Draghi's Warning Over Automaticity of Banks' Debt Bail-Ins

Summary | Today's News in Detail | Latest Issues of Sovereign Debt Crisis Update | Macroeconomic Forecasts | Recent Research

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Economics

Western Europe

Industrialised G7 Countries

Summary

ECB President Draghi warned about automaticity of subordinated debt bail-in when plugging capital shortfalls of banks, until a Europe-wide banking union is fully operational. Mr. Draghi reportedly made the point that state aid should be possible without junior bondholders getting hit first in order to reduce risks of major instability for the European financial sector.

Eurogroup Working Group aims to bring forward bail-in rules to 2016, instead of 2018, according to the German weekly *Der Spiegel*, in order to help win over German concerns about the creation of a banking union.

Germany: SPD party convention approves start of formal coalition talks with CDU/CSU. Formal coalition talks are scheduled to start on Wednesday and the SPD issued a list of 10 'core demands' for a coalition, which include a national minimum wage and a financial transactions tax, but no call for higher income taxes.

German tax revenues rise by 2.8%YY in Q3. Tax revenues in September were up 7.8%YY after softer receipts in July and August.

Germany: Green Party opens up to coalition with the Left or the CDU in the future. At its party convention, the Green Party produced a decision to be open in principle to future coalitions of SPD-Green-Left or CDU/CSU-Green, *Handelsblatt* reports.

Italy – Milan Court decides on two-year ban from public office for Mr Berlusconi, as part of the sentence for tax fraud issued against him in August. Separately, some newspapers report that Mr Berlusconi may still avoid the ban in the final Senate vote, thanks to the recent split within centrist party Scelta Civica.

Italy – 2014 Budget starts parliamentary journey in Senate today, with government trying to find more resources to reduce taxes. Several small changes are likely to be made to the original draft, but nothing likely to be a game-changer.

Spain – Economic reforms starting to pay off, PM Mariano Rajoy says, while Economic Minister de Guindos says recovery is still *"tenuous".* Separately, the **NPL ratio rose to a new record high** of 12.12% of total lending in August**.**

Greece – no third bailout package if it requires more austerity measures, Greek FinMin said to the newspaper *Kathimerini*.

Consumer confidence rises in the Netherlands and Belgium.

Recent Research

Euro Economics Weekly — Portugal – What After June 2014?

18 October 2013

The Portuguese bailout programme ends in June 2014 and it remains uncertain if Portugal will require additional help. Given the fiscal tightening still to come, on-going private deleveraging and ensuing poor nominal GDP growth prospects, doubts still exist about the sustainability of the Portuguese public debt in our view.

Giada Giani | Guillaume Menuet | Michael Saunders | Ebrahim Rahbari | Ann O'Kelly

UK Economics Weekly — We Stick to 3% Growth Forecast for 2014

18 October 2013

Our growth forecasts are little changed, and we continue to look for growth of 1.4% in 2013 and 3.0% in 2014. Consensus forecasts for 2014 growth also are picking up but, at about 2¼%, seem too low in our view. We expect that the combination of strong economic growth and falling real wages will help

Today's News in Detail

ECB President Draghi's warning about automaticity of subordinated debt bail-in – Italy's daily *La Repubblica* reported on Saturday that European Central Bank President Mario Draghi had written to the European Commission on July 30 to warn that imposing losses on banks' bondholders to plug capital shortfalls could be destabilizing for many euro-zone economies until a Europe-wide banking union is fully operational. The newspaper cited sources with direct knowledge of the letter and reported Mr Draghi saying that at least for the moment, those losses should be avoided, if this could destabilize Europe's financial system. Reuters reported that Mr. Draghi had made the point that there could be cases when, if a viable bank could not raise the capital needed in the market quickly enough, state aid should be possible without junior bondholders getting hit first. Comment: In the run-up to the asset quality review and the subsequent bank stress tests, this situation highlights that the ECB remains mindful of imposing automatic losses on bondholders in order to reduce banks' capital needs, particularly if their number were to prove relatively large, which could have negative consequences for banks' funding costs. Note that the bail-in rules are due to take effect in 2018, as part of the euro area's objective of banking union, although some ECB members have expressed some desire for the rules to be implemented earlier.

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Eurogroup Working Group aims to bring forward bail-in rules to 2016 – German weekly *Der Spiegel* reported on Sunday that Thomas Wiesner, the head of the Eurogroup Working Group, had suggested that "bail-in" rules should come into effect from 2016 instead of 2018, in order to help win over German concerns over creating a banking union. Reuters noted that the magazine reported that the acceleration of the plans could help persuade Germany, which has called for a 2015 deadline, to agree to a European bank resolution scheme. Comment: the 2016 suggestions would seem to be an acceptable compromise for most of the parties involved, as it would likely come immediately after the theoretical 12-month window of recapitalisation following the AQR/EBA stress tests whose results are expected during the fourth quarter of 2014. This would leave member states liable for any recapitalisation of their own banking system – even if the resolution rules could still differ from one member state to the other – and would limit any mutualisation of losses before the full start of banking union.

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Germany: SPD party convention approves start of formal coalition talks with CDU/CSU. *Handelsblatt* reports that the SPD's party convention on Sunday approved with a large majority (85% of delegates) a motion to start formal coalition talks with Chancellor Merkel's CDU/CSU party. The SPD leadership presented a list with 10 'core demands' for agreeing to a coalition, according to *Spiegel*. These include a national minimum wage of €8.50/hr, a financial transactions tax, flexible retirement conditions, preventing old age poverty, investments in infrastructure, increased financial support for communities, promoting gender equality and increasing the support for growth and employment at the European level. The CDU has yet to finalise the process through which it will decide about an eventual coalition agreement. According to *Süddeutsche Zeitung*, Chancellor Merkel is against a party congress to decide on the issue, preferring to hold a congress on Europe-related topics next year. Comment: Yet another hurdle was cleared on the way to the next German government. Quite a few remain, including the actual coalition agreement, and the allocation of ministries. Importantly, an affirmative vote by SPD party members on the final coalition agreement is also needed, and *Handelsblatt* reports that many party members continue to be quite vocal about their displeasure at the prospect of a Grand Coalition. Many items on the list of SPD core demands remain quite vague, but a call for tax increases was absent. Formal coalition negotiations are

pull the jobless rate down to the MPC's 7% threshold around end-2014. Markets are likely to price in a sizeable premium for uncertainties over the post-guidance rate outlook for 2015 onwards.

Michael Saunders | Ann O'Kelly

UK — Retail Sales Show Buoyant Trend

17 October 2013

Retail sales volumes rose 0.6% MM in September, a little ahead of consensus (0.4%), with a 1.8% rebound in sales by non-food retailers after a weak August and a 0.2% drop in sales by food retailers. The trend in retail sales is buoyant. This is the best QQ gain in retail sales volumes for a calendar quarter since a matching 1.5% QQ gain in Q1-2008. There has been only one calendar quarter in the last 10 years with retail sales volume growth above 1.5% QQ, and that was in Q1-2004.

Michael Saunders

Norway — Stable Rate and Neutral Statement, but with Note of Low Inflation

16 October 2013

At the 24 Oct monetary policy meeting, we expect Norges Bank to keep the key policy rate stable at 1.50% and to issue a relatively neutral statement. For sure, NB will note the substantial downside surprise in annual core inflation in Sep, and with one additional inflation release ahead of the Dec MPR, the outcome will prove very important for the Bank's inflation projections and conditional interest rate path. As of now, downside risks to the short-end of the rate path prevail.

Tina Mortensen

Sweden — Riksbank Forecast: Stable Rates, Confirmation of Rate Path

16 October 2013

At the upcoming 24 Oct monetary policy meeting, we expect a split Riksbank board (4:2) to leave the key policy rate unchanged at 1.0% and confirm its conditional interest rate path from Sep, hence, maintaining its near-term easing bias (a 16% probability of a near-term rate cut) and continuing to signal an initial interest rate hike in late-2014. A

to start on Wednesday.

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Germany: German tax revenues up in Q3. *Handelsblatt* reports that data from the German finance ministry shows that German tax revenues rose by 7.8% YY in September, bringing the YY% increase to 2.8% in Q3, despite the fact that revenues were relatively soft in July and August. September is one of the more important months for tax revenues, as corporate taxes for Q3 are due, and turned out to be quite buoyant, while sales taxes and personal incomes taxes rose more modestly.

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Germany: Green Party opens up to coalition with the Left or the CDU in the future. At its party convention, the Green Party produced a decision to be open in principle to future coalitions of SPD-Green-Left or CDU/CSU-Green, *Handelsblatt* reports. However, motions to actually begin coalition talks for either were rejected. Meanwhile, the convention also rejected a motion by its centre-right wing to declare its campaign to call for tax increases *"a mistake"*. Meanwhile, *Spiegel* reports that CDU/CSU and SPD have agreed to grant the opposition parties more rights during the next parliamentary term, lowering the threshold to call for a parliamentary committee to investigate potential misbehaviour in the government from the 25% of parliamentary seats needed currently (the opposition of Green and Left parties has only 20% of seats).

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Italy – Milan Court decides to ban centre-right leader Berlusconi from public office for two years, as part of the sentence for tax fraud issued against him in August. Berlusconi's lawyers said they will appeal the sentence again to the Supreme Court, as they claim the conviction should have been for one year only. Separately, some newspapers close to Mr Berlusconi's family report that Mr Berlusconi may still avoid the ban in the final vote Senate vote. It remains uncertain whether senators will be asked to cast a secret vote or an open one, with a secret ballot reportedly raising the chances of a favourable outcome for Mr Berlusconi. Aside from his PdL party, *Libero* newspaper reports that the recently-emerged fracture within the small centrist coalition party Scelta Civica – Civic Choice (whose leader Mario Monti resigned last week) may offer some additional votes in support of Silvio Berlusconi. The date of the Senate vote has not been scheduled yet, but it is reported to occur in the first half of November. Comment: after the Senate committee voted in favour of ousting Mr Berlusconi from the Senate, it is widely expected that a similar outcome is reached in the plenary vote. However, a secret ballot may increase the chances of an unexpected result which preserves Mr Berlusconi's senate seat. If this is the case, this could once again create some instability for the Letta government, supported by a shaky right-left coalition.

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Italy –2014 Budget starts parliamentary journey in Senate. *La Stampa* reports that the government is working to try to increase the resources (currently at €2.5bn, or 0.1% of GDP) made available to cut the tax wedge on labour income by reducing other transfers to businesses. According to some calculations, the resources made available so far would allow for an increase in take-home pay for a median worker of some €15 per month – hardly something that would have a major impact on incomes and competitiveness. The government is reportedly determined to maintain its fiscal deficit target at 2.5% of GDP in 2014. Comment: several small changes are likely to be made to the original proposal for the 2014 Budget, but nothing likely to be a game-changer. The resources to reduce tax pressures are limited, unless major spending cuts are agreed. Cutting public spending remains a very controversial issue for all parties forming the governing coalition. Actually recent data suggest primary spending has started to increase

slightly lower 2013 GDP growth forecast, following the downward revisions to 2Q GDP and lower-than-expected inflation support such an outcome.

Tina Mortensen

Scandi Economics Update —

21 October 2013

Sweden — Further financial stability measures likely to be introduced — In an interview yesterday with SVT, Prime Minister Fredrik Reinfeldt said that his party, the Moderates will not go to elections with promises of new tax cuts — Data preview: most important event this week is the Riksbank's interest rate decision on Thursday.

Norway — Data preview: On Thursday, Norges Bank announces its interest rate decision (no MPR will be released).

Tina Mortensen

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again in H1 13, after three years of sideways or slightly declining trend.

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Spain – Economic reforms starting to pay off, PM Mariano Rajoy said. Rajoy said that Spain is *"already out of the crisis"* as a result of the *"ambitious"* structural reforms implemented by the government, *El Economista* reports. Economic Minister Luis de Guindos noted however that the recovery is still *"tenuous, gentle, and has to get stronger".* Separately, OECD head Angel Gurria noted that Spain is *"starting to see the results"* from reducing deficits and labour costs, with unemployment no longer rising as wages *"converge"* with productivity, according to Bloomberg. Comment: while recession has probably ended in Q3 (we expect growth of 0.1% QQ), economic growth will need to pick up much more before translating into reductions in the unemployment rate, in our view. We expect the economy will contract by 0.2% in 2014, and the unemployment rate will rise to 27.4% (from 26.5% in 2013).

Spain – non-performing loans rose to a new record high of 12.12% of total lending in August, from 11.97% in July, data from Bank of Spain showed. However, the pace of increase in NPLs continued to slow in August, to 1.1% YY from 3.1% YY in July and from 40% YY in August 2012. The contraction in lending to the non-bank private sector continued at a fast speed of 12.3% YY and 9.4% in quarterly annualised terms. Comment: bank deleveraging has been gathering pace in recent months, probably favoured by the transfer, earlier on in the year, of banks' deteriorated assets to the bad bank.

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Greece – no third bailout package if it requires more austerity measures, Greek FinMin said to the newspaper *Kathimerini*. FinMin Stournaras said his government is open to accept new *"structural measures"* but no new *"horizontal"* budget cuts. The newspaper reports that the FinMin said the negotiations are tough and that the troika is due to come back in Athens on 28 Oct. Comment: the Greek government is trying to convey a strong stance against additional austerity to the population in order to support the mildly less negative economic sentiment emerging in the past few months. We doubt however that additional international support could come without additional efforts from Greece. The upcoming negotiations are likely to be long and tough.

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Consumer confidence rises in the Netherlands and Belgium – Dutch consumer confidence rose by 6 points to -33 in October, recording its best performance since August 2011. In particular, the future economic situation measure improved by 14 points in October, the second highest monthly gain this year. The Belgian central bank also reported that Belgian consumer confidence had risen by one point to -6 in October, marking the highest reading since July 2011 as households became more optimistic about the job market and their own finances, but a little more pessimistic about the economic outlook after months of uninterrupted gains. Comment: these are encouraging signs from the soft core countries, suggesting that the contraction in domestic demand will be less of a drag on economic activity in the coming quarters. However, contrary to what has been the case in most peripheral countries, we doubt that the pent-up demand has risen to such a level where one should anticipate a rapid rebound in household expenditure.

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Latest Issues of Sovereign Debt Crisis Update

SPD and CDU/CSU to Start Formal Coalition Talks

18 October 2013

Germany: SPD and CDU/CSU to start formal coalition talks. Fitch warns on public debt ratios in Cyprus, Spain, Portugal, Slovenia and Netherlands. Fitch reaffirms Netherlands' AAA rating, negative outlook. Italy's former PM Monti resigns as leader of coalition party Scelta Civica. Spain's budget savings to reach 1.6% of GDP in 2014, but central govt debt soars. Greece: corporate tax debts to be written off. Portugal's govt to start debt restructuring of SOEs. Slovenia's real estate tax.

Ebrahim Rahbari | Giada Giani | Guillaume Menuet

Spain to Exit Programme by Year-End

17 October 2013

Spain to exit bailout programme at year-end, says de Guindos. Moody's says outlook on Italian banks remains negative. Bank of Italy says GDP stabilised in 3Q. Greek government says it cannot take more fiscal tightening, as political instability would increase. Portugal: Troika sees major challenges to 2014 Budget from Constitutional Court. Germany's economic institutes oppose minimum wage, but CSU head indicates minimum wage could be part of eventual Grand Coalition agreement.

Ebrahim Rahbari | Giada Giani | Guillaume Menuet

No Agreement on EA Common Bank Recap Facilities

16 October 2013

No agreement on common direct bank recap facilities or on single resolution mechanism, but Ecofin signs off on single supervisory mechanism. Italy's government approves marginally expansionary 2014 budget. Portugal's 2014 budget sees fiscal tightening of 2.3% of GDP. Third bailout looming for Greece, says Ekathimerini. In Germany, CDU/CSU-Green talks flounder. Germany's ZEW expectations survey continues to rise. Eurogroup's Dijsselbloem to visit Slovenia on 21 Oct.

Giada Giani | Guillaume Menuet | Ebrahim Rahbari

CDU and SPD Coalition Talks Still Without Breakthrough

15 October 2013

Germany: No breakthrough in CDU/SPD coalition talks. EcoFin to decide SSM legislation today. ECB's Mersch expects AQR announcement on Oct 23. ECB's Bonnici on deposit rate. ECB's Coeure warns on possible ECB conflicts of interest. Italy's 2014 Budget: tax changes to speed up loan loss recognition. Spanish house sales slump in Aug, banks continue to reduce ECB borrowing. Portugal's 2014 Budget: major spending cuts, reduction in corporate tax rate. Greece must close fiscal gap, says ECB's Asmussen

Giada Giani | Guillaume Menuet | Ebrahim Rahbari

New Backstop Facility for Ailing Banks Under Scrutiny

14 October 2013

EU FinMins to discuss new backstop facilities for failing banks today. ESM does not want to be euro area's single resolution authority, says Regling. Private German banks call for tough stress tests. Germany's Greens discuss SPD-Green-Left alliance. President Hollande's popularity declines again. 2014 Dutch Budget deal. Italy's 2014 Budget. Greece's funding gap to be covered by rolling over domestically held bonds, 2012 fiscal deficit revised lower. Portugal's 2014 Budget's spending cuts.

Giada Giani | Guillaume Menuet | Ebrahim Rahbari

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Macroeconomic Forecasts

European Economic Forecast Highlights — September 2013

27 September 2013

This companion to Global Economic Outlook and Strategy - September 2013 contains detailed more quarterly forecasts for main European countries to end 2014, as well as annual forecasts to 2017.

Ann O'Kelly | Michael Saunders | Guillaume Menuet | Giada Giani | Ebrahim Rahbari

Global Economic Outlook and Strategy — September 2013

25 September 2013

We have a slight tilt to forecast upgrades this month, and we look for growth of 2.5% in 2013 (up a tenth from last month) and 3.2% in 2014 (unchanged). Over the last six months as a whole, we have raised our 2014 growth forecast for advanced economies by 0.5%, while cutting our 2014 EM forecast by 0.5%. Our forecasts are below consensus in all four BRIC countries.The recovery in advanced economies is unlikely to cause early tightening, given ample slack. .

Willem Buiter | Nathan Sheets | Michael Saunders | Robert V DiClemente | Kiichi Murashima

Emerging Markets Macro and Strategy Outlook — Will DM's Recovery Be EM-friendly?

27 September 2013

Of the EM central banks that have held policy meetings since last week's FOMC, the governors of the two largest - India's and South Africa's - have both emphasized the temporary nature of the relief that emerging economies will enjoy from the Fed's decision. If that's the case, and if capital flows to EM continue to become scarcer, the market will rely more and more on signs that EM can export its way out of its problems. There is some good news: strengthening export growth from China and Korea in August was part of the story behind the EM rally that we've seen since early September. But we have some reasons to question whether the EM export recovery we'll see will be really robust. This makes us cautious about the economic environment EM is about to enter. While export data seem likely to continue to recover, we think the recovery might be a shallow one, and thus not a reason to discount the growth risks that have plagued EM in the past couple of years.

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Appendix A-1

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