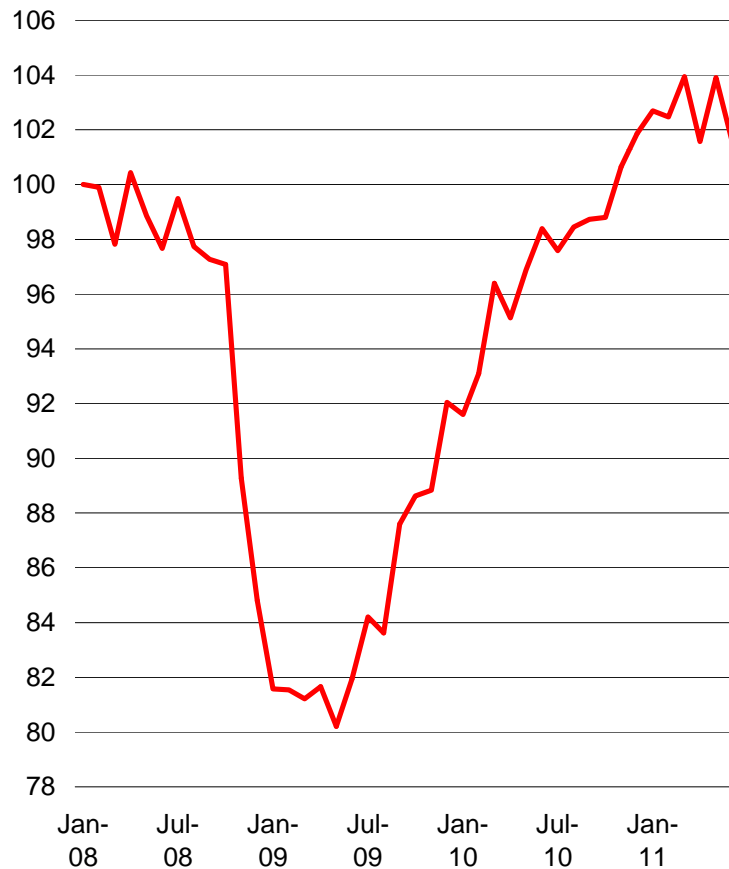

Macroeconomic outlook

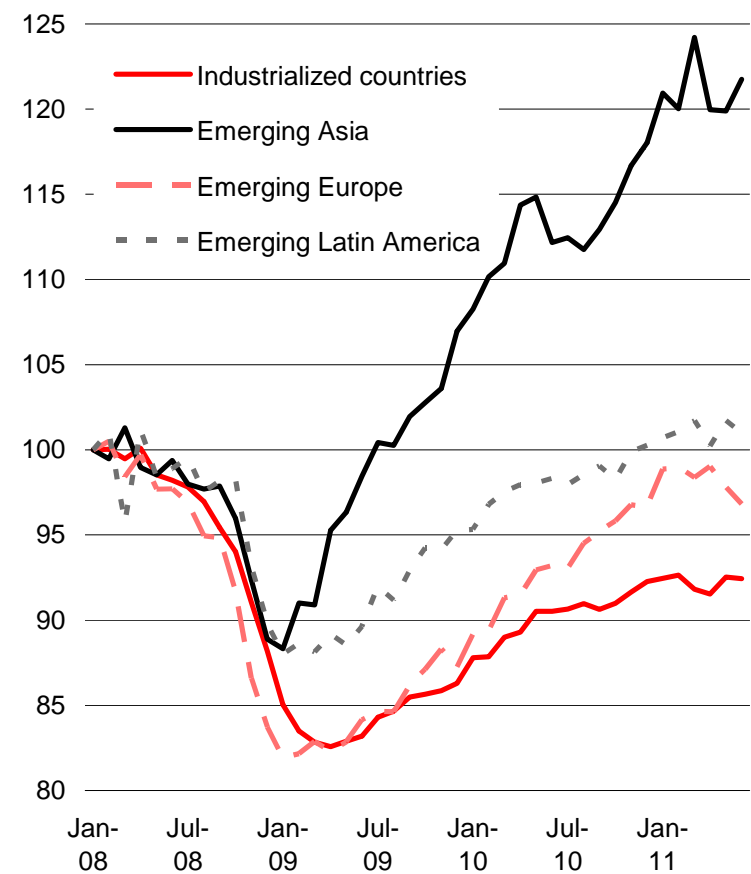
Chiara Corsa, UniCredit Group

The global recovery is running out of steam – especially industrialized countries lagging behind

Global Trade (exports + imports), volume, Index (Jan-2008=100)



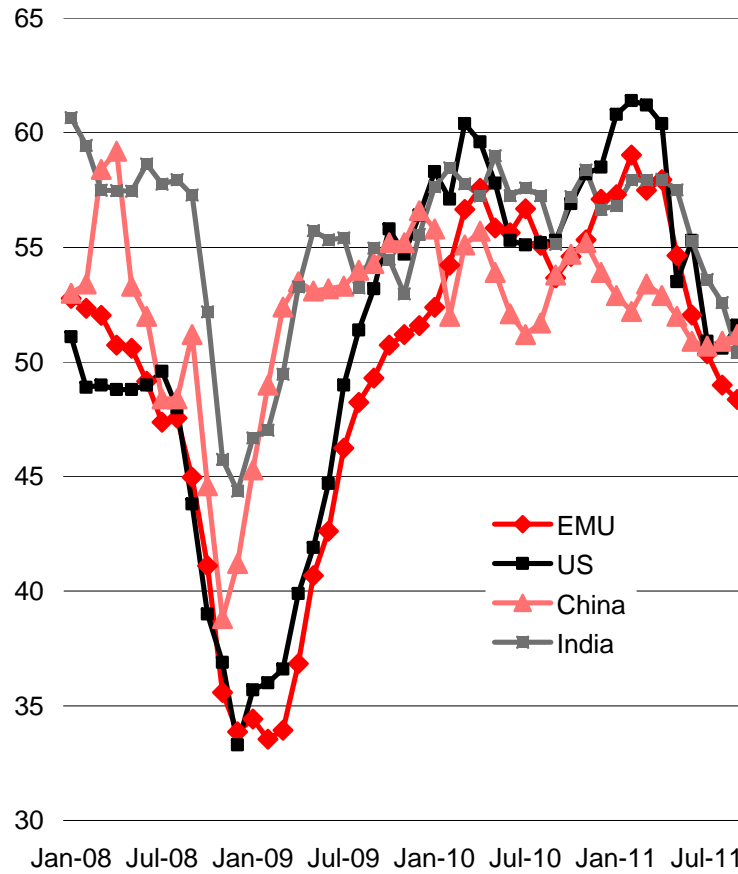
Industrial production, Index (Jan-2008=100)



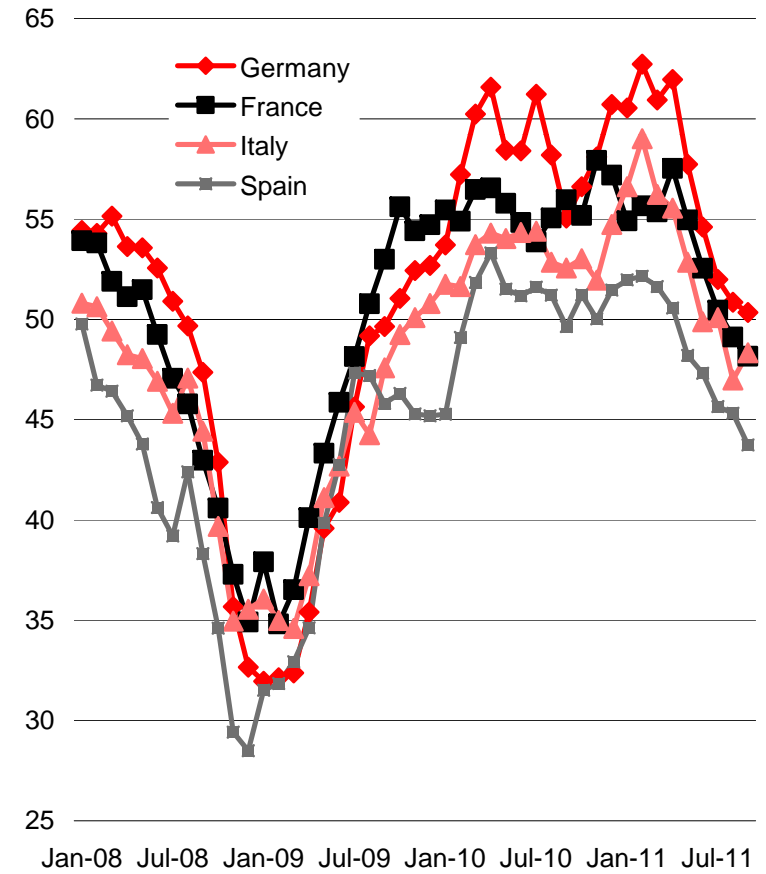
Source: CPB trade monitor, UniCredit Research

Companies' mood deteriorating on a worldwide level

Manufacturing PMIs

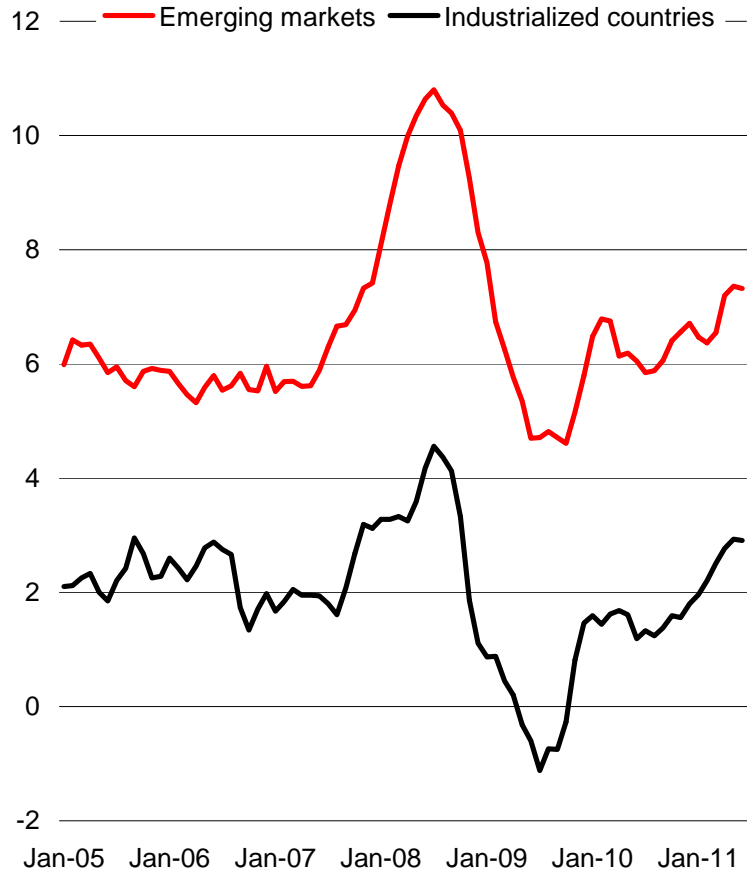


Manufacturing PMIs

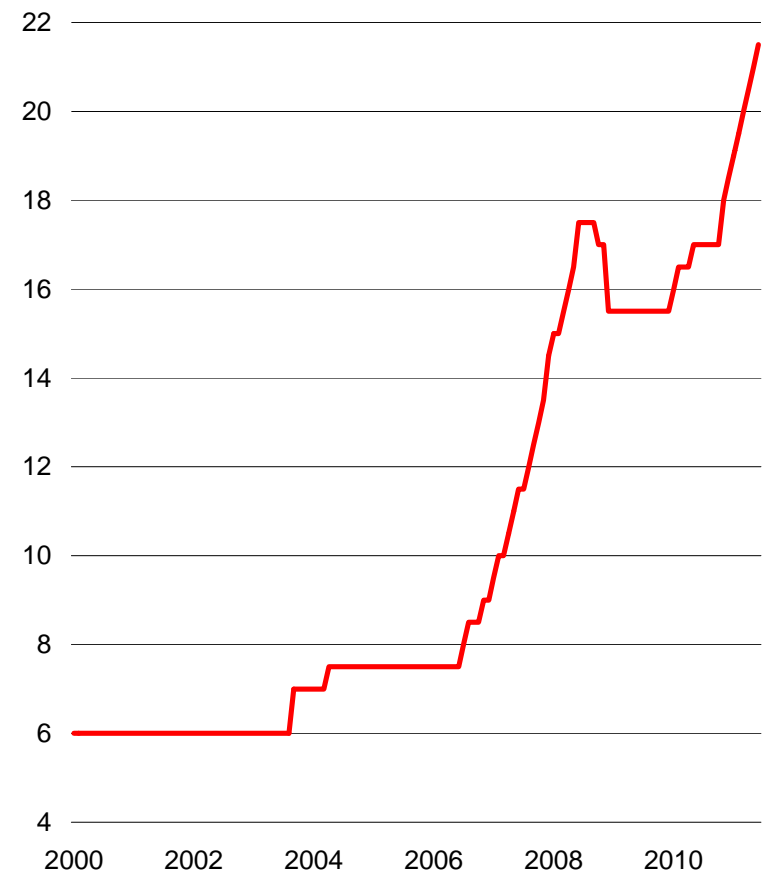


Also growth locomotive Asia is slowing down, driven by higher food prices and monetary tightening

Consumer prices, in % yoy



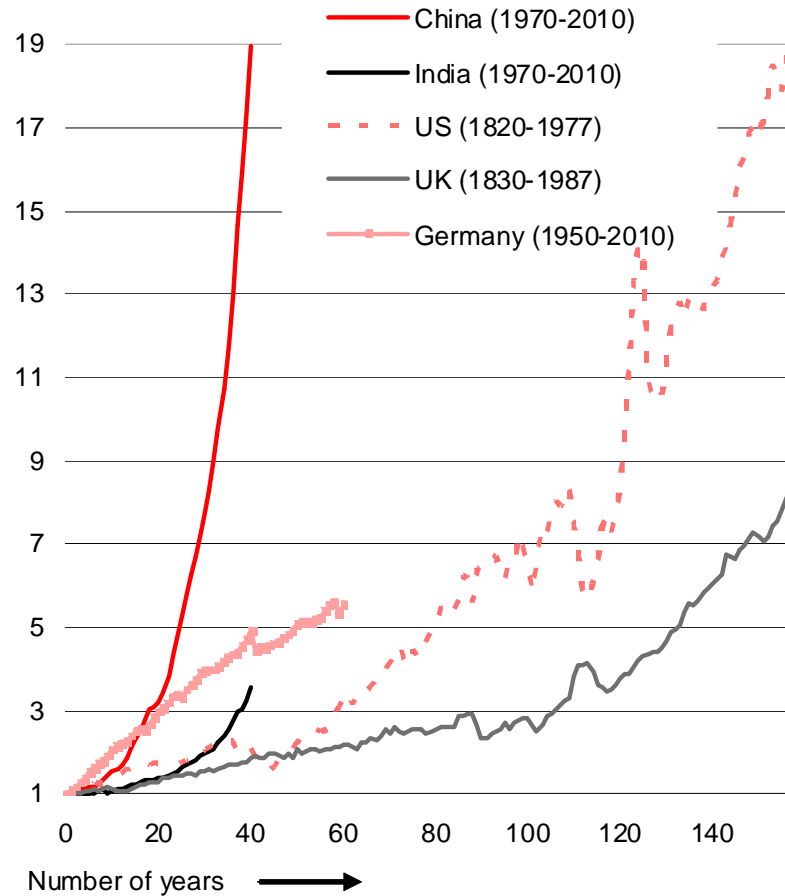
Chinese minimum deposit reserve ratio for major banks, in %



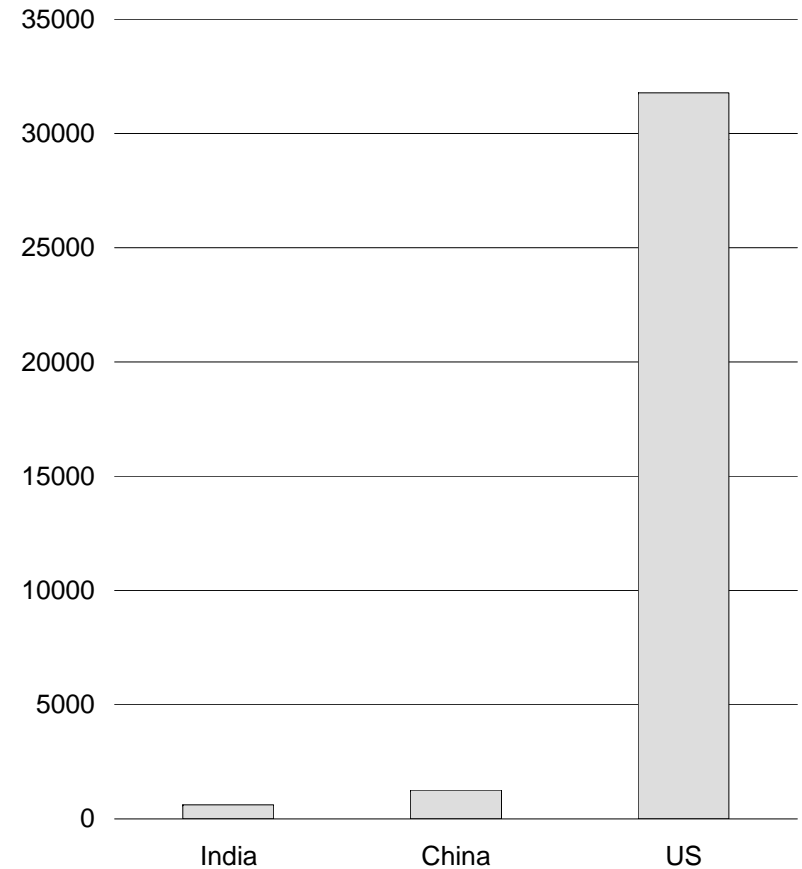
Source: Thomson Datastream, Bloomberg, UniCredit Research

China: Despite preceding breathtaking growth, still high catch-up potential in the medium term

Real GDP per capita (index with start of development=1)



Private consumption per capita (in USD, 2009)

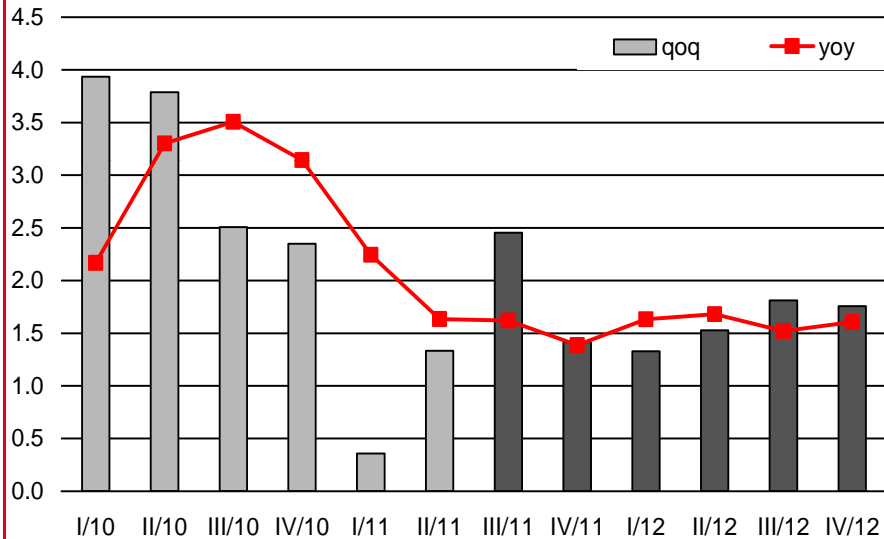


Source: Thomson Datastream, UniCredit Research

US acceleration in 3Q no more than a temporary rebound

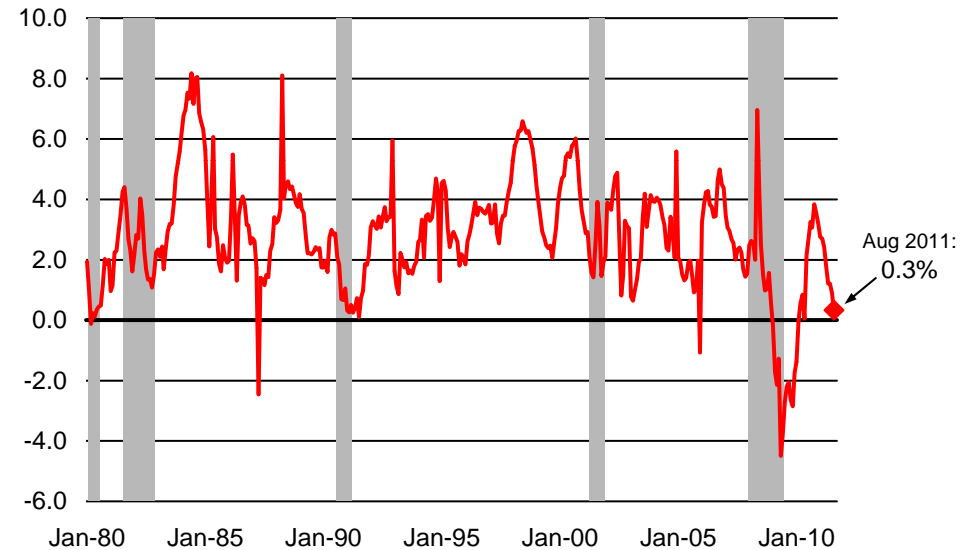
Our GDP forecast

Real GDP, annualized rates of change in %



Disposable income basically flat

Real disposable income, in % yoy

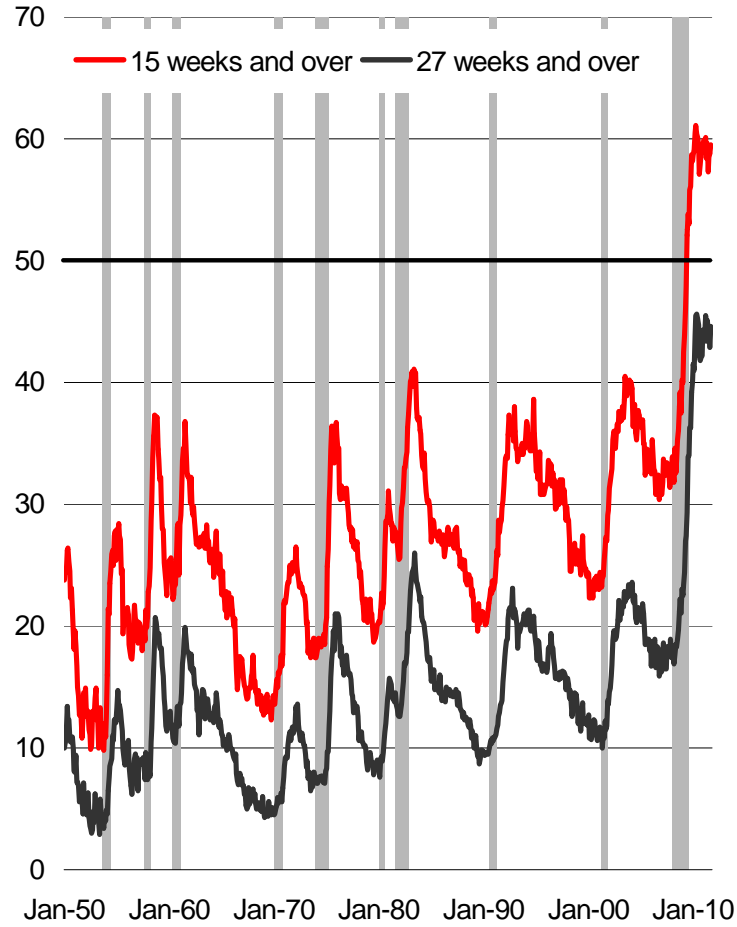


- GDP growth accelerated to 2.5% (saar) in 3Q
- A temporary bounce: fundamental situation remains weak (sluggish recovery in the labor market and weak real income)
- We expect the recovery to lose momentum in the coming months although we do not expect a recession

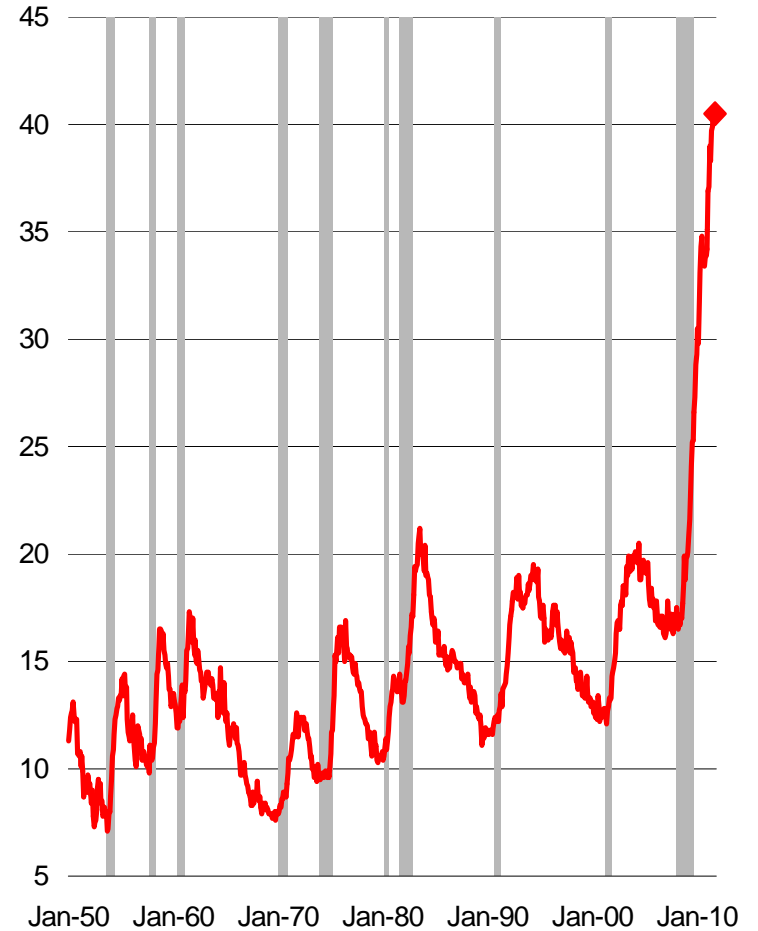
Source: BEA, Datastream, UniCredit Research

US labor market faces structural problems

Distribution of unemployed by duration, in %



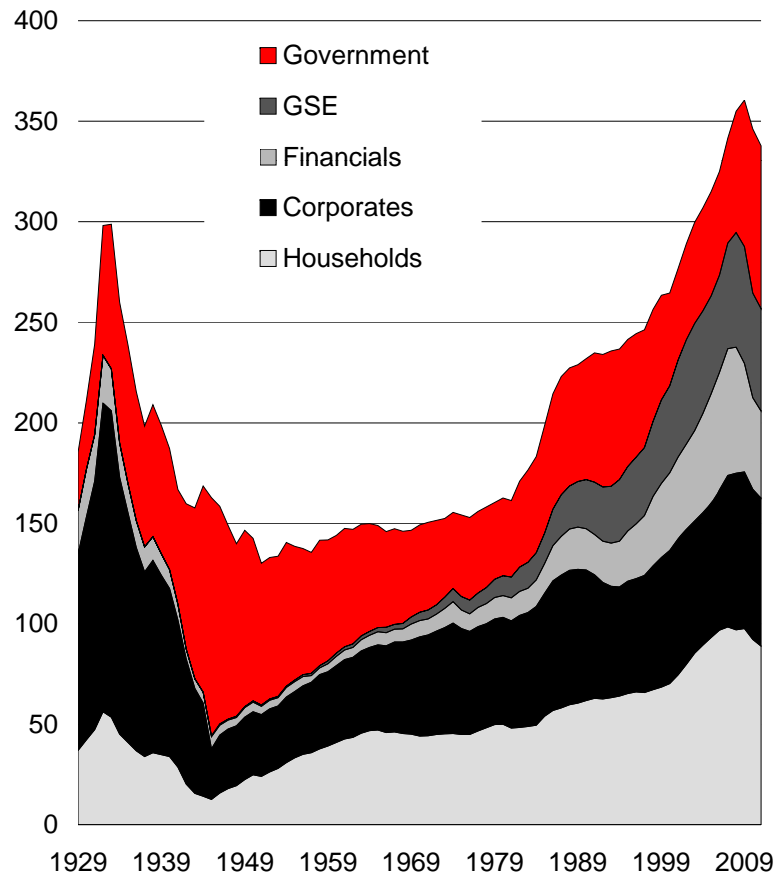
Average duration of unemployment, in weeks



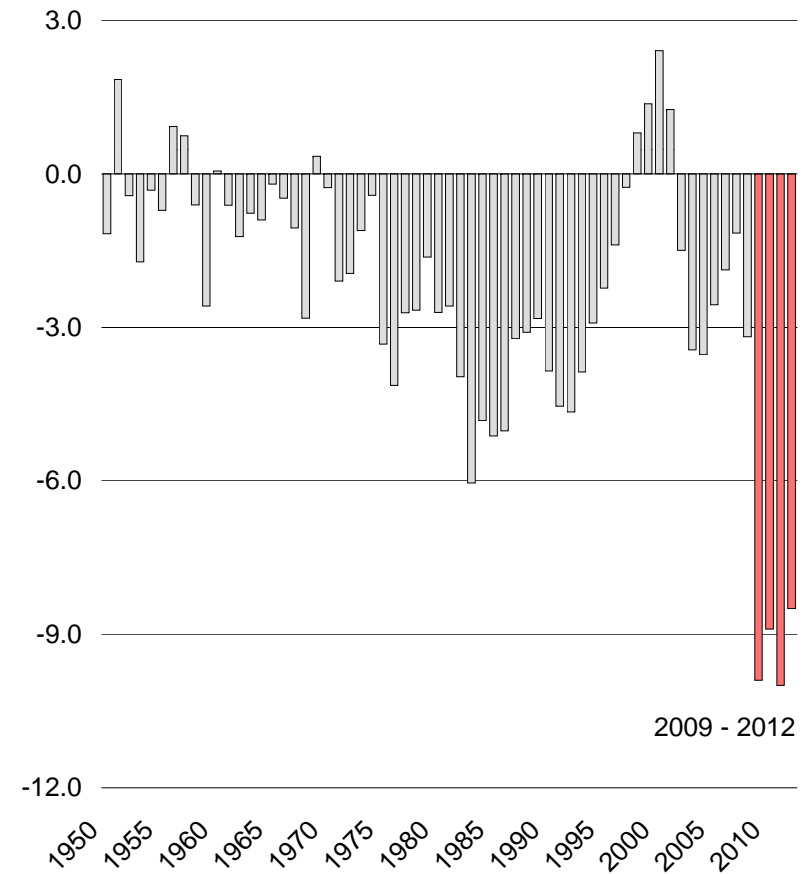
Source: BLS, UniCredit Research

US: Fiscal stimulus keeps economy afloat; But growth is borrowed from the future – new public debt finances old private debt

Credit market debt outstanding, in % of GDP (until 1Q11)

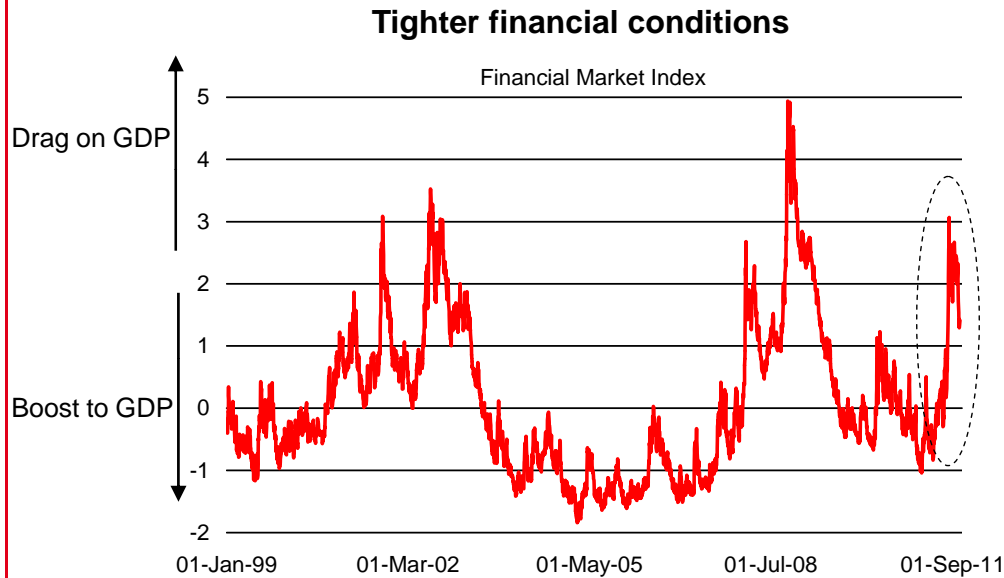


Fiscal balance, in % of GDP

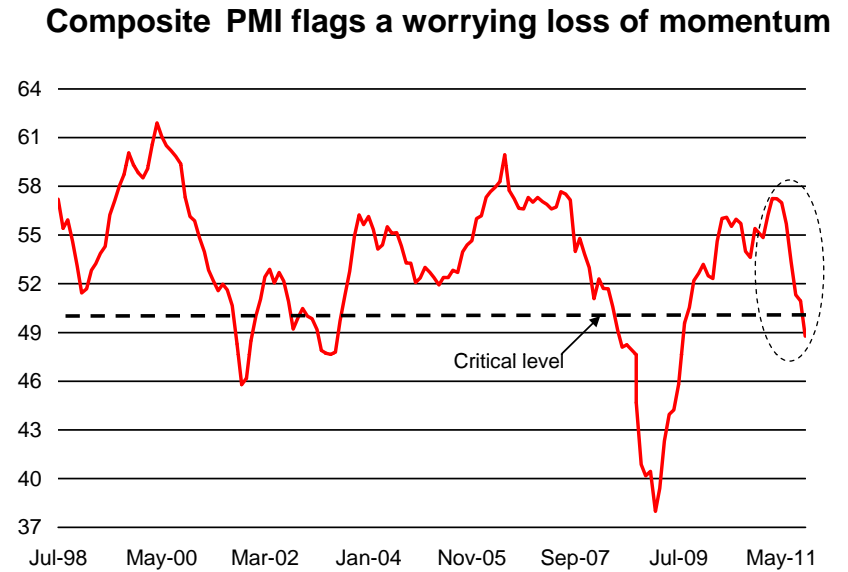


Source: FoF, IMF, CBO, UniCredit Research

EMU: Tighter financial conditions push the eurozone to the brink of recession



The Financial Market Index (FMI) aggregates in one indicator the signal of the VDAX, DJ Euro Stoxx 50 and non-financial corporate spread (BBB, 5-7y). Volatility and spread enter the algorithm with a positive sign, equity with a negative sign. The FMI is negatively correlated with economic growth and leads eurozone GDP by one quarter and Ifo expectations by one month.



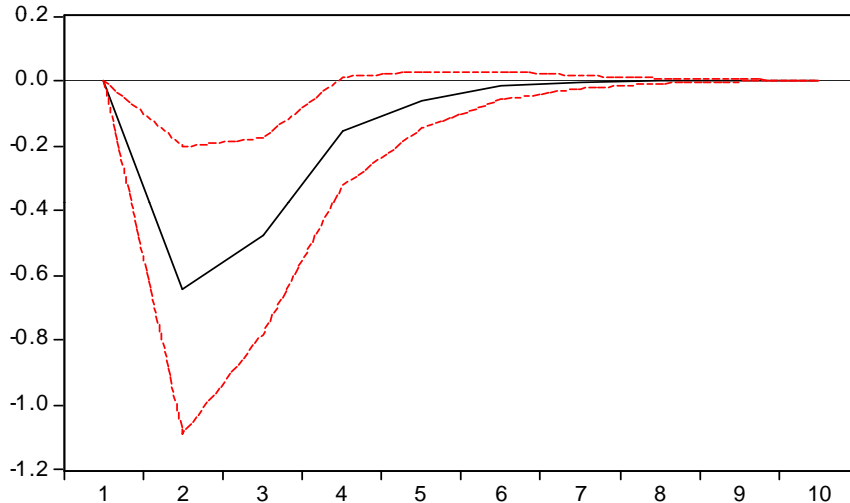
Source: Bloomberg, Markit, UniCredit Research

- Our Financial Market Index (FMI) signals intense market stress, although off the August peak.
- The GDP outlook has quickly deteriorated in response to tighter financial conditions, a stronger-than-expected slowdown in global growth, and tougher fiscal consolidation than previously assumed (particularly in Italy).
- In 4Q 2011, we see the economy contracting, although we do not expect a full-blown recession.

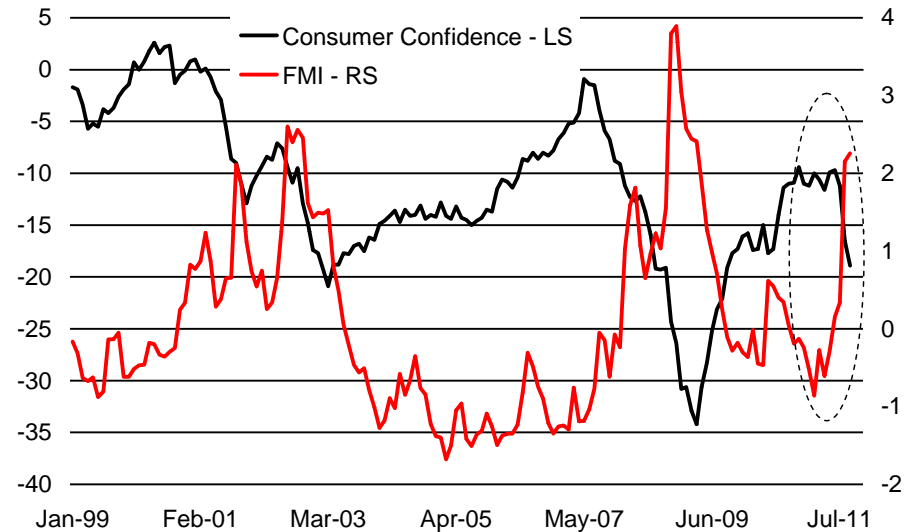
EMU: How tight financial conditions impact GDP – sentiment channel

Composite PMI response to tighter financial conditions

Response of D_EMU_PMI to D_FMI



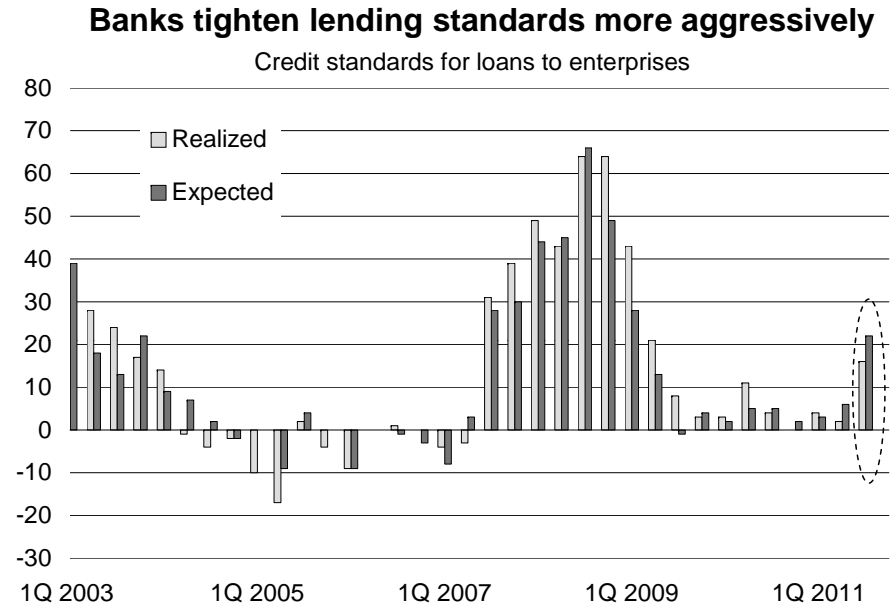
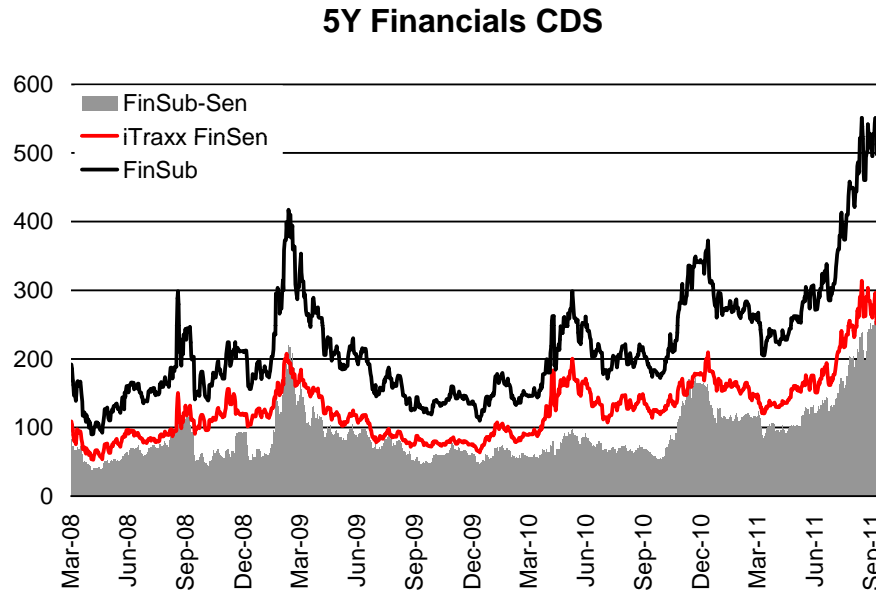
Households turn more cautious



Source: Bloomberg, EC, Markit, UniCredit Research

- The growth response to the financial shock via the sentiment channel is strongly significant and materializes quickly.
 - For any 1-point increase in our Financial Market Index (i.e. financial conditions tighten), the eurozone composite PMI drops 1.3 points in the three months post shock, equivalent to -0.1/-0.15pp in GDP growth.
 - Labor market trends and inflation are the most important determinants of consumer confidence, but their explanatory power decreases significantly at times of suddenly rising financial tensions.
- > household confidence (and hence consumption) is very sensitive to severe market stress.

EMU: How tight financial conditions impact GDP – banking channel

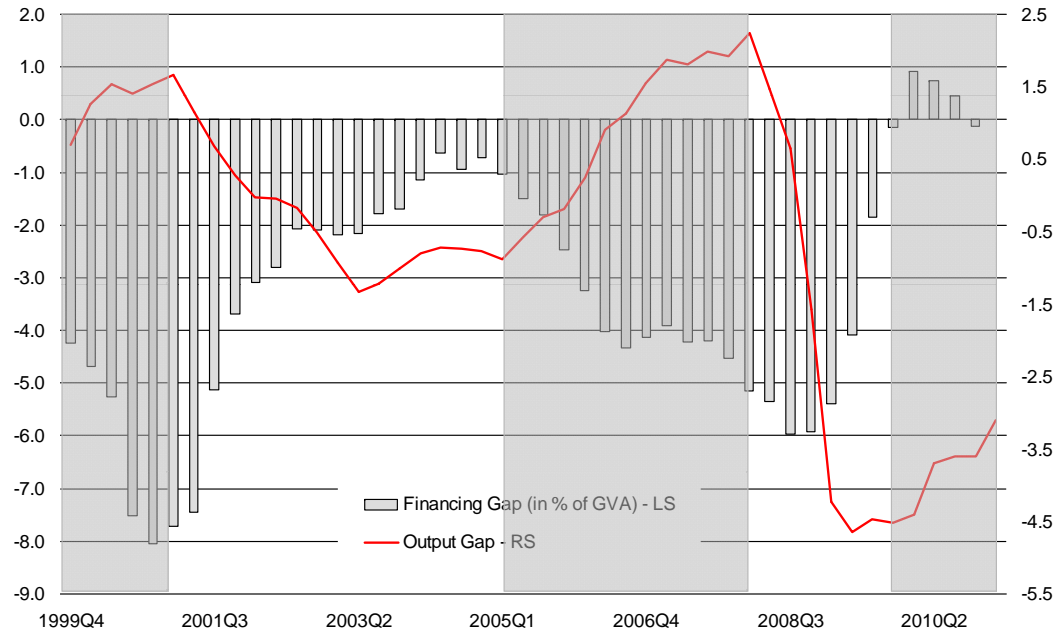


Source: Bloomberg, ECB, UniCredit Research

- Financials CDS spreads surged above the post-Lehman → Sovereigns are no longer lenders of last resort.
- The BLS shows that in 3Q11 banks tightened significantly their credit standard both on loans to corporates and households. This deterioration was mainly due to the re-intensification of the sovereign debt crisis.

EMU: Tug-of-war between declining confidence and still good fundamentals

Financing gap far from an end-of-cycle position



Financing Gap = Savings-Investment
Shaded Areas = Above-Potential Growth

Source: Eurostat, OECD, UniCredit Research

- NFCs' financing gap – a proxy for the need for external finance to fund investment plans – looks healthy.
- The financing gap is highly cyclical, with turning points in correspondence of the main cyclical junctures.
- The broadly-balanced financing gap indicates that corporates are still far from a vulnerable end-of-cycle position.
- Sound private-sector fundamentals in the core countries suggest that GDP should re-accelerate in the course of 2012. But risks are clearly to the downside.

What needs to be done?

Top priority



Avoid negative feedback loop between markets and real economy

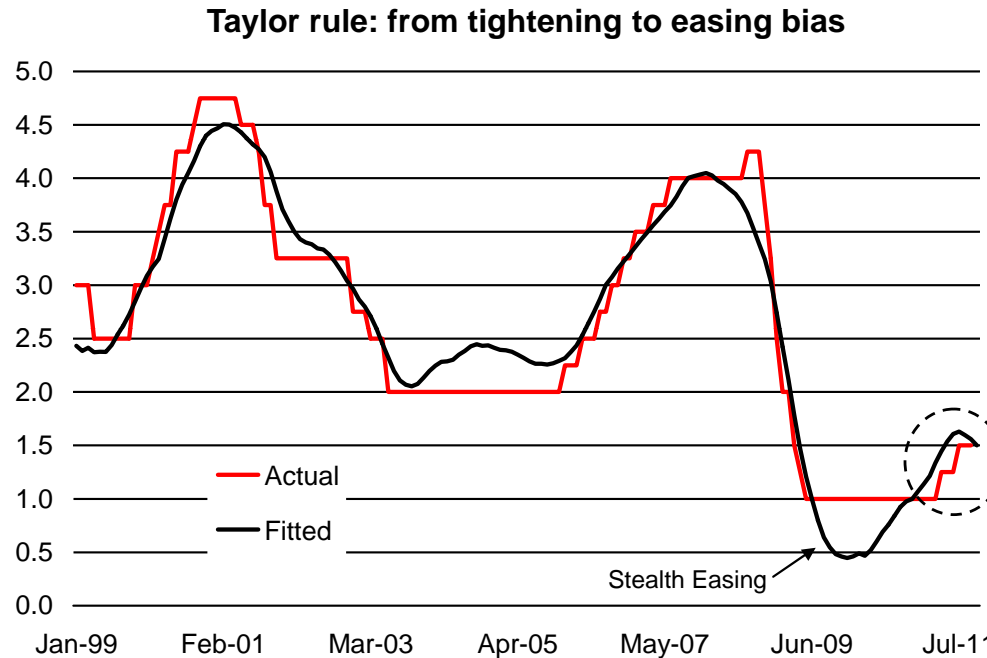


How ?



- ECB: emphasis on non-standard measures. In case of need, there is room for rate cuts. But this is not sufficient
- Ultimately, governments are responsible for a lasting solution to the crisis

ECB pulls out all stops on unconventional measures



Source: ECB, Markit, UniCredit Research

- Faltering GDP and market woes pushed the ECB from a tightening to an easing bias within just a couple of months.
- Our Taylor rule says that the refi rate level is appropriate, but will probably become somewhat restrictive in the coming months.
- However, if the environment remains non-recessionary and financial tensions do not escalate significantly further, the ECB may prefer to continue resorting to non-standard tools to counter downside risks to growth.
- At the end of the day, conventional monetary stimulus can do little in this environment.

Roadmap for government action...

- **Further structural and fiscal reforms**
 - liberalization of labor and product/services markets to boost potential growth
 - binding constitutional limits for the budget deficit
- **Establishing a proper rescue mechanism with adequate flexibility and resources**
 - crucial to provide strict rules for engagement (EFSF/ESM interventions never addressing solvency problems but acting exclusively in liquidity situations)
- **In case of solvency problems (Greece, maybe Portugal), debt relief is needed**
- **Bank recapitalization**

...and political risks to EMU growth and stability

- No deliverance of more and sustained structural reforms in peripheral and core European countries to generate growth
- Failure of Greece or other peripheral country to deliver, with corresponding bond default, EMU exit and massive contagion to other countries
- Permanent fiscal transfer system by introducing eurobonds without political union

Euro Summit: good progress in the right direction

- Agreement on two options to leverage the EFSF: 1) Insurance on new debt issued by member states 2) Create an SPV to collect resources from private and public investors. The options could be combined. The leverage effect could be up to four or five. Details will be discussed by the Eurogroup in November.
 - Recapitalisation of the banking sector: banks should increase the capital ratio to 9% by June 2012. Banks should first use private resources of capital and should be subject to constraints regarding the distribution of dividends and bonuses. If necessary, national governments should provide support and, if this is not available, the EFSF should be used.
 - Haircut of 50% on Greek bonds held by the private sectors to bring the Greek debt down to 120% vs. the IMF new baseline of 152%. This would help reducing EU/IMF financing support under the new version of the second aid package
-

Eurozone balance sheets: the devil is in the details

Debt (in % of GDP)

	NFCs		HHs		Govt		IIP	
	2009	2010	2009	2010	2009	2010	2009	2010
EMU	103.8	103.5	65.9	65.9	79.3	85.1	-16.3	-12.9
IT	84.4	81.5	43.9	45.2	116.1	119.0	-25.3	-24.3
DE	67.0	65.5	64.1	61.7	73.5	83.2	37.7	42.4
ES	138.8	139.0	86.0	84.9	53.3	60.1	-92.1	-87.1
FR	103.5	104.8	53.2	55.2	78.3	81.7	-8.6	-10.0
GR	68.3	62.1	52.6	59.9	127.1	142.8	-85.2	-99.5
AT	91.1	91.2	56.5	57.1	69.6	72.3	-12.3	-5.2
IR	204.5	185.9	123.1	119.0	65.6	96.2	-103.1	-90.9
PT	156.1	152.9	95.8	95.2	83.0	93.0	-109.0	-107.6
UK	118.6	112.0	103.5	99.8	69.9	80	-20.3	-13.0
JP	89.1	85.2	64.9	62.2	216.3	220.3	56.5	52.5
US	49.4	48.6	97.6	92.2	84.6	91.6	-17	-16.9

NFCs = Non-Financial Corporations

HH = Households

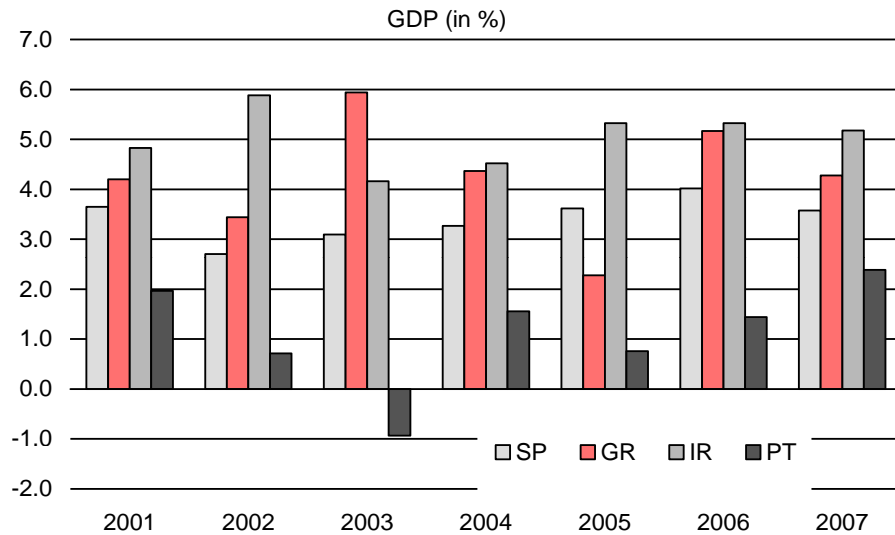
Govt = Government

IIP = International Investment Position

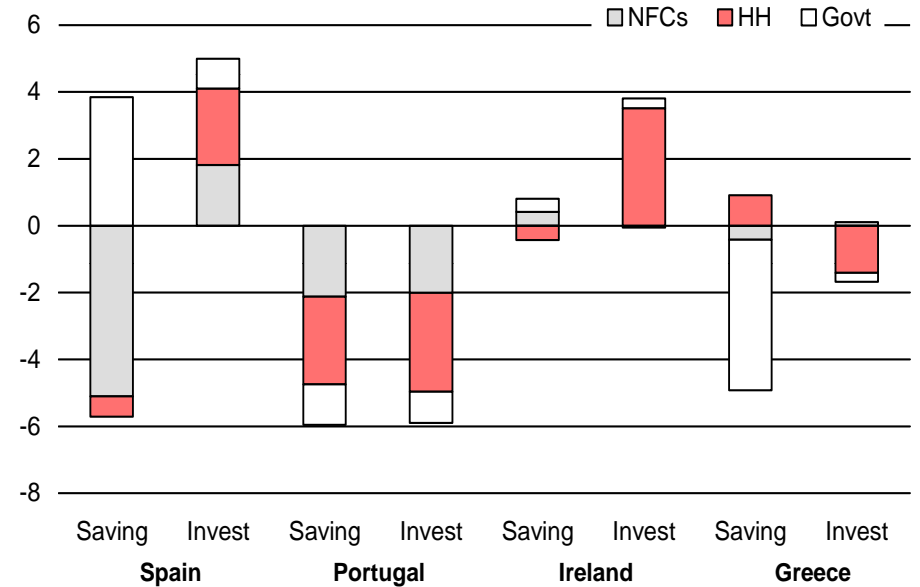
Source: National Sources, UniCredit Research

Portugal looks problematic

Massive growth underperformance



Savings/Investment balance (in % of GDP) - changes (in pp) in 2000-07

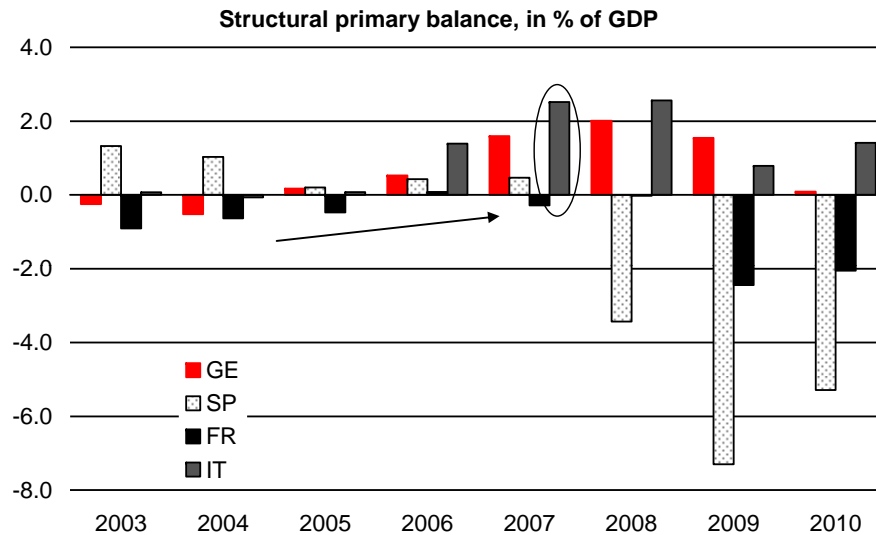


Source: Eurostat, UniCredit Research

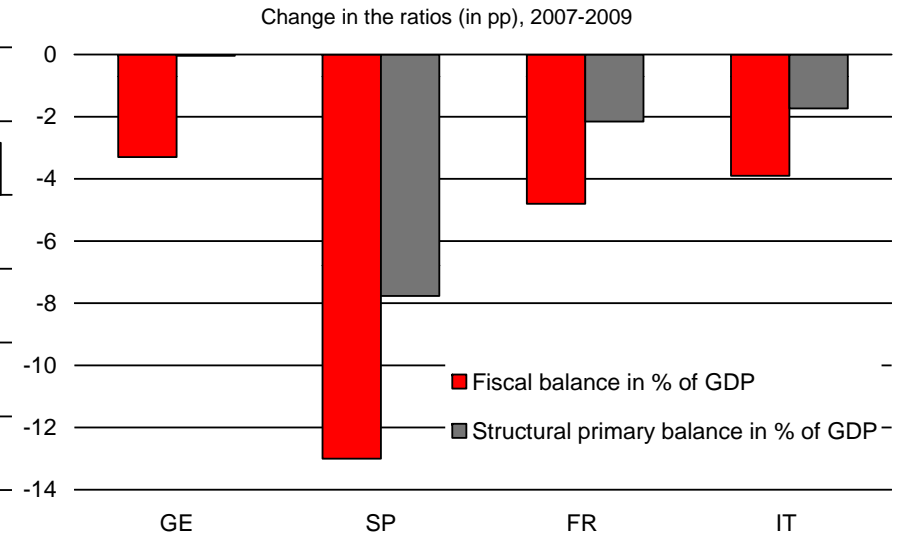
- Before the crisis, Portugal massively underperformed the rest of peripheral countries.
- Unlike most other peripheral countries, dissaving was not accompanied by a sustained increase in investment.
- A rapid decline in savings by all sectors was behind the large widening of the current account deficit.
- High indebtedness and structurally weak growth are a toxic mix difficult to overcome.
- Growth underperformance during the good years implies that now the social acceptance of austerity will be lower than in the rest of the periphery.

Italy's fiscal performance: flow variables look good

Structural primary balance: Italy outperforms



Cautious handling of public finance during the crisis

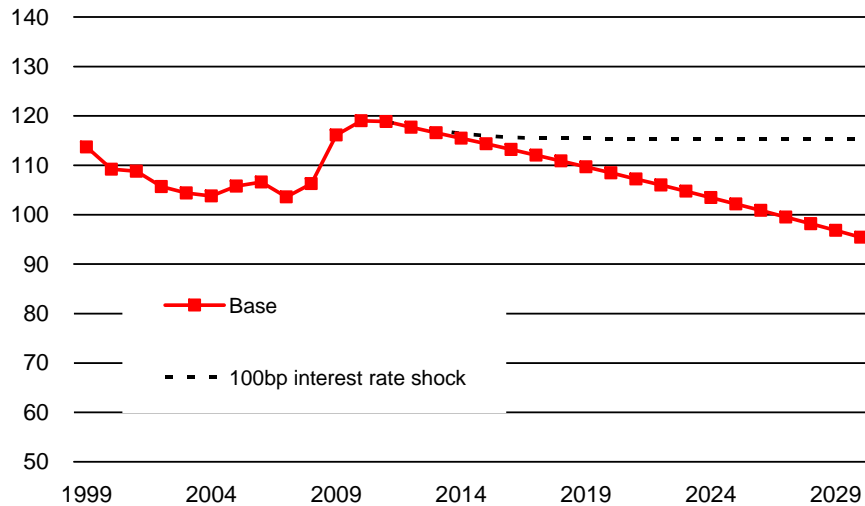


Source: Eurostat, IMF, MEF, UniCredit Research

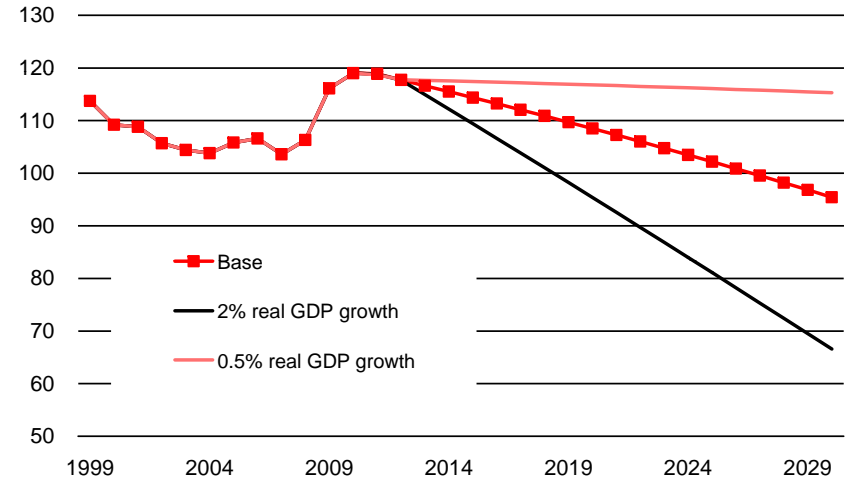
- When we consider flow variables, Italy's fiscal performance looks good and compares favorably not only to the periphery, but also to the core countries of the eurozone.
- This comes from the combination of a cautious handling of public finances during the crisis and a sizeable fiscal effort by the government between 2010 and this summer, which is worth a cumulative 5% (1.5% in 2010 and 3.5% in 2011).
- Moreover, recent belt-tightening measures come on top of a fiscal consolidation effort which had been in place for some time and which had brought Italy towards a sound structural primary balance ahead of the financial crisis.

Italy: debt is sustainable even with weak economic growth

Debt dynamics is not explosive even if rates spike...



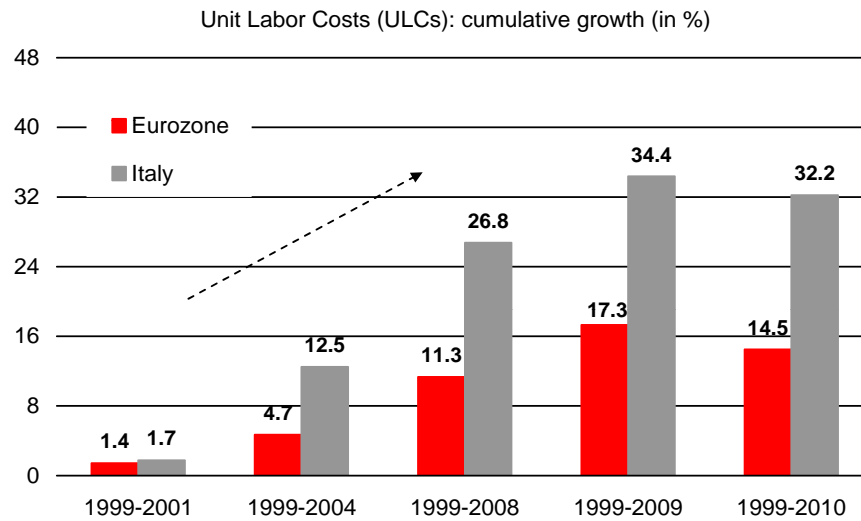
...or GDP remains structurally weak



Source: Eurostat, MEF, UniCredit Research

- Under our baseline scenario of 1% GDP growth, 2% inflation and a constant interest rate at 4.4%, a decline in debt/GDP to 95% in 2030 requires Italy to run a primary surplus of 2.7% of GDP (average since euro inception: 2.4%).
- Stressed scenario on the effective interest rates:
 - > +100bp increase: a 5.4% (4.4% + 100bp) interest rate represents a break-even level which stabilizes the debt dynamics through the forecast horizon.
- Stressed scenario on real GDP growth:
 - > Under a worst case scenario of only 0.5% GDP growth, the debt-to-GDP dynamics is not explosive;
 - > Needless to say, a much more benign debt patten would emerge if the government successfully boosts the country's growth potential via far-reaching reforms on the supply side of the economy.

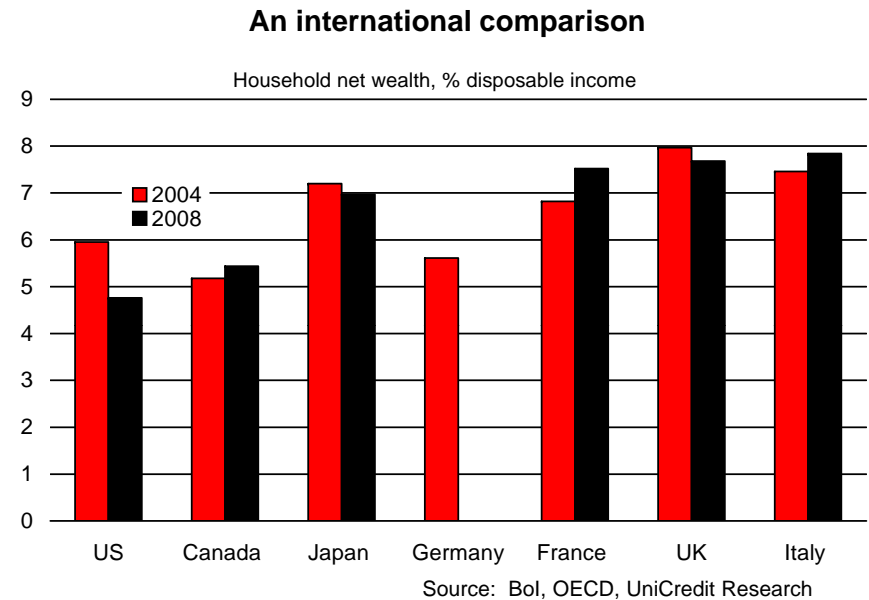
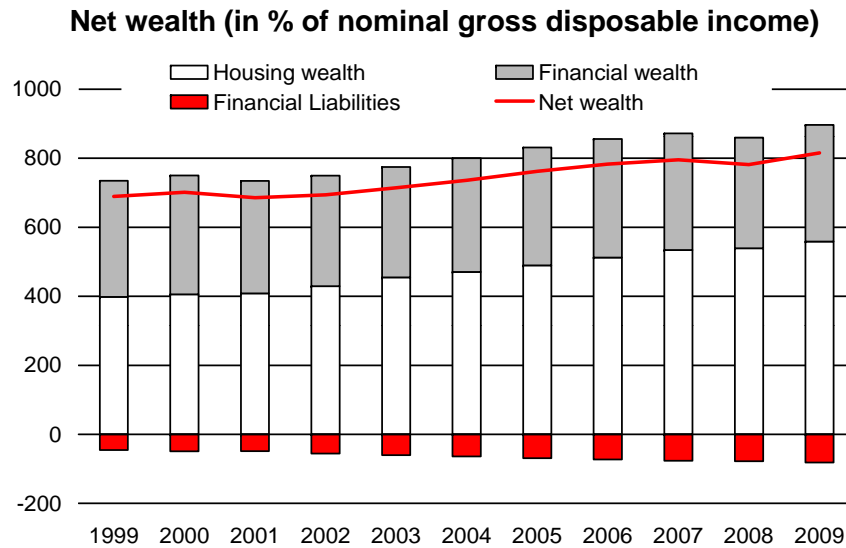
Italy: loss of competitiveness is due to productivity underperformance



Source: EC, ISTAT, Eurostat, UniCredit Research

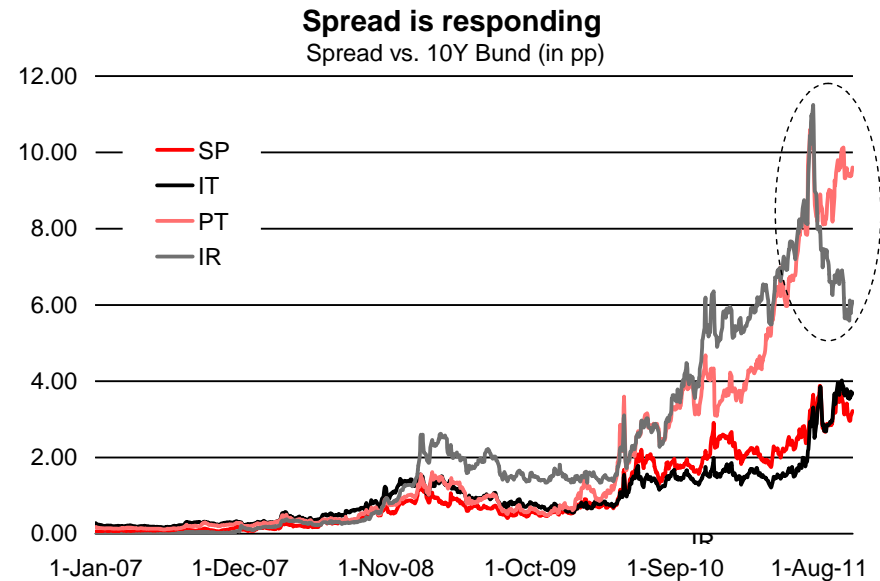
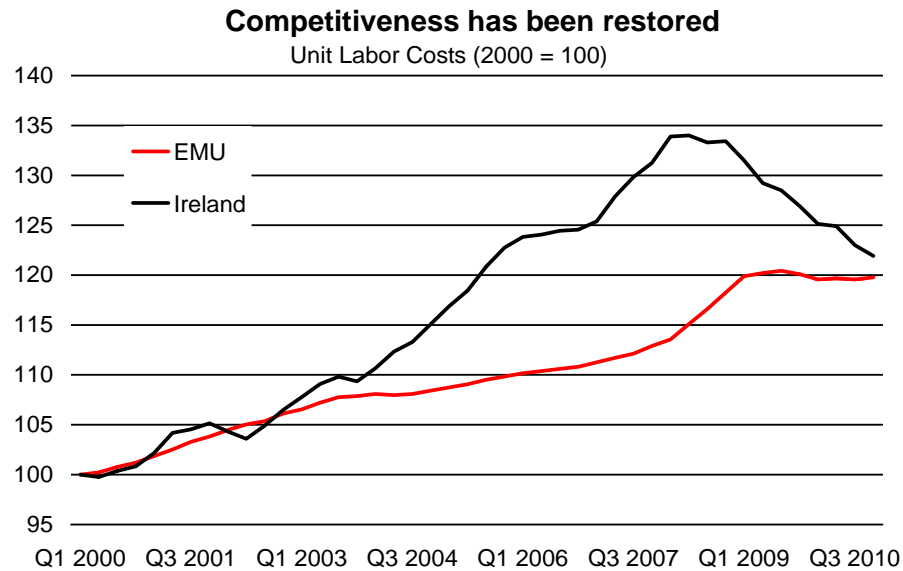
- Italy's main challenge remains the structurally low growth potential.
- Italy's loss of competitiveness in terms of unit labor costs vis à vis Germany was huge in the last decade.
- This is mostly the legacy of a structural decline in labor productivity and does not stem from an excessive increase in compensation.
- Raising productivity is the way to go.

Italy: households finances remain safe



- An asset/liability analysis suggests that households' finances remain relatively safe.
- Italian households not only remain among the least leveraged in the eurozone (around 45% of GDP vs. around 70% in the eurozone)...
- ...if we look at the assets owned by households, we see that in 2009 (latest data available), Italian households enjoyed an increase of both their financial and real assets (as a percentage of disposable income). As financial liabilities remained stable at a low level (81% of disposable income), net wealth increased to 814% of real disposable income.
- Moreover, a cross-country analysis shows that Italy has one of the highest net wealth-to-disposable-income ratio among the largest advanced economies (8x vs. 5x in the US). As a reference, Italian households' share of global net wealth is at 5.7%, larger than the country's share of world GDP (3%).

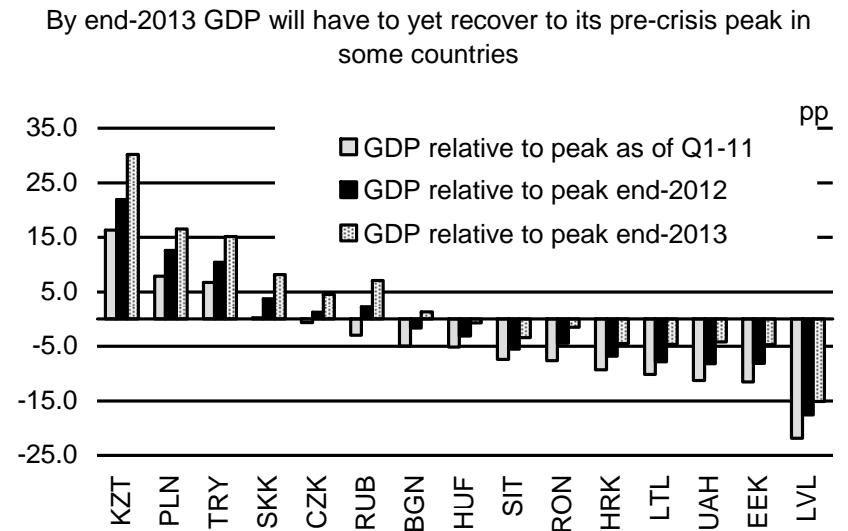
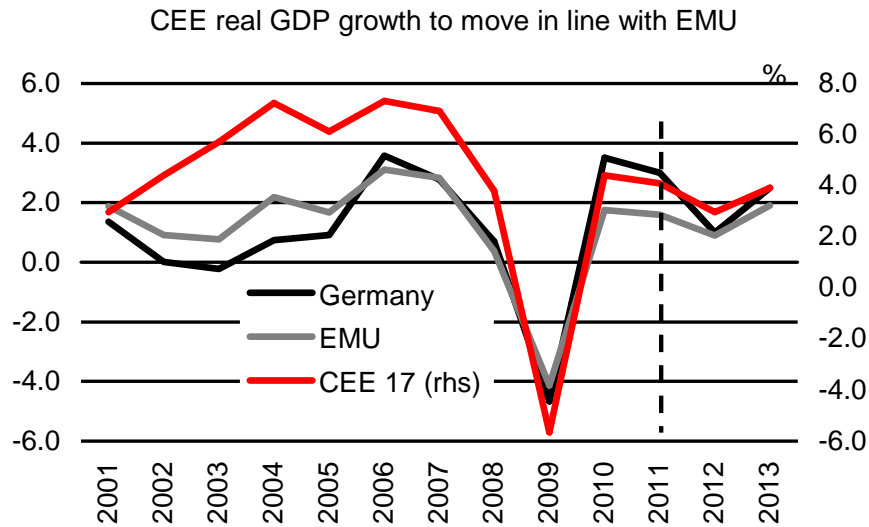
There is light at the end of the tunnel: Ireland shows the way!



Source: Bloomberg, Eurostat, UniCredit Research

- Among peripheral countries, Ireland is the one that saw the swifter adjustment in ULCs.
 - This is allowing the country to quickly re-gain lost competitiveness.
 - Falling ULCs led to a slightly positive CA position (it was -6% of GDP before the crisis).
- > The spread is responding nicely!

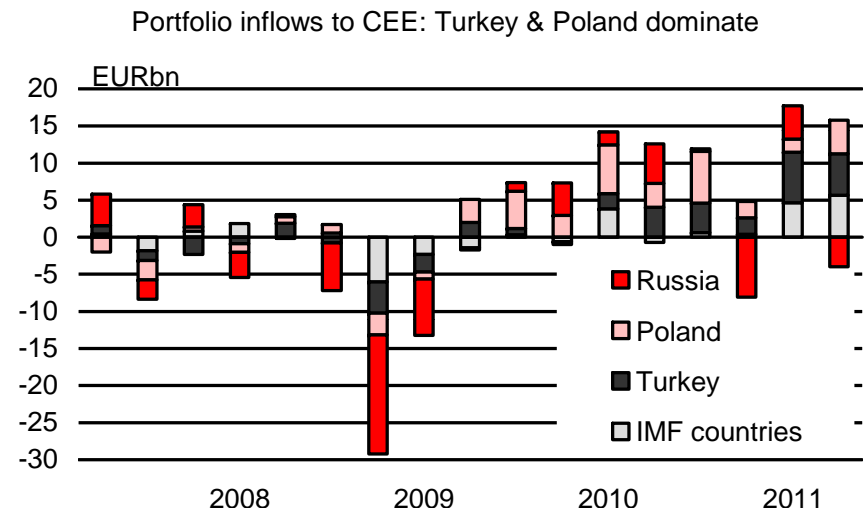
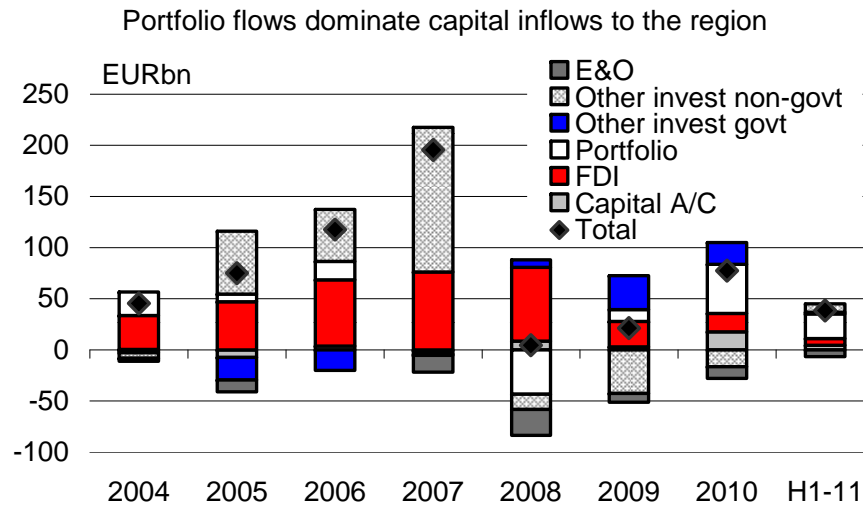
CEE: Regional growth to move in line with global trends



Source: CEE national statistics offices, Eurostat, UniCredit Research

- Economic activity in Central and Eastern Europe will move in line with the developed world.
- But we cannot look at CEE as a uniform region any longer. Instead there is large differentiation across countries, with some having already seen GDP recover to its pre-crisis peak but others lagging considerably.

CEE: Risks – outflow of capital

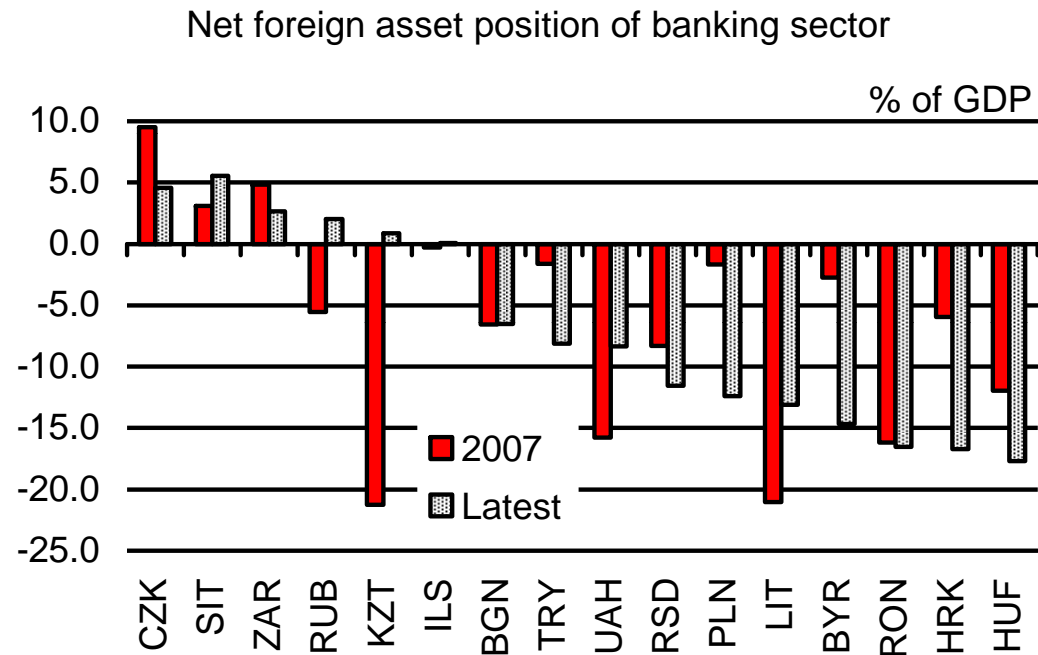


IMF countries refer to the aggregate of inflows to Hungary, Latvia, Romania and Ukraine.

Source: IMF, UniCredit Research

- In Turkey and Poland we monitor closely the risk of a sharp outflow of short term capital. This is also a risk in Hungary.
- To date weekly data flows have shown that EM bond funds continue to show inflows, though at a much slower pace, but equity funds have shown outflows for a number of weeks now. In Hungary, as well as Poland, pronounced outflows would threaten sovereign financing.

CEE: Risks – the banking sector



Source: IMF, UniCredit Research

■ Banking sectors in countries such as Russia and Kazakhstan have significantly reduced their exposure to foreign funding since the 2008 crisis but others remain much more at risk of a shut down in foreign funding. Hungary, Croatia and Romania are worse positioned.

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