

Economics

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Euro Area: Sovereign Debt Crisis Update

- **After the approval of the EFSF amended framework agreement, the EFSF yesterday published a new issuance calendar**, taking into account that with the new structure of an over-guarantee of up to 165%, new issuance of bonds to fund the Ireland and Portugal package will not require a holding of cash reserves any more. As a result, the required bond issuance to fund the Irish and Portuguese programme will be smaller. EFSF chairman Klaus Regling said that the October 23 Council meeting will take decisions of substance to respond to markets, adding that he is confident that the EFSF will keep its AAA rating, even including extra measures to increase the firepower of the EFSF.
- The *WSJ* and various French newspapers are writing that **France will push for the EFSF to be leveraged by providing insurance on bonds issued by countries that cannot tap markets**. This option would have the advantage of not requiring approval by national parliaments. France would also continue to push for the EFSF to be turned into a bank despite a *"wall of opposition"* from Germany and the ECB. Another option would be to bring the support of other European or international funds to the EFSF. Ahead of the G20 meeting of finance ministers and central bankers on Friday, the newspapers were reporting that delegates will work towards having two to three proposals per country to support sustainable global growth in time for the G-20 heads of state summit at the beginning of November. Since France, which presently heads the G-20, does not have any room for stimulus, its proposals would focus on rebalancing the country's finances. Comment: There appears to be a growing consensus between the main players (Germany, Commission, Eurogroup) that the best way to leverage the EFSF will be through guarantees covering a percentage of first loss, perhaps around 20%, which would multiply the firepower five times. The other idea which appears to be making progress would be to bring forward the ESM from 2013 to 2012.
- **Ahead of the G20 finance ministers' meeting today in Paris**, Reuters reports that BRIC countries would be willing to increase capital to the IMF in order to give the IMF more room to support the strained European sovereigns. Comment: In addition to extra measures from the Europeans, there seems to be also extra support from the G20 countries in the pipeline for euro area sovereigns.
- **Italian Prime Minister Silvio Berlusconi faces a confidence vote in parliament today**. The debate for the vote of confidence starts at 10.00 am London time with the vote at 11.30 a.m. London time. Prime Minister Berlusconi declared yesterday he was confident of winning the vote with an absolute majority (320 seats). He also argued that, if the vote was lost, the most probable outcome would be earlier elections, and he added that *"countries' problems cannot be solved by a technocratic government without democratic legitimacy."* In the event if the PM wins the vote, the point will be whether Berlusconi can demonstrate he is capable of ending the paralysis blocking decisions on economic reform and the nomination of a Central Bank successor.

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- **Departing Comments from ECB's Trichet** – In an interview with the FT, departing ECB President Jean-Claude Trichet said that *"the ECB has done all it could to be up to its responsibilities in exceptional circumstances"*. He added that the ECB will not act as *"a lender of last resort"* to the governments. Furthermore, he said *"to do anything that would let governments off their responsibilities would be a recipe for failure"*. In the direction to politicians Mr. Trichet also said that *"one of the lessons of the crisis is precisely that they need more unity"*.

Comment: With his statement Mr. Trichet set a very high hurdle for the ECB and his successor as President, Mario Draghi, to become engaged in additional measures to support the sovereigns – e.g. being part of leveraging up the EFSF. However, we do not agree with the statements of Mr. Trichet that interest rate cuts in coming months are off the table. While we do not expect a rate cut in November, because inflation is likely to be around 3% and recent hard economic data surprised on the upside, **we continue to expect a rate cut in December** when, in addition to likely further deterioration in sentiment data, activity data probably will be showing clear signs of weakness, while inflation rates are likely easing somewhat.

- **Future Rescues to Come with Increased Control of National Budgets?** – In an interview with FTD, Dutch Finance Minister Jan Kaas de Jager repeated the need to obtain influence on the national budgets of countries that require support from the rescue facilities. Mr. de Jager was very explicit, saying that the Netherlands would only agree to provide funding to countries for bank recapitalization or other support through the EFSF if the EU summit (on 23 October) agrees on a system of more control of national budgets of countries that require this support. In order to implement this, he demanded the creation of a special EU Commissioner. **According to the Dutch Finance Minister, Germany and Finland would strongly support these demands and also Austria and Luxembourg** would support the proposal – but France would not. However, Mr. de Jager also said that he is open to ideas about leveraging-up the EFSF in combination with the private sector. Comment: The statement of Mr. de Jager highlights that additional control on national budgets in countries that require financial assistance from the EFSF will be a condition for providing extra help.

- **Slovak National Council (Parliament) approved the EFSF** in the 2nd vote after it failed to be approved on Tuesday (when it was combined with a confidence vote). The Parliament decided to vote on the EFSF on Thursday after its afternoon session started. This quick action likely reflects the fact that many politicians felt that Tuesday's vote decreased the credibility of Slovakia abroad. Early elections were approved, to be held on 10 March 2012. This was a condition of the opposition SMER-SD in order to vote for the EFSF. The SAS does not rule out a complaint to the Constitutional Court on the EFSF vote. For details, see [Slovakia Macro Flash: EFSF Approved; Early Elections Approved; Constitutional Court?](#)

- **Spain's credit rating was downgraded by S&P** who announced a one-notch downgrade to AA- from AA, while leaving the rating on a negative outlook. Spain is rated AA-by Fitch and one notch higher at Aa2 by Moody's. S&P cited high unemployment, tightening credit conditions and a high level of public sector debt as some of the main reasons for the rating downgrade. It also noted the *"incomplete state"* of the labour market reform and the likelihood of a further deterioration for Spain's banks. Finally, it cut the 2012 GDP forecast to 1% from 1.5%, warning about growing recession risks. Comment: We share many of the rating agencies' concerns regarding the economy. Our recent note: ["Spain – Tough Tasks For The New Government"](#) – warns that fiscal slippages and a

worsening economic environment are likely to offset any positive news from the election results. Together with a likely economic recession in 2012, this makes the medium-term fiscal target – a deficit of 3% of GDP by 2013 – very difficult to achieve, in our view.

- **Greece's new package of austerity measures** including wage and pension cuts and plans to dismiss 30,000 state workers **was approved yesterday to proceed to a plenary session in parliament.** Later in the day, Greece's biggest private sector union GSEE called a 48-hour strike from October 19 to protest against government austerity measures. Moreover, Finance Minister Evangelos Venizelos declared Greece's parliament must approve changes to collective labour laws before the nation can receive the next bailout loan. Greek Prime Minister Papandreou said "*Greece is moving forward*" after a meeting with the EU President Herman Van Rompuy. "*We are determined to implement (the necessary) changes, painful as these may be*", he said, and added that the goal is to cooperate and find a comprehensive solution to the crisis facing the euro area, including fixing problems at the institutional level.
- **Portugal's President Urges Action on European Debt Crisis** – Yesterday the Portuguese President Anibal Cavaco Silva said the European Central Bank has to do more to end the sovereign debt crisis that has stretched over two years. "*A wider and more foreseeable intervention is necessary in the sovereign debt market of the solvent countries that face problems of liquidity, including the availability for intervention in the secondary market*". The European Financial Stability Facility must be strengthened, he said, and the ECB and EFSF operations must be tied to strict conditions to ensure that nations comply with their budgetary and structural policies, adding that European banks must be recapitalized.
- **French socialist primaries for 2012 Presidential Election** - Former Socialist party head Francois Hollande (39% of first round votes) is seeing his lead over the current party head Martine Aubry (31%) shrink, with three days to go before the second and final round of the Socialist primary election on Sunday. Opinion polls suggest his lead is shrinking with a 53/47 split. Comment: it is not clear what will happen on Sunday given the margin of error and the lack of accuracy of polling estimates before the first round. Arnaud Montebourg who finished third with 17% of the first round votes has not yet made his opinion known as to whom he would support. With the attention focusing on banks and the Greek sovereign debt crisis, it is possible that left wing voters might give more credence to the harder message coming from the left side of the political spectrum rather than the most centrist view peddled by Hollande.
- **Belgium - six parties will begin talks on Friday to form a new government** 16 months after the June 2010 elections. Elio Di Rupo, the head of the French-speaking Socialists who has been entrusted by the King to lead coalition talks for the past few months, indicated that the new government would consist of the Socialists (PS [26 seats] and Sp.A [13]), Liberals (MR [18] and Open.VLD [13]) and Christian Democrats (CdH [9] and CD&V [17]) on both sides of the linguistic divide. Their first task is to agree a budget framework for 2012, having to find an extra €4bn for the rescue of Dexia. The next task will involve reaching an agreement on social and economic issues including immigration, justice and the benefits systems. Comment: With 96 seats in the 150-seat parliament, this coalition would probably have enough room for manoeuvre to last until the end of the parliament's four-year term.

Appendix A-1

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