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Europe

Euro Area: Sovereign Debt Crisis Update

German Parliament to vote on amended Greek package today

- **Euro Area** — ECB's Draghi expects economic recovery in 2H 2013, repeats that ECB will do *"whatever it takes"* to stabilize the monetary union, asks governments to take further action. Yesterday; EU Commission surveys showed a surprise gain in the headline measure of economic confidence.
- **Greek debt buyback** — Press reports yesterday suggested that Greek banks may not be willing to take part in the debt buyback offer, claiming significant losses if they do so. But IMF says buyback success is necessary for the payout of the next bailout tranche, of which banks will be major beneficiaries, as it includes €23bn for bank recapitalisation.
- **Greek buyback likely to get German parliamentary approval today, but Left Party to challenge in Constitutional Court** — The German lower house votes on the amended Greek bailout package today. As opposition SPD and Greens have signalled support, a large majority in favour is likely. However, the Left party announced legal action at the German Constitutional Court, claiming that the transfer of central bank profits from the SMP and also the reduction of interest payments are not covered by existing law.
- **Dutch Parliament to rule on Greek package next week,** after the cancellation of a finance committee meeting on Greece yesterday.
- **Greek tax system** — According to *Ekathimerini*, the Greek government has to pass a draft bill overhauling the tax system as part of the conditions set by the Eurogroup for the release of the next tranche of bailout money.
- **Spain** — EU should be ready to provide financial assistance to Spain says OECD chief Gurria, stressing the need *"to have the bazooka ready, loaded, and with the finger on the trigger. That doesn't mean it has to be used"*. Latest OECD report on Spain says recovery will be slow, noting that "*the prospect of an immediate recovery remains remote as deleveraging of the private sector still has a long way to go while the feedback loop between government finances and the banking sector remains strong*". Spanish HICP inflation unexpectedly dropped to 3.0% YY in November from 3.5% YY in October.
- **France** — BdF Governor criticises Moody's downgrade of France, describes the economy as still resilient. French court suspends State's decision to cap natural gas tariff increases while government begins six-month debate about energy policy.
- **Ireland** — 3Q12 sees falls in unemployment, in employment and in the labour force.
- **UK** — Latest on Funding for Lending Scheme (FLS) and on CBI retail Survey.

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- **Draghi expects economic recovery in 2H 2013.** In an interview with French radio *Europe 1* ECB President Mario Draghi said that the euro area was not yet out of crisis, adding that a recovery in the economy would only happen in 2H 2013. Mr. Draghi repeated that the ECB would do *"whatever it takes"* to stabilize the monetary union. While he welcomed previous action taken by euro area governments he asked for further action including short-term budgetary consolidation, which in his view is inevitable. He also said that euro area governments must learn to share sovereignty and asked them to push ahead with banking union. According to Mr. Draghi, the SSM, as part of the banking union, should apply to all banks**. Comment:** Mr. Draghi made clear that the ECB is willing to take further action, but also stressed that it is now up to governments to act. The comments on the economic recovery suggest that the ECB staff is likely to revise down its growth projections, which will be published next week.

- **Euro area November sentiment data shows first uptick since February** - The European Commission surveys showed a surprise gain in the headline measure of economic confidence across the euro area, with the composite reading rising by 1.4 points to 85.7 from 84.3 (revised down from 84.5) in October. This was the first uptick since February. We had been expecting another fall to 83.8, while the consensus had been looking for a stable outcome compared to October. Most of the rebound stemmed from a better print in industrial confidence (+3.3pts to -15.1, a two-month high) and retail trade (+2.5pts to -14.9). Construction and household confidence fell (2.6pts to -35.5, and by 1.2pts top -26.9, respectively), while services confidence was largely unchanged, up 0.2pt to -11.9. The EU press release noted that the industrial investment survey, however, hints at stagnating real investment in 2013, casting some doubts on these first signals of a recovery. Our composite measure of demand expectations rebounded to a four-month high at -1.56std, with employment expectations also gaining marginally (+0.04std to -0.26std), while price expectations fell to their lowest level in four months (-0.59std). **Comment**: A better than expected economic sentiment survey in November matches the very slight improvement seen in the flash composite PMI in the previous week. However, the rebound is not particularly broad-based, relying on the industrial sector which could have benefited from better global prospects. Domestically (households, services and construction), the picture across the euro area remains challenging. We argue that there is not enough in this report to change the ECB's view of the risks to economic activity, which are likely to remain skewed to the downside at next week's meeting. We continue to expect more cuts from the ECB, with the next move a 25bp reduction in rates in Q1 2013E.

- **Greek debt buyback**. Press reports yesterday suggested that Greek banks may not be willing to take part in the debt buyback offer, claiming that they will incur significant losses if they do so. Offered prices will vary for each of the 20 eligible bonds (for a total of €62bn), according to a Greek official reported by Reuters. The Eurogroup decided on Monday night the offer price for the buyback should not exceed the closing prices as of Friday 23 November – ranging between 25.15 to 34.41 cents in the euro, according to Reuters. Some Greek bank officials reportedly said banks are holding their Greek bonds at a book value below Friday 23 Nov levels (22-25 cents in the euro), but said foregone interest for the next ten years would amount to €3-5bn, possibly leaving them with an overall shortfall. The troika report – a new version of which was leaked yesterday – indicated Greek banks hold €15bn of Greek bonds, while another €8bn are held by Greek pension funds. The report also stated the buyback will target not only the PSI bonds, but also the holdouts (€4bn still outstanding) from the debt restructuring in March.

- **IMF and IIF on Greek buyback:** The IMF says the success of the buyback is necessary for the next bailout tranche – which will include €23bn for bank recapitalisation – to be paid out from their side. The IIF (Institute of International Finance) – dealing on behalf of foreign private bondholders in the buyback offer – said the terms of the buyback should be purely voluntary. **Comment**: although domestic banks may be unwilling to incur additional losses on their already-restructured Greek bond portfolio, the failure of the buyback scheme would further delay the release of the next tranche of bailout money – of which Greek banks are the main beneficiaries. This reduces the credibility of their threat of not participating in the buyback.

- **German parliament likely to approve Greek package today...** Today the German Bundestag – lower house – votes on the amended Greek bailout package. Following an address by Finance Minister Wolfgang Schäuble to parliament at 8:00 London Time and a debate, the MPs are likely to vote between 10 and 11 London Time on the amended package. In a TV interview yesterday evening, Finance Minister Schäuble said that a *"few hundred million"* to support Greece would be well spent to prevent a break-up of the euro, which would lead to a global economic crisis. According to finance ministry calculations, the reduction in interest rates for Greece and the transfer of the SMP related share of the Bundesbank profits to Greece will reduce German central bank revenues by €730 million in 2013. As opposition SPD and Greens have signalled support for the new version of the Greek programme, despite criticism that potential costs were not transparent, there will be likely be a large majority for the package. If this turns out to be the case, then the German Finance Minister is allowed to vote in favour of the programme in the upcoming Eurogroup decision on December 13. **Comment**: While many MPs of the government and opposition parties are not happy with the amendments to the Greek package, they are likely to vote in favour of the deal.

- **…however, German Left party invokes Constitutional Court:** Yesterday the Left party announced that it was taking legal action at the German Constitutional Court against the aid to Greece. According to Gregor Gysy – head of the parliamentary group – the transfer of central bank profits stemming from the SMP and also the reduction of interest payments are not covered by the existing law.

- **Decision in Dutch Parliament on Greek package next week.** After the cancellation of a finance committee meeting on Greece yesterday, there will be no decision on the Greek package in the Dutch parliament today, as earlier envisaged. The decision is now re-scheduled for next week.

- **Overhaul of Greek tax system:** According to *Ekathimerini*, the Greek government has to pass a draft bill overhauling the tax system, including scrapping tax breaks for families with children, as part of the conditions set by the Eurogroup to be met before the release of the next tranche of bailout money. The newspaper says a meeting with junior coalition parties PASOK and Democratic Left will take place today to reach an agreement on the draft bill.

- **EU should be ready to provide financial assistance to Spain says OECD chief** - Angel Gurria, the OECD's secretary general, told a press conference that Spain's European partners should now state clearly that financial aid would be granted if the country requested it. Mr. Gurria called on "*Spain's European partners and the international community to send this unequivocal message",* stressing the need *"to have the bazooka ready, loaded, and with the finger on the trigger. That doesn't mean it has to be used"*. Regarding a potential rescue of Spain, the country's economy minister Luis de Guindos also told reporters that

the key factor for the Spanish government was not so much *"concrete and specific actions*" but more the mere existence of backstops, such as the European Central Bank's OMT. **Comment**: The debate continues, internally and externally, about whether and when Spain will request financial assistance from the ESM, which remains a pre-condition for some possible support from the OMT. We argue that yield levels will probably need to increase in order to push Spain into asking for a precautionary credit line in the first quarter of 2013.

- **Spain's recovery will be slow, says OECD** - An OECD report on Spain released on Thursday noted that "*the prospect of an immediate recovery remains remote as deleveraging of the private sector still has a long way to go while the feedback loop between government finances and the banking sector remains strong*". It added that spending cuts and tax measures to reach the 2014 deficit targets and permanent budgetary steps should be spelled out, stressing that the government also needed to implement further structural reforms to boost employment, especially among the youth, and further pension reform would improve the long-term sustainability of the system. Spanish Economy Minister Luis de Guindos ruled out lowering Spanish firing costs and insisted that there are no plans for a further increase in VAT. **Comment**: The road towards recovery will be longer than that envisaged by the government, according to various international organisations. Note that while the introduction of a simpler, standardised labour market contract will likely help in the recovery phase, the intensity of private sector deleveraging makes this a distant prospect. Mr. de Guindos is conveying a clear message that the Spanish government has concluded that fiscal policy tightening is done for 2013, in order partly to limit the pro-cyclicality of the current fiscal policy stance.

- **Spain: HICP inflation unexpectedly dropped to 3.0% YY in November**, according to the flash estimate released this morning, down from 3.5% YY in October. The national measure of inflation (CPI) dropped even further to 2.9% YY. No breakdown details are yet available. We had expected the sharp increase in fuel taxes in November, after the 3pp VAT rate hike in September, to lift overall inflation; however, this has likely been offset by significant weakness elsewhere, probably driven by the sharp recession and large spare capacity in the economy. Yet, inflation at 3% represents a significant headwind to households' real disposable income and spending.

- **BdF Governor criticises Moody's downgrade of France, describes the economy as still resilient** - Banque de France governor Christian Noyer criticised Moody's downgrade of France, making specific references to a *"factual mistake"* in the rating agency's judgment of France's exposure to peripheral countries in Europe, as well as the *"serious misconception"* in its opinion that France does not have access to a national central bank to assist in the event of market disruption. Speaking in Hong Kong on Friday, Mr. Noyer went on to describe the French economy as being *"still resilient",* seeing some *"room for French household demand to grow given the high savings ratio"*, but acknowledged that the government need to *"make bigger steps to reform the labour market"*. **Comment**: The relationship between the French authorities and the rating agencies has never been the easiest, although the criticism has been relatively muted so far given the lack of movement in French government bond yields. While the French household savings ratio remains elevated (averaging 16.3% in 1H 12), there is a sizeable risk that a further increase could materialise in the coming quarters and reduce household spending, given the low level of consumer confidence.

- **French court suspends the State's gas-price cap just as government begins six-month debate about energy policy** - France's highest administrative court, the Council of State, suspended a government decision taken in October to cap natural gas tariff increases to 2%. The Court argued that evidence provided by the smaller gas providers *"cast serious doubt on the legality*" of the price cap, noting that French power regulator Commission de Regulation de l'Energie, or CRE, had cleared the way for a 6.1% increase. Its ruling tasked the ministries involved to come up with a new policy within a month, prompting the Environment and Energy Minister, Delphine Batho, to declare that the government would announce revised tariffs on December 10. The new rates will take effect at the start of 2013. One of Mr. Hollande's campaign pledges was to reduce reliance on nuclear power from 75% to 50% of the country's energy mix by 2025: in September he announced a six-month public debate on energy policy starting November 29. This debate will help shape a framework energy law in 2013 that will define how to cut France's nuclear capacity, boost renewable energy and lift energy efficiency. **Comment**: This ruling could add a decimal point to headline inflation in early 2013E, with the upside likely to be limited by suggestions in the press of overcharging in electricity tariffs. France's debate about energy policy will probably review shale gas despite the existence of a moratorium on extraction.

- **Ireland: Unemployment fell YY in 3Q12, but so did the number of those in work, in shrinking labour force.** Unemployment fell by 3,600 over the year to September 2012, a decline of 1.1%, the first fall in the number of those out of work since early 2005. The seasonally adjusted unemployment rate ticked down to 14.8% at end September, from an (upwardly revised) figure of 14.9% at end 2Q12. However, the fall in unemployment cannot mask the fact that the long-term unemployed (over a year) now account for 59.5% of all those out of work. The number of people in work also fell, down 0.2% YY in 3Q, with the fall in the workforce likely due to people leaving the country, retiring or going back to education. By comparison, employment fell by 1.3% in 2Q12 and fell 2.1% YY in 3Q11.

- **UK – Funding for Lending Scheme (FLS).** The latest monetary data suggest that the FLS continues to have only a very limited effect on credit availability, especially for small firms. For more, *see* ***BoE Data Suggest FLS Impact Remains Limited.***

- **UK: In the CBI retail survey**, the net balance of retailers who report sales up YoY rose to +33% in November from +30% in October, and the latest figure is the best since August. However, in our view, one should not get too carried away about with the theme of 'recovery in the high street'. For more, see ***CBI Report Better Retail Sales, Squeeze On Prices***

Appendix A-1

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