Economics

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# Euro Area: Sovereign Debt Crisis Update

## Moody's Rating Changes

- **Overnight, Moody's published its credit rating updates for euro area sovereigns.** Moody's put the Aaa-rated countries France and Austria – which have already lost S&P's AAA rating – on negative outlook and reduced its rating by one notch for Italy (to A3), Portugal (to Ba3), Slovakia (to A2), Slovenia (to A2) and Malta (to A3). Moody's downgraded Spain by two notches to A3. The UK was put on negative ratings outlook (although retaining its Aaa-rating). Moody's left the rating for Germany and the other Aaa-rated countries, Netherlands, Luxembourg and Finland, unchanged, adding that the rating is appropriately positioned. Moody's left the rating for the EFSF unchanged at Aaa. See inside for further discussion.

- ***Global Economics View:*** The ECB's decision to allow nation-specific collateral eligibility criteria not only means the fragmentation of ECB monetary, credit and liquidity policy along national lines, it permits accelerating and mostly unchecked balance sheet growth of soft Eurozone NCBs, thus raising the spectre of gradual 'Roublezoneification' of the euro area - *Global Economics View - Is the Eurozone at Risk of turning into the Rouble Zone?*

- **Greece:** We discuss the next milestones for the ratification of the 2nd bailout and the PSI. There is a possible Cabinet reshuffle this week, while elections are still expected in April.

- **Ireland:** The government unveils its Action Plan for Jobs.

- **Spain's** new labour law could result in job cuts by one-third of listed companies. PM Rajoy believes that his widespread labour market reforms may win him some leeway with regard to negotiations on the deficit targets for this year.

- We expect a cut in **Sweden**'s repo rate on Thursday, while **Norway**'s Trade Minister finds NOK strength "a challenge".

- **Northern European Alliance:** Yesterday evening, the heads of governments of Germany, the Netherlands, Denmark and Estonia met to discuss the future structure of the European Union. It was the second meeting of this *"northern European Alliance".*

- **Short Selling:** Yesterday, the regulators in France and Belgium said that they would not extend the short selling ban of stocks and related financial instruments on financials.

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- **Overnight, Moody's published its credit rating updates for euro area sovereigns.** Moody's put the Aaa-rated countries France and Austria – which have already lost S&P's AAA rating – on negative outlook. The negative outlook reflects *"a number of specific credit pressures that would exacerbate the susceptibility of these sovereigns' balance sheets*". Moody's reduced its rating by one notch for Italy (to A3), Portugal (to Ba3), Slovakia (to A2), Slovenia (to A2) and Malta (to A3). Moody's downgraded Spain by two notches to A3. Note that even after the downgrade for Italy and Spain to A3, there will be no change in the valuation haircuts for sovereign bonds used as collateral in the Eurosystem collateral framework. There will be an extra 5% haircut, if a sovereign security has a lower than 'single A' rating from all ECB-approved rating agencies.

- **According to Moody's the downgrades and introduction of negative outlooks reflect three main factors**: "uncertainty over (i) the euro area's prospects for institutional reform of its fiscal and economic framework and (ii) the resources that will be made available to deal with the crisis and (iii) Europe's increasingly weak macroeconomic prospects." In Moody's view, "these factors will continue to have an impact on market confidence, which is likely to remain fragile, with a high potential for further shocks to funding conditions for stressed sovereigns and banks."

- **Unchanged:** Moody's left the rating for Germany and the other Aaa-rated countries, Netherlands, Luxembourg and Finland, unchanged, adding that the rating is appropriately positioned. Moody's left the rating for the EFSF unchanged at Aaa.

- **Comment: Moody's action regarding the euro area countries is in line with our forecasts** in *Sovereign Ratings Outlook - January 2012***.** It seems that Moody's is not impressed by the measures taken on an institutional level to deal with the crisis. As a change in that respect seems unlikely to take place any time soon, we expect that France and Austria will lose their Aaa rating over time and that further downgrades for the currently non-Aaa countries are in the pipeline.

- **UK: Moody's last night put the UK on negative ratings outlook** (while leaving the rating at the top-rated Aaa) as part of a series of downgrades and negative outlook statements across Europe. Moody's cite two factors: (1) the weak economy and (2) the UK's vulnerability to the EMU crisis. We do not expect that this announcement by itself will trigger a significant fiscal or monetary policy response. For details, see *UK – Moody's Put UK on Negative Outlook*.

- **French reaction to Moody's:** In initial reactions French Finance Minister Francois Baroin said that the French *"government is determined to press ahead with its actions to boost growth and competitiveness… and the reduction of public deficits".* In the case of Austria, the Central Bank Governor in a radio interview said that the government with its recent budget plans targeting a balanced budget for 2016 made an *"important contribution"* towards restoring market confidence and in contrast to Moody's he played down the risks for Austrian banks stemming from their exposure to central and Eastern Europe.

- ***Global Economics View:*** On February 9, 2012, the ECB announced *"specific national eligibility criteria and risk control measures for the temporary acceptance of additional credit claims as collateral in Eurosystem credit operations"* for seven euro area national central banks (NCBs). After the use of emergency liquidity assistance (ELA), this is the second significant deviation from a single Eurozone monetary, credit, and liquidity policy. Unlike for ELA, the nation-specific collateral policy is not subject to explicit quantity limits by the centre. Like ELA, losses from nation-specific collateral operations are not pooled and shared with the rest of the Eurosystem. The ECB's decision to allow nation-specific collateral eligibility criteria not only means the fragmentation of ECB monetary, credit and liquidity policy along national lines, it permits accelerating and mostly unchecked balance sheet growth of soft Eurozone NCBs, thus raising the spectre of gradual 'Roublezoneification' of the euro area. For details, see *Global Economics View - Is the Eurozone at Risk of turning into the Rouble Zone?*

- **Greece - Next Milestones for the 2nd bailout and PSI Deal**. Statements by European officials yesterday suggest that with Parliamentary approval of the reform measures in Greece, the chances have increased that the new bailout package will go ahead. While we do not expect a decision on the 2nd bailout programme at the Eurogroup meeting tomorrow, the Eurogroup probably will give its blessing to the PSI deal, which likely will be announced by the end of the week: bondholders will then be given roughly two weeks to accept the offer made by the Greek Government. On Wednesday, Greece is expected to present to the Eurogroup the detailed plans for savings of €325 million in addition to the €3bn that it has already agreed to make. National parliaments, such as Germany's, are then expected to hold votes on the new loan deal so that a final decision can be reached at the EU leaders' summit on March 1 and 2. According to the chairman of the German parliament, Norbert Lammert, the scheduling of the vote on the Greek package for February 27 might be too tight. In the meantime, according to the *Ekathimerini*, Venizelos has given the leaders of PASOK and National Democracy the letters that they will need to sign to reassure EU leaders that whichever party wins the April elections will not renege on its promise to adhere to the conditions of the 2nd bailout loan.

- Comment: The ratification of the new loan by national parliaments is required because the 2nd loan package includes funding from the EFSF which cannot be awarded without formal ratification of the deal by parliament in at least some contributing countries (Germany and Finland, for example). We therefore expect that if the Eurogroup has confidence in the Greek action plan for the additional savings and in the country's guarantees on the implementation of the agreed austerity and reform measures, then the Eurogroup will give the go-ahead for the PSI deal when it meets tomorrow, although it will not be able to formally agree on the new loan package. Regarding the PSI, with the still open question on a contribution of the Eurosystem to Greek debt reduction, it remains uncertain if Greece will retrospectively put Collective Action Clauses (CAC) into national law and use them to enforce the participation of all bondholders in the deal.

- **Greek Default?** In a television interview German Finance Minister Schäuble said that the euro area is better prepared for a Greek default than it was two years ago. In the interview, he also insisted that the euro area member countries and the EU institutions would do everything to rescue Greece.

- **Greek elections still expected to take place in April**. According to the *Ekathimerini*, a Government spokesman confirmed yesterday that PM Papademos's coalition government will keep to the commitment made when it was formed in November of holding elections as soon as the 2nd bailout package is approved and the PSI deal is concluded. With both expected to be wrapped up by 20 March, elections are therefore still expected to be held in April, although no specific date has yet been advanced.

- **Greek government re-shuffle this week?** According to the Greek press, the new PASOK leader could be elected as soon as the end of this week and once that is out of the way, PM Papademos will go ahead with a small re-shuffle of his Cabinet to replace the transport minister who resigned from his post last week and to appoint a new finance minister if Mr Venizelos wins the PASOK leadership and decides to step down as the Coalition Government's Finance Minister.

- **Does Greece need more money?** This week the troika is due to produce a report on Greece's debt sustainability, which European policymakers will use to assess whether they need to consider increasing the loans to Greece or thinking about whether other measures need to be taken.

- **Finance Minister says Portugal is in a better position than Greece**. The Greek Finance Minister said in an interview with Portugal's news agency *Agencia Lusa* that Portugal is in a better position than Greece because its debt is lower and because the Portuguese people are more patient and less temperamental than Greek people, but also because the austerity measures which are being asked of Greece are deeper than those which Portugal is adopting.

- **The Irish Government unveiled its new Action Plan for Jobs 2012** yesterday, which aims to create 100,000 new jobs by 2016 and a further 100,000 by 2020. The programme includes 270 measures for delivery across 15 government departments and 36 state agencies. The plan includes measures to help small and medium sized businesses (SMEs), such as a State guarantee for 75% of loans to SMEs, a new Micro-Finance Fund supplying investment in small companies seeking less than €25,000, an extension of the corporation tax exemption for start-ups until 2014 and a request to Government departments to identify, by next month, charges levied on businesses that could be frozen or reduced for 24 months. Many of the proposals listed are not new: what is new is that each measure is accompanied by a timetable for implementation and that the whole action plan is to be overseen by a Monitoring Committee that will produce quarterly progress reports. Launching the action plan yesterday, PM Enda Kenny said *"No government can directly create jobs, but they can directly remove the barriers to job creation."*

- **Ireland's Minister for Social Protection Joan Burton said yesterday** that social welfare recipients who do not participate in the Government's new Pathways to Work initiative could be dropped from the benefits register or have their benefits reduced by €44 per week. This new initiative (which is to be rolled out next week) brings together for the first time the State's employment services with the welfare services, and aims to provide better training and support for jobseekers. Up to now there has been no penalty for benefit claimants who consistently fail to accept reasonable offers of training or employment. One of the requirements of Ireland's bailout programme is to present by end March 2012 an implementation plan *"to improve the activation of the unemployed".*

- **Spain's new labour law could result in job cuts by one-third of listed companies**. According to *El Pais*, the new law which makes it cheaper for companies experiencing losses for three consecutive quarters to make large-scale redundancies will make it easier for some 43 companies (one third of all listed companies) listed on the Madrid Stock Exchange and employing 283,415 to reduce their workforce in response to weak profits. According to the newspaper, given that listed companies tend to enjoy relatively healthy profit conditions and to have greater access to non-bank financing than non-listed companies, it is likely that non-listed companies will be harder hit by the deteriorating economy and that the resulting economy-wide increase in job cuts will therefore be much larger as a result of the new law.

- **Spain expects labour market reforms to buy more flexibility on deficit reduction**. According to the newspaper *El Pais*, the Spanish PM believes that his widespread labour market reforms will win him some leeway from EU institutions and German Chancellor Merkel with regard to negotiations on the deficit targets for this year. Mrs Merkel praised the Spanish labour market reforms in a speech yesterday saying that others should follow the country's example. Comment: Last year Spain agreed to reduce its deficit from an expected 6.0% of GDP in 2011 to 4.4% this year and 3.0% in 2013. However, large slippages last year which meant that the 2011 deficit is around 8% of GDP, together with a sharp deterioration in the outlook for the Spanish economy, have led the IMF to revise its forecasts for the Spanish deficit to 6.8% in 2012 and 6.3% in 2013. We expect that Spain will try to renegotiate a set of more realistic deficit reduction targets with Brussels.

- **Sweden:** The Riksbank cut the repo rate by 25bp to 1.75% at its last meeting on 21 December and looks likely to cut rates further in coming months in response to the deteriorating international and domestic economic growth prospects and benign domestic inflation outlook. We expect the policy rate to trough at 1.0% around midyear. The speed at which we will get there, though, is uncertain. We expect another 25bp rate cut at the upcoming 16 February meeting, although there is a risk that the bank will stay sidelined for now, pending further clarification regarding the severity of the downturn. Either way, rates are likely to fall further in subsequent months. For further discussion, see *Sweden - February Rate Cut Likely, But No Certainty*.

- **Norway — NOK strength a "challenge".** The NOK surged to its strongest level versus the EUR since early-September during yesterday's trading session, prompting Trade Minister Trond Giske to attempt to talk down the currency. Policy makers are monitoring the exchange rate, which continues to be a "challenge" for the government, he said. In a speech from September 8, 2011, the Norges Bank signalled that it was ready to take steps to curb the domestic currency's strength after it soared to an eight-year high. Governor Olsen said: *"A krone that is too strong can over time result in inflation that is too low and growth that is too weak. In that case, monetary policy measures will be taken. In Norway, the key policy rate is the relevant instrument".* These comments proved very effective as the NOK weakened by approx 5% over the following two weeks. **Comment:** If the NOK extends its gains versus the EUR over the next couple of days, we would not be surprised if Governor Olsen decides to use part of his Annual Address on the state of monetary policy to talk down the currency (on Thurs).

- **French non-farm payrolls declined** by 0.2% QQ in 4Q after remaining unchanged in 3Q. The decline in employment at the end of 2011 was in line with our forecast.

# Appendix A-1

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