

Economics

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Euro Area: Sovereign Debt Crisis Update

- **Germany's six-point plan for growth** — According to *Der Spiegel*, the German government's six-point plan to propel growth in the periphery countries includes the introduction of tax incentives and lower regulation for foreign investments, the creation of agencies to organise privatisation and the introduction of a German-style dual apprentice system to reduce youth unemployment. .
- **Greece** — Large majority want to stay in the euro but support for anti-austerity Syriza continues to increase. Caretaker PM said yesterday it was "*self-evident*" Greece would remain in the Eurozone, but equally "*self-evident*" that Athens must stick to the terms of the bailout. Eurogroup's Juncker says the working assumption is that Greece will stay in the Eurozone but countries need to consider all kinds of events. Tax revenues in May could fall short. The Hellenic Financial Stability Facility (HFSF) is to provide €18bn capital to four banks by Monday at the latest. Greek State may use funds from HFSF to cover financing gap in June. Citi's International Interest Rate Strategist discusses "the Grexit Gamble".
- **ECB** — Draghi signals no change in policy.
- **EFSF** — Unlikely to be used for direct lending to banks.
- **Germany** — It looks unlikely that Germany will ratify the ESM before its targeted start date of July 1, due to ongoing differences of position between government and opposition. More wage deals in Germany suggest an economy-wide wage increase of around 3.5%. Stable consumer sentiment in Germany.
- **Netherlands** — Lower House approves ESM.
- **France** — Minimum wage to increase in June. Business confidence falls in May. Moody's confirms France's Aaa sovereign debt rating and negative outlook.
- **Spain** — Spanish government could inject over €15bn into Bankia. Spain ponders merging all failed banks into a single nationalised entity. Spanish bank audit to get international scrutiny.
- **Portugal** — PM rejects Commission idea to soften deficit targets in the name of growth. Troika says no need to adjust targets for the Portuguese programme in their ongoing 4th review of the country.
- **Italy** — Second round of local elections delivers a large blow to traditional parties.
- **Ireland** — Property prices continue to fall nationally, but some signs of recovery in Dublin.
- **Emerging Markets** — We don't think it is right to assume that EM rates will be cut dramatically in the next few months

Jürgen Michels

+44-20-7986-3294

juergen.michels@citi.com

Guillaume Menuet

+44-20-7986-1314

guillaume.menuet@citi.com

Michael Saunders

+44-20-7986-3299

michael.saunders@citi.com

Tina Mortensen

+44-20-7986-3284

tina.mortensen@citi.com

Ann O'Kelly

+44-20-7986-3297

ann.okelly@citi.com

With thanks to

Carla Clifton

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- **German Six Point Plan for Growth.** According to *Der Spiegel*, the German government has proposed a six-point plan to propel growth in the periphery countries. The plan includes the introduction of tax incentives and lower regulation for foreign investments, the creation of agencies to organise privatisation and the introduction of a German style dual apprentice system to reduce youth unemployment. The blue print for the proposal (including the Treuhand style privatisation agency) is similar to the measures Germany implemented in East Germany after unification. **Comment:** Germany seems to be taking more initiative on the growth agenda, but the proposal does not suggest that Germany is willing to commit to more funding to the periphery countries.
- **Greece: Large majority of Greeks want to stay in the euro but support for anti-austerity party Syriza continues to increase.** According to the results of a poll carried out by Sky TV, Syriza obtained 30% of the voting intentions, 2ppts higher than last week. The same poll also revealed that 85% of those interviewed favour Greece's permanence in the Eurozone with only 12% preferring a return to the Drachma. The polls also show opposition to further austerity measures. The ND's share of voting intentions also increased 2ppts to 26%, PASOK gained a lower 0.5ppts since the last poll to claim 15.5% of voting intentions, with the Independent Greeks and Democratic Left securing 8% and 6.5% respectively. The communist KKE has 5.0% and the far-right Golden Dawn 4.0%. Another poll by DRC has ND as the winner of the election with a share of 29.4% of votes, just slightly ahead of Syriza with a share of 28.8%. That poll has PASOK at 13.3%, Independent Greeks at 6.6%, Democratic Left at 4.1%. The DRC poll has the KKE at 5.8% and Golden Dawn at 6.4%. **Comment:** While the outcome of the polls remains very volatile, there is a clear signal that the anti-austerity Syriza party will receive more votes on June 17 compared to the May 6 election. This suggests that the Greek public puts more weight on the message of Syriza leader Alexis Tsipras, who promises that Greece can keep the euro without further austerity measures, rather than the message sent by EU leaders that Greece can only get further support from the other euro area countries (and stay in the euro) if the country sticks to the Memorandum of Understanding which requires more austerity and structural reforms.
- **Greece's caretaker PM said yesterday at the end of the EU Summit that it was "self-evident" Greece would remain in the Eurozone, but equally "self-evident" that Athens must stick to the terms of the Troika bailout.** German Chancellor Angela Merkel stated that *"We want Greece to remain in the euro area,"* but adding *"We expect that they will stick to their commitments"*. European Council President Van Rompuy said EU leaders recognised the sacrifices made by Greeks and pledged to release structural funding to boost growth. But he noted, *"the Euro zone has shown considerable solidarity"* and called on Athens to *"continue vital reforms."* According to *Ekathimerini*, the Greek premier Pikrammenos took the opportunity to seek support for his country at the Summit by proposing to EU leaders that the European Investment Bank (EIB) set up a *"risk-sharing instrument"* to manage stalled infrastructure projects in Greece and suggested the use of project bonds to help get such works off the ground.
- **According to Eurogroup Chairman Juncker, the working assumption is that Greece will stay in the Eurozone but countries need to consider all kind of events.** Eurogroup President Jean-Claude Juncker told reporters after yesterday's EU Summit that Euro zone countries *"have to consider all kinds of events,"* an apparent allusion to the need for contingency plans for a Greek exit from the euro. He added however that *"the working assumption"* was that Greece would remain part of the currency union.

- **Greek tax revenues in May could fall short of targets.** According to news reports, May has been a particularly bad month for state revenues, as in the first 20 days of the month that included a general election, the inflow of revenues was 20% lower than in the same month last year. However, the ministry is pinning its hopes on the payment of corporate tax in the last 10 days of this month and on the revenues from the Special Property Tax of 2009 due by June 30.
- **Greek bank recapitalisation.** After a meeting with the Greek President Karolos Papoulias, the head of the Greek Central Bank Giorgos Provopoulos said yesterday that the Hellenic Financial Stability Facility (HFSF) would go ahead in providing €18bn of capital to four banks by Monday, at the latest. The HFSF had earlier received €25bn from the EFSF for bank recapitalisation and was due to pass on the funds after making an assessment of the balance sheets of the banks. **Comment:** With increasing pressure from the Bundesbank highlighting the weakness of Greek Banks, the Eurosystem probably exerted pressure to make the capital injection to the four banks, which lost access to ECB funding last week. Without recapitalisation, the ECB Governing Council might have considered vetoing the use of ELA by the Greek Central Bank for those four banks.
- **Greek State may use funds from the Hellenic Financial Stability Facility (HFSF) to cover financing gap in June.** According to *Ekathimerini*, the Greek finance ministry is examining ways to increase the state's liquidity, as it is now understood that the next tranche from the Troika bailout is unlikely to materialise before the end of June. According to press reports, the possibility has been discussed of using the funds that the Hellenic Financial Stability Facility (HFSF) has at its disposal to secure some cash for the state for as long as possible. After the disbursement of capital to banks, the HFSF has some means left which the state might be able to use it to cover its own obligations, especially for July when it is likely to fall into the red. **Comment:** Greece is trying to find ways to cope with a delay in the next Troika payment.
- **International Interest Rate Strategist on the EMU Crisis:** in light of recent developments, we discuss contagion, the dangers for the bond market in Europe whether Greece remains in or goes out, and the pivotal role that the ECB finds itself cast in. We also see a genuine glimmer of hope for the future amongst the unrelenting gloom, but for Europe, not for Greece. See "Overview: ECB = European Circuit Breaker?" in [The Grexit Gamble](#).
- **Draghi does not signal change in policy.** At a speech in Rome yesterday, ECB President Mario Draghi repeated earlier comments that the ECB's liquidity measures would take time to unfold. He highlighted that the ECB was not responsible for the survival of insolvent banks. This morning Executive Board Member Peter Praet said that "*we have to disconnect the banks from the sovereigns, but it's complicated.*" Mr. Draghi and Mr. Praet highlighted the need for governments to improve their balance sheets. **Comment:** The statement from Mr. Draghi suggests that the ECB is not ready to provide extra multi-year LTROs immediately. Furthermore, the comments from Mr. Praet highlight that the use of LTRO money to buy government securities is not a preferred outcome for the ECB. However, we expect that with increasing pressure from markets and deposit holders in periphery banks, the ECB will put in place more multi-year LTROs in coming months.

- **EFSF unlikely to be used for direct lending to banks** - EFSF CFO Christophe Frankel interviewed by Reuters repeated that he does not see direct lending to recapitalise the banks as advocated by the IMF and some member states, also indicating that there was no contact between the institution and Spain over helping its banks. He concluded that the EFSF/ESM stood ready to tap any of the tools available as soon as a country put in a request. Note that candidates to head the ESM job need to be submitted by the end of May and a decision will be likely be taken by Heads of States and Governments at the 28-29 EU Summit.
- **Germany – the path to ratification:** Yesterday, the German government coalition parties (CDU/CSU and FDP) met with leaders of the opposition parties (SPD, Greens and Left Party) to discuss the process to approve the ESM and the Fiscal Compact. The target remains to combine both votes and there will be further talks between all party leaders taking place on June 13. The opposition parties highlight that they want to see more measures by the German government to support a European growth agenda and to press for the introduction of a financial transaction tax. While there was broad consensus against uncapped common issuance of bonds in Europe, the SPD and the Greens are pushing for measures to institute pooling the debt of all euro-area countries exceeding 60% of GDP and to put these countries under programmes to run down the debt over time. **Comment:** With ongoing different positions between the government and the opposition it looks unlikely that Germany will ratify the ESM before July 1, the targeted start of ESM.
- **More wage deals in Germany.** Yesterday, employers and the trade union IG BCE agreed on a wage increase of 4.5% over a 19-month period for around 500K employees in the chemicals industry. The agreement also includes the introduction of more flexible and shorter workweeks for older employees to smooth the move into retirement. Furthermore, yesterday the trade union and the employers in the metal industry in North Rhine Westphalia (NRW) agreed – as expected – to adopt the 4.3% wage increase negotiated for the metal industry in the region of Baden-Württemberg. **Comment:** The chemicals industry deal is widely in line with the other agreements this year. This suggests an economy-wide wage increase in a range around 3 1/2% in 2012, which is likely to support private consumption.
- **Stable Consumer Sentiment in Germany.** GfK consumer sentiment edged down lightly from 5.8 in April to 5.7 in May and GfK projects an unchanged reading for June.
- **Dutch Lower House Approves ESM.** Yesterday, the Dutch Parliament approved the ESM by a majority of 100 out of the 150 MPs. To ratify the ESM, so far done only by France and Portugal, the Senate (upper house) has to approve the treaty as well. Note that there will be also a hearing by the constitutional court of a legal case brought by PVV leader Geert Wilders challenging the approval of the ESM before Dutch general election scheduled for September 12.
- **French minimum wage to increase in June** - French labour minister Michel Sapin rejected a sizeable hike in the minimum wage according to *Les Echos*, but a modest bonus of around 1% could be announced in June, for the first time in six years. President François Hollande had made suggestions during his campaign that the minimum wage would be revalued beyond the standard formula this year. He had also suggested during the campaign that a new formula could be introduced that would add a growth component to the standard formula, adding up to half of the previous year's GDP growth if activity grows above a certain threshold. Some of the more vocal trade unions such as FO are

arguing in favour of a hike worth 21.8% in the net minimum wage from the current level of 1,100 per month. **Comment:** at a time when France must make specific efforts with respect to its competitiveness and the unemployment situation is deteriorating (many firms were reported to have put on ice plans to reduce staffing levels ahead of the presidential elections), a hike in the minimum wage could make the situation even more precarious for SMEs. The government plans to hold a social summit before the middle of July in order to discuss employment and competitiveness.

- **French business confidence fell in May** - The main business climate indicator summarising the performance of four sectors recorded a 4-point drop to 92 in April, marking a three-month low. The largest falls worth 7 points affected the retail and wholesale trade sectors. Within the industrial sector, order books declined sizeably, recording their largest monthly decline since December 2011. At -0.6 standard deviation, industrial order books are judged to be the weakest since January 2012. This deteriorating situation was confirmed by a fresh decline in the flash manufacturing PMI, which recorded a 3-point decline (equalling the Oct-08 drop) to 44.4. **Comment:** These numbers suggest that French GDP growth will probably be negative in the second quarter and that unless the Greek situation can be resolved quickly, a mild double-dip recession is likely during the second half.
- **Moody's on France** - Moody's confirmed France's Aaa sovereign debt rating and the negative outlook, highlighting three areas of weakness: i) the uncertainty over the euro area's prospects for institutional reform of its fiscal and economic framework and over the resources that will be made available to deal with the crisis, ii) ongoing deterioration in France's government debt metrics, which are now among the weakest of France's Aaa peers and iii) the significant risk attached to the government's medium-term ability to implement consolidation targets and achieve a stabilisation and reversal in its public debt trajectory. Moody's noted that while the new President's medium-term fiscal consolidation and economic growth objectives are quite similar to those of former President Sarkozy, the *"path to a robust economic recovery is not yet clear and remains an uncertain variable in France's debt equation"*. The ratings agency concluded that *"during the second half of the year, and in particular after upcoming general elections in June, Moody's expects to get a clearer picture of the actual government program to be adopted and the risks to achieving policy targets stemming from ongoing challenges in the euro area"*. **Comment:** we continue to believe that Moody's will likely downgrade France's sovereign rating by one notch to Aa1 in the autumn, given an adverse combination of lower growth and a larger use of European rescue facilities to mitigate the Euro area sovereign debt crisis.
- **Spanish government could inject over €15bn into Bankia** - Reuters is quoting financial sector sources suggesting that a new restructuring plan will be presented on Friday requiring the Spanish government to inject over €15bn into the nationalised lender. This would amount to another upward revision of the recent estimate from Spanish finance minister Luis de Guindos who told a congressional committee that the state would have to put at least €9bn in Bankia. This latest capital injection would come on top of the €4.5bn in state loans that the government converted into equity in Bankia's parent company BFA as part of the state takeover, giving the government a majority stake in the lender. Last Wednesday, the government had announced that it would provide any capital outlined in the new management's recapitalisation plan through the state-backed restructuring fund, the FROB.

■ **Spain is pondering merging all the failed banks into a single nationalised entity**

- Reuters ran another story on Spanish banks, quoting another senior Economy Ministry source suggesting the government could combine all other state-rescued banks into a single entity if no attractive offers were to be found in the auction process for failed lenders scheduled in June. On Wednesday, Spanish Finance Minister Luis de Guindos had remarked that the nationalisation of Bankia had given the government *"new options in terms of actions and combinations"*.

- **Spanish bank audit to get international scrutiny** - A government source said the European Central Bank and International Monetary Fund would oversee an external audit aimed at easing concerns over the health of the banking sector, according to Reuters. The source noted that the full details were yet to be decided. **Comment:** If accurate, this involvement could be a step in the right direction, helping to tackle the significant amount of distrust placed by investors on figures provided by the Bank of Spain and the Treasury. However, this is a high-risk strategy for the IMF and the ECB as, if the figures turn out to be too optimistic, it hurts their credibility.

- **Portugal's PM rejects Commission idea to soften deficit targets in the name of growth.** In a statement given yesterday after the Summit of EU leaders in Brussels, the Portuguese PM argued that introducing greater flexibility with regard to the deficit reduction targets built into the Fiscal Compact could harm those countries which like Portugal and Ireland tend to be penalised the most by the markets whenever news of a softening of the fiscal targets emerge. In his view, allowing Portugal to defer by one year the reduction of the deficit to 3% of GDP, which is currently planned for 2014, could have damaging consequences from the viewpoint of how the markets price Portuguese debt. Moreover, in his view, the Fiscal Compact is not *"stupid"* and already has enough provisions to allow for exceptional circumstances to be taken into account.

- **Portugal: Troika says that there is no need to adjust the targets for the Portuguese programme in their ongoing 4th review of the country.** According to the *Jornal de Negocios*, the Troika team currently in Lisbon to assess the country's progress against the targets under the 4th review of the assistance programme, said in meetings with the country's main parliamentary groups yesterday that they believe that implementation is going well and that it is too early to say whether the recent fall in tax revenues will put the deficit reduction targets at risk. **Comment:** If the Troika assess Portugal's progress against the reforms programme as on track, it will pave the way for the IMF to release €1.6bn and the EU a further €2.4bn in assistance by end July.

- **Italy: The results of the second round of local elections in Italy delivered a large blow to the country's traditional parties.** The results of the second round of local elections in Italy showed crumbling support for the centre-right alliance that was led by Berlusconi and gave unprecedented success to a protest group called Five Stars, led by comedian Beppe Grillo. All the big parties in Italy are currently stained by major corruption scandals and the separatist Northern League - a key ally of Berlusconi - has been impacted by an anti-corruption investigation. An opinion poll on Tuesday for the general election showed the protest group led by Grillo had pushed Berlusconi's once dominant PDL party into third place for the first time since it was formed in 2008. According to various press reports, and as a result of the rapidly eroding support for the traditional parties, Italy's main political parties are scrambling to find new, more saleable, identities before elections take place next year. However, this could add pressure on Mr Monti as the leaders of the country's largest parties try to distance themselves from the PM's austerity policies in an attempt to regain popularity.

■ **Italy's reforms going in the right direction but may need to do more.**

According to an unseen report quoted by the newspaper *La Stampa*, the European Commission will tell Italy in a forthcoming assessment of the country's Stability Programme for 2012-2016, that the Government's structural reforms and deficit reduction plans are headed in the right direction but that more may have to be done.

- **Ireland: Property prices continue to fall nationally, but some signs of recovery in Dublin.** After residential property prices remained unchanged on the month in March, prices fell again in April, according to data released yesterday. Residential property prices fell by 1.1% month on month in April: it gives some idea of the pace of decline seen in recent years that – apart from the unchanged prices seen in March – the 1.1% fall in April is the smallest monthly fall since April a year ago. In Dublin, property prices rose 0.5% month on month, the second consecutive monthly rise (+0.7% MM in March) – two consecutive monthly rises have not been seen in Dublin since Jan-Feb 2007. On an annual basis, prices continued lower, edging down to -16.4% year on year in April, compared to 16.3% YY in March. Over the whole country, residential property prices are now down 50% from their peak in 2007, with prices in Dublin down 57%. Prices for apartments in Dublin are now down 60% from the peak, which perhaps explains why Dublin apartments have seen price rises of over 2% month on month in both March and April.

- **Emerging Markets:** Against a background of very high risk premia, yields in EM have shifted sharply down since the start of April, and rate cuts are now being priced into a number of markets. The question is: will policymakers actually do what the markets think they'll do, and cut rates? There are a number of elements to the argument that EM policymakers will ease policy. Above all is the idea that the Eurozone crisis could produce Lehman-like outcomes for the global economy that would require aggressive loosening by policymakers almost everywhere. And even without considering tail-risks, there are other factors pushing inflation pressures down. The most obvious of these is the downside risk to global growth in the wake of the April data from China; and to a lesser extent, weakening economic surprises from the US. Falling commodity prices also point to lower inflation expectations. All this considered, though, we *don't* think it is right to assume that EM rates will be cut dramatically in the next few months: the idea that EM rates will be slashed across the board is not one we subscribe to. For details, see [Emerging Markets Macro and Strategy Outlook - Who can cut rates?](#)

Appendix A-1

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