

Euro Area: Sovereign Debt Crisis Update

- **Eurogroup mulls next steps** — Eurogroup's Juncker indicated in *Le Figaro* that the Eurogroup will decide what steps to take after reviewing the state of markets in the next few days, adding that there is "*no time to lose*". His comments suggest that the EFSF could buy government bonds on the primary market on behalf of euro zone countries, supported by ECB purchases on the secondary market.
- **EA Big-3 statements** — German Chancellor Merkel issued joint statements with French President Hollande on Friday and with Italian President Monti on Sunday highlighting that governments would do "*everything*" needed to protect the euro and stressing the importance of implementing the decisions of the 29 June EU Summit "*as soon as possible*". In contrast to Mr Juncker's remarks above, the EA-3 statements do not suggest immediate action.
- **Schäuble meets Geithner today** on North Sea island of Sylt (where Mr Schäuble is on holiday). After the meeting the two ministers will release a statement.
- **Germany** — Politicians against bond buying, take hard line on Greece.
- **Gloomy news on Spain** — Spain not readying itself to ask for financial assistance according to Schäuble. Full Spanish bailout could be around €300bn according to EU source. GDP falls for third consecutive quarter, July inflation rises more than expected. IMF lowers its forecasts for Spanish GDP in 2012 and 2013. Rajoy's popularity suffers from repeated austerity packages. Madrid accumulates five months worth of arrears to suppliers.
- **France** — Constitutional court may rule that the fiscal compact treaty requires an amendment to the Constitution. This could be a lengthy process and likely will require the support of the opposition.
- **Italy** — Spending Review commissioner hints at potential for sub-national administrations to make further savings.
- **Greece** — Reuters report says that there is a 70% chance of OSI for Greece. Troika to stay in Athens as long as necessary to obtain an outline of the measures that Greece will adopt to make €11.5bn worth of savings and comply with the terms of the 2nd bailout agreed in March.
- **Cyprus** — Bailout needs more discussion, says government spokesman.
- **Slovakia** — Minister of Finance Peter Kazimir (SMER-SD) sees a risk of a wider general government deficit of 5.3% of GDP compared to the approved 4.6% unless additional austerity measures are introduced. Confidence indicator drops in July.

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- **Eurogroup mulling over the next steps** - Eurogroup chairman Jean-Claude Juncker gave an interview in *Le Figaro* in which he indicated that the Eurogroup will decide what steps it should take after reviewing the state of markets in the next few days, adding that there is *"no time to lose"*. Mr Juncker remarked that *"we (the EFSF) will act together with the ECB without threatening its independence"*. He reiterated that he had *"no doubt that we will implement the agreements of the last summit"*, stressing that *"we will work in close agreement with the ECB, and we will, as [ECB President] Mario Draghi said, see results. I don't want to drive expectations, but I must say, we have reached a decisive phase."* He concluded that *"the euro countries have reached a point where we have to use all means possible to show that we are determined to protect the stability of the euro zone... nobody should doubt the will of those involved, to prove our determination."* **Comment:** this joint interview given to both *Le Figaro* and German paper *Süddeutsche Zeitung* suggests that the temporary rescue fund - the European Financial Stability Facility (EFSF) - could buy government bonds on the primary market on behalf of euro zone countries, supported by ECB purchases on the secondary market.
- **EA Big-3 statements:** German Chancellor Angela Merkel issued joint statements with French President Francois Hollande (on Friday) and with Italian President Mario Monti (on Sunday). Both statements highlighted that the governments would do *"everything"* needed to protect the euro and stressed the importance of implementing the decisions of the 29 June EU Summit *"as soon as possible"*. According to *Les Echos*, this means that the heads of the three largest euro area member states have agreed to activate the financial support mechanisms. The newspaper writes that the ECB would determine when and how it would act, suggesting that the central bank might only act as an agent of euro area governments. The EFSF could intervene whenever Spain decides to formally ask for financial assistance, given the €30bn immediately available for use on the primary market. The paper added that the ECB could provide some support on the secondary market if the situation were to warrant it. **Comment:** The statements are intended to highlight that the large EMU countries are united in their commitment to the euro. Time is running out for the euro area member states to act decisively to act in order to support peripheral countries and demonstrate their commitment. Although verbal intervention appears to have worked, it probably needs to be followed soon by some intervention in the financial markets. By clarifying that some action will be taken if necessary and once Spain requires it, euro area governments have taken a decision in principle which will need to be followed through. In contrast to Mr. Juncker's statements, the EA-3 statements do not suggest immediate action.
- **Schäuble meets Geithner today:** In an interview with *Welt am Sonntag*, German Finance Minister Wolfgang Schäuble said that he is against a new bailout programme to Greece and is also against another round of debt restructuring. In respect of Spain, Mr. Schäuble said that there was nothing in reports that Spain would ask the EFSF to support the sovereign through bond purchases – see further on Spain below. Today, Mr. Schäuble holds talks with US Treasury Secretary Timothy Geithner on the North Sea island of Sylt (where Mr Schäuble is on holiday). After the meeting the two ministers will release a statement.
- **German politicians against bond buying, take hard line on Greece:** German Economics Minister Philipp Rösler and head of the junior coalition party FDP, criticised potential bond purchases of the ECB as those would undermine the credibility of the central bank and could lead to inflationary pressure. His party colleague Uwe Hahn went a step further, saying that the German government

should considering whether bond purchases by the ECB warrant a lawsuit at the European Court of Justice. He also reiterated that Greece would have to fulfil its commitments and that a Greek exit from the monetary union has lost its terror. Horst Seehofer, CSU head and Bavarian PM, supported Mr. Rösler's comments on Greece and said he was "very sceptical" in respect of possible ECB bond purchases. German opposition politicians also clearly against the ECB again buying bonds. **Comment:** While the German Chancellor and her Finance Minister seem to be willing to take further action and at least tolerate more action by the ECB, other parts of the government coalition and also the opposition are very sceptical on this. While Germany or the Bundesbank can't stop the ECB expanding its bond purchases, Germany might block further action by the EFSF and the ESM.

- **ESM:** The Finance Minister of Estonia criticised Germany for delaying the implementation of the ESM. He also made clear that his country was not willing to increase the ESM capacity and said that he hopes to get support from Germany.
- **Spain not readying itself to ask for financial assistance according to Schäuble** - German Finance Minister Wolfgang Schäuble denied that there was any truth to speculation that Spain would shortly ask the euro zone rescue fund for help via buying its bonds. Asked about fears that Spain might not be able to sell its bonds, Schaeuble said: *"We know about these concerns. This is why we tied up an aid package that was sufficiently large. Spain will get up to €100bn to recapitalise its banks and of this we have made €30bn in the European Financial Stability Facility (EFSF) available as a potential immediate help."* **Comment:** We doubt that Spain will be able to obtain financial assistance from the EFSF without formally requesting some financial assistance, unless it were to be a unanimous decision from the Eurogroup on the grounds that a precautionary €30bn line has already been approved, albeit for the banks.
- **Full Spanish bailout could be around €300bn according to source - *El Confidential*** is running a story suggesting that Spanish Economy Minister Luis de Guindos had brought up the prospect of a €300bn bailout last week at a meeting with Germany's Finance Minister Wolfgang Schäuble. A euro zone official indicated that *"De Guindos was talking about €300bn for a full programme, but Germany was not comfortable with the idea of a bailout now."* The source noted that the question would be put off until the ESM is up and running. He also said Germany appeared to be softening its opposition to giving the ESM a banking licence. *El Confidential* also wrote that Germany was demanding a roadmap going beyond budget adjustments in order to support purchases of Spanish debt. Separately, Saturday's version of *Expansion* noted that Spain's deputy PM had to deny in the post-cabinet-meeting press conference that the Finance Minister and the German Finance Minister had discussed a €300bn bailout. **Comment:** The question is essentially one of timing, and depends on both the ECB's stance at Thursday's press conference, and how the auction of the last tranche of Spanish debt issuance goes before the country needs to return to the market in September.
- **Spain's GDP falls again, inflation rises more than expected:** INE reported the flash estimate for Q2 GDP in Spain as -0.4% QQ (-1.0% YY) in Q2, in line with the preliminary estimate of the Bank of Spain and slightly better than our forecast of -0.6%QQ (-1.2%Y). This is the third consecutive quarter of contraction (Q4 and Q1 both saw falls of 0.3% QQ). No split is available at this stage (it will only be published with the second estimate on August 28), but the Bank of Spain last week estimated a negative contribution of domestic demand of -1.2% QQ, while

net trade contributed positively. INE also reported the **flash estimate for July HICP inflation** as 2.2%YY, up from 1.8%YY in June and above our forecast of 1.8%YoY. The accompanying press release notes that this result was driven by price rises of medicine and other pharmaceuticals. National CPI inflation also came in at 2.2%YY in July. The final estimate comes on August 14. **Comment:** Spain's recession is deepening, but at a somewhat slower pace than anticipated. We expect GDP growth in H2 to become even more negative, as large fiscal cuts are due to be implemented in the second half of the year.

- **IMF on Spain:** In its yearly Article IV report released on Friday, the IMF lowered its forecasts for Spain, now expecting GDP to fall 1.7% in 2012 (vs. -1.5% before the recently announced adjustment programme), and to fall by 1.2% in 2013 (vs. -0.6%) and for GDP growth to become positive in 2014 (+0.9%). The IMF expects the budget deficit to meet the 6.3% of GDP deficit target in 2012, but for additional measures to be necessary to meet the 4.5% of GDP and 3% targets for 2013 and 2014 (it forecasts deficits based on no additional cuts of 4.7% of GDP in 2013 and 3.6% in 2014). **Comment:** The IMF's GDP growth forecasts are now more negative than those of the Spanish government, which expects -1.5% growth in 2012 and -0.5% in 2013, but still more benign than our forecasts of -1.8% in 2012 and -3.3% in 2013.
- **Rajoy's popularity suffers from repeated austerity packages** - A Metroscopia poll published monthly in *El País* shows that if a general election was to take place now, the ruling People's Party would still win with a 30% share of the vote. This would reduce its margin over the Socialist opposition to 5.3 percentage points compared to 15.9 in the November vote. The 25-26 July poll showed 80% of Spaniards now have little or no confidence in Rajoy, with 72% saying he is not being efficient to fight the economic crisis. While 74% of people interviewed say they have a negative view of the government, the Socialist opposition is not seen as gaining from the PP's fall. The socialist PSOE would get only a 24.7% share of the vote if an election was organised now, down from 28.7% in the November vote. The centrist party UPyD registered the biggest jump in the poll, with its 9.9% of voting intentions, up from 7.8% in June and 4.6% in November. The communist Izquierda Unida also remains near historic highs, with a backing of 12.3% in July, down from 13.2% in June but up from 7.7% in November.
- **Madrid accumulates five months worth of arrears to suppliers.** According to the newspaper *El Confidencial*, just two months after receiving €35bn from the Government to settle unpaid bills to suppliers, many of the country's major cities are once more building up arrears in payments to suppliers. According to the press report, Madrid is the city which appears to be accumulating arrears the fastest having already reached a five-month delay in payments to major service companies.
- **Reuters report says that there is a 70% chance of OSI for Greece.** According to a Reuters report which cited anonymous European officials, Greece's European partners are contemplating a second restructuring of the country's debt so as to bring it down by €70-€100bn (30% of GDP) and to contain it close to 100% of GDP. The report says that European officials believe that a second debt restructuring, which would now be a case of official sector involvement (OSI), is the last chance for Greece to remain in the euro area and that the most likely scenario is for a haircut on the bonds held by the European Central Bank, the national central banks and possibly the euro area Governments. *La Tribune* argues that, in this case, national central banks and the ECB could suffer a 30% haircut. Under this scenario, the paper suggests that the NCBs (and the ECB) might be reviewing some recapitalisation options that could involve gold sales.

The ECB refused to comment on the report. **Comment:** A 30% hit could correspond to the difference between the average purchase price of these Greek bonds and their par value. If this was the case, then central banks could simply agree to sell their bonds to Greece without a profit – which would avoid them having to record any loss.

- **Troika to extend its stay in Athens.** According to a Greek finance ministry official, the Troika officials were due to leave the country at the end of this month to return again at the end of August but have changed their plans and will now stay for as long as necessary to obtain an outline from the Government of the measures that Greece will adopt to make €11.5bn worth of savings and comply with the terms of the 2nd bailout agreed in March. The Troika officials are also expected to complete their review of the progress made by the Greek authorities in the year to date with respect to the implementation of the prior actions agreed in March. According to *Ekathimerini*, the Greek finance ministry official added that the Troika's stance had changed and was "*no longer hostile*" and this change in stance could result in a swifter disbursement of the next tranche of the 2nd rescue package for Greece. Note that the Troika team refused to comment on the ministry official's claim that the Troika was "*no longer hostile*".
- **Cyprus bailout needs more discussion.** According to *Ekathimerini*, a government spokesman said on Friday that Cyprus needs more discussions with its potential rescue creditors to iron out differences on the terms of a bailout for its banks. According to spokesman Stefanos Stefanou, "*differences in approach*" remain after a second round of talks with officials from the EU and the IMF ended on Friday. Cyprus last month sought financial support from its euro area partners partly to recapitalize its banks which are estimated to need at least €2.8bn after suffering heavy losses on their holdings of Greek debt. However, Standard & Poor's estimates suggest that Cyprus needs as much as €15bn worth of external financial assistance over three years. At present, Cyprus can't raise the money it needs on international debt markets because of its sub-investment credit rating and is depending on a low-interest €2.5bn loan from Russia to meet its financing needs for the year and has already asked for another €5bn Russian loan that President Dimitris Christofias has defended as perfectly compatible with an EU-IMF bailout. According to Mr Stefanou, Troika officials will return to Cyprus in September.
- **France: Fiscal compact ratification may need constitutional amendment** - A constitutional revision appears unavoidable for the ratification of the fiscal compact according to *Les Echos*. The newspaper notes that within the next 15 days, French President Hollande will be informed of the ruling of the constitutional court. If the verdict indicates that the Fiscal Compact Treaty is compatible with existing French law, no changes will be necessary. If not, a lengthy procedure to amend the constitution will need to be initiated. Under this scenario – judged to be the most likely by a majority of legal experts – the government will have two choices: i) a referendum and ii) a 3/5th majority in the congress (lower + upper house). The first option is not favoured by the Elysée palace given the trauma of the 2005 referendum on Europe. The second option will require votes from the opposition. **Comment:** The 2005 referendum on the Treaty establishing a Constitution for Europe was held on 29 May 2005 to decide whether France should ratify the proposed Constitution of the European Union. The result was a victory for the "No" campaign, with 55% of voters rejecting the treaty on a turnout of 69%. This has left a mark on the mainstream political class in France, suggesting that a referendum will probably be ruled out. At this stage, it seems probable that the opposition will support a ratification of the Fiscal

Compact treaty, having argued in favour of it during the presidential election campaign.

- **Italy: Spending Review commissioner hints at potential for sub-national administrations to make further savings.** According to *Il Sole 24 Ore*, the Spending Review (SR) bill will arrive in the senate today amidst claims that Enrico Bondi, the Commissioner in charge of identifying areas of Government spending which should be rationalised, has identified some €7.2bn in excess spending by the country's municipalities, provinces and regions. According to the newspaper report, this is substantially above the cuts which the sub-national tiers of Government are currently being asked to make as part of the SR which amount to €3.2bn.

- **Slovakia – Government to discuss risk of wider deficit.** Slovak Minister of Finance Peter Kazimir (SMER-SD) sees a risk of a wider general government deficit of 5.3% of GDP compared to the approved 4.6% unless additional austerity measures are introduced. The wider deficit reflects lower tax revenue, particularly from VAT. However, the cabinet is likely to focus on getting central government expenditures under control as the year-to-date expenditure has continued to accelerate to 8% YY in June, while revenues have increased 2% YY. In other words, the annual central government deficit reached €4bn in the middle of the year (which is the same as our forecast for the whole year, while the approved deficit is at €3.7bn). The trajectory of the fiscal deficit is closer to 2010, when the total deficit reached €4.4bn which would be around -6.2% of GDP, 1% pt more than the government plan. The cabinet meets today to discuss possible steps to control the government deficit after the Minister of Finance cut the expected revenue of the central budget by €222mn (0.3% of GDP).

Comment: The risk of a wider general government deficit is beyond our baseline expectations of 4.8% of GDP. Nevertheless, the wider fiscal gap is likely to be covered by this year's bond issuance as the debt management agency ARDAL has already tapped €8bn from the market this year. Our existing forecast implies a borrowing requirement of €8.3bn (including the initial contribution to the capital of the ESM), while the wider deficit foreseen by FM Kazimir would, in the case of no further government action imply a borrowing requirement at €8.7bn this year, we estimate. All in all, given our forecast of milder economic growth at 1.6% YY in 2013 (government expects 2.6%), we think that the government is likely to call for more consolidation measures of €2bn in 2013 (beyond its planned €1.2-€1.5bn) to meet the fiscal target of below 3% of GDP. This would require almost the whole list of consolidation measures (worth €2.3bn) that PM Robert Fico introduced in June.

- **Slovakia – Confidence indicator drops in July.** The confidence indicator dropped to 1.1 standard deviations below its long-term average in July, a level last seen in October last year. The decline in overall confidence reflects all sectors (excluding the trade sector) and in particular industrial confidence, due to a lower assessment of order-books (although foreign order books improved) and expectations of lower production. The worsening industrial confidence particularly reflects negative developments in the electronics industry, while the car industry has so far remained positive. **Comment:** The lower industrial confidence supports our expectations of milder GDP growth of 1.6% YY in 2013 compared to 2.6% expected by the government and 3.1% by the central government.

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