was already unexpectedly low in the first quarter, because of lower-than-expected harvests after adverse weather events, and growth may be held back again in the second quarter. Other underlying indicators of demand are solid, however, including capital goods imports, formal employment and domestic auto sales, so we do not expect a significant reduction in trend growth. With GDP growing at a 3%–4% underlying rate, Mexico's margin of unused capacity will be only slowly used up, which argues for a gradual reduction in nonfood inflation pressures. Accordingly, the central bank seems in no rush to increase interest rates and in its last policy statement even mentioned the possibility of rate cuts. We don't expect any changes in rates through early next year.

Slower activity and inflation in China

Asia ex Japan: The Purchasing Managers' Index (PMI) showed continued moderation of manufacturing activity across the region in July. China's manufacturing slowdown was particularly severe among small- and medium-sized enterprises as reflected in the HSBC PMI survey. The official PMI results were better than the private survey thanks to its high concentration on state-owned enterprises, which were less affected by the year-long monetary tightening. The input price component has further eased, reinforcing our conviction of an improving inflation environment moving forward.

India's manufacturing slows but inflation stays high

India's PMI continued to show elevated inflation and slowing manufacturing activity. Although the July PMI remained high on the expansionary side at 53.6, the indicator has declined sharply from close to 60 early this year. Output, new orders and export orders all fell, while stock of both finished and purchased goods rose. In addition, both input and output prices increased, with the latter rising faster. We still expect the Reserve Bank of India's policy priority will focus on inflation rather than growth for the rest of this year, with a further 50 basis points hike in interest rates.

A competitive won underpins Korea's export manufacturing sector

The regional bright spot is Korea, where the economy did not suffer much of a soft patch in the second quarter of 2011 unlike many of its Asian counterparts. Strength in the July PMI—led by an increase in both domestic and export orders—plus the continued upside surprise of its export expansion, suggest that the economy's growth momentum remains robust. While

Korea's electronics exports were impeded by Japan's supply-chain disruption, shipments of motor vehicles, chemical products and machinery remained strong thanks to the competitiveness of these industries and aided by a still competitive Korean won (KRW), especially against the Japanese yen. With JPY/USD at 77.5, the KRW/JPY cross is still 45% below levels before the financial crisis in 2008. In our view, the Bank of Korea will not mind letting the currency appreciate further as long as inflation remains an issue.

Taiwan's sharp deceleration caused by Japan's supply-chain disruption

In stark contrast, Taiwan's high concentration on the tech and electronics sectors, and its lack of other highly competitive industries like Korea's, prompted a sharp drop in manufacturing sentiment in July. The overall PMI fell by 3.8 points to 46.1, with output down while new orders and new export orders all declined significantly below the 50 expansionary threshold level that separates expansion from contraction. Despite the fall in manufacturing activity, input prices still edged up further last month. Overall, we still expect the central bank to raise policy rates by a further 25 b.p. before ending the tightening cycle in the final quarter.

Emerging Europe, Middle East and Africa: The past month brought further evidence of a soft patch across the EEMEA region, similar to trends in the global economy. The pace of economic activity, as measured by industrial output, appears to have slowed to just over 3% (on a GDP-weighted, seasonally adjusted three-month basis) in May from a peak of more than 10% in February. Meanwhile, the regional GDP-weighted manufacturing PMI fell more than five points to 50.6 in July, predicting further deceleration and increasing the risk of a slide into contraction territory in the months ahead.

Further evidence of second-quarter manufacturing slowdown . . .

The most dramatic deceleration in manufacturing momentum was seen in Turkey and South Africa although the sequential slowdown has been somewhat masked by still robust, if falling, year-over-year expansion rates of about 5% for the whole region. In contrast, Russia's manufacturing momentum picked up during the second quarter, reflecting resilience of domestic demand amid strong wage and credit growth as the country continues to benefit from elevated commodity prices.

. . . outside Russia.

Headline inflation peaked across the region in May and slowed in June—significantly in several countries—on the back of negative food inflation. These declines reflect stabilizing global soft commodity markets, and, in central Europe, the potentially dampening impact of an E. coli scare on demand for fresh fruit and vegetables. The only major country in the region where inflation trended up in June was South Africa. Unlike the rest of the region, food prices didn't spike in South Africa during the second half of 2010 (owing to a bumper maize crop), so the country isn't benefitting now from moderating food inflation elsewhere.

Headline inflation has peaked in most countries

Softening economic activity, uncertainty about the global outlook and slowing inflation caused a meaningful shift in tone by most of the region's central banks and implies that the current pause in rate normalization may extend beyond the end of 2011. In Hungary, stagnant retail sales and fragile output growth outside the export-oriented sector prompted the central bank to acknowledge that weak domestic demand might justify rate cuts. However, the central bank decided to remain on hold, possibly for an extended period, given external risks related to the euro-area periphery and Hungary's outstanding financial vulnerabilities, which require an interest-rate cushion against potential bouts of global risk aversion. The strengthening of the Swiss franc (CHF) to more than 50% above the average rate at which many Hungarian households and local governments borrowed during the credit boom years of 2006-08, adds further complications. Indeed, it prompted local governments to seek an extension of a grace period on CHF-denominated debt repayments. CHF-linked liabilities in Hungary amount to approximately 20% of GDP. The government's program intends to provide temporary relief to indebted households by fixing the CHF exchange rate at a more favorable rate for the next three years. However, although this may provide a

Central banks have turned more dovish

partial cushion, we now think that our growth forecasts might need to be revised downwards. This, in turn, will also make the government's very ambitious, if praiseworthy, fiscal consolidation plan more challenging.

In Poland, the fresh inflation report took a fairly sanguine view on the outlook for inflation. The report's projection of a gradual convergence of inflation from 4.2% towards the 2.5% target over the next year amid normalizing food inflation and softer economic growth explains the bank's wait-and-see approach adopted last month. The Monetary Policy Committee now believes that the "substantial monetary tightening implemented since the beginning of 2011" has put it sufficiently ahead of the curve to anchor inflation expectations. Global developments since the last MPC meeting only add conviction behind this decision and are likely to push a resumption of the hiking cycle out into 2012.

In Russia, the central bank appears very confident that inflation will be subdued in the second half of the year owing to the reversal of earlier food price increases. The bank expects headline CPI to end the year below 7% year over year, down significantly from the latest print of 9.0% in July. Hence, monetary tightening, including through allowing additional ruble appreciation, will be on hold at least through the end of the third quarter, despite the rising core inflation or until it becomes clear that the bank's inflation projection is unrealistic. Needless to say, the upcoming double elections and the ongoing downward adjustment in oil prices are both adding a clear constraint on acting preemptively.

In Turkey, the central bank (CBRT) turned more dovish as well, despite the rapidly widening current account deficit, which now exceeds 10% of GDP on a seasonally adjusted annualized basis, and continued weakening pressure on the currency. In its new inflation report released last week the CBRT has taken comfort in the ongoing slowdown in the domestic economy and continued to exude confidence in the efficacy of its unconventional policy mix, which aims to reduce credit growth to 20%–25% year over year from 35% currently without hiking the key policy (1-week repo) rate.

In fact, as the outlook for the global economy deteriorated this week with the release of surprisingly weak PMI data across the world, the CBRT took its unorthodoxy to a new level and shocked the markets by preemptively cutting the 1-week repo rate by 50 basis points to 5.75%, the lowest on record. This move was complemented by a 350 b.p. hike in the overnight borrowing rate to 5.00% (which establishes the floor for market rates) and an announcement that forex sales will be forthcoming. Both moves tighten lira liquidity and make sense as measures to stabilize the sliding Turkish lira exchange rate. But the markets were flabbergasted by the repo rate cut, given the widespread belief that the Turkish economy is currently overheating and needs less rather than more credit growth (through which interest rate policy affects the real economy) in order to reign in the external imbalances. With this move, the central bank has clearly shifted its priorities: away from its self-proclaimed dual objective of price stability (it targets headline inflation of 5.0% next year) and financial stability (i.e. current account deficit reduction) towards supporting growth. By doing so, it has raised further question marks over its credibility at a time when credibility may prove to be the most valuable tool.

To the policymakers' credit, data released by the bank regulator (BRSA) for the latter part of July began to show some sequential deceleration in credit growth to the private nonfinancial sector. This may imply that the tightening of regulations on consumer credit loans by the BRSA after the June elections, as well as BRSA 'moral suasion' and outright threats to the banks may have started to bite. Yet it remains to be seen whether this sequential slowdown in credit growth can be sustained. Even if it is, we're not sure that it will be enough to reign in the problematic current account deficit fast enough in order to arrest the weakening of the lira without additional measures in a global environment of rising risk aversion.

	Real Growth ¹			Inflation ¹			Official Rates ²			Long Rates ²		
	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F	2010	2011F	2012F
Global	4.1%	3.0%	3.7%	2.4%	3.4%	2.8%	1.95%	2.45%	3.05%	3.64%	4.02%	4.25%
(PPP Weighted)	5.0%	3.9%	4.3%	3.0%	4.0%	3.3%	2.6%	3.2%	3.7%	4.0%	4.40%	4.60%
Industrial Countries	2.6%	1.7%	2.8%	1.5%	2.5%	2.0%	0.63%	0.94%	1.72%	3.04%	3.19%	3.55%
Emerging Countries	8.1%	6.4%	6.1%	4.7%	5.8%	5.0%	5.34%	6.46%	6.59%	5.29%	6.29%	6.16%
United States	3.0%	2.3%	3.8%	1.6%	3.1%	2.5%	0.13%	0.13%	1.25%	3.30%	3.50%	4.00%
Canada	3.2%	2.7%	2.6%	1.8%	1.9%	2.2%	1.00%	1.50%	2.00%	3.11%	4.00%	4.25%
Europe	1.7%	1.8%	1.7%	1.9%	2.8%	2.0%	0.96%	1.62%	2.37%	3.25%	3.30%	3.55%
Euro Area	1.7%	1.8%	1.5%	1.6%	2.5%	1.9%	1.00%	1.75%	2.50%	3.19%	3.25%	3.50%
United Kingdom	1.4%	1.3%	1.5%	3.3%	4.3%	2.3%	0.50%	0.50%	1.25%	3.49%	3.50%	3.75%
Sweden	5.4%	4.5%	2.5%	1.3%	3.0%	2.4%	1.25%	2.50%	3.25%	3.28%	3.25%	3.50%
Norway	2.1%	2.8%	3.3%	2.4%	1.9%	2.2%	2.00%	2.75%	3.75%	3.68%	3.75%	4.00%
Japan	4.0%	-0.8%	3.4%	-0.7%	0.2%	0.2%	0.05%	0.10%	0.10%	1.13%	1.25%	1.65%
Australia	2.7%	3.5%	4.5%	2.9%	3.6%	3.5%	4.75%	5.25%	6.00%	5.51%	5.55%	5.75%
New Zealand	1.7%	2.2%	4.2%	2.3%	4.2%	2.4%	3.00%	3.00%	3.75%	5.87%	5.60%	5.75%
Asia ex Japan	9.3%	7.6%	7.2%	4.1%	5.4%	4.2%	4.99%	5.95%	5.76%	4.63%	4.54%	4.26%
China ³	10.3%	9.2%	8.5%	3.3%	5.2%	3.8%	5.81%	6.56%	6.31%	3.91%	3.75%	3.50%
Hong Kong ⁴	7.0%	6.1%	4.2%	2.3%	4.5%	4.0%	0.50%	0.50%	1.00%	2.86%	2.50%	3.00%
India ⁵	9.0%	7.7%	7.5%	9.5%	9.0%	7.5%	6.25%	8.50%	8.25%	7.91%	8.25%	7.80%
Indonesia ⁶	6.1%	5.9%	5.5%	5.1%	6.5%	5.0%	6.50%	7.00%	6.75%	7.61%	7.10%	6.75%
Korea ⁷	6.2%	4.1%	4.6%	3.0%	4.0%	3.5%	2.50%	3.75%	3.75%	4.47%	4.00%	3.75%
Thailand ⁸	7.8%	2.8%	4.0%	3.3%	3.5%	3.0%	2.00%	3.75%	3.50%	3.71%	4.25%	3.75%
Latin America	7.0%	4.1%	4.1%	5.3%	6.2%	6.1%	7.61%	9.66%	10.00%	5.16%	10.92%	10.60%
Argentina	9.2%	7.6%	2.4%	10.5%	13.0%	17.0%	-	-	-	-	-	-
Brazil	7.5%	3.7%	4.4%	4.9%	6.3%	5.5%	10.75%	12.50%	12.75%	4.17%	13.50%	13.00%
Mexico	5.4%	3.5%	4.3%	4.2%	3.5%	3.4%	4.50%	4.50%	5.00%	6.96%	6.25%	6.25%
EEMEA	4.8%	4.8%	4.4%	6.2%	6.6%	6.3%	4.17%	5.19%	6.21%	7.62%	7.85%	8.43%
Hungary	1.2%	2.5%	2.5%	4.9%	4.1%	3.6%	5.75%	6.25%	7.00%	7.97%	7.00%	7.25%
Poland	3.7%	4.1%	3.8%	2.7%	4.5%	3.3%	3.50%	4.75%	5.25%	6.06%	6.25%	6.50%
Russia ⁹	4.0%	4.6%	4.8%	6.9%	8.5%	7.4%	2.75%	4.00%	5.00%	7.48%	8.00%	9.00%
South Africa	2.8%	4.0%	3.8%	4.1%	4.9%	5.8%	5.50%	6.00%	6.50%	8.28%	8.55%	8.75%
Turkey	8.9%	6.5%	4.5%	8.6%	5.5%	6.9%	6.50%	7.25%	9.00%	8.61%	8.55%	8.75%

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: Overnight repo rate and 10-year government bond yield

6) Indonesia: Intervention rate and 5-year government bond yield

7) Korea: Overnight call rate and 5-year government bond yield

8) Thailand: 1-day repo rate and 5-year bond yield

9) Russia: Longest fixed-rate government bond until April 11, 2011;

10-year bond thereafter. Official Rates: CBR's O/N fixed deposit rate

Note: Real growth aggregates represent 27 country forecasts, not all of which are shown.

Source: AllianceBernstein