



30 April 2010

## Focus Europe

# Germany and the euro area

The data flow from Germany is very favourable, strengthening our call that, after a mediocre start of the year largely on account of exceptional weather conditions, GDP in Germany will be relatively strong this year. We expect a gain in annual average of 2.0% this year.

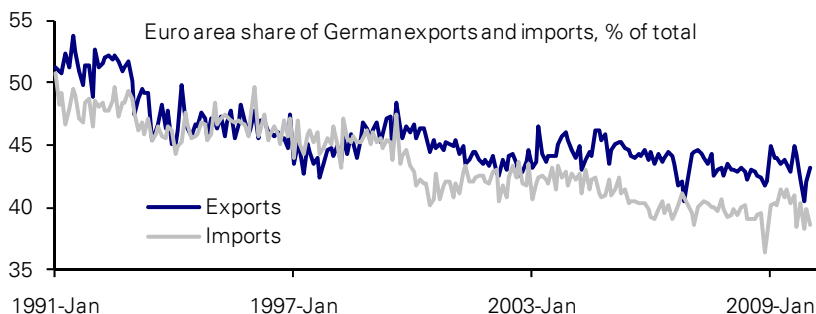
We also expect a significantly positive growth differential vis-à-vis the rest of the Euro area in 2010 (growth of 0.9% in euro area ex-Germany). A stimulative fiscal stance in Germany is a part of the explanation, but the higher sensitivity of the German economy to the rebound in demand outside the Euro area plays the most important role.

We do not expect the relatively strong German growth to have any major spill-over effect on the rest of the Euro area. German trade is becoming less integrated to the rest of the Euro area not only on the export side, but also on the import side. The German export machine is less and less reliant on intra-Eurozone inputs. Euro area countries, and more particularly the peripherals, will have to look to extra-eurozone demand for support while domestic demand is likely to be dampened for several years by the adjustment of private and public balance sheets.

This is consistent with our call that one of the long term consequences of the 2008/2009 downturn for Europe will be a generalized conversion to the "German model", i.e. a situation in which domestic demand is constrained by the competitiveness imperative, while exports increasingly focus on extra-Eurozone markets.

Also in this week's Focus Europe we preview the ECB's May Council meeting. Attention will focus on Greece, the euro sovereign debt market tensions, the ECB's liquidity protocols and their policy flexibility. We also update the outlook for the UK general election on Thursday and explore the recent trends in core inflation indicators across the US, UK and euro area.

### The euro area's share of German trade has fallen significantly



Source: Deutsche Bank, Haver

Deutsche Bank AG/London

All prices are those current at the end of the previous trading session unless otherwise indicated. Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies. Deutsche Bank does and seeks to do business with companies covered in its research reports. Thus, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1. MICA(P) 106/05/2009

## Special Report

### Table of Contents

ECB flexibility is key.....	Page 03
Germany's limited spillover into euro area.....	Page 08
Euroland Inflation.....	Page 12
UK Election Update: Into the final week.....	Page 14
Rate Views.....	Page 19

### Research Team

#### Euroland

**Thomas Mayer**

(+44) 20 754-72884

**Gilles Moec**

(+44) 20 754-52088

**Mark Wall**

(+44) 20 754-52087

#### UK/Scandinavia

**George Buckley**

(+44) 20 754-51372

#### Central Europe

**Gillian Edgeworth**

(+44) 20 754-74900

#### Inflation Strategy/Economics

**Markus Heider**

(+44) 20 754-52167

## Economic Forecasts

	Real GDP % growth <sup>b</sup>			Consumer Prices % growth <sup>c</sup>			Current Account % of GDP <sup>d</sup>			Fiscal Balance % of GDP		
	2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F	2009F	2010F	2011F
<b>Euroland (top-down)</b>	-4.0	1.1	1.2	0.3	1.3	1.3	-0.6	0.2	0.1	-6.1	-6.7	-5.5
<b>Germany<sup>b</sup></b>	-5.0	2.0	1.3	0.2	0.9	1.0	5.0	6.4	6.1	-3.2	-5.3	-4.6
<b>France</b>	-2.2	1.2	1.3	0.1	1.4	1.1	-2.0	-1.9	-2.1	-7.9	-8.3	-6.9
<b>Italy</b>	-5.1	0.9	1.1	0.8	1.4	1.5	-3.3	-3.0	-3.1	-5.3	-5.1	-4.1
<b>Spain</b>	-3.6	-0.2	0.7	-0.3	1.2	1.3	-5.0	-3.9	-3.6	-11.4	-10.2	-8.1
<b>Netherlands</b>	-4.0	0.9	1.4	1.0	0.8	1.2	3.0	3.5	4.0	-4.8	-5.8	-4.7
<b>Belgium</b>	-3.0	1.5	1.4	0.0	1.6	1.5	0.0	0.5	1.0	-5.9	-4.8	-4.0
<b>Austria</b>	-3.5	1.3	1.4	0.4	1.3	1.3	1.5	2.0	2.5	-3.4	-4.4	-3.7
<b>Finland</b>	-7.8	1.3	2.0	1.6	1.4	1.3	1.0	1.5	2.0	-2.2	-3.4	-2.5
<b>Greece</b>	-2.0	-4.0	-1.0	1.3	2.6	1.1	-11.3	-2.0	2.0	-12.7	-9.3	-7.1
<b>Portugal</b>	-2.7	0.7	1.1	-0.9	0.6	0.8	-9.0	-6.0	-4.0	-9.2	-8.3	-6.7
<b>Ireland</b>	-6.9	-0.3	1.9	-1.7	-1.2	0.5	-3.0	-1.5	-0.5	-11.7	-10.7	-8.7
<b>UK</b>	-5.0	1.5	2.5	2.2	2.7	0.7	-1.1	-1.0	-0.8	-12.1	-11.3	-8.5
<b>Sweden</b>	-4.7	1.2	2.7	-0.3	1.5	2.0	7.4	7.5	8.0	-5.8	-5.0	-3.5
<b>Denmark</b>	-5.1	1.5	2.0	1.3	2.0	1.0	3.0	2.5	2.0	-6.7	-7.0	-5.0
<b>Norway</b>	-1.4	1.5	2.8	2.2	1.6	1.6	13.9	15.0	16.0	7.6	8.0	10.0
<b>Switzerland</b>	-1.5	1.7	2.0	-0.5	1.0	1.0	8.0	9.0	10.0	1.4	1.0	1.2
<b>Poland</b>	1.7	3.2	3.1	3.5	2.5	2.5	-0.7	-3.3	-4.1	-6.5	-6.5	-5.7
<b>Hungary</b>	-6.3	1.5	3.4	4.2	4.2	2.2	0.3	-1.0	-2.4	-4.0	-5.0	-3.6
<b>Czech Republic</b>	-4.2	2.7	3.0	1.0	1.6	2.3	-1.1	-2.0	-2.8	-6.5	-5.0	-4.1
<b>US</b>	-2.4	3.8	3.6	-0.3	2.0	1.9	-2.9	-3.0	-3.2	-10.2	-8.6	-6.3
<b>Japan</b>	-5.2	2.8	0.9	-1.4	-1.2	-0.6	2.8	4.4	5.5	-5.6	-6.2	-6.4
<b>World</b>	-1.1	4.3	4.0	1.2	3.2	2.9						

(a) Euro Area and the Big 4 forecasts are frozen as of 23/03/2010. All smaller euro area country forecasts are as of 23/03/2010. Bold figures signal upward revisions. Bold, underlined figures signal downward revisions. (b) GDP figures refer to working day adjusted data. (c) HICP figures for euro-zone countries and the UK (d) Current account figures for Euro area countries include intra regional transactions. (e) The forecasts assume Brent oil of \$85/bp on average in 2010 and \$80/bp on average in 2011.

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

Forecasts: Euroland GDP growth by components<sup>1</sup> and central bank rates

Euroland, % qoq	09-Q1	09-Q2	09-Q3	09-Q4	10-Q1F	10-Q2F	10-Q3F	10-Q4F	2009F	2010F	2011F
<b>GDP</b>	-2.5	-0.1	0.4	0.1	0.3	0.5	0.3	0.2	<b>-4.0</b>	<b>1.1</b>	<b>1.2</b>
Private Consumption	-0.5	0.1	-0.2	0.0	0.1	0.2	0.0	0.1	<b>-1.0</b>	<b>0.2</b>	<b>0.6</b>
Gov. Consumption	0.6	0.6	0.8	-0.1	0.4	0.4	0.3	0.3	<b>2.2</b>	<b>1.4</b>	<b>1.2</b>
Investment	-5.4	-1.7	-0.9	-0.8	-1.5	1.0	-0.2	0.0	<b>-11.0</b>	<b>-2.4</b>	<b>1.2</b>
Stocks (contribution)	-0.9	-0.7	0.5	0.0	0.4	0.2	0.1	0.0	<b>-0.8</b>	<b>0.7</b>	<b>0.1</b>
Exports	-8.3	-1.1	2.9	1.7	2.0	1.4	1.0	0.8	<b>-13.2</b>	<b>6.3</b>	<b>4.9</b>
Imports	-7.6	-2.9	2.8	0.9	1.8	1.8	0.5	0.6	<b>-11.8</b>	<b>5.1</b>	<b>4.4</b>
Net Trade (contrib.)	-0.3	0.7	0.0	0.3	0.1	-0.2	0.2	0.1	<b>-0.8</b>	<b>0.5</b>	<b>0.3</b>
HICP inflation, % yoy	1.0	0.2	-0.4	0.4	1.1	1.2	1.4	1.4	<b>0.3</b>	<b>1.3</b>	<b>1.3</b>
Core inflation, % yoy	1.6	1.6	1.3	1.1	0.9	0.7	0.7	0.6	<b>1.4</b>	<b>0.7</b>	<b>0.7</b>
<b>EMU4 GDP, % qoq</b>											
Germany	-3.5	0.4	0.7	0.0	0.2	1.1	0.5	0.3	<b>-5.0</b>	<b>2.0</b>	<b>1.3</b>
France	-1.4	0.3	0.2	0.6	0.2	0.3	0.2	0.2	<b>-2.2</b>	<b>1.2</b>	<b>1.3</b>
Italy	-2.7	-0.5	0.5	-0.3	0.5	0.4	0.3	0.2	<b>-5.1</b>	<b>0.9</b>	<b>1.1</b>
Spain	-1.7	-1.0	-0.3	-0.1	0.1	0.3	-0.3	0.2	<b>-3.6</b>	<b>-0.2</b>	<b>0.7</b>
<b>Central Bank Rates (eop)</b>											
ECB refi rate	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00			
US fed funds target rate	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.75	1.00			
BoE bank rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75			
BoJ O/N call rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10			

# ECB flexibility is key

- **The focus of the ECB's May press conference is unlikely to be on the monetary policy stance. For sure, the latest data point to improving activity and rising inflation. The ECB is unlikely to bank on a strong, sustained recovery yet and is likely to continue to conclude a low inflation environment lies ahead. We do not expect the ECB to raise rates until Q1 2011.**
- **Rather, the focus will be on Greece, the euro sovereign debt market tensions, the ECB's liquidity protocols and their flexibility.**
- **The ECB should take comfort from that fact that as tensions in sovereign markets escalated and spread, the interbank market showed only little sign of strain. The ECB is likely to leave its liquidity protocols unaltered and stick with gradual exit.**
- **Trichet is likely to say that it is not exit at all costs. The ECB's liquidity provision remains generous and if need be, if market financial conditions deteriorate, it can be made more generous. The ECB has proven itself responsive and flexible during the credit crisis.**
- **The ECB may be forced to address the minimum collateral requirement for government bonds. There is a not insignificant threat that Greece loses all its investment grade ratings and thus its eligible collateral status. The ECB cannot afford to not accept Greek government paper as collateral. The ECB has shown flexibility in changing the collateral rules once. Further changes cannot be ruled out.**
- **Additionally, the markets will be keen to hear the strength of Trichet's verbal support for the peripherals in general (he has been willing to praise Ireland and, more recently, Greece) and whether the ECB rules out the purchasing of government bonds.**

The ECB Governing Council meets again on May 6. A rate change is not on the agenda. The focus will be on Greece and the escalation of the euro sovereign debt crisis over the last month. Specifically, journalists are likely to quiz Trichet on the Greek aid deal and the strength of the ECB's conviction that Greece won't default; what Greece's junk status means for the collateral rules; contagion and the ECB's willingness to vouch for all peripheral sovereigns; and, finally, whether the ECB's exit from monetary stimulus is flexible and whether it would countenance purchasing government bonds.

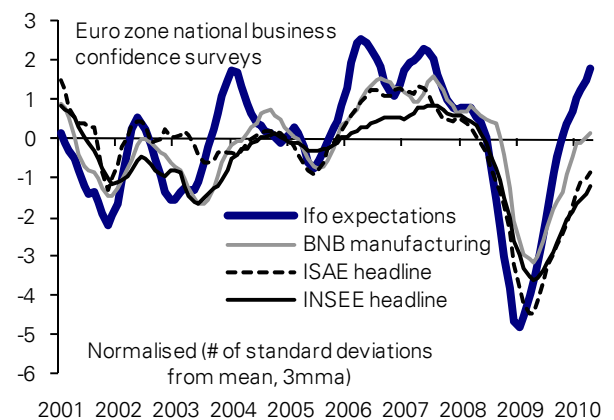
## Standard monetary policy: Stance to remain neutral

We expect the ECB to once again describe the level of rates as being "appropriate", the recovery "moderate" and "uneven", inflation "low" and inflation expectations "well-anchored". In short, the ECB is unlikely to give any indication of shifting away from the neutral bias on the monetary policy stance. This was likely to have been the case irrespective of the escalation of euro sovereign debt crisis over the last month.

We think it unlikely the ECB upgrades its perceptions of the state of the recovery. Last month the ECB expected the recovery to proceed "at a moderate pace", but with a growth pattern that is possibly "uneven". We expect a similar description of growth on May 6. In June, the ECB staff will be updating their macroeconomic forecasts. Trichet can claim that the Council's opinion is unchanged pending the updated staff forecasts.

Recent survey data such as PMI and IFO have exceeded expectations and point to increasingly strong economic momentum into Q2. The ECB already acknowledged this momentum last month but, like last month, we would expect the ECB not to bank this as a sign of an increasingly secure recovery. There remain challenges to a strong, sustained recovery, such as incomplete balance sheet and labour market adjustments.

**Figure 1: Recovery strengthening into Q2**



Source: Deutsche Bank, ECB

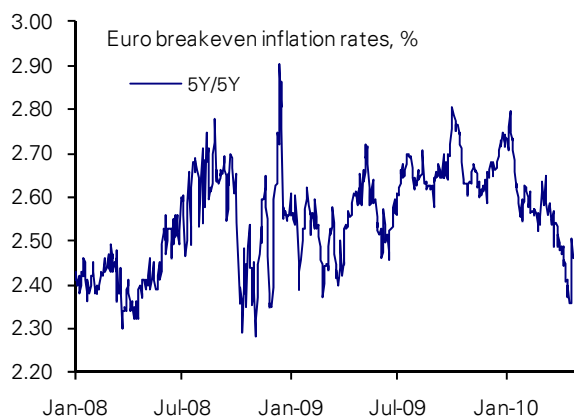
Additionally, although the strength of the signal from surveys is good news, the escalation of the fiscal crisis over the last month further dampens prospects for an upgrading of the ECB's opinion on the recovery. Without the ECB having to incentivise governments, the market is pushing for an immediate tightening of fiscal policy. As a result, the ECB will still see an "uneven" recovery.

We expect the ECB to continue to conclude that the risks to growth are “broadly balanced”. The upside risks are global growth, returning confidence, and macro stimulus. On the downside, financial market tensions, a negative feedback loop between the real economy and the financial sector, higher commodity prices, protectionist measures and global imbalances.

On inflation, March HICP inflation was revised down one tenth to 1.4% yoy, but remained above initial expectations for 1.1%. The April flash estimate was 1.5%. Available data suggests rising food and energy prices in April, but core inflation is likely to have fallen, reversing the March (at least partly holiday-related) rise.

Survey-based measures of inflation have continued to rise over the last month, in line with the recovery in economic activity. With oil prices up and the EUR down, forecasts for inflation this year are under upward pressure. However, given questions about the sustainability of the current pace of growth, we don't expect the ECB to alter its opinion that inflation will remain “moderate over the policy-relevant horizon”. We expect further downside from wages and unit labour costs and still very well-anchored inflation expectations will limit the pass-through from current inflation dynamics.

**Figure 2: Medium-term inflation expectations still very well-anchored**



Source: Deutsche Bank, Bloomberg

As with growth, we expect the ECB to continue to view the risks to inflation as being “broadly balanced”, including economic activity to the downside and commodity prices and indirect taxes to the upside.

The banking sector balance sheet remained fairly stable once again in March, according to the latest M3 report. M3 year-on-year growth was -0.1%, a slightly smaller rate of contraction than the previous month. Private sector credit growth was also negative at -0.1%.

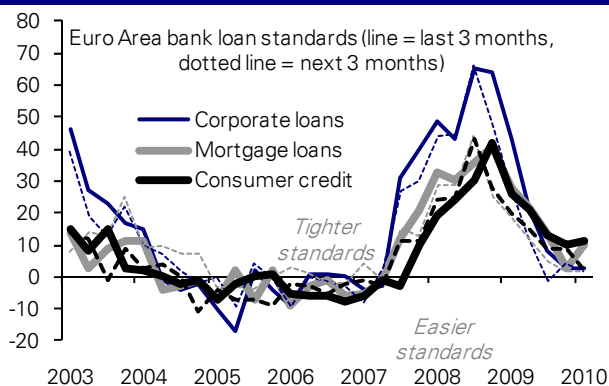
Shifts among the M3 and the counterparts were generally subdued. Most notable of all, banks continued to shift into public sector assets and out of private sector assets. The

flow of lending to households remained positive, but there was another contraction in lending to non-financial corporate. Banks also reduced their holdings of private debt securities and equities by EUR30bn in March.

The stability of the money and credit aggregates, coupled with the view that M3 and loan growth “is likely to remain weak also in the coming months”, will encourage the ECB to retain its opinion of “low” inflationary pressure over the medium term. The results of the latest Bank Lending Survey, which showed a slowing in improvements in loan standards—and in some cases a re-tightening of standards—and a decline in demand for loans, give the ECB no reason to fear they are behind the curve on policy tightening.

We expect the ECB to continue to conclude that rates are ‘appropriate’. Despite evidence of strengthening economic dynamics, the ECB will remain cautious about prospects. There is unlikely to be a shift in the ECB’s neutral stance on rates. Indeed, we don’t expect the ECB to raise rates until Q1 2011. We continue to question the transition from the production and export dominated recovery into a sustainable domestic recovery because of the incomplete balance sheet and labour market adjustments and—care of the Greek crisis—a more rapid tightening of fiscal policy. We expect GDP growth of 1.1% this year and 1.2% next year.

**Figure 3: Some signs that the improvement in loan standards has stalled**



Source: Deutsche Bank, ECB

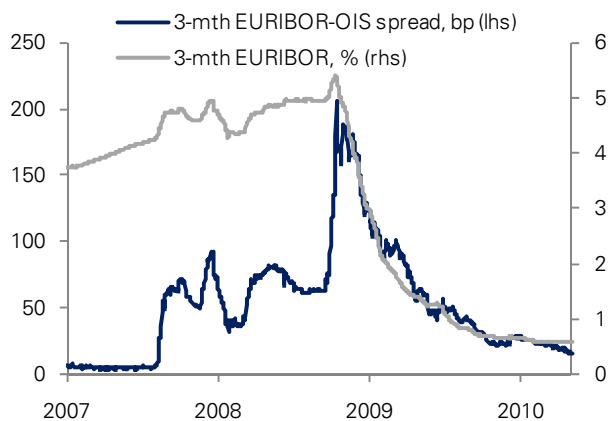
## Non-standard monetary policies: gradual exit is not unconditional

There is no reason for the ECB to consider tightening its monetary policy stance. Nor, as of yet, is there reason for the ECB to consider altering its non-standard monetary policies. Despite the Greek crisis, we expect the ECB to hold to its gradual exit from its expanded liquidity operations. But the exit is not unconditional.

The sovereign debt crisis has the potential to cause the ECB to re-think its exit from the non-standard policy measures. The deterioration in peripheral government bond markets could affect the stability of the banking sector given the likely losses on banks' holdings of sovereign debt, margin calls on those bonds pledged as collateral to the ECB and the erosion of the perceived value of implicit and explicit state guarantees for banks.

However, despite the sharp sell-off in peripheral bond markets, there has only been a slight tightening in money market conditions. Despite the spiralling concerns and markets moving to price in significant haircuts on Greece bonds, which are held widely throughout the euro area banking system, the pre-existing excess liquidity in the euro system kept quite a firm lid on interbank conditions. In essence, the banks whose balance sheets are likely to have been most affected by the recent sovereign tensions are the same banks who were likely the prime beneficiaries of the ECB's expanded liquidity. Nothing has changed.

**Figure 4: Little sign of spill-over tension into bank funding market**



Source: Deutsche Bank, Bloomberg

This week saw the re-introduction of variable rate tenders on the LTRO (long-term refinancing operations). The ECB has pledged to meet liquidity demands and wants to keep the average rate close to the refi rate. The ECB estimated liquidity demand of EUR15bn, but bids amounted to less than EUR5bn. The highest bid rate was 1.50% (the minimum bid rate was set at the refi rate of 1%), implying there are some constrained borrowers. But considering the banking sector fears that could have emerged of the spiralling sovereign debt crisis, the results were encouraging.

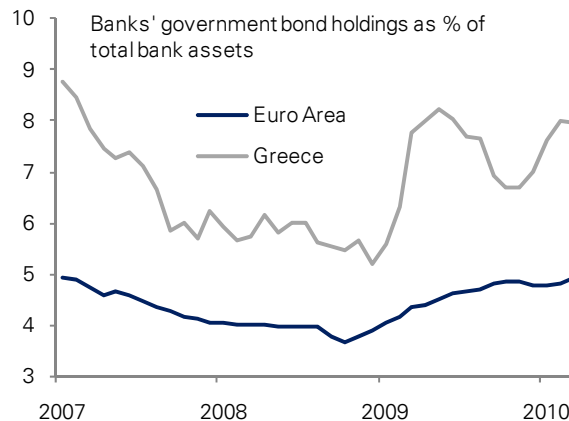
If the sovereign crisis intensified to such an extent that the interbank market was seizing up as it did post-Lehman, the ECB could reconsider its decision to exit some of its non-standard policy measures. So far, the ECB has returned the duration of its tenders to the pre-crisis maximum of 3-months (having extended 6-month and 12-

month money during the peak of the banking crisis) and from this week ended the fixed price, full allotment regime on the longest duration tenders. Full allotment tenders was the ECB's key quantitative policy which, if necessary, could be re-introduced. Given the ECB's pledge to meet liquidity demands at the LTRO, there is a de facto full allotment regime in place. If, for example, Greek or Portuguese banks were struggling to secure alternative forms of finance, the ECB intends to provide enough liquidity to meet demand. In any case, the weekly tender is still on full allotment and the ECB intends to keep it so until at least mid-October.

Unless the escalation of the sovereign debt crisis is spilling over into the banking system, the ECB will maintain its exit steps. Exit is gradual and in the face of the uncertainties in the sovereign area, exit is likely to remain gradual.

However, the exit is not unconditional. If there is seizure in interbank markets, the ECB can reverse course. If this were the case, in the first instance we would expect a return to full allotment on the LTRO. In the second instance, the ECB could lengthen the duration of liquidity.

**Figure 5: Can the ECB afford not to accept Greek government bonds as collateral?**



Source: Deutsche Bank, ECB

### Collateral rules: ECB has shown it can be flexible

The ECB is not inflexible. One exit measure has already been revised, namely the plan to return the minimum collateral requirement rules to the pre-crisis norm of A- from the start of next year. Last month, the ECB confirmed that it would continue to accept government bonds with ratings down to BBB-. Since then, S&P have downgraded Greece to junk status, Moody's has said it is on the verge of a multi-notch downgrade but is awaiting the details of the aid package and Greece's new austerity measures before determining the extent of the downgrade (junk status is a non-zero possibility) while

Fitch, already at BBB-, may adjust further in the light of the conditions of the aid deal. Junk status will already preclude some investors from holding Greek government bonds.

Can the ECB afford not to accept Greek government bonds as collateral? ECB ineligibility would reduce the market for Greek government debt substantially further, imparting a significant shock to an already fragile situation. The ECB would create the kind of crisis policymakers are trying to prevent. The ECB has shown flexibility in changing the collateral rules once. Further changes cannot be ruled out. The ECB cannot afford to not accept Greek government paper as collateral.

### Bond purchases: Extreme, but possible

Given the tensions in peripheral euro area bond markets, journalists are likely to ask Trichet about the possibility of the ECB purchasing government bonds to bring relief to markets. The tensions are easing as the market's confidence in a large enough EU/IMF package grows, so the need to consider this kind of policy is declining. The ECB has been loath to consider such a policy which risks blurring the boundary between the strictly politically independent ECB and sovereign national governments. When asked about the possibility earlier this week, ECB Board Member Stark said it was not being discussed "at present" and pointed out that the ECB had not resorted to such a policy during the earlier credit crisis. Board Member Bini-Smaghi called the talk of government bond purchasing "speculation". Bundesbank President Weber, talking this week, gave no indication of such radical thinking. For a Council Member who has seemed one step ahead of the consensus on ECB policy making throughout the crisis, this may suggest limited chances for this policy, at least without a further deterioration in conditions.

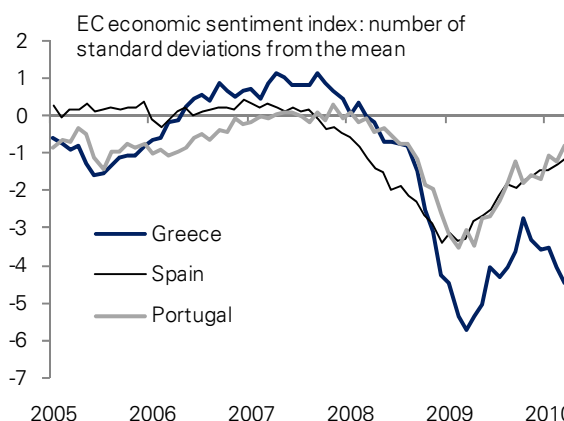
However, in the context of a sovereign crisis and given that such purchasing is legally permissible under the Maastricht Treaty (if only from the secondary market, not the primary market), at least markets can take some comfort from knowing that the ECB has this extreme option available. If confidence in the EU/IMF solution dropped, causing spiralling tensions and contagion that threatened the stability of the euro area at large, such a policy response cannot be ruled out. There would be challenges in determining how much, for which countries, etc. There may be political criticism in some quarters. But the option is in the ECB's policy set. It is a pure QE policy which would worry the more traditional monetarists on the ECB, but the inflation concerns could be trumped by the potentially deflationary concerns of not acting to smoothen a destabilising sovereign contagion crisis.

### Will Trichet talk up all peripherals? Can he afford not to?

The ECB was involved in the negotiation of the conditionality and Trichet will be in a position to discuss details. The various approvals from EU governments and the IMF are unlikely to have been secured by the time of the ECB's press conference, but Trichet should be expected to give a positive spin on the deal and Greece's prospects, albeit with appropriate recognition for the burden of adjustment that Greece faces. Trichet and various board members have been adamant that default is not an issue for Greece. Expect this line to be repeated.

Beyond Greece, the markets will be keen to hear the ECB's opinion on Portugal, Spain and Ireland. Trichet has been willing to make positive comments on Ireland previously. For example, in the January press conference he called Ireland's fiscal consolidation plans "impressive", "bold" and "courageous". He repeated the positive sentiment in February. With the markets having targeted Portugal and Spain as well in recent weeks, markets will be keen to hear a vote of confidence for the peripheral markets in general from Trichet.

**Figure 6: Recovery dynamics: Portugal and Spain are not the same as Greece**



Source: Deutsche Bank, EC

Trichet will be well aware of the potential for contagion and the sensitivity to his comments. At the recent G20 meetings in Washington, Trichet did say "of course Spain is not Greece". Others Council members have made similar, broader statements. The Austrian central bank governor, Ewald Nowotny, said "The fiscal situation of Spain and Portugal cannot be compared with Greece". The French central bank governor, Christian Noyer, was broader still: "Is there a risk for other countries in the zone? No, the other situations have absolutely nothing to do with that of Greece". Nevertheless, the market will want to hear similarly supportive statements for the periphery more broadly from Trichet.

Playing in favour of getting such a broad statement of support from Trichet is the news that both Spain and Portugal—who unlike Ireland have suffered ratings downgrades over the last week—are thinking about how to make their fiscal consolidations more credible. Spain has promised to clarify the non-wage savings element of its consolidation plans. Portugal is talking about accelerating some of its proposed structural changes to social security. Portugal's main opposition party is also pushing for a pact to reduce this year's fiscal deficit by another 1pp to 7.3% of GDP.

---

## Conclusion

The Greek crisis took a very significant turn for the worse over the last month. Encouragingly, despite the 'exit' steps from the ECB's supplementary liquidity—including the return to variable rates on the LTRO this week—the system remains flush with funds and access to the ECB's balance sheet remains easy. The ECB, no doubt nervous about the crisis, should take comfort from that fact that as tensions in sovereign markets escalated and spread, the interbank market showed only little sign of strain.

The refi rate is likely to remain on hold (we think until Q1 2011) and, in the absence of renewed problems in banking funding markets, the ECB is likely to leave its

liquidity protocols unaltered and stick with its gradual exit steps. But Trichet will probably stress that it is not exit at all costs. The ECB's liquidity provision is generous and if need be, if conditions deteriorate, it can be made more generous.

The one policy the ECB may be forced to address is the minimum collateral requirement for government bonds. There is a not insignificant threat that Greece loses all its investment grade ratings. ECB ineligibility would reduce the market for Greek government debt substantially further, imparting a significant shock to an already fragile situation. The ECB has shown flexibility in changing the collateral rules once. Further changes cannot be ruled out. The ECB cannot afford to not accept Greek government paper as collateral.

Policymaking can be as much about confidence as about technical measures. Trichet will have to play the confidence game at the May press conference. He has to express confidence in Greece, the euro peripherals in general, the stability of the banking sector, the stability of the euro area in general, ECB policymaking, its flexibility and the EU's ability to recover from the crisis, move forward and strengthen its rules, institutions and capacity to coordinate policy.

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

# German growth to have limited spill-over effect in the Euro area

- **The data flow from Germany is very favourable, strengthening our view that, after a mediocre start to the year largely on account of exceptional weather conditions, GDP in Germany will be relatively strong in 2010. We expect an annual average gain of 2.0% this year, the most for any Euro area economy.**
- **We also expect a significantly positive growth differential vis-à-vis the rest of the Euro area in 2010 (we forecast a gain of only 0.9% there). A maintained stimulative fiscal stance in Germany – a now unique feature in the Euro area - is a part of the explanation, but the higher sensitivity of the German economy to the rebound in demand outside the Euro area should play the most important role.**
- **We do not expect the relatively strong German growth to have any major spill-over effect on the rest of the Euro area. German trade is becoming less integrated with the rest of the Euro area not only on the export side, but also on the import side. The German export machine is less and less reliant on intra-Eurozone inputs. Euro area countries, particularly the peripherals, will have to look to extra-Eurozone demand for support while domestic demand is likely to be dampened for several years by the adjustment of private and public balance sheets.**
- **This is consistent with our call that one of the long-term consequences of the 2008/2009 downturn for Europe will be a generalized conversion to the “German model”, i.e., a situation in which domestic demand is constrained by the competitiveness imperative, while exports increasingly focusing on extra-Eurozone markets. This could lead to political pressure in favour of a further depreciation of the currency from the countries which, unlike Germany, do not enjoy a high level of non-cost competitiveness.**

---

Monetary union normally is conducive to cyclical convergence. Beyond the direct impact of the elimination of intra-zone exchange rate shocks on relative export performances, the adoption of a single currency reduces

transaction costs, which reinforces trade integration. Heightened cyclical synchronism minimizes the risk of the single monetary policy being inappropriate for large swathes of the union. In turn, common monetary impulses bring national cycles closer to one another. This was the theory. The latest downturn has revealed quite a few cracks.

As expected, the economic downturn of 2008/2009 has been remarkably synchronized across Euroland countries... but the recession actually started within a quarter throughout the whole industrial world. Moreover, significant divergences within EMU, across a core/periphery dividing line, have appeared on the path to recovery. This calls for taking a hard look at the binding power of the EMU.

**The current difficulties of the peripheral countries can be traced back to the leveraging spree they experienced after joining the EMU, which core countries (German, France and Italy) largely escaped.** In hindsight, the very different reaction across Euroland to a same set of nominal monetary conditions acts as a reminder that transmission mechanisms can continue to differ widely in a currency union, according to banking practices and specific balance sheet positions. More fundamentally, the 2000/2007 debt glut in the peripherals revealed that **significant differences between the common nominal interest rate and various paces of trend nominal growth can precipitate situations of capital over-accumulation** which can prove painful to absorb, as countries such as Ireland and Spain are currently experiencing.

**Trade patterns, also, have not evolved in a direction conducive to more cyclical convergence.** We show here that while Germany is benefiting substantially from the rebound in world demand, the direct impact of stronger growth in the US or the emerging areas will likely remain small in the rest of the Euro area. Moreover, we do not think that a “two-tier trading system” has emerged, in which the rebound in extra-Euroland demand first translates into higher German exports, before in turn benefiting the rest of EMU through intraregional trade. Stronger German exports to the rest of the world chiefly translate into more demand for extra-zone inputs, rather than into more German imports from the rest of the Euro area.

We believe that all member states will have to emulate Germany and redirect their efforts towards extra-Euroland markets. This is unlikely to occur at a very fast pace and will entail sizeable adjustment costs. This suggests that, in the peripheral countries, the support from exports, in

offsetting the drag from domestic demand, is unlikely to be significant.

## Germany wins in the foreign demand rebound

The myth of the Euro area being neatly divided in the first 10 years of its existence between a spending-hungry periphery providing welcome support to a too-thrifty-for-its-own-good Germany needs to be debunked. The European “deficit countries” (Greece, Ireland, Portugal, Spain) contributed only 6.8% to an overall rise in German exports of goods of 89% between 1999 and 2007, a period of extremely fast growth there. At the peak of their current account deficit, these four countries absorbed only 6.4% of German exports. Symmetrically, this means that the current collapse in their domestic demand is likely to have only a marginal impact on Germany.

Over the last 20 years, German exporters have increasingly focused on extra-Eurozone markets. The advent of the EMU did not significantly alter this trend. In 1991, what is now the Euro area absorbed 51.3% of total German shipments of goods. That ratio fell to 45.1% in 1998, just before parities froze within the EMU, and declined again to 43.7% in 2007.

This means that after having struggled in 2008 on account of the freeze in global trade, Germany is now in a very favourable position to reap the benefits of the positive rebound in demand from the rest of world, which contrasts with the sluggishness of the recovery in European domestic demand.

**Indeed, demand to the Euro area from the rest of the world has clearly picked up.** In the US, a large fiscal stimulus has protected domestic spending. After a sharp improvement between early 2008 and the summer of 2009, the US current account deficit has started to widen again. In the emerging areas, and particularly in Eastern Asia, the conversion to a domestic demand-led model is successful, epitomized by the materialization of a (small) trade balance deficit in China in March 2010, for the first time since 2004. Latin America also is performing well. Together, **these two emerging areas have contributed 40% to the overall 10% yoy increase in Euroland exports in February 2010.** Naturally, the depreciation in the currency (-6% in trade-weighted terms by March 2010 from a peak in October 2009) is also helping.

Traction from external demand is not evenly spread among individual Eurozone countries. In February 2010 Germany contributed nearly half to the overall Eurozone yoy gains in exports although German GDP now accounts for only 29% of the EMU's. **The rebound in extra-Eurozone exports has contributed 2.0% to GDP growth in the year to Q1 2010 in Germany, against 0.8% in the rest of the Euro area.** This reflects both the fact that the share of extra-Euro area exports in Germany's

total trade is higher than in most other EMU states, and that the share of exports in GDP also is higher (figure 2).

### Figure 1: Significant impact on German growth from rebound in extra-Euroland demand

Extra-Euroland exports of goods	Germany	Euro area excl. Germany
Q1 2009 / Q1 2008		
% change	-23.3	-20.2
% cont. to GDP	-5.3	-3.1
Q1 2010 / Q1 2009		
% change	10.8	6.3
% cont. to GDP	2.0	0.8

Source: Eurostat, StBA

### Figure 2: Germany in a unique position among large Euroland countries

	Extra-Euroland exports in % of total	Total exports in % of GDP
FR	50.1	29.0
GE	56.5	47.8
IT	54.2	27.1
SP	42.6	29.5
PT	36.0	34.8
GR	56.6	22.8
IR	58.2	99.4

Source: Eurostat

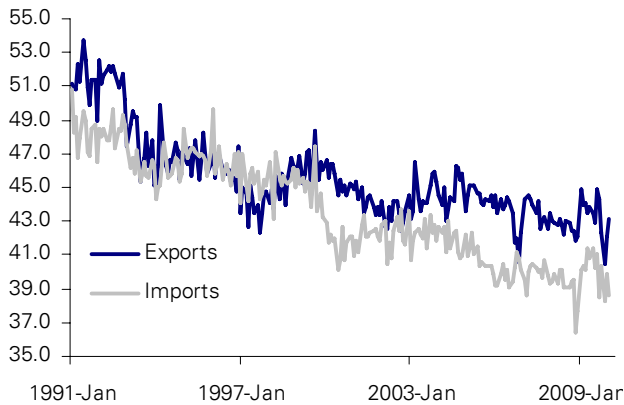
Among the peripherals, Ireland is the only country likely to reap any major benefit from the rebound in extra-Euroland demand compounded by the depreciation in the euro. A relatively large share of Greek exports is directed outside of the EMU, but little traction can be expected from this over the rest of the economy, given the low overall weight of exports in GDP. In Spain and Portugal, which are more open to foreign trade, high exposure to intra-EMU trade is likely to have only a subdued impact on economic activity.

Strong extra-Euro area traction is one of the reasons why we think that Germany will significantly outperform the rest of the Euro area this year. We expect German GDP to rise by 2.0% in 2010, against 0.9% in the rest of the EMU. Beyond the lesser immediate sensitivity of most other Euro area countries to non-euro demand, we expect Germany, in spite of its size, to exert very little traction over the rest of EMU for two main reasons. Indeed, **German trade is becoming less integrated with the rest of the Euro area not only on the export side, but also on the import side.** The German export machine is less and less reliant on intra-Eurozone inputs.

### Arrested trade integration

Contrary to a popular view, the German economy is not a “black hole”, exporting more and more while contributing less and less to global growth by restraining domestic demand. Actually, in cumulated terms since the start of the monetary union in 1999, the volume of imports of goods and services has increased much more in Germany (48.1%) than in France (39.5%). However, increasingly, these imports are sourced outside the Euro area. Indeed, the share of the Euro area in total German *imports* fell even more rapidly than that of exports (see Figure 3).

**Figure 3: Eurozone’s overall share in German trade has fallen significantly**



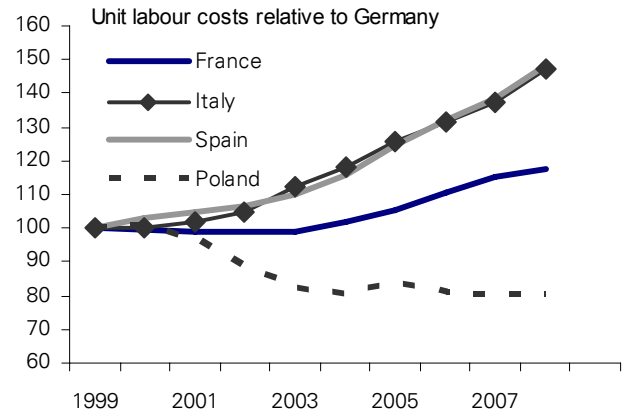
Source: StBA

There are three main reasons behind this trend, in our view:

First, when German industry had to correct for the loss of competitiveness incurred at the time of Unification in the early 1990s, it engaged in a steady effort of supply diversification, investing in low-cost countries to source inputs. This means that the import content of German exports has increased, but to the benefit of non-Euro area countries.

Second, the rest of the Euro area has lost significant competitiveness vis-à-vis Germany since the start of the EMU (see Figure 4). This contrasts sharply with the strong gains in competitiveness observed in some CEE countries, such as Poland, thanks to their considerable productivity gains.

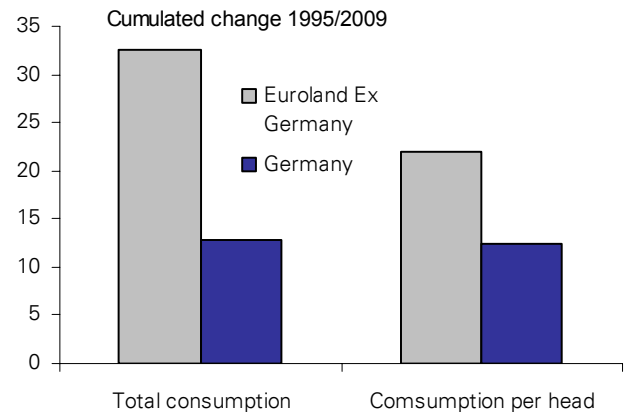
**Figure 4: Significant loss of competitiveness in the Euro area countries**



Source: OECD

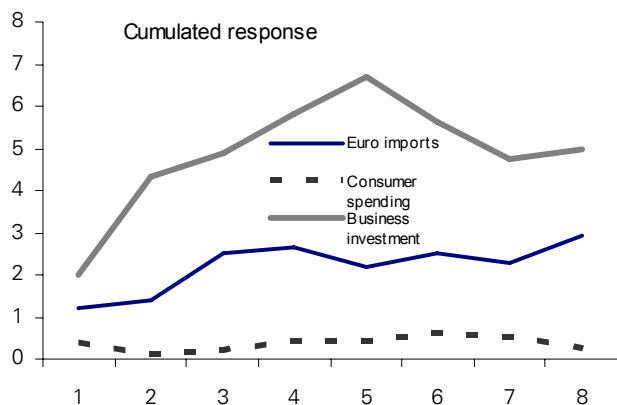
Third, even if the correction of the competitiveness losses of the early 1990s is having a direct dampening impact on domestic demand, through subdued wage growth, consumption dynamics in Germany would probably be weak anyway. Indeed, the German population has started to decline. A simple calculation can illustrate how powerful this factor is. In cumulated terms in the 10 years to 2009, consumer spending grew by 19.7% less in Germany than in the rest of the Euro area. The gap falls to 9.4% when looking at consumer spending per head (see Figure 5)

**Figure 5: Demographic dynamics matter**



Source: Eurostat, StBA

We attempt a quantification of these different factors in a systematic, econometric approach, by constructing a VAR model for Germany linking exports, business demand for factors such as labour and capital, consumer spending and finally imports, distinguishing intra- and extra-Euro area. We are interested in the response function of German imports from the Euro area to an initial rise in German exports (see box).

**Figure 6: Response function to a rise in German exports**

Source: Deutsche Bank Global Markets Research

According to our model, an initial one standard deviation change in German exports (3.1%) would trigger a cumulated gain in business investment in machinery and equipment peaking at more than 6% after 5 quarters, a limited reaction of consumer spending, peaking at 0.6% after 6 quarters, and a gain in euro imports of 2.9% after 2 years.

#### Our model

We look at the behaviour of 6 key variables in the German economy expressed in QoQ % change: total exports, employment, investment in machinery and equipment, private consumption, imports from the Euro area, imports from outside the Euro area. Each variable is explained by its lagged values as well as by the lagged values of the other 5 variables (four lags). The model is estimated on 1999Q1-2009Q4.

A shock on exports triggers a direct impact on imports (this captures the import content of exports) but also lifts employment (which in turn boosts consumer spending) and investment in equipment. The response of consumer spending and investment generates its own impact on imports.

No breakdown in intra and extra Euro area is available for German imports in volume. We proxy this by applying to the national accounts data the breakdown from the customs data. It is an imperfect proxy since the customs data are available only in current euros (we have to assume that the import deflator is the same across intra- and extra-euro area imports).

Since German imports from the Euro area account for 4% of the GDP for the rest of the Euro area, this means that a 9% rise in German exports (our forecast for 2010) would result in a cumulated 0.4 gain in GDP after 2 years in the rest of the EMU (before second round effects).

## Conclusions

Germany has relied more and more extensively on extra-Eurozone markets as a base for growth, while most other EMU member states have continued to focus on domestic demand and intra-regional trade. This means that Germany can afford to be relatively indifferent to a prolonged period of subdued demand in the Euro area countries currently struggling with the consequences of past debt excesses. At the same time, our model suggests that even strong growth in Germany will not provide any major support for ailing member states.

This is consistent with our call that one of the long-term consequences of the 2008/2009 downturn for Europe will be a generalized conversion to the "German model", i.e., a situation in which domestic demand is constrained by the competitiveness imperative, while exports increasingly focus on extra-Eurozone markets. The transition to this model was painful for Germany in the early 2000s. It will probably be even more painful for the peripherals, which will have to adjust in a context of extreme constraints on public finances. Slow aggregate growth in the Euro area is likely to be the outcome. In such a context, political pressure in favour of a further depreciation of the currency, in the countries which, unlike Germany, cannot rely on a high non-cost competitiveness, is likely to appear.

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

# Euroland Inflation

- Euro area inflation rose 0.1pp to 1.5% y/y in April, as expected.
- Various indicators of core inflation support the view that the underlying trend in inflation is still pointing lower in the US and the euro area. We do not expect this to change in the coming months.
- In the UK, an emerging downturn in core inflation has been interrupted by the January VAT-hike, but we would expect a renewed easing in trend ahead.

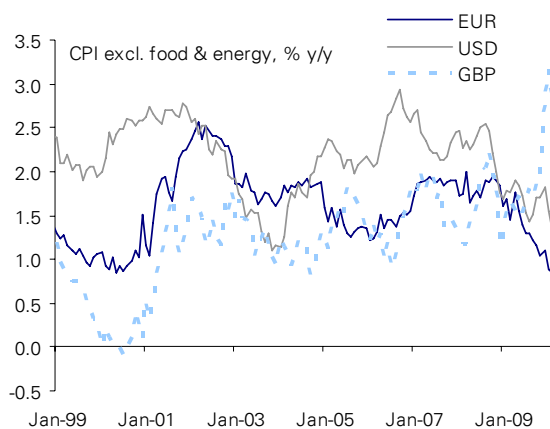
First evidence on euro area April price trends this week showed inflation increasing further, with Eurostat estimating that aggregate euro area year-on-year inflation rose to 1.5%, from 1.4% in March. Country details suggest that trends in CPI components were in line with expectations, with accelerating food and energy inflation more than offsetting a renewed fall in core inflation, which has been quite volatile over the past few months. Rising oil prices in particular have recently led to upward revisions to forecasts again, with current projections showing inflation at the end of this year not too far from historical average levels again.

In the following, we take a quick look at various indicators of the inflation trend in the euro area, the US and the UK, starting with the most commonly followed 'total excluding food & energy' measure. In the US, this core indicator has eased quickly as the crisis hit, falling from 2.5% in September 2008 to 1.7% in January 2009, but then moved broadly sideways through last year, before declining quickly again at the start of 2010 (chart 1). In the euro area, it has remained stickier in autumn 2008, but has been on a clear downtrend since early 2009, which appears to have accelerated from mid-2009. In the UK, 'total excluding food & energy' has shown no clear trend over 2008 and 2009, but increased markedly at the start of this year as VAT has been raised (chart 1).

Alternative indicators paint perhaps a somewhat clearer picture of the inflation trend. For example, looking at our 'volatility re-weighted' measure which adds to each consumption weight a weight proportional to the relative volatility of each item (so that the relative importance of more volatile items is reduced), shows inflation in the US, the UK and the euro area trending lower through 2009 (chart 2). In the US and the euro area this trend appears to have remained in place at the start of 2010, while the UK VAT-hike has interrupted the trend there; the most recent data do however appear to signal a renewed slowdown.

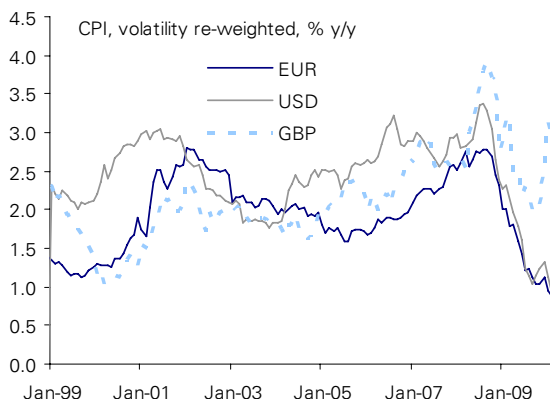
Finally, we look at the breadth of the slowdown in trend by considering the difference in number of components

## 1. Total CPI excluding food & energy slowing



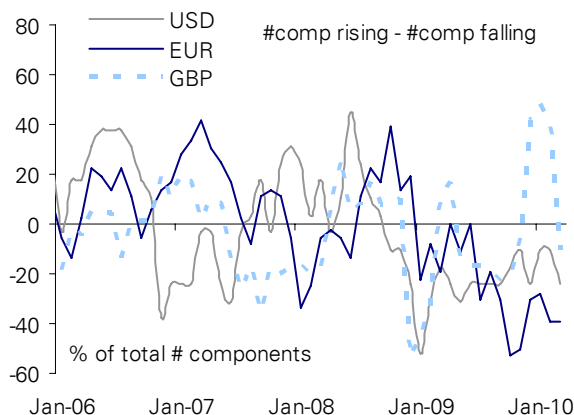
Source: BLS, ONS, Eurostat, Deutsche Bank

## 2. Other indicators show even clearer trend



Source: BLS, ONS, Eurostat, Deutsche Bank

## 3. Downturn is broad-based



Source: BLS, ONS, Eurostat, Deutsche Bank

showing an increase in year-on-year inflation (on a three-month moving-average basis) vs components showing a slowdown in inflation. We exclude food and energy items as their trend over the past two years is well known. The results show that the downtrend has been quite broad-based, and hence in the US has not been due solely to the heavy-weight shelter (and in particular owner-equivalent rent) components as argued by some (chart 3).

On the contrary, right after the Lehman shock, 75% of all core components were showing easing inflation and only 25% were rising; hence the balance of -50% in chart 3. This balance has then moved back up somewhat, but has stayed well in negative territory (at around -20%, meaning that still 20% more components show falling inflation than

rising). In the euro area, the downward trend in inflation has become increasingly broad-based since mid-2009, while in the UK, the trend appears to be turning down again after the VAT-hike related rise early this year.

In all, the various trend indicators seem to consistently suggest that inflation is still trending lower in the US and in the euro area, and there are some early signs that UK core inflation may be turning lower as well. We would not expect any turnaround in this trend in the coming months. Until then, energy and food inflation may however put some upward pressure on headline inflation.

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

### DB Inflation Forecasts

	Headline HICP			Euro area HICP excl. tobacco			HICP xefat*			France CPI excl. tobacco		
	Index	% mom	% yoy	Index	% mom	% yoy	Index	% mom	% yoy	Index	% mom	% yoy
Aug-09	108.1	0.3	-0.18	107.89	0.4	-0.3	106.7	0.3	1.3	118.41	0.5	-0.2
Sep-09	108.2	0.0	-0.33	107.91	0.0	-0.5	106.9	0.2	1.2	118.12	-0.2	-0.4
Oct-09	108.4	0.2	-0.13	108.17	0.2	-0.3	107.2	0.3	1.2	118.23	0.1	-0.2
Nov-09	108.5	0.1	0.48	108.28	0.1	0.4	107.1	-0.1	1.0	118.31	0.1	0.3
Dec-09	108.9	0.3	0.93	108.61	0.3	0.8	107.7	0.5	1.1	118.60	0.2	0.8
Jan-10	108.1	-0.8	1.00	107.75	-0.8	0.9	106.0	-1.5	0.9	118.32	-0.2	1.0
Feb-10	108.4	0.3	0.90	108.09	0.3	0.8	106.5	0.5	0.9	118.99	0.6	1.2
Mar-10	109.4	0.9	1.44	109.09	1.0	1.3	107.4	0.8	1.0	119.58	0.5	1.5
Apr-10	109.8	0.4	1.51	109.57	0.4	1.4	107.7	0.3	0.8	120.10	0.43	1.8
May-10	110.0	0.2	1.63	109.75	0.2	1.5	107.8	0.1	0.8	120.48	0.3	1.9
Jun-10	110.1	0.0	1.47	109.79	0.0	1.4	107.7	0.0	0.8	120.45	0.0	1.8
Jul-10	109.6	-0.4	1.71	109.30	-0.4	1.7	107.1	-0.6	0.7	120.13	-0.3	2.0
Aug-10	109.8	0.2	1.58	109.54	0.2	1.5	107.4	0.3	0.7	120.62	0.4	1.9
Sep-10	110.1	0.2	1.80	109.81	0.2	1.8	107.7	0.3	0.7	120.40	-0.2	1.9
Oct-10	110.4	0.2	1.79	110.06	0.2	1.7	107.9	0.3	0.7	120.42	0.0	1.9
Nov-10	110.4	0.0	1.69	110.07	0.0	1.7	107.8	-0.1	0.7	120.42	0.0	1.8
Dec-10	110.8	0.4	1.75	110.50	0.4	1.7	108.3	0.4	0.6	120.72	0.2	1.8
Q3 09	108.0	-0.3	-0.4	107.8	-0.3	-0.5	106.6	-0.3	1.3	118.1	-0.1	-0.4
Q4 09	108.6	0.5	0.4	108.4	0.5	0.3	107.3	0.7	1.1	118.4	0.2	0.3
Q1 10	108.6	0.0	1.1	108.3	-0.1	1.0	106.7	-0.6	0.9	119.0	0.5	1.2
Q2 10	110.0	1.3	1.5	109.7	1.3	1.4	107.7	1.0	0.8	120.3	1.2	1.8
Q3 10	109.9	-0.1	1.7	109.6	-0.1	1.7	107.4	-0.4	0.7	120.4	0.0	1.9
Q4 10	110.5	0.6	1.7	110.2	0.6	1.7	108.0	0.6	0.6	120.5	0.1	1.8
2008	107.8		3.3	107.7		3.3	105.2		1.8	118.0		2.8
2009	108.1		0.3	107.9		0.2	106.6		1.4	118.0		0.1
2010	109.7		1.5	109.4		1.4	107.4		0.7	120.1		1.7
2011	111.4		1.5	111.0		1.5	108.1		0.7	121.5		1.2
Next release												
Source: Deutsche Bank												
				Apr: 18 May						Apr: 12 May		

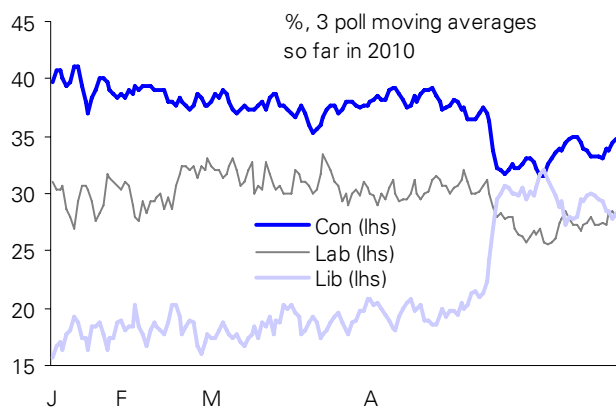
# UK Election Update: Into the final week

- **Recent opinion polls continue to suggest a hung parliament will result from this Thursday's election. However, the Conservatives have been gaining in support; the polls taken following the final leaders' debate showed Conservative leader David Cameron coming out on top.**
- **In the event of a hung parliament, the Liberal Democrats may well hold the balance of power – particularly if they maintain their current level of support into Thursday's vote. Deficit reduction and electoral reform could prove sticking points if a coalition or pact is required with the Lib Dems.**
- **Relative to Labour and the Lib Dems, the Conservatives want to reduce the deficit faster and to a lower level in the next parliament. We investigate the implications for both the economy (growth, inflation, monetary policy) and the markets (gilts, sterling, equities). We also list some useful resources for election night.**

## Latest opinion polls

Now in the last week of campaigning before this coming Thursday's general election, the polls have shown the Conservatives having made inroads relative to the incumbent Labour Party and the Liberal Democrats.

## The state of the parties going into the election

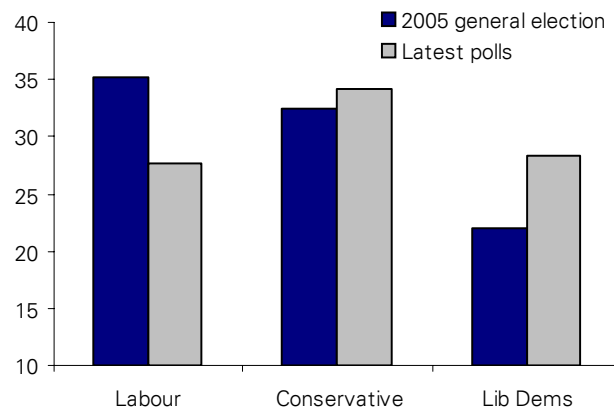


Source: DB Global Markets Research, UK Polling Report

The average of the opinion polls conducted over the past three days gives the Conservative opposition 34.1% of the vote, Labour 27.7% and the Liberal Democrats 28.4%. This compares with the national vote share in the 2005 general election of 32.4% for the Conservatives, 35.2% for Labour and 22% for the Lib Dems (see chart below). The percentage of the 646 seats in the House of

Commons that the three parties won in 2005 were 31%, 55% and 10% respectively.

## Swing from last election



Source: DB Global Markets Research, UK Parliament, UK Polling Report

This Conservative lead would probably be insufficient to produce a majority outcome, however. Indeed, the current state of the parties in vote shares would give the Conservatives 272 seats, Labour 254 seats and the Lib Dems 92 seats (from 198, 356 and 62 respectively in the 2005 election). While the Conservatives would be the largest party, they would still be 54 seats short of a majority in the now 650 seat House of Commons.

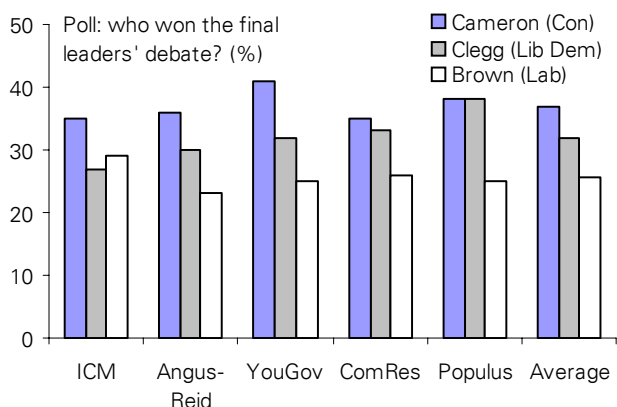
It is important to be cautious when interpreting the opinion polls. There are a number of reasons why they may not be an accurate reflection of the final general election result:

- Polls can and do change materially, even over the course of just a week. It remains to be seen whether the events of this week (the Prime Minister's visit to Rochdale or the final leaders' debate) will have a lasting impact on the polls going into Thursday's election.
- The polls can be wrong (after all, each poll is usually a sample of just 1,000-1,500 people). Consider the 1992 general election, for example. An average of four polls published in the press on the day of the election put the Conservatives on 38.4% and Labour one point ahead on 39.4%. In the event, Labour won just 34.4% of the national vote and the Conservatives nearly 42% - a 7.5pp margin the other way.
- The polls are intended to capture the mood across the country, but with the Conservatives aggressively targeting marginal seats they may do better in these

important constituencies than the national average suggests. That said, a poll published in last week's Sunday Times suggested the swing in the marginals was very similar to that of the national average.

- There is a large turnover of MPs at this election. Close to 150 MPs will not be contesting their seats, so to the extent that some people vote for the *person* not the *party* this raises the risk of a surprise relative to the current polls (consider the Republican victory in Edward Kennedy's Massachusetts seat earlier this year).
- Turnout could have an important bearing on this general election. It has been especially low over the past two elections (in 2001 and 2005). A rise in turnout is widely considered to be beneficial to Labour.
- Finally, with only a week to go until polling day, there remain a large number of undecided voters, according to the opinion polls. This could change the outcome substantially relative to what the polls are currently saying (the survey, by Ipsos-Mori, suggests that accounting for floating voters could raise support primarily for the Liberal Democrats but also for Labour).

#### Cameron won the third and final leaders' debate



Source: DB Global Markets Research, ICM, Angus-Reid, YouGov, ComRes, Populus

## Aftermath of the election

It is worth considering the various possible outcomes of this Thursday's election.

- **Outright majority.** In the event of an absolute majority by any one party, then that party will form the government immediately on Friday 7 May. The current polls suggest this is unlikely at the moment, however.
- **Hung parliament, incumbent remains in office.** If, alternatively, a hung parliament results, then

incumbent Prime Minister Gordon Brown is entitled to the first shot at forming a government. This can be done either by forming a coalition or pact with one or more of the smaller parties, or by running the government as a minority until either a) they are confident that a fresh election would produce a majority, or b) they lose a vote of confidence in the House of Commons.

- In the case of a hung parliament, the Prime Minister would have to be sure that whatever shape the government takes it could command the confidence of parliament when the new legislative programme is presented to the House of Commons in the Queen's Speech on 25 May. Losing the vote on the speech is equivalent to losing a vote of confidence, and the government would be forced to resign.
- **Hung parliament, opposition forms a government.** If the incumbent party is sufficiently short of a majority that a minority government is untenable (as the current polls suggest might be the case), and at the same time is unable to form a pact or coalition with one of the other parties, then the opposition Conservative Party may attempt to form the government. Again, this may take the form of a minority government or a coalition/pact. There is no need for either party in a coalition to have the most seats in the House of Commons (although the Liberal Democrats have suggested they may support the party with the biggest mandate). All that is required initially is that the new government's legislative programme be voted for following the debate on the Queen's Speech.
- **Fresh elections.** If no party can form a government then the Queen may be requested to dissolve parliament so that another election may be called. However, this is considered a last resort, and the Queen's advisors will want to be sure before granting a second dissolution that every possible avenue to form a government has been explored.

The process of forming a government can be done in a matter of hours after the election (in the case of an absolute majority for a single party the government will be formed on Friday 7), days (in the case of the political wrangling that typically follows on from a hung parliament ahead of the Queen's speech) or weeks (in the event that another election is called).

Recall that the negotiations between the incumbent Conservative Party and the Liberals following the election of February 1974 lasted over the weekend but came to nothing, the opposition Labour Party finally forming a minority government (33 seats short of a majority).

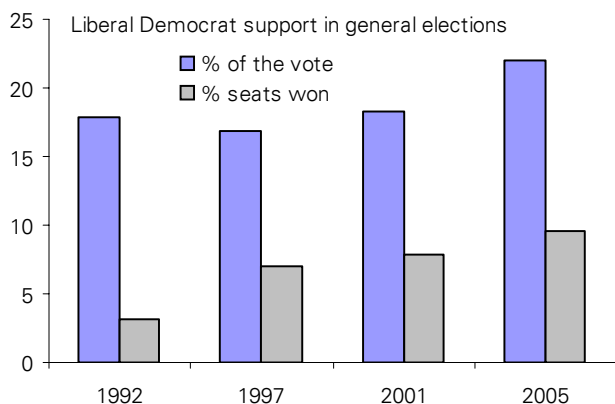
## Lib Dems could hold balance of power

If the polls are right and the Liberal Democrats win a substantial number of seats (around 100), then it may be difficult for either the Conservatives or Labour to win an outright majority. Currently, the polls point to the Conservatives being 50-60 seats short of a majority – too large a gap to be filled by any party other than the Liberal Democrats. As a result, it seems likely that the Liberal Democrats might hold the balance of power in the next parliament.

While the incumbent Prime Minister has the right to the first attempt in forming the next government in the event of a hung parliament, both Labour and the Conservatives may court the support of the Liberal Democrats with a view to forming a pact or coalition government.

In this case, which of the two largest parties are the Liberal Democrats most likely to strike a deal with? The key policies of the Lib Dems include: a) reducing the deficit at least as quickly as Labour's plans from 2011, b) making taxation fairer by raising the income tax threshold, making local taxes more redistributive and introducing a mansion tax on properties above GBP2m, c) cut low priority spending to support key services and education, d) replace the first past the post electoral system with the single transferable vote (STV).

### Liberal Democrat support – votes versus seats



Source: DB Global Markets Research, UK Parliament

Based on these policies, Labour seems a more natural ally for the Lib Dems than the Conservatives given its generally more left leaning policy stance and its desire to wait until next year before beginning to reduce the deficit (unlike the Conservative Party which would like to cut the deficit immediately). In terms of electoral reform, Labour has offered the possibility of a referendum on the Alternative Vote (AV) but the Electoral Reform Society notes that while this would increase the number of Liberal Democrat seats in the House of Commons it may also

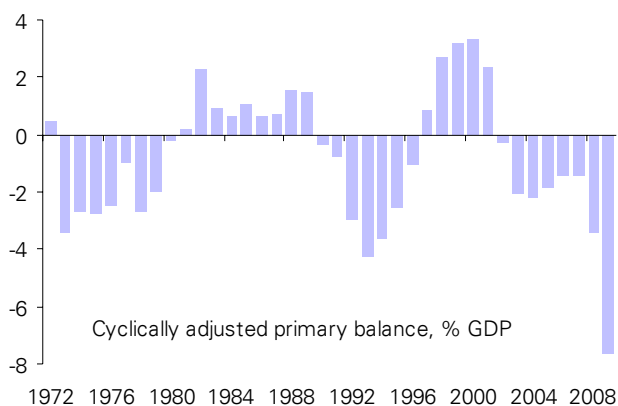
have produced a larger majority for Labour at the 2005 general election<sup>1</sup>. It is worth noting that the Conservatives' discussions with the Liberals back in 1974 came unstuck partly on a request for the introduction of proportional representation. It would perhaps not be surprising were this to prove a difficult negotiating issue once again.

## Deficit, debt and ratings

On the face of it, the three parties have differing views over the speed, scope and style (tax increases versus spending cuts) of deficit reduction going forward. Both Labour and the Lib Dems would like to begin the tightening in 2011 (as opposed to the Conservatives who would like to start immediately); the Conservatives would like to reduce the deficit to a lower level over the course of the next parliament than either of the other two parties; and the Conservatives are more focused on spending cuts rather than tax rises in achieving the necessary adjustment (the Institute of Fiscal Studies, IFS, noted in an article this week that the ratios of spending cuts to tax rises for Labour is 2:1, Liberal Democrats 2½:1 and the Conservatives 4:1). It is worth noting recent IMF comments that, "international experience does show that restraining expenditure brings about longer-lasting adjustment". However, the IFS argues that the scale of fiscal consolidation will mean more tax rises will be needed than the parties currently care to admit.

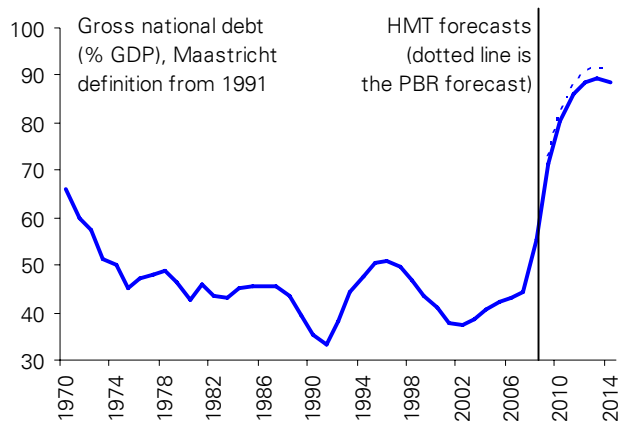
In the final leaders' debate ahead of the election (which focused on the economy) the three parties highlighted these differences on deficit reduction – particularly in relation to the timing of fiscal tightening. However, in reality the differences may not be so significant. The Conservatives have said they would like to cut the deficit more quickly and to a lower level over the next five years relative to either Labour or the Lib Dems, but they have also said that they want to "eliminate the bulk of the structural deficit over a Parliament". Given that Labour's plans are already for a sharp reduction in the structural deficit from 8.4% currently to 2.5% by 2014-15, this suggests that the Conservatives' plans are not substantially different.

<sup>1</sup> The AV system preserves the existing constituency arrangements. The way it differs from first past the post is that rather than a simple majority being required to win a constituency, the successful candidate must attain more than 50% of the vote. Voters rank candidates, and if none have received more than 50% of first choices, then the candidate with the fewest votes is eliminated and their second choices redistributed among the remaining hopefuls. Iterations continue until one candidate has more than 50% of the vote and is declared the winner.

**Deficit reduction high on the agenda**

Source: DB Global Markets Research, OECD

While there are differences between the parties on how best to reduce the deficit, these seem quite superficial given that all parties are committed to reducing borrowing over the coming parliament. In the event of a hung parliament, these differences may prove to be sticking points if a coalition or pact is required, but the fact that all parties are advocating substantial fiscal consolidation suggests that some kind of agreement can be brokered.

**Treasury forecasts consolidation, not a fall, in debt**

Source: DB Global Markets Research, ONS, HM Treasury

What are the risks of a sovereign rating downgrade from the UK's current AAA status? This cannot be ruled out whichever party (or combination of parties) takes office after this election. Consider what one rating agency said back in July last year: "Fitch would see a path whereby debt was falling by 2% to 3% pa relatively soon after 2011 as providing a fiscal cushion in the face of future shocks consistent with the UK's AAA status and will require more aggressive fiscal effort than outlined in the 2009 Budget". As the chart above shows, we are currently a long way off achieving even small declines in the government debt/GDP ratio – and this is likely to be the case whichever party is in office. It seems reasonable

to expect that a Conservative majority government, given its desire to consolidate the finances more quickly, would reduce, but not eliminate, the risk of a ratings downgrade.

**Economic & market impact**

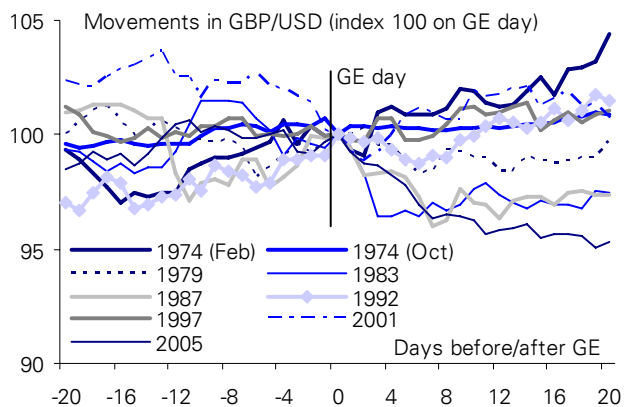
We summarise here our view of what the election could mean for both the economy and the markets.

- **Economic growth.** Shadow Chancellor George Osborne has written recently (in the Financial Times) about the possibility of negative fiscal multipliers – i.e. that a speedier the reduction in the deficit should lower borrowing costs and support economic growth in the private sector. While economic growth during past fiscal consolidations has been strong (e.g. in the early- to mid-1980s and the mid- to late-1990s), this is probably due to the fact that tighter fiscal policy tends to come after a recession, a period during which growth usually recovers due to loose policy settings. This time round, however, the scale of government and household debt levels may impose a speed limit on the rate of economic growth (see Reinhart & Rogoff, *Growth in a Time of Debt*, January 2010).
- **Inflation.** The most significant impact on inflation from the parties' different policy decisions post-election might be a rise in VAT following the election. Labour has pledged not to increase the scope of VAT, the Conservatives have said they have no plans to raise VAT, while the Liberal Democrats say that they will not have to raise VAT to deliver their election promises. Still, there is a real risk that these aspirations cannot be met in the next parliament. More fundamentally, the speedier the fiscal tightening (relative to Labour's current plans), the more likely (in our view) that the economy will be weaker than the Bank of England's current forecasts and the greater the likelihood of inflation undershooting its target more substantially next year.
- **Monetary policy.** The Bank of England would likely look through the near-term positive impact of a rise in VAT on inflation (assuming it were not to generate second round effects), just as the rise in January was. But it would have negative repercussions on household demand, which in turn might mean lower inflation over the medium term. It is commonly assumed that a sharper tightening in fiscal policy, as the Conservative Party is suggesting, would lead to slower growth than would otherwise have been the case and thereby lower inflation. In turn, and as the Conservatives have argued in their manifesto, this may, "help keep interest rates lower for longer". With fiscal policy differences being minimal between the parties, the impact on monetary policy relative to

the current base case outlined in the March Budget could be limited. As such, we continue to believe that the Bank of England will raise rates at a very gradual pace from the end of this year.

- **Gilts.** There is a general view that a hung parliament may be bad for gilts, as difficult decisions which need to be taken on fiscal tightening are delayed. While it seems reasonable that gilt yields will probably be higher than they otherwise would have been in the event of a hung parliament, the fact that there is general agreement between the parties about the need to tighten fiscal policy is encouraging. Also, the outcome of a hung parliament is probably already priced into the markets, potentially limiting any move in market rates if such a situation were to result. Still, there may well be a period of uncertainty in the immediate aftermath of the election about what form the government may take, which could lead to a rise in yields. We investigate this more in our *UK Election 'what if?'* document from 7 April.

#### Movements in sterling around elections



Source: DB Global Markets Research, Bloomberg

- **Sterling.** The last time an election led to a hung parliament was in February 1974, following which sterling *rallied* against the US dollar (in the three weeks after the result) by more than any election since (see chart above). We suspect that, on balance, a hung parliament would be negative for sterling, but our FX team argues that the election may be overrated as a currency driver (particularly in light of the dominance of fiscal issues recently in driving the euro lower). As we have discussed above, a Conservative victory would mean more significant tightening in fiscal policy than that of Labour or the Liberal Democrats. While this would be beneficial for fiscal credibility, it could potentially mean lower

interest rates – which have opposite implications for sterling. The impact of the election outcome on the currency is therefore particularly uncertain.

- **Equities.** A hung parliament may be negative for equities, but to have a marked impact our equity strategy team believes that we would need to see a simultaneous sharp rise in gilt yields. A move lower in sterling could offset the potentially negative effect on equities that uncertainty associated with a hung parliament could create (since a significant portion of the FTSE 100 income is earned abroad).

#### Conclusions and key resources

This Thursday's election is wide open. Not since the early 1970s has an election produced a hung parliament, but this one may well do so. Recent polls look to have moved in favour of the Conservative opposition, but the rise in support for the Liberal Democrats – if it persists until election-day – could make it difficult for any one party to achieve a majority in the House of Commons.

Following the publication of the exit polls at 10pm on election-day, Thursday 5 May (which were especially accurate in the 2005 general election, predicting the Labour majority to within one seat) it then becomes a waiting game. The first results are expected after around an hour, but most of the results will not be available until after 1am UK time. Judging overall swings in support from initial results can be dangerous (not only may they be unrepresentative of the polls nationwide, but boundary changes make it important to compare the results with the *notional* results from 2005). Below we've listed some key resources that we find useful for the election.

- 1) An excellent web page from the BBC summarising the parties' manifesto promises on different areas of policy: [http://news.bbc.co.uk/1/hi/uk\\_politics/election\\_2010/parties\\_and\\_issues/default.stm](http://news.bbc.co.uk/1/hi/uk_politics/election_2010/parties_and_issues/default.stm)
- 2) A summary of all the latest opinion polls can be found here: <http://ukpollingreport.co.uk/blog/voting-intention>
- 3) Converting these polls into seats in the House of Commons can be done here: [http://news.bbc.co.uk/1/hi/uk\\_politics/election\\_2010/8609989.stm](http://news.bbc.co.uk/1/hi/uk_politics/election_2010/8609989.stm) or here: <http://www.electoralcalculus.co.uk/>
- 4) The BBC's results page can be found here (particularly useful when it comes to judging the key battlegrounds or monitoring constituency by constituency results): <http://news.bbc.co.uk/1/shared/election2010/results/>

**George Buckley +44 20 7545 1372**

# Rate Views

## Euro Area

The focus of the ECB's May press conference is unlikely to be on the monetary policy stance. For sure, the latest data point to improving activity and rising inflation. The ECB is unlikely to bank on a strong, sustained recovery yet and is likely to continue to conclude a low inflation environment lies ahead. We do not expect the ECB to raise rates until Q1 2011. Rather, the focus will be on Greece, the euro sovereign debt market tensions, the ECB's liquidity protocols and their flexibility. There is still excess liquidity in the system and the sovereign tensions have not spilled over into general interbank tensions. A cautious ECB will likely stress that liquidity exit is not unconditional. More pressing may be collateral rules. There is a risk that Greek debt falls out of investment grade, but the ECB cannot not accept Greek government debt as eligible collateral.

	Current	Jun10	Sep10	Mar11
<i>3m Libor projections</i>				
Mkt	0.61	0.80	0.91	1.14
DB	—	0.65	0.90	1.50
<i>refi rate forecast</i>				
DB	1.00	1.00	1.00	1.25
<i>10-year government yields</i>				
DB	3.02	3.20	3.25	3.60

## UK

The Bank's February *Inflation Report* showed its forecasts for growth still well above market consensus for 2011 (despite downward revisions), but inflation failing to rise back to target after a near-term spike. As a result, we recently revised down our forecast for the Bank Rate to 0.75% by year-end (from 1.50% previously), and 2.50% by the end of 2011 (from 3.50% previously). As expected, the Bank left the policy rate at 0.5% in April and voted to maintain the stock of assets purchases at GBP200bn.

	Current	Jun10	Sep10	Mar11
<i>3m Libor projections</i>				
Mkt	0.68	0.77	0.90	1.44
DB	—	0.70	0.70	1.20
<i>Bank Rate forecast</i>				
DB	0.50	0.50	0.50	0.75
<i>10-year government yields</i>				
DB	3.86	4.30	4.50	4.90

## Switzerland

The SNB left policy rates unchanged at the March meeting. With the economy having performed better than expected, we see the first move up in rates before the end of the year. Next meeting: June 17.

	Current	Jun10	Sep10	Mar11
3M Libor tgt	0.25	0.25	0.25	1.00

## Sweden

The Riksbank left policy unchanged at its April meeting, and said that rates could begin rising as soon as the summer. Next meeting: 1 July.

	Current	Jun10	Sep10	Mar11
Repo rate	0.25	0.25	0.50	1.50

## Norway

Norges Bank did not surprise the markets and left rates on hold at 1.75% at its March meeting. Further near-term tightening looks likely to us. Next meeting: 5 May.

	Current	Jun10	Sep10	Mar11
Deposit rate	1.75	2.00	2.50	3.25

## Denmark

The central bank has narrowed the spread of its lending rate to ECB official interest rates (to just 5bps in mid-January) following rising reserves and central bank FX intervention. We expect the spread to remain at this level.

	Current	Jun10	Sep10	Mar11
Lending rate	1.05	1.05	1.05	1.30

## Poland

The key question remains the timing of the first hike. We see Q4, in line with the ECB, as most likely.

	Current	Jun10	Sep10	Mar11
2-week repo	3.50	3.50	3.75	4.00

## Hungary

In the near term the NBH should remain on its easing path.

	Current	Jun10	Sep10	Mar11
Base Rate	5.25	5.00	4.75	4.75

## Czech Republic

We believe that most likely the CNB is on hold until Q4-2010.

	Current	Jun10	Sep10	Mar11
Repo rate	1.00	1.00	1.00	1.25

Source for all tables: DB Global Markets Research

## Euroland Data Monitor

	B'berg code	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Dec 2009	Jan 2010	Feb 2010	Mar 2010	Apr 2010	May 2010
<b>Business surveys and output</b>											
<i>Aggregate</i>											
PMI composite		49.5	53.6	54.4		54.2	53.7	53.7	55.9	57.3f	
<i>Industry</i>											
EC industrial conf.	EUICEMU	-26.3	-18.5	-12.2		-16.0	-13.8	-12.8	-9.9	-7.3	
PMI manufacturing		47.9	51.2	54.4		51.6	52.4	54.2	56.6	57.5f	
Headline IP (% pop1)	EUITEMUM	3.5	8.2	12.7		0.8	1.7	0.7			
Capacity Utilisation	EUUCEMU	69.6	71.0	72.3	75.5						
<i>Construction</i>											
EC construction conf.	EUUCEMU	-31.4	-27.9	-27.4		-28.3	-29.1	-28.5	-24.6	-24.6	
<i>Services</i>											
EC services conf.	EUSCEMU	-12.3	-4.3	0.4		-2.5	-0.8	0.8	1.3	5.4	
PMI services		48.8	53.1	52.8		53.6	52.5	51.8	54.1	55.5f	
<i>National Sentiment</i>											
Ifo	GRIFPBUS	89.9	93.5	96.5		94.6	95.9	95.3	98.2	101.6	
INSEE	INSESYNT	83.0	87.7	91.3		88	91	90	93	97	
<b>Consumer demand</b>											
EC consumer survey	EUCCEMU	-21.4	-17.0	-16.8		-16.1	-15.8	-17.4	-17.3	-15.0	
Retail sales (% pop)	RSSAEMUM	-0.6	-0.2	-1.1		0.8	-0.3	-0.6			
New car reg. (sa, % yoy)		7.6	17.3	8.2		13.2	13.4	2.9	8.8		
<b>Foreign sector</b>											
Foreign orders	EUI3EMU	-60.0	-51.2	-41.3		-48.9	-45.3	-42.1	-36.4	-31.8	
Exports (sa val. % pop)		10.8	13.5	13.0		2.3	-0.2	2.7			
Imports (sa val. % pop)		9.6	8.1	17.4		2.6	1.1	1.5			
Net trade (nsa EUR bn)	XTTBEZ	9.5	14.5	-6.3		4.0	-9.0	2.6			
<b>Labour market</b>											
Unemployment rate (%)	UMRTEMU	9.7	9.9	10.0		9.9	9.9	10.0			
Change in unemployment (k)		497.7	299.0	172.5		47.0	105.0	61.0			
Employment (% yoy)		-2.2	-2.1								
<b>Prices, wages and costs</b>											
<i>Prices (% yoy)</i>											
Harmonised CPI	ECCPEMUY	-0.5	0.4	1.1		0.9	1.0	0.9	1.4	1.5	
Core HICP (Eurostat)	CPEXEMUY	1.3	1.1	0.9		1.1	0.9	0.9	1.0	1.0	
Harmonised PPI	PPTXEMU	-7.1	-4.0	0.0		-2.2	-0.6	0.0			
Oil Price (USD)	EUCRBRDT	68.2	74.6	76.3		74.2	76.3	73.7	79.0		
EUR/USD	EUR	1.43	1.48	1.38		1.46	1.43	1.37	1.36		
<i>Inflation expectations</i>											
EC household survey	EUA8EMU	-13.9	-10.2	0.7		-6.1	-2.0	0.2	4.0	8.3	
EC industrial survey	EUI5EMU	-9.6	-8.8	-3.7		-9.6	-5.7	-3.7	-1.6	5.1	
<i>Unit labour cost (% yoy)</i>											
Unit labour cost		3.4	1.3								
Labour productivity		-1.9	-0.1								
Compensation.		1.4	1.2								
Hourly labour costs (sa)											
<b>Money (% yoy)</b>											
M3	ECMAM3YY	2.4	-0.1	-0.1		-0.3	0.1	-0.3	-0.1		
M3 trend (3m cma)	ECMA3MTH					-0.2	-0.2	-0.1			
Credit - private	ECMSCDXE	1.7	0.7	0.0		0.6	0.0	0.0	-0.1		
Credit - public	ECMSCDGY	12.5	14.0	9.7		12.1	9.9	9.3	9.9		

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

Quarter on quarter growth rates are annualised.

'f' stands for flash estimate

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

**The Week Ahead: Euro Zone**

- In **Euroland**, the **ECB rate setting meeting** is on Thursday (with no change expected focus will be on the subsequent press conference). Markets will watch the release of **April manufacturing** (Mon) and **services** (Wed) **PMI** from across the **euro area**. The release of **area-wide** and **German retail sales** along with **Spanish consumer confidence** data will tell us something about trends in consumption, while **German** (Fri) and **Spanish** (Wed) **IP** provide an update on industrial activity in the region.
- Elsewhere, **Euroarea PPI** (Tue) and the **French trade balance** (Fri) are also due this week.

Source: Deutsche Bank

**Key Data & Events**

Day	Time (GMT)	Release	DB Forecast	Consensus	Previous
Mon	-	German retail sales (Mar)		-0.1% (0.6%)	-0.4% (-0.9%)
	07.15	Spanish PMI manufacturing (Apr)			51.8
	07.45	Italian PMI manufacturing (Apr)		54.2	53.7
	07.50	French PMI manufacturing (Apr)			56.5
	07.55	German PMI manufacturing (Apr)		61.3	60.2
	08.00	Euroland PMI manufacturing (Apr)		57.5	56.6
Tue	07.00	Spanish unemployment change (Apr)			36.0k
	08.00	Spanish consumer confidence (Apr)			72.7
	09.00	Euroland PPI (Mar)		0.7% (0.9%)	0.1% (-0.5%)
Wed	07.00	Spanish industrial production (Mar)			(-1.9%)
	07.15	Spanish PMI services (Apr)			51.3
	07.45	Italian PMI services (Apr)			55.3
	07.50	French PMI services (Apr)			53.8
	07.55	German PMI services (Apr)		55.0	54.9
	08.00	Euroland PMI services (Apr)		55.5	54.1
	08.00	Euroland PMI composite (Apr)			55.9
	09.00	Euroland retail sales (Mar)		0.0%	-0.6% (-1.1%)
Thu	10.00	German domestic factory orders (Mar)			-1.9% (18.6%)
	10.00	German factory orders (Mar)		1.4%	0.0% (24.5%)
	10.00	German foreign factory orders (Mar)			1.8% (29.7%)
Fri	06.45	French exports (Mar)			0.6%
	06.45	French imports (Mar)			0.8%
	06.45	French trade balance (Mar)			-EUR3.6bn
	10.00	German industrial production (Mar)		1.5%	0.0% (5.8%)

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

**Thu, 06**

ECB to hold Governing Council meeting – 11.45 GMT; news conference to follow at 12.30 GMT

**Fri, 07**

ECB's Trichet to speak in Lisbon

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

**The Week Ahead: Rest of Europe & the USA<sup>1</sup>**

- In the **US**, all eyes will be on the release of April **employment** report. Elsewhere, we expect further improvement in the **ISM** (both manufacturing & non-manufacturing) indices, while **factory orders** and **consumer credit** should remain unchanged. Other data due this week are **personal income**, **motor vehicle sales** and **pending home sales**.
- In the **UK**, we expect the **manufacturing** and **services PMI surveys** to improve in April. Elsewhere, we expect input prices to remain stable but headline **output prices** to rise due to petrol costs. **M4 money supply** data is also due this week.

Source: Deutsche Bank

**Key Data & Events**

Day	Time (GMT)	Release	DB Forecast	Consensus	Previous
Mon	12.30	US core PCE deflator (Mar)	0.1%		0.0% (1.3%)
	12.30	US PCE (Mar)	1.0%	0.7%	0.3% (3.4%)
	12.30	US personal income (Mar)	0.2%	0.3%	0.0% (2.0%)
	14.00	US construction spending (Mar)	-0.2%	-0.5%	-1.3% (-12.8%)
	14.00	US ISM (Apr)	60.2	59.9	59.6
	21.00	US total vehicle sales (Apr)	12.5m	11.4m	11.8m
Tue	08.30	UK M4 growth (Mar)	0.1% (3.5%)		0.2% (3.9%)
	08.30	UK mortgage approvals (Mar)	51.0	50.0k	47.1k
	08.30	UK net consumer credit (Mar)	GBP0.5bn	GBP0.5bn	GBP0.5bn
	08.30	UK PMI manufacturing (Apr)	57.5	57.3	57.2
	14.00	US factory orders (Mar)	0.0%	0.0%	0.6% (10.5%)
	14.00	US pending home sales (Mar)	4.0%	3.1%	8.2%
Wed	14.00	US ISM non-mfg (Apr)	56.0	56.0	55.4
Thu	08.30	UK PMI services (Apr)	57.0	56.4	56.5
	12.30	US initial jobless claims (May 1)		443.0k	448.0k
	12.30	US productivity prelim (Q1)	6.9%	2.5%	6.9% (5.8%)
	12.30	US unit labor costs prelim (Q1)	-5.9%	-0.5%	-5.9% (-4.7%)
Fri	07.15	Swiss adjusted real retail sales (Mar)			3.1%
	07.30	Swedish industrial production (Mar)			-0.8% (-1.5%)
	08.30	UK core output PPI (Apr)	0.3% (3.5%)	0.3% (3.5%)	0.7% (3.6%)
	08.30	UK input PPI (Apr)	0.0% (12.1%)	0.6% (12.8%)	3.6% (10.1%)
	08.30	UK output PPI (Apr)	0.6% (4.8%)	0.5% (4.8%)	0.9% (5.0%)
	12.30	US avg hourly earning (Apr)	0.1%	0.1%	-0.1% (1.8%)
	12.30	US avg workweek (Apr)	34.1	34.1	34.0
	12.30	US payrolls (Apr)	225.0k	176.0k	162.0k
	12.30	US unemployment rate (Apr)	9.6%	9.7%	9.7%
	19.00	US consumer credit (Mar)	USD0.0bn	-USD2.7bn	-USD11.5bn

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

**Mon, 03**

Riksbank to publish minutes of its Apr 19 monetary policy meeting – 07.30 GMT

**Tue, 04**

Treasury's Geithner to testify in Washington – 14.00 GMT

**Wed, 05**

Norges Bank to announce overnight rate decision – 12.00 GMT  
Fed's Rosengren to speak in Boston (12.30 GMT) and New York (23.00 GMT)

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

**Wed, 05 (continued)**

Fed's Lacker to speak in Richmond – 14.10 GMT

**Thu, 06**

Czech National Bank to announce interest rate decision – 11.00 GMT

Fed's Evans to speak in Chicago – 13.20 GMT

Fed's Bernanke to speak in Chicago – 13.30 GMT

**Fri, 07**

Fed's Plosser to speak in Delaware – 16.30 GMT

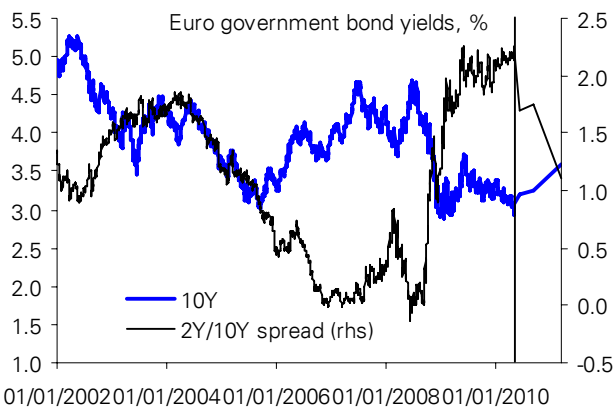
Source: Various National Statistical Offices, Bloomberg, Reuters, S&P MMS, DB Global Markets Research

**Financial Forecasts**

		US	Jpn	Euro	UK	Swiss*	Swe*	Den*	Nor*	Pol*	Hun*	Cze*
<b>3M Interest</b>	<b>Actual</b>	0.34	0.40	0.61	0.68	0.25	0.25	1.05	1.75	3.50	5.25	1.00
<b>Rates<sup>1</sup></b>	<b>Jun-10</b>	0.30	0.40	0.65	0.70	0.25	0.25	1.05	2.00	3.50	5.00	1.00
<b>DB forecasts</b>	<b>(futures)</b>	(0.45)	(0.39)	(0.80)	(0.77)	--	--	--	--	--	--	--
<b>&amp; Futures,</b>	<b>Sep-10</b>	0.40	0.40	0.90	0.70	0.25	0.50	1.05	2.50	3.75	4.75	1.00
<b>*Central Bank</b>	<b>(futures)</b>	(0.58)	(0.37)	(0.91)	(0.90)	--	--	--	--	--	--	--
<b>Rates</b>	<b>Mar-11</b>	1.50	0.40	1.50	1.20	1.00	1.50	1.30	3.25	4.00	4.75	1.25
	<b>(futures)</b>	(1.08)	(0.37)	(1.14)	(1.44)	--	--	--	--	--	--	--
[----- Spreads -----] [----- Rates -----]												
<b>10Y Gov't2</b>	<b>Actual</b>	3.73	1.29	3.02	3.95	-1.25	-0.09	0.15	0.57	5.65	6.86	3.76
<b>Bond</b>	<b>Jun-10</b>	3.75	1.40	3.20	4.30	-1.20	0.05	0.30	0.80	6.20	7.70	4.20
<b>Yields/</b>	<b>(futures)</b>	(3.86)	(1.35)	(3.18)	(4.07)	--	--	--	--	--	--	--
<b>Spreads<sup>3</sup></b>	<b>Sep-10</b>	4.00	1.50	3.25	4.50	-1.10	0.15	0.30	0.80	6.25	7.75	4.25
<b>DB forecasts</b>	<b>(futures)</b>	(3.99)	(1.40)	(3.26)	(4.17)	--	--	--	--	--	--	--
<b>&amp; Forwards</b>	<b>Mar-11</b>	5.00	1.30	3.60	4.90	-1.25	0.00	0.30	1.00	6.60	7.35	4.40
	<b>(futures)</b>	(4.19)	(1.49)	(3.42)	(4.35)	--	--	--	--	--	--	--
		<b>EUR/ USD</b>	<b>USD/ JPY</b>	<b>EUR/ GBP</b>	<b>GBP/ USD</b>	<b>EUR/ SEK</b>	<b>EUR/ DKK</b>	<b>EUR/ NOK</b>	<b>EUR/ CHF</b>	<b>EUR/ PLN</b>	<b>EUR/ HUF</b>	<b>EUR/ CZK</b>
<b>Exchange</b>	<b>Actual</b>	1.32	94.0	0.86	1.53	9.60	7.44	7.83	1.43	3.91	266.1	25.5
<b>Rates</b>	<b>3M</b>	1.35	<b>92.0</b>	0.85	1.59	<b>9.50</b>	7.46	<b>7.80</b>	<b>1.40</b>	3.90	<b>265.0</b>	<b>25.2</b>
	<b>6M</b>	1.35	<b>88.0</b>	0.85	1.59	<b>9.25</b>	7.46	<b>7.70</b>	<b>1.45</b>	3.88	<b>267.0</b>	<b>25.0</b>
	<b>12M</b>	1.35	<b>85.0</b>	<b>0.80</b>	<b>1.69</b>	<b>9.00</b>	7.46	<b>7.60</b>	<b>1.50</b>	3.82	<b>271.0</b>	<b>24.5</b>

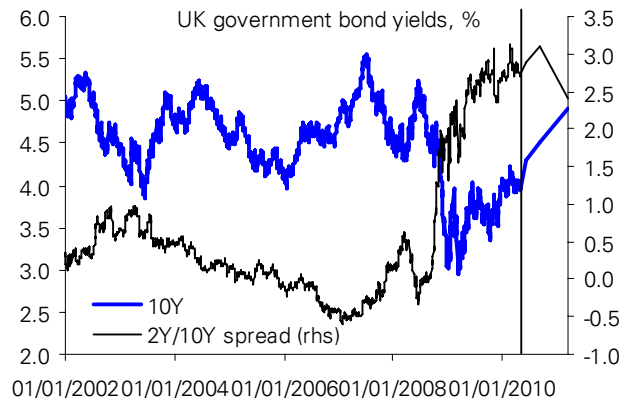
(1) Future rates calculated from the June, September and March 3M contracts. Forecasts are for the same dates. Central bank rates for the CE-4, Scandinavia and Switzerland  
 (2) Forecasts in this table are produced by the regional economists, and are not obtained from DByield. 10-year forwards estimated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

**Euro government bonds: yield and slope**



Source: Deutsche Bank

**UK government bonds: yield and slope**



Source: Deutsche Bank

# Appendix 1

## Important Disclosures

Additional information available upon request

**For disclosures pertaining to recommendations or estimates made on a security mentioned in this report, please see the most recently published company report or visit our global disclosure look-up page on our website at <http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr>.**

## Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Mark Wall

### Deutsche Bank debt rating key

**CreditBuy ("C-B"):** The total return of the Reference Credit Instrument (bond or CDS) is expected to outperform the credit spread of bonds / CDS of other issuers operating in similar sectors or rating categories over the next six months.

**CreditHold ("C-H"):** The credit spread of the Reference Credit Instrument (bond or CDS) is expected to perform in line with the credit spread of bonds / CDS of other issuers operating in similar sectors or rating categories over the next six months.

**CreditSell ("C-S"):** The credit spread of the Reference Credit Instrument (bond or CDS) is expected to underperform the credit spread of bonds / CDS of other issuers operating in similar sectors or rating categories over the next six months.

**CreditNoRec ("C-NR"):** We have not assigned a recommendation to this issuer. Any references to valuation are based on an issuer's credit rating.

**Reference Credit Instrument ("RCI"):** The Reference Credit Instrument for each issuer is selected by the analyst as the most appropriate valuation benchmark (whether bonds or Credit Default Swaps) and is detailed in this report. Recommendations on other credit instruments of an issuer may differ from the recommendation on the Reference Credit Instrument based on an assessment of value relative to the Reference Credit Instrument which might take into account other factors such as differing covenant language, coupon steps, liquidity and maturity. The Reference Credit Instrument is subject to change, at the discretion of the analyst.

## Regulatory Disclosures

### 1. Important Additional Conflict Disclosures

Aside from within this report, important conflict disclosures can also be found at <https://gm.db.com/equities> under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

### 2. Short-Term Trade Ideas

Deutsche Bank equity research analysts sometimes have shorter-term trade ideas (known as SOLAR ideas) that are consistent or inconsistent with Deutsche Bank's existing longer term ratings. These trade ideas can be found at the SOLAR link at <http://gm.db.com>.

### 3. Country-Specific Disclosures

**Australia:** This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

**EU countries:** Disclosures relating to our obligations under MiFiD can be found at <http://globalmarkets.db.com/riskdisclosures>.

**Japan:** Disclosures under the Financial Instruments and Exchange Law: Company name – Deutsche Securities Inc. Registration number – Registered as a financial instruments dealer by the Head of the Kanto Local Finance Bureau (Kinsho) No. 117. Member of associations: JSDA, The Financial Futures Association of Japan. This report is not meant to solicit the purchase of specific financial instruments or related services. We may charge commissions and fees for certain categories of investment advice, products and services. Recommended investment strategies, products and services carry the risk of losses to principal and other losses as a result of changes in market and/or economic trends, and/or fluctuations in market value. Before deciding on the purchase of financial products and/or services, customers should carefully read the relevant disclosures, prospectuses and other documentation.

**Malaysia:** Deutsche Bank AG and/or its affiliate(s) may maintain positions in the securities referred to herein and may from time to time offer those securities for purchase or may have an interest to purchase such securities. Deutsche Bank may engage in transactions in a manner inconsistent with the views discussed herein.

**New Zealand:** This research is not intended for, and should not be given to, "members of the public" within the meaning of the New Zealand Securities Market Act 1988.

**Russia:** This information, interpretation and opinions submitted herein are not in the context of, and do not constitute, any appraisal or evaluation activity requiring a license in the Russian Federation.

## Risks to Fixed Income Positions

Macroeconomic fluctuations often account for most of the risks associated with exposures to instruments that promise to pay fixed or variable interest rates. For an investor that is long fixed rate instruments (thus receiving these cash flows), increases in interest rates naturally lift the discount factors applied to the expected cash flows and thus cause a loss. The longer the maturity of a certain cash flow and the higher the move in the discount factor, the higher will be the loss. Upside surprises in inflation, fiscal funding needs, and FX depreciation rates are among the most common adverse macroeconomic shocks to receivers. But counterparty exposure, issuer creditworthiness, client segmentation, regulation (including changes in assets holding limits for different types of investors), changes in tax policies, currency convertibility (which may constrain currency conversion, repatriation of profits and/or the liquidation of positions), and settlement issues related to local clearing houses are also important risk factors to be considered. The sensitivity of fixed income instruments to macroeconomic shocks may be mitigated by indexing the contracted cash flows to inflation, to FX depreciation, or to specified interest rates – these are common in emerging markets. It is important to note that the index fixings may – by construction – lag or mis-measure the actual move in the underlying variables they are intended to track. The choice of the proper fixing (or metric) is particularly important in swaps markets, where floating coupon rates (i.e., coupons indexed to a typically short-dated interest rate reference index) are exchanged for fixed coupons. It is also important to acknowledge that funding in a currency that differs from the currency in which the coupons to be received are denominated carries FX risk. Naturally, options on swaps (swaptions) also bear the risks typical to options in addition to the risks related to rates movements.

---

## David Folkerts-Landau

Managing Director  
Global Head of Research

---

Stuart Parkinson  
Chief Operating Officer

Guy Ashton  
Global Head  
Company Research

Marcel Cassard  
Global Head  
Fixed Income Strategies and Economics

---

Germany

Andreas Neubauer  
Regional Head

Asia-Pacific

Michael Spencer  
Regional Head

Americas

Steve Pollard  
Regional Head

### Principal Locations

---

#### Deutsche Bank AG London

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

---

#### Deutsche Bank AG New York

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

---

#### Deutsche Bank AG Hong Kong

Cheung Kong Center,  
2 Queen's Road Central  
Hong Kong  
Tel: (52) 2203 8888

---

#### Deutsche Bank AG Japan

2-11-1 Nagatacho  
Sanno Park Tower  
Chiyoda-ku, Tokyo 100-6171  
Tel: (81) 3 5156 6701

---

#### Deutsche Bank AG Frankfurt

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

---

#### Deutsche Bank AG

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

---

#### Deutsche Bank AG Singapore

One Raffles Quay  
South Tower  
Singapore 048583  
Tel: (65) 6423 8001

---

#### Deutsche Bank AG Australia

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

---

#### Deutsche Bank Dubai

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

---

**Subscribers to research via email receive their electronic publication on average 1-2 working days earlier than the printed version.**

**If you would like to receive this or any other product via email please contact your usual Deutsche Bank representative.**

#### Publication Address:

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

#### Internet:

<http://gmr.db.com>  
Ask your usual contact for a username and password.

---

## Global Disclaimer

The information and opinions in this report were prepared by Deutsche Bank AG or one of its affiliates (collectively 'Deutsche Bank'). The information herein is believed to be reliable and has been obtained from public sources believed to be reliable. Deutsche Bank makes no representation as to the accuracy or completeness of such information.

Deutsche Bank may (1) engage in securities transactions in a manner inconsistent with this research report, (2) with respect to securities covered by this report, sell to or buy from customers on a principal basis, and (3) consider this report in deciding to trade on a proprietary basis.

Opinions, estimates and projections in this report constitute the current judgement of the author as of the date of this report. They do not necessarily reflect the opinions of Deutsche Bank and are subject to change without notice. Deutsche Bank has no obligation to update, modify or amend this report or to otherwise notify a recipient thereof in the event that any opinion, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. Prices and availability of financial instruments are subject to change without notice. This report is provided for informational purposes only. It is not an offer or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy. Target prices are inherently imprecise and a product of the analyst judgement.

The financial instruments discussed in this report may not be suitable for all investors and investors must make their own informed investment decisions. Stock transactions can lead to losses as a result of price fluctuations and other factors. If a financial instrument is denominated in a currency other than an investor's currency, a change in exchange rates may adversely affect the investment. Past performance is not necessarily indicative of future results.

Unless governing law provides otherwise, all transactions should be executed through the Deutsche Bank entity in the investor's home jurisdiction. In the U.S. this report is approved and/or distributed by Deutsche Bank Securities Inc., a member of the NYSE, the NASD, NFA and SIPC. In Germany this report is approved and/or communicated by Deutsche Bank AG Frankfurt authorized by the BaFin. In the United Kingdom this report is approved and/or communicated by Deutsche Bank AG London, a member of the London Stock Exchange and regulated by the Financial Services Authority for the conduct of investment business in the UK and authorized by the BaFin. This report is distributed in Hong Kong by Deutsche Bank AG, Hong Kong Branch, in Korea by Deutsche Securities Korea Co. This report is distributed in Singapore by

Deutsche Bank AG, Singapore Branch, and recipients in Singapore of this report are to contact Deutsche Bank AG, Singapore Branch in respect of any matters arising from, or in connection with, this report. Where this report is issued or promulgated in Singapore to a person who is not an accredited investor, expert investor or institutional investor (as defined in the applicable Singapore laws and regulations), Deutsche Bank AG, Singapore Branch accepts legal responsibility to such person for the contents of this report. In Japan this report is approved and/or distributed by Deutsche Securities Inc. The information contained in this report does not constitute the provision of investment advice. In Australia, retail clients should obtain a copy of a Product Disclosure Statement (PDS) relating to any financial product referred to in this report and consider the PDS before making any decision about whether to acquire the product. Deutsche Bank AG Johannesburg is incorporated in the Federal Republic of Germany (Branch Register Number in South Africa: 1998/003298/10). Additional information relative to securities, other financial products or issuers discussed in this report is available upon request. This report may not be reproduced, distributed or published by any person for any purpose without Deutsche Bank's prior written consent. Please cite source when quoting.

Copyright © 2010 Deutsche Bank AG