Economics

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Euro Area: Sovereign Debt Crisis Update

- **ECB** – President Draghi says he is against any suggestion of Greece leaving the eurozone and dismissed the prospect of Spain defaulting. He is against the introduction of joint eurobonds because they would run counter to the interests of taxpayers in Europe.
- **Germany** – Bundesbank President Weidmann says German budget plans are not too ambitious. Germany to issue €2bn more debt in 2Q than previously indicated. According to Finance Ministry official Schuknecht, Germany is still not keen to discuss a larger euro area firewall. Sunday sees early State election in Saarland.
- **Euro Area** – Sizeable drop in flash PMIs while consumer confidence improves.
- **France** – Government raises its 2012 GDP forecast but lowers 2013. Poll shows a shrinking second round winning margin for Socialist Presidential challenger Hollande.
- **Belgium** – Business confidence unexpectedly fell in March.
- **Portugal** – The country could get more help, according to Dutch Finance Minister. Government announces creation of technical unit to keep close watch on the PPPs.
- **Italy** – Italians would choose a party led by Monti according to poll. PM Monti's drive to push through reforms of the country's labour market is hitting opposition.
- **Spain** – New transparency law is on its way. The government examines options to ensure that Autonomous Regions can access the financing they need. PP looks likely to win Sunday's elections in Andalucía after 34 years of socialist rule according to a recent poll.
- **Ireland** – Although GDP in 2011 recorded the first calendar-year rise (+0.7% YY) since 2007, the economy is now back in recession, with GDP recording -0.2% QQ in 4Q and -1.1% QQ in 3Q.
- **Greece** – Poll shows that the Greek parliament could end up with eight parties after the election.
- **Sweden** – Corporate tax rate could be lowered by 2pp.
- **Hungary** – Faces fiscal risks related to telecom tax rejection.
- **Poland** – MPC minutes still a little hawkish.

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- **Draghi on Greece:** In the second part of the Interview with *Bild Zeitung* ECB President Mario Draghi said he was against any suggestion of Greece leaving the eurozone because that would not solve the country's woes. He said that in order to restore competitiveness Greeks would have to deal with a decline in their standard of living. He added it would be easier to do this inside the euro area -- as they currently were doing with wage cuts -- than outside.

- **Draghi on Spain:** Regarding Spain, he dismissed the prospect of the country defaulting on its debts. He stressed that *"Spain is carrying out a labour reform, a financial reform, and is about to present a budget that will aim to cut the deficit from 8.5 percent to 5.3 percent."*

- **Draghi on Eurobonds:** Mr. Draghi also said that he was against the introduction of joint eurobonds because they would run counter to the interests of taxpayers in Europe. He added that he would be against *a "transfer union in which one or two countries pay while the rest spend the money and the whole thing is financed with eurobonds. That cannot be allowed to happen"*. In Mr. Draghi's view the *"new fiscal pact for the euro states is the right way to go and that's why it would be too early for eurobonds"*. He added that *"without the pressure of the markets and the Germans, then many of the advances in various eurozone countries would not have been made".*

- Comment: With these remarks **Mr. Draghi wants to keep pressure** on Greece and other countries to implement solid budgets and structural reforms. ECB Board member Jose Manuel Gonzalez-Paramo said that governments would have to act now and that *"the leaders need to decide on the size of the firewall. We think it must be of sufficient size to avoid contagion"*. He repeated the often used statement that Greece is *"a unique case"* and can't be compared with Portugal.

- **Yesterday Bundesbank President Jens Weidmann** said that the German budget plans were not too ambitious. Germany should not repeat the mistakes of the past by starting fiscal consolidation too late in an improving economic environment. In the view of Mr. Weidmann it would be too late to target a balanced budget in 2016, as currently foreseen in the government plans. The Bundesbank President added that Germany should give a good example to the other euro area countries in terms of budget consolidation. Comment: In addition to the overall aim to improve general government budgets, the Bundesbank President probably wants to get support from restrictive fiscal policy in order to keep inflation in Germany low, in an environment in which the ECB is likely to keep interest rates very low because of poor economic performance and the outlook of very low inflation in the periphery countries.

- **German debt issuance:** Yesterday, the German debt agency said that Germany will issue €2 billion more debt in the second quarter than previously indicated. Germany needs the extra funding to make its capital contribution to the ESM.

- **Germany still not keen to discuss a larger euro area firewall** – German Finance Ministry official Ludger Schuknecht who heads the department of fiscal policy, international finance and monetary policy in Wolfgang Schäuble's ministry said that *"Italy and Spain are too big to be saved by these kind of numbers that we are putting into the window",* adding that making the firewall credible to markets *"is much more important than talking about big numbers that are afterwards just a show".* Schuknecht said euro-leaders have agreed to discuss *"some possibly temporary increase"* and *"we have to wait"* until the end of March.

Policy makers must realise that large firewalls may undermine governments' incentive to reduce debt, he said. He reiterated the government's opposition to common euro bonds, arguing that adopting them would create a moral hazard by weakening member states' readiness to adhere to fiscal discipline. He repeated that reforms and institutional changes to boost fiscal discipline are an *"absolute key"* to solve the crisis, seeing grounds for optimism that euro area states are achieving those aims. Comment: European finance ministers are due to decide at a meeting on 30-31 March whether to augment the region's crisis backstop. Germany, the biggest single contributor to euro-region bailouts, rejects raising the €500 billion ceiling on the European Stability Mechanism, the permanent rescue fund.

- **German State election:** On Sunday 25 March, early elections are being held in the German federal state of Saarland.

- **Euro Area: Sizeable drop in flash PMIs while consumer confidence improves** – The Eurozone flash composite PMI recorded a 0.6 point drop to a three-month low of 48.7 in March, indicating some acceleration in the contraction of economic activity. Later on Thursday, the EU Commission reported that the flash estimate of euro area consumer confidence improved for a third straight month in March, climbing to a seven-month high of -19 from -20.3. Comment: We found no redeeming features in the flash PMI report, with activity falls in services (48.7) and manufacturing (47.7). These numbers were below our pessimistic forecasts (Citi 49.0), while the consensus (Mkt. 49.6) was looking for gains across the board. While seasonal factors might account for the larger-than-expected drop, we argue that the softness of domestic demand in core countries will be an issue for peripheral member states whose strategy to exit recession relies on exports to larger trading partners. See ***Euro Area - Renewed Downside in Flash PMIs Signals Continuing Recession.***

- **French government raises its 2012 GDP forecast but lowers 2013** – The French government announced on Thursday that it had raised its 2012 growth estimate to 0.7% from 0.5% previously, but cut its 2013 outlook to 1.75% from 2.0%. This change was related to the French National Statistics Institute's announcement that GDP growth would likely be flat in Q1, before increasing to 0.2% in the second quarter, implying acquired GDP growth of 0.5% in 1H 2012. INSEE's forecast was that French GDP would return to its pre-crisis levels by the end of Q2, a six-month delay compared to Germany. INSEE notes that unemployment will likely continue to increase towards the 10% mark in Q2-2012. **A BVA poll on the French Presidential election** showed Hollande obtaining 29.5% of the first round vote to Sarkozy's 28%, and a shrinking second round winning margin of 54%-46% compared to 59%-41% a fortnight earlier. Comment: While the French economy has displayed some resilience in Q4, we still believe that some payback is likely during the first quarter, while the expected fiscal drop for additional rounds of austerity after the Presidential elections should weigh on economic activity. Nevertheless, with downside economic risks mitigated by the ECB's ample provision of liquidity, there appears to be room for confidence to recover slightly going into the elections, likely helping President Sarkozy to narrow the gap with Hollande in the polls.

- **Belgium: Weaker BNB survey** – Belgian business confidence unexpectedly fell in March to -9.6 from -7.7 in February, with a noticeable decline in manufacturing industry, construction and trade – the latter two recorded second and third successive monthly falls. Slightly better signals came from the services sector which recorded a 1.8-point increase to +1.2.

Comment: We believe that the combination of additional fiscal policy tightening and the challenging growth perspectives across the euro area is likely to keep confidence muted in coming months. On balance, the most relevant forward-looking indicators related to aggregate demand expectations remained depressed at -1.3 std below their long-term average in March, also averaging -1.3 in Q1, unchanged from Q4. By comparison, the reading stood at +0.8 std in Q1 2011. Employment perspectives remain muted too, unchanged at -0.3 std in Q1 2012.

- **Portugal could get more help** – Dutch Finance Minister Jan Kees de Jager speaking before the Dutch Parliament on Thursday characterised Portugal's economic situation as worrisome, although he noted that Portugal is committed to work with the IMF programme, and the country is a different case to Greece because of its much lower debt level. Asked if there were more options to help the Portuguese economy, de Jager suggested turning to the EIB. Reuters wrote that de Jager declined to speculate about a Portuguese debt restructuring, noting that one could not say that Europe will never again see a restructuring of debt. S&P's Mortiz Kraemer said on Thursday that a Portuguese debt restructuring is avoidable as its debt level is lower than Greece's and it has shown more capacity to reform, while noting that its institutional framework is also much stronger.

- **Portuguese government announces creation of technical unit to keep close watch on the PPPs**. The Portuguese government announced yesterday that it will establish a technical unit within the Finance Ministry to exercise scrutiny on the evolution of the costs associated with the country's large number of PPPs over the short-, medium- and long-term; and to ensure that SOEs will only enter into PPPs if they can demonstrate that the benefits will outweigh the costs to the tax-payer. Comment: Portugal's large stock of PPPs has been identified by the Troika as a key risk to the country's public finances due to fact that the government's outlays on PPP-related obligations are likely to peak at some €1.35bn per annum over the 2011-21 period.

- **Italians would choose a party led by Monti according to poll**. A recent poll of voting intentions carried out by a major polling agency for one of Italy's largest papers showed that if faced with the option of voting for a party led by Mr Monti, 24.4% of voters would vote for the current PM's party. This compares with 19.8% who said that they would vote for the Conservatives (PdL); 18.5% who would support the Democratic Party (PD) and 9.4% who would support the Northern League. In addition, when asked to rank Mr Monti's government's performance on a scale of 1 to 10, 61.7% of the respondents revealed approval rates of 6 or higher, compared to 57.7% in February.

- **PM Monti's drive to push through reforms of the country's labour market hits opposition**. According to Reuters, the coalition supporting Mr Monti in parliament could splinter over the labour reforms as the Democratic Party (PD) adopts a more sympathetic stance to the resistance of the CGIL union to Mr Monti's proposed overhaul of the country's redundancy laws. At the centre of the stand-off is the law which will make redundancies for economic and budgetary reasons legal. On the other side of the negotiations, the leader of Italy's main employers' association, Confindustria, argued that any watering down of the current government's proposal will render the reforms useless. Comment: We believe that the markets will watch developments in the negotiations over the Monti government's labour reforms with attention, as reforming the country's labour laws has been made a key pillar of the government's plan to boost Italy's competitiveness and growth potential over the medium-term, thereby making them key to the markets' perception of the country's ability to reduce its large debt burden.

- **Spain: New transparency law on its way**. According to *El Pais*, the Spanish government announced yesterday that its initiative to publish information on how taxpayers' money is being spent (including details of all government contracts, salaries of government directors and senior officials, etc) will be up and running shortly. The new law is expected to pave the way for a dramatic change in the way in which such information is displayed in Spain. Moreover, although the law will only apply to central government spending, the Autonomous Regions too will have to open up information on contracts and spending to the wider public since the law refers to health and education spending for which the regions are directly responsible. Comment: In countries such as the UK, such initiatives have helped the government to keep some degree of public support for cuts in public spending by exposing what can often be small, but embarrassing spending of government departments.

- **Spain's Autonomous Regions' financing needs:** According to *El Pais*, the Spanish government is examining options to ensure that its Autonomous Regions (ARs) can access the financing they need to pay their suppliers (which include hospitals, schools, pharmaceutical companies, etc). According to the paper, the financing needs – of around €35bn – faced by the ARs in 2012 alone, make a decision on this urgent and could include the issuing by the Spanish Government of so-called Hispanobonos on the ARs' behalf. A decision on how the Spanish government will deal with the financing needs of the regions is expected in the next couple of weeks.

- **PP is likely to win Sunday's elections in Andalucía after 34 years of socialist rule.** According to a recent poll by Metroscopia a majority of voters in Andalucia which is home to nearly 20% of the Spanish population, support the PP's policies to reduce the country's deficit and the government party is expected to gain 59 seats – up from a current 47 – in the 109 seat legislature. However, according to a poll by the state-owned CIS polling company, the PP will only secure 54 or 55 seats, which would allow the socialists and the United Left to form a coalition.

- **Ireland back in recession:** Data released yesterday showed that real GDP fell 0.2% QQ in Q4-2011, close to our forecast (unchanged) and well below the consensus (+0.4% QQ). This follows a drop in GDP of 1.1% in Q3 (revised from -1.9% QQ), and so puts Ireland back in recession, in the sense of having two negative quarters. Real GNP, which is often viewed as a better guide to the economy's underlying trend, fell 2.2% QQ after dropping 1.9% QQ in Q3 (revised from -2.2%). The Q4 split shows consumer spending up 0.5% QQ, with investment rebounding 14.0% QQ (probably helped by a weather-related rebound in construction), while government consumption fell 3.4% QQ (and this is consistent with the weakness of government spending evident in recent fiscal data). Export and import volumes both fell quarter on quarter (exports -1.1%, imports -1.0%). Nominal GDP fell 0.9% QQ in Q4 after falling 1.0% in 3Q. **In 2011 as a whole, real GDP rose** by 0.7% YY, the first calendar-year rise since 2007. However, the quarterly data show expansion only in early 2011, with a marked loss of momentum thereafter. Ireland's economy faces a range of major headwinds, with heavy fiscal tightening, large deleveraging by banks and households, and high trade exposure to Europe. We believe the government's commitment to fiscal consolidation cannot be doubted, but their fiscal consolidation plans will only succeed in returning Ireland to fiscal sustainability if the economy picks up as well. Indeed, the end-2011 budget assumes that real GDP will rise by 1.3% this year. By contrast, we believe the economy will markedly undershoot official forecasts, with GDP probably shrinking this year. As a result, tax revenues will probably undershoot official forecasts, and the fiscal deficit will probably overshoot. Ireland is often held up as a success story among high-deficit euro area countries, but in practice current policies probably will not succeed in returning the economy to fiscal sustainability.

- **Greece: Poll shows that the Greek parliament could end up with eight parties after the election**. According to an opinion poll conducted last week, Greece's parliament may end up with as many as eight political parties after the next election, with none gaining an absolute majority. The New Democracy party led by Samaras would secure the most votes with 22.5%, a five percentage point drop on the previous month, whilst Pasok, now led by former Finance minister Evangelos Venizelos, and the Communist Party of Greece would each get 12.5%. The poll had a margin of error of plus or minus 3.5%.

- **Sweden** — **Corporate tax rate could be lowered by 2pp.** At a press conference yesterday, Finance Minister Anders Borg indicated that the overall Swedish corporate tax rate may be cut by 2pp after the government proposed new rules, which would cap deductions companies can make on internal interest payments in an effort to prevent "aggressive" tax planning. The proposal implies that internal interest payments to entities in countries with which Sweden does not have a tax agreement would no longer be eligible. In other words, deductable payments to tax-haven countries would be blocked. If the new rules are to be implemented, this would imply an expected extra SEK 6.3bn in revenue, money that could be used to lower the current corporate tax rate of 26.3% by 2pp. Mr Borg said: *"The corporate tax is our most hurtful tax. That is worth pointing out on a day like today, when perhaps our toughest competitor, together with Denmark and Finland, Great Britain, is flagging very big corporate tax reductions"*.

- See today's ***Emerging Markets Daily and Week Ahead - CEEMEA Edition*** for the following stories:
  - **Hungary** — **Fiscal risks related to telecom tax rejection.** The European Commission referred Hungary to the European Court of Justice on Thursday over the telecom tax it applied in 2010-12. If the ECJ rules that Hungary must repay the tax collected in 2010-12, this might add, as a one-off, up to 0.7% of GDP on top of the required fiscal adjustments under the EDP – but most likely not before 2013.
  - **Poland** — **MPC minutes still a little hawkish.** We expect a gradual softening of the MPC's tone in the following months assuming the economy slows and inflation declines in line with central bank's projections.

Appendix A-1

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