Economics

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Euro Area: Sovereign Debt Crisis Update

- **Greece** — European officials highlight that it is up to Greek population to decide on EMU membership. Confusion over weekend on whether German Chancellor Merkel had suggested a referendum on EMU membership during a conversation with Greek President Papoulias. France wants Greece to stay in the euro zone. Syriza leader Tsipras says if elected he will seek talks on new bailout terms to keep Greece in the euro. Opinion polls suggest ND and Syriza are neck and neck.
- **No strong signal from G8.** Despite increasing demands for growth-supporting measures, Germany insisted on high importance of fiscal consolidation. Italian PM Mario Monti made a proposal for a European bank deposit guarantee scheme
- **May 23 informal EU meeting** — Hollande to challenge Germany on its key red lines. No subject will be taboo for the informal EU meeting on May 23, according to new French PM Ayrault.
- **Netherlands** — S&P confirms its rating for the Netherlands.
- **Germany** — High increase in wages in German metal industry likely to support domestic demand in Germany.
- **Spain:** Spanish bank recapitalisation likely to feature when Hollande and Rajoy meet in Paris on Wednesday for lunch. Spain's 2011 budget deficit revised up to 8.9% of GDP. Bad Spanish bank loans are increasing again. 62% of Spanish people believe that the country will receive a European bailout.
- **Portugal:** Popularity of governing coalition's largest party PSD falls slightly but majority still agree that the country should fulfil the agreement with the Troika.
- **Ireland:** Referendum campaign enters final 10 days. We consider the Irish recession casts doubt on fiscal sustainability.
- **Denmark —** One-fifth of Danish banks found risky.
- **Norway —** Moody's praises Norway.

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- **European officials highlight that it is up to Greek population to decide on EMU membership**. German Finance Minister Wolfgang Schäuble said that Greek exit (Grexit) could be prevented, but it is up to the Greeks to decide. Similar to comments from other European officials, Mr. Schäuble highlighted in an interview with *Bild am Sonntag* that *"European solidarity isn't a one-way street"* and that Greece has to stick to its agreements. Separately, Bundesbank President Jens Weidmann said in *Frankfurter Allgemeine Sonntagszeitung* that, given the political uncertainty in Greece it would not be right for the Eurosystem to increase the level of risk for Greece. In his view it would be up to the Greek public to decide if they want to stay in the euro. Mr. Weidmann did not want to speculate on possible losses for the ECB and the Bundesbank in case of Grexit. On Friday, EU trade Commissioner Karel de Gucht said that the EU and the ECB are working on scenarios to react to Grexit. According to *Der Spiegel*, Eurogroup chairman Juncker told the Greek finance minister Fillippos Sachinides that in a secret vote, an overwhelming majority of euro area finance ministers would be in favour of Grexit.

- **Referendum on EMU Membership?** Over the weekend there was confusion over a conversation between German Chancellor Angela Merkel and Greek President Karolos Papoulias. According to a Greek government spokesman, Ms Merkel proposed holding a separate referendum on Greek membership together with the general election at June 17. A German government spokesman denied that Ms. Merkel made such comments.

- **France wants Greece to stay in the euro zone** - French President François Hollande indicated during the G8 meeting that he wanted Greece to stay in the Euro zone, but stressed that Greece should respect its commitments. The quid pro quo would be that Europe would do its utmost to stimulate growth.

- **Tsipras open for talks.** The leader of the far left Syriza party, Alexis Tsipras, said that if elected he would seek talks with European leaders on new terms for the bailout package in order to keep Greece in the euro.

- **Latest Poll results.** According to the latest polls, the ND and Syriza parties are neck and neck in the race to win the upcoming election. According to a poll by MRB out on Saturday, ND gets 24.4% of the vote and Syriza 23.8% while a Metron poll show Syriza with 25.1% ahead of ND with 23.8%.

- **Comment:** While euro area leaders highlight that there is little room to negotiate the bailout package, they appear to be starting to prepare for Grexit. The situation in Greece remains very uncertain.

- **No strong signal from G8.** There were few surprises in the G8 Statement at the weekend. Despite increasing demands for growth-supporting measures, particularly from new French President François Hollande, Germany insisted on keeping a high importance for fiscal consolidation. In that respect, the statement was only a bit more growth oriented and included the statement that *"We welcome the ongoing discussion in Europe on how to generate growth, while maintaining a firm commitment to implement fiscal consolidation to be assessed on a structural basis."*

- **Monti proposes European deposit guarantee scheme**. According to *Corriere della Sera*, Italian PM Mario Monti made a proposal for a European bank deposit guarantee scheme at the G8 summit. To stop the flight of deposits *"from the south to the north"* Mr. Monti proposed that European governments jointly fund guarantees for depositors. **Comment**: The newspaper report suggests that the

next talks to limit the contagion of Grexit are under way, but far from being concluded. It probably requires much more market pressure to go ahead with a pan-European deposit guarantee scheme.

- **Hollande to challenge Germany on its key red lines** - Questioned about the upcoming 23 May informal EU meeting, Hollande noted that he would present a package of proposals, which will include eurobonds. He noted that he has received confirmation during the G8 meeting that he would not be alone in proposing them, suggesting that Italy's PM Mario Monti could also be offering his support to the measure. Another possibility would be to ask Berlin to accept that the ECB would lend directly to governments. **Comment**: faced with the choice between the two red lines, it seems that euro bonds might be the easiest solution, but would require more steps towards political and fiscal union. The ECB will likely remain off limits since it would require a change of the European Treaty to modify its statutes.

- **No subject will be taboo for the informal EU meeting on May 23** - Jean-Marc Ayrault told French newspaper *Liberation* that a wide range of issues would be discussed at Wednesday's meeting. *"Finance, the banking system, growth and protectionism"* would be on the table, adding that *"no subject is taboo"*. With respect to Greece, he noted that direct ECB lending to Greece would need to be discussed, and also envisaged that a significant amount of EU structural funds would likely be diverted to Greece to help its economy.

- **S&P on Netherlands.** In a note on Friday, S&P confirmed its rating for the Netherlands. As strengths they regard NL as a *"wealthy, open, competitive, and diversified economy."* However, among the weaknesses S&P mentions the *"uncertain growth prospects in light of high domestic leverage, and eurozone-related financial pressures"* and the *"longer-term fiscal challenges related to an aging population, especially in the area of health care."*

- **High increase in wages in German metal industry.** On Saturday employers and the trade union IG Metall in the region of Baden-Württemberg agreed on a wage increase of 4.3% over 12 months starting in May, following a month with unchanged wages in April. With this agreement, industrial action in the sector has been prevented. The outcome of the wage negotiations in this district is likely to be the pattern for the whole sector with its 3.6 million employees in Germany. The wage increase is the highest since 1992. While the employers accepted the substantial wage increase, the trade union gave in over the treatment of temporary workers, where the existing rules remain in place. **Comment:** The wage increase is above the range of 3.5% to 4% we had expected. With this deal, the gap in unit labour costs (ULC) between Germany and the rest of the euro area narrows somewhat. Regarding the competitiveness of the German metal industry to non-euro area countries, the weaker euro probably will compensate for the increase in ULC. The wage deal is likely to support domestic demand in Germany.

- **Spanish bank recaps** - French President Hollande indicated that it would be desirable that a recapitalisation of the Spanish banking system be done with the European solidarity mechanism. While Spanish Economy Minister Luis de Guindos rejected EU pressure this week to take an IMF credit line to help shore up the nation's lenders, according to the Madrid-based ABC newspaper, Spanish PM Mariano Rajoy noted that it would be necessary for the ECB to back up Spain's efforts. **Comment**: The topic will likely feature prominently in the discussion between Hollande and Rajoy when they meet in Paris on Wednesday for lunch.

- **Spain's 2011 budget deficit revised up to 8.9% of GDP** - Spain revised up its 2011 public deficit by 0.4 ppt to 8.9% of GDP compared to an original target of 6%. Adjustments to the regional accounts which incorporated unpaid bills to suppliers were to blame for this latest revision in the budgetary accounts. Valencia's budget deficit was revised up to 4.5% instead of 3.8%, Madrid's budget deficit was revised up to 2.2% instead of 1.1%, while Castilla y Leon's deficit was revised up slightly. The new figures were published in the regions' 2012 budget plans which the government approved last week, with the exception of Asturias. Fitch ratings noted on Friday that while the agreement was positive, it considered that *"there is a risk that potential reforms might have a limited impact on 2012 accounts"*. **Comment**: All three regions cited above were controlled by the ruling People's Party, putting PM Mariano Rajoy in a difficult position after his repeated criticisms of the previous Socialist administration's failure to control their accounts.

- **Bad Spanish bank loans increasing again** - Data from the Bank of Spain showed that bad loans rose to 8.37% of banks' outstanding loans in March 2012 – the highest level since August 1994 – up from 8.3% in February. The total amount of loans in arrears increased by €1.6bn to €148.0bn. Spain is expected to release the name of the two auditors it has selected to assess the Spanish banking system, particularly to identify how large the eventual losses might be and how much funds will be necessary to recapitalise the banks. Deputy PM Soraya Saenz de Santamaria indicated that the exercise is expected to be conducted in two parts, starting with a one-month stress test (top-down) to be followed by a more detailed review of all assets held in the financial sector.

- **Spanish opinion poll:** According to *El Pais*, a survey showed that 62% of Spanish people believe that the country will receive a European bailout like Ireland, Portugal and Greece. However, the same survey also showed that 38% believes that the Euro faces little risk of disintegrating while 30% believe the risks are nil. Moreover, of those surveyed, only 27% expressed a desire to see the return of the Peseta as the national currency and 68% sees Spain's future in the Eurozone.

- **Portugal: Popularity of governing coalition's largest party PSD falls slightly** but majority still agree that the country should fulfil the agreement with the Troika. According to the results of a survey shown in the newspaper *Expresso*, when asked what did they think the Portuguese Government should do in relation to the Memorandum of Understanding which it signed with the Troika, 18.1% said they didn't know or didn't answer; 30% said that the Government should ignore the agreement and 51.9% said that the country should fulfil the agreement. According to the same survey, which was conducted on the 15/16 May, the largest of the two governing parties in the coalition PSD lost a bit of ground since the last poll, but continues to be in the lead with 34.8% of the voting intentions.

- **Ireland: Referendum campaign enters final 10 days.** According to the Irish Times, Labour leader and deputy PM Eamon Gilmore said *"If we don't pass the stability treaty I think it's far more likely that we would need a bailout and of course in those circumstances we wouldn't have access to the ESM. So you would have the worst of both worlds.* Michael McGrath, finance spokesman of opposition (but pro-Yes) Fianna Fail party said: *"We need to recognize that there's a distinct possibility… that Ireland will require access to the ESM, which you may call a second bailout, sometime next year."* Opposition Sinn Fein party continue to advocate a No vote, with party spokesman on jobs Peader Toibin saying *"There is now an urgent need to send the government a clear signal that austerity is not working. A strong No vote on May 31 will send such a signal… for investment in jobs and growth."*

- **Ireland:** Weak real and nominal economic growth is likely to cap government revenues and keep the general government debt/GDP ratio rising in coming years, probably heading above 130% of GDP in 2014 or 2015. We continue to expect that — regardless of the referendum outcome over the Fiscal Compact — Ireland will need (and get) a second bailout beyond 2013. We doubt this will include PSI initially, but, with the high debt burden, the risk of eventual debt restructuring (public and private) remains real. For details, see ***Ireland — Recession Casts Doubt On Fiscal Sustainability.***

- **Denmark — One-fifth of Danish banks found risky.** The Danish business daily, *Borsen*, reports that a report on Danish banks capital ratios by researcher Niro Invest finds that 19 banks out of the 91 covered in the survey are facing significant challenges. For comparison, the six lowest ranking banks in the two previous reports from 2010 and 2011 are now either dismantled or under winding-up under the state-owned Financial Stability Company (which was established in Oct-08 as part of an agreement between the Danish State and the Danish financial sector on a scheme to secure financial stability in Denmark). As in previous years, the lowest ranking banks face significant challenges, suggesting a continued need for consolidation in the Danish banking sector, the report concludes. In addition, with the new accounting principles from the Danish FSA, more write-downs are likely under way. In this perspective, it is important to keep in mind that Denmark has healthy public finances and a strong external position.

- **Norway — Moody's praises Norway.** In a recent statement, Moody's says that Norway's *"better-than-expected fiscal outcome and continuing commitment to fiscal discipline"* are credit positive for the country's debt rating. Recall that the revised budget, out last Tuesday, showed an expected general government budget surplus of 13.6% of GDP for 2012, up from 11.5% in the original budget proposal from October last year, reflecting higher oil revenues (the government raised its forecast for the oil price from NOK 650/barrel on average this year vs. NOK 575/barrel previously).

Appendix A-1

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