

Economics

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Euro Area: Sovereign Debt Crisis Update

- On the first day of the two-day EU Council Meeting – scheduled for the “economic part” of the agenda – the Heads of State and Government delivered in line with earlier press reports. We agree with Herman Van Rompuy that the **Council has taken “important decisions” by approving the Competitiveness Package – which is now called Euro Plus Pact – and starting the European Semester** – under which governments have to present their budget plans for the following year to the Commission. The Heads of State also adopted the ESM, after amending the structure of the capital payments as demanded by Germany.
- **However, as press reports suggested before the Council meeting, the European Leaders did not make any decision in several important areas.** The Council did not decide on how to extend the lending capacity of the EFSF from €255bn to targeted €440bn. Instead the European leaders *“agreed to ensure that the temporary Facility has an effective lending capacity of 440 billion euro. It will be in place in June.”* There was also no decision on the reduction in the interest rate for the loans of the rescue package for Ireland. This decision will be postponed until after the publication of the Irish bank stress test – which is due next week.
- It can be regarded as a success that **six non-euro area countries (Denmark, Poland, Latvia, Lithuania, Bulgaria and Romania) plan to join the Euro Plus Pact** targeted at increasing the countries’ competitiveness. However, the Pact remains quite fuzzy and there are no penalties involved for non-compliance.
- **Regarding the ESM, the change in the schedule of the capital payments might have an impact on the lending capacity of the ESM.** In contrast to the previous plan to pay-in 50% of the initial capital of €80bn by July 1 2013 and the rest in three annual instalments thereafter, the new schedule will build up the paid-in capital in five annual instalments starting in 2013. Hence, the ESM will start with much less paid-in capital and will meet the point at which the capital is paid-in two years later. However, as in the transition period the ESM shall have a *“minimum 15% ratio between paid-in capital and the outstanding amount of ESM issuance”* the member countries might have to pay-in additional capital earlier. Otherwise, in order not to breach this 15% ratio, the ESM would only to be able to issue (and lend) €107bn in 2013, and €213bn in 2014.
- **Regarding the bank stress test, the Council decision highlights that “governments must be ready to deal with the outcome of the test”.** However, in contrast to some earlier press reports, there was no extension of the EFSF in order to use it as a bank recapitalisation facility.

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- **The delay in the decision on the EFSF has mainly to do with upcoming elections** in Germany (March 27) and Finland (Apr 17). However, when the European Leaders publicly committed themselves to approve the EFSF extension at the current Council meeting, this election schedule was well known. In that respect, we have to be careful not to take for granted the new commitment that the €440bn will be in place in June. Depending on what measures are chosen to increase the lending capacity, it might take much longer before the EFSF will be able to effectively lend €440bn.
- **On the interest rate of the Irish package**, French Economics Minister Christine Lagarde highlighted the need to discuss the Irish corporate tax rate and she also claimed that *"there should be no tax competition between euro zone member states"*.
- Comment: The European leaders took important steps in order to increase the stability of the euro area in the medium term. However, because of conflict with national interests, the Leaders did not deliver decisions on the most time-critical points. **Overall, the Council results suggest that the euro area governments are willing to go ahead with more integration, but it probably requires severe market pressure to force immediate action.**
- **Portugal – Two rating agencies reacted yesterday to the deterioration in the political situation in Portugal, downgrading the credit rating of Portuguese debt.** Fitch cut the rating by two notches, from A+ to A-, and S&P cut the rating also by two notches, from A- to BBB. Both agencies left the sovereign under negative watch, implying further downgrades are looming. The failure of the Portuguese government to gain parliamentary support for its set of austerity measures and the consequent resignation of the government were the triggers for both rating actions, as these events increase Portugal's refinancing risks and the chances of Portugal to be forced to request an international bail-out.
- **Apart from the political issues, S&P also noted that another downgrade of the Portuguese debt may be imminent** (possibly as soon as next week) if/when the final version of the ESM – the European rescue facility to be in place from 2013 onwards – will confirm to have *preferred creditor status* relative to bondholders and/or the final version of the ESM will increase the likelihood of euro sovereign bondholders to be restructured/haircut. Comment: this is an important remark, we think. S&P has been stressing this argument since the ESM draft was first announced last autumn, and not just with regard to Portugal but to all the other troubled euro countries. Therefore, **the final announcement of the details of the ESM may trigger another round of rating downgrades among euro sovereigns.**
- **The Portuguese President, Mr Cavaco Silva, will start consultations today among the political parties to explore what are the options available** for either forming a large coalition among the major parties behind a temporary government, or for calling early elections straight away.
- **A new opinion poll showed that the main centre-right opposition party, the PSD, gained support of 46.7% of the voters**, while the current governing party, PS, wins only 24.5% of the votes, down four percentage points relative to the previous month. The other smaller centre-right party, CDS, gained 2 percentage points and reached 6.3%. For the sixth consecutive month, the combination of the centre-right opposition votes (of PSD and CDS) exceeds 50% of the voting intentions.

Appendix A-1

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