Five Questions about Europe

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1. When will Greece default?

2. What stops bank runs throughout Europe?

3. Who buys Spanish and Italian debt?

4. How will peripheral countries grow?

5. What is Germany’s willingness to pay?

Greece must default

1. “Official sector estimates” finally concede no growth until 2013
2. Debt to GDP currently over 160. Even with the new program ratio will be over 120
3. Perpetual problems collecting taxes and implementing cuts
4. Limited public support for the pain associated with austerity
5. They are running out of cash
6. When the default comes the Greek banks will be broke

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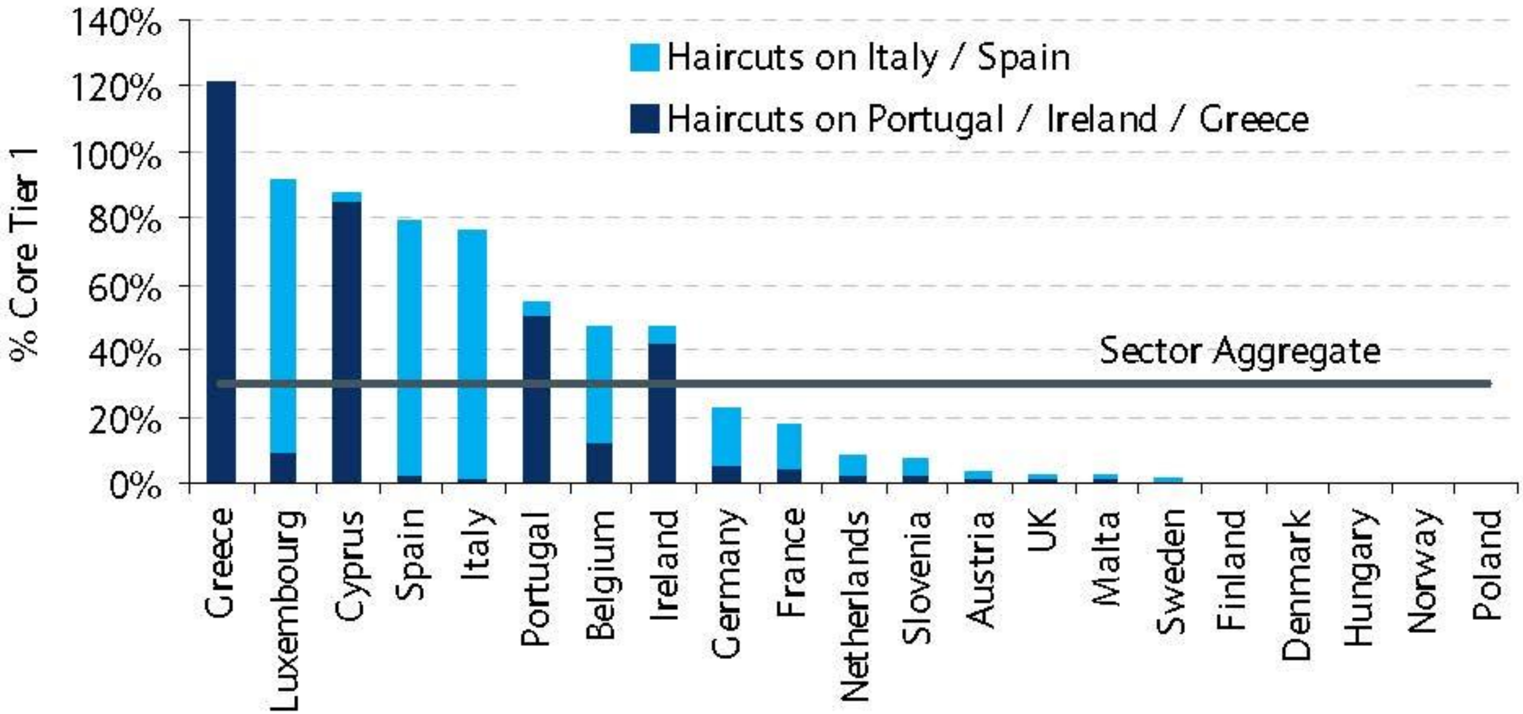
Which banks go bust?

Figure 3: 50% Haircuts to SGIIP sovereign exposures, % Core Tier 1, by banking system



Source: EBA, Barclays Capital

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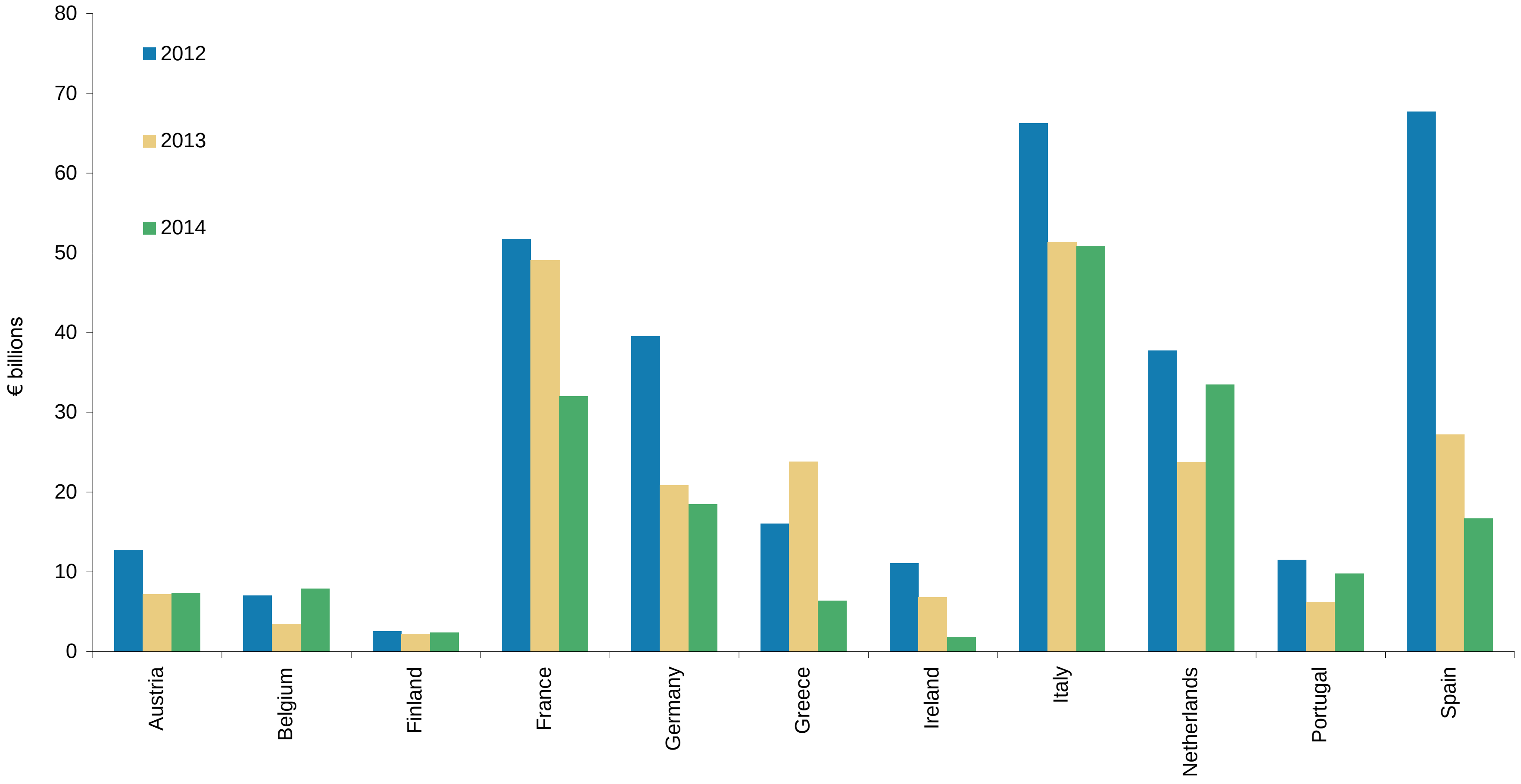
Bank runs

1. Multiple potential triggers
   - Images of Greeks lining up to get money
   - Default of a counterparty when Greece does default
   - Concerns over a failed Italian bond auction
   - Definitive statement by Germany that their exposure is limited!

2. Need a full backstop
   - ECB can print money to do it
   - Germany can do it, at the risk of trashing its credit rating

Bank funding needs



Source: Morgan Stanley

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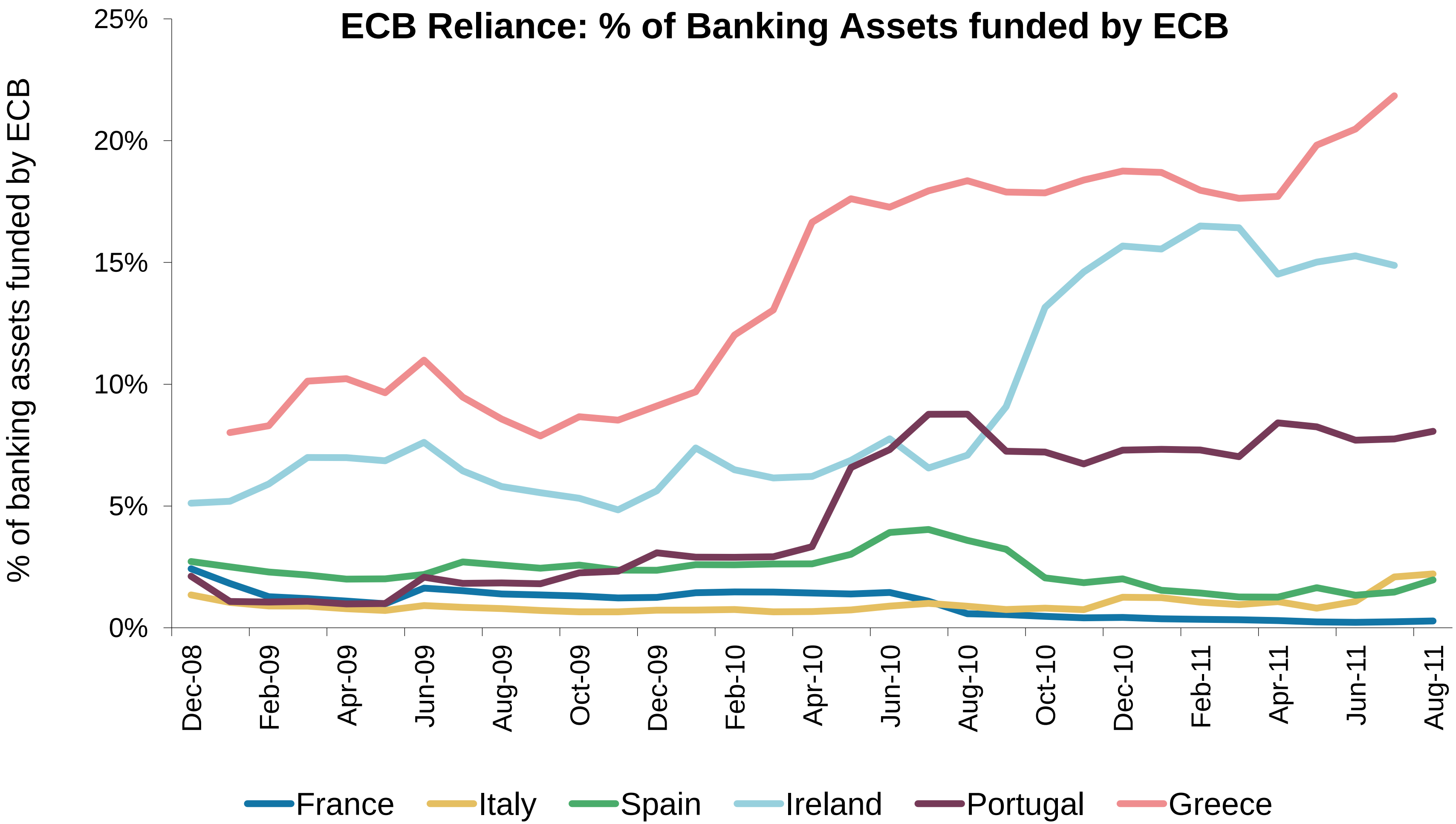
ECB bank support



Source: ECB, Central Bank of Ireland, Morgan Stanley Research
Note: Time lags on data releases mean latest data not available for all countries

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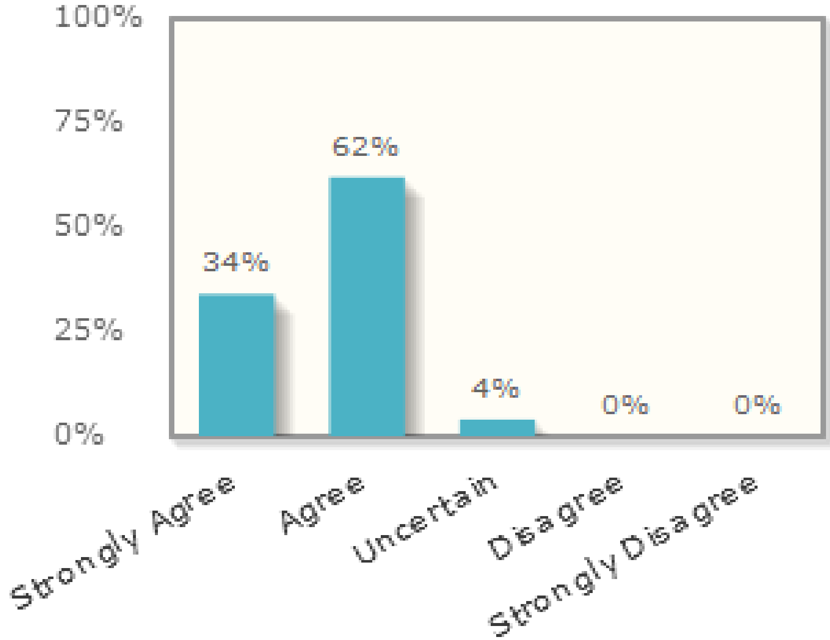
Credible assumptions for inflation, GDP growth and primary budget deficits in Italy imply that either the Debt-to-GDP ratio in Italy would increase sharply if Italian interest rates on 10-year government debt remained at the November 30 level of around 7 percent or Italy would lose access to the bond market.

Responses weighted by each expert's confidence



Source: IGM Economic Experts Panel
www.igmchicago.org/igm-economic-experts-panel

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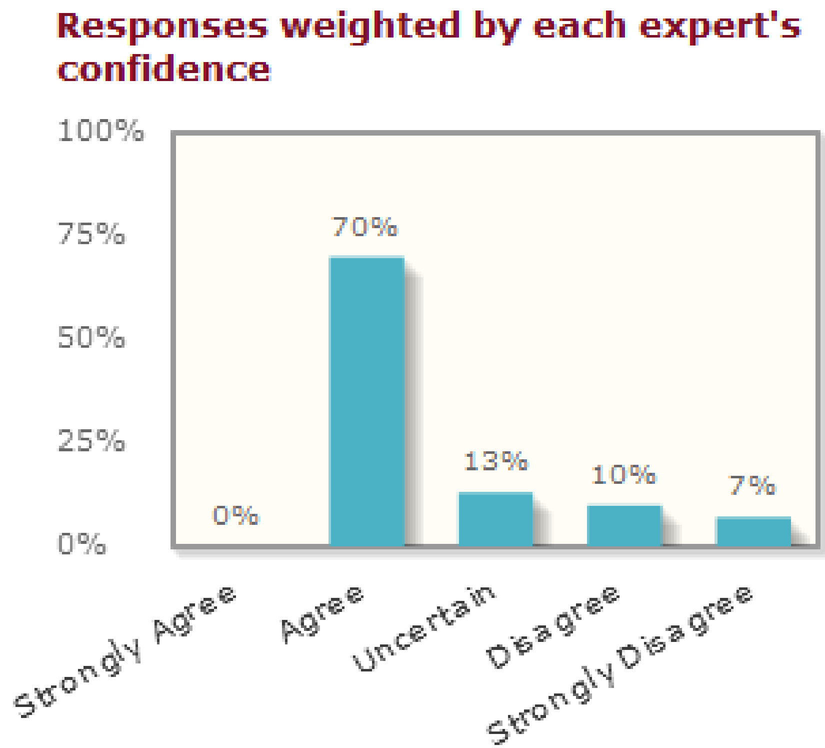
Absent outside help to deal with runs, such as a pledge of fiscal support from Germany or an unlimited commitment by the ECB to buy bonds, there is no spending-and-tax plan Italy can announce that would be credible enough to hold its interest rates low enough to stabilize its Debt-to-GDP ratio.



Source: IGM Economic Experts Panel
www.igmchicago.org/igm-economic-experts-panel

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Who buys Spanish and Italian debt?

1. Spreads for Italy over the Germany now exceed 500 basis points
2. Anemic growth prospects

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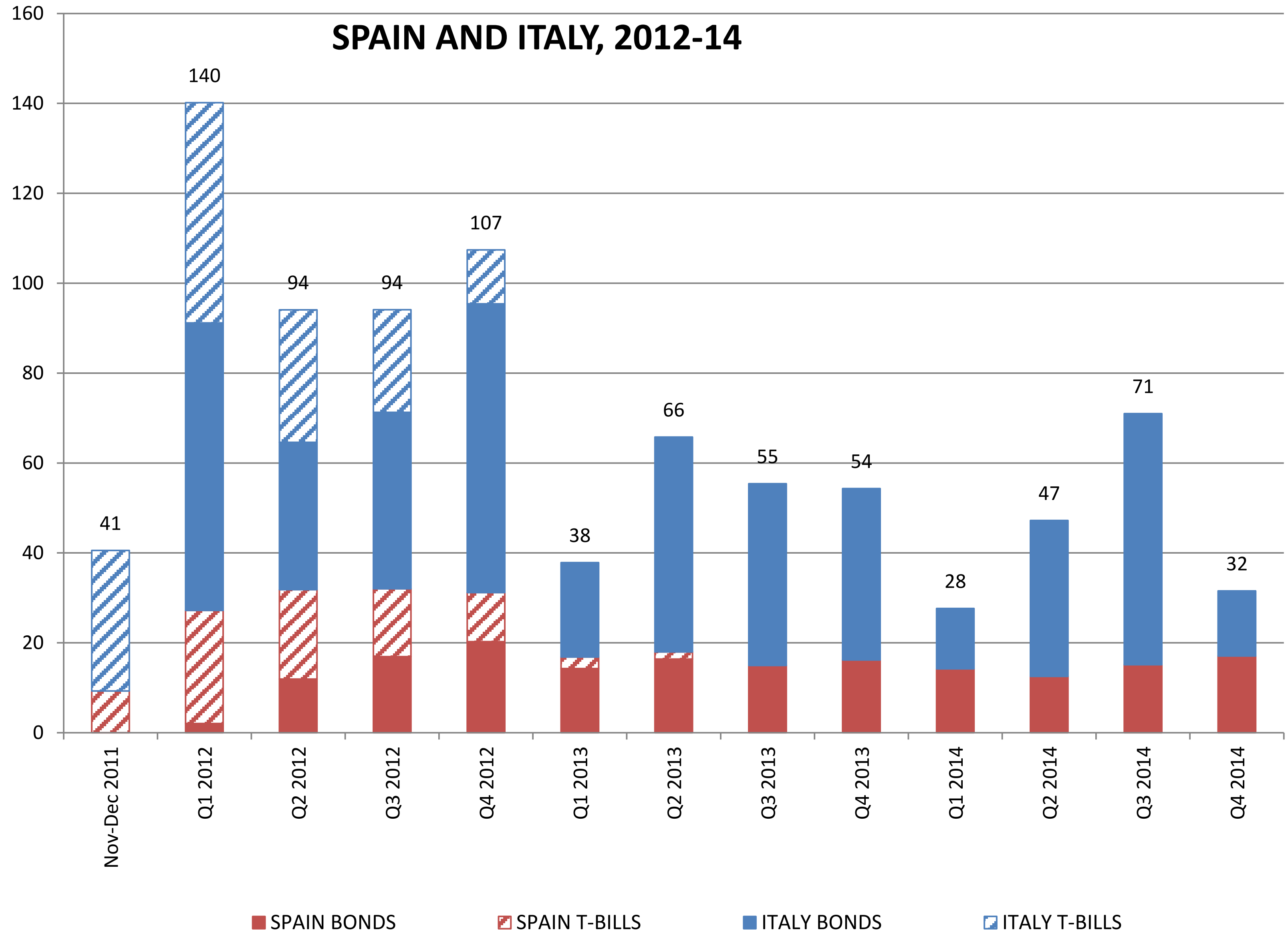

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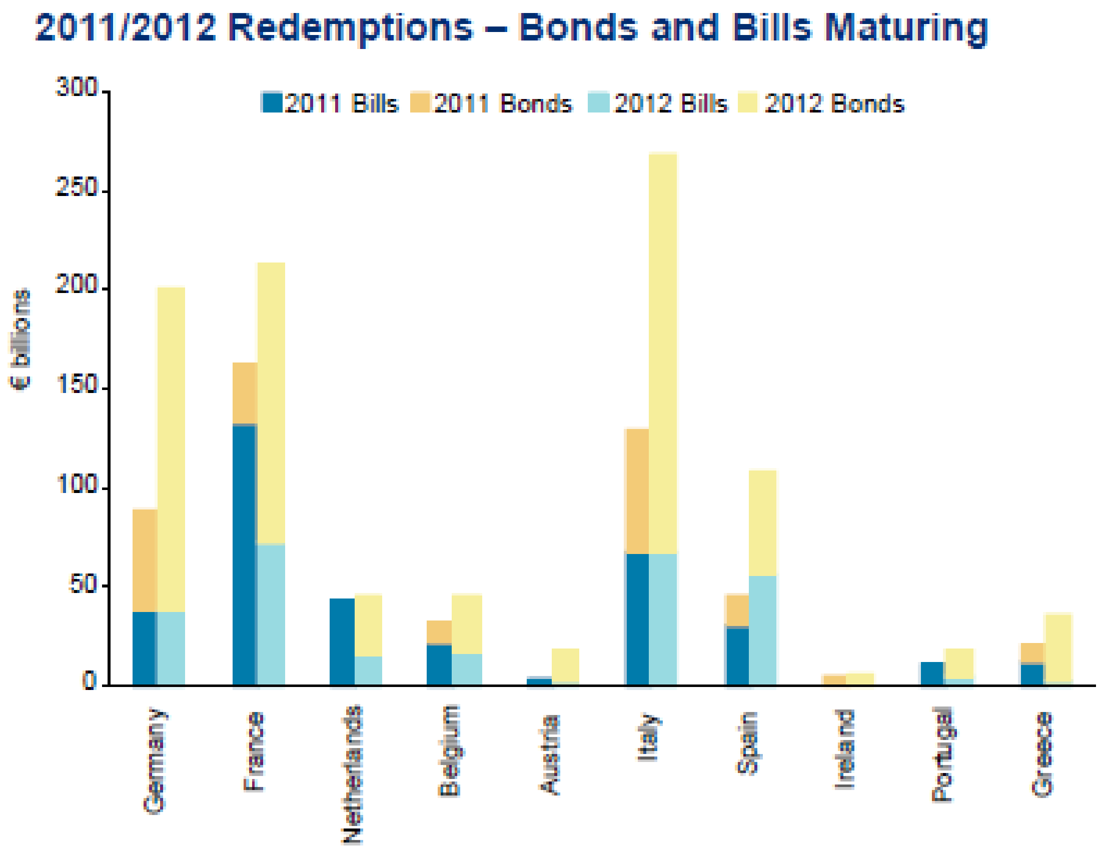
Ugly sovereign funding risk

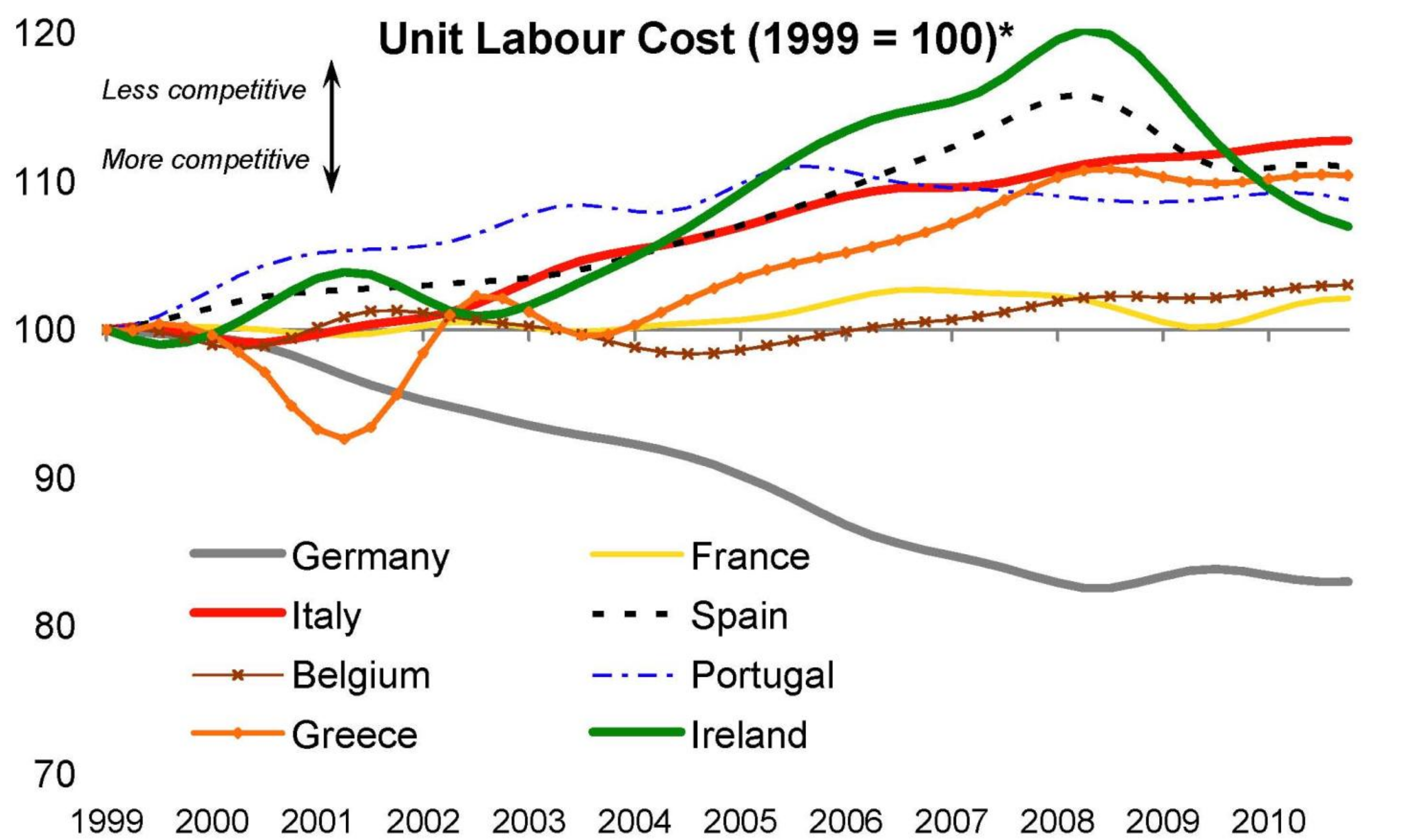


Source: Morgan Stanley

Where does growth come from?

Exhibit 13

Competitiveness gap



*Relative to 36 industrial countries; total economy

Source: Haver Analytics, Morgan Stanley Research

Barclays latest forecasts

	Real GDP % over previous period, saar					Real GDP % annual chg		
	2Q11	3Q11	4Q11	1Q12	2Q12	2010	2011	2012
Euro area	0.7	0.7	-0.6	0.2	0.6	1.8	1.6	0.4
Belgium	2.1	0.0	↓ -0.4	0.6	0.6	2.3	2.1	0.6
France	0.0	1.6	-0.4	0.5	1.0	1.4	1.7	0.7
Germany	0.5	2.1	-0.4	0.3	0.6	3.6	2.9	0.6
Greece	-3.0	-2.4	-2.8	-3.7	-3.8	-4.2	-6.0	-3.3
Ireland	6.4	-4.5	-5.2	0.3	3.9	-0.4	1.1	0.9
Italy	1.2	-0.7	-0.8	0.2	0.6	1.2	0.6	0.3
Netherlands	1.0	1.3	-0.5	0.1	0.7	1.6	1.9	0.6
Portugal	-0.2	-7.9	-6.8	-4.0	-3.1	1.4	-2.2	-4.0
Spain	0.6	0.3	-0.4	0.0	0.6	-0.1	0.7	0.5
United Kingdom	0.4	1.9	↑ 0.5	1.3	1.7	1.8	0.9	1.5
Switzerland	1.6	1.6	1.2	1.6	1.4	2.6	2.0	1.4

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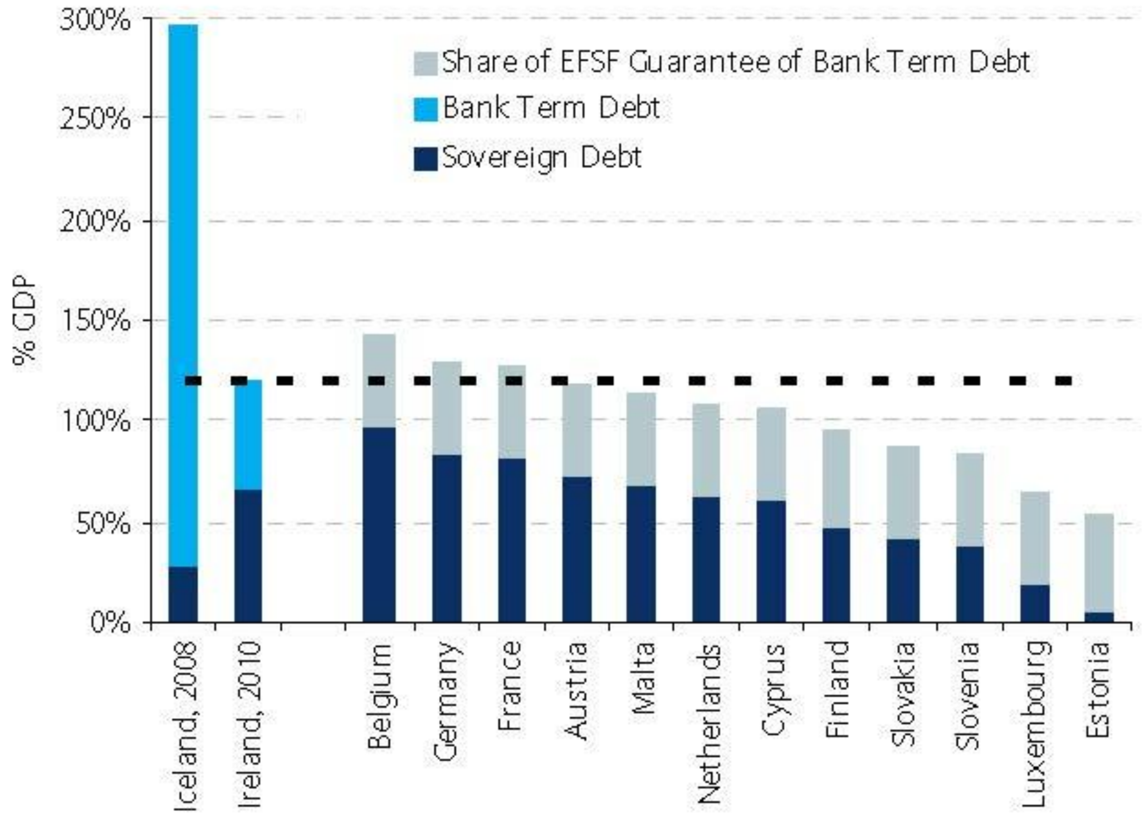
Size of the hole

Figure 9: Total potential commitments, % GDP – excluding program countries plus Italy & Spain



Source: Central bank data, Bloomberg, Dealogic, Barclays Capital

Germany’s willingness to pay?

1. ECB buys everything in sight and also repos against bad debt. ECB eventually recapitalized.

2. Germany accedes to “joint and several” guarantees for all euro area debts. Trashes its own credit rating.

3. Germany and France (and a few others) exit to form a new monetary union.