

Economics

25 June 2012 | 40 pages

Global Economics View

What's Next for Spain and Italy?

- After Spain's still-to-be-finalised euro area bank bail-out, we expect it to be in a troika programme with sovereign conditionality, quite possibly soon.
- After Spain's bank bail-out, Cyprus or Italy will be the next euro area countries to apply for a troika bail-out, in our view
- We believe the need for a sovereign bail-out for Spain and Italy will be driven by a lack of affordable access to market funding and a lack of credibility of the respective sovereigns' commitments to engage in sufficient fiscal and structural reform.
- These sovereign bail-outs are highly likely to involve fiscal and structural reform conditionality for the sovereign. They are also likely to aim to retain partial market access for Italy and Spain, relying on a mix of ECB-subsidised funding and financial repression to ensure take-up of the residual government funding needs by domestic banks and other financial institutions.
- Spain or Italy may be able to access one of the precautionary EFSF/ESM programmes, but those programmes would still likely come with sovereign conditionality. Primary or secondary market purchases by EFSF/ESM could be part of either a precautionary or a normal EFSF/ESM programme. Any programme would require a request from Spain or Italy and unanimous non-objection by the Eurogroup.
- At present, we consider it unlikely that Italy or Spain meet the conditions for a precautionary IMF programme, but the IMF could contribute to the funding of a 'normal' troika programme.
- Even a partial programme for Italy and Spain is likely to highlight the inadequate size of the euro area rescue facilities. In time, we expect these to be increased and to be provided with access to a reliable funding backstop, e.g. by making the ESM an eligible counterparty to the Eurosystem, probably with a joint and several or pro rata guarantee from the euro area member states.
- At present, we do not expect the ECB to restart its SMP secondary market purchases of euro area sovereign debt. The IMF cannot contribute to a bond purchase programme.

Willem Buiter

+44-20-7986-5944

willem.buiter@citi.com

Ebrahim Rahbari

+44-20-7986-6522

ebrahim.rahbari@citi.com

With thanks to Deimante Kupciuniene, Guillaume Menuet, Juergen Michels, Antonio Montilla, and Michael Saunders

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

Citi Investment Research & Analysis is a division of Citigroup Global Markets Inc. (the "Firm"), which does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

What's Next for Spain and Italy?

Introduction

Spain has joined the list of euro area member states to request financial support from the euro area (EA) funding facilities – but so far only for its banks.

We consider it likely that Spain will require a troika programme with sovereign conditionality, too, and possibly quite soon.

Cyprus and Italy are also likely to request financial assistance.

The drivers behind sovereign troika programmes in Italy and Spain are lack of access to affordable market funding and a credibility deficit on the part of their respective governments.

The nature of the programmes for Spain and Italy are not clear, but they are likely to involve fiscal and structural conditionality on the sovereign and funding from the EFSF/ESM and IMF.

Predictably and widely predicted, Spain has joined the list of euro area member states to request financial support from the euro area (EA) funding facilities – probably from the EFSF initially and, when it becomes operational in July or August 2012, the ESM. There are two differences from the earlier programmes for Greece, Ireland and Portugal. First, there is no financial contribution from the IMF, although the expertise of the IMF will be called upon to implement and monitor the programme. Second, the programme will, at least for the time being, focus exclusively on recapitalising the Spanish banking sector, with conditionality likely to be imposed on the banks but probably not on the sovereign. The EFSF/ESM funds will, however, reach the banks via the Spanish sovereign, likely through the FROB, the Spanish Fund for Orderly Bank Restructuring, and will therefore add to the Spanish sovereign debt.

In what follows we argue that Spain is likely to require, possibly quite soon, another programme, this time with sovereign conditionality. Following Spain's formal request for a bank bail-out by its EA partners, we argue that Cyprus and Italy are likely to be next to request a financial support programme.¹ For reasons of space, we focus on the more systemically important case of the likely request by Italy for financial support. We see an Italian programme as likely this year, but it could be deferred until 2013.

In both Spain and Italy, the drivers of the need for a troika programme with sovereign conditionality will be a lack of access to affordable market funding, coupled with a credibility deficit on the part of the respective governments as regards their ability and willingness to undertake the necessary fiscal austerity and structural reform.

The nature of the programmes for the Spanish or Italian sovereigns is unclear, and they need not get exactly the same kind of programme. In particular, there is intense debate about whether Italy and Spain could possibly get a 'precautionary programme' (rather than a 'normal' programme) from the EFSF and whether the EFSF (and later the ESM) could buy Spanish and Italian bonds in the secondary or maybe the primary market. The likely features of such programmes or actions are widely misinterpreted. In our view, a Spanish and Italian programme is very likely to involve fiscal and structural reform conditionality on the sovereign – in fact, such conditionality is necessary to address the credibility deficit of the sovereigns. But some (and potentially substantial) conditionality would be imposed even under precautionary programmes. Conversely, primary and secondary market purchases by the EFSF/ESM can be part of a 'normal' troika programme. The nature and process of applying the conditionality can differ between the various alternatives, but in our view the (rather vague and untested) eligibility criteria for accessing precautionary programmes would likely need to be stretched substantially to justify using these facilities in the case of Italy or Spain.

¹ Spain formally applied for assistance on June 25, 2012, after it had indicated its intent to do so over the June 9-10 weekend (<http://www.mineco.gob.es/portal/site/mineco/menuitem.ac30f9268750bd56a0b0240e026041a0/?vgnextoid=751eacc6eb228310VgnVCM1000001d04140aRCRD&vgnextchannel=864e154527515310VgnVCM1000001d04140aRCRD>). A formal Memorandum of Understanding is meant to be agreed by July 9, 2012. For Cyprus and Italy, see also [Cyprus — Next in Line for a Bailout?](#) and [Focus on Italy](#)

If and when Spain or Italy enter a programme, they are likely to continue to fund themselves partially in the market, aided by financial repression of banks by national authorities to buy domestic government debt, and subsidized Eurosystem funding – but larger rescue facilities will be necessary in time.

We think the first Spanish programme is likely to be underfunded, even if only the likely capital needs of the Spanish banking sector are meant to be covered.

By going through the sovereign, the programme will both weaken the solvency of the sovereign and miss an opportunity to advance banking union in the euro area.

We also consider it likely that if and when Spain and Italy enter programmes with sovereign conditionality, such programmes will only partially fund the requirements of these sovereigns, with the residual to be provided through the by now well known combination of subsidized ECB funding to euro area banks and financial repression by national authorities to push banks in their jurisdiction to buy domestic sovereign debt at yields below what they would have required if the purchases had been voluntary. Even partial programmes are still likely to highlight both the inadequate size of the current rescue facilities and their own unreliable market access. In time, we therefore expect both an increase in the size of the rescue facilities and the creation of some mechanisms to ensure that the rescue facilities can themselves be funded at the speed of crises, e.g. by making the ESM an eligible counterparty to the ECB for accessing its collateralized financing facilities. This would be more acceptable to the ECB if any loans to the ESM were jointly and severally (or even just pro-rata) guaranteed by the 17 EA member state governments. Size increase and credible funding backstops for the rescue facilities would come in handy, as domestic banks may become increasingly resistant to further financial repression and may be tempted to refuse to absorb ever-larger amounts of domestic government bonds. Also, the move towards banking union may put an end to the ability of national sovereigns to use financial repression at the national level, thus necessitating moving from programmes that only partially fill sovereign funding requirements to those that take these sovereigns off the market entirely. A possible alternative under banking union would be centrally imposed but possibly still asymmetric (across countries) financial repression.

Turning back to the first Spanish programme, it is likely to be underfunded, even if only the likely capital needs of the Spanish banking sector are meant to be covered.² Its design is also seriously flawed and represents a missed opportunity to take a first step towards banking union in the EA, in our view. We expect that more money than the currently earmarked €100bn will eventually have to be found to recapitalise the Spanish banks adequately, with the additional resources coming either from the EA support facilities or from the unsecured creditors of the Spanish banks. In the meantime, the first programme provisionally announced for Spain will further weaken the Spanish sovereign's balance sheet. The recent downgrade by Moody's of the Spanish sovereign (by three notches from A3 to Baa3, that is, one notch above junk, and leaving it on review for a possible downgrade) suggests that the Spanish sovereign may soon lose the tier one (Step 1 and 2) status its bonds enjoy for use as collateral for Eurosystem operations, leading to increased valuation haircuts on Spanish bonds.³ It is also

² A statement from the Eurogroup finance ministers on June 9 gave the amount of money likely to be borrowed by the Spanish sovereign as "up to €100bn".

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/130778.pdf. It is not clear what this amount is based on, but it appears to have been informed by the recent IMF Financial Stability Assessment Programme (FSAP) report of Spain which reported that "several banks would need to increase capital buffers by about EUR 40 billion in aggregate to comply with the Basel III transition schedule (core tier 1 capital of 7 percent). Capital needs in these banks would be larger than this, as they would also include restructuring costs and reclassification of loans—for instance for lender forbearance—that may be identified in the recently launched independent valuations of assets." International Monetary Fund "IMF Says Spain's Core Financial System is Resilient, but Important Vulnerabilities Remain", Press Release No.12/212, June 8, 2012,

<http://www.imf.org/external/np/SEC/pr/2012/pr12212.htm>. Roland Berger and Oliver Wyman, two consulting firms, hired to carry out independent assessment of the asset quality of Spanish banks indicated capital needs of €51-62bn (Oliver Wyman) and €52bn (Roland Berger) under their respective adverse scenarios (assuming a post-stress core tier one capital ratio of 6%).

³ This is assuming that the ECB does not change its ratings-based internal risk assessments before, as has been reported in the media recently, see <http://in.reuters.com/article/2012/06/21/us-ecb-collateral-ratings-idINBRE85K12520120621>

The 'growth vs austerity debate' is a logical nonsense.

Banking union, a minimal fiscal Europe, a limited amount of ex-post mutualisation of public debt and a significant amount of sovereign debt and bank debt restructuring are a more likely scenario for the future of the euro area than full fiscal and political union.

possible that Spain soon loses its investment grade rating from one or more of the main rating agencies (S&P, Moody's, Fitch and DBRS).⁴

The new programmes for Italy and Spain will be designed and implemented in an era when 'growth' is supposed to have been prioritised relative to 'austerity' in the design of stabilisation and structural adjustment programmes. We argue that the 'growth vs. austerity' debate is mostly based on confused thinking and sloppy use of language.

As noted, as further troika programmes for Spain and Italy are contemplated, it will become obvious just how inadequate the size of the current sovereign liquidity facilities in the euro area are (EFSF, ESM and the European Financial Stabilisation Mechanism, EFSM). But the end-game for the twin sovereign and debt crises in the EA is not restricted to a choice between full fiscal union and the associated comprehensive mutualisation of sovereign debt, or break-up. Rather, we believe that a package of institutional developments leading to banking union, a minimal fiscal Europe falling well short of most popular notions of fiscal union, a limited amount of ex-post mutualisation of public debt and a significant amount of sovereign debt and bank debt restructuring remains a strong – and in many ways more plausible – contender.

The first Spanish programme: the wrong design and too small

Wrong design

Weakening the Spanish government's balance sheet and a missed opportunity to expedite Banking Union

The first Spanish programme:

- up to €100bn to recapitalise Spanish banks
- routed through FROB and the Spanish government's balance sheet

We argue that the right thing to do would have been to have the EFSF/ESM recapitalise banks directly, bypassing the Spanish sovereign.

The loans from the EFSF/ESM to recapitalize the Spanish banks will not be paid directly to the banks. Instead they will be paid to an agency of the Spanish sovereign, the FROB (Fund for the Orderly Restructuring of the Banking Sector) which will then recapitalize the banks. This means that the Spanish central government is responsible for the repayment of the €100bn bank recapitalisation loan, about 9.3% of Spain's 2011 GDP, bringing the official estimate of the general government gross debt-to-annual GDP ratio to about 90%. There is likely to be little or no conditionality for the general government attached to these loans, although the European Commission (EC), ECB and IMF will impose, monitor and enforce banking sector conditionality.

We argue that the right thing to do as regards the modalities of the disbursement of the EFSF/ESM loan would have been not to turn this bank recapitalisation loan into a sovereign exposure, but instead to pay it directly into the banks, bypassing the sovereign. This would have been a decisive signal that the EA is moving towards banking union – a necessary condition for the survival of the euro area. True, direct recapitalization of banks, bypassing the respective sovereign, is not currently an option for either the EFSF or the ESM. But a unanimous decision by the Eurogroup heads of state and heads of government (HoSHoGs) to allow the ESM to recapitalize banks directly could have been taken over the weekend of June 9-10, 2012. Any parliamentary ratification could have been achieved by the time the ESM is supposed to come online. This would likely have required agreeing to some other necessary ingredients of 'banking union', including having a single regulator and supervisor for systemically important euro area banks. In any case, we view the lack of agreement on a European recapitalization facility as an opportunity missed. The improvement in the

⁴ Currently DBRS has Spain's ratings at four notches above junk (AH), S&P at three (BBB+), Fitch at two (BBB) and Moody's at one (Baa3). For Moody's and DBRS, Spain's rating is currently on negative watch, and for S&P and Fitch on negative outlook.

capital position of the banks is therefore bought at the expense of a worsening of the credit risk of the sovereign. Should any future recapitalization needs for Spanish banks also be routed through the sovereign and end up on its balance sheet, the risk that the Spanish sovereign debt will have to be restructured eventually would rise further, and possibly quite sharply.

Presumably, euro area governments, in combination with the various parliaments that need to be consulted, could still (ie before the first tranches of the recapitalization programme are disbursed) change the design of the Spanish programme. In fact, such a change in design could be effected even after the first tranche had been paid out, for the remaining tranches or even retroactively. Other voices suggest that the loan to the government could be structured in a manner that would allow for explicit burden sharing by the other European governments with the Spanish one.⁵ The extended time horizon over which the recapitalisation programme would be implemented in principle allows for enough time to change particular aspects of the design, including the source of the capital for the banks.⁶ However, we harbour little hope that this design flaw will be remedied in time for the Spanish sovereign to escape from having to shoulder the full weight of the current round of banking recapitalization efforts in the near term.

Failure to use externally imposed conditionality to bridge sovereign credibility gap

The second key weakness of the first Spanish programme is that it does nothing to bridge the credibility gap of the Spanish government.

The second design error was not to impose any significant fiscal austerity and structural reform conditionality on the Spanish sovereign. Spain needs this, in our view, because, ever since the previous Spanish government belatedly recognized the need for fiscal austerity and structural reform, the implementation of the Spanish fiscal austerity and structural reform plans, and the communication with the troika, the other EA member state governments, the markets and the citizens of Spain and the EA by both the previous and the incumbent government have been poor. As a result, the Spanish authorities have very little credibility left and need all the external support, including troika or EA conditionality, they can get. The sources of the credibility gap are as follows:

First, the revisions in the general government deficit estimates for 2011 have been embarrassing and disconcerting. The general government financial deficit forecast for GDP in 2011 was revised from 6.0% to 8.0% in late December 2011; then the deficit estimate for 2011 was revised from 8.0% to 8.5% on February 27, and, again, on May 18, 2012, to 8.9%, after Madrid, Valencia, Andalusia and Castilla-Leon reported higher deficits.⁷ We suspect that the general government *debt* figures for 2011 too may yet be revised upwards or the 2012 estimates further marked up, as debt of insolvent public sector enterprises not counted as part of the general government migrates to the balance sheet of the Spanish sovereign and as (off-balance-sheet) local and regional government arrears are turned into general government debt.⁸ The frequent deficit revisions will leave a question mark over

⁵ See e.g. <http://www.bruegel.org/nc/blog/detail/article/815-the-weekender-enhancing-the-spanish-program-a-new-greek-program/>

⁶ http://www.bde.es/webbde/en/secciones/prensa/info_interes/background_proc_evale.pdf

⁷ See <http://fta.reuters.com/article/topNews/idLTA5IE7BT04N20111230>, <http://www.minhap.gob.es/Documentacion/Publico/GabineteMinistro/Notas%20Prensa/2012/SE%20P RESUPUESTOS%20Y%20GASTOS/27-02-12%20Ejecución%20cierre%20presupuestos%202011.pdf> and <http://www.minhap.gob.es/Documentacion/Publico/GabineteMinistro/Notas%20Prensa/2012/SE%20P RESUPUESTOS%20Y%20GASTOS/18-04-12%20Estimación%20deficit%20%202011.pdf>

⁸ As Eurostat guidelines vary for debts and deficits, an increase in Eurostat deficit figures does not necessarily imply increases in Eurostat-compliant debt figures. For example, arrears are included in

incoming fiscal and macroeconomic data releases in Spain, too, despite the fact that the availability and coverage of data provided by Spanish authorities generally tends to compare favourably with many other European countries.

Second, local and regional public authorities have been designated as the source of most of the fiscal slippage and debt revisions. In response, the central government has instituted legislative reform, including constitutional amendments and a new budgetary stability law, according to which the central government is supposed to be able to impose strict control of the borrowing of the 17 autonomous regions. However, until now these new powers (which indeed look formidable on paper) are untested, and until they are actually tested in the political arena and shown to be effective, doubts will continue to exist about the extent to which the Spanish central government is able to rein in overspending regions.

Third, the implementation of the government's overall fiscal strategy appears somewhat haphazard. First, the new Spanish government missed a golden opportunity to use its first months in office to present a realistic, multi-year budget plan. Instead it postponed its (admittedly tough) budget for 2012 until the end of March 2012, in the hope that waiting to publicise the full scale and scope of the necessary fiscal austerity until after the regional elections in Andalusia and Asturias would be electorally advantageous. Second, the government has also repeatedly drawn fiscal lines in the sand, including that it would not raise VAT or reduce public wages in the face of the widely recognised reality that budgetary consolidation without changing VAT (base or rates) and the public payroll would be very difficult. On VAT, both the IMF and the EC have recently publicly called for urgent further changes to VAT rates and the VAT base.

Thus, the IMF's Concluding Statement after its recent Article IV Mission to Spain also noted that *'the fiscal slippage in 2011 greatly undermined the credibility of Spain to deliver fiscal consolidation'* and that *'the bulk of the planned consolidation in 2013-15 is based on expenditure savings, many of which are yet to be specified'*.⁹

Fourth, the PM, Mariano Rajoy, alienated key allies in Brussels and Frankfurt when, a day after signing the Fiscal Compact, he announced that the Spanish government had decided to revise the target deficit for 2012 from 4.4% of GDP to 5.8%. Although this was, in our view, the right decision in substance (because it avoided an even more excessively pro-cyclical fiscal policy), the manner in which it was taken and announced ("I did not consult other European leaders and I will inform the Commission in April... This is a sovereign decision by Spain.")¹⁰ was unlikely to have been popular with the ECB, the European Commission and the other HoSHoGs in the Eurogroup.

Fifth, and perhaps most glaringly, since the Spanish construction and housing bubble burst at the end of 2007, both the actions and the communication of the Spanish authorities regarding the likely scale of losses in the banking sector have been fallen well short of what was required to minimize the adverse consequences of the housing and construction bust. The bank regulator (the Banco d'España, BdE, – Spain's central bank), and successive senior government officials have

general government debt figures prepared on an accrual basis, but are not captured by the Excessive Deficit Procedure measure of general government debt.

⁹ 2012 Article IV Consultation with Spain Concluding Statement of IMF Mission, June 14, 2012, <http://www.imf.org/external/np/ms/2012/061512.htm>

¹⁰ See http://articles.businessinsider.com/2012-03-02/markets/31115657_1_eu-summit-madrid-higher-deficit

repeatedly presented public estimates of the capital needs of the Spanish banking system that have turned out to be highly optimistic – and were characterised as such by outsiders. The result has been a damaging loss of credibility.¹¹

The likely next round of banking sector reform, consolidation and recapitalization will be the sixth round of reform measures since 2009. And the pace is accelerating – while there had been one reform effort a year between 2009 and 2011, the measures included in the imminent bail-out will already be the third such effort in the first six months of 2012.¹²

The various reforms announced and partially implemented over the past few years clearly constitute progress, including in the much-needed consolidation of the banking sector (for instance, 45 savings banks or ‘cajas’ have now been consolidated into 11). Recently, there has also been an admission that the credibility of the authorities in charge of the Spanish banking sector has been eroded to such an extent that only external verification can restore investor confidence in the Spanish banking sector.¹³

The belated admission that the credibility of the Spanish regulatory and supervisory authorities has been damaged to the point that external verification of the capital needs and expected losses of the Spanish banking system is necessary is likely to be useful. However, it is not likely to be sufficient to restore the credibility of the Spanish authorities in the banking sector or elsewhere.

First, it remains doubtful whether in particular the residential mortgage portfolio will be sufficiently stressed in these assessment exercises, and whether the degree of lender forbearance will both be published and fully taken into account when calculating estimates of past and likely future losses on this portfolio. The IMF’s FSAP highlighted the lack of access to comprehensive data on lender forbearance and the risk that this omission could bias downward its loss estimates.¹⁴

¹¹ On January 24, 2011, the then Spanish finance minister Elena Salgado announced that Spanish banks required no more than €20 bn in additional capital (Bloomberg, “Spain Bonds, Bank Shares Fall On Capital Plan Concern”, <http://www.bloomberg.com/news/2011-01-24/spanish-banks-capital-need-won-t-exceed-27-billion-finance-minister-says.html>). On March 10, 2011, the Banco de España announced that the additional capital needs of the Spanish banking sector amounted to €15.15bn, of which €5.8bn was for Bankia (Banco de España Press Release, March 10, 2011 “The Banco de España informs 12 banks they must increase their capital to comply with the Royal Decree-Law” http://www.bde.es/webbde/en/secciones/prensa/Notas_Informativ/anoactual/presbe2011_9e.pdf). The new government, which took office on December 21, 2011, required an additional €53.8 bn of provisioning by the Spanish banks in February 2012. On May 11, it ordered a further €30bn worth of provisioning to cover potential losses on still-performing loans on the real estate book.

¹² The Spanish government has to date taken five sets of banking sector measures, which i) created the Fund for Orderly Bank Restructuring (FROB) in June 2009 to liquidate non-viable entities and to support viable restructuring processes, ii) initiated reforms of the savings banks in 2010 (the ‘cajas’) whose number was subsequently reduced from 45 to 17, iii) increased core capital ratio requirements to 8-10% in 2011, and iv) mandated additional provisions and capital for real-estate-related exposure (February 2012) and again in May 2012. A sixth round of reforms is likely to come very soon.

¹³ The government has commissioned two consulting firms to conduct a ‘top down’ stress test of Spanish bank balance sheets, with the results due to be published on June 21, 2012. In addition, four auditing firms were hired to conduct a bottom-up evaluation of the asset quality and valuation and assessment procedure of Spanish banks, with the results to be reported to the Bank of Spain by the end of July. See Spanish Treasury, ‘Translation of the Press Statement published on June 8th, 2012, by the Ministry of the Economy and Competitiveness’, June 12, 2012.

¹⁴ See e.g. “Although important caveats attach to the team’s assessment, including the extent to which lender forbearance—which the supervisory authorities have indicated they are monitoring closely—may have affected the underlying data and the risk of an even more severe downside shock

Second, the degree of involvement of the IMF and the European authorities in the design and implementation of the bail-out remains uncertain at present, even though details are likely to emerge, both on the nature of the monitoring process and the substantive contribution to the design of the conditionality, when the agreement is announced formally.

Third, statements by the Spanish authorities continue to suggest that they remain unwilling to present uncomfortable truths in an objective fashion.

Thus, following the announcement of the bail-out package, the Spanish Treasury stated *"This financial assistance will not only not undermine the present conditions of the current stock of Spanish Public Debt: it will also reinforce its overall solvency. Furthermore, a sound and duly capitalized banking system will reduce future contingent liabilities of the State and will therefore reinforce the sustainability of Spanish debt."*

*The upper limit of 100 billion Euros guarantees a credible backstop, sufficient to cover the system's eventual capital needs in the most stressed hypothetical scenarios, plus an additional buffer.*¹⁵

Statements like this, which contain logical non-sequiturs and are indeed counterfactual, do nothing to restore the credibility of the Spanish sovereign. The financial assistance is likely to weaken the creditworthiness of the current stock of Spanish public debt and of future Spanish sovereign debt issued in the markets. That is because the financial assistance implies up to €100bn worth of additional financial exposure for the Spanish sovereign.

Certainly, other things being equal, a sound and duly capitalised banking system will reduce future contingent liabilities of the State, compared to an unsound and undercapitalised banking system that either has an implicit financial backstop from the sovereign or whose weakness and threatened or actual collapse damages economic activity and thus government revenues. Regrettably, other things are not equal. The financial assistance only improves the soundness and reduces the degree of undercapitalisation of the Spanish banking system by increasing the contingent liabilities of the Spanish sovereign. Of course, the damage to the solvency of the sovereign is limited by the fact that it will be able to borrow the funds at an interest rate of around 3% rather than the 6% or 7% rate it would have to pay in the markets (assuming it would have been able to borrow at all). But clearly, even at 3%, it worsens the solvency of the Spanish sovereign compared to the situation where it would not have had to borrow for its banks at all.

The statement that €100bn is sufficient to cover the Spanish banking system's eventual capital needs in the most stressed hypothetical scenarios, plus an additional buffer, seems to be based on an uncritical acceptance of the conclusions of the IMF's FSAP. As we argue below, the IMF, Oliver Wyman and Roland Berger estimates of the likely capital needs of the Spanish banking system appear too optimistic.

Finally, the spectacle of a public spat between the Spanish prime minister and the German minister of finance about the nature of the Spanish bail-out did nothing to enhance the reputations of those involved. The Spanish PM described the financial assistance as "the opening of a credit line", "a cushion" and a "victory for Europe". However, the public insistence of the German finance minister Wolfgang Schäuble, that

than embodied in the analysis, the results suggest that...", IMF (2012), "Spain: Financial Stability Assessment", June 2012, <http://www.imf.org/external/pubs/ft/scr/2012/cr12137.pdf>

¹⁵ Treasury Statement on Financial Assistance to recapitalise the Spanish banking sector, June 10th, 2012, <http://www.thespanisheconomy.com/SiteCollectionDocuments/en-gb/Financial%20Sector/120610%20Spanish%20Treasury%20Statement.pdf>

Some meaningful reforms have been instigated for Spain, but the effectiveness of the government has been significantly hampered by very poor communication.

The IMF, Oliver Wyman and Roland Berger studies indicated capital needs for Spanish banks of between €37bn-62bn.

In our view, even €100bn in new capital will be too little to put doubts about the solvency of the Spanish banking system to rest.

before any payments are made, Spain would have to present a bank restructuring plan to the European Commission and the ECB for approval, came across as a direct contradiction of the interpretation of the bail-out offered by the Spanish Prime Minister.¹⁶

All this is not to say that the Spanish government has not produced any substantial reforms. It has. The labour market reform it passed in February is monumental by Spanish standards even though it has not yet been implemented and, even when implemented, would at best bring the level of Spanish labour market rigidity closer to the European average. The reform of the budgetary stability law also looks formidable on paper, and the sequence of banking sector reforms has led to much-needed consolidation and a partial clean-up of the banking sector. Allowing at long last an independent review of the banking sector also shows some resolve to address the credibility gap. But, in our view, to save the credibility of the Spanish government it is too little, too late. And if a nation is short on domestically generated sovereign credibility, it can only be underpinned, albeit imperfectly, by externally enforced credibility. It seems clear to us that Spain has arrived at that point.

Too little money to put doubts to rest

As noted above, the IMF's FSAP study reported that Spanish banks would, in the worst scenario included in their report, need around €37bn of additional capital to achieve a post-stress core tier one capital ratio of 7%. Roland Berger and Oliver Wyman, using different methodologies and slightly harsher macroeconomic assumptions, suggested €52-62bn in the case of Oliver Wyman and €52bn for Roland Berger to achieve a post-stress core tier one capital ratio of 6% in their reports published on June 21, 2012.¹⁷ Total likely credit losses over the next three years were put at €250-270bn by Oliver Wyman and €170bn by Roland Berger.¹⁸

Based on estimates such as these, the 'up to €100bn' in funds provided by the EFSF or ESM for the recapitalization of Spanish banks has been interpreted by various officials as putting all doubts about the solvency of Spanish banks to rest (see [Spain: Bank bail-out on the way](#)). In our view, this interpretation is not credible. Additional credit losses by Spanish banks are likely to exceed this number in a variety of plausible scenarios. Other avenues to absorb those losses could be found, including contributions by private investors, there may be uncertainty over the time horizon over which these losses would arise or regulatory forbearance could help banks to avoid realizing 'mark to market' losses for substantial periods of time. But, in our view, there are various reasons to suspect that €100bn in additional losses beyond and above those reflected in previous rounds of provisioning, is likely to be a significant underestimate of the banks' future exposure.¹⁹

Let's start by making two simple points. We already noted above that the track record of estimating Spanish bank losses has been extremely poor and the sign of the forecast error was always the same. Second, the recently announced (but not yet implemented) recapitalization of Bankia involved an additional €19bn of capital

¹⁶ "A breathing space for Spain", The Irish Times, Tuesday June 2012.
<http://www.irishtimes.com/newspaper/opinion/2012/0612/1224317752696.html#>

¹⁷ The reports are available on
http://www.bde.es/webbde/en/secciones/prensa/info_interes/reestructuracion.html

¹⁸ The differences between credit losses and capital needs arise from the existence of provisions, capital buffers and the ability to generate positive pre-provision income.

¹⁹ We prefer to frame the discussion in terms of credit losses to mostly avoid conflating the issue of likely capital losses with the related, but distinct, issue of the appropriate target level and quality of capital.

(€23.4bn if a conversion of debt into equity is included). Applying the same ratio of capital needs as in the Bankia case to the rest of the Spanish banking system would imply additional capital needs of around €140bn. We realise, of course, that Bankia may be a special case, and that the appropriate loss estimate for Bankia may be higher than for the Spanish banking system as a whole, but it is worth noting that the recently announced capital increase for Bankia was not subject to independent external verification, and included only a tiny allowance at best for increased losses on the residential household portfolio. It may therefore still turn out to be too small.

Why the IMF, Roland Berger and Oliver Wyman estimates are likely too low

The neglect of the risk of substantial losses from residential mortgages is the main weakness of the three recent bank assessments.

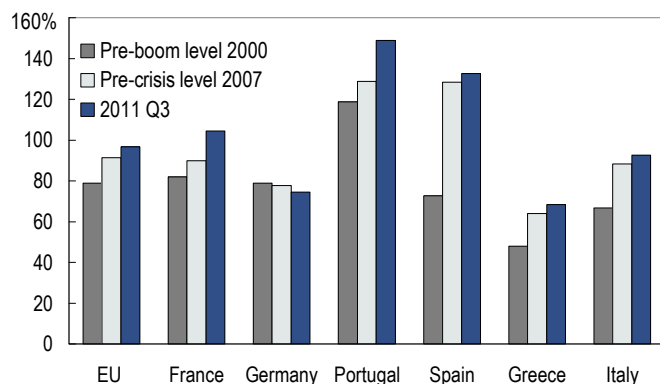
But let us turn to the issue of residential mortgages in general. At the end of 2011, residential mortgages worth €626.6bn were outstanding, of which only 2.8% (€17.5bn) were reported as non-performing. We suspect a considerable amount of lender-forbearance, aka evergreening of non-performing residential mortgage loans, aided and abetted by past regulatory forbearance. In contrast, the real estate portfolio (excluding retail mortgages) that has been the focus of all past capital needs assessments and the stress tests for the Spanish banking system (including the IMF's FSAP and the Oliver Wyman report, and to some extent the Roland Berger report) amounts to just €240bn, with foreclosed assets about one-third of this, at just over €87bn.

It has been argued variously, that 'Spain is different' when it comes to the payment of residential mortgages, due to i) high unemployment benefits, ii) large family support, iii) a large shadow economy, iv) low mortgage rates, and v) very strict personal insolvency laws.

We are aware of the arguments in support of the view that "Spain is different" as regards the ability and willingness of households to service their mortgages. These sum to the assessment that, in the words of Banco Santander SA Chief Executive Officer Alfredo Saenz on April 26, 2012, "*Mortgages get paid in good times and in bad,*" ... "*Anyone raising this problem as one of the issues for the Spanish financial system is saying something stupid.*"²⁰ Consider the key facts. At the end of 2011, household debt was still 88.2% of GDP and 133.1% of household disposable income (see Figure 2). The debt service burden as a share of household disposable income was 15.1% and the interest burden a low 3.5%, reflecting the fact that 98% of residential mortgages are at variable rates, and therefore benefited from the reduction in short-term interest rates in the euro area.

²⁰ See <http://www.bloomberg.com/news/2012-04-26/santander-ceo-derides-surge-in-spain-defaults-mortgages.html>

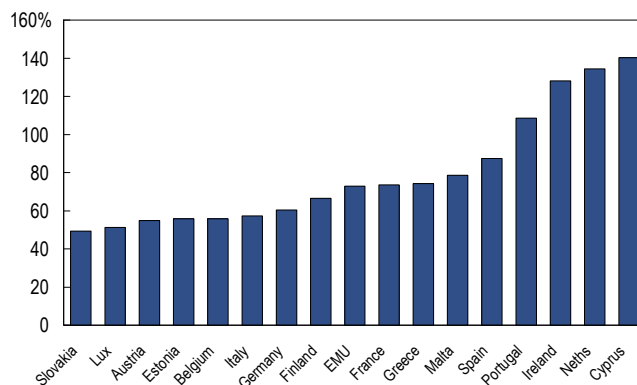
Figure 1. Selected Euro Area Countries – Nonfinancial Corporations' Gross Debt (% of GDP), 2000-2011 Q3



Note: Gross debt defined as total financial liabilities of consolidated nonfinancial corporations less shares and financial derivatives.

Source: OECD and Citi Investment Research and Analysis

Figure 2. Selected Euro Area Countries – Households' Gross Debt (% of GDP), 2011



Note: Gross debt defined as total financial liabilities of consolidated households

Source: IMF and Citi Investment Research and Analysis

As long as mortgage rates are tied to Euribor, they are likely to remain low.

Mortgages are full recourse: borrowers cannot legally walk away from negative equity. Loan to value ratios are reported as low (on average 58%, according to the IMF)²¹, although it is likely in our view that the value used to calculate these ratios is in excess of the fair value of the real estate in most cases. Unusually high (by international standards) family support and additional income from shadow economy activities are argued to further boost Spanish residential mortgage servicing capacity above what would be expected in other West-European countries.

As long as variable mortgage rates continue to be driven by Euribor rather than by an interest rate that incorporates a country-specific risk-premium, there is, in our view, little risk of a sharp increase in the rate of interest charged on variable rate mortgages. In fact, as we expect the ECB to soon cut rates, possibly by the time of the July meeting, rates could fall slightly from here, if lending spreads do not rise substantially ([ECB - Weaker Data Likely to Spur ECB Action in July](#)). The risks mostly lie elsewhere.

²¹ <http://www.imf.org/external/pubs/ft/scr/2012/cr12137.pdf>

But:

- **Household debt is very high**
- **The generosity of unemployment benefits is likely to fall over time**
- **Political and public pressure may force banks to accept writedowns on residential mortgages and reduce foreclosures**
- **Public pressure may also soon result in momentum to change the very strict personal insolvency law.**

First, very high unemployment is likely to take its toll on households' *ability* to service mortgages. We take little comfort from the reported muted impact on residential mortgage loan-loss ratios from rising unemployment (the economy-wide unemployment rate in April 2012 stood at 24.4% overall, close to the 1994 high of 24.5%). In addition to the lender forbearance we suspect, it is likely that negative income shocks like those caused by unemployment are partially absorbed by the income of other household members and by unemployment benefits. However, as the incidence and duration of unemployment spells increase and as unemployment insurance benefits run out and are replaced by the less generous assistance benefits, which are themselves time-limited, we expect that inability to pay will become an increasingly important driver of bank losses on residential mortgages.²²

Second, potential changes in bank loan modification and home household eviction processes and personal or household insolvency laws could sharply raise household delinquency rates through reductions in household *willingness* to pay.

Repossession of properties because of the mortgage borrower's non-performance on the mortgage contract, especially when it involves the physical eviction of families from the homestead, is a highly politically charged act. Whatever the letter of the law, there will be growing resistance, at all levels of the political process – from the doorstep to the streets to parliament – to repossessions involving evictions. Casual empirical evidence on this development is already available.²³ In 2011, there were 58,000 evictions in Spain – a 22% rise, and four in every five involve families with children. We expect the growing popular resistance to repossession and eviction to find political expression before long in legislation, regulations, directives or moral suasion that results in banks having to write down more of their non-performing residential mortgage exposure.

Spanish personal or household insolvency law continues to be very strict.²⁴ This is apparent from the fact that in the first quarter of 2012, the number of families filing for bankruptcy increased just by 1.5% over the same quarter a year earlier, to a grand total of 266. Over the same period, the number of companies filing for insolvency rose by 24.9% to reach 1,958 – the highest since the start of the crisis.²⁵ Even though the Spanish corporate insolvency/business bankruptcy rate itself is low by international standards (see Celentani, Carcía-Posada and Gómez (2012)), the household insolvency or personal insolvency rate is extraordinarily low (Figure 3). For all of 2011, the total number of personal insolvencies in Spain was 945, and the total number of

²² The contributory unemployment insurance benefit lasts from 4 to 24 months, depending on contributions. It is set at 70 percent of reference earnings for a maximum period of 6 months and 60 percent of reference earnings for the remaining period of the benefit. The non-contributory benefit ('subsídio de desempleo') is targeted at those who no longer qualify for the contributory benefits due to duration of unemployment or lack of contributions. It is much less generous than the contributory benefit and, unlike the contributory benefit, it is means-tested. See <http://www.comfama.com/contenidos/servicios/Subsidio/Informaci%C3%B3n%20general/subsidiodesempleoinfo.asp>

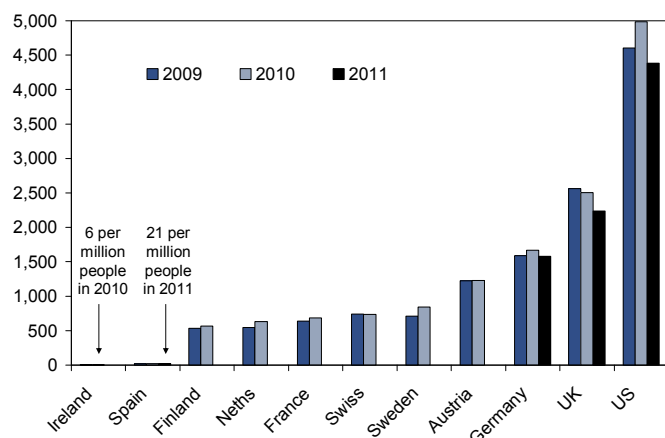
²³ See e.g. "Spaniards Fight Banks Over Home Evictions", Sky News, 7 June 2012. <http://news.sky.com/home/world-news/article/16242764>; "Spanish Homeowners rally together to fight evictions by banks", The Telegraph, 2 May 2012. <http://www.telegraph.co.uk/finance/financialcrisis/9241430/Spanish-homeowners-rally-together-to-fight-evictions-by-banks.html#>

²⁴ The Spanish insolvency system is governed by Law 22/2003 of 9 July 2003 (the Insolvency Law). This established a single insolvency procedure applicable to all commercial and non-commercial debtors. To keep up with the increased work-load created by the crisis and the ensuing recession, the Spanish insolvency system has recently been reformed by Law 38/2011 of 10 October which amends Law 22/2003. Law 38/2011 entered into force on 1 January 2012.

²⁵ Instituto Nacional de Estadística, Bankruptcy Proceedings Statistics, <http://www.ine.es/jaxi/menu.do?type=pcaxis&path=/t30/p219&file=inebase&L=1>

corporate insolvencies 5,837. In contrast, in England and Wales, personal insolvencies in 2011 numbered 119,941 (which was down 11.3% on the record high of 2010) and corporate liquidations numbered 16,886, 5.2% higher than in 2010.²⁶

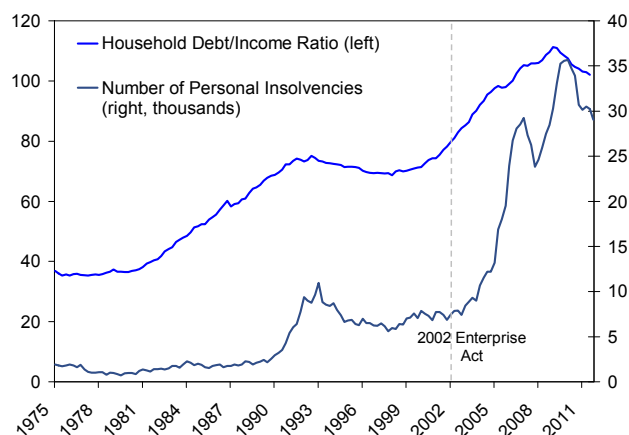
Figure 3. Selected Countries – Number of Personal Insolvencies (per Million People), 2009 – 2011



Note: Values correspond to insolvencies for total persons (non-business) per 1 million of people.

Source: DataStream, Creditreform, and Citi Investment Research and Analysis

Figure 4. UK – Household Debt and Insolvencies, 1975 – 2011



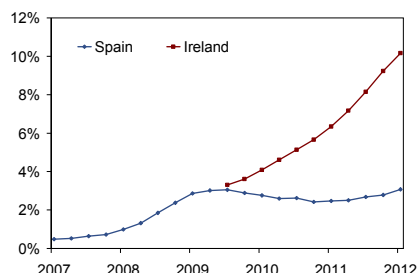
Note: Household Debt/Income ratio corresponds to total gross financial liabilities over household gross disposable income. Number of personal insolvencies are for England and Wales.

Source: The Insolvency Service, Bank of England and Citi Investment Research and Analysis

Again we expect that political economy considerations will force a change in the law and its application, especially in the personal insolvency field, that will permit homeowners to walk away from much of their mortgage debt, potentially not just without recourse beyond the repossession by the lender of the mortgaged property but even without the delinquent borrower being evicted. To our knowledge, no such legislative initiative is currently circulating, but that could change relatively quickly. We therefore anticipate an increase in write-downs on residential mortgages, of the kind that we are already seeing in Ireland, even before the new Irish personal insolvency law has gone into effect.

²⁶ Personal insolvencies for England and Wales include bankruptcies (41,876 in 2011), individual voluntary arrangements (IVAs, 49,056 in 2011) and Debt Relief Orders (29,009 in 2011). Source: <http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/201205/table2.pdf>

Figure 5. Spain and Ireland – Non-Performing Residential Mortgages (% of total), 2007-2012 Q1



Note: Residential mortgage arrears for Ireland, doubtful household mortgage loans for house purchases for Spain.

Source: Bank of Spain, Central Bank of Ireland, and Citi Investment Research and Analysis

Figure 6. Ireland – Loan Losses Under 2011 Stress Test (% of total balance)

| | Base | Stress |
|---------------------------------|------|--------|
| Residential Mortgages | 7.1 | 12 |
| Corporate | 3.7 | 5.8 |
| SME | 14.8 | 19 |
| CRE | 20.1 | 25.5 |
| Non-mortgage Consumer and Other | 19.5 | 27.1 |
| Total | 10 | 14.6 |

Note: Table shows BlackRock lifetime loan losses post-deleveraging, as a percentage share of notional loan balances as at 31 December 2010. CRE stands for Commercial Real Estate, SME - Small and Medium Enterprises.

Source: "The Financial Measures Report", Central Bank of Ireland, March 2011, Table 8, page 19 and Citi Investment Research and Analysis.

In Ireland, new personal insolvency legislation is under consideration (the publication of the new legislation has been postponed till the end of June 2012), which is expected to cut the bankruptcy period from 12 to three years. It also proposes three voluntary debt-settlement systems, outside of formal court insolvency. Both unsecured and secured debt, mainly mortgages, would be covered by the new legislation. The banking industry opposes the inclusion of mortgages and has warned of dire consequences for the sector if people who can't service their debts are allowed to get write-downs on their mortgages. This view is shared by Moody's, which wrote in February 2012 that up to a quarter of Irish residential mortgages could be written down if the new proposed legislation were implemented.²⁷ Figure 5 shows that since September 2009, the percentage of Irish mortgages (by number) more than 90 days in arrears has gone up from levels close to those currently observed in Spain (3.3%) to 10.2% and the value of the mortgages more than 90 days in arrears has gone up from €4.8bn in September 2009 (with the value of the arrears equal to €354m) to €15.4bn in March 2012 (with the value of the arrears equal to €1.3bn).²⁸ And these increases in arrears are occurring under the old punitive Irish mortgage recourse and personal insolvency regimes.

In England and Wales, personal insolvencies grew dramatically in the anticipation of the 2002 Enterprise Act and continued rising after its implementation; insolvency rates are much, much higher than in Ireland or Spain (see Figure 4).

A 25% loss rate on residential mortgages is far in excess of the 12% loan loss rate assumed by Blackrock under the adverse scenario in the Irish stress test (Figure 6).²⁹ With €626bn in residential mortgages outstanding in Spain this loss rate would generate losses of €157bn. The IMF FSAP did not make its loan loss estimates on any part of the bank portfolio explicit, including on household mortgages. In the Oliver Wyman and the Roland Berger stress test, the loan loss rates on residential mortgages in the adverse scenario were 4% and 8%, respectively, implying around €22bn and €45bn in residential mortgage losses, respectively (Figure 7).

Figure 7. Spain – Loan Loss Rates for Bank Stress Test (adverse scenario, % of total balance), 2012

| | Citi | Oliver Wyman | Roland Berger |
|------------------------|------|--------------|---------------|
| RE Developers | 50% | 44% - 46% | 25% |
| Retail Mortgages | 4% | 3% - 4% | 8% |
| Large Corporate | 7% | 12% - 13% | 8% |
| SMEs | 7% | 15% - 17% | 11% |
| Public Works | | 21% - 23% | 20% |
| Other Retail | 5% | 16% - 18% | 19% |
| Total Credit Portfolio | 12% | 14% - 16% | 12% |

Note: Projected loan losses by type are for loans for 2012 through Q4 2014 (for Citi for 2012-2013) under the hypothetical supervisory stress scenario, shown as portfolio loss rates (%). RE is Real Estate, SME stands for small- and medium-sized enterprises. Public works for Roland Berger correspond to infrastructure and Civil Construction finance. RE developers correspond to Commercial Real Estate for Citi and Roland Berger.

Source: Oliver Wyman, Roland Berger, and Citi Investment Research and Analysis [Spanish Banks - Bank Recapitalisation Ahead](#)

²⁷ "Proposed Irish Legislation Opens Door To Widespread Debt Forgiveness", Moody's Investors Service, February 8, 2012, http://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_SF275722

²⁸ Source: Central Bank of Ireland.

²⁹ "The Financial Measures Programme Report", Central Bank of Ireland, March 2011, <http://www.centralbank.ie/regulation/industry-sectors/credit-institutions/documents/the%20financial%20measures%20programme%20report.pdf>

Figure 8. US – Loan Losses Under the Adverse Scenario of the 2012 Stress Test (% of total)

| | |
|---------------------------|------|
| Total Loan losses | 8.1 |
| First Lien Mortgages | 7.4 |
| Junior Liens and HELOCs | 13.2 |
| Commercial and Industrial | 8.2 |
| Commercial Real Estate | 5.2 |
| Credit Cards | 17.2 |
| Other Consumer | 5.9 |
| Other Loans | 2.5 |

Note: Projected loan losses by type of loans for Q4 2011 through Q4 2013 under the hypothetical supervisory stress scenario. HELOC stands for home equity line of credit.

Source: "Comprehensive Capital Analysis and Review 2012: Methodology and Results for Stress Scenario Projections", Board of Governors of the Federal Reserve System, March 13, 2012; page 23 and CIRA.

Third, the macroeconomic assumptions in the IMF and the two consulting firms' studies are not particularly harsh.³⁰ For example, the three studies' adverse scenario assumes a house price decline for 2012 of 19.9% and further declines of between 3.6% and 4.5% in 2013 (see Figure 9). Given the large stock of unsold housing (estimated at between 700,000 and 1 million units), the fact that sales prices are already reported to be 20-25% below asking prices and the estimated 200,000 units of repossessed residential assets that the banks still need to offload³¹, the IMF assumptions do not seem to us like much of a stress scenario, but more like a 'base case'. Thus, a recent report by Standard & Poor's, for example, spoke of an *expectation* of a further 25% fall in house prices, even though they left the time period it applies to unspecified.³² True, an assumption of a 4.1% fall in 2012 GDP is the lowest growth figure that appeared in either the latest US, Irish or Spanish bank stress tests, and is quite a bit lower than our central scenario. But relative to the base case (which is -1.7% growth according to the Spanish authorities and -2.2% according to our estimates), the adverse scenario is not particularly harsh for a stress test. In the latest US stress test, for example, the assumption for 2012 growth of -4.0% was more than 6pp of GDP below the official or our own forecasts. For 2013, the adverse scenarios of the studies are in fact more optimistic than our central scenario (though that was also true in the Irish 2011 stress test as regards 2012). The assumptions on unemployment also do not look very tough.

Figure 9. Selected Countries – Selected Bank Stress Test Macroeconomic Assumptions

| | Base | 2011 Stress | CIRA | Base | 2012 Stress | CIRA | Base | 2013 Stress | CIRA |
|---------------------|------|-------------|------|------------|-------------|------|------------|-------------|------|
| Ireland | | | | | | | | | |
| GDP | 0.9 | -1.6 | 0.7 | 1.9 | 0.3 | -0.8 | | 1.4 | 0.4 |
| Unemployment rate | 13.5 | 14.9 | 14.4 | 12.7 | 15.8 | 15.1 | | 15.6 | 16.6 |
| House prices | | -17.4 | | | -18.8 | | | 0.5 | |
| Commercial property | | -22.0 | | | 1.5 | | | 1.5 | |
| Inflation | | 0.7 | -0.4 | | 0.9 | 0.1 | | 1.0 | 0.2 |
| USA | | | | | | | | | |
| GDP | | | | 2.2 to 2.7 | -4.0 | 2.1 | 2.8 to 3.2 | 2.2 | 2.1 |
| Unemployment rate | | | | 8.2 to 8.5 | 11.7 | 8.0 | 7.4 to 8.1 | 12.9 | 7.8 |
| House prices | | | | | -11.9 | | | -8.9 | |
| Commercial property | | | | | -17.2 | | | -3.6 | |
| Inflation | | | | 1.4 to 1.8 | 1.2 | 1.9 | 1.4 to 2.0 | 0.3 | 1.7 |
| Spain | | | | | | | | | |
| GDP | | | | -1.7/-1.7 | -4.1/-4.1 | -2.2 | -0.3/-0.3 | -1.6/-2.1 | -2.6 |
| Unemployment rate | | | | 23.8/23.8 | 25.0/25.0 | 24.5 | 23.5/23.5 | 26.6/26.8 | 25.9 |
| House prices | | | | -5.6/-5.6 | -19.9/-19.9 | | -2.8/-2.8 | -3.6/-4.5 | |
| Commercial property | | | | | | | | | |
| Inflation | | | | 1.0/1.8 | 0.0/1.6 | 2.2 | 1.0/1.1 | -0.5/0.0 | 2.3 |

Note: CIRA forecasts are from [Spanish Banks - Bank Recapitalisation Ahead](#). US "Base" scenario shows FOMC central projections from January 2012. Spanish Stress scenario show IMF values and / assumptions in Oliver Wyman Report and Roland Berger Report. For Spain, Stress scenario is "Adverse" scenario from each report. CIRA column shows forecasts as of May 2012. US inflation "Stress" scenario relates to CPI inflation, "Base" and "CIRA" forecasts to changes in the PCE deflator. For Spain, CIRA forecasts are for CPI inflation, while "Base" and "Stress" scenarios relate to the GDP deflator. "Base" scenario forecasts for Ireland are EU Autumn 2010 forecasts.

Sources: "The Financial Measures Report", Central Bank of Ireland, March 2011; "Comprehensive Capital Analysis and Review 2012: Methodology and Results for Stress Scenario Projections", Board of Governors of the Federal Reserve System, March 13, 2012; "Spain: Financial Stability Assessment", IMF, June 2012 and CIRA.

³⁰ The three studies share the same assumptions for the macroeconomic base scenario. For the adverse scenario, the assumptions are slightly harsher in the studies of the two consulting firms.

³¹ <http://www.imf.org/external/pubs/ft/scr/2012/cr12137.pdf>

³² "Spain's Housing Market May Need Four More Years To Rebalance", Standard Poor's, June 14, 2012, http://www.standardandpoors.com/spf/upload/Ratings_EMEA/Jun2012_Spain.pdf?elq=429e3d5fd9334d45a8834b487f018b64

Ireland, Latvia and Estonia are the only European countries to have experienced in recent times a construction and house price boom and bust comparable to Spain. All four countries also have similar, very high home ownership rates.³³ Even restricting our comparison to Ireland, the only West-European comparator in our sample, there are a number of relevant differences between the two countries, but the Irish experience is still likely to be a useful reference point. In this context, it is worth noting that the loan loss assumptions by loan type that were used by Blackrock in the Irish stress test would have implied very high total credit losses in Spain – €364bn for loans alone (ie excluding real estate assets owned by banks outright as a result of foreclosures).³⁴ And the Irish stress test still did not capture two major sources of credit losses in Ireland – assets transferred to NAMA and the higher mortgage losses likely to result from the upcoming change in personal insolvency laws.³⁵ Simply applying the harsher of the two assumptions made for each loan category by either Roland Berger or Oliver Wyman in the recent stress tests would yield losses of €334bn.

Most euro area member states (core as well as periphery) are experiencing a banking sector crisis, with many undercapitalised banks, hidden legacy losses, growing new losses as a result of slowing activity or outright recession, and a significant number of de-facto insolvent banks. These banks are kept alive by regulatory forbearance and by the willingness of the ECB to continue to fund, through the Eurosystem or through the national ELAs, most likely insolvent banks that offer as collateral securities issued or guaranteed by most likely insolvent governments. A number of euro area sovereigns are, in addition, insolvent or most likely insolvent. Some of these (most likely) insolvent sovereigns would have been most likely solvent but for their decision to take over (on better than fair terms) the bad assets of their banks and/or to guarantee the unsecured creditors of their banks. Ireland falls into that category, in our view. Greece, by contrast, is an example of a country whose banks would mostly likely have been solvent but for their exposure to their insolvent sovereign and for the deep recession caused by the (failed) fiscal austerity programmes pursued by that sovereign in an attempt to forestall default. We think Spain is closer to the Irish case, in the sense that the consolidated sovereign and banking sector is most likely insolvent. Forcing the Spanish government to guarantee the EFSF/ESM funds that will be used to recapitalise the Spanish banking sector may therefore save Private Paul by causing Sovereign Peter to drown.

If, as the IMF argues, no more than €40bn (4% of GDP) is required to put the Spanish banking system on a sound footing, no harm will be done. If the total is instead €150bn or even €250bn, we may have another candidate for the unwanted distinction of being an otherwise solvent sovereign dragged down by insolvent banks that are, collectively, too big to bail.

³³ Source: OECD

³⁴ These losses are obtained by applying loan loss rates presented in Figure 6 to the loan balances as of December 2011 for Spanish banks as provided by Bank of Spain data.

³⁵ Assets with a face value totaling €74bn were transferred to NAMA, at an average discount of 55%.

Fiscal and macroeconomic risks are likely to be the main focus in Spain in the months to come.

The recently begun recession in Spain is likely to deepen in Q2 2012 and in the quarters to come.

Spanish general government debt will rise to around 90% of GDP in 2012E – very close to the euro area average.

Available data for 2012 on public finances do not suggest a substantial reduction in the deficit so far relative to 2011.

We expect growth to undershoot and the fiscal deficit to overshoot government targets in both 2012 and 2013.

Fiscal and Macroeconomic risks in Spain

Even if we give the IMF and the Spanish authorities the benefit of the doubt, and accept that the concerns about banking sector solvency will be put to rest after the latest round of reforms and recapitalizations, the Spanish sovereign is not home free. Rather, concerns about the macroeconomic and fiscal trajectories are likely to rise in the weeks and months to come.

The Spanish economy has reentered recession after GDP fell by 0.3%QoQ in both Q4 2011 and Q1 2012. Back in late May, Finance Minister de Guindos said that he expected GDP to contract at a relatively similar pace in the second quarter as in the first one (also noting the limited data available to date).³⁶ The latest data suggest greater weakening in Q2 and we expect GDP growth to undershoot government forecasts also for the rest of the year and even more so for 2013 (Figure 10 and Figure 11).³⁷

Figure 10. Spain – General Government Overall Balance (% of GDP), 2010 – 2015F

| | 2010 Actual | 2011 Actual | 2011 Target | 2012 Target | Change 2012/ 2011 | 2013 Target | 2014 Target | 2015 Target |
|------------------------|----------------|----------------|----------------|----------------|-------------------------|----------------|----------------|----------------|
| Central Govt | -5.7 | -5.1 | -4.8 | -4.0 | 1.1 | -2.5 | -1.9 | -1.1 |
| Autonomous Communities | -2.9 | -3.3* | -1.3 | -1.5 | 1.8 | -0.5 | -0.3 | 0.0 |
| Local Authorities | -0.5 | -0.4 | -0.3 | -0.3 | 0.1 | 0.0 | 0.0 | 0.0 |
| Social Security | -0.2 | -0.1 | 0.4 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 |
| Total | -9.3 | -8.9 | -6.0 | 5.8 | 14.7 | -3.0 | -2.2 | -1.1 |

Note: *Corresponds to preliminary amount of -2.9% plus -0.4pp of assumed increase in deficit (no final split available). For 2012 and beyond, target values are targets (and forecasts) of the Spanish government as included in the Stability Programme update 2012-2015.

Source: Spanish Ministry of Finance and Public Administration, and Citi Investment Research and Analysis

Of course, as noted above, the banking sector is scheduled to be bailed out on the back of the sovereign, adding up to 9.2% of GDP to general government gross debt in 2012. Spain's gross debt to GDP ratio is thus likely to catch up rapidly with the euro area average and to continue rising, even if there are no unpleasant public debt surprises emerging from the lower-tier authorities, adding to the stock of debt in the same way earlier revisions have added to estimates of the general government deficit (Figure 13). The Spanish general government deficit also remains large. The latest reading of the general government deficit for 2011 was at 8.9% of GDP. The target for this year is a very ambitious 5.3% of GDP. And the available fiscal data from January to April do not suggest any clear improvement on last year's figures. The central government accrual deficit from January to April 2012 stood at €25.7bn compared to €16.9bn in 2011. In cash terms, the year-to-date deficit was €9.2bn against €6.1bn in 2011. The Spanish government insists that it is still on track to meet the 2012 targets. It justifies the lack of progress in the central government budget with the arguments that i) frontloaded transfers to the local and regional governments to make up for their lack of access to alternative sources of financing, have resulted in higher expenditure for the central, but not the general, government and ii) any slippage relative to expectations for the general government balance (general government deficit data for Q1 are not available to our

³⁶ <http://es.reuters.com/article/topNews/idESMAE84K02N20120521>

³⁷ For instance, industrial production fell by 7.9%YoY (1.1%MoM) in April, retail sales were down 7.4%YoY in April and at just below 42 (seasonally adjusted) both manufacturing and services PMIs in May were very weak, even though the services PMI had been even weaker as late as November 2011.

knowledge) will not be a problem because a number of measures announced in late March in the 2012 budget are yet to take effect.³⁸

Figure 11. Spain – Real GDP Growth Forecast (%YoY), 2012F-2013F

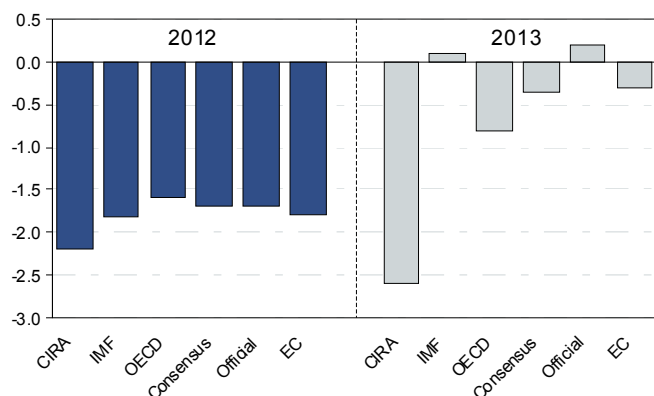
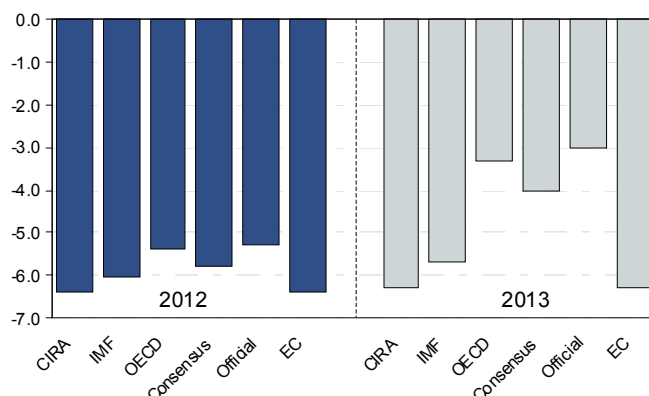


Figure 12. Spain – General Government Overall Balance (% of GDP), 2012F-2013F



Note: Consensus refers to average of forecasts provided by Bloomberg.

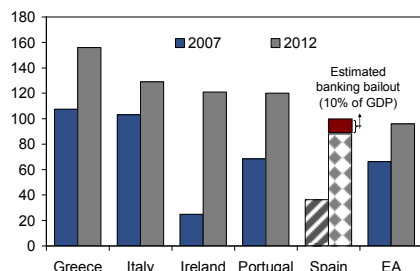
Source: IMF, OECD, Spanish Ministry of Finance and Public Administration, Bank of Spain, Bloomberg and Citi Investment Research and Analysis

Although these arguments are plausible to some extent, they are unlikely to tell the full story. First, the effectiveness of a number of the measures announced in the 2012 budget – even when fully implemented – is yet to be seen, particularly if the economic outlook deteriorates by more than the government expects, which is our base case. Second, the large number of revisions in the 2011 budget and the lack of a clear explanation for why the original estimates were off by so much create doubts about data quality and reliability, and raise concerns that the any incoming data might also be revised eventually. In addition, both the IMF and the EC have recently criticized the lack of detail on the precise measures to be taken to achieve the very ambitious fiscal targets for 2013-15, and the EC and the European Council have noted that the macroeconomic scenario after 2012 is 'optimistic'.³⁹

³⁸ To our knowledge, no timely data on quarterly general government deficits are available. See e.g. <http://online.wsj.com/article/BT-CO-20120529-703859.html> for an official reassurance that public finances were on track for 2012. According to Treasury Minister Montoro, the regional governments on aggregate balanced their budgets in Q1 2012 and were on track to meet their 2012 target of 1.5% of GDP. See Spain says regions' deficit on track", Reuters, June 1, 2012, <http://www.reuters.com/article/2012/06/01/spain-regions-idUSL5E8H1APY20120601> and <http://www.minhap.gob.es/Documentacion/Publico/GabineteMinistro/Notas%20Prensa/2012/CONSEJO%20DE%20MINISTROS/01-06-12%20Nota%20Ejecuci%F3n%20CCAA.pdf>

³⁹ See <http://www.imf.org/external/np/ms/2012/061512.htm> and "Recommendation for a Council Recommendation on Spain's 2012 national reform programme and delivering a Council opinion on Spain's stability programme for 2012-2015", European Commission, May 30, 2012

Figure 13. Selected Euro Area Countries – General Government Gross Debt (% of GDP), 2012F



Note: General government gross debt. 2012 values correspond to CIRA forecasts as 23 May 2012.

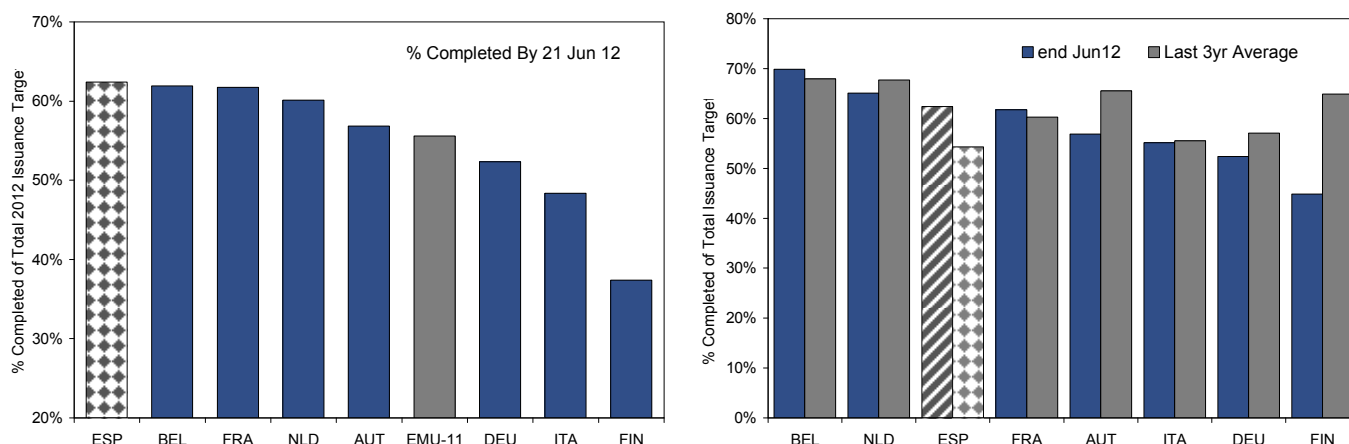
Source: Eurostat and Citi Investment Research and Analysis.

It is true that the EC and the IMF recently opened a small fiscal window to the Spanish government by arguing that the pace of consolidation implied by the fiscal targets may be too fast, given the challenging economic environment, and advised that fiscal slippage due to a deeper-than-expected recession should not be made up by additional fiscal consolidation measures in the original time-frame. However, that should not be interpreted as meaning that the pace of future fiscal consolidation will be slower than it is now (or than it has been in the recent past) nor that it will be slower relative to what has been announced as part of the 2012 budget or the Spanish Stability Programme. All it means is that no further, additional austerity measures may be required within the original time span set aside for fiscal consolidation. We expect both additional fiscal measures to be announced in due course and for the deficit to still overshoot targets both in 2012 and 2013 (see Figure 12).

Funding needs, funding access and funding costs

As a result of the challenges discussed above, it is unlikely, in our view, that the Spanish government will have access to affordable market funding anytime soon, even if aided by a combination of financial repression and subsidized ECB funding.

Figure 14. Selected Euro Area Countries – Central Government Bond Issuance, 2012



Source: DMOs, Bloomberg, and CIRA [International Interest Rate Strategist - Navigating the maelstrom](#)

The Spanish general government still has substantial funding needs for this year, once potential budget overruns, and funding needs of regional governments and agencies are taken into account.

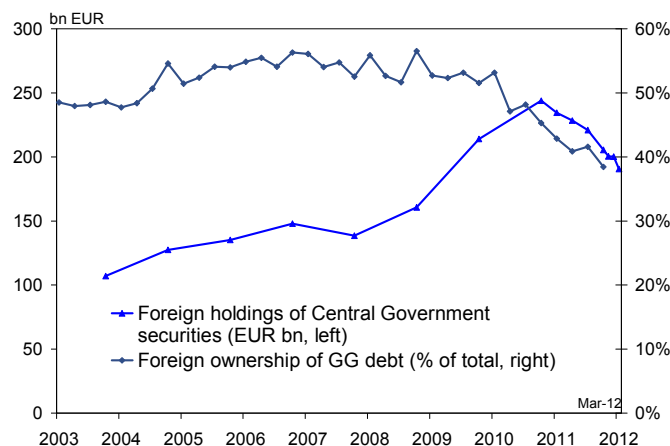
Much has been made of the fact that the Spanish central government has frontloaded much of its funding programme in 2012, even though, due to relatively low issuance in recent months, the degree of frontloading has diminished. Our rates strategists estimate that by the end of June 2012, the Spanish sovereign will have achieved more than 60% of its gross issuance target for 2012, leaving only around 25bn of bonds (excluding bills) to be issued for the remainder of 2012 (Figure 14, [International Interest Rate Strategist - Navigating the maelstrom](#)). This is both more than other euro area countries have achieved this year, and more than Spain had managed in the same period in previous years. Our rates strategists also estimate that net issuance, i.e. gross issuance minus redemptions, is likely to be negative for the remainder of 2012 for the Spanish sovereign. And one positive aspect of the imminent Spanish bank bail-out is that this will not need to be funded through market issuance by the Spanish sovereign, much reducing one major upside risk to its funding requirements for this year. However, once we take the funding requirements of regional governments and agencies and potential budget overshoots into account, general government funding needs for the remainder of the year are probably still quite substantial. For instance, recent reports suggest that

It is questionable whether Spanish banks will continue to display the extreme appetite they had between November and February to buy Spanish government debt – April data suggested not.

redemptions for the regions alone for the remainder of 2012 amount to around EUR36bn.⁴⁰

The question then poses itself where demand for the remaining issuance this year and in the future is supposed to come from. It is possible that Spanish banks will continue to exhibit their eagerness, aided and abetted with a good dosage of financial repression by the Spanish authorities, to absorb most of the gross issuance of the Spanish government. Even that may not be enough, as foreign investors continue to retreat from Spanish government bond markets and there is as yet little sign of this trend reversing (see Figure 15). Domestic banks' appetite was indeed voracious between November 2011 and March 2012, but the latest available data (for April) may have already indicated that their appetite has started to wane – gross holdings of Spanish government securities by Spanish credit institutions in April fell by €3bn to €252bn, the first fall since October 2011 (Figure 16). Between October 2011 and March 2012, Spanish government bond holdings by Spanish banks had risen by almost 50%. On the other hand, loans to the general government stayed relatively flat in April, having risen more slowly over the preceding months.

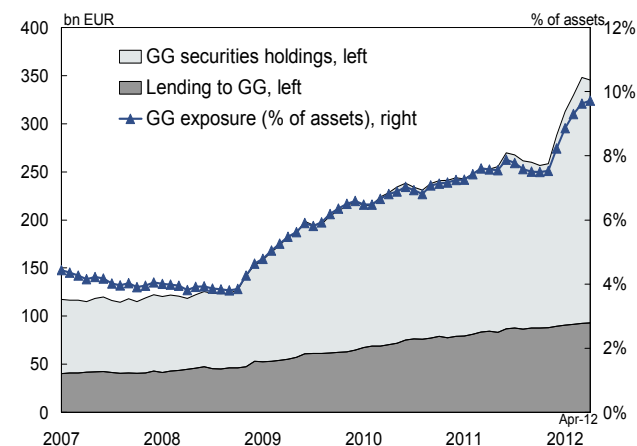
Figure 15. Spain – Foreign Ownership of Government Debt, 2003 – Mar 2012



Note: GG is general government. GG debt includes securities and loans. Foreign holdings of Central Government securities include term investment holding of securities as well as net position in "repo". All values are in gross terms.

Source: Bank of Spain, Spanish Treasury, and Citi Investment Research and Analysis

Figure 16. Spanish Banks – Exposure to Spanish General Government, 2008 – Apr 2012



Note: GG is general government. Total holdings of GG securities are in gross terms. GG exposure include both GG securities holdings and lending

Source: Bank of Spain and Citi Investment Research and Analysis

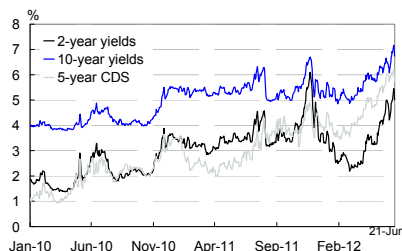
Additional extraordinary funding measures by the ECB and heavy financial repression of domestic financial institutions could help the Spanish government to keep technical market access – but yields or funding costs are also a big concern at current levels.

It is also possible that the willingness of *some* Spanish banks to buy Spanish bonds will be kept high or even boosted, based on the fact that the Spanish government will likely soon become a major bank equity holder following the upcoming round of bank recapitalization. But willingness to buy Spanish bonds is, of course, only one side of the equation. Ability is the other. Continued liquidity outflows and concern about credit risks in respect of the Spanish sovereign are likely to weigh on Spanish bank appetite for Spanish government bonds. The very large bond purchases of the past six months were boosted by the two ECB LTROs and we cannot rule out another round of long-duration LTROs or another round of measures to ease collateral requirements, beyond even the collateral requirements relaxation announced by the ECB on June 22, 2012 – in fact, we expect it.⁴¹ But we consider

⁴⁰ <http://uk.reuters.com/article/2012/05/23/uk-spain-regions-idUKBRE84M1AS20120523>

⁴¹ ECB Press Release, 22 June 2012 - ECB takes further measures to increase collateral availability for counterparties, <http://www.ecb.int/press/pr/date/2012/html/pr120622.en.html>

Figure 17. Spain – Yields on Government Bonds (%), 2010 – June 2012



Source: Bloomberg and Citi Investment Research and Analysis

Italy is likely to be the next systemically important euro area country to request a troika bail-out.

With very high government debt and a primary surplus, Italy appears to be a prime candidate for rational sovereign default.

it unlikely that Spanish banks – and other domestic financial institutions – will continue exhibit the extreme appetite to absorb ever-increasing amounts of domestic government debt displayed during 2011 and in Q1, 2012.

Even if funding access were not a concern, funding costs and secondary market yields could be. Figure 17 show how secondary market yields of the Spanish government have risen strongly again in recent weeks, fully reversing the fall in yields in the wake of the ECB LTROs in Q4 2011 and Q1 2012. 10-year yields in Spain recently exceeded 7% on a number of occasions. With total general government refinancing needs of around €150bn a year in 2012 and 2013, a 2ppt increase in average funding cost would add EUR3bn a year to the deficit in the first year alone. Higher actual interest costs are already making it more difficult for the Spanish government to bring down the fiscal deficit – and, of course, such very high interest costs, if maintained over extended periods of time, would threaten the solvency of the Spanish sovereign. With debt at almost 90% of GDP, a 2pp increase in average interest rates would raise the steady state interest burden by almost 2% of GDP. Higher secondary market yields also make life much harder for some holders of Spanish bonds, notably Spanish banks, as they reduce the MTM valuation of collateral at the ECB and raise their own funding costs.

Italy next?

The next euro area member state to request financial support from the EFSF/ESM is likely to be either Cyprus ([Cyprus — Next in Line for a Bailout?](#)) or Italy ([Focus on Italy](#)). We focus here on the more systemically important case of Italy.

We see at least five domestic reasons why Italy is an early candidate for recourse to external financial support: (1) the large stock public debt, the constant reminder this provides to opportunistic politicians of the benefits of sovereign debt default and the constant risk of loss of market access that it brings; (2) slower-than-expected growth; (3) a prime minister committed to not implementing additional austerity should the government deficit overshoot its target level because of weaker-than-expected activity, together with our expectation that growth in Italy will undershoot official forecasts; (4) disappointing progress on growth-enhancing structural reform and privatisation and (5) the continued dependence of PM Monti's technocratic government on the same parliament that brought the country close to losing market access in the autumn of 2011. Solvency and access to market funding for the Italian banking sector are an additional concern.

Rational default

Italy has the highest general government gross and net stocks of debt as a percentage of GDP in the euro area except for Greece at, respectively 120% and 100% of GDP at the end of 2011. Its (general government) primary budget, on the other hand, showed a small surplus of 0.8% of GDP in 2011 (according to the latest IMF Fiscal Monitor) and its structural or cyclically corrected primary budget surplus was estimated by the IMF at 1.9% of GDP.

The theory of rational sovereign default implies that a sovereign is more likely to default the larger its debt and the smaller its likely post-default borrowing requirement, typically measured by the general government primary (non-interest) surplus. The reason is that the benefits from sovereign default (as from all default) are measured by the stock of debt that no longer needs to be serviced while the costs of sovereign default tend to be limited to a period of exclusion from the capital markets (or at least the international capital markets) and continued higher borrowing costs even after access is restored. So why has the Italian sovereign not defaulted already?

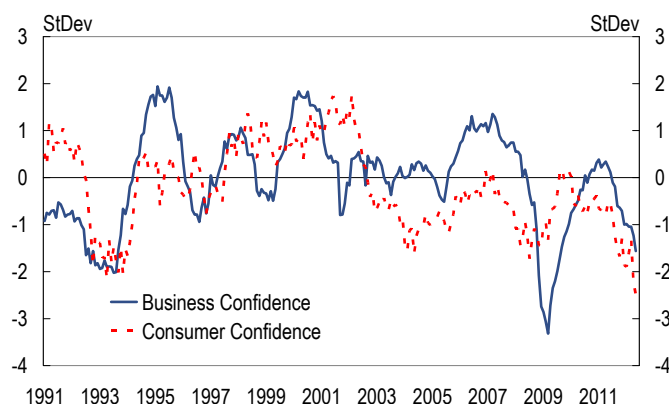
Even if the theory of rational (or opportunistic) default tells the whole story, there are at least two reasons consistent with the theory why the Italian sovereign would continue to service its debt despite the high debt burden and the structural primary budget surplus. The first is that the Italian banking sector is highly dependent on Eurosystem funding and that opportunistic default by the Italian sovereign would likely mean that defaulted Italian sovereign or sovereign-guaranteed debt would no longer be acceptable as collateral within the Eurosystem or for an Italian Emergency Liquidity Assistance (ELA) facility, should one be created. The second reason is that the future is uncertain and that a structural primary budget surplus today is no guarantee that there will not be future periods when the government might wish to borrow. In addition, there are reasons for honouring sovereign debt obligations that are not captured by the theory of rational default. These include the moral argument that governments should honour their debt because it is the right thing to do. Furthermore, there are systemic rule of law externalities from a sovereign default. The sovereign is ultimately responsible for the enforcement of legal contracts in its jurisdiction. For the sovereign to play fast and loose with its own contractual obligations would therefore not do much to enhance or maintain the respect for the inviolability of contracts in the rest of its jurisdiction. These reasons suggest that, despite high debt and a primary surplus, default may not be all that rational currently for Italy's sovereign after all, but it would be rash to dismiss the temptation of default too lightly.

Recession is deepening

Italy is sinking deeper into recession.

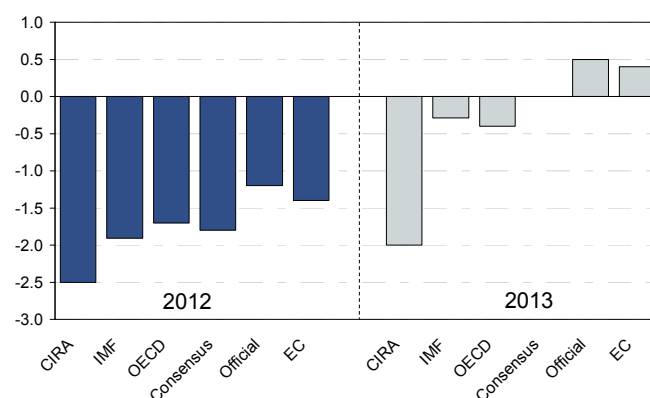
Italy's GDP has contracted for three consecutive quarters (from 3Q11 to 1Q12), and recent sentiment indicators indicate that the recession will deepen further in Q2 12 (Figure 18). The Italian government's GDP growth forecasts (of a contraction of 1.2% for 2012 and an expansion of 0.5% for 2013) look optimistic to us, and our own forecasts indicate a recession for both 2012 and 2013 (of 2.5% in 2012 and 2.0% in 2013, see Figure 19).

Figure 18. Italy — Consumer and Business Confidence (Standard Deviation Around Average), 1991-May 2012



Sources: Haver and Citi Investment Research and Analysis.

Figure 19. Italy — Comparison of GDP Forecasts for 2012 - 2013 (%)



Note: Consensus refers to average of forecasts provided by Bloomberg.

Source: IMF, OECD, Italian Ministry of Economy and Finance, Bank of Italy, Bloomberg and Citi Investment Research and Analysis

After initial success, PM Monti's government reform drive has disappointed, notably on structural reforms.

Disappointing reform progress and political gridlock

After the departure from office of premier Silvio Berlusconi on November 12, 2011, the incoming technocratic government of premier Mario Monti initially made all the right noises about austerity and growth and passed a number of fiscal and structural reforms. Most of these reforms were initially passed by decree, but were subsequently confirmed in parliament. Since then, however, the reform agenda has stalled, although the Monti government has continued to benefit from a consistently high ratio of PR to performance.

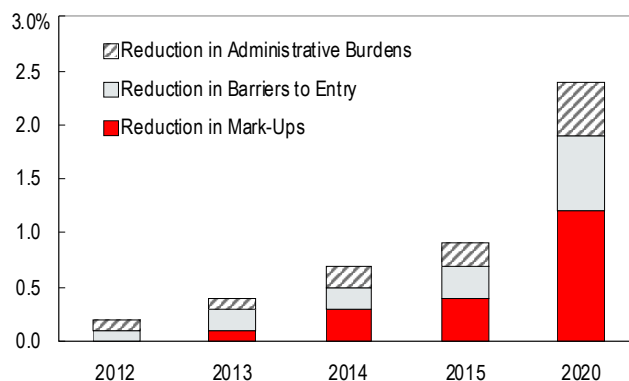
The main achievement of the Monti administration remains the completion, in December 2011, of the pension reforms initiated under Berlusconi – part of a fiscal package adopted by decree on December 5, 2011, that is supposed to save about €30bn over the three years 2012-2014, and will continue to produce large savings thereafter. Together with other fiscal measures, the December 2011 package could sum to a credible fiscal effort towards consolidation, as long as growth can be raised from the morose levels of the past decade (Figure 20). Structural reform becomes even more essential for pressures on public debt to be contained, as Monti has been an early standard bearer for the 'growth rather than austerity' school of thought, stressing that fiscal slippage in a deteriorating growth environment would not be made up with additional fiscal measures.

Figure 20. Cumulative Effect of Measures Introduced by Various Decrees on GG Net Borrowing, 2011-14F

| | 2011 | 2012 | 2013 | 2014 |
|-------------------------|------------|-------------|-------------|-------------|
| Decree Law 98/2011 | 2.1 | 5.6 | 24.4 | 48 |
| Decree Law 138/2011 | 0.7 | 22.7 | 29.6 | 11.8 |
| Stability Law (2012-14) | 0 | 0.4 | 0.2 | 0.1 |
| Decree Law 201/2011 | 0 | 20.2 | 21.3 | 21.4 |
| Total (bn EUR) | 2.8 | 48.9 | 75.5 | 81.3 |
| Total (% of GDP) | 0.2 | 3.1 | 4.7 | 4.9 |

Source: Ministry of Finance

Figure 21. Cumulative Impact of Product Market Reforms on GDP (% of GDP), 2012-2020F

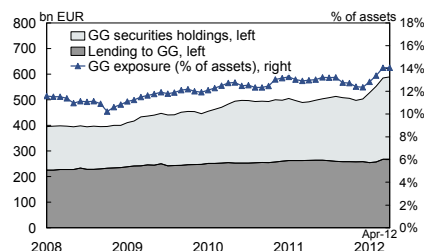


Sources: OECD

However, on the structural reform side, progress has been disappointing. The long-awaited labour reform – meant to be the signature structural reform – has been bogged down in acrimonious disputes between the different parties, employer representatives and the unions.⁴² That may not matter all that much, as its latest draft has in any case been watered down to the point of ineffectiveness. On the opening of professions, service sector liberalization and privatization, the Monti government has also failed to make much progress to date (Figure 21).

⁴² Please see [Euro Area: Sovereign Debt Crisis Update](#) – 19 June 2012

Figure 22. Italian Banks – Exposure to Italian General Government, 2008 – Apr 2012



Note: GG is general government. Total holdings of GG securities are in gross terms. GG exposure includes both GG securities holdings and lending.

Source: Bank of Italy and Citi Investment Research and Analysis

The likely ingredients of troika programmes for Italy and Spain would be some degree of fiscal and structural reform conditionality on the sovereign, funding for the sovereign provided by the EFSF/ESM, and involvement of the IMF in the design and monitoring.

EFSF's precautionary programmes: the Precautionary conditioned credit line (PCCL), the Enhanced conditions credit line (ECCL) and the enhanced conditions credit line with partial risk protection (ECCL+).

With a general election due by the spring of 2013 at the latest, increasing frictions within the Monti government and between the different parties on whose support the government relies and an increasingly restive public, renewed reform momentum seems unlikely, even though the labour reform, another 'growth package' and the spending review are currently still under discussion. To restore lasting access to market funding for the sovereign on affordable terms, we believe the country likely needs a government that has procedural or input legitimacy and is committed to the deep structural reforms Italy needs to restore growth and to generate the sustained moderate additional fiscal austerity required to put Italy on a decisive downward path for its public debt to GDP ratio. Without a sustained reduction in its public debt burden, the country will be permanently at risk of an ambush by markets withdrawing funding because of a self-fulfilling fear that prohibitive borrowing costs will force the government to default on its debt, and it is unlikely that Italy can indefinitely count on its financially repressible financial institutions to purchase its sovereign debt (Figure 22). In the absence of such a government, credibility as regards the delivery of serious fiscal and structural reform may be, imperfectly, provided by a troika programme.

Which types of programmes?

Troika programmes for both Spain and Italy are likely because of both countries' lack of access to affordable funding and because of the credibility deficits incurred by both countries' governments with investors, European institutions, other European governments and the ECB as regards the ability or willingness to pursue serious fiscal and structural reform. What exactly such programmes would or should contain is not clear. To us, the likely ingredients would be some degree of fiscal and structural reform conditionality on the sovereign, funding for the sovereign provided by the EFSF (or ESM once it is born), and involvement of the IMF in the design and monitoring of the programme, with IMF co-funding possible but not essential. Desirable features of these programmes – from the perspective of euro area policymakers – would be for the IMF to also partially fund the programme and for the sovereigns in question to retain some form of market access. Both of these features would be desirable to limit the amount of funding to be provided by the euro area rescue facilities, which we argue are too small. Continued market access would also be useful to possibly prevent Spain and Italy from becoming step-out guarantors for the EFSF, and as a PR effort to distinguish Spain and Italy in the eyes of the public, investors and the Spanish and Italian voters from Greece, Ireland and Portugal. It is also possible that normal market access could be regained more easily if a semblance of market access is maintained all the way through.

Since October 2011, the EFSF has been able to fund precautionary as well as macroeconomic adjustment programmes. There are three types of precautionary programmes, the Precautionary Conditioned Credit line (PCCL), closely modeled on the IMF's Flexible Credit Line (FCL) and the IMF's Precautionary Credit Line (PCL, now modified and renamed into the Precautionary and Liquidity Line, PLL), the Enhanced Conditions Credit line (ECCL) and the Enhanced Conditions Credit line with partial risk protection (ECCL+) (Figure 23). The precautionary programmes are meant to have 'lighter procedures' (presumably meaning less strict or less extensive conditionality and less extensive assessment and monitoring) and 'be more swiftly implementable' than regular programmes.⁴³ They are also meant to be of shorter duration (one year, twice renewable for six months) and, while they do not specify an upper limit, are intended to be relatively small (2-10% of GDP).

⁴³ http://www.efsf.europa.eu/attachments/efsf_guideline_on_precautionary_programmes.pdf

Figure 23. EFSF – Precautionary Programmes

| | Precautionary conditioned credit line (PCCL) | Enhanced conditioned credit line (ECCL) |
|----------------------|---|--|
| Access | robust policy frameworks / strong track records in economic performance | sound policies and fundamentals / no sufficient criteria to use the PCCL |
| Benchmark | IMF's Flexible Credit Line (FCL) | IMF's Precautionary Credit Line (FCL) |
| Ex-ante conditions | Yes | Yes |
| Ex-post conditions | No | Yes |
| Cap | No upfront cap | No upfront cap |
| Typical size | 2-10% of GDP | 2-10% of GDP |
| Information exchange | Yes | Yes |
| Duration | 1 year, renewable for 6 months twice | 1 year, renewable for 6 months twice |

Note: ECCL features in this table also apply to the ECCL+.

Source: EFSF and Citi Investment Research and Analysis

EFSF/ESM precautionary programmes are conditional and require unanimous non-objection by the Eurogroup.

Some things precautionary programmes are not. First, they are not unconditional – the individual facilities even have 'conditioned' in their name. Second, they are not available without a prior request for assistance.

Both the PCCL and the ECCLs involve ex-ante (qualifying or eligibility) conditionality, compliance with which is to be maintained over time. The ECCLs also include ongoing or ex-post conditionality. The ex-ante conditionality or eligibility criteria are supposed to follow those of the IMF facilities, with the PCCL aimed at 'member states where the economic and financial situation is still fundamentally sound and which remain evidently committed to maintaining sound and credible policies in the future', and the ECCLs aimed at 'member states whose general economic and financial situation remains sound, but which do not comply with some of the eligibility criteria required for accessing a PCCL'. The PCCL criteria specified are based on a 'global assessment', 'using as a basis the following criteria':

Eligibility criteria for access to EFSF precautionary programmes are:

- Respect of the SGP commitments
- A sustainable public debt
- Respect of countries' EIP commitments
- A track record of access to international capital markets on reasonable terms.
- A sustainable external position
- The absence of bank solvency problems posing systemic threats to euro area banking system stability

- Respect of the SGP commitments. Countries under excessive deficit procedure could still access PCCL, provided they abide fully by the various Council decisions and recommendations aimed at ensuring a smooth and accelerated correction of their excessive deficit.
- A sustainable public debt.
- Respect of their EIP commitments. Countries under an excessive imbalance procedure could still access PCCL, provided that they can demonstrate that they are committed to addressing the imbalances identified by the Council.
- A track record of access to international capital markets on reasonable terms.
- A sustainable external position.
- The absence of bank solvency problems that would pose systemic threats to the euro area banking system stability.

The basis of the judgment of being of fundamentally sound status is left open for the PCCL.

The process for activation is not conceptually all that different between precautionary and normal programmes, either. Both require a request for assistance by a EA member state to the remainder of the Eurogroup, followed by an assessment by the EC and ECB (the IMF is not explicitly named but could clearly be 'invited' to participate), culminating in the need for the unanimous non-objection by the members of the Eurogroup on whether to grant access, or which type of programme, which amount and which duration to offer. The Memorandum of Understanding (MoU) and the Financial Assistance Facility Agreement (FFA) may be signed at the same time.

In addition, precautionary programmes are also subject to quarterly monitoring (even before 'activation', i.e. before any money has actually been disbursed)

Precautionary programmes are also subject to quarterly monitoring (even before 'activation', i.e. before any money has actually been disbursed). Activation of the programme would again be at the applicant's request, and the applicant needs to give the EFSF at least a week's notice of its intention to draw funds. For precautionary programmes a decision on whether the applicant steps out would be taken on a 'case-by-case basis' (once a country becomes a 'step-out guarantor', its loan agreements before it stepped out remain, but it no longer contributes to future loan guarantees).⁴⁴ The terms of the funding provided would be the same as for EFSF loans and the Eurogroup could cancel the credit line after an assessment by the EC that the member state was no longer in compliance with the policy conditions of access.

There have not been any precautionary EFSF programmes to date, so we cannot say with much confidence how the criteria for accessing the PCCL and the ECCL would be interpreted. There have also not been any programmes under the modified PLL of the IMF.⁴⁵ However, the fact that Spain does not clearly meet *any* of the criteria for the PCCL suggests that this facility should be out of the question, and it would be quite a stretch to offer access to Italy on this facility. But we cannot rule out a fudge that would eventually allow the use of the ECCL or the ECCL+ by Spain and/or Italy. However, even if Spain and Italy qualified, the 1-2-year horizon of the programmes would not seem adequate.

Primary and secondary market purchases, partial protection certificates and loans can be provided as part of normal or precautionary programmes

A separate, but related question is how the assistance would be provided under whatever type of programme Spain or Italy qualify for. In July 2011, the EA HoSHoGs decided to give the EFSF the option not only to lend to sovereigns, but also to purchase their bonds in primary and secondary markets, and in October 2011 they added the option of using partial protection certificates, providing first loss protection for a portion of the principal value of a sovereign bond issued by the sovereign at a primary auction. These partial protection certificates could be separable and traded freely after issuance, to avoid dividing the sovereign's outstanding stock of debt into safer and a less safe portions. Primary and secondary market purchases, partial protection certificates and loans can be provided as part of normal or precautionary programmes, with the conditionality applied depending in principle on the programme, not the channel through which the assistance is provided. However, in particular for secondary market purchases, the EFSF guidelines do reflect the fact that a request for such purchases may be more urgent and note that the EC, in liaison with the ECB, would prepare a MoU within 1-2

⁴⁴ http://www.efsf.europa.eu/attachments/efsf_guideline_on_precautionary_programmes.pdf. Section 8.2 of the EFSF Agreement states the following regarding stepping-out guarantor:

"In the event that a Guarantor experiences severe financial difficulties and requests a stability support loan or benefits from financial support under a similar programme, it (the "Stepping-Out Guarantor") may request the other Guarantors to suspend its commitment to provide further Guarantees under this Agreement. The remaining Guarantors, acting unanimously and meeting via the Eurogroup Working Group may decide to accept such a request and in this event, the Stepping-Out Guarantor shall not be required to issue its Guarantee or incur any new liabilities as Guarantor in respect of any further issues of or entry into Funding Instruments by EFSF and any further Guarantees to be issued under this Agreement or any new liabilities to be incurred as Guarantor shall be issued and/or incurred by the remaining Guarantors and the Adjusted Contribution Key Percentage for the issuance of further Guarantees or incurrence of any new liabilities as Guarantor shall be adjusted accordingly. Such adjustments shall not affect the liability of the Stepping-Out Guarantor under existing Guarantees. It is acknowledged and agreed that the Hellenic Republic is deemed to be a Stepping-Out Guarantor with effect from the entry into force of this Agreement, Ireland became a Stepping-Out Guarantor with effect from 3 December 2010 and Portugal, with effect from 16 May 2011."

http://www.efsf.europa.eu/attachments/20111019_efsf_framework_agreement_en.pdf

⁴⁵ In fact, the guidelines for the access to and use of this programme have only been published recently. See <http://www.imf.org/external/pp/longres.aspx?id=4660>

In our view, it is much more likely that the IMF will contribute to the funding if Spain and Italy enter a normal programme, rather than a precautionary programme.

If and when Spain or Italy enter a programme, they are likely to continue to fund themselves partially in the market, in our view

days.⁴⁶ The need for a request and unanimous approval and some assessment, and the scope for conditionality remain untouched, however.

It is not clear whether or in what form the IMF might be involved in a likely Italian or Spanish programme, beyond contributing to the design and monitoring of the programme. As noted previously, the IMF is not expected to contribute to the funding of the Spanish bank bail-out, although it did provide part of the funding for the 1st and 2nd Greek programme, and the Irish and Portuguese troika programmes. In our view, it is much more likely that the IMF will contribute to the funding if Spain and Italy enter a normal programme, rather than a precautionary programme. For precautionary programmes, the EFSF/ESM facilities seem to duplicate the IMF's existing facilities and the IMF would decide on the criteria to be applied to assess eligibility, reducing the scope for the European governments to fudge access, should they be so inclined. The IMF only lends to sovereigns, so it would not be involved in any primary or secondary market purchases. However, even though the IMF requires that an adjustment programme be funded at least 12 months in advance, partial funding of Italy and Spain by the EFSF/ESM and IMF would not rule out IMF participation if a plausible case can be made for the assumption of market access by the sovereign for the residual.

Partial funding by the programme would require other investors to take up the residual of the respective sovereign's funding needs. It is possible, perhaps plausible, that the willingness of non-captive ("financially irrepressible") private investors to purchase the residual issuance of sovereign bonds would fall after entry into a troika programme, or at least that the yield at which they would be prepared to do so would go up. This is because private investors would likely be effectively subordinated to official lenders in this scenario (with virtual certainty in the case of IMF funding). In our view, it is therefore likely that a variation of the arrangement that has existed for the past six months or so, according to which the ECB provides highly subsidized funding to periphery banks and for some of these banks and some other financial institutions, prodded by their national authorities, to buy domestic government bonds, would have to continue for the presumption of partial access to market funding to be validated for Italy and Spain.

⁴⁶http://www.efsf.europa.eu/attachments/efsf_guideline_on_interventions_in_the_secondary_market.pdf

Figure 24. Selected Countries — Financing Needs, Bond Redemptions and Budget Deficits, 2012-2014

| Country/Group | 2012 | | 2013 | | 2014 | | 2012 - 2013 Q2 | | 2012 - 2014 Q2 | |
|-------------------------------|-------------|----------------|-------------|----------------|-------------|----------------|----------------|----------------|----------------|----------------|
| | redemptions | budget deficit | redemptions | budget deficit | redemptions | budget deficit | redemptions | budget deficit | redemptions | budget deficit |
| Austria | 12.5 | 5.6 | 16.1 | 7.9 | 24.8 | 6.8 | 15.4 | 9.5 | 32.2 | 16.9 |
| Belgium | 17.2 | 5.3 | 31.6 | 5.9 | 29.7 | 1.6 | 31.4 | 8.3 | 63.9 | 12.0 |
| Cyprus | 2.2 | 0.4 | 2.2 | 0.3 | 0.9 | 0.0 | 3.7 | 0.5 | 4.8 | 0.6 |
| Finland | 6.1 | 1.7 | 6.2 | 1.6 | 6.9 | 0.7 | 6.1 | 2.5 | 12.5 | 3.6 |
| Greece | 0.0 | 12.6 | 12.0 | 4.7 | 15.3 | 4.4 | 9.2 | 14.9 | 21.7 | 19.4 |
| Ireland | 0.0 | 8.4 | 6.0 | 15.2 | 8.2 | 11.9 | 6.0 | 16.0 | 14.3 | 29.6 |
| Italy | 103.6 | 26.0 | 158.2 | 40.9 | 151.6 | 42.8 | 172.5 | 46.5 | 327.4 | 88.3 |
| Spain | 72.5 | 39.6 | 95.5 | 66.8 | 68.8 | 51.7 | 125.6 | 73.0 | 199.0 | 132.3 |
| Portugal | 2.7 | 2.3 | 11.3 | 5.8 | 14.2 | 6.5 | 3.0 | 5.2 | 20.3 | 11.4 |
| France | 67.6 | 52.6 | 126.3 | 85.0 | 112.9 | 79.8 | 115.9 | 95.1 | 248.3 | 177.4 |
| Germany | 106.3 | 7.4 | 208.2 | 8.7 | 156.6 | 6.5 | 223.6 | 11.8 | 411.3 | 19.4 |
| Netherlands | 45.5 | 16.3 | 34.7 | 22.0 | 32.0 | 15.0 | 62.7 | 27.3 | 96.1 | 45.8 |
| GR+IR+PO | 2.7 | 23.3 | 29.4 | 25.6 | 37.7 | 22.9 | 18.3 | 36.1 | 56.3 | 60.4 |
| SP+IT | 176.1 | 65.6 | 253.7 | 107.7 | 220.5 | 94.5 | 298.1 | 119.5 | 526.4 | 220.6 |
| GR+IR+PO+BE+SP+CY+IT+FR+NE+AU | 323.9 | 169.1 | 494.1 | 254.4 | 458.5 | 220.5 | 545.4 | 296.3 | 1028.1 | 533.8 |

Note: Excludes bailout programmes. Data collected as of 20 June. Budget deficit values correspond to CIRA forecasts as 23 of May and for 2012 are distributed evenly throughout the year. 2012 redemptions apply to the remainder of the year.

Source: CIRA forecasts, Bloomberg

Financial repression of domestic banks may get more difficult over time.

However, it is plausible that these banks will balk at the ever-heavier weight of financial repression, or, perhaps even more plausibly, that moves towards banking union would no longer permit periphery sovereigns to continue to impose de-facto taxes on the banks formerly under their sole jurisdiction, through financial repression, that is, by forcing banks to purchase more sovereign debt than they would voluntarily do and at prices higher than their fair value. In such a case, the partial troika programme could eventually morph into a full troika programme, with full funding of the sovereign. It is, of course, in principle possible that, even after full banking union, some form of financial repression would be imposed by the single EA regulator/supervisor on the EA banks in its jurisdiction. The degree of financial repression need not be uniform across member states (or even across banks in the same member states), and the end-result could potentially be not all that different from the nationally differentiated financial repression we have at the moment.

But even for troika programmes that are 'only' supposed to fill part of the funding requirements of the Spanish and Italian sovereigns, some issues would still need to be addressed. One is that the EFSF, and later also the ESM, are only pre-funded to a very limited extent and would in principle need to raise most of the funds in the market. Simply assuming that the EFSF could do so fast enough and on financially acceptable terms would seem ill-advised. As regards the ESM, it may not yet be as tainted in the eyes of the market as the EFSF, but it again would be very imprudent simply to assume that it could issue unquestionably liquid instruments at short notice and on acceptable terms to fund the Italian and Spanish sovereigns in periods of market turmoil.

We think alternative, more robust funding backstops would need to be found in time. First among these alternatives would be making the ESM an eligible counterparty for the Eurosystem's financing facilities. For this to be acceptable to the ECB, a joint and several or possibly just a pro-rata guarantee by the EA member state governments is likely to be required. Without such a guarantee, the quasi-fiscal exposure to the sovereigns of the Eurosystem would grow virtually without bound, unless the Eurosystem imposes deep haircuts on ESM borrowing from its facilities. Another possibility would be to use the EIB as a conduit for fundraising (it already is an eligible counterparty for collateralized borrowing at the Eurosystem), or the EFSF/ESM's Co-investment Funds, once they come into existence. Numerous

political, legal and operational hurdles would undoubtedly need to be overcome for this to happen, but we expect that some arrangement would be found to shield the funding of the rescue facilities from the vagaries of the markets.

Another issue that would need to be confronted even assuming troika programmes were only partial is the inadequate size of the EA funding vehicles (Figure 25). Again, in time an increase in the size of the rescue facilities will likely come back onto the agenda, in our view.

Figure 25. Euro Area – Lending Capacity of Rescue Facilities (EUR bn)

| | EFSF | ESM | EFSM | IMF (USD bn) |
|--------------------|------|----------|------|--------------|
| Maximum capacity | 440 | 700-EFSF | 60 | 1,301 |
| Remaining capacity | 148 | 700-EFSF | 13 | 840 |

Note: ESM lending capacity will be EUR200bn for 2012 and in principle up to EUR500bn from 2013 onwards, but it is not expected to exceed EUR700bn together with the EFSF. EUR148bn for the remaining EFSF capacity are arrived at by deducting committed funds for the Irish, Portuguese and 2nd Greek programme as well as EUR100bn for the Spanish programme from EUR440bn. IMF values are arrived at by adding to the total IMF resources of USD845bn (for maximum capacity) and to the forward commitment capacity of USD384bn (for remaining capacity) the estimated increase of USD456bn in IMF resources agreed in the Spring Meeting (<http://www.imf.org/external/np/sec/pr/2012/pr12231.htm>)

Source: IMF, European Commission, EFSF, and Citi Investment Research and Analysis

What conditionality?

Actual programme conditionality is likely to build on but go beyond existing recommendations of the European Commission (Excessive Deficit Procedure and the Macroeconomic Imbalance Procedure) and the IMF (Article IV)

If and when Spain and Italy enter troika programmes involving conditionality on the sovereign, we expect the conditionality to be applied to build on existing recommendations of the European Commission in the context of the Excessive Deficit Procedure and the Macroeconomic Imbalance Procedure and by the IMF as part of its Article IV discussions.

Actual programme conditionality is likely to go beyond these recommendations and to be made more precise – these recommendations tend to be rather vague and unintrusive. For Spain, the European Commission and the IMF have suggested some fiscal measures (broadening the VAT tax base and raising VAT rates) and many structural ones (implementing the labour reform, improving training and active labour market policies, improving the employability of young people), including some that also have a fiscal dimension. These include moving from taxes on wages towards consumption and environmental taxation; reviewing spending priorities to support access to funds for SMEs, research, innovation and young people; accelerating the increase in the statutory entitlement age for the state retirement pension and introducing of a sustainability factor linking the entitlement age, benefits or contributions to demographic developments; and implementing a proper multi-year budgeting process. Some of the EC's and IMF's recommendations have focused on banking (dealing with legacy assets, 'addressing' weak institutions, clarifying the funding and use of bail-out facilities, introducing a resolution regime).

For Italy, fiscal measures suggested by the EC and the IMF have thus far been limited to reducing the scope for tax exemption, cutting allowances and reducing VAT rates, and limiting the size of the shadow economy by stepping up checks and controls. Structural measures suggested include strengthening some aspects of the institutional fiscal framework, increasing the quality and efficiency of public expenditure, strengthening the link between wages and productivity, opening up the professions, liberalizing the service sector, and streamlining some judiciary procedures.

In both countries, a major focus of the conditionality would likely be to ensure implementation of reforms, both those that have already been agreed, approved by decree or legislative decision and announced, but have yet to be implemented, and additional reforms.

Sovereign ratings and related considerations

Currently, DBRS has Spain's ratings at four notches above junk (AH), S&P at three (BBB+), Fitch at two (BBB) and Moody's at one (Baa3).

For Italy: DBRS ratings at six notches above junk, Moody's and Fitch at four notches above, and S&P at three

The ratings of the Spanish sovereign in particular have recently been in free-fall. Currently, DBRS has Spain's ratings at four notches above junk (AH), S&P at three (BBB+), Fitch at two (BBB) and Moody's at one (Baa3). For Moody's and DBRS, Spain's rating is currently on 'negative watch', and for S&P and Fitch it is on 'negative outlook'. Spain's sovereign bond rating is thus kept in the first two steps of the ECB's credit quality assessment only by the grace of DBRS – which has indicated an intention to review the Spain rating soon. It therefore seems likely that Spain will soon fall out of the first-quality tier at the ECB, raising haircuts on Spanish government bonds as collateral by 5pp across the board (Figure 26).

Italy has some more wiggle room, again due to DBRS which rates Italy at AH (four notches above junk, though with negative watch), with Moody's and Fitch at four notches above (and negative outlook in both cases), and S&P at three (again with negative outlook).

LCH Clearnet on June 19 raised its haircuts on Spanish bonds used as collateral. The increase appears relatively small but the overall level of haircuts at LCH Clearnet are already much higher than those applied at the ECB.⁴⁷ Spain's haircuts at LCH Clearnet are also now generally higher than haircuts on Italian bonds, which were also raised recently.

Figure 26. Eurosystem – Levels of Valuation Haircuts Applied to Eligible Marketable Assets

| Credit Quality | Residual Maturity (Years) | Liquidity categories | | | | | | | | Category V |
|----------------|---------------------------|----------------------|-------------|--------------|-------------|--------------|-------------|--------------|-------------|--------------|
| | | Category I | | Category II | | Category III | | Category III | | |
| | | fixed coupon | zero coupon | fixed coupon | zero coupon | fixed coupon | zero coupon | fixed coupon | zero coupon | |
| Steps 1 and 2 | | | | | | | | | | |
| (AAA to A-) | 0-1 | 0.5 | 0.5 | 1.0 | 1.0 | 1.5 | 1.5 | 6.5 | 6.5 | 16 |
| | 1-3 | 1.5 | 1.5 | 2.5 | 2.5 | 3.0 | 3.0 | 8.5 | 9.0 | |
| | 3-5 | 2.5 | 3.0 | 3.5 | 4.0 | 5.0 | 5.5 | 11.0 | 11.5 | |
| | 5-7 | 3.0 | 3.5 | 4.5 | 5.0 | 6.5 | 7.5 | 12.5 | 13.5 | |
| | 7-10 | 4.0 | 4.5 | 5.5 | 6.5 | 8.5 | 9.5 | 14.0 | 15.5 | |
| | >10 | 5.5 | 8.5 | 7.5 | 12.0 | 11.0 | 16.5 | 17.0 | 22.5 | |
| Step 3 | | | | | | | | | | |
| (BBB+ to BBB-) | 0-1 | 5.5 | 5.5 | 6.0 | 6.0 | 8.0 | 8.0 | 15.0 | 15.0 | Not eligible |
| | 1-3 | 6.5 | 6.5 | 10.5 | 11.5 | 18.0 | 19.5 | 27.5 | 29.5 | |
| | 3-5 | 7.5 | 8.0 | 15.5 | 17.0 | 25.5 | 28.0 | 36.5 | 39.5 | |
| | 5-7 | 8.0 | 8.5 | 18.0 | 20.5 | 28.0 | 31.5 | 38.5 | 43.0 | |
| | 7-10 | 9.0 | 9.5 | 19.5 | 22.5 | 29.0 | 33.5 | 39.0 | 44.5 | |
| | >10 | 10.5 | 13.5 | 20.0 | 29.0 | 29.5 | 38.0 | 39.5 | 46.0 | |

Note: For categories II to V individual asset-backed securities, covered bank bonds (jumbo covered bank bonds, traditional covered bank bonds and other covered bank bonds) and uncovered bank bonds are subject to an additional valuation haircut. This haircut is directly applied at the level of the theoretical valuation of the individual debt instrument in the form of a valuation markdown of 5%.

Source: ECB and Citi Investment Research and Analysis

Another issue is ratings-based bond index eligibility. For the EGBI index, for example, a sovereign needs to be rated investment grade by at least one of Moody's and S&P to be included. Italy's distance from the ratings threshold at which it would drop out of the index is therefore currently four notches (from Moody's; S&P has Italy at three notches above junk). For Spain the distance is three notches (this time from S&P; Moody's has Spain at only one notch above junk). In the case of Portugal, the exclusion from major bond indices following the loss of its investment grade rating is commonly cited as a major driver of the massive run-up in yields in January 2012.

⁴⁷ http://www.lchclearnet.com/Images/Notice_FixedIncome_Parameters_20120619_GB_tcm6-61558.pdf

Moody's has already mentioned that it does not consider programme access consistent with an investment grade rating:

"Given the experience with PSI in Greece and the intentions expressed by euro area officials around the development of the ESM, Moody's believes the debts of euro area sovereigns that are dependent upon funding support from official sources represent non-investment grade risks..."⁴⁸

Figure 27. Spain – Sovereign Ratings, 2008 – 2012

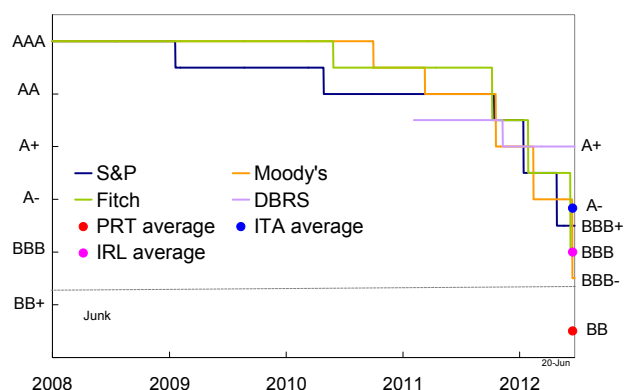
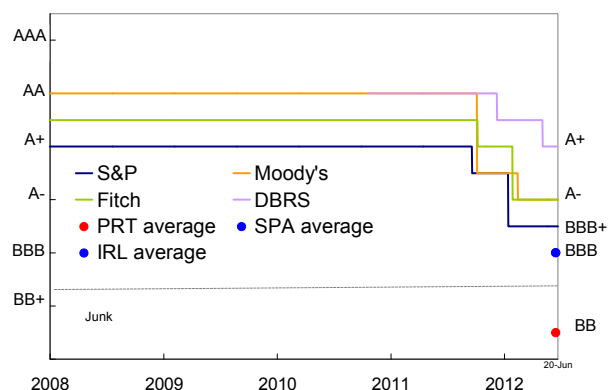


Figure 28. Italy – Sovereign Ratings, 2008 – 2012



Note: as of 20 June 2012. Averages for Portugal (PRT), Italy (ITA), Ireland (IRL) and Spain (SPA) correspond to the average of ratings in S&P, Fitch and Moody's.

Source: Rating agencies, Citi Investment Research and Analysis

Growth vs. Austerity

The growth vs. austerity debate is a logical nonsense: the former is an outcome rather than a policy

Will future troika programmes, perhaps starting with those for Spain and Italy, strike a different balance between 'growth' and 'austerity'? In our view, the growth vs. austerity debate is largely the product of fuzzy thinking. Austerity is a policy, or a set of policies: tax increases and cuts in public spending. Growth is not a policy. Growth is an outcome a country gets if it has the right set of policies, the right institutions, the right culture, the right initial conditions, the right external environment, a bit of luck and *funding*. Funding is, inevitably, required for a reduction in fiscal austerity (dosage and/or timing). A demand for less fiscal austerity is all that most growth advocacy amounts to. Funding, that is, funding on affordable terms for the sovereign and for the systemically important financial institutions, is a key necessary condition for relaxing the severity and or timing of fiscal austerity aimed at restoring fiscal sustainability.

Fiscal contractions are not self-defeating in the technical sense that higher taxes or lower public spending actually increase the government deficit: there is no evidence of a 'Keynesian Laffer curve'.

Contrary to what some commentators appear to believe, there does not seem to be a widespread view in Europe that fiscal austerity is expansionary under the economic conditions that have prevailed in Europe since 2008. Fiscal tightening *is* contractionary: it depresses the level of economic activity. There is no evidence that fiscal tightening under Europe's current conditions is self-defeating in the technical sense that higher taxes or lower public spending actually increase the government deficit: there is no evidence of a 'Keynesian Laffer curve'. Fiscal tightening may be self-defeating in the political sense, in that the minimal degree and duration of austerity required to restore fiscal sustainability is greater than the maximum amount of austerity the polity will tolerate. In that case, of course, the alternative to austerity is still not growth, but either sovereign default or sovereign access to funding on concessional or subsidised, non-

⁴⁸ "Rating Euro Area Governments Through Extraordinary Times – Implications of Spain's bank recapitalisation needs and the rising risk of a Greek Exit" Moody's Investor Service, 8th June 2012.

market terms, which will indeed support higher growth (more precisely, a higher level of economic activity) than would have prevailed under continued austerity. But it is key to be explicit about the need for one of the crucial intervening variables between less austerity and a higher level of activity – either sovereign default or an external Santa Claus (EFSF/EFSM/ESM, ECB, IMF, assorted deep-pocketed EM or Middle Eastern sovereigns or sovereign wealth funds).

It is in principle possible that there are euro area member states for which austerity is mandated not by the absence of funding on affordable terms but by European Commission *dictat* – e.g. through the application of the Excessive Deficits Procedure of the Stability and Growth Pact, through the Macroeconomic Imbalance Procedure, or through a self-imposed sense of urgency. We don't believe this to be the case for the euro area periphery countries (Greece, Ireland, Portugal, Spain, Italy and Cyprus) although for some members of the 'soft core' (Belgium, Austria, France and the Netherlands) this may be the case, especially for the Netherlands, where the government's own conviction that its credibility is at stake appears to be the prime driver behind the additional austerity the country is about to undergo.

There are just three large G7 countries – the US, Japan and Germany – that can for the time being choose the timing and dosage of their fiscal austerity at will. Specifically, they can delay raising taxes or cutting public spending with apparent impunity. For Germany this is unsurprising, as the sovereign is most likely fiscally sustainable despite a gross general government debt-to-GDP ratio in excess of 80 percent. For the US and Japan, the willingness of the markets to fund the sovereign at all maturities at extremely low interest rates, despite the manifest fiscal unsustainability of both the US and the Japanese sovereign, is paradoxical, indeed perplexing. The explanations we can provide suggest that the respite granted the US and Japanese sovereigns from the unwanted attention of the bond market vigilantes is time-limited. The rest of the world (give or take the Netherlands) has austerity imposed on it by the markets. We assume that Germany will be able to restore itself to good fiscal health without being pressured to do so by the markets. For the US and Japan we expect that there will most likely have to be a shift from the safe haven equilibrium (with its very low sovereign interest rates at all maturities) to the fear equilibrium (with much higher sovereign interest rates for the same fundamentals).

It is unclear what will trigger the shift from the safe haven equilibrium to the fear equilibrium, or when this will happen. In the case of the US, a continuing fiscal stalemate lasting into the new year, after the Presidential and Congressional elections of November 2012, could be a trigger.

In the euro area we believe that, until more concessional funds are made available through the EFSF/ESM, the IMF or indeed the ECB, there will be very limited scope for meaningful reductions in the pace and dosage of fiscal austerity for all member states where market access to funding at affordable rates is either under threat or gone completely. Some additional funding of infrastructure projects in the periphery by the EIB, other projects funded through the issuance of Project Bonds that can be jointly and severally guaranteed even under the existing Treaties and the selective and accelerated disbursement of Structural Funds and Cohesion Funds may help a little. The €130bn programme proposed by President Hollande amounts to just 1.4% of annual euro area GDP, however, and it is unclear over how long a period this money is meant to be spent or when spending under the Growth Pact will actually hit the real economy.

It is likely that, even with the limited concessional resources available, Greece will be granted a longer period over which to meet its fiscal austerity targets under the existing MoU. Similar concessions to common sense – don't engage in egregiously pro-cyclical behavior by requiring a country to make up for a government deficit overshoot due to

bad luck rather than bad faith – may be forthcoming for Ireland, Portugal and Spain (in the case of Spain this would be concessions relative to the fiscal objectives agreed with the EC). But unless the envelope of official concessional resources gets a lot larger, only limited reductions in the pace and severity of fiscal austerity are likely for the periphery.

We believe that supply-side measures (reforming labour markets, opening up the professions, deregulation of services and public utilities, privatization, reductions in marginal effective tax rates etc.) are essential for medium- and long-term growth in the euro area, but because many of them increase uncertainty in the short run, they could raise private precautionary saving and thus depress aggregate demand. Supply-side measures that boost investment, especially if this can be funded by FDI from outside the periphery, would be our best hope for getting a prompt GDP return for structural reform.

Germany is likely to respond to the sharp decline in its economic growth rate and the likely imminent rise this implies in its unemployment rate (now at a post-reunification low) by allowing the automatic stabilisers to operate and even through selective expansionary fiscal measures, should the slowdown deepen and persist. Like all euro area member states, it will be guided in its national fiscal policies by its domestic economic and political imperatives. Until very recently, with Germany growing at a rate above the growth rate of potential output, with historically low unemployment, historically high capacity utilization and signs of overheating in the labour market, there was no case for a German fiscal stimulus. The notion that Germany had a duty to spend more or tax less because it runs a current account surplus makes no sense. Rich and aging economies should run current account surpluses. The rest of the euro area ought to do so too. After all, the euro area is an open block of rich and ageing societies. A German current account surplus does not imply or require an Italian current account deficit.

Conclusion

The euro area sovereign debt and banking crisis has returned with a vengeance.

The future of the euro area is not simply between full fiscal union and comprehensive debt mutualisation, and break-up.

Partial ex-post mutualisation – of past losses mostly, e.g. through official sector involvement (OSI) in periphery sovereign debt restructuring – coupled with very little ex-ante mutualisation of sovereign risk and a good dose of burden sharing with private investors in banks and sovereign debt, and banking union are a more likely alternative.

Market concerns about the viability of the euro area periphery sovereigns, euro area core and periphery banks and indeed about the viability of the Economic and Monetary Union project as a whole have returned with a vengeance. The bank bail-out in Spain clearly failed to calm these concerns – and we argued that this was predictable, given that the programme used the wrong design and further burdened the Spanish sovereign. Meanwhile, reports of deposits and other funding outflows out of Greece, Spain and Italy continue to come in.

These developments have further reinforced a widely held view that unsustainable public sector debts and deficits in the euro area, and vulnerable banking systems that are too large to save for individual countries, will eventually require the mutualisation of that debt, that is, the pooling of sovereign and banking risk. The leading candidate for a mutualisation programme for sovereigns is the one proposed by the German Council of Economic Advisers, the Debt Redemption Fund. Our discussion and conclusion that Spain and Italy are likely to need (additional) troika programmes could lead some to support the prediction of or even the logical necessity for such mutualisation. It does not. Political, legal and some economic concerns stand in the way of large-scale ex-ante mutualisation becoming the most plausible route to return to manageable levels of public and private debt in the euro area. But it would also be wrong to conclude that the path we chart leads straight to disorderly default or a break-up of the euro area. Rather, the alternative could involve partial ex-post mutualisation – of past losses mostly, e.g. through official sector involvement (OSI) in periphery sovereign debt restructuring – coupled with very little ex-ante mutualisation of sovereign risk and a good dose of burden sharing with private investors in banks and sovereign debt. Banking union could and should be one step in this direction.

References

International Monetary Fund (2012a), "IMF Says Spain's Core Financial System is Resilient, but Important Vulnerabilities Remain", Press Release No.12/212, June 8, 2012, <http://www.imf.org/external/np/SEC/pr/2012/pr12212.htm>

International Monetary Fund (2012b), "Spain: Financial Stability Assessment", June 2012, IMF Country Report No. 12/137, <http://www.imf.org/external/pubs/ft/scr/2012/cr12137.pdf>

Celentani, Macro, Miguel García-Posada and Fernando Gómez (2012), "The Spanish Business Bankruptcy Puzzle", February, http://denning.law.ox.ac.uk/news/events_files/GOMEZ_SPANISH_BANKRUPTCY_PUZZLE_.pdf

Notes

Notes

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability which includes investment banking revenues.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citi Investment Research & Analysis product ("the Product"), please contact Citi Investment Research & Analysis, 388 Greenwich Street, 28th Floor, New York, NY, 10013, Attention: Legal/Compliance [E6WYB6412478]. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at https://www.citivelocity.com/cvr/epublic/citi_research_disclosures. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

NON-US RESEARCH ANALYST DISCLOSURES

Non-US research analysts who have prepared this report (i.e., all research analysts listed below other than those identified as employed by Citigroup Global Markets Inc.) are not registered/qualified as research analysts with FINRA. Such research analysts may not be associated persons of the member organization and therefore may not be subject to the NYSE Rule 472 and NASD Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account. The legal entities employing the authors of this report are listed below:

Citigroup Global Markets Ltd

Willem Buiters; Ebrahim Rahbari

OTHER DISCLOSURES

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the issuer(s) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. The Firm's research department has received assistance from the subject company(ies) referred to in this Product including, but not limited to, discussions with management of the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citi Investment Research & Analysis (CIRA) does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of CIRA to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

Important Disclosures for Morgan Stanley Smith Barney LLC Customers: Morgan Stanley & Co. LLC (Morgan Stanley) research reports may be available about the companies that are the subject of this Citi Investment Research & Analysis (CIRA) research report. Ask your Financial Advisor or use

smithbarney.com to view any available Morgan Stanley research reports in addition to CIRA research reports.

Important disclosure regarding the relationship between the companies that are the subject of this CIRA research report and Morgan Stanley Smith Barney LLC and its affiliates are available at the Morgan Stanley Smith Barney disclosure website at www.morganstanleysmithbarney.com/researchdisclosures. For Morgan Stanley and Citigroup Global Markets, Inc. specific disclosures, you may refer to www.morganstanley.com/researchdisclosures and https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.

This CIRA research report has been reviewed and approved on behalf of Morgan Stanley Smith Barney LLC. This review and approval was conducted by the same person who reviewed this research report on behalf of CIRA. This could create a conflict of interest.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by.

The Product is made available in **Australia** through Citigroup Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992), participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Australia to Private Banking wholesale clients through Citigroup Pty Limited (ABN 88 004 325 080 and AFSL 238098). Citigroup Pty Limited provides all financial product advice to Australian Private Banking wholesale clients through bankers and relationship managers. If there is any doubt about the suitability of investments held in Citigroup Private Bank accounts, investors should contact the Citigroup Private Bank in Australia. Citigroup companies may compensate affiliates and their representatives for providing products and services to clients. The Product is made available in **Brazil** by Citigroup Global Markets Brasil - CCTVM SA, which is regulated by CVM - Comissão de Valores Mobiliários, BACEN - Brazilian Central Bank, APIMEC - Associação dos Analistas e Profissionais de Investimento do Mercado de Capitais and ANBID - Associação Nacional dos Bancos de Investimento. Av. Paulista, 1111 - 11º andar - CEP. 01311920 - São Paulo - SP. If the Product is being made available in certain provinces of **Canada** by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. This product is available in **Chile** through Banchile Corredores de Bolsa S.A., an indirect subsidiary of Citigroup Inc., which is regulated by the Superintendencia de Valores y Seguros. Agustinas 975, piso 2, Santiago, Chile. The Product is made available in **France** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 1-5 Rue Paul Cézanne, 8ème, Paris, France. The Product is distributed in **Germany** by Citigroup Global Markets Deutschland AG ("CGMD"), which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). CGMD, Reuterweg 16, 60323 Frankfurt am Main. Research which relates to "securities" (as defined in the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong)) is issued in **Hong Kong** by, or on behalf of, Citigroup Global Markets Asia Limited which takes full responsibility for its content. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Research is made available through Citibank, N.A., Hong Kong Branch, for its clients in Citi Private Bank, it is made available by Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citibank N.A. is regulated by the Hong Kong Monetary Authority. Please contact your Private Banker in Citibank N.A., Hong Kong, Branch if you have any queries on or any matters arising from or in connection with this document. The Product is made available in **India** by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. The Product is made available in **Indonesia** through PT Citigroup Securities Indonesia. 5/F, Citibank Tower, Bapindo Plaza, Jl. Jend. Sudirman Kav. 54-55, Jakarta 12190. Neither this Product nor any copy hereof may be distributed in Indonesia or to any Indonesian citizens wherever they are domiciled or to Indonesian residents except in compliance with applicable capital market laws and regulations. This Product is not an offer of securities in Indonesia. The securities referred to in this Product have not been registered with the Capital Market and Financial Institutions Supervisory Agency (BAPEPAM-LK) pursuant to relevant capital market laws and regulations, and may not be offered or sold within the territory of the Republic of Indonesia or to Indonesian citizens through a public offering or in circumstances which constitute an offer within the meaning of the Indonesian capital market laws and regulations. The Product is made available in **Israel** through Citibank NA, regulated by the Bank of Israel and the Israeli Securities Authority. Citibank, N.A. Platinum Building, 21 Ha'arba'ah St, Tel Aviv, Israel. The Product is made available in **Italy** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. Via dei Mercanti, 12, Milan, 20121, Italy. The Product is made available in **Japan** by Citigroup Global Markets Japan Inc. ("CGMJ"), which is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Shin-Marunouchi Building, 1-5-1 Marunouchi, Chiyoda-ku, Tokyo 100-6520 Japan. If the Product was distributed by SMBC Nikko Securities Inc. it is being so distributed under license. In the event that an error is found in an CGMJ research report, a revised version will be posted on the Firm's Citi Velocity website. If you have questions regarding Citi Velocity, please call (81 3) 6270-3019 for help. The Product is made available in **Korea** by Citigroup Global Markets Korea Securities Ltd., which is regulated by the Financial Services Commission, the Financial Supervisory Service and the Korea Financial Investment Association (KOFIA). Citibank Building, 39 Da-dong, Jung-gu, Seoul 110-180, Korea. KOFIA makes available registration information of research analysts on its website. Please visit the following website if you wish to find KOFIA registration information on research analysts of Citigroup Global Markets Korea Securities Ltd. <http://dis.kofia.or.kr/fs/dis2/fundMgr/DISFundMgrAnalystPop.jsp?companyCd=A03030&pageDiv=02>. The Product is made available in **Malaysia** by Citigroup Global Markets Malaysia Sdn Bhd (Company No. 460819-D) ("CGMM") to its clients and CGMM takes responsibility for its contents. CGMM is regulated by the Securities Commission of Malaysia. Please contact CGMM at Level 43 Menara Citibank, 165 Jalan Ampang, 50450 Kuala Lumpur, Malaysia in respect of any matters arising from, or in connection with, the Product. The Product is made available in **Mexico** by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, Integrante del Grupo Financiero Banamex ("Accival") which is a wholly owned subsidiary of Citigroup Inc. and is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In **New Zealand** the Product is made available to 'wholesale clients' only as defined by s5C(1) of the Financial Advisers Act 2008 ('FAA') through Citigroup Global Markets Australia Pty Ltd (ABN 64 003 114 832 and AFSL No. 240992), an overseas financial adviser as defined by the FAA, participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in **Pakistan** by Citibank N.A. Pakistan branch, which is regulated by the State Bank of Pakistan and Securities Exchange Commission, Pakistan. AWT Plaza, 1.1. Chundrigar Road, P.O. Box 4889, Karachi-74200. The Product is made available in the **Philippines** through Citicorp Financial Services and Insurance Brokerage Philippines, Inc., which is regulated by the Philippines Securities and Exchange Commission. 20th Floor Citibank Square Bldg. The Product is made available in the Philippines through Citibank NA Philippines branch, Citibank Tower, 8741 Paseo De Roxas, Makati City, Manila. Citibank NA Philippines NA is regulated by The Bangko Sentral ng Pilipinas. The Product is made available in **Poland** by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Nadzoru Finansowego. Dom Maklerski Banku Handlowego S.A. ul.Senatorska 16, 00-923 Warszawa. The Product is made available in the **Russian Federation** through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the

meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in **Singapore** through Citigroup Global Markets Singapore Pte. Ltd. ("CGMSPL"), a capital markets services license holder, and regulated by Monetary Authority of Singapore. Please contact CGMSPL at 8 Marina View, 21st Floor Asia Square Tower 1, Singapore 018960, in respect of any matters arising from, or in connection with, the analysis of this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). The Product is made available by The Citigroup Private Bank in Singapore through Citibank, N.A., Singapore Branch, a licensed bank in Singapore that is regulated by Monetary Authority of Singapore. Please contact your Private Banker in Citibank N.A., Singapore Branch if you have any queries on or any matters arising from or in connection with this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). This report is distributed in Singapore by Citibank Singapore Ltd ("CSL") to selected Citigold/Citigold Private Clients. CSL provides no independent research or analysis of the substance or in preparation of this report. Please contact your Citigold/Citigold Private Client Relationship Manager in CSL if you have any queries on or any matters arising from or in connection with this report. This report is intended for recipients who are accredited investors as defined under the Securities and Futures Act (Cap. 289). Citigroup Global Markets (Pty) Ltd. is incorporated in the **Republic of South Africa** (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in **Spain** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 29 Jose Ortega Y Gasset, 4th Floor, Madrid, 28006, Spain. The Product is made available in the **Republic of China** through Citigroup Global Markets Taiwan Securities Company Ltd. ("CGMTS"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan and/or through Citibank Securities (Taiwan) Company Limited ("CSTL"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan, subject to the respective license scope of each entity and the applicable laws and regulations in the Republic of China. CGMTS and CSTL are both regulated by the Securities and Futures Bureau of the Financial Supervisory Commission of Taiwan, the Republic of China. No portion of the Product may be reproduced or quoted in the Republic of China by the press or any third parties [without the written authorization of CGMTS and CSTL]. If the Product covers securities which are not allowed to be offered or traded in the Republic of China, neither the Product nor any information contained in the Product shall be considered as advertising the securities or making recommendation of the securities in the Republic of China. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security or financial products. Any decision to purchase securities or financial products mentioned in the Product must take into account existing public information on such security or the financial products or any registered prospectus. The Product is made available in **Thailand** through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in **Turkey** through Citibank AS which is regulated by Capital Markets Board. Tekfen Tower, Eski Buyukdere Caddesi # 209 Kat 2B, 23294 Levent, Istanbul, Turkey. In the **U.A.E.**, these materials (the "Materials") are communicated by Citigroup Global Markets Limited, DIFC branch ("CGML"), an entity registered in the Dubai International Financial Center ("DIFC") and licensed and regulated by the Dubai Financial Services Authority ("DFSA") to Professional Clients and Market Counterparties only and should not be relied upon or distributed to Retail Clients. A distribution of the different CIRA ratings distribution, in percentage terms for Investments in each sector covered is made available on request. Financial products and/or services to which the Materials relate will only be made available to Professional Clients and Market Counterparties. The Product is made available in **United Kingdom** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in **United States** by Citigroup Global Markets Inc, which is a member of FINRA and registered with the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority. Pursuant to Comissão de Valores Mobiliários Rule 483, Citi is required to disclose whether a Citi related company or business has a commercial relationship with the subject company. Considering that Citi operates multiple businesses in more than 100 countries around the world, it is likely that Citi has a commercial relationship with the subject company.

Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to CIRA's Products can be found at https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.

Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations.

The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would not be permitted.

Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. The Product does not purport to identify the nature of the specific market or other risks associated with a particular transaction. Advice in the Product is general and should not be construed as personal advice given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs. Prior to acquiring any financial product, it is the client's responsibility to obtain the relevant offer document for the product and consider it before making a decision as to whether to purchase the product. With the exception of our product that is made available only to Qualified Institutional Buyers (QIBs), CIRA concurrently disseminates its research via proprietary and non-proprietary electronic distribution platforms. Periodically, individual CIRA analysts may also opt to circulate research posted on such platforms to one or more clients by email. Such email distribution is discretionary and is done only after the research has been disseminated via the aforementioned distribution channels. CIRA simultaneously distributes product that is limited to QIBs only through email distribution.

The level and types of services provided by CIRA analysts to clients may vary depending on various factors such as the client's individual preferences as to the frequency and manner of receiving communications from analysts, the client's risk profile and investment focus and perspective (e.g. market-wide, sector specific, long term, short-term etc.), the size and scope of the overall client relationship with Citi and legal and regulatory constraints.

CIRA product may source data from dataCentral. dataCentral is a CIRA proprietary database, which includes Citi estimates, data from company reports and feeds from Reuters and Datastream.

© 2012 Citigroup Global Markets Inc. Citi Investment Research & Analysis is a division of Citigroup Global Markets Inc. Citi and Citi with Arc Design are trademarks and service marks of Citigroup Inc. and its affiliates and are used and registered throughout the world. All rights reserved. Any unauthorized use, duplication, redistribution or disclosure of this report (the "Product"), including, but not limited to, redistribution of the Product by electronic mail, posting of the Product on a website or page, and/or providing to a third party a link to the Product, is prohibited by law and will result in prosecution. The information contained in the Product is intended solely for the recipient and may not be further distributed by the recipient to any third party. Where included in this report, MSCI sourced information is the exclusive property of Morgan Stanley Capital International Inc. (MSCI). Without prior written permission of MSCI, this information and any other MSCI intellectual property may not be reproduced, disseminated or used to create any financial products, including any indices. This information is provided on an "as is" basis. The user assumes the entire risk of any use made of this information. MSCI, its affiliates and any third party involved in, or related to, computing or compiling the information hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of this information. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. MSCI, Morgan Stanley Capital International and the MSCI indexes are services marks of MSCI and its affiliates. The Firm accepts no liability whatsoever for the actions of third parties. The Product may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the Product refers to website material of the Firm, the Firm has not reviewed the linked site. Equally, except to the extent to which the Product refers to website material of the Firm, the Firm takes no responsibility for, and makes no representations or warranties whatsoever as to, the data and information contained therein. Such address or hyperlink (including addresses or hyperlinks to website material of the Firm) is provided solely for your convenience and information and the content of the linked site does not in anyway form part of this document. Accessing such website or following such link through the Product or the website of the Firm shall be at your own risk and the Firm shall have no liability arising out of, or in connection with, any such referenced website.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

EU20625E
