

Economics

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Euro Area: Sovereign Debt Crisis Update

- **EFSF chairman Klaus Regling said that he will discuss the new EFSF instruments with investors – He meets Chinese officials today in Beijing.** He said that investors could be assured of the solid AAA rating of the EFSF. According to Mr. Regling, the EFSF would be able to offer China a good product to invest its surpluses. And he added that there would be no special deal with China, stating that Chinese officials have not asked that Europe accepts China as a market economy as a condition for China investing in the leveraged EFSF products. However, in an interview with the FT, Li Daokui from the Chinese Central Bank said that the Chinese government might request the Europeans not to criticize Chinese economic policy as a condition for EFSF investments. In addition Mr. Li said that China would make investment in EFSF products dependent on the involvement of other non-European countries. Comment: **The talks in Beijing are the first test of whether international investors are willing to accept the proposed guarantees of the EFSF as part of the leveraged products.** While we expect support from sovereign wealth funds for the EFSF operations, we doubt that there will be a very strong commitment for such investments. And regarding the AAA rating, we do not expect that this is at risk in the near term. However, with some rating vulnerabilities of the AAA-rating guarantors on the horizon (we expect a negative outlook for the French AAA rating next year), this might change over time. Furthermore, it is not clear if the EFSF backed SPV will get an AAA rating.
- **European Commissioner for Economic and Financial Affairs Olli Rehn** confirmed on Thursday that the Commission will shortly present a green paper on “**stability bonds**” and their alternatives in order to start the debate on the topic, without making any legislative proposals on the issue. Comment: whatever name Eurobonds will be given eventually, these instruments are unlikely to be used in the near future, given the problem envisaged in many northern member states about the socialisation of risk and questions about the required conditionality. We argue that their adoption probably remains some years away, requiring countries to reduce their budget deficit to at least 3% of GDP as a pre-condition, alongside debt-brake rules embedded in their constitutions.
- **Austrian central bank governor Ewald Nowotny** voiced what many investors are thinking, wondering how long the market would have to wait for the details of the measures and perhaps more importantly for the implementation of these agreements. He warned that “*speed is very important*”. Comment: European policy makers have a lot on their plate for the next few weeks and months in order to provide details about the various measures announced on Thursday – and enact them.
- **Greek Finance minister Evangelos Venizelos** indicated that the country would save €4.5bn or 2.2% of GDP every year from the debt write-down plan. He noted that the Greek government did not intend to introduce further fiscal measures for 2011 and 2012 as lawmakers prepare to vote the 2012 budget.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Jürgen Michels

+44-20-7986-3294

juergen.michels@citi.com

Guillaume Menuet

+44-20-7986-1314

guillaume.menuet@citi.com

Ann O'Kelly

+44-20-7986-3297

ann.okelly@citi.com

With thanks to

Alessandra Gaia

- **Greek Haircut** – the head of Greece's debt agency Petros Christodoulou noted that talks with private creditors about a voluntary 50% haircut as part of the new PSI deal will last two to three weeks and that various options will be proposed to investors, one of which could see private bondholders being offered 70% in new bonds and 30% in cash.
- **Bundesbank President Jens Weidmann** welcomed the outcome of the Euro summit on Thursday. He argued that *"the crisis decisions should ensure that the risks for monetary policy can be reduced markedly and the separation between monetary and fiscal policy will become clearer again"*. He also expressed relief that the EFSF was not allowed to leverage itself through the ECB. Finally, he warned that agreeing to leverage the rescue fund was not without problems since it opened the door to *"higher risks of losses, and to increased socialisation of risk."* Comment: His stance contrasts with various reports that incoming ECB President Mario Draghi had indicated that the ECB would continue to support countries in difficulty, although he qualified the SMP as temporary. We expect Draghi to follow the careful path laid out by outgoing President Trichet that the SMP is designed to alleviate problems caused by an impeded transmission mechanism. However, if the EFSF paper were to fail to attract sufficient investor interest, there is very little doubt in our mind that the ECB would quickly intervene on the grounds of safeguarding financial stability, given the risks that a disorderly situation would exacerbate the downside risks to its medium objective of price stability. We suspect that the forthcoming SPV used to leverage the EFSF guarantees would be eligible as collateral at the ECB.
- **Irish Finance Minister Michael Noonan was keen to distance himself from the Greek situation**, arguing that it is not in Dublin's interests to impose a haircut on its sovereign bond holders. He remarked that the EU summit deal secured the future of the euro and ended the threat of global recession, while stressing Ireland has so far passed each of its EU/IMF bailout reviews and returned the economy to growth this year. He also hoped that incoming ECB president Mario Draghi's signal that the bank stood ready to keep buying the bonds of troubled euro zone countries would amount to a policy change.
- **Belgium's central bank governor Luc Coene** spoke to Belgian daily *Het Laatste Nieuws* on Thursday, warning that while the debt crisis of 2011 is not as bad as the credit crunch of 2008-2009, he was expecting economic growth to decline very slightly and the subsequent recovery to take longer to materialise as governments no longer have the resources to kick-start economies. He also acknowledged that **Belgium's weak spot was its government debt**, hoping that the prompt formation of a new government would reduce the number of market concerns.
- **France has reduced its GDP growth forecast for 2012 to 1.0%** from 1.75%, acknowledging the negative impact of the financial crisis. President Sarkozy, speaking on French TV after the summit, announced that between €6-8bn would need to be found over the next 10 days. The Treasury estimates that around €4bn of savings must be found for every half point of GDP growth lost. The preferred options currently under discussion would be: i) an exceptional tax on the largest firms until the budget deficit is reduced to 3% of GDP, a hike in the reduced 5.5% VAT rates (applied among others to restaurants, food, residential construction work) and a reduction of the 2.8% planned increase in social security spending for 2012. Unemployment hit an 11-year high on Wednesday, and consumer confidence remains close to all-time lows. Comment: France's GDP growth forecast is now in line with that of Germany and the Netherlands. This is a welcome move that goes some way towards addressing the issue of

credibility which had been surrounding fiscal policy. While there are many options on the table to earmark some savings, it is unlikely that a generalised VAT rate hike will be implemented ahead of the presidential elections. We argue that more savings will probably need to be found in early 2012, in addition to those under review, if as we expect, growth dynamics were to deteriorate throughout the fourth quarter. We forecast paltry GDP growth of 0.1% in 2012.

- **Eurozone sentiment surveys** for October showed that the headline measure of confidence had eased only slightly to 94.8 from 95.0 in September. Private sector credit numbers for September confirmed a further deceleration to 2.0% in Q3 from 2.4% in Q4. Comment: the tightening of lending standards looks set to continue in the months and quarters ahead, despite the government's best efforts to envisage a solution to unfreeze long-term funding for banks in order to limit deleveraging. Forward-looking indicators for hiring and prices continued to ease at the start of the fourth quarter, suggesting that the economy will probably experience mild contraction in the quarters ahead. The reduction in price pressures should make the ECB more comfortable about cutting interest rates. **We look for a 50bp rate cut in the refinancing rate to 1% in December.**

Appendix A-1

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