Research

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Euro Area Economics

Europe at a crossroads

October 2012

PLEASE SEE ANALYST CERTIFICATIONS AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 50.

Part 1: Global Outlook

2012: Global economic slowdown at work

Since the previous Global Outlook, we have trimmed our projections for GDP growth. We expect global growth of 3.1% in 2012 (down 0.5pp) and 3.5% in 2013 (down 0.6pp). Asia and the emerging world share the biggest downwards revision, followed by Europe, while US forecasts are virtually unchanged. Our scenario is very similar to the one of the IMF (Oct. 2012)

Sources of the economic slowdown:

- Retrenchment of demand in the euro area (fiscal consolidation, credit restraint and political uncertainties) is lasting longer and is deeper. Sovereign debt crisis hiccups are generating volatility down the road
- Impact of previous tightening measures in the emerging economies (China, Brazil, India)
- Structurally lower growth rates, particularly in China. Chinese rebalancing under way, authorities tolerant to slower growth.
- US labour market gains traction but not enough for the Fed. Housing market stabilizes.

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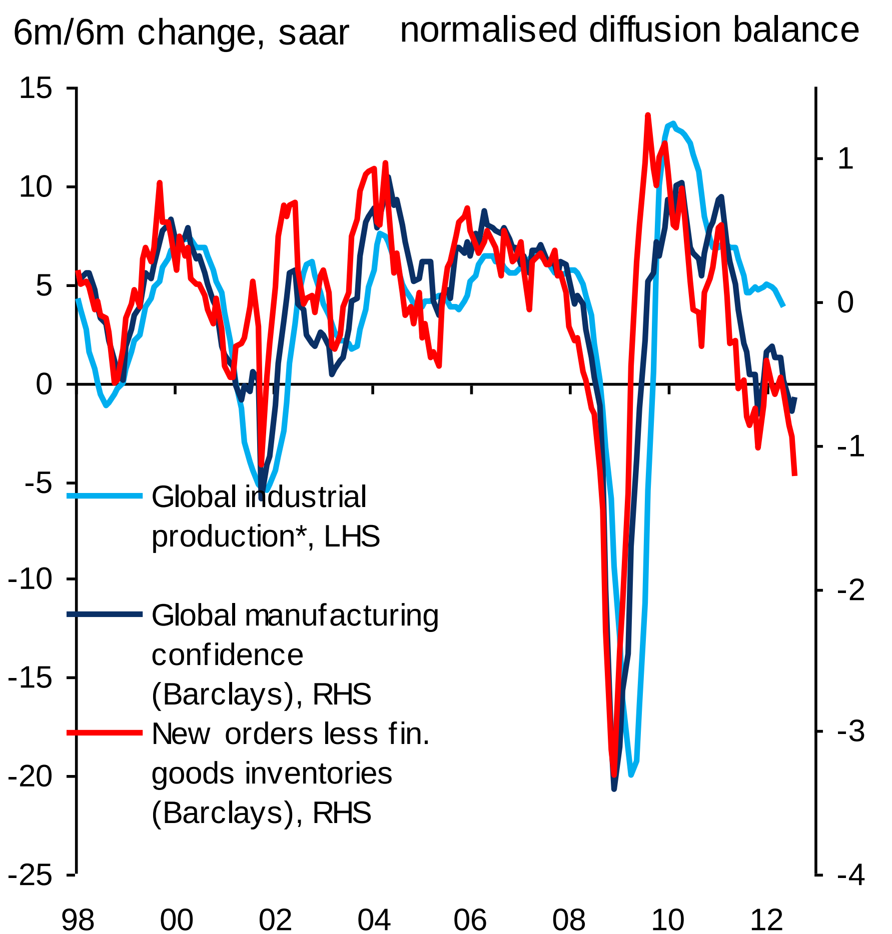
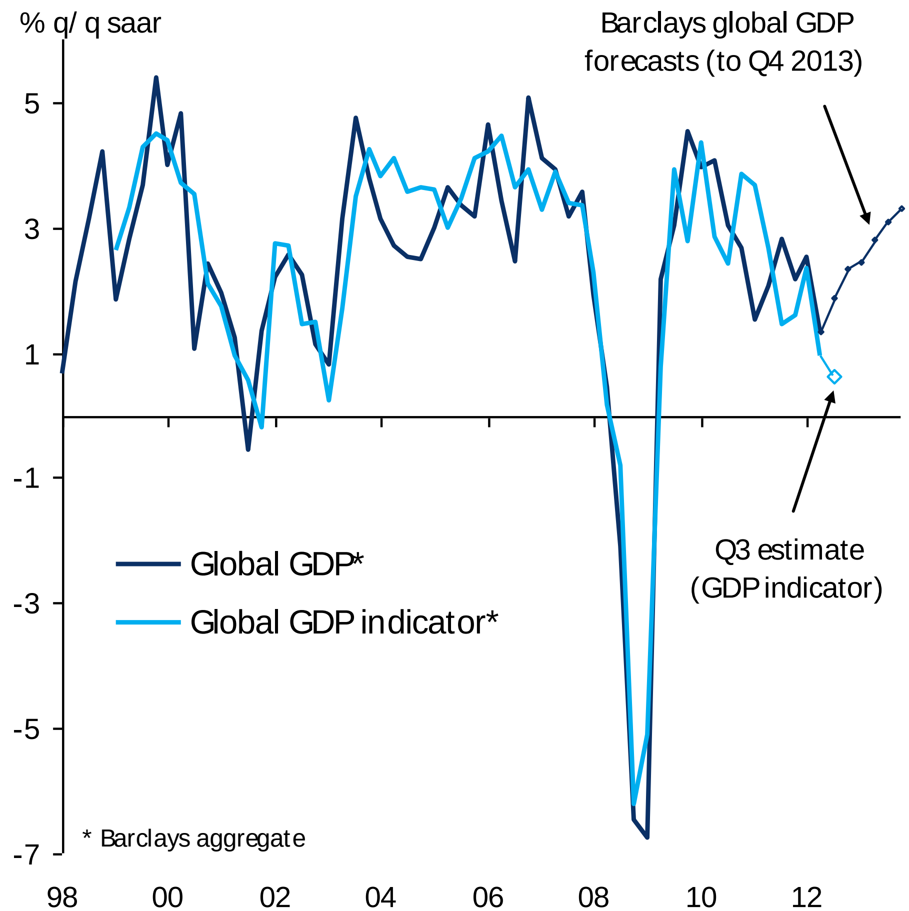
Ongoing signs of downside risk in global economy

- Global business confidence data suggest industrial stagnation and downside risks to projections.
- A mild recession in the euro area is prevailing; downside risks in H2.

Global manufacturing confidence



Global business confidence



*Barclays series
Source: Barclays Research, Markit, Haver

Deleveraging : challenges for advanced countries

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	236	88	85	90	99	89	79	153	113	123	70	112	79
2	***Government gross debt (2017 est.)***	*113*	*257*	*87*	*74*	*87*	*88*	*85*	*71*	*137*	*109*	*119*	*79*	*109*	*92*
3	**Government net debt (2012)**	84	135	84	35	70	84	83	54	153	103	102	36	111	67
4	**General government balance***	-8.1	-10.0	-8.0	-3.7	-3.2	-2.9	-4.6	-0.8	-7.2	-8.5	-2.4	-4.5	-4.5	-6.0
5	**Required fiscal adjustment[2]**	10.9	18.2	7.5	4.0	4.0	4.4	5.0	0.3	7.3	10.7	4.4	5.3	3.8	7.9
6	**Req'd fisc.adj't. (inc. age costs)[3]**	17.6	18.9	11.3	7.9	5.8	9.3	6.6	2.3	10.7	12.2	3.4	10.3	8.1	10.0
	PRIVATE SECTOR BALANCES														
7	**Households' gross debt**	88	74	99	89	70	53	63	59	70	120	51	130	105	89
8	**Non-fin. corporates' gross debt[4]**	87	143	118	53	138	178	152	63	75	244	112	114	154	196
	EXTERNAL BALANCES														
9	**Current account***	-2.9	1.4	-1.8	-2.1	0.3	-0.1	-1.7	6.0	-4.5	1.6	-1.3	11.7	-0.9	-0.9
10	**Net external assets**	-16	52	-11	-11	-14	64	-9	33	-97	-93	-23	37	-107	-93
	POTENTIAL GROWTH														
11	**Real GDP growth, 2001-11 % ar***	1.6	0.6	1.4	1.9	1.1	1.5	1.1	1.0	0.9	2.0	0.2	1.3	0.3	1.8
12	**Population growth 2012-17 % ar***	1.0	-0.4	0.7	1.2	0.2	0.7	0.5	-0.2	0.1	-0.6	0.4	0.2	0.1	0.4

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.

2013: gradual and moderate re-acceleration

NEGATIVE

- Fiscal policy is set to remain restrictive and weigh on demand in most advanced countries (in the euro area and in the US by the end of the year).
- Private sector deleveraging ongoing in the US but only in its early stages in PT, SP and UK. (non-financial private sector gross debt is at a historical high as a share of GDP) Only in Germany did leverage remain very low. (see next slide)

POSITIVE

- Monetary policy remains extremely accommodative in advanced countries. ECB tries to repair the transmission's channels of monetary policy , Fed commitment to QE to boost job creation. BoJ unexpectedly cut rates.
- Europe is making progress to sort out the euro area crisis
- Significant monetary and fiscal leeway in emerging countries to support growth.

► **Re-balancing processes of diverse forms but happening at similar time: can create frictions; downside risks to demand expansion can arise from financial stresses.**

Global forecasts

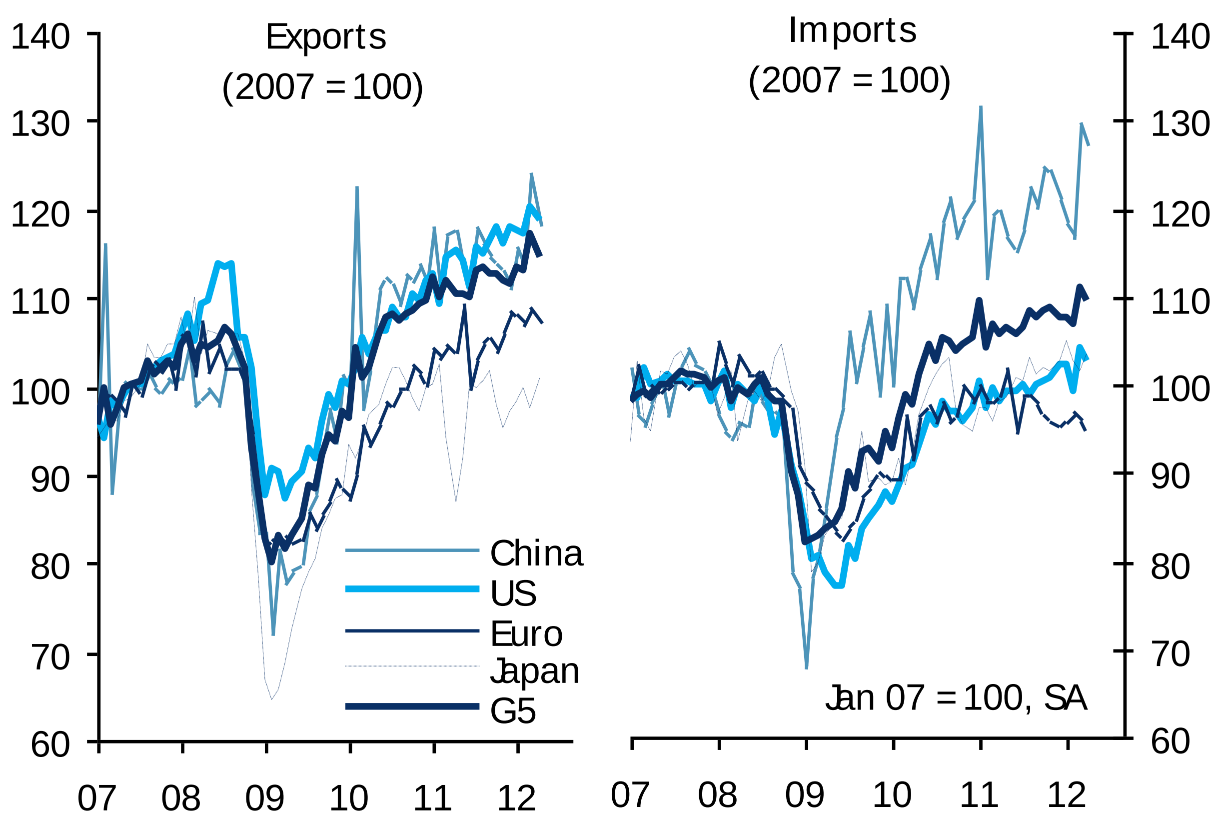
	Real GDP (% y/y)					
	Barclays		vs June 2012 forecasts		vs consensus forecasts	
	2012	2013	2012	2013	2012	2013
Global	3.1	3.5	-0.4	-0.4	0.0	-0.1
Developed	1.3	1.3	-0.2	-0.3	0.0	0.0
Emerging	5.1	5.6	-0.5	-0.6	-0.1	-0.3
BRIC	6.0	6.6	-0.6	-0.7	-0.2	-0.3
America	2.5	2.6	0.0	-0.1	0.1	0.0
United States	2.3	2.0	0.1	0.0	0.1	-0.1
Canada	2.2	2.2	0.0	0.0	0.2	0.2
Latin America*	3.2	4.0	-0.4	-0.1	0.2	0.1
Asia/Pacific	5.4	5.6	-0.6	-0.8	-0.2	-0.4
Japan	2.1	0.9	-0.7	-0.8	-0.3	-0.4
Australia	3.7	2.9	-0.1	-0.3	0.2	0.0
Emerging Asia	6.1	6.6	-0.6	-0.8	-0.2	-0.4
China	7.5	7.6	-0.6	-0.8	-0.2	-0.5
Europe and Africa	0.5	1.3	-0.3	-0.4	0.0	0.0
Euro area	-0.5	0.3	-0.2	-0.5	0.0	0.1
France	0.1	0.5	-0.3	-0.5	0.0	0.1
Germany	0.9	1.4	-0.2	-0.4	0.1	0.4
Italy	-2.3	-0.4	-0.4	-0.1	-0.1	0.2
Spain	-1.8	-1.8	0.1	-1.2	-0.2	-0.4
United Kingdom	-0.4	1.3	-0.8	-0.7	-0.1	0.0
EM Europe & Africa	2.9	3.0	-0.3	-0.4	0.0	-0.3

Notes:* Consensus inflation forecasts for Latin America and Russia are Dec/Dec. ** Consensus forecasts for India are for fiscal years. Source: Barclays Research

Global trade has slowed

- Exports of Japan and China have slowed in July-Aug., mainly due to Europe
- In contrast, euro area exports have been growing, helped by euro's 10% depreciation
- US exports have also been performing well

Global trade volumes



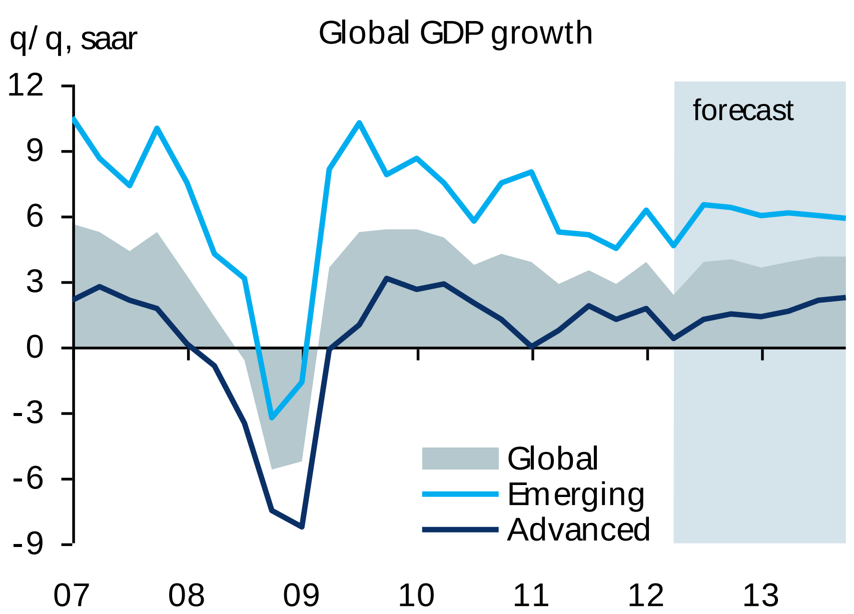
- Chinese imports surged earlier this year but have been levelling out more recently
- Euro area imports have slowed sharply given the contract in domestic demand
- US imports have shown mild expansion

*
Source: Barclays Research, Markit, Haver

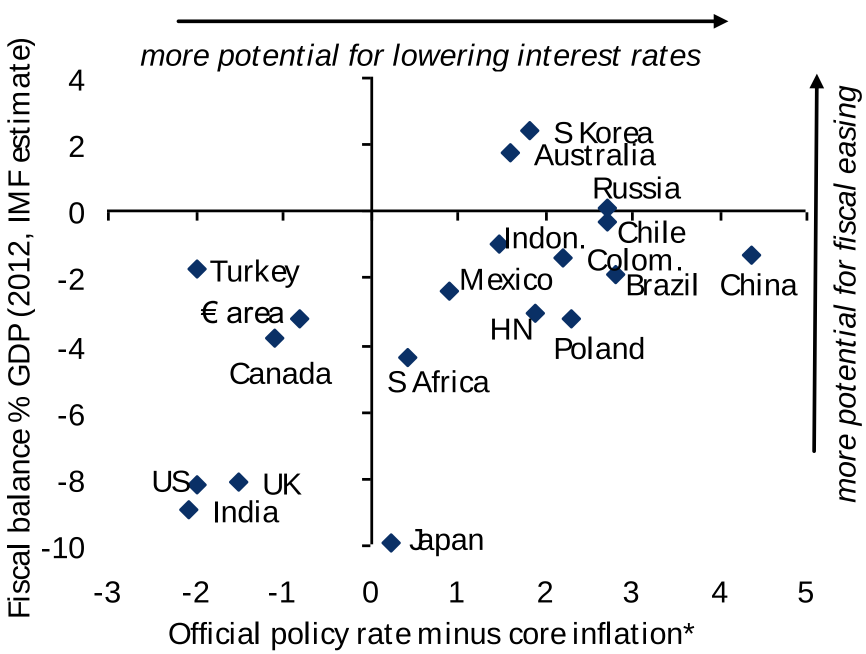
Emerging economies have more scope for easing

- While the slowing global economy is apparent across the board, our projections assume a slightly stronger rebound for emerging economies during H2.
- Emerging economies have significant scope on the monetary and fiscal side (except India).

EM projected to lead the way



Global business confidence

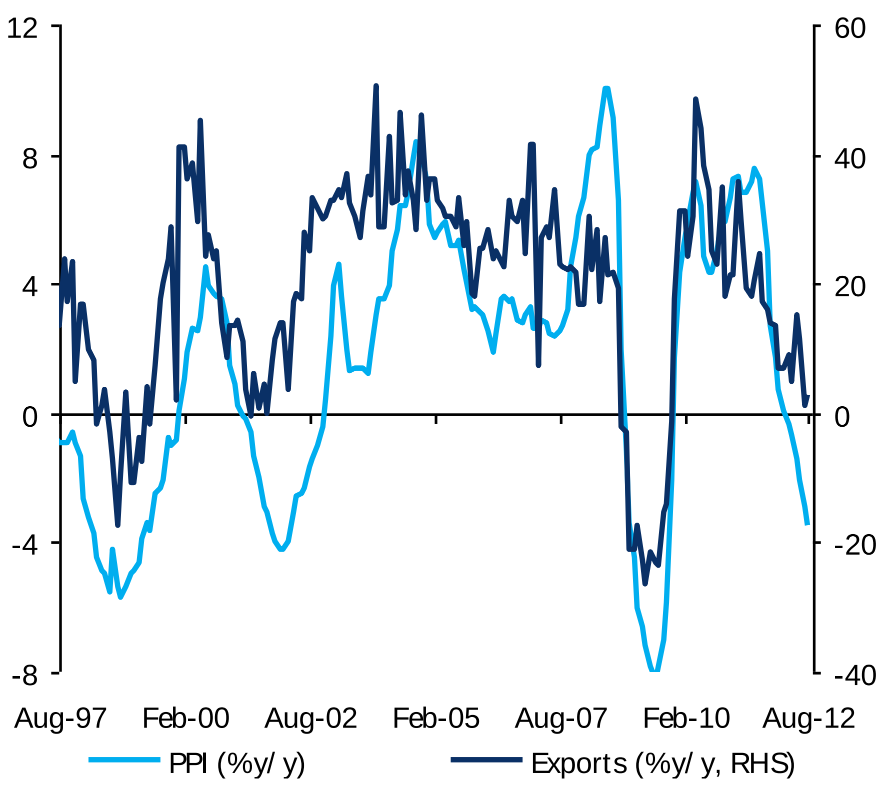


Source: Barclays Research, Haver Analytics * Uses headline inflation for India and Colombia

China: moderating inflation provides more policy flexibility

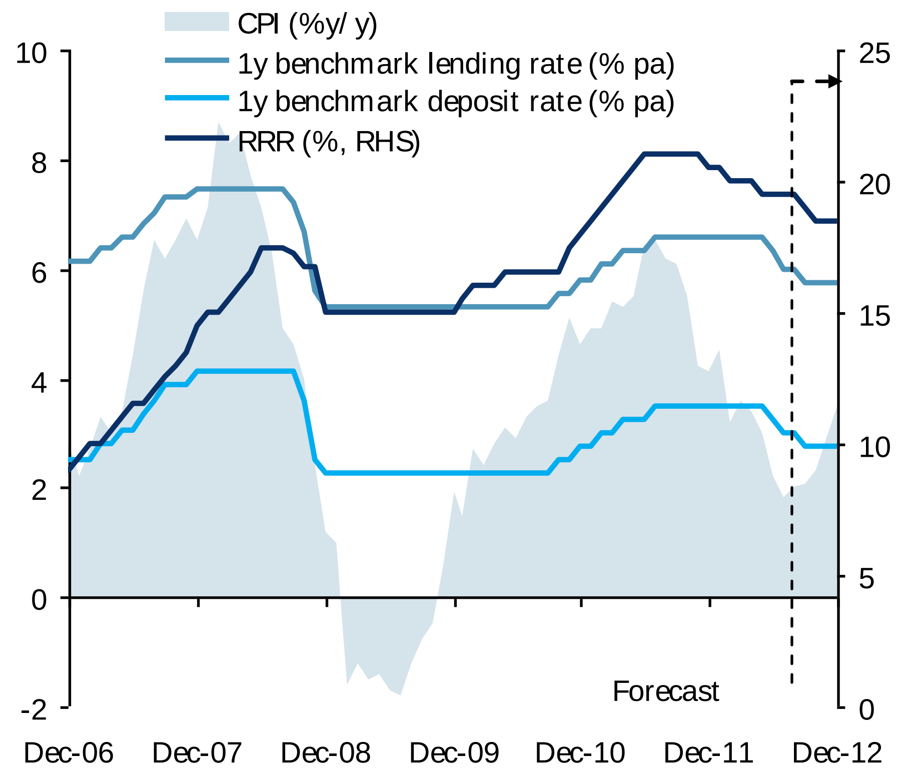
- We expect another 25bp benchmark interest rates cut. Frequent use of reverse repos to stabilise liquidity by the PBoC implies reduced need for reserve requirement ratio cuts.

Inflation moderating as domestic demand remains soft, as indicated by PPI



Source: CEIC, Barclays Research

But the willingness of further PBoC easing appears to be absent

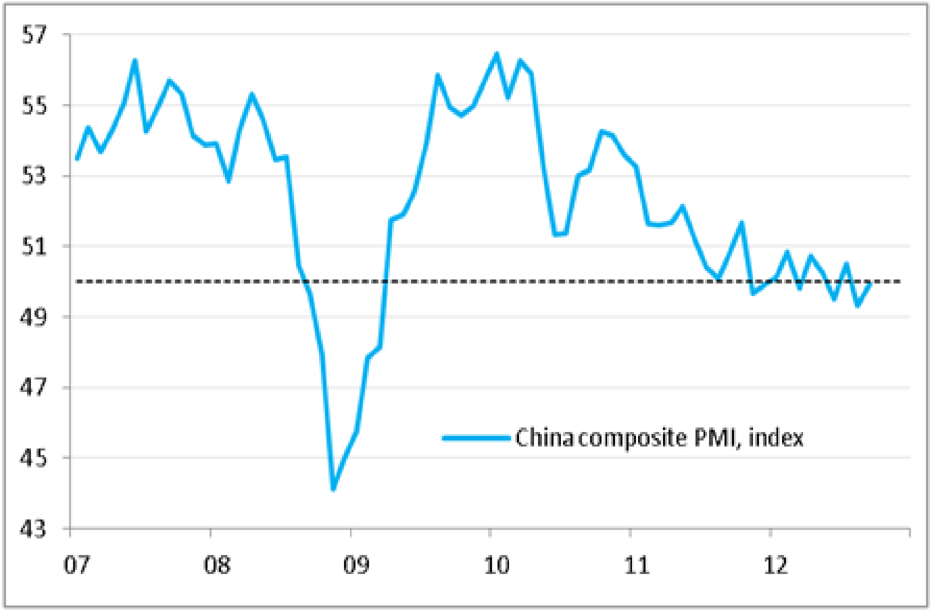


Source: CEIC, Barclays Research

Chinese hard-landing fears ease

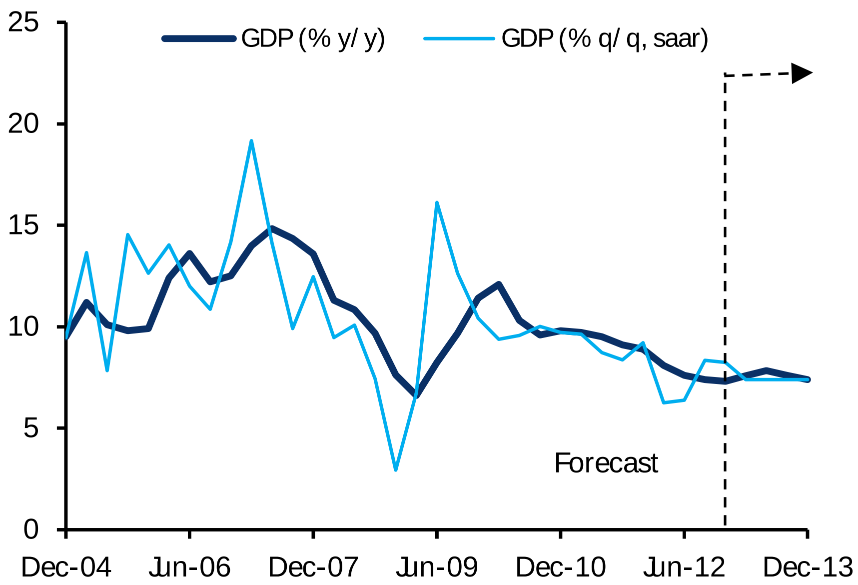
- Chinese activity data improved across the board in September, pointing to stabilizing growth in H2 12. The bottoming of growth in China appeared to stem from domestic and foreign factors, as retail sales, investment, and export growth all improved.
- Real GDP growth slowed to 7.4% y/y in Q3 from 7.6% in Q2 and 8.1% in Q1. According to the NBS, quarterly growth has risen throughout the year, from a cyclical bottom of 1.5% in Q1 to 2.0% in Q2 and 2.2% in Q3 (versus our own estimates of a pickup to 1.6% in Q2 and 2% in Q3).

Business surveys have started to improve



Source: PMI-Reuters, Barclays Research

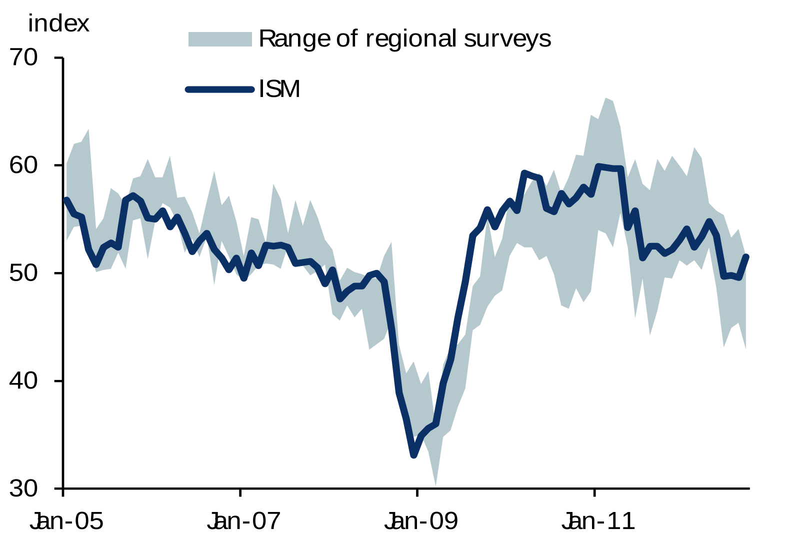
GDP trend growth is likely to have slowed



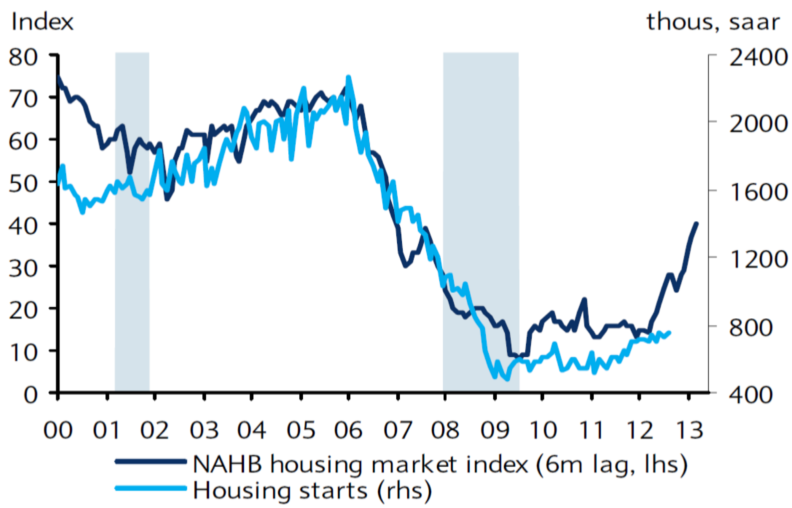
Source: CEIC, Barclays Research

US Outlook: not enough for Fed standards

US manufacturing production has stalled



Housing starts and Home builder Index

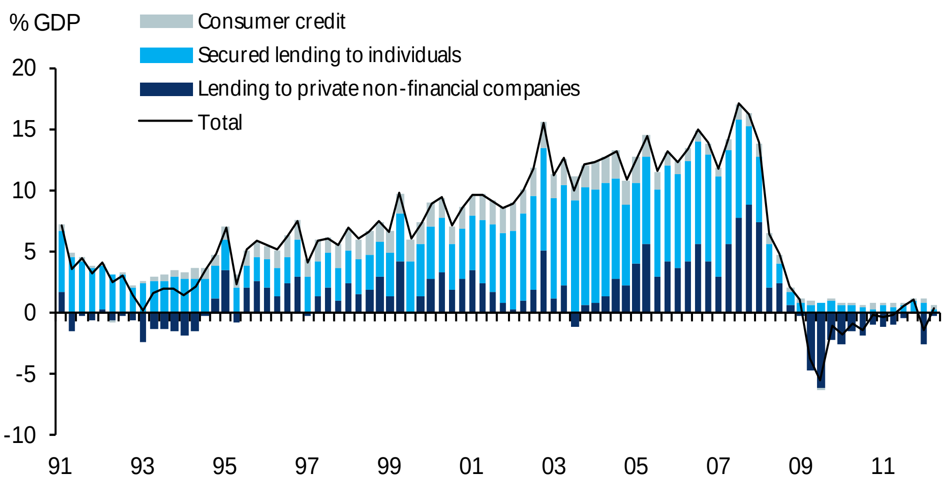


Source: NAHB, Census Bureau, Haver Analytics

- Our GDP forecasts for the US are virtually unchanged at +2.3% this year and 2.0% next.
- However, US manufacturing sector has been slowing down on weaker global growth. ISM new orders fell temporarily below 50 but recovered somewhat lately.
- Soft Payroll growth has led the Fed to launch QE3 which will continue until the labour market improves.
- Housing recovery seems entrenched. Sales, starts and indexes have been improving solidly and suggest further rises ahead.
- US fiscal politics difficult to predict ("fiscal cliff", debt ceiling, consolidation). Negative scenario include partisan wrangling until the 2014 congressional elections.
- We expect inflation to persist above 2% in 2012 and 2013.

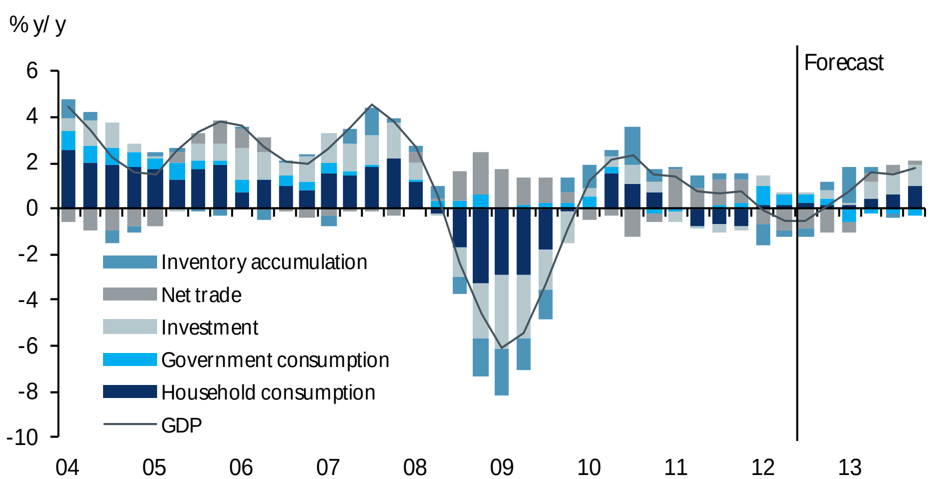
UK Outlook: HH demand the main source of weakness

Bank lending to the non-bank private sector



Source: Haver Analytics, Barclays Research

Subdued growth outlook

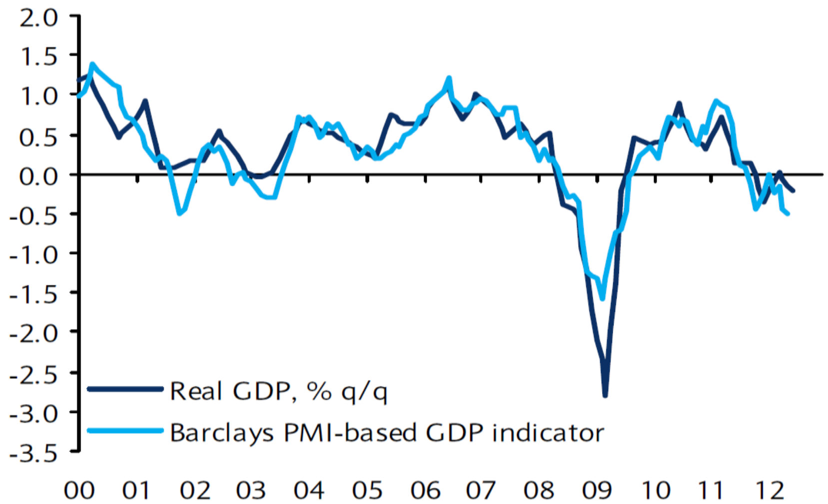


Source: Haver Analytics, Barclays Research

- Real disposable income has been falling, reflecting weak pay growth, high inflation and fiscal consolidation (which has led to higher taxes and substantial public sector job-shedding).
- The euro area crisis has depressed export demand and prompted some tightening in domestic credit conditions.
- The BoE has increased QE to 25% of GDP and introduced the Funding for Lending Scheme (FLS) in an attempt to increase the flow of credit.
- However, ongoing balance sheet adjustment and household and business confidence are low; we do not expect the FLS to deliver a significant boost to aggregate demand, and the MPC is likely to loosen policy further in November.
- Any pickup in activity is likely to be modest, and we expect GDP to contract 0.4% this year and grow just 1.3% in 2013.

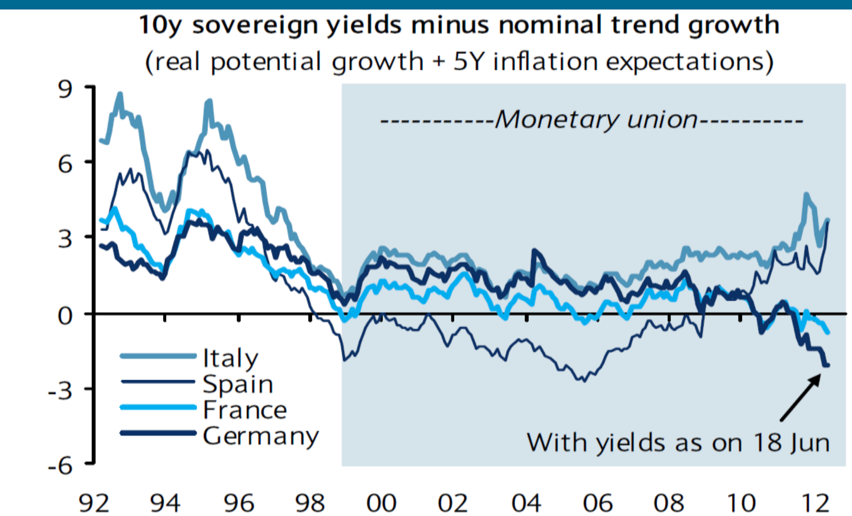
EA Outlook: stabilisation under way but downside risks

Weak but not catastrophic growth



Source: Haver Analytics, Barclays Research

Euro Area financial conditions vary widely

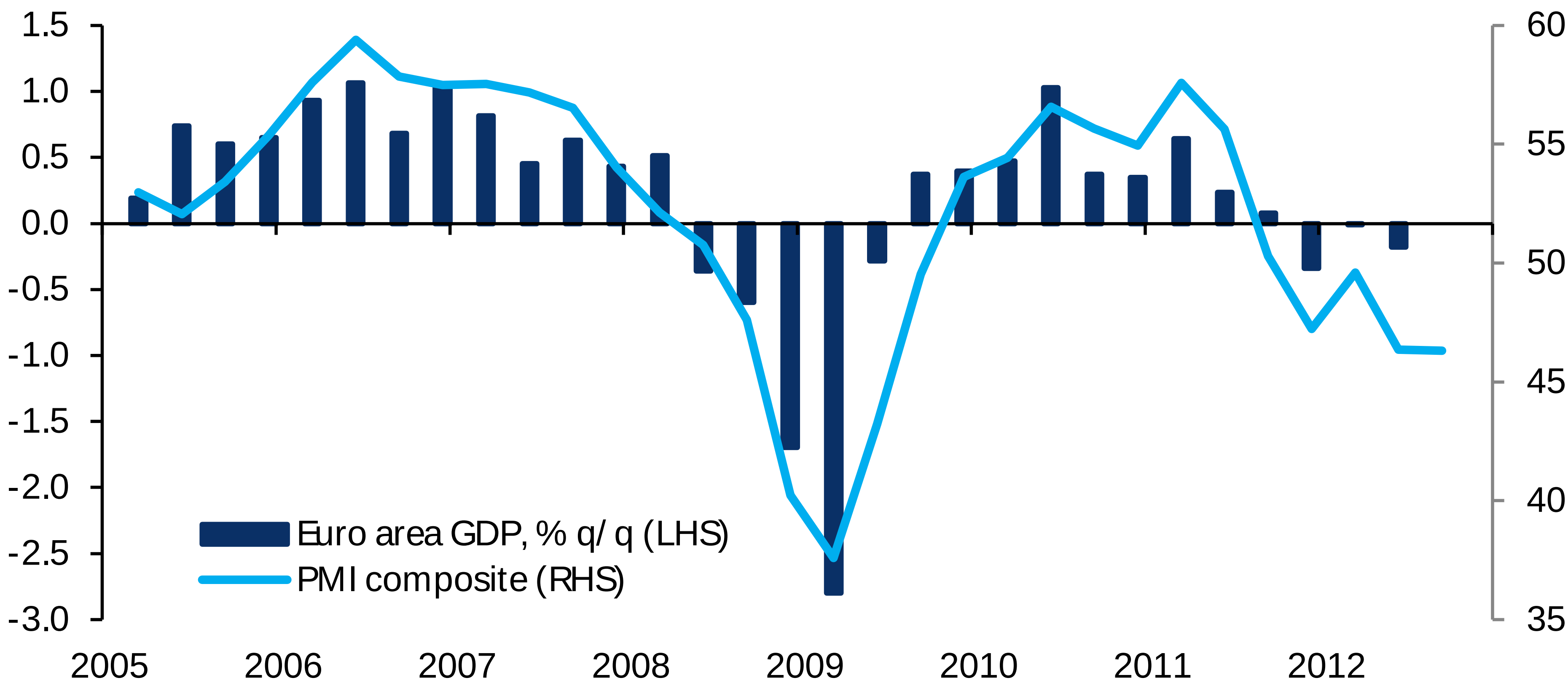


Source: Haver Analytics, Barclays Research

- Major divergences across countries, driven by divergence in financial conditions, fiscal policy and real exchange rates.
- German consumption should be bolstered by stronger real wages and a nascent recovery in the housing market, while the weaker value of the euro supports German manufacturing sector.
- In contrast, financial and fiscal conditions remain exceptionally tight in southern Europe, and this is likely to prolong the deepening recessions by at least several quarters.
- While we continue to view Spain and Italy as fiscally solvent, market assessment of solvency depends crucially on there being economic recovery within sight. Therefore, it is essential for these economies to obtain some aggregate relaxation in overall financial/fiscal conditions in order to afford some breathing space for GDP to stabilise.

Euro Area GDP and PMI

PMIs excessively pessimistic since Q4 2011

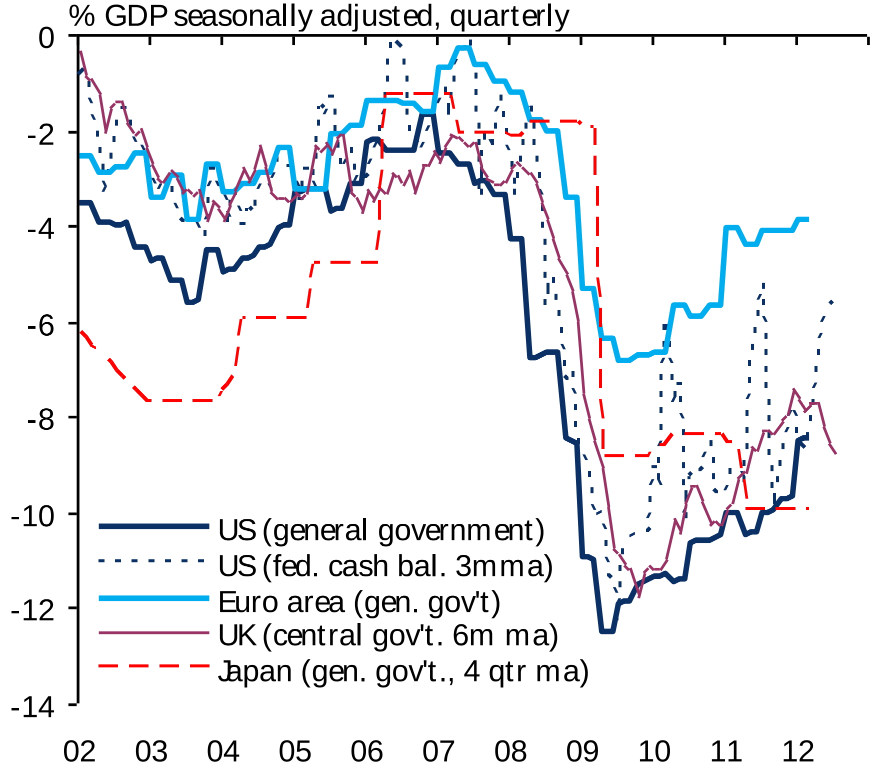


Source: INSEE, Barclays Research

Fiscal consolidation has already been significant in EU

- The euro area had a general government deficit/GDP ratio of 4.1% in 2011, down from over 6% in 2009 and 2010, and compared with 8.3% in the UK and 10.0% in the US.
- Fiscal consolidation is at a record level in the euro area this year, particularly in southern Europe.

Euro area deficit < US, UK, Japan



Change in structural budget balance/GDP

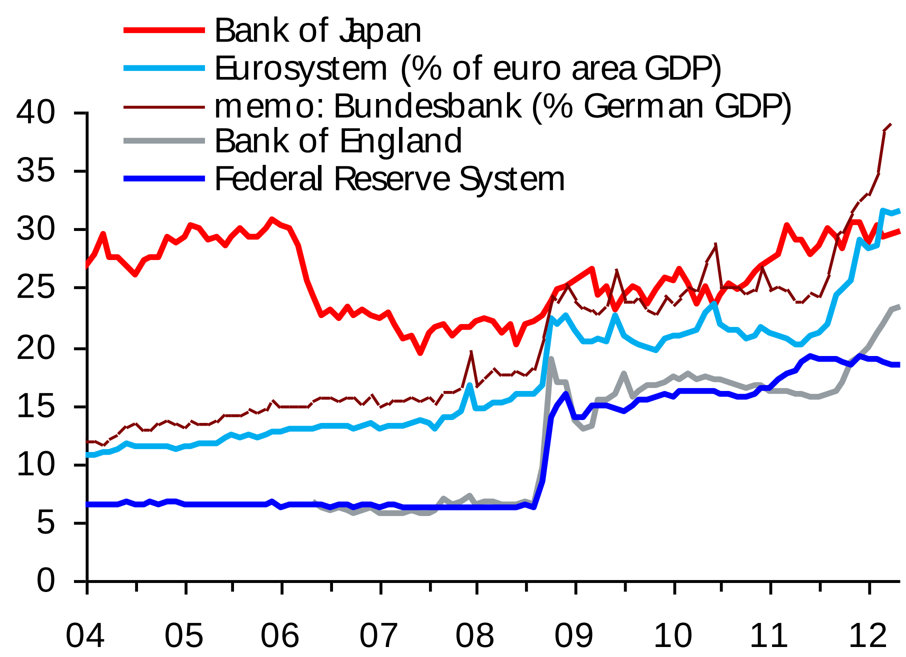
pp	2009	2010	2011	2012 E	2013 F	*€A weight*
Austria	-0.9	0.4	0.6	0.4	0.7	*3.1%*
Belgium	-2.2	0.6	-0.3	1.0	0.5	*3.8%*
Finland	-2.5	-0.6	1.4	0.4	0.5	*1.9%*
France	-2.2	0.8	1.7	1.3	2.0	*21.4%*
Germany	-0.8	-0.9	1.2	0.5	0.0	*26.8%*
Greece	-2.8	5.9	4.6	2.8	2.8	*2.6%*
Ireland	4.7	2.4	2.0	2.0	1.5	*1.8%*
Italy	-1.0	1.1	0.2	2.9	1.6	*16.9%*
NL	-4.1	1.1	-0.2	0.8	1.6	*6.4%*
Portugal	-4.2	0.8	3.1	3.0	2.0	*1.8%*
Spain	-3.6	2.9	1.6	2.0	2.0	*11.7%*
Others	...	...	...	...	...	*1.8%*
Euro area	-1.8	0.7	1.1	1.4	1.2	*100.0%*
Japan	-3.9	-0.3	-0.6	-0.2	0.3	...
Sweden	0.0	-0.7	-0.5	0.2	0.5	...
UK (FY)	-3.3	1.8	2.1	1.1	1.4	...
US	-2.9	0.6	1.0	1.0	1.5	...
OECD	-2.7	0.6	0.9	1.0	1.2	...

Source: Barclays Research, OECD, IMF, Haver Analytics   In LH chart data are adjusted to exclude one off capital transfers.

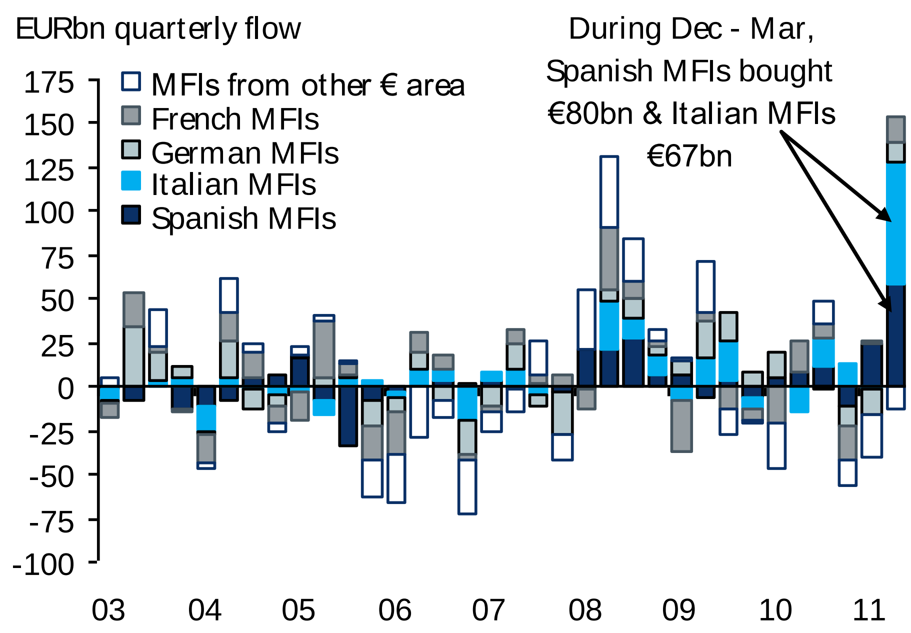
Aggressive monetary easing to combat fiscal austerity

- The Eurosystem has dramatically expanded its balance sheet, particularly to intermediate in support of banking liquidity, reaching 31% of GDP in April 2012.
- MFIs in southern Europe have purchased significant levels of government debt in recent months.

Central bank balance sheets (% GDP)



Net purchases of government debt by MFIs*



Source: Barclays Research, Haver Analytics *excluding the Eurosystem, quarterly

Accounting for euro area weakness

- Euro area GDP has weakened in response to various factors: tighter financial conditions; increased fiscal austerity; weaker demand for exports; uncertainty.
- These factors have been especially apparent in southern Europe, where we expect domestic demand to contract by around 3% this year (c.f. 1% contraction for euro area overall).
- Germany and to a lesser extent France have easier financial conditions, and can benefit more from the weaker euro.

A case study: Estimating sources of revision to Banca d'Italia's projection for Italian GDP

- **Projection for 2012 GDP growth (July 2011): +1.1%**
  - *Increase in sovereign spreads (pp impact): -0.4*
  - *Impact of restricted access to credit by firms: -0.6*
  - *Additional fiscal austerity measures: -1.0*
  - *Slower global economic growth: -0.5*
  - *Impact of uncertainty on confidence: -0.5*
  - *Residual: -0.1*
- ► **Revised projection (July 2012): -2.0%**

Source: Barclays Research, BdI Bulletin (July 2012)

Global Bond Yield Forecast (21/09/2012)

US Treasuries	Fed funds	3m Libor	2y	5y	10y	30y	10y RY
Q4 12	0.00-0.25	0.35	0.25	0.60	1.50	2.50	-1.10
Q1 13	0.00-0.25	0.35	0.25	0.70	1.50	2.50	-1.25
Q2 13	0.00-0.25	0.35	0.25	0.70	1.50	2.50	-1.00
Q3 13	0.00-0.25	0.35	0.25	0.70	1.60	2.60	-1.15

US swap spreads	2y	5y	10y	30y
Q4 12	15	20	5	-25
Q1 13	20	25	5	-25
Q2 13	20	25	5	-25
Q3 13	20	25	5	-25

Euro government	Refi rate	3m	2y	5y	10y	30y	10y RY
Q3 12	0.75	0.30	0.05	0.45	1.45	2.2	-0.25
Q4 12	0.50	0.30	0.05	0.5	1.5	2.25	-0.25
Q1 13	0.50	0.30	0.1	0.55	1.55	2.35	-0.25
Q2 13	0.50	0.35	0.2	0.65	1.8	2.6	-0.2

Euro area swap spreads	2y	5y	10y	30y
Q3 12	65	60	45	5
Q4 12	60	55	45	5
Q1 13	60	55	45	5
Q2 13	60	55	45	5

UK government	Bank rate	3m	2y	5y	10y	30y	10y RY
Q3 12	0.50	0.75	0.10	0.75	1.65	3.00	-0.60
Q4 12	0.25	0.55	0.10	0.85	1.75	3.05	-0.60
Q1 13	0.25	0.55	0.15	1.00	1.85	3.10	-0.55
Q2 13	0.25	0.55	0.25	1.15	2.00	3.15	-0.40

UK swap spreads	2y	5y	10y	30y
Q3 12	65	35	40	-15
Q4 12	62	35	40	-15
Q1 13	60	30	40	-15
Q2 13	60	25	30	-15

Japan government	Official rate	3m	2y	5y	10y	30y	10y RY
Q3 12	0.10	0. 20	0.10	0.20	0.75	1.80	0.50
Q4 12	0.10	0. 20	0.10	0.20	0.85	1.95	0.50
Q1 13	0.10	0. 20	0.10	0.20	0.85	1.95	0.50
Q2 13	0.10	0. 20	0.10	0.20	0.85	1.95	0.50

Japan swap spreads	2y	5y	10y	30y
Q3 12	15	15	10	0
Q4 12	15	15	10	0
Q1 13	15	15	10	0
Q2 13	15	15	10	0

G10 FX forecasts

A little less risk, a little more carry

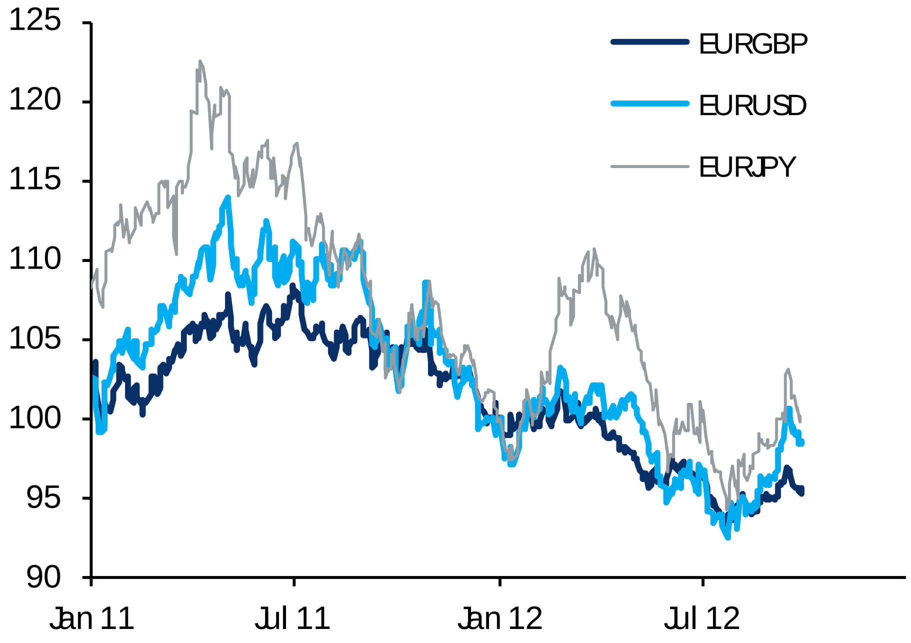
- The Fed decision should support global risk appetite and the ECB's reduce local risks.
- Both central banks' decisions are positive for EUR/USD. We have therefore revised up our EUR forecasts, especially over the next quarter.
- We still expect pressure to return to the EUR in the medium term.

FX, 26 Sep 2012, End of Period

	Spot reference	1 Month	3 Month	6 Month	1 Year
EUR/USD	1.29	1.32	1.35	1.28	1.22
USD/JPY	77.7	81	83	84	86
GBP/USD	1.62	1.63	1.65	1.60	1.56
USD/CHF	0.94	0.92	0.91	0.98	1.02
USD/CAD	0.98	0.97	0.96	0.95	0.94
AUD/USD	1.04	1.06	1.05	1.04	1.04
NZD/USD	0.82	0.84	0.83	0.82	0.82
EUR/SEK	8.50	8.70	8.80	8.40	8.20
EUR/NOK	7.40	7.55	7.60	7.30	7.15
USD/CNY	6.34	6.29	6.30	6.30	6.26
USD/BRL	2.03	2.00	2.00	2.00	1.95
USD/MXN	12.89	12.70	13.00	12.65	12.50
EUR/PLN	4.14	4.10	4.10	4.15	4.15
USD/TRY	1.79	1.80	1.80	1.85	1.85

Source: Barclays Research

Euro exchange rate



Source: Barclays Research

Part 2: Euro Area

The outlook for a resolution of the euro area crisis

Is the euro area crisis just a debt crisis ?

Public Deficit / Public Debt (% of GDP)				
	2012 Deficit	2012 Debt	2013 Deficit	2013 Debt
Euro Area	3.3	93.6	2.6	94.9
UK	8.2	104.2	7.3	108.4
US	8.7	107.2	7.3	111.7
Japan	10.0	236.6	9.1	245.0

Source: IMF World Economic Outlook, OCTOBER 2012

… the euro area as a whole is in a better fiscal situation than other advanced countries, and there is no major external imbalance at the aggregate level.

Hence, the root of the European crisis lies elsewhere.

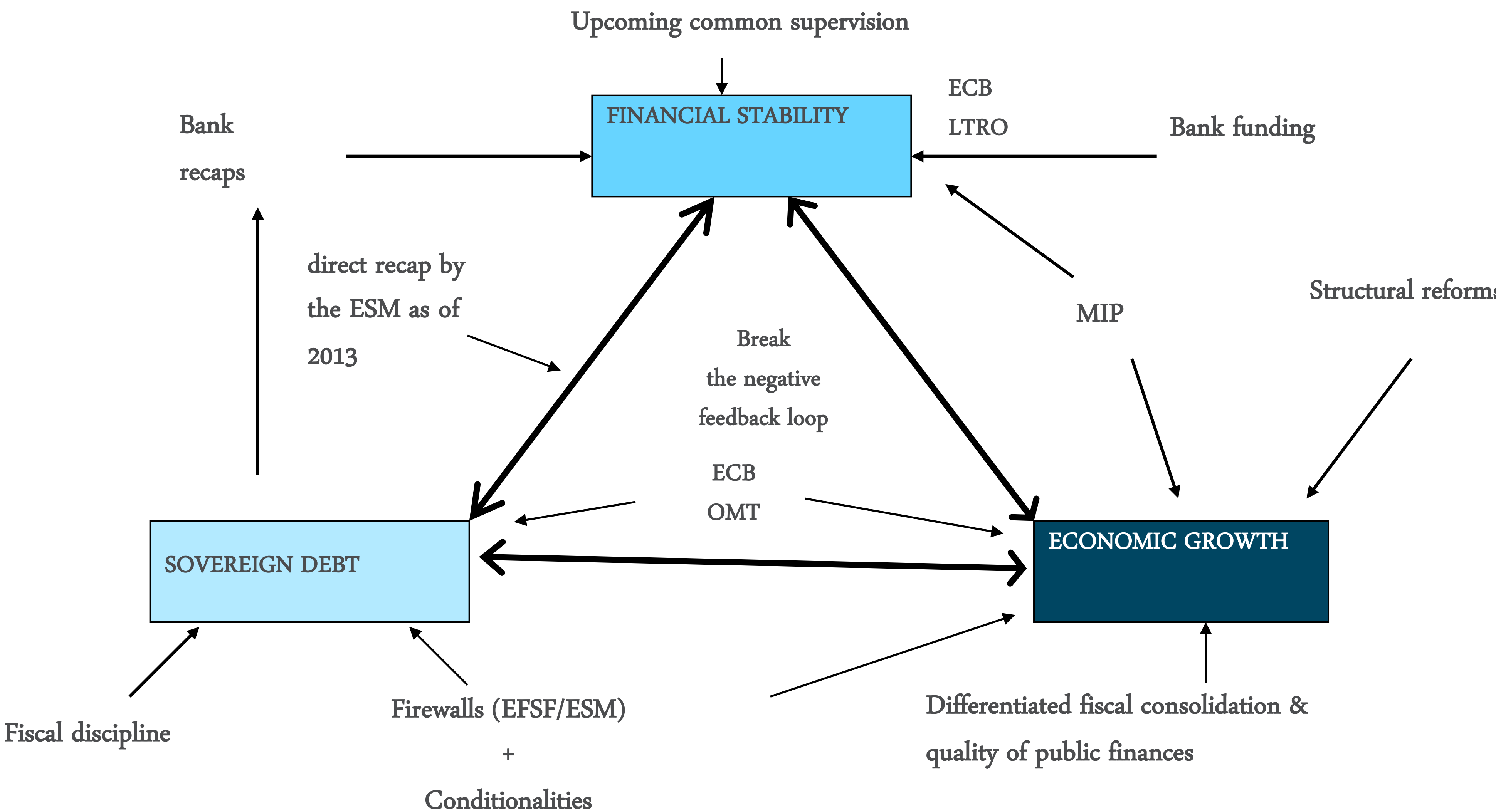
European sovereign crisis

EU response to the crisis

1. **Member state to take actions on the fiscal front**
   - Multiyear fiscal adjustment program within the new governance framework
   - Adjustment under EU-IMF programme.
2. **Establish and reinforce firewalls**
   - EFSF+ESM = total intervention capacity of EUR700bn. ESM started: 8 Oct.12.
3. **ECB steps in**
   - Interest rates, collateral, LTRO, SMP, CBPP,…Outright Monetary Transmission (6 Sept.12).
4. **Growth compact**
   - EUR120bn for growth (EIB, project bonds, structural funds), European Council 28-29 Jun.12.
5. **Improving European governance**
   - Enhanced fiscal and macro surveillance (6-pack, TSCG…)
   - Towards a more integrated EMU
     - Banking Union
     - The roadmap of the "Four presidents report".

Source: French Treasury, Barclays Research

Euro crisis resolution framework



Source: IMF, French Ministry of Finance, Barclays Research

European sovereign crisis

28/29 EU Summit : a big step forward

The final statement of the 28/29 June EU summit revealed important breakthroughs

- Establishment of a **single bank supervisor** for EA banks, "involving the ECB“. Following the establishment of the single supervisor, the ESM could recapitalise EA banks directly.
- Financial assistance to **Spanish banks** would be provided by the EFSF and transferred to the ESM as soon as available without acquiring seniority status.
- Support to **Irish banks** will be examined "with the view of further improving the sustainability" of the official programme and "similar cases will be treated equally".
- Use “the existing **EFSF/ESM** instruments in a flexible and efficient manner in order to stabilise markets for Member States respecting their Country Specific Recommendations and their other commitments including their respective timelines, under the European Semester, the Stability and Growth Pact, and the Macroeconomic Imbalances Procedure".
- “Compact for growth and Jobs” incl. EUR120bn for “fast-acting” growth measures (Project bonds, EIB capital increase, Structural funds…).

➔ Markets reacted strongly positively but have given up some of the optimism since…

European sovereign crisis

European institutions building: Complements the actual framework

The reform of economic governance in the EU (the six-pack)

First attempt to strengthen the stability and growth pact, to launch a new surveillance of macro-economic imbalances and to enhance coordination in the « European Semester »

Enhanced surveillance for euro area member states (the two-pack)

The text is currently in final discussion between the parliament, the Council and the Commission. Base on Article 136, it should help re-inforce economic policy coordination and monitoring countries under financial market stress.

Enhanced economic policy coordination (The Fiscal Compact)

The New Treaty is expected to enter into force as soon as the ratification process is completed. The Fiscal rule, at the constitutional or equivalent level, requires a structural balance (maximum structural deficit of 0.5%). An automatic correction mechanism in the event of deviation, *ex ante* reporting by Member States of their national debt issuance plans, automaticity of procedures and sanctions in the event of a breach of the 3% ceiling, are to be incorporated into European Treaties within five years at most after coming into force.

The report of the four president (towards a more integrated Europe)

European sovereign crisis

October EU Summit : one more step towards further integration

- Banking Union: EU leaders confirmed their goal to get an agreement on the legislative framework on the Single Supervision Mechanism by December. Gradual implementation in the course of 2013, full-fledge supervision in the end. Next steps : common resolution scheme and deposit guarantee scheme (still diverging views of member States).
- Fiscal Union: build on existing regulation (6-pack, 2-pack, TSCG), explore the possibilities to create a Euro area Budget (“fiscal capacity”) to accommodate asymetric shocks.
- Economic coordination: ensuring convergence, promoting growth enhancing policies, contractual arrangements to undertake reforms compliant with country specific recommendations (labour markets, competition, competitiveness…) .
- Democratic control and accountability: lots of issues still pending (euro area vs. EU as a whole, new Treaty, role of Parliaments,…) .
- “Compact for growth and Jobs” incl. EUR120bn for “fast-acting” growth measures (Project bonds, EIB capital increase, Structural funds…).

➔ Discussion will continue in December and the negotiations will take several years …

European sovereign crisis

The main characteristics of the upcoming OMT

Technical features of Outright Monetary Transactions

- **Strict conditionality** attached to EFSF-ESM programmes provided that they include the possibility of EFSF/ESM primary market purchases. The Governing Council could stop the OMT if programme implementation is off-track.
- **Coverage:** OMTs will be considered for future cases of EFSF-ESM programmes or programme countries regaining market access. They will be focused on the shorter end of the curve and in particular on sovereign bonds with 1-3y maturity. "No *ex ante* quantitative limits are set on the size of transactions".
- S**eniority:** The Eurosystem intends to clarify in the legal act that it accepts the same *(pari passu)* treatment as private or other creditors with respect to bonds issued by EA countries and purchased by the Eurosystem through OMTs.
- **Sterilisation:** The liquidity created through OMTs will be fully sterilised.
- **Transparency:** Aggregate holdings and market values to be published weekly; average duration and outright holdings by country, monthly.
- **SMP:** The SMP will be terminated, sterilised and the purchases held till maturity.

European sovereign crisis

Things to watch in the coming weeks

- Spain:
  - The government presented the 2013 budget, an additional structural reform package and of the bank recap programme.
  - The Spanish government is expected to officially request financial assistance from the EU and the IMF with a "precautionary programme". Discussions with the Troïka on the MoU are ongoing although not officially. We expect formal request to come soon.
  - The MoU is likely to endorse the Spanish multi-annual projections but additional reforms are likely to be required to ensure the financial sustainability of the regions. The Implementation of the Stability Law is a main issue.
  - Pensions: the government is still rejecting the idea of cutting pensions but an compromise might be found.
  - Turmoil in Catalonia, election on November 26.

  - The final agreement should come together with the agreement on Greece

European sovereign crisis

Things to watch in the coming weeks

- **Greece: risk of a fully fledged default and a Greek exit has diminished in recent weeks**
  - The Greek government has to find a compromise on an €13.5bn package of spending cuts to meet the programme target. Close to an agreement.
  - Agreement with the troïka on a set of prior actions, mostly structural reforms to restart growth (enhancing competion measures, additional labour market reforms)
  - An extension of the period to cut the deficit is also likely to be granted by European leaders, provided that the Greek government shows its good will.
  - Final budget for 2013 expected to be submitted to Parliament by early November
  - Discussions on how to fill the financing gap: OSI, debt buy-bcak, additional financing?
  - Final agreement expected in November.

European sovereign crisis

Things to watch in the coming weeks

- **Italy: How to secure the continuation of the Monti reforms ?**
  - Italy has achieved an impressive fiscal consolidation in 2012 (2.9% of GDP in structural terms). We expect the deficit to stand at 2.5% of GDP in 2013
  - Unlike Spain, Italy did not experience severe macroeconomic imbalances, private debt is low
  - However, structural reforms are required to revive growth in the medium term and ensure debt sustainability.
  - General elections will take place before April, and the outcome is very uncertain at this stage. It is unclear whether Monti could stay thereafter, although he recently said he would be available if necessary.
  - A request of a precautionary programme signed by the two main parties would help securing the continuation of reforms and would avoid renewed tensions in the Italian debt market at the time of the election, but very unlikely for now.

European sovereign crisis

Things to watch in the coming weeks

- **France: time for structural reforms**
  - The French government is committed to reducing the deficit to 3% of GDP next year. 2/3 tax hikes 1/3 spending cuts in 2013 – spending cuts only thereafter
    - This will be a drag on domestic demand in the near term
    - The target looks too ambitious
  - France is lagging behind in terms of labour market reforms and measures to boost competitiveness. Both issues are currently debated by the government and social partners. Outcome still not clear (strong resistance within the ruling majority)
    - The French non financial corporate sector has suffered from a squeeze in profit margins over the last decade due to a decline in cost competitiveness vs. Germany
    - The government would like to promote the « flexsecurity» model

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