

Euro Area: Sovereign Debt Crisis Update

ECB Dampens Market Expectations of SME Lending Programme

- **ECB not so keen on SME lending programme, says FT** — the ECB is "*backing away from any big bazooka*" style intervention to revive lending within the euro zone, judging that the lending blockage is the result of weakened balance sheets, a situation that would not warrant direct intervention. The FT notes while senior officials view the initiative as worthwhile, it is "*unlikely to be concluded soon or to have a big impact*", warning that "*expectations for the policy may have risen too high*". A more important milestone will be the ECB's asset quality review. Comment: given the complexity of the process and the fact that the ECB has only just started discussing it with the EIB and EC, we are not surprised that some ECB members downplay market expectations ahead of the June meeting. As argued in our [Euro Economics Weekly](#), we believe that some announcements on a loosening of the collateral policy are more likely.
- **EU Bank Resolution** — the FT quoted the summary of an EC plan on banking resolution proposing to create a body that would have power to overrule banks' home countries, operate its own bank resolution fund, giving it ability to access the market.
- **ECB's Coeuré on recovery and FTT** — Benoit Coeuré noted that the ECB expects GDP growth to "*move back into positive territory by the end of this year*" but growth to remain on a "*slow recovery path*". He re-iterated that the ECB would reserve the right to engage with governments if it found that the FTT could distort the funding markets.
- **IMF halves 2013 German GDP forecast** — the IMF halved its 2013 German GDP growth forecast to 0.3% and warned that it could lower the 2014 estimate to 1.3% from the current 1.5%. The IMF recommended a "*marginal loosening*" in the country's budget policy and only modest austerity measures in the coming years.
- **France makes additional budget savings by taxing child benefits** — the French government announced on Monday that it would save €2bn by 2016 with belt-tightening measures taking the form of reduced income tax exemptions for better-off families as part of its objective to close the social security deficit.
- **Spain - 3rd review of bank bailout and deleveraging** — the IMF's third review of the bank bailout programme noted that "*a close monitoring of the system should continue*", welcoming the BoS initiative on stricter criteria for classifying refinanced and restructured loans as a mean to ensure adequate provisioning. Lending data showed that deleveraging of the private sector had accelerated in April.
- **Italy cash-basis state deficit widening** — in the first five months of 2013 the borrowing requirement stood at €56.2bn, up from €35.5bn in 2012.
- **Greece** — Hirings outnumbered sackings by 55,000 jobs in May for the third consecutive month according to the Labour Ministry.
- **Slovakia** — Gradual improvement in central government budget in May.
- **Slovenia** — Manufacturing confidence improved in May with better order-books.

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- **ECB not so keen on SME lending programme, says FT** - The European Central Bank is "*backing away from any big bazooka*" style intervention to revive lending within the euro zone according to an article in Tuesday's Financial Times. As suggested by some Governing Council members previously, the assessment appears to be that the blockage in lending is the result of weakened balance sheets, a situation that would not warrant direct intervention in the SME borrowing process. The FT article notes while senior officials view the initiative as worthwhile, it is "*unlikely to be concluded soon or to have a big impact*", warning that "*expectations for the policy may have risen too high*". A more important milestone will be the ECB's asset quality review scheduled to start in September or October, involving up to 140 of the euro area's largest banks' balance sheets. The process will also rely on national supervisors, as well as external advisers, and will be followed by an EBA stress test in May or June 2014. Comment: given the complexity of the whole process and the fact that the ECB has only started discussing the issue with the EIB and European Commission, we are not surprised that some Governing Council members downplay market expectations ahead of the June meeting on Thursday. As argued in our [Euro Economics Weekly](#), we believe that some announcements on a loosening of the collateral policy are more likely.
- **EU Bank Resolution** - the FT ran another article on Tuesday, citing from the summary of a European Commission (EC) plan on banking resolution proposing to create a body to handle bank shutdowns with a board dominated by EC and ECB nominees. The body would have power to overrule banks' home countries, and operate with its own bank resolution fund, giving it ability to borrow from the market. Comment: this draft proposal seen by the FT is part of the plan to release a formal blueprint in June, as suggested by ECB President Draghi on Monday. Although the proposal would likely run contrary to some member states' desire to control bank resolutions nationally, a centralised mechanism would probably be the only way to remove some of the link between sovereigns and their captive banks.
- **ECB's Coeuré on recovery and the FTT** - Executive Board member Benoit Coeuré noted that the ECB expects GDP growth to "*move back into positive territory by the end of this year*" but growth to remain on a "*slow recovery path*". Turning to the question of consensus-building policy making process, Mr. Coeuré remarked that there is "*room for diversity to be expressed in the Governing Council*", describing the situation as "*useful*". On the topic of the FTT, he reiterated that the ECB would "*stand ready to engage governments to discuss alternative measures, if we find the project can induce distortion on funding markets and in money markets in Europe*". Comment: no opposition in principle to the FTT, mainly on the grounds that the taxation issues are outside the ECB's remit, but keeping a close eye on any potentially severe market distortions, particularly with respect to repos. Given the recent statements by various officials on the tax, it seems that there will be a significant delay in its introduction, and possibly a complete revamp in the intervening period.
- **The ECB is not doing enough about the euro, says French Industry minister** - French industry minister Arnaud Montebourg remarked on Monday that the ECB was "*remarkably inactive*" on the euro. He argued that "*we need a slightly weaker euro*" to boost growth, noting that the exchange rate was a handicap for exports. Comment: Mr. Montebourg seems to be ignoring the fact that the ECB does not have a mandate to steer the currency. Rather, this is the remit of the euro area finance ministers. Criticism about an excessively high euro has been few and far between in the last few months.

- **IMF halves the 2013 German GDP forecast** - the IMF halved the German GDP growth forecast to 0.3% for 2013, and Germany mission chief Subir Lall indicated during a news conference that the 2014 GDP growth forecast of 1.5% would probably be revised downward to 1.3%. These numbers compare with the German government's baseline of 0.5% and 1.6% for 2013 and 2014, respectively. The IMF noted that Germany should "*avoid over-performing on (fiscal) consolidation*", warning about the potential damage to growth. The IMF recommended a "*marginal loosening*" in the country's budget policy and only modest austerity measures in the coming years to ensure that "*fiscal policy will not act as a drag on the recovery of the economy*". In its list of policy recommendations, the IMF suggested that Berlin lower workers' tax burden, particularly for lower wage and secondary earners and make additional reforms to improve productivity of the services sector. Comment: Fiscal policy loosening is probably too much to ask Berlin to deliver, particularly at a time when the electoral campaign is gaining momentum. Anything that could boost the growth potential of the euro area's largest economy should be encouraged, given the difficulties with demographics.
- **France makes additional budget savings by taxing child benefits** - The French government announced on Monday that it would save €2bn by 2016 with belt-tightening measures taking the form of reduced income tax exemptions for the better-off families as part of its objective to close the social security deficit. PM Jean-Marc Ayrault declared that "*it is perfectly possible to reduce our deficit while preserving the core of our social model*". The ceiling on tax exemptions parents can claim per child will be reduced from €2,000 to €1,500, meaning that some 1.3 million households will pay an extra €64 of tax per month on average. Comment: maintaining the principle of universality of child benefits for every family with two or more children, the government had no choice but tax the benefits. While necessary to balance the books and curtail a very generous family benefits programme, the consequences will likely be negative for household confidence. This runs contrary to the government's promise of stabilising fiscal pressure.
- **Spain – risks to the economy and hence to the banks remain elevated**, the IMF third review of the bank bailout programme says. While the Troika acknowledged the improvements in the process of bank restructuring with the completion of the transfers of assets to the "bad bank" SAREB, the review highlights the "*continued deleveraging needs of the Spanish non-financial sector, and adjustment in the real estate market that continue to severely affect lending volumes and to impact the asset quality of the Spanish banking sector*". Hence "*a close monitoring of the system should continue*". The IMF report calls for a timely implementation of banking union and ensuring maintenance of a sufficiently accommodative monetary stance at the euro area level in order to support the restructuring process of the Spanish banks. The IMF welcomes the Bank of Spain initiative on stricter criteria for classifying refinanced and restructured loans as a mean to ensure adequate provisioning. Comment: while their capital and liquidity positions have improved since the bailout, Spanish banks still face a sizable deterioration in the quality of their assets (real estate prices are still falling at 8%-10% per year and NPLs are rising fast) and also face large macro risks as the economy continues to shrink. In this environment it is unlikely that lending will resume any time soon.
- **Spain – deleveraging of the private sector accelerates in April**. Total financing of non-financial corporations dropped by 7.2% YY in April, down from -6.8% YY in March, the lowest reading since the series began in 1996. Loans from domestic banks were down by 9.0% YY in April and foreign loans were also

down by 6.3% YY. These flows were only marginally offset by an increase in debt securities issuance (+9.9% YY). Financing of the household sector also decelerated further in April, falling by 4.3% YY (-3.9% in March). The annual comparison does include the effect of the credit claims transferred to the “bad bank” at the end of 2012, which makes the annual declines look somewhat bigger. Yet, the negative monthly flows since last January do confirm that the pace of deleveraging in the private sector has remained substantial in the first four months of 2013. Comment: the indebtedness ratios of the private sector – at 86% of GDP for households and 132% of GDP for businesses in 2012 – have started to subside but are still very high by historical and cross-country comparisons. We think it will still take several years before the deleveraging process of the non-financial sector is completed. This will continue to work as a drag on GDP growth.

- **Italy – cash-basis state deficit widening.** The state sector borrowing requirement rose to €8.8bn in May, up from €4.3bn in May 2012. In the first five months of 2013 the borrowing requirement stood at €56.2bn, up from €35.5bn in 2012. Comment: financing requirements in the first months of 2013 have been affected by several one-off items (eg, EIB and ESM capital contributions), which raised the borrowing requirement relative to last year. However, even when these effects are taken into account, the cash-basis state deficit is widening relative to last year. The fiscal dynamics are expected to worsen further in H2 2013, as some tax hikes planned by the previous government are being reversed and the repayment of government arrears will lift financing needs (although it will probably have a smaller effect on the general government accrual deficit).
- **Spain – registered unemployment dropped by 98.3K in May (-2.0% MM), more than expected (consensus: -50K; Citi: -100k).** Based on our calculations of seasonal factors, the drop corresponds to an unchanged reading in seasonally-adjusted terms, as increased hirings ahead of the summer typically reduces by a large amount the jobless count in May and June. Comment: once seasonal fluctuations are accounted for, registered unemployment has stopped rising in the last few months. This was partly due to some changes in the criteria to access the unemployment register but also probably to an increasing number of jobless people falling out of the eligibility criteria. We think the stabilisation in registered unemployment is not a sign of a real stabilisation in the Spanish labour market. In fact, registered unemployment stood at 4.89m in May, while total unemployment (as measured by the labour force survey) is rising much faster and exceeded 6m in Q1 13. The large divergence between the two series is worrying as it suggests that an increasing number of jobless workers are not covered by the benefits.
- **Greece – Hirings outnumbered sackings by 55,000 jobs in May for the third consecutive month,** according to the Labour Ministry’s Ergani electronic database reported by *Ekathimerini* newspaper. The ministry said that the net positive job creation is 33.3% higher than in May 2012 and 21% YY higher in the first five months of the year. Comment: as this series is not seasonally adjusted it is difficult to use it as a guide for the labour market performance. The more reliable data on the labour force survey (including both salaried and self-employed) available up to February still shows large declines in total employment (-7% YY).
- **Slovakia – Gradual improvement in central government budget in May.** The central government deficit narrowed to 4.5% of GDP in May, which is the lowest ratio since end-2009. The year-to-date deficit reached €1.6bn in May 2013, narrower by €0.6bn compared to the same period in 2012. The improvement

reflects the 11.1% contraction in year-to-date expenditures, while a year ago expenditure increased by 9%. However, weaker economic growth is also reflected in lower revenue growth that fell by 3.7% (-1.4% a year ago). Having said this, May data confirmed a development from previous months that pointed to some improvement after the 12m cumulative deficit remained on average above 5% of GDP in the first four months of this year. However, the government has to maintain focus on the consolidation process as the seasonal pattern suggests a wider deficit of around 5.5% of GDP in 2013 instead of the planned 4.1% (above €4bn vs. plan of €3.1bn). Though central government finances have improved in May, there is probably no additional buffer in the 2013 budget in the event of a worsening economy.

- **Slovenian manufacturing confidence improved in May accompanied by better order-books.** Manufacturing confidence improved to a level last seen in 1Q13, which was moreover accompanied by better order-books (levels last seen in February 2012). The improvement in foreign order-books suggests an acceleration in exports to above 7% YY in June after 1.5% in May, though in our view a milder recovery is likely (in 1Q13 actual exports undershot our forecast based on the confidence survey). In quarterly terms the survey points to an acceleration of exports to above 4% YY in 2Q13, after 1.5% a quarter ago. Hence, industrial production is likely to avoid a larger contraction after it fell by 0.6% YY in 1Q and is likely to gradually recover thanks to better (ex-EU) foreign demand. Nevertheless, consumer and services confidence worsened in May suggesting the economy is likely to continue to contract in the forthcoming quarters of 2013, though likely by less than in 4Q12 (when GDP fell by -1% QQ) or in 1Q13 (-0.7%).

Appendix A-1

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