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# Focus Europe

## One step back from the brink

**There are two hurdles to getting a new Greek loan programme in place: Greek approval of the austerity measures to keep the deficit trajectory on track and EU agreement on the form of private sector involvement (PSI). The last week has seen the Greek politics dip dramatically and recover somewhat, improving the chances of agreeing the austerity. Significant risks remain, however. We have also seen a virtual capitulation by Germany on PSI, with Angela Merkel now seeing a "Vienna Initiative" as a good foundation and a pledge to work out the details with the ECB. By the end of the week a better sense of the hurdles being crossed was emerging.**

**Spain suffered from contagion this week. The situation of banks remains central there, and the recent spike in ECB lending is a reminder of the necessity to move fast on recapitalization. However, in the short run it may help to ease sovereign funding, as banks, in need of collateral, will probably increase their purchases of government paper. The fear of contagion may also trigger calls for pre-emptive fiscal action, notably in the form of further VAT hikes. We think that this should be avoided as long as market pressure remains manageable.**

**We have revised our UK inflation forecasts out to the end of next year, with CPI inflation now briefly heading above 5% this autumn. Higher utility prices are the main culprit. Euro area inflation remains above-target and is expected to rise further into the second half of this year. We expect inflation to slow next year but to remain at above target levels.**

**The significant foreign ownership of CEE banking systems proved to be a source of strength during the global crisis as foreign parent banks maintained capital and provided adequate funding. Any default or restructuring of Greek sovereign debt could be very different with parent bank funding likely to be reduced and subsidiaries possibly sold. Among the CEE, Bulgaria has the largest exposure to Greek parent banks.**

**Greece's cost of adjustment has risen, compounding the political cost**

| *% of GDP* | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| Fiscal measures planned | | | | |
| Original plan (May10) | 4.0 | 2.0 | 2.0 | n/a |
| Current estimate | 9.1 | 2.8 | 2.2 | 2.0 |
| *difference* | 5.1 | 0.8 | 0.2 | n/a |
| | | | | |
| Privatisations planned | | | | |
| Original plan (May10) | 0.4 | 0.4 | 0.4 | 0.4 |
| Current estimate | 1.1 | 2.2 | 4.3 | 6.4 |
| *difference* | 0.7 | 1.8 | 3.9 | 5.9 |

*Source: Deutsche Bank*

## Special Report

### Table of Contents



### Research Team

**Euroland**
**Thomas Mayer**
**(+44) 20 754-72884**
**Gilles Moec**
**(+44) 20 754-52088**
**Marco Stringa**
**(+44) 20 754-74900**
**Mark Wall**
**(+44) 20 754-52087**

**UK/Scandinavia**
**George Buckley**
**(+44) 20 754-51372**

**Central Europe**
**Caroline Grady**
**(+44) 20 754-59913**

**Inflation Strategy/Economics**
**Markus Heider**
**(+44) 20 754-52167**

## Economic Forecasts

| | Real GDP % growth[b] | | | Consumer Prices % growth[c] | | | Current Account % of GDP[d] | | | Fiscal Balance % of GDP | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2010 | 2011F | 2012F | 2010 | 2011F | 2012F | 2010 | 2011F | 2012F | 2010 | 2011F | 2012F |
| **Euroland (top-down)** | 1.7 | 1.9 | 1.5 | 1.6 | 2.7 | 2.0 | -0.4 | -0.9 | 0.0 | -6.0 | -4.6 | -3.5 |
| **Germany[b]** | 3.5 | 3.3 | 2.0 | 1.2 | 2.5 | 2.0 | 5.7 | 5.5 | 5.5 | -3.3 | -2.1 | -1.5 |
| **France** | 1.4 | 2.0 | 1.4 | 1.7 | 2.2 | 1.7 | -1.8 | -2.0 | -2.3 | -7.0 | -6.0 | -4.6 |
| **Italy** | 1.3 | 0.9 | 1.3 | 1.6 | 2.7 | 2.1 | -3.5 | -2.6 | -2.1 | -4.6 | -4.0 | -2.9 |
| **Spain** | -0.1 | 0.8 | 1.0 | 2.0 | 3.1 | 1.6 | -4.5 | -4.0 | -3.4 | -9.2 | -6.5 | -5.0 |
| **Netherlands** | 1.8 | 2.3 | 1.9 | 0.9 | 2.4 | 2.1 | 7.7 | 4.5 | 5.5 | -5.4 | -3.5 | -2.0 |
| **Belgium** | 2.1 | 2.5 | 1.9 | 2.3 | 3.2 | 2.1 | 1.4 | 2.0 | 2.5 | -4.1 | -3.7 | -3.5 |
| **Austria** | 2.0 | 3.0 | 1.9 | 1.7 | 3.1 | 2.3 | 2.7 | 3.0 | 3.5 | -4.6 | -3.2 | -2.3 |
| **Finland** | 3.2 | 3.6 | 2.3 | 1.7 | 3.3 | 2.3 | 3.0 | 1.5 | 1.5 | -2.5 | -1.3 | -0.5 |
| **Greece** | -4.4 | -2.9 | -0.4 | 4.7 | 2.7 | 0.7 | -10.4 | -8.0 | -7.0 | -10.4 | -8.9 | -7.8 |
| **Portugal** | 1.3 | -1.9 | -1.8 | 1.4 | 3.3 | 1.7 | -9.9 | -8.1 | -7.1 | -9.1 | -6.1 | -5.1 |
| **Ireland** | -1.0 | 0.5 | 1.8 | -1.6 | 1.2 | 1.2 | -0.7 | 1.0 | 1.5 | -32.2 | -10.0 | -8.0 |
| **UK** | 1.3 | 1.8 | 2.0 | 3.3 | 4.6 | 3.2 | -4.6 | -4.6 | -4.2 | -10.0 | -7.6 | -5.6 |
| **Sweden** | 5.4 | 4.5 | 2.8 | 1.3 | 2.5 | 2.0 | 6.3 | 6.5 | 6.0 | -0.1 | 0.5 | 1.5 |
| **Denmark** | 2.1 | 2.0 | 2.0 | 2.3 | 2.5 | 2.0 | 5.1 | 4.0 | 3.5 | -5.3 | -4.0 | -2.5 |
| **Norway** | 0.3 | 2.5 | 2.5 | 2.4 | 1.9 | 2.2 | 12.5 | 13.5 | 14.0 | 10.6 | 7.5 | 9.0 |
| **Switzerland** | 2.6 | 2.5 | 2.0 | 0.7 | 0.9 | 1.2 | 14.6 | 11.5 | 11.0 | 0.8 | 0.0 | 1.0 |
| **Poland** | 3.8 | 3.9 | 3.5 | 2.6 | 3.8 | 3.1 | -3.3 | -3.6 | -4.0 | -7.9 | -5.8 | -4.7 |
| **Hungary** | 1.2 | 3.0 | 3.2 | 5.0 | 4.2 | 3.5 | 2.1 | 0.8 | 0.2 | -4.3 | 1.5 | -2.8 |
| **Czech Republic** | 2.2 | 2.3 | 3.1 | 1.5 | 1.9 | 2.1 | -3.9 | -3.9 | -3.7 | -4.7 | -4.3 | -3.6 |
| **US** | 2.9 | **2.6** | **3.8** | 1.6 | 3.0 | 2.6 | -3.2 | -4.0 | -4.2 | -8.7 | -9.7 | -6.9 |
| **Japan** | 4.0 | -1.5 | **2.5** | -0.7 | 0.5 | 0.0 | 3.6 | **2.5** | **3.2** | -8.7 | **-8.8** | -9.3 |
| **World** | 4.9 | **3.9** | 4.4 | 3.2 | 4.2 | 3.4 | | | | | | |

*(a) Euro Area and the Big 4 forecasts are frozen as of 20/05/11. All smaller euro area country forecasts are as of 20/05/11. Bold figures signal upward revisions. Bold, underlined figures signal downward revisions. (b) GDP figures refer to working day adjusted data. (c) HICP figures for euro-zone countries and the UK (d) Current account figures for Euro area countries include intra regional transactions. (e) The revised inflation forecasts assume brent oil of $75/pb at the end of 2009 and $63.9/pb on average in 2010.*

*Source: National statistics, national central banks, Deutsche Bank forecasts.*

## Forecasts: Euroland GDP growth by components[1] and central bank rates

| **Euroland, % qoq** | 10-Q1 | 10-Q2 | 10-Q3 | 10-Q4 | 11-Q1F | 11-Q2F | 11-Q3F | 11-Q4F | 2010 | 2011F | 2012F |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **GDP** | 0.3 | 1.0 | 0.4 | 0.3 | 0.8 | 0.4 | 0.3 | 0.3 | ***1.7*** | ***1.9*** | ***1.5*** |
| Private Consumption | 0.4 | 0.2 | 0.2 | 0.3 | 0.3 | 0.1 | 0.1 | 0.2 | ***0.8*** | ***0.8*** | ***0.7*** |
| Gov. Consumption | -0.2 | 0.2 | 0.2 | -0.1 | 0.8 | 0.1 | 0.1 | 0.1 | ***0.3*** | ***0.6*** | ***0.4*** |
| Investment | -0.6 | 2.2 | -0.2 | 0.0 | 2.2 | 0.4 | 0.7 | 0.7 | ***-1.0*** | ***2.4*** | ***3.0*** |
| Stocks (contribution) | 0.4 | 0.3 | 0.1 | -0.1 | 0.1 | 0.0 | 0.0 | 0.0 | ***0.3*** | ***0.0*** | ***0.0*** |
| Exports | 3.5 | 4.2 | 1.7 | 1.7 | 1.9 | 1.3 | 1.0 | 0.8 | ***11.1*** | ***8.2*** | ***4.1*** |
| Imports | 3.9 | 4.0 | 1.2 | 1.3 | 1.9 | 0.9 | 0.9 | 0.7 | ***9.3*** | ***6.4*** | ***3.4*** |
| Net Trade (contrib.) | -0.6 | 0.0 | 0.2 | 0.5 | 0.3 | 0.2 | 0.1 | 0.1 | ***0.9*** | ***0.9*** | ***0.4*** |
| HICP inflation, % yoy | 1.2 | 1.6 | 1.7 | 2.0 | 2.5 | 2.5 | 2.6 | 2.6 | ***1.6*** | ***2.7*** | ***2.0*** |
| Core inflation, % yoy | 0.9 | 0.9 | 1.0 | 1.1 | 1.3 | 1.3 | 1.3 | 1.4 | ***1.0*** | ***1.4*** | ***1.7*** |
| **EMU4 GDP, % qoq** | | | | | | | | | | | |
| Germany | 0.5 | 2.1 | 0.8 | 0.4 | 1.5 | 0.5 | 0.4 | 0.3 | ***3.5*** | ***3.3*** | ***2.0*** |
| France | 0.2 | 0.5 | 0.4 | 0.3 | 1.0 | 0.3 | 0.3 | 0.2 | ***1.4*** | ***2.0*** | ***1.4*** |
| Italy | 0.6 | 0.5 | 0.3 | 0.1 | 0.1 | 0.2 | 0.4 | 0.4 | ***1.3*** | ***0.9*** | ***1.3*** |
| Spain | 0.1 | 0.3 | 0.0 | 0.2 | 0.3 | 0.2 | 0.2 | 0.2 | ***-0.1*** | ***0.8*** | ***1.0*** |
| **Central Bank Rates (eop)** | | | | | | | | | | | |
| ECB refi rate | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.25 | 1.50 | 1.75 | | | |
| US fed funds target rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | | | |
| BoE bank rate | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.75 | | | |
| BoJ O/N call rate | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | | | |

*Source: National statistics, national central banks, Deutsche Bank forecasts. (1) Forecasts in lower table as of 20/05/11.*

# Eurostress: Greece

- **There are two key hurdles to getting a new Greek loan programme in place: Greek approval of the austerity measures to keep the deficit trajectory on track and agreement among the EU on the details of private sector involvement (PSI) in the new loan programme.**
- **The last week has seen the Greek politics dip dramatically and recover somewhat, improving the chances of Greece crossing the first hurdle. Significant risks remain, however. We have also seen a virtual capitulation by Germany on PSI, with Angela Merkel now seeing a "Vienna Initiative" as a good foundation and a pledge to work out the details with the ECB. There remain challenges and details to work through, but by the end of the week a better sense of the hurdles being crossed was emerging.**
- **The protagonists are grinding towards what we have been expecting: a new loan programme with a voluntary rollover agreement. Is this a lasting strategy? The voluntary roll-over does not reduce the burden of Greece's debt, but it buys time, both for Greece to show what it may be capable of but more importantly for the other peripherals to differentiate themselves with their own adjustments. Whether the strategy is durable depend on Greece's capacity to keep delivering austerity. There is a rising risk that it cannot. Another round of austerity is due by year-end in the 2012 Budget.**

## Greek politics stares into the abyss and steps back

Last week we said that Greece's domestic political hurdles should not be underestimated and this week's events amply demonstrated the point. Greek PM Papandreou undertook a failed attempt to build a government of national unity between his socialist PASOK party and the main opposition conservative New Democracy (ND) party. Talks quickly unraveled due to ND demands to renegotiate the EU-IMF loan MoU. Pushing for the latter would have undermined financial stability inside and outside Greece.

Although criticized for the failure, perhaps Papandreou knew the overture would never work and that the attempt needed to fail in order to create the political momentum necessary for his follow-up strategy, a substantial cabinet reshuffle or what is effectively a new PASOK government. This was needed to remove reform roadblocks, bolster authority as well as appeal to opposition benches for consensus support.

In our opinion, the re-constituted cabinet is market positive. The new cabinet is composed of political heavyweights to direct government policy. Pro-MoU and pro-reformist cabinet ministers have been given more prominent roles and those more openly opposed to change have been demoted. The new cabinet re-invigorates reform prospects and creates a broader coalition within government. The immediate local press interpretation of the re-cast government is positive.

George Papaconstantinou was replaced as Finance Minister, as was widely predicted, although he remains in cabinet as Environment Minister (from where he can direct the challenging privatization of Public Power Corporation). Evangelos Venizelos was appointed Finance Minister and vice-president of the government. He is a professor of constitutional law, a reformist, the second most important member of the ruling party, and was a contender to the PM job in last party elections.

The new cabinet will face a vote of confidence early next week. PASOK have the majority 155 seats in the 300 seat parliament. Assuming no internal rebellion, the government should hold. A few PASOK MPs resigned this week, but having resigned they can be replaced and therefore do not affect the parliamentary mathematics.

Assuming the new government succeeds with the vote of confidence (tentatively scheduled for Tuesday; following the positive cabinet reshuffle, we believe the odds of success have increased from 50% to 70%) the new government must move forward quickly to enact the austerity measures to get Greece's funding back on track. The headline "budget bill" had begun to be debated at the Treasury committee in parliament earlier this week and was passed by the committee on Thursday. Having avoided a loss of momentum, the tentative unofficial date for the parliamentary vote of 28 June may still be achievable. However, the "implementation bills" to complement the headline budget bill have not yet been submitted to parliament and the new Finance Minister will want to design those to minimize the risk of opposition.

The tone is improving but Greece's domestic political risks are not inconsiderable. We continue to believe the austerity measures will be approved by the Greek parliament and this will secure the next tranche of the original loan programme from the EU and IMF. In our view, the economic ramifications of not accepting the austerity will ultimately help the politics of approval. The European Commission recently estimated Greece's primary budget deficit in 2011 at 2.8% of GDP (on the usual Commission assumption of no policy change). Having the EU and IMF withdraw from the loan programme because the austerity conditions fail to be met would result in a shock fiscal rebalancing, worse than the managed rebalancing which the programme offers. If the ECB follows through on its threat to reject collateral in the event of a default, the Greek banking system would collapse, adding financial shock to economic shock. We assume the Greek parliament will seek to avoid such a catastrophic outcome.

**Figure 1: Greece's additional financing requirement (relative to original loan programme) and a possible refinancing scenario**

| *EUR bn* | 2012 | 2013 | 2014 | '12-'14 |
|---|---|---|---|---|
| *Funding gap* | 30.0 | 32.5 | 42.4 | 104.9 |
| | | | | |
| *Gap financed by* | | | | |
| -- new loans (EU & IMF) | 14.4 | 13.7 | 17.5 | 45.7 |
| o/w EU | 9.6 | 9.1 | 11.7 | 30.4 |
| IMF | 4.8 | 4.6 | 5.8 | 15.2 |
| -- privatisations | 5.0 | 10.0 | 15.0 | 30.0 |
| -- rollover (assume 30%) | 10.6 | 8.8 | 9.9 | 29.3 |

Source: Deutsche Bank; for assumptions, see Focus Europe 10 June 2011

The EU and IMF appeared to make moves to accommodate the deteriorating Greek politics this week. From the public comments from Olli Rehn, the EU Commission for Economic and Monetary Affairs, it seems that the decisions on the disbursement of the fifth tranche of the original loan and the form of a new multi-annual loan will be split. The latter, where the hold-up relates more to the current lack of agreement between EU members on the form of PSI, will wait until the Eurogroup finance ministers meeting on 11 July. On 19 June, Rehn claimed euro area finance ministers could reach a conditional agreement to disburse the fifth tranche.

However, while this positive gesture could help the political debate in Athens, it would be an agreement conditional on Greece approving the austerity (which Rehn still expects in late June). Moreover, while it will also need to see the austerity approved before deciding to disburse its portion of the fifth loan tranche, the IMF will also need some assurances from the EU that it will have a funding plan for Greece from 2012.

## PSI: Merkel and Sarkozy find the right soothing words

Angela Merkel and Nicolas Sarkozy met on Friday. Their joint statement should be seen as the first concrete step towards the resolution of the "European leg" of the Greek problem — the difficulty on agreeing the conditions of a new package. The statement pointed to a soft approach on private sector involvement, leaning more towards the French solution (and likely ECB preference) of pure rollover and away from German FinMni Schaueble's preference for a debt exchange. Such a rollover would in all likelihood not trigger CDS and would have no impact on NPVs.

There were three key elements in the short joint statement:

1. Merkel stated that the "Vienna Initiative" was a good "foundation" for private sector participation. While this allows for some room for manoeuvre when discussing the details, we see this as code word for the roll-over solution.

2. Both Sarkozy and Merkel stated that any deal with the private sector would have to be voluntary.

3. Both Sarkozy and Merkel stated that any deal would involve the ECB - which was clearly in favour of the roll-over, the least disruptive one from a financial stability point of view. There was a slight difference between them. Sarkozy said that the solution had to be "agreed in accordance with the ECB" while Merkel said that it had to be "worked out" with the ECB. This may simply be a semantic distinction to play down any sense of capitulation of Merkel's administration to the ECB's demands.

Much will be revealed in the detail and a press conference at Heads of State level is not the right place to get into the technical details. While both Merkel and Sarkozy said they wanted "a quick decision", they also insisted that it would take some time to work out the details. This implies resolution at the Eurogroup meeting on 11 July rather than the one this coming Sunday. In any case, Merkel hinted that September — which had been reported as the preferred deadline for the German administration — would be too far away.

## Schedule of Greek Events

**19-20 June: EU finance ministers meet, conditional approval of fifth loan tranche**. This was originally a one-day event on Monday but after the failure to reach agreement on the form of private sector involvement (PSI) earlier this week the meeting has been brought forward to include Sunday. Olli Rehn, the EU Commissioner for Economic and Monetary Affairs, this week said the EU decision on the disbursement of the fifth tranche of the original Greek loan is set to be made on Sunday. However, it will only be conditional approval -- it still requires Greece to approve the near EUR7bn (3% of GDP) of austerity measures, which Rehn continues to expect around the end of June. EU finance ministers are also expected to discuss the strengthening of the Stability and Growth Pact, the prevention and correction of macroeconomic imbalances and enforcement measures for Excessive Deficits.

**21 June (unconfirmed): Vote of confidence in new Greek government**. The Greek parliament will hold a vote of confidence in the newly constituted government.

**21 June: T-bill auction**. The PDMA has announced its intention to auction EUR1.25bn of 13-week T-bills on Tuesday. It successfully issued a similar volume of bills earlier this week.

**23-24 June: European Council meeting**. The leaders of the 27 EU member states will meet for their quarterly summit. There are several events on the agenda, including EFSF reforms (primary purchasing as well as normalizing the effective lending capacity with the intended EUR440bn lending capacity), ESM terms and conditions and approval of Mario Draghi as successor to Jean-Claude Trichet at the ECB (from November). Although long seen as a key occasion for major decisions on Greece's finances, it seems those decisions will be taken largely by finance ministers on 19-20 June and 11 July. This is nevertheless an occasion for EU leaders to discuss the options on Greece and crisis policy in general.

**28 June (unconfirmed): Greek parliament votes on austerity**. This is the original but unofficial date for the vote on the headline “budget bill” containing the new austerity measures.

**Early July: IMF Board approval of the fifth loan tranche**. Assuming Greece approves the austerity measures, the IMF Executive Board can meet and approve their portion of the fifth loan tranche (EUR3.3bn of the EUR12bn tranche). The IMF will also require sufficient assurances from the EU that Europe will arrange financing for Greece in 2012. With Merkel and Sarkozy indicating that a deal will be done on PSI, it seems as long as Athens approves the austerity, the pieces will be in place for the IMF to disburse.

**11 July: European finance ministers meeting, decide on new Greek loan programme**. This is the Eurogroup meeting at which Olli Rehn claims the decisions will be made on the new multi-annual loan programme for Greece.

**15 July: Greek sovereign liability due**. This is the date of Greece's first sovereign liability in July. It is a T-bill. Assuming the T-bills continue to be rolled, this is not the hard date by which time Greece will need to have received the fifth tranche. If bills roll, the first hard date is July 19 when a bond coupon is payable. For markets to be confident that a technical default will be avoided, the formal decisions to disburse the EU and IMF aid will probably have to be taken by July 8.

## Austerity fatigue

The last week has seen the Greek politics dip dramatically and recover, improving the chances of Greece approving the necessary austerity conditions to trigger the fifth loan tranche and securing a new loan programme. Nevertheless, domestic events inside and outside parliament over the last few weeks raise the question, how much more austerity can Greece and the Greek people sustain? More austerity is due at year-end. There is a risk that Greece’s capacity to deliver will have been exhausted.

Revenues have continued to underperform, even against downwardly revised expectations. Mounting austerity may be creating a negative feed-back loop, undermining activity and with it revenues. Alternatively, the mounting austerity is driving activity and potential revenues into the shadow economy, something that can only be addressed through better enforcement. The result is that the fiscal savings necessary to hit the programme’s fixed deficit targets have risen repeatedly.

For example, at the time the Greek MoU was signed in May 2010, there was expected to be 4% of GDP of savings measures in 2011 followed by a further 2% of GDP of fiscal measures in 2012 and 2013 respectively. This followed on from the 5% of GDP of measures in 2010 before the programme and 7.5% of GDP of measures enacted with the MoU in mid-2010. This gave a clear front-loading of the adjustment, a specific design consideration to minimize the risk of adjustment fatigue—each year has new austerity, but a sharply declining rate to make it easier to accept and absorb.

At the time of the second loan review at the end of 2010, Greece was already off-track (the upward revisions to the 2009 deficit meant the starting point was worse than anticipated) and had to enact supplementary austerity of 2.2% of GDP to be capable of hitting the 2011 deficit of 7.5% of GDP. Today, with the forth review, Greece is having to undertake another manoeuvre worth 2.9% of GDP to remain on target.

Relative to the original plan, a combined 5.1% of GDP of additional fiscal measures have been required in 2011. And this is not the end of the surprises either. According to the Troika interim “main findings” report, the savings measures for 2012 are now estimated at 2.8% of GDP (2.0% in the original programme) and 2.2% in 2013 (2.0% originally). If austerity drives a negative feedback loop through activity/revenues and/or declining compliance, the austerity required to hit the 2012 targets, which will be due to be enacted in the 2012 Budget at the end of this year and to meet the conditions of the sixth quarterly review, will be at least 2.8% of GDP. Given the political cost of enacting today’s austerity, there are no assurances that the next round of austerity in six months time will be any easier to agree.

As large as they are, the additional fiscal savings measures are only part — and the smaller part — of the rising cost of adjustment to Greece. The other cost, which is politically toxic in its own way, is the privatization programme. From the original MoU through to the third review this Spring, privatization proceeds expected in the period 2011-2015 rose from EUR5bn to EUR12.5bn. It is now pinned at EUR50bn. That is, the privatization proceeds forecast has over the last 12 months risen from 2% of GDP to 20% of GDP. Although the IMF estimates that Greece has public assets worth as much as EUR280bn, there is popular resentment at the scale of the sell-off of assets.

**Figure 2: Greece's cost of adjustment have risen…**

| *% of GDP* | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| Fiscal measures planned | | | | |
| Original plan (May10) | 4.0 | 2.0 | 2.0 | n/a |
| Current estimate | 9.1 | 2.8 | 2.2 | 2.0 |
| *difference* | 5.1 | 0.8 | 0.2 | n/a |
| Privatisations planned | | | | |
| Original plan (May10) | 0.4 | 0.4 | 0.4 | 0.4 |
| Current estimate | 1.1 | 2.2 | 4.3 | 6.4 |
| *difference* | 0.7 | 1.8 | 3.9 | 5.9 |

Source: Deutsche Bank

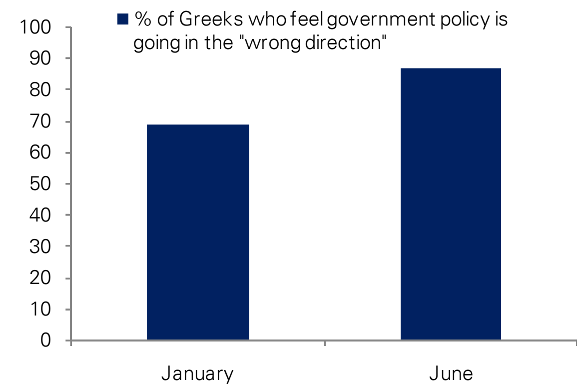
There is a significant risk that Greece's austerity becomes self-defeating, compounding the political challenge. Assume that the European Commission's latest primary balance deficit forecast of 2.8% of GDP turns out to the correct for 2011 and assume that Greece must hit the programme target of a primary surplus of 1.0% of GDP in 2012. What fiscal adjustment is required to tighten the primary budget balance by 3.8% of GDP in 2012?

Assume an elasticity of growth with respect to the fiscal stance (change in the cyclically adjusted primary budget balance) of 0.65 (based on 1 minus imports/GDP). In other words, GDP would be 2.5pp worse than baseline if the cyclically adjusted primary balance was to tighten by 3.8% of GDP in one year. For baseline economic growth, assume 1% real GDP growth (0.5% short-term trend growth plus a 0.5% competitiveness boost, generously assuming some external benefit from declining wage costs). There is also the cyclical component of the fiscal deficit. For every 1pp deterioration in GDP, the cyclical deficit for Greece is assumed to be 0.4pp of GDP larger.

Putting all this together means that to get a 3.8pp adjustment in Greece's non-cyclically adjusted primary budget balance in 2012 -- that is, to comply with the programme objective for the primary balance in 2012 -- would require a tightening of the cyclically-adjusted primary balance ("fiscal stance") by 5% of GDP in 2012. This would result in a contraction of GDP of 2.3% in 2012, following contractions of about 4 and 3.5% in 2010 and 2011.

A recent opinion poll showed that 87% of Greeks believe that government policy is going in the wrong direction. This is up from 69% in January. 9 out of 10 Greeks are "dissatisfied with how democracy works". In short, Greece is still some distance – economically and politically – from achieving the programme adjustment.

**Figure 3: …along with a growing sense of political disaffection**




Source: Deutsche Bank, Kathimerini, 12 June 2011

## Conclusion

A "muddle through" solution for Greece is being found to address today's issues. Greek politics had rebounded somewhat by the close of the week, raising the chances of the austerity being passed. Work needs to be done, but German and French differences on the form of burden-sharing are being resolved and the ECB's demands for a PSI strategy with minimal financial market impact is winning out. The protagonists are grinding towards what we have been expecting: a new loan programme with a voluntary rollover agreement.

Is this a lasting strategy? The voluntary roll does not reduce the burden of Greece's debt, but it buys time, both for Greece to show what it may be capable of but more importantly for the other peripherals to differentiate themselves with their own adjustments. The news-flow this week on Ireland's desire to revisit senior bank bond burden-sharing, the threat of downgrades to French banks due to Greek exposures and fear of disruption to Spain's Caja recapitalization plans amply demonstrate how Greece should not be considered in isolation. However, whether the strategy is durable depends in significant part on Greece's capacity to keep delivering austerity. There is a rising risk that it cannot.

***Mark Wall, (44) 20 7545 2087***

# Spain Watch: steering through contagion

- **Spain suffered from contagion this week, even if the pressure eased on Friday. In our view, the bank situation remains central there, and the recent spike in ECB lending – albeit to a significantly lower level than last year - is a reminder of the absolute necessity to move decidedly on the recapitalization process. However, paradoxically, in the short run it may help to ease sovereign funding, as banks, in need of collateral, will probably increase their purchases of government paper.**
- **The fear of contagion may also trigger calls for pre-emptive fiscal action immediately, notably in the form of further VAT rate hikes. The Bank of Spain seems to be of this opinion. We think that this should be avoided as long as market pressure remains manageable. Another round of austerity at the central level will not likely solve the real issue at stake, i.e. the need to rein in spending in the regions. Corrective action there should be taken if and when a large drift appears in the data for the second quarter, which will probably be released at the end of August/early September. Taking the risk to increase fiscal pressure this summer when the macroeconomic picture is dim could be counter-productive.**

## The return of the bank/sovereign nexus?

With the further deterioration of the situation in Greece, Spanish sovereign bonds took another hit, peaking at 5.73% at one point on Thursday, breaking the 5.1/5.6% range in which it had settled since November 2010. This spike corrected somewhat on Friday, with a correction to 5.58%, but with the return of the "risk off" mood, Spain needs to be "extra careful" and cannot afford any perceived drift from the steady progress it had been able to display since last summer. In the current environment, the market will probably react to any sign of weakness in any of the three "tests" we highlighted in Focus Europe[1] two weeks ago: i) resolution of the banking stress ii) managing a fiscal slippage in the regions and iii) maintaining GDP growth in positive territory in spite of a soft patch in global demand and tough fiscal retrenchment at home.

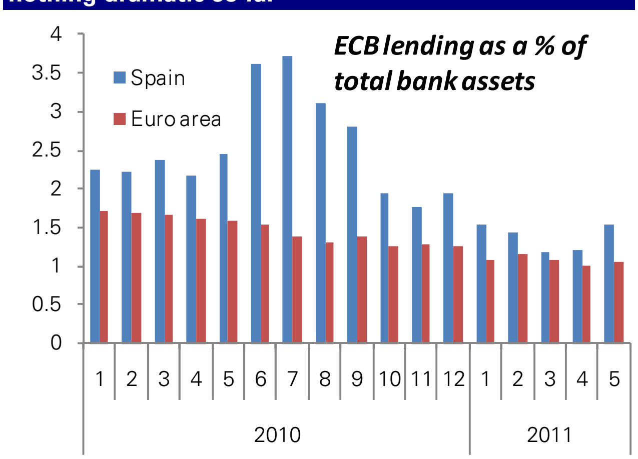
On the first issue, the most recent data flow suggests that a comprehensive overhaul of the banking sector must remain a top priority for the government.

[1] See "Spain's summer tests, 3 June 2011.

Contrary to what happened in Ireland and Portugal, Spanish banks retained market access and managed in the first few months of the year to maintain a fairly brisk pace of bond issuance (overwhelmingly covered bonds). This was probably always conditional on a continuous improvement in market perceptions of the peripherals in general. However, **with the turmoil in Portugal and another phase of intense stress on Greece unsurprisingly the flows of market funding to Spanish banks have recently dried up.** According to the Bloomberg monitor, the two largest Spanish banks issued a combined EUR 17.9bn in euro-denominated bonds in the first quarter of 2011, and only EUR 4.45bn so far in Q2. True, they have been more active on the US market via their subsidiaries there, but that is not an option easily accessible to smaller institutions. **Against such a background, it is not surprising that net ECB lending to Spanish banks rose to EUR 53.0bn in May from EUR 41.0bn in April, the highest figure since January 2011.**

**As such, Spanish banks' reliance on central bank money is not dramatically higher than in the Euro area as an average** (1.5% of total banks' assets in Spain against 1.1% in the Euro area and a staggering 8.1% in Portugal, assuming total assets in May stayed at their April level). It also remains much lower (see Figure 1) than at the peaks of last summer (EUR130.2bn and 3.7% of total banks' assets in July 2010). Still, it suggests that Spain will continue to need some support from the extraordinary liquidity framework prolonged (again) by the ECB until the end of Q3 to help it along its delicate restructuring/recapitalization process.

**Figure 1:Spanish bank are returning to the ECB…but nothing dramatic so far**




*Source: Bank of Spain, Deutsche Bank Global Markets Research*

**Further increases in reliance on ECB funding may appear in the coming months, as an indirect**

**consequence of the government's decision to put an end to the "deposit war" which has been opposing Spanish banks for the last two years.** Indeed, in order to beef up their liquidity position, credit institutions started to offer very generous remunerations to attract deposits. Under a new system, to be implemented from 3 July onward, their contributions to the Deposit Guarantee Fund - a fixed percentage of outstanding deposits - will be multiplied by 5 for deposits paying more than 100 or 150bps above EURIBOR. While the "deposit war", by eroding Spanish banks' profitability, had become a medium-term vulnerability for the country, in the short run it may force some credit institutions to rely more on ECB lending to offset lesser deposit dynamics.

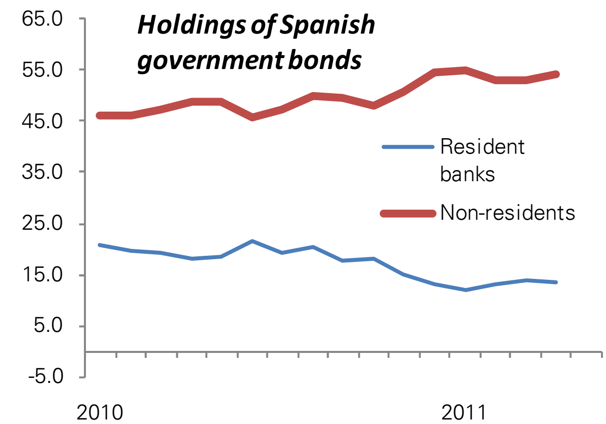
The state of the Spanish banking system will probably remain a market focus as long as no full clarity on the recapitalisation/restructuring process for the Cajas is available. Under the current timeline, while the results of the stress tests - just as for the rest of the EU - will come out probably in early July, the amount of cash that the state is ready to pour into the Cajas via the FROB will not be known before 30 September. In the meantime, as we highlighted in Focus Europe two weeks ago, the most pressing issue for the Spanish government on these matters will be to ensure that the FROB has enough space for its issuance in the last 3 months of this year, and this implies a continuation of the "over-issuance" for the sovereign. Over the first 4 months of the year, bonds and bills issuances exceeded by EUR 16bn funding needs.

This week was contrasted from this point of view. The bill auction, which raised EUR 5.4bn, close to the top of the expected range, was successful and was probably another example of this willingness to beef up reserves. Reuters reported that 60% of the demand in this auction came from non-residents. Conversely, the bond auction on Thursday – at the worst moment given the uncertainties about Greece - was less successful, stopping close to the bottom of the pre-announced range.

However, paradoxically, that Spanish banks may be faced with some "market funding drought" may help the sovereign go through a delicate patch this summer, faced with the necessity to continue to over-issue against a background of a large refinancing spike in July (EUR21.4bn in our estimate).

**Looking for collateral, Spanish banks may be readier to take a large share of government bonds**. Last year, when Spanish banks were resorting quite heavily on ECB lending, their participation to government funding was also significant, even if non-residents still accounted to roughly half the holdings in Spanish sovereign bonds (see Figure 2). The peak in ECB lending also corresponded to the peak in banks' exposure to government debt. Conversely, when the bond market re-opened to Spanish banks in late 2010/early 2011 and reliance on ECB lending diminished, the share of banks in government funding also declined. Collateral management probably is the cause of this correlation.

**Figure 2: Time for Spanish banks to return to government funding?**




Source: Spanish treasury, Deutsche Bank Global Markets Research

**A re-instatement of the banks/sovereign financing loop cannot be sustained in the long run, but it may be an acceptable transitory patch** if it allows for a final resolution of the banks' capital gap by the end of this year, which we note is, intrinsically, the very source of Spain's difficulties in the market.

## The pros and cons of pre-emptive fiscal action

Two weeks ago in Focus Europe we highlighted two sources of potential drift from targets for public finances. First, the regions may be unable to stick to their ambitious objective to bring their deficit back to 1.3% of GDP in 2011 from 2.8% last year. Second, we maintain that the government's growth forecasts for this year are too optimistic, and that the combination of a soft patch in global demand and unexpected imported inflation shock creates a downside risk on our own projection of 0.8% GDP growth for this year, already less ambitious than the 1.3% assumed by the government. If all the regions with a deficit above 3.0% of GDP emulate Catalonia and reduce their deficits by only 30% (against 55% on average in the government program), the additional deficit would amount to 0.6% of GDP, while the mechanical impact of a 0.5% shortfall in GDP growth would amount to 0.25%. In this case, the general government deficit would stand at 6.85% of GDP this year instead of 6.0%, the official target. The European Commission has a similar – albeit probably more diplomatic - view, with a growth forecast of 0.8% as well, and a deficit at 6.3% of GDP.

**In our view, that Spain exceeds by a margin its targets would not necessarily be problematic.** Even if the deficit corrects to only 6.8% in 2011, the effort from the peak of 2009 (11.2% of GDP) would still be very encouraging. It would not differ significantly from the performance of core countries such as France (which would post a deficit of 5.8% this year according to the European Commission). It would also be manageable from a debt dynamic perspective, given its low level (60.1%n of GDP in 2010 against 85.4% on average in the Euro area). **However, it may be important, given the intensification in market stress, for Spain to re-state its commitment to its multi-year program.**

**The Bank of Spain is already calling on the government to more action on the deficit**, devoting a large part of its last annual report to defining a fiscal strategy for Spain. Its approach is twofold: first, it urges a swift conversion to fiscal rules, notably to establishing a strict spending ceiling under which public expenditure growth could not exceed the path of nominal GDP. This would be in line with the "new Stability and Growth Pact" which will impose this sort of automaticity for all the member states. Second, the chapter finishes on a comparison of the level of indirect taxes (especially VAT) in Spain relative to the rest of Europe. It concludes that Spain, even after taking into account the hikes of July 2010 could improve noticeably its tax income by simply bringing these rates on part with that of its main partners and/or bringing more products under the normal rate instead of the reduced rate.

The report does not give a timeline for this sort of action, but **it could be interpreted as a call for further pre-emptive VAT hikes in the coming months to offset any fiscal drift.** While adopting the fiscal rules would make a lot of sense and contribute to reassure the markets, we also think that it is only if market pressure were to increase markedly within the next few weeks – for instance if the resolution of the "Greek issue" remains elusive and leads to more "risk off" attitude in the market- that the government should embark in such additional austerity measures. We see three main reasons for this:

**First, we may enter in counter-productive territory there.** Private consumption is already struggling against a background of renewed inflation, high unemployment and cuts in public sector wages. It has escaped a complete collapse simply because the savings ratio fell markedly in the recent quarters. Another blow on real income in the next few months should probably be avoided. Domestic demand will likely matter more in the next few months as the latest surveys point to some deterioration in manufacturing, in line with softening world demand. The only source of support is now coming from the services sector. We suspect that the latter stems from a strong start of the tourism season. Normally, VAT hikes are good for competitiveness – they raise the price of imports and do not affect exports – but not necessarily in the Spanish case, where tourism – which is taxed - accounts for 12% of GDP.

**Second, austerity fatigue should be avoided.** Another round of tax hikes now could further damage an already fragile government, and thus jeopardizing the structural reforms – for instance the changes in the collective agreements system – which are an essential part of the strategy aiming at reassuring the markets as to the long term sustainability of the country.

**Third, forever increasing the pressure on central government decisions** – which has the responsibility on VAT rates – **cannot be a lasting answer to the lack of austerity in the regions.** As it is the layer of general government with the highest probability of fiscal drift, it should also be there that the additional restraint should come from. **In our view, corrective action should be taken on regional spending if it appears that the second quarter deficits – to be released towards the end of the August/early September, showed signs of slippage.** The government ultimately controls the regions' finances by authorizing debt issuance.

## Conclusions

Recapitalising the Cajas is a pressing issue, but avoiding a double dip in the second half of the year is also in our view crucial for the ultimate success of the adjustment. These two issues are interconnected.

Indeed, so far the bulk of the "vanilla mortgage" portfolio has escaped the consequences of the economic slump. While the NPL ratio now stands at 14.5% for loans to property developers, construction companies and real estate agents, it stands at only 2.5% for mortgages granted to households, and has not shown any sign of material increase over the last few months. We believe maintaining GDP growth in positive territory is central to seeing a continuation of the stabilization of the labour market – albeit at a very elevated level of unemployment – which itself can protect the quality of the ordinary mortgage portfolio.

***Gilles Moec, (44) 20 7545 2088***

# Euroland Inflation

- **US, UK and euro area inflation remains at above-target levels and is expected to rise further into the second half of this year. Strong increases in food inflation were a common trend in May.**
- **We expect inflation to slow next year but to remain at above target levels. These forecasts are consistent with projections from a simple top-down forecasting model.**

This week's May inflation reports showed little surprises in GBP and EUR, but a higher than expected outcome in USD. In all three cases, inflation remains at above-target levels and is expected to rise further into the second half of this year. Strong increases in food inflation were a common trend and survey as well as producer price data suggest that more upward pressure is in the pipeline.

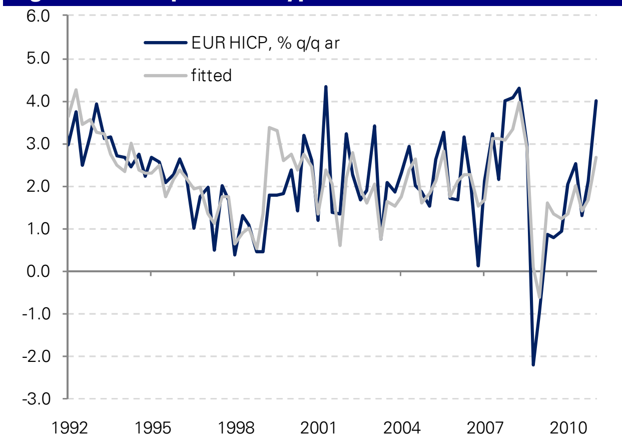
Core inflation fell in the UK and the euro area, but this was mostly due to volatility related to the late timing of Easter this year and at least in the euro area, the underlying trend appears to be pointing higher. In the US, core inflation surprised on the upside, rising 0.3% m/m in seasonally adjusted terms for the first time since July 2008. Some of the gains may have been amplified by monthly volatility, but the uptrend appears to be well established and broad-based across components and we expect US core inflation to continue to rise through this year.

Given the recent weakness in oil prices in particular, headline inflation may remain broadly unchanged in the main markets in June, but we forecast further gains into H2 and see inflation peaking close to 4% in the US, close to 6% in the UK (RPI) and around 3% in the euro area this autumn. Inflation is then expected to ease again into next year.

These forecasts, which are obtained from a bottom-up approach, are broadly consistent with projections from standard top-down forecasting models. We regress q/q changes in CPI on (i) CPI with one quarter lag (to capture persistence), (ii) survey inflation expectations, (iii) the q/q change in oil prices and (iv) a HP output gap. To get around the end-point problem of the latter, we assume that GDP grows at an annualized quarterly rate of 1.5% in the euro area and 2.5% in the US for the next five years before applying the HP filter. The fitted line of the regressions for the euro area and the US are shown in charts 1 and 2.

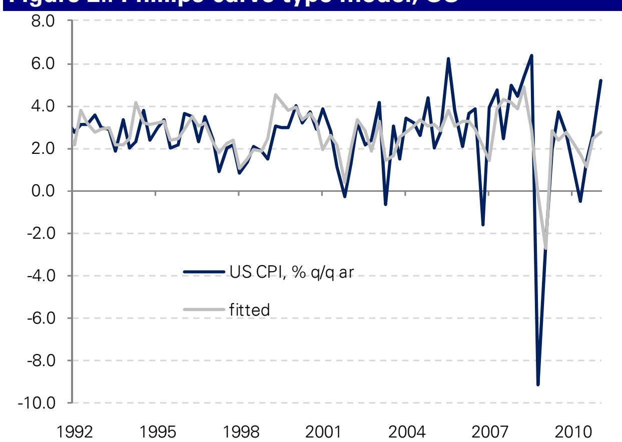
In the US, model projections have been somewhat too high in H1 2010, but in both markets, outcomes have been higher than predicted in Q4 2010 and Q1 2011. The models reinforce the view that inflation expectations have played an important role in stabilizing inflation through the recent economic downturn.

**Figure 1: Phillips-curve type model, euro area**



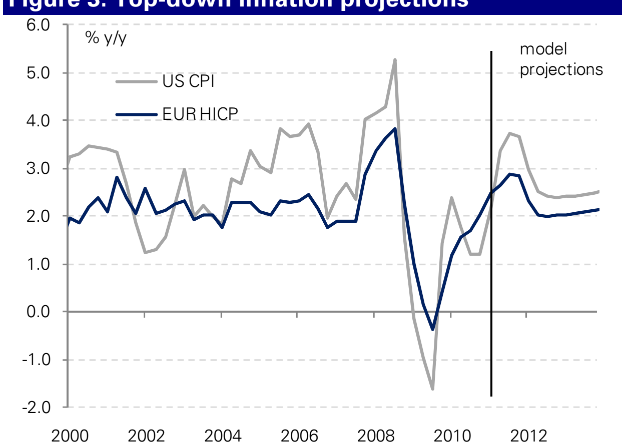

*Source: Eurostat, Deutsche Bank*

**Figure 2:. Phillips-curve type model, US**




*Source: BLS, Deutsche Bank*

**Figure 3: Top-down inflation projections**




*Source: BLS, Eurostat, Deutsche Bank*

Assuming expectations to remain at their latest reading (1.9% in EUR, 2.3% in USD), the output gap in line with the HP filter output (closing in Q1 2012 in the US, in H2 2011 in EUR) and oil prices to rise by 1% per quarter (against an average 3% since 1990), would yield predictions broadly in line with our bottom-up forecasts. US CPI inflation is projected to fall from above 3.5% in H2 2011 to 2.4% in Q4 next year (chart 3). Euro area HICP inflation is predicted to rise to close to 3% in H2, before falling to 2.0% in H2 2012 (chart 3).

***Markus Heider, (44) 20 7545 2167***

# UK: Inflation to breach 5% by autumn

- **With the latest inflation print being published this week (at 4.5% it was in line with both consensus and our own forecasts) we have revised our forecasts out to the end of next year. Our new view is higher than previously, with CPI inflation briefly heading above 5% this autumn.**
- **The main reason for this relates to higher utility prices over the summer relative to our original expectations. If the remaining utility firms raise prices by the same 15% average that Scottish Power announced recently, then this would add around 0.7pp to the annual rate of inflation relative to if prices were unchanged.**
- **In this article, we explain the procedure of how we have arrived at our new inflation forecasts, and publish month-by-month forecasts for CPI, RPI and RPIX inflation along with the level of RPI for those interested in index-linked gilts. With CPI breaching 5% in the autumn RPI peaks above 6%.**

## Inflation unchanged at 4.5% in May

The headline rates of inflation in this week's May report were all broadly (or actually) unchanged versus the previous month and generally in line with expectations. CPI remained at 4.5%, but the core rate fell from 3.7% to 3.3%, below expectations of 3.5%. Part of the rise and subsequent fall in core can be explained by air and sea fares, which went up sharply in April and have since fallen back somewhat (airfares rose almost 30% mom in April due to the extra public holiday, correcting by 11% in May). RPI inflation remained at 5.2% and RPIX at 5.3% in May.

**Real wages remain under intense pressure**

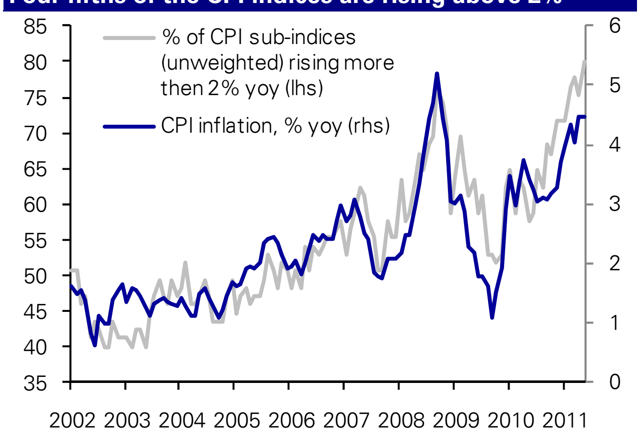

*Source: DB Global Markets Research, ONS*

Two key other measures of inflation are worth mentioning. First, CPIY – which strips out the effect of indirect taxation – remained unchanged at 3%. Second, the tax and prices index (or TPI) which measures how much an average person's gross income needs to rise in order to purchase the RPI basket given changes in income tax and national insurance, edged slightly lower but remains high at 4.8%. With average earnings growing at a rate of 1.7% according to this week's labour market report, that implies a negative real rate of around -3%.

A substantial portion – if not all – of the current rate of inflation can be explained by three factors: i) the impact of the fall in the exchange rate since 2007, ii) higher world commodity prices, and iii) higher indirect tax rates. In fact, the Bank of England argues that if we were to strip out the contribution of these items from headline inflation we would be left with inflation running at a rate of around 0% yoy (Chart 4.1 on page 30 of the May *Inflation Report* illustrates this – the Bank believes the range of inflation stripping out these items is between -1% and +1% yoy).

While that is true, a startling statistic is that some 80% of the sub-indices (both by weight and by number of indices) within the CPI are rising at a rate of above the 2% target, highlighting how broad based rising inflation is. This is a greater proportion than back in the autumn of 2008, when inflation was rising at an even more elevated rate than that of today at just above 5%.

**Four fifths of the CPI indices are rising above 2%**




*Source: DB Global Markets Research, ONS*

What could become a concern is that households begin to think that current high rates of inflation are 'normal', i.e. that the Bank of England has lost sight of the inflation target. After all, inflation has been above its target now for the past year and a half, and during the past five years inflation has been above the target for 85% of the months reported. Fortunately, research published in this week's Bank of England *Quarterly Bulletin* (see Macallan and

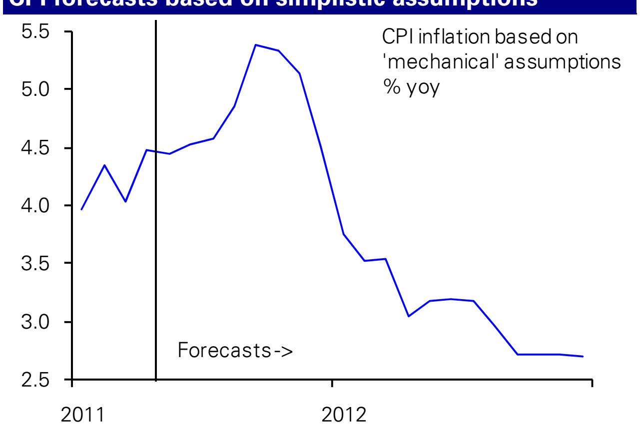
Taylor, pp100-110) suggests that long-term inflation expectations have remained well anchored; and while some measures of shorter-term expectations have risen they reach the conclusion that, "there is little evidence that they have become significantly de-anchored".

## A 'mechanical' forecast for inflation

Where is inflation likely to be by the end of this year and during the course of next? Before updating our official forecasts in the following section it is worth considering how inflation might develop using the basis of a purely 'mechanical' forecast. This helps us understand just how powerful the base effects can be over the next year – particularly in relation to energy prices and VAT.

What we mean by a 'mechanical' forecast is one based on three simple assumptions: i) petrol prices falling by 0.5% mom in June (consistent with the latest European Commission statistics) remaining unchanged thereafter (in line with our generally flat oil price forecast), ii) the average 15% rise in energy bills already announced by one utility company for August being replicated across the entire market with a further 5% rise in mid-2012, and iii) that all other components of the CPI rise at the same mom rate they have in each month over the past five years, excluding January 2010/11 when VAT was raised.

**CPI forecasts based on simplistic assumptions**




*Source: DB Global Markets Research, ONS*

The upshot of this highly simplistic model would be that inflation would peak at almost 5.5% in September this year, before falling back to 2.5% by the autumn of next year. This mechanical forecast would also keep core inflation running around the 3-3.5% mark for the remainder of this year before falling to around 2% by spring 2012 (and flattening out at that level for the remainder of the year).

## New official forecasts for CPI

We forecast medium-term inflation on a quarterly basis out to the end of 2012 by breaking CPI inflation down into a number of component parts. To simplify the analysis, we begin at the very top level by identifying goods and services inflation.

Goods inflation

We break goods price inflation down into two key components: core and non-core. The non-core is made up of food, alcohol & tobacco, household energy bills and petrol:

- *Food, alcohol & tobacco* (16% of CPI): We assume that food prices continue to grow at between 5% and 6% yoy over the duration of our forecast as a lagged response to the rise in wholesale food prices since the start of 2009. This would be slightly over double the average rate since the Bank began inflation targeting back in 1997. We forecast alcohol & tobacco price inflation to fall gradually from its current elevated rate of around 10% to around half that rate by the end of the forecast horizon.

- *Utility bills* (4.4% of CPI). So far, one utility company (Scottish Power) has announced a new round of energy price increases (19% for gas and 10% for electricity from the start of August). We expect this average 15% rise in household energy bills to be replicated across the remaining five power companies, spread evenly during August and September. We have penciled in a further 5% rise over the same two months of 2012.

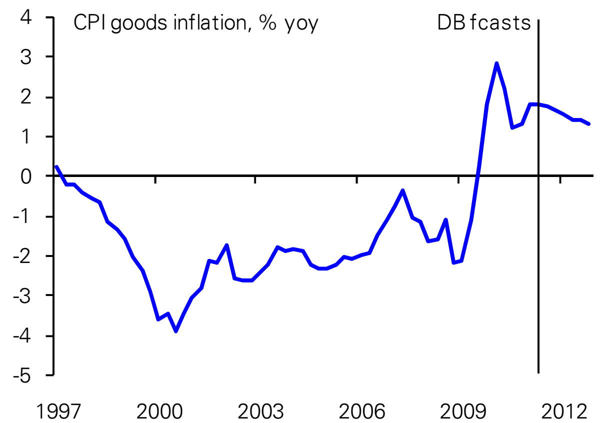
- *Petrol prices* (4.3% of CPI). Data from the European Commission suggests that petrol prices will fall by roughly 0.5% during June. We assume no further changes to petrol prices during the forecast horizon.

The ONS amalgamates the remainder of goods in the CPI into something called 'non-energy industrial goods' (31.4% of CPI). We model this econometrically assuming that core goods prices will be dependent on the trade weighted exchange rate (reflecting the fact that the UK imports a substantial portion of these goods), commodity prices (which we proxy with the sterling price of oil) and the output gap (to reflect domestic demand pressures) – all of which are assumed to affect inflation with a lag of around a year.

The upshot of this simple model is that core goods price inflation falls linearly from 1.8% currently to 1.3% by the end of our forecast horizon in 2012. When added to the non-core portion of goods discussed above, overall goods price inflation (the above components sum to 56.1% of

CPI) first of all rises from its current 4.5% rate to 5,5% over the next few months, before falling back to 2.5% by the end of 2012.

**DB forecast for goods price inflation**

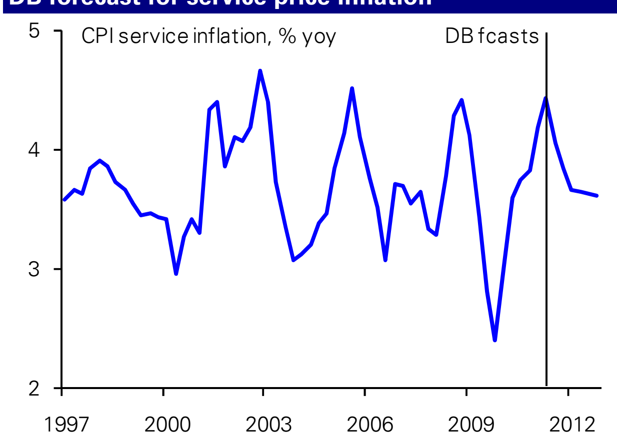



Source: DB Global Markets Research, ONS

Services inflation

We model services inflation (the remaining 43.9% of CPI) as a whole similar to the way we model core goods prices, i.e. using a regression which, in the case of services inflation, contains two explanatory variables; unit labour costs (acknowledging that wages represent a key input cost for service sector firms) and commodity prices (which we have again proxied by sterling oil prices) lagged by between six and twelve months.

**DB forecast for service price inflation**




Source: DB Global Markets Research, ONS

In terms of the inputs into this model, our official forecasts are for USD oil prices and the GBP/USD exchange rate to be broadly stable over the next two years, so for simplicity we have assumed static sterling oil prices in constructing the forecast. Our assumptions for the path of unit labour costs are based on our separate forecasts for average earnings, employment and economic growth going forward, but the upshot is that growth in unit labour costs rises from sub-1% yoy at the end of last year to a peak of 3% by the end of this year.

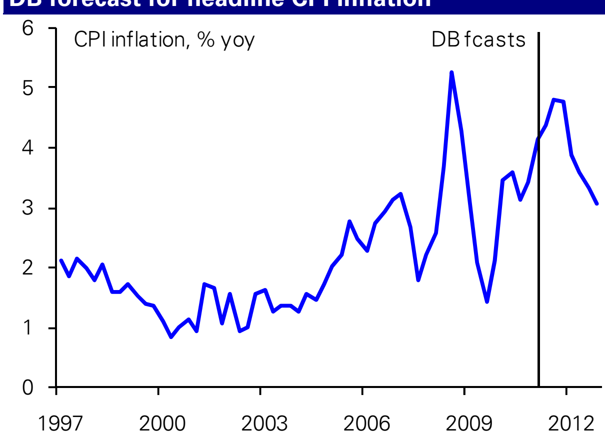
The results of the model for overall service sector inflation seem entirely reasonable to us: they show service sector inflation falling from a peak of nearly 5% two months ago to 3.5% by the middle/end of next year (slightly below its average since the Bank of England was made independent).

Overall CPI inflation

Combining our forecasts for goods and services inflation gives us a quarterly profile for overall CPI inflation which rises to around 5% yoy in Q3 and Q4 this year before falling sharply in early 2012, helped by energy and tax related base effects. Inflation ends next year at just under 3% on this forecast (see chart and table below). The quarterly profile for inflation is as follows (from Q2 2011 through Q4 2012): 4.5%, 5.0%, 4.9%, 3.8%, 3.4%, 2.8%. The annual rates are 4.6% for this year (which would be the highest rate for twenty years) and 3.2% next.

Our forecasts are rather higher than the Bank of England's current end-2012 forecast for inflation published in its May *Inflation Report* (2.3%), and thereby support our call for higher interest rates later this year (with the recent escalation of concerns about the euro area peripheral government debt crisis the market has pushed out further the timing of the first 25bps rate hike in the UK – it is now not fully discounted until July 2012).

**DB forecast for headline CPI inflation**




Source: DB Global Markets Research, ONS

## Translating CPI into RPI

To get from our view on CPI to RPI we need to forecast the four key differences between the indices: housing components excluded from CPI, other differences in coverage, the formula effect and other differences including weights. We consider each of these below.

• *Housing*. The three key components of housing related prices that are present in the RPI but excluded from the CPI are mortgage interest payments (MIPS), depreciation and Council Tax.

Up to January 2010, the MIPS component was a function of banks' standard variable mortgage rates. The ONS has since changed its methodology and now uses an average effective mortgage rate which is based on data published by the Bank of England. This average effective mortgage rate is made up of a fixed and a floating rate component. We assume, for the purposes of forecasting RPI, that the fixed component remains unchanged over the projection period (it has in the past fluctuated only very modestly) and that the floating rate moves one-for-one in line with Bank Rate (our current forecast is for quarterly 25bps rises beginning in November this year). We recognise, however, that the risks to our forecast for Bank Rate are on the downside, and when rates do eventually rise a potential compression in mortgage spreads could mean a smaller rise in the floating rate component of the effective rate than the rise in Bank Rate. As such, the risks to our forecast of the MIPS related spread between RPI and CPI inflation could be to the downside.

On the other hand, we forecast that house prices will fall by 5% during the course of this year, then flatten out during 2012. This helps to limit the rise in the wedge between RPI and CPI. Council Tax has been frozen for 2011-12, but we expect increases to return from April next year (we assume an average 3% yoy increase in 2012-13).

• *Formula effect*. Prior to the start of last year the formula effect – the difference between RPI and CPI inflation that can be attributed to the use of arithmetic versus geometric means respectively – averaged a little more than 0.5%. However, since early 2010 this has doubled to 1% on account of methodological changes to the way clothing & footwear prices are measured (for more details see the ONS publication *CPI and RPI: increased impact of the formula effect in 2010*). We have assumed that the formula effect remains at this level throughout the duration of our forecast.

• *Other differences in coverage* and *Other differences including weights*. These differences are presently around their long-run averages and so we have maintained them at their current levels over the forecast horizon.

In summary, the wedge between RPI and CPI looks set to increase over the course of the next year and half on our forecast but only because of a rise in mortgage interest payments in turn due to higher official interest rates. Given that the risks to our forecast for Bank Rate are to the downside, so too are the risks to the RPI-CPI wedge. The current difference between RPI and CPI is 0.75%, and we expect this to roughly double by the end of 2012. We calculate that the long-run average of the wedge between RPI and CPI is around 1.1-1.2% made up of: 1% formula effect, 0.4% housing, and -0.3% other coverage and weights. For further details see article in *European Fixed Income Weekly*, 8 April 2011.

The result is that, based on our forecasts for the CPI and the wedge, RPI inflation is likely to peak at just above 6% in the autumn before falling back towards the end of this year/ turn of next. Unlike the CPI, it does not continue to fall on account of our view of higher Bank Rate and thereby mortgage rates. The average rates of RPI inflation in our forecast are 5.5% for this year and just under 4.5% for next.

**New forecasts for CPI, RPI and RPIX**

| | CPI % yoy | Core % yoy | RPI % yoy | RPI index | RPIX % yoy |
|---|---|---|---|---|---|
| Jan 2011 | 4.0 | 3.0 | 5.1 | 229.0 | 5.1 |
| Feb 2011 | 4.4 | 3.4 | 5.5 | 231.3 | 5.5 |
| Mar 2011 | 4.0 | 3.2 | 5.3 | 232.5 | 5.4 |
| Apr 2011 | 4.5 | 3.7 | 5.2 | 234.4 | 5.3 |
| May 2011 | 4.5 | 3.3 | 5.2 | 235.2 | 5.3 |
| Jun 2011 | 4.5 | 3.2 | 5.3 | 236.0 | 5.2 |
| Jul 2011 | 4.6 | 3.4 | 5.3 | 235.5 | 5.2 |
| Aug 2011 | 4.9 | 3.2 | 5.7 | 237.2 | 5.5 |
| Sep 2011 | 5.4 | 3.3 | 6.1 | 239.0 | 6.0 |
| Oct 2011 | 5.2 | 3.2 | 5.9 | 239.1 | 5.8 |
| Nov 2011 | 5.0 | 3.1 | 5.6 | 239.5 | 5.5 |
| Dec 2011 | 4.4 | 2.9 | 5.2 | 240.3 | 4.9 |
| Jan 2012 | 3.8 | 2.6 | 4.6 | 239.5 | 4.3 |
| Feb 2012 | 3.7 | 2.5 | 4.4 | 241.6 | 4.1 |
| Mar 2012 | 3.7 | 2.5 | 4.6 | 243.2 | 4.1 |
| Apr 2012 | 3.3 | 2.2 | 4.4 | 244.7 | 3.9 |
| May 2012 | 3.5 | 2.5 | 4.5 | 245.8 | 4.0 |
| Jun 2012 | 3.4 | 2.4 | 4.6 | 246.8 | 4.0 |
| Jul 2012 | 3.3 | 2.3 | 4.5 | 246.1 | 3.8 |
| Aug 2012 | 2.9 | 2.2 | 4.1 | 246.9 | 3.4 |
| Sep 2012 | 2.7 | 2.2 | 4.1 | 248.8 | 3.3 |
| Oct 2012 | 2.8 | 2.3 | 4.2 | 249.1 | 3.3 |
| Nov 2012 | 2.9 | 2.4 | 4.3 | 249.7 | 3.4 |
| Dec 2012 | 2.8 | 2.3 | 4.4 | 250.9 | 3.4 |

Source: DB Global Markets Research, ONS

***George Buckley, (44) 20 7545 1372***

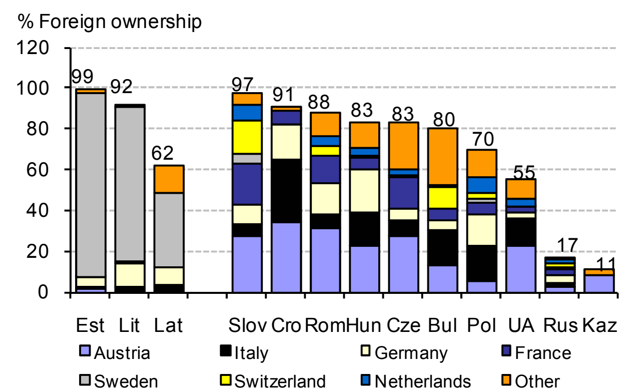
# CEE: Examining the Greece link

- **The significant foreign ownership of CEE banking systems proved to be a source of strength, rather than weakness, during the global crisis as foreign parent banks maintained capital and provided adequate funding. Any default or restructuring of Greek sovereign debt could be very different with parent bank funding likely to be reduced or withdrawn and the possibility of subsidiaries being sold.**
- **Bulgaria is likely to be the hardest hit in CEE with 28% of the country's banking sector assets in the hands of Greek parent banks, 38% of total foreign bank claims coming from Greece, 8% of exports destined for Greece and 7.5% of worker remittances sourced from Greece. Bulgaria also has the highest short-term banking sector external debt coming due this year as a share of GDP, in our CEE sample. Romania looks to be the next most vulnerable to Greece followed by Serbia.**
- **The CE3 are unlikely to be immune to Greece contagion however despite minimal direct financial and trade links. German and French banks have EUR16.9bn and EUR11.2bn respectively in exposure to Greek sovereign debt which could potentially mean parent funding from these subsidiaries is reduced. Hungary and Poland have fairly sizeable external financing requirements for this year and non-resident holdings of domestic securities have also increased sharply in recent months. This leaves local debt markets vulnerable to a period of risk aversion while another bout of Swiss franc appreciation would also hit household balance sheets.**

## Greece contagion: Bulgaria is the most exposed

Significant foreign ownership of local banking system proved to be a source of strength, rather than weakness, for the CEE region during the global crisis with foreign parent banks maintaining capital and providing adequate support to subsidiaries to help local banking systems weather the crisis. Foreign banks in Hungary, Romania, Bosnia, Latvia and Serbia all committed to maintaining capital at pre-crisis levels under the European Bank Coordination Initiative (Vienna Initiative) for the duration of IMF/EU programs which significantly allayed external financing concerns. The recent heightened concern over a Greek sovereign default or debt restructuring brings the vulnerabilities of foreign bank ownership back into focus in the region. We examine trade and financial sector linkages between Greece and Central and Eastern Europe to determine the likely spillover from any default or restructuring and find Bulgaria, Romania and Serbia the most directly exposed to Greece through both trade and financial channels. Direct trade and financial links are very small between Greece and the CE3 but these economies may also be impacted given the fairly large external financing requirements, direct exposure to other European countries with Greece sovereign exposure and the recent run-up in non-resident holdings of local debt.

**Foreign bank ownership is high across the CEE region**




Source: DB Global Markets Research

**Bank ownership:** Banking systems in Bulgaria, Serbia and Romania have sizeable direct linkages with Greece. In Bulgaria, the country's 3rd largest bank, United Bulgaria Bank, is fully owned by the National Bank of Greece and accounts for 10% of Bulgaria's banking system assets. Eurobank EFG (Postbank) accounts for 8.5% of system assets, Piraeus Bank accounts for 5.4% of system assets and Alpha Bank 2.7% of system assets. This leaves a total of 27.4% of Bulgarian bank assets owned by Greek parent banks with two banks within the 5 largest in the country. The largest two banks in Bulgaria, UniCredit and DSK Bank, are also foreign owned by Italy's UniCredit and Hungary's OTP respectively while around 20% of the banking system is locally owned. In Romania, the list of Greek-owned banks includes Eurobank EFG (Bankpost), Alpha Bank, National Bank of Greece (via Banca Romaneasca), Piraeus Bank and Emporiki Bank. A key difference between Bulgaria and Romania is that the share of banking system assets from the largest Greek-owned banks in Romania, Alpha Bank and Bankpost, are both below 6% of total system assets. The total share of assets by Greek banks in Romania is also significantly below Bulgaria at 17%. Austria's Erste Bank owns the majority stake in Romania's largest bank, BCR (which accounts for around 25% of assets), and France's Societe Generale owns the second largest bank, BRD (which accounts for around 15% of assets). For Serbia, Eurobank EFG, Alpha Bank, Vojvodanska Banka, Piraeus Bank and Agricultural Bank of Greece account for a combined 16.1% of total banking system assets. Eurobank EFG is the largest Greek bank in Serbia accounting for 6.3% of total banking system assets and Alpha Bank accounts for 4% leaving a situation similar to Romania. The largest bank in Serbia is owned by Italy's Intesa Sanpaolo and the second largest bank is 45% state shareholding.

**28% of Bulgaria's banking system is owned by Greek parents banks, 17% for Romania, 16% for Serbia**

| BULGARIA | | ROMANIA | | SERBIA | |
|---|---|---|---|---|---|
| *ownership share of banking system assets (% total)* | | | | | |
| Greece | 27.6 | Austria | 38.4 | Serbia | 27.5 |
| Bulgaria | 20.9 | Greece | 17.0 | Italy | 21.5 |
| Italy | 15.2 | France | 14.8 | Austria | 17.9 |
| Hungary | 13.6 | Romania | 14.0 | Greece | 16.1 |
| Austria | 8.6 | Netherlands | 7.1 | France | 7.9 |
| France | 5.3 | Other | 6.5 | Other | 6.6 |
| Other | 8.8 | Italy | 2.2 | Germany | 2.6 |

| POLAND | | HUNGARY | | CZECH | |
|---|---|---|---|---|---|
| *ownership share of banking system assets (% total)* | | | | | |
| Poland | 30.9 | Hungary | 28.8 | Belgium | 20.8 |
| Other | 24.3 | Austria | 20.6 | Austria | 20.8 |
| Italy | 14.1 | Italy | 18.3 | France | 16.4 |
| Germany | 10.8 | Germany | 13.2 | Italy | 6.4 |
| Netherlands | 7.5 | Belgium | 12.1 | Austria | 4.5 |
| Spain | 7.2 | Other | 4.6 | Other | 31.1 |
| Austria | 5.2 | US | 2.5 | - | - |

Source: National central banks, local commercial banks, DB Global Markets Research

The situation in Hungary and Poland is different with the largest bank in both countries locally owned (for Poland this is state ownership). Banking sectors are still majority foreign-owned, but the distribution of countries is more skewed towards Austria, Germany and Italy. The situation in Czech Republic is similar with the top five banks (which account for 76% of system loans) all foreign owned with Belgium, Austria, France and Italy dominating.

**Foreign claims:** BIS data on foreign creditor exposure also details bank exposure from Greece outside the direct ownership link. In the table below we show claims from Greece, Ireland, Italy, Portugal and Spain on our CEE sample. Bulgaria again stands out with 31.6% of 2010 GDP (EUR11.4bn) in foreign claims by Greek banks on Bulgaria. Serbia is next in line with 18.5% (EUR5.4bn) and then Romania with 13.1% (EUR15.9bn). Claims from Greece on the CE3 are zero/ negligible.

**Greek banks have 32% of GDP in claims on Bulgaria, 18.5% for Serbia and 13% for Romania**

| *(% GDP)* | Bulgaria | Romania | Serbia | Czech | Hungary | Poland |
|---|---|---|---|---|---|---|
| Total Foreign claims | 82.6 | 70.0 | 67.8 | 96.8 | 98.0 | 62.8 |
| European banks | 77.4 | 67.3 | 67.3 | 94.0 | 87.2 | 58.3 |
| Greece | 31.6 | 13.1 | 18.5 | 0.0 | 0.2 | 1.7 |
| Ireland | - | - | - | - | - | - |
| Italy | 17.0 | 8.4 | 19.5 | 8.6 | 16.1 | 10.0 |
| Portugal | - | 0.0 | 0.0 | 0.0 | 0.2 | 3.2 |
| Spain | 0.2 | 0.2 | 0.0 | 0.3 | 0.7 | 1.4 |

Source: BIS

If we instead look at the country composition of foreign bank claims this shows 38% of all foreign claims on Bulgaria are from Greece and almost 19% for Romania and 27% for Serbia. For the CE3, Austria, Germany and Italy are the main sources of foreign bank claims.

**38% of total foreign claims on Bulgaria are from Greece, 18.7% for Romania**

| BULGARIA | | ROMANIA | | SERBIA | |
|---|---|---|---|---|---|
| *foreign creditor exposure (% total exposure)* | | | | | |
| Greece | 38.3 | Austria | 35.4 | Italy | 28.8 |
| Italy | 20.6 | Greece | 18.7 | Greece | 27.3 |
| Austria | 13.4 | France | 16.4 | Austria | 26.5 |
| France | 10.5 | Italy | 12.0 | France | 13.1 |
| Germany | 3.8 | Netherlands | 6.2 | Germany | 2.4 |
| Belgium | 3.6 | Germany | 2.7 | Switzerland | 0.3 |
| Netherlands | 1.2 | UK | 2.0 | Belgium | 0.3 |

| POLAND | | HUNGARY | | CZECH | |
|---|---|---|---|---|---|
| *foreign creditor exposure (% total exposure)* | | | | | |
| Germany | 20.2 | Austria | 26.7 | Austria | 33.1 |
| Italy | 16.0 | Germany | 20.4 | Belgium | 24.5 |
| Netherlands | 12.3 | Italy | 16.4 | France | 20.0 |
| France | 9.5 | Belgium | 12.6 | Italy | 8.8 |
| Belgium | 5.3 | US | 5.8 | Germany | 5.3 |
| Portugal | 5.1 | France | 5.2 | UK | 2.2 |
| Austria | 5.0 | Netherlands | 2.8 | Netherlands | 2.0 |

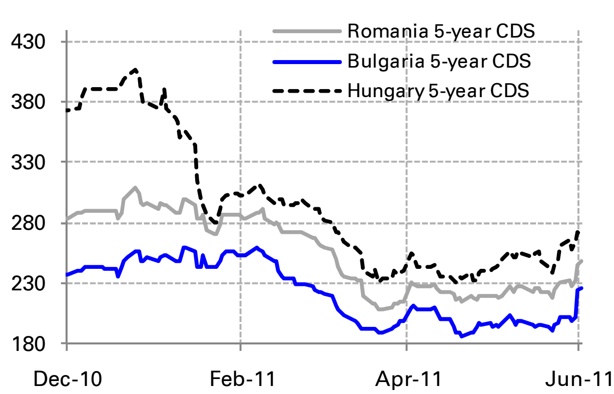
Source: BIS

The impact on local banks in Bulgaria, Romania and Serbia of potential insolvency at the Greek parent banks from a sovereign default or restructuring will largely be dependent on the degree to which the funding base comes from Greek parents. National Bank of Romania Deputy Governor Cristian Popa said recently that the Romanian subsidiaries of Greek banks are well capitalized and funding from parent banks accounts for just one-third of total liabilities. In terms of the funding base for the entire banking system Popa said that only 5.7% of total liabilities came from parent banks. The NBR also said this week that it had a planned response in the case Greek funding freeze although did not disclose any detailed measures. The NBR also pointed to the government securities held bank the Greek subsidiaries which could be used as collateral for NBR funding if required. On a system-wide level Romania's banking sector holds 9.7% of GDP in government securities as of March 2011. In Bulgaria, a recent S&P downgrade for National Bank of

Greece meant a downgrade to United Bulgarian Bank given the assumption that the parent would be less able to maintain funding support. Despite the downgrade for United Bulgarian Bank S&P stated that it expects the bank would be "independently sustainable" in a scenario of severe difficulties at National Bank of Greece and that United Bulgarian Bank could repay its obligations to its parent "without damaging its own financial profile".

Another scenario for Greek parent banks in the case of recapitalization triggered by sovereign restructuring could be sales of foreign subsidiaries. Any sale to another non-resident bank should not have an impact on the country's external position similar to the April Banco Santander purchase of Poland's Bank Zachodni WBK bank from Allied Irish Bank. But a more worrying situation would be where CEE governments are forced to step in and purchase Greek subsidiaries. While we do not expect such a scenario to occur this would raise external funding needs for the sovereign and could put currencies under pressure. It would also mean a potential fiscal cost. Such a scenario does not appear to be expected by the rating agencies. Fitch upgraded the outlook on Bulgaria's BBB- rating in May despite the substantial link to Greece noting the well capitalized nature of the banking system (17.4%) and that the Bulgarian subsidiaries did not have significant holdings of Greek sovereign debt or exposure to Greek corporates. In March Serbia was granted a one-notch upgrade to it LT foreign currency rating to BB (stable) from S&P. While sovereign takeover of Greek banking sector liabilities in Bulgaria, Romania or Serbia is probably unlikely, concerns that this may happen has pushed CDS wider in recent days, particularly for Bulgaria and Romania.

**CDS for Bulgaria and Romania has widened on the back of concerns over funding from Greek subsidiaries**

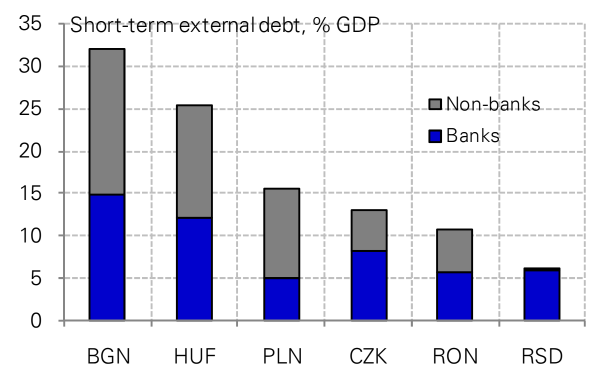



*Source: DB Global Markets Research*

Despite limited trade and financial links with Greece, the CE3 countries are unlikely to be immune to a sovereign default or restructuring. Out of the major European economies Germany has the largest exposure to the Greek sovereign at EUR16.9bn (0.7% of GDP), followed by EUR11.2bn (0.6% of GDP% of GDP) for France according to BIS data. The French and German parent banks may come under pressure to reduce funding to subsidiaries across CEE with the CE3 subsidiaries likely to be the bigger banks in group portfolios than those in Bulgaria, Romania or Serbia.

**Short-term bank rollover:** Another factor to consider is the knock-on impact of any Greek sovereign default on the external financing environment. Our chart opposite shows the short-term external debt stock for the six countries in our sample which is likely to be the largest component in the 2011 external financing requirements. All countries except Hungary are running C/A deficits which will also add to external financing as will amortization on medium-long term external debt (Hungary is expected to record another small surplus this year).

**Bulgaria has 32% due in ST debt this year of which almost half is banking sector debt**




*Source: Haver Analytics (data as of Q4 2010)*

Once again Bulgaria stands out as the most vulnerable with 32% of GDP due in ST debt this year with almost half of this due from the banking sector. Hungary and Poland also face fairly substantial external debt rollover this year. Hungary has completed its sovereign external financing for this year with EUR4bn (euro equivalent) in external issuance YTD but the majority of the overall external financing requirement comes from the banks.

**Direct trade links:** To the extent that Greece is an important export destination for the CEE region any severe economic downturn could also have real economy implications for CEE. Yet again Bulgaria sticks out with 8% of total exports destined for Greece with Serbia's share to Greece at 2.1% and Romania's at 1.5%. For the CE3, export share with our sample of peripheral Europe is generally tiny other than Italy and even this is still swamped by the share of exports destined for Germany.

**Greece accounts for 8% of Bulgaria's exports**

| | Bulgaria | Romania | Serbia | Czech | Hungary | Poland |
|---|---|---|---|---|---|---|
| | *Share of total exports to:* | | | | | |
| Greece | 8.1 | 1.5 | 2.1 | 0.3 | 0.4 | 0.5 |
| Ireland | 0.1 | 0.2 | 0.0 | 0.2 | 0.3 | 0.4 |
| Italy | 9.9 | 14.1 | 10.8 | 4.5 | 5.5 | 6.3 |
| Portugal | 0.3 | 0.5 | 0.1 | 0.4 | 0.4 | 0.4 |
| Spain | 2.7 | 3.1 | 1.1 | 2.4 | 3.2 | 2.8 |
| Total | 21.2 | 19.4 | 14.2 | 7.7 | 9.8 | 10.3 |
| *Memo:* | | | | | | |
| Germany | 10.9 | 18.4 | 9.4 | 32.4 | 25.0 | 26.9 |

*Source: Haver Analytics*

Greece is also the third largest source of worker remittances for Bulgaria with 7.5% of total receipts arriving from Greece versus 19.2% from Spain and 10.9% from Italy. For Romania, Italy is also an important trade partner and accounts for the largest share of worker remittances at 42.7%. Greece is the third largest source of remittances for Romania but this is small compared with Italy and Spain.

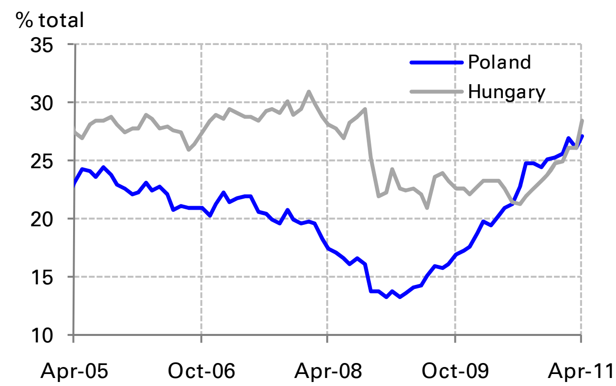
**Greece accounts for 7.5% of Bulgaria's worker remittances and 7% for Romania**

| BULGARIA | | ROMANIA | |
|---|---|---|---|
| *source of worker remittances (% total)* | | | |
| Spain | 19.2 | Italy | 42.7 |
| Italy | 10.9 | Spain | 30.6 |
| Greece | 7.5 | Greece | 7.0 |
| UK | 7.2 | US | 5.3 |
| Germany | 6.3 | Germany | 3.7 |
| Austria | 3.2 | Hungary | 2.8 |
| Other | 45.6 | Other | 7.8 |

*Source: Eurostat*

**Non-resident holdings of government securities:** A final channel of contagion from any Greek default and therefore risk aversion is non-resident exposure to CEE. The run-up in non-resident holdings of government securities seen in both Hungary and Poland during the past several months leaves both countries vulnerable to any flight to quality. This is also true in Romania where non-resident investment increased sharply earlier this year. Portfolio outflows would very likely mean currency weakness and this has already been seen in Romania with recent RON depreciation against the EUR already reversing this year's gains. Weakness in both HUF and PLN against EUR has been more moderate but another bout of Swiss Franc appreciation will put pressure on household balance sheets in Hungary and Poland given the still-large stock of CHF-denominated mortgages.

**Non-resident holdings of government securities reached 28% in both Hungary and Poland at end April**




*Source: AKK, Ministry of Finance*

The bottom line is that while Bulgaria is the most directly exposed to Greece, all of the CEE is likely to be impacted from any Greek sovereign default. And with domestic demand remaining fragile across the region (ex Poland) further delay to any recovery in lending will very likely slow the return to the pre-crisis level of growth.

***Caroline Grady, (44) 207 545 9913***

# Rate Views

## Euro Area

We consider that the June press conference, beyond the telegraphed rate hike for July, is consistent with a fairly slow pace of tightening consolidation afterwards, especially in a context of loss of momentum in the US which delays the start of the monetary normalization there. Accordingly, we now only expect one more rate hike this year after July, instead of two, bringing the refi to 1.75% by December 2011, instead of 2.0% previously. Separately, we think that Trichet's forceful argumentation against re-profiling of Greek debt increases significantly the chances that "pure" voluntary roll over comes out as the compromise solution among European decision makers in the following weeks. After the virtual capitulation by Merkel, it seems the EU politics is moving towards a rollover-type agreement to minimise the risks of a credit and/or default event.

| | Current | Sep11 | Dec11 | Jun12 |
|---|---|---|---|---|
| *3m Libor projections* | | | | |
| Mkt | 1.45 | 1.73 | 1.83 | 1.96 |
| DB | --- | 1.80 | 1.90 | 2.35 |
| *refi rate forecast* | | | | |
| DB | 1.25 | 1.50 | 1.75 | 2.25 |
| *10-year government yields* | | | | |
| DB | 2.94 | 3.30 | 3.50 | 3.70 |

## UK

As a result of the weaker detail of the Q1 GDP report (both consumption and investment fell sharply during the quarter) and generally softer activity data of late, we have recently taken our view of an August rate hike off the table. Our revised forecasts for inflation (see this week's UK article) suggest that rates still need to rise this year, thus we have put back our view of the first rise until November (with quarter point moves each quarter thereafter). We therefore see official rates at 0.75% by the end of this year, and 1.75% by the end of next.

| | Current | Sep11 | Dec11 | Jun12 |
|---|---|---|---|---|
| *3m Libor projections* | | | | |
| Mkt | 0.83 | 0.90 | 0.96 | 1.17 |
| DB | --- | 0.85 | 1.05 | 1.55 |
| *Bank Rate forecast* | | | | |
| DB | 0.50 | 0.50 | 0.75 | 1.25 |
| *10-year government yields* | | | | |
| DB | 3.20 | 3.60 | 3.80 | 4.10 |

## Switzerland

We had forecast the first rise in SNB rates in June but in the event they were left on hold, thanks in part to the strength of the franc. We now expect a hike on 15 Sep.

| | Current | Sep11 | Dec11 | Jun12 |
|---|---|---|---|---|
| 3M Libor tgt | 0.25 | 0.50 | 0.75 | 1.00 |

## Sweden

The Riksbank raised rates from 1.50% to 1.75% at its April meeting, as the market expected. The next meeting is on 5 July when we expect a further 25bps rise.

| | Current | Sep11 | Dec11 | Jun12 |
|---|---|---|---|---|
| Repo rate | 1.75 | 2.25 | 2.75 | 3.25 |

## Norway

Norges Bank resumed its tightening cycle in May after a year-long pause, raising rates by 25bps. We expect only modest further tightening. No move forecast for 22 June.

| | Current | Sep11 | Dec11 | Jun12 |
|---|---|---|---|---|
| Deposit rate | 2.25 | 2.25 | 2.50 | 3.00 |

## Denmark

The central bank followed the ECB by raising interest rates a quarter point at its April meeting, maintaining a constant 5bps spread. We expect the spread to remain at this level.

| | Current | Sep11 | Dec11 | Jun12 |
|---|---|---|---|---|
| Lending rate | 1.30 | 1.55 | 1.80 | 2.30 |

## Poland

The NBP hiked once again in June and communicated it is now on hold. We see scope for another 50bps in rate hikes towards year end.

| | Current | Sep11 | Dec11 | Jun12 |
|---|---|---|---|---|
| 2-week repo | 4.50 | 4.50 | 5.00 | 5.00 |

## Hungary

Despite ongoing weakness in consumer spending we do not yet see scope for rate cuts in Hungary.

| | Current | Sep11 | Dec11 | Jun12 |
|---|---|---|---|---|
| Base Rate | 6.00 | 6.00 | 6.00 | 6.00 |

## Czech Republic

With inflation at target and the CNB revising down its 2011 GDP growth forecast we think the first 25bps hike will probably come in August at the earliest.

| | Current | Sep11 | Dec11 | Jun12 |
|---|---|---|---|---|
| Repo rate | 0.75 | 1.00 | 1.25 | 1.50 |

*Source for all tables: DB Global Markets Research*

## Euroland Data Monitor

| | B'berg code | Q3 2010 | Q4 2010 | Q1 2011 | Q2 2011 | Jan 2011 | Feb 2011 | Mar 2011 | Apr 2011 | May 2011 | Jun 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Business surveys and output** | | | | | | | | | | | |
| *Aggregate* | | | | | | | | | | | |
| PMI composite | | 55.7 | 54.9 | 57.6 | 56.8 | 57.0 | 58.2 | 57.6 | 57.8 | 55.8 | |
| *Industry* | | | | | | | | | | | |
| EC industrial conf. | EUICEMU | -2.5 | 2.7 | 6.5 | 4.8 | 6.2 | 6.7 | 6.6 | 5.6 | 3.9 | |
| PMI manufacturing | | 55.2 | 55.7 | 57.9 | 56.3 | 57.3 | 59.0 | 57.5 | 58.0 | 54.6 | |
| Headline IP (% pop1) | EUITEMUM | 4.3 | 7.4 | 4.7 | | 0.2 | 0.6 | 0.0 | 0.2 | | |
| Capacity Utilisation | EUUCEMU | 77.3 | 78.2 | 80.3 | 81.3 | | | | | | |
| *Construction* | | | | | | | | | | | |
| EC construction conf. | EUCOEMU | -28.0 | -26.3 | -25.0 | -24.5 | -26.0 | -24.0 | -25.0 | -24.0 | -25.0 | |
| *Services* | | | | | | | | | | | |
| EC services conf. | EUSCEMU | 6.9 | 9.0 | 10.6 | 9.8 | 9.9 | 11.2 | 10.8 | 10.4 | 9.2 | |
| PMI services | | 55.3 | 54.3 | 56.6 | 56.4 | 55.9 | 56.8 | 57.2 | 56.7 | 56.0 | |
| *National Sentiment* | | | | | | | | | | | |
| Ifo | GRIFPBUS | 111.1 | 113.3 | 114.8 | 114.2 | 113.9 | 115.4 | 115.0 | 114.2 | 114.2 | |
| INSEE | INSESYNT | 98.7 | 101.7 | 107.7 | 108.0 | 107 | 106 | 110 | 109 | 107 | |
| **Consumer demand** | | | | | | | | | | | |
| EC consumer survey | EUCCEMU | -12.1 | -10.4 | -10.6 | -10.7 | -11.2 | -10.0 | -10.6 | -11.6 | -9.8 | |
| Retail sales (% pop) | RSSAEMUM | 1.8 | -1.0 | -0.5 | | 0.2 | 0.2 | -0.9 | 0.9 | | |
| New car reg. (sa, % yoy) | | -16.2 | -10.6 | -2.4 | | -3.2 | 0.5 | -4.3 | 0.0 | | |
| **Foreign sector** | | | | | | | | | | | |
| Foreign orders | EUI3EMU | -18.3 | -9.6 | -0.9 | -0.4 | -1.2 | -0.5 | -0.9 | 0.1 | -0.9 | |
| Exports (sa val. % pop) | | 19.9 | 6.9 | 24.7 | | 4.1 | 1.6 | 1.1 | | | |
| Imports (sa val. % pop) | | 15.8 | 6.3 | 29.9 | | 5.1 | 0.8 | 0.3 | | | |
| Net trade (nsa EUR bn) | XTTBEZ | 1.1 | 0.3 | -16.2 | | -16.0 | -3.0 | 2.8 | | | |
| **Labour market** | | | | | | | | | | | |
| Unemployment rate (%) | UMRTEMU | 10.1 | 10.1 | 10.0 | | 10.0 | 10.0 | 9.9 | 9.9 | | |
| Change in unemployment (k) | | -37.7 | -112.3 | -150.3 | | 4.0 | -53.0 | -15.0 | -115.0 | | |
| Employment (% yoy) | | -0.2 | 0.2 | | | | | | | | |
| **Prices, wages and costs** | | | | | | | | | | | |
| Prices (% yoy) | | | | | | | | | | | |
| Harmonised CPI | ECCPEMUY | 1.7 | 2.0 | 2.5 | 2.5 | 2.3 | 2.4 | 2.7 | 2.8 | 2.7 | 2.8 |
| Core HICP (Eurostat)) | CPEXEMUY | 1.0 | 1.1 | 1.1 | 1.5 | 1.1 | 1.0 | 1.3 | 1.6 | 1.5 | 1.5 |
| Harmonised PPI | PPTXEMU | 4.2 | 4.8 | 6.4 | | 6.1 | 6.5 | 6.6 | 6.3 | | |
| Oil Price (USD) | EUCRBRDT | 76.7 | 86.6 | 104.8 | 119.4 | 96.4 | 103.5 | 114.5 | 123.6 | 115.2 | |
| EUR/USD | EUR | 1.3 | 1.4 | 1.4 | 1.4 | 1.3 | 1.4 | 1.4 | 1.4 | 1.4 | |
| *Inflation expectations* | | | | | | | | | | | |
| EC household survey | EUA8EMU | 10.8 | 11.9 | 25.8 | 29.1 | 20.9 | 25.7 | 30.8 | 30.7 | 27.4 | |
| EC industrial survey | EUI5EMU | 6.9 | 11.9 | 21.1 | 20.6 | 17.3 | 22.1 | 24.0 | 21.3 | 19.8 | |
| *Unit labour cost (% yoy)* | | | | | | | | | | | |
| Unit labour cost | | -0.7 | -0.3 | -0.4 | | | | | | | |
| Labour productivity | | 2.1 | 1.7 | 2.2 | | | | | | | |
| Compensation. | | 1.5 | 1.6 | | | | | | | | |
| Hourly labour costs (sa) | | 1.0 | 1.4 | | | | | | | | |
| **Money (% yoy)** | | | | | | | | | | | |
| M3 | ECMAM3YY | 0.8 | 1.6 | 2.0 | | 1.6 | 2.1 | 2.3 | 2.0 | | |
| M3 trend (3m cma) | ECMA3MTH | | | | | 1.8 | 2.0 | 2.1 | | | |
| Credit - private | ECMSCDXE | 1.0 | 1.5 | 2.1 | | 2.0 | 2.2 | 2.2 | 2.2 | | |
| Credit - public | ECMSCDGY | 7.6 | 12.6 | 10.3 | | 12.0 | 10.8 | 8.0 | 7.4 | | |

Quarterly data in shaded areas are quarter-to-date. Monthly data in the shaded areas are forecasts.(1) % pop = % change this period over previous period. Quarter on quarter growth rates are annualised.

'Source: Deutsche Bank forecasts, Eurostat, Ifo, INSEE, Reuters, European Commission, National statistical offices, Bloomberg Finance LP.

## The Week Ahead: Euro Zone

- In **Euroland**, key survey indicators such as the **ZEW** for **Germany** and **Euroland** (both on Tue), **French INSEE** (Wed) **German IFO** (Fri), **Belgian BNB business confidence** (Thu) and the flash **PMIs** from the **region** (Thu) will tell us something about the recovery momentum.

- **Italian** (Mon) and **French consumer confidence** (Fri) along with **Italian retail sales** (Fri) will capture the demand side of respective regions, whereas the industrial sector will be represented by **industrial orders** from **Italy** (Mon) and across the **region** (Wed). **German** (Mon) and **Spanish** (Fri) **PPI** reports are also scheduled for release.

*Source: Deutsche Bank*

## Key Data & Events

| Day | Time (GMT) | Release | DB Forecast | Consensus | Previous |
|---|---|---|---|---|---|
| Mon | 06.00 | German PPI (May) | | 0.0% (6.2%) | 1.0% (6.4%) |
| | 08.00 | Euroland current account (Apr) | | | -EUR4.7bn |
| | 08.00 | Italian industrial orders (Apr) | | | 8.1% (21.2%) |
| | 08.00 | Italian industrial sales (Apr) | | | 2.0% (12.2%) |
| | 09.00 | Euroland labour costs (Q1) | | (1.9%) | (1.6%) |
| Tue | 09.00 | German ZEW survey (econ.sentiment) (Jun) | | -5.0 | 3.1 |
| | 09.00 | German ZEW survey (current situation) (Jun) | | 91.0 | 91.5 |
| | 09.00 | Euroland ZEW survey (econ. sentiment) (Jun) | | | 13.6 |
| | 09.00 | Euroland ZEW survey (current situation) (Jun) | | | 13.6 |
| Wed | - | Spanish trade balance (Apr) | | | -EUR4.6bn |
| | 06.45 | French INSEE business confidence (Jun) | | | 107.0 |
| | 06.45 | French personal production outlook (Jun) | | | 11.0 |
| | 06.45 | French production outlook indicator (Jun) | | | 15.0 |
| | 06.45 | French recent output trend index (Jun) | | | 19.0 |
| | 09.00 | Euroland industrial new orders (Apr) | | 1.4% (14.0%) | -1.8% (14.1%) |
| Thu | 08.00 | Euroland PMI manufacturing, flash (Jun) | | 53.7 | 54.6 |
| | 08.00 | Euroland PMI services, flash (Jun) | | 55.4 | 56.0 |
| | 08.00 | Euroland PMI composite, flash (Jun) | | | 55.8 |
| | 08.00 | Italian consumer confidence (Jun) | | | 106.5 |
| | 13.00 | Belgian BNB business confidence (Jun) | | | -0.5 |
| Fri | 06.45 | French consumer confidence (Jun) | | | 84.0 |
| | 07.00 | Spanish PPI (May) | | | 0.6% (7.3%) |
| | 08.00 | German IFO - business climate (Jun) | | 113.7 | 114.2 |
| | 08.00 | - current assessment (Jun) | | 121.0 | 121.4 |
| | 08.00 | - expectations (Jun) | | 106.6 | 107.4 |
| | 08.00 | Italian retail sales (Apr) | | | -0.2% (-2.0%) |

***dbCalendar**: For more forward-looking calendars of data and events, as well as various tools to analyse data surprises, go to our new online calendar: **http://gm-secure.db.com/dbCalendar***

**Mon, 20**
EU finance ministers (EcoFin) to meet in Luxembourg
Eurogroup of Euro area finance ministers to meet in Luxembourg
ECB's Trichet to speak in Brussels – 14.30 GMT
ECB's Stark to speak in Munich – 16.00 GMT

**Tue, 21**
ECB Governing Council and General Council meets in Frankfurt

**Thu, 23**
ECB's Noyer to speak in Paris – 09.00 GMT

**Fri, 24**
ECB's Gonzalez-Paramo to speak in Malaga – 10.00 GMT

*Source: Various National Statistical Offices, Bloomberg, Reuters, S&P MMS, DB Global Markets Research. Growth rates in parentheses are year-on-year, while those without parentheses are this period over last period. * signifies provisional release day (or time if asterix beside time*

## The Week Ahead: Rest of Europe & the USA[1]

- In the **US**, Q1 **GDP** revisions are due. In the housing sector, while we expect **existing home sales** to rise modestly, **new home sales** could decline. **Durable goods orders** are expected to rebound.

- In the **UK**, the **minutes of the June MPC meeting** alongside **public finance** data and the **CBI monthly survey** are due for release.

*Source: Deutsche Bank*

## Key Data & Events

| Day | Time (GMT) | Release | DB Forecast | Consensus | Previous |
|---|---|---|---|---|---|
| Tue | 08.30 | UK PSNB (May) | | | GBP7.7bn |
| | 08.30 | UK PSNCR (May) | GBP15.0bn | | GBP3.3bn |
| | 10.00 | UK CBI industrial trends survey (Jun) | 20.0 | | 20.0 |
| | 14.00 | US existing home sales (May) | 5.2m | 4.9m | 5.1m |
| Wed | 07.00 | Swedish consumer confidence (Jun) | | 17.0 | 17.9 |
| | 07.00 | Swedish economic tendency indicator (Jun) | | | 112.4 |
| | 07.00 | Swedish NIER business survey (Jun) | | 9.0 | 11.0 |
| | 07.00 | Danish consumer confidence (Jun) | | | 2.6 |
| | 07.30 | Swedish unemployment rate (May) | | | 7.9% |
| | 08.00 | Polish retail sales (May) | | -1.3% (12.7%) | 2.3% (18.6%) |
| | 08.00 | Polish unemployment rate (May) | | 12.1% | 12.6% |
| | 12.00 | Polish net core inflation (May) | | 0.3% (2.3%) | 0.4% (2.1%) |
| | 14.00 | US house price index (Apr) | | -0.2% | -0.3% |
| Thu | 06.00 | Swiss trade balance (May) | | | CHF1.4bn |
| | 07.30 | Swedish PPI (May) | | | 0.0% (1.9%) |
| | 10.00 | UK CBI distributive trades survey (Jun) | | | 18.0 |
| | 12.30 | US initial jobless claims (Jun 17) | | | 414.0k |
| | 12.30 | US continuing claims (Jun 11) | | | 3675.0k |
| | 14.00 | US new home sales (May) | 300.0k (-7.1%) | 310.0k (-4.0%) | 323.0k (7.3%) |
| Fri | 07.00 | Hungarian retail sales (Apr) | | (0.2%) | (-0.9%) |
| | 12.30 | US GDP (Q1) | 1.8% | 1.9% | 3.1% (2.8%) |
| | 12.30 | US GDP deflator (Q1) | 1.9% | 1.9% | 0.4% (1.3%) |
| | 12.30 | US corporate profits (Q1) | | | 2.3% (18.3%) |
| | 12.30 | US durable goods (May) | 2.0% | 1.6% | -3.6% (5.3%) |
| | 12.30 | US durable goods ex transport (May) | 1.2% | 1.0% | -1.5% (6.8%) |

***dbCalendar**: For more forward-looking calendars of data and events, as well as various tools to analyse data surprises, go to our new online calendar: **http://gm-secure.db.com/dbCalendar***

**Mon, 20**
National Bank of Hungary to hold rate meeting – 12.00 GMT

**Tue, 21**
BoE's Fisher to speak in London
SNB's Hildebrand to speak in Zurich – 17.00 GMT

**Wed, 22**
BoE to publish minutes of its June 8-9 monetary policy committee meeting – 08.30 GMT
Norges Bank to announce interest rate decision– 12.00 GMT
Federal Reserve to announce rate decision– 16.30 GMT
Fed's Bernanke to speak in Washington – 18.15 GMT

**Thu, 23**
Czech National Bank to announce interest rate decision – 11.00 GMT

**Fri, 24**
BoE's King to speak in London - 09.30 GMT

*The list of data and events for the US is not comprehensive. Please see the web-based week ahead for a more complete list.*

*Source: Various National Statistical Offices, Bloomberg Finance LP Finance LP, Reuters, S&P MMS, DB Global Markets Research*

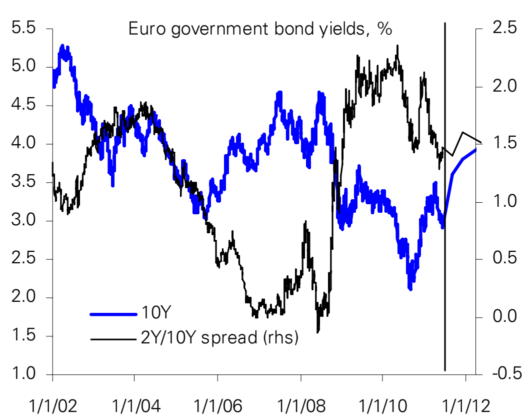
## Financial Forecasts

| | | US | Jpn | Euro | UK | Swiss* | Swe* | Den* | Nor* | Pol* | Hun* | Cze* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 3M Interest | Actual | 0.25 | 0.33 | 1.45 | 0.83 | 0.25 | 1.75 | 1.30 | 2.25 | 4.50 | 6.00 | 0.75 |
| Rates[1] | Sep-11 | 0.40 | 0.35 | 1.80 | 0.85 | 0.50 | 2.25 | 1.55 | 2.25 | 4.50 | 6.00 | 1.00 |
| DB forecasts | (futures) | (0.42) | (0.34) | (1.73) | (0.90) | -- | -- | -- | -- | -- | -- | -- |
| & Futures, | Dec-11 | 0.40 | 0.35 | 1.90 | 1.05 | 0.75 | 2.75 | 1.80 | 2.50 | 5.00 | 6.00 | 1.25 |
| *Central Bank | (futures) | (0.48) | (0.34) | (1.83) | (0.96) | -- | -- | -- | -- | -- | -- | -- |
| Rates | Jun-12 | 1.25 | 0.35 | 2.35 | 1.55 | 1.00 | 3.25 | 2.30 | 3.00 | 5.00 | 6.00 | 1.50 |
| | (futures) | (0.62) | (0.35) | (1.96) | (1.17) | -- | -- | -- | -- | -- | -- | -- |
| | | | | | | [ ---------- Spreads ----------] | | | | [ ---------- Rates ----------] | | |
| 10Y Gov't[2] | Actual | 2.94 | 1.13 | 2.94 | 3.20 | -1.23 | -0.06 | 0.20 | 0.40 | 5.91 | 7.36 | 3.85 |
| Bond | Sep-11 | 3.25 | 1.30 | 3.30 | 3.60 | -1.20 | 0.00 | 0.20 | 0.50 | 6.60 | 7.35 | 4.40 |
| Yields/ | (futures) | (3.05) | (1.18) | (2.99) | (3.29) | -- | -- | -- | -- | -- | -- | -- |
| Spreads[3] | Dec-11 | 3.50 | 1.30 | 3.50 | 3.80 | -1.20 | 0.00 | 0.20 | 0.50 | 6.60 | 7.35 | 4.40 |
| DB forecasts | (futures) | (3.16) | (1.23) | (3.05) | (3.38) | -- | -- | -- | -- | -- | -- | -- |
| & Forwards | Jun-12 | 4.00 | 1.40 | 3.70 | 4.10 | -1.20 | 0.15 | 0.20 | 0.50 | 6.60 | 7.35 | 4.40 |
| | (futures) | (3.35) | (1.31) | (3.14) | (3.52) | -- | -- | -- | -- | -- | -- | -- |

| | | EUR/ USD | USD/ JPY | EUR/ GBP | GBP/ USD | EUR/ CHF | EUR/ SEK | EUR/ DKK | EUR/ NOK | EUR/ PLN | EUR/ HUF | EUR/ CZK |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Exchange | Actual | 1.42 | 80.6 | 0.88 | 1.61 | 1.21 | 9.17 | 7.46 | 7.85 | 3.98 | 269.2 | 24.2 |
| Rates | 3M | 1.40 | 75.0 | 0.86 | 1.63 | 1.25 | 8.50 | 7.46 | 7.80 | **3.81** | 273.4 | 24.4 |
| | 6M | 1.35 | 78.0 | 0.84 | 1.61 | 1.28 | 8.20 | 7.46 | 7.60 | **3.70** | 274.6 | 24.3 |
| | 12M | 1.30 | 78.0 | 0.79 | 1.65 | 1.30 | 8.00 | 7.46 | 7.40 | **3.65** | 280.0 | 24.0 |

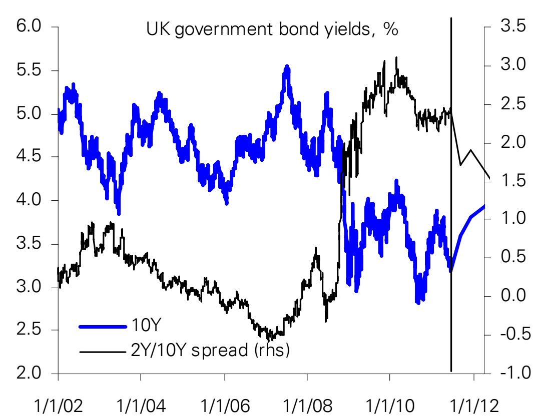
*(1) Future rates calculated from the June, September and March 3M contracts. Forecasts are for the same dates. Central bank rates for the CE-4, Scandinavia and Switzerland*
*(2) Forecasts in this table are produced by the regional economists, and are not obtained from DByield. 10-year forwards estimated from the asset swap curve.*
*(3) Bond yield spreads are versus Euroland.*
*Source: Bloomberg Finance LP, DB Global Markets Research. Revised forecasts in bold type. All current rates taken as at Friday 11:00 GMT.*

## Euro government bonds: yield and slope




*Source: Deutsche Bank. Forecasts to right of vertical line.*

## UK government bonds: yield and slope




*Source: Deutsche Bank. Forecasts to right of vertical line.*

# Appendix 1

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**David Folkerts-Landau**
Managing Director
Global Head of Research

Stuart Parkinson
Associate Director
Company Research

Marcel Cassard
Global Head
Fixed Income Research

Europe
Guy Ashton
Regional Head

Asia-Pacific
Fergus Lynch
Regional Head

Germany
Andreas Neubauer
Regional Head

Americas
Steve Pollard
Regional Head

Principal Locations

**Deutsche Bank AG**
**London**
1 Great Winchester Street
London EC2N 2EQ
Tel: (44) 20 7545 8000

**Deutsche Bank AG**
**New York**
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250-2500

**Deutsche Bank AG**
**Hong Kong**
Filiale Hongkong
Intl. Commerce Centre
1 Austin Road West Kowloon,
Hong Kong
tel: (852) 2203 8888

**Deutsche Securities Inc.**
**Japan**
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Tel: (81) 3 5156 6770

**Deutsche Bank AG**
**Frankfurt**
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

**Deutsche Bank AG**
Aurora business park
82 bld.2 Sadovnicheskaya street
Moscow, 115035
Russia
Tel: (7) 495 797-5000

**Deutsche Bank AG**
**Singapore**
One Raffles Quay
South Tower
Singapore 048583
Tel: (65) 6423 8001

**Deutsche Bank AG**
**Australia**
Deutsche Bank Place, Level 16
Corner of Hunter & Phillip Streets
Sydney NSW 2000
Tel: (61) 2 8258 1234

**Deutsche Bank Dubai**
Dubai International Financial Centre
The Gate, West Wing, Level 3
P.O. Box 504 902
Dubai City
Tel: (971) 4 3611 700


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**Publication Address:**
Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
(44) 20 7545 8000

**Internet:**
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