

**Institutional  
Banking & Markets**

# What's on the Economic Horizon?

## Risks & Issues in 2009

### Exploration Group Forum Launceston

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14 May 2009



**Commonwealth**Bank

# Important Information

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# Outlook

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- **Global Growth – including China**
- **Domestic Growth**
- **Interest Rates**
- **Infrastructure Spending**
- **Housing Sector**
- **AUD & Equities**

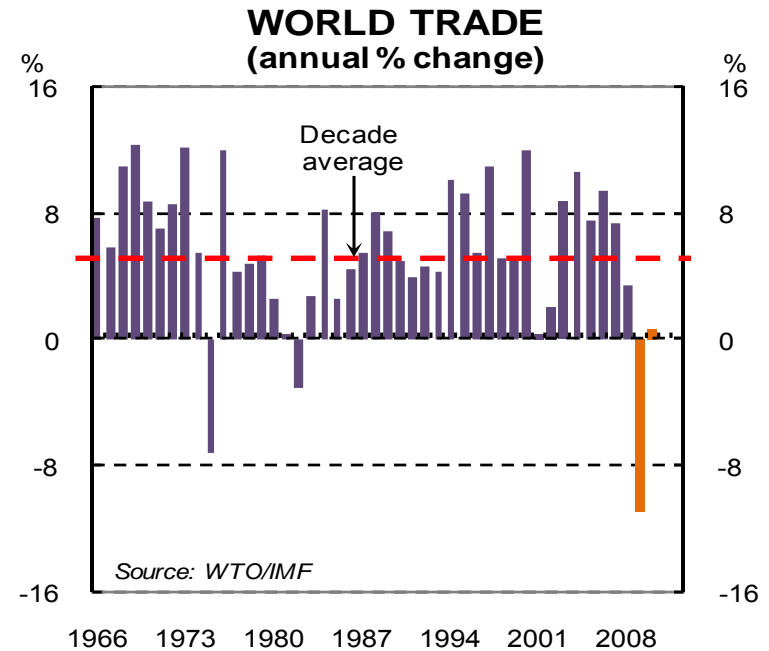
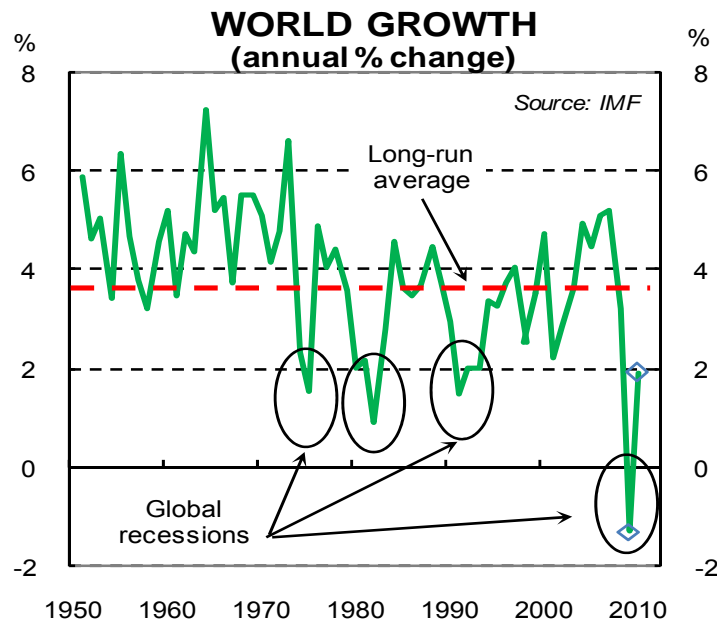
# Our View

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- **Advanced economies in deep recession & emerging economies have slowed**
  - global initiatives will restore market stability and support activity (eventually);
  - no lasting return of market confidence until 1) US house prices level out; & 2) US financial system stabilises and is heading back to normalcy;
  - Australia needs China's GDP to be growing >7%; commodity prices have overshot.
- **Australia's non-farm economy in recession – relatively shallow versus G7 nations**
  - Oz policy makers acting pre-emptively – rate cuts and fiscal spending still work;
  - bursting of the mining/capex boom the main domestic downside risk;
  - growth diverse - some sectors (ie housing, non-discretionary retail, infrastructure) will be OK.
  - headline inflation slowing quickly but some *core* inflation *risks* remain.
- **Economic policy and markets**
  - RBA to cut further – likely terminal cash rate 2¾% - with downside risks;
  - powerful fiscal initiatives in play; more substantial stimulus in latest 2009/10 Budget;

# The Global Backdrop

## Global recession

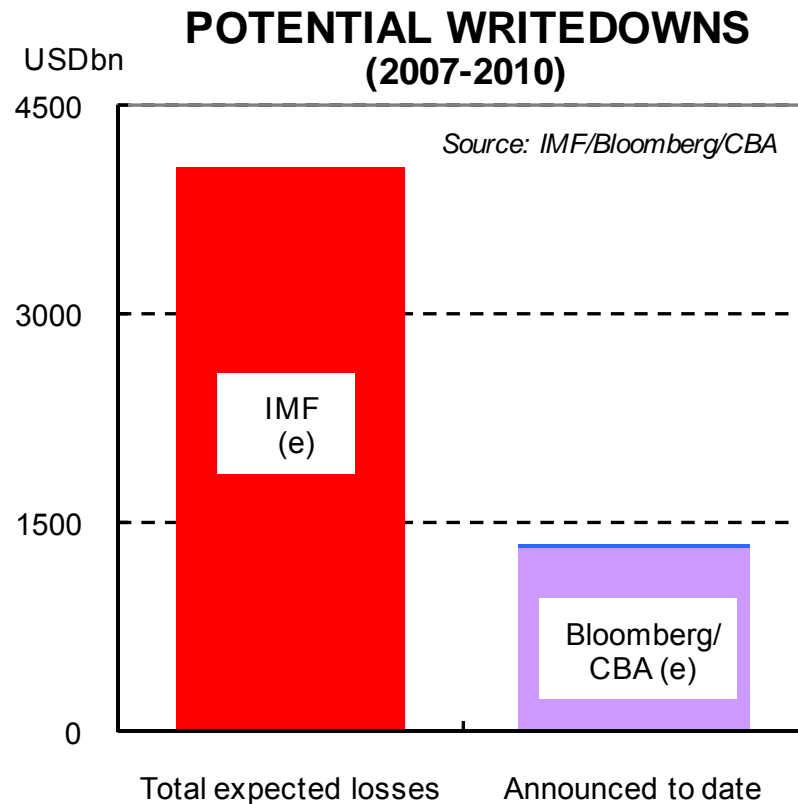


### US, UK & Europe in deep recession but Asia still growing

- no lasting return of confidence & G7 recovery until:
  - US house prices bottom out; and
  - Credit markets become “unclogged” to revive “pole-axed” global financial system.
- Global growth to post first drop (-1.3%pa) since World War II in 2009.
- Global trade to shrink for first time since 1982/83 recession.

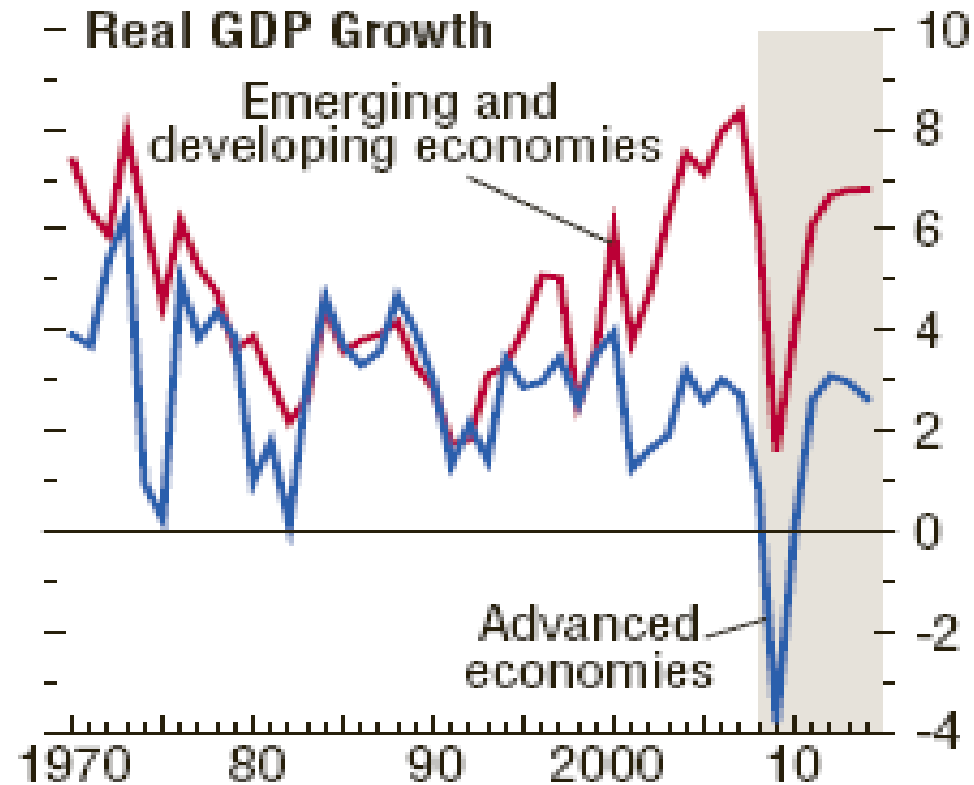
# Liquidity, Capital & Confidence

## Disclosure scorecard



- IMF estimates potential financial sector write downs at USD4.1trn.
- USD1.3trn written off to date.
- So 33% of potential losses accounted for so far.

# World Growth: Asia's outlook much better than G7

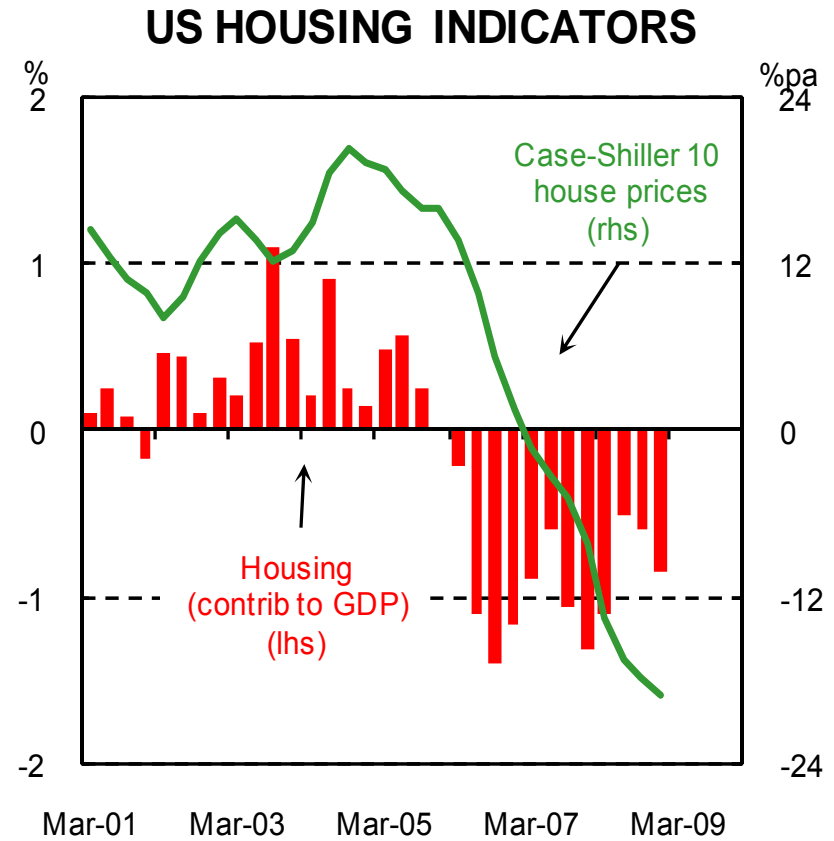
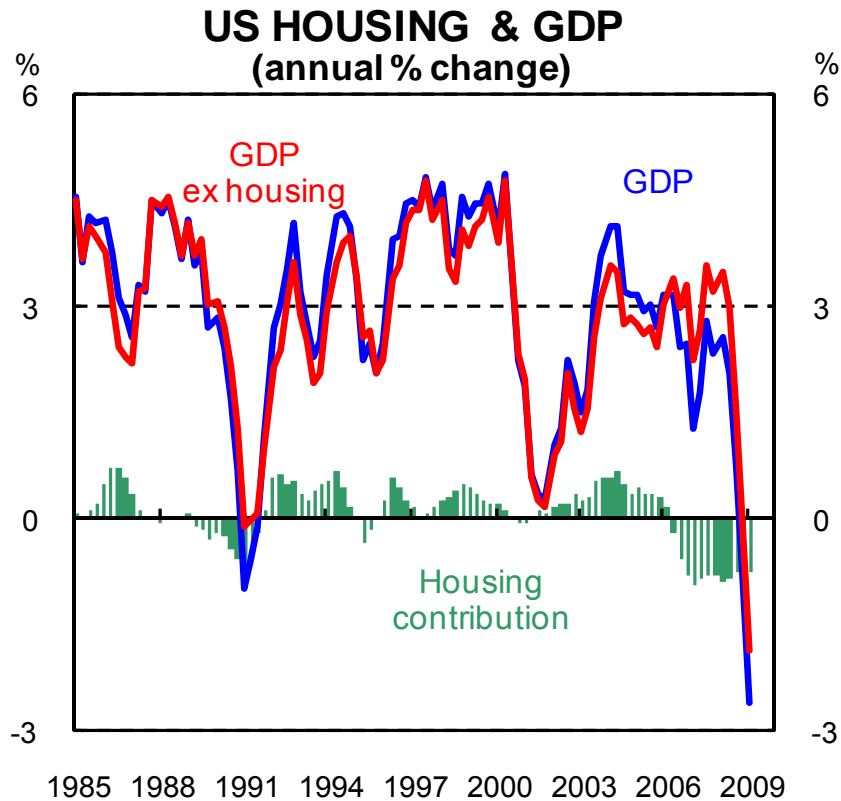


SOURCE: International Monetary Fund

- ❑ IMF sees developing Asia GDP growing by 4.8%pa in 2009 from 7.8%pa. in 2008.
- ❑ G7 economies to shrink (by 3.8%pa) in 2009, & then modest 1.9%pa growth in 2010.

# US Housing on the Ropes!!

## Train Wreck !



- **US housing sector in black hole – dragging US economy down...and out!**
- **US house prices and building activity continue to slump.**

# What's Happening

## All hands to the pump

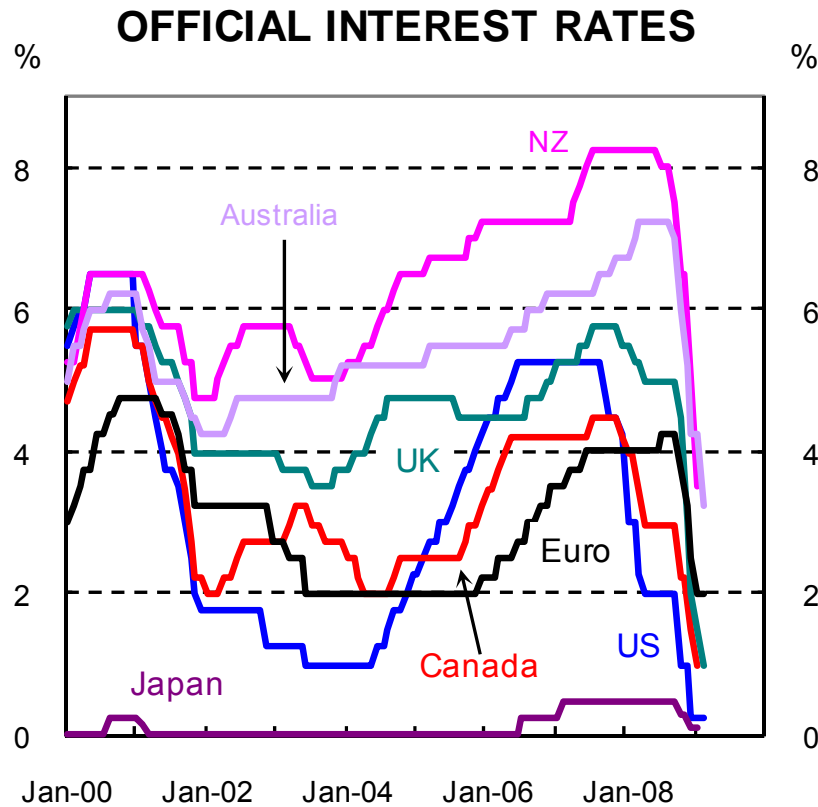
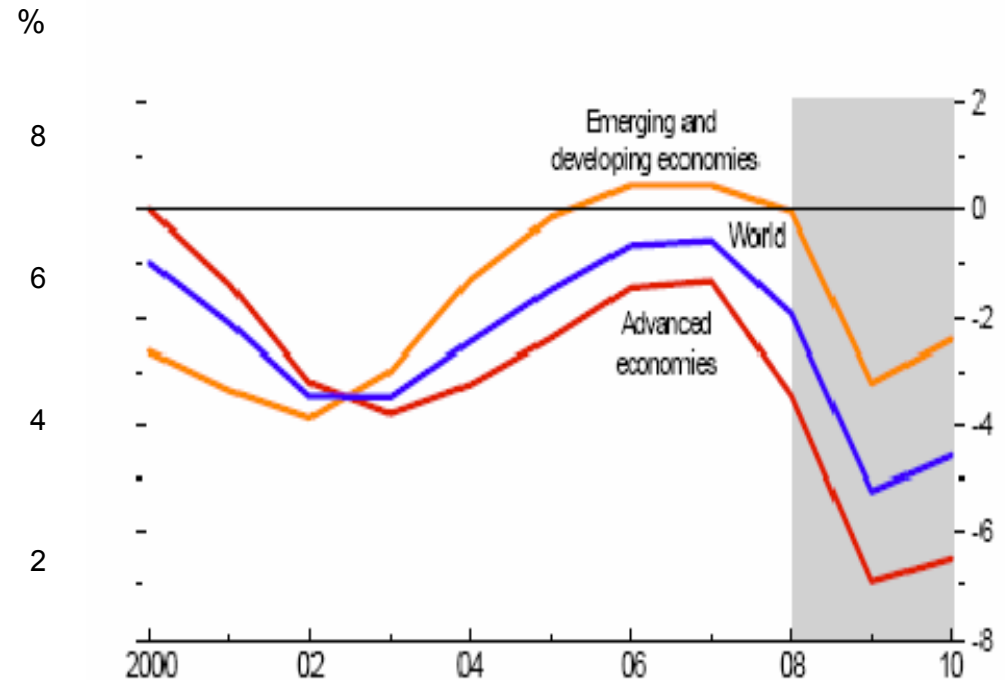


Figure 6. General Government Fiscal Balances (Percent of GDP)



Source: IMF staff estimates.

- Interest rate cuts have been large and rapid.
- Fiscal policy playing a major role.

## Australia has been “fire-proofed” to a degree:

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- ***Well regulated financial system*** with banks in comparatively good shape
- ***Oz housing sector*** in good shape in sharp contrast to US & UK
- ***Massive deregulatory reforms*** of Fed Governments in 1980s & 1990s modernising economy resulted in an open, efficient, flexible, outward looking, low inflation and high productivity economy. Oz poised to take advantage of global recovery led by China & emerging economies.
- ***Monetary and fiscal policy levers*** have allowed authorities and Government to impart large pre-emptive stimulus at maximum speed.
- ***Australia in the right place*** in the sense that many of our major trading partners in Asia continue to grow –ie China, India & ASEAN. These partners, especially China, are also showing glimmers of hope for some revival in activity, and will likely be first economies to recover.
- ***AUD has fallen 30% vs USD*** since mid 2008 – a boost to exporters & import competing sectors.

# Australian Economic & Financial Market Outlook

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## Direction of Risks in 2009

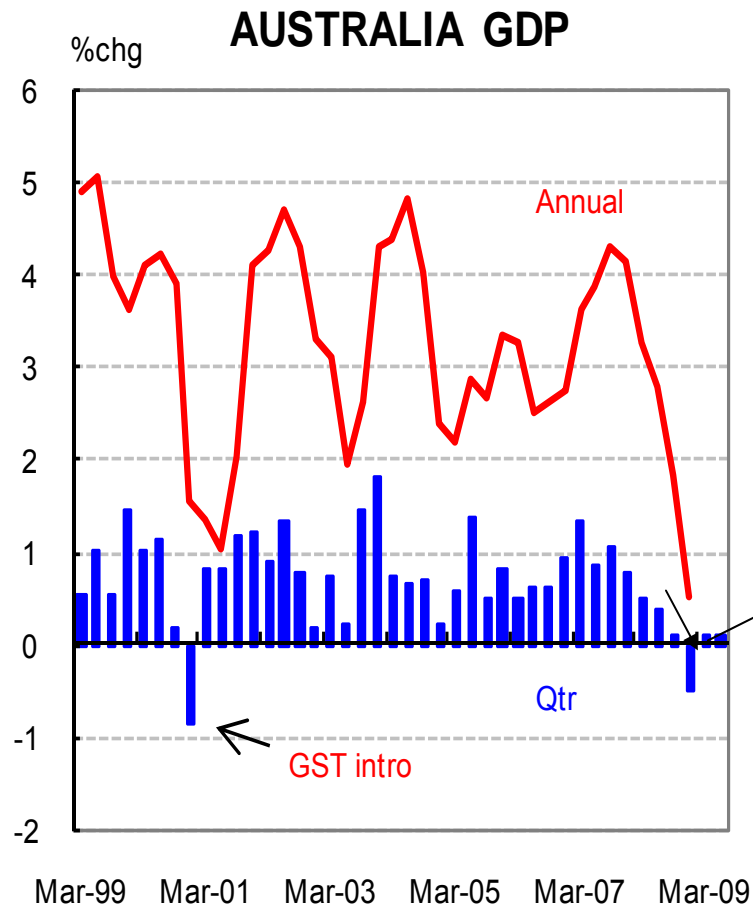
<b>International Growth</b>	↓	<b>Global growth to slump to -1.3% pa</b> - Advanced economies to shrink by 3.8%pa
<b>Domestic Growth</b>	↓	<b>To contract by 0.5%pa</b> - Household spending & dwelling investment <i>weak</i> - Business invest. <i>easing</i> . Fed & State Govt spending <i>strong</i> . Farm sector & net exports to <i>post positive growth</i>
<b>Monetary Policy</b>	↓	RBA has cut rates by 4.25% to 3% since Sep <b>Biggest cuts since early 1990s &amp; now at early 1960's levels</b> - We see more easing (ie 2¾% cash) by mid 09
<b>Underlying CPI</b>	↓	To ease to 2½–3½% in 2009/10.
<b>AUD Outlook</b>	↑	<b>US\$ 0.77 by end December 2009</b>

## Key Risks to Australian Outlook:

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- ❑ **Further faltering consumer spending as unemployment rises**
- ❑ **Sharply deflating capex boom**
- ❑ **Further loss of momentum of China & major trading partners like India & ASEAN.**
- ❑ **A further meltdown in global credit markets (like in wake of Lehman Bros fiasco) – eg failure of US Administration’s current banking bailout package.**

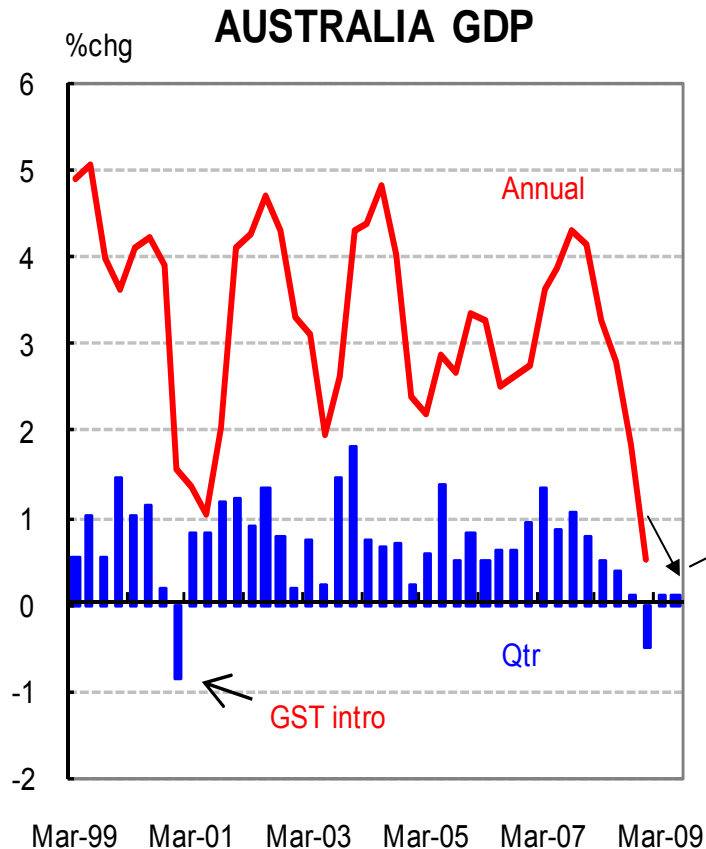
# Australia: 2009 GDP headed for 0% to -0.5%pa



## SECTORS WITH WEAKEST GROWTH OUTLOOK

- Retail (discretionary) & new car sales
- Manufacturing – car industry, textiles
- Commercial construction, rentals & fit-outs
- Professionals: architects, surveyors, legal/finance
- Mining construction, related services groups
- Finance, stockbroking, commercial lending
- Mining export sectors & related loading/transport

# Australia: 2009 GDP headed for 0% to -0.5%pa

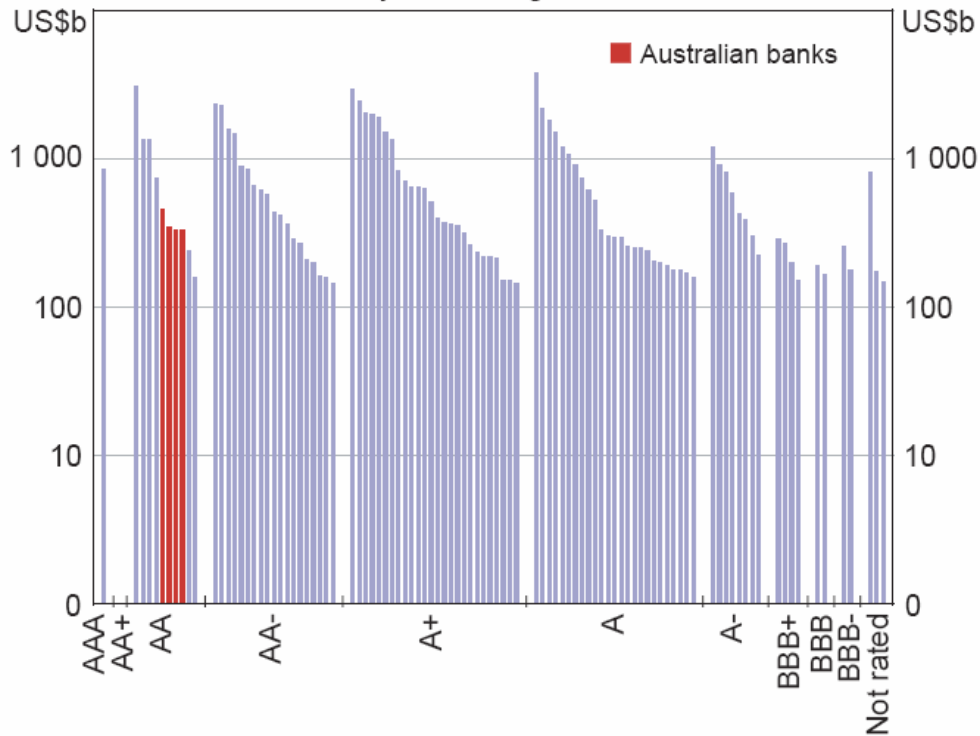


## SECTORS WITH STRONGEST GROWTH OUTLOOK

- Infrastructure – roads, rail, water, power related construction, engineering & services
- Government – defence, education, health
- New housing construction, alts & adds
- Domestic tourism
- Insolvency

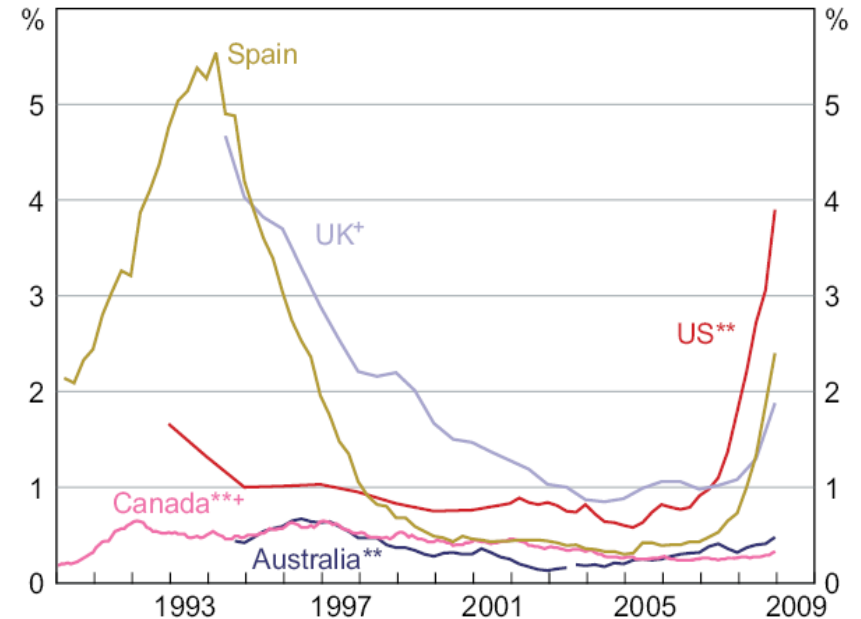
# Oz banks in much better shape than G7 banks

**Credit Ratings of the Largest 100 Banking Groups\***  
By assets, log scale



\* Holding company ratings  
Sources: Bloomberg; *The Banker*

**Non-performing Housing Loans**  
Per cent of loans\*



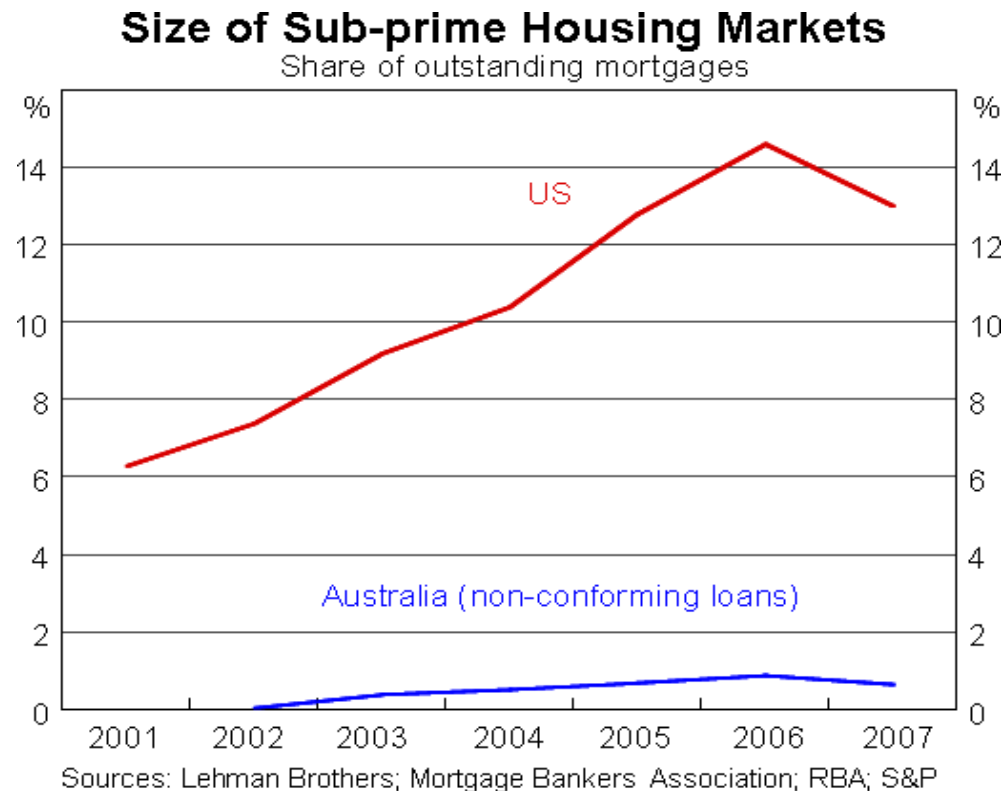
\* Per cent of loans by value. Includes 'impaired' loans unless otherwise stated.  
For Australia, only includes loans 90+ days in arrears prior to September 2003.  
\*\* Banks only.  
+ Per cent of loans by number that are 90+ days in arrears.  
Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC

- **4 Oz major banks are among only 11 globally with AA Rating or better!**



# Australia is Different

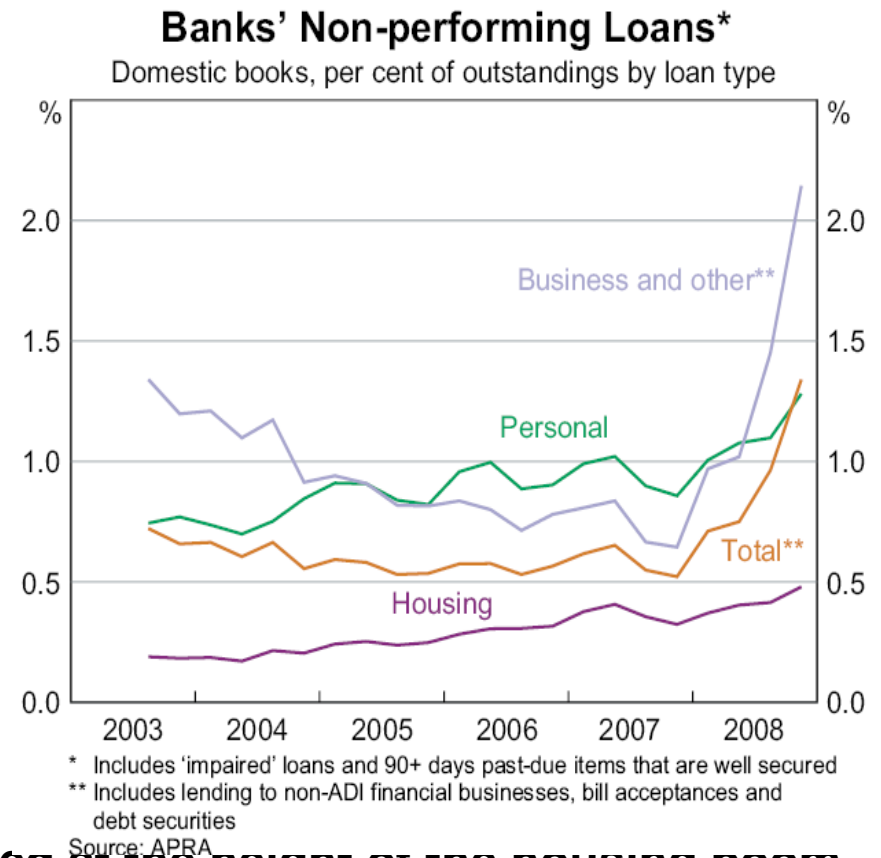
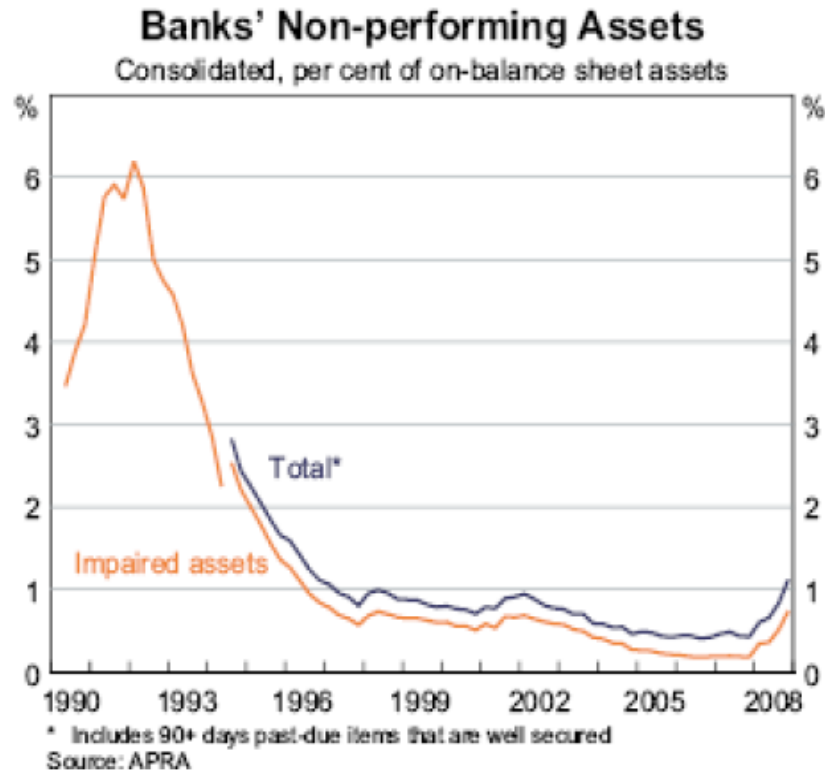
## Less sub-prime risk



- **Non-conforming segment closest approximation to US sub prime.**
- **Arrears in non-conforming segment up – but <1% of loans (vs 13% in US).**

# Contagion & Australia

So Far So Good !!



■ **Strains greatest for those who borrowed at the height of the housing boom.**

Source: RBA Financial Stability Review, March 2009

# Honey I shrunk the Banks !!

Oz banks in much better shape than G7 banks



Source: JP Morgan: Market Value: QII 2007 = \$US1,726bn; QI 2009 = \$US511bn

# An apt quote as US, UK & Europe nationalise banks

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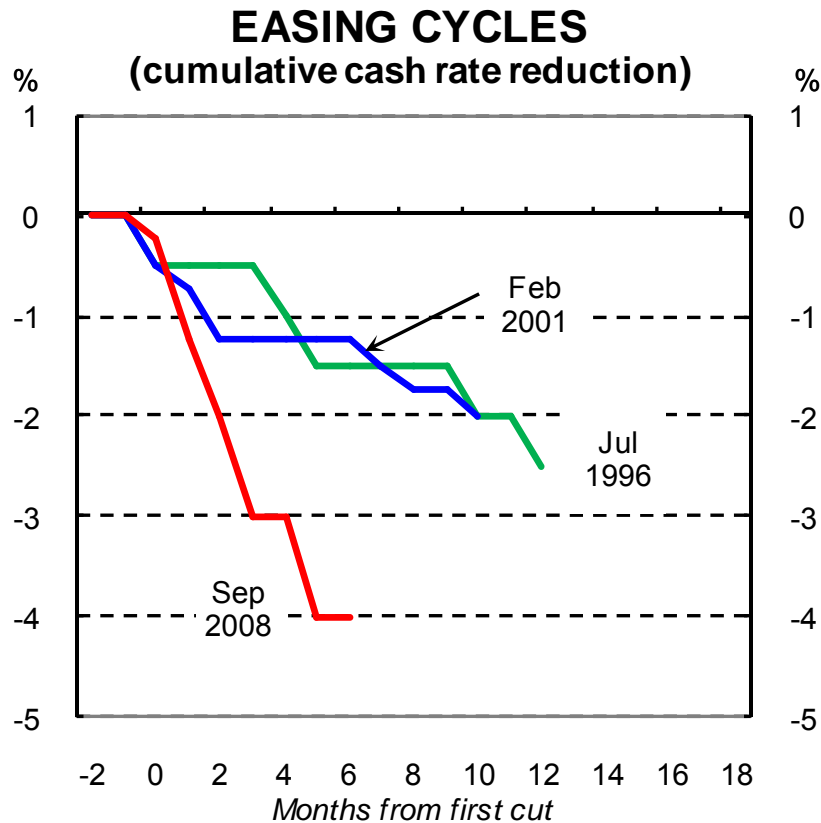
Doing whatever it takes!

***“ It does not matter if a cat is black or white  
....as long as it can catch mice!...”***

**The late Chinese Premier Deng who  
commenced market revolution in China in late  
1970s and 1980s.**

# How Far Will The RBA Go?

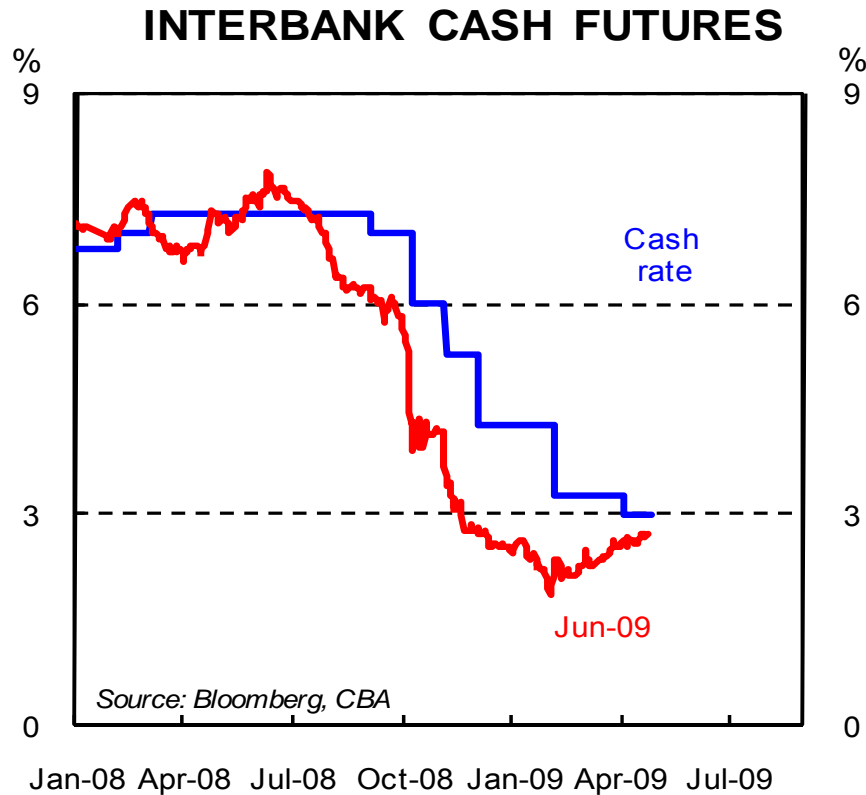
All change



- Speed of turnaround in global economy and step up in financial crisis surprised RBA (and others).
- Rate *rises* were being debated up until May.
- Policy settings over tight for the changed environment.
- Needed to get back to neutral (and beyond) as quickly as possible.

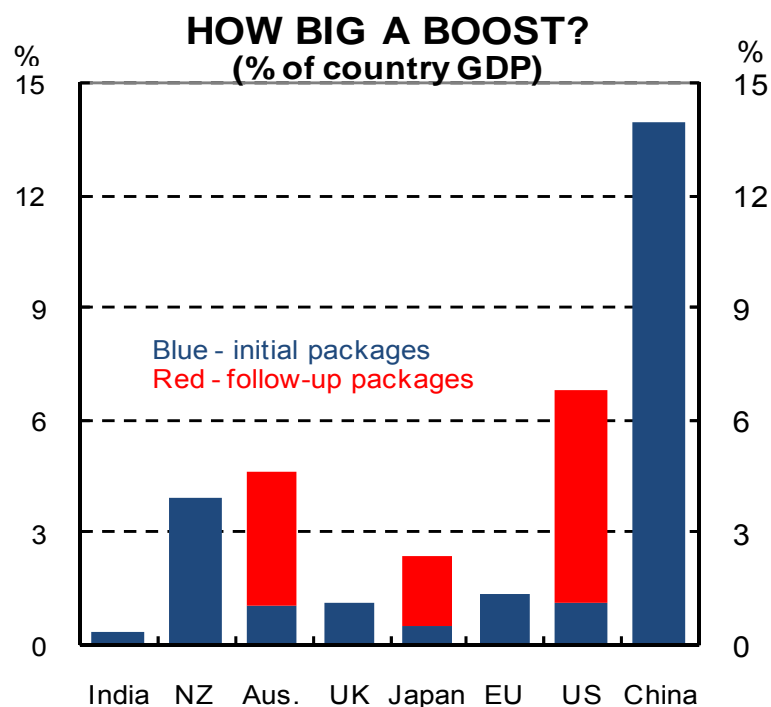
# How Far Will The RBA Go?

## CBA view



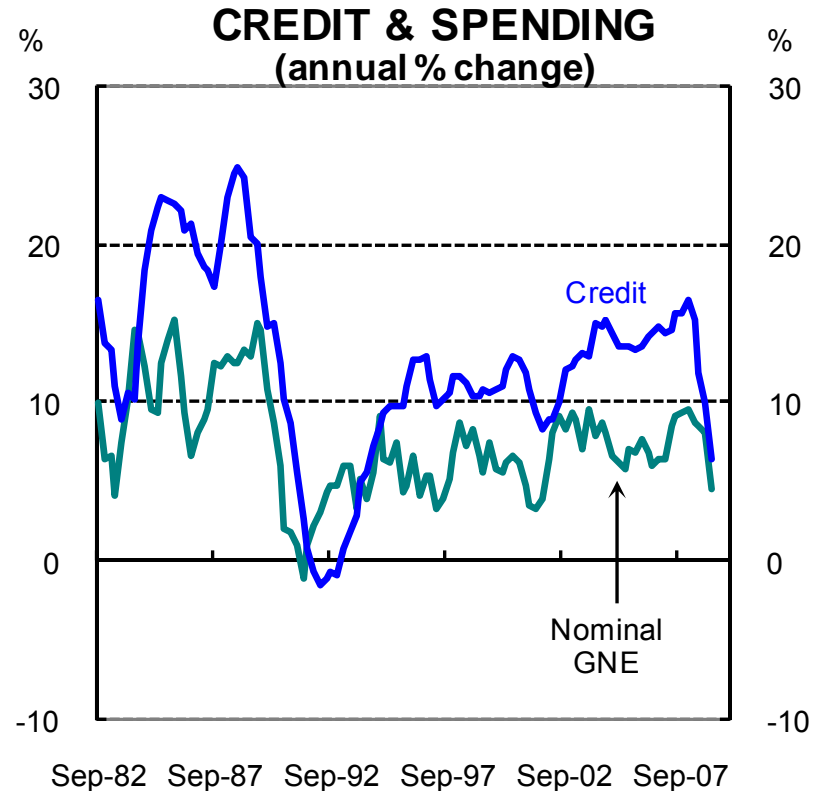
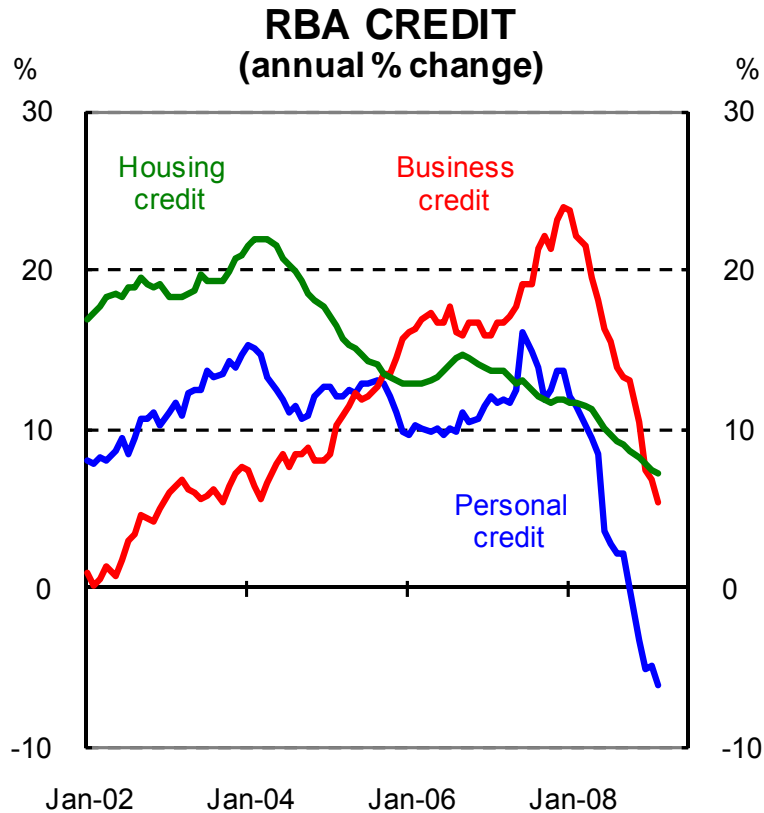
- The risks favour further rate cuts.
- We expect the cash rate to reach 2¾% by mid 2009.
- Our background economic views, global stabilisation packages and domestic fiscal stimulus mean we favour a profile a little more restrained than current market pricing.

## All hands to the fiscal pump... as growth tumbles !!



- The Federal Government has announced a \$42 billion fiscal package,
  - immediate stimulus of \$12.7 billion, coupled with
  - a \$28.8 billion infrastructure package aimed at schools, housing, energy efficiency, and roads infrastructure.
- These measures are aimed at lifting productivity in the longer term.
- The Global Financial Crisis sideswiped the Budget numbers, gouging the bottom line via diving tax revenues and sharply higher spending.
- The 2008/09 Budget is now forecast to post a deficit of \$22.5 billion (1.9% of GDP) from a MYEFO forecast surplus of \$5.4 billion, and from a lofty \$21.7 billion surplus forecast last May.

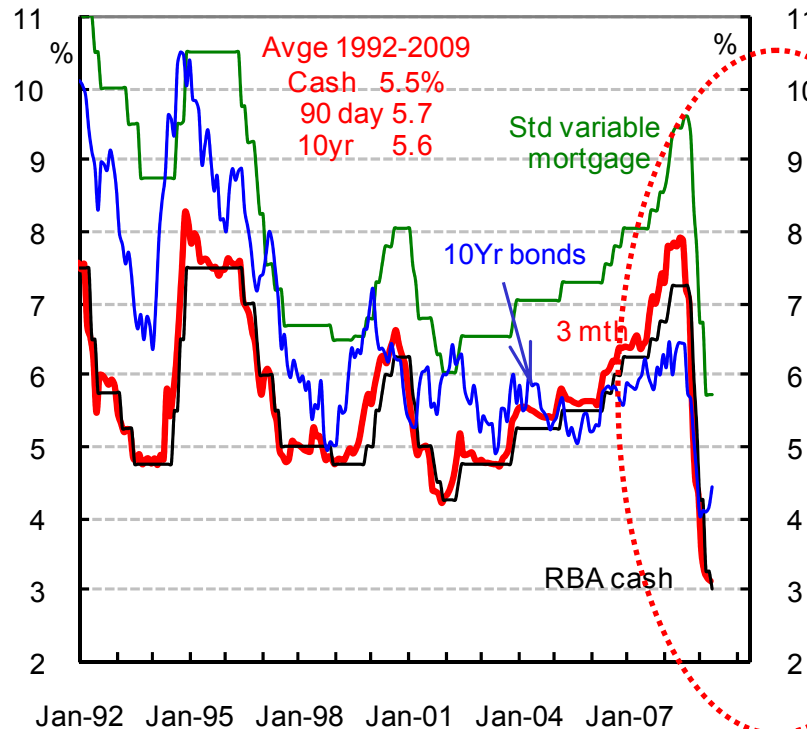
# Credit slowdown means recession through 2009



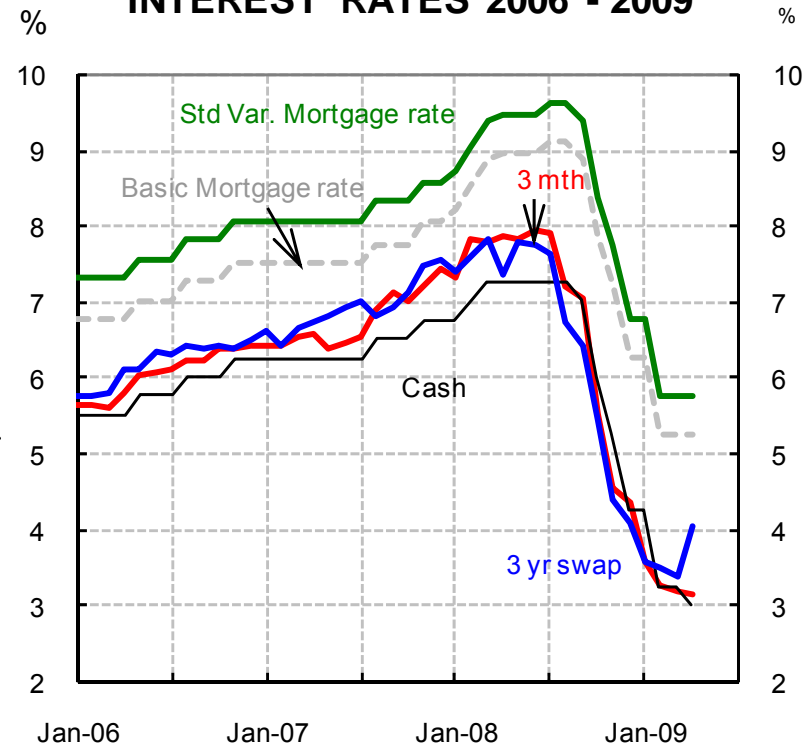
- **Credit growth rates falling towards ZERO, which means recession.**
- **Lending to businesses falling....so large falls in business investment possible.**
- **Nominal spending growth will be contracting later this year in annual terms.**

# Australian interest rates falling

**INTEREST RATES 1992 - 2009**



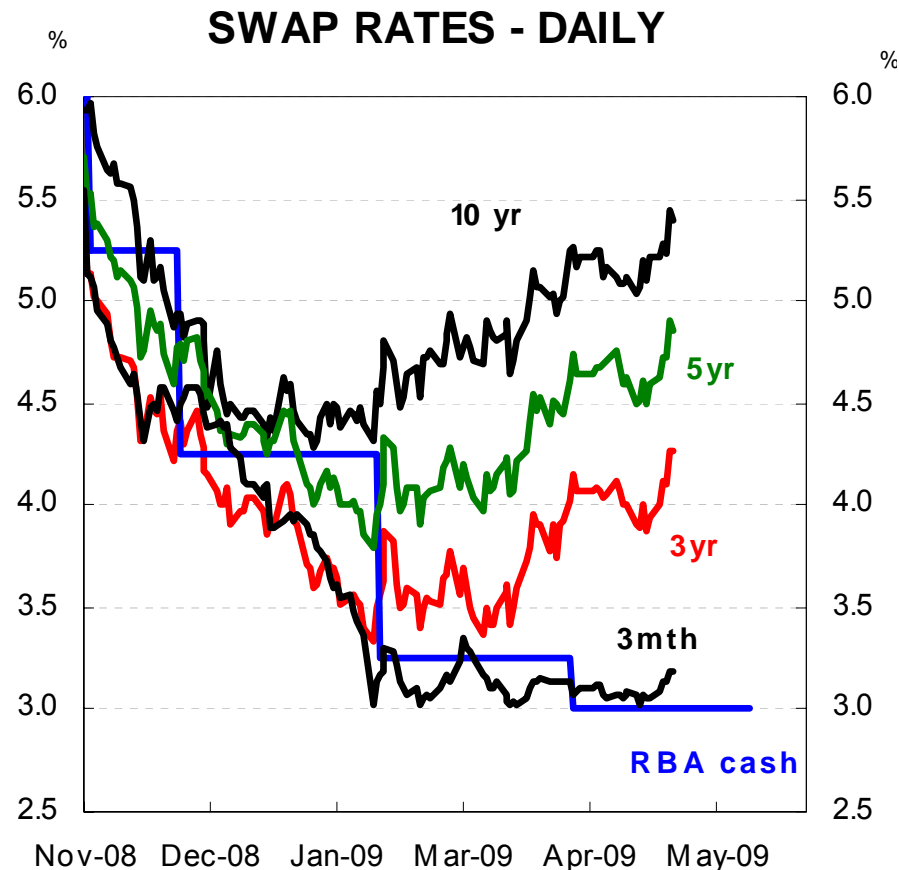
**INTEREST RATES 2006 - 2009**



- RBA at 3.0%.....cuts to 2.5% in mid 2009. Downside risk as job losses mount.
- Australian 3 month bills to range from 2.8% to 3.5%.
- Swaps curve steepening, but shifting lower.

# But Australian swap rates – rising since February

Why?



❑ Global credit markets are wary of high levels of debt issuance by US & European governments.

❑ Investors are reluctant to buy longer dated debt with such large amounts of supply coming.

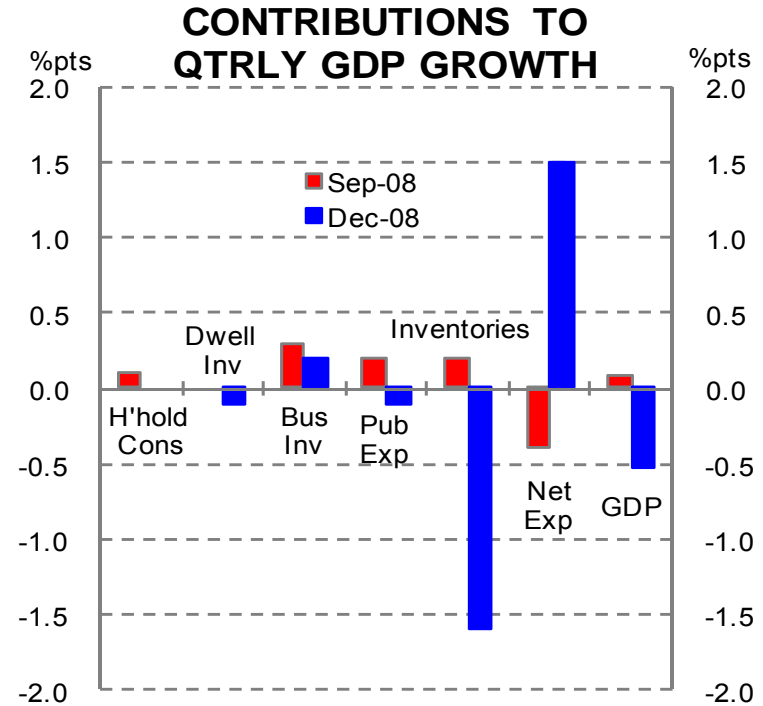
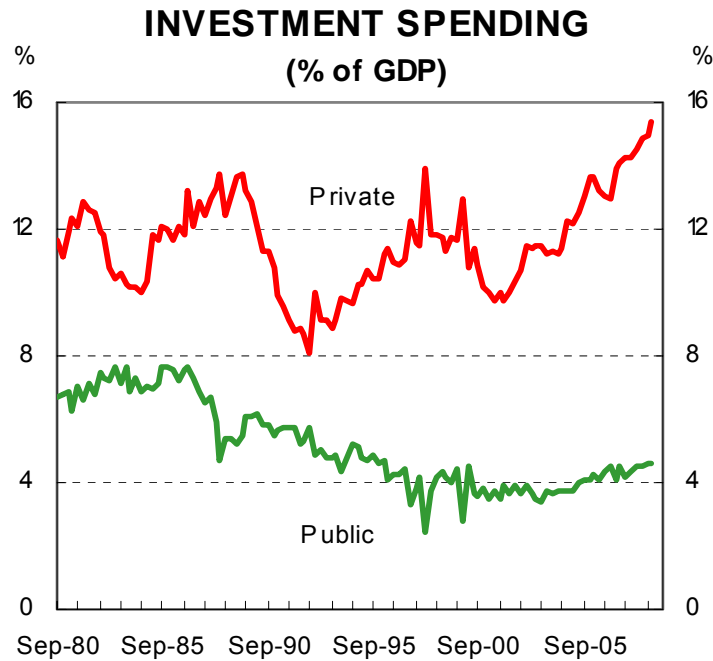
❑ Global short term rates are very low but the longer term rates have been rising since February.

❑ Coincided with new large US stimulus package.

❑ Markets want some signs of lower budget deficits before longer term rates can fall.

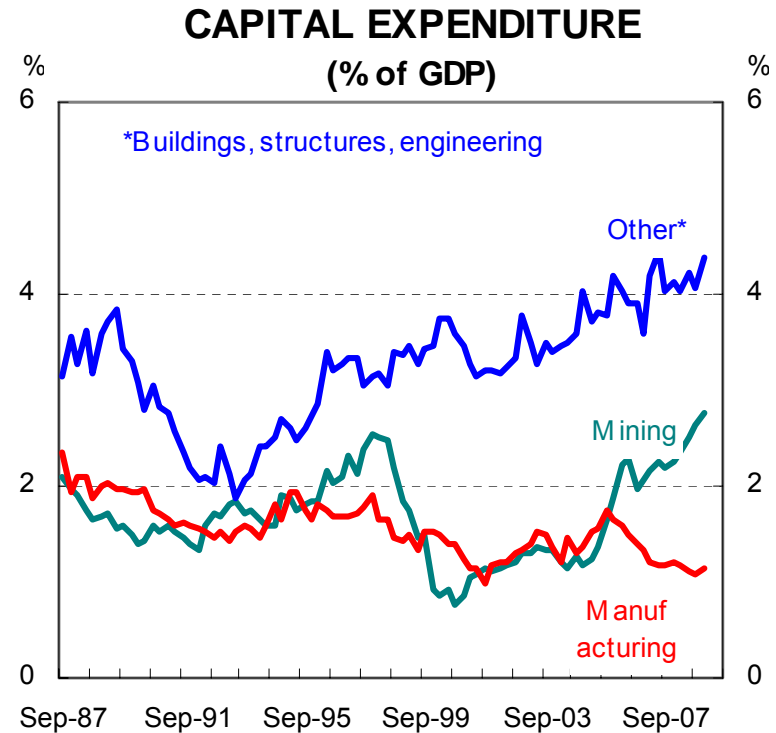
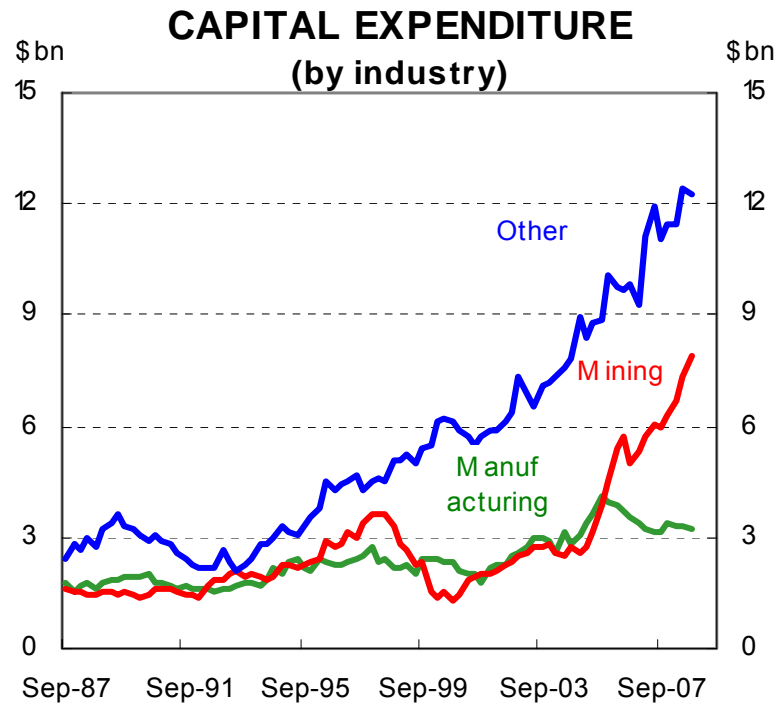
# Australia's Business Investment Resilient in QIV 2008

## Private & public spending rising still



# Australia's Capex Spending Still Resilient in QIV 2008

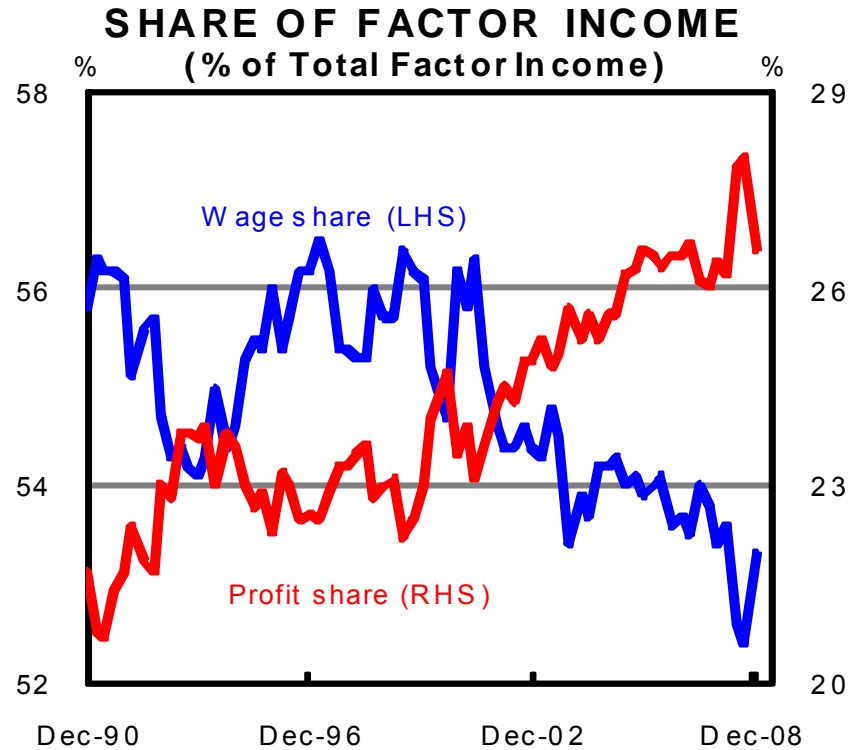
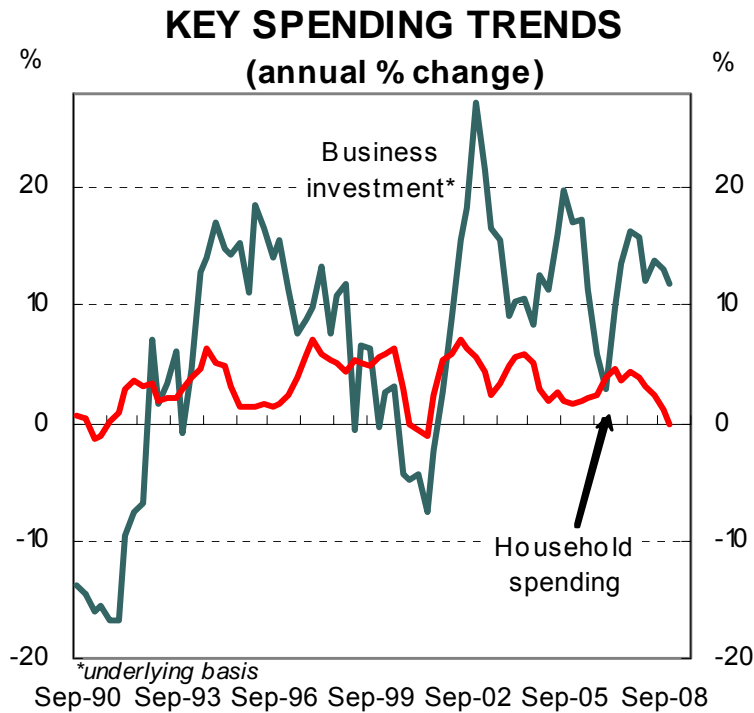
## QIV Capex rose again



- New capital spending rose by solid 6.0% in QIV and was 17.8% above year ago.

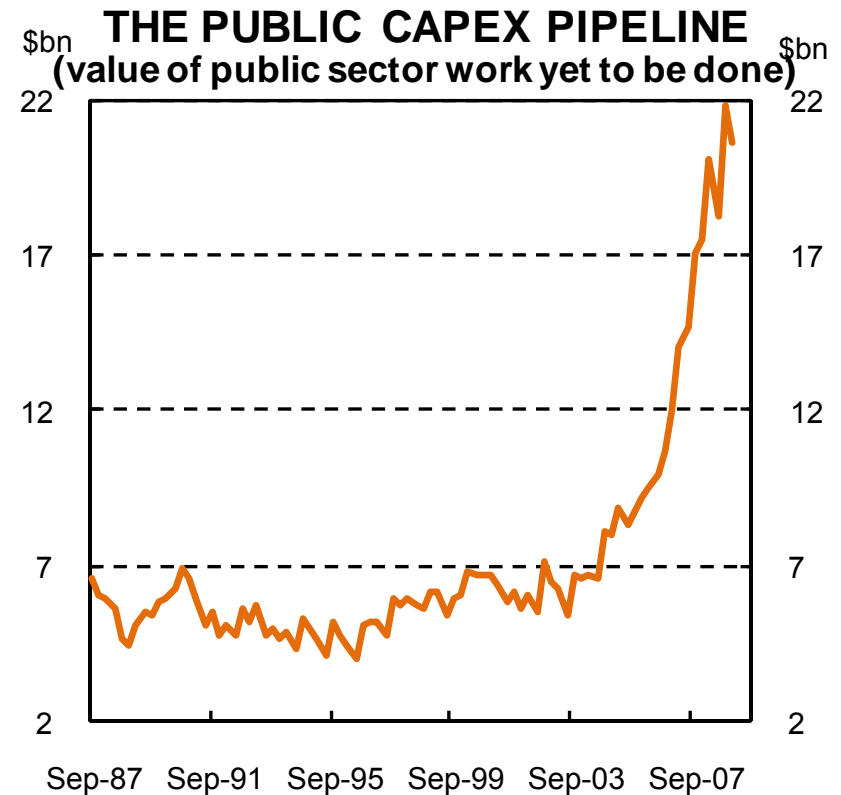
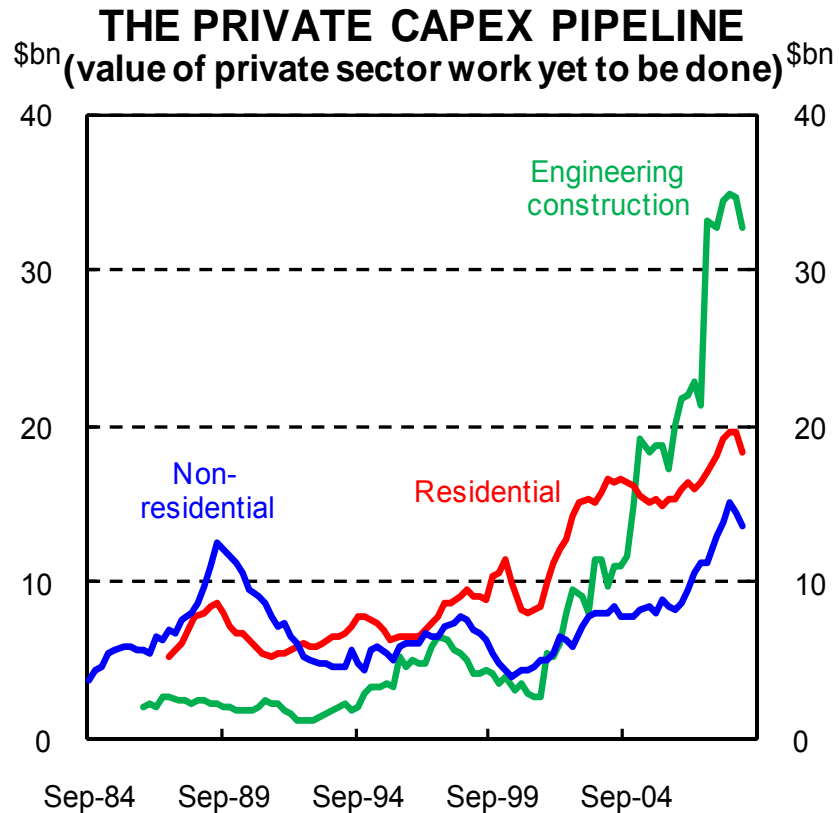
# Australia's Business Investment Resilient in QIV 2008

## Business investment still solid in QIV



# Australia: Different

Long lags = full pipeline

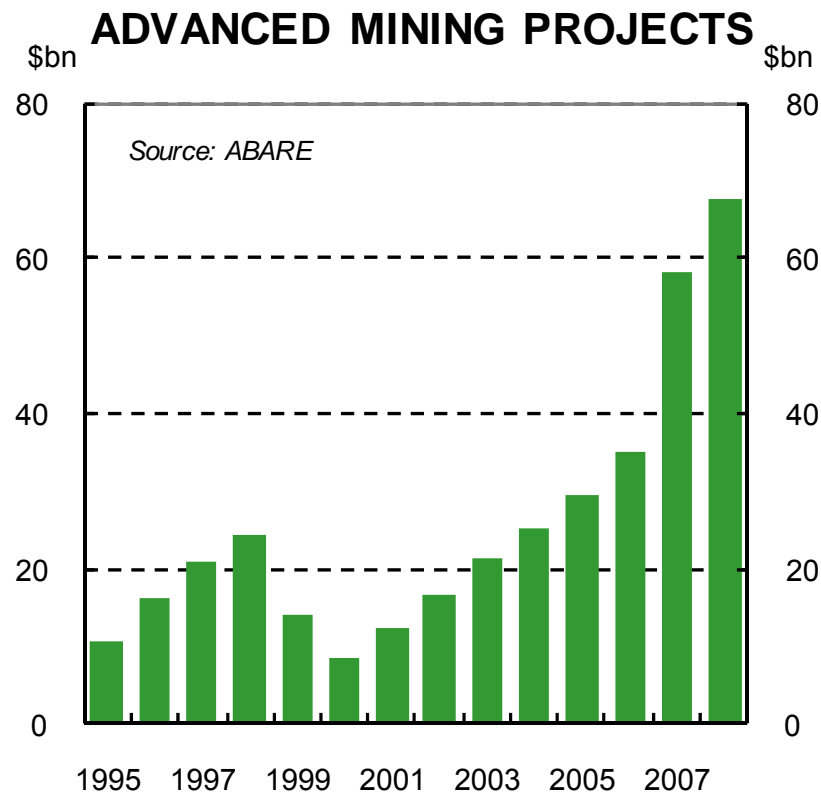


- The fundamentals were strongly supportive of private capex.
- Need to refurbish the public capital stock means strong public capex as well.



# Australia is Different

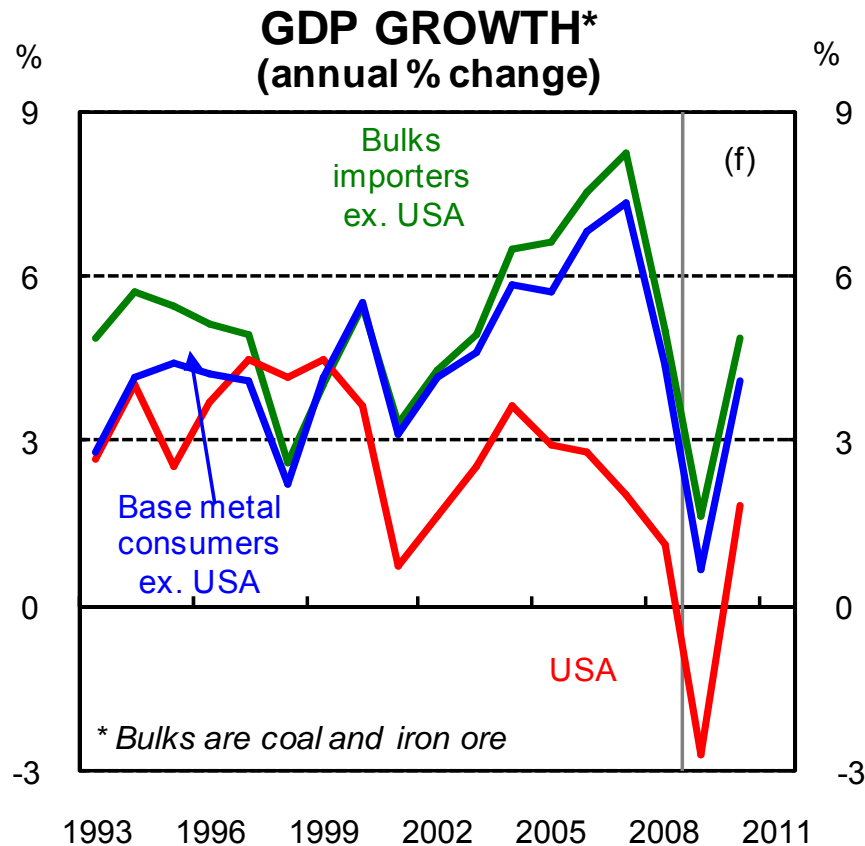
## The pipeline - mining



- A record number of resource projects (worth AUD67bn) are underway.
- The majority of these projects will go through to completion.

# Commodity Bust?

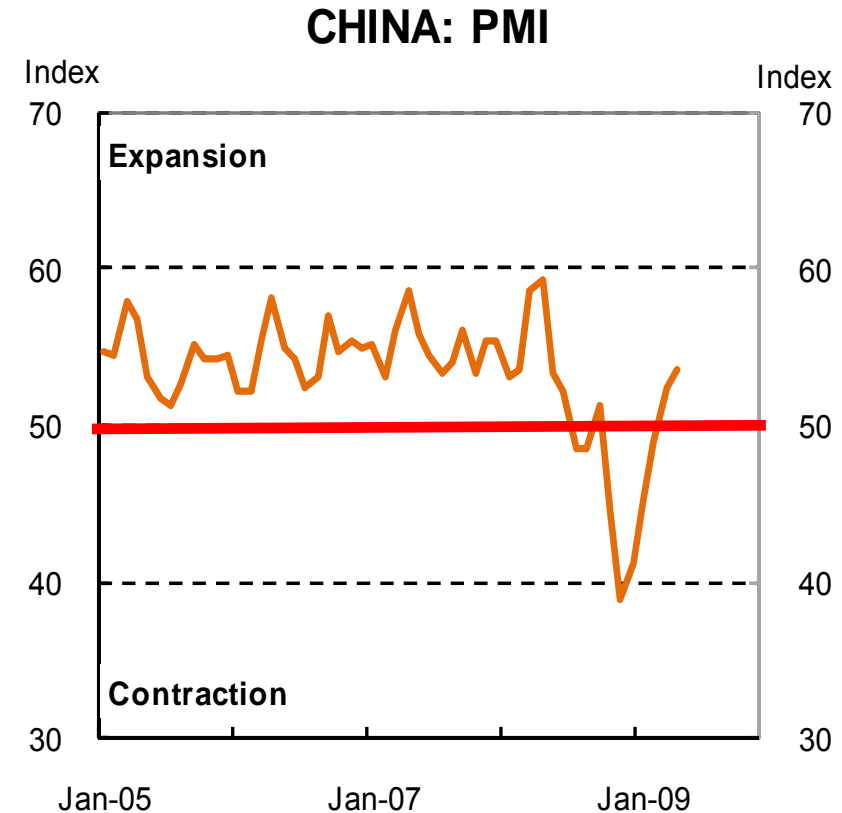
## Cyclical overshoot? – Pt I



- Even after downward revisions, projected global growth forecasts imply that commodity consuming nations will outperform.

# Commodity Bust?

## Structural positives remain

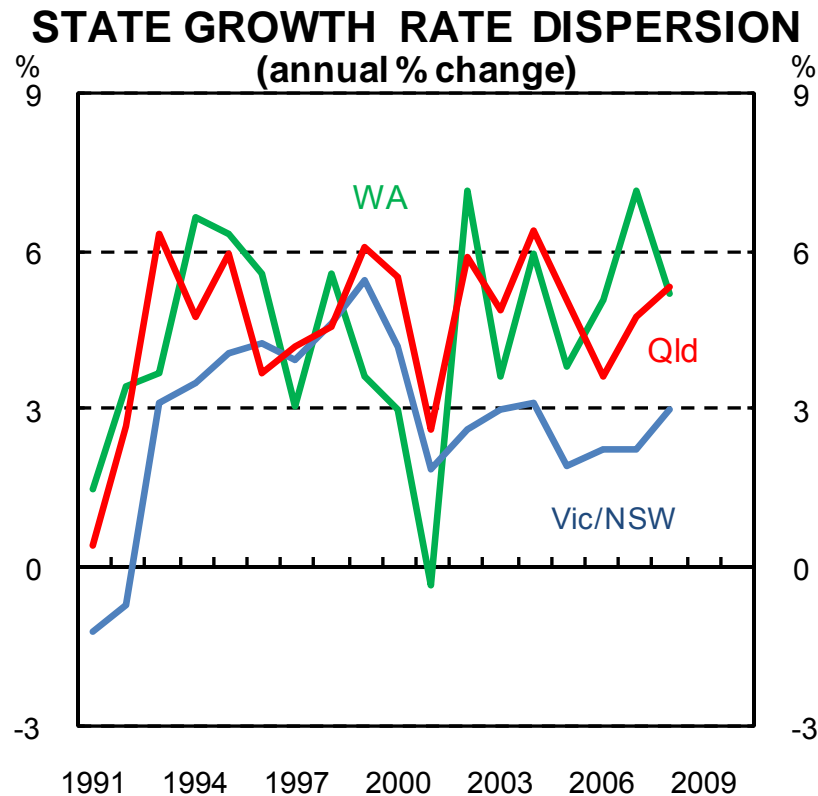


- Chinese export growth has slowed.
- But rising consumer spending filling some of the gap left by slowing export growth.



# Commodity Bust

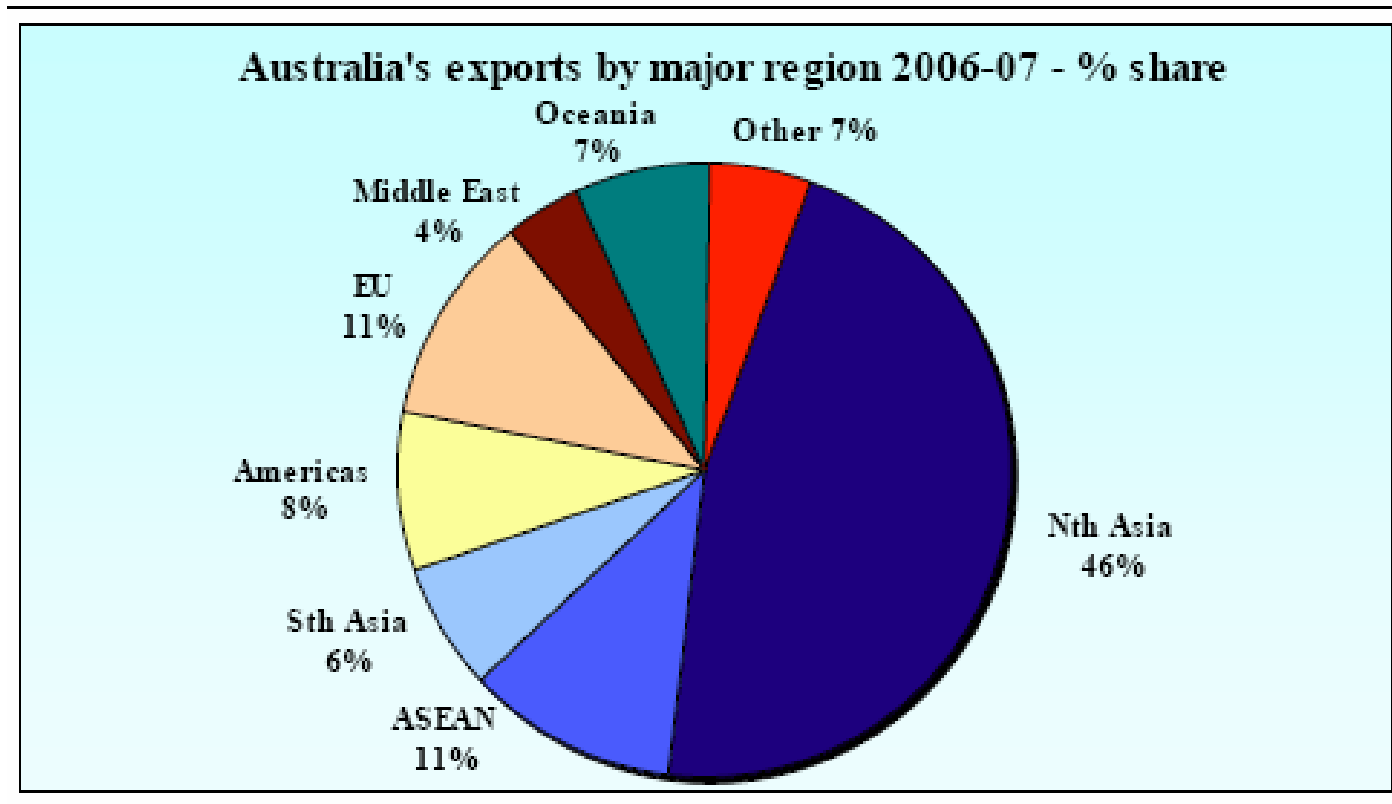
## Convergence



- States growth rates have diverged.
- Convergence in 2009 – but to the low side.
- Commodity cycle turns against Qld/WA and credit crunch weighs on NSW/Vic.

# The Australian economy coupled to Asia not US.

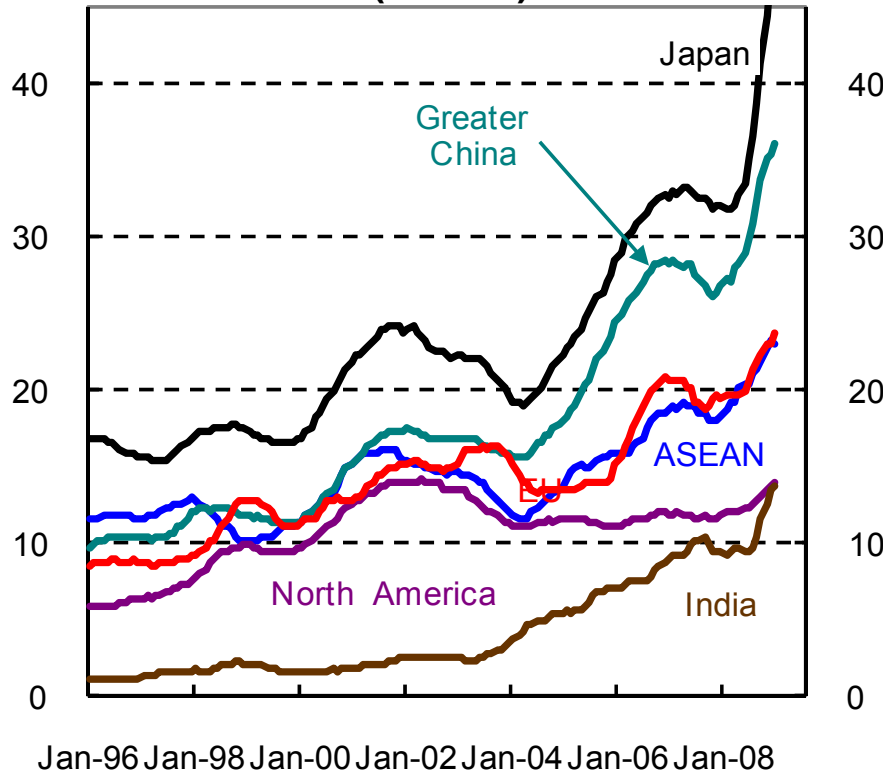
Structural break: Asia & Middle East account for 75% of Oz exports



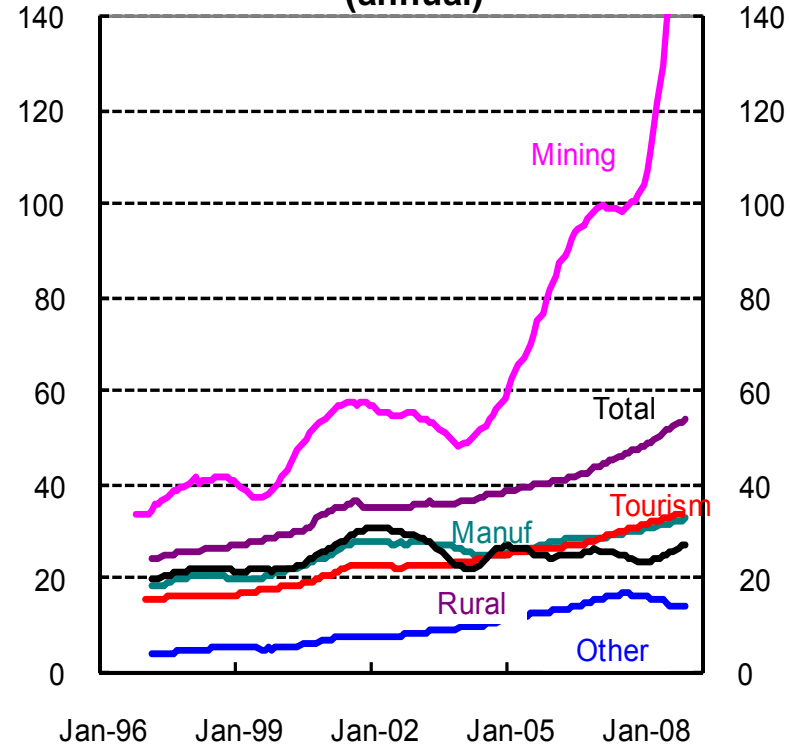
Source: RB/

# Trade: China & Asia overwhelm US

**GOODS EXPORTS MARKETS (annual)**



**EXPORTS \$bn (annual)**

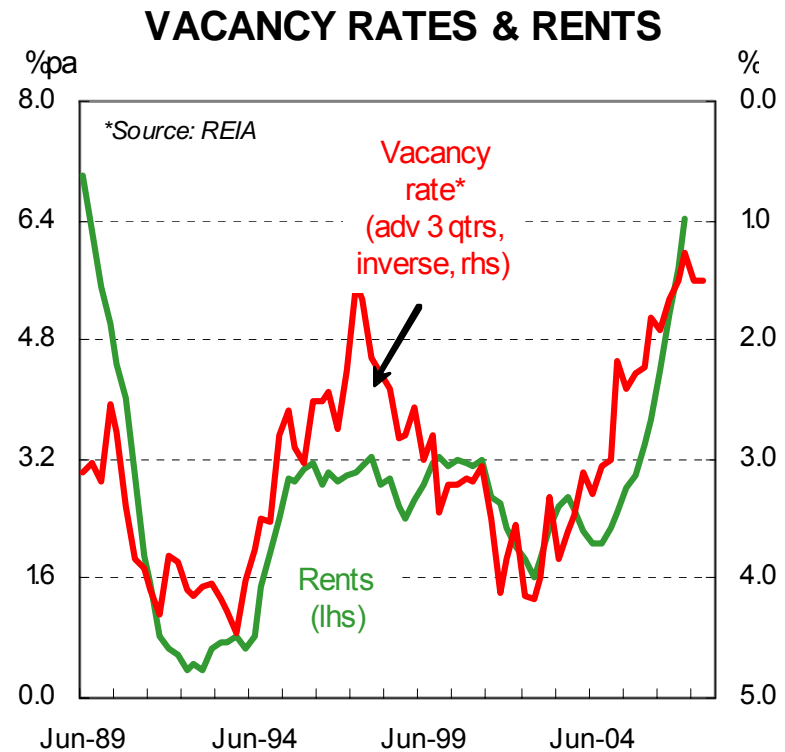
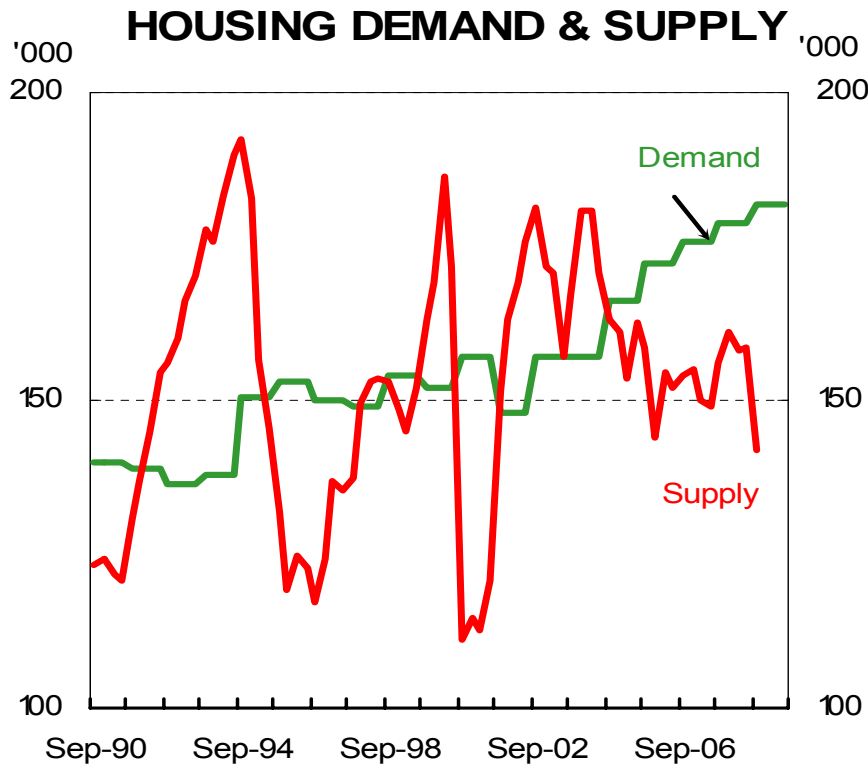


**75% of Australia's exports go to Asia which still has some positive growth.  
 Lower AUD will offset commodity price falls.  
 India will surpass North America as our 5<sup>th</sup> largest export market in 2009.**



# Housing Activity – Plenty of pent-up demand!

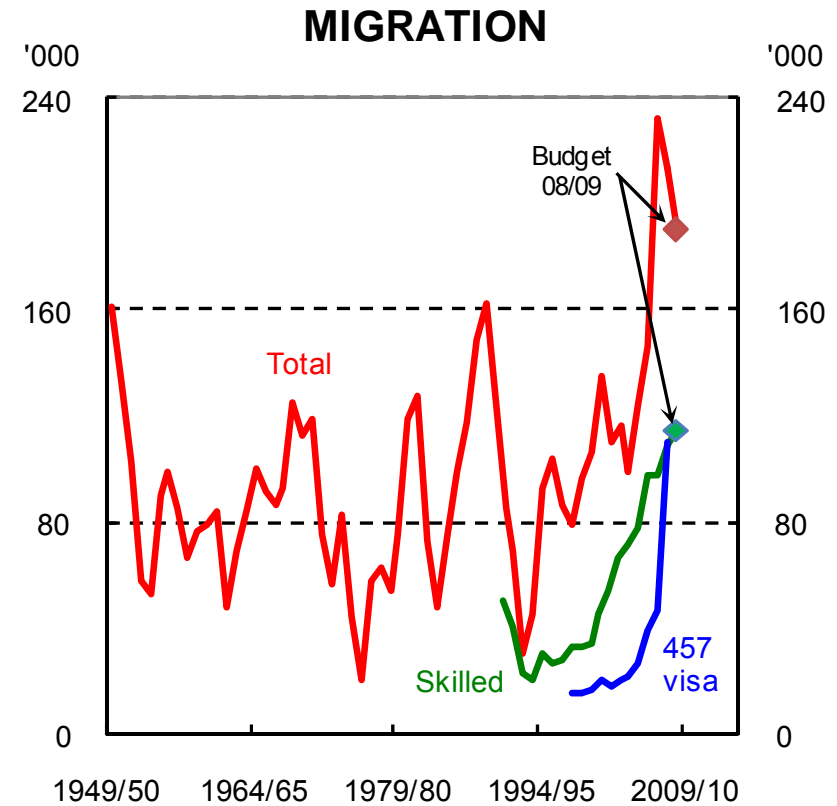
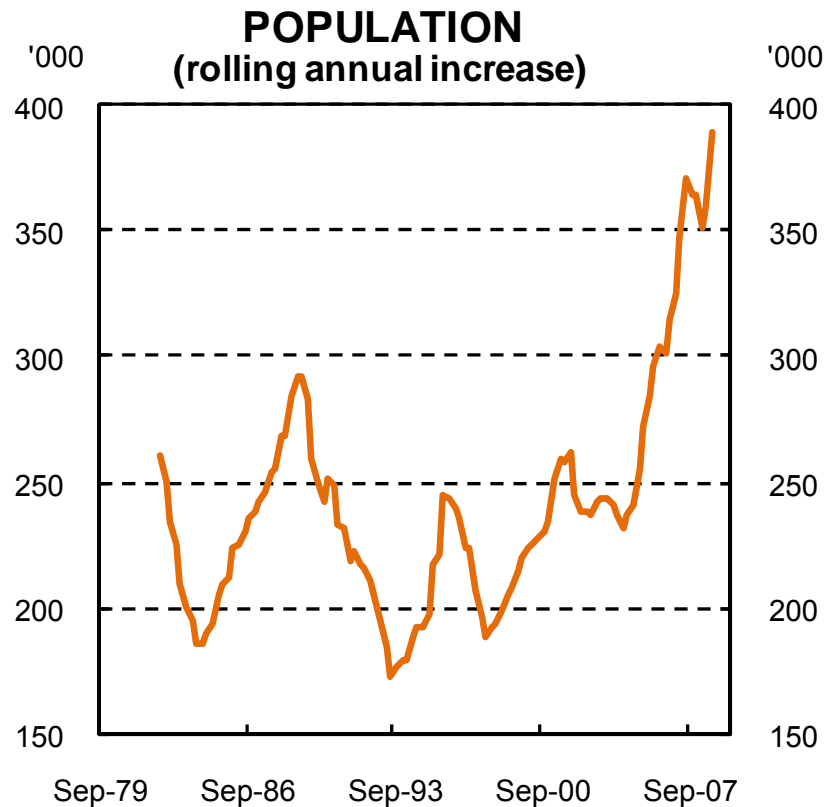
## Solid underlying demand



- Commencements (145k pa) running below underlying demand (190k pa).
- Also vacancy rates low & rents rising.
- Immigration boosting demand – skill shortages mean more to come.

# Australia is Different

## Demographics

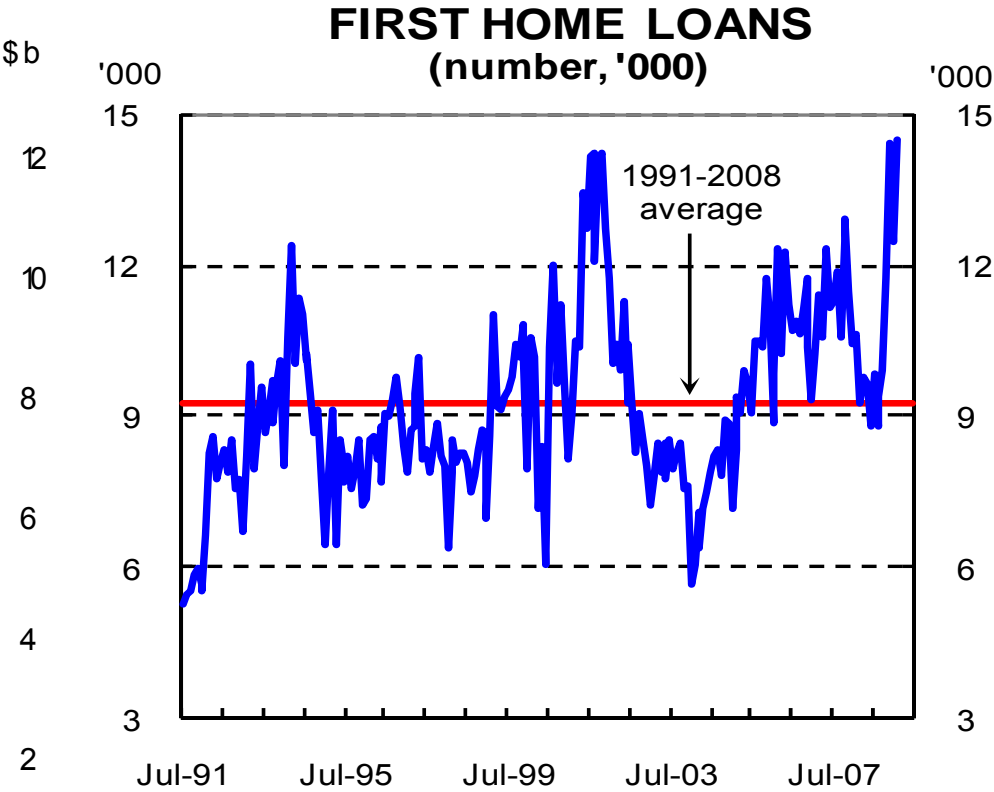
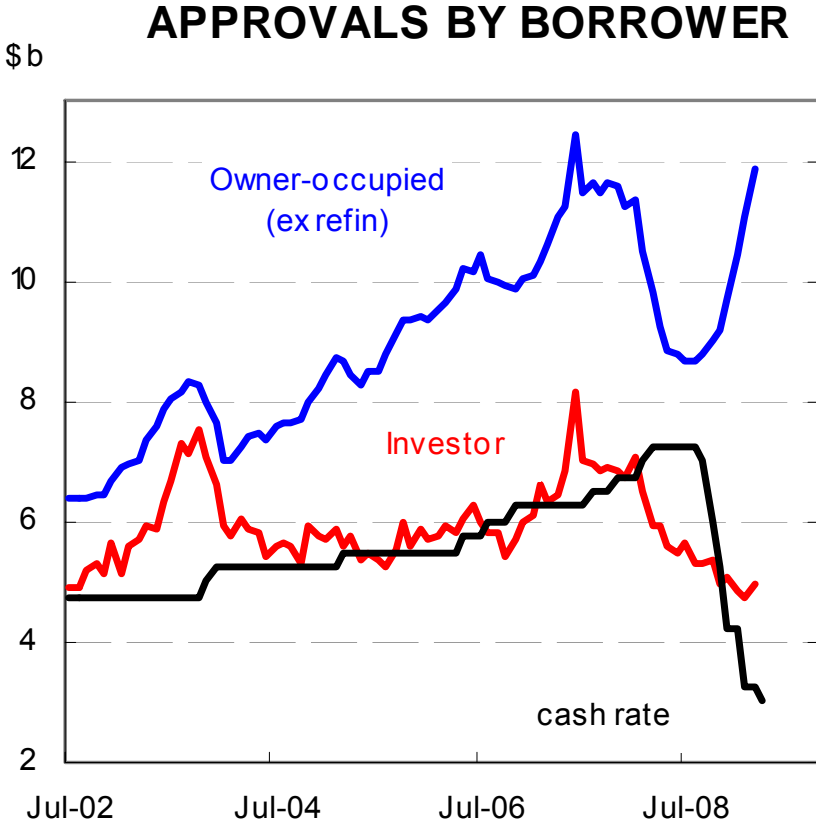


- A rising birth rate and a record immigration intake is boosting population growth.
- A net 235k migrants arrived in calendar 2008 according to ABS.



# Australia is Different; Home loans lifting

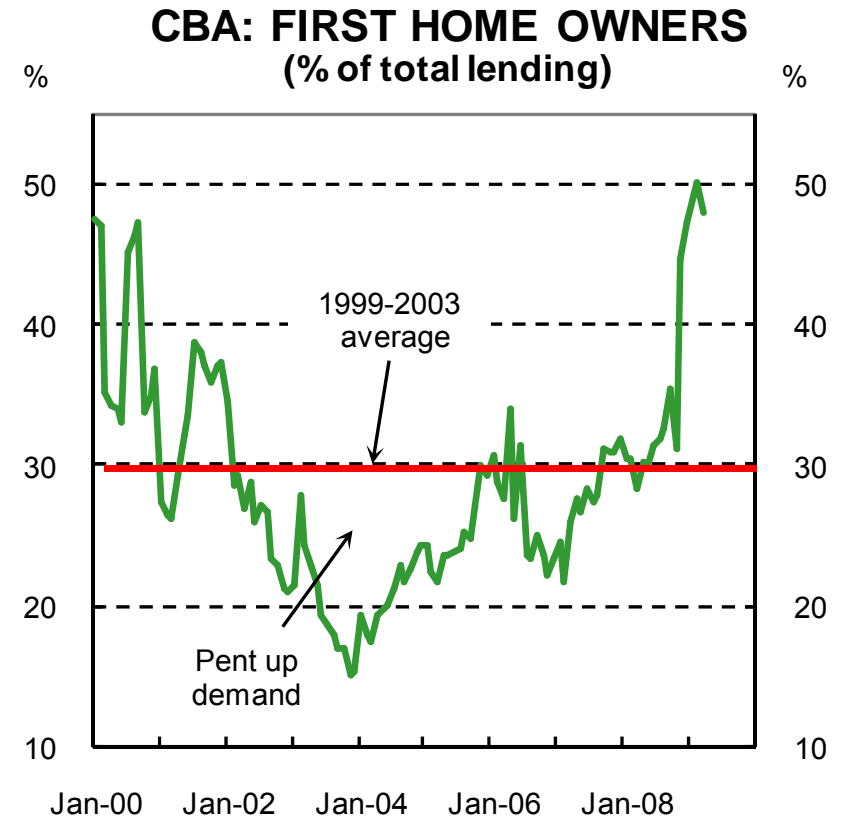
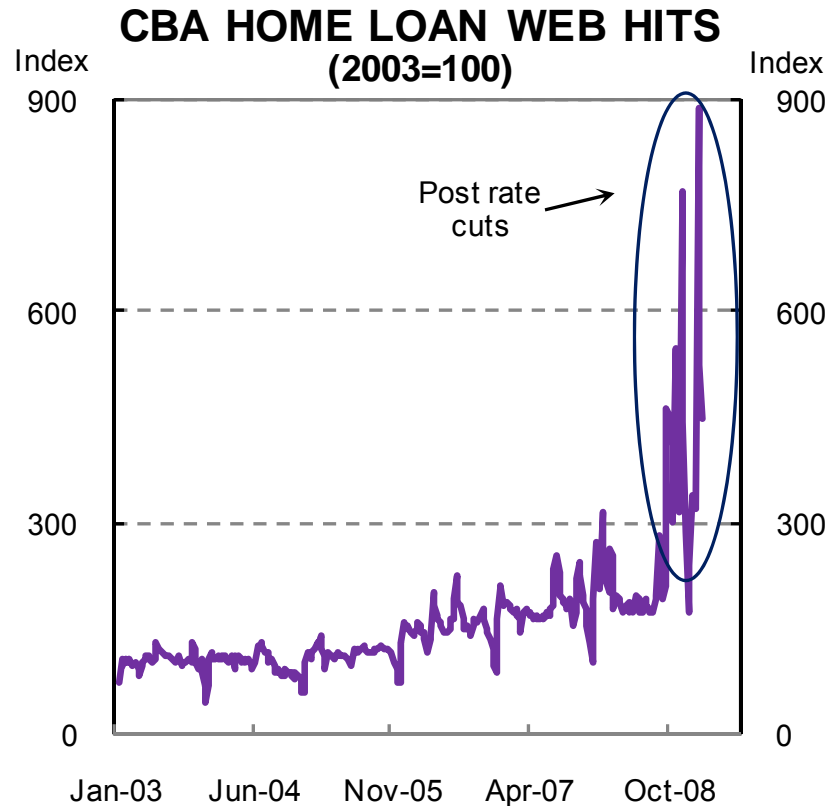
Demographics, Interest rates, FHOS, lifting rents



- A rising birth rate and a record immigration intake is boosting population growth.

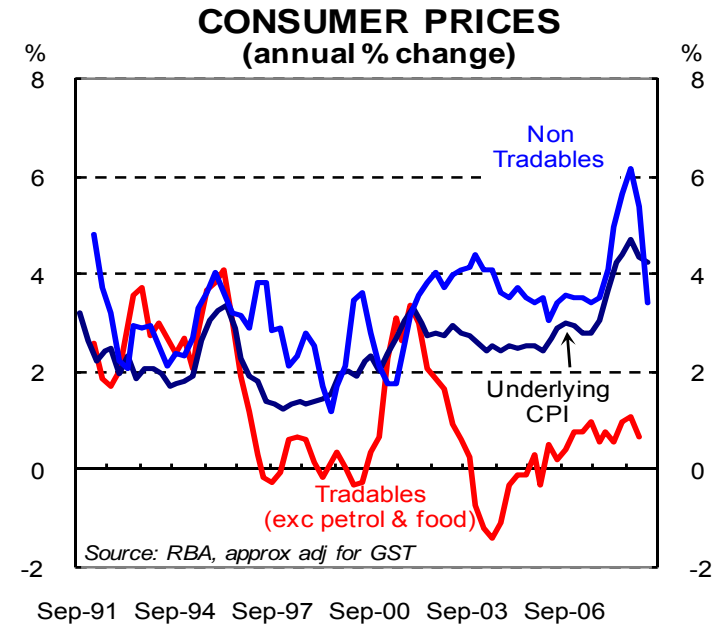
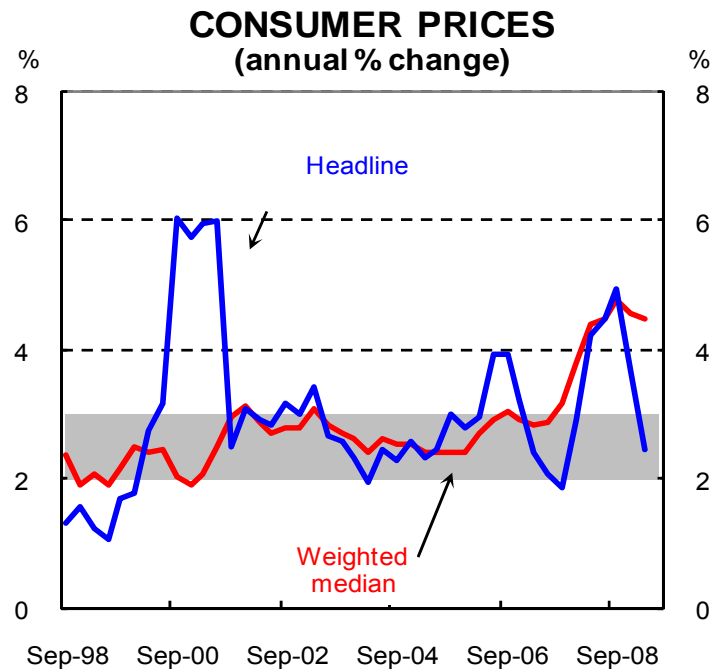
# Economic Policy Still Works

## Monetary policy



- Lower interest rates have lifted housing sentiment.
- Improved sentiment is flowing through to activity.

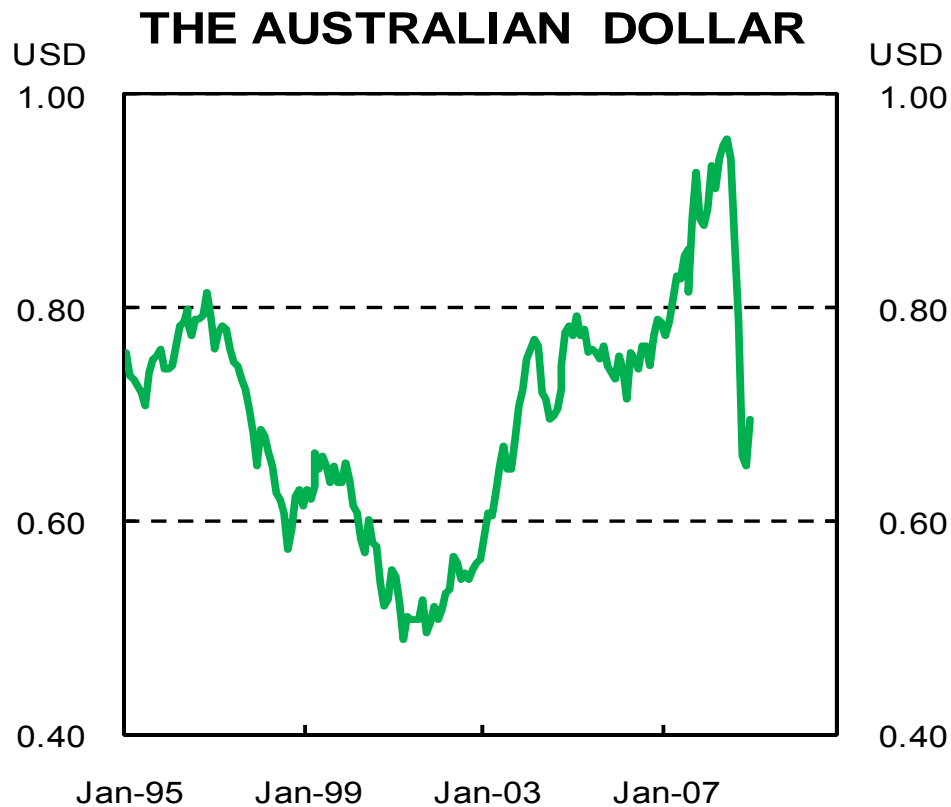
# Underlying CPI to track lower in 2009/10



- The CPI rose by 0.1% in Q1. Annual inflation eased to 2.5% from 3.7%.
- Inflation set to fall back to 2-3% target zone more quickly than previously expected opening the door to more rate cuts- if required.

# Australia: The Same But Different

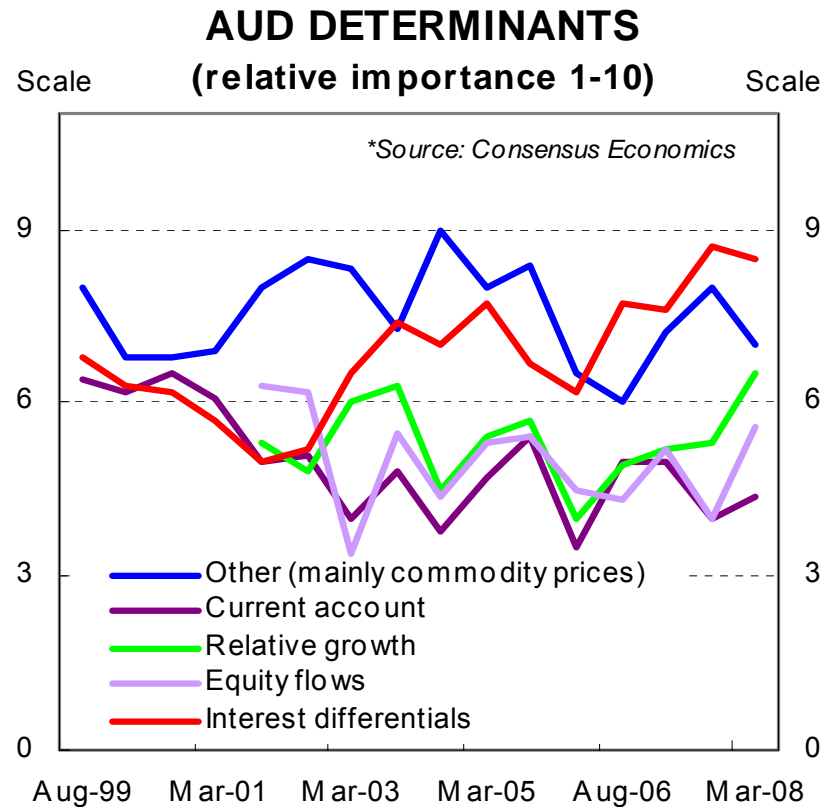
“Automatic stabiliser”



- **The Aussie dollar is providing its usual buffer against the global negatives:**
  - offsetting impact of lower USD commodity prices;
  - easing financial conditions.
- **Lower AUD also means upside inflation risks.**

# The AUD

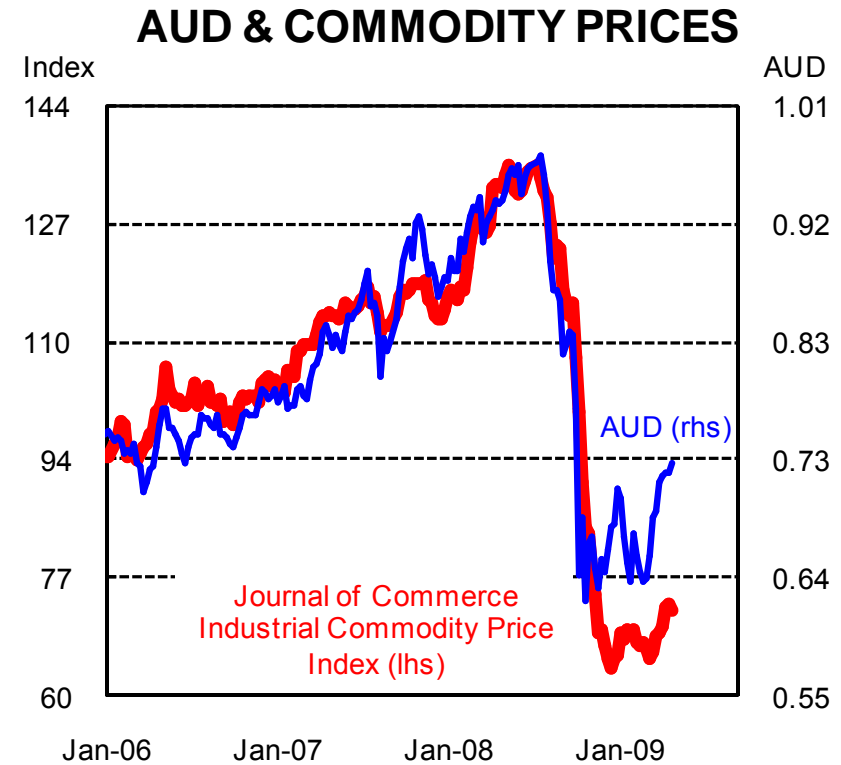
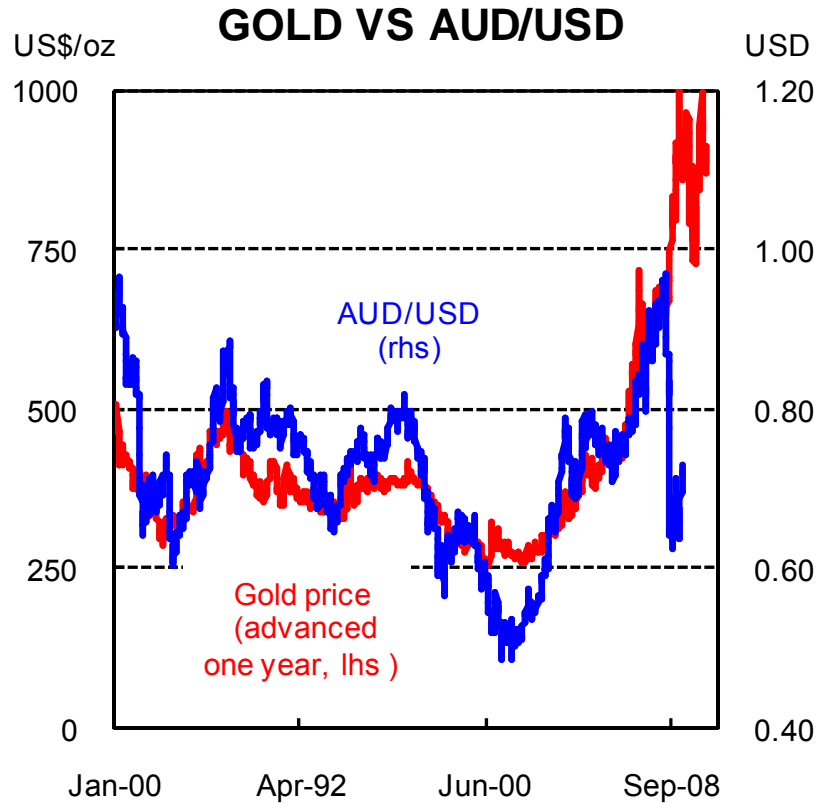
## What moves markets?



- Market perceptions of what drives the AUD evolve over time.
- Commodity prices remain a key fundamental driver.
- But weight on “returns” (interest-rate differentials) has increased.
- And weight on the current account deficit has declined.

# The AUD

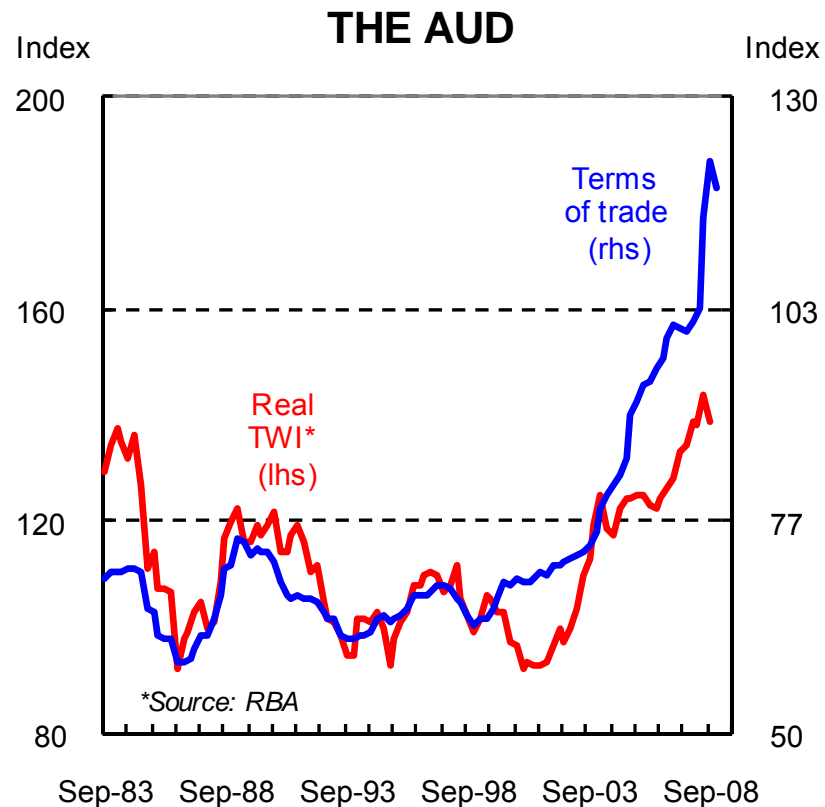
## Commodity prices



- Low commodity prices weighing on the AUD.
- Some signs that commodities are bottoming.

# The AUD

## Long-run structural change

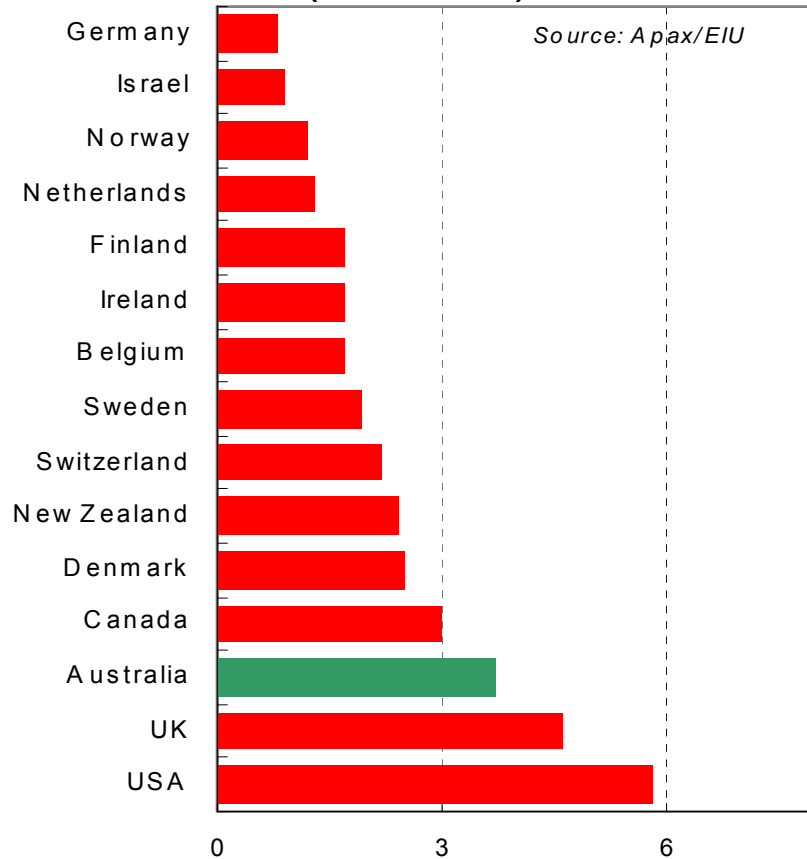


- The terms-of-trade a good proxy for the fundamentals that drive the AUD over time - pointing to a structural lift.
- This means next 25 year average of AUD should be closer to 0.77 rather than 0.71.

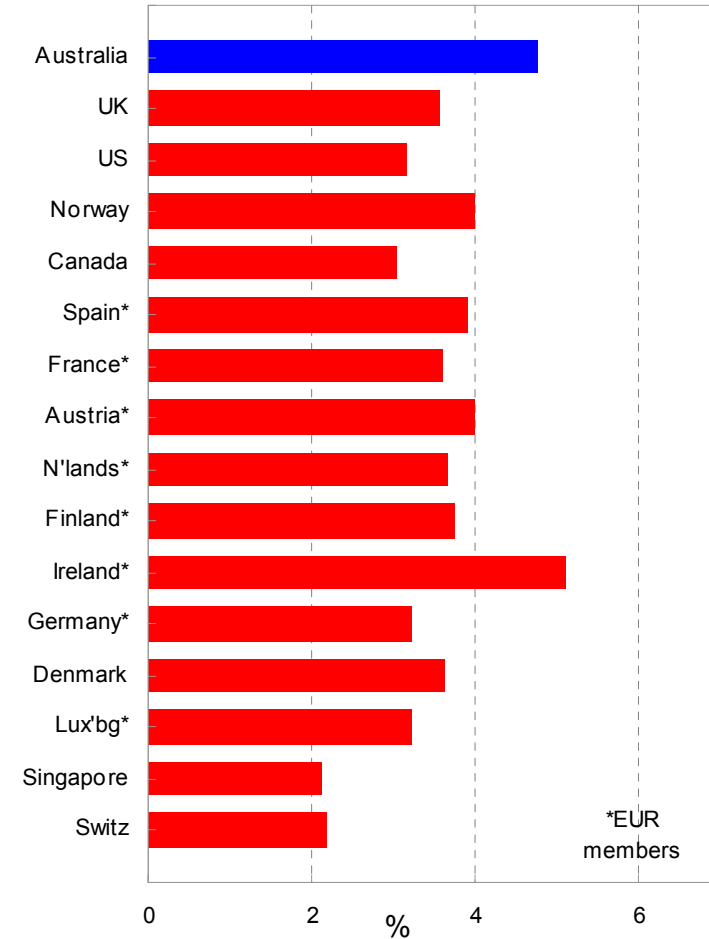
# The AUD

## An attractive investment destination

**PRIVATE EQUITY ENVIRONMENT  
(EIU scores)**



**10-YR BOND YIELDS  
(S&P AAA-rated economies)**



■ Longer-term attractiveness of Australia as an investment destination intact.

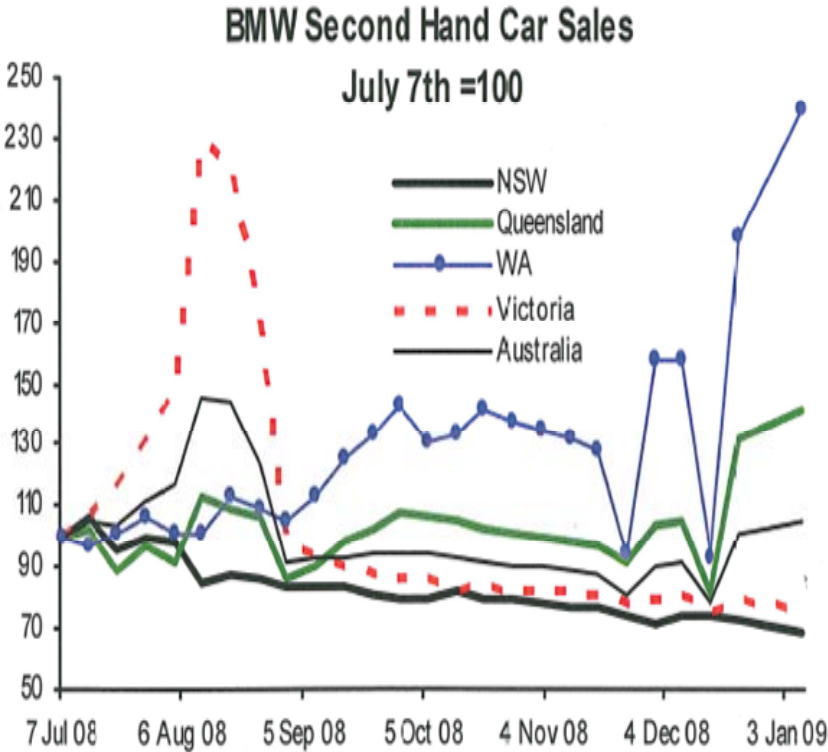
## Factors to cushion Australia against global slump.

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- Aggressive RBA rate cuts - more as RBA stays pre-emptive.
- Fiscal stimulus = 5% of GDP: 3.5% from recent packages ie \$10.4 billion & \$42 billion plus 1.5% from rundown in surplus as economy slows - due to automatic stabilisers.
- Housing in relatively good shape, with demand >supply.
- 20% fall in AUD on trade weighted terms; 30% versus USD
- Historically *high terms of trade* despite easing commodity prices. Still 40% above long term average. Most major trading partners still growing.
- Strong record company profits (stand at 27% of GDP vs historical average of 14%) – also companies lowly geared.
- Relatively low unemployment – still near 3 decade lows.
- Large States' large pipeline of infrastructure spending.
- Fat order book of investments in engineering, construction and mining.

# Household Deleveraging

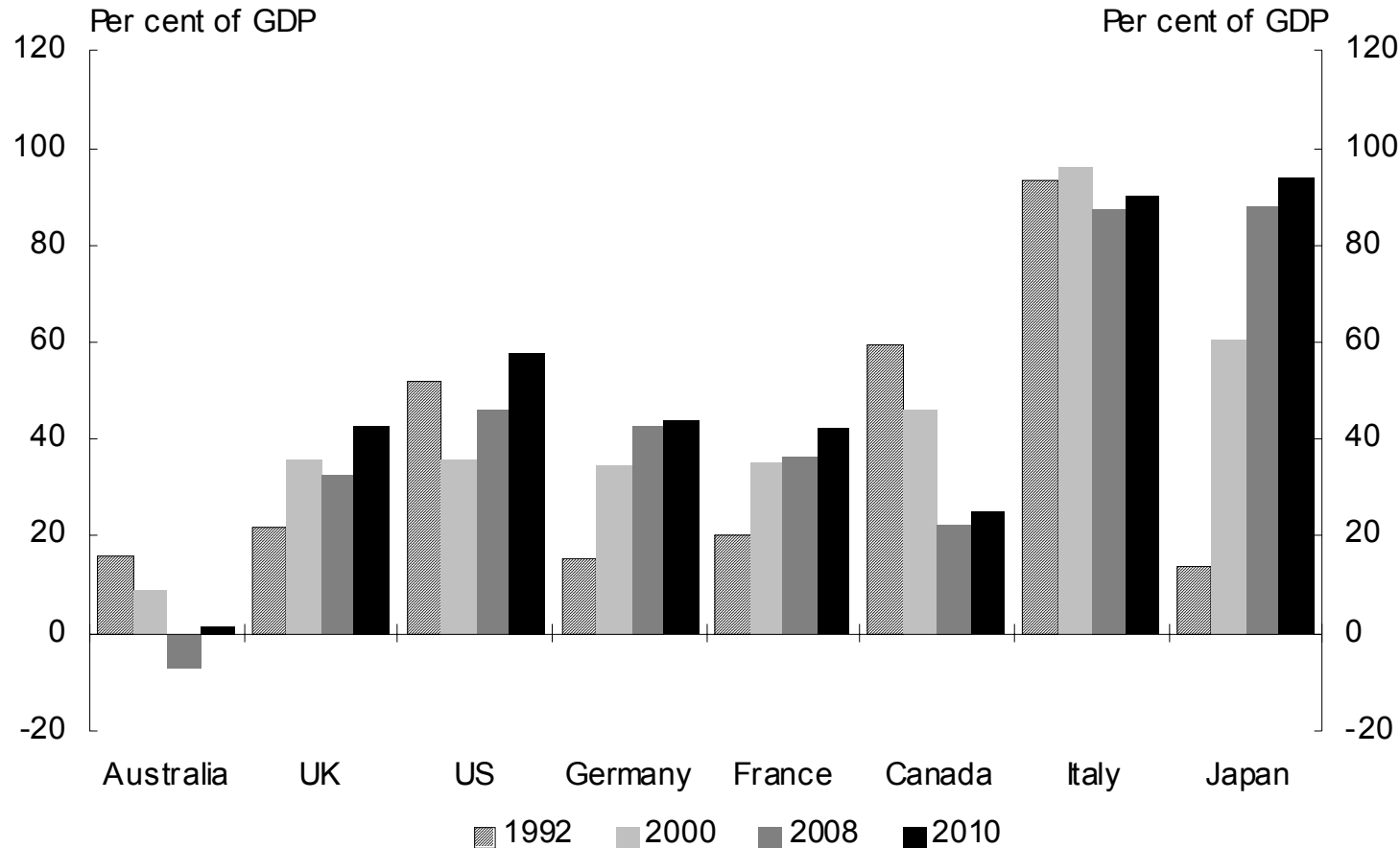
Deleveraging underway?



Source: Drive.com.au / GS JBW

# Public Sector Debt: Don't Worry, Be Happy

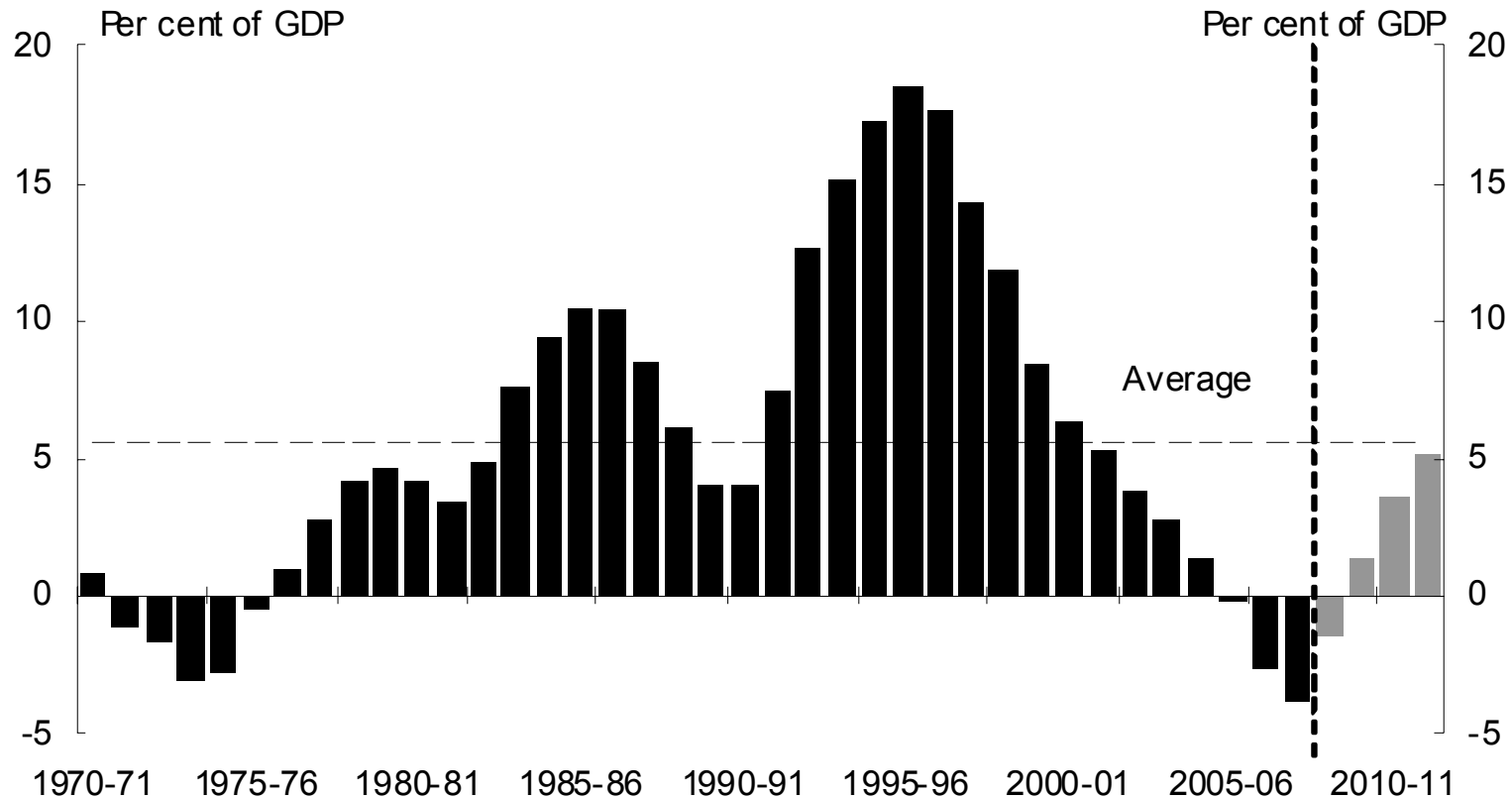
Chart 2: Australian and G-7 public sector net debt



Source: Australian Treasury and OECD *Economic Outlook 84* (November 2008). Net debt figures are from the OECD *Economic Outlook 84* except for Australia's 2010 figure which is the sum of the most recent forecasts for Australian, State and Territory general government sector net debt levels for financial year 2009-10.

# Australian Government net debt to GDP

**Chart 6: Australian Government net debt to GDP**

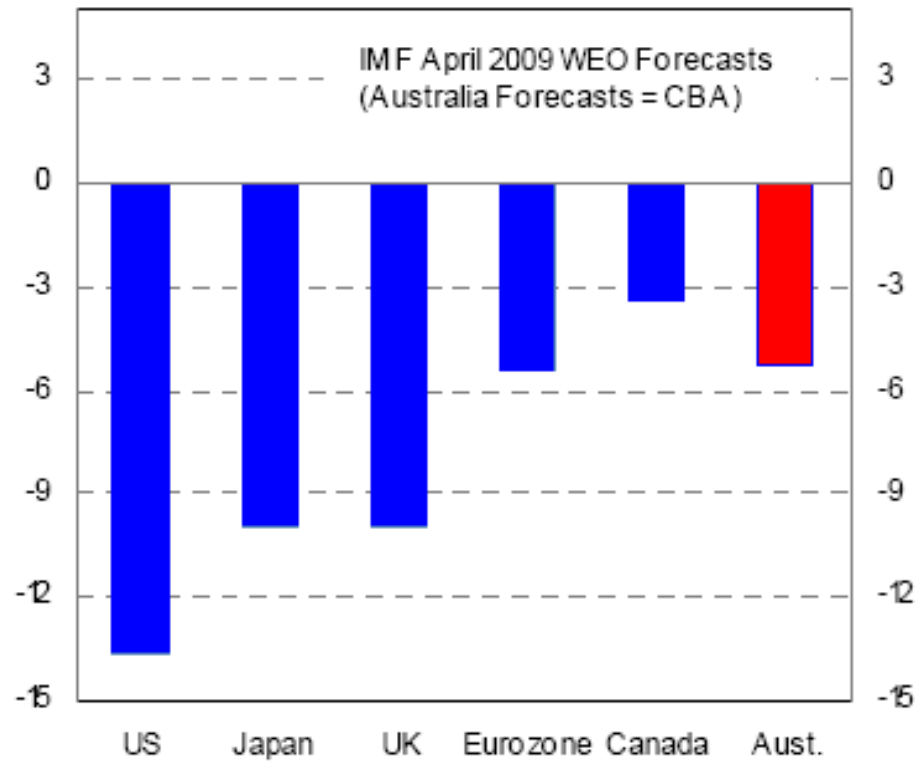


Source: *Mid-Year Economic and Fiscal Outlook 2008-09* and *Updated Economic and Fiscal Outlook November 2008* and the Australian Treasury.

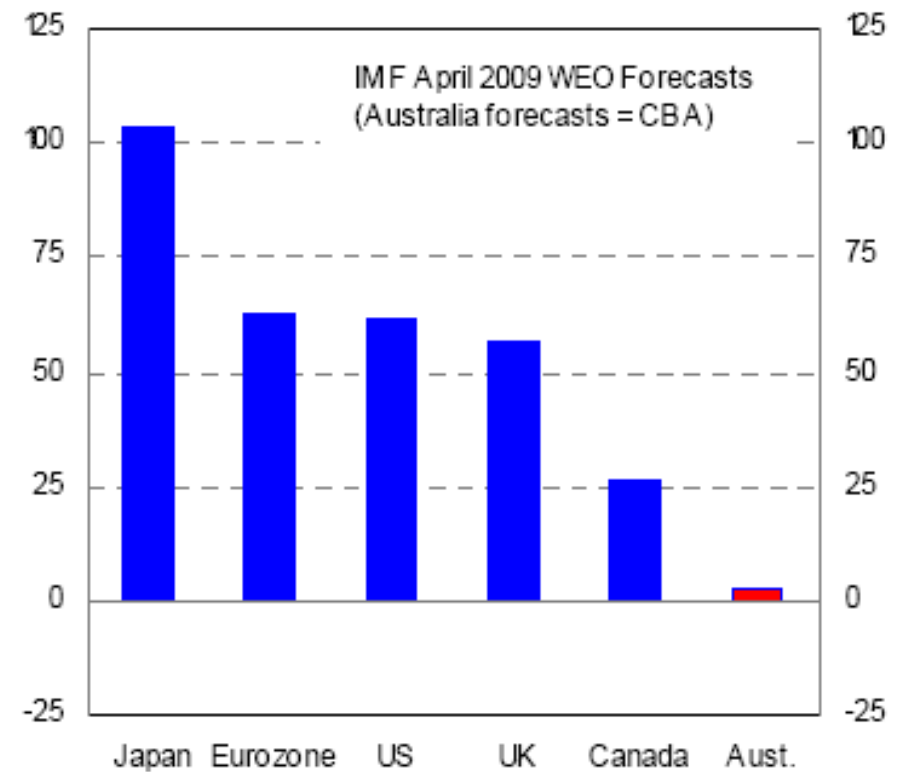
# Public Sector Debt: Don't Worry, Be Happy

6.

**BUDGET DEFICIT 2009**  
% of GDP



**NET GOVERNMENT DEBT**  
% of GDP



# Australia: Interest Rate and FX Forecasts

End Period	Interest Rates					Exchange Rates			
	Cash Rate	90-day Bank Bill	180-day Bank Bill	3-year Bond	10-year Bond	USD versus AUD	JPY	EUR	GBP
Jun-06	5.75	5.98	6.10	5.79	5.78	0.77	114.0	1.26	1.88
Sep-06	6.00	6.17	6.26	5.76	5.51	0.78	118.5	1.28	1.90
Dec-06	6.25	6.44	6.55	6.11	5.88	0.79	120.0	1.32	1.96
Mar-07	6.25	6.52	6.64	6.21	5.88	0.79	120.0	1.32	1.97
Jun-07	6.25	6.44	6.59	6.45	6.26	0.85	123.2	1.35	2.01
Sep-07	6.50	6.89	6.99	6.44	6.15	0.89	114.8	1.43	2.05
Dec-07	6.75	7.24	7.36	6.89	6.33	0.88	111.7	1.46	1.98
Mar-08	7.25	7.86	7.96	6.13	6.05	0.91	99.7	1.58	1.98
Jun-08	7.25	7.84	7.96	6.70	6.45	0.96	106.2	1.58	1.99
Sep-08	7.00	7.32	7.04	5.09	5.40	0.79	106.1	1.41	1.78
Dec-08	4.25	4.15	3.70	3.07	3.99	0.70	90.7	1.40	1.46
Mar-09	3.25	3.14	3.06	3.40	4.42	0.69	99.0	1.33	1.43
Jun-09	2.75	2.80	2.80	3.00	4.00	0.68	98.0	1.31	1.45
Sep-09	2.75	2.80	2.80	2.80	3.80	0.75	105.0	1.35	1.54
Dec-09	2.75	2.90	2.90	3.00	3.80	0.77	112.0	1.35	1.55
Mar-10	2.75	3.00	3.00	3.10	4.00	0.78	115.0	1.35	1.55

Forecast

# Summary – Key FX Forecasts

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## The CBA view

	End period				
	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10
AUD-USD	0.68	0.75	0.77	0.78	0.77
AUD-EUR	0.52	0.56	0.57	0.58	0.58
AUD-NZD	1.28	1.25	1.18	1.11	1.10
AUD-GBP	0.47	0.49	0.50	0.50	0.50
AUD-JPY	67	79	86	90	89
Cash rate	2.75	2.75	2.75	2.75	2.75

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# Key Economic Forecasts

	2005/06 (a)	2006/07 (a)	2007/08 (a)	2008/09 (f)	2009/10 (f)	2010/11 (f)	2004 (a)	2005 (a)	2006 (a)	2007 (a)	2008 (a)	2009 (f)	2010 (f)
<b>Economic Activity</b>													
<b>Private final demand</b>	<b>4.2</b>	<b>4.3</b>	<b>5.7</b>	<b>1.6</b>	<b>0.4</b>	<b>2.0</b>	<b>5.7</b>	<b>4.3</b>	<b>3.5</b>	<b>6.1</b>	<b>3.9</b>	<b>0.1</b>	<b>1.4</b>
<i>Of which:</i> Household spending	2.6	4.0	3.7	0.7	1.8	3.3	5.9	3.0	3.2	4.3	2.1	0.7	2.9
Dwelling investment	-4.3	1.9	1.6	-0.3	5.6	8.1	3.0	-3.4	-2.7	2.7	2.0	-0.8	10.1
Business investment	16.4	7.6	15.6	7.2	-7.0	-5.4	9.9	16.7	8.2	14.9	13.1	-2.1	-7.5
<b>Public final demand</b>	<b>3.8</b>	<b>3.3</b>	<b>4.0</b>	<b>4.0</b>	<b>5.4</b>	<b>5.1</b>	<b>5.0</b>	<b>4.3</b>	<b>3.6</b>	<b>2.8</b>	<b>5.0</b>	<b>4.2</b>	<b>5.6</b>
<b>Domestic final demand</b>	<b>4.1</b>	<b>4.1</b>	<b>5.3</b>	<b>2.1</b>	<b>1.5</b>	<b>2.7</b>	<b>5.6</b>	<b>4.3</b>	<b>3.5</b>	<b>5.3</b>	<b>4.1</b>	<b>1.0</b>	<b>2.4</b>
Inventories (contrib to GDP)	-0.4	0.1	0.2	-1.0	0.7	0.1	-0.1	0.1	-0.6	0.6	-0.6	-0.2	0.5
<b>GNE</b>	<b>3.7</b>	<b>4.1</b>	<b>5.5</b>	<b>1.1</b>	<b>2.2</b>	<b>2.8</b>	<b>5.4</b>	<b>4.4</b>	<b>2.8</b>	<b>5.9</b>	<b>3.5</b>	<b>0.8</b>	<b>2.8</b>
Exports	2.2	3.8	4.3	0.2	-0.9	10.0	4.3	2.3	3.3	3.2	4.7	-4.5	6.9
Imports	7.2	9.2	13.0	2.8	5.2	9.1	15.0	8.9	7.2	11.5	10.6	0.2	8.6
<i>Net exports (contrib to GDP)</i>	<i>-1.0</i>	<i>-1.1</i>	<i>-1.9</i>	<i>-0.6</i>	<i>-1.5</i>	<i>0.0</i>	<i>-1.7</i>	<i>-1.2</i>	<i>-0.8</i>	<i>-1.8</i>	<i>-1.4</i>	<i>-1.0</i>	<i>0.0</i>
<b>GDP</b>	<b>3.0</b>	<b>3.3</b>	<b>3.6</b>	<b>0.2</b>	<b>0.9</b>	<b>3.3</b>	<b>3.8</b>	<b>2.8</b>	<b>2.8</b>	<b>4.0</b>	<b>2.1</b>	<b>-0.3</b>	<b>2.5</b>
<b>Prices &amp; Wages</b>													
<b>CPI</b>	<b>3.2</b>	<b>2.9</b>	<b>3.4</b>	<b>3.1</b>	<b>2.5</b>	<b>2.6</b>	<b>2.3</b>	<b>2.7</b>	<b>3.5</b>	<b>2.3</b>	<b>4.4</b>	<b>1.9</b>	<b>2.8</b>
Underlying CPI	2.6	2.9	3.8	4.3	3.4	2.5	2.5	2.5	2.9	3.1	4.4	3.9	2.8
AWOTE	4.7	3.7	5.0	5.2	3.5	4.3	3.9	5.4	3.4	4.8	4.9	4.6	3.7
<b>WPI</b>	<b>4.1</b>	<b>3.9</b>	<b>4.2</b>	<b>4.2</b>	<b>3.7</b>	<b>3.9</b>	<b>3.5</b>	<b>4.1</b>	<b>4.0</b>	<b>4.1</b>	<b>4.1</b>	<b>4.0</b>	<b>3.6</b>
Real h/hold disposable income	4.8	6.8	1.8	7.7	1.0	3.2	6.7	4.7	5.6	4.6	3.9	5.1	1.9
<b>Labour Market</b>													
Employment	2.9	2.9	2.6	1.1	-0.1	2.2	1.9	3.5	2.6	2.8	2.2	-0.1	1.1
Unemployment rate	5.0	4.5	4.2	5.0	6.9	6.5	5.4	5.0	4.8	4.4	4.2	6.2	6.8
<b>External Accounts</b>													
<b>Current Account: \$bn</b>	<b>-53.1</b>	<b>-59.5</b>	<b>-70.4</b>	<b>-44.3</b>	<b>-79.9</b>	<b>-75.7</b>	<b>-52.8</b>	<b>-54.0</b>	<b>-53.6</b>	<b>-68.1</b>	<b>-50.1</b>	<b>-68.3</b>	<b>-78.5</b>
<i>% of GDP</i>	<i>-5.5</i>	<i>-5.7</i>	<i>-6.2</i>	<i>-3.7</i>	<i>-6.5</i>	<i>-5.8</i>	<i>-6.1</i>	<i>-5.8</i>	<i>-5.3</i>	<i>-6.3</i>	<i>-4.2</i>	<i>-5.6</i>	<i>-6.2</i>

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