

Economics

27 October 2011 | 6 pages

Euro Area: Sovereign Debt Crisis Update

- **Euro Summit Outcome** – After lengthy negotiations, the euro area Heads of State and Government (HoSG) agreed at the Summit on a **second Greek rescue package**, including a 50% PSI haircut, and a larger contribution from the public sector, in total amounting to €130bn. The new funding is conditional on the Commission having more control in implementing the reforms.
- There was also an agreement, as widely expected, to set up a **programme to recapitalise European banks** in order to meet a 9% Core Tier 1 capital ratio. According to the EBA the total need for bank recapitalisation is €106.5bn. In addition to that, the EU HoSG agreed to provide sovereign guarantees for bank term funding in a coordinated manner at the EU level.
- **Regarding the EFSF**, the HoSG agreed to proceed with the two previously discussed options to increase the leverage of the EFSF: 1) an insurance scheme for new debt and 2) the creation of a Special Purpose Vehicle (SPV), which would be supported by funding from third parties, including sovereign wealth funds and private investors. The aim is to have a leverage of 4 to 5 times and a total leverage amount of at least €1 trillion. There were no references to the requested support from the ECB in the Summit statement, but EU Commission President Herman Van Rompuy welcomed remarks by the new ECB President Mario Draghi suggesting that the ECB would continue to support markets in case stabilization is not achieved.
- **Comment:** Although the package covers many areas in dealing with the sovereign debt crisis, several details have been left out of the solution which could present substantial hurdles going forward. In our view, the measures regarding Greece are not likely to bring the country back onto a sustainable fiscal path. Hence, the pressure for additional haircuts will persist, creating tension in markets. Overall, **the package is a step in the right direction, but we do not expect it to calm markets permanently**. Hence, we think that the ECB will probably have to take a larger role at a later stage. With his comments, Mr. Draghi appears to have left the door open for future ECB bond purchases. For details, see [Euro Summit Part 2 – Comprehensive Package Leaves Many Open Questions](#).
- **Greece** – our Chief Economist Willem Buiter's latest piece is called [Why we should not panic if deep Greek sovereign debt restructuring triggers CDS](#).
- **Ireland** – The polls are open today from 7am to 10pm to elect the Irish President, a largely ceremonial role. There are seven candidates, to be elected under the single transferable vote system, with approximately 3.2 million people eligible to vote. The vote count begins tomorrow morning, Friday, with the result possibly not available until Saturday. Two referenda are also being held today, one on judges' pay and the other on Parliamentary enquiries, and also a by-election to fill the seat left vacant by the death of former Minister of Finance Brian Lenihan.

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- In our [*Global Economic Outlook and Strategy, October 2011*](#), released yesterday, our **2011-13 growth forecasts are little changed this month**, a notable contrast to the heavy forecast downgrades of recent months. Overall, we have edged up our 2011 forecast for global growth (at current exchange rates) by 0.1%, while cutting 2012-13 forecasts by 0.1%. Our forecast implies that global GDP growth will slow markedly, from 4.2% in 2010 to 3.1% in 2011 and 2.8% in 2012, while avoiding a global recession.
- **Many advanced economies continue to face sizeable headwinds** from high private savings rates as companies and households seek to deleverage, plus poor bank credit availability – and in many cases fiscal restraint as well. **We continue to expect the Euro Area to slip into renewed recession**, with heavy restructuring of Greek government debt likely to be followed, in our view, by restructuring also in Portugal and Ireland over the next year or two.
- We still expect the **ECB to cut rates by 50bp by yearend**, most likely at the December meeting. The **UK MPC is likely to expand QE further** in coming months, while we continue to expect the Fed to keep policy rates low for an extended period.
- **We expect further sovereign ratings downgrades in Europe**, including downgrades (by at least one major ratings agency) to Portugal and Greece in the next 3-6 months, with a high risk that France is put on “Negative Outlook” by mid-2012.

Appendix A-1

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