«TOWARDS A MORE COHESIVE EUROZONE»

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MIDEUROPA PARTNERS

London
- November 13th, 2014 -

Summary

1) The worst of the Euro crisis is behind us

2) ECB policies have been a major driver

3) Fundamentals have also improved since 2010

4) Structural reforms are now needed to revive growth

5) CEE countries have, on the whole, weathered well the crisis

Summary

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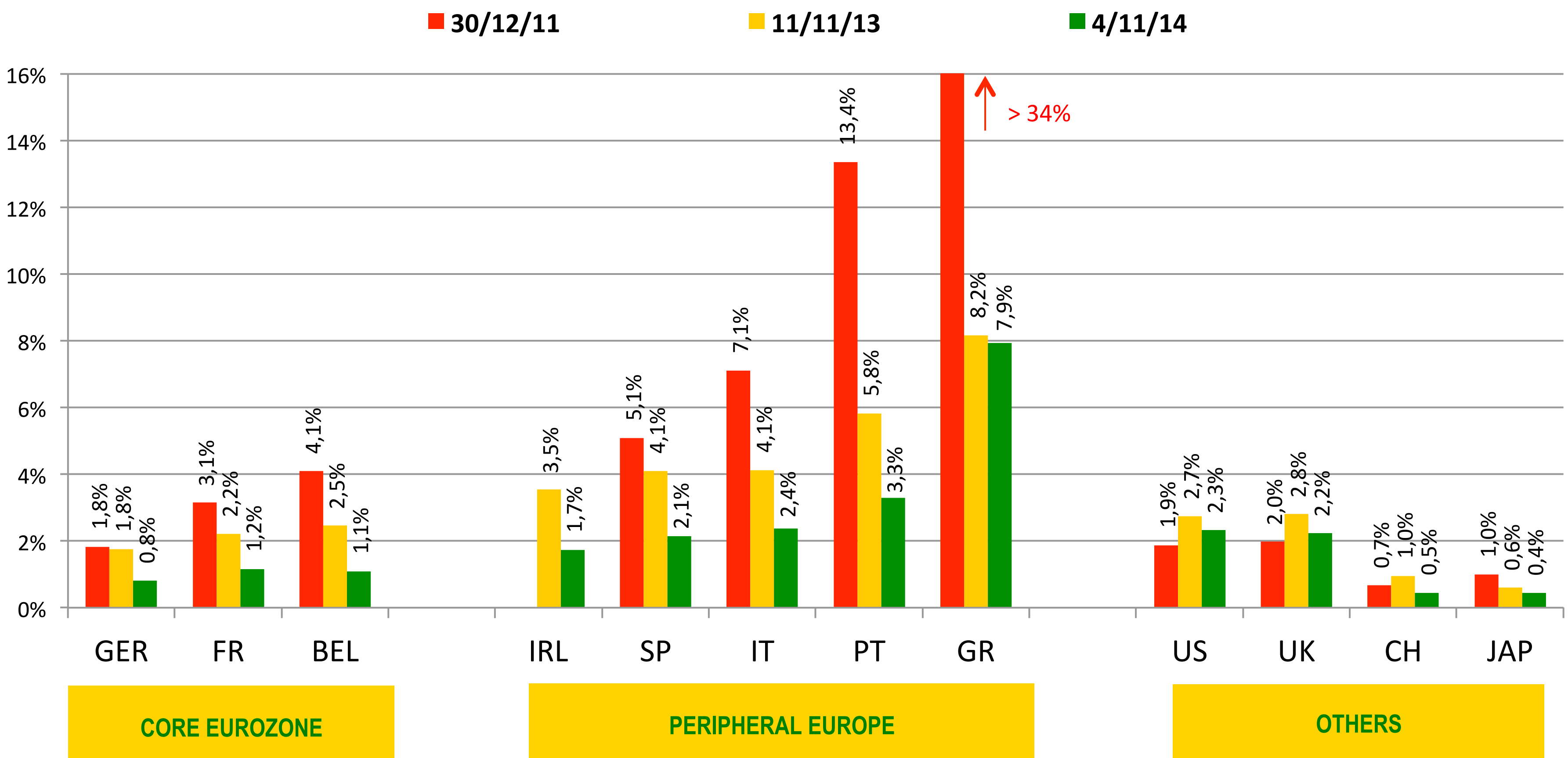
1) From the 2011 peak, there has been a spectacular downward convergence of rates in the Eurozone

Graph 1

Government 10-years benchmark yields (%)



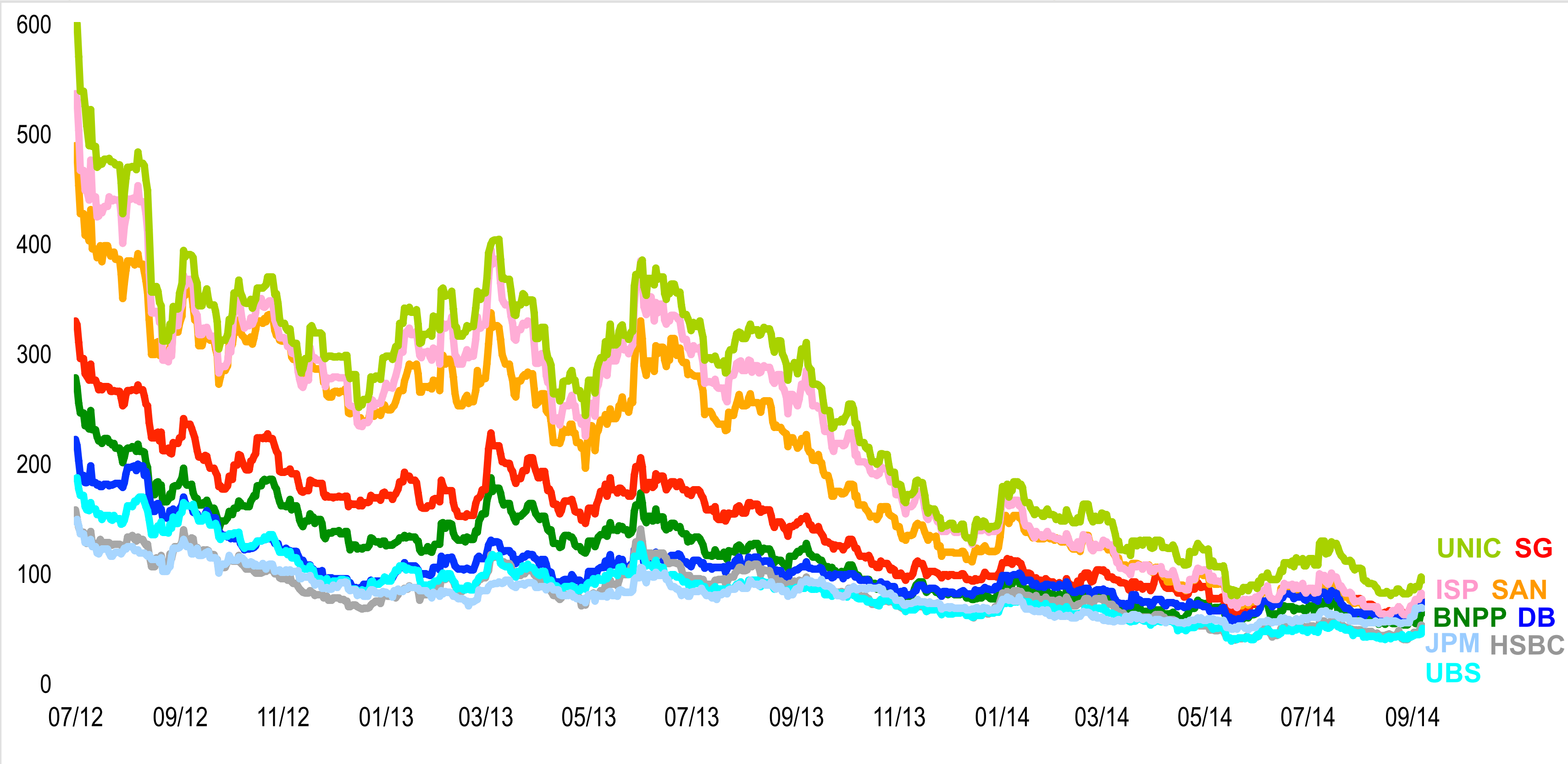
Ireland, Spain and Italy borrow today at rates comparable to those of the US or the UK

Source : Bloomberg

2) Perceived risk on banks has reduced and converged since 2012

Graph 2

5-years CDS spreads (in bp)



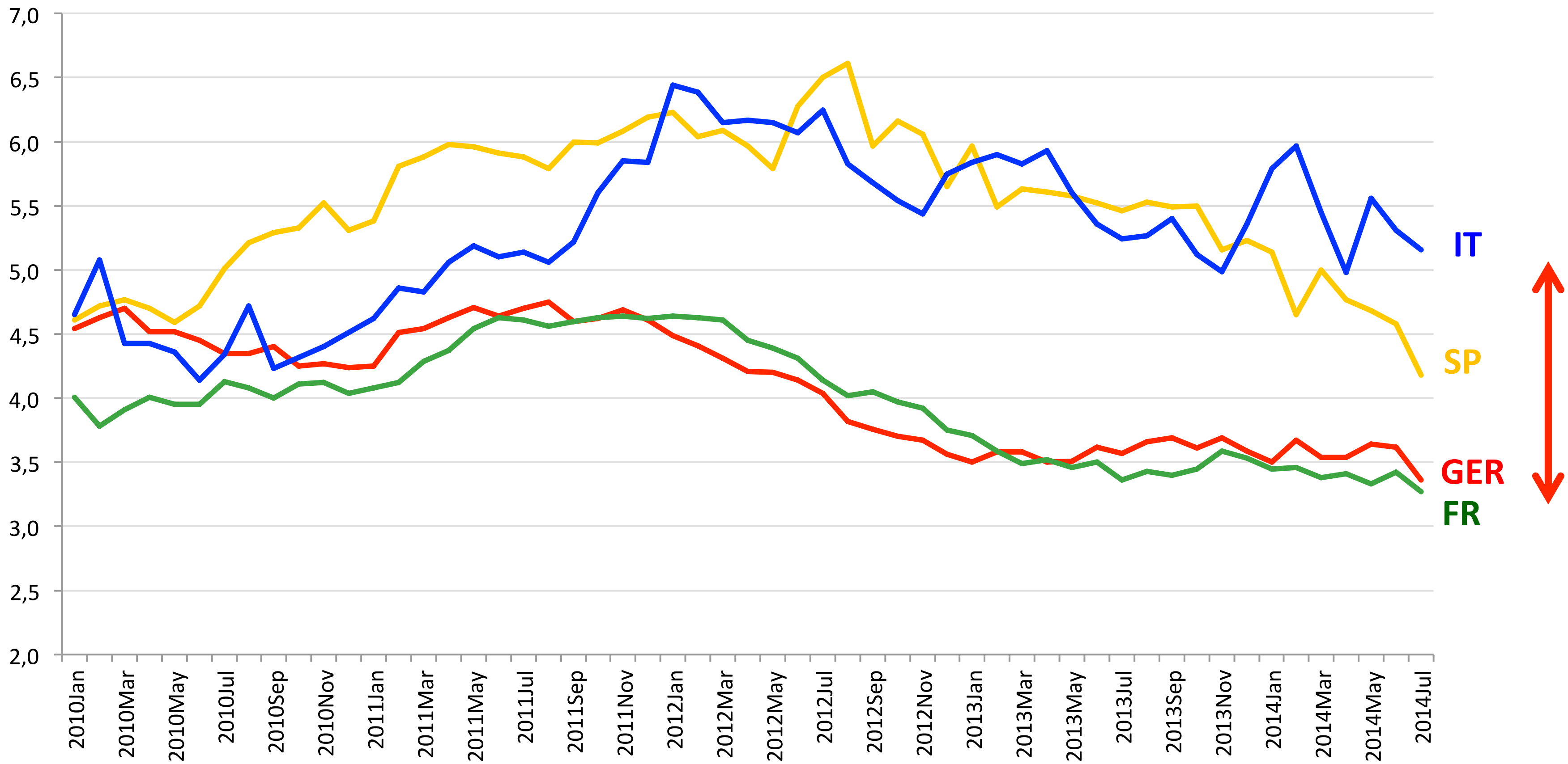
Still seen as riskier in March 2013,
banks in the periphery have now almost joined the pack

Source : Bloomberg

3) Although reducing for Spain, cross-country divergence in lending rates remains high, especially for Italy

Graph 3

Bank lending rates (in %) up to € 1 mln, of maturity 1-5 years



Spanish rates are roughly 90 bp higher than in the core, while last year in November 2013 this figure was 160 bp !!

Source : BNP Paribas Economic Research

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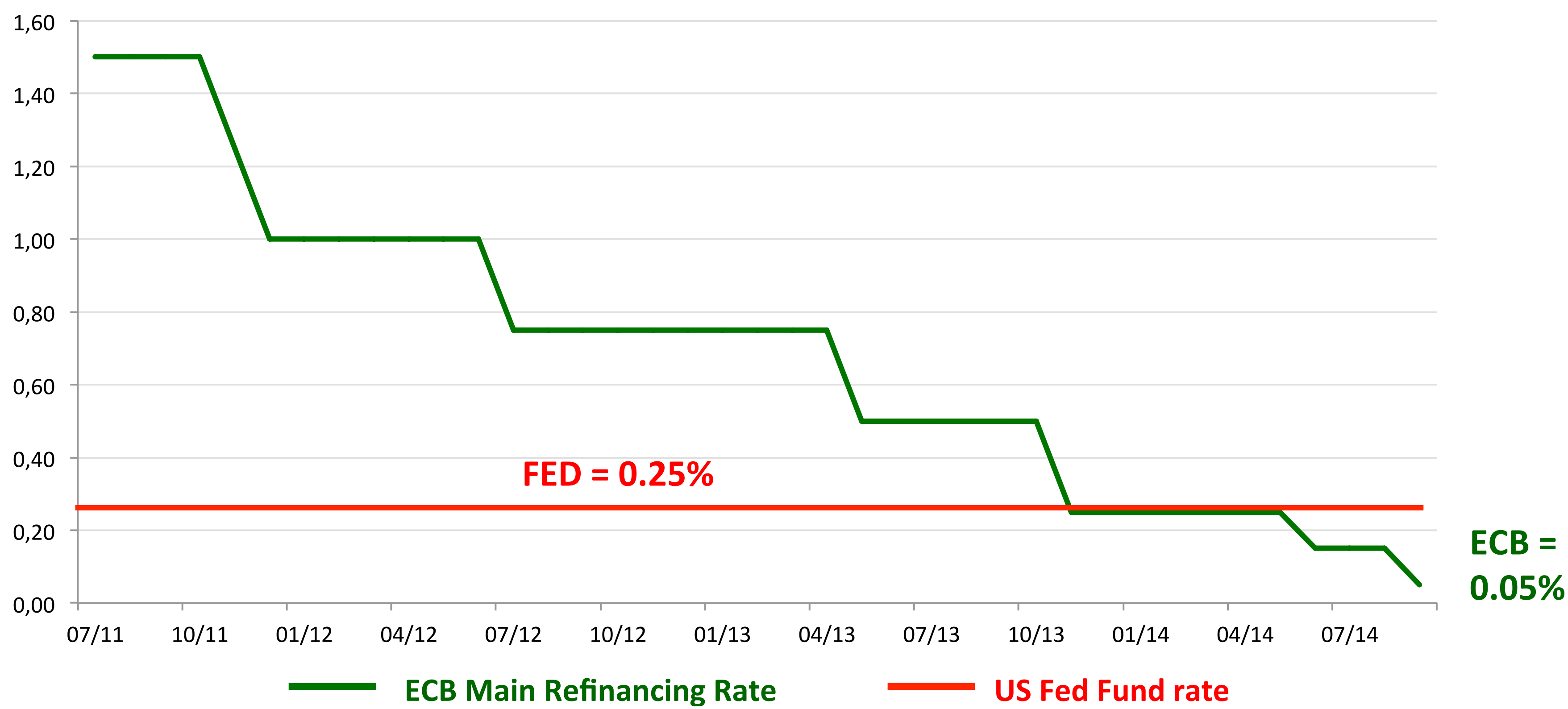
ECB has now reached the lower bound of its rates

Graph 4

Central banks rates (in %)



Because of sluggish economy and very low inflation, the ECB has gone further down than the Fed in terms of rates

Source : Bloomberg

ECB assets have doubled since the beginning of the crisis (against 4x for the Fed)

Graph 5

ECB total assets (€bn)

ECB latest stimulus measures are expected to significantly re-boost its balance sheet

Source : Bloomberg

ECB has recently announced new measures targeted at reviving credit growth in the economy

Graph 6

Targeted LTROs:

- 4-year refinancing subject to conditions and commitments in 2 tranches, to be followed by others depending on the evolution of lending
- September 18th 2014: First allotment of €82.6 bn
- December 2014 : Second allotment (to be announced)
- Cheap liquidity (0,15%) injection into the banking system
- Conditional on a rebound in loans to corporates and households (excluding housing)
- A potential support to the economic recovery in Europe

ABS :

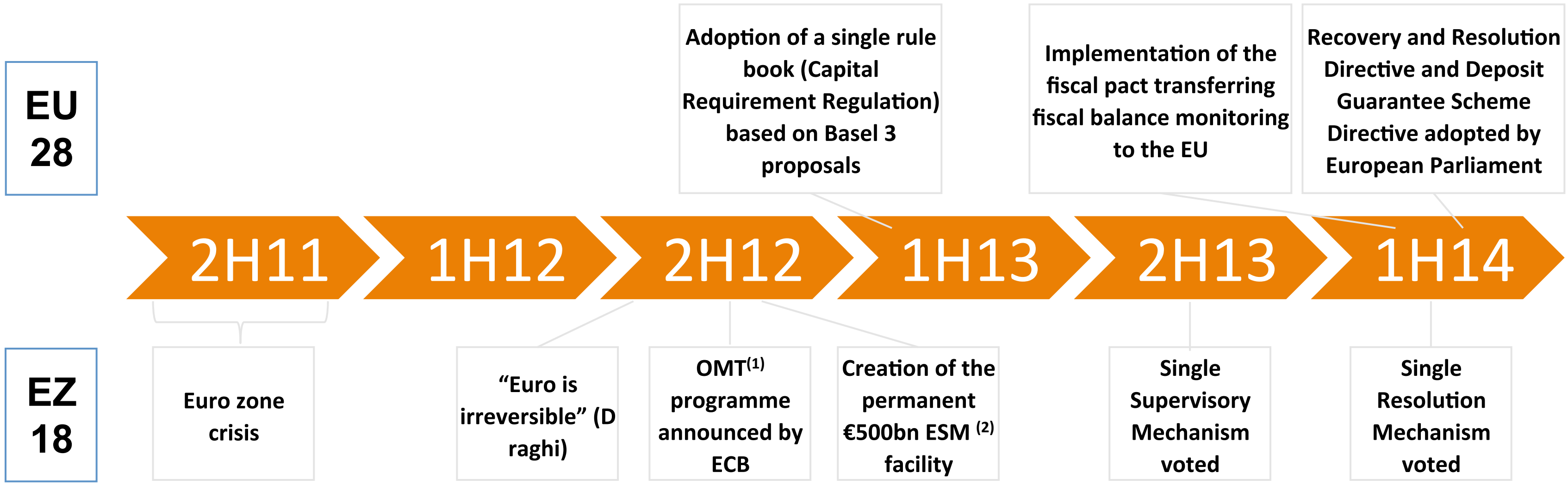
- ECB plans to buy ABS and covered bonds
- Simple, transparent and of high quality

FULL QE :

- When and if needed

The new European banking framework is shaping up

Graph 7



- The three pillars of the Banking Union decided in 2013 are being rolled out
  - Single Supervisory Mechanism (SSM) voted in October 2013, started on November 4th 2014
  - Single Resolution Mechanism (SRM) voted in April 2014, to be fully effective January 2016
  - Deposit Guarantee Scheme voted in April 2014, to be transposed by July 2015
- "Comprehensive Assessment" of banks' balance sheets
  - ECB started to take on new banking supervision tasks
  - AQR and Stress Tests completed and announced on October 26th 2014
  - Almost all 130 banks passed the tests, with 12 exceptions

(1) Outright Monetary Transactions; (2) European Stability Mechanism

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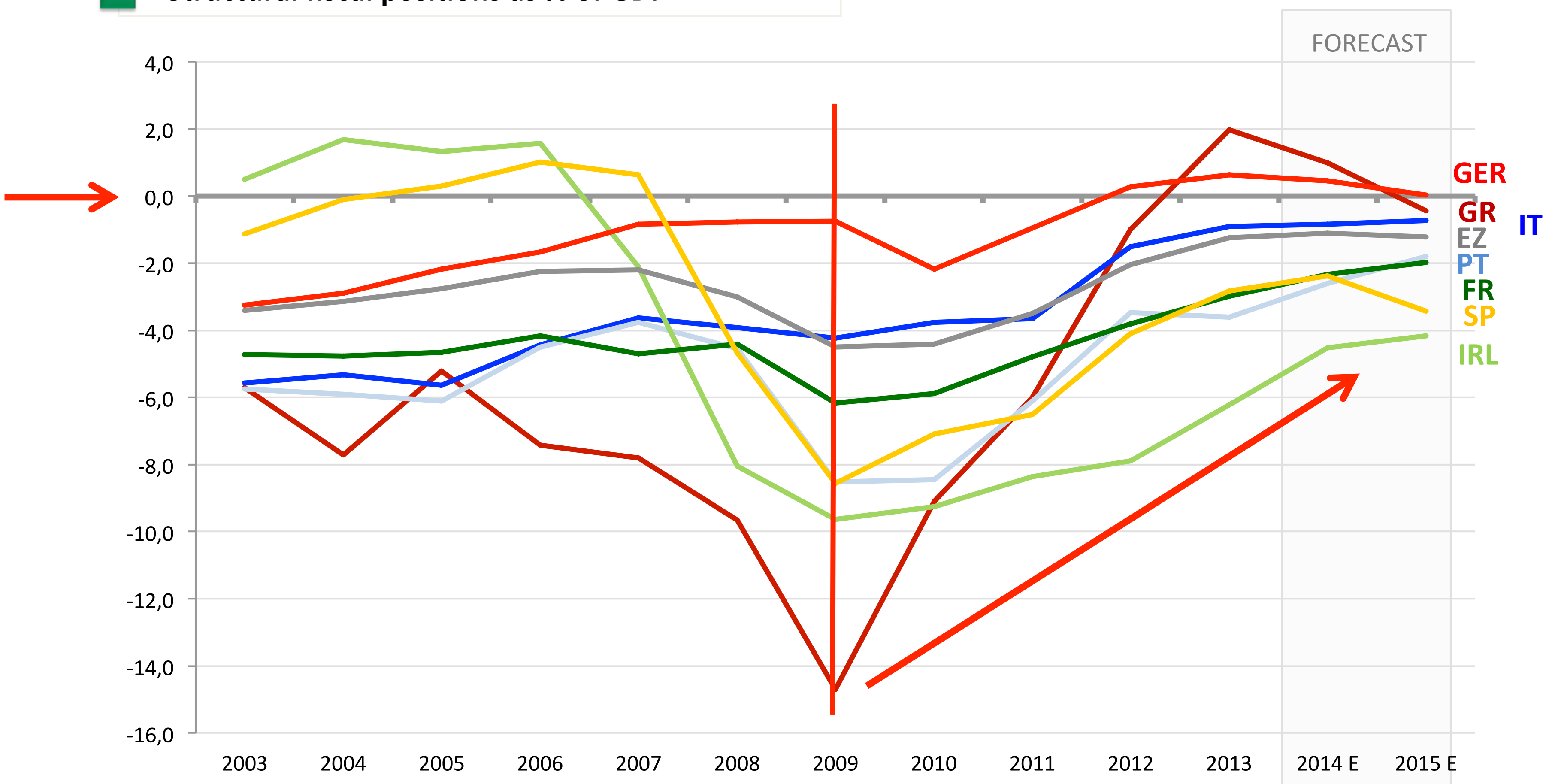
Structural fiscal imbalances are significantly improving

Graph 8

Structural fiscal positions as % of GDP



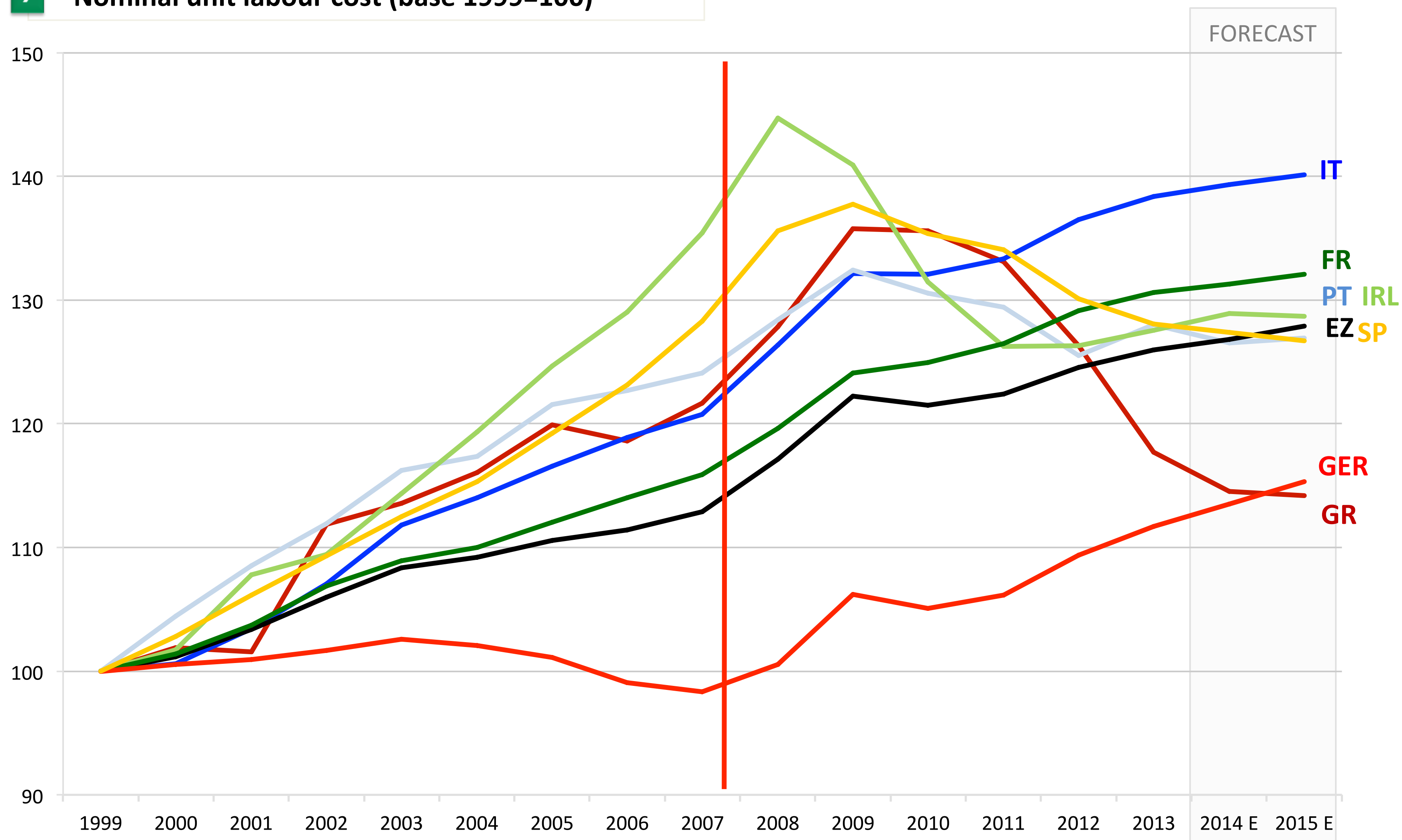
All countries are moving towards structural fiscal balance

Source and forecasts : EUROPEAN COMMISSION (Ameco)

Unit labour costs of most of the Euro countries are converging towards Germany, except for Italy and France

Graph 9

Nominal unit labour cost (base 1999=100)

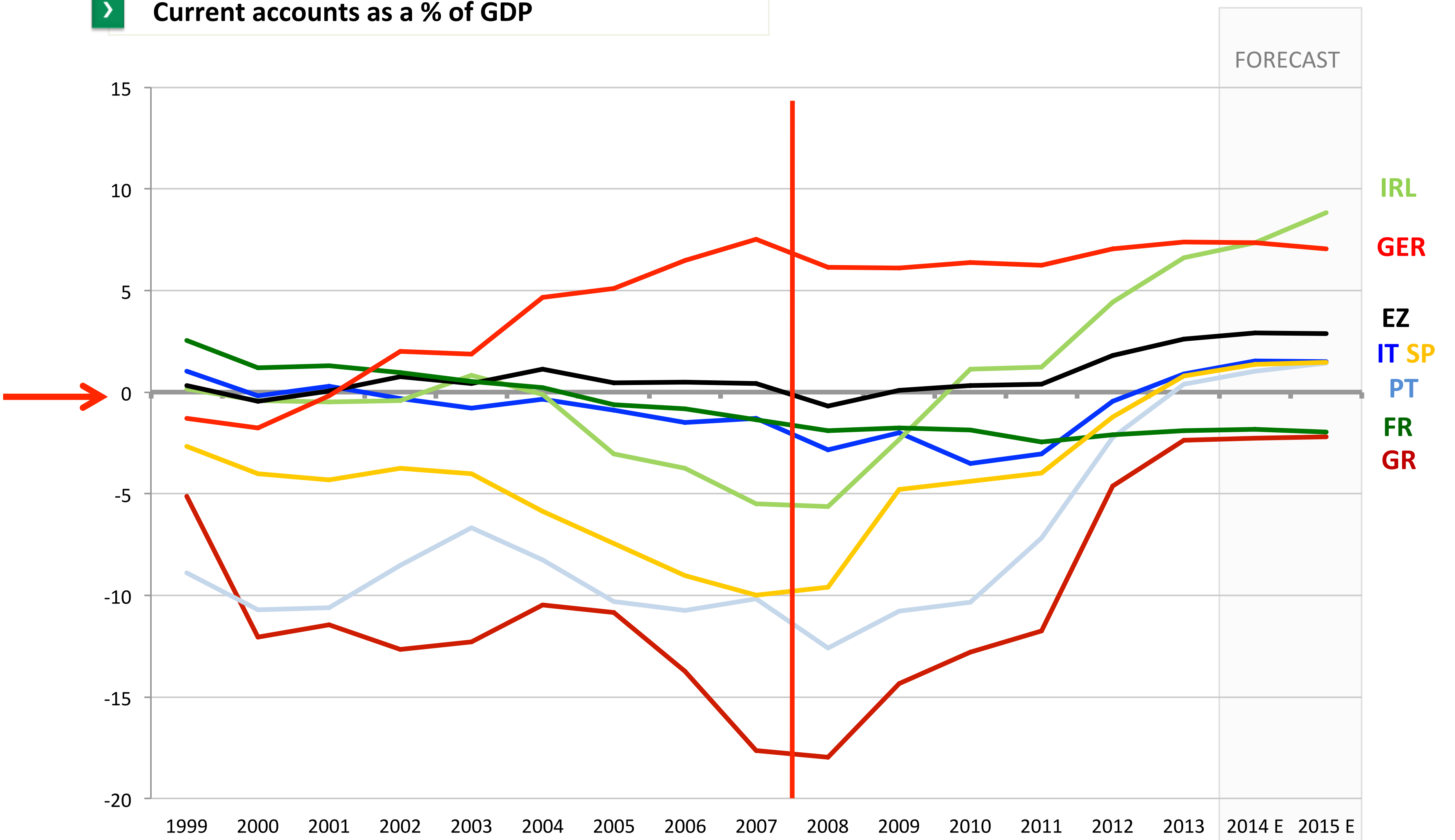


Source and forecasts : EUROPEAN COMMISSION (Ameco)

Except for a couple of countries, the Eurozone is now in current account surplus

Graph 10

Current accounts as a % of GDP

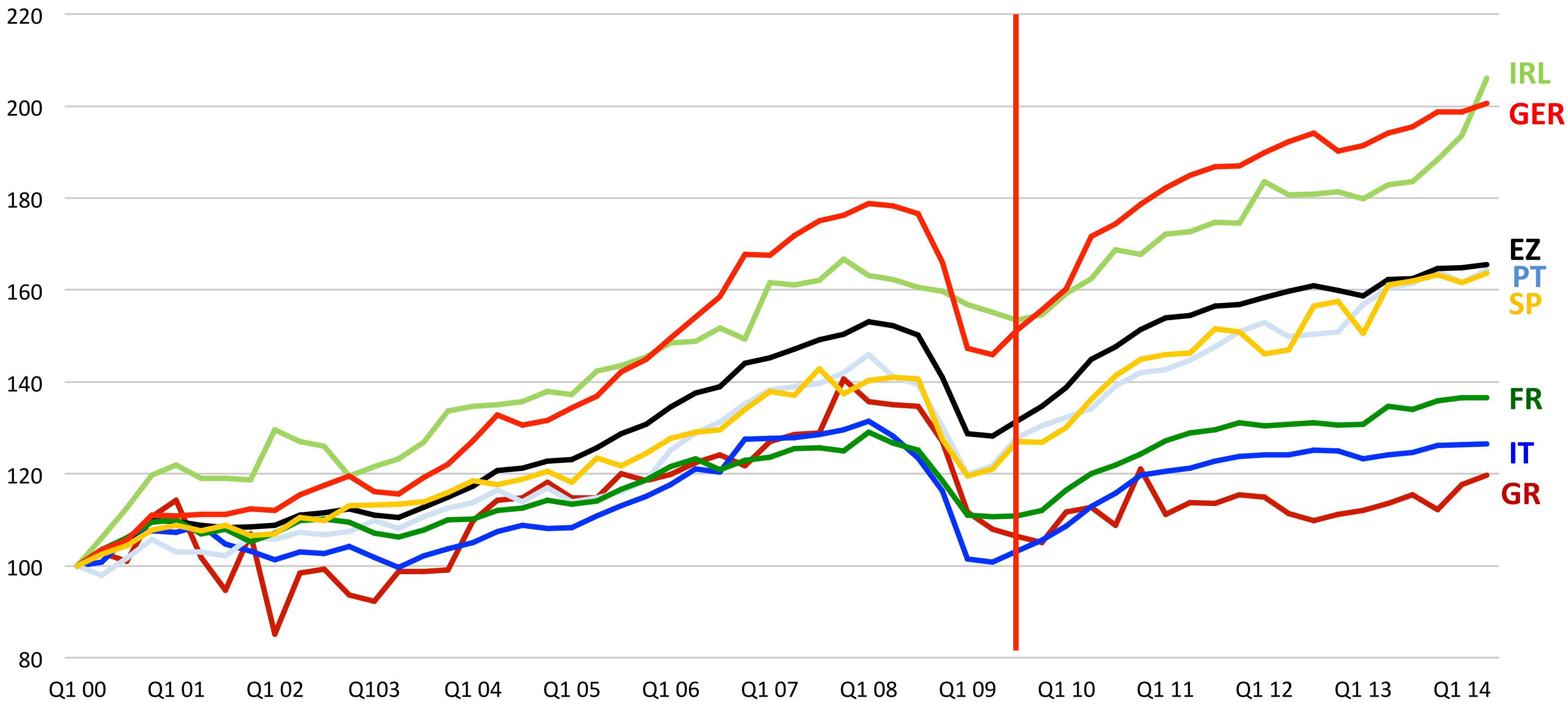


Source and forecasts : EUROPEAN COMMISSION (Ameco)

Exports are the main driver of the improvement of current accounts

Graph 11

Exports, Goods and Services, volume (Base Q1-2000=100)



Growth in exports is the litmus test of competiteviness

Source : EUROPEAN COMMISSION

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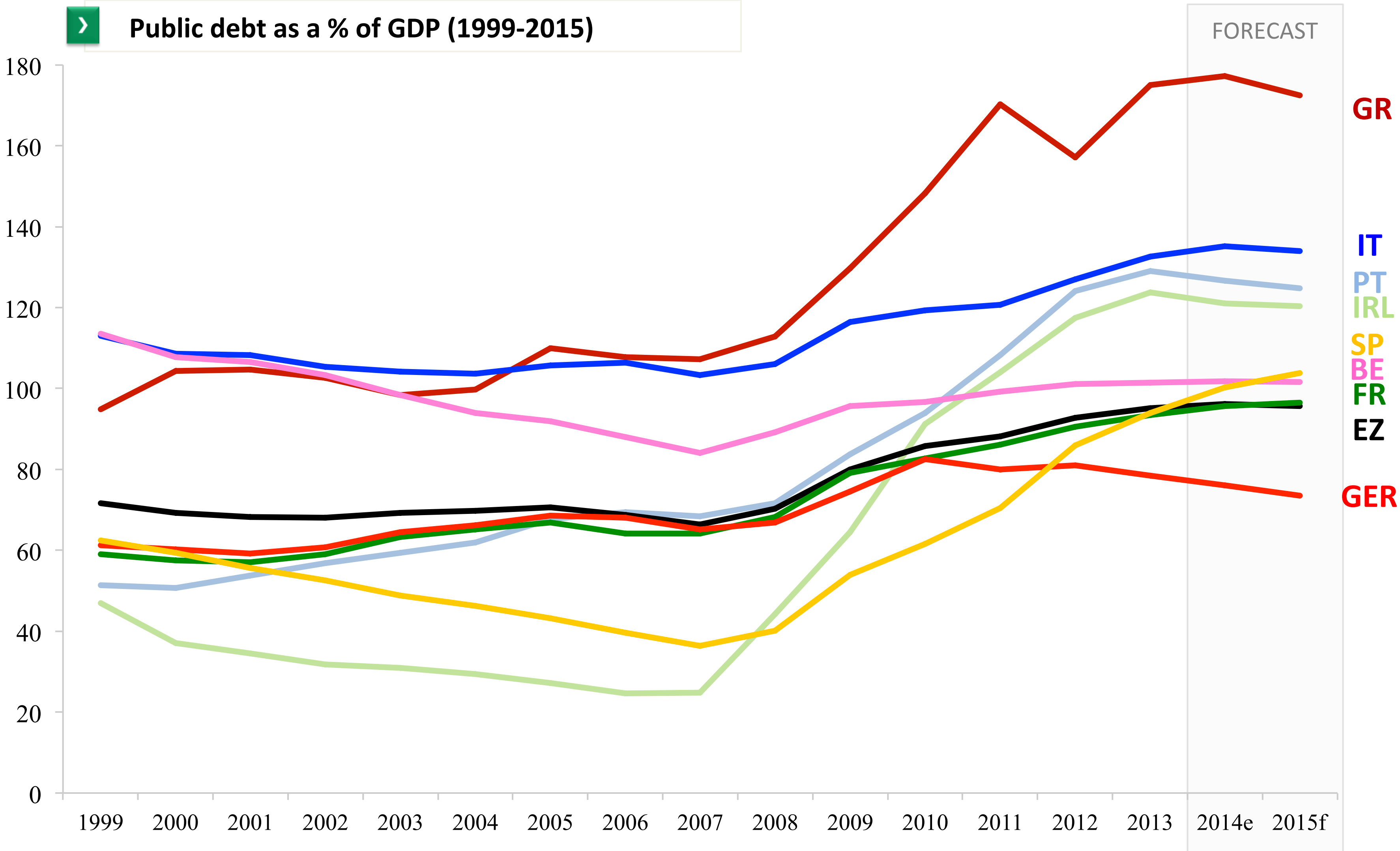
Public debt is stabilising albeit at high levels…

Graph 12

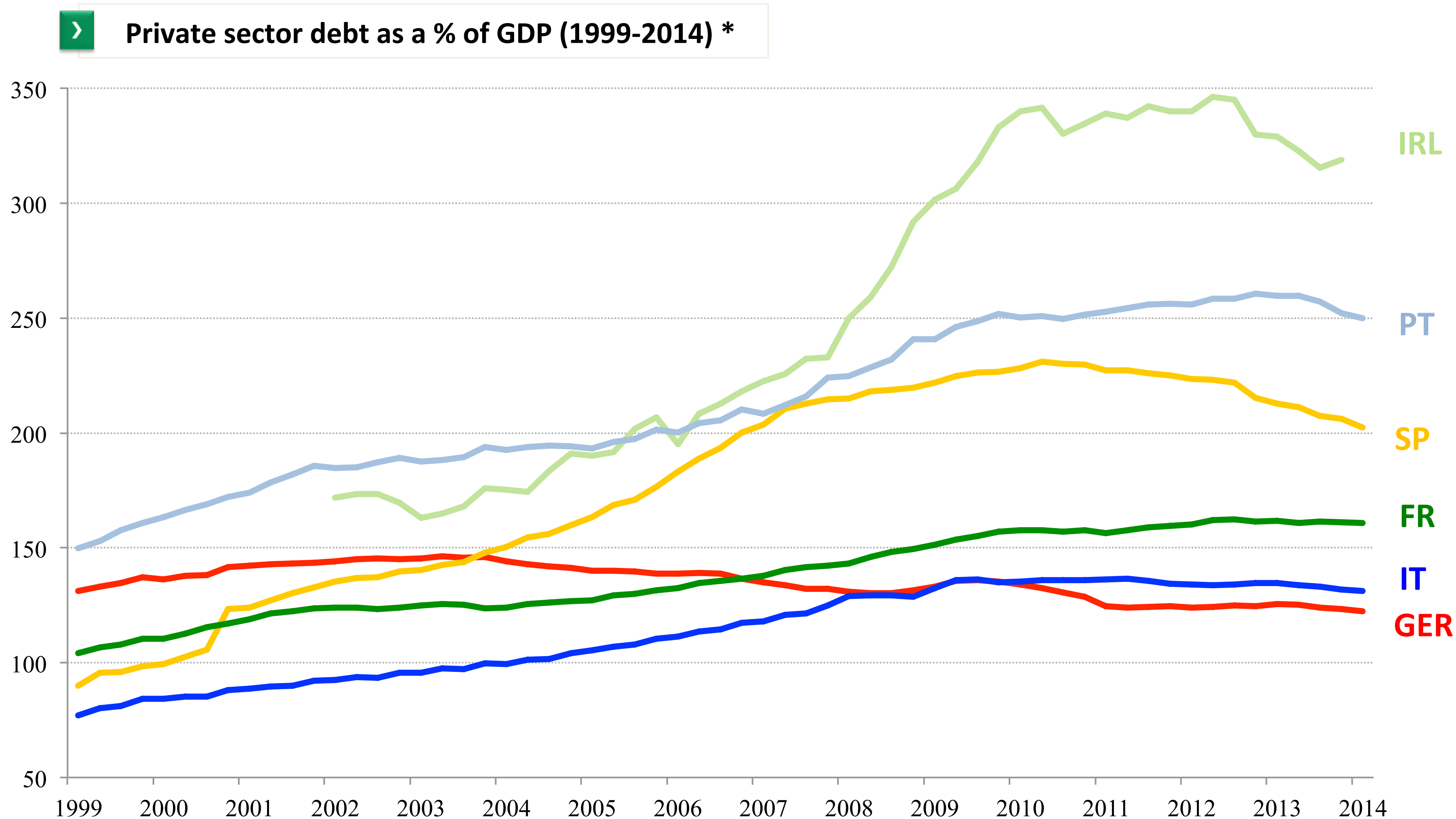
Public debt as a % of GDP (1999-2015)



Source and forecasts : EUROPEAN COMMISSION (Ameco)

… while the private debt is declining

Graph 13



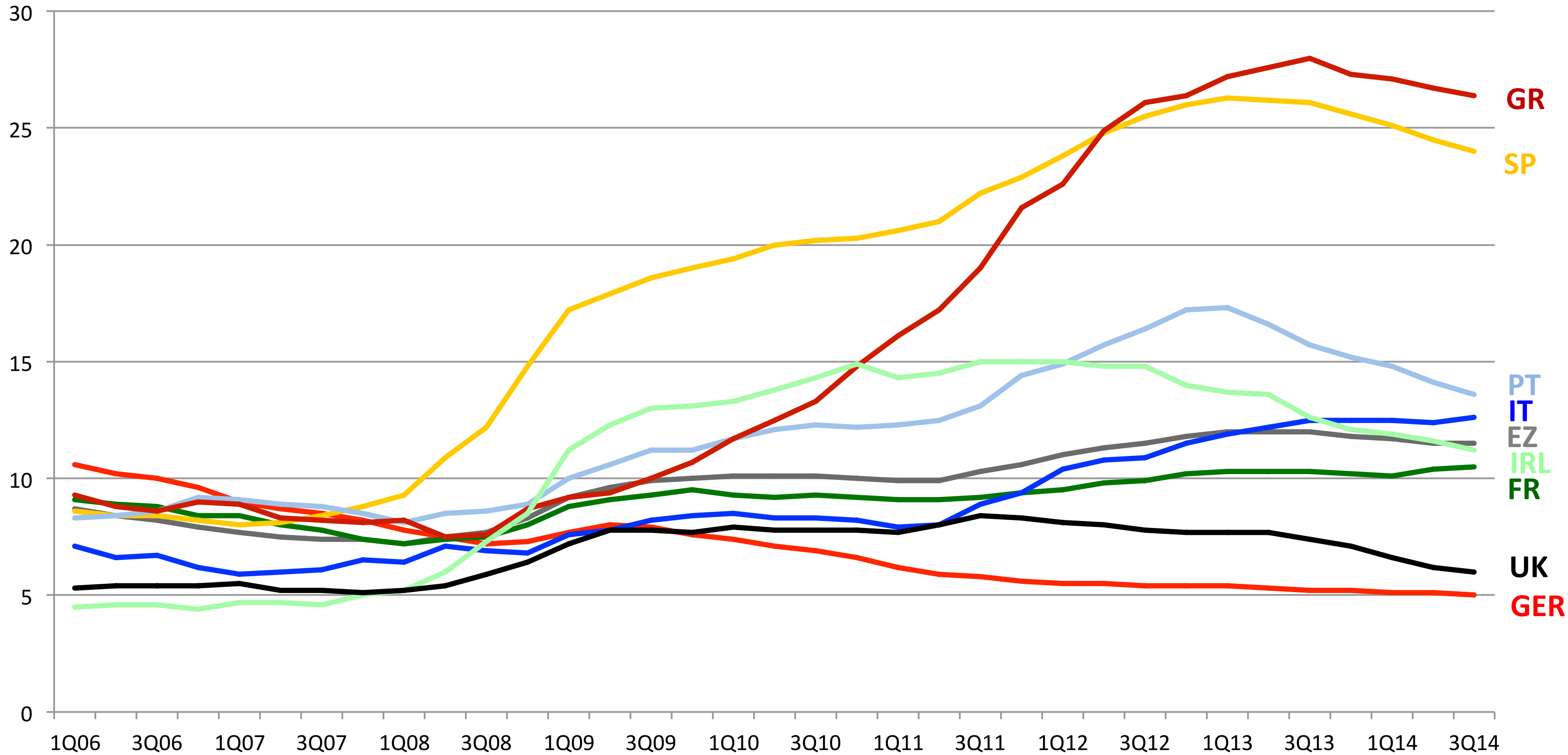
* Households & non-financial companies

Source : EUROPEAN CENTRAL BANK EUROSYSTEM

Although reducing, unemployment remains unacceptably high in many countries

Graph 14

Unemployment rates (%)

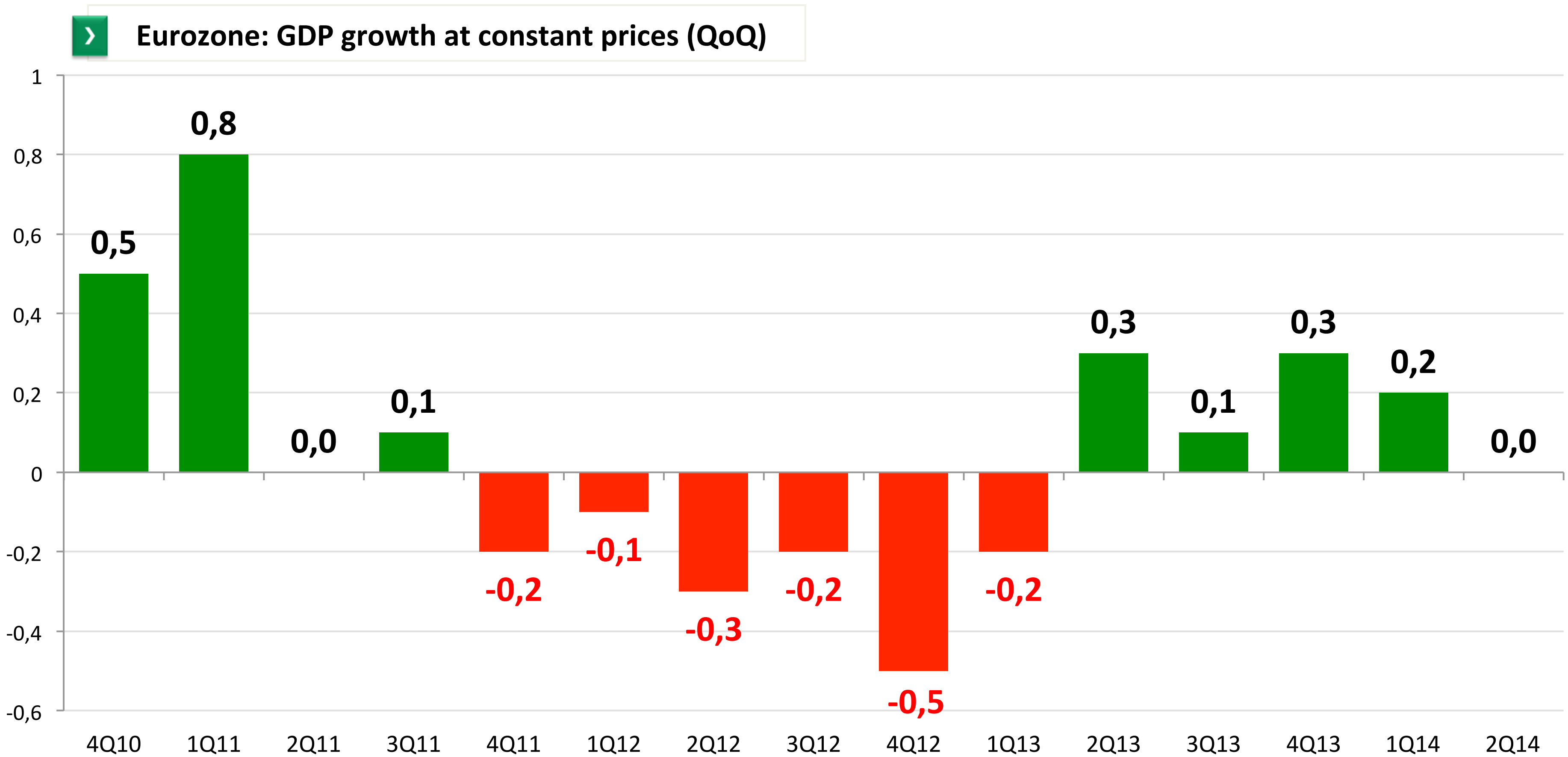


Peripheral countries are improving since 2013 (excluding Italy)

Source : Bloomberg

After the 2011-'12 recession, growth has picked up but remains low

Graph 15



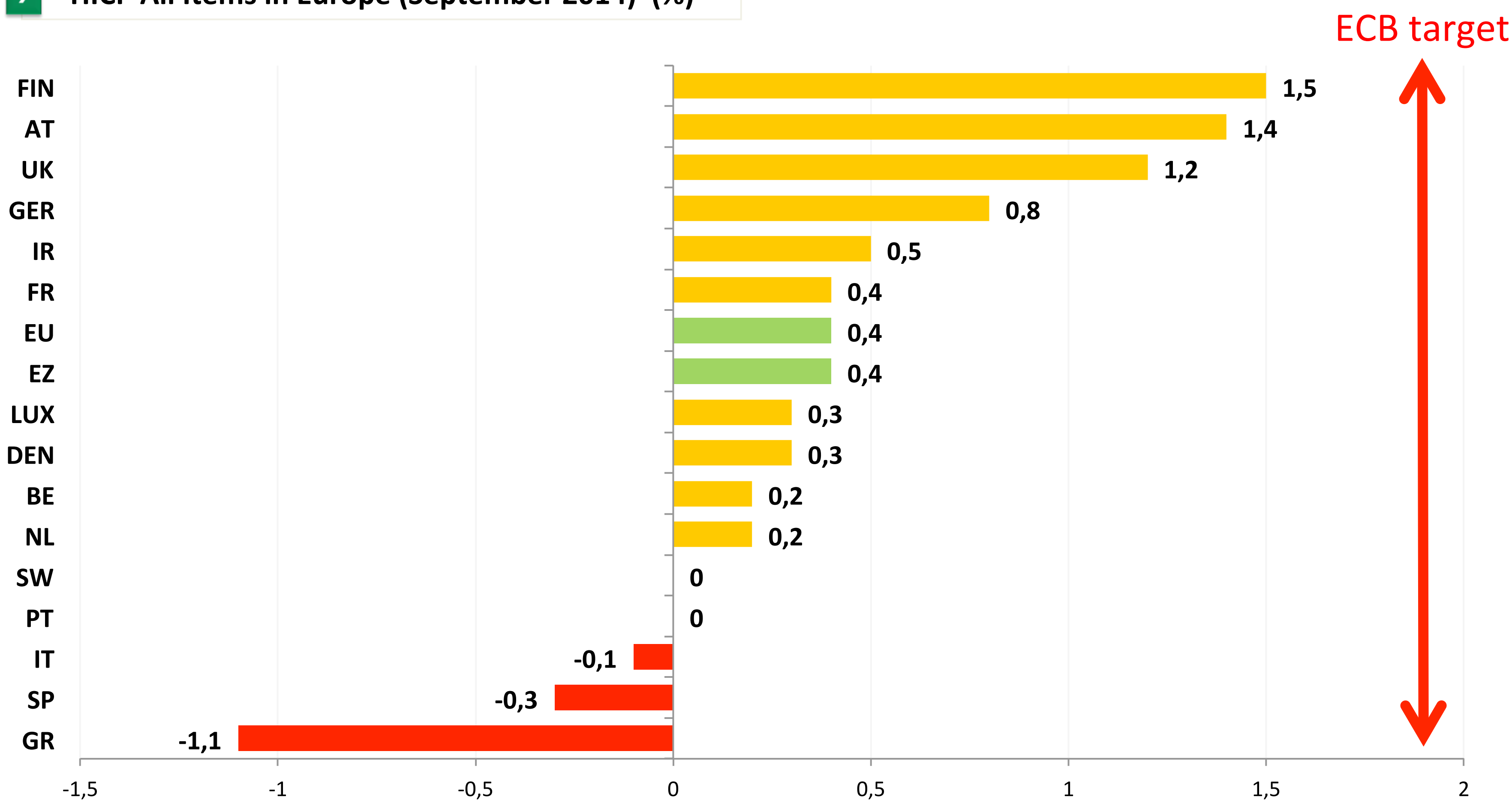
« Eurozone growth is expected to resume, while remaining modest » (Mario Draghi 10.10.14)

Source : eurostat

Low inflation is now becoming a source of concern

Graph 16

HICP All Items in Europe (September 2014) (%)



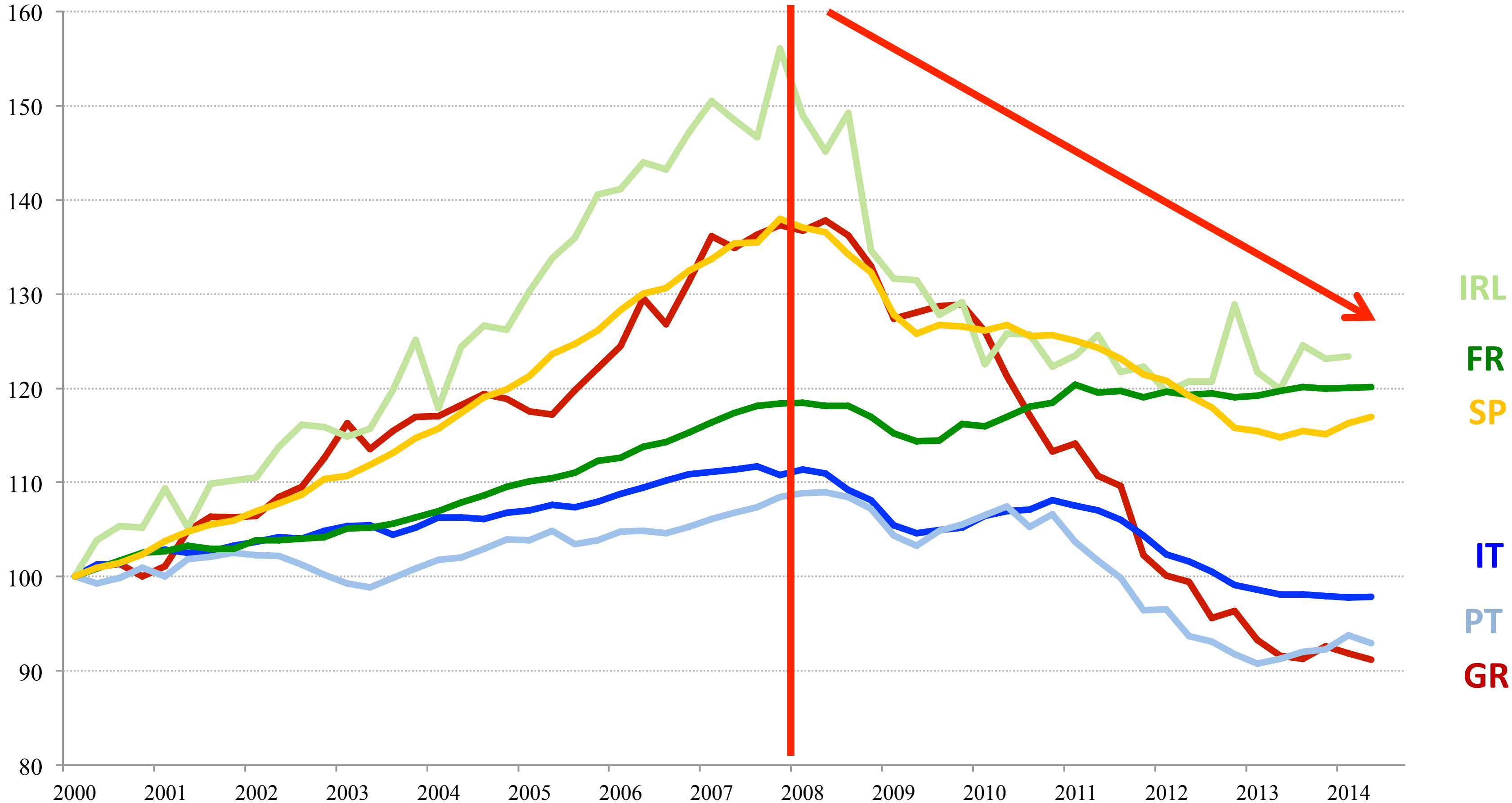
Several countries present now negative inflation rates

Source : eurostat

Peripherals have particularly suffered in terms of domestic demand, but they seem to have bottomed out

Graph 17

Domestic Demand, volume (Base Q1-2000=100)

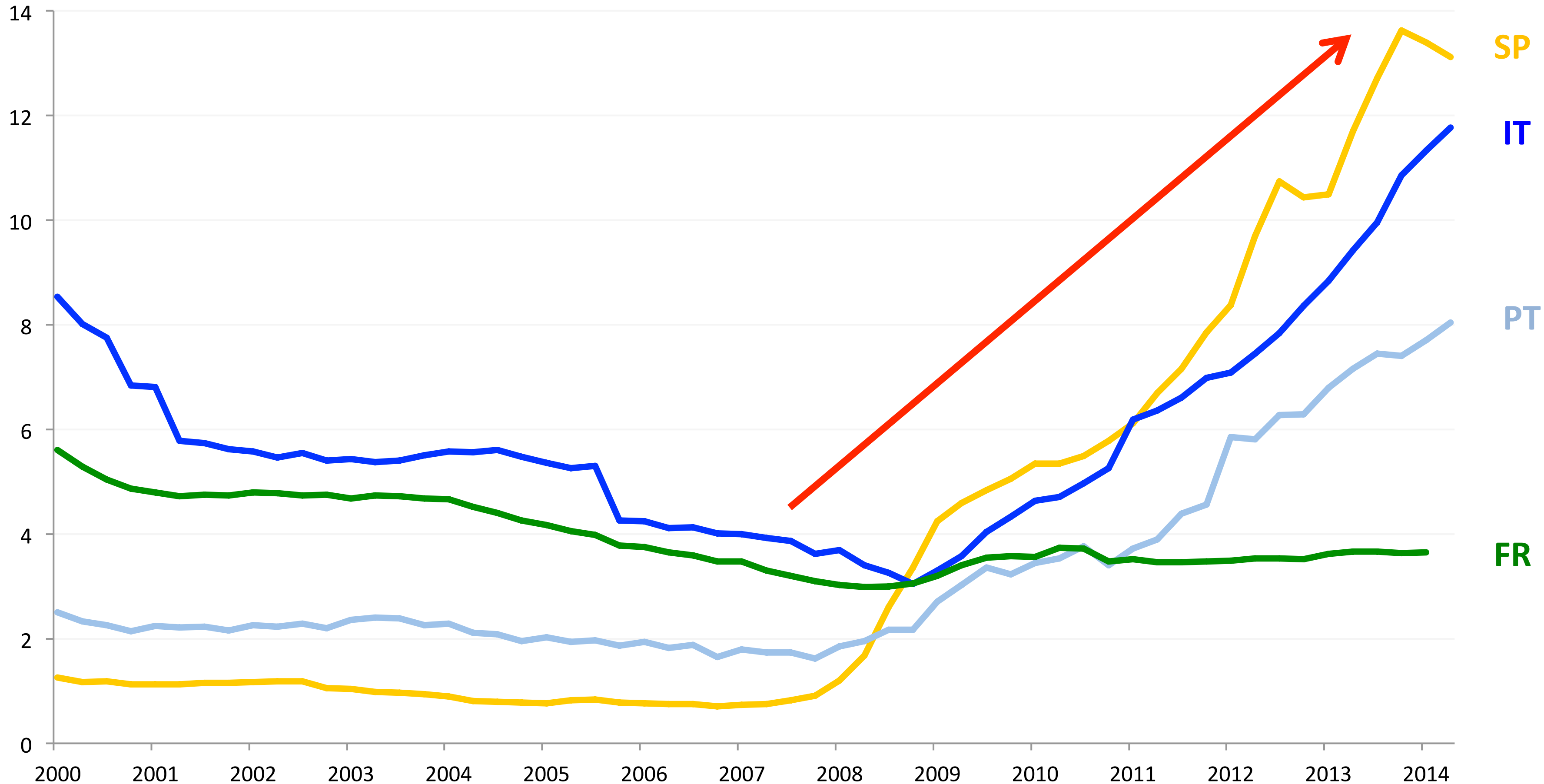


Source : eurostat

Doubtful loans, pushed by the recession, keep growing in the periphery expect for Spain

Graph 18

Doubtful loans as a % of total private sector borrowing *



* Households + non-financial companies

Source : eurostat

Reforms are of the essence for the revival of growth in the Eurozone

Graph 19

- Structural reforms are being implemented in some European countries, but more has to be done
- **Spain** and **Italy** have acted on labour market and pensions
- **Portugal** has reduced labour market rigidity, improved efficiency of state-owned enterprises and lowered structural fiscal deficit
- **Greece** is expected to operate an average primary surplus of 2% over the next four years, is widening its tax base, is improving tax collection and has made labour market more flexible
- **Ireland** continues to comply with its fiscal consolidation targets, to improve competitiveness and has started reforms to the local government system. Foreign direct investments are strong thanks to an innovative and flexible labour force
- **France** has to intensify its own efforts

Accomodating monetary policy can help to gain time, but cannot be a substitute for structural reforms

Source : eurostat

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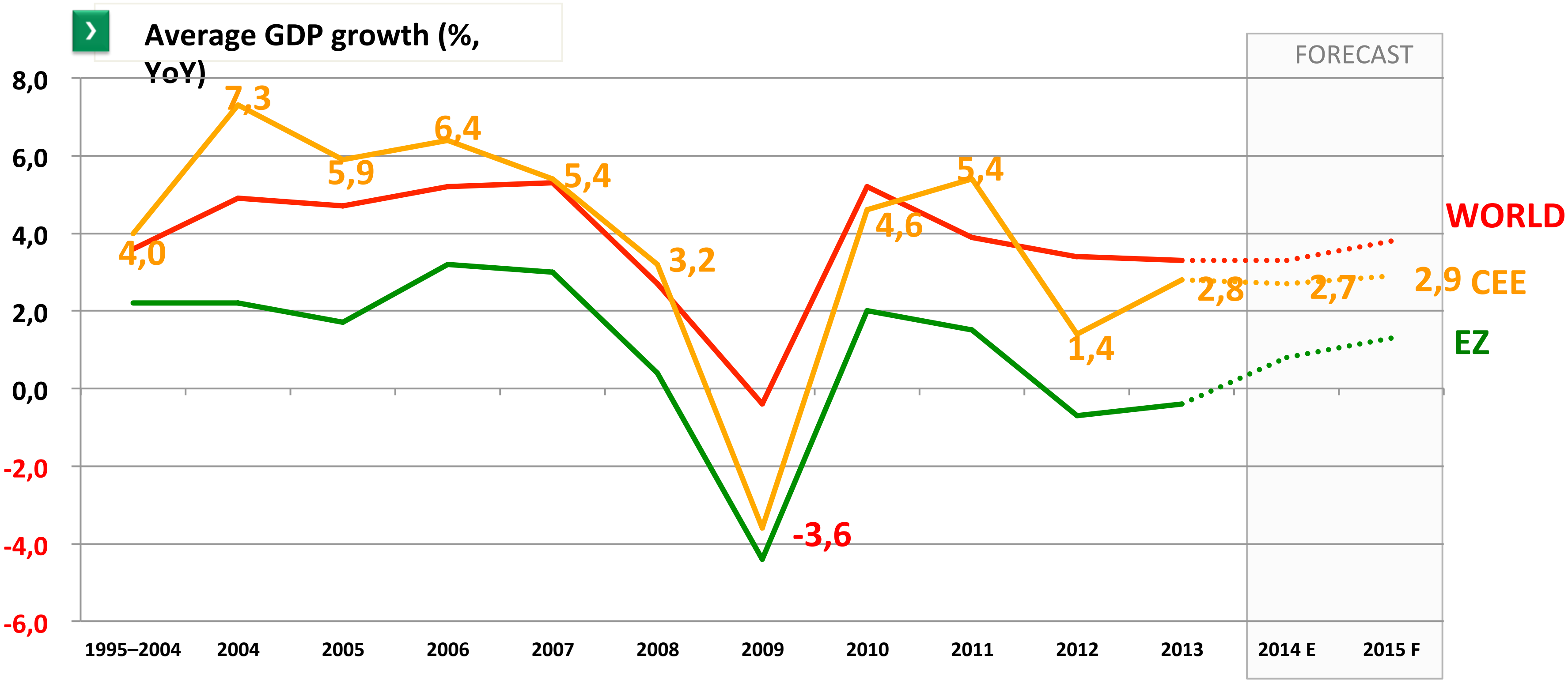
Growth rates in CEE countries compare well with those of the Eurozone

Graph 20



Source : IMF (October 2014)

1) CEE growth is correlated to the EZ, but has always shown a more dynamic trend

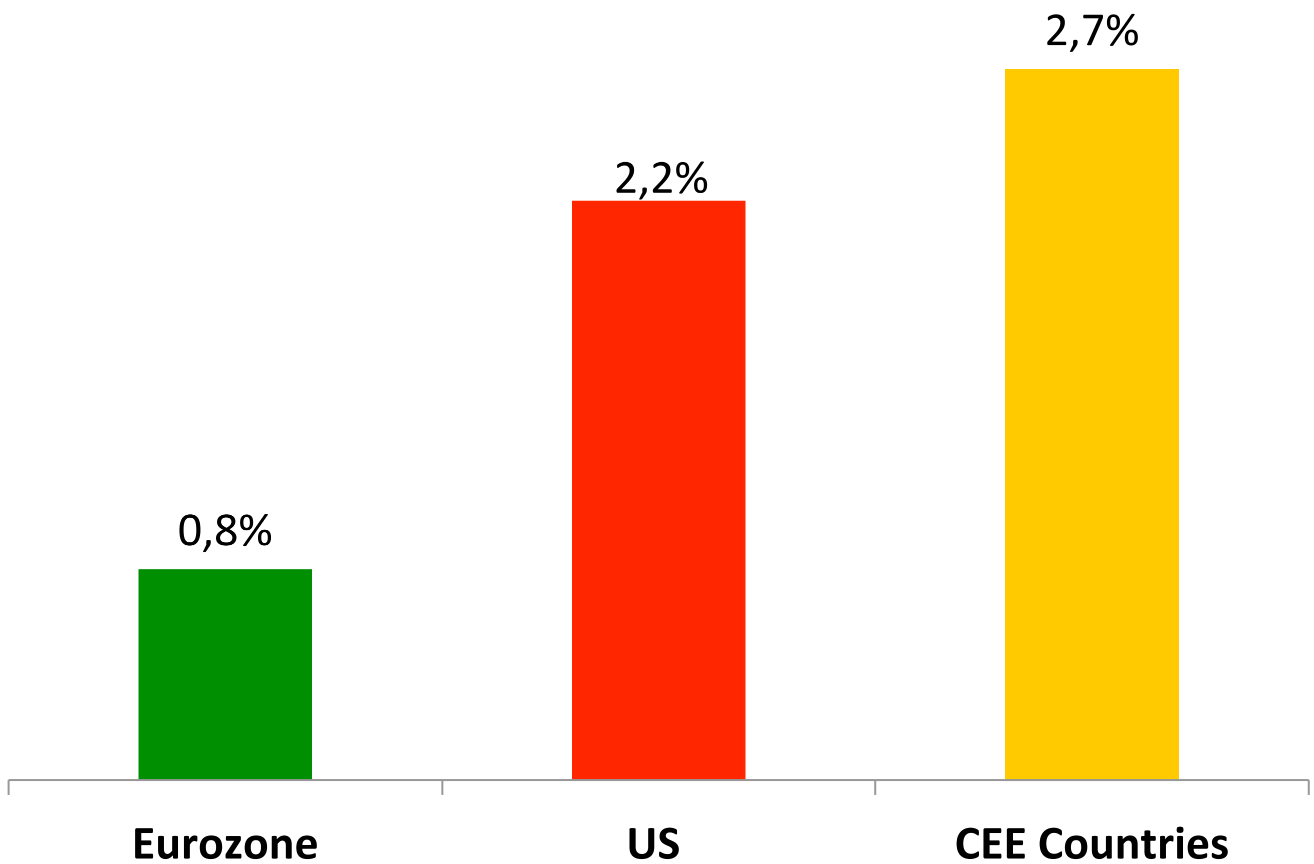
2) After the 2012 fall, the recovery in 2013 has been significantly higher than in the EZ

3) Compared to the World, CEE growth has outperformed 7 years out of 11 up to now

CEE countries are expected to perform significantly better than the Eurozone and the US in 2014

Graph 21

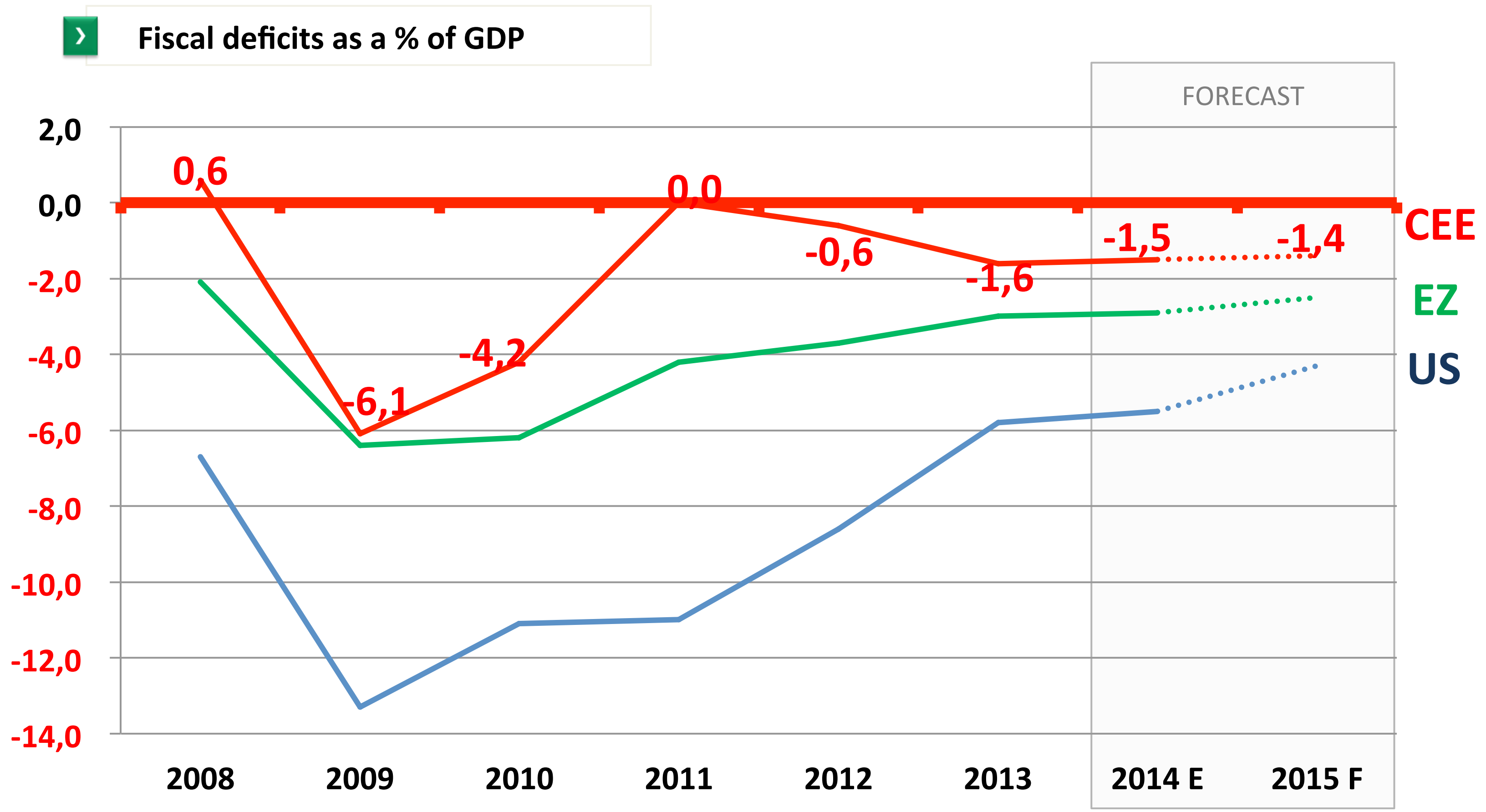
Expected GDP growth in 2014 (%)



Source : IMF (October 2014) and EU Commission (November 2014)

CEE fiscal positions remain close to balance, still better than in advanced countries

Graph 22



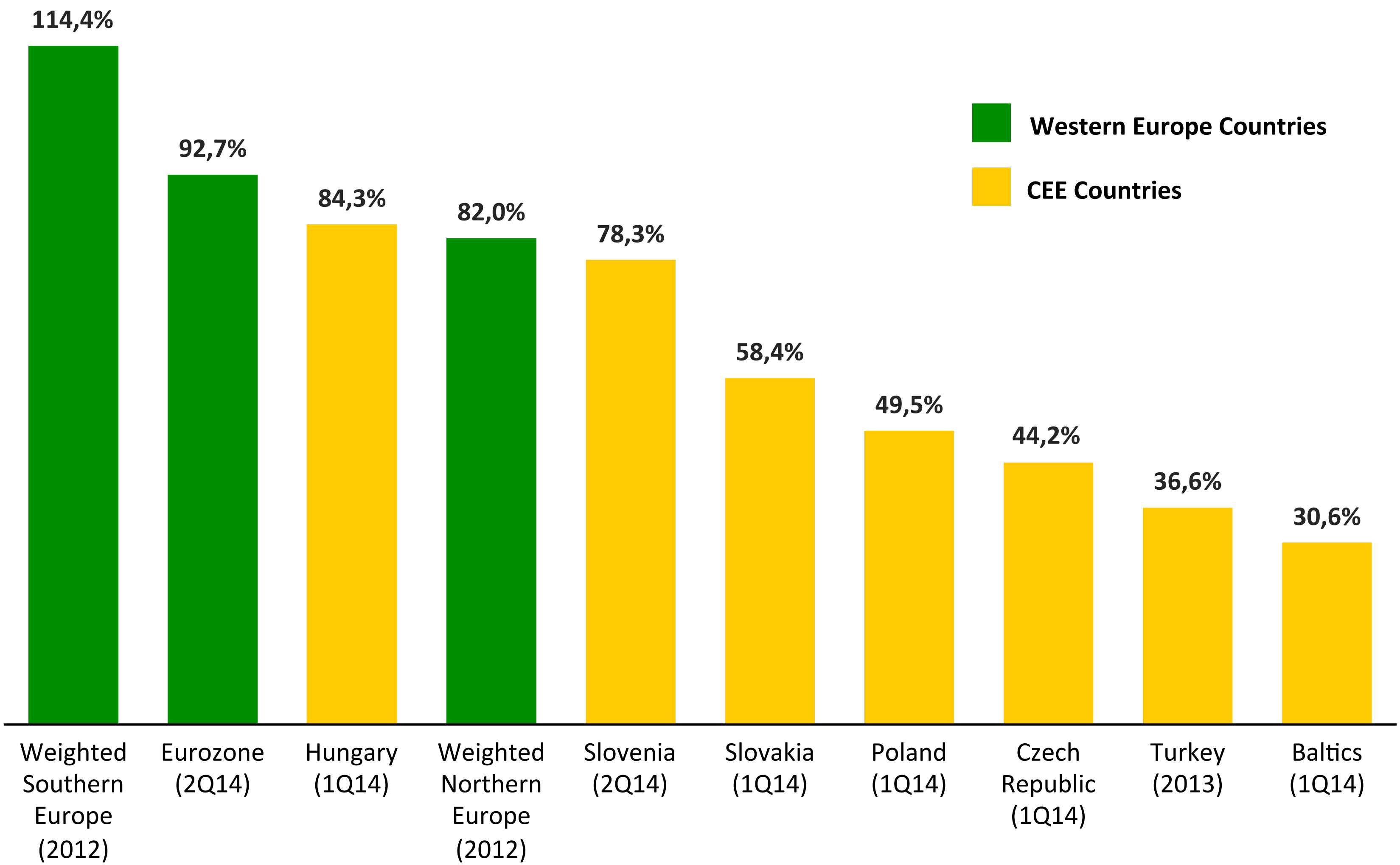
After the 2009-2010 global crisis, CEE countries have maintained their fiscal positions close to balance, while US and the EZ – although improving - are well below

Source: IMF, Fiscal Monitor (October 2014)

Lower public debt levels compared to Western Europe, expect for Hungary

Graph 23

Government debt levels (% of GDP)



Source: EIU, Eurostat, Bloomberg

Majority of CEE countries are rated as «Investment Grade»

Graph 24

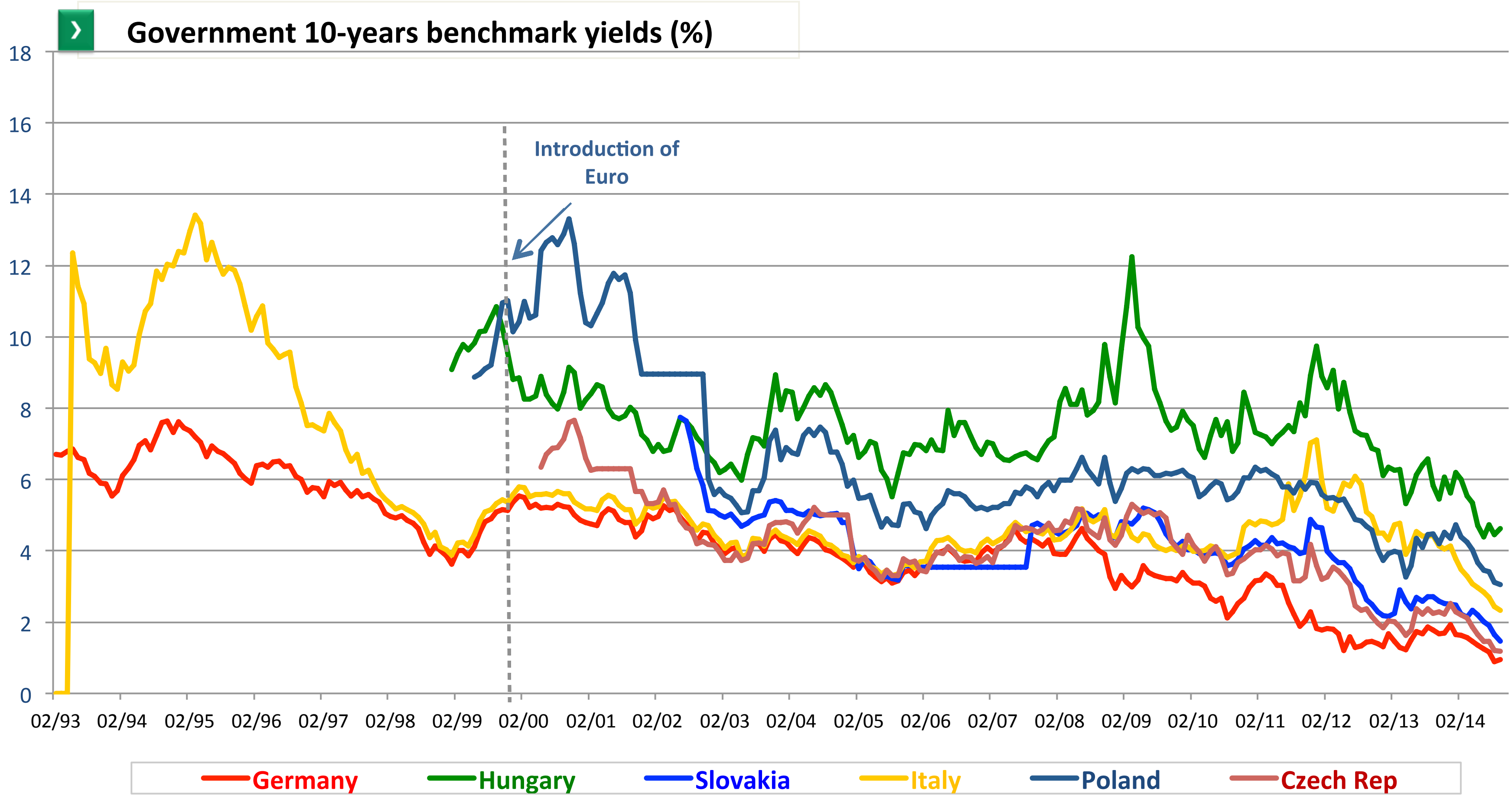
S&P Country ratings (October 2014)

Country	S&P Rating	Outlook
Czech Republic	**AA-**	**Stable**
Estonia	AA-	Stable
Slovakia	A	Positive
Poland	**A-**	**Stable**
Latvia	A-	Stable
Lithuania	A-	Stable
Slovenia	A-	Negative
Turkey	**BB+**	**Negative**
Croatia	BB	Stable
Hungary	BB	Stable
Serbia	BB-	Negative

Source : Bloomberg

Long-term interest rates in Eastern Europe are converging with Northern Europe

Graph 25



Note : Figures indicate the 10-year government bond yields of each country (updated up to 30/09/14)

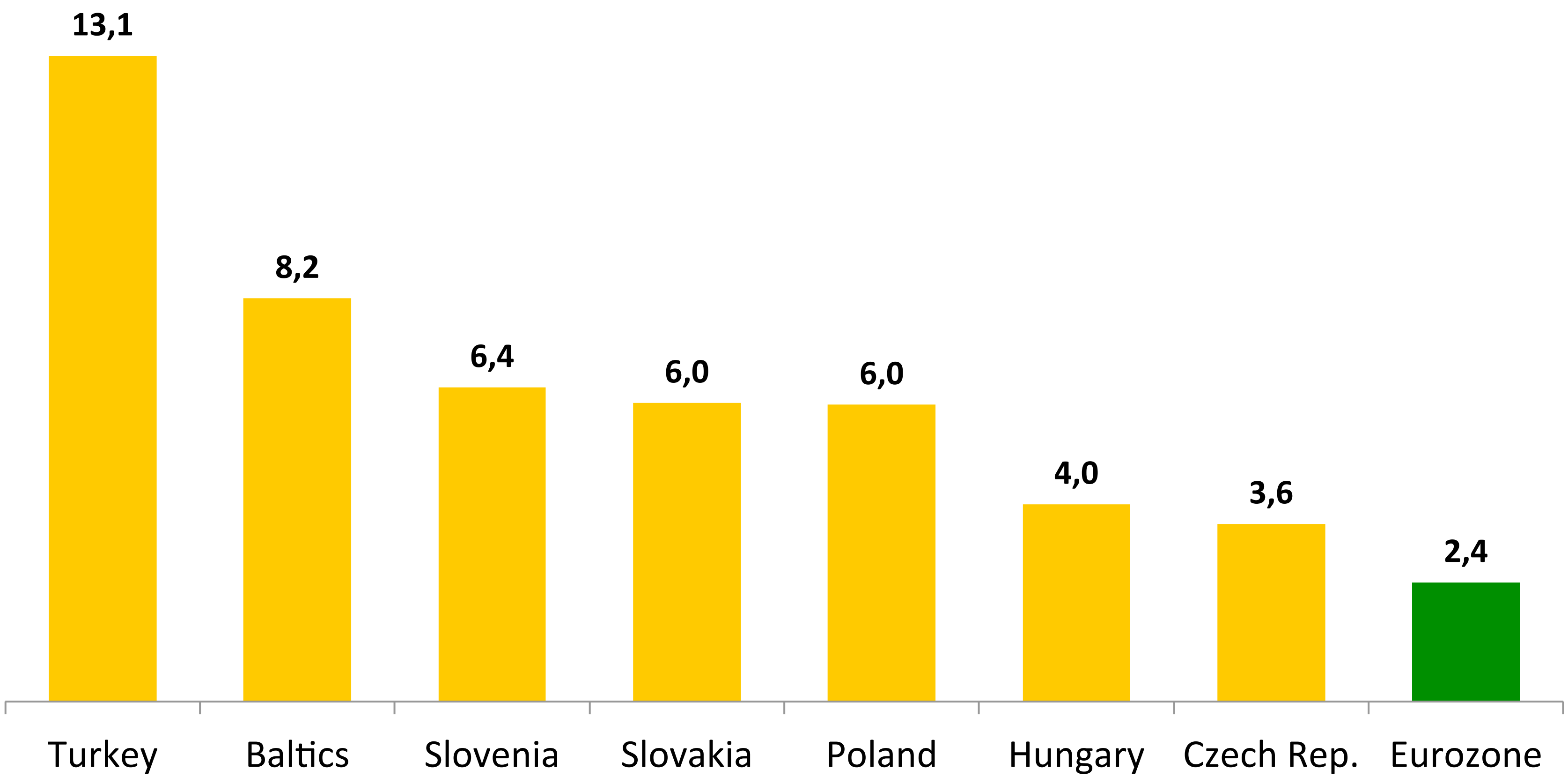
Czech Republic and Slovakia can borrow now at lower rates than Italy

Source : Bloomberg

Private consumption shows a robust growth in CEE countries over the last 10 years

Graph 26

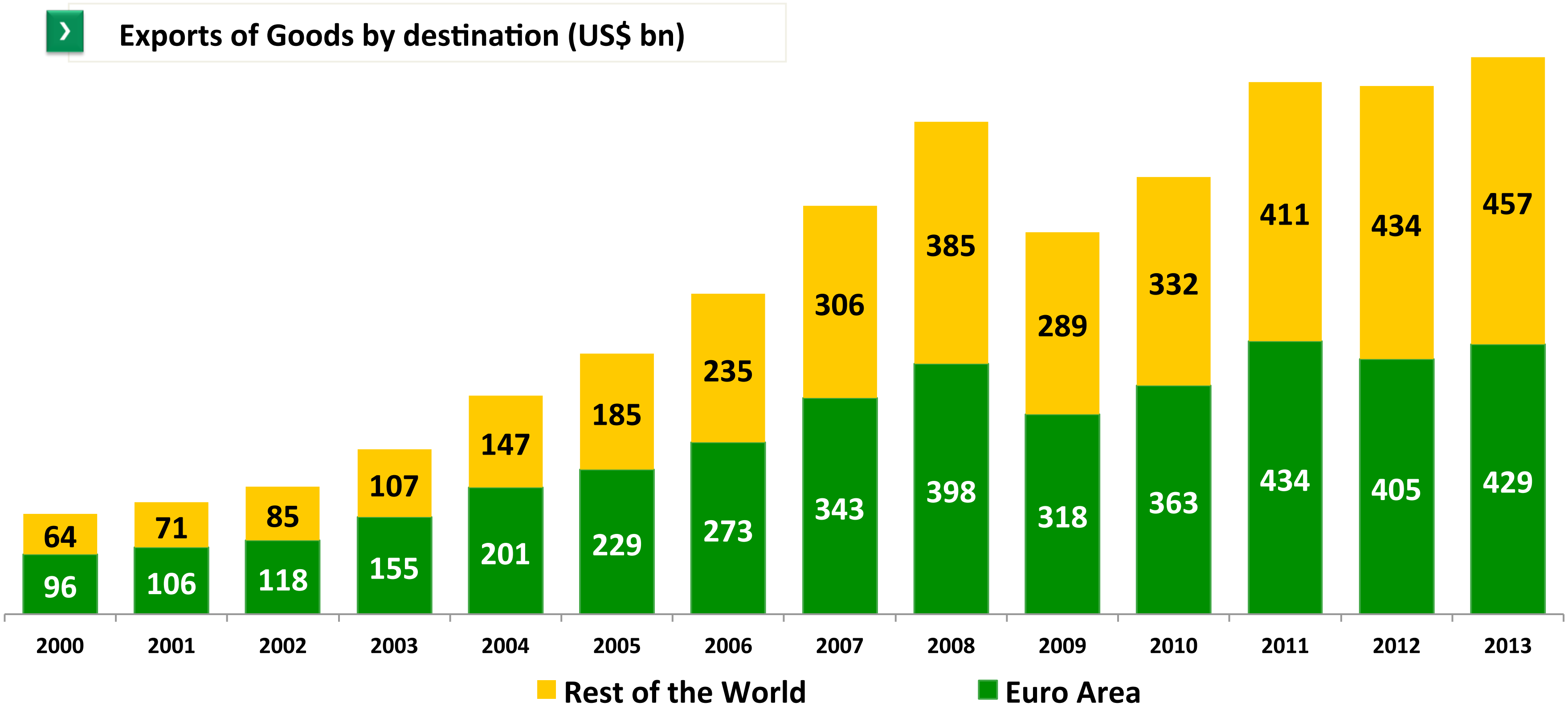
Annual average growth of Nominal Private Consumption 2003-2013 (%)



Source : Oxford Economics (2014)

CEE exports are expanding strongly

Graph 27



Exports from the region continue to grow

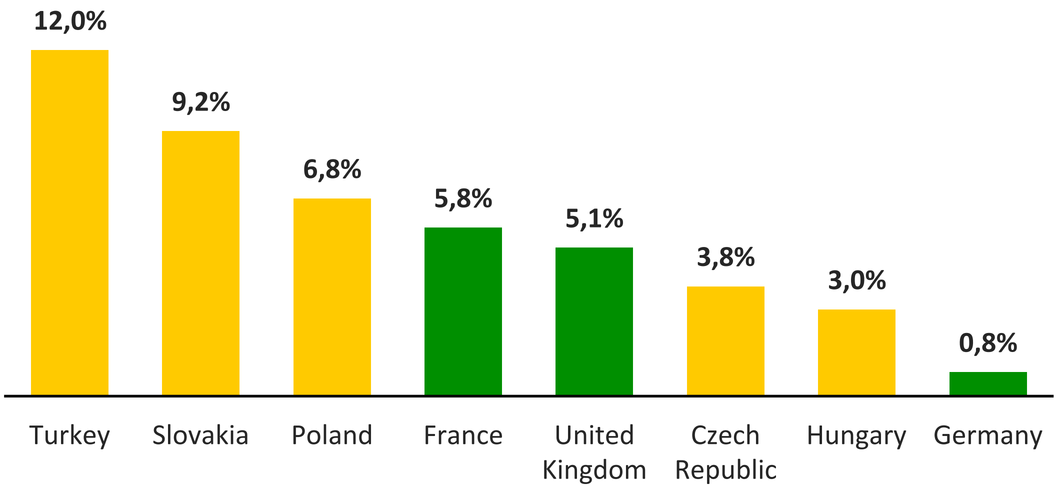
They have increased more than four fold over the past 11 years

The share of region's exports outside EZ has increased significantly and is now more than half of the total

Foreign direct investments in the region have done well, attracted by relatively low wages

Graph 28

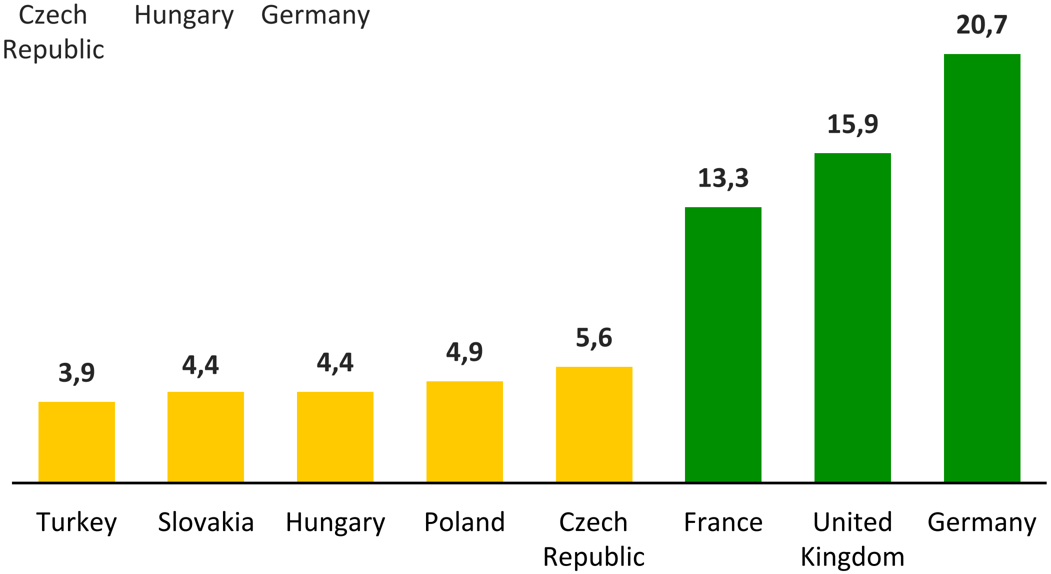
Growth of FDI in the region (2002-2012)



Western Europe Countries

CEE Countries

Wage per Hour (€)



Source: MIDEUROPA PARTNERS

Conclusion

“Many commentators in the US looked at the Eurozone and were convinced it would fail. They mistook the Euro for fixed exchange-rate regime, when in fact it is an irreversible single currency. It is irreversible because it is born out of the commitment of European nations to closer integration.”

Mario Draghi

Source: Harvard Speech 09/10/2013

“Eurozone expected to grow +1.1% in 2015, vs. +0,8% this year”.

EU Commission

Source: Reuters 04/11/14

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