

Q3 2010 SA QUARTERLY PERSPECTIVES

Recovery extends beyond the World Cup

South Africa Outlook

- South Africa's economic recovery from last year's recession has so far exceeded our expectations, with GDP growth rising to 4.6% q/q in the first quarter from 3.2%. We generally remain constructive on the economic upturn and project the economy to grow by 3.3% in 2010.
- The near term inflation outlook remains favourable and we believe that consumer price inflation is likely to remain below the upper inflation target band for the remainder of 2010. Administered price increases and wage price inflation continue to pose medium- to longer-term upside risks to inflation.
- Although a more comfortable inflation outlook in the coming months could provide room for a further interest rate cut, the generally stronger-than-expected outturn in real economy data suggests that sufficient monetary stimulus has been delivered; and together with uncertainty around the impact from global events, argues for a cautious approach to policy. As a baseline, we expect the policy interest rate to be held at 6.5% into mid-2011.
- The rand remains well supported through portfolio flows. International news and events rather than domestic developments are likely to continue underpinning moves in the currency. From a fundamental perspective, we see the rand retaining its 7.40-7.90/USD range for the coming quarters.

International Outlook

- The cyclical factors that have been driving growth for the past six quarters will likely begin to yield to medium-term secular forces.
- We believe markets may be overly pessimistic about the possibility of a near-term debt incident in peripheral Europe. The longer-term implication of the European crisis is likely not to be default, but rather fiscal consolidation among advanced economies too early in the cycle. Policy inflexibility increases the downside risks to growth.
- Emerging markets are decoupling again, and absent a large negative shock, we believe medium-term strong economic outperformance is likely to continue.
- China's soft landing is under way, but we do not believe it poses a large risk to global growth. Chances of a hard landing appear low despite deflation of the property bubble.

Key South African forecasts			
	2009	2010	2011
GDP (%)	-1.8	3.3	4.3
CPI (%)	7.1	4.9	5.7
Repo (eop %)	7.0	6.5	8.0
Prime (eop %)	10.5	10.0	11.5
Budget (% of GDP)	-6.7	-5.7	-4.8
USDZAR (ave)	8.44	7.60	7.94

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SOUTH AFRICA: THE RECOVERY EXTENDS BEYOND THE WORLD CUP

Economic growth gained pace in Q1 10, with GDP rising by 4.6% at a seasonally adjusted and annualised pace

South Africa's recovery from last year's recession continues to impress, as first quarter GDP came in at 4.6% q/q saar (1.6% y/y). Output in the mining sector jumped by about 15% q/q (6.5% y/y) as production in the diamonds, coal, nickel and non-metallic mineral products sub-sectors picked up on the back of stronger export demand. Similarly, manufacturing production growth remained firm at an annualised quarterly 8.4% in the first quarter as ongoing strong domestic and foreign demand for new vehicles boosted output in the motor vehicles, parts and accessories-sub sector. Other export-orientated manufacturing sub-sectors such as chemical products and the basic iron and steel sub-sectors also benefited from the general improvement in the global economy.

Admittedly, certain sectors of the economy performed better than others

The strong growth observed in the primary and secondary sectors of the economy was not mirrored in the tertiary sector of the economy, however. Against first quarter annualised q/q growth rates of nearly 12% in the primary sector and 7% in the secondary sector, the tertiary sector grew at a relatively modest 2.7% in the first quarter. This shows that the further removed the sector is from the consumer, generally the stronger the cyclical recovery has been so far. Importantly, however, all sectors of the economy are now growing again, attesting to a broad-based and broadening – if still somewhat tepid – economic recovery.

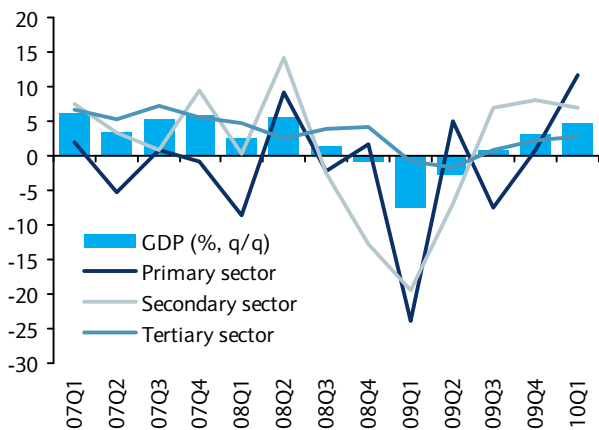
Business confidence remains fragile, following from last year's recession

Psychologically, the pain of last year's recession remains fresh. For example, note the vulnerability of business confidence, which slipped back 7 points to +36 in Q2 as headline concern over potential spill-overs from Europe's debt problems raised its head again and the transport workers strike hit business logistics. These same factors, along with manufacturers having cut down on production hours during the Soccer World Cup, may have also contributed to the fourth consecutive monthly decline in the headline PMI to 48.4 in June from 51.1 the prior month. In our view, near-term volatility and relative weakness in the data are likely to continue as the impact of the transport strike and productivity losses associated with the World Cup continue to filter through the data until early in Q3 10. We would therefore caution in reading too much into the data flow in the coming few months and interpreting it as signs of a faltering economic recovery.

Consumers are opening their pocketbooks a little wider

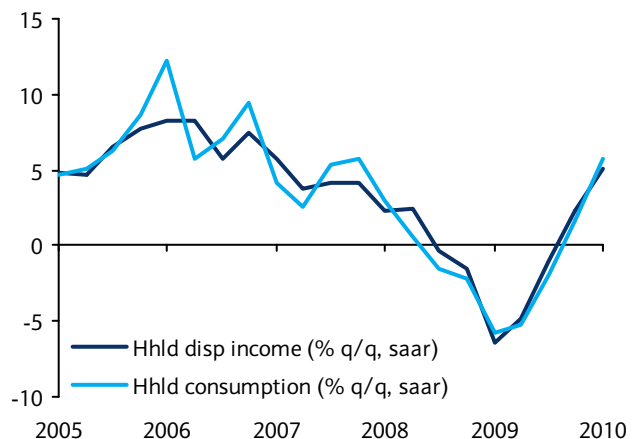
Critical to a sustainable recovery is the spread of the upturn to the demand-side of the economy, and here the consumer remains key. The first quarter expenditure-side GDP

Figure 1: Up to now the recovery has been driven through the supply-side of the economy...



Source: Statistics South Africa, Absa Capital

Figure 2: ...but demand-side indicators are now also showing signs of revival



Source: South African Reserve Bank, Absa Capital

data from the Reserve Bank showed that real gross domestic expenditure jumped an annualised quarterly 12.1% in Q1 10, with all major components showing signs of strength. Importantly though, household consumption expenditure grew an impressive 5.7% q/q annualised from the prior quarter's 1.6%, underpinned by surges in durable (16.8%), semi-durable (28.4%) and non-durable goods expenditure (9.5%). Household spending on services was the only component of household consumption expenditure to contract in the quarter, falling 4.6%, worse than the prior quarter when outlays on services grew 1.6%.

Household spending is benefiting from strong income growth, low interest rates and positive wealth effects

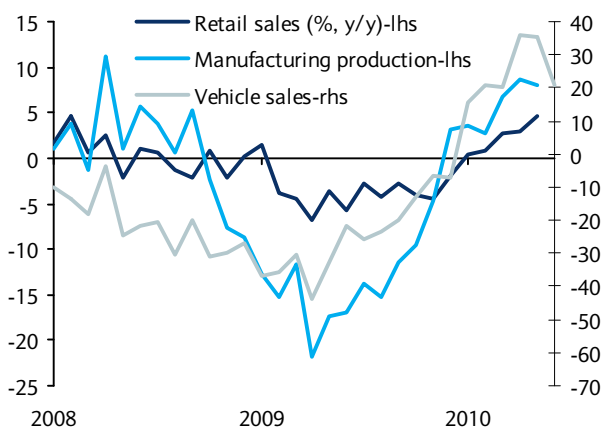
This surge in household consumption expenditure was driven mainly by a 5.1% rise in real disposable income in the first quarter, which in turn found support from employment growth at a provincial government level (even as overall employment growth fell in the quarter), and strong real wage growth as high nominal wage increases combined with a more comfortable inflation environment. Aside from these factors, the 550bp in interest rate cuts administered since December 2008, and positive wealth effects emanating from rising house prices and better equity market valuations both helped to support the increase in household spending. Further support to household spending also came from an improvement in consumer confidence levels to 15 in Q1 10 from 6 the prior quarter.

Even though consumer confidence slipped one point in the second quarter, it remains well above its 10-year average and its crisis low of -6, pointing to an ongoing improvement in household consumption expenditure in the quarters ahead. Retail sales bested our expectations in May (4.6% y/y), while vehicle sales grew about 21% in June. These positive readings, along with the lagged effect of past interest rate cuts that are still filtering through the economy, March's interest rate cut that provided further relief to consumers, a labour market that is showing signs of stabilisation and wealth effects continuing to move in a favourable direction (particularly house prices which rose more than 14% y/y in Q2 from 10% in Q1, according to the Absa House Price Index) suggest to us that the recovery in household demand will be sustained.

It is important not to mix growth rates with levels; however, in level terms much improvement is needed before the activity peak of 2008 can be attained

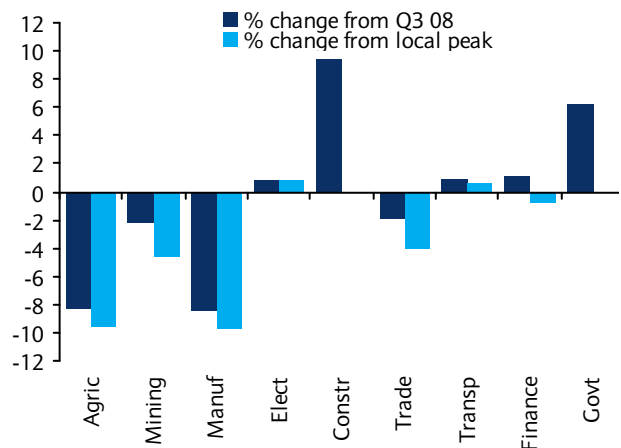
Admittedly, optimism over the consumer recovery is tempered somewhat when variables are considered in level rather than growth rate terms. Auto sales have been growing at a double-digit pace in the first half of the year, but in level terms they are still more than 30% down from their 2006 peaks. Private sector credit extension remains flat-lined, and outside some growth in mortgage extension, other components of consumer credit are actually still shrinking (marginally) on a y/y basis. Part of the explanation may be the labour market where about one million jobs were lost since the

Figure 3: Headline growth in a number of high frequency indicators continues to look encouraging...



Source: South African Reserve Bank, Absa Capital

Figure 4: ...but many highly visible sectors remain well off their peaks when observed in level terms



Source: South African Reserve Bank, Statistics South Africa, Absa Capital

beginning of 2009. While there seems to be some stabilisation in the pace of job losses, it is unlikely that the economy will be able to create sufficient employment opportunities to re-absorb the jobs lost during the recession. This is likely to continue weighing on a faster pace of the recovery in household consumption expenditure.

Investment is also starting to show some signs of life

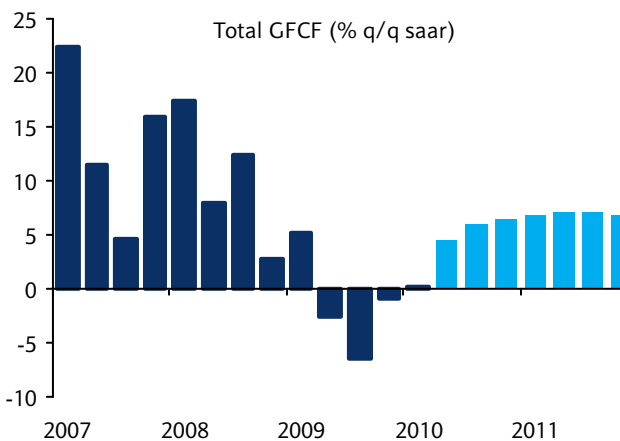
Not only has the consumer side of the economy turned more positive, but so too has investment. Following three consecutive quarters of decline, gross fixed capital formation grew 0.2% q/q in Q1 thanks, in part, to the push on final preparations for the Soccer World Cup. The stronger first quarter performance was mainly the result of a 25.3% q/q increase in public corporation investment and a slow down in the pace of contraction in private sector investment. In contrast, investment by the general government showed a broad based decline, falling 14% q/q after having increased by about 9% the prior quarter. Although the general improvement in overall investment growth is encouraging, we believe it may still take some time for gross fixed capital formation growth to show significant resilience given the amount of slack that was built up in the economy during the recession.

Where business confidence leads, investment is likely to follow

In the first quarter of this year, manufacturing capacity utilisation stood at 78.4% which was a bit lower than the 80% recorded in the final quarter of last year and also below its long term average of about 82%. Despite the still low levels of capacity utilisation, the Chief Economist of the Reserve Bank, Dr Mnyande, noted that capacity utilisation looks to have troughed during the second half of 2009 in about 60% of the industry, with a further 30% only having witnessed a turn in Q1 this year. The recovery in business confidence has also been tepid thus far, though we would be cautious in reading too much into the volatile series. For instance, business confidence jumped 15 points in the first quarter, just to fall back by 7 points in the subsequent quarter. Dr Mnyande suggested that this second quarter fall may point to a normalisation of business growth following a strong surge, rather than a signal of a possible double-dip. We share this view, and note that jitters around Europe’s debt challenges and the strike in the transport sector in May could have also contributed to the decline in business sentiment.

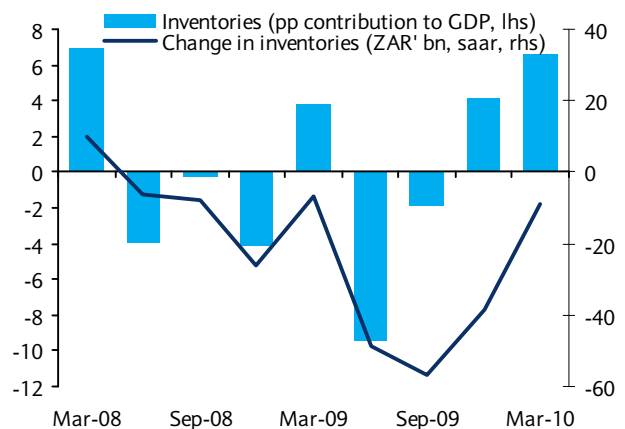
We had expected that companies were likely to have started adding to inventories by the first quarter of this year, but instead the drawdown continued – albeit at a much more subdued pace. Compared with the ZAR38.4bn drawdown in inventories in the final quarter of last year, inventories declined by a more modest ZAR8.7bn in the first quarter of 2010, contributing an impressive 6.7 percentage points to real gross

Figure 5: Investment picking up, but likely to be a slow recovery given the still significant slack in the economy



Source: South African Reserve Bank, Absa Capital

Figure 6: Continued inventory drawdown in Q1 suggests a fair amount of inventory rebuilding still needs to take place



Source: South African Reserve Bank, Absa Capital

domestic expenditure growth in the quarter. Despite the slower pace of destocking, commercial and industrial inventories nonetheless fell to a record low 12.5% of GDP in the first quarter after already having declined to a low 13% in the prior quarter. The Bureau for Economic Research’s second quarter manufacturing sector survey showed that manufacturers who rate the current stocks of finished goods relative to expected demand as “too high” fell to a net 15%, below the survey’s long term average of 18%. This, along with the already record low economy wide inventory levels, suggest to us that a fair amount of inventory restocking will need to take place should demand turn sharply higher.

We see GDP growth of 3.3% this year, with some upside risks

This continues to pose an upside risk to our growth forecast, where we have left our full-year GDP forecast unchanged at 3.3% from our previous Quarterly Perspective. We expect q/q growth rates to remain above 4% for the remainder of the year. In level terms, this would see the economy rise above its previous peak during Q2 10. The impact of the World Cup remains one key uncertainty, where our macro models continue to show little overall impact on GDP (and that impact spread over two quarters).

A post-World Cup slump in infrastructure spend unlikely

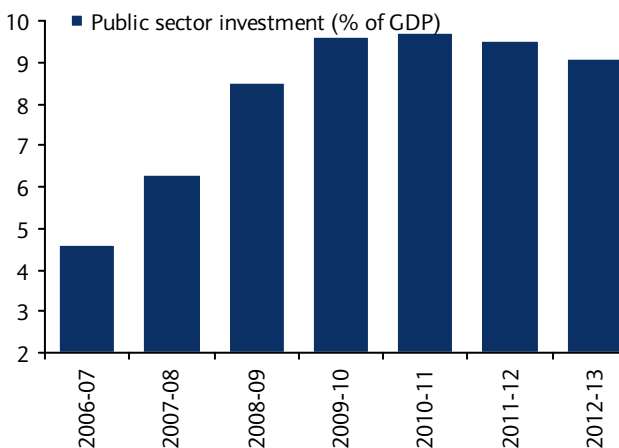
Concerns have been raised that there will be a post-World Cup slump in infrastructure spend, but this sits at odds with the plans of the broader public sector. The National Treasury projects that public sector infrastructure investment spending will be maintained at just above 9% of GDP over the medium term, with the bulk of the spending going towards electricity and transport infrastructure. That said, one area of concern remains the potential lack of capacity at a government level to effectively drive the infrastructure projects.

Where to with interest rates?

Consumer price inflation has impressed to the downside

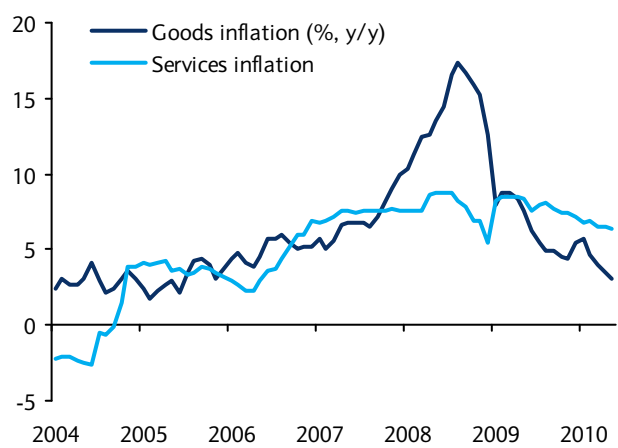
Monetary policy makers, we believe, will remain focused on three key issues. The first, clearly, is inflation, where the recent CPI prints have continued to impress on the downside. At 4.6% y/y in May, consumer price inflation has fallen to its lowest level since May 2006, led by goods’ price inflation (at 3.1% y/y). Food price inflation also remains benign (0.1% y/y) and even the inflationary impact of the rand’s depreciation against the USD since the beginning of the year disappears when considering that on a trade-weighted basis, by mid-July the rand was trading 3% stronger to its Q1 10 average, and 13% stronger than its 2009 average.

Figure 7: Public sector infrastructure plans stretch well beyond the 2010 World Cup preparations



Source: National Treasury, Absa Capital

Figure 8: Goods prices have been driving the moderation in CPI, service prices however remain a concern



Source: Statistics South Africa, Absa Capital

Administered price hikes and wage inflation pose medium- to longer- term upside risks to the inflation outlook

Consumer inflation at current levels and a favourable near-term outlook should provide some comfort to monetary policy makers, but upside risks to the medium- to longer-term outlook remain. Pressure on administered prices, which are already rising at double the inflation target ceiling, are likely to intensify from the second half of the year as electricity tariffs as well as other rates and tax hikes at a municipal level kick in. A recent *Business Day* article indicated that even as the average increase in electricity tariffs are likely to weigh in at around 22% (not much higher than the 20% Reserve Bank assumption), some metropolitan municipalities have applied for substantially higher hikes to the National Electricity Regulator.

Aside from administered prices, wage settlements well in excess of the prevailing rate of inflation and the 6% inflation target upper limit also poses an upside risk to the inflation outlook. This risk was also recently emphasised by SARB Governor Marcus, who said that “wage settlements remain well above inflation, particularly in the public sector. If this is not matched by productivity improvements there are likely to be inflationary consequences.” Even more important than the actual wage settlements is the trend in nominal unit labour cost, which has not been favourable of late. After having moderated from around 11% y/y at the end of 2008 to 5.7% in the third quarter of last year, unit labour cost growth rose to 8.8% in the final quarter of 2009 mainly as a result of nominal wage hikes outstripping increases in labour productivity.

We see inflation remaining below 5% for most of year

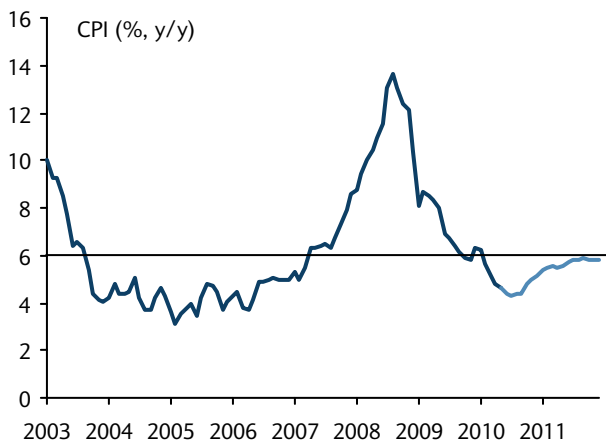
While we believe that consumer price inflation is likely to move higher over the medium- to longer term, the more favourable near term inflation environment has seen us push our 2010 inflation forecast marginally lower again. In our view, consumer inflation is likely to trough at around 4.3% in Q3 and remaining below 5% for most of the second half of the year. We believe that the Reserve Bank’s central forecast is also likely to be tweaked lower in the coming MPCs.

The MPC will also look at the labour market and real economic developments when considering the right monetary policy stance

The second focus issue for the MPC is that of the real economy and whether monetary policy is sufficiently loose to help ensure a smooth recovery path. Judging from a recent speech by Reserve Bank Governor Marcus, the SARB has upgraded its GDP growth forecast modestly to “about 3 per cent” from the 2.7% growth number published at the time of the May MPC meeting. In addition, the upside surprise in May’s retail trade sales and still strong new vehicle sales growth suggest to us that the demand-side recovery is

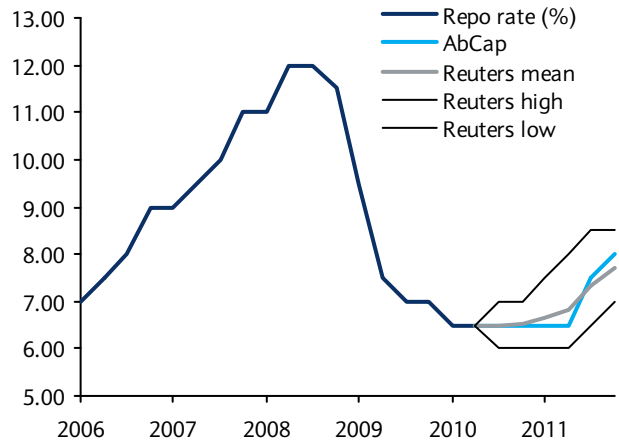
becoming more firmly entrenched. While credit extension remains weak, this may be

Figure 9: Inflation likely to trough in Q3 2010, picking up toward the end of the year



Source: Statistics South Africa, Absa Capital

Figure 10: Interest rates likely to remain low for longer on a still somewhat uncertain global backdrop



Source: South African Reserve Bank, Absa Capital, Reuters Economist (June '10)

more a function of labour market problems than an interest rate problem. It therefore appears that there is little to be gained from further monetary stimulus.

The third focus for monetary policy will be an external one, and reflects the MPC's desire to watch carefully for any sign that the impact of the debt challenges in Europe might generate a spill-over into SA. This received particular attention in the 7 July speech by the SARB Governor where a substantial part of the speech was dedicated to the risks to the global outlook. In the Governor's view, the global environment remains "very challenging" and the sustainability of South Africa's "hesitant, fragile and uneven" recovery depends "on the global recovery in general and in Europe in particular".

We believe interest rates will be left on hold until well into 2011.

There is a minority of analysts that expects further interest rate cuts before the end of this year

Where does this leave the outlook for policy rates? Although the comfortable CPI outlook over the coming months could provide some room for a further rate cut, the generally stronger-than-expected outturn in real economy data suggests that enough monetary stimulus has already been delivered, and together with some uncertainty around the impact from global events argues for a cautious approach to policy. As a baseline, therefore, we do not believe that monetary policy makers are likely to base their interest rate decisions on risks that may or may not materialise. We now expect policy rates to be held at the current 6.5% into mid-2011, after which we expect the hiking cycle to commence as interest rates are normalised.

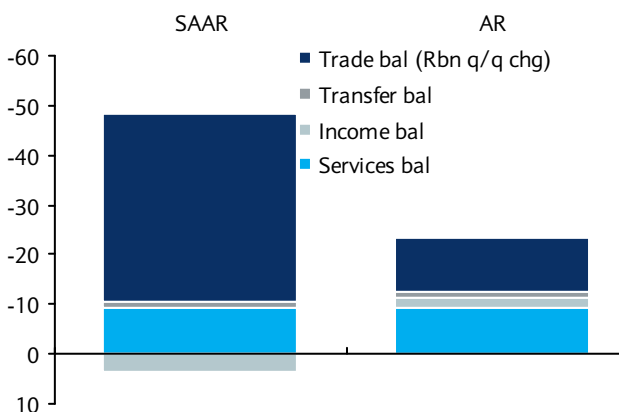
The deterioration in the current account balance, poses little risk to the currency

The headline current account deficit widens to 4.6% of GDP in Q1 10

Turning to South Africa's balance of payments data, the latest Reserve Bank Quarterly Bulletin showed that the current account deficit widened to 4.6% of GDP in the first quarter of 2010 from 2.9% at the end of last year. Looking at the main components of the quarterly annualised current account data, the 1.7pp of GDP deterioration can be decomposed into a 1.5% of GDP deterioration in the trade account, a 0.3% slip in the services account, with transfers flat and net income improving by about 0.2% of GDP.

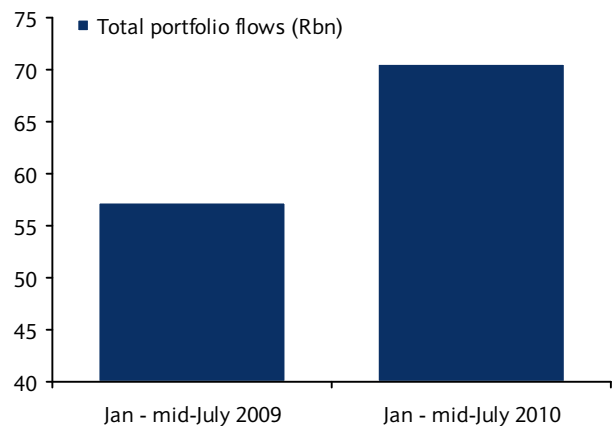
Before becoming overly concerned that the deterioration in the trade account may have resulted from the impact on exports stemming from the macroeconomic problems in some European countries and the strong rand, we would first highlight the way in which the current account figures are presented. The headline numbers reported by the SARB are made on a quarterly seasonally adjusted and annualised adjusted basis. However, as a measure of actual flows through the current account during a particular quarter, the adjusted measure can sometimes distort the actual movement within the

Figure 11: Deterioration in external accounts exacerbated through the seasonal mapping of the data



Source: South African Reserve Bank, Absa Capital

Figure 12: Portfolio flows into SA continue to help the rand and are running ahead of record flows witnessed last year



Source: Bloomberg, Absa Capital

period. Considering the actual non-adjusted, non-annualised data, South Africa's trade balance slipped from +R1.6bn in the fourth quarter of 2009 to -R1.1bn in the first quarter of this year – a deterioration that looks much less dramatic than the headline deterioration from a R25bn surplus in the final quarter of last year to a deficit of R13bn in the first quarter of 2010. Similarly, the current account deficit rose to R24.9bn in the first quarter from R19.1bn in Q4, again a comparison that looks less dramatic than the headline deterioration from 2.9% of GDP to 4.9% of GDP over the same period.

We do not expect the current account deficit to deteriorate significantly beyond the first quarter number

Based on our observation, we do not believe that the first quarter current account deterioration heralds the return to the worries of a few years ago. Admittedly, the domestic economy has grown more quickly, but we believe that the pace of import growth will remain moderate on cautious rather than aggressive optimism from consumers. In addition, even as international markets seem to move from optimism to scepticism on the global growth outlook, we believe that global growth will be sustained at above 4% this year and next, a growth level that is likely to leave commodities well supported. Second and third quarter data may also be well buffered from World Cup flows, but our general sense is that the current account deficit is unlikely to push beyond the first quarter's 4.6% for most of the year.

Portfolio flows are running slightly ahead of last year's record-setting pace, helping to support the rand even as fears over Europe hit some risky assets

In the absence of a marked deterioration in the current account deficit, its financing requirement becomes less onerous and the risk of massive currency volatility also reduces. Global risk appetite, and in particular portfolio flows, have been critical currency drivers. In line with the global trend in emerging market flows, South Africa has continued to see substantial portfolio inflows this year. Through 15 July, net portfolio inflows have totalled about ZAR67bn against the ZAR57bn in inflows over the corresponding period last year. Although there have been periods of volatility, these inflows has generally been sufficient to see the rand retain a broad range against the USD, and to appreciate against other major trading partner countries. On our view that the major moves in G7 currency pairs have already been delivered, fundamentally we see the rand retaining its 7.40-7.90/USD range for the coming quarters.

Fiscal consolidation is a global theme currently, but we expect little policy maker pressure in South Africa as debt levels remain low when compared to our global peers

Despite the increasing focus on fiscal issues globally, we believe that this will remain a peripheral issue in South Africa. Finance Minister Gordhan announced recently that the preliminary 2009-10 budget deficit outcome was 6.7% of GDP (against an official estimate of 7.3%). Our expectation for the economy to perform somewhat better than the Treasury's estimates is likely to lead to the budget deficit narrowing to around 5.7% in 2010-11. Although there is a global push towards a greater commitment to deficit normalisation, South Africa's favourable starting point in terms of debt levels means that an explicit tightening of fiscal policy through hiking existing taxes or cutting expenditure remains unlikely. Rather, the introduction of perhaps new consumption-based "green" taxes similar to the vehicle emissions tax introduced in the past budget, and not fully compensating tax payers for the effects of bracket creep, could see an implicit tightening of fiscal policy as the tax burden creeps modestly higher in coming years.

Figure 13: South African macroeconomic forecast summary

	2009				2010				2011				2009	2010F	2011F
	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Real GDP (% q/q saar)	-7.4	-2.8	0.9	3.2	4.6	4.4	4.3	4.2	4.2	4.3	4.3	4.4	-1.8	3.3	4.3
Real GDP (% y/y)	-0.7	-2.7	-2.2	-1.6	1.4	3.3	4.1	4.4	4.3	4.3	4.3	4.3	-1.8	3.3	4.3
Pvt consumption (% q/q saar)	-5.8	-5.2	-1.9	1.6	5.7	3.9	3.8	3.9	4.1	4.3	4.5	4.7	-3.1	2.6	4.1
Public consumption	6.7	0.8	8.2	2.1	7.3	0.7	3.3	3.3	3.3	3.3	3.3	3.4	4.7	4.0	3.2
Investment	5.2	-2.5	-6.5	-0.9	0.2	4.4	5.9	6.5	6.8	7.0	7.0	6.9	2.3	0.8	6.6
Exports	-56.9	-12.6	11.0	20.0	-15.3	7.4	5.7	6.7	6.9	7.3	7.9	8.3	-19.5	2.2	7.0
Imports	-28.7	-36.2	-1.0	26.2	14.2	9.6	8.8	8.4	8.5	8.6	8.8	9.0	-17.4	8.3	8.7
Prices (% y/y)															
CPI inflation	8.4	7.7	6.4	6.0	5.7	4.6	4.3	5.0	5.4	5.6	5.8	5.8	7.1	4.9	5.7
Core CPI (ex food/fuel)	8.1	8.6	7.8	6.9	5.8	4.7	4.8	4.9	4.9	5.0	5.0	5.1	7.9	5.1	5.0
PPI inflation	7.2	-1.5	-3.8	-1.3	3.3	6.3	7.4	6.5	6.3	6.2	6.1	5.6	0.2	5.9	6.1
External and Govt accounts															
Current account (% of GDP)	-6.7	-3.5	-3.1	-2.9	-4.6	-3.9	-4.3	-4.7	-4.9	-5.0	-5.1	-5.1	-4.0	-4.4	-5.0
Government balance (% GDP)*	...	...	...	...	...	...	...	...	...	...	...	...	-6.7	-5.7	-4.8
Currencies (average)															
USD/ZAR	9.97	8.48	7.81	7.50	7.51	7.54	7.67	7.67	7.81	7.86	7.92	8.15	8.44	7.60	7.94
EUR/ZAR	13.00	11.56	11.16	11.09	10.41	9.61	9.24	9.33	9.77	9.82	9.90	10.18	11.70	9.64	9.92
GBP/ZAR	14.31	13.15	12.81	12.25	11.74	11.25	11.40	11.86	12.50	12.57	12.68	13.08	13.13	11.56	12.71
EUR/USD	1.30	1.36	1.43	1.48	1.39	1.27	1.20	1.22	1.25	1.25	1.25	1.25	1.39	1.27	1.25
GBP/USD	1.43	1.55	1.64	1.63	1.56	1.49	1.49	1.55	1.60	1.60	1.60	1.61	1.56	1.52	1.60
Commodity prices															
Gold price (USD)	908	915	960	1101	1110	1196	1215	1235	1070	1022	987	960	971	1189	1010
Brent crude oil price (USD)	45	59	68	75	76	79	81	85	86	88	90	91	62	80	89
Interest rates (eop %)															
Repurchase rate	9.5	7.5	7.0	7.0	6.5	6.5	6.5	6.5	6.5	6.5	7.5	8.0	7.0	6.5	8.0
Prime rate	13.0	11.0	10.5	10.5	10.0	10.0	10.0	10.0	10.0	10.0	11.0	11.5	10.5	10.0	11.5

Note: *Refers to start of the fiscal year. Source: SARB, National Treasury, Absa Capital.

GLOBAL OUTLOOK: SLOUCHING TOWARDS THE NEW NORMAL

With cyclical factors supporting global growth for the next two to three quarters...

...we focus on the more medium-term secular forces that will be the key drivers of growth in 2011

In past publications we have highlighted that global economic momentum remains positive. Incoming data suggest, for example, that manufacturing output is booming in most economies. Also, we believe that cyclical factors, including unprecedented policy stimulus and inventory rebuilding, will support global production for the next two or three quarters.

With cyclical forces having driven growth over the past six quarters, we focus on the more medium-term secular forces that will likely be the key drivers of growth in 2011. Those forces will, in our view, be determined largely by three major factors: the longer-term implications of the European debt crisis; the effects of the changes in banking regulation; and management of the policy-induced soft landing in China.

Peripheral Europe's debt problem

The European mega-package was effective in short-circuiting negative feedback loops and preventing a restructuring

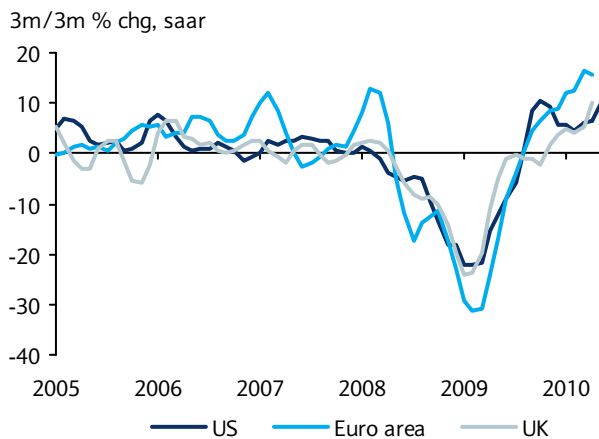
Absent the 9 May mega-package, market dynamics may have forced one or more of the countries in the euro periphery to restructure. In that respect (short circuiting the negative feedback loops), we think the package was reasonably successful. But it has not dispelled solvency concerns, and yields have remained elevated, in some cases trending higher again.

Obviously, dispelling such concerns was never the program's intention. Indeed, some market pressure is still needed to encourage countries to continue making the required fiscal adjustments to stabilize debt dynamics. However, if yields continue to move higher, new measures could be needed.

Greece's fiscal realities remain challenging, but a near-term restructuring appears unlikely

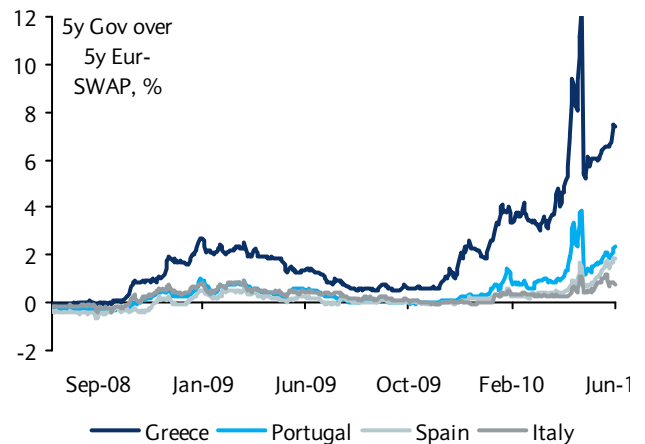
Greece's fiscal realities have not changed; the required fiscal adjustments remain unprecedented for a country that is expected to grow little over the next few years. However, barring implementation risk of the mega-package (including an unlikely but not fully discarded negative ruling by the German Constitutional Court), a near-term Greek restructuring appears unlikely. This is not to say, however, that yields should fall significantly from current levels. This is because recovery values are projected to be low, and beyond one year, default probabilities are high. This suggests that Greek yields will remain elevated and that the country will be out of the markets for some time.

Figure 14: Manufacturing production growing sharply



Source: Barclays Capital

Figure 15: Peripheral Europe yields are lower, but still elevated



Source: Bloomberg, Barclays Capital

Spain has attracted attention recently because of its size and banking sector problems

The need to reduce market nervousness suggests that Spain could choose to draw resources from the EU-IMF pre-emptively

Given overinvestment during the credit boom years, commercial real estate is by far the riskiest segment in banks' portfolios

We expect credit conditions in Spain to remain tight as banks continue deleveraging

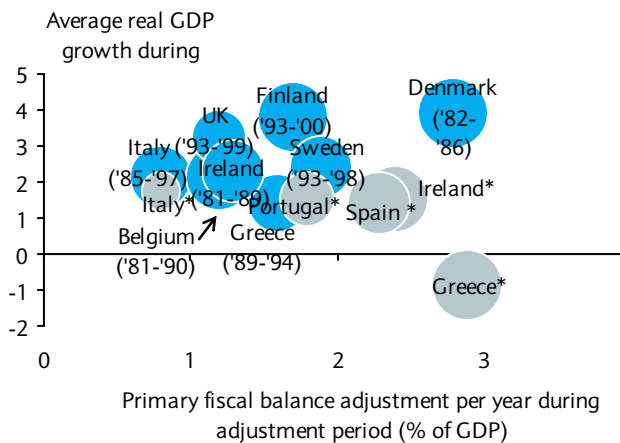
Among the other countries in the euro periphery, Spain has attracted the most attention recently because of its size and potential problems associated with its banking system's involvement in the real estate sector after the bubble burst. Spain's sovereign debt dynamics are not as bad as Greece's and should not be a huge source of market concern. But deterioration over the past few years implies that the fiscal room to absorb potential banking system losses is much smaller, and the possible credit crunch associated with banking system problems could slow growth in a way that negatively affects debt dynamics. The need to reduce market nervousness (which can quickly spiral out of control) suggests that Spain could choose to draw resources from the EU/IMF pre-emptively.

We believe that Spanish banking system losses are manageable. Yet with unemployment hovering around 20%, deflating housing prices (down 13% from the peak in mid-2007), and rising funding costs, credit institutions will likely face further increases in problem loans in the second half of 2010, as well as shrinking profitability. While most of the banks and the larger savings institutions should be able to absorb additional portfolio losses, some of the medium-sized and small saving banks may need to go through the restructuring and resolution process, which has already started under the financial support of a government-sponsored program (the "FROB").

Given overinvestment in the real estate sector during the credit boom years, commercial real estate is by far the riskiest segment in banks' portfolios. Bank of Spain data show that the system has approximately USD445bn of exposure to the commercial real estate sector (25% of total bank credit to residents, or about 45% of GDP). Of this total, approximately USD166bn is in 'problem loans' (calculated as the sum of doubtful loans, substandard loans, foreclosed assets, and loan write-offs). Current provisions cover 35% of these potential losses, and considering expectations of net income for this year, the collateral value of the loans could fall at least 50% (and probably as much as 70%) before the banking system incurs further losses.

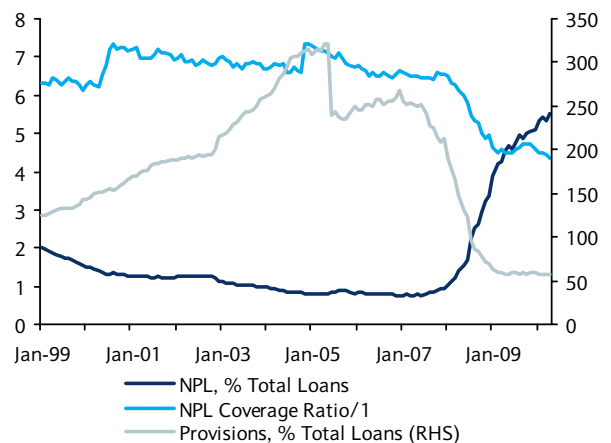
We expect credit conditions in Spain to remain tight as banks continue deleveraging. Credit institutions have reportedly started to dispose of real estate assets, forced in part by tighter provisioning requirements from the Bank of Spain. Sales of large stocks of real estate held by banks will likely push real estate prices down further, contributing to imbalances in the real estate sector.

Figure 16: Fiscal adjustment in peripheral Europe in context



Note: *Light blue bubbles show adjustment needs 2010-14. Size of bubble = total primary balance adjustment (% GDP). Source: Eurostat, Greece Ministry of Finance, Haver, Barclays Capital

Figure 17: Indicators of the Spanish banking system



/1: NPLCR = (Capital + Provisions - NPLs), % Assets Source: Bank of Spain, Barclays Capital

Change in the policy mix

Debt sustainability concerns are not exclusive to the euro periphery ...

Debt sustainability concerns are not exclusive to the euro periphery. According to the IMF, the expected increase in debt-to-GDP ratios in advanced economies (considered the announced fiscal plans) will be approximately 37pp between 2007 and 2015. Figure 18 shows both the stock of gross debt and the primary fiscal adjustment required to reduce debt-to-GDP ratios to pre-crisis levels (as a percentage of GDP and of government revenues). An observation of solvency ratios encompassing a subset of advanced economies suggests that while the euro peripheral countries are, on average, worse than Japan, the UK and the US, the differences are not enormous. Also, the euro area as a whole has the best solvency ratios in the G4.

...but differences in yields are large because of safe-haven status and credibility

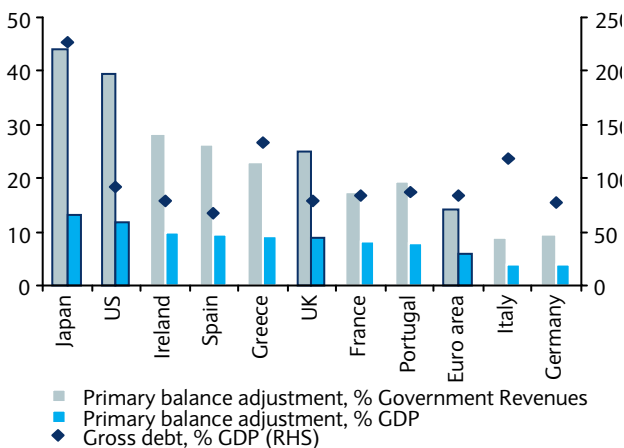
Small differences in debt dynamics but larger variances in yields are related to safe-haven status (for the US and Japan), credibility in the countries' ability to make fiscal adjustments, and the ability to (if everything else fails) use central bank balance sheets to buy government bonds. But there is an element of circularity here. If markets were to start questioning the ability of these core countries to stabilize debt dynamics, changes in yields could be abrupt. Cognizant of those potential risks and how rapidly market dynamics can change, we believe that a strong case can be made for a pre-emptive initiation of the required fiscal consolidation, even if current yields suggest that it is not something that markets are demanding right now. Recent tightening measures in the UK and Germany, while only down payments on the consolidation that will ultimately be required, have provided a useful signal of the countries' willingness to shift public finances onto a more sustainable footing. In the coming quarters, investors may look for similar signals from Japan, the United States, and other systemically important economies with challenging fiscal situations.

However, yields can change abruptly if the market starts questioning the ability to adjust

Independent of whether policymakers decide to bring debt-to-GDP ratios back to pre-crisis levels or stabilize them at higher post-crisis levels, the magnitude of fiscal adjustment needed will be sizable; and for the foreseeable future, public debt levels will remain high in the systemically significant industrial economies. This implies both that fiscal retrenchment will likely be a drag on domestic demand in the next few years and that, in advanced economies, fiscal policy will not be a serious countercyclical policy tool.

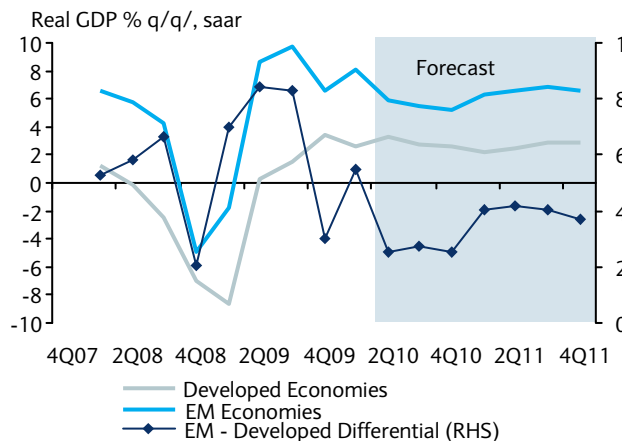
This last point is not immediately relevant in light of our view that the global economic recovery is self-sustaining and unlikely to need additional policy support in the near future. But as we emerge from the current cycle, virtually every systemically important economy in the world, other than China, will be saddled with public debt that is likely to

Figure 18: Gross debt and required fiscal adjustment



Source: IMF, Barclays Capital

Figure 19: Growth rotation



Source: Barclays Capital

preclude the kind of counter-cyclical policy response that was available in 2008-09. A useful case in point is Italy, which was unable to mount an ambitious fiscal response to the recent recession because its public debt was so high, at roughly 100% of GDP. The fiscal constraints that applied to Italy are likely to apply to major industrial economies almost across the board. This is a sea change in the global economy that will likely amplify downside economic risks over the longer run.

Fiscal consolidation should lead directly to a reduction in demand, but countervailing adjustments will likely be created elsewhere

Turning to the immediate future, measuring the effect of fiscal consolidation on growth is not a straightforward exercise. The direct effect will, of course, be a reduction in demand. But that should trigger changes in interest rates, exchange rates, and other relative prices that will create countervailing adjustments in demand elsewhere in the economy. In a process as gradual and generally foreseeable as the fiscal adjustments in the industrial economies are likely to be, there is plenty of time for changes to be made. Also, these adjustments will, of course, be facilitated by monetary policy, which will likely need to remain loose for a long time to offset the fiscal tightening.

Monetary policy needs to remain loose for longer to offset fiscal tightening, as well as ongoing banking system concerns

Monetary policy will also likely need to remain loose because of ongoing concerns about the banking system, particularly in Europe. The health of the European banking system has been called into question recently as a result of potential exposure to countries under sovereign stress, making it vulnerable to the increase in wholesale funding costs associated with the increase in sovereign risk. We do not want to downplay those risks, but as Figure 20 shows, exposure to peripheral Europe assets is moderate, and to the extent that we do not see an escalation of sovereign problems, risk should be easily contained.

A much more important force is global financial regulation, which will likely reduce the supply of credit to the economy

Potentially much more important are the upcoming global financial regulatory changes, which, while still uncertain in terms of detail, suggest some clear objectives: raising capital ratios, improving liquidity requirements, relying on longer-term wholesale and deposit funding, and increasing bank taxes. This suggests a higher cost of funding, lower bank profits, and smaller balance sheets and is likely to reduce the supply of credit to the economy and affect growth, suggesting another reason monetary policy is likely to remain loose – to help offset these forces.

A much more important force is global financial regulation, which will likely reduce the supply of credit to the economy

As long as there are no observed trade-offs, a policy mix of tighter fiscal/looser monetary is not necessarily a problem for the growth outlook, and we are not reducing our growth projections for advanced economies. But if inflation expectations in advanced economies were to increase, monetary policy could be more constrained. Downward risks to our growth projection have certainly increased.

Figure 20: Banks' holdings of Greek and southern European assets

	France	Germany	US
Holdings of Greek assets			
Amount (\$bn)	78.8	45.0	16.6
Share in the total external claims of the banking sector (%)	2.1	1.4	0.7
Share in total banking sector assets (%)	0.8	0.5	0.1
Banking sector capital and reserves (\$bn)	354.0	413.0	1,410.0
Holdings of Greek, Portuguese and Spanish assets			
Amount (\$bn)	334.9	330.4	79.3
Share in the total external claims of the banking sector (%)	9.1	10.1	3.2
Share in total banking sector assets (%)	3.6	3.7	0.6

Source: BIS Locational and Consolidated Banking Statistics April 2010, OECD Banking Statistics 2009, Barclays Capital

Inflation expectations could increase for a number of reasons, including reduced output gaps. In that case, there would be no problem tightening monetary policy, as it would be the optimal policy response to a demand-driven increase in inflation and inflation expectations. If an increase in inflation expectations were driven by commodity price increases (say, from strong growth in EM), it is not obvious that monetary policy would need to be tighter, except to the extent that the supply-side shock begins to affect expectations and underlying inflationary pressures, which is likely to be modest if industrial country output gaps are large.

The biggest problem could arise if high debt-to-GDP ratios and incomplete fiscal adjustments lead to concerns about more sustained deficit financing, the creation of seigniorage, and efforts to partly liquefy public debt. It is worth noting that a perceived linkage between public sector debt problems and monetary policy (called “fiscal dominance” of monetary policy in emerging market economies) need not be a high probability base case to complicate monetary policy management – even if “fiscal dominance” is perceived as a low probability but significantly disruptive outcome, it can affect asset prices and the economy.

We think secular variables will play a more significant role in 2011 and beyond; growth in advanced economies is likely to be slower and more volatile than before the crisis

To summarize, as we think about 2011 and later, secular variables beyond the cyclical bounce are likely to play a more significant role. Growth in advanced economies is likely to be not only slower than before the crisis but also, perhaps, more volatile. Monetary policy could play an increasingly important role in offsetting both the upcoming fiscal consolidation and tighter banking regulations.

Emerging Markets are different

The outlook for EM countries is different – low debt ratios mean there is no need for fiscal consolidation

It is always dangerous to claim decoupling, but the outlook for most EM countries is different from the above scenario. Precisely because they were not provided with the financial rope to hang themselves, their debt-to-GDP ratios are significantly lower than in advanced countries – there is no need for fiscal consolidation; hence, it is unlikely to be a drag on growth.

Slower growth in advanced economies is not neutral for EM growth, but EM performance over the past few years supports the view that the beta of EM growth to advanced economies has declined, absent global disturbances. We expect emerging markets to continue on the decoupling path started around the beginning of the last decade and interrupted briefly by the Lehman Brothers collapse.

Figure 21: EM tightening at full steam

2009-Q2 10	2010		2011		
	Q3	Q4	Q1	Q2	Q3
Brazil	Korea	China	Colombia	Euro area	South Africa
Chile	Thailand	Indonesia	Czech	Egypt	
India		Philippines	Mexico	Hong Kong	
Israel		Sri Lanka	Poland	US	
Malaysia		Turkey			
Peru					
Vietnam					
Australia					
New Zealand					
Taiwan					

Source: Barclays Capital

This differentiated outlook implies that monetary policy normalization will continue

The differentiated growth outlook implies that monetary policy normalization will continue among EM economies. The process is likely to be uneven (Latin American countries seem to be willing to tighten earlier than Asian and Emerging European countries), but the increase in interest rate differentials, coupled with higher risk-adjusted growth, is likely to continue.

Have the risks increased in China? Only marginally

China has been a huge source of stability, but two recent developments require scrutiny

China has been a huge source of stability for the global economy over the past 18 months, and we expect this to continue over the next several quarters, but two recent developments require scrutiny: the potential effects of the deflation of the real estate sector bubble and recent wage pressures, which suggest that the days of surplus labour may be coming to an end.

We see the Chinese wage increase as more benign and a natural result of rapid growth and, hence, a relative scarcity of labour

Of the two, the wage increase has attracted more attention recently but is likely to be the more benign. We believe that China may be reaching a phase at which labour is becoming scarcer, and as a result, wage increases may continue. We see this as a natural result of high growth, an improvement in rural sector conditions, and Chinese demographics. However, we do not expect the wage increases to result in significant near-term inflationary pressure, as they have been confined to a few coastal cities and profit margins are likely to absorb some of the increase.

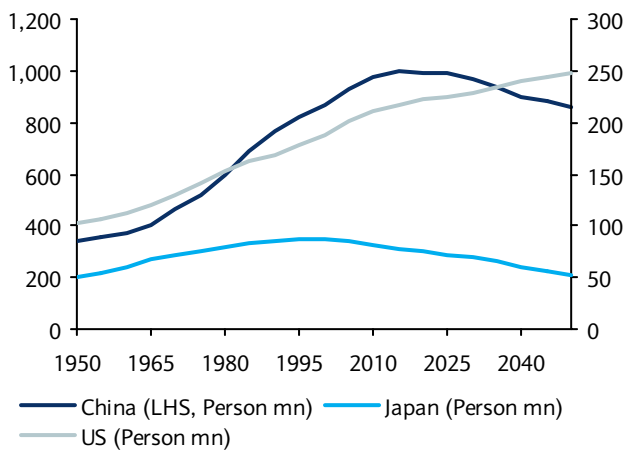
We are not overly concerned about near-term inflationary pressures or the negative effect on import demand for now

At the same time (and using the Japanese and Korean experiences as an example), over the medium term, this may result in somewhat lower growth and higher inflation. But the effect on import demand from the rest of the world should be modest, as Chinese GDP growth in constant dollars is unlikely to be affected, even if lower in constant renminbi terms.

The policy-induced deflation of the real estate bubble carries implementation risks...

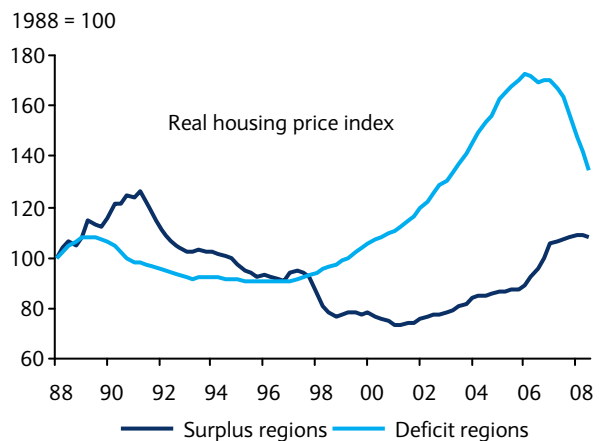
The policy-induced deflation of the real estate bubble carries more implementation risks, in our view. We expect housing prices to decline 20-30% over the next few quarters. In countries with different characteristics, a correction of that magnitude could lead to a hard landing, but China may be exceptional. One key difference is that Chinese consumption is unlikely to be affected by housing prices through the wealth effect. Indeed, in our view, this is neutral, as 50% of the population lives in rural areas where there is no active property trading, and low income and migrant workers could benefit from housing price declines, as they would become more likely to buy. Another important difference is that most countries that experienced asset price bubbles in the

Figure 22: China's working age population to peak soon



Source: Haver, UN, Barclays Capital

Figure 23: Housing price bubbles associated with deficits



Note: Regional housing price indices are weighted by GDP. Surplus region index includes Germany, China, Korea, HK, Indonesia, Taiwan, Russia, and Norway. Deficit region index include US, UK, Australia, and Spain.
Source: Haver, Barclays Capital

past also ran current account deficits and, hence, were vulnerable once capital stopped flowing. This is not the case in China, which is an exporter of capital. Perhaps most important, the main channel through which housing price deflation typically affects economic activity and leads to an undershooting of the correction is banking. Again, China is somewhat different in this respect. Mortgage-related loans represent approximately 20% of total loans. Even a 30% reduction in housing prices is unlikely to wipe out bank capital (CAR is at 10%, and 17% of deposits are kept at PBOC as reserve requirements). But even if bank capital were wiped out, banks are unlikely to limit credit lending to the non-bank sector; since they are state owned for the most part, credit conditions would be determined by top-down political directives.

This is not to say that there are no implementations risks, as errors can be made and we must be vigilant, but we should not automatically extrapolate the deflation of housing price bubbles in other countries to China, as the country's peculiarities suggest that the outcome is likely to be different.

Figure 24: Summary of Barclays Capital economics projections: GDP and inflation

	Weight*	Real GDP % y/y					CPI inflation % y/y**				
		2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Canada	1.8	2.5	0.5	-2.5	3.8	3.1	2.1	2.4	0.3	1.9	2.2
US	20.5	2.1	0.4	-2.4	3.6	3.5	2.9	3.8	-0.4	1.7	1.7
North America	24.4	2.2	0.4	-2.4	3.6	3.5	2.8	3.7	-0.3	1.7	1.7
Argentina	0.8	8.7	3.3	-4.0	6.1	3.8	18.4	26.7	16.3	22.8	27.2
Brazil	2.9	6.1	5.1	-0.2	7.3	4.4	4.5	5.9	4.3	6.1	5.0
Chile	0.3	4.7	3.7	-1.5	4.2	6.6	4.4	8.7	1.5	1.9	3.5
Colombia	0.6	7.5	2.4	0.4	4.5	4.3	5.5	7.0	4.2	2.2	3.1
Mexico	2.1	3.3	1.5	-6.5	5.0	3.6	4.0	5.1	5.3	4.4	3.8
Peru	0.4	8.9	9.8	0.9	7.1	6.4	1.8	6.7	0.2	2.7	2.7
Venezuela	0.5	8.4	4.8	-3.3	-5.4	2.0	18.7	30.9	25.1	34.3	29.3
Latin America	5.6	5.9	3.9	-2.5	5.0	4.1	6.5	10.0	7.2	9.1	8.5
The Americas	30.0	3.1	1.3	-2.5	4.0	3.6	3.4	2.8	2.6	2.6	2.5
Austria	0.5	3.4	1.8	-3.4	1.1	2.5	2.2	3.2	0.4	1.7	1.7
Belgium	0.6	2.8	0.8	-3.0	1.5	2.5	1.8	4.5	0.0	2.4	2.0
Finland	0.3	4.9	1.2	-8.1	0.5	2.4	1.6	3.9	1.6	1.6	1.6
France	3.0	2.3	0.1	-2.5	1.3	1.8	1.6	3.2	0.1	1.7	1.5
Germany	4.0	2.6	1.0	-4.9	2.0	2.5	2.3	2.8	0.2	1.2	1.3
Greece	0.5	4.5	2.0	-2.0	-3.1	-2.7	3.0	4.2	1.3	4.5	2.4
Ireland	0.3	6.0	-3.0	-7.1	0.0	1.6	2.9	3.1	-1.7	-2.1	-1.3
Italy	2.5	1.4	-1.3	-5.1	1.2	1.6	2.0	3.5	0.8	1.5	1.6
Netherlands	0.9	3.6	2.0	-4.0	1.3	2.1	1.6	2.2	1.0	0.8	0.8
Portugal	0.3	2.4	0.0	-2.6	1.1	0.1	2.4	2.7	-0.9	0.8	1.0
Spain	2.0	3.6	0.9	-3.6	-0.9	-1.1	2.8	4.1	-0.2	1.9	1.9
Euro area	15.1	2.8	0.4	-4.1	1.1	1.8	2.1	3.3	0.3	1.6	1.5
Norway	0.4	5.4	2.0	-1.5	1.5	2.4	0.7	3.8	2.2	2.5	1.9
Sweden	0.5	2.7	-0.6	-5.1	3.3	2.9	2.2	3.4	-0.3	1.1	1.7
UK	3.1	2.6	0.6	-4.9	1.2	2.4	2.3	3.6	2.2	3.1	3.0
W Europe	19.8	2.8	0.5	-4.1	1.1	1.7	2.1	3.3	0.6	1.7	1.7
Czech Republic	0.4	6.1	2.5	-4.1	1.1	2.8	5.5	3.6	1.0	2.0	1.8
Hungary	0.3	1.2	0.6	-6.3	1.1	3.6	7.4	3.5	5.6	2.9	3.1
Poland	1.0	6.8	4.9	1.7	2.9	3.3	4.2	3.3	3.5	2.3	2.3
Central Europe	1.8	6.2	3.9	-1.3	2.3	3.4	3.4	4.0	3.0	2.4	2.5
Russia	3.0	8.1	5.6	-7.9	4.5	5.0	11.9	13.3	8.8	6.1	6.8
Turkey	1.2	4.7	0.9	-4.7	6.3	4.0	8.4	10.1	6.5	7.7	6.9
Europe	27.1	3.7	1.3	-4.4	1.8	2.1	2.8	4.2	1.4	2.2	2.2
Australia	1.2	4.0	2.4	1.3	3.4	3.9	2.3	4.4	2.1	3.3	3.4
PR China	12.5	14.2	9.6	8.7	10.1	9.0	4.8	5.9	-0.7	3.5	3.5
Hong Kong, SAR	0.4	6.4	2.2	-2.8	5.1	4.0	2.0	4.3	0.5	2.5	2.5
China, Taipei	1.0	5.7	0.7	-1.9	7.5	4.0	1.8	3.5	-0.9	1.2	1.8
India	5.1	9.4	7.4	6.7	8.8	8.3	4.7	8.4	3.8	7.0	5.5
Indonesia	1.4	6.3	6.1	4.5	6.4	6.3	6.4	10.3	4.3	4.5	5.8
Japan	6.0	2.3	-1.2	-5.2	3.4	1.7	0.0	1.5	-1.3	-1.0	-0.3
Malaysia	0.5	6.2	4.7	-1.7	7.5	5.0	2.0	5.4	0.6	1.5	1.8
Philippines	0.5	7.1	3.7	1.1	6.0	5.0	2.8	9.4	3.2	4.4	3.7
Singapore	0.3	7.8	1.8	-1.3	9.5	4.0	2.1	6.6	0.6	2.8	1.7
South Korea	1.9	5.1	2.2	0.2	5.7	4.0	2.5	4.7	2.8	2.6	1.5
Asia	31.6	8.5	5.3	3.7	6.6	6.4	2.8	3.5	-0.8	2.4	2.7
South Africa	0.7	5.5	3.7	-1.8	3.3	4.5	7.1	11.5	7.1	5.0	5.7
G10	43.4	2.4	0.3	-3.6	2.8	2.6	2.1	3.3	0.0	1.4	1.5
Above countries	96.0	5.3	2.9	-0.8	4.7	4.3	3.1	4.3	0.9	2.5	2.4

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