China soars while the West looks on

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The summer of 2011 is not about to be forgotten: it was a very stressful season, if not very hot (at least in Paris…). In August, global equity markets marked the fourth anniversary of the financial crisis with a market sell-off big enough to qualify as a crack. At the worst of the month, the European and American stock markets were down 17% and 12%, respectively. A rebound of 7% and 8%, at the end of August finally limited the monthly decline to 11% and 4%. Indeed, there have been few reasons for cheeriness. At least, we were spared the worst: the US Congress did manage to reach a last-minute agreement to raise the Federal debt ceiling and European leaders finally came up with a second rescue package for Greece.

10-year government bond yields

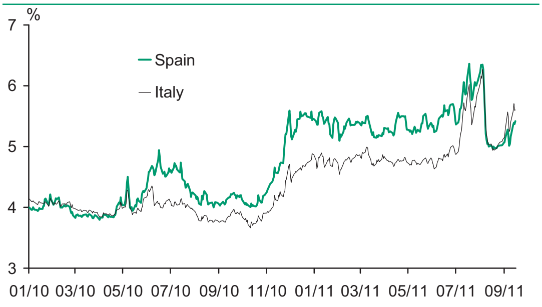

Chart 1 Source: NTM

Yet these decisions failed to reassure the markets. The first two weeks of August were extremely turbulent as contagion fears grew that the sovereign debt crisis could spread to Spain or even Italy. On 4 August, 10-year yields on Spanish and Italian government bonds peaked at 6.284% and 6.195%, respectively, lifting spreads with the German bund to nearly 400bp. The ECB announced that it would restart its Securities Markets Purchasing programme (SMP). Over the following six weeks, the ECB purchased nearly €69bn in European government securities, bringing its total portfolio to €202bn as of 9 September 2011. Yet even this failed to fully restore calm in the markets. Indeed, the deplorable state of public finances in the advanced countries was only one of several problems, and by far the biggest source of concern was the global slowdown in economic growth.

China's brazen growth

The impact of the financial crisis on the real economy began to be felt in 2008. World growth slowed from an average of about 5% a year in 2004-07 to less than 3% in 2008. In 2009, the global economy contracted 0.5%, dropping into recession for the first time since the 1929 depression. Yet these figures mask gaping regional disparities: the recession was much more severe in the advanced economies (-3.4% in 2009 after virtually stagnating in 2008) than in the emerging economies, where growth simply slowed (from +8% a year in 2004-07 to 6.1% in 2008 and +2.7% in 2009). This is where China stands apart: in 2009, during the worst of the global crisis, the Middle Kingdom reported growth of 9.2% and contributed 1.2 points to world growth. Without China, the recession would have been much worse, with global economic activity contracting by nearly 2%.

World growth

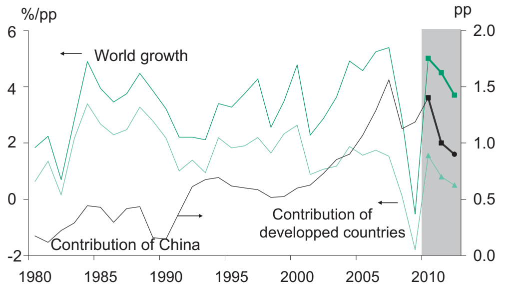

Chart 2 Sources: FMI and BNP Paribas forecast

China pulls through the 2009 crisis almost unscathed

In 2009, China managed to decouple, at least partially, its growth from that of the advanced economies. Faced with the collapse of the country's exports, the Chinese authorities made a bold move. In November 2008, they introduced an enormous stimulus plan that placed priority on infrastructure development and the injection of credit by local banks. This sparked a very rapid expansion in investment in 2009, just as net foreign trade began making a negative contribution to growth.

Yet the government's gamble was not a sure-fire bet. In the decade prior to the crisis, Chinese growth had become highly dependent on world demand for manufactured goods. Merchandise exports as a share of Chinese GDP rose from 20% in 2001 to 35% prior to the crisis in 2007 (before falling back to 27% in 2010). In 2007, net foreign trade contributed nearly three points to GDP growth.

While becoming the "world's factory", China also confirmed its role as a formidable growth engine for the global economy. In 2000-07, China reported an average annual growth rate of 10.5%. The reasons for this spectacular growth are well known. China took full advantage of its immense resources in terms of production factors, including labour (with a rapid increase in low-cost labour, thanks notably to the rural exodus) and capital (with a very high investment rate of over 40% of GDP, easily financed through abundant domestic savings). The country also generated major productivity gains and managed to gradually work its way up the export industry's value added ladder. This led to market share gains, with China accounting for 9% of world exports in 2007, up from 4% in 2000.

With the sudden downturn in the global economic activity, Chinese growth lost some of its vigour, slowing from a record high of 14.2% in 2007 to 9.6% in 2008 (the slowdown in exports coincided with a sharp correction in the housing market) and on to 9.2% in 2009. Nonetheless, the slowdown was still relatively small, and by 2010, growth had already rebounded to more than 10%.

The collapse in foreign trade in late 2008 and 2009 was offset by a solid rebound in investment. The increase in Gross Fixed Capital Formation rose from 10%-15% in real terms in 2004-08 to over 20% in 2009. Strongly encouraged by the central government's stimulus plan, public investment was the first to rebound. Local administrations, in particular, invested massively in infrastructure (notably railways) and real estate projects. A dramatic easing of monetary policy combined with fiscal incentives also fuelled a rapid turnaround in private investment and household consumption in 2009. In 2010, public investment slowed in response to austerity measures introduced by Beijing, as the authorities became alarmed by the surge in property prices as well as in the indebtdness of provincial and municipal governments. Even so, the positive momentum of private demand remained intact. Higher revenues continued to drive household spending; investments in the real estate market maintained signs of overheating; and the rebound in exports helped fuel the recovery of capital expenditure in the manufacturing sector.

As a result, Chinese exports picked up rapidly in mid-2009 and 2010, thanks to the improvement in world demand and new market share gains. Chinese export prices rose very slowly over this period, maintained notably by the stability of the yuan-dollar exchange rate. Chinese exports as a share of world exports continued to increase, rising above 10% in 2010.

China's global market share

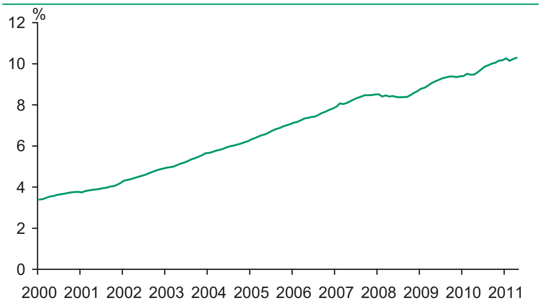

Chart 3 Sources: CEIC, IMF

China : exchange rate

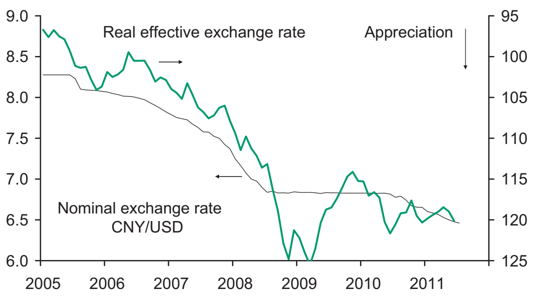

Chart 4

Source: IMF

The yuan is not all that weak

Some accuse China of "cheating" by maintaining the value of its currency at an artificially low level. Admittedly, between July 2008 and June 2010, Beijing pegged the yuan to the dollar to foster financial stability and boost the export sector in the midst of an international crisis. But the truth is that the yuan has steadily appreciated since 2005, and should continue to strengthen in the medium term. Between July 2005 and July 2011, the yuan gained 20% against the dollar in nominal terms and appreciated nearly as much in real effective terms.

China is unlikely to change significantly its foreign exchange policy in the near future. The current "managed" forex regime will probably be preserved. The yuan will continue to fluctuate with reference to a basket of currencies; the composition of this basket is unknown as, in practice, China only publishes the yuan's exchange rate against the US dollar. The peg to the USD, set up during the crisis, ended in June 2010 and the Chinese authorities allowed the yuan to appreciate 2.6% against the dollar through the end of 2010, and then by 2.6% in H1 2011. This pace will probably be maintained over the next twelve months. The authorities will continue to keep a tight grip on the yuan and will probably rule out a strong revaluation of the currency in a context of narrowing trade surpluses and rising industrial labour costs. Moreover, the yuan's appreciation against the dollar might be automatically contained if the European currency weakens.

Although they denounce the practice whenever possible, the Americans and the Europeans have reasons to rejoice in China's currency "manipulation". China holds 27% of the total amount of US Treasuries owned by non-residents. Moreover, China recently said it may be ready to massively buy securities issued by the European Financial Stability Fund (EFSF). By "managing" its currency, China is also financing the advanced countries.

Growth slowdown in 2011 is under control

In 2011, Chinese growth slowed to 9.7% (year-over-year) in Q1 and 9.5% in Q2 in response to a tighter economic policy, deteriorating production conditions in the manufacturing sector (higher costs, tighter lending conditions) and an increasingly lacklustre international environment. The Chinese economy is expected to continue losing steam in the quarters ahead, although it will maintain a still robust growth rate of 9.2% this year and 8.5% in 2012.

The downturn in US and European growth prospects over the summer months has led to only mild adjustments in our 2011 and 2012 forecasts for Chinese growth. Once again, the sluggishness of the advanced economies should rather sharply reduce the contribution of net foreign trade to Chinese growth. And as mentioned above, the authorities are unlikely to use the exchange rate policy to try to stimulate exports (by halting the nominal appreciation of the yuan). Domestic demand, while still proving solid, is also expected to keep with the slowdown trend observed since the beginning of the year.

Faced with the ongoing surge in inflation, which hit 6.2% in August 2011, the authorities have continued to tighten monetary policy and are expected to maintain this stance in the very short term. The government's number one concern is the risk of social unrest arising from higher food and housing prices. Consequently, the fight against inflation will remain at the top of its priorities, even if that means more moderate growth. The authorities will also probably continue to tighten their credit policy in order to strengthen further their grip over the financing activities of the banking sector – this possibly explains why it was decided in late August to expand the deposit base on which banks must calculate their required reserves. As a matter of fact, banks will now have to manage the consequences of the surge in lending and off-balance sheet activities since 2009 on the quality of their assets.

China's real GDP growth

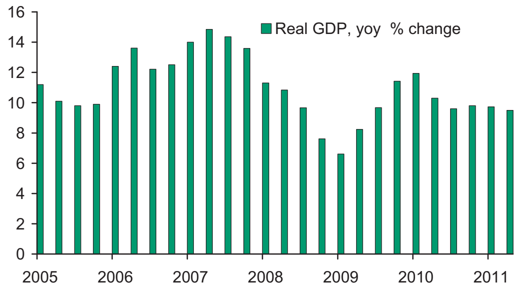

Chart 5 Source: CEIC

China's inflation

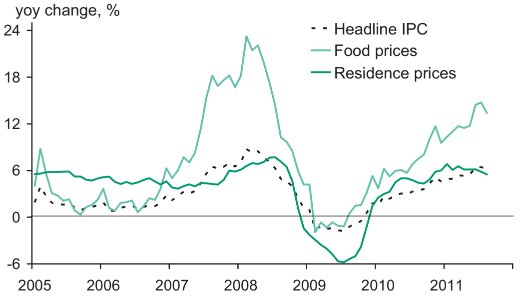

Chart 6 Source: DataInsight

Nonetheless, a hard landing scenario for the Chinese economy is unlikely in the short term. China benefits from major growth stabilizers. For instance, thanks to rising wages, household spending proves solid, and public investment will continue to be supported by the ambitious programme to build low-income housing. Besides, some leeway on the monetary policy front could emerge once inflationary pressures lessen, which is expected sometime before the end of the year.

On the fiscal policy front, some options exist, even if not numerous following the rapid increase in the debt of provinces and municipalities in 2009-2010 (now estimated at 35% of GDP) with growing concerns over their medium term solvency. But the central government continues to have ample resources to respond to a severe slowdown in activity. With official debt of less than 20% of GDP and deficits of less than 3%, the central government has the resources to launch new public investment projects, for example, or to reintroduce tax incentives to stimulate household spending.

Towards single-digit growth rates

The current downturn in world demand and its impact on China's economic cycle coincide with a more structural slowdown in Chinese growth. China is indeed expected to strike a new balance between its sources of growth in the years ahead – a process that has been engaged with the launch of the 12th five-year plan in 2011. The 2011-2015 plan calls for "harmonious" rather than "double-digit" growth, which implies reaching a better equilibrium between exports, investment and household consumption, and also between the inner provinces and coastal regions. It also implies a better distribution of wealth within the population. By shifting the priorities of its growth model, the Chinese authorities will still aim for robust growth, although they should become more tolerant of slightly milder growth rates.

Consequently, GDP growth is expected to average about 9% a year in 2011-15, down from 11.7% in 2003-2007. Exports will remain a major growth engine, although export growth will not be as buoyant as in 2000-2008. Chinese industry is well positioned to continue winning global market shares. While labour costs continue to rise and the yuan gradually appreciates in the medium term, China should be able to remain the world export leader, for several reasons. First, China's "non-price" competitiveness is also high (thanks to its infrastructure, supply networks...). Then, higher wage costs in the coastal regions will encourage companies to relocate factories not only to neighbouring countries with lower labour costs, but also to the inner provinces of China where production costs are still low. Also, higher wage costs should lead the coastal regions to continue to climb the industrial value-added ladder, all the more so as some sectors could benefit from the financial support of the government.

Moreover, household consumption, which currently accounts for only 35% of GDP, should gradually rise over the years ahead. Its expansion will be driven by the continued increase in wages and by structural reforms aimed at enlarging the supply of low-income housing, improving pensions and healthcare services, and reducing the cost of education. These reforms should encourage Chinese households to reduce their savings in the medium-long term. Although the process is likely to be very slow, it nonetheless seems to be underway, as illustrated by the big minimum wage hike in 2010 and accelerated efforts to complete projects to build public housing or to advance healthcare and pension system reforms.

The developed world runs out of steam

Consequently, we expect resilient growth in China as well as in most of the emerging countries (see box). The big question is whether this contribution will be big enough to offset the slowdown taking shape in the advanced economies? The first half of 2011 was very disappointing for the developed countries. In the US, GDP growth averaged only 0.7% (quarterly annualised rate) in the first six months. At +2%, the figure for the euro zone was much stronger, but this was due to a Q1 rebound after the year-end period was hit by severe weather conditions. The slowdown in growth from the first to the second quarter is particularly striking, from 3.4% to 0.7%. Of course, there were numerous external shocks: the Arab Spring, the wave of freedom that swept across North Africa and the Middle East, triggered an upsurge in oil prices while the natural disaster that devastated Japan disrupted global supply chains.

Global manufacturing PMI

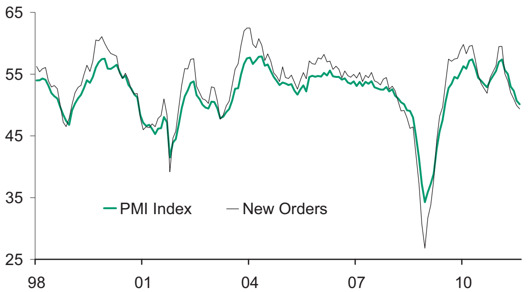

Chart 7 Source: Markit Group Limited

Just a few months ago we were still expecting a strong rebound in activity in H2 2011. The surveys released in the meantime, however, have dampened our enthusiasm. Between February and August, purchasing manager indexes (PMI) for the manufacturing sector plunged, down 10 points in the euro zone and nearly 11 points in the US. The decline in the new orders component was even more dramatic (-14 and -19, respectively). Yet in the US, the composite index held above 50 points and the new orders component rebounded (albeit very slightly).

Could this be signalling that the worst is over? Even if this were the case, the recent slowdown in activity will continue to strain employment for quite some time.

Job market slump

Indeed, the only countries with favourable unemployment rates are Germany (6.1%, under the standards of the International Labour Organization) and Japan (4.7%). In the euro zone as a whole, the unemployment rate is still about 2.5 points higher than pre-crisis levels. Jobless rates have reached alarming levels in Spain (21%), Greece (16.6%) and Ireland (14.3%). In the US, the spread is nearly 5 points. During the worst of the crisis, unemployment soared by nearly 9 million, and this figure has since declined by only 1.6 million, or by about 20% of the increase. In the euro zone, the number of unemployed did not increase as much (by less than 5 million), but the subsequent rebound was also more limited (300,000, or about 6.5% of the increase). As a result, disposable household income is being squeezed on two sides: job destructions have driven up the unemployment rate, curbing nominal wage growth, and inflation has surged, notably for energy and food prices. Consequently, real disposable household income is still about 2% below the mid-2008 peak in the US.

Unemployment

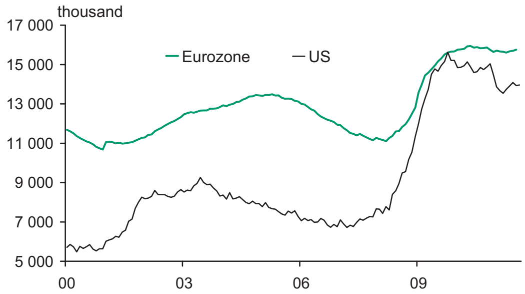

Chart 8 Sources: US Bureau of Labor Statistics, Eurostat

Box: Financial turmoil: What impact on the emerging countries?

With the spectre of a severe economic slowdown, if not a recession, looming over the advanced countries in the months ahead, we are once again faced with the question of the resilience of the emerging economies. Events in late 2008 and early 2009 largely discredited the "decoupling" theory, at least in absolute terms. Will this still be the case in 2012? This is a tough question because we must not minimise the real contagion effects via foreign trade, while taking into account the fact that so far the financial shock has been much smaller than the one following the collapse of Lehman Brothers in September 2008.

Financial contagion: limited and differentiated

So far, the financial contagion effects on the main emerging countries have been fairly limited on the whole, and differentiated by country and by issuer quality (for risk premiums).

In the wake of the downturn in the US and European equity markets, the MSCI emerging countries index has lost 17% in dollar terms since the end of July. All of the emerging country equity markets were affected. According to EPFR data from fund managers, dedicated emerging market equity funds reported withdrawals of $15bn in August 2011, as much as the cumulative total for September and October 2008. Yet as a percentage of total assets under management, last month's withdrawals were more or less equivalent to the average of September/October 2008 (about 2%). Moreover, available national statistics on capital flows do not indicate any massive outflows. The equity market correction was also nowhere near as severe as the one following the collapse of Lehman Brothers.

The correction has also been severe on the forex markets. Currencies in Asia have generally less suffered than in other regions with depreciations of less than 10%. Excluding Asia, the strongest depreciation moves (between 15% and 20%) have affected currencies of the "large economies" (Brazil, Mexico, Poland, Hungary, South Africa) having received extensive capital inflows since 2010 and/or seen as highly exposed to the growth slowdown in the advanced economies. During a similar time period, the correction is therefore as severe as after "Lehman".

Risk premiums rose on debt denominated in international currencies: by about 110 bp for sovereign debt according to the JP Morgan-Chase composite EMBI+ index and by 130 bp for corporate debt according to Credit Suisse's CEMB index. Yet the spreads for emerging market issuers were still moderate at 390bp and 470bp, respectively. Once again, the deterioration was much smaller than in 2008, when the EMBI+ spread widened to a little over 500bp between mid-September and the end of October. The premium on the dollar in cross-currency swaps also widened, but much less than in 2008.

Exports are expected to contract, especially for central European countries and many of Asian ones

The emerging countries were not sheltered from the slowdown in world trade, which was already underway as early as mid-2010. According to estimates by the Netherlands Bureau for Economic Policy Analysis (CPB), merchandise export volumes for the main emerging countries slowed from a little more than 20% a year in mid-2010 to 7.3% in June 2011. Since spring, exports have stagnated or declined in value terms in a growing number of countries. The new export orders component of the PMI indexes has dropped below 50% since July or August in all of the countries covered by the surveys, which normally signals a decline in exports.

Of course, survey results have not eroded as much as in late 2008, but they have deteriorated at a similar, alarming speed.

Central European and Turkey are by far the ones with the highest direct exposure to a slowdown in the developed countries, since i/ the European market accounts for a very big share of the exports of each country (more than or equal to 50%). ii/ for several of these countries, exports make up a very big share of GDP (notably the Czech Republic, Hungary and Slovakia). Latin America is still relatively well protected despite the weight of the United States in Mexico's foreign trade. For the emerging countries of Asia and even more so for the region of North Africa (excluding Algeria) + South Africa, the aggregated results mask wide disparities that bias the analysis. In Asia, Hong Kong, Malaysia, Singapore and Thailand are particularly exposed since exports to the advanced countries (as a share of GDP) is close to or higher than 20%. India and Indonesia are the only countries in which the share of exports is less than 10%. In North Africa, Tunisia has the highest exposure due to its trade relations with Europe, while Israel is hard hit given its trade with the United States. Yet if we solely take into account manufactured goods exports and tourism revenues (a slightly more indirect effect), then Morocco and Egypt are also vulnerable. Lastly, we must also point out that the oil producing countries, despite their special status, are also highly dependent on imports from the developed countries, especially when the decline in world oil prices (which ordinarily fall more rapidly than prices of manufactured goods) coincides with a decline in export volumes.

More reactive monetary policies

Faced with the slowdown in growth observed in H1 2011 and with forecasts of worse to come in H2, the monetary tightening phase initiated in mid-2010 has come to an end in most of emerging countries. Only the central banks of China, India and Thailand continued to raise their key policy rates over the summer due to persistent inflationary pressures. Inversely, the central banks of Brazil and Turkey began to lower their key rates.

Inflation has slowed in all countries, as illustrated by the levelling off of year-on-year inflation in both the headline and core consumer price indexes (the later excludes energy and food prices). Oil and food prices have slowed sharply since last spring.

Compared to 2008, the central banks are expected to be more reactive because most of inflation rates will already have passed its peak during the summer months, precisely due to the slowdown in commodity prices. In August 2008, oil prices were still rising by 60% yoy and food price inflation was near 30%, compared with 20% and 25%, respectively, in August 2011. Moreover, the central banks should be even more prompt to ease their refinancing conditions since exchange rates are more resilient than in 2008.

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The financial contagion effects on the emerging countries seem to be fairly limited so far, and in any case are much smaller than in the aftermath of the collapse of Lehman Brothers, the benchmark event that triggered a systemic financial shock. In 2008, foreign trade surely had an even bigger multiplying effect since the financial shock was more severe. Even though corporate surveys are now showing a sharp downturn in order books, it seems unlikely that world trade would freeze up like it did in late 2008. Moreover, the central banks can be more reactive given the slowdown in commodity prices. Consequently, the real shock should be less severe, and growth in the emerging countries as a whole is likely to hold within a range of 4.5-5.5% vs 2.5% in 2009.

François Faure

Households' disposable income

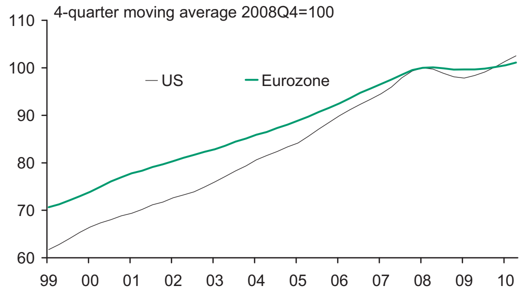

Chart 9 Sources: US Bureau of Economic Analysis, Eurostat

Austerity!

In brief, households in the rich world are unable to make a big contribution to growth. In many countries, like the US, Ireland and Spain, households must clean up their balance sheets, reducing debt and raising savings ratio. Job markets are also too tight to provide households with the necessary revenues. This brings us to the question of government support. Yet the markets have made it clear that the advanced countries are too heavily in debt and must reduce their public deficits. This is why austerity has become the guiding principle for fiscal policies in both the euro zone and the US. The only exception is the UK, one of the first countries to set out on the path to austerity in early summer 2010: although it is not abandoning austerity, the government does not plan to tighten the screws any further. In the rest of Europe, numerous budget savings plans have been announced during the summer. Of course, the countries placed under the protective wing of the IMF and EFSF have been particularly aggressive.

At the end of June, Greece had to approve another series of measures to save the equivalent of 2.8 points of GDP in order to win acceptance of a second rescue package. In mid-September, some more drastic austerity measures were announced (increasing the number of civil servants to be suspended on partial pay to 30,000 this year from 20,000; monthly pensions above EUR 1 200 will be subject to a 20% cut and the tax-free limit on annual income will drop to EUR 5 000). In Portugal, the government is determined to balance the budget within the next five years through drastic spending cuts (equivalent to 7 points of GDP, including an extended freeze on public sector wages, accelerated cutbacks in public sector jobs and a reduction in welfare benefits) and tax increases (including the introduction of a new "solidarity" income tax on the highest earning households and companies).

In other countries, interest rates have risen sharply even though there are no signs of solvency issues. Italy was particularly quick to react: it took the Chamber of Deputies just a week to approve measures to reduce the deficit by €48bn! The Italian government then announced four additional measures designed to balance the budget by 2013 instead of 2014 as initially planned. These measures include reducing pension financing, tightening measures against tax fraud, reducing the government's general standard of living and eliminating certain local administrations, while increasing the VAT rate and taxes on gambling and financial assets. Between 2011 and 2014, Italy's public deficit will be reduced by €145bn, equivalent to about 9% of GDP. These measures were judged insufficient by Standard & Poor's, which decided to downgrade Italy's sovereign rating (from A+ to A, with a negative outlook). Once more, we question this decision: Italy may have a high level of debt, however its sustainability is no problem (see EcoWeek #11-33 "Debt dynamics in Italy"). In comparison, the Spanish government's reaction seems more like fine tuning, with only €5bn in additional measures aimed at ensuring it meets this year's deficit target.

The Italian and Spanish governments also agreed to adopt the "golden rule" balanced budget amendment. This could encourage other euro zone countries to adopt the balanced budget rule, a proposal made by Nicolas Sarkozy and Angela Merkel in mid-August. At the 21 July summit, the leaders of the euro zone also decided to tighten the fiscal targets of all member countries: all budget deficits must be brought below 3% by 2013. To meet this new development, France and Germany announced their own fiscal austerity measures (see EcoWeek #11-30 "France: summer revisions" and "Germany: public deficit below 3% of GDP as of 2011").

Central bankers at the bedside of an ailing economy

In an ideal world, the economic situation would call for fiscal stimulus, not austerity. But as the summer months have made all to clear, we do not live in an ideal world. Yet although growth is slowing, it is hard to imagine another global recession. The factors that normally spark a sharp contraction in activity, such as excessive stock-building, over-consumption (notably of durable goods) or over-investment (notably in the housing sector), are absent from the current picture. It is clear that the developed economies are convalescing, and the least supply-side shock (surging oil prices, a major natural disaster) could weaken them further. Under these circumstances, central banks remain a non-negligible source of support.

Monetary policy rates

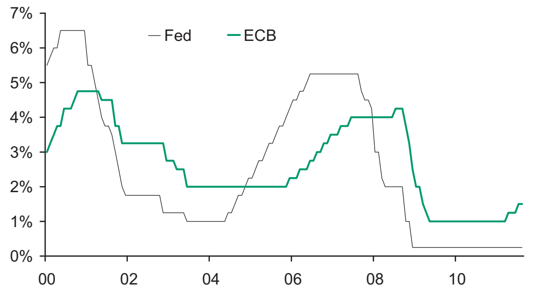

Chart 10 Sources: US Federal Reserve and ECB

ECB balance sheet

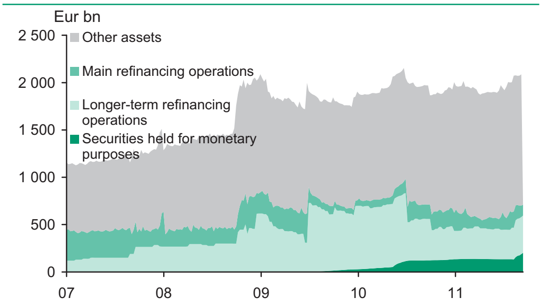

Chart 11 Source ECB

The central banks have come out in force recently by deciding to act in unison to provide unlimited liquidity in dollars (the Fed, ECB, BoE, BNS and BoJ). In Europe, the economic slowdown and milder inflation paves the way for the ECB to cut its key rate. In the US, the Fed no longer has room to lower key rates, but this does not mean it is helpless. At the FOMC meeting in early August, the Fed reviewed the non-conventional tools at its disposal:

1) Clearly report FOMC guidelines on the likely path of monetary policy;

2) Extend the average maturity of the Fed's portfolio without increasing its size;

3) Lower the interest rate paid on excess reserves balances of banks held at the Fed;

4) Launch another round of quantitative easing.

The first tool was already used in August when the FOMC members announced their intentions to hold interest rates at current, very low levels through mid 2013. At the September meeting, FOMC members (at least part of them, see EcoWeek #11-33 “Twist and shout”) decided on using the second tool, namely Operation Twist, the sequel. Over nine months, the Fed will purchase long-term Treasuries (maturities of 6 to 30 years) worth USD 400 bn, while selling short-term Treasuries (maturities of 3 years and less) for an according amount. This will leave its balance sheet unchanged… at least for now. Indeed, we cannot rule out another wave of quantitative easing (QE3) to be decided later on. Such a decision would be highly controversial, though. QE2 was what led to dissidence among FOMC members, raising harsh criticisms from numerous politicians. Additionally, QE2 played a key role in the episode of surging commodity prices. However, the Fed will decide on another wave of quantitative easing based on the trend of the US labour market… and nothing else.

Federal Reserve balance sheet

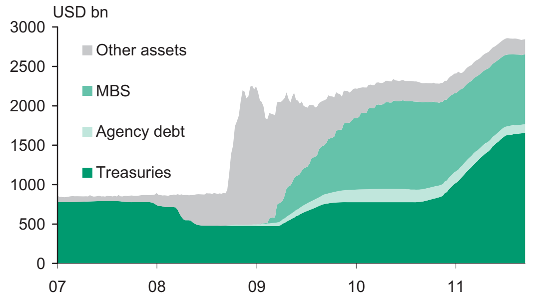

Chart 12 Source: US Federal Reserve

All of these factors have obviously led us to forecast a global economic slowdown next year. Even so, growth should be stronger in 2012 than in 2009. With growth ranging between 1% and 1.5% in the advanced countries and about 8.5% in China, world growth should hold above 3%. This breakdown of growth will have consequences on prices for commodities. They are likely to remain high despite the Western slowdown. Let’s hope the winter will not be too cold…

22 september 2011

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Registered Office: 16 boulevard des Italiens – 75009 PARIS
Tél : +33 (0) 1.42.98.12.34 – Internet : www.bnpparibas.com
Publisher: Michel Pébereau
Printed in France by: Ateliers J. Hiver SA – Dépôt légal: September 2011
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