

Investing in Bulgaria

The strategic business destination in Central and Eastern Europe



Julian Callow

Managing Director, Head of International Economics,
Head of European Economics
Barclays Capital

Investing in your future



EUROPEAN UNION
European Regional
Development Fund



OP "Development of
the Competitiveness
of the Bulgarian
Economy" 2007-2013



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Julian Callow
Chief International Economist
julian.callow@barclays.com
+44 20 777 31369

The age of austerity

December 2012

2012-14: Global economy still in rebalancing mode

- The pace of global growth has moderated significantly in recent quarters:
 - Barclays projections: 3.3% in 2013, rising to 4.0% in 2014, after 3.1% in 2012
 - Ongoing sustained dampening forces relate to re-balancing in both private and public sectors around the world:
 - Policymakers in many EM countries tightened policy in 2011 (economies then slowed)
 - Chinese authorities seeking to re-balance towards consumption from investment
 - US fiscal tightening in 2012: headwind likely to be 1.5% of GDP (similar to euro area)
 - Europe witnesses major fiscal austerity and acute financial stress in some countries; de-leveraging also apparent , leading to sharply rising unemployment
 - ▶ Re-balancing processes of diverse forms at similar time:
Generates frictions and uncertainty: Downside risks to demand expansion arise
However: Negative 'tail' risks are being reduced, particularly in Europe
- Central banks likely to maintain a highly accommodative monetary policy
 - ▶ Fed now embarked upon third QE programme; could be substantial
 - ▶ ECB set to adopt major asset purchase programme (Outright Monetary Transactions)
- Concerns about euro area resolution are likely to overhang financial markets ▶ weaker euro
- 'Emerging' economies set to adopt renewed stimulus, but now face greater constraints

Global forecasts – near term

Real GDP (% y/ y)	weight*	Actual			Barclays forecast (<i>consensus</i>)			
		2009	2010	2011	2012	2013	2014	
Global	100.0	-0.8	5.0	3.8	3.1 (3.1)	3.3 (3.4)	4.0	
Developed	51.5	-3.6	2.5	1.4	1.2 (1.2)	1.2 (1.2)	1.9	
US	21.5	-3.1	2.4	1.8	2.3 (2.2)	2.1 (1.9)	2.5	
Japan	6.3	-5.5	4.5	-0.7	1.6 (1.8)	0.1 (0.8)	0.9	
Euro area	15.4	-4.3	1.9	1.5	-0.4 (-0.5)	0.1 (0.2)	1.4	
France	3.1	-3.1	1.6	1.7	0.1 (0.1)	0.4 (0.2)	1.6	
Germany	4.4	-5.1	4.0	3.1	1.0 (0.8)	1.2 (0.8)	1.8	
Greece	0.4	-3.2	-4.8	-7.2	-5.9 (-6.5)	-4.1 (-3.8)	-0.5	
Ireland	0.3	-5.5	-0.8	1.4	0.4 (0.1)	1.3 (1.0)	2.4	
Italy	2.5	-5.5	1.8	0.6	-2.1 (-2.4)	-0.8 (-0.7)	1.0	
Portugal	0.3	-2.9	1.4	-1.7	-3.0 (-3.2)	-1.7 (-2.1)	0.8	
Spain	1.9	-3.7	-0.3	0.4	-1.4 (-1.5)	-1.5 (-1.6)	0.8	
Sweden	0.5	-5.0	6.3	3.9	0.9 (1.2)	1.3 (1.7)	2.4	
Denmark	0.3	-5.8	1.3	0.8	-0.1 (0.1)	0.9 (1.1)	1.8	
Norway	0.4	-1.5	1.8	2.4	3.4 (3.6)	2.8 (2.8)	3.0	
UK	3.2	-4.0	1.8	0.9	-0.1 (-0.1)	1.4 (1.3)	2.1	
Switzerland	0.5	-1.9	3.0	1.9	1.0 (0.8)	1.2 (1.1)	1.5	
Emerging	48.5	2.6	8.0	6.5	5.0 (5.1)	5.5 (5.7)	6.0	
Brazil	3.3	-0.3	7.5	2.7	0.9 (1.5)	3.0 (3.8)	3.6	
Mexico	2.4	-6.0	5.3	3.9	3.8 (3.9)	3.0 (3.5)	4.0	
China	17.0	9.0	10.5	9.3	7.6 (7.7)	7.6 (8.1)	8.1	
India**	6.5	6.4	8.8	7.4	5.4 (5.6)	6.7 (6.6)	7.4	
Indonesia	1.7	4.6	6.2	6.5	6.3 (6.2)	6.3 (6)	6.4	
Turkey	1.5	-4.9	9.5	8.5	2.9 (2.9)	4.2 (4.0)	4.7	
South Africa	0.8	-1.5	3.1	3.5	2.5 (2.5)	3.0 (2.9)	3.6	

Source: Haver, Barclays Research, Consensus Economics, Nov 2012

* Based on the IMF PPP based GDP weights, 5yr centred moving averages

** Consensus forecasts for India are for FY

Global forecasts – medium term

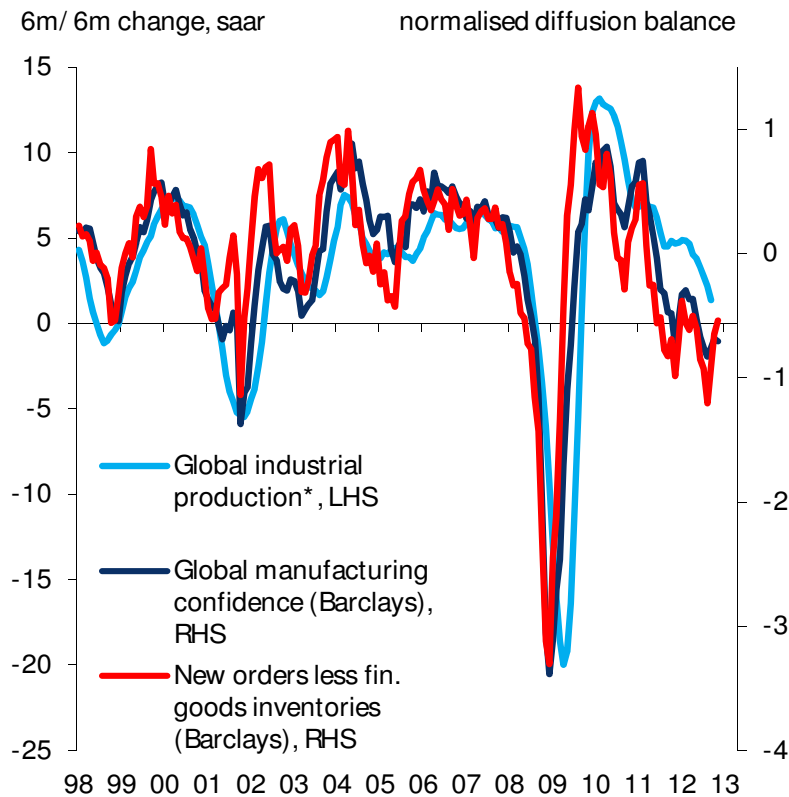
	Real GDP (% pa)		Per capita income level (K\$ current)				Nominal GDP (annual, \$trn)				GDP change (\$trn)	
	05-10	10-15f	2000	2005	2010	2015f	2000	2005	2010e	2015f	2005-10	10-15f
Germany	1.3	1.9	23.0	33.6	40.5	43.7	1.9	2.8	3.3	3.5	0.54	0.24
France	0.8	1.1	22.6	35.1	40.9	41.9	1.3	2.1	2.6	2.7	0.43	0.13
Italy	0.0	0.2	19.5	30.6	34.2	32.9	1.1	1.8	2.1	2.0	0.27	-0.04
Spain	1.3	0.0	14.5	26.1	30.2	29.2	0.6	1.1	1.4	1.4	0.26	-0.02
Greece	0.6	-2.9	11.7	21.7	27.0	21.4	0.1	0.2	0.3	0.2	0.06	-0.06
Ireland	1.4	1.3	25.8	49.1	46.4	49.6	0.1	0.2	0.2	0.2	0.00	0.01
Netherlands	1.5	1.0	24.2	39.2	47.0	47.8	0.4	0.6	0.8	0.8	0.14	0.03
Portugal	0.5	-0.2	11.5	18.3	21.5	20.2	0.1	0.2	0.2	0.2	0.04	-0.01
Euro area	1.0	1.0	20.0	31.5	36.6	40.9	6.3	10.1	12.2	12.6	2.03	0.40
Emerging Europe	3.6	3.5	3.6	6.8	9.7	13.4	0.6	1.2	1.7	2.2	0.58	0.43
Russia	4.1	4.0	1.8	5.3	10.4	18.0	0.3	0.8	1.5	2.5	0.72	1.04
UK	1.0	1.3	25.1	38.2	36.4	43.4	1.5	2.3	2.3	2.8	-0.03	0.53
US	1.1	2.5	35.3	42.6	46.8	55.0	10.0	12.6	14.5	17.8	1.88	3.27
Japan	0.5	1.6	37.3	35.8	42.9	49.9	4.7	4.6	5.5	6.3	0.92	0.84
Brazil	4.3	4.0	3.8	4.8	11.1	14.2	0.6	0.9	2.1	2.9	1.26	0.72
Latam & Carib.	4.2	4.3	4.3	5.0	8.6	11.1	2.1	2.7	4.9	6.7	2.24	1.79
China	11.2	8.8	0.9	1.7	4.4	8.0	1.2	2.3	5.9	10.9	3.67	5.00
India	8.6	6.8	0.5	0.7	1.4	2.0	0.5	0.8	1.6	2.5	0.82	0.92
Indonesia	5.7	6.4	0.8	1.3	3.0	5.4	0.2	0.3	0.7	1.4	0.42	0.66
Korea	3.9	4.0	11.3	17.6	20.5	27.9	0.5	0.8	1.0	1.4	0.17	0.40
Malaysia	4.6	5.2	4.0	5.4	8.7	13.0	0.1	0.1	0.2	0.4	0.10	0.15
Developing Asia	9.3	7.7	0.7	1.2	2.7	4.5	2.3	4.1	9.6	16.9	5.52	7.27
Egypt	5.9	3.7	1.6	1.3	2.8	3.3	0.1	0.1	0.2	0.3	0.13	0.07
Saudi Arabia	3.4	5.1	9.2	13.7	16.5	23.6	0.2	0.3	0.5	0.7	0.14	0.27
ME + N Africa	...	...	2.6	3.6	5.8	8.1	0.8	1.3	2.4	3.4	1.04	1.00
South Africa	3.6	3.3	3.0	5.3	7.3	8.4	0.1	0.2	0.4	0.4	0.12	0.08
Sub-Saharan Africa	5.6	5.4	0.5	0.9	1.4	1.7	0.3	0.6	1.1	1.6	0.46	0.46

Source: IMF

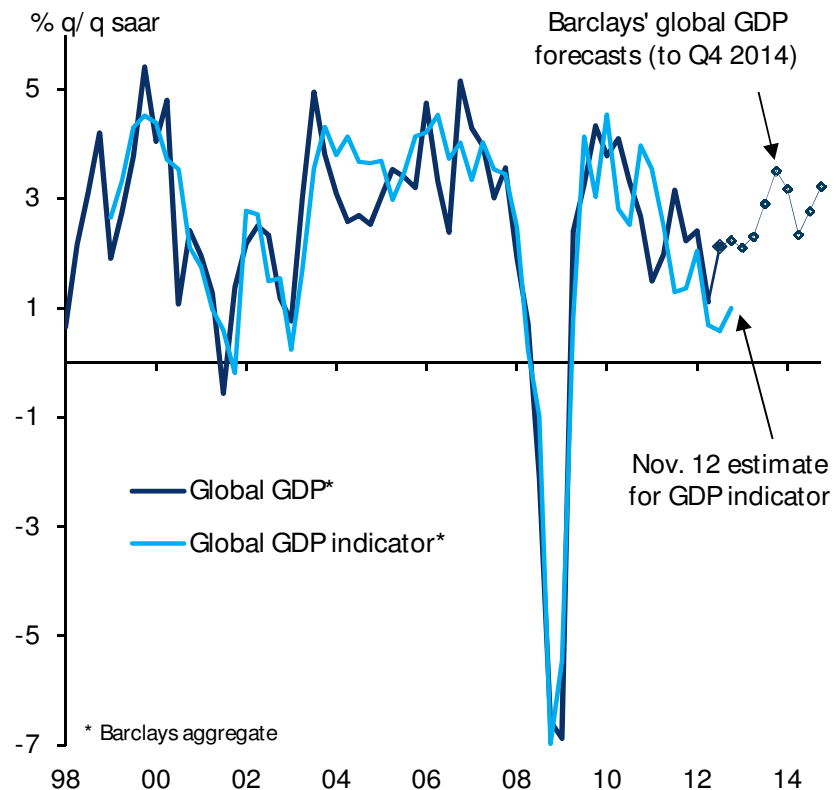
Signs of some near-term downside risk

- Global business confidence data suggest industrial stagnation and downside risks to projections

Global manufacturing confidence



Global GDP indicator vs GDP growth



* Barclays aggregate

Source: Barclays Research, Markit, Haver

Fiscal adjustment: OECD 'headwind' to intensify in 2013

Fiscal impulse: change in structural budget balance/GDP ratio (pp)						
pp	2010	2011	2012 E	2013 F	2014 F	€A weight
Austria	0.4	0.6	0.4	0.7	0.3	3.1%
Belgium	0.6	-0.3	1.0	0.5	0.2	3.8%
Finland	-0.6	1.4	0.4	0.5	-0.2	1.9%
France	0.8	1.7	1.3	2.0	0.4	21.4%
Germany	-0.9	1.2	0.5	0.0	0.0	26.8%
Greece	6.0	3.3	3.9	2.2	2.1	2.6%
Ireland	1.7	1.6	2.3	2.1	1.8	1.8%
Italy	1.1	0.2	2.3	1.1	0.4	16.9%
NL	1.1	-0.2	0.8	1.1	0.3	6.4%
Portugal	0.8	2.2	2.1	1.6	1.6	1.8%
Spain	1.1	0.1	1.2	2.3	2.0	11.7%
Others	...	...	...	...		1.8%
Euro area	0.5	0.9	1.2	1.1	0.5	100.0%
Japan	-0.5	-0.7	-0.5	-0.2	0.6	...
Sweden	0.2	-0.7	-0.2	-0.8	0.1	...
UK (FY)	0.6	2.1	1.1	1.4	1.4	...
US	0.6	1.0	1.0	1.5	0.5	...
OECD	0.4	0.8	0.8	1.1	0.6	...

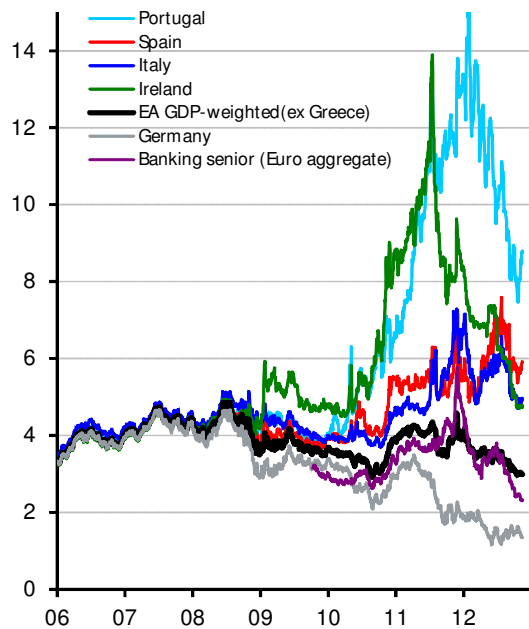
Source: OECD, European Commission, IMF, Barclays, Bdl, BdE

ECB 'LTROs' were needed to restore market confidence

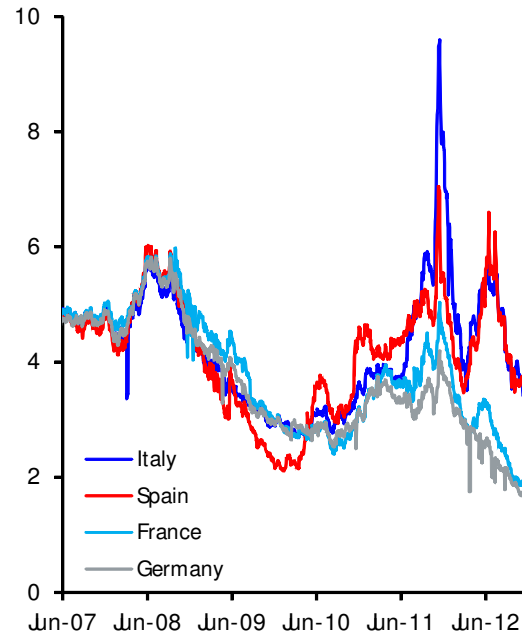
- The euro area GDP-weighted bond yield has been running around 3.0% (ex Greece)
- The rising divergence of bond yields is leading to a pronounced tightening of monetary conditions in the periphery: gap still too wide in periphery (RH chart below)

Increasingly divergent financial conditions across the euro area

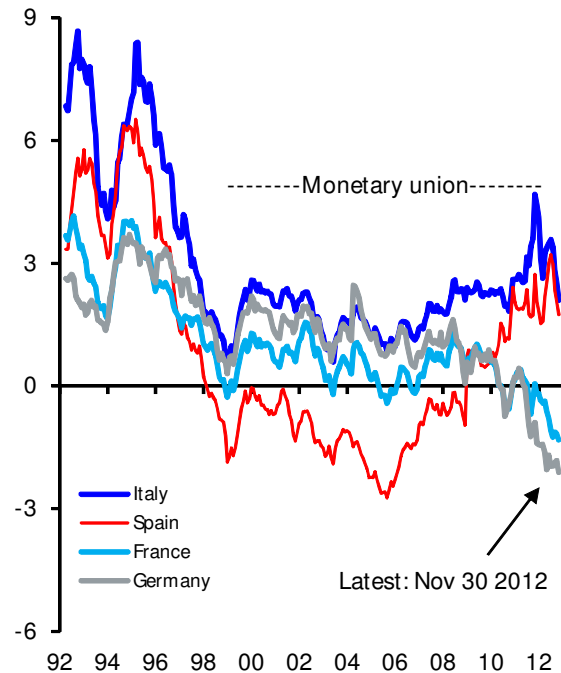
10y sovereign yields (%)



Senior bank debt yields (%)



**10y sovereign yields minus nominal trend growth
(real potential growth+5Y inflation expectations)**

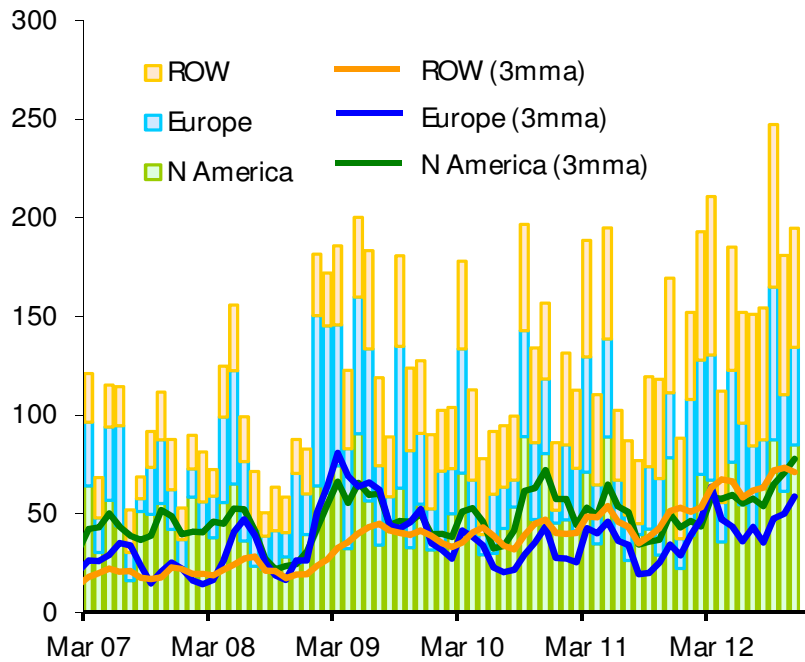


Source: Barclays Research, Haver Analytics

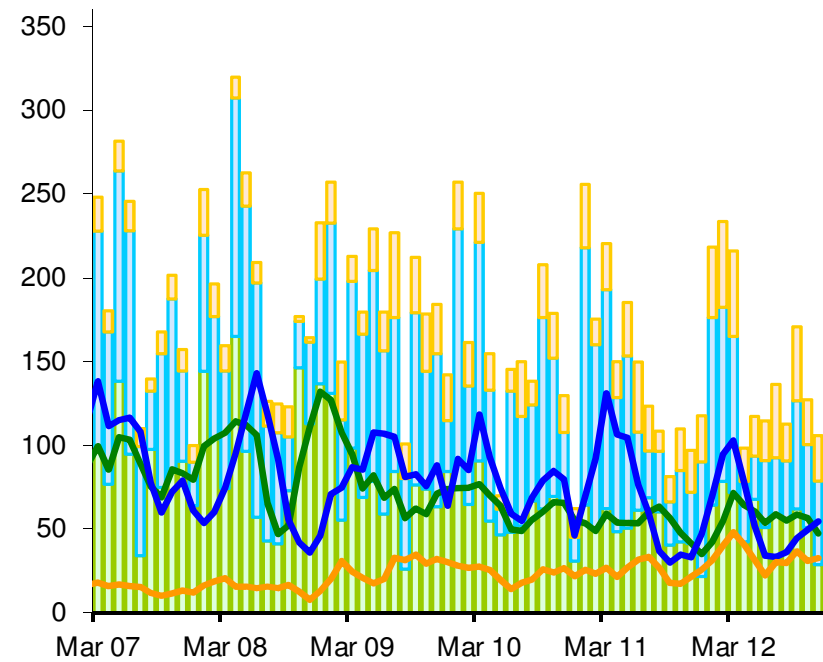
Central bank actions unleash a flood of issuance

Gross Bond Issuance: Monthly (\$ bn)

Non-financials

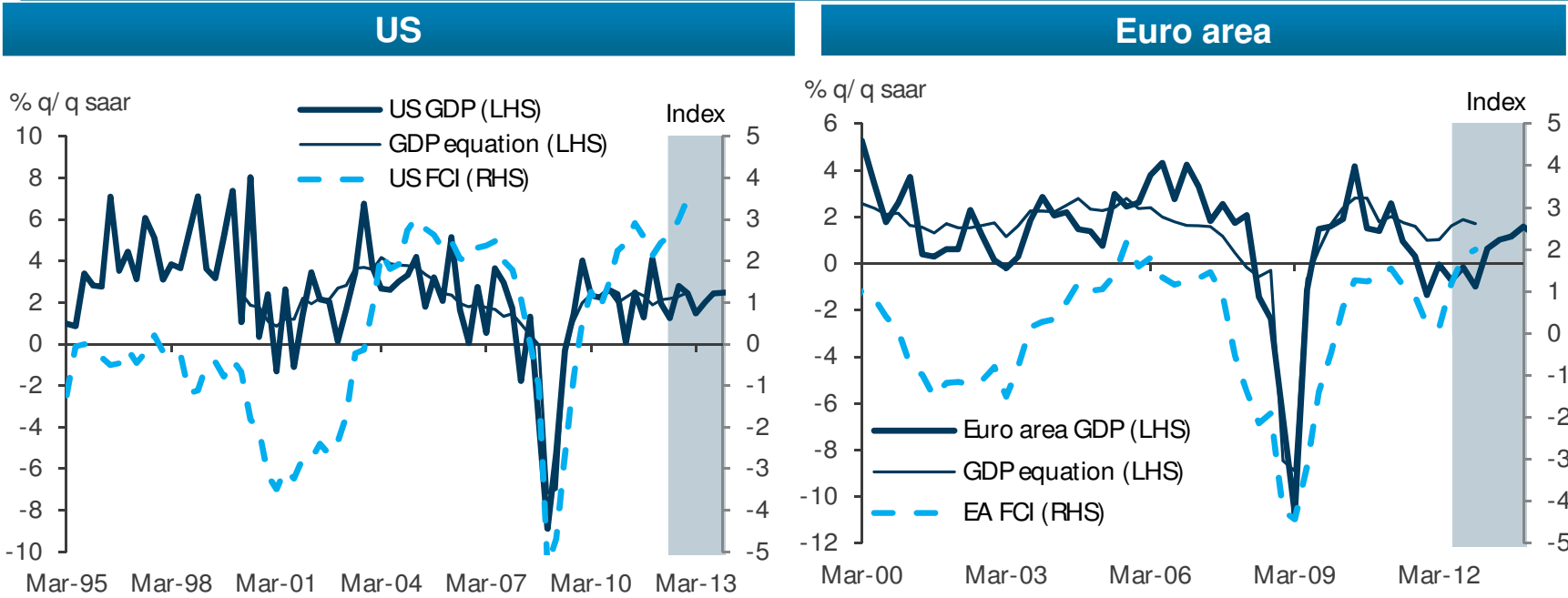


Financials



Source: Barclays Research, Dealogic

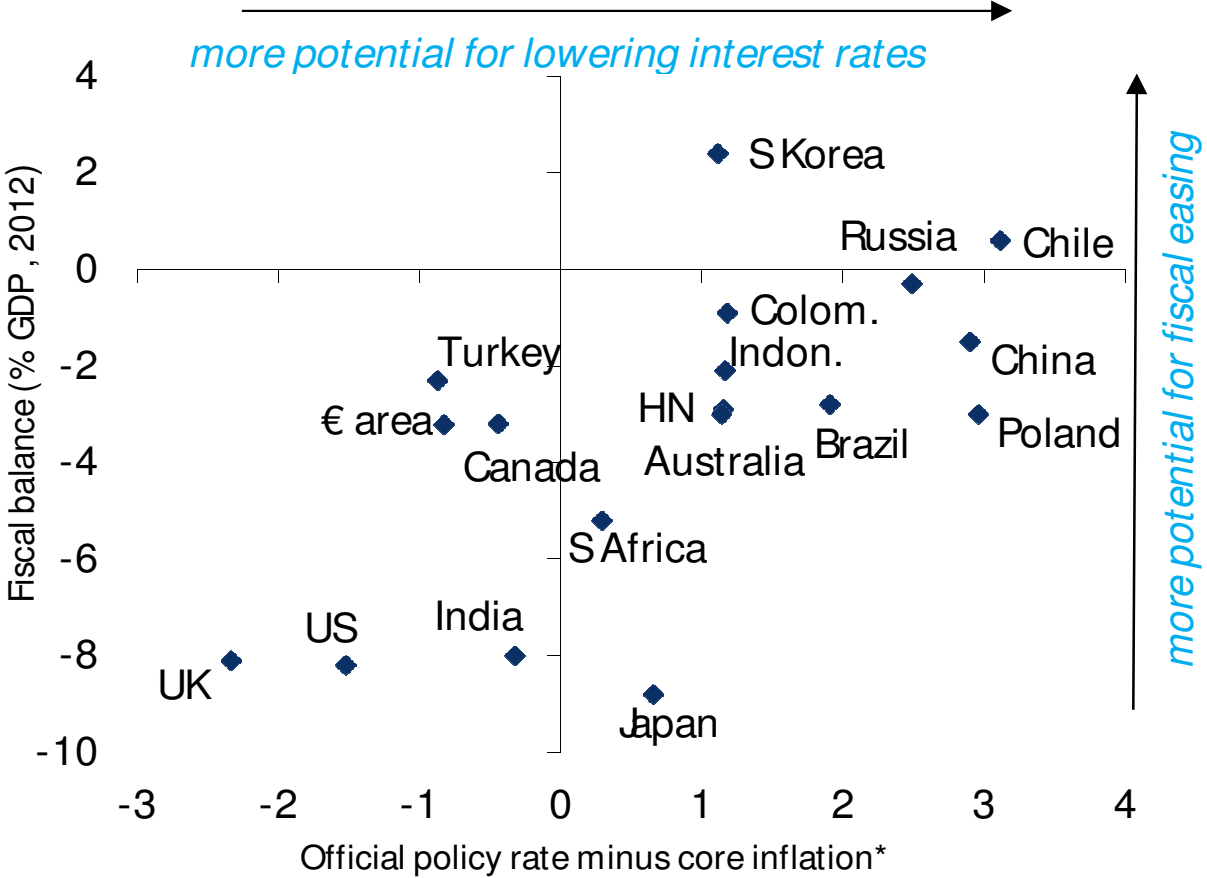
Financial conditions indices signal modest growth



Source: Barclays Research, OECD, Haver Analytics

Emerging economies have more scope for easing

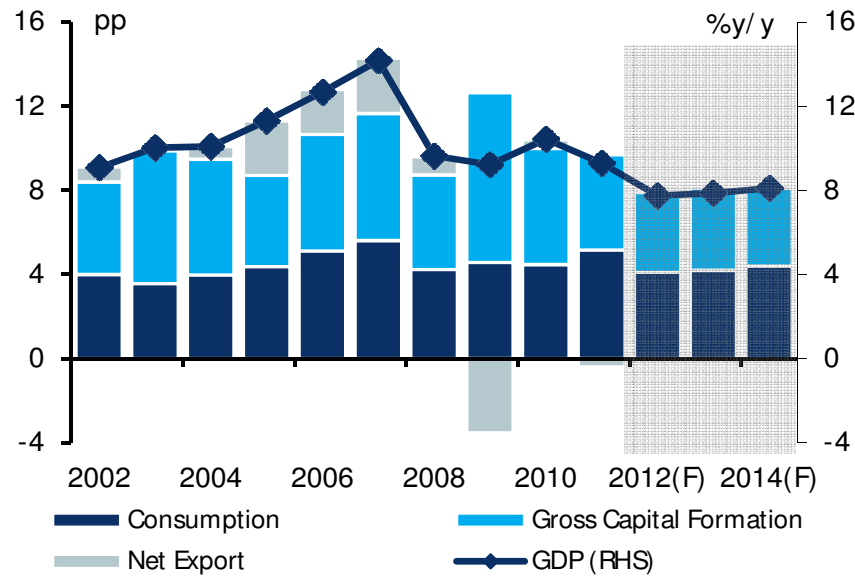
Comparing budget balances and real interest rates



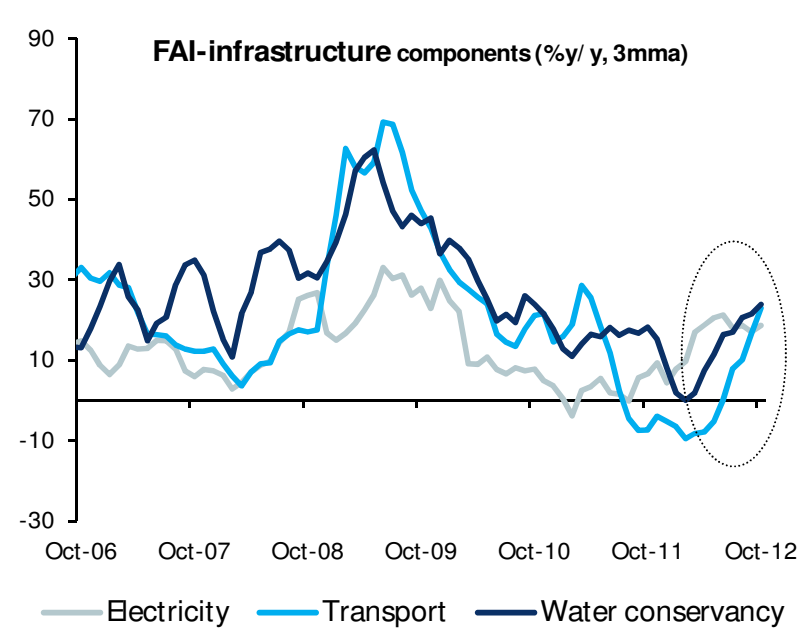
Source: Barclays Research, Haver Analytics * Uses headline inflation for India and Colombia

China: slowing to 7½% growth; transition from investment

Chinese GDP: key contributions



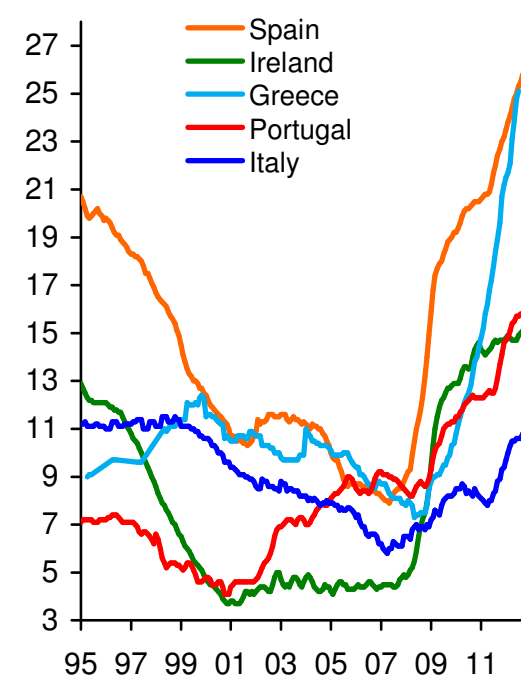
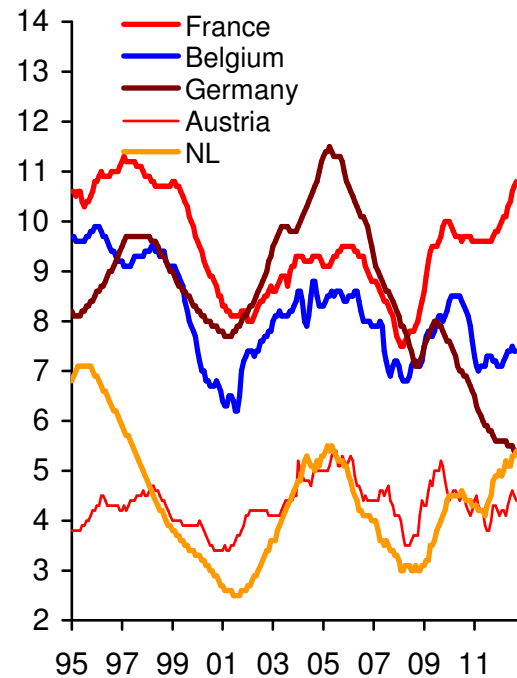
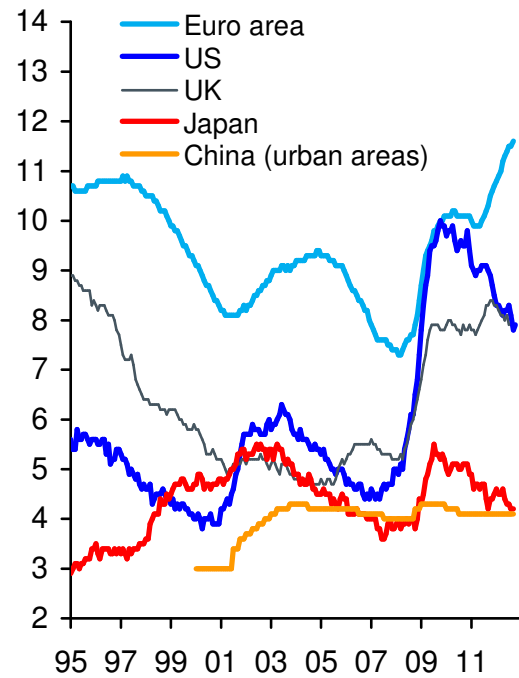
Government support for infrastructure



Source: Barclays, Haver

Europe *must* tackle surging unemployment in the south

Unemployment rates (%)



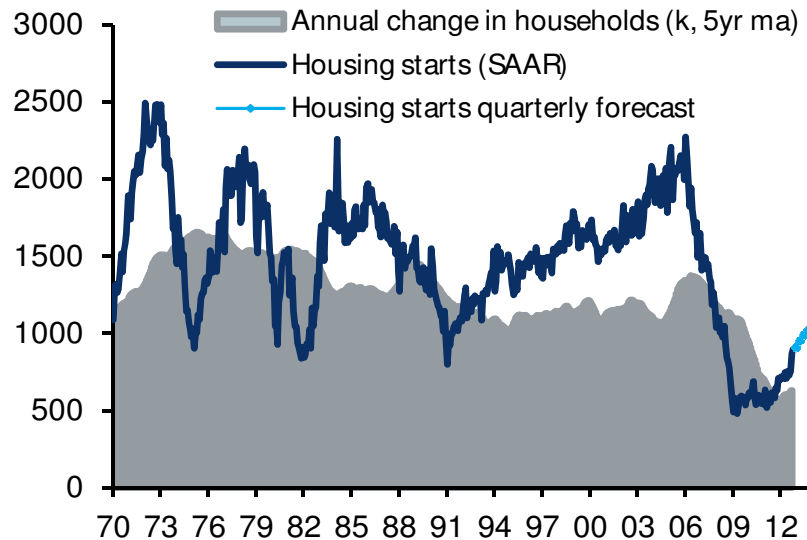
Source: Barclays Research, Haver

- Unemployment has begun to fall more sharply in the US, while it continues to decrease in a sustained way in Germany. However, it is surging in the 'periphery' in Europe

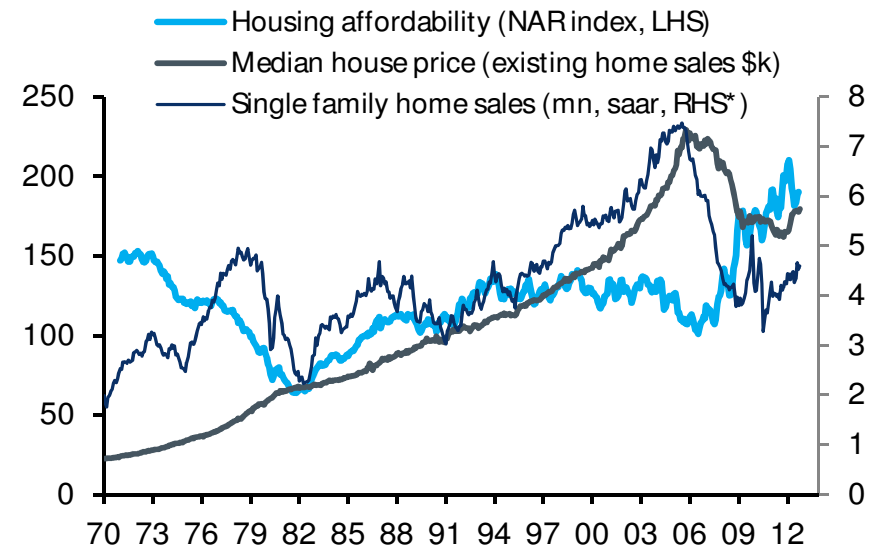
Evidence that US housing is stabilising

- Housing activity and prices are showing some signs of improving, from a very low base
- Housing affordability is at record highs, helping prices to stabilise

US housing starts vs. household formation



Housing affordability vs. prices & sales

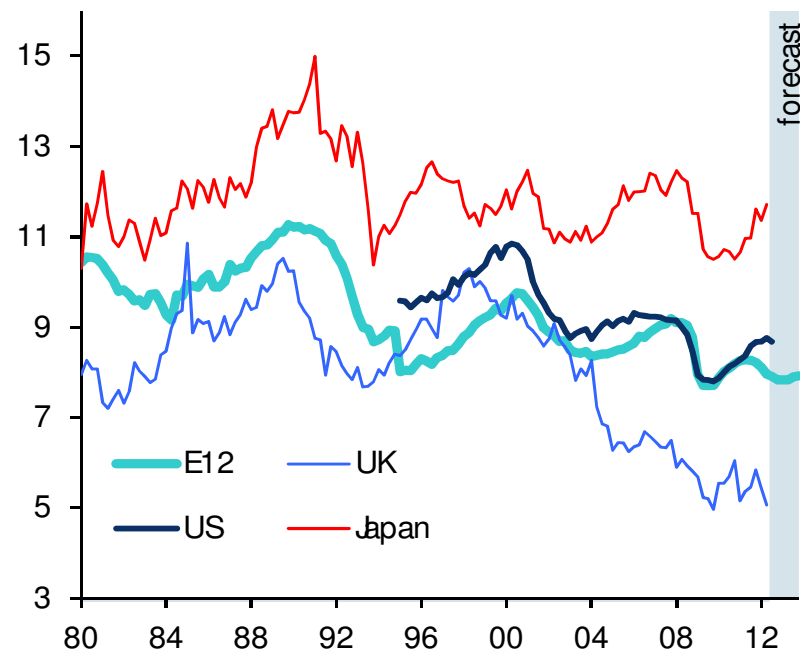
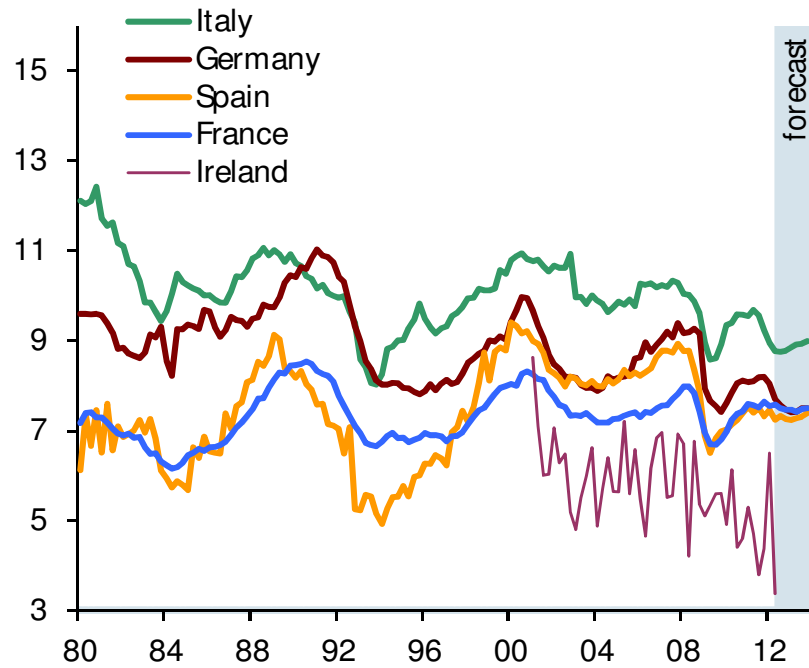


* Sum of existing and new home sales
 Source: Barclays Research; Haver Analytics (updated: 18 Nov. 2012)

Capital goods investment trends: a mixed picture

- The German ratio continues to improve: scope for further improvement also for US + UK. Japan recovers post-earthquake.

Investment excluding construction (% nominal GDP)



Note: Updated 26 Nov. 2012. Source: OECD, national statistics, European Commission, Datastream, Barclays Research

The US 'fiscal cliff'

- In our baseline there will be c. \$200bn (1.5% of GDP) of fiscal consolidation from 2013 on account of non-extension of measures.
- If the next Congress does not undertake any extension, the total tightening would be \$600bn.

Political positions on US 'fiscal cliff' measures

Likelihood of fiscal drag	Measure	Level of agreement	Latest positions (R= Republican; D = Democrat)	Size (\$bn)	Cumulative	Cumulative, % GDP
Most Likely ↓ Least Likely	Payroll Tax Cut	High	Neither party proposes extending	120	120	0.7
	Emergency Unemp. Comp.	Fairly high	Neither party proposes extending	30	150	0.9
	Estate Tax	Fairly high	Both propose extension; disagree on details	25	175	1.1
	Spending Cuts (Sequester + Medicare Rates)	Mixed	Both propose extension; disagree on details	100	275	1.7
	2001/ 2003 Tax Cuts (\$250k+)	Mixed	R. propose extension, D. expiration	35	310	1.9
	Obama Tax Credits	Low	D. propose extension, R. expiration	20	330	2.0
	Affordable Care Act	Low	D. favor, R. against	25	355	2.2
	Patch for Alternative Minimum Tax	Low	D. propose AMT extension, R. elimination	100	455	2.8
	Other Expiring Provisions	Fairly high	Repeatedly extended in the past	75	530	3.2
	2001/ 2003 Tax Cuts (Lower/ Middle Income)	High	Both parties have proposed extending	120	650	4.0
Total:					650	4.0

Source: Barclays Research

US economic outlook

	2011				2012				2013				Calendar year average			
% Change q/ q saar	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2011	2012	2013	2014
Real GDP	0.1	2.5	1.3	4.1	2.0	1.3	2.7	2.5	1.5	2.0	2.5	2.5	1.8	2.3	2.1	2.5
Private consumption	3.1	1.0	1.7	2.0	2.4	1.5	1.4	2.5	1.5	2.0	2.5	2.5	2.5	1.9	2.0	2.5
Public consump and invest.	-7.0	-0.8	-2.9	-2.2	-3.0	-0.7	3.5	-2.0	-2.0	-2.0	-1.5	-1.5	-3.1	-1.4	-1.2	-1.1
Residential investment	-1.4	4.1	1.4	12.1	20.5	8.5	14.2	15.0	10.0	10.0	12.0	12.0	-1.4	12.0	11.7	10.2
Equip. & software investment	11.1	7.8	18.3	8.8	5.4	4.8	-2.7	3.0	5.0	8.0	10.0	10.0	11.0	6.3	5.1	8.2
Structures investment	-28.2	35.2	20.7	11.5	12.9	0.6	-1.1	3.0	5.0	8.0	8.0	8.0	2.8	9.7	4.7	6.7
Net exports (\$bn, real)	-417	-400	-398	-418	-416	-407	-403	-396	-394	-392	-393	-394	-408	-405	-394	-394
Net exports (contr to GDP, pp)	0.0	0.5	0.0	-0.6	0.1	0.2	0.1	0.2	0.1	0.1	0.0	0.0	0.1	0.0	0.1	0.0
Final sales	0.6	2.4	2.3	1.5	2.4	1.7	1.9	2.3	1.4	2.1	2.7	2.7	2.0	2.1	2.0	2.4
Ch. inventories (\$bn, real)	30.3	27.5	-4.3	70.5	56.9	41.4	61.3	67.0	71.0	71.0	72.0	73.0	31.0	56.7	71.8	75.5
Ch. inventories (contr to GDP, pp)	-0.5	0.0	-1.1	2.5	-0.4	-0.5	0.8	0.2	0.1	0.0	0.0	0.0	-0.1	0.2	0.1	0.0
GDP price index	2.0	2.6	3.0	0.4	2.0	1.6	2.7	1.7	1.7	2.0	3.2	2.8	2.1	1.8	2.1	2.5
Nominal GDP	2.2	5.2	4.3	4.2	4.2	2.8	5.5	4.2	3.2	4.0	5.8	5.4	4.0	4.2	4.2	5.0
Industrial output	4.4	1.2	5.6	5.1	5.9	2.3	0.0	5.0	4.0	4.5	4.5	5.0	4.1	3.9	3.8	4.9
Employment (avg mthly chg, K)	192	130	128	164	226	67	174	160	150	180	200	200	153	157	183	200
Unemployment rate (%)	9.0	9.1	9.1	8.7	8.2	8.2	8.1	7.8	7.7	7.5	7.3	7.1	8.9	8.1	7.4	6.8
CPI inflation (%y/ y)	2.1	3.4	3.8	3.3	2.8	1.9	1.7	2.0	1.7	1.9	2.2	2.3	3.2	2.1	2.0	2.8
Core CPI (%y/ y)	1.1	1.5	1.9	2.2	2.2	2.3	2.0	2.0	2.2	2.2	2.4	2.7	1.7	2.1	2.4	2.9
Core PCE price index (%y/ y)	1.1	1.3	1.6	1.7	1.9	1.8	1.6	1.7	1.7	1.8	2.1	2.4	1.4	1.7	2.0	2.6
Current account (%GDP)	-3.2	-3.2	-2.9	-3.1	-3.5	-3.0	-3.1	-2.9	-2.9	-2.9	-2.9	-2.9	-3.1	-3.1	-2.9	-2.9
Federal budget bal. (%GDP)													-8.7	-7.0	-6.2	-5.6
Federal funds rate (%)	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25				

Numbers expressed in q/q saar % unless otherwise specified. The budget balance is fiscal year. Source: BEA, BLS, Federal Reserve, US Treasury, Barclays Research

Reduction in euro area tail risks, but not entirely eliminated

- **Four sources of risk in southern Europe:**

- ***PUBLIC SOLVENCY***

- A determined effort by governments, but a very long way to go

- ▶ Conclusion: 2013 another critical year for fiscal adjustment; fiscal policy to continue to be a major drag on domestic demand

- ***PRIVATE SOLVENCY***

- Sharply rising bad debts in countries with excessively leveraged real estate

- Major bank recapitalisation and restructuring

- ▶ Conclusion: Banks have come a long way to raise capital ratios and to write down bad debts and problems now increasingly localised, but still major in Spain

- ***EURO MEMBERSHIP RISK***

- Substantial adjustment in current account deficits, mainly through demand

- However, exports are improving in Spain, Portugal and Ireland, & unit labour costs reduced

- ▶ Conclusion: Substantial adjustment has happened more on demand; extent to which prices adjust down depends on flexibility and ongoing structural reforms

- ***POLITICAL SUSTAINABILITY***

- So far electorates have been supportive of conservative policies

- However, unemployment is advancing rapidly in southern Europe

- ▶ Conclusion: Warrants close ongoing attention, and depends on pro-growth environment

Euro area business confidence has weakened sharply

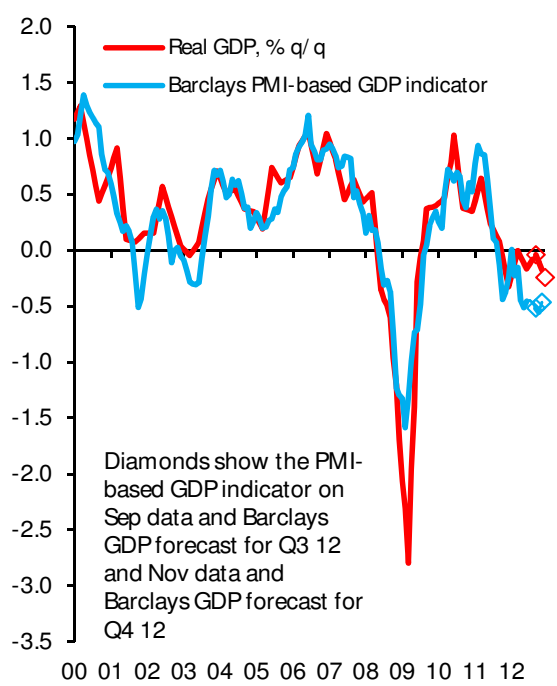
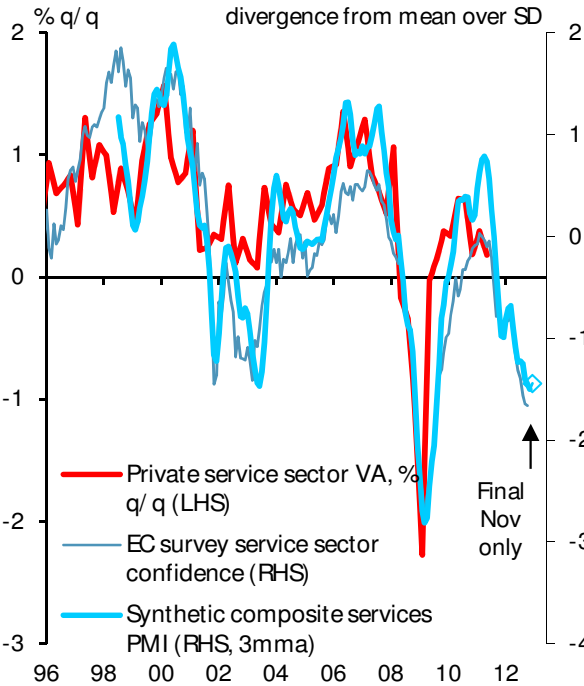
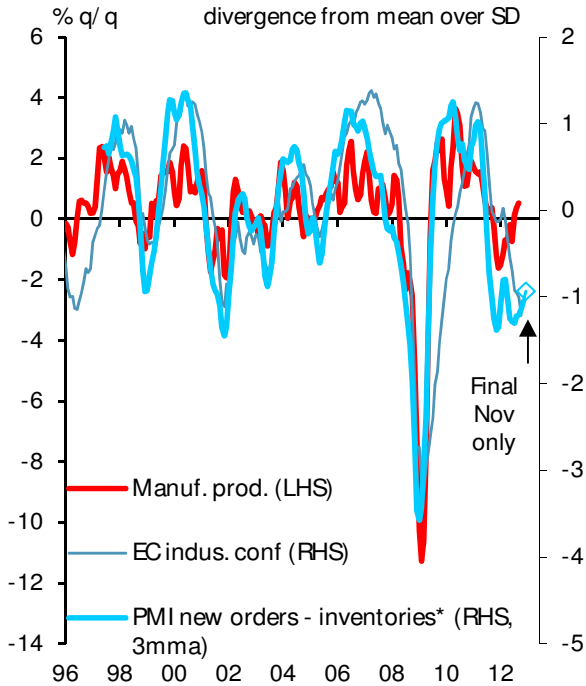
- Latest euro area surveys show a sharp downturn in confidence, consistent with our forecast that real GDP will contract in H2 12

Comparing business survey data (PMI and EC) with euro area activity data

Manufacturing confidence

Services confidence

PMI based GDP indicator

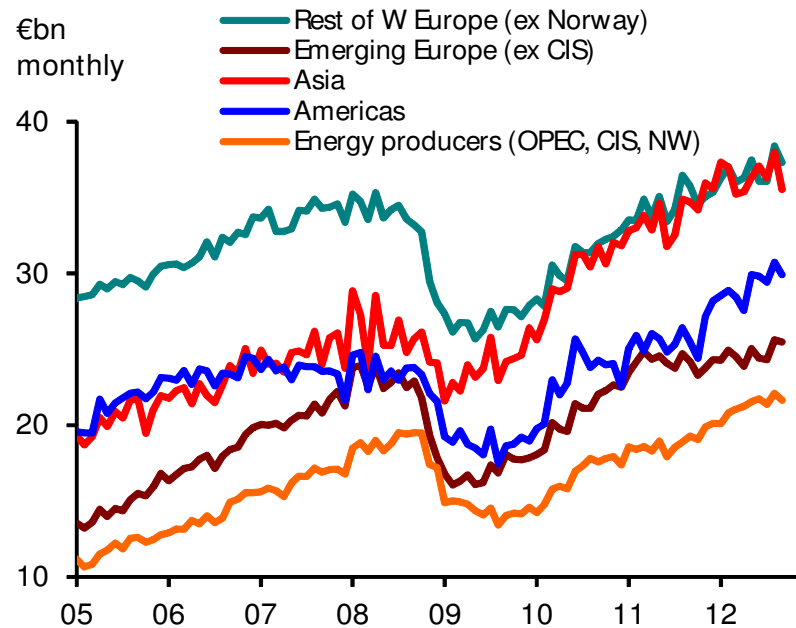


Note: Updated 05 December 2012. Surveys are shown as "normalised", i.e. difference from mean divided by standard deviation * 'Inventories: finished goods Our PMI based indicator is based on the estimation of our own weighted average of PMI indices against GDP. Source: Markit, Datastream, Barclays Research

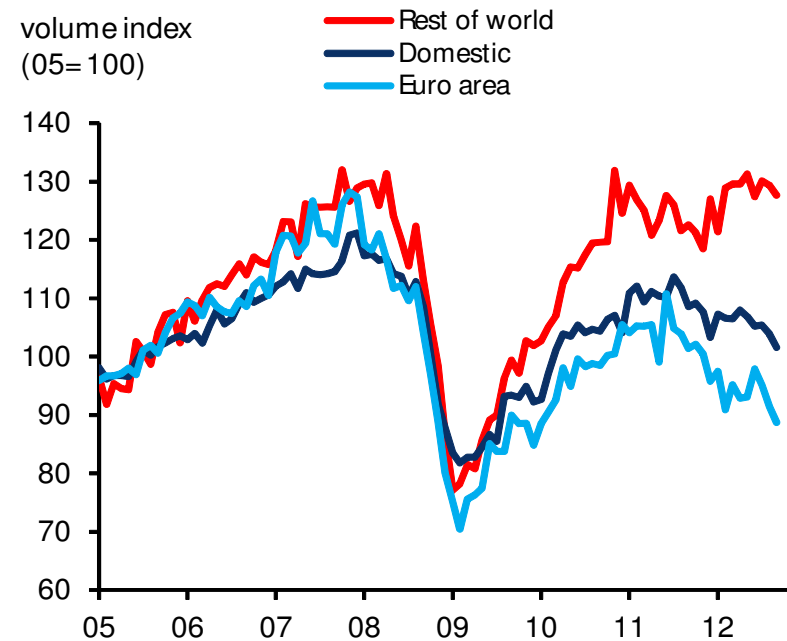
A loss of momentum from global trade

- From the European perspective, Asian exports (particularly to China) drove the recovery . . . the slowdown had been in export orders from outside the eurozone, but more recently weakening within it
- Americas & energy producers were taking up the baton as momentum ebbs from Asia

Euro area exports by region



German new industrial orders (ex. special transport)



Source: Barclays Research, Markit, Haver

Euro area outlook: Key forecasts

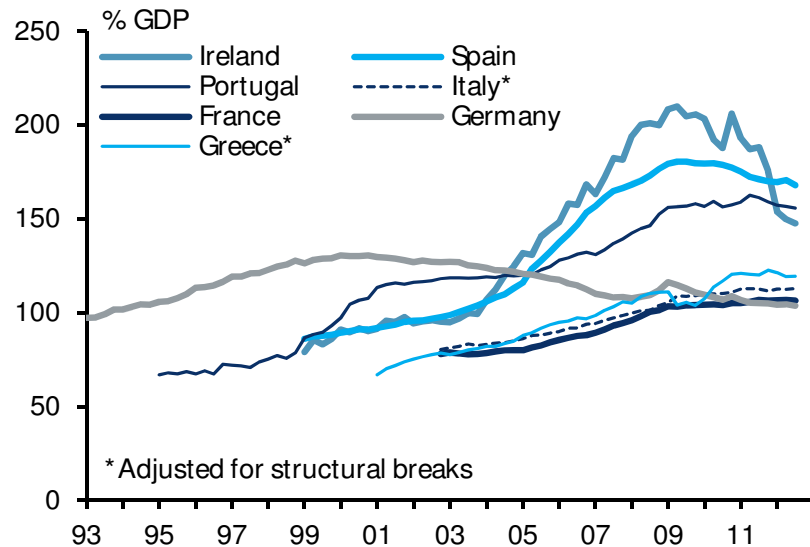
	2011				2012				2013				Calendar year average			
% change q/ q*	Q1	Q2	Q3	Q4	Q1	Q2	Q3E	Q4E	Q1E	Q2E	Q3E	Q4E	2011	2012E	2013E	2014E
Real GDP	0.6	0.2	0.1	-0.3	0.0	-0.2	-0.1	-0.3	0.0	0.2	0.2	0.3	...	...	...	...
Real GDP (saar)	2.6	0.9	0.3	-1.3	0.0	-0.7	-0.1	-1.1	0.1	0.7	1.0	1.3	...	...	...	...
Real GDP (y/ y)	2.4	1.6	1.3	0.6	0.0	-0.4	-0.6	-0.5	-0.5	-0.1	0.2	0.8	1.5	-0.4	0.1	1.4
Private consumption	0.0	-0.4	0.2	-0.5	-0.2	-0.4	0.0	-0.3	-0.2	-0.1	0.1	0.1	0.1	-0.9	-0.5	0.6
Public consumption	-0.2	0.1	-0.2	0.0	0.1	0.0	-0.1	-0.4	-0.3	-0.2	-0.1	0.0	-0.1	-0.1	-0.8	0.0
Investment	2.0	-0.2	-0.4	-0.5	-1.2	-1.5	-0.5	-0.5	-0.1	0.3	0.5	0.5	1.6	-3.3	-0.5	2.2
- Residential construction	3.0	-0.6	-0.6	-0.2	0.2	-1.5	0.2	-0.2	-0.2	-0.1	0.1	0.3	0.9	-1.4	-0.6	1.2
- Non-residential construction	2.0	-1.1	-1.0	-0.3	-2.1	-1.4	-0.7	-0.5	0.0	0.1	0.5	0.5	-1.4	-4.5	-0.7	1.5
- Non-construction investment	1.5	0.6	0.0	-0.9	-1.6	-1.5	-0.9	-0.9	-0.1	0.7	0.8	0.8	3.8	-3.9	-0.4	3.7
Inventories contribution (pp)	0.0	0.3	-0.4	-0.4	-0.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.2	-0.6	-0.1	0.0
Final dom. demand cont. (pp)	0.3	-0.3	0.0	-0.4	-0.3	-0.5	-0.1	-0.4	-0.2	0.0	0.1	0.2	0.3	-1.2	0.7	0.8
Net exports contribution (pp)	0.2	0.2	0.5	0.5	0.4	0.3	0.3	0.1	0.2	0.2	0.1	0.1	1.0	1.4	0.7	0.2
Industrial output (ex construct.)	1.0	0.2	0.5	-1.8	-0.5	-0.5	-0.5	-1.4	-0.9	-0.4	-0.3	-0.1	3.4	-2.5	-2.8	0.0
Employment (q/ q)	0.1	0.2	-0.1	-0.3	-0.3	0.0	-0.1	-0.1	-0.1	-0.2	-0.1	-0.1	0.3	-0.4	-0.5	0.0
Unemployment rate %	9.9	9.9	10.2	10.6	10.9	11.3	11.5	11.7	11.9	12.0	12.1	12.3	10.2	11.4	12.1	12.1
CPI inflation (y/ y)	2.5	2.8	2.7	2.9	2.7	2.5	2.5	2.3	2.0	1.9	1.8	1.7	2.7	2.5	1.8	1.7
Core CPI (ex food/ energy) y/ y	1.1	1.6	1.3	1.6	1.5	1.6	1.6	1.4	1.4	1.4	1.4	1.3	1.4	1.5	1.4	1.2
Current account % GDP	0.0	-0.3	0.0	0.5	0.9	1.2	1.4	1.5	1.7	1.9	2.0	2.1	0.1	1.3	1.9	2.1
Government balance % GDP	...	...	...	...	...	...	...	...	...	...	...	...	-4.1	-3.1	-2.4	-1.8
Refi rate (period end %)	1.00	1.25	1.50	1.00	1.00	1.00	0.75	0.75	0.50	0.50	0.50	0.50	1.00	0.75	0.50	0.50

Note: Data show percent seasonally adjusted q/q rates of change (unless stated otherwise)
Source: Barclays Research

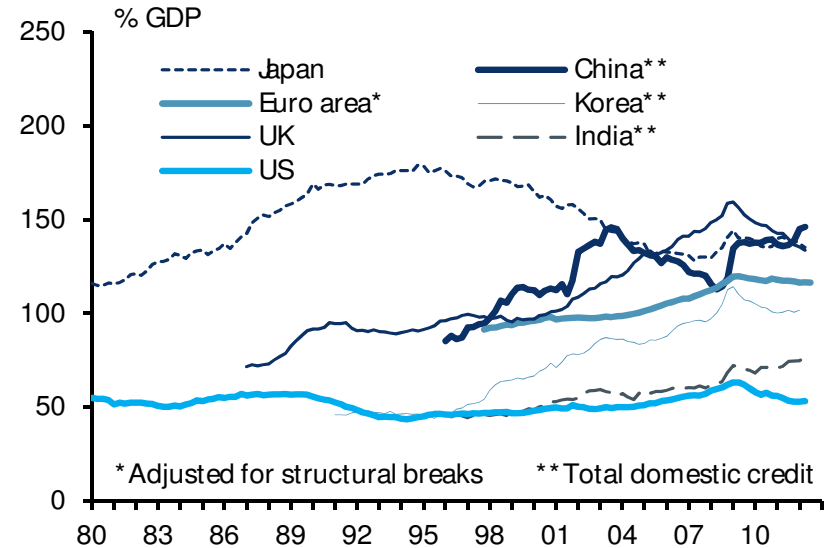
De-leveraging: emerging in periphery

Bank loans to non-financial domestic sector (% GDP)

Euro area



International comparisons



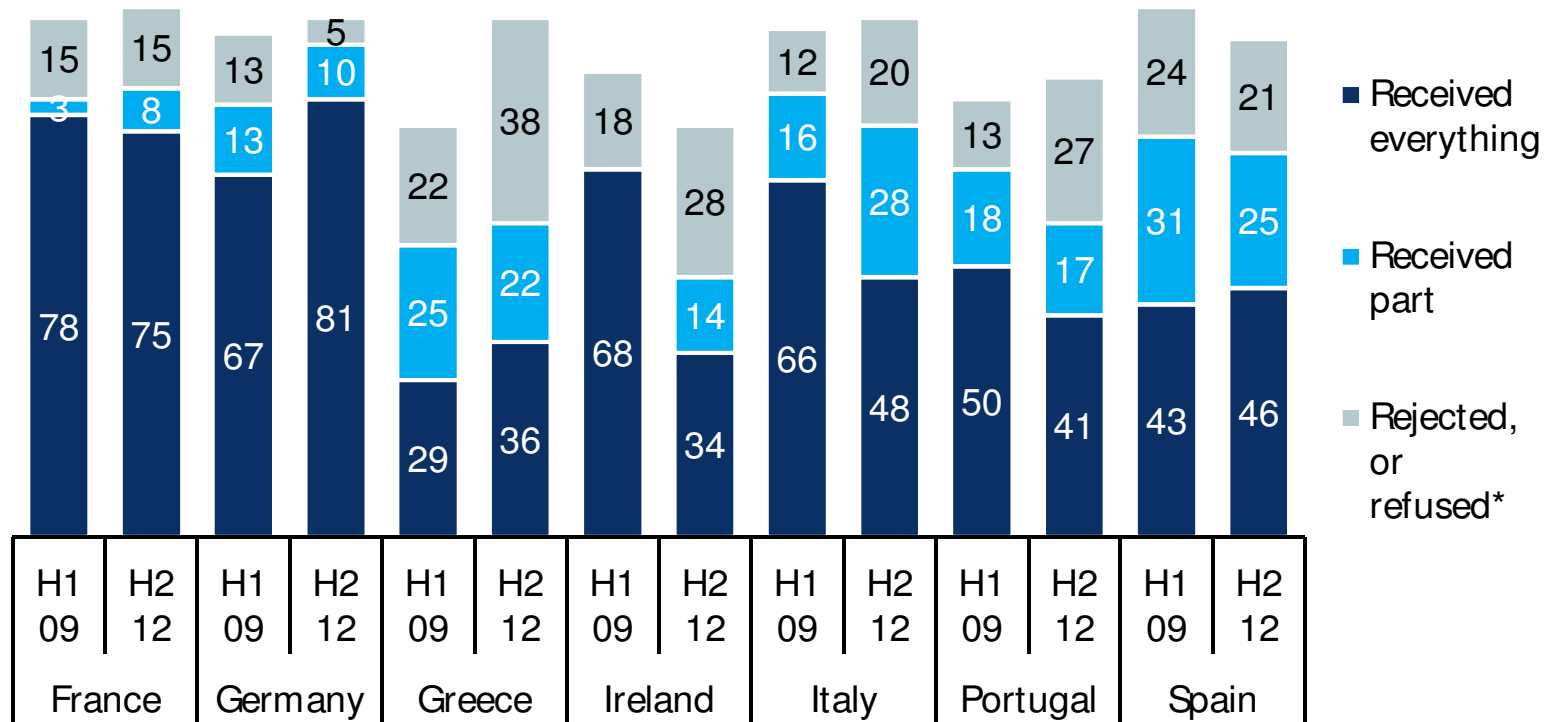
The pace of increase in bank leverage, and the subsequent peak in the euro area “periphery” ratio of bank lending to GDP, has been much greater than that seen in Japan in the 1980s-1990s

Note: Updated 15 October 2012. ** This is an IMF series (“domestic credit”) that represents loans by banks to the domestic non-financial sector.
Source: IMF, Haver Analytics, Barclays Research

Evidence of asymmetric monetary transmission

Eurosystem survey of SMEs

Response of those who applied for new/renewed bank loan (ex. overdraft, credit line), past 6 months (%)



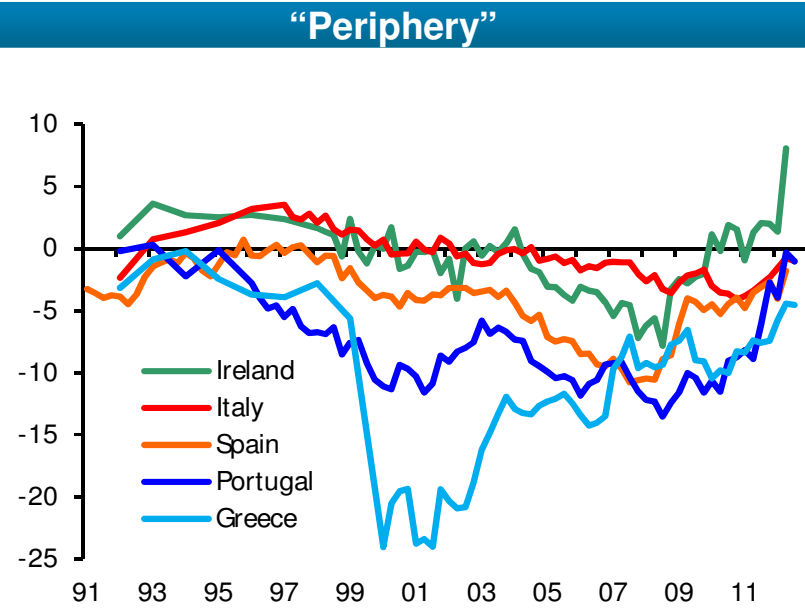
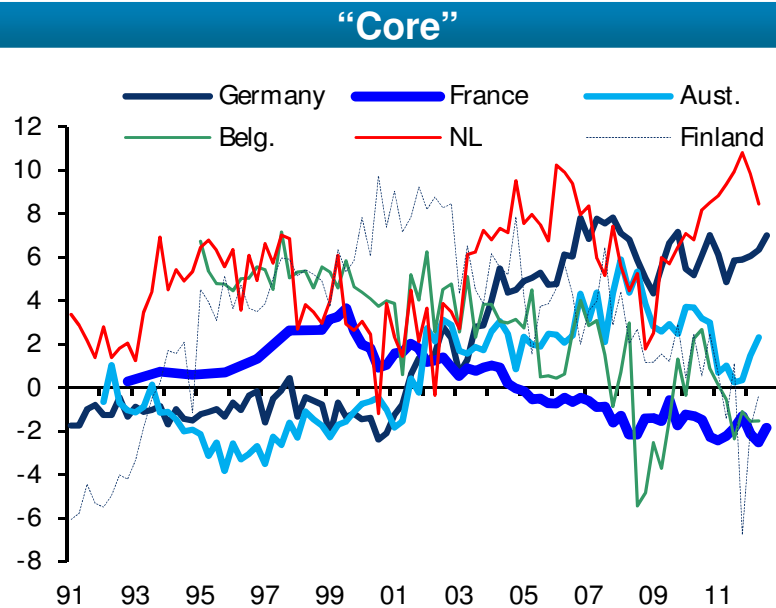
* Refused by the SME because cost too high

Source: Barclays Research, ECB

External imbalance adjustment: work in progress

- The superior performance of industrial unit labour costs has resulted generally in rising current account surpluses in the “core” countries (with France the main exception)
- In the “periphery” current accounts deteriorated rapidly from the start of EMU in 1999 to 2007; they are since narrowing sharply

Current account balances (as % GDP, seasonally adjusted)



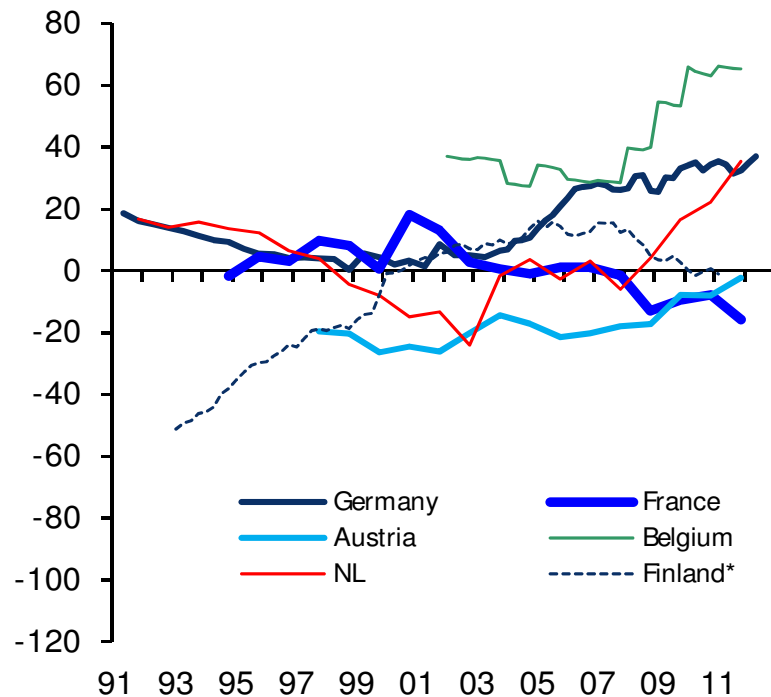
Source: Haver Analytics; Barclays Research

But investment positions still very negative

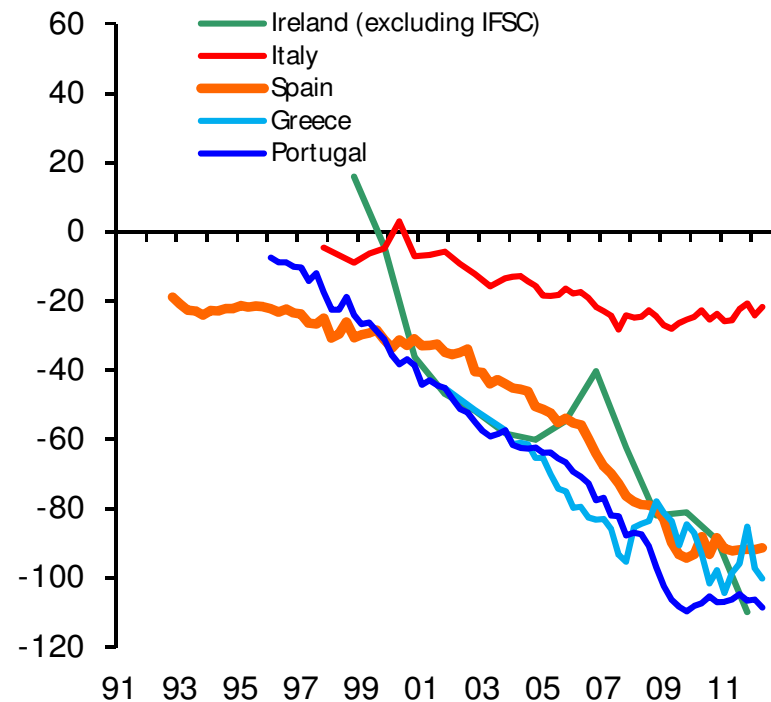
- The divergent trends in current accounts is reflected in major divergence in net international investment positions, with the “core” generally in strong surplus . . . But the “periphery” generally in a very negative position (Italy to a much lesser extent)

Net international investment position (% GDP)

“Core”



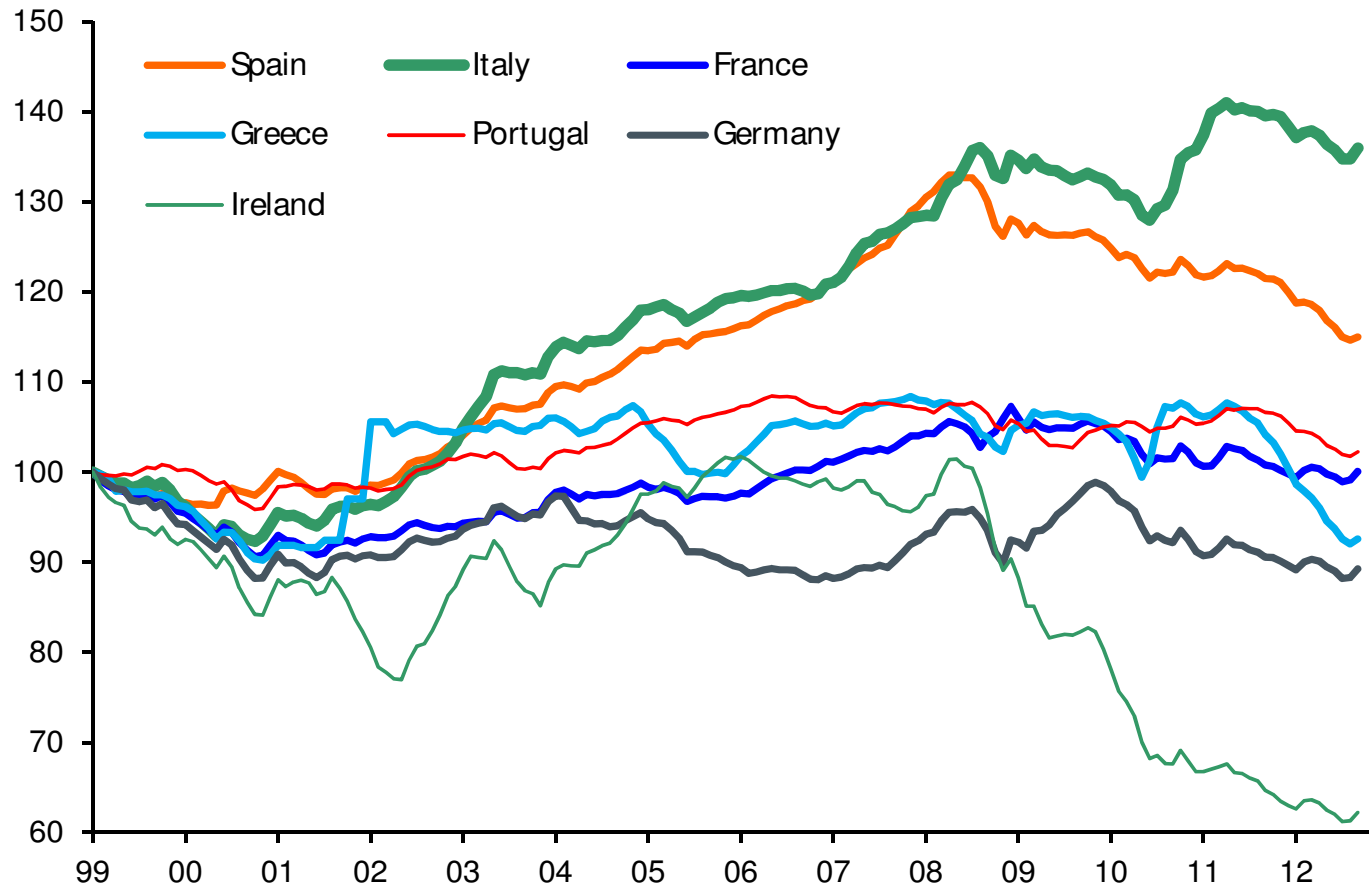
“Periphery”



Source: Haver Analytics; Barclays Research *Finland excludes equity portfolio position

Competitiveness adjustment in the euro area

Real effective exchange rates adjusted for unit labour costs in manufacturing
(Jan 99=100)



Note: Latest month: Sep. 2012. Source:IMF

Challenges for the euro area (& elsewhere)

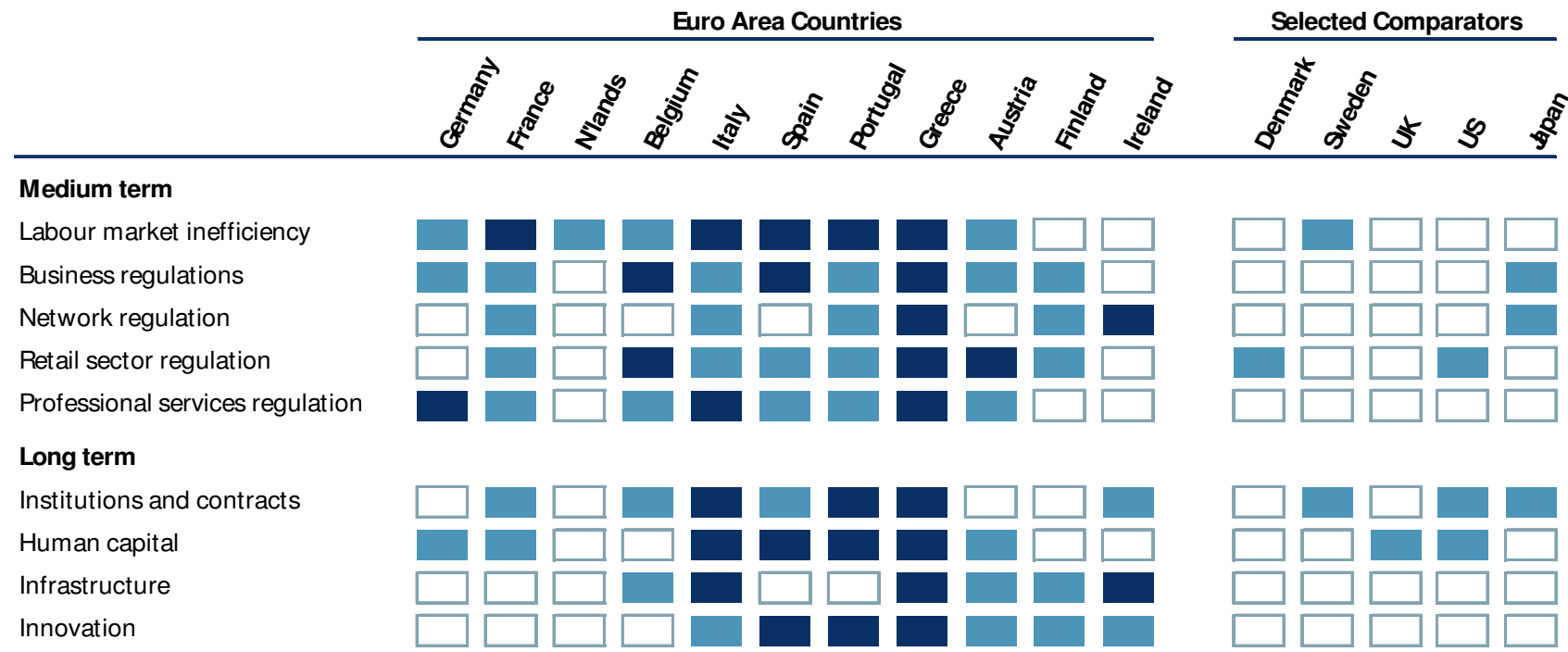
Financial balances & economic performance compared														
2012 % GDP (unless otherwise stated)	US	Japan	UK	Can.	Euro	Belg.	France	Germ.	Greece	Ire.	Italy	NL	Port.	Spain
GOVERNMENT BALANCES														
1 Government gross debt (2012)	107	237	89	88	94	99	90	83	171	118	126	68	119	91
2 Government gross debt (2017 est.)	114	250	94	78	90	91	86	74	153	108	121	75	115	101
3 Government net debt (2012)	84	135	84	36	73	83	84	58	171	103	103	38	113	79
4 General government balance*	-9.4	-8.8	-6.9	-3.8	-3.2	-2.9	-4.5	-0.4	-8.9	-8.3	-2.6	-2.4	-4.9	-7.0
5 Required fiscal adjustment²	12.8	20.3	9.4	4.3	5.0	5.2	5.8	0.9	10.5	11.4	5.6	4.5	6.2	10.6
6 Req'd fisc.adj't. (inc. age costs)³	19.6	21.1	13.1	8.2	6.8	10.1	7.4	3.0	13.9	12.9	4.6	9.5	10.4	12.7
PRIVATE SECTOR BALANCES														
7 Households' gross debt	86	76	99	91	71	55	67	58	69	117	51	135	104	87
8 Non-fin. corporates' gross debt⁴	89	145	116	54	138	186	134	64	73	289	114	119	158	186
EXTERNAL BALANCES														
9 Current account*	-3.1	1.0	-4.2	-2.1	1.3	-1.1	-2.3	6.3	-3.4	3.8	-0.8	8.2	-1.0	-1.8
10 Net external assets	-26	57	-9	-12	-12	65	-16	38	-96	-99	-24	35	-108	-92
POTENTIAL GROWTH														
11 Real GDP growth, 2001-11 % ar*	1.6	0.6	1.6	1.9	1.1	1.5	1.1	1.1	1.0	2.3	0.2	1.3	0.3	1.7
12 Real GDP growth, 2012-17 % ar*	3.0	1.1	2.2	2.3	1.2	1.1	1.3	1.2	1.2	2.5	0.8	1.5	1.1	0.9
13 Population growth 2012-17 % ar*	1.0	-0.3	0.7	1.2	0.2	0.8	0.5	-0.2	0.1	-0.6	0.4	0.2	0.1	0.4
CREDIT RATINGS														
14 S&P	AA+ (neg)	AA- (neg)	AAA	AAA		AA (neg)	AA+ (neg)	AAA	CCC (neg)	BBB+ (neg)	BBB+ (neg)	AAA (neg)	BB (neg)	BBB- (neg)
15 Fitch	AAA (neg)	A+ (neg)	AAA (neg)	AAA		AA (neg)	AAA (neg)	AAA	CCC	BBB+	A- (neg)	AAA	BB+ (neg)	BBB (neg)
16 Moody's	Aaa (neg)	Aa3	Aaa (neg)	Aaa		Aa1 (neg)	Aa1 (neg)	Aaa (neg)	C	Ba1 (neg)	Baa2 (neg)	Aaa (neg)	Ba3 (neg)	Baa3 (neg)

Sources: BIS; EU Consolidated Banking Data; FDIC; IMF, BIS-IMF-OECD-World Bank Joint External Debt Hub (JEDH); IMF staff estimates ; Barclays Research estimates
 1 Cells shaded in red indicate a value in the top 25 percent of a pooled sample of all countries shown in the table from 1990 through 2009 (or longest sample available), except for rows marked * (for which the shading is applied according to a Barclays Research assessment of riskiness). Grey shading indicates values in the bottom 50 percent, and orange in the 50th to 75th percentile. The sample for bank leverage data starts in 2008 only. 2 IMF estimate of fiscal adjustment needed to achieve a 60% debt/GDP ratio (80% for Japan) by 2030, from 2012 onwards as % GDP 3 IMF estimate, including age-related expenditure costs on budget balance 4 Nonfinancial corporates' gross debt includes intercompany loans and trade credit, and these can differ significantly across countries.

Structural reforms needed in the periphery

- The 'periphery' tends to have the biggest need for structural reforms – particularly Greece
- Scandinavia, the Netherlands, UK and US tend to have achieved the most liberalisation

Structural reform gaps in euro area economies



Source: IMF. The dark shaded areas show where the IMF staff's quantitative assessment suggests a major need for structural reform based upon a quantitative assessment

European sovereign crisis

The “Four Presidents’ Report”

- Four building blocks
 - An integrated financial framework
 - Key elements are the single banking supervision and a common deposit insurance and resolution framework
 - An integrated budgetary framework
 - Set up mechanisms that prevent and correct unsustainable fiscal policies (common agreements on annual budget balances and government debt levels of MS)
 - Set up mechanisms that ensure budgetary discipline and promote competitiveness (EA treasury office)
 - An integrated economic policy framework
 - Enforce policy coordination, promote economic integration, ensure stability of the EMU
 - Strengthening democratic legitimacy and accountability
 - Promote mechanism making joint decision-making legitimate and accountable
- First steps taken during the 28/29 June Summit (“compact for growth and jobs”, single market of goods and services, single supervisory body, Intervention procedures for the EFSF/ESM...)

Source: Benoît Coeuré, ECB, “response to the Euro Area crisis”, 20 July 2012.