

## Economics

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# Euro Area: Sovereign Debt Crisis Update

## Win for Merkel's CDU, PM Rajoy's PP doesn't quite make it

- **ESM/EFSF:** It looks increasingly likely that there will be a commitment to increase the lending-capacity of the ESM/EFSF at the informal Eurogroup meeting at the end of the week.
- **ECB** — ECB Executive Board Member Benoît Coeuré said that it was not the ECB's job to cure weak financial institutions or to ease concerns about unsustainable fiscal policy.
- **Germany:** the CDU won the early State elections in Saarland with 35.2% of votes, ahead of the SPD with 30.6% – the two parties are to start talks on building a grand coalition. The big loser was the FDP, a member of the previous coalition, which failed to enter parliament, and the big surprise was the 7.5% share of the vote obtained by the Pirate party.
- **Spain:** PM Mariano Rajoy's PP failed to win a majority in Andalucía, so that a coalition between the smaller Socialists and United Left is a possibility. Unions have called a nationwide general strike for March 29. On Friday Finance Minister Montoro presents Spain's 2012 budget.
- **Italian PM Mario Monti tells Spain to concentrate on its budget reduction efforts,** warning that *"it doesn't take much to recreate risks of contagion"*.
- **Italian strikes loom** as labour market reform bill is sent through parliament.
- **Greece** extends deadline for foreign bond holders to swap notes to April 4.
- **The Netherlands** has left the core of the euro area in our view.

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*With thanks to*

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- **ESM/EFSF:** Ahead of the informal meeting of the Eurogroup and the EcoFin on March 30 and 31, **ECB Executive Board Member Jörg Asmussen** said to a Finnish newspaper that he expects a compromise regarding the extension of the firepower of the ESM/EFSF. He said that an increase in the firepower of the facilities was a pre-condition to increase the resources of the IMF in the spring meeting on April 20-22. The **Finnish PM Jyrki Katainen** said that his country would be prepared to agree a compromise on a larger European rescue facility. And according to *Der Spiegel*, Germany would also be ready to agree to an increase in the facility. However, so far the CSU, the Bavarian branch of the CDU, is still opposing an increase.
- **EU's Rehn and EFSF's Regling pushing for larger firewall** – EU Economic and Monetary Affairs Commissioner Olli Rehn indicated that he was confident that ministers would resolve their differences on providing additional funding to the firewalls. Klaus Regling, head of the EFSF, put his weight behind a higher lending capacity for the bailout fund, indicating that *"more money would reassure markets. Wrongly or rightly, the fact is that big numbers in the shop window create calm"* in an interview with Germany's *Focus* magazine. Regling stressed that *"the bailouts haven't cost German taxpayers a penny. The belief that this money is gone and will never come back is wrong. These are loans that must be paid back."* Comment: It looks increasingly likely that there will be a commitment to increase the lending-capacity of the ESM/EFSF at the informal meeting of euro area finance ministers in Copenhagen on Friday and Saturday 30-31 March. However, due to some outstanding issues in Germany, there might be no agreement on a fixed amount. Note that the ESM treaty has still to be approved by the euro area member countries and it requires a small change in the EU treaty that has to be approved by all 27 EU countries.
- **ECB Comments:** In a speech in Japan, **ECB Executive Board Member Benoit Coeuré** said that it was not the ECB's job to cure weak financial institutions or to ease concerns about unsustainable fiscal policy. He added that monetary policy is not and cannot be a substitute for sustainable fiscal policies and structural reforms and he stressed the importance of central bank independence. In Mr. Coeuré's view prolonged accommodative monetary policy might fuel asset bubbles, therefore it will be important to exit from non-standard measures and to return to less accommodative policy when the time is ripe. In that respect, he said that the ECB strategy would ensure symmetric policy with respect to financial misalignments. Regarding the current situation, Mr. Coeuré said that there were *"some encouraging, albeit early"*, signs of normalisation across financial markets segments. Earlier this month, Mr. Coeuré highlighted that it was still too early to decide on an exit strategy from the non-standard measures. His colleague **José Manuel González Páramo** said in a speech on Friday, that it was still too early to discuss details of the exit strategy. Comments: The statements from Mr. Coeuré are somewhat more hawkish than his earlier comments. However, in our view this does not signal that the ECB is somewhere close to exiting the non-standard measures. To us, it is just another ECB board member trying to increase the pressure on governments to act and to tame fears regarding increasing inflation in the medium- to long-term.
- **In early state elections in Saarland**, the CDU won the election with 35.2% of votes (+0.7 points compared to 2009), ahead of the SPD with 30.6% (+6.1%). PM Annegret Kramp-Karrenbauer (CDU) and the SPD Chairman Heiko Maas said that the parties would start talks about building a grand coalition soon, as both had suggested in the election campaign. With this decision, the SPD have opted not to take the PM position, which would have been possible as an SPD-led coalition with the Left Party (16.1%, -5.2 points) and the Greens (5.0%, -

0.9%) would have had a mathematical majority in Parliament. Of the former CDU/FDP/Greens coalition, the FDP was the largest loser. With a share of only 1.2% of votes (-8.0%), the FDP did not make 5% minimum requirement for entry into Parliament. The biggest surprise was the 7.4% share of the Pirate party: according to polls around 85% of those who voted for the Pirate party did so because of dissatisfaction with the established parties. After Berlin, this is the second Parliament to contain the Pirate party. Comment: It is no big surprise that Saarland probably will get a grand coalition. But the clear lead of the CDU compared to the SPD is somewhat surprising. The biggest surprise however was the share of votes of the Pirate party. Looking forward, it will be important to see how the FDP reacts in order to obtain better outcomes in the two upcoming state elections in Schleswig Holstein and North Rhine Westphalia in May.

- **Spanish PM Mariano Rajoy's PP fails to win a majority in Andalucía** - The PP won 50 seats in the 109-strong regional assembly, falling short of a majority, while the Socialists won 47 seats, and United Left won the remaining 12, making a ruling coalition between the two smaller groups possible. Bloomberg reports that Andalucía voted against the budget goal of 1.5% of GDP for the Autonomous Regions this year in a meeting of regional finance chiefs, and that its deficit in 2011 was more than twice the target of 1.3%. **Spanish unions plan a nationwide general strike on Thursday 29 March** to protest against the government's measures to reduce spending and cut subsidies, as well as changing the labour law to make it easier to cut workers' wages and reduce firing costs. On Friday, **Finance Minister Cristobal Montoro will present Spain's 2012 budget.** Comment: Andalucía is Spain's most populous region and the result will likely weaken Rajoy's ability to force the regions – which account for nearly 40% of public spending – to meet the budget targets for 2012 when the combined regional deficit is expected to be reduced to 1.5% of GDP from an overshoot in 2011 to 2.9% (versus the 1.3% target for 2011).
- **Italian PM Mario Monti tells Spain to concentrate on its budget reduction efforts**- Italian PM Mario Monti said yesterday that Spain risks reigniting the debt crisis, warning that *"it doesn't take much to recreate risks of contagion"*. Bloomberg reported that Monti praised Spain's efforts to loosen work regulations, but advised Spain to focus on cutting the national budget, arguing that Spain *"hasn't paid enough attention to its public accounts."* Turning to domestic matters, Monti indicated that he *"could not promise growth in 2012, but less recession"*, acknowledging that the economy is *"not in a brilliant situation, and that the emergency stage cannot be solved in a year"*.
- **Italian strikes looming as labour market reform bill is sent through parliament** – Italy's biggest labour union threatened on Saturday to step up strikes to protest against plans to open up the job market that the government says will encourage investment but critics say will fail to boost employment and the economy. Reuters reports that the bill, which proposes a radical overhaul of the jobs market, could be debated for several months in parliament as the government opted not to pass it by means of a decree. Unions are particularly angered by a proposal that would weaken an obligation for companies to re-hire workers if a court rules they have been wrongfully laid off, and allow employers to offer monetary compensation when facing economic difficulties.
- **Greece extends deadline for foreign bond holders to swap notes** – Greece has extended the deadline for foreign law bondholders to swap notes for a second time, giving investors until 4 April to sign up to PSI according to a source quoted by Reuters. The newswires indicated that Greece could continue to extend the deadline until 15 May, which is the maturity of the holdouts' bond of

choice, a €450mn floating rate note. Any non-payment of the foreign law bonds would then spark a cross-default and provoke further actions by holders of larger issues, such as the €5.6bn 2016s.

- **The Netherlands has left the Core of the euro area in our view.** The poor performance of the Dutch economy should make it very difficult for the country to reduce its general government deficit below 3% of GDP in 2012 or 2013. As a consequence of the euro area sovereign debt and banking crisis, financing conditions in the Netherlands have tightened, creating pressure on the country's highly leveraged households, which is likely to lead to further contractions in house prices and domestic demand. The minority centre-right government is unlikely to implement the necessary measures to reduce the deficit quickly in our opinion. Moreover, in order to secure the Netherlands' ratification of the fiscal compact treaty, PM Rutte needs the support of the left-wing opposition parties, which are against additional austerity measures in the current environment. While we do not expect the Netherlands to lose its AAA rating in the near-term, we expect that at least S&P will put the rating on negative outlook and that spreads to Bunds will widen. See [Euro Weekly - Netherlands — No Longer Core\\*](#)

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