An end to recession?

Estudio elaborado por

Atradius Economic Reseach

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Contents

All views expressed here are those of Atradius Economic Research and represent ongoing research into the determinants of corporate insolvency and the impact of the economic cycle within Atradius. The views do not represent an expression of intent and should not be seen as investment advice. Macroeconomic forecasts are subject to considerable judgement and uncertainty and bespoke forecasts contained herein represent our best estimates given the current environment. Not only are these forecasts subject to change given different economic information, materialised outcomes may also depart considerably from forecasts. Atradius cannot be responsible for any decision taken on the basis of these forecasts.

Executive summary

- **All major developed markets experienced an economic contraction in 2009**. The Eurozone economies shrank by 3.8% compared to 2008, in what can be characterised as the deepest and most synchronised global recession since the Great Depression.

- **Recent evidence suggests that the rate of contraction in output has slowed.** The outlook for economic activity is now indicative of a modest recovery in developed markets during 2010, although performance will vary markedly. Consensus GDP expectations suggest that the United States will rebound quickly in 2010 whereas in Eurozone and UK the upturn will remain more muted, displaying below-trend growth of 1.2%.

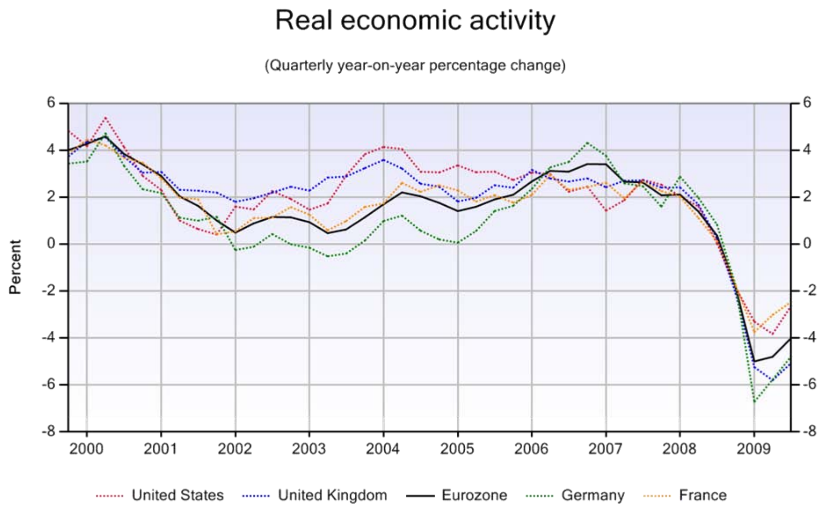
- **While the consensus opinion is that we have reached the bottom of the negative cycle there is still considerable uncertainty around the sustainability of the recent pick-up.** The recovery process is fragile and we attach significant downside risk to the main scenario.

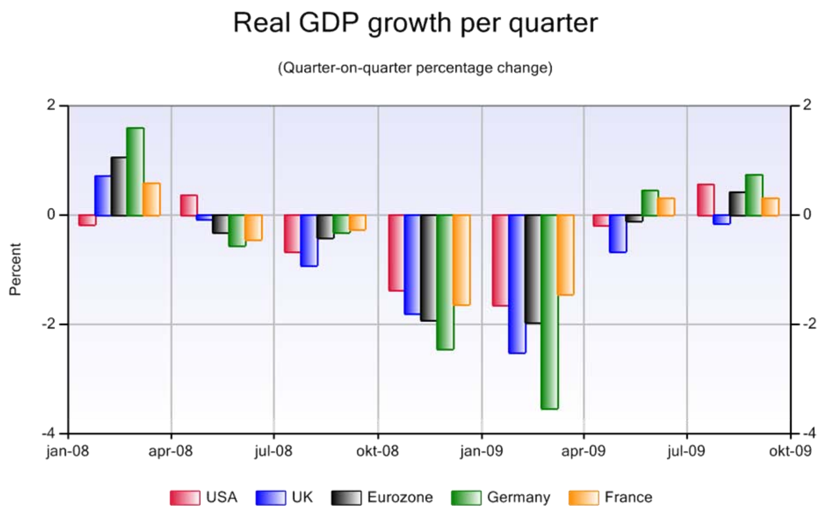
- **Unprecedented fiscal and monetary policy stimulus is currently supporting economic activity in our major markets.** These actions have already resulted in a steep increase in public indebtedness and the need to ensure an orderly exit from these stimulus programmes in becoming increasingly critical. Emerging fiscal constraints coupled with an unclear path for interest rates and credit conditions translate into an unusually high degree of forecast uncertainty.

- **The main scenario of emergent economic recovery implies that we will see a moderation in insolvency growth throughout 2010.** Several advanced economies are projected to see slight improvements in the insolvency environment, although a few large Eurozone countries are expected to continue witnessing increasing insolvency numbers. Despite these expected improvements, a prolonged period of weak corporate credit conditions is anticipated. Economic recovery will not herald an immediate return to the benign insolvency conditions that prevailed prior to the onset of the crisis.

- Executive summary
- **The outlook for economic activity**
- Implications for the insolvency environment
- Risks to the current outlook

Advanced economies start to recover…

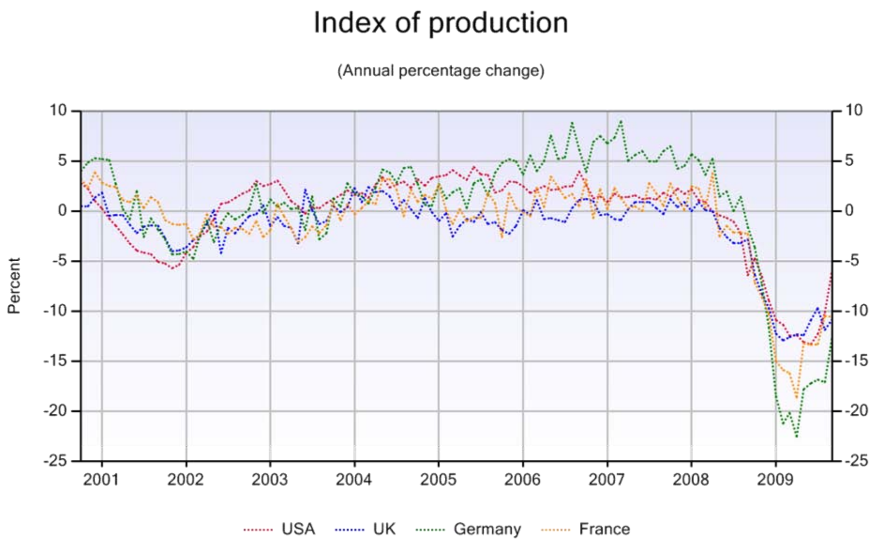


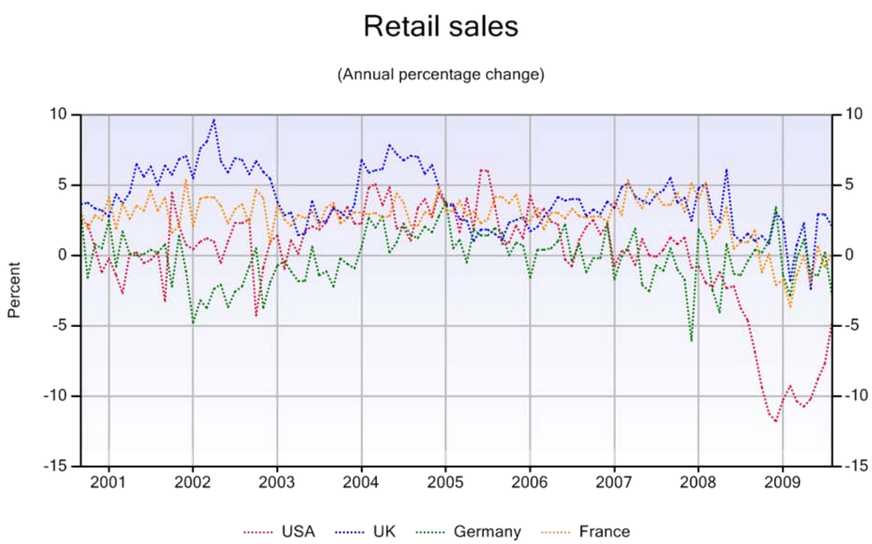


- Advanced economies succumbed in a remarkably concerted fashion to the credit crisis. Financial losses affected collateral values, credit availability and confidence, which in turn translated first into moderating economic activity and then into outright contraction.
- The scale of this downturn has been so dramatic that it has led to a contraction in global GDP in 2009 – the first in the post war era. Some major markets saw extreme falls in output: e.g. German GDP contracted some 6% (y-o-y) in the first quarter of 2009.
- There was a wide scale disruption of economic activity as order books, inventories, investment and exports all fell at a record pace. Had it not been for extensive state support both to the financial sector and to domestic consumption, the recorded contraction would doubtless have been steeper.
- This support has also meant that the annualised pace of contraction has slowed as the year has progressed. More pertinently, major Eurozone and US economies have started to grow again (in quarter-on-quarter terms).
- The Eurozone, for instance, exited from recession in the third quarter with GDP growth of 0.4%, while the corresponding figure for the USA was 2.8%. Of the major global economies, Japan and the UK continue to act as a drag on this recovery process.

Source: Global Insight.

…as production and sales slowly pick up…





Source: Global Insight.

- Industrial production in several major markets fell extremely sharply. Mirroring the contraction in aggregate demand, German industrial production fell over 20% in annualised terms during the second quarter of the year. However, in recent months the pace of decline has slowed, leading to the hope that recovery is becoming entrenched.
- While certainly a positive sign, the modest pace of the pickup suggests it will take some time to get back to pre-crisis output levels. In several countries, schemes such as ‘cash for clunkers’ have had a beneficial impact in terms of supporting production and spending, but their ability to create a sustained increase in consumption remains debateable.
- The magnitude of the fall in industrial production implies that many firms have idle capacity, which in turn will make them wary of upgrading plant and equipment and/or engaging in any expansion. The current recovery should be considered incipient at this stage and we require firmer evidence through sustained growth in several components of demand.
- Domestic sales, though depressed, have displayed less aggressive contraction compared to the production side. Once again it is arguable that measures in specific countries, such as the temporary VAT cut in the UK, have provided some support. Expectations for a sequential removal of these public support measures over time add considerable uncertainty to the forecast.

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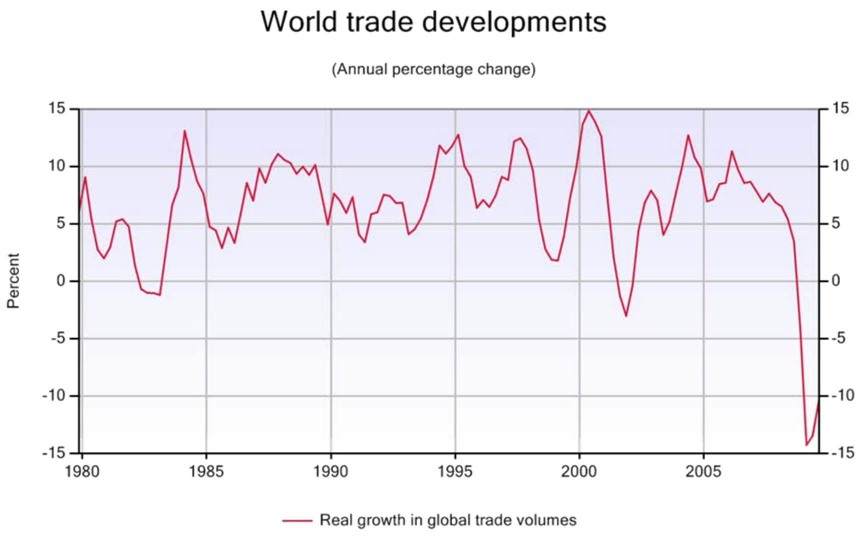
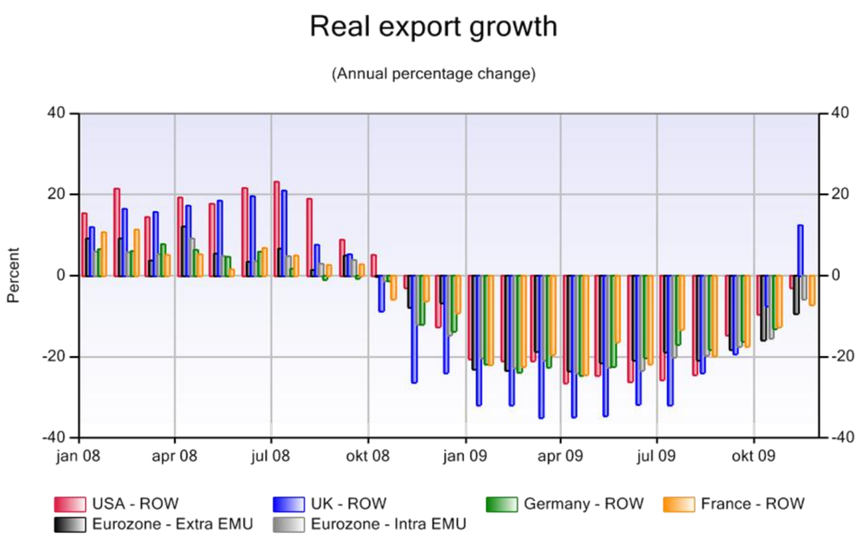
…together with world trade.

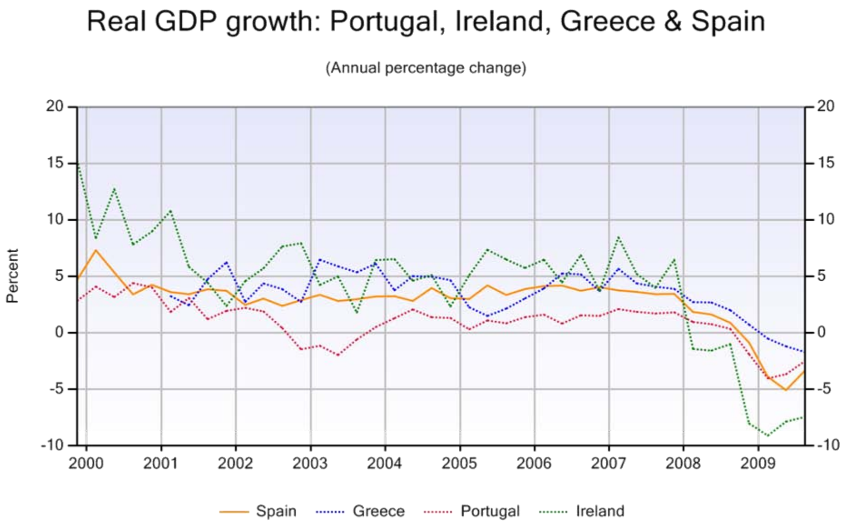




- Similar to industrial output in advanced economies, world trade has experienced an historical contraction in 2009. Data from the first three quarters of the year suggests that the rate of decline will be in excess of12%.
- No part of the world has remained immune from this deep and synchronised crisis and all regions have followed similar patterns in terms of declining exports. Highlighting the degree of trade and financial interlinkages, trade slowdown in regions as far apart as Eastern Europe and South East Asia has occurred concomitantly. The credit crisis has resulted in sharp corrections in many countries and the effect on world trade is clearly visible.
- A significant proportion of the fall in Eurozone trade witnessed since the last quarter of 2008 is attributable to the steep contraction in intra-regional economic activity. Countries such as the Netherlands, with deep trade links with the rest of the Eurozone, have been significantly affected.
- Encouraging, however, is the fact that trade picked up in the third quarter, fuelling confidence in the economic recovery. Nonetheless, projections for 2010 remain modest, with overall export growth expected to be limited to 2.5%. This means that it will take time before trade flows return to pre-crisis levels, even if positive trends continue.

Source: Global Insight.

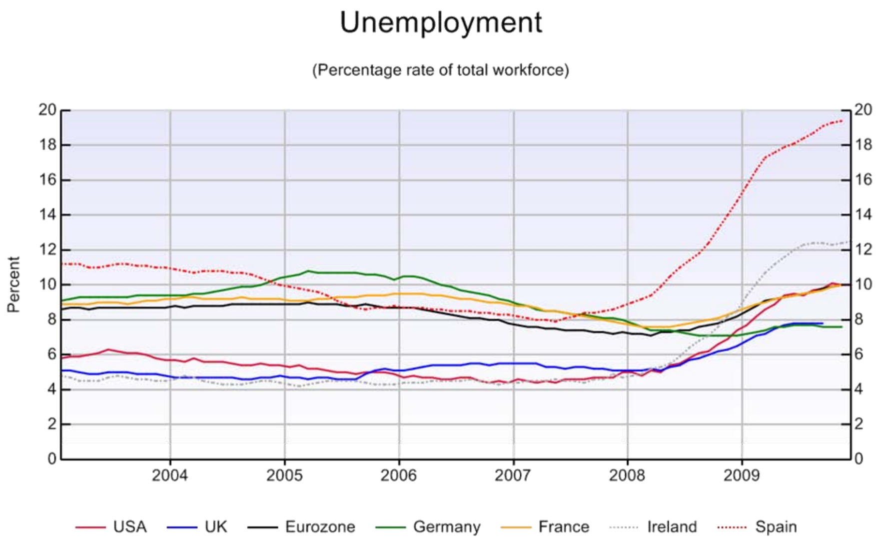
But deep pockets of weakness persist…

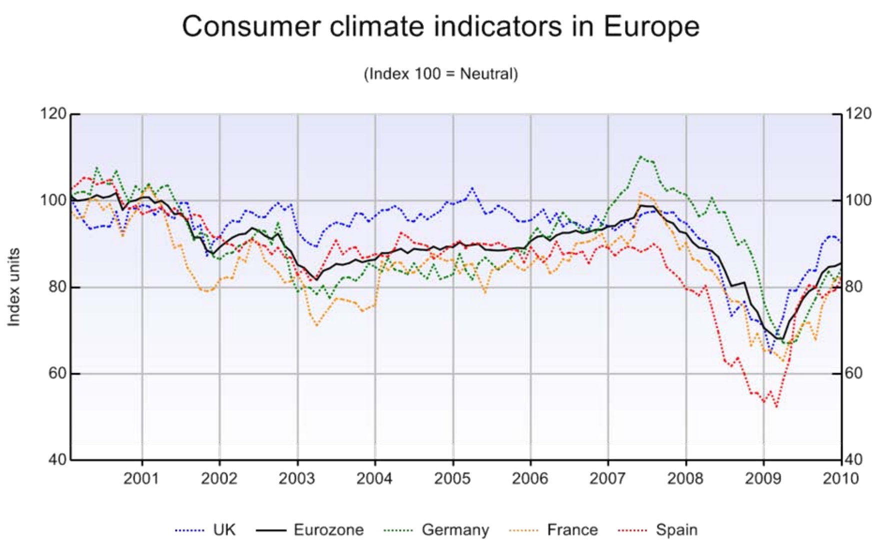


Source: Global Insight.

- Although the picture of an emergent recovery is broad in scope, the relative performance of the advanced economies will diverge. Some Eurozone members in particular, need to address severe economic challenges.
- Four countries - Portugal, Ireland, Greece and Spain - are worthy of mention. Though each has distinct problems, three are recurrent:
  - Growing budget deficits in excess of Eurozone criteria. In the case of Spain, this looks likely to surpass 9% of GDP in 2010;
  - Large and growing debt burdens which put pressure on sovereign capacity. Collectively, advanced economy governments have significantly higher borrowing needs in 2010. This poses a risk that weaker countries will be crowded out, resulting in rising yields and higher debt service burdens;
  - Unbalanced economic structures. Factors such as an over-reliance on a few sectors of activity, high levels of indebtedness, weak and over-extended banking sectors, rising real wages and decreasing productivity have resulted in unsustainable economic structures.
- As a consequence, internal devaluation is inevitable. The turn in the cycle has been particularly steep for some of these countries and, more pertinently, promises to be prolonged. Eurozone membership brings with it several important advantages but does not leave any of these countries with flexibility to devalue their way back to competitiveness.

…and unemployment is high and confidence fragile.





- Contrary to the emerging turnaround in output growth, unemployment has charted a steady upward path throughout 2009, as firms continue to take measures to combat the fall in production and sales. In some Eurozone countries (e.g. Germany) schemes such as enforced part time work and unpaid leave have softened the impact of declining firm revenues.
- In an historical context, this is the first time in decades that advanced economies have seen such aggressive increases in unemployment. The US last saw an unemployment rate in the region of 10% back in the early 1980s.
- Considerable heterogeneity exists within the Eurozone: Unemployment increases in Spain, Ireland and Portugal have been much more aggressive than in other parts of the Eurozone. Spanish unemployment breached 19% in the third quarter of the year, while in Ireland the corresponding figure is in excess of 12%, and implies a near three fold increase in under 24 months.
- Despite high levels of unemployment, households appear to hold a brighter view of the future than previously. While acknowledging this as a fundamentally positive sign, it should be noted that confidence remains subdued when compared to levels prevailing prior to the onset of the crisis. While there has been a clear upturn, these movements, at best, represent a rebound from severely depressed levels.

Source: Global Insight.

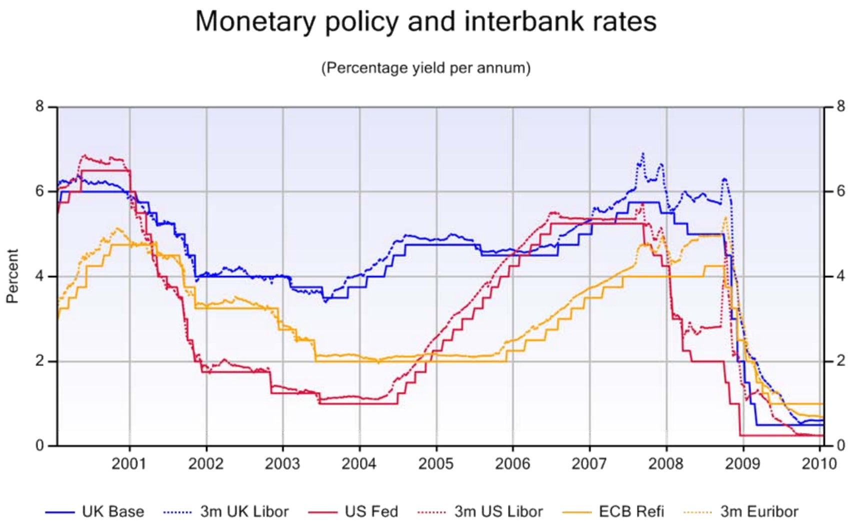
The consensus predicts an economic recovery in 2010…

	Consensus Forecast December 2009 Survey	Real GDP % Growth 2007	2008	2009	2010	2010 Trend	2010 M-o-M forecast revision
Major Markets	France	2.1	0.3	-2.2	1.5	↑	↑
	Germany	2.5	1.3	-4.8	1.7	↑	↑
	Italy	1.4	-1.0	-4.8	0.9	↑	↑
	Japan	2.4	-0.7	-5.3	1.5	↑	↑
	Netherlands	3.5	2.0	-4.0	1.0	↑	↑
	Spain	3.7	0.9	-3.7	-0.4	↓	↑
	United Kingdom	3.0	0.6	-4.5	1.4	↑	↑
	United States	2.0	0.4	-2.5	2.7	↑	→
Major Regions	Western Europe	2.8	0.6	-4.0	1.2	↑	↑
	Eastern Europe	7.0	4.2	-5.8	2.5	↑	↑
	Euro zone	2.6	0.5	-3.9	1.3	↑	↑
	Asia Pacific	6.3	3.8	1.3	5.2	↑	↑
	Latin America	5.5	4.2	-2.1	3.6	↑	↑
	Total	3.9	2.0	-2.2	2.9	↑	↑

Source: Consensus Forecasts (Survey date 7 December).

- Consensus forecasts suggest that the recent turnaround in economic activity noted in several countries will turn into a slow and modest recovery in 2010. As more positive signals in real economic data have become available over past months, in production, sales and trade, these forecasts have gradually been revised upwards.
- There are visible differences in expectations of performance across regions. The United States, which was first to succumb to the slump, is expected to out perform the Eurozone in 2010. The US economy is expected to grow by 2.7% in 2010 while, at 1.3%, Eurozone output growth projections are much more modest. Heterogeneity of performance across European markets remains substantial. Whereas Germany will grow by 1.7%, Spain is expected to contract.

…that is modest in strength susceptible to a reversal.



- The conduct of monetary policy will be crucial to supporting the recovery. While the low interest rate policy stance adopted in the past was consistent with the sharp drop in aggregate demand and prices, the current prospects for inflation imply that such policy may not be so desirable in 2010.
- Monetary policy remains extremely accommodative, which has resulted in historically low interest rates in all three regions. This stance has so far been consistent with overall activity as inflation rates dropped sharply in tandem with aggregate demand, reflecting policymakers concerns that a a protracted slump remains a high risk.
- However, while the view is that we have reached the bottom of the cycle, there is a high degree of uncertainty around the sustainability of a continued pick-up in activity. The economic recovery hinges on the successful resolution of a number of imbalances (see: *Risks to the current outlook*).
- Policy makers are therefore faced with the dilemma of raising interest rates to combat inflation or maintaining their accommodative stance for an extended period until such imbalances are resolved and countenancing a higher rate of inflation. This potential dilemma necessitates a delicate balancing act between supporting incipient recovery and avoiding a renewed slump.

Source: Global Insight.

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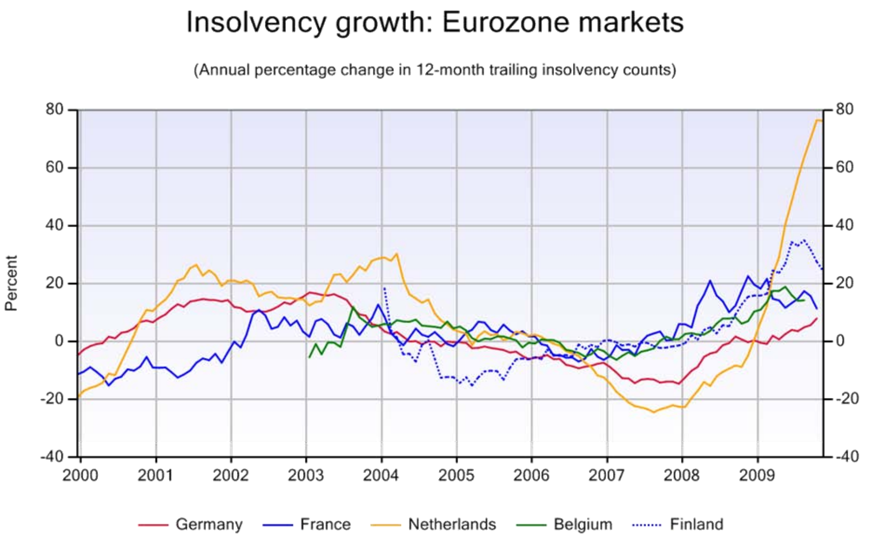
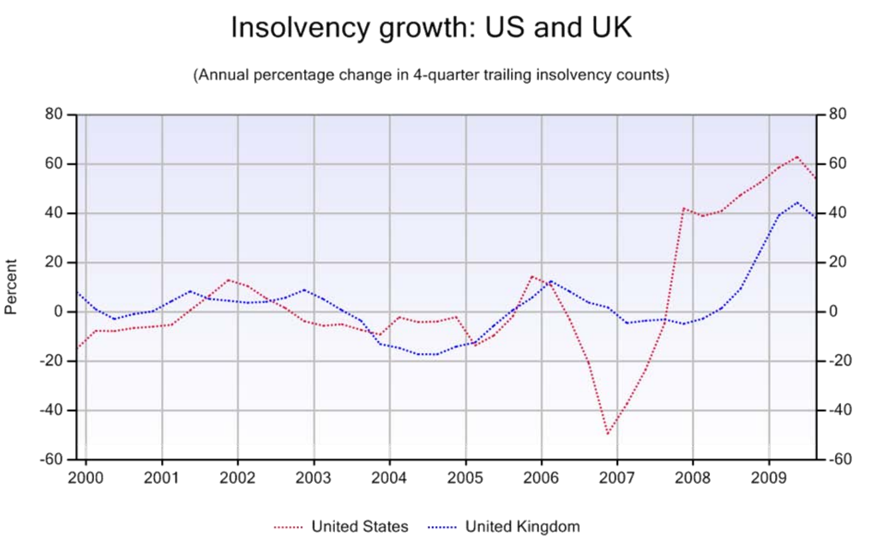
The steep increase in insolvencies seen during 2009…

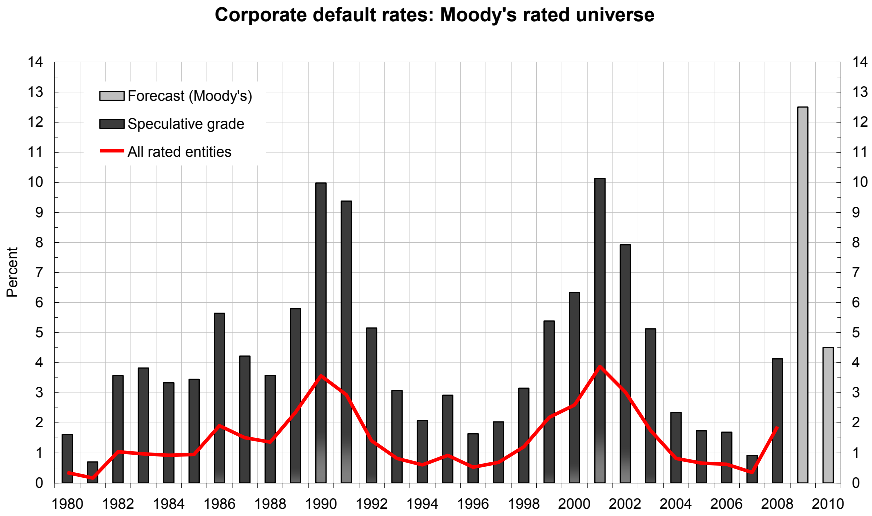


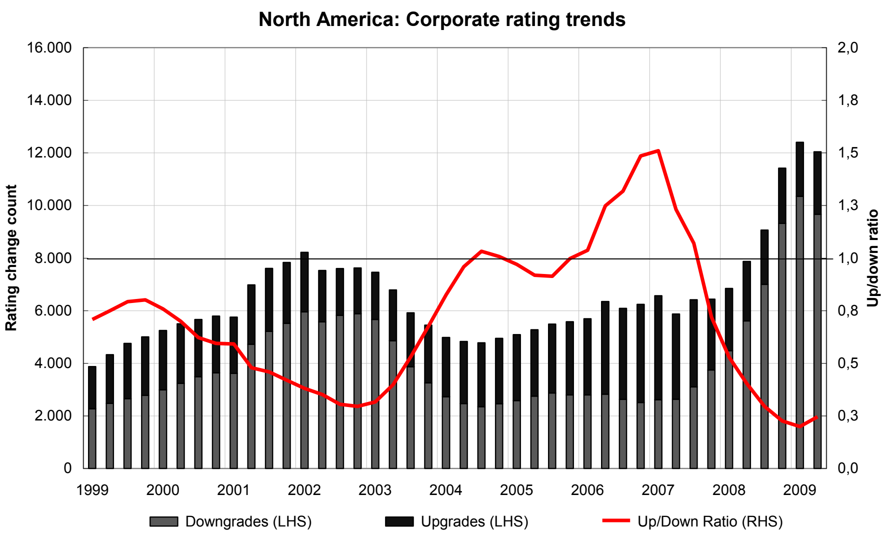


- Lower real economic activity and difficulties in credit markets led to a widespread deterioration in the corporate environment in 2009. This in turn, led to an increase in insolvencies, though the severity and timing of this increase varied from country to country.
- In the United States and the United Kingdom, insolvencies continued to increase at a rate of roughly 50% per annum until the second quarter, and fell back only slightly in the third. Similar patterns are in evidence across other European markets: for example, in Spain, France and Belgium.
- By contrast, the number of business failures in the Netherlands continued to rise at an accelerating rate, reaching a growth rate of 100% per annum in the third quarter. Similarly, the insolvency environment has continued to deteriorate slowly in Germany. This may suggest that firm failures are beginning to increase as public support is being withdrawn.

Source: Global Insight.

…has been accompanied by an increasing number of large defaults.





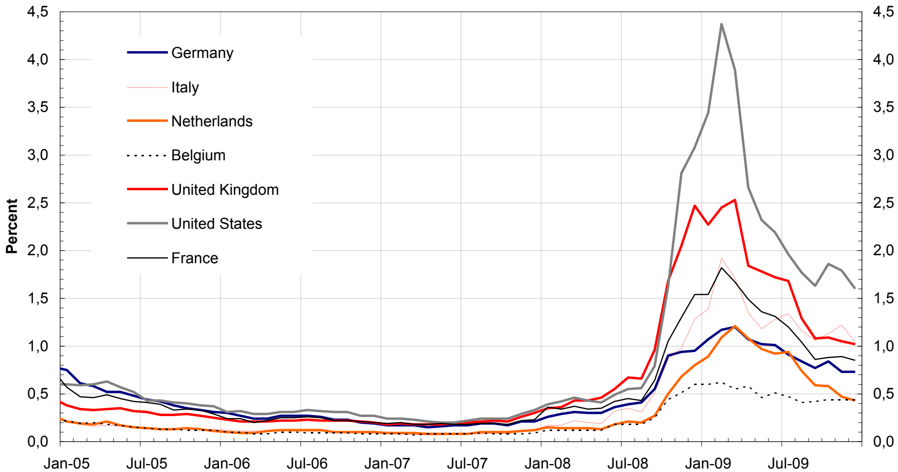
- The default experience in the (predominantly North American) rated universe displays cyclical patterns, where large default events tend to rise sharply in response to what we might refer to as crisis periods (e.g. the Asian crisis or the bursting of the tech-bubble).
- Given that the current downturn displays virtually all the characteristics of previous crisis episodes, including frozen credit markets in a high leverage environment, it is hardly surprising that the global default rate reached 12% in October 2009. In terms of multiples, the degree of deterioration is unprecedented, being 12 times higher than in 2007 when the level of default recorded a historical low.
- Alongside the rising number of large-scale defaults, there has been a general deterioration in credit quality in recent quarters, reflected in the actions of rating agencies. Negative rating actions are still outstripping positive ones both in Western Europe and in North America, even if a moderation in the number of downgrades is in evidence since the third quarter.
- These rating developments suggest that a significant financial weakening has taken place in the corporate sector as a whole since the onset of the crisis. The corollary is that firms may now be regarded as substantially less resilient to any future adverse shocks.

Sources: Standard and Poor's; Moody's; Fitch Ratings; Bloomberg.

Note: Tracking the activities of rating agencies gives a good indication of the general direction in which credit quality is moving. The upgrade and downgrade actions of Moody's, S&P and Fitch are counted (moving annual total), and a ratio of the two calculated. The sample is confined to large debt-issuing companies.

Listed company default expectations are now moderating…

Median EDF evolution by country



Long-term corporate bond spreads: United States

(Average long-term corporate bond yield per rating class minus a 10-year government benchmark)

- A major factor driving the general perception of an approaching recovery is the strong uplift in stock markets that has taken place since April. This rebound in equity prices and a simultaneous reduction of market volatility have translated into lower corporate default expectations.
- Expected Default Frequencies (EDFs) have fallen back significantly in recent months, both in North America and across European countries. The median corporate EDF in the US pool is back below 175 basis points, which implies a 50 basis point reduction since the second quarter. The trend is similar across European markets
- Despite this improvement, it is worth emphasising that current levels still reflect default conditions well above a long term average. All firms in the listed corporate universe are considered to have significantly higher default risk compared to previous years.
- Long-term corporate bond spreads also show levels far higher than their pre-crisis readings. While these measures suggest that the perception of risk has declined, it is clear that credit risk has risen on a sustained basis over the past two years and remains high.

Sources: Moody's KMV Credit Monitor; Global Insight.

Note: The EDF represents a tool for tracking default risk among stock listed companies. Combining balance sheet and stock market information for a particular firm yields a 1-year ahead default forecast. The median EDF represents the 50th percentile in the firm aggregate of interest.

…which is largely reflected in aggregate insolvency projections.

Insolvency Forecast December 2009	Number of insolvencies (change in % from previous year)					
	2006	2007	2008	2009	2010	2010 Trend
United Kingdom	13,137 (1.9)	12,507 (-4.8)	15,535 (24.2)	19,420 (25)	18,500 (-5)	↓
United States	19,814 (-49.3)	28,137 (42.0)	42,861 (52.3)	60,000 (40)	57,000 (-5)	↓
France	40,407 (-6.3)	42,840 (6.0)	51,254 (19.6)	56,400 (10)	53,400 (-5)	↓
Germany	34,137 (-7.3)	29,160 (-14.6)	29,291 (0.5)	32,200 (10)	35,500 (10)	↑
Netherlands	5,941 (-12.4)	4,602 (-22.5)	4,635 (0.7)	8,340 (80)	8,500 (2)	↑
Denmark	1,987 (-20.4)	2,401 (20.8)	3,709 (54.5)	6,000 (62)	6,500 (8)	↑
Finland	2,285 (0.3)	2,254 (-1.4)	2,612 (15.6)	3,200 (23)	3,000 (-6)	↓
Norway	3,032 (-14.4)	2,845 (-6.2)	3,637 (27.8)	5,275 (45)	4,700 (-10)	↓
Sweden	6,160 (-9.2)	5,791 (-6.0)	6,298 (8.8)	7,900 (25)	7,500 (-5)	↓

Source: Atradius Economic Research. Forecasts are based on the outcome of statistical models and expert opinion. Estimates for 2009 comprise several quarters actual data plus forecasts for remaining periods.

- The rate of growth in insolvencies in 2009 has depended on a number of factors, including the specific economic and financial profiles of countries, Central Bank and fiscal measures taken to combat the credit crisis and the extent to which firms have been able to adjust to their new environment. As a result, and as previously noted, we have seen insolvency rates rise in excess of 70% for the Netherlands and by rates varying between 10% and 65% in other countries.
- While we expect an improvement in the insolvency environment in 2010, there is considerable heterogeneity and levels will remain high. The default outlook for the Eurozone is mixed. Germany and the Netherlands are expected to continue with their deteriorating trends though the expected rates of increase vary. Other countries, such as the UK and the USA, are expected to display a slight decline in insolvency levels as they climb out of recession.

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Exiting from public sector support now poses a serious risk…

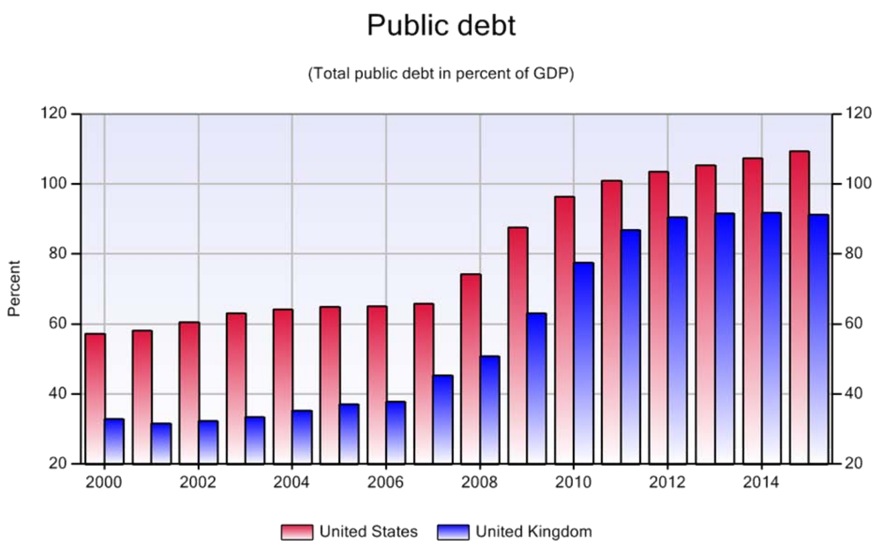
- Though confidence in the robustness of the recovery appears to be strengthening, some concerns over its durability remain, given its seeming reliance on alternative channels of state support. Swift action by governments may have thwarted a wholesale collapse of the banking sector and arrested the sharp contraction in output, but the corollary is that the subsequent economic recovery has, ultimately, been underwritten by the state.

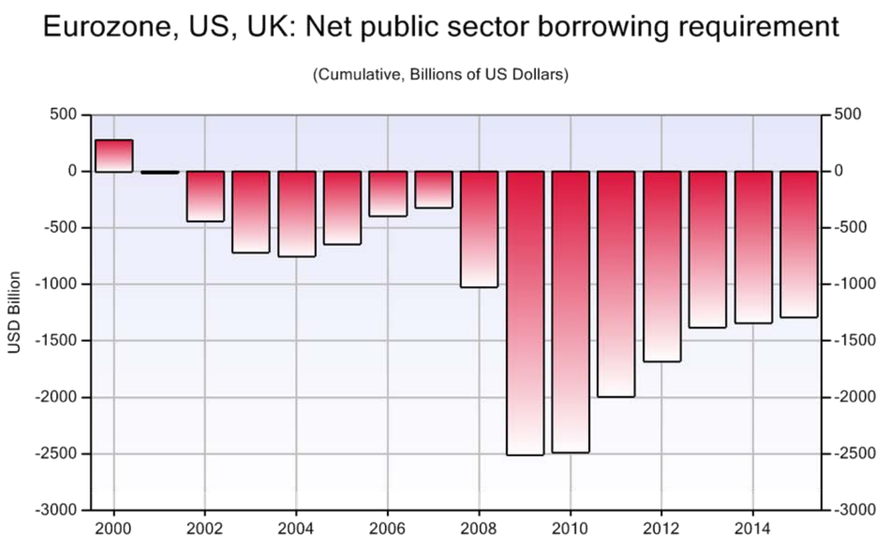
- Support has come through three principal channels:
  - bank sector recapitalisation and the placing of sovereign guarantees on market based bank funding channels;
  - an unprecedented easing of monetary conditions and extraordinary liquidity support through central bank balance sheet operations and;
  - direct economic support offered via discretionary fiscal spending.

- The first two have resulted in the transfer of substantial financial sector liabilities from the private to the public sector in order to stabilise banks. Simultaneously, authorities have sought to unblock the credit channel for firms and consumers. The third, designed to arrest the collective loss of confidence and collapse in final demand, has ensured an expedient recovery in growth.

- Reliance on such policies to sustain the recovery is an increasing concern as recovery gathers pace and policymakers start to plan exit strategies from their highly supportive policy stance. As such, we see four principal risks on the horizon.
  - Large fiscal deficits will require correction which in turn could threaten growth in business investment and household consumption.
  - The substantial increase in public sector borrowing across most industrialised markets will impact on sovereign strength with attendant impact on funding costs.
  - Though the financial system has been saved, weaning the sector from extraordinary central bank support will be a challenge given the still weak capital position of many institutions.
  - Finally, there is evidence to suggest that the credit channel is not yet functioning effectively.

…as sovereign balance sheets come under increasing stress.





- Public sector net borrowing requirements have increased sharply across the Eurozone, US and United Kingdom.
- Rising expenditures were initially driven by the cost of bank sector recapitalisation, but the fall of output in the aftermath of Lehman's collapse subsequently forced authorities to unleash significant discretionary fiscal stimulus.
- Revenues have also been impacted, as the fall in output and expenditure and rising unemployment have had a serious impact on state tax receipts.
- Deficits will rise to post-war highs. The UK will record a deficit of 12.3% of GDP in 2009 while the US deficit is set to increase to 8.2% of GDP. Consolidation is expected to be slow over the medium term and public sector debt is expected to double in several markets.
- On a cumulative basis, the total net public sector borrowing requirement for the UK, US and Eurozone will reach a record 2.5 trillion dollars in both 2009 and 2010.
- Such an increase in supply poses upside risks to long-term interest rates as investors demand additional compensation for perceived increases in risk. Ultimately, this can be expected to result in higher borrowing costs for households and firms which would limit long-term growth prospects.
- Financial markets will also become increasingly discriminatory in their assessment of risk. Countries with poor fundamentals will face higher funding costs as credit spreads widen. This makes fiscal discipline increasingly imperative for those markets where the deterioration has been most serious.

Source: Global Insight.

The effect of stimulus is substantial but temporary…

	Breakdown of fiscal packages & GDP impacts				
	Total net impact (%)	Tax (%)	Spending (%)	2009 GDP Effect (%)	2010 GDP Effect (%)
United Kingdom	-1,4	-1,5	0,1	0,4	0,1
Germany	-3,0	-1,6	1,4	0,5	0,7
France	-0,6	-0,2	0,4	0,2	0,15
Italy	0,0	0,3	0,3	N/A	N/A
Spain	-3,5	-1,6	1,9	1,0	0,4
United States	-5,6	-3,2	2,4	1,2	1,5

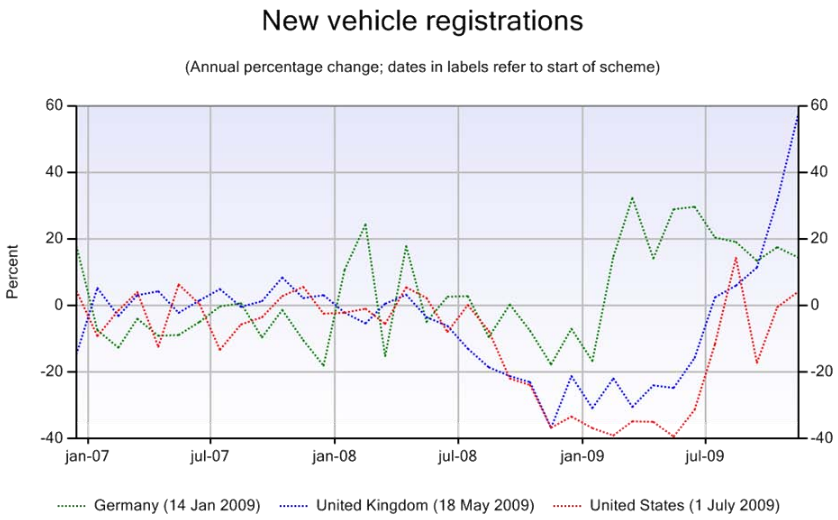
Source: Global Insight. Note: Total over 2008-10 as percentage of 2008 GDP.

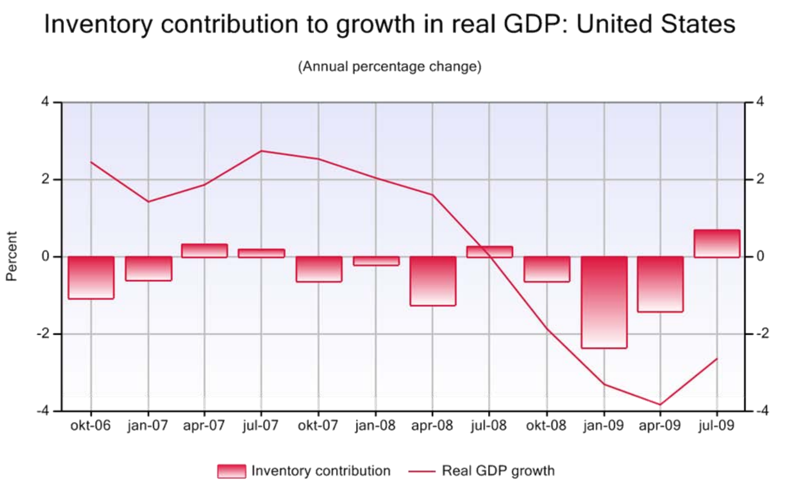
	Total net Impact (%)	Size & timing of fiscal packages Distribution over 2008-10 (%)		
		2008	2009	2010
United Kingdom	-1,4	15	93	-8
Germany	-3,0	0	46	54
France	-0,6	0	75	25
Italy	0,0	0	15	85
Spain	-3,5	31	46	23
United States	-5,6	21	37	42

Source: Global Insight. Note: Total over 2008-10 as percentage of 2008 GDP. Italy's net total of 0.0% reflects a 0.3% rise in tax revenue matched by a -0.3% cut in spending as percentages of 2008 GDP.

- We have seen co-ordinated action by the G-20 directed at arresting a sharp contraction in output and a rise in unemployment. These injections have been justified by the fact that the recent disruptions to the monetary and credit transmission mechanisms have impaired the ability of Central Bank actions alone to support demand.
- Governments have engaged in a wide range of activities, including tax cuts, public investment and business subsidies, but the magnitude and the impact of the stimulus have displayed considerable cross country variation.
- The OECD estimates that the magnitude of the 2008-2010 discretionary fiscal stimulus differs markedly across the US (5.6% of 2008 GDP), UK (1.4%), and Eurozone (0.0% to 3.5% depending on the specific country).
- These variations in the size of the net injections help to drive country differences in their GDP impacts. However, other factors, such as temporal allocation and the split between tax and spending measures, also matter.
- For example, the relatively muted UK 2010 effect which is equivalent to 0.1% of 2008 GDP reflects its emphasis on tax cuts (which have a lower multiplier effect) as well as the fact that all of the stimulus is concentrated in 2008 and 2009 with 2010 seeing some fiscal tightening.
- What is clear, however, is that such extraordinary support is considered finite and that an end to the programmes is already in sight. It is an open question as to whether these programmes will result in sustainable growth.

…and seemingly remains critical to growth.





- Car scrappage schemes demonstrate both the positive impact and potential drawbacks of discretionary stimuli across our key markets. These schemes were introduced between December 2008 and July 2009 and were aimed at supporting the car industry by subsidising the cost of a new car in part-exchange for an older model.
- While the schemes succeeded in boosting new registrations and reversing the contraction in sales, there are concerns that they merely served to bring forward expenditure and that registrations may weaken again when the schemes end.
- There is also evidence to suggest that the pickup in car sales has been at the expense of other components of spending. For example, the ECB estimates that the rise in Eurozone registrations during the first half of 2009 was almost completely offset by falls in other purchases. The net impact left total consumption basically flat.
- Moreover, the recent pick up in growth appears to have been heavily dependent on a cyclical pick up in inventory re-stocking. US data certainly suggests that the slowdown in the rate of contraction corresponded almost exactly to the positive contribution of private sector inventory accumulation.
- Such observations lead us to question the sustainability of growth as inventory stocks are replenished and fiscal programmes are wound down. Eventually, growth will have to come from other components of aggregate demand.

Source: Global Insight.

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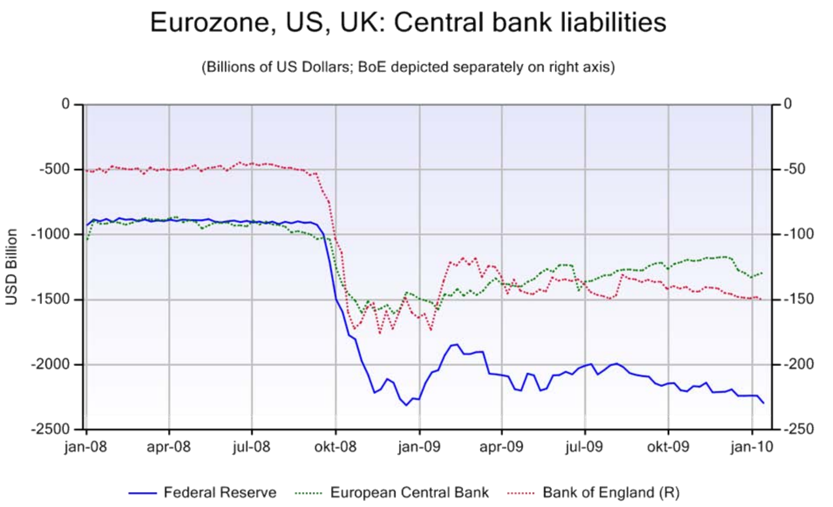
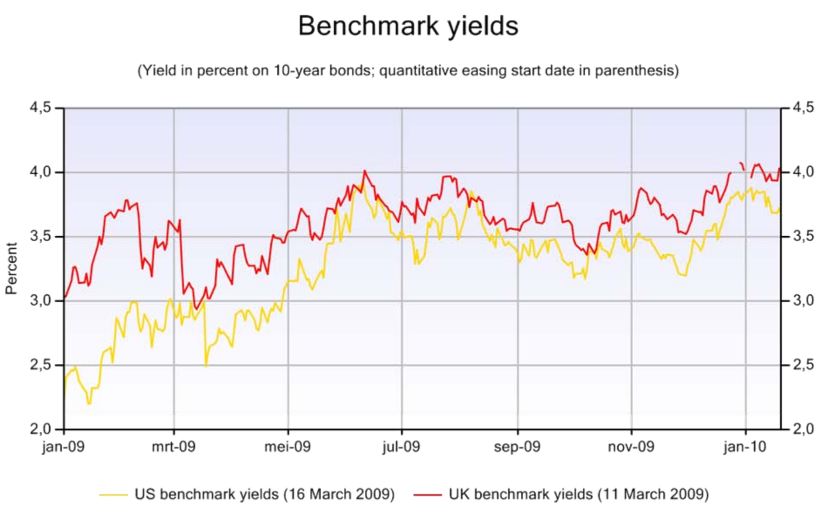
Bank support is still crucial…

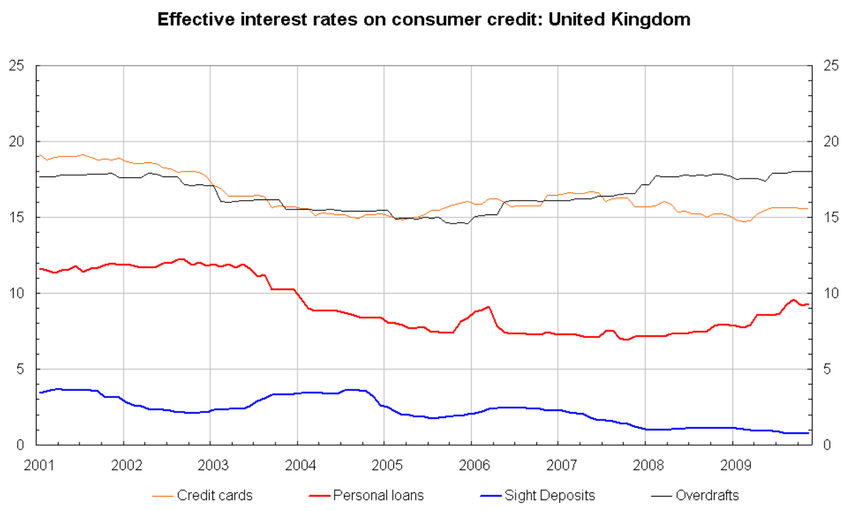


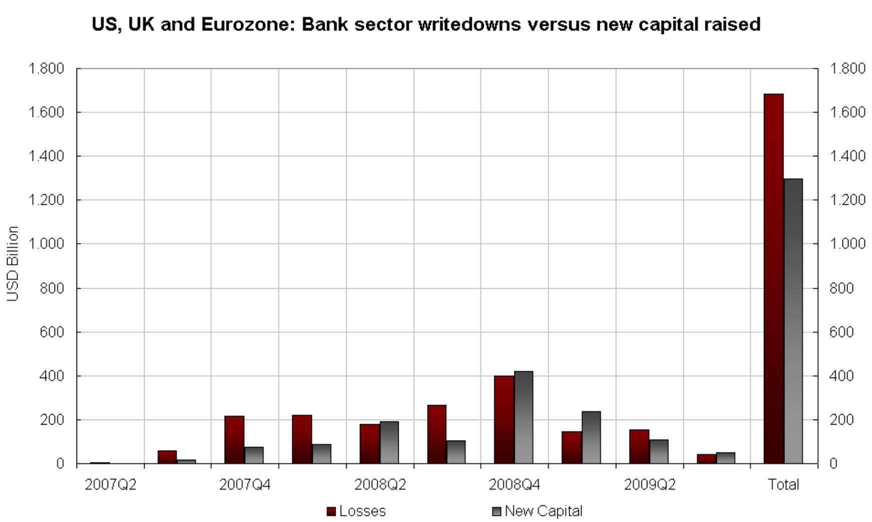


- We remain considerably concerned about the ability of household consumption and investment to provide this pick up once the support wanes. Indeed, there is evidence to suggest that a degree of bank, corporate and household deleveraging will continue into 2010 while the supply of credit remains impeded.
- Central Bank actions in the Eurozone, U.S. and U.K to ease bank sector funding difficulties have centred on extraordinary liquidity operations and quantitative easing.
- The aim of QE is twofold. First, it brings down borrowing costs throughout the entire economy, and second; by purchasing traded debt instruments directly from the banking sector, central banks deposit funds directly into commercial bank reserve accounts, furnishing them with increased funds from which to create credit.
- To this end, the Federal Reserve has deployed US$300 billion to QE, the Bank of England £175 billion and the ECB 60 billion euro. The three fold expansion in Central Bank balance sheets in the UK and the USA since the start of the crisis suggests that QE support, at least for these two countries, has been considerable.
- However, its effect in reducing the cost of debt issuance and re-opening the credit channel remains debatable. Detecting lasting changes in the yield curve in either the US or UK remains difficult.

Source: Global Insight.

…given continuing capital problems…





- These impediments are further evidenced in bank lending data, which suggests that banks have actually sought to increase margins and raise the cost of credit during the crisis in order to increase their profitability.
- In fact, it seems that, though large scale bank collapse has been averted, the sector still faces considerable headwinds, stemming from the typical credit losses that arise out of recession, the need to replenish depleted capital and the likelihood that future capital requirements will be increasingly onerous.
- Though emergency recapitalisation of banks by governments has been augmented by commercial banks moving to raise funds both in the equity and debt markets to replenish capital, recent data suggest that banks are still short of capital. A simple comparison of write downs against capital raised suggests that banks have still some way to go to replenish depleted capital.
- State support to the sector will almost certainly ensure that renewed bank failures are unlikely. However, a return to more typical conditions will remain difficult while capital remains constrained and funding conditions remain unusually benign.

Sources: Bank of England, Bloomberg.

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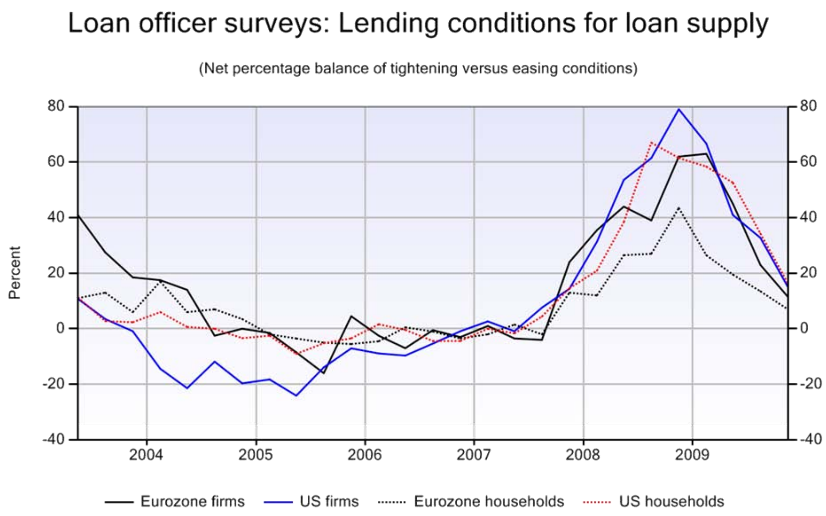
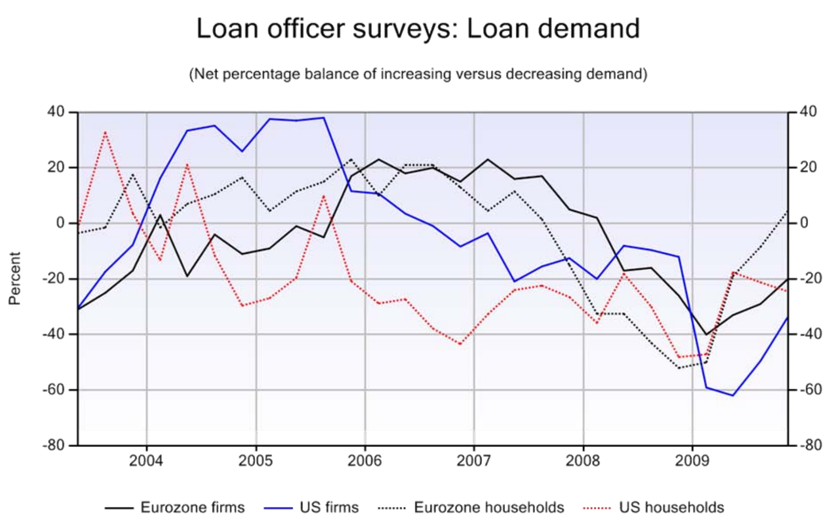
…which is inhibiting credit appetite…

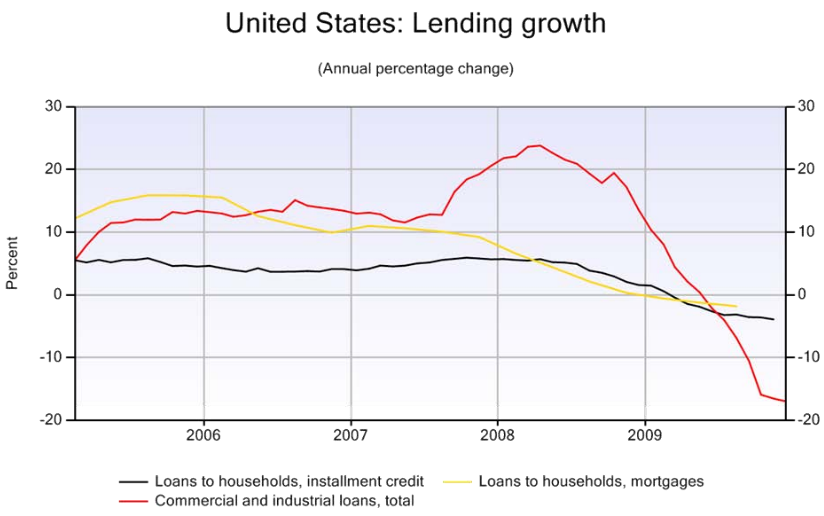


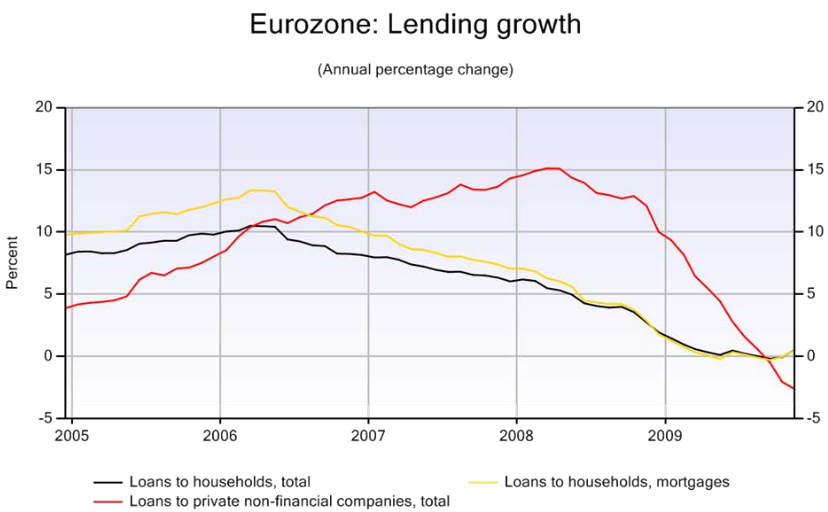


- This weak capital position of banks may help explain why bank lending still remains relatively muted and continues to pose a downside risk to the recovery.
- These ongoing risks are illustrated by loan officer surveys across our key markets. These indicate that the net balance of credit standards as applied to corporate and household loans or credit lines remains above zero, which signifies that they are tightening. However, the net balances have fallen sharply from their peaks earlier in the year, which means that the pace of tightening is slowing considerably. However, further unexpected capital losses could well see this unwinding of credit tightness move into reverse.
- These same surveys suggest that the net balance of credit demand from the corporate sector is still below zero, signifying that demand for loans continues to fall. However, the pace of decline has slowed since the spring.
- On the household front, loan demand in the Euro zone has levelled off and seems set to pick up over the next few quarters. However, loan demand from US households, who proved to be one of the key drivers of global growth before the downturn, shows no sustained signs of near-term recovery. This provides further evidence that the process of household deleveraging has some way to run and this lack of appetite for borrowing may well act as a drag on private consumption expenditure.

Source: Global Insight.

…and with clear spillovers into reduced credit flows.

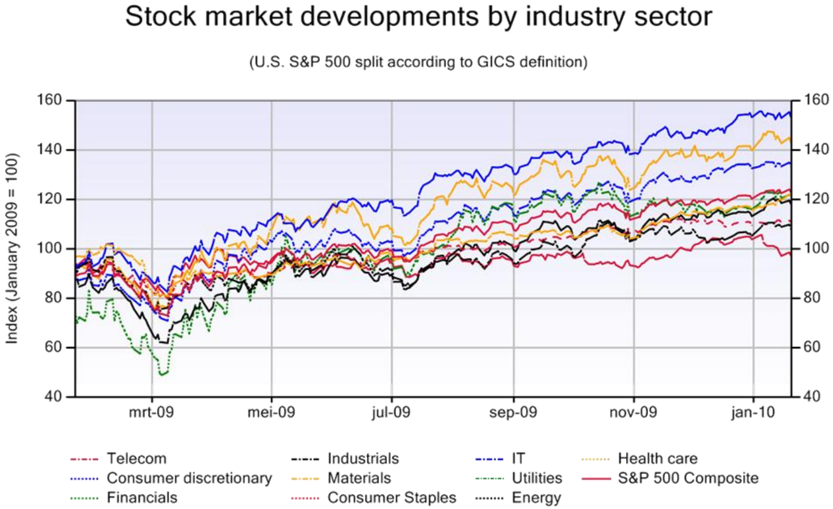


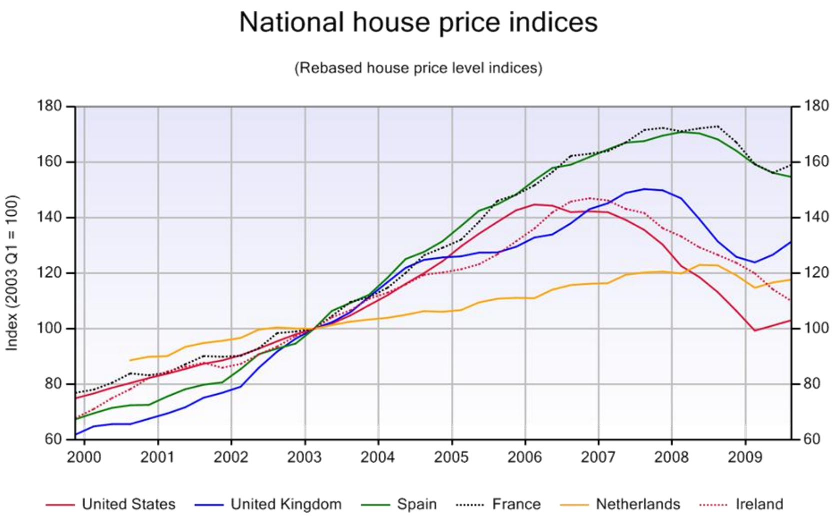


- As might be expected, the tightened credit standards and lower credit demand during the downturn has translated into marked declines in corporate and household lending growth.
- Household lending growth has been falling steadily for the last three years, partly as a result of the downturn in the housing market which also weighs on the collateral available for unsecured borrowing. It has been relatively flat in the Eurozone since the second quarter, but still declining at around 4% per year in the US.
- By contrast, corporate lending has adjusted rapidly. In the US, the annual rate of firm lending growth has fallen from around 20% in October 2008 to -17% in November 2009. Lending to Eurozone firms has undergone a similar, though slightly less aggressive, switch.
- Concerns about the difficulties faced by businesses in securing credit and the extent to which this may act as a drag on investment and consumption growth has spurred government actions to increase the availability of funds. These initiatives include securing banking sector commitments on loan provision (UK), compelling banks to fully explain their decisions to refuse corporate credit applications (Ireland), and government loan guarantees (Germany).
- Without such steps, it remains difficult to see how lending growth can recover to levels compatible with sustainable growth. This again underlines the continuing reliance of the current recovery on state support.

Source: Global Insight.

Are rebounds in asset prices sustainable?





Source: Global Insight.

- One central feature underpinning this recovery process has been the recent strong rebound in asset prices, which, if proven to be short-lived rather than sustainable, will add considerable uncertainty to the outlook.
- The recovery process has so far proven to be modest and the improvement in economic fundamentals cannot fully explain the movements in financial markets.
- The fact that credit growth and lending conditions have remained subdued, despite the ample amount of money pumped into the economic system, might suggest that the public actions are about to drive financial asset prices into overvaluation.
- Since April 2009 equity markets have posted value increases in the order of 40% and price-earnings ratios are now considerably elevated. At the same time, the price of gold and other commodities has also increased considerably.
- At the same time as financial wealth has recovered, signs of a stabilisation in house prices have started to emerge. In the UK and the US, house price levels picked up again during the second quarter. Across several Eurozone countries, however, the house price levels has continued to decline.
- Although this stabilising trend in home equity levels and other asset prices is a sign of recovery we have been waiting for, it should be noted that many of the fundamental issues that triggered the initial sub-prime crisis remain unresolved. While the public support has been successful in avoiding an outright systemic collapse, the underlying asset quality remains poor.
- As such, the recovery in asset prices may be fragile and a negative shock will have serious implications for collateral values and credit.

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