

Economics

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Euro Weekly

Banking Stress to Hit Firms and the Economy

- Tighter financial conditions, the growing threat of rapid bank deleveraging and the protracted policy makers' response are likely to result in an aborted 2010-11 recovery. Key forward-looking indicators are also continuing to weaken, pointing to a probable contraction in Q4, which is likely to continue at least in early 2012.
- The abrupt correction in demand forecasts recorded since early 2011 bears a close resemblance to the downtrend of 2008.
- With events in recent weeks, the stress for euro area banks has increased further and funding difficulties have broadened to a larger group of countries. With banks in a larger number of countries struggling with their own financing, it is only a question of time before the non-financial private sector will face tighter conditions as well.
- We expect the ECB to announce additional measures to support banks soon, probably in January 2012 (Guillaume Menuet and Jürgen Michels see page 2).

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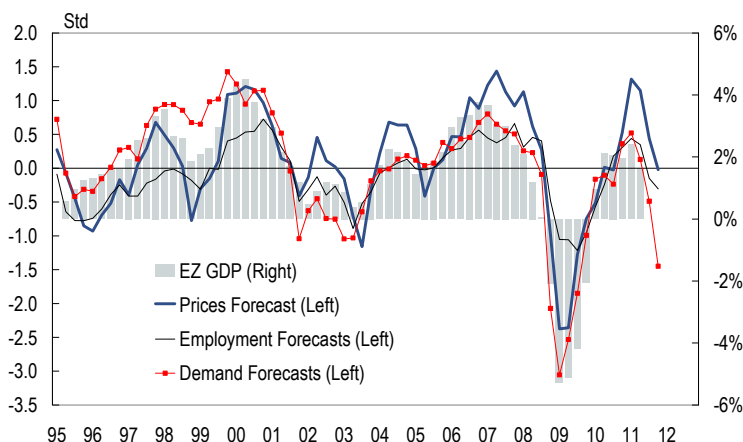
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With thanks to Carla Clifton

Figure 1. Citi Market Forecasts

	\$/€	Euro Repo	10-yr Bunds	£/€	U.K. Bank Rate	10-yr Gilt-Bund	SEK Policy Rate	NOK Policy Rate	NOK/€	SFr/€	CHF Policy Rate	CHF Spread vs Bunds
End 4Q 11	1.33	1.00	1.75	0.85	0.50	50	9.30	2.00	7.86	2.25	1.24	0.00
End 2Q 12	1.27	1.00	1.50	0.84	0.50	35	9.14	2.00	7.81	2.25	1.21	-84

Source: Citi Investment Research and Analysis

Figure 2. Eurozone GDP and Belgian Leading Indicators, 1995-2012


Sources: Belgian National Bank and Citi Investment Research and Analysis

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The Good Times Are Over

Much slower GDP growth and rapid weakening in leading indicators point to an imminent recession

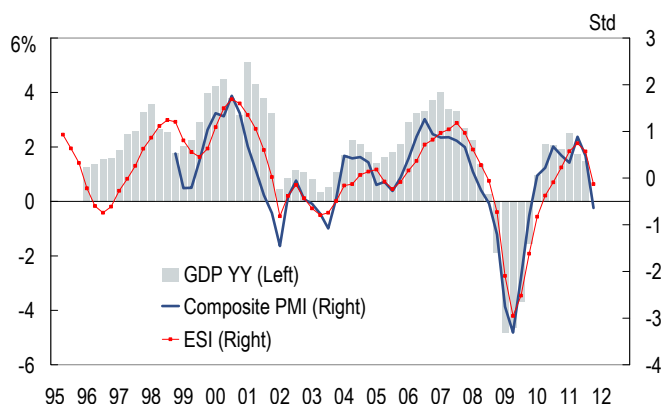
Third quarter flash GDP estimates released earlier this week showed that economic activity had slowed further at the start of the second half. After an encouraging start to the year when GDP growth averaged an annualized rate of 1.9% in the first two quarters, Q3 GDP came in at a meagre 0.6%. In our view, the Eurozone economy is dangerously close to recession: the four-quarter average annualized growth rate of 1.4% is the lowest since Q2 2008. Not only are there omnipresent signs of softening economic activity across euro area member states, but some of the key forward-looking indicators are also continuing to weaken, pointing to a probable contraction in Q4, which is likely to continue at least in early 2012 (see Figure 3).

October ECB rate cut signals that all is not well

A larger output gap will require further ECB monetary policy support

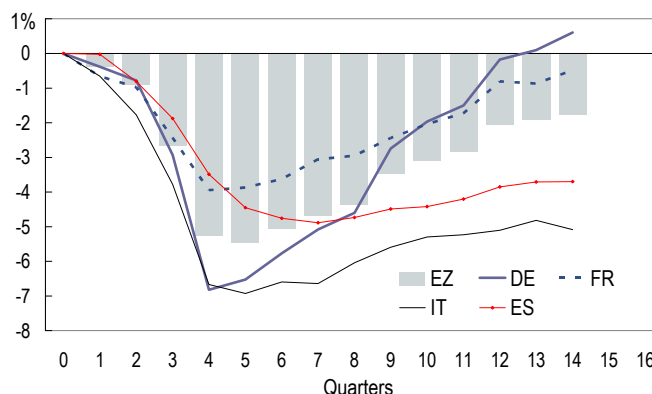
Under our baseline scenario, the output gap will not close for some time. This implies greater downside risks to the ECB's medium-term objective of price stability. No wonder that the Governing Council decided to lower its refinancing rate by 25bp to 1.25% on 3 November, concluding that it was urgent to unwind one of its two earlier hikes (April and July). Tighter financial conditions, the growing threat of rapid bank deleveraging and the protracted policy makers' response are likely to result in an aborted 2010-11 recovery: as of Q3, GDP remains some 1.8% below its pre-crisis peak (see Figure 4).

Figure 3. Eurozone — Real GDP Growth and Leading Indicators, 1995–Q4 2011



Sources: Haver and Citi Investment Research and Analysis

Figure 4. Real GDP Growth — Cumulative Change, 2008–Q3 2011



Sources: Eurostat and Citi Investment Research and Analysis

Austerity cures are making peripheral countries' adjustment difficult

The available data show that countries receiving financial assistance did not perform well in Q3, even if Ireland might be an exception once we obtain its GDP estimate in the last week of December. Indeed, the country is reaping the benefits of a sustained and ample devaluation compared to the other euro area countries after a contraction in nominal wages. By contrast, Portugal and Greece are headed for a deep(er) recession: the former because its newly elected government is implementing more ambitious fiscal tightening measures than demanded by the EU/ECB/IMF Troika; the latter because political uncertainty and the deteriorating economic situation are accelerating the country's downward spiral.

Peripherals trapped by a weakening core

But core countries are also being affected by the prevalent uncertainty

However, the slowdown has now spread beyond the weaker periphery to the core economies. This is the worst possible scenario for countries such as Ireland and Spain (see Figure 5) since both are relying on positive external dynamics to counterbalance their weak domestic demand. Given our October baseline of a Q4

Precautionary ratcheting down in investment intentions in core economies highlights the extent of the problem

The recent collapse in demand forecasts bears a close resemblance to the 2008 episode

GDP contraction in Germany and other core countries, and the further softening in leading indicators such as the OECD's and the composite PMIs, there is little prospect of near term recovery in peripherals if their main export markets also struggle to expand. Therefore, a double-dip recession looks likely.

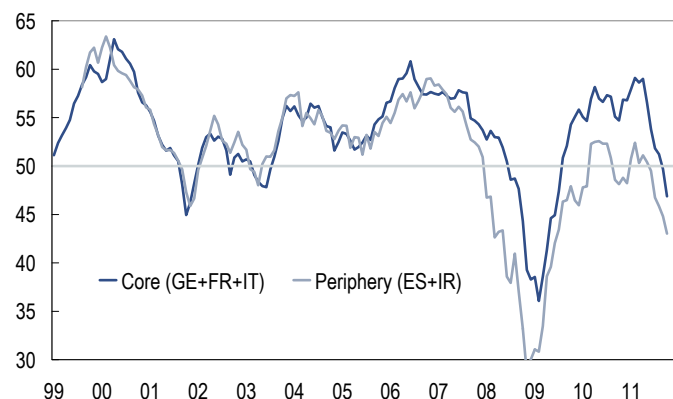
Investment is invariably the first expenditure to be curbed

Despite sound fiscal policy and a diversified economy, the Netherlands has not been immune to a GDP correction, recording the sharpest deterioration of all euro area countries (see Figure 6). In core countries, flash Q3 GDP expenditure breakdown from France and the Netherlands confirmed that some softening occurred in gross fixed capital formation, and to a lesser extent in government spending due to the much tighter control of the public purse strings. A cross-check with industrial sentiment surveys suggests that the recent softening is related to the postponement of investment decisions against a backdrop of tightening bank lending standards to firms. Indeed, industrial orders remain above their long-term average (+0.14std) while stocks of finished goods are below their historical norm (-0.41std).

Collapsing demand forecasts point to sizeable recession ahead

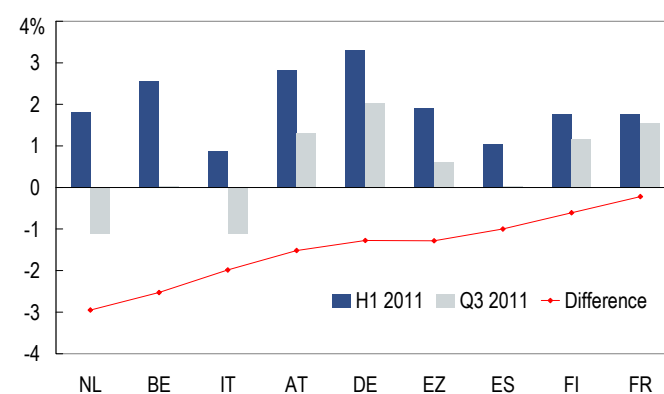
As the euro area sovereign debt crisis threatens to engulf one country after the other, a recession seems unavoidable. To get a different angle on the situation, we turn to Belgium, a small and very open economy with decent leading indicator properties. We use responses from the National Bank's business survey and compute an aggregate measure of demand, employment and inflation perspectives from four key sectors (manufacturing, retail, construction and services). We find that the abrupt correction in demand forecasts recorded since the peak in early 2011 bears a close resemblance to the downtrend of 2008 (see Figure 2 on the front page). Hence, barring an unforeseen rebound in economic sentiment in the next few months, Belgium GDP growth will likely turn negative. We doubt that the Eurozone will behave differently, given the degree of interconnectedness between member states.

Figure 5. Euro Area — Composite PMIs (Geographical Aggregation) – Manufacturing Services, Jan 1999-Oct 2011



Sources: Markit and Citi Investment Research and Analysis

Figure 6. Eurozone — Real GDP Annualised Growth, 2011 to Date



Sources: Eurostat and Citi Investment Research and Analysis

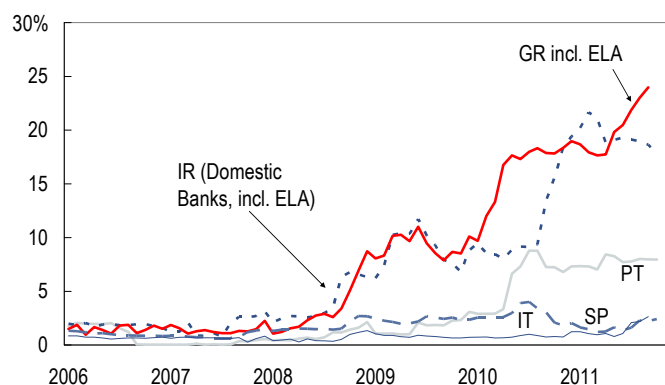
Funding Stress: Moving from Banks to Firms

Banks from more countries rely increasingly on Eurosystem

We have addressed the negative impact of tighter financing conditions on the euro area economies before.¹ With events in recent weeks the stress for euro area banks has increased further. In the past we looked at the banks' use of ECB funding as a measure for banks' funding stress. The recent trends in these data — in most cases available up to October — suggest that funding difficulties have broadened to a larger group of countries. In addition to Greece, where banks increasingly use the national Central Bank's Emerging Liquidity Assistance (ELA), reliance on the Eurosystem also increased clearly in Spain, Italy, France, Belgium and the Netherlands since the summer (see Figures 7 and 8).

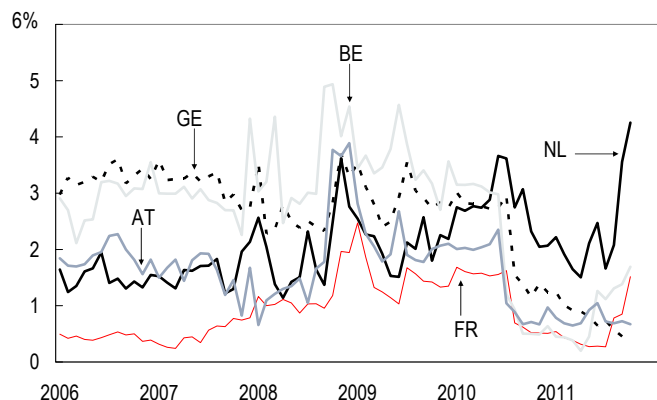
However, Irish and Portuguese banks' dependency on Eurosystem funding was unchanged or came down respectively. Furthermore, German banks tapped the Eurosystem facilities less in recent months and the data up to October do not show that Austrian banks — which are highly exposed to Central and Eastern Europe and Italy — have short-term liquidity constraints.

Figure 7. Italy, Spain, Greece, Portugal and Ireland — Banks' Funding From Eurosystem as a Share of Bank Assets, 2006–Oct 2011



Sources: Eurosystem and Citi Investment Research and Analysis

Figure 8. Germany, France, Netherlands Belgium and Austria — Banks' Funding From Eurosystem as a Share of Bank Assets, 2006–Oct 2011



Sources: Eurosystem and Citi Investment Research and Analysis

Manufacturers start to feel the pain

With banks in an increasing number of countries struggling with their own financing, it is only a question of time before the non-financial private sector will face tighter lending conditions as well. According to the quarterly EU Commission survey, manufacturing companies in most countries see few production limitations from financial conditions. However, there are obvious differences between the core and the periphery. Whereas the share of companies reporting difficulties due to financing constraints continued to shrink in the core countries, the reverse was apparent in the peripheral countries where more manufacturers indicated limitations from tighter lending conditions.

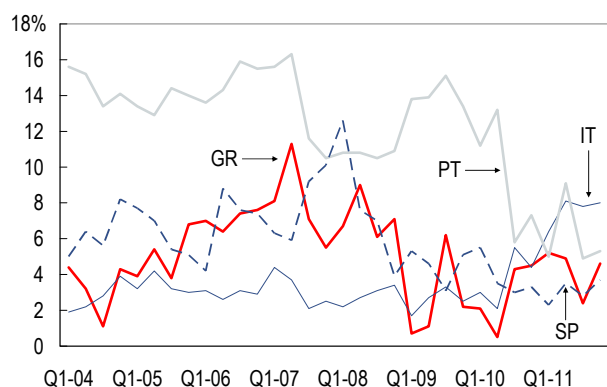
In addition to the problems of getting easily affordable bank funding, capital market access for companies from the sovereign crisis countries probably has also tightened. Looking forward, companies are likely to be hit even more from tighter financing conditions and as a result economic activity, particularly capital expenditure, is likely to be affected.

¹ See "[Credit Matters: Recession Ahead](#)", *Euro Weekly*, Citi, 21 October 2011

ECB likely to enact more measures to support banks

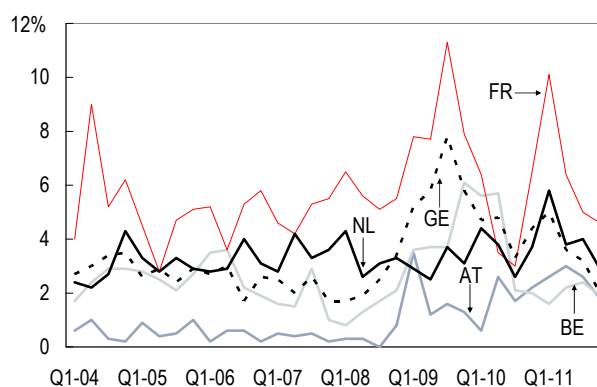
In order to ease the lending conditions and to improve the transmission of monetary policy, we expect the ECB to take further action to support banks' short- and longer-term funding conditions. While it looks unlikely that the ECB will announce additional LTROS (probably with a maturity of up to 2 or 3 years) before they run the 12M LTRO at the end of December, we expect the ECB to announce additional measures to support banks soon, probably in January 2012.

Figure 9. Italy, Spain, Greece and Portugal — Manufacturing Companies Reporting Production Limitations Through Financing Constraints, 2004–4Q 2011



Sources: Haver and Citi Investment Research and Analysis

Figure 10. Germany, France, Netherlands, Belgium and Austria — Manufacturing Companies Reporting Production Limitations Through Financing Constraints, 2004–4Q 2011



Sources: Haver and Citi Investment Research and Analysis

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Key Economic Indicators (21 November – 25 November 2011)

Monday 21 November		Forecast	Last
08:30	Netherlands: Consumer Spending, Sep		
09:00	Euro Area: Balance of Payments, Sep		
	UK: Confederation of British Industry Annual Conference, London		
Tuesday 22 November		Forecast	Last
07:00	Switzerland: Trade Balance, Oct		
08:30	Sweden: Unemployment, Oct		
09:00	Norway: GDP, 3Q		
09:30	UK: Public Sector Net Borrowing, Oct	£7.3 Billion Deficit	Year Ago: £7.7 Billion Deficit
	Fiscal Year To Date, Apr-Oct	£70.8 Billion Deficit	Year Ago: £78.7 Billion Deficit
	Greece: Current Account, Sep		
15:00	Euro Area: Consumer Confidence, Nov Flash	-21.0	-19.9
Wednesday 23 November		Forecast	Last
07:45	France: Business Confidence, Nov	93	97
	Own Company Production Outlook, Nov	0	4
09:00	Norway: AKU Unemployment, Sep		
09:00	Euro Area: Manufacturing PMI, Nov Flash	45.5	47.1
	Services PMI, Nov Flash	45.0	46.4
	Composite PMI, Nov Flash	45.0	46.5
09:30	UK: MPC Minutes (Nov 10)		
09:30	UK: BBA Loans for House Purchase, Oct		
09:30	UK: BoE Agents' Summary of Business Conditions, Nov		
10:00	Euro Area: Industrial New Orders, Sep	-1.8% MM, 8.8% YY	1.9% MM, 6.7% YY
Thursday 24 November		Forecast	Last
07:00	Germany: GDP Details, 3Q	0.5% QQ, 2.6% YY	0.3% QQ, 2.9% YY
08:15	Switzerland: Unemployment, 3Q		
08:15	Sweden: Business and Consumer Confidence, Nov		
08:30	Netherlands: Producer Confidence, Nov		
08:30	Sweden: Producer Prices, Oct		
09:00	Germany: ifo Business Climate, Nov	104.0	106.4
09:00	Italy: Consumer Confidence, Nov		
09:30	UK: GDP, 3Q (2 nd Release)	Provisional: 0.5% QQ, 0.5% YY	2Q: 0.1% QQ, 0.6% YY
09:30	UK: Service Sector Output, Sep	0.0% MM, 1.1% YY	0.3% MM, 1.2% YY
11:00	UK: CBI Industrial Trends Survey – Output Expectations, Nov	-15%	-11%
	Order Books, Nov	-20%	-18%
	Selling Prices, Nov	0%	+1%
Friday 25 November		Forecast	Last
07:00	Germany: Import Prices, Oct		
07:45	France: Consumer Confidence, Nov	79	82
08:00	Spain: Producer Prices, Oct		
09:00	Italy: Retail Sales, Sep		

Sources: National statistical offices, central banks and Citi Investment Research and Analysis

Economic Indicators

Euro Area

Nov 22 15:00	Consumer Confidence, Nov Flash	Forecast: -21.0	Prior: -19.9
London Time	The intensification of the sovereign debt crisis and the announcement of additional austerity measures in some countries (incl. France) will probably lead to a further contraction in consumer sentiment in November to the lowest reading since August 2009.		
Nov 23 09:00	Manufacturing PMI, Nov Flash	Forecast: 45.5	Prior: 47.1
	Services PMI, Nov Flash	Forecast: 45.0	Prior: 46.4
London Tim	Composite PMI, Nov Flash	Forecast: 45.0	Prior: 46.5
	The contraction in the PMI is likely to continue in November. The tightening of financing conditions in a broader range of countries and the announcement of additional austerity measures are likely to have negative consequences on purchasing managers' sentiment. The November reading will probably be the lowest since June 2009.		
Nov 23 10:00	Industrial New Orders, Sep	Forecast: -1.8% MM, 8.8% YY	Prior: 1.9% MM, 6.7% YY
London Time	Industrial orders have been very volatile in recent months, as is usual during the summer months. Available data from some large member countries signal a significant fall in September. In 3Q on average, orders would be down by 0.3% QQ after a gain of 2.5% QQ in 2Q.		

Germany

Nov 24 07:00	GDP, 3Q Details	Forecast: 0.5% QQ, 2.6% YY	Prior: 0.3% QQ, 2.9% YY
London Time	We expect a confirmation of the flash estimate. As the statistical office has already mentioned, private consumption and investment in machinery and equipment were the driving forces for the increase in GDP in 3Q. Net exports probably made only a marginal contribution to GDP growth.		
Nov 24 09:00	Ifo Business Climate, Nov	Forecast: 104.0	Prior: 106.4
London Time	We expect the fifth consecutive fall in business confidence in November to the lowest level since March 2010. Business expectations probably will fall by 3.0 points MM to 94 and the assessment of the current business situation is likely to drop by 2.2 points to 114.5. We expect that the fall in sentiment will be broad-based among sectors, with particularly large declines in the manufacturing sector.		

France

Nov 23 07:45	Business Confidence Indicator, Nov	Forecast: 93	Prior: 97
	Own-Company Production Outlook, Nov	Forecast: 0	Prior: 4
London Time	Sentiment is expected to have weakened sizeably in November as the euro area sovereign debt crisis intensified, with the subsequent departure of the Greek and Italian PMs. Businesses are battening down the hatches, preparing to reduce output in the face of slowing demand and deteriorating visibility. Both measures are expected to fall to their lowest levels since Feb/Mar 2010, standing 0.5 std below their longterm averages.		
Nov 25 07:45	Consumer Confidence Indicator, Nov	Forecast: 79	Prior: 82
London Time	Household confidence likely deteriorated in November. We look for a three-point drop, unwinding the surprising two-point gain recorded in October, bringing the composite index within two points of its 2008 record lows. Expectations regarding standards of living and the financial situation are unlikely to rebound in the near term given the fiscal tightening plans announced for 2012 by the government ahead of the elections.		

United Kingdom

Nov 22 09:30	Public Sector Net Borrowing, Oct	Forecast: £7.3 Billion Deficit, £70.8 Billion Deficit Fiscal Year To Date	
	(Figures Exclude Costs of Financial Intervention)	Year Ago: £7.7 Billion Deficit, £78.7 Billion Deficit Fiscal Year To Date	
London Time	Over the first six months of the fiscal year, the deficit (excluding financial interventions) fell by £7.5bn from a year ago, an underlying improvement of £11.0bn excluding last year's one-off £3.5bn proceeds from the bank bonus tax. This represents an underlying improvement of £1.8bn per month. We expect a slightly slower pace of improvement over the rest of the fiscal year, because spending – which has been running below the Budget target so far – is likely to catch up a bit.		
Nov 24 09:30	GDP, 3Q (2nd Release)	Provisional: 0.5% QQ, 0.5% YY	Prior: 0.1% QQ, 0.6% YY
London Time	We do not anticipate any significant revisions to the overall figures for 3Q GDP growth. The split is likely to show a modest improvement in consumer spending (we expect 0.4% QQ), although investment may well fall back. Nominal GDP growth is likely to remain soft, probably at a similar pace to 2Q (3.0% YY).		
Nov 24 09:30	Service Sector Output, Sep	Forecast: 0.0% MM, 1.1% YY	Prior: 0.3% MM, 1.2% YY
London Time	Surveys suggest that service sector output growth has weakened recently, and hence we expect a roughly flat reading for September. Such a figure would leave overall 3Q services output up 0.6% QQ, but 4Q is likely to show a weaker reading.		
Nov 24 11:00	CBI Industrial Trends Survey, Nov		
	Monthly Output Expectations Net Balance, Nov	Forecast: -15%	Prior: -11%
London Time	Monthly Order Books Net Balance, Nov	Forecast: -20%	Prior: -18%
	Monthly Selling Prices Net Balance, Nov	Forecast: 0%	Prior: +1%

The CBI survey weakened abruptly in October and, while there may be chances of a technical bounce this month, on balance we look for further weakness, as the headwinds from the euro crisis and high private debts dominate.

Sources: National Statistical Offices, National Central Banks, Bloomberg, CIRA forecasts

Key Economic Indicators (28 November – 2 December 2011)

During The Week		Forecast	Last
07:00	Germany: Retail Sales, Oct (by Dec 2)		
07:00	UK: Nationwide House Prices, Nov		
Monday 28 November		Forecast	Last
	Germany: Inflation, Nov Preliminary		
07:00	Germany: GfK Consumer Confidence, Dec		
09:00	Italy: Business Confidence, Nov		
09:00	Euro Area: M3, Oct		
17:00	France: Jobseekers, Oct		
Tuesday 29 November		Forecast	Last
08:00	Spain: HICP, Nov Flash Estimate		
08:00	Spain: Retail Sales, Oct		
08:30	Sweden: GDP, 3Q		
09:00	Italy: Contractual Wages, Oct		
09:00	Norway: C2 Credit Indicator, Oct		
09:30	UK: Personal Borrowing, Oct		
10:00	Euro Area: Business and Consumer Surveys, Nov		
12:00	UK: Chancellor Osborne makes Autumn Statement to Parliament		
	Euro Area: Eurogroup Meeting of euro-area Finance Ministers, Brussels		
Wednesday 30 November		Forecast	Last
00:01	UK: GfK Consumer Confidence, Nov		
	EU: EcoFin Meeting of EU Finance Ministers, Brussels		
07:45	France: Household Consumption, Oct		
07:45	France: Producer Prices, Oct		
08:30	Netherlands: Producer Prices, Oct		
08:55	Germany: Unemployment, Nov		
09:00	Italy: Unemployment, Oct		
09:00	Norway: Retail Sales, Oct		
10:00	Italy: HICP, Nov Flash Estimate		
10:00	Euro Area: HICP, Nov Flash Estimate		
10:00	Euro Area: Unemployment, Oct		
10:30	Switzerland: KOF Economic Barometer, Nov		
11:00	Italy: Producer Prices, Oct		
Thursday 1 December		Forecast	Last
06:45	Switzerland: GDP, 3Q		
07:30	France: Unemployment, 3Q		
09:00	Euro Area: Manufacturing PMI, Nov Final		
09:30	UK: Manufacturing PMI, Nov	46.5	47.4
18:00	Italy: Budget Balance, Nov		
Friday 2 December		Forecast	Last
08:00	Spain: Unemployment, Nov		
08:15	Switzerland: Retail Sales, Oct		
09:00	Norway: Unemployment, Nov		
09:30	UK: New Construction Orders, 3Q		
10:00	Euro Area: Industrial Producer Prices, Oct		
During The Weekend		Forecast	Last
Dec 4	Slovenia: General Election		
Dec 4	Russia: Parliamentary Election		

Sources: National statistical offices, central banks and Citi Investment Research and Analysis

Recent Research Publications	Author	Date of Publication
Euro Area		
Euro Area — Sovereign Debt Crisis Update	Ann O'Kelly	Nov 18, 2011
ECB — Draghi Starts With a Rate Cut, But Does Not Change SMP Policy	Jürgen Michels	Nov 3, 2011
European Economic Forecast Highlights	Ann O'Kelly	Oct 27, 2011
Euro Summit: Part 2 — Comprehensive Package Leaves Many Open Questions	Jürgen Michels/Guillaume Menuet	Oct 27, 2011
Euro Area Summit Results Part 1	Jürgen Michels/Guillaume Menuet	Oct 24, 2011
France		
France Macro View — Determined to Protect its Aaa/AAA Rating	Guillaume Menuet	Nov 8, 2011
Euro Weekly		
Italy — Too Big to Fail, But Difficult to Bail Out	Jürgen Michels	Nov 11, 2011
European Sponsorship Search Continues	Jürgen Michels	Nov 4, 2011
Draghi Unlikely to Start With Rate Cut	Jürgen Michels	Oct 28, 2011
Credit Matters: Recession Ahead	Guillaume Menuet	Oct 21, 2011
How Comprehensive Can A Solution Be?	Jürgen Michels	Oct 14, 2011
Switzerland		
Switzerland — Inflation Goes Negative — More Deflation To Come	Michael Saunders	Nov 7, 2011
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Global Economics View: Why We Should Not Panic If Deep Greek Sovereign Debt Restructuring Triggers CDS	Willem Buiter	Oct 26, 2011
Global Economics View: Can Sovereign Debt Insurance by the EFSF be the 'Big Bazooka' that Saves the Euro?	Willem Buiter	Oct 18, 2011
UK		
UK — BoE IR Signals More QE Likely	Michael Saunders	Nov 16, 2011
UK — Unemployment Surges Higher Again	Michael Saunders	Nov 16, 2011
UK — Inflation Begins to Decline	Michael Saunders	Nov 15, 2011
UK — "Project Merlin" — Do The Numbers Reflect Reality?	Michael Saunders	Nov 14, 2011
UK — No Move From the MPC	Michael Saunders	Nov 10, 2011
UK — Credit for Small firms Remains Expensive	Michael Saunders	Oct 31, 2011
UK — CBI Survey Shows Marked Weakness	Michael Saunders	Oct 26, 2011
UK — YouGov Reports Lower Long-Term Inflation Expectations	Michael Saunders	Oct 25, 2011
UK — Fiscal Deficit Continues to Fall	Michael Saunders	Oct 21, 2011
UK — Retail Sales Stagnation Continues	Michael Saunders	Oct 20, 2011
UK — MPC Vote 9=0 For QE	Michael Saunders	Oct 19, 2011
UK — BoE Governor Speech	Michael Saunders	Oct 19, 2011
UK — Inflation Surges Above 5%	Michael Saunders	Oct 18, 2011
UK — Employment Falls Sharply	Michael Saunders	Oct 12, 2011
Sterling Weekly		
Dovish Inflation Report Expected	Michael Saunders	Nov 11, 2011
MPC Meeting — Scope for a Surprise?	Michael Saunders	Nov 4, 2011
Slow Progress in Deleveraging	Michael Saunders	Oct 28, 2011
Recovery Stalled by Headwinds	Michael Saunders	Oct 21, 2011
Options for 'Plan A+'	Michael Saunders	Oct 14, 2011

Source: Citi Investment Research And Analysis

Notes

Notes

Notes

Appendix A-1

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